House of Commons
Business, Innovation and Skills Committee

Stamp Prices

Fifteenth Report of Session 2010–12

Report, together with formal minutes

Ordered by the House of Commons to be printed 1 March 2012

HC 1841-I
Published on 2 March 2012
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

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.

Current membership

Mr Adrian Bailey MP *(Labour, West Bromwich West)* (Chair)
Mr Brian Binley MP (*Conservative, Northampton South*)
Paul Blomfield MP (*Labour, Sheffield Central*)
Katy Clark MP (*Labour, North Ayrshire and Arran)*
Julie Elliott (*Labour, Sunderland Central*)
Rebecca Harris MP (*Conservative, Castle Point*)
Margot James MP (*Conservative, Stourbridge*)
Simon Kirby MP (*Conservative, Brighton Kemptown*)
Ann McKechin (*Labour, Glasgow North*)
Mr David Ward MP (*Liberal Democrat, Bradford East*)
Nadhim Zahawi MP (*Conservative, Stratford-upon-Avon*)

The following members were also members of the Committee during the parliament.
Luciana Berger MP (*Labour, Liverpool, Wavertree*)
Jack Dromey MP (*Labour, Birmingham, Erdington*)
Dan Jarvis MP (*Labour, Barnsley Central*)
Gregg McClymont MP (*Labour, Cumbernauld, Kilsyth and Kirkintilloch East*)
Ian Murray MP (*Labour, Edinburgh South*)
Nicky Morgan MP (*Conservative, Loughborough*)
Chi Onwurah MP (*Labour, Newcastle upon Tyne Central*)
Rachel Reeves MP (*Labour, Leeds West*)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the internet at www.parliament.uk/parliament.uk/bis. A list of Reports of the Committee in the present Parliament is at the back of this volume.

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.

Committee staff

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

Contents

1 Introduction

1. In October 2011, under the Postal Services Act 2011, Ofcom inherited responsibility for regulating postal services from the previous regulator, Postcomm. The transfer from Postcomm to Ofcom was a recommendation of the Hooper report[1] which also proposed more regulatory flexibility for Royal Mail on mail prices. Current price regulation involves the regulator setting specific prices for mail, with Royal Mail being obliged to apply to the regulator for approval of any price increase. In the absence of any interim provisions (which we understand are not currently proposed), this regime will end on 31 March 2012. The Postal Service Act obliges Ofcom to formulate alternative proposals.

2. Accordingly, on 20 October 2011, Ofcom launched a consultation on the future framework for economic regulation entitled 'Securing the Universal Postal Service',[2] on which it briefed us in a private session on 25 October 2011. The consultation highlighted the unsustainable nature of Royal Mail's pricing structure[3] and outlined proposals to remove the price cap on first class mail and set a cap on second class mail of between 45p and 55p, linked to the retail price index (RPI).

3. The current price of a first class stamp is 46p. For second class the price is 36p. An increase in second class prices to 45p would therefore represent a 25% price rise while an increase to 55p would represent a 53% rise. Despite prices having risen since the period 2003–2006, the current first class price is among the lowest in Europe, while the second class price is at the very lowest end of the scale. However, less than three years ago these prices were 36p and 27p respectively. Underlying that context on prices is the Universal Service Obligation on Royal Mail to provide for delivery and collection of letters six days a week (five days a week for other postal packets) and for prices to be affordable and uniform throughout the UK.

