



All interested stakeholders

Date: 2 April 2007

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Dear Stakeholder,

**Royal Mail's Proposal to Charge Large Mailers by Delivery Location
"Zonal Pricing"**

Royal Mail has asked Postcomm, the independent regulator for postal services in the UK, to be allowed to vary certain business tariffs according to the geographic location of the recipients of mail (known as "zonal pricing"). Broadly, under this proposal, prices for items delivered in some areas (Greater London, rural and less populated areas) would rise, while prices for delivery to other areas would fall.

Postcomm has nine months, i.e. up to 2 January 2008, in which to decide whether to allow the introduction of zonal pricing. Royal Mail's proposal is to introduce the new prices from 1 April 2008 and to discontinue the current pricing structure – which would initially operate in parallel – six months later.

I am writing to seek your views on this important development. Postcomm will take these views into account in a process that is likely to lead to the publication of a consultation document setting out our provisional conclusions on Royal Mail's application in July 2007.

The products affected by the proposal are bulk mail products called Mailsort 120, 700, 1400 (3rd class), Presstream, and Walksort. These products generated about 25 per cent or £1.4 billion of Royal Mail's total regulated revenue in the last financial year.

Under Royal Mail's proposal, prices would differ across five zones which are broadly defined on the basis of population density, with the exception of a zone covering Greater London. Changes in postage prices would initially range from a premium of just under 5% to a discount of up to 5% from the standard uniform price but by April 2010 these differentials could be substantially greater.

This proposal *does not* affect postal services that Royal Mail is required to provide under its Universal Service Obligation (USO). In particular, the prices of

stamped and franked mail, and Mailsort 1400 (1st and 2nd class) would not be affected.

As part of its application, Royal Mail has also requested Postcomm to be allowed to replace Presstream Profile Pricing with its proposed zonal pricing structure. Furthermore, it has proposed certain changes to non-price terms such as mandatory electronic submission and sortation into zonal sequence.

Background

In July 2006, Royal Mail submitted a zonal pricing application to Postcomm. Under the terms of Royal Mail's licence, Royal Mail can introduce a zonal pricing structure unless Postcomm rejects it on specific grounds, within nine months of having received sufficient information of good quality to consider the application from Royal Mail.¹ Postcomm is required to consult Postwatch and other stakeholders as part of this process.

In September 2006, Postcomm issued a consultation document on the concept of zonal pricing and asked interested parties for comments on the appropriate approach to assessing Royal Mail's application. A summary of the non-confidential responses that Postcomm received is reported in Annex A. These responses are also available on Postcomm's website.

At the same time as this consultation, Postcomm was gathering cost data in order to begin the process of assessing Royal Mail's application. Before Postcomm could satisfy itself that it had sufficient information of good quality, Royal Mail decided unilaterally to revise its application and submitted a new one on 20 February 2007.

Postcomm wishes to make interested parties aware of the process it intends to follow and, importantly, to seek your views on Royal Mail's application and how it will affect you and your business.

Responses to this letter will be very important to us in informing the consultation document which we plan to issue in July 2007.

Postcomm's approach to assessing the proposal

In considering Royal Mail's application, Postcomm will assess whether the proposal satisfies certain criteria set out in Royal Mail's licence. The licence indicates that Postcomm would need to be satisfied that a proposal to introduce prices which are not geographically uniform would:

¹ Licence Condition 21, paragraphs 17-19.

- (a) be revenue neutral within the terms of the price control, i.e. it would not affect the revenue Royal Mail is allowed to collect under the 2006-10 price control settlement;
- (b) lead to prices for the service being more reflective of costs;
- (c) be introduced in a manner that avoids unreasonable changes for users of the services;
- (d) not lead to a circumvention of the requirement to provide Regulated Services on as wide a basis within the United Kingdom as they were previously provided; and
- (e) not lead to a failure to provide services priced in a manner consistent with the Postal Services Directive of the European Union (*e.g. requirements for prices to be set in a transparent and non-discriminatory manner*).

Postcomm will set out its assessment of Royal Mail's proposal against the revenue neutrality and cost reflectivity tests in its next consultation document. This will outline Postcomm's view on whether to accept (either whole or with modifications) or reject Royal Mail's proposal.

Although Postcomm's assessment will primarily be conducted through the criteria above, it must, in exercising any of its functions, have regard to its statutory duties. Specifically, in exercising these functions, Postcomm is required to have regard to its statutory duties set out in the Postal Services Act which are:

- to exercise its functions in a manner which it considers is best calculated to ensure the continued provision of the universal postal service;
- to exercise its functions in a manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators. In performing this duty Postcomm is required to have regard to the interest of customers who are disabled or chronically sick, pensioners, customers on low income and customers who live in rural areas; and
- to exercise its functions in a manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.

