



Department for  
Business, Energy  
& Industrial Strategy

## Post Implementation Review of Part 3 and Part 4 of the Postal Services Act 2011

Presented to Parliament pursuant to Section 67 and Section 88 of the Postal  
Services Act 2011





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	<b>Date:</b> 28/12/2017
	<b>Type of regulation:</b> Domestic
	<b>Type of review:</b> Statutory
<b>RPC Opinion: Green</b>	

### 1. What were the policy objectives of the measure?

The intended objectives of Part 3 and Part 4 of the Act are:

1. To secure an efficiency and financially sustainable universal postal service.
2. Subject to this, to ensure that the postal services market is competitive and delivering good outcomes for consumers and other users of postal services.

The Act aims to achieve the objectives by creating an effective regulatory regime for postal services

### 2. What evidence has informed the PIR?

The review is informed by two main sources of evidence:

1. Evidence submitted by Royal Mail, other postal services operators, Ofcom and other stakeholders (eg Citizens Advice).
2. Evidence obtained from existing sources of evidence including Ofcom's annual monitoring reports, Ofcom's Review of the Regulation of Royal Mail and Royal Mail's annual reports and accounts.

### 3. To what extent have the policy objectives been achieved?

The Act is meeting its objectives of securing the financial sustainability of the universal postal service and has made good progress towards its other objectives:

- Royal Mail's reported business (the network that delivers the USO) has gone from being loss-making to profitable in each of the five financial years since the Act was introduced. The current EBIT margin of the reported business is 4.6%, just outside the 5-10% range that Ofcom considers consistent with a reasonable commercial rate of return.
- Efficiency savings within Royal Mail have contributed to this improvement. The regulatory regime provides strong incentives for Royal Mail to find efficiencies and we expect that further efficiencies will be made in future.
- Following changes to letter and parcel prices in 2012, subsequent letter price rises have been relatively small and parcel prices have fallen in recent years. Investment, delivery quality and consumer satisfaction have all risen while complaints have fallen.
- Competition has increased since 2011 in parcel delivery and Royal Mail's competitors in the collection and sorting of letters have increased their market share. Competition has delivered significant benefits to users of postal services.
- The cost of regulating the sector has halved since the move from Postcomm to Ofcom.

***I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.***

Signed: 

Date: 02/05/2018

#### **4. What were the original assumptions?**

The main estimates made in the original impact assessment were that: (i) Royal Mail had made efficiencies averaging £120m per year from 2007-08 to 2009-10. This estimate assumed that 60% of Royal Mail's costs were fixed in the short run; (ii) Royal Mail would make efficiency savings averaging between £170m and £230m per year; and (iii) the cost of regulating the sector would decrease by 10% (equivalent to £0.8m per annum).

#### **5. Were there any unintended consequences?**

The only significant undesirable outcome linked to the new regulatory regime that our review identified is the exit of Whistl from the letter delivery market. In April 2012 Whistl entered the end-to-end letter delivery market and became the only major competitor to Royal Mail. In June 2015, following the announcement of changes to access pricing and terms and conditions by Royal Mail, Whistl announced that it was closing its end-to-end delivery operations following regulatory issues that according to Whistl "impacted on our ability to deliver a long term sustainable service." Following a complaint from Whistl, Ofcom launched an investigation into Royal Mail under the Competition Act 1998. In July 2015 Ofcom announced its provisional view which was that Royal Mail breached competition law by engaging in conduct that amounted to unlawful discrimination against postal operators competing with Royal Mail in delivery. We cannot comment further since this investigation is still ongoing however, since Whistl has left the market and there appears to be little prospect of future entry, this case provides evidence that the regulatory regime may not have been effective in supporting end to end competition.

#### **6. Has the evidence identified any opportunities for reducing the burden on business?**

The regulatory regime established by the Act imposes a significantly lower regulatory burden on postal operators than the previous regime operated by Postcomm. For example, it replaced Postcomm's licencing regime with a general authorisation approach. Our review did not highlight any major unnecessary burdens that the Act had imposed on Ofcom, Royal Mail, or other postal operators. There were suggestions that the burden of Ofcom's regulatory framework could be reduced further, particularly reporting requirements of the universal service provider. However, since Ofcom is already required to have regard to the need to keep regulatory activities proportionate and have the power to implement changes to the regulatory regime, we did not consider that changes to the Act are required. We will instead work with Ofcom and other stakeholders following this review to explore non-legislative options for simplifying the regulatory regime. The Secretary of State took the power under section 41 of the Act to direct Ofcom to impose a notification condition, requiring postal operators to notify Ofcom in advance if they intended to enter or expand letter delivery operations. Our review concluded that Ofcom's monitoring regime would identify material changes in operations and so the notification condition is no longer required. The Secretary of State will therefore direct Ofcom to remove the notification condition.

**7. For EU measures, how does the UK's implementation compare with that in other EU member states in terms of costs to business?** The Postal Services Act 2011 transposes the Postal Services Directive. The Act goes beyond the EU minimum requirements by specifying a 6 day per week letter delivery service (EU minimum is 5 days per week) and at uniform price (EU specifies 'affordable'). Going beyond EU requirements may increase the cost to Royal Mail of providing the universal postal service but also ensures a better service for businesses and consumers that rely on postal services. We do not believe there is a case for changing the specification of the universal service obligation at present. Ofcom is planning to monitor user needs more closely in future to help it assess whether the current specification of the universal postal service meets user needs or whether changes to it should be considered.

## Introduction

1. Section 67 and Section 88 of the Postal Services Act 2011 (“The Act”) require the Secretary of State to review Part 3 (the regulatory regime) and Part 4 (the special administration regime) of the Act five years after they came into force. The Act requires that the review:
  - a. sets out the objectives intended to be achieved by the regulatory system established by those provisions
  - b. assesses the extent to which those objectives have been achieved
  - c. assesses whether those objectives remain appropriate and, if so, the extent to which they could be achieved with a system that imposed less regulation
2. The Review does not cover Part 1 and Part 2 of the Act, which concern the privatisation of Royal Mail.

## Policy Background

3. The Act was introduced following Richard Hooper’s 2008 and 2010 reviews<sup>1</sup> of the postal services sector, which concluded that the universal postal service was under serious threat. In particular the 2010 review highlighted that:
  - a. there had been a 15% decline in postal volumes between 2005 and 2010 and it was expected that there would be a further 20% decline in letter volumes by 2015<sup>16</sup>.
  - b. Royal Mail made a pre-tax loss of £320m in 2009-10 and the Royal Mail accounting pension deficit had risen to £8bn in 2010.
  - c. Royal Mail was inefficient and needed to accelerate modernisation.
  - d. the regulatory regime was over-burdensome and no longer appropriate given the pressures facing the universal service.
4. To address these issues the Act facilitated the privatisation of Royal Mail; introduced a new regulatory regime and established Ofcom as the regulator of the postal services sector; and established a special administration regime to ensure the continued provision of the universal postal service should Royal Mail be at risk of entering insolvency proceedings.
5. The new regulatory regime is very different to the one operated previously by Postcomm. For instance, Ofcom has reduced price regulation on Royal Mail, granted Royal Mail greater operational freedom, and scaled back regulation of downstream access. Ofcom has also removed the requirement for postal services operators to be licenced and replaced licence conditions with general authorisation conditions.
6. The Act gives Ofcom a duty to secure the provision of the universal postal service and to have regard to the need for the universal postal service to be financially sustainable and efficient. Ofcom also has a primary duty under the Communications Act 2003 to further the interests of citizens and of consumers, where appropriate by promoting competition. If there is a conflict between these duties, Ofcom is to give priority to the duty to secure the provision of the universal postal service.

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<sup>1</sup> Modernise or Decline: Policies to maintain the universal postal service in the United Kingdom (2008) and Saving the Royal Mail’s universal postal service in the digital age (2010)

7. Ofcom meets these duties by:
  - a. setting the specifications of the universal service obligation, subject to the minimum specifications set out in the Act
  - b. monitoring Royal Mail's performance, in particular their efficiency, financial performance and performance against quality of service targets
  - c. regulating access to Royal Mail's delivery network to enable Downstream Access (DSA) operators to compete with Royal Mail in the collection and sorting of bulk mail
  - d. setting a cap on 2nd class stamp prices
  - e. enforcing competition law in the postal services sector
8. The current universal service obligation (USO) requires Royal Mail to collect and deliver letters 6 days a week (and parcels 5 days a week) nationwide at a uniform price. The specification of the USO is set by Ofcom but must meet the minimum requirements set out in the Act. These minimum requirements exceed those in the Postal Services Directive which requires a minimum 5 day per week, affordable letter delivery service.

