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Business, Innovation and Skills
Committee

Stamp Prices

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Oral and written evidence

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Business, Innovation and Skills Committee

The Business, Innovation and Skills Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Innovation and Skills.

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in a printed volume. Additional written evidence may be published on the internet only.

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The current staff of the Committee are James Davies (Clerk), Neil Caulfield (Second Clerk), Peter Stam (Inquiry Manager), Ian Hook (Senior Committee Assistant), Jennifer Kelly (Committee Assistant), Pam Morris (Committee Assistant), Henry Ayi-Hyde (Committee Support Assistant).

Contacts

All correspondence should be addressed to the Clerk of the Business, Innovation and Skills Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is biscom@parliament.uk

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Oral evidence

Taken before the Business, Innovation and Skills Committee on Tuesday 21 February 2012

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Katy Clark
Rebecca Harris

Simon Kirby
Ann McKechin
Mr David Ward
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Stuart McIntosh**, Group Director of Competition, **Chris Rowsell**, Competition Policy Director, and **Gavin Knott**, Postal Services Competition Specialist, Ofcom, gave evidence.

Q1 Chair: Welcome back, and thank you for agreeing to speak to us again. If you would like to introduce yourselves for voice transcription purposes, that would be helpful.

Stuart McIntosh: My name is Stuart McIntosh. I am an Executive Member of the Ofcom Board. I lead the Competition Group within Ofcom, which is primarily responsible for the work that we are doing on the regulation of post. On my left is Chris Rowsell, a colleague from my group who is leading the work on what we call the economic framework for the regulation of post. On my right is Gavin Knott, also a colleague from my group. Gavin is working on the economic framework as well; he joined us from Postcomm, so has provided continuity from the previous regulator to the current position.

Q2 Chair: Thank you very much. We have 45 minutes, so want to crack on quickly. While we have quite a few questions, do not feel that all of you have to answer all of them; only respond if you need to add to or subtract from anything that is said by the previous speaker. Can I just start the ball rolling? Following the consultation that ended in January, can you outline the main price regulation options being considered, and what the pros and cons are of each?

Stuart McIntosh: I will take a minute to provide a bit of context, because that is very important in terms of understanding the options. We assumed responsibility for regulating the postal sector in October of last year. We found an industry facing very significant structural challenges: demand volumes in the sector have declined by over 25% over the past five to six years. Royal Mail—as you know and understand—was not making profits and, indeed, was incurring significant losses in its traditional mail business. That situation seemed to be deteriorating. Notwithstanding the fact that Royal Mail had been making quite significant investments in the modernisation of its operations, it appeared at that point to be struggling to realise efficiency savings to keep up with the reductions in demand. That was the industry context we found.

To some extent the situation that the industry was in was compounded by the regulatory framework. This is not a criticism of my colleagues from Postcomm; with the benefit of hindsight, we would all do things

differently. There was an environment where charge controls or restrictions applied to the vast majority of Royal Mail's revenues. The specific core controls on mail revenues were too tight in light of what had subsequently happened in terms of the level of demand. There were also arrangements that were very advantageous to Royal Mail with regard to access to their network by other providers, who take advantage of Royal Mail's network to deliver mail. Compounding all of that was quite a restrictive regulatory environment, in many respects similar to the regulatory controls that used to apply to BT going back 10 or 15 years: a licence-based regime where the regulator was very intimately involved in a lot of the detailed decision making.

That was the context we found: it was covered in considerable detail by Richard Hooper in his two reports on the sector. That led to the passage of the Postal Services Act last year, where we in Ofcom were given the primary responsibility to discharge our duties in a way that would help secure the provision of universal service. That is particularly important, because that is the key point of reference in relation to the work that we are doing in the sector and the specific options that we are considering.

As you can see from reading our document, there is a lot of detailed discussion of options in individual areas. If I could step back from that detail, there are two broad options that we have considered: one is to persevere with what might be called a traditional form of price regulation of the type that we have applied in other industries that we regulate; and the other was to adopt a different approach, which tries to deal with and respond to the specific challenges that the postal sector finds itself in today.

With the regard to the first approach—the use of price regulations—that is something we know how to do. Ofcom and Oftel, prior to Ofcom, have been implementing price control regimes for the best part of 25 years here in the UK, and in large measure have done so quite successfully from the point of view of consumers, and also in promoting competition. However, we have worried quite seriously about whether that approach is appropriate and viable in this context. The structural decline in demand for the use of postal services is ongoing: in truth, no one quite

knows where this industry might proceed over the next five to 10 years. Some people suggest volumes might decline by 20%; some suggest it may decline by even more than that.

Second, because our primary duty is with regard to the provision of universal service, we felt the incentive properties that we have seen operate well in the context of BT were less likely to work well in this context. Royal Mail would always have the option of coming back to us and saying, "Universal service is threatened; we need to do something about prices." That is exactly what happened under the old regime. The third element is we believe that Royal Mail needs a lot more flexibility than it had previously to be able to respond to this quite challenging and difficult environment. In light of that, in October we consulted on a different approach: i.e. not price regulation of a traditional form, but a different portfolio of measures, which we think is more likely to be successful in ensuring that universal service is sustained. That is built around a few things. Firstly, universal service is at the heart of it. Secondly, it removes the traditional price controls that apply to Royal Mail. It puts in place a safeguard cap specifically in the context of the second class standard letter, not as a general price control but as a measure to ensure that particularly vulnerable consumers are protected as we go through these changes over the coming years.

Thirdly, it maintains the access regime: we see real benefits from competition, and we have seen them work well in the other industries we regulate. We concluded that the way the access regime used to work was weighted against Royal Mail—we feel aspects of that need to change, and that is what we are proposing. Fourth, it establishes quite a detailed monitoring regime to determine very specifically the extent to which Royal Mail is doing what we want them to do under our duties: i.e. providing universal service and doing so in a sustainable way; to understand what is happening to its profitability; critically, to understand what is happening to the affordability of prices; and to understand what is going to happen to efficiency levels in Royal Mail. Those are the options at an aggregate level.

Q3 Chair: It was a broad question and you have given a very broad response. I would remind you that we have got 21 questions, and if everyone took that long we would be here until the division bell goes at 10 o'clock. If you could make your answers very brief, I would be grateful, and equally questions.

Stuart McIntosh: I will endeavour to be much more concise.

Q4 Chair: How did you arrive at the range of 44p to 55p for a second class letter?

Stuart McIntosh: We have done a lot of international benchmarking to understand what operators, both commercial and state owned, charge in other markets to get a sense as to what might be a reasonable commercial rate. We have provided some evidence in the consultation document, and we can provide more evidence to the Committee if that would be helpful. If you look across Europe, for example, you would typically find that in most countries where second

class is provided, the price tends to be above the rate currently charged by Royal Mail, and tends to be in the range of 42p to 55/56p.

The second thing we looked at, because it is of particular concern, was affordability. We looked at how much consumers and small businesses spend on postal services to understand, if prices were to be set within this range, whether this would be a problem for vulnerable consumers. On the basis of those two considerations, and bearing in mind the need to provide Royal Mail with flexibility, we concluded that a price in the range of 45p to 55p is where that safeguard cap ought to be set.

Q5 Chair: If I can summarise that, I hope fairly, it was price comparisons with other countries and the affordability, not directly related to the cost of service. What would the cost of a second class stamp be if you just related it to the cost of the service?

Stuart McIntosh: It was not related directly to the cost of service in the way you have described, but it was indirectly, because what we are looking at is providing an environment where all the prices and revenues associated with those services are sufficient to cover costs overall.

Q6 Simon Kirby: A 53% increase: some people would say that was an outrageous increase. Surely that cannot be right in these difficult times?

Stuart McIntosh: We do not know at this stage what Royal Mail will do in the event that we do proceed with the proposals on which we consulted: we do not know what the percentage increase in the prices might be. Our primary responsibility is to ensure the provision of universal service: ensuring that mail is delivered everywhere in the country, to every address in the country, six days a week; that mail is collected either five or six days a week; and that there are uniform prices for services across the UK, and that those are sustained. There are structural changes in the industry that mean prices are going to have to change. We would almost certainly have come to exactly the same conclusion about the need for radical change had we tried to put in place a traditional charge control.

Chair: Before I bring in Paul Blomfield on vulnerable consumers, Brian wants to redefine my question.

Q7 Mr Binley: If Ofcom consider that the level of the proposed cap is somewhat arbitrary, calling it essentially a matter of judgment and saying that it would value stakeholder input and views, what would be your recommendation on second class mail price if cost and profitability of the service were the main consideration? What is a commercial rate for second class mail, ignoring other factors?

Stuart McIntosh: I am not sure I quite agree with your characterisation of it as arbitrary. Our judgment on that has been based on the need to ensure that universal service is financially sustainable, and then to take a view as to what is potentially affordable. In looking at the profitability of individual services, this is a network business, as is telecommunications and a number of others, which means there is a very large fixed cost base. It does not matter if the mail is all

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business or all consumer mail; the postman still has to go on his round, and he still potentially has to visit every home on that round, depending on the mail volumes that day.

The actual average cost of a letter, or particular type of letter, is very difficult to determine with great confidence, and what you have to look at is whether the overall revenues coming from the services are sufficient to cover the overall cost.

Q8 Mr Binley: Are you saying to me that you cannot establish a cost, irrespective of the factors that we are discounting?

Stuart McIntosh: One can establish a cost, and the easiest way of establishing the cost is to take the average mail volumes and divide that into the total cost. What I am saying is that it is a slightly more complicated story than that, because you need to take account of the extent to which changes in prices—

Q9 Mr Binley: Forgive me, Mr McIntosh. I said, “If those were excluded, what would be the actual cost?” I specifically asked you to exclude those, and so you are left with two sides of an equation: the first is how much does it cost to get out there, and the second is what does that end up to be, by dividing that into the number of letters that you are delivering. It is a relatively simple calculation. So how much would it be?

Stuart McIntosh: I understand fully the point you are making. It is the case that the margins—the profitability—on these services, is likely to be higher than the margins of some other—

Q10 Mr Binley: I am not asking about margins. I am asking what the cost would be if you excluded those other factors. I want to make a judgment between what you are saying is the cap and what the actual cost is, and then I can relate that judgment to the situation that you find yourselves in with regard to the service.

Chair: Yes, if you don’t know, please say so, so that we are clear about that and can move on.

Stuart McIntosh: We do have estimates of the costs of the individual services, but I am hesitant to give you a precise number at the moment in case I mislead you. We would be very happy to follow up—

Q11 Chair: Could you send us a written assessment? Thank you.

Stuart McIntosh: Yes.

Q12 Paul Blomfield: You have talked about the attention given to vulnerable consumers. Could you explain in more detail how you attempted to estimate the impact of your policies on those vulnerable consumers?

Stuart McIntosh: In looking at vulnerable consumers, we are looking at two or three classes of consumers: those on low incomes and pensions, and those with disabilities. First we looked at how much consumers use mail services. Nowadays, partly because of people using other means—telephones, email and text messages—the vast majority of consumers, whether

they are vulnerable or not, do not send very much mail. It will tend to be three or four pieces per month. We looked at that on average, and then we looked to find what information we could get in terms of lower income households and their usage of those services. While it is a little different, it is not hugely different. We were able to conclude that the average family spends less than 50p per week on mail services. With vulnerable consumers, I do not think the picture is markedly different: it may be a little different, but not hugely so. If stamp prices went up in the range that we were setting for the cap, it does not suggest that those services would be unaffordable to those vulnerable consumers.

Q13 Paul Blomfield: Not unaffordable, but did you make any assessment of what the impact in usage would be? The issue here is whether you are going to tip people into a lower level of use, and a spiral of decline.

Stuart McIntosh: It is important to remember that the vast majority of mail sent in the UK today is sent by businesses. It is a scale business, so it is dependent on the mail from them. It is possible that you would see some reduction in the level of mail, which is typically what happens when prices go up.

Q14 Paul Blomfield: Did your modelling quantify what level of reduction in use?

Stuart McIntosh: We have estimates of that: in the short term, it would not be hugely material, but it may be in the longer term. One of the points I would go on to argue is that there are many different types of mail: ensuring the mail volumes are sustained is vital to ensuring the sustainability of the universal service. One of our objectives in setting the regime as we have is to give Royal Mail the flexibility so that, with their much more detailed knowledge of the market, they are able to set prices across the market, including for stamp services, in a way that least disrupts the demand for service, so that they do not have a precipitant decline in volumes.

Q15 Paul Blomfield: When you were looking at the affordability of mail to vulnerable consumers, you drew comparisons with fuel and water costs. Would another approach have been to look at consumer behaviour: whether families would be willing to stop buying a food item to switch an extra pound to mail services? Did you explore customer behaviour in that way? Do you think there is some merit in doing that?

Stuart McIntosh: We have not yet done that fully: in the first instance our work has been concentrated around the approach I described earlier. Now that we have taken on responsibility for regulating post, as a matter of routine we are going to be tracking and looking to understand consumer behaviour in relation to the use of postal services. Just as we regularly produce information for users of telecommunications, broadcasting, and other services, we will be providing that sort of detailed information on the use of postal services by consumers in the UK. That is work that we are now starting, and it will bear fruit in the coming months and years.

Q16 Paul Blomfield: You have not got that sort of evidence available to you now to make the recommendations that you are?

Stuart McIntosh: We do not have all of that detailed evidence, but we have taken some reassurance from the fact that, if you look at the level of usage, which is three or four pieces for most families per month, and the price of the stamps, it does not appear that for the vast majority of consumers, including vulnerable consumers, price increases would be unaffordable. I am not saying that it is desirable, but it does not look as though they would be unaffordable.

Q17 Paul Blomfield: Isn't there a difference between unaffordable and leading to significant behavioural change? That is clearly the issue we are trying to get at.

Stuart McIntosh: It has to be borne in mind that many consumers today use first class services: they elect to pay the higher price of first class services. Research done previously by Postcomm—and we are doing further research to understand this—suggests that, if you ask people what they need in terms of reliability and predictability with regard to getting the letter there at the appropriate time, it is quite possible that second class would meet most of those objectives. Were that the case, then most of those consumers could switch from first to second, and would pay very little in addition, if anything.

Q18 Paul Blomfield: Does that statement about first class usage hold good for vulnerable groups as well?

Chris Rowsell: Broadly. Vulnerable consumers or those who have disabilities use second class slightly more than other socioeconomic groups, but predominantly still use first class. They use first class slightly less, second class slightly more, but still mostly first class even when it is not time sensitive.

Q19 Paul Blomfield: Can you quantify slightly?

Chris Rowsell: I do not have the numbers in front of me. We have got a number of different research sources working on this. Consumer Focus, for example, recently provided us with some research as part of a consultation response. We have got some preliminary results from an Omnibus survey we have commissioned; Royal Mail has provided some. I could put together a short note summarising some of those different methodologies—it is quite difficult to give a precise answer.

Q20 Ann McKechin: If I could turn, Mr McIntosh, to the impact on small businesses in particular. Can I ask why you took it as your working hypothesis that small businesses can afford price increases as much as consumers, given that their usage patterns are likely to be hugely different.

Stuart McIntosh: I will ask my colleagues to come in on this question, but I will make a start. There is a body of research available that gives us an understanding of the level of spend on postal services by small businesses, and how that changes by scale of business. It does seem to be the case that many small businesses use stamp services, so insofar as they are protected by universal service, if there were changes

in prices they would be affected somewhat similarly. It is also the case that small businesses do not spend huge amounts on postal services: there is quite a lot of evidence that over the years a number of those have been reducing their spend on services, because they are relying more on the use of email and other means.

Q21 Ann McKechin: It would very much depend on the sector in which they operate. A corner newsagent is not likely to use many envelopes, but someone running a small office would.

Stuart McIntosh: Absolutely, but people whose businesses are office and communications based are more inclined to use mobile phones, text, and email nowadays. Do you want to come in on numbers?

Chris Rowsell: The vast majority of SME mail is being sent by stamp, and a large proportion of it is being put into post boxes, just like residential consumers, so the safeguard cap on second class post also applies there. Businesses are more likely to use second class post than residential consumers; 71% of SMEs spend £100 or less per month on postal services, with 35% spending £25 or less a month. Rural SMEs have a lower average spend than the national average; 47% of rural SMEs have a mail spend of £1 to £25 per month. For all these universal service products, which include metered and pre-paid services, there are other discounts available and convenience benefits for SMEs who are sending larger volumes of mail.

Q22 Ann McKechin: It is a question of affordability. Why did you think there was a connection between affordability for small businesses and their profit margins and someone who is running a household budget? To my mind they are different things.

Stuart McIntosh: They are different things, but it is also based on the notion that, if you look at the data, it does not appear to be the case that the vast majority of small businesses spend huge amounts on postal services. If there was an increase—which I agree would be regrettable—it is likely to be affordable: i.e. it is not likely to have a material impact on their profitability.

Q23 Ann McKechin: Did you segment this into different sectors? That would be a more valid comparison than taking SMEs as a whole across the UK. That, to my mind, is fairly meaningless.

Mr Ward: It is also tax deductible.

Chris Rowsell: We do have more detailed research that cuts across different types of business. I do not have those numbers to hand.

Chair: Again, further evidence would be welcome.

Q24 Mr Binley: Ann is right: many small businesses in rural areas—one man, two men at most, businesses—should be considered as vulnerable consumers; I believe the Federation of Small Business thinks that is the case too. Why do you seem to reject that advice?

Stuart McIntosh: I am not saying that we would necessarily reject that advice. I think—Chris will correct me if I am wrong—vulnerable consumers in the context of our duties are defined in the

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Communications Act. I had better ensure that is correct so I am not misleading the Committee. We thought clearly about business users both large and small, because business users are the engine of volumes of mail in the UK, and without usage from those users the service would be fundamentally challenged.

Q25 Ann McKechin: Royal Mail evidence on this particular area in its published form was redacted. How robust did you think it was?

Stuart McIntosh: The information that was redacted in Royal Mail's response was largely to do with commercial information specific to them, quite a bit of it related to their own Government submissions in respect of the state aid application to Brussels regarding their pension deficit, which it would not have been appropriate to put into the public domain. We were able to replicate and understand the financial information that they provided to us, because we have independent models and analysis, some of which we have inherited from Postcomm, which allowed us to validate that. The more detailed information that they provided to us, which it would not have been appropriate to publish, allowed us to understand a lot of the specifics regarding their efficiency programmes, and so forth, so we were able to test and understand it.

Q26 Ann McKechin: The redaction was primarily on the basis of—

Stuart McIntosh: It was on the basis of confidentiality.

Q27 Ann McKechin: Contractual confidentiality?

Stuart McIntosh: Yes, and there was nothing different with regard to the approach on redactions in respect of Royal Mail from what we applied to BT, Sky, TalkTalk, or anybody else who responded to our consultation. They were treated exactly the same way.

Q28 Ann McKechin: Thank you for that clarification. Could I come on to the Consumer Focus alternative, which proposes retention of price controls with an RPI linking over a five-year period? What were your views on that proposal?

Stuart McIntosh: That is something that we considered in formulating our proposals in the first instance. As I said earlier on, one of the major factors that led us not to propose that approach is that the uncertainties regarding mail volumes in this context are very large. The likelihood of getting it wrong is quite significant. If you contrast it with most of the price controls that we applied with BT, there are one or two decisions that, if we made them here and got them wrong, would have huge impacts and implications.

It also introduces inflexibility, because if we get it wrong, Royal Mail has to come back, and there is a lengthy process to go through before a change can be made. Given the dynamic nature of the market and the uncertainties about the declines in volumes in the market, we felt that that was taking on a lot of risk, not for us as a regulator but possibly posing a risk to the financial sustainability of the USO.

Q29 Ann McKechin: On the accuracy modelling, are there too many variations to predict accurately?

Stuart McIntosh: Yes. It is highly uncertain. We visited a European operator two weeks ago: they have seen volume declines for this past decade; in the past year, they have seen volume declines of 8%.

Q30 Nadhim Zahawi: Consumer Focus are obviously very concerned. They point to the reason that they believe underlines Royal Mail's announcement: that Royal Mail want to set the price of a standard second class letter as high as possible, so that they could charge more for first class without causing people to switch to second class. Were you surprised that Royal Mail responded by arguing for the top of the range in second class, the price of 55p?

Stuart McIntosh: As a regulator I am getting a bit long in the tooth, so I am never surprised. I was not surprised. I can understand from their perspective that they would wish to see the maximum flexibility.

Q31 Nadhim Zahawi: With your experience, what do you think that indicates, in terms of Royal Mail's response, for their plans for the future price of first class?

Stuart McIntosh: I could speculate about that.

Q32 Nadhim Zahawi: Why don't you?

Stuart McIntosh: We are not taking our decisions on the basis of what we think they may or may not do, but rather what we think is appropriate to protect vulnerable consumers. We think it is very important we provide Royal Mail with flexibility, so that they are able to support the continued provision of universal service.

Q33 Nadhim Zahawi: You mentioned you could speculate: could you speculate a little bit in front of this Committee, and tell us what you think will realistically happen to first class mail prices if controls are lifted?

Stuart McIntosh: I do not want to do that, for the simple reason that we are in the process of the consultation. During the course of the next few weeks we will reach a conclusion on this point, and take a decision ourselves. Royal Mail will have to abide by that decision. That may be some point in this range, it may be at one of the extremes of the range, and we have not taken a decision on that: indeed, we wanted to have this discussion today as part of the input to that decision. It would be inappropriate for me to speculate, to be honest.

Q34 Nadhim Zahawi: Can I tempt you to set aside the conclusions and place yourself in the shoes of someone who is wanting to run Royal Mail? What do you think would happen to first class prices?

Stuart McIntosh: You are going to have the CEO with you in the next week or so.

Q35 Nadhim Zahawi: We certainly are, but I would like to hear from you, Mr McIntosh.

Stuart McIntosh: I don't know what they would do to first class prices.

Q36 Nadhim Zahawi: What would you do if you were in their place?

Stuart McIntosh: I would set it at the level I thought was appropriate.

Q37 Nadhim Zahawi: What would that level be?

Stuart McIntosh: I am not sure, because I am not responsible for their commercial strategy. We are not micromanaging Royal Mail. I do not know what the trade-offs are between the prices they set for bulk mail and the prices they set for retail business mail—it is a very complex set of equations. One of the problems with the previous regime was that Postcomm, because of the way it operated, got involved in a lot of detail with the regard to the way that Royal Mail functioned. We do not think that is the right way to regulate the company. The management are there to run the company.

Q38 Nadhim Zahawi: You are absolutely right. At the end of the day, human nature being what it is, at some point they will inevitably get to the place where they will set second class at the highest limit of the cap so that, if they then do increase first class, you will not get people falling away into second class. That is where we are inevitably heading, isn't it?

