

Zonal pricing by Royal Mail  
TNT Post UK's Response to Consultation September 2006

1. TNT Post considers that the proposed introduction of zonal pricing will have a more profound and damaging effect on emerging competition than any other measure in recent years.
2. We are therefore delighted that Postcomm is seeking views at this early stage in the process.
3. Royal Mail is proposing to introduce zonal pricing in order to block emerging competition by selective price-cutting in non-captive zones, under the guise of greater cost-reflectivity.
4. By Royal Mail's own admission, no retail customer has requested zonal pricing.
5. By Royal Mail's own admission, as presented to a workshop hosted by Postcomm on 30 November 2006, the primary objective of zonal pricing

**“Allows customers to access lower prices”.**

There is, worryingly, not least because of the need for the proposal to be revenue neutral, no mention of corresponding price increases.

6. Zonal pricing is designed to prevent the establishment of competing delivery services in urban areas – precisely the areas where competition must establish itself at the outset and from which to build a wider network. If Royal Mail loses volume to competitors – which as holder of 99.8% of licensed letter deliveries it must – Royal Mail needs to react to competition by adopting a more flexible and cheaper cost model: not by introducing an exclusionary pricing structure.
7. Royal Mail is protected from competition by a VAT distortion which protects it from competition for 40% of business mail volumes. Postcomm must take this into account when exercising its statutory duty in assessing what will be:  
  
**“best calculated to further the interests of postal users, wherever appropriate, through the promotion of effective competition between postal operators.”** [emphasis added]
8. Royal Mail also has a number of benefits which make competition very difficult which will act to counter the extent and speed of any market entry.
  - enormous economies of scale - post depends on such economies
  - huge economies of scope
  - a valued and trusted brand
  - a VAT advantage when dealing with customers who send 40% of the UK's business mail – which is unlikely to change before 2010
  - very low prices – both retail and wholesale

- good quality service
  - scope for material price increases for captive services
  - a regulatory obligation to reduce prices for non-captive services at close to 2% below inflation, year on year
  - the richest shareholder in the UK (the Government)
  - an undemanding shareholder which does not insist on normal financial returns on investment
  - access to shareholder funding which allows substantial investment in technology which will make them increasingly more efficient in the future
  - a 99.8% share of licensed letter mail delivery – with a turnover of over £6 Billion
  - the capability, unlike any of its competitors, to ride out the roughest of storms, no matter how long it lasts.
9. The zonal pricing proposal, if accepted, will result in a very substantial reduction in revenue for Royal Mail which may, or may not, be offset from customers paying higher prices in the non-urban “captive zones”.
10. Higher prices in rural areas will lead to (a) arbitrage through retail services or national access services in the absence of measures to prevent this and/or (b) de-selection by customers of rural areas, causing unit costs of delivery to escalate, causing a death spiral for rural deliveries. This clearly does not protect the interests of “**individuals residing in rural areas**” and Postcomm has a statutory duty, under section 5(2) of the Postal Services Act 2000 to make sure that it exercises its powers to do just that.
11. Postcomm, on receipt of sufficient information of good quality from Royal Mail, is required to exercise its statutory duties to determine whether or not it is satisfied that the proposal from Royal Mail to introduce zonal retail pricing meets each of the requirements in paragraph 19 of Condition 21 of Royal Mail’s licence.
12. We believe that Postcomm’s only proper reaction will be to conclude that it is not satisfied that, in light of its statutory duties and the very early phase of market opening, Royal Mail may price services on the basis proposed in its application of July 2006.

The licence tests

### Revenue neutrality

13. The pricing will not, in reality, be revenue neutral: Royal Mail, at a workshop on 30 November, gave no adequate assurance that it would require customers to use zonal services for all their mail and not arbitrage other retail and national access services to achieve a net discount on the current nationally averaged prices. In other words, Royal Mail is offering a range of services where they allow themselves to be voluntarily cream-skimmed. This clearly does not involve effective competition between postal operators. Rather than being designed to be a revenue neutral pricing move, Royal Mail’s first stated objective “Allows customers to access lower prices”.

