



# **Response to Postcomm's Consultation on Royal Mail's Application to Introduce Zonal Pricing for Non-Universal Service Bulk Mail Products**

**17 October 2007**

## EXECUTIVE SUMMARY

Royal Mail's Postal Services Act Licence allows it to apply to Postcomm with a proposal to price its non-Universal Service Obligation ("USO") retail services on a zonal basis. Postcomm is required to consider whether such an application is consistent with Condition 21(19) of the Licence and unless Postcomm rejects the application within nine months on the basis of the criteria set out in Condition 21(19) then Royal Mail may proceed with the introduction of retail zonal pricing. What is clear is that Postcomm accepts that Royal Mail's retail zonal pricing application meets two fundamental Condition 21(19) criteria which are that it is both revenue neutral and cost reflective.

Postcomm claims that Royal Mail's retail zonal pricing application is discriminatory. Royal Mail rejects such an assertion. Postcomm's consultation rationale is inconsistent with EU and UK competition law on discriminatory behaviour and it has not undertaken a competition economics assessment of the retail zonal pricing application to demonstrate how competition would be harmed by the proposals. This is a fundamental flaw in Postcomm's consultation proposal which Royal Mail believes is legally incorrect.

Postcomm also suggests that Royal Mail's application represents unreasonable changes for users. We do not agree with this analysis. However, we are suggesting a small number of changes in this respect which will take this beyond doubt. We are confident that any changes for users as a result of zonal pricing are reasonable.

### **1. The principle underpinning zonal pricing is simple and has been validated**

Royal Mail started discussions with Postcomm on a retail zonal pricing application eighteen months ago. Since then access competition has been established much more rapidly than predicted, niche delivery competition has developed and larger scale delivery trials have started, regulatory interventions have brought continued market uncertainty and most importantly the universal service is at risk today. These changes render Royal Mail's retail zonal pricing application even more critical.

The principles underpinning the application remain the same. In general, densely populated areas have lower delivery costs per unit than less densely populated areas. Mail that has to be uniformly priced is therefore more vulnerable to delivery competition in high density areas than in low density areas since Royal Mail's competitors face no obligation to price uniformly or to maintain a fixed network that enables delivery to every point next day. Entrants will therefore target cheaper to deliver areas with a high density of delivery points leaving Royal Mail with low volumes in those (more profitable) areas and sustained volumes in low density (and unprofitable) areas, putting the financing of Royal Mail Group at risk. High delivery point density can broadly be equated with urban areas and low density with rural areas, although this is not universally the case. For example, the town centre of some quite remote communities is in zone A or B (high density zones) whilst some areas within the M25 fall within zone D (low density zone).

The validity of this principle has been confirmed by the extensive cost reflectivity analysis and the market impact assessments carried out by both Royal Mail and Postcomm's consultants.

Royal Mail therefore wishes to gain the ability to compete fairly on a cost reflective basis.

## **2. Retail zonal pricing only affects bulk mail customers who can already choose between postal providers**

Royal Mail retail's zonal pricing application only affects non USO bulk mail services which are now commodities and where pricing is the key variable. Bulk mail services are services used by very large business customers and require a minimum of 4,000 items per posting. On these services alternative postal operators to Royal Mail have a significant price advantage through Licence Condition 21(5) that guarantees these providers up to a 21.54% headroom on access prices. Indeed the rapid growth in competitor volumes is proof that, overall, competitors face a very benign competitive environment in the UK. The growth in upstream competition has exploded since 2004 and is estimated to reach 4bn items this year – some 60% higher than Postcomm forecast when it set the price control. This more than anything demonstrates that bulk mail customers have choice.

Royal Mail retail's zonal pricing application **does not** alter those services that form part of the provision of the Universal Service and therefore will not affect stamp or meter prices, or those of smaller posters.

## **3. Royal Mail disputes Postcomm's reasons for rejecting the application**

In Postcomm's published proposals regarding Royal Mail's retail zonal pricing application, it states that two of the five Licence criteria Royal Mail must satisfy to be able to charge non geographically uniform prices are not met by the retail zonal pricing application.

- (i) Postcomm states that the retail zonal application could result in discrimination between customers, with the necessary implication that the proposal would lead to a failure by Royal Mail to provide services priced in a manner referred to in the Postal Services Directive.
- (ii) Postcomm also states that the proposed method and timing for the introduction of zonal pricing would lead to unreasonable changes for some users.

Royal Mail rejects both of these conclusions. However, it proposes modifications to the operational requirements that will reduce the onus on those customers who do not use off-the-shelf software to sort mail as well as a lengthening of the notice period.

## **4. Postcomm legal and economic basis for rejecting zonal pricing on the basis of discrimination is flawed**

The primary legal criteria Postcomm must use in considering the retail zonal pricing application is Condition 21(19) of the Licence. Royal Mail is also required to comply with the competition provisions in Condition 11 of its Licence which also requires Postcomm to follow EU and UK competition law precedents and principles. Postcomm's current proposal to reject the retail zonal pricing application on the basis of discrimination under competition law is flawed because it is inconsistent with EU and

UK competition law. As with all companies Royal Mail is required to comply with competition law and its enforcement.

Royal Mail believes that Postcomm's conclusion to reject the application on the grounds of discrimination is incorrect for two reasons. First, Postcomm has not shown that the proposed pricing would be unduly discriminatory, nor has it adduced evidence to support such a conclusion. Secondly, Postcomm has sought to apply Article 12 to services which fall outside its scope.

Postcomm's attempt to interpret Article 12 of the Postal Services Directive so as to import ex ante discrimination principles is incorrect. Article 12 clearly applies only to universal services and therefore cannot apply to Royal Mail's retail zonal pricing application.

Royal Mail accepts the approach taken by Postcomm in relation to the application of its statutory duties to the retail zonal application, namely that Postcomm should ensure that it does not reach a decision under Condition 21(19) which is incompatible with its statutory duties. However, it also believes that any decision taken in accordance with a proper application of Condition 21(19) will, by definition, be consistent with Postcomm's wider statutory duties.

In addition to the legal arguments, Royal Mail believes that Postcomm's analysis of zonal costs – which leads to the conclusion of discrimination between zones – is unnecessary, incorrect and incomplete. It is unnecessary because Postcomm's Code of Practice<sup>1</sup> expressly states that it "*seek[s] to establish a firm factual basis for its decisions and advice*" and to use economic analysis only where firm facts do not exist. Here statistical analysis has been carried out even though firm facts do exist, yet the latter have been discounted. It is also unnecessary because Postcomm's remit is to assess the application put in front of it under Licence Condition 21(19), not to postulate alternative zonal structures. Even if statistical analysis were appropriate, the analysis is incorrect because it fails to use the average unit cost (weighted by volume) when considering zonal costs. It is also incomplete because it fails to take into account the commercial and operational aspects associated with alternative zonal structures.

Royal Mail rejects Postcomm's conclusion that the application would introduce discrimination between access and retail customers. There is nothing preventing customers from switching between retail and access services in order to achieve the best price for them. Customers are also able to switch from Royal Mail to other postal services providers. Royal Mail notes that Postcomm has not carried out any economic analysis to justify its conclusions that the differences proposed would amount to undue discrimination in a manner consistent with EC and UK competition law, nor has it produced any evidence of a possible adverse effect on competition. Royal Mail is pleased to note that Postcomm confirms that Royal Mail is not obliged to ensure that its retail and access pricing structures (and specifically zonal structures) must always replicate each other exactly.

Finally, Royal Mail is surprised by Postcomm's proposal not to allow the cessation of Presstream Premium should zonal pricing be allowed. Royal Mail currently has only

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<sup>1</sup> "A Code of Practice Governing the Discharge of Postcomm's Functions", Postcomm, May 2002.

one customer for this service which has not attracted interest from any other customer. Postcomm's proposals in this respect appear unjustified.

Royal Mail believes the zonal structure it has proposed strikes a balance between revenue neutrality, cost reflectivity, simplicity and transparency.

## **5. Royal Mail has listened to its customers and proposes to modify the operational requirements**

For the vast majority of customers, no significant operational changes are required. The operational changes required are a major issue for a small number of customers that have developed in-house IT solutions that are not future proof. It is in any event disproportionate to link Royal Mail's development pace to that of customers that have chosen not to adopt future proof technologies. Such an unreasonable approach would seriously undermine Royal Mail's competitiveness and the development of the postal market.