4. The Ofcom consultation closed on 5 January 2012. In Royal Mail's response, which was published in redacted form on 18 January 2012, Royal Mail argued against any form of price capping. Alternatively, it argued that if price capping were adopted, the cap should be restricted to second class letters (rather than extending to parcel services, for instance) and that it should be set at the 55p upper end of Ofcom's proposed range. However, Royal Mail stressed that that did not necessarily mean it would actually set prices at that level:

> It is important to note that setting the cap at the upper end of the range would not imply that RM would set its prices at this level but a cap at this level would provide RM with the pricing freedom it needs to deal with adverse changes in market conditions by re-optimising pricing. RM needs to apply careful judgement to the level at which it sets prices.[4]

1 'Modernise or decline; www.berr.gov.uk/files/file49389.pdf

2 http://stakeholders.ofcom.org.uk/consultations/securing-the-postal-service/

3 For example, paragraph1.8 of the consultation states that the part of Royal Mail responsible for delivering the universal service made a loss of £120m in 2010–2011 on a cost base of £7bn and that since Royal Mail's current price control was imposed in 2006, its cumulative cash performance has been around £3bn worse that was expected by the regulator in 2006.

4 Royal Mail consultation response, 'Level of the safeguard cap for 2nd class stamps', page 1

5. In light of Royal Mail's public position we decided to conduct a short inquiry into the factors driving the decisions on future prices and price regulation. This Report contains our conclusions based on evidence sessions with Ofcom and Consumer Focus (21 February 2012), and with Royal Mail (28 February 2012).

2 The current framework and the proposed removal of price controls

Current pricing and the costs of the service

6. The UK currently has the fourth lowest first class stamp price among EU-15 (pre-expansion EU) states.[5] Only Spain (37p), Ireland (42p) and Luxembourg (45p) are cheaper. The highest price is 69p (Italy).[6] UK second class prices are at the lowest end of the EU scale, which ranges from 36p for the UK and Portugal to 50p for Denmark and 54p for Greece. Ofcom explained that international benchmarking was one of two factors that it had looked at when considering price changes, the other being affordability.[7]

7. We asked Royal Mail's Chief Executive about the current costs of providing mail services. Our purpose in doing so was to try to get to the crux of what would be realistic commercial rates for first and second class mail—especially the latter, in view of its potential role as a protective backstop for those on lower incomes.

8. Moya Green's initial response was to refer to the complexity of the business:

> It is quite complex, Mr Chairman, because this is a network business. [...] 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.[8]

9. On being pressed, she referred instead to the need for price rises:

> 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.[9]

10. When we put the question in a different way and asked what would price rise would be required to wipe out the Royal Mail deficit, Ms Greene was still not in a position to answer:

> I cannot tell you offhand, Mr Chairman; I just cannot tell you that offhand.[10]

11. Later in the session, however, Ms Greene indicated that the revenue increase required to cover costs would be 8–9% while the increase required to reach a commercial rate of

5 As at the date of the consultation

6 Consultation, figure 3, page 25

7 Q 4

8 Q 75

9 Q 79

10 Q 81

return would be 10–15%.[11] We return to the significance of this in the section of this Report on maintaining volumes.

12. The following exchange proved particularly telling on Royal Mail's lack of detailed internal cost attribution:

> **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.[12]

13. Ultimately, Royal Mail said that it would try to produce the data:

> **Chair:** But surely it is possible to at least work out a theoretical calculation there.
>
> **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.[13]

14. The fact that proper cost attribution does not happen as a matter of course is clearly a highly unsatisfactory state of affairs. What we were looking for and frustratingly failed to obtain was an approximate order of magnitude of the costs of providing the second class mail service and a similar figure for a commercial second class mail price. Notwithstanding the understandable need to protect detailed commercially confidential accounting line items, which evidently was not the problem anyway,[14] it should have been possible for Royal Mail to give us that broad picture.

Views on price controls

15. In its oral evidence, Ofcom set out the interventionist position it had inherited:

> 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. […] 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.[15]

16. Ofcom went on to set out its reasons for not proposing continued price regulation:

11 Qq 98–99

12 Q 86

13 Q 89

14 See Q 90

15 Q 2, paragraph 2

> 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.[16]

It further argued:

> We felt the incentive properties that operated 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.[17]

17. Summing up, Ofcom asserted that retaining price controls would not provide a solution to the problems of falling volumes and the consequent risk to the financial viability of the universal service. In oral evidence, Stuart McIntosh reiterated that "the situation was dire and is still very severe".[18]

