# Retail zonal pricing review – Analysis of forecast mail volumes and switching behaviour

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# EXECUTIVE SUMMARY


In this report we set out the findings to our study of volumes forecasting and price elasticity in relation to Royal Mail's proposals to introduce zonal prices.

To study the likely impacts of the introduction of zonal pricing we reviewed the literature in relation to price elasticity for postal products and undertook a survey of bulk mailers.

We adopted this approach, which was consistent with Postcomm's terms of reference for the study, as the introduction of zonal pricing represents a quite new development in the UK, for which existing time series data provides limited evidence for an econometric analysis.

From our literature review we found that in general price elasticity for postal services appears to be low and that elasticity is related to the usage of mail, for example with transactional mailers being less price elastic than marketing mailers.

In considering the potential reactions to the introduction of zonal prices we distributed detailed questionnaires to a sample of over 200 bulk mailers drawn from the 500 largest customers of Royal Mail's services and followed this up with 28 interviews of these mailers. Results of the survey were analysed where useful into sector categories, following Royal Mail's own customer classifications.

The results of our survey suggested that:

- For transactional mailers the location of their customers is the main driver of mailing destination;
- In light of this, and of the finding that very few mailers intend to change the volumes of mailings to zones, it appears unlikely that there will be significant volume effects (in relation to the volumes mailed to each of the geographic zones) as a result of the introduction of zonal pricing;
- Mailers have indicated that it may take them some time before they can implement zonal prices;
- However, our findings also suggest that a significant proportion of mailers may consider using arbitrage, ie temporarily splitting mailings to take advantage of different prices of uniform and zonal products during the period whilst both products co exist.

We end the study by drawing some initial conclusions from our survey about the market effects of the introduction of zonal pricing, which we consider may well be substantial, if the difference between zonal prices and uniform prices becomes wider.

# 1 INTRODUCTION AND METHODOLOGY

1.1 In this section we set out the purpose of this study, the background to it and the structure of the report and the rationale for its methodology and our approach.

## The purposes of this study

1.2 This study has been undertaken for Postcomm by Europe Economics to assess the likely reaction of Royal Mail's customers to Royal Mail's application to introduce zonal prices.

1.3 Key areas of investigation include:

- The extent to which customers may react to zonal pricing proposals by changing their mailing profile, in particular by avoiding sending mail to more expensive zones.
- The scale of any consequent likely aggregate volume changes across the proposed zones;
- The changes in the use of Royal Mail's products or the organisation of the sending of mail which may derive from the introduction of zonal prices;
- An assessment of the likely robustness of initial zonal price elasticity estimates which underpin Royal Mail's proposals.

## The structure of this report

1.4 This report includes the following sections:

**Introduction and methodology:** This section sets out the purpose of the study, the structure and background to the report and our approach.

**Desk research:** In this section we outline the findings of our literature review of postal elasticity studies.

**Our survey and our main findings:** In this section we set out the scope and design of our survey and our main findings.

**Conclusion:** In this section we consider the meaning of our findings.

## Royal Mail's application to introduce zonal prices

1.5 On 20 February 2007 Royal Mail submitted a modified application to Postcomm for approval to offer geographic zonal prices for non universal bulk mail services.[1] This

[1] Royal Mail:: "Application under Licence Condition 21 for approval to offer geographic zonal prices for bulk mail services (modified)." 20 February 2007

application proposed the replacement of uniformly priced services with geographic zonally priced services for the following services:

- **Mailsort 120** - first and second class, OCR and CBC
- **Mailsort 700** - first, second and third class
- **Mailsort 1400** - third class
- **Presstream** - first and second class
- **Walksort** - first and second class

1.6 Table 1 below shows the proposed geographic zones.

**Table 1: Proposed zones for geographic zonal pricing**[2]

| Zone | Name | Business Density | Delivery Point Density |
|---|---|---|---|
| London | Greater London | N/A | N/A |
| A | Business District | Greater than 10 % | Greater than 500 per sq. km |
| B | High Density | N/A | Greater than 1000 per sq. km |
| C | Average Density | N/A | Greater than 100 per q. km and less than or equal to 1000 per sq. km |
| D | Low Density | N/A | Less than or equal to 100 per sq. km |

*Source: Royal Mail*

1.7 Indicative discounts and surcharges under the application are shown in Table 2 overleaf.

[2] Royal Mail:: "Application under Licence Condition 21 for approval to offer geographic zonal prices for bulk mail services (modified)." 20 February 2007

**Table 2: Proposed Discount and surcharges at the introduction of zonal pricing [3]**

| | Zones | | | | |
|---|---|---|---|---|---|
| | London | A | B | C | D |
| Price Premium/Discount on Geographically Uniform Price | +2.5% | -4.9% | -2.0% | -1.7% | +4.8% |

*Source: Royal Mail*

## The assumptions underpinning Royal Mail's application

1.8 In its application Royal Mail proposed a Pricing Model with estimates of future volumes based upon assumptions about price elasticity and customer switching.[4] In this model the zonal price elasticity is assumed to be constant at -0.32, whilst there are assumed to be potential volume movements between substitutory uniform and zonally priced services.

## Key issues of analysis

1.9 In considering the likely response of bulk mailers to these proposals, the key issues of analysis include:

- The extent to which bulk mailers (who use the services included in these proposals) would react to the proposals by changing their geographic mailing profile- potentially creating "dead zones" where mail is no longer sent;

- The extent to which these bulk mailers would react by switching between uniform tariff (universal service) products and new zonal products- i.e. the pattern of switching between Royal Mail products;

- The extent to which bulk mailers may switch between zonal products for example between different zonal Mailsort or Walksort products ;

- The effects of the timing and implementation of zonal pricing proposals (for example whether these bulk mailers could take advantage of any arbitrage period, or whether there would be significant implementation costs related to the zonal pricing proposals.

- The extent to which these bulk mailers may switch to another operator (than Royal Mail) because of these proposals.

- The extent to which the reactions of bulk mailers may be determined by their own pattern of internal organisation, their sector, and their use of mail services.

[3] Royal Mail Zonal Pricing Application (Modified), February 2007, Table 2.4.
[4] Royal Mail.: "Application under Licence Condition 21 for approval to offer geographic zonal prices for bulk mail services."

## Techniques for measuring likely zonal price elasticity

1.10 In order to estimate the likely response of these bulk mailers to zonal pricing proposals, economists could use a number of methods which include:

- Econometric analysis (using regression techniques) of previous demand panel data and of panel data from comparative markets;
- A literature review or desk research to discover useful comparative information about likely reactions to zonal pricing proposals;
- Survey techniques (using questionnaires and/or interviews with a sample of mailers) to assess directly what their reactions may be to the current proposals.

## The terms of reference and our approach to this study

1.11 In setting the terms of reference for this study Postcomm was aware of need to consider a range of techniques in considering the impact of zonal pricing on mailing volumes.

1.12 Whilst econometric analysis has been used to estimate general price elasticity for postal services, in this context we do not consider that such an approach would have been reliable. This is due primarily to a lack of reliable time series or panel data in relation to the introduction of zonal pricing, which is a relatively new development in the postal sector.

1.13 In this context any econometric approach which simply transposed data and assumptions from studies which considered issues of general price elasticity or cross elasticity between postal products would not have been reliable.

