ROYAL MAIL WHOLESALE

DECISION DOCUMENT:
A NEW WAY OF CALCULATING THE URBAN DENSITY MEASURE OF NATIONAL PRICE PLAN ONE (SSCs)

5 September 2017

1. Thank you for your responses to the recent Access consultation which closed on 21 July 2017. We received 5 responses. The consultation was on a change to the mathematics that sits behind the proposed new Urban Density Methodology of National Price Plan One (SSCs) that we first presented in the September 2016 Access consultation.[1] This change was designed to correct an error inherent in the September 2016 methodology. It proposed that we multiply a percentage shortfall (or surplus) of urban items by the total number of items in an SSC, rather than the number of urban items, to derive the adjustment volume needed to meet the benchmark.

2. In reaching our final decision, we considered the responses we received to the two questions posed:
    a. Question 1: Do you have any comments in response to the proposed Urban Density methodology and calculation?
    b. Question 2: Do you have any comments in response to changing to the new methodology from the start of the next contract year?

Responses to Question 1

3. All respondents agreed that the new methodology has more logic, is a better measure of urban density and will be more effective at limiting arbitrage. These are all objectives we expect to fulfil by making the change.

4. All respondents commented that the new methodology has the potential to significantly increase the size of surcharges, compared to the incorrect method originally proposed in September 2016. This is because the multiplier is the (larger) total item count rather than the (smaller) urban item count. This is not in fact correct. Compared to the current methodology, and factoring in the change to the Baseline Year which reduces total surcharges by c.50%, the new calculation means that, under 16/17 volumes, the majority of NPP1 customers would not face a surcharge. For the four customers that would, their combined total potential increase in surcharges is less than £11k.

5. Respondents suggested two changes to the calculation:
    a. the surcharge rate should be the percentage difference between the national and the urban rate rather than between the national and the rural rate; and
    b. introduce a rebate if the customer's urban density profile has a net surplus of urban items relative to the Royal Mail benchmark.

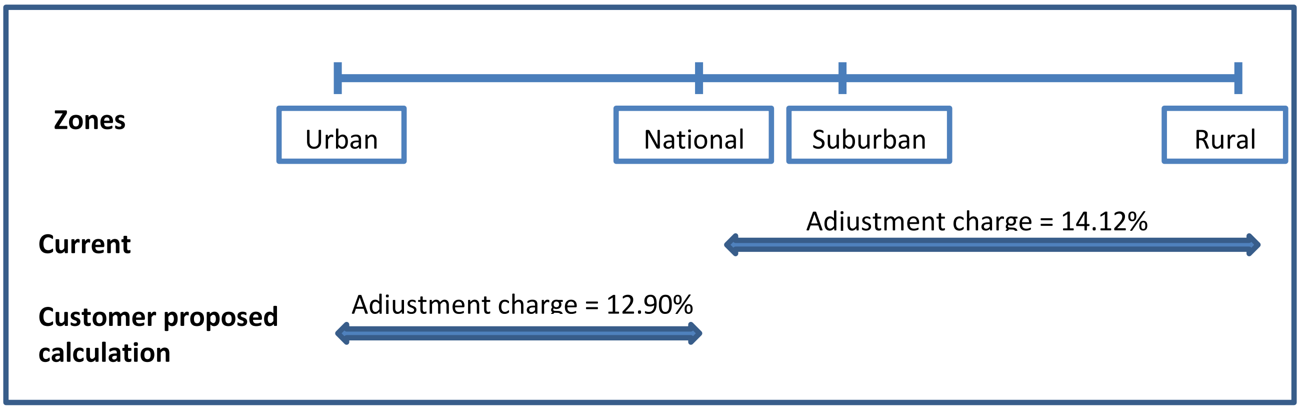
6. We have considered the two suggestions in the context of continuing discussions on how best to reduce or remove arbitrage and formed the following conclusions:
    a. **Customer suggestion 1: the surcharge rate should be the percentage difference between the national and the urban rate**

    We understand that customers have suggested this change as the surcharge relates to an insufficient number of urban items, which cost less to deliver than the national price. Customers proposed that Royal Mail's compensation for the loss of urban items should therefore be set by the percentage difference between the urban and national rate.