## **Policy objectives**

9. The intended objectives of Part 3 and Part 4 of the Act (hereafter referred to as "The Act" for simplicity) are:
  - a. to secure an efficient and financially sustainable universal service
  - b. subject to this, to ensure that the postal services market is competitive and delivering good outcomes for consumers and other users of postal services
10. The Act aimed to meet these objectives by creating a more effective regulatory regime. In particular, it was hoped that the new regulatory regime would lead to:
  - a. a reduction in regulatory burdens
  - b. greater regulatory certainty to allow Royal Mail to focus more fully on modernisation and less time on seeking regulatory consents
  - c. a greater focus on competition law enforcement (unlike Postcomm, Ofcom has competition enforcement powers) to facilitate a reduction in ex-ante regulation
  - d. a reduction in the cost of regulation
11. This review assesses the effectiveness of the Act by considering the progress made against each of its two objectives. The review will also consider whether the four expected benefits of the new regulatory regime have been realised.
12. The review is informed by two main sources of evidence:
  - a. evidence submitted by Royal Mail, other postal services operators, Ofcom, and other stakeholders (e.g. Citizens Advice)
  - b. evidence obtained from existing sources of evidence including Ofcom's annual monitoring reports, its Review of the Regulation of Royal Mail and Royal Mail's annual reports and accounts

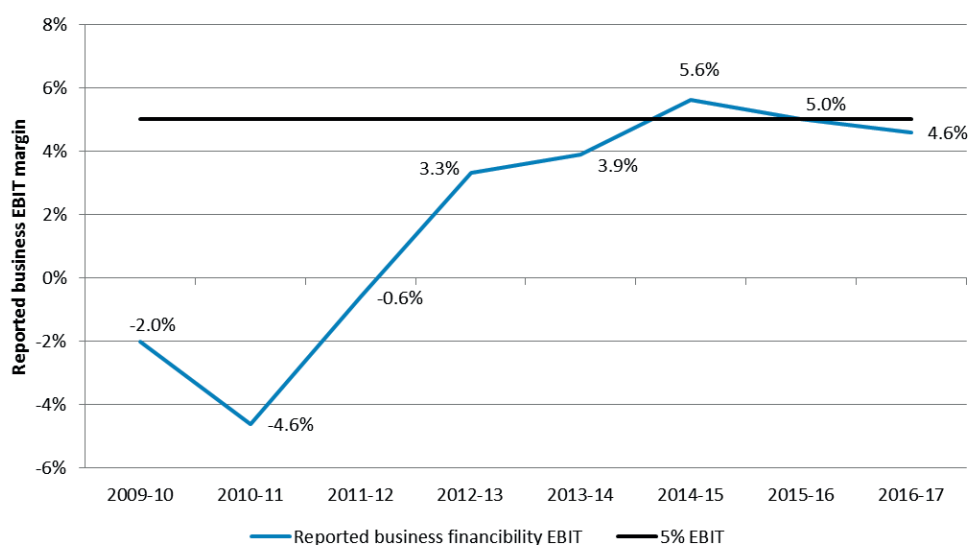


## Sustainability and efficiency of the universal postal service

### Financial sustainability of the universal postal service

13. The financial position of Royal Mail's reported business (the network that delivers the USO) has improved significantly following the introduction of the Act.
14. The main indicator that Ofcom use to assess the financial sustainability of the USO is the financeability EBIT margin<sup>2</sup> of Royal Mail's reported business. In 2011-12 (before any changes to the regulatory regime were implemented) the reported business was loss making and recorded an EBIT margin of -0.6%. The EBIT margin increased significantly following the introduction of the Act and now stands at 4.6%, just below the 5-10% range that Ofcom considers is consistent with a reasonable commercial rate of return.

Figure 1: EBIT margin of Royal Mail's reported business



Source: Ofcom

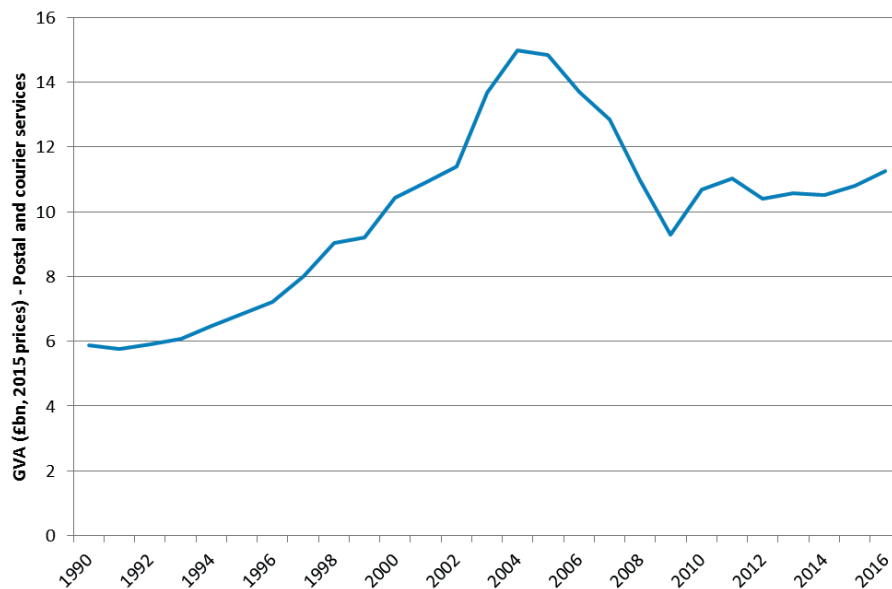
15. A large proportion of the improvement in EBIT margin can be attributed to the new regulatory framework. Under the previous Postcomm regime around 80% of Royal Mail revenues were subject to price control. In its March 2012 statement<sup>3</sup>, Ofcom removed almost all price controls on Royal Mail and chose to retain only a cap on 2<sup>nd</sup> class stamp prices (accounting for less than 10% of Royal Mail revenues). The relaxation of price controls was necessary to allow Royal Mail to earn a commercial rate of return and to thus secure the financial sustainability of the universal postal service and to attract private investment.
16. Another driver of the improvement in Royal Mail's financial performance has been growth in the parcel delivery market. The original Hooper review was conducted during a severe contraction in the sector which saw output fall 38% from its peak and which put huge pressures on Royal Mail's finances. Since then the parcels

<sup>2</sup> The financeability EBIT margin is a measure of profitability and is equal to earnings before interest payments and tax as a % of total revenue. The EBIT margin is adjusted to reflect Royal Mail's actual pension payments, which differ from the pension costs recorded under the relevant accounting standards.

<sup>3</sup> Securing the universal postal service: Decision on the new regulatory framework (2012), Ofcom

market has seen strong growth (driven by online retail) which has offset the decline in letters – for example, in the two years to 2016-17 parcel volumes grew by 20% while letter volumes contracted by 8%<sup>4</sup>. Consequently, the contraction in the postal services sector has ended and output has increased slightly since the Act was introduced, creating more favourable trading conditions.

Figure 2: Output in the postal services sector



Source: Office for National Statistics

17. Royal Mail has benefitted from these developments and report that their overall workload<sup>5</sup> has increased in the past two years and has been broadly flat since the Act was introduced<sup>6</sup>. Since 2011-12 Royal Mail's parcel volumes have increased by 15%, which have offset an 18% decline in letters<sup>7</sup>. Parcel revenues grew by 28% over the same period and now account for 44% of total revenue in Royal Mail's UK business (UKPIL).

18. As figure 3 shows, the initial improvement in Royal Mail's EBIT margin came from revenue growth rather than cost reduction. In 2012-13 revenues in Royal Mail's UKPIL division<sup>8</sup> increased by 8% (or £580m). Royal Mail has also made efficiency improvements over this period (these are discussed in more detail below) and these have contributed to the improvement in profitability. Cost reduction is likely to be more important for Royal Mail's financial performance in future since market conditions, in particular growing competition in parcels, have diminished Royal Mail's ability to profitably increase prices.

