



## **ROYAL MAIL'S RETAIL ZONAL PRICING APPLICATION: POSTCOMM'S PROPOSALS**

### **CWU SUBMISSION**

#### **Introduction**

1. The Communication Workers' Union (CWU) represents around 250,000 employees in the postal, telecom and related industries. It is the recognised union in the Royal Mail Group for all non-management grades, including those responsible for the collection, sortation and delivery of letters and parcels.
2. Royal Mail has applied to Postcomm under Condition 21, paragraphs 17-19, of its licence to introduce zonal pricing from April 2008 for certain bulk mail products that are not covered by its universal service obligation (USO). Royal Mail first applied on 5 July 2006, followed by revised applications on 20 February 2007 and 17 July 2007. Royal Mail's proposals would introduce different prices for mail sent to addresses in each of five different zones. This would mean increasing prices where Royal Mail believes its operating costs are higher than the current price and decreasing where it believes them to be lower.
3. Postcomm has twice consulted with stakeholders over Royal Mail's proposals. This third consultation seeks stakeholder views on Postcomm's proposal to reject Royal Mail's application on the grounds that they fail to meet condition 21.19 of the licence for the following reasons.

- a) They discriminate between different classes of postal users in the following cases:
  - i. Between users sending mail to zone A (business districts) and to zone B (high density areas), because the two zones would face a different level of zonal pricing discount, but appear to have the same underlying costs;
  - ii. Between users within the London zone, because deliveries to the “London A-zone” and the rest of London have different underlying costs but would be priced the same; and
  - iii. Between access and retail users, as access and retail pricing structures would be the same.
  
- b) They would result in unreasonable changes for customers, because:
  - i. there is no adequate mitigation scheme to alleviate the adverse impact of non-price changes on the most affected users;
  - iii. Royal Mail has not demonstrated a commitment to develop and implement an effective communication plan; and
  - iv. the notice period Royal Mail would give to its customers is too short.
  
- 4. Postcomm also proposes to reject Royal Mail’s request to treat Presstream Premium as a bespoke product outside of zonal pricing as it does not consider it appropriate for Royal Mail to treat different classes of Presstream customers differently without any compelling rationale.

## **CWU Response**

- 5. The CWU has been a consistent critic of the liberalisation of the UK postal market. We believe Postcomm’s competition agenda to be fundamentally in conflict with its primary duty to defend the universal service. Postcomm has allowed rival operators to ‘cherry pick’ Royal Mail’s most profitable bulk mail services, while simultaneously preventing Royal Mail from lowering retail prices to compete effectively. This is having a serious impact on Royal Mail’s ability to fund the USO. As a consequence we are now seeing Royal Mail

seek to reduce the number of services contained within the USO and to significantly increase stamp prices to pay for it.

6. Royal Mail previously operated a model of cross-subsidies which allowed business users to subsidise social users and 'local-to-local' mail and deliveries into cities to subsidise long distance mail and rural deliveries. The introduction of competition has allowed competitors to undercut prices on the most profitable services leaving Royal Mail haemorrhaging business and unable to lower prices due to its requirement to price uniformly.
7. Royal Mail is currently unable to compete effectively as it cannot align its prices with costs. We do not believe the business should be prevented from introducing greater cost-reflexivity simply to support the development of competitors by encouraging operations based on false business assumptions. Royal Mail must be able to respond to competition in order for the business to remain viable, for the sake of its customers and to protect the USO.
8. Nevertheless, we have very serious concerns about the potential decline in rural mail volumes caused by zonal pricing and the discrimination this would cause. An increase in prices is likely to see rural residents excluded from some business mailings and further excluded from access to services. This impact may initially be minimal but will increase as Royal Mail further aligns its prices with rural costs. In the absence of a medium to long-term assessment of the risk of mail volume decline and after careful consideration of the views expressed by other stakeholders, the CWU are unable to support Royal Mail's zonal pricing application.
9. Postcomm acknowledges that the long-term impact of zonal pricing on rural mail volumes is difficult to quantify and that its econometric and survey evidence may fail to predict changes in future behaviour. Nevertheless, the regulator does not believe there is any compelling evidence that its duty under the Postal Services Act 2000 to "have regard to the interests of... individuals residing in rural areas" is compromised. The CWU believe that in the absence of any compelling evidence to suggest that they will not be so compromised,

Postcomm should err on the side of caution and treat this as a sufficient condition for rejecting zonal pricing.

10. While Royal Mail should be able to compete fairly, we also believe that, on balance, the risk of zonal pricing and the potentially damaging precedent it sets are too great. Rather than further unpicking the system of cross-subsidies that have helped support access to postal services for those in rural areas, we believe Postcomm should seek to address the disastrous impact of competition on Royal Mail in other ways. The CWU is seeking a full parliamentary review of the impact of liberalisation to date – in line with the Government’s manifesto commitment. This review should look at the role of the regulator in defending the USO and give serious consideration to Universal Service Support Fund to help finance Royal Mail's future universal service obligations.
11. The CWU’s concerns over potential discrimination resulting from Royal Mail’s proposals are distinct from Postcomm’s reasons for rejection and would apply whether or not Postcomm’s conditions were met. We acknowledge that should Postcomm choose to allow Royal Mail to introduce zonal pricing at a later date, Royal Mail may need to adapt to its proposals to avoid unreasonable changes for customers. Should Postcomm see fit to introduce zonal pricing, we would strongly urge them to try to mitigate the unsatisfactory consequence of creating potential ‘dead zones’ where bulk mail is not sent on the grounds of cost.
12. We note that the consultation process has been dominated by customers who fear an increase in price and who would experience increased costs under Royal Mail’s proposals. However, we have heard very little from those who stand to gain, such as former customers who may return to Royal Mail if the business were able to compete fairly on price. A fair assessment of the proposals should take into account the winners and losers across the whole market, not just among Royal Mail’s current customers.