18. The Communication Workers Union recognised the need for a shift in regulatory approach:

> Subject to the protection of universal service customers—domestic customers and small businesses—we believe Royal Mail should be given freedom to price products commercially, unrestrained by regulatory price controls. As Ofcom notes, price controls have previously been unsuccessful. We endorse the conclusion that Royal Mail's best chance of success is to allow it to compete fairly and in a deregulated commercial environment. These changes must be implemented in full if Royal Mail is to secure its financial position and ensure the future of the universal service.[19]

19. Royal Mail's Chief Executive contrasted the historic UK position with that in Canada:

> 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.[20]
>
> 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.[21]

---

16 Q 3

17 Q 3

18 Q 51

19 Consultation response, paragraph 28

20 Q 110

21 Q 150

20. Moya Greene hinted that to some extent the previous interventionist approach might have been responsible for the lack of clarity on cost base:

> I have to say that, in the prior regulatory model, oftentimes costs were quite artificially attributed.[22]

However, while the interventionist regulatory framework may indeed have undermined accounting clarity, we are not convinced that this fully explains the picture. As we have already observed, on a matter as fundamental as the broad cost of the second class service, Royal Mail should have been able to give us a clearer analysis even allowing for the constraints of commercial confidentiality.

21. Our concerns about the vagueness of Royal Mail's oral evidence on costs and profitability gave us some pause for thought on whether removing the price control reins was necessarily such a good idea. Of some reassurance, however, is that Ofcom will remain Royal Mail's regulator for the purposes of financial reporting. The Ofcom consultation recommended that future financial reporting objectives should include:

- Understanding how costs and revenues are apportioned to different products and activities within the integrated business
- Monitoring the relative profitability of different product groups.[23]

22. It verges on astounding that these monitoring activities are not already in place, and it is clear from our exchange with Royal Mail's Chief Executive that there will be plenty of work for Ofcom to do in getting Royal Mail into shape in this area. We suggest that it focus the resources likely to be freed up as a result of the removal of express price controls on doing just that.

23. **Although we heard arguments in favour of retaining price controls, no persuasive case was made that continuing with lengthy price determination procedures was a practical future means of supporting Royal Mail's business. However, alongside removal of price controls Royal Mail will need, rapidly, to get a much clearer grasp of the costs and profitability of its product lines. As Royal Mail's financial reporting regulator, Ofcom must ensure that this happens.**

22 Q 92

23 Consultation, paragraph 8.11

3 Future stamp pricing

24. The consultation undertaken by Ofcom recognised that potential price increases would be occurring against a background of falling demand and competing service provision:

> The UK postal sector is the largest in Europe, but it has also seen the steepest decline in volumes. The volume of mail in the UK has fallen by 25% since 2006, as consumers have moved away from traditional mail and towards digital means of communication.[24]

25. It was frank about the likely uncertainties associated with rapid, large price increases, including from the risk of consumer shifts from post to e-mail:

> Price rises will result in lower volumes, as some customers will be unwilling to pay higher prices and stop sending mail or move to alternatives. This effect (price elasticity) is taken account of in Royal Mail's models, which assume that the use of mail declines with higher prices. However, it is possible that the large price rises in 2011–12 will result in a change to the way customers respond to such price changes. **There is no observable precedent for the impact of significant price rises at a time when volumes are already declining**, and the rate of price related volume decline will therefore be subject to significant uncertainty and risk.
>
> [...] On balance, our assessment is that the combined assumptions around e-substitution and price elasticity result in plausible central case for volume decline. However, Royal Mail has not directly modelled how the 2011–12 price rises or any future price rises may specifically impact the pace of e-substitution. [25]

26. Significantly, however, Ofcom told us that:

> 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. [26]

In other words, overall prices were always likely to be going up appreciably.

