

Royal Mail, Independent Postal Operators,
Postwatch and other interested parties

Date: 20 February 2007

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Dear Colleague,

**ROYAL MAIL'S APPLICATION TO EXTEND PRICING IN PROPORTION TO
PACKETPOST RETURNS**

1. Pricing in Proportion (PiP) was introduced for most UK mail services up to 1 Kg on 21 August 2006. As a result of PiP, Royal Mail's charges for postal items were moved from a system based primarily on the weight of items to one based on both the format and weight of items.
2. In November 2006, Royal Mail made an application under Condition 21 (paragraphs 20-22) of its Licence to extend PiP to Packetpost Returns up to 1 Kg. As part of its application, Royal Mail has also requested that Packetpost Returns is moved from Basket A to Basket B of its price control. Royal Mail's application is available on Postcomm's website.
3. Packetpost Returns is a service that allows packets to be returned from customers with the postage cost being borne by the original sender.
4. Having fully considered this application, Postcomm is minded to approve Royal Mail's request to apply PiP to Packetpost Returns. However, Postcomm is minded to reject Royal Mail's request to move the product from Basket A to Basket B of its price control. Before finalising Postcomm's decision, we would like to seek views from interested parties on this assessment.
5. This letter sets out the background to Royal Mail's application, the reasons underlying Postcomm's minded-to position and some questions for consultation.
6. Responses to this consultation letter should be sent no later than 21 May 2007 either by email to samanta.padalino@psc.gov.uk or by post to Samanta Padalino, Deputy Director, Competition & Regulation, Postcomm, Hercules House, 6 Hercules Road, London SE1 7DB.

Background

Licence condition 21 (20-22) of Royal Mail's licence

7. Condition 21 (20-22) of Royal Mail's licence refers to changes to the

price basis for Controlled Services. The full text of the licence is attached in Annex A.

8. According to Condition 21 (21), in assessing this application, Postcomm must be satisfied that the change sought by Royal Mail will:
 - (a) be revenue neutral;
 - (b) lead to prices for the service being more reflective of costs than they would be if the existing pricing basis was retained;
 - (c) be introduced in a manner that avoids unreasonable changes for users of the service;
 - (d) not lead to a circumvention of paragraph 1 of Condition 21; and
 - (e) not lead to a failure to provide services priced in a manner referred to in the Directive.

Product description

9. Packetpost Returns is a service that allows packets to be returned from customers. The service is mostly used to support goods fulfilment (i.e. E-Retailers and Mail Order Companies). The customer returning the goods is sent a postage label pre-printed with the return address, pre-paid payment indicia and service indicator. The customer takes the item to the Post Office and receives a certificate of posting. A minimum of 2,000 packets per year must be returned in order for Royal Mail's business customers to qualify for this service.
10. Currently the price per item paid by the business customer is based on the average weight of the mail returned. This average weight is calculated and set for approximately three months at a time following sampling by Royal Mail. Customers are subsequently billed based on the number of items received into Royal Mail's network.

Product Size

11. As part of PiP a Packet is defined as larger in either dimension than 250mm x 353mm x 25mm, with maximum dimensions of 460mm x 460mm x 610mm or, for tubular packages, the length plus twice the diameter must not exceed 1040mm, with a maximum length of 900mm.
12. There is a maximum weight limit of 5kg Second Class items and of 20kg for First Class items. The annual revenue from Packetpost Returns First Class items is currently about £0.6m, around 49 per cent of which has an average weight below 1kg. The annual revenue from Packetpost Returns Second Class items is about £5.8m, around 43 per cent of which has an average weight below 1kg.
13. The table below provides a break down between Packetpost Returns

First Class and Second Class items below 1kg.

Table 1: Packepost Returns First and Second Class items below 1kg

| Revenue estimates (assuming all items are Packets) | | |
|---|--|--|
| Below 1kg | Revenue Total 2005/06 (£millions) | Volume Total 2005/06 (millions) |
| First class | 0.3 | 0.2 |
| Second class | 2.5 | 1.7 |
| Total | 2.8 | 1.9 |

