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11<sup>th</sup> May 2005

Dear Consultee,

### **Re: Code of Practice for Common Operational Procedures**

On 18 March 2005, Postcomm published a consultation document on proposals for a Postal Code of Practice for Common Operational Procedures.<sup>1</sup> In this document Postcomm indicated it would issue an open industry letter during the consultation period. The purpose of this letter is to provide further detail and refinement of earlier proposals, namely the structure of the price for the 'extraction service' proposed in the consultation. It also introduces a report by consultants Frontier Economics and PLCWW which has informed Postcomm's thinking with regard to establishing a price for handling misdirected mail. The letter seeks consultees' views on a 'two-part tariff' price structure and on the duration of the price review period. The letter begins with a brief summary of the purpose of the proposed Code, it then details pricing proposals and concludes with next steps. The terms used in this letter have the same meaning as those set out in the consultation document.

#### **Purpose of the Code**

The purpose of the proposed Code is to further the interests of senders and receivers of mail and to facilitate the introduction of competition in postal services. The Code achieves this through setting out the minimum 'duty of care' licensees must provide, primarily to ensure:

1. misdirected mail is repatriated to the correct licensee; and,
2. miscollected mail is repatriated to the correct licensee; and
3. misdirected customer services calls are transferred to the correct licensee; all in an efficient, economic and timely manner.

The Code is viewed by Postcomm as the minimum or the 'safety net' for the industry. It does not prevent bi or multi-lateral arrangements between licensees for managing common operational issues, provided those agreements are in excess of, not instead of, the Code.

A key purpose of the Code is to ensure misdirected mail is repatriated to the correct licensee in an efficient, economic and timely manner. Postcomm would like to stress the Code is not intended to provide for the intentional injection of licensees' mail into Royal Mail's network i.e.

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<sup>1</sup> "Postal Code of Practice for Common Operational Procedures" March 2005, see [www.psc.gov.uk](http://www.psc.gov.uk)

as a de facto 'upstream access' service. Royal Mail does, however, have an obligation, under Condition 9 of its licence, to negotiate in good faith in relation to access to its postal facilities. Postcomm would assess any case referred to it, under Condition 9 of Royal Mail's Licence, on its merits and against the criteria established by Condition 9.

### **Background to Postcomm's proposals**

Postcomm's motive for developing the Code was driven by the absence of effective or efficient arrangements for managing common operational issues. Postcomm's view is that existing arrangements, or lack thereof, for dealing with these issues are neither in the interests of postal users nor conducive to the development of effective competition. For example, misdirected mail may be delayed, and the sender, receiver or originating postal operator may be subjected to significant additional charges.

Postcomm believes that as more operators enter the market, with the introduction of a fully opened postal market, the existing arrangements for managing common operational issues will quickly become unsustainable. Postcomm is concerned that procedures to manage these operational issues are introduced to further the interests of senders and receivers of mail by facilitating the quick and efficient repatriation of misdirected mail.

Postcomm's view is that the procedures established by the Code for managing common operational issues provide an important safety net for senders and receivers of mail and remove a real barrier to entry to competition in the postal market. In addition Postcomm believes that the establishment of the Code will provide protection to new entrants especially those who may be in an unfavourable bargaining position. To ensure minimum standards are met, and to provide a level playing field, Postcomm believes that adherence to the Code must be a requirement of every licence. Postcomm believes that this is important for the long term health of the market but that this is particularly relevant in the early stages of market opening.

Postcomm firmly believes that promulgation of the Code is consistent with its statutory duties and is working towards introducing the Code as part of its preparations for full market opening on 1<sup>st</sup> January 2006. It has been working with existing licensees since late 2003 to identify key common operational issues and develop suitable procedures for dealing with them.

### **Prices for Services**

In this section Postcomm presents pricing proposals for handling misdirected mail. Postcomm's proposals are informed by independent advice provided by Frontier Economics and PLCWW on the operational process and the cost of handling misdirected mail.<sup>2</sup> Postcomm has calculated the prices by including an appropriate mark-up above Frontier-PLCWW's cost estimates to account for the fixed cost of collection, joint costs and a profit allowance. A detailed description of the

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<sup>2</sup> Frontier-PLCWW, "Process and costs of misdirected mail", April 2005, see [www.psc.gov.uk](http://www.psc.gov.uk).

approach taken by Postcomm to establish the pricing proposals in Table 1 is provided in the annex to this letter.