13. Postcomm has argued that there is not enough evidence to suggest that zonal pricing would impact on Royal Mail's ability to finance the USO. Some stakeholders have claimed that a decline in the amount of mail posted to more high-cost areas would increase Royal Mail's unit cost for delivery to these areas and thus make the USO less affordable. While unit costs may rise, we acknowledge that zonal pricing could increase Royal Mail's revenue by helping it to compete more effectively and win back business. However, this is dependent on Postcomm allowing Royal Mail to retain sufficient revenue to continue to support all parts of the USO through cross-subsidisation. Postcomm's repeated attacks on Royal Mail's revenue streams make this steadily more difficult. Furthermore, we are concerned that Royal Mail could use increased unit costs for mailings to rural areas as an argument to decrease the scope of the USO and to increase the price of USO products.

## **Summary**

14. The CWU is greatly concerned that the USO – previously successfully supported by a complex system of cross-subsidies – is being undermined by the artificial form of competition introduced which allows private operators to cherry pick the most profitable parts of Royal Mail's business. Consequently Royal Mail is less able to fund the USO, more inclined to reduce its scope and under pressure to introduce unpopular and divisive measures such as zonal pricing in order to be able to compete. We believe the risks to the USO are such that we need a full parliamentary review of the impact of liberalisation to date – in line with the Government's 2005 manifesto commitment.

15. In our earlier submission the CWU argued that Royal Mail's zonal pricing application reflects the unfortunate consequence of the way competition has been introduced. But following the extensive consultation process and considering the lack of clarity about its potentially damaging impact and the possible long-term decline in mail volumes posted to rural areas, we must oppose Royal Mail's zonal pricing application.

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17th October 2007



## **Unite Communication Managers Association Section response to the Postcomm Consultation on Zonal Pricing**

### **1. Introduction**

**1.1. This response is submitted by Unite Communication Managers Association Section. Unite is the UK's largest trade union with 2 million members across the private and public sectors. The union's members work in a range of industries including manufacturing, financial services, print, media, construction, transport, local government, education, the health service and not for profit sectors.**

1.2. The Communication Managers Association (CMA) Sector of Unite represents some 12,000 communications professionals of whom the majority are managers in the Royal Mail Group, PO Ltd, Parcelforce, Guernsey Post Limited, Jersey Post and Isle of Man Post Office. Unite CMA is the only union recognised for managers in Royal Mail and represents all grades. A percentage of Unite CMA members work in joint ventures with Royal Mail or outsourced companies such as Romec, Quadrant, Capita, Atos Origin, CSC, Xansa. Unite CMA also has members in other postal operators such as Deutsche Post.

## 2. Background

- 2.1. The CMA Sector of Unite is broadly in support of the measures needed to create an open and level playing field for competition for all concerned in postal and parcel communication. Postcomm's competition agenda has in the recent past been heavily weighted against the Royal Mails operations, in order to open the market up to competition. As a result the Royal Mail has been placed in a position where it has no option but to move to a position more in line with market forces, on bulk mail, if it is to preserve the Universal Service Obligation (USO) to deliver collect and deliver mail to the UK customer's doors, six days a week, at the same affordable rates.
- 2.2. Zonal Pricing is a move towards a pricing regime for large volume mail items more in line with the actual costs incurred to provide this service. Royal Mail is currently being compelled to carry mail at less than half the price of a first class stamp and is swiftly losing its market share to entrants who do not have to bear the USO costs. Adjusting the cost for bulk mailing, more in line with the competition, fits more readily with Postcomm's agenda. It is therefore surprising that Postcomm have rejected these proposals, creating a position where the market can utilise the Royal Mail to pick up the high cost scraps while the competition enjoys the cream.
- 2.3. In many respects Postcomm has failed to ensure it meets its objective of introducing competition into the mails market. Effectively what Postcomm has achieved is competition in the logistics leg of the mails pipeline, where competitors to the incumbent collect high volume, clean machinable mail and transport this, with minimum sorting, to inward mail centres. These high volumes have previously been the backbone of the natural monopoly that existed with the USO whereby Royal Mail would collect and process all items some of which would be cheaper than others to deal with.
- 2.4. Unite CMA has been critical of competition for the sake of it but consistently supportive of competition where it does not threaten the public service enjoyed and expected by the general public and business. There was a demonstrable need to respond to the European Directive on Postal Services but only in a structured, measured and considered way. Unite CMA believes that Postcomm

has failed in this regard and competition is not being implemented in the way that was originally envisaged.

- 2.5. Unite CMA is also concerned that the shape of the competitive mails market in the UK places in jeopardy the future of the USO and that changes to the market make initiatives such as Zonal Pricing, particularly where it levels the playing field and allows Royal Mail to compete with others without regulatory handcuffs.
- 2.6. Postcomm has therefore, in the opinion of Unite CMA, opened up profitable areas of operation to competition without redressing the balance in any way. Their actions are putting at risk job security for staff and our members, as the Royal Mail struggles to remain operational.

### **3. The Impact of Zonal Pricing**

- 3.1. In practical terms, the introduction of Zonal Pricing is seen as complex and perhaps overly so. Unite CMA considers that Royal Mail has failed to get its message across and, indeed, may have added to the confusion. Businesses will have to make some investment in technology to accommodate Zonal Pricing and it will be a matter for them to consider the cost benefit analysis of so doing. Royal Mail should also review its approach and ensure that there is sufficient information and resources available to support customers who opt to make use of the new arrangements.
- 3.2. Although the Royal Mail would like to see a price increase in the cost a stamp to the consumer, this pressure would have been deferred if Zonal Pricing had been approved.

