

Annex: Tariff Baskets, the Price Control and Sub-caps

This annex contains a brief explanation of tariff baskets, the price control and price sub-caps.

Tariff Baskets

The current price control differentiates between two groups of Royal Mail services:

- a) Tariff Basket A, which comprises services for which there are very limited prospects for competition in the period of the control; and
- b) Tariff Basket B, which comprises services that are more likely to become subject to competition over the period of the price control.

Below is a list of services contained in each of the two baskets.

Tariff Basket A	Tariff Basket B
First class mail not conveyed by other services listed	Special Delivery (Next Day) other than when sold to users having an account with Royal Mail buying the service using this account
First class - Metered	Cleanmail OCR – First Class
Second class mail not conveyed by other services listed	Cleanmail CBC – First Class
Second class - Metered	Cleanmail OCR – Second Class
Standard Parcel	Cleanmail CBC – Second Class
Airmail Europe	Mailsort 120 OCR – First Class
Airmail - World Zone 1	Mailsort 120 CBC – First Class
Airmail - World Zone 2	Mailsort 120 OCR – Second Class
Surface Mail	Mailsort 120 CBC – Second Class
Response Services - First class	Mailsort 700 - First Class
Response Services - Second class	Mailsort 700 - Second Class
First Class - Postage Paid Impression (PPI)	Mailsort 1400 - First Class
Second Class - PPI	Mailsort 1400 Residues - First Class
	Mailsort 1400 - Second Class
	Mailsort 1400 Residues - Second Class
	Presstream - First Class
	Presstream - Second Class
	Packetpost - First Class
	Packetpost - Second Class
	Packetsort 8 - First Class
	Packetsort 8 - Second Class
	Walksort - First Class
	Walksort - Second Class
	Mailsort 700 – Third Class
	Mailsort 1400 – Third Class (incl. Flatsort 1400 – Third Class)

The Price Control and price sub-caps

The revenue Royal Mail is allowed to recover in a particular year of the price control is worked out by multiplying observed mail volumes by notional maximum allowed prices (product by product). Notional prices are those that were in place immediately preceding the new control, rolled forward by RPI-X each year, i.e. inflation less an 'X' factor that represents Royal Mail cost efficiency being passed onto the customer. At the end of each year the revenue actually earned by Royal Mail is calculated by multiplying actual volumes by actual prices charged (product by product). There are many reasons why allowed and earned revenue may differ, including unforeseen price elasticity effects from price changes by Royal Mail. Any difference between earned revenue and allowed revenue is added or deducted to allowed revenue in the following year of the control.

In the first year of the Price Control (2006-07), the notional change in prices for both baskets was limited to a maximum increase of 4%. For the 3 remaining years of the current Price Control (2007-08 to 2009-10), the notional price caps for each year were set at RPI-X. For Tariff Basket A, the price cap for the services is constrained by 'RPI -0.14%', i.e. that the notional prices may only increase annually by 0.14% below inflation. For Tariff Basket B, the increase in the notional price is restricted to 'RPI -1.96%'.

Provided Royal Mail remains within the overall allowed revenue limit for each basket¹, Royal Mail has additional flexibility to increase prices on individual services by a maximum of 3% above the relevant RPI-X for the tariff basket in which the service is allocated. These are the 'sub-caps'. This increase can be implemented on a 2-year rolling basis.

¹ The prices that Royal Mail can set are complicated by a series of additional adjustments within the Price Control. As well as the adjustments for under or over-recovery of revenue in the previous year, these include Royal Mail's performance under the quality of service incentive, unexpected changes in mail volumes and/or Royal Mail's pension fund liabilities.