Postcomm has used the most up to date information available in developing the proposed prices. It is seeking further clarification from Royal Mail of certain data and cost information and their views generally on the alternative process developed by Frontier-PLCWW. Postcomm will also ensure volume assumptions, for total market volume and end-to-end other licensed operator (OLO) market share, are brought into line with the yet to be defined figures in the price control due to commence on 1 April 2006. Postcomm aims to resolve these matters over the next 2 months with a view to publishing finalised prices in its decision document in July 2005.

Since the release of the consultation document Postcomm has engaged with Royal Mail on its approach to account for the fixed cost of collection, joint costs and profit allowance elements of the extraction service price.<sup>3</sup> Royal Mail has indicated that it agrees in principle with Postcomm's approach in these areas, subject to some revisions. Postcomm will incorporate any changes resulting from Royal Mail's proposed revisions in its finalised prices in July.

Table 1: Postcomm's pricing proposals and Royal Mail's proposal for the extraction service, 2006-07.

		Single per item charge (pence per item)	Two-part charge (pence)	
			Item charge	Contact charge
Royal Mail's proposal		58.17*	20	219
Postcomm's proposals	Royal Mail process with revised costs and revised assumptions about external cost drivers	10**	7.50	218
	Alternative process	8.60	7.30	115

Notes: Postcomm received Royal Mail's current proposal on 24<sup>th</sup> November 2004. Royal Mail indicated that the single per item charge was its preferred option. \*In the March consultation document Postcomm incorrectly quoted Royal Mail's current proposal as 45.56 pence per item. \*\*The proposal presented by Postcomm in the March consultation document.

Postcomm presents four pricing proposals in Table 1. The 10 pence per item price is identical to the price presented in the March consultation document. This price is based on Royal Mail's proposed process for handling misdirected mail with Frontier-PLCWW's recommended revisions to process costs. In undertaking their research, Frontier-PLCWW highlight some potential

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<sup>3</sup> To date Postcomm has not sought Royal Mail's view on the alternative process developed by Frontier-PLCWW and, as indicated earlier in the letter, plans to engage with Royal Mail on this matter over the next 2 months.

modifications to Royal Mail's proposed process that led them to develop an 'alternative process' for handling this mail.<sup>4</sup> Under the alternative process the extraction service price is 8.60 pence per item.

Table 1 also presents a two-part charging structure, which involves an OLO being charged a price per item of misdirected mail plus a contact charge each time the OLO collects mail from Royal Mail. The reason Postcomm presents the detail of this charging structure now is due to greater clarity resulting from the Frontier-PLCWW report around the risks Royal Mail and other licensees face with a single per item charge. The source of this risk is the uncertainty surrounding misdirected mail volumes. If volumes are lower than expected, the single per item charge will be set too low and Royal Mail will not recover its fixed costs. The converse is true if volumes turn out to be higher than forecast. A two-part charging structure reduces this risk as it more closely reflects the actual costs of handling misdirected mail (see figure 1 in the letter annex). Further detail is also provided, in the letter annex, in relation to the relative benefits of different price review periods and the relationship between price structure and the price review period.

Though uncertainty is a feature of every product or service, Postcomm believes the uncertainty of the assumptions underpinning the cost of providing the extraction service are sufficient to warrant serious consideration of a two-part charge as an alternative to a single per item charge.

## **Miscellaneous**

### *Communication cost*

In Chapter 5 of the consultation document Postcomm refers to "the cost of notification" for licensees advising one and other that they are in receipt of misdirected mail without defining parameters for that cost. Postcomm envisages that the range of costs for providing notification would be 50-70p per transaction, allowing approximately two minutes for establishing contact details and making contact in addition to an allowance for communication cost (electronic or voice<sup>5</sup>). Postcomm will confirm the contact cost when it publishes the Code in July.

### *Applicability of charges between licensees*

It is implied but not explicitly stated in the consultation document that the prices developed based on Royal Mail's costs also would be applied to misdirected mail in other licensees' networks. Postcomm takes this view on the basis that very little misdirected mail is expected to end up in the network of other licensees and that the operational process costs are likely to be similar for the specific activities of extracting and exchanging misdirected mail. Postcomm plans to validate this belief with licensees over the next two months.

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<sup>4</sup> See letter annex for a comparison of the alternative process and Royal Mail's proposed process.

