Annual monitoring update on the postal market

Financial year 2013-14

Market update

Publication date: 2 December 2014

About this document

This report sets out the key data and trends in the postal sector for the 2013-14 financial year. An effective and ongoing monitoring regime is one of the key safeguards of the regulatory framework that Ofcom put in place in the postal sector in March 2012 alongside greater pricing freedom for Royal Mail. We also committed to publishing an annual report summarising the results of our monitoring programme. This is our third annual monitoring update on the postal sector.

This report covers four key areas: the financial performance of the universal service, Royal Mail's rate of efficiency improvement; the impact of Royal Mail's pricing and quality of service on customers and consumers; and the level and impact of competition for business customers.

Contents

Section 1

Executive Summary

1.1 As part of the new regulatory framework introduced in our 27 March 2012 statement – *Securing the Universal Postal Service, Decision on the new regulatory framework* ('the March 2012 statement')[1], Royal Mail was given greater pricing freedom.[2] This decision was taken to provide Royal Mail with the opportunity to return the universal service to financial sustainability, subject to certain safeguards. One such safeguard was an effective and on-going monitoring regime to track Royal Mail's performance. As part of this safeguard, we committed to publishing an annual report summarising the results of our monitoring programme. This is our third annual monitoring update on the postal sector.

1.2 This report covers the four key areas that we set out in the March 2012 statement that our monitoring regime would focus on and sets out the key data and trends for the 2013-14 financial year.[3] These are:

- The financial performance of the universal service;
- Royal Mail's rate of efficiency improvement;
- Customers and consumers; and
- Business customers and competition

1.3 The metrics in this report are also consistent with those in our 2012-13 report published in November 2013[4] (enabling year-on-year comparisons), although we present some additional data in this document.

1.4 In summary, with respect to *financial performance,* for the Reported Business,[5] the financeability EBIT margin increased to 3.9%.[6] This is an improvement on the previous year (3.3%) and closer to the indicative 5% to 10% range we considered in March 2012 was consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term. The main reason for the increase in financeability EBIT margin was due to improved trading performance, driven by revenue growth as a result of increased prices as volumes across all formats declined.

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[1] http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf.
[2] The March 2012 statement removed the majority of price controls on Royal Mail.
[3] Although our report also considers the impact of price changes that took effect from April 2014.
[4] Ofcom *Annual Monitoring Update on the Postal Market - Financial year 2012-13*, 22 November 2013 http://stakeholders.ofcom.org.uk/binaries/post/post/Annual_monitoring_update_2012-13.pdf.
[5] The part of Royal Mail's business that is responsible for the universal service – this is explained further in Section 2.
[6] Based on Earnings Before Interest and Tax (EBIT) after transformation exceptional costs as a proportion of revenue, calculated using the cash pension rate. 2013-13 includes £104m management reorganisation cost.

1.5 With regard to *efficiency,* Royal Mail's physical productivity continued to gradually improve in 2013-14. As part of our ongoing work on efficiency, we have developed a new efficiency measure – the PVEO analysis.[7] This indicates that in 2013-14 Royal Mail reduced costs by c.0.2% due to efficiency. The cost per unit workload adjusted for inflation increased by c.0.2% in 2013-14, which was largely due to the above inflation pay increase and pension contributions offsetting to some degree the reduction in non-people costs. Royal Mail's productivity improved by 1.7%, the same as in 2012-13 and has continued to improve since 2010-11 (due to a slow but steady decline in gross hours worked); however the rate of improvement has slowed in recent years. Our work on monitoring Royal Mail's efficiency is on-going. In particular, we have commissioned a review into Royal Mail's assumptions about how it can reduce costs in response to volume decline (marginality), in order to further improve our efficiency metrics. In addition to this and as set out in our "Review of *end-to-end competition in the postal sector*" decision document ("end-to-end decision document") published today,[8] we intend to look at what might contribute a reasonable rate of efficiency improvement for Royal Mail, as part of a wider review into factors that affect the financial sustainability of the universal service in the longer term.

1.6 In terms of *customers and consumers,* our research indicates the vast majority of consumers are satisfied with their postal services and that prices remain affordable for almost all consumers. Whilst First and Second Class stamp letter and large letter prices did not increase in 2013, prices of these increased above inflation in 2014. However the safeguard cap on Second Class stamps will continue to protect vulnerable consumers in the future. Royal Mail significantly improved its quality of service, following a number of failed targets in the last year. First and Second Class national targets were met, however the Postcode Area (PCA)[9] target was missed, albeit narrowly. We will nonetheless continue to monitor Royal Mail's progress on quality of service performance.

1.7 In relation to *business customers and competition,* business mail volumes (retail bulk mail and access) continued to decline by 3.3% overall. For the first time since its introduction in 2004, access volumes declined by 1.0% in 2013-14. However, as total volumes fell faster than the decline in access volumes, the proportion of access in total volume has grown from c.49% in 2012-13 to c.50% in 2013-14. There was also a proportionately significant increase in end-to-end letter volumes delivered by other operators due to the further rollout of Whistl's end-to-end delivery service in 2013-14. However, end-to-end competition still only accounts for c.0.6% of the addressed letter mail market volumes.

1.8 This is our second report since the introduction of the new regulatory framework in March 2012. In this time the postal landscape has witnessed further change with the partial privatisation of Royal Mail in October 2013 and further end-to-end competition. It is therefore important that we continue to monitor the market and Royal Mail's

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[7] Price, Volume, Efficiency, Other. This measure looks at the different factors that affect Royal Mail's financial performance, including efficiency.

[8] http://stakeholders.ofcom.org.uk/post/end-to-end-statement/.

[9] PCAs are the geographic areas into which the UK is divided by Royal Mail for operational purposes. The postcode area is the largest geographical unit used by Royal Mail for mail processing purposes, and forms the initial characters of the alphanumeric UK postcode; for example, Cardiff postcodes begin 'CF', Glasgow postcodes 'G', and Leicester postcodes 'LE'. Royal Mail's target is 118 out of the 121 PCAs achieving at least 91.5% of its First Class items delivered on time.

metrics closely. This will allow us to better understand the market trends (including the financial sustainability of the universal service) and help us to assess the effectiveness of the regulatory framework. As set out in our "*Review of end-to-end competition in the postal sector*" document ("end-to-end decision document") published today,[10] we intend to broaden our review of the factors that could materially impact Royal Mail's ability to continue to provide the universal service in the future, and will therefore look at:

- developments in the parcels market and Royal Mail's position within it – to inform our view of future parcels volume and revenue forecasts; and
- what rate of efficiency improvement Royal Mail should reasonably be able to achieve.

[10] http://stakeholders.ofcom.org.uk/post/end-to-end-statement/.

Section 2

Introduction

Background

2.1 In October 2011, the Postal Services Act 2011 ("the PSA 2011") came into force and Ofcom gained responsibility for regulation of the postal sector. Our duty under the PSA 2011 is to secure the provision of a universal postal service. In performing this duty,[11] we must have regard to the need for the provision of a universal postal service to be:

- Financially sustainable (including the need for a commercial rate of return on the universal service);[12] and
- Efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.

2.2 Our approach to regulating the postal sector was set out in our March 2012 statement. This included the decision to give Royal Mail greater pricing freedom to enable it to return the universal service to financial sustainability, subject to certain safeguards.

2.3 One of these safeguards was an effective and on-going monitoring regime to track Royal Mail's performance (for example on quality of service and affordability of universal services, and progress on efficiency), as well as monitoring changes in the postal industry.

2.4 As part of this regime, we committed to publishing an annual update which set out key data and trends in the postal sector, focusing on the progress towards securing the provision of a universal service.

Measuring the outcomes of the regulatory regime

2.5 We published our first annual monitoring update in November 2012 which covered the 2011-12 financial year – the last year under the previous regulatory framework.[13] As such, it provided a baseline position for our future monitoring which allowed us to measure whether the new regulatory regime is achieving the desired outcomes. Our second update in November 2013 covered the financial year 2012-13 – the first full year following the implementation of the new regulatory framework in March 2012.

2.6 This report focuses on the 2013-14 financial year and continues to address the four key areas that the March 2012 statement noted our monitoring regime would initially focus on, namely:

- The financial performance of the universal service – Section Three;

[11] Under Section 29(3) of the PSA 2011.
[12] Section 29(4) of the PSA 2011.
[13] Ofcom *Annual Monitoring Update on the Postal Market - Financial year 2011-12*, 20 November 2012 http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf.

- Royal Mail's rate of efficiency improvement – Section Four;
- Customers and consumers – Section Five; and
- Business customers and competition – Section Six.

The wider monitoring programme

2.7 To recap, our wider monitoring programme includes:

- industry stakeholders providing market specific information, identifying any concerns with how the regime is operating and potential market developments;
- regular internal review of data and indicators for the four key areas set out above (including through our internal governance process);
- (in this report) publishing an annual update which sets out our view of how the regulatory regime is meeting our duty to secure the provision of a universal service; and
- increasing transparency through:
  - external publication by Royal Mail of some annual financial data;
  - publication of prices and changes to non-price terms and conditions by Royal Mail;
  - presenting market developments in the postal sector in Ofcom's annual Communications Market and International Communications Market reports; and
  - publication of additional key postal market data (subject to confidentiality) in this annual update.

2.8 Royal Mail (along with other postal operators) provides a range of confidential data to us. Although the confidential nature of this data means that we cannot publish it, it will nonetheless inform our ongoing internal monitoring programme, and be used to identify any potential or emerging problems in relation to the provision of the universal service.

2.9 In January 2014, we published a Statement to update the March 2012 regulatory financial reporting requirements in order to ensure the information we collect and use remains fit for purpose.[14] So that stakeholders are aware of the information that we gather, a list of data that we currently collect, some of which is not published for confidentiality reasons, is listed in Annex 1 to this report.

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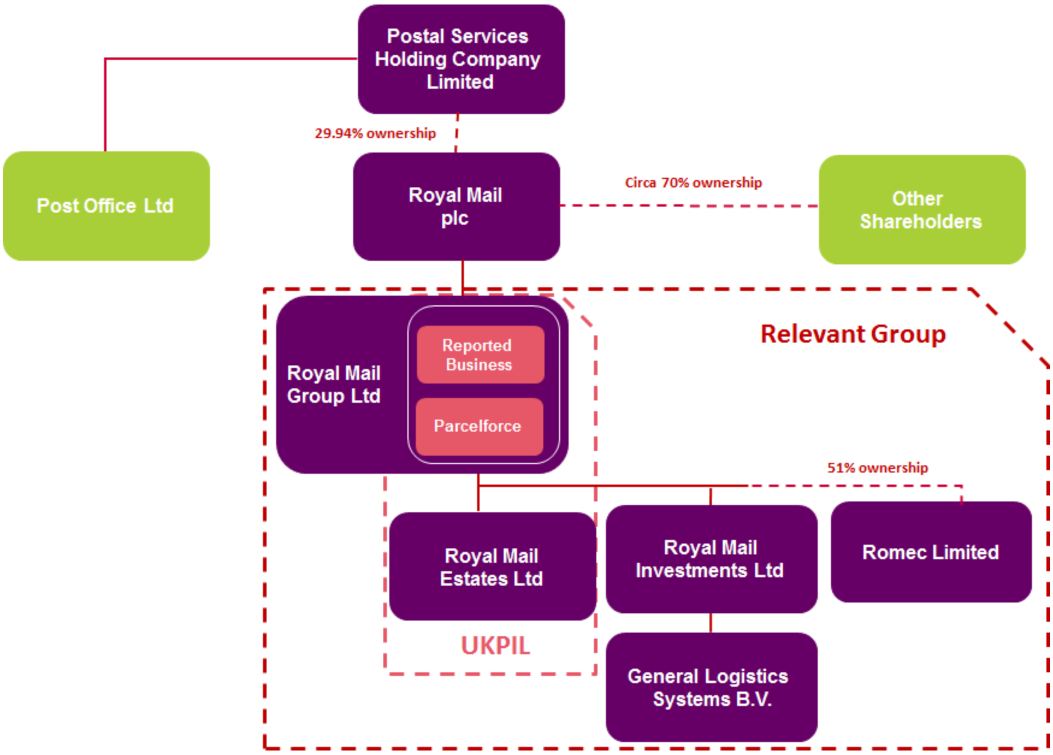
[14] http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/statement.pdf. The statement included requirements for new information, which we now consider as relevant and important for our monitoring regime; a reduction or removal of certain information, which is not essential or necessary for our regular monitoring needs; and amendments to the deadline or frequency of some of the information provided to us, so that the information is available in a more timely and expedient manner for our monitoring purposes.

Royal Mail is the focus of our monitoring regime

2.10 The focus of our monitoring is Royal Mail. It is currently the only postal business in the UK which operates a network capable of delivering letters and parcels to all 29 million business and household addresses nationwide. As such we designated it as the universal service provider.

2.11 However, not all of Royal Mail's business is subject to regulation. The parts that are subject to our monitoring regime are known as the 'Reported Business', which sits within a group of business units referred to as Royal Mail UK Parcels, International and Letters (UKPIL). This, in turn, sits within a wider group of companies – the 'Relevant Group'. The structure of Royal Mail plc as at 31 March 2014 is shown in Figure 2.1 below.

Figure 2.1 – Structure of Royal Mail plc



2.12 As part of the pre-IPO structuring, a new company Royal Mail plc (which is the entity listed on the London Stock Exchange) was inserted between Postal Services Holdings Company Limited (previously called Royal Mail Holdings plc) and Royal Mail Group Limited. Postal Services Holdings Company Limited holds the remaining HM Government stake in Royal Mail plc. Post Office Limited (POL) does not form part of the Royal Mail Group.

2.13 Ofcom has imposed requirements on Royal Mail as the designated provider of the universal postal service, to provide certain services.[15] The services we have required Royal Mail to provide include undertaking collection and delivery services for letters

[15] Ofcom imposed a designated USP condition on Royal Mail in March 2012; it has been amended from time to time since that date. A consolidated version of the condition is available at http://stakeholders.ofcom.org.uk/binaries/post120713/dusp1.pdf

six days per week;[16] providing priority (next day) and standard (within three days) delivery services; and minimum quality of service targets. The Reported Business includes all universal services,[17] as well as retail bulk mail,[18] access products and parcels which also use the universal service network.[19]

Privatisation of Royal Mail

2.14 In October 2013, the UK Government sold some 60% of the shares in Royal Mail to private investors via a stock market flotation. A further 10% of shares were transferred to Royal Mail employees and the remaining 30% continue to be held by the Government.

2.15 We will continue to monitor market developments and Royal Mail's performance in relation to the four key areas outlined above. We will also continue to periodically review the regulatory reporting framework to ensure the information provided continues to remain fit for purpose.

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[16] Five days per week for parcels.
[17] http://www.royalmailgroup.com/regulation/how-were-regulated/universal-service-obligation.
[18] Retail bulk mail relates to a range of services provided directly to sending customers by Royal Mail that are subject to volume or presentation discounts. This category represents bulk mail collected and delivered by Royal Mail itself, as opposed to bulk mail delivered by Royal Mail under an access agreement. Access is discussed further in Section 6.
[19] In December 2013, we published a Statement implementing technical and minor amendments to the Universal Postal Service Order and related regulatory conditions. See Ofcom *Technical and Minor Amendments in Postal Regulation*, 10 December 2013. http://stakeholders.ofcom.org.uk/binaries/consultations/post/statement/statement.pdf None of the amendments has any practical impact on users, Royal Mail and other postal operators as they do not require any changes to Royal Mail's current provision of the universal postal service.

Section 3

Royal Mail's financial performance

3.1 As set out in Section 2, we must have regard to the need for the provision of a universal postal service to be both financially sustainable and to become efficient before the end of a reasonable period and remain so. The PSA 2011 does not exhaustively define the concept of 'financial sustainability'. However it states that it includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.[20]

3.2 As set out in paragraphs 2.10 - 2.11, Royal Mail is the universal service provider and more specifically, the fully regulated part is known as the 'Reported Business'. This Section therefore summarises the financial performance of the Reported Business, unless otherwise stated. We present the financial performance over the last year, and where relevant, a five year trend.

3.3 We discuss in sequence:

- Changes in the volumes at a total sector level – looking at both letter and parcel volumes and the contributory factors affecting the overall trends for each format;
- Changes in overall volumes and revenues for the Reported Business – and then by product groups, formats and universal service products, to help us understand what is driving overall revenue and volume changes of the universal service provider;
- Changes in the costs of the Reported Business – to understand what progress has been made in relation to cost reduction. This information is also an important input when considering the efficiency of the universal postal service, which is discussed further in Section 4; and
- Profit margins and cash flow – we need to monitor Royal Mail's progress on these because, as outlined in paragraph 2.1, the PSA 2011 requires us to have regard to the need for the provision of a universal service to be both efficient before the end of a reasonable period and financially sustainable, the latter of which includes the need for a reasonable commercial rate of return for any universal service provider.

3.4 Where we discuss absolute or percentage movements, we are referring to the comparisons to the previous financial year i.e. 2012-13 to 2013-14 (unless otherwise stated).[21]

[20] Section 29(4).

[21] Royal Mail reports its financial statements using whole weeks. The 2013-14 results represent the usual 52 week period. However, Royal Mail reported a 53 week period for its 2012-13 financial year. In order to perform a like-for-like year-on-year comparison, the 2012-13 results have been adjusted to 52 weeks by Royal Mail, where possible.

In 2013-14, overall letters continued to decline whilst the total parcels grew

Trends in the overall mail sector

3.5 The total UK mail market (letters and parcels combined) has continued to decline since 2005.

3.6 A 2013 PwC report commissioned by Royal Mail on UK mail volumes suggested this is due to a combination of factors:

- E-substitution – electronic forms of communication, such as e-mail, replace mail volumes;
- Low GDP growth – it is likely that the recession experienced in the UK over the last few years reduced or slowed the growth (or increased the rate of decline) of some mail volumes more than would otherwise have been the case;[22] and
- Price rises – particularly those that were above inflation, were also likely to have impacted the consumption of mail products.

3.7 It is likely that all three factors have been influencing the decline in UK mail volumes in recent years to some degree although it is difficult to determine their individual effects on the overall decline in any precise way.[23]

3.8 In order to further understand the contributory factors behind the overall mail trend, we take each of letters and parcels in turn.

Trends in the overall letters sector

3.9 Prior to 2000, letter volume growth in the UK was closely correlated with economic growth. Increases in economic activity led to growth in letter volumes, while a slowing economy led to slow down in letter volumes, as businesses looked for ways to reduce costs.[24]

3.10 However, after 2000, volumes started to diverge from this trend as technology and e-substitution offered consumers and businesses alternatives to traditional mail. Technologies such as broadband, email and text messaging have increasingly been

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[22] For example, see the PwC report *The outlook for UK mail volumes to 2023* at http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf slides 9, 26 and 33. The rate of mail volume declines seem to have been more pronounced since 2008 indicating there has been a macroeconomic impact. In particular, the recession seems to have been a key contributor to the rapid decline of direct mail volumes in recent years (see slide 40).

[23] Mail volumes have been falling in other countries as well, to varying degrees. The PwC report shows that volumes appear to have fallen more sharply in some countries particularly those which have been more focused on digitising mail such as in Denmark (where the Government is seeking to make all government interactions paperless within a few years) and less so in countries like Germany where the public sector has given comparatively low priority to the digitisation of mail and there is a lower acceptance of 'digital signatures'.

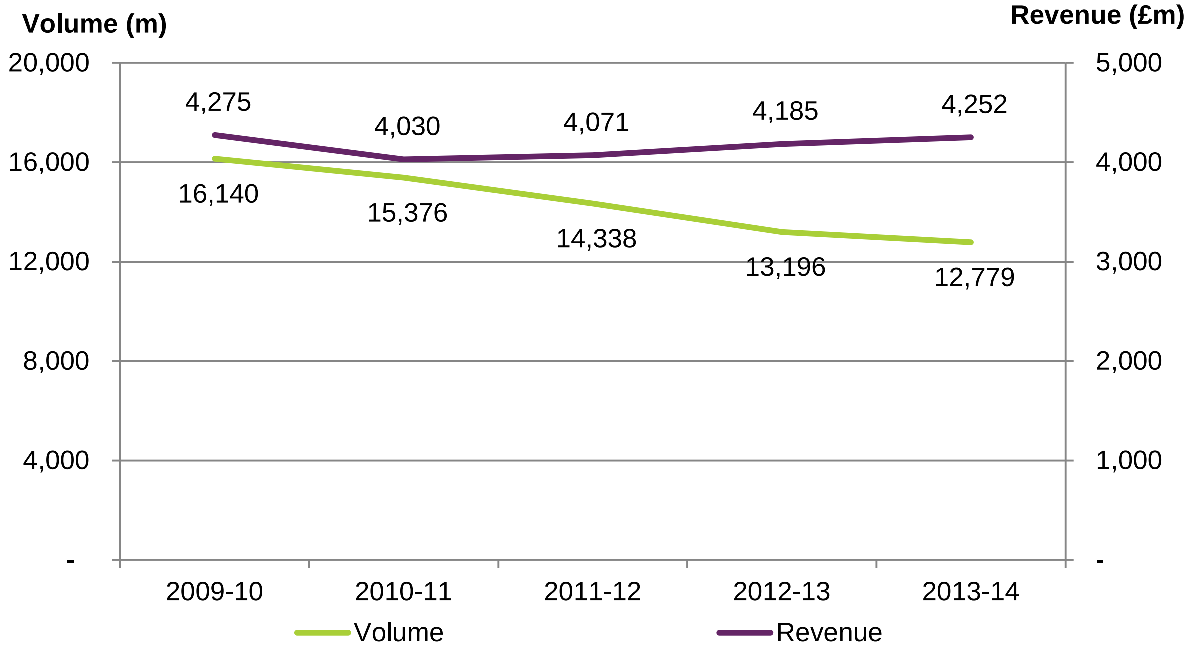
[24] *Modernise or Decline – Policies to maintain the universal postal service in the United Kingdom, An independent review of the UK Postal services sector*, 16 December 2008.

used by consumers as immediate, low cost alternatives to postal services, resulting in a gap between economic growth and the growth of mail volumes, often referred to as the 'technology wedge'.

3.11 Figure 3.1 shows the total letter volumes and revenues declined over the past five years. Total addressed letters volumes continued to fall in 2013-14, declining by 3.2% to 12.8bn items. Although this is a slightly slower rate of decline than the previous year (which was 8.0%), it still represents a 21% decline over the past five years.

3.12 Despite the fall in volumes, total letters revenue grew by 1.4% to £4.2bn. As discussed later in this Section, the principal reason for this was price rises.

Figure 3.1 – Total letter volumes and revenue



Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, operator returns to Ofcom, Ofcom estimates. Note: Royal Mail figures relate to the Letters and Large Letters[25] in the "Reported Business". Royal Mail end-to-end refers to Royal Mail total letter mail volumes excepting access. Prior data is not comparable. Addressed mail only

Trends in the overall parcels sector

3.13 A 2014 UK parcel report by Apex Insight[26] stated the current market,[27] which it valued at £8bn, has seen significant growth since the economic downturn in 2009.

