



# **Review of the impact of competition in the postal market on consumers**

**Final report to Citizens Advice, 20 March 2015**

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## Executive summary

### Background

The universal postal service has been a vital piece of society infrastructure, ensuring everyone can communicate with everyone else across the UK and overseas. It has served a particularly important role to vulnerable postal consumers and those with special needs, as well as business and Government wanting to communicate with all.

Over recent years, following an extensive programme of postal reform in the EU, national postal operators, called universal service providers (USPs) have been corporatised and, in some cases, fully or partly privatised. The postal market has become more dynamic, with declines in traditional letter products set alongside strong growth in distribution of goods bought online. Although the market is moving from communication to distribution, regulatory obligations remain focused on the need for a universal service obligation (USO). While postal markets have been opened to competition across the EU, safeguards have been included in the European Community framework, such as the possibility of granting state aid to USPs for net costs of the universal service, and of introducing funds to compensate USPs for such losses.

In the UK, this question has recently been highlighted by the emergence in the market of end-to-end (E2E) competition for mail market delivery, and of a greater intensity of competition in the parcel delivery market. Royal Mail, the provider of the universal service in the UK, is now a private sector company accountable to commercial shareholder interests. Letter volumes have declined significantly due to higher prices for mail products, the effects of the economic downturn in 2007/8, and because consumers have chosen to move to electronic communication, while packets and parcels have grown dramatically through online shopping.<sup>1</sup> Competitors have emerged in various parts of the postal market, particularly Whistl and Amazon, with their recent moves into new E2E services.

The letter and parcel markets are very different in respect of their customers and competitive challenges. This report has therefore been separated into two sections for the sake of clarity. The first covers letter mail impacted by a direct threat to the USP, Royal Mail, posed by competitors entering the E2E market, and the second covers the parcel market, which is of increasing commercial importance to the future of Royal Mail. It is also subject to major competition from many other established suppliers, as well as new entrants such as Amazon.

The analysis in both sections is underpinned by recognition that EU citizens still have the right to receive a universal postal service. As the USP, Royal Mail is still subject

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<sup>1</sup> British Retail Consortium (2014). BRC – KPMG retail sales monitor, March 2015. *March sales underpinned by slow but steady growth.* <http://bit.ly/1KjZ3bk>  
IMRG (2015). *IMRG MetaPack UK Delivery Index Report, February 2015.* <http://bit.ly/1HtUok3>

to certain regulatory controls, for example, it is the USP until 2021 but not necessarily thereafter.

## Research design

This document also updates a previous market review undertaken in 2011 for Consumer Futures, previously the statutory representative for consumers of postal services across the United Kingdom, prior to becoming part of the Citizens Advice Service.

The major events since the last market review are:

- Whistl (previously TNT Post UK) in October 2013 announced its plan to deliver downstream access (DSA) items to around 42 per cent of households in the most densely populated urban locations, covering just 8.5 per cent of the UK geographic area, by 2019.
- Royal Mail responded by submitting new DSA price proposals to Ofcom in January 2014. This was followed by a regulatory submission to Ofcom in June 2014,<sup>2</sup> which stated that Whistl's E2E expansion plan amounted to 'cherry picking' and would result in Royal Mail losing up to £200 million by 2017, which it felt could put at risk its ability to sustain the finance of the USO, and asked Ofcom to intervene.
- Royal Mail were privatised in October 2013 and the Government has retained a 30 per cent stake.
- In 2014, Amazon, until recently Royal Mail's biggest customer for packets and parcels, announced it was introducing its own delivery operation, which would also be made available to its expanding Amazon Marketplace partners.

In undertaking this assignment, Postal Logistics and Consulting Worldwide (PLCWW) has taken account of Ofcom's decisions on the DSA price proposals and the Direct Delivery submission announced at the beginning of the review.

This report is based on information in the public domain and PLCWW knowledge and experience of the postal industry. This process has included the development of the models to help support our key findings and conclusions. These are:

## Key findings

- a. The letter market in the UK has declined by 37 per cent since its peak in 2005, mainly due to electronic substitution from digital media.
- b. Royal Mail's track record on efficiency improvements is not good. Despite shedding 50,000 jobs since 2003 and the move to single delivery, Royal Mail admitted in 2007 that it was 40 per cent less efficient than its competitors. In

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<sup>2</sup> Royal Mail (2014). *Direct Delivery: A Threat to the Universal Postal Service*. Regulatory submission to Ofcom. <http://bit.ly/1LEQkl7>

the last 2 years it has failed to meet its own efficiency targets of 2 to 3 per cent per annum.

- c. We find no substantive evidence that competition from business models such as Whistl and Amazon present any short-term threat to Royal Mail's financial ability to continue to provide the range or quality of services it is required to deliver as the USP. PLCWW concludes that the projected loss of volumes and revenue in the early years of implementation is within a containable range for Royal Mail, provided that appropriate efficiency and cost control measures are taken.
- d. Royal Mail's USO services are currently profitable, with margins of 10 to 15 per cent in the last 2 years. However, Royal Mail has qualified its accounts with a note on operating profit, stating it *'believes that the cost of the combined network should most appropriately be allocated to USO products in the first instance, in which case USO services would be significantly loss making'*. However, the European Commission, in its consideration of the net costs of the universal service, has preferred to use an approach that considers only incremental costs. The different views around the accuracy of the Activity Based Costing (ABC) model<sup>3</sup> to calculate the net costs of the USO must be resolved between Royal Mail and Ofcom, in order to provide clarity about any financial risk to the sustainability of the USO.
- e. The parcels industry is highly competitive, with low margins and an increasingly demanding customer base. Royal Mail has tried to be innovative but is playing catch-up, and has stated it will need significant investment to modernise its operational capability to both deliver growth and handle increased volume economically and efficiently. Royal Mail's success in the parcel market is critical to sustaining an affordable USO service to consumers, especially consumers in rural, remote and island areas who may have no access to other carriers.
- f. Royal Mail has lower average unit revenues in both the business-to-business (B2B) and business-to-consumer (B2C) segments of the parcel market than its competitors. Given its high employee cost operating model, one may presume it has higher average costs. Either Royal Mail delivers parcels that are in the very lightweight ranges or it has lower margins than its competitors.

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<sup>3</sup> Activity Based Costing is a widely used and accepted method of costing the products, services, customers and sales required to produce certain outputs. The method identifies the resources consumed by each activity and assigns a cost to each resource. These are aggregated to derive activity costs, which are then assigned to outputs, based upon defined cost drivers. These cost drivers provide a measure of the intensity or frequency of an activity demanded by a product or service that reflect a cause and effect relationship.

New E2E letter services should result in consumer benefits from an expanded competitive market, similar to those experienced since market liberalisation in 2006. Although limited in the UK, it can be argued that increased competition led to providers improving efficiency, reducing costs and contributing to price stability through lower levels of price increases. It also offers consumers increased choice and service innovation.

- g. Given the relatively low level of financial risk to the USO in the short term, from initiatives of competitors, PLCWW does not envisage any strong financial pressure for any changes to the USO service specifications, at least for the next three years.
  
- h. PLCWW found no evidence of the need to provide alternative funding options for the USO in the foreseeable future. If such a need did arise, Ofcom has the power to set up a USO fund, to which service providers must contribute. All other options to sustain the USO would need to be exhausted before consideration of any general tax or levy.

PLCWW concludes that the USO is not at risk for at least the next two to three years, as Ofcom completes its reviews of Royal Mail's efficiency and its competitive position in the parcel market. At that point, the full impact of the Whistl and Amazon entry into the E2E market should be quantifiable. By that time, the effects of privatisation on Royal Mail as a commercial entity, operating in fully competitive markets, should also be felt.

PLCWW recommends that the Citizens Advice Service continue to monitor the various parties and initiatives being deployed across the UK's postal sector to ensure that changes to the market and its regulation, including those around the USO, are in line with consumer interests.



## 1. Introduction

Citizens Advice represents the interests of consumers across essential, regulated markets. It uses compelling evidence, expert analysis and strong argument to put consumer interests at the heart of policy-making and market behaviours. The Citizens Advice service in England, Wales and Scotland provides free, confidential and impartial advice to help people resolve their problems. The service aims to:

- provide the advice people need for the problems they face
- improve the policies and practices that affect people's lives.

Citizens Advice Bureaux deliver advice services from over 3,500 community locations in England and Wales, run by 382 independent registered charities. Citizens Advice itself is also a registered charity, as well as being the membership organisation for these 382 member bureaux. In Scotland, there are 61 Citizens Advice Bureaux.

On 1 April 2014, Consumer Futures (previously Consumer Focus) – the statutory representative for consumers of postal services across the UK, for energy consumers across Great Britain, and for water consumers in Scotland – became part of the Citizens Advice service. Consumer Futures' responsibility for post in Northern Ireland transferred to the Consumer Council for Northern Ireland.

In its role as the statutory representative for consumers of postal services, Citizens Advice contributes a consumer perspective to Ofcom's approach to regulating and reviewing competition in the postal market. Two significant changes have taken place since the UK consumer advocacy body for postal services, Consumer Focus, examined the economic impact of competition in the postal market: Royal Mail has been privatised and TNT Post UK (now Whistl) expanded its end-to-end (E2E) operations in three major cities. Ofcom has also undertaken a review of competition following Royal Mail's claim that the impact of E2E competition threatened its ability to economically sustain the universal service obligation (USO). Given these developments, Citizens Advice decided it was time to undertake a further review of the market, with particular emphasis on the consumer perspective.

The information from the review will assist Citizens Advice in making an informed contribution towards Ofcom's approach to the E2E threat to Royal Mail, as well as other competition issues in the postal market. It will enable Citizens Advice to engage meaningfully with Ofcom and other key stakeholders, and provide a basis for challenging assumptions and approaches.

## 2. The research objectives

To help inform its view, Citizens Advice engaged Postal and Logistics Consulting Worldwide (PLCWW) to undertake a study of the impact on UK consumers of

increased competition in the postal services market, with particular emphasis on examining the following points:

- The economic impact on the USO of privatisation and of increasing E2E competition, including an assessment of Royal Mail's assumptions and modelling in relation to increasing E2E competition.
- The impact of other possible changes to the USO, such as lower specifications for universal service requirements or quality of service standards on sustainability of the service.
- The impact of alternative funding options for the USO identified by the regulator or other stakeholders, such as taxpayer funding arrangements, customers paying a flat fee levy (similar to a BBC licence fee) to send/receive mail, or postal operators paying a levy to go to the universal service provider (USP) to help fund the USO.
- The likely outcomes of alternative regulatory options for sustaining the USO, including the impact of price raises, levies and reduced service levels on consumers. Citizens Advice wanted to pay particular attention to the impact of changes to residential consumers, including those in vulnerable circumstances such as having low incomes or living in rural locations, and also small and micro-businesses.

In the light of Ofcom's response to Royal Mail's Direct Delivery submission<sup>4</sup> and Royal Mail's access pricing proposals, the review would focus on examining the likely implications of these decisions on the letter market. It would also consider how these activities might affect Royal Mail's ability to continue to deliver a financially sustainable universal service for the benefit of all consumers.

### 3. Method

This study is based on information in the public domain, and our knowledge and experience of the postal industry. PLCWW has undertaken a comprehensive search for available data relevant to this review; our research found extensive literature available on this subject from Ofcom, the archived Postcomm website, Royal Mail Group, Whistl, other mail operators, consumer and industry bodies, and the trade press. We also found relevant data from the Royal Mail share flotation literature and stock market analyst reports.

PLCWW carried out a detailed examination and analysis of the available data to determine the impact on consumers in the short and medium term, and sought to establish the issues for Citizens Advice to consider when Ofcom launches its next market review (Ofcom has announced it will be reviewing the parcel market during 2015).

In compiling the data collection, we encountered some problems with both the quality and completeness of the data, which are essential to the accuracy and validity of the analysis, findings and recommendations. However, this is inevitable given the

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<sup>4</sup> Royal Mail (2014). Direct Delivery: A Threat to the Universal Postal Service, submission to Ofcom. <http://bit.ly/1LEQkI7>

commercial sensitivity of the issues that are the subject of the review. For instance, we have no access to the business plans of Royal Mail or Whistl and have found other sensitive data redacted in the published versions of Royal Mail's submission and Ofcom reports. Detailed financial data is also limited to that available in company annual reports and other financial market updates. Despite this, PLCWW has gathered the available data, and analysed and modelled it where possible to assess the potential economic impact on Royal Mail and its ability to sustain the USO at its current or reduced level of service. We have also considered the potential requirement for subsidies or alternative funding options over the period to 2019.

In light of Ofcom publishing its decisions at the start of this project,<sup>5,6</sup> PLCWW adapted their approach to include a review of Ofcom's decisions and its intention to review Royal Mail's efficiency and ability to compete in the parcel market. PLCWW also developed models to evaluate the financial impact on Royal Mail.

We have used the results of our analysis and modelling as required in the research objectives, and to inform our findings and conclusions.

## 4. Background

The USO is a minimum right for EU citizens, as set out in the European Directive requirements transposed into UK law by the Postal Services Act 2000.<sup>78</sup> Under the Community framework for EU postal services and subsidiarity requirements, Member States can define the universal service above this minimum. The Postal Services Act 2011<sup>9</sup> transposes Directive requirements and sets out the minimum requirements that the USP must deliver the UK. These are statutory and can only be altered with the consent of the UK Parliament.

Under the Postal Services Act 2011, Ofcom's primary duty in relation to postal services is to carry out its functions in a way that it considers will secure the provision of a universal postal service. The Act implements the EU's Third Postal Directive, the objective of which is to create a single market for postal services in the EU while ensuring a high-quality universal service. Consumers rely on the USO services for their postal needs. Reforms introduced in 2011 and 2012 ensure that Royal Mail is the designated provider of the universal service until at least 2021, ten years after the Postal Services Act 2011 was passed. Royal Mail has a duty to fulfil the USO – defined as the collection and delivery of letters six days a week (parcels and packets five days a week) to any address in the UK, all at geographically uniform, affordable prices. The minimum requirements are as follows:

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<sup>5</sup> Ofcom (2014). *Review of End-To-End Competition In The Postal Sector*. <http://bit.ly/1vfUGtl>

<sup>6</sup> Ofcom (2014). *Royal Mail Access Pricing Review*. <http://bit.ly/1Kk1PgJ>

<sup>7</sup> There are three EU Directives covering postal matters (Directive 97/67/EC, Directive 2002/39/EC and Directive 2008/06/EC) <http://bit.ly/1NvmCjr>

<sup>8</sup> Postal Services Act 2000: <http://bit.ly/1NifMwQ>

<sup>9</sup> Postal Services Act 2011: <http://bit.ly/1G62pRx>

- At least one collection of letters every Monday to Saturday from every access point in the UK that is used to receive letters and postal packets for onward transmission.
- Delivery of letters every Monday to Saturday to every address in the UK.
- Postal services at an affordable, uniform tariff across the UK.
- A registered items service at an affordable public tariff.
- An insured items service at an affordable public tariff.
- A free-of-charge postal service to blind or partially sighted people.
- Free carriage of legislative petitions and addresses.
- A service for postal packets under 20kg.

In 2012/13, following the introduction of a new regulatory regime, the products in the USO were defined in relation to postal products in the market provided by Royal Mail as follows:

- 1st and 2nd class stamped and metered letters and parcels
- 1st and 2nd class single piece letters and parcels
- Special Delivery stamped and metered letters and parcels
- Redirections
- Royal Mail Signed For letters and parcels
- International Standard (previously Airmail) and International Economy (previously Surface Mail) letters and parcels
- Local Collect and Keepsafe letter and parcels

In addition, Royal Mail as the USP must provide sufficient post boxes and other access points (for example, at post offices) to meet the reasonable needs of users of the universal postal service. This includes a requirement that there should be a post box within 0.5 miles of at least 98 per cent of premises, nationally. For the remaining 2 per cent of premises, Royal Mail must provide sufficient access points or other means of access to the universal service (for example, collection on delivery from very remote or isolated locations such as farmhouses) to meet the reasonable needs of users (having regard to the costs and operational practicalities of doing so). Currently, the UK has over 115,000 post boxes and 11,696 post offices.<sup>10</sup>

When Ofcom took over regulation of post in October 2011, it gave Royal Mail greater commercial freedom to compete by removing the vast majority of price regulation, retaining only a simple price cap on 2nd class letters, large letters and parcels under 2kg to protect vulnerable consumers and ensure a basic universal service was available to all. In securing the provision of the universal service, the USP must ensure that provision of the universal postal service is both financially sustainable (while still enabling the USP to make a reasonable commercial rate of return on the universal service) and becomes efficient before the end of a reasonable period (and then remains efficient). Ofcom has general duties to promote competition where appropriate, which apply to its regulation of postal services. Where it considers there is a conflict between these duties, it must give priority to securing the universal

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<sup>10</sup> Ofcom (2014). *The Consumer Experience of 2014*. <http://bit.ly/1Kko4Dd>



postal service. As the UK's USP, Royal Mail is regulated significantly more closely than other postal operators; this is a key part of the protection for consumers.

In March 2012, Ofcom considered what a reasonable level of return might be, given market conditions and the level of risk within the business, and concluded that an indicative Earnings Before Interest and Tax (EBIT) margin range of 5 to 10 per cent in the reported area was appropriate and consistent with securing a financially sustainable universal service. Ofcom made clear that this was an exercise of judgment that would not represent a cap on earnings or an automatic right for Royal Mail to earn a return within this range, and it comes with the requirement for Royal Mail to improve efficiency, not just rely on price increases to meet profitability targets.