27. Royal Mail's Chief Executive did not wish to disclose its pricing intentions,[27] and Ofcom similarly declined to speculate on Royal Mail's likely pricing plans, but it argued that there were parallels for compatibility between managed price increases within the framework of a cap and maintaining affordability and service levels:

> There are operators across Europe who, during the past 10 years, through a combination of selective price increases and through changing their whole operational model, have managed to secure an outcome where, even in the face of

24 Consultation response, paragraph 1.5

25 Consultation, paragraphs 5.45–5.46. Emphasis added.

26 Q 6

27 Q 102

> 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.[28]

28. Ofcom cited the example of the Netherlands, where prices had not been set at the maximum level despite several years of operation under a cap.[29] However, Consumer Focus pointed out how first and second class prices are likely to be interlinked:

> 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.[30]

29. It seems inevitable that prices are going to go up. However, a second class stamp price of 55p would take the UK price to the high end of the EU scale, and given the de facto connection between first and second class prices it is difficult to see how a second class price of 55p would not result in first class prices jumping to the higher end of the EU price range as well. While this may be justifiable in terms of the underlying cost base, it leads to concerns about affordability for certain users and about potential resulting loss of business.

30. **We acknowledge that some increase in stamp prices is appropriate. However, we have concerns on three issues: the effect that price increases will have on vulnerable consumers and small businesses; the possible resulting decrease in volume of business that Royal Mail will experience; and the need for higher prices not to operate as a disincentive against efficiency measures.**

Vulnerable consumers

Affordability

31. A key concern about any significant price increase is the effect it would have on vulnerable groups. Ofcom cited evidence from Postcomm on the current usage of first and second class stamps to justify protecting vulnerable consumers' use of second class mail in particular:

> The profile of residential customers who send second class items is weighted more heavily to those living in rural areas, retired, with a disability, with lower household incomes and without access to the internet. The evidence suggests that vulnerable consumers are more likely than other classes of consumer to use second class when sending letters. We therefore consider that vulnerable consumers are likely to need some protection from significant price increases, which as set out above, Royal Mail would be able to introduce if, as proposed, we give it pricing freedom.[31]

32. Ofcom's review of price regulation acknowledged the need to protect vulnerable groups but argued that individual spending on postal services was low by comparison with other utilities:

28 Q 45

29 See email from Ofcom dated 28 February 2012

30 Consumer Focus evidence, paragraph 3.6

31 Consultation, paragraphs 6.98–6.99

> Total spending on postal services in the UK in 2010 exceeded £6bn, but direct consumer spending on post is very low. Average weekly household direct spending in 2009 was only 40p—around 0.1% of household income. By comparison, weekly expenditure on other utilities such as telephone services, electricity and gas, at £10.80p, £10.20p and £9.70p respectively, were each over 20 times the level of spend on post.[32]

33. In oral evidence, Ofcom's Stuart McIntosh reiterated that line of argument:

> 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.[33]

Proceeding from that position on affordability, Ofcom recommended a cap on second class stamps for standard letters (with no cap on other items) on the basis that it was willing to hear counter-arguments from consumer groups.[34]

34. We doubt, however, whether assessing affordability based on comparisons with spending on fuel is the right approach. As the Communications Workers Union (CWU) pointed out:

> 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.[35]

35. The CWU pointed to an alternative approach to affordability:

> Postcomm considered the Joseph Rowntree Foundation '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.[36]

36. We asked both Ofcom and Royal Mail whether the comparison with fuel prices was valid and whether a better measure might be vulnerable households' ability to switch resources from food budgets to spending on mail. Ofcom conceded that this was an approach that it had yet to begin working on:

32 Consultation, paragraph 1.2

33 Q 12

34 Consultation, paragraphs 6.111ff

35 CWU evidence, page 4, paragraph 2

36 CWU evidence, page 4, paragraph 4

> We have not yet done that fully: in the first instance our work has been concentrated around the approach I described earlier.[37] 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. […] That is what we are just starting, and it will bear fruit in the coming months and years.[38]

We encourage Ofcom to start on that process quickly.

