



# **APPLICATION UNDER LICENCE CONDITION 21 FOR APPROVAL TO OFFER GEOGRAPHIC ZONAL PRICES FOR BULKMAIL SERVICES**

**5 July 2006**

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## Overview

Under the European Postal Services Directive (the “Directive”)<sup>1</sup> there is an obligation on member states to ensure that the provision of the universal postal service is guaranteed. Under the terms of the Postal Services Act 2000 (the “Act”), Postcomm has issued Royal Mail with a postal services licence that requires it to provide a universal postal service within the UK<sup>2</sup>. This includes a requirement to provide a service of conveying relevant postal packets from one place to another by post and the incidental services of receiving, collecting, sorting and delivering such packets at affordable and geographically uniform prices throughout the United Kingdom<sup>3</sup>.

Royal Mail’s Licence has been modified in order to designate the following services as discharging Royal Mail’s obligations to provide a universal postal service which includes services for letters posted individually and in bulk (sorted and unsorted), registered and insured services and services for letters posted to and from addressed outside the UK<sup>4</sup>: First and Second Class public tariffs (stamped, metered and PPI mail), Cleanmail 1st and 2<sup>nd</sup> class (OCR and CBC), Mailsort 1400 1st and 2<sup>nd</sup> class, Standard Parcel, Special Delivery (Next Day)<sup>5</sup>, Airmail Europe and Zones 1 and 2 and Surface Mail. Consequently, Mailsort 120 (all classes), Mailsort 700 (all classes), Mailsort 1400 (third class), Walksort (all classes) and Presstream (all classes), amongst other things, are not required to be provided as part of the universal postal service.

Under the Act, Postcomm has a primary duty to ensure the provision of the universal service<sup>6</sup>. Subject to this duty it has a duty to exercise its functions in the 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, and in so doing have regard to, amongst others, the interests of individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes and individuals residing in rural areas. Subject to these two duties Postcomm is required to promote efficiency and economy on the part of postal operators. Further it has a duty to ensure that licence holders are able to finance activities authorised or required by their licences.<sup>7</sup>

In undertaking its duties, Postcomm has opened up the postal market in the UK to competition from 1 January 2006. Geographical zonal pricing, where charges are lower for delivery to high-density areas than low-density areas, is already applied to Condition 9 Access Services that are available to bulk mail customers either directly or through other postal operators. Consequently, other postal operators have the potential to offer lower prices for services to high-density areas. Under the terms of the recently modified Licence<sup>8</sup>, this option is denied to Royal Mail Letters without the approval of Postcomm. The requirement to price uniformly prevents Royal Mail Letters

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<sup>1</sup> Directive 97/67/EC on the common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2002/39/EC and regulation (EC) No. 1882/2003

<sup>2</sup> Condition 2 of Royal Mail’s Licence dated 23<sup>rd</sup> March 2001, as amended.

<sup>3</sup> Except in such geographical or other circumstances as Postcomm has designated as exceptional.

<sup>4</sup> Condition 2 (1), (2) and (3) of Royal Mail’s Licence, as modified with effect from 25 May 2006.

<sup>5</sup> Other than when sold to users having an account with Royal Mail buying the service using their account

<sup>6</sup> Section 3 (1) Postal Services Act 2000

<sup>7</sup> Section 5 Postal Services Act 2000

<sup>8</sup> May 2006, Condition 21 (17) and (18)

competing to service this mail, thereby exposing the business to the loss of this mail to downstream access or bypass and associated adverse financial consequences.

To promote effective competition between postal operators and enable the licence holder to be able to finance activities authorised or required by its Licence, it is necessary to allow Royal Mail to compete for this mail. The modified Royal Mail Licence facilitates this by expressly providing the scope for Royal Mail to apply to Postcomm to introduce geographical zonal pricing for end-to-end services. Specifically, the modified Licence Condition 21 states, under the heading "Geographic price uniformity" in paragraphs 17-19:

*"(17) Subject to paragraphs 18 and 19, in relation to each of the Controlled Services that are not required by Condition 2 to be provided as universal services (except Access Services priced on a zonal basis and provided under contracts entered into on or before 1 April 2006 and any Access Service subsequently provided under a contract having all the terms referred to in paragraphs (i) to (xii) of paragraph 2(b) of Condition 9 in common with such a contract) the tariffs under which the services are offered shall be geographically uniform.*

*(18) The Licensee may apply to Postcomm in writing at any time for approval to offer any of the Controlled Services on a tariff under which prices are not geographically uniform and where Postcomm has confirmed by notice in writing that it has been provided by the Licensee with sufficient information of good quality to consider the application then paragraph 19 shall apply.*

*(19) Where this paragraph applies, if Postcomm has not, after consultation with the Council and with such other persons as it sees fit, and after consideration of such further information (if any) as it may require to be furnished, within nine months of the date of giving notice under paragraph 18, by determination in writing indicated that it is not satisfied that the change sought by the Licensee will –*

- (a) be revenue neutral,*
  - (b) lead to prices for the service being more reflective of costs than they would be if the existing geographically uniform tariff were retained,*
  - (c) be introduced in a manner that avoids unreasonable changes for users of the service, and*
  - (d) not lead to a circumvention of paragraph 1, and*
  - (e) not lead to a failure to provide services priced in a manner referred to in the Directive,*
- then the Licensee may change the tariff structure for the service to one in which prices are not geographically uniform in the manner proposed in its application."*

This document is an application by Royal Mail under Licence Condition 21 (and specifically paragraphs 17 to 19) to introduce non-geographically uniform (ie zonal) prices for certain bulk mail services and to shortly thereafter remove the uniform tariff pricing options for those services thereby achieving the replacement of services that are currently uniformly priced, within the Regulated Services of Basket B, by geographically zonal prices. More specifically, the application is in respect of the services within Controlled Services 19 to 24, 29 to 30 and 35 to 38 as set out in Licence Condition 21(38). These services are not designated as fulfilling the specific universal service obligations in Condition 2. The application also proposes the replacement of the current Presstream Profile service under Controlled Services 29 and 30 in order to accord with the new geographical zonal pricing structure whilst retaining the multi-copy pricing element. The application involves non-price changes to these services, relating to Condition 21(2-4). It includes the withdrawal of Presstream Premium as a standard product (which has been treated as a Regulated Service) and move to a bespoke basis, relating to Condition 21(1). In addition, the application seeks amendment to Condition 21(22) relating to the sub-cap provision within Royal Mail's Licence for the years following the introduction of zonal pricing before 1 April 2010.

Through this application, Royal Mail proposes that the zonally priced services are introduced whilst retaining the uniformly priced service, with the latter being withdrawn from service 6 months later. Hence a two-stage replacement programme is proposed.