Nevertheless, Royal Mail acknowledges those concerns raised by stakeholders and is prepared to modify its proposals to meet these concerns by changing the requirements for zonal sequencing, zone indication and bag forecasting. In addition, Royal Mail proposes to retain the six month transition period during which uniform and zonal price structures would operate in parallel, recognising that customers have their own scheduled dates for their IT changes. However, it will extend the notice period prior to the commencement of the transition period from three months to six months, thus giving customers a full twelve months' notice of the withdrawal of geographically uniform prices.

Royal Mail believes that experience of the introduction of Pricing in Proportion demonstrates its effectiveness at communicating price changes to customers. It is therefore disappointed that Postcomm has not taken into account Royal Mail's experience and past success in this area. In fact, despite many similarities with Pricing in Proportion, retail zonal will affect only around 7,000 accounts, not all postal users. Thus even if the impact of zonal pricing for customers using bulk mail services will be "as big as PiP", zonal pricing will affect a minority of customers.

## **6. Result of Postcomm's "Minded to" decision**

Approving Royal Mail's RZA gives Postcomm the opportunity to allow Royal Mail to improve its ability to finance its activities.

Postcomm states that "*whilst Royal Mail indicated that retail zonal pricing is critical to its financial stability, it has submitted very limited evidence to support this view*". However, Postcomm also notes that Royal Mail has stated that zonal pricing "*would lead to an increase in contribution towards its fixed costs of £25m per annum*". Given the underlying financial position of the Royal Mail business (as outlined in Royal Mail's response of 9<sup>th</sup> of October to Postcomm's Interim Review Proposals) this increase in contribution is critical. Specifically, this additional contribution can be compared with Royal Mail's reported loss of £12m on the price controlled area for 2006/07<sup>2</sup> compared to Postcomm's assumption (from its Price Control proposals) of an operating profit of £779m even though it achieved its 3% efficiency target, which highlights the

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<sup>2</sup> Regulatory Financial Statements 2006-07, Royal Mail Group, 31 July 2007

recent changes in market conditions<sup>3</sup>. Postcomm has an opportunity to enable Royal Mail Group to improve its financial position in accordance with Postcomm's statutory duty to ensure the licence holders can finance their licensed activities<sup>4</sup> in a proportionate, sensible manner that is consistent with the aims of the Postal Services Directive. The starting point should be that it is the imposition of a requirement for a uniform tariff for non universal services that ought to be justified, rather than the removal of that requirement.

## 7. Conclusion

Royal Mail's retail zonal pricing application only relates to the competitive bulk mail market. In this market, Royal Mail's retail market share is declining rapidly. Retail zonal pricing will introduce greater cost reflectivity in pricing and allow Royal Mail to compete fairly and will therefore benefit business customers by ensuring they can access the lowest cost of supply and will benefit social customers by better ensuring the provision of the universal service.

In summary, Royal Mail's views are:-

- The proposed retail zonal prices are more cost reflective than uniform prices and are revenue neutral as required by Royal Mail's licence.
- Retail zonal pricing is a key pricing lever that will allow Royal Mail to compete fairly in a developing market
- Retail zonal pricing will help maintain the financial stability of Royal Mail Group
- The operational changes for customers are not unreasonable or disproportionate
- Postcomm does not have a sound legal or economic basis to reject the retail zonal application on the grounds of discrimination

We therefore urge Postcomm to review the changes proposed to the operational requirements and notice period, take into consideration the successful implementation of PiP.

For the reasons summarised above and in the Concluding Summary and as more fully set out in this response Royal Mail believes that the grounds on which Postcomm proposes to reject Royal Mail's application are flawed, and that Postcomm should therefore approve the application when it reaches its final decision. Royal Mail notes that the purpose of issuing a "minded to" document is to test Postcomm's preliminary conclusions and does not fetter its discretion to reach a different ultimate conclusion taking account of the views and evidence put forward at this stage.

Alex Batchelor  
17 October 2007

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<sup>3</sup> Royal Mail Price and Service Quality Review. Final proposals. Postcomm December 2005 – Table 10.1

<sup>4</sup> S 5(4) Postal Services Act 2000

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## 1. Statutory and administrative framework

In its assessment of Royal Mail's retail zonal application (the "RZA"), Postcomm must have primary regard to the provisions of Royal Mail's Postal Services Licence<sup>5</sup> (the "Licence"), and in particular Condition 21 of the Licence.

Royal Mail also accepts that, when applying the provisions of the Licence, Postcomm must have regard to its statutory duties, as set out in The Postal Services Act 2000 (the "PSA").

Postcomm's interpretation of both the Licence and the PSA must be consistent with the Postal Services Directive<sup>6</sup> ("Directive"), whose provisions the PSA is intended to implement.

Finally, in reviewing the RZA, Postcomm must comply with established principles of administrative law and better regulation, which are incumbent on all public bodies in the United Kingdom, and ensure consistency with European and UK competition law.

### a. Royal Mail's Licence

#### Condition 21(19)

The criteria for assessing the RZA are set out in Condition 21(19) of the Licence. In order to reject the RZA, Postcomm must demonstrate that it is not satisfied that these criteria are met.

In its published Proposals, Postcomm concludes that Royal Mail's application fails to satisfy two of these criteria, but that the remaining three are satisfied. The two in question are:

- (i) Postcomm states that the RZA could result in discrimination between customers, with the necessary implication that the proposal would lead to a failure by Royal Mail to provide services priced in a manner referred to in the Directive.
- (ii) Postcomm also states that the proposed method and timing for the introduction of zonal pricing would lead to unreasonable changes for some users.

Each of these points is addressed in detail below. Postcomm is satisfied that the remaining criteria in Condition 21(19) are met..

#### Other relevant provisions

While Condition 21 remains the most pertinent Condition to the assessment of the RZA, Royal Mail acknowledges that its proposal must also be consistent with its other Licence obligations, and that Postcomm has a duty to monitor this consistency on an on-going basis. Of particular relevance, Royal Mail is subject to an obligation under Condition 11 not to engage in undue discrimination.

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<sup>5</sup> As amended on 25 May 2006

<sup>6</sup> Directive 97/67/EC (as amended)



The necessary corollary of this dual-layered obligation is that where Postcomm has no reason to reject an application made under Condition 21(19), it may nevertheless take enforcement action (for example under Condition 11) should this become necessary at any later stage.

Royal Mail is also subject to competition law more generally, and notably is subject to Article 82 of the EC Treaty and Chapter II of the Competition Act 1998 in markets where it may be dominant. Thus the OFT has the ability to enforce Article 82 and Chapter II against Royal Mail if appropriate.

Royal Mail therefore believes that in circumstances where Postcomm has other enforcement powers under the Licence (and the OFT has powers under competition law), it is disproportionate, and inconsistent with the Directive, to seek to apply further ex ante provisions to non-USO services which do not appear in Condition 21(19) or other Licence provisions.

#### *The Licence and Other Statutory Duties*

Royal Mail accepts that, as with all economic regulators, Postcomm is required to be mindful of its wider statutory duties. However, Royal Mail submits that it is necessary for Postcomm to articulate the relevant statutory duties in a transparent and clear manner if postal services providers and consumers are to have an understanding of how the regulator will apply and enforce the Postal Service Act licences. Royal Mail believes that Postcomm has never clearly articulated or defined what the relevant statutory duties are and how they were to be applied in an unambiguous manner to its consideration of the retail zonal pricing application in addition to the primary assessment under the Licence.

A clear articulation of how the relevant statutory duties would be applied in this case is also required as a general principle of administrative law. Royal Mail is entitled to understand all the criteria Postcomm are to use in its consideration of the retail zonal pricing application as an administrative law principle of procedural fairness. Otherwise Royal Mail cannot be expected to properly respond to Postcomm's concerns and neither can Postcomm be said to be transparent in exercising its regulatory functions.

#### **b. The Postal Services Act 2000**

The PSA requires that in exercising its functions, Postcomm's primary duties are: (i) the safeguarding of universal postal services; and (ii) the protection of consumers' interests wherever appropriate by promoting effective competition between postal services operators. These duties are consistent with the principles of the Directive.

Royal Mail accepts that Postcomm must execute its statutory duties when reviewing the RZA, namely that Postcomm should ensure that it does not reach a decision under Condition 21(19) which is incompatible with its statutory duties. However, it also believes that any decision taken in accordance with a proper application of Condition 21(19) should, by definition, be consistent with Postcomm's wider statutory duties.