<sup>4</sup> Source: Ofcom annual monitoring updates on the postal market and Royal Mail annual reports

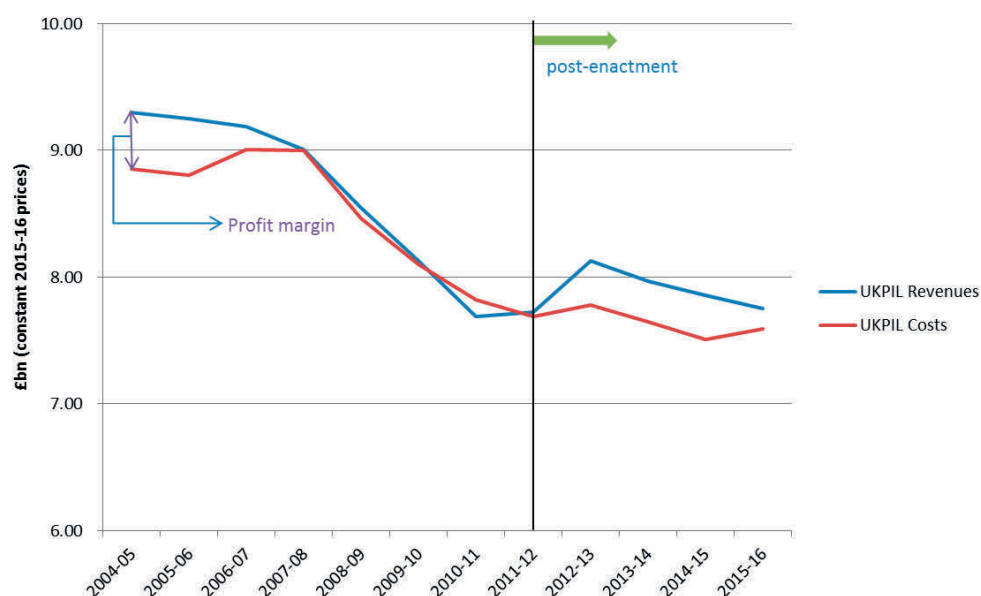
<sup>5</sup> Workload is a measure of total postal volumes. Volumes are weighted by the theoretical different amounts of time it should take to process and deliver letters, large letters and parcels.

<sup>6</sup> Royal Mail annual reports

<sup>7</sup> Ibid

<sup>8</sup> Royal Mail's UKPIL (UK parcels, international and letters) division primarily contains the reported business (i.e. the USO delivery network) and Parcelforce UK.

Figure 3: Royal Mail UKPIL financial performance



Source: BEIS analysis of Royal Mail annual reports.

19. Although the EBIT margin of Royal Mail’s reported business is slightly below the 5-10% range, the reported business is still profitable (operating profit was £330m in 2016-17 on a cash basis) and Ofcom has concluded that “the universal service is likely to remain financially sustainable in the immediate future”<sup>9</sup>.

20. Other indicators of financial sustainability also present a positive picture. For example, Ofcom report that Royal Mail’s 10-year €500 million bond was awarded an investment grade BBB credit rating by S&P<sup>10</sup>. S&P analysed Royal Mail’s ability to service its debt and found that in 2016-17 Royal Mail’s interest coverage rate was 53 (i.e. EBITDA was 53 times debt interest payments), net debt was 60% of EBITDA (below the 300% level required in Royal Mail’s debt covenants) and cash flow was around 70% of net debt (a level which S&P consider to be low risk). All of these indicators suggest Royal Mail’s credit risk is relatively low.

21. Royal Mail has highlighted that there are several downside risks to their financial sustainability, including increased pension costs, a slowdown in online retail, competition in parcels and e-substitution of letters. We acknowledge these risks and recognise that ensuring the financial sustainability of the universal postal service requires long-term planning to ensure that BEIS, Ofcom and Royal Mail are able to respond effectively to any deterioration in the financial performance of the universal service delivery network.

#### Efficiency of the universal postal service

22. The Hooper review was clear that price increases were not a long-term solution to sustainability. The Act was introduced with the intention of ensuring that greater efficiency is the main route through which Royal Mail improves its financial position.

<sup>9</sup> Annual monitoring update on the postal market 2016-17, Ofcom

<sup>10</sup> Annual monitoring update on the postal market 2015-16, Ofcom

23. At the time of the 2008 Hooper review, Royal Mail estimated that it was 40% less efficient than international comparators. Since the 2011 Act Royal Mail has spent over £1bn on its transformation programme and has made significant progress on some of these efficiency challenges identified in the Hooper review. In particular:

*Rationalisation of mail centres*

24. Royal Mail has reduced the number of mail centres from 64 in 2009-10 to 38 mail centres in 2016-17<sup>11</sup>, close to the 35 recommended in the Hooper review.

*Automation in delivery offices*

25. In 2010 only 8% of Royal Mail letters were sequenced by machine, compared to 85% for leading EU operators.<sup>12</sup> The most recent data shows that Royal Mail has closed the gap and that 83% of Royal Mail letters are now sequenced by machine<sup>13</sup>, compared to 90-95% for the leading EU operators.<sup>14</sup>

26. Data collected by Ofcom indicates that these investments have led to greater efficiency. Labour productivity in delivery and processing has increased by 5.6% from 2011-12 to 2014-15 which has translated into a reduction in the cost per unit of output of roughly 2.2% in real terms<sup>15</sup>.

27. Ofcom's preferred indicator of efficiency is only available from 2013-14 and shows that Royal Mail made efficiency savings of 0.7% in 2013-14, 2.6% in 2014-15, 1.5% in 2015-16, and 2.2% in 2016-16. This is equivalent to cumulative savings of £490m or an average of £120m per year<sup>16</sup>.

28. This is below the £170m-£230m p.a. savings estimated in the original impact assessment for the 2011 Act and similar to estimated efficiency gains between 2007 and 2010 of £120m per year<sup>17</sup>. However, methodological differences between the two sets of estimates mean that the two sets of figures are not comparable.

29. Ofcom, in its recent review of postal services regulation, concluded that Royal Mail could take additional steps to improve efficiency, for example by improving performance in relatively poor performing delivery offices and mail centres.

30. Royal Mail's target is to save £600m in annualised costs in the 3 years from 2015-16 to 2017-18<sup>18</sup>. This figure isn't comparable to those referred to above, but it represents a greater rate of cost reduction than the amount Royal Mail achieved in the 3 years up to and including 2014-15 (£200m)<sup>19</sup>.

31. Royal Mail is also in discussions with unions on proposals on pension reform. Royal Mail estimate that without reform annual pension costs could increase from £400m

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<sup>11</sup> Source: Royal Mail annual report 2016-17

<sup>12</sup> Saving the Royal Mail's universal postal service in the digital age, Richard Hooper, 2008

<sup>13</sup> Source: Royal Mail annual report 2016-17

<sup>14</sup> Review of the projects costs within Royal Mail's business plan, Wik-Consult, 2016

<sup>15</sup> Annual monitoring updates on the postal market, Ofcom

<sup>16</sup> *ibid*

<sup>17</sup> Source: Impact Assessment – Postal Services Bill, Department for Business, Innovation and Skills

<sup>18</sup> Source: Royal Mail Annual Reports

<sup>19</sup> Royal Mail Half Year Results Announcement 2015-16

to £900m<sup>20</sup>. The savings from any reforms to the Royal Mail Pension Plan may not be captured by Ofcom's estimates of efficiency (since potential costs that are ultimately avoided wouldn't appear in Royal Mail's accounts) but could still make a significant contribution to the financial sustainability of the universal postal service.

### Conclusions

32. Overall the Act is meeting its objective of ensuring the financial sustainability of the universal service and is making progress towards its objective of an efficient universal postal service.
33. Most stakeholders we spoke to as part of this review agreed that Royal Mail had improved efficiency since the Act, although some argued that greater competitive pressure (in letter delivery or low weight parcels) or regulatory action would prompt further efficiency gains.
34. Ofcom's recent review<sup>21</sup> concluded that Royal Mail was making reasonable progress on efficiency, but that efficiency gains had been "at the lower end of a reasonable range for improvement."
35. Royal Mail is targeting greater efficiency savings in the three years to 2017-18 than it achieved previously. This could be expected given increased competition in the parcels market and the likelihood that Royal Mail will not be able to increase prices substantially in future. Royal Mail is also targeting reforms to pensions, which could have a significant impact on financial sustainability.
36. With Royal Mail's profit margin just below the 5-10% range that Ofcom consider consistent with a reasonable commercial rate of return, Royal Mail should have strong incentives to make further efficiency savings. This, in addition to Ofcom's monitoring of Royal Mail efficiency, gives us confidence that the regulatory regime is sufficiently incentivising efficiency gains.
37. Given these factors, we have concluded that the Act is making progress against its objective of an efficient universal postal service.
38. We recognise that these incentives may weaken should Royal Mail's EBIT margin increase, however we consider that Ofcom has the ability to amend the regulatory regime should they become concerned about Royal Mail's progress on efficiency.