Data on affordability

37. As well as having issues with the approach to affordability, Consumer Focus had some concerns about the robustness of Royal Mail's data on vulnerable group, including the sample size:

> 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 Panel fully, accurately and sufficiently captures the behaviours and attitudes of vulnerable consumers.
>
> 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.
>
> This is of particularly concern as Consumer Focus research 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.[39]

38. When questioned on this, Royal Mail appeared unable to provide definitive answers and was somewhat confused about whether its sample groups were focus groups, or alternatively groups of sufficient size to provide statistically significant data.[40] Tellingly, its Chief Executive also appeared unfamiliar with some important competitor offerings on which it had based its arguments concerning consumer choice:

---

37 The reference is to the answer given at Q 12

38 Q 15

39 Consumer Focus evidence, paragraphs 5.2–5.3

40 Qq 112–122

> **Nadhim Zahawi:** 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.[41]

Peak spending

39. We put it to Royal Mail that affordability at the Christmas peak spending period was far more of an issue than at other times, which Royal Mail acknowledged.[42] During the evidence session, Moya Greene announced that Royal Mail would be holding Christmas 2012 stamp prices at 2011 levels for vulnerable consumers. It subsequently clarified that:

> 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 5 million people will be eligible under those criteria.[43]

40. Given that family expenditure on mail increases by factors of ten or more over the Christmas period, this announcement is not unwelcome, but we have substantial concerns about how the scheme might work in practice. Furthermore, it should not detract from the need to address the needs of vulnerable consumers beyond 2012 and in other areas, and to develop more robust statistics to support the relevant pricing decisions.

41. **It seems to us that Ofcom's approach of measuring affordability based on comparing stamp and fuel prices is misguided. The more pressing issue is whether vulnerable consumers have extra money to spend on stamps at periods of peak spending. This should have been at the forefront of Ofcom's mind, and research data on it should have been obtained in time to inform the forthcoming regulatory decision. This makes it all the more important for Royal Mail to consider reliable data on likely spending patterns before setting prices.**

42. **We note Royal Mail's announcement that Christmas 2012 stamp prices will be held at their 2011 level for vulnerable consumers. While protecting vulnerable consumers in this way is a welcome aspiration, it is not a fully-formed policy. In the absence of any detail we are concerned about the practicalities of introducing it. Royal Mail will need to reassure us that this initiative will not be open to fraud and will not be introduced as a crude form of means testing. In any event this should not detract from the need for data on actual effects of price increases and for appropriate follow-up action to help vulnerable parties further if necessary. The consequences of price increases for vulnerable consumers should remain a priority for Ofcom, and the regulatory model should include the ability to re-open this issue if need be.**

---

41 Q 128

42 Q 125

43 Email from Royal Mail of 28 February 2012

Maintaining volumes

43. Consumer Focus provided supplementary evidence (albeit on a fairly limited sample of 220 customers) of a possible tipping point for customers to move to substitute services at prices for first and second class of 75p and 50p respectively:

> 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'. […]
>
> 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.[44]

44. When questioned on this, Ofcom seemed to want to move the argument elsewhere; namely to the point that most mail is sent by businesses. However, it conceded that

> 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.[45]

45. Royal Mail acknowledged the issue and indicated that it had researched possibly effects:

> 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.[46]

It agreed to share the results of that work with the Committee.[47]

46. However, when we put to Royal Mail the apparent inconsistency between a proposed stamp price increase of the order of 50% and its stated need to increase revenues by 8–9% to cover costs, it sought to move the discussion to the issue of current value:

44 Consumer Focus supplementary evidence

45 Q 42

46 Q 102

47 Q 106

Paul Blomfield: 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.[48]

47. The Communications Workers Union was worried about the possible effect of prices increasing differentially between service offerings:

> 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.[49]

48. We endorse this concern. There needs to be great sensitivity to potential fall-off in business in setting future stamp prices and consumers should not solely bear the brunt of price increases.