[25] "Standard Letters" or "Letters" means any item up to length 240mm, width 165mm, thickness 5mm and weighing no more than 100g. "Large Letters" means any item larger than a Letter and up to length 353mm, width 250mm, thickness 25mm and weighing no more than 750g.
[26] UK Parcels, Market Insight Report, September 2014.
[27] Defined into three segments: business-to-business, business-to-customer and consumer/small business-consigned products.

3.14 The Apex Insight report largely attributes the continued parcel volume growth observed in recent years to two factors:

- Level of GDP growth – the business-to-business parcel segment has historically been correlated with GDP growth, showing a downturn in 2009 and subsequently recovering; and

- Online shopping – the growth of retail sales, including marketplaces such as eBay and Amazon, is a key contributor to the growth in parcel volumes, in particular for the business-to-consumer and consumer-consigned segments.[28]

3.15 While parcel volumes have grown significantly over the recent years, the average price per parcel has remained low, which the Apex Insight report stated was due to the high level of competition and the limited differentiation between postal operators thus enabling customers to easily switch between postal operators. Furthermore, the Apex Insight report states efficiency gains[29] have largely been passed onto customers thereby putting further downward pressure on parcel prices.

3.16 Operators in the parcels market are using digital technology to drive innovation. Royal Mail noted in its June 2014 regulatory submission to Ofcom about the threat that end-to-end competition poses the universal postal service ("*Royal Mail's June 2014 submission*"),[30] that innovation is a key feature of the UK parcels market.[31] For example, earlier this year, Parcelforce launched an interactive service enabling customers to arrange for a parcel to be delivered on a different day or to a different address by SMS or email. Most operators also offer tracking of shipments as standard across their product ranges.

3.17 Click and collect services, where goods ordered remotely can be collected directly from retailer's shops or from intermediary locations (such as parcel lockers) are becoming more widely used.[32] Amazon, InPost and other companies are rolling out automated parcel lockers throughout the UK.

3.18 The Apex Insight report forecasts 7.0% growth of the parcels market from 2014 to 2018, which it notes is significantly more than the 3.9% growth experienced from 2008 to 2014. Apex Insight expects growth to continue to arise from parcel volumes, as the economy is expected to continue to recover and online retail sales are expected to grow. However, Royal Mail stated recently that while it expected growth in the parcels market to be about 4% per annum in the medium term, the UK addressable market growth rate was only 1-2%.[33]

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[28] The UK is the leader in online shopping compared to other EU countries. This has been facilitated by further rollout of broadband across the UK, as well as the increased usage of mobile data and mobile devices such as tablets and smartphones for online shopping.
[29] For example, merger and organic growth leading to improved collection and delivery processes; productivity gains via investment in automation; and lower levels of loss and damage as a result of parcel tracking.
[30] http://www.royalmailgroup.com/about-us/regulation/end-end-competition.
[31] Royal Mail's June 2014 Submission (non-confidential version), page 17.
[32] Data from the Interactive Media in Retail Group indicates that 4% of online orders were fulfilled in this way in Q1 2010-11, with 19% of online orders fulfilled through click and collect in Q3 2013-14.
[33] Royal Mail plc, Half Year 2014-15 Results, 19 November 2014, Slide 4.

3.19 As set out in the our decision document on the review of end-to-end competition, we are intending to undertake further work in order to understand the parcels market in the UK better, including collecting parcel volume and revenue information directly from operators.

In 2013-14, Reported Business total volumes continued to fall but revenues increased

3.20 We note that the total volumes of (addressed and unaddressed) mail for the Reported Business continued to fall in 2013-14, by 4.3% to 17.7bn. This was due to fewer addressed mail items handled by Royal Mail, which fell by 4.5% to 14.5bn (as illustrated in Figure 3.2).

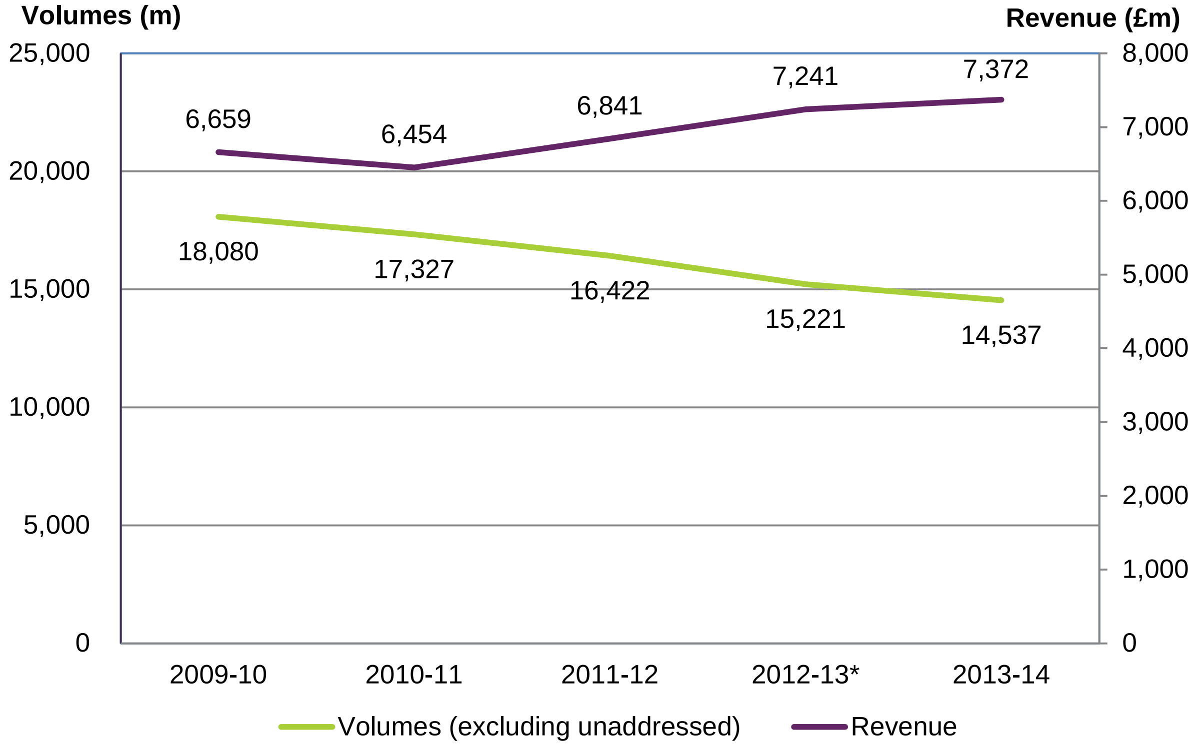
3.21 Although 2013-14 total Reported Business volumes continued to follow the downward trend as seen in recent years and reflective of the overall sector trend, the rate of decline in 2013-14 was less than in 2012-13, when total volumes fell by 5.2%. The steep volume decline in 2012-13 may be partly attributable to the price increases Royal Mail introduced in April 2012. Price rises were introduced for some products in 2013, such as customer and small-business parcels[34] and access products. This alongside the improved UK economic conditions in 2013 may have contributed to the lower rate of volume decline in 2013-14.

3.22 Despite volume declines, total revenue for the Reported Business continued to rise in 2013-14, by 1.8% to £7.4bn. This was lower than the revenue growth in the prior year, which increased by 5.8% to £7.2bn. These trends are illustrated in Figure 3.2 which shows total revenues and addressed mail volumes over the past five years.

3.23 As we discuss later in paragraph 3.31 and in Section 5, a contributory factor to the increase in revenue during the period (despite the continuing decline in total volumes) are the price rises for customer and SME parcels, referred to as 'size-based pricing'.

[34] Price rises were introduced in April 2013. This resulted in some significant price rises for "medium" sized parcels (in some cases over 100%). As a result, consumer volumes fell by more than Royal Mail had expected. Royal Mail consequently amended its size-based pricing structure in October 2013, such that the dimensions for "small" parcels were expanded. See Section 5 for further price change commentary.

Figure 3.2 – Reported Business volumes and revenue



Source: Royal Mail Regulatory Accounts
** adjusted 52 weeks*

Changes in Reported Business volumes and revenue by product group[35]

3.24 Figures 3.3 and 3.4[36] illustrate the trend in the volumes and revenues of First Class, Second Class, access[37] and retail bulk mail[38] products. This analysis by product

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[35] In 2012-13, some reclassifications were made to these categories as part of the changes Royal Mail made to its business mail products;
i) PPI mail was reclassified from the '*First class Stp (Stamp)/Mtr (Meter)* and '*Second class Stp/Mtr*' product groupings to the '*Bulk mail'* grouping. PPI (Printed postage impressions) mail is an indication on the envelope that the postage has been paid and can be used by customers with an account with Royal Mail. It offers a pre-printed alternative to stamps and franking machines. Meter is a way of paying postage in advance, and items have a franking impression made by a franking machine licensed by Royal Mail; and
ii) a single-piece PPI product was introduced, which we have classified within the '*First Class single piece'* and '*Second Class single piece'* groupings. We have reclassified the '*First class Stp/Mtr'* and '*Second class Stp/Mtr'* categories, to '*First Class single piece*' and '*Second Class single piece*' respectively.

[36] Figures reflect Royal Mail's groupings and therefore the reclassification of PPI to the Bulk Mail grouping effective from 2012-13. Where relevant, we have provided figures below the historical PPI volumes to reflect the impact of this change in classification, thus enabling a like-for-like comparison. We have done this by categorising First Class PPI and Second Class PPI (in 2011-12 and preceding years) as Bulk Mail. It should be noted that the First Class (and Second Class) single piece figures from 2012-13 include stamp, meter and account (the single piece PPI product introduced in 2012-13).

[37] Access means allowing other companies to use a postal operator's facilities for the partial provision of a postal service. In the UK this involves Royal Mail accepting mail collected and processed by third parties at its inward mail centres under wholesale contracts. Access mail is therefore the mail which is partially handled by users of these wholesale services.

group enables us to gauge the impact each has on the overall Reported Business volume and revenue trend.[39]

3.25 We note that:

- First Class single piece letter and parcel volumes fell by 5.4% in 2013-14. This was partly driven by both the continuing structural decline in letter volumes and the adverse effect the introduction of size-based parcel pricing in April 2013 had on single piece parcel volumes. Whilst the trend of declining First Class single piece letter and parcel volumes continued in 2013-14, it was to a lesser extent than in the previous year (13.9% decline in 2012-13).[40] This was partly due to both the strengthening of the UK economy in 2013 and the absence of stamp price increases in 2013.

  First Class single piece letter and parcel revenues fell by 0.9%, compared to a 3.5% increase in 2012-13.[41] The revenue increase in 2012-13 was largely attributable to the price rises that took effect in April 2012.

- The decline in Second Class single piece letter and parcel volumes slowed in 2013-14, falling by 2.9% (compared to 6.9% in the previous year).[42] However their revenues increased by 15.2% (compared to a 14.2% increase in the previous year);[43]

  The fall in Second Class volumes continued to be significantly less than the fall in First Class volumes. Furthermore, Second Class revenue continued to increase whilst First Class revenue fell. There may be a variety of reasons for this. Firstly, consumers of Second Class products may have been less sensitive to price increases compared to consumers of First Class products. We note that the proportion of business mail in Second Class single piece products is higher than the comparative First Class products (as consumers tend to send more First Class than Second Class mail). It is also possible that some customers may have been choosing cheaper Second Class products perhaps as a result of the price rises and perhaps a greater desire to economise due to wider macroeconomic factors.

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[38] Bulk mail means mail for which the price per postal item is subject to discounts related to (i) the number of postal packets sent; (ii) the positioning or formatting of text on the postal packet; (iii) the requirement to apply markings which facilitate the use of machines to sort postal packets; (iv) pre-sortation into geographical areas for delivery; or (v) the purchase of any other conveyance of the same or any other postal packet..

[39] We were provided with adjusted unaudited 52 week comparative results for the 2012-13 volume and revenue split by product groups (Figures 3.3 and 3.4, respectively) from Royal Mail. We have therefore restated the 2012-13 results to reflect the 52 weeks in order to perform a like-for-like year-on-year comparison. As these figures exclude non-revenue generating volumes, they do not reconcile to the figures published in Royal Mail's annual Statutory and Regulatory accounts.

[40] Based on restated adjusted 52 week 2012-13 figures and like-for-like year-on-year movement i.e. 2011-12 First Class PPI and Second Class PPI have been reclassified to Bulk Mail.

[41] Based on restated adjusted 52 week 2012-13 figures and like-for-like year-on-year movement i.e. 2011-12 First Class PPI and Second Class PPI have been reclassified to Bulk Mail.

[42] Based on restated adjusted 52 week 2012-13 figures and like-for-like year-on-year movement i.e. 2011-12 First Class PPI and Second Class PPI have been reclassified to Bulk Mail.

[43] Based on restated adjusted 52 week 2012-13 figures and like-for-like year-on-year movement i.e. 2011-12 First Class PPI and Second Class PPI have been reclassified to Bulk Mail.

- For the category of retail bulk mail (including bulk PPI) and business parcels, volumes declined by 7.6% and revenues declined by 1.0%.[44]

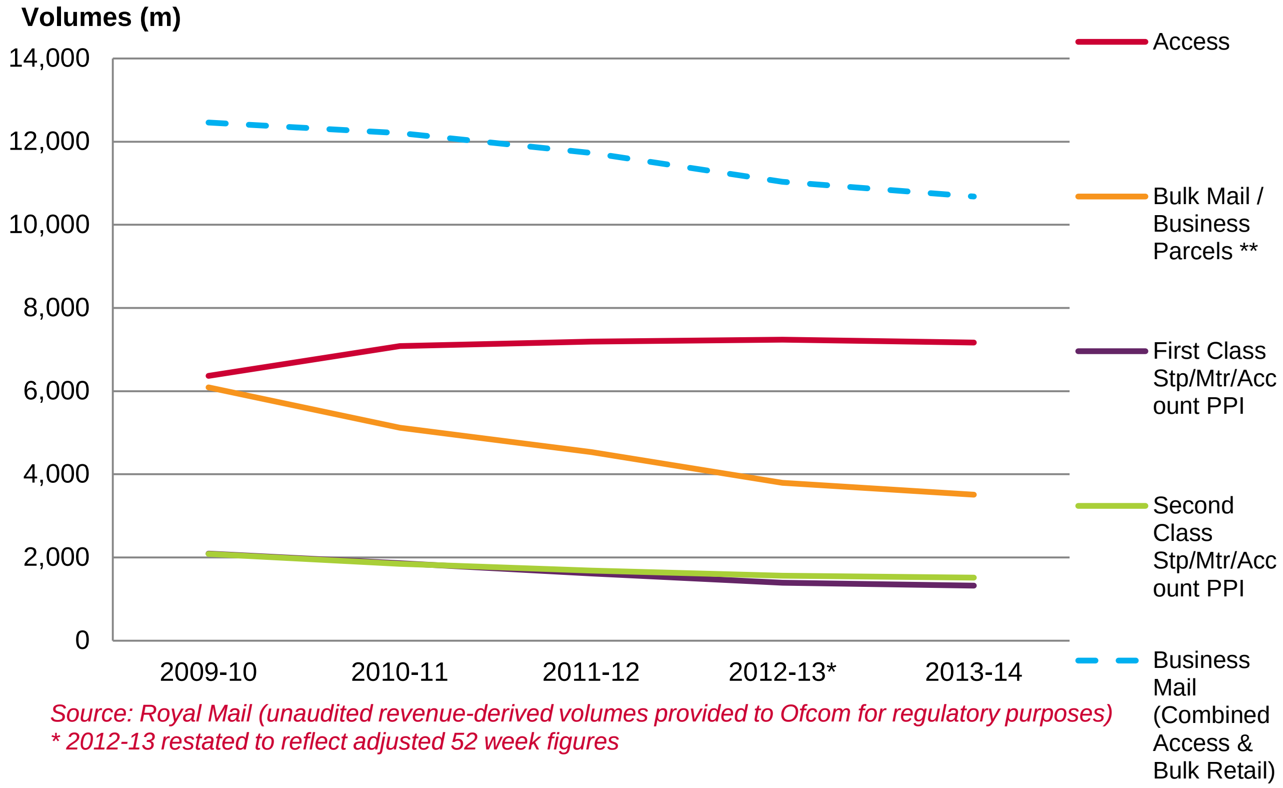
  Royal Mail's access volumes declined by 1.0% to 7.2bn items. This is the first time access volumes have declined since access was introduced in 2004. However due to price rises, access revenues increased by 0.8% to £1.5bn over the same period. Access and end-to-end competition is discussed in Section 6.

- Finally, combined access and retail bulk volumes declined by 3.3% and revenues declined by 0.3% in 2013-14.

  This volume decline continues to be lower than the overall addressed mail volume decline of 4.5%,[45] which would suggest business mail volumes (which include transactional mail) may have been less affected by factors, such as e-substitution, which are contributing to the decline in some other forms of addressed mail. The decline in revenues reflects Royal Mail's shrinking bulk mail market share.

3.26 The price rises over the last five years are discussed further in Section 5.

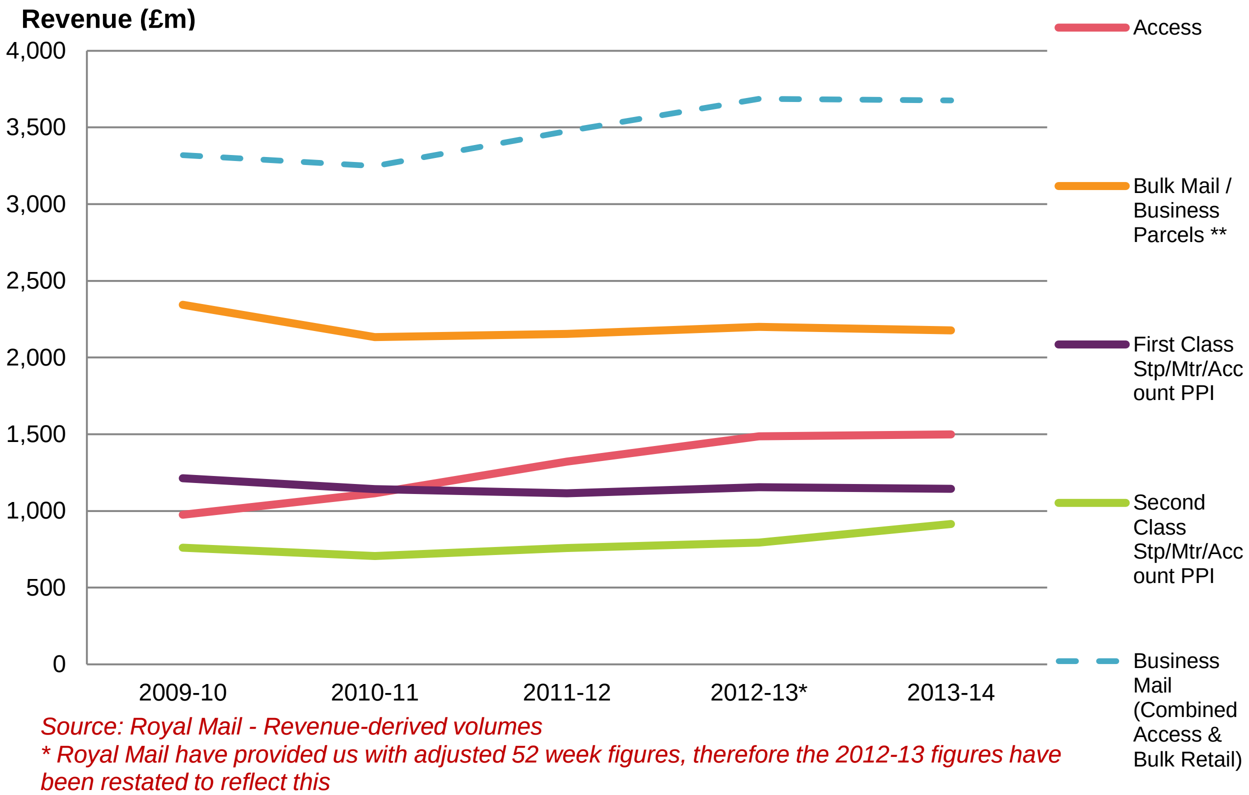
Figure 3.3 – Volumes split by product group - First and Second Class, access, bulk



Source: Royal Mail (unaudited revenue-derived volumes provided to Ofcom for regulatory purposes)
** 2012-13 restated to reflect adjusted 52 week figures*

[44] These figures include all Special Delivery items (i.e. they include universal service Special Delivery items as well as contract Special Delivery).
[45] 2012-13 adjusted to 52 weeks.

Figure 3.4 – Revenue split by product group - First and Second Class, access, bulk



Source: Royal Mail - Revenue-derived volumes
** Royal Mail have provided us with adjusted 52 week figures, therefore the 2012-13 figures have been restated to reflect this*
*** includes all Special Delivery items*

Changes in Reported Business volumes and revenue by format

3.27 We have considered changes in the volumes and revenues of different product groups to ascertain if and how they have contributed to the overall decline in volumes and increase in revenues for the Reported Business. Figures 3.5 and 3.6 below plot the trend for Letters/Large Letters (including retail and access), Other items (including unaddressed and international mail) and Parcels (both retail and access).[46]

3.28 As illustrated in Figure 3.5, Letters/Large Letters volumes reduced by 3.6%, albeit at lower rate than the peak decline in 2012-13, where volumes fell by 8.1%. Figure 3.6 shows Letters/Large Letters revenues increased by 1.4% (in the previous year they were up by 2.7%). The peak volume decline and revenue increase in 2012-13 may be attributable to a number of reasons. Firstly, the tough economic climate at the time. Secondly, the April 2012 price rises across most postal products may be a contributory factor and as the majority of these prices were not increased further in 2013, the rate of volume decline and revenue increase for Letters/Large Letters in 2013-14 was lower compared to the previous year. This is against the backdrop of continued end-to-end rollout by Whistl[47] into parts of South West and North West London, Manchester and Liverpool in 2013-14, [48] representing around 0.5% of the total letter market volumes. We discuss Whistl and end-to-end competition further in Section 6.

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[46] Figures are from unaudited and unpublished submissions provided to Ofcom.
[47] Previously TNT Post UK.
[48] In addition to areas of West and Central London to which Whistl was already delivering.

3.29 Figure 3.5 shows total parcel volumes fell by 1.2% in 2013-14, which is in contrast to the Reported Business' historic trend of parcel volume growth. It is also in contrast to the overall parcel market growth as noted earlier in this Section, thus indicating the Reported Business parcel share of supply declined in 2013-14. This was partly due intensified parcel competition, for example in January 2014 Amazon rolled out its own delivery service which Royal Mail states accounted for c.6% of UKPIL parcels revenue.[49]

3.30 Figure 3.6 shows that despite the parcel volume decline, parcel revenues increased by 7.4% in 2013-14, albeit at a slower rate than the previous year (14.3%). A contributory factor to the 2013-14 revenue increase was size-based pricing, introduced in April 2013.