### **Outcomes for users of postal services**

39. There are four sets of data we can look at to assess the impact of the Act on users of postal services:
  - a. Prices
  - b. Quality of service
  - c. Investment
  - d. Satisfaction

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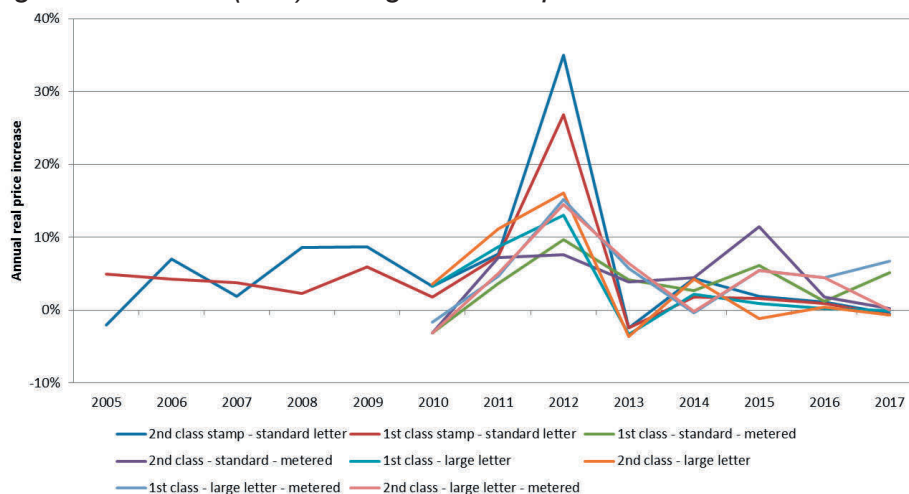
<sup>20</sup> Royal Mail Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail

<sup>21</sup> Review of the regulation of Royal Mail (2016), Ofcom

### Prices for letter delivery

40. Letter volumes have fallen by approximately 40% from their peak in 2004<sup>22</sup>. Since a significant proportion of the costs of Royal Mail's delivery network are fixed, the decline in volumes has put upward pressure on Royal Mail's average costs and prices. From 2004-05 to 2017-18 1<sup>st</sup> class stamp prices rose by 132% (from 28p to 65p) while 2<sup>nd</sup> class stamps rose by 167% (21p to 56p).
41. In 2012, following the relaxation of price regulation by Ofcom, Royal Mail increased the price of 1<sup>st</sup> class stamps by 30% (from 46p to 60p) and 2<sup>nd</sup> class stamps by 39% from 36p to 50p. Prices for metered mail products also increased but at a lesser rate.
42. Overall however, UK letter delivery prices compare well internationally, especially when considering that the level and quality of service provided by the UK's universal postal service is higher than in most EU countries. UK letter prices are below the EU average and cheaper than in Italy and France<sup>23</sup>. UK prices are also found to be below the EU average when adjusted for labour costs and average incomes.
43. We also note that prices are largely determined by Royal Mail's costs and we consider that the Act had led to greater efficiency at Royal Mail which has therefore allowed for lower prices than would otherwise have been the case.
44. Figure 4 shows that since 2012 price increases have generally been smaller than those in the past, and in 2017 all stamp prices fell in real terms (although prices for metered mail increased above the rate of inflation).

*Figure 4: Annual (real) change in letter prices*



Source: Royal Mail, Ofcom and Office for National Statistics

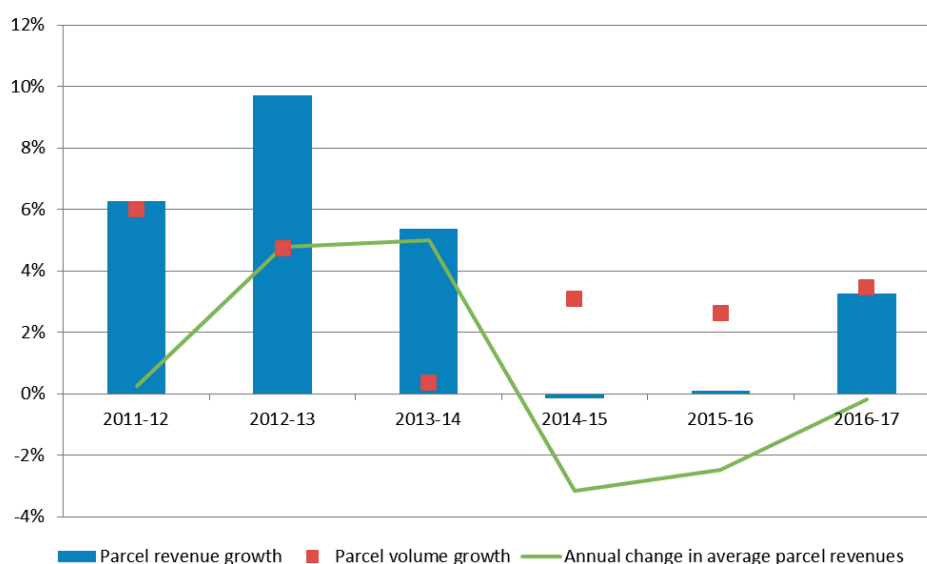
<sup>22</sup> Source: The outlook for UK mail volumes to 2023, PWC and Communications Market Report 2017, Ofcom

<sup>23</sup> Source: Letter Prices in Europe (2017), Deutsche Post

### Prices for parcel delivery

45. Royal Mail's average revenue per parcel has risen by 11% from 2011-12 to 2016-17<sup>24</sup>. Since Royal Mail has seen a relative increase in more expensive heavier parcels and next day parcels over this period average prices are likely to have increased at a lesser rate.
46. The rate of parcel price increases is lower than the increase in average letter prices over the same period (16%) and likely reflects the fact that Royal Mail faces greater competition in the parcels market.
47. Although average parcel revenues have increased since the Act was introduced, Royal Mail's average parcel revenue fell in real terms in each of the past three years (2014-15, 2015-16 and 2016-17) and by 3% cumulatively, highlighting the benefits of competition to consumers.

Figure 5: Annual (real) change in Royal Mail parcel revenues and volumes



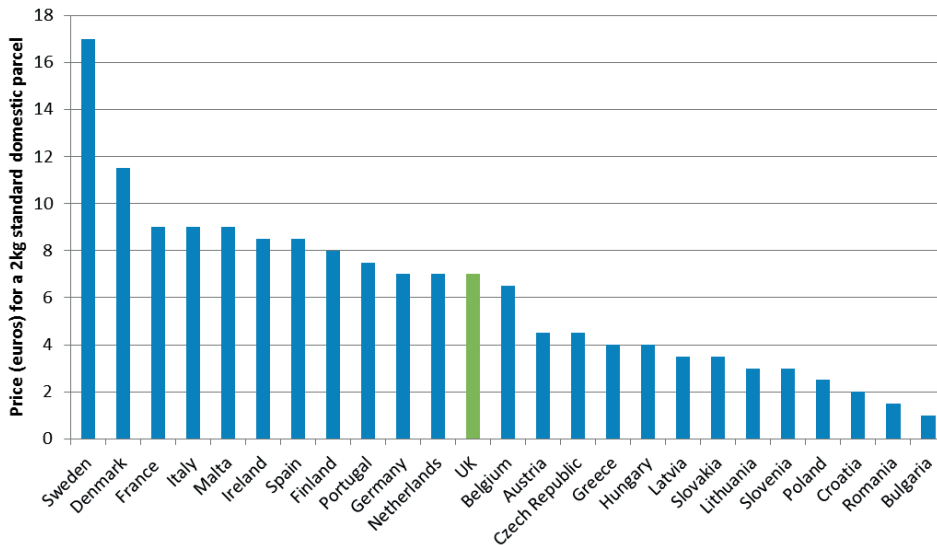
Source: Royal Mail annual reports.

48. Data from Ofcom shows that this trend holds for the wider parcel delivery sector (i.e. not just Royal Mail). In the two years to 2016-17, parcel volumes increased by 21% while revenues only increased by 15%.<sup>25</sup> Average revenues fell by 5%.
49. Parcel delivery prices in the UK compare favourably to other EU countries. A 2016 study found that Royal Mail's list price for delivering a 2kg parcel was around the EU median, but lower than the major European economies including France, Italy, Germany and the Netherlands.