Stuart McIntosh: Not necessarily. I can think of charge controls, which are a bit different from the caps, that we have applied to BT, where BT, for a variety of reasons, have not taken full advantage of them. We were in the Netherlands two weeks ago to talk to both the regulator and the company in the Netherlands, and the prices they have set for some of their stamps are significantly below the ceiling that they could set and they think that is the right commercial judgment for them.

Q39 Nadhim Zahawi: How long has the ceiling been in place in the Netherlands?

Stuart McIntosh: I would need to come back and confirm the details, but I believe from memory that it has been for some time: it is not just a very recent phenomenon.

Q40 Chair: Could I come in from a slightly different angle? I can understand your reticence, but do you think I would be behaving sensibly if I bought all of my Christmas card second class stamps now before they go up?

Chris Rowsell: I have already bought my Christmas cards—in the sales.

Stuart McIntosh: I am a regulator. I do not advise on financial speculation.

Q41 Nadhim Zahawi: I think your colleague, Mr Rowsell, answered that question for us. Lifting the cap on first class is likely to take the UK overnight from one of the lowest first class stamp prices in the EU to the highest. You have said there is no observable precedent for this in the evidence you have given us. Does that mean we are leaping into the unknown—anything could happen here?

Stuart McIntosh: I do not think that an increase in first class stamp prices would be unprecedented. I suspect you have this evidence, but if not we would

be more than happy to provide you with details as to where the UK currently stands relative to other countries in Europe. From memory, and we have some of the charts here—

Q42 Nadhim Zahawi: I think in your evidence you said, “There is no observable precedent for the impact of significant price rises at a time when volumes are already declining.” My point is that you cannot model this, because we are going into the unknown here and there is nothing for us to compare with.

Stuart McIntosh: Sorry, I misunderstood your point. There is uncertainty: there is no question about that, and that is a big factor Royal Mail will have to factor in to its decision making as to where it chooses to increase prices and where it does not.

Q43 Rebecca Harris: Coming back to the possible 55p price of a second class stamp, which works out as a 53% rise, what estimate have you made as to what volume of that mail might move over to other forms of communication?

Stuart McIntosh: The first point to make is that we have not assumed that is where this will come out, either in terms of what our decision will be or in relation to what Royal Mail will choose to do. If there are increases, one would expect to see demand volumes shift, but it is going to be heavily dependent on what happens to other prices. If first class prices move up, and consumers decide that the balance of the value for them is they can get what they need using second class mail, and the overnight delivery is not critical, you may find that second class volumes do not change that much. It will depend on what happens to the relativities of prices. Overall it must be the case that, if prices are going up, volumes will decline.

Q44 Rebecca Harris: You said earlier that, typically, when a price rises there is a reduction in volume, and you have also said that ensuring we keep the volumes up is essential to keeping the universal service obligations. Have you made any estimates? For example, if second class post increases to 55p, that is about 10 text messages. Could it be that it moves to other media?

Stuart McIntosh: Absolutely. One of the reasons we are in the situation we are in today is that text messages cost almost nothing at the point at which you use them, and over the course of the past 10 years consumers in large numbers have adopted these other means. If prices go up, it is going to encourage consumers to continue to switch.

Q45 Rebecca Harris: What will prevent a scenario whereby we get an ever-declining number of customers to sustain an ever-increasing postal price?

Stuart McIntosh: We know that structurally the trend is against mail; some parts of the industry are growing, particularly around fulfilment, but currently those are not large enough to compensate. There are operators across Europe who, during the past 10 years, through a combination of selective price increases and through changing their whole operational models, have managed to secure an outcome where, even in

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the face of sustained declines in volume, they have been able to maintain a sustained universal service. There is every reason to believe that the same is possible here in the UK.

Q46 Rebecca Harris: What would prevent that happening in the UK?

Stuart McIntosh: What would prevent that happening is if Royal Mail is not able to use the opportunity that this regime would provide it to continue to drive efficiency improvements. If we do not see improvements in efficiency, and the only way the universal service can be made financially viable is for prices to go up, there will come a point at which users, and particularly large business users, will make the investment in the systems to transfer their mail activities on to the internet.

Q47 Rebecca Harris: What I have not worked out here is what work has been done, and what you are aware of, to ensure the pricing regime is right to maintain customer loyalty and will maintain those volumes, and at what point we reach a tipping point. Is there not a case for having a more modest price rise to maintain customer loyalty? What work have you done on that?

Stuart McIntosh: We have looked at the overall market environment in terms of what is happening in the industry. It is clear to us that there is a great deal of uncertainty about that market environment. We believe the Royal Mail and the industry is in a much better position than the regulator to figure out how prices need to be set across the whole market in order to sustain its viability, rather than us attempting to second guess the management of the companies. In some respects you could say that was one of the faults of the previous regulatory regime, which failed.

Q48 Mr Ward: Can you talk about efficiency savings? The antidote to increased price is reduced volume, leading to increased price, which reduces volume, and so it goes on: there needs to be efficiency savings. Concerns have been raised by Consumer Focus about the history of managing to generate efficiency savings. In the past you have had the constraints of the universal service and price control. Why did that not generate sufficient savings?

Stuart McIntosh: I would have to be honest and say that we were not closely involved in observing the industry, so we cannot speak on the basis of first-hand experience. In an environment where volumes fell very rapidly, the need to act quickly was not fully anticipated. We have been looking at other environments, and we had a detailed session with the senior management of the Dutch postal company two weeks ago. They started working on the transformation programme that they have been implementing over the past few years almost 10 years ago. It takes a long period of forward planning to anticipate and respond to the changes.

Royal Mail will be able to talk about this more knowledgably when you see them, but it is probably fair to say that the same efforts did not get under way fully here in the UK until towards the latter part of

the last decade—the investments in the machinery and the sorting equipment.

Q49 Mr Ward: In October you said that efficiency savings had proved very challenging. What confidence have you got that they will overcome those challenges in the future?

Stuart McIntosh: The confidence is in part that the changes we are putting in place are going to take away the dead hand of regulation from the day-to-day management of the company: they will have some more flexibility. It is also clear from the experience in a number of other countries, places like the Netherlands, Germany, and some of the Nordic companies, that it is possible to deal with a situation where volumes have declined, and to rationalise and improve your operation very significantly. I am not an apologist for Royal Mail, but they have made very significant and important strides in respect of that, in relation to the investments they have made in recent years in automating a lot of their processes. There is still some considerable way to go, and there is quite a lot that needs to be done to take advantage of the investment in equipment by designing new processes and putting those into place. It takes time, but the experience of others suggests it is possible.

Q50 Mr Ward: My wife will laugh at this analogy, but if you allow prices to increase, does that not release some of the pressure in the cooker, enabling you to cook—here we go—the efficiency meal?

Stuart McIntosh: I recognise the analogy and I can see that there is definitely something in it. In the short term there is the need to improve the financial viability of both Royal Mail and the universal service. In the short term prices have got to play a significant role in relation to dealing with that. In the longer term, however, we will be looking to track closely what is happening to the delivery of universal service: i.e. is Royal Mail delivering what it is supposed to in respect of universal service? What is happening to its profitability? Where are prices relative to the best of the prices we see across Europe? What is happening to efficiency? Are the efficiency targets that the company set itself being achieved and realised? Part of the monitoring regime that we are putting in place is designed to pull those things out.

Q51 Mr Ward: Is there a temptation to retain the price control until they have proved themselves able to deliver on the efficiency saving?

Stuart McIntosh: It goes back to one of my answers earlier, which is: in an environment where the volumes are falling as rapidly as they have been in this market, that would expose the financial viability of universal service to very considerable risk. It is worth remembering that during the course of the past five to six years, Royal Mail has been losing significant amounts of money—hundreds of millions of pounds—on its mail operations. During the period of the current price control, which runs from 2006 to March of this year, the cash flow in those operations has been almost £3 billion less than was anticipated when that charge control was set. The situation was

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dire and is still very severe: we should not lose sight of just how severe it has been and remains.

Q52 Mr Ward: One area where volume could increase is in second class post, where the satisfaction levels are currently very high. How would you envisage the pressure being on the organisation to deliver such high standards with an increased volume of second class post?

Stuart McIntosh: Is this on the basis of the...?

Mr Ward: Shifting from first to second.

Stuart McIntosh: Given that prices have been going up overall, we would expect some aggregate reduction in the volumes, and I would imagine, although Royal Mail would be able to answer your question as well, that if the volume is largely a shift from first to second class, the delivery network ought to be able to support that and sustain the quality of service levels. In many respects it is supporting a higher quality service level for the same volume through delivering some of that first class to date.

Q53 Mr Binley: Why have you chosen the RPI to index the price cap?

Stuart McIntosh: We have not chosen it yet. What we have done traditionally in the charge control regulations that we have applied in other industries, certainly in telecoms, is use RPI, and we have tended to be consistent in the use of RPI across all those controls. However, we did flag in our consultation document that there are some arguments for considering the CPI in this area, and we are still looking at that. That is one of the decisions we will take over the next few weeks.

Q54 Mr Binley: I am delighted about that, because you will know there are vulnerable customers—the

elderly, disabled, or those on low incomes—who are reliant upon benefits. You know that the Government has totally adopted CPI as their measure of inflation, and it would seem to me to be sensible that you should do the same. Will you do so? Go on—get out there on a limb.

Stuart McIntosh: Well, I will not repeat what I just said, but it is still in very active consideration and we are very alive to exactly the issues you have just mentioned.

Q55 Mr Binley: I am quite elderly—

Stuart McIntosh: I am too.

Mr Binley: If I am going to buy my Christmas stamps next year, can I expect that I will be doing it on an increase of CPI rather than RPI?

Stuart McIntosh: You won't have too long to wait.

Q56 Mr Binley: Go on. Really, really go out on a limb—be adventurous.

Stuart McIntosh: You don't get hired to be a regulator because you are adventurous.

Mr Binley: Sadly.

Q57 Chair: On that note, can I thank you for your contribution? There were a number of issues that we asked for further information on: if you could submit that in writing, we would be grateful. If you feel there is a response to a question that we need to know but did not ask, feel free to send that information to us, and if we feel that there was a question that we should have asked but did not, we will do that as well and await your response. Thank you very much.

Stuart McIntosh: Chairman, thank you.

Examination of Witnesses

Witnesses: **Adam Scorer**, Director of Policy and External Affairs, and **Robert Hammond**, Director of Postal Policy and Regulation, Consumer Focus, gave evidence.

Q58 Chair: Thank you very much. For voice transcription purposes, could you just introduce yourselves?

Adam Scorer: Thank you very much. I am Adam Scorer. I am the Director of Policy and External Affairs at Consumer Focus.

Robert Hammond: I am Robert Hammond. I am the Director of Postal Policy and Regulation at Consumer Focus.

Q59 Chair: Thanks very much, and I reiterate what I said to the previous panel: don't feel that you both have to answer every question.

Ofcom argues that price controls have failed. Do you agree?

Adam Scorer: It is not so much that the previous regime has failed; rather, the market fundamentals and the regulatory framework have changed significantly, and it is right that Ofcom take a serious and robust view of what is needed. As with Ofcom, we have to recognise the decline in volumes of mail, in particular

over the past four years, and the prospect of that continuing, and the use of electronic substitution—even though it will never be a total substitution—for letters is on the increase. We have had price controls rolled over twice. We have had change in the regulatory framework from Postcomm to Ofcom. We have had Hooper, a couple of Postal Service Bills. It is appropriate to have a fresh look at what price control and regulation of the market needs to do.

For us, as a consumer organisation, we are particularly concerned about the interests of vulnerable consumers. I would not restrict that to disabled people and pensioners. I would look at remote and rural communities, at low income and low internet usage, and SMEs that do not have the ability to take advantage of discounted bulk purchasing. The consequences of the changes that Ofcom will come up with for those consumers should be at the front of their minds to determine what the appropriate final solution they reach should be, and there should be a

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model to assess its success and the need to review it going forward.

Q60 Chair: You broadly believe there should be some degree of price regulation in the future. Given that Royal Mail's current problems have occurred under price regulation, where do you think it can work in the future?

Robert Hammond: It is not just about the price regulation mechanism that existed in the past. Adam Scorer has already set out the fundamental change that there has been in the market over the last few years. It is also about something you have touched on before in the Committee here: Royal Mail getting control of its costs and also making itself an efficient organisation, rather than one that is just able to increase its income by raising prices. Our belief is, and the modelling that we have done suggests, that if it stays on its current course it is in for a very rough few years ahead, but if it does get to grips with its costs, and makes some very modest efficiency gains of around about 5% per annum, the business can be turned around quite significantly. We do not see price rises as the saviour of Royal Mail; it is potentially one aspect, but the other two parts of that trinity—cost control and efficiency—are just as important.

Adam Scorer: We do not underestimate the scale of the challenge that Royal Mail faces to drive out inefficiencies from their business and build a sustainable, profitable model, given the characteristics of the market fundamentals that are out there. We do not want to see any pressure taken off that impetus by a price control mechanism that would allow it to do the far easier thing of raising prices in what is often a captive market, rather than addressing those difficult and stubborn inefficiencies issues that will plague every large network industry and company, not just Royal Mail.

Q61 Chair: Do you not agree that, to get the investment needed, there has to be some degree of price increase to generate the extra money required?

Robert Hammond: That is why our suggestion to Ofcom was to make it an RPI minus zero. That would give Royal Mail the ability to raise prices within a fairly narrow band, but at the same time places far greater emphasis on these areas where its track record to date is not very good. Under previous price regimes, it has not engendered the cost constraints that we would like to see. That has to be the central issue that is addressed.

Adam Scorer: You warned both of us not to answer every question—I am aware of that. You are right: Royal Mail needs greater flexibility to reflect the market and to address the short-term revenue issues—we would not dispute that. If Ofcom goes the portfolio way of introducing minimal caps, but has other requirements on it, we would say there is more that Ofcom could do down that route by having structural reviews halfway through a seven-year period, which seems to us a long period, as well as strengthening that part of the Royal Mail offer and product range that would be captured by the price regulation framework they suggest: not just second class standard letters, but large letters, which would be

excluded, and packets up to a certain size, which is a growth part of the market.

Royal Mail needs a degree of flexibility—that is uncomfortable for us, because that will mean higher prices. But within the regulatory framework that is brought about by this consultation and review process, consumers must have a protected group of services and products that makes sense and provides a viable, affordable communication product.

Q62 Mr Binley: Can I put it to you that it is inevitable that there will have to be a period of higher prices to compensate for under-pricing and underinvestment in the period up to 2007?

Robert Hammond: That is true, but Royal Mail has enjoyed some fairly large price hikes over the last few years: typically since 2003 first class has gone up 75% and second class by 80%. In the rollover periods that we have had, the previous regulator, Postcomm, was sympathetic to the financial plight of Royal Mail, and so was Consumer Focus. We did not stand in the way of those price increases that Royal Mail wanted, because we recognised how universal service needed to be protected for all consumers. It is not the case that we are saying no to price rises under any circumstances; we are saying it must be done in a measured way so there is not a free licence to print your own prices. There must be a quid pro quo, which is to bring your business under control.

Q63 Mr Binley: You talk about possible tipping points with regard to pricing. Can you explain your evidence for those tipping points?

Robert Hammond: Yes. In December of 2011, just a couple of months ago, we did a piece of research—with this consultation by Ofcom very much in mind—and we looked at three distinct consumer groups. We looked at, if you like, a general consumer group; we looked at a vulnerable consumer group that was based on age and also income; and we took a third group, which was that vulnerable group, but also with a very low internet usage. We asked them a series of questions about what sort of levels prices would have to achieve for it to make a difference to their current behaviour, and where it was that they were likely to make some significant changes.

The tipping point evidence is very interesting, inasmuch as it clearly shows that, as prices rise, general consumers—and, to some extent, vulnerable consumers—will decrease their usage of Royal Mail services, whether it is first class or second class, across the product range. This will reduce quite dramatically, as far as consumers are able to.

The difficulty, though, is with regard to the third group—the group that do not have an alternative, or very much of an alternative, in terms of communication in its own right—in other words, the vulnerable consumers who are low internet users. That group we found, in particular, were very sticky—if I can put it that way—in terms of the prices. They could not switch away in the numbers because they had no other option, and that is an area that gives us grave concern, inasmuch as if Ofcom is going to pursue a policy of allowing Royal Mail to set its own first class prices, we feel that the suite of second class prices

needs some protection so that consumers—and particularly vulnerable consumers—have a safety net. At the moment, these proposals provide none whatsoever.

Q64 Mr Binley: I am glad you raised the issue about vulnerable and low-web users, because the predicted rate of drop-off is relevant. Can you explain your modelling in that respect?

Robert Hammond: Yes. As I say, we did a number of face-to-face interviews with this particular consumer group.

Q65 Mr Binley: Can I ask how many?

Robert Hammond: 220 was the number.

Q66 Mr Binley: Which is what percentage of representation of the total market in that respect?

Robert Hammond: I don't have that figure with me but we can certainly provide that for you.

Mr Binley: Thank you; I think that is relevant.

Robert Hammond: That was against a sample size of just over 2,000 that we did on an online basis, which covered—if I can put it like this—general consumers and those from a low-income elderly age bracket that did have internet connections. We have looked at it, as I say, and our model has looked at the different segments of the group, so that what we have done is we have predicted something that could be used as a proxy for the nation.

I absolutely accept that, with a sample size of 220 or whatever it is, it is indicative research only, and that has to be said with that caveat in mind, but, nevertheless, I think this is a better sample than perhaps has been used for some of the other evidence that Royal Mail has used in support of its case. I think that what it does show is that, as I say, whilst the general consumer or vulnerable consumer groups decline their use of mail, switch to other things, downsize from first to second class post, a very common trend is that these vulnerable, low-internet users do not do so to the same extent.

Adam Scorer: It is important to recognise the point previously made by the Committee that affordability is a critical issue, of course, but so is consumer behaviour.

Q67 Mr Binley: I understand that. I am glad you offered to send us the figures, and not only of the number of surveys; we would also like to see the sort of questioning processes you went through, and we would like to see what percentage of the total market you were dealing with, because I think it is pretty important evidence, and whilst I recognise it is only 220, you are right in saying it is the largest survey done in this respect, so it has a considerable relevance to us.

Can you expand on your concerns about the reliability of evidence, which, in a way, leads on from what I have just said, on vulnerable consumer usage patterns?

Robert Hammond: Yes. Royal Mail, in their response to Ofcom, have provided some evidence, and you have already heard that there have been some redacted elements of that. Some of it relates to vulnerable

consumers; it is difficult to imagine that could contain information that would constitute being commercially sensitive, but nevertheless it is not there. As I understand it, the Royal Mail survey is built on its consumer group, which is around 600 consumers, and I am assuming that the social group D and E element of that would typically be about 30%. Royal Mail will doubtless be able to confirm this. If so, you are talking about a relatively small number, less than our 220, and you are talking about that social group. You have not included in that those who do not have the alternative who are not internet users; actually, it could be an even smaller group.

Now, to base one's policy—and, particularly, lobbying for a drastic change to the regulatory framework and requesting the ability to be able to set second class and first class stamp prices at will—on that kind of evidence, I have to say, does give us some concerns. We would like to see a far more in-depth impact assessment being done that looks at all of the contingent parts of our society. Let us not forget that universal service is not there for its own sake and it is not there to keep Royal Mail in business; it is actually for us, as citizens, as users of the service, and for the businesses that use Royal Mail. So we would like to see a far greater impact assessment before a massive decision is taken that will be very hard to reverse.

Mr Binley: Can I thank you for that? I accept what you say and I would urge the Chairman to think about writing to the regulator in that respect. I think it is very important to do so before they make the decision, and it needs to be done quickly. Thank you.

Chair: Our intention is to complete this very quickly and then we can incorporate it in. That is the purpose of holding it now.

Q68 Katy Clark: Can you explain your concerns about whether substitute parcel delivery providers can provide a realistic alternative to Royal Mail, particularly in remote areas?

Robert Hammond: Yes, indeed. Thank you for that question. Yes, part of the Royal Mail evidence to Ofcom was a suggestion—firstly for SMEs—that they could use AllSort and PremierSort products, which are offered by a company called TNT, as an alternative, but both of these products—on the research that we have done—show that you would have to be sending out some fairly hefty amounts in terms of volume to be able to qualify for the lower prices. You have already heard how SMEs and, indeed, microbusinesses behave in a not too dissimilar way to us, the ordinary domestic consumer. That, as an option, really is not an option.

Also, it has been suggested that if consumers were to look on a website called Parcel2Go, they could see that there were different courier services that could act as competitors, if you like, to Royal Mail for us domestic consumers to use as alternatives. Again, looking at those, they generally offer a next day service or a two-plus day service, unlike the three- to five-day standard parcel service of Royal Mail. A lot of these companies, as well, impose a surcharge, particularly if you are sending to Northern Ireland or the Highlands and Islands of Scotland, and some of

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these companies won't deliver there at all, so your options are very limited. Regarding other outfits that exist that we could, as domestic consumers, perhaps access, as you move away from the urban centres, the pick-up points or the drop-off points for this type of mail become few and far between.

Quite frankly, regarding a universal option to Royal Mail, at the present time in this country there is not one. There are a few options if you are prepared to pay three or four times more than Royal Mail is currently charging, and it is not absolutely certain whether or not that service will be offered.

Q69 Katy Clark: On a separate issue, how exactly do you arrive at the conclusion that a safeguard cap is required across all second class products?

Robert Hammond: I think it is one of logic to start with, inasmuch as what we see from the survey and the research that we have done is that, whilst general consumers and vulnerable consumers may move away as prices rise—and typically it may be 58% down to 25% or 51% down to 12% for the general consumers—it is because they have an alternative. You can text someone. You can pick up the phone. You can send an email. If you do not have that option, you are immediately constrained by how you can express that communication. Everything here shows that a small but significant group in our society cannot do that, and that is why we feel this protection needs to be there.

You also cannot send a parcel electronically. You cannot send it through your mobile phone or by text. The thing has physically got to get from A to B. That affects all of us, not just vulnerable consumers, and so that is why we feel that as a very basic service—a safety net—there has to be an element there that protects all of us from potentially overpricing.

Q70 Chair: Thank you. Can I just conclude? Royal Mail said it needs business certainty and that the regulatory framework, therefore, needs to be stable or constant for seven years. What is your view on this?

Adam Scorer: We think seven years is a rather unnecessarily excessive period of time. We think that five years is perfectly adequate to provide that certainty. Royal Mail do need certainty. We should not give the impression that they do not. Every business needs regulatory certainty to be able to invest and plan and price plan and all of those sorts of things, but we think that five years would be an adequate period of time.

Should it be the case that Ofcom decide they will go for a seven-year price control period, we think it is absolutely vital that they institute some form of formal, structured review process during that period of time. I think the intention is that they will monitor, they will observe, they will keep on top of the situation by the data that is available to them. We are uncertain about the quality and the adequacy of the data that would be available through an informal monitoring process, so we think five years would be ideal. We think that seven years has some issues with it, and those issues would need to be mitigated by a formal structural review process, perhaps halfway thorough.

