

Royal Mail's zonal pricing application: revised treatment of Presstream services

In February 2007, Royal Mail applied to Postcomm to be allowed to introduce zonal prices for most bulkmail services (i.e. prices that vary according to the destination of mail).¹ Postcomm commissioned Frontier Economics to review the likely impact of Royal Mail's proposed zonal prices on bulkmail volumes and revenues, with particular reference to the licence requirement for any change to be revenue neutral. Our report was sent to Postcomm in July.²

Subsequently, Royal Mail modified its application by altering the proposed full price (before volume or geographic discounts) of most large letters for Presstream Standard and Presstream Profile.³ This follows representation from the Periodical Publishers Association (PPA) and other publishers and is designed to mitigate the impact of price changes in the earlier application for customers using Presstream Profile. It is also designed to improve cost reflectivity.

This note updates the analysis and conclusions in our earlier report in light of this change to Royal Mail's application. As before, we review the likely volume impact of the price changes and comment on the implications of the changes for the revenue neutrality calculation.

1. PROPOSED CHANGES TO PRESSTREAM SERVICES

Presstream is a service that Royal Mail offers for publishers sending journals and magazines. In order to qualify for the service, all mail items must contain a minimum editorial content. There are currently four different kinds of Presstream services:

- Presstream Standard;
- Presstream Profile (which offers discounts for some geographic areas);
- Presstream >250k (which offers discounts for large mailings); and
- Presstream Premium (which offers a faster service to some destinations).

The treatment of Presstream >250k and Presstream Premium is not affected by this latest application and we therefore do not consider these products further in this report.

Presstream Profile currently offers discounts for sending mail to be delivered in city centres. As part of its application, Royal Mail is proposing to remove these

¹ Royal Mail "Application under licence condition 21 for approval to offer geographic zonal prices for bulkmail services (Modified), 20 February 2007

² Frontier Economics "Retail zonal pricing: impact on Royal Mail's volumes and revenues: A report prepared for Postcomm" July 2007.

³ Royal Mail "Application under licence condition 21 for approval to offer geographic zonal prices for bulkmail services (Modified)", 17 July 2007

discounts and instead offer Presstream Profile customers the same geographic uplifts and discounts as would be applied to other bulkmail services, shown in Table 1.

	London	Zone A	Zone B	Zone C	Zone D
Zonal uplifts and discounts	+2.5%	-4.9%	-2.0%	-1.7%	+4.8%

Table 1: Proposed zonal uplifts

Source: Royal Mail application Table 2.4

In our July report we estimated that the introduction of zonal prices would increase average revenues by 0.03% (based on unchanged volumes) across all products in the zonal pricing application except Presstream Profile. For Presstream Profile, by contrast, the change would increase average revenues by 12.7% (also on unchanged volumes). This average increase would, however, vary significantly by zone, as shown in Table 2.

	London	Zone A	Zone B	Zone C	Zone D
Zonal uplifts and discounts	70.2%	7.2%	4.1%	2.3%	9.5%

Table 2: Estimate price changes for Presstream Profile

Source: Royal Mail Zonal Tariff Model (February application)

Royal Mail's recent July application still proposes removing the existing geographic discounts for Presstream Profile and replacing them with the common zonal bulkmail uplifts and discounts. However, it also reduces the full price of most large letters for Presstream Standard and Presstream Profile, as shown in Table 3. The zonal uplifts and discounts are then applied to these lower full prices. Prices for other formats remain unchanged. The price discounts only apply to the prices under the zonal tariff, not to the uniform prices which will still be available during the transition period.

	Presstream 1 st class	Presstream 2 nd class
Large letter 0-100g	-5.2%	0%
Large letter 101-250g	-5.3%	-4.0%
Large letter at 750g	-0.8%	-7.7%

Table 3: Change in full price before sortation and zonal discounts

Source: Royal Mail application Table 1.2 and Table 1.3

The impact of this change is to reduce the average price of Presstream Products under the zonal tariff. Presstream Standard customers will now see an average price fall of 2.9% (based on unchanged volumes), while Presstream Profile

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customers will see an average price increase of 9.4%, compared to 12.7% under Royal Mail's February application (also based on unchanged volumes).

The remainder of this note updates the analysis in our July report to take account of these revised prices. The note follows the structure of the July report:

- Part 2 reviews Royal Mail's own analysis of the impact of zonal prices on Presstream volumes and revenues;
- Part 3 analyses the likely volume response of Presstream services to the introduction of zonal prices;
- Part 4 confirms the analysis in our July report that no substantial volumes of mail are likely to switch between Presstream products and alternative uniformly price services;
- Part 5 explains why we consider that the price changes are unlikely to significantly affect market entry; and finally
- Part 6 updates our overall conclusions on the impact of zonal prices on bulkmail volumes and revenues in the light of the new analysis of Presstream services.