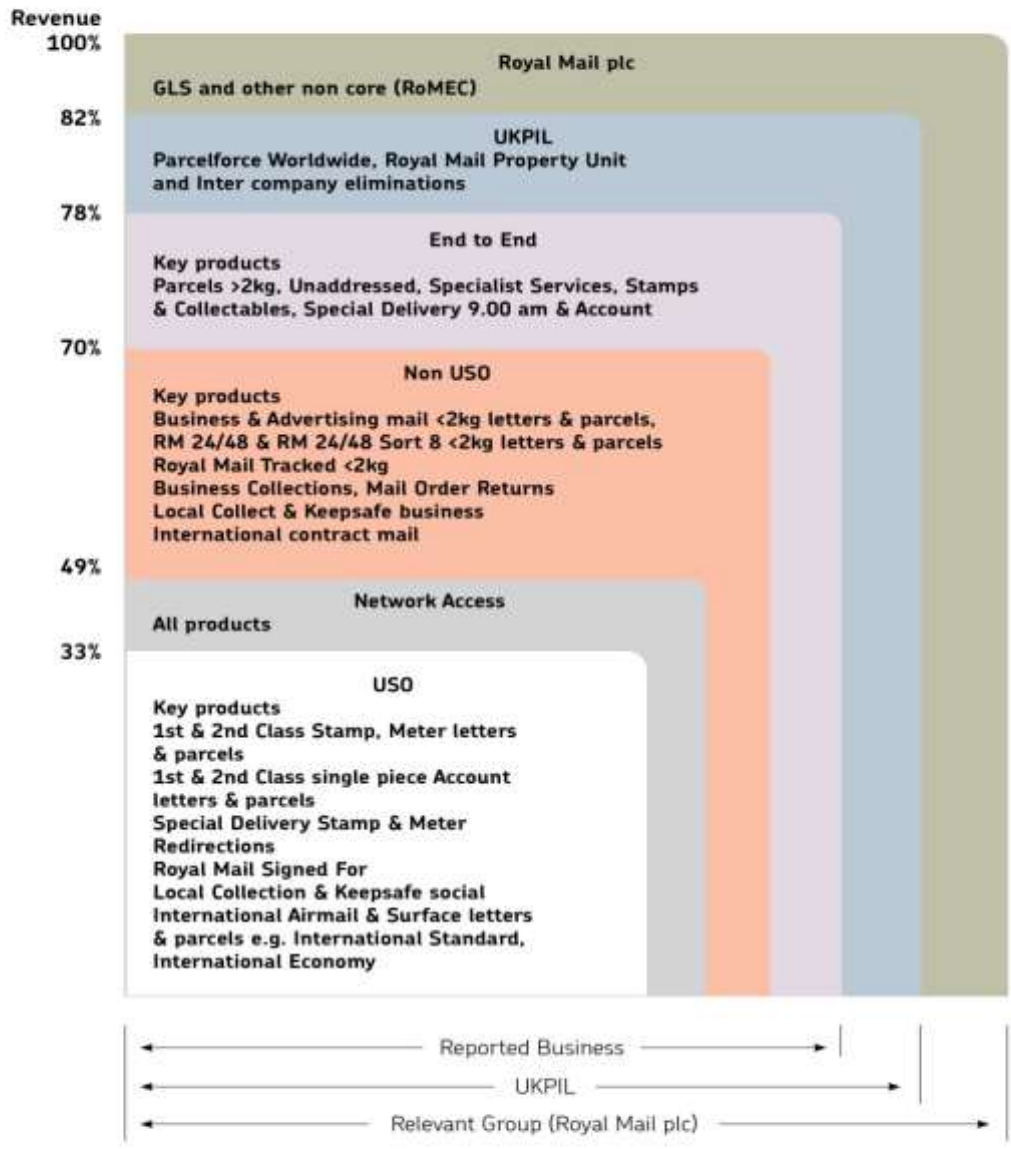
The universal service is delivered through the Royal Mail Group, UK Parcels, International and Letters (UKPIL) business. Royal Mail collects, processes and delivers letters and parcels in accordance with the USO. It also provides other non-USO services to businesses and consumers across the UK, including downstream access (DSA) services.<sup>11</sup>

Figure 4.1 illustrates the structure of Royal Mail plc, its various businesses and products, and the revenue contribution from them. It also defines the USO and non-USO parts of the business.

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<sup>11</sup> DSA services: Mail from customers and other licensed postal operators that enters the Royal Mail pipeline after collection, outward sortation and distribution processes, for subsequent delivery by Royal Mail.

Figure 4.1 Royal Mail business structure



UK letter mail volumes have declined from 20.1 billion in 2005/6 to 12.7 billion in 2013/14;<sup>12</sup> a fall of 37 per cent, with every segment of the market in decline, including posted international mail, which fell from 1,200 million to 600 million in the same period. This is due to a number of factors, including higher prices, the impact of electronic substitution and the economic downturn. The internet has transformed

<sup>12</sup> Royal Mail Report & Accounts 2013-14: <http://bit.ly/1IHSYHV>

the way businesses and Government communicate and transact with their customers and citizens respectively, reducing the need for some types of traditional letter products. It has now attained mass adoption by nearly all segments of the market. The early adopters of digital technology were businesses, which considered it a more cost effective and efficient channel. Utilities now offer incentives for paperless invoicing and statements, as do companies in the financial and insurance sector, where recent regulation changes allowed insurance certificates to be sent electronically. However, although mail volumes have fallen, revenues have largely been sustained due to the impact of price raises, the introduction of size-based pricing and changes in the composition of mail volumes, with increases in volumes of higher price, higher weight packets and of added value products.

Although the majority of consumers are now connected online and are comfortable with technology, certain consumer groups have more limited online access – for example, 5.2 million households in the UK do not have internet access,<sup>13</sup> and only 46 per cent of people aged 65 and over have home internet access,<sup>14</sup> while 16 million consumers aged over fifteen do not have basic online skills.<sup>15</sup> It is perhaps not surprising that some groups of consumers see this as a penalty for continuing to use paper, especially if they have no access to online services. The Keep Me Posted campaign recently claimed customers who prefer to be sent paper bills for household services are being hit with fees of up to £1.90 a time, for a charge that should only be around 35p. Among older consumers, the preference for postal statements is significantly higher than average; varying from 36 per cent of 15 to 24-year-olds, up to 80 per cent of adults aged 65 and over and 90 per cent of adults aged 80 and over.

Government policies like the Digital Strategy, launched in November 2012 to drive the development and use of online Government services to reduce non-digital transactions (post, phone and face to face meetings), have also contributed to electronic substitution and the UK decline in letter mail. The majority of Government mail is transactional in nature, relating to services such as benefits and taxation, and has traditionally been one of Royal Mail's largest customers. Government surveys estimated that the cost of a digital transaction could be up to 30 times lower than a postal transaction, and calculated that £1.8 billion could be saved by switching to digital channels where possible. A recent example of the shift to reduce non-digital transactions is the Government decision that tax discs are no longer required to be displayed on cars, resulting in Royal Mail no longer carrying the 17 million discs previously sent by post in response to online requests. All central government departments with over 100,000 transactions each year were required to redesign transactional services to meet the digital standard, and implement them by March 2015. However, there is no published data on the success rate, although one of the government's main initiatives – the rollout of Department of Work and Pensions universal credits – is behind schedule.<sup>16</sup>

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<sup>13</sup> Office for National Statistics (2012): <http://bit.ly/1dqZana>

<sup>14</sup> PwC Outlook for UK mail volumes to 2023: <http://bit.ly/1lhtHnw>

<sup>15</sup> [www.go-on.co.uk](http://www.go-on.co.uk)

<sup>16</sup> Universal Credit at work (2014): <http://bit.ly/1FHeRUr>

Partly as a result of these initiatives, total inland letter volumes declined by 3.1 per cent per annum from 2005 to 2008, and by 6.3 per cent per annum from 2008 to 2013, as the economic downturn increased the rate of decline and businesses sought further economies.<sup>17</sup>

However, new technology has also had significant benefits for postal operators, both through growth in demand for delivery of goods bought online and in fostering new opportunities for postal operators to cut costs, for example, through more efficient automation or better targeting of services. It has also allowed postal operators to better target their services and innovate in delivery, for example, by texting consumers directly to avoid miss-delivery costs. As a result of these shifts in consumer demands, the UK parcel volumes grew by 4.3 per cent per annum from 2005 to 2008 and by 3.7 per cent per annum from 2008 to 2013, mainly reflecting consumers' increased use of online shopping.

Several major postal service providers around the world report they are all suffering the same problems faced by Royal Mail due to the electronic substitution of the traditional addressed letter. In New Zealand, letter volumes were down 9.8 per cent compared with the same period up to December 2013, and the country is now in the process of moving to an alternate day delivery schedule by July 2015 to cut its operating costs further, in the light of the ongoing decline in letter volumes and to safeguard its future as a commercial entity.<sup>18</sup>

Australia Post reported an 8.2 per cent year-on-year decline in addressed letter volumes in the second half of 2014; its worst decline since volumes began to fall in 2008. The company said it had reached a tipping point where it could no longer manage the decline of letter volumes by cutting costs and urgently needed reform of the regulations that apply to its letters service, to ensure it can continue to maintain a reliable, accessible postal service for all Australians.

The USP in France, La Poste, saw revenue for its mail and domestic parcels division down by 1.8 per cent, year-on-year, in 2014, as addressed mail volumes fell 5.8 per cent and operating profit fell 23.2 per cent. PostNL, the parent company of Whistl in the UK, reported a 10.7 per cent decline in addressed mail volume in the Netherlands in 2014 but declared that the ongoing improvement of its mail operations resulted in significant cost savings that, together with the impact of price increases, more than compensated for the loss of volume. At the same time, it claimed that delivery quality and customer satisfaction improved, as did employee engagement.

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<sup>17</sup> Royal Mail data, *Ofcom Postal Tracker Q4 2012*, PwC analysis: <http://bit.ly/1lhtHnw>

<sup>18</sup> See <http://bit.ly/1zZkWcd>



## 5. The current profile of the UK letter market

### 5.1 Value and size of the market

Total letter revenue in 2013/14 was £4.6 billion, of which 73 per cent was business and marketing mail sent by large and medium-sized businesses and Government. The full segmentation by application, as presented by Royal Mail in its full-year results, is shown in Figure 5.1:<sup>19</sup>

Figure 5.1: Royal Mail letter market segmentation, by application

	£m	%
Business mail	2,254	49
Marketing mail	1,104	24
Social mail	414	9
International mail	414	9
Publishing	230	5
Other	184	4

The total addressed letter volume was 13.3 billion, of which 12.7 billion was inland. DSA mail accounted for 56 per cent of inland volume and the remainder was USO and retail volume, made up as shown in Figure 5.2:<sup>20</sup>

Figure 5.2: Royal Mail volume segmentation by product

Service	Volume m	Revenue £m	Average price
DSA	7,100	1,500	21p
1st class USO	300 (approx.)	1,150 (approx.)	88.5p
2nd class USO	1,400 (approx.)	900 (approx.)	64p
International	600	414m (approx.)	69p
Other bulk/business	2,900 (approx.)	636 (approx.)	22p

<sup>19</sup> Royal Mail (22 May 2014) *Full Year Results 2013-14 Presentation*: <http://bit.ly/1IHSYHV>

<sup>20</sup> Ofcom. *Annual Monitoring Report 2013/14*: <http://bit.ly/1FEluT8>

## 5.2 Royal Mail's recent performance in the letters part of its business

Royal Mail has a single national network, which is used by USO and non-USO services. The cost of the network in 2013/14 was £7.2 billion. Royal Mail assesses the USO share of the cost of running the network using its activity-based costing (ABC) system.<sup>21</sup> In 2012/13, costs were allocated to each product channel by allocating common costs, such as those incurred undertaking collections and deliveries, across all services and, for the first time, introducing transfer charging between different product channels. In 2013/14, the ABC model was updated to reflect the near-full deployment of new van-based delivery methods, as part of the Royal Mail modernisation programme. Figure 5.3 illustrates the allocation of these costs to USO services.

Figure 5.3: Royal Mail USO network cost allocation

Year	Cost of network £billion	USO cost allocation £billion	USO % share of total cost
2011/12	6.691	2.779	41.5
2012/13	7.147	2.813	39.4
2013/14	7.200	2.662	36.8

Over the last three years, the performance of USO services, as reported in the Royal Mail regulatory reported accounts,<sup>22</sup> has been increasingly profitable. Revenue increased as a result of price increases, and costs fell in response to declining volumes and the impact of Royal Mail's transformation programme, as illustrated in the figure below:

<sup>21</sup> Activity Based Costing is a widely used and accepted method of costing the products, services, customers and sales required to produce certain outputs. The method identifies the resources consumed by each activity and assigns a cost to each resource. These are aggregated to derive activity costs, which are then assigned to outputs, based upon defined cost drivers. These cost drivers provide a measure of the intensity or frequency of an activity demanded by a product or service, and reflect a cause and effect relationship.

<sup>22</sup> The reported business is a subset of the Royal Mail Group Ltd core UK business, UK Parcels, International & Letters (UKPIL), including Network Access but excluding Parcelforce Worldwide and Royal Mail Property Unit.

Figure 5.4: Profitability of USO services

Year	Reported revenue £m	USO revenue £m	USO costs £m	USO profit £m	% profit
2011/12	7,164	2,953	2,779	174	5.9
2012/13 (53wks)	7,367	3,125	2,813	312	10
2013/14	7,372	3,146	2,662	484	15.4

The indication, therefore, is that within a network product portfolio operation, where costs are shared, the USO services are currently profitable at a level that exceeds the 5 to 10 per cent EBIT range.<sup>23</sup>

However, in the reported accounts for each of the three years, Royal Mail has qualified the results:

*‘Costs were allocated to each product channel by allocating daily collection and delivery common costs across all services. However, Royal Mail believes that the cost of the combined network should most appropriately be allocated to USO products in the first instance. If this were the case under the current revenue structure, USO services would be significantly loss making, whilst the non-USO products would be profitable’.*

Royal Mail goes on to argue that the integrated nature of the network means that product cost allocations below this level, to individual services, are only theoretical. This is an important unresolved issue, which will be fundamental to future calculations of the funding required to sustain the USO.

The remaining network costs are attributed to the other UKPIL services that share the network. Of these, the DSA service has the highest volume (7.1 billion in 2013/14) but only uses the inward and delivery parts of the network. Royal Mail claims that it made no profit on DSA until 2011/12, when it made £72 million on revenues of £1.3 billion as a result of price increases, having reported losses of £800 million over the previous five years.<sup>24</sup> In 2013/14, the reported profit fell to £17 million (1.1 per cent) on revenue of £1.5 billion, and for the first time Royal Mail experienced

<sup>23</sup> EBIT: earnings before interest and transformation costs

<sup>24</sup> Royal Mail Regulatory Financial Statement 2011/12: <http://bit.ly/1LzibWA>

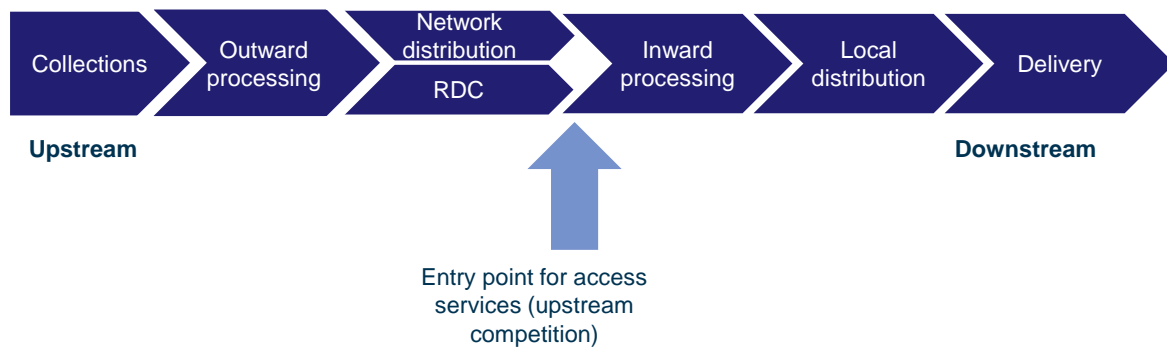
a decline of 100 million items in the service, part of which would be due to the impact of Whistl diverting items into their new direct delivery operation.

## 6. Development of competition in the UK mail market

### 6.1 Downstream access competition

Royal Mail has been facing competition in the UK since early in 2004, when it signed an agreement with UK Mail to deliver its mail. This system resulted in several companies entering the market (such as TNT, UK Mail, DHL Global Mail and Citipost DSA) to exploit the new agreement. By 2010, 33 companies had signed DSA agreements with Royal Mail. These companies tended to operate only upstream, that is, they collected, outward-sorted and transported mail from business customers and handed it over to Royal Mail at each of its inward mail centres, as illustrated in Figure 6.1.

Figure 6.1: Royal Mail DSA service



Royal Mail carried out revenue protection on each mailing before inward-sorting and sequence-sorting the mail and transporting it to delivery offices for delivery.

