

Zonal Pricing

**Answers to questions raised at the Zonal Pricing
Mini Workshop on 30th November 2006**

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Workshop Discussion on Retail Zonal Pricing

30th November 2006

The purpose of this document is to respond to the questions raised at the Retail Zonal Pricing forum hosted by Postcomm on 30th November 2006. These questions were answered during the workshop, but may be of interest to a larger audience.

Questions relating to the impact for receiving customers

1. Is there a risk of abusively high pricing in rural zones?

Royal Mail is firmly committed to the one price goes anywhere universal service which includes deliveries to low density areas. It is enshrined in law and is a condition of our licence from Postcomm. It is also at the heart of everything we do and we are the only company who deliver to the UK's 27m addresses every working day.

Retail Zonal Pricing is designed to make prices more cost-reflective and this will be assessed by Postcomm. In addition, the risk of abusively high prices in rural zones is constrained by the Price Control and by Stamp and Franking prices which will remain uniformly priced and therefore act as a cap to Mailsort prices.

2. Is there a longer term risk of de-selection of rural zones?

Customer profiling and geo-demographics will continue to be the main driver for mailing a customer or a prospect. At a very high level there may be a different impact by database type. For example Zonal Pricing will have a smaller effect on customer databases than advertising databases since decisions on whether to mail customers are less dependent on return on investment criteria than decisions on whether to mail prospects.

3. What evidence do we have that the customer profile will not change following the introduction of zonal?

We have no evidence that customer profile will not change. However, similar to the findings of Postcomm's 2006 Competitive Market Review, customers we have spoken to do not believe that Zonal Pricing will significantly affect their mailing behaviour in the short term.

Questions relating to the development of competition

4. Is there a risk of predatory pricing where customers do not pay the rural price?

Predatory pricing is an economic and legal concept and the test for there being anti-competitive predatory pricing is clear. In very simple terms it is based on whether the prices are set above a certain level of costs. Royal Mail is confident that its prices are not predatory and furthermore,

Postcomm has been given pricing and costing information for the retail Zonal Pricing proposals and will be able to confirm this for itself.

5. Is there a risk of above-cost but exclusionary pricing?

As explained above, Postcomm has Royal Mail's pricing and costing information to retail Zonal Pricing and will be able to verify for itself that Royal Mail's prices are not excessive or "exclusionary".

Questions relating to the operational impact for customers

6. How do we plan to address the increase in both costs and operational burden due to the additional operational requirements for customers that use machines rather than software for sortation?

The sortation and presentation specification is a pragmatic response to the need for non-uniform geographic pricing. It is the first major change to the Mailsort specification since the introduction of Mailsort 120 in 1998. Royal Mail has never been prescriptive as to how customers achieve a specific level of sortation, whether using a computer programme to sort before print, a machine to sort after print, or an entirely manual operation. Services for unsorted mail have been and remain available. Mailsort can represent value for both the purchaser and supplier but it is possible that as the specification evolves the means by which the purchaser achieved the level of sortation required ceases to be an economic proposition and an unsorted product becomes a more viable proposition.

7. Why do we need to know the exact number of bags?

The current user manual for Mailsort Walksort and Presstream specifies that the computer planning report should include the number of bags for each direct and each residue selection. This requirement is repeated and emphasised in the "zonal" version of the Mailsort User Guide section 3.9. Where the actual mailing process varies from the planned mailing the computer planning report should be manually corrected to reflect the actual mailing being presented.

Mails verification is a process by which Royal Mail satisfies itself that the service the customer states that they are purchasing is the service that Royal Mail will provide. That process takes the form of a cascade of checks that start with the actual number of bags compared with the declared number; then within specific bags, actual format of item versus declared, actual weight of item versus declared, actual number of items per standard selection code versus declared, actual number of items per zone versus declared.

