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Review of the Regulation of Royal Mail

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Statement

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About this document

This statement concludes our review of the regulation of Royal Mail. The review was undertaken to ensure regulation remains appropriate and sufficient to secure the efficient and financially sustainable provision of the universal postal service.

Following the publication of a discussion document in July 2015, we issued a consultation in May 2016 which set out our proposals for the future regulatory framework for post. In preparing this statement, we have considered stakeholder responses to both of these documents.

This statement sets out our decision on the future regulatory framework for post, focussing on five key areas:

- Maintaining a regulatory approach that recognises the structural decline in letters and increasingly competitive parcels sector, and extending the regulatory framework for a further five years;
- Supporting competition and innovation in the parcels sector;
- Tightening rules on access competition;
- Focusing mail integrity regulation on appropriate areas and securing good consumer outcomes; and
- Ensuring all regulatory conditions remain appropriate and fit-for-purpose.

This statement puts the new regulatory framework in place with immediate effect, aside from the new Universal Service Provider (USP) Access Condition. This will take effect from 1 April 2017 to allow Royal Mail to make any necessary changes to its commercial arrangements.

In addition, following feedback from consultation respondents, we have decided to amend our original proposal in relation to Postal Common Operational Procedures (PCOP) Code of Practice. We set out a new proposal in this document, and seek responses on this issue by 3 April 2017.

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Section 1

Executive Summary

Securing an efficient and financially sustainable universal postal service that meets the reasonable needs of users

- 1.1 This document sets out our final decisions on the regulatory framework for postal services. It sets out how we will continue to fulfil our duties under the Postal Services Act 2011 (the ‘**PSA 2011**’) to secure the provision of an efficient and financially sustainable universal postal service which meets the reasonable needs of users.
- 1.2 It follows a comprehensive review of the regulation of Royal Mail, covering a wide range of areas, including Royal Mail’s financial sustainability and efficiency; competition in the parcels and letters sectors; levels of customer satisfaction and the appropriateness of regulatory conditions.

Key decisions

Maintaining the current regulatory approach for a further five years: We have decided that the approach to regulation we established in 2012 should remain in place until 2022. We consider that the imposition of wholesale or retail price controls and/or efficiency targets on Royal Mail would not be appropriate in order to secure the objectives of the regulatory regime. Market conditions and the shareholder discipline which Royal Mail is subject to as a privatised company are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation.

Supporting competition and innovation in the parcels sector: Consumers’ interests are best served by competition. The UK has one of the most competitive parcels sectors in the world. However, Royal Mail retains a strong position in single piece and light-weight bulk parcels. We have decided that the safeguard cap on Second Class stamp parcel prices should remain in place to ensure vulnerable consumers can access a basic universal service. We have also decided to retain the current position on standard universal service parcels, i.e. that tracking is not included. This reflects how consumers are actually using the universal service and supports competition by not granting Royal Mail an unfair competitive advantage.

Tightening rules on access competition: Access competition continues to perform well and meets the needs of large senders of mail. We have decided it is appropriate to retain a regulatory regime for access mail which affords Royal Mail commercial and operational flexibility subject to ensuring that charges to terms and conditions are fair, reasonable and not unduly discriminatory. To ensure that access competition continues to perform well, we have decided to retain in a modified form a set of access pricing principles. We have also amended the relevant regulatory condition to clarify the circumstances under which less than 10 weeks’ notice of changes to terms, conditions and charges for access is permitted.

Focusing mail integrity rules: We have decided to amend the current mail integrity regulation to ensure that it is focused on postal items which do not have additional protections such as tracking but which may contain personal or confidential information. The regulation will therefore apply to untracked letters and large letters, and untracked universal service parcels but not to other parcel services or access mail more widely, which are usually subject to additional protections.

Ensuring regulation remains appropriate and fit-for-purpose: We are implementing a number of changes which will ensure that regulations do not impose an undue burden on postal operators, while protecting consumers. These include reducing the advance notice period for specified collection times to one month and removing the advance notice period for latest delivery times. However, following feedback from consultation respondents, we have decided not to remove the current Postal Common Operational Procedures (PCOP) Condition and Code of Practice. The purpose of this regulation is to ensure that mail which enters the wrong postal operator's network is returned to the intended operator, and delivered to the recipient, as quickly as possible. We instead propose to retain the requirement that relevant postal operators should sign up to the PCOP Agreement, unless they enter into appropriate alternative arrangements. We are now consulting on those proposals.

Background

- 1.3 In March 2012, Ofcom published a statement putting in place a new seven-year regulatory framework for the postal sector (the “**March 2012 Statement**”). This gave Royal Mail greater commercial and operational flexibility so that it could return the universal service to financial sustainability and adapt to the changing market environment. At the same time, we put in place three key safeguards. These were:
- **Monitoring:** an effective and on-going monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels, pricing and competition;
 - **Affordability:** a cap on the price of Second Class stamps for letters and parcels up to 2kg so vulnerable consumers can access a basic universal service; and
 - **Competition:** we required Royal Mail to continue to provide access to its network for letter competitors.
- 1.4 There have also been a number of significant developments in the postal market since 2012. These include:
- An improvement in the financial position of the universal service;
 - An intensification in the level of competition and innovation in parcel services, which could have implications for the future financial sustainability of the universal service network; and
 - Whistl's exit from the end-to-end letter delivery market in 2015, which means Royal Mail no longer faces any end-to-end competition of significant scale for letters.
- 1.5 As a consequence of these changes, we announced a fundamental review of the regulation of Royal Mail on 16 June 2015.¹ The objective of the review was to ensure that regulation remains appropriate and sufficient to secure the universal postal service.

¹ See <http://media.ofcom.org.uk/news/2015/royal-mail-regulation-review/>.

- 1.6 On 17 July 2015 we published a discussion paper (the “**July 2015 Discussion Document**”) setting out the proposed scope of the review.² The paper sought stakeholder views and evidence to assist our analysis.
- 1.7 On 25 May 2016, we published a consultation (the “**May 2016 Consultation**”) setting out proposals for the future regulation of postal services.³
- 1.8 This statement sets out our final decisions. It also seeks views on one aspect of the regulatory framework (PCOP) where we have revised our proposals following consultation.

We intend to retain the current regulatory approach for a further five years

- 1.9 In assessing the current regulation, we have analysed Royal Mail’s financial sustainability and efficiency, the competitive conditions in letters and parcels, and the consumer experience of postal services.

We consider Royal Mail is financially sustainable although it faces a number of challenges

- 1.10 We consider that the universal postal service is likely to remain financially sustainable in the immediate future. However, there are a number of credible downside scenarios which may impact Royal Mail’s ability to make future returns within the 5% to 10% EBIT margin range, which we consider indicates a reasonable commercial rate of return.
- 1.11 We have decided to retain the current approach to measuring financial sustainability based on Royal Mail’s return on sales, and consider that the 5-10% EBIT (Earnings Before Interest and Tax) margin range we identified in 2012 remains an appropriate benchmark. Royal Mail is currently making returns at the lower end of this range.

Royal Mail has made some efficiency improvements in recent years, but there is potential for it to do more

- 1.12 Royal Mail has strong incentives to improve its efficiency in future to remain financially sustainable. Our analysis indicates that there is scope for Royal Mail to make further efficiencies and we consider that the market conditions it faces incentivises it to pursue these efficiencies. We will continue to monitor its efficiency performance closely.

Since 2012 Royal Mail has increased prices moderately

- 1.13 We consider that the constraints Royal Mail faces are unlikely to be sufficient to prevent it from raising prices in many sectors of the postal market. In particular, Royal Mail continues to deliver the vast majority of letters and may therefore face few constraints on its prices. However, we also note that it has not raised prices as much as it could have done. Following the significant price rises introduced in 2011-12 and

² See the July 2015 Discussion Document, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

³ See the May 2016 Consultation, <https://www.ofcom.org.uk/consultations-and-statements/category-1/royal-mail-review2016>.

2012-13 in order to return to profitability, its price increases have been relatively restrained.

- 1.14 Some parts of the parcels sector are competitive, particularly heavier parcels (above 2kg) and those requiring fast delivery. However, despite increasing competition, we consider Royal Mail retains an advantage for single piece parcels used by consumers and small and medium enterprises (SMEs) and small, lightweight bulk parcels.

Consumers and businesses are satisfied with the postal market

- 1.15 The majority of consumers continue to be satisfied with postal services and continue to consider that stamps represent fairly or very good value for money. In addition, satisfaction levels with Royal Mail and other postal operators are high amongst SMEs. Royal Mail's quality of service performance has generally improved since the current regulatory framework was put in place.

We consider the current regulatory approach remains appropriate

- 1.16 We have considered whether the imposition of price controls and/or efficiency targets on parts of Royal Mail's business, as advocated by a number of consultation respondents, is warranted in order to secure the provision of the universal postal service which meets the needs of consumers.
- 1.17 We consider that market conditions and shareholder discipline are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation.
- 1.18 We have also considered Royal Mail's argument that further regulatory intervention is necessary to secure the financial sustainability of the universal postal service.
- 1.19 We do not agree that regulatory intervention is necessary to secure the provision of the universal postal service at this time. We consider that commercial flexibility, subject to certain safeguards, along with the achievement of a reasonable rate of efficiency improvement, is the most likely means by which Royal Mail will be able to secure the financial sustainability of the universal postal service despite the challenges it faces.

We intend to retain the current regulatory approach until 2022

- 1.20 Having carried out this fundamental review, we propose that the regulatory framework should remain settled for a further five years.
- 1.21 We will continue to closely monitor the market and retain the right to intervene. While it is not possible to identify all of the circumstances in which we might step back in, examples might include:
- The emergence of threats to the financial sustainability of the universal postal service, which Royal Mail could not deal with through commercial action alone.
 - Negative outcomes for consumers, such as significant price increases or poor quality of service, where there is no or very little competition.

- Failure on Royal Mail's part to make sufficient progress on improving its efficiency, exposing consumers to higher prices and/or a lower quality of service than might be the case in a competitive market.

1.22 In addition, we will continue to measure and gather information about the reasonable needs of postal users. This is particularly important given changing consumer preferences for some postal services, particularly parcels. It is likely that Ofcom will conduct a review of postal users' needs during the course of the five-year period.

Supporting competition and innovation in the parcels sector

1.23 Royal Mail argued that regulation unfairly prevents it from offering full tracking of standard parcels within the universal service. It argued that this prevents it from responding to customer demand and keeping its universal service products relevant.

1.24 We have decided to retain the current position on standard universal service parcels, i.e. that tracking is not included. We are not opposed to the principle of including tracking on such parcels in future if that would help consumer needs to be met. However, there is a risk that allowing Royal Mail to offer tracking in the universal service could give it an unfair advantage over its competitors since universal service products are currently exempt from VAT. Royal Mail would therefore benefit from a price advantage for tracked parcels which could harm competition in the parcels sector.

1.25 We have also considered whether the safeguard cap on Second Class stamp parcels up to 2kg remains necessary given the emergence of competition in the parcels sector. We consider that competition has not yet developed to a sufficient degree to constrain Royal Mail's pricing on single piece parcels and we have therefore decided to retain the safeguard cap.

1.26 We also intend to consider later this year Royal Mail's costs of delivery for parcels and letters and whether there might be competition concerns with certain pricing strategies, for example cross-subsidisation. This will include reviewing the relevant Regulatory Accounting Guidelines and building a costing model to help develop our own view of Royal Mail's costs in delivery.

Tightening rules on access competition

1.27 We have reviewed whether access regulation remains appropriate both in relation to price and non-price elements of the existing regulatory framework. We have decided that it is appropriate to retain access regulation largely in its current form.

1.28 However, we have decided to tighten the rules around changes to contractual terms, conditions and charges, to clarify the circumstances in which a shorter notification period may be agreed to prevent Royal Mail from circumventing the regulatory notification period in respect of all future changes to terms and conditions relating to new access products.

1.29 We have decided not to pursue our proposal to require Royal Mail to respond to requests for mandated access within a six-week time period, where it already offers an equivalent retail product. We will closely monitor how Royal Mail's process for considering requests for new access products develops in practice before considering whether any regulatory intervention is required.

- 1.30 We have also decided not to implement the proposals in our 2014 Access Pricing Review (the “**December 2014 Consultation**”).⁴ However, we will continue to closely monitor Royal Mail’s changes to its access prices and zonal pricing structure, and have decided to retain in a modified form a set of access pricing principles against which its behaviour will be monitored.

Focusing mail integrity regulation

- 1.31 Mail integrity is about ensuring postal items are protected from loss, theft or damage. Postal items that are most vulnerable include those items which do not have additional protections (e.g. tracking) but may contain personal or confidential information, such as bank or credit card details, tax information or medical appointments.
- 1.32 We have decided to amend the current mail integrity regulation to focus on untracked letters, large letters and universal service parcels, but not other parcel services or access mail more widely, which are usually subject to additional protections. We have also changed the regulation to ensure that postal operators are incentivised to concentrate on good consumer outcomes rather than process. This will ensure that the current high standard of mail integrity is retained and improved.

Ensuring regulations remain appropriate and fit-for-purpose

- 1.33 With the exception of those regulatory conditions which implement the universal postal service obligation, we have reviewed all the regulations applying to Royal Mail and other postal operators to ensure they remain appropriate and fit-for-purpose. As a result, we have decided to:
- reduce the advance notice that Royal Mail must give for changes to specified collection times from three months to one month;
 - remove the requirement for Royal Mail to provide advance notification for changes to the latest delivery times;
 - remove requirements on Royal Mail to notify price decreases while retaining the requirement for consumers to be given advance warning of price increases;
 - continue to require all postal operators to comply with transparent, simple and inexpensive procedures for dealing with customer complaints;
 - continue to require Royal Mail, as the universal service provider, to comply with more detailed complaints handling and redress requirements; and
 - remove a redundant consumer protection condition which requires postal operators to deliver the mail, because contractual arrangements and other existing regulation already requires postal operators to do this.
- 1.34 Following feedback from stakeholders, we no longer propose to remove the Postal Common Operational Procedures (PCOP) Code of Practice or Agreement. The purpose of this regulation is to ensure that mail which enters the wrong postal

⁴ Ofcom, *Royal Mail Access Pricing Review – Proposed amendments to the regulatory framework*, 2 December 2014,

https://www.ofcom.org.uk/_data/assets/pdf_file/0029/78248/royal_mail_access_pricing_review.pdf

operator's network is returned to the intended operator, and delivered to the recipient, as quickly as possible. Instead we are consulting on a proposal to retain the requirement that relevant postal operators should sign up to the PCOP Agreement, unless they enter into appropriate alternative arrangements. We are also proposing to make some changes to the current PCOP Condition and Code of Practice to provide greater flexibility to relevant postal operators and ensure it remains fit for purpose.

Next steps

- 1.35 This statement closes the review and puts the new regulatory framework in place with immediate effect, aside from the new Universal Service Provider (USP) Access Condition. This will take effect from 1 April 2017 to allow Royal Mail to make any necessary changes to its commercial arrangements.
- 1.36 Separately, we are undertaking the following work:
- consulting on proposals for amending the USP Accounting Condition and Regulatory Accounting Guidelines to ensure they remain fit-for-purpose and make some technical changes to the detailed workings of the margin squeeze control; and
 - reviewing whether the regulation in relation to Royal Mail's quality of service remains appropriate in light of market developments.
- 1.37 We seek responses from stakeholders to our revised PCOP proposals by 3 April 2017.

Section 2

Introduction & Summary of the Regulatory Framework

2.1 In this section, we briefly summarise the legal framework and Ofcom's duties in respect of postal services. We then summarise the current regulatory framework for postal services and the circumstances that led us to instigate our review.

Ofcom's duties are to further the interests of citizens and consumers and to secure the provision of a universal postal service

2.2 The legal framework relating to the regulation of postal services is set out in the PSA 2011.

2.3 Ofcom's principal duty under the Communications Act 2003 (the "CA 2003") is to further the interests of citizens and of consumers, where appropriate by promoting competition. For postal services, we also have a duty under the PSA 2011 to secure the provision of the universal postal service, to which we must give priority if we consider that there is any conflict with our principal duty.

2.4 Section 29(1) of the PSA 2011 provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service. Section 29(2) provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1).

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

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

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

2.7 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom's general duties in the CA 2003 in the case of conflict between the two where Ofcom is carrying out its functions in relation to postal services. However, if we consider that no conflict arises, Ofcom must carry out our functions in accordance with these general duties and so must further the interests of citizens and of consumers, where appropriate by promoting competition.

2.8 Ofcom does not consider that any conflict has arisen between its duty to secure the provision of the universal postal service and its general duties in respect of any aspect of this review.

The current regulatory framework for postal services has been in place since March 2012

- 2.9 In March 2012, Ofcom published a statement putting in place a new regulatory framework for the postal sector (the “**March 2012 Statement**”).⁵ The new regulatory framework gave Royal Mail greater commercial and operational flexibility in recognition of the major challenges facing the postal sector at that time.⁶
- 2.10 In granting Royal Mail increased commercial and operational flexibility, it was essential to ensure it would use this in a way that benefited consumers. Given this, we put in place the following three key safeguards:⁷
- **a monitoring regime:** an effective and ongoing monitoring regime to track Royal Mail’s performance in respect of the universal service, efficiency levels, pricing and competition;
 - **a cap on the price of Second Class stamps up to 2kg:** to ensure that vulnerable consumers remained able to access a basic universal service; and
 - **access regulation:** we put in place regulation to maintain access competition given the benefits it could bring such as lower prices to consumers.⁸
- 2.11 We decided to put the regulatory framework in place for a period of seven years in order to provide an appropriate degree of certainty as to the regulatory framework for Royal Mail, potential investors and other stakeholders. We considered that this would better encourage efficiency incentives and allow the benefits of a financially sustainable universal service to be shared with customers.
- 2.12 However, we recognised that there might be circumstances in which we could decide to re-open the regulatory framework earlier than seven years.⁹ These included if Royal Mail used its commercial freedom to act in a way that did not benefit consumers, undermined the universal postal service or in the event of significant unanticipated market challenges.

Changing market circumstances led us to announce a review of the regulation of Royal Mail

- 2.13 On 10 June 2015, Whistl announced that it was closing down its end-to-end delivery operations. At this point Whistl was delivering to around 7% of addresses¹⁰ and had

⁵ Ofcom, *Securing the Universal Postal Service, Decision on the new regulatory framework*, 27 March 2012, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>.

⁶ For example, see March 2012 Statement, paragraphs 1.5-1.12.

⁷ For example, see March 2012 Statement, paragraph 6.158.

⁸ In accordance with the USP access condition Royal Mail has to grant access at Inward Mail Centres for the provision of retail D+2 and later than D+2 letter and large letter services. While we do not directly regulate the price of access, we ensure, by means of an ex-ante margin squeeze test, that the difference between its access price and the equivalent retail price is consistent with principles that will provide for effective competition between Royal Mail and access operators.

⁹ For example, see March 2012 Statement, paragraphs 7.77-7.91.

¹⁰ Whistl presentation to the MarketForce annual conference on The Future of the UK Postal Services, 21 October 2014.

a maximum share of total addressed letters of 1.3% for the 2014-15 financial year.¹¹ On average this represented around 20% of the total letter volumes in the areas that Whistl was delivering.

- 2.14 Whistl's exit means Royal Mail no longer faces any end-to-end competition of significant scale for letters, although competition is stronger in relation to other postal products such as parcels and 'access mail' – where operators collect, sort and transport mail before handing it over to Royal Mail for delivery.
- 2.15 There have also been a number of other significant developments in the postal market since we put the new regulatory framework in place in March 2012. These include:
- An improvement in the financial position of the universal service; and
 - an intensification in the level of competition and innovation in parcel services, which could have implications for the future financial sustainability of the universal service network.
- 2.16 As a consequence of these changes, we announced a fundamental review of the regulation of Royal Mail on 16 June 2015.¹² The objective of the review was to ensure that regulation remains appropriate and sufficient to secure the universal postal service, given recent market changes.
- 2.17 On 17 July 2015 we published the July 2015 Discussion Document setting out the proposed scope of the review.¹³ The paper sought stakeholder views and evidence to assist our analysis.
- 2.18 On 25 May 2016, we published the May 2016 Consultation setting out proposals for the future regulation of postal services.¹⁴ This statement sets out our final decisions. It also seeks views on one aspect of the regulatory framework where we have revised our proposals following consultation.

General impact assessment

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

Equality impact assessment

- 2.20 We have considered what (if any) impact the decisions in this statement may have on equality. Having carried out this assessment, we are satisfied that our decisions are not detrimental to any group defined by the protected characteristics identified in the Equality Act 2010.

¹¹ See the Annual Monitoring Report for 2014-15, paragraph 4.29
http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.

¹² See <http://media.ofcom.org.uk/news/2015/royal-mail-regulation-review/>.

¹³ See http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

¹⁴ See <https://www.ofcom.org.uk/consultations-and-statements/category-1/royal-mail-review2016>

Outline of the rest of this document

2.21 The remainder of this document is set out as follows:

- Section 3 sets out stakeholder responses to our proposed approach for the overall regulatory framework and our final decision;
- Section 4 sets out stakeholder responses to our proposals for the future regulation of parcels and our final decision;
- Section 5 sets out our stakeholder responses to our proposals for the future access framework and our final decision;
- Section 6 sets out stakeholder responses to our deregulatory proposals and our final decision;
- Annex 1 provides instructions on how to respond to our consultation on our revised PCOP proposals;
- Annex 2 sets out Ofcom's consultation principles;
- Annex 3 lists our consultation question;
- Annex 4 is a non-exhaustive glossary of acronyms and defined terms used throughout this statement;
- Annex 5 lists the organisations and individuals who responded to our May 2016 Consultation; and
- Annex 6 is a non-exhaustive list of the sources of evidence we have relied upon for our review.
- Annexes 7, 8, 9, 11, 12 and 13 published alongside this document set out the legal notifications confirming modifications to the regulatory conditions, and Annex 10 sets out a further legal notification for one regulatory condition where we have updated our proposal since the May 2016 Consultation.

Section 3

Assessing the 2012 Regulatory Framework

Introduction

3.1 In this section, we summarise the analysis and proposals we set out in our May 2016 Consultation in relation to the overall regulatory framework for postal services. We then set out stakeholder responses to those proposals. Finally, we set out our assessment of these responses and any new information, and our final decision.

We consulted on retaining the current regulatory approach for a further five years

3.2 In the May 2016 Consultation, we said that on the basis of the evidence set out in relation to consumer satisfaction, Royal Mail's financial sustainability, its position in the letters and parcels sectors and its efficiency, we did not consider that the imposition of further retail or wholesale price controls on Royal Mail was justified. In particular, we found that:

- consumer and small and medium-sized enterprise (SME) satisfaction was high and improving with the majority of residential and business consumers satisfied or very satisfied with postal services;
- the universal postal service was financially sustainable and Royal Mail was making profits in line with what we had described as a reasonable commercial rate of return;
- Royal Mail occupied a very strong position in the letters sector and retained a strong position in certain segments of the parcels sector. However, Royal Mail had not exercised its ability to raise prices to the extent that it could profitably have done; and
- Royal Mail's future efficiency plans demonstrated greater ambition than its past performance and were within a reasonable range. However, we believed that there was potential for Royal Mail to make greater efficiency gains than those it was forecasting.

3.3 In light of this evidence, we said that the current regulatory framework and market conditions appropriately incentivised Royal Mail to pursue efficiency improvements rather than excessively raising prices. As such, and having regard to the principles of regulatory certainty and predictability, we said that it would not be appropriate to amend the regulatory framework to impose price controls on Royal Mail or set efficiency targets.

3.4 We therefore provisionally concluded that the most appropriate option was to maintain the current regulatory framework including the safeguard cap, giving Royal Mail pricing freedom, alongside safeguards for consumers and effective monitoring.

3.5 In the remainder of this chapter, we briefly summarise the factors underpinning our proposal in the May 2016 Consultation. We then set out stakeholder responses to

both our proposal and the analysis which underpinned it. We also present updated analysis where appropriate, before we set out our final decision.

The experience of users

Summary of initial findings

- 3.6 Our May 2016 Consultation found that the experience of postal users under the current regulatory framework has been largely positive. We found that consumer satisfaction with postal services was high and improving among both residential consumers (89% satisfied or very satisfied in 2015) and SMEs (77% satisfied or very satisfied with Royal Mail and 89% with other postal operators in 2015).¹⁵
- 3.7 In addition, from 2005 to 2015, the postal services and delivery sector saw an increase in customers' perception of value for money at a time when value for money ratings declined in many other sectors; most markedly banks, gas and electricity providers, and supermarkets.¹⁶ We provisionally concluded that this indicated the postal and delivery sector offered relatively good value for money.
- 3.8 We noted that Royal Mail had met the Second Class quality of service target every year from 2011-12, but that the First Class quality of service target had been more challenging with Royal Mail only meeting the target twice in the past five years.¹⁷ We confirmed that Royal Mail's requirement to provide universal services to a high standard is an essential part of the regulatory framework.

Stakeholder responses

- 3.9 Consumer groups tended to agree that consumers are largely satisfied with postal services under the current regulatory framework.¹⁸ Citizens Advice said its own research indicated that most consumers felt Royal Mail provides good value for money for posting letters. It considered that consumers continue to value the universal postal service.
- 3.10 However, these respondents also noted some specific areas where consumer satisfaction was lower, such as value for money perceptions of Royal Mail's parcel services. Overall, it said its research indicated that affordability, along with reliability/safety and ease, continue to be key considerations for users of postal services.
- 3.11 Referring to Ofcom's Residential Tracker Survey 2015,¹⁹ the Consumer Council for Northern Ireland (CCNI) noted that consumer satisfaction with prices tended to be lower in Northern Ireland than other parts of the UK. It also noted that some retailers apply surcharges to parcel deliveries in Northern Ireland (and parts of Scotland) which may partly explain lower consumer satisfaction with postal services in these parts of the UK. It said that Ofcom should continue to monitor the experience of users

¹⁵ See the May 2016 Consultation, paragraph 4.9.

¹⁶ See the May 2016 Consultation, paragraph 4.12.

¹⁷ Royal Mail is required to deliver 93% of First Class universal service letters and parcels the next working day after posting nationally, and 98.5% of Second Class universal service letters and parcels within three working days of posting. See paragraphs 4.6-4.8 of our May 2016 Consultation.

¹⁸ See responses to the May 2016 Consultation from Citizens Advice, the CCNI and the CCP.

¹⁹ Ofcom, *Residential Consumer Postal Tracker 2015*, 24 February 2016,

http://webarchive.nationalarchives.gov.uk/20160703021429/http://stakeholders.ofcom.org.uk/binaries/research/statistics/2016Feb-Apr/Residential_Postal_Tracker_2015_data_tables_tbp.pdf.

across the UK in order to fully understand how any future price rises affect consumers in the different nations.

- 3.12 The Communications Consumer Panel & Advisory Committee on Older and Disabled People (CCP) said that while Royal Mail's customer satisfaction ratings are improving across the UK, Ofcom's Communications Market Report (CMR) 2015 showed that about the same proportion of consumers had concerns about postal deliveries (particularly in relation to high prices or long waiting times) as did not (45% v 46%).²⁰ It urged Ofcom to do all that it can to ensure that improved customer satisfaction is a key outcome from the review.
- 3.13 Royal Mail welcomed our finding that satisfaction with postal services was high. It noted that its customer satisfaction ratings in letters is between 87% and 90% based on its own Consumer Satisfaction Survey.²¹
- 3.14 Royal Mail said that it was committed to delivering a high quality of service. However, it noted that regulatory targets in the UK were higher than those required by the European Postal Services Directive. It argued that certain elements of the quality of service regime in the UK should be reduced or removed to enhance the sustainability of the universal postal service. In particular, it said that the Post Code Area quality of service target was high and that no other European postal operator was subject to such a requirement. It also said that the Post Code Area target is inconsistent with the national First Class quality of service target.

Our assessment

- 3.15 Since publishing the May 2016 Consultation we have updated our assessment of customer satisfaction and value for money with postal services based on the latest available information from our residential and business tracker survey results for 2016. These are summarised in the following paragraphs.

Residential consumer satisfaction levels

- 3.16 Our latest residential consumer satisfaction results show that the large majority of consumers continue to be satisfied with most aspects of postal services. These results are not directly comparable to those presented in the May 2016 Consultation due to a change in survey methodology.²² Nonetheless, the results suggest that consumer satisfaction remains high, and at similar levels to that reported last year.

²⁰ See Ofcom, *The Communications Market Report*, 2015, page 387, Figure 6.9 https://www.ofcom.org.uk/_data/assets/pdf_file/0020/13934/uk_6.pdf.

²¹ Ipsos MORI on behalf of Royal Mail, Royal Mail Consumer Satisfaction Survey 2015/16, 90% satisfaction based on receiving experience (7,068 respondents) and 87% satisfaction based on sending experience (5,585 respondents).

²² The research agency which Ofcom uses to conduct this survey changed during this period. The research methodology was changed, the relevant questions were phrased differently and the order of the questions was changed.

Figure 3.1 – Residential consumers’ satisfaction with aspects of postal services

Source: Ofcom Residential Postal Tracker 2016²³

Base: All respondents (n=6419)

QG2 How satisfied are you overall with the postal services in terms of delivering value for money for sending mail?; QG6 How would you rate your overall satisfaction with postal services?; QG5 How would you rate your overall satisfaction with Royal Mail?

- 3.17 As shown in Figure 3.1, a large majority (85%) of residential consumers said that they were fairly or very satisfied with postal services overall. A large majority (82%) of residential consumers also said they were fairly or very satisfied with Royal Mail. In addition, 75% of residential consumers said that they were either fairly or very satisfied with the value for money of postal services.
- 3.18 We have also considered how overall satisfaction with Royal Mail varied across the nations of the UK. While overall satisfaction with Royal Mail is generally high (over 82% of all respondents, as stated above) with minimal variation between nations, consumers in Northern Ireland were the most satisfied, as 88% said they were either fairly or very satisfied with Royal Mail. We also specifically considered satisfaction with the value for money of postal services among consumers in the nations. Though our consumer research shows slight variation, over 70% of consumers in all nations expressed satisfaction with the value for money of postal services; Northern Ireland was the nation with the highest percentage of consumers stating that they were fairly or very satisfied (80%).
- 3.19 As shown in Figure 3.2, most residential consumers believe stamps – which continue to be the main way consumers use Royal Mail’s services – are either fairly or very good value for money. 64% of consumers think First Class stamps are fairly or very good value for money; while 56% of consumers think Second Class stamps are fairly or very good value for money.

²³ Ofcom, *Residential Postal Tracker 2016*, 27 February 2017, https://www.ofcom.org.uk/_data/assets/pdf_file/0034/97747/Ofcom-Residential-Postal-Tracker-Q1-Q4-2016-tables-240217.pdf

3.20 We have also considered how stamp prices in the UK compare to stamp prices in other comparable countries based on typical envelope sizes. Universal service providers in other comparable countries typically have three sizes of letter products – ‘small’, ‘medium’ and ‘large’; whereas Royal Mail has two – ‘letters’ (equivalent to other countries’ ‘small’ and ‘medium’ letters) and ‘large letters’.²⁴ Effectively this means that consumers in the UK pay the same price to send a letter that meets the dimension of ‘small’ and ‘medium’ sized letters in other countries.

3.21 At 64p,²⁵ the UK is therefore one of the most expensive countries in which to send a ‘small’ First Class letter, after Italy and Australia.²⁶ However, the UK is one of the least expensive countries in which to send both ‘medium-sized’ and ‘large’ letters.

Figure 3.2 – Residential consumers’ perception of value for money of First and Second Class stamps



Source: Ofcom Residential Postal Tracker 2016

Base: All respondents (n=6419)

QF4: A First Class stamp currently costs [price at time of interview]. How would you rate Royal Mail’s First Class service in terms of value for money?; QF5: A Second Class stamp currently costs [price at time of interview]. How would you rate Royal Mail’s Second Class service in terms of value for money?

SME satisfaction levels

3.22 Figure 3.3 shows that satisfaction levels with Royal Mail and other postal operators are high amongst small and medium enterprises (SMEs). Satisfaction rates are higher for other postal operators with 88% of SME survey respondents being either fairly or very satisfied with services from other providers, compared to 78% being either fairly or very satisfied with Royal Mail.

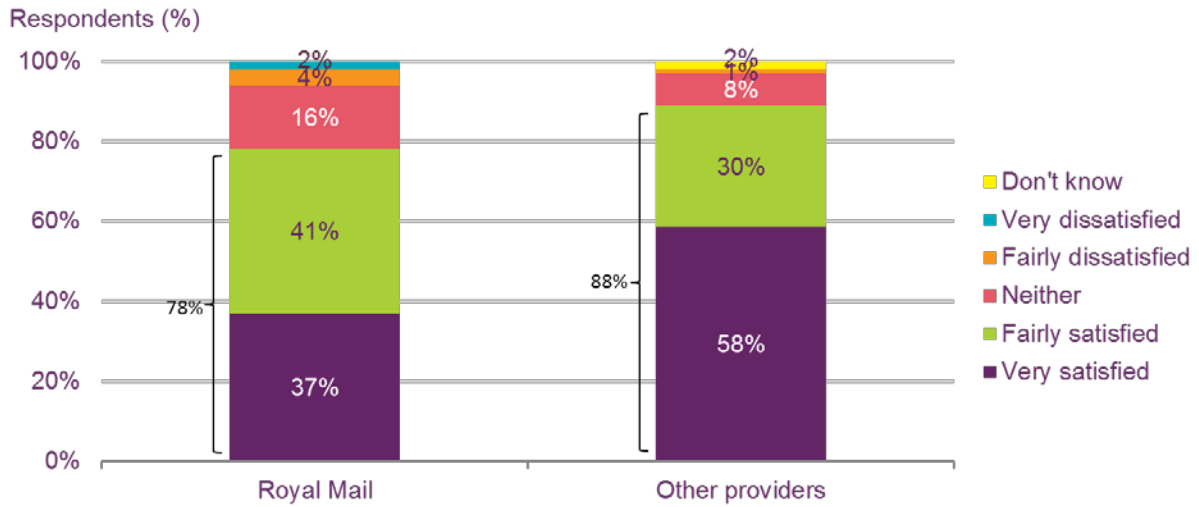
²⁴ A small letter is based on a DL envelope, a medium letter a C5 envelope and a large letter a C4 envelope.

