Annual monitoring update on the postal market

Financial year 2018-19

Market Update

Publication Date: 19 December 2019

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Annex

1. Overview

This report sets out key data and trends in the postal sector for the 2018-19 financial year.

The regulatory framework Ofcom put in place in March 2012, and reviewed in March 2017, is designed to fulfil our statutory duty of securing a universal postal service, having regard to financial sustainability and efficiency. An effective and ongoing monitoring regime remains one of the key safeguards of the regulatory framework, alongside greater pricing freedom for Royal Mail.

This document, together with a broad range of interactive data, constitutes our eighth annual monitoring update on the postal sector. This report covers six key areas: analysis of the letters market; the parcels market; consumer and small business experience of postal services; the financial performance of Royal Mail's Reported Business; the efficiency of Royal Mail's Reported Business; and Royal Mail's regulatory compliance. The Reported Business is the part of Royal Mail's business responsible for the universal service, which requires Royal Mail to collect and deliver letters six days a week and parcels five days a week, at an affordable and uniform price to all UK addresses.

What we have found

Letter volumes and revenues continued to decline. Addressed letters volumes declined by 8% to 10.2 billion items in 2018-19. The decline was larger than in the previous year, which saw a 5% decline. Overall letters revenues fell by 7% in real terms to £3.8 billion.

Parcel volumes and revenues continued to grow. Total volumes increased by 10% year-on-year, reaching a total of 2.6 billion items. This increase was slightly lower than last year's increase of 11% year-on-year. Total revenues increased by 4%, reaching £10 billion.

Consumers continued to be satisfied with postal services. Over eight in ten residential consumers were satisfied with Royal Mail (84%) and postal services overall (86%). Similarly, over eight in ten SMEs who use Royal Mail (86%) and other providers (84%) said they were satisfied.

We launched two investigations against Royal Mail for breach of regulatory obligations. One was for compliance with certain quality of service performance targets and one for pricing above the permitted level for Second Class Mail for the last week of the financial year. In relation to compliance with the quality of service performance targets, in 2018-19, Royal Mail only delivered 91.5% of its First Class mail next day against a target of 93%.

There was a downward trend across efficiency metrics. Real costs increased slightly and efficiency overall was negative. Royal Mail did not achieve its target productivity range of 2-3% or offset the increases in pay with gross hour reduction. We continue to believe that efficiency gains are crucial in ensuring the sustainability of the universal service.

Profitability of the part of Royal Mail that provides the universal service declined. Royal Mail's Reported Business EBIT margin was 1.6% for 2018-19 (on a 52-week basis), though the financial position and financial health metrics (including credit rating) of the Royal Mail Group do not indicate any short-term financial health issues. The longer term sustainability depends on a range of factors, including the extent to which the revenue growth and Royal Mail's transformation programme, set out in its five-year strategy, can be delivered.

Recent developments

1.1 In May 2019, Royal Mail set out its five-year strategy, which envisaged a Group revenue growth of 2-3% per year from 2019-20 to 2023-24.[1] Royal Mail's strategy has a strong focus on parcels, which is in line with the strategy of comparable operators internationally to transform their operations from a letters to a parcels business.[2] If the implementation of the new strategy proceeds as Royal Mail foresees, Royal Mail expects its UK business to return to revenue growth by 2023-24.[3]

1.2 We note that the strategy is subject to some risks, notably the outcome of discussions between management and unions on how this will be delivered, as well as broader market and macro-economic risks which could affect Royal Mail's ability to grow parcel revenues at the rate envisaged and/or suppress overall levels of demand for letters and parcels.

1.3 In its half-year results announcements, Royal Mail noted that transformation is running behind schedule and is likely to impact productivity in the second half of the year. Royal Mail also revised its forecast for the full year's letter volume decline, expecting letter volumes to decrease by 7-9% in 2019-20, instead of 5-7% as previously forecast. Royal Mail stated that, combined with the industrial relations situation and lower than anticipated productivity gains, its UK business is expected to be break-even or loss making in 2020-21.

1.4 Therefore, we believe that uncertainty remains about the longer-term sustainability of the universal service. As in previous years, we will continue to monitor the sustainability of the universal service, and engage with management to understand better how they plan to mitigate the risks to the sustainability of the universal service.

[1] The 2-3% growth per year is calculated on a Compound Annual Growth Rate (CAGR). See Royal Mail, 2018-19 results and strategy presentation, slide 43: https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf

[2] For instance postal operators in the Netherlands, Denmark and Sweden have widely introduced parcel automation.

[3] Royal Mail reports that between 2015-16 and 2018-19 (on a 52-week basis), UKPIL revenues declined from £7,671bn to £7,595bn (-0.3%). Slide 36, Royal Mail's 2018-19 results and strategy presentation, https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf

2. Introduction

2.1 Ofcom has a duty under the Postal Services Act 2011 to carry out our postal functions in a way that we consider will secure the provision of a universal postal service, having regard to its financial sustainability and efficiency. The minimum universal service requirements are set by Parliament and require Royal Mail to provide certain postal services at affordable, uniform prices throughout the UK. In light of this duty, our approach to regulating the postal sector was set out in our March 2012 Statement.[4] This included the decision to give Royal Mail greater pricing freedom to enable it to return the universal service to financial sustainability, subject to certain safeguards.

2.2 One of the key safeguards was an effective and ongoing monitoring regime to track Royal Mail's performance, as well as monitoring changes in the postal market. As part of this regime, we committed to publishing an annual monitoring update which sets out key data and trends in the postal sector, focusing on the progress towards securing the provision of a universal service. In our March 2017 statement where we confirmed we would broadly maintain the current regulatory framework until 2022, we said that our ongoing monitoring of the postal market remains a key safeguard of our regulatory framework, alongside the Second Class safeguard caps on certain universal service products and mandated access regulation.[5]

2.3 In order to ensure that the regulatory framework continues to work effectively we monitor a range of factors including competition in parcels and letters, consumers' and businesses' experiences in the postal sector, Royal Mail's performance on efficiency and the financial performance of the universal service network, and Royal Mail's prices and quality of service results.

Measuring the outcomes of the regulatory regime

2.4 This report focuses on the 2018-19 financial year and in particular on:

- The letters market – Section Three
- The parcels market – Section Four
- Residential and SME users' experience of postal services – Section Five
- The efficiency of the Reported Business – Section Six
- The financial performance of the Reported Business – Section Seven
- Compliance with regulation – Section Eight

2.5 We continue to monitor market developments and Royal Mail's performance in the key areas outlined above.

[4] https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf
[5] https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

The wider monitoring programme

2.6 In addition to this annual monitoring update, the aims of which are discussed above, the wider programme includes:

- monitoring potential market developments through requests to industry stakeholders for market specific information, and identifying concerns raised by stakeholders with how the regime is operating. This year, we sought the views of some bulk mailers to understand better the drivers of their current and future usage of post. We are also in the process of engaging with parcel operators to deepen our understanding of the wider parcels market in light of growing demands for parcel services. We report our findings to date later in this report;
- regular review of data and indicators for the key areas set out above; and
- monitoring developments in other markets internationally.

2.7 Furthermore, in our Annual Plan for 2019-20, we set out our intention to bring forward some of the work we had planned to undertake as part of our next review of the regulation of Royal Mail, which was intended to be undertaken by 2022. Accordingly, this year we have commenced work on reviewing Royal Mail efficiency, and the reasonable needs of postal users.

2.8 Within this report we provide our view of how the regulatory regime is meeting our duty to secure the provision of a universal service by publishing some information on the financial performance of the Reported Business, the part of Royal Mail Group's business responsible for the universal service. We also highlight compliance with regulatory requirements, market developments in the past year, and postal users' experience of postal services.

2.9 Royal Mail (along with other postal operators) provides a range of confidential data to us. Although the confidential nature of this data means that we do not publish it, the data informs our ongoing monitoring programme, and is used to identify any potential or emerging problems in relation to the provision of the universal service and wider competition in the postal markets. So that stakeholders are aware of the information we gather, our financial monitoring data is listed in Annex 1.

Royal Mail is the focus of our monitoring regime

2.10 The focus of our monitoring is Royal Mail, although we undertake our monitoring within the context of the broader postal services market. This is because Royal Mail is the designated universal postal service provider, operating a network capable of delivering letters and parcels to approximately 30 million business and household addresses nationwide.

2.11 Not all of Royal Mail's business is subject to Ofcom regulation. The parts that are subject to our monitoring regime are known as the 'Reported Business', which sits within a group of business units referred to by Royal Mail as 'UK Parcels, International and Letters' (UKPIL).

2.12 The Reported Business includes all universal services, as well as other services which are delivered over the universal service network, namely retail bulk mail and access products and parcels.

2.13 Although we focus on the financial year 2018-19, in parts we deviate from this time period to include more recent events and price changes, including analysing residential letter and parcel prices (which are typically revised in April and apply for the rest of the financial year), business prices (which are normally revised every January), developments in the parcels market, and wider developments relevant to Royal Mail's financial position.

Presentation of data in this annual monitoring update

2.14 Financial data presented in the annual monitoring update on the postal market is in real terms, unless otherwise stated, except for the revenue, price and cost data presented in Sections 6 and 7. This is consistent with how it is presented in Royal Mail's Regulatory Financial Statements.

2.15 Where we report real terms changes, we have elected to use the Consumer Price Index (CPI) as the basis for our calculations, as has been our custom since the 2014-15 annual monitoring update on the postal market. This year we have used a yearly average CPI index (from April 2018 - March 2019).

2.16 Royal Mail reports its financial statements using whole weeks. This means that for the 2018-19 financial year Royal Mail has reported a 53-week year. In Sections 6 and 7, where possible, 2018-19 results have therefore been adjusted to 52 weeks to enable a like-for-like year-on-year comparison. Where we discuss changes, we are referring to the comparisons to the prior financial year i.e. 2018-19 to 2017-18 on a 52-week basis (unless otherwise stated).

2.17 The metrics in this update are, unless otherwise stated,[6] consistent with those in our previous two annual monitoring updates on the postal market, published in November 2017 and 2018 respectively (enabling year-on-year comparisons). As mentioned above, while the majority of the analysis in this report focuses on 2018-19, pricing information focuses on the most recent pricing data available (i.e. 2019), which is in line with previous monitoring updates. This annual monitoring update comprises both this report and accompanying interactive data available on the Ofcom website.[7] Data presented in the annual monitoring update is available in csv files on the Ofcom website.

[6] For instance, our change to use a yearly average instead of March CPI index.
[7] Annual monitoring reports and interactive data avalible here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

3. Letters

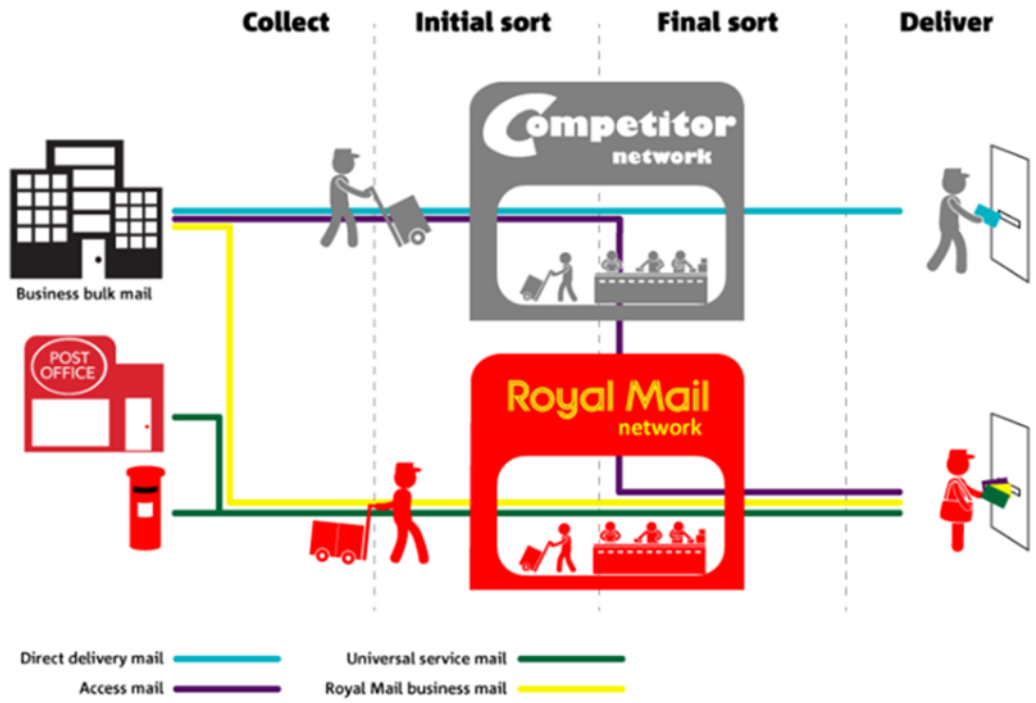
Letters market in the UK

3.1 This section covers recent developments and trends in the end-to-end and access letter markets. Together, the letters and large letters[8] mail sector consists of three parts:

- mail collected and delivered by Royal Mail (Royal Mail end-to-end) which consists of both bulk and non-bulk mail;
- mail collected by other operators and delivered by Royal Mail (Royal Mail access); and
- mail collected and delivered by other operators (other operators' end-to-end).

3.2 Therefore, within the postal sector, there are two main forms of letters competition: access and end-to-end.

Figure 3.1: Forms of competition in UK postal market



Source: Ofcom

3.3 Access competition continues to be the main form of competition in the letters market in the UK, accounting for 65% of all letter volumes in 2018-19, an increase of 2 percentage points (pp) on the previous year. This is where a postal operator other than Royal Mail collects mail from the customer, sorts it and then transports it to Royal Mail's Inward Mail Centres, where it is handed over to Royal Mail for delivery. Royal Mail is subject to a regulatory condition requiring it to offer access at its Inward Mail Centres to other postal

[8] Letters can be up to 24cm long, 16.5cm wide and up to and including 0.5cm thick. In contrast large letters are letters with a length up to 35.3cm, width up to 25cm and can up to and including 2.5cm thick, with a maximum weight of 750g.

operators and customers for certain letters and large letter services with a routing time of two working days or later. This enables other operators to offer postal services to their customers (normally large businesses) for these formats without setting up a delivery network.

3.4 Royal Mail also offers a similar access service for parcels; this product, used by some access mail operators, is currently offered on a commercial basis by Royal Mail and is not a regulatory requirement. Access parcels volumes and revenues remain small compared to access letters volumes and revenue. In contrast, the UK parcels market is generally characterised by end-to-end competition with operators using their own networks.[9]

3.5 End-to-end competition relies on network competition and does not rely on Royal Mail for collection, sortation or delivery of letters to end customers. The scale of end-to-end competition in the letters market is small, with no nationwide end-to-end competitor to Royal Mail.[10]

3.6 As in previous years, there continues to be examples of mergers and acquisitions (M&A) related to businesses involved in the letters sector. M&A activity may offer the opportunity for businesses to grow scale within their existing market, and potentially reduce cost, or else allow for diversification, for example, letters operators such as Whistl purchasing businesses in the e-commerce fulfilment sector.[11]

3.7 In June 2019, the Delivery Group, owner of Secured Mail (an access operator) and CMS (an operator with an end-to-end network in London), completed its acquisition of Portishead-based access operator OnePost for an undisclosed sum. According to PrintWeek, between March 2018 and March 2019 there were 77 M&A transactions involving a UK-firm in the printing sector.[12] As an example, one of these larger transactions was US-based OSG Holdings' £154m acquisition of Communisis Plc, a provider of outsourced transactional and marketing communications on behalf of major senders of bulk letters mail, which was completed in December 2018. As well as producing transactional and direct mail on behalf of its clients, Communisis manages the handover of this to the client's selected letters operator. According to Communisis' chairman, the transaction will benefit Communisis by enabling it to take advantage of greater scale and OSG's technology.[13]

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[9] Though some parcel operators do rely on third party networks for delivery in some parts of the UK where they lack a delivery network themselves.

[10] There is also a nationwide Document Exchange service operated by DX which enables documents to be sent between member organisations. Volumes and revenues from this service are not included the addressed letters volumes and revenues data.

[11] Printweek, 2018. Whistl bolsters fulfilment offering with Spark acquisition. https://www.printweek.com/print-week/news/1166306/whistl-bolsters-fulfilment-offering-with-spark-acquisition

[12] Printweek, 2019. Better together: print M&A activity shows no sign of abating. https://www.printweek.com/print-week/briefing/1168287/better-together-print-m-a-activity-shows-no-sign-of-abating

[13] Insidermedia, 2018. £150m deal agreed for marketing services specialist. https://www.insidermedia.com/news/yorkshire/150m-deal-agreed-for-marketing-services-specialist

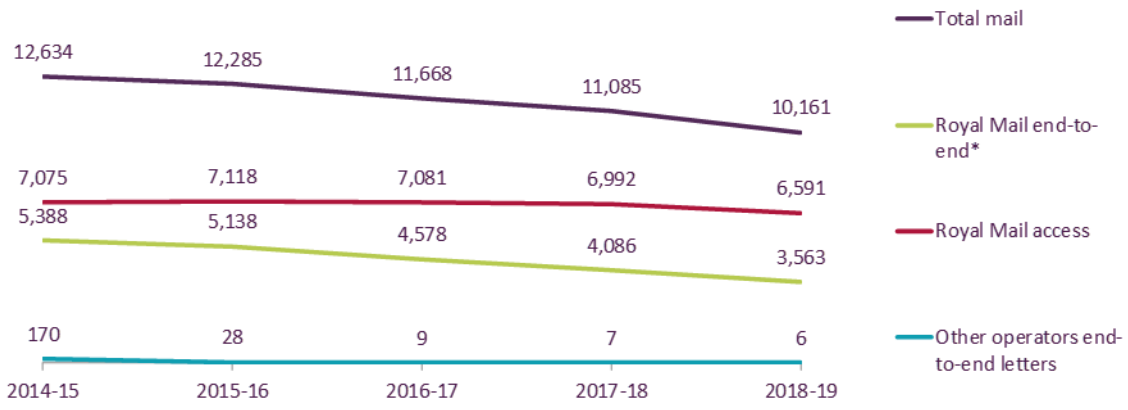
Letters volumes and revenues

Addressed letters volumes declined by 8% in the year to March 2019

3.8 Addressed letters volumes (which include letters and large letters) declined by 8% to 10.2 billion items in 2018-19, reflecting continued structural decline in transactional mail (such as bills and statements) and advertising mail. As shown in Section 7, such business mail drives the volume of letters sent, but the volume of letters and parcels sent using the universal service is also declining (in 2018-19, the volume of letters and parcels sent under the universal service obligation (USO) declined by 9.8%). The overall letter volume decline of 8% was larger than in the previous year, during which addressed letters volumes fell by 5%. In its half-year (H1) 2019-20 results, Royal Mail indicated it expected to see volumes decline to be between 6% and 8% in 2020-21, reflecting the economic cycle and business uncertainty (Royal Mail did not expect an impact from the General Data Protection Regulation (GDPR) in 2020-21).[14]

3.9 The proportion of letters carried by downstream access providers[15] increased by two percentage points in the year to March 2019 to 65% of addressed letters. Overall access volumes fell by 6%, compared to a 13% decline in Royal Mail end-to-end addressed letters volumes, which may indicate some senders switching business from Royal Mail to access operators. The number of letters delivered by operators other than Royal Mail in 2018-19 fell to 6 million items (less than 0.1% of total letters volumes).

Figure 3.2: Addressed letters volumes (millions)



*Source: Operator returns, Ofcom estimates. NB: Due to change in methodology from 2015-16 data, it is not possible to make direct comparisons between pre-and post-2016. *Royal Mail end-to-end is*

[14] Royal Mail, 21 November 2019. Half Year 2019-20 Presentation Results. https://www.royalmailgroup.com/media/10974/rmg-h1-2019-20-results-presentation-print.pdf, slide 14

[15] Where a postal operator other than Royal Mail collects mail from a customer, and hands it over to Royal Mail to complete the delivery. See the section above for further details.

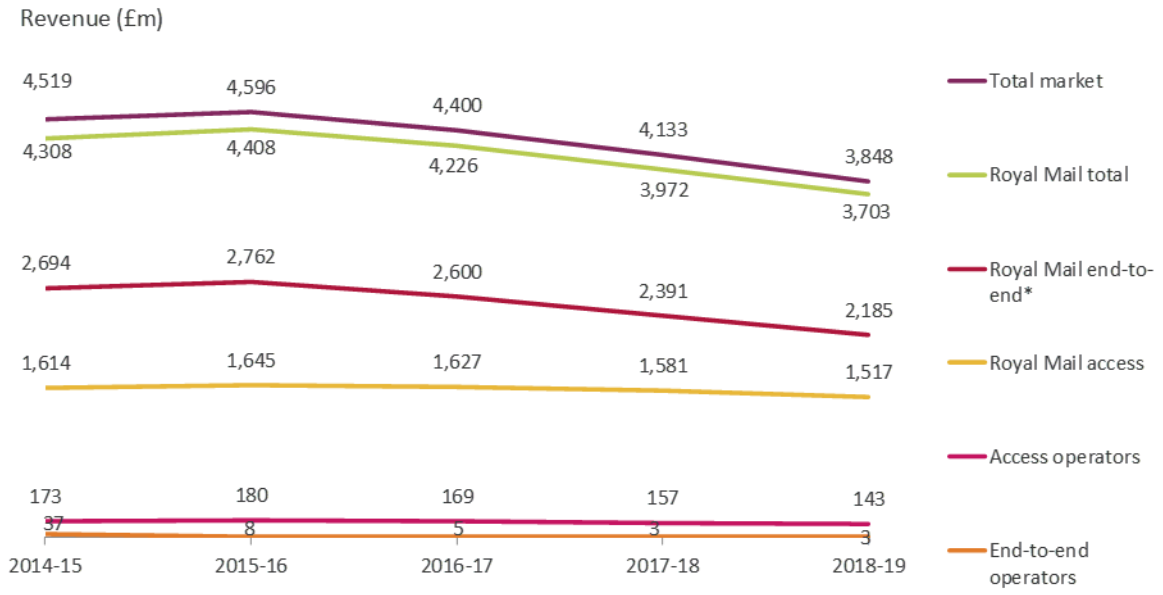
an Ofcom calculation and refers to Royal Mail total letters, excepting access. Figures exclude international. Access volumes include access parcels.

Letters revenues fell by 7% in real terms between 2017-18 and 2018-19

3.10 Overall letters revenues fell by 7% in real terms to £3,848m in 2018-19, driven by a 9% real-terms decline in Royal Mail end-to-end letters revenues. Royal Mail access revenues fell by 4% to £1,517m.

3.11 Reported revenues retained by access operators fell by 9% in real terms to £143m. This figure reflects the revenues retained by access operators for the delivery of mail, once payments to other operators (mainly Royal Mail) have been made. This may reflect price competition between access operators to secure and maintain contracts with their customers. We note that access operators may bundle postal services with a range of value-added services such as mailroom management, mail collection, magazine distribution and printing. Revenue from these other services is not reported in the figures below but forms an important part of the revenue mix for some access operators.

Figure 3.3: Addressed letters revenues



*Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates. Adjusted for CPI at 2018-19 prices. Royal Mail figures relate to the 'reported business'. *Royal Mail end-to-end is an Ofcom calculation and refers to Royal Mail total letters revenues, excepting access. Access revenues include access parcels. Due to changes in methodology from 2015-16 data it is not possible to make direct comparisons between pre- and post-2016 data. 2017-18 access operator revenues include operator restatements.*

3.12 Marketing mail revenues declined further than overall letter revenues. Overall spend on direct mail advertising continued to fall in 2018-19. Overall expenditure (which includes

production and elements of postage) fell by 12% in real terms to £1502m[16], compared to a 6% real-term decline in the prior year. Royal Mail Marketing mail[17] revenues fell by 10% in nominal terms (12% in real terms) to £994m in 2018-19, which Royal Mail said reflects the impact of the General Data Protection Regulation (GDPR).[18] According to Royal Mail, products such as partially addressed mail (where mail is addressed to a location but not to a named individual) offer advertisers the potential to reach audiences at a potentially lower cost than with traditional marketing mail, while potentially offsetting concerns about GDPR.[19]

Bulk Mailers

3.13 This section outlines the views of some bulk mailers[20] about recent changes in the postal market. It also explores what further changes they anticipate in coming years, and the factors driving these changes.

3.14 As bulk mail consists of the vast majority of the letters sent, we were keen to understand better how bulk mailers use post and what is driving their decisions about usage of post. We sought the views of a small sample of large mailers via an online survey, followed by a workshop exploring the themes identified in the survey.[21] The survey was completed by 21 respondents and the workshop attended by ten organisations. The findings below represent a snapshot of views on bulk mail and are not representative of the market as a whole.[22]

3.15 The survey and workshop collected views from various sectors including banking, financial services, retail and the public sector. Participants' details were provided by their postal operators. The majority of participants use Royal Mail and one access operator, and the majority of mail sent was transactional mail (e.g. bills) and marketing mail, with some publication and fulfilment mail. Respondents to the survey were generally very large mailers. They collectively reported sending c.2.8bn items a year.

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[16] Source: AA/WARC Expenditure Report. Adjusted for CPI at 2018-19 prices by Ofcom.
[17] Includes revenues from addressed and unaddressed advertising mail, redirections and Address Management Unit.
[18] Royal Mail Group, 2019. Journey 2024: FY 2018-2019 results and strategy presentation. https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf. Please also see p.25 of the 20181-19 Royal Mail Group Annual Report https://www.royalmailgroup.com/media/10924/royal_mail_ar19_190918.pdf
[19] Royal Mail, 2018. Introducing Partially Addressed Mail, https://www.royalmailtechnical.com/rmt_docs/User_Guides_Nov_2018/Partially_Addressed_Product_Presenter_Retail_November_2018.pptx
[20] We refer to bulk mailers as companies and organisations that send very large quantities of mail, here primarily letters.
[21] The survey was issued on 18 June 2019 and the workshop held on 22 July 2019.
[22] The survey asked questions on respondent's postal usage including volume of letters and parcels sent, type of mail product used, and type of mail sent e.g. transactional or promotional. Other questions asked why respondents send mail and why mail can be preferable to online communications. Respondents who were moving to online communications were asked their motivation for this. Respondents were also asked to rate how the importance of different factors driving their usage of mail had changed over the past two years.

Key findings

3.16 The views emerging from both survey and workshop participants were broadly consistent. A high level summary is set out below:

- Participants anticipated that they would use post less in future, but that generally the decrease in postal usage would be gradual.
- Participants highlighted legislative requirements and customer preferences are key reasons to use post. Another reason highlighted was the need to deliver physical products such as magazines, credit cards and loyalty cards.
- For many participants, the price of mail is an important factor in their decisions to use post instead of other methods of communication.

Past and future usage of post

3.17 Participants reported that they had been using post less in the last two years and anticipated that this trend would continue. Moving to other forms of communication is the key reason reported for their decreasing use of post. However, participants did not completely substitute post for other forms of communication. While some used other methods of communications instead of post, others used both post and other methods of communication.

Legislative and regulatory requirements

3.18 Most participants identified that legislative and regulatory requirements are one of the biggest drivers for using post to contact customers or clients rather than online communications. For example, this was the case for workshop attendees from the financial sector. They reported that the mail that bulk mailers are legally required to send is a significant proportion of the volume of post that they send. Conversely, if regulatory and legislative requirements were to change, most workshop attendees believed they would send considerably less post.

3.19 Specifically, workshop attendees were asked about the impact of GDPR has had on the way that they send post. Attendees highlighted that GDPR meant organisations could no longer send mail combining advertising mail with transactional mail such as bank statements, because recipients may not have 'opted in' to receive advertising mail. This meant that they needed to send more post if they wanted to send advertising mail in addition to bills and statements. Partially addressed mail (a new postal product where mail is addressed to a location but not to a named individual) was discussed as an alternative, although it was noted that take up is still at an early stage.[23]

Customers' preferences

3.20 Participants reported that another key reason they use post over other forms of communication is customers' preferences. Attendees at the workshop identified that there

[23] Partially Addressed Mail enables targeted mail marketing without the use of personal data about recipients.

is a subset of customers who continue to prefer to receive bills and statements via post, and that they are likely to continue to require physical copies of statements in the short to medium term. Attendees highlighted that they seek to respond to customers' preferences, although should the price of mail increase substantially, some attendees said they may pass this cost onto their customers. Some attendees also explained that their organisations focus on the delivery of physical items well suited to distribution by post (e.g. magazines and vouchers).

Pricing and quality of service

3.21 Some participants believed that price increases are triggering a move towards e-substitution in communicating with customers. Those participants stressed that the importance of price as a factor in using post has increased for them. Some attendees indicated that, for them, mail price rises usually result in efforts to drive down non-essential post usage to partially off-set the increased costs of post, and that they expect this to continue to drive down post volumes. Some participants also highlighted the potential difficulty in budgeting for price increases for which they have not planned.

3.22 Finally, some attendees noted that on occasion Royal Mail offers special incentives or discount offers[24] but were of the view that these could be better communicated and with more notice, which would allow clients to plan discounts into their marketing strategies.

3.23 Attendees to the workshop in general believed that quality of service was important to them, but that they are not currently able to track the progress of letters through the Royal Mail network, or negotiate individual service level agreements. For instance, mail arriving on time was noted as vital for banks sending out time-sensitive documents. In terms of marketing communications in the retail sector, respondents said that it was important to have certainty over on-time delivery.

Price trends for retail bulk mail and access customers

Retail bulk mail prices

3.24 Royal Mail and other operators offer several products and services to business customers who send larger volumes of mail, which are not within the universal service.

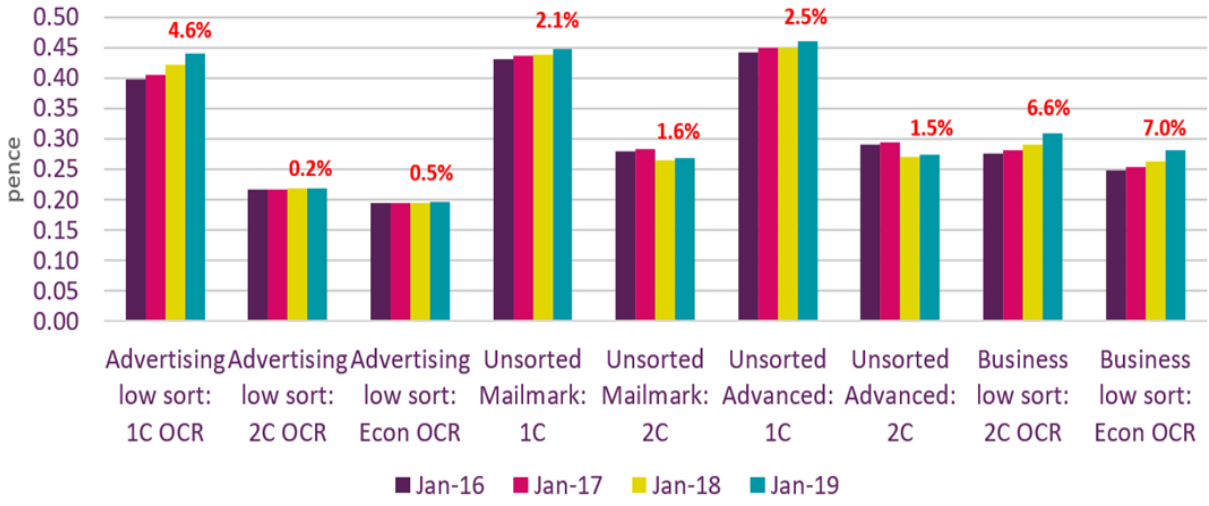
3.25 This includes products like Mailmark, which is a type of barcode product. Barcoding on envelopes means that they can be better read by letter sorting machines. This in turn helps Royal Mail sort and route mail more efficiently. Compared to standard barcoding, Royal Mail considered that Mailmark —introduced in November 2013 — enables even greater

[24] To encourage the posting of Letters and Large Letters Royal Mail offers an incentive scheme, whereby customers can apply for certain incentives when using certain mail services. Customers signing up for the incentive earn credits to use against future mail postings. For example, 'Back to School' incentive, which in 2019 awarded postage credits to advertising customers posting above certain volumes of eligible mail during the offer period. See: https://www.royalmail.com/sites/default/files/rmg-back-to-school-incentive-terms-2019.pdf

automated sortation, trackability and enhanced reporting and feedback to customers on the quality of their address data.[25]

3.26 Royal Mail has offered its Mailmark product at a lower rate compared to other barcode products (i.e. Barcode and Optical Character Recognition (OCR)).[26] Discounts are also given for sortation level and volumes sent, as well as machine-readability. There is a similar Mailmark product offered both by Royal Mail Retail and for access products.

Figure 3.4: Royal Mail Retail Business Mail and Advertising Mail prices – Jan 2016-Jan 2019[27]



Source: Royal Mail, Ofcom calculation based on maximum discounted prices and low sort barcode discount for standard letter sizes. Prices adjusted for CPI.

3.27 For different retail bulk products, where both First Class and Second Class services are offered as part of a product category, First Class products have increased more than Second Class products. For instance, the Advertising low sort OCR First Class product increased by 4.6% in real terms (7% in nominal terms), compared with a real term increase of 0.2% for the Advertising low sort OCR Second Class product (2.5% in nominal terms).