1.14 In reacting to zonal pricing proposals bulk mailers affected will consider issues which range beyond price imperatives, for example the extent to which they may be able to subdivide their mailings to take advantage of zonal discounts, and if so, for which mailings might this be possible. However, this is not to say that we cannot learn anything from previous work on general price elasticity- given that in part the reaction to zonal pricing proposals relates to price. Such research should help us formulate initial conclusions- where the evidence allows for this, about the likely reaction of mailers affected by these proposals.

1.15 This study uses survey methods to reveal evidence of the likely impact to the introduction of zonal pricing. As the demand for mail services (in terms of the senders of mail) is quite concentrated, a survey which interrogated a sample of the bulk mailers affected by the proposals directly, could reveal useful insights into, both their general plans in relation to zonal pricing and their immediate reaction to these proposals if they were introduced.

1.16 Details of our survey which included distribution of a questionnaire and interviews with a sample of bulk mailers are included in Section 3 of this study.

# 2 DESK RESEARCH

## Introduction

2.1 In this section we set out the results of our literature review of postal price elasticity.

## Previous research on the price elasticity of postal items

2.2 Price elasticity is an area which has been extensively studied by postal economists, most notably in relation to the likely development of a competitive postal market and the potential for customers to switch to entrants undercutting uniform tariffs.

2.3 Relevant recent studies include the following.

### Evaluating the format switching and price elasticity estimates used by Royal Mail in their Sized Based Pricing Application

2.4 In their report *"Evaluating the format switching and price elasticity estimates used by Royal Mail in their Sized Based Pricing Application"*[5], Frontier sets out its findings of its review of the methodology behind the derivation of format switching and price elasticity estimates and their reasonableness.

2.5 Frontier reviewed four Royal Mail documents provided by Postcomm and confirmed that the propensity to switch coefficients used in Royal Mail's model were consistent with Royal Mail's written submission.

2.6 Frontier also sent a questionnaire to a selection of postal regulators in countries where the incumbent had adopted size based pricing to find out about their impacts. The evidence from overseas was found to be mixed with the introduction of sized based pricing having a greater impact in Denmark than in Canada.

2.7 Frontier's overall conclusion was that there were "few shortcomings in RM's approach". However, they had concerns about the robustness of the estimates of switching parameters and the applicability of price elasticity estimates derived from the analysis of price responses under a weight based pricing regime. They suggested that due to the uncertainty around the estimates there should be extensive sensitivity analysis.

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[5] Frontier Economics, Report prepared for Postcomm, 2003.

### Share shifts across postal products

2.8 The article *Share shifts across postal products*[6] examined how customers and mail service providers were shifting mailings between product classes and mail streams in response to market conditions and postal developments.

2.9 The paper's conclusions with regard to overall product substitution trends included:

(a) Increases in postage prices, particularly in times of economic downturn have driven mailers to seek cost avoidance alternatives such as outsourcing; shifting mail into economy categories; and using techniques such as pre-automating, pre-sorting or downstream entry.

(b) Price elasticity of demand seems to be changing with customers in key business segments becoming increasingly price sensitive and seeking opportunities to reduce mailing costs.

(c) The predicted large decline in mail volume due to electronic alternatives has not happened. However, there has been a trend in a number of countries for a reduction in first class or priority mail accompanied by growth in economy or standard addressed volumes.

(d) Postal volumes and revenues are concentrated among a few large business users. Concentration has increased with the rapid growth of direct mail.

(e) Decline in growth of letters delivered by National Postal Operators particularly in liberalising markets is influenced by competition from couriers, private sector entrants and foreign posts operating in each others markets.

### A Panel Data Study of Mail Demand in Advanced Economies

2.10 *A Panel Data Study of Mail Demand in Advanced Economies*[7] aims to explain differences in disaggregated mail volumes over time and across countries. They seek to find out to what extent countries over time are similar to each other and to the other countries with respect to a given mail flow. They employ a clustering method which characterise difference performance and explanatory factors. Two sets of country clusters are identified: the first is the US (first cluster); UK, FR, IT (second cluster); and the other Western European countries (third cluster); the second consists of the US (first cluster): and all other countries (second cluster).

2.11 The effects of the following variables are considered: market size (population), economic performance (GDP, unemployment, median household income, investment),

[6] Fouad H Nader (Adrenale Corporation), background paper No. 10, June 15, 2005.
[7] Matthew C. Harding, Department of Economics, MIT, 2006.

macroeconomic volatility (economic growth, investment growth), business activity (retail sales, retail sales growth, direct marketing expenditure, B2C distance selling, advertising selling), household characteristics (lending per household, number of bankable households), substitution (phone subscribers, internet users), politics (election year dummy) and prices (estimate of the advertising mail price).

2.12 Regression analysis identifies a number of economic factors which determine mail volumes. The most important determinants of mail volumes are found to be: business expansion and opportunities, household prosperity, a strong financial sector and a larger market size.

**A hedonic model of the demand for US Mail[8]**

2.13 This paper analyses the demand for mail by treating it as a bundle of "hedonic" properties. The authors focus on seven hedonic indices: weight per piece, the type of delivery service, the level of presortation, the distance travelled, the extent of automation preparation, the place where the mail enters the postal system and the size of the mailing.

2.14 The hedonic prices of the identified properties are evaluated using the sixty different United States Postal Service (USPS) tariffs in operation from 1969 to 2006. The authors also use USPS data over this period to estimate the demand responses of mail volumes to changes in the hedonic prices.

2.15 The authors find that hedonic price elasticities are lower than for conventional demand models as mailers can alter the hedonic characteristics of their mailings as well as the volume. The article concludes that mail can be successfully described in a hedonic fashion with separate prices for each of the hedonic properties.

**A review of price elasticity models**

2.16 This recent paper by Alan Robinson found that previous research has found the following:

(a) Postal products are relatively price inelastic: less than -1, and generally ranging between -0.2 and -0.8;

(b) The price elasticity of postal products varies depending on the use of the mail: mail products that serve senders of bills and statements have a lower elasticity than other mail products;

(c) The reaction of postal customers to price changes takes some time: around four quarters;

8 Lawrence Fenster, Diane Monaco, Edward Pearsall, Charles Robinson and Spyros Xenakis, presented to 14th Conference on Postal and Delivery Economics, 2006

(d) Price decreases may show a higher price elasticity;

(e) Advertising products that are flat shaped (eg. magazines) are more price elastic than letter-shaped products.

2.17 Research from France and the US has provided some indication of usage elasticity. These findings are set out in Table Three below:

**Table 3: Different elasticities for different mail usage (types), France and the US[9]**

| Mail uses | Price elasticities US depending on various models | Price elasticities France (1969-1999) |
|---|---|---|
| Regular bills, notices and account statements | -0.067 (1990-1996)<br>-0.0019 (1990-1999)<br>-0.044 (1990-2000)<br>-0.334 (1991-1997)<br>-0.409 (1991-2000)<br>-0.019 (1991-2001)<br>-0.221[10]* (1990-1999) | -0.30 |
| Letters and franchises (sent by the government) | | -0.04 |
| Subscription journals or magazines | | |
| Advertising / information material (letter-shaped) | -0.598 (1987-1996)<br>-0.808 (1987-2000)<br>-0.770 (1987-2001)<br>-1.093 (1987-2004) | -0.68 |
| Advertising / information material (magazine-shaped, catalogues) | | -0.68 |
| Packages (i.e. delivery of purchased products) | | |

*Source: Europe Economics from studies discussed in Alan Robinson: "A Review of Price Elasticity Models for Postal Products"*

[10] This value was a result of a model which no longer considered that workshared mail in the United States was unaffected by prices. However, in 2005 the elasticity measures reported indicated that work-shared mail had remained inelastic to price.