3.31 Size-based pricing led to significant price increases for medium sized parcels, resulting in prices more than doubling in some cases. The introduction of size-based pricing in April 2013 led to a year on year decline in consumer parcel volumes,[50] which in turn contributed to the total parcel volume decline of 1.2% in 2013-14 (paragraph 3.29).

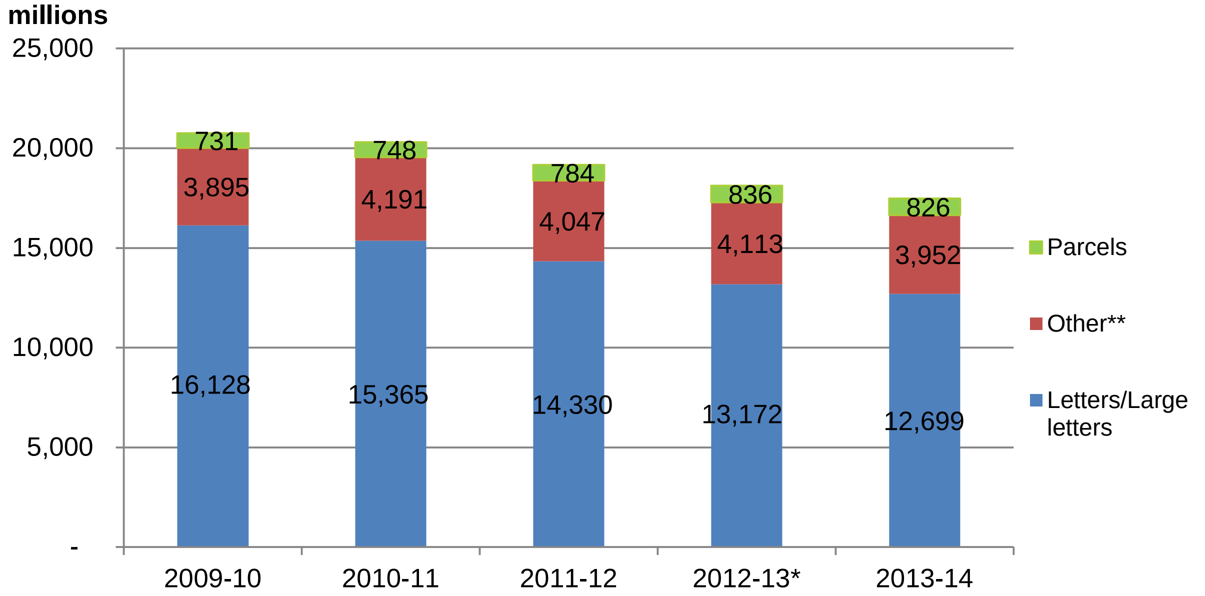
3.32 As discussed further in Section 5, in response to the consumer and SME parcel volume decline, Royal Mail replaced the cube format of the small parcel with a deeper 'shoebox' of increased dimensions in October 2013, resulting in a greater number of parcels meeting the small parcel size criteria. Following further customer feedback, Royal Mail made additional amendments to its small parcels dimensions in October 2014; whereby the two dimensions that previously met the small parcel under 2kg criteria[51] were changed to a single format size – 45cm length x 35cm width x 16cm depth.

3.33 Figure 3.5 shows Other volumes (which consist of unaddressed letters and international mail) decreased by 3.9% (compared to a 1.6% increase in the previous year). This is due to declines in both unaddressed and international mail, whilst in the previous year the increase in unaddressed mail more than offset the decline in international mail.

3.34 Other revenues decreased by 6.9%, compared to a 7.6% increase in the previous year (see Figure 3.6). This was due to the decline in unaddressed advertising mail volumes.

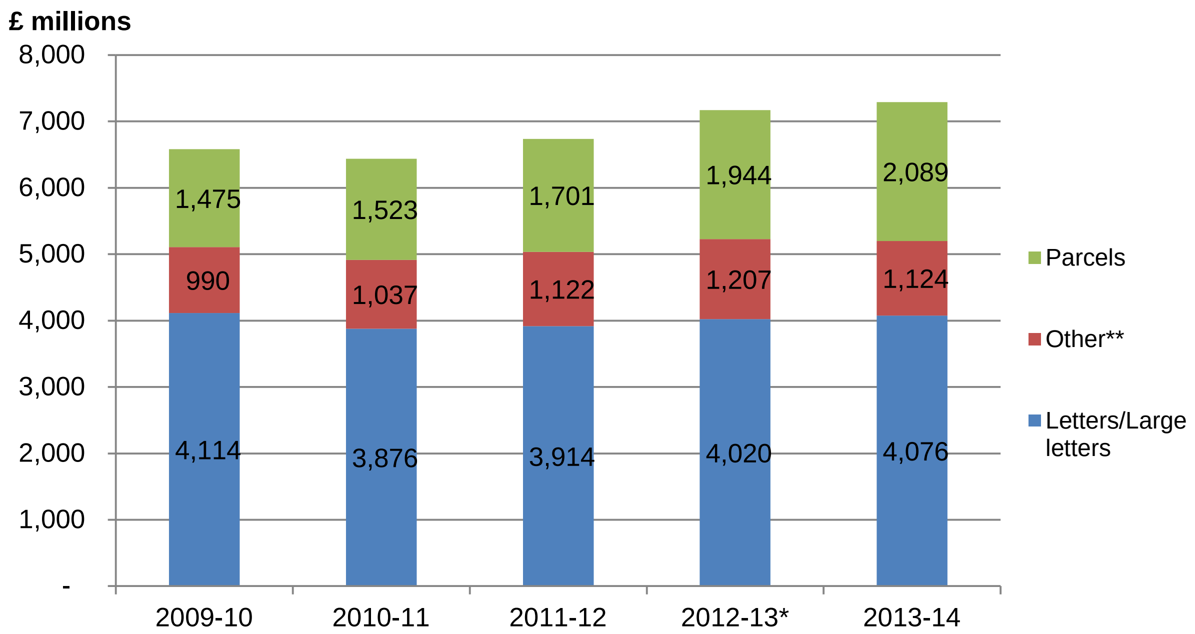
[49] Royal Mail plc Preliminary Results for the year ended 30 March 2014, Thursday 22 May 2014, page 5.
[50] Combined First and Second class parcel volumes i.e. First and Second class Single, Meter, PPI and non-revenue generating parcel volumes. Figures are based on unaudited and unpublished submissions to Ofcom, using unadjusted 53 week 2012-13 data.
[51] 'Wide': 45cm length x 35cm width x 8cm depth or 'deep': 35cm length, 25cm width, 16cm depth.

Figure 3.5 – Volumes split by format – Letters/Large Letters, Parcels and Other items



Source: unpublished submission provided to Ofcom. Volumes shown are UKPIL excluding Parcelforce
** adjusted 52 weeks*
*** Other includes unaddressed and international mail*

Figure 3.6 – Revenue split by format – Letters/Large Letters, Parcels and Other items



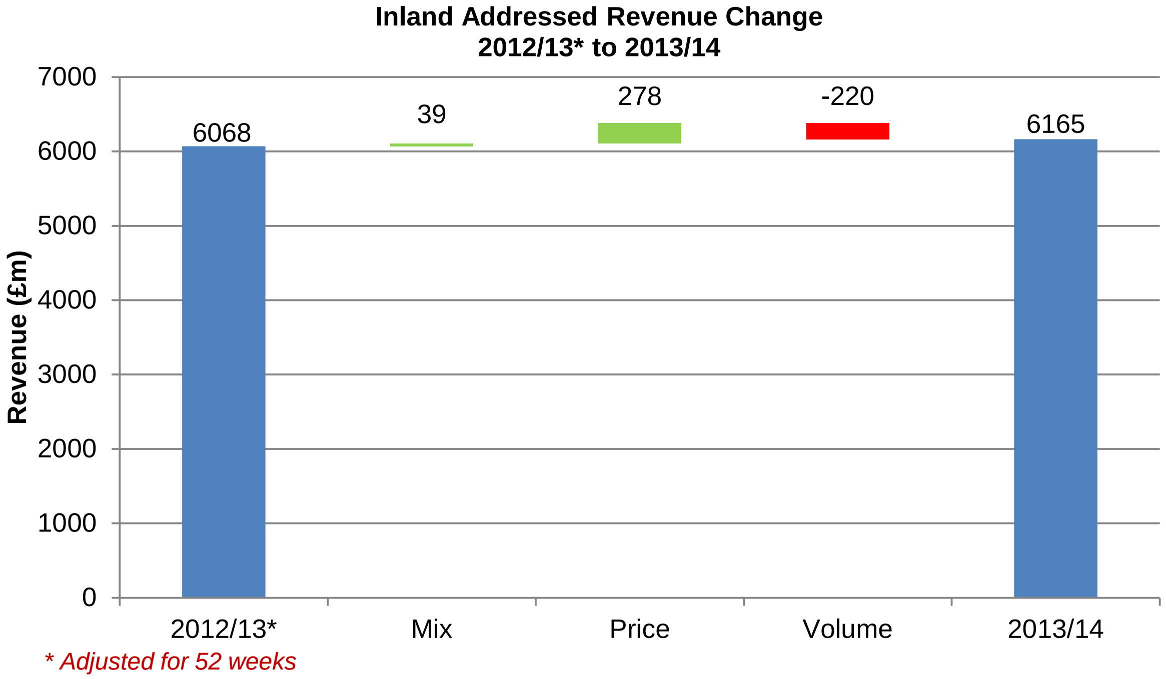
Source: unpublished submission provided to Ofcom. Volumes shown are UKPIL excluding Parcelforce
** adjusted 52 weeks*
*** Other includes unaddressed and international mail*

3.35 We have undertaken some high level analysis to ascertain how much of the overall increase in total Reported Business revenue in 2013-14 was due to mix and how much was attributable to price rises.

3.36 Our analysis[52] – set out in Figure 3.7 – shows the relative contributions of price increases, overall volume decline and the change in volume mix (i.e. higher proportion of parcels) towards the increase in revenue for inland addressed mail. This analysis suggests that price increases are the main driver of revenue growth in addressed mail, accounting for around 88% of the revenue increase. This is higher than in 2012-13, where price increases accounted for 73% of the total revenue increase, due to the introduction of size-based parcel pricing in April 2013.

3.37 In 2013-14, the change in mix represented 18% of the volume impact, which is considerably less than in 2012-13 (46%).

Figure 3.7 – Contributions of mix, price and volumes to inland addressed revenue change



Universal service and non-universal service volumes and revenues

3.38 As set out in Section 2, the Reported Business includes all universal service products, as well as other products which use the universal service network (for example, retail bulk mail and access products).

[52] The analysis looks at the drivers behind the change in addressed mail revenue between 2012-13 and 2013-14. This is calculated with reference to the overall change in revenue for letters/large letters (combined) versus parcels. The calculation is undertaken in three steps: a) to estimate the impact of changes in mix the 2012-13 total volumes and average prices were used alongside the 2013-14 change in mix (i.e. the proportion of letters/large letters compared to parcels); b) to estimate the impact of the change in prices, 2013-14 average prices and mix was used alongside the 2012-13 total volumes; and c) to estimate the impact of the volume decline total volume was scaled to reflect 2013-14 total volumes along with the 2013-14 prices and mix.

3.39 Figure 3.8 shows the Reported Business volumes, broken down into universal service and non-universal service products. Note these are the same volumes as those shown in previous Figures in this Section, only categorised in a different manner.

3.40 The volume of universal service products continues to decline significantly. In 2013-14, universal service volumes declined by 7.8% and over the last five years, they have fallen by 37.7%.[53] As part of Postcomm's August 2011 review,[54] some products were removed from the scope of the universal service, which consequently reduced universal service volumes. The volume of non-universal service products also continues to fall but less so, with a 3.4% reduction in 2013-14 (and 11.3% reduction over the last five years).[55] This was mainly due to the growth of access volumes, which results in other operators taking upstream volume from Royal Mail. However, as shown above and later in Figure 6.1, 2013-14 a saw reduction in Royal Mail's access volumes for the first time in the past five years. This is likely to be due to a combination of increased end-to-end competition and the access market potentially nearing maturing.

3.41 As discussed in paragraph 3.25, combined access and retail bulk volumes declined by 3.3% in 2013-14. This decline in bulk business mail volumes has been significantly slower than the decline in volume of universal services predominantly used by consumers and small business, as shown in Figure 3.8.

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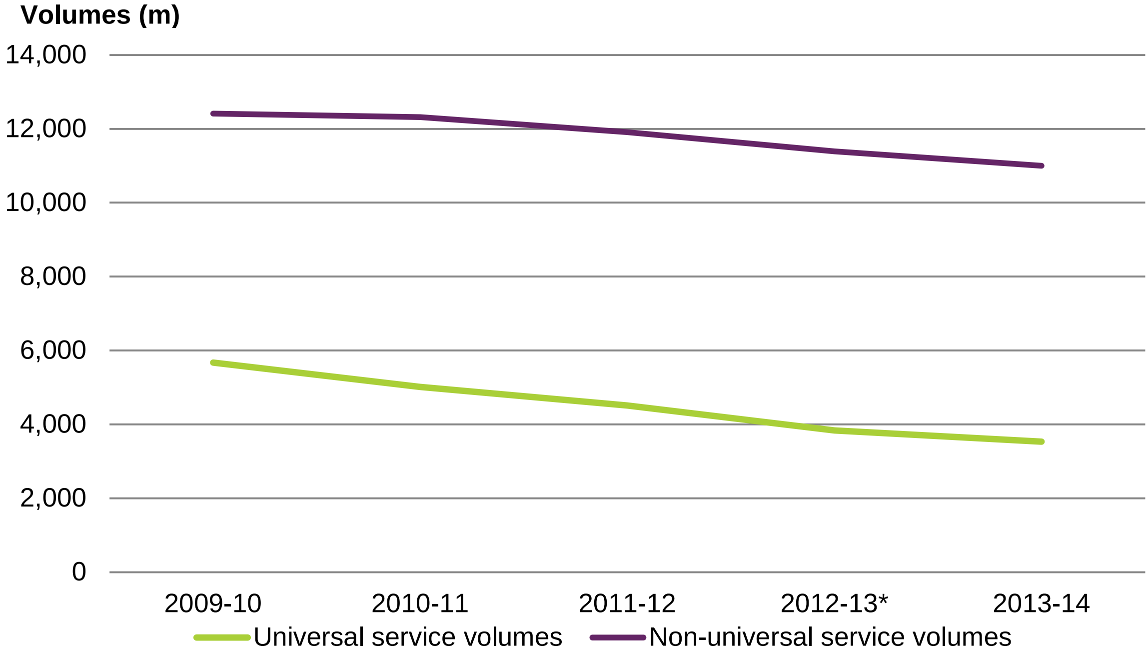
[53] Based on the 2012-13 universal service product scope where Mailsort 1400 and Cleanmail were redesignated to non-USO services, like-for-like volumes fell by 27.9% over the past five years

[54] See Postcomm *Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document* http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf

[55] Based on the 2012-13 universal service product scope where Mailsort 1400 and Cleanmail were redesignated to non-USO services, like-for-like volumes fell by 16.5% over the past five years

Figure 3.8 – Volumes split by universal service and non-universal service products



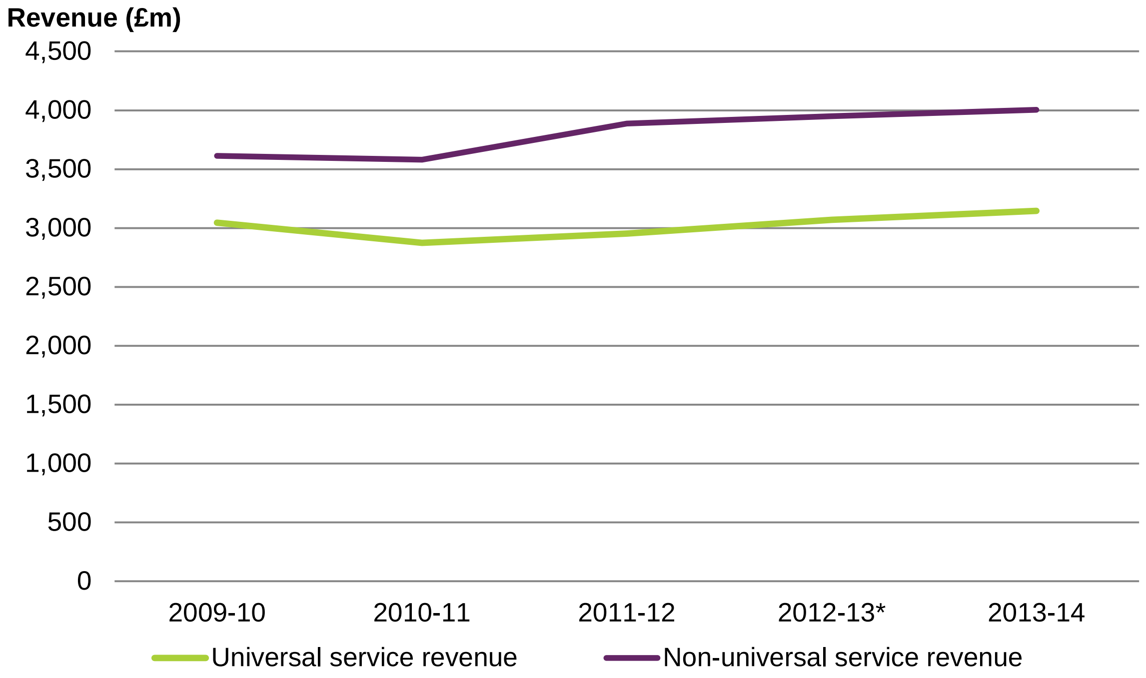
Source: Royal Mail Regulatory Accounts, addressed volumes
** adjusted 52 weeks*

3.42 Figure 3.9 sets out the corresponding revenue for the Reported Business split between universal and non-universal service products. Despite the volume decline discussed above, revenues from universal service products have increased over the last four years, largely due to price rises.[56] In 2013-14, revenues rose 2.5% and in nominal terms, are higher than the revenue levels seen five years ago.

3.43 Non-universal service products contain discounts for presentation, sorting of the mail and/or volume which reduces the cost of processing these items for Royal Mail. They therefore have lower unit revenue than universal services. This explains why the gap between universal service and non-universal service volumes is much larger than their respective revenues.

[56] Based on adjusted 52 week 2012-13 period.

Figure 3.9 – Revenue split by universal service and non-universal service products



Source: Royal Mail Regulatory Accounts; addressed revenue
** adjusted 52 weeks*

Reported Business costs

3.44 Costs including transformation costs for the Reported Business increased by 1.4% to £7.2bn in 2013-14. These costs can be broken down into people costs, non-people costs and transformation costs. The breakdown of costs to these categories is shown in Figure 3.10[57] and we note that:

- *People costs* – increased to by 4.4% to £4.6bn, despite a slightly lower headcount. This is largely due to the 3% pay deal[58] and increased pension contributions;

- *Non-people costs* – fell by 5.5% to £2.3bn, partly due to a one-off £42m VAT credit and lower Post Office Limited commission costs[59] due to lower parcels volumes as a result of size-based pricing; and

- *Transformation costs* – transformation costs were £0.2bn in 2013-14, representing a 19.2% increase compared with 2012-13. This is largely due to the £104m management reorganisation cost that was incurred in 2013-14, which we discuss further later in this Section. Underlying transformation costs excluding the management reorganisation cost incurred in 2013-14 decreased by 32%.

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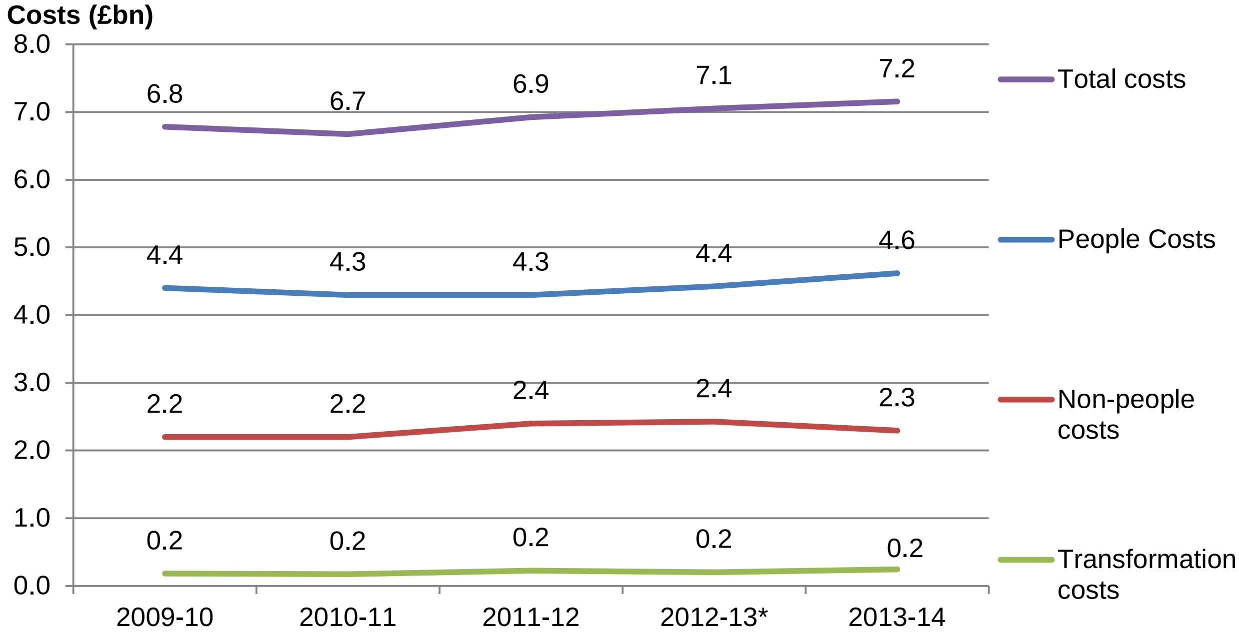
[57] Based on 2012-13 adjusted 52 week period.
[58] Agreed with the CWU in December 2013.
[59] Commission paid to Post Office Limited to handle Reported Business parcels

3.45 As volumes handled by Royal Mail continue to fall, particularly parcel volumes which in 2013-14 fell for the first time in the last five years, the ability to offset the lower letter revenue impact by parcel revenues is constrained.

Figure 3.10 – Reported Business costs



Source: Royal Mail audited regulatory accounts
** adjusted unaudited 52 weeks*

Reported Business profit margin

3.46 In considering the financial sustainability of the universal postal service, we are required to take into account the need for the universal service provider to be able to earn a reasonable commercial rate of return in connection with its provision of the universal service. In the March 2012 statement, we considered that an indicative earnings before interest and tax ('EBIT') margin range of 5-10% was consistent with this need.

3.47 Royal Mail reports the EBIT margin figure 'after transformation costs' which includes, amongst other costs, the recurring restructuring and redundancy costs related to modernisation. Whilst we consider Royal Mail's EBIT margin after transformation costs to be broadly in line with our approach outlined in the March 2012 Statement,[60] the pension cost used within Royal Mail's EBIT margin calculation is in accordance with the relevant accounting standards (the "accounting pension rate"). [61] This differs

[60] We set out in the March 2012 statement that the EBIT margin would be calculated on a pre-exceptional basis. We noted that we would not expect recurring costs, such as restructuring or redundancy costs that are likely to be incurred year on year, to be included in exceptional items. We also noted that we would determine the exceptional nature of items on a case by case basis. Footnote 69 of the March 2012 statement: http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf.
[61] International Accounting Standards 19, which states pension costs, must be based on market yields.