<sup>24</sup> Source: Royal Mail Annual Reports

<sup>25</sup> Ofcom Annual monitoring update on the postal sector 2016-17

Figure 6: International comparison of domestic parcel prices

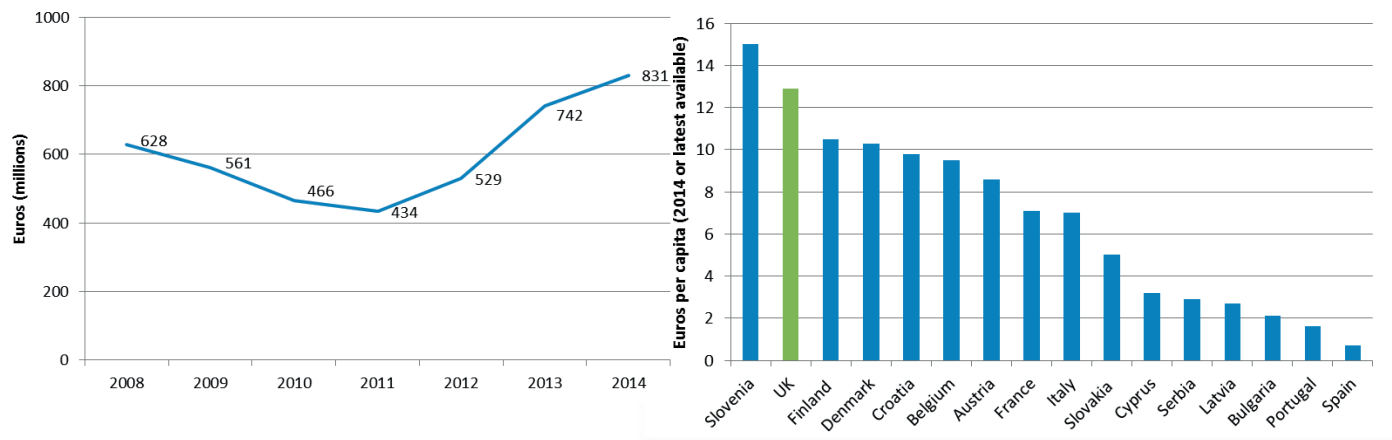


Source: Claes, A. and Vergote, W. (2016) Econometric study on parcel list prices

Investment

50. It was expected that enabling Royal Mail to access private capital in the Act would lead to greater investment. Data from the European Regulators Group for Postal Services indicates that this has been the case. Royal Mail has increased investment by 90% (in euros) since 2011 and investment per capita is now among the highest in EU<sup>26</sup>.

Figure 7: Royal Mail Investment



Source: European Regulators Group for Postal Services. Data is not available for all European countries.

51. We note that competition in the parcels market has forced Royal Mail to invest heavily in their parcels network in response to new technologies provided by competitors.

Delivery quality

52. Ofcom set quality of service targets for Royal Mail's delivery performance as permitted under section 36(6) of the Act. These are a key component of the

<sup>26</sup> Report on core indicators for monitoring the European postal market (15) 27 - European Regulators Group for Postal Services

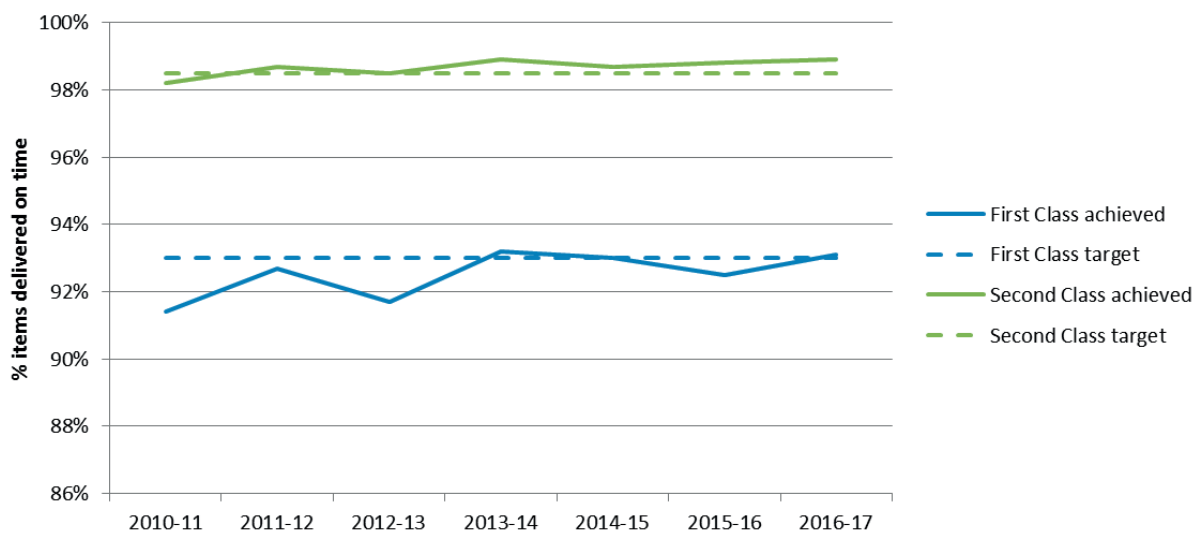


universal service obligation which ensure that individuals and businesses have access to a reliable postal service. Royal Mail's main quality of service targets are:

- a. 93% of 1<sup>st</sup> class items to be delivered on time
- b. 91.5% of 1<sup>st</sup> class items to be delivered on time in each of 118 post code areas (PCAs)<sup>27</sup>
- c. 98.5% of 2<sup>nd</sup> class items to be delivered on time

53. Performance against these delivery targets has increased since the introduction of the Act. Royal Mail now deliver 98.9% of 2<sup>nd</sup> class items on time (exceeding their target of 98.5% and up on 2010-11 performance of 98.2%) and 93.1% of first class items on time (exceeding their target by 0.1 percentage points and up on 2010-11 performance of 91.4%).

Figure 8: Royal Mail delivery performance

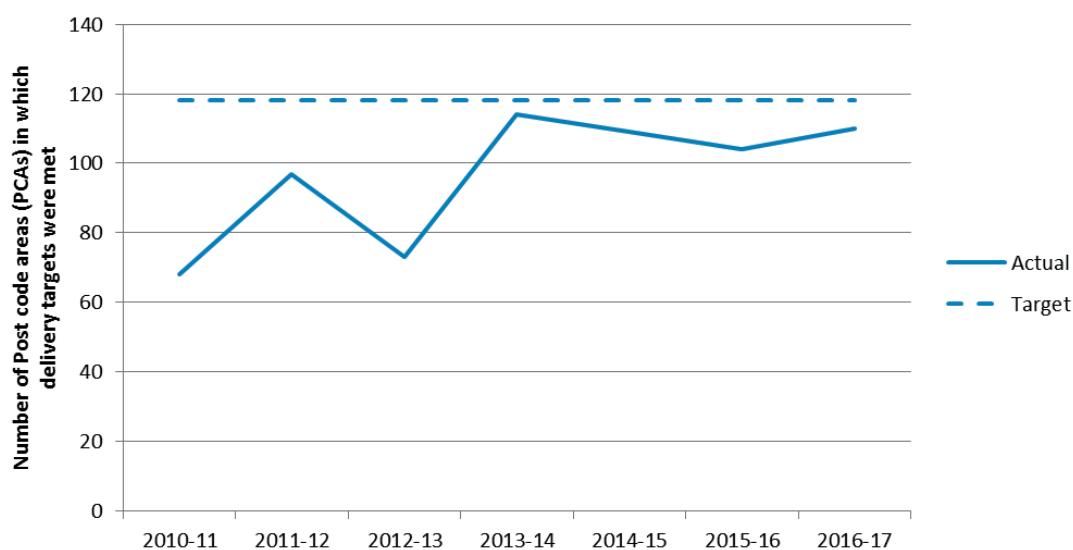


Source: Royal Mail Quality of Service Reports

54. In addition to Royal Mail's improvement in national 1<sup>st</sup> class delivery performance there has been a significant increase in the number of PCAs in which Royal Mail has met their delivery target. The target was met in 110 PCAs out of 118 in 2016-17. Royal Mail is still short of meeting its target of 118 PCAs, but the improvement shows that Royal Mail has increased consistency of delivery performance across the country.