2.18 The values in the table above suggest very different results for usage elasticity showing the sensitivity of such findings to sampling and data assumptions.

## Conclusions to be drawn from this review

2.19 From this review of general price elasticity we could draw the following conclusions:

- In general demand for mail is fairly price inelastic and fairly constant over time;
- Price elasticity appears to vary with the mailers use of mail- with those sectors which use mail as a means of communication with their customers who may be spread on a uniform geographic distribution, being less price elastic than those who send mail as a product in itself e.g. as a marketing tool or as a publication;
- In this context relatively low general price elasticity may be misleading in relation to possibly more nimble sectors with greater possibility for substitution such as direct mailers or where postal costs are more significant in terms of a proportion of total costs such as publishers.

## The relationship between zonal and general price elasticity

2.20 Intuitively, zonal price elasticity may differ from general price elasticity due to a number of important factors:

- Customers may not be able to/or wish to divide their mail geographically;
- The costs of dividing mail zonally and switching pricing arrangements may outweigh the price benefits for some customers

## Factors affecting zonal price elasticity

2.21 We can build upon the research on general elasticity to formulate key assumptions about likely zonal elasticity. Intuitively, and from the existing research, it can be argued price elasticity generally, and in relation to zonal pricing, depends on factors including:

- General elasticity factors related to the usage of the mail item (type of mail), the cost awareness of the customer, where and how it is injected in Royal Mail's value chain and the importance of postal costs in relation to other costs of the mailed item;
- The sub-divisibility of mail- is it necessary to send the item nationally or can it be targeted to cheaper zones;
- The practical costs of switching or dividing up mailings in relation to the potential cost savings;
- The availability of substitutes;

- Economic factors such as the state of the economy;
- Mailing specific factors;

## Royal Mail's letter volumes by sector

2.22 The pattern of usage can also be considered through the sector composition of demand for Royal Mail's products. This can allow also for a consideration of the relative importance of mail costs to the mailers.

2.23 The main customer sectors of Royal Mail as a percentage of mail volumes is shown in Table Four below.

**Table 4: Main customer sectors of Royal Mail as a percentage of mail volumes**

| Sector | Percentage of volumes |
|---|---|
| Financial services | 29 |
| Distance selling | 22 |
| Publishing | 9 |
| Utilities | 8 |
| Media and co-suppliers | 8 |
| Government and Health | 7 |
| Retail | 7 |
| Other businesses | 3 |
| Manufacturing | 3 |
| Wholesale and Distribution | 2 |
| Undefined | 1 |

*Source: Royal Mail*

# 3 SURVEY AND KEY FINDINGS

## Introduction

3.1 In this section we set out the dimensions of our survey and its findings.

## Survey design

3.2 In seeking to understand the likely reactions of bulk mailers to the introduction of zonal prices we used a two-stage survey, including distribution of a detailed questionnaire to a large sample of bulk mailers (who use Royal Mail services) and more targeted in-depth interviews with bulk mailers.

### The content of the questionnaires and interviews

3.3 Our questionnaire covered the following key sections:

- Mailing profile: In this section customers provided details on their use of mail services;
- Reactions to a change in prices: In this section customers provided details on their general price elasticity and previous reactions to changes in prices including switching to other operators competing with Royal Mail;
- Reactions to the introduction of zonal prices: In this section customers provided details on their likely reaction to the zonal pricing proposals.

3.4 Key areas of inquiry included not only the above but also issues in relation to the geographic distribution of mail, implementation costs in relation to zonal pricing proposals and the possible volume effects of the introduction of zonal prices on the mail sent to different geographic areas. We were interested also in the possible differences between sectors in the use of mail and likely reactions to zonal pricing.

3.5 Sector definitions are attached at Annex 1.

3.6 The interviews lasted about an hour and were conducted by phone. In these, we explored the issues covered by the questionnaire in greater depth with additional questions being asked in relation to the use of mail, the possible geographic implications of zonal pricing and factors influencing the destination of mail.

### Sample selection

3.7 The questionnaire was sent to a sample of 200 customers randomly selected from the top 500 by revenue of Royal Mail's customers.[11]

3.8 We used a random sample of large bulk mail customers, to avoid bias in the sample. However, we also then added to our original sample to ensure adequate representation of all the main sectors of bulk mailers and to include contacts who had previously expressed an interest in responding to the survey.

3.9 All respondents to our survey are users of bulk mail services, although one respondent (Essex County Council) currently only uses Clean Mail services.

3.10 We then looked to identify contacts from these companies using web searches and phone calls and information from previous studies undertaken for Postcomm.

3.11 Questionnaires were then distributed to named contacts where possible, with bounce-backed emails being followed up by further searches for appropriate contacts and redistribution. Table 5 below sets out details of the coverage of our survey of bulk mailers.

**Table 5: Our survey of bulk mailers**

| Number of questionnaires distributed and delivered | No of follow up contacts to each customer contact | Total responses from the questionnaire distribution | Number of interviews | Total number of questionnaires and interviews |
|---|---|---|---|---|
| 203 | 3 reminder contacts for every mailer | 5 | 28 | 33 |

*Source: Europe Economics*

3.12 Further details about the responses for each question are attached at Annex 2.

### Response rate and the robustness of our conclusions

3.13 In practice achieving a full response from customers surveyed proved very difficult and it appears that many customers were only in the initial stages of considering what their

[11] The 200 customers were chosen using the first 200 numbers in a random number sequence of the numbers 1 to 500, which were taken to correspond to the rank numbers of the top 500 customers. The sequence was obtained using a random number generator which produces random numbers from atmospheric noise. For more details of how the numbers were generated see www.random.org

reactions to zonal pricing may be in the future and had barely begun to focus on the proposals themselves. Overall we were only able to get 33 responses from our sample of over 200 mailers.

3.14 In part this limited response was also due to the nature of the zonal pricing proposals- which are fairly modest in scale and had not presented immediate issues for mailers- and the rather unique context in which they are being proposed in the UK, alongside other measures and in the midst of the development of a competitive market.

3.15 The early nature of the survey also presents some issues of timing which may affect the reliability of our findings.

3.16 For example, whilst our findings do not suggest significant immediate effects from the introduction of zonal pricing, we cannot exclude, for example, the possibility of a future “bandwagon” effect- as mailers become aware of the possible savings which zonal prices may offer. Alternatively it may be the case that some large mailers will simply use zonal pricing as part of the wider fabric of their negotiations with Royal Mail about prices and discounts- in which case its effects may be difficult to separately observe.

3.17 In these respects, even if we had garnered a larger response from our questionnaire we may still have had some caveats about the robustness of our findings as a predictor of actual behaviour.

