

**Postwatch Response to
Postcomm's Consultation
on Zonal Pricing**

11th December 2006

Executive summary

Postwatch is concerned at the frequency and pace Royal Mail is submitting applications to change its pricing strategy. We understand the logic of aligning prices more closely to costs but we believe that this has to be done in a timely and phased manner in order that services remain affordable to all consumers and disruption is kept to a minimum. What is required is a period of stability within the market after the introduction of Pricing in Proportion especially for business customers who will be primarily affected by zonal pricing.

The potential impact this change could have on stifling competition and the possible risks to the future of the universal service make it a risky initiative for Royal Mail to pursue and Postcomm must therefore be confident that it has sufficient costing information prior to deciding whether or not to proceed with a consultation. It is also very important that a full assessment of the impact this change could have for customers is undertaken and that the customer impact does not get lost in the revenue neutral and cost reflectivity arguments.

We are concerned at the potential impact this initiative may have on rural dwellers, competition, customers and the future of the universal service and we address these areas in more detail below. We are also of the opinion that there is no compelling evidence to support the case for Zonal Pricing, and its potential adverse effects are outweighed by potential disadvantages to customers.

We acknowledge the fact that there are many lessons to be learnt from the Pricing in Proportion consultation and we look forward to Postcomm undertaking a full, open and transparent consultation with the industry while keeping everyone regularly informed of developments.

1. Introduction

- 1.1 Postwatch welcomes the opportunity to contribute to this initial 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 Postwatch welcomes this consultation and initiative taken by Postcomm in gathering stakeholder views on key issues raised by Royal Mail's Zonal Pricing application and key factors to consider at this initial stage. We are aware that this consultation is not on the application but we feel compelled to

outline our position on Zonal Pricing given the feedback we have received on this issue.

- 1.4 Zonal Pricing is not a new concept, it exists as a pricing strategy within the current access regime. It is also practised in a simplistic form in other countries around the world. Postwatch understands Royal Mail's drive for cost reflectivity in a competitive market and Royal Mail has responded to the new competitive environment by commencing a programme of rebalancing of tariffs in order to achieve more cost-reflectivity. However, we are unsure as to Royal Mail's motives for bringing forward these changes at this time so soon after implementing Pricing in Proportion, the biggest change in the postal industry for 350 years.

2. Key Factors

- 2.1 As well as the important Condition 21 criteria there are other essential criteria that should be considered and given significant weight prior to approaching Royal Mail's application.
- 2.2 Postcomm may wish to consider the potential impact Zonal Pricing could have on mail volumes and revenue. Early indications, since the introduction of PiP, are that mail volumes have declined as a result of introducing the new system and it would not be beneficial, or in the interest, of post as a form of communication should further pricing initiatives result in a further decline of mail volumes.
- 2.3 It is clear that the document focuses rather more on Royal Mail's application and rationale than on the impact of the considerable changes on customers. A lesson from the PiP consultation is that Postcomm should engage with the industry and assess customer views and the impact any change will have. Postwatch is particularly concerned the potential impact that this will have on the magazine industry, the PPA has stated that some customers could experience upwards of 20% price increases. The 'unreasonableness' customer criterion does not appear to be considered on a similar level as the cost reflectivity and revenue neutrality criterion leaving customers at a distinct disadvantage on issues that have a direct and potentially detrimental affect. Postcomm should be clear on what the key areas for customers are, on what issues it would like customer comment and what weight it will give to such information. It should also be clear on the definition of what an unreasonable introduction is for customers.
- 2.4 Postwatch believes that Postcomm should test the data Royal Mail's application is based on. Should any postcode areas be incorrectly classified then the application is flawed and should not be consulted on. There is evidence to suggest this is the case and Postcomm should consider this carefully prior to making a decision on how to proceed with the consultation.