²⁵ We note that Royal Mail has announced price increases that will take effect on 27 March 2017. This does not change our assessment of stamp prices’ value for money.

²⁶ Ofcom, *The International Communications Market Report*, 2016, pages 192-193

https://www.ofcom.org.uk/_data/assets/pdf_file/0030/95664/ICMR-2016-7.pdf.

Figure 3.3 – Satisfaction levels amongst businesses for Royal Mail and other postal operators



Source: Ofcom Business Postal Tracker 2016²⁷

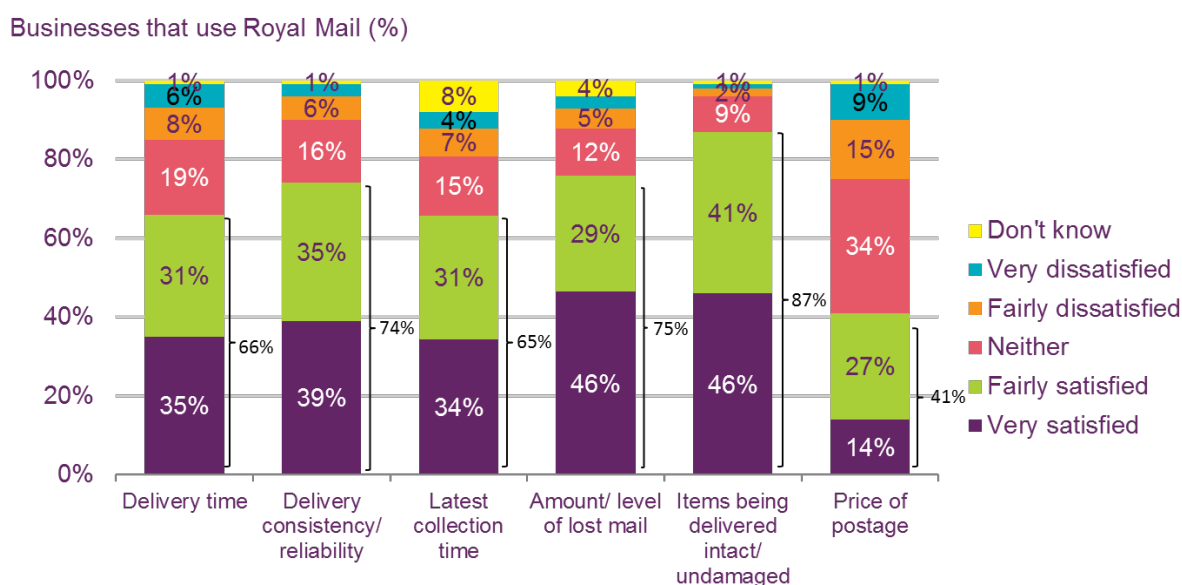
Base: All businesses using Royal Mail (n=1951); All who do not use Royal Mail (n=389)

QRM2: Thinking generally about the service your organisation receives as a whole, how satisfied are you with the overall quality of the services you receive from Royal Mail as a recipient and sender?; QOP1a. You said earlier that you also use [QV4 provider] for your postal services needs. Thinking generally about the service you receive as a whole as a sender and recipient of mail, on a scale of 1 to 5 where 1 is very dissatisfied and 5 is very satisfied, how would you rate the quality of the services you receive from [QV4 provider]?

3.23 As shown in Figure 3.4, there were high levels of satisfaction with all aspects of Royal Mail’s services except for ‘price of postage’, which was the only aspect where less than 50% of businesses said they were either ‘fairly satisfied’ or ‘very satisfied’. Despite this, only 24% said they were either ‘fairly dissatisfied’ or ‘very dissatisfied’ with the price of postage.

²⁷ Ofcom, Business Postal Tracker 2016, 27 February 2017, <http://static.ofcom.org.uk/static/pdf/Ofcom%20Business%20Postal%20Tracker%202016%20Annual%20tables%2024-02-2017.pdf>

Figure 3.4 – Businesses’ satisfaction with aspects of Royal Mail



Source: Ofcom Business Postal Tracker 2016.

Base: All businesses using Royal Mail (n=1951)

QRM3 How would you rate the performance of Royal Mail, as a recipient and sender, in the following areas on a 5 point scale where 1 is very dissatisfied and 5 is very satisfied? (Delivery time – when you receive your mail delivery; Delivery consistency / reliability (e.g. arrives as promised consistently); Latest collection time; Amount/level of lost post sent.

Quality of Service

- 3.24 Since the current regulatory framework was put in place in 2012, there has been a general improvement in Royal Mail’s quality of service performance compared to the five-year period prior to 2012.
- 3.25 In the period from 2007-08 to 2011-12, Royal Mail met its First Class target only once (in 2008-09). In 2007-08 and 2009-10 it failed its First Class target by a significant margin, while it narrowly failed in 2010-11 and 2011-12. Its Second Class quality of service performance was only marginally better during this period. It met or exceeded its Second Class target twice (in 2008-09 and 2011-12 respectively) but failed to meet the target in 2007-08, 2009-10 and 2010-11. On two of these occasions, it failed by a significant margin while in 2010-11 it narrowly failed.²⁸
- 3.26 Since the regulatory framework was put in place in 2012, Royal Mail’s First and Second Class quality of service performance has improved. It has met or exceeded its First and Second Class targets in most years and where there have been failures these have generally been by a narrower margin than in the period 2007-08 to 2011-12.
- 3.27 Although it failed to meet its First Class target in 2012-13, it exceeded the target in both 2013-14 and 2014-15 before failing again in 2015-16. Royal Mail has met or exceeded its Second Class target every year since the framework was put in place.²⁹

²⁸ See Ofcom, *Annual Monitoring Update on the Postal Market 2011-12*, pages 16-18

https://www.ofcom.org.uk/_data/assets/pdf_file/0020/49502/monitoring-update2011-12.pdf.

²⁹ See the Annual Monitoring for 2015-16, Interactive Data, https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data.

In addition, Royal Mail's performance against its Post Code Area (PCA) target (a minimum of 91.5% First Class items met in 118 of 121 PCAs) has been better since 2012 than in the prior period. It has achieved the 91.5% target in more PCAs since 2012 than it did in the prior period when it failed to meet the target by a significant margin on a number of occasions.³⁰

- 3.28 Following an investigation into Royal Mail's failure to meet some of its quality of service targets in 2015-16, in October 2016 we concluded that Royal Mail had contravened Designated Universal Service Provider (DUSP) condition 1.9.1. In particular, Royal Mail missed its First Class delivery target. Although we did not impose a financial penalty we said that if it breaches the condition again, we may consider the imposition of a significant financial penalty.³¹ High but achievable quality of service targets remain a key element of the postal regulatory framework, in order to ensure that the interests of consumers are met.
- 3.29 We note that Royal Mail raised some specific concerns with the quality of service regime in its consultation response. However, we expect Royal Mail to ensure it meets quality of service requirements going forward. We monitor Royal Mail's performance against its quality of service targets closely so that we can take prompt and appropriate action if we identify failures.
- 3.30 In November 2016 Ofcom received a submission from Royal Mail requesting a review of the quality of service regime in light of changes in the postal sector over the last 10 years. We are in the process of reviewing Royal Mail's submission and will consider what, if any, changes may be necessary to the quality of service regime during the first half of 2017-18.

Summary

- 3.31 Having considered the responses to the May 2016 Consultation and the new information received, we consider that the 2012 regulatory framework has been largely positive for consumers – both residential and business customers. In particular, satisfaction with postal services among both residential consumers and SME businesses remains high. In addition, while Royal Mail has not met all its quality of service targets in all years since the introduction of the regulatory framework in 2012, its performance against its First and Second Class delivery targets has generally improved over this time. Its overall performance in the five years since the introduction of the regulatory framework in 2012 is better than its performance in the previous five years.
- 3.32 However, we note that stakeholders raised concerns about some particular elements of consumer satisfaction. In particular:
- Concerns about delivery (particularly high prices or long waiting times) preventing consumers placing an order online;
 - Varying levels of satisfaction with postal services across the nations of the UK; and

³⁰ See Ofcom, *Annual Monitoring Update on the Postal Market 2011-12*, and Ofcom, *Annual Monitoring Update on the Postal Market 2015-16*, for a comparison of performance in these periods.

³¹ Ofcom, *Decision to conclude investigation of Royal Mail Group Limited in relation to a contravention of Designated Universal Service Provider Condition 1.9.1*, October 2016

https://www.ofcom.org.uk/_data/assets/pdf_file/0028/92746/161020-non-confidential-decision-v3.pdf

- Surcharging for parcel delivery in Northern Ireland and the Highlands & Islands of Scotland.
- 3.33 These consumer concerns appear to focus on delivery, and in particular the price of delivery in certain circumstances. Given that some retailers use delivery providers which charge a surcharge for delivering to Northern Ireland, this may explain why consumers in Northern Ireland are more likely to have abandoned an online delivery order.³² We are currently working with the CCNI and Citizens Advice Scotland to better understand the causes and effects of parcel surcharging in Northern Ireland and the Scottish Highlands & Islands, and we published a summary of the work undertaken so far in our 2015-16 Annual Monitoring Update on the Postal Market (the '**Annual Monitoring Report 2015-16**').³³
- 3.34 We will continue to monitor levels of satisfaction and perceptions of value for money through our consumer and business surveys and provide analysis on survey findings in our annual monitoring updates. Although satisfaction with postal services is currently high (at least 80%) in each of the nations of the UK, we intend to monitor and report on the experience of consumers both across the UK as a whole and in each of the nations – in order to ensure that we are able to observe any differences within the UK. In order to better monitor consumers' experiences in the postal sector, specifically with regards to monitoring the evolution of postal user needs and preferences, we have added additional questions to our postal trackers. We will continue to monitor quality of service closely, and will consider what, if any, changes may be necessary to the quality of service regime during the course of 2017-18.

Scope of the universal service

May 2016 consultation

- 3.35 In the May 2016 Consultation we explained that prior to changing the scope of the universal service (as set out in the Postal Services (Universal Service) Order 2012) we are required by the PSA 2011 to first undertake a review of users' needs.
- 3.36 We noted that while we continue to monitor the preferences of postal users in our postal tracker surveys and other information provided to Ofcom, we had not carried out such a review with a view to determining whether the current postal market is meeting the reasonable needs of postal users. Given this, we explained that changes to the scope of the universal service were outside the scope of this review. However, we noted that we would continue to monitor changes in consumer preferences and said that we expected to undertake a review of users' needs before the end of the proposed regulatory period (i.e. 2022).

Responses to consultation

- 3.37 In response to the May 2016 Consultation a number of stakeholders argued there was a need to change the scope of the universal service now. This included Royal Mail's request for tracked parcel services to be included in the universal service and an argument from DX and CFH that meter services should no longer be included in the universal service.

³² See for example 'The Online Parcel Premium', CCNI, June 2015

http://www.consumercouncil.org.uk/filestore/documents/Online_Parcel_Premium_%28FINAL%29.pdf.

³³ See Ofcom, Annual Monitoring Report for 2015-16, paragraphs 5.36–5.60

https://www.ofcom.org.uk/_data/assets/pdf_file/0029/94961/2015-16-Annual-Report.pdf.

- 3.38 Royal Mail argued that tracking should be included as standard on universal service parcels. In particular, it considered more consumers will expect to be able to track their parcels as this is the standard in the rest of the industry. This view was supported by CWU, Unite, the National Federation of Subpostmasters and the CCP.
- 3.39 CFH said that our analysis ignored the issue of metered items being considered a universal service product as defined by the Postal Services (Universal Postal Service) Order 2012 and considered that meter services should no longer be included in the universal service.

Our assessment

- 3.40 As set out in the May 2016 Consultation, prior to making any change to the scope of the universal service as defined in the Universal Postal Service Order, we would need to have carried out an assessment of users' needs. We currently monitor the evolution of postal user needs and preferences as part of our annual postal tracker surveys and through our monitoring regime and, in addition, we expect to undertake a further review of users' needs within the next five years.
- 3.41 We discuss our view on whether tracked parcels should be included in the universal service in paragraphs 4.5 to 4.31.
- 3.42 We note that CFH has argued that meter services do not meet the definition of universal services set out in the Universal Postal Service Order and that they should not be included in the universal service. We continue to consider that meter services may be used as a payment method for universal services provided that they meet the definition of single piece universal services as set out in the Universal Postal Service Order and DUSP 1. When used as a payment method for bulk mail, meter mail is not included in the universal service.
- 3.43 Given that the scope of this review does not include consideration of potential changes to the scope of the universal service, we have not made an assessment of whether the particular characteristics of the products identified by CFH meet the definition of single piece universal services as set out in the Universal Postal Service Order and DUSP 1. However, we intend to separately look into this matter in due course.

Approach to financial sustainability assessment

- 3.44 In March 2012, in light of our duty to secure the provision of a financially sustainable and efficient universal postal service, we adopted the Earnings before Interest and Taxation (EBIT) margin metric for assessing the commercial rate of return and financial sustainability of the Reported Business.³⁴ We also stated that we considered that an indicative EBIT margin range of 5%-10% was consistent with a commercial rate of return for the Reported Business.

Summary of initial findings

- 3.45 In the May 2016 Consultation, we:
- reviewed the continued appropriateness of the Financeability EBIT margin metric;

³⁴ The Reported Business is the regulatory entity which contains the universal postal service network and all the products provided through or in relation to that network.

- reviewed the continued appropriateness of the 5%-10% EBIT margin range to assess the medium to long-term financial sustainability of the universal service; and
 - considered whether there were any other metrics that would give us a better understanding of the short to medium-term financial sustainability of the universal service.
- 3.46 We refer to our particular measure of EBIT margin, which we use for our financial sustainability assessments, as the ‘Financeability EBIT margin metric’.³⁵ To calculate the EBIT margin metric, we deduct transformation costs³⁶ and adjust EBIT to restate pension costs on a cash basis, rather than the rate derived in accordance with the accounting standards. We consider the cash based rate to give a better view of current and future pension costs.
- 3.47 In reviewing the continued appropriateness of the Financeability EBIT margin metric, we considered other metrics such as using a Return on Asset (ROA) methodology. We found that a key difficulty in adopting the ROA approach would be the practicability issues involved in determining a robust value for the Regulatory Asset Base (RAB) of the Reported Business. We therefore proposed to continue to use the Financeability EBIT margin of the Reported Business to assess the commercial rate of return of the universal postal service provider for the purposes of assessing financial sustainability over the medium to long-term.
- 3.48 To determine a Financeability EBIT margin range that is consistent with a commercial rate of return, we considered the EBIT margins of appropriate benchmark companies, and the levels of EBIT margin that are consistent with a satisfactory score on various financial health metrics. We provisionally concluded that the 5-10% indicative range that we had applied since 2012 continued to be consistent with a commercial rate of return for the Reported Business.
- 3.49 We noted however that our work on the EBIT margin benchmark had been from the financial sustainability viewpoint. We recognised that the top end of our indicative EBIT margin range may be relevant to an assessment of potentially excessive returns, but we expected that, to carry out such an assessment, we may need to consider further ways of benchmarking the EBIT margin, and perhaps revisit other metrics such as ROA.
- 3.50 To assess the short to medium-term financial sustainability of the universal service we proposed to supplement the cash flow projections of the Relevant Group³⁷ with a consideration of both the ‘Viability Statement’ which Royal Mail now presents in its Annual Statutory Accounts, and a range of financial health metrics that assist in the assessment of the Relevant Group’s ability to meet its financial obligations.

Stakeholder responses

- 3.51 Stakeholders that responded to our proposal to continue to use the EBIT margin metric agreed that it was the appropriate approach for assessing the financial

³⁵ See the May 2016 Consultation, paragraph A6.8, and the 2014 End-to-end Statement, paragraphs 3.12–3.28.

³⁶ Transformation costs are annually recurring costs which Royal Mail incurs in order to modernise its business and operations, including redundancy and restructuring costs.

³⁷ We refer to Royal Mail PLC and the group of companies it holds collectively as the Relevant Group.

sustainability of the provision of the universal service. However, Royal Mail was concerned that Ofcom may augment its monitoring with an ROA approach if its financial returns reached the upper end of the 5-10% range. It stated that there were significant practical challenges involved in using a ROA approach for a people-based business.

- 3.52 In relation to the proposed indicative 5-10% EBIT margin range for a reasonable commercial rate of return, Hermes agreed that this approach should be maintained. Royal Mail said that an EBIT margin of 5-10% was the minimum necessary to ensure financial sustainability and returns within this range were important to delivering the long-term sustainability of the universal service. The CWU questioned whether the proposed range was adequate to ensure the financial sustainability of the universal service, citing FTI Consulting's July 2015 discussion document response which argued that Moody's methodology suggested that an EBIT margin between 8% and 12% was required for an investment grade credit rating.
- 3.53 Royal Mail agreed with our proposal to supplement our present approach with consideration of the Viability Statement and financial health metrics, but argued that we should also consider "dividend-related metrics" given equity was a fundamental part of Royal Mail's capital structure.

Our assessment

- 3.54 There was general support amongst those who responded to our financial sustainability proposals relating to our continued use of the indicative 5-10% EBIT margin range to assess Royal Mail's medium to long-term financial sustainability.³⁸
- 3.55 We agree with Royal Mail that there are challenges in using a ROA approach for the Reported Business (as we set out in the consultation).³⁹ However, we continue to believe that, were the difficulties addressed, the strong theoretical underpinning behind the ROA approach means it could be informative in an assessment of potentially excessive returns.⁴⁰
- 3.56 The only objection to the maintenance of the 5-10% EBIT margin range that we proposed as the benchmark for the reasonable commercial rate of return of the Reported Business came from the CWU. It noted that Moody's methodology for the postal sector indicated that an 8-12% EBIT margin was required for an investment grade rating.
- 3.57 We note that Standard & Poor's have been providing the credit rating for Royal Mail's 10-year €500 million bond and the EBIT margin is one of many metrics Standard & Poor's consider in determining the credit rating. From discussions with Royal Mail we understand that FFO/Net debt⁴¹ is the most important metric used by Standard &

³⁸ The reasoning for these proposals is set out in the May 2016 Consultation, Annex 6, paragraphs A6.16-A6.42.

³⁹ See the May 2016 Consultation, paragraphs A6.16-A6.42.

⁴⁰ As we set out in the May 2016 Consultation, our work on the EBIT margin benchmark has been from the financial sustainability viewpoint. We recognise that the top end of our indicative EBIT margin range may be relevant to an assessment of potentially excessive returns, however, we expect that in order to carry out such an assessment, we may need to consider further ways of benchmarking the EBIT margin, and perhaps revisit other metrics such as ROA.

⁴¹ Net Debt is a measure of a company's liabilities at a certain point in time which nets off the company's cash and other liquid assets against its debts. FFO (Funds From Operations) is a measure of the net cash flows generated by a company's operations in a financial period, typically one year.

Poor's in assigning its credit rating. In the consultation we used information received from Royal Mail (which included Royal Mail's Business Plan 2015) to assess the level the FFO/Net debt metric would need to fall below for the investment grade credit rating to be at risk.

- 3.58 We investigated scenarios where there is a revenue loss in the Reported Business both accompanied and unaccompanied by a cost reduction. We found the EBIT margins associated with these scenarios were all below 5%. This means the risk to the credit rating is likely to arise at EBIT margins below 5%. This provides further support for the appropriateness of the 5-10% range as a benchmark for a commercial rate of return of the Reported Business.
- 3.59 We have updated this analysis (using Royal Mail's Business Plan 2016) and the results continue to show that the relationship between the FFO/Net Debt ratio and EBIT margin supports our view that the lower end of the 5-10% range remains appropriate.
- 3.60 We have also updated our analysis of the EBIT margins of appropriate benchmark companies.⁴² The results continue to support our view that the 5-10% EBIT margin is an appropriate range for assessing what is a reasonable commercial rate of return for the Reported Business.
- 3.61 Royal Mail was the only stakeholder that responded on our proposal to supplement our current approach with consideration of the Viability Statement and financial health metrics, and it welcomed our proposal. We continue to believe that consideration of this wider range of information and metrics will assist us in our assessment of the Relevant Group's ability to meet its financial obligations.
- 3.62 We consider that dividend-related metrics suggested by Royal Mail may be useful to the extent that they are relevant to the financial sustainability of the universal service. However, listed companies such as Royal Mail are expected to preserve their dividend levels as long as possible in order to maximise returns to their shareholders and the value of the company. This means dividend-related metrics tend to be among the last metrics to indicate any problems. We therefore do not intend to focus on or limit ourselves to these metrics. Additionally, while Royal Mail's main objective is to maximise returns to its shareholders, our primary duty is to secure the provision of a universal service, having regard for the need for it to be financially sustainable and efficient (as discussed further below).
- 3.63 For the reasons set out above, we have decided to supplement our current approach for assessing whether the provision of the universal service is financially sustainable (Financeability EBIT margin of the Reported Business with an indicative range of 5-10% and cash flow of the Relevant Group) with consideration of a range of financial health metrics and indicators assessed at the Relevant Group level.

⁴² In paragraph A6.74 of the May 2016 Consultation we set out the companies we consider to be appropriate comparators to the Reported Business, we have reviewed the EBIT margins of those companies for any update in their achieved returns.

Update on financial sustainability

Summary of initial findings

3.64 In the May 2016 Consultation we said that, based on the information available at the time, we expected the Reported Business to make returns within the next two years consistent with the indicative 5-10% EBIT margin range. Additionally, Royal Mail's current and forecast cash headroom, our assessment of its position against other financial health metrics and its Viability Statement indicated no short to medium term financial health issues.⁴³ On this basis, we considered that the universal service was likely to remain financially sustainable in the immediate future. However, we recognised that there were various downside scenarios which had the potential to impact the future financial sustainability of the universal postal service.

Our assessment

3.65 Since the publication of our consultation in May 2016, we have received further relevant information, with which we have updated our assessment of the financial sustainability of the provision of the universal service. This includes:

- Royal Mail's regulatory accounts for 2015-16;
- A new business plan from Royal Mail ('Business Plan 2016') which supersedes its previous business plan ('Business Plan 2015' which we reviewed as part of our work on the consultation); and
- Royal Mail's half year results for 2016-17 and Q3 trading update (for the quarter ended December 2016).

3.66 Our assessment indicates that the universal service is likely to remain financially sustainable in the immediate future. However, we recognise that downside risks remain in the forecasts that inform our assessment. These downside risks include economic and market downturn (which could cause higher decline or lower growth in volumes than expected), cost challenges such as those relating to Royal Mail's defined benefit pension scheme and the new pay deal under negotiation, and the competitive pressures on Royal Mail's parcel volumes and revenues.

3.67 The Financeability EBIT margin of the Reported Business was 5.0% in 2015-16 (5.6% in 2014-15).⁴⁴ Our review of the quarterly regulatory accounts for the first three quarters of 2016-17 and the forecast for the remainder of the financial year shows the Financeability EBIT margin is expected to be [redacted] for 2016-17. [redacted].

3.68 Royal Mail's Business Plan 2016 forecasts the Financeability EBIT margin for the Reported Business to be [redacted]. The Business Plan 2016 forecasts the Financeability EBIT margin to [redacted]. The Business Plan 2016 forecast for 2017-18 is [redacted].

3.69 [redacted], we consider that the universal service is likely to remain financially sustainable in the immediate future. Our key reasons are:

⁴³ See the May 2016 Consultation, paragraphs 4.27-4.33, pages 37-39.

⁴⁴ See the Annual Monitoring Report for 2015-16, page 45, Figure 6.1, https://www.ofcom.org.uk/_data/assets/pdf_file/0029/94961/2015-16-Annual-Report.pdf.

- As we explain below, the financial position (including cash flow projections) and financial health metrics (including credit rating) of the Relevant Group do not indicate any short to medium-term financial health issues; and
 - The challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable (see paragraphs 3.170 – 3.174 below). Continued progress on efficiency is likely to improve the profitability of the Reported Business and ensure the financial sustainability of the universal service.
- 3.70 We have considered the cash position of the Relevant Group and reviewed the current and forecast cash headroom⁴⁵ for the next six quarters following December 2016.⁴⁶ These forecasts show [3<].
- 3.71 Our review of the actual values of financial health metrics and forecast values of those metrics over the next three financial years (2016-17 to 2018-19) – in particular the metrics that the credit rating agencies and Royal Mail’s lenders use⁴⁷ – indicate no short to medium-term financial health issues.
- 3.72 Royal Mail has maintained its investment grade credit rating. In July 2016, Standard & Poor’s, which provides Royal Mail with its credit rating, affirmed its BBB and A-2 ratings with a ‘Stable Outlook’ stating that: “We view Royal Mail’s liquidity as exceptional, reflecting our expectation that the company’s sources of liquidity will exceed uses by more than 2x over the coming two years. This is supported by our view that Royal Mail has well-established relationships with banks, a high standing in credit markets, ample headroom under its financial covenants, and generally prudent risk management.”⁴⁸
- 3.73 Royal Mail’s trading update for the nine months ended 25 December 2016, which was released on 19 January 2017, stated: “Our performance in the first nine months of the financial year was in line with our expectations.”⁴⁹ In addition, Royal Mail’s half year results for 2016-17 (April to September 2016) announced in November 2016 set out details of an increase in the interim dividends paid.⁵⁰
- 3.74 In light of the above, we consider that the universal service is likely to remain financially sustainable in the immediate future. However, we recognise that there are various downside risks to the forecasts that inform this view (including economic and market downturn, cost challenges including future pension costs, and the competitive pressures in the parcels sector).

⁴⁵ Cash headroom is defined as cash balances plus undrawn available borrowing facilities.

⁴⁶ Royal Mail provides us, in accordance with the USP Accounting Condition, with quarterly cash flow forecasts which cover the following six quarters.

⁴⁷ Funds From Operations (FFO) / Net Debt; Net Debt / Earnings before Interest, Tax, Depreciation, and Amortisation (EBITDA); and EBITDA / Interest (also known as Interest cover).

⁴⁸ Standard and Poors, Research Update: Royal Mail Ratings Affirmed at 'BBB/A-2'; Outlook Stable; 25 July 2016, www.standardandpoors.com/ratingsdirect (accessed July 2016).

⁴⁹ Royal Mail, *Trading Update for the nine months ended 25 December 2016*, 19 January 2017, page 3, <http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%209M%202016-17%20Trading%20Update.pdf>.

⁵⁰ Royal Mail, *Royal Mail plc Half Year 2016-17 Results*, page 14 <http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20Half%20Year%202016-17%20Results%20Presentation.pdf>.

- 3.75 In the Viability Statement set out in the 2015-16 Annual Report of Royal Mail plc published on 3 June 2016,⁵¹ the Directors stated that they had assessed the viability of the Group (Relevant Group) over the next three financial years, focusing on the risks “that could have plausible and severe financial impact.” They stated that “the risks were quantified to create a downside scenario that took into account the levels of committed investment and expenditure, as well as other short-term cost and cash actions which could mitigate the impact of the risks... The downside scenario was tested to determine whether the Group would remain solvent.” The Directors concluded that they “have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2019.”
- 3.76 One of the key downside risks to the forecasts that inform our views on financial sustainability relates to Royal Mail’s future pension costs. Pension costs are a significant component of the total costs used to calculate the Financeability EBIT margin, and, as such, changes in these costs have the potential to have a significant impact on this measure of financial sustainability. The largest component of Royal Mail’s pension costs relates to its defined benefit pension scheme, the Royal Mail Pension Plan (RMPP).
- 3.77 In its November 2016 half year report, Royal Mail stated: “... the cost of the benefits being accrued each year, based on market conditions at the end of September 2016, would currently be around £1.4 billion. This is significantly greater than the total annual contributions of around £500 million that the Company and employees make. Accordingly, we expect that the actuarial funding surplus will be exhausted during 2018. After this time, the annual cost would be more than double the current contributions, which, as we pointed out to Plan members in a letter we sent in June 2016, is unaffordable for the Company.”⁵²
- 3.78 Royal Mail also stated in its November 2016 half year report that: “We are well advanced with the triennial review of the Royal Mail Pension Plan (RMPP, the Plan), which remains open to future accrual by around 90,000 members. We wrote to these colleagues in the summer, indicating that it was unlikely that Royal Mail could afford to keep the Plan open in its current form beyond the committed period to March 2018. We are in active discussions with the Trustee about the 2015 valuation, and with the unions about the nature of our future pension arrangements. We are targeting to have this resolved around the end of this financial year.”⁵³
- 3.79 In January 2017, Royal Mail commenced a consultation process with the active members of the RMPP and its unions about its proposal for the future of the Plan from April 2018.⁵⁴ This consultation closes in March 2017.
- 3.80 As we stated in our May 2016 Consultation, we undertook work to gain a better understanding of Royal Mail’s future pension costs. This has helped us develop a better understanding of the RMPP’s financial position and the range of possible scenarios that could arise in the future and following any pension negotiations. We

⁵¹ Royal Mail, *Annual Report and Financial Statements 2015-16*, page 35, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202015-16_0.pdf.

⁵² Royal Mail, *Results for the half year ended 25 September 2016*, Page 19,

<http://www.royalmailgroup.com/sites/default/files/Half%20Year%20Results%202016-17.pdf>.

⁵³ Royal Mail, *Results for the half year ended 25 September 2016*, Page 6.

⁵⁴ <http://www.royalmailgroup.com/media/press-releases/royal-mail-begins-consultation-active-members-royal-mail-pension-plan-part-2018>

will continue to monitor how the pension agreement process develops and the consequences this will have on future changes in pension costs. Overall, we remain of the view, as set out in the May 2016 Consultation, that we would not expect Royal Mail to agree a level of future contributions which are unaffordable and could jeopardise its financial sustainability.

Efficiency

Summary of initial findings

- 3.81 Ofcom has a duty to have regard to the need for the provision of the universal service to become and remain efficient. Given that efficiency can play an important role in ensuring that Royal Mail is able to continue providing a financially sustainable universal service, it is essential that the regulatory framework continues to provide appropriate incentives for Royal Mail to realise its potential to become more efficient. The framework should be such that Royal Mail is incentivised to make efficiency savings rather than rely on raising prices in order to achieve financial sustainability.
- 3.82 In the May 2016 Consultation we reviewed Royal Mail's efficiency in the provision of the universal service. Our assessment included a third party review of Royal Mail's business plan (the "**2015 Business Plan**") by WIK-Consult, including a comparison of Royal Mail's modernisation plans with the plans of comparable postal operators. We also considered Royal Mail's business plan, historic performance and econometric analysis by Deloitte of Royal Mail's performance in its delivery offices and mail centres.
- 3.83 We found that Royal Mail had made progress on efficiency in recent years, and that its future plans (if successfully executed) would result in greater efficiency improvements than its historic achievement. However, our analysis also indicated that there remained potential for Royal Mail to make greater efficiency gains than those it was forecasting.⁵⁵
- 3.84 We also observed a number of factors which might limit Royal Mail's ability to realise further efficiency gains, including the need for Royal Mail to reach a new labour agreement and pension settlement. Further, we noted that the flexibility of its frontline operations in delivery and processing had reduced which may make it more difficult to remove costs in response to short term fluctuations in volume.
- 3.85 Taking all of this into account, we provisionally concluded that Royal Mail's proposed efficiency initiatives and levels of cost reduction were reasonable. We proposed not to impose efficiency targets or price controls on Royal Mail's universal service network. We considered that Royal Mail had sufficient incentives to improve its efficiency and that the rate of efficiency improvement proposed in its 2015 Business Plan was reasonable, but at the lower end of a reasonable range for improvement.⁵⁶

⁵⁵ For example, our econometric analysis indicated that Royal Mail could further increase its efficiency by raising the performance of poorer performing delivery offices and mail centres to match their higher performing peers, and from fully realising the efficiency gains from the initiatives already implemented as part of the modernisation programme. In addition, WIK identified a number of initiatives available to Royal Mail which it had not yet implemented but have improved the efficiency of some other postal operators. See the May 2016 Consultation, paragraphs A5.149-A5.189.

⁵⁶ See the May 2016 Consultation, paragraph A5.1.

Stakeholder responses

- 3.86 Some stakeholders disagreed with our proposal not to impose efficiency targets on Royal Mail.⁵⁷ These respondents argued that the evidence presented in our consultation was sufficient to justify the introduction of efficiency targets. In particular, these respondents argued that despite making some progress, Royal Mail had not realised the efficiency gains that our analysis indicated were available. They argued that the regulatory framework did not therefore appropriately incentivise efficiency improvement.
- 3.87 The CCP stopped short of calling for the imposition of efficiency targets but said that the level of transparency of Royal Mail's performance in improving efficiency should be increased. It argued that Ofcom should require Royal Mail to publish a plan setting out details of how it intends to secure its more ambitious efficiency gains – including contingency options if its plans do not succeed.
- 3.88 Royal Mail, the CWU and Unite agreed with our proposal not to impose efficiency targets.⁵⁸ However, each of them disagreed with our finding that Royal Mail's efficiency plans were at the lower end of a reasonable range. Royal Mail said it had a stretching efficiency programme and that there was no need for any additional efficiency incentives. In response to the analysis conducted by WIK-Consult on our behalf, Royal Mail argued that it had already assessed the efficiency initiatives identified and did not believe there were further significant opportunities, although this was subject to continuous review. Royal Mail further argued that the efficiency gap across delivery offices and mail centres, as evidenced by our econometric analysis, is small and narrowing. CWU and Unite argued that regulatory pressure to improve efficiency was causing a race to the bottom which would drive down standards across the industry and threaten quality of service.