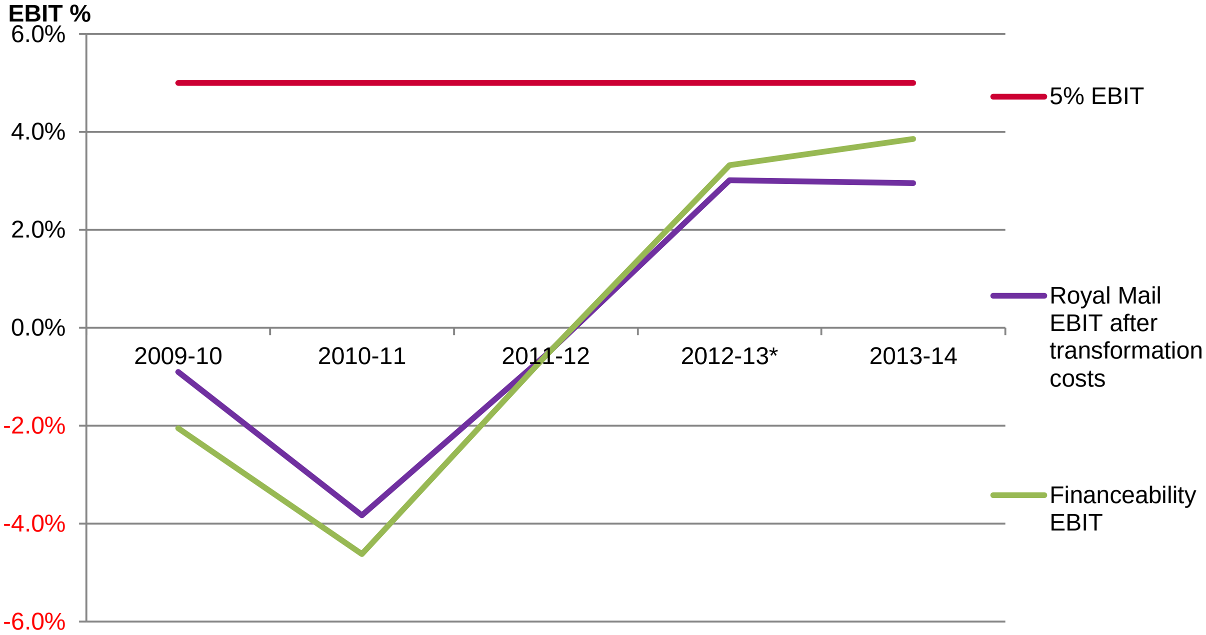
from the amount Royal Mail pays into its pension scheme each year (the "cash pension rate").[62] For example, in 2013-14, the accounting pension rate was 20.3% whilst the cash pension rate was 17.1%.[63]

3.48 We explained in the March 2012 guidance that we considered the EBIT operating margin to be an appropriate proxy for operating cash generation, as the operating cash flow and EBIT were projected to become broadly comparable towards the end of Royal Mail's plan. Since the March 2012 guidance the accounting rate and cash rates have diverged and will move further apart in 2014-15. The accounting rate for pensions is therefore not a good measure of the impact of pensions on Royal Mail's cash flow. We have therefore adjusted Royal Mail's reported EBIT after transformation costs to reflect the pension cash cost, as shown in Figure 3.11 below.

3.49 We refer to the cash pension rate adjusted EBIT margin after transformation costs as the 'financeability EBIT margin'. It is the financeability EBIT margin that we measure against the indicative 5-10% range which we considered in March 2012 was consistent with a commercial rate of return, and therefore use to assess the financial sustainability of the universal service.

[62] The actual cash pension cost (which is based on an actuarial valuation) is determined by the agreement with the Pension Trustees.
[63] As part of the pension's reform that took effect on 1 April 2014 and as agreed with the Communications Workers Union, Royal Mail's pensionable pay increases were reduced from RPI +1% to RPI. The Trustee of the Royal Mail Pension Plan ("the Trustee") also agreed to reduce Royal Mail's cash contributions to 17.1% of pensionable pay. This was in return for Royal Mail transferring its surplus pension assets over a number of years to the Trustee, which would have been used to fund the additional 1% pensionable pay increases.

Figure 3.11 – Reported Business EBIT margin



** 2012-13 EBIT margin is based on 53 weeks*

3.50 Figure 3.11 shows that both Royal Mail's reported EBIT margin after transformation costs and the financeability EBIT margin continued to remain positive in 2013-14. However whilst Royal Mail's EBIT margin after transformation costs remained flat year on year at c.3.0%, the financeability EBIT margin increased from 3.3% in 2012-13 to 3.9% in 2013-14. This difference in 2013-14 EBIT margin is attributable to the impact of using the cash pension rate rather than the accounting pension rate.

3.51 The year on year financeability EBIT margin increase from 3.3% in 2012-13 to 3.9% in 2013-14 is largely due to improved trading performance, driven by revenue growth. As discussed earlier in this Section, this was due to price increases as a result of the size-based parcel pricing introduced in April 2013, which offset volume declines across all formats.

3.52 The financeability EBIT margin also shows a significant improvement over the past five year period and is closer to the indicative 5-10% range we considered in March 2012 was consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.

3.53 In the five year period from 2009-10, Royal Mail has incurred management reorganisation costs in two years – £51m in 2010-11 and £104m in 2013-14. We note that the management reorganisation costs are significant in size and have been incurred every three years since 2007-08. With regard to the 2013-14 changes, Royal Mail stated these are intended to take effect during 2014-15 and are expected to generate annual cost savings of £70m – with at least £25m expected to be realised in the second half of 2014-15.[64]

[64] Royal Mail half year ended 28 September 2014 financial report, page 4.

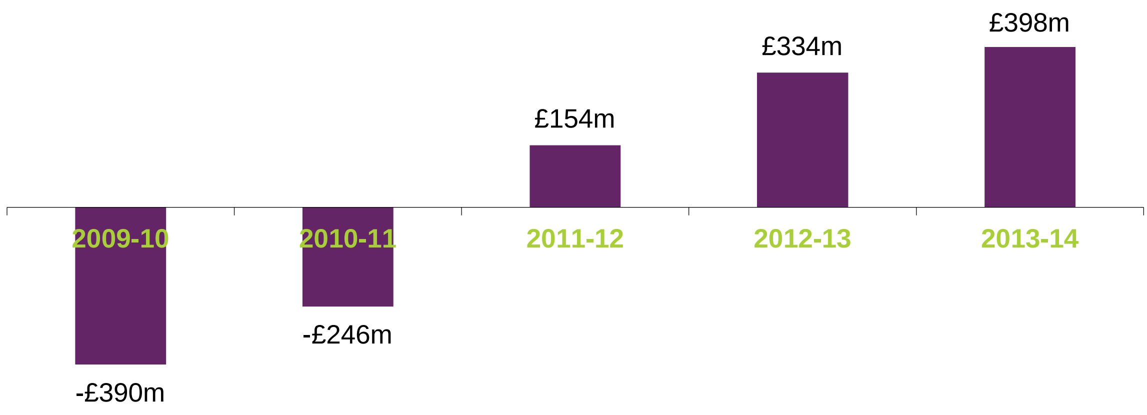
Royal Mail Group's cash flow

3.54 Cash flow is also an important component in ensuring the financeability of the universal service. We set out in the March 2012 statement that we considered the EBIT margin was an appropriate proxy for operating cash generation, as Royal Mail had projected the operating cash flow and EBIT to be broadly comparable towards the end of its plan.

3.55 The cash flow of the Relevant Group was a concern prior to 2011-12. Free cash flow was negative in 2007-08 and as shown in part by Figure 3.12, remained so until 2010-11. However as the Figure also illustrates, free cash flow improved and turned positive in 2011-12. Royal Mail Group saw a further improvement in its cash flow in 2013-14 where it reached £0.4bn, which represents a 19.2% increase on the previous year.

3.56 The main reasons for this are the improvement in its overall trading performance and a lower level of investment due to the removal of the pension deficit payment in 2011-12[65] (which removed approximately £300m per annum pension deficit payments).

Figure 3.12 – Relevant Group free cash flow*



Source: Royal Mail Statutory Accounts
** Free cash flow: net cash flow before financing activities (except finance costs paid), less the net cash purchase/sale of financial asset investments*

[65] Following its approval by the European Commission in March 2012 (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:279:0040:0068:EN:PDF), the UK Government transferred Royal Mail's historic pension deficit assets and liabilities to the Treasury in the first half of 2012. In addition, Royal Mail stated in its prospectus that it also received £124 million in restructuring aid. Royal Mail still needs to provide for the ongoing pension costs accrued for its staff.

Summary of financial performance

3.57 We have reviewed a broad set of financial performance data in this Section. In summary, the key trends for the 2013-14 financial year were:

- On an overall sector level, letter volumes fell (due to e-substitution), whilst parcels grew (as a result of the growth in e-commerce);
- Reported Business letter volumes continued to decline, albeit at a lower rate than previous years. However parcel volumes declined for the first time, reflecting a shrinking of Royal Mail's share of supply as the overall parcels sector grew. The decline in the Reported Business parcels volumes was caused by the adverse impact of size based pricing and intensified parcel competition i.e. Amazon rolling out its own delivery service and other providers competing with lower prices;
- Despite letter and parcel volume declines, Reported Business overall revenue in 2013-14 increased, as a result of price rises;
- Costs for the Reported Business increased by 1.4% in 2013-14 compared to 2012-13. The main reason for this was higher people costs due to the 3% pay deal and higher pensions contributions, offset by reductions in non-people costs;
- The financeability EBIT margin increased from 3.3% to 3.9% in 2013-14, which was due to the improved trading performance (largely due to the increase in revenue, although volumes across all formats fell). Whilst this is below the indicative 5-10% range we consider is consistent with a reasonable commercial rate of return for a financially sustainable universal service, it has shown a significant improvement over the past five year period; and
- Free cash flow continued to improve in 2013-14 where it reached £0.4bn, which represents a 19.2% increase on the previous year, due to improved trading performance.

Section 4

Efficiency

4.1 In this Section we discuss efficiency, covering:

- why it is an important aspect of our monitoring regime;
- the further work we are doing to better understand Royal Mail's efficiency; and
- what Royal Mail itself has been doing to improve its efficiency.

4.2 We then set out in more detail efficiency metrics which provide useful indicators in considering Royal Mail's efficiency.

Efficiency is an important element of our monitoring regime

4.3 In discharging our duties in relation to post, the PSA 2011 requires us to have regard to the need for the provision of a universal service to be financially sustainable and for it to become efficient within a reasonable period of time and then remain efficient at all subsequent times.

4.4 In the March 2012 Statement, we noted that we expected Royal Mail to improve its efficiency levels and to sustain such improvements thereafter. This was to avoid Royal Mail relying solely on price increases with the associated risk of exacerbating volume decline. However, we did not set specific efficiency targets.

4.5 Therefore efficiency is one of the key areas we assess as part of the monitoring regime. As part of this, it is important to understand what Royal Mail's actual rate of efficiency improvement is which we discuss within this Section

4.6 As explained in our March 2013 guidance,[66] an understanding of Royal Mail's achieved and planned future rate of efficiency improvement would also be important in any future review of the need for intervention in relation to end-to-end competition. This set out that we would need to reach a view on the expected financial position of Royal Mail, taking account of expected future efficiency savings. This would include an assessment of Royal Mail's potential commercial response to end-to-end competition, including the impact of stronger incentives to improve efficiency. If we found that there was a potential threat to the universal service, we would also consider the extent to which any poor financial performance was the result of factors within Royal Mail's control, including an assessment of whether Royal Mail had achieved and was planning to achieve a reasonable rate of efficiency improvement.

[66] Ofcom *End-to-End Competition in the Postal Sector*, 27 March 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/statement.pdf.

We are continuing our work to understand the efficiency of the universal service better

4.7 In January 2014, we published two independent reports that we commissioned as part of our preliminary work to understand how we might assess what constitutes a reasonable rate of efficiency improvement for Royal Mail.

4.8 The first report was "*Approaches to measuring the efficiency of postal operators*" by NERA Economic Consulting.[67] This assessed the advantages and disadvantages of different efficiency measures for Royal Mail and postal operators in general in different policy contexts. The report also considers different methodologies to inform our view of what might represent a reasonable rate of efficiency improvement. These methodologies included Royal Mail's business plan; evidence from other UK regulated industries; previous improvements achieved by Royal Mail; assessment of total factor productivity trends;[68] and internal benchmarking.

4.9 The second report, "*Review of Postal Operator Efficiency*" by WIK-CONSULT,[69] is a study on the efficiency initiatives undertaken by postal operators in six European Countries (Austria, Denmark, France, Germany, Netherlands and Sweden). It provides a useful background for understanding efficiency initiatives in the postal sector by explaining how and to what extent the six postal operators have improved their efficiency to ensure financial viability.

4.10 We have used the NERA and WIK reports to review existing and inform further development of new efficiency metrics to understand and monitor Royal Mail's level of efficiency improvement. As each metric has its own different strengths and weaknesses, we will continue to work towards refining our current metrics, as well as developing new measures.

4.11 In particular, we are continuing our review of the extent to which Royal Mail's costs change as a result of volume changes, referred to as marginality. We have commissioned a review to understand Royal Mail's marginality calculations and underlying assumptions to further improve our efficiency metrics. We expect to finalise our review of Royal Mail's marginality in time for the next annual monitoring report in late 2015.

4.12 The review is expected to include key components of the efficiency metrics contained in this Section; marginality, as discussed above; and workload.

4.13 Workload is a volume measure weighted by the theoretical different amounts of time it should take to process and deliver letters, large letters and parcels. In this way, it is more reflective of the amount of work undertaken by Royal Mail than a simple volume count as it accounts for changes in mix. Change in workload provides an estimate of marginality as it reflects the theoretical change in hours due to change in volume. Currently, Royal Mail's workload is based on processing and delivery activities only. It therefore represents a partial measure as it excludes all other parts of Royal Mail's business. However delivery and processing people costs account for a significant proportion of Royal Mail's regulated business costs. We understand Royal Mail is

[67] http://stakeholders.ofcom.org.uk/binaries/post/postal-efficiency/nera.pdf.
[68] Divides a measure of outputs by an aggregate measure of inputs.
[69] http://stakeholders.ofcom.org.uk/binaries/post/postal-efficiency/wik.pdf.

currently working towards expanding its workload calculation across other parts of its pipeline.

4.14 As set out in our end-to-end decision document, we are intending to do some further analysis to inform our view of what rate of efficiency improvement Royal Mail should reasonably be able to achieve as part of a wider review into the factors that affect the future financial sustainability of the universal service.[70]

Royal Mail's transformation programme

4.15 Since 2008, Royal Mail has been implementing a large scale transformation programme (also described by Royal Mail as 'transformation activities').[71] The key transformation activities from this phase of operational modernisation neared completion in 2013-14. Royal Mail has implemented changes to collection, sortation, logistics and delivery.

4.16 These transformation activities included greater automation in Royal Mail's letters sorting processes (for instance, increased sequence sorting technology which enables letters to be sorted into address order, ready for final delivery by postmen and women), the rationalisation of its mail centres, implementation of new working practices in mail centres and delivery offices and more recently, changes to Royal Mail's delivery operations (such as greater use of trolleys and shared vans for the delivery of parcels and letters by postmen and women).[72]

4.17 In terms of Royal Mail's on-going rationalisation of Mail Centres, eight further centres were closed in 2013-14, leaving 40 in operation, compared to 69 operational mail centres in 2007-08. Since 2007-08, Royal Mail has modernised 94% of its Delivery Offices.[73] Royal Mail said that as well as more efficient operations, these changes are expected to bring about improvements in working conditions and safety for Royal Mail's staff.

4.18 Royal Mail submitted its new Business Plan to us in July 2014 ('the 2014 Business Plan').The 2014 Business Plan sets out more detail of its latest plans to reduce costs and improve efficiency. As much of this plan is commercially sensitive, we have not disclosed its details in this report. However, the 2014 Business Plan and Royal Mail's progress against its own targets informs our on-going internal monitoring of Royal Mail's efficiency.

4.19 In 2013-14, Royal Mail recognised in its statutory and regulatory accounts a £104m exceptional cost relating to the reorganisation of its management. The management redundancies are intended to take effect during 2014-15 and Royal Mail have stated the programme is expected to generate annual cost savings of £70m – with at least £25m expected to be realised in the second half of 2014-15.[74]

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[70] http://stakeholders.ofcom.org.uk/post/end-to-end-statement/.
[71] These activities are described in more detail in the Royal Mail plc Prospectus 2013 http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf - for instance, in pages 72-74.
[72] Mail Centres now make greater use of sorting machines and 'walk sequencing' technology. This has resulted in a reduction in the manual sorting of mail and the time taken to sequence the mail into delivery order in the delivery office.
[73] Royal Mail 2013-14 statutory financial statements, page 5.
[74] Royal Mail half year ended 28 September 2014 financial report, page 4.

Provisional indicators of Royal Mail's efficiency improvements

4.20 In this sub-section, we first assess Royal Mail's efficiency on an overall level using PVEO[75] and Unit Cost analysis. We then use People Cost per FTE and Revenue per FTE analysis to further understand the underlying efficiency trends. In addition to these, we also analyse productivity - a non-financial measure.

4.21 As noted above, we are continuing to refine our measures of Royal Mail's efficiency in particular work on marginality and workload is on-going.

Price, Volume, Efficiency and Other Analysis

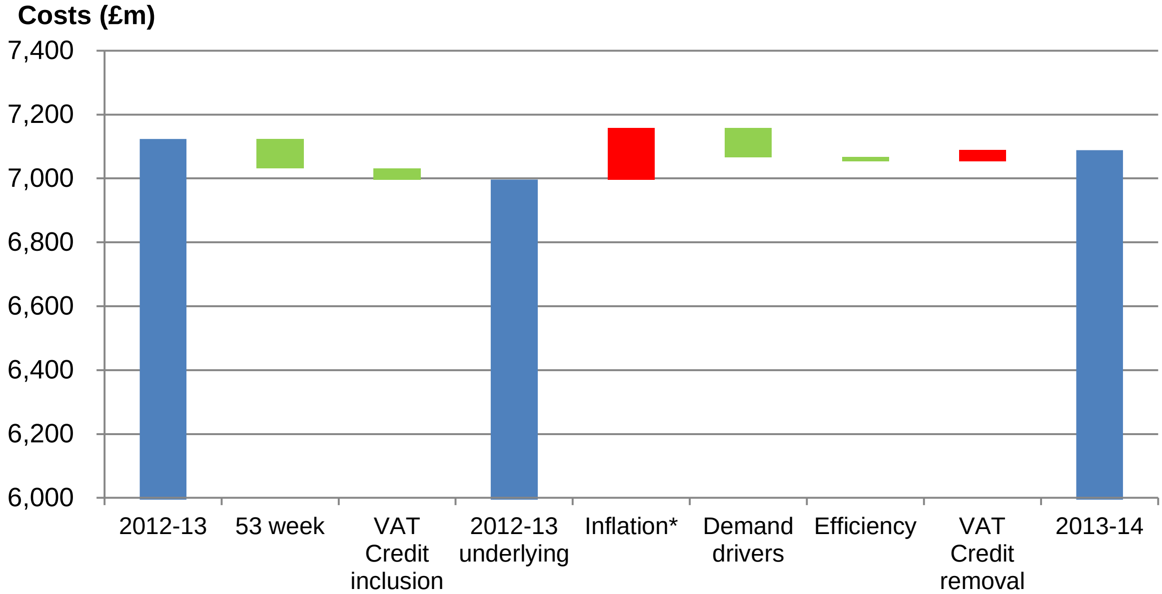
4.22 In our continued work with Royal Mail to formulate an efficiency metric, we have disaggregated movements in costs in terms of Price (i.e. inflation) changes, Volume effects, Efficiencies achieved and Other one-off costs. We refer to this form of cost bridge analysis as PVEO analysis.

4.23 This analysis applies marginality at a more granular level than unit costs adjusted for CPI.[76] It also has the benefit of adjusting for one-off items and therefore isolating a truer indicator of efficiency in costs. To the extent that pay rises outweigh CPI, the PVEO classifies this as an inefficiency (i.e. it reduces efficiency).

4.24 Figure 4.1 explains changes in total costs[77] from 2012-13 to 2013-14 classified between price (inflation), volume, efficiency and other one-off costs. Figure 4.1 shows an efficiency improvement of c.0.2% in 2013-14 using the PVEO analysis. Since this analysis is completed on total costs, including transformation costs, it represents the efficiency taking into account the costs of achieving the efficiency. As discussed in paragraph 3.53, management reorganisation costs are significant in size and are typically not evenly incurred across years. As such, the 2013-14 efficiency estimate calculated on this basis, may underestimate the underlying efficiency.

[75] Price, Volume, Efficiency and Other
[76] Consumer Price Index. Source: ONS.
[77] Reported Business people, non-people (including depreciation) and transformation costs. Costs are adjusted for cash pension rate. Source: Royal Mail's Regulatory Financial Statements. Cash pension figures provided by Royal Mail.

Figure 4.1 – PVEO bridge from 2012-13 to 2013-14



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)
**ONS 12 month average CPI figures (April to March)*

Unit Costs

4.25 Unit cost analysis is a simple way of assessing efficiency. For this report we have provided the simplest form of unit cost metric – i.e. a straightforward unit cost over time and also an adjusted unit cost taking into account inflation. The unit costs measures we have included are:

- Cost per unit workload – this metric considers the total cost[78] against Royal Mail's derived workload; and
- People cost[79] per Full Time Equivalent Employee (FTE) [80] compared with Revenue per FTE.

4.26 As shown in Figure 4.2, using workload as the volumetric, real unit operating costs increased by c.0.2% indicating cost increases were slightly greater than inflation. This suggests that absent any other changes, the cost incurred by the Reported Business per unit of workload slightly increased.