3.28 For non-advertising products, the most significant price rises in January 2019 were seen on OCR products, compared to Advanced or Mailmark products. For instance, Business low sort Economy OCR products increased by 7% in real terms (9.5% in nominal terms).

3.29 For advertising products, there was a weighted average price increase of 0.5% in real terms (2.8% in nominal terms).[28] However, aside for the First Class increase noted above,

[25] https://www.royalmail.com/corporate/mailmark
[26] Royal Mail uses scanning software with OCR to allow mail to be machine sorted, but the address needs to be printed in specific fonts and sizes for this to work. See: https://www.royalmailwholesale.com/addressing-your-mail
[27] Figures in red bold represent price increases or decreases, relative to inflation, in percentage terms from January 2018 to January 2019.
[28] Given the data relates to products with different mail volumes, we have decided to change our methodology in how we calculate average price rises over different products, from using an unweighted mean to using a weighted average mean, as we believe it is a more accurate approach. As the basis of our calculations is different from previous years, the information on average price rises is not directly comparable with former Annual Monitoring Updates.

increases on Advertising low sort OCR Second Class and Economy products were minimal compared with their Business equivalent: 0.2% and 0.5% real term increases for the Advertising low sort OCR Second Class and Economy products respectively, compared with 6.6% and 7% real term increases for Business low sort OCR Second Class and Economy products respectively. This may reflect Royal Mail's view in 2016 that transactional mail has lower e-substitution risk than advertising mail.[29]

3.30 Page 4 of the interactive data shows historic trends in business and advertising mail prices.[30]

Access prices

3.31 Royal Mail, under regulatory obligation, is obliged to offer access to its postal network to operators for certain letter and large letter services with a routing time of two working days or later. Figure 3.5 sets out the prices that Royal Mail charges access operators for national access products.[31]

3.32 As noted in our previous report, Royal Mail announced its intention to increase its access prices in January 2019. In a letter to customers, sent on 11 October 2018, Royal Mail said it was increasing prices for business mail services by an average of 9% and for advertising mail by an average of 1% (those are nominal price rises).[32] Royal Mail set out that price increases were implemented in the context of "rising UK inflation and a decline in letter volumes." Royal Mail also said that its planned price increases on some products were "necessary for us to maintain, protect and invest in the Universal Service."

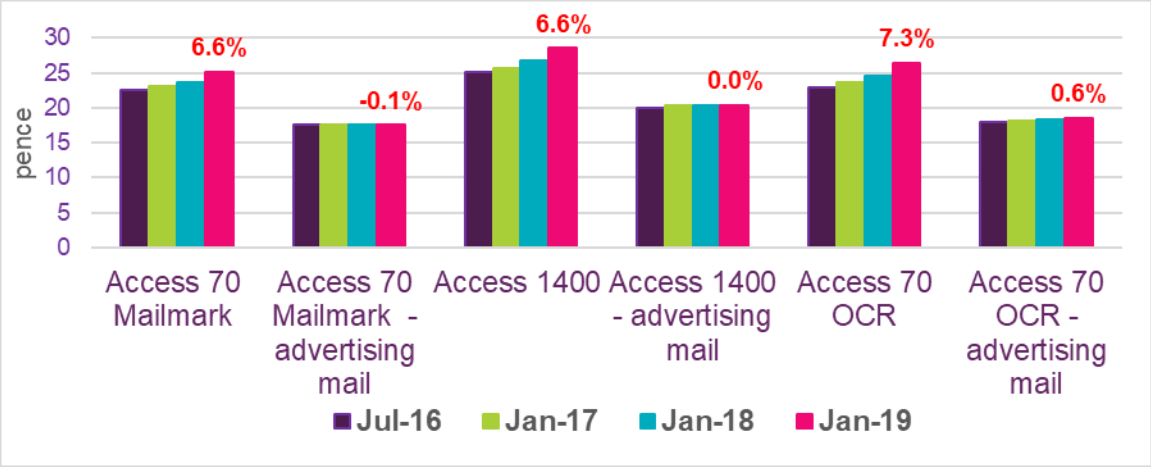
[29] Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail, Royal Mail Submission, August 2016. See p.13: "It is economically rational to price transactional and advertising mail in relation to their respective competitive constraints. Under such a pricing strategy, transactional mail prices would be expected to increase more than advertising mail. […] Transactional mail has lower substitution risks than advertising mail." https://www.ofcom.org.uk/__data/assets/pdf_file/0033/90789/Royal-Mail.pdf

[30] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

[31] In 2018, Royal Mail discontinued one type of of its access services (Customer Barcode or CBC). The prices of these products are no longer reported in the Annual Monitoring Updates.

[32] Royal Mail, 2019. Price changes for the access letters contract. https://www.royalmailwholesale.com/news/price-changes-for-the-access-letters-contract

Figure 3.5: Royal Mail national access prices in real terms from January 2016 to January 2019[33] [34]



3.33 Non-advertising access products saw the highest real term price increases compared with advertising products: Access 70 OCR saw a 7.3% real term increase, Access 1400 Customer Barcodes (CBC) a 6.6% real term increase, and Access 70 Mailmark a 6.6% real term increase. In comparison, for advertising access products, real terms prices for Access 70 Mailmark advertising declined by 0.1% compared with last year, whereas Access 1400 advertising remained stable (0.0%) and Access 70 OCR advertising increased by 0.6%

3.34 Royal Mail retains a price differential between Access 70 Mailmark and Access 70 OCR products, and continues to encourage take up of the Mailmark product.

3.35 In early 2015, Royal Mail introduced a provision to the terms of its contract with access operators that increased its flexibility to offer incentive schemes and promotions in access products to stimulate mail volume growth. These discounts are not included in Figure 3.5.

3.36 Page 5 of the interactive data shows historic trends in access mail prices.[35]

Summary

3.37 Addressed letter volumes declined by 8% in the year to March 2019, and letters revenues fell by 7% in real terms. The proportion of letters carried by downstream access providers increased by two percentage points in the year to March 2019 compared with last year, to reach 65% of addressed letters.

3.38 This year we sought the views of some large mailers about changes in the letters market, and the factors driving those changes. Our findings represented a snapshot of views from large mailers who responded to us or participated in our workshop, and are not

[33] Royal Mail offers a variety of access mail products, which vary by level of sortation, and type of mail, among other factors. The terms 'Access 70' and 'Access 1400' refer to two different levels of mail sorting which must take place before access mail enters Royal Mail's network. OCR is a mail format specification whereby the printed address can be read by Royal Mail's automated sorting machines and a barcode is applied to the envelope.
[34] As above, figures in red bold represent price increases or decreases, relative to inflation, in percentage terms from January 2018 to January 2019.
[35] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

representive of the market. Among other things, participants said that they expected to gradually use post less in the future, and explained that current legislation and customer preferences are among the factors which drive their continued usage of postal services.

3.39 For bulk mail, business mail saw the biggest price increases, particularly on First Class products, compared with advertising mail prices.

4. The Parcels Market

4.1 This section outlines trends in the UK parcels sector for domestic parcels, and inbound and outbound international parcels.[36] We then summarise recent developments in the parcels market and conclude by looking at parcel pricing trends over time.

Collecting information on parcels

4.2 In 2018-19 we have continued to collect revenue and volumes data from major parcel operators in the UK as part of our ongoing monitoring of the postal sector. These operators are: The Alternative Parcels Company, Amazon Logistics (encompassing both Amazon Marketplace and Amazon Retail)[37], DHL International and DHL Parcel UK (rebranded from UK Mail in October 2018)[38], DPD Group, DX, FedEx and TNT UK (a subsidiary of FedEx), Hermes, Royal Mail Group including Parcelforce Worldwide, Tuffnells, UPS and Yodel. We have not collected information from operators who offer only same-day delivery services and as in previous years same-day services are excluded from the reported data.

4.3 It is our view that the information we have collected represents the significant majority of UK parcel volumes and revenues carried by national parcel operators (excluding same day parcels). We recognise, however, that the range of operators we have collected information from may differ from other market sizing exercises, and therefore may not be directly comparable.[39] In addition, the international volumes and revenues reported here include parcels only and not other methods of moving goods (such as freight). Where we state proportions of total volumes and revenues below, the figures presented are (unless otherwise stated) shares of the data collected. Unless stated otherwise, revenue data is presented in real terms at 2018-19 prices.

4.4 In light of the continued growth in the e-commerce and parcels sector, we are undertaking further work as part of our monitoring programme to assess how the market is responding to the needs of parcel users, for instance considering business-to-consumer (B2C) and consumer (C2X) parcel deliveries.

4.5 This year we have also decided to gather further information on parcel surcharging. In 2017 we identified additional costs to parcel deliveries when items begin or end their journeys from more difficult to reach locations. Such higher costs were priced into services offered to customers, including retailers sending bulk parcels. We found these additional

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[36] International data is collected from operators within the United Kingdom. Ofcom is unable to confirm whether data captured in international outbound includes revenue from external shipping or delivery.
[37] Excluding same-day and within the hour delivery.
[38] The list of operators from whom we collected information is unchanged from the 2017-18 Annual monitoring update on the postal market. UK Mail was acquired by DHL in December 2016 and is now listed as part of the latter.
[39] While Ofcom's definition of parcels in monitoring includes those postal items which are neither letters nor large letters and which weigh no more than 31.5kg, the preamble to Regulation (EU) 2018/644 on cross-border parcel delivery services assumes that all postal items more than 20mm thick are likely not to contain correspondence. See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018R0644.

costs were driven by reduced economies of scale, delivery route/sector size and density, and fuel or other transportation costs (related to flights and ferries, for example). We are currently testing the extent to which these costs remain relevant to pricing variations for parcel delivery across the UK. This updated analysis is planned in support of work undertaken by the Consumer Protection Panel[40] and other stakeholders exploring pricing arrangements across delivery routes.

Parcel volumes and revenues

4.6 Total measured volumes and revenues continued to grow in 2018-19, though at a slightly lower rate compared to the previous year. Total volumes increased by 10% year-on-year, reaching a total of 2.6 billion items. Total revenues increased by 4% in real terms, a lower rate than volumes, reaching £10 billion. This is shown in Figure 4.1 below. Taking all measured parcels into account, the average unit revenue per parcel decreased by 5% year-on-year, from £4.08 in 2017-18 to £3.86 in 2018-19.

4.7 In 2018-19 measured domestic parcel volumes increased by 9% to 2.1 billion items and measured domestic revenues reached £6.25bn, an increase of 4% in real terms.[41] As illustrated in Figure 4.1, domestic parcels continue to make up the majority of parcel volumes and revenues, as in 2017-18. While domestic parcels represented 81% of total volumes in 2018-19 (the same proportion as in 2017-18), they only make up 62% of total revenues (a decrease of 1% from 2017-18). The average unit revenue for a domestic parcel was 5% lower than in 2017-18 at £2.98 and continues the trend of year-on-year real-terms decline in average unit revenue for domestic parcels.

4.8 International inbound parcel volumes reached 309 million items in 2018-19, an increase of 15% year-on-year. However, inbound revenues did not grow as fast as volumes at 7% year-on-year in real terms; the average unit revenue for inbound parcels therefore decreased 9% year-on-year from £5.22 to £4.75. Inbound parcels made up 12% of total measured parcels and 15% of total measured revenues.

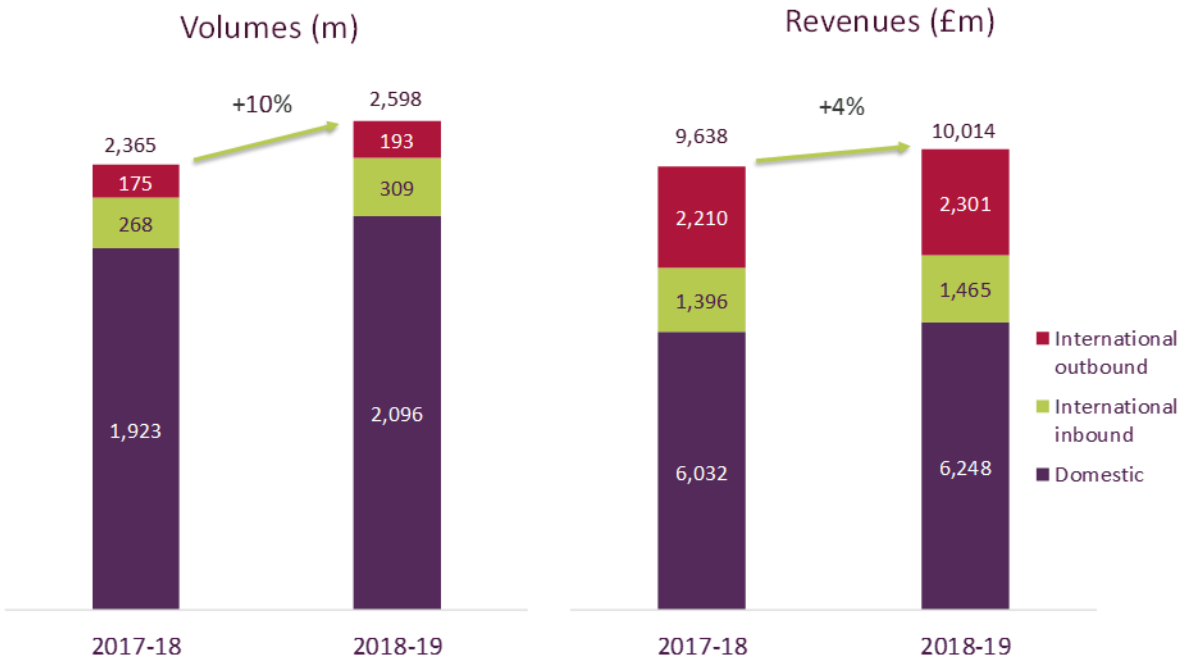
4.9 There may be a number of factors behind the significant increases in international inbound volumes, with cross-border e-commerce purchases, particularly from China, being the most likely significant driver of growth. The International Post Corporation survey found that Chinese parcels accounted for 38% of all global cross-border parcels in 2018. The same survey found that in 2018, 50% of international e-commerce shoppers in the UK had bought their most recent cross-border purchase from China (up from 40% in 2017), with the next highest proportion being purchases from the US at 19%.[42] Within China itself there is continued growth in outbound parcels: the Chinese State Post Bureau estimates found

[40] Set up by BEIS the CPP identifies and prioritises areas where there is greatest harm caused to consumers in the UK and coordinates action by its members, including the Competition and Markets Authority, Chartered Trading Standards Institute and equivalent national bodies, and UK consumer advocacy bodies.
[41] At 2018-19 prices.
[42] IPC, 2018. Cross-border e-commerce shopper survey 2018. https://www.ipc.be/sector-data/e-commerce/cross-border-e-commerce-shopper-survey.

that there has been significant growth in Chinese parcel volumes during 2018 and that Chinese express delivery firms dispatched around 34% more items globally in 2018 than in the previous year.[43]

4.10 There was a year-on-year increase of 10% in international outbound parcel volumes in 2018-19 (reaching 193 million items), in line with the rate of growth for total parcels (10%). However, the rate of growth in outbound parcel revenues was lower than the growth in volumes, at 4% in 2018-19 in real terms (reaching £2.3bn), an increase at the same rate as the revenues for the overall UK parcels market (4%). Outbound parcels represented 23% of total parcel revenues in 2018-19 despite only making up 7% of total parcel volumes. Average unit revenues for outbound parcels in 2018-19 fell from £12.62 to £11.92, a 6% year-on-year decrease in real terms.

Figure 4.1: Total measured parcels volumes and revenues (including international)



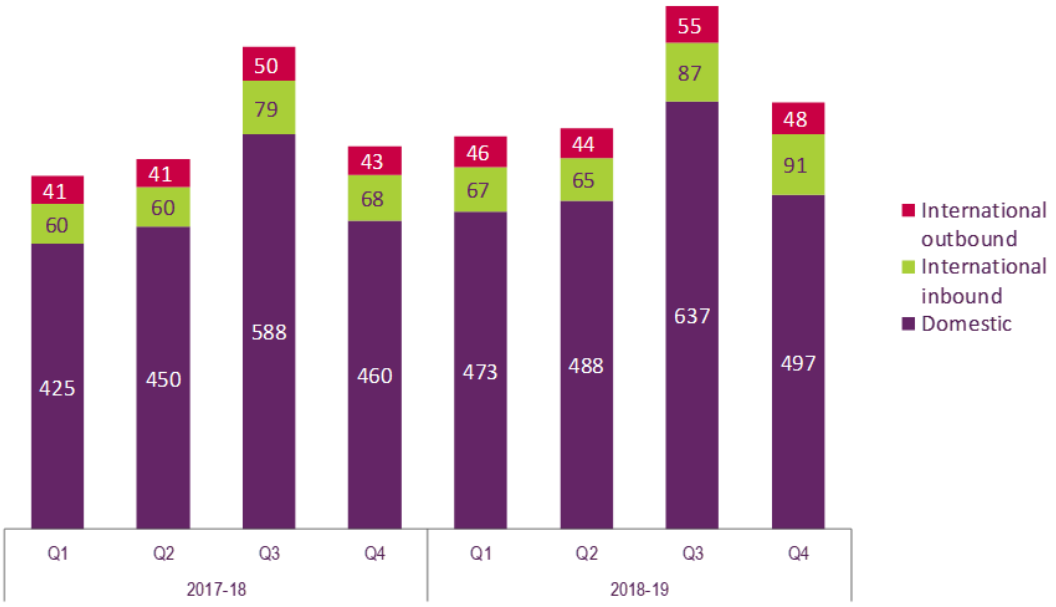
Source: Operator returns to Ofcom/Ofcom estimates. Revenue figures adjusted for CPI at 2018-19 prices. Includes access volumes. 2017-18 figures include operator restatements and so may vary from those published previously.

4.11 Figures 4.2 and 4.3 below show the measured total parcel volumes and revenues on a quarterly basis for both 2017-18 and 2018-19. The Q3 period continues to be the busiest period for domestic and international parcels. During this period, e-commerce was driven by Christmas shopping and retail events like Black Friday and Cyber Monday. According to the Office for National Statistics (ONS), growth in total retail spend in November 2018 (the

[43] State Post Bureau of The People's Republic of China, 2019. http://www.spb.gov.cn/xw/dtxx_15079/201905/t20190510_1828821.html.

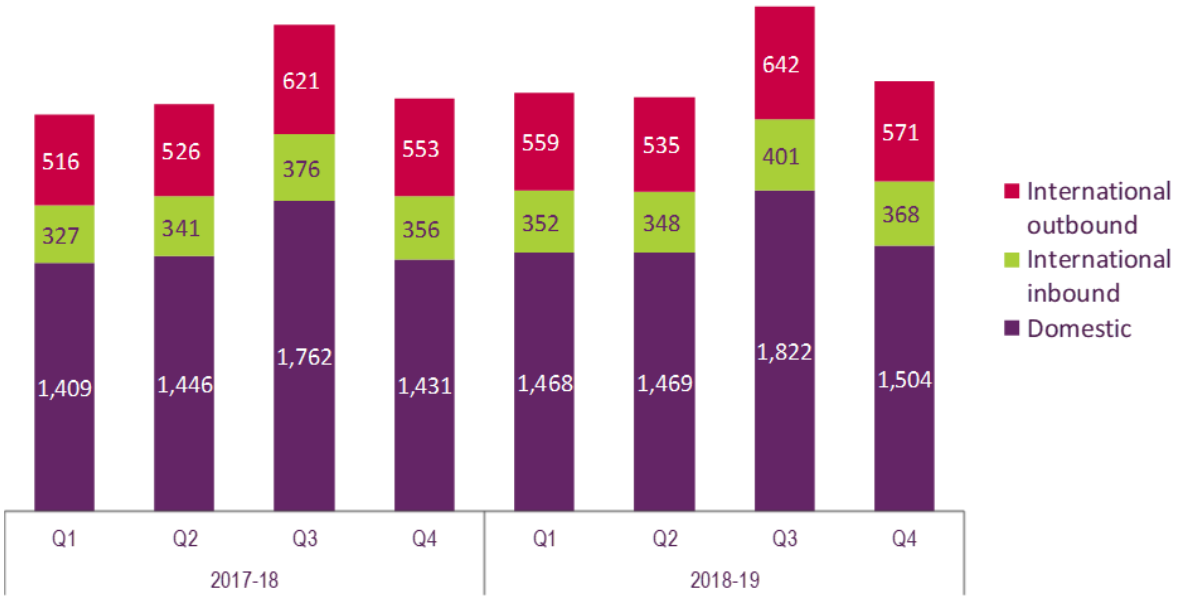
month of Black Friday) was 5% greater and the quantity bought was 3.6% greater than in the same month in 2017.

Figure 4.2: Quarterly measured volumes for parcels, 2017-18 to 2018-19 (million)



Source: Operator returns to Ofcom. Includes access volumes. 2017-18 figures include operator restatements.

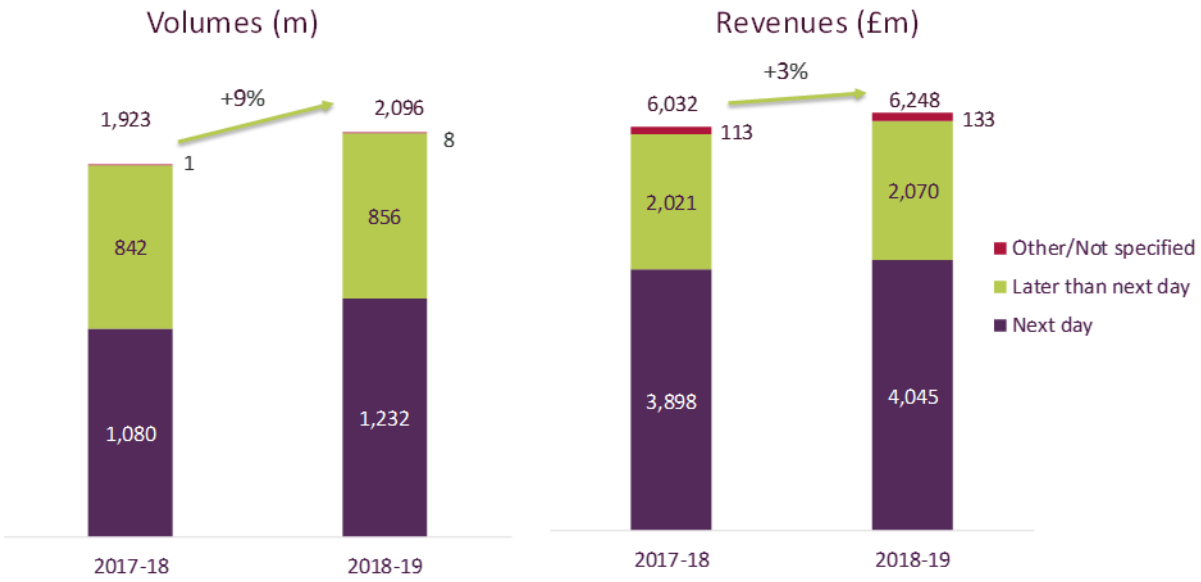
Figure 4.3: Quarterly measured revenues for parcels, 2017-18 to 2018-19 (million)



Source: Operator returns to Ofcom. Revenue figures adjusted for 2018-19 prices on a quarterly basis so will differ from annual totals presented above. 2017-18 figures include operator restatements.

4.12 Next day (D+1) delivery items made up the majority of measured domestic parcel volumes (59%) and revenues (65%) during 2018-19. Next day delivery items were a more substantial part of parcel operators' revenues than other parcel products, reflecting the higher prices which are typically charged for next day services. The proportion of revenue accounted for by next day items remained the same between 2017-18 and 2018-19, but the proportion of overall volumes increased for next day by 3%. The average unit revenue for next day items decreased by 9% in real terms, from £3.61 to £3.28. Conversely, the average unit revenue for later than next day deliveries increased, to £2.42, up from £2.40 from 2017-18.

Figure 4.4: Domestic parcel volumes and revenues by speed of delivery: 2017-18 and 2018-19



Source: Operator returns to Ofcom/Ofcom estimates. Revenue figures adjusted for CPI at 2018-19 prices. Includes access volumes. 2017-18 figures have been restated. Due to a change in data collection methodology from 2018-19, certain day-specific products listed as later than next day in 2017-18 may be reported as next-day from 2018-19 onwards.

Developments in the parcels sector

e-Commerce continues to grow in the UK

4.13 The growth in parcel volumes and revenues set out above reflects the continuing rise of e-commerce in the UK and worldwide. The ONS reported that internet sales made up 18.0% of total UK retail sales in 2018, up from 16.3% in 2017 and 14.7% in 2016.[44]

[44] Office of National Statistics. Internet sales as a percentage of total retail sales. https://www.ons.gov.uk/businessindustryandtrade/retailindustry/timeseries/j4mc/drsi

4.14 According to research by Mintel, around 81% of British consumers used express and courier services in the six months to February 2019, and the top three reasons for consumers shopping online are cost, ease of finding products online and greater variety.[45]

4.15 Parcel operators are seeking to meet the demand for flexibility in parcel services from this expansion of the e-commerce market by making collection and sending of parcels easier for customers. We look in more detail at residential consumers' attitudes and experiences of sending and receiving parcels in Section 5.

4.16 One trend concerns the growth in e-commerce between the UK and China. In November 2018 Yodel opened its first international office in Chengdu, China to meet the demand from UK consumers for goods from China.[46] The new office is positioned to be accessible from both Shenzhen and Hong Kong, and its sorting facility is close to Heathrow Airport. Royal Mail has also launched a Tracked and Signed service to China in partnership with China Post to meet demand for UK goods in China.[47]

4.17 Amazon, the largest e-commerce retailer in the UK with net UK sales of $14.5 bn in 2018 (a nominal increase of 28% from its $11.3 bn net sales in 2017), launched its Business Prime service for business procurement in the UK in summer 2019, offering free next day delivery, for subscribing businesses.[48] [49] Pricing of the service at the time of writing is £80-£4,500 a year, depending on the number of user accounts required by the business.[50]

Parcel operators are continuing to invest in infrastructure

4.18 In this section we cover some recent developments that operators are undertaking to support growth and automation. These investments may also support the initiatives focusing on the consumer experience, in particular around tracking. Alongside investment in improved consumer access and functionality (discussed below), operators are making a number of wider investments in infrastructure to meet growing demand for e-commerce. Amazon currently operates 17 fulfilment centres across the UK and has opened four new sites in 2018 in Rugby, Bolton, Bristol and Coventry, and in March 2019 announced plans to open another site in Chesterfield later in the year.[51]

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[45] Mintel, 2019. Delivering the goods: British courier and express delivery market hit £12.6 billion in 2018. https://www.mintel.com/press-centre/retail-press-centre/delivering-the-goods-british-courier-and-express-delivery-market-hit-12-6-billion-in-2018

[46] Yodel, 2018. Yodel announces launch of first international office in China. https://www.yodel.co.uk/news/2018/november/yodel-announces-launch-of-first-international-office-in-china/.

[47] Royal Mail Group, 2018. Royal Mail launches tracked and signed service to China. https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail/royal-mail-launches-tracked-and-signed-service-to-china/.

[48] Amazon, 2018. Amazon annual report 2018. https://ir.aboutamazon.com/static-files/0f9e36b1-7e1e-4b52-be17-145dc9d8b5ec.

[49] Amazon, 2019. Amazon business launches business Prime in the UK. http://phx.corporate-ir.net/phoenix.zhtml?c=251199&p=irol-newsArticle&ID=2402817.

[50] Amazon, 2019. Business Prime plans. https://www.amazon.co.uk/businessprime.

[51] Amazon, 2019. Amazon to Create 200 New Permanent Jobs with the Opening of a new Fulfilment Centre in Chesterfield. http://phx.corporate-ir.net/phoenix.zhtml?c=251199&p=irol-newsArticle&ID=2395959.

4.19 Following the opening of its largest depot in Scotland at EuroCentral near Glasgow in September 2018, DPD continues to build its £150m hub in Hinckley, Leicestershire, which once operational in 2022 will be the largest parcel hub in Europe, according to the firm.[52]

4.20 With the announcement of its five-year strategic plan in May, Royal Mail stated it is planning £400-500 million incremental investment to support its development of the UK business. Part of this investment will be spent in further automating the handling of parcels through Royal Mail's network, via the deployment of additional small parcel sorting machines in mail centres (handling single-piece untracked parcels) and the construction of three new fully automated parcel hubs, to handle small tracked and larger and late-acceptance parcels.[53] Recent deployments of automated parcel machines by Royal Mail include Bristol Mail Centre in July 2019, with work also starting on planning the fit-out of the first of three parcel hubs (in Warrington) in the same month.[54] [55] We discuss Royal Mail's strategy further in Section 7.

4.21 Following its opening in 2017, Hermes upgraded its Rugby hub in 2019, allowing capacity to be increased by 40%, thus enabling the handling of 1.35 million parcels per day at peak periods.[56]

Operators are investing in customer convenience and functionality

4.22 In addition to investments to increase capacity, operators are also developing ways to offer senders and receivers of parcels greater convenience and choice.

4.23 In relation to pick-up points, operators are creating pick-up points partnerships with high-street retailers, such as Amazon's Amazon Counter service offered with Next and PayPoint, allowing consumers to pick up Amazon parcels from its retail stores.[57] Another example is DHL Parcels UK's purchase of Pass My Parcel to take over their service points, as well as its partnership with PayPoint, announced in August 2019 to offer click and collect and sending services.[58] In December 2019, FedEx entered an agreement with PayPoint to join Collect+, allowing FedEx parcels to be delivered to 2,300 PayPoint locations in the UK.[59] Lockers are

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[52] Post&Parcel, 2019. DPD's fifth UK hub starting to take shape. https://postandparcel.info/106441/news/dpds-fifth-uk-hub-starting-to-take-shape/.

[53] Royal Mail Group, 2019. Journey 2024: FY 2018-2019 results and strategy presentation.

[54] Royal Mail Group, 2019. Royal Mail rolls out advanced technology to speed up parcel sorting in its Bristol mail centre. https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail/royal-mail-rolls-out-advanced-technology-to-speed-up-parcel-sorting-in-its-bristol-mail-centre/.

[55] Parcel and Postal Technology International, 2019. Royal Mail starts work on state-of-the-art North West hub as part of network extention. https://www.parcelandpostaltechnologyinternational.com/news/construction-development/royal-mail-starts-work-on-state-of-the-art-north-west-hub-as-part-of-network-extension.html.

[56] Apex Insight, 2019. Hermes Rugby super-hub expands capacity by 40%. https://apex-insight.com/hermes-rugby-super-hub-expands-capacity-by-40/.

[57] Amazon. Amazon hub, Counter. https://www.amazon.co.uk/b?ie=UTF8&node=16302375031

[58] Convenience Store, 2019. DHL Parcel partners with PayPoint to expand click and collect service. https://www.conveniencestore.co.uk/news/dhl-parcel-partners-with-paypoint-to-expand-click-and-collect-service/596271.article

[59] Retail Times 2019, FedEx partners with PayPoint to offer convenient package pickup solutions http://www.retailtimes.co.uk/fedex-partners-with-paypoint-to-offer-convenient-package-pickup-solutions/

another option: Hermes has partnered with InPost, with the agreement providing Hermes customers with access to InPost parcel lockers through its ParcelShop network.[60]

4.24 Following Royal Mail's trial in 2018, parcel postboxes will be available in 1,400 locations across the country including Birmingham, Leeds, Aberdeen and Cardiff which allow people to send parcels without the need to visit a post office. In order to use the postboxes, users must pay for the postage in advance and print a label at home.[61]

4.25 During the past year, several operators have developed their tracking services, increasing convenience for consumers and decreasing the costs of delivery by enabling more successful first time deliveries. For example, Yodel launched its Inflight app in October 2018, allowing customers to change their delivery details up to an hour before delivery is due.[62] In April 2019, Royal Mail announced the launch of delivery windows as short as two-hours, with recipients being notified of these the windows the day before delivery.[63]

4.26 Operators are also investing in the equipment used to track and record deliveries. For example, Hermes has started to replace stand-alone scanners with smartphones for verification and recording proof of delivery.[64] Hermes has also added functionality to its consumer app to allow senders to record a video message that parcel recipients can access by scanning a barcode on the parcel label when they receive it.[65] In June this year, Royal Mail launched new features in its consumer-facing mobile app allowing users to choose the online Tracked 24/48 service to send items using the app.[66] The app also allows users to track deliveries, access automatic notifications, and create QR codes for printing postage at a Customer Service Point (a QR code is a 'Quick Response' code, a type of barcode that can, among other things, be read by cameras and therefore on smartphones).

Mergers and acquisitions activity

4.27 A range of mergers and acquisitions involving companies in the parcels sector have taken place over the past year. As noted in Section 3, access letters and parcels operator the Delivery Group acquired ONEPost, another access letters and parcels operator in March 2019. Following previous purchases of companies in the fulfilment sector to develop its

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[60] The Chartered Institute of Logistics and Transport, 2019, Hermes is first UK carrier to have parcel lockers in ParcelShop network https://ciltuk.org.uk/News/Latest-News/ArtMID/6887/ArticleID/21197/Hermes-is-first-UK-carrier-to-have-parcel-lockers-in-ParcelShop-network

[61] BBC News, 2019. Royal Mail to launch parcel postboxes. https://www.bbc.co.uk/news/business-48334721

[62] Yodel, 2018. Yodel announces launch of inflight. https://www.yodel.co.uk/news/2018/october/yodel-announces-launch-of-inflight/.