In 2004, Royal Mail charged upstream operators about 13p an item to deliver a DSA letter. The upstream operators charged their customers between 15p and 17p per letter (to cover the Royal Mail DSA cost plus their own upstream costs). This compared with Royal Mail's prices of 21p for a Mailsort 1 letter, 16p to 17p for a Mailsort 2 letter and 15p to 16p for a Mailsort 3 letter.<sup>25</sup> As the DSA upstream operators were principally offering a two-day delivery service, they provided a significantly lower price for business customers posting standard 2<sup>nd</sup> class metered and Mailsort 2 items. As a result, many of Royal Mail's large and medium-sized customers transferred their postings to one or more of the upstream operators. This trend has continued for the last ten years and now DSA mail accounts for 56 per cent of all inland addressed mail.

<sup>25</sup> Mailsort was Royal Mail's bulk pre-sorted discount product at the time, offering 1<sup>st</sup> class (Mailsort 1), 2<sup>nd</sup> class (Mailsort 2) and Economy (Mailsort 3) options. It has now been replaced by Business Mail (with 1<sup>st</sup> class, 2<sup>nd</sup> class and economy options) in Royal Mail's product portfolio.

## 6.2 End-to-end competition

In April 2012, TNT Post UK (rebranded Whistl in September 2014) began providing a full E2E service to its DSA customers for mail to be delivered in West London. In February 2013, Whistl's parent company, PostNL, published information on the current scale of its E2E operations in London and its future intentions. It reported that, as of December 2012, Whistl was delivering 345,000 letters per week in its London operations. This equated to 0.13 per cent of the relevant market by volume. It expanded its London coverage, doubling its delivery workforce in the capital, and also set up delivery operations in Manchester in November 2013. By the end of 2013, Whistl delivered to 1.2 million households and businesses, had 23 delivery units, and over 2,000 postmen and women delivering over 1 million items a week, with a consequential loss of revenue to Royal Mail of £10.4 million. PostNL also said that, due to its cash constraints, it was looking for €50 million to €80 million of external investment to complete the rollout of its plan for E2E services in the UK.

In December 2013, PostNL formed a joint venture with the private equity arm of Lloyd's Bank – LDC – and gained additional funding from the Royal Bank of Scotland to roll out the E2E direct delivery service. PostNL has a 40 per cent stake in the joint venture. In March 2014, it expanded into Liverpool, employing 500 staff and increasing its workforce to 3,000 people employed in postal delivery. It subsequently announced plans to deliver to 42 per cent of UK addresses by 2017 in 8.5 per cent of the UK's geographical area, creating 20,000 new jobs, delivering business-to-consumer (B2C) mail such as bills, statements and direct mail, along with some smaller packets in key urban areas. Its plan to implement a selective delivery capability enables it to offer a full E2E service to its DSA customer base, for mail addressed to postcode areas where it has set up a full delivery operation – thereby enabling it to offer those customers a lower bundled price than other DSA operators. Further planned expansion in 2014 to Birmingham, Edinburgh and East London has been postponed until more certainty over Royal Mail's DSA zonal pricing plan becomes available.<sup>26</sup>

In December 2014, Ofcom revealed that Whistl's planned rollout had been delayed, and would now not be completed until 2019.<sup>27</sup> If Whistl were to successfully implement its plan at a 50 per cent conversion rate (which is what Royal Mail claim) of the DSA volume it currently holds, that would equate to 33 million items per week (currently 1 million per week), or around 15 per cent of the market. On the basis of the modelling we have undertaken, and using available information about Whistl's current operations, we estimate it can achieve this by delivering to 44 postcodes within the areas it has indicated. This would involve targeting 200 to 250 of Royal Mail's 1,400 delivery offices. This, in turn, equates to the 20,000 staff it has forecast that it will employ, based on the ratios deployed in the offices it has established so far.

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<sup>26</sup> Ofcom. (2/12/2014) *Royal Mail Access Pricing Review: Proposed Amendments to The Regulatory Framework*: <http://bit.ly/1Kk1PgJ>

<sup>27</sup> Ibid



Whistl is now Royal Mail's biggest DSA customer and its biggest competitor. More than a quarter of Royal Mail's letter delivery volume comes from Whistl, which processes 3,500 million items of addressed mail each year for blue chip enterprises such as Barclays, BT, Centrica, Npower and Sky. This is in addition to serving small and medium-sized enterprises (SMEs) and the public sector through the DSA service, which it is using as the business platform to enter the E2E market. Royal Mail believes Whistl has over 5,000 business relationships with key customers, to whom they will offer the service. The service provides mail delivery on two or three days per week, which broadly equates to Royal Mail's 2nd class delivery standard<sup>28</sup> and that offered by the normal DSA service.

Whistl has also targeted local businesses across London, offering its Local Sort service, a two to three-day postal service for businesses sending mail within the London area, at cheaper rates than those published by Royal Mail for 2nd class business post. This local-to-local service will be offered in all areas it expands to and will affect revenue from one of Royal Mail's most profitable mail streams. Royal Mail has stated that Whistl's two or three-day delivery system gives it a 40 per cent cost advantage over the six-day delivery service performed by Royal Mail.<sup>29</sup> This is partly because Whistl can cover the same ground as Royal Mail with less than half the number of delivery staff, but also because Whistl's employment, overhead and fixed costs are also likely to be substantially lower. Whistl pay is at the minimum/living wage end of the scale, with part-time and flexible-hour contracts, and none of the generous pension benefits that Royal Mail employees receive. Its operation is also based in lower-cost premises and uses cycle delivery rather than the vans utilised by Royal Mail.

In contrast, Whistl has alleged that Royal Mail's VAT status<sup>30</sup> gives it an unfair advantage in the postal market. However, the High Court has recently determined, in the course of proceedings brought by Whistl, that it is lawful for the UK Government to exempt Royal Mail's DSA services from VAT. As a consequence, Ofcom's view is that VAT-exempt customers (such as financial institutions and charities) are not likely to find E2E services provided by Whistl financially attractive unless it can offer prices including VAT that match (or are lower than) Royal Mail's VAT-exempt access prices, and is likely to limit the market share that Whistl will reach. However, Royal Mail argues that the VAT exemption is not enough to counter the price differential Whistl can offer, which it claims is supported by the fact that Whistl is winning business from financial institutions such as banks, which are unable to reclaim VAT. While Royal Mail's DSA charges are exempt from VAT, its non-USO services are not. Royal Mail's competitors must, however, charge VAT on all E2E products, while those using Royal Mail's DSA services must pay VAT on the upstream element (that is, collections, sorting and transport) of the items.

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<sup>28</sup> D plus two to three days, where D is the day of posting.

<sup>29</sup> Royal Mail. *Direct Delivery: A Threat to the Universal Postal Service Regulatory Submission to Ofcom June 2014*: <http://bit.ly/1LEQkI7>

<sup>30</sup> Most USO postal services in the European Union are exempt from VAT.

Whistl plans its delivery routes using Routesmart, the Postcode Address File and Geographic Information Systems software, which has enabled it to find the right locations for delivery units and to assist in defining new delivery areas as further rollouts occur. The system also provides the ability to create delivery rounds based on varying mail volume and provides detailed maps for delivery guidance. Mail for delivery is sequence-sorted (that is, sorted into delivery route order) at its sortation depots, currently located in Iver, Bristol, Manchester, Leeds, Scotland and Belfast. Whistl postmen and women do two hour rounds initially, which can be flexed depending on daily workload volume, and its mail is scanned on delivery. Because it does not have a daily delivery obligation, it has the flexibility to switch volumes and deliveries between days. Given the relative fixed cost of a delivery, it could, for example, decide only to do two deliveries in one week instead of three. Whistl has more flexible employment terms than Royal Mail; for example, Whistl at one time used zero-hours contracts for some of its workforce – a practice that is banned in Royal Mail by union agreement.

Although Whistl (as TNT Post UK) has been operating in the UK since 2003, the company had never been unionised until Community approached it to discuss how to ensure strong industrial and employee relations within the company as it embarked on a period of rapid expansion. A partnership agreement between the union and the company was signed in 2012, covering all the sortation depots and E2E sites as they are rolled out. Community soon recruited over 80 per cent of the workforce in the sortation depots. As recruitment into the E2E business has grown, Community has maintained a membership density of over 90 per cent and used its organisational strength within the company to deliver significant improvements in pay, terms and conditions. Prior to the union's involvement, zero-hour contracts had been used across the business. Community negotiated an end to zero-hour contracts in the sortation depots and is pushing hard for a similar agreement for the postal workforce. The union's involvement has meant that Whistl has started to pay a living wage.

### 6.3 Regulatory view on E2E competition

As a result of the situation discussed above, in June 2014, Royal Mail made a detailed submission to Ofcom on E2E competition, in which it urged Ofcom to impose regulation on Whistl (in the form of particular regulatory conditions known as 'general universal service conditions') on the basis that competition from Whistl posed a serious threat to its ability to provide the universal service.<sup>31</sup> Royal Mail argued, amongst other things, that Whistl is unfairly selecting high-density, low-cost areas in which to provide E2E competition, such as London, which leaves Royal Mail to deliver in the remaining unprofitable areas and unwinding the cross-subsidies from other mail services needed to support the universal service. Royal Mail also argued that the USO puts it at a competitive disadvantage, relative to an entrant, because it is required to deliver six days per week whereas an entrant faces no such requirement.

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<sup>31</sup> Ofcom (2014) *Securing universal postal service*: <http://bit.ly/1GNmfOF>

In order for Ofcom to impose such conditions, it has to be satisfied that the obligations they contain are necessary for securing the provision of a universal postal service. To impose such conditions in response to E2E competition to Royal Mail, Ofcom would need to be able to show a causal relationship between competition from Whistl and finding that Royal Mail was not able to provide the universal service in a financially sustainable manner.

E2E competition currently accounts for 0.6 per cent of all letter delivery by volume and 0.4 per cent of all letter delivery by value. Royal Mail accounts for 99.4 per cent of all letter delivery by volume and 95.9 per cent of all letter delivery by value. Also, bulk mail, whether it is access mail or E2E bulk mail, is the lowest value and smallest margin mail per item. The average price for an access letter is 23p, whereas a 2nd class stamped letter is 53p and a 2nd class meter letter is 37p.<sup>32</sup> Price increases to 54p and 38p take effect from April 2015.

In its December 2014 response, Ofcom stated that it did not consider Whistl's entry on a selective geographic basis to represent 'unfair competition' or undermine the cross-subsidies needed to finance the universal service. Ofcom found that 'universal service mail is currently more profitable than many other types of mail, including bulk mail' and 'Royal Mail's ability to provide the universal service in a financially sustainable way is not threatened from end-to-end competition at this point in time'. Ofcom considered Royal Mail's delivery network, which 'is characterised by a significant proportion of fixed costs so the average cost of delivering universal service mail increases when volumes fall which would occur even if entry was on a national basis and could also occur for a variety of reasons other than E2E competition, including e-substitution and competition in parcels'. Ofcom added that, should it consider it necessary to intervene in light of emerging evidence, a general universal service condition could be put in place 'within six to nine months'.

In parallel with its decision on direct delivery competition, Ofcom also published its response to Royal Mail's access price proposals. The regulator rejected Royal Mail's proposals and proposed that 'Royal Mail set their zonal prices based on the actual (fully allocated) cost of servicing those zones', and also referred the Royal Mail proposal to the competition authority. This outcome was a result of Ofcom's concerns that Royal Mail's proposals could 'manipulate charges to its zonal prices by charging significantly more than warranted in rural areas and less in urban areas to counteract the threat of direct delivery competition in urban areas'. Ofcom noted that Whistl hands over all other DSA mail to Royal Mail for delivery using the zonal pricing plan, which it does not deliver, and stated that 'there is a danger that Whistl, which is the only credible competitor, might withdraw from the market if it does not receive some certainty on the future pricing model for access mail'.

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<sup>32</sup> As at December 2014.



## 6.4 Potential impact of Whistl E2E competition on Royal Mail

The Whistl venture to compete for E2E business potentially changes the landscape of competition in the UK letters market. For the first time in over 350 years, the largest customers will have a real choice of service provider for E2E services. While it will not happen overnight, the timescale for such a transition has been declared; Whistl now intends to complete its rollout by 2019, although there are uncertainties about its ability to achieve this.

The evidence emerging from the Ofcom decision documents on the DSA price proposals, the Royal Mail Direct Delivery submission and the Ofcom 2013/14 annual monitoring report enables indicative forecasting of scenarios and outcomes to be made, along with the potential impact on Royal Mail, consumers and small businesses. Accordingly, we have developed a range of scenarios that reflect the potential impact on Royal Mail volume and finances as the Whistl direct delivery venture is rolled out over the next five years. This will determine either the need for Ofcom to intervene or the extent to which Royal Mail must respond to counteract the competitive threat. The model uses information in the public domain and is largely drawn from the June 2014 Royal Mail Direct Delivery submission, Ofcom's response published on 2 December 2014, and its 2013/14 annual monitoring report. Scenarios are predicated on a number of assumptions, which have been derived from the information and our knowledge of the postal industry. Due to the commercial sensitivity of this information, the results of this modelling have been redacted.

## 6.5 Competition scenario conclusions

PLCWW modelling across different cost recovery and Whistl rollout plans shows that the rate of conversion to Whistl's own delivery network is a critical factor. Since the available evidence indicates Whistl has achieved 50 per cent conversion in London, Manchester and Liverpool, there is every chance it will improve on this as it expands its network and further develops its E2E service. If Royal Mail fails to reduce its costs in urban delivery areas or to find other commercial offers to combat the Whistl service, it will need to find efficiencies elsewhere in its business to counteract the loss of revenue. For example, in one of the scenarios produced, each delivery office and its associated mail centre will need to save about £1m per annum to mitigate the loss in revenue completely. However, that same figure spread across the network represents a much less challenging task.

Ofcom in its own modelling considered the different types of mail volumes that Whistl might be able to win.<sup>33</sup> It considered that access volumes would make up the majority of Whistl's E2E volumes, and that the share of the access market it could convert to its access operations could be over 85 per cent. It also assumed in this maximum entry scenario that an entrant could conceivably win around 25 per cent of Royal Mail's retail bulk mail volumes and, to a lesser extent, some single piece volumes. It does not consider that E2E entrants would be likely to set up 1st class networks or to develop the collection points required for residential customers and

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<sup>33</sup> Ofcom review of E2E competition in the postal sector, statement 2/12/2014, page 26, para 3.96-3.102. <http://bit.ly/1vfUGtl>

small businesses. Combining these assumptions in its analysis suggests that an entrant could potentially gain a maximum share of around 50 to 55 per cent in its delivery areas by 2018/19.

If this was to happen, Ofcom estimates that Royal Mail's EBIT margin could be reduced<sup>34</sup> by 2018/19. It would also be possible that, if the entrant's local market share increases, it will be incentivised to enter additional areas. It is therefore possible that this level of market share would mean the universal service would not be financeable. However, Ofcom does not consider it is likely that Whistl will win a market share that is even close to the maximum local market share it modelled in this example. The E2E volumes under this scenario are higher<sup>35</sup> than the final rollout volumes assumed by Whistl in both its December 2013 business plan and the November 2014 plan seen by Ofcom. But Ofcom would have safeguards in place to respond quickly if necessary.

The main short-term beneficiaries from Whistl's operation will be its own DSA business customers, who will get a reduced average price for largely the same level of service. This may help to sustain that stream of business and marketing mail, and slow down the rate of decline. For those customers who rely on that method of communication, it will be a positive outcome. However, based on Ofcom's analysis, all postal users should benefit from Whistl's competition in the longer term by motivating Royal Mail to improve its efficiency, and thereby reducing its costs and limiting future price increases. Though in the medium term, even a reasonably efficient Royal Mail, if forced to operate the USO as defined, will argue that average unit prices must rise because of the fixed nature of Royal Mail's delivery operation. This is at the heart of the dilemma the regulator will face. Further, it is possible that the consumer and small businesses, as posters of mail, will not have access to bulk prices and can expect a continuation of price raises from Royal Mail for its retail mail services.

There is also the opportunity for Whistl to extend into other local-to-local streams of addressed mail, posted, for example, by local authorities and the NHS, which are sufficient to justify a collection. This could be followed by intra- and inter-district streams of mail within their network, once it is fully established. They could also compete for a larger share of the 3 billion unaddressed items that Royal Mail deliver in those areas. Over time, these would increase the volumes lost by Royal Mail and also the cost, hence the price pressure on its network.

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<sup>34</sup> Bracketed information redacted in Ofcom statement.

<sup>35</sup> Bracketed information redacted in Ofcom statement.

## 7. Development of competition in the parcel market

### 7.1 The UK parcel market

The UK parcel market has always been competitive, with the market split between thousands of local parcel operators, e-commerce delivery firms and the 'integrator' express and courier providers.

Competition in retail parcel delivery intensified following a strike in the Post Office (as it was known at the time) in the 1970s, which the home shopping companies of the time saw as a threat to their existence. In response, they set up competing operations, which still largely exist within what is now Yodel and Hermes Parcelnet.

They, with Royal Mail, are the main providers of parcel services in the B2C market. This market has grown considerably in recent years, boosted by the internet, enabling consumers to shop at a time and place convenient to them and to make easy comparisons between potential suppliers.

The other main parcel market is the business-to-business (B2B) market, in which growth has tended to follow the general economic growth of the country, generally measured against and compared with growth in GDP. There is a third market, designated often as C2X, of consumers sending items to other consumers or to businesses (for example, returns of products purchased online). This category often includes eBay posters and micro-businesses that do not have enough volume to qualify for a business account.