Source: Royal Mail

Royal Mail's proposal

14. In its November 2006 application, Royal Mail stated that Packetpost returns was overlooked when it made its original PiP application in August 2003. Royal Mail added that the proposed charges for Packetpost Returns reflect those introduced for Packetpost in August 2006 and, in addition, recover extra costs of the items returned (5p per item returned).
15. It is proposed that an item returned through Packetpost Returns will be treated and charged as a packet. Large Letters and Letters¹ may be sent through Packetpost Returns as a Packet but would be charged a lower charge if sent through the Response Service instead.
16. Furthermore, it is proposed that the current minimum limit of 100g on the Packetpost Returns will be removed to allow for returns between 0 and 100g (as with Packetpost). The existing weight based charges and arrangements will continue to apply for items above 1kg.
17. Royal Mail also argued that, consistent with the greater alignment of Packetpost Returns prices to those of Packetpost as part of its proposal, Packetpost Returns should also transfer from Basket A to Basket B of the price control. This proposal was made on the basis that Packetpost is currently in Basket B.
18. Royal Mail argues that its proposal meets the requirements of Condition 21 (20-22) of its licence by being, among other things, more cost reflective and revenue neutral. The proposal involves no other non-price

¹ Under PIP, a Large Letter is defined as a postal item no larger than 353mm long, 250mm wide, or 25mm thick. A letter is defined as no larger than 240mm long, 165mm wide, or 5mm thick.

changes to terms and conditions. Royal Mail proposed to provide at least 3 months notice of changes to Packetpost Return prices.

19. Royal Mail has also shared with Postcomm the outcome of its own consultation on this proposal. Royal Mail wrote to 134 current users of its Packetpost Returns service to seek their views on these proposals. Royal Mail received nine replies, five of which expressed support for the application. One respondent had no comments as it no longer used the service.

Postcomm's initial assessment

20. Postcomm has information of sufficient good quality to process Royal Mail's application. This information has been carefully reviewed by Postcomm to make the assessment outlined below.
21. Postcomm is minded to conclude that Royal Mail's proposal meets the requirements under condition 21 (21) of its licence. Therefore Postcomm considers that, subject to the outcome of this consultation, the proposal can be implemented.
22. In finalising this assessment, Postcomm has focussed its analysis on the revenue neutrality and cost reflectivity tests. These tests are described in the following sections. Clearly there will be a margin of error in calculating these tests given the product's small size and uncertainties. However, Postcomm believes that the tests we have applied are proportional in these circumstances.

Revenue Neutrality

23. Based on 2005/06 volumes and revenue data, assuming all items are charged at Packetpost Returns prices, and using the average weight for the year for each customer in that year, the proposed price change would yield Royal Mail an estimated net additional revenue of about £0.1million.
24. However, in 2005/06 about 0.2million items within Packetpost Returns actually fell within the format of Large Letters. Royal Mail expects these customers to switch to Response Services, given that the prices for Response Services Large Letters will be lower than those for Packets by around 60p per item. This should result in an estimated net reduction in revenue of £0.1million.
25. Postcomm does not disagree with Royal Mail's expectations and, on this basis, the overall revenue impact is expected to be neutral.

Cost Reflectivity

26. The cost reflectivity of the August 2006 PiP prices for Packetpost was

approved by Postcomm². Royal Mail proposes to reflect the approved Packetpost prices in the Packetpost Returns prices along with an additional charge of 5p per item returned.

27. Royal Mail argues that the additional charge per item returned would address two costs:
- a) a 30p charge levied by the Post Office to Royal Mail for accepting the Packetpost Return item;
 - b) 25p of avoided costs per item compared to standard Packetpost delivery due to the fact that Packetpost Returns are delivered in bulk by Royal Mail and, therefore, in comparison with normal packet delivery costs, Royal Mail avoids individual attendance calls.
28. For Packetpost Returns this yields a net charge of 5p per item, in addition to the Packetpost charges.
29. Postcomm has assessed the cost reflectivity of the proposal by calculating Cost Reflectivity Ratio's (CRR)³. Postcomm believes that overall, this proposal is more cost reflective and satisfies the cost reflectivity test, with:
- (a) First Class being 153 per cent more cost reflective; and
 - (b) Second Class being 348 per cent more cost reflective.

Moving Packetpost Returns from Basket A to Basket B

30. Royal Mail argued that consistent with the greater alignment of Packetpost Returns prices to those of Packetpost within the proposal, Packetpost Returns should form part of Controlled Services 31 and 32 (Packetpost first and second class) rather than being included within Controlled Services 10 and 11 (Response Services first and second class) as it currently happens. Controlled Services 31 and 32 are part of Basket B in Royal Mail's price control while Controlled Services 10 and 11 form part of Basket A.
31. Under Royal Mail's (2006-2010) price control, regulated products have been placed in two tariff baskets. Basket A is the so called "captive basket" and includes products where the prospects for competition over the course of the price control are considered to be limited or weak.