Our assessment

- 3.89 Since our consultation, Royal Mail has reported its full year financial results for 2015-16. We analysed the results and summarised the efficiencies achieved in our Annual Monitoring Report for 2015-16.⁵⁹ Royal Mail has also submitted a new business plan, the 2016 Business Plan. We reviewed this updated information to inform our analysis and final conclusions on Royal Mail's efficiency.
- 3.90 Our review of the efficiencies achieved by Royal Mail in 2015-16 showed that it has continued to achieve efficiency savings but at a level lower than in 2014-15:
- Real costs of the Reported Business reduced by 1.7%⁶⁰ compared to 2.1% in 2014-15.
 - Efficiency of the Reported Business, as calculated by PVEO analysis⁶¹ was 1.5%, a reduction on the efficiency achieved in 2014-15, which was 2.6% (excluding

⁵⁷ See the May 2016 Consultation responses from Whistl, MUA, MCF, Secured Mail and DMA.

⁵⁸ See the May 2016 Consultation responses from Royal Mail, CWU and Unite.

⁵⁹ See Ofcom's Annual Monitoring Report for 2015-16, Chapter 7

https://www.ofcom.org.uk/_data/assets/pdf_file/0029/94961/2015-16-Annual-Report.pdf.

⁶⁰ In the Annual Monitoring Report for 2015-16, paragraph 7.11 this figure is presented as 1.6%, due to rounding.

⁶¹ "PVEO" analysis identifies cost movements due to inflation, volume, efficiency and other (one-off activities). Efficiency is calculated as the residual item once the other three categories of cost movements have been accounted for.

transformation costs, which are the costs incurred in achieving efficiencies). At the same time, transformation costs increased.

- The hours' reduction achieved in frontline delivery and processing (2.0% reduction) was slightly lower than that achieved in the prior year (2.3% reduction in hours).

3.91 [redacted]⁶² [redacted].

3.92 In addition to considering the latest actual results, we have reviewed the efficiencies targeted in Royal Mail's 2016 Business Plan and the high level view presented in its longer term strategic plan.

3.93 The table below (Figure 3.5) summarises our quantitative assessment. It shows a series of metrics to compare actual efficiency with that assumed within both the 2015 and 2016 Business Plans.

Figure 3.5 – Summary of Efficiency Metrics

Year on Year Change	2015/16 Actual	2015/16 Forecast 2015 Plan	2015/16 to 2017/18 2015 Plan 3 Year Average	2016/17 to 2018/19 2016 Plan 3 Year Average ⁶³
Delivery Hours ⁶⁴	[redacted]	[redacted]	[redacted] ⁶⁵	[redacted] ⁶⁶
Gross Hours ⁶⁷	-2.0% ⁶⁸	[redacted] ⁶⁹	[redacted] ⁷⁰	[redacted] ⁷¹
Pay Rate	2.8%	[redacted]	[redacted] ⁷²	[redacted]
PVEO Efficiency	1.5% ⁷³	[redacted]	[redacted] ⁷⁴	[redacted] ⁷⁵
Real Costs ⁷⁶	-1.7% ⁷⁷	[redacted]	[redacted]	[redacted]

⁶² [redacted]

⁶³ 2018-19 is a 53-week accounting year. This has been adjusted to 52-week so that figures are comparable.

⁶⁴ Excluding change in hours due to volume.

⁶⁵ See the May 2016 Consultation, paragraph A5.164 and Figure A5.6.

⁶⁶ Ofcom estimate based on extrapolation of budget year assumptions. 2018-19 has been adjusted to a 52 week year.

⁶⁷ Delivery and Processing combined.

⁶⁸ See Annual Monitoring Report for 2015-16, paragraph 7.20.

⁶⁹ [redacted]

⁷⁰ Ibid

⁷¹ [redacted]

⁷² [redacted]

⁷³ [redacted]

⁷⁴ See the May 2016 Consultation, Figure A5.1.

⁷⁵ [redacted]

Source: Ofcom analysis

- 3.94 [§<].⁷⁸
- 3.95 As outlined in our May 2016 Consultation, our quantitative assessment of efficiency considers the changes in the costs of the Reported Business, including pension costs on a cash basis.⁷⁹
- 3.96 Royal Mail has recently begun a consultation with employees in the RMPP defined benefit scheme on proposed changes for the future of the Plan from April 2018. Royal Mail has publically stated that it is proposing to pay “around the same amount in pensions and National Insurance contributions in 2018-19 as it did in 2015-16” and has described the pension proposal as being about “avoiding an unaffordable increase in the cost of funding the pension”.⁸⁰ Hence, the actual pension costs for the final year of the plan are currently unknown [§<].
- 3.97 Our efficiency metrics summarised in the above table, do not capture avoided pension costs (i.e. the potential for Royal Mail to avoid any unaffordable increases in pension costs from 2018 onwards) However, we consider this cost avoidance relevant to our overall view of Royal Mail’s actual and planned efficiency performance.
- 3.98 Although Royal Mail’s actual rate of efficiency improvement in 2015-16 declined compared to the prior year (2014-15), it continues to make progress on efficiency.
- 3.99 Overall, we consider that the efficiencies in Royal Mail’s 2016 Business Plan, when considered in combination with its proposed pension cost reforms, demonstrate that it remains incentivised to improve its efficiency.
- 3.100 Further, Royal Mail’s strategic plan which sits alongside its business plan provides us with an indication of Royal Mail’s commitment to efficiency savings in the longer-term. [§<].
- 3.101 However, we remain of the view that Royal Mail has the potential to make greater efficiency gains than those it is currently forecasting and those contained in the 2015 Business Plan. As discussed further below, we intend to continue to monitor Royal Mail’s performance against the efficiency projections set out in the 2015 Business Plan. We expect Royal Mail’s performance on efficiency to improve from the levels achieved in 2015-16 once it has reached a settlement on its future pension plans.

Market Analysis

- 3.102 In the May 2016 Consultation, we considered how the competitive dynamics in the letter⁸¹ and parcel sectors have changed in recent years and published our analysis

⁷⁶ Including depreciation but excluding transformation costs.

⁷⁷ In the Annual Monitoring Report for 2015-16, this figure is presented in paragraph 7.11 as 1.6% due to rounding.

⁷⁸ [§<]

⁷⁹ See the May 2016 Consultation, paragraph A5.54.

⁸⁰ Royal Mail press release: <http://www.royalmailgroup.com/media/press-releases/royal-mail-begins-consultation-active-members-royal-mail-pension-plan-part-2018>.

⁸¹ In this section, when we discuss letters we are referring to both letters and large letters as defined in DUSP Conditions 2.1.2 and 3.1.2 unless otherwise specified.

of each sector. Below we consider both sectors separately, setting out stakeholder responses and our assessment of the letter and parcel sectors in turn.

Letters

Summary of initial findings

- 3.103 In the May 2016 Consultation, we noted that the letters sector was in structural decline and that the fall in letter volumes, of 18% between 2010-11 and 2014-15, was consistent with this longer term trend.⁸² To reflect potential differences in the competitive constraints Royal Mail faces in providing letter services to different types of customers, we considered the single piece and bulk mail segments of the letters sector separately.⁸³ Only single piece services are included in the universal postal service; however, both single piece and bulk letters are delivered across Royal Mail's universal service network.
- 3.104 For single piece services, we provisionally concluded that Royal Mail continued to be a near monopolist, delivering greater than 99% of end-to-end single piece letter volumes.⁸⁴ We considered it was likely that Royal Mail faced some limited constraints on its pricing behaviour, particularly given the on-going decline in single piece volumes due to e-substitution, but these were unlikely to prevent it from profitably raising prices for single piece letters. However, we noted that Royal Mail had not raised prices as much as we considered it could profitably have sustained in recent years following the significant price increases in 2011-12 and 2012-13. We considered it was possible that other factors such as political pressure, negative publicity and our monitoring regime have limited Royal Mail's incentive to implement significant further price increases.⁸⁵
- 3.105 In relation to bulk mail letter services we noted that Royal Mail provides the overwhelming majority of bulk letter mail delivery (>99%) and there was little prospect of any significant future entry.⁸⁶ We acknowledged that access competition provided some constraint to Royal Mail's bulk mail prices but only to a limited part of the value chain as access prices account for around 85-90% of the total retail price.⁸⁷ We also considered that the threat of a large increase in e-substitution may constrain Royal Mail from increasing prices substantially above current levels, and that pricing constraints may vary by application (e.g. there may be greater competitive constraints from other media in relation to advertising mail). However, we provisionally concluded that Royal Mail was likely to be able to unilaterally and profitably raise prices for some bulk mail letter services and a number of other factors (such as our monitoring regime and the potential impact of further significant price increases following on from 2011-12 and 2012-13 leading to a step change in e-

⁸² See the May 2016 Consultation, paragraph A7.4,

https://www.ofcom.org.uk/_data/assets/pdf_file/0030/57954/annexes-5-11.pdf

⁸³ We define single piece letters and large letters as those where the price per item is not discounted on the basis of volume, sender, format or pre-sortation. Bulk letters and large letters are subject to such discounts.

⁸⁴ See the May 2016 Consultation, paragraph 4.85. End-to-end competition only accounted for the delivery of 0.2% of letters in 2015-16 (see paragraph 4.11 of the Annual Monitoring Report 2015-16). In 2014-15 this figure was 1.3%; the decrease reflects Whistl's withdrawal from the end-to-end letters sector in May 2015.

⁸⁵ See the May 2016 Consultation, paragraph 4.86.

⁸⁶ See the May 2016 Consultation, paragraph A7.100.

⁸⁷ See the May 2016 Consultation, paragraph A7.42.

substitution) were likely to account for Royal Mail’s relatively modest price increases since 2012.⁸⁸

Stakeholder responses

- 3.106 Most postal operators,⁸⁹ trade associations⁹⁰ and other organisations⁹¹ agreed that the analysis in our May 2016 Consultation accurately reflected the UK postal market.
- 3.107 The MCF considered the letters sector did not provide sufficient constraint on Royal Mail as evidenced by its consistently above RPI price increases. UK Mail said that the current regulatory framework had not been effective in ensuring Royal Mail’s pricing remains competitive and has therefore contributed to switching to other media, the overall decline of letter mail volumes and impacted on the sustainability of the universal service. It argued that one of the reasons Royal Mail had not increased prices by as much as it was able to was very likely to have been the threat of end-to-end competition and as this is not likely to be a constraint in the future Ofcom should not rely on it. Whistl said that as Royal Mail had a captive market with no significant competition, there was nothing constraining its pricing policies.
- 3.108 Royal Mail disagreed with our assessment of the UK letters sector. In particular, it considered:
- The letters sector is significantly more competitive than Ofcom found – Royal Mail argued that e-substitution was a potent form of competition citing the quantum of letter volume and revenue decline since 2011-12 to support this view.
 - Ofcom’s analysis relied too heavily on historical price elasticities and did not take account of future market changes as a driver of Royal Mail’s pricing strategy. Royal Mail also argued that the letter applications have different elasticities given their different demand conditions. It considered it was economically rational to price transactional and advertising mail in relation to their respective competitive constraints.
 - Ofcom did not adequately recognise the significant risk that a ‘tipping point’ in letter volumes could be reached – Royal Mail considered Ofcom had not fully addressed the potential for sudden and irreversible large volume declines due to e-substitution. It considered that price increases might be profitable in the short-term but over the medium-term this would mean lower overall revenues due to e-substitution. Royal Mail pointed to the 50% decline in mail volumes Denmark experienced in a six-year period and the fact that both the Netherlands (50%) and Italy (44%) had seen significant volume declines in the last decade.
- 3.109 Royal Mail also argued that it had a track record of fair and reasonable letter pricing, citing consumers’ perceptions of value for money, that its prices were 18% lower than the European average for First and Second Class stamps and that it is the only major UK regulated company pricing below its price caps. It pointed out that its average

⁸⁸ See the May 2016 Consultation, paragraph 4.90.

⁸⁹ See responses to the May 2016 Consultation from CFH, ONEPOST, Secured Mail and UK Mail.

⁹⁰ See responses to the May 2016 Consultation from the MCF, National Federation of SubPostmasters and Unite.

⁹¹ See responses to the May 2016 Consultation from Citizens Advice, BBC Licence Fee Unit, Direct Marketing Association, techUK and the Scottish Council for Development and Industry, among others.

overall letter and large letter price increases since the large increases in April 2012, were only around 0.7% above RPI (and only 0.3% above RPI for access).⁹²

Our assessment

- 3.110 Any assessment of a market that is in structural decline is difficult and requires some judgement to assess the impact of price increases separate to the ongoing structural decline. It is therefore not necessarily the case, as Royal Mail suggests, that significant and ongoing volume and/or revenue decline is evidence of a high level of competitive constraint. Royal Mail has not provided any evidence to suggest that price increases in letter mail have had a significant impact on e-substitution. In the case of the Danish letters sector, referred to by Royal Mail in its consultation response, the volume decline is likely to have been primarily due to an initiative by the government to move communication between the Danish government and citizens online and the provision of a secure electronic document system for each citizen, rather than the pricing behaviour of the universal service provider.⁹³
- 3.111 What we do know, looking at the decline in overall UK letter volumes over the last five years, is that the rate of decline was higher in 2011-12 and 2012-13 following significant price increases by Royal Mail. However, this has resulted in increased letter revenue for Royal Mail which suggests that these price increases were profitable for Royal Mail.⁹⁴
- 3.112 We have also analysed the rate of letter volume decline to determine if the significant price rises experienced in the letters sector have led to an increase in e-substitution rates in the medium term (particularly with respect to bulk mail as business customers often need a significant lead time to put IT platforms in place before switching). This does not appear to be the case, with letter volume declines in the last three years being at the lower end or below the range Royal Mail was expecting (4-6%). However, Royal Mail's Q3 trading update in January 2017 noted that letter volume decline from April to December 2016 had increased to 6%. The decline in Q3 (i.e. October to December 2016) must have been higher than this (given Royal Mail reported a decline of around 4% in its half year results) so it is possible this may represent an increase in e-substitution. It is too soon to conclude this from one quarter and, even if e-substitution has increased, it may be due to other factors (e.g. increasing internet access and usage and greater acceptance of electronic billing methods) rather than Royal Mail's 2011-12 and 2012-13 price increases.
- 3.113 As we set out in the May 2016 Consultation, we consider it is appropriate to assess the competitive constraints for single piece customers (who have very few alternatives to Royal Mail) separate to bulk mail customers – 70% of whom now use another operator to collect, sort and transport their mail. We discuss any further evidence we have received and set out our conclusion of the competitive constraints on these different types of customer below.

⁹² See Royal Mail's response to the May 2016 Consultation, Chapter 1.

⁹³ In a report commissioned for Ofcom, WiK found that a major driver for e-substitution in both Denmark and the Netherlands was the successful implementation of e-government initiatives – see WIK-Consult on behalf of Ofcom, *Review of the Projected Costs within Royal Mail's Business Plan*, March 2016, page 29, https://www.ofcom.org.uk/_data/assets/pdf_file/0019/72145/projected-costs-review.pdf

⁹⁴ This does not take into account the ongoing e-substitution that would likely have happened even if Royal Mail had not increased its prices.

Single piece letters

- 3.114 Royal Mail has argued that as its prices below the Second Class safeguard cap and as its stamp prices compare well against European average stamp prices, it has a track record of fair and reasonable pricing. It also noted that the perception among UK consumers that postal services offer value for money is high (Ofcom's latest results are discussed in paragraph 3.16 above onwards). We agree that Royal Mail's stamp price increases in recent years have been relatively restrained, with prices typically increasing by around one pence per year. However, this does not mean that it has significant competitive constraints on its pricing behaviour for single piece letters.
- 3.115 First, it is not appropriate to compare Royal Mail's decision to price under the caps for Second Class stamp letters and large letters with the price caps for other regulated companies in the UK. The safeguard cap on Second Class letters is not based on Royal Mail's costs. It also gave Royal Mail the freedom to increase prices by 53% in the first year in which the cap was in place (increasing by CPI in further years). Many of the price controls Royal Mail cited are based on the costs of the incumbent, including an adjustment to future costs to reflect expected efficiency improvements, and are likely to have limited the pricing flexibility of the relevant companies to a much greater extent than the Second Class safeguard cap has limited Royal Mail's pricing freedom.
- 3.116 Second, as discussed above, it is difficult to compare prices between countries as they have different pricing structures. In particular, Royal Mail has one price for letters up to 100g but a number of the other operators it cited in its response have smaller weight steps (e.g. 0-20g or 0-50g) and/or pricing based on weight alone rather than weight and format as Royal Mail does. For these reasons, we do not consider that international comparators of this type offer good evidence to assess pricing constraints in the UK letters sector. We discuss how Royal Mail's universal service prices compare against international comparators in paragraphs 3.20 to 3.21 above.
- 3.117 As we noted in the May 2016 Consultation, volume decline for single piece letters has been considerably higher than bulk letter volume decline. [38]. At least some of this volume reduction was likely to be due to existing structural decline and would probably have occurred without price increases.
- 3.118 Given this and the fact that Royal Mail's price increases for single piece letters since 2011-12 have been profitable, we consider there is limited evidence that e-substitution represents a meaningful constraint on Royal Mail's ability to profitably raise prices for single piece letters (particularly with respect to moderate price increases i.e. 5-10%). We therefore remain of the view that Royal Mail faces only limited competitive constraints on its prices for single piece letters. Given the moderate price increases Royal Mail has put in place since 2012-13, we continue to consider that political pressure, negative publicity and our monitoring regime act as additional constraints on Royal Mail's pricing of single piece letters.⁹⁵

Bulk letters

- 3.119 As set out in the May 2016 Consultation and noted by a number of respondents, it is likely that the constraint on Royal Mail's bulk mail pricing has weakened since the

⁹⁵ [38].

exit of Whistl from end-to-end letter delivery. Royal Mail continues to deliver the overwhelming majority of bulk mail letters⁹⁶ and this is unlikely to change as we consider the prospect of another significant end-to-end letter delivery entrant to be remote.

- 3.120 Following significant bulk mail letter price increases in 2011-12 and 2012-13, Royal Mail has kept average access price increases at slightly above RPI in the following five years.⁹⁷ We have also seen a significantly lower overall decline in bulk mail letter volumes (Royal Mail retail and access) compared to single piece letters. Since 2011-12, Royal Mail's bulk letter volumes have declined by [X] with a higher decline in 2012-13 of around [X] reducing to around [X] per annum for the remaining years. As discussed above, it is possible that this rate of decline has increased in 2016-17 but it is too soon to determine whether this will be an on-going trend.
- 3.121 We note that Royal Mail argued that our analysis in the May 2016 Consultation was too focused on historical price elasticities and did not take sufficient account of the threat that increasing e-substitution has on its pricing behaviour, particularly the significant risk of a "tipping point" being reached. We also note that other stakeholders, such as Whistl, considered that we have over-stated the level of constraints on Royal Mail's bulk mail pricing, and that Royal Mail faces no real constraints.
- 3.122 While we did consider historical price elasticities in our analysis of the bulk mail sector in our May 2016 Consultation, we also took into account the views of stakeholders (including the Royal Mail commissioned FTI Consulting⁹⁸ and PwC reports⁹⁹), confidential internal Royal Mail documents on its pricing strategies provided under our formal information gathering powers, and the potential impact of the price increases in 2011-12 and 2012-13 on bulk mail volumes. Although we provisionally concluded that there were no significant competitive constraints on Royal Mail's pricing of bulk letter mail overall, we acknowledged that Royal Mail faced some constraint from access operators and the threat of e-substitution.
- 3.123 With respect to Royal Mail's argument regarding e-substitution reaching a "tipping point", we understand Royal Mail to mean a step change increase in the rate of e-substitution. The impact of e-substitution in transactional mail (which accounts for nearly 50% of Royal Mail's letter revenue¹⁰⁰) is likely to be higher than advertising mail as it is unlikely to switch back to physical mail in the future (due to the very low incremental cost of electronic communication).¹⁰¹ It is also possible that there could

⁹⁶ Royal Mail delivers circa 99.8% of all letter mail. See Annual Monitoring Report for 2015-16, Figure 4.1.

⁹⁷ Royal Mail stated in its response to consultation that the average price increases were 0.3% greater than RPI. See Royal Mail's response to the May 2016 Consultation, Chapter 1.

⁹⁸ See for example, FTI Consulting, *Competitive Constraints on Pricing Faced by Royal Mail*, September 2015, paragraph 3.3

https://www.ofcom.org.uk/data/assets/pdf_file/0021/84216/royal_mail_fti_report_on_competitive_constraints.pdf.

⁹⁹ PwC, commissioned by Royal Mail, *Outlook for UK mail volumes to 2023*, 15 July 2013, <http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf>

¹⁰⁰ Royal Mail plc, *Full Year 2015-16 Results*, 19 May 2016, page 7, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20Full%20Year%202015-16%20Results%20presentation_0.pdf

¹⁰¹ See for example, FTI Consulting, *Competitive Constraints on Pricing Faced by Royal Mail*, September 2015, paragraph 3.3

be a significant increase in the rate of e-substitution for transactional mail in the future, as has been seen in countries like Denmark and the Netherlands.

- 3.124 However, it is not clear that the current e-substitution or an event that triggers a greater step change in e-substitution for transactional mail would be likely to be in response to a Royal Mail pricing decision. Once online IT platforms have been put in place, the price difference between sending correspondence via physical mail compared to electronic alternatives is significant (the marginal cost of electronic communication is likely to be close to zero). This is one of the reasons many of the banks are encouraging their customers, particularly those with access to online banking, to switch to electronic statements.
- 3.125 This view is supported by Royal Mail's pricing behaviour. On average it has been increasing the price of transactional access mail significantly more than advertising access mail. This is despite the more significant impact of e-substitution for these volumes (as discussed above) and the fact that the decline in advertising mail since 2011-12 has been [X] compared to a decline of [X] in transactional mail volumes.¹⁰²
- 3.126 As we set out in the May 2016 Consultation and noted by Royal Mail, we consider that advertising mail is likely to be more sensitive to price than other bulk mail applications. This is supported by Royal Mail's relatively modest advertising access price increases since 2012 (around 0.6% below RPI per annum from 2012-13 to 2015-16¹⁰³).
- 3.127 Taking account of all the responses to the consultation and additional evidence from Royal Mail and its financial reporting information, we continue to believe that Royal Mail is likely to be able to profitably raise prices for bulk letter mail. Consistent with the May 2016 Consultation, we consider Royal Mail may be subject to more competitive constraints in relation to advertising mail and that other factors, such as our monitoring regime and the impact of price shocks on e-substitution, may provide some constraint on its pricing behaviour.

Parcels

Summary of initial findings

- 3.128 In the May 2016 Consultation we provisionally found that although the parcels sector was becoming more competitive, Royal Mail still held a strong position in single piece parcels. Furthermore, we considered that Royal Mail continued to have a high share of the overall volume and revenue of lightweight bulk parcels, although we noted that competition was growing.
- 3.129 Our analysis of the single piece parcels sector indicated that Royal Mail held a share of between 60-80% of volumes in the single piece parcel sector in 2014-15.¹⁰⁴ Furthermore, through its relationship with the Post Office, Royal Mail continued to have the single largest network of access points. However, we also observed the emergence of competition, as demonstrated by the rapid increase in the volumes of

https://www.ofcom.org.uk/data/assets/pdf_file/0021/84216/royal_mail_fti_report_on_competitive_constraints.pdf.

¹⁰² See Royal Mail's response to the May 2016 Consultation, Chapter 1, pages 10-11. Although Royal Mail noted in its 2016-17 half years results that marketing mail revenue had fallen by 8% on an underlying basis.

¹⁰³ See the May 2016 Consultation, paragraph A7.91.

¹⁰⁴ See the May 2016 Consultation, paragraph A8.31.

single piece parcels carried by Royal Mail’s competitors between 2013-14 and 2014-15.¹⁰⁵

- 3.130 Our analysis of the bulk parcel sector indicated that Royal Mail continued to retain an advantage for small lightweight parcels. For bulk parcels that weigh less than 2kg Royal Mail had a 60-80% share of volume and revenues in 2014-15.¹⁰⁶ We noted that Royal Mail’s foot delivery network gives it an advantage for small lightweight parcels, as well as a cost advantage for parcels that fit through a letterbox.¹⁰⁷

Stakeholder responses

- 3.131 Most stakeholders agreed with our finding that Royal Mail continued to hold a strong position in the single piece and bulk parcel sectors for parcels under 2kg.¹⁰⁸ The only parcel operator that responded¹⁰⁹ considered that Royal Mail held a dominant position in the single piece sector and in the bulk parcels sector for deliveries under 2kg.
- 3.132 Both CWU and Unite broadly agreed with our analysis of the parcels sector. However, both raised concerns regarding the link between employment conditions and quality of service in the parcels sector. The CWU submitted that we should examine quality of service and customer satisfaction in the parcels industry, claiming the quality of service provided by many of Royal Mail’s parcel delivery competitors had been deteriorating.
- 3.133 Access operators mostly agreed with our analysis of the parcels sector. However, some believed that we could do more to encourage competition, with several suggesting that, given Royal Mail carries the majority of parcels under 2kg, we should consider the introduction of mandated access to Royal Mail’s network for lightweight parcel services.¹¹⁰
- 3.134 Citizens Advice agreed with our analysis and added that its own research¹¹¹ indicates that when it comes to sending parcels as opposed to letters, consumers (across income levels and ages) considered Royal Mail was too expensive.
- 3.135 Royal Mail disagreed with Ofcom’s findings on the level of competition in the lightweight bulk and single piece parcel sectors. It said that our analysis relied excessively on market shares and disagreed with the market segmentation we used. It argued that we did not sufficiently consider the role of other competitive constraints, including countervailing buyer power and low barriers to entry. Furthermore, Royal Mail raised concerns over the accuracy of our parcel data in relation to the weight of the items. It also criticised our provisional segmentation of the bulk sector arguing that using the 2kg weight step was “artificial”.

¹⁰⁵ See the May 2016 Consultation, paragraph A8.32.

¹⁰⁶ See the May 2016 Consultation, paragraph A8.53.

¹⁰⁷ See the May 2016 Consultation, paragraph A8.56.

¹⁰⁸ See responses to the May 2016 Consultation from CWU, Hermes, MCF, ONEPOST, Secured Mail, techUK, Citizens Advice, UK Mail, Unite and BBC Licence Fee.

¹⁰⁹ See Hermes’ response to the May 2016 Consultation.

¹¹⁰ See responses to the May 2016 Consultation from Whistl, UK Mail, ONEPOST, MCF and Secured Mail.

¹¹¹ Citizens Advice, ‘The future of consumer needs for postal services’, 11 August 2016, page 41, <https://www.citizensadvice.org.uk/Global/CitizensAdvice/essential%20services%20publications/Post/Citizens%20Advice%20-%20The%20future%20of%20consumer%20needs%20for%20postal%20services%20090816.pdf>

- 3.136 Regarding single piece parcels, Royal Mail argued that Ofcom should give greater recognition to the competitive intensity created by three factors:
- a) Little investment is required to set up a pick up and drop off access network that would compete with the Post Office, thereby arguing there are low barriers to entry for competitors.
 - b) Consumers are increasingly aware of the alternatives to Royal Mail through price comparison websites and when buying parcel services through ‘marketplaces’, such as eBay.
 - c) Competitors often offer lower prices for single piece parcels than Royal Mail. Furthermore, its own consumer research found that many online sellers used Royal Mail’s competitors to send parcels weighing under 2kg, indicating there is competition.
- 3.137 With respect to lightweight bulk parcels, Royal Mail argued that we should also recognise the competitive intensity created by three factors:
- a) The customer buyer power that can be leveraged by large retailers (such as Amazon, Argos and John Lewis), which can enable them to sponsor the emergence of a competing parcel operator.
 - b) The fact there is active competition from rival parcel operators, resulting in Royal Mail losing major bulk parcel contracts to lower cost operators. Royal Mail stated it has had to increase investment in its quality of service in order to win bulk contracts back.
 - c) There are low barriers to entry for companies from other sectors to enter the parcels sector. In particular, Royal Mail highlighted the entry of Amazon Logistics.

Our assessment

- 3.138 Since the publication of the consultation we have received volume and revenue information from parcel operators for the 2015-16 financial year, and have also taken into account some restated information for the 2014-15 financial year where more reliable data has been made available. In addition, our analysis now includes information on the parcels delivered by Amazon Logistics and DHL, which has allowed us to obtain a fuller understanding of the bulk parcels sector.¹¹²
- 3.139 In the May 2016 Consultation, we defined single piece parcels as parcels where “the price per item is not discounted on the basis of volume, format or pre-sortation” in contrast to bulk parcels, which we said were subject to such discounts.¹¹³ Some parcel operators told us that some of their products do not fall neatly within either the ‘single piece’ or ‘bulk’ categories as we had defined them. In addition, we have observed that the sector is developing in ways that make it harder for our definitions to capture the types of services that would allow us to segment the parcels sector

¹¹² The restated parcels information for the 2014-15 financial year, which included the new information received from DHL and Amazon Logistics, was recently used in the Annual Monitoring Report for 2015-16. See Annual Monitoring Report for 2015-16, page 28.

¹¹³ See the May 2016 Consultation, paragraph 4.91. The previous definition of a single piece parcel outlined in the consultation was “Parcels sent by consumers and small businesses, that are posted at access points or collected from the sender, where the price per item is not discounted on the basis of volume, sender, format or pre-sortation”.

and consider the extent to which Royal Mail is competitively constrained within these segments. In light of this, and following consultation with the parcel operators we collect data from for the purposes of our ongoing monitoring of the parcels sector, we have revised our view on what constitutes single piece and bulk parcels.

- 3.140 For the purposes of our analysis in this statement, we now define single piece parcels as any parcel delivery service which is available for purchase by any member of the public and can be used for sending an individual parcel. This is intended to include products that are sold through parcel reseller websites, such as Parcels2Go, as well as parcels services that are resold to users at a discounted price through marketplace websites, such as eBay. This is on the basis that we think these services are likely to be substitutes for single piece services offered directly by parcel operators.¹¹⁴ This definition of single piece parcels excludes items sold on Amazon Marketplace that are delivered by Amazon Logistics. This is because Amazon Logistics delivery services are only available to those selling products through the Amazon website and are also required to be purchased in combination with other Amazon services (such as warehousing). They are not available to postal users generally and are therefore not substitutable for the single piece services offered directly by parcel operators, such as Royal Mail.
- 3.141 We categorise any parcel product that does not fall within the scope of the single piece definition as a bulk parcel product.
- 3.142 We consider that this approach is better able to identify those parcel services which are in competition with Royal Mail's single piece services, including its Second Class stamp universal service parcels under 2kg to which the safeguard cap applies.

Single piece parcels

- 3.143 In 2015-16 the overall number of single piece parcels being delivered remained broadly stable. However, this contrasts with the 13% increase in total parcel volumes, which therefore means that the growth in parcels is occurring in the bulk parcels sector (largely as a result of online shopping).
- 3.144 As was highlighted in the May 2016 Consultation, although Royal Mail still delivers the majority of single piece parcels, competition in the sector has been growing in recent years.
- 3.145 Royal Mail continues to deliver the majority of single piece parcels. In the 2015-16 financial year Royal Mail held a 60-80% share of both volumes and revenues in the single piece parcel sector [3<], although the volume of single piece parcels that it carried declined in comparison to the previous year.¹¹⁵ Furthermore, our estimates indicate that Royal Mail continues to hold a higher share of the volumes [3<] and revenues [3<] for single piece parcels under 2kg than for single piece parcels as a whole.¹¹⁶

¹¹⁴ We have not been able to identify the volumes of all parcels sold through reseller websites and marketplaces for every parcel operator. However, we intend to collect more detailed information on this from parcel operators in the future as part of our ongoing monitoring.

¹¹⁵ Royal Mail has told us that it improved its recording of single-piece parcel volumes from 2014-15 to 2015-16. It also made a series of sized based pricing changes during this period. It considered that these factors may have affected its volumes.

¹¹⁶ Due to the differing nature of their product offerings, not all parcel operators were able to provide us with information on the volume of their single piece parcels that weighed less than 2kg. We

- 3.146 Royal Mail argued that as part of our analysis we should take greater account of the competitive intensity created by three factors – the low cost involved in setting up access networks, consumer awareness of alternative operators and competitive pricing by its rivals. We considered these issues in our analysis of single piece parcels for the May 2016 Consultation and have reassessed some of these issues in light of the new information we have been able to obtain.
- 3.147 As part of their expansion into single piece services, other parcel operators have established alternative pick up and drop off access networks to Royal Mail's Post Office network. The other operators have agreed arrangements with existing retailers, such as Yodel's CollectPlus product which uses a variety of local businesses to offer collection and delivery services across the country and DHL's agreement with Rymans.
- 3.148 However, Royal Mail (through its relationship with the Post Office) still has the largest network of access points in the country.¹¹⁷ As we noted in the May 2016 Consultation, these alternative networks tend to have lower coverage in rural areas compared to urban areas, meaning the Post Office is likely to still be the primary option available to customers in many rural areas.¹¹⁸ We continue to consider that is the case. Furthermore, some consumers will find sending an item through one of the parcel shops offered by the new entrants to be less convenient than using the Post Office.¹¹⁹ However, we did also consider that competition, even where it is largely limited to urban areas, will tend to constrain Royal Mail's prices, and since Royal Mail is obliged to offer a geographically uniform price this has the potential to benefit all consumers.¹²⁰
- 3.149 In the May 2016 Consultation we also acknowledged the emergence of comparison websites that allow consumers to aggregate offers from different parcel operators.¹²¹ These should help increase awareness of Royal Mail's competitors. In addition to making consumers aware of cheaper deals, these websites can provide customers with discounts to the standard rates normally charged by single piece parcel operators and allow them to access products from a wider range of operators.¹²² Furthermore, the online marketplaces, such as eBay, are able to leverage the aggregate demand of its customers in order to negotiate discounts for its customers, who would normally purchase standard priced single piece products directly from parcel operators.¹²³
- 3.150 However, consumers are still far more likely to be aware of Royal Mail's parcel delivery services compared to those offered by its competitors. Our most recent research found that although 94% of consumers had heard of Royal Mail, 76% had

therefore included similar lightweight parcels categories offered by such operators (e.g. parcels under 5kg, 3kg or 1kg) as part of our analysis of the single piece parcels that weigh under 2kg.