These descriptions do not suggest something new. Businesses and consumers have long been posting items to each other. However, these submarkets behave in different ways. Business-originated parcels tend to be collected in bulk, and consumers have mainly had only Post Offices as a service from which to send items. Deliveries to businesses tend to be of multiple items, while deliveries to consumers are mostly single items. Businesses tend to be in urban areas while rural areas consist of mainly consumers. This means that the cost dynamics are different.<sup>36</sup>

Designations such as B2B and B2C, however, cannot be exact. People run businesses from their homes and also work from home, receiving what are

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<sup>36</sup> See Rural Communities, Volume 1. Pages 5 and 29 state that 25 per cent of England's population live in rural areas. While rural businesses in England make up 28 per cent of all businesses, they provide only 19 per cent of the business contribution to the economy, i.e. on average they are smaller. Rural areas make up 86 per cent of England, so these smaller proportions are spread over a much wider area. With parcels, the costs are not just driven by the numbers of parcels to be delivered but also the distances between the delivery locations. <http://bit.ly/1Cyiadp>

effectively business deliveries.<sup>37</sup> Also, some employers allow staff to receive personal parcels at their workplace.<sup>38</sup>

There is also segmentation used between parcel, express and courier services, although again these categories can overlap. Express is used to determine services with a certainty of day of delivery (such as next day or two-day) or time of delivery (for example, before 9am, before 10am, before noon). These are normally guaranteed services with compensation payable if the parcel does not arrive on time. Such services need parcels to be barcoded to allow their tracking in time and location ('track and trace'), and IT systems to ensure proactive management. Such services are mainly for B2B customers, cost more than traditional parcel services and are provided by more specialist operators. Royal Mail's Special Delivery product offers an express service with options for before 9 am and 1pm, with full tracking, but is outside the USO (except for stamped items). There is no USO product that offers tracking as standard. Proof-of-delivery and signature services are also outside the USO. There is a requirement to provide registered and insured services within the USO. Special Delivery fulfils the USO requirement to provider registered and insured services.

Parcels tend to be a delivery regime with a promised day of delivery (usually just next day) or a time period for expected delivery (as with 2nd class mail). This is measured by average quality of service standards, not with regards to the service on any particular parcel. Compensation can be paid but only if insurance is obtained in advance and paid for. In the UK, such guarantees are available but sit outside the USO.

A Consumer Focus report in July 2012 included a survey of what customers actually wanted from the universal postal service.<sup>39</sup> There were degrees of willingness to merge 1st and 2nd class, reduce the number of days of delivery and accept zonal pricing. They did, however, want reliability and punctuality (and for that to be regulated), and better innovation in getting things to people. Ofcom, in its *Review of Postal Users' Needs* in March 2013,<sup>40</sup> quoted Consumer Focus as part of its consultation, which also highlighted a willingness to make trade-offs in order to secure reliability, with better delivery options such as evenings and weekends, better tracking to allow time slots for delivery and better pick-up options sought. The MetaPack report, *Delivering Consumer Choice*,<sup>41</sup> published in November 2014,

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<sup>37</sup> In February 2013, ONS gave figures of 630,000 people working from home, 210,000 people working on the same grounds of their home and 1.6 million self-employed using their home as a base. See <http://bit.ly/1Kh2inh> and <http://bit.ly/1HjE8rG> for analysis of this.

<sup>38</sup> DPD produced a report in September 2013 claiming that 200 million parcels per annum were being delivered to people's workplaces. While this may seem high against Royal Mail's view of the size of the marketplace, it does indicate that there is some scale to such practices. The delivery to workplaces is encouraged by many parcel operators as it is easier for them to find someone there to receive a parcel than at home during the day. Employers may not be happy about this, especially at Christmas when volumes could be high. There is evidence that, even if allowed, parcels could be opened. See <http://bit.ly/1LtQtJP>

<sup>39</sup> See <http://bit.ly/1RCoM1c>

<sup>40</sup> See <http://bit.ly/1dkCgBb>

<sup>41</sup> See: <http://bit.ly/13MyxYT>

echoed these consumer needs, with a fear expressed at not being in when deliveries are made and wanting delivery options seven days a week.

Meeting these aspirations makes the parcel carriers' task more difficult and adds cost. The most efficient routes call once at an address and are able to make an immediate delivery. Consumers are not always at home. The investments (see section 7.7) that carriers have made are to help ensure a first-time delivery, which is the basic requirement, not something exceptional from the point of view of a consumer wanting their goods.

Courier services traditionally require that a courier accompany the parcels at all stages of its journey, but otherwise they have the same characteristics as express services and typically take items under 2kg. They originally developed as document services, as a more time-certain alternative to postal services, but are now also used for small items of value or importance.

While the parcel market is a highly competitive one, rapid development of e-commerce has led to capacity constraints in the sector, which in turn have led to issues of poor service quality and contract failures at peak periods, particularly during Christmas shopping. Indeed, some internet operators argue that concern over the lack of delivery quality and flexibility is dampening growth of online shopping,<sup>42</sup> although Yodel being owned by Shop Direct's parent organisation and Amazon setting up their own network may start to counteract this.

Companies are often reluctant to disclose details that they feel are of use to their competitors. Reports are available for purchase that provide competitor and market analyses, but for the purposes of this report, PLCWW has used sources of data available from Ofcom,<sup>43</sup> three reports from Royal Mail,<sup>44, 45, 46</sup> and internal assessment gathered through company reports and accounts.<sup>47</sup> It should also be noted that, while there are about ten significant parcel companies of national coverage (including Royal Mail), there are many small local operations often willing to go long distances as required, which may also offer other services such as motorcycle couriers, taxis and mini-bus services. Hence any definition can only be approximate.

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<sup>42</sup> See the Yorkshire Post article proposing that e-commerce growth was running out of steam: <http://bit.ly/1e7JetN>

<sup>43</sup> Ofcom (2014). *Annual Monitoring Update On The Postal Market, Financial Year 2013-14*. <http://bit.ly/1RCprQ3>

<sup>44</sup> Royal Mail plc (2014). *Annual Report And Financial Statements For The Year Ended 30 March 2014*. <http://bit.ly/1U7lmr8>

<sup>45</sup> Royal Mail plc. *Full Year Results 2013-14 Presentation, 22<sup>nd</sup> May 2014*. <http://bit.ly/1HSHYHV>

<sup>46</sup> Royal Mail plc. *Prospectus 2013*. <http://bit.ly/1NiuiVu>

<sup>47</sup> If not accessed from the company's own website, information has been obtained from Companies House, where a fee of £1 is payable for such reports.

## 7.2 Volume and value of the UK parcel market

### 7.2.1 UK market valuations

In Ofcom's assessment of the parcel market, it quotes a report by Apex Insight, published in September 2014, giving a total value of the UK parcel market worth £8 billion – a considerable growth since 2009. Growth was attributed to GDP growth in B2B, following the trend in the general economy and the growth in online shopping in the C2C and C2X segments. Apex Insight has stated that this figure includes revenues for parcels collected in the UK for delivery overseas and international inbound items. MetaPack reported a 21.7 per cent increase in parcels resulting from e-commerce that were shipped in December 2014, compared with December 2013.<sup>48</sup> MetaPack also forecasted an increase of 13 per cent for 2015, while the Centre for Retail Research is forecasting a 16.2 per cent increase in the value of UK online retail sales in 2015.<sup>49</sup>

Royal Mail estimated their domestic market share by revenue in 2012 to be 36.2 per cent, and by volume 34.3 per cent.<sup>50</sup> In Royal Mail's 2013-2014 Annual Report and Accounts, they updated Triangle Management's research and quoted these respective figures as 38 per cent revenue share, with volume share as 52 per cent.<sup>51</sup> A summary of how Royal Mail saw the market dividing by revenue is detailed in Figure 7.1 below.

Figure 7.1: UK parcel market share by revenue, full year to April 2013<sup>52</sup>

Company	Market share (%)
Royal Mail	31.5
Yodel	7.7
TNT	6.5
DPD	5.1
UPS	5.0
Hermes	4.8
Parcelforce	4.7

<sup>48</sup> See <http://bit.ly/1SPKDEE> also see <http://bit.ly/1AeSgxm>

<sup>49</sup> See <http://bit.ly/1hncVko> . There is a report in the Yorkshire Post that felt the boom was running out of steam, <http://bit.ly/1e7JetN> and, from Cap Gemini, a report that e-commerce experienced a slow start for 2015 <http://bit.ly/1NiuBjd>

<sup>50</sup> Royal Mail Presentation and Prospectus cited Triangle Management Services/Royal Mail Group Fulfilment Market Measure, 2013: <http://bit.ly/1NiuiVu>

<sup>51</sup> Estimates were as at December 2013.

<sup>52</sup> Royal Mail plc. *Prospectus 2013*: <http://bit.ly/1NiuiVu>

City Link	4.4
Others*	30.3

\* This includes revenue from some of the quoted businesses for their international traffic.

Royal Mail's 2013-2014 Annual Report also states that their research shows the split of destinations for UK parcel volume to be one-third B2B and two-thirds B2C and C2X.<sup>53</sup> Copenhagen Economics gave an EU-wide figure for market segmentation as 56 per cent B2C, 29 per cent B2B and 14 per cent C2X.<sup>54</sup>

Using Royal Mail and Ofcom figures, PLCWW can produce the following table:<sup>55</sup>

*Figure 7.2: Parcel volumes, revenues and average unit revenues, 2014<sup>56</sup>*

	Volume (m items)	Revenue (£m)	Average unit revenue (£)
Royal Mail total	991	3,162	3.19
Royal Mail Ofcom figures	826	2,089	2.53
Parcelforce & international	165	1,073	6.50
Parcelforce only	70	509	7.27
Royal Mail total domestic	896	2,598	2.90
Royal Mail's claimed market share	52%	38%	
Implied total domestic	1,723	6,837	3.97

<sup>53</sup> The context suggests that this estimate was as at December 2013.

<sup>54</sup> Copenhagen Economics (2013) *E-commerce and delivery*: <http://bit.ly/1w0kupA>

<sup>55</sup> A Royal Mail presentation gives figures for that financial year to 30<sup>th</sup> March 2014. These have a volume of 991 million items through the core network and 77 million for Parcelforce, with a total value of £3,162 million. Ofcom gives a volume of 826 million with a value of £2,089 million, which is said to exclude Parcelforce. The volume difference has to be more than Parcelforce's 77 million items, so it can be assumed that the difference includes just international traffic. Hence international items are assessed at 88 million items, with a combined revenue with Parcelforce of £1,073 million. Parcelforce will include some international items, hence an estimate for their domestic volume is 70 million. Royal Mail's domestic parcels total is therefore 826 million plus 70 million, giving 896 million. In 2012/2013, the Royal Mail Prospectus gives Parcelforce's turnover as £469 million, delivering 71 million parcels and thus giving an average revenue per item of £6.61. Assuming a similar level of turnover for 2013/2014 gives £509 million revenue for 77 million items. That leaves international revenue at £564 million. Note: there is inevitably some degree of error in this but we are seeking an understanding rather than exactitude.

<sup>56</sup> Extracted from Ofcom report, *Annual Monitoring Update on the Postal Market, Financial Year 2013-14* and Royal Mail plc, *Annual Report and Financial Statements for the Year Ended 30 March 2014*. <http://bit.ly/1KswHJd>

market			
Implied competitor figures	827	4,239	5.13

Average unit revenues depend upon the type and speed of service, as well as the dimensions and weight of the parcel. International parcels are more expensive on a like-for-like basis than those posted and delivered domestically. These figures indicate that, for USO parcels, Royal Mail tend to deliver smaller, lighter parcels by 2nd class services. It should be noted that Parcelforce provide parcel services for larger, bulkier items outside the scope of dimensions for USO parcels. While this is a generalisation in some respects, we will compare these revenues with their competitors in Section 7.

PLCWW analysis highlights that that Royal Mail are supplying services in the cheaper end of the parcel delivery market, which means volume becomes important and the services may not have the features their customers are increasingly demanding and their competitors can provide.

#### 7.2.2 Market segments by sender and recipient

Royal Mail's *Prospectus* gave market splits of 38 per cent B2B, 56 per cent B2C and 6 per cent C2X in 2012.<sup>57</sup> In another piece of research used by Postcomm in 2010 to review and change the regulatory framework for postal packets,<sup>58</sup> it identified that competitive conditions varied across the market for packet and parcel services. In some areas, it was found that Royal Mail had market power in collection points (due to the exclusivity of their collection points in Post Offices). There was also market power in the deferred B2B and B2C markets (that is, non-express) for weights below 2kg, with particular concerns at the 500g point. This has started to change, with both Hermes and Yodel offering to deliver lightweight packets at prices similar to Royal Mail and offering competition to post offices via convenience stores for drop off and collection. However, the average prices and the volumes of parcels Royal Mail deliver indicate they still are the predominant supplier at the lightweight end of the market. Given this assessment, it can be suggested that Royal Mail may still have a market share in C2X of 80 per cent, with a volume of 83 million items out of 103 million items.

Royal Mail's 2013/14 annual report states that they considered that the B2C volumes are two-thirds and B2B volumes one-third of total parcel volumes.<sup>59</sup> PLCWW uses this split after removing the C2X volumes and value from our calculations. Royal Mail still has the market power in this low-priced area, which we see as mainly B2C, so PLCWW has assumed that Royal Mail have about a 50 per cent market share by

<sup>57</sup> Royal Mail Prospectus page 52, exactly when during 2012 is not specified here. <http://bit.ly/1NiuiVu>

<sup>58</sup> Postcomm (2010). *Laying the Foundations For A Sustainable Postal Service*. November 2010. <http://bit.ly/1NivzVL>

<sup>59</sup> Use of Triangle Management survey and context suggest this was as at December 2013.



volume. Finally, PLCWW takes the balance of volume that Royal Mail has declared is in the scope of B2B. The parcel market split, and Royal Mail's share of it, is estimated as follows:

Figure 7.3: Parcel market split by market segment<sup>60</sup>

Market segment	Split (%)	Volume (m)	Royal Mail market share (%)	Royal Mail volume (m)
B2B	38	655	40	261
B2C	56	965	50	482
C2X	6	103	80	83
Total		1,723		826

While Royal Mail is a major player in the parcel market, it is predominant in C2X, where low-cost operators such as Hermes and Yodel are increasingly able to offer these services via parcel shops and services such as Collect+. In B2C, Royal Mail faces Hermes and Yodel again, who are actively seeking to increase market share. This market has also seen the entry of Amazon. Some B2B suppliers, such as DPD, are now entering the B2C market with additional features such as time-slot delivery, seeking to deliver the higher-value goods that consumers buy online. In the B2B market, where average prices are higher, Royal Mail does not have the type of service required by business customers but Parcelforce does. In this section of the market, Royal Mail is under pressure from better capabilities.

For an average C2X parcel price, PLCWW has taken the figure of £5 per item, which is similar to Royal Mail's 1kg medium parcel tariff price in the financial year ending 2014. This would give Royal Mail's C2X business a value of £415 million, valuing the rest of Royal Mail's parcel business at £1,674 million for 743 million items, giving an average revenue of £2.25 per item. For our calculations for Royal Mail's B2B and B2C business, we shall use this figure. PLCWW also assumes Royal Mail's competitors in C2X have an average price of £5 per item, giving a segment value of £515 million. This leaves a domestic market of £6,322 million, which is split one-third B2B (£2,107 million) and two-thirds B2C (£4,214 million) as a best estimate. PLCWW also assumes that the same average revenue applies for Royal Mail in both B2B and B2C segments, giving them values for Royal Mail of £1,116 million in the B2C segment and £558 million in the B2B segment. The remaining volumes and revenues in both segments are ascribed to Royal Mail competitors, giving the suggested Royal Mail position in Figure 7.4 against their competitors.

<sup>60</sup> Derived from figures quoted in the text.

Figure 7.4: Estimated B2C market shares

	B2C volume (m)	B2C estimated value (£m)	Average revenue (£)
Total	965	4,214	4.37
Royal Mail	482	1,116	2.25
Competitors	483	3,098	6.41

Figure 7.5: Estimated B2B market shares

	B2B volume (m)	B2B estimated value (£m)	Average revenue (£)
Total	665	2,107	3.17
Royal Mail	261	558	2.25
Competitors	404	1,549	3.83

These tables indicate that Royal Mail has lower average unit revenue in both the B2B and B2C segments than their competitors. Their employee operating model will be discussed later on in this report, but we may presume they have higher average costs. Therefore, either the parcels Royal Mail delivers are in the very lightweight ranges, or they have lower margins than their competitors.

The current Royal Mail tariff has a price of £2.80 for a 2nd class small parcel up to 1kg,<sup>61</sup> which is stated to be a promotional price after a large increase that resulted in a loss of volume. This pricing more than suggests that, with an overall average unit price for its parcels of £2.53 (excluding Parcelforce), most of Royal Mail's volume is in the lightweight range. In February 2015, Royal Mail announced it will be keeping the £2.80 price concession and going further by reducing the price of a medium parcel up to 2kg from £8 to £4.89.<sup>62</sup>

### 7.2.3 Average unit revenues for Royal Mail and its competitors

Part of our evidence on Royal Mail's market position is the average revenue received by other carriers. Not all companies quote actual volumes of parcels sent, and some

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<sup>62</sup> See <http://bit.ly/1NlypR8>

only give indications in articles or press releases. Of the operators that do, it is clear that Royal Mail has among the lowest average revenues (see Figure 7.6).