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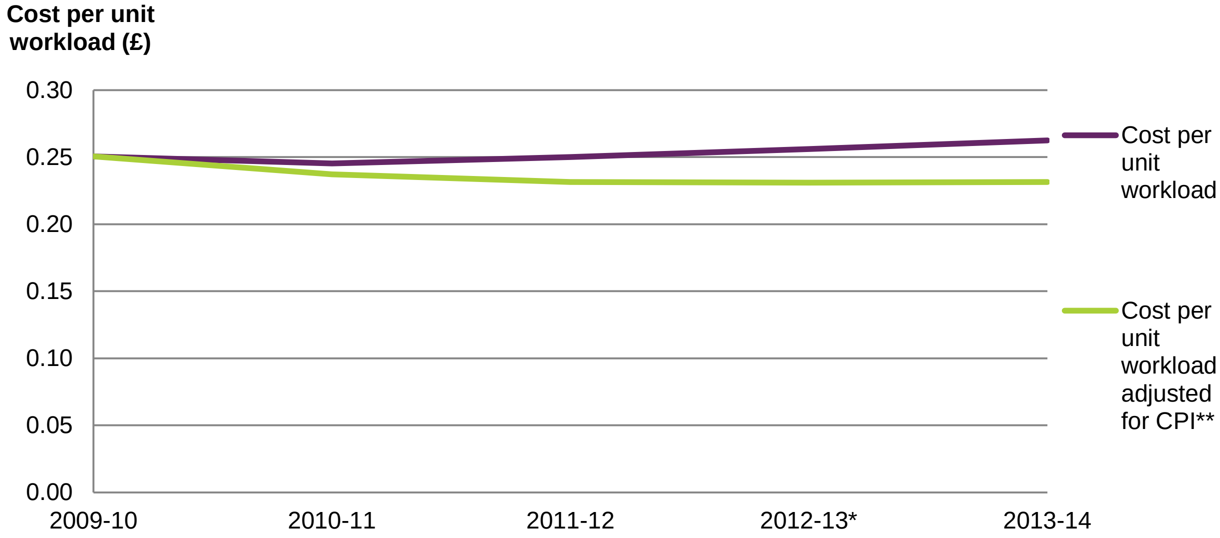
[78] Reported Business people, non-people (including depreciation) and transformation costs. Costs are adjusted for cash pension rate. Source: Royal Mail's Regulatory Financial Statements. Cash pension figures provided by Royal Mail. Figures are both adjusted and unadjusted for inflation, using CPI per the ONS.
[79] Reported Business people costs (using a cash pension rate). Source: Royal Mail's Regulatory Financial Statements.
[80] As defined in the Regulatory Accounting Guidelines, as at January 2014 http://stakeholders.ofcom.org.uk/binaries/post120713/Regulatory_Accounting_Guide.pdf.

Figure 4.2 – Cost per unit workload (real and nominal)



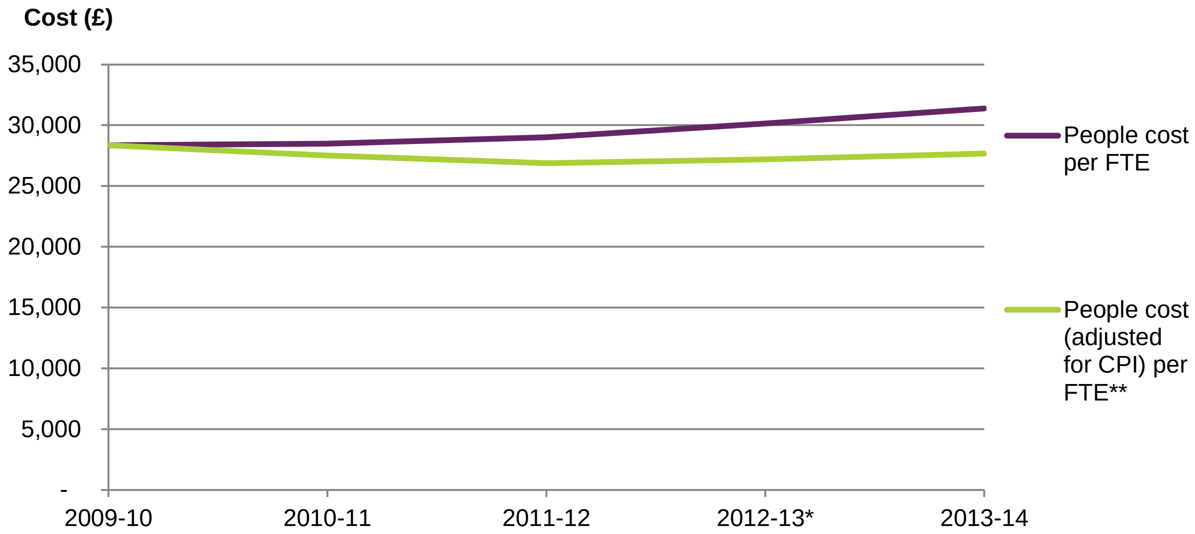
Source: Royal Mail (figures constructed for regulatory purposes and are unaudited)
** 53 week data used in calculation*
*** ONS 12 month average CPI figures (April to March)*

4.27 Comparing People Cost per FTE and Revenue per FTE also provides an indication of efficiency. For example, if Revenue per FTE increases at a greater rate than People Cost per FTE, it may indicate that each FTE is generating greater revenues than their relative expense. There may however be other contributory factors, such as price changes, which could influence Revenue per FTE, thereby lessening the direct relationship with People Cost per FTE.

4.28 People costs represent a significant proportion of Royal Mail's costs. However, it may not provide a reliable indicator on its own as a company may have a high cost per employee but a low cost per customer dependent on the company's structure. Nevertheless, it is useful in highlighting a trend.

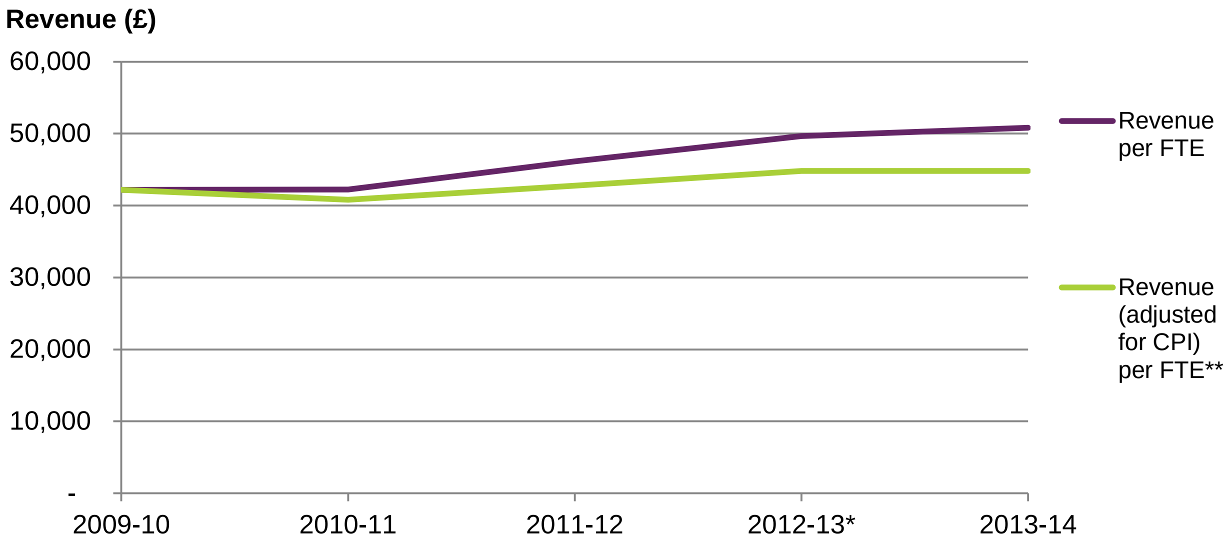
4.29 We see in Figure 4.3 that People Costs per FTE have increased on a real and nominal basis since 2011-12. Figure 4.4 shows Revenue per FTE, which has been increasing. The rate of increase in People Costs per FTE has been greater than Revenue per FTE.

Figure 4.3 – Reported Business people cost per FTE



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)
FTE data (including agency staff) provided by Royal Mail.
** 53 week data used in calculation*
*** ONS 12 month average CPI figures (April to March)*

Figure 4.4 – Reported Business revenue per FTE



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)
FTE data (including agency staff) provided by Royal Mail.
** 53 week data used in calculation*
*** ONS 12 month average CPI figures (April to March)*

Productivity metrics

4.30 In contrast to the financial efficiency metrics analysed above, productivity provides a non-financial measure of efficiency. Productivity can be considered to be the efficiency of the operational activity e.g. how many items are worked in a given amount of time or by an employee.

4.31 In this report we consider Royal Mail's own productivity metric defined as items worked or workload (processed and delivered) per unit of time. As discussed previously Royal Mail's workload calculation accounts for changes in volume and product mix over time but currently only covers delivery and processing activities. It should be note that the measure is not a financial measure as it does not cover the costs involved in achieving that rate of work i.e. how much people are being paid

4.32 We are continuing to work with Royal Mail to understand the productivity metric's advantages and limitations.

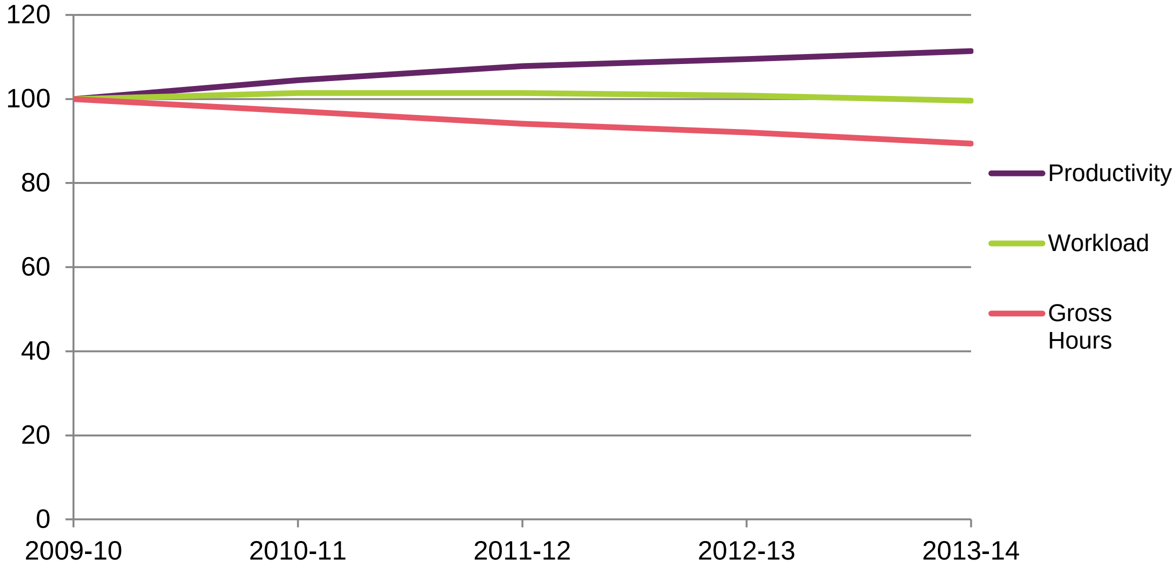
4.33 Royal Mail's recent productivity improvement, employing this approach, is shown in Figure 4.5. This shows an improvement in productivity as the time taken to work the items has decreased relative to the change in workload.

4.34 Overall total productivity for both mail centres and delivery offices improved by 1.7% in 2013-14.[81]

4.35 Productivity, on this measure, appears to have been improving since 2010-11. If 2009-10 is used as a baseline year, Royal Mail has increased its productivity by around 11% over this five year period. At the same time, workload has been relatively stable and gross hours have declined by 11%.

4.36 Whilst productivity has increased over the past five years, we note that the rate of productivity improvement remained flat year-on-year in 2013-14 at 1.7%.[82] The 2013-14 rate of productivity improvement was less than Royal Mail's own target of 2-3%.[83]

Figure 4.5 – Productivity in Delivery and Processing



Source: Royal Mail figures

Summary of efficiency metrics and rate of improvement

4.37 We have worked with Royal Mail to develop and understand appropriate metrics to measure change in efficiency levels over time. We have explored a range of metrics

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[81] Against a 52 week comparative in 2012-13
[82] Royal Mail's 2013-14 Statutory Financial Statement
[83] Royal Mail's 2013-14 Statutory Financial Statement

– both financial and non-financial – to show the changes in Royal Mail's efficiency as detailed in this Section. In summary, the key efficiency trends for the 2013-14 financial year were:

- The PVEO analysis indicates a small (c.-0.2%) change in costs due to efficiency, when calculated taking account of transformation costs.;
- Cost per unit workload adjusted for CPI shows a small year-on-year increase of c.0.2%.This is against a backdrop of declining year-on-year real cost per unit workload since 2009-10; and
- Royal Mail's own measure of productivity improvement for 2013-14 was 1.7%, which was below Royal Mail's own target of 2-3%. Productivity has continued to improve since 2010-11 (due to a steady decline in gross hours worked), however the rate of improvement has slowed in recent years;

4.38 Our work on monitoring Royal Mail's efficiency is on-going and will continue to be refined. As noted in our end-to-end decision document, we will conduct a review as to what rate of efficiency improvement Royal Mail should reasonably be able to achieve.[84]

[84] http://stakeholders.ofcom.org.uk/post/end-to-end-statement/.

Section 5

Customers and consumers

5.1 In this Section we discuss the impact of Royal Mail's pricing and operational decisions on its customers and consumers. As noted in our March 2012 Statement, we are monitoring:

- Prices of universal service products – particularly any impact on vulnerable groups and those that rely on postal services. We discuss Royal Mail's price rises (as well as changes to non-price terms) within this Section; and

- The quality of service achieved by Royal Mail in the provision of universal services.[85] Our March 2012 Statement set out the quality standards that Royal Mail is required to meet. This was to ensure appropriate levels of universal service performance were maintained for consumers.

5.2 In March 2013, we published the results of our review of users' needs from the universal service – this found that overall the needs of customers were being met by the current universal service and as a result Ofcom did not propose any significant changes to the universal service. [86]

5.3 In December 2013, Ofcom made a number of technical and minor amendments to the Universal Postal Service Order and related conditions.[87] These minor amendments were intended to clarify the drafting of the Order and the scope of the regulatory obligations on Royal Mail to reflect current provision. These amendments had no effect on the scope of the universal service in practice. None of the amendments had any practical impact on users, Royal Mail and other postal operators.

5.4 This Section also includes relevant findings from our residential and business consumer surveys on postal services, which were introduced in July 2012. These surveys help us monitor public perceptions about the postal market. In this Section, we cover the results for the year April 2013 – March 2014. We intend to cover year-on-year analysis for the same period in our future reports.

Pricing of universal services

5.5 Until 2012, the significant majority of Royal Mail's retail and wholesale prices were subject to price controls. This meant that while prices generally increased over time, there were regulatory limits on the level of the price rises. In our review of the

[85] We also monitor Quality of Service closely given the risk Royal Mail could degrade quality in order to reduce costs rather than improve efficiency.
[86] Ofcom, *Review of postal users' needs*, 27 March 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf We made a series of technical and minor amendments to the universal service, following consultation, in December 2013: see http://stakeholders.ofcom.org.uk/consultations/post/statement/.
[87] Technical and minor amendments in postal regulation - Notifications of technical and other minor amendments to the Universal Postal Service Order and related conditions, http://stakeholders.ofcom.org.uk/consultations/post/statement/.

regulatory framework, completed in March 2012, we removed nearly all of these price controls in order to give Royal Mail greater freedom to respond to changes in the market. In addition, we put a number of safeguards in place, including a cap on the price of Second Class stamps (for letters and parcels of less than 2kg) to ensure that a basic universal service is available to all for the seven year period of the regulatory framework.

5.6 We considered that it was necessary to give Royal Mail sufficient commercial freedom to enable it to return the universal service to a financially sustainable position. It was expected that there would be some restructuring of prices given the low and negative returns that Royal Mail had been making in recent years in the Reported Business and the threat that this posed to the financial viability of the universal service. However, we considered that Royal Mail would need to make efficiency improvements to ensure the provision of the universal service in the medium term.

5.7 In its share prospectus, Royal Mail noted its expectation that any letter price increases for the next few years ending in the 2015-16 financial year would be broadly in line with RPI. It also stated that its parcel prices would increase broadly in line with RPI subsequent to the implementation of size-based pricing in 2013-14. We note in our subsections below that the stamp price increases implemented in 31 March 2014 were more than inflation[88], whilst certain size-based parcel prices reduced. In addition, as discussed above, the safeguard cap on Second Class stamps will continue to protect consumers and small businesses.

Royal Mail has complied with the safeguard caps

5.8 As noted above, the new regulatory framework gave Royal Mail significantly more pricing flexibility subject to certain key safeguards. This included a safeguard cap on Second Class stamp Letters and Second Class stamp Large Letters and parcels up to 2kg. This was to ensure all consumers could afford a basic universal postal service.[89]

5.9 For Second Class standard letters, the cap is 55p in 2012-13 plus the relevant CPI inflation rate for the remaining seven year period of the regulatory framework. This means that the level of the cap was 56p in 2013-14, increasing to 58p in 2014-15. The large letter and parcel (up to 2kg) cap is a basket which allows Royal Mail to increase the prices of these products by up to 53%[90] on average in 2012-13, increasing by CPI for the remainder of the regulatory framework. This reflects the same percentage price increase as the letter cap over 2011-12 prices.

5.10 Royal Mail's prices for Second Class stamps complied with the level of these safeguard caps in 2013-14.

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[88] Both RPI and CPI, as per the ONS website.

[89] The safeguard cap on Second Class stamp Letters came into effect on 1 April 2012 and can be found at: http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex7.pdf. The safeguard cap on Second Class stamp Large Letters and packets up to 2kg came into effect on 20 July 2012 and subsequently modified in our March 2013 statement: http://stakeholders.ofcom.org.uk/binaries/consultations/safeguard-cap/statement/statement.pdf.

[90] Over 2011-12 prices.

5.11 We set out in the March 2012 statement that we would review the level of the caps if we considered they were unduly impacting Royal Mail's pricing flexibility and therefore its ability to return the universal service to a sustainable footing, or if we had evidence to suggest the prices were no longer affordable. We do not consider there is any evidence to suggest pricing flexibility or (as explained later in this Section in paragraphs 5.27 to 5.30) affordability are under threat at this point in time.

All prices increased in 2014, except for small parcels 1-2kg which reduced

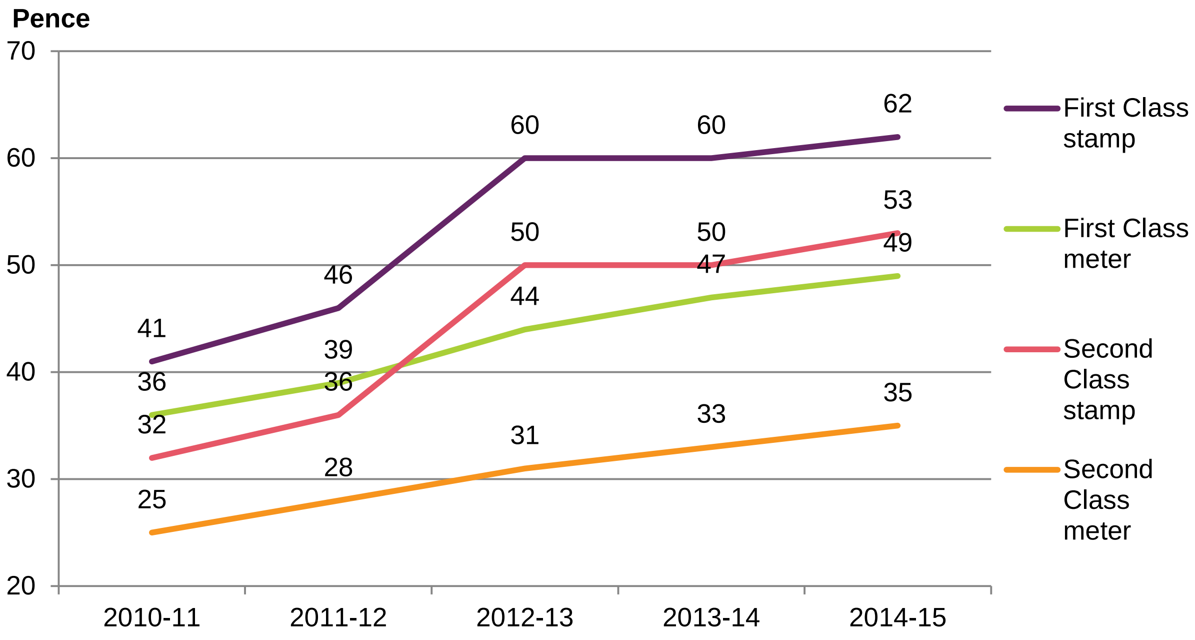
5.12 In this subsection, we discuss the prices which took effect from 31 March 2014 including First and Second Class stamp and meter prices for letters / large letters and parcel prices. Our analysis is conveyed in nominal terms i.e. excluding any adjustment for inflation.

Standard letter stamp and meter prices

5.13 As shown in Figure 5.1, Royal Mail increased its prices for both First and Second Class stamp and meter on 31 March 2014. First Class standard letter stamps increased by approximately 3% to 62p whilst First Class meter stamps increased by approximately 4% to 49p.

5.14 Both Second Class stamp and meter prices rose by approximately 6% to 53p and 35p, respectively. The difference between 2014 First Class stamp and meter prices has remained unchanged at 13p, whilst the difference between Second Class stamp and meter prices has increased by 1p since 2013 to 18p in 2014.

Figure 5.1 – Standard Letter First and Second Class stamp and meter prices 2010-11 to 2014-15



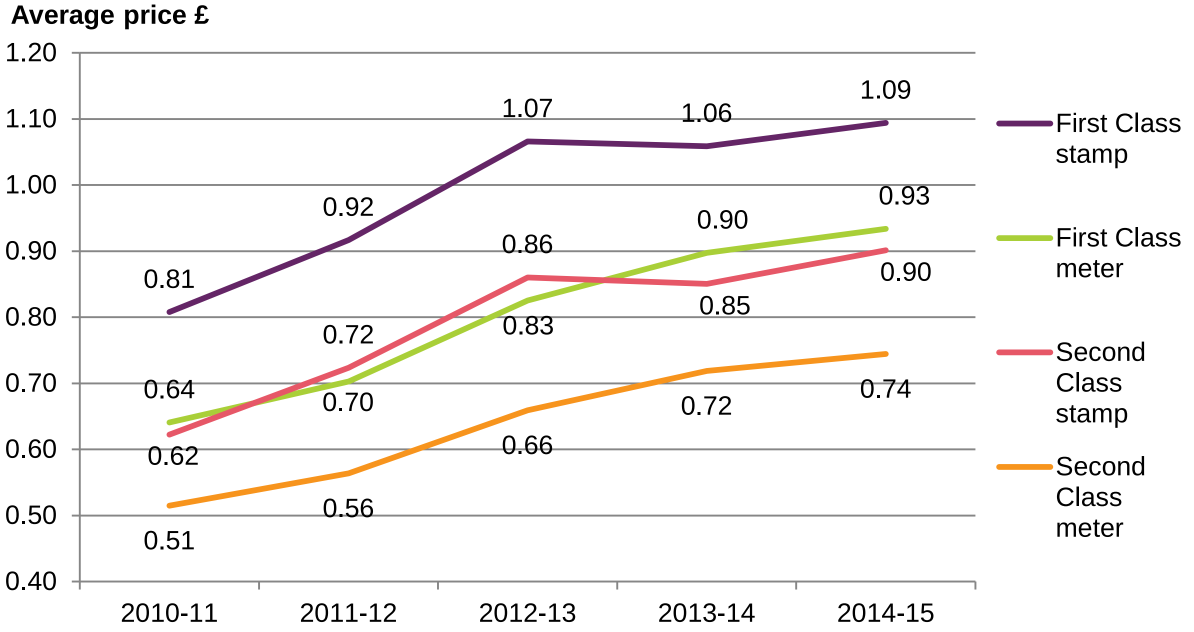
Source: Royal Mail

Large letter stamp and meter prices

5.15 There are several weight steps for Large Letters – 0-100g, 101-250g, 251-500g and 501-750g. Figure 5.2 shows the average price for Large Letters in recent years (across the weight steps and taking account of volumes in each weight step).[91]

5.16 Prices rose for Large Letters in 2014-15 compared to the previous year. The average price for First Class Large Letter stamps rose by 3.3% while First Class Large Letter meter prices rose by 4.1%. For Second Class, Large Letter stamp prices rose by 6.0%, the largest increase, while meter prices increased by 3.6%.