### **4. Conclusion**

- 4.1. Although this is not a popular move with the market, it is a step which is a necessity. Unite CMA has already seen the knock on effects to the Royal Mail of attempting to cut overheads and staffing costs. To break even and not become a burden to the tax payer, change is needed.
- 4.2. Unite CMA considers that Zonal Pricing is becoming more and more necessary as competition develops. The threat of ongoing losses of mail items to Down Stream Access (DSA) whilst Royal Mail is encumbered through regulatory restrictions is unjust and unwarranted. In 2006/7 DSA accounted for over 10.8%

of total mail volume, accounting for over 2 billion items<sup>1</sup> with this figure set to grow in popularity with the business to business and business to customer markets.

- 4.3. Unite CMA believes that the market has developed to the extent that Zonal Pricing is required by Royal Mail, and would not be anti competitive, and that Postcomm should accept the Royal Mail amended application to introduce it.

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<sup>1</sup> Source Royal Mail

## **Consultation: Postcomm's Proposals on Royal Mail's Zonal Pricing Application**

### **The Highland Council's Response to Postcomm**

The Highland Council welcomes the opportunity to respond to Postcomm on its proposals relating to Royal Mail's Zonal Pricing Application. The Council is pleased to note that Postcomm proposes to reject Royal Mail's application to implement Zonal pricing at present, and we would hope this position is maintained in the future. In relation to these proposals, the Council would wish to raise a number of points with Postcomm. These are outlined below.

The Council supports Postcomm's decision to consider compliance of the application with its statutory duties. Postcomm has been given a role to safeguard postal services within the UK and to protect vulnerable customers and it would be inappropriate to consider any application that could be contrary to these duties.

In relation to these duties, the Council is concerned with the impact zonal pricing may have on rural areas. This concern is threefold:

- The increased costs of sending bulk mail to remote and rural areas is likely to result in higher and perhaps damaging costs to small businesses operating in these areas.
- That banks and utilities companies sending essential mail may pass the increased costs of sending mail to rural areas to customers in these areas.
- There may be a reduction in circulatory mail sent to customers in rural areas, with companies more likely to focus upon distributing items in low cost urban areas.

It is this latter concern which could have the most damaging impact upon rural areas in the longer term. Already people within remote and rural areas of the Highlands and Islands experience discrimination from companies that refuse to deliver to the area or charge increased costs. This is likely to be exacerbated within the future should zonal pricing be introduced. Any reduction in mail volumes sent to rural areas, may lead to possible attempts by Royal Mail to reduce the frequency and level of service delivery within these areas, to address the cost deficits created by this reduction. This could lead to the erosion of the Universal Service Obligation within rural areas. The Council believes it vitally important that Postcomm reflects on the long term future of postal services within rural areas, when considering the introduction of zonal pricing.

Whilst the Council acknowledges the work Postcomm has undertaken to try and clarify whether or not the introduction of zonal pricing will lead to the reduction of mail volumes to rural areas, we would ascertain that the evidence collated is by no means conclusive. The surveys relate to a small group of mail users and it is unclear the long-term impact zonal pricing may have on the mail policies of these companies and others in the future. Given that the introduction of zonal pricing could cause irrevocable damage to the service provided in certain areas of the country, it

would be inappropriate to approve a policy which may have such a detrimental impact upon the Universal Service Obligation.

In addition to the criteria Postcomm has detailed it intends to use, it will be important to ensure that quality of service is maintained. The Council would be concerned that the introduction of zonal pricing could have a negative effect in the long term on the universal service and lead to the erosion of the quality of this service. Most significantly though is the need to consider the impact upon customers across the UK and the need to ensure that all sectors of the population will not negatively affected by any changes introduced by Royal Mail. The needs of customers must come before any commercial gain and therefore Postcomm needs to ensure that within its criteria for assessing this and any future application from Royal Mail, a clear focus is made upon the impact of any changes upon customers.

The Highland Council welcomes Postcomm's decision to dismiss Royal Mail's zonal pricing application at present but is disappointed that Postcomm continues to indicate that it will not dismiss the principal of Zonal pricing. We feel it unlikely under any circumstances that Royal Mail could operate such a system without a negative impact upon rural areas and with the risk of damaging the Universal Service Obligation.

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**ANDREW GEORGE MP**



Sarah Chambers  
Chief Executive, Postcomm  
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SE1 7DB

17<sup>th</sup> October 2007

Our ref: 07/7.7/ag/ac

Dear Ms Chambers,

**RE: CONSULTATION ON ROYAL MAIL ZONAL SURCHARGES**

I represent one of the most rural constituencies – West Cornwall and the Isles of Scilly – in the country and would encourage Postcomm to maintain its stance of disagreeing with Royal Mail in respect of the proposal to introduce zonal pricing.

Such a proposal could undermine the spirit of the Universal Service Obligation. People should not be penalised simply because of where they have been brought up or have chosen to live. Rural areas have lost many Post Offices through closure or downgrading and this proposed measure would marginalise them further.

The Mail Competition Forum suggest that nearly a third of business mailers would send less post to rural destinations if a greater cost was involved.

I look forward to meeting you next week to talk further about this issue and also that of the decision to stop Sunday and Bank Holiday collections.

Yours faithfully,

Andrew George  
Member of Parliament for the West Cornwall and Isles of Scilly constituency of St Ives

## **TNT Post response to Postcomm's August 2007 proposals on Royal Mail's Zonal Retail Pricing Application**

TNT Post UK Limited (**TNT Post**) fully supports Postcomm's "minded to" proposal to reject the Royal Mail application to introduce zonal retail pricing.

**Postcomm should now move to confirm its proposal to reject this application in a final decision.**

Zonal pricing would have been as damaging as it is unpopular: As clearly seen, customers are almost unanimously against the proposal and interest groups and elected representatives looking after the interests of those living in rural areas have clearly voiced profound concern about the effect of zonal pricing on both rural mail deliveries and rural post offices which make some of their income from involvement in rural mail deliveries. Royal Mail's competitors have raised similar concerns and have collectively contested the motive of zonal retail pricing – namely, to foreclose competition in newly liberalised postal delivery services.