An analogy would be the receipt of cash from a security firm. The notes come in predefined bundles each of a specific number per denomination. The customer would check the number of bundles for each denomination and might randomly check the content of a sealed bundle. Imagine how complex the job for the customer becomes if bundles arrive of random numbers of notes with the denominations mixed.

8. What is the process for updating the postcode sectors?

Changes to postcodes (i.e. introduction or cessation of postcodes) will be included in the Mailsort

Database. The Mailsort Database is derived from PAF and responsibility of allocating zones to new postcode sectors rests with Royal Mail Letters. 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.

Questions relating to costs

9. Would delivery points per road length be a more appropriate measure for Zonal Pricing?

The principal drawback with using this alternative measure is knowing which pieces of road to include in the calculation. Clearly motorways should not be included but should dual carriageway A roads? There is no clear rule to follow. In addition this measure would include less of the variation due to the type of premises e.g. it would not reflect the impact of 'garden path' length – which is an important element of the cost drivers of delivery.

10. Would the percentage of postcode units by sector be a more appropriate measure?

This question has been interpreted as “Could a more appropriate allocation of sectors to zones be made by using the underlying distribution of postcode units to zones, within the sector”?

Defining the zone of a sector on the basis of its constituent postcode units is not satisfactory because the cost of serving a postcode unit is not just a function of the detail of the postcode unit itself but also of the sector of which it forms a part. This is because the cost of getting mail to the postcode unit is an important element of the cost of serving that unit and that cost relates to the area as a whole (ie the postcode sector) rather than the individual postcode unit. The consequence of this is that the allocation of postcode units to zones is flawed as it does not take full account of the relevant cost drivers.

11. What is the effect of different mail volumes per zone?

The volume per delivery point is an important factor for the outdoor operation. Approximately 90% of UK delivery points receive mail each day, and in terms of the outdoor operation, it costs much the same to deliver 10 items to an address as it does to deliver just one item. Therefore Delivery Offices with higher volumes per delivery point will have lower unit delivery costs.

The costing takes this into account because we divide delivery office costs for each zone by the volume delivered by those delivery offices. For those delivery offices with higher volumes per delivery point, the unit cost of delivering these extra items will be proportionately lower. This is confirmed by the results of the outdoor zonal costing analysis, e.g. although zone A (Business District) has lower delivery point density (and hence higher travel distances) than zone B, the unit outdoor staff cost in zone A is lower because the volume per delivery point is twice as high. It should also be noted that there is relatively little difference in the volume per delivery point between zones B and E.

12. What is the impact on zonal costs of real estate and employment cost variables?

London weighting is reflected in the "actual" delivery office costs used to calculate the outdoor delivery element. It is not reflected in the cost allocation for the other two staff cost elements (indoor delivery and local distribution).

London weighting (and other regional pay differences) does not have a major impact on zonal costs. All zones are represented in and around London although zone E is less common than national average.

In general, Royal Mail has focussed on the costs that are driven by the specific geographical factors that define the five zones.

Clearly, real estate costs do vary by location – depending on whether sites are owned, rented or leased as well the location – but these are largely the result of the historical development of the organisation and its property portfolio rather than anything to do with specific geography. There is no *a priori* reason for the costs to be caused to be different by the zonal geographical factors so any differences in these costs have not been included.

13. What is the impact on zonal costs of transportation means – foot v. vehicle delivery?

Although there will be a mixture of different delivery types in each zone, in general the delivery mode is likely to be as shown in the table below.

Zone	Name	Delivery Mode
A	Business District	Primarily by van but some foot deliveries (including trolley assistance)
B	High Density	Primarily foot deliveries, but some vans
C	Average Density	Van / foot (including trolley assistance) / Cycle delivery
D	Low Density	Van / Cycle / some foot
E	Very Low Density	Van / Cycle / some foot

Royal Mail has used the relevant delivery costs for each Delivery Office in its cost analysis so the contribution of each mode of delivery has been allowed for in the cost analysis and the resulting price differences.