The remainder of this document outlines information for this application relating, amongst other elements identified above, to the requirements set out in paragraph 19 of Licence Condition 21, and the non-price terms, that are subject to the review and approval of Postcomm. Postcomm reviewed Royal Mail's application for 'pricing in proportion' (2003) against similar requirements. Royal Mail has sought to apply a similar approach to this application.

## Contents

<b>Section</b>		<b>Page</b>
	<b>Overview</b>	
<b>1.</b>	<b>The Services Proposed for Change</b>	<b>6</b>
<b>2.</b>	<b>Proposed Structure and Pricing</b>	<b>8</b>
<b>3.</b>	<b>Non Price Terms and Conditions</b>	<b>13</b>
<b>4.</b>	<b>Meeting the Requirements of Licence Condition 21</b>	<b>15</b>
<b>Annex 1</b>	<b>Definition of Pricing Zones</b>	<b>21</b>
<b>Annex 2</b>	<b>Direction of expected volume movements between zonally priced services and uniformly priced services</b>	<b>23</b>

## 1. The Services Proposed for Change

This document is an application by Royal Mail under Licence Condition 21 (in particular paragraphs 17 to 19) for the introduction of zonally priced variants of certain Controlled Services and the subsequent withdrawal of the existing uniform tariff pricing variants, such that those currently uniformly priced services within the Controlled Services of Basket B are replaced by the geographic zonal prices. More specifically, the application applies to those Controlled Services listed in Table 1.1. These Controlled Services have not been designed by Royal Mail's Licence as fulfilling the universal service obligations set out in Condition 2 of that Licence.

**Table 1.1: Replacement of uniformly priced services with geographic zonally priced services**

Controlled Service number in Condition 19(21)	Controlled Service	Comment
19	Mailsort 120 OCR 1 <sup>st</sup> Class	
20	Mailsort 120 CBC 1 <sup>st</sup> Class	
21	Mailsort 120 OCR 2 <sup>nd</sup> Class	
22	Mailsort 120 CBC 2 <sup>nd</sup> Class	
23	Mailsort 700 1 <sup>st</sup> Class	Including Direct and Residue
24	Mailsort 700 2 <sup>nd</sup> Class	Including Direct and Residue
29	Presstream 1 <sup>st</sup> Class	Including: Presstream Standard and Presstream Profile; Direct and Residue; and Presstream >250k. <sup>9</sup>
30	Presstream 2 <sup>nd</sup> Class	Including: Presstream Standard and Presstream Profile; Direct and Residue; and Presstream >250k
35	Walksort 1 <sup>st</sup> Class	
36	Walksort 2 <sup>nd</sup> Class	
37	Mailsort 3 700	Including Direct and Residue
38	Mailsort 3 1400	Including Direct and Residue, and Flatsort 3 1400 Direct and Residue

Note: A corresponding change will be implemented for Mailsort 3 120, though this is not a Regulated Service and therefore not subject to approval by Postcomm under Royal Mail's Licence.

This application includes the replacement of the current Presstream Profile service under Controlled Services 29 and 30 to accord with the geographical zonal pricing structure whilst retaining the multi-copy pricing element. Further, the Presstream Premium service, which has a single customer, will transfer from its existing status to a bespoke service. These options to the main Presstream service have relatively few customers. Nevertheless, it is important that these options are not overlooked and hence they are discussed in more detail below.

**Presstream Profile:** Royal Mail's Presstream service is a bulk mail service for publishers with a minimum editorial content qualification. Profile Pricing was introduced in September 1993 and granted additional discounts from the standard Presstream prices for delivery in city centres. The profile discount applicable to a standard price is predicated on the subscription list of publications remaining relatively static. A multi-copy element was introduced into Profile Pricing in April 1996. The Profile Pricing discount is thus based on a synthesis of two factors:

<sup>9</sup> Presstream Premium will transfer status to a bespoke service.

- (a) The geographic profile generated by the proportion of the items mailed being addressed to specific postcode areas.
- (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, the current pricing of the Presstream Profile service would overlap with the proposed zonal pricing for the 1<sup>st</sup> and 2<sup>nd</sup> Class Presstream services, being designed to some extent to achieve the same end state for the customer. Accordingly, Royal Mail's application to offer zonal prices includes the removal of the current profile pricing mechanism of Presstream Profile : the geographic pricing element to be substituted by the new zonal pricing mechanism. The geographic element, which is currently static (reviewed annually), and based purely on a discount to city centres, would become a live pricing structure based on discounts and surcharges to the defined postcode sectors under zonal pricing. This will standardise the approach to geographic pricing with other Royal Mail services, for the ease of the customer.

In addition, the multi-copy element, available on application, will be introduced as a stand-alone multi-copy discount available with all 1<sup>st</sup> and 2<sup>nd</sup> Class Presstream services. The multi-copy element would be static (reviewed annually) and would be a discount applied after the mailing had been zonally priced. The multi-copy element would be derived from the following formula: Discount % = 20% \* (1-M), where M = (Number of Delivery Points) / (Number of Delivered Items).

**Presstream Premium:** This is a bulk mail option for publications which enables customers to deliver<sup>10</sup> pre-sorted and prepared items to Royal Mail at specified times where Royal Mail aims to deliver those items the following morning. Accordingly the customer pays a higher price for this option<sup>11</sup> than would otherwise be the case. The option can only be provided by certain Mail Centres serving selected postcode areas such that it has only ever been available with Royal Mail's prior agreement.

The option has been available for over five years and currently only has one customer. Even though the availability of the option is published on Royal Mail's website, product literature and 'The Sum of It'<sup>12</sup> there has only ever been minimal interest in it.

Presstream Premium is currently treated as a part of the Presstream 1 group of Regulated Services under Condition 21. In this application, Royal Mail seeks Postcomm's agreement to Presstream Premium no longer being treated as a Regulated Service and thus falling outside the remit of Condition 21. Royal Mail intends to continue providing the service to the existing customer and to negotiate in good faith with any customer who wishes to use the service. There are no plans to change the existing customer's current pricing although when the contract comes up for renewal the customer would be offered a price using the zonal pricing methodology.

As Presstream Premium has only ever been available on a limited basis its removal from the scope of Regulated Services would not have any major impact under Condition 21 (1). Furthermore, withdrawing the current revenue (below £1 million p.a.) will have limited effect on calculations of allowed revenue for the price control baskets<sup>13</sup>.

