

# **Zonal Pricing by Royal Mail**

**Mail Users' Association**

**Formal Response**

## **MUA RESPONSE TO POSTCOMM'S ZONAL PRICING CONSULTATION**

### **Background**

#### **B.1. Who are Mail Users' Association?**

**B.1.1** Mail Users' Association was formed in the 1970's when a number of major business mailers joined forces to fight for the restoration of postal services in the UK at a time of escalating prices and deteriorating quality of service.

**B.1.2** MUA is the UK's only independent association of business users concerned wholly with commercially related postal matters. Its members are drawn from a wide range of business interests including direct mail, banking and finance, communications and the Utilities, publishing and postal related industries.

**B.1.3** Collectively, it is estimated MUA members generate more than 15% of annual postal traffic in the UK.

#### **B.2. MUA's Objectives**

**B.2.1** MUA's primary objective is to secure a healthy and cost effective set of postal services for all business users and their customers. This not only applies to physical mail, but also includes electronic and hybrid mail areas.

**B.2.2** Members continue to believe that this will be achieved in a mixed market, offering users a real choice between the obligatory USO services of Royal Mail that exist at present, and a set of competing value added options - particularly for the business mailers.

**B.2.3** In order to achieve this goal, the MUA believes it necessary to ensure service providers are:

- customer focused in their approach to the products and services they offer;
- able to offer cost effective services at realistic prices the market can bear;
- have flexibility in their approach to customers whose needs are continually changing;
- and, are able to provide reliable, high quality services on a continual basis.

## **ZONAL PRICING BY ROYAL MAIL**

### **1. Introduction**

**1.1** MUA thanks Postcomm for the opportunity to respond to its initial consultation on the Regulator's proposed approach to assessing Royal Mail's application for the introduction of zonal pricing to certain non-universal service bulk mail products – namely:

- Mailsort 120 – 1<sup>st</sup> and 2<sup>nd</sup> Class, OCR and CBC
- Mailsort 700 – 1<sup>st</sup>, 2<sup>nd</sup>, and 3<sup>rd</sup> Class
- Mailsort 1400 – 3<sup>rd</sup> Class
- Presstream – 1<sup>st</sup> and 2<sup>nd</sup> Class
- And Walksort – 1<sup>st</sup> and 2<sup>nd</sup> Class

**1.2** Postcomm will not be surprised to hear that given the diversity of MUA membership, opinion on whether it is appropriate to implement zonal pricing for bulk mail products and the underlying reason for why Royal Mail deem it necessary to zonally price at this juncture, varies widely across the spectrum of industry. The Regulator will be aware of magazine publishers' strong concerns regarding the implementation of zonal pricing, and whilst fully supporting the arguments its' members in magazine industry put forward, MUA would defer Postcomm to PPA's individual consultation response for the full detail around publishers' specific concerns.

**1.3** As stated in MUA's recently submitted Strategy Review response members generally identify with the concept of Royal Mail better aligning prices with costs. However, in the interests of the long-term future of the postal industry, members consider Postcomm needs to be extremely cautious regarding the pace of change it permits, given that Royal Mail remains a dominant player in the marketplace. Cross subsidisation has historically been prevalent across many facets of Royal Mail's operations, and to some extent members would expect Royal Mail's infrastructure to be set up to deal with these anomalies. MUA would therefore strongly advise caution at every stage in the elimination of cost discrepancies, particularly in relation to the implications this may have on pricing in a competitive market still in its infancy.

**1.4** Whilst MUA accepts Royal Mail may well be applying to introduce zonal pricing for all the right reasons, members would note Postcomm needs to be mindful of the fact that as has been demonstrated in the publishing industry, it could be argued Royal Mail has adopted pricing strategies in the past designed to undermine emerging competition. For example, in the late 1990's a number of large magazine publishers attempted to develop an Approved Magazine Distributor Scheme, designed to accredit and promote alternative magazine carriers, and encourage publishers to devote a certain percentage of their magazine distribution to enable the carriers to accrue much needed economies of scale, on which to develop their distribution networks.

