



# **Costing methodology to support zonal pricing: a decision**

**Royal Mail Wholesale**

4th March 2011

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## 1 INTRODUCTION

The purpose of this document is to inform our customers and the wider market of the decisions Royal Mail Wholesale has taken following our Consultation<sup>1</sup> with customers that ran from 29<sup>th</sup> October to mid December 2010.

That document explained the background to the consultation; summarised the need for the change as required by Postcomm in its Licence Modification of 2009; and put forward three questions on our proposal to revise the methodology to determine zonal costs, to which we asked our customers and other interested parties, including Postcomm, to respond.

The questions comprised:

1. A question about the appropriateness of the objectives of the Review into zonal costing methodology (*“Do you agree that the above requirements are appropriate? Do you propose any others?”*)
2. A set of three options as to the way development of the costing methodology could be approached and the opportunity to suggest others (*“Do you propose any other options for the development of the costing methodology?”*)
3. The opportunity to add to our own appraisal, provided in the Consultation document, of the three options (*“Do you have any further observations on the above appraisal of the Options? And do those observations lead you to a different conclusion to ours?”*)

This document provides the background to this consultation in Section 2, including Royal Mail’s Licence requirement; the scope of our review; the options considered.

Section 3 provides our responses to the input provided by our customers

Section 4 describes our conclusions, our decision on the way forward and the next steps.

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<sup>1</sup> A Consultation on Royal Mail’s Costing Methodology to Support Zonal Pricing, 29<sup>th</sup> October 2010

## 2 BACKGROUND

### 2.1 Purpose of the Consultation

The purpose of the late October 2010 Consultation document was to propose a revised methodology to determine zonal costs which uses as far as reasonably practical,

- (a) actual cost and volume data by delivery office
- (b) a statistical model that determines estimates of the unit cost for each zone based on specific data associated with each postcode sector within each delivery office.

This would fulfil Royal Mail's requirements of Condition 21 (5A) as required by Postcomm's Licence Modification of May 2009. The proposal is required to be implemented no later than July 2011. We explained that, as Royal Mail is required to provide six months' notice of the methodology ahead of any price change, we would expect to implement any consequential changes to the zonal access prices through our prices from April 2012.

In addition to a change in costing methodology, the Licence makes provision for a change to the allocation of postcode sectors to zones, and thereby to the definition of those zones for the purpose of zonal access pricing.

In the consultation we proposed a revision to the costing methodology, using estimates of postcode sector costs that would retain the current definition of zones. We looked at a further option that would involve redefining the zones on the basis of estimated postcode sector costs better to reflect costs. Prior to April 2012 this option might need to be explored further to ensure that the zones are fit for purpose beyond 2012.

### 2.2 Licence requirement for review

During its review of the zonal structure and methodology in 2008/09, Postcomm expressed a preference to have the zonal costs allocated by postcode sector, and therefore at a more disaggregated level than that of the delivery office. They identified the need for Royal Mail Wholesale to take this forward. Royal Mail's Licence states that:

*"the Licensee shall develop, publish and implement no later than July 2011 a costing methodology for the purpose of calculating the cost of GZones which uses, as far as reasonably practical –*

- (a) *actual cost and volume data which can be directly assigned to a particular delivery office, and*
- (b) *a statistical model that determines the unit costs for each GZone based on specific data associated with each postcode sector within each delivery office.”*

Further, there is a requirement under its Licence for Royal Mail to consult on changes to the zonal costing methodology for its zonal access prices (Annex A contains more on the current Condition 21(5A)).

## **2.3 Scope of the Costing Methodology Review**

### **2.3.1 Current position**

In April 2010, Royal Mail amended the zonal pricing structure to comprise of a London zone (based on Standard Selection Codes (SSCs) within the M25) and three other zones defined by the density of delivery points and percentage of delivery points that are businesses. Postcomm had previously consulted on the licence modifications for this change in February and May 2009 and set out a requirement for Royal Mail to undertake a review, consultation and revision of the costing methodology used to determine the zonal access prices.