Figure 7.6: Estimated average unit revenues, by selected carriers<sup>63</sup>

Company	Revenue (£m) <sup>64</sup>	Indicated volume <sup>65</sup>	Annual volume figure we have used (m)	Estimated average unit revenue (£)
DPD	671.6	1.6m per week	83.2	8.07
APC	88.5	1m per month	12	7.38
UK Mail	219.9	200k per day	50.4	4.36
FedEx	53.2	53.2m per annum	53.2	4.12
Yodel	350	135m per annum	135	2.59
Royal Mail	2,089	826m per annum	826	2.53
Hermes	382.3	190m per annum	190	2.02

The specialist areas and customers bases will vary so this is not a full reflection of comparison, but does give an indication of market positioning.

Royal Mail is clearly a major player in the UK parcel market, yet its domestic volumes are skewed towards the B2C and lightweight ends of the market. Its role in B2B is in the lighter, lower-priced end of the market, away from the higher values that command higher average prices and more potential for profitability.

<sup>63</sup> These figures are calculated using the data sources referred to in the individual columns.

<sup>64</sup> See revenue figures in Section 7.1 and 7.2

<sup>65</sup> Sources:

DPD – see <http://bit.ly/YXt66X>

APC – website

UK Mail – annual report

FedEx – Companies House accounts

Royal Mail – from above

Hermes – article in Motor Transport on 1st September 2014.

It is less easy to make size and weight comparisons regarding international parcel traffic, as information is limited and can only be gleaned by recourse to the USPs' published tariffs. Royal Mail has split out its international traffic as part of its flotation process and USO reporting but, given that parcels is a competitive business, its competitors have shown less interest in publishing material that could prove to be useful market data. A study published in 2011 for the European Commission showed that tariffs for cross-border parcels were higher than domestic tariffs and sought to understand why.<sup>66</sup> The report found that average prices are clearly higher than UK prices as they include the costs of getting parcels around the world, yet concerns were highlighted that these price differences are caused by inefficiencies in the pipeline and not true additional costs. However, the parts of the pipeline responsible for these inefficiencies were subject to debate.

Royal Mail has stated that, in 2012, it had a market share of 27 per cent of UK parcel exports.<sup>67</sup> These exports are mainly, we understand, going to other postal administrations, with postal operators' dedicated express and parcel divisions such as DHL (Germany), TNT (Netherlands), DPD (France) and GLS (Royal Mail) located outside the USO. These four postal companies are unlikely to see these exports as an opportunity to provide surplus profits to support the USO and are more geared towards their other non-USO activities.

### 7.3 Analysis of competition in the UK parcel market

The analysis completed by Apex Insight was based upon available turnover figures for the companies concerned, and adjusted according to whether these figures included other business activity or international inbound and outbound mail. Royal Mail said it excluded the latter, hence its estimated market value is lower than that stated by Apex Insight. Based upon PLCWW estimates for Parcelforce and Royal Mail's international parcel revenue, our assessment of the competitors is shown in Figure 7.7.

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Intra-Community cross-border parcel delivery by FTI Consulting. Chapter 5 looks at comparative European prices and discusses the difficulties of getting good data.

<sup>66</sup> European Commission (2011). *Intra-Community Cross-Border Parcel Delivery By FTI Consulting*. Chapter 5 looks at comparative European prices and discusses the difficulties of getting good data. The report, published in December 2011: <http://bit.ly/1J9wg9Y>

<sup>67</sup> Royal Mail plc. *Prospectus 2013*: <http://bit.ly/1NiuiVu>

Figure 7.7: Estimated market shares for the main UK parcel operators<sup>68</sup>

Company	Date accounts made up to	Turnover (£)	Profit (£)	Turnover for parcels to be used (£)	Estimated market share (%)
Royal Mail	30/03/2014	2,653,000,000	N/A	2,653,000,000	33.16
UPS Ltd	31/12/2013	758,021,000	39,230,000	758,021,000	9.48
DHL	31/12/2013	724,437,000	7,968,000	724,437,000	9.06
DPD	29/12/2013	671,612,000	116,512,000	671,612,000	8.40
TNT UK Ltd	31/12/2013	742,880,000	(9,512,000)	557,160,000	6.96
Parcelforce	30/03/2014	509,000,000	N/A	509,000,000	6.36
Hermes	28/02/2014	382,314,000	33,226,000	382,314,000	4.78
Yodel	30/06/2013	389,198,000	(98,297,000)	350,278,200	4.38
City Link Ltd	29/12/2013	289,472,000	(20,107,000)	289,472,000	3.62
UK Mail	31/03/2014	508,500,000	22,400,000	219,900,000	2.75
FedEx UK Ltd	31/05/2013	219,374,000	32,200,000	219,374,000	2.74
DX UK Ltd	30/06/2014	312,000,000	4,000,000	163,600,000	2.05
Tuffnells	31/12/2013	127,801,000	10,820,000	127,801,000	1.60
APC	31/03/2014	88,652,669	3,846,931	88,652,669	1.11
City Sprint	31/12/2013	112,672,827	3,695,110	-	
Total		8,488,934,496		7,714,621,869	
Apex Insight market figure				8,000,000,000	
Residual other operators				285,378,131	3.57

The estimated market shares above do not take into account the many small companies and individuals, from taxi drivers to small local delivery companies, who will also offer to go any distance. Within this sector are many so-called 'lifestyle

<sup>68</sup> Figures extracted from company reports, from the companies' own websites or Companies House. Turnover has been adjusted if revenue other than parcels is included. City Sprint is a same-day operator and so excluded from this analysis. TNT turnover for express assumed at 75 per cent. No separate profit figures for Royal Mail or Parcelforce. DX and UK Mail parcel figures are from their own accounts. DHL data combines figures for DHL Express (UK) Ltd and DHL International (UK) Ltd.

couriers', who deliver parcels for the likes of Yodel and Hermes using the family car. These companies will deliver a letter if someone is willing to pay a price above that of a stamp to get greater urgency or certainty. There are no real barriers to entry at this level, all that is needed is a base to work from and possible capacity to store parcels and some transport – not necessarily motorised, as highlighted by the presence of bicycle couriers.

A further fragmentation of the supply market could come from Uber, the taxi and private hire car service where individuals provide the cars rather than a taxi company. It has been suggested that Amazon and Uber could be a 'click-and-collect' dream combination, as the Uber driver is in many ways no different to the lifestyle courier.<sup>69</sup> Uber began delivering parcels in April 2014, in New York City;<sup>70</sup> in March 2015, FedEx's Chief Executive Officer said he did not see their delivery business being threatened but acknowledged that Uber would be some sort of player in the market.<sup>71</sup> The UK is yet to see the growth of Uber parcel delivery but it could provide a cheap same-day delivery option for consumers needing urgent delivery of goods.

Larger organisations with large trucks will require operator licences and administrative structures, but these are not much different from the necessary bureaucracy that any company faces. Parcel carriers are not postal operators; while some of the UK parcel carriers are owned by postal authorities, parcel operations sit outside that remit. Apart from Royal Mail, in its provision of the parcel elements of the USO, there are no special regulations for parcel operators.

The business structures of Hermes and Yodel are primarily B2C. They offer low prices, recognising that the value of the goods consigned can often be low. They look mainly for dense areas where they can recruit lifestyle couriers who will deliver their parcels at around 50p per item. These rates have hardly moved in the last 15 years and, as parcel companies experience price pressure, they are often the ones who have to bear the stress. This is highlighted by the recent closure of City Link, which has been included in the estimated market share analysis above. In its latter days of trading, City Link was reported to be paying only 45p per parcel,<sup>72</sup> with a range of customers in B2B, although mainly B2C.

The B2C businesses, including Royal Mail, must now invest in technology such as hand-held scanners to provide proof of delivery and some means of understanding where parcels are, and if they have been delivered.<sup>73</sup> Consumer demands for notification of when to expect a parcel require this type of technology, and it is becoming a required standard as consumers become increasingly internet-linked, wherever they are. Nightline in Ireland has developed and trialled Parcel Pilot,<sup>74</sup> to offer consumers more specific information about when their e-commerce parcel will

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<sup>69</sup> See <http://on.ft.com/1FEOV8A>

<sup>70</sup> See <http://engt.co/1dkFWTk>

<sup>71</sup> See <http://bloom.bg/1H2qqVs>

<sup>72</sup> See <http://bit.ly/1GNklhc>

<sup>73</sup> Royal Mail is coming late to this and is behind their competitors. We cover this issue of technological 'catch up' in Section 7 of this report.

<sup>74</sup> See <http://bit.ly/1zxe45C>

arrive, and will be able to redirect items during shipment to alternative addresses, a safe place at home, or their local Parcel Motel location for 24-hour access. This is almost certainly an expanding type of service across the UK.

Ofcom has previously concluded that postal users would like more convenient options for the delivery of parcels.<sup>75</sup> Ofcom is of the view that Royal Mail was taking steps in this and the competitive nature of the parcel market means that consumer benefits are more likely to be delivered through innovation by Royal Mail and other postal operators than through additional regulation.

### 7.3.1 Consumers' expectations of parcel services

Consumer Focus, the UK postal consumer advocacy organisation that preceded Citizens Advice, has previously identified that USO services require more reliability. Consumers in rural and deprived areas, as well as elderly consumers, need more choice, while consumers of packet services need better delivery options (evening and weekend), better tracking, the offer of time slots, and better pick-up options for those posting packets.

A 2012 Consumer Focus report identified that some consumers are prepared to accept trade-offs, such as less deliveries in order to get better delivery options and better innovations in getting things to people.<sup>76</sup> Options on removing the distinction between 1st and 2nd class for Royal Mail (not particularly applicable to parcel operators, who tend to have a fixed service such as next-day or a two to three-day service), zonal prices or a universal price were suggested. PLCWW considers that the difficulty for Royal Mail, and its competitors, is to apply possible trade-offs to those consumers that might accept them while not impacting on those who want a basic service with clear achievable standards.

### 7.3.2 The impact of technological innovation

The issue with service innovations for Royal Mail and its competitors is that these capabilities need technology to enable and deliver them. These are the type of capabilities that mainline B2B operators have, but are not often called upon because their typical delivery is to a place where employees are usually available during business hours.

The issue for the parcel industry is that technology that enables increased capabilities has to be paid for, and when it becomes a required standard then charging consumers for it becomes near-impossible. The issues with Cyber Monday volumes<sup>77</sup> and problems with Yodel and Hermes, along with the demise of City Link,

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<sup>75</sup> Ofcom (2013). *Review of Postal Users Needs*. <http://bit.ly/1tEEW6>

<sup>76</sup> *Sense and Sustainability: A Report for Consumer Focus by Accent on the Universal Postal Service*. July 2012. <http://bit.ly/1eMIsVj>

<sup>77</sup> Dick Stead, Yodel's Executive Chairman, March 2015 issue of Focus, published by the Chartered Institute of Logistics and Transport.

suggest opportunities for Royal Mail. Others are not so confident.<sup>78</sup> All those operators are mainly active in the B2C market space, without the B2B-type systems needed to generate more volume or become more efficient to pay for their technology. The problems around Cyber Monday and Christmas 2014 that Yodel experienced<sup>79</sup> may also help Royal Mail in the B2C sector, though Amazon may prove an alternative option.

Royal Mail now view Amazon as another operator,<sup>80</sup> which is likely to set its own standards and put more pressure on parcel operators. Amazon's recent move to expand Sunday deliveries to 15 cities, with Royal Mail's extension of Sunday deliveries will come to be a demand upon lifestyle couriers as well as employees in traditional businesses. Since its inception, Amazon has been willing to forego profits in favour of growth and market share, and could secure a major market share if it opens up the network to others. In 2014, it also launched the 'Pass My Parcel' service at 1,000 retail outlets, which enables customers to collect or post items at convenient locations.<sup>81</sup>

The main B2B carriers are UPS, FedEx, TNT (owned by the Dutch Post Office) and DHL (owned by the German Post Office, which sold its B2C business to Home Delivery Network, which then become Yodel). They provide time-definite (for example, before 9am, before 10am, before noon) and day-definite (next-day, occasionally two-day) services. They principally serve the B2B market, looking for higher-value shipments that can sustain a higher price that reflects the inherent higher technology and network capability that they offer. They can provide access to worldwide services and high standards of quality of service.

It is too early to be able to judge what impact the proposed takeover of TNT by FedEx will make on the market, or indeed if the European Commission will allow the takeover to happen, given its opposition to the proposed UPS takeover of TNT.<sup>82</sup> There appears to be a better fit for TNT with FedEx than with UPS, and this would allow FedEx to begin to build a business in Europe that can try to expand beyond B2B into the growing B2C market, which promises so much. Looking at Figure 7.7, the combined business from FedEx and TNT would create a UK market share of 9.7 per cent, making it a sizeable competitor for Royal Mail and one that could provide a greater competitive challenge in the future.

DPD (owned by La Poste) is moving from being a specialist B2B business to becoming a high-end B2C business. It is trialling technology to give consumers a two-hour time window for expected deliveries and opening a parcel shop network that aims to be within 10 minutes of everyone's home.<sup>83</sup> This reflects a desire to

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<sup>78</sup> *Royal Mail 'Under Pressure' Despite Extra Trade From City Link Collapse*. Accessed 26/01/2015: <http://bit.ly/1CikBSY> ; Financial Times article, 22/01/2015 <http://on.ft.com/1FEPq2w> and Financial Times blog <http://on.ft.com/1GwKG0C>

<sup>79</sup> See <http://bit.ly/1HkwKdT> and <http://bit.ly/1Jnw3Tg>

<sup>80</sup> See November 2014 announcement: <http://bit.ly/1J9xnWZ>

<sup>81</sup> See <http://amzn.to/1LCMc6R>

<sup>82</sup> See <http://bit.ly/1Jnw9uh> and <http://bit.ly/1dkH09M> as two relevant pieces of briefing material.

<sup>83</sup> See DPD announcement on 20/01/2015, <http://bit.ly/1qF4bZ4> and <http://bit.ly/1upc5vw>





benefit from the growth of e-commerce parcels without compromising their desire for higher unit revenue.

DX and UK Mail are relatively small but with ambitions to grow, and are also mixed B2B and B2C businesses. They have been picked out as companies likely to make the most of e-commerce growth,<sup>84</sup> but retain networks that are based upon the required technology and have managements who need to prove to the markets that they have the right capability.

In addition to the larger operators in the parcel market, there are a large number of local and regional players that have continued to succeed commercially. For example, APC and Tuffnells tend to keep to established patterns and have managed to survive and prosper. They are more likely to follow industry trends and stick to the things they do well. APC is B2B and B2C, but Tuffnells mainly B2B.

Royal Mail, however, can be seen as the biggest player in this market, assisted by its universal coverage and easily accessed by the public and businesses alike via Post Offices. It is not surprising, therefore, that Royal Mail and Parcelforce are the companies of choice for consumers when choosing to send a parcel, with Ofcom claiming that 92 per cent of those who have posted parcels within the last month used them.<sup>85</sup>

Royal Mail's competitors do not always offer, or wish to offer, these services – often using local subcontractors in the likes of the Highlands and Islands, where they feel they cannot justify the cost of their own network. Royal Mail has completed the rollout of over 74,000 scanners to allow parcel tracking, and they are providing SMS and e-mail notifications on Special Delivery and Parcelforce (both outside the USO, except for stamped Special Delivery).<sup>86</sup>

The question is, can Royal Mail provide the required technology demanded by businesses and consumers purchasing higher-value items for home delivery? Royal Mail's business model depends upon an employee model that is inherently more expensive than the franchise or lifestyle courier models, although it can currently balance that with greater volumes and, potentially, more reliable quality. The USO, with a need to pass every address six days a week, provides a platform for being able to access everyone quickly and reliably. With such a strong platform, it might be considered surprising that Royal Mail has strong competition. This suggests that companies are not totally convinced that a go-everywhere provider, such as Royal Mail, is essential to meet their parcel delivery needs.

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<sup>84</sup> Investors Chronicle. *The Last Post For Mail Investments?*: <http://bit.ly/1CvjTPK>

<sup>85</sup> Ofcom. *The Consumer Experience of 2014: Research Report*. Paragraph 6.8.3: <http://bit.ly/1Kko4Dd>

<sup>86</sup> For Parcelforce, see the Royal Mail plc (2013) *Prospectus* <http://bit.ly/1NiuiVu>. Stamped Special Delivery is the insured items service, to be provided at an affordable public tariff, required by the USO provided by Royal Mail. The regulatory target set for Royal Mail is for Special Delivery (Next Day), other than when sold to users with a Royal Mail account who are using that account to purchase the service (though the measurement system is unable to separate the performance for account and non-account customers in this way). See <http://bit.ly/1QTdLgR> and <http://bit.ly/1GwLkeA>

One of Royal Mail's challenges is to make more of its universal coverage; this could mean offering wider services and even going beyond its remit of a provider of postal services. Royal Mail may have to consider acquisitions of skills and services that can add value to its services. However, a broadening of activities would bring it into areas of more competition.