**1.5** Many observers believe the impetus for Royal Mail's introduction of Profile Pricing was a direct response to the development of the AMDS, given that in its infancy a number of the large publishers involved in the trials were offered Profile Pricing packages which included exclusivity clauses, thus severely limiting the amount of magazines postal operators had access to. Now whilst this may or may not have been the case, members do believe it serves to demonstrate the importance of Postcomm fully assessing the validity of the case for change.

### **Key Questions for Consultation**

- **'Recognising the fact that Postcomm will issue a second consultation document on Royal Mail's 5 July application in due course, is there anything in the application that respondents would like to bring to Postcomm's attention at this stage?'**

### **2. Royal Mail's Case for Change**

**2.1** MUA would raise strong concerns about the underlying reasons for Royal Mail making this application at this point in time. Members recognise Royal Mail wishes to become more competitive and the ramifications cost inefficiencies have on achieving this goal, however they also question the underlying motives of applying for zonal pricing in a market that from Royal Mail's perspective is most vulnerable to entry from end-to-end competition, at this time.

**2.2** Having said this, MUA also recognises the importance of potential competition entering the market using sustainable business models, and the need to guard against artificially supporting prices in the longer-term. Members therefore believe in the best interests of the overall postal market, Postcomm needs to establish an appropriate balance between facilitating the emergence of end-to-end competition, and the speed at which a dominant player is permitted to introduce a cost reflective pricing structure, which will ultimately serve to subdue that emerging market.

**2.3** The timing of the introduction of zonal pricing is therefore seen as paramount in this respect, and Postcomm's provision of a set timescale for the introduction of any cost reflective pricing strategy over the next 3-5 years, would go some way to allowing emerging competition to plan and develop viable market entry strategies based on sustainable business models, whilst at the same time providing a flight path for many customers who will need to mitigate for any new price differentials.

### **3. Price Differential Transition**

**3.1** MUA would also raise the issue of how Royal Mail's intends to phase the transition from the initial price differentials to the final price differentials it wishes to put in place by 2010.

**Indicative Price Differentials Sought by Royal Mail at Introduction and at Maximum by 2010**

Zone A	Zone B	Zone C	Zone D	Zone E
-4.6% / -11.4%	-1.6% / -3.0%	0% / 0%	+4.5% / +8.7%	+7.3% / +33.8%

**3.2** Postcomm states that ‘Royal Mail has so far given no clear indication of how it would phase the transition from initial prices to the final 2010 prices’<sup>1</sup>. MUA also notes that the application ‘seeks to allow Royal Mail the option to implement the zonal price differentials below (in this case above) without having to make a further application to Postcomm’<sup>2</sup>. These facts concern members greatly, in the respect that they would appear to offer Royal Mail the ability to manipulate the market in response to the extent of developing competitor activity, and ultimately allow them to ‘price out’ emerging competition without recourse to the Regulator. This is a dangerous place for a dominant market leader to be, and one which Postcomm must strongly guard against in the interests of the emergence of end-to-end competition.

**3.3** Members therefore strongly advise Postcomm to fully establish the price differential transition timetable Royal Mail intends to put in place before taking the application further, and were the application to be approved, publish this timetable in the public domain. This will again enable emerging competition to plan for the future using sustainable business models.

#### **4. Customer Cost Implications**

**4.1** MUA believes it is pertinent to also highlight members’ concerns around the cost implications of Royal Mail implementing zonal pricing. Whilst members recognise these concerns will be more properly addressed in Postcomm’s second consultation, they nevertheless believe it necessary to raise these concerns at an early stage in the proceedings, given their relevance to customers’ own business activities.