[63] Royal Mail Group, 2019. A step change in convenience: Royal Mail launches delivery time notifications the day before. https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail/a-step-change-in-convenience-royal-mail-launches-delivery-time-notifications-the-day-before/.

[64] Scandit, 2019. Hermes UK Delivers the Goods with Smartphone Barcode Scanning Technology from Scandit. https://www.scandit.com/hermes-uk-delivers-the-goods-with-smartphone-barcode-scanning-technology-from-scandit/.

[65] SHD Logistics, 2019. Hermes launches unique technology designed to 'make parcels personal'. https://www.shdlogistics.com/news/hermes-launches-unique-technology-designed-to-make-parcels-personal.

[66] Royal Mail Group, 2019. Royal Mail launches new app features including purchasing and printing postage. https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail/royal-mail-launches-new-app-features-including-purchasing-and-printing-postage/.

business in this area, in December 2018 Whistl acquired the Spark Ecommerce Group, a fulfilment and contact centre company based in Gateshead.[67] 'Fulfilment' in this context refers to the services purchased by businesses in order to get their items to customers. Fulfilment encompasses delivery, but often also involves other services, such as warehousing and delivery management software. This purchase follows its takeover of Parcelhub and Mail Workshop in July 2018, and Prism DM in August 2017.

4.28 In September 2018 Smiths News and DHL Parcel UK (part of Deutsche Post DHL) reached an agreement that saw DHL Parcel UK take over the parcel shop network used by Smith News' Pass My Parcel. In contrast to other parcel shop networks, Pass My Parcel allowed retailers to directly send parcels to local retail outlets for click and collect.[68]

Environmental sustainability and the parcels sector

4.29 Sustainability has become a highly salient issue for the parcels sector, reflecting societal concerns about the environment, public policy interventions to reduce carbon emissions and congestion (especially in urban areas), and the desire for operators to increase efficiency to maintain or grow their margins.

4.30 The use of congestion and emissions regulation in public policy continues to increase in urban areas across the UK. In central London the Ultra-Low Emission Zone (ULEZ) was established in April 2019, expanding on the Low Emissions Zone (LEZ) initially introduced in February 2008. Other cities around the UK including Bath and Birmingham are also planning or considering Clean Air Zones, which may require drivers of vehicles which do not meet scheme emissions standards to pay to enter the area.[69]

4.31 Operators are investing to reduce the emissions produced by their fleets. One way of doing this is the replacement of petrol or diesel vehicles with electric vehicles, which a range of operators are doing. For example, in May 2019 Yodel announced a £15.2 million investment in their fleet, while DPD has commissioned 10 fully-electric vans and opened an electric parcels depot in Westminster, with plans for seven more across London and additional investment in electric vehicles planned in future.[70] [71] Other operators deploying electric vehicles in London include Hermes and UPS which has converted its London delivery fleet to be all electric. Royal Mail, which introduced 100 electric vans into its fleet in 2018, announced in July 2019 that it had introduced an additional 190 electric vans for

[67] Whistl, 2018. Whistl announce the acquisition of The Spark Ecommerce Group. https://www.whistl.co.uk/news/whistl-announce-the-acquisition-of-the-spark-ecommerce-group.
[68] Post&Parcel, 2018. Deutsche Post DHL take over operation of The Parcel Shop Network. https://postandparcel.info/98271/news/deutsche-post-dhl-take-over-operation-of-the-parcel-shop-network/.
[69] BBC, 2019. Clean air zones: Where will UK drivers pay for polluting? https://www.bbc.co.uk/news/uk-47389830.
[70] Yodel, 2019. Yodel makes £152m investment in greener fleet. https://www.yodel.co.uk/news/2019/may/yodel-makes-152m-investment-in-greener-fleet/.
[71] DPD, 2019. DPD adds to all-electric fleet with UKs first Mercedes-Benz Evito vans. https://www.dpd.com/group/en/2019/05/09/dpd-adds-to-all-electric-fleet-with-uks-first-mercedes-benz-evito-vans/.

deliveries in the London area.[72] Gnewt, a last-mile focused operator in London, operates a fully electric fleet.[73]

4.32 Sustainability concerns related to the parcel sector go beyond emissions, with policy makers seeking ways to reduce road congestion, for example by introducing congestion charges, reducing the number of parking and loading bays or restricting or banning vehicles from parts of cities. In response to this, researchers are working with operators to examine ways in which changes in operations (for example by introducing portering, where individuals on cycles or foot are used for the final element of delivery) or consolidation (where an operator carries out last mile deliveries on behalf of other operators) may help to reduce congestion, emissions, and reduce the cost of delivery for operators.

4.33 There is also some evidence to suggest that consumers are actively seeking more environmentally friendly deliveries. According to the International Post Corporation's 2018 Cross-Border e-commerce shopper survey 47% respondents across the countries surveyed (including the UK) stated they would like carbon-neutral delivery for their parcels.[74] With the increases in spending through e-commerce helping to drive the demand for postal services in the UK there may be an increase in these kinds of consumer demands over time, as well as an increase in the demands of policy makers on postal operators to reduce the net carbon emissions produced by their delivery networks.

Parcel pricing

Royal Mail single piece price trends

4.34 As part of our ongoing programme of work we have decided to report on the pricing trends of some of Royal Mail's single-piece domestic and international parcels products.

4.35 For delivery within the UK, Royal Mail offers two sizes of untracked parcel (Small and Medium) within the First Class and Second Class services, and Special Delivery 1pm, within the USO. Tracked products outside of the USO are also available for purchase.

4.36 Royal Mail offers a range of tracked and untracked international parcels products both within and outside of the USO. Ofcom has not imposed price controls on these products with the exception of the price cap on Second Class domestic parcels. The section below shows the prices of untracked domestic and European parcels products. We also compare the stamp price of domestic untracked parcels with the price of sending a parcel to Europe.

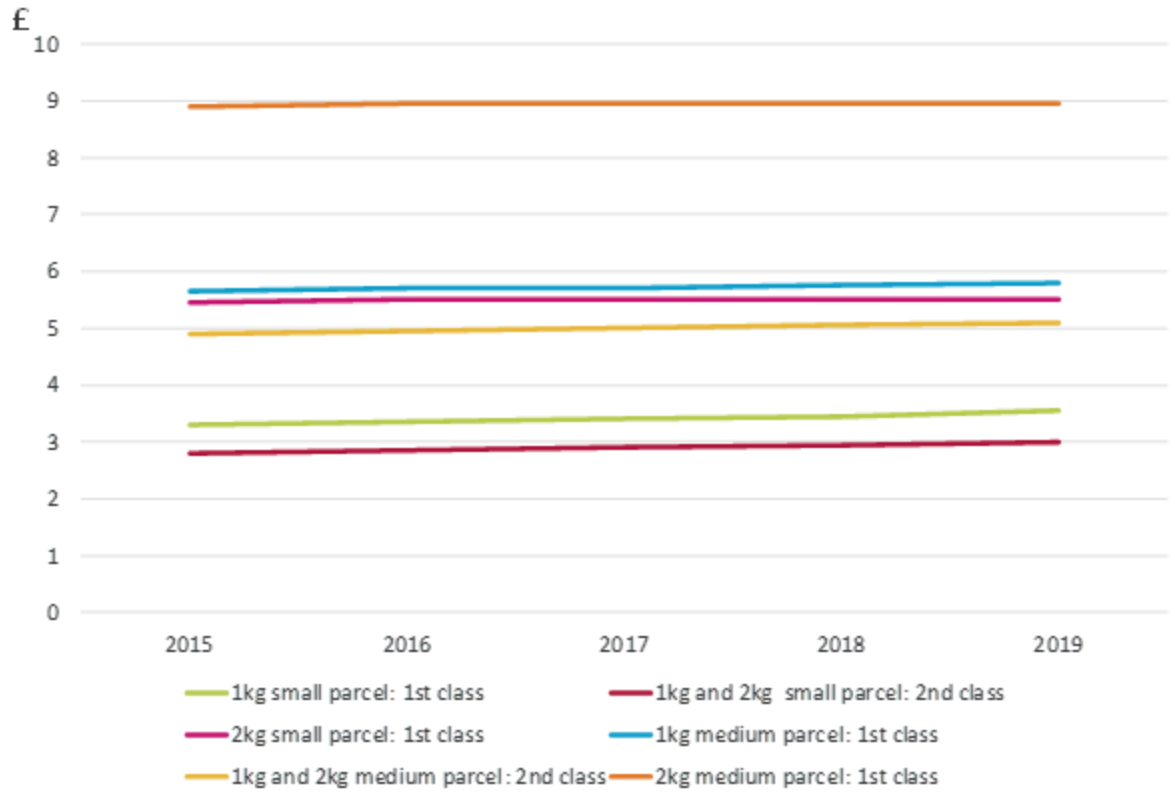
4.37 Overall we note that the prices of the domestic parcels we report below have stayed relatively constant in nominal terms in the last five years, compared with more variations over the years in the prices of parcels sent from the UK to Europe. When comparing domestic parcels and parcels to Europe, we note that the difference between the domestic

[72] SMMT, 2019. Royal Mail delivers on green ambitions with new electric vans. https://www.smmt.co.uk/2019/07/royal-mail-delivers-on-green-ambitions-with-new-electric-vans/
[73] About Gnewt. https://www.gnewt.co.uk/about.html
[74] IPC, 2019. Cross-border e-commerce shopper survey 2018.

tariff and the Europe Zone[75] tariff is smaller for the fastest service (First Class/International Standard Europe) than the slower service (Second Class/International Europe Economy).

4.38 As can be seen below in Figure 4.5, in the past five years the nominal price of Royal Mail's single piece untracked domestic parcel service up to 2kg has remained relatively constant, sometimes equating to a price reduction in real terms. For example, between March 2015 and March 2019, the price of a 2kg Second Class Small Parcel increased by 20p in nominal terms to £3.00 – a 0.7% increase in real terms. The real-terms price of its First Class equivalent fell by 5.2% over the same period, the nominal price having remained constant since March 2016. A key distinction between First Class and Second Class pricing is that the price of a 2kg Second Class Small or Medium Parcel is the same as the 1kg equivalent.

Figure 4.5: Selected single piece untracked/unsigned domestic parcels pricing



Source: Royal Mail price lists. Prices are nominal and relate to stamp price and exclude online discounts where offered. Royal Mail prices as at March each year.

4.39 For its international single piece service, Royal Mail categorises each destination into one of three price zones for the majority of its products: Europe (which includes both EU and non-EU countries, including Russia), World Zone 1 (The Americas, Africa and the majority of Asia), and World Zone 2 (Singapore, Papua New Guinea, Australasia and certain remote islands). From 25 March 2019, a 1kg parcel cost £8.95 to send to Europe, £13.80 to World

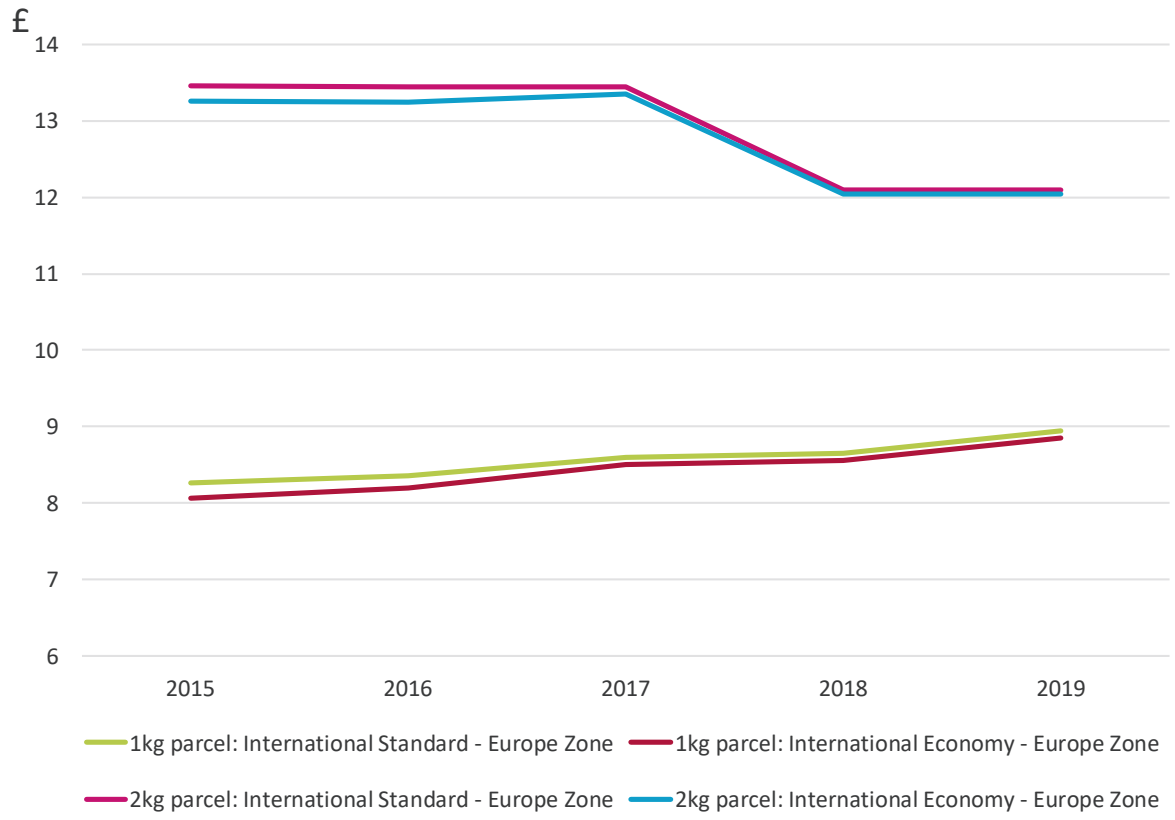
[75] One of the three geographic pricing zones used by Royal Mail for international services

Zone 1 and £14.55 to World Zone 2 using the Royal Mail International Standard service. This is an untracked service.

4.40 Royal Mail also offers International Economy, a slower, but less expensive service, which is also untracked. The price differential between the Economy and Standard service for Europe zone varies between 5p and 10p but is as much as £8 for 2kg parcel to International Zone 2.[76]

4.41 Between March 2015 and March 2019 the price of 2kg parcels to Europe has fallen both in real and nominal terms, while there has been an increase both in nominal and real terms in the price of lighter 1kg parcels. Between March 2015 and March 2019 the price of a 1kg Standard International Parcel from the UK to the Europe Zone rose by 8.4% (1.8% when adjusted for CPI), compared to a 10.1% nominal fall in the price of the equivalent 2kg service, a 15.5% reduction in real terms over the period.

Figure 4.6: Selected Royal Mail single-piece untracked/unsigned products pricing: Europe zone



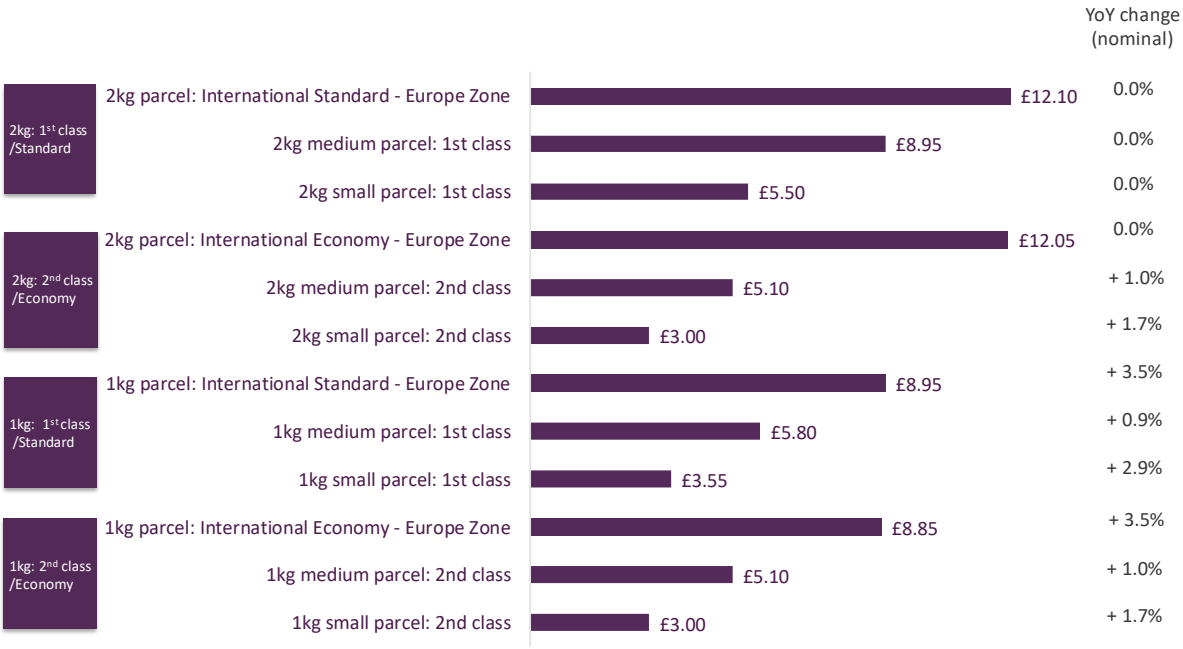
Source: Royal Mail price lists. Figures are nominal and relate to stamp price and exclude online discount if offered.

4.42 When comparing domestic and Europe zone tariffs, the difference between the domestic tariff and the Europe Zone tariff is higher for the Second Class/International Europe Economy than for the First Class/International Standard Europe equivalent. For example, a

[76] £20.05 compared £12.05, prices from 25 March 2019. https://www.royalmail.com/sites/default/files/royal-mail-our-prices-25-march-2019.pdf.

1kg International Standard parcel is priced at 252% of the 1kg First Class small parcel and 154% of the 1kg First Class Medium Parcel product. In comparison, the Second Class International Economy Europe/Second Class Small and Medium parcel price difference is 295% and 174% respectively.[77]

Figure 4.7: Selected Royal Mail domestic and international parcel products: prices from March 2019 and nominal change from prior year



Source: Royal Mail price lists. Figures are nominal and relate to stamp price and exclude online discount if offered. Note: Maximum size dimensions for international parcels fall between size limits for domestic small and medium parcels.

Publication of cross-border parcel tariff data

4.43 From January 2019 certain parcel operators in the European Union have been required to provide the relevant national regulator with their public tariffs as at the 1st of January each year.[78] These public tariffs are then published on the European Commission's website by 31 March of each year. This measure, set out in Regulation (EU) 2018/644 on cross-border parcel delivery services, aims to increase transparency of pricing of cross-border parcels services in the EU.[79]

[77] As the maximum dimensions of an International parcel fall between those of the domestic small and medium parcel, both sizes of domestic parcel are included for comparison.
[78] European Commission, 2019. Public tariffs on cross-border parcel delivery services. https://ec.europa.eu/growth/sectors/postal-services/parcel-delivery/public-tariffs-cross-border_en
[79] EUR-Lex, 2018. Regulation (EU) 2018/644 of the European Parliament and of the Council of 18 April 2018 on cross-border parcel delivery services. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018R0644.

4.44 The price to send a parcel of a given weight from the UK to another European country can vary considerably between operators. This may reflect differences in product specification (for example size limits, speed of delivery, level of insurance and the presence of tracking), and differences in business models adopted by operators.

Summary

4.45 Parcels volumes and revenues continued to grow, with total volumes growing 10% year-on-year, reaching a total of 2.6 billion items, and total revenues increasing by 4% year-on-year, reaching a total of £10 billion. Online retailing continues to increase its share of all retail in the UK. E-commerce is likely a major factor in driving the growth in volumes, while competition in the market may be reducing the rate of growth in revenues.

4.46 The period in the run-up to Christmas (quarter 3 of the financial year) accounts for 30% of annual volumes for parcel operators. Next day deliveries remain the most popular option for sending parcels.

4.47 Policy changes and consumer concerns around sustainability have encouraged some parcel operators to make environmentally friendly investment choices, particularly in electric vehicles, to meet new demands around emissions and congestion in conurbations across the UK. Some parcel operators are also trialling innovative methods of final mile delivery to increase efficiency and to meet these new demands.

4.48 This year we show the prices of some of Royal Mail's untracked domestic and European parcels products. Overall prices for many of the domestic products reported on have remained relatively constant in nominal terms, providing a real term decrease in prices over time for consumers for some products. There have been more variations over the years in the prices of parcels sent from the UK to Europe.

5. Consumer and business experience of postal services

Introduction

5.1 In this section, we present data from our ongoing market research programme. We run two separate surveys to track use of and attitudes to post, one focused on residential consumers and the other focused on small and medium enterprise (SME) business customers.[80] The data reported here is from the period of Q3 2018 to Q2 2019 reflecting the most up-to-date data we have at the time of publication.

5.2 The data from these surveys is published on our website going back to 2012 when the research programme began.[81] The research was briefly paused in 2015, as a review was carried out to consider what additional data it might be necessary for us to obtain in light of changing Residential and SME users' experience of postal services. Methodological and questionnaire changes at the start of 2016 for the residential tracker mean that data from prior to this time are not directly comparable. Comparisons are made to 2017-18 results in the same period (Q3 2018 to Q2 2019) where relevant.

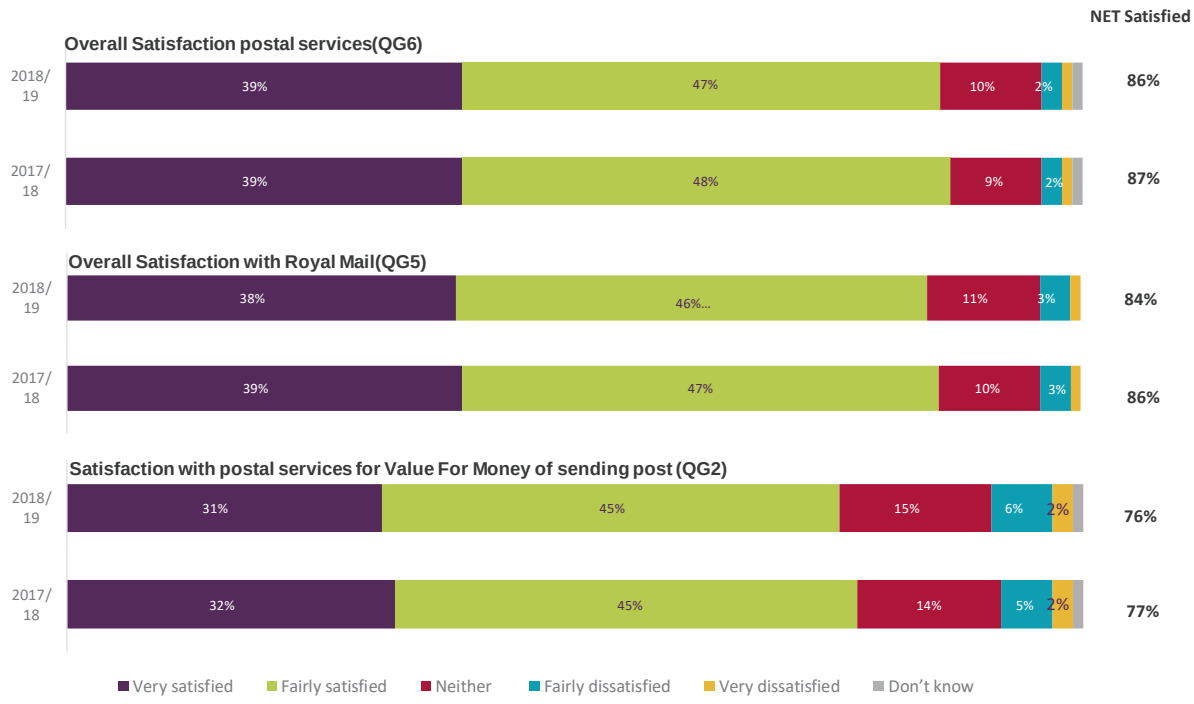
Residential consumers

5.3 Over eight in ten residential consumers are satisfied with Royal Mail (84%) and postal services overall (86%), with dissatisfaction levels at 4% and 3% respectively. Three quarters (76%) are satisfied with the postal services in delivering value for money of sending mail overall, with 8% dissatisfied. These results are in line with 2017-18. Overall satisfaction with Royal Mail is at a similar level in each of the UK Nations, at 84% in England, 85% in Scotland, 85% in Wales and 87% in Northern Ireland. Satisfaction with the postal services in delivering value for money of sending mail overall stands at 76% in both England and Scotland, 78% in Wales, and 80% in Northern Ireland. Satisfaction with value for money in rural locations is comparable to rural (75%) vs urban (77%).

[80] Businesses that have under 250 employees.

[81] Ofcom, 2017. Communications Market Report. https://www.ofcom.org.uk/__data/assets/pdf_file/0017/105074/cmr-2017-uk.pdf ; our Statistical Release Calendars can be found at https://www.ofcom.org.uk/research-and-data/data/statistics. The Q3 2018-Q2 2019 residential and business postal tracker data is available from our Statistical Release Calendar on 15 August 2019. Our data files show further information on the results of the survey broken down by categories of customers, for instance by age groups or nations. Examples of results by nations, where relevant, are included in footnote.

Figure 5.1: Residential consumers' satisfaction with postal services[82]



Source: Ofcom Residential Postal Tracker Q3 2018-Q2 2019 (5,956), Q3 2017-Q2 2018 (5,779)

Base: All Respondents

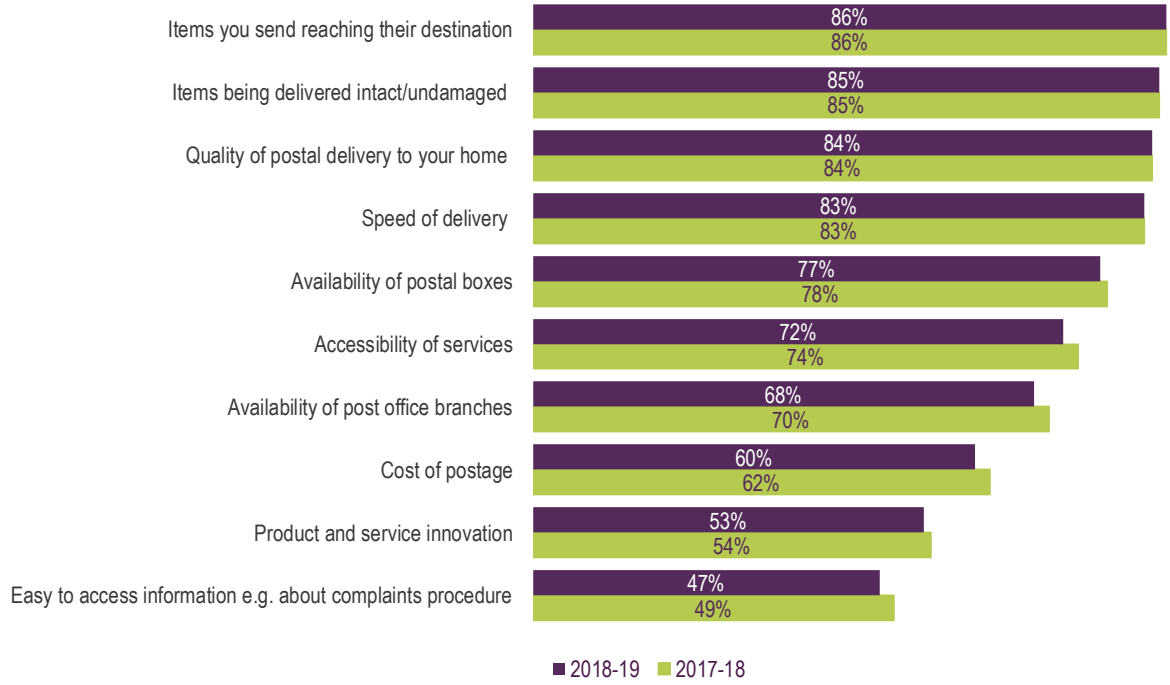
"QG2: How satisfied are you overall with the postal services in terms of delivering value for money for sending mail? QG5: How would you rate your overall satisfaction with Royal Mail?" "QG6: How would you rate your overall satisfaction with postal services? (ALL providers)"

5.4 Looking at specific aspects of Royal Mail's service, as in 2017-18, residential consumers are most satisfied with items sent reaching their destination (86%), items being delivered intact/undamaged (85%), the quality of postal delivery to the home (84%) and the delivery speed (83%).[83] Also in line with 2017-2018, the lowest levels of satisfaction were with the cost of postage (60%), product and service innovation (53%) and easy access to information, for example about complaints procedures (47%). Easy access to information is the only aspect of Royal Mail's service with which less than half of customers are satisfied.

[82] 1% of repondents say 'don't know' to satisfaction postal services (QG6) , satisfaction with Royal Mail (QG5) and satisfcation with postal services for value for money of sending (QG2) in both years.

[83] Respondents in Northern Ireland were more likely to be satisfied with the availability of post office branches than respondents in the UK overall (net satisfaction 80% vs 68%), and respondents in Scotland (63%) Wales (68%) and England (69%) are significantly less satisfied than respondents in Northern Ireland (80%).

Figure 5.2: Residential consumers' satisfaction with specific aspects of Royal Mail's service



Source: Ofcom Residential Postal Tracker), Q3 2018-Q2 2019 (5,779), Q3 2017-Q2 2018 (5,796)

Base: All Respondents

"QG3: How satisfied are you with the following aspects of Royal Mail's service? (NET: 'very satisfied' and 'fairly satisfied')"

5.5 About two thirds (65%) of residential consumers think that First Class stamps represent good value for money, with a lower percentage (56%) thinking that Second Class stamps are good value. One in five (21%) said that Second Class stamps are poor value, while a lower proportion said this about First Class stamps (15%). In both cases, perceptions of good value for money are in line with Q3 2017 to Q2 2018 (67% for First Class stamps, and 58% for Second Class stamps).

Figure 5.3: Residential consumers' perception of value for money of stamps

Source: Ofcom Residential Postal Tracker

Base: All Respondents Q3 2018-Q2 2019 (5,779), Q3 2017–Q2 2018 (5,836)

"QF4: A First Class stamp currently costs 67p/70p. How would you rate Royal Mail's First Class service in terms of value for money?" "QF5: A Second Class stamp currently costs 58p/61p. How would you rate Royal Mail's Second Class service in terms of value for money?"

5.6 Respondents were asked whether they had experienced one or more of a range of problems with Royal Mail's service over the past year. Just over half overall (53%) reported a problem, and problems experienced were similar to those reported in 2017-2018. Just over a third (36%) said their mail was mis-delivered while just over a fifth (22%) said they had received a card from Royal Mail saying that an item could not be delivered when someone was at home and could have taken delivery. In both cases reported experience is slightly down from last year. Around one in five (18%) reported a problem with delayed mail.

Figure 5.4: Residential consumers' problems with Royal Mail

Source: Ofcom Residential Postal Tracker

Base: All Respondents Q3 2018-Q2 2019 (3712), Q3 2017-Q2 2018 (5,836)

"QH1: In the last 12 months, have you experienced problems with Royal Mail's service in terms of..."

5.7 Consumers were asked if they were sending more, less or the same amount of different types of mail as two years ago. As in previous years, for each of the eight types of post asked about, the proportion of residential consumers saying that they are sending less than two years ago was higher than the proportion reporting that they are sending more, except for tracked post[84] where 2% more consumers say they are receiving more than two years ago.

[84] The question refers to post in general and therefore does not distinguish between letters and parcels.

Figure 5.5: Consumers say they send different types of post compared to two years ago

Type of mail	Sent more (%)	No change	Sent less (%)	Net more/ Less
Invitations/ greeting cards / postcards	8	56	35	-27
Personal letters (e.g. to a friend/ relative)	7	55	37	-30
Formal letters to organisations/ individuals	9	56	33	-24
Payment for bills	7	54	37	-30
Smaller parcels	17	61	21	-4
Larger parcels	15	62	22	-7
Items requiring a signature	13	66	19	-6
Tracked post	18	65	16	+2
Other items not mentioned	2	30	6	-4

Source: Ofcom Residential Postal Tracker

Base: All Respondents Q3 2018-Q2 2019 (3,004)

"QD12: Frequency of sending ... compared to two years ago (note this question was asked in alternate months)"

5.8 Consumers were also asked if they were receiving more, less or the same amount of different types of mail as two years ago. A higher proportion of consumers reported receiving less post than consumers receiving more post (a net decrease) across most types of letter mail. There was a higher proportion of consumers reporting more post received than less post received (a net increase) for a minority of types of mail.

5.9 The biggest net decreases in mail received are seen in social mail: 6% say they are receiving more personal letters compared to three in ten (31%) receiving fewer than 2 years ago. Similarly, 7% say they are receiving more invitations, greeting cards and postcards than two years ago compared to 29% receiving fewer. Receipt of transactional mail such as bills, invoices or statements have also declined considerably, 14% of respondents reported receiving more of these than two years ago compared to more than a third (35%) who reported that they are receiving less.

5.10 The biggest net increase reported was for direct mail from unknown organisations, with three in ten reporting that they are receiving more of this type of mail compared to just over a fifth receiving less. Net increases are also noted for parcels both large and small. Just under a quarter (23%) reported receiving more smaller parcels (that will fit through a letter box), compared to just over one in ten (13%) receiving less, resulting in a net increase of +10% saying they are receiving more smaller parcels compared to two years ago. Similarly, just under a quarter (23%) reported receiving more larger parcels (that will

not fit through a letter box) compared to 15% who say they receive fewer resulting in an overall net increase of +8% compared to two years ago.