- 2.5 Timing is a key factor to be considered at an early stage. Postwatch understands that Postcomm are restricted by the nine month time limit and it is a very tight timescale to work to. It is likely there will be two three-month consultations within the nine months. Given the fact that PiP had taken nearly four years in total and the final plans were a monumental change from the first draft, timing, and indeed implementation, should be given considerable thought in advance.
- 2.6 It is important for customers to know, should Zonal Pricing be introduced, how is it to be reviewed over time with population changes and amendments to postcodes – the building blocks of the proposed system. On this basis it is also important for Postcomm, during the next consultation stage, to explain how the discounts/increases can be projected (e.g. zone E to increase from +7.3% to + 33.8%) without specific population expansion and shift knowledge and if a robust revenue neutrality and cost reflectivity test can also be undertaken.

3. Condition 21 Criteria

- 3.1 It is important to point out that customers have had to deal with the introduction of Pricing in Proportion and the 2006 price control in the past year, as well as some smaller changes in Royal Mail's pricing methodology. Zonal Pricing will be introduced after a raft of pricing changes which are greater in scope than those in any other regulated industry in such a short space of time.
- 3.2 Further, Postcomm's statutory duties mean that it is supposed to take account of the interests of customers in rural areas. Postwatch is concerned that no acknowledgement or reference to this duty appears in the consultation document when a 34-65% increase in posting to those areas must affect those interests adversely. As the customer organisation, Postwatch finds it appropriate to remind Postcomm of its obligations in these areas.
- 3.3 The application of the criteria in the licence should only be considered once Postcomm has made a decision in principle that Zonal Pricing is both justifiable and desirable. Should Postcomm decide that Zonal Pricing, implemented correctly, is consistent with its statutory duties (on the grounds *for example* that the revised prices are more cost-reflective) the two most relevant of the criteria, from a customer point of view, are revenue neutrality and that the changes be introduced in such a manner as to avoid unreasonable changes for users of the service. The former speaks for itself: it is clearly undesirable that Royal Mail should recover more revenue than it was allowed at the time of the price control review simply through changing its pricing structure. It must be appropriate, however, for Postcomm to define exactly what it would regard as a reasonable change, and what it would consider unreasonable. This was unclear throughout the PiP consultation.

- 3.4 The assessment of cost reflectivity is less directly relevant to customers, but it is as important that Postcomm, and Postwatch, be satisfied that the considerable impact that this change has, particularly on rural customers, be counterbalanced by the possible improvements in cost reflectivity. No doubt Postcomm and Royal Mail are undertaking this work at the moment, and Postwatch wish to be copied in on the results.
- 3.5 As Royal Mail's pricing structure comes more into line with its costs, it should be that the "customer-facing" criteria such as revenue neutrality and avoiding unreasonable changes to users of services become more important. However, it may be that, with liberalization, Royal Mail's costs change more rapidly and unpredictably than previously, and therefore cost reflectivity retains a high level of importance.
- 3.6 On cost reflectivity, Postcomm states that it has not received sufficient information of good quality upon which to judge Royal Mail's application. It would be helpful if it set out exactly what information it would regard as sufficient, and to what extent it is prepared to work with Royal Mail in developing its application. It should be learnt from PiP, that constant communication with the industry and transparency is key in engaging key stakeholders giving them confidence in the actions of the regulator.

4. Potential Impact of Zonal Pricing

- 4.1 A pricing change of the nature of Zonal Pricing could have a widespread impact on the market, in both a positive and negative way, on groups such as customers, rural dwellers and competitors. Additionally, it could have an impact on the universal service. We address each area below.