Q71 Chair: What are the issues? Because although you have said, effectively, you think it is too long, you have not really articulated any specific reasons.

Adam Scorer: I shall defer to my colleague.

Robert Hammond: I think there are a number of issues. If I could just flag up one thing, the USO—let us be honest about it—is largely underpinned by big mailers sending out lots and lots of mail, and that helps the price of stamps for you and me to be kept perhaps lower than would otherwise be the case. What banks and insurance companies are telling us is that the price increases they sustained last year, in the April 2011 price increase round, has not yet fed through to their mailing habits. It takes time if you are going to substitute electronic communication for mail. There is the purchasing of that and the infrastructural changes. So we know that is already in the pipeline but has not happened.

What they are also saying to us is that if Royal Mail is allowed this *carte blanche* to raise their prices, that may well accelerate their move away from post, so we have a very uncertain future here that will play out in the next few years. We need to see what happens with mail volumes. We need to see how consumers react if these price rises go ahead and, also, it is true to say that Ofcom have begun a review of the USO and whether it is meeting the needs of consumers today. We ourselves are looking at this. The USO is not set in aspic. It needs to reflect the needs of the 21st century consumer as well as the business. So we feel that all of this could radically change the landscape in the next three to four years, and that is really why we feel it is right to have this type of review at that point in time.

Q72 Chair: Sorry, can I just understand this correctly: are you saying that the USO, basically, is potentially reneged upon, or could be over the next few years?

Robert Hammond: I am not saying it can be reneged upon. Clearly it is set out in very clear legal terms at this moment in time and would require an Act of Parliament to change what it is. What we are saying is that some research that we did in 2010 jointly with Postcomm reflects the fact that for a lot of consumers the necessity, shall we say, to have deliveries six days a week is not one that they particularly value now as much as they used to perhaps 20 years ago. The problem with that is that consumers will say to you, "Yes, by all means lose a day during the week." Whereas businesses will say to you, "No, lose Saturday. We want mail during the weekdays."

What I am saying is that I think to inform both perhaps potential changes at a European level to what would constitute a USO and nationally over a medium to long term, what needs to be looked at is what people need now, not what they have just enjoyed for the last 100–150 years.

Q73 Chair: Okay. Can I just come to the issue of CPI and RPI? What is your view on CPI being adopted to index price increases?

Robert Hammond: Generally speaking, I think we probably favour CPI over RPI because of the nature of the index itself, and it is probably far more relevant.

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It has to be said, in terms of the Ofcom response, we have not made a big deal about it, simply because we would just like to get them on board about having a price index-related price control at all.

I have to say the moment the difference between CPI and RPI is very minimal. As of January this year, last month, RPI was running at 3.9% and CPI at 3.6%. The projection going forward is not too much of a change. It is a refinement, but let us get to the principle, first of all, of having some form of price control.

Chair: Yes. That will be the case until interest rates go up.

Robert Hammond: Yes, indeed.

Chair: Right, that concludes the questioning. Thanks very much and, again, I will repeat that if there is any information that you feel we have not teased out of you that we should have, please send it to us. If there is any question we feel that we would like an answer to but didn't ask, we may do the same to you, but thanks very much.

Adam Scorer: Thank you very much.

Tuesday 28 February 2012

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Katy Clark
Julie Elliott
Rebecca Harris

Simon Kirby
Ann McKechin
David Ward
Nadhim Zahawi

Examination of Witness

Witness: **Moya Greene**, CEO, Royal Mail, gave evidence.

Q74 Chair: Good morning, Moya, and thank you very much for coming to speak to the Committee. Could I just ask you to introduce yourself so that we can check voice levels for transcription purposes?

Moya Greene: Good morning Chairman, and members of the Committee. My name is Moya Greene. I am the CEO of Royal Mail.

Q75 Chair: Thanks very much. I am going to start straight away; I will open the questioning. It caused some surprise at our meeting with Ofcom last week, which I have no doubt that you followed, when Ofcom did not seem to be able to tell us what cost levels should be covered by a second class stamp—the service cost. Can you?

Moya Greene: It is quite complex, Mr Chairman, because this is a network business and it is a vast business; it has to be in order to deliver the service that we do to 29 million addresses every day, six days a week, with the on-time performance standards that have been set. Because it is such a vast network, involving 59 mail processing facilities, 11 regional facilities, 35,000 vehicles, 54 flights every day, 1,350 delivery offices, 11,500 postal outlets, 115,000 collection points—it is a vast network—it is very difficult to say what cost is attributable to a single segment of the product that we carry. I can tell you what the whole universal service costs: the universal service that we provide is probably £6.5 billion a year. But it is very difficult to say what would be attributable to a single second class stamp.

Q76 Chair: You must have done some sort of calculation of at what level you needed to pitch the second class related to the volume to cover these costs. I appreciate to a certain extent it would depend on the price of a first class stamp as well, and the volume levels for first class mail. What research have you done?

Moya Greene: For pricing of all of our products, we are looking to cover our costs and to have a commercial rate of return. As you know, this is something we have not been able to do for a number of years in the core business. In fact, the core business has lost about £1 billion in the past four years and has been cash negative until very recently; it just turned cash positive. Across the entire product set, we look to cover all of the costs and to achieve a commercial rate of return. We do a huge amount of analysis when we price anything—when we price any of our

products. We have to look at the competitive landscape; we have to be prudent; we have to be aware of what our customers are prepared to pay for our service relative to other options that they might have, and we are very pleased to say that we are still, for all of our products, the highest value in the UK marketplace.

Q77 Chair: How do you define value in this context?

Moya Greene: If you look at the price of a second class stamp or a first class stamp or a packet or a parcel, and you consider the kind of service, the quality of service, that Royal Mail delivers, Royal Mail is the only participant in the market that collects the mail from all of these points every day and delivers to 29 million addresses every day; the number of addresses goes up by about 300,000 every year. We are the only one that delivers to minimum service standards across 11 different product areas. We have some of the highest minimum service standards in the world; we have some of the lowest rates in the world. In the case of the second class stamp, amongst 27 European countries only half of them have a second class stamp, and of the ones that do, the second class stamp is not uncommonly more than our first class stamp.

If we look at what our customers can expect to receive by way of service from Royal Mail, and if we look at the cost of that service and we compare it with other services, for example, the price of a first class stamp today is only about 25% of the cost of a single fare on the bus in London. People in Britain enjoy a very high quality service at a very reasonable price. There are very few things that one can buy for 46p today, Mr Chairman, and I would say for us to be able to take a letter from any part of the UK and to send it anywhere in the UK, overnight delivery, for 46p is very high value.

Q78 Chair: I suppose, crudely, the approach has to be the projected volume of first class mail plus the projected volume of second class mail, multiplied by the price of the respective stamps, factoring in a potential displacement cost of any increase. Would that be a reasonable basis for how the price of stamps is calculated?

Moya Greene: Those are some of the considerations, yes, but we have to look at all segments of the traffic that we have, all of the costs of universal service, and we have to look at the competitive landscape as well.

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We have to look at all factors when we are pricing our products.

Q79 Chair: I understand that these would have to be factored into the calculation. Arising from that, where would you like the second class price to be—not where you are allowed to have it, but where would you like it to be, to cover those costs?

Moya Greene: I am not in a position to say just yet, but given that we have lost in the past four years £1 billion in the core business, and that until very recently Royal Mail was cash negative, and therefore universal service has been in peril for some time—we have not had a sufficient amount of capital available to us to modernise the business—I can say that prices in the UK will have to come up.

Q80 Chair: Yes, that is generally understood. Given the losses you have made, what is your calculation for how much you would have to increase the price of a second class stamp, assuming all other factors were equal, to cover that loss?

Moya Greene: We do not look at it in isolation. As I mentioned, because it is a network business, we look at the whole cost of the network, the whole cost of universal service, and we try to take account of the competitive environment we are in and price all of our products in a way to cover those costs with a commercial rate of return.

Q81 Chair: You know from your current accounts the amount that you lost; you know the price of the stamps at the moment. Keeping all the other factors equal, what would have been the increase in the cost of a stamp necessary to wipe out that deficit?

Moya Greene: I cannot tell you offhand, Mr Chairman; I just cannot tell you that offhand.

Q82 Chair: Could you give us a written calculation of it afterwards?

Moya Greene: I can try, but as I mentioned to you, we do not look at products in isolation like that. We look at the entire product suite, the competitive landscape, the costs of universal service, and we are seeking to put our prices for all of our products at a level that would cover all of those costs.

Chair: I understand that, and it would be perfectly valid to put that as a qualifier, but it still must be possible to do a theoretical, statistical projection of what price would be needed to wipe out that particular deficit. I am going to bring in Brian Binley, and then Simon Kirby has indicated he would also like to ask a supplementary on that.

Q83 Mr Binley: I really am confused and I need your help, Ms Greene. I am a simple small businessman, who looks at his monthly P&L, looks at his budget centres, analyses his cash flow, has a knowledge of his wage and salary outgoings, and I know what each level of service provision my company provides costs. If I did not, I could not run my company successfully, because I would not know where the problems were—where the drag was on gaining additional profitability. Any business, to my mind, would want to know that information. I just wonder whether you do not want

to talk about it, because it is either that or you do not have at your fingertips the information necessary to run your business. Which is it?

Moya Greene: I have explained it as best I can.

Q84 Mr Binley: You have not, or I would not have asked the question, so go from that point.

Moya Greene: It is a network business.

Q85 Mr Binley: No, you have said that. We have heard all of your talk; I am saying I do not understand the situation. Go from my question please.

Moya Greene: Let me see how else I can try to say—

Q86 Mr Binley: I asked whether you did not know, and therefore that is an inefficiency in your management, or whether you did not want to say for some reason, which is a different reason altogether. Which of those two is it?

Moya Greene: We do not attribute costs in that way, Mr Binley.

Mr Binley: Then that may be the reason why you have had so much trouble in the past, Ms Greene.

Q87 Simon Kirby: If you do not attribute costs in that way, could I put it to you that it may be possible that you are already making a profit on second class stamps, and indeed first class stamps, and there is no need for any increase at all? In the absence of that information, how do you justify any increase at all?

Moya Greene: Because we look at the entire UK business, the UK core business, and in the UK core business, our accounts—

Q88 Simon Kirby: If I may interrupt you, the people who queue up in Post Offices to buy stamps to send important letters and to send cheques off, often older people who do not have a great deal of money, are not frankly very interested in your inefficient business where you are losing money. They will want to know whether or not you are making a profit on the stamp that they buy. I put it to you that, if you are not able today to tell us that you need to charge a certain level to break even on either a second class or first class stamp, you cannot justify any increase at all.

Moya Greene: Our reported financial statements make it very clear, Mr Kirby, that we are losing money and have been losing money in the core universal service business, which includes taking mail via second class service. In fact, the amounts are very clearly stated. Last year alone in the core business we lost £120 million and, as I mentioned, over the last four years we have lost £1 billion. That is how we keep our accounts—they are there for all to see; they are audited financial statements—but we do not publish or keep accounts on a specific product such as the second class stamp. We look at the whole core business, which includes second class mailing—of course it includes it—but there are other segments and products in that category as well, and we are able to say what the losses are for the whole UK business.

Q89 Chair: But surely it is possible to at least work out a theoretical calculation there.

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Moya Greene: Mr Bailey, it may be, and I can take that back if you wish, but I am saying that we do not do that as a matter of course.

Q90 Chair: Could you? It might inform our deliberations. Can I just put it to you that your vagueness on this a reflection that there are certain areas of information that you cannot discuss publicly because competitors are going to be listening?

Moya Greene: No, that is not the reason for my explanation. My explanation was given to you because that is what I know. That is how we keep the accounts in the business.

Q91 Chair: Okay. Lifting the cap on first class is likely to take the UK overnight from one of the lowest first class stamp prices in the EU to the highest. Ofcom has said there is no observable precedent for this. In this case, “Anything could happen”—that is an Ofcom quote. How are you planning for that?

Moya Greene: We have done a lot of work, analytical work—like any business would—to price all of our products, including the first class letter. We are very mindful of the options that our customers have, and in fact, as you know, most business customers do not pay that amount. There is quite a convention of discounting in the UK market for large volume mailers who are able to pre-sort their mailings for us. We spend an awful lot of time working through elasticity information, trying to understand where the tipping points might be—how much more might go via electronic communication.

We have seen very significant declines, a structural decline, in this industry, not just here in the UK but in all other places as well, as people resort to other means of communication to get their messages to their customers. We look at all of these factors; we look at what has happened in other countries, and we, of course, look in the whole broad suite of products that we have to cover all of our costs, including a commercial rate of return. The reason why things are difficult in calculating elasticities in our business today is because it is a business that is in structural decline.

Q92 Mr Binley: I just want to know how you can assess discount when you have no idea of the cost.

Moya Greene: We do have some idea of our costs; this is of course the case. For example, we are able to figure out what some of our upstream costs are. But I have to say that, in the prior regulatory model, oftentimes costs were quite artificially attributed. We are able, for some aspects—for example we can figure out what the sortation side may cost; we can figure out what 100,000 feet on the street will cost—but we cannot figure out what is the cost attributable to a single second class letter, or at least we have not yet done that, Mr Bailey.

Mr Binley: So nobody asked that question?

Q93 Chair: No, but it is reasonable to say you should be able to figure out what the price would be to cover those costs—the volume of letters and the price of the stamp to go on them. I would have thought there was a simple formula that you could use.

Moya Greene: It is not a simple formula.

Q94 Chair: Ofcom has said that basically prices should be fixed at an appropriate level. You must have done some sort of calculation to determine what in theory would be an appropriate level to cover those costs.

Moya Greene: Yes, of course. We have a very big team that works on pricing and looks at all of the factors I have mentioned that go into our view of what is a reasonable amount for us to charge for a product. This pricing team looks at everything: the competitive landscape, the options that are available, including electronic transmission of messages; historical rates of decline; and what has happened in other countries when similar products have been priced at different levels. But there is no question that it is a very complex matter, particularly when you are in a business that has undergone the kind of structural decline that mailings have experienced.

Q95 Ann McKechin: Ms Greene, you have stated to the Committee that you are unable to break down per category of product where the actual cost is.

Moya Greene: I said that we do not do that.

Q96 Ann McKechin: Yes, okay, but given that you have a basket of products that you deliver through the Royal Mail service, by what percentage on average do you think you need to increase the price of all those products grouped together to achieve the level of profit that Royal Mail requires to be sustainable? Presumably you do have a figure for an approximate average increase in price across the range that you need to meet your costs. What would that be?

Moya Greene: Overall, we would need to improve our revenue position via all of our products by about £250 million to £300 million, in order for us to cover all of our costs. Then of course we would need additional on top of that to achieve a commercial rate of return.

Q97 Ann McKechin: What percentage are we talking about, then?

Moya Greene: If we take out the Post Office, overall we are probably talking about an increase of 8% or 9%.

Q98 Ann McKechin: 8% or 9%. Thank you very much.

Moya Greene: Overall.

Q99 Chair: What percentage would you reasonably add for a commercial rate of return?

Moya Greene: If we look at other postal administrations that are able to access capital, a reasonable commercial rate of return in this business would be between 10% and 15%.

Q100 Chair: So 8% or 9% and then 10% and 15%. We are beginning to arrive at some sort of statistical basis. You talked about discounting. If you get more pricing freedom—and Ofcom is proposing that you do—will you decrease prices as well as increase them in response to the market situation in different sectors?

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Moya Greene: I am certainly not thinking about that right now, Mr Bailey, because the company has been losing so much money. I am looking across the entire suite of products; I am looking at the competitive landscape, which is vastly different today from what it was even 10 years ago. As a management team we are looking at every single product and service that we offer in the market and trying to see how we can best price them to retain the loyalty of our customers and to be successful in what is a very complex market.

Q101 Chair: Broadly, you do not think there is any scope in the market for reductions in prices?

Moya Greene: I would not like to be categorical; there may be some services that we could, but I am certainly not thinking that way now, Mr Bailey.

Q102 Paul Blomfield: I must say, I share my colleagues' incredulity about the approach to pricing. Before I was elected to this place, I ran a much more modest commercial operation, with a turnover of about £9 million but several hundred lines in different areas of business. I cannot imagine how we could have maintained profitability without understanding each of those lines individually, their respective costs and so on. My question is building on your point on elasticity and the work you say you have done around elasticity, and also incorporating the point that my colleague Ann McKechin made a moment ago, to which you replied that, for the overall basket of products, you needed to increase prices by about 8% or 9% to wipe out your deficit. A price increase to 55p for second class mail is a 53% price rise. That is quite out of proportion with the overall level of increase you say you need. I wonder what work you have done around elasticity of demand on second class mail, and where you think the tipping point is in terms of what volume of mail might switch to other communication as a result of a price increase of that order?

Moya Greene: I am not in a position to talk about what the price of the second class stamp will be today, but we have done a lot of work with every single product area—a huge amount of analytical work—to try to anticipate what the behaviour of various categories of customer would be as you increase prices for each and every product and service that we deliver. Yes, we have done that work.

Q103 Paul Blomfield: Because there is a proposal that there should be a 55p cap for second class mail, let us assume theoretically, because I guess you must have done, you took advantage of moving up to that cap. What would be the consequence of customer behaviour if that happened? You must have done some modelling on that.

Moya Greene: When you increase the price of anything, obviously some customers look to the alternatives that they have. In the case of people who are using second class mailing, they can go to an economy mailing, they can change the channel—they do not have to use a stamp. They could go to meter mailing, so they could reduce the price by anywhere from 15% to 20% by choosing to go to a meter. They can look to other forms, other media. If they have

sufficient volume and the ability to pre-sort on our behalf, they can reduce the price even further. When we do the elasticity work, we try to anticipate all of the options that a particular category of customer might have in response to any price increase.

Q104 Paul Blomfield: If the price of second class mail did rise to the cap being considered, 55p, what does your work suggest in terms of the falloff in demand?

Moya Greene: There would certainly be some falloff in demand.

Q105 Paul Blomfield: How much?

Moya Greene: I cannot give you the exact number right here.

Q106 Paul Blomfield: Presumably your modelling would give the precise number; could you share it with the Committee in subsequent written evidence?

Moya Greene: I am just thinking—yes, I think we can do that.

Q107 Paul Blomfield: Okay, thanks. On that point, I wonder if a more modest second class price increase to the 49p, 50p level—which Consumer Focus suggest is below the tipping point that might lead the service into a spiral of decline—would signal Royal Mail's wish to recognise affordability issues and nurture better customer relations.

Moya Greene: We think that we have great customer relations, and as far as affordability goes, I am very sensitive that this is a difficult time for anybody in the UK. Families are having difficulty putting the two ends together at the end of the month, but it is worthwhile to point out for the Committee's benefit that the average household spends less than £50 a year on postage: about 40p a week. We do not think there is an affordability issue. This is not like electricity or gas, where households have to spend between £1,200 and £1,500 a year. This is really not even like telephone or the internet, where families would easily spend £50 a month. We do not feel there is an affordability issue, and in point of fact the former regulator, Postcomm, had done quite a bit of analytical work with consumers on that very point, and people did not feel there was an affordability issue.

That said, it is always going to be difficult for some people. One of the things we are planning to do for people who have very modest means is keep Christmas mailings in year 2012 at the same price as Christmas mailings in 2011, to recognise that that is the time of the year when about 55% of consumer mailings happen. Whilst we do not think there is a general affordability issue, Mr Blomfield, I do take your point that it is important for all corporations today to realise that this is a difficult time for many families.

Q108 Chair: Can I just pick up on that point? You are effectively telling us that you are going to have a Christmas stamp at the same price as the 2011 stamp.

Moya Greene: That is what we are trying to do.

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Q109 Chair: It is an aspiration, not a commitment; is that correct?

Moya Greene: No, I think you can take it as a commitment, Mr Bailey. I have to work through the details of how to do it and how to present it, but it is more than an aspiration.

Chair: That is good news, because I was going to make the point about affordability. Most people probably spend most on stamps at Christmas, and their other commitments are at the heaviest then, so it does become an affordability issue at that point. Paul, can I bring you back in?

Q110 Paul Blomfield: Christmas mail aside, specifically on the point that you do not think there is an affordability issue with second class mail, do you think an observer looking at the process of your pricing consideration might conclude that, if you only need to raise your price levels overall by 8% or 9%, you have made a calculation that you can clobber second class mail users to the tune of 53% because they are still going to stick with you?

Moya Greene: No, I do not think that would be a fair comment, Mr Blomfield. I think it is incredible value to have a letter go anywhere in the United Kingdom, with the service standards and the quality that our people put into the delivery of that letter anywhere, to 29 million addresses every day, in all kinds of weather, at today's rate of 46 pence. It is incredible value in and of itself, but compared with other postal administrations around the world, it is undeniable value. If this were Germany, it would be close to 60 pence; if it were Italy, it would be even more.

What has happened in the United Kingdom is that the regulatory model was quite a punitive model. There were price controls that went across about 85% of our revenue. Almost every product and service was the subject of price controls, and as a result the cherished, universal service in Britain, this great company—the company that taught the whole world how to do this business—fell into a state of true financial peril to the point where the very service that people have a right to expect of Royal Mail is in jeopardy. So I think we need to put it in that context. It is incredible value and it is just not sufficient to pay the total bill of this very high quality service.

Q111 Simon Kirby: I am very interested in your comparisons from around the world. I noticed from your CV that you were the Chief Executive Officer of the Canada Post Corporation. Am I correct in assuming that first class stamps in Canada from 16 January 2012 are 61 cents, which is some 39p in UK money?

Moya Greene: Not in terms of purchasing price parity. In terms of purchasing price parity, the stamp in Canada is much higher priced than the stamp in the UK.

Chair: Right, can I bring in Nadhim Zahawi now?

Q112 Nadhim Zahawi: Ms Greene, you have made your points very forcefully about value for money. I just want to take you back to the research you conduct and your Consumer Panel. I completely understand the point you make about the average household and

the amount they spend on postage. I am really interested in the vulnerable households. What part of your panel is representative of the vulnerable households, the Ds and Es?

Moya Greene: I cannot answer that specifically for you, Mr Zahawi, because I do not know, but I can get that for you. When Consumer Focus and Postcomm did the research, it included several consumer panels. I will attempt to get back to you on that.

Q113 Nadhim Zahawi: Well, I will try to help you. I think your Consumer Panel is about 600, of which your Ds and Es are about 30%, so it is a relatively small number in that sense. In fact it is less than what Consumer Focus would consider a reliable number. Therefore, my question to you is: how would you address or deal with the accusation that the numbers you have supplied to Ofcom are not reliable, especially for those vulnerable groups? That is the just the general Ds and Es, and you do not even split out people who are low users or no users of the internet within that panel.