### c. The Postal Services Directive

The underlying purpose of the Directive is the improvement of the quality of European postal services. It seeks to achieve this by promoting the controlled liberalisation of postal services across Europe (leading to the creation of a single internal market), while at the same time ensuring the provision across the EU of a minimum universal postal service.<sup>7</sup> The latter objective is implemented in the UK by Royal Mail's Universal Service Obligation (the "USO"). USO services are not affected by the RZA.

Consistent with general principles of EC law, Member States cannot apply the provisions of the Directive in a more restrictive manner than that prescribed. Thus, while the Directive determines the minimum steps required by Member States to promote market opening, the Directive does not prevent Member States from adopting more liberal measures<sup>8</sup>. Member States should not apply more restrictive measures. Furthermore, the proposed EU Postal Services Directive will require further market liberalisation.<sup>9</sup>

In common with all provisions of EC law, it is necessary to adopt a purposive approach to its construction, i.e. the spirit and intention of the Directive must be adhered to, in addition to the strict letter.<sup>10</sup>

As stated above, the PSA and, consequently, Royal Mail's Licence are derived from the Directive. They must therefore be interpreted consistently with its provisions and objectives. This requires Postcomm, wherever possible, to carry out its functions consistently with the principle of promoting competition and market liberalisation while safeguarding universal services.

The Directive is also relevant to Postcomm's assessment of the RZA by virtue of Condition 21(19)(e) as set out in detail below.

### d. Postcomm's commitment to principles of good regulation

The Better Regulation Commission has adopted the five principles of better regulation first developed by the Better Regulation Taskforce in 1997<sup>11</sup>, being: proportionality, accountability, consistency, transparency and targeting. Royal Mail believes that the government intends these principles to be applied by all regulators in the exercise of their statutory duties. Postcomm has also publicly espoused these principles.<sup>12</sup> As identified throughout this submission and summarised below, Royal Mail believes that Postcomm's Proposal to reject the RZA is inconsistent with these principles.

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<sup>7</sup> See Recitals (1), (8) and (11).

<sup>8</sup> See Recital 4

<sup>9</sup> See recital 24 of the latest EU Council and Parliamentary proposals amending Directive 97/67/EC (Postal Services Directive). The proposed directive will require that the principle that prices reflect normal commercial conditions and costs is only departed from in order to protect the public interest.

<sup>10</sup> See paras. 18 to 20 of the joint opinion for Postcomm dated 4 June 2003 re the exercising of its licensing powers under the Postal Services Act 2000 and compatibility of the Postal Services Directive, by Nigel Plemming QC and Stephen Morris QC.

<sup>11</sup> In particular see the Policy Maker's Checklist in "Principles of Good Regulation", Better Regulation Taskforce (2003). It is intended that these principles apply to all aspects of a regulator's activities

[http://publications.brc.gov.uk/publication\\_by\\_criteria.asp?Page=2&Category=The%20Regulators](http://publications.brc.gov.uk/publication_by_criteria.asp?Page=2&Category=The%20Regulators)

<sup>12</sup> See, for example, Postcomm's current consultation on its Enforcement Guidance, 2 August 2007.

- *Proportionality*: Royal Mail believes that it is disproportionate for Postcomm to seek to introduce an additional non-discrimination requirement (within Condition 21(19)) to non-USO services when none is provided for in the Directive, the PSA or elsewhere in the Licence, and also to seek to reject the RZA on the grounds of discrimination without any evidence of undue discrimination and subsequent adverse effect on competition.
- *Accountability*: this requires that regulators must be able to justify their decisions and be subject to public scrutiny. As stated above, since Postcomm has not provided any evidence of economic analysis to support its assertions that the RZA would result in undue discrimination, Royal Mail believes that Postcomm has failed to satisfy this requirement.
- *Consistency*: this requires both that Postcomm's decisions are consistent with one another and also that its decisions be taken in a manner consistent with other economic regulators'. Postcomm's assessment of the RZA (and in particular its assessment of undue discrimination) is not consistent with established economic or legal principles. In addition, Postcomm's assessment of Royal Mail's communication plan and revenue neutrality calculations under the RZA are inconsistent with its recent approach to the introduction of Pricing in Proportion.
- *Transparency*: this requires that Postcomm be open in its dealings with licensees and other stakeholders. Royal Mail is therefore concerned that Postcomm is seeking to impose an additional non-discrimination provision on non-USO services by the back door, despite the clear wording of the Licence and the Directive. Royal Mail is also disappointed that despite expressing views on discrimination in its Proposals, Postcomm has not sought to put these concerns to Royal Mail in any level of detail at any time during the application process before publishing its proposed minded to reject consultation proposals.
- *Targeting*: this requires that regulators target their resources on matters where there is a serious risk of consumer harm. In the absence of any evidence that the RZA will lead to undue discrimination, Royal Mail does not believe that it is justifiable for Postcomm to target its resources on seeking to make a case to reject the RZA.

#### e. Postcomm's Code of Practice, May 2002

Postcomm has committed to following a Code of Practice in the discharge of its duties as part of its framework of over-arching general principles. Its stated aim is to provide regulatory certainty.

In the Code's Explanatory Notes, Postcomm has stated that its general aim as regulator for the UK postal industry is to seek:

*"a range of reliable, innovative and efficient postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market"*<sup>13</sup>.

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<sup>13</sup> See paragraph 11 of Postcomm's "A code of practice governing the discharge of Postcomm's functions – A Decision Document" May 2002

Where there are different ways of fulfilling its statutory duties, Postcomm has stated that:

*“...in making these sorts of choice, it should work with the interests of consumers in mind and through the market. In this way, regulation should support the market rather than seek to determine its shape.”<sup>14</sup>*

Royal Mail supports this stated intention, i.e. the adoption of a light touch approach to economic regulation by deferring to the postal industry's commercial freedom in directing its business.

However, in its published Proposals, Postcomm has foregone an opportunity to support the market in this way, by taking an unwarranted interventionist approach in two ways. Specifically, Postcomm is seeking to reject Royal Mail's application by extending the provisions of Article 12 of the Directive relating to USO services and apply these to non-USO services. Furthermore Postcomm has not limited itself to considering the retail zonal application before it but has proposed alternative zonal definitions. This is not light touch regulation and is contrary to the better regulation principle of proportionality.

Postcomm has also made a public commitment to establish a firm factual basis for its decisions and advice<sup>15</sup>, and to rely on measurable facts when adopting a policy or taking a decision. It has rightly expressed the view that it should rely on the use of economic theory or estimation only in circumstances where empirical evidence is unavailable.<sup>16</sup> However, Royal Mail believes that in its proposal to reject the RZA Postcomm has chosen to disregard factual evidence provided by Royal Mail (including costing information for the proposed zones which demonstrates the cost-reflectivity of the proposal) in favour of speculative theories of discrimination which have no economic or evidential basis.

#### **f. Consistency with EC and UK Competition Law**

Finally, as a matter of legal principle Postcomm is obliged to reach decisions which are consistent with principles of EC and UK competition law as are those sectoral regulators with concurrent competition powers. In Postcomm's case this obligation is further expressly provided for in Condition 11 of Royal Mail's Licence. It is also required by the principle of regulatory consistency.

Thus, when assessing whether the RZA would result in undue discrimination, Postcomm is obliged to ensure that it applies the established economic principles of competition law. Royal Mail believes that Postcomm has failed to ensure this required level of regulatory consistency in its analysis of potential discrimination concerns.

By virtue of Postcomm's Code of Practice (May 2002) and the Principles of Better Regulation, Postcomm has also committed itself to act in accordance with good regulatory practice and coordinate its activities with other regulatory bodies.

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<sup>14</sup> Ibid

<sup>15</sup> Ibid

<sup>16</sup> Paragraph 27, Postcomm Code Explanatory Notes

Regulatory coordination is reasonably expected to involve consistency in how competition law is interpreted and applied. This would mean that Postcomm is committed to having regard to how competition issues are decided by the Office of Fair Trading, the European Commission and other UK competition regulatory bodies. The principle of the supremacy of EC law means that all UK regulators are required to apply competition law at the national level in a manner consistent with the European Commission and the case law of the European Courts.