3.18 However, despite these caveats we do consider that our findings- which were based upon detailed interviews with the mailers provide useful evidence of where large mailers currently are in their consideration of zonal pricing, even if this may present a somewhat confusing (and confused) picture.

3.19 They present a snapshot of the postal market in a state of flux- where mailers are becoming accustomed to new choices and a more dynamic market, but where they have not yet fully escaped from the habits of dealing with a monopoly provider.

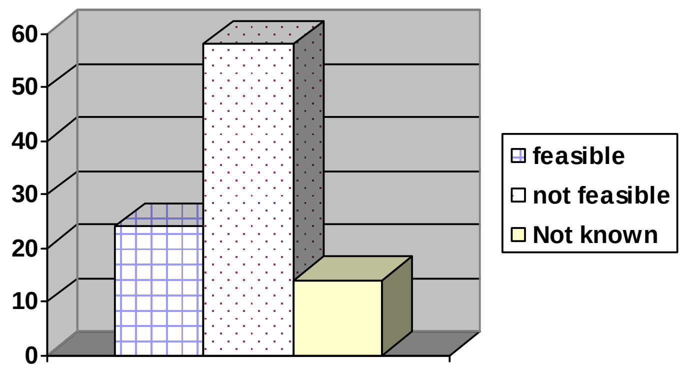
## Our major findings

3.20 In such a context of limited response we have presented our findings in aggregate form, as sector level responses have not been evenly spread with only very few responses from some sectors.

### a) Geographic effects of zonal pricing proposals

3.21 Figure 1 overleaf shows the results of our survey into the feasibility for mailers of changing the proportion of mail going to different geographic destinations.

**Figure 1: Feasibility of changing the proportion of mail going to different destinations: Percentages of respondents[12]**




*Source: Europe Economics*

3.22 Overall, our findings show that for a majority (58 per cent) of customers across sectors, it does not appear to be feasible to of alter the relative proportion of mail going to different zones. Indeed, only approximately a quarter of our respondents stated that this would be feasible.

3.23 However, eighteen per cent of our sample did not answer this question suggests a number of respondents may still be unclear as to the feasibility of altering their mailing proportions geographically.

3.24 Among the reasons given for why changing the proportion of mail going out to different destinations might be feasible, were those of internal logistics and the practicalities of specific cost effective marketing strategies. For example, for some operating in the retail sector, data manipulation is already relatively easy in that they are able to exclude customers on an individual basis.

3.25 Among the most common reasons cited among those stating that it would not be feasible for them to change the proportion of mail sent by destination tended to be that of customer location.

3.26 At the sector level, all respondents operating in the distance selling, utilities, media and co-suppliers and Government and health sector industries were unanimous in expressing the view that it would not be feasible for them to change where they send their mail.

[12] Based on 27 responses

3.27 Only the financial services, retail, and other business industries indicated a mixed view on the level of feasibility (approximately an equal split). This also appears to reflect the sector's use of mail, for example where the location of customers is particularly important to a mailer who needs to communicate with its own customers or client base changing the destination of mail is seen as impossible. However, we caveat this finding due to the limited nature of the sample[13].

**Case study**

**One of our respondents was a large government department who noted that they could not change their mailing profile due to their need to communicate in particular to citizens in rural communities.**

**In this respect the contact noted that any move to zonal pricing may have particular implications for mailers such as this who needed to send mail largely to more expensive zones.**

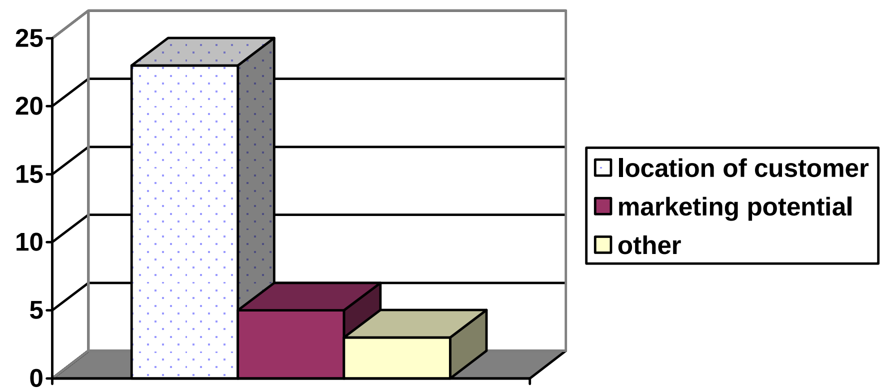
**However, the contact was unclear as to whether they could exploit further opportunities to substitute electronically for mail services or to use competing postal operators.**

3.28 These findings were supported by the results of our inquiry into the reasons for the destination of mail.

3.29 These are set out in Figure 2 overleaf.

[13] To some extent this may have reflected our sample contacts– in that in some cases we were discussing this issue with those responsible for mailing but not for marketing in the sampled businesses- and this may understate their perceived flexibility where a number of parties in a company may make the decisions about mailing.

**Figure 2: The reasons given by mailers for the destination of their mailings Total %**[14]




*Source: Europe Economics*

3.30 Our findings were that customer location was by far the greatest factor in driving the geographical distribution of mailings sent by firms/institution across sectors in the sample. We found the second most important driver to be that of marketing potential.

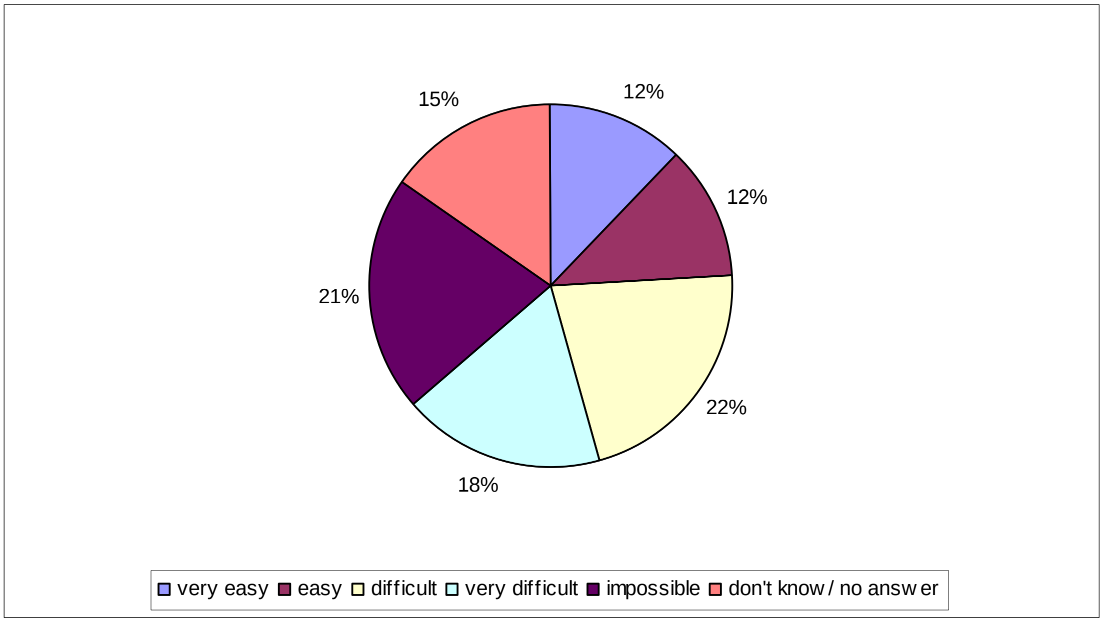
3.31 This suggests that, given that customer location will not be affected by zonal pricing proposals the geographic profile of large mailers may not change substantially as a result of the introduction of zonal pricing. However, where large mailers use marketing products which can be mailed separately from the larger all-customer mailings there may be scope for targeting these geographically.