¹¹⁷ See the May 2016 Consultation, Annex 8, Figure A8.5.

¹¹⁸ See the May 2016 Consultation, paragraphs A8.34-A8.35.

¹¹⁹ Using alternative parcel operators can be less convenient, for example, by requiring printer access and payment online, whereas customers can purchase postage in store at the Post Office. See the May 2016 Consultation, paragraph 5.24.

¹²⁰ See the May 2016 Consultation, paragraph A8.36.

¹²¹ See the May 2016 Consultation, paragraph 5.21.

¹²² For example, although DX does not sell single piece parcel services directly to consumers, it does sell individual parcel services to consumers through parcel websites, such as 'Parcel Monkey'.

¹²³ eBay, <http://sellercentre.ebay.co.uk/private/buy-print-postage>, (accessed 1 February 2016). In the 'Postage discounts' section eBay outlines the discounts it has been able to negotiate with Yodel and Parcelforce for its customers.

heard of DHL or FedEx and only 63% had heard of Yodel or Hermes.¹²⁴ ¹²⁵ We have also found that consumers are far more likely to send parcels with Royal Mail, as opposed to its competitors.¹²⁶

- 3.151 In the May 2016 Consultation, we did observe that there were other parcel operators that offered single piece parcel services for next day and standard services at prices that were broadly comparable to Royal Mail. Our analysis found that for parcels over 2kg, a number of alternative providers have lower prices than Royal Mail.¹²⁷ A more limited number of rival providers also offered services below 2kg that were cheaper than Royal Mail's corresponding services (in addition to including enhanced services such as tracking).¹²⁸ From our analysis of current single piece prices, we continue to consider that this remains the case.
- 3.152 We expect that the growth in competition will continue to put downward pressure on prices. However, given Royal Mail's share of the single piece parcels sector and its past pricing behaviour, its ability to raise prices in the future remains a concern. This concern is particularly relevant to the question of whether the safeguard cap on parcels under 2kg should be retained (as discussed further in paragraphs 4.32 to 4.46).
- 3.153 We have also considered Royal Mail's historic pricing behaviour in order to assess its ability to implement significant price rises for Second Class stamp parcels under 2kg. Royal Mail has increased basket prices¹²⁹ by approximately 39% (against a permitted increase of around 64%) since 2011-12.¹³⁰ Although Royal Mail is still currently pricing below the level permitted by the cap, which may indicate that there are pricing constraints on these parcels, this nevertheless shows that it has been able to significantly increase prices for single piece services.
- 3.154 In April 2013, Royal Mail modified its pricing structure for single piece parcel services. This involved differentiating between small and medium sized parcels and led to substantial price increases for very lightweight and larger format parcels (see Figure 3.6).¹³¹ By consolidating the weight steps, Royal Mail also reduced the price of some small but heavier weight Second Class stamp parcels in relation to 2011-12 prices.¹³² However, we consider Royal Mail's overall pricing behaviour demonstrates

¹²⁴ See the Ofcom Residential Postal Tracker 2016, Q11- *Which, if any, of these companies that can be used to send parcels or letters have you heard of before today?* (Base: All respondents).

¹²⁵ These levels of awareness may overstate the importance of these companies as alternative providers of single piece parcel services to consumers, as consumers may be aware of Hermes and Yodel from receiving parcels delivered by them, while not being aware of their single piece parcel services.

¹²⁶ Although 92% had sent a parcel with Royal Mail in the last month, only 13% of respondents had sent a parcel with Hermes. See the Ofcom Residential Postal Tracker 2016, QD5 – *Which of the following companies have you used to send parcels in the last month?* (Base: Those who sent any parcels).

¹²⁷ See the May 2016 Consultation, paragraph A8.38, Figure A8.7.

¹²⁸ See the May 2016 Consultation, paragraph A8.38, Figure A8.8.

¹²⁹ The basket includes Royal Mail Second Class stamp large letter products and parcels up to 2kg.

¹³⁰ This is the estimated basket price increase and level of the safeguard cap in relation to the 2017-18 financial year, assuming the same volume trend as used in the cap formula for 2015-16. This increase should be assessed against actual CPI inflation from September 2011 to September 2016 (the rate used to calculate the safeguard cap for 2017-18) of 7.0%.

¹³¹ As can be observed in Figure 3.6, medium Second Class stamp parcel prices between 0-100g and 101-250g increased by 268% and 184% respectively since 2011-12.

¹³² As can be observed in Figure 3.6, small Second Class stamp parcel prices between 751g-1kg and 1-2kg have reduced by 11% and 37% respectively since 2011-12.

it has the ability to significantly raise the prices of parcels, particularly at certain weight steps.

Figure 3.6: Second Class stamp parcel prices 2011-12 to 2016-17

	Medium Second Class 2011-12 Price	Medium Second Class 2016-17 price	% change to price from 2011-12 to 2016-17	Small Second Class 2011-12 Price	Small Second Class 2016-17 price	% change to price from 2011-12 to 2016-17
0-100g	£1.33	£4.89	268%	£1.33	£2.80	111%
101-250g	£1.72	£4.89	184%	£1.72	£2.80	63%
251-500g	£2.16	£4.89	126%	£2.16	£2.80	30%
501-750g	£2.61	£4.89	87%	£2.61	£2.80	7%
751-1kg	£3.15	£4.89	55%	£3.15	£2.80	-11%
1-2kg	£4.41	£4.89	11%	£4.41	£2.80	-37%

Source: Ofcom analysis of Royal Mail Second Class stamp and parcel prices from 2011-2016.

Bulk parcels

- 3.155 The bulk parcels sector is becoming increasingly competitive. The sector continued to grow in 2015-16, with the volume of bulk parcels delivered increasing by 15% to 25%. Royal Mail continues to deliver more bulk parcels than any other operator. However, Royal Mail does not deliver the majority of bulk parcels and several of its competitors experienced sizeable growth in volumes carried during the past year.
- 3.156 Royal Mail outlined in its response that it is facing active competition from other parcel operators, as well as new players, in the bulk parcels sector. From our own analysis it is evident that the provision of bulk parcels overall is broadly competitive. In making our final conclusions set out in this statement, we have also taken into account parcels volume data provided by Amazon Logistics, which was not available to us for the May 2016 Consultation. This has provided us with a more complete dataset, which allowed us to gain a wider view of the bulk parcels sector and better understand how competition in bulk parcels is developing. In particular, it is important to understand the volume of parcels that Amazon is delivering itself (both its own parcels and those delivered for other retailers and sold on the Amazon Marketplace platform) as these are unlikely to switch to other parcel operators.
- 3.157 We have also updated our analysis of the segment for lightweight bulk parcels. We continue to consider that Royal Mail retains an advantage for lightweight bulk parcels due to the cost advantage that its foot delivery network provides in delivering small, lightweight parcels which can fit through a letterbox.¹³³ ¹³⁴ Based on the information

¹³³ See the May 2016 Consultation, paragraph A8.56.

¹³⁴ We also note that a number of the other operators agreed with our assessment that Royal Mail has a strong share of lighter weight parcels.

we have collected for the 2015-16 financial year, we estimate that Royal Mail is continuing to deliver the majority of lightweight bulk parcels [8<].¹³⁵

3.158 With respect to the CWU and Unite's concerns about the quality of service for parcels, we discuss this in relation to mail integrity and complaints handling in Section 6 (see paragraphs 6.3 to 6.21). The issue of whether to mandate access for parcels is discussed in Section 5 (see paragraphs 5.65 to 5.70).

We intend to retain the current regulatory approach for a further five years

Our proposals

3.159 In the May 2016 Consultation, we proposed to maintain the approach to regulation we established in 2012. Given Royal Mail's reasonable efficiency improvements, its moderate profitability, the increase in parcels competition and increasing consumer satisfaction with postal services, we considered that a significant change in our regulatory approach – for example, the re-introduction of price controls – would be inappropriate. We also proposed that the three key safeguards we established in 2012 should be retained. These are:

- **Monitoring:** an effective and on-going monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels and pricing and competition;
- **Affordability:** a cap on the price of Second Class stamps for letters, large letters and parcels up to 2kg so vulnerable consumers can access a basic universal service; and
- **Competition:** we require Royal Mail to provide access to its network for letter competitors.¹³⁶

3.160 In 2012 we said that the new regulatory framework should remain in place for seven years (unless fundamental concerns arose through the monitoring regime).¹³⁷ In the May 2016 Consultation, we proposed that the regulatory framework should remain settled for a five-year period from the date we close the review, i.e. from 2017 to 2022.

3.161 We also proposed to continue to closely monitor the market and retain the right to intervene, giving the following examples in which we might step back in:

¹³⁵ Our estimate of Royal Mail's volume share of lightweight bulk parcels is based on information provided by Amazon Logistics, Hermes, Yodel, DPD and Royal Mail. Royal Mail's volume share was based on its lightweight bulk parcels items that weighed under 2kg. However, not all parcel operators were able to provide similar data on volumes and revenues for bulk parcels under 2kg. Our estimate therefore relies on an examination of comparable lightweight bulk parcel products offered by other parcel operators (e.g. under 1kg and 3kg). Royal Mail's Large Letter products have been excluded from our estimate of its share of lightweight bulk parcels volumes.

¹³⁶ Under the USP Access Condition, Royal Mail has to grant access at Inward Mail Centres for the provision of retail D+2 and later than D+2 letter and large letter services. Access competition is discussed in further detail in section 5 of this Statement.

¹³⁷ See the March 2012 Statement, paragraph 6.190, https://www.ofcom.org.uk/_data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.

- The emergence of threats to the financial sustainability of the universal postal service, which Royal Mail could not deal with through commercial action alone.
- Negative outcomes for consumers, such as significant price increases or poor quality of service, where there is no or very little competition.
- Failure on Royal Mail's part to make sufficient progress on improving its efficiency, exposing consumers to higher prices and/or a lower quality of service than might be the case in a competitive market.

3.162 In addition, we also proposed to continue to measure and gather information about the reasonable needs of postal users and noted that it is likely that Ofcom will conduct a review of postal users' needs during the course of the five-year period.

Stakeholder responses

3.163 A number of stakeholders – in particular, competing postal operators and large senders of mail¹³⁸ – expressed concerns about our proposals not to impose further price controls or efficiency targets on Royal Mail's Reported Business. These respondents said that price controls and/or efficiency targets are warranted, as there are insufficient competitive constraints on Royal Mail's behaviour in the letters sector and Royal Mail's pricing behaviour to date is not necessarily an indication as to its future behaviour. Some of these stakeholders also argued that price controls or efficiency targets are necessary because the current regulatory framework does not sufficiently incentivise Royal Mail to become more efficient.

3.164 In addition, Whistl, UK Mail and the MCF argued that the universal service is now secure, and that we should therefore give prominence to our duty under the Communications Act 2003 to further the interests of consumers by promoting competition. These respondents argued that the current regulatory regime does not adequately promote competition and that some form of pricing control and/or efficiency target was necessary in order to protect the interests of consumers.

3.165 Royal Mail¹³⁹ and the CWU agreed with our proposal not to impose price controls, citing e-substitution as a significant constraint and noting Royal Mail's adoption of a fair and reasonable pricing strategy. However, Royal Mail said that the regulatory framework needed to be updated to proactively sustain the revenue pools needed to ensure the financial sustainability of the universal service. In particular, Royal Mail argued that Ofcom should:

- “remove the prohibition of end-to-end tracking of standard parcels in the USO”;
- “remove the current Second Class safeguard price caps” which apply to letters and large letters and parcels respectively; and
- “introduce a single consumer protection standard for all major players in both letters and parcels”.

3.166 Royal Mail argued that the safeguard caps for Second Class letters and for Second Class large letters and parcels should be removed. It said the retention of the

¹³⁸ See responses to May 2016 Consultation from CFH, ONEPOST, Secured Mail, UK Mail, Whistl, individual, BBC Licence Fee Unit, DMA, MCF and MUA.

¹³⁹ See Royal Mail's response to the May 2016 Consultation, Chapter 1.

safeguard caps was not consistent with Ofcom's stated principle of only intervening where necessary. It argued that, unlike other regulated industries, Royal Mail does not have any significant degree of pricing power. It said its prices were subject to downward pressure from competitors and e-substitution, which it said was demonstrated by the fact prices are well below the maximum levels allowed by the caps.

- 3.167 Furthermore, Royal Mail said that the safeguard caps should not be retained without their level being reviewed. Royal Mail said that if this was not done it could increase risks to the financial sustainability of the universal service. It also said that as the caps were only intended to be in place until 2019, simply rolling the caps forward until the end of the new regulatory period might reduce Royal Mail's capacity to sustain the universal service by increasing prices. Royal Mail considered that Ofcom would need to conduct new analysis to ensure the cap is set at a suitable level, so that both the affordability and sustainability criteria are met for the duration of the regulatory period.
- 3.168 In addition, Royal Mail said that it had made significant progress on efficiency and had a stretching efficiency and cost avoidance programme in place, and that the imposition of efficiency targets was therefore unnecessary. It also considered there were significant risks to the financial sustainability of the universal service and that "the Reported Business could easily fall below the 5%" EBIT margin considered representative of a reasonable commercial rate of return. It said that the universal service has high fixed costs that "needed to be paid for through the generation and maintenance of significant USO and non-USO revenue pools". It therefore said there was no need for Ofcom to further promote competition.

Our assessment and final decision

- 3.169 Consistent with our duties under the PSA 2011 and CA 2003, the objectives we are seeking to achieve through the regulatory regime for postal services are to secure the provision of an efficient and financially sustainable universal postal service and to further the interests of citizens and consumers of postal services, where appropriate by promoting competition.
- 3.170 We have carefully considered whether the imposition of price controls and/or efficiency targets on parts of Royal Mail's business, as advocated by a number of consultation respondents, may be beneficial in furthering these objectives. As we explained in the May 2016 Consultation, we have considered in particular whether the potential re-introduction of price controls or efficiency targets could be required in order to ensure that Royal Mail has sufficient incentives to improve its efficiency, rather than relying on price rises to remain profitable.
- 3.171 In light of the evidence set out in this chapter, we remain of the view that the imposition of wholesale or retail price controls and/or efficiency targets would not be appropriate in order to secure the objectives of the regulatory regime. We consider that market conditions and the shareholder discipline which Royal Mail is subject to as a privatised company are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation. This is for the reasons set out below.
- 3.172 While we consider that the universal postal service is likely to remain financially sustainable in the immediate future, there are a number of credible downside scenarios which may impact Royal Mail's ability to make returns within the 5% to 10% EBIT margin range, which we consider indicates a reasonable commercial rate

of return. In particular, the letters sector remains in structural decline (with the latest data indicating that the rate of decline is increasing), competition in the parcels sector is growing and Royal Mail must reach a settlement on pension reform as a priority. In these circumstances, we continue to believe it is necessary that Royal Mail is afforded some pricing flexibility to respond to the challenges it faces.

- 3.173 In addition, the majority of consumers continue to be satisfied with postal services and continue to consider that stamps represent fairly or very good value for money. This follows a period of relative pricing restraint by Royal Mail, in which it has not raised prices as much as it could have done. Moreover, despite occupying a very strong position in the letters sector and a strong position in certain segments of the parcels sector, the challenges of structural letters decline as a result of e-substitution and growing competition in the parcels sector appear to provide some constraint on its pricing behaviour.
- 3.174 Furthermore, we consider that the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. Our analysis, as set out in the May 2016 Consultation, indicates that there is scope for Royal Mail to make further efficiencies and we consider that the market conditions it faces incentivises it to pursue these efficiencies. For this reason, we remain of the view that Royal Mail is incentivised to pursue efficiency improvement despite its efficiency performance in 2015-16 being lower than that achieved in 2014-15. We expect Royal Mail's performance on efficiency to improve from the levels achieved in 2015-16 once it has reached a settlement on its future pension plans.
- 3.175 We have a well-established monitoring regime which provides us with sufficient information to make an informed judgement as to whether the regulatory framework continues to incentivise Royal Mail to pursue efficiency improvement. In these circumstances, we do not consider that an efficiency target is necessary for us to make a judgement about its efficiency performance. We will continue to monitor Royal Mail's efficiency performance closely and publish our analysis of its efficiency in our annual monitoring update on the postal market.
- 3.176 Finally, as we explained in 2012 when we established the regulatory framework, there are a number of risks inherent to introducing a price control in highly uncertain market environments. More specifically, where the level and pattern of demand is unclear, it is not feasible to predict accurately whether a given price trajectory would be adequate to ensure the provision of the universal service is financially sustainable. For all of these reasons, we do not consider that the imposition of price controls or efficiency targets is justified at this time.
- 3.177 However, we do not agree with Royal Mail's argument that further regulatory intervention is necessary to secure the financial sustainability of the universal postal service. The regulatory regime already affords Royal Mail significant commercial flexibility and we remain of the view that such flexibility, along with the achievement of a reasonable rate of efficiency improvement in future, is the most likely means by which Royal Mail will be able to secure the financial sustainability of the universal postal service despite the challenges it faces. We do not therefore consider it necessary to review the safeguard cap and tracking of universal service parcels in the context of financial sustainability. We consider these issues as a matter of regulatory policy in Section 4.
- 3.178 More specifically, we do not consider that the removal of the safeguard caps on Second Class letters or large letters is warranted. Royal Mail continues to be a near

monopolist in single piece letters and therefore has the ability to profitably raise prices above the current level of the safeguard cap, despite its recent relative pricing restraint. Data from our monitoring regime shows that Second Class revenue has increased at a time when First Class revenue has fallen, which may indicate that some customers now favour cheaper Second Class products, perhaps due to price rises and the desire to economise.¹⁴⁰ We consider that this highlights the importance of maintaining the safeguard cap as an affordability measure, in order to ensure that consumers, in particular, vulnerable consumers, continue to have access to a universal service at affordable prices. We therefore continue to consider that the retention of the safeguard cap is justified.

- 3.179 The current safeguard caps are due to expire in March 2019. We agree that it is appropriate to review the level of the safeguard caps prior to their expiration. We intend to consult on the level of the cap from 2019 to 2022 during the course of the 2018-19 financial year. This will allow us to review the level of the safeguard caps with access to the most up to date market information including the level of competition in the sectors where the safeguard caps apply and in light of any changes to the financial sustainability of the universal service and/or the prices vulnerable consumers can afford. We deal with Royal Mail's arguments in relation to the application of the safeguard cap on Second Class parcels and tracking of universal service parcels in Section 4 and mail integrity regulation in Section 6.
- 3.180 In conclusion, in light of the evidence set out in this chapter, we have decided that the imposition of further retail or wholesale price controls or efficiency targets on Royal Mail is not justified at this time, and that the regulatory framework and market conditions appropriately incentivise Royal Mail to pursue efficiency improvements rather than excessively raising prices. We also remain of the view that the three key safeguards to the regulatory framework (monitoring, affordability and competition) should be retained.
- 3.181 We have taken the views of stakeholders into account in reaching this decision and consider that our regulatory framework appropriately balances our duties to secure the provision of an efficient and financially sustainable universal postal service while ensuring that the interests of citizens and consumers are met, including by promoting competition where appropriate. We discuss specific concerns raised by respondents in relation to access competition in Section 5.

We will continue to closely monitor the postal market

- 3.182 As we made clear in the May 2016 Consultation, our on-going monitoring of the postal market remains a very important component of our regulatory framework, representing one of the three safeguards on which the framework rests. In order to ensure that the regulatory framework continues to work effectively in furthering the regulatory objectives we will continue to monitor a range of factors including Royal Mail's performance on efficiency, quality of service, the financial performance of the universal service network, and competition in parcels and letters. We will also continue to publish our view of Royal Mail's efficiency in our annual monitoring updates.

¹⁴⁰ See the Annual Monitoring Report for 2014-15, page 56, https://www.ofcom.org.uk/_data/assets/pdf_file/0025/56923/annual_monitoring_update_2014-15.pdf.

- 3.183 Following the analysis which underpinned our assessment of Royal Mail's efficiency in the May 2016 Consultation, and in this Statement, we intend to monitor Royal Mail's future efficiency performance with reference to its 2015 Business Plan.
- 3.184 To ensure that we continue to receive sufficient information to inform our monitoring regime, we intend to shortly publish a consultation which will propose some amendments to the regulatory financial reporting framework. Our proposals are designed to ensure we have access to sufficient information to assess whether the regulatory framework continues to work in the interests of consumers, as well as to assess the financial sustainability of the universal postal service and Royal Mail's efficiency performance consistent with our duties.

Section 4

Regulation of Parcels

Introduction

- 4.1 In our May 2016 Consultation, we said that despite the growth of competition in recent years, Royal Mail continued to have the largest share of both volume and revenue in the parcels sector overall. We noted that this was particularly the case in relation to small/lightweight bulk and single piece parcels.
- 4.2 This section considers whether existing parcels regulation remains fit for purpose in light of developments over the past few years. In particular, we have considered:
- Royal Mail's request to include tracked parcels in the universal service; and
 - whether there is still a need to protect vulnerable consumers through the safeguard cap on Second Class stamp parcels under 2kg.
- 4.3 This section briefly summarises our proposals in relation to the regulation of parcels, and sets out stakeholder comments on these proposals and our final decision.
- 4.4 In this section we also discuss stakeholders' comments on our next steps, including developing a costing model of Royal Mail's delivery network and reviewing the allocation of costs between letters and parcels.

Tracking of parcels in the universal service

- 4.5 A tracked parcel service enables a sender or recipient to monitor the progress of a parcel through the postal network. Alternatives to tracking include 'confirmation of delivery' and 'signed for' features, which provide information about delivery to the sender. 'Confirmation of delivery' and 'signed for' features are permitted on universal service products.

Our proposal

- 4.6 When putting the regulatory framework in place in 2012, we considered that tracking was a premium feature and specified that single piece parcels within the universal service should not include tracking services.¹⁴¹ In its response to our July 2015 discussion document, Royal Mail suggested Ofcom should allow it to offer tracked services within the universal service.¹⁴²
- 4.7 In order to allow tracking for priority and standard parcels in the universal service, we would need to modify the Designated Universal Service Provider (DUSP) condition. As with any change to a regulatory condition this would need to be objectively justified, not unduly discriminatory, proportionate and transparent. In practice, we consider this would require undertaking research of consumers' needs to determine whether these had changed such that tracking should be a core feature of the

¹⁴¹ See the March 2012 Statement, paragraphs 4.39-4.43.

¹⁴² Royal Mail, Response to Ofcom's July 2015 Discussion paper, 18 September 2015, https://www.ofcom.org.uk/_data/assets/pdf_file/0017/72053/royal_mail.pdf

universal service. Furthermore, we would also have to be satisfied that suitable alternatives were not being provided by the wider postal market.

- 4.8 Under the VAT Directive (Directive 2006/112/EC) all “public postal services”, which include universal service products, are VAT exempt. Therefore, one of the results of extending the universal service would be to broaden the application of the VAT exemption to those services. This would mean that for customers who are unable to reclaim VAT, such as consumers, very small businesses and VAT exempt businesses, Royal Mail would have a 20% price advantage compared to its competitors.
- 4.9 Having taken these issues into account, and particularly given our concerns as to the impact on competitors of Royal Mail benefitting from a VAT exemption for tracked parcels, and the absence of information supporting a consumer need for tracking on universal service parcels, we proposed not to amend the DUSP Condition to include tracking as standard on First and Second Class single piece parcels.

Stakeholder responses

- 4.10 The majority of respondents supported our proposal not to amend the DUSP Condition to include tracking as standard on First and Second Class single piece parcels.¹⁴³ Several said that the tracking of parcels did not appear to be an essential consumer need and agreed that Royal Mail could provide tracked services outside the universal service.¹⁴⁴ Some respondents also mentioned concerns about the impact that making tracking a standard feature of all universal service products could have on the affordability of parcel products.¹⁴⁵
- 4.11 Some respondents commented that there were other factors that would be more important to consumers compared to tracking, such as the arrival of their parcels in a good condition¹⁴⁶ or being provided proof of delivery.¹⁴⁷ Royal Mail intends to introduce its confirmation of delivery feature as standard for all its universal service parcel products in 2017.¹⁴⁸ The CCNI believed that, while not being a fully tracked service, this confirmation of delivery feature would meet the needs of most customers who currently use tracked parcel services, since it would provide the proof required to support a complaint with a retailer or customer.¹⁴⁹
- 4.12 Hermes also supported our proposal. It said that extending the universal service to include tracked standard parcel delivery would create “a 20% price distortion in the C2X tracked parcel market” and argued that because all other parcel operators would have to pay VAT, their prices would be “automatically 20% higher” than the products offered by Royal Mail. Hermes said this would lead to its single piece services (as well as other C2X operators) becoming financially unsustainable.
- 4.13 However, Royal Mail considered we should allow universal service products to remain up to date with contemporary users’ needs. It argued that more consumers

¹⁴³ See responses to the May 2016 Consultation from AICES, Hermes, MCF, ONEPOST, Secured Mail, techUK, Citizens Advice, UK Mail, Whistl and CFH.

¹⁴⁴ See responses to the May 2016 Consultation from AICES, Citizens Advice and Hermes.

¹⁴⁵ See responses to the May 2016 Consultation from Citizens Advice, the CCNI and Unite.

¹⁴⁶ See Unite’s responses to the May 2016 Consultation.

¹⁴⁷ See the CCNI’s response to the May 2016 Consultation.

¹⁴⁸ Royal Mail, <http://www.royalmail.com/delivery-confirmation>, (accessed 22 February 2017).

¹⁴⁹ See the CCNI’s response to the May 2016 Consultation.

will come to expect the facility to track parcels because competing parcel operators normally offered such services.

- 4.14 While Royal Mail recognised that most single piece parcels are sent untracked, it argued that this did not indicate a lack of consumer need for tracking, but instead that the majority of single piece parcels are sent through the universal service, which happen to be subject to a “regulatory prohibition” on tracking.
- 4.15 Royal Mail also claimed that it would “not make commercial sense” for it to develop a non-universal service consumer tracked product. It said that a tracked non-universal service product would need to be priced similarly to the current universal services to be attractive to consumers (on the basis that such a product would lack the enhanced compensation or guaranteed delivery that its Special Delivery Guaranteed service offers). However, this pricing would then undermine revenues of other universal service products.
- 4.16 Royal Mail also argued that the impact of extending the VAT exemption should not be a reason for excluding tracked products from the universal service. It argued that any advantage gained from the VAT position on universal service products would be outweighed by the large network and high fixed costs it incurs as the designated universal service provider. It also commented that its competitors were not required to deliver to the same specification as it does under the universal service obligations or have the same “legacy labour model” of Royal Mail.
- 4.17 In addition to Royal Mail, four other respondents disagreed with our proposal.¹⁵⁰ The CWU believed that including tracking as standard for First and Second Class single piece parcels would allow Royal Mail to compete on a level playing field and in turn help secure the universal service. The National Federation of Subpostmasters argued that the current exclusion of tracked parcels is a “negative regulation” that is preventing the universal service from being contemporary.
- 4.18 The CCP acknowledged the price advantage that Royal Mail would gain from offering tracked parcels as part of the universal service. However, it said that given the improved choice, innovation and service that access to tracked services would offer, it did not believe an “industry issue” should prevent the provision of these services for consumers.

Our assessment

Impact on competition

- 4.19 As stated in the May 2016 Consultation we consider that consumers’ interests in the parcel sector are best served by competition, as it promotes increased choice, product innovation and value for money in the market. Therefore, an important concern for us is the impact on competition in the single piece parcel sector that allowing tracking in the universal service could have.
- 4.20 As outlined in paragraph 3.145, Royal Mail continues to deliver the majority of single piece parcels, holding a 60-80% share of both volumes and revenues generated in the sector. We consider Royal Mail has several advantages over its competitors in the delivery of single piece parcels due to the large size and coverage of its access

¹⁵⁰ See the responses to the May 2016 Consultation from Unite, National Federation of Subpostmasters, CWU and CCP.

network, as well as its strong brand awareness among consumers. Furthermore, the VAT exemption for parcels that Royal Mail delivers as part of its universal service obligation provides its single piece parcels with a pricing advantage compared to its competitors.

- 4.21 However, in recent years, competition has begun to emerge from rival operators delivering parcels on a commercial basis (which are subject to VAT) and Royal Mail's share of the single piece sector has reduced. Alternative single piece providers have mainly been able to compete in two ways. First, rival parcel operators compete with Royal Mail's single piece parcel products by offering lower prices, particularly for larger parcels at higher weight-steps.¹⁵¹ Second, rival parcel operators are able to differentiate their single piece products by providing enhanced product characteristics, such as tracking.
- 4.22 In its response, Hermes claimed that its myHermes single piece service was possible due to it being able to sell a fully tracked service to its customers at a competitive price compared to Royal Mail's single piece Second Class parcel service. As set out above in paragraphs 3.151, there are several rival parcel operators that also currently offer tracked parcel services at prices that consumers may see as competitive with Royal Mail at several weight steps.
- 4.23 If tracked single piece parcels were included in the universal service, and they were priced in a similar way to Royal Mail's existing universal service parcels,¹⁵² there is a risk that rival operators would no longer be offering a single piece product that is both competitively priced and distinct from Royal Mail's standard universal service products. Allowing Royal Mail to offer tracked services within the universal service could therefore have a negative impact on the single piece parcel competition that has only begun to emerge in recent years. This could risk undermining the benefits consumers have gained in choice, innovation and value for money from an increasingly competitive single piece parcels sector.

Consumer demand for tracking

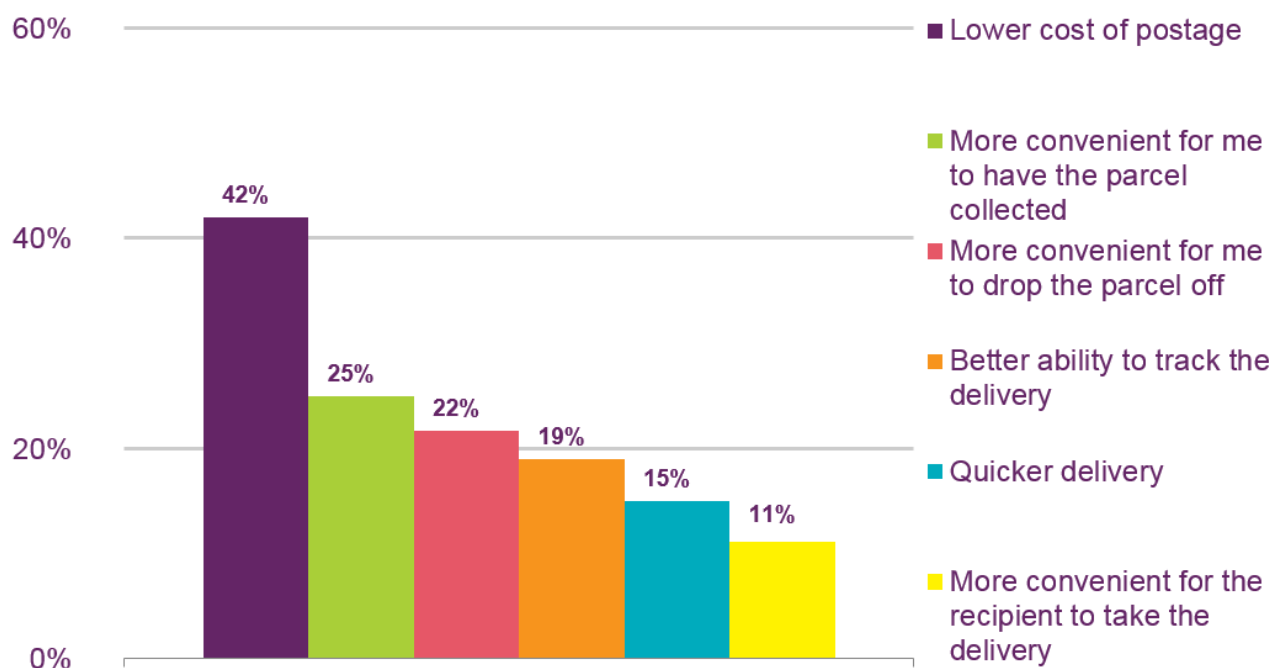
- 4.24 The latest results from the Ofcom Residential Postal Tracker appear to confirm that the availability of tracking is not a high priority for most consumers, particularly when compared to cost considerations.¹⁵³ Figure 4.1 shows that, when asked for their reasons for not using Royal Mail or Parcelforce, 19% of consumers used a rival operator due to their better ability to track deliveries. This indicates that the availability of a tracked service does motivate some consumers to use Royal Mail's competitors. However, the most stated reason for using an alternative parcel operator to Royal Mail or Parcelforce was the lower costs of postage (at 42%), with 25% and 22% citing the convenience of collecting and dropping off parcels respectively. This indicates that tracking is not as high a priority for most consumers compared to cost and convenience considerations.

¹⁵¹ See the May 2016 Consultation, paragraph A8.38 and Figures A8.7 and A8.8, https://www.ofcom.org.uk/_data/assets/pdf_file/0030/57954/annexes-5-11.pdf.

¹⁵² Royal Mail suggested in its response that it would not be commercially viable to offer a tracked product outside of the universal unless it was priced comparably to its current standard universal service products. It did not consider higher prices could be charged unless it included additional features such as enhanced compensation and/or guaranteed delivery. This might indicate that a tracked universal service product without those features might be priced comparably to Royal Mail's current non-tracked universal service products. See Royal Mail's response to the May 2016 Consultation, Chapter 6, paragraph 6.11.