Figure 5.6: Consumers receiving different types of post compared to two years ago

Type of mail	Received more (%)	No change	Received less (%)	Net change
Invitations/ greeting cards / postcards	7	63	29	-22
Personal letters	6	62	31	-25
Formal letters from known organisations	13	62	23	-10
Bills, invoices and statements	14	50	35	-21
Magazines you subscribe to	6	66	21	-15
Catalogues and brochures	20	48	30	-10
Newsletters, leaflets and promotions from known organisations	19	54	25	-6
Items requiring a signature	20	65	14	+6
Addressed direct mail from unknown organisations	30	47	22	+8
Smaller parcels	23	62	13	+10
Larger parcels	23	62	15	+8

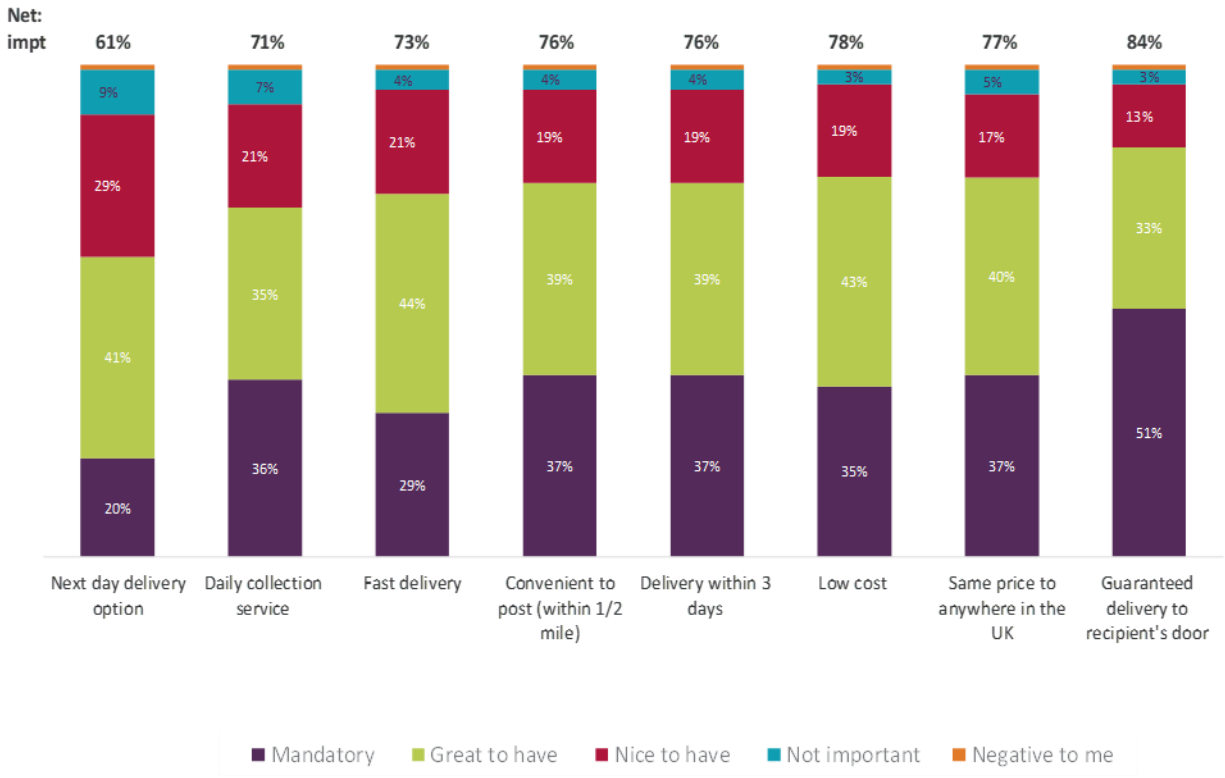
Source: Ofcom Residential Postal Tracker

Base: All respondents in odd months only Q3 2018-Q2 2019 (3,004)

"QE11. Thinking about these different types of mail, would you say that you now receive them more or less often than two years ago? Or has there been no change? Please think only about items that are addressed to you personally."

5.11 Residential consumers were asked to rate the importance of several different factors when sending letters. Over four in five (84%) said that guaranteed delivery to recipient was 'mandatory' or 'great to have'. This was followed by 'low cost', 'same price to send anywhere within the UK', 'delivery within three days', 'convenient to post' (around half a mile), 'fast delivery' and 'daily collection service', all with more than seven in ten saying these factors are important to them. The option receiving the lowest level of importance attached was a next day delivery option (61%). These are broadly in line with 2017-2018 results.

Figure 5.7: Factors rated as important for people when sending letters 2018-19



Source: Ofcom Residential Postal Tracker Base: all who use Royal Mail for letters or large letters and selected a service Q3 2018-Q2 2019 (3,499).

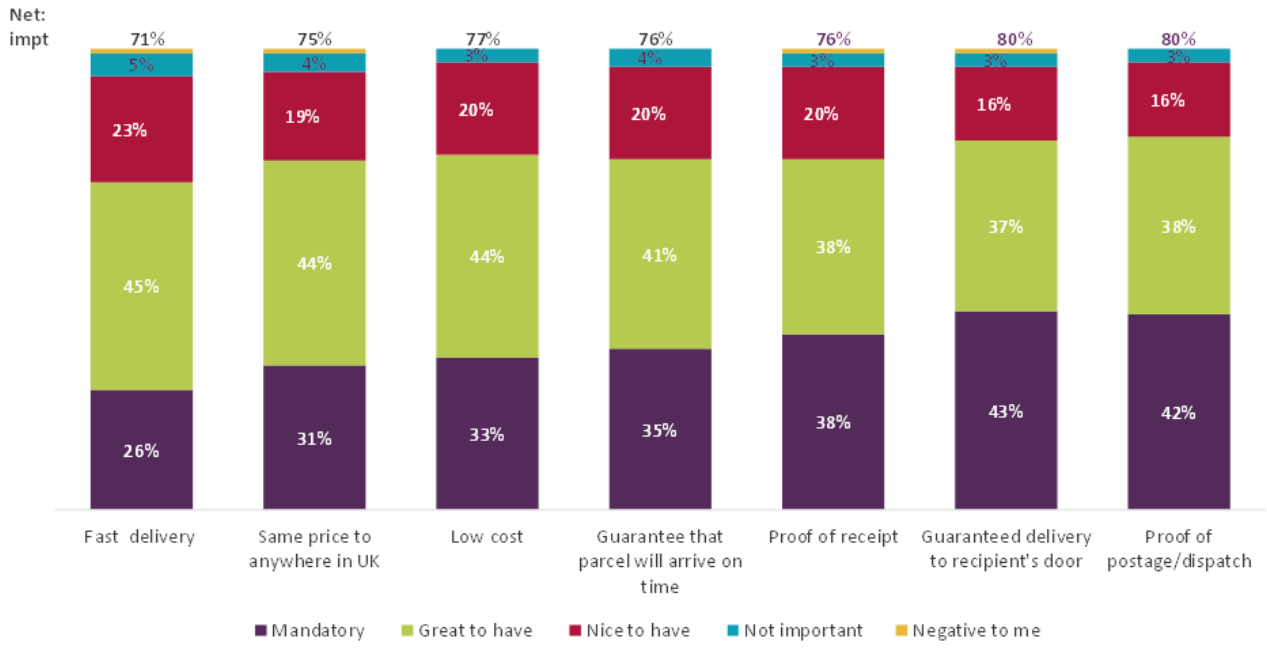
"QD10b. Below, are a list of factors people tell us they consider when sending letters. For each factor, please tell us how important it is to you in choosing a postal provider or service."

5.12 The same question was asked about sending parcels. A range of factors were rated as 'mandatory' or 'great to have' by at least seven in ten respondents. The most important factors for parcels remain those around knowing the parcel has been sent and arrived within the desired time frame, i.e. proof of postage/dispatch and guaranteed delivery (both 80%). Other factors, specifically, low cost (77%), proof of receipt and guarantee that the parcel will arrive on time (both 76%), same price to anywhere (75%), fast delivery (71%) and the ability to track delivery (70%) were also very important.

5.13 Others rated as important by at least six in ten people are: convenient options for me to drop off parcel (64%), convenient options for recipient to accept delivery (62%), and a daily collection service (61%). The options that were rated as the least important were the ability to select a specific date/time for delivery (49%) and convenient options for operator to pick parcel up (47%).

5.14 As with letters, these results are all broadly in line with 2017-18.

Figure 5.8: Factors rated as important for people when sending parcels (2018-19)

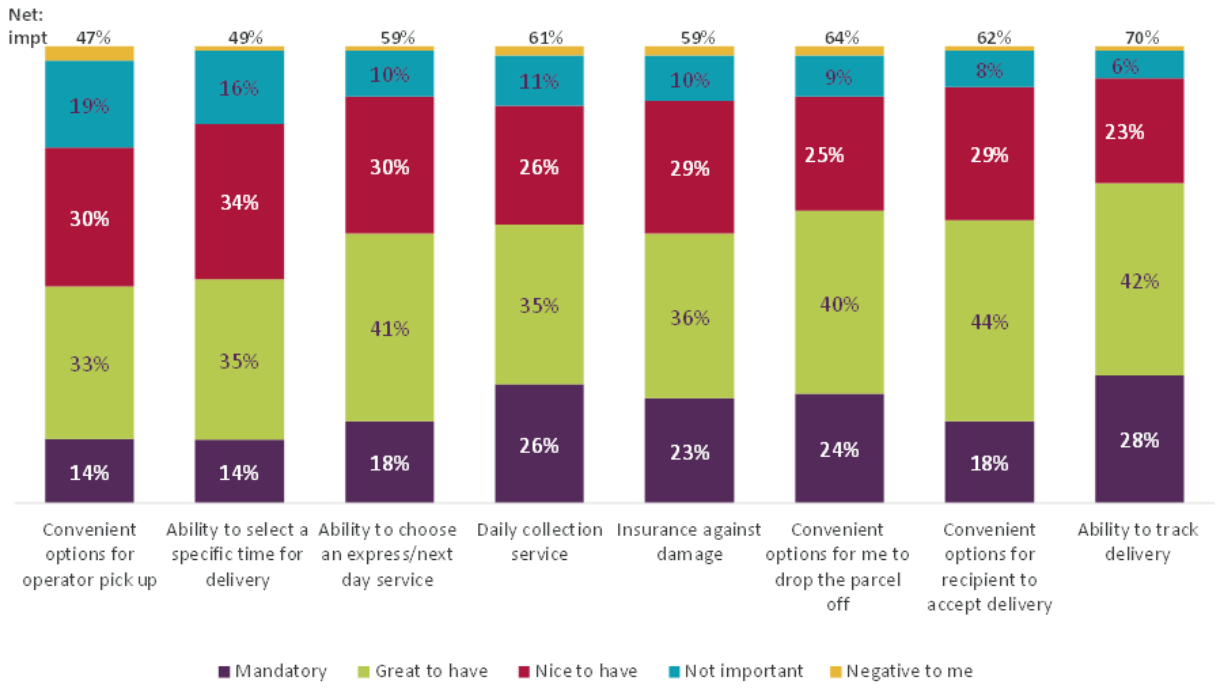


Source: Ofcom Residential Postal Tracker Q3 2018-Q2 2019.

Base: Those who have sent a parcel or tracked item/item requiring signature in the past month (3,499)

"QD10a: List of factors people consider when sending parcels... (NET: 'mandatory' and 'great to have')."

Figure 5.9: Factors rated as important for people when sending parcels (2018-19)



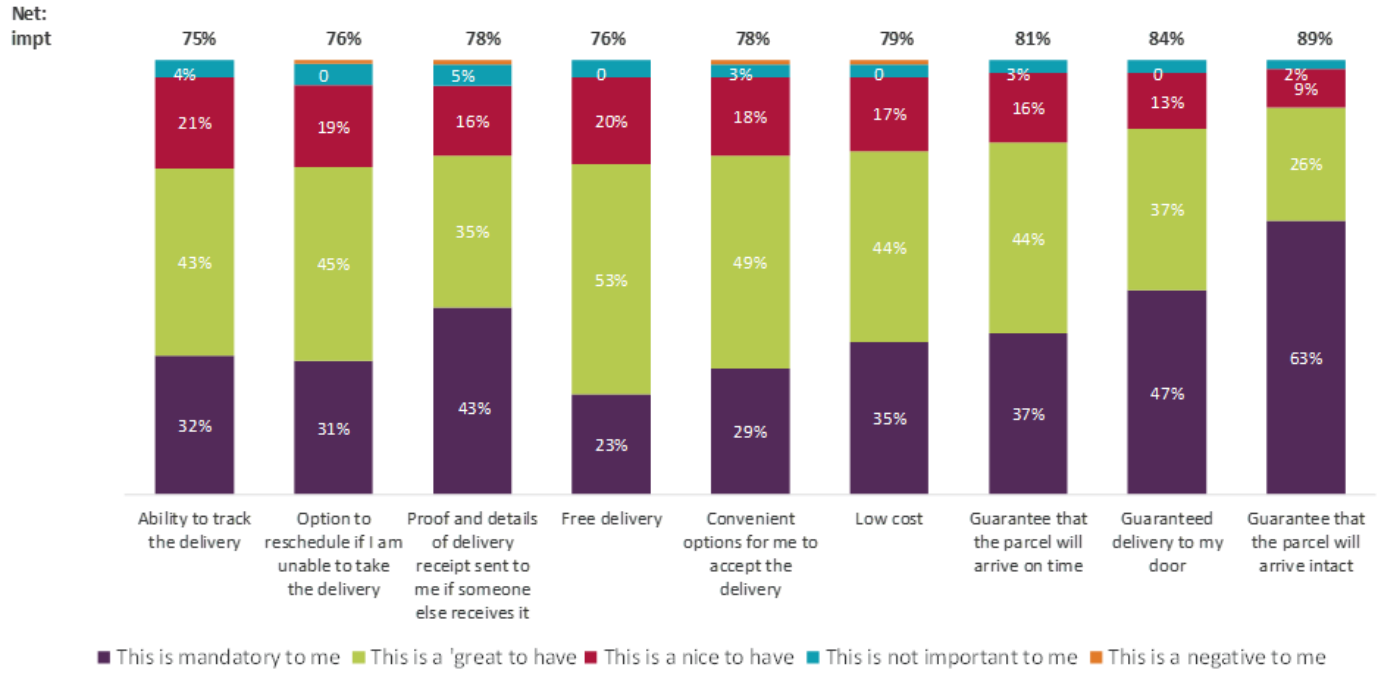
Source: Ofcom Residential Postal Tracker Q3 2018-Q2 2019

Base: Those who have sent a parcel or tracked item/item requiring signature in the past month (3,499).

"QD10a: List of factors people consider when sending parcels... (NET: 'mandatory' and 'great to have')."

5.15 Consumers were also asked about the importance of various factors when choosing a provider for a letter or parcel they will receive. The results show that consumers are concerned with the safe delivery of parcels when choosing a provider to deliver to them. When asked, nine in ten said that the guarantee that the parcel will arrive intact was "mandatory" or "great to have", followed by guaranteed delivery to my door (86%), guarantee that the parcel will arrive on time (81%) and low cost (80%). Most of the other options were rated important by at least two thirds of consumers. The option that received the lowest proportion of these responses was the inclusion of insurance, which was rated as important by half of respondents. These are similar to the results in 2017-18.

Figure 5.10: Factors rated as important for people when choosing delivery for letters/parcels that they will receive (2018-19)

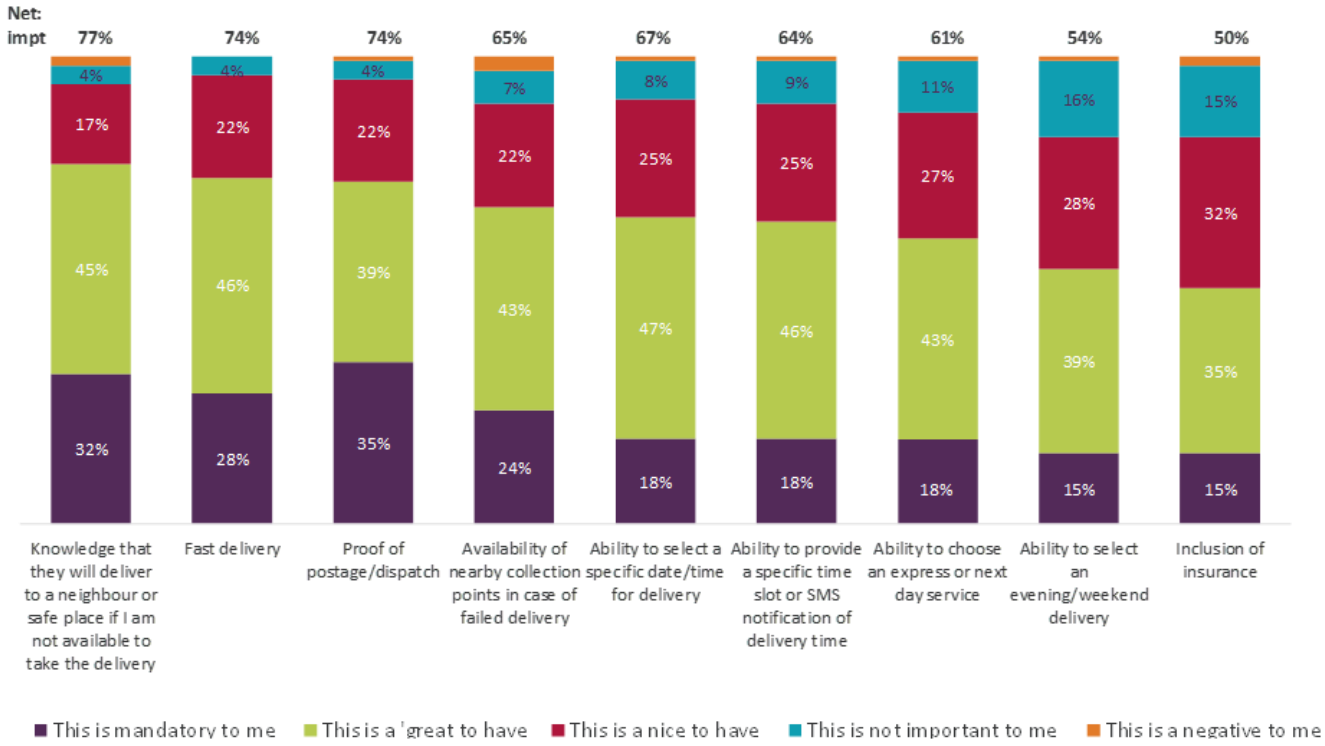


Source: Ofcom Residential Postal Tracker Q3 2018-Q2 2019

Base: Those who were required to select a postal/delivery option for letters or goods that were delivered to themselves in the previous month (2,671)

"QE10b: List of factors people consider when choosing delivery for letters/parcels that they will receive... (NET: 'mandatory' and 'great to have')"

Figure 5.11: Factors rated as important for people when choosing delivery for letters/parcels that they will receive (2018-19)

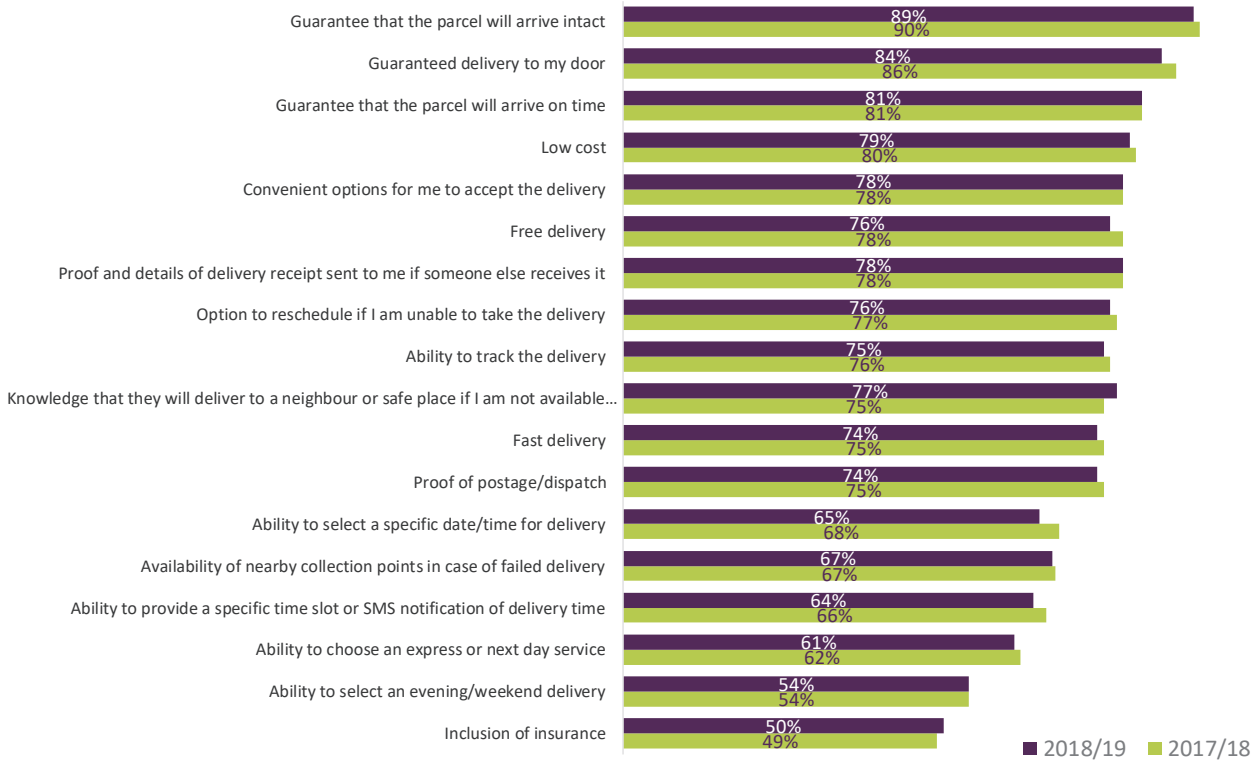


Source: Ofcom Residential Postal Tracker Q3 2018-Q2 2019

Base: Those who were required to select a postal/delivery option for letters or goods that were delivered to themselves in the previous month (2,671)

"QE10b: List of factors people consider when choosing delivery for letters/parcels that they will receive... (NET: 'mandatory' and 'great to have')"

Figure 5.12: Factors rated as important for people when choosing delivery for letters/parcels that they will receive. Nets: 2017-18, 2018-19



Source: Ofcom Residential Postal Tracker) Q3 2018–Q2 2019 (2,671), Q3 2017 – Q2 2018 (2,528)

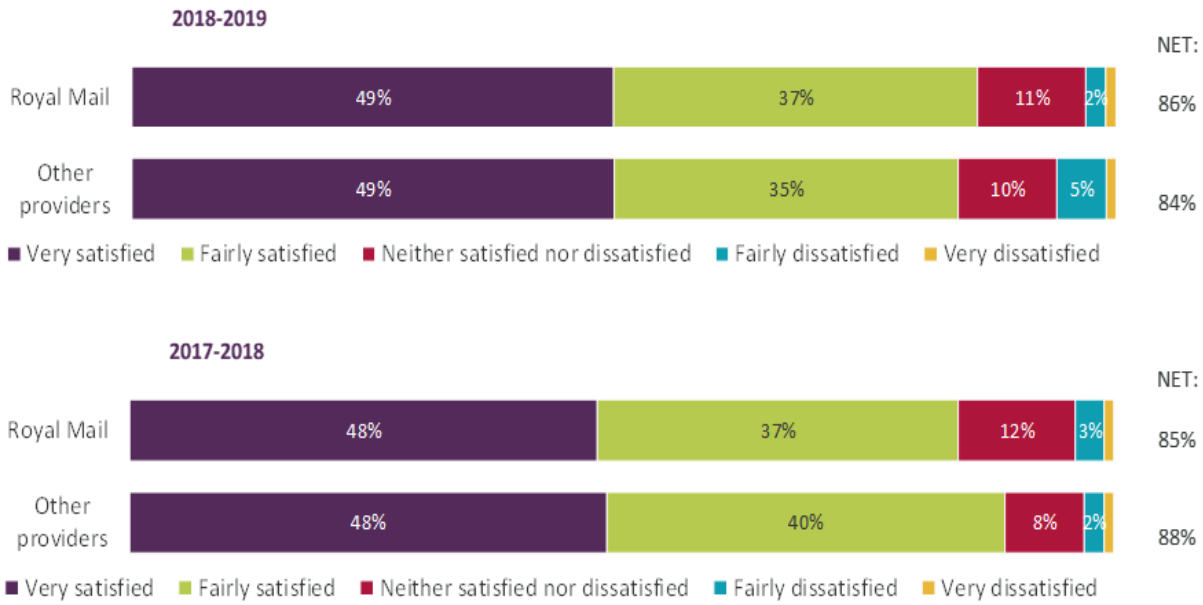
Base: Those who were required to select a postal/delivery option for letters or goods that were delivered to themselves in the previous month.

"QE10b: List of factors people consider when choosing delivery for letters/parcels that they will receive... (NET: 'mandatory' and 'great to have')"

SME consumers

5.16 Similar to residential consumers, when asked about their satisfaction with the service from their postal provider, over eight in ten SMEs who use Royal Mail (86%) said they were satisfied, compared with a similar proportion of those who use other providers (84%). Overall dissatisfaction was higher for other providers (6%) compared to Royal Mail (3%). The overall level of satisfaction with Royal Mail amongst SMEs remains in line with the previous year while it is lower amongst SMEs using other providers (84% vs 88%).

Figure 5.13: SME satisfaction with postal services



Source: Ofcom Business Postal Tracker

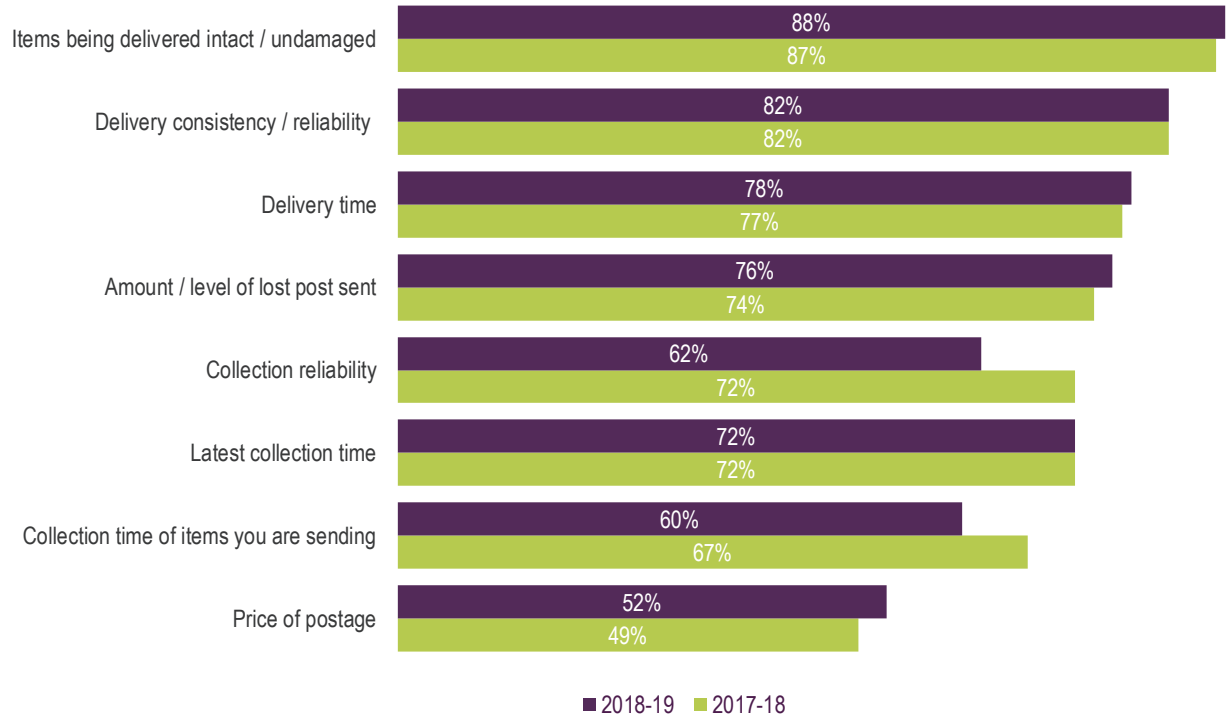
Base: Q3 2018–Q2 2019 All who use Royal Mail (1,869), All those who use other providers than RM (435). Q3 2017–Q2 2018 All who use Royal Mail (2,266), All those who use other providers than RM (434).

"QRM2: Thinking generally about the service your organisation receives, how satisfied are you with the overall quality of the services you receive from Royal Mail as a recipient and sender?"

"QOP1a: Thinking generally about the service you receive as a whole… how would you rate the quality of the services you receive from [QV4 provider]?"

5.17 Looking at specific elements of Royal Mail's service, similarly to 2017-18, SMEs are most satisfied with items being 'delivered intact/undamaged' (88%), 'delivery consistency/reliability' (82%) and 'delivery time' (78%). Satisfaction is lowest with 'collection time of items being sent' (60%) and 'price of postage' (52%). Satisfaction levels have dropped for collection factors such as 'collection reliability' (to 62% from 72% in 2017-18) and 'collection time of items you are sending' (to 60% from 67% in 2017-18). There have been no big increases year on year; the level of satisfaction for 'cost of postage' went up from 49% to 52%.

Figure 5.14: SME satisfaction with specific elements of Royal Mail's service



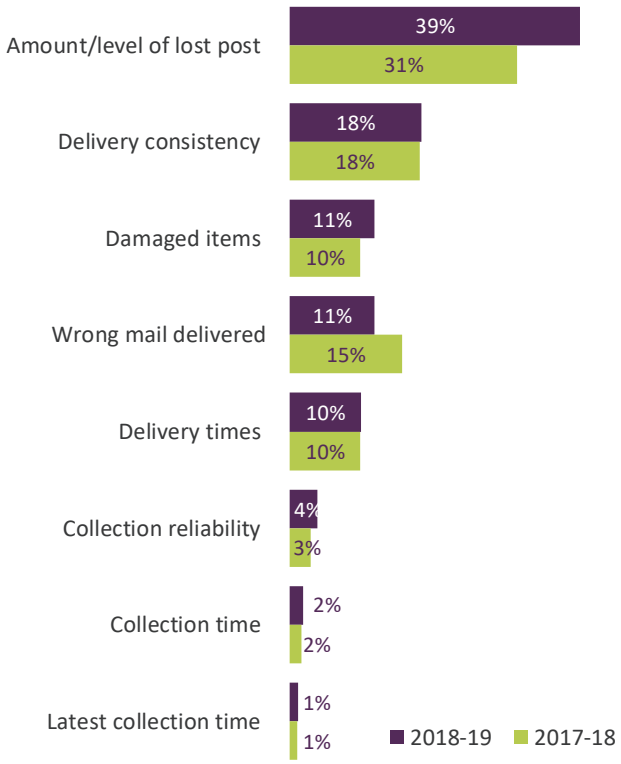
Source: Ofcom Business Postal Tracker.

Base: All respondents who use Royal Mail Q3 2018-Q2 2019 (1869), Q3 2017–Q2 2018 (1,933).

"QRM3: How would you rate the performance of Royal Mail, as a recipient and sender, in the following areas on a five-point scale where 1 is 'very dissatisfied' and 5 is 'very satisfied'? NET: % fairly/very satisfied."

5.18 SMEs were asked whether they had experienced a list of possible problems with Royal Mail in the last six months. More than eight in ten (85%) reported that they had not experienced any problems. This is in line with 87% who said the same in 2017- 2018. Where problems were reported, as with previous years, the biggest problem was the 'amount/level of lost mail' reported. Around four in ten (39%) of those who have had a problem said it was with the 'amount/level of lost mail'.