49. **Notwithstanding data on affordability, the uncertainties in the mail market mean that in setting prices Royal Mail will need to have very careful regard to the possibility of a tipping point affecting volumes. We do not believe that a 53% price increase can be sustained in current economic circumstances, and we recommend serious consideration of a more modest increase.**

SMEs

50. The Ofcom review also considered the effect of price rises on business. In its report, Ofcom came to the following conclusion:

> While the issue of affordability is more complicated for small businesses, it is our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses.[50]

The Federation of Small Business disputed this:

> We do not agree with Ofcom's suggestion. […] Firstly, most small businesses are likely to use Royal Mail's services on a more frequent basis than the consumer.

48 Q 110

49 CWU evidence, page 2, paragraphs 6–7

50 Consultation, paragraph 6.95

> Secondly, small businesses use a more diverse range of Royal Mail services than the consumer, and Ofcom is only proposing protecting the costs of a basic USO.[51]

51. When challenged on whether affordability for small businesses and households was comparable, Ofcom conceded that they were different but asserted that there was unlikely to be a material impact in either case. It had its data on SME spending readily to hand:

> 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.[52]

52. Royal Mail further argued that there were plenty of competitive offerings available to SMEs:

> Many SMEs have both electronic alternatives and cheaper RM alternatives to send letters, so the question—as with social customers—is whether the scope of the cap is extended to include a parcels product. […] TNT already provides 'Allsort' and 'Premiersort' as products targeted directly at SMEs which are comparable to RM's 2nd class service—letters, large letters, packets and parcels up to 15kg are able to be posted via these services. Additionally, for packets and parcels SMEs are able to access numerous comparison websites (as discussed in section 3) for the best price linking into the many parcels operators that will collect from a customer's premises.[53]

53. Consumer Focus disagreed with this analysis, however:

> 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; 1000 for Light Large Letter items; 1000 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.

54. It seems to us that there is work yet to be done in addressing affordability issues for SMEs and in obtaining robust data on their realistic choices for sending mail. In any event,

51 Consultation response, page 2

52 Q 21 [Rowsell]

53 Consultation response, 'Scope of Safeguard cap', page 3

it is important that Royal Mail seek to develop good customer relations with small businesses, and not dismiss affordability issues as of little concern.

55. **We were not convinced by the working hypothesis that affordability for small businesses is the same issue as for consumers. This was entirely the wrong starting point for addressing the diverse needs of SMEs operating on tight margins. We firmly recommend that Ofcom and Royal Mail reconsider the evidence on this and that Royal Mail adapt its pricing structures to nurture and grow its small business customer base; otherwise many SMEs struggling with other cost pressures in the current climate may find price increases a real problem.**

4 Efficiency savings

56. The Ofcom consultation acknowledged the fact that efficiency savings were central to the financial stability of Royal Mail and that without them, price increases alone would not protect the universal service:

> As volumes have dropped, Royal Mail's average unit costs have increased. Unless Royal Mail can deliver efficiency gains that exceed the effect of volume decline, it will have to rely on increasing prices, which in turn is likely to suppress demand, further increasing unit costs, and putting further upward pressure on prices.[54]
>
> The risks of efficiency savings not being achieved, or not being achieved sufficiently quickly, are significant. With no improvement in efficiency, declining volumes will translate into higher prices, which would only serve to lock the postal sector and the universal service into an inexorable spiral of decline.[55]

57. It commented on Royal Mail's planned timescale for cost reductions:

> In addition, our analysis indicates that while Royal Mail's plans to reduce costs are ambitious compared to its past performance, the timescale assumed to be needed to deliver resource management improvements is longer than some other companies have needed to deliver comparable programmes.