Moya Greene: I think they are reliable, Mr Zahawi. If I look at the share of weekly income of even vulnerable families that is attributable to post, it is less than 0.25%. I do not want to seem insensitive; I know that for many families any amount, any increase on any purchase, is difficult, but I think we have to put it in context. If we compare it with transportation, heating, telephone or electricity, even for vulnerable families it is a very small share of their weekly expenditure.

Q114 Nadhim Zahawi: Right, but you must be going on your gut instinct because your sample size is too small. I tell you that because I used to run a research company; I would like that as a point of my own declaration. Your sample does not include people who are low or non-users of the internet in your submission, so you cannot know what you have just told me is true.

Moya Greene: Well, I know what the price of a stamp is; I know how many of them are sold. I know what a vulnerable family probably has by way of income per week. I know what that family would be likely to spend on transportation, electricity, gas, telephone and food, and I can compare what they spend on average on postage with all of these other expenditures, and I can tell you that it is a fraction of 1%.

Q115 Nadhim Zahawi: Therefore, the point you have just made is we should throw away all your research from your Consumer Panel because it is unreliable. We should just look at hard data, which you quite rightly just outlined—what the price is and what vulnerable families earn. We should forget looking at your Consumer Panel because it is meaningless.

Moya Greene: I do not agree with that, Mr Zahawi, with respect. I do not think it is meaningless at all. You need several points of validation for anything you do in business, and a focus group is one point of validation. But all of the points of validation that we have used have come together to allow us to conclude that postage in the UK is not an affordability issue,

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and this is not a conclusion that only we have drawn. This is also a conclusion that Postcomm, the previous regulator, drew, Ofcom has drawn, and that Consumer Focus itself has drawn.

Q116 Nadhim Zahawi: Now I am confused, because I thought your Consumer Panel was quantitative data, not qualitative as in a focus group. How many in your Consumer Panel are vulnerable groups that are low users or non-users of the internet? Can you answer that question?

Moya Greene: I do not know the answer to that question. I will get that for you.

Q117 Nadhim Zahawi: Is it focus group, which is qualitative—i.e. you cannot rely on the hard number—or is it quantitative?

Moya Greene: It is both.

Q118 Nadhim Zahawi: It does both?

Moya Greene: It does both.

Q119 Nadhim Zahawi: Right. Why have you redacted so much of the evidence when it comes to vulnerable consumers in your submission to Ofcom?

Moya Greene: All of the redactions that are in our submission are in response to the sensitivity of the commercial information.

Q120 Nadhim Zahawi: You really think it is that commercially sensitive to provide data on very vulnerable users who nobody else is offering a service to?

Moya Greene: I think vulnerable users have services that are provided by others as well.

Q121 Nadhim Zahawi: Who else provides them with the service that you provide?

Moya Greene: I assume all of the vulnerable consumers have the same choices in the marketplace that anyone else does.

Q122 Nadhim Zahawi: To send a second class letter?

Moya Greene: Well, personal messages now, sadly, are a very small part of the business of Royal Mail.

Q123 Nadhim Zahawi: I do not disagree with you. I opened it by saying you were absolutely right.

Moya Greene: It is only about 6%.

Nadhim Zahawi: I do not disagree with you.

Moya Greene: If I may just continue, Mr Zahawi—and this is true, I think, for vulnerable consumers as it is for any consumer—most personal messages are now not in the mail; they are sent via electronic means. In fact if you look at the share of personal messages overall in the United Kingdom, there are probably 100 billion a year. The share that is attributable to mailing a personal message is far less than 1%. So I think vulnerable consumers have the same options to get their personal messages across as any other consumer, and that is text, telephone and email. I grant you that not everybody has email, but if I look at the statistics that Ofcom publishes on the availability of mobile telephones in the UK, it looks

like there are more than two per person. I think vulnerable consumers have access to telephones as well, so it is not accurate to say that vulnerable consumers are not properly represented in our business.

Q124 Nadhim Zahawi: I hear what you say, but the message I take away from that is the message you are sending to vulnerable consumers is: send a text message, do not send a letter—do not bother us with your letter.

Moya Greene: Well, we are absolutely proud to deliver every letter that is given to us, and we have the best people in Britain on the streets of Britain in every town, village and city every day doing just that, so we are very proud. But the truth is that for the past 15 years consumers have had other options and they have used those options to convey their personal messages.

Q125 Nadhim Zahawi: I do not disagree with you. I just want to focus on that very small group who do not have those options. What is your predicted rate of usage fall off for vulnerable and vulnerable low-web-usage groups who might not be able to shift to those other communication methods like text or email?

Moya Greene: I would have to get that exact calculation for you but, as I said, this is not a big part of vulnerable consumers' weekly expenditure today. We know that 50% of the service all consumers ask of us is at Christmas time, and we are planning to put in place a programme for vulnerable consumers that will retain the same price for Christmas mailings for them—

Q126 Nadhim Zahawi: For one year?

Moya Greene:—as it was this year.

Q127 Nadhim Zahawi: I completely appreciate that, but I hope you also appreciate that this Select Committee worries about vulnerable consumers.

Moya Greene: I do appreciate that.

Q128 Nadhim Zahawi: I would have thought that you and your staff would have had some of that data for us, because you would not have been surprised that we would be focusing on vulnerable consumers when questioning you.

Can I just move on very quickly? You stated that a price cap on standard parcels is unnecessary partly due to consumer choice increasing and, in their evidence, Royal Mail referred to the Parcel2Go website. Have you had a look at the Parcel2Go website, Ms Greene?

Moya Greene: No, I have not. I personally have not.

Q129 Nadhim Zahawi: I suggest you do, because actually there is not much choice for exactly that group I was questioning you about, the vulnerable consumer. There is choice for businesses absolutely when it comes to parcels. When you look at the packages available, other than from you, there is no choice in that, so I suspect you will be surprised to find that submission in your evidence is actually totally wrong.

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Moya Greene: Well, we think there are about 50 national players in the parcel business in the UK, and there are literally hundreds of local and regional players in the parcel business. We are very proud that we have a strong share through our company Parcelforce. We are certainly not the lowest price in Parcelforce, but we have the highest customer service rating of them all, so people are prepared to pay for quality.

Last Christmas, not the one just past but the previous one, when we had worse snowfalls than the UK had seen in probably 30 years, there was one company that was out there in all kinds of weather delivering not just for us but on behalf of our competitors who could not in some cases, and that was Royal Mail. So we are pretty proud of the service that we provide in the parcel space, and I think the fact that we have been rewarded with the loyalty of consumers as well as businesses speaks volumes about how good it is. But like everything else, we have to make sure that we are pricing this very high quality service in a way that certainly retains the loyalty of our customers but does not operate as a subsidy to our customers such that we lose money whilst they make money.

Chair: Okay, can I bring in Brian Binley now on vulnerable consumers? Some of the issues you have already touched upon, so do not feel that you need to go over it again. I am conscious that time is marching on. Brian, can I just bring you in?

Q130 Mr Binley: Yes, I think my colleague Nadhim has talked about the way you attempt to estimate the actual effect on vulnerable consumers of the proposed policies, and he has dealt with that pretty well. But I am particularly concerned about the validity of looking at affordability of mail based on comparisons with fuel and water costs. I am particularly concerned with that, bearing in mind the fact that 50% of vulnerable users' purchases with mail are at Christmas time. We have to recognise the unevenness. You talk about 1% being the cost that it impacts upon their budget, but if you looked at the costs that have impacted upon their budget at Christmas time, it would be sizeably higher. It is that peak and trough scenario that needs to be taken into account too. But I do not understand your comparisons with fuel and water costs. Would another approach be to look at whether families will be willing to stop buying a food item to switch an extra pound to mail services? Is that another way of looking at it?

Moya Greene: Vulnerable consumers are certainly, like any consumer, having to look at all of the things that they want and need to purchase, and make trade-offs all the time. So yes, to that extent, I agree with you. But I just want to point out, though, that people, individual families, whether they are vulnerable or not, do not spend a lot on postage. That is the only point I am trying to make.

Q131 Mr Binley: I understand. I just feel that the way you have presented the argument is not the most effective, quite frankly. I think it brings you into some disrepute, because it seems to me that spreading that sort of information over the sort of time period, when the thing is a much more disjointed process, does not

do you a lot of credit, that is all. Can I go on to ask whether you have polled that kind of data at all? It seems to me that your polling has been very limited actually, and that concerns me because you are basing a lot of argument on surveys and polling, when in fact your polling is, from any business perspective, a very limited exercise and not a very focused one, quite frankly. So have you polled the sort of data that I have just talked about?

Moya Greene: Yes, we have relied on quite extensive consumer research that was done by Postcomm and Consumer Focus.

Q132 Mr Binley: Could you let us see it?

Moya Greene: I am quite happy to provide that to you.

Q133 Mr Binley: That would be great. You are suggesting that affordability will only be a serious issue when families are spending as much on stamps as on fuel and water; that is the other side of the coin of the argument you are making. It seems to me to be verging on the ridiculous.

Moya Greene: I agree with you, Mr Binley, that, if I had said that, it would be ridiculous, but that is not what I said.

Q134 Mr Binley: It is what you intimated.

Moya Greene: I said there is no evidence anywhere that there is an affordability issue. There is no evidence on how much people spend or the share of their weekly household income that is attributable to postage based on work that has been done by the former regulator—Postcomm—Consumer Focus or our own research. There is simply no evidence that there is an affordability issue. The price of the first class stamp is 20% of the price of a London bus ticket, so there is no evidence. That is all I am saying.

Q135 Mr Binley: But if the bill is sizeable at Christmas time, that is the point at which it matters. If you say they only spend 40p a week or whatever, they do not. In fact most weeks they do not spend anything; it is at Christmas, when half their spend goes on postal services, so your argument seems to be pretty weak in that respect. You do not know the impact of that affordability at that particular time.

Moya Greene: Well, I think we do. Even at Christmas time, it would be less than £20. As I said, whilst I do not believe—and there is no evidence to support it—that there is an affordability issue, I am sensitive to the fact that for some families any increase on any item is a problem. That is the reason why we are designing a special programme that will hold Christmas mailings at the current price for vulnerable families.

Q136 Mr Binley: In other words you do understand my point or you would not be doing that. Can I ask whether you see it just for one year only, or do you see it as a possibility for the next two or three years? Could you give them a real Christmas present and announce that now?

Moya Greene: I am talking about 2012, Mr Binley.

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Mr Binley: I knew you were. I just wanted to stretch it further.

Chair: Nice try, Brian.

Q137 Mr Binley: How much realistic competition do you have in parcels provision in remote and rural areas?

Moya Greene: It is true that most of our competitors do not wish to deliver to remote areas, and we are very proud that we go everywhere in the United Kingdom, to all 29 million addresses.

Q138 Mr Binley: But you have an obligation to do that.

Moya Greene: But we are very proud to do it.

Q139 Mr Binley: I am delighted you are proud of it, but it is an obligation.

Moya Greene: That is right, and it is an obligation that is a very costly obligation. In fact the cost of delivering mail at the same price everywhere in this country is in excess of £6.5 billion, but we are still proud that we are the competitor in the marketplace that does that. That is our reputation and we are very pleased to do that.

Chair: Okay, can I bring in Rebecca Harris on small businesses?

Q140 Rebecca Harris: Could you tell me why you agree with Ofcom's working hypothesis that small business users can afford price increases as much as consumers can, given the very complicated and different usage patterns of different SMEs?

Moya Greene: I think most small businesses can afford it. About 70% of small businesses would spend no more than £50 a month on postage. They do have other options, as you know. We are very proud that we are the highest value in the market, and I think the best service in the market. Small business pays for quality just like big business, and we are the quality provider. We have to be very cognisant of other participants in the market and their offers, and we certainly want to invest in the company so that we can provide the sort of technology underpinnings that small business and big business appreciate from parcel companies such as ours. But I do not think there is a real affordability problem there either, Ms Harris.

Q141 Rebecca Harris: Thank you. Again, as with a few of the areas we have discussed already today, your evidence on this was published in a redacted form, presumably for commercial sensitivity. How robust was that research? What kind of evidence size did you take for the impact on small businesses? We want to get a feeling for that. At the moment it is a good assertion that you have given us—that you think that you are competitive and are offering a good deal to small businesses and they can afford it—but I would like to know what kind of evidence you have got for that.

Moya Greene: The same sort of research was relied upon in relation to small business as for consumers. That is Postcomm and Consumer Focus research.

Q142 Ann McKechin: I wonder if we could turn to the issue about efficiency savings within Royal Mail. The Committee accepts that Royal Mail still has a journey to go in terms of transformation, but I wonder if you could just very succinctly explain to us why you believe the existing price control failed to produce the efficiency savings sufficient for profitability?

Moya Greene: The efficiency targets that were set were actually quite artificial, and they did not take sufficient account of the fact that this company has to have a network that is vast, because we are going to every single address. We have to be able to do that. We have to be able to do that with overnight delivery and with an incredibly high minimum service standard. It is 93% for the first class stamp, which is one of the highest minimum service standards in the world. Just to put it in comparison, the minimum service standard for Deutsche Post is 80%, and for Belgium and Italy it is below 90%. So to say that you must have a network that is sufficiently vast that it can get to every single town, village and city overnight with a 93% minimum standard is an extremely high-cost service. When efficiencies were first calculated by Postcomm, in my opinion it did not take sufficient recognition of that. That said, any business has to be aware of its costs and we have to do whatever we possibly can to control our costs, and we do.

The other problem that Royal Mail faced with respect to efficiency is that it did not have access to capital to modernise. The regulatory regime was put in place before the modernisation had even begun, and that is very unlike other postal administrations in Europe, where the postal administration was given the time and the capital to modernise before the competitive landscape was changed by regulation and before the company had the ability to price its products in a more competitive way. So Royal Mail was at a very big disadvantage. First, I think the calculations on what was achievable by way of efficiency, given the vast network that had to be put in place to deliver this service, were wrong. Secondly, the order in which things occurred—modernisation; the competitive landscape changed; the regulatory approach; the price controlling—just made it impossible.

That said, we have now started what I consider to be probably the biggest transformation programme that any company in the UK is undergoing. It will affect almost every single job in Royal Mail. In that past few years Royal Mail has sadly seen very large numbers of people leave our company. These are great people. Many of them had given decades of service to Royal Mail and universal service in Great Britain. So far we have lost about 50,000 of our people. Every year we have reduced the number of hours in our operation that we must have in order to handle the traffic that has been available to us.

Q143 Ann McKechin: I will just stop you there. I fully accept the comments you make regarding the lack of mechanisation and capital investment, and I think the Committee will be very sympathetic to that issue. But Ofcom's presentation to this Committee in October last year said that the efficiency savings had proved very challenging, and clearly there was a very

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substantial, steep decline in mail, which has made that even more difficult. Does that mean that they are not going to happen under any scenario, and do you actually think you are going to be able to achieve the level of capital investment that is going to ensure that Royal Mail can compete with other European countries in the same way?

Moya Greene: I am certainly very optimistic that, if we can move the company into profitability and get the company to a state where we are making a commercial rate of return, we should have access to outside capital. I am very optimistic on that front. In terms of efficiency, the change that is currently under way in Royal Mail is vast, and I invite you, Mr Chairman, and any Member of the Committee to come to our mail processing facilities and delivery offices and just see the scale of change that is under way.

Q144 Chair: We have a pretty well annual invitation to attend sorting offices at Christmas, and whilst I cannot speak for other members of the Committee, I regularly have gone to see this at first hand.

Moya Greene: Thank you. So last year alone we were able to process all of the traffic that had been given to us, and there has been a radical change in the mix of traffic as well. If the white envelopes are declining, the parcels and packets are going up, and they take an entirely different approach to processing. Delivery of parcels and packets is much more time consuming. Not all of them are letterboxable, as you know, so we have a huge change under way. You will have seen many of our postmen and postwomen now are using trolleys. They have been equipped with these trolleys simply because of the change in the mix of the traffic. In the past 15 months we have consolidated 12 of our postal facilities. We are now down to 59.

Q145 Ann McKechin: On that point, one of the problems that has bedevilled Royal Mail for many years is, frankly, the relationship with its employees and staff, which at times has been very fractious. This is clearly a very difficult situation that Royal Mail is facing in terms of diminishing numbers of staff and changes in work shifts, etc. Obviously bringing everyone along with you is vital to achieving efficiency. Are you confident that staff relations are improving and that you are bringing your staff along with you in terms of this change process? I think that is one element where there have been a lot of problems in the past.

Moya Greene: You are absolutely correct. It has been a real issue at Royal Mail. I am confident that things have improved. I think things have improved dramatically. We have an agreement with our operating union, the CWU. We are very fortunate that the executive of the CWU know the business inside out. They know that the company has to modernise to be successful and that the income security of everybody is only going to be there if Royal Mail is successful. So in my discussions with Dave Ward, the Deputy Secretary of the CWU, I am very pleased to see the understanding that changes are unavoidable. That said, it is very difficult; it is very hard on our people. When we talk about efficiency, most of our cost is in our people. Efficiency is an antiseptic word.

What does that really mean? Sometimes it means that people that have given their careers to Royal Mail cannot finish their careers. It meant that their pensions were in jeopardy where we could not afford the pension promise that had been made. It means that their starting times may be quite different today than they were even two or three years ago. It means that they probably have to work a longer day. It means they have to contend with different traffic.

Chair: I think we have got the message. Most of us who have been to a sorting station get it in first hand. Have you finished Ann?

Ann McKechin: Yes.

Q146 Katy Clark: You will be aware that we have already heard evidence from Consumer Focus, and they talked about 5% efficiencies as modest. What level of year-on-year efficiency do you envisage in percentage terms? What do you think is realistic?

Moya Greene: Not 5% every year, certainly not—with the change in traffic that we have, Ms Clark. As more and more of the traffic is parcels and packets, items that have to be signed for and tracked at the door, it takes longer and it is bulkier. We can certainly achieve some efficiencies because we do not have any automation for parcels and packets at all yet. It is still all handled manually, so you can certainly achieve some efficiencies as you introduce automation and technology to the business. But I think 5% year on year is simply too high a number, and it probably never was achievable.

When you start down the road of modernisation, in the earlier days of course it is easier to capture those kinds of gains, but as you get further and further down the road it gets more difficult. I think we will probably finish this year a little over 3%, and I am pretty proud that we have been able to do that, given that we are handling a different mix of traffic and that we are handling the parcel and packet side of it mostly manually. About one-quarter of our delivery offices are now enabled with the new methods, and that certainly has helped, but we have still got quite a bit to go. As I mentioned, we have managed to consolidate out of 12 mail processing facilities, so that has helped, but I am proud of the 3% that we will achieve this year.

Q147 Katy Clark: Just to be clear what we are talking about, when you say 3% efficiency, does that mean reduction in staff or in all sorts of ways?

Moya Greene: In all sorts of ways. I am really referring to the number of hours it took to process the traffic that we have—they are down by 3%. In terms of the number of people, we will probably end the year with 5,400 fewer people this year. 2,000 of them will have come from management, and the balance will have come from our core operation.

Q148 Katy Clark: I see. There is a view that price controls have not worked before. How do you think re-regulating is going to be an effective sanction in future, and how likely do you think that is with the proposed privatisation that is supposed to be happening?

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Moya Greene: We have had 10 years of a failed regulatory model; there is just no other way to say it. The regulator had one company to worry about, Royal Mail, and it was supposed to protect universal service in Britain. That company is balance sheet insolvent, unable to pay the historical pension promise that it made, and has for some time been cash negative and unprofitable in the core business. Every prediction they made about cash or rates of return was wrong. I think we can look at what we had, and it was certainly the most unusual regulatory model in the world, and say we know what does not work. Price controlling every aspect of this company's revenue in the face of the sort of decline that we had to cope with and the changing competitive landscape made it impossible for the company to be successful.

I have looked at all the work that Ofcom has put out, and the indications of their approach and the approaches that they have taken in other businesses, and I have to say that I think we are now going in the right direction. Hopefully it is not too late.

Q149 Katy Clark: Given what you were saying earlier, do you think price regulation should be kept in place and, if there is a privatisation, at least until efficiency savings have been delivered, that you are in the place that you want to be?

Moya Greene: I personally do not believe we need price regulation. That is for others to decide. The Government has given that decision to Ofcom to make, and I respect that. But personally I do not think we need price regulation because the competitive landscape is vastly different today from what it was 10 years ago.

Q150 Katy Clark: One of the issues that have been raised with us is about satisfaction levels, particularly in relation to second class mail. There is obviously a concern that if first class prices go up, people will shift to second class, and that is going to affect the quality of the service that people get. How would you respond to that?

Moya Greene: I think the quality of service that people get in the United Kingdom is outstanding. Even for all the challenges that Royal Mail has had, this is an outstanding company, and I say that as a person who ran a similar company in Canada. I thought I did a great job there. I did not have a regulator at all in Canada. With a couple of conversations, I could set the price for our products. I

had much more time to deliver than we do in the UK. So where do I think service is going to go in the future? I think you can expect the same high quality service that you get now.

Q151 Katy Clark: How are you going to do that?

Moya Greene: Because people in this company are totally devoted to that, Ms Clark. On second class, I think the service standard is about 98%, and we meet it. So it is outstanding.

Q152 Katy Clark: We were talking about vulnerable customers earlier on, and you will be aware that many people are dependent on benefits. One of the debates that has been happening in this place is about shifting the upgrading of benefits and pensions from RPI, Retail Price Index, to Consumer Price Index. Given that is happening, how can you justify having a higher level of increase, and do you not think you should also be linked to the Consumer Price Index if the incomes of those on low incomes are?

Moya Greene: No, I do not. You have to look at the very low base we are talking about. The percentages are meaningless if it is from such a low base, so no, I do not agree with that.

Q153 Chair: Okay, any further questions? Can I thank you very much? It has been a pretty thorough going over. I suppose you may well have heard my comments over the session with Ofcom. Can you reassure me that, in view of what you said, I do not need to go out and buy my Christmas card stamps now, as opposed to Christmas time?

Moya Greene: Mr Bailey, I am sure that you make these judgments on all kinds of matters every day. Far be it for me to tell you what you should do about your Christmas obligations.

Q154 Chair: But regarding my previous question, you are committed to keeping the price of stamps for next Christmas the same as last Christmas.

Moya Greene: For vulnerable consumers, yes.

Chair: Ah, for vulnerable consumers. I am very vulnerable. That is very interesting. Thank you; I am glad that I have clarified that. Thank you very much, and we understand the time constraints that we have got and you have got on this issue, so we will be publishing a report very quickly. Can I thank you?

Moya Greene: Thank you.

Written evidence

Written evidence submitted by Consumer Focus

About Consumer Focus

Consumer Focus is the statutory consumer watchdog for the postal and energy markets for England, Wales, Scotland and (for postal consumers) Northern Ireland. We work to secure a fair deal for consumers across the economy.

We consider that securing the universal postal service for all UK and Northern Ireland consumers is the most important priority of regulatory policy for the postal sector.