<sup>5</sup> Cost for a 3 minute business telephone call is 10p [www.bt.com](http://www.bt.com)

Postcomm welcomes consultees' views on these matters and the pricing proposals. In particular, Postcomm welcomes views on pricing structure and, depending on the price structure selected, the period of time before the proposed prices should be reviewed. Postcomm welcomes comments or questions in relation to the annex to this letter and the Frontier-PLCWW report.

### **Next steps**

Postcomm anticipates that at the conclusion of the current consultation exercise the Code will be finalised and published by Postcomm in July or August 2005. After publication, Postcomm expects to consult on any necessary modification to existing licences (in accordance with the consultation process for licence modification set out in the Postal Services Act 2000).

Postcomm has proposed that the Code will take effect from 1 January 2006. Prior to the introduction of the Code, Postcomm envisages there will be some practical issues that licensees will need to address, for example, identifying mail centres where regular collections will take place and determining collection times. Postcomm would encourage licensees to take any necessary steps, as soon as possible after the Code is finalised, to ensure arrangements are in place for 1 January 2006.

Responses to the consultation document (including this letter) should reach Postcomm by 17 June 2005. They can be sent by post, electronically or by fax. Contact details are set out in the consultation document. If you would like to discuss any points raised in the letter (or the consultation document) please contact Jeremy Cain 020 7593 2159) or Ros Poulson (020 7593 2119) by telephone or email ([Jeremy.Cain@psc.gov.uk](mailto:Jeremy.Cain@psc.gov.uk) or [Ros.Poulson@psc.gov.uk](mailto:Ros.Poulson@psc.gov.uk)).

Yours sincerely,

**Debbie Gillatt**  
**Director - Market Infrastructure**

## Annex: Prices for Services

Postcomm expects almost all misdirected mail will end up in Royal Mail's network and for this reason has been working with Royal Mail but also other licensees since late 2003 on the process and cost of handling misdirected mail.<sup>6</sup> During this time Royal Mail has presented various proposals for an extraction service. Essentially, these proposals involve five main steps, as follows:

- Collection from pillar boxes or other entry points to Royal Mail's network.
- Segregation of the misdirected mail from other mail at the outward mail centre.
- Sorting and counting of misdirected mail.
- Billing of other postal operators.
- Handover of misdirected mail to other licensees at the outward mail centre.

Royal Mail estimated the cost of the service with each proposal. The estimated cost per item depends upon the assumed cost of the activities involved in the proposed process and (heavily) on assumptions about the operating environment (principally the volume of misdirected mail and the number of other licensed postal operators). Royal Mail's most recent cost estimate is 58.17 pence per item.<sup>7</sup>

### Frontier Economics and PLCWW report

Postcomm engaged consultants Frontier Economics and PLCWW to review Royal Mail's process and cost estimates for the extraction service. Their final report includes a detailed analysis of the approach taken to review Royal Mail's proposals and Postcomm directs the reader to the consultants' report on its website for the detailed analysis underlying their recommendations.<sup>8</sup> The consultants' cost estimates for the extraction service form an important part of Postcomm's calculation of the price for the extraction service (see next section).

The consultants show that the key drivers of cost of the extraction service can be categorised as either factors largely external to Royal Mail (external drivers) or factors largely internal to Royal Mail (internal drivers).

**External drivers** refer to factors that affect the environment within which Royal Mail operates and are not directly controllable by Royal Mail in relation to the cost of handling misdirected mail. The most important external drivers are the volume of misdirected mail and the frequency of contacts between Royal Mail and OLOs.<sup>9</sup> The volume of misdirected mail and the frequency of contacts are in turn driven by other factors. The volume of misdirected mail depends upon the share of the end-to-end market captured by OLOs and what proportion of each OLO's total mail

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<sup>6</sup> Specifically Postcomm has been working with Royal Mail to define the process and costs for the misdirected mail service that Postcomm has chosen to define as the "extraction service".

<sup>7</sup> Received 24 November 2004. This proposal included a two-part charge of 20p per item and £2.19 per contact. Royal Mail indicated that the single per item charge was its preferred option.

<sup>8</sup> Frontier-PLCWW report "Process and costs of misdirected mail", April 2005, see [www.psc.gov.uk](http://www.psc.gov.uk)

<sup>9</sup> A "contact" is the term used to describe the handover by Royal Mail of misdirected mail to an OLO at a mail centre.

volume is misdirected. Contacts depend upon the number of OLOs, the number of mail centres at which an OLO collects misdirected mail and the number of days between collections.

Table 2 provides a comparison of Royal Mail and the consultants' assessment of external drivers for handling misdirected mail. Assumptions about external drivers relate to the 2006-07 financial year.