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<sup>10</sup> No Royal Mail collections for this service

<sup>11</sup> The 0-60g weight price is 23.3p per item and thereafter priced on a straight-line basis. The service is priced at the 1<sup>st</sup> Class Presstream Price without any sortation discounts, but the customer is required to pre-sort the mail 1400 ways. A Presstream profile discount is then allowed in addition to this.

<sup>12</sup> For example, 'The Sum of It' tariff guide was sent to over 400,000 business customers.

<sup>13</sup> Presstream 1 is part of Basket B.

## 2. Proposed Structure and Pricing

### 2.1 Geographic zones

This application uses the same five geographic zones that are applied for Royal Mail's geographic zonally priced Condition 9 Access Service. As with Condition 9 Access therefore the zones are defined in terms of delivery destination, not the distance that mail travels or origin of mail. The zones are identified by postcode with the postcode sector, represented by the first numeric digit of the inward area code eg [BN1 6]YD, used to define the zones. At the time of developing the zonal Condition 9 Access terms, this was preferred over the alternatives of postcode area (BN), postcode district (BN1), or postcode unit (BN1 6YD). The postcode sector significantly improves cost reflectivity (much more so for example than using the postcode area) without becoming too impractical (this may have been the case if we used postcode units). The number of zones is limited to the five used for Royal Mail's geographic zonally priced Condition 9 Access Service to facilitate understanding and price comparison, and to ensure that the geographic zonal pricing is relatively easy to implement and understand.

It is important that the mapping of postcodes to zones is transparent, such that a clear set of objective and measurable rules is applied in a consistent and mechanistic fashion. Each of the five zones encompasses areas with similar characteristics and delivery costs. Delivery costs are segmented into five categories; Delivery Point Density and Business Density provide a suitable proxy for delivery costs. Zones are allocated based on the Delivery Point Density (DPD) and Business Density (BD) of the postcode sector, using the rules shown in Table 2.1.

**Table 2.1: Algorithm used to associate Delivery Point Density and Business Density to Zones**

Zone	Name	Business Density	Delivery Point Density
A	Business District	Greater than 10%	Greater than 500 per km <sup>2</sup>
B	High Density	NA	Greater than 1000 per km <sup>2</sup>
C	Average Density	NA	Greater than 100 per km <sup>2</sup> And Less than/equal to 1000 per km <sup>2</sup>
D	Low Density	NA	Greater than 10 per km <sup>2</sup> And Less than/equal to 100 per km <sup>2</sup>
E	Very Low Density	NA	Less than/ equal to 10 per km <sup>2</sup>

The analysis<sup>14</sup> carried out by Royal Mail for the deployment of Condition 9 Access zonal pricing identified three breakpoints for defining zones: at Business Density equal to 10%; and Delivery Point Density equal to 10 per km<sup>2</sup> and 100 per km<sup>2</sup>. These breakpoints support four zones. A further breakpoint, at Delivery Point Density equal to 1000 per km<sup>2</sup>, was added to establish a middle zone with approximately the same unit cost as the national average.

<sup>14</sup> See Annex 1: The Definition of Pricing Zones for an overview of the methodology used to define Zonal Pricing Zones

## 2.2 Costing Analysis

Postcomm’s review of Royal Mail’s application for ‘pricing in proportion’ included an extensive review of Royal Mail’s Activity Based Costing (ABC) system and the costs underlying the proposed change to the structure (including an adjustment to the ABC costing data). Royal Mail recognises that the approach to costing is an important element of the current application. This is summarised below with further information in Annex 1.

For this application an adjustment is made to the average delivery costs that are produced by Royal Mail’s ABC system, such that the delivery cost in zone  $i$ ,  $c_i$ , is given by

$$c_i = c + (c_i^{del} - c^{del})$$

where  $c$  is the national average delivery cost sourced from the ABC system,  $c_i^{del}$  is the adjusted cost in zone  $i$  for the subset of activities that have non-uniform geographical costs, and,  $c^{del}$ , is the national average cost for these activities (as sourced from the ABC system).

**Table 2.2: Zonal costing drivers**

Activity/cost	Cost driver and application
Local distribution (conveying mail from inward mail centre to local delivery office)	<p><b>(a). Average journey length (distance) between Mail Centre and Delivery Office (DO).</b> Distances are measured as straight-line between map co-ordinates and should be very accurate. The simplified approach ignores vehicle fills and this could underestimate the cost differential between zones (vehicles to remote DOs and Scale Payment Delivery Offices are likely to be less full).</p> <p><b>(b). Total volume delivered in each zone</b> Measured using fall-to-earth data from Royal Mail’s Mails Characteristics Survey (MCS). This 5-way split of national volume is not dependent on DO traffic measurement system that is known to have data quality issues.</p>
Outdoor delivery – staff	<p><b>(a). Total outdoor delivery costs recorded at Delivery Offices in each zone</b> This approach is reliant on the quality of Resource Control System data. However, offices are aggregated up to the 5 delivery zones and therefore individual observations that are inaccurate should “average out” (assuming there is no bias in measurement error across zones). The outdoor costs by zone reflect “actual” differences in the average time taken to deliver each mail piece. The unit delivery time is higher in rural areas because of increased travel distance between delivery points and because rural delivery does not benefit from the same economies of scale (high volumes per delivery point) as more commercial areas. The outdoor costs by zone also reflect differences in regional pay rate.</p> <p><b>(b). Total volume delivered from Delivery Offices in each zone</b> Weighted volumes measured by DOs. Data quality issues are minimised by aggregating volumes to the level of 5 zones (results are almost identical to MCS fall-to-earth).</p>
Outdoor delivery – vehicles	<p><b>(a). Total vehicles registered at Delivery Offices in each zone</b> Sourced from the vehicle asset register with anomalies (of which there were few) resolved using Delivery Office Base Information (DOBI) and walk data. The number of vehicles registered at each office reflects the average travel distance between delivery points in the area. Offices in low population areas are more dependent on vehicle transportation to ensure every delivery point can be visited on every day. The simplified approach ignores the average mileage travelled by vehicles in each zone – this could understate the cost differential between zones because rural vehicles are likely to travel a greater distance and incur higher fuel costs.</p> <p><b>(b). Total volume delivered from Delivery Offices in each zone</b> Weighted volumes measured by DOs. Data quality issues are minimised by aggregating volumes to the level of 5 zones (results are almost identical to MCS fall-to-earth).</p>

Several activities have costs that are variable by geography. These are shown in Table 2.2 together with the cost drivers that are used to apportion costs to delivery zones (and a summary of the data issues involved). Other activities not mentioned in the table are assumed to have geographically uniform costs, e.g. indoor office work<sup>15</sup>.