Any future application must address fundamental concerns: As the spectre of zonal retail pricing has not gone away, even if (hopefully, when) Postcomm proceeds to confirm its rejection of the application, it is extremely important that the lessons learned from the exercise are borne in mind when assessing any future application. It should, however, be noted that any proposal to introduce retail zonal pricing has a disruptive effect on the market and it is hoped that Royal Mail will think very long and very hard before it considers making a new application.

Cost reflective – apparently not: The claimed move to greater cost reflectivity has been shown to be highly questionable in a significant number of ways. The real motive for zonal retail pricing was to undermine final delivery competition – by targeting discounts in urban areas (where competition is most likely to first emerge).

Competition destructive – the real motive: It is extremely relevant that Royal Mail was unable to provide any evidence that the introduction of zonal retail pricing – massively unpopular to customers and rural residents - was not critical for Royal Mail's financial viability. What then was the motive if not to foreclose competition and customer choice?

Failure to tackle arbitrage indicates desire to deliver 100% of mail: The lack of real desire to reach greater cost-covering prices and operate more efficiently has been illustrated most clearly by the fact that Royal Mail appeared to have no clear measures for preventing arbitrage between zonal and national pricing systems (i.e. stopping customers from using a combination of cheap urban prices for urban deliveries and national prices – retail or wholesale - for rural deliveries). Arbitrage between zonal and national access services is increasingly widespread. Royal Mail knowingly tolerates this.

Significant errors in cost claims undermined credibility of proposal: The finding that the costs of delivery in zones A and B are the same is also extremely worrying, since Royal Mail had proposed to price these on very different bases. Similarly, the U-turn to turn most of the Greater London area into a single zone appears to have had no foundation in gearing prices to costs. This exposes the absence of any serious claims to greater cost-reflectivity.

Effect on rural mail volumes substantially understated: We believe that the analysis of the effect on rural deliveries – and the universal service – was insufficient and failed to demonstrate anything like the true extent of the likely reduction in mail volumes. While

Postcomm's consultants appear to have attempted to play down the significance of the customer reaction to the Royal Mail proposal, even based on the relatively modest rural price increases proposed for the first year, around 1 in 4 customers confirmed that they would already change their behaviour. Far from being a modest proportion, this is an extremely significant volume of mail. It fully supports the widely held belief that increasing prices to rural areas will lead to decreased volumes and a vicious cycle of increased prices and the subsequent decline of rural postal services.

Rural delivery volumes must be a key focus in any future analysis: We urge Postcomm – in any future application – to give especial attention to the effects (short, medium and long term) of rural price increases on volumes and the ability of Royal Mail to provide a universal postal service.

Customer reaction to increased prices inadequately analysed: It is of interest (paragraph 9.12) that customers are supposedly “not likely to adjust volumes much” in response to rural price increases. This does not tally with our own experience or indeed the views of many experienced commentators. Indeed, it seems that price sensitivity is so high that this is always likely to act as a cap on prices generally (so long as there are competitive wholesale prices and / or competing final delivery services). Postcomm, in the recently concluded “Interim Review” noted that market forces constrained Royal Mail in introducing price increases. While this must never be a reason for permitting (or, worse still, imposing) pricing which is anti-competitive (e.g. because it leads to margin squeeze or pricing which is below fully allocated cost), it does indicate that customers are very price sensitive. In the context of zonal pricing, it means that rural deliveries would – without any doubt – suffer as a result of applying higher prices for rural areas.

Migration to email irreversible – zonal pricing would accelerate volume decline: As a general rule, it is crucial to observe that, once a customer has converted a physical mail stream – particularly of transactional mail – to an electronic mail stream, it is extremely unlikely to reverse that decision. In other words, the prospect for growing volumes to rural areas from such customers (and other customers) becomes increasingly unrealistic. If Postcomm is serious about its vision of growing the mail market, rather than operators resigning themselves to its long term decline, then rejecting the zonal retail pricing application is a wise and appropriate move.

Primacy of Postcomm's statutory duties: Postcomm's statutory duties are paramount when making any decision and we are encouraged that Postcomm, aside from analysing the proposal under the relatively limited tests under condition 21 of the Royal Mail licence, confirmed that it must also have regard to the will of Parliament, which clearly defined its statutory duties. Any future application needs to be considered in light of this.

Errors in classifying sectors highlights difficulty of regulating future price moves: The apparent lack of cost justification for the classification of sectors within a particular zone is alarming and indicates just how difficult it would be to regulate zonal pricing going forward. In any future application, particular attention needs to be paid on future regulation and re-classification. It seems that it will be a near impossible task.

Uncertainty on sector boundaries makes for instable foundation: The building blocks of the zonal application are postcode sectors but, as has been seen, the delineation of these sectors is not as accurate as it needs to be. Much greater attention needs to be paid to such a fundamental basis for a sectoral based pricing model.

Zonal pricing removes the “oxygen” for end-to-end competition: Final delivery competition will emerge only if operators are able to generate volume and increase drop density. If Royal Mail had been – or is ever - allowed to introduce geographically targeted discounts

they will be able – by virtue of their super-dominant position in both the discounted and surcharged areas – to foreclose delivery competition.

Need to analyse the interplay of costs of supply, wholesale prices and retail prices before Postcomm is able to properly understand the impact of zonal retail pricing: Wherever there is a difference between wholesale and retail prices, there is a risk of discrimination and margin squeeze. For so long as wholesale prices are based on a discount from retail prices, there is a risk that wholesale prices may be set at anti-competitive levels. This tremendously important issue of the interaction among the costs of *supply*, the prices charged by *wholesale* and the prices charged by *retail* is, actually, a fundamental and complicated question which Postcomm needs to consider as part of its strategy review and the ensuing price control deliberations. Logically, this interaction must be addressed and resolved before such a fundamentally different form of retail pricing can be introduced.

