Legal and Regulatory Update

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Postal tariff strategies: From volumetric pricing to size-based pricing to pricing in proportion

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Abstract

This paper looks at the various postal tariff strategies employed in the UK since the mid-1990s, culminating in the forthcoming introduction of 'pricing in proportion' (PIP) later this year.

Size-based pricing first reared its head, under the guise of volumetric pricing, approximately ten years ago. Its driver was the desire of Royal Mail to align its cost base with its prices. This was despite what was generally regarded as its inefficient operation. The internal pressures within Royal Mail came from a perspective of reducing processing costs for very often hand-sorted mail (large flat-sorting mechanisation was still in relative infancy) in growing volumes.

After a series of ill-fated attempts to persuade industry to adopt or consider size-based pricing, Royal Mail decided to launch a consultation on the issue in 2002. Royal Mail made it very clear that the reason for the consultation and why it wanted to move to size-based pricing was twofold.

- Commercial reasons. Royal Mail believed it would improve its commercial position, improve efficiency and make it simpler and easier for Royal Mail customers to use its services.
- The secondary aim was to provide Royal Mail with a way to bring about a better alignment of prices to costs.

First consultation

Commercial gain

Here it is worth noting that the principal aim was not to ensure prices are geared to costs but to maximise commercial gain for Royal Mail. This is very pertinent in the context of later developments.

Royal Mail actually defined size-based pricing at this stage.

'Size Based Pricing measures the dimensions of postal items and prices them according to their length, width and thickness. These dimensions are not multiplied together to obtain a price — as in "volumetric" pricing — because all three dimensions are important individually. However we have found no mail company which prices only by size. They all have weight limitations (or weight caps) and it is normal to have some weight breaks within each of the larger sizes. For our purposes therefore we have defined Size Based Pricing as "a system of pricing mail which takes account of the size of each mail

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item”. This definition does not exclude weight, which we propose to retain in the form of weight limits for our sizes, and as the basis of a single weight break in each of our two larger sizes.’

Although the explanation is quite detailed, it is confusing. It is difficult to see how Royal Mail could obtain cost efficiencies if it is still using weight as one of the pricing parameters.

The underlying external factors which impinged and impacted on Royal Mail at this time were both regulatory. The first Postal Services Directive 97/67EC established in Article 12 the concept that prices must be geared to costs. Within this article the EU Commission established three concepts: gearing, transparent and non-discriminatory. As with many EU concepts, the devil lies with the detail or how the member state interprets the article — for instance, having sufficient information to verify that prices are, in fact, based upon costs. This article gave Royal Mail and of course Postcomm, the UK independent regulator established through the directive, the means to pursue a postal pricing regime based on costs. Here one has gone from a pricing concept driven in the mid-1990s by a Royal Mail agenda to one in 2002 driven by a regulatory imperative agenda, in essence giving Royal Mail the regulatory authority to pursue such a pricing route. In addition Royal Mail’s licence had recently been granted; it was now a regulated company and facing the prospect of real competition within the UK postal services marketplace. This competitive threat focused the minds of Royal Mail and gave it something of a steely resolve to pursue size-based pricing, even though it was looking to price according to size on an existing inefficient operation. The other regulatory constraint on Royal Mail was that any pricing changes had to result in a revenue-neutral approach. This on the face of it seems eminently sensible, but considered in the light of Royal Mail’s overall stated priority of commercial gain and the need for business mailers to change their behaviour to make size-based pricing work, the neutral concept appears very weak.

The consultation, a very brave move from Royal Mail, shifted the size-based concept to centre stage. The reaction from industry was broadly against, with a common thread of penalising existing formats, lack of investment from Royal Mail and whether or not Royal Mail understood the cost base. This paper does not seek to rehearse all the arguments from industry, but merely to show how such arguments and positions led to change.

The response to this consultation was extensive, played out in the national and trade media, although skilfully from Royal Mail’s perspective it had managed to get size-based pricing on Postcomm’s agenda. Following the consultation Royal Mail engaged with industry, which led to further refinements in the proposals but effectively watered down the concept. In 2003 Royal Mail submitted its proposals to Postcomm, which spent an inordinate time examining them. Its fundamental concern was the cost-base analysis which Royal Mail had used to underlie its assumptions. Finally, in 2004, Postcomm issued a consultation on Royal Mail’s proposals. This consultation, with proposals

Competitive threat

Compelling arguments

which had been watered down in terms of the concept of size-based pricing, received the highest number of submissions for any Postcomm consultation. Again, the responses to this consultation played out the same well-rehearsed arguments on why size-based pricing would not benefit industry and would lead to cost increases.