14. Customers will, if they cannot arbitrage, de-select more costly areas. The Periodical Publishers Association have confirmed this and stated that an increase in rural prices could even undermine the financial viability of a number of customer publications. This de-selection of areas, designed to off-set discounts in non-captive zones, will necessarily lead to the prices paid not being revenue neutral.

15. Zonal pricing will be revenue negative. While it may be tempting to see this as a “good thing”, Postcomm does need to worry about this at this will have a profoundly damaging effect on emerging competition. The absence of competition will be detrimental to customers and to the postal industry as a whole.

### **Prices more reflective of cost than uniform prices**

16. There can be no doubt that prices would be more cost reflective if the cost of delivery to certain addresses is higher than it is to others and the prices reflect this.

17. If, however, the prices are not coupled with measures to ensure that customers who pay less for deliveries to some areas also pay more for deliveries to other areas, the prices paid by those customers will not be more reflective of cost. The reality is that customers will never pay more than the cheapest price available to them. To suggest otherwise is to insult their intelligence and that of those who would seek to offer such services – as is currently occurring. In the absence of a prohibition on arbitrage, the prices will be less cost reflective than the current uniform prices.

18. Indeed, it is conceivable that, unless measures are put in place to stop such arbitrage, the overall price offered by Royal Mail, taking together the combination of services offered by Royal Mail to any given customer or class of customers, may be discriminatory or even predatory. Royal Mail’s licence requires it to “**take all reasonable precautions against the risk of failure to comply with the conditions of [Part 4 – Promotion of Effective Competition between Postal Operators]**” and, therefore, does not permit it to run such a risk. They must therefore take all necessary steps to ensure that this could not happen.

19. The proposals contain no such safeguards to ensure that the prices are more cost reflective. Unless they do, the prices will be less cost-reflective than the current uniform prices.

20. By our calculations, close to 9% of the sectors in Great Britain have been wrongly classified by Royal Mail. The effect of incorrect classification undermines the overall cost-reflectivity.

21. We have seen an enormous disparity between the current zonally-based discounts for Royal Mail’s unaddressed services and its proposed prices for addressed mail. We note that the Door to Door service is not a regulated service but believe that Postcomm must understand the underlying delivery costs and internal wholesale price which Royal Mail charges its retail business for the provision of this service and fully understand why the pricing is so different. The disparity has been mapped and is included in Annex A.

22. Royal Mail is seeking to divide the country along the lines of postal sectors. We accept that some form of delimitation of areas is needed but are aware of a number of areas where the postal sector is unlikely to reflect the true underlying costs of delivery e.g. where there are large uninhabited areas; sectors which include sea or river; sectors with few roads. We also question the absence of some, we would think, key cost drivers e.g. average volumes to different types of address; foot versus vehicle versus bicycle delivery; real estate costs; personnel costs etc..

#### **Avoids unreasonable changes for users**

23. Any customers who machine sort their mail will be required to geographically sort their mail and then sort that mail a second time to present it in zonal order, to meet the Royal Mail revenue protection requirements. There is a very tight time window in which to sort mail in order to meet the despatch or collection time to meet next day delivery. The need to sort the mail twice (first geographically and then zonally), at least, halves the capacity on sorting machines and yet yields no additional discount to the customers. This is a wholly unreasonable change.

24. This double-sortation requirement also applies to those using zonal access services. This has the effect of, at least, doubling the costs of sorting machine purchase, housing and running costs. Requiring the use of zonal services by retail and wholesale customers, therefore, imposes unreasonable changes on, both, retail and wholesale customers.

25. Customers and their mailing houses will need to make software changes to be able to geographically and zonally sort the mail. The additional cost of such software changes will not result in any benefit for those customers.

#### **Not lead to Royal Mail ceasing to provide the Regulated Services as widely as on 31 March 2006**

26. We do not see that the offering of zonal retail prices would necessarily lead to a breach of this condition.

#### **Not lead to a failure to price in accordance with the EU Directive**

27. There is a very real risk that the zonal retail prices will lead to a failure to price in accordance with the EU Directive.

28. With an increase of 33.8% (65.3% for zonal access) in Zone E, it is, at least, arguable that the prices are not affordable. Postcomm has previously said that, in the context of addressing the VAT distortion, a 17.5% increase could call into question the affordability of prices. The proposed zonal retail price increase is close to twice that amount. This would be contrary to the requirement under the Directive that price must be affordable.