Figure 5.2 – Average Large Letter First and Second Class stamp and meter prices 2010-11 to 2014-15



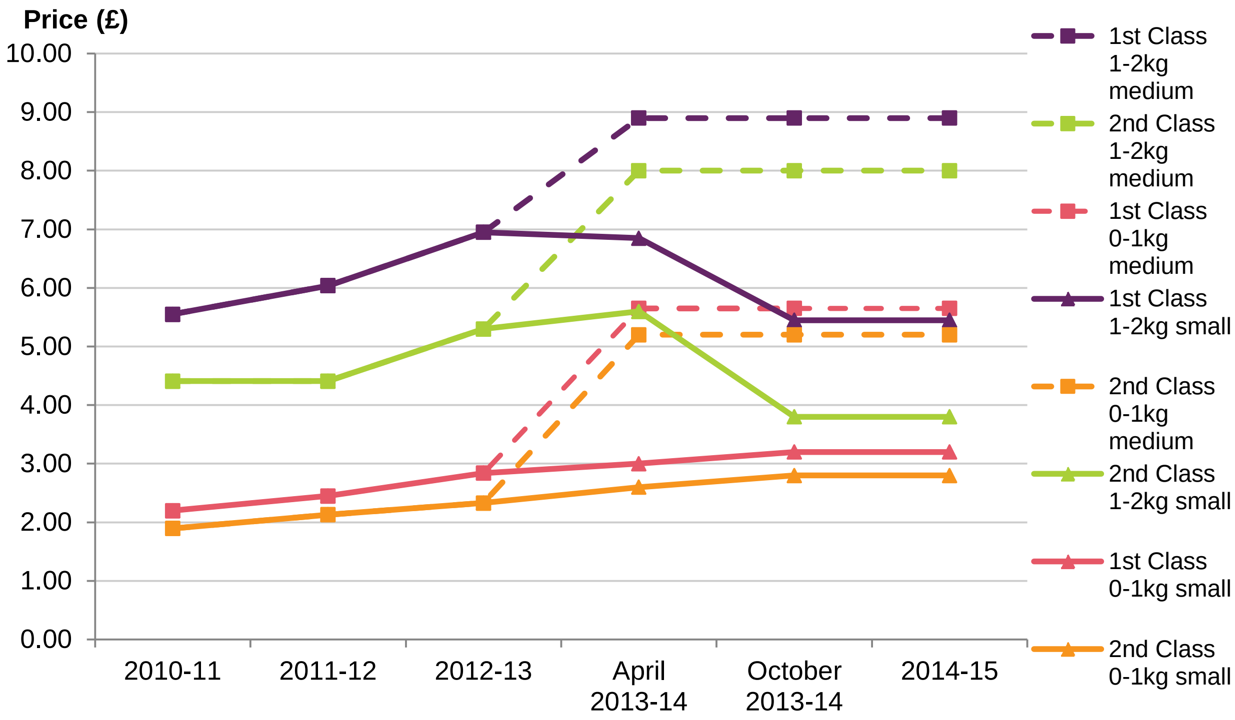
Source: Royal Mail. Ofcom calculation based on volume weighted average by weight step

Parcel prices

5.17 Figure 5.3 shows the trend in parcel stamp prices between 2010-11 and 2014-15, including two size-based price changes that took place during 2013-14. The weight bands shown are the current weight bands Royal Mail uses. Some of these weight bands have changed over the years. However, as we have data on the volumes sold in each year in the different weight steps set out below, we have been able to show a trend in the weighted average prices.

[91] We note that in 2011-12, the majority of volumes for First and Second Class stamp and meter Large Letters were in the 0-100g and 101-250g weight steps.

Figure 5.3 – Weighted average price for First and Second class stamp parcels 2010-11 to 2014-15



Source: Royal Mail, Ofcom calculation based on volume weighted average price

5.18 In April 2013, Royal Mail introduced a key change in its parcel formats which affected universal postal service parcel charges – pricing was no longer based solely on weight but on size/dimensions as well as weight. This is because Royal Mail had determined that the cost of delivery is driven more by the size of a parcel than its weight.[92] From 2 April 2013, Royal Mail offered two new parcel formats for its universal service parcel products, 'Small Parcel' and 'Medium Parcel'[93] (and shown in the graph above).[94]

5.19 The introduction of size-based pricing in April 2013 led to significant price rises for medium sized parcels, resulting in prices more than doubling in some cases. Prices for First Class 0-1kg medium parcels increased by 98.9%, while First Class 1-2kg

[92] For example, while small parcels can be delivered by postmen and women on their standard delivery round, bulkier parcels require a more costly delivery operation as they have to be delivered by van. 'Large parcels' – with maximum dimensions of L1.5M and 3m length and girth combined up to 30kg – will be carried by Parcelforce Worldwide as that business can carry larger items more efficiently than Royal Mail.

[93] 'Small parcel' no bigger than: 45cm length x 35cm width x 8cm depth, no heavier than 2kg
'Medium parcel' no bigger than 61cm length x 46cm width x 46cm depth, no heavier than 20kg.
In addition Royal Mail made an exception to allow small cubes[93] to be sent as a 'Small Parcel' – with maximum dimensions of 16 x 16 x 16cm and no heavier than 2kg.
For more details see: http://www.royalmail.com/parcels-made-easy.

[94] Royal Mail's Standard Parcel service for non-priority items weighing more than 1kg (but less than 20kg) was withdrawn and replaced by an extension of the Second Class parcels product, which previously only went up to 1kg (we have represented this as a Second Class from 1-2kg in Figure 5.3 above).

medium parcels increased by 28.1%. Second Class medium parcels increased by 123.1% for 0-1kg parcels and by 50.9% for 1-2kg parcels. The prices for both First and Second Class heavy and light small parcels also rose slightly at this time, with the exception of First Class 1-2kg small parcels, which fell by 1.4%.

5.20 We received a small number of complaints regarding the new parcel formats (in relation to the dimensions of the ‘small parcels’). Following its own consumer feedback, Royal Mail replaced the cube format of the small parcel with a larger ‘shoebox’ sized format in October 2013,[95] resulting in a greater number of parcels qualifying as small parcels.[96]

5.21 As part of its October 2013 decision, Royal Mail also again amended its parcels prices, as shown by Table 5.1 below. Although the prices for medium sized parcels remained flat, the prices for small 1-2kg parcels were reduced significantly, by 20.4% for First Class to £5.45 and 32.1% to £3.80 for Second Class. The prices for First and Second Class small 0-1kg parcels rose slightly at this time by 6.7% and 7.7% respectively, decreasing the difference in price between small light and small heavier parcels.

5.22 Although size-based pricing led to an increase in Royal Mail’s revenues, particularly in the months immediately following its introduction in April 2013, there was a decline in consumer parcel volumes as a result. Royal Mail acknowledged that the introduction of size-based pricing contributed to volume decline in parcels.[97] This was a contributing factor to the overall 1.2% parcel volume decline in 2013-14, which is in contrast to the historic trend of parcel volume growth.

5.23 In response to further customer feedback, Royal Mail made additional amendments to its small parcels dimensions on 20 October 2014.[98] The two dimensions that previously met the small parcel under 2kg criteria were replaced by a single format size – 45cm length x 35cm width x 16cm depth in. Prices for small parcels remained unchanged, as did the maximum size for medium parcels.[99] Royal Mail also introduced a pricing promotion such that the price of Small Parcels weighing 1-2kg would be the same as Small Parcels weighing 0-1kg. This promotional period will be effective through the Christmas and New Year period, until 18 January 2015.

5.24 Table 5.1 below shows the year-on-year change in stamp prices for Second Class parcels which meet the small parcel dimensions.

5.25 We note that the level of the price changes for small parcels from 2013 differs depending on the weight of the product – but that the stamp price increase is greatest for small 0-750g packets which now cost around 27.3% more. However as noted above, the prices for small second class parcels 1-2kg fell significantly by 32.1%.

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95 http://www.royalmailgroup.com/royal-mail-makes-changes-its-small-parcels-range
96 ‘Small parcels’ can be ‘wide’: 45cm length x 35cm width x 8cm depth or ‘deep’: 35cm length, 25cm width, 16cm depth.
97 Royal Mail 2013-14 audited Statutory Financial Statement.
98 http://www.royalmailgroup.com/royal-mail-increasing-its-small-parcel-format-and-launching-festive-price-promotion.
99 61cm length x 46cm width x 46cm depth.

Table 5.1 - Prices for Second Class stamp Small Parcels

Prices applying prior to April 2013		'Small Parcel' format prices from April 2013		Price change from pre-April 2013	'Small Parcel' format prices from October 2013 (remained unchanged in March 2014)		Price change from pre-April 2013	Price change from April 2013
Format	Price	Format	Price		Format	Price		
0-750g packet	£2.20	'Small Parcel' 0-1kg	£2.60	+18.2%	'Small Parcel' 0-1kg	£2.80	+27.3%	+7.7%
751g–1kg packet	£3.50	'Small Parcel' 0-1kg	£2.60	-25.7%	'Small Parcel' 0-1kg	£2.80	-20.0%	+7.7%
Standard parcel up to 2kg	£5.30	'Small Parcel' 1-2kg	£5.60	+5.6%	'Small Parcel' 1-2kg	£3.80	-28.3%	-32.1%

5.26 In the next subsection, we discuss the work we have undertaken to consider the affordability of universal postal services.

Affordability of universal services

5.27 The PSA 2011 requires universal postal service prices to be affordable. In our March 2012 statement, we committed to an effective and ongoing monitoring regime to track Royal Mail's performance on (amongst other things) the affordability of universal postal services.

5.28 We also committed to further consider our approach to assessing whether universal postal services are affordable. We therefore published a report of our findings on the affordability of universal postal services in March 2013,[100] which included some consumer research we had undertaken. In summary, the evidence we collected indicated that universal postal services are affordable for both residential consumers (including low income and other vulnerable consumers) and businesses (including small and medium businesses) at both the 2012 and 2013 prices.

5.29 As noted further in this Section, Figure 5.8 shows 55% of residential consumers surveyed are satisfied with the cost of postage. Furthermore, Figure 5.9 shows consumer perceptions on the value for money have remained unchanged over the past year, despite First and Second Class stamp price increases.

5.30 The latest ONS data shows weekly household expenditure on postal services to be around 0.1% (60p) of total expenditure based on 2012 prices.[101] This is a little less than the current price of a single First Class stamp.

Monitoring affordability in the future

5.31 We will continue to use our quantitative consumer survey for residential consumers and businesses – which is discussed later in this Section – to enable us to monitor use of postal services, and to assess the affordability of services in the universal service, value for money and satisfaction with post and postal prices.

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[100] Ofcom report on the "*Affordability of universal postal services*" 19 March 2013 http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf.

[101] ONS Trends in household expenditure, Table 3.1, published 11 December 2013 http://www.ons.gov.uk/ons/rel/family-spending/family-spending/2013-edition/rpt-chapter-4--trends-in-household-expenditure-over-time.html.

Non-price terms of universal services

5.32 In our March 2012 statement, we stated that as part of the monitoring regime, we would also consider the impact of non-price changes for universal services. In addition to the format change to small parcels introduced in October 2014 (which is discussed above), two further universal service non-price term changes were made.

5.33 The first relates to the Franking scheme.[102] Effective from 31 January 2014, Royal Mail made changes to the Franking scheme. This included re-writing it into plainer English and moving the operational and technical section into a new Operational Requirements Document.

5.34 The second relates to international services.[103] Effective from 31 March 2014, Royal Mail renamed and restructured its international products with the intention of making them simpler for customers to understand. In addition, the enhanced compensation amounts for the newly named International Tracked, International Signed and International Tracked & Signed services were set at a uniform £250, irrespective of destination country. At the same time Royal Mail withdrew its signature on delivery service on its International Economy service, i.e. its slow outgoing international service. This reflected revised rules issued by the Universal Postal Union (UPU), the United Nations body that co-ordinates international postal arrangements, which made the service impractical to supply.

Quality of Service

Royal Mail exceeded its First and Second Class national targets but narrowly failed to achieve its Postcode Area targets

5.35 The EU Directive requires that universal service providers be subject to quality of service targets. Ofcom takes this issue very seriously as customers have a right to know what quality of service they can expect when they purchase universal service products. Royal Mail is therefore subject to a number of quality of service (QoS) targets. We monitor its performance against these targets and these are discussed in turn below. The figures cited in this subsection (and shown in Figures 5.4 to 5.7) are those from Royal Mail's QoS reports and do not reflect any adjustment by Royal Mail to account for force majeure events such as very severe weather.

5.36 Regulatory conditions imposed by Ofcom require Royal Mail to deliver 93% of all First Class retail items (single piece stamp, meter and PPI letters and parcels) on the day after collection, and 98.5% of all Second Class[104] retail items within three days of collection. These targets are set below 100% to allow for commonly experienced

[102] See Royal Mail's decision statement: http://www.royalmailgroup.com/sites/default/files/Decision%20document_Franking%20Scheme.pdf.

[103] See Royal Mail's decision statement: http://www.royalmailgroup.com/sites/default/files/OLPS%20Decision%20Document.pdf.

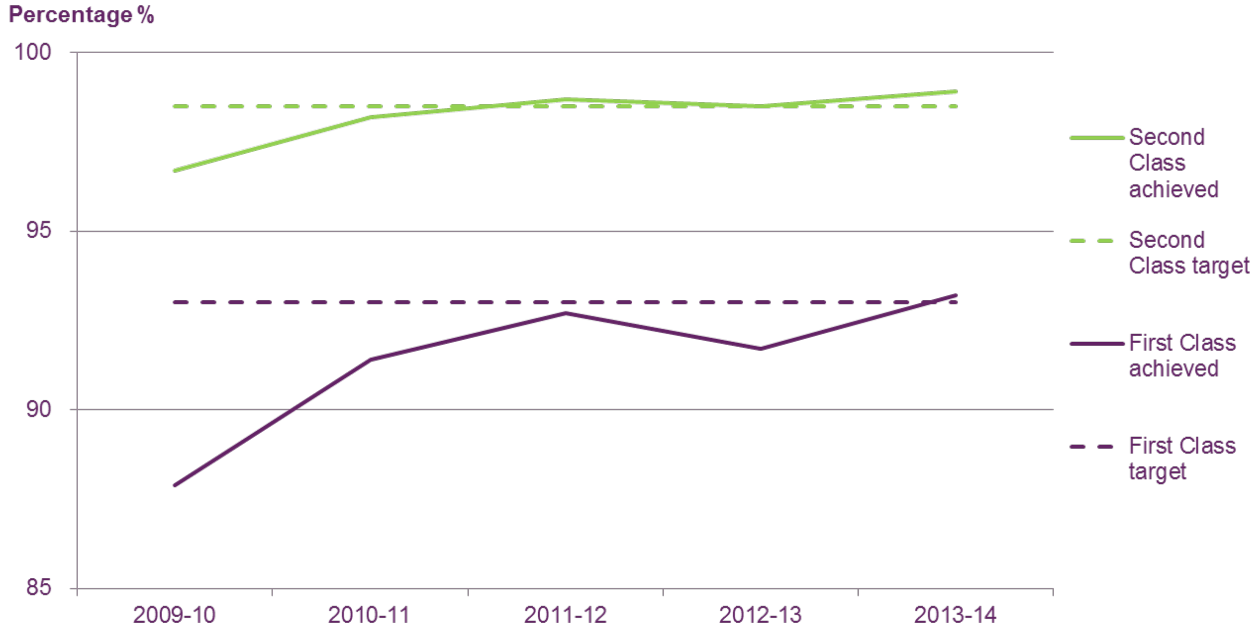
[104] Until 2 April 2013, consumers could send parcels up to 20kg First Class and up to 1kg Second Class (with a Standard Parcels product for consumers wishing to send items weighing between 1kg to 20kg, but more cheaply than First Class) – Standard Parcels were subject to a lower than 2nd class QoS target. From 2 April 2013, Royal Mail replaced its Standard Parcel service with Second Class parcels up to 20kg, with performance measured against the Second Class letter quality of service target.

circumstances that may arise in the transportation, processing and delivery of mail (for example, disruption to aircraft flights due to bad weather or missed network connections due to road traffic delays and breakdowns). If the targets were set at a higher level it would be likely to increase Royal Mail's costs and, potentially, universal service prices. In the case of the 93% first class target this was originally agreed as achievable by Royal Mail and Postcomm.

5.37 As set out in last year's report, we wrote to Royal Mail in May 2013 to underline our expectation that all necessary steps would be taken to ensure that it significantly improved its QoS performance in 2013-14, particularly in relation to eight Postcode Areas ("PCAs")[105] that we identified as persistently failing over a period of years. [106] Royal Mail put in place an action plan to improve performance, particularly in the identified underperforming PCAs, and reported progress to Ofcom on a quarterly basis.

5.38 As shown in Figure 5.4 (which also shows historic performance), in 2013-14, Royal Mail exceeded its First Class target by 0.2%, reaching 93.2%; and exceeded its Second Class target by 0.4% reaching 98.9%.

Figure 5.4 – Retail First and Second Class: Performance against (items delivered on time) targets



Source: Royal Mail QoS reports, 2007-2014. Note: 2013-14 figures are unadjusted for force majeure

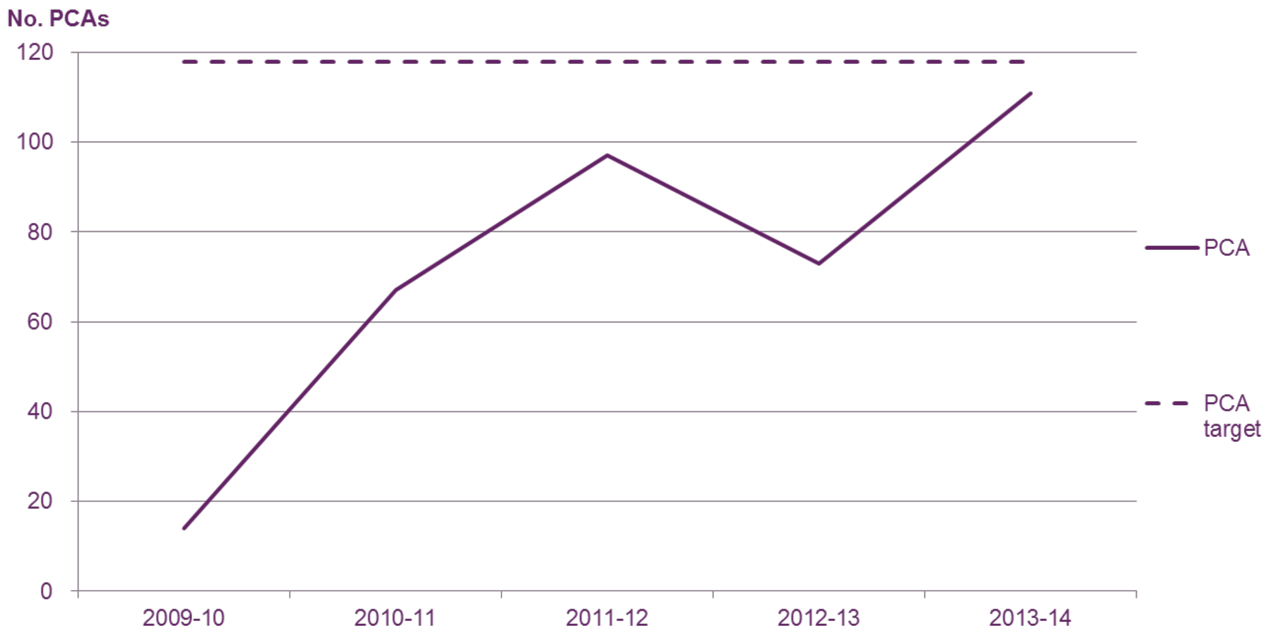
5.39 There are 121 PCAs in total, of which Royal Mail is required to deliver 91.5% of all First Class single piece mail the day after collection to 118 PCAs. This is to ensure

[105] PCAs are the geographic areas into which the UK is divided by Royal Mail for operational purposes. The postcode area is the largest geographical unit used by Royal Mail for mail processing purposes, and forms the initial characters of the alphanumeric UK postcode; for example, Cardiff postcodes begin 'CF', Glasgow postcodes 'G', and Leicester postcodes 'LE'.
[106] South East London, East London, Stoke on Trent, Bromley, Guildford, Newport, Liverpool and Southend-on-Sea.

Royal Mail provides a good level of service across the UK – not just in more densely populated areas, but also in less densely populated areas and those where addresses may be harder to reach. Three of the PCAs – HS (Hebrides), KW (Kirkwall, Orkney) and ZE (Shetlands) – are excluded from this target, principally because it is not practical logistically to achieve a next day service for 91.5% of First Class mail sent from across the UK to these remote destinations. In addition, these offshore areas are more frequently subject to weather related disruption of ferry and air services.

5.40 As shown in Figure 5.5, in 2013-14 Royal Mail achieved the 91.5% target in 114 of its 118 PCAs. The eight persistently failing PCAs, about which we wrote to Royal Mail in May 2013, all exceeded the target in 2013-14. The four PCAs that did not reach 91.5% in 2013-14 failed to do so narrowly and within the margin of error for the independent survey measurement process used to calculate performance and therefore did not justify intervention or further investigation.[107] This represents a significant improvement on 2012-13 when the target was met in only 73 PCAs. It should be noted that performance in 2009-10 was very poor due to national industrial action.

Figure 5.5 – Number of PCAs in which First Class delivery targets were met



Source: Royal Mail QoS reports, 2007-2014. Note: 2013-14 figures are unadjusted for force majeure

[107] These PCAs were Huddersfield (HU) with 90.8% First Class delivered D+1 (+/- 1.2%); Nottingham (NG) with 91.1% D+1 (+/- 0.9%); Taunton (TA) with 91.4% (+/- 1.1%); and Warrington (WA) with 91.4% (+/- 1.1%).