## 2. Assessment of Postcomm's discrimination concerns

Postcomm proposes to reject the RZA on two grounds, the first being that it is discriminatory and as a result, falls foul of Condition 21(19)(e) of its Licence. As set out below, Royal Mail believes that Postcomm is seeking to import an extraneous and legally inappropriate criterion into this Condition in order to extend the ambit of its power of review. In any event, Royal Mail believes firmly that on a proper analysis the RZA is not discriminatory and that Postcomm has failed to adduce any evidence or analysis to show that it would be.

### a. Application of Article 12 of the Directive

Condition 21(19) provides that one of the criteria against which Postcomm must assess the RZA is whether the proposal would lead to a failure by Royal Mail to provide services priced in a manner referred to in the Directive. Specifically, as acknowledged by Postcomm in its Proposals, this refers to Article 12 of the Directive.

Article 12 is concerned with the prices and other terms on which postal services operators may offer universal services. Relevant here is the requirement that universal services may not be offered on terms which are unduly discriminatory.

Postcomm has stated that, in its view, the proposed pricing under the RZA would be unduly discriminatory (a view which Royal Mail believes to be unfounded). Postcomm concludes that the proposed pricing would for this reason be inconsistent with Article 12 of the Directive, and would therefore "lead to a failure [by Royal Mail] to provide services priced in a manner referred to in the Directive". The result, in Postcomm's view, is that the RZA falls foul of Condition 21(19)(e) of Royal Mail's Licence and should be rejected.

Postcomm's conclusion is incorrect. Postcomm has sought to apply Article 12 to services which fall outside its scope. It is seeking to apply provisions relating to universal services to other postal services, and thereby import an additional criterion into Condition 21(19).

Royal Mail does not accept Postcomm's reading of Article 12 (i.e. that it could also be applied to non-universal postal services). The fact that Article 12 is limited to universal services is stated clearly at the beginning of Article 12:

*"Member States shall take steps to ensure that the tariffs for each of the services forming part of the provision of the universal service comply with the following principles ..."*

Thus Article 12 deals specifically with the tariff principles as they apply to the universal service (in this case, Royal Mail's USO services).

The reference to "special tariffs" under the fifth indent of Article 12 (which Postcomm seeks to extend to non-USO services) was inserted specifically to allow universal

service providers flexibility to offer discounts to its standard universal service tariffs for “work-sharing” arrangements, reflecting the operator’s avoided costs.<sup>17</sup>

Moreover, as stated above, it is necessary to interpret the Directive and its implementation into domestic law purposively. The Directive’s objective is to liberalise postal services in the EU but to balance this with protecting what have been identified as an essential communications service, i.e. universal postal services.

Had this requirement been intended to extend to non-USO services it would have been included expressly in the Directive.

By seeking to import an equivalent obligation on non-USO services into Condition 21(19) Postcomm is seeking to apply a provision which is not in fact applicable and which it is incorrect to import and is thus having regard to irrelevant considerations.

Postcomm itself recognises this tension at paragraph 7.5. It seeks to justify its approach by making a semantic distinction between the wording “priced in a manner referred to in the Directive” from hypothetical alternative wording “... required by the Directive”.

In Royal Mail’s view this distinction is neither appropriate nor accurate. On that basis Postcomm could import any criteria, however inappropriate, into the Licence. First, the relevant provisions of the Directive do not refer to the pricing of non-USO services; they expressly refer to USO services only.

Moreover, Postcomm’s hypothetical alternative wording (“required by”) would not make sense in this context. A European Directive places obligations on Member States to implement legislation according to its provisions (expressly stated in Article 12 also); it is not directed at individuals or companies. Thus it is the UK government who is required by the Directive to take measures to ensure that USO services are priced according to these principles. Similarly Postcomm (as an emanation of the state) is required not to allow pricing of universal services which would be inconsistent with the principles referred to in the Directive.

Extending a requirement which expressly applies only to universal services to services outside the USO is inconsistent with the principles of the Directive set out above: to protect the universal service while fostering free market competition outside this protected area.

In short, Postcomm is attempting to reject the RZA on the grounds of discrimination without any legal basis, and to apply powers of ex ante regulation under Condition 21(19) which it does not have.

Such an approach would not only be unlawful, it is also unnecessary. As stated above, along with all other commercial undertakings, Royal Mail is already bound to comply with the EC and UK competition law. Furthermore, Condition 11 of Royal Mail’s licence specifically requires the company to price in a way which is consistent with section 18 of the Competition Act 1998 and Article 82 of the EC Treaty.

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<sup>17</sup> See also Recital 29 to the Directive and the report of the co-decision procedure introducing this amendment ([2001] OJ C 232/287-300)

## b. Discrimination in Competition Law

In any event, Royal Mail believes firmly that on a proper analysis the RZA is not discriminatory.

Postcomm makes two specific allegations:

- (i) that Royal Mail's retail zonal pricing application is discriminatory as between customers posting to different zones (zones A and B) or posting to customers within a hypothetical "London-A" zone and the rest of London; and
- (ii) that it would be discriminatory for Royal Mail to use a different zonal structure for its retail pricing from that used for its access zonal pricing.

Postcomm has stated that Royal Mail's RZA is discriminatory on a number of grounds. However, Postcomm has not undertaken any legal or economic assessment to justify its claim that the retail zonal pricing application is (a) discriminatory, (b) that the discrimination is undue nor (c) that the discrimination has an adverse effect on competition in the UK. Postcomm therefore has not justification for its conclusion that Royal Mail's proposals are discriminatory as understood by EU and UK competition regulatory authorities.<sup>18</sup>

Royal Mail believes that in consideration of the retail zonal pricing application Postcomm have not applied the competition law principles regarding discrimination consistently with EU and UK law and principles. Postcomm is required to interpret competition law principles regarding discrimination in a manner consistent with the EU as it has also committed to do under Condition 11 of the Licence.

The supremacy of EU law is a fundamental principle of UK law. This principle requires both national courts and any public body which is susceptible to judicial review to give effect to EU law and not apply national provisions in a manner which is inconsistent with it.<sup>19</sup> National laws and their implementation must comply with the provisions of EU law. In Case 106/77 Simmenthal (1978) ECR 629, the ECJ stated not only that EU law prevails over domestic legislation but also that national provisions must be consistent with EU law by stating

*"... every national court must...apply Community law in its entirety and protect the rights which the latter confers on individuals and must accordingly set aside any provision of national law which conflict with it, whether prior or subsequent to the Community rule."*

### Undue discrimination

It is established in competition law, and recognised in the Directive and Royal Mail's Licence, that differential pricing is not unlawful (even for dominant undertakings)

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<sup>18</sup> The European Commission has initiated a review of the policy underlying Article 82 and the way in which it should enforce that policy. The review aims to set out in a clear and consistent manner theories of harm underlying the application of Article 82 based on sound economic assessment and to develop practical and workable rules which take into effect the realities of the market. The Economic Advisory Group on Competition Policy report of July 2005 entitled "An economic approach to Article 82" advocates an effects based approach to Article 82

<sup>19</sup> See Case 103/88, Costanzo SpA, (1989) ECR 1839



unless those differences can be shown to be undue, i.e. that the differences are excessive, arbitrary or both.

#### Excessive Differences

By its very nature zonal pricing (and indeed Royal Mail's pricing in general) requires that different customers be charged the same prices even though the exact costs of supplying those customers may differ. This, of itself, is not discriminatory and, indeed, unless prices are set on a very individualised basis, i.e. customer by customer, will always be the case.

In its current proposals Postcomm has simply asserted that price differences exist between certain customers. It has not sought to analyse whether, or on what measure, these differences are excessive. Moreover, as stated above, the differences in margin are significantly smaller than those obtained under the current position. That is the appropriate test (i.e. it would result in prices being "*more reflective of costs than they would be if the existing geographically uniform tariff was retained*"). Postcomm's conclusion is devoid of any supporting evidence or analysis.

#### Arbitrary Differences

Prices will be considered arbitrary only where there is no justification for charging different prices to equivalent customers (for equivalent transactions), or for charging the same prices for non-equivalent transactions.

Under the RZA proposal, prices would become more cost-reflective across the board, as is acknowledged by Postcomm. Royal Mail therefore submits that, far from introducing arbitrary distinctions between customers, the prices charged to all customers will become more cost-reflective.