Figure 5.15: SME problems experienced with Royal Mail



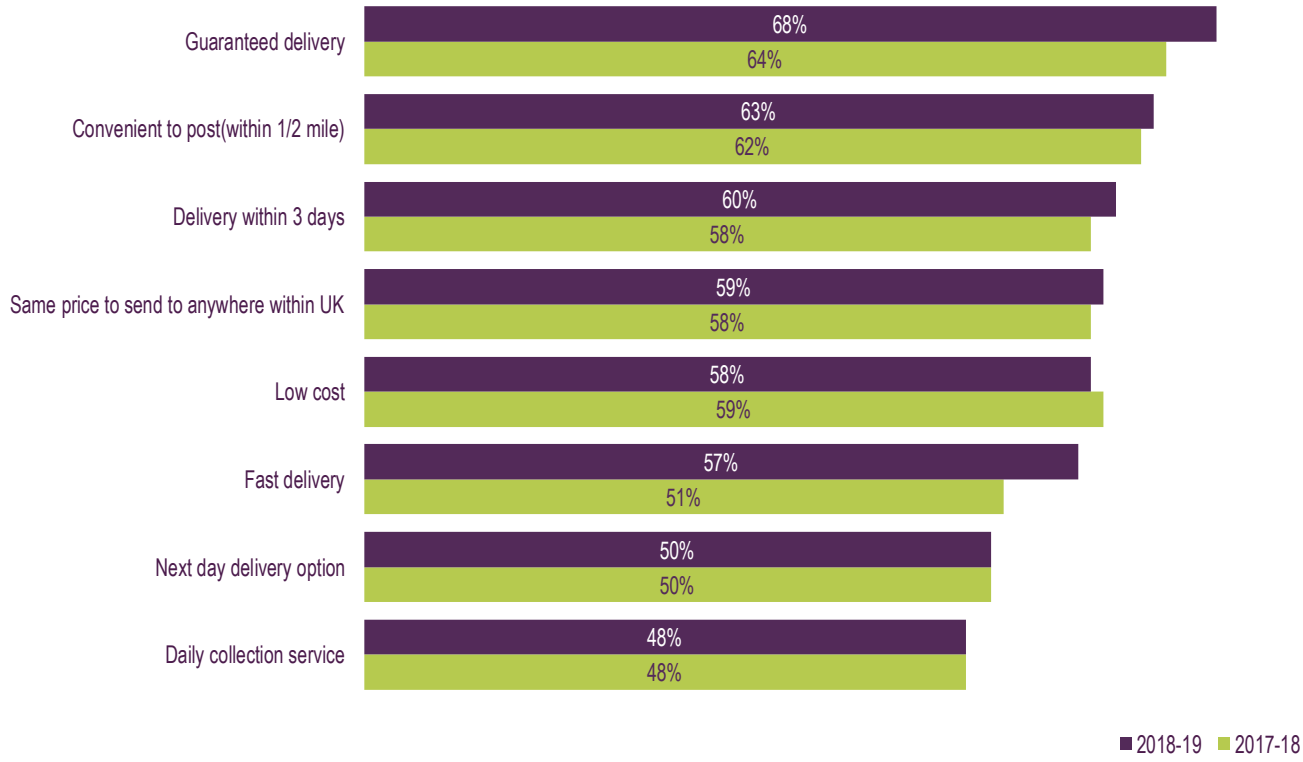
Source: Ofcom Business Postal Tracker Q3 2018-Q2 2019 (271), Q3 2017–Q2 2018 (251).

Base: All respondents who use Royal Mail who had reported a problem in the last 6 months.

"QRM4: Have you experienced any problems with your service from Royal Mail (as a sender or recipient of mail) in the last 6 months?"

5.19 SMEs were asked to rate the importance of various factors when choosing a provider when sending letters. The most important factors for SMEs are 'guaranteed delivery' rated as 'mandatory/great to have' by more than two thirds (68%) and 'convenience of posting items (within half a mile)' (63%). 'Delivery within three days' and 'same price to anywhere in the UK' were both rated as important by around six in ten SMEs (60% and 59% respectively), followed by 'fast delivery' (57%) and 'low cost' (58%). The options that received the lowest importance ratings were 'next day delivery option' (50%) and 'daily collection service' (48%). The importance rating for 'fast delivery' has increased from 51% to 57% while 'guaranteed delivery' has also increased from 64% to 68%. There are no decreases year on year.

Figure 5.16: Factors rated as important for SMEs when sending letters

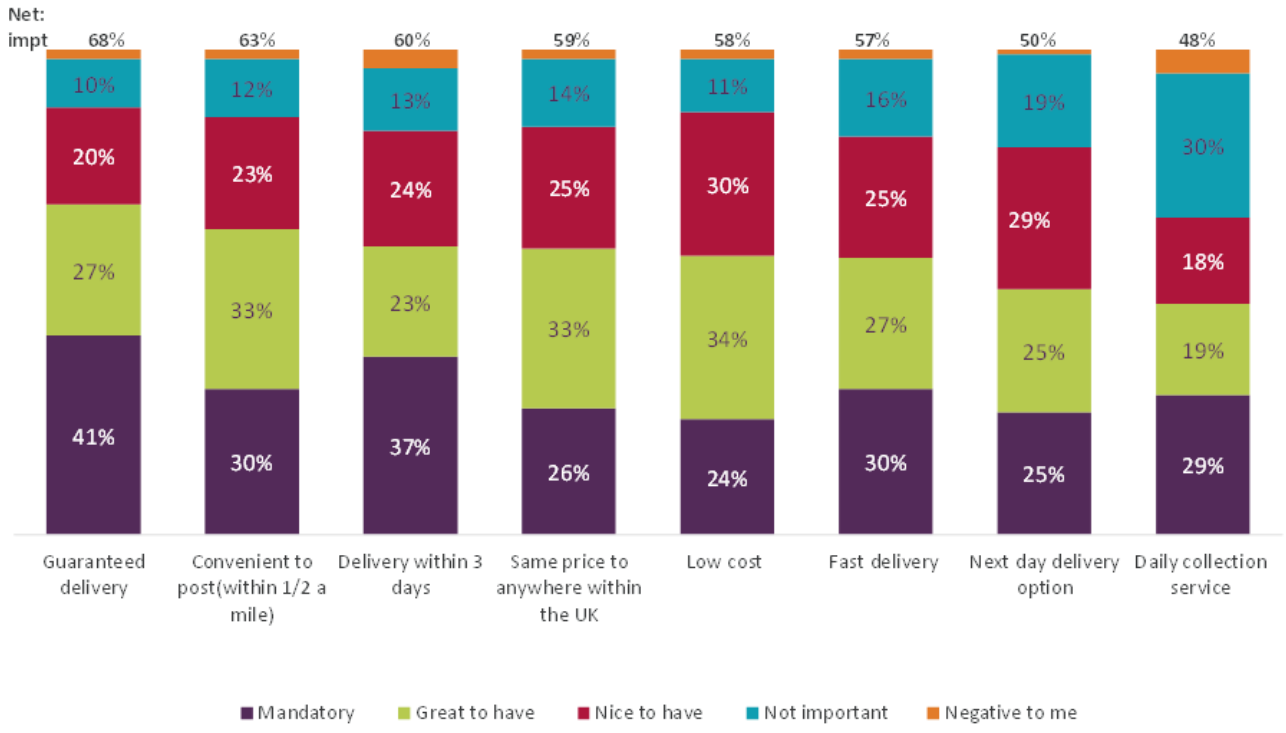


Source: Ofcom Business Postal Tracker.

Base: All respondents who use Royal Mail to send letters or large letters and selected a service Q3 2018-Q2 2019 (1326), Q3 2017–Q2 2018 (1,620).

"QD10b. Below, are a list of factors people tell us they consider when sending letters. For each factor, please tell us how important it is to you in choosing a postal provider or service. (NET: 'mandatory' and 'great to have')."

Figure 5.17: Factors rated as important for SMEs when sending letters (2018-19)



Source: Ofcom Business Postal Tracker Q3 2018 – Q2 2019.

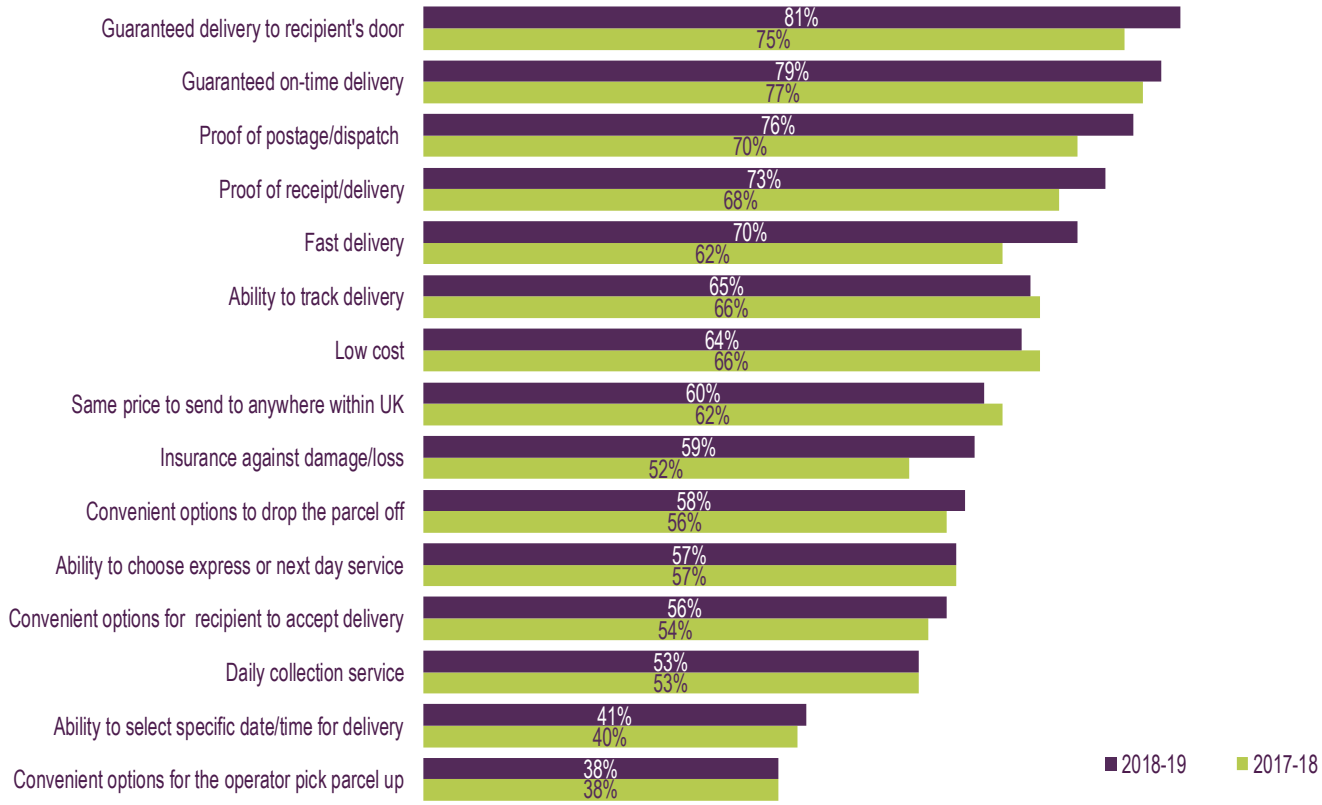
Base: All respondents who use Royal Mail to send letters or large letters and selected a service (1,326)

"QD10b. Below, are a list of factors people tell us they consider when sending letters. For each factor, please tell us how important it is to you in choosing a postal provider or service. (NET: 'mandatory' and 'great to have')."

5.20 SMEs were asked the same question about sending parcels. Guaranteed delivery to the recipient's door and guaranteed on time delivery remain the most important factors 'mandatory' or 'great to have' (81% and 79% respectively), followed by 'proof of postage/dispatch' (76%) and 'proof of receipt/delivery' (73%). The options that were rated as least important were 'ability to select specific date/time for delivery' (41%) and 'convenient options for the operator to pick the parcel up' (38%).

5.21 Most factors were rated similarly to 2016-17 results, though there were a few with importance ratings considerably higher than 2017-18: 'guaranteed delivery to recipient's door' (81% in 2018-19 vs 75% in 2017-18), 'proof of postage/dispatch' (76% in 2018-19 vs 70% in 2017-18), 'fast delivery' (70% in 2018-19 vs 62% in 2017-18) and 'insurance against damage/loss' (59% in 2018-19 vs 52% in 2017-18). Most factors are either in line or more important than they were last year. No factors were rated as being significantly less important.

Figure 5.18: Factors rated as important for SMEs when sending parcels. Nets: 2017-18, 2018-19



Source: Business Postal Tracker.

Base: all using Royal Mail to send parcels and packets Q3 2018-Q2 2019(563), Q2 2017-Q3 2018 (673).

"QD10a. Below, are a list of factors people tell us they consider when sending parcels. For each factor, please tell us how important it is to you in choosing a postal provider or service."

Summary

5.22 Residential and SME postal service users continue to be generally satisfied with services provided by both Royal Mail and other service providers.

5.23 Residential and SME postal users are most satisfied with key features of Royal Mail's delivery service relating to reliability and mail integrity. Residential postal users are most satisfied with 'sent items reaching their destination' and 'sent items being delivered intact and undamaged'. SMEs are asked about slightly different features, but overall are most satisfied with 'the items being delivered intact/undamaged' and 'delivery consistency/reliability'.

5.24 About half of residential postal consumers overall said they have experienced a problem with their post in the last year. The biggest problem reported was with 'mis-delivered

mail'. Fewer SMEs have experienced problems with their post. SMEs mostly had problems with the 'amount/level of lost post'.[85]

5.25 Residential post users rated 'proof of postage' as the most important factor when sending parcels; SMEs rated guaranteed delivery for both letters and parcels as the most important factor.

5.26 Residential customers reported continuing to send less post, with the exception of tracked mail. Residential customers also reported receiving more parcels, but less personal mail.

[85] Different questions and codes therefore not directly comparable. SME tracker question wording: "*Have you experienced any problems with your service from Royal Mail as a sender or recipient of post in the last 6 months?" Residential consumer tracker question wording: "In the last 12 months, have you experienced problems with Royal Mail's service in terms of……"*

6. Efficiency of the Reported Business

6.1 In this section, we discuss efficiency of the Reported Business[86] covering:

- Why it is an important aspect of our monitoring regime;
- Our estimate of Royal Mail's efficiency performance in 2018-19;
- Royal Mail's views on its efficiency and what it has been doing to improve its efficiency; and
- Summary of the efficiency of the Reported Business and recent events.

Efficiency is an important aspect of our monitoring regime

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

6.3 In the March 2017 Statement, we concluded that the imposition of additional price controls or efficiency targets on parts of Royal Mail's business was not necessary. In reaching our conclusion we considered Royal Mail's efficiency performance, the incentives on Royal Mail to make further efficiency improvements in the future and our ability to intervene if Royal Mail failed to make enough progress on improving its efficiency whilst exposing customers to higher prices or lower quality of service. We also considered the challenges Royal Mail faced in the short term, including the pay and pension negotiations, which were then ongoing. In reaching our conclusion, we highlighted the importance of our monitoring regime in providing a safeguard.

6.4 The pay and pension negotiations were subsequently concluded in February 2018, when Royal Mail announced the Pensions, Pay and Pipeline Agreement (later referred to as 'the Agreement') with the Communication Workers Union (CWU). As part of the Agreement, the Royal Mail Pension Plan (RMPP) closed in March 2018. This avoided an increase in annual cash contributions of around £800m, according to Royal Mail's estimation.[87] [88]

Indicators of Royal Mail's efficiency performance

6.5 In the March 2017 Statement, we set out the metrics and framework we proposed to adopt to monitor Royal Mail's efficiency performance.[89] We proposed to use a variety of

[86] The Reported Business is a part of Royal Mail's UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of Parcelforce International and Royal Mail Estates Ltd.
[87] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, pages 53- 54. https://www.royalmailgroup.com/media/10924/royal_mail_ar19_190918.pdf.
[88] Total pension contributions would have been £1.2bn per year had the deal not been reached. However, because of the new deal this was reduced to £400m, meaning that Royal Mail avoided costs of c. £800m per year.
[89] Ofcom, *Review of the Regulation of Royal Mail*, March 2017, paragraph 3.90.

metrics and adopt Royal Mail's 2015 Business Plan, on which a lot of our analysis was based, as a reference point to review performance.

6.6 Here we report on our high-level indicators of efficiency: the overall change in real costs; the change in cost excluding the impact of inflation, volume, and one-off costs (PVEO analysis outlined in paragraph 6.10 below); frontline gross hours in delivery and processing; productivity; and the ratio of revenue to average Full-Time Equivalent (FTE) versus people cost to average FTE.

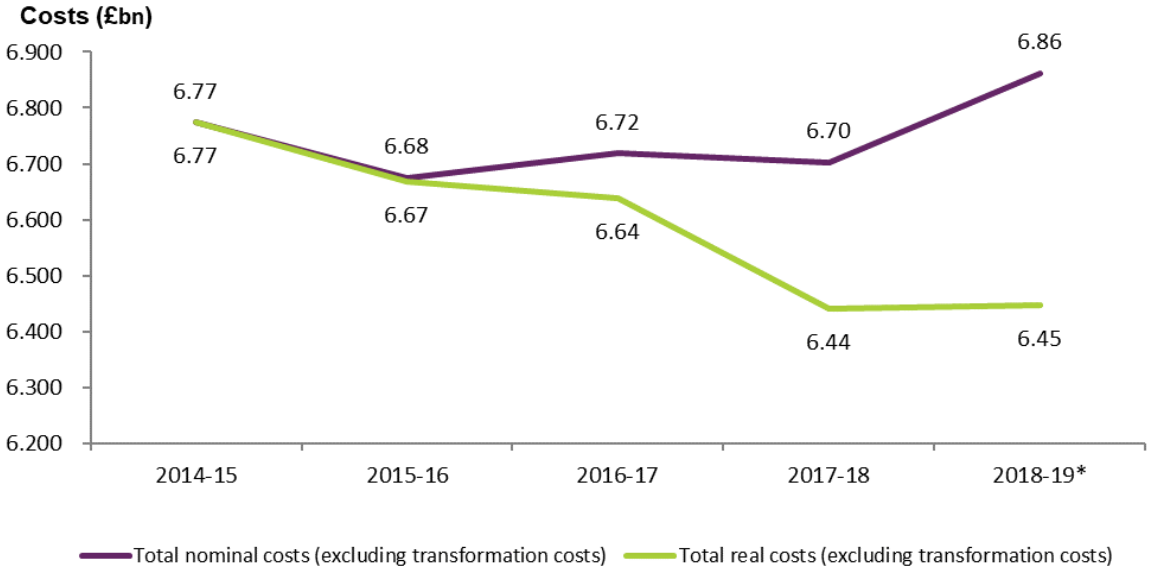
6.7 Royal Mail reports its financial statements using whole weeks. This means that for the 2018-19 financial year Royal Mail has reported a 53-week year. Where possible, 2018-19 results have therefore been adjusted to 52 weeks to enable a like-for-like year-on-year comparison. Where we discuss changes, we are referring to the comparisons to the prior financial year i.e. 2018-19 to 2017-18 on a 52-week basis (unless otherwise stated).

Real cost reduction[90]

6.8 Real cost reduction provides a high-level simplified view of efficiency as costs change due to volume and one-off costs are not adjusted for in this metric.

6.9 Figure 6.1 below shows that real costs (excluding transformation costs) did not reduce in 2018-19 on a 52-week basis. They increased by 0.1%, hence, no real cost savings were realised. See Section 7 for a more detailed discussion on the cost movements driving this result.

Figure 6.1: Total real and nominal costs (excluding transformation costs) from 2014-15 to 2018-19*



Source: Royal Mail Regulatory Financial Statements and Ofcom analysis
** Adjusted to 52 weeks*

[90] Total costs (excluding transformation costs) have been adjusted by CPI based on 2014-15 values. Annual CPI change calculated based on average monthly CPI across financial year April to March.

Price, Volume, Efficiency and Other (PVEO) Analysis

6.10 PVEO analysis provides a measure of efficiency by disaggregating movements in costs[91] in terms of price changes (i.e. cost inflation), volume effects, efficiencies achieved and other one-off costs.

6.11 Our analysis assumes an inflation index of CPI across all costs. Cost movements due to volume (demand drivers) apply to a subset of the total cost base: frontline costs of delivery and processing, payments to Post Office Limited (POL) and international terminal dues. Change in frontline costs due to volume are calculated based on the year-on-year change in workload using Ofcom's methodology (see paragraph 6.23 below). The remainder of costs are considered to be fixed. Efficiency is calculated to be the residual cost movement once price, inflation, volume and one-off items have been taken into account.

6.12 Our PVEO analysis (Figure 6.2 below) shows that Royal Mail did not achieve any efficiencies in 2018-19 (on 52-week basis) with an increase in total costs (excluding transformation costs) after accounting for inflation, volume effects/demand drivers and one-off costs. The PVEO analysis shows an inefficiency of 0.6% (£42m) in 2018-19 on a 52-week basis. This is significantly lower than the efficiencies achieved in prior years of 2.8% in 2017-18 and 2.3% in 2016-17.

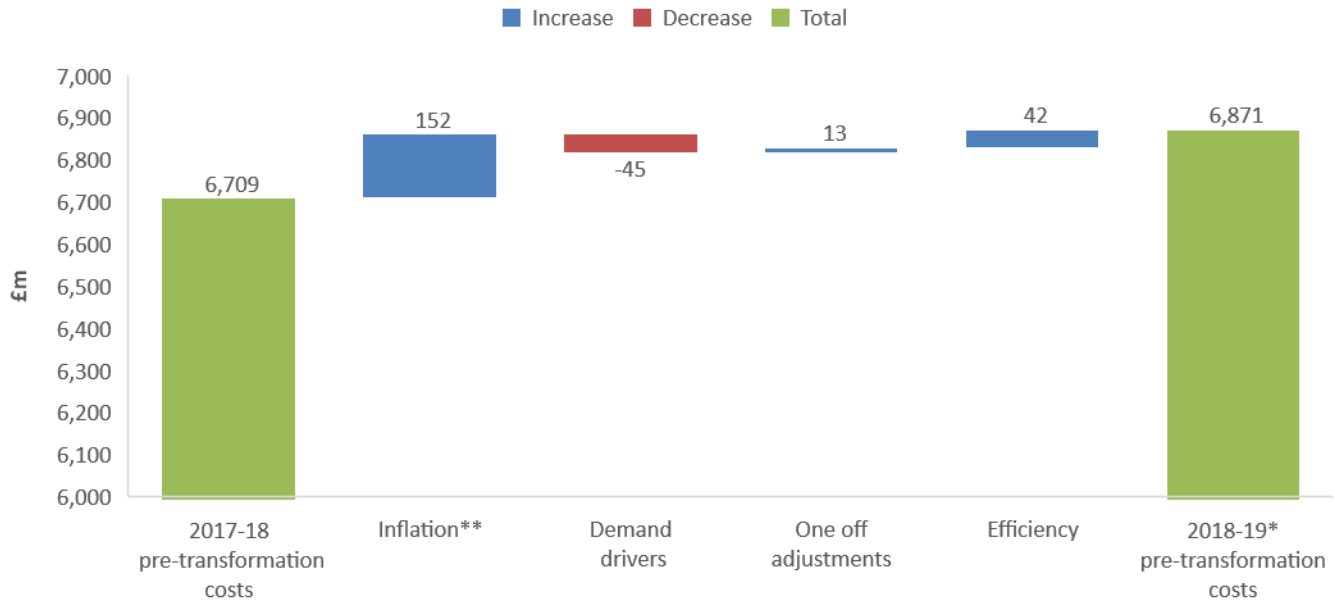
6.13 The PVEO analysis shows an inefficiency of 0.5% (£21m) on people costs. This was due to the reduction in gross hours not being sufficient to offset pay increases and the introduction of the Shorter Working Week in accordance with the Pension, Pay and Pipeline Agreement (see below). The Agreement, which was agreed with the CWU, includes a pay increase of 5% for full-time employees, which was backdated to October 2017 (this equates to an annual impact of 2.5% for 2017-18 and 2018-19 respectively).[92] Part-time staff received an equivalent pay rise. Additionally, the Agreement included a reduction in the weekly contract of full-time staff from 39 hours to 38 effective from October 2018, known as the 'Shorter Working Week'. The 2018-19 impact of the Shorter Working Week was a 1.3%[93] reduction in full time ordinary hours[94] at the same pay. Hence the Shorter Working Week resulted in an increase in the hourly rate paid, in addition to the pay rise. The implementation of the Shorter Working Week was intended to incentivise greater efficiencies, which would offset the cost of it (i.e. increase in hourly rate), however these efficiencies were not fully achieved, hence the costs of the Agreement were greater in 2018-19 than expected.

[91] Total costs include Reported Business people (adjusted for cash pension rate) and non-people (including depreciation) and exclude transformation costs.
[92] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 27.
[93] Calculated as 1 hour reduction as a portion of 39 hours in a working week apportioned for 6 months in 2018-19.
[94] Ordinary hours are an employee's regular hours of work, excluding overtime and temporary or casual resource.

6.14 However, had the closure of the RMPP not been achieved as part of the Agreement with the CWU, Royal Mail estimates that it would have incurred additional costs of around £800m per annum.[95]

6.15 Furthermore, in addition to inefficiencies on people costs as discussed above, Royal Mail did not achieve any efficiencies on non-people costs. The PVEO analysis shows an inefficiency of 1.0% (£21m) on non-people costs. This was largely driven by higher vehicle repair costs due to adverse weather at the beginning of the year and delays to the delivery of new vehicles, resulting in higher maintenance costs on older vehicles.[96]

Figure 6.2: PVEO bridge 2017-18 to 2018-19*



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

** Adjusted to 52 weeks*

***ONS 12-month trailing average CPI figures (April to March)*

Frontline gross hours (delivery and processing)

6.16 We analysed the hours paid for by Royal Mail for the its frontline delivery and processing activities which account for the majority of people costs. These are referred to as 'gross hours' and include both worked hours and paid absences such as sickness and leave. The gross hours metric captures year-on-year changes in hours worked as a result of volume changes as well as efficiency, both of which are relevant to our analysis.

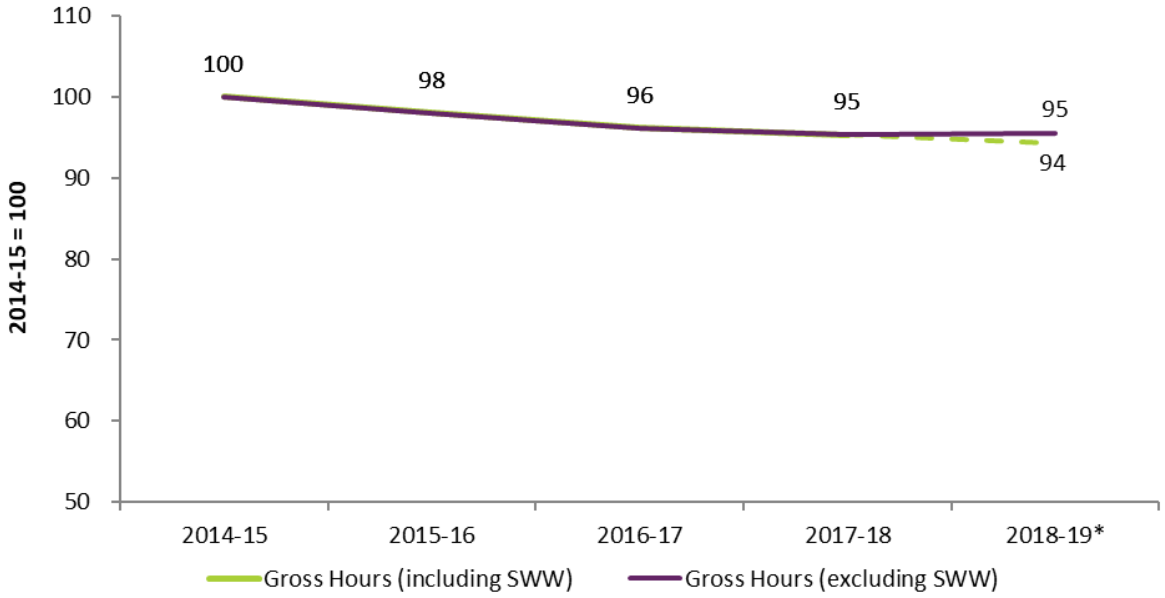
[95]Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, pages 53-54. Total pension contributions would have been £1.2bn per year had the deal not been reached. However, because of the new deal this was reduced to £400m, meaning that Royal Mail avoided costs of c. £800m per year.

[96] Ibid, page 42.

6.17 Figure 6.3 below shows that Royal Mail achieved a total gross hours' reduction in delivery and processing of 1.2%[97] in 2018-19 on 52-week basis, slightly up from the prior year reduction of 0.9% in 2017-18 but down from the 1.9% reduction in 2016-17.

6.18 However, as outlined in paragraph 6.13, the Shorter Working Week was implemented in 2018-19, which resulted in a one hour reduction in ordinary hours (excluding overtime) per week, without corresponding reduction in pay. Hence, part of the hours' reduction achieved in 2018-19 did not give rise to a reduction in costs. The change in contracted hours equates to a 1.3% reduction in ordinary frontline hours for 2018-19. Excluding the impact of the Shorter Working Week, gross hours increased by 0.1% for 2018-19 (on a 52-week basis), which is lower than the hours reduction achieved in 2016-17 and 2017-18.

Figure 6.3: Gross hours' reduction (excluding RDCs) indexed from 2014-15 to 2018-19*



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

** Adjusted to 52 weeks*

Productivity

6.19 The gross hours metric (used as a proxy for costs) captures year-on-year changes in hours worked that result from both volume changes and efficiency. In order to isolate the changes in hours worked that result from efficiency only, Royal Mail calculates a productivity metric whereby it excludes the effect of changes in volume on hours worked.

[97] Royal Mail now includes hours related to regional distribution centers (RDCs) in its total hours' calculation. To present data on a consistent basis, we have excluded these hours from the calculation. If we were to include them in 2018-19, total hours would have decreased by 1.1% on 52-week basis, as stated by Royal Mail, as RDC hours represent a small percentage of total hours and therefore do not influence the calculation significantly.

6.20 Royal Mail's measure of volume is weighted to reflect the change in the product mix which is delivered by the business. This is done by using appropriate weights that are associated with each product group. This is to reflect the fact that, for example, it is on average more time consuming to deliver a parcel than it is to deliver a letter. The workload (or weighted volumes)[98] measure which is used by Royal Mail to calculate productivity reflects the relative effort required to deliver each of its products.[99]

6.21 In summary, Royal Mail's productivity metric[100] is calculated as the ratio of workload (weighted volumes) to gross hours, that is, the ratio of output (workload) to input (frontline gross hours).

6.22 Royal Mail's calculation of workload (weighted volumes) depends on the assumptions made on the relative weightings associated with each product group. To calculate the weights, Royal Mail uses engineering studies which record the time taken to work a given volume at a point in its operation. As Royal Mail's operation changes and it develops its approach, it updates the weighting and methodology/scope applied, resulting in different weightings being applied in different years.

6.23 Our approach to calculating productivity differs slightly, in that we apply consistent weights and methodology/scope for each product group year-on-year. This is to ensure consistent comparison of workload year-on-year. This results in a different estimate of output or workload. Specifically, in our calculation of productivity, we use the assumptions and methodology/scope adopted in the Strategic Business Plan submitted to us by Royal Mail on 14 May 2015.

6.24 While Royal Mail and our methods both capture people efficiency, our method also captures efficiency that results from operational structure changes and updated processes, such as automation. This is because our estimate of workload is not adjusted to account for operational structure changes or updated processes and as such the resulting productivity measure captures any efficiency realised as a result of these changes. It is worth noting that both measures of productivity do not consider pay efficiency nor do they capture non-people efficiencies.

6.25 Figure 6.4 below presents both estimates of productivity. As seen from the figure, Royal Mail's estimated productivity improvement was 0.9% for 2018-19 on 52-week basis.[101] Our

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[98] The weights used to calculate workload derive from the amount of time required for frontline staff to carry out the tasks to process the mail volumes presented in a given Operational Business Process (e.g. indoor delivery, outdoor delivery, inward and outward processing) in a given period, relative to the time taken to process 1000 sequenced letters in all relevant Operational Business Processes.

[99] FTI Consulting, 2015. Efficiency Metrics for Royal Mail, paragraph 5.52. https://www.ofcom.org.uk/__data/assets/pdf_file/0023/83723/royal_mail_fti_report_on_efficiency_metrics.pdf

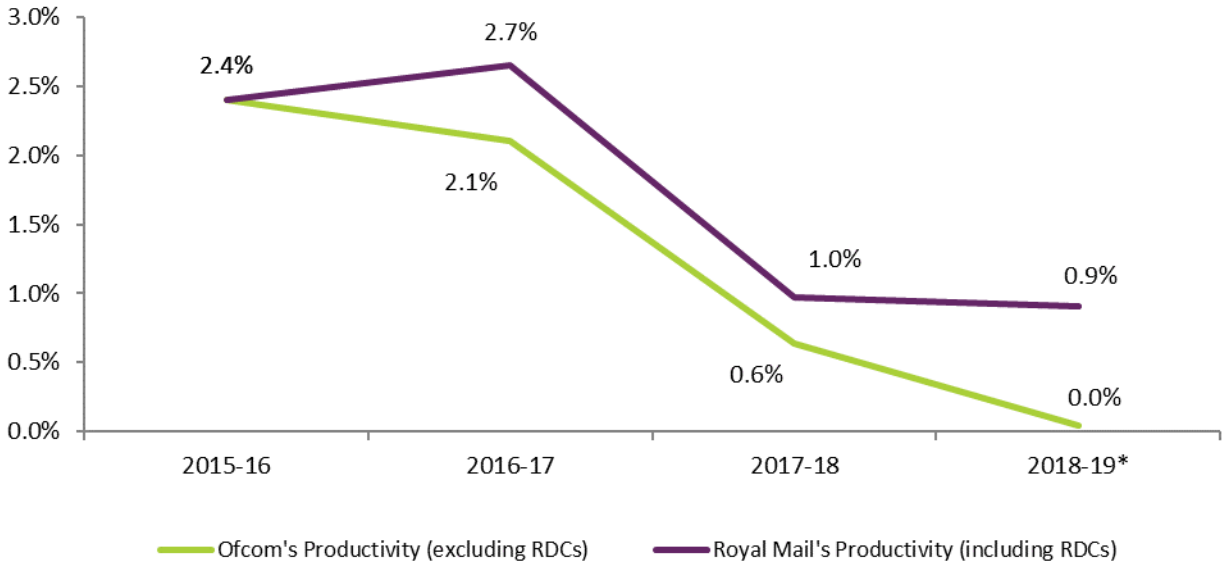
[100] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 38. Defined as "Percentage change year-on-year in the number of weighted items per gross hour paid in Delivery Units and Mail Centre Units (delivery and processing, including regional logistics and collections) and Regional Distribution Centres"

[101] Royal Mail includes RDCs in its calculation of productivity. Excluding RDCs, Royal Mail's estimate of productivity improvement was 0.6% for 2018-19.

estimate of productivity of delivery and processing shows no improvement (i.e. productivity estimate of c. 0%) for 2018-19 on 52-week basis.

