



1 June 2007
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Dear Samanta

Re: Royal Mail Zonal Pricing Application

Royal Mail welcomes the opportunity to comment on Postcomm's consultation letter of the 2 April on our Retail Zonal Pricing Application.

Zonal pricing is not new to Royal Mail and many of our customers understand the principle of zonal pricing and benefit from it. Specifically zonal pricing is available:

- To publishers through Presstream Profile. (Presstream profile has been available for more than 10 years.)
- To international customers through International Profile Pricing
- To Royal Mail wholesale customers
- To Parcelforce Worldwide customers

Zonal pricing is similar to many other distribution models where different charges are levied for areas where costs are different, even though the service provided is nominally identical.

In the rest of this letter we focus on three areas: why retail zonal pricing is critical to us, the impact on our customers and the length of the notification period.

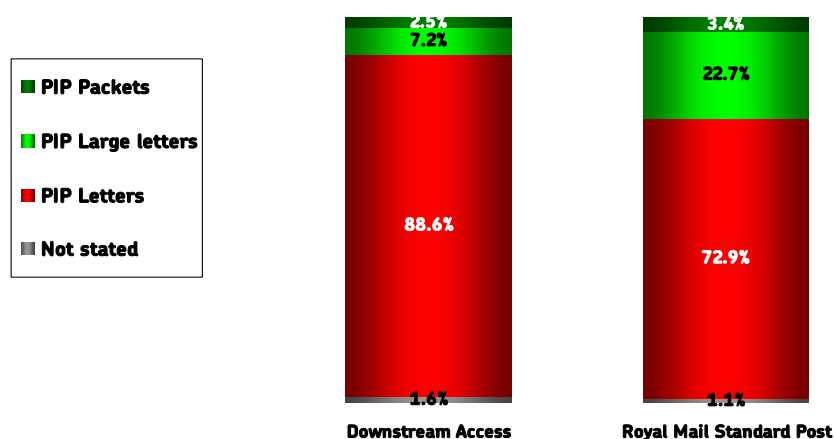
Why retail zonal is critical to us

At Royal Mail we believe that zonal pricing is critical to our financial stability and the continued provision of the USO. As we stated in our application and in numerous papers and conferences since, retail zonal pricing will introduce greater cost reflectivity in pricing and thus free us to compete fairly. With zonal pricing we will be able to price to market; similarly to our competitors, we will not be constrained unfairly to price uniformly. Our ability to price to market will benefit business customers by ensuring they can access the lowest cost of supply and will benefit social customers by ensuring the provision of the universal service. These simple commercial principles were the basis of Pricing in Proportion (PiP) and underpin our zonal pricing application.

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Like PiP, zonal pricing is more cost reflective (according to Postcomm's cost reflectivity calculation, our proposed zonal pricing application is 15% more cost reflective). This means it will allow us to compete fairly and help us maintain financial stability. We introduced PiP for similar reasons. It just does not make sense for us to have prices which are significantly out of line with our costs. The old system of weight based pricing allowed entrants to the mail market to cherry pick high margin machineable Letter formats and leave Royal Mail to provide costly Large Letters and Packets at a uniform rate. While we will review PiP more fully once sufficient data is available, as the two charts below show, our understanding of how the market would develop was correct: 88% of items delivered by DSA providers are Letters and we retain a large proportion of the more difficult to handle Large Letters and Packets. Our commercial strategy appears therefore to be sound; if we had not introduced PiP our financial position would be comparatively worse.

Distribution of DSA and Royal Mail volumes by format
(source: Royal Mail Consumer Panel undertaken by TNS April 2006 – March 2007)



The same is already happening in terms of geographic distribution. We are aware that competing postal operators are offering to extract items in a mailing that are destined to high density areas, price these items competitively, and leave Royal Mail with the provision of service to low density areas at a uniform rate. This situation will be exacerbated with the development of end to end networks. Experience in The Netherlands, Sweden and Germany shows how easily competitors can set up 2 -3 day delivery networks in high density cost effective areas and cherry pick the most profitable volumes. In these countries, entrants have been able to achieve significant market share (between 9 – 12%) in the geographic areas where they offer service.