<sup>27</sup> There are 121 post code areas in total but 3 are excluded from this target.

Figure 9: Royal Mail delivery performance



Source: Royal Mail Quality of Service Reports

55. Royal Mail’s delivery performance compares well internationally. Its 2016-17 1<sup>st</sup> class delivery performance of 93.1% on time was above the EU average of 85.5% and higher than that of France (84.9%), Germany (89.8%) and Italy (83.9%)<sup>28</sup>. National Postal Operators in 8 other European countries achieved higher performance scores, but many of these are small countries with fewer remote areas (e.g. Luxembourg or the Netherlands).

### Consumer satisfaction

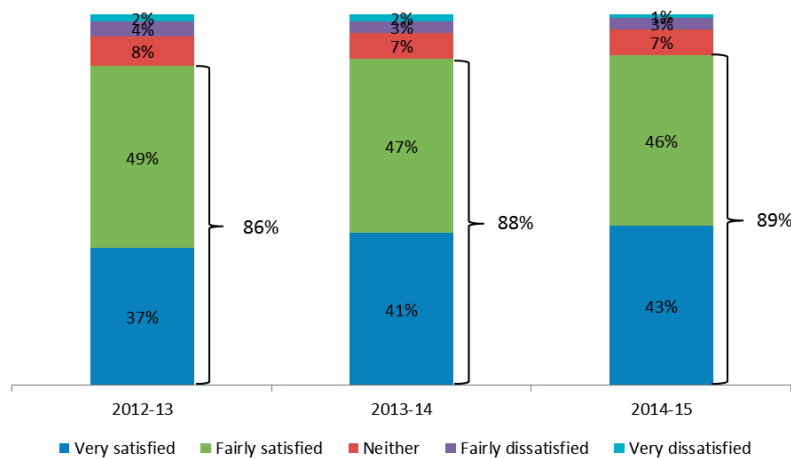
56. Despite increases in stamp prices, there has been a small increase in residential consumers’ satisfaction with postal services since 2012-13 (see figure 10) and a large increase in the perceived value for money of postage (satisfaction with the value for money of second class stamps increased from 40% in 2012-13 to 50% in 2014-15)<sup>29</sup>. The rate of complaints to Royal Mail has fallen by 16% since 2010-11<sup>30</sup> and stands at 7.29 complaints per 100,000 items in 2016-17.

<sup>28</sup> Source: Report on the quality of service, consumer protection and complaint handling (ERHP PL (17)35), The European Regulators Group for Postal Services, 2017

<sup>29</sup> Source: Ofcom annual monitoring update on the postal market

<sup>30</sup> *ibid*

Figure 10: consumer satisfaction with postal services



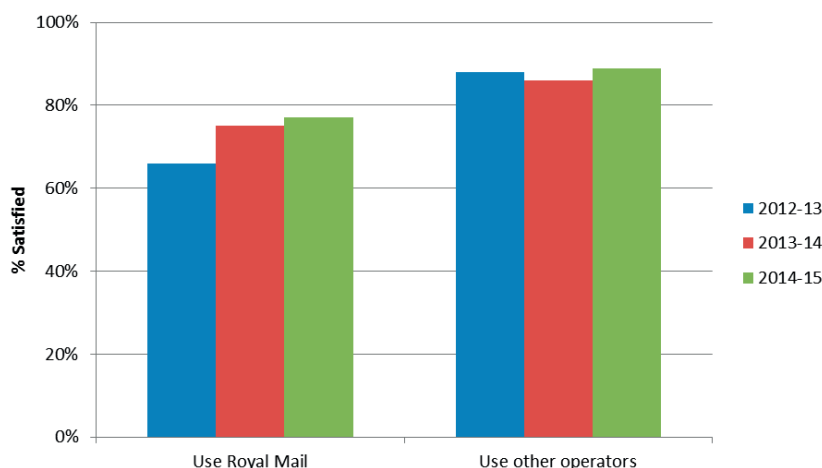
Source: Ofcom annual monitoring update on the postal market

57. More recent data shows that 86% of consumers were fairly satisfied with postal services in 2016-17, and 75% were satisfied with the value for money of postal services. Due to changes in survey methodology however, these figures are not consistent with earlier data.

58. Figure 11 shows that SMEs' satisfaction with Royal Mail has also increased since the Act was introduced, although SMEs are still more satisfied with Royal Mail's competitors than with Royal Mail.

59. More recent data from 2016-17 shows similar levels of SME satisfaction (81% with Royal Mail and 87% with other operators) however as with the consumer satisfaction data this figure is not comparable with data for previous years.

Figure 11: SME Satisfaction with postal services



Source: Ofcom annual monitoring update on the postal market

60. While consumer and SME satisfaction has improved, large businesses are not surveyed. Conversations with stakeholders have indicated that larger senders may be less satisfied with the service they are receiving. For example, we note that the Royal Bank of Scotland's response to Ofcom's 2015 consultation expressed concerns over what they view as "uncompetitive and unfair practices" by Royal Mail. Ofcom is aware of these concerns and has encouraged users of Royal Mail's

services to raise material concerns related to changes implemented by Royal Mail with them<sup>31</sup>. We support Ofcom's role in considering and, where necessary, resolving complaints, and consider that this is preferable to ex-ante regulation of terms and conditions.

61. There is some evidence of consumer dissatisfaction in the parcel sector. A survey by MetaPack<sup>32</sup> found that 43% of online consumers have had a negative delivery experience in the past. To investigate this issue Ofcom collected data on mail integrity complaints to six large parcel operators and found that the average number of complaints was equal to 0.0875% of total items delivered<sup>33</sup>. On this basis, the Government is content with the current approach to delivery quality regulation set out in the Act (s51) and implemented by Ofcom's Essential Conditions.
62. Ofcom's Consumer Protection Condition recognises that regulation of delivery standards is not needed where competition between delivery operators is sufficient to ensure high standards. Competition is currently strongest in the markets for heavier parcels and bulk parcels. These are the markets that the majority of parcel operators focus on and so comprehensive regulation of parcel delivery operators is unlikely to be necessary. Ofcom's Consumer Protection Condition only covers Royal Mail's USO parcel products. While we recognise that this creates a greater regulatory burden on Royal Mail, we also note that Royal Mail's USO parcel products are focused on smaller senders and lighter parcels for which there is less competition and where market forces may be insufficient to ensure high delivery standards.

### Conclusions

63. The evidence shows that there have been improvements in investment, satisfaction and service quality since the Act was introduced. For example, Royal Mail now meet their 1<sup>st</sup> class delivery targets in 110 PCAs (up from 97 PCAs in 2011-12), the proportion of SMEs satisfied with Royal Mail rose from 66% in 2012-13 to 77% in 2014-15, and the rate of complaints to Royal Mail has fallen by 16% since 2010-11.
64. Following the changes in 2012, subsequent letter price rises have been relatively small and below the safeguard caps on the price of second class stamps for letters, large letters and parcels weighing up to 2kg that were put in place by Ofcom to ensure that consumers can access an affordable universal postal service. Average parcel prices have fallen with average parcel revenues falling by 5% in the two years to 2016-17. With growing competition in the parcels market and with Royal Mail making greater efficiency savings, the outlook for consumer prices is more positive than when the Act was introduced. We therefore consider that the Act is making progress against its objectives of delivering good outcomes for users of postal services.

## **Competition in postal services**

65. The UK has one of the most competitive postal services markets in Europe and the government is committed to promoting competition in postal services. Promoting

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<sup>31</sup> Review of the regulation of Royal Mail (2016), Ofcom

<sup>32</sup> Delivering Consumer Choice: 2015 state of ecommerce delivery, MetaPack

<sup>33</sup> Review of the regulation of Royal Mail (2016), Ofcom

competition is the most effective way of incentivising efficiency improvements, improving outcomes for users and facilitating further deregulation.

66. For example, competition in the parcels market has led to lower prices and the introduction of new innovations and services such as same day delivery, pick up and drop off locations (e.g. at convenience stores or Amazon Lockers), and the ability to track and redirect parcels via smartphone.

67. As presented previously, there is evidence that SMEs that use access operators are more satisfied than those that use Royal Mail. Ofcom, in its submission to this review, stated that “the presence of a number of access operators in the UK market has led to price competition... leading to lower prices for bulk mail senders.”