Zonal access prices are formed by a mark up or mark down to the National (uniform) access price. The mark up or mark down reflects an estimate of the cost differences observed in ‘Local Distribution’ and ‘Delivery’.

### **2.3.2 2010 Consultation**

Table 1 shows that aside from regional wage differences, the parts of the operation where the downstream activities influence the zonal costs are the Local Distribution and Delivery elements. The Outdoor Delivery element is the focus of the analysis described here. No change is proposed to the treatment of the other costs such as Inward Mail Centre, local distribution and indoor delivery, except that where possible (i.e. the London Zone) the cost data associated with the specific Mail Centre or Delivery Office will be used.

**Table 1: Change of methodology**

Element	Current Treatment	Proposed methodology
Inward Mail Centre	All items in mail centre area bear similar cost, aside from regional wage differences	All items in mail centre area bear similar cost, aside from regional wage differences
Local Distribution	Cost by DO modelled (distance, number of trips) and total in MC area normalised to actual	Cost by DO modelled (distance, number of trips) and total in MC area normalised to actual
Outdoor Delivery	DOs allocated to zones based on DO area characteristics; and zonal costs are average unit costs across relevant DOs	To be amended to directly estimate sector specific costs

Currently, for both staff and non-staff Outdoor Delivery costs, delivery offices are allocated to zones based on Delivery Office area characteristics (e.g. delivery point density and business point density) and zonal costs are then averaged across relevant delivery offices. The principal concern with the current methodology expressed by Postcomm is that it relies on the allocation of delivery offices to zones, based on the overall average delivery point density of the Delivery Office area. On average a delivery office serves around eight sectors. This method would be satisfactory if, in general, each postcode sector in a delivery office area were allocated to the same zone. However, this is not the case as there are many cases where, for example, a delivery office might serve sectors in zones A, B and C yet be allocated to zone A because the zone A postcode sectors are predominant.

When enabling the change from five zones to four from April 2010, Postcomm accepted that the current methodology could continue to be applied. However, Postcomm sought to ensure that Royal Mail undertook a review to revise this methodology by July 2011 to one that more closely reflected the delivery costs of postcode sectors<sup>2</sup>. This defines the scope of the review to be the methodology for establishing delivery costs by postcode sector.

### **2.3.3 Objectives of the Methodology Review.**

Our Licence requires the costing methodology to use:

- (a) actual cost and volume data which can be directly assigned to a particular delivery office, and

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<sup>2</sup> Royal Mail's Retail Zonal Pricing Application for Non-Universal Service Bulk Mail Products, decision document (Chapter 4). Published by Postcomm 5th February 2008

- (b) a statistical model that determines the unit costs for each GZone based on specific data associated with each postcode sector within each delivery office.

In addition to these requirements, in our Consultation document we proposed an approach that also takes into account:

- (i) improved cost reflectivity, including account of improved efficiency over time;
- (ii) a degree of stability in the way the zonal costs are reflected in the zonal definitions;
- (iii) an approach that is reasonably straightforward for customers to comprehend ; and
- (iv) a path of consultation and change that avoids shocks.

**CONSULTATION QUESTION 1: Do you agree that the above requirements are appropriate? Do you propose any others?**

### 2.3.4 Options Arising From Our Costing Methodology Review

#### 2.3.4.1 Revised Methodology

We used a statistical model to estimate a cost function for delivery offices and then applied that estimated cost function to postcode sector data to form estimates of the costs for each postcode sector. The cost function includes the main explanatory variables used in recent research papers. Further details of the approach were included in Annex B of the original Consultation document<sup>3</sup>.