Large Business & Government Departments

- 4.2 Postwatch is unaware of any customers or groups of customers who would welcome this initiative. If costs, however, were to be reduced for customers as a result of the introduction of Zonal Pricing, then it is certain that there will be customers (or groups of customers) who would welcome the proposal. We look forward to viewing any market research undertaken by Royal Mail from the customer perspective to support its application.
- 4.3 The introduction of Zonal Pricing will mean that there will be an increase in the range of charging systems and new software required by customers, potentially, at a cost. This will make the charging system difficult to understand adding more confusion for business customers, to an already complicated process.
- 4.4 There could be advantages if 'mail users' is defined as business customers and such businesses are sending more mail to high-density (and therefore lower price) zones. However, normal social users, from a posting perspective,

will not recognise much change if Zonal Pricing was to be implemented in its present form as detailed in Royal Mail's application. There is potentially a possibility that unaddressed direct mail may be reduced in rural areas where delivery is more expensive. Some customers have also acknowledged that Zonal Pricing is positive, that it was a commercial reality and in line with competitors' strategies.

- 4.5 Government Departments currently spend £650 million on postal services and the recent NAO report has recommended that a cost cutting exercise take place within departments. Zonal Pricing has the potential to increase the postage bills of departments and defeat the cost cutting thrust of the report. A typical local council, which has only one main population centre, informed Postwatch that it will potentially cost more for them to contact their residents with essential communications when there is a downward trend on local government budgets.

Rural Dwellers

- 4.6 Given our remit we are very cautious about Zonal Pricing in relation to rural dwellers and those on low incomes. Postcomm also has an especial duty under section 5(2)(d) to ensure that when promoting effective competition they have regard to the interests of individuals residing in rural areas. It is not clear how they intend to exercise this particular statutory duty.
- 4.7 Zonal Pricing seems to represent a significant first blow in the process leading to the probable diminishing of the Universal Service Obligation. Any significant reduction in volumes to rural areas would presumably make daily delivery less economic. Differential Zonal Pricing provides proportionately greater disincentives to mailing to remote rural areas. The impact is likely to be for many bulk mailers to concentrate limited resources on mailing to urban areas and to withdraw mailing to rural areas completely or to surcharge such service.
- 4.8 This concept of Zonal Pricing solely focussing on bulk mail products makes the incorrect assumption that the changes outside the universal services do not have an impact on the social customer. Zonal Pricing would incentivise the mailer to target A, B C areas (already agreed as 80% of the population) which would attract lower postage rates. However, people living within D-Z areas are probably more dependent upon the service. Greater concern would be when moving away from mailshots to companies that use mailsort/presstream for statements/billing e.g. utilities, banks. These companies are unlikely to absorb the higher cost to the D-Z areas and may pass on this to the consumer.
- 4.9 Borders Council (Scotland) informed Postwatch that 25 of the 27 postcode areas it serves are located in D or E which will ultimately lead to increased costs. There is a concern that there will be an increase in the costs to many parts of Scotland and eventually this will reduce the services available in such

areas. A mail order company expressed opposition to Zonal Pricing stating Royal Mail should be encouraging customers to use bulk mail, not introducing measures that will introduce further cost and complication.

- 4.10 Rural residential groups have contacted our regional offices to express their opposition to the possibility of Zonal Pricing. They believe they are already targeted with higher postal costs. Residents obtain many goods and services through mail order and there is a genuine concern that companies would either pass on additional costs or refuse to supply. Additional postage costs are likely to be passed on to service users in more remote areas adding to the existing burden of higher service costs in rural areas and where accessibility and disposable income already compare badly with urban areas.
- 4.11 One regional example of how Zonal Pricing will impact on senders focuses on Northern Ireland although the example is not exclusive and may be transferable to all regions. Businesses in Northern Ireland will be greatly disadvantaged when mailing customers within Northern Ireland. For example, a business in Belfast mailing to Derry will be posting to a low density population therefore higher priced zone, whereas presently the business has uniformity of pricing. It would seem more logical to have uniformity within Northern Ireland but recognise that sending to Northern Ireland would incur higher costs, though it is not necessarily desirable to do this.
- 4.12 One potential benefit for customers opposed to receiving direct mail is that Zonal Pricing could result in reduced volume of direct mail for rural areas. Recipients may welcome a reduction in unsolicited mail, but this may result in substantially increased costs for the delivery of small volumes of letters each week in rural areas.