¹⁵³ See the Ofcom Residential Postal Tracker 2016, questions QD7 and QD10.

Figure 4.1 – Reasons consumers used an alternative parcel company to Royal Mail or Parcelforce



Source: Ofcom Residential Postal Tracker 2016

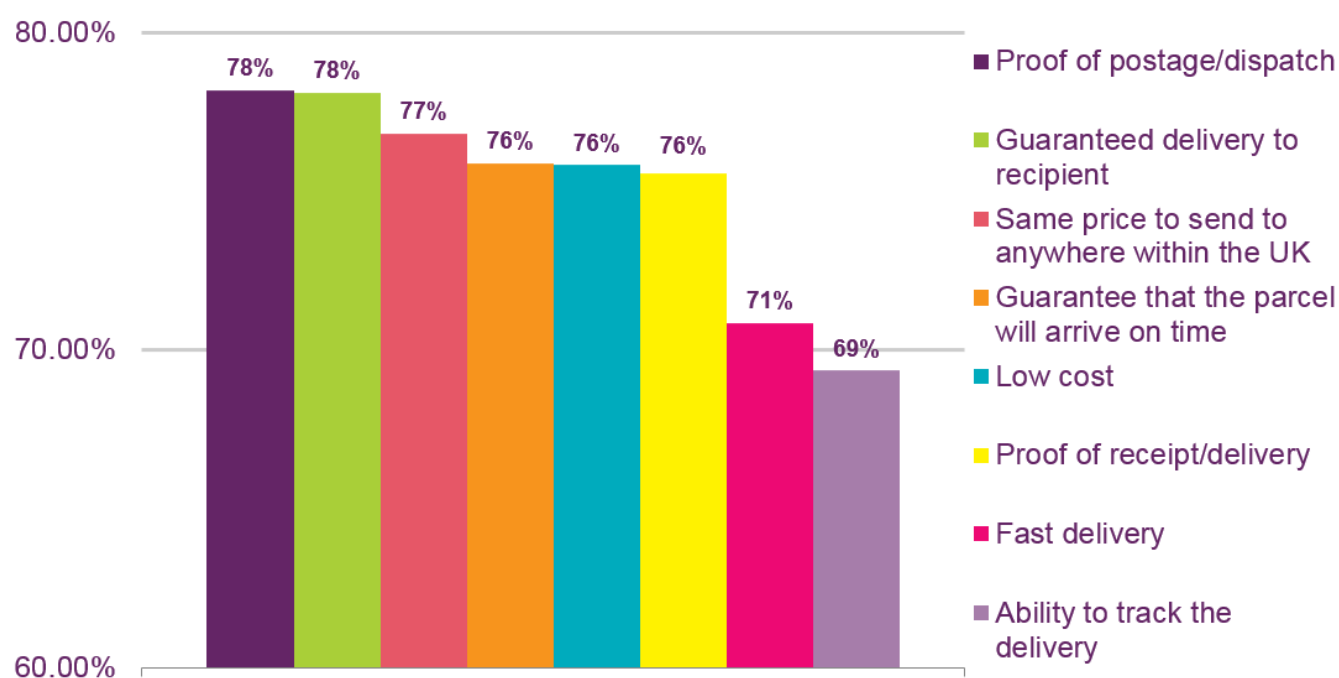
Base: Respondents who have used competitors to Royal Mail to send a parcel (n=570).

QD7: And why did you (sometimes) choose not to use a post-box or Royal Mail / Parcelforce over the counter services at a Post Office to send your parcel/s?

- 4.25 When consumers were asked about the factors that they take into consideration when choosing a postal operator, more consumers identified other features as being important factors compared with the ability to track deliveries (see figure 4.2).¹⁵⁴
- 4.26 27% of consumers regarded tracking as a ‘mandatory’ feature, indicating that tracking is not perceived as a necessary feature by the majority of consumers.¹⁵⁵ The fact that the majority of consumers do not regard tracking as being a necessity is also reflected in our own analysis of the parcels sector, which found that in 2015-16 the majority of single piece parcels were sent untracked.

¹⁵⁴ Factors considered to be important are those identified as ‘great to have’ or ‘mandatory’.

¹⁵⁵ For the ‘the ability to track the delivery’ of parcels, 27% regarded it as ‘mandatory’ and 43% regarded it as ‘great to have’. For comparison, in the same question, 39% felt that Proof of postage/dispatch was ‘mandatory’ – see the Ofcom Residential Postal Tracker 2016, ‘QD10a’.

Figure 4.2 – Factors regarded as important when sending parcels

Source: Ofcom Residential Postal Tracker 2016

Base: Parcel senders (n= 1860)

QD10a: List of factors people consider when sending parcels. (Important factors are those identified as either 'great to have' or 'mandatory').

4.27 Furthermore, tracked parcel products are already being provided by some of Royal Mail's competitors at broadly comparable prices to Royal Mail's universal service products, and it is therefore not clear that there is a consumer need for tracked services to be included within the universal service. We also note that Royal Mail has been trialling confirmation of delivery on its parcel services and intends to roll this out to all universal service parcels soon. We consider that this feature would not be considered tracking because it does not allow the sender or recipient to monitor the progress of a parcel through the postal network. Confirmation of delivery would provide the sender notification of the item being delivered to the recipient or, if this was not possible, where the item has been sent to for pick-up (e.g. neighbour, Post Office, delivery office). It is possible that this will provide many of the same benefits to the sender that tracking does and we will monitor the impact of this change in our postal tracker.

4.28 We have also taken into account the views put to us by stakeholders regarding whether there is a consumer need for tracking on single piece parcels within the universal postal service. However, we did not receive any evidence from Royal Mail, or any other stakeholder, which supported the proposition that there is a particular consumer need for this.

Final decision

4.29 We consider that allowing Royal Mail to offer tracking on First and Second Class parcels would be likely to have a detrimental impact on competition for single piece parcels that has only emerged in recent years. This would likely lead to a reduction in choice, innovation and value for money for consumers.

- 4.30 In particular, we consider that the potential detriment to competition is unjustified given there is insufficient evidence to demonstrate that consumers consider tracking to be a necessary feature of the universal service. Our assessment is that the needs of those who are currently using tracked products are likely to be adequately served by the provision of tracked single piece services by a competitive market outside of the universal service. Royal Mail already offers its tracked Special Delivery Next Day service within the universal service. Furthermore, Royal Mail is free to provide tracked parcel services outside of the universal service, in competition with other operators. In addition, Royal Mail's intention to provide confirmation of delivery on single piece parcels in the universal service is likely to provide consumers and small businesses with many of the same benefits of using a tracked parcel product.
- 4.31 The risks to damaging emerging competition in the single piece sector appear unjustified in the circumstances. We have therefore decided not to include tracking for parcel services within the universal service. However, as part of our monitoring programme we will continue to monitor both users' needs and the development of the market. If there was evidence of sufficient consumer need for tracked parcel services and we did not consider that inclusion of tracking in the universal service would damage competition (if, for example, there was a change in the tax treatment), we would be likely to reconsider our position.

Safeguard cap on Second Class stamp parcels under 2kg

Our proposal

- 4.32 In the May 2016 Consultation we proposed to retain the safeguard cap on Second Class stamp single piece parcels weighing up to 2kg. Although we noted some emerging competition in single piece parcels that was not present in 2012, we considered that Royal Mail remained the most widely used operator for single piece parcels and retained the ability to significantly increase prices. We also noted that Royal Mail was not currently choosing to price up to the level of the safeguard cap and therefore it did not appear to unduly constrain its pricing flexibility.
- 4.33 We said that, depending on how competition develops in single piece parcels (which we will actively monitor), we would reconsider the need for the safeguard cap in relation to parcels in the future.

Stakeholder responses

- 4.34 All respondents who expressed a view,¹⁵⁶ other than Royal Mail, were in favour of our proposal to retain the safeguard cap. Royal Mail opposed its retention.
- 4.35 Consumers groups strongly supported the retention of the safeguard cap. Citizens Advice stressed the importance of affordability and how price caps appeared to have protected consumers from steep price rises. The CCP and the CCNI also highlighted the importance of having an affordable universal service to consumers in the Highlands, Islands and Northern Ireland, who were often subject to surcharges for parcel deliveries by other (non-universal service) parcel operators.
- 4.36 Unite and the CWU supported the retention of the safeguard cap, noting that Royal Mail did not charge up to the level of the cap and therefore it does not constrain its

¹⁵⁶ See responses to the May 2016 Consultation from CCP, CCNI, CWU, Hermes, MCF, ONEPOST, Secured Mail, Citizens Advice, UK Mail, Unite, Whistl and CFH.

ability to set prices. The CWU also recognised that the withdrawal of the safeguard cap could be counter-productive for vulnerable consumers. Furthermore, the CWU felt that Ofcom should continue to monitor the parcels sector and review its position if competition in the single piece parcels sector eventually brought pricing constraints for Royal Mail.

- 4.37 The access operators who responded¹⁵⁷ were broadly supportive of the safeguard cap on Second Class parcels. They considered that Royal Mail was not subject to adequate competitive constraints and therefore the factors that led to the safeguard cap being implemented in 2012 still applied.
- 4.38 Hermes argued that the safeguard cap indirectly acts as a deterrent to Royal Mail from engaging in anti-competitive behaviour, commenting that Royal Mail may wish to reduce competition by reducing prices to the extent that competitors are forced out of the market. Without the safeguard cap Royal Mail would be able to increase prices and benefit from its anti-competitive behaviour once it has driven its competitors out of the market.
- 4.39 As noted above, Royal Mail believed that the safeguard caps for Second Class letters and for Second Class large letters and parcels should be removed. In particular, it argued that it was no longer necessary to retain the safeguard caps, because it did not have any significant degree of pricing power and its prices were subject to downward pressure from competitors, which it said was demonstrated by the fact that prices were well below the maximum levels allowed by the caps.
- 4.40 Furthermore, Royal Mail said that the safeguard cap should not be retained without its level being reviewed.

Our assessment

- 4.41 We consider that Royal Mail's commercial position in the supply of single piece parcels has not substantially changed since we introduced the safeguard cap in 2012. Although the volume of single piece parcels carried by Royal Mail's competitors has increased in recent years, the majority of single piece parcels are still delivered by Royal Mail [3<].
- 4.42 As outlined above in paragraph 3.148, through its relationship with the Post Office, Royal Mail has the largest network of access points, which most consumers (particularly in rural areas) will find easier to access and more convenient than the parcel services offered by the new entrants. Royal Mail and the Post Office also benefit from strong well-known brands, whereas we have evidence that the level of awareness of alternative parcel services is comparatively low.¹⁵⁸
- 4.43 As set out earlier in paragraphs 3.152 to 3.154, we considered Royal Mail's pricing behaviour in order to assess its ability to implement significant price rises for Second Class stamp parcels under 2kg. We concluded that although Royal Mail is currently pricing below the level permitted by the cap, it has been able to significantly increase

¹⁵⁷ See responses to the May 2016 Consultation from MCF, ONEPOST, Secured Mail, UK Mail, Whistl and CFH.

¹⁵⁸ See the Ofcom Residential Postal Tracker 2016, *Q11- Which, if any, of these companies that can be used to send parcels or letters have you heard of before today?* (The relevant results are outlined above in paragraph 3.150).

prices for very lightweight and larger format single piece parcels since 2011, as demonstrated above in Figure 3.6.

Our decision

- 4.44 We remain of the view that the retention of the safeguard cap plays an important role in ensuring affordable services are available. This is of particular importance to vulnerable consumers and those in rural areas who, as discussed above in paragraph 3.148, have far more limited access to alternative parcel services compared to those in urban areas. This view was shared by several respondents.¹⁵⁹ Therefore, we have decided to retain the safeguard cap for Second Class parcels.
- 4.45 We consider that Royal Mail's significant share of the single piece parcel sector (which includes an even larger share of single piece parcels under 2kg), combined with its extensive access network and strong brand awareness, provides it with a significant degree of pricing power. Similar to our conclusions on retaining the safeguard cap for the provision of Second Class letters and large letters in paragraph 3.178, we consider that we cannot rely on competitive constraints to prevent Royal Mail from raising prices.
- 4.46 Furthermore, we consider that the current level of the safeguard caps provides Royal Mail with appropriate flexibility, given that, as noted above, Royal Mail is not yet pricing up to the level of the cap. As discussed in paragraph 3.179 we intend to review the level of the safeguard caps prior to their expiry in March 2019.

Risk of Royal Mail unfairly leveraging its position in the letters sector into parcels

- 4.47 We noted in the May 2016 Consultation that, as a result of its integrated network for delivering letters and small parcels, there was a risk that Royal Mail had the ability and incentive to unfairly leverage its strong position in the letters sector into parcels. We set out our intention to consider, as part of our review of Royal Mail's regulatory reporting requirements, whether Royal Mail is appropriately allocating costs between parcels and letters. We also set out our intention to build a costing model to develop our view of Royal Mail's costs in delivery.
- 4.48 Some respondents expressed concerns about the possibility that Royal Mail could allocate costs from areas where it does not face competition in order to fund "uncommercial" prices in competitive areas (although we have not received a formal complaint or evidence in support of these concerns).¹⁶⁰ A number of respondents supported the next steps that we intended to undertake in relation to cost allocation and building a costing model.¹⁶¹ However, the MCF considered Ofcom should also require Royal Mail to:
- Publish its rates structures, including discount mechanisms;
 - Not bundle services;
 - Price above long run incremental cost;

¹⁵⁹ See responses to the May 2016 Consultation from the CCNI and the CCP.

¹⁶⁰ See responses to the May 2016 Consultation from DMA, MCF, Hermes, ONEPOST and Secured Mail.

¹⁶¹ See responses to the May 2016 Consultation from the DMA, MCF and the CCNI.

- Not cross-subsidise across services; and
 - Account in an open and transparent way.
- 4.49 Royal Mail argued that there was no need for a review of cost allocation between letters and parcels, and that any fears of cross-subsidisation were unfounded. It said it was already subject to extensive monitoring and that this review would create unnecessary uncertainty. Instead Royal Mail suggested that we should work more closely with it within the existing framework and engage on its long run average incremental cost (LRAIC) model. It also submitted a paper by FTI Consulting which argued that any test for cross-subsidisation should not rely on fully allocated cost (FAC) measures and that the appropriate cost standards are incremental costs and standalone costs (SAC).
- 4.50 We will shortly be publishing the first consultation on our review of the regulatory reporting requirements on Royal Mail. This consultation sets out our proposals in relation to simplifying and better targeting Royal Mail's financial reporting requirements including in relation to accounting separation, efficiency information and its business plans. We intend to publish a second consultation later this year that will, amongst other things, consider whether the methodology for allocating costs between parcels and letters within Royal Mail's activity based costing FAC system (used in Royal Mail's regulatory financial statements) remains appropriate. We expect that this review will look at issues raised by the MCF such as cross-subsidisation and open and transparent accounting. However, we do not consider it would be appropriate to constrain Royal Mail's commercial practices, particularly in the increasingly competitive parcels sector, by requiring it to publish rate cards and discount structures and/or prohibiting bundling.
- 4.51 In addition, and separate to the work we are undertaking as part of our review of the regulatory financial reporting requirements, we also propose to build a costing model to help develop our own view of the costs of Royal Mail's delivery network and how these might change over time under different scenarios. This will also enable us to consider whether there might be competition concerns with certain pricing strategies.
- 4.52 We note Royal Mail's suggestion for us to work more closely with it on its LRAIC model. We have engaged with Royal Mail as it has developed its LRAIC modelling over an extended period of time and it has made some improvements to its model based on this engagement. We recently concluded that there were a number of limitations to the model's structure and methodology, and transparency of the underlying data which meant that it was not suitable for our regulatory purposes, specifically, for the purpose of assessing compliance with the margin squeeze test imposed under USPA 6 by reference to LRIC.¹⁶² We have therefore decided to build our own costing model. We are still currently in the process of formulating the methodology and cost standard to use for our costing model of Royal Mail's delivery network.

¹⁶² We explained our position to Royal Mail in a letter of 30 June 2016.

Section 5

Access Framework

Introduction

Background to access regulation

- 5.1 We set out our provisional views on the effectiveness of the regulatory regime for access in the May 2016 Consultation. We explained that we considered that the principles of the regime we adopted in 2012 continue to be appropriate. This gave Royal Mail commercial and operational flexibility to set and change the access terms, conditions and charges subject to obligations to ensure that these are fair, reasonable and not unduly discriminatory. However, we set out proposals on a number of specific aspects of the access regime to ensure that it continues to meet our regulatory objectives. These were:
- Not to implement the proposals consulted on in the ‘December 2014 Consultation’¹⁶³ but to retain, in a slightly modified form, the access pricing principles set out in the March 2012 Statement that act as guidance on the application of the fair and reasonable condition to access prices;
 - To amend USPA 7 to clarify the circumstances in which changes can be made to the terms and conditions of access with less than 10 weeks’ notice; and
 - To amend USPA 4 so that Royal Mail would need to respond to requests for new access products where there is an equivalent retail product within 6 weeks.
- 5.2 A number of stakeholders responded to our proposals. These are set out in more detail below, alongside our assessment and final decision.

Summary of conclusions

- 5.3 Overall we remain of the view that it is appropriate that Royal Mail has commercial and operational flexibility to set the terms, conditions and charges of its access products subject to ensuring that these charges, terms and conditions are fair, reasonable and not unduly discriminatory. In relation to our specific proposals:
- We confirm our decision not to implement the access pricing proposals set out in the December 2014 Consultation and we continue to consider it is appropriate to retain in a modified form a set of access pricing principles originally set out in the March 2012 Statement;
 - We continue to consider it is appropriate to amend USPA 7 to clarify the circumstances under which less than 10 weeks’ notice of changes to terms, conditions and charges for access is permitted and to do so by implementing the proposed amendment set out in the May 2016 Consultation; and

¹⁶³ Ofcom, *Royal Mail Access Pricing Review – Proposed amendments to the regulatory framework*, 2 December 2014, https://www.ofcom.org.uk/data/assets/pdf_file/0029/78248/royal_mail_access_pricing_review.pdf.

- We do not intend to proceed with our proposal for a six-week access product request process where there is an existing retail product. However, we will closely monitor how Royal Mail's process for considering requests for new access develops in practice.

Access pricing regulation

5.4 This section discusses Ofcom's proposal not to implement the access pricing proposals we consulted on in December 2014 and our proposal to retain, in a slightly modified form, a set of principles which would act as guidance on the application of the fair and reasonable condition. Accordingly, this section deals with structural aspects of access pricing as the question of whether wholesale or retail price controls are appropriate is addressed in Section 3.

Our proposals

5.5 In the May 2016 Consultation we explained that we did not intend to implement the proposals set out in the December 2014 Consultation. This was because the purpose of the proposed changes was to ensure that Royal Mail was not able to set access prices in a way which could undermine confidence in investment and deter, or potentially prevent, entry in end-to-end letter delivery and, as we considered there was now little prospect of significant entry in end-to-end letter delivery,¹⁶⁴ the concerns upon which the 2014 proposals were based were no longer relevant.

5.6 However, we considered that the principles of zonal pricing set out in the March 2012 Statement, which are important for considering whether terms, conditions and charges were fair and reasonable, remained fundamental to protecting consumers and competition. We proposed some further guidance on these principles to provide additional clarification to stakeholders on how we would be likely to assess whether access prices were fair and reasonable, particularly with respect to zonal prices and their relationship to the national access price.

5.7 The revised principles we proposed in the May 2016 Consultation were:

- Alignment of zonal prices with costs – i.e. that the ratio of zonal prices should be broadly equivalent to the ratio of zonal costs. We did not consider it appropriate that Royal Mail recovers its fixed costs differentially depending on the type of area that recipients live in. We also considered that Royal Mail should take into account the alignment of prices and costs when changing geographic areas (such as postcode sectors or SSCs). In addition, we clarified that the appropriate cost measure in relation to assessing zonal prices should be fully allocated costs (FAC) and that zonal costs should be derived in accordance with Royal Mail's Regulatory Financial Reporting obligations.
- All national (or sub-national) access prices should equal the weighted average of zonal access prices – this would mean that there is no price disadvantage for access users on the zonal price plans compared to any national (or sub-national) price plan.
- Stability and cost justification for changes to the zonal structure – we also considered that there should be a reasonable level of stability in relation to zonal structures (i.e. the number and make-up of zones) and/or how geographic areas

¹⁶⁴ This follows the exit of Whistl from the delivery of bulk mail letters in June 2015.

are allocated to zones. We argued that any changes should be cost justified to minimise the potential for manipulation to disadvantage end-to-end competitors. We noted that Royal Mail should also consider how it can minimise the transaction costs for users if cost justified changes are made.

Stakeholder responses

- 5.8 Several access operators emphasised the importance of zonal prices to the access market.¹⁶⁵ For example, the MCF noted that zonal prices directly impact over 50% of access mail and argued that in order to ensure there was a clear, transparent and cost reflective framework the 2014 proposals should be implemented.¹⁶⁶ ONEPOST and UK Mail agreed with this view highlighting the importance of cost reflectivity and zonal prices on many of the price plans and related surcharges.¹⁶⁷
- 5.9 Some stakeholders, including Whistl, expressed concerns about the price differential between transactional and advertising mail which they argued was based on elasticities rather than cost differences.¹⁶⁸ They were also concerned that Royal Mail's incentive schemes (designed to generate growth in mail volumes) were only targeted at advertising mailers.
- 5.10 Royal Mail expressed significant concern about our proposed revised principles which it said would restrict its commercial freedom in unnecessary and disproportionate ways.¹⁶⁹ In addition, Royal Mail considered that Ofcom had, in substance, proposed to introduce the principles underpinning the December 2014 Consultation in the form of guidance. Royal Mail argued that this raised issues of procedural fairness and administrative law, that Ofcom had not provided sufficient justification to support its proposal to introduce the new principles and that Ofcom must carry out a full consultation and assessment of these proposals, including publishing an assessment of the responses to the December 2014 Consultation.¹⁷⁰
- 5.11 Royal Mail set out a number of specific objections to our revised guidance:
- In relation to the first principle on the alignment of zonal prices with cost, Royal Mail argued that any requirement for it to set zonal prices with broadly the same mark up in each zone would provide entrants with an artificial competitive advantage and could lead to inefficient entry. It also considered earning different margins across zones was a rational competitive response and would maximise total welfare (i.e. according to the accepted economic principle of 'Ramsey pricing'). It further argued that this principle would mean that it had to set zonal and national prices at around FAC and that this would limit Royal Mail's commercial freedom to compete on price so as to maintain volumes and revenues to support the fixed costs of the universal service network.¹⁷¹
 - Royal Mail argued that, as revised, the second principle on the relationship between zonal and national prices goes beyond the 2012 principle by requiring national prices to equal the weighted average of zonal prices rather than being

¹⁶⁵ See responses to the May 2016 Consultation from MCF, ONEPOST and UK Mail.

¹⁶⁶ See responses to the May 2016 Consultation from MCF, ONEPOST and UK Mail.

¹⁶⁷ See responses to the May 2016 Consultation from ONEPOST and UK Mail.

¹⁶⁸ See responses to the May 2016 Consultation from MCF and Whistl.

¹⁶⁹ See Royal Mail's response to the May 2016 Consultation, Chapter 5.

¹⁷⁰ See Royal Mail's response to the May 2016 Consultation, Chapter 5.

¹⁷¹ See Royal Mail's response to the May 2016 Consultation, Exhibit 5.4.

‘broadly comparable.’ Royal Mail argued that this would limit its ability to use price as a mechanism to incentivise user behaviour and could harm its ability to improve efficiency through innovative price driven incentives (such as a price plan for customers who provide forecasts).¹⁷²

- In relation to the third principle on changes to the zonal structures, Royal Mail said that the 2012 principle, as drafted, offered the necessary certainty for access operators as it required regard to be given to minimising transaction costs and the frequency of changes. Royal Mail objected to the proposal that such changes need to be cost justified and considered this was unnecessarily, and unjustifiably, restrictive.¹⁷³

Our assessment

- 5.12 Some stakeholders argued that we should implement the proposals set out in the December 2014 Consultation.¹⁷⁴ These proposals were intended to address particular concerns associated with competition in end-to-end letter delivery. As we explained in the May 2016 Consultation, following the closure of Whistl’s end-to-end letter delivery operations, we do not consider there is likely to be another end-to-end entrant of sufficient scale and scope to provide a significant level of letter delivery competition to Royal Mail in the foreseeable future. We are not aware of any new evidence to suggest otherwise. We therefore remain of the view that it would not be appropriate and proportionate to implement the 2014 proposals.
- 5.13 We continue to consider however that the principles of zonal access pricing as originally set out in the March 2012 Statement remain fundamental to protecting consumers and competition. We consider that these principles should be modified along the lines set out in the May 2016 Consultation.
- 5.14 We note Royal Mail’s concerns that the updated guidance set out in the May 2016 Consultation went too far in restricting its commercial flexibility. In our view, however, the revised principles are consistent with the underlying objectives of the access regime put in place in 2012 through the USPA Condition, and reflected in the guidance set out in our March 2012 Statement on zonal access pricing.¹⁷⁵ We set out our response to Royal Mail’s specific comments on the principles below.
- 5.15 The first principle addresses the alignment of zonal prices with Royal Mail’s costs. This means that we would expect Royal Mail to consider the relationship of prices within each zone to the costs of providing access in that zone and ensure that this relationship is broadly consistent across zones. In any future assessment of whether prices are fair and reasonable, Ofcom would be concerned about circumstances where a misalignment of this relationship across zones caused harm to access operators, wholesale customers in general and ultimately consumers that live in different types of geographic areas.
- 5.16 In those circumstances we would expect Royal Mail to have a clear justification for recovering its costs differently between zones. As we made clear in the December 2014 Consultation, seeking to influence the commercial choices of competitors through manipulation of the alignment of zonal prices is unlikely to be a suitable

¹⁷² See Royal Mail’s response to the May 2016 Consultation, Exhibit 5.4.

¹⁷³ See Royal Mail’s response to the May 2016 Consultation, Appendix 5.2.

¹⁷⁴ See responses to the May 2016 Consultation from MCF, ONEPOST and UK Mail.

¹⁷⁵ See March 2012 Statement, paragraph 10.153.

justification. As such, and given Royal Mail's continuing significant pricing flexibility including the ability to set the level of access prices, we do not consider this will have a significant impact on Royal Mail being able to respond competitively and/or take appropriate steps to maximise universal service network revenues.

- 5.17 We also note Royal Mail's concern that the reference to FAC in the principle creates a *de facto* cost floor based on FAC which Royal Mail considers is inappropriate, particularly as it believes it would create inappropriate incentives for entry. As noted above this principle is not intended to influence the level at which Royal Mail sets zonal and/or national prices. It places no expectation on Royal Mail's overall approach to the recovery of costs (whether assessed on an FAC basis or otherwise) but rather sets out our expectation that it will recover costs in a similar fashion across zones. We have adjusted the guidance to emphasise this. In addition, we note that Royal Mail has significant pricing flexibility so that it can determine how it recovers its fixed costs across both access and retail services.
- 5.18 In any event we have decided to remove the explicit reference to FAC from the guidance. In our May 2016 Consultation, we made this reference to FAC to emphasise the importance that all zones are considered against the *same cost standard*. It also reflected the fact that FAC information is the most robust measure of Royal Mail's costs currently available for these purposes and Royal Mail's Regulatory Financial Reporting obligations are based on FAC, including the zonal costing model. Should, however, another cost standard be appropriate and the associated information sufficiently robust and reliable, Ofcom would have regard to this in any assessment of whether zonal or national prices are fair and reasonable. We have adjusted the principle to reflect this.
- 5.19 The second principle addresses the relationship between zonal prices and national prices. In our May 2016 Consultation we sought to set out clearer guidance on this point, reflecting our increased understanding of the importance of the link between zonal and national prices and the impact that unjustified differences between these could have on users of the average, regional and zonal price plans. The changes from 'broadly equivalent' to 'equal' reflects the fact that, in a highly competitive access market characterised by relatively low margins, even small differences between price plans could cause harm. In the absence of a clear and cogent rationale for such differences, we would expect relevant prices to be equal.
- 5.20 The third principle addresses the structural aspects of providing access on a zonal basis. In the May 2016 Consultation we sought to improve the clarity of our guidance on this issue by focussing on the general importance of the stability of the zonal framework in terms of the number and make-up of zones and the process by which geographic areas are allocated between zones. In our guidance in the March 2012 Statement we focused only on the frequency of changes, which is only one factor in general stability.
- 5.21 The revised guidance on this in our May 2016 Consultation also set out that changes to the zonal framework should be cost justified, i.e. linked to the costs of delivery in the respective zones. In our view this is consistent with the rationale underpinning the original introduction of zonal access, which was to take account of the fact that the cost of delivery varies between different geographic areas (for access operators or customers whose mail did not follow the national geographic average). In addition, the stability of the zonal framework has a real value to wholesale customers in so far as it improves predictability and enables these customers to manage their operations more effectively. Any change therefore potentially has implications for wholesale customers and would, we expect, be undertaken only for the purposes of taking

account of a cost consideration (based on the relevant cost standard). Capricious or arbitrary changes without cost justification are unlikely to be regarded as fair and reasonable where these result in harm for wholesale customers.

- 5.22 Some stakeholders also argued that we should introduce additional access pricing regulation to limit differentials in pricing between the different uses of mail (particularly between transactional and advertising mail items). We consider, however, that it is appropriate that Royal Mail has general pricing flexibility, including the ability to price access products differently taking into account the characteristics of the products and its users. This was one of the key considerations we took into account when setting the regulatory framework in 2012, where we acknowledged that Royal Mail was better positioned to determine how to set its prices so that it can ensure the financial sustainability of the universal service. As set out in Section 3, we continue to consider this approach is appropriate and consistent with our regulatory duties. To the extent that such pricing could be regarded as not fair and reasonable, we consider this could be addressed with existing regulation.

Our decision

- 5.23 We therefore consider that the following principles are fundamental to protecting consumers and competition:
- a) Alignment of zonal prices with costs – i.e. that the ratio of zonal prices should be broadly equivalent to the ratio of zonal costs on a consistent and robust basis across each zone. We do not consider it is appropriate that Royal Mail recovers its fixed costs differentially depending on the type of area that recipients live in. Royal Mail should take into account the alignment of prices and costs when changing geographic areas (such as postcode sectors or SSCs). We would expect that the cost information used is robust and has been derived in accordance with Royal Mail's Regulatory Financial Reporting obligations.
 - b) All national (or sub-national) access prices should equal the weighted average of zonal access prices – this would mean that there is no price disadvantage for access users on the zonal price plans compared to any national (or sub-national) price plan.
 - c) Stability and cost justification for changes to the zonal structure – we also consider that there should be a reasonable level of stability in relation to zonal structures (i.e. the number and make-up of zones) and/or how geographic areas are allocated to zones. Any changes should be cost justified to minimise the potential for manipulation to disadvantage end-to-end competitors. Royal Mail should also consider how it can minimise the transaction costs for users if cost justified changes are made.
- 5.24 We consider that the updated guidance set out above, which is not legally binding and does not involve any change to the regulatory obligations to which Royal Mail is subject as set out in the USPA Condition, will provide additional clarity on the issues that Ofcom is likely to have regard to when considering whether the terms, conditions and charges for access (or a proposed change in those terms, conditions and charges) are fair and reasonable. Our aim in setting out this revised guidance is to provide greater clarity as to how Royal Mail may seek to ensure that it is complying with the fair and reasonable condition going forward; to avoid unnecessary disputes, so far as is possible; and to facilitate the resolution of disputes, should these arise. We consider that setting out this additional guidance is the most proportionate and least intrusive means to meet these objectives, consistent with our statutory duties.

- 5.25 In the context of a dispute or an investigation, we would expect to use these principles as a starting point in assessing whether Royal Mail's terms, conditions and charges for access are fair and reasonable. In doing so, we would consider all relevant circumstances, and it would ultimately be open to Royal Mail to demonstrate to Ofcom how it has complied with the condition, including how it considers any alternative approach is appropriate and justifiable.
- 5.26 We consider that the decision on our approach to access pricing set out above, is consistent with our statutory duties and administrative law. In particular, in reaching our decision we have had regard to our duty under section 3(3) of the CA 2003 to ensure that our regulatory activities are transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and to our duty under section 6 of the CA 2003 to ensure that our regulation does not involve the imposition of burdens which are unnecessary. We have also had regard to our regulatory principles,¹⁷⁶ in particular, operating with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required, and always seeking the least intrusive regulatory mechanisms to achieve our policy objectives. In our view, in setting out the revised guidance on access pricing, we will further the interests of citizens and consumers by providing Royal Mail and access operators with additional regulatory certainty on how we would interpret the fair and reasonable obligation under the USPA Condition, which should support access competition without imposing unnecessary regulatory burdens on Royal Mail, to the benefit of the interests of consumers of postal services.

Non-pricing terms and conditions of access

Our proposals

- 5.27 In the May 2016 Consultation we said that the commercial flexibility available to Royal Mail to change the terms and conditions of access continued to be appropriate and that we had not received any complaints or identified any material concerns with changes implemented since 2012 (aside from the January 2014 changes that were ultimately withdrawn). We considered that Royal Mail had undertaken genuine consultation processes and that we expected consultation and engagement between Royal Mail and access operators would continue. In addition, we said that should these processes be unable to resolve disagreements about changes to terms and conditions, the issues could be escalated to Ofcom by way of a complaint or dispute.
- 5.28 We also explained that we did not consider it was appropriate to issue further guidance on the application of the fair and reasonable condition. We noted that the access arrangements that have evolved (including specific protections for access operators) through negotiations between Royal Mail and the access operators have been complex and related to highly specific concerns from relevant stakeholders. We therefore considered that it was unlikely a guidance document, which must be general in nature and scope, would make a useful contribution to the functioning of the access market.