Executive Summary

Ofcom's consultation document "*Securing the Universal Service: The future framework of economic regulation*" (Oct 2011) proposes a series of measures to deregulate the UK postal market, including measures to relax price controls for First Class or heavier letters and other postal items but only to retain a cap on standard Second Class letters of between 45p and 55p.

Our response and supplementary evidence submitted to the Ofcom consultation¹ outlines our views and concerns:

- despite Ofcom's assurance that these steps will give Royal Mail the commercial freedom necessary to make the financial returns required to secure the Universal Service, the proposed measures may have the opposite effect;
- Royal Mail needs to make significant efficiencies in order to secure the Universal Service—however, the pricing freedom proposed will enable it to raise prices but provides no incentive to make vital efficiencies;
- increased prices could lead to many users switching away from post, decreasing mail volumes and threatening the viability of the Universal Service;
- domestic consumers, and especially vulnerable ones, who lack alternatives to Royal Mail (for example, online options) will be captive to any price rises;
- a safeguard cap is required across all Second Class products to ensure that vulnerable and low web users are not left to bear the brunt of price increases;
- the proposals could impact upon micro-businesses and small and medium enterprises, which all rely upon an affordable and value-for-money postal service; and
- the risks of widespread de-regulation upon the Universal Service Obligation (USO) warrant greater research and understanding of the impacts of the proposals upon consumers before proceeding.

1. The Ofcom proposals for economic regulation of the postal market

1.1 In its document "*Securing the Universal Service: The future framework of economic regulation*" (Oct 2011), Ofcom outlines a series of measures to deregulate the UK postal market. These include:

- that proposed regulatory arrangements will last for a period of seven years;
- measures to relax price controls for first class and for heavier letters and other postal items;
- setting a cap on standard Second Class letters only of between 45p and 55p;
- introducing regulatory safeguards in relation to the monitoring of Royal Mail's performance;
- a threat to re-impose ex ante regulatory techniques if Royal Mail does not undertake necessary cost controls and efficiencies;
- setting a mandatory access condition on Royal Mail;
- moving to contract headroom pricing; and
- assessing impacts of potential end to end entrants before considering whether to impose Universal Service Provision conditions upon them.

1.2 Ofcom asserts that these measures are necessary to provide Royal Mail with the pricing freedom to continue to fund the Universal Service in the face of uncertain market conditions.

¹ *Response to Ofcom consultation in relation to Securing the Universal Postal Service: Proposals for the future framework of economic regulation* (Dec 2011) available at http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/Consumer_Focus.pdf and *Consumer Focus report on potential impacts of stamp price increases on consumers—A supplement to the Consumer Focus response to Ofcom's consultation* (Jan 2012) available at <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/ConsumerFocusreport.pdf>

2. *Regulating in the consumer interest*

2.1 We recognise that Ofcom is facing difficult and complex judgements with risks associated with uncertain economic conditions combined with financial problems at Royal Mail and moves to sell the business. It is imperative that the right balance is struck between the contra policy aims of giving Royal Mail the ability to compete equally in those areas of the postal market where real competition exists; safeguarding the USO; and ensuring that users of mail pay a fair price for the service they receive.

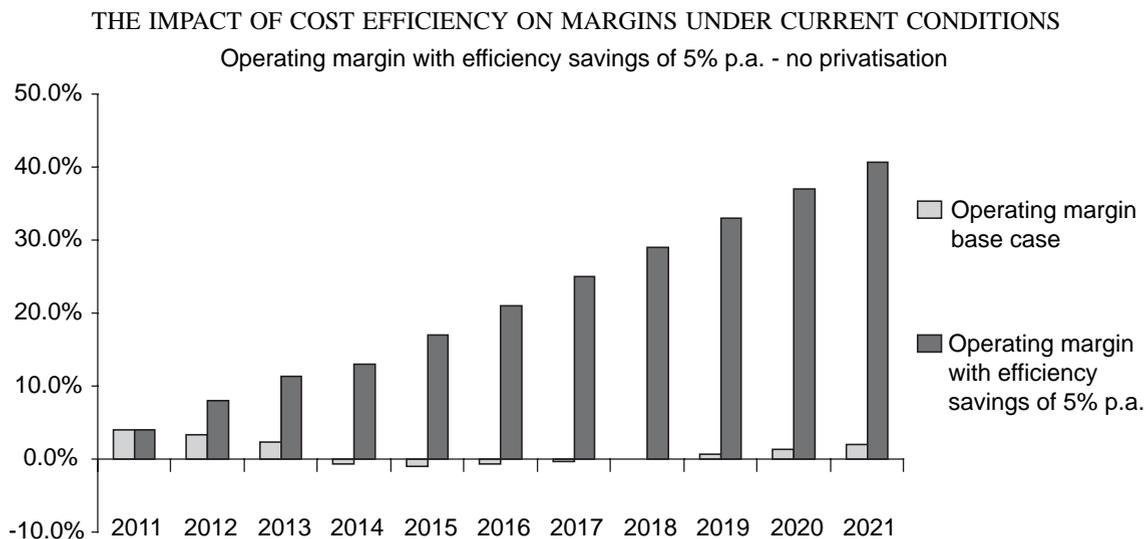
2.2 In particular, Consumer Focus considers that a relaxation of ex ante price controls on Royal Mail at this stage of postal market development, and before a sale of Royal Mail has been achieved, is a very high risk approach that could damage the UK postal services market and act against Ofcom’s primary duty to safeguard the universal postal service.

2.3 Royal Mail has yet to tangibly demonstrate that customers and consumers lie at the heart of its business strategy. Consumer Focus is concerned that Royal Mail’s ethos, as seen through the decisions it has taken recently, is one of protecting its business model and not looking at what its customers need or want. Given that Royal Mail has not delivered on efficiencies under the previous price control, we are sceptical that Royal Mail, with the shackles off on prices, would get the balance right between raising its profits through efficiencies and doing so through price rises.

2.4 This could lead to steep price rises for customers and could further persuade bulk mailers to make a permanent switch away from mail, critically reducing the revenues which underpin the universal service. Such a scenario would present reputational risks for Ofcom as it sought to establish itself as a postal regulator. In the worst case it could result in a financially troubled Royal Mail, which remained in public hands, imposing higher and higher prices on a dwindling customer base.

2.5 Consumer Focus commissioned experts to undertake financial modelling (see Figures 1 and 2 below) which indicates that Royal Mail could achieve reasonable returns without price rises, under current arrangements or following a sale of Royal Mail. However, this would be dependent upon achieving significant progress in implementing operating efficiencies and cost discipline strategies in, what are likely to be, tough market conditions. Internal incentives for such progress are critically important. In an environment where Royal Mail retains significant market power it is not clear how a regulator could provide such incentives without using ex ante price controls.

Figure 1



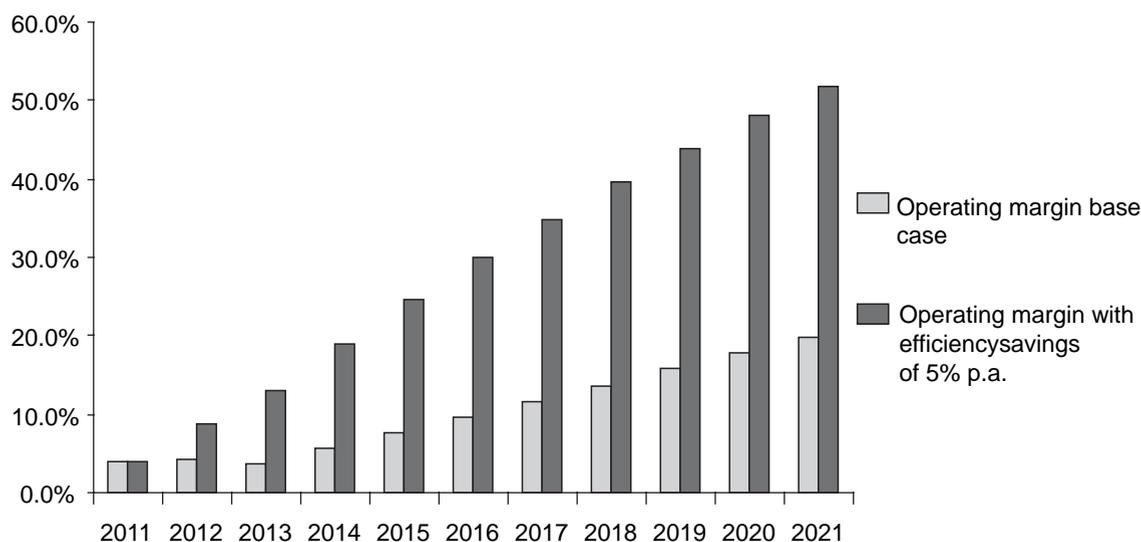
Source: ESL UK for Consumer Focus

This suggests that even modest efficiency gains would transform Royal Mail’s financial performance.

Figure 2

THE IMPACT OF COST EFFICIENCY ON MARGINS FOLLOWING A SALE OF ROYAL MAIL

Operating margin with cumulative 5% p.a. efficiency gains - privatisation



Source: ESL UK for Consumer Focus

The data above shows that Royal Mail's decisions in relation to cost control and efficiency can have significant impact on its financial performance; and that privatisation may also significantly improve margins at the company.

However, Figure 1 also indicates that without privatisation and without efficiency savings of 5% p.a., Royal Mail's operating margin will be negative by 2014.

We consider that while there are downside risks from Royal Mail's financial performance, these are strongly related to decisions which the company may take in relation to cost control and efficiency and also to the timetable of the sale of the company.

2.6 Ofcom's own analysis suggests that Royal Mail has found it difficult to manage down its costs even with the current ex ante price controls. But this is not an argument for removing price controls. The starting point should be that the current balance of regulation has set insufficient incentives for the company to be cost efficient. We consider that, by itself, further weakening of positive incentives by removing existing controls appears counter-intuitive.

2.7 Consumer Focus is also concerned about the suggested duration of the proposed package of measures which raises the possibility of higher prices exacerbating mail volume declines over a seven year period without the prospect of any remedial measures. If Ofcom decides to proceed with its proposals we would strongly urge that it conducts a formal review to assess their market outcomes at around a mid-point of the price control period.

3. The impact on consumers of stamp prices increases resultant from the proposals

3.1 Consumer Focus is concerned that significant price increases could lead to consumers and businesses switching away from mail entirely to other communication services (like e-mail), which would then cause mail volumes to decline further. As volumes decline, those consumers who are reliant on post (such as those without online options) would be left to pay even more to sustain the service.

3.2 A study by the Office for National Statistics revealed that in 2010 19.2 million households in the UK had Internet access (73% of households).² This study also revealed that in 2008, households in the highest 10% of the income distribution in the UK were over three-and-a-half times as likely as those in the lowest 10% to have an Internet connection (96% of households compared with 26%).³

3.3 Research commissioned by Consumer Focus, and published in January 2012, indicated that vulnerable, low-internet-users are relatively unlikely to switch away from mail products when compared with consumers who have access to online alternatives and, as a consequence, are more likely to be captive to price increases.⁴ This is shown particularly with packets services, on which Ofcom does not propose to set a price cap.

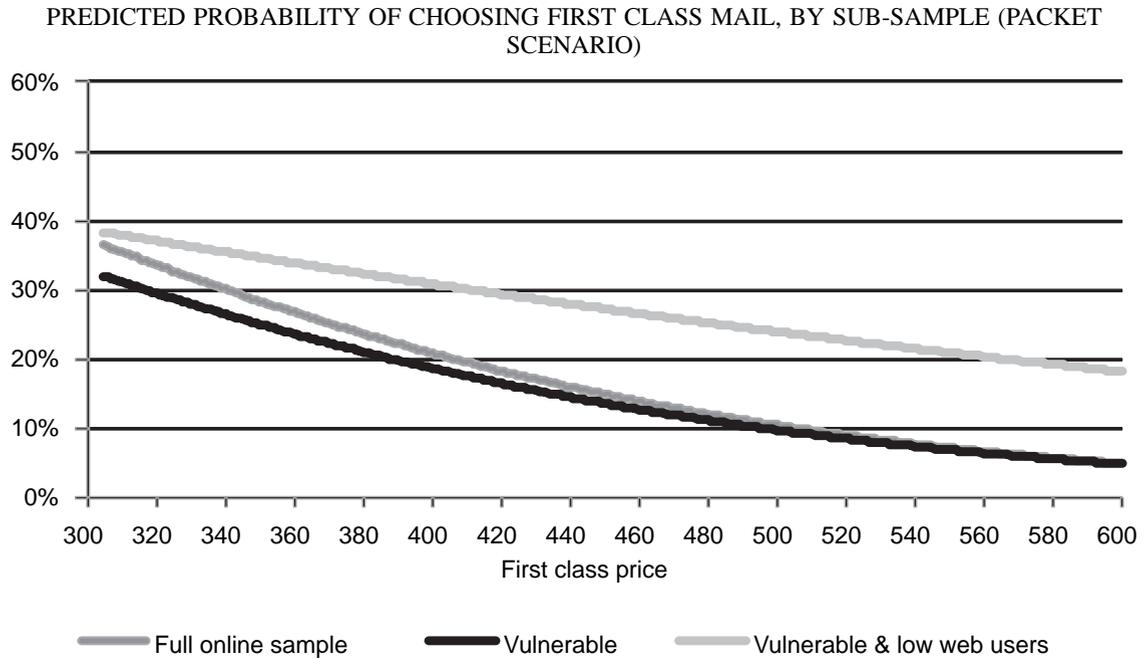
² *e-Society*, Chris Randall, Office for National Statistics (Sep 2010) available at <http://www.ons.gov.uk/ons/rel/social-trends-rd/social-trends/social-trends-41/social-trends-41—e-society.pdf>

³ *Ibid*;

⁴ *Consumer Focus report on potential impacts of stamp price increases on consumers—A supplement to the Consumer Focus response to Ofcom's consultation* (Jan 2012) available at <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/ConsumerFocusreport.pdf>

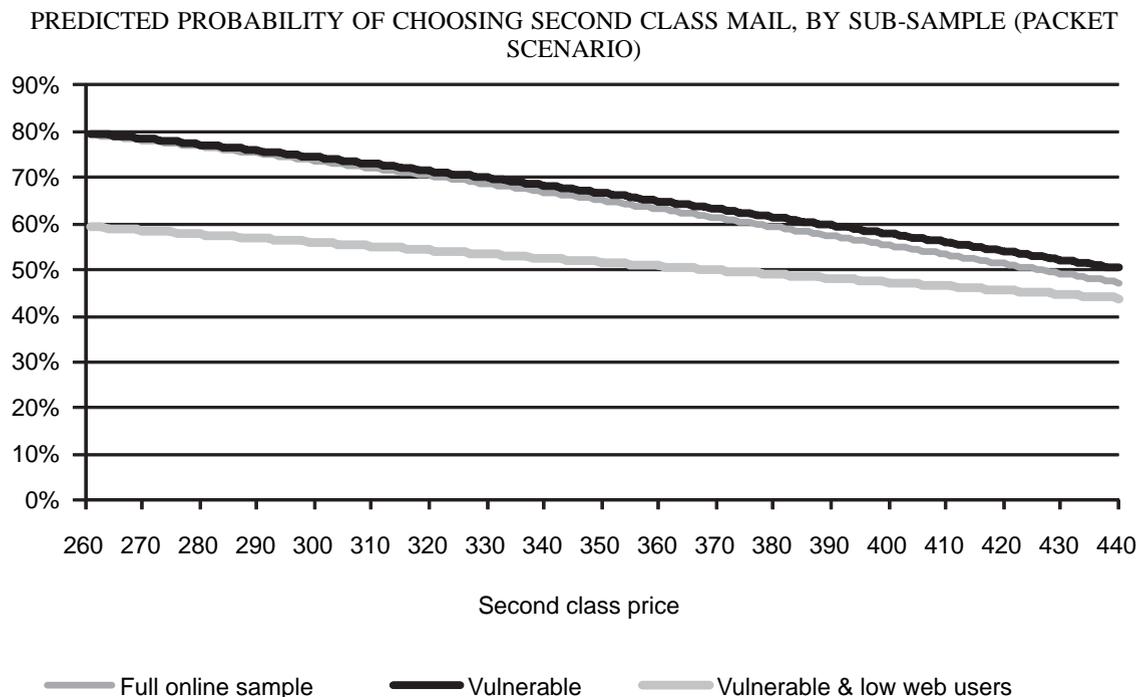
3.4 Figure 3 below shows that vulnerable & low web users are predicted to reduce their usage of First Class packets mail at a slower rate as price increases. This may reflect the fact that vulnerable & low web users value speed over price. However this may also indicate that they are less able or willing to switch to alternative providers of packet delivery services, as those who choose Second Class show a similar lack of price sensitivity, demonstrated by Figure 4 (below).

Figure 3



Source: London Economics for Consumer Focus

Figure 4



Source: London Economics for Consumer Focus

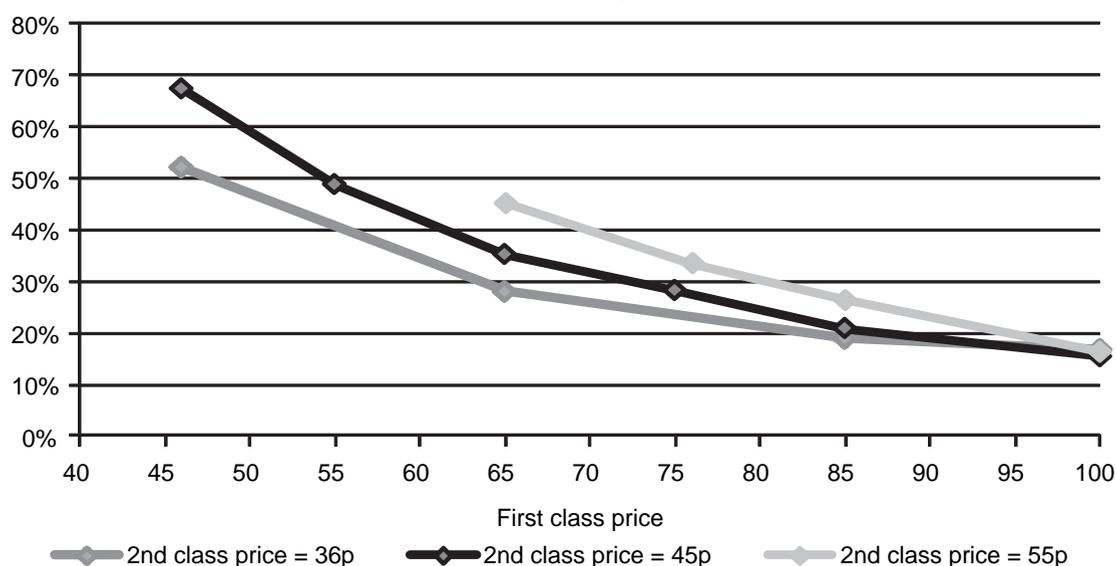
3.5 Consumer Focus is very aware that for domestic consumers and SMEs, Royal Mail is the only show in town and there is no alternative operator (see next section for further information). There is no competition in the lower weight end of the market and Royal Mail is the monopoly provider. Ultimately, the consumer will pay, either directly and transparently or indirectly and opaquely, for the mailing costs associated with the delivery of goods purchased online or via mail-order.

3.6 Our research also indicated that First Class mail is still considered a vital service by many consumers with 19.5% of online respondents stating they use First Class all the time versus 8.7% who use Second Class all the time, and 28% of vulnerable low internet users stating they use First Class all the time versus 10% who use Second Class all the time.⁵ Consumers' significant use of First Class could be because they value the speed of a First Class service, whilst vulnerable low internet users of both First and Second Class products could be as a result of a lack of alternate means of both priority items and mail more generally, and so we have urged Ofcom to reconsider the removal of the price caps.

3.7 Our research showed that as the price difference between First and Second Class options for mail products increased, more people would, not unexpectedly, switch away from First Class to Second Class. This is shown in Figure 5 below.

Figure 5

PERCENTAGE OF CHOICES WHERE FIRST CLASS MAIL WAS CHOSEN (STANDARD LETTER SCENARIO)



Source: London Economics for Consumer Focus

3.8 Royal Mail would want to set the price for standard Second Class letters as high as possible so that they could charge more for First Class without causing a switch away to Second Class.

3.9 Royal Mail has responded to the Ofcom consultation stating that they disagree with proposals to put caps on any of their products, but if a safeguard cap must be imposed on standard Second Class letters it should be set at the upper end of the proposed range at 55p. Part of the reason for this is the price differential, with Royal Mail stating publicly that: "If [RM] increase the class differential ie increase 1st class out of line with 2nd class, volume will switch to the 2nd class service and RM will only be marginally better off in revenue terms... this is due to many consumers being able to down trade due to the type of mail they send and, therefore, RM needs to be careful not to stretch the price differential too far, as this could actually result in a reduction in revenue overall... It is therefore essential that Ofcom sets the safeguard cap at the upper end of its proposed range."⁶

3.10 Whilst we have not attempted to anticipate the scale of the price rises which may result from Ofcom's proposals, our research has indicated that a safeguard cap is required across all Second Class products to ensure that vulnerable and low web users are not left to bear the brunt of price increases, particularly as our research also showed that consumers with online alternatives are much more likely to switch away from mail entirely as prices increase.

⁵ Ibid; pg 9

⁶ *Level of the Safeguard Cap for 2nd Class stamps*, Royal Mail, pgs 4–5, available at http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/royalmail/Level_of_2c_cap.pdf

4. *The impact on Small & Medium Enterprises (SMEs) of stamp prices increases resultant from the proposals*

4.1 Small and medium enterprises SMEs are a vital part of the UK economy⁷ with some 4.5 million small businesses operating in the UK and accounting for circa 99% of all enterprise; 58.8% (est. 13.8 million people) of private sector employment; and 48.8% of private sector turnover.

4.2 Royal Mail states in its response to the Ofcom consultation that affordability is not an issue for SMEs partly because they have access to alternative operators for low weight 2nd class products. Royal Mail names the TNT products “Allsort” and “Premiersort” as examples of alternative products for SMEs; however, we note that the required volumes to qualify for collection under these products are large. For example, for TNT Allsort the minimum volume requirement is 250 items per collection, whereas for TNT Premiersort the minimum volume per collection are 10,000 letter items; 1,000 for Light Large Letter items; 1,000 for Heavy Large Letter items; and 250 for Packet items. There is a distinct possibility that many micro-businesses and SMEs will not send enough mail to qualify for the Allsort or Premiersort services but will still send enough mail to be adversely impacted by stamp price increases.

4.3 In its discussion paper on affordability (Feb 2011), Postcomm stated that an affordability test for businesses based on an assessment of the affordability of a universal postal service product price would be unworkable as “*given the range of businesses and business models, it is likely that at any (non-zero) price some marginal business would face financial difficulty from that price.*” Given the variation in business types and posting profiles of SMEs and the statement from Postcomm, Royal Mail should provide transparent evidence to support its assertions that affordability is not an issue for SMEs.