#### 7.4 Other issues affecting Royal Mail's market position

The parcels industry is highly competitive, with low margins and an increasingly demanding customer base. Royal Mail has tried to be innovative but is playing catch-up, and has no parcel automation. In addition, its IT systems are not as sophisticated as many of its competitors. It will need significant investment to modernise its operational capability to both deliver growth and handle increased volume, economically and efficiently. Royal Mail's success in the parcel market is critical to sustaining an affordable USO service to consumers, especially those in rural areas who have no access to other carriers. Its forecasts, which bear similarities to other analyses of the growth of the parcel market,<sup>87</sup> include B2B growth in parcels following GDP but B2C growth following a steeper projector to 2018, then falling behind GDP growth. In looking forward, PricewaterhouseCoopers examined how the growth in B2C may arise, based upon the product markets served – that is, what is likely to be in the parcels themselves. They looked at the three main product areas shown in Figure 7.8 and forecasted growth in two of these areas but decline in the third. This latter area, 'Music, DVDs, Books and Games', is increasingly moving to consumer downloads rather than the purchase of physical items. PwC's forecasts for the areas are as follows:

Figure 7.8: Share of parcel market for selected products<sup>88</sup>

B2C parcels	Homewares, DIY & Gardening, Other	Clothing & Footwear, Health & Beauty, Electricals	Music, DVDs, Books & Games
% split 2012	23	36	41
% split by 2023	26	56	18
Compound Annual Growth 2013-2018	4.5	9.3	(4.2)
CAGR 2018-2023	2.7	4.5	(4.7)

<sup>87</sup> See A T Kearney's report, *The Internet Economy in the UK* at <http://bit.ly/1dkHFRL> and the e-commerce Europe free reports at <http://bit.ly/1kZVxJs>

<sup>88</sup> PwC report, *Outlook for the Mail Market to 2023*: <http://bit.ly/1lhtHnw>

All these categories require delivery of small parcels to some degree, but this is predominantly the case for the category of Music, DVDs, Books and Games. The decrease in growth here suggests a shift towards heavier items being handled by parcel carriers.

Royal Mail admits to being impacted by Amazon's network capability to supply customers within a reasonable distance of its fulfilment centres. Royal Mail stated, in its half-year results for 2014-2015, that it expects to see growth in the UK addressable market reduced by 1 to 2 per cent for about 2 years as a result of Amazon's direct incursion into the urban parcel delivery market.<sup>89</sup> This forecast leaves Royal Mail with the less attractive items to deliver at a likely higher unit cost, with higher percentages being delivered in more rural areas.

Another B2C competitor, Hermes Parcelnet, has introduced low-weight parcel pricing with a consumer tariff of £2.32 plus VAT (£2.78) for parcels up to 1kg dropped off at a ParcelShop,<sup>90</sup> or £2.48 plus VAT (£2.98) for a courier collection. The delivery expectation may not be as good as Royal Mail 2nd class; there is a warning that it could take up to five days in outlying areas of the UK. Also, the offer may not attract too many consumers as the price offers no real advantage and the service times offered are the same or slower than Royal Mail's. However, for any small business that is above the VAT threshold or registered for VAT due to the nature of its business, and with customers in urban areas, there could be temptation to try an alternative to Royal Mail.

Royal Mail's move to format-based pricing caused a significant price increase in lower-weight parcels, making it easier for Amazon to decide to deliver its own parcels in urban areas and for Hermes to compete in the low-weight segment. Though Royal Mail stated that the parcels they lost due to the new pricing method were unprofitable,<sup>91</sup> they were disturbed enough to reduce the tariff for small parcels under 2kg in the run up to Christmas – an offer that was extended to 29<sup>th</sup> March 2015 and then carried forward, along with a reduction for medium parcels below 2kg.<sup>92</sup> The extent of their concerns will not become apparent until this year's results are declared. In its nine-month trading statement, Royal Mail confirmed that its parcel volumes had increased by 3 per cent over the previous year, although revenue was flat compared with a 2 per cent growth in the first 6 months. This growth seems to have been helped by a 4 per cent growth in December 2014 over the previous year.<sup>93</sup>

Competition, therefore, is growing at the lower price part of the market, with more access for consumers and prices competitive with Royal Mail. Its previous market

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<sup>89</sup> November 2014 announcement of half-year results: <http://bit.ly/1J9xnWZ>

<sup>90</sup> A network of approaching 5,000 neighbourhood shops, often open 24/7 but not necessarily taking parcels over this time span. Post Office Counters still tend to work office hours and do not open Sundays: <http://bit.ly/1GBHU9n>

<sup>91</sup> *Royal Mail Annual Results Presentation*, slide 4

<sup>92</sup> From <http://bit.ly/1NlypR8> quoted earlier

<sup>93</sup> Royal Mail plc. *Trading Update for the Nine Months Ending 28th December 2014*. 22/01/2015: <http://bit.ly/1BRBf5>

power, as described above, is under real challenge. The entry of Amazon into the marketplace, even if it decides not to offer capacity to others or a C2C product, will still create capacity and further competition. This will be good for consumers as it will challenge Royal Mail to invest in its parcel operations (see section 7.5), allowing it to exploit economies of scale that its current labour intensive methods prevent. This is a part of the market that Ofcom is planning to look at as part of its investigation of the sustainability of the USO.<sup>94</sup>

## 7.5 Royal Mail's costs and productivity

Royal Mail does not give any breakdown of its costs for the various parcel streams, nor for any of its mail products, so as not to reveal sensitive information to its competitors. However, Royal Mail's regulatory accounts did provide some data by broad product stream, split into USO and non-USO.<sup>95</sup> Its regulatory accounts for 2013 describe the current regulatory regime, in which it provides Ofcom with detailed confidential reports but does not disclose this information publicly. Royal Mail makes the point that it considers the nature of the USO to be such that its total network should bear the cost of the USO.<sup>96</sup> Royal Mail has highlighted that the move to format-based pricing caused the loss of unprofitable traffic, either to other providers or out of the market altogether (for example, items now sold solely online, such as music or film). The question is, then, can Royal Mail sustain profitability while being competitive in the marketplace, facing the growing competitive pressure?

As an indication of the difference in parcel delivery costs between Royal Mail and a typical private parcel operator, PLCWW estimates that it costs Royal Mail at least 62p per parcel,<sup>97</sup> compared to about 50p for the private operator (see section 7). The Royal Mail figure may be even higher, as it is based upon packets (lightweight items) rather than parcels and takes no account of Royal Mail's delivery changes in recent years.

While the specialist parcel carriers, including Parcelforce, have dedicated hubs with high-speed parcel sortation equipment and simple hub-and-spoke networks,<sup>98</sup> Royal Mail has more stages of sortation and sorts manually. To some extent, this is because parcels are feeding into a network and a set of arrangements created for

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<sup>94</sup> See <http://bit.ly/1GNmfOF> about Ofcom's intentions to review various aspects of the USO, including the impact of growing parcel volumes.

<sup>95</sup> Royal Mail Group Ltd. *Regulatory Financial Statements, 2008-2009*: <http://bit.ly/1LtQFcd>

<sup>96</sup> Royal Mail Group Ltd. *Regulatory Financial Statements, 2012-2013*: <http://bit.ly/1lhAvl6>

<sup>97</sup> A Frontier Economics Ltd report prepared for Postcomm on access costs, in May 2003, identified the inward sort and delivery costs for a packet at 45.34p. We have updated this figure by 37% to allow for intervening inflation. See: <http://bit.ly/1lhAuxB>

<sup>98</sup> The collection depots send their parcels to the hub to be sorted, and the vehicles return with sorted parcels for that depot to deliver to their catchment area. The depot then sorts by route, which can be varied depending upon that day's demand, which offers efficiency and simplicity. With Royal Mail's method, the collection centres feed their local mail centre. The collection centres will sort by mail centre for the area for delivery, then parcels are sent to that mail centre, where they are sorted by delivery office responsible for delivery to that address. Parcels are then sorted by the fixed routes that postmen and women have.

the delivery of letters. Also, small items have traditionally been difficult to sort using parcel sortation systems. Royal Mail's reluctance to modernise in these areas is a legacy from the time that letter volumes were growing, and parcels and packets were not a major revenue stream. All the efforts to use mechanised sorting were focused on sorting the easier letters, the majority of which were of consistent size and thickness, making them ideal material for high-speed automation.

Given the changing nature of the market, with increasing demand for parcels and declining letter volumes, if Royal Mail wishes to retain and grow its volumes then it will need to raise productivity. Royal Mail has recently invested in Parcelforce, its non-USO parcel company, introducing a third hub to increase capacity to about 93 million items.<sup>99</sup> For USO parcels, Royal Mail now recognises that parcel automation presents an opportunity and has offered an 18-month timeframe for a scoping study that could lead to a commercial case. A business case and approval process is assumed to have concluded as a tender has been issued for work in this area.<sup>100</sup> Royal Mail stated they considered that 80 per cent of parcels handled could be automated, and is a potentially significant area of growth.

## 7.6 Issues with parcel provision across the UK and the cost of the USO

Currently, a key principle of the USO is that one price gets a parcel anywhere in the UK. Consumers in dense areas of collection or delivery, or sending items locally, are effectively cross-subsidising long-distance traffic and items to remote areas and islands.<sup>101</sup> Royal Mail's competitors tend to have zones they work to, with the best prices for collection and delivery in lower-cost areas, and surcharges for items outside of those.<sup>102</sup> The people in those areas see these surcharges as excessive.<sup>103</sup> Research by Citizens Advice Scotland in 2012 found at least one million Scots faced surcharges, delayed parcels or were refused delivery altogether. Consumers in the Highlands were charged an average of £15 extra for delivery, and island communities faced a 500 per cent mark up on the standard delivery price for goods ordered online. A later report in 2014 found that there had been no real change, and that businesses in those areas were also being disadvantaged.<sup>104</sup> In responding on 26<sup>th</sup> February 2015 to Ofcom's *Draft Annual Plan 2015/16*, Citizens Advice Scotland asked for a review of the working of the parcel market in Scotland as they still felt

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<sup>99</sup> *Royal Mail Annual Results Presentation 2014-2015*, slide 5.

<sup>100</sup> *Royal Mail Half-Year Results Report*, 2014: <http://bit.ly/1CykocJ>

<sup>101</sup> Amongst the various sources, there is a report compiled by Frontier Economics Ltd and PLCWW Ltd that looked at the costs of the USO and the impact that changing a specification would have on costs or service. <http://bit.ly/1JnUQqt>

<sup>102</sup> Examples are DHL, which applies a £16 surcharge for delivery to the Scottish Highlands and Islands. TNT quotes a next-day UK mainland price of £9.50 plus VAT for a small 5kg package, but £52.49 plus VAT and a 2-8 day service for the Highlands and Islands. Information is from the relevant company's websites.

<sup>103</sup> Citizens Advice Scotland (2012). *The Postcode Penalty: How Some Online Retailers Are Disadvantaging Scottish Consumers*. <http://bit.ly/1eMpehk>

<sup>104</sup> Citizens Advice Scotland (2014). *The Postcode Penalty: The Business Burden* : <http://bit.ly/1FFgQFw>

that some consumers were being disadvantaged.<sup>105</sup> Highlighting several pieces of research had found that consumers living in remote and rural areas across the UK had reported particular delivery issues, including higher prices and companies refusing to deliver to them, excluding them from an important market.<sup>106</sup>

#### Parcel provision in rural areas

It is noticeable that, while UPS, DHL and DPD have depots in Inverness, they have none north or west of there. FedEx has a depot at Oban as well as Inverness, while Royal Mail has delivery offices across the Highlands and sorting offices in the Inner and Outer Hebrides, Orkney and Shetland.

AJG Parcels, which is based in Inverness and covers the Highlands, Western Isles and Orkney, stated that they deliver to 250,000 people in an area the size of Belgium. This lack of density means the distances between calls are significant and a major cost.<sup>107</sup> AJG provides final-mile delivery for parcel carriers DPD, APC, UPS, UK Mail and XDP Express, and did for City Link, delivering almost 10,000 items a day. There are a number of other smaller carriers.

Based upon Royal Mail's 'Direct Delivery Volume at assumed percentage of current DSA Volume', the Highlands, Western Isles and Orkney amount to 0.0045 per cent, which, based upon our annual volume figures of 1,723 million items above, gives a total estimated daily volume (6 days a week for 50 weeks) of about 25,800 items a day. In order to avoid surcharges, a solution might be to channel this volume into one carrier or at most two, given that AJG seems to be successful.<sup>108</sup> With a turnover of £8.61 million, which, if all parcel delivery at a rate of 10,000 items per day (2.5 million items a year), would imply an average revenue of £3.44. However, this requires forcing the private sector into a relationship of common carriage with their competitors. This appears to be acceptable for AJG's partners but its list does not seem to include any of the majors.

The only other significant alternative would be Royal Mail, which has an existing infrastructure that covers the Highlands and Islands as part of its USO commitment. This provides the capability of next-day delivery throughout the region. We do not believe the other majors would wish to use Royal Mail and feel that the private carriers may not want what might have to be a state-sponsored agency acting upon their behalf. An option might be for the Scottish Government to seek to broaden the scope of parcel deliveries that are considered part of the universal service that

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<sup>105</sup> See <http://bit.ly/1CyBAyB>

<sup>106</sup> Consumer Focus Scotland (2012), *Effective parcel delivery in the online era – what consumers in Scotland need* <http://bit.ly/1Gxq7RI> ; Consumer Futures (2013), *Signed, sealed...delivered?* <http://bit.ly/19gTLRE>; Citizens Advice *Measuring Consumer Awareness of online delivery rights* (2015) <http://bit.ly/1CyBSWk>

<sup>107</sup> See <http://bit.ly/1Ja1Hkq>

<sup>108</sup> Their annual report and accounts from Companies House, to 30<sup>th</sup> June 2013, reports a turnover of £8,861,168 and a pre-tax profit of £2,033,263, i.e. 22.9%.

comprises a Service of General Economic Interest (SGEI)<sup>109</sup> under the Community framework, and to seek to set up an entity to provide this broader parcel delivery as an alternative to Royal Mail or as part of a Scottish variant on the USO. This might be supported financially in the same way as the ferries, which use a tariff based upon equivalent road costs.<sup>110</sup> Whether a business would step forward to deliver this service, and whether the Scottish Government would accept the potential penalty costs, is not clear. The solution for the ferries was accepted by the European Commission as a necessary way of preventing the depopulation of rural areas under threat. This solution might then apply to other remote areas. Scotland, with its large land mass, could be a key test ground.

Alternative models for Royal Mail may face other challenges. A move to zonal pricing would only add to the complaints of areas disadvantaged by higher prices, due to reflecting the true cost situation. While some of those areas are in England, large areas of Scotland (including the islands), Wales and probably the whole of Northern Ireland would be impacted by such a change, at a time of increased devolution and regional governments looking to protect their residents and voters. The issue of Royal Mail ownership came up in the recent referendum in Scotland, with the SNP saying they wished in an independent Scotland to regulate services to allow them to address the high cost of parcel delivery in rural areas.<sup>111</sup> The Labour Party acknowledged that the high cost of renationalising Royal Mail would prevent them doing that, but claimed that their manifesto promises would include securing the USO beyond 2015, ensuring an appropriate degree of price control and reviewing the standards that other postal operators are subject to, compared with Royal Mail, which has delivered questionable outcomes for consumers.<sup>112</sup>

An outright subsidy to Royal Mail may be opposed by the parcel companies, who operate in a competitive environment and cannot expect such treatment. It is likely that other postal operators could object as well, since the same service would be delivering mail and parcels so a subsidy would have beneficial effects on both parts of the operation. Despite the lack of interest in small lightweight items shown by many of the parcel companies, they are unlikely to support such a move. A price set by government and underpinned by individual parcel operators is unlikely to get much attention, and would be seen as state aid. Postal services (including some parcel services) are seen as a Service of General Economic Interest (SGEI),<sup>113</sup> and so would be eligible for state aid. However, while a postal letter service in a remote area may be deemed worthy of subsidy, there could well be opposition for a wider application, especially to e-commerce purchases for well-off consumers in urban areas.

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<sup>109</sup> Damien Geradin and Christopher Malamataris (2012) *Framework on Public Compensation for SGEIs: Application in the Postal Sector*. <http://ssrn.com/abstract=2233200>

<sup>110</sup> See <http://bit.ly/1LtUIVP>; for current status see <http://bit.ly/1CUSQ3B> See also <http://bit.ly/1SQi367> where the National Farmers Union of Scotland wanted the scheme to be extended to commercial vehicles.

<sup>111</sup> Scottish Government (2013). *Scotland's Future: Your Guide to an Independent Scotland*, page 326. <http://bit.ly/1o6ycaL>

<sup>112</sup> Parliamentary Briefing Note SN06763 <http://bit.ly/1R4cQdD>

<sup>113</sup> <http://ssrn.com/abstract=2233200>

UK competitors have argued that the scope of the USO should be kept to the minimum necessary to meet users' needs, so as to reduce the potential for competitive distortions created by the VAT exemption.<sup>114</sup> The options, as seen by the European Group for Postal Services (ERGP) consultation on the net cost of the USO (and the application of VAT to post), could be:

- direct public funding out of state funds, by paying a service provider directly for any shortfall in an affordable price and the cost of the service
- the provider of the service funding it from the revenues they collect (as we currently have in the UK)
- a contribution by consumers (presumably by a fee paid to have deliveries made or the consumer has to collect from, say, a delivery office or a nominated outlet)
- an apportionment of the additional cost of the USO above the revenue gained from an affordable and efficient universal service provision to all postal service providers.

Ofcom's new regulatory framework provides lighter controls for Royal Mail than it has experienced before, while ensuring it provides a viable and efficient USO with an EBIT of 5 to 10 per cent.<sup>115</sup>

The European Commission commissioned WIK Consult to produce a report on what initiatives can be made to improve the functioning of parcel delivery systems in Europe, to support the growth of e-commerce.<sup>116</sup> The report lists six initiatives: the development of information platforms; having an e-commerce scoreboard on delivery and price performance; providing trust marks for the carriers; improving services in rural areas; getting interoperability of cross-border delivery; and developing a methodology to measure cross-border transit times.