It is noted that the approach potentially understates the cost differential between zones in the following ways:

- (a) The costing is done at a delivery office level rather than at the more disaggregated postcode sector level at which the zones are defined. Delivery office areas can cover a number of different zones and therefore the extremes of delivery geography will tend to be “averaged out”.
- (b) The costing data for Scale Payment Delivery Offices (the smallest delivery units) that tend to be located in the most outlying or rural areas is often incomplete; therefore this granular information has been consolidated into the appropriate parent delivery office.

The approach supports a significant variation in cost between zones. The costing analysis in this application uses 2004/05 Fully Allocated Cost (FAC) costing data (including Postcomm’s weight driver adjustment to the ABC costing data updated with 2004/05 data<sup>16</sup>). Zonal is added as an overlay<sup>17</sup>. Table 2.3 shows the resulting variation in delivery costs per zone and indicates the price differentials in pence that could be applied between zones to be more cost reflective. It shows the difference between Zone A and E to be 10.3 pence.

### **Table 2.3: Delivery costs by zone**

Confidential table removed

## **2.3 Discount and surcharge levels**

To simplify customer communication geographic zonal prices will be presented as a discount from, or surcharge on, the price in the Average Density Zone C, with Zone C representing the existing geographically uniform tariff price<sup>18</sup>. The prices for Zones A and B will be shown as discounts from the geographic average price to reflect lower delivery costs whilst the prices for Zones D and E will be shown as surcharges to reflect higher delivery costs.

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<sup>15</sup> Indoor delivery office work includes receiving mail from Inward Mail Centres, sorting it to delivery route and then sequencing the mail in route order. The time taken to perform these activities is relatively independent of the geographical location of delivery offices (the time required to sort a letter to a selection should be the same in all delivery offices). An exception to this rule might be made for mail destined for rural areas which is likely to require additional sorting.

<sup>16</sup> See Postcomm’s decision document on ‘Pricing in Proportion’, Royal Mail’s Proposals for Pricing in Proportion: A Decision Document.

<sup>17</sup> Options are being explored to enable the costing system to produce required outputs to support zonal pricing in the future.

<sup>18</sup> Licence Condition 21 (5) (b) (ii) requires that where Access Services are not priced on a geographically uniform basis, then the access prices are to be set by reference to zones and “for each Price Range in respect of each service, the zone C price shall equal the uniform national [access] price” calculated in accordance with para (1) of that sub-condition. Though there is no such requirement for retail zonal prices, this application adopts the same constraint of the zone C price equating to the uniform tariff price for the introduction of retail zonal prices.

The introduction of zonal prices will introduce three potential areas of arbitrage, which would leave Royal Mail exposed over its ability to recover the costs of providing its service requirements. These are potentially in areas where:

- (a) the zonally priced service for Zones A & B has prices that are less than the prices of the uniformly priced service and the prices of the uniformly priced service for Zones D & E are less than the prices of the zonally priced service.
- (b) the prices of the uniformly priced service of a close substitute service are lower than the zonally priced service for Zones D & E. See Annex 2 for the direction of expected volume movements between uniformly priced and zonally priced services.
- (c) the prices resulting from combining Royal Mail's Condition 9 Zonal Access Services with upstream cost are higher or lower than the zonally or uniformly priced retail service from Royal Mail Letters.

The first of these arbitrage opportunities (a) is addressed through this application by the proposal to replace the uniformly priced service by the zonally priced service (i.e. withdraw the uniformly priced option). The second arbitrage opportunity (b) is a market distortion created by the retention of the requirement for some of Royal Mail Letters' services to remain uniformly priced, and could be addressed with the lifting of this requirement. The third arbitrage opportunity would not exist if the zonal prices for Royal Mail Letters fully reflected the variation in delivery cost, but arise where the arbitrage opportunity of the uniform pricing requirement in (b) acts as a constraint on the ability for Royal Mail Letters to more fully reflect delivery costs in its zonal prices.

Royal Mail Letter's zonal prices that mirror the more cost reflective zonal Condition 9 Access charges would yield price differences between zones akin to the cost differences in Table 2.3. Consequently within this application, Royal Mail applies for the scope to reach this within the period of the current control in steps before 1 April 2010 (see Section 4.7). The introduction of zonal prices in April 2007 will involve the establishment of the 5 separate zonal prices with smaller price differences across the zones than that shown in Table 2.3. Further, to keep the pricing structure simple and easy to understand at the time of the introduction of retail zonal pricing, the same percentage discounts and surcharges will be applied to all retail zonally priced services for its introduction.

The indicative discounts and surcharges for the introduction of zonal pricing are shown in Table 2.4, and range from a discount of 4.6% in Zone A to a surcharge of 7.3% in Zone E. The discounts and surcharges would mean that the zonal price for Mailsort 120 in Zone E is marginally below the Cleanmail price as shown in Table 2.5. On this basis the difference between the prices in Zones A and E will be about 2 pence, compared to the potential cost difference in Table 2.3 of 10.3 pence.

The discounts and surcharges at the time of the introduction of zonal pricing in April 2007, and subsequently within the current control period before 1 April 2010, may need to be amended to reflect developments between the timing of this application and final implementation, and are therefore indicative.

**Table 2.4: Zonal Pricing Discounts and Surcharges at the Introduction of Zonal Pricing**

Zones				
A	B	C	D	E
-4.6%	-1.6%	0%	+4.5%	+7.3%

Negative numbers are discounts off Zone C whilst positive numbers are surcharges on Zone C

**Table 2.5: Comparison of indicative prices for August 2006**

Service	Class	Geographic Uniform Price August 06 (£)	Zone D surcharge (%)	Zone D Price (£)	Zone E surcharge (%)	Zone E Price (£)
<b>Uniformly priced service</b>						
Cleanmail plus OCR	2	0.189				
Cleanmail plus CBC	2	0.185				
Mailsort 1400 Direct selection	2	0.185				
<b>Zonally priced service</b>						
Mailsort 120 OCR	2	0.1764	4.5%	0.1843	7.3%	0.1893
Mailsort 120 CBC	2	0.1743	4.5%	0.1821	7.3%	0.1870
Mailsort 700	2	0.1701	4.5%	0.1778	7.3%	0.1825

Table 2.6 shows the calculation that would be carried out in Royal Mail's Accounts Receivable System (SAP) to establish the price paid by the customer. Each bulk mail service has a base price that reflects class of service, weight and format. For example, the base price for a 3rd class large letter item weighing 343 grams is £0.383. SAP would deduct from this base price the sortation discount (in the example this corresponds to the 1400 way sortation); the machineability discount (in the example this is 0%); and the zonal discount. The sum of the values after the zonal and machineability criteria is the total price excluding volume related discounts (if applicable). The appropriate volume related discount is then deducted from this total to form the invoice total. The structure and order of this calculation was developed with a view to simplicity so as to aid transparency, easy of understanding, and replicability for customers.