### Competition in the letters market

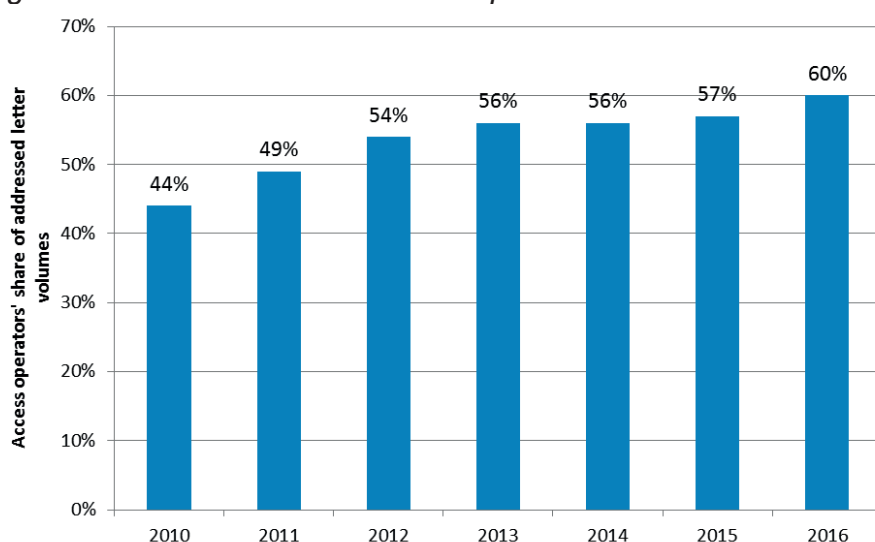
68. There are two main forms of competition in the letters market:

- a. Access competition. Access operators compete with Royal Mail to collect and sort letters from large senders. Access operators do not deliver letters but instead pass them on to Royal Mail after sorting to complete the delivery.
- b. End to end competition. End to end (E2E) competitors compete with Royal Mail in delivery as well as collection and sorting.

69. The UK has the most competitive access market in the EU. In 2016 access operators handled 60% of all addressed letter volumes in the UK<sup>34</sup>. Access operators in Germany (which has the 2<sup>nd</sup> most competitive market) have only ¼ of the market share of UK access operators (as of 2013)<sup>35</sup>.

70. The share of the letter market held by access operators has continued to increase after the Act was introduced, despite Ofcom relaxing access regulation to reduce the burden on Royal Mail. Access operators have also moved into new segments of the market. For example, in 2017 Whistl and Parcel2Go launched a service aimed at smaller senders of letters.

Figure 12: Market share of access operators



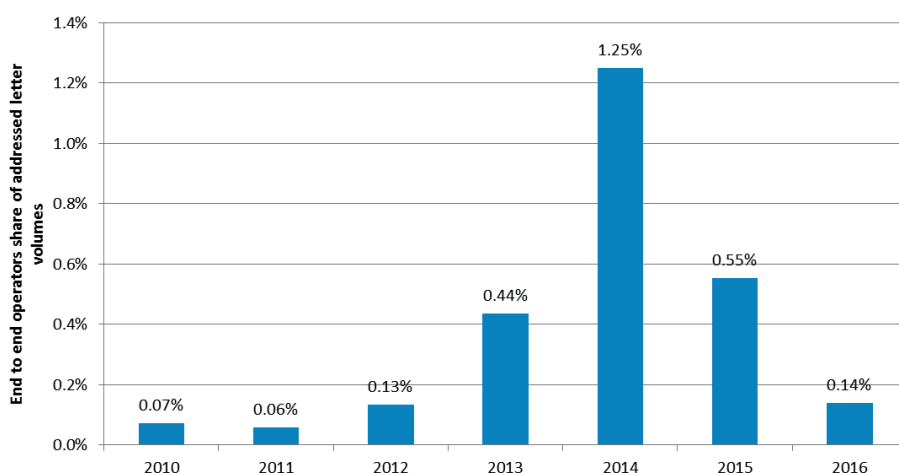
<sup>34</sup> Source: Ofcom – Communications market report 2017.

<sup>35</sup> Royal Mail – Response to Ofcom’s May 2016 Fundamental Review of the Regulation of Royal Mail

Source: Ofcom – Communications market report 2017. Data from 2015 onwards is not comparable to previous data.

71. End to end competition has not fared as well and has weakened in recent years with the exit of Whistl, Royal Mail's only significant competitor in the delivery of letters.

Figure 13: Market share of end to end competitors



Source: Ofcom – Communications market report 2017. Data from 2015 onwards is not comparable to previous data.

72. Whistl entered the end-to-end letter delivery market in 2012 becoming the only major competitor to Royal Mail. However in June 2015, following the announcement of changes to access pricing and terms and conditions by Royal Mail, Whistl announced that it was closing its end-to-end delivery operations following regulatory issues that according to Whistl “impacted on our ability to deliver a long term sustainable service.”

73. Ofcom launched an investigation under the Competition Act 1998 and this investigation is still ongoing. While we cannot comment on the merits of the case, the outcome observed indicates that the regulatory regime is not as supportive of entry in the end to end market as it could have been.

74. Ofcom recognised this in their 2014 consultation on the regulation of access and proposed changes to remove Royal Mail's ability to use access pricing to discourage entry in the delivery market. Ofcom has recently announced that they do not plan on implementing these changes due to the low likelihood of entry into the letter delivery market in future.

#### Competition in the parcels market

75. The parcel delivery market is more competitive than the letter delivery market and Ofcom has identified 12 major operators that compete with Royal Mail in parcel delivery<sup>36</sup>. Royal Mail report that they have a 53% share of the UK parcel market by volume and 41% share by revenue<sup>37</sup> as of 2015.

76. Competition has been highly beneficial for consumers. Prices have been pushed down (in the past two years average parcel revenues have fallen by 7%<sup>38</sup>) and many

<sup>36</sup> Annual monitoring update on the postal market 2016-17, Ofcom

<sup>37</sup> Source: Royal Mail Half Year 2017-18 Results

<sup>38</sup> BEIS analysis of Ofcom annual monitoring updates on the postal market

new innovations have been introduced, for example same day delivery, pick up and drop off locations (e.g. at convenience stores), and the ability to track and redirect parcels via smartphone. Royal Mail has responded and have worked with the Post Office to expand opening times, invested in parcel tracking and automated parcel sortation and has opened 100 delivery offices on Sundays.

77. As figure 14 shows, the market for >2kg bulk parcels is most competitive with Royal Mail accounting for under half of all volumes. Royal Mail still maintains a large market share in light parcels and single piece parcels, although these figures do not include deliveries by Amazon.

Figure 14: Royal Mail's share of the parcels market

	Volumes (2014-15)	Royal Mail market share
Single piece (all weights)	350m	60-80%
Bulk (<2kg)	500m	60-80%
Bulk (>2kg)*	900m	30-50%
<b>All parcels</b>	<b>1.8bn</b>	<b>54%</b>

Source: Rows 1 and 2 are sourced from Ofcom's review of the regulation of Royal Mail, Annex 8, Figure A8.1, Row 4 presents data from Ofcom's annual monitoring update on the postal market 2015-16 and Royal Mail's Half Year 2016-17 results. \*Figures in row 3 are inferred using the information in the other rows.

78. Since 2011 there have been several positive developments which indicate that competition in these market segments is increasing:

- a. Amazon has established its own parcel delivery arm that it makes available to sellers using Amazon Marketplace. Amazon's delivery network offers same day delivery in selected cities.
- b. DPD has increased its presence in the B2C market, having previously focused on B2B deliveries.<sup>39</sup>
- c. There is evidence that consumer awareness of Royal Mail's parcel competitors has increased<sup>40</sup>.
- d. DPD, Hermes and UPS have established drop-off points for single piece parcels. Ofcom report that the volume of single piece parcels carried by Royal Mail's competitors increased by 34% between 2013-14 and 2014-15<sup>41</sup>
- e. Ofcom reported several price promotions for single piece parcels in 2017<sup>42</sup>. For example, between July and October 2017 Royal Mail more than halved the price of sending a second class medium parcel (from £13.75 to £6.29). In summer 2017, MyHermes reduced the price of a 2.5kg parcel from £6.49 to £5.49.

## Conclusions

79. Since the Act was introduced competition has continued to grow in the parcels market and in the letters access market. It is clear however that the regulatory regime was not as supportive of end to end competition in letter delivery as it could have been, and that competition in this market may have suffered as a consequence.