[1] A Discussion Document On The Impact Of Removing The Requirement To Print A Zonal Indicator On Mailmark Zonal Mail, 12 September 2016.

Figure 1 shows that the customers' proposal would imply a surcharge rate of 12.90% (the urban to national price variance). The current surcharge rate is defined by rural to national price variance (14.12%). The customer proposal would therefore result in a small, 1.22 percentage point, decrease in the UDB surcharge rate (based on 2017 prices).

Figure 1: Price variance by zone to address shortfall in urban items



Note: Diagram not to scale

Any shortfall in the proportion of lower cost urban items is, by definition, made up by a higher proportion of higher cost items in suburban and rural areas.[2] Technically speaking, for the surcharge rate to fully reflect zonal prices, the additional suburban items should be charged by the difference between suburban and urban price variance (13.05 percentage points). Similarly, additional rural items should be charged by the difference between rural and urban price variance (27.02 percentage points).

Therefore, we do not believe the customer proposal, with a surcharge rate of 12.90%, would adequately compensate Royal Mail for the shortfall in lower cost items that make up the national average.

The current surcharge rate (14.12%) does not fully align with zonal prices either. Royal Mail considered a change to the surcharge rate to align it with zonal prices for all customers. However, if we were to surcharge in this way, surcharges are highly likely to increase. Such a change would also significantly increase the complexity of the calculation and reduce transparency. Finally, NPP1 surcharges reflect the combined impact of UDB surcharges and National Spread Benchmark surcharges. Therefore in the interests of customers, we do not propose changing the surcharge rate.

b. Customer suggestion 2: a rebate for a surplus of urban items

We briefly discussed this proposal at an access customer workshop on 5 July 2017 and agreed to look at this in more detail. It may have some merit in discouraging exploitative arbitrage. However this is a complex area. We would need to better understand the possible scenarios in which a surplus of urban items could occur to ensure we are not opening up different avenues for arbitrage. We also need to understand the effects on

[2] We do not include London SSCs in the Urban Density measure because they form the discrete separate London zone.

Royal Mail revenues of operating rebates and tolerances, and whether the two can work simultaneously under national averaged price plans. Our initial thoughts, in line with our views at the July workshop, are that it is counter-productive to offer a rebate in an environment of high tolerances. We shall put this on the agenda to discuss with customers at the next workshop on 27 September 2017. In the meantime, and as previously advised, we do not believe this suggestion prevents us from proceeding with the revised Urban Density methodology as customers with a surplus of urban items can (and do) access the urban prices by using the zonal price plan.

Responses to Question 2

7. All customers agreed that we should change the Urban Density methodology for the start of the next contract year. We would like to thank customers for acknowledging the flaw of the current Urban Density methodology and supporting the need to change it.

8. Three customers suggested however that we apply the incorrect September 2016 Urban Density methodology because it minimises the surcharges for customers that are due surcharges and it helps to avoid price shocks in the market.[3]

9. As mentioned in the consultation document, the original September 2016 methodology is incorrect. It provides a mechanism to remove urban volume proportionately or in totality from SSCs without incurring any surcharge. In other words, it provides a mechanism to easily arbitrage without surcharge. We do not believe it is reasonable to replace one flawed methodology with another flawed methodology.

Our decision

10. Customers agree that the change to the Urban Density methodology, as proposed in our June 2017 consultation, provides a correct measure for urban density profiling. We will therefore deploy the change at the start of the next contract year, 26 March 2018.

11. Finally, we would like to acknowledge that all respondents made reference to the change in Urban Density methodology being a first step on a 2 – 3 year change programme to remove arbitrage. We welcome the industry's recognition that arbitrage is an issue which needs to be addressed and this is a positive first step. We look forward to continuing to work collaboratively with customers to develop a planned, phased and proportionate change programme. This would ideally be put in place before the end of this year. We look forward to progressing discussions at the next customer workshop on 27 September regarding a framework for reducing tolerance levels, use of actual customer data to serve as the base for the profile measures and proposals on what an "end state" could look like for Access price plans.

[3] The same three customers said that we should only introduce the correct Urban Density methodology once we implement the two customer suggestions at paragraph 6 above. Please refer to paragraph 6 for our response to the suggestions.