3.32 This is also reflected in customer responses to questions in relation to the ease of changing destination.

3.33 This is shown in Figure 3 overleaf.

[14] Based on 25 responses

**Figure 3: Ease of changing destinations: Total (%)**[15]




*Source: Europe Economics*

3.34 Overall, only a minority of our respondents (24%) would find it relatively easy to change destinations, while the majority (61%) would find it difficult to impossible to make substantial alterations to where they send their mail.

3.35 These results- which appear a little counter-intuitive are more easily understood when we look at the sector pattern which underpins this response. From our limited sample we could deduce that those sectors which view this as least possible are those which appear to take the least benefit currently from the discounted products offered by Royal Mail- for example utilities and Government and Health.

3.36 Overall, it seems unlikely that the introduction of zonal pricing is likely to have a significant impact on altering the present composition of mail sent to different destinations as factors other than price, namely customer demand/location and transactional requirements will continue to be among the key drivers in determining the geographical destination of mailings sent by Royal Mail's customers.

[15] Based on 28 responses

**b) The pattern of switching between Royal Mail's products if zonal prices were introduced**

3.37 Of our sample of customers, 16 out of 29 respondents suggested they would not switch as a result of the introduction of zonal prices.

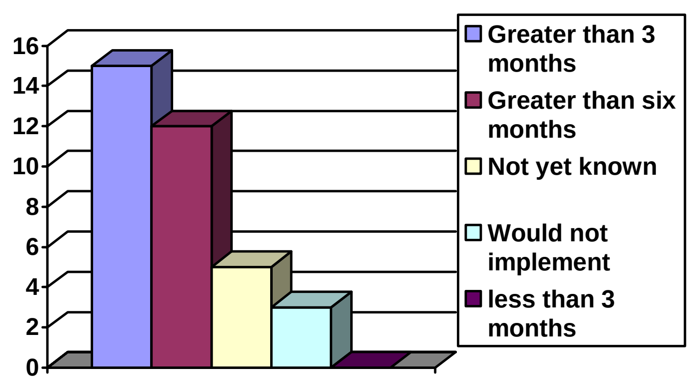
3.38 Two mailers suggested they would switch from switching exclusively from uniform to zonal products, four from zonal to uniform and additional seven reporting that they may use both types of switching between uniform to zonal and zonal to uniform products. Reasons given included the potential for taking advantage of costs savings.

3.39 Further, it was noted by the interviewers that these responses appeared to be indicative and respondents acknowledged that they were often at an early stage in considering their course of action in response to these proposals.

**c) The timing and costs associated with the implementation of zonal pricing**

3.40 Figure 4 below shows customer views about the likely response time they would need to implement zonal pricing.

**Figure 4: Response time needed to implement zonal pricing**




*Source: Europe Economics*

3.41 Overall we found that fifteen of the thirty respondents believe that they would need an implementation period of greater than three months (with twelve in this category stating they would expect to require longer than six months). We also found that five could not as yet predict how long they might need, whereas 3 of the respondents claimed that they did not expect that they would implement zonal pricing at all.

3.42 Interviewers noted that in practice many respondents had not yet fully considered the proposals internally, and that this itself revealed evidence that there may be a considerable lag in response.

3.43 At the sector level, customers that expected to need the longest implementation period tended to be concentrated in the financial services, publishing and distance selling, publishing and manufacturing sectors.

3.44 For those expecting to need the longest implementation period, the dominant reasons cited for determining how long they might expect to require as implementation time, included the following.

a) Assessing what changes need to be made;

b) Re-writing software programs etc;

c) Assessing the budgetary implications of zonal pricing and changes to budgets (annual) that have to be made as a response;

d) Implementing the necessary changes;

e) Training of staff.

**Case study: a large retailer**

**One of our respondents was a large retailer who explained that mail criss-crossed between the retail outlets of the business and was also sent out by these outlets and from a central mailing and parcels point.**

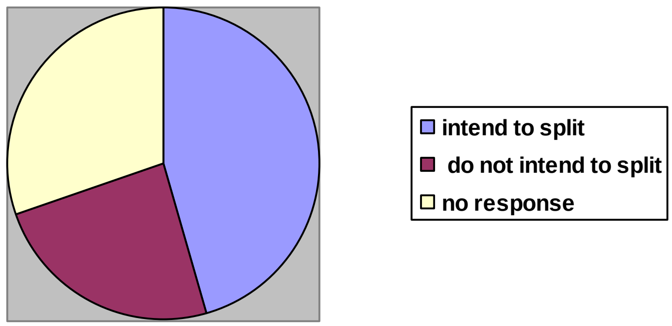
**In this context implementation of zonal pricing would require the mailer to coordinate mailings in a different way to maximise potential cost savings, for example to aggregate all mailings to a central point including those currently sent out by the retail outlets.**

**d) The effects of the transition period and the potential for arbitrage**

3.45 On the issue of the point in the transition period at which customers expected to start purchasing zonally priced products, we found mixed views. However, it appeared that many envisage using the transition period as a possibility for splitting mailings to arbitrage to save costs.

3.46 This is shown in Figure 5 overleaf.

**Figure 5: Transition period arbitrage (%)**[16]




*Source: Europe Economics*

3.47 However, in this context interviewers have noted that there may have been some confusion amongst customers in responding to the question on arbitrage opportunities and that answers here should be considered in the context of a more cautious general view on the likely reaction to zonal pricing.

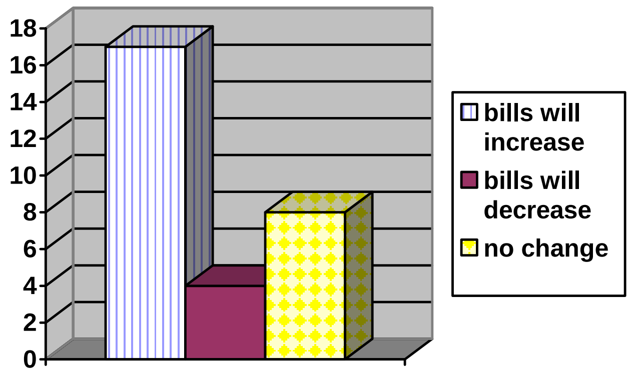
**e) The extent to which zonal pricing may encourage switching to other operators**

3.48 In theory if zonal prices increase customers bills it could be expected that some customers may seek to use other operators to deliver their mail.

3.49 Figure 6 overleaf shows that the majority of bulk mail customers in our sample expect that their bills may increase as a result of the introduction of zonal pricing.