Furthermore, in exercising its functions in relation to licence holders, Postcomm must also have regard to the need to ensure that Royal Mail is able to finance its activities, including a universal postal service.

Before making a decision, Postcomm will take into account stakeholders' views on Royal Mail's revised proposal and on the practical issues associated with the introduction of zonal pricing, if it is allowed to proceed. These would include

views on Royal Mail's proposed changes to non-price terms and conditions of its products.

Royal Mail is required to notify any price changes three months before they are introduced.² Postcomm would like to understand whether three months notice would be sufficient in this case or whether a longer notification period would be required in order to avoid unreasonable changes for users.

Details of Royal Mail's Proposals

Royal Mail's zonal application is published on both Royal Mail's and Postcomm's websites.³ Royal Mail will also make available other information including a list of postcode sectors by zone and a calculator of zonal prices. Royal Mail will make this information available by 23 April 2007 at www.mailsorttechnical.com.

Annex B includes a description of the main components of Royal Mail's proposal and information that you may need to inform your response to the questions outlined in the section below.

Questions for consultation

Postcomm would like your views on Royal Mail's application in general and, in particular, on the following:

- whether you would support Royal Mail's revised zonal pricing application;
- whether the standard three month notification period would be sufficient for users to adjust their businesses to zonally-priced products;
- what the impact of the non-price terms changes proposed by Royal Mail would be;
- what the impact of this proposal would be on your use of mail or provision of mail services either in general or in particular zones;
- whether there would be any adverse impact on those vulnerable groups of customers to which Postcomm must have particular regard;
- whether Postcomm should consider reviewing the zonal structure of access prices as part of its review of this application and whether it should

² Condition 7 of Royal Mail's licence.

³ The addresses are www.royalmail.com/portal/rm/content2?catId=400147&mediaId=29900664 and <http://www.psc.gov.uk/policy-and-consultations/consultations/zonal-pricing-by-royal-mail.html>.

make any possible decision to allow Royal Mail to implement this proposal conditional on access and retail prices having similarly defined zones;

- what your views are on the proposed replacement of Presstream Profile Pricing with zonal pricing and what difference this part of the proposal might have on your use of mail; and
- whether there are any further issues you wish Postcomm to have in mind when responding to Royal Mail's proposal.

Postcomm seeks your views

I would encourage you to respond to this letter as Postcomm has found early input on other major changes proposed by Royal Mail to be very valuable. However, we will also offer other opportunities for interested parties to make their views known.

On 12 June 2007, zonal pricing will be discussed at Postcomm's Annual London Forum event. Details of this event are available on request. If you would like to attend, please use the email address below to request a place.

Postcomm also proposes issuing a consultation document at the beginning of July. This document will include Postcomm's assessment of Royal Mail's proposal and will outline Postcomm's provisional conclusion on whether Royal Mail should be allowed to introduce zonal prices. After having considered the responses received to its minded-to consultation document, Postcomm proposes to issue a decision on this application before the end of the year.

If you wish to respond

Responses to this consultation letter should be sent no later than **7 May 2007** either by email to samanta.padalino@psc.gov.uk or by post to Samanta Padalino, Deputy Director, Competition & Regulation, Postcomm, Hercules House, 6 Hercules Road, London SE1 7DB.

However, if Royal Mail were unable to provide on its website the revised calculator for zonal prices and associated information by 23 April 2007, Postcomm will consider extending the deadline for responding to this letter.

Postcomm may at a later date publish non confidential responses, so please indicate if your response should be treated as confidential. If you would like to arrange a meeting to discuss this letter or any aspect of Royal Mail's proposal, please write to the same email address or contact Samanta Padalino on 020 7593 2186.

Thanks for taking time to respond to this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Peter Swatridge". The signature is fluid and cursive, with a prominent flourish at the end.

Peter Swatridge
Director, Competition and Regulation

Annex A
Summary of responses to Postcomm's September 2006 consultation document on zonal pricing by Royal Mail

Background

Postcomm issued a consultation document on 11 September 2006 on zonal pricing by Royal Mail.

In particular, the consultation document asked the following three questions:

- Recognising the fact that Postcomm will issue a subsequent consultation document on Royal Mail's 5 July 2006 application in due course, is there anything in the application that respondents would like to bring to Postcomm's attention at this stage?
- What are the factors to which you think Postcomm should give particular attention in applying the criteria set out in Royal Mail's licence (in Condition 21 Paragraph 19)?
- How do you think the importance of these factors may change over time?