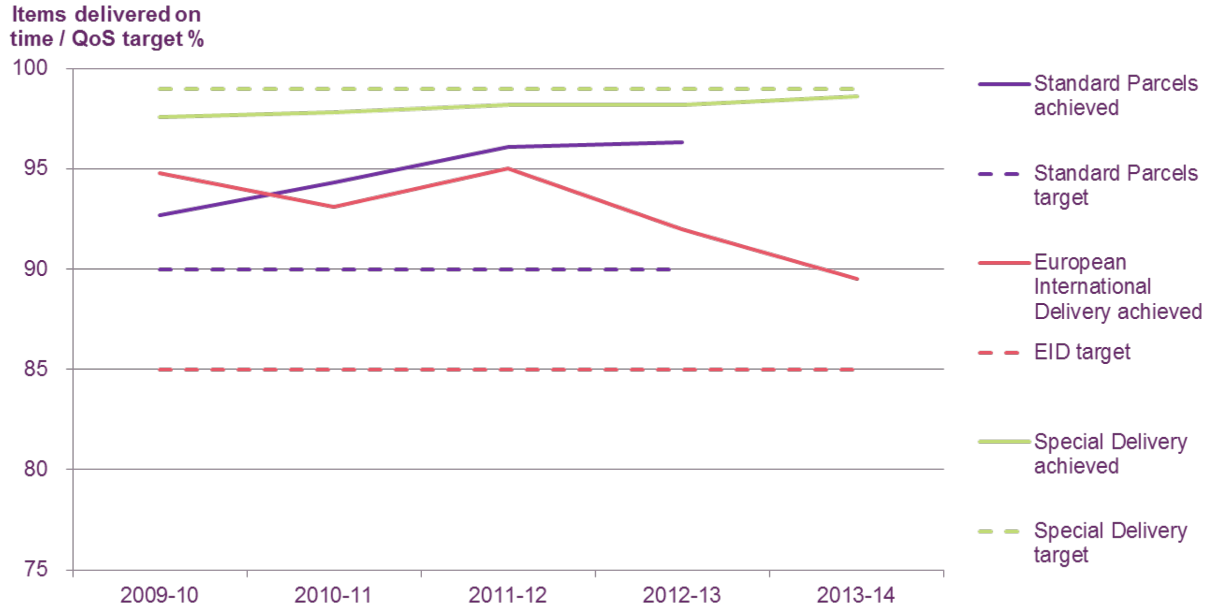
Targets were achieved for European International, collection points served daily and items correctly delivered but narrowly missed for Special Delivery and for delivery routes completed daily

5.41 Also included within the universal service are European International Delivery and Special Delivery (Next Day) Services.[108]

5.42 As shown in Figure 5.6 below, for the Special Delivery (Next Day by 1pm) product 99% of items are required to be delivered on the next delivery day. As with previous years, in 2013-14 Royal Mail narrowly missed the target for Special Delivery items, achieving 98.6% on time delivery.

5.43 In addition, 85% of European International items should be delivered in three days. Royal Mail clearly exceeded its targets achieving 89.5%.

Figure 5.6 – Performance on targets for other universal service products



Source: Royal Mail QoS reports, 2007-2014. Note: 2013-14 figures are unadjusted for force majeure and there is no 2014 data for Standard Parcels, as these are now contained within Second Class parcels

5.44 In addition to the above product-related targets, Royal Mail has a number of service-oriented targets – six days per week it should: collect from 99.9% of its collection points; complete 99.9% of its delivery routes; and deliver 99.5% of items correctly.

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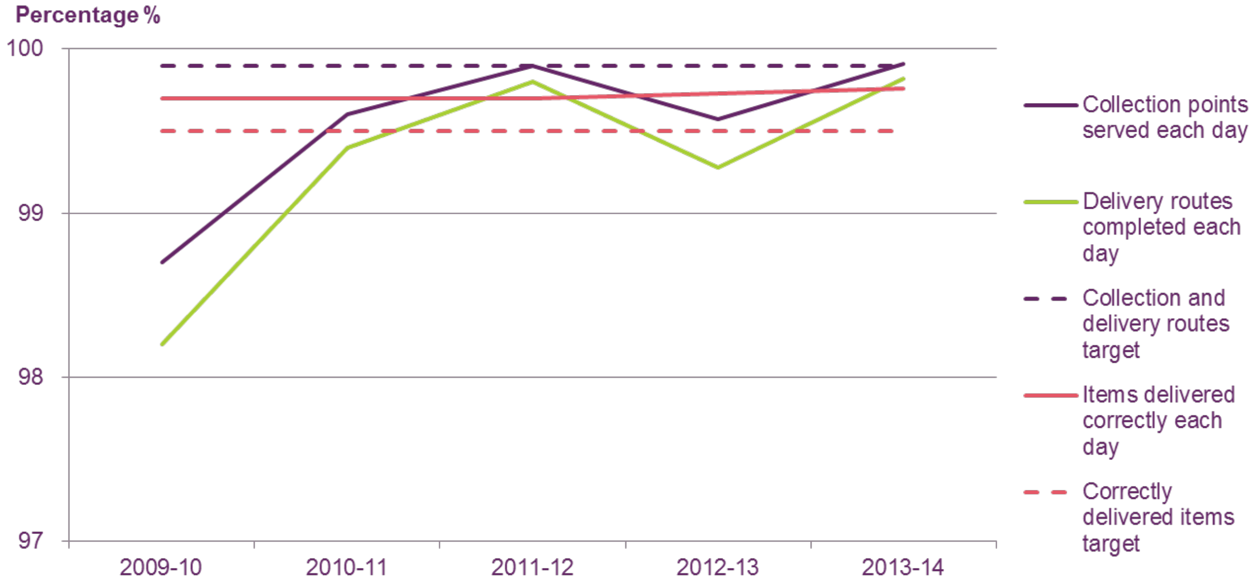
108 Standard parcels were historically included within the universal service. At least 90% of standard Parcels were required to be delivered within five days of posting. Until 2 April 2013, consumers could send parcels up to 20kg First Class and up to 1kg Second Class (with a Standard Parcels product for consumers wishing to send items weighing between 1kg to 20kg, but more cheaply than First Class) – Standard Parcels were subject to a lower than 2nd class QoS target. From 2 April 2013, Royal Mail replaced its Standard Parcel service with Second Class parcels up to 20kg, with performance measured against the Second Class letter quality of service target.

5.45 As shown in Figure 5.7, in 2013-14 Royal Mail met the target for correctly delivered items and collection points served but just failed to meet its targets for delivery routes completed each day.

Figure 5.7 – Performance against targets for correctly delivered items, collection points served and delivery routes completed



Source: Royal Mail QoS reports, 2007-2014. Note: 203-14 figures are unadjusted for force majeure

We will continue to monitor Royal Mail's QoS closely

5.46 We are pleased that Royal Mail met the majority of its quality of service targets in 2013-14 and those products / services which failed did so narrowly. Given the significant improvement over 2012-13 following Ofcom's intervention discussed in paragraph 5.37 above, we decided that enforcement action would not be a proportionate response to the targets that were narrowly missed in 2013-14. We will continue to monitor Royal Mail's QoS closely and if Royal Mail fails to meet its QoS targets in future, we will consider opening a formal investigation. This could result in enforcement action, following the procedures under Schedule 7 of the PSA 2011, which includes the potential imposition of financial penalties.

Residential and business customer surveys

5.47 As part of our ongoing monitoring regime, we run a market research programme to ensure we have up-to-date views of consumers on the postal market. The research began in July 2012.

5.48 We run two separate surveys, one focused on residential consumers and the other on business customers, to track their use of and attitudes to post. This is the second year since the surveys have been introduced and we therefore present the results for the twelve month period from July 2013 to June 2014.

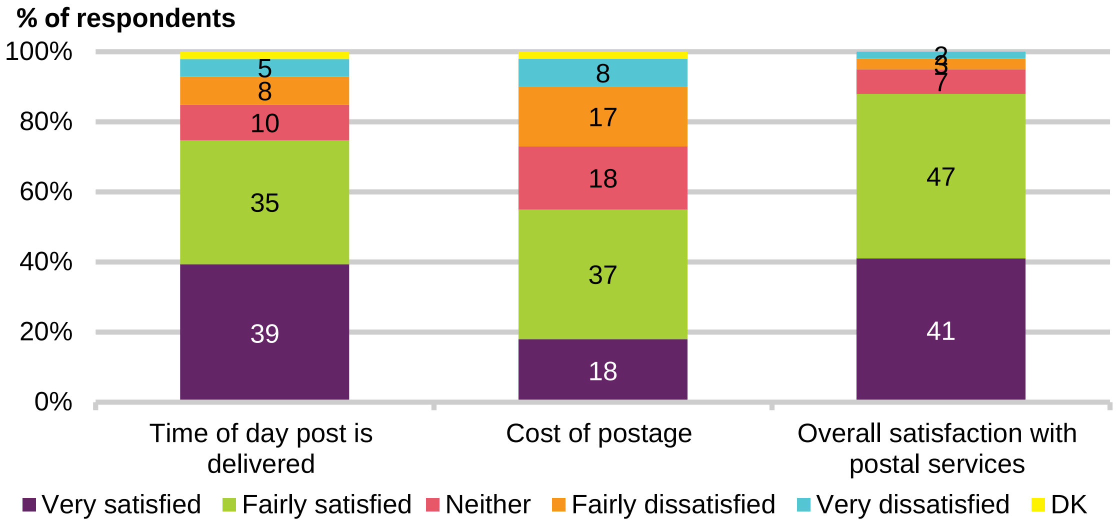
5.49 A full range of data from these surveys is summarised in our Communications Market Report.[109] Below we discuss some of the consumer metrics which we consider are particularly relevant to our monitoring regime.

Our findings suggest the majority of consumers are satisfied with postal services

5.50 As shown in Figure 5.8, the majority of residential consumers claimed to be satisfied with postal services overall, with 88% of respondents stating they were either "very satisfied" or "fairly satisfied." Around 74% were either very or fairly satisfied with the time of day when post is delivered, although the actual number of respondents who were fairly or very dissatisfied was lower than this would suggest at around 13% as a number of respondents were "neither". Satisfaction with the cost of postage was not as high among respondents, although over half (55%) were satisfied with this aspect of postal services.

5.51 Residential consumer satisfaction results showed an improvement against the prior year, with more respondents being either "very satisfied" or "fairly satisfied."

Figure 5.8 – Residential consumers' views on delivery times, cost of postage and overall satisfaction with post



Source: Ofcom Residential Postal Tracking survey. Base: All respondents (4853) July 2013 - June 2014

Perceptions about value for money are better for First Class stamps compared to Second Class stamps and remain unchanged despite price increases

5.52 Our survey also considered consumer perceptions on the value for money of postal services. Once informed of the correct price for First and Second Class stamps,[110]

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[109] http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr14/2014_UK_CMR.pdf.
[110] 42% of respondents were aware of the correct price of a First Class stamp whilst 26% were aware of the correct price of a Second Class stamps. The first three quarters were carried out when prices were 50p and 60p respectively. The final quarter was conducted shortly after the April 2014 price changes took effect. The percentage of respondents aware of the April 2014 price changes was lower than the previous three quarters and therefore reduced the average across the year.

Figure 5.9 below shows the extent to which people think they offer good value for money.

5.53 Over half (54%) of residential consumers considered that First Class stamps offer fairly or very good value for money compared to 46% who thought the same of Second Class stamps. [111] Consumer perceptions on value for money have remained unchanged over the past year, despite First and Second Class stamp price increases.

Figure 5.9 – Perceived Value for Money of First and Second Class Stamps

Source: Ofcom Residential Postal Tracking Survey.
Base: All respondents (4853). July 2013 – June 2014
QF3: It currently costs 60p (62p from Q2 2014) to send a standard letter first class within the UK, how would you rate Royal Mail's first class service in terms of value for money? (Single coded). QF3: It currently costs 50p (53p from Q2 2014) to send a standard letter second class within the UK, how would you rate Royal Mail's second class service in terms of value for money? (Single coded)

Misdelivered or delayed mail continues to be the most common problem experienced by residential consumers

5.54 In addition, our survey asked residential consumers about the types of problems they have experienced with postal services.

5.55 When asked specifically about the service received from Royal Mail about 37% had experienced some problem. When prompted, the main problem experienced with Royal Mail was with mis-delivered or delayed mail, as shown in Figure 5.10.

[111] These figures are not as strong as those from a previous Postcomm[111] survey (in 2009) in which 82% of adults rated First Class stamps 83% Second Class stamps as good value for money. This may be due to the fact that there have been significant above inflation increases in both First and Second Class stamp prices since 2009 - First Class stamp prices have increased by 59% since 2009 and Second Class by 77%.

5.56 Mis-delivered mail continues to be the main problem with the percentage of respondents increasing by seven percentage points from last year. However, the percentage of respondents experiencing lost mail problems has decreased from 35% to 27% year on year.

Figure 5.10 – Main postal issues experienced by residential consumers (who have reported problems)

Source: Ofcom Residential Consumer Postal Tracking Survey
Base: All respondents (997) July 2013 - June 2014

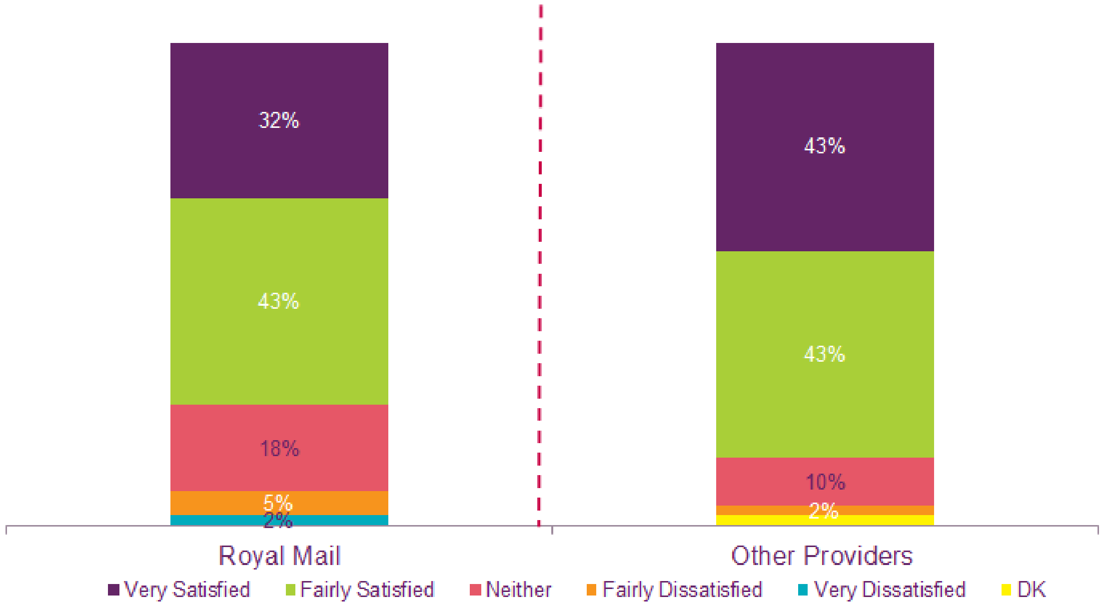
Business satisfaction levels

5.57 As discussed above, we also obtain feedback from business consumers about postal services[112]. Business users are particularly important in the postal sector as they account for the significant majority of all sent mail (around 92%).[113] Almost eight in ten businesses surveyed (82%) use Royal Mail as their only postal operator and less than a fifth (16%) also use another provider in addition to Royal Mail.

5.58 Figure 5.11 below shows the satisfaction levels amongst businesses for Royal Mail and other postal operators. The majority of business consumers are either very or fairly satisfied with postal services although satisfaction rates are better for other postal operators compared to Royal Mail, with the level of satisfaction remaining broadly similar against last year.

[112] 1,524 SME businesses were sampled as part of our Business Postal Tracker, with a further 50 semi-structured interviews conducted with businesses that employ more than 250 employees.
[113] WIK-Consult, Main Developments in the Postal Sector (2010-2013): Country Reports, August 2013.

Figure 5.11 – Satisfaction levels amongst businesses for Royal Mail and other postal operators



Source: Ofcom Business Post Tracking Survey. July 2013 – June 2014
QRM2/QOP1a: Thinking generally about the service your organisation receives as a whole, on a scale of 1-5 where 1 = very dissatisfied and 5 = very satisfied, how satisfied are you with the overall quality of the service you receive from Royal Mail vs other provider as a recipient or a sender?
Base: Royal Mail (1492), Other Providers (272)

We will continue to monitor views on the postal sector through our consumer surveys

5.59 The findings from our business and residential surveys provide us with a useful measurement of the consumer experience of postal services – for example, in terms of general satisfaction with the service, satisfaction with the cost of postage, value for money and the problems encountered. We will continue to provide analysis from both the residential and business surveys in our future annual monitoring updates.

Complaints data

5.60 Finally, we also note that all regulated postal operators including Royal Mail are required to publish annual complaints data. Additionally, Royal Mail is required to publish quarterly reports showing the amount of compensation paid in relation to complaints about most universal services.[114]

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[114] See Consumer Protection Condition 4.3. See also: http://www.royalmailgroup.com/sites/default/files/RM_Annual_Consumer_Complaints_2013_14.pdf. Please note that Royal Mail reports on two different complaint figures. First it reports the number of complaints relating to regulated postal services. Secondly in relation to the compensation paid this relates to the payments made to all customers (consumer and business) in accordance with product terms and conditions, the regulatory compensation scheme for delay, and any goodwill payments made in respect of customer complaints received.

5.61 We have observed that since 2008 complaints to Royal Mail have generally fallen. [115] However, average compensation payments have been increasing over the period, due to (1) compensation policies becoming more transparent; (2) a change in Royal Mail's policy so that all first time claims received compensation of six First Class stamps; and (3) more higher value items being sent.[116]

5.62 Royal Mail reports the top ten categories of complaint. In 2013-14, the greatest number of complaints was in relation to lost items, followed by complaints where a customer says they were at their property when a card was left notifying the recipient the mail item could not be delivered, known as a "P739 Failure".[117] These two categories account for 43% of all complaints.

5.63 We will continue to examine any complaints data that we receive. This, along with our consumer survey findings, will help to highlight whether there is degradation and/or any areas of concern in postal services used by residential and small business customers.

Summary

5.64 The key findings relevant to customers and consumers are:

- Stamp prices remain affordable and Royal Mail is complying with the safeguard caps that we have put in place;
- Royal Mail has significantly improved its QoS, following a number of failed targets in the last year. First and Second Class national targets were met, however four PCA targets were narrowly missed. We will continue to monitor its progress; and
- Our market research indicates that the vast majority of residential consumers (and the majority of business customers) are satisfied with their postal services.

[115] Complaint figures referred to here relate to all Royal Mail complaints not just those relating to regulated postal services.

[116] An increase in parcels sent 'over the counter' by non-account small businesses. Also any items using 'Signed For' now attract compensation up to £50.

[117] P739 Failure also relates to complaints where a card could not be left due to controlled access to a building or loss of the card itself.

Section 6

Business customers and competition

6.1 As set out in the March 2012 Statement, competition in the postal market has a number of potential benefits for customers. This includes providing choice for customers and incentives for Royal Mail to become more efficient and to innovate. However, we also recognised that competition has the potential to threaten the future sustainability of the universal service if it results in a significant acceleration in Royal Mail's volume and revenue decline.

6.2 This Section discusses the different types of competition and market trends for the alternative types of mail volumes. We then discuss Royal Mail's price increases for its retail bulk mail products and the price changes for access products effective from April 2014 and January 2015. Finally we discuss trends and new developments in both access and end-to-end competition in the UK.

Types of competition

6.3 Within the postal sector, there are two main forms of competition: access and end-to-end.

6.4 Access competition is where the operator collects mail from the customer, sorts it and then transports it to Royal Mail's Inward Mail Centres, where it is handed over to Royal Mail for delivery. Royal Mail is subject to a regulatory condition requiring it to offer access at its Inward Mail Centres to other postal operators and customers for letters and large letters. This enables other operators to offer postal services to larger business customers for these formats without setting up a delivery network. Access has been the predominant form of competition in the UK since the first access contract was signed in 2004.

6.5 End-to-end competition is where an operator other than Royal Mail undertakes the entire process of collecting, sorting and delivering mail to the intended recipients.

6.6 Together, the total bulk letters and large letters mail sector comprises three parts: mail collected and delivered by Royal Mail ("Royal Mail end-to-end"); mail collected by other operators and delivered by Royal Mail ("Royal Mail access"); and mail collected and delivered by other operators ("Other operators end-to-end").

6.7 "Royal Mail access revenue" is the revenue paid to Royal Mail by other operators for the delivery of access mail; "other operator's access revenue" is that paid to other operators by customers for the delivery of their mail, minus the portion of that revenue paid to Royal Mail for delivery (i.e. the Royal Mail access revenue).

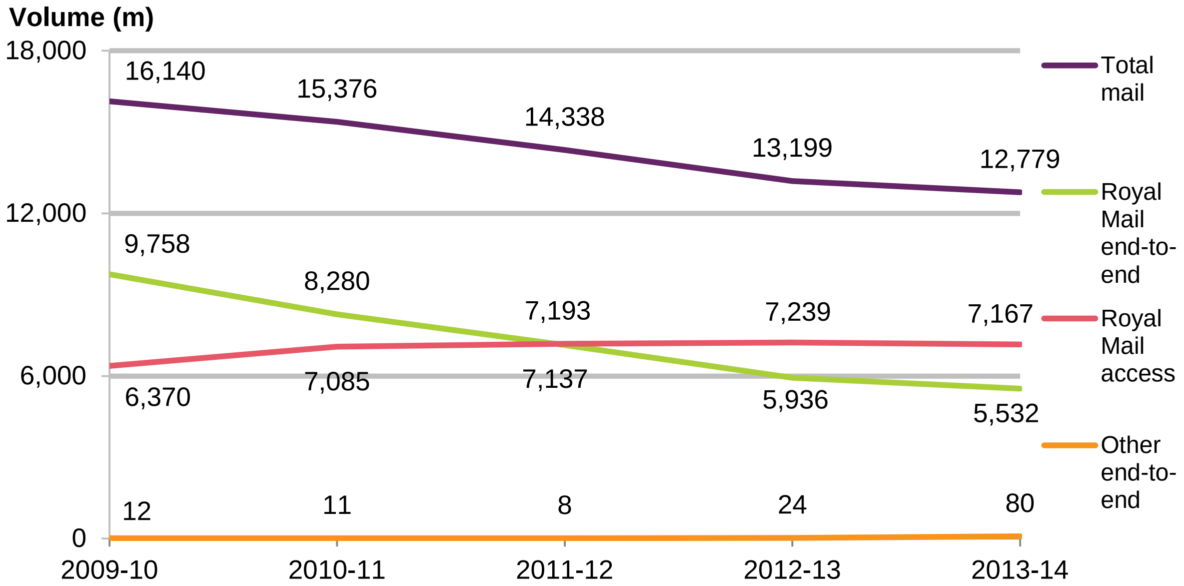
Letters competition

6.8 Figure 6.1 below, and as discussed in Section 3, shows that total letter volumes have fallen over the past five years. Total letters volumes continued to fall in 2013-14, declining by 3.2% to 12.8bn items. Although this is a slightly slower rate of decline than the previous year, which was 8.0%, it still represents a significant 21% decline over the past five years.