#### 2.3.4.2 Options on Which We Consulted

We have identified from this model three main options for the development of the costing methodology used for the costing of GZones. These are:

**Option 1:** *No change:*

This uses current zonal definitions and actual costs for the London zone; and allocates non-London delivery cost to zones by reference to the cost of each delivery office and a mapping of the delivery offices to zones. We recognise that Postcomm had a concern with this approach. It also, of current necessity until mid 2011, uses the Mails Characteristics Survey (MCS) data for end-to-end items only. Nevertheless, it has provided continuity, is understood by our customers and is inherently stable in relation to movements in costs (and hence price relationships).

**Option 2:** *Change to estimated postcode sector costs:*

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<sup>3</sup> Ibid: footnote 1

This uses current zonal definitions and actual costs for the London zone; and allocates non-London delivery costs to zones by reference to the estimated cost of each postcode sector (as explained at 3.1 and Annex B) and a mapping of postcode sectors to zones. We believe this option is also inherently stable and is more cost reflective than Option 1. Again, though, of necessity until mid 2011 it would use the MCS data for end-to-end mail only.

**Option 3; *Change to estimated postcode sector costs and redefinition of zones:***

This identifies the delivery costs for four zones by reference to the estimated cost of each postcode sector and redefines those zones (including London) to regrouping postcode sectors on the basis of lowest to highest unit cost; and allocates delivery costs to new zones by reference to the estimated cost of each postcode sector. This assumes four zones would still apply. As for Options 1 and 2, of necessity until mid 2011 it would use the MCS data for end-to-end mail only.

We believe this option to be inherently unstable at present and subject to volatility whilst Royal Mail continues with its Modernisation Programme. This is because the Programme is addressing both absolute and relative inefficiencies across Royal Mail. To adopt this option ahead of the Modernisation Programme's completion would mean that significant annual changes to the composition of each Zone, in terms of which Postcode Sectors fall within each cost band represented by each Zone. However, we believe that the highly cost reflective nature of this option has merit once increased stability in relative costs is achieved.

**CONSULTATION QUESTION 2: Do you propose any other options for the development of the costing methodology? If so, please explain your proposal.**

Our appraisal of the options was provided at paragraph 3.3 of the October 29<sup>th</sup> 2010 Consultation document.

**2.3.4.3 Our appraisal of the Options**

Zonal prices are expressed as a percentage mark-up on the uniform price of the NGPP contract. For ease of reference, our analysis and results correspond to the data used for setting the current access zonal mark-ups and are shown in Table 2 using 2008/09 data. The analysis is shown for the average over all formats.



(Please note that the figures in Table 2 do not necessarily reflect the current mark-ups on prices: those prices take account of other factors including the sub-cap constraint on the degree to which a zonal access mark-up on price can move from one year to the next.)

**Table 2: Zonal mark-ups for current and alternative cases (Using 2008/09 data)**

Zone	Option 1 %	Option 2 %	Option 3 %
A	-8.5	-8.1	-19.1
B	-2.4	-1.8	-1.3
C	+11.0	+9.9	+10.3
D	+10.4	+10.5	+33.2

Note: Options 1 and 2 assume the same definition of zones as currently apply (including a zone D for London), whereas Option 3 assumes a change to the definition of the 4 zones.

From our review of these results we conclude the following:

- (a) The results for Options 1 and 2 are similar. The direct impact of changing the costing methodology is relatively small. The main difference is that the methodology for Option 2 takes account of postcode sector data, whereas that for Option 1 does not.
- (b) The results of Option 3 are dissimilar to Options 1 and 2. This option would be more cost reflective as it would reflect the greatest differential in unit costs across zones. However, sector costs movements would be significant during the course of Royal Mail's on-going Modernisation Programme and, if applied, would introduce significant annual changes and potential cost shocks for customers. Further consideration might also be given to the number and size of the zones for Option 3.

We have also looked at 2009/10 data which will be used to form the relative zonal access prices for 2011/12. While the percentages across zones differ when 2009/10 is applied, we can confirm that the above observations still hold.