Postcomm itself also acknowledges that Royal Mail's RZA proposal would move away from a legacy model of geographically universal pricing (of services which do not compromise the USO) which is, by its nature, discriminatory:

*"Postcomm is aware that the current uniform pricing may be seen to allow a form of price discrimination, in so far as, under uniform prices, some customers are paying a high price and some a low price, compared to underlying costs for the service they receive"<sup>20</sup>.*

The differences that remain are an inevitable consequence of, and justified by, the need to delineate between zones. Indeed, it could be argued that under Postcomm's logic no pricing proposal, short of end-user individualised pricing, could ever be non-discriminatory because any other structure will result in some customers paying higher prices than others, compared with the underlying costs of the service they receive.

As stated above, Postcomm has not set out by what measure it has judged these differences to be material. Similarly, where the concern identified by Postcomm relates to the correlation between access prices and retail prices across different zones, Postcomm has not sought to assess how (or whether) the differences between the margins in different zones are material.

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<sup>20</sup> Paragraph 7.6

Royal Mail notes that retail and access customers are served by different business units within Royal Mail which are managed independently in order to meet the requirements of Licence Condition 10. Moreover, to the extent that any customer believes it can achieve a better price by switching between access and retail services, it is free to do so.

#### No anti-competitive effect

Postcomm has also failed to carry out any assessment of the anti-competitive effect it expects to result from the Royal Mail's proposed pricing structure with regard to either of the allegations above. Rather, it makes a bald statement that "*discriminatory aspects of the proposal would be felt*" by certain hypothetical customers.<sup>21</sup>

In order to show discrimination to be an issue from a competition law and licence Condition 11 perspective, Postcomm must be able to demonstrate that the proposal would result in an exclusionary or exploitative effect. This approach was upheld by the ECJ in the recent British Airways case.<sup>22</sup>

The ECJ stated that in order for discrimination to be unlawful (on the part of a dominant undertaking):

*"there must be a finding not only that the behaviour of an undertaking in a dominant market position is discriminatory, but also that it tends to distort that competitive relationship, in other words to hinder the competitive position of some of the business partners of that undertaking in relation to the others."*

This principle is a long established one. By way of example see *Suiker Unie v. Commission*.<sup>23</sup>

The Office of Fair Trading (also consistent with European precedent) adopts an identical approach to discrimination, as set out in its Guidelines.<sup>24</sup> In considering conduct under Chapter II of the Competition Act 1998 and Article 82 it states:

*"the OFT considers that the likely **effect** of a dominant undertaking's conduct on customers and on the process of competition is more important to the determination of an abuse than the specific **form** of the conduct in question. Conduct may be abusive when, through the effects of conduct on the competitive process, it adversely affects consumers directly or indirectly"*<sup>25</sup>

These Guidelines also make it clear that it is necessary to show the effect to be exploitative or exclusionary.

In 2005 a report commissioned by the OFT recommends that an effects based approach be used to identify anti-competitive behaviour which should establish a consistent framework for the analysis of foreclosure effects of the conduct. This effects

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<sup>21</sup> Paragraph 7.34

<sup>22</sup> Case C-95/04 P, 15 March 2007

<sup>23</sup> Case C-40/73, 16 December 1975, paragraphs 523 and 524.

<sup>24</sup> See OFT Guidance "Abuse of a dominant position: Understanding competition law", 2004

<sup>25</sup> Paragraph 5.2 Ibid

based approach is intended to minimise the need for regulatory intervention, which chills price competition and innovation.<sup>26</sup>

Not only is this effects based approach clearly adopted by the OFT it is also adopted by the Office of Communications (Ofcom).<sup>27</sup> On the issue of undue discrimination Ofcom has clearly stated its position to be as follows:

*“... undue discrimination describes when an SMP provider does not reflect relevant differences between (or does not reflect relevant similarities in) the circumstances of customers in the transaction conditions it offers, and where such behaviour could harm competition. ...*

*“... Harm may be caused by limiting one customer's ability to compete in a downstream market or by excluding a competitor from a substantial part of a market.”*

Postcomm is obliged to act consistently with these established legal and economic principles as a matter of law, as a matter of its own stated policy and to ensure regulatory consistency (in line with the Principles of Better Regulation).

Royal Mail therefore believes that in seeking to assert discrimination concerns without any evidence of such an effect, Postcomm is exceeding its legal powers. However, it also believes that Postcomm is unable to produce any evidence, because there is no prospect that the RZA would produce any anti-competitive effects.

No exclusionary effect

Postcomm has not identified any evidence that the effect of Royal Mail's proposal would exclude competitors from the market.

As shown in the Zonal Cost Template in Royal Mail's RZA, there is a difference of [X] per item between the costs of zones A and B, corresponding to some [X%] of the price of a typical Mailsort 120 item. This cost difference easily justifies the price differences proposed for these zones of 2.9%<sup>28</sup>.

Postcomm's allegation is that retail customers are being charged higher prices than access customers in some areas of London (Postcomm fails to show how these price difference are material or arbitrary). In fact, the proposed pricing structure increases the margin between wholesale and retail prices for deliveries to areas of London (the area about which Postcomm has expressed concern) and therefore ought to be seen as encouraging retail competition. Postcomm's conclusion at paragraph 7.28 of its Proposals that this could “hamper the development of effective competition” therefore seems perverse as well as vague.

Similarly there is no prospect that exclusionary effects will arise in any downstream market. This appears to be the scenario Postcomm has in mind in its Proposals

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<sup>26</sup> See “Selective Price Cuts and Fidelity Rebates – Economic Discussion Paper July 2005 (OFT 804)

<sup>27</sup> See “Undue discrimination by SMP providers – How OFCOM will investigate potential contraventions on competition grounds of Requirements not to unduly discriminate imposed on SMP providers” Office of Communications, 15 November 2005

<sup>28</sup> This is the difference in the proposed discount for zone A (4.9%) and zone B (2%)

document. It cites a hypothetical example of two companies, one an access customer and one a retail customer, who would be charged different prices for mailing to the same address in London.<sup>29</sup>

Postcomm does not state what exclusionary effect on competition it believes would result. Perhaps it is based on a concern that certain customers could be tied to a particular access or retail service, Royal Mail notes that no such effect could arise as all customers are able to switch between the different types of service.

#### No exploitative effect

In order to demonstrate an exploitative effect, Postcomm would have to show that Royal Mail is proposing to charge higher prices to customers who are unable to switch to other suppliers or services than those customers who are able to switch. This is not the case. In fact, Postcomm has not been able to demonstrate such an effect nor has it sought to do so.

As stated above, Royal Mail is not aware of any class of customers who would be unable to switch between retail and access services, or indeed to a third party service provider.

In any event, even if such a class of customer were to exist, the pricing proposal under the RZA does not permit any discrimination between them (or any group of customers) from other retail customers, i.e. all are charged according to the same pricing model.

#### c. Postcomm's assessment of discrimination

##### Relevance of Postcomm's statistical analysis

In addition to the legal arguments, Royal Mail believes that Postcomm's analysis of discrimination between zones is economically and statistically incorrect. In reaching its conclusion Postcomm relies on its consultant's theoretical model to conclude that the retail zonal application will lead to discrimination between zones. Royal Mail has very serious concerns about this approach. In the summary of its findings LECG notes in its report (para 1.31) "*Whether one wants to rely on statistical results or factual figures in defining the optimal zonal classification is a matter of policy*". This is a very relevant statement; a model can seek to explain the relationship between various inputs (volume, geography, wage rates etc) and outputs (unit cost) and is potentially very useful if it is necessary to forecast ahead or to estimate an unknown figure. However, we are not here working with unknowns<sup>30</sup> but with the actual unit costs of each delivery office so a model is not necessary. Royal Mail has provided Postcomm and LECG with detailed factual cost data. There is therefore no need to ignore this data in favour of theoretical modelling, nor any justification for doing so.

The accuracy and appropriateness of the unit cost information provided by Royal Mail has not been questioned by Postcomm or LECG, with Postcomm concluding that '*Overall, it (LECG) concludes that Royal Mail has adopted a broadly acceptable approach*

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<sup>29</sup> Paragraphs 7.28 and 7.34

<sup>30</sup> Except within the well established and understood ranges due to measurement errors.