[16] Based on 23 responses

**Figure 6: Customer views on the effect of zonal pricing on postal bills (%)**[17]




*Source: Europe Economics*

3.50 We found that seventeen of the twenty nine respondents expect that their overall postal bill will increase with the introduction of zonal pricing (assuming no change in current behaviour as a response to zonal pricing). Those that expected no overall change to their postal bills tended to be relatively confined to the manufacturing and retail sectors.

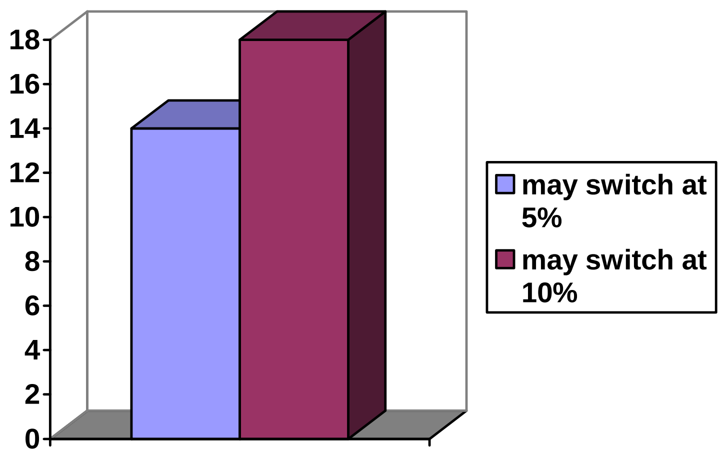
3.51 However, this may reflect a lingering pessimism amongst respondents rather than a completely accurate picture of expectations. For a mailer with an average national geographic profile zonal pricing would not lead to a significant change to their mailing bill.

3.52 Figure 7 overleaf identifies the level of discount which customers in our sample suggested was required before they would consider switching to another operator than Royal Mail.

---

[17] Based on 29 responses

**Figure 7: Level of discount at which would switch to another operator (%)[18]**




*Source: Europe Economics*

3.53 Of the twenty six respondents to this question, fourteen suggested they may switch to another operator at a discount of 5 per cent or above and eighteen at ten per cent or above. From this we could infer that current zonal pricing proposals (which range below 5 per cent discount and price rise levels) could result in significant switching if taking advantage of zonal discounts, i.e. splitting mailings, were as easy to achieve as switching between operators.

3.54 However, given that our findings also suggest that there are some added complexities in splitting mailings and that mailers are unlikely to change the geographic destination of mail, we could infer that zonal switching may not be a prevalent as that between operators.

**f) Other findings**

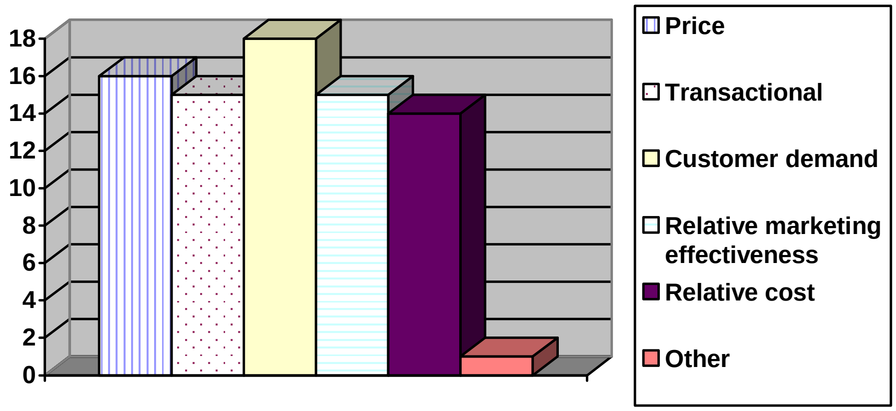
*General price elasticity and postal volumes*

3.55 In general, and consistent with the findings of other studies, we have found that there appears to be relatively low price elasticity.

3.56 Figure 8 overleaf shows that for the customers we surveyed, price is an important but not overwhelmingly significant driver of postal volumes.

[18] Based on 26 responses

**Figure 8: Main factors customers say affect total volumes by sector (%)**[19]




*Source: Europe Economics*

3.57 We found that although price was mentioned by a majority of respondents, customer demand also tended to be a highly rated factor in driving Royal Mail's customers total mailing volumes.

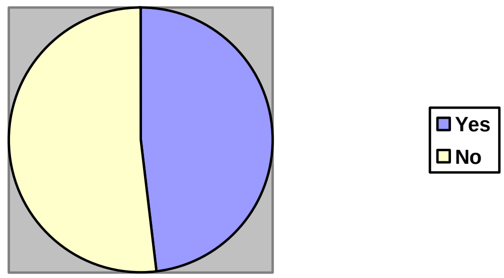
3.58 Also noteworthy, was that transactional requirements was also highlighted as a relatively significant volume driver by a majority of customers across sectors.

3.59 This relatively low responsiveness to price is reflected also in the proportion of mailers who have adjusted volumes due to price movements.

3.60 This is shown in Figure 9 overleaf.

[19] Based on 33 responses

**Figure 9: Proportion of mailers who have adjusted volumes due to price changes by Royal Mail [20]**

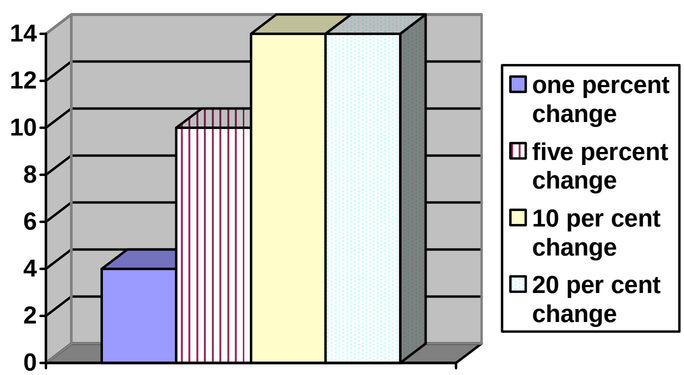



*Source: Europe Economics*

3.61 Of those who responded to the question of whether they have or have not adjusted the volume of their mailings in the past, we found that overall, thirteen said they had not. Those customers claiming that they had, tended to be those in the financial services, distance selling, retail and wholesale and distributions sectors.

3.62 This is also shown in customers' responses about their likely volume response to price movements. This is shown in Figure 10 below.