Parts 2 to 5 only consider Presstream Standard and Presstream Profile, as these are the two products for which prices have changed since our July report. Part 6 updates our conclusions across all bulkmail products in Royal Mail's application.

2. EFFECT OF PROPOSED PRICE CHANGES IN ROYAL MAIL'S MODEL

Royal Mail has submitted an updated version of its Zonal Tariff Model which estimates the volume and revenue impact of introducing zonal prices. A full description of the model is contained in our July report. The model considers three ways in which zonal prices will affect volumes and revenues:

- a direct price impact;
- a volume response to changing prices (i.e. a price elasticity response); and
- potential switching between uniform and zonal tariffs during the transition period.

Separately, as part of its application, Royal Mail considers switching between products on the zonal tariff and USO products that will retain a uniform tariff after the introduction of zonal prices. However, it considers that there will be little such switching and therefore does not model this effect explicitly. Royal Mail's application does not present estimates of the impact of zonal prices on market entry.

Table 4 shows the size of each of these effects on Presstream Standard based on the prices in Royal Mail's revised application. It shows that:

- the direct price impact would be expected to be a revenue reduction of £3.49m relative to initial revenues under the uniform tariff;

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- overall volumes would be expected to increase by 3.14m items in response to the lower prices, leading to an overall revenue fall of £2.46m; and
- the transition period would be expected to increase volumes by a further 50,000 items (3.19m in total) with revenues falling by around another £50,000 (£2.51m in total).

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial levels – price impact</i>						
Volumes	-	-	-	-	-	-
Revenues	-£0.12m	-£0.56m	-£1.46m	-£1.74m	£0.40m	-£3.49m
<i>Total change excluding transition period – price impact + volume response</i>						
Volumes	0.15m	0.47m	1.27m	1.52m	-0.27m	3.14m
Revenues	-£0.09m	-£0.40m	-£1.02m	-£1.22m	£0.27m	-£2.46m
<i>Total change including transition period</i>						
Volumes	0.16m	0.47m	1.27m	1.52m	-0.24m	3.19m
Revenues	-£0.10m	-£0.40m	-£1.02m	-£1.22m	£0.23m	-£2.51m

Table 4: Bulkmail volumes and revenues for Presstream Standard services.

Source: Royal Mail Zonal Tariff Model

Table 5 shows the equivalent changes to revenues and volumes for Presstream Profile predicted by Royal Mail's model. It shows that:

- the direct price impact would be expected to be a revenue increase of £10.07m (reduced from a £13.63m increase under Royal Mail's February application);
- overall volumes would be expected to fall by 11.92m items in response to the higher prices, reducing the overall revenue increase to £5.07m (reduced from £7.18m under the February application); and
- the transition period would reduce the revenue increase further to £1.45m, as customers remain on the cheaper existing tariff during the transition period.⁴

⁴ This estimate of revenue during the transition period may reflect an error in Royal Mail's model. We discuss this point further in section 4.1.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial levels – price impact</i>						
Volumes	-	-	-	-	-	-
Revenues	£8.23m	£0.30m	£0.29m	-£0.27m	£1.51m	£10.07m
<i>Total change excluding transition period – price impact + volume response</i>						
Volumes	-10.72m	-0.23m	-0.15m	0.35m	-1.17m	-11.92m
Revenues	£3.88m	£0.20m	£0.19m	-£0.19m	£0.99m	£5.07m
<i>Total change including transition period</i>						
Volumes	-7.92m	-0.15m	-0.02m	0.45m	-0.78m	-8.43m
Revenues	£1.01m	£0.12m	£0.04m	-£0.30m	£0.58m	£1.45m

Table 5: Bulkmail volumes and revenues for Presstream Profile services.

Source: Royal Mail Zonal Tariff Model

3. VOLUME RESPONSE TO PRICE CHANGES

Customers could react to price changes by altering the volume of mail that they send (a price elasticity response). An important question for this report is whether customers will react to the overall change in price for entire mailings, or whether they will react to price changes in individual zones. As customers have rarely faced similar decisions before, there is limited past information with which to decide which is more likely. Based on discussions with mailers, we believe that many mailers will not be in a position to react to changes in price by zone, at least initially. Over time, however, more mailers are likely to change their systems to enable them to respond.

In order to capture this uncertainty, we identified two benchmark cases in our July report which we analyse again here:

- **lower impact case:** mailers only react to the total price of their mailing bill and ignore price variations between zones; and
- **upper impact case:** mailers consider each zone independently when they send mail.