*given that it does not have reliable cost data at a zonal level for DOs and IMCs....<sup>31</sup>*. In fact Postcomm concludes that the RZA meets the cost reflectivity tests. There is therefore no obvious reason why the 'true' data should be discarded in favour of estimates produced by a model. This is especially surprising given that Postcomm appears to be deviating from its own Code of Practice<sup>32</sup>. One of the stated aims of the Code is Postcomm's commitment to "seek to establish a firm factual basis for its decisions and advice".

In addition it appears that LECG and Postcomm both acknowledge that their duty is not to propose alternative zonal structures but to assess the application presented to Postcomm. Despite this, LECG proceeded to carry out a wide range of assessments of alternative zonal structures.

In consequence of these points Royal Mail believes that the statistical analysis carried out is not necessary for a satisfactory assessment of Royal Mail's application.

### *Pricing between retail zones*

Even if it were appropriate to apply the statistical analysis supported by Postcomm as the basis for its case for discrimination, Royal Mail has some concerns about this. The analysis carried out by LECG comprises a multitude of statistical tests which do not seem to have a clear purpose or relevance and which are not applied in a consistent fashion. The analysis is flawed for a number of reasons.

Firstly, in carrying out its statistical tests LECG has failed to take into account key data. It is the unit cost attributable to each item of mail destined for each zone which is relevant for the purposes of establishing the cost figure that underpins the zonal prices. As shown in the Zonal Cost Template, there is a difference of [X] per item between the costs of zones A and B, corresponding to some [X%] of the price of a typical Mailsort 120 item. This cost difference justifies the price differences proposed for these zones of 2.9%.

Secondly, LECG has also concluded that the London zone (as defined in the RZA) could be split into two zones: namely 'London A' (i.e. those delivery offices in the London zone that would be allocated to zone A if the delivery point density rules were applied) and 'London R' (i.e. the rest of the London delivery offices).

Postcomm, or its consultant, has selected particular delivery offices to create this suggested hypothetical two London zone structure. It is possible to postulate any number of hypothetical zones based on cost differences within London, and indeed in the rest of the UK. This is a necessary concomitant of a zonal structure, and particularly one which is conceptually simple to understand and operate. As noted previously the 'optimum' structure of zones to fully reflect costs could involve different prices for every delivery point, which would clearly not be a practical proposition.

Thirdly, LECG has also concluded that "London A" and zone D do not have significantly different costs, and that as a consequence "London A" and zone D should be combined. It has reached this conclusion despite the fact that the average actual unit costs for

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31 Royal Mail's Retail Zonal Pricing Application : Postcomm's Proposals (Postcomm, August 2007) – para 5.39

32 "A Code of Practice Governing the Discharge of Postcomm's Functions", Postcomm, May 2002.

these zones are [X] and [X] respectively. In fact average unit costs for Postcomm's hypothetical 'London R' zone are closer to those of zone D.

Fourthly, in contrast to the London analysis noted above, LECG concludes that zones D and E<sup>33</sup> do have different costs (the average unit costs are [X] and [X] respectively) but that there is no requirement to price them differently. Postcomm's comment on this is instructive : *'...Postcomm is less concerned.....because there is less chance of a competitive affect from the merging of these two zones because there is no evidence that end-to-end competition is likely to develop in these places'*<sup>34</sup>. Royal Mail welcomes this acknowledgement that cost reflective pricing plays an important role in responding to competition. However, even whilst agreeing that Royal Mail's proposed zonal prices are more cost reflective than the current uniform prices Postcomm denies Royal Mail the opportunity to compete.

Finally, Royal Mail also notes that there is a further inconsistency in Postcomm's Proposals. Postcomm appears to conclude that its preferred zonal structure would have six zones ('London A', 'London R', AB, C, D, E), as opposed to the five proposed in the RZA. This contradicts Postcomm's implied preference elsewhere in its proposals for a smaller number of zones (two or three zones), by reference to the Swedish model.

#### Retail pricing versus access pricing

Royal Mail is not obliged to ensure that its retail and access pricing structures (and specifically zonal structures) replicate each other exactly. Postcomm itself acknowledges this fact in its Proposals.<sup>35</sup>

In spite of this Postcomm has not carried out any economic analysis to justify its conclusions that the differences proposed would amount to undue discrimination in a manner consistent with EC and UK competition law, nor has it produced any evidence of a possible adverse effect on competition.

Moreover, Royal Mail notes that there is no impediment to customers switching between its retail and access services in order to achieve the best price for them. Customers are also able to switch from Royal Mail to other postal services providers.<sup>36</sup>

Bulk mail services are viewed by customers as a commodity and procurement decisions are driven almost exclusively by price. Indeed the rapid growth in access (wholesale) volumes is proof that Royal Mail's competitors face a benign competitive environment in the UK, not least because of the headroom guaranteed to these competitors by Royal Mail's Licence. As a result, the growth in upstream competition has exploded since 2004 and is estimated to reach 4 billion items this year – some 60% higher than Postcomm forecast when it set the price control. This clearly demonstrates that bulk mail customers are able to switch volumes away from Royal Mail if they feel that Royal Mail's pricing is too high.

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33 Zones D and E were part of Royal Mail's July 2006 Application. They were merged to form zone D within the application being considered here. Zone E corresponded to a very low density of delivery points ("deep rural")

34 Para 7.26, Royal Mail's Retail Zonal Pricing Application: Postcomm's Proposals, August 2007)

35 Paragraph 7.35

36 Customers may get access services directly or possibly through consolidation arrangements.

In such circumstances it is difficult to see how any customer would be discriminated against.

In any event, Postcomm has failed to explain how (if at all) it has assessed whether Royal Mail's proposed approach would lead to a material difference between zones in the margins between access prices and retail prices. It has simply noted that the pricing structures are different without making any assessment of what these differences are, how they translate into margins or even whether the differences are material.

Postcomm has also failed to establish (or assess) whether these differences are such as to outweigh the increased alignment of Royal Mail's proposed retail prices to costs, compared with the current position.

Finally, Postcomm has failed to identify or quantify any anti-competitive effect which it believes the discrepancy between the different zonal structures would have.

In the absence of any evidence of undue discrimination, Royal Mail believes that Postcomm has no legal basis on which to reject the RZA and that there is no basis to reject the RZA by virtue of paragraph (e) of Condition 21(19).

### 3. Unreasonable Changes for Users

#### a. Summary of issues raised

The second reason Postcomm gives for proposing to reject the RZA is that it would result in unreasonable changes for customers and therefore fall foul of Condition 21(19)(c) in three respects: (i) the application does not mitigate the impact of the operational changes required, (ii) the proposed notice period is too short, and (iii) Royal Mail does not have an effective communication plan. Royal Mail contends that this position is unreasonable for the following reasons.

- For the vast majority of customers, no significant operational changes are required.
- The small number of customers who will have to adjust their operations considerably are those who use in-house developed sortation software or those that sort mail by machine.
- It is in any event disproportionate to link Royal Mail's development pace to that of customers that have chosen not to adopt future proof technologies. Such an approach would seriously and unnecessarily undermine Royal Mail's competitiveness and the development of the postal market<sup>37</sup>.
- Royal Mail believes that its proposal to give a total of nine months notice would be sufficient for customers to be aware of, and prepare, for the price changes.
- There is no formal requirement in its Licence to develop a comprehensive communication plan and for this reason Royal Mail did not include it in its application. Royal Mail is of the view that it was most appropriate to deliver a communications plan once the retail zonal proposal had been approved and was ready to be implemented. It is only for this reason that a communications plan was not included in the RZA. Royal Mail believes that past experience and, notably, its communication plan in relation to Pricing in Proportion demonstrate the effectiveness of this approach. We note however, that the existence (or lack) of a communication plan is unrelated to the question of whether the introduction of retail zonal pricing results in unreasonable changes for customers.

Nevertheless, Royal Mail acknowledges those concerns raised by stakeholders and is prepared to modify its proposals in order to meet and allay these concerns. These modifications are described below.

#### b. Operational requirements

The RZA affects only those customers producing large volumes of mail; it does not affect social customers or companies sending less than 4000 items per posting as this is the minimum volume requirement for bulk mail services. Mail production in this

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<sup>37</sup> We also note that Postcomm's distinction between operational changes required to implement zonal pricing and requirements for revenue protection is not relevant. Revenue protection is an intrinsic part of the delivery of a service and the operational changes required with zonal pricing are necessary to revenue protect.



context is properly regarded as an industrial process where the mass print, personalisation, and enveloping of mail is a complex and technology-driven process.