**CONSULTATION QUESTION 3: Do you have any further observations on the above appraisal of the Options? And do those observations lead you to a different conclusion to ours?**

#### **2.3.4.4 Proposed Change to the Zonal Costing Methodology**

We proposed that the revised costing methodology be applied to estimate the costs at a postcode sector level, ahead of any further consideration of the definition of zones (i.e. we advocated Option 2), although we explained that we believed there is merit in giving further consideration to the zonal definition for costs from April 2012. However, we said that we believed that any such consideration, and indeed any costs from April 2012, should be based on the revised costing methodology in which estimated zonal costs are formed at the level of postcode sector.

### 3. OUR RESPONSES TO INPUT FROM CUSTOMERS

3.1 A total of six customers responded to the three questions that we posed. Most of these responses were brief; one was to confirm that the customer had no input to make; another made general comments as they affected their business model; and none disagreed with our proposal to proceed on the basis of our Conclusions paragraph in the Consultation document. We have provided commentary below on the main points made. One believed that Postcomm's expertise was required, and, indeed, we sent the Regulator our document and received a response, the relevant extracts of which are reproduced below in Section 4.

#### 3.2 Consultation Question 1

**This was a question about the appropriateness of the objectives of the Review into zonal costing methodology:**

**"Do you agree that the [above] requirements are appropriate? Do you propose any others?"**

Of the specific responses directed at this question, one customer said they believed the requirements, which we stated in the Consultation document (re-produced above at para 2.3) to be appropriate; a second agreed with our stated requirements in the Consultation and stressed that "stability, ease of understanding and shock avoidance are all extremely important for customers and market development".

#### 3.3 Royal Mail Wholesale Commentary and Way Forward on Review Objectives

We are pleased that our stated objectives of the zonal costing methodology review have been endorsed and that no further objectives were proposed. Consequently, our decision is based on the original objectives of the review.

#### 3.4 Consultation Question 2

This comprised responding to a set of three options as to the way development of the costing methodology could be approached and the opportunity to suggest others:

**"Do you propose any other options for the development of the costing methodology?"**

None of the respondents put forward any further options, although one argued that a two zone system was preferred. This issue has been the subject of a previous Postcomm determination, when it was rejected in favour of the current four zone approach. Each respondent preferred Option 2, although one said that the difference in outcomes between it and Option 1 "does appear to be so marginal

that I have to ask if it's worth making the change". The Consultation described Option 2 as follows:

*"Change to estimated postcode sector costs:*

This uses current zonal definitions and actual costs for the London zone; and allocates non-London delivery costs to zones by reference to the estimated cost of each postcode sector (as explained at 3.1 and Annex B of the original Consultation document) and a mapping of postcode sectors to zones. "

All respondents agreed that Option 3 was the least stable and would introduce significant cost shocks. One said that "[RMW] implied that after the completion of the [Royal Mail Operations] Modernisation Programme this approach might become more stable. We do not agree.....the drive for cost efficiency is perpetual and does not stop.....therefore the inherent instability in Option 3 would remain."

The same customer said "Option 3 as presented is not fit for purpose being illogical and arbitrary.....Option 1 is only marginally less cost reflective but does have the strong benefit of being in place, logical and widely understood".

Another disagreed, saying customer said that Option 3 "is better in principle as it is the most cost reflective but is not a stable option at the moment; it should be revisited once operational costs have become less fluid than they are now (say in 2012)".

### 3.5 Royal Mail Wholesale Commentary and Way Forward on Options

In relation to the comment that "the inherent instability in Option 3 would remain", we do not agree. Whilst we do agree that the drive for cost efficiency is perpetual, we consider that beyond the Modernisation Programme there will be a more stable downward cost trend.

We note that respondents have not come up with any additional options.