Zonal pricing would have confused the (long overdue) need to have all prices based on fully allocated costs: As a more general point, Postcomm acknowledges that Royal Mail has pricing which is not aligned to costs. Royal Mail has been licensed for over six years and it is really not acceptable that historical, political price setting (paragraph 3.13) is still being cited as an apparent justification for below cost pricing. If the UK postal market is to work properly (which it must), it is critical that Royal Mail's prices are all set at a level which covers fully allocated costs (not least to comply with Postcomm's recent statement in the decision in the Business Mail Secure complaint that pricing below fully allocated cost may amount to predatory pricing). As a competitor, it is critical that Postcomm removes all regulatory restrictions which prevent Royal Mail from pricing at a commercial level which is based on fully allocated costs and which enables Royal Mail to trade profitably.

Competition will drive efficiency and create the best prospect for market growth: Despite Postcomm's best intentions, it has become apparent that price caps are failing to make Royal Mail more efficient. It seems increasingly apparent, that only actual delivery competition will be sufficient to make Royal Mail address its inefficiencies.

**Conclusion:** The primary motive of zonal retail pricing – as exposed by the analysis which demonstrates the rather crude and barely substantiated proposal – was to stop end to end competition.

It is final delivery competition that will create the real and enduring benefits of efficiency, choice and innovation – and thus create the best prospect for the market to grow. Postcomm must use its powers and exercise its duties to stop Royal Mail depriving the UK economy of those benefits – in this particular instance through rejecting the Royal Mail application to introduce geographically targeted discounts and rural surcharges.

By rejecting the zonal pricing application, Postcomm will be exercising its regulatory powers in a way which is consistent with maintaining a universal service and which gives customers the best chance of benefitting from competition.

TNT Post UK Limited  
17 October 2007

**Postcomm's Consultation on  
Royal Mail's Proposal to  
Charge Large Mailers  
by Delivery Location "Zonal Pricing":  
The Postwatch Response**

**17<sup>th</sup> October 2007**

## **Executive summary**

Postwatch reiterates its position set out in our response to the original consultation in that we agree with cost reflective pricing in principle but that we oppose this Zonal Pricing application given the overwhelming opposition to it by customers and the potential impact this initiative could have on competition, rural dwellers and the universal postal service.

Postwatch believes that this consultation document appears confused as it is caught between a minded to reject decision but is still requesting information on several significant issues if the application was allowed to proceed. We are also concerned that during our own consultation some key stakeholders viewed this document as a 'check list' for Royal Mail to address in order for it to proceed with Zonal Pricing. We believe that a rethink, rather than a tweak, of the current proposal is required. In fact, it might be more beneficial for all concerned for Royal Mail to take a fresh approach and come back with a completely revised proposal.

We welcome the fact that Postcomm has placed significant importance on the customer element of condition 21 and that Royal Mail must focus on this area in future. However, we greet this document with an element of caution. It must be noted that with Pricing in Proportion (PiP), Postcomm's 'minded to accept' decision would only have been changed if there was a 'compelling' argument to do so. We believe the same must level of argument must apply to the Zonal Pricing 'minded to reject' decision.

We urge Royal Mail to revisit this issue and engage with Postcomm, and the wider industry, to overcome the current difficulties. Postwatch is not opposed to cost reflective pricing or zonal pricing in principle, however, we are concerned that the current proposal has not been thought through and Royal Mail has not shown sufficient commitment by engaging with customers to satisfy all condition 21 criteria. Additionally, thought must go into the timing of introduction of any new pricing system, there must be stability prior to any further change and the recent spate of strikes has shown how volatile the market currently is.

Postwatch would welcome a revised, less complex, form of zonal pricing that has the customer as a focus and is sensitive to effects on competition, the universal postal service and rural dwellers. Prior to any new application being submitted Postwatch would also urge Royal Mail to undertake its own consultation with those most affected by Zonal Pricing as this would allow it to incorporate and address customer issues upfront and assist it in any future transition to a zonal pricing model. In addition, it would allow Royal Mail to work closely with the industry illustrating a strong commitment to attribute significant importance to satisfying the customer element of condition 21.

Postcomm commissioned LECG to independently review Royal Mail's costing model including the zonal structure on which the model is based. This report illustrates how unduly complex and flawed the submitted application is. There is a real concern that any application from Royal Mail will reflect a lack of understanding of its own costs. The current application developed, at the request of Postcomm, to include the separation of London as a surcharged zone with the lack of a clear associated explanation. This created confusion within the industry.

### **1. Introduction**

- 1.1 Postwatch welcomes the opportunity to contribute to this consultation on Zonal Pricing.
- 1.2 As a statutory body with a specific remit to protect and promote the interests of consumers of postal services in the UK, including rural dwellers, Postwatch is uniquely positioned to represent the views of all senders and recipients of mail. Our regionally based structure and our complete independence from Government, the Regulator, Royal Mail, postal trade unions and potential competitors, combined with our well-established formal network of contacts give us the ability to speak authoritatively on behalf of consumers throughout the UK.
- 1.3 We welcome the publication, by Postcomm, of the reports and research conducted by consultants which provide an evidence base on which to reach a decision. The reports, primarily that produced by LECG, illustrate the key flaws in the application and offers little supporting evidence to allow it to proceed on any level.
- 1.4 Postwatch wishes to see a financially fit and healthy Royal Mail in the market and we believe that this, in part, can be achieved through a well thought out, customer-friendly pricing system that satisfies all the condition 21 criteria in full. We are also encouraged by Postcomm's focus on the potential impact on customers any move to Zonal Pricing could have and we believe that customer support is essential prior to allowing Royal Mail permission to introduce Zonal Pricing system.
- 1.5 In its current format Postwatch continues to believe that the Zonal Pricing proposed will have a negative impact on rural dwellers, the universal postal service, mail volumes and competition. We therefore reiterate our previous response in relation to these areas and would request that Postcomm considers those arguments in the context of this second stage of consultation. Additionally, we believe that the onus must now be placed on Royal Mail to produce a compelling case in order for Zonal Pricing to proceed, however, it is apparent that Royal Mail may not have the evidence base, both costing and customer based, to achieve such an outcome.