² For more information please see "Royal Mail's Proposals for Pricing in Proportion, A Decision Document, August 2005" available at www.psc.gov.uk.

³ The CRRs were calculated using the methodology used as part of for the Pricing in Proportion consultation in 2005. For a technical description of how the CRRs are calculated please see Annex 4 of "Royal Mail's Revised Proposals for Size Based Pricing (Pricing in Proportion), Annexes to Postcomm's Consultation Document" published in April 2005 and available at www.psc.gov.uk.

Basket B, the so called “non-captive basket”, groups together products where the prospects for competition are considered to be stronger. Royal Mail is allowed to rebalance prices within each basket but not between baskets. The rationale for having separate baskets is to prevent Royal Mail simply reducing prices in competitive services by increasing prices for services used by “captive” customers.

32. Postcomm does not agree with Royal Mail's argument that Packetpost Returns should be moved from Basket A to Basket B. Postcomm believes that Packetpost Returns operates as a Response Service for packets and is therefore correctly located with Response Services in Basket A. Royal Mail has not provided a convincing argument to support its request to treat Packetpost Returns as having the potential to become a competitive service. At the time the two baskets were fixed, Royal Mail did not advance any arguments to suggest the product was in the wrong basket.
33. Furthermore, it is important to note that the purpose of paragraphs 20 – 22 of Condition 21 of Royal Mail's licence is limited to the accommodation of changes in pricing criteria. It does not extend to changing the basket in which a service is placed for the purpose of the price control. This aspect of the application could only properly be entertained as a licence modification request.
34. Postcomm therefore believes that this element of Royal Mail's application should be rejected.

Changes for Users of the Service

35. Royal Mail has indicated that, if implemented, it will provide customers with a three month notice period before any price changes under this proposal is introduced. Postcomm seeks customers' views on the appropriateness of this notice period and how they should be given notice. It may be appropriate to allow a shorter notice period given that PiP has already been introduced, and customers are likely to be familiar with this pricing format.

Licence Condition 21(1)

36. There is no proposed change to the provision of the service in this application and therefore no circumvention of Licence Condition 21(1).

The Directive

37. The proposal is not considered to raise any issues with regard to the Directive.

Questions for consultation

38. In order to fully inform Postcomm's final decision, we would welcome

your views on the following questions:

- a. Do you support Royal Mail's proposal, as outlined in this letter, to apply Pricing in Proportion to Packetpost Returns?
- b. Do you agree with the projections on which revenue neutrality and cost reflectivity have been assessed by Royal Mail?
- c. Do you agree that Packetpost Returns is similar to Response Services and is therefore correctly located in Basket A of Royal Mail's price control?
- d. Is a three months notice of any Packetpost Returns price changes adequate notice before a change is made, or would you accept a shorter notice period?

Next steps

39. Postcomm expects to be able to issue a final decision on Royal Mail's application in June 2007.
40. All comments received will be placed on Postcomm's website at www.postcomm.gov.uk unless respondents indicate that their response, or part of their response, is confidential. It would be helpful if your reply could indicate if you are a current customer of the service.
41. If you have any questions or if you would like to arrange a meeting with Postcomm to discuss any aspect of this letter, please do not hesitate to contact me or Pavanjit Dhesi (telephone: 020 7593 2120).

Yours sincerely,

Samanta Padalino
Deputy Director, Competition & Regulation

Annex A: Licence condition 21 (20-22) of Royal Mail's licence

Licence condition 21 (20-22) of Royal Mail's licence refers to changes to the price basis for Controlled Services, and states:

21. "Without prejudice to Pricing in Proportion which may be introduced on or after 21 August 2006 subject to compliance by the Licensee with such direction in respect of the provision of information to users of postal services as may be made in writing by Postcomm, the Licensee may apply to Postcomm in writing at any time for approval for a change to the criteria by which the price or prices for a Controlled Service are determined 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 21 shall apply.
22. 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 20, by direction 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 pricing basis was retained,
 - (c) be introduced in a manner that avoids unreasonable changes for users of the service,
 - (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 pricing criteria for the service in the manner approved in the direction.

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, –

- (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”.