The consultants' view of the likely end-to-end market share of other licensees is broadly consistent with Royal Mail's view. They anticipate, however, other licensees will experience a higher rate of misdirected mail than Royal Mail.<sup>10</sup> The consultants' assumptions lead to a higher estimate of OLO misdirected mail volumes than Royal Mail which in turn results in a lower average unit cost for the extraction service. Postcomm notes that volume assumptions, for total market volume and end-to-end OLO market share, in the consultants' report will need to be brought into line with the yet to be defined figures in the price control due to commence on 1 April 2006.

Table 2: Royal Mail and the consultants' views on external drivers for estimating the cost of handling misdirected mail, 2006-07.

External drivers	Royal Mail's proposal	The consultants' assumption
OLO's market share (%)	Approximately 1%	0.5 to 2%
Proportion of misdirected mail (%)	0.5%	1 to 3%
Number of national licensed E2E OLOs	5	1 to 3
Number of local E2E OLOs	150	20 to 30

Source: Royal Mail proposal received 24 November 2004 and Frontier-PLCWW report "Process and costs of misdirected mail", April 2005, see [www.psc.gov.uk](http://www.psc.gov.uk).

The consultants' assumptions lead to a lower number of contacts between OLOs and Royal Mail; this reduces the cost of handling misdirected mail and results in a lower average unit cost for the extraction service.

Postcomm appreciates and recognises the difficulty of correctly forecasting the external drivers presented in Table 2. Postcomm's view is that cost reflective prices are more attractive than those heavily reliant on assumptions, as cost-based prices minimise the revenue risk to Royal Mail and OLOs. Postcomm considers the merits of alternate pricing structures later in this letter Annex.

**Internal drivers** refer to factors that are largely within the control of Royal Mail. Such factors include the process design and the cost of each activity within the process. The consultants

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<sup>10</sup> See section 5 of the Frontier-PLCWW report.

reviewed Royal Mail's proposed process for handling misdirected mail; the research led them to propose some revisions to the cost of certain activities in Royal Mail's proposed process and to develop an alternative process.

The elements of Royal Mail's proposed process are presented in the middle column of Table 3. The proposed process assumes the handling of OLOs' mail will essentially be a manual operation, using a standard method on standard equipment. Elements 1 to 7 are existing elements of Royal Mail's process. The remaining elements have been introduced to allow the breakdown of misdirected mail by licensee, administration and billing, and handover to the correct licensee. The consultants' analysis led them to propose reductions in the cost of certain process elements proposed by Royal Mail. The four largest contributors to the fall in the average item cost of handling misdirected mail are:<sup>11</sup>

- a. **Training.** Royal Mail has proposed that all mail centre staff will receive training to implement the proposed process, in addition to training for specialist activities. The consultants' revised the number of staff requiring training downwards<sup>12</sup> and spread the training cost over 5 years (instead of 3 years as assumed by Royal Mail).
- b. **Operators frame and sorting to individual OLOs.** Royal Mail has assumed a dedicated frame, and importantly the associated floor-space, will be required for sorting misdirected mail. The provision of a dedicated frame for this activity was considered unnecessary as it is possible to use an existing sorting frame. This is because volumes of misdirected mail are not expected to warrant a dedicated frame and as the mail can be sorted at a time when sorting equipment will be available for use i.e. between 6.00am and 12.00pm. The cost for this activity should therefore be restricted to sorting to individual licensees and tying of bags each day.
- c. **Miscellaneous and contingency costs.** Royal Mail has not provided any information about the derivation of miscellaneous costs and contingency costs. Since costs for individual elements have been allowed, these additional costs appear excessive unless Royal Mail is able to provide more detailed information about their justification.  
  
Note: Postcomm has made provision for joint costs and a profit allowance in its pricing proposals, see chapter 5 of the consultation document.
- d. **Night wages.** Royal Mail has assumed the night wage rate when estimating the costs of elements 8, 9, 10, 11 and 15 in Table 3. The consultants' research suggests that no additional benefit accrues (to licensees or customers) from sorting misdirected mail during the night or early morning shifts but that there are significant cost implications of doing so. Therefore, these activities could be carried out during the hours that attract the day wage rate without compromising the needs of licensees or postal users. The consultants use the day wage rate for all elements that previously assumed a night wage rate.

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<sup>11</sup> The reader is referred to the Frontier-PLCWW report on Postcomm's website for a detailed analysis of each activity.