**Figure 10: Price decrease by Royal Mail at which mailers would increase volumes [21](%)**



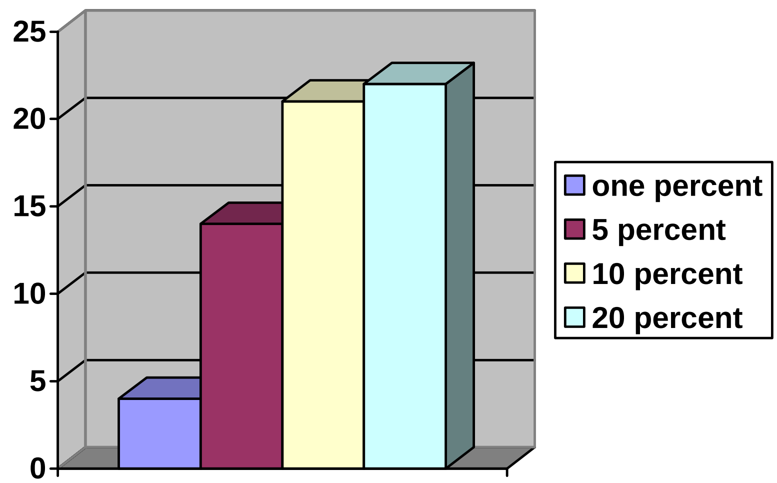

*Source: Europe Economics*

[20] Based on 27 responses
[21] Based on 24 responses

3.63 Across sectors, we found that fourteen of the twenty four mailers who could give an answer on this would only consider increasing their volumes of mail in response to a decrease in price of ten per cent and above. The ten mailers who predicted no change at all in the volumes of their mail even at a 20 per cent decrease to their postal bill were in the financial services, utilities, retail and wholesale distribution sectors.

3.64 This is also reflected in customers' responses concerning the levels of price increases at which they would decrease volumes. This is shown in Figure 11 below.

**Figure 11: Price increase by Royal Mail at which mailers would decrease volumes (%)[22]**




*Source: Europe Economics*

3.65 Our findings revealed that at an increase of 5 per cent and over, fourteen of the customers would consider reducing overall mail volumes. For those who would consider reducing the volume of mail, most tended not to know by how much (percentage wise) they would reduce their mail volumes by.

3.66 However, mailers did express the expectation that, where volumes are reduced they would try to do so by an amount that negates the effect of the overall increase in price. This also merged in their responses with a view that this was all somewhat a negotiation with Royal Mail, rather than a fixed process.

[22] Based on 28 responses

**Case study: a large financial services provider**

**One of our respondents a large financial services provider noted that the postal prices are largely unimportant to the quantity of their mailings which depend on their customers needs. Quality of service is a much more important issue.**

**They noted that only for some niche marketing products was price considered to be important.**

# 4 CONCLUSIONS

4.1 In this section we consider the results of our survey.

## Geographical effects of zonal pricing

4.2 Our survey of postal customers supports the view at least that it is unlikely that there will be significant effects on the volumes of mail sent to geographic destinations as a result of the introduction of zonal prices as proposed by Royal Mail.

4.3 In part this is due to the importance that customer location plays in the destination of mailings sent by Royal Mail's large customers. In part our findings suggest it is partly due to the fairly modest nature of the current discounts and price rises proposed. Our survey suggests that these price changes may not be sufficient to provide strong incentives for mailers to quickly make the changes necessary for implementation of zonal pricing or to move to reduce volumes to more expensive zones, or to switch to competitors.

4.4 Our survey confirms that transactional mailers generally need to send mail to where their customers are, and will continue to do so. Such mailers often regard quality of service as more important than price, and see mailing costs as part of the service which they offer their customers, rather than a distinct commodity in itself.

4.5 Further, discussions with interviewees suggest that those sectors and uses of mail which are potentially most able to respond- direct mail and other marketing- may find cost differentials outweighed by other factors- such as the desire to target particular customer segments and this may limit their actual potential to subdivide mail geographically.

4.6 In general we do not consider on the basis of our survey that the introduction of zonal prices as foreseen in these proposals will reduce volumes substantially which are sent to rural areas or Greater London.

## Implementation issues

4.7 Many of our respondents have outlined some transitional problems that they may face in implementing zonal prices and indicated that the implementation of zonal pricing will take them some time.

4.8 To some extent these problems may come from their own organisational of the use of mail services- where they may not currently be sorting currently in a way which may allow for zonal pricing or from their own internal organisation of the distribution of mail which would need to be reworked if mail was geographically subdivided (as for example where retail organisations send out their mail from one point).

4.9 However, our survey results are also a little paradoxical, suggesting that mailers may take some time in implementing zonal pricing but also that some mailers would actively seek to exploit any arbitrage possibilities during the transition period.

4.10 We consider that this ambiguity can be explained by mailers seeing the potential attraction for arbitrage in the interviews outside the context of the complexity of achieving such an arbitrage despite the structure of the interviews and questionnaires.

## Market effects of zonal pricing

4.11 There may also be long term market effects from zonal pricing.

4.12 We regard the move to zonal pricing as likely to be another agent of change in the postal market. These proposals, if introduced, would provide a further stimulus to an increasingly commercial viewpoint amongst large mailers- which is driving increased switching to access providers and over the medium term could create a greater sensitivity to the opportunities for reducing mail costs potentially offered by zonal pricing products.

4.13 In this context it is clear that the general move towards more cost reflective pricing- in unscrambling historic mis-pricing which it can be argued has been instrumental in the growth of some products (such as some publishing products)- may create a new composition of demand for postal services.

4.14 Within this general trend, zonal pricing may also create new opportunities for niche products and for customers to optimise their mailing structure and sorting.

4.15 Finally, as the gap between zonal and uniform prices may become wider, our findings on the effects of discounts on mailers behaviour suggests that much more substantial switching between uniform and zonal products may occur.

# ANNEX 1: SECTOR CLASSIFICATION

A1.1 The sector classification is based upon Royal Mail’s categories which describe its main customers. These are as follows:

## SECTOR STRUCTURES

A1.2 There are 11 sectors in total. Each sector is broken down into a number of sub sectors as defined in the example below. The sectors are coded using letters, Distance Selling being "D" and the sub sectors are coded using letters and numbers, Charities being "D4" and Entertainment being "D6"

A1.3 The 11 Sectors are classified as follows :

| | |
|---|---|
| D | DISTANCE SELLING |
| E | EDUCATION |
| F | FINANCIAL SERVICES |
| G | GOVERNMENT |
| M | MANUFACTURING |
| C | MEDIA & CO SUPPLIERS |
| P | PUBLISHING |
| R | RETAIL |
| U | UTILITIES |
| W | WHOLESALE & DISTRIBUTION |
| Z | OTHER BUSINESSES |

A1.4 It is important to remember that we are segmenting companies according to their main business e.g. Barclays Bank PLC will be classified as a bank even though it does sell insurance, Next PLC will be classified as a retailer even though it does offer mail order.