As the Mail Competition Forum (MCF) acknowledges in its response to Postcomm's September consultation, decreased mail volumes threaten the viability of the universal service. We would like to take this opportunity to clarify that this principle applies most strongly to volumes lost in high density areas as items delivered in these areas generate a higher contribution than the items delivered in less dense areas.

Thus, retail zonal pricing is necessary to compete fairly with both end to end and DSA competition. The very rapid development of DSA based competition in the UK demonstrates how critical it is for us to be allowed to compete fairly on price. This is particularly important in a highly commoditised

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market such as bulk mail services. By allowing us to price to market, zonal pricing is fundamental to our financial stability and the continued provision of the USO.

The impact on customers

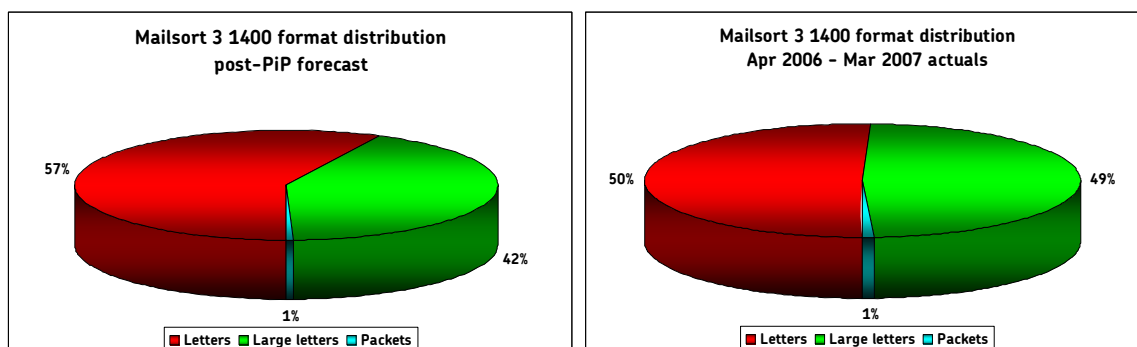
We believe that zonal pricing will not have a major impact for the majority of our bulk mail customers. We review below the potential impact focusing on how zonal pricing may impact volumes, the operational requirements and quality of service.

Impact of zonal pricing on volumes

Our customers recognise that mail is increasingly but one of many communication channels they use to communicate with their customers and they are changing their business models to maximise profitability in this new environment. The publishing industry provides an interesting example of how customers' business models change. End users increasingly have the choice of receiving business magazines in printed copy or accessing them online (E-books). In this new environment, a publisher can position the delivery of a printed copy as a value-add compared to the basic online service and factor the delivery cost of the item into the cover price. This is resulting in an important change in the publishing industry as some publishers move to paid subscriptions for the magazine rather than having controlled circulation where the magazine is sent out free of charge. We believe that Postcomm and other stakeholders must take into account these and other sector specific emerging business models when evaluating how pricing strategies may affect volumes.

Given the above, we took on board the concerns expressed by our customers following publication of the July 2006 proposed application that the large premium to be charged in the least dense zone (Zone E) would significantly discourage posting to those areas and could reduce the overall service received by people living in such areas. We acted upon this concern and as part of our reassessment of the Retail Zonal proposal merged the zones D and E of the July 2006 proposed application thus reducing the surcharge for items delivered to very low density areas,

We believe that zonal pricing will not have a detrimental impact on volumes to areas where a surcharge would apply (Zone D and London). There are many customers in Zone D and in London that have a high propensity to spend and it will therefore continue to be in the interest of businesses to mail these customers. When we introduced PiP, the direct mail industry stated that PiP would be the end of creative Large Letter formats. As shown in the chart below, this is not the case, as the percentage of Large Letter items is to date broadly as we had forecast it.



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The creation of the London zone explicitly addressed Postcomm's concerns regarding cost reflectivity, and overall, the prices that are being proposed are more cost reflective than the current uniform prices. It has been suggested (by Postwatch) that Retail Zonal is the first step to further larger price increases in London. This is unlikely – it is self evident that simply reflecting different costs in our prices is of less benefit to us than addressing the cost base. We are asking for pricing flexibility but we will not necessarily use all the flexibility – if we had a straight choice of increasing prices by 1p per item or reducing costs by 1p per item we would pursue the latter – so we are not solely interested in increasing prices.