Proposed amendment to USPA 7

- 5.29 Royal Mail is required by USPA 7 to provide a minimum of ten weeks' notice before implementing changes to terms and conditions ('unilateral changes'), unless it has agreed a shorter notice period with access operators. In the May 2016 Consultation,

¹⁷⁶ See <https://www.ofcom.org.uk/about-ofcom/what-is-ofcom>

we identified an issue with Royal Mail's use of contractual schedules that enable operators to make use of certain key new D+2 Access products (such as the Mailmark product) where Royal Mail has embedded a right for it to make unilateral changes to the terms and conditions of those schedules with less than ten weeks' notice.¹⁷⁷ We were concerned that in order to use these D+2 Access products, access operators had to agree generally to a shorter notification period for changes to those terms and conditions than the minimum period required under USPA 7. We argued that this could undermine the regulatory protection which is intended to be offered under USPA 7.3 and 7.4, particularly where the access operators have no real choice but to agree to these terms or not take the relevant D+2 Access product.

- 5.30 To address this, we proposed to amend USPA 7 to clarify that any agreement for a notification period shorter than ten weeks may relate only to a particular change ('one-off change') and that any term or condition included in the standard terms and conditions for D+2 Access which purports to provide for general agreement to a notice period shorter than ten weeks ('category change') is not permitted by USPA 7.3 or 7.4.

Stakeholder responses

- 5.31 Many access operators disagreed with Ofcom's proposal not to impose additional constraints on Royal Mail's commercial flexibility.¹⁷⁸ They argued that in some cases Royal Mail had not genuinely consulted on changes it wanted to make with its access customers and not taken account of the needs of its customers.¹⁷⁹ They cited examples which they consider showed that Royal Mail had, following consultation, withdrawn welcome changes but proceeded with changes that had been opposed. In addition, some access operators reiterated their view that the fair and reasonable condition was too imprecise and that detailed guidance on its application was needed.¹⁸⁰
- 5.32 Most respondents, including all access operators, agreed with our proposal to prevent access customers from being forced to agree to shorter notification periods.¹⁸¹ Unite did not agree with the proposal as it considered a 10-week notice period for changes to be excessive in a fast moving industry.
- 5.33 While Royal Mail said it agreed in principle with our proposal to allow shorter notification periods to be used when all parties are in agreement, it did not agree with the proposed amended wording of USPA 7, which it did not think reflected Ofcom's intention. It argued that the use of schedules provides a number of advantages to access customers and emphasised that it has not used schedules to the detriment of those customers. It also reiterated its view that it had complied with its regulatory and contractual requirements as access operators elected to add new schedules to their contract when they signed up to the new products. It said that the shorter notification

¹⁷⁷ Specifically, the Business Mail large letter schedule provides for changes or withdrawal on at least 30 days' written notice, the Mailmark schedule allows changes to the terms of the schedule (except pricing changes) on at least 30 days' written notice, and also allows for surcharges which may be amended from time to time and the Digital Stamp schedule allows for changes to the terms of the schedule (except pricing changes) on at least 30 days' written notice. See the May 2016 Consultation, paragraph 6.53.

¹⁷⁸ See responses to the May 2016 Consultation from DMA, MCF, MUA, Secured Mail and Whistl.

¹⁷⁹ See responses to the May 2016 Consultation from MCF, UK Mail, Secured Mail and CFH.

¹⁸⁰ See responses to the May 2016 Consultation from ONEPOST, MCF, Secured Mail and UK Mail.

¹⁸¹ See responses to the May 2016 Consultation from BBC, CWU, CFH, CCP, Citizens Advice Service, MCF, Secured Mail, UK Mail and Whistl.

periods in the schedules were consistent with existing practice for product specification changes under the user guides, which have been possible on a 30-day notification basis since the first access contract was agreed in 2004. Royal Mail argued that the notification periods in all of the documents making up the Access contract should remain unchanged. Royal Mail therefore suggested some further amendments to the wording of USPA 7.¹⁸²

- 5.34 Royal Mail also noted that it was committed to working with the Access operators and that it was in its best interests to do so. It added that its access contracts and relationship with access operators are supervised by Ofcom. Royal Mail noted that if there are disagreements about particular changes these can be referred to Ofcom (and their implementation will be suspended if we opened an investigation).¹⁸³

Our assessment

Fair and reasonable condition

- 5.35 We remain of the view that it continues to be appropriate that Royal Mail has commercial flexibility to make changes to the terms and conditions of access so long as these are fair, reasonable and not unduly discriminatory. We have noted the comments by access operators that Royal Mail should be prevented from making unilateral changes to the access contracts, and about Royal Mail's proposed changes over recent years.
- 5.36 As we noted in the May 2016 Consultation, we have not received formal complaints, or identified material concerns, in relation to changes that had been implemented since 2012 (aside from the November 2013 and January 2014 changes to zonal access prices, national access prices and their related surcharges that were ultimately withdrawn in March 2015).
- 5.37 We do not consider that any additional evidence has been provided that would change our assessment that, should Royal Mail seek to introduce changes to terms and conditions that were unfair or unreasonable, the existing requirements on Royal Mail under the USPA Condition would be sufficient to address any concerns around such conduct.
- 5.38 We also consider that it is important that Royal Mail implements changes to the terms and conditions of access in a consultative way and exercises its commercial freedom in compliance with the relevant regulatory requirements. We welcome Royal Mail's commitment to working with access operators and actively consulting with them when seeking to make material changes to its access terms and conditions.
- 5.39 We would note that, while Ofcom has a role in regulating Royal Mail's conduct and ensuring that, among other things, its conduct complies with the USPA Condition, Ofcom does not supervise the access contracts or its relationship with customers. Royal Mail is responsible for these.

Guidance on the application of the fair and reasonable condition

- 5.40 We note that many access operators disagreed with our decision not to produce detailed guidance on the application of the fair and reasonable condition. As we said

¹⁸² See Royal Mail's response to the May 2016 Consultation, Chapter 5.

¹⁸³ See Royal Mail's response to the May 2016 Consultation, Chapter 5.

in the May 2016 Consultation, the complexity of the operational and commercial arrangements that have evolved in recent years, together with the specific procedural protections that have been agreed between Royal Mail and access operators, mean that it would be very difficult to produce guidance that meaningfully related to the specific concerns that stakeholders have expressed.

- 5.41 In our view, contractual and operational arrangements are best agreed between Royal Mail and the access operators themselves as they are best placed to work out the detail of appropriate commercial and operational arrangements. It is, in our view, difficult to predict specific terms and conditions which are, or could prove to be, problematic. Similarly, it is possible that market conditions change over time such that a term or condition that was once acceptable may no longer be so (to the extent that changing conditions render it unfair or unreasonable.) As a result, we do not believe guidance can make a valuable contribution and could result in unhelpful unintended consequences particularly as market conditions change over time.
- 5.42 In our view it is generally more appropriate to determine whether particular terms and conditions, or changes to those terms and conditions, are, or are not, fair and reasonable based all the relevant circumstances, including the precise wording of the relevant term or condition in question and the relevant factual, operational and market context in which it is applied.

Amendment of USPA 7

- 5.43 Most respondents welcomed our proposed changes to USPA 7 to clarify the circumstances in which unilateral changes to the terms and conditions of access can be made on less than 70 days' notice.
- 5.44 We carefully considered Royal Mail's representations on the drafting of our proposed variation to USPA 7. It argued our proposed amendments may inappropriately reduce its ability to make changes to the user guide or schedules for D+2 Access products such as the Mailmark product with only 30 days' notice as is presently permitted under the terms of the Access Letters Contract. We do not agree that the amendment would unduly or disproportionately restrict Royal Mail's ability to make changes to the user guide or terms and conditions of D+2 Access products. We remain of the view that it is important that the regulatory protection which is intended to be offered under USPA 7.3 and 7.4 is not undermined by access operators being required to agree generally to a shorter notice period for changes to those terms and conditions than that required under USPA 7.
- 5.45 Although Royal Mail will no longer be able to rely on a general contractual term to impose a 30-day notice period, it will still be able to seek agreement from its wholesale customers to apply a shortened period for any particular changes which it wishes to introduce in a shorter timeframe. To the extent that the changes are uncontroversial, beneficial to the access operators or otherwise urgent, we would expect that Royal Mail's customers would be likely to agree to such a shorter notice period.
- 5.46 Should there be any categories of changes which Royal Mail regards as generally likely to be so urgent that a 70-day notice period would be disproportionate, or which would be mutually beneficial to implement in a shorter notice period, it could apply to Ofcom for a consent under USPA 7.1 to exempt those changes from the notice period requirements of USPA 7. Before giving consent, Ofcom would be required to carefully review such an application and consult with stakeholders in accordance with the requirements of Schedule 6 to the PSA 2011.

Our decision

5.47 In summary we have therefore decided to:

- Implement the proposed amendment in relation to price changes under USPA 7.3. This confirms that Royal Mail cannot implement pricing changes with less than ten weeks' notice on the basis of general agreement set out in its standard terms and conditions to a shorter period, and that specific agreement is required from D+2 Access operators for a particular change to be introduced with less than ten weeks' notice. We note that this is consistent with the current terms of the Access Letters Contract,¹⁸⁴ under which at least 70 days' written notice is required for changes to access charges, which also applies to the Mailmark and Digital Stamp schedules.
- Implement the proposed amendment in relation to non-price changes under USPA 7.4. This confirms that Royal Mail cannot implement changes to non-price terms with less than ten weeks' notice on the basis of a general agreement set out in its standard terms and conditions to a shorter period and that a specific agreement is required from D+2 Access operators for a particular change to be introduced with less than ten weeks' notice. This would mean that, in respect of future changes to the terms and conditions of access which Royal Mail seeks to introduce, it would not be able to rely on any terms of the Access Contract (including any terms in the contract schedules) which would provide for a general ability for it to introduce particular types of changes to the terms and conditions of access with less than ten weeks' notice. Instead, as noted above, Royal Mail would need to seek agreement from D+2 Access Operators in order to introduce a particular change with less than ten weeks' notice, where it wishes to do so.

5.48 We have therefore decided to revoke the USPA Condition and replace it with a revised USPA Condition, as proposed in the May 2016 Consultation (subject only to some minor drafting changes to some of the definitions for consistency with definitions in other regulatory conditions). The statutory notification setting out the revised USPA Condition is at Annex 7. We have decided that this change will take effect one month after the publication of this statement (i.e. 1 April 2017) to allow for a short period of time for Royal Mail to make any necessary changes to its commercial arrangements to take these changes into account.

5.49 We consider that these amendments satisfy the relevant legal test for modifying USPA 7 (as set out in paragraph 1 of Schedule 6 to the PSA 2011) in that:

- It is objectively justifiable because it strengthens safeguards that we consider to be important in the regulation of access (specifically by ensuring that changes to terms, conditions and charges cannot be introduced unduly quickly such that access operators cannot adequately prepare and/or object to the change prior to its commencement);
- It does not unduly discriminate against Royal Mail because it reflects Royal Mail's position as the only postal operator with a downstream delivery network capable of facilitating participation by access operators in the relevant markets;

¹⁸⁴ See clause 13.2.3 of the Access Letters Contract, <https://www.royalmailwholesale.com/mint-project/uploads/149666951.pdf>.

- It is proportionate in what it is intended to achieve because we consider the protections associated with the notification requirements are the minimum necessary to safeguard the provision of access and ensure the benefits of access competition can be achieved; and
- The revised condition transparently sets out a clarification to the existing notification requirements in a way which should give greater certainty as to the circumstances in which shorter time periods may apply for notification of changes to the terms and conditions of access.

5.50 In addition, we note that in some circumstances the notification periods contained within the contract schedules (together with other recent changes to the Access Letters Contract) have not been set out in Royal Mail's statement of notice that it is required to publish under USPA 7.5. It is important that this statement is regularly updated to reflect changes to relevant notification periods and/or the introduction of new contractual schedules and we expect Royal Mail to keep this under review.

Non-discrimination and equivalence

Our proposal

5.51 In the May 2016 Consultation we said that we considered it continued to be appropriate to align the concept of equivalence with the principle of requiring Royal Mail not to unduly discriminate in the provision of access services. Having reviewed the concerns raised by stakeholders, we said we had not seen any evidence of Royal Mail acting in an unduly discriminatory manner or in a way so as to cause harm to access operators. We said that if such problems arose in the future, they could be addressed by the existing regulation and therefore proposed that it would not be necessary, proportionate or effective for Ofcom to introduce any more detailed regulation relating to non-equivalence in Royal Mail's operational practices.

Proposed amendment to the new product request process requirements under USPA 4

5.52 One way in which the regulatory regime for access seeks to deal with potential non-equivalence issues is through the obligations relating to the new product request process under USPA 4, which require Royal Mail to publish a Statement of Process that it must apply in considering requests for new access products and changes to access terms and conditions. In the May 2016 Consultation we identified a concern about the process for access operators to request new products. Specifically, we were concerned that Royal Mail did not currently face sufficient incentive to process requests for access in a timely manner in order to meet the reasonable needs of access operators, particularly in circumstances where it may be possible to process requests more quickly. We considered that it should be possible for Royal Mail to process access requests more quickly where it already offers an equivalent retail product, and that a six-week process should be possible. We therefore proposed to amend USPA 4 to require Royal Mail to process a request for D+2 Access in relation to which it already offers an equivalent retail product within six weeks (compared to the current three-month period which applies under its Statement of Process).

Stakeholder responses

- 5.53 Access operators expressed their disappointment that we had not proposed additional regulation to require full operational equivalence.¹⁸⁵ One suggestion from Secured Mail was that we should require Royal Mail to demonstrate that any difference between its retail and wholesale products is fair and reasonable, rather than the burden of proof being on access operators to demonstrate that the difference was not fair and reasonable. Whistl also suggested that a form of functional or structural separation between Royal Mail and its wholesale division should be implemented.
- 5.54 While access operators generally supported the proposal to reduce the time period under which new access products must be offered (where there is already an existing retail product), they identified a number of other problematic issues, such as difficulties in the pre-application phase and high development costs.¹⁸⁶ Whistl also argued that Ofcom must go further and “develop a new service request process which is much more even-handed, effective, speedy and transparent.”¹⁸⁷
- 5.55 Royal Mail strongly objected to our proposed amendment to USPA 4.¹⁸⁸ It said that we had not provided evidence to show that the current process did not meet the needs of users and that we had not demonstrated that a six-week timetable was technically viable, which it said we were required to do under section 38(8)(a) of the Act.¹⁸⁹
- 5.56 Royal Mail explained that the current 13-week process was very challenging to achieve and that meeting the timeframe was dependent on holding preliminary discussions with customers before the application is received. It also identified other events that could make the timeframe challenging including multiple requests and the need for extensive IT development. It said each request was different and that complexity can vary significantly and as such greater flexibility was required.
- 5.57 Royal Mail provided a detailed description of its current process. Most notably, it said that one part of the eight step process involving analysing systems requirements (including an impact assessment and the obtaining of IT development costs) could take up to six to eight weeks. It noted that a recent request for ‘Confirmation of Delivery’ means that new interfaces would have to be developed to facilitate live data transfer between Royal Mail and the relevant access operators.¹⁹⁰

¹⁸⁵ See responses to the May 2016 Consultation from MCF, Secured Mail and UK Mail.

¹⁸⁶ See MCF’s response to the May 2016 Consultation.

¹⁸⁷ See Whistl’s response to the May 2016 Consultation.

¹⁸⁸ See Royal Mail’s response to the May 2016 Consultation, Chapter 5.

¹⁸⁹ We consider that Royal Mail may have misinterpreted section 38(8)(a) of the PSA 2011. That provision requires Ofcom, when deciding what obligations to impose in a USP access condition, to take into account the “*technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed access unnecessary*”, which relates to whether the form of access envisaged is genuinely needed or whether postal operators could undertake the activities themselves without mandatory access, rather than placing the burden on Royal Mail. We note that under section 38(8)(b) of the PSA 2011 we are required to take into account the feasibility of giving the proposed access.

¹⁹⁰ See Royal Mail’s response to the May 2016 Consultation, Exhibit 5.3.

Our assessment

- 5.58 We note that some respondents have argued that there should be further regulatory intervention to increase equivalence between Royal Mail's retail bulk mail and access services. However, we are not aware of any additional evidence to suggest that Royal Mail is acting in an unduly discriminatory manner or in a way so as to cause harm to access operators, and we remain of the view that the no undue discrimination obligations under USPA 5 are sufficient to address potential concerns about non-equivalence in Royal Mail's operational practices. As a result, we continue to consider that additional regulation is not appropriate or necessary at this time.

New access product request process

- 5.59 We note Royal Mail's concerns that it may not be possible for it to process requests for new access products, even where there is an 'equivalent' retail product, within 6 weeks, particularly where IT developments are required. Recent experience suggests that IT requirements are likely to be an increasingly important part of future requests. This means that a six-week timeframe may be unsuitable for handling future requests if it provides insufficient time for Royal Mail to fully develop the access product proposal it puts back to access operators.
- 5.60 In addition, it has become clear that in certain cases it may be appropriate for there to be minor, but important, differences between a Royal Mail retail product and the version of a product eventually offered to access operators, for example, features which address specific operational and information requirements of access operators. This makes defining a 'retail equivalent' product problematic and would potentially make it difficult for stakeholders to determine whether the shortened six-week process applies.

Our decision

- 5.61 For these reasons, we have decided not to proceed with our proposed amendment to USPA 4 which would have required Royal Mail to handle requests for new access products where there is already an equivalent retail product within six weeks. We remain of the view, however, that the access product request process may need to be improved in order to ensure that it is sufficiently timely and responsive to the needs of access customers.
- 5.62 Following the publication of the May 2016 Consultation, there have been a number of formal requests made by access operators for new access products. This is the first time that the new product request process governed by USPA 4 has been used since it was put in place in 2012. Stakeholders have expressed concerns about the way the process has worked in these cases.
- 5.63 Our discussions with stakeholders have demonstrated the need for an improved process that identifies all steps (including currently undefined pre-application steps), specifies the expected timeframes associated with each step and sets out the information and engagement needed from both parties. We note in this context that Royal Mail has indicated that meeting its current timeframe depends on pre-application engagement. We also consider there is a need for Royal Mail to formalise its process for dealing with requests under USPA 4.3 which require it, upon reasonable request, to provide an access operator with information that is reasonably necessary to enable the operator to complete the new access product request application appropriately. In our view this would assist both access operators and Royal Mail and in making and handling such requests.

- 5.64 Given the need for extensive engagement between parties, we consider that it is appropriate that Royal Mail and the industry determine how best to deal with new product requests. Under USPA 4.2 Royal Mail is required to keep its Statement of Process under review and consult access operators (and Ofcom) on proposed changes. Although it has not been appropriate to review the process in recent years (because it was not used) we consider that there is now an opportunity, based on the experience of recent access product requests, for Royal Mail to carry out such a review in order to ensure the process functions effectively for both Royal Mail and access operators.

Scope of access

Our proposal

- 5.65 In the May 2016 Consultation we explained that we had not received sufficient evidence that additional forms of mandated access to Royal Mail's network met the statutory tests,¹⁹¹ but that we remained open to considering requests in the future.

Stakeholder responses

- 5.66 Some access operators expressed disappointment that we had not proactively assessed how the existing access remit could be extended in a way that would benefit customers and promote competition.¹⁹² Operators also expressed concerns that current non-mandated forms of access provided by Royal Mail could be withdrawn and proposed that, to address this, Ofcom should impose a requirement for Royal Mail to maintain (in substance) any existing forms of access.¹⁹³
- 5.67 Royal Mail, noting that we had said we were open to considering requests for additional forms of access argued that, in its view, there was no need to extend mandated access. It considered that introducing mandated access to parcels would threaten the revenue streams needed to secure the provision of the universal service and impede Royal Mail's ability to compete in the parcels sector.¹⁹⁴ It added that the highly developed nature of letters competition in the UK meant there is no need for more regulatory intervention to incentivise competition in letters.¹⁹⁵

Our assessment

- 5.68 We note stakeholders' comments that Ofcom should proactively seek opportunities to extend the scope of regulated access. In practice this would mean gathering, or otherwise identifying, evidence that showed it was appropriate to mandate additional forms of access. In the 2012 Statement we considered whether there might be a need to mandate additional forms of access, such as D+1 and parcels access, and concluded that the statutory tests were not met at that time.¹⁹⁶ We are not aware of any evidence which would suggest that we should review whether it would be

¹⁹¹ Under section 38(4) of the PSA 2011, we cannot impose a condition requiring access to the universal service provider's network unless it appears that a condition is appropriate for the purposes of promoting efficiency, promoting effective competition and conferring significant benefits on the users of postal services.

¹⁹² See response to the May 2016 Consultation from MCF, Secured Mail and UK Mail.

¹⁹³ See response to the May 2016 Consultation from MCF, Secured Mail and UK Mail.

¹⁹⁴ See Royal Mail's response to the May 2016 Consultation, Chapter 5.

¹⁹⁵ See Royal Mail's response to the May 2016 Consultation, Chapter 5.

¹⁹⁶ See the March 2012 Statement, paragraph 10.213.

appropriate to impose any additional forms of access at this time, for example we note that Royal Mail continues to offer D+1 and parcels access on a commercial basis. We also note that, as set out in Section 3, the bulk parcels sector overall is becoming increasingly competitive.

5.69 Our position has, however, not changed from the consultation and we remain open to considering additional forms of access in accordance with the statutory tests set out in the PSA 2011. This means we remain open to receiving evidence that we might not otherwise be aware of that would support additional forms for access, including:

- the access seeker's business case for the proposed form of access;
- a description of the perceived operational requirements of the proposed form of access; and
- an assessment of how the form of access meets the tests set out in the Act. In addition, an assessment of how this form of access will be consistent with Ofcom's primary duty to secure the provision of the universal postal service.

5.70 We also note the request from access operators to introduce an additional regulatory requirement that would prevent Royal Mail from withdrawing any non-mandated form of access that it currently provides. This would not be possible without mandating access to those particular services and, as we have described above, we do not presently consider it appropriate (based on the evidence we currently have) to mandate such access.

Section 6

Deregulation

- 6.1 In the May 2016 Consultation we proposed certain changes to the regulatory conditions applying in the postal sector in order to remove regulatory burdens where we considered they were no longer necessary to achieve our regulatory objectives. In this section, we summarise our proposed changes to Essential Condition 1, Consumer Protection Conditions 2, 3 and 5 and DUSP 1.10, stakeholder responses to these proposals and our assessment and final decision or revised proposals for re-consultation. Each of these conditions is discussed in turn.
- 6.2 We also explain that we intend to review Consumer Protection Condition 1 and consult on any proposed amendments to this Condition separately in future.

Essential Condition 1: Mail integrity

Summary of our consultation proposals

- 6.3 We proposed to amend the scope of Essential Condition 1 so that it would apply to end-to-end, untracked letter and large letter mail services (with the exception of mail sent in closed user group networks, such as document exchanges) and untracked universal parcel services.¹⁹⁷ We said that we did not consider it necessary to extend the scope of Essential Condition 1 to access mail or non-universal service parcel services.
- 6.4 We proposed to remove the current Mail Integrity Code of Practice, which specifies in detail particular processes which operators must follow, and instead allow postal operators greater flexibility to design their own procedures in order to meet the objectives of Essential Condition 1.^{198,199}
- 6.5 We proposed to streamline the reporting requirements on mail integrity incidents by removing the requirement to report on ‘serious incidents’, moving to annual reporting, and only requiring such reports from relevant postal operators delivering over 250,000 relevant mail items per year.²⁰⁰

Summary of stakeholder responses

- 6.6 The majority of respondents agreed with our proposals in relation to Essential Condition 1,²⁰¹ in particular the idea of moving to a more flexible, and principles-based approach which would allow the relevant postal operators to design their own procedures in order to meet the objectives of Essential Condition 1. This was true of both postal operators, and respondents representing the interests of consumers.

¹⁹⁷ See the May 2016 Consultation, paragraphs 7.22-7.31, in addition to E1.1.2 of our proposed revised Essential Condition 1 in Annex 13.

¹⁹⁸ See the May 2016 Consultation, paragraph 7.37, for a complete list.

¹⁹⁹ See the May 2016 Consultation, paragraphs 7.35-7.41.

²⁰⁰ See the May 2016 Consultation, paragraph 7.39.

²⁰¹ See the responses to the May 2016 Consultation from AICES, CCP, Hermes, MCF, ONEPOST, Secured Mail, Citizens Advice, UK Mail, Unite, BBC Licence Fee Unit, CFH.

- 6.7 A few respondents disagreed with our proposals. For example, Royal Mail and the CWU argued that existing mail integrity regulation should be extended to parcel operators and access operators. Royal Mail provided us with some consumer research carried out on its behalf by Illuminas which it said demonstrated that there was a need to improve the standards of mail integrity in the parcels sector.²⁰²
- 6.8 Royal Mail also disagreed with our proposed drafting of Essential Condition 1. It said that rather than allowing operators greater flexibility to comply with the objectives of Essential Condition 1, the proposed updated condition represented “a potentially very significant and unwarranted increase in the regulatory burden on Royal Mail.” In particular, it was concerned that the proposed requirement for operators to take “all necessary steps” to minimise mail integrity instances placed an “unlimited commitment to mail integrity and represented unmanageable and impractical regulation.” Royal Mail provided a number of drafting proposals for amending Essential Condition 1.²⁰³
- 6.9 The CCP sought clarification as to how we will monitor mail integrity standards under the new condition.

Our assessment and final decision

Move to principles-based regulation and scope of the condition

- 6.10 We note that some respondents asked us to reconsider the scope of the condition, and assess whether Essential Condition 1 should be extended to access mail and non-universal service parcels. We set out in the May 2016 Consultation our reasons for considering that extension of regulation to non-universal service parcels was not justified.²⁰⁴ In particular we said that:
- operators are already incentivised to maintain aspects of quality of service due to competition;
 - parcels are often tracked and are therefore less at risk of being lost or stolen;
 - parcels are often expected by the recipient and, therefore, non-arrival is likely to be noticed; and
 - where the parcel delivery is fulfilling an online order, the receiving consumer is protected by consumer legislation and the retailer is liable until the parcel is safely in the recipients’ hands.
- 6.11 In relation to access mail, we said there are a number of reasons to believe that mail integrity issues are less likely to arise in respect of access mail:
- the contractual requirements of bulk senders (and the threat of that contract being terminated due to poor quality of service or reputation concerns if there were any mail integrity issues);

²⁰² See Royal Mail’s response to the May 2016 Consultation, Exhibit 7.2 – ‘Illuminas market research report, July 2016’, for a summary of the research data. Royal Mail provided the research to us in full confidentially (*Parcels Delivery Experience*, 27 July 2016).

²⁰³ See Royal Mail’s response to the May 2016 Consultation, Chapter 8 and Annex 3.

²⁰⁴ See the May 2016 Consultation, paragraphs 7.28-7.34.

- the level of competition in the bulk mail market between access operators and Royal Mail; and
- the fact that access operators do not deliver mail to end recipients, which is where mail integrity issues are more likely to occur compared to the collection and sortation process (where mail is more closely monitored within a contained environment).

6.12 However, in light of stakeholder responses, we have reassessed whether the scope of the condition should be extended to access mail and non-universal service parcels. In particular, we used our formal powers to request information from some of the largest access and parcel delivery companies in the UK to establish their current level of mail integrity incidents and complaints, and to see whether there had been any significant change since we last undertook this exercise.²⁰⁵

6.13 The complaints and incidents figures provided for parcels are set out in Figure 6.1 below, and the access mail figures are set out in Figure 6.2 below.

Figure 6.1: Total mail integrity complaints and incidents per item conveyed (2015-16) – Parcel operators

Operator	Total number of items conveyed	Total number of complaints received in relation to mail integrity issues ²⁰⁶	Percentage of items generating complaints
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
Total	803,676,120	701,507	0.087%

Source: Operator data received in response to Ofcom s55 information requests, sent on 16 November 2016. Data covers the period from April 2015 to March 2016.

²⁰⁵ We sent formal information requests under s55 of the PSA 2011 to seven parcel operators (who along with Royal Mail collectively made up over 80% of market revenues in 2015/16) and the three largest access operators on 16 November 2016.

²⁰⁶ [X]

Figure 6.2: Total mail integrity complaints and incidents per item conveyed (2015-16) – Access operators

Operator	Total number of items conveyed	Total number of complaints received in relation to mail integrity issues	Percentage of items generating complaints
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]
Total	7,068,723,541	627	0.00001%

Source: Operator data received in response to Ofcom s55 information requests, sent on 16 November 2016. Data covers the period from April 2015 to March 2016.

- 6.14 As the two figures above indicate, the percentage of parcel items generating complaints in 2015-16 was unchanged from 2014-15, at 0.087%.²⁰⁷ The percentage of access mail items generating complaints was very small, at 0.00001%. These figures indicate that there does not appear to be a widespread issue of low mail integrity standards among parcel operators, and even less so with respect to access mail.
- 6.15 We also received confirmation and evidence from the operators from whom we sought information that they have relevant procedures in place to ensure the integrity of the mail they convey.²⁰⁸ The majority of these operators also confirmed that their processes and procedures reflect the key elements of Essential Condition 1, e.g. recruitment, training, and covering both employees and third party workers, despite this regulation not applying to them. This would appear to indicate that parcel and access operators are incentivised to put in place mail integrity procedures absent Ofcom regulation.
- 6.16 We also note that Royal Mail provided some consumer research to us which it claimed showed that there were problems with the standard of mail integrity in the parcels sector which justified the extension of Ofcom’s regulation to parcel operators. We have analysed this research.
- 6.17 We note that the research was specifically commissioned by Royal Mail with a view to “demonstrating that there is a need for consistent regulation within the parcel delivery market”,²⁰⁹ rather than seeking to objectively understand the current position. In addition, we note that many of the research findings appear to indicate that consumers are well protected through existing complaints processes and compensation arrangements that operators have in place despite not being subject to Ofcom’s mail integrity regulation.

²⁰⁷ See the May 2016 Consultation, Figure 7.3.

²⁰⁸ Operator responses received in response to Ofcom s55 information requests, sent on 16 November 2016. [X]

²⁰⁹ Illuminas, *Parcel Delivery Experience*, 27 July 2016 – consumer research carried out on behalf of Royal Mail.

- 6.18 For example, although not referred to in Royal Mail's consultation response, we note that the research indicates that where parcel delivery problems do arise most consumers find that the complaints process is easy to navigate, is often resolved quickly and with compensation being paid where appropriate, and mail users are usually satisfied as a result. It also indicates that consumers are more concerned with other issues such as having access to clear delivery information before placing an order or that a retailer's website is easy to use, than they are with loss, damage or theft. We do not consider that this research supports the extension of mail integrity regulation to parcels.
- 6.19 In summary, taking into account all of the available evidence, we continue to consider that our proposal to amend the scope of Essential Condition 1 to cover untracked letters and large letters, and untracked universal service parcels but not to extend it to other parcels and access mail more widely, remains appropriate.
- 6.20 We have also decided to implement our proposal to remove the Mail Integrity Code of Practice and move to principles-based regulation. With regards to monitoring compliance with the revised condition, we intend to continue to monitor the incidents recorded under the annual reports for those operators and mail types subject to the condition. We will also continue to request information periodically from parcel and access operators not in scope of the Condition about the number of complaints they receive, and mail integrity incidents they have recorded, in order to ensure we have visibility of mail integrity performance among these operators. Should we observe an increase in customer complaints or mail integrity instances, we will consider the regulatory implications of this in the future.
- 6.21 However, we have made some further amendments to the drafting of the condition following feedback from Royal Mail. These are shown at Annex 9. These amendments do not alter our overall policy in relation to mail integrity and as such we do not consider that they warrant a further period of consultation. The specific changes are set out below.

Royal Mail's detailed proposed changes to Essential Condition 1

- 6.22 Royal Mail suggested a number of specific drafting amendments to Essential Condition 1. We have considered each of these points and set out our response on the key issues raised below.²¹⁰
- 6.22.1 Royal Mail argued that the proposed drafting of Essential Condition 1, which would have required relevant postal operators to take "all necessary steps to minimise the exposure of relevant postal packets to the risk of loss, theft, damage and/or interference", was overly burdensome and would lead to "unmanageable and impractical regulation".²¹¹ We acknowledge Royal Mail's concern that if the condition required "all necessary steps" to be taken to minimise the risk of mail integrity issues occurring, this could be interpreted as requiring relevant postal operators to take steps which are potentially disproportionate to the risk of loss that the condition seeks to prevent. It is not our intention that relevant postal operators should be required to take steps which are not reasonably necessary or proportionate to the risk of loss that the condition is designed to prevent. We have therefore amended this drafting such that the Condition will require

²¹⁰ See Royal Mail's response to the May 2016 Consultation, Annex 3.

²¹¹ See Royal Mail's response to the May 2016 Consultation, Section 8.

operators to take “all reasonable steps” to minimise the risk of mail integrity issues. We consider that is sufficient to achieve the objective of Essential Condition 1 and proportionate.