List of Respondents

Postcomm received 23 responses to the consultation, 11 of which were non-confidential. These 11 respondents were:

- Charterhouse Intelligent Print Solutions
- Communication Workers Union
- The Direct Marketing Association
- Eden District Council
- Highland Council
- Mail Competition Forum
- Mail Matters
- Mail Users Association
- Postwatch
- TNT Post
- Royal Mail

The non-confidential responses are available in full on the Postcomm website (<http://www.psc.gov.uk/policy-and-consultations/consultations/zonal-pricing-by-royal-mail.html>). A high-level summary of these responses is provided below.

High-level Summary of non-Confidential Responses

Royal Mail stressed the importance for Postcomm to process this type of application quickly and to explain the parameters of the term “sufficient information of good quality”. Postwatch also commented that it would be helpful if Postcomm set out exactly what information it would regard as sufficient. Royal Mail also commented that the interpretation of Postcomm’s statutory duties should not be used to create additional criteria beyond those set out in the licence.

Other operators raised concerns over the impact of zonal pricing on competition, with the MCF stating that this is probably the most important single decision in terms of its effect on the UK’s postal market that Postcomm will make over the next few years. TNT stressed that zonal pricing would have a more profound and damaging effect on emerging competition than any other measure in recent years.

TNT also stated that it believed that up to 9% of postal sectors had been classified into the wrong zone and that there are a number of areas where the postal sector is unlikely to reflect the true underlying costs of delivery, e.g. where there are large uninhabited areas, sectors which include sea or river and sectors with few roads.

Postwatch was concerned about the frequency and pace with which Royal Mail is submitting applications to change its pricing structure. Postwatch also commented that Postcomm should consider, in particular, the potential impact of the proposal on publishers. They noted that the PPA has stated that some publishers could experience 20 per cent price increases.

Postwatch also raised concerns that, in taking account of its statutory duties, Postcomm should take particular care of the impact on rural customers. A number of other respondents also noted the potential effects of zonal pricing on mail volumes in rural areas and said that Postcomm should consider the potential impact of a fall in rural mail volumes on the costs of the USO.

The Direct Marketing Association (DMA) indicated that none of their members wanted zonal pricing and all were concerned that zonal pricing would make direct mailing more complex and expensive.

A number of respondents highlighted the impact of the non-price terms and conditions included in the zonal pricing application. In particular, respondents mentioned the costs associated with the requirement for customers to sort their mail by zone prior to it being handed over to Royal Mail.

Respondents also commented on the transition of prices up to April 2010. The DMA and Postwatch said that Postcomm should consider how zonal prices

would change and how they could be projected up to April 2010. The MUA suggested that Postcomm should fully establish the price transition timetable that Royal Mail intended to put in place before taking the application further.

The interplay between access prices and the proposed bulk mail prices was also raised by a number of respondents. Respondents wanted to know why the access pricing review would take place after the retail zonal application had been assessed and whether Royal Mail would continue to offer a uniformly priced access product.

Annex B

Details of Royal Mail's Proposal

This section describes briefly the main elements of the proposal.

In its application, Royal Mail has defined four different zones based on two proxy measures for delivery costs, i.e. delivery point density (DPD) and business density (BD), and one zone covering Greater London.

Table 1 define these five zones. As an example, if a postcode sector is assessed to have a delivery point density greater than 1,000 per square kilometre, but a business density less than 10% of delivery points, then the sector will be determined to be in zone B.

Table 1 - Definition of zones

Zone	Name	Business Density	Delivery Point Density
London	Greater London	Not applicable	Not applicable
A	Business District	Greater than 10%	Greater then 500 per km ²
B	High Density	NA	Greater than 1000 per km ²
C	Average Density	NA	Greater than 100 per km ² And Less than/equal to 1000 per km ²
D	Low Density	NA	Less than/equal to 100 per km ²

Source: Royal Mail

Greater London is defined by Royal Mail to comprise the postcode sectors within the following postcode areas: AL, BR, CR, DA, E, EC, EN, HA, IG, KT, N, NW, RM, SE, SM, SW, UB, TW, W, WC, WD. This approximates to the area within the M25 motorway.

Under its proposal, zonal pricing would be applied to the following Royal Mail's bulk mail products:

- **Mailsort 120** - first and second class, OCR and CBC
- **Mailsort 700** - first, second and third class
- **Mailsort 1400** - third class
- **Presstream** - first and second class
- **Walksort** - first and second class

Currently, Royal Mail charges geographically uniform prices for these bulk mail products and says that introducing zonal prices would help it to align its prices more closely with its underlying costs.

Royal Mail proposes that in the first year of implementation, the price in each zone would be calculated as a premium or a discount over the existing geographically uniform price. Prices would be lower in zones A, B and C and higher in Greater London and zone D.