## **2. Assessing whether Zonal Pricing will be introduced in a manner that avoids unreasonable changes for users of the services**

- 2.1 Postwatch welcomes the fact that Postcomm has attributed significant weight to the impact on customers and viewed this as of great importance prior to making a decision. On too many occasions customer concerns been disregarded or considered less significant in relation to other condition 21 criteria.
- 2.2 We also welcome the fact that Postcomm has explicitly set out the key customer issues that Royal Mail must address going forward, however, it is of some concern that this would be Royal Mail's second major pricing change within a short period of time and they do not appear to have learnt the lessons from developing and implementing PiP. The implementation of PiP was successful by putting customers at the top of the agenda. In addition, Postwatch believes that the market is not ready for this change as competition has not sufficiently developed nor is the market stable enough after a long period of strikes – the conditions must be right prior to any change being introduced.
- 2.3 We welcome the analysis set out by Postcomm on the major customer issues

including the effect on competition, USO and rural dwellers. We understand that this analysis does not conclude there would be a significant impact in the aforementioned areas if Zonal Pricing were to be introduced. However, having consulted key stakeholders and our regional network we remain convinced that Zonal Pricing, as currently proposed, would have a negative impact in these areas resulting in a pricing system that does not benefit anyone in the postal market, including Royal Mail.

#### Universal postal service obligation (USP)

- 2.4 Postwatch remains concerned that Zonal Pricing, in its current proposed form, would have an adverse impact on the USP, particularly deliveries in rural areas. Evidence from our regional network during stage one highlights this concern and this view remains unaltered. We believe that a reduction in volumes to rural areas would increase the cost to deliver to these customers and eventually put considerable pressure on the universal service obligation.
- 2.5 It is also worth stressing that the LECG report claims that Royal Mail has not been able to provide any evidence to indicate the pricing difference between zone A and zone B but it wants to price zone A differently to zone B. Postwatch is of the impression that Royal Mail is taking every precautionary step before end-to-end competition fully develops at the possible expense of the USP.

#### Mail volumes

- 2.6 The LECG report forecasts that mail volumes would fall, although not significantly, as a result of Zonal Pricing being introduced. Any decrease may be the beginning, resulting in a sustained decrease leading to more problems over the coming years. Royal Mail should be trying to grow the market rather than introducing initiatives that will decrease volumes sent to a certain areas resulting in a negative impact on the universal service obligation in rural areas. Royal Mail, as indicated in Postcomm's Strategy Review, should be taking steps to be more innovative in the market and promoting mail as a medium rather than turning users away from it.

#### Impact on bills & customer costs

- 2.7 Postwatch is aware that with any pricing structure change some users may suffer a negative, or positive, impact on bills and costs, it is an inevitability that some customers will either bear or pass on to their own customers. As was the case with PiP there were 'winners and losers'. Postwatch, in relation to Zonal Pricing, has struggled to identify any customer who will gain financially from this proposed change and it appears that all customers will experience some degree of additional cost on postal bills or due to additional processes. This eventuality is representative of a totally customer negative system that is therefore surely set to result in unreasonable changes for users.
- 2.8 Postcomm states that some customers may face an increase of 'only 5%' but, considering the amount of volume some customers send this could be considerable, especially when viewed in the context of recent changes such as PiP, annual increases and associated sortation/software costs. These issues should be viewed collectively rather than in isolation. It may also be the case that some customers who are affected by Zonal Pricing may also suffer further increases through the

interim review of the price control – again the impact of these pricing changes should be viewed collectively.

- 2.9 The concern remains that publishers will have to bear unreasonable additional cost and in tandem with the interim review proposals these costs could be more significant than first anticipated. Royal Mail should provide some form of mitigation for this defined customer group should this application proceed.
- 2.10 Postwatch is aware of the possible increase in costs and inconvenience to some mailers with residue items after the introduction of Minimum Order Value. Should Zonal Pricing proceed it would then be unreasonable to charge customers at the expensive zone price as well. Postwatch believes that any residue items, no matter what the zonal system, should be charged at the average price in the interests of fairness.

### Competition

- 2.11 Postcomm considers the potential impact of Zonal Pricing on competition to be minimal. But Postwatch, and the industry, continues to believe that this will not be the case. Royal Mail claims that Zonal Pricing is not a customer initiative but a reaction to a competitive threat and the introduction of Zonal Pricing has the potential to eliminate any competition before it gets off the ground.

### Rural dwellers (senders & recipients)

- 2.12 Postcomm indicates that there will be little impact on rural dwellers. However, through liaising with our regional structure we believe that rural dwellers will be affected. There is concern among rural residents and groups that they will see a deterioration in service and higher costs passed on as a result of zonal pricing. Additionally, zonal pricing in this current format may affect rural dwellers, however, if Royal Mail return with a less complex, customer friendly system that doesn't result in rural areas attracting a significant surcharge then the impact on rural dwellers may very well be minimal.
- 2.13 Having discussed this in detail with our regional offices they remain opposed, in particular Postwatch Scotland, to the introduction of Zonal Pricing due to the potential adverse implications for rural Scottish mail users - both domestic and commercial alike. For example, some local authorities who have no option but to post items to highly priced zones, a situation that is would also occur in London. Indeed at a recent Postwatch meeting involving London Local Authorities it was reiterated that Zonal Pricing would result in a higher postal bill for these authorities and would have no choice but to bear the cost. It should also be noted that an Early Day Motion<sup>2</sup> objecting to Zonal Pricing on the grounds that it will have an adverse impact on rural dwellers has attracted over 40 signatures.