- 6.22.2 Royal Mail suggested that the number of working days before an item which has not been delivered by its due delivery date is considered a ‘lost item’ should be reduced from 15 working days to 10 working days for the purposes of record keeping and reporting. Royal Mail explained that this was to bring the condition closer into line with its own procedures and reporting.²¹² We consider that it remains appropriate for all items which have not been delivered within 15 working days of their due date of delivery to be classified as ‘lost’ for the purposes of the recording and reporting requirements. However, we also acknowledge that some postal operators, such as Royal Mail, may choose to treat an item as ‘lost’ for contractual and/or operational purposes if they fail to arrive at an earlier point in time than 15 working days after their due date of delivery – for example, Royal Mail currently classifies such items as ‘lost’ where they have not been delivered within 10 working days. This can bring subsequent benefits to consumers. Therefore, we have decided to clarify in Essential Condition 1 that relevant postal operators have the flexibility, where they choose to do so, to classify relevant postal items as ‘lost’ for the purposes of the Condition if they fail to be delivered at an earlier point in time than 15 working days after the due date of delivery. However, all items must in any event be classified as ‘lost’ where they are not delivered within 15 working days after the due date, in line with the current requirements. We have amended the definition of ‘lost’ items in the Condition accordingly.
- 6.22.3 Royal Mail proposed removing the requirement to report ‘substantially delayed’ items (i.e. items which are delayed more than 15 working days beyond their due delivery date, but which are then delivered). However, we consider that it remains important that relevant postal operators report details of ‘substantially delayed’ items separately from those which are not eventually delivered, for the purposes of giving more transparency about potential mail integrity issues. We have therefore decided to retain this requirement and have amended the drafting of Essential Condition 1 to give effect to this, as well as including a specific definition of ‘substantially delayed’ items for clarity.
- 6.22.4 Royal Mail said it would be disproportionate to require the mail integrity procedures to apply to employees or contractors whose job functions do not directly involve conveying, receiving, collecting, sorting, delivering or otherwise handling mail items, but who potentially have access to mail (for example maintenance engineers).²¹³ We remain of the view that relevant postal operators should ensure that employees and workers who are reasonably likely to have access to mail during the course of their work, even if they are not directly handling it, follow appropriate procedures to safeguard the security of the mail. In addition, we consider relevant postal operators should also have an appropriate recruitment policy in connection with the hiring or engagement of such personnel in order to facilitate the

²¹² Email from Royal Mail to Ofcom regarding clarification questions on Essential Condition 1 drafting, dated 9 December 2016.

²¹³ Email from Royal Mail to Ofcom regarding clarification questions on Essential Condition 1 drafting, dated 9 December 2016.

mail integrity objectives. However, we accept that it is less likely to be relevant for there to be specific mail integrity training and disciplinary procedures covering such employees or contractors. We have therefore amended the wording in the condition to make clear that such personnel need not be subject to all of the requirements of Essential Condition 1 (e.g. in relation to training and disciplinary procedures), but that relevant postal operators must ensure that appropriate processes are followed by such employees in order to safeguard the security of relevant postal packets. It is up to operators to design appropriate processes and ensure they are adhered to.

- 6.22.5 Royal Mail said that we should update the definition of ‘public holiday’ to take account of our 1 October 2015 direction regarding exemption to delivery time targets for when the 26th December falls on a Saturday.²¹⁴ We do not consider that any change is necessary because the definition of ‘public holiday’ in our proposed Essential Condition 1 (E1.1.2(m)) states that it includes “any day in relation to which OFCOM has by direction stated that exceptional circumstances require it to be treated as a public holiday”. This wording is sufficient to cover the exception provided for under the October 2015 direction.
- 6.22.6 Royal Mail proposed that we remove the requirement to submit the annual mail integrity report to the Consumer Advocacy Bodies in addition to Ofcom. We disagree with this proposal. We think it remains important that the relevant Consumer Advocacy Bodies are provided with this information so as to provide a level of transparency, and to ensure that these bodies are able to fulfil their consumer advocacy functions with access to appropriate information which is relevant to consumers. Given that relevant postal operators already provide this information to Ofcom, we do not consider that there is any material additional burden in providing this information to the Consumer Advocacy Bodies too. We have therefore retained this wording in the condition.
- 6.22.7 Royal Mail disagreed with our proposal that we retain a power to require postal operators to comply with “any direction” made by Ofcom in relation to the adoption of policies and procedures to ensure mail integrity. It said it was concerned that Ofcom could require operators to “put in place measures that are potentially disproportionate to the risk of loss that they are designed to prevent”.²¹⁵ In adopting a principles-based approach to regulation, operators will have much greater flexibility to adopt and put in place procedures which are proportionate to the level of risk in their businesses. We consider that the retention of a direction power is an important backstop option in ensuring the objectives of Essential Condition 1 are met, should operators not put in place effective procedures. We would not envisage exercising this direction power unless there were clear failures on the part of operators to put in place effective procedures themselves.

²¹⁴ Ofcom, *An exception to Royal Mail’s universal service obligation - no requirement for deliveries and collections when 26 December falls on a Saturday*, 1 October 2015, Annex 1 https://www.ofcom.org.uk/_data/assets/pdf_file/0022/78304/uso_exception_for_sat_26_december.pdf.

²¹⁵ See Royal Mail’s response to the May 2016 Consultation, Chapter 8.

- 6.22.8 Royal Mail said that “Ofcom was proposing a shift in mail integrity reporting from providing estimated loss of mail to actual loss of mail data, which would reduce the accuracy of the data”.²¹⁶ We believe that Royal Mail may have misinterpreted our position on this point. We are intending to retain a requirement for relevant postal operators to report actual figures regarding mail integrity incidents where they are aware of specific incidents and have sufficient information to provide these details. However, in circumstances where relevant postal operators may not be aware of the precise details of the mail integrity incident but are able to provide an estimate, we continue to consider that it is appropriate for estimates to be provided as under the current condition. We have amended the drafting in Essential Condition 1 in order to clarify this.
- 6.22.9 Royal Mail also proposed a number of other small drafting amendments to the Mail Integrity Code of Practice (MICOP).²¹⁷ However, given that we have proposed to revoke the MICOP and move to a more principles-based approach, many of these drafting changes are no longer relevant. In respect of its other proposed drafting changes, we have decided that the drafting we originally proposed is already sufficiently clear. Therefore, we have not made any further revisions to Essential Condition 1.
- 6.23 We have therefore decided to revoke Essential Condition 1 and replace it with a revised Essential Condition 1 as outlined above. The statutory notification setting out the revised Essential Condition 1 is at Annex 8. We have also set out a mark up for information only showing the changes to the drafting of Essential Condition 1 from the version we consulted on in the May 2016 Consultation in Annex 9.

Consumer Protection Condition 2 (CP 2): Postal Common Operational Procedures

Summary of our consultation proposals

- 6.24 The purpose of CP 2 is to ensure that mail which enters the wrong postal operator’s network is returned to the intended operator, and delivered to the recipient, as quickly as possible. For example, if an item of mail being delivered by a competitor to Royal Mail accidentally entered Royal Mail’s network via a post box, this item would need to be returned to the correct postal operator. CP 2 is designed to ensure that this process takes place quickly and fairly.
- 6.25 We proposed to remove the current Postal Common Operational Procedures (PCOP) Code of Practice and requirement on relevant postal operators to sign up to the Postal Common Operational Procedures (PCOP) Agreement, and move to a more principles-based condition, which would set out the objective of PCOP but allow postal operators greater operational flexibility to meet this objective subject to some key safeguards (including that charges for the repatriation of mail were fair and reasonable). We considered this appropriate and proportionate given the low levels

²¹⁶ See Royal Mail’s response to the May 2016 Consultation, Chapter 8.

²¹⁷ These include, for example, changes to requirements around Serious Incidents, having staff responsible for compliance as well as implementing procedures, changes in definitions such as “standards of conduct” to “code of business standards”.

of PCOP mail received by Royal Mail and the fact that a significant entrant in end-to-end letter delivery was unlikely.²¹⁸

- 6.26 We also proposed to amend the scope of CP 2 so that it would apply to end-to-end untracked letter and large letter mail²¹⁹ due to the fact that these types of mail are the most likely to end up in the wrong operator's network (because they are 'letterboxable'), untraceable and receivers are not necessarily expecting them.
- 6.27 In addition, we proposed that CP 2 should apply only to Royal Mail, as the owner of the UK's largest post box network (and therefore the most common recipient of mail intended for another operator), and given that it was likely that other end-to-end operators would be incentivised to ensure repatriation of their own letter and large letter items back to them without the need for regulation.²²⁰

Summary of stakeholder responses

- 6.28 Many respondents, including Royal Mail, agreed with our proposals,²²¹ in particular with the idea of moving to a more flexible, and principles-based approach.
- 6.29 CCNI raised concerns about the detail in the proposals, in particular, in relation to the need to be able to clearly identify the intended operator on the mail items, and the need for the agreements to be monitored.
- 6.30 The MCF agreed in principle to a move to a more flexible approach and a more pragmatic approach to "inter operator operational arrangements". However, it argued that the current system is not burdensome, works well in the main and that the benefits of moving to a more flexible system were not clear. It also expressed concerns that it would not be possible to establish a shared view between Royal Mail and other postal operators about what represented a fair and reasonable cost of returning PCOP items.²²²
- 6.31 Three other respondents disagreed with our proposals,²²³ raising concerns about a lack of protection for both the other postal operators and consumers, and with the proposed level of protection:
- CFH considered that the PCOP Code of Practice and Agreement gave significant protection to end-to-end competitors to Royal Mail and was concerned about its ability to negotiate adequate terms on a commercial basis with Royal Mail absent the Code and Agreement.
 - Citizens Advice was concerned about the removal of the requirement for the intended postal operator to be identified on mail items and the impact this might have in terms of complaints being dealt with correctly and efficiently.
 - The CWU considered that PCOP was an important safeguard for postal users and disagreed with the proposals to move to a principle based approach as well

²¹⁸ For example, see the May 2016 Consultation, paragraph 7.51.

²¹⁹ For the specific proposed definition of the relevant mail, see the May 2016 Consultation, Annex 14.

²²⁰ See the May 2016 Consultation, paragraphs 7.58-7.65.

²²¹ See responses to the May 2016 Consultation from ONEPOST, Secured Mail, UK Mail, Unite, Royal Mail and BBC Licence Fee Unit.

²²² See MCF's response to the May 2016 Consultation, Annex page 5.

²²³ See responses to the May 2016 Consultation from CFH, Citizens Advice and CWU.

as limit the scope to Royal Mail and letter and large letter mail and the removal of the reporting requirements.

- 6.32 Given the range of views on our proposals, we held a meeting with affected postal operators²²⁴ to discuss PCOP and how the proposed changes to CP 2 could be implemented on 17 November 2016.
- 6.33 In this meeting, Royal Mail said that our proposed changes to CP 2 would allow it more flexibility to respond to significant changes in PCOP volumes (such as there was when Whistl started delivering letters), and as such the condition would be more “future proof”. Royal Mail also said that the current CP 2 was no longer proportionate given the low volumes and revenues involved.
- 6.34 CFH and DX said that the current CP2 and accompanying Code of Practice and Agreement worked well and should not be changed. DX argued that it was disproportionate to change CP 2 and expect operators to re-negotiate their agreements with Royal Mail when the current system already worked well, and the cost of renegotiating these contracts would be higher than the current cost to operators (for example, DX informed us that its direct cost of handling PCOP mail was around £16,000 per year).
- 6.35 CFH said that our proposed changes to CP 2 would remove protections for smaller letter delivery companies (particularly in relation to the cap on PCOP charges), and feared that Royal Mail could potentially increase PCOP charges which CFH would have to accept unless it could successfully bring a dispute to Ofcom. It argued that this would most likely take too long to resolve.
- 6.36 All attending operators agreed with our proposals to amend the scope of CP 2 to only include postal operators delivering letters and large letters, and remove the current reporting requirements (but with an obligation to keep records). CFH also agreed that requiring charges to be cost-based was also a good proposal in principle, but it believed it was too difficult to measure the cost of these activities, and CFH preferred that Ofcom have oversight (and approval) of Royal Mail’s charges.
- 6.37 Following this workshop, we also received an additional submission from Royal Mail which reiterated its position that it was supportive of our consultation proposals.²²⁵
- 6.38 In addition, Royal Mail made some specific comments about the proposed changes to CP 2. First, it said that Ofcom should clarify that only those letters which have been accidentally or unintentionally mis-posted should be considered mis-posted letters, rather than letters which had been deliberately mis-posted (e.g. letters that have been deliberately put into a Royal Mail post box despite them being the responsibility of another postal operator).
- 6.39 Second, Royal Mail said it did not agree with Ofcom’s proposal to remove the requirement for code identifiers. It said a more reasonable approach would be to remove the code identifier but require that a ‘clearly identifiable logo, or similar’ was included on the mail piece to ensure that it could be repatriated if it entered Royal Mail’s network in error.

²²⁴ Royal Mail, CFH and DX accepted Ofcom’s offer of a meeting to discuss our PCOP proposals following an invitation to a number of industry stakeholders.

²²⁵ Royal Mail letter to Ofcom, dated 2 December 2016.

Our assessment and final decision

- 6.40 Taking into account the responses to the May 2016 Consultation and subsequent discussions with stakeholders, we have considered whether it is still appropriate to move to a principles-based condition to manage the repatriation of mail to the intended operator.
- 6.41 We agree with DX, CFH and CWU that the current CP 2 provides sufficient protection for consumers (both senders and receivers of mail). The intention behind our May 2016 proposals was to give greater flexibility to all affected postal operators on how the arrangements to identify and return mail to the intended operator should work. Given that the majority of PCOP mail comes from customers of smaller end-to-end letter delivery operators and ends up in Royal Mail's network, it is important that the regulatory arrangements ensure the repatriation process works in an efficient, economic and timely manner for these smaller operators and their customers, as well as Royal Mail.
- 6.42 We note the strong objections that CFH and DX made to our proposed changes to the PCOP arrangements. In particular, we agree that the volume of PCOP mail is very low²²⁶ and the total amount of charges currently paid is also very low.²²⁷ It is important therefore to consider the potential benefits that are likely to come from a more flexible condition against the cost of implementing new arrangements for both Royal Mail and the smaller postal operators who use PCOP, especially given the current arrangements appear to be working effectively.
- 6.43 Our proposals would likely have required operators to negotiate new contracts with Royal Mail initially. In addition to the time that it would take for operators to agree new contracts, one respondent (CFH) expressed a concern about its ability to negotiate fair and reasonable commercial terms with Royal Mail. The MCF was also concerned that the only regulatory protection for operators with PCOP mail that ends up in Royal Mail's network would be a requirement for terms to be fair and reasonable.
- 6.44 In its response to the 2013 Codes of Practice CFI,²²⁸ Royal Mail argued that an industry-managed Code and Agreement would be more flexible and effective given the rate of change in the postal market. Much of that change (at least in relation to the amount of PCOP mail that ends up in Royal Mail's network and the processes used to identify and extract it) had been due to Whistl's end-to-end letter delivery operations. Since Whistl has stopped its letter delivery operations, the volume of PCOP mail has reduced by around 95%. In addition, as set out in the May 2016 Consultation, we consider it unlikely that a significant end-to-end letter delivery operator will enter the UK market. In this context, the benefits of more flexible PCOP arrangements are likely to be lower than was the case in 2013.
- 6.45 Royal Mail has argued that the current PCOP arrangements are disproportionate given the low volume of PCOP mail. However, given the cost to other operators of renegotiating contracts with Royal Mail and any uncertainty this might create for

²²⁶ The total volumes of PCOP mail in 2015/16 were [redacted]. Royal Mail, *Royal Mail's annual report to Ofcom in relation to the total number of Misdirected Code Letters*, June 2016.

²²⁷ The cost of identifying and extracting PCOP mail within Royal Mail's system equates to less than [redacted] of the revenue of the Reported Business. The cost of repatriation depends on the method the intended operator chooses to have its mail returned.

²²⁸ Ofcom, *Review: Mail Integrity and Postal Common Operational Procedures: Call for inputs*, 28 February 2013, https://www.ofcom.org.uk/_data/assets/pdf_file/0031/46399/condoc.pdf

smaller end-to-end operators, we consider that the benefits that this additional flexibility would bring are likely to be outweighed by the costs to all market participants of moving to a new system.

- 6.46 On reflection, we have therefore decided not to move to a more principles-based condition. Instead, we propose to retain the existing condition and the requirement for all relevant postal operators to follow the PCOP Code of Practice and to sign up to the PCOP Agreement (in the absence of having entered into appropriate alternative arrangements for the repatriation of mail).
- 6.47 We note that Royal Mail has previously told us that the charges set out in the PCOP Agreement do not cover its cost for the repatriation of mail.²²⁹ To the extent that this is still the case (given the significant change in the volume of PCOP mail), we note there is a mechanism for modifying the PCOP Agreement (which contains the schedule on charges) set out in CP 2.2.5, as discussed further below.
- 6.48 We propose to amend the scope of the condition so that it would apply to all postal operators who handle untracked end-to-end letter and large letter mail as this is the type of mail which is most likely to require repatriation (as is currently the case). This would include document exchange mail given the likelihood that a small proportion of it would end up in Royal Mail's network, but would exclude express and secured services, access mail and other closed user group networks (such as Royal Mail's Relay service²³⁰). In relation to access mail, we remain of the view that it is not necessary to apply CP 2 to such mail, as the relevant contractual arrangements between access operators and Royal Mail already provide for the repatriation of such mail.
- 6.49 We also propose to introduce some further flexibility into the way changes can be made to the PCOP Agreement (as set out in CP 2.2.5), so that the relevant postal operators who are parties to that Agreement would be able to introduce changes which they agree among themselves, without having to seek a direction from Ofcom. Instead, we propose that Ofcom would need to be notified of the proposed changes to the Agreement, and would retain the power to intervene by issuing a direction to make changes to the Agreement in the event that Ofcom considered such changes were necessary in order to achieve the Code Objectives (see the proposed amendments to CP 2.2.6).
- 6.50 We consider this should provide greater flexibility for changes to be introduced where there is general agreement among the parties to the Agreement, while also ensuring there is an appropriate level of regulatory oversight. While we acknowledge that these proposed changes would require some amendments to the existing clauses in the Agreement relating to how variations of the terms of the Agreement may be made, we do not expect these to be costly or burdensome for the parties to the Agreement to introduce. We would expect the parties to the Agreement to negotiate and agree among themselves how changes to the Agreement should be agreed and introduced. We would expect this to involve appropriate consultation among all

²²⁹ See for example Royal Mail's response to Ofcom's Mail Integrity and Postal Common Operational Procedures: Call for inputs, 28 February 2013, https://www.ofcom.org.uk/_data/assets/pdf_file/0031/46399/condoc.pdf; and Royal Mail's response is available at: https://www.ofcom.org.uk/_data/assets/pdf_file/0026/58850/royal_mail_pcop.pdf.

²³⁰ This involves scheduled collection and delivery to and from different sites within a business and we consider the likelihood that mail of this type will end up in another postal network (including the universal service network) is very low.

parties to the Agreement and appropriate publicity for the proposed changes, before these are notified to Ofcom.

- 6.51 We also remain of the view that there is scope to reduce the reporting requirements on relevant operators. Therefore, we intend to remove the requirement on operators to submit annual reports, but intend to add a requirement to keep appropriate records for three years following the date on which they handle the relevant PCOP mail, and to provide copies of any records made as soon as reasonably practicable to Ofcom on request.
- 6.52 In relation to Royal Mail's comments regarding mis-posted letters, we consider mis-directed letters can include letters mis-directed both accidentally and intentionally. This would include, for example, mail accidentally put into the wrong operator's network by sending customers, such as businesses that use more than one postal operator to send their mail. In addition, we consider the PCOP arrangements should include mail that has been intentionally posted into another operator's access point (typically Royal Mail's as other operators do not generally have access points accessible by members of the public) for example by the receiving customer where they have had mail delivered that is not for a recipient at their address (i.e. the previous occupants).
- 6.53 Attempting to design a regulation that distinguished between letters which were accidentally or deliberately mis-directed would be impractical and unmanageable as this would depend on whether the person responsible for causing the letters to enter into the postal network of another operator did so knowingly or not, which would likely be impossible to tell on any objective basis. In addition, if other end-to-end letter operators had to set up their own access points for mail that was not for a recipient at the address delivered (for example, due to an incorrect address or mis-sort by the postal operator) this might become a barrier to market entry and, in any event, would be likely to lead to confusion amongst consumers for both mis-directed mail and when they are sending normal mail.
- 6.54 In addition, on the basis of our consultation proposals, we proposed to remove requirements in relation to code identifiers²³¹ in the revised condition. However, we said that, in practice, some form of identification will remain necessary to ensure that other operators' mail can be easily identified and that it would be up to the relevant industry participants to decide the form of any identification mark. Under our revised proposal, we intend to retain the current requirements in relation to code identifiers, meaning that Ofcom would remain responsible for managing and distributing code identifiers. We note that it is not necessary for document exchange networks to have a CL code on the mail (as is current industry practice) as the address itself makes it clear who the intended operator is. We therefore intend to designate the code identifier for any of the document exchange networks as the pre-fix to their relevant unique addresses (for example, DX [ABC XYZ]).
- 6.55 Finally, we propose to make some further changes to the drafting of CP 2 and the PCOP Code of Practice which we consider are redundant. Specifically, we are proposing:

²³¹ Code identifiers are codes which are printed onto letters covered by the PCOP Code so that the intended operator can be identified. Under the current CP 2, all postal operators within the scope of the condition are required to put a code identifier on the mail in order to identify mail that is subject to the PCOP code and the intended operator. These can be found here:

http://stakeholders.ofcom.org.uk/binaries/post120713/register_of_code_identifiers.pdf.

- 6.55.1 To delete the requirement for the costs of the postal operator who acts as the Secretary to the PCOP Agreement to be reimbursed by Ofcom. Currently, Ofcom has nominated Royal Mail to act as Secretary to the PCOP Agreement.²³² The Secretary to the PCOP Agreement is responsible for fulfilling the contractual requirements for allowing new postal operators to become parties to the Agreement and giving effect to the withdrawal of parties from the Agreement. We do not consider it to be appropriate for Ofcom to reimburse Royal Mail (or any other postal operator) for the costs of fulfilling this function. We would expect the costs involved in fulfilling this role to be relatively low, and consider that it would be more appropriate for the parties to the Agreement to decide between themselves how to cover the costs of this function. We note that the Secretary to the PCOP Agreement has not sought any reimbursement from Ofcom for costs incurred in fulfilling this role to date.
- 6.55.2 To delete reference to the application of the PCOP Code of Practice to access operators and intermediaries (as set out in the current CP 2.3.9 - CP 2.3.10), as we intend to clarify that the CP 2 does not apply to access operators or intermediaries, and we consider that all relevant postal operators who would be within the scope of CP 2 would need to use code identifiers as allocated by Ofcom (or Postcomm as relevant), in line with current practice.
- 6.55.3 To delete reference to the voluntary application of the PCOP Code of Practice to other types of mail (i.e. which would not fall under the definition of untracked letter and large letter mail). We do not consider it necessary for it to be set out in CP 2 or in the PCOP Code of Practice that relevant postal operators may choose to use the same arrangements for handling other types of mail which would fall outside of the scope of CP 2. We note that it would remain open to parties to the PCOP Agreement (or any other postal operators not subject to CP 2) to agree between themselves to handle other types of mail in accordance with terms and conditions of the Agreement and in accordance with the standards required by the PCOP Code of Practice if they so choose.
- 6.55.4 To remove the requirement for relevant postal operators to take all reasonable steps to ensure they have sufficient personnel properly trained to handle complaints or other enquiries which relate to misdirected letters or mis-collected letters for which they are not the intended operator. We consider this is an unnecessary level of detail for the purposes of the PCOP Code of Practice, and that it is for the relevant postal operators to ensure that they have in place suitable arrangements for ensuring that their obligations in relation to complaints handling under the PCOP Code of Practice are fulfilled.
- 6.56 In view of our proposed change of approach to CP 2, we are now consulting on the proposed drafting of the revised CP 2 as set out above. The notification of the proposed modification to CP 2 can be found at Annex 10.

Question 1: Do you agree with our proposal to retain the PCOP Code of Practice and the PCOP Agreement and the proposed drafting of the revised condition, as set out

²³² See Ofcom's direction under CP 2 of 27 March 2012, as published as part of the March 2012 Statement, Annex 8, https://www.ofcom.org.uk/_data/assets/pdf_file/0027/71685/annex8.pdf.

at Annex 10? Please provide a written response to Ofcom by 3 April 2017 setting out your reasons.

Consumer Protection Condition 3: Complaints handling and redress

Summary of our consultation proposals

- 6.57 We proposed to retain the general requirement as set out in CP 3.2 for all postal operators to establish, make available, and comply with transparent, simple and inexpensive procedures for dealing with complaints of consumers of postal services, which facilitate the fair and prompt settlement of disputes.²³³
- 6.58 We proposed to apply CP 3.3, which sets out more detailed complaints handling requirements, including a requirement to be a member of a ‘qualifying redress scheme’, only to Royal Mail as the universal service provider, and no longer apply it to smaller postal operators currently in scope of the Condition. We considered this was appropriate given that:
- all postal operators must have a simple, transparent and inexpensive complaints handling procedures in place as a minimum requirement under CP 3.2;
 - postal operators other than Royal Mail primarily deal with bulk mail sent by businesses, and as such have contractual remedies or termination options available to them (without the need for redress via a dispute resolution agency);
 - most postal operators currently in scope of the Condition are of small scale, and given the general complaints handling procedures requirement under CP 3.2, we considered it disproportionate to apply the requirements of CP 3.3 to them; and
 - it was important to ensure that there was sufficient consumer protection in place for users of universal services, including access to a robust complaints handling procedure and to a redress scheme where appropriate.

Summary of stakeholder responses

- 6.59 The majority of respondents agreed with our proposals, including most postal operators and consumer bodies.²³⁴
- 6.60 However, while the consumer bodies largely agreed with our proposal, they suggested that we consider whether parcel operators should also be subject to requirements for complaints handling, albeit with a volume threshold.²³⁵ Citizens Advice provided research it commissioned which showed that consumers value having access to a clear and easy to use complaints procedure.²³⁶ Citizens Advice

²³³ See the May 2016 Consultation, paragraphs 7.81-7.82.

²³⁴ See responses to the May 2016 consultation from AICES, CCP, CCNI, Hermes, MCF, ONEPOST, Secured Mail, Citizens Advice, UK Mail, BBC Licence Fee Unit, and CFH.

²³⁵ See, for example, responses to the May 2016 Consultation from CCNI and Citizens Advice.

²³⁶ Citizens Advice, *The future of consumer needs for postal services: research report for Citizens Advice*, Breaking Blue, June 2016,

<https://www.citizensadvice.org.uk/Global/CitizensAdvice/essential%20services%20publications/Post/Citizens%20Advice%20-%20The%20future%20of%20consumer%20needs%20for%20postal%20services%20090816.pdf>.

also suggested that any operator delivering over 250,000 items should be required to be a member of a redress scheme. The consumer bodies also asked how we would monitor complaint levels in the postal market.

- 6.61 Royal Mail, CWU and Unite disagreed with the proposal. They said that the proposals would mean an unfair burden for Royal Mail²³⁷ and a weakening of consumer protection.²³⁸ They considered that complaints handling and redress requirements should apply equally to all single piece postal operators, including single piece parcel operators.²³⁹ Both Royal Mail and CWU said that there was an issue with the complaint handling procedures of parcel operators.

Our assessment and final decision

- 6.62 In response to stakeholders' comments, we agree with Citizens Advice that complaints handling is important to consumers. However, we consider that the requirements to have "transparent, simple and inexpensive procedures for dealing with complaints of consumers of postal services, which facilitate the fair and prompt settlement of disputes" provides sufficient protection for most consumers.
- 6.63 We set out in the May 2016 Consultation why we did not consider it necessary to extend the additional complaints requirements in CP3.3 to postal operators apart from the universal service provider.²⁴⁰ In summary, we noted that:
- the requirements under CP 3.2 provide a minimum level of protection for all senders and receivers of mail;
 - other postal operators delivering untracked end-to-end letter and large letter mail tend to be focused on bulk mail sent by businesses under commercial arrangements rather than by individual consumers, and therefore there would be other means of dispute resolution available to the senders of the mail (e.g. contractual remedies, alternative dispute resolution where appropriate, or even, the termination of the contract so that the customer could switch to another bulk mail operator). This is also true of Royal Mail's non-universal service products; and
 - it was unclear whether the recipients of such bulk mail need to have a right of recourse to a specific post-related redress scheme to resolve disputes which cannot be resolved through the complaints handling procedure required to be put in place under CP 3.2, but given that other postal operators delivering untracked end-to-end letter and large letter mail are of a very small scale, it appeared disproportionate to apply the requirements of CP 3.3 to them.
- 6.64 We have not seen any evidence to suggest that there is a significant issue in the complaints handling processes in relation to either non-universal service parcels or access mail which would indicate further regulation is required.
- 6.65 From our analysis of the consumer research data provided by Royal Mail, we note that mail users find the complaints processes are easy, complaints are often resolved quickly and mail users are satisfied with the processes. We also note that when mail

²³⁷ See for example Unite's response to the May 2016 Consultation.

²³⁸ See CWU's response.

²³⁹ See for example Chapter 8 of Royal Mail's response to the May 2016 Consultation.

²⁴⁰ See the May 2016 Consultation, paragraph 7.83.

users did complain, they were less likely to recommend or use the same carrier again. This was also the case when talking about the recommendation or re-use of a retailer.²⁴¹

- 6.66 We also asked large parcel operators and access mail operators²⁴² whether and how they monitor the speed and satisfaction with the way consumer complaints are dealt with. All operators who responded to our requests confirmed that they have complaints handling procedures in place, and the majority said that they had escalation procedures and service level targets in terms of the time taken for a response and/or resolution of customer complaints, and offered compensation where appropriate.
- 6.67 Given the above, we do not consider it necessary to extend the scope of CP 3.3 to any other operator beyond the universal service provider. However, we remain of the view that it is important that there is sufficient consumer protection in place for users of universal services, including both senders and recipients. As we noted in the May 2016 Consultation, the majority of Royal Mail's universal service products are offered to mail users under a Scheme,²⁴³ rather than a contract.
- 6.68 We recognise that users of universal service products can take action against Royal Mail for a breach of the terms of a Scheme under sections 91 and 92 of the PSA 2000. However, in practice this could be costly and time consuming. We consider that it is appropriate that the universal service provider, as the postal operator most likely to be relied on by vulnerable consumers or those particularly reliant on postal services, should have access to transparent and robust complaints handling procedures, and a free of charge and easy to use means of redress. We note that under the PSA 2011, we are required to ensure that the universal service provider publishes reports on the number of complaints it has received and how they have been dealt with. We consider the requirements of CP 3.3 support these transparency objectives. We therefore intend to retain the requirement for the universal service provider to be subject to CP 3.3.
- 6.69 In summary, we have decided to revoke CP 3 and replace it with a revised CP 3, as proposed in the May 2016 Consultation (subject only to some minor drafting changes to some of the definitions for consistency with definitions in other regulatory conditions). The statutory notification setting out the revised CP 3 is at Annex 11.

Consumer Protection Condition 5: Delivery

Summary of our consultation proposals

- 6.70 We proposed to revoke CP 5 because we considered that it was a redundant condition.
- 6.71 We considered that postal operators already have a requirement to deliver mail through contractual arrangements and, in the case of the universal service provider,

²⁴¹ Illuminas, *Parcel Delivery Experience*, 27 July 2016, carried out on behalf of Royal Mail.

²⁴² We sent formal information requests under s55 of the PSA2011 to seven parcel operators (who along with Royal Mail collectively made up over 80% of market revenues in 2015/16) and the three largest access operators on 16 November 2016.

²⁴³ A 'Scheme' is a document where a postal operator publicly sets out the charges, terms and conditions it has for its products and services. These allow customers to purchase services under specific terms without the need for individual contracts.

the requirement to deliver universal service products under DUSP 1.6 and performance targets under DUSP 1.9. We considered that mail integrity requirements in Essential Condition 1 also provide an additional incentive to deliver mail.²⁴⁴

Summary of stakeholder responses

- 6.72 The majority of respondents to this question, including many postal operators, access operators and Royal Mail, and some of the consumer groups,²⁴⁵ agreed with our proposal to revoke CP 5, with many stating that the condition was unnecessary or redundant.²⁴⁶
- 6.73 The CWU disagreed with our proposal, and suggested that rather than revoke the condition, we should extend it to cover parcel operators as it was not convinced that contractual remedies were sufficient.²⁴⁷ The CCP also disagreed with our proposal as it did not believe that CP 5 was unduly burdensome. It also said that CP 5 was a safeguard for consumers and should not be removed just because it has not been used.²⁴⁸

Our assessment and final decision

- 6.74 Having considered stakeholders' comments, we continue to believe that CP 5 is a redundant and unnecessary condition, and that the requirement and incentive to deliver mail is already present without the need for this condition.
- 6.75 We continue to consider that contractual arrangements, mail integrity requirements and, in the case of universal service mail, DUSP 1.6 and DUSP 1.9, provide sufficient incentives and requirements on postal operators to deliver mail. We do not agree that we should retain this condition as a safeguard when the aim of the condition would be achieved without it.
- 6.76 We have therefore decided to revoke CP 5. The notification of revocation is set out at Annex 12.

Designated Universal Service Provider (DUSP) Condition 1.10

Summary of our consultation proposals

- 6.77 In the May 2016 Consultation, we proposed to:
- Remove the requirement in DUSP 1.10.1 for Royal Mail to provide advance notification of any price decreases to its universal service products, enabling Royal Mail to have the same flexibility to lower prices as its competitors (while retaining the one-month notification obligation for other non-price changes to terms and conditions and for price increases);²⁴⁹

²⁴⁴ See the May 2016 Consultation, paragraphs 7.88 to 7.93.

²⁴⁵ See responses to the May 2016 Consultation from Royal Mail (Chapter 8), MCF, ONEPOST, Secured Mail, UK Mail, CFH, BBC Licence Fee Unit, CCNI and Citizens Advice – who all agreed.

²⁴⁶ For example, see Responses BBC Licence Fee Unit's response to and Section 8 of Royal Mail's response.

²⁴⁷ See the CWU's response to the May 2016 Consultation.

²⁴⁸ See CCP's response to the May 2016 Consultation.