Table 2 sets out the initial price differences proposed and shows that Royal Mail proposes to increase the postage price of certain bulk mail products to an address in Greater London by 2.5% and reduce the postage price for mail to zone A by 4.9%.

Table 2 - Proposed Discounts and Surcharges at the introduction of Zonal Pricing⁴

	Zones				
	London	A	B	C	D
Price Premium/Discount on Geographically Uniform Price	+2.5%	-4.9%	-2.0%	-1.7%	+4.8%

Source: Royal Mail

It is important to highlight that, under Royal Mail’s proposal, zonal pricing would not apply to all bulk mail products. Those bulk mail products that are currently supplied under the USO will continue to be priced uniformly. Specifically, Mailsort 1400, 1st and 2nd class, and Cleanmail would continue to be priced uniformly.

As part of its submission, Royal Mail has also applied for the flexibility to introduce steeper zonal price variations before 1 April 2010. This would allow Royal Mail to reflect the actual costs it states it incurs in delivering mail in each zone. This could imply that, if introduced, zonal prices would vary by more than the initial prices in later years. Table 3 illustrates the differences in Royal Mail’s unit costs between zones when compared to the national average.

Table 3 - Variation in delivery costs by zone

Zones	Greater London	Zone A	Zone B	Zone C	Zone D
Delivery costs by zone (relative to national average)	+12%	-28%	-11%	-4%	+11%

Source: Royal Mail and Postcomm

⁴ Royal Mail Zonal Pricing Application (Modified), February 2007, Table 2.4.

Table 3 indicates that prices could increase further in Greater London and zone D where Royal Mail states that its costs are higher than the national average. It also shows that prices could fall further in zones A, B and C.

Royal Mail has indicated to Postcomm that it has no plans at present to change the existing zonal structure for access prices. This structure is substantially different to the proposed zones for the retail bulk mail products, particularly as it does not include a Greater London zone.

Presstream

As part of its proposal, Royal Mail would like to extend zonal pricing to Presstream, thus replacing Profile Pricing. Presstream is a bulk mail service for publishers with a minimum editorial content qualification. Profile Pricing was introduced in 1993 giving additional discounts from the standard Presstream prices for delivery in city centres. A multi-copy discount was added to Profile Pricing in 1996. The Profile Pricing discount is based on two factors:

- (a) The geographic posting profile generated by the proportion of the items mailed being addressed to specific postcode areas; and
- (b) The multi-copy profile, driven by the number of delivery points compared to the number of items mailed.

Since it contains an element of geographic pricing, Royal Mail considers that the Presstream Profile Pricing would overlap with the proposed zonal pricing structure. Accordingly, Royal Mail's application to offer zonal prices proposes the removal of the current Profile Pricing mechanism of Presstream. The geographic pricing component would be substituted by the new zonal pricing mechanism, while the multi-copy component would become a stand-alone discount available with all 1st and 2nd Class Presstream services.

Changes in non-price terms

Royal Mail has indicated that in order to implement zonal pricing a number of changes to non-price terms and conditions would be required. Table 4 summarises the new terms and conditions compared to those of the current uniformly priced products.

Among the changes to its terms and conditions that Royal Mail sets out in its application there is a mandatory requirement to include Standard Selection Code and Zone Code on the mail piece. Also, to facilitate mails verification, customers will need to print and bundle their mailings in zone order. Within a Direct or Residue selection all items for Zone A would need to be produced first, then Zone B, then Zone C and so forth.

Table 4 - New terms and conditions

	Obligatory electronic ordering	Obligation to print the Standard Selection Code on mail item	Obligation to print Zone Code on mail item	Obligation to produce mail in zone order within SSC	Obligation to quote exact no. of bags in mailing
National pricing	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	NA	NA	✓
Zonal pricing	✓	✓	✓	✓	✓

Source: Royal Mail

Customers may find that these changes require modifications to their sortation software and other processes. Postcomm welcome views on these proposed new requirements.

Proposed implementation date and transition period

Under the current application Royal Mail has requested to be allowed to introduce Zonal Pricing from April 2008. However, Royal Mail is also proposing that there should be a transition period so that zonal prices, if introduced in April 2008, would be offered in parallel to uniform prices until October 2008. During this transition period mailers will be able to continue using uniformly priced products, or switch their entire mailing to zonally priced products or split their mailing between uniformly priced and zonally priced products.

As part of its assessment, Postcomm will consider whether Royal Mail's request for an implementation date of April 2008 is feasible, or whether a longer notice period should be required. Postcomm will also assess the implications and the need for the proposed transition period.