Perhaps the most compelling arguments came from the direct marketing and publishing sectors. The direct marketing argument focused on how creativity could be stifled by the proposals. By penalising large sizes creativity would be impacted and stifled, especially as one of the most effective sizes for direct mail was the oversize A4 or large flats. Within the publishing sector, the main concern lay around subscriptions and how the proposals would penalise some publications. Interestingly, both these strong arguments led to a modification in the size-based pricing proposals, with a specific negotiated proposal for publishers within the overall proposals.

After an extended delay and a series of meetings behind closed doors between Royal Mail and Postcomm, the final consultation (using the term loosely) was published. The delay was primarily due to Postcomm trying to satisfy itself that it had confidence in Royal Mail's cost data, which were crucial in respect of prices reflecting costs. Perhaps the most disturbing aspect of this consultation was the way Postcomm announced it in its press release. It was 'minded to accept' Royal Mail's proposals. In legal speak 'minded' means it has made its decision or is a sign it will decide a particular way. This by its very definition set the tone for the consultation: effectively one was examining proposals where the regulator had already made its mind up.

'Minded to accept'

These proposals had gone through much iteration, and were now referred to as 'pricing in proportion' (PIP). They probably reflected the many iterations and changes over the last year. There were now fewer winners and losers, so dampening the effect on business. A range of weight steps was introduced, in recognition that weight does have an impact on price as an indicator of cost. The thickness for large letters was increased, so reducing price impacts for certain mailers.

The requirement for uniform thickness on large letters and A3 packets was removed, so increasing flexibility and reducing price impact. This measure would significantly benefit publishers. There was a reduction in prices for large letters, so benefiting direct mailers. A facility for customers to present bags with items of mixed weight was introduced, in recognition of the range of sizes and formats used within campaigns and the on cost in keeping same weight bagged together. A true recognition of the impact of PIP was the introduction of a mitigation scheme to soften the impact of the price increases.

Faced with these many changes and the minded stance of the regulator, industry to a large extent accepted the proposals, subject to a few key elements such as an introduction period. Due to the nature of PIP and the need for clients to test a range of new formats, a 12-month introduction period was pushed for. There were many practical issues around this final Postcomm consultation on which industry pushed for answers or changes.

Practical issues

- Examination of cost base and review of impacts of single delivery and transport review, with any changes to be fed into the Postcomm PIP analysis.
- A 12-month notice period from the date of the Postcomm decision.
- Delaying the introduction of price control to ensure PIP was implemented at same time.
- Introduction and publication of actual PIP prices as soon as possible after the Postcomm decision.
- Mid-year review on price control to evaluate revenue neutrality and possible cap adjustments.
- Reduced qualifying criteria for the mitigation scheme, to include all bulk mail users and those affected by an increase in postage bills of over 10 per cent.
- A communication scheme that addresses all key sectors (business and consumer) through a multichannel approach and deploys a significant budget to meet its objectives.

Conditions

The final Postcomm decision, published later in 2005, formalised Postcomm's acceptance of Royal Mail's proposals but added many key conditions to this acceptance. These conditions were pronounced, with the extension of the notice period to 12 months and the requirement for an effective communication scheme to business and consumers.

With PIP's introduction now set for August 2006, there are still practicalities to be considered such as the impact on the 2006 price control and the level of the final prices. As Royal Mail is a regulated business, its prices within the licensed area are price controlled. Here price control acts as a surrogate for competition until competition becomes established. The control acts as a RPI minus x mechanism, with x a percentage to encourage Royal Mail to maximise its cost efficiencies. The new price control, still not determined as at November 2005, comes into force in April 2006, yet PIP is to be introduced in August 2006, so users could face two price hikes within six months. The final PIP prices will not be known until March 2006, which makes it very difficult for mailers to plan effectively.

So over a period of 11 years we have gone from volumetric pricing to size-based pricing to pricing in proportion. The final accepted proposals are not fully cost reflective. The proposals have gone through so many iterations that weight is still a key part of the proposals, despite having no relation to cost, according to Royal Mail. The aim always was to have a pricing system that reflected costs, and efficient costs at that. What we have arrived at is a pricing system which is a hybrid, with size and weight as key parameters. The debate is whether such a system will serve Royal Mail and users over the forthcoming years.