²⁴⁹ See the May 2016 Consultation, paragraphs 7.100-7.113.

- Remove the requirement in DUSP 1.10.2 and 1.10.3 for Royal Mail to provide advance notification of any changes to its latest delivery times and reduce the length of the advance notification period in DUSP 1.10.2 and 1.10.3 which Royal Mail is required to give when it intends to make changes to its latest collection times from three months to one month. We considered that these changes would allow Royal Mail more operational freedom by allowing it to make changes to delivery and collection times more quickly;²⁵⁰ and
- Restructure the drafting of these three conditions (DUSP 1.10.1, 1.10.2 and 1.10.3) in order to make the requirements clearer.²⁵¹

Summary of stakeholder responses

DUSP 1.10.1 – Notification of price decrease

- 6.78 Some respondents²⁵² agreed with our proposal to remove the notification requirement for price decreases to universal service products, noting that it provided operational freedom to Royal Mail and meant that beneficial price decreases could be passed on to consumers as soon as possible.²⁵³
- 6.79 Most respondents agreed that one month was too long for notification of price decreases. However, some respondents disagreed with our proposal that the notification for price decreases should be removed entirely, and suggested that it should instead be reduced to a shorter period such as one to two weeks.²⁵⁴ The postal operators who disagreed with the proposal argued that it would be hard for them to react to price decreases by Royal Mail if there was there no notification period, which may cause them to lose market share.²⁵⁵ Other respondents suggested that a reduced notification period (rather than no notification period) would minimise the impact on suppliers.²⁵⁶
- 6.80 Some of the consumer bodies raised a concern that those businesses who purchase stamps in bulk may be impacted if prices were to decrease after their purchase.²⁵⁷
- 6.81 Royal Mail welcomed our proposal to remove the advance notification requirement for price decreases for universal service products. However, it said that Ofcom should go further and remove the advance notification period for what it described as “beneficial (or minor) non-price changes to USO services, along with the consultation period”.²⁵⁸

²⁵⁰ Paragraphs 7.114 to 7.128 of the May 2016 Consultation.

²⁵¹ Paragraphs 7.129 to 7.133 of the May 2016 Consultation.

²⁵² See responses to the May 2016 Consultation from Royal Mail, BBC Licence Fee Unit, CCNI, Citizens Advice and CWU, who all agreed.

²⁵³ See for example BBC Licence Fee Unit’s response.

²⁵⁴ See responses to the May 2016 Consultation from DMA, Hermes, MCF, ONEPOST, Unite, CFH, and John Knowles – which all disagreed.

²⁵⁵ For example, see responses to the May 2016 Consultation from Hermes, MCF, CFH and ONEPOST.

²⁵⁶ For example, see DMA’s response to the May 2016 Consultation.

²⁵⁷ See CCNI’s and Citizens Advice’s responses to the May 2016 Consultation.

²⁵⁸ See Royal Mail’s response to the May 2016 Consultation, Chapter 8.

DUSP 1.10.2 and 1.10.3 – Delivery and collection times notifications

- 6.82 Most respondents to this question agreed with our proposal to reduce the advance notification period for changes to specified collection times to one month.²⁵⁹
- 6.83 Respondents were split in their response to the proposal to remove the requirement to provide advance notice of changes to latest delivery times. Six respondents agreed with the proposal,²⁶⁰ with one respondent noting that it provided operational flexibility to Royal Mail which should in turn help it reduce its cost base.²⁶¹
- 6.84 However, five respondents made up of unions and consumer bodies disagreed with this proposal.²⁶² They were concerned that the removal of the notification could have an impact on SMEs and their ability to respond to correspondence the same day.²⁶³ They said that the current regulation provides certainty for recipients of mail,²⁶⁴ and that a reduction to one month's notice, rather than a complete removal, would achieve a better balance between operational freedom for Royal Mail and meeting postal users' needs.²⁶⁵ One union was also concerned that such a change may impact the work-life balance of postal workers.²⁶⁶

Redrafting of DUSP 1.10

- 6.85 Those respondents who agreed with the proposals, generally agreed with the proposed changes to the drafting of DUSP 1.10.²⁶⁷ Those that disagreed with it did so because they did not agree with the underlying proposals for change.²⁶⁸

Our assessment and final decision

DUSP 1.10.1 – Notification of price decrease

- 6.86 With regard to advance notification for price decreases, we consider that the purpose of the current regulation is to minimise the impact of changes to universal service products on users of those services. However, we consider that price decreases are beneficial to consumers, and should be passed on to them as soon as possible. As such, we consider that it is appropriate to remove the requirement for advance notification for price decreases.
- 6.87 We do not consider that it is appropriate that the advance notification requirement should allow Royal Mail's competitors to gain an advantage as a result of requirements on Royal Mail to notify a reduction in its prices when no such notice is available to Royal Mail when a competitor alters its prices. This is not the aim of the

²⁵⁹ See the responses to the May 2016 Consultation from CCP, CCNI, CWU, CFH, MCF, ONEPOST, Citizens Advice, Unite, John Knowles, Royal Mail and BBC Licence Fee Unit – who all agreed.

²⁶⁰ See the responses to the May 2016 Consultation from MCF, CFH, ONEPOST, John Knowles, Royal Mail and BBC Licence Fee Unit – who all agreed.

²⁶¹ See BBC Licence Fee Unit's response to the May 2016 Consultation.

²⁶² See the responses to the May 2016 Consultation from the CCP, Citizens Advice, and CWU.

²⁶³ For example, see CWU's response to the May 2016 Consultation.

²⁶⁴ For example, see Unite's response to the May 2016 Consultation.

²⁶⁵ For example, see CCNI's response to the May 2016 Consultation.

²⁶⁶ See CWU's response to the May 2016 Consultation.

²⁶⁷ See the responses to the May 2016 Consultation from MCF, ONEPOST, Royal Mail, CFH, and BBC Licence Fee Unit.

²⁶⁸ See the responses to the May 2016 Consultation from the CCNI, CWU, Unite and Citizens Advice.

regulation, and we consider that it would be inappropriate to retain this restriction on Royal Mail when there is no consumer benefit or need.

- 6.88 We do not consider that the purchasing of stamps in extremely large quantities is a common occurrence and, in any case, a price fall after a purchase is something that can happen with any commodity. Increasing Royal Mail's ability to reduce prices quickly is beneficial to most consumers.
- 6.89 We also consider that it remains appropriate to retain a requirement on Royal Mail to provide advance notification for non-price changes to universal services, and to consult on such changes for a minimum period of one month,²⁶⁹ so that relevant groups and individuals have an opportunity to comment on and, if necessary, adapt their behaviour to accommodate any such changes before they come into effect. The opportunity to comment on and adapt behaviour ahead of non-price changes coming into effect is important, given that such changes have the potential to have an impact on some users of universal services but not others, while price decreases are likely to have a universally positive impact and therefore we do not consider that advance notification is necessary.
- 6.90 We have therefore decided to implement our proposal, and remove the requirement in DUSP 1.10.1 for the universal service provider to provide advance notification of price decreases to universal service products, while retaining a one-month notification period for non-price changes and price increases.

DUSP 1.10.2 and 1.10.3 – Delivery and collection times notifications

- 6.91 We note that no respondent disagreed with our proposal to reduce the advance notification requirement for changes to specified collection times from three months to one month, and we have decided to make this change. We consider that this will provide Royal Mail with greater operational freedom, while still allowing consumers (particularly small businesses) to have sufficient notice in order to adapt to a change in collection times.
- 6.92 In terms of notification of changes to latest delivery times, we note that most of the concerns raised related to the impact it could have on the time recipients of mail would actually receive their mail, rather than a need for advance notification of changes to the final delivery time. We would like to clarify that Royal Mail is ultimately responsible for setting the latest delivery time, and dealing with any implications this may have in relation to its employees' hours of work (as is currently the case). Ofcom's proposal has no effect on the latest time that mail would be delivered, rather it relates to the notice period that Royal Mail must provide currently before changing final delivery times in a given location.
- 6.93 In terms of the ability of consumers and SMEs to react to changes to latest delivery times, recipients are not in control of the time mail is delivered as Royal Mail has discretion to revise its delivery routes (on a daily basis if necessary) to optimise its operational efficiency. As such consumers are generally not in a position to change

²⁶⁹ This relates to the requirement under section 89A(1)(b) of the Postal Services Act 2000 for Royal Mail to carry a consultation exercise in relation to making a Scheme in accordance with requirements contained in a notification published by Ofcom. As noted above, Royal Mail makes its universal service products available under a Scheme. In the March 2012 Statement, we explained that we considered that postal operators intending to make a scheme should consult for a period of not less than one month with those customers or users likely to be affected by the scheme and with any relevant groups representing such customers or users (see paragraph 12.139).

their behaviour in response to latest delivery times. We therefore remain of the view that it is not necessary for there to be advance notification given before a change to the latest delivery time. While Royal Mail is responsible for setting delivery times itself, we note that it does offer a number of services to businesses which could address the concerns of a later delivery time (e.g. Early Collect, Mail Collect and Timed Delivery).²⁷⁰

- 6.94 We have therefore decided to implement both of our proposals, i.e. to reduce the advance notification period for changes to specified collection times from three months to one month; and to remove the requirement for an advance notification period for changes to the latest delivery times. For the purposes of consistency and clarity, we have also decided to implement our proposal to remove the advance notification period for when a re-classification of addresses leads to a change in delivery time.

Restructure of DUSP 1.10

- 6.95 For the purposes of consistency and clarity, we have also decided to implement our proposal to restructure and redraft DUSP 1.10.1 and 1.10.2 and remove DUSP 1.10.3.
- 6.96 We have therefore decided to revoke DUSP 1 and replace it with a revised DUSP 1 as proposed in the May 2016 Consultation (subject only to a minor change to the definition of ‘public holiday’ to align it with the definition of ‘public holiday’ in other regulatory conditions). The statutory notification setting out the revised DUSP 1 is at Annex 13.

Legal tests – decisions

- 6.97 In the above section, we have confirmed a number of amendments to CP 3, Essential Condition 1 and DUSP 1.10 following our proposals in the May 2016 Consultation. We explain below why we consider our decisions satisfy the relevant tests set out in Schedule 6 of the PSA 2011 which must be met where we impose or modify a regulatory condition, namely that they:
- are objectively justifiable;
 - do not unduly discriminate against a particular person of a particular description of persons;
 - are proportionate; and
 - are transparent in relation to what it is intended to achieve.
- 6.98 As we have not proposed any modification to CP 1, and we have confirmed the revocation of CP 5 completely, we do not consider these Conditions below.

Objectively justifiable

- 6.99 We consider that our amendments to the scope of Essential Condition 1 and CP 3 are objectively justifiable because they will ensure, for the reasons discussed in paragraphs 6.10 to 6.21 and 6.62 to 6.69 respectively, that our regulation is targeted

²⁷⁰ For example, see Royal Mail’s website, <http://www.royalmail.com/corporate/mail-management>.

at the most appropriate postal operators and postal items in order to meet our regulatory objectives.

- 6.100 We further consider that the amendments to Essential Condition 1 are justified, for the reasons set out in paragraphs 6.22 to 6.23, in order to ensure that the obligations which are imposed under those conditions are no more onerous than necessary to meet the objectives of ensuring that relevant postal operators protect the integrity of the mail they carry, so that postal users can have confidence in the postal services they use.
- 6.101 We consider that the requirements relating to complaints handling as set out in CP 3 remain appropriate to ensure appropriate protection for consumers as to how their complaints are dealt with, but we do not consider it necessary for the additional requirements set out under CP 3.3 to be imposed on any postal operators other than the universal service provider (i.e. Royal Mail) in respect of complaints relating to its universal service products for the reasons set out in paragraphs 6.62 to 6.66.
- 6.102 We consider our decision to amend DUSP 1.10 is justified because it will ensure an appropriate balance is achieved between protecting postal users and removing unnecessary regulatory burdens.

Not unduly discriminatory

- 6.103 We consider that our changes to CP 3, Essential Condition 1 and DUSP 1.10 are not unduly discriminatory because they will ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives.
- 6.104 For CP 3, we consider that it is not unduly discriminatory to apply the additional requirements set out in the condition to Royal Mail for its universal service products only for the reasons set out in paragraphs 6.67 to 6.69.
- 6.105 For Essential Condition 1, we consider that it is not unduly discriminatory to apply the requirements to Royal Mail's untracked universal service parcel products because these are not covered by the protections of tracking, unlike other parcel operators' services. For the reasons set out in paragraphs 6.10 to 6.19, we do not believe it would be appropriate to apply Essential Condition 1 to parcel operators and access mail operators.
- 6.106 For DUSP 1.10, these continue to apply to Royal Mail as the universal service provider.

Proportionate

- 6.107 We believe that our changes to CP 3, Essential Condition 1 and DUSP 1.10 are proportionate because they will ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives. They will only impose requirements that we consider are necessary to meet our regulatory objectives, without imposing undue burden on the relevant postal operators which are subject to these obligations.

Transparent

- 6.108 We consider that our proposed changes to the revised scope of CP 3, and Essential Condition 1 are transparent because the proposed revised conditions would set out

clearly and transparently the postal operators and postal items which would be within scope of those conditions. We also consider that the revised conditions clearly and transparently set out the revised obligations which would apply under those conditions.

Legal tests – consultation proposals

6.109 In the above section, we are proposing certain amendments to CP 2, which are different to those we consulted on in the May 2016 Consultation. We consider these proposals satisfy the relevant tests set out in Schedule 6 of the PSA 2011 which must be met where we impose or modify a regulatory condition, namely that they:

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

Objectively justifiable

6.110 We believe that our proposed amendments to the scope of CP 2 are objectively justifiable because they will ensure, for the reasons discussed in paragraph 6.48, that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives.

6.111 We further consider that the proposed amendments to CP 2 are justified, for the reasons set out in paragraphs 6.49 to 6.55, in order to ensure that the obligations which are imposed under this condition are no more onerous than necessary to meet the objectives of ensuring that mis-collected or mis-directed mail items are returned to the correct postal operator or otherwise handled appropriately (such as being delivered to the relevant addressee).

Not unduly discriminatory

6.112 We consider that our proposed changes to CP 2 are not unduly discriminatory because they will ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives.

Proportionate

6.113 We believe that our proposed changes to CP 2 are proportionate because they will ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives. They will only impose requirements that we consider are necessary to meet our regulatory objectives, without imposing undue burden on the relevant postal operators which are subject to these obligations.

Transparent

6.114 We consider that our proposed changes to the scope of CP 2 are transparent because the proposed revised conditions would set out clearly and transparently the postal operators and postal items which would be within scope of that condition. We

also consider that our proposed changes would clearly and transparently set out the revised obligations which would apply under that condition. We are also now consulting on the precise wording of the revised condition, as set out in the Notification in Annex 10.

Update on other conditions

Consumer Protection Condition 1

- 6.115 We noted in the May 2016 consultation that we had not completed a review of CP 1 because we intended to “reconsider this condition alongside a review of our Statement of Charging Principles for Postal Services to ensure that there is greater alignment between the two.”²⁷¹
- 6.116 We intend to undertake such a review during the 2017-18 financial year. Our review will consider both CP 1 and our own charging principles for post; and will include an assessment of whether the criteria for sharing regulatory fees across the postal market should be amended. It is not a review of the level of our regulatory fees, which are determined on an annual basis by Ofcom to reflect our work plan.
- 6.117 The issue of fees paid by postal operators for the work of the Consumer Advocacy Bodies is a matter for government (the Department for Business, Energy & Industrial Strategy); we have no role in setting the level or examining the calculation of these costs, we only recover the fees under CP 1 as we are required to do by the Secretary of State. Our review will therefore not consider the level or calculation of consumer advocacy costs.

²⁷¹ See the May 2016 Consultation, paragraph 7.5.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom would like to receive views and comments on the consultation question contained in this document relating to Postal Common Operational Procedures, **by 5pm on 3 April 2017**.
- A1.2 We strongly prefer to receive responses via the online form at <https://www.ofcom.org.uk/consultations-and-statements/category-1/royal-mail-review2016>. We also provide a cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>) for responses sent by email or post; please fill this in, as it helps us to maintain your confidentiality, and speeds up our work. You do not need to do this if you respond using the online form.
- A1.3 If your response is a large file, or has supporting charts, tables or other data, please email it to postal.regulation@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>).
- A1.4 Responses may alternatively be posted to the address below, marked with the title of the consultation.
- Richard Orpin
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- A1.5 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the question asked in this document. The question is listed at Annex 3. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.

Confidentiality

- A1.7 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on our website, www.ofcom.org.uk, as soon as we receive them.
- A1.8 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to

remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further at <https://www.ofcom.org.uk/about-ofcom/website/terms-of-use>.

Next steps

- A1.11 If you wish, you can register to receive mail updates alerting you to new Ofcom publications; for more details, please see <https://www.ofcom.org.uk/about-ofcom/latest/email-updates>

Ofcom's consultation processes

- A1.12 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 2.
- A1.13 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.

If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact Steve Gettings, Ofcom's consultation champion:

Steve Gettings
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Email: corporationsecretary@ofcom.org.uk

Annex 2

Ofcom's consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

- A2.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

- A2.2 We will be clear about whom we are consulting, why, on what questions and for how long.
- A2.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.
- A2.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.
- A2.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.
- A2.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

- A2.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	<input type="checkbox"/>	Name/contact details/job title	<input type="checkbox"/>
Whole response	<input type="checkbox"/>	Organisation	<input type="checkbox"/>
Part of the response	<input type="checkbox"/>	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 3

Consultation question

- A3.1 **Question 1:** *Do you agree with our proposal to retain the PCOP Code of Practice and the PCOP Agreement and the proposed drafting of the revised condition, as set out at Annex 10? Please provide a written response to Ofcom by 3 April 2017 setting out your reasons.*

Annex 4

Glossary and defined terms

A4.1 This glossary is a non-exhaustive list of defined terms and acronyms used throughout this statement. It is designed to help readers understand the terms and acronyms we have used in order to help them understand the document and our decisions with greater clarity and transparency.

Term	Definition
2013 Codes of Practice CFI	Ofcom's Call for Inputs dated 28 February 2013 entitled <i>Review: Mail Integrity and Postal Common Operational Procedures - Call for inputs</i> .
2014 End-to-end Statement	Ofcom's statement dated 2 December 2014 entitled <i>Review of end-to-end competition in the postal sector</i> .
2014 proposals	The access pricing proposals as initially set out in the December 2014 Consultation.
Business Plan 2015	The strategic business plan submitted by Royal Mail to Ofcom between April and May 2015. Royal Mail is required to submit a strategic business plan each financial year under USPAC 1.3.9(b).
Business Plan 2016	The strategic business plan submitted by Royal Mail to Ofcom in July 2016.
Access	Allowing other companies operating in the postal market, or other users of postal services, to use Royal Mail's facilities for the partial provision of a postal service. Access to Royal Mail's postal facilities could in principle be at any point in the pipeline, though in our regulations we require access at the Inward Mail Centre only.
Access Letters Contract	A standard form bi-lateral contract which enables access customers to procure products from Royal Mail using one of four price plans.
ACOD	Advisory Committee on Older and Disabled People. Since 2012 there has been cross-membership for the CCP and ACOD.
AICES	Association of International Courier & Express Services
Annual Monitoring Report for 2014-15	Ofcom's market update dated 27 November 2015, entitled <i>'Annual monitoring update on the postal market – Financial year 2014-15'</i>

Annual Monitoring Report for 2015-16	Ofcom's market update dated 30 November 2016, entitled ' <i>Annual monitoring update on the postal market Financial year 2015-16</i> '
Closed user group network	We have defined closed user group network as a system providing for the conveyance of postal packets (and the incidental services of receiving, collecting, sorting and delivering postal packets), where both the sender and the recipient of the postal packets have entered into specific arrangements with the postal operator for the conveyance of postal packets to or from other members of that system.
Code identifier	Code identifiers are codes which are printed onto letters covered by the PCOP Code so that the intended operator can be identified. Under CP 2, all postal operators within the scope of the condition are required to put a code identifier on the mail they deliver.
Consumer Advocacy Bodies	This refers to the three consumer bodies – Citizens Advice, Citizens Advice Scotland and General Consumer Council Northern Ireland (CCNI).
C2X	Consumer to Anywhere
CA 2003	The Communications Act 2003
CCP	Communications Consumer Panel. Since 2012 there has been cross-membership for the CCP and ACOD (Advisory Committee on Older and Disabled People).
CFH	CFH Docmail
CFI	Call for Inputs
CMR	Communications Markets Report. An annual research report published by Ofcom.
Consumer Protection Condition (CP)	Ofcom may impose a consumer protection condition on every postal operator or every postal operator of a specified description.
CPI	Consumer Price Index
CWU	Communications Workers Union
D+2	A postal service that aims to deliver two working days after collection, also known as a day C service.
D+2 Access	Access to Royal Mail's postal network at the Inward Mail Centre for the purposes of providing D+2 and later than D+2 Letters and Large Letters services.

The December 2014 Consultation	Ofcom's consultation dated 2 December 2014, entitled 'Royal Mail Access Pricing Review – Proposed amendments to the regulatory framework'.
Document exchange	We have proposed to define a document exchange as a system providing for the conveyance of postal packets by reference to numbered boxes at document exchange points between users subscribing to the specific document exchange mail network and which uses addresses which are unique to the specific document exchange mail network.
DMA	Direct Marketing Association
Downstream	The activities of sortation in the Inward Mail Centre and delivery of mail items from the Inward Mail Centre to the final destination.
DUSP Condition	Designated Universal Service Provider condition. A condition Ofcom may impose on the designated universal service provider under section 36 of the PSA 2011.
EBIT	Earnings Before Interest and Tax.
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation.
End-to-end operators	Operators other than Royal Mail that provide a postal service from collection to delivery without using Royal Mail's postal network (usually only in some parts of the country).
Essential Condition	A condition Ofcom may impose under section 49 of the PSA 2011 on every postal operator or every postal operator of a description specified in the condition containing such obligations as Ofcom considers necessary for the purposes of safeguarding confidentiality in connection with the sending, conveyance and delivery of letters, safeguarding security where dangerous goods are transported, safeguarding the confidentiality of information conveyed, guarding against the theft or loss of or damage to postal packets and securing the delivery of postal packets to the intended addressee.
European Postal Services Directive	Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service (as amended by Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008)
FAC	Fully allocated cost
Financeability EBIT	EBIT of the Reported Business used for assessing financeability of the universal service.

FFO	Funds from Operations
Inward Mail Centre	The part of a Royal Mail mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre's catchment area) of mail received from the upstream part of Royal Mail's network, or from other postal operators etc., to the final addresses take place.
January 2014 changes	On 10 January 2014, Royal Mail announced increases to Access prices, as well as changes to its contracts with Access customers.
July 2015 Discussion Document	Ofcom's discussion paper dated 17 July 2015 entitled <i>Review of the regulation of Royal Mail</i> .
Large Letter	A large letter is any postal item larger than a Letter and up to 353mm in length, 250mm in width and 25mm in thickness, with a maximum weight of 750g.
Letter	A Letter is any postal item up to 240mm in length, 165mm in width and 5mm in thickness, weighing no more than 100g.
LRIC	Long run incremental cost
LRAIC	Long run average incremental cost
Mailmark	Mailmark is a barcode system used by Royal Mail on certain letter and large letter products. Royal Mail defines Mailmark as an option for making letters and large letters machine-readable, involving the addition of a Mailmark barcode to each item to make that item uniquely identifiable.
March 2012 Statement	Ofcom's Statement dated 27 March 2012 entitled <i>Securing the Universal Postal Service – Decision on the new regulatory framework</i> .
May 2016 Consultation	Ofcom's Consultation document dated 25 May 2016 entitled <i>Review of the Regulation of Royal Mail – Consultation</i> .
MCF	Mail Competition Forum
MICOP	Mail Integrity Code of Practice
MUA	Mail Users' Association
PCOP	Postal Common Operational Procedures
PCOP Agreement	Postal Common Operational Procedures Agreement is a default agreement for postal operators to ensure that they follow the PCOP Code of Practice and CP 2. The PCOP Agreement itself is not part of the regulatory conditions, however, CP2 provides for a process that Ofcom must follow when modifying the PCOP Agreement if it receives a proposal for change from a signatory

	to the Agreement.
PCOP Code of Practice	Postal Common Operational Procedures Code, which can be found at Annex 1 of CP 2. The PCOP Code sets out a code of practice for the repatriation of mail which has entered the network of one postal operator but which was intended for another.
PCA	Postcode Area
Pipeline	Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item.
Postal operator	Defined in section 27(3) of the PSA 2011 as meaning a person who provides the service of conveying postal packets from one place to another by post, or any of the incidental services of receiving, collecting, sorting and delivering postal packets.
Postal service	Defined in section 27(1) of the PSA 2011 as meaning the service of conveying postal packets from one place to another by post, the incidental services of receiving, collecting, sorting and delivering postal packets, and any other service which relates to, and is provided in conjunction with, any of those services.
Postal network	Defined in section 38(3) of the PSA 2011 as meaning the systems and all the resources used by the provider for the purpose of complying with its universal service obligations (and, accordingly, includes arrangements made with others for the provision of any service).
Postal Packet	According to section 27(2), the expression 'postal packet' means a letter, parcel, packet or other article transmissible by post.
Pre-sorted	Where the sender has sorted its mailing items to a predetermined level before handing them to the postal operator. Some postal operators call this type of mail 'sorted'.
Price Plans	The respective national and zonal pricing options which Royal Mail offers in relation to its agreements with other persons for D+2 Access. It includes the price plans known as 'National Price Plan One (SSCs)', 'Average/National Price Plan Two (Zones)' and 'Zonal Price Plan', respectively, as well as the price plans for D+2 Access that preceded these price plans from time to time (known as Condition 9 agreements, whether or not they remain in force).
Postcomm	The Postal Services Commission, which was the regulator responsible for postal services in the UK, until it was merged into Ofcom in 2011.

PSA 2000	The Postal Services Act 2000
PSA 2011	The Postal Services Act 2011
PVEO	Price, Volume, Efficiency and Other
RAB	Regulatory Asset Base
Regulatory Accounting Guidelines (RAG)	A document setting out such requirements as Ofcom may direct from time to time relating to the preparation, auditing, reporting and publication, of regulatory financial statements and other regulatory financial reports to be prepared and maintained by Royal Mail under the USP Accounting Condition.
Regulatory financial reports	The financial reports produced for Ofcom by Royal Mail in accordance with the RAG; they include both the regulatory financial statements and additional financial reports produced by the Royal Mail as per the guidance in the RAG.
Regulatory financial statements	The income statements, balance sheet statements and cash flow statements produced by Royal Mail in accordance with the guidance in the RAG.
Relevant Group	Royal Mail PLC and the group of companies it collectively holds.
Reported Business	The part of Royal Mail's UKPIL business that undertakes activities for the purpose of, or in connection with, the provision of universal service and non-universal service products, excluding the activities and products of Parcelforce International and Royal Mail Estates Limited. For the avoidance of doubt, the activities and products of the Reported Business shall be treated to include all the activities and products which fall within the scope of Royal Mail's National Costing Methodology as documented in the Costing Manual from time to time.
RMPP	Royal Mail Pension Plan
ROA	Return on Assets
Royal Mail	Royal Mail Group Limited, whose registered company number in England and Wales is 04138203.
RPI	Retail Price Index
SAC	Stand-alone cost
Safeguard cap	In 2012 Ofcom introduced a safeguard cap on Second Class stamp items up to 2kg, with one price for letters, and a separate basket price for parcels and large letters.
Single piece service	We have defined a single piece service in the Universal Service Order as a postal service for the conveyance of an individual

	postal packet to the addressee, for which the price per postal packet is not subject to any discounts related to (a) the number of postal packets sent in connection with the person who paid for the service; (b) the positioning or formatting of text on the postal packet; (c) the use of markings which facilitate the use of machines to sort postal packets; (d) pre-sortation into geographical areas for delivery; or (e) the purchase of any other conveyance of the same or any other postal packet. This is the definition we have used for the purposes of our letters market analysis.
Single piece parcel	For the purposes of our market analysis of the parcels sector and our ongoing monitoring regime, we have defined a single piece parcel as any parcel delivery service which is available for purchase by any member of the public and can be used for sending an individual parcel.
Standard Selection Code (SSC)	A numeric code used by Royal Mail to sequence addresses, identify selection breaks and match items to mailing bag labels.
Statement of Process	Royal Mail is required to publish a statement of process that sets out the processes that will apply to requests for D+2 Access and variations to existing D+2 Access made to it by access operators and users of access services. This should include the form in which the request should be made, information required by Royal Mail and the reasonable timescales within which such requests will be handled by Royal Mail.
UKPIL	UK Parcels, International and Letters – Royal Mail business unit that includes the Reported Business and Parcelforce International.
Universal Service Obligation (USO)	The obligations imposed on the universal service provider by any designated universal service provider (DUSP) condition.
Universal Service Order	This refers to the Postal Services (Universal Postal Service) Order 2012 (as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013), which defines the scope of a universal service by setting out a description of services that should be provided in the UK as a universal postal service, including a set of required characteristics of those services.
Universal Service Provider (USP)	Any postal operator for the time being designated by Ofcom as the universal service provider under the Postal Services Act 2011.
Upstream	The activities of collection, outward sortation (where necessary – pre-sorted mail may not require further outward sortation) and trunking or transporting the mail to the inward mail centre.
User	Defined in section 65(1) of the PSA 2011 as including addressees and potential users.

USP access condition (USPA Condition)	A condition that Ofcom may impose under section 38 of the PSA 2011 that requires the universal service provider to give access to its postal network to other postal operators or users of postal services and/or requires the universal service provider to maintain accounting separation.
USP Accounting Condition (USPAC Condition)	A condition Ofcom may impose under section 39 of the PSA 2011 that requires the universal service provider to provide regulatory financial statements and information, and may from time to time direct the universal service provider to do one or more of the following: to maintain accounting separation; to comply with rules about the identification of costs and cost orientation; to comply with rules about the use of cost accounting systems; and to secure that compliance with those systems is audited annually.
Viability Statement	An assessment of the viability of Royal Mail Group undertaken as part of Royal Mail Directors' ongoing risk management and monitoring processes. Presented in its Annual Report.
Zones	The geographical zones into which Royal Mail divides the United Kingdom based on the density of delivery points and the proportion of business delivery points of postcode sectors, currently known as Zone A (Urban), Zone B (Suburban), Zone C (Rural) and Zone D (London).

Annex 5

List of respondents to the May 2016 Consultation

- A5.1 We published our consultation on the Review of the Regulation of Royal Mail Discussion Document on 25 May 2016, setting out the findings of our review and inviting input from stakeholders. This document can be found here: https://www.ofcom.org.uk/data/assets/pdf_file/0028/78184/review-of-royal-mail-regulation.pdf
- A5.2 26 stakeholders provided written responses to the Review of the Regulation of Royal Mail:
- Association of International Courier and Express Services
 - BBC Licence Fee
 - CFH
 - Citizens Advice
 - Communications Consumer Panel and ACOD
 - Consumer Council for Northern Ireland
 - Countryside Alliance
 - CWU
 - DMA UK
 - Farmers' Union of Wales
 - Hermes
 - Institute of Directors (IoD) in Wales
 - John Knowles
 - MCF
 - MUA
 - National Federation of SubPostmasters
 - ONEPOST
 - Post Office
 - Royal Mail

- Sam Squirrel Post and Parcel Box
- Scottish Council for Development and Industry
- Secured Mail
- TechUK
- UKMail
- Unite
- Whistl

A5.3 We have published the non-confidential versions of the responses from all the stakeholders listed above. These can be found on our website:
<https://www.ofcom.org.uk/consultations-and-statements/category-1/royal-mail-review2016>

Annex 6

Sources of evidence

A6.1 This annex presents a non-exhaustive list of the sources of evidence we have used, relied upon and/or referred to throughout this statement. It is designed to help readers understand and locate the evidence we have used to form our proposals and decisions with greater clarity and transparency.

UK legislation

- The Communications Act 2003 (as amended)
- The Equality Act 2010 (as amended)
- The Postal Services Act 2011 (as amended)
- The Postal Services (Universal Postal Service) Order 2012 (S.I. 2012/936), as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, S.I. 2013/3108

European legislation

- Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008 amending Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services - <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997L0067-20080227&from=EN>
- Directive 2006/112/EC of the European Parliament and of the Council of 28 November 2006 on the common system of value added tax - <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0112&from=en>

Ofcom documents (excluding research)

- Ofcom, *The Postal Services (Universal Postal Service) Order 2012, SI 2012/936, as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108* - <http://stakeholders.ofcom.org.uk/post/upso/>
- Ofcom, *Securing the Universal Postal Service, Decision on the new regulatory framework* (referred to as 'March 2012 Statement'), 27 March 2012, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>.
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Information gathered using our statutory powers

A1.1 During this review, we have issued several notices under Section 55 and Schedule 8 of the Postal Services Act 2011, requiring Royal Mail and other postal operators to provide us with information, as set out in the notice. The information provided has been used in informing the decisions set out in this document. These information requests are listed below.

- Information from postal operators on their volumes and revenue for letters, large letters and access mail has been monitored on an ongoing basis. The information has been obtained in response to notices issued on a quarterly basis.
- Information request dated 13 July 2016 to a number of postal operators on their quarterly volumes and revenue for parcels.
- Information request dated 18 July 2016 to Royal Mail relating to quarterly volumes and revenue data for parcel services carried by both Royal Mail and Parcelforce Worldwide.
- Information request dated 3 August 2016 to Amazon UK Services Limited relating to quarterly volumes and revenue data for parcels services carried by Amazon Logistics.
- Information request dated 25 August 2016 to a number of parcel operators covering specified information about surcharges for parcel deliveries to certain parts of the UK.

- Information request dated 16 November 2016 to a number of postal operators covering specified information about mail integrity procedures and complaints data.

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