As a whole, the print industry is highly advanced and evolves rapidly, embracing change in a very competitive environment. However there are a few producers of mail who have chosen not to adopt future-proof technology, and as a result are unable to sort mail by zone using their existing system. This maybe the case where a Mailsort customer has loaded selection codes (in hard code format) onto its mainframe computer, rather than using proprietary or off-the-shelf software.

Royal Mail believes that it is unreasonable for it to be prevented from evolving its presentation specifications in circumstances where the vast majority of its customers would have no problem meeting them and would suffer no on-going cost increase. Royal Mail cannot operate effectively in the market place if it is always constrained by customers that choose not to adopt future proof technology. Such an approach would hamstring Royal Mail's ability to modernise its services. Nor are Royal Mail's competitors so impeded.

However, as stated above, Royal Mail acknowledges the concerns expressed by a small number of stakeholders. It therefore proposes to amend its mailing presentation standards under the RZA in such a way that will allow it to confirm the price of the service it is providing, while allowing customers greater flexibility.

Selection Code and Zone indicator: the RZA specified that this text should appear on each item and be printed within the address window. While it is still essential that this text be printed on each item, Royal Mail is prepared to modify its approach to allow the text to be printed anywhere on the front of the item, so long as it is visible, avoids clear zones and is positioned identically on all items throughout each print run. This change to the zonal requirements will not make any difference to the vast majority of customers who sort mail by software as they print the zonal indicator on the enclosed mail item. However, it will make a difference to customers who sort by machine. These customers will be able to print the zone code on the outer envelope in the first pass if they use the option of not zonally sequencing their mail as per the paragraph below.

Bag Numbers and Zone Sequence: the RZA specified that mailers quote the exact number of bags of mail per selection code that were being presented to Royal Mail, and that within each selection code the mail be presented in zone sequence. These requirements represent a concern to a small number of customers, principally because of software coding issues. These concerns are summarised in Table 1 below.

**Table 1 – Operational impact of zonal pricing requirements by customer segment**

| Sortation method   | Customer type  | Impact of zonal pricing                                    |
|--|--|--|
| Customers using off-the-shelf software to sort mail      | Vast majority of customers posting machineable items   | Zonal pricing does not create any operational difficulties |
| Customers using in-house developed software to sort mail | Minority of customers who make software choices that are not principally economically driven (e.g. for security reasons) | Zonal pricing creates additional cost and complexity       |

| Sortation method                  | Customer type  | Impact of zonal pricing   |
|-----------------------------------|--|---|
| Customers sorting mail by machine | Consolidators or major customers who use in-house solutions to address business process issues.        | Zonal pricing creates additional cost for the extra pass(es) and complexity   |
| Customers sorting manually        | Customers posting non-machineable items. (These customers typically use Mailsort 3 1400 packet format) | Zonal pricing will create additional complexity. Royal Mail offers alternative services which these customers can use. Most notably Packetpost and Royal Mail Tracked. Royal Mail recognises that these services may not be as cost effective as residue sort on Mailsort 3 1400. |

In order to address the concerns of customers who either sort mail manually or who use incompatible IT systems, Royal Mail proposes to amend its proposal by offering customers two alternatives:

- Royal Mail will accept a mailing where the mail within a selection code is properly zone-sequenced and the bags quoted per selection code are best estimates.
- Royal Mail will accept a mailing where the mail within a selection code is not zone-sequenced and the number of bags quoted per selection code are within a tolerance level of 5%. Under this option there would be an additional fee payable of 0.23p per item and all bags for any selection code would have to be presented in the same Rigid Stackable Container (RSC) or bundled on the same pallet.

These proposed changes would resolve substantially all the customer concerns expressed, while at the same time maintaining the operational and cost-reflectivity advantages of the RZA as a whole. Table 2 shows the impact of these changes.

**Table 2 – Operational impact of zonal pricing following revised proposals**

| Sortation method   | Impact of zonal pricing  |
|--|--|
| Customers using off the shelf software to sort mail      | No issues with zonal pricing   |
| Customers using in-house developed software to sort mail | Customers will continue to have a problem producing the zonal indicator, but other major issues resolved |
| Customers sorting mail by machine                        | All major operational problems should be resolved  |
| Customers sorting manually                               | All major operational problems should be resolved  |

Postcomm's proposal that Royal Mail develops a mitigation scheme for the customers facing the issues highlighted above is unreasonable. The customers for whom the changes will be difficult are a minority who have chosen to deploy certain internal

processes even though they may not be future proof because these suit them commercially in some way.

Royal Mail also notes that customers were entitled to a mitigation scheme under PiP if the annual postage bill increased by more than 50% as a direct result of the PiP changes. Given the price changes proposed with zonal pricing it is highly unlikely that any customer would qualify for mitigation if a similar scheme were deployed with zonal pricing.

Royal Mail submits that there is no need for a mitigation scheme in light of the changes proposed. In any event Royal Mail disagrees that absent any changes, a mitigation scheme is necessary or appropriate for the retail zonal application to meet the requirements of the Licence.

Royal Mail urges Postcomm to reconsider its position regarding the mitigation scheme in light of the changes proposed and to more carefully consider the type and number of customers that may have issues in deploying zonal pricing.

**c. Notice period**

Royal Mail has proposed that zonal pricing be introduced in April 2008 to be formally communicated in December 2007, and geographically uniform prices be withdrawn in October 2008. This proposal would give customers nine months during which to make the transition. Royal Mail believes that this period would be sufficient for all customers, without placing any unreasonable demands on its customers' businesses.

However, Royal Mail acknowledges the feedback given by some stakeholders and, as a result, proposes to increase the notice period.

Royal Mail proposes to retain the six month transition period during which uniform and zonal price structures would operate in parallel, recognising that customers have their own scheduled dates for their IT changes. However, it will extend the notice period prior to the commencement of the transition period from three months to six months, thus giving customers a full 12 months' notice of the withdrawal of geographically uniform prices.

**d. Communication plan**

Royal Mail believes that the experience of the introduction of Pricing in Proportion demonstrates its effectiveness at communicating price changes to customers. It is therefore disappointed that Postcomm has not taken into account Royal Mail's experience and past success in this area.

In fact, despite many similarities with Pricing in Proportion, the RZA is different (and less demanding) in three important respects. Firstly, the RZA is limited to bulk mail services, and will thus affect only around 7,000 accounts, not all postal users. Thus even if the impact of zonal pricing will be for customers using bulk mail services "as big as PiP", zonal pricing will affect a minority of customers. Secondly, the price changes brought about by the RZA are much smaller than those introduced by Pricing in Proportion. Thirdly, for many mailers the concept of zonal pricing is now familiar. As well as it being applied by Royal Mail Wholesale in the form of zonal access prices,

Royal Mail's retail business already deploys destination-distinct pricing with Presstream Profile, Royal Mail Tracked and International Profile pricing.

As stated above, Royal Mail proposes to mitigate the impact on customers by introducing retail zonal pricing over a transition period. This will be supported by a communication plan that would be based on the following key principles:

- Frequent communication with customers mainly by direct mail and email. This is a proven formula which creates awareness and will be timed to give customers sufficient notice to implement changes.
- Facility for hand-raisers to opt into additional communications such as "e-updates". Royal Mail has already developed an area for its website which includes updates and tool kits to assist customers in planning for the transition, including a "zonal analyser".
- A focus on key audiences, who include trade bodies, advertisers, agencies, mailing agents and bulk mail business customers and implementers.
- The communication on zonal pricing would also form part of Royal Mail's integrated marketing communication plan which includes information cascades into OBA (online business account), field sales support and telesales support.
- Royal Mail also intends to include details of zonal pricing in its annual tariff literature and cascade (dependent on the respective timing of the two).

Thus the RZA pays particular attention to the need for a smooth and gradual introduction of retail zonal prices for bulk mail customers, and ensuring that all customers affected are made aware of the changes.

In conclusion, Royal Mail firmly believes that there are no grounds for Postcomm to reject the RZA under Condition 21(19). However, without prejudice to its position in relation to the other issues raised in this document, Royal Mail is prepared to take these further mitigation measures on the basis that Postcomm otherwise accepts the RZA.