4.4 Furthermore, we are particularly concerned that any price increases could be passed on from SMEs to their customers. This is also suggested by Postcomm’s discussion paper on affordability in which it is stated that a business could mitigate the impact of higher prices by increasing prices for its products.⁸

4.5 Royal Mail has stated on page 8 of the document “*Scope of Safeguard Cap*” that it would be “*disproportionate to provide a greater degree of regulatory protection to SMEs than is required for vulnerable social groups.*” Royal Mail is basing this on its view that the safeguard cap should not be extended beyond Second Class standard letters as vulnerable consumers do not have any affordability concerns and their use of mail is low. From this position they have then attempted to argue against there being any affordability concerns for SMEs which would also justify an extension of the cap.

4.6 Consumer Focus report on potential impacts of stamp price increases on consumers has provided strong evidence for the need for a safeguard cap to be extended in particular to protect vulnerable consumers. As a consequence, and given that many micro-businesses and SMEs are captive in using standard Royal Mail products, we would expect any extension of the safeguard cap to benefit both vulnerable consumers and SMEs, negating any disproportionate bias.

5. *The evidence base for decision making*

5.1 Royal Mail has issued its own response to Ofcom’s document “*Securing the Universal Postal Service: Proposals for the future framework of economic regulation.*” We have raised a number of concerns with Ofcom regarding information Royal Mail has provided as part of this response, particularly information contained in the document “*Scope of the Safeguard Cap.*”⁹ The accuracy and robustness of information and analysis provided to Ofcom is of critical importance in ensuring their ability to undertake evidence-based decision-making. It must be able to stand up to scrutiny if it is to be of benefit in informing major policy decisions.

Understanding the impact on vulnerable consumers

5.2 We are particularly concerned about Royal Mail’s statements regarding vulnerable consumers’ use of mail services. We are unable, and would question whether Ofcom is able, to robustly assess whether information provided from a seemingly small and unspecified “DE” segment of the Royal Mail Consumer Panel¹⁰ fully, accurately and sufficiently captures the behaviours and attitudes of vulnerable consumers.

5.3 We are of the view that the “DE” category used by Royal Mail is very broad; only considers social grade and would not necessarily capture online and offline users. It is not as robust a method for capturing vulnerable consumers as we have used in the modelling for our report on potential impacts of stamp price increases on consumers, where, most significantly, we distinguished between online users and those who used the internet at most once a month. As a consequence we are concerned that Royal Mail’s analysis of this segment regarding vulnerable consumers’ use of mail is flawed as it does not distinguish between those that do and do not have access to the internet.

⁷ <http://www.fsb.org.uk/stats>, updated Nov 2011. (micro: zero to nine employees, small: 10–50 employees, medium: 50–249 employees).

⁸ *Discussion paper on affordability*, Postcomm, (Feb 2011), Page i.

⁹ *Scope of the Safeguard Cap*, Royal Mail, available at http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/royalmail/Scope_of_safeguard_cap.pdf

¹⁰ The Royal Mail consumer panel is “*a panel of 600 respondents who record what they send and receive through the post each day... The results are aggregated to an annual level*” *Scope of the Safeguard Cap*, Royal Mail, pg2, available at http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/royalmail/Scope_of_safeguard_cap.pdf

5.4 This is of particular concern as Consumer Focus research¹¹ showed that the habits of low internet users often significantly differed from users with online alternatives, and they appear to rely more upon the mail. Unfortunately we also recognise that without Royal Mail explicitly stating the amount of low internet users it surveyed we cannot make an assessment as to the validity of its claims.

Residential consumers use of mail delivery services

5.5 Royal Mail has stated that a price cap on Standard Parcels is unnecessary partly due to consumer choice increasing. As evidence of this statement, Royal Mail referenced the “Parcel2Go” website. Having assessed this service, we are far from assured that this provides an adequate alternative for residential consumers—the number of couriers offering a delivery service varies significantly by parcel size and many do not offer a 3–5 day service only a next-day or 2+ day service, both of which are more expensive than Royal Mail’s Standard Parcel service.

5.6 Parcel2Go also revealed that delivery charges for “Highlands and Islands” and “Northern Ireland” are up to four times as much as Royal Mail’s Standard Parcels service when using alternative couriers. For example, it costs £4.41 to send a 2kg parcel with Royal Mail’s Standard Parcels service, whereas Yodel Northern Ireland and Yodel Highlands and Islands charge £18.43 to send a (3–5 days) parcel. A random test using three different parcel sizes on the Parcel2Go website also revealed that Yodel Northern Ireland and Yodel Highlands and Islands are the only courier services listed on the website that offer delivery to those areas.

5.7 Further to this, the findings of a report commissioned by Citizens Advice Scotland (CAS) and published in December 2011 identified the importance of affordable parcel services for those in rural communities. Consumers in remote and rural areas in Scotland rely heavily on online shopping. The CAS report found that rural consumers were particularly vulnerable as end receivers as some alternative operators charged excessive prices to deliver packets and parcels to certain locations or sometimes refused to deliver them altogether—*“84% of consumers said that they had been refused delivery because of their ‘remote’ location”*.¹²

5.8 Royal Mail also cites Collect+ as an alternative for delivering parcels. While it offers a direct-to-door service from anywhere in the UK, for a price up to £4.99, unfortunately the service still does not have a significant coverage of parcel drop-off points, unlike Post Offices.

6. A strategy for postal consumers

6.1 De-regulation of stamp prices should not occur until Ofcom has undertaken substantial research as to the impact of their proposals.

6.2 Ofcom should carefully monitor the potential impact of their proposals not only on poorer consumers in respect of second class letter products but also on rural consumers and on SMEs in relation to packet and parcels services where competition may be limited or absent.

6.3 Consumer Focus have proposed a different regulatory approach to Ofcom that would involve the retention of the current ex ante controls, but would also allow Royal Mail sufficient rises in the prices subject to such controls (maybe set at RPI) to put its finances in order without threatening market stability. To ensure regulatory certainty these controls could be set for a five year period, with a review after two or three years. During this period, Ofcom would continue to review the scope of the control in light of the development of competition in the market with a view to reassuring market players that price control regulation will remain proportionate as the market develops. Ofcom should also continue to monitor Royal Mail’s performance, and that of the postal market as a whole in the UK, the EU and internationally, to provide it with sufficient benchmarks to assess the company’s performance in order to ensure that its efficiency is in line with its peers.

6.4 Such an approach would also avoid the potentially severe impacts on customers, SMEs and vulnerable consumers of unchecked price rises and consequent risks of market decline.

14 February 2012

¹¹ *Consumer Focus report on potential impacts of stamp price increases on consumers—A supplement to the Consumer Focus response to Ofcom’s consultation* (Jan 2012) available at <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/ConsumerFocusreport.pdf>

¹² *Free Delivery*, Consumer Advice Scotland (Dec 2011), pg6 available at www.cas.org.uk/Resources/CAS/Migrated%20Resources/Documents/Evidence%20reports/Free%20delivery%20FINAL.pdf

Supplementary written evidence submitted by Consumer Focus

“TIPPING POINT” FOR STANDARD LETTERS

As part of our research, referenced in the original submission from Consumer Focus, a representative sample of consumers were given a range of prices for First and Second Class stamps for standard letters and asked whether they would choose to use stamped mail, or choose an alternative—“*something else*”.

Our research indicated that when presented with the current prices (36p for Second Class and 46p for First Class) around 4.8% of those surveyed chose “*something else*”. Around the range of 40p for Second Class and 55p for First Class, 5.3% of those surveyed chose “*something else*” and around the range of 45p for Second Class and 65p for First Class, 7.2% of people surveyed chose “*something else*”.

Beyond the 45p/65p price combination the share of respondents choosing “*something else*” levelled out to around 10–11% between the 45p/65p and 55p/75p price combinations, whereas previously the percentage of respondents choosing “*something else*” was increasing.

A “*tipping point*” is expected to be where a pattern that is being measured changes significantly. The survey results indicate that a “*tipping point*” occurs somewhere around the 50p for Second Class and 75p for First Class price combination, as the percentage of respondents choosing “*something else*” reached the 10–11% range here and then stayed at that level through all subsequent increasing price points.

17 February 2012

Further supplementary written evidence submitted by Consumer Focus

Introduction

During the oral evidence session on 21 February 2012, members of the Committee asked for additional information about the research commissioned by Consumer Focus. This note sets out further detail about the methodology employed and findings and from that research.

1. Research methodology

1.1 Consumer Focus commissioned London Economics to undertake research to inform our response to Ofcom’s consultation on the Royal Mail price control. The research was carried out in November and December 2011 and covered First and Second Class stamped inland services for standard letters; large letters (at two different weights); and packets, sent by consumers in their personal capacity (ie not including mail sent in relation to running a business).

1.2 The methodology for the research was based on two consumer surveys: an online survey with 2,020 respondents including both general and vulnerable consumers;¹³ and 212 face-to-face interviews designed to capture the views of vulnerable consumers who were also low-internet-users.

1.3 The online survey was designed to achieve a broadly representative sample of the UK population in terms of key demographics, specifically age and gender, social grade (AB, C1, C2, DE), and region.

1.4 We are not aware of any definitive, publicly available statistics for the number of vulnerable consumers who are low-internet-users in the UK and thus our face-to-face survey sample size could not reflect this unknown. The survey was, however, targeted to capture the views of vulnerable consumers who are also low-internet-users, dispersed across the gender and regional categories. As stated in our oral evidence, the results for the face-to-face survey are therefore considered to be indicative of the behaviour of vulnerable, low-internet-users.

1.5 The online and face-to-face surveys included questions about mail usage, postal requirements and a choice experiment.

1.6 In the choice experiment, respondents were presented with a series of options and asked to make a preference, given the price and description of each option. The options presented for each mail product categories were: “*First Class*”, “*Second Class*” and “*something else*”.

1.7 Respondents were told the price of sending the item by First or Second Class post along with the indicative speed by which it would arrive. A pictorial description of the mail item being sent was given along with maximum dimensions and an example of the type of item that may be contained inside to aid the understanding of the respondents.

1.8 Each respondent was presented with 12 scenarios across different prices and different mail product categories. The scenarios included questions on each of the following four mail product categories:

- standard letters;
- large letters weighing under 100g;

¹³ For the purposes of this survey, vulnerable consumers were defined as those who a) were aged 65 or over; or b) were in socio-economic group D or E; or c) had a gross household income of £15,000 or less.

- large letters weighing 200g; and
- postal packets.

1.9 The respondents were randomly allocated price combinations for each category.

1.10 The face-to-face interview questionnaire posed scenarios across the same mail product categories. However, given the different nature of the survey approach, respondents were only presented with five scenarios across the four categories of mail products.

2. The “tipping point”

2.1 Our “tipping point” data was derived from online respondents’ answers to the choice experiment.

2.2 As previously mentioned, the online survey also included some vulnerable consumers who have internet access (28.6% of the total online survey respondents), so the preferences of vulnerable consumers do feature in our “tipping point” data, albeit only those with internet access.

2.3 The “tipping point” data provides a useful indicator of when stamp prices become too high and might need to be capped. If the price of mail is so high that online respondents will switch away, it will also be too high for vulnerable, low-internet-users with no alternative options to Royal Mail’s services.

2.4 The “tipping point” data is also of crucial importance as it identifies at what point online respondents will switch to alternative options as the price of mail increases. The more online users switch away, the higher the risk of captive, vulnerable, low-internet-users being left to bear a disproportionate burden of rising prices to sustain the Universal Service.

3. Vulnerable, low-internet-users

3.1 As previously mentioned in this note, we are not aware of any definitive, publicly available statistics on the number of vulnerable, low-internet-users in the UK. However, the annual OFCOM UK Communications Market Report provides some useful insights. The most recent report, from August 2011, notes:

“Broadband take-up in the UK increased by three percentage points in the last year to 74%. Within this, take-up increased in Wales by 7pp (to 71%) and in Northern Ireland by 5pp (74%). However, broadband take-up in Scotland has remained stable over the past two years, and is lower than the other nations at 61%...”¹⁴

3.2 The 2011 report also states that broadband take-up is “particularly low among low income homes and older consumers”.¹⁵ It notes that, by 2011, some 55% of those aged 65–74 had internet access at home but the same was true for only just over a quarter (26%) of those aged 75+.¹⁶

3.3 The picture across both broadband and other forms of internet access provides further useful information. The OFCOM report states that:

“Virtually all of the 77% of homes with a computer are now connected to the internet, with many households having more than one connection. When including internet access via a mobile phone, total internet penetration has reached 78%.”¹⁷

3.4 From these figures, it appears that 23% of UK households do not have internet access at home, a large proportion of which are likely to be low income and/or older consumers.

3.5 The face-to-face interviews accounted for around 10% of the total number of survey respondents. While we recognise that this is not as complete a representative sample of vulnerable, low-internet-users in the UK as we would like, the figure is robust enough to consider any such patterns of behaviour shown in the interview findings to be indicative of the behaviour of vulnerable, low-internet-users as a whole. Hence our recommendation, in oral evidence before the Select Committee, for a more detailed impact assessment to be undertaken by OFCOM to be able to properly assess how their proposals may affect all consumer groups, but especially the vulnerable and vulnerable, low-internet-user groups.

4. Additional key findings of interest

4.1 The research indicated that for both online and vulnerable, low-internet-users mail remains a vital communication tool:

- it was the third most favoured communication tool for online respondents. E-mail was first with 95.9%, landline telephone was second with 80.4%, and mail was third with 78.4%; and
- mail was the most favoured communication tool for vulnerable, low-internet-users with 77% choosing it. Landline telephone was a close second with 75%.

¹⁴ *Communications Market Report: UK*; Ofcom; 4 August 2011; Pg 5

¹⁵ *Ibid*; Pg 5

¹⁶ *Ibid*; Pg 4

¹⁷ *Ibid*; Pg 19

4.2 Our research, demonstrated in Tables 1 & 2 below, showed that all consumers still overwhelmingly use the First Class service to send standard letters.

Table 1

TYPICAL SENDING HABITS (ONLINE USERS)

<i>Usual postal method used</i>	<i>Letters</i>	<i>Large letters</i>	<i>Packets</i>
First Class all of the time	19.5%	10.7%	7.4%
First Class most of the time	28.5%	17.4%	10.4%
First and Second Class an equal amount	13.2%	12.3%	11.2%
Second Class most of the time	26.1%	30.3%	26.7%
Second Class all of the time	8.7%	13.3%	16.8%
Alternative service (eg Recorded or Special Delivery)	:	:	13.5%
Never send letters/large letters/packets	2.6%	13.2%	10.8%
Don't know	1.3%	2.8%	3.2%

Table 2

TYPICAL SENDING HABITS (VULNERABLE, LOW-INTERNET-USERS)

	<i>Letters</i>	<i>Large letters</i>	<i>Packets</i>
First Class all of the time	28%	19%	13%
First Class most of the time	22%	11%	9%
First and Second Class an equal amount	14%	7%	5%
Second Class most of the time	24%	18%	10%
Second Class all of the time	10%	19%	18%
Alternative service	:	:	11%
Never send letters/large letters/packets	1%	23%	32%
Don't know	:	2%	2%

4.3 Online respondents tend to place more value on price rather than delivery speed for all mail products, shown in Table 3 below. Nevertheless, they still value speed, particularly for standard letters.

Table 3

AVERAGE IMPORTANCE RATING GIVEN TO DELIVERY SPEED AND PRICE (ONLINE USERS)

	<i>Speed</i>	<i>Price</i>
Letter	7.31	8.13
Large letter	6.75	8.11
Packet	6.65	8.26

(10 = very important, 1 = Not at all important)

4.4 Our research shows that while those with access to online services are price sensitive, those who are low-internet-users do not demonstrate similar price sensitivity. For example, in the Large Letter weighing under 100g category, vulnerable, low-internet-users switched to Second Class from First Class at a higher rate than online users (30% switching away versus 10%); however, when the price of Second Class rose, vulnerable, low-internet-users switched away at a far lower rate than online users (21% of online users switched away versus 5% of vulnerable low internet users). This could be explained by the lack of an alternative to the Second Class service for those without an online option.

4.5 This could result in lost volumes, caused by online consumers switching away to alternatives to Royal Mail, leading to an increase in prices, in order to fund the Universal Service, which would fall disproportionately on vulnerable, low-internet-users.

Written evidence submitted by Ofcom

When Chris Rowsell, Gavin Knott and I appeared before you on 21 February, I promised to write with additional information in a number of areas. I set these out below.

International Benchmarking of the UK's Stamp Prices

The Committee asked for more evidence on Ofcom's international benchmarking and details on where the UK's stamp prices currently stand in comparison to other countries in Europe. Below we have summarised information that we published in our October consultation (and associated documents), and relevant information we received as responses from key stakeholders.

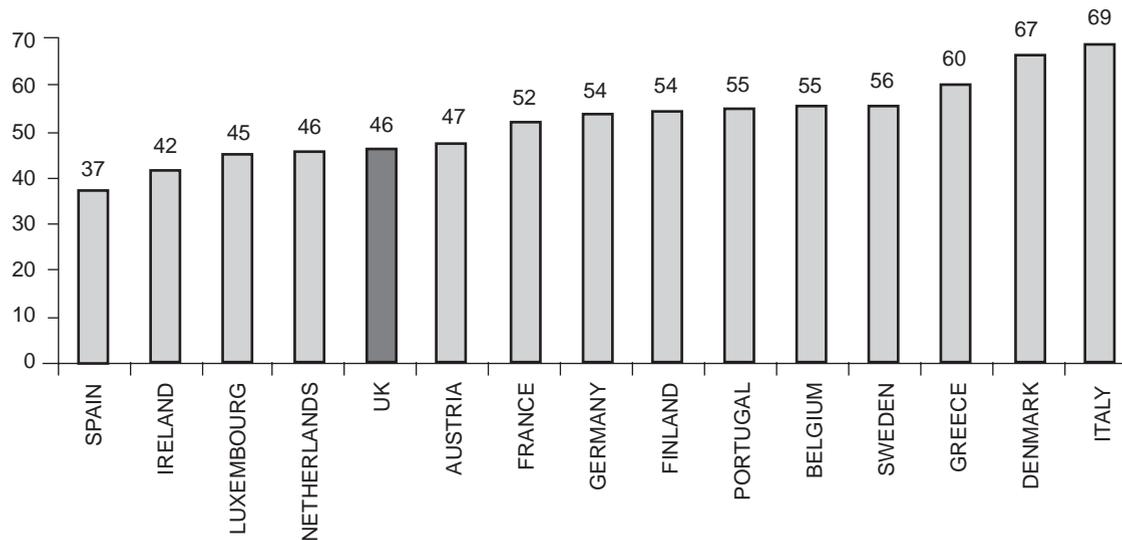
In the consultation document *Securing the universal postal service: Proposals for the future framework for economic regulation*,¹⁸ pages 24–25, we state:

Until recently Royal Mail's prices compared favourably with those in other EU countries. Due to the more recent price rises, its prices for basic weight stamps are now much more aligned with international comparators, although Figure 3 shows that a like-for-like analysis of prices across First Class services, Royal Mail's prices for 0–100g services remain low.

Footnote 23: It is important, however, to recognise the caveats that need to apply to international comparisons—in particular the universal service requirements vary considerably between different EU member states, it does not include both a First and Second Class service for most countries, and other countries offer more than one service in the 0–100g range. In addition, costs will vary significantly due to factors such as geography and quality of service standards.

Figure 3

EU-15 AVERAGE FIRST CLASS STAMP PRICES UP TO 100G USING UK VOLUME WEIGHTS, MAY 2011



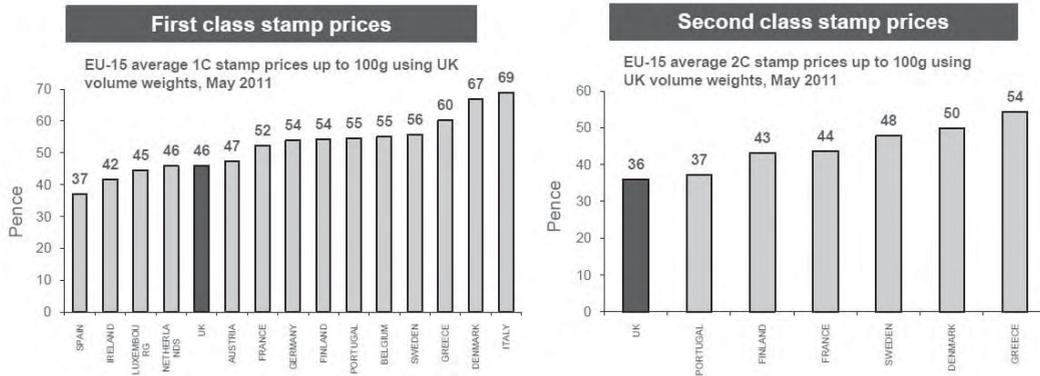
¹⁸ <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>

The two slides below come from Ofcom’s stakeholder briefing presentation of 20 October 2011 on *Securing the universal postal service: The future framework for economic regulation*.¹⁹



Prices have been low and unsustainable

- Prices for products have in many cases been below cost
- Until recently prices have been among the lowest in Europe, despite one of the most demanding USOs



The UK’s universal service is set at the high end

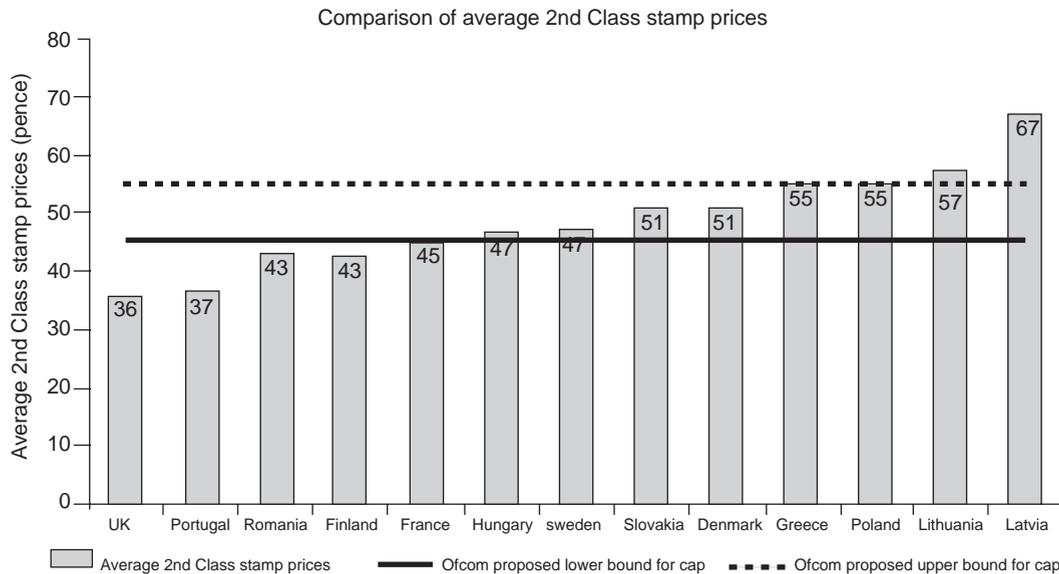
Directive requirement					
5 day per week delivery and collection	6 day per week delivery and collection	6 days per week	6 days per week	5 days per week	6 days per week
Minimum standards of service	D+1 = 93% D+3 = 98.5%	D+1 = 93% D+3 = 93%	D+1 = 80% D+2 = 95%	D+3 = 90% D+5 = 98%	D+1 = 87% D+2 = 95%
Priority service price comparison (pence)	D+1 = 46p	D+1 = 66.8p	D+1 = 53.8p	D+3 = 37p	D+1 = 69p

D= day of posting
D+X = day of arrival

In its response to the October consultation, Royal Mail provided the following chart comparing stamp prices in Europe.²⁰

¹⁹ <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/slides.pdf>

²⁰ http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/royalmail/Level_of_2c_cap.pdf



Average prices reflect the fact that some countries vary pricing by weight. Prices are in pence adjusted for purchasing power parity. For methodological details see Annex A and Chart 10 in particular.