In each case we use a price elasticity of -0.32 taken from Royal Mail's Inland Letter Traffic Model (ILTM). We discuss the implications of using this elasticity further in our July report, but in general are satisfied that it is an appropriate figure to use. The numbers given in this section exclude the impact of the transition period.

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3.1 Lower impact case

In the lower impact case, the relevant price change is the price change experienced by each service across all zones. Although all services are subject to the same zonal discounts and surcharges, they will not necessarily experience the same average price changes as the zonal mix of each product varies slightly.

The average price changes for Presstream services are shown in Table 6 below. For comparison, the table shows the both price changes under the current (July) application, and the price changes under the original February application.

Product	Feb application	July application
Total exc. Presstream	0.02%	0.02%
Presstream 1 Standard	0.04%	-2.71%
Presstream 2 Standard	0.15%	-3.03%
All Presstream Standard	0.03%	-2.93%
Presstream 1 Profile	13.15%	10.05%
Presstream 2 Profile	12.10%	8.55%
All Presstream Profile	12.67%	9.36%
All products in application	1.04%	0.51%

Table 6: Overall price changes for Royal Mail bulkmail products assuming no change in zonal mix

Source: Frontier Economics, Royal Mail Zonal Tariff Model

Presstream Standard

Table 7 shows the predicted changes in volumes and revenues for Presstream Standard services that would result from the introduction of zonal pricing given our lower impact scenario. This shows that under our lower impact base case:

- volumes would rise by 2.88m items; and
- revenues would fall by £2.4m.

Presstream Standard experienced a small price rise under the February application, and would therefore have been predicted to experience a small revenue increase and volume fall.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial volumes and revenues</i>						
Volumes	0.48m	0.17m	0.72m	0.90m	0.62m	2.88m
Revenues	£0.06m	-£0.50m	-£1.20m	-£1.41m	£0.65m	-£2.40m

Table 7: Bulkmail volumes and revenues for Presstream Standard

Source: Frontier Economics, Royal Mail

Presstream Profile

Table 8 shows the equivalent predicted changes in volumes and revenues for Presstream Profile services in our lower impact scenario. This shows that under our low impact base case:

- volumes would fall by 8.98m items; and
- revenues would rise by £6.54m.

These changes are lower than predicted in our July report (where we predicted volumes would fall by 12.2m items and revenues would increase by £8.7m) as the average price changes for Presstream Profile are now smaller than in Royal Mail's February application.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial volumes and revenues</i>						
Volumes	-1.55m	-0.62m	-2.15m	-2.78m	-1.87m	-8.98m
Revenues	£7.61m	£0.07m	-£0.53m	-£1.34m	£0.74m	£6.54m

Table 8: Bulkmail volumes and revenues for Presstream Profile.

Source: Frontier Economics, Royal Mail

All bulkmail products

In this lower impact case, across all bulkmail products in the application:

- volumes are predicted to fall by 6.3m items, (compared to a 12.5m fall predicted under Royal Mail's February application); and
- revenues are predicted to rise by £4.3m, (compared to an £8.9m increase predicted under Royal Mail's February application).

3.2 Higher impact case

Under our higher impact scenario, mailers treat mail going to different zones independently. We assume they will respond to different price changes in different zones independently rather than responding to an overall price change

for a particular service. This is the assumption made by Royal Mail in their Zonal Tariff Model.

Presstream Standard

Table 9 shows that in this case, Presstream Standard is likely to see:

- volumes rise by 3.14m items; and
- revenues fall by £2.46m.

There is also more variation by zone than in the lower impact case.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial volumes and revenues</i>						
Volumes	0.15m	0.47m	1.27m	1.52m	-0.27m	3.14m
Revenues	-£0.09m	-£0.40m	-£1.02m	-£1.22m	£0.27m	-£2.46m

Table 9: Volumes and revenues for Presstream Standard

Source: Frontier Economics, Royal Mail

Presstream Profile

Table 10 shows the equivalent information for Presstream Profile services. It shows:

- volumes would be expected to fall by 11.9m items (compared to a 15.7m fall with the larger price rises under Royal Mail's February application); and
- revenues would be expected to rise by £5.1m (compared to a £7.2m rise under Royal Mail's February application).

The table also shows that the volume fall in London (where it is predicted to be biggest) would reduce to 10.72m items from 11.67m items under Royal Mail's February application.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change relative to initial volumes and revenues</i>						
Volumes	-10.72m	-0.23m	-0.15m	0.35m	-1.17m	-11.92m
Revenues	£3.88m	£0.20m	£0.19m	-£0.19m	£0.99m	£5.07m

Table 10: Volumes and revenues for Presstream Profile.