<sup>39</sup> Source: Ofcom and Royal Mail.

<sup>40</sup> Source: Review of the regulation of Royal Mail (2016), Ofcom

<sup>41</sup> Source: Review of the regulation of Royal Mail (2016), Ofcom

<sup>42</sup> Source: Annual monitoring update on the postal market 2016-17, Ofcom

80. The evidence gathered through our review indicated that entry in the letters delivery market is unlikely in the near future and that reforms to the regulatory regime are unlikely to affect this. We are therefore not proposing any changes, but we will continue to monitor the state of competition in the postal services market and the extent to which the regulatory regime is conducive to entry. We also note that Ofcom's Competition Act investigation is still ongoing and we will await the conclusions of this investigation.

## **The regulatory regime for postal services**

81. The original impact assessment predicted the following benefits from abolishing Postcomm and moving responsibility for postal regulation to Ofcom:

- a. a reduction in regulatory burdens
- b. greater regulatory certainty to allow Royal Mail to focus more fully on modernisation and less time on seeking regulatory consents
- c. a greater focus competition law enforcement (unlike Postcomm, Ofcom has competition enforcement powers) to facilitate a reduction in ex-ante regulation
- d. a reduction in the cost of regulation

82. Our review has concluded that overall the regulatory regime is working effectively and that many of the expected benefits have been realised. Progress against each of the four objectives is considered below.

### Regulatory burdens on postal operators

83. The evidence suggests that conditions imposed by Ofcom resulted in a lower regulatory burden than the previous Postcomm requirements. Royal Mail in particular saw a large reduction in the regulatory burden, while other postal operators are likely to have experienced a small increase in regulation.

84. The main deregulatory changes that have taken place under the Act or as a result of the transfer of regulation to Ofcom are:

- a. the removal of the requirement for all postal service operators to be licenced. Operators now need to comply with general authorisation conditions
- b. the removal of price controls on Royal Mail for all products other than 2<sup>nd</sup> class stamps
- c. a reduction in notification, publication and pre-approval requirements for Royal Mail product changes and new services
- d. a reduction in the scope of access regulation

85. The main regulatory changes that have taken place are:

- a. parcel operators (excluding Royal Mail) are now required to provide an annual return to Ofcom on their parcel revenues and volumes.

86. Neither we nor Ofcom have attempted to quantify the impact of these deregulations however the cost savings to business are expected to be significant. Following the relaxation of price controls by Ofcom in 2012-13 Royal Mail UKPIL revenues rose by £580m.



87. Despite the regulatory changes Royal Mail's view is that the administrative burden of regulation has not reduced. Since section 6 of the Communications Act 2003 gives Ofcom a duty to keep its functions under review to ensure that regulation does not impose or maintain unnecessary burdens, we do not consider that changes to the Act are needed to address these concerns. We also note that Ofcom's recent review of regulation considered whether their regulatory framework remains appropriate and fit-for-purpose and proposed changes to ensure that regulations do not impose an undue burden on postal operators, while ensuring consumers remain protected. We will work with Ofcom and other stakeholders following this review to follow up on specific suggestions and explore non-legislative options for simplifying the regulatory regime.

#### Regulatory certainty

88. The relaxation of price regulation has given Royal Mail greater control over its financial position and has reduced the importance to Royal Mail of influencing the regulator to secure a favourable settlement. Whereas the previous Postcomm regime regulated prices relating to around 80% of Royal Mail revenue, Ofcom regulate prices relating to less than 10% of Royal Mail's revenue.

89. The relaxation of price controls and the reduction in notification, publication and pre-approval requirements for Royal Mail product changes and new services indicates that regulation plays a smaller role in Royal Mail's business than in the past. We therefore consider that this expected benefit has been realised.

90. Ofcom's decision to review the regulatory framework in 2015-16, as with all policy reviews, has created some uncertainty and increased Royal Mail's focus on influencing regulatory decisions. While there are costs from conducting reviews, there is also a value in reviewing policy, especially after a major change in approach, and note that Ofcom has provisionally decided to maintain the current regulatory approach for the next five years which should give greater certainty in future.

#### Enforcement of competition law

91. Ofcom has launched one enforcement case under the Competition Act 1998 since they took over responsibility for postal regulation.

92. Following a complaint from Whistl, Ofcom launched an investigation into Royal Mail in relation to proposed changes to access pricing and terms and conditions. In July 2015 Ofcom announced its provisional view which was that Royal Mail breached competition law by engaging in conduct that amounted to unlawful discrimination against postal operators competing with Royal Mail in delivery.

93. We cannot comment further since this investigation is still ongoing, however since Whistl has left the market and there appears to be little prospect of future entry, this case provides evidence that the combination of access regulation and competition law enforcement may not have been effective in supporting end to end competition.

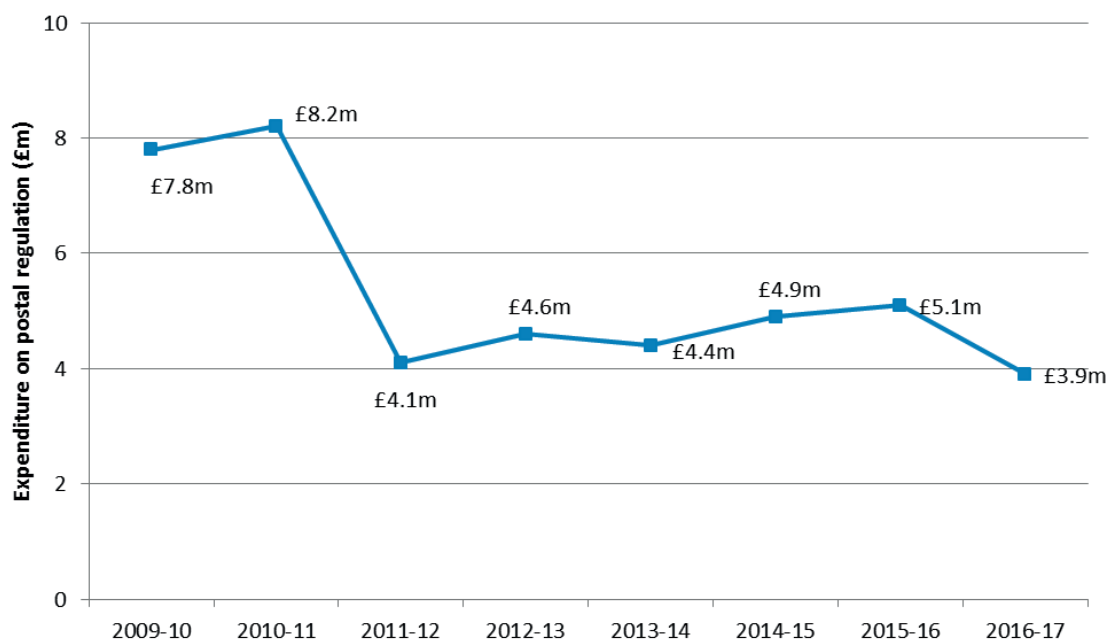
#### The cost of postal regulation

94. The transfer of postal regulation from Postcomm to Ofcom resulted in a 50% reduction in the cost of regulation, far in excess of the 10% reduction estimated in the original impact assessment. Ofcom's postal regulation work is funded by Royal

Mail via a levy, and so this represents a significant reduction in the regulatory burden to Royal Mail.

95. Although we can't be sure what Postcomm's expenditure would have been in the absence of any changes, assuming that it would have followed the same trend as Ofcom's would imply that the savings to Royal Mail so far are around £27m.

Figure 15: expenditure on postal regulation



Source: Ofcom and Postcomm

### Effectiveness of Ofcom as the postal services regulator

96. The evidence we gathered from stakeholders was largely positive. Ofcom is well regarded and all stakeholders we consulted with agreed that the move from Postcomm to Ofcom was beneficial.

97. We received several suggestions from stakeholders in relation to the way Ofcom operates, for example some postal operators felt that Ofcom's procedures for submitting complaints were over-formal and burdensome. We are aware that Ofcom has discussed its complaints process, in particular the level of detail/evidence needed to raise a complaint, with postal operators and has encouraged postal operators to raise material concerns with them. We will stay in regular contact with Ofcom and postal operators to monitor progress in this area.

### **The special administration regime**

98. The special administration regime has so far not been required and stakeholders have not raised any significant concerns with the regime. We have therefore not sought to assess the impact that the special administration regime or review the design of the regime.



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