14. Has the increased revenue protection cost been factored into the costing analysis?

This is a relatively small item of cost and will not differ by zone in any measurable way. Even if the cost does increase due to the introduction of Zonal Pricing it will still be small and will not be material when expressed as a cost per item.

15. Should the pricing include the number of items per delivery point?

It is not appropriate to set prices for one customer based on the behaviour of others so an overall policy of relating zonal prices directly to volume per delivery point has not been pursued.

In the specific case where a single posting might have multiple items per delivery points then it may be appropriate to adjust prices on this basis. This currently only applies within Presstream profile and this element of pricing will be retained under Zonal Pricing. Presstream profile mail has the distinguishing features of being regular and predictable and the multi-copy element is relatively significant. These conditions are unlikely to be met for any other products so this pricing option has not been pursued.

Miscellaneous questions

16. Are there errors in the classification of zones?

Royal Mail classification is derived from PAF and associated GIS data. We do not know which data set has been used by TNT but it is understood not to be the same data set. Therefore it is unsurprising that there are some differences of classification.

Royal Mail has made it clear that, for the sake of transparency, it has used PAF/GIS totally unedited. This may on occasion lead to 'odd' classifications. We will consider whether it would be appropriate to move away from this transparent approach by making adjustments to these 'odd' classifications.

17. How do we factor in the arbitrage opportunity?

The arbitrage opportunity arises because the prices of the uniformly priced service of a close substitute service may be lower than the zonally priced service for Zones D & E. To avoid this situation, we seek not to raise the Zone D price for any given service above the price of the nearest uniformly priced comparable service, for example Mailsort 2 120 OCR and Cleanmail 2nd class.

18. What is the real reason for introducing Zonal Pricing?

Retail Zonal Pricing will allow Royal Mail's retail business to align its offering with that of competitors and Royal Mail's Wholesale users, and thereby compete effectively for bulk mail business. Customers will therefore be able to obtain the lowest cost source of supply. Also, by enabling Royal Mail to compete for bulk mail items retail Zonal Pricing better ensures the provision of the universal service (where retail Zonal Pricing does not apply).

Retail Zonal Pricing represents another step towards better cost reflectivity in pricing. Royal Mail's proposed Zonal Pricing focuses on local delivery cost drivers and demonstrates a self-evident improvement in cost reflectivity.

Retail Zonal Pricing also reduces cross subsidies and encourages efficient entry into the market. In the medium to long term inefficient entry will result in higher prices, lower volumes and higher unit costs – bad for most stakeholders, but particularly bad for competitors basing their entry strategies on unsustainable business models and distorted prices which will eventually have to be unwound.

19. Why will Presstream Profile customers incur a price increase of up to 30% if the maximum surcharge is 7.5%?

The current Presstream Profile discount structure offers very high discount levels for items within a magazine circulation addressed to particular Postcode Areas. This form of geographic pricing is incompatible with the application for Zonal Pricing. Royal Mail have applied to withdraw the profile pricing structure and the withdrawal of this structure will lead to price increases depending on the level of discount any particular magazine title currently enjoys.

20. How will Royal Mail phase the transition to the fully cost reflective position?

These proposals are designed to make prices more cost reflective than the uniform tariff prices. They may be changed over time to reflect changes in costs or to more fully reflect the cost differentials between zones. Royal Mail would endeavour to raise the price of Zones D & E and reduce the price of Zones A & B over time.

There are two constraints to achieving greater cost reflectivity: the first is the existence of uniformly priced substitutes that would enable effective arbitrage were we to raise the prices of zones D & E too much, the second is the operation of the price caps within the control.

21. What is the difference between Door-to-Door Zonal Pricing and Bulk Mail Zonal Pricing?

Door-to-Door is an unregulated product in a fully competitive market. Door-to-Door prices are aligned to audience and therefore customer value. They also reflect geo-demographics and cost and are in line with the purchasing of other advertising media.