6.26 Both productivity measures are below Royal Mail's target range of 2-3% and this has been the case for the prior year. Royal Mail stated that this was due to "the after effects of the industrial dispute, delayed implementation of cost avoidance projects and the complexity of implementing elements of [its] Agreement with CWU."[102]

Figure 6.4: Productivity gains/(deterioration) 2015-16 to 2018-19*



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.
** Adjusted to 52 weeks* Adjusted to 52 weeks* Adjusted to 52 weeks* Adjusted to 52 weeks*

Revenue and people cost per average FTE

6.27 Comparing revenue per average FTE and people cost per average FTE also provides an indication of efficiency. For example, if revenue per average FTE increases at a greater rate than people cost per average FTE, it may suggest that each average FTE is generating increasing revenues as compared with the expense to the company for that FTE. However, there may be other contributory factors, such as price changes, which could influence revenue per average FTE, thereby lessening the direct relationship with people cost per average FTE.

6.28 People costs represent a significant proportion of Royal Mail's costs. However, people cost per average FTE may not provide a reliable indicator of efficiency performance on its own as a company may have high cost per employee but low cost per customer dependent on

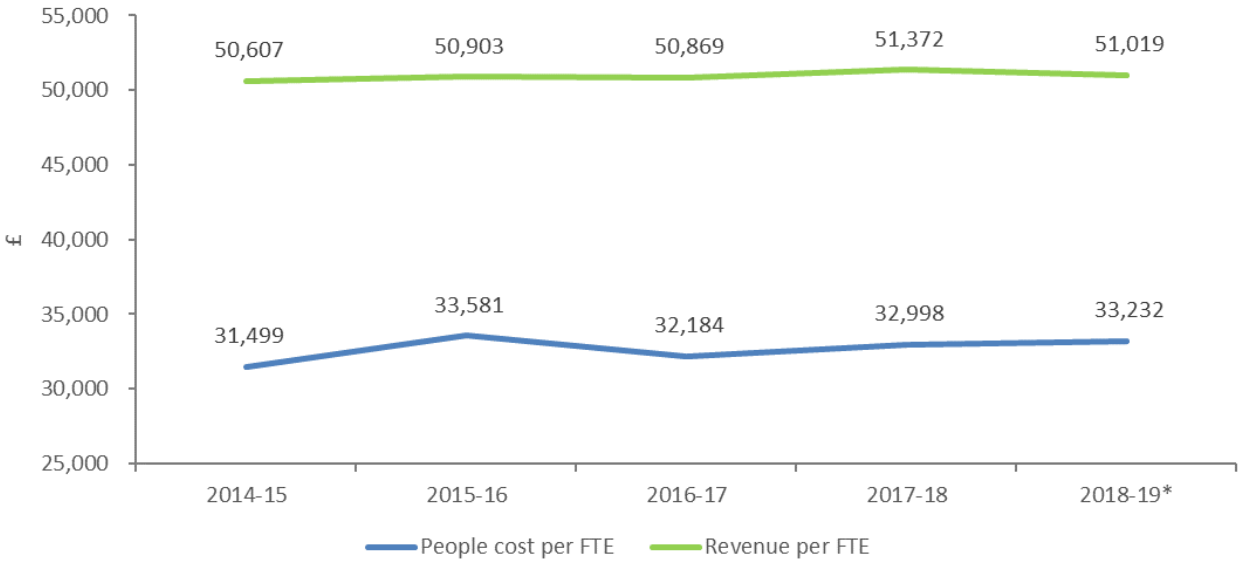
[102] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 24.

the company's operations. Nevertheless, it is useful in highlighting a trend to ascertain whether people cost per average FTE is declining year-on-year.

6.29 We see in Figure 6.5 below that while people costs per average FTE have increased, revenues per average FTE have decreased from 2017-18. This suggests people costs per average FTE have increased proportionally more than the equivalent revenues generated in 2018-19. People cost per average FTE as a percentage of revenue per average FTE ratio has increased from c.64% in 2017-18 to c.65% in 2018-19 on 52-week basis, reflecting that people costs incurred have increased while revenues have decreased.

6.30 Average FTEs continued to increase due to a higher than expected increase in overtime and temporary staff as a result of the introduction of the Shorter Working Week and in order to recover Quality of Service standards.

Figure 6.5: Reported Business people cost and revenue per average FTE from 2014-15 to 2018-19*



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.
FTE data (including agency staff) provided by Royal Mail and average calculated by Ofcom.
** Adjusted to 52 weeks*

Royal Mail's own statements on efficiency

6.31 Royal Mail's public statements relating to efficiency include statements on targets on cost avoidance and productivity.

6.32 Royal Mail stated in its Annual Report and Financial Statements that UKPIL collections, processing and delivery productivity improved by 0.9% on 52-week basis, which was below its target range of 2.0% to 3.0% per annum improvement.[103]

[103] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, pages 24 and 42.

6.33 Royal Mail's costs avoidance target for UKPIL for 2018-19 was £230m. This was revised down in its half year trading update, to £100m. Royal Mail stated that this was due to difficult industrial relations, delayed implementation of cost avoidance projects and the complexity of implementing elements of the Agreement with CWU. In its full year results announcement, Royal Mail said that performance improved in the second half of 2018-19 and it was able to reach its revised target of £100m cost avoided with a performance of £107m.[104]

6.34 Royal Mail stated that: "the costs avoided comprised a number of initiatives, including short-term actions where [it] saw reductions in discretionary spend and central costs. [It] performed a review of [its] organisational structure and management roles in support and central functions, which resulted in management headcount reduction that will deliver financial benefits in 2019-20. [It] also achieved savings through a reduction in core network hours including partial absorption of the one-hour reduction of the working week, modernisation of [its] Heathrow Worldwide Distribution Centre, a linehaul review, supplier contract renegotiation and rationalisation of operations management".[105]

6.35 In addition, the Agreement with CWU to close the RMPP on 31 March 2018 avoided an estimated increase in annual pension cash contributions of £800m by reducing future annual pension contributions from £1.2bn to £400m (see paragraph 6.14).[106]

Summary and recent events

6.36 In summary, the key efficiency trends for the 2018-19 financial year showed a deteriorating trend across most metrics:

- Total real costs for the Reported Business increased by 0.1% on 52-week basis against a reduction of 3.0% in the prior year.
- The PVEO analysis indicates an underlying inefficiency (excluding transformation costs) of 0.6% (£42m) on 52-week basis against a 2.8% efficiency in the prior year. People costs inefficiencies of 0.5% (£21m) were mainly due to gross hours' reduction not being sufficient to offset pay increases and the introduction of the Shorter Working Week. Non-people costs inefficiencies of 1.0% (£21m) were mainly due to higher vehicle repair and maintenance costs.
- Royal Mail reduced frontline gross hours in delivery and processing by 1.2% on 52-week basis, higher than the reduction of 0.9% in the prior year. However, the underlying increase in gross hours of 0.1%, after taking account of the impact of the Shorter Working Week, was lower than the hours reduction achieved in both 2016-17 and 2017-18.
- Royal Mail estimated productivity improvement of 0.9%107 for 2018-19 on 52-week basis, whereas our estimate of productivity shows no improvement (i.e. productivity

[104] ibid, pages 24 and 42.
[105] ibid, page 42.
[106] ibid, pages 53- 54.
[107] Royal Mail includes RDCs in its calculation of productivity whereas ours does not. Excluding RDCs, Royal Mail's estimate of productivity improvement was 0.6% for 2018-19.

estimate of 0%) for the same period. Both estimates are below Royal Mail's target range of 2-3%.

- The ratio of people costs per FTE as a percentage of revenue per FTE increased from c.64% in 2017-18 to c.65% in 2018-19 on 52-week basis reflecting that people costs incurred have increased whilst revenue has declined.
- Royal Mail achieved cost avoidance of £107m against an original target of £230m.
- Royal Mail managed to avoid an increase in pension cash contributions of around £800m in 2018-19 (and onwards), which was due to the closure of the RMPP, following the completion of the pay and pension negotiations with the CWU in 2018.

6.37 Efficiency performance continues to be concerning as efficiency is critical to the longer-term sustainability of the universal service.

6.38 Last year, we reported on efficiency against the backdrop of Royal Mail's UK business productivity performance being significantly below plan in the first half of 2018-19 and that full year performance was expected to be significantly below target. We explained this was a concern to us given our view that continued progress on efficiency was likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.

6.39 In line with Royal Mail's revised expectation, efficiency performance for 2018-19 deteriorated across the metrics reported. Notably, the Shorter Working Week has not led to the expected reduction in hours. Royal Mail only reduced gross hours by 1.2% in 2018-19, leading to its stated productivity improvement of 0.9% being significantly below its target range of 2-3%.

6.40 However, Royal Mail has strong incentives to improve its efficiency in future to remain financially sustainable. In particular, in its five-year strategy, Royal Mail announced a goal of 15-18% productivity improvement over the life of the strategy.

6.41 As noted in Section 7, Royal Mail faces a number of risks to the implementation of its strategy. It also recently noted in its half-year results that transformation is behind schedule and this is likely to impact efficiency in the second half of 2019-20.

6.42 Progress on efficiency is key to improving the profitability of the Reported Business and help ensure the financial sustainability of the universal service. If Royal Mail is successful in the implementation of its transformation programme (which includes but is not limited to planned productivity improvement of 15-18%), this will help sustain the universal service in the longer term. We will continue to monitor Royal Mail's efficiency and engage with Royal Mail's management to understand better their plans to transform the business.

7. The financial performance of the Reported Business

7.1 This section summarises the financial performance of the Reported Business[108] for 2018-19, including a five-year trend. We monitor the financial performance of the Reported Business as we have a duty to have regard to the need for the provision of a universal service to be financially sustainable, as set out in the March 2012 Statement.[109]

7.2 We discuss in sequence:

- changes in overall volumes and revenues for the Reported Business and then by universal service products, product groups and formats to help us understand what is driving overall revenue and volume changes for the Reported Business;
- changes in the costs of the Reported Business to understand what progress has been made in relation to cost reduction. This information is also an important input when considering the efficiency of the universal postal service which is discussed further in Section 6;
- profit margins for the Reported Business;
- cash flow and financial health metrics110 of Royal Mail Group and Royal Mail Group's most recent Viability Statement; and
- summary and our comments on financial sustainability of the Reported Business and recent events.

7.3 Revenue, prices and cost figures presented in this section are in nominal terms. This is consistent with Royal Mail's Regulatory Financial Statements.

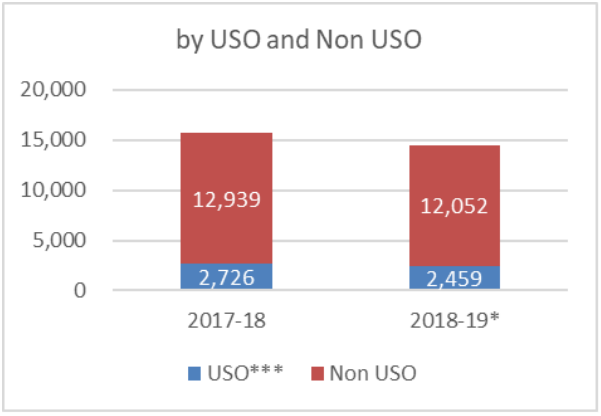
7.4 Royal Mail reports its financial statements using whole weeks. This means that for the 2018-19 financial year Royal Mail has reported a 53-week year. Where possible, 2018-19 results have therefore been adjusted to 52 weeks to enable a like-for-like year-on-year comparison. Where we discuss changes, we are referring to the comparisons to the prior financial year i.e. 2018-19 to 2017-18 on a 52-week basis (unless otherwise stated).

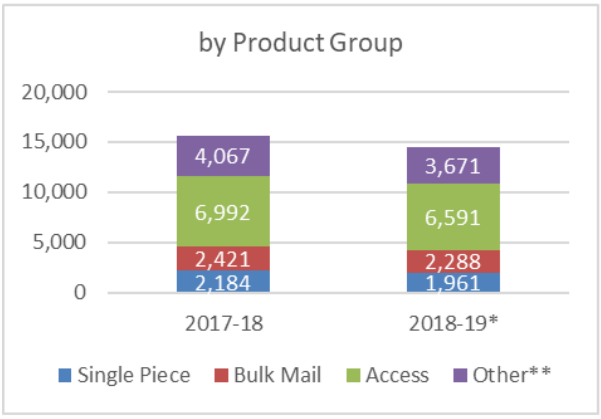
[108] The Reported Business is a part of Royal Mail's UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of Parcelforce International and Royal Mail Estates Ltd.
[109] Ofcom, 2012. Securing the Universal Postal Service. https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.
[110] In the Review of the Regulation of Royal Mail 2017 statement, we committed to monitoring the following short to medium term financial health metrics: Funds from operations/net debt, net debt/EBITDA and EBITDA/interest. While we cannot publish forward looking metrics as these rely on Royal Mail's confidential Business Plan, we can provide historic metrics as an indicator of financial health over the period considered.

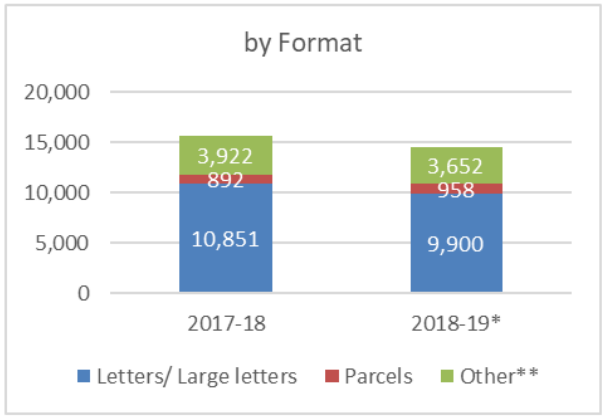
Volumes and revenues for the Reported Business fell in 2018-19*

Figure 7.1: Reported Business volumes and revenues split by universal service products, product groups and formats

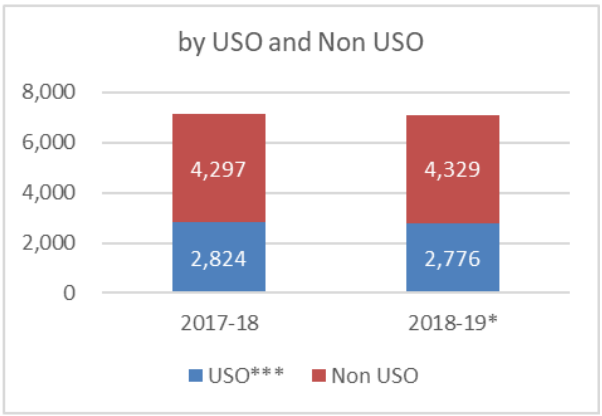
Volumes (millions): 14,511m (7.4% decrease)

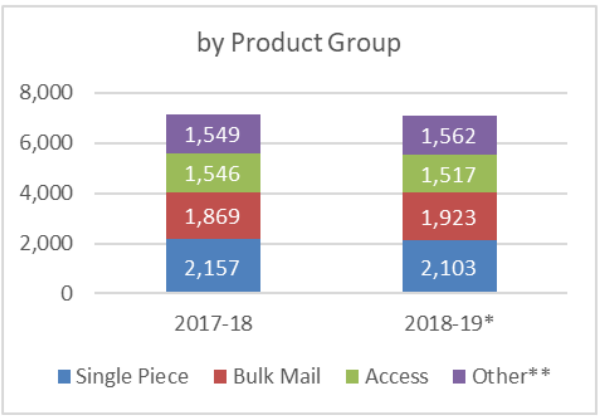


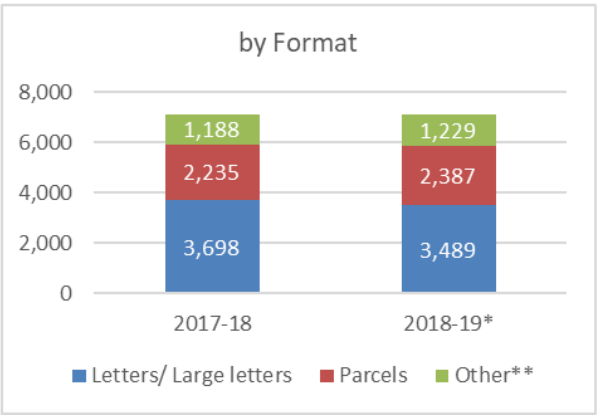




Revenues (£m): £7,105m (0.2% decrease)







Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

**Adjusted to 52 weeks*

***Other products mainly consists of unaddressed, elections and international mail*

****USO products consists of First and Second Class stamp, Meter letters and parcels, First and Second Class Single Piece Account letters and parcels, Special Delivery Stamp and Meter, Redirections, Royal Mail Signed For, Local Collect, International Airmail and Surface letters and parcels*

7.5 Reported Business total volumes (addressed and unaddressed mail) continued to fall in 2018-19 by 7.4% to 14.5bn on a 52-week basis (a higher rate of decline as compared to the 2.8% decline observed in the prior year). The decline in volumes is driven by continuing structural decline in addressed letter volumes of 7.3% in 2018-19 on a 52-week basis. This was in line with Royal Mail's revised expectations of a 7-8% decline. Royal Mail attributes the decline in letter volumes to structural decline due to e-substitution, business uncertainty and General Data Protection Regulation (GDPR). [111]

7.6 Parcel volumes grew by 7.4%.[112] According to Royal Mail, its parcel business benefited from Royal Mail's targeting of fast-growing sectors such as online clothing retailers and new features like estimated delivery times and the extension of customer Latest Acceptance Times (LATs).[113] International parcels also continued to benefit from Royal Mail's cross border initiative.[114] [115]

7.7 Total revenue fell by 0.2% to £7.1bn as price increases and change in mix towards parcels were not sufficient to offset the effect of addressed letter volume decline. This is the sixth consecutive year in which overall revenue of the Reported Business has fallen, following the period from 2010-11 to 2013-14 when total revenue grew year-on-year despite volume decline. See Sections 3, 4 and 8 in particular for more information on prices.

7.8 We discuss below revenues and volumes for each of the splits in Figure 7.1 above (i.e. by product groups, formats and universal service products).

7.9 Letter and parcel price trends are available as part of the interactive data published on the Ofcom website.[116]

Changes in Reported Business volumes and revenue by universal and non-universal services

7.10 The services within the Reported Business include all universal service products and other products which use the universal service network (for example, retail bulk mail and access). Page 8 of the interactive data shows longer-term historic trends.[117]

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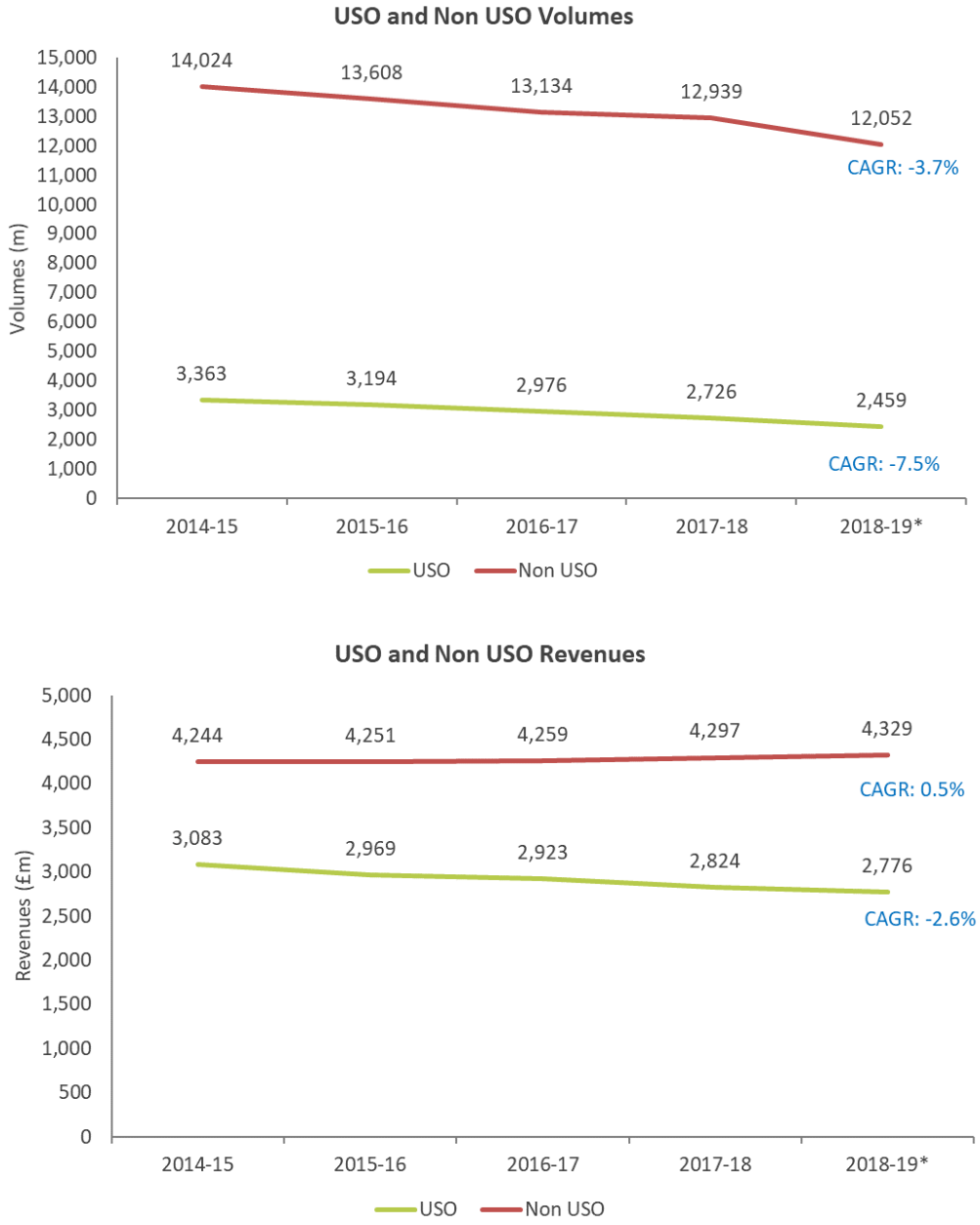
[111] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 42-43. https://www.royalmailgroup.com/media/10924/royal_mail_ar19_190918.pdf.
[112] Parcel volumes are based on Royal Mail's definition of parcels and include RM 24/28 large letters, some fulfilment letters and large letters and are therefore not directly comparable to the parcel market volumes collected by Ofcom and reported in Section 4.
[113] Royal Mail has extended the latest time it will accept items on its Tracked 24 products for delivery the next day.
[114] The international cross-border initiative allows Royal Mail to increase traffic in Europe from Asia (mostly China). Traffic arrives through their Heathrow processing plant from customs and clearance for onward travels to Europe. Royal Mail is responsible for paying associated terminal dues to local postal operator.
[115] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42.
[116] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports
[117] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

Figure 7.2: Universal and non-universal services volumes and revenues



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

** Adjusted to 52 weeks*

7.11 The volumes of both USO and non-USO products (including unaddressed mail) continued to decline. In 2018-19, they declined by 9.8% and 6.9% respectively. This follows the historic trend where the volume of USO items has been declining at a faster rate than non-USO items. Non-USO volumes mainly consist of access, bulk, international and unaddressed products. The decline in USO volumes was driven by the same factors that explained the decline in addressed letters generally: as mentioned above, ongoing

structural decline due to e-substitution, business uncertainty and GDPR (which particularly impacted marketing mail). Non-USO volume decline was driven by these factors as well as 'low average unit revenue (AUR)' unaddressed letter volumes lapping a period of strong growth in 2017-18 which benefited from initiatives to encourage incremental volumes.[118]

7.12 The revenues from USO products declined by 1.7% whilst non-USO revenues increased by 0.7% in 2018-19. For USO products, price increases were not enough to offset the volume decline in letters described above. For non-USO products, revenues increased due to business mail price rises implemented in January 2019 and growth in Domestic Account parcels.[119]

Changes in Reported Business volumes and revenue by product group

7.13 The analysis below focuses on year-on-year trends. Page 9 of the interactive data provides longer historic trends.[120]

Single Piece revenues and volumes

7.14 Single Piece volumes (both letters and parcels) decreased by 10.2% in 2018-19. This decline was driven by the ongoing structural decline due to e-substitution and business uncertainty which is affecting Single Piece letter volumes.

7.15 Single Piece revenue decline of 2.5% in 2018-19 was less than that of volume. The impact of volume decline was partially offset by price increases in both First and Second Class stamps (2p for both First and Second Class letters from 26 March 2018). See Sections 3, 4 and 8 in particular for more information on prices.

Bulk and Access revenues and volumes

7.16 Bulk Mail[121] (excluding Access) letter and parcel volumes declined by 5.5% despite increased growth in Domestic Account parcels volumes. This decline in letter volumes was driven by a strong prior year comparative period which benefited from initiatives to encourage incremental volumes.[122] The corresponding increase in revenues of 2.9% was driven by the business mail price increases implemented in January 2019. See Section 3 for more detail.

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[118] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42. 'Low AUR' unaddressed letter volumes were up 6% in 2017-18 refecting initiatives to encourage incremental volumes. In 2018-19, 'low AUR' unaddressed letter volumes were down 7% on an underlying basis, reflecting strong growth in 2017-18 due to initiatives that encouraged incremental volume growth. There was a once off spike in 'low AUR' unaddressed letter volumes in 2017-18.

[119] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42.

[120] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

[121] Bulk Mail includes RM24&48, Tracked, Tracked Returns and Special Delivery.

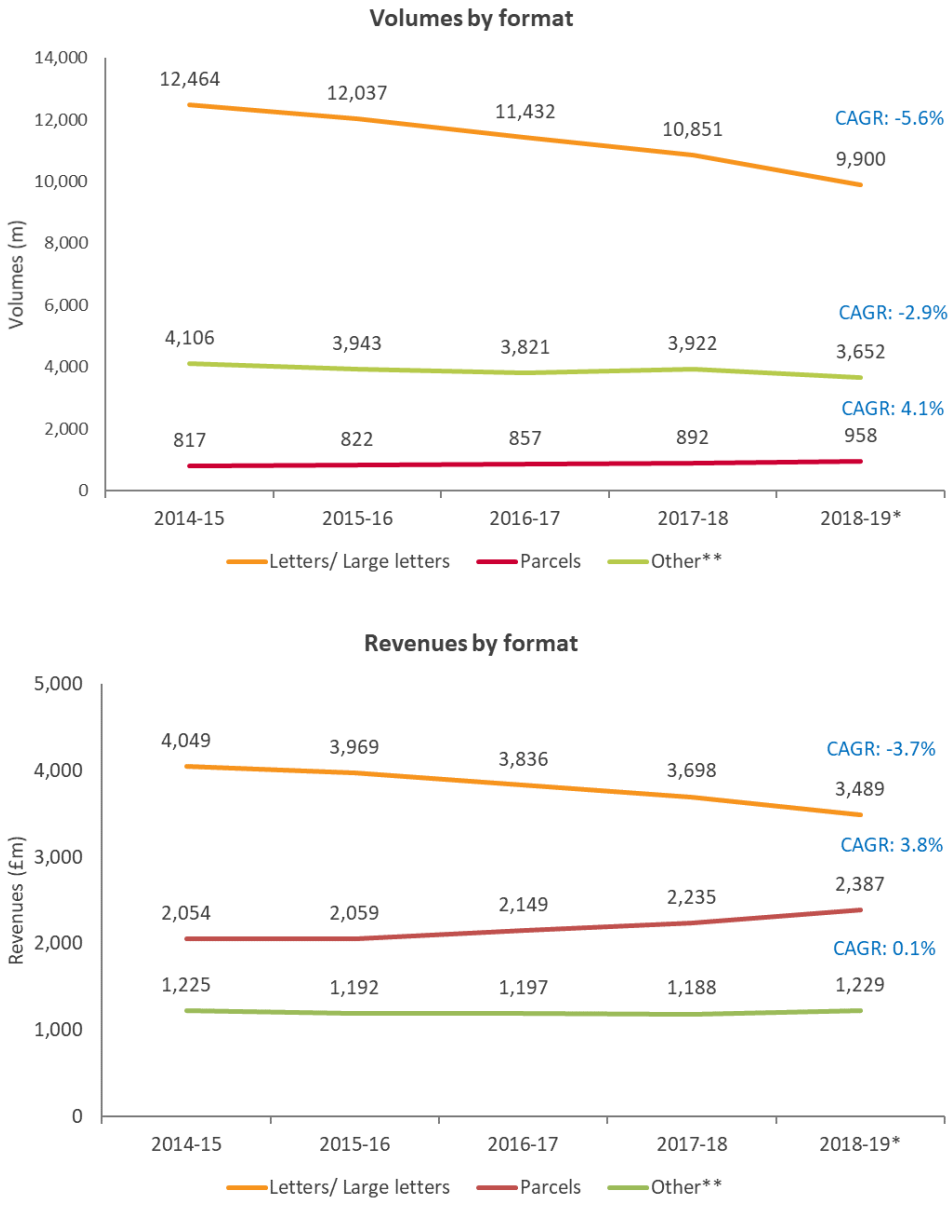
[122] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42.

7.17 Access volumes decreased by 5.7% while Access revenues declined by 1.9%. See Section 3 for more detail.

Changes in Reported Business volumes and revenue by format

7.18 Below we consider the year-on-year variances in letters and large letters volumes and revenues (including retail and access), other items (including unaddressed, election and international mail) and parcels (both retail and access). Page 10 of the interactive data shows longer-term historic trends.[123]

Figure 7.3: Letters/large letters, parcels and other volumes and revenues



[123] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

* Adjusted to 52 weeks

*** Other products mainly consist of international, election and unaddressed mail*

Letters/large letters revenues and volumes

7.19 Combined letter/large letter volumes reduced by 8.8% in 2018-19 compared to 5.1% in the prior year. Revenues decreased by 5.7% in 2018-19 compared to 3.6% in the prior year. As discussed above e-substitution, business uncertainty and GDPR account for declining letter and large letter volumes and revenues.[124]

Parcels revenues and volumes

7.20 Reported Business parcel volumes[125] increased by 7.4% in 2018-19 compared to 4.1% in the prior year, while revenues grew by 6.8% in 2018-19 compared to 4.0% in the prior year. This was the highest parcel volume growth for Royal Mail since 2013.

7.21 As discussed above, this was due to Royal Mail's targeting of fast-growing sectors such as online clothing retailers and new features like estimated delivery times and the extension of customer LATs. In addition, Domestic Account parcels also performed well in 2018-19, as Royal Mail gained new customers and additional traffic from existing ones.[126]

Other revenues and volumes

7.22 Other volumes (which mainly consist of unaddressed letters[127], election and international mail) decreased by 6.9% in 2018-19. Unaddressed letter volumes decreased by 7.5% as Royal Mail had lapped a period of strong growth in the prior year due to initiatives that encouraged incremental volume growth. International letter and parcel volumes declined at a rate of 3.2%. This was due to export letter volumes being impacted by business uncertainty, e-substitution and a competitive international environment. This was partially offset by growth in import parcel volumes which continued to benefit from Royal Mail's cross border initiative.[128]

7.23 Other revenues increased by 3.4% in 2018-19. This is mainly driven by a 3.6% increase in international letter and parcel revenues, due to growth from the Asia into Europe cross-border initiative. This was partially offset by decline in unaddressed letter revenues of

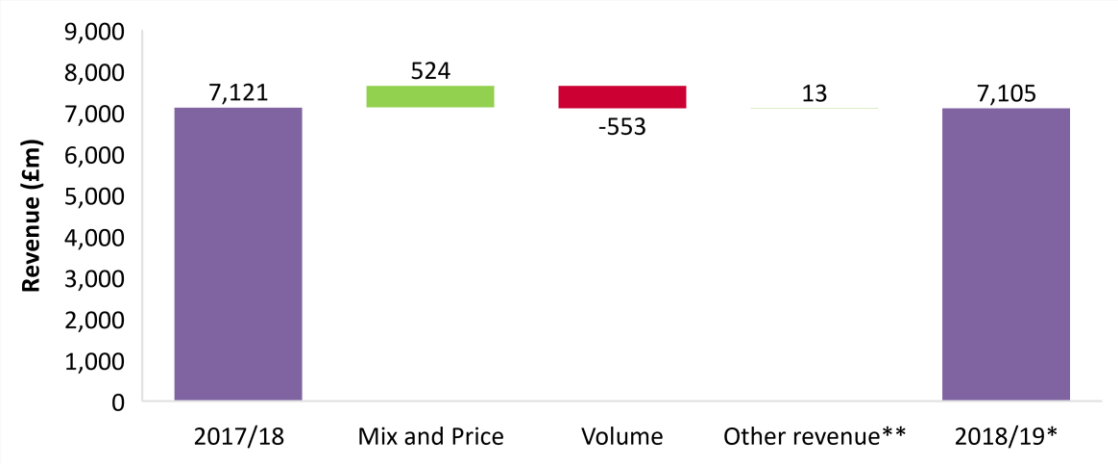
[124] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42.
[125] Parcel volumes are based on Royal Mail's definition of parcels and include RM 24/28 large letters, some fulfilment letters and large letters and are therefore not directly comparable to the parcel market volumes collected by Ofcom and reported in Section 4.
[126] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41 -42.
[127] Addressed mail is mail which is either addressed to a specific individual or to a generic recipient (for example, 'to the occupier'). All other mail is categorised as unaddressed mail.
[128] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 41-42

4.0%, as Royal Mail had lapped a period of strong growth in the prior year because of initiatives that encouraged incremental volume growth.[129]

Impact of change in mix of format on Reported Business revenues

7.24 We have undertaken some high-level analysis to ascertain how much of the overall change in total Reported Business revenue in 2018-19 was due to a change in mix of format, price and volumes.