### 3.6 Consultation Question 3

This question gave customers the opportunity to add to our own appraisal of the three Options, which are in Section 3.3 of the original Consultation and summarised above at 2.3.4.3:

**"Do you have any further observations on the above appraisal of the Options? And do those observations lead you to a different conclusion to ours?"**

One customer commented "I am surprised that differential property costs are not included. Rent/rates costs do vary significantly.....and could be allocated to zones in much the same way as the methodology now being used. The issue about

allocation by zone is not major given that the most significant rent/rates variation will be for London, which is a specific Zone defined by postcodes.”

Another said “The consultation provides insufficient data on which to make an educated and informed opinion on the relative merits of the three different options. Given the far-reaching impact of these changes, more information needs to be provided.”

The same customer said that they believed that “the changes in efficiency over time are best dealt with by changes in the wholesale price overall rather than a change in zonal definitions. Regular changes to methodology and definitions are we believe inconsistent with stability, ease of understanding and to the points above. In particular, we do not accept that there is a need for a “path of consultation” as this indicates future uncertainty and instability.”

### **3.7 Royal Mail Wholesale Commentary and Way Forward on Further Observations**

We have subsequently held several meetings with the customer who said that more information needed to be provided and explained in some technical detail the basis of our proposals. We also discussed their point on how to deal with changes in efficiency, where we believe that their view of wholesale price and any change in zonal definitions relates to two different issues: the latter in itself is independent of overall prices – it’s about how the overall price is allocated. On their stability and uncertainty point, we believe that infrequent changes that nonetheless relate to cost trends and so improve cost reflectivity are fine as long as “shocks” are avoided in the way change is managed.

In relation to the point on differential property costs, Royal Mail’s properties are predominantly old and when considered under a historical cost accounting method differences by zone are not significant. However, it is a point to be noted for the future, for example if we were to adopt a current cost accounting approach. The further observations from customers illustrate that there are varying points of view on this subject, even from the small number of customers who replied. None of the comments that we have received has fundamentally affected our proposed approach and we intend to proceed as described below in Next Steps.

#### 4. CONCLUSIONS AND NEXT STEPS

- 4.1 There was a variety of views expressed by the few customers who responded on each of the questions we posed: some were diametrically opposed to each other. None of the comments from our customers has caused us to change our proposal. RMW intends to take forward Option 2 from our original consultation document: we have identified a statistical model that estimates postcode sector costs as an improvement on the current costing methodology used to form zonal access prices.
- 4.2 We have explained that the application of the Mail Characteristics Survey to Wholesale mail has begun: the effect of this on the outcome of the geographical spread of mail is not yet known. When it is, it may be appropriate to re-consider the definitions of zones.
- 4.3 Respondents have acknowledged the importance of stability and the avoidance of 'shocks'. Views differed as to whether this should mean that the definition of zones should remain static over time. RMW believes that it is right to flag its intention to re-consider this issue (see "Option 3" at paragraph 3.3.4.2) at the appropriate time.
- 4.4 Other issues that affect the zonal costing methodology also need to be considered in the future approach, for example the cost of property, rent and rates – as highlighted in one response.
- 4.5 We give all due recognition to the response received in December from Postcomm, with whom we have since met on this subject. Postcomm welcomed the consultation and noted our view that the proposal fulfils the requirement to initiate the process specified in Condition 21 (5A) of our Licence. They went on to say "As part of their work towards a new regulatory framework from 2012, among other things Postcomm "will be considering in some detail Royal Mail's costing systems to support the 2012 regime and the access provisions in the current licence. We will therefore consider the outcome of your costing methodology consultation in the context of these 2012 projects". This Postcomm consultation is due to be published later in March but will not conclude before mid June
- 4.6 We therefore will proceed to meet our Licence obligation to propose a revised methodology to determine zonal costs – as described in paragraph 2.1 – on the basis described at 4.1 and taking into account such issues as those outlined in 4.2 to 4.4, subject to Postcomm's conclusions following their Price Control 2012 consultation that is scheduled for late March.

Paul Bates  
4th March 2011