Customers in the publishing sector using Presstream Profile will be most affected by Zonal Pricing. This is a consequence of the need to align the existing zonal pricing structure available to publishers, with that which we propose to offer to mailsort and walksort customers and thus avoid issues of discrimination. Advertising sales are evidently an important revenue stream for publishers, fuelled by circulation levels – the delivery of an audience. As a route to market, subscriptions offer publishers and their advertisers a direct channel to the consumer, bringing with it the associated benefits of knowing who that consumer is. Publishers are increasingly recognising these benefits, evidenced by the growth in subscriptions' share of magazine sales, which ABC figures show has risen from under 10% to nearly 14% in the last 7 years.

A number of customers and associations have raised the issue that budgeting will become more complex with zonal pricing. We would be pleased to engage with our customers and identify how we can make this easier. The increasing complexity in postage pricing is something that Royal Mail has been assessing very carefully since before the Zonal proposal and will continue to assess as the issue goes beyond the simple introduction of zonal pricing and PiP. Customers increasingly require a broad spectrum of products and services at a range of price points that meet their requirements, more sophisticated pricing options and simplified purchasing processes. On Line Business Account (OBA) is our initial response to delivering increasingly sophisticated pricing in a relatively simple and easy to understand way.

Operational requirements

The majority of our bulk mail customers use sortation software. As Postcomm and Postwatch were able to ascertain at an operational workshop organised for them, the operational requirements for these customers are not very onerous. To prepare for zonal pricing customers using sortation software will need to carry out the following activities:

- Download and use the new Zonal Mailsort and Walksort Databases
- Upgrade their sortation software (either themselves or by purchasing it from software suppliers).
- Prepare to use OBA if they are still using paper dockets
- Familiarise themselves with the Zonal Mailsort User Guide
- Arrange for standard selection codes and the zonal indicator to be printed on each mailpiece. The sortation software will enable this, but the printing process will need to be adjusted to pick up these two items.
- Ensure mail is printed and produced in zonal order within each Mailsort/Walksort selection. (Note there will be no requirement to bundle or bag pricing zones discreetly)
- Train the print room personnel on the new requirements for producing and bundling mail in zone order.

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We recognise that the operational requirements will be more complex to deploy for the minority of our customers that use some form of physical sortation rather than electronic sortation as these customers will have to physically sort their items in zone order as well as by standard selection.

Impact of zonal pricing on quality of service

Zonal pricing will not affect quality of service

The notification period

Royal Mail proposes to introduce zonal pricing in April 2008, nearly two years after the introduction of pricing in proportion in August 2006 and nearly two years after its original application. We propose to notify zonal pricing 3 months prior to launch and to deploy a 6-month transition period after the launch 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, the uniformly priced services will cease at the end of this migration period.

The standard period used by Royal Mail for customers to adopt a revised technical specification, once launched and made available has been 3 months. In addition Royal Mail typically provides between 3 and 6 months prior notification of the change requirement. The prior notification is to enable the customer to schedule IT maintenance time with their supplier / in house provider.

The provision of a 6 month transition recognises that there are three changes, a software change, a print change and a requirement for some customers to adopt our electronic transaction interface (OBA) and leave paper based transaction recording behind.

Royal Mail notes that transition periods can cause significant disruption in its operation and therefore this phasing should be kept to a minimum e.g. mail to the same destination and sent from two different customers based in the same place can be routed differently until the late adopter catches up with the early adopter.

As discussed, zonal pricing is critical to our financial stability and the continued provision of the USO. We have thought long and hard to develop a pricing structure that is simple and easy to understand and that can be deployed by the majority of our bulk mail customers with minimal disruption. As PiP has shown, we have the capability to deploy major change programmes successfully and our commercial assumptions have proved sound. Without PiP and zonal pricing, our financial position would be comparatively worse.

Yours sincerely

Luisa Fulci
Head of Commercial Pricing