Figure 7.4: Contributions of mix, price and volumes to total revenue change



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

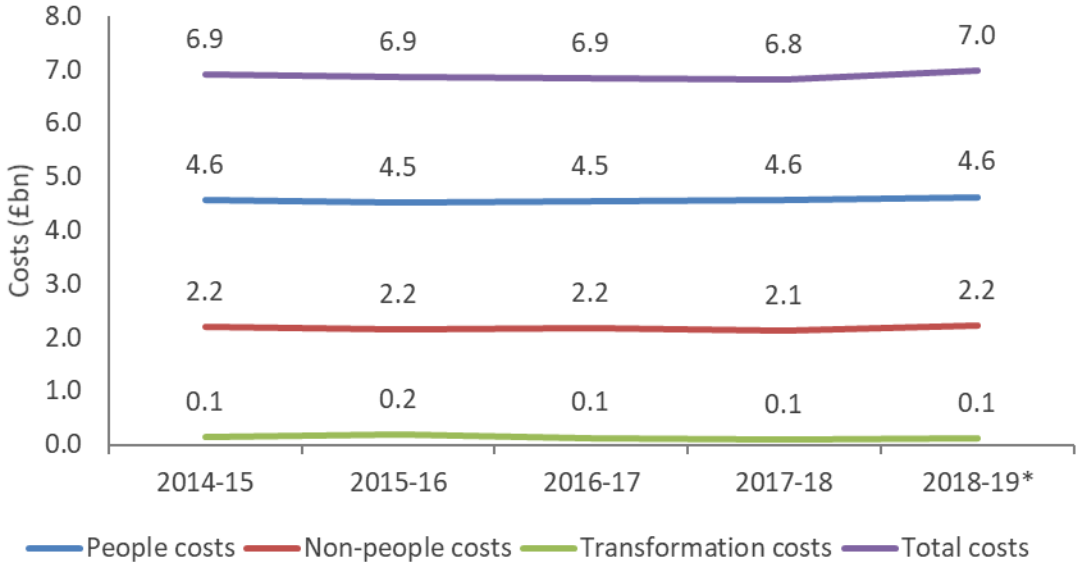
** Adjusted to 52 weeks*
*** Other revenue consists of inter-company charges*

7.25 Our analysis[130], set out in Figure 7.4 above, shows the relative contributions of changes in price together with mix and volume towards the decrease in total revenue. Overall, the shift in mix from letters to higher AUR parcels had a positive impact on total revenue. Furthermore, the increase in letter and business mail prices caused total revenues to increase marginally. However, this was not enough to offset the negative impact on revenue from letters volume decline.

[129] Ibid
[130] The analysis looks at the drivers behind the change in total revenue between 2017-18 and 2018-19. This is calculated with reference to the overall change in revenue for end to end inland, access and international letters/large letters, end to end inland, access and international parcels, unaddressed mail and other. The calculation is undertaken in two steps: a) to estimate the impact of changes in mix and price, the 2017-18 total volumes were used alongside the 2018-19 change in average unit revenue (which accounts for changes in prices and mix i.e. the proportion of letters/large letters compared to parcels and other); and b) to estimate the impact of the volume decline, total volume was scaled to reflect 2018-19 total volumes along with the 2018-19 prices and mix.

Reported Business costs

Figure 7.5: Reported Business costs[131]



Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

** Adjusted to 52 weeks*

7.26 Costs, including transformation costs, for the Reported Business rose by 2.6% in 2018-19 to £7.0bn. These costs can be broken down into people costs, non-people costs and transformation costs. The breakdown of costs by these categories is shown in Figure 7.5 above and we note that:

- People costs132 – increased by 1.2% to £4.6bn*. According to Royal Mail this was mainly driven by the frontline and manager pay award. The frontline pay award consisted of a 5% salary increase, backdated from October 2017 in accordance with the Pensions, Pay and Pipeline Agreement133 (equivalent to an annual pay increase of 2.5% in 2018-19). Furthermore, Royal Mail incurred costs related to overtime and casual resource in order to cover the Shorter Working Week134; high levels of sick absences; and at the start of 2019, adverse weather conditions. In addition, the

[131] People costs are adjusted to reflect the cash cost of the defined benefit pension scheme rather than the accounting charge.
[132] Adjusted to reflect the cash cost of the defined benefit pension scheme rather than the accounting charge.
[133] As part of the Pensions, Pay and Pipeline Agreement, the Royal Mail Pension Plan (RMPP) closed in March 2018. This avoided an increase in annual cash contributions of around £800m according to Royal Mail's estimation
[134] In 2017-18, Royal Mail agreed a pay deal with the CWU which resulted in 5% pay award from October 2017 to March 2019, a further annual pay rise of 2% from April 2019 and a one-hour reduction in hours worked for the same pay i.e. the Shorter Working Week from October 2018.

implementation of LATs for certain account parcels also led to incremental people costs. This was offset by lower management bonus costs as Royal Mail missed its threshold profitability level.135

- Non-people costs – increased by 4.9% to £2.2bn*. This was mainly driven by an increase in infrastructure costs informed by a review of the recoverable amounts of intangible assets136 which led to the write-off of the historic cost of these intangible assets. In addition to this, management decided to write-off the historic cost of letter sorting machines which are to be decommissioned (i.e. increased impairment costs) due to the higher than expected decline in letter volumes. Technology costs also increased due to the implementation of data projects and upgrade to IT systems. In addition, distribution and conveyance costs increased due to higher vehicle repair costs, higher fuel costs and increased terminal dues.137
- Transformation costs – increased by 18.9% to £0.1bn* in 2018-19. This was mainly driven by higher project costs to support future productivity improvements and the cost avoidance programme. These mainly consisted of data projects to support future productivity improvements, investment to upgrade IT and parcel systems. Voluntary redundancy costs were also higher due a reduction in management headcount across support and central functions.138

Reported Business profit margin

7.27 In considering the financial sustainability of the universal postal service, we are required to take into account the need for the universal service provider to be able to earn a reasonable commercial rate of return in connection with its provision of the universal service.[139] In our March 2012 and 2017 Statements on the postal regulatory framework[140], we concluded that an earnings before interest and tax (EBIT) margin range of 5-10% was indicative of a reasonable commercial rate of return.

7.28 We noted that if the forecast EBIT margin was above 5% or showed an increasing trend that exceeds 5% over the forecast period, then the indications are that the Reported Business is financially sustainable. We said that, if this was not the case – for example if the forecast EBIT margin stayed consistently below 5% or had a decreasing trend taking it below 5% – then there may be indications that the universal postal service faced financial sustainability issues in the long term. However, concerns about financial sustainability may not arise if, for example, the EBIT margin went below 5% for a short period due to specific circumstances which may be addressed by Royal Mail, without affecting its longer-term

[135] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 42
[136] Intangible assets are non-monetary assets which are without physical substance and identifiable e.g. franchise licences, customer listing, software and brands.
[137] Royal Mail PLC, Annual Report and Financial Statements for the full year ended 31 March 2019, page 42-43.
[138] Ibid
[139] Section 29(4) of the Postal Services Act 2011.
[140] Ofcom, 2017. Review of the Regulation of Royal Mail, paragraph 3.60.
https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf.

financial sustainability.[141] We use this range as one factor that leads us to monitor Royal Mail's long-term prospects more closely.

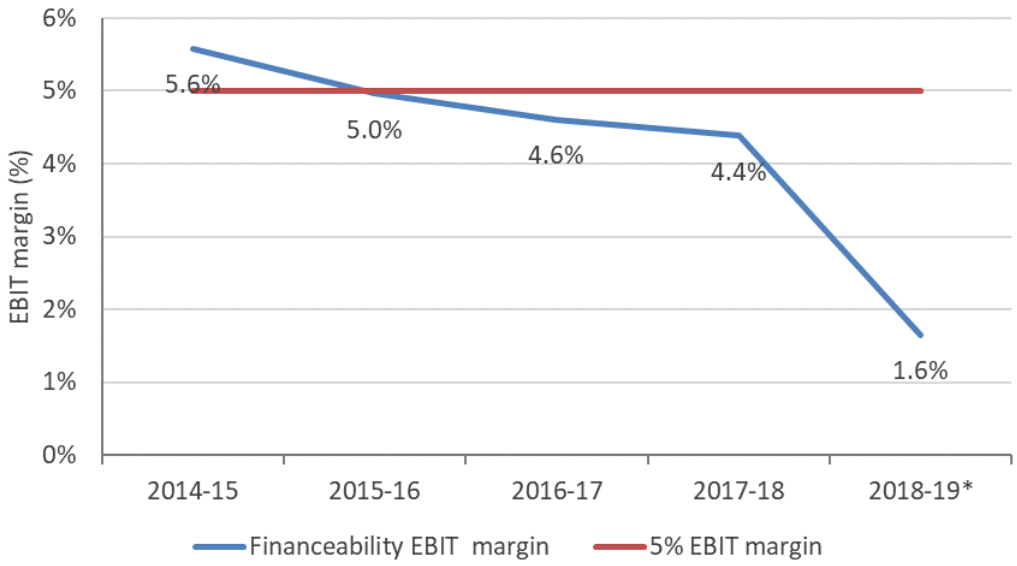
7.29 Additionally, in considering the financial sustainability of the universal service provider and its ability to earn a reasonable commercial rate of return, we also have regard to efficiency. Progress on efficiency is key to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.

7.30 As in the past, we refer to our particular measure of EBIT margin, which we use as part of our financial sustainability assessments, as the financeability EBIT.[142]

7.31 In the March 2017 Statement,[143] we confirmed our decision to continue calculating the financeability EBIT margin by deducting transformation costs[144] and restating pension costs on a cash basis.[145] In 2018-19, the accounting pension rate was 18.9% (compared to 41.1% in 2017-18) whereas the cash pension rate was 15.6% (compared to 17.1% in 2017-18).[146] The changes to accounting and cash pension rate were as a result of the closure of the Royal Mail Pension Plan (see paragraph 6.4). We have reported on the financeability EBIT margin in each of our annual monitoring updates since 2013-14.[147]

[141] Ofcom, 2016. Review of the Regulation of Royal Mail, A6.92. https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf.
[142] Ibid, paragraph A6.8.
[143] Ofcom, 2017. Review of the Regulation of Royal Mail, paragraph 3.46. https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf.
[144] Transformation costs are restructuring or redundancy costs which are likely to recur year-on-year and are not considered to be exceptional costs. Exceptional costs are considered to be large and uncommon (non-recurring) costs. See Ofcom, 2012. Securing the Universal Postal Service, paragraph 5.41 and footnote 69. https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.
[145] In the 2014 Review of End-to-End Competition Statement, we said it was appropriate to adjust Royal Mail's Reported Business EBIT margin to restate pension costs on a cash basis (i.e. the rate the contributions are actually paid at), rather than the rate calculated using the accounting standards. We considered that this methodology takes account of the true cost of pensions and we refer to this EBIT margin measure as the 'financeability EBIT margin'. See Ofcom, 2014. Review of end-to-end competition in the postal sector, page 15. https://www.ofcom.org.uk/__data/assets/pdf_file/0024/31956/end-to-end.pdf
[146] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 48.
[147] For more explanation of this approach please see earlier annual monitoring updates, in particular Paragraph 6.6 in the 2014-15 Annual monitoring update on the postal market: https://www.ofcom.org.uk/__data/assets/pdf_file/0025/56923/annual_monitoring_update_2014-15.pdf.

Figure 7.6: Reported Business financeability EBIT margin

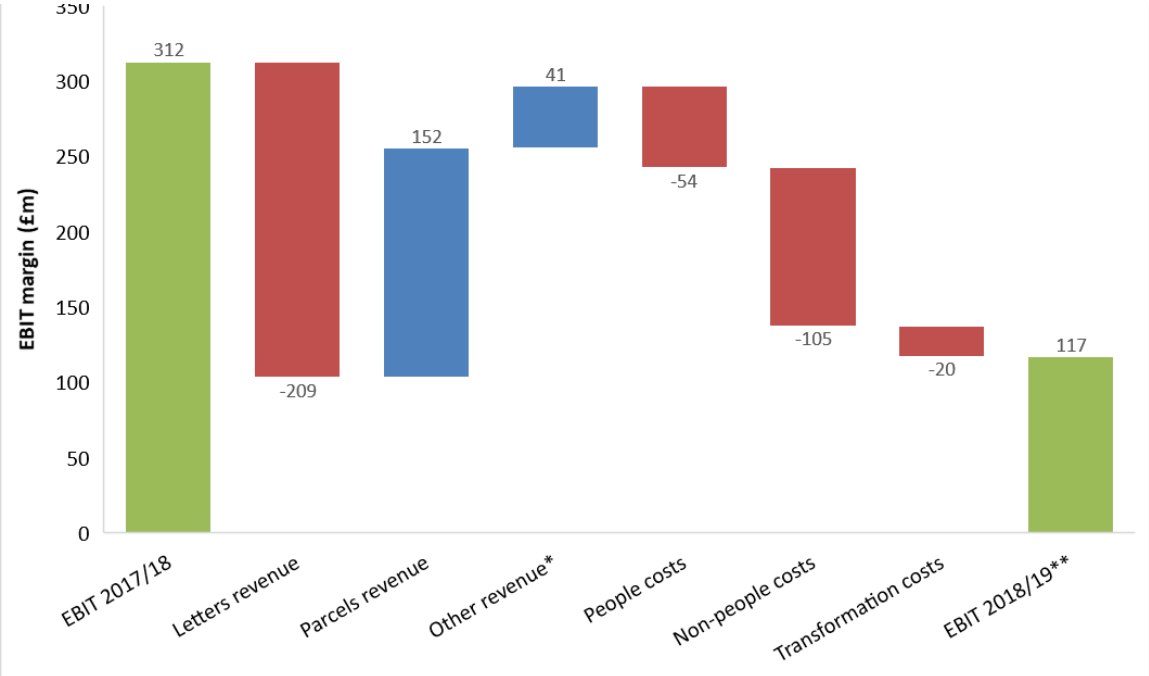


Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

**Aadjusted to 52 weeks *Aadjusted to 52 weeks*

7.32 Figure 7.6 above shows that the 2018-19 financeability EBIT margin of 1.6% is below the 5-10% range[148] and is substantially lower than the prior year margin of 4.4%.

Figure 7.7: Reported Business financeability EBIT margin breakdown



[148] The range that we consider to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.

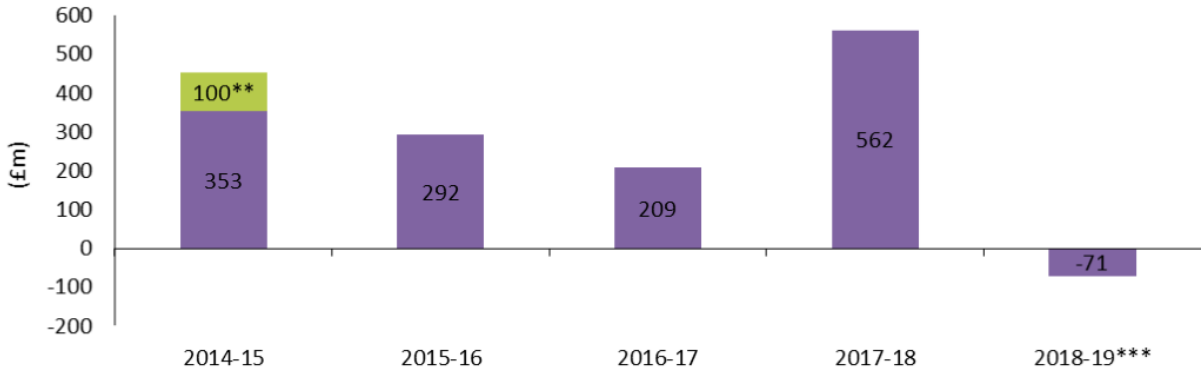
Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.

** Other revenue consists of revenue from unaddressed letters, international letters and parcels, and inter-company charges*
*** Adjusted to 52 weeks*

7.33 Figure 7.7 above breaks down the decrease in profitability year-on-year. As seen from the graph, the decrease in the EBIT margin was mainly driven by the decrease in letter revenues not being offset by the increase in parcels revenues, while costs increased significantly year-on-year (see paragraph 7.26).

Royal Mail Group's cash flow

Figure 7.8: Royal Mail Group free cash flow*



Source: *Source: Royal Mail Regulatory Financial Statements, unaudited submissions from Royal Mail and Ofcom analysis.*

** Free cash flow: net cash flow before financing activities (except finance costs paid), less the net cash purchase/sale of financial asset investments, including profit on disposal of properties*

*** Relates to a one-off disposal of a property in the London property portfolio, separately restated in Royal Mail's 2015-16 statutory accounts*

**** 53-week year (unadjusted)*

7.34 Cash flow is also an important component in ensuring the financial sustainability of the universal service. In 2018-19, free cash flow of the Royal Mail Group decreased by 112.6% to an outflow of £71m. The main drivers for this were the acquisition of Dicom Canada by GLS of £212m; the cash payment of the 2017-18 frontline pay award occurring in the 2018-19 financial year; and the 53rd week in 2018-19, which led to cash outflows in the form of an additional payroll and VAT payments.[149]

[149] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 50-51.

7.35 Despite the fall in free cash flow in the year, Royal Mail Group had a significant cash headroom[150] of £1.1bn as at 31st March 2019.[151] This cash can be drawn upon depending on business needs.

Financial health metrics and the viability statement

7.36 In the March 2017 Statement,[152] we confirmed our decision to supplement the approach we had previously used for considering sustainablity with consideration of a wider range of financial health metrics and indicators such as Standard & Poor's (S&P) credit rating, including Funds from Operations (FFO)/Adjusted Net Debt, and borrowing covenants assessed at Royal Mail Group level.

7.37 FFO/Adjusted Net Debt is one of the key metrics that S&P uses in order to assess the credit worthiness of Royal Mail Group. As part of its assessment, S&P reviews Royal Mail Group's historical and forecast performance against a number of metrics including FFO/Adjusted Net Debt. Royal Mail has also informed us that this is a key metric that it monitors.

7.38 S&P's latest credit research affirmed Royal Mail Group's credit rating at BBB as it considered the outlook stable based on Royal Mail Group's FFO/Adjusted Net Debt being above 45% (see Figure 7.9 below) in an operating environment that will remain difficult. S&P believed that the company will have sufficient cash headroom at the current rating level to pursue moderate business diversification opportunities and to mitigate volume risk, which is worsened by its high level of fixed costs. They also considered that Royal Mail will continue to successfully manage its transformation programme and productivity improvements to ensure a sustainable profitability enhancement.[153] S&P categorised Royal Mail Group as modest risk from a financial risk viewpoint as its FFO/Adjusted Net Debt percentage was above 60%.[154]

7.39 As at 31st March 2019, Royal Mail Group had a revolving credit facility provided by a syndicate of banks which it uses for general corporate and working capital purposes. The total undrawn committed borrowing facility with the syndicated credit facility amounts to £1.05bn, of which £952m expires in March 2022 and £98m in March 2020..[155] Since the year end Royal Mail have renegotiated its revolving credit facility, see paragraph 7.48 below.

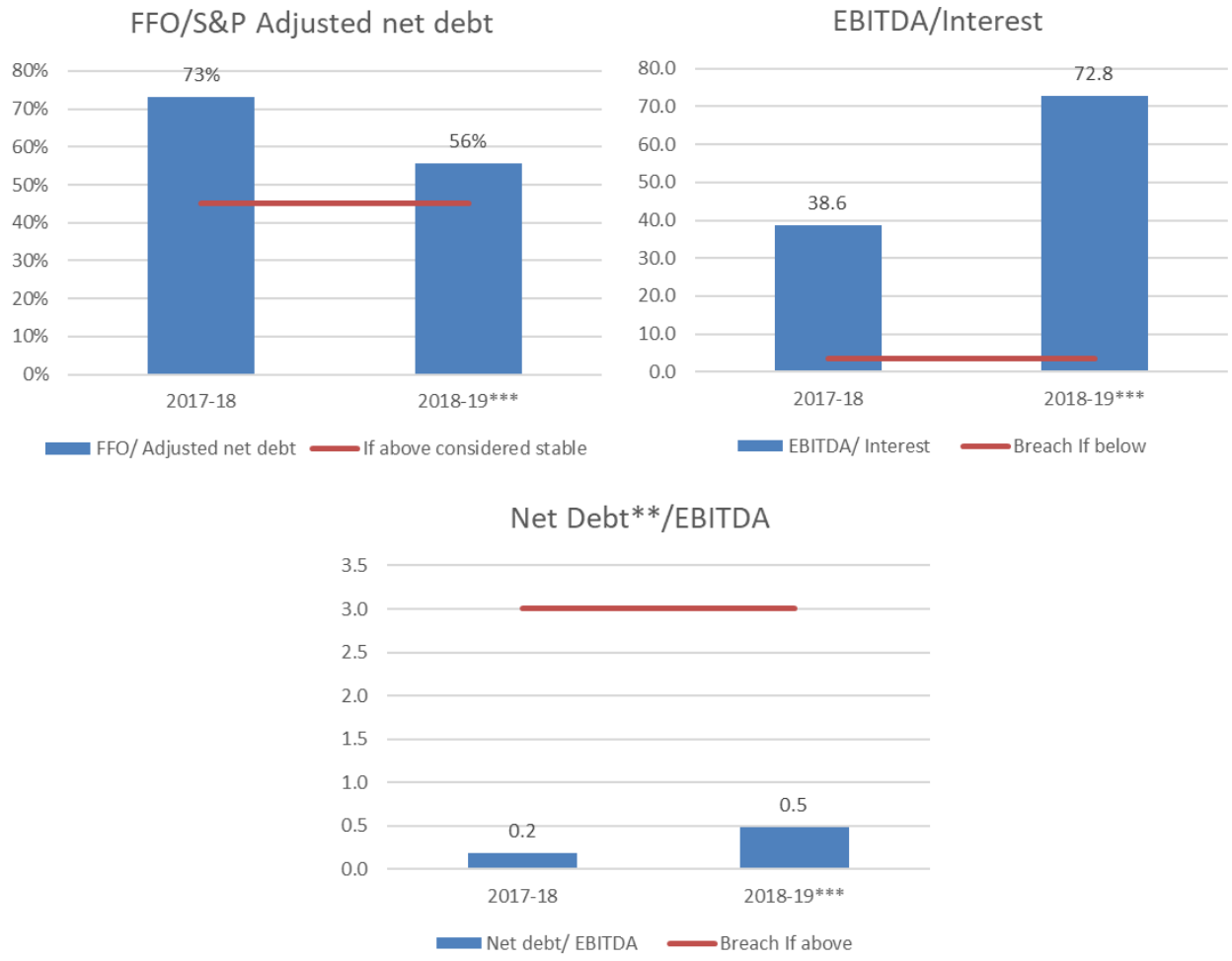
7.40 The Net Debt/EBITDA (leverage ratio) and EBITDA/Interest (interest cover) metrics are used as financial covenants relating to Royal Mail Group's syndicated credit facility. The leverage ratio metric helps assess Royal Mail Group's ability to repay its debts using its

[150] The cash headroom is the difference between the available cash resources and required cash resource i.e. total undrawn committed borrowing facility less the amount utilised plus the available cash less the loan-to-value (LTV) constraint.
[151] See paragraph 7.39
[152] Ofcom, 2017. Review of the Regulation of Royal Mail, paragraph 3.63.
[153] Alacra Store, 2019. S&P Global Ratings' Credit Research: Royal Mail Plc. http://www.alacrastore.com/s-and-p-credit-research/Royal-Mail-PLC-2281986
[154] S&P Ratings Direct, 2013. Corporate methodology, page 35. https://www.spratings.com/scenario-builder-portlet/pdfs/CorporateMethodology.pdf.
[155] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 195.

operating profits (measured before non-cash elements of depreciation and amortisation). It broadly represents the number of years of annual profit required to repay all of the company's net debt. The interest cover metric is used to assess how easily Royal Mail Group can pay interest on its outstanding debt. Royal Mail Group's banking covenants require leverage ratio to remain below 3 and its interest cover to remain above 3.5.

7.41 Royal Mail Group passed its banking covenant tests in 2018-19 (as shown in Figure 7.9 below).

Figure 7.9: Financial health metrics



Source: S&P Ratings Direct and Royal Mail Annual Report and Accounts (page 195)

**S&P make certain adjustments to Royal Mail's reported net debt. S&P ratings methodology can be found on its website.*

*** Net debt is adjusted for letters for credit for bank covenant purposes. This differs from S&P's calculation of net debt.*

**** 53-week year (unadjusted)*

7.42 In addition to the above health metrics, we stated we would also have regard to Royal Mail Group's Viability Statement as published in its Annual Report and Financial Statements.

Under the 2014 Corporate Governance Code, directors are required to make a statement that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. In order to do this, they must take into account the company's current position and principal risks.

7.43 In its Annual Report and Financial Statements for the year ended 31 March 2019, Royal Mail Group explained that it stress-tested the key assumptions within its detailed annual forecasts and projected performance over the next three years and quantified these risks to create a downside scenario. Key risks considered by the Directors included potential industrial action, deteriorating economic and market conditions, a no deal Brexit and increased competition in the UK parcels sector. The downside scenario took into account committed capital and expenditure as well as other short-term costs and cash actions which would mitigate the impact of risks (e.g. reducing variable hours and cost of sales, removing discretionary pay, reducing internal investment and suspending the acquisitions programme). The downside scenario was tested to determine whether the Group would remain solvent. Based on the results of their analysis, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2022.[156]

Summary and recent events

7.44 In summary, the key trends for the 2018-19 financial year were:

- Reported Business addressed letter volumes and revenues declined by 7.3% and 0.1% respectively in 2018-19 on a 52-week basis due to e-substitution, business uncertainty and GDPR. This was in line with Royal Mail's revised expectations of a 7-8% decline.
- Parcel volumes and revenues grew by 7.4% and 6.8% respectively year-on-year, largely driven by new contract wins in Domestic Account parcels, Royal Mail's targeting of fast-growing sectors, new features like estimated delivery times and the extension of LATs.
- Reported Business revenues continued to decline by 0.2% as the structural decline in letter volumes was not offset by increasing parcels revenue.
- Reported Business costs increased by 2.6% year-on-year due to an increase in non-people costs of 4.9%, an increase in transformation costs of 18.9%, and an increase in people costs of 1.2%. Cost reductions and efficiency analysis are covered in more detail in Section 6.
- As a result of the trends noted above, the financeability EBIT margin decreased from 4.4% to 1.6% in 2018-19 on a 52-week basis.
- Free cash flow turned negative to £71m. As at 31 March 2019, Royal Mail Group had access to c. £1.1bn of funds from its undrawn banking facilities.

[156] Royal Mail PLC, 2019. Annual Report and Financial Statements for the full year ended 31 March 2019, page 73.

- Royal Mail Group's FFO/S&P adjusted net debt of 56% in 2018-19 exceeds the 45% threshold which is considered to be stable by S&P. It also passed its banking covenant tests in 2018-19.
- In Royal Mail Group's Viability Statement, the Directors have said they have reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2022.

7.45 As explained above, the financeability EBIT margin for 2018-19 was 1.6% on a 52-week basis. This is below prior year of 4.4% and the 5-10% range, which we consider as indicative of a reasonable commercial rate of return and one factor that leads us to monitor Royal Mail's long-term prospects more closely. Profitability for 2018-19 was down from the prior year mainly due to lower letters revenue and higher costs.

7.46 However, we consider that the universal service is likely to be sustainable in the immediate future. This is because up to now the Reported Business has been profitable, and despite possible profitability challenges in the 2020-21 financial year as indicated by Royal Mail in its half-year results (see below), the Group's financial health metrics do not indicate any short-term financial health issues. Ultimately the sustainability of the universal service rests on the long-term prospects for the Reported Business.

7.47 In May 2019, Royal Mail set out its five-year strategy, which envisaged a Group revenue growth of 2-3% per year from 2019-20 to 2023-24.[157] Royal Mail's strategy has a strong focus on parcels, which is in line with the strategy of comparable operators internationally to transform their operations from a letters to a parcels business.[158] If the implementation of the new strategy proceeds as Royal Mail foresees, Royal Mail expects its UK business to return to revenue growth by 2023-24.[159]

7.48 In September 2019, Royal Mail renewed its revolving credit facility (overdraft loan facility provided by a syndicate of banks). The total undrawn facility has been revised down from £1,050m to £925m. The maturity date of the facility has been extended to September 2024 with options to extend for a further two years. In addition, on 8 October 2019, Royal Mail issued €550m of Guaranteed Notes with an interest rate of 1.25% with a maturity date of 8 October 2026. This is in addition to its current €500m Eurobond with an interest rate of 2.375% and maturity date of 29 July 2024. The issue of the bond has increased Royal Mail Group's cash headroom. The main purpose of the revolving credit facility is to provide certainty of funding over the period of the new strategy, whilst the bond provides diversity of funding for the Group and to prefund the additional capital expenditure required under the new strategy.

[157] The 2-3% growth per year is calculated on a Compound Annual Growth Rate (CAGR). See Royal Mail, 2018-19 results and strategy presentation, slide 43: https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf

[158] For instance postal operators in the Netherlands, Denmark and Sweden have widely introduced parcel automation

[159] Royal Mail reports that between 2015-16 and 2018-19 (on a 52-week basis), UKPIL revenues declined from £7,671bn to £7,595bn (-0.3%). Slide 36, Royal Mail's 2018-19 results and strategy presentation, https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf

7.49 We note that Royal Mail's strategy is subject to some risks, notably the outcome of discussions between management and unions on how this will be delivered, as well as broader market and macro-economic risks which could affect Royal Mail's ability to grow parcel revenues at the rate envisaged and/or suppress overall levels of demand for letters and parcels.

7.50 In its half-year results announcements, Royal Mail noted that transformation is running behind schedule and is likely to impact productivity in the second half of the year. Royal Mail also revised its forecast for the full year's letter volume decline, expecting letter volumes to decrease by 7-9% in 2019-20, instead of 5-7% as previously forecast. Royal Mail stated that, combined with the industrial relations situation and lower than anticipated productivity gains, its UK business is expected to be break-even or loss making in 2020-21.

7.51 Therefore, we believe that uncertainty remains about the longer-term sustainability of the universal service. As in previous year, and in relation to efficiency, we will continue to monitor the sustainability of the universal service, and engage with management to understand better how they plan on mitigating the risks to the sustainability of the universal service.

8. Regulatory compliance

8.1 In this section we discuss Royal Mail's compliance with its regulatory obligations.

8.2 As part of its role as the designated universal service provider, Royal Mail is subject to a set of minimum requirements and service standards in the provision of universal services. These include: maintaining daily delivery (to all UK addresses) and collection (from all access points)[160] of letters (six days a week) and parcels (five days a week), providing services at affordable prices under uniform public tariffs to all UK addresses, meeting performance standards for First and Second Class deliveries, and reporting on the most common causes for complaint.

8.3 As noted in our March 2012 Statement, in addition to matters relating to Royal Mail's financial sustainability, we monitor:

- prices of universal service products, with particular focus on any impact on vulnerable groups and those that rely on postal services. We discuss Royal Mail's price changes (as well as noting changes to non-price terms) within this section;
- the quality of service achieved by Royal Mail in the provision of universal services, to ensure that Royal Mail does not degrade quality, for instance in order to reduce costs (rather than reducing costs through improving efficiency). Our March 2012 Statement set out the quality standards that Royal Mail is required to meet to ensure that appropriate levels of universal service performance are maintained for consumers; and
- the complaint and compensation figures reported annually by Royal Mail.

Pricing of universal services

8.4 In March 2012, Ofcom removed the majority of price controls to give Royal Mail sufficient commercial freedom to enable it to return the universal service to a financially sustainable position. At the same time, we introduced a number of safeguards, including a cap on the price of Second Class stamps (for letters, large letters and parcels less than 2kg – see below), so that vulnerable consumers remain able to access a basic universal service.

8.5 While the majority of the analysis in this report relates to 2018-19, the pricing information detailed below focuses on Royal Mail's pricing announcements for 2019-20, which is in line with previous monitoring updates.