**Table 2.6: Example of the calculation of charges with zonal pricing: Mailsort 3 1400<sup>19</sup>**

Service details						
Service	Mailsort 3					
Weight	343 gm					
Format	Large Letter					
Invoice		Volume (m)	Base price/item (£)	Sortation & machineability discount	Zone discount/surcharge	Total price
Zone A	Direct	5648	0.383	12%	4.6%	1,804.10
	Residue	562	0.383	7%	4.6%	190.28
Zone B	Direct	17895	0.383	12%	1.6%	5,921.67
	Residue	1254	0.383	7%	1.6%	438.98
Zone C	Direct	24864	0.383	12%	0%	8,380.16
	Residue	5687	0.383	7%	0%	2,025.65
Zone D	Direct	7894	0.383	12%	-4.5%	2,796.65
	Residue	2457	0.383	7%	-4.5%	917.51
Zone E	Direct	4589	0.383	12%	-7.3%	1,674.98
	Residue	3658	0.383	7%	-7.3%	1,405.22
No Zone	Residue	2369	0.383	7%	-7.3%	910.05
Invoice sub total						26,465.25
Volume related discount					3.7%	761.37
Invoice total						25,703.88

<sup>19</sup> Prices and discounts quoted in this example are for illustrative purpose only

### 3. Non Price Terms and Conditions

The change to the zonal pricing structure for bulk mail services will necessitate slightly different terms to the services in relation to the zonal pricing option. Consequently, this application includes a requirement to change the non price terms of some Controlled Services existing in the month ending 31 March 2006, relating to Condition 21(2-4). These are summarized in Table 3.1 and discussed further below.

**Table 3.1: 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	<input checked="" type="checkbox"/>
Zonal pricing	✓	✓	✓	✓	✓

For the zonal pricing structure each postcode sector is assigned to one of five zones. If zonal pricing were to be implemented manually, customer quoting and billing would be very time consuming and prone to errors<sup>20</sup>. Therefore customers will be required to interface electronically with Royal Mail (via ePro<sup>21</sup> or its successor Online Business Account (OBA)) to order zonally priced services and Royal Mail will dynamically price all mail items. Customers who currently use paper dockets will be required to change their interface with Royal Mail and paper dockets will not be available to customers purchasing a zonally priced service.

Whereas including the Standard Selection Code is currently optional, it will become mandatory to include Standard Selection Code and Zone Code on the mail piece and to provide the exact number of bags on the Line Listings. These requirements will facilitate mails verification (ie checking that the customer is paying the correct amount of postage and is complying with the terms of the service specification).

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 should be produced first, then Zone B, then Zone C etc. Bundles should be made as they are produced. A bundle can consist of more than one zone but not a random selection of zones.

To print the Standard Selection Code and Zone Code on the mail item and to produce the mail in zone order, customers will need to have their sortation software upgraded and accredited to carry out the necessary zonal processing. Customers who develop their own sortation software in-house will need to make the necessary amendments themselves. The cost for this software will vary according to the arrangement they have with their software supplier<sup>22</sup>. As with 'pricing in proportion', Royal Mail proposes not to fund the upgrade of this software but we consider that

<sup>20</sup> A manual approach to pricing would mean that Royal Mail would have to estimate a special price for each customer, based on historical data, with an ongoing three monthly review. This is a manual, time consuming, resource hungry process particularly in terms of set up within E\*Pro and the revenue systems and is therefore not scaleable into the future. This process also means that each individual mailing is not accurately priced, and thus could lead to under / over recovery of revenues relevant to that mailing's specific profile, which in itself could lead to potential disputes over invoices that would be avoided through Royal Mail's proposed approach.

<sup>21</sup> Royal Mail's electronic automated ordering platform for end-to-end customers.

<sup>22</sup> It is estimated that this cost would be in the region of £1500 per customer.

these changes are readily achievable by customers and will not prevent them accessing the services.

Residue selection via Post town matching will still be possible but as sortation takes place on the Postcode sector code these items will be assigned to Zone Z and priced at Zone E prices (the most expensive of the zones). The opportunity to post items that cannot be matched by postcode or post town will continue to exist. However, as with current practice in Royal Mail Letters these items will be charged at Public Tariff rates.

Changes to postcodes (i.e. introduction or cessation of postcodes) will be included in the Mailsort Database<sup>23</sup>. Royal Mail will release a new Mailsort Database monthly, but mandatory Mailsort Database changes will continue to be made no more than once a year.

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<sup>23</sup> The Mailsort Database is derived from PAF and responsibility of allocating zones to new postcode sectors rests with Royal Mail Letters. Similarly they are currently responsible for reviewing the appropriateness of the zoning allocation.

## **4. Meeting the Requirements of Licence Condition 21**

### **4.1 Introduction**

Royal Mail's Licence Condition 21(19) sets out the requirements that need to be satisfied for the introduction of zonal pricing as follows

*"Where this paragraph applies, if Postcomm has not, after consultation with the Council and with such other persons as it sees fit, and after consideration of such further information (if any) as it may require to be furnished, within nine months of the date of giving notice under paragraph 18, by determination in writing indicated that it is not satisfied that the change sought by the Licensee will –*

- (a) be revenue neutral,*
- (b) lead to prices for the service being more reflective of costs than they would be if the existing geographically uniform tariff was retained,*
- (c) be introduced in a manner that avoids unreasonable changes for users of the service, and*
- (d) not lead to a circumvention of paragraph 1, and*
- (e) not lead to a failure to provide services priced in a manner referred to in the Directive, then the Licensee may change the tariff structure for the service to one in which prices are not geographically uniform in the manner proposed in its application."*

The same Licence requirements were in place for the introduction of 'pricing in proportion'. Hence, the review and tests applied by Postcomm in that case provide the regulatory framework with which to assess this current application.

Royal Mail has developed a spreadsheet model for post 21 August 2006 prices to assess the revenue neutrality and cost reflectivity required by Licence Condition 21. This takes into account 'pricing in proportion' and is outlined further below.