A1.5 The complete list of sub sectors is as follows;

| Sub Sector Code | Sub Sector Description |
|---|---|
| C01 | Mailing & Fulfilment Houses |
| C02 | Broadcasters & Film Makers |
| C03 | Direct Marketing Agencies |
| C04 | Other Co-suppliers |
| D02 | Consumer Mail Order |
| D03 | Commercial Mail Order |
| D04 | Charities |
| D05 | Travel & Tourism |
| D06 | Entertainment |
| E01 | Higher Education |
| E02 | Research & Development |
| E03 | Vocational Education |
| E04 | Schools |
| F01 | Banks |
| F02 | Building Societies |
| F03 | Credit Card Companies, Processors and Finance Houses |
| F04 | Insurance and Assurance Companies |
| F05 | Investment Companies and Financial Specialists |
| F06 | Solicitors, Legal & Accountancy |
| G01 | Government Departments, Ministries and Agencies |
| G02 | Local Authorities |
| G03 | Health |
| M01 | Manufacturing of Vehicles, Aerospace & Ships |
| M02 | Manufacture of Textiles Clothing & Footwear |
| M03 | Manufacture of Rubber & Plastics |
| M04 | Manufacture of Wood Products & Furniture |
| M05 | Manufacture of Soap, Detergents, Perfumes etc. |
| M06 | Manufacture of Food, Drink & Tobacco |
| M07 | Manufacture of Electrical Goods & Electronics |
| M08 | Manufacture of Paper & Packaging |
| M09 | Engineering & Metal Goods Manufacture |
| M10 | Mining & Manufacture of Metals, Minerals, Fuel |
| M11 | Manufacture of Chemicals & Pharmaceuticals |
| M12 | Agriculture, Fisheries & Forestry |
| M13 | Other Manufacture |
| P03 | Magazine & Periodical Publishing |
| P04 | Political Organisations and Pressure Groups |
| P05 | Professional Organisations |
| P06 | Book Publishers |
| P07 | Newspaper Publishers |
| P08 | Other Publishing & Printing |

| | |
|---|---|
| R01 | Food, Beverages & Tobacco Stores |
| R02 | Retail of Motor Vehicles & Automotive Fuel |
| R03 | Other Retailers |
| R04 | Real Estate Activities |
| U01 | Telecommunications |
| U02 | Gas Supply |
| U03 | Electricity |
| U04 | Water |
| U05 | Production of Other Energy |
| W01 | Haulage & Distribution |
| W02 | Wholesale |
| W03 | International Consolidators |
| Z02 | Construction Industry |
| Z03 | General Business Activities |

# ANNEX 2: RESPONSE PER QUESTION BY SECTOR

## Section 1

| sector | Number of respondents per sector | Question 1: number of responses | Question 2: number of responses | Question 3: number of responses | Question 4: number of responses | Question 5: number of responses | Question 6: number of responses | Question 7: number of responses | Question 8: number of responses | Question 9: number of responses | Question 10: number of responses |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | |
| **financial services** | 10 | 10 | 10 | 7 | 9 | 10 | 7 | 9 | 8 | 9 | 9 |
| **distance selling** | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 0 | 0 | 1 |
| **publishing** | 3 | 3 | 3 | 2 | 3 | 3 | 1 | 3 | 2 | 2 | 2 |
| **utilities** | 1 | 1 | 1 | 0 | 1 | 1 | 0 | 1 | 0 | 0 | 1 |
| **media and co-suppliers** | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 1 |
| **government & health** | 5 | 5 | 5 | 5 | 5 | 5 | 1 | 4 | 0 | 3 | 5 |
| **retail** | 4 | 4 | 4 | 3 | 3 | 4 | 1 | 4 | 3 | 1 | 2 |
| **other businesses** | 4 | 4 | 3 | 3 | 4 | 4 | 0 | 4 | 0 | 2 | 4 |
| **manufacturing** | 3 | 3 | 1 | 1 | 2 | 3 | 2 | 3 | 2 | 2 | 3 |
| **wholesale and distribution** | 1 | 1 | 0 | 0 | 1 | 1 | 0 | 1 | 0 | 0 | 1 |
| **undefined** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | |
| **education** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | |
| **total sample** | **33** | **33** | **29** | **23** | **30** | **33** | **13** | **31** | **15** | **20** | **29** |

## Section 2

| sector | Number of respondents per sector | Question 11: number of responses | Question 12: number of responses | Question 13: number of responses | Question 14: number of responses | Question 15: number of responses | Question 16: number of responses |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| **financial services** | 10 | 8 | 8 | 10 | 10 | 9 | 10 |
| **distance selling** | 1 | 0 | 0 | 1 | 1 | 0 | 1 |
| **publishing** | 3 | 2 | 3 | 3 | 3 | 2 | 3 |
| **utilities** | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **media and co-suppliers** | 1 | 0 | 1 | 1 | 1 | 0 | 1 |
| **government & health** | 5 | 4 | 4 | 5 | 5 | 5 | 5 |
| **retail** | 4 | 3 | 3 | 4 | 4 | 4 | 4 |
| **other businesses** | 4 | | 4 | 4 | 4 | 4 | 4 |
| **manufacturing** | 3 | 3 | 3 | 3 | 3 | 3 | 3 |
| **wholesale and distribution** | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **undefined** | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **education** | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **total sample** | **33** | **22** | **28** | **33** | **33** | **29** | **33** |

## Section 3

| sector | Number of respondents per sector | Question 17: number of responses | Question 18: number of responses | Question 19: number of responses | Question 20: number of responses | Question 21: number of responses | Question 22: number of responses | Question 23: number of responses | Question 24: number of responses | Question 25: number of responses | Question 26: number of responses | Question 27: number of responses | Question 28: number of responses |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | |
| **financial services** | 10 | 9 | 7 | 8 | 9 | 9 | 9 | 9 | 10 | 9 | 9 | 10 | 9 |
| **distance selling** | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **publishing** | 3 | 3 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| **utilities** | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 1 |
| **media and co-suppliers** | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **government & health** | 5 | 4 | 3 | 5 | 3 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| **retail** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 4 | 3 | 3 | 3 |
| **other businesses** | 4 | 4 | 4 | 3 | 4 | 4 | 4 | 4 | 4 | 3 | 4 | 3 | 4 |
| **manufacturing** | 3 | 2 | 2 | 3 | 2 | 2 | 3 | 2 | 3 | 2 | 3 | 2 | 1 |
| **wholesale and distribution** | 1 | 1 | 1 | 1 | 1 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **undefined** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **education** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **total sample** | **33** | **30** | **26** | **28** | **28** | **31** | **31** | **30** | **30** | **29** | **30** | **29** | **28** |

**Section 3 (Cont)**

| sector | Number of respondents per sector | Question 29: number of responses | Question 30: number of responses | Question 31: number of responses | Question 32: number of responses | Question 33: number of responses | Question 34 number of responses | Question 35: number of responses | Question 36: number of responses | Question 37: number of responses |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| **financial services** | 10 | 8 | 10 | 1 | 3 | 8 | 8 | 6 | 6 | 7 |
| **distance selling** | 1 | 1 | 1 | 0 | 0 | 1 | 1 | 1 | 1 | 0 |
| **publishing** | 3 | 2 | 3 | 0 | 1 | 2 | 2 | 1 | 2 | 2 |
| **utilities** | 1 | 1 | 1 | 0 | 0 | 1 | 1 | 0 | 1 | 1 |
| **media and co-suppliers** | 1 | 1 | 1 | 0 | 0 | 1 | 1 | 1 | 1 | 1 |
| **government & health** | 5 | 5 | 5 | 0 | 3 | 5 | 4 | 2 | 3 | 4 |
| **retail** | 4 | 4 | 4 | 0 | 2 | 4 | 4 | 2 | 2 | 3 |
| **other businesses** | 4 | 4 | 3 | 0 | 0 | 4 | 3 | 2 | 4 | 2 |
| **manufacturing** | 3 | 3 | 2 | 0 | 1 | 1 | 2 | 1 | 2 | 2 |
| **wholesale and distribution** | 1 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 1 | 0 |
| **undefined** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **education** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **total sample** | **33** | **29** | **31** | **1** | **11** | **27** | **26** | **16** | **23** | **22** |