<sup>12</sup> See footnote 30 on page 35 of the Frontier-PLCWW report for their approach to estimating the number of employees requiring training in the handling of misdirected mail.

The consultants also present an alternative process for handling misdirected mail. A comparison of the consultants' alternative process and Royal Mail's proposed process is provided in Table 3. The main differences between Royal Mail's proposed process and the alternative process are<sup>13</sup>:

- a) **Simplify the 'cull, face and cancel' (CFC) activity.** The consultants simplify Royal Mail's proposed process by consolidating the cull, face & cancel elements into two single activities which are driven by format rather than access channel. This results from changing Royal Mail's assumption about likely access channels (reflecting an expectation that misdirected mail will enter via the pillar box network rather than through meter or PPI collections).
- b) **Clarify 'face & seg' activities.** The consultants' clarify the 'face & seg' activities to be the stage where misdirected mail is segregated from the general mail stream for special processing.
- c) **Removal of the 'outward manual primary' and 'outward primary secondary' activities.** The consultants' view is that the 'outward manual primary' activity replicates the purpose of the 'face & seg' activity and therefore is redundant. Removal of the 'outward primary secondary' activity results from changing Royal Mail's assumption about access channel for misdirected mail.
- d) **Adjust the time allowed for central communications.** The costs of this activity appear to be driven by the number of OLOs. The consultants recommend a reasonable estimate of costs per licensed operator would be derived by allocating Royal Mail's estimated total cost for this activity across Royal Mail's assumption regarding the number of licensed operators.
- e) **Removal of 'general movements of mail around mail centre' activity.** This activity is based on an assumption that misdirected mail would need to be moved about the mail centre in addition to the movements explicitly assumed for each process element. The consultants remove this activity in the alternative process as they associate movement of mail with specific activities within the process.
- f) **Reduce the time allowed for misdirected mail handover to OLOs.** Royal Mail includes an allowance of 5 minutes for misdirected mail handover. On the assumption that mail has been previously transferred to an area near the handover point, as implied by the process, the consultants' view is that an allowance of 5 minutes for this activity seems excessive. The time required to handover mail was adjusted to be 2 minutes per operator per mail centre.

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<sup>13</sup> The reader is referred to the Frontier-PLCWW report on Postcomm's website for a detailed analysis of the alternative process.

Table 3: Comparison of the consultants' alternative process and Royal Mail's proposed process.

Royal Mail proposed process		Alternative process
1	Collection from Pillar Boxes	Same process as Royal Mail
2	Process Through Collection Hub	Same process as Royal Mail
3	MC Platform work	Same process as Royal Mail
4	Items Processed Through CFC/PPI/Handstamp/Meter	Revised process (minor)
5	Face & Segregate Letters @ CFC/PPI/Handstamp/Meter	Revised process (minor)
6	Outward Manual Primary	Removed this activity
7	Outward Manual Secondary (Blind)	Removed this activity
8	Operators Frame (Sorting to individual operators & cost of frame)	Revised element cost
9	Counting Items and recording count	Same process as Royal Mail
10	Web browser input (daily)	Same process as Royal Mail
11	Central communication co-ordinator	Revised process
12	General Movements of Mail Around MC	Removed this activity
13	Transfer to Storage Point	Revised process
14	Retrieve Mail from Storage and Hand Over at Dock	Revised process
15	Training	Revised element cost

Notes: Royal Mail's most recent cost estimate for the extraction service is 58.17 pence per item.<sup>14</sup> The consultants' cost estimates for the extraction service, based on revised assumptions about internal and external drivers, range from 4.79 to 11.81 pence per item in 2006/07 (see Table 4).

In their report the consultants recommended that until more is understood about the feasibility of the alternative process Postcomm base its cost projections for the extraction service upon Royal Mail's proposed process with the consultants' revised costs (column 3 in Table 4). In the March consultation document Postcomm adopted a cautious approach to estimate the price of the

<sup>14</sup> Received 24 November 2004.

extraction service, based on the consultants' revised cost of Royal Mail's proposed process and its medium level scenario of external assumptions (i.e. 6.99 pence per item).

Table 4: Comparison of the consultants' *cost estimates*\* for the extraction service under different assumptions, 2006/07.