However, it added:

> Our analysis indicates that, once enabling measures are in place, it might be feasible to re-optimise the network quicker than assumed by Royal Mail.[56]

58. In oral evidence, Ofcom said that previous investment had not been the answer:

> Notwithstanding the fact that Royal Mail had been making quite significant investments in the modernisation of its operations, it appeared […] to be struggling to realise efficiency savings to keep up with the reductions in demand. That was the industry context we found.[57]

59. Consumer Focus also had concerns about deliverability:

> Given that Royal Mail has not delivered on efficiencies under the previous price control, we have no confidence 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.[58]

54 Consultation, paragraph 1.10

55 Consultation, paragraph 1.12

56 Consultation, paragraph 5.55

57 Q 2

58 See briefing paper to Chair

60. Ofcom has stated that it would step in and reregulate if it were dissatisfied with progress on efficiency.[59] While conceding that previous progress had not been quick enough, Moya Greene was optimistic that outside investment would achieve better results,[60] and pointed to likely percentage efficiency savings this year, saying, “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”.[61]

61. Royal Mail has asserted its need for regulatory stability in the form of an uninterrupted seven-year period before any revisiting of the regulatory framework,[62] but notwithstanding proposed privatisation Consumer Focus argued that this would be too long:

> To ensure regulatory certainty […] 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.[63]

62. **We agree with Ofcom that it should retain the ability to step in and reregulate prices if a failure to deliver efficiency savings results in additional significant price rises. However, we believe that seven years is too long for the overall duration of the regulatory framework and that five years would be more suitable and provide greater incentives for rapid progress with efficiency measures.**

59 Consultation, paragraph 1.41

60 Q 143

61 Q 146

62 Consultation response, page 2

63 Consumer Focus evidence, paragraph 6.3

5 Choice of inflation measure

63. For prices not related to the housing market, it might be considered that CPI (which does not include housing costs) might be a more appropriate inflation indexing measure than RPI (which does). When we asked the Ofcom witnesses why Ofcom had chosen RPI, they said, "We have not chosen it yet. We did flag in our consultation document that there are some arguments for considering CPI in this area, and we are still looking at that."[64] Royal Mail did not favour the CPI option, arguing that the baseline level to which either of RPI or CPI would be applied was too low for the choice to be significant.[65]

64. We disagree. We cannot see the logic of adopting an index that includes housing costs in this context. For the time being the difference between RPI and CPI is not significant, but this might change if interest rates rise and we cannot see any reason not to protect consumers against that possibility.

65. **We recommend that Ofcom give serious consideration to linking any price cap with CPI rather than RPI.**

64 Q 53

65 Q 152

Conclusions and recommendations

Current pricing and the costs of the service

1. Although we heard arguments in favour of retaining price controls, no persuasive case was made that continuing with lengthy price determination procedures was a practical future means of supporting Royal Mail's business. However, alongside removal of price controls Royal Mail will need, rapidly, to get a much clearer grasp of the costs and profitability of its product lines. As Royal Mail's financial reporting regulator, Ofcom must ensure that this happens. (Paragraph 23)

Future stamp pricing

2. We acknowledge that some increase in stamp prices is appropriate. However, we have concerns on three issues: the effect that price increases will have on vulnerable consumers and small businesses; the possible resulting decrease in volume of business that Royal Mail will experience; and the need for higher prices not to operate as a disincentive against efficiency measures. (Paragraph 30)

Vulnerable consumers

3. It seems to us that Ofcom's approach of measuring affordability based on comparing stamp and fuel prices is misguided. The more pressing issue is whether vulnerable consumers have extra money to spend on stamps at periods of peak spending. This should have been at the forefront of Ofcom's mind, and research data on it should have been obtained in time to inform the forthcoming regulatory decision. This makes it all the more important for Royal Mail to consider reliable data on likely spending patterns before setting prices. (Paragraph 41)

4. We note Royal Mail's announcement that Christmas 2012 stamp prices will be held at their 2011 level for vulnerable consumers. While protecting vulnerable consumers in this way is a welcome aspiration, it is not a fully-formed policy. In the absence of any detail we are concerned about the practicalities of introducing it. Royal Mail will need to reassure us that this initiative will not be open to fraud and will not be introduced as a crude form of means testing. In any event this should not detract from the need for data on actual effects of price increases and for appropriate follow-up action to help vulnerable parties further if necessary. The consequences of price increases for vulnerable consumers should remain a priority for Ofcom, and the regulatory model should include the ability to re-open this issue if need be. (Paragraph 42)