In 2012, the European Commission launched a Green Paper consultation on completing the single market for parcel delivery.<sup>117</sup> This sought views on how to address the issues faced by consumers when purchasing from e-commerce providers not in their home country, where a parcel has to cross an international boundary. The Commission considered that taking action in this area to improve cross-border parcel delivery (and by implication, national parcel delivery) would be good for consumers, good for strengthening and improving the single market, and good for jobs. Royal Mail, in its response,<sup>118</sup> stated clearly that it considered that the growth of e-commerce was 'booming' and the market for parcel provision was competitive enough to meet consumer needs without additional legislation or

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<sup>114</sup> [http://ec.europa.eu/internal\\_market/ergp/docs/consultations/2014/150126-ergp-14-27-2015-work-programme\\_en.pdf](http://ec.europa.eu/internal_market/ergp/docs/consultations/2014/150126-ergp-14-27-2015-work-programme_en.pdf)

<sup>115</sup> See <http://bit.ly/1hWisP>

<sup>116</sup> See <http://bit.ly/1hWo3K>

<sup>117</sup> See <http://bit.ly/1LxGRfG>

<sup>118</sup> Royal Mail Group response to European Commission's Green Paper "An integrated parcel delivery market for the growth of e-commerce in the EU" February 2013



regulation. It firmly supported retaining the status quo and letting the market develop as demand required it to. The Commission, in publishing its Road Map,<sup>119</sup> had to accept a route of exhorting stakeholders to improve information and transparency along the whole value chain. The aim was to promote enhanced interoperability of parcel delivery operations to support efficient cross-border trade and enhance consumer protection, focusing notably on complaint handling and redress mechanisms but not a route for more regulation and therefore a change to the USO.

In order to provide an effective and efficient USO, the service needs to be of value to the provider and affordable in its costs to consumers (assuming they are facing the full cost of it). If the service is subsidised in some way, it is likely that governments would want the subsidy to deliver value and be affordable for their citizens. The provider, therefore, needs to deliver the service within cost constraints and remain viable and successful. Within the existing UK framework, Royal Mail will need to be strong and profitable to deliver the service required while remaining competitive with other providers of equivalent services to the USO (such as parcel delivery), thus ensuring that the network is sustainable and financially viable.

## 7.7 Meeting consumer needs

Ofcom has highlighted that Royal Mail's parcel volume has increased from 731 million to 826 million over the last five years; a 13 per cent increase.<sup>120</sup> Within Europe, the UK has seen substantial growth driven by e-commerce, as seen in the report WIK-Consult produced for the European Commission.

Ofcom's *Consumer Experience 2014* report stated that, in the UK (overall, including other carriers), there was a net increase in the number of parcels sent in the last two years.<sup>121</sup>

Royal Mail has recognised it has to extend the days and hours that it can receive parcels into its network, introduce Sunday delivery and improve technology. Consumers not at home for their delivery are still required to collect it from a delivery office, however the 'Delivery to Neighbour' scheme was launched in October 2012<sup>122</sup> and the Local Collect service is now available at about 10,500 Post Offices, some of which now offer extended hours early in the morning and late in the evening, as well as Sunday morning.<sup>123</sup> Despite this, many delivery offices and post offices do not have opening hours or locations that can compete with convenience stores or the

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<sup>119</sup> See <http://bit.ly/1GC4gHX>

<sup>120</sup> Ofcom *Annual monitoring update on the postal market: financial year 2013-14*, page 18: <http://bit.ly/1RCprQ3>

<sup>121</sup> Page 91. <http://bit.ly/1NjzCYx>

<sup>122</sup> <http://www.royalmailgroup.com/delivery-neighbour-roll-out-across-uk>

<sup>123</sup> <http://www.royalmailgroup.com/media/press-releases/royal-mail-make-uk's-largest-'click-and-collect'-network-available-20000-smes>

growing number of parcel lockers.<sup>124</sup> Post offices also recently opened up for Amazon collections.<sup>125</sup> Other carriers may seek such access to Post Offices and a business that is officially separate from Royal Mail may wish to do this if it leads to more footfall for them.

Other service providers have been more proactive, although it is as yet unknown how successful they will be. Doddle<sup>126</sup> offers options to collect parcels on the way home from a dedicated parcel shop at a convenient location. Others, such as Hermes and DPD, mentioned earlier, have signed up convenience stores operating 24/7 (though not always for parcels), for customers to collect and drop off returns. Yodel is in partnership with Collect+,<sup>127</sup> which offers 5,500 stores for customers to collect or drop off parcels. These parcels may be on their way to other businesses or consumers, or they may be goods that consumers want returned to the organisation they bought them from.

InPost is providing parcel lockers in many locations, with over 2,000 outlets claimed to be within reach of 70 per cent of UK households.<sup>128</sup> However, ByBox has recently pulled out of its B2C locker business after seven years.<sup>129</sup> This follows InPost's decision to sell its interests in Ireland to its partner, Nightline.<sup>130</sup> Lockers can cost in the order of £100 each,<sup>131</sup> and a quick turnaround of parcels is needed to produce profitable revenue streams. The business case for such lockers will rely on a minimum number of uses per week, as each use earns revenue. As well as the direct loss of revenue that occurs when a parcel occupies a locker for a day longer than expected, the lack of an available locker can close off the opportunity for someone else to use it. This may prevent a prospective consumer from using the service and leave them unwilling to try it again.

Click-and-collect<sup>132</sup> is gaining ground, with the retailer, John Lewis, declaring that 55 per cent of its online orders were collected from shops.<sup>133</sup> In its Waitrose grocery business, John Lewis reported gross sales up by 31.2 per cent (on a 52-week basis) and a 5 per cent growth in average order value.<sup>134</sup> Royal Mail see click-and-collect as presenting opportunities,<sup>135</sup> but it remains to be seen how many of these parcels will be delivered to the store by parcel carriers or within its existing supply chains, by the retailers' own logistics providers.

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<sup>124</sup> Generally sited in areas with high numbers of passing pedestrians, e.g. railway stations, a parcel is delivered into a secure locker. The recipient is sent a text or email with a code that allows them to access the locker at a time of their convenience. They then need to carry their parcel home.

<sup>125</sup> See amongst others <http://ind.pn/1LKplEt>

<sup>126</sup> See <https://www.doddle.it/>

<sup>127</sup> See <http://www.collectplus.co.uk/>

<sup>128</sup> *Postal Technology International Awards*, Issue 2015. <http://bit.ly/1FFkMG6>

<sup>129</sup> See <http://bit.ly/1FQIDTj>

<sup>130</sup> See <http://bit.ly/1dlyEyQ>

<sup>131</sup> *Logistics & Transport Focus*, January 2015, *Parcel shop and locker networks*, page 44. <http://bit.ly/1GMI8e1>

<sup>132</sup> *Postal Technology International*, January 2015 Issue. <http://bit.ly/1FFkMG6>

<sup>133</sup> See <http://bit.ly/1LAdPyx>

<sup>134</sup> See annual results report on the John Lewis <http://bit.ly/1NS9s1r>

<sup>135</sup> *Royal Mail Annual Results 2013-14 Presentation*, May 2014, slide 6 <http://bit.ly/1IHSYHV>

MetaPack, in its *Delivering Consumer Choice* report published in November 2014,<sup>136</sup> identified that, of those surveyed, 94 per cent had a delivery to their home, 63 per cent collected in store, 25 per cent had a delivery to a local shop or pick-up point, 24 per cent had a delivery to work, and 10 per cent had a delivery to a locker. The group they described as heavy shoppers (although this was not defined) were three times more likely to use lockers or collection points and twice as likely to have a delivery to work than lighter shoppers. Looking forward, they envisaged that, in terms of speed of delivery, 76 per cent of consumers would seek a same-day delivery, 73 per cent seek a Sunday delivery, and 69 per cent seek a one-hour delivery window following a purchase. When questioned on alternative locations, 60 per cent of surveyed consumers would seek a delivery to a locked box outside their house, 35 per cent a delivery by drone, 26 per cent a delivery to the boot of a car and 26 per cent would pick up their item at a railway station. Based upon this evidence, the challenge for parcel operators to meet consumer delivery options will only increase.

GFS, a parcel delivery management specialist, claimed in December 2014 that 12 per cent of e-commerce deliveries were being made through click-and-collect.<sup>137</sup> Retailers such as Debenhams<sup>138</sup> will typically offer, in addition to standard delivery, a menu of options that might include next-day, next-evening, day of choice, evening of choice or click-and-collect.

To manage all these options, track and trace – the ability to know where your parcel is in the system through a series of real-time scans by barcode readers, which is standard for all B2B parcel carriers – will be necessary for all. Royal Mail has also announced it is about to start tracking 80 per cent of its parcels via its Royal Mail Tracked system.<sup>139</sup>

With all these opportunities for parcel carriers, it remains to be seen how far new capabilities are accepted and adopted. Royal Mail needs to be seen to offer these services, but not at the expense of its core delivery service to consumers' homes and workplaces.

With consumers looking for more delivery options that meet their needs, e-retailers will look for the carriers with the best capabilities and will require full E2E traceability and options to ensure a first-time delivery that suits the recipient.

## 7.8 How will Amazon's competition impact upon Royal Mail?

Amazon has been a major customer of Royal Mail since it set up in the UK. In 2013,<sup>140</sup> when Christopher North, Amazon's UK Managing Director, defended

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<sup>136</sup> See <http://bit.ly/1BSxtmi>

<sup>137</sup> See <http://bit.ly/1wvm9IC>

<sup>138</sup> See <http://bit.ly/1BAJuwc>

<sup>139</sup> *Royal Mail Half-Year Results Report*, 19<sup>th</sup> November 2014. <http://bit.ly/1CykocJ>

<sup>140</sup> See <http://bit.ly/1dlyNST>

Amazon after criticism by MPs, he stated that they had paid over £1 billion to parcel companies over the previous five years. A lot of that, if not most, will have been to Royal Mail. Now Amazon is a competitor and Royal Mail expects to lose between 1 and 2 per cent of B2C growth to Amazon over the next 2 years. This lost volume could equate to 20 million parcels, which could be worth about £50 million and would result in lost revenue. The losses could be more if Amazon feels that its delivery operation can extend even further.

Amazon also now has access to post office counters, so could collect consumer parcels from there. This is the source of most of Royal Mail's C2X business, which is sold at full tariff, not the discounted rates that Amazon will get. Amazon has always viewed revenue growth as more important than profit, so could prove to be a competitor with deep pockets.<sup>141</sup> Yet, as one of Royal Mail's major customers, it will also challenge Royal Mail to maintain service quality and price.

Royal Mail may well find itself pulled in different directions by Amazon over the next five years, with Amazon demanding more from Royal Mail as a supplier while simultaneously taking the attractive dense traffic away from it, leaving the less-dense traffic in more remote areas at a higher average cost. If Royal Mail can contain those losses without impacting upon the cost of the USO, then consumers should benefit from a better range of service options and affordable delivery costs. Amazon may go beyond delivering their own parcels, as the antecedents of Hermes and Yodel did, and become a new player in the B2C market. For all three to prosper, and presumably grow in order to achieve this, the volumes will come from Royal Mail in attractive-to-deliver areas. This could leave Royal Mail with stagnating volumes to deliver in areas of higher delivery costs, putting pressure on the costs to support the USO.

## 8. Alternative options for the USO

If Royal Mail or another USP became unable to sustain the USO, there are a number of options that the regulator could consider, including:

- Allow Royal Mail to increase its prices to cover the deficit, regardless of efficiency improvements (it is unlikely that Ofcom would give Royal Mail a blank cheque to increase customer prices without getting some benefit in return).
- Invite a consortium of operators to provide the USO (it is unlikely that any other operator would take on the USO commitment of a six-day service on the same terms as Royal Mail).
- Seek a government subsidy to operate the USO (this occurs in a number of countries, particularly in the Middle East and Africa, but would probably not be

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<sup>141</sup> See <http://bbc.in/1SQjdyw> as two typical analyses.

favoured by any UK government – still a 30 per cent shareholder in Royal Mail – that was trying to reduce the national deficit).

- Revise the USO to reduce the cost of provision.

Options previously examined by Royal Mail and Postcomm that might produce significant cost reductions for the USO include the following:

- Cease internal air services (except one service to/from Northern Ireland) to transport 1st class mail.
- Collect and deliver mail on only five days per week instead of six.
- Offer only a single D+2 standard mail service in place of 1st class and 2nd class.

The implications for consumers would be as follows:

*Figure 8.1 Options and implications of some possible changes to the USO*

Option	Impact on service	Customers impacted	Other implications
Cease internal air services	No next-day service for standard mail between far distant parts of Great Britain	Mainly in Scotland, Wales, south-west England and East Anglia; business customers reliant on 1 <sup>st</sup> class mail service	Unless the service is re-priced to reflect the need for dedicated air services, then Special Delivery mail will need to restrict its next-day coverage
5-day delivery service (Monday-Friday)	No collection or delivery on Saturday	Customers receiving parcels, e.g. e-commerce items (Saturday is a favoured delivery day); e-commerce posters (many of whom operate a seven-day service)	From Royal Mail's perspective, it evens up the delivery workload across each day of the week
Single 2-day delivery service	No next-day service for standard mail	Any customers relying on a next-day service, e.g. some e-commerce firms	Again, Special Delivery will need to increase its costs if it is to maintain a next-day service – or become a 2-day service

## 9. Royal Mail efficiency

Following a recent review of E2E competition, Ofcom has concluded there are a wider set of issues that affect both the financial sustainability and the efficiency of the provision of the universal service. Of particular importance are Royal Mail's own efficiency in providing the service, and Royal Mail's performance in the parcel market in which it is facing increasing competition. Ofcom believes these factors could potentially significantly outweigh the current and likely future effects of E2E competition in bulk mail on Royal Mail's ability to provide the universal service. Ofcom will be undertaking studies in 2015 to understand these effects, in order to secure the universal service in accordance with its duty.

Royal Mail's track record on efficiency improvements is not good. Despite shedding 50,000 jobs since 2003, Royal Mail admitted in 2007 that it was 40 per cent less efficient than its competitors.<sup>142</sup> In the last two years, it has failed to meet its own efficiency targets of 2 to 3 per cent per annum in a period of low inflation and preparation for privatisation. It has also failed to achieve the EBIT target of 5 to 10 per cent considered necessary to sustain the USO.

In 2008, the Hooper Report concluded that inefficiency was a much greater problem than competition for Royal Mail.<sup>143</sup> In August 2013, Ofcom commissioned NERA to report on the approaches used by other regulators that it might adopt, to measure the efficiency of Royal Mail.<sup>144</sup> NERA reported that the methodologies fitted into one of three classifications:

- Cross-section studies, which provide a top-down assessment of a firm's efficiency relative to a set of similar firms, in order to determine the overall scope for efficiency improvements.
- Time series analyses, which examine historical trends in efficiency measures, either for the firm itself or for a set of comparators, in order to decide upon a reasonable rate of future efficiency improvements.
- Expert review, which involves a detailed assessment of aspects of a firm's plans or activities, and makes use of specific industry or operational knowledge to identify efficiency opportunities.

Since 2008, Royal Mail has taken action to make itself a more sustainable business by launching large-scale operational modernisation changes to collection, sortation, logistics and delivery processes, which are currently nearing completion. These transformation activities included greater automation in Royal Mail's letter sorting processes, such as increased sequence-sorting technology, which enables letters to be sorted into address order, ready for final delivery by posties, and the

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<sup>142</sup> Statement by Royal Mail Chief Executive Adam Crozier, 2006-07 Report and Accounts: <http://bit.ly/1eiJWoh>

<sup>143</sup> *Modernise Or Decline: Policies To Maintain The Universal Postal Service In The United Kingdom – An Independent Review Of The UK Postal Services Sector*, 16 December 2008.

<sup>144</sup> NERA report to Ofcom: *Approaches to Measuring the Efficiency of Postal Operators*. August 2013.

rationalisation of its mail centres down to 39, compared to 69 operational mail centres in 2007/08. It has implemented new working practices in mail centres and delivery offices and, more recently, changes to its delivery operations, such as greater use of trolleys and shared vans for the delivery of parcels and letters. Since 2007/08, Royal Mail has modernised 94 per cent of its delivery offices. More recently, it has also combined collections with deliveries in rural and semi-rural areas to reduce costs with a minimum impact on service levels. It has also reorganised its management structure, which Royal Mail has stated is expected to generate annual cost savings of £70 million, with at least £25 million expected to be realised in the second half of 2014. However, despite the significant costs associated with the modernisation programme, Royal Mail has not achieved significant cost reductions and people costs are continuing to rise, despite falls in mail volumes.

There is also now the threat that the Whistl venture will impact much of the financial and operational benefits expected to be delivered from the transformation activities. We calculate that, under some scenarios, the loss of volume will ultimately impact on the operation of about 20 per cent of Royal Mail's 1,400 delivery offices. In addition, there could be a consequential knock-on effect on the relative costs and profitability of the remaining DSA volumes and other E2E services (such as 1st and 2nd class stamped and meter letters and parcels) that are delivered via the universal service network. As volume is lost to Whistl, the ABC system will allocate a higher share of delivery costs to USO services because the lost DSA volume is outside the USO.