29. As mentioned above, the absence of anti-arbitrage measures means that the prices would not be more “geared to costs” than they are under the current uniform pricing.

30. In order to assess if the prices are “geared to costs”, it is critical that other possible methodologies, levels of granularity and cost drivers are taken into account. Under the application, we are not convinced that they are.

31. It is significant that the EU Directive specifically confirms that a Member State may decide that a uniform tariff should be applied. This clearly indicates that, should Postcomm determine that the proposal before it fails to meet the licence conditions and that Royal Mail’s prices must remain uniformly priced, it is not in any way precluded by the EU Directive from doing so determining.

32. Any individual agreements need to be non-discriminatory and non-predatory and otherwise comply with the applicable competition rules (and with the requirements of the licence). This provision, in itself, does not have a bearing on a generally applicable zonally-based pricing tariff.

33. There is a risk that, given the disparity between customers using uniform tariffs (either wholesale or retail) and those using zonal access, there will be discrimination.

34. The tariffs may be public, but the prices are based upon the customers’ specific geographical profiles. There is also a suggestion that multi-copy discounts may be offered (i.e. where there are a number of addressees at a single postal address, typically business premises) and, we believe, that further discounts will be offered in the future. This means that it will be very difficult to know exactly what prices are being charged and this will call into question the requirement for transparency. With uniform pricing, tariff multiplied by volume gives the relevant price. This is transparent. Zonal pricing is not.

## General

35. Our concerns were demonstrated in a presentation given to a workshop on zonal pricing, held on 30 November 2006. That presentation forms part of our submission and the slides are attached as Annex A to this response.

36. Aside from the mis-classification of certain sectors; questions over the extent of the sectors and underlying economics; concerns about zonal pricing having an exclusionary effect.

37. Postcomm needs to consider carefully the interplay between zonal retail and zonal access. We continue to maintain that zonal access has a damaging effect on competition. For example, the national access agreement contains a surcharge mechanism which is based upon postcode areas and which applies levels of prices which are in excess of the zonal prices. The two systems are incompatible and, thus, discriminatory.

38. In light of the significant risk of rural de-selection, which is likely to grow as the price differential between urban and rural zones grows, (see paragraph 10(b)), Postcomm will need to be completely satisfied itself that the introduction of zonal pricing - and subsequent pricing moves after its introduction - will not undermine Royal Mail’s ability to provide a universal service at an affordable price.

## Summary

The proposal:-

- appears to contain significant errors in applying the classification criteria to postal sectors;
- potentially ignores significant cost-drivers;
- may use an excessive level of granularity;
- does not satisfy all the tests set out in paragraph 19 of Condition 21;
- would potentially lead to a number of breaches of Royal Mail's licence conditions;
- would (as we are convinced it is designed to do) undermine effective competition;
- burdens customers with unnecessary change and expense;
- adds considerable complexity and so soon after the introduction of another major pricing change
- would damage Royal Mail's ability to provide a rural postal service far more than competition would ever do;
- may lead to unnecessary strains being put on Royal Mail's ability to finance the universal service, following rural de-selection, and would thus be properly subject to a veto by Postcomm pursuant to its primary statutory duty to act "[in the manner which it considers is best calculated to ensure the provision of a universal postal service](#)";
- will be revenue negative – not revenue neutral;
- is significantly different from the zonal pricing model used for un-addressed mail services;
- may cause Postcomm to conclude it would not be able to demonstrate that it had had sufficient "[regard to the need to ensure that \[Royal Mail is\] able to finance activities authorised or required by \[its\] licence ..](#)" - section 5(4) PSA 2000
- increases the likelihood of state funding and/or further increases in prices for captive services (e.g. stamps);
- involves non-commercial pricing.

Postcomm should, in our view, having exercised its statutory obligations and considered carefully the impact of the proposal, determine that it does not satisfy the licence conditions and that Royal Mail must continue to price its services on a uniform tariff basis.

TNT Post UK Limited  
December 2006

Annex A  
Presentation slides from 30 November 2006 zonal pricing workshop