	Scenario	Consultants' revised cost of the Royal Mail proposed process (pence per item)	Consultants' alternative process cost (pence per item)
Consultants' external assumption	Low	11.81	8.74
	Medium	6.99	5.72
	High	5.45	4.79

Notes: \*The numbers in the table are the process costs Royal Mail incurs in providing the extraction service and should not be viewed as prices. Postcomm calculates prices by including an appropriate mark-up above cost to account for the fixed cost of collection, joint costs and a profit allowance.

Postcomm is in the process of seeking Royal Mail's feedback on the feasibility of the alternative process developed by the consultants with a view to publishing finalised pricing proposals in its decision document in July 2005.

### Getting from costs to prices

In the consultation document Postcomm presents an "extraction service" price of 10 pence per item. The cost basis for this price estimate is the consultants' medium level scenario for external assumptions and the revised cost of Royal Mail's proposed process (i.e. 6.99 pence per item in Table 4). Postcomm arrives at the price of the extraction service by applying an appropriate mark up to this cost estimate.<sup>15</sup> The mark up includes:

- an adjustment to Royal Mail's cost of collection to include an appropriate contribution to the fixed costs of collection as cost estimates provided by Royal Mail represented only the marginal cost of this activity.
- an adjustment to include an appropriate contribution to joint costs. Postcomm concluded that it was reasonable to expect a product or service Royal Mail is being mandated to provide, to make a contribution to joint costs.<sup>16</sup> This is because it would be unreasonable to place the burden of recovering joint costs on only a subset of customers (e.g. public stamp customers).
- a 6% profit allowance. Postcomm accepted that it was reasonable for Royal Mail to recover an element of profit. This reflects the view that there should be some incentive to Royal Mail to provide the service as otherwise it could use its resources for more productive

<sup>15</sup> The reader is referred to chapter 5 of the consultation document for greater detail on Postcomm's approach to calculating the extraction service price.

<sup>16</sup> Joint costs refer to overhead costs that cannot be causally attributed to any operational activity, product or service (e.g. certain headquarter costs such as the HR department).

purposes. When setting the current price control, Postcomm considered it appropriate to allow Royal Mail to achieve a profit margin of 6% by the final year of the control. This was based on certain assumptions relating to factors such as Royal Mail's costs and the potential for it to make efficiency gains (which Royal Mail may or may not exceed). Postcomm considers a similar allowance appropriate in this instance.

This uplift adds approximately 3 pence per item to the cost of the single per item extraction service charge.

Since the release of the consultation document Postcomm has engaged with Royal Mail on its approach to account for the fixed cost of collection, joint costs and profit allowance elements of the extraction service price. Royal Mail has indicated that it agrees in principle with Postcomm's approach in these areas, subject to some revisions. Postcomm will incorporate any changes resulting from Royal Mail's proposed revisions in its finalised prices in July 2005.

### **Pricing structure**

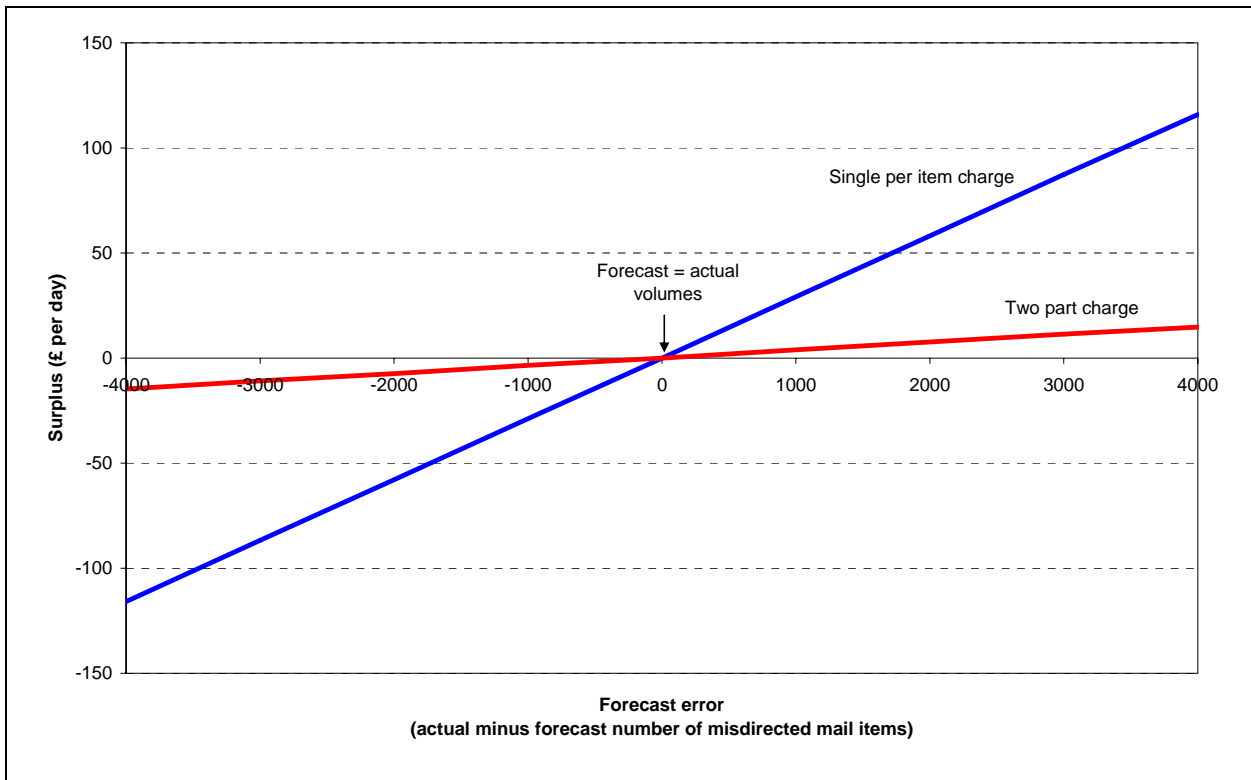
Postcomm presented a single per item charge for the extraction service of 10 pence in the March consultation document. However, the consultation document alluded to alternate pricing structures. For example, a two-part charging structure that would involve an OLO being charged a price per item of misdirected mail plus a contact charge each time an OLO collects misdirected mail from Royal Mail.