Competition

- 4.13 We believe Zonal Pricing may prove a hindrance to developing competition. Royal Mail could significantly deter competition by reducing its prices in densely populated areas while increasing prices in sparsely populated areas which are less attractive to competitors.
- 4.14 There is potential for Royal Mail to abuse its significant market power over deliveries in rural areas through price increases there to fund further discounts for large businesses. We are aware that this is a real concern amongst competitors in the market and that it may halt any innovative developments that may further competition and lead to choice and competitive prices for customers.

Universal Service Obligation

- 4.15 Postwatch, during several consultations on the universal service, stated that we believed, in the absence of real competition, business customers required

protection through the universal service. Therefore, should all business products be placed outside the universal service, then Royal Mail may decide to apply to price these services on a zonal basis, making it more expensive to deliver to rural areas. Business may decide not to mail to these areas, thus isolating such areas leaving rural dwellers at a distinct loss. We reiterate our comments that it is key that Postcomm must assess the wider impact on customers and undertake an extensive consultation exercise prior to excluding all business products from the universal service. These proposals make it more essential than ever that some bulk mail products remain within the universal service.

- 4.16 Zonal Pricing could potentially result in reduced volumes for rural areas. This would reinforce Royal Mail's case for fewer deliveries each week to rural addresses or a reduction in the universal service to rural areas.
- 4.17 Should Zonal Pricing go ahead for bulk mail products, Postwatch would seek assurances that it would not extend to products within the universal service including stamped and metered mail, as the social implications would be considerable as well as leading to increased cost and confusion. The practical implications for SMEs would be unreasonable, as not only would they have to sort mailings into size (letter, large letter or packet) but they would also have to sort mailings further into each zone which would eliminate the efficiency element of a franking machine. In research conducted by Postwatch¹, 59% of SMEs did not prefer a pricing system based on an urban/rural divide.

5. Conclusion

- 5.1 In summary, Postwatch is opposed to Zonal Pricing on a number of grounds including the continued risk of price increases in rural areas to compensate high density area discounts and almost inevitable increased unit costs of delivery resulting from de-selection of rural areas.
- 5.2 At some point in the future (e.g. when the VAT distortion has been lifted), Royal Mail should be free to price non-USO products depending on the area of distribution but it must be a simple, customer-friendly and not anti-competitive system. Like in Sweden, it may be appropriate to allow cost justified price reductions in clearly defined urban areas but with a national price everywhere else. This would be more transparent, simple and less prone to constant manipulation in the future.
- 5.3 It would also mean that no areas would be more expensive than the national price (and, the facts show that arbitrage is happening and will continue to happen because customers will not pay more than the national price in any event), only that some areas would be cheaper. Such a system may benefit

¹ Pricing in Proportion Research: November 2006

recipients in urban areas but it would not disadvantage those living in rural areas

- 5.4 The potential benefit of Zonal Pricing is outweighed by the potential disadvantages to customers, rural dwellers and competition and Postwatch is not aware of any compelling evidence supported case to introduce Zonal Pricing at this time. Furthermore , Royal Mail may be damaging its own interests by potentially reducing mail volumes and revenues.

List of Respondees

1. Postwatch North
2. Postwatch Northern Ireland
3. Postwatch East
4. Postwatch South & West
5. Postwatch Scotland
6. Postwatch Wales
7. Postwatch South East
8. Postwatch Greater London
9. Postwatch Midlands
10. Association for the Protection of Rural Scotland
11. Aberdeenshire Council
12. Communities Scotland
13. Borders Council
14. East Ayrshire Council
15. North Lincolnshire Council
16. Otto Mail Order Catalogue Group
17. Cumberland Building Society
18. Business Customers (2 responses)
19. Social Customers (2 responses)