**4.2** Royal Mail wishes to introduce zonal pricing to meet its own financial and operational ends, arguably at the expense of customers who are to all intents and purposes a captive audience. As has historically been the case, unlike other customer/supplier relationships Royal Mail continues to benefit from being in a position to dictate to the market, the conditions by which it will do business. In the absence of end-to-end competition and/or any other nationwide final delivery network, any customer who wishes to use bulk mail services other than products in the universal service (such as Mailsort 1400 1<sup>st</sup> and 2<sup>nd</sup> Class), they will therefore be obliged to use Royal Mail services well into the foreseeable future.

**4.3** The way in which Royal Mail is proposing to implement its zonal pricing strategy will have cost implications for many mailers in terms of mail presentation requirements they will be expected to adhere to, in order to use zonally priced services. There will be an obligatory requirement for them to interface electronically

<sup>1</sup> Postcomm Zonal Pricing by Royal Mail consultation document – Page 8 – Para 2.8

<sup>2</sup> Postcomm Zonal Pricing by Royal Mail consultation document – Page 8 – Para 2.7

with Royal Mail, and they will be required to alter end of line mailing procedures to produce mail in zone order within SSC, print SSC codes on individual mail items, and carry out various additional procedures to accommodate Royal Mail's revenue protection criteria. Customers will also apparently be expected to purchase the upgraded software required to carry out these processes, and presumably procure year-on year upgrades to this software.

- 4.4** MUA is therefore concerned that the costs of operational changes associated with using Royal Mail's zonally priced bulk mail services will impact directly on essentially captive customers, and may even prohibit less technologically based small and medium sized enterprises from benefiting from zonal pricing.
- 4.5** Many businesses presently run their operations 24/7, and do not have the capacity to 'double pass' mail items through end of line machinery, without incurring substantial additional costs. It could also be argued that those businesses that do have the capacity and/or decide they are prepared to finance alterations to their operations to accommodate zonal pricing, are indirectly being coerced into perpetuating the usage of Royal Mail products in the future, over other potentially emerging end-to-end competitors, in respect of their operations being set up 'the Royal Mail way'.
- 4.6** MUA would therefore question whether the proposed changes to mail presentation have any significant relevance to the key issue of introducing zonal pricing, and members would argue there is a strong case to say the required changes are simply stealth tactics employed by Royal Mail to change mail presentation specifications for the benefit of Royal Mail, and not the customer.
- 4.7** Finally MUA would highlight the indirect disadvantage some business mailers may be put at, having already signed up to 3-5 year contracts with Downstream Access providers.

## **5. The Future of the USO**

- 5.1** MUA recognises some of the costs incurred by customers in setting up for zonal pricing may be offset by lower prices offered by zonally priced products. However, this in itself is cause for concern in that some mailers may either be enticed into skewing national posting profiles to take advantage of lower prices in business districts and higher density areas, to the detriment of addresses in rural and remote areas, or in extreme cases actively adopt policies which positively discriminate against addresses in rural and remote areas.
- 5.2** This will obviously have long term implications for the maintenance of the universal service at a uniform geographical tariff, leading some observers to believe zonal pricing may be the thin end of the wedge, in terms of Royal Mail making a case for its inability to viably continue providing the USO without assistance from some form of 'all in' postal carrier universal service financial support mechanism. Indeed, some members would argue the validity of this line of reasoning is made all the more real, when taking into account discussions presently underway in Europe

surrounding the drafting of the 3<sup>rd</sup> EU Postal Directive, concerning the concept of 'Pay to Play' USO compensation funds.

**5.3** Business mailers faced with zonally priced services may also be more predisposed to redirect marketing spend away from postal activities in certain areas of the country, in favour of other electronic mediums, thereby increasing downward pressure on the viability of maintaining the universal service.

## **6. The Proposed Zonal Pricing Structure**

**6.1** MUA is not at all confident in the methodology Royal Mail has employed in defining the zonal pricing structure, given representations provided to Postcomm by potential end-to-end competitors. Aside from the zonal classification errors highlighted at Postcomm's recently held workshop, members have to agree with persuasive arguments in respect of the considerable differences in Royal Mail's retail zonal pricing structure when compared with its Door-to-Door unaddressed prices.