Postcomm is considering alternate pricing structures because depending on the nature of costs the choice of pricing structure can have a significant impact on the revenue risks faced by licensees. Royal Mail, in modelling the process and cost of handling misdirected mail, focused on recovering costs through a single per item charge (though a two part structure is also contemplated). The consultants' research shows that this pricing structure creates significant risks for both Royal Mail and OLOs. The source of this risk is the high proportion of total costs (over 80%) that do not relate to the volume of misdirected items.<sup>17</sup> Since not all costs change with volumes a single per item charge has the effect that any volume forecast error results in a divergence between costs and revenues (see Figure 1). If volumes are lower than assumed, the single per item charge will be set too low and Royal Mail will under-recover fixed costs. The converse is true if volumes turn out to be higher than assumed.

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<sup>17</sup> See Frontier-PLCWW report, figure 3 on page 19.

Figure 1: Effect of incorrect forecast of misdirected mail items, 2006/07.



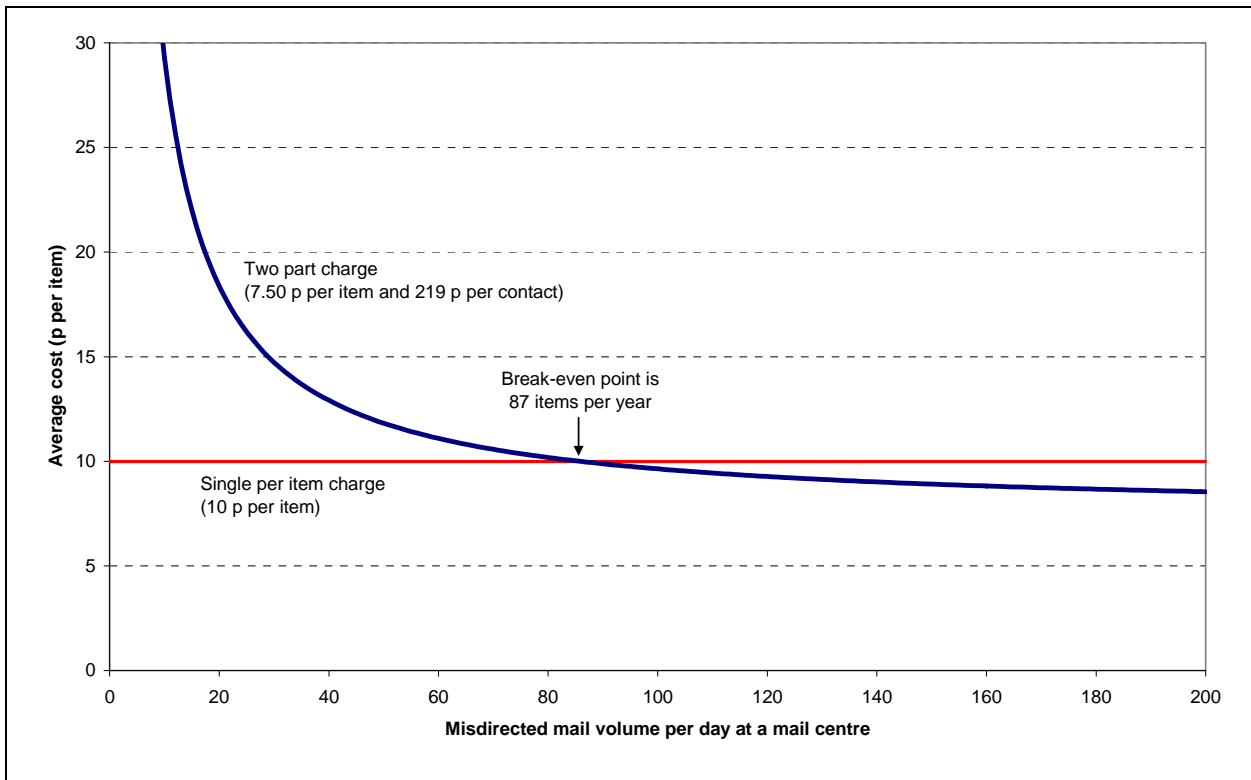
Note: Based on Royal Mail’s proposed process with the consultants’ cost revisions.