[160] As defined at section 29(11) of the Postal Services Act 2011: "'access point' means any box, receptacle or other facility provided for the purpose of receiving postal packets, or any class of postal packets, for onwards transmission by post."

Royal Mail increased its prices in 2019-20 but most parcel prices fell in real terms

8.6 Royal Mail changed its prices for 2019-20 on 25 March 2019. Page 3 of the interactive data shows historic trends in prices for letters and large letters, and page 4 shows historic trends for parcel prices.[161]

Standard letter stamp and meter prices

8.7 First Class stamp prices rose by 3p to 70p (a 4.5% increase), and meter[162] prices rose by 4p to 64p (a 6.7% increase), in nominal terms. This was a larger increase than last year when stamp prices rose by 3.1% and meter prices rose by 5.3% in nominal terms. This was also a real terms price increase compared with last year (from 2018-19 to 2019-20).[163] The First Class stamp price rose by 2.2% in real terms, and the meter price rose in real terms by 4.3%, which is a larger increase than last year.[164]

8.8 Second Class stamp prices rose by 3p to 61p and meter prices rose by 3p to 47p. This represents a real terms increase of 2.8% for stamp prices and 4.5% for meter prices, both greater than last year.

Figure 8.1: Standard letter First and Second Class stamp and meter prices and price rises for 2019-20 (nominal terms)

[161] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

[162] Metered mail refers to a method of payment or payment channel for Royal Mail services where customers pre-pay for postage and apply an impression to the envelope, label or wrapper using a franking machine licensed by Royal Mail.

[163] Real terms is the increase in nominal terms minus any increase in price from inflation at 2.3% for 2018-19 calculated as a yearly average based on the ONS CPI calculations.

[164] In 2018-19, the First Class stamp price rose by 0.2% and the First Class meter price rose by 2.4% (in real terms).

Stamp	70p	3p (4.5%↑)	61p	3p (5.2%↑)
Meter	64p	4p (6.7%↑)	47p	3p (6.8%↑)

Source: Royal Mail price lists.[165] Prices and price rises for 2018-19 to 2019-20 are in nominal terms.

8.9 First Class meter prices for letters moved closer to First Class stamp prices this year, as Royal Mail increased First Class meter prices by 1p more than stamp prices. The differential for Second Class letters has stayed the same at 14p and for First Class has decreased from 7p to 6p.

Large letter stamp and meter prices

8.10 There are four weight steps for large letters: 0-100g, 101-250g, 251-500g and 501-750g. Prices rose in real terms for large letters across all weight steps in 2019-20 compared to the previous year.

8.11 The average First Class stamp price for large letters[166] rose in real terms by 3.3%, and the average meter price rose by 4.2%. As a result, the weighted average price for First Class stamps and the weighted average price for First Class meter mail were both £1.24. As these are weighted averages, the weighted average price of £1.24 reflects not only the price differences but also the volumes of different weight steps for large letters sent using stamp and meter; on balance, meter prices are generally lower than stamp prices. Across First Class products, compared with last year, the largest nominal price rise was 15p, which applied to metered large letters weighing 501-750g.

8.12 The average Second Class stamp price for large letters rose in real terms by 2.6% and the average meter price rose by 4.4%. The weighted average price for Second Class stamps was £1 and for metered mail was 96p. Across Second Class products, compared with last year, nominal prices rose between 4p and 12p, with the largest price rise of 12p applying to metered large letters weighing 501-750g.

[165] For price lists see: Royal Mail, 2019. Franking prices from 25 March 2019. https://www.royalmail.com/sites/default/files/royal-mail-franking-wallchart--25-march-2019.pdf. For price changes see: Royal Mail, 2019. Prices 2019. https://www.royalmail.com/prices2019.

[166] We have calculated a weighted average price using 2018-19 volumes across the four weight steps for large letters. To do so, we have taken the volume for each weight step and multiplied this by the price for that weight step. We have then added this result (for each weight step) together and divided it by the total volumes (across each weight step).

Figure 8.2: Large letter First and Second Class stamp and meter prices and price rises for 2019-20 (nominal terms)

Large Letter Product	Stamp		Meter	
First Class 0-100g	£1.06	5p (5.0% ↑)	£1.01	6p (6.3% ↑)
First Class 101-250g	£1.50	10p (7.1% ↑)	£1.40	9p (6.9% ↑)
First Class 251-500g	£1.97	10p (5.3% ↑)	£1.85	11p (6.3% ↑)
First Class 501-750g	£2.72	12p (4.6% ↑)	£2.59	15p (6.1% ↑)
Second Class 0-100g	£0.83	4p (5.1% ↑)	£0.77	5p (6.9% ↑)
Second Class 101-250g	£1.32	6p (4.8% ↑)	£1.09	7p (6.9% ↑)
Second Class 251-500g	£1.72	8p (4.9% ↑)	£1.41	8p (6.0% ↑)
Second Class 501-750g	£2.33	11p (5.0% ↑)	£1.98	12p (6.5% ↑)

Source: Royal Mail price lists.[167] Prices and price rises for 2018-19 to 2019-20 are in nominal terms.

8.13 For 2019-20, the differential between stamp and meter prices ranges from 5p to 35p depending on the type of product, and rises with the increase in product size. There is a greater differential between stamp and meter prices for Second Class products, and it was generally the case that Royal Mail made greater price increases for meter prices compared to stamp prices for both First and Second Class.[168]

Parcel Prices

8.14 Since March 2016, Royal Mail has offered two prices for each parcel product that it provides within the universal service, depending on whether postage is purchased via an online account or at the Post Office. Purchase of parcel postage via an online account is between 5p and 10p cheaper than purchase via the Post Office. The price differences can be seen in Figure 8.3 below, along with the price rises for 2018-19 to 2019-20.

[167] For price lists see: Royal Mail, 2019. Prices 2019 and Royal Mail, 2019. Business price guide. https://www.royalmail.com/sites/default/files/Business-Price-Guide-September-2019.pdf. For price changes see: Royal Mail, 2019. Prices 2019.

[168] However, First Class 101-250g and Second Class 251-500g were exceptions to this rule.

Figure 8.3: Royal Mail parcel prices and price rises for 2019-20 (nominal terms)

Parcel product	Post Office price		Royal Mail online account price	
First Class 0-1kg small	£3.55	10p (2.9% ↑)	£3.48	10p (3.0% ↑)
First Class 0-1kg medium	£5.80	5p (0.9% ↑)	£5.73	5p (0.9% ↑)
First Class 1-2kg small	£5.50	0p (0.0%)	£5.45	0p (0.0%)
First Class 1-2kg medium	£8.95	0p (0.0%)	£8.90	0p (0.0%)
Second Class 0-1kg small	£3.00	5p (1.7% ↑)	£2.90	5p (1.8% ↑)
Second Class 0-1kg medium	£5.10	5p (1.0% ↑)	£5.00	5p (1.0% ↑)
Second Class 1-2kg small	£3.00	5p (1.7% ↑)	£2.90	5p (1.8% ↑)
Second Class 1-2kg medium	£5.10	5p (1.0% ↑)	£5.00	5p (1.0% ↑)

Source: Royal Mail price list, March 2019.[169] Prices and price rises for 2018-19 to 2019-20 are in nominal terms.

8.15 In order to ensure a consistent comparison with prior years, we have used Post Office prices in the interactive data accompanying this report.[170]

8.16 In 2019-20, most Post Office and online account parcel prices rose by 5p in nominal terms. As in previous years, Second Class small and medium parcels up to 2kg are priced by size rather than weight, costing the same in the 0-1kg and 1-2kg weight steps.

8.17 However, prices fell in real terms for all parcel products excluding First Class 0-1kg Post Office and online small parcel products which rose by 0.6% and 0.7% above inflation respectively. The largest reduction in price applied to First Class small and medium parcels weighing 1-2kg (2.2%).

[169] For price lists see Royal Mail, 2019. Online prices. https://www.royalmail.com/sites/default/files/royal-mail-our-online-prices-march-2019-47652473.pdf and Royal Mail, 2019. Franking prices from March 2019. https://www.royalmail.com/sites/default/files/royal-mail-franking-wallchart-25-march-2019-40966280.pdf

[170] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

Safeguard caps in 2018-19

8.18 Ofcom introduced the safeguard cap for Second Class products in 2012. There are two safeguard caps in place for stamp prices, the basket cap for Second Class large letters and small and medium parcels up to 2kg,[171] and the cap for Second Class standard letters.

8.19 In March 2017, we concluded that the safeguard caps should be retained as an affordability measure, to ensure that consumers (in particular vulnerable consumers) continue to have access to a universal service at affordable prices.[172] In 2018-19, we reviewed the levels of the caps, publishing our decision in January 2019. We decided:

- to maintain the basket cap at its current level.173 Royal Mail is currently pricing the products within the baskect cap at 30.1% below the level of the cap.
- to amend the Second Class standard letters cap to 65p, a 5% real terms rise, which would take effect on 1 April 2019.

8.20 Both the Second Class basket cap and the Second Class letter cap will increase by CPI inflation on the 1st of April each year, until they expire on 31 March 2024.[174]

8.21 In February 2019 Royal Mail announced that it would be raising the price of a Second Class letter stamp by 3p to 61p on 25 March, exceeding the price cap of 60p which was due to stay in place until 1 April. Ofcom has determined that there are reasonable grounds for believing Royal Mail contravened its obligations under DUSP condition 2.2.2 by charging over the maximum price for Second Class standard letters, from 25 March 2019 to 31 March 2019, and issued a notification to that effect.

8.22 Royal Mail has made representations to Ofcom and we are carefully considering these; we expect to make a decision on the next steps shortly.

Affordability of universal services

8.23 One of the key safeguards in the current regulatory framework is ensuring that universal postal services are affordable. In March 2013 we published a report[175] which set out that we considered that universal postal services remained affordable in 2012 and 2013 for both residential consumers (including low income and other vulnerable consumers) and businesses (including small and medium businesses). Since then we have been monitoring the affordability of postal services through the responses to questions in our postal tracker surveys and where appropriate through reviewing Office for National Statistics (ONS) data.

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[171] The level of the basket cap is calculated using a weighted average.
[172] Ofcom, 2017. Review of the Regulation of Royal Mail, March 2017, paragraphs 3.178-9, 4.44-6.
[173] Ofcom, 2019. Review of the Second Class Safeguard Caps 2019. https://www.ofcom.org.uk/__data/assets/pdf_file/0019/133660/Statement-Review-of-the-Second-Class-safeguard-caps-2019.pdf.
[174] It is open to Ofcom to make a change before 31 March 2024 if necessary.
[175] Ofcom, 2013. The affordability of universal postal services. https://www.ofcom.org.uk/__data/assets/pdf_file/0014/10445/affordability.pdf.

8.24 We remain of the view that postal services are currently affordable for most residential consumers. As noted in Section 5, 60% of residential consumers surveyed were satisfied with the cost of postage.[176] The majority also agree that First and Second Class stamps are good value for money (65% and 56% of residential respondents respectively).[177]

8.25 However, a minority (9%) of respondents to our postal tracker survey reported that they had had to reduce their use of postage stamps to afford essentials like food or heating in the previous three months.[178] Those cutting back on essentials to afford stamps typically spend more than average on postage.

8.26 A higher proportion of younger people said they reduced their use of postage stamps to afford essentials compared to the older respondents: 11% of 16-24 year olds and 13% of 25-44 year olds compared with 7% of 45-64 year olds, 5% of 65-74 year olds and 3% of 75+ year olds.

8.27 While we consider that universal service products are currently affordable for most residential consumers, we will continue to monitor respondents' views regarding affordability. As noted in our review of the affordability of universal postal services in 2013, there are some circumstances where a consumer could be at risk from not being able to afford these services. This reflects very particular circumstances and severe financial hardship and it is likely that consumers in such circumstances would unfortunately have concerns about the prices of universal postal services, even at much lower prices.[179]

8.28 Separately, Citizens Advice published a research report in August 2018 about the affordability of redirections.[180] Royal Mail provides a redirection service in the UK for consumers moving house which enables mail to be rerouted to their new address.[181] Citizens Advice highlighted that the price of redirections has increased substantially, more than the prices of First and Second Class stamps. According to their research, 21% of consumers found the service too expensive or not worth the money, and 8% of consumers wanted to use redirections but could not afford it.[182]

8.29 Citizens Advice suggested a number of changes including concessionary rates for consumers with low incomes and a change in the cost of mail redirections from a 'per surname' to a 'per household' basis. From 25 March 2019 Royal Mail have changed the

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[176] Ofcom, Residential Postal Tracker Q3 2018-Q2 2019, QG3_7: "How satisfied are you with the following aspects of Royal Mail's service? Cost of postage".
[177] Ofcom, Residential Postal Tracker Q3 2018-Q2 2019, QF4. We can tell you that a First Class stamp for a standard letter currently costs 67/70p. How would you rate Royal Mail's First Class service in terms of value for money? QF5. We can tell you that a Second Class stamp for a standard letter currently costs 58/61p. How would you rate Royal Mail's Second Class service in terms of value for money?
[178] Ofcom, Residential Postal Tracker Q3 2018-Q2 2019, QF1_1: "In the last 3 months have you had to… Reduce your use of postage stamps so that you can afford essentials like food or heating?"
[179] Ofcom, 2013. The affordability of universal postal services, paragraph 6.3.
[180] Citizens Advice, 2018. A new redirection? How to make mail redirections fairer and more affordable for consumers. https://www.citizensadvice.org.uk/Global/CitizensAdvice/Post%20and%20Telecoms/Mail%20Redirection%20Research%20Report%20FINAL%20(5).pdf.
[181] Consumers pay an upfront fee, and there are three packages available: £33.99 for up to 3 months, £46.99 for up to 6 months, and £66.99 for up to 12 months.
[182] Citizens Advice, 2018. A new redirection?, Figure 5.

way redirections are priced, charging a 'lead applicant' fee and an 'additional person' fee, rather than on a per surname basis. Royal Mail have also introduced a concession scheme for those who rent and are on certain benefits.[183] We will continue to monitor the affordability of this service.

Non-price terms of universal services

8.30 As part of our monitoring regime, we also consider the impact of non-price changes to the terms of universal services, which involve changes to Royal Mail's Postal Schemes.

8.31 Postal Schemes set out the terms and conditions of postal services for consumers and business customers who use Royal Mail's services but who do not hold an individual contract with Royal Mail. Customers who use stamps, online postage or franking meters to pay for Royal Mail services do so under a Postal Scheme rather than a contractual arrangement. Details of the Postal Schemes are available on Royal Mail's website.[184]

8.32 Before making changes to the Schemes, Royal Mail must consult customers and stakeholders, including Ofcom, and the consumer advocacy bodies, including Citizens Advice. This must occur at least one month before the date on which Royal Mail proposes to implement the change.

8.33 During 2018-19, Royal Mail made one change to non-price items. In April 2018, Royal Mail confirmed its decision to implement changes to its Schemes to reflect the new data protection legislation GDPR.[185]

8.34 We further note that in August 2019, in the context of the Offensive Weapons Act 2019, Royal Mail made proposals to prohibit bladed items, including knives, to be delivered using its universal service postal products. Its consultation closed on 12 September, with Royal Mail stating that it will evaluate responses before finalising its decision.[186]

8.35 We will continue to monitor any changes Royal Mail makes to non-price terms of universal services.

Quality of Service

8.36 Royal Mail is subject to annual quality of service (QoS) targets. We monitor its performance against these targets so that we can take prompt and appropriate action, where we consider it necessary to do so, if we identify failures.

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[183] Royal Mail, 2019. Redirection Pricing Guide 25 March 2019. https://www.royalmail.com/sites/default/files/royal-mail-redirection-pricing-guide-25-march-2019.pdf.
[184] Roayl Mail. Non-contract terms and conditions. https://www.royalmail.com/non-contract-terms-and-conditions/.
[185] Royal Mail, 2018. Royal Mail decision: Changes to postal schemes to reflect new data protection legislation. https://www.royalmailgroup.com/media/9751/gdpr-decision-final.pdf.
[186] Royal Mail, 2019. Royal Mail Consultation on Postal Schemes covering changes to the carriage of bladed items due to changes in legislation. https://www.royalmailgroup.com/media/10884/royal-mail-consultation-on-bladed-articles-final.pdf.

8.37 Figure 8.4 summarises Royal Mail's performance in 2018-19 and, for comparison, 2017-18, against the QoS targets we have set.[187] Page 6 of the interactive data shows historic trends for each target below.[188]

Figure 8.4: Quality of Service Summary[189] [190]

KPI	Target		2018/19 Result	2017/18 Result	Change from prior year
First Class delivery	**93.0%**	Items delivered day after collection	**91.5%** ✗	91.6% ✗	▼
Second Class delivery	**98.5%**	Items delivered within 3 days of collection	**98.6%** ✓	98.4% ✗	▲
Post Code Area (PCA)1 Target: First Class single piece mail	**118/121** PCAs	91.5% items delivered day after collection	**75/121** ✗	72/121 ✗	▲
PCA Target (with confidence interval)	**118/121** PCAs	91.5% items delivered day after collection	**105/121** ✗	96/121 ✗	▲
Special Delivery	**99.0%**	Items delivered next delivery day	**98.2%** ✗	98.1% ✗	▲
European International Delivery	**85.0%**	Items delivered in 3 days	**86.6%** ✓	85.2% ✓	▲
Collection points: 6 days per week	**99.9%**	Collection points served	**99.85%** ✗	99.39% ✗	▲
Delivery routes: 6 days per week	**99.9%**	Delivery routes completed	**99.55%** ✗	98.88% ✗	▲
Correct delivery: 6 days per week	**99.5%**	Items correctly delivered	**99.76%** ✓	99.74% ✓	▲

Source: Royal Mail Quality of Service Reports[191], Year End Adjusted 2017-18 and 2018-19

[187] The figures cited in this subsection are taken from the Quality of Service reports submitted to Ofcom by Royal Mail and do not include any adjustments that Royal Mail makes to account for force majeure events, such as very severe weather.
[188] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports
[189] Descending or ascending arrows: Royal Mail performance declined or improved compared with last year, respectively. Green or red arrows: Royal Mail met/exceeded the target, or did not meet the target, respectively.
[190] The post code area is the largest geographical postcode unit and forms the initial characters of the alphanumeric UK postcode.
[191] Royal Mail. Quality of service. https://www.royalmailgroup.com/en/about-us/regulation/quality-of-service/. [Last accessed 17.11.19]

Royal Mail missed key quality of service targets in 2018-19 and we launched an investigation

8.38 Royal Mail is required to deliver 93.0% of all First Class retail items (single piece stamp, meter and PPI[192] letters and parcels) on the next working day after collection, and 98.5% of all Second Class retail items within three days of collection.[193]

8.39 Royal Mail did not meet its target for First Class in 2018-19, for the second year running. Royal Mail reported delivering 91.5% of First Class items next day, missing the target by 1.5%. However, Royal Mail met its Second Class delivery target of 98.5%, achieving a performance of 98.6%, an improvement of 0.2pp relative to the prior year.

8.40 The Post Code Area (PCA) target requires Royal Mail to deliver 91.5% of First Class mail the day after collection from a postbox, Post Office or other collection point, to 118 of the 121 postcode areas.[194] Royal Mail's performance has increased slightly compared to the previous year, but it is still meeting the target in only 75 PCAs, compared to 72 PCAs in 2017-18. Of the 43 PCAs where Royal Mail did not meet the target, 30 were within the margin of error associated with the survey used to calculate performance. Therefore, Royal Mail was within the confidence error margin or above the target level (91.5%) in 108 of the 118 postcodes where the PCA target applies.[195]

8.41 Royal Mail did not meet its Special Delivery target. This has been the case since Ofcom first began monitoring Royal Mail's performance in 2011-12, but performance has improved relative to last year by 0.1 pp.

8.42 Performance against the European International Delivery target improved compared with last year, although overall performance fell from 95% in 2011-12 to 86.6% in 2018-19. It remains above the required performance level of 85%.

8.43 Royal Mail exceeded its requirement to ensure at least 99.50% of items are correctly delivered, achieving 99.76%. It did not meet the target for completing 99.90% of delivery routes on each working day, a target Royal Mail has only successfully completed once (in 2017-18) since 2010-11 . Royal Mail did not achieve its target to ensure that at least 99.90% of collection points are served each day, achieving 99.85%, which was an improvement on 2017-18.

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[192] Printed Postage Impressions, or PPIs, is a printed alternative to a postage stamp or franking to indicate that postage has been (or will be) paid. These are not included in our assessment of PCA targets, which relate only to stamped and metered postal items (see paragraph 8.39).

[193] These targets are set below 100% to allow for commonly experienced circumstances that may arise in the transportation, processing and delivery of mail, for example disruption to aircraft flights due to bad weather or missed network connections due to road traffic delays and breakdowns.

[194] The HS (Hebrides), KW (Kirkwall, Orkney) and ZE (Shetlands) post code areas are excluded from this target, principally because logistically it is not practical to achieve a next day service for 91.5% of First Class mail sent from across the UK to these remote destinations. In addition, these offshore areas are more frequently subject to weather-related disruption of ferry and air services.

[195] The confidence error margin describes the range within which there is a 95% probability of the true result occurring.

8.44 These QoS targets aim to ensure people receive a good, reliable service from Royal Mail. We closely monitor its performance throughout the year and can take action if it fails to meet these standards. Overall, quality of service performance increased from 2017-18 to 2018-19.

8.45 In 2018-19 we investigated Royal Mail's failure to meet quality of service targets in 2017-18. We concluded that Royal Mail had contravened DUSP condition 1.9.1 by not meeting specified performance targets associated with First Class mail delivery during 2017-18.[196]

8.46 We are currently investigating Royal Mail's compliance with the First Class and Post Code Area targets in 2018-19 and expect to publish a decision in early 2020.[197]

Competition Act findings

8.47 In August 2018 we published a Decision fining Royal Mail £50 million for abusing its dominant position in bulk mail delivery services, contrary to EU and UK competition law. In our Decision, we found that Royal Mail had pursued a deliberate strategy of pricing discrimination targeted at TNT (now Whistl), which was its only major competitor in end-to-end bulk mail delivery services.

8.48 In October 2018 Royal Mail appealed against our Decision to the Competition Appeal Tribunal. On 12 November 2019 the Competition Appeal Tribunal handed down its judgment dismissing Royal Mail's appeal in its entirety. A copy of the judgment can be found on the Tribunal's dedicated webpage.

8.49 At the time of writing Royal Mail has confirmed that it has asked for permission to appeal the Competition Appeal Tribunal judgement in the Court of Appeal.[198]

Complaints data

8.50 Ofcom requires Royal Mail, as the universal service provider, to publish an annual report setting out the number of complaints received in each financial year and the amount of compensation paid in relation to those complaints. It is also required to report the top ten categories of complaint.

Complaints

8.51 Page 7 of the interactive data[199] contains the top ten categories of complaint to Royal Mail since 2013-14 in further detail.

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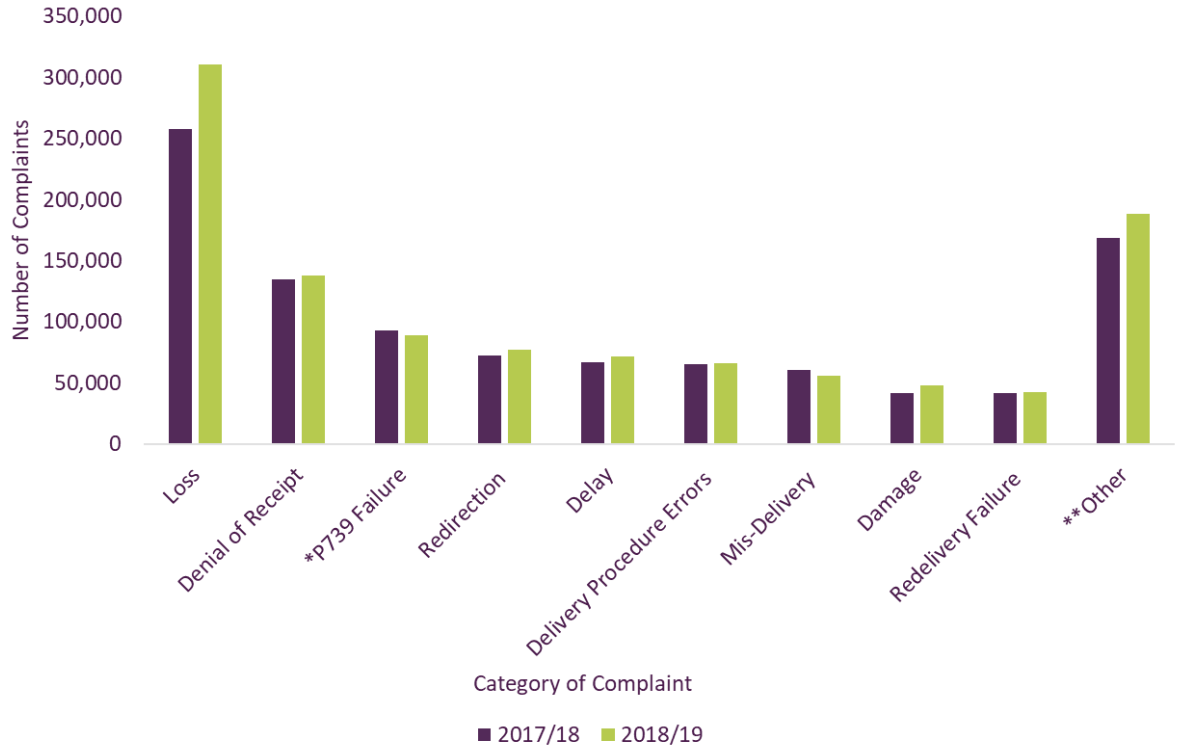
[196] Ofcom, 2019. Decision to conclude investigation into Royal Mail's compliance with its quality of service performance standards in 2017/18. https://www.ofcom.org.uk/__data/assets/pdf_file/0015/152241/decision-non-confidential-royal-mail-quality-of-service-17-18.pdf.

[197] Ofcom, 2019. Investigation into Royal Mail's quality of service performance in 2018/19, open case. https://www.ofcom.org.uk/about-ofcom/latest/bulletins/competition-bulletins/open-cases/cw_01244. [Last accessed 17.11.19]

[198] https://otp.tools.investis.com/clients/uk/royal_mail_group/rns/regulatory-story.aspx?cid=2414&newsid=1350106

[199] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports

Figure 8.5: Royal Mail's top ten complaint categories, 2018-19 compared to 2017-18



Source: Royal Mail[200]

**A P739 form is issued by a postal worker when a customer is not at home, or is otherwise unable to receive an item of mail at the delivery address.*

***Other refers to any complaints that do not fall into the top ten and includes a number of categories.*

8.52 Overall complaint volumes increased to 1,120,559 in 2018-19, representing an increase of 7.3% from 2017-18.[201] There was an increase in complaints in all of the top ten complaint categories except for P739 and mis-delivery which both saw small decreases.

8.53 Loss continues to account for the highest proportion of complaints (27.7%) which was an increase of 3.1% from last year. The second largest specific category, denial of receipt, increased in terms of volume of complaints but decreased as a proportion of overall complaints by 0.6%. Complaint numbers for denial of receipt increased by 2.1% year on year, increasing from 134,712 in 2017-18 to 137,499 in 2018-19.

[200] Royal Mail, 2019. Annual Consumer Complaints and Compensation Report 2018-19. https://www.royalmailgroup.com/media/10814/royal-mail-annual-consumer-complaints-2018-19.pdf and Royal Mail, 2018. Annual Consumer Complaints and Compensation Report 2017-18. https://www.royalmailgroup.com/media/9998/royal-mail-annual-consumer-complaints-2017-18.pdf.

[201] The total number of complaints in 2017/18 was 1,044,522. This has been calculated by adding the complaints recorded in each category.

Compensation

8.54 Royal Mail is required to provide compensation on a fair and reasonable basis where a customer experiences loss, delay or damage in relation to certain universal postal services.

8.55 When compensation was given, the average compensation paid per complaint increased by less than £1 to £23.14. The total number of complaints where compensation was paid increased by 4.8%. Total compensation paid by Royal Mail rose 26.3% from last year, to approximately £9.8 million.

8.56 We will continue to examine complaints and compensation data on an ongoing basis as part of our monitoring programme.

Exceptions to the universal service

8.57 Royal Mail is required to collect and deliver letters six days a week, and parcels five days a week, to all UK addresses as part of the universal service. Ofcom takes exceptions to this requirement seriously.

8.58 We have put rules in place setting the circumstances which we consider to be exceptional and in which Royal Mail's universal service obligations do not need to be met. These include health and safety of postal staff, security of mail, and access difficulties.[202]

8.59 To provide transparency, we require Royal Mail to publish an annual report of the addresses of the delivery points (at postcode area-level) in relation to which exceptional circumstances have persisted for 12 months or more and the relevant circumstances.[203] A total of 3,485 delivery points were reported by Royal Mail as subject to exceptional circumstances in its June 2019 annual report, meaning that they are not able to receive deliveries to the frequency required under the universal service obligation.[204] However, there are around 30 million delivery points in the UK, so excepted delivery points represent a very small proportion of the total footprint.[205] People can appeal decisions made by Royal Mail to suspend deliveries to their property. Under our rules, Royal Mail considers stage one and stage two appeals. If the issue remains unresolved, consumers can make a stage three appeal to Ofcom for a final decision.[206]

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[202] Ofcom, 2013. Direction relating to exceptions to the postal deliveries Universal Service Obligation and approval of alternative delivery points. www.ofcom.org.uk/__data/assets/pdf_file/0023/78314/statement_delivery_exceptions.pdf; and https://www.ofcom.org.uk/__data/assets/pdf_file/0033/79656/statement_collections_exceptions.pdf

[203] Royal Mail's most recent Annual Delivery Exceptions Report (published in June 2019) is available here: www.royalmailgroup.com/media/10813/uso-delivery-exceptions-over-12-months-publish-june-2019.pdf.

[204] Reported delivery exceptions may include delivery points that receive deliveries but on fewer days a week than required under the universal service obligations. This might be the case where an excepted delivery point is on an island where there is a ferry service only on certain days of the week. Reported delivery exceptions would also include delivery points where daily deliveries are made but to an alternative delivery point (i.e. to a secure box on the perimeter of an address rather than to a building where there may be access difficulties).

[205] Royal Mail. Deliver public. https://www.royalmail.com/deliverpublic3 [Last accessed 16.12.19]

[206] Royal Mail explains the delivery exceptions policy and the appeals process on its website here: https://personal.help.royalmail.com/app/answers/detail/a_id/277/~/delivery-exceptions

8.60 Royal Mail is also required to publish an annual report of the collection points (typically postboxes or post offices) in relation to which exceptional circumstances have persisted for 12 months or more, and the relevant circumstances preventing the collection of letters (six days a week) and parcels (five days a week) from these locations. In its June 2019 report 1,748 collection points were subject to such exceptions.[207] There are around 115,000 postboxes and 11,500 Post Offices across the UK, so the number subject to exceptions represents a very small proportion of the total number of access points.[208]

8.61 We will continue to monitor levels of both exceptions to delivery and collection as part of our wider monitoring programme.

Summary

8.62 Royal Mail's Quality of Service (QoS) performance improved on nearly all measures against the previous year and they met their Second Class target. However, Royal Mail still failed to meet most of its QoS targets in 2018-19. We are currently undertaking an investigation into Royal Mail's compliance with the First Class and Post Code Area targets during 2018-19.

8.63 Royal Mail increased its prices in January 2019, but in real terms the price of most of its parcel products fell. Most residential consumers we surveyed are satisfied with the cost of postage, and we continue to be of the view that the universal service remains affordable.

8.64 Ofcom provisionally found that Royal Mail breached the Second Class letter safeguard cap between 25 March 2019 when its new prices applied, and 31 March 2019 when the new cap took effect.

8.65 Customer complaints increased by 7.3% compared with 2017-18 levels, with loss of mail representing the biggest share of complaints.

[207] Royal Mail, June 2019. Annual Collection Exceptions Report. https://www.royalmailgroup.com/media/10810/uso-collection-exceptions-over-12-months-2019.pdf

[208] Royal Mail, 2019. Annual report and financial statements 2018-19.

A1. Summary of Royal Mail reporting requirements

A1.1 The following table sets out the financial information reporting requirements and relevant deadlines applicable to Royal Mail as the universal service provider.

Table A1.1: Regulatory financial reporting submissions and deadlines

Submissions	Submission deadline
Annual regulatory accounts *Including income statement, statement of capital employed, and cash flow statement of Reported Business; reconciliation of Relevant Group accounts to Reported Business accounts; Product Profitability Statements (PPSs, proposed to be access products and PAF only); and accompanying notes to include Cost Matrix and PVEO Analysis*[191]	90 days after Financial Year end
Annual cost and volume input and output data at SPHCC level	90 days after Financial Year end
Quarterly regulatory accounts *Including income statement of Reported Business; PPSs (proposed to be access and PAF only); and accompanying notes proposed to include Cost Matrix*	54 days after Financial Quarter end
Quarterly revenue and volume report	54 days after Financial Quarter end
Quarterly cost metrics report *Including RDT to workload bridge*	54 days after Financial Quarter end
Quarterly revenue, volume and cost granular data submission	54 days after Financial Quarter end
Management Accounts for the Board for the 6th and 12th Financial Month of the Financial Year	54 days after Financial Month end
Second Class safeguard caps submission	One month after the implementation of any new prices