Source: Frontier Economics, Royal Mail

All bulkmail products

Over all bulkmail services in the application, the higher impact case is predicted to lead to a:

- 9m item fall in volumes (compared to a 16m fall in our July report); and
- £2.5m increase in revenues (compared to an increase of £7.1m in our July report).

3.3 Comparison of the two cases

The overall changes across all zones in the two cases look broadly similar. Within zones however, there is more variation in volumes between the two cases.

Presstream Standard

Table 11 compares the higher impact and lower impact scenarios for Presstream Standard services. In individual zones, volume changes are generally larger under the independent zones scenario (upper benchmark case). This is because the zonal price change (to which customers respond in the higher impact case) is generally larger than the average price change across all zones (to which mailers respond in the lower impact case). The one exception is the London zone where the zonal price change is actually smaller than the average price change.

Since the volume response is generally larger in the upper benchmark case, the revenue changes tend to be lower, as volume increases partially offset price reductions and vice versa.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change to current volumes</i>						
No change in zonal mix	0.48m	0.17m	0.72m	0.90m	0.62m	2.88m
Independent zones	0.15m	0.47m	1.27m	1.52m	-0.27m	3.14m
<i>Change to current revenues</i>						
No change in zonal mix	£0.06m	-£0.50m	-£1.20m	-£1.41m	£0.65m	-£2.40m
Independent zones	-£0.09m	-£0.40m	-£1.02m	-£1.22m	£0.27m	-£2.46m

Table 11: Bulkmail volumes and revenues for Presstream Standard under the high and low impact cases.

Source: Frontier Economics, Royal Mail

Presstream Profile

Table 12 compares the low and high impact scenarios for Presstream Profile. Again, the differences between the two scenarios in individual zones are greater than the differences overall. The largest differences are in London. This is because Presstream Profile experiences an average price rise in London of 65.2%, larger than the average price rise of 9.4% experienced by Presstream Profile over all zones.

	London	Zone A	Zone B	Zone C	Zone D	Total
<i>Change to current volumes</i>						
No change in zonal mix	-1.55m	-0.62m	-2.15m	-2.78m	-1.87m	-8.98m
Independent zones	-10.72m	-0.23m	-0.15m	0.35m	-1.17m	-11.92m
<i>Change to current revenues</i>						
No change in zonal mix	£7.61m	£0.07m	-£0.53m	-£1.34m	£0.74m	£6.54m
Independent zones	£3.88m	£0.20m	£0.19m	-£0.19m	£0.99m	£5.07m

Table 12: Bulkmail volumes and revenues for Presstream Profile under the low and high impact cases.

Source: Frontier Economics, Royal Mail

4. SWITCHING TO OTHER ROYAL MAIL PRODUCTS

The introduction of zonal pricing may encourage customers to switch between Royal Mail services that will be zonally priced and Royal Mail services that will remain uniformly priced. This could happen in two ways:

- in Zones A-C (where zonal prices will fall), mailers might switch out of uniformly priced services into zonally priced services; and
- in London and Zone D (where zonal prices will rise) mailers might switch out of zonally priced services into uniformly priced services.

We do not consider it likely that significant volumes of mail will switch to or from Presstream services for the following reasons.

- Presstream is currently cheaper than the likely uniformly priced substitutes. Customers who have not already switched are therefore likely to be prevented from doing so by the minimum editorial content requirements. As this will not change with the introduction of zonal prices, few additional customers are likely to switch to Presstream.

- Similarly, in our July report we found that all potential substitutes for Presstream which will remain on the uniform tariff are at least 5% more expensive, while the largest zonal uplift is only 4.8%. Extra price reductions for Presstream services will make Presstream more attractive relative to the uniformly priced substitutes, and therefore customers are unlikely to switch away from Presstream.

4.1 Transition period

Royal Mail is proposing to have a six month transition period during which both uniform and zonal tariffs will be available. For most products, this creates an opportunity to arbitrage between the two tariffs by using zonal tariffs for zones A, B and C (where there are zonal discounts) and using the uniform tariffs for zone D and London (where there are zonal uplifts).

The proposed changes in price for Presstream mean that this type of arbitrage is unlikely to be relevant for most Presstream customers. Instead, the price change is likely to determine the time at which customers switch to the zonal tariff.