### Zone anomalies & zone appeals/redefining

- 2.14 Postwatch continues to have serious concerns surrounding the zone data the application is based on and the misallocation of postcodes to zones, additionally our concerns in relation to the definition of the London zone (areas reaching out

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<sup>2</sup><http://edmi.parliament.uk/EDMi/EDMDetails.aspx?EDMID=33837&SESSION=885>

into Hertfordshire) also remain.

- 2.15 With reference to future allocation of postcodes to zones Postwatch believes that option one could be a lengthy process with the onus on the affected to bring the issue to Royal Mail. Option 2 is unduly complex and inconsistent across UK countries with no real level of transparency. We believe that option 3 is the most appropriate as it would provide the market with the most confidence as it is dealt with by a third party bringing a degree of transparency and overcoming the difficulties with options 1 and 2.

### Discrimination issues

- 2.16 Postcomm proposes to reject Royal Mail's application because, amongst other things, it could result in a pricing structure that would discriminate against different classes of postal users. We understand that discrimination appears to arise between users sending mail to zone A (business districts) and to zone B (high density areas). As a result the zones could be merged and this calls into question Royal Mail's motivation for separation of zones and pricing it accordingly. It also begs the question of how well Royal Mail understands its own costs.
- 2.17 Postcomm also states that discrimination could arise between users sending mail within the London zone, *because deliveries to the "London-A zone" and the rest of London have different underlying costs but would be priced the same*. Postwatch does not dispute the underlying principle behind this but we are concerned that Postcomm requested that Royal Mail address the London issue as it had a different cost base. This issue has confused customers throughout the process and it continues to do so with this latest development. It may be that a truly cost reflective system will have to include London as a separate entity from the remainder of the country and include several zones within the boundary which could result in further pricing complexity.
- 2.18 Postwatch is concerned that although Postcomm states that discrimination may potentially arise between Access users and customers using the proposed system it is almost impossible to eliminate this without replicating the Access zonal system for bulk mail products – something Royal Mail originally proposed and moved away from at Postcomm's request to address the London anomaly.

### **3. Implementation, mitigation and communication**

- 3.1 We understand that Royal Mail was not totally successful in satisfying the key implementation criteria and that, in isolation, would not have been able to halt the application. This highlights the flaws within condition 21 and the lack of clarity and protection customers have under these criteria. It must be set out that Postcomm must be clearly and completely satisfied that Royal Mail has achieved all criteria collectively, and in isolation, prior to allowing Royal Mail to proceed with any application.
- 3.2 Postwatch believes that April 2009 would have been a realistic implementation date for Zonal Pricing, in its current format, to be implemented. Should Royal Mail devise a new more simplistic system that would be welcomed by customers, we would

envisage an implementation date of April 2010 as highly appropriate and achievable. However, this is dependent on Postcomm being able to undertake the appropriate analysis and consultation. Overall, as consistent with PiP, Postwatch would expect a minimum of 12 months notice prior to any new pricing structure being implemented.

- 3.3 Prior to Zonal Pricing being introduced Postcomm should ensure it has a commitment from Royal Mail to implement a mitigation plan for those most adversely affected, in addition to a commitment to implement an extensive communication plan tailored for those specifically affected customers. This plan should be rolled out at various stages throughout an ample notice period rather than a mass mailing closer to the live date.
- 3.4 We understand that a range of customers would be adversely affected due to additional sortation as well as having a higher postal bill. Should this application, or any application with a similar impact, proceed then we would envisage a two-tier mitigation system addressing the needs of customers who are adversely affected financially and those affected of a practical nature. We would also expect Royal Mail to engage with these affected customers through out the process to ensure their respective needs are addressed and a suitable solution is developed.
- 3.5 It is clear that those with legacy systems would be detrimentally affected and although we are encouraged by Royal Mail engaging with these customers we are unaware of any real progress having taken place. We understand the difficulty in trying to reach agreement when neither Royal Mail nor the affected customers is able to fully assess the potential impact Zonal Pricing has on their respective business as no final outcome on structure has been taken. However, we believe that continued engagement by Royal Mail with customers can only benefit all parties concerned.
- 3.6 We believe that using the PiP communications plan as a template would be of benefit as research has shown it to have been effective in delivering the key messages to relevant customer groups and it would take little effort/expense for Royal Mail to identify affected customers and tailor the plan to these customers needs.

#### **4. Cost reflectivity and revenue neutrality**

- 4.1 Postwatch remains supportive of the move to more cost reflective pricing but this must be undertaken in a measured and tested (condition 21) manner. We therefore welcome this rejection by Postcomm and urge Royal Mail to rethink its application giving more consideration to those who will be impacted upon by the change – customers.
- 4.2 Postwatch is concerned that although the application is flawed the prices set by Royal Mail, under Postcomm's tests, remain more cost reflective. This highlights the concern that this particular criterion is very much open to interpretation and lends more weight to the fact that each criterion should be afforded equal weight.
- 4.3 Postwatch agrees that moving forward in a competitive market Royal Mail should be afforded greater commercial flexibility, however, this must be balanced by ensuring

sufficient certainty and predictability over future prices for customers. We believe a robust case has to be made by Royal Mail when seeking any pricing change, be it a price control revisit or a pricing structure change, and the potential impact on customers must also be assessed.

- 4.4 It is important for the market and Royal Mail to have sufficient certainty and predictability over prices balanced through commercial flexibility. There is a real challenge for Postcomm in the coming years to produce a robust and fair price control for all customers, and operators, to provide a platform for Royal Mail to have more pricing flexibility and, for customers, more pricing certainty. Postcomm should also take steps to reinforce competition resulting in prices being dictated by the market whilst setting Royal Mail realistic, but challenging, efficiency targets to remove costs from the business whilst protecting the USO.