Maintaining volumes

5. Notwithstanding data on affordability, the uncertainties in the mail market mean that in setting prices Royal Mail will need to have very careful regard to the possibility of a tipping point affecting volumes. We do not believe that a 53% price increase can be sustained in current economic circumstances, and we recommend serious consideration of a more modest increase. (Paragraph 49)

SMEs

6. We were not convinced by the working hypothesis that affordability for small businesses is the same issue as for consumers. This was entirely the wrong starting point for addressing the diverse needs of SMEs operating on tight margins. We firmly recommend that Ofcom and Royal Mail reconsider the evidence on this and that Royal Mail adapt its pricing structures to nurture and grow its small business customer base; otherwise many SMEs struggling with other cost pressures in the current climate may find price increases a real problem. (Paragraph 55)

Efficiency savings

7. We agree with Ofcom that it should retain the ability to step in and reregulate prices if a failure to deliver efficiency savings results in additional significant price rises. However, we believe that seven years is too long for the overall duration of the regulatory framework and that five years would be more suitable and provide greater incentives for rapid progress with efficiency measures. (Paragraph 62)

Choice of inflation measure

8. We recommend that Ofcom give serious consideration to linking any price cap with CPI rather than RPI. (Paragraph 65)

Formal Minutes

Thursday 1 March 2012

Members present:

Mr Adrian Bailey, in the Chair

Paul Blomfield
Rebecca Harris
Margot James
Simon Kirby
Ann McKechin
Mr David Ward
Nadhim Zahawi

Draft Report (*Stamp Prices*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 65 read and agreed to.

Resolved, That the Report be the Fifteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Tuesday 6 March at 10.00 am

Witnesses

The following oral evidence is published in Volume II (HC 1841-II).

Tuesday 21 February 2012

Stuart McIntosh, Group Director of Competition, **Chris Rowsell**, Competition Policy Director, and **Gavin Knott**, Postal Services Competition Specialist, Ofcom

Adam Scorer, Director of Policy and External Affairs, and **Robert Hammond**, Director of Postal Policy and Regulation, Consumer Focus

Tuesday 28 February 2012

Moya Green, Chief Executive Officer, Royal Mail

List of printed written evidence

The following written evidence is published in Volume II (HC 1841-II).

1 Communication Workers' Union
2 Consumer Focus
3 Ofcom
4 Royal Mail

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2010–12

First Report	The New Local Enterprise Partnerships: An Initial Assessment	HC 434 (HC 809)
Second Report	Sheffield Forgemasters	HC 484 (HC 843)
Third Report	Government Assistance to Industry	HC 561
Fourth Report / First Joint Report	Scrutiny of Arms Export Controls (2011): UK Strategic Export Controls Annual Report 2009, Quarterly Reports for 2010, licensing policy and review of export control legislation	HC 686
Fifth Report	Government Assistance to Industry: Government Response to the Committee's Third Report of Session 2010–11	HC 1038
Sixth Report	Is Kraft working for Cadbury?	HC 871
Seventh Report	Rebalancing the Economy: Trade and Investment	HC 735 (HC 1545)
Eighth Report	Trade and Investment: China	HC 1421 (HC 1568)
Ninth Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code	HC 1224-I
Tenth Report	Pub Companies	HC 1369-i *(Cm 8222)*
Eleventh Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code: Government Response to the Committee's Ninth Report of Session 2010–12	HC 1546
Twelfth Report	Government reform of Higher Education	HC 885-I/II/III
Thirteenth Report	Pre-Appointment Hearing: Appointment of Director of the Office for Fair Access	HC 1811
Fourteenth Report	Debt Management	HC 1649-I & -II