- Almost all Presstream Standard customers would be better off under the new zonal tariffs than under the existing uniform tariffs. Many large letter prices would fall and there are only a few combinations of zones and product where prices will be higher under the new zonal tariffs. In this case, Presstream Standard customers are likely to switch to the new zonal tariff as soon as possible.
- By contrast, almost all Presstream Profile customers would be better off under the existing tariff. They are therefore not likely to switch to the zonal tariff until the end of the transition period. Since we predict Royal Mail will earn extra revenues of £5.07m-£6.54m in a typical year by moving customers to zonal prices, this would mean that Royal Mail would only earn half the additional revenues, or £2.54m-£3.27, in the first year for which zonal prices are introduced.
- Royal Mail also predicts that it would earn extra revenues of £5.07m in typical year by moving customers to zonal prices and assumes that all Presstream Profile customers would switch only at the end of the transition period. This would imply that Royal Mail should also predict additional revenues of £2.54m for the first year of zonal prices. However, there is an error in Royal Mail's Zonal Tariff Model which over-estimates the loss of revenue associated with the transition period. Consequently, Royal Mail's model predicts additional revenues of just £1.45m for the first year of zonal prices.

5. ENTRY

In our July report, we provided results from our Competitive Postal Market Model (CPMM) showing the estimated impact of zonal pricing on entry and Royal Mail's market share. The changes made to Presstream Profile in Royal Mail's revised application will not materially affect the estimates of entry we would derive from the CPMM and we have therefore not re-run any scenarios, although we repeat our conclusions here for completeness.

In the July report, we stated that the introduction of zonal bulkmail prices would limit the scope for mailers to practise arbitrage by splitting individual mailings between bulkmail and access products. If this arbitrage is moderately widespread at present, we estimate that the introduction of zonal bulkmail prices would:

- increase bulkmail volumes by 63 million items and revenues by £20.6 million (if access prices keep their existing zonal definition); and
- increase bulkmail volumes by 102 million items and revenues by £29.4 million (if access prices adopt the zonal definition proposed for bulkmail prices).

However, if there is currently little arbitrage between retail and access services, we found that the introduction of bulkmail zonal prices (which would tend to reduce the price variation across zones between retail and access products) would have a smaller impact on entry. These estimates consider a typical year and therefore exclude the impact of the transition period.

These estimates reflect the expected price changes contained in Royal Mail's February application. They therefore embody the larger increases in average revenues assumed for Presstream under the earlier application.

6. CONCLUSION

This final section updates our conclusions about the volume and revenue impact of the introduction of zonal prices across all bulkmail products, taking account of the revised prices for Presstream products in Royal Mail's July application.

Average price changes

Across all bulkmail products, the introduction of zonal prices would increase revenues by £6.78m (over a typical year with no transition period) if there were no change in volumes, based on the revised prices in Royal Mail's July application. This is approximately half the £13.97m that was expected under Royal Mail's February application. The difference is due to lower prices for Presstream Standard and for Presstream Profile.

Volume response to price changes

The introduction of zonal pricing is also likely to affect the volume of mail that customers send. We have presented two possible scenarios in which customers react to zonal prices in different ways.

- Under our lower impact scenario, customers are assumed to react only to the average price change for each product across all zones and to keep the zonal mix of their mail unchanged. In this case, the introduction of zonal prices would now be predicted to increase Royal Mail's bulkmail revenues by £4.3m and to reduce bulkmail volumes by 6.3m over the course of a typical year. These changes are smaller than the £8.9m increase in revenues and 12.5m item reduction in volumes envisaged under the February application.
- Under our higher impact scenario, customers are assumed to react to price changes for each individual zone. In this case, Royal Mail's revenues would

be predicted to increase by £2.5m under the revised application over the course of a typical year, compared to a predicted £7.1m increase on the basis of the February application. The reduction in Royal Mail volumes is now predicted to be 9m items, compared to the 16m item fall predicted for the February application.

Market entry

The largest market impact of introducing zonal prices is still predicted to be the effect on market entry. The price changes that Royal Mail is proposing to make to Presstream are not expected to materially affect the assessment of market entry we carried out in our July report where we predicted that the introduction of zonal prices could:

- increase Royal Mail's bulkmail volumes by up to 63m-102m items; and
- increase Royal Mail's bulkmail revenues by up to £20.6m-£29.4m.

The variation in these estimates depends on the extent to which customers currently split mailings between Royal Mail's end to end and access services, and on whether Royal adopts a common zonal definition for bulkmail and access prices.

These estimates also embody the impact of price changes and a volume response (based on our higher impact scenario), based on the expected price changes contained in Royal Mail's February application. They therefore include the larger increases in average revenues assumed for Presstream under the earlier application. If the revised Presstream prices were included, the predicted increase in revenues would fall by around £5m (the difference between the revenue increases in the higher impact scenario described above under the February and July applications).

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