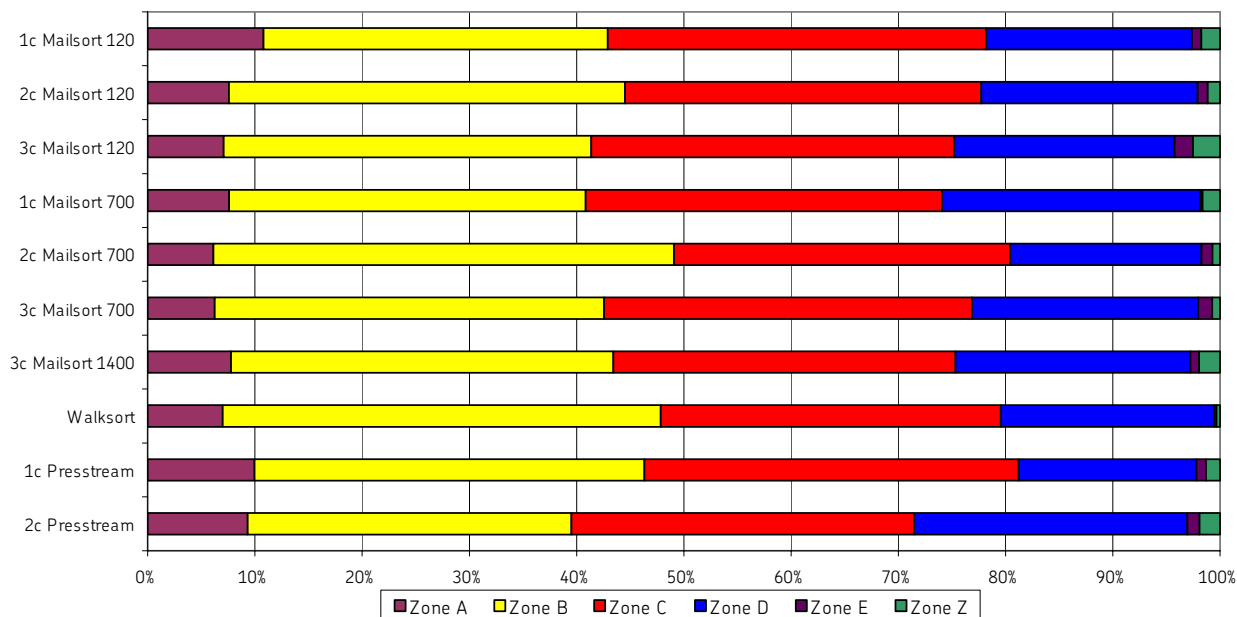
### **4.2 Revenue neutrality**

The model assesses the revenue neutrality of the services set out in Table 1.1. The zonal prices applied within the model are based on the uniform prices to be implemented on 21 August 2006 adjusted by the discounts and surcharges on the Zone C price set out in Table 2.4. The model uses a volume forecast of 2006/07 (post entry and switching). It uses an own price elasticity of  $-0.32$  for all the affected services and also takes account of the switching caused by the arbitrage associated with (a) discussed in Section 2.3<sup>24</sup>. The distribution of volumes by zones is available for each product group and is derived from the Royal Mail's Mails Characteristics Survey (2004/05). As Figure 4.1 shows 70% of volumes are delivered to Zones A, B and C.

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<sup>24</sup> The allowed revenue calculation applies forecast actual revenues and therefore takes account of all of the effects of entry and switching.

**Figure 4.1: Percentage of mail volumes by zone**



**Table 4.1: Volumes by Zone (000s), 2004/05**

Confidential table removed

### 4.3 Cost reflectivity

The approach adopted by Postcomm to assess the cost reflectivity of proposed “pricing in proportion” prices used a reference price from the Fully Allocated Costs (FAC) of Royal Mail’s costing system adjusted to reflect 2006/07 revenues. Royal Mail notes that the fully cost reflective price need not be the reference price based on the Fully Allocated Cost, but to be consistent with Postcomm’s previous approach for ‘pricing in proportion’ it has used the same approach to the reference prices in this application.

The costing analysis is based on the FAC costing data for 2004/05, which is the most recent full year of data available. Zonal cost differences are overlaid onto these costs.

The cost reflectivity calculation squares the difference between the old price and the reference price and multiplies by the relevant volumes. This is then compared with the same measure for the new price (summing over the various prices to the relevant level of aggregation). A ratio of the two figures in excess of 1 indicates that the new price is closer to the reference price and is taken to be more cost reflective. Over all services and prices the coefficient is 1.08, demonstrating that the new price structure is more cost reflective than the existing price structure. Table 4.2 shows the cost reflectivity ratios for individual services.

**Table 4.2: Cost reflectivity by service**

Service	Cost Reflectivity
Mailsort 1 120 OCR	1.02
Mailsort 1 120 CBC	1.02
Mailsort 1 700	1.00
Mailsort 2 120 OCR	1.16
Mailsort 2 120 CBC	1.26
Mailsort 2 700	1.54
Mailsort 3 700	1.50
Mailsort 3 1400	1.03
Walksort 1	1.04
Walksort 2	1.30
Presstream 1 Standard	1.04
Presstream 2 Standard	1.03
Presstream 1 Profile	1.34
Presstream 2 Profile	1.26
Presstream 2 >250k	1.01

#### 4.4 Changes for users of the service

Licence Condition 21(19) identifies a period of 9 months for Postcomm to make a decision on an application once it has received sufficient information of good quality. Royal Mail, in addition to this application, is providing additional detailed information to enable Postcomm to make an early assessment of any additional information requirements.

Royal Mail proposes to introduce zonal pricing in April 2007, seven months after the introduction of pricing in proportion in August 2006. Given this 9-month timescale from this application, Royal Mail proposes that the launch is followed by a 6-month period to enable customers to migrate from the uniformly priced service to the zonally priced service. To complete the replacement of the uniformly priced service by the zonally priced service at the end of this migration period the uniformly priced services will cease. Table 4.3 summarises the key deployment dates for this.

**Table 4.3: Key implementation dates**

Activity	Date
Publish final zonal prices for April 2007	December 2006
Launch zonal prices	April 2007
Launch multi-copy Presstream discount	April 2007
Withdraw Presstream Premium from regulated services	April 2007
Migration Period	April – September 2007
Cease uniformly priced services	October 2007

To facilitate the introduction of the non-price terms and conditions in Section 3, the migration will consist of three strands as follows:

- (a) **Software upgrades:** Customers will be required to access the upgraded Mailsort Database and acquire the new Sortation Software. A revised Mailsort User Guide is available to software suppliers detailing software changes required. An Upgraded Mailsort Database is available free of charge on the Mailsort technical web site to enable static upload of all existing postcode sectors and allocated zonal definition. As software is accredited it will be added to a list of upgraded sortation software which will be available to customers.