**6.2** MUA believes the considerable variance in how Royal Mail chooses to breakdown the country for each classification of mail, does merit a full and extensive investigation by Postcomm into the methodology used by Royal Mail, and indeed should be grounds for an independent reassessment (carried out by Postcomm) of the proposed zonal breakdown, at the next stage in the consultation process.

**6.3** Members would also seek further information on whether figures provided to Postcomm by Royal Mail include breakdowns of avoided costs for the delivery and collection of USO mail, given that operatives are in any case obligated to cover the same ground to deliver the remaining 66%<sup>3</sup> of mail volumes that will not be included in the zonal pricing proposals.

- **What are the factors to which you think Postcomm should give particular attention in applying the criteria set out in Royal Mail's Licence (in Condition 21 Paragraph 19)?**
- **How do you think the importance of these factors may change over time?**

## **7. Revenue Neutrality**

**7.1** MUA is perplexed by Royal Mail's approach to engaging industry interest in zonal pricing by stating business mailers will as a result have access to lower prices. Surely, if the overall exercise is to be defined as being revenue neutral, businesses with national geographical posting profiles will see prices go down in some areas, and rise in others. Members consider the only occasions when a business mailer will see prices go down across the board, are in circumstances where their posting profile is naturally skewed towards business districts (i.e. by dint of the fact that they are

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<sup>3</sup> This figure has been deduced from Postcomm's table on Page 7 of its consultation document.

predominantly business-to-business mailers), or if they were to actively pursue a policy of address de-selection, which could be argued is verging on a discriminatory issue for Postcomm.

- 7.2** There is an argument to say that zonal pricing for Royal Mail, could potentially end up being a revenue negative exercise, were customers to de-select rural and remote addresses in favour of either other forms of electronic media, or cheaper alternative delivery arrangements. Members would argue this would seriously threaten the universal service and compromise Postcomm's statutory duties in this respect.

## **8. Cost Reflectivity**

- 8.1** Although MUA is not privy to the cost breakdowns associated with how Royal Mail has arrived at the percentage price differentials for zonal pricing, members would state they believe it will be incredibly difficult for Postcomm to arrive at accurate cost reflective figures for this zonal pricing application, given the bespoke geographical anomalies inherent in Royal Mail's operational infrastructure, and the avoided costs associated with irrespectively having operatives on the ground, collecting and delivering mail that has not been zonally priced.

- 8.2** Furthermore, as and when these factors are taken into account, member would question whether the differentiated zonal prices for delivery of mail into rural and remote locations may not actually be subsidising the delivery of USO mail to the same locations. Postcomm must therefore be careful that in future the same arguments are not used in reverse to perhaps justify Royal Mail's being unable to maintain the universal service obligation, without financial assistance.

## **9. Unreasonable Changes for Users of the Service.**

- 9.1** MUA believes it has made sufficient reference in this document to the potentially unreasonable changes for users were zonal pricing to be introduced in this manner. At this point in the consultation process, members would only wish to further state that there are a number of outstanding issues that need to be addressed in order to ensure customers do not simply have to pay 'through the nose' for changes that Royal Mail otherwise wishes to make to its own operations.

## **10. Provision of Future Services**

- 10.1** MUA would state that on the face of it there appears to be no conclusive evidence that the introduction of zonal pricing may not eventually lead to a circumvention of Paragraph 1 of Condition 21<sup>4</sup> of Royal Mail's licence, or a failure on behalf of Royal Mail to provide services priced in a manner referred to the EU Directive, in respect of the universal service provider in future making the case for the need to geographically zonal price universal products also, in order to maintain the USO.

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<sup>4</sup> Paragraph 1 of Condition 21 requires Royal Mail at all times offer and provide the Regulated Services on as wide a basis within the United Kingdom as they were offered and provided in the month ending on 31<sup>st</sup> March 2006.