The Definition of “Vulnerable Consumers”

We undertook to clarify the definition of “vulnerable consumers” we have applied in undertaking our work on affordability.

The concept of a vulnerable consumer is not specifically defined in either the Postal Services Act 2011 or the Communications Act 2003. Rather, it is a description we have applied to those groups of consumers to which we are required to have regard and/or whom we consider are in need of special protection.

Section 3 of the Communications Act 2003 sets out the general duties of Ofcom. These also apply (where relevant) to the carrying out of our functions under the Postal Services Act 2011. Subsection (4) of this section says: “*OFCOM must also have regard, in performing those duties, to such of the following characteristics as appear to them to be relevant in the circumstances*”, Subsection 3(4)(h) identifies “*the vulnerability of children and of others whose circumstances appear to OFCOM to put them in need of special protection*”, and Subsection 3(4)(i) identifies “*the needs of persons with disabilities, the elderly and of those on low incomes*”.

This section does also identify other groups to which we are to have regard; in particular, “*the different interests of persons in different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas*” (Section 3(4)(l) of the Communications Act 2003). While we have had regard, where relevant, to these groups in making our proposals these groups are not in our view inherently vulnerable.

In assessing affordability in the context of vulnerable consumers we have therefore have attached particular significance to the potential impact of any price changes on “*the needs of persons with disabilities, the elderly and of those on low incomes*”. As we noted during the discussions with the Committee on 21 February, and as is reflected below, we have also taken account of the impact of changes in prices on consumers overall as well as on business users.

Affordability and Consumer Behaviour Research

The Committee requested further information on our analysis of affordability and consumer behaviour and detail on our assessment of the impact of our proposals on different types of business.

In assessing the impact of our proposals to give Royal Mail commercial flexibility we have considered a range of evidence as to the likely impact of price changes on customers, including business and residential customers. We have used the results from three different pieces of research and Royal Mail’s relevant models:

- (a) Research undertaken in 2010 by Postcomm and Consumer Focus of 1,398 residential consumers and 460 businesses;²¹
- (b) Consumer Focus research undertaken in November and December 2011 on 2,020 residential online consumers and 212 vulnerable consumers (over 65 or in the DE social class) who did not access the internet at least once a day;²²

²¹ Report on the findings for residential customers: <http://stakeholders.ofcom.org.uk/binaries/post/1183.pdf> and for business customers: <http://stakeholders.ofcom.org.uk/binaries/post/1184.pdf>

²² Discussed in Consumer Focus’ supplementary response to Ofcom’s October consultation on securing the universal postal service (link <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/ConsumerFocusreport.pdf>)

- (c) Ofcom survey of 3,621 residential consumers in December 2011;²³ and
- (d) Royal Mail's relevant models.

We have considered the issues of affordability and the impacts on small business and residential customers separately below.

(1) Affordability of universal service products

Postcomm published a discussion paper on affordability in early 2011.²⁴ This concluded that as the average weekly household expenditure on postal services is £0.40 per week, universal service prices remained affordable for residential customers now and for the foreseeable future. In addition, we set out our assumption in the October consultation document²⁵ that while the issue of affordability is more complicated for small businesses, it was our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses.²⁶

A number of respondents to this consultation challenged these assumptions, particularly with respect to small businesses. However, no respondent provided specific evidence on affordability in respect of either residential or small business customers.

We recognise that, if implemented, our proposal to deregulate to remove the substantial majority of price controls opens the possibility that some universal service prices will increase and could raise affordability concerns in the future. We are in a position where we have to balance such risks against the wider risk to the maintenance of the Universal Service. Therefore, we intend to monitor universal service price changes, and retain the power to intervene as appropriate. We are also planning to undertake further research and analysis on affordability levels for different universal services and types of universal service customers.

(2) Residential customers

As set out above, the average weekly household expenditure on post is very low (£0.40 per week), particularly in comparison to other forms of communication. Vulnerable customers in general appear to send less mail than other residential customers, however older customers (over 65) appear to send more mail (and in particular more letters).

The different surveys of residential mail usage undertaken over the last couple of years consistently show that residential customers are more likely to use First Class rather than Second Class mail. For example the 2010 Postcomm/Consumer Focus research found that 66% of customers say they use First Class all or most of the time when sending letters. When looking at what class of mail vulnerable customers use, there are some differences in the findings from the different pieces of research. Consumer Focus' 2011 research suggests that while vulnerable customers use mail less, their overall pattern of usage is similar to other residential customers. However, the 2010 Postcomm/Consumer Focus research suggests that vulnerable customers are more likely to use Second Class mail than other residential customers. All of the different surveys did show that vulnerable customers claim to use First Class more than Second Class mail.

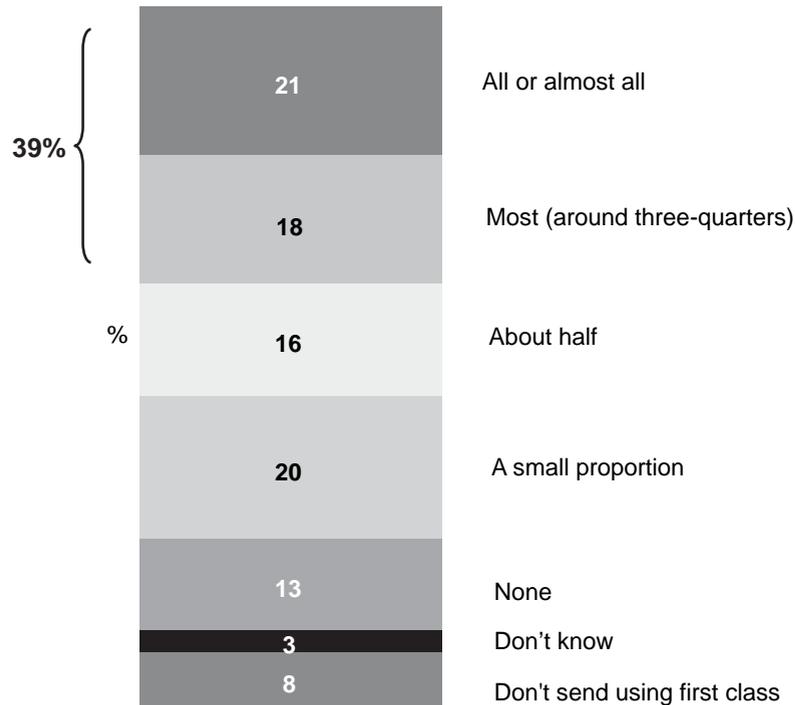
However, not all of this mail needs to be delivered the next day. The 2010 Postcomm/Consumer Focus research found that only 39% of residential customers considered all or most of their mail needed to be delivered the next day. The more recent Consumer Focus research found that 65% of people claimed that all or most of their mail needed to be delivered the next day (see figure 1 below). This may be overstated to an extent as the most common types of mail sent at least once per month were personal communications and general correspondence which may be able to be sent Second Class if this was planned in advance.

²³ This research has not been published

²⁴ The building blocks for a sustainable postal service: Universal service—Discussion paper on affordability. February 2011. <http://stakeholders.ofcom.org.uk/binaries/post/1809.pdf>

²⁵ See <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>

²⁶ Paragraph 6.955 of the October consultation

Figure 1**PROPORTION OF LETTERS SENT FIRST CLASS THAT HAVE TO ARRIVE AT THEIR DESTINATION THE NEXT WORKING DAY**

Source: B4 Proportion of letters sent first class that have to arrive at their destination the next working day?
Base: All respondents (1,387)

We are also reviewing the usage of large letter and packet products by residential customers in general and vulnerable customers in particular to determine whether the scope of the safeguard cap should be extended to these products. While the data sets involved different questions and methodologies there are some related themes. Consumers as a whole send significantly less large letters and packets than standard sized letters. Royal Mail's customer data for Second Class stamps shows that nearly 90% of volumes are standard sized letters and our omnibus research indicates that only 9% of residential consumers stated that they use large letter stamps (of which 40% used them for packets and 23% for parcels).

We are considering these areas in more depth in coming to our decision on the appropriate scope of a safeguard cap for vulnerable consumers.

(3) Small business customers

The main source of data for our analysis of business users is the 2010 business research undertaken by Postcomm and Consumer Focus. This research considered small business usage (spend, use of products) by business size, location (ie rural, suburban, urban) and business sector (although as the survey design was based more around company size not much analysis on the weighted data by industry sector was possible).

As can be seen in figure 2 below, SMEs' monthly spend on postal services is correlated to the size of the business, ie businesses with fewer employees spend less on postal services and those with more employees spend more. The research also found that businesses in rural areas are more likely to use mail than businesses in urban or suburban areas but that they are also more likely to have a low spend of £1 to £25 per month (47%).

Figure 2**MONTHLY MAIL SPEND BY ESTABLISHMENT SIZE**

	Total	1-10	11-50	51-249	250+
	(460)	(153)	(106)	(108)	(93)
	%	%	%	%	%
£1-£25	35	38	18	16	3
£26-£100	36	37	37	13	10
£101-£500	19	17	29	31	24
£501+	10	8	16	39	63
Mean	£344	£294	£390	£806	£4,768

	<i>Total</i>	<i>1–10</i>	<i>11–50</i>	<i>51–249</i>	<i>250+</i>
Median	£37.50	£37.50	£75	£350	£2,812
Mode	£7.50	£7.50	£75	£750	£3,500

The research also shows (figure 3 below) that overall businesses were more likely than residential customers to say they use Second Class mail all or most of the time, and smaller businesses were more likely to use Second Class than larger businesses. In addition, we found that businesses in rural areas and production and public services were more likely to say that they use First and Second Class postal services equally.

Figure 3

PERCENTAGE THAT MAINLY USE SECOND CLASS BY ESTABLISHMENT SIZE

	<i>Total</i>	<i>1–10</i>	<i>11–50</i>	<i>51–249</i>	<i>250+</i>
	(460)	(153)	(106)	(108)	(93)
	%	%	%	%	%
Second Class all/most of the time	38	40	31	32	23

We also asked businesses what proportion of the mail sent First Class has to arrive at their destination the next working day. Only 55% of respondents considered that all or most of their First Class mail needs to be delivered the next day suggesting that some businesses will also be able to switch to Second Class services if the price of First Class increases significantly in relation to the Second Class price.

Figures 4 and 5 below show SMEs' usage of different products split by size of business and sector. Larger businesses are more likely to use all products than smaller businesses.

Figure 4

USE OF ROYAL MAIL SERVICES BY ESTABLISHMENT SIZE

	<i>Total</i>	<i>1–10</i>	<i>11–50</i>	<i>51–249</i>	<i>250+</i>
	(460)	(153)	(106)	(108)	(93)
	%	%	%	%	%
Recorded Delivery	84	84	88	90	91
Standard Parcel	71	72	67	74	80
Special Delivery	71	70	75	84	94
Packetpost	52	54	39	53	66
Business collection service	23	22	24	44	61

Figure 5

USE OF ROYAL MAIL SERVICES BY SECTOR

	<i>Total</i>	<i>Production</i>	<i>Retail leisure services</i>	<i>Financial and business</i>	<i>Public services</i>	<i>Other services</i>
	(460)	(93)	(83)	(96)	(93)	(95)
	%	%	%	%	%	%
Recorded	84	79	85	97	73	71
Standard Parcel	71	78	90	60	73	45
Special Delivery	71	70	83	75	52	64
Packetpost	52	45	61	45	74	35
Business collection service	23	33	8	37	5	14

All businesses have been increasingly using online alternatives to physical mail over the last few years but larger businesses are more likely to have moved some of their communication to these channels.

Most SMEs use post in a very similar way to residential consumers, ie the vast majority of SME mail is stamped (86%) and posted by hand (82% in post boxes). Therefore, while we do not consider small business fall into the definition of vulnerable customers (as discussed above), our proposal to put in place a safeguard cap on Second Class is also likely to benefit these SME customers.

Royal Mail's modelling

The analysis presented above does not in itself show how these different business customers will respond to price changes particularly if these are not implemented uniformly across Royal Mail's products. Royal Mail

has undertaken extensive statistical modelling of these impacts for all businesses. We have considered Royal Mail's analysis and built a modelling tool to test the implications of Royal Mail's models. Our model is based on Royal Mail's survey evidence and assumptions around the impact of price increases on volumes. This allowed us to understand the potential implications of any changes in price on different customers. The analysis is split by size and type of customer (as different customers use different products), by type of mail used (eg bulk mail customers and universal service customers) and for different uses of mail (eg advertising, transactional, e-fulfilment, magazines or social mail). We have also tested Royal Mail's analysis by talking to individual customers.

Our overall assessment is that the majority of business customers may be willing to accept price rises to some degree, but that there remains very significant uncertainty over the rate of volume decline resulting from e-substitution in the context of price rises. The analysis indicates that some customers, particularly large transactional mailers (eg banks) could accelerate their moves to electronic alternatives. Other customers, such as magazine publishers and direct mailers, are likely to significantly reduce their use of mail if prices increase materially. Our conclusion is that this all supports the need for Royal Mail to have commercial flexibility as we consider that it is in a better position to understand its different customers than the regulator. However, are very clear that we expect Royal Mail to use that commercial flexibility appropriately and retain the power to intervene in future as appropriate.

The Commercial Cost of a Second Class Stamp

The Committee requested further information on the commercial cost of the Second Class stamp service for standard mail.

As recommended in the Hooper report and as discussed in Postcomm and Ofcom's consultations, we require Royal Mail to provide extensive evidence to Ofcom on the costing of its different services. While we therefore hold information on the estimated costs of the Second Class stamp service, including Royal Mail's calculation of what activities drive the cost of the service, Royal Mail does not publish service costing information at this level of detail. We consider that we are prevented by section 56 of the Postal Services Act 2011 from disclosing to the Committee the cost estimates that we have received from Royal Mail, without Royal Mail's agreement.²⁷ We would of course be happy to seek such consent in the event that the Committee does not obtain the information directly from Royal Mail.

Notwithstanding this, the Committee may find the following information helpful:

- Royal Mail's profitability as a whole has been weak in recent years. In 2010–11, Royal Mail's business unit for UK Letters & Parcels and International (UKLPI) made a loss of £120 million on turnover of £6.9 billion, compared to a small profit of £20 million on turnover of £7.0 billion in the previous year.²⁸
- Reported operating profits on the regulated business have been low or negative in every year since the start of the current regulatory framework in 2006—never exceeding 3% of sales.²⁹
- The most recent publicly available data (which is for 2008–09) shows losses of £82 million on Second Class stamps³⁰, and losses of £244 million for First and Second Class stamps combined, which was equivalent to 8.7p per item.³¹

Since then price increases and some changes to the method of costing for stamps have improved this picture.

Care must also be taken when interpreting the costs and profitability of individual mail services. Mail is a network business where the costs of individual services depend on the scale and type of other services delivered over the same network and on the implications of the universal service obligation. This is particularly the case for Second Class stamps which only account for less than 10% of total letter volumes. Were there to be a significantly lower volume of business and bulk mail, for example, the average cost of all mail services, including Second Class mail services, would be higher than current levels, possibly quite significantly (all other things equal). Sustaining the financial viability of the universal service therefore requires Royal Mail to set prices across its different mail services in a manner that helps maintain mail volumes overall. This in turn should help contain costs and prices for all mail users, but it does also mean that the reported accounting margins and profitability across mail services will vary, again possibly significantly.

Confirmation of how long the Price Ceiling had been in Place in the Netherlands

The Netherlands' price control with a price cap on postal prices regime was introduced on 1 January 1989. Prior to that date prices were proposed by the company, set by the responsible minister and approved by parliament.

²⁷ Section 56 of the Postal Services Act makes it a criminal offence for Ofcom to disclose information about a business without its consent, except in specified cases or except to bodies/for purposes prescribed by order of the Secretary of State. No such bodies or purposes have yet been prescribed by the Secretary of State.

²⁸ <http://www.royalmailgroup.com/news/2011/royal-mail-group-annual-results-2010-11>

²⁹ <http://www.royalmailgroup.com/how-were-performing/regulatory-financial-statements>

³⁰ See p. 7 of <http://www.royalmailgroup.com/sites/default/files/pdfs/regulatory-financial-statements-2008-09-unaudited.pdf>

³¹ See p.3 of <http://www.royalmailgroup.com/sites/default/files/pdfs/regulatory-financial-statements-2008-09.pdf>

I trust this letter responds fully and satisfactorily to the questions on which the Committee requested further information. We obviously remain very keen and willing to support the Committee's on-going work on postal services and would be pleased to provide further input or assistance if that would be helpful.

Stuart McIntosh
Group Director, Competition

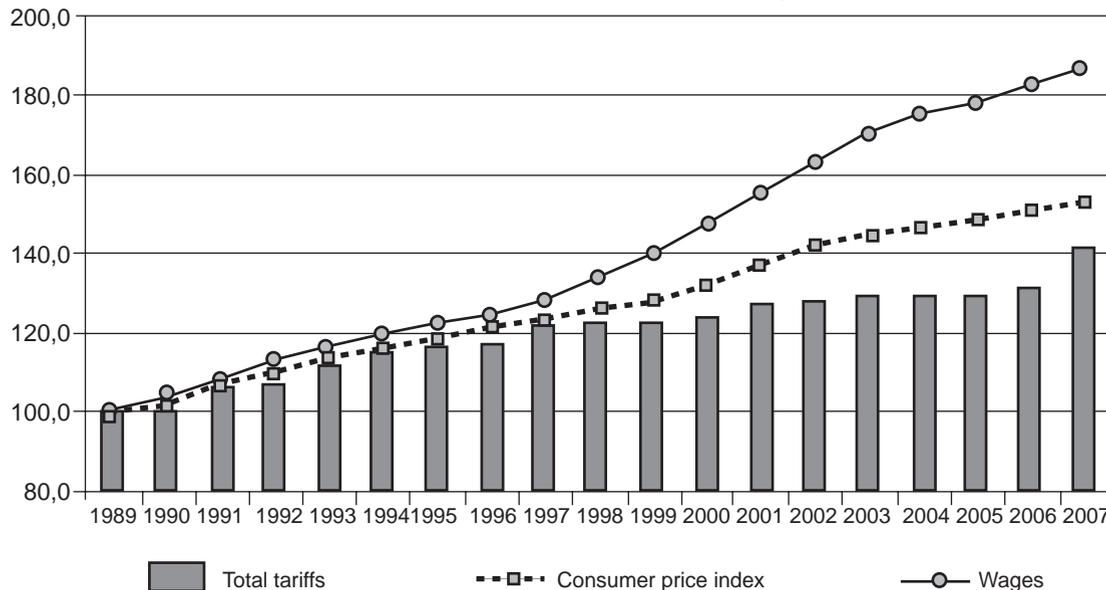
28 February 2012

APPENDIX

The Dutch parliament decided to put a price cap on PTT Post (later TNT, now PostNL) at the date of corporatisation, ie 1 January 1989. This was to address the concern that as a privatised postal operator PTT Post would raise prices extremely. Before that date prices were proposed by the company, set by the responsible minister and approved by parliament.

From 1989 until 2008 tariff regulation in the Netherlands was based only on affordability. The increase in the weighted average of domestic tariffs was not allowed to exceed the increase in the index of wages. From time to time, when the gap between the tariff index and the wages index became too large, both indices were reset at 100 to avoid large tariff increases at once. According to PostNL its improvements in efficiency and productivity led to good financial results together with very limited price raises.

Development of tariffs, price index and wages



Sources: CPI: CBS (2007 temporary figure) Wages: CPB - Wage-index Total tariffs: TNT - reporting to OPTA

In 2009 the size of the USO changed drastically and the price cap system was changed as well. CPI became the relevant index for the price cap, whereas a capped letters basket and a separate basket for parcels were introduced. International items are included in both the letter and the parcel baskets.

In addition to affordability-regulation, there is now, also, regulation on Return on Sales. Every four years PostNL has to send the Supervisory body (ie OPTA) a tariff-proposal showing that the calculated RoS does not exceed 10%. In 2011 our first proposal, with all tariffs as of 2012 was duly submitted.

Written evidence submitted by the Communication Workers' Union (CWU)

The Communication Workers' Union (CWU) is the largest union in the communications sector in the UK, representing over 200,000 employees in the postal, telecoms and related industries. It is the recognised union in the Royal Mail Group for all non-management grades.

The union welcomes the opportunity to submit evidence to the Business Innovation and Skills (BIS) committee inquiry into stamp prices. As the committee is aware, the postal industry has been experiencing a period of unprecedented change in recent years. The Postal Services Act 2011 allows for further significant change by allowing for future privatisation of Royal Mail, the transfer of a large proportion of Royal Mail's pension assets and liabilities to government and the establishment of a new regulatory regime under Ofcom.

Ofcom has now taken over regulation of postal services and has been consulting on a new regulatory framework to take effect from April 2012. The regulator has recognised many of the failings of the previous regulatory regime and is proposing significant deregulation of Royal Mail's products and services.

All universal service products—including stamps—are currently subject to price controls by the postal regulator; Ofcom now proposes the removal of price controls from all universal service products, with the exception of 2nd class letters under 100g which would be subject to a price cap. No proportionate price controls would be applied to other second class products, such as larger letters or parcels.

The principle driver for this change is to allow Royal Mail greater commercial flexibility. Ofcom rightly recognises that Royal Mail's difficult financial position threatens the future sustainability of the universal service. Royal Mail has faced unprecedented circumstances in recent years: premature liberalisation, damaging regulation, the legacy of chronic underinvestment, a massive pension deficit, declining mail volumes and a modernisation programme requiring extensive change for workers.