6.9 For the first time since its introduction in 2004, access volumes have declined, falling by 1.0% year-on-year to 7.2bn items in 2013-14. However, as total letters volumes are falling faster than the decline in access volumes, the proportion of access in total letters volumes has grown. Access now accounts for approximately 56% of total letters market volume.

6.10 Royal Mail's end-to-end volumes fell by 6.8% as there was continued decline in its First and Second Class single piece and retail bulk mail volumes (as it lost additional upstream bulk mail volumes to competitors, as noted in Section 3).

Figure 6.1– Total letters volume by type of operator



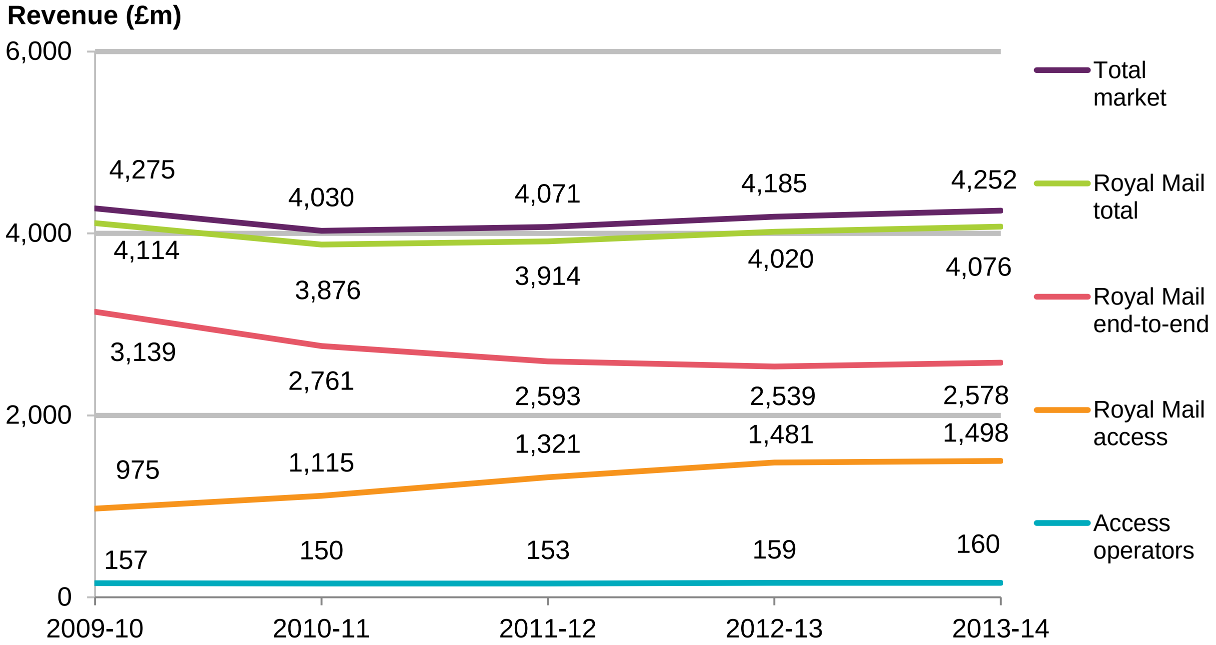
Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates.[118]

6.11 As shown in Figure 6.2, despite the fall in volumes, total letters revenue grew by 1.5% to £4.2bn. This is due to Royal Mail's increasing prices for some of its products.

6.12 Revenue from access operations increased slightly both for Royal Mail and for the access operators. Price rises for these products meant that Royal Mail grew its access revenues by 1.2% to £1.5bn. Access operators also increased their revenues by 0.8% to £160m, despite the 1.0% decline in access volumes. This is likely to be due to access operators gaining unsorted volumes which have a higher unit price and cost.

[118] Total Royal Mail letter volumes (access and end-to-end) are consistent with the volumes split by format in Figure 3.6. Royal Mail access volumes are as per its Regulatory Financial Statements and include a small amount of parcels. The effect of this is that Royal Mail's access volumes are slightly overstated and its end-to-end volumes are slightly understated.

Figure 6.2 – Total letters revenue by type of operator



Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, operator returns to Ofcom, Ofcom estimates.[119]

Price trends for retail bulk mail and access customers

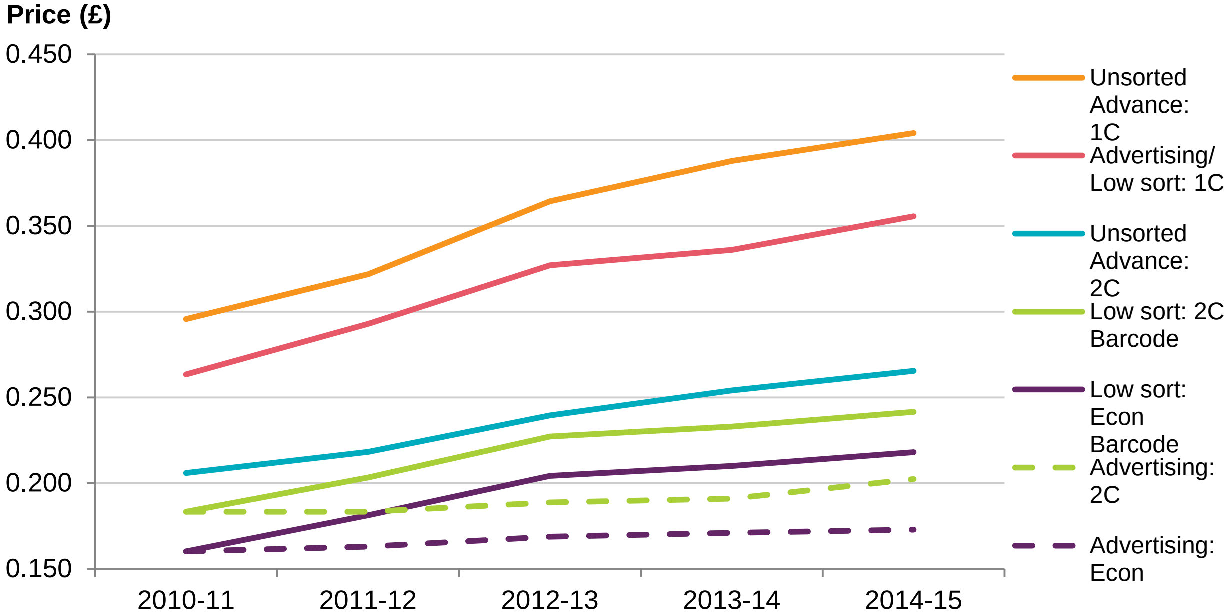
Retail bulk mail prices

6.13 Royal Mail and other providers also offer a number of products and services to business customers who send larger volumes of mail, which are not within the universal service. These include letter, large letter and parcel products that are subject to discounts for factors such as the volume of mail sent, the way the mail has been presented (for example using fonts to make it easier for the machine to read the address), applying machine barcodes or the level of sortation, and/or the purchase of any other conveyance of the same or any other postal packet.

6.14 Figure 6.3 shows the trend in the maximum discount prices of several of Royal Mail's main retail pre-sorted bulk mail products in recent years. Royal Mail has continued to increase the price of these products into 2014-15. Although it offers larger discounts on its retail advertising mail products than transactional products (introduced in 2010-11), the price of Second Class advertising mail increased by 5.9% in 2014-15, reducing the differential between Second Class advertising and Second Class Low Sort barcode mail.

[119] Total Royal Mail letter revenue (access and end-to-end) are consistent with the revenues split by format in Figure 3.7. Royal Mail access revenues are as per its Regulatory Financial Statements and include a small amount of parcels. The effect of this is that Royal Mail's access revenues are slightly overstated and its end-to-end revenues are slightly understated.

Figure 6.3 - Royal Mail Business Mail prices – 2010-11 to 2014-15[120]



Note - The product name changed from Mailsort to Business Mail in 2012-13.

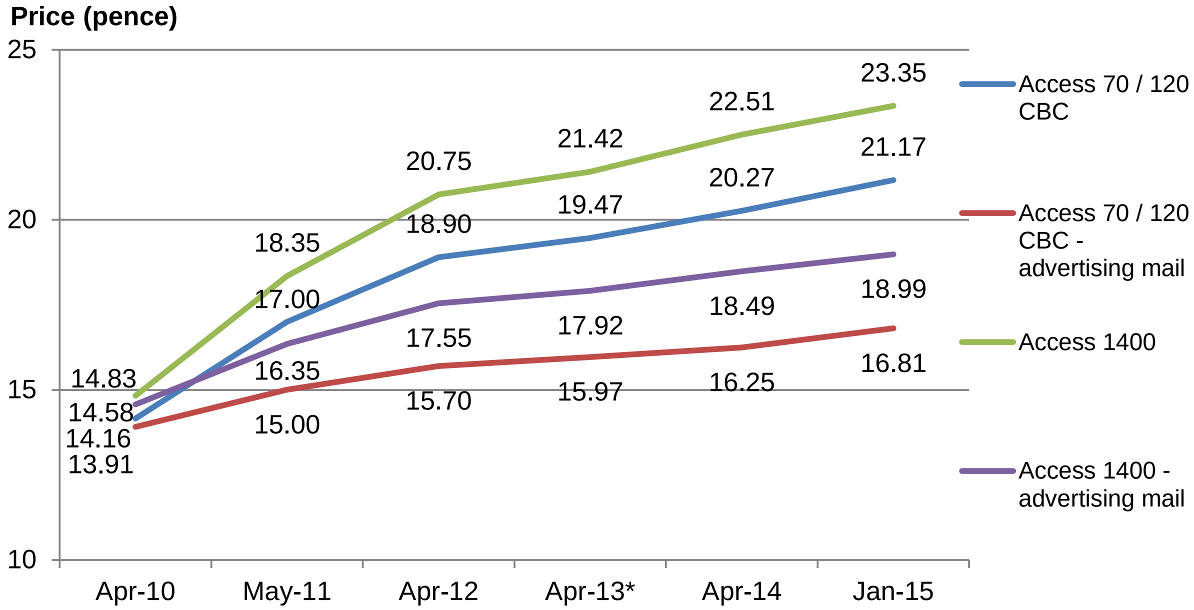
Source: Royal Mail, Ofcom calculation based on maximum discounted prices

Access prices

6.15 As set out in Figure 6.4, Royal Mail has steadily been increasing its access prices since 2010, particularly in 2011 and 2012 (where the overall price increase for some services was around 20% across both years). As with its retail business mail prices, the access price increases have been lower for advertising mail compared to transactional mail.

[120] Low sort Barcode was previously called Mailsort 70 CBC (prior to 2011-12 Mailsort 120 CBC), Economy was previously Mailsort 3 and Unsorted Advance was previously called Cleanmail Advance. Advertising Mail was introduced in 2011-12 and the relevant Mailsort price has been used prior to this date.

Figure 6.4 – National access prices: April 2010 – January 2015



Source: Royal Mail, based on National access prices, weighing 0-100g
** 2013-14 prices restated to reflect NPP1 prices*

6.16 In January 2014, Royal Mail notified new access prices that it planned to implement in April 2014. This included the introduction of a price differential between the two national price plans – National Price Plan 1 ("NPP1") and National Price Plan 2 ("APP2"), [121] the requirement for customers of the national geographic pricing plan (NPP1 only) to provide forecasting information two years in advance and a significant change to zonal prices (the zonal tilt). As seen from Table 6.5 below, the changes to zonal prices would have had the effect of significantly decreasing urban and London zonal prices and increasing the rural and suburban zonal prices.

[121] Under the 2013 access contracts, the National Price Plan 2 was known as "National Price Plan 2 (zones)". The name of the price plan was changed by Royal Mail as part of its suite of contract changes in January 2014. As this suite of changes has been suspended by Royal Mail, the name change has not yet come into effect. However, for the avoidance of doubt, we refer to this price plan exclusively as APP2.

Table 6.5: Royal Mail's zonal access price differentials*

	Urban Zone	Suburban Zone	Rural Zone	London Zone
Charge under 2013 access contracts for Letters	-12.9%	0.3%	+13.9%	+9.9%
Charge under 2013 access contracts for Large Letters	-13.1%	-0.6%	+15.0%	+10.9%
Charge under 2013/14 Notices for Letters	-25%	+10.4%	+44.1%	-25%
Charge under 2013/14 Notices for Large Letters	-25%	+10.4%	+44.1%	-25%

*** *Percentage change is a variance from APP2 access charges*

Source: Charges under the 2013 access contracts for Letters and Large Letters: Royal Mail pro-forma letter to customers, https://www.royalmailwholesale.com/mint-project/uploads/507938298.pdf.

Source: Charges under the 2013/14 Notices for Letters and Large Letters: Royal Mail Contract Change Notice 003-005, 10 January 2014 https://www.royalmailwholesale.com/mint-project/uploads/815176917.pdf

6.17 Under the terms of Royal Mail's contract with access operators, these proposed prices are suspended pending the outcome of Ofcom's investigation of the 2013/14 notifications under the Competition Act 1998.

6.18 Royal Mail notified its 2015 access price increases in October 2014 (as shown in Figure 6.4 above). These price increases do not change the zonal tilt or introduce any discounts between the national price plans and are expected to come into effect in January 2015.

6.19 We also opened a policy project to look at the access pricing regulatory conditions to determine if these remain fit for purpose. Our proposals for changes to conditions relating to Royal Mail's access pricing are set out in the access pricing consultation[122] that is published alongside this update.

Access competition

6.20 Access represents a significant portion of the market by volume (almost 50% of all delivered mail), though the proportion of revenue retained by other operators from access is much smaller (£160m out of a total market revenue of £7.5bn).

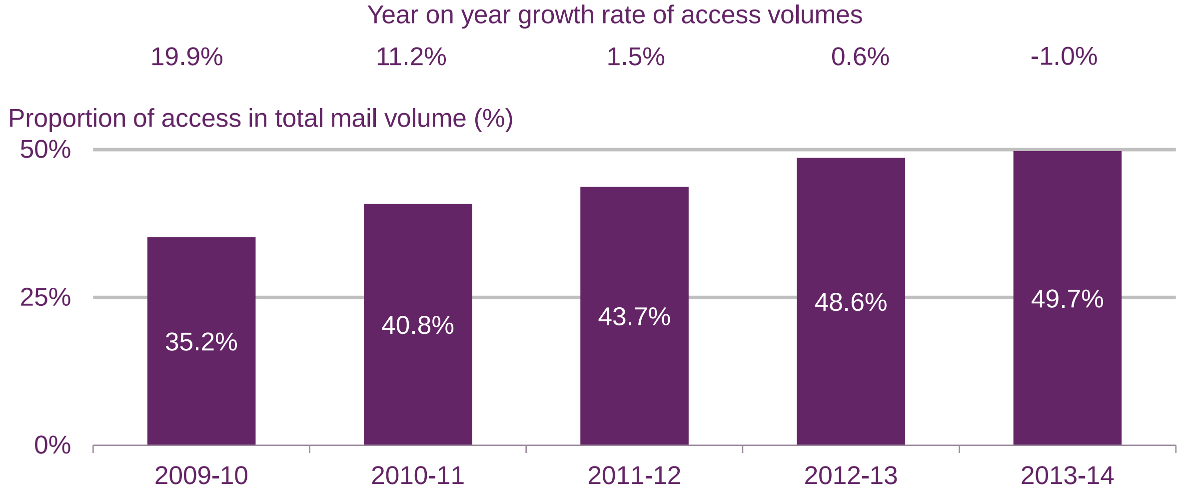
6.21 Figure 6.6 shows that access has continued to grow as a proportion of total mail volumes, despite volumes falling for the first time this year. Access grew from just under 44% of the market by volume in 2011-12, to account for nearly 50% of the market by volume in 2013-14.

6.22 Although there are a number of operators handling access mail, the bulk of volumes are handled by two companies – Whistl and UK Mail. Whistl's parent company Post NL has stated in its annual report that Whistl has a 54% share of downstream access

[122] http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/.

volumes in the UK,[123] and UK Mail has stated that carries almost 3 billion items through downstream access each year.[124]

Figure 6.6 – Growth of access mail



Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale

6.23 Royal Mail is subject to a margin squeeze control on its retail prices for D+2 Letter and Large Letter bulk mail. The control seeks to ensure that the upstream element of the revenues of these bulk mail services is sufficient to cover the costs of the relevant upstream activities carried out by Royal Mail to provide the services. The objective of the control is to ensure Royal Mail does not unfairly compete with the access operators that purchase wholesale access services from Royal Mail to provide bulk mail services in the market. We note that in accordance with the requirements in our USP Access Condition, we have received quarterly compliance reports from Royal Mail which set out details of the prices, volumes, revenues, costs and the contract information needed to demonstrate compliance with the control.

6.24 Following consultation which commenced on 28 November 2013, we published a statement on 26 February 2014 that modified the margin squeeze control. The modification clarified how Royal Mail must treat unrecoverable VAT as part of the costs considered in the margin squeeze control.[125]

6.25 The cost standard used in the control is FAC. However, in our March 2012 statement,[126] we stated that in principle we consider that in the long-term any margin squeeze test should use LRIC (a minimum of LRIC margin to be maintained between the wholesale access price and the equivalent retail price). We also said that we would endeavour to review the margin squeeze control in around 18-24 months but

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[123] Post NL, *Annual Report 2013*, February 2014, https://www.postnl.nl/Images/postnl-annual-report_2013_tcm10-8758.pdf.
[124] UK Mail, *Written Evidence from UK Mail Group plc (USO 27)*, October 2014, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/competition-in-the-uk-postal-sector-and-the-universal-service-obligation/written/14766.pdf.
[125] http://stakeholders.ofcom.org.uk/consultations/royal-mail-margin-squeeze/.
[126] paragraph 10.150 to 10.151.

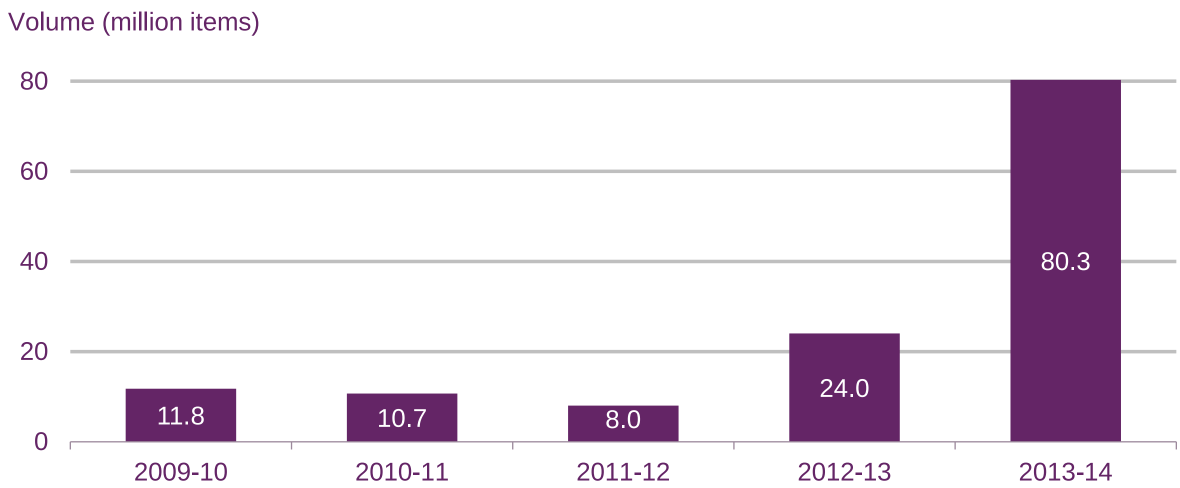
recognised that (i) a key condition for such a review would be the availability of robust LRIC data from Royal Mail, and (ii) LRIC is complex and we will need to consider various issues in ensuring it that any LRIC figures are fit for purpose. Following our consultation on access pricing,[127] we intend to consider whether the conditions are met to commence a review of the margin squeeze control and any LRIC data which may be used in the control.

End-to-end competition

6.26 There is very little end-to-end competition in the UK letters market (unlike some other European countries where end-to-end competition is the main form of competition). Despite the entry of Whistl (previously TNT Post UK) into the delivery market in 2012, alternative operators to Royal Mail only delivered 80m letters in 2013-14 – which equates to around 0.6% of the addressed letter mail market.

6.27 However, this does represent an increase of over 200% compared to 2012-13 and reverses the downward trend seen since the market was opened in 2006, as shown in Figure 6.7.[128] This increase in volumes was largely due to Whistl expanding its delivery areas into parts of South West and North West London, Manchester and Liverpool.[129] Whistl has publically stated that it plans to deliver to around 42% of households by 2017[130], but it has not rolled out in any additional areas since Liverpool in March 2014.

Figure 6.7 – Other operators' end-to-end delivered volumes



Source: Operators' returns, based on former licensed area delivered volumes

[127] http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/.
[128] Figure 6.shows the volume of addressed letter mail delivered end-to-end by operators other than Royal Mail. It does not include packet and parcel volumes. There is significantly more end-to-end competition in the delivery of packets and parcels and for closed user group services. We plan to collect more information on volumes and revenues in the growing packet and parcel markets and will report on this in future annual updates.
[129] In addition to areas of West and Central London to which Whistl was already delivering.
[130] Whistl presentation to the MarketForce 12th annual conference: The Future of UK Postal Services, 21 October 2013.

Summary of trends in competition

6.28 The decline in business mail volumes was broadly similar to the overall market reduction, falling 3.4% while total volumes fell by 3.2%.

6.29 Access volumes declined for the first time since its introduction in 2004 this year, falling by 1.0%. However, the proportion of total volumes it accounts for continued to grow and just under 50% of total mail volumes are now handled by other postal operators. However, other operators only retain about 2% of total market revenue.

6.30 End-to-end competition has increased significantly in 2013-14 (231%) but this was from a very low base and only represents around 0.6% of total market volumes.

Annex 1

Current information collected as part of the monitoring programme

Information for financial monitoring	Frequency
Relevant Group consolidated income statement, balance sheet, and cash flow statement	Annually
Royal Mail Strategic Business Plan and Annual Budget	Annually
Reported Business income statement, product profitability statements, capital employed statement, and cash flow statement (including accounting separation)	Annually
RM data on compliance with the safeguard cap	Annually
Relevant Group consolidated cash flow projections	Quarterly
Reported Business income statement, and product profitability statements (including accounting separation)	Quarterly
RM Costing Manual (including zonal costing) and Accounting Methodology Manual	Quarterly
Other operators' volume and revenue data split by product	Quarterly
Reported Business Revenues and Volumes report	Monthly
Relevant Group Monthly Management and KPI Performance Pack	Monthly

Information for monitoring impact on customers and consumers	Frequency
RM quality of service reporting	Annually/quarterly*
RM Mail integrity reporting	Annually/quarterly
RM changes to latest delivery and collection times	Three months before change
RM request to change terms and conditions for USO products	One month before proposed change
RM request to change prices for USO products	One month before proposed change
RM notification of changes to terms and conditions for non-USO products	One month before change
RM notification of changes to prices for non-USO products	One month before change
RM change to compensation policies	One month before change