## **5. Conclusion**

- 5.1 Postwatch remains concerned that this current Zonal Pricing application is illogical and that there are few positive elements that would lend weight to any argument for it to be introduced. However, we are not opposed to Zonal Pricing and cost reflective pricing in principle and would encourage Royal Mail, if it is serious about competing, making efficiencies and taking costs out of the business, to reconsider this issue and come back with a fresh application.
- 5.2 We believe that Royal Mail should take a fresh approach and work with the industry, software providers, customer groups and Postcomm to produce a less complex customer friendly version of zonal pricing that satisfies, in total, the criteria as set out in condition 21. Only this approach can benefit Royal Mail and the market as a whole.

## **MCF RESPONSE TO POSTCOMM'S PROPOSALS TO REJECT ROYAL MAIL'S APPLICATION TO INTRODUCE ZONAL RETAIL PRICING**

The members of the Mail Competition Forum (“**MCF**”) fully support the Postcomm proposal to reject Royal Mail’s application to introduce retail zonal pricing. As highlighted by the MCF, the proposals would have undermined competition (as they were intended to do) and Royal Mail’s own ability to provide a universal service to rural areas.

The MCF strongly urges Postcomm to issue a final decision to reject the application.

Customer impact: the MCF endorses the finding that customers were opposed to the introduction of zonal retail pricing. All of our members experienced overwhelming opposition from their customers to the proposal. Rather than the objection being one against the timing of introduction, there was a widespread sentiment against the proposal, in principle. This sentiment was particularly pronounced in Scotland where zonal pricing would have had a very extensive and negative impact on postal deliveries.

Uncertainty will halt investment: there is no clarity or transparency about what prices would have done in the future or how the zones may (or may not) have been re-classified. This was, and is, a very serious concern. Such uncertainty would have a very significant effect on investment decisions. It is broadly accepted that, without full delivery competition, Royal Mail will not face the competitive pressure needed to become more efficient. The near complete dependency of postal customers on Royal Mail has been thrown into very sharp relief by the recent national strikes. By rejecting the application which would have introduced enormous uncertainty, Postcomm is removing a very significant barrier to entry.

Motive is to eliminate competition: the suggestion by Royal Mail that zonal pricing was to be introduced to ensure that competitive entry is sustainable is laughable. The motive has always been to eliminate competition. Royal Mail would have foreclosed any significant competition, by offering selective discounts in the areas where Royal Mail expects delivery competition to emerge, and funding these discounts from increases in prices where there is no competition.

Does not address delivery costs: as mailers decide to reduce their mailing activity to high-cost zones (especially rural areas), the number of items available for delivery in these areas will fall. As Royal Mail is committed to providing delivery to all UK addresses, this will push unit costs for these areas still higher. Further price increases to resolve this could have further consequential impacts on volumes and unit costs, leading to a perpetual upward spiral in prices for these zones. In consequence Royal Mail could be left with greater stranded cost to manage within its delivery services. To this end zonal pricing would not cure a perceived problem in variable delivery costs in different areas, but would exacerbate it still further. Any future application would need to take this into account.

Profound damage to rural deliveries: the MCF predicted that an increase in prices to rural areas would cause customers to alter their mailing behaviour by sending less mail to rural areas. Based only on the modest price increases to be introduced in the first year, already a very significant proportion of customers (28.6%) said that they would alter their behaviour by mailing less to the more expensive areas. This fully supports our profound concern that, over time, as rural prices increased, the reduction in mail volumes would accelerate, thus undermining the USO. The subjective (and prejudicial) statement that “only” six out of 21 customers expected to make early changes and that “only” 24% thought it would be feasible to change the proportion of mail going to rural areas totally understates the damaging

impact. Such a dismissive attitude is highly surprising, given that Postcomm's primary statutory duty is to ensure the maintenance of a nationwide universal service.

With the LECG finding that it would be necessary to have a separate zone E if Royal Mail were to achieve its stated goal of greater cost-reflectivity, the dilutive effect on mail volumes in zone E areas would have been far more significant – putting the universal services under tremendous pressure.

Data concerns: there remain a significant number of fundamental questions about the underlying reliability of cost data and of the boundary information used to identify the sectors (and thus calculate delivery point density). This is highlighted by the finding that, despite significantly different prices, zones A and B apparently have the same underlying cost structure. It also demonstrates that the U-turn on London pricing was wholly unjustified, with LECG concluding that London would need to be split to reflect significantly different costs in inner and outer London.

Significant Royal Mail losses expected: there are no measures to stop arbitrage. This means that the stated intention to offset discounted zone deliveries by surcharges elsewhere will not materialise, leaving a gap in incumbent finances. Royal Mail will, it seems, wilfully lose money in order to keep out competition, looking to recover the losses at a later date when it has restored its monopoly. The longer term losers will be both customers and also taxpayers, as shareholders in Royal Mail.

Margin squeeze: while Postcomm acknowledged the discrimination inherent in retail pricing, which is not in line with wholesale pricing, Postcomm failed to address properly the effect of margin squeeze on national access operators. Logically, retail and wholesale prices need to be aligned to avoid discrimination.

The MCF supports the proposed decision to reject the application and would agree that Postcomm would appear to have no option but to issue a final decision confirming such rejection.

The MCF further notes that Postcomm has clearly recognised that the five point test in the licence cannot supplant the statutory duties under which all Postcomm decisions must be made. It is critical that the maintenance of the universal service and benefitting users through promoting competition remain uppermost in Postcomm's minds when addressing such radical proposals such as these. The MCF believes that only a decision rejecting the application would satisfy the five licence tests and, more importantly, the statutory duties.

While Postcomm indicates that Royal Mail may submit a further (albeit different) application for zonal retail pricing in the future, any such application would clearly need to address the issues of cost justification, discrimination, arbitrage and effect on rural mail volumes. If it did not, it would be presumed that Postcomm would again need to reject the application.

MCF  
October 2007