Ofcom proposes to establish a regulatory regime which will stay in place for seven years, ending a period of regulatory uncertainty for Royal Mail. A review of the second class price cap is proposed after two years.

CWU Position

The CWU welcomes Ofcom's acknowledgement that the long term viability of the universal postal service depends on Royal Mail's ability to continue to provide that service. We have consistently argued that Royal Mail is the only operator capable of providing the universal service, and that previous policies which damaged the company's financial position threaten the viability of the universal service.

In particular we welcome Ofcom's proposals to deregulate non-universal service products, and to improve the downstream access regime. It is striking that many of the measures proposed by Ofcom in the business mail market simply establish regulatory parity between Royal Mail and its competitors. It is deeply regrettable that competition was allowed by the previous regulator to take place under unequal regulatory regimes, and is undoubtedly a major factor in Royal Mail's loss of business to access operators and consequent financial difficulties. The CWU supports those proposals which seek to level the playing field between Royal Mail and its competitors.

The CWU accepts that increases in stamp prices will be necessary for Royal Mail to stabilise its financial position: there has been a long-term trend of stamp prices failing to keep up with inflation; falling mail volumes have meant increasing unit costs for the business; and international comparisons show that postal workers in this country deliver an impressive service at a good price.

Royal Mail needs to be able to increase revenue if it is to be able to have a successful future. Mail volumes are continuing to fall while the number of delivery points the business must visit everyday is rising. This will have a major impact on the sustainability of the universal service. Royal Mail needs to be able to cover these costs and to do so it will inevitably need to raise prices. This will apply to stamp prices as well as the price of business mail.

The Postal Services Act introduced the important condition that the universal service provider should be able to earn a commercial rate of return on expenditure connected with the universal service. We welcome Ofcom's proposal to apply this to all activities in Royal Mail's former Letters division.

However, while we recognise that stamp prices will need to rise, we do not wish to see the burden of sustaining the universal service fall solely on the users of universal service products. Large business mailers and Royal Mail's private competitors benefit from the existence of the universal service and have benefited from the introduction of competition. They should play a major part in ensuring the sustainability of the universal service; either through prices which reflect its importance or, if this is not possible, through a form of universal service support fund.

We are concerned that Ofcom's proposals might shift the balance of funding the universal service too far towards universal service product users and in so doing make it unaffordable. We believe the interests of universal service customers continue to require some protection.

An Affordable Universal Postal Service

The CWU believes it is important that the full range of universal service products remain affordable. We are concerned that Ofcom's proposals might result in only one universal service product remaining affordable.

A universal postal service is by definition one which is affordable for all users. EU Directive 97/96/EC requires the government to ensure "a universal service...at affordable prices for all users." (Ch 2 Article 3 s. 1).

Ofcom states its belief that: "it is essential that the role of the universal service in society is preserved and that the price of a basic universal service in society is preserved and that the price of a basic universal service is not allowed to rise above an affordable level" (Securing the Universal Postal Service, s. 1.44). The implication is that the regulator is only concerned that there be one affordable universal service product and would accept other universal service products becoming unaffordable.

We appreciate that the removal of price controls, or the setting of a cap, does not necessarily entail large increases in price. That will be a decision for Royal Mail who will of course make a judgement on profit maximisation and the likely effects on demand. Nonetheless, we believe it is desirable for the regulator to avoid the possibility of an increase in prices which would render universal service products unaffordable.

We are concerned that the current proposals raise the possibility that for some users at least, the only truly universal service would be for posting of a second class letter weighing less than 100g, while first class or larger second class post would have many of the features of the universal service, but not necessarily affordability.

Defining Affordability

Given the importance of ensuring affordability for all users, we are concerned that Ofcom's approach to the issue of affordability does not appear to have considered the principle, or the impact of proposals, rigorously enough. Whilst we recognise that establishing a definition of affordability is not straightforward, we believe further consideration needs to be given to the issue of affordability before far reaching changes to the pricing of stamps can go ahead.

Ofcom has referred to Postcomm's February 2011 discussion paper on affordability which claimed postal services represent 40p of the average £455 average weekly expenditure, and conclude this means postal services are affordable for consumers. Despite acknowledging that it has not undertaken any analysis of affordability for small businesses, Ofcom concludes that if prices are affordable for consumers they will also be for small businesses.

Ofcom seeks to argue that since postal services make up such a small proportion of weekly household spend, prices can rise significantly and still be deemed affordable. While this argument seems initially compelling, it fails to establish an objective standard for assessing affordability, or to take into account the needs of business or vulnerable users.

We are concerned that Ofcom's analysis does not appear to establish what would constitute an unaffordable increase. A tenfold increase in postage costs would still constitute a very small proportion of average expenditure, but may well make the service unaffordable for many users.

While we disagreed with Postcomm's 2011 analysis of affordability, it had the advantage of establishing a firm test for what level of increase would be unaffordable. Any serious attempt to protect affordability ought to do the same.

Postcomm considered the Joseph Rowntree Foundation (JRF) "Minimum Income Standard" as an alternative method of assessing affordability. JRF concluded that around £3 per week could be allocated to postage from minimum income budgets, which would need to cover three first class stamps as well as the cost of paper envelopes and pens to write the letter with. Postcomm were satisfied at the time that these requirements would be met, noting that "The weekly figure is more than enough to cover the cost of three first class stamps." It is not clear that under the current proposals the cost of three 1st class stamps would remain within the limits of the £3 budget. We recommend Ofcom re-examine the merits of adopting a more developed definition of affordability, such as the Minimum Income Standard.

Impact Assessment

We believe that further analysis of the impact on users of proposed changes to stamp prices is required before such far reaching changes are implemented. In particular, we believe Ofcom should have greater regard for the needs of small businesses and vulnerable domestic consumers.

We do not support the assertion that small business needs can be inferred from domestic consumer budgets. Small businesses are very dependant on stamped mail. The Federation of Small Businesses has found that 90% of small businesses use stamped mail and use the post office to buy stamps and send mail. Changes in stamp prices for both 1st and 2nd class stamps are likely to have impacts on business models and viability of small businesses, and their needs deserve greater attention.

Vulnerable domestic consumers including the disabled and those on low incomes are likely to have expenditure profiles which differ substantially from the average. Serious consideration should also be given to the effect of price changes on vulnerable people who do not have internet access, and are therefore likely to bear the brunt of price increases, as highlighted by Consumer Focus in their report³² on potential impacts of stamp price increases on consumers.

Monitoring

We are also concerned that the monitoring of the effects of the changes to the pricing regime is insufficient to protect users. Ofcom state their intention only to review the second class price cap, and that only after two years. We would like to see the regulator retain more robust monitoring and control mechanisms to ensure universal service products remain affordable. Ofcom should fully assess the impact of price rises on domestic consumers and small businesses on an annual basis.

³² "Consumer Focus report on potential impacts of stamp price increases on consumers", Consumer Focus, January 2012

Economic Context

The timing of these proposals is also a cause for concern. Domestic consumers are enduring the biggest squeeze on living standards in living memory, while the difficulties facing small businesses are well documented. The Federation of Small Business reports plummeting confidence in the sector, with their Small Business Index reaching record lows. We believe there has been insufficient consideration of the broader circumstances facing users, which impact on affordability and Royal Mail's long term customer base.

Competition—Who Benefits?

As Richard Hooper acknowledged in his interim report of May 2008, universal service users have not seen the benefits of competition, which have largely profited larger business customers. Prices of universal service products have risen sharply since competition was introduced, while service levels have reduced, for example through later deliveries and earlier collections. We do not believe universal service users should be responsible for paying for damage done to Royal Mail's finances by early liberalisation and poor regulation.

Considering Alternatives

Royal Mail needs to generate additional revenue to sustain the universal service. Increasing stamp prices is one way of contributing towards this, but it should not be the only way. Ofcom needs to look at alternatives if it is to ensure a sustainable and an affordable universal service. To this end we would like to see the regulator address the balance of price increases to ensure that large business mailers and private competitors—who have benefited from competition and from the universal service make—make an adequate contribution to sustaining the universal service. If this cannot be achieved through pricing, we would like to see the regulator consider alternatives such as a universal service support fund.

Conclusion

The CWU welcomes the new regulatory framework for non-universal service products, and the recognition of the importance of Royal Mail's financial position for the long term viability of the universal service. Royal Mail faces a very challenging commercial environment, with falling mail volumes and increasing delivery points. The company must be able to increase revenues if it is to have a sustainable future and this will mean price rises.

Ofcom's duties to ensure the sustainability and the affordability of the universal service stand side by side. The current proposals however potentially prioritise sustainability above affordability and risk creating a two tier universal service, with some services becoming unaffordable for important groups of consumers.

The universal postal service needs to be sustainable *and* affordable to fulfil its crucial role in society, and a failure to ensure either aspect would represent regulatory failure. While universal service product prices will need to rise, Ofcom must ensure the right balance is struck; universal service product users should not bear the full burden of the cost of sustaining the universal service. Business mailers and private mail operators who have benefited from competition and the existence of the universal service network must contribute more to its future financing. We are concerned by the potential implications of Ofcom's proposals and urge the regulator to consider alternatives, including the possibility of a universal service support fund.

While it is important to assess whether the affordability risks to the universal service are necessary to make it sustainable, we would also like to stress the significant improvements Ofcom is proposing regarding regulation in areas beyond universal service pricing.

27 February 2012

Supplementary written evidence submitted by Royal Mail

CHRISTMAS STAMP PRICES—FOLLOW-UP TO THE EVIDENCE SESSION HELD ON 28 FEBRUARY 2012

We will be announcing a scheme for this Christmas that will allow the most vulnerable members of society to buy first and second class stamps at 2011 prices. Even though research has shown that postage accounts for a modest proportion of household expenditure for all social groups, we understand that there are some people for whom any price rise will be difficult. It is important to help them at this time.

The scheme is not yet finalised and there is more work yet to be done. The basic details, however, are as follows:

Royal Mail is planning for those on pension credit, and employment and support allowance (previously called incapacity benefit) to be eligible for participation in the scheme. Around five million people will be eligible under those criteria.

We are working with our colleagues at the Post Office to make sure those who qualify will be able to get their discounted stamps from any of the 11,801 Post Office branches. As soon as we have finalised the arrangements, we will write to all Members of Parliament and other stakeholders.

We intend to communicate this offer with a national mailing to every UK household when the details are finalised.

28 February 2012

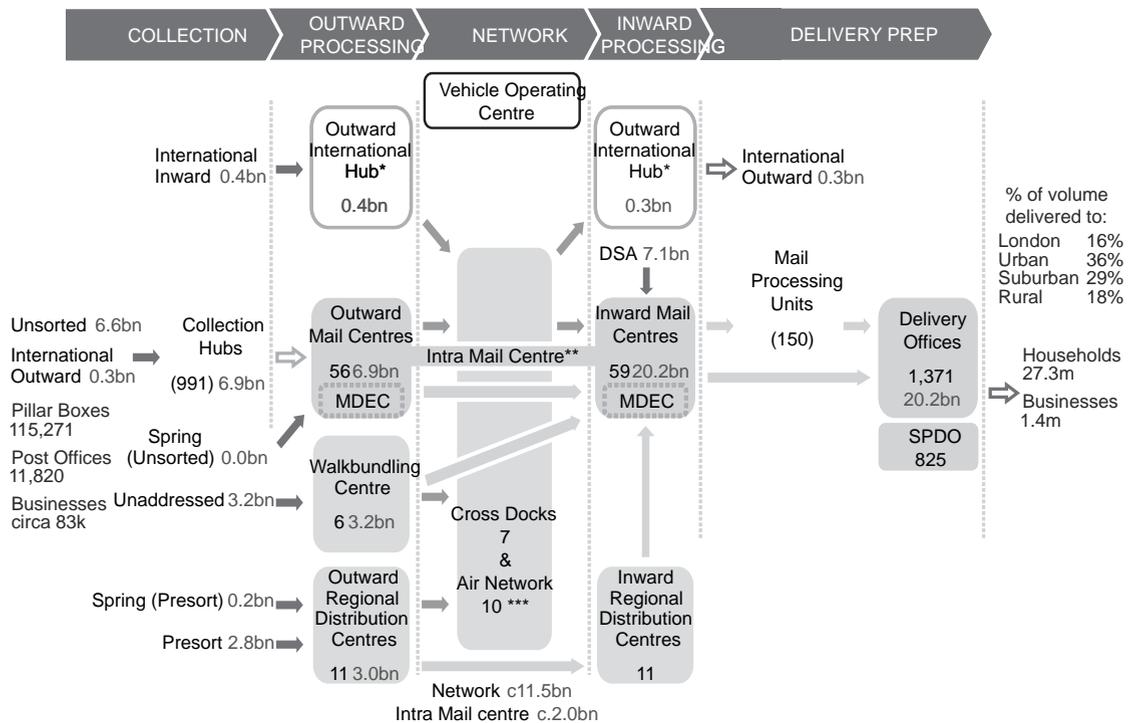
Further supplementary written evidence submitted by the Royal Mail

Cost of the USO and Second Class USO Services

1. Royal Mail’s statutory obligation, as the designated universal service provider, drives the architecture and the economics of the universal service mails network. This obligation, re-confirmed by Parliament in the Postal Services Act 2011, results in Royal Mail needing to collect mail from circa 12,000 post offices, circa 115,000 pillar boxes and circa 83,000 businesses on a daily basis, as well as the capability to visit up to 29 million delivery addresses six days per week.

2. Royal Mail has developed a network to collect, move and deliver mail throughout the country, overnight, to ensure it can offer a next day service. The diagram below illustrates the scale of the integrated mails network used to provide the universal service, including:

- six day collection and delivery services;
- an overnight domestic service for First Class USO and Special Delivery³³ USO items;
- a domestic service for Second Class USO items;
- exit from and entry to the network for outbound and inbound international mail; and
- capability to deliver to up to 29 million delivery addresses 6 days each week.



Source: Royal Mail Data 20

Source: Royal Mail Data—2010–11

3. This mails network is shared by both USO services (for example stamped and franked First and Second Class mail) and, to varying degrees, by non-USO services (for example, First, Second and Third Class bulk retail and access mail, other First and Second Class business mail services which are not part of the USO). The costs of running this network are therefore shared by both USO and non-USO services.

4. In 2010–11 the cost of running this network was c£6.7 billion (including modernisation costs), whilst the revenue generated from the products which used the network was c£6.4 billion. The scale of the financial challenge for Royal Mail is significant. Over the last four years Royal Mail has lost c£1 billion and the core USO mails business remains loss making.

5. The cost of the universal service network is, to a large degree, insensitive to changes in volume or changes in the mix between USO and non-USO services. The critical cost is the need to visit every address every day whether there is one letter for delivery or ten. It is therefore neither straightforward, nor informative when

³³ Special Delivery Next Day stamped and franked services form the USO registered and insured service.

looking at financeability and profitability of the USO, to identify those costs which relate solely to *individual* services using the USO network.

6. The revenue generated from USO services in 2010–11 was £2.9 billion, of which stamped mail accounted for £1.1 billion. Given the cost of the USO mails network is £6.7 billion this clearly illustrates that the revenue contribution from non-USO services is essential to USO financeability. It also demonstrates the scale of the financial challenge for Royal Mail in covering the cost of the universal service.

7. Allocating costs to individual products using the USO mails network implies that Royal Mail could cease to offer a particular product with a consequent and definable reduction in its underlying costs. This is simply not the case for the USO mails network. Royal Mail's network architecture and associated costs are driven by the universal service obligation. The joint/common nature of the network costs mean that if Royal Mail was to cease to provide a non-USO service which uses the USO mails network, a broadly unchanged cost base would need to be spread across a smaller portfolio of remaining services, raising their notional cost. This would undermine the financial viability of the universal service and increase the pressure to raise prices on the remaining services.

8. Given the integrated nature of the USO mails network, Royal Mail has long argued that the right way to assess USO financeability and profitability is to consider all of the costs of the activities required to deliver a universal service against all of the revenues generated by all of the services which make use of the universal service mails network, even when these are not USO services. This approach has been recognised by Ofcom as the appropriate starting point for considering the financeability of the universal service in their October 2011 consultation document on the future regulatory regime for postal services.³⁴

9. Product cost allocations can be generated by Royal Mail's internal costing systems based on allocation rules which have been devised to comply with the EU Postal Services Directive. Royal Mail believes that these allocations are artificial and potentially misleading due to the integrated nature of the mails network, the requirements of the Directive and the predominance of joint/common as the CEO pointed out to the Committee³⁵ for the reasons described in paragraph 7. In summary, all of the costs of delivering the USO need to be covered by the total revenues of all products which use the USO mails network, and a reasonable commercial rate of return needs to be generated.

10. As the Committee will be aware, up to and including the 2009/10 financial year, Royal Mail produced Regulatory Accounts which included profitability information for USO services split by a consolidated view of both First and Second Class services. This information was generated on the basis of an operational traffic measure (Reported Operational Traffic or ROT). This publicly available information showed that in 2009–10 Royal Mail made a loss for first class stamp and meter services of £(22) million and for second class stamp and meter services of £(42) million.

11. For clarity, Reported Operational Traffic (ROT) data for account based traffic is sourced from accounts receivable, while Stamp and Meter traffic is sourced from sampling within operations through a combination of machine counts and average number of items in a container.

12. Following discussions with the former Regulator (Postcomm), from 2010–11 Royal Mail moved to a revenue derived traffic measure (RDT). This movement was in response to a regulatory consultation on the most appropriate basis for traffic measurement and the fact that Royal Mail's broader approach to strategic business planning and Statutory Reporting was based on RDT. Revenue Derived Traffic (RDT) data for account based traffic is sourced from accounts receivable. However, differently from ROT, Stamp and Meter traffic is sourced from the revenue received divided by average unit prices, both of which are identified through business sampling.

13. In 2010–11 Royal Mail also moved to the reporting of a regulatory cashflow in the audited financial statements and away from the provision of financial information at the level of a particular class of service.

14. However, for the Committee's information, in 2010–11 on both the revised RDT and the historic ROT traffic definitions for First Class Stamped Mail alone, and Second Class Stamped Mail alone, we can confirm that Royal Mail made a loss (after modernisation costs).³⁶

15. In summary, Royal Mail has now been cash flow negative for several years and our core mails network has made losses of c£1 billion over the last four years. This clearly indicates the scale of the challenge facing Royal Mail to move the USO to a financially sustainable position in which it both covers its cost of provision and generates a reasonable commercial rate of return.

Impact on Volumes of Potential Second Class Stamp Price Increase

16. Advances in technology such as the internet are increasing the level of competition between different communication channels. This has led to a serious decline in the volume of letters sent in the UK and other countries with advanced postal networks independently of the price of mail.

³⁴ Ofcom *Securing the Universal Service: Proposals for the future framework for economic regulation*, para 5.12.

³⁵ In response to Q92.

³⁶ Single piece inland mail paid for using stamps.

17. Given the structural change it is extremely difficult to assess the individual impact of new technologies on the demand for mail and on the impact of price. Ofcom, in the October 2011 consultation document on the future regulatory regime for postal services stated, “*Not only is the market in a state of long-term structural decline, it is also characterised by great uncertainty ... the extent to which post will continue to be relied upon as a means of communication competing with electronic substitutes has yet to become clear.*”

18. Despite this challenge, Royal Mail clearly invests in customer research and econometric modelling to attempt to provide some insight into price and non-price impacts on demand. This analysis is part of the information Royal Mail uses when assessing its pricing decisions and we understand and expect that, regardless of structural changes as prices rise, there will be a negative impact on volumes, although the exact impacts are difficult to assess.

19. The Committee specifically asked what theoretical reduction in demand Royal Mail expected to see if the price of a second class stamp rose to the top of the proposed price cap range, ie 55p. This analysis can only be conducted on a theoretical basis using econometric analysis of historical data. We believe that the price elasticity for stamps (First Class and Second Class letter mail) is in the region of 0.2 to 0.4. That implies that a 1% increase in the price of stamps is associated, on average, with a decrease in total (First and Second Class) stamped letter mail volumes in the region of 0.2% to 0.4%. This attempts to isolate the impact of other movements, such as the impact of new technologies.

20. This analysis does not imply Royal Mail’s intent to set prices at a particular level. Royal Mail will only be able to announce its prices for USO services, including stamps, once Ofcom has made its final decision on the regulatory framework.

21. For the Committee to appreciate how this analysis can be applied, it is essential that we make clear that the behaviour which informs it is based on historical price rises of lower magnitude. These could potentially be less reliable.

22. Regardless, stamp prices should be put in a European context, where UK compares very favourably. Royal Mail charges below the European average for 0–20g items for First Class Stamps and for 0–100g (using UK mail weight characteristics) the UK is the seventh cheapest in the EU. Royal Mail also provides one of the cheapest Second Class mail services in the EU for items weighing 0–20g. Indeed a number of European operators charge more for their Second Class service than Royal Mail charges for First Class.

23. Given the scale of losses in Royal Mail’s core mails business in recent years, and the legacy of low prices for the level of service enjoyed in the UK, there does need to be a resetting of prices to match the value which is offered in order to allow a financially sustainable universal postal service in the UK. Royal Mail seeks to strike an appropriate balance between the commercial return and the impact on customers, and one which meets the regulator’s and other stakeholders’ expectations now and in the future. This includes balancing the effect on revenue of declining demand, including reductions which are the result of price rises.

Customer Research

24. Following the questions raised by Mr Binley and Mr Zahawi, we would draw to the Committee’s attention that Royal Mail takes consumer research very seriously and uses a range of sources of information to build a picture of our customer base to inform our decision making processes. As noted by the Committee, we naturally used research undertaken by Postcomm and Consumer Focus on consumers and SME’s to inform the analysis undertaken to understand the impact of increases in the price of stamps, the question of affordability and the development of its views on the level and the scope of Ofcom’s proposed safeguard price cap. To assist the Committee this research is attached in full.³⁷ Other research used by Royal Mail to inform its analysis, from the Office of National Statistics and Postcomm, is also attached.³⁸ We believe it is right that our decisions should be underpinned by evidence from third parties with a specific remit to protect the consumer.

25. As there was some debate over the consumer expenditure analysis which Royal Mail undertook to support its submission to Ofcom’s consultation on the future regulatory framework for postal services, we would like to clarify the position for the Committee.

26. When discussing the level and scope of the safeguard cap, Royal Mail made use of data drawn from our Consumer Panel Survey. The Consumer Panel Survey comprises a panel of 600 households who record what they send and receive through the post each day. Panel members are recruited to statistically represent the UK population—the proportion of vulnerable customers on the panel is therefore representative of the proportion in the UK population as a whole—31% of households on the panel are in vulnerable (D/E) socio-economic groups. The Consumer Panel survey is a quantitative survey independently run by TNS on behalf of Royal Mail and has been in place continuously since 1985.

9 March 2012

³⁷ Not printed here.

³⁸ Not printed here.