- (b) **Mail preparation training:** Customers will be required to print SSC code and zonal indicator on each item and print and bundle mailings in zone order. A Mailsort User Guide is available detailing mail preparation requirements. For the period December 2006 to September 2007, there will be technical communication and a helpline to advise customers and mailing houses.
- (c) **Training on ordering and billing changes.** Customers will be required to order zonally priced services through either Electronic Dockets Standard or Bulk Import Facility. From April 2007, zonally priced options appear on ePro and OBA (online business account) screens and zonally priced invoicing deployed.

For April 2007 introduction, customer communication will start in December 2006 with the publication of prices and continue throughout the migration period to September 2007. The communication plan will be driven by two main considerations:

- (a) zonal pricing mainly impacts account managed business customers. Efforts will therefore focus on training account managers and their support staff to enable them to communicate directly with their customers. Tools will be provided to enable account managers and customers to assess the financial impact of zonal pricing (see below). Royal Mail Letters' Business Development team will develop and manage the communications plan for customers in Segments H-U who may not be account managed.
- (b) the communication plan needs to detail the operational requirements associated with zonal pricing. Communication will therefore be with software suppliers and mailing agents as well as customers directly. Communication will primarily be by e-mail. All the technical information will be available on the web site and a new A-Z page will be created.

To enable customers to assess the financial impact of zonal pricing, Royal Mail will make the following tools available:

- (a) the Mailsort Pricing calculator (available at [www.mailsorttechnical.com](http://www.mailsorttechnical.com)) will be extended to allow customers to calculate the cost of services with zonal pricing. During the migration period this calculator will exist alongside the uniform Pricing Mailsort pricing calculator (currently available). Having the two calculators available at the same time will enable customers to calculate the impact of zonal pricing;
- (b) a "Zonal Mailings Analyser" will be available to calculate the number of items per zone in a mailing. Customers can drop their postcode list into the analyser, which then returns the number of items per zone;
- (c) a "Zonal Look-up" tool will be made available for customers to establish which zone a postcode is tagged to.

#### **4.5 Licence Condition 21(1)**

Licence Condition 21(1) states that

*“Except in so far as Postcomm on the application of the Licensee and after consultation with the Council directs otherwise, the Licensee shall at all times offer and provide the Regulated Services on as wide a basis within the United Kingdom as they were offered and provided in the month ending 31 March 2006.”*

This application does not involve any change to the geographic scope and coverage of the Regulated Services for which consent is being sought to zonally price other than in respect of Presstream Premium. For Presstream Premium the application involves it no longer being treated as a Regulated Service and thus falling outside the remit of Condition 21 (see Section 1). Otherwise, the application involves the introduction of zonal pricing for certain bulk mail services and the subsequent replacement of the uniform geographic prices with those zonal prices, whereby the sender of bulk mail, relative to the price in Zone C, will be charged a lower price for mail delivered to Zones A and B and a higher price for mail delivered to Zones D and E. There is no circumvention of Licence Condition 21(1) as the bulk mail services will be offered and provided on as wide a basis within the United Kingdom as they were in the month ending 31 March 2006.

#### **4.6 The Directive**

The Directive sets out specific requirements for the setting of tariffs for each service that forms part of the universal service (around affordability and gearing to costs) which do not apply to the services covered by this application as they are not designated as universal services<sup>25</sup>. However, it also requires, amongst other things, that where universal service providers apply special tariffs “for example for services for businesses, bulk mailers or consolidators ...” the principles of transparency and non-discrimination should be applied<sup>26</sup>.

Royal Mail’s proposals for zonal pricing do not “lead to a failure to provide services priced in a manner referred to in the Directive”. Royal Mail’s aim through the development of zonal pricing has been to make pricing more cost reflective. Section 2.2 of this document discusses the zonal costs and Section 4.3 discusses cost reflectivity and finds the proposed zonal pricing structure to be more cost reflective than the existing uniform prices. Section 2 sets out the coverage, structure and prices for zonally priced services.

Following approval of the application, zonal pricing will be available to all customers who can meet the criteria of the relevant zonally priced bulk mail services, without discrimination. The prices in this application are indicative and applied to ‘pricing in proportion’ prices to reflect the structure of prices in place prior to the introduction of zonal pricing. The final pricing will be published and a programme of communication to customers developed, as outlined in Section 4.4.

#### **4.7 Licence Condition 21(22)**

Licence Condition 21(22) states:

*“Where the criteria by which the price or prices for a Controlled Service are determined are changed pursuant to paragraph 21, this Condition shall apply with such variations as may be specified by Postcomm by direction in writing, including, without prejudice to the generality of this paragraph, –*

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<sup>25</sup> Article 12, Directive 96/67/EC, as amended

<sup>26</sup> Article 12

*(a) variations to apply paragraph 5 to the service so that, notwithstanding the provisions of paragraph 9, the term  $br_{st}$  shall be calculated with reference to that service in such manner as may be provided in the direction, and*

*(b) variations to the tariff rebalancing provisions set out in paragraphs 15 and 16 so that, as far as possible in the circumstances, they may apply for the benefit of users of postal services as effectively after any change made pursuant to paragraph 21 as they applied before that change”*

Licence Condition 21(21) sets out the same requirements for an application to change the pricing structure under paragraph 20 as for zonal pricing under Licence Condition 21(17-19).

Royal Mail applies under Licence Condition 21(22) for changes to the application of Licence Condition 21(15-16) to provide the scope for the zonal prices to move in steps to the price differentials discussed in Section 2.3 (above) before 1 April 2010 which are in addition to the existing scope under Licence Condition 21(15-16) to move the uniformly priced service (and Zone C price). This is necessary to ensure that the Royal Mail Letter's zonal prices mirror the more cost reflective Condition 9 Access zonal prices within the current price control.

## Annex 1: Definition of Pricing Zones<sup>27</sup>

The following steps have been used to define zones.

- (a) Identify the cost drivers that could influence geographical variations in cost,
- (b) Identify proxy variables for these cost drivers that are measurable and transparent,
- (c) Analyze proxy variables to identify "break-points" to define zones,
- (d) Define zones and map all postcode sectors onto one of these zones,
- (e) Calculate unit costs for each zone based on "actual" observed costs sourced from the costing system

As stated in the last step, the costing was based on "actuals" rather than a theoretical construct of what the costs "should be" in each zone. This approach is considered to be the most robust for demonstrating that costs do vary with geography (not just theoretically but in practice as well). It allows Royal Mail to show that geography has a real influence on costs that is not dominated by other factors such as variations in office efficiency or regional pay. It also avoids potential differences of opinion concerning the importance of theoretical cost drivers and their inter-relationships.

The most important factors that influence geographical cost variations are found to be the travel distance between delivery points, the average volume of mail per delivery point, and the remoteness of the area from major hubs.