Ofcom has decided it will not act in the short term to deter Whistl's competition – believing that E2E competition is good for all postal users as it will stimulate Royal Mail to be more efficient, and therefore force it to reduce costs and thereby keep prices down. Neither will it sanction Royal Mail's proposed changes to its zonal pricing structure (fearing that, if Royal Mail did not set zonal prices at a fair cost-related level across all delivery zones, then it might disproportionately increase prices in its rural zone to offset the competitive threat in urban zones). It also believes that Royal Mail should not use price increases alone to support its continuing profitability, and will investigate Royal Mail's future plans to reduce its costs to determine whether it could go further.<sup>145</sup> In the letter market, despite the efficiencies made since 2008, there remains room for improvement, as the 40 per cent gap quoted by Adam Crozier in 2007/08 has still not closed significantly.

The recourse open to Royal Mail, therefore, is to further improve its efficiency to levels beyond those achieved over recent years (1.7 per cent in both 2012/13 and in 2103/14), particularly in those areas affected by competition from Whistl (and, in the case of parcels, from Amazon). In the parcel market, Royal Mail has responded to competition by reducing some of its prices and improving its product offerings (introducing the Royal Mail Tracked product, shoebox-size parcels at its lowest weight step at very competitive prices, Sunday and evening parcel deliveries, click-and-collect service at post offices, and extended opening hours for some Post Offices).

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<sup>145</sup> Tender issued in March 2015: *A Review of The Projected Costs within Royal Mail's Business Plan*.

Royal Mail's three-year agreement with its trade union, the CWU, has given staff an above-inflation pay rise of 3 per cent in the year to 01/04/2013, a one-off payment of £200 in October 2013, and increases of 3 per cent in the year to 20/04/2015 and 2.8 per cent in the year to 20/05/2016. Royal Mail also committed to a basic full-time workforce with no added franchising or outsourcing, and a desire to manage change without recourse to compulsory redundancy.<sup>146</sup> In order to hold prices or grow profitability, Royal Mail will have to increase productivity by more than these amounts. However, Ofcom raised concerns in its annual update that overall productivity in mail centres and delivery offices remained flat at 1.7 per cent a year, and is below Royal Mail's own target of 2 to 3 per cent per annum.<sup>147</sup>

There is the risk that any further attempts to change working practices and develop more flexible staffing models may bring Royal Mail into conflict with the trade unions. This might be a situation that Royal Mail would seek to avoid, as it would not be in the interests of consumers (because they have little alternative options for posting letters) or shareholders. Strike action would accelerate further the permanent switch to digital media by letter customers, and would drive parcel customers to competitors. As a result of these issues, Ofcom are about to launch a major review of Royal Mail's efficiency.

## 10. Consumer needs

The continued evolution of the UK postal market to fulfil both communications and logistics needs requires regulatory vigilance and robust oversight, in order to ensure the sustainability of the universal postal service, which provides a vital service to consumers and small businesses. Evidence in the public domain on the sustainability of the universal postal service does not currently point to an immediate material threat, to either E2E letter mail or parcel delivery services, from increased competition. However, the continued decline in mail volumes and the growth of competition will be the primary influencing factors on the dynamics and shape of the UK postal market, and the future sustainability of the USO.

As Royal Mail is currently the USP, issues in relation to the financing of the USO are linked to the ability of Royal Mail to finance its activities. There is a complex web of demands, from both Royal Mail stakeholders and the market conditions in which it operates, that will determine whether it can balance the often-conflicting challenges successfully.

The factors that can be seen to affect competition in the postal market include:

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<sup>146</sup> See <http://bit.ly/1FFI53P>

<sup>147</sup> Ofcom Annual monitoring report on the postal market financial year 2013-14, pages 34-36  
<http://bit.ly/1RCprQ3>



- changing demand for postal services, which may lead, for example, to static or falling volumes in traditional mail products and growth in e-commerce delivery products
- developments in ancillary sectors such as advertising, retail and financial services sectors
- evolution of the regulatory environment for the USO and competitors
- broader economic growth and the availability of finance for competitors and operators
- changes in technology that drive new customer demands and changes in postal cost structures.

The results of competition will be felt in the following areas:

- Royal Mail's pricing strategy, quality of service and prices for USO products for consumers and funding required for the USO.
- The impact of competition will be experienced differently by the various consumer segments in different areas of the UK<sup>148</sup>; the quality of service levels, the choice of services outside USO services and the variation of price of USO services could increase overall.

While competition has generally been to the benefit of postal consumers, it is of concern that there is still evidence of some market failure in development of services for some groups of consumers, particularly those in rural and remote areas who have limited choice and are more reliant on the USO. There is a significant body of evidence of detriment in relation to Royal Mail and other operators' provision of these services to rural and remote consumers in the parcel market, including non-deliveries, delivery surcharges and lengthy journeys to collect undelivered items. Evolving consumer needs in the postal market need to be continually reflected in the universal service.

Consumers still rely on and value the universal service as a communication tool, and the USO acts as a critical safety net to avoid social exclusion and the potential lack of services due to market failure. Traditionally, rural consumers value and appear to have a greater reliance on postal services than users in other geographic locations. Recent research published by Ofcom, in their user needs review, also showed that other categories of users, such as older, disabled or housebound users, are more likely to use postal services and to feel cut off from society if they are unable to send or receive post. Access for vulnerable and rural consumers (at affordable rates) must be maintained, as this is becoming increasingly important for these groups to effectively participate in the growing online economy.

Research undertaken by Ofcom reveals the following:

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<sup>148</sup> These consumer segments include rural, remote, island consumers, urban consumers, vulnerable consumers in rural/remote/island areas, vulnerable consumers in urban areas and small and micro-businesses across all of these areas.

- 64 per cent of adult postal users claim to be ‘very’ or ‘fairly’ reliant on postal services, although the average annual spend per household is only £7.94 (0.11 per cent of household budgets).<sup>149</sup>
- 63 per cent of adults said that the number of items they have sent by post has remained at the same level over the past two years.
- 21 per cent of adults claimed that their use of post had decreased in the past 2 years and 16 per cent claimed it had increased. This is broadly the same as the claimed use of post in 2013, when 24 per cent said their use of post had decreased and 15 per cent said it had increased in the 2 previous years.
- Of those who said that their use of post had decreased, 51 per cent said they were sending fewer personal letters; this was followed by 41 per cent claiming to send fewer invitations and greetings cards, and 29 per cent claiming to send fewer formal letters to organisations and individuals.
- Overall, there was a net increase in small and larger parcels being sent for fulfilment of e-commerce and return of internet purchases.

Regardless of how frequently people are using post, there is evidence that consumers remain reliant on postal services as a means of communication; 64 per cent of adults stated they were either ‘very’ or ‘fairly’ reliant on the postal service. Furthermore, 51 per cent, including categories such as older, disabled or housebound users, said that they would feel cut off from society if they could not send or receive post. Levels of reliance on the postal service increase with age, particularly the proportion claiming to be ‘very reliant’, with 17 per cent of 16 to 24-year-olds stating they were ‘very reliant’ on the postal service, compared to 33 per cent of those aged 65 to 74 and 35 per cent of those aged 75 and over.

The USO acts as a critical safety net to avoid social exclusion and the potential lack of services due to market failure. Traditionally rural consumers value and have a greater reliance on postal services than users in other geographic locations, and are more likely to use postal services. It is important that access for vulnerable and rural consumers (at affordable rates) is maintained. It is also becoming increasingly important for their effective participation in the economy. Ofcom must continue in its role to monitor Royal Mail’s quality of service and the level of provision.

Ofcom’s user needs research produced similar findings to the Consumer Focus 2012 report, *Sense and Sustainability*, and pointed to user needs being more than met by the current specifications of the service. Both examinations revealed that, although the current universal service largely satisfies users’ core needs, respondents were willing to consider some changes to the service. Changes considered include removal of Saturday deliveries, providing there was greater innovation and they were given more convenient packet services and re-delivery options, including extending the number of pick-up points, longer opening hours and more convenient locations, including pre-specified locations such as pubs or corner shops. Meeting these needs is the key to future sustainability of the service

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<sup>149</sup>Ofcom, *The Consumer Experience 2014 Report*, page 97: <http://bit.ly/1NjzCYx>

The picture, therefore, is of a changing use of postal services by consumers who are turning more and more to electronic media for their communication needs. The exception is the need to send and receive parcels and greetings cards, particularly at Christmas. Ofcom's 2013 research revealed that Royal Mail's prices at the time did pass an affordability test, despite the standard price of a 1st class stamp having risen by 37 per cent and a 2nd class stamp by 50 per cent over the last five years, with post only accounting for 0.11 per cent of household budget share. Since then, basic 2nd class letter prices have been capped at 55p (plus an annual inflationary allowance), along with large letter and packets up to 2kg. However Royal Mail has announced the standard price of a stamp will rise 1p, taking the price of a 1st class stamp to 63p and a 2nd class stamp to 54p from 30 March 2015. Royal Mail has also held the promotional £2.80 price for small parcels up to 2kg, introduced for Christmas 2014.

*Figure 10.2 Summary of standard stamp price changes, April 2011 to April 2015*

Product	April 2011	April 2012	April 2013	April 2014	April 2015	increase 2011-15
1st class stamp	46p	60p	60p	62p	63p	37%
2nd class stamp	36p	50p	50p	53p	54p	50%

Increasing tariffs will continue to be one measure for Royal Mail to safeguard revenue and remain profitable. However, the success of this strategy depends on the reaction of postal customers, in economic terms, to the price elasticity. The pre-condition for the success of this strategy is that postal customers do not switch, either to competitors or to other communication channels, due to increasing postal tariffs. A Copenhagen Economics study highlights that the price elasticity of consumers is particularly low.<sup>150</sup> For this reason, it is less risky for postal operators to increase tariffs for single-piece items than for bulk mail products. This pricing strategy has generally been adopted by developed European postal operators, as they struggle to remain economically viable in the face of falling letter volumes.<sup>151</sup> Ofcom's 2014 *Consumer Experience Research Report* found that over half of consumers (54 per cent) considered that 1st class stamps offered good value for money, while 46 per cent considered 2nd class stamps good value.

However, consumer needs are changing, and overall, consumers have reduced their use of post for communications needs while increasing their use of post and logistics

<sup>150</sup> Copenhagen Economics (2012), *Pricing Behaviour of Postal Operators*, Chapter 5. <http://bit.ly/1KhR0iS>

<sup>151</sup> WIK-Consult study for EC: *Main Developments in the Postal Sector 2010-13*: <http://bit.ly/1IRMclj>

services for fulfilment of e-commerce. This signals a clear shift for the relevance of the postal service, from a letter-based communication system to a parcel delivery fulfilment service through logistics networks. This is not to minimise the importance of letter mail and the USO to social consumers and small and micro-businesses, but points to a different focus for a regulator charged with ensuring sustainability of the service.

Initiatives at the European level, especially within ERGP,<sup>152</sup> have begun the debate on the contours of the minimum requirements for a universal service. Policy makers need to ensure that regulatory actions are coupled over the longer term with a robust review of user needs from the universal service, and consideration by key national and European stakeholders on the appropriate parameters for a universal postal service in the digital age.

## 11. Royal Mail privatisation

Privatisation is bringing Royal Mail added scrutiny of performance from the financial market and pressure to deliver commercial rates of return on its investment from shareholders. It could be argued that the most influential appraisal of its business has now passed from the regulator to its shareholders and the market analysts and traders, such as Hargreaves Lansdown, which, following the publication of Royal Mail's interim results in November 2014 and January 2015, commented that Royal Mail is now facing the harsh realities of a listed company.<sup>153</sup> With most of the key metrics flat to negative, and a decrease in operating profit, margin and earnings per share accompanied by an increase in costs, the share price has fallen 25 per cent over the year. Hargreaves Lansdown highlighted what it considered to be the main issues underpinning the results that feature in this report:

- The group's UK parcels delivery company market 'remains challenging'.
- Royal Mail's settlement agreement with the French competition authority in respect of alleged breaches of antitrust laws by GLS France, with a provision of £18 million.
- As the UK's designated universal postal service provider, in future it may not be able to recover all of the costs it incurs in providing the universal postal service to which it is bound by certain regulatory obligations. In December 2014, Ofcom announced that it had decided against imposing stricter regulations on direct delivery operators, which dealt a blow to Royal Mail's share price. Regulatory uncertainty is part and parcel of investing in Royal Mail shares.
- Royal Mail's performance and results of operations are significantly influenced by the wider economic environment and online consumer spending.

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<sup>152</sup> See <http://bit.ly/1NISqr1>

<sup>153</sup> See <http://bit.ly/1Kg09H5>

- There is a risk that one or more material disagreements or disputes between the company and the trade unions could result in widespread localised or national industrial action. About 80 per cent of the company's workforce are members of a union, principally the CWU.
- Royal Mail's business is labour-intensive and necessitates a large workforce. The size of, and high fixed employment costs associated with, the company's workforce in the UK may make it less competitive compared with other postal operators in the UK. As Royal Mail spent so long in public hands, there is little doubt that efficiency savings could be found in its new structure as a commercial entity, which could help drive margins higher.

While these issues are not new, the significance is that, through the stock market, Royal Mail now have greater continuous exposure and will influence investor confidence, and therefore the share price. Royal Mail will be expected to respond to investor demands, and will have to balance them with those of the Government and the regulator while pursuing its commercial strategy. Investors' timescales for seeking good news and maintaining their support and funding tend to be shorter, with regular six-monthly results and forecasts or declarations of dividend payments required. If Royal Mail is to grow its profitability in line with market expectations, which it is struggling to deliver, it must deliver a step change in parcel volume and revenue. Investors will be interested in its plan to deliver the size of growth required and the investment required to fund it.

## 12. Conclusions and recommendations

The key findings of the impact of competition in the postal market on consumers from our extensive research, detailed economic evaluation of data and modelling of the impact of competition from Whistl in the letter market, and increasing competition in the parcel market, are as follows:

**12.1** PLCWW finds no substantive evidence that the Whistl and Amazon competition presents any short-term threat to Royal Mail's financial ability to continue to provide the range or quality of services it is required to deliver as the USP to UK consumers. PLCWW concludes the projected loss of volume and revenue in the early years of implementation is within the range that should be containable with appropriate efficiency measures from Royal Mail. The USO services are currently profitable, but the difference of view about the accuracy of the ABC model must be resolved to provide clarity about any financial risk to the sustainability of the USO. However, if competition went beyond Whistl's and Amazon's current plans and Royal Mail's revenue loss exceeded £300 million, then this could be the point that results in the company being loss-making on USO services. In such a scenario, PLCWW would consider it important that the regulator uses the mechanisms contained within the European Community framework to ensure the continued financing of the universal service. Citizens Advice should continue to promote the need for a certain amount of vigilance from the regulator and an inclination to intervene earlier, before it is 'too late', rather than after the event.

**12.2** The new E2E services should result in consumer benefits from an expanded competitive market, similar to those experienced since market liberalisation in 2006. This forces providers to deliver improved efficiency and reduction in costs, and price stability through lower levels of price increases, as well as providing increased choice and service innovation.

**12.3** Privatisation potentially creates greater commercial awareness and profit focus, together with improved access to investment, which Royal Mail needs to combat the challenge of Whistl and Amazon in its traditional markets and to achieve the significant growth it needs in the parcel market.

**12.4** The parcels industry is highly competitive, with low margins and an increasingly demanding customer base. Royal Mail has tried to be innovative but is playing catch-up; it has no parcel automation and its IT systems are not as sophisticated as many of its competitors. It will need significant investment to modernise its operational capability to deliver growth and also handle increased volume economically and efficiently. Royal Mail's success in the parcel market is critical to sustaining an affordable USO service to consumers, especially those in rural, remote or island areas who may have no access to other carriers. The protection of USO parcel services will be increasingly important for vulnerable consumers wishing to access the full range of products at an affordable price, especially in remote areas.

**12.5** USO services are currently profitable. Given the low level of financial risk to the USO in the short term, PLCWW does not envisage the need for any changes to the USO service specifications. The USO services are sufficiently profitable to withstand the potential loss of revenue from the increased competition for the next few years and PLCWW expects Ofcom to maintain its requirement for considerable efficiency improvements, to prevent the need for erosion of services. If such a need were to arise, there are a range of measures to reduce costs that have been examined in the past, such as ceasing air services, which would minimize the impact on service levels generally that are detailed above. There is also the experience of New Zealand Post, which has decided to adopt changes to the USO that will provide delivery of standard letter mail six days a week to more than 95 per cent of delivery points, and not less than three days per week to 99.88 per cent of delivery points, with deliveries five days per week to rural delivery points (except for those rural delivery points that had lower frequency as at 30 June 2013).

**12.6** Consumers are now generally protected by the price caps, indexed in line with CPI, that now apply to 2nd class standard and large letters for a period of seven years through to the end of Royal Mail's designation as the USP.

In the light of the findings, PLCWW concludes that the USO is not at risk for at least the next two to three years, as Ofcom completes its reviews of Royal Mail's efficiency and its competitive position in the parcel market, which is likely to take the rest of the year. At that point, if there are actions for Royal Mail to respond to, it will take at least another year to implement and obtain the results on which to base future decisions. By then, the full impact of the Whistl and Amazon entry into the E2E market should also be quantifiable, as should the effect of privatisation on Royal Mail as a commercial entity operating in fully competitive markets. A further review to



safeguard the interests of consumers may be warranted at that point. Meanwhile, PLCWW recommends that Citizens Advice continue to monitor the various parties and initiatives being deployed to ensure they are able to act on behalf of the consumer, should any major change arise that might accelerate the risk to the USO.