A two-part charging structure reduces this risk as it more closely reflects the actual costs of handling misdirected mail. Figure 1 illustrates the risk of errors in the forecast of misdirected mail volumes under different pricing structures. The horizontal axis shows the actual number of misdirected mail items per day less the forecast number, i.e. a positive number indicates that the number of items per day has been underestimated. The vertical axis shows Royal Mail’s daily surplus or deficit. For any given volume of misdirected mail Royal Mail and OLOs face greater risk with a single per item charge than with a two-part charge.

*Break-even point between 1 and 2 part charge*

Postcomm has also estimated the break-even point at which an OLO is indifferent between a single or two-part charging structure. The break-even point is around 22,500 items of misdirected mail per mail centre per year, or 87 items per day on average, (see Figure 2). This implies that OLOs with higher volumes of misdirected mail may prefer a two-part charge. However, Postcomm would like to stress the break-even point is still highly dependent on the estimate of misdirected mail volumes as it impacts on the price of the single per item charge. For example, if we apply the Royal Mail estimate of misdirected mail volumes the break-even point is 1,500 items of misdirected mail per year, or 6 items per day, on average at each mail centre.

Figure 2: Average per item cost of a one and two part charge, 2006/07.



Note: Based on Royal Mail’s proposed process with the consultants’ cost revisions.

Postcomm appreciates licensees with lower volumes of misdirected mail may incur a higher average cost of collecting misdirected mail from certain Royal Mail mail centres. For this reason Postcomm developed the ‘return service’<sup>18</sup> in the consultation document. The return service allows a licensee to request Royal Mail, or the receiving licensee, to return misdirected mail either on a one-off basis or as the default arrangement for a specific mail centre. The development of a return service aims to ensure the introduction of the Code does not impose unreasonable costs on small licensees, licensees with limited areas of operations, or licensees that experience low levels of misdirected mail. Licensees are of course still able to use Royal Mail’s publicly available services such as its ‘response services’ if these remain the most effective and efficient solution.

*Duration of applicable price*

Postcomm is also exploring the merits of a single versus multi-year review period for the extraction service. A multi-year review period has appeal as it provides greater efficiency incentives. However, Postcomm’s view is that the duration of the review period is, in part, influenced by the choice of pricing structure. Given the challenge of estimating misdirected mail volumes and the importance of the volume estimate in establishing a single per item charge,

<sup>18</sup> The return service is outlined in chapter 4 of the consultation document.

Postcomm's view is that a shorter price review period may be required if this pricing approach is introduced. However, Postcomm's view is that the greater cost reflectivity of a two-part charging structure provides scope for a longer pricing period (for example, a two or three-year period). Postcomm anticipates a multi-year two-part charge may result in a slightly lower charge than the one-year charge (as presented in column three of Table 1). For example, with a three-year pricing period, licensees would pay the multi-year charge for the duration of the three-year period, resulting in licensees paying a slightly lower price than the one-year charge in 2006-07, a similar price to the one-year charge in 2007-08, and a slightly higher price in 2008-09.