It was important to identify robust data to measure these characteristics by postcode, and to be able to group postcodes with similar cost characteristics into zones.

The first major cost driver characteristic – average travel distance between delivery points – is a joint function of road distances and the number of delivery points in a postcode. Royal Mail has approximated this driver by measuring the Delivery Point Density (DPD) of each postcode, which is defined as total surface area (measured in square kilometres) divided by the number of delivery points.

The relationship between DPD and the average road distance between delivery points shows that when DPD is in excess of 100, the average road distance between delivery points is between 10-20 meters, which would enable most delivery points to be visited on foot or cycle. Road distances begin to increase significantly as DPD drops below 100, and there is a further "shift" in average road distance between delivery points when DPD falls below 10.

Measurement of the second major cost driver – volume per delivery point – becomes increasingly difficult as postcode areas are disaggregated into smaller areas, such that the resource needed to produce accurate volume measurements is unlikely to be justified on a cost basis. The measurement would also be unverifiable by outside parties and would therefore fail Royal Mail's stated objective of transparency. An alternative proxy measurement is the proportion of delivery points that are registered as businesses – business density (BD). Businesses tend to receive a much

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<sup>27</sup> Source: August 2005 Paper entitled Establishing Non-Uniform Access Prices in the UK available at [ftp://ftp.royalmail.com/Downloads/public/ctf/rm/rmg/10-Establishing\\_Non-Uniform\\_Access\\_Prices\\_in\\_the\\_UK.pdf](ftp://ftp.royalmail.com/Downloads/public/ctf/rm/rmg/10-Establishing_Non-Uniform_Access_Prices_in_the_UK.pdf)

higher volume of mail than residential addresses, and hence, high BD postcodes have a high average volume per delivery point.

An analysis of the relationship between BD and average volume per delivery point shows that postcodes with an average BD below 10% receive about 80% of total UK mail, with the average delivery point in these areas receiving just over 2 items of mail per day. The daily average volume per delivery point increases above 10 items when BD approaches 60%.

It is concluded that the vast majority of postcodes are predominantly residential with a low BD, and it is very difficult to separate these postcodes in terms of average volume per delivery point. However postcodes with a BD above 10% have a much higher than average volume per delivery point, and typically are located in commercial centres that include the very largest receivers of mail.

DPD is also a good proxy for the third major driver of cost variations between geographical areas - the remoteness of the area from major hubs. This is useful because it avoids the need to add a third dimension to the definition of delivery zones.

The analysis above suggests 3 "breakpoints" for defining zones: at BD equal to 10%, and DPD equal to 10 and 100. This justifies 4 zones. A further breakpoint at DPD equal to 1000 was added to establish a middle zone with approximately the same unit cost as the national average access product. This was a practical consideration to ensure that one zone had the same price as the national average price, so that the zone could be a default option if information about a postcode's DPD or BD is missing.

Zone A accounts for less than 1% of the UK surface area, but 8% of delivery points and as much as 15% of national mail volume. In contrast, Zone E accounts for 32% of UK surface area but only 1% of national delivery points and mail volume. Zones D and E have low DPD and therefore the road distance between delivery points is relatively great (43.7 meters and 121.0 meters respectively). These delivery zones are more likely to have motorised transport and this can double the costs of delivery.

It is important to note that postcodes are mapped to zones by reference to cost driver characteristics rather than the actual reported costs of delivering to specific postcodes. This ensures that zones are not influenced by whether delivery offices in a particular area are more or less efficient than average.

## Annex 2: Direction of expected volume movements between zonally priced services and uniformly priced services

Figure 1 below summarises the direction of the expected movement in volumes between uniformly and zonally priced services. The products listed in the left hand column are those that Royal Mail will deploy zonal pricing for in April 2007 and the geographically uniform versions of these products will be withdrawn in October 2007. The existing business products Cleanmail 1<sup>st</sup> and 2<sup>nd</sup> class and Mailsort 1400 1<sup>st</sup> and 2<sup>nd</sup> class remain within the Licence's definition of the universal service and will therefore continue to be priced on a geographically uniform basis. Thus potential volume switching will continue after the transition phase since Royal Mail will be offering both zonally priced services and uniformly priced services which are close substitutes. The ticked cells in Figure 1 represent areas where there is a potential volume movement between services.

**Figure 1: Potential volume movements between uniformly and zonally priced services.**

Zonally priced services	Uniformly priced services					
	Cleanmail 1 <sup>st</sup> cl OCR	Cleanmail 1 <sup>st</sup> cl CBC	Cleanmail 2 <sup>nd</sup> cl OCR	Cleanmail 2 <sup>nd</sup> cl CBC	Mailsort 1 1400	Mailsort 2 1400
M1 120 OCR	✓					
M1 120 CBC		✓				
M1 700		✓				
M2 120 OCR			✓			
M2 120 CBC				✓		
M2 700				✓		
M3 120 OCR						
M3 120 CBC						
M3 700						
M3 1400						
Walksort 1st cl						
Walksort 2 <sup>nd</sup> cl						
Presstream 1 <sup>st</sup> cl std					✓	
Presstream 2nd cl std						✓
Presstream 1 <sup>st</sup> cl PP					✓	
Presstream 2nd cl PP						✓
Presstream 2nd cl >250k						✓

There are in essence two specific groups of services that are close substitutes: Cleanmail / Mailsort 120 & 700 and Mailsort 1400 / Presstream. We discuss below how the introduction of zonal pricing may affect volume switching between these two groups of services.

Lowering Zone A and B prices: We do not expect to see any significant movement from Cleanmail to MS 120/700 nor Mailsort 1400 to Presstream. The price differential that currently exists

between these pairs of services is such that any customer who could take advantage of the lower priced service could have done so. Customers using the Cleanmail service do not use Mailsort 120 because of the volume entry criteria rather than because the sortation requirement is insufficiently rewarded as to make that additional activity attractive. The potential for customers using Mailsort to switch to Presstream is restricted by the Presstream entry criteria around the registered title of the publication and the minimum editorial content.

Raising Zone D and E prices: We would expect to see significant volume movement in this area from Mailsort 120/700 to Cleanmail and from Presstream to Mailsort 1400 as there are no material entry requirements for the two substitute services that would not be met by customers already producing the zonally priced products. To limit the revenue dilution that would result from this switching, this application does not propose to introduce Zone D prices to the point at which transfer to the product within the universal service would be attractive even if the result is less cost reflective pricing than that which could be achieved otherwise. This market distortion, created by the retention of the requirement for some of Royal Mail Letters' services to remain uniformly priced, can be addressed by Postcomm taking the existing products of Cleanmail and Mailsort 1 and 2 1400 out of the universal service.