For the reasons set out above, Royal Mail believes that Postcomm has no grounds for rejecting the RZA on the basis of paragraphs (c) or (e) of Condition 21(19). Postcomm states that it is satisfied that the remaining criteria in this condition have been met. Royal Mail therefore believes that Postcomm should accept the RZA (as amended above) when it reaches its final decision.

For completeness, Royal Mail has set out in the remaining sections of this document its response to the other comments made by Postcomm, even though Postcomm is not minded to (nor, in Royal Mail's view, would it have grounds to) reject the RZA on the basis of these issues.

#### 4. Balancing cost reflectivity with operational simplicity

Royal Mail welcomes Postcomm's conclusion in its published Proposals that the RZA satisfies the criterion in Condition 21(19)(b), i.e. that under the proposal pricing would be more cost-reflective than is currently the case.

Indeed, Royal Mail would have been surprised if Postcomm had reached a different conclusion. Postcomm's duty under Condition 21(19) is to examine the application put to it by Royal Mail and conclude whether that proposal is more cost-reflective than the present pricing structure. Royal Mail's current retail pricing is geographically uniform, i.e. the same price is charged for the delivery of mail items regardless of their destination. This model cannot reflect, in any way, the significant differences in delivery costs between different areas.

##### a. How the zonal pricing structure was established

Royal Mail has worked hard to balance the competing demands of a pricing proposal which is more reflective of cost differences across the UK, while at the same time ensuring that its proposal is user-friendly and not overly complex. To establish the pricing structure, Royal Mail identified the cost drivers that could influence geographical variations in cost; identified proxy variables for these cost drivers that are measurable and transparent; analyzed these variables to identify "break-points" to define zones; and mapped all postcode sectors onto one of these zones. The result of this analysis was three "breakpoints" for defining zones. These breakpoints were at business density equal to 10%, and delivery point density (delivery points per kilometre squared) equal to 10 and 100. This justified 4 zones. Greater London was then added as a result of discussions with Postcomm, as it became clear that cost differences in London (due principally to higher wage rates) justify a separate zone that can improve the cost reflectivity of the proposed prices. The resulting division of zones broadly reflects differences in costs across the country without unfair cliff-edges in pricing or costs.

In carrying out this exercise, Royal Mail recognised that no pricing model short of individual end-user pricing will ever be 100% cost-reflective and that, inevitably, any system based on zones will result in each zone encompassing a range of delivery costs.

As Postcomm has shown, international experience is very limited in this area. The only other country which has adopted a zonal pricing structure based on delivery costs is Sweden. However, there are significant differences between Sweden and the UK, notably in terms of size, population and its distribution<sup>38</sup>. The other international examples cited by Postcomm are of distance-based, rather than zonal, pricing structures and are therefore not direct comparators.

Royal Mail is also aware that, within the constraints of ensuring greater cost-reflectivity, there has been some representation (most notably from Postwatch) for a pricing structure based on fewer zones. Such a pricing structure may be simpler to understand, but reducing the number of zones further would be in the vast majority of cases no simpler or cheaper for customers to deploy. With the exception of manual

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<sup>38</sup> Sweden's population is just 17% of the UK population and 84% of Sweden's population lives in less than 2% of its land area.

sortation, the change from a uniform pricing structure to a geographic one will require the same operational changes regardless of the number of zones.

Royal Mail's proposed zonal pricing structure is a compromise of different requirements: the requirement to improve cost reflectivity, the requirement to develop a pricing structure that is transparent, the requirement for a pricing structure that is easy to understand and the requirement for a pricing structure that can be deployed.

#### **b. Postcomm's assessment of alternative pricing structures**

Royal Mail is concerned that Postcomm and its consultants, LECG, have sought to critique Royal Mail's proposed zonal structure and compare it with a number of hypothetical alternative structures.

Postcomm's function in assessing the RZA is to determine whether that proposal satisfies the criteria set out in Condition 21(19), not to contemplate hypothetical alternatives. This is acknowledged in the LECG report:

*"Postcomm informed us that its role and power under the licence is simply to determine – among other things – whether this specific zonal pricing proposal by Royal Mail is more cost reflective than the existing uniform pricing and not to propose alternative models."<sup>39</sup>*

Notwithstanding this guidance, LECG did not simply carry out an analysis of the proposal put to it. It did in fact propose, and Postcomm has sought to analyse, alternative models, referring to the cost-reflectivity of alternative zonal structures, although without presenting any meaningful measure of cost reflectivity of zonal structures.

In doing so, Postcomm has not sought to identify how these structures have been grounded on any shortcomings in Royal Mail's proposal. Indeed, Postcomm is satisfied that Royal Mail's proposal is cost-reflective as required by the Licence.

Moreover, in carrying out this alternative modelling, Postcomm and LECG have effectively ignored empirical evidence in favour of statistical theory. In the summary of its findings LECG states<sup>40</sup>:

*"Whether one wants to rely on statistical results or factual figures in defining the optimal zonal classification is a matter of policy."*

This is a surprising statement for three reasons. Firstly, LECG's approach relies (by its nature) on forecast or estimated figures, to the exclusion of the unit cost figures Royal Mail provided for each delivery office. This is despite Postcomm's confirmation in its Proposals that the figures provided by Royal Mail were in fact adequate.<sup>41</sup> There is therefore no obvious reason why this data should have been ignored in the analysis.

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<sup>39</sup> Retail Zonal Pricing Review : Analysis of Zonal Costs (LECG, 4 July 2007) – paragraph 1.9

<sup>40</sup> Paragraph 1.31

<sup>41</sup> Postcomm's Proposals, paragraph 5.39

Secondly, such an approach runs counter to Postcomm's stated policy in its Code of Practice<sup>42</sup> (mentioned above). One of the aims of the Code is to provide overarching principles to which Postcomm will adhere in order to provide greater regulatory certainty about how it will execute its duties. One of these principles is that Postcomm should "*seek to establish a firm factual basis for its decisions and advice*". In its explanatory notes on this principle Postcomm states:

*"There is likely to be uncertainty on occasions as to the effects of adopting a policy or taking a decision especially where this involves future changes. The firmest possible factual basis in such circumstances may involve estimation on the basis of economic theory, rather than measurable fact. Whilst absence of measurable fact means that it may be difficult to justify the adoption of a new policy simply as the basis of evidence alone, it also makes it difficult to justify the continuation of an existing policy. Postcomm therefore will not necessarily see an absence of measurable fact as a reason for not proceeding with a policy; however it generally will be reason for caution. This need for caution is a reason for Postcomm extending the scope of consultation to the consideration of experience from overseas and in other regulated sectors; it is also a potential justification for policy trials and for the use of sound statistical sampling methodologies in the collection and evaluation of information."*

In the present case Postcomm has overlooked available measurable fact in favour of LECG's modelled results. In keeping with its own Code of Practice Postcomm's conclusion should instead be based on the data provided.

Thirdly, despite Postcomm's apparent reluctance to base its conclusion on the factual data supplied by Royal Mail, it has however been prepared to use this data as the basis of the cost adjustments made within the Cost Reflectivity calculation (which it was able to conclude satisfies the cost reflectivity requirements of Licence Condition 21(19)).

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<sup>42</sup> "A Code of Practice Governing the Discharge of Postcomm's Functions", Postcomm, May 2002. See Explanatory Notes, paragraph 27.

## 5. Revenue Neutrality

### a. Issues raised

Royal Mail welcomes Postcomm's and Frontier's assessment that the RZA is revenue-neutral (and therefore satisfies Condition 21(19)(a) of its Licence).

However, and for the record, Royal Mail notes below its comments on Postcomm's views regarding the appropriate treatment of the transition period and on the inclusion of market share effects in its revenue neutrality model.

The modelling work carried out by Royal Mail to ascertain the revenue neutrality of the proposal drew extensively from its experience of the introduction of Pricing in Proportion, and is based on three established principles:

- The new price structure must be revenue-neutral in the year of deployment and, thus its modelling be based on volumes and distributions of the year of implementation. The RZA pricing model is based on 2007/08 volume forecasts and forecasts of how those volumes would be distributed between services in 2007/08 together with prices at 2007/08 levels
- A new price structure must be revenue-neutral given the change in the mix of mail volumes between Royal Mail services that the new pricing might cause.
- Royal Mail's revenue-neutrality calculations are based on a series of assumptions, notably: forecast volumes in the year of deployment; and the mix of volumes between services. Royal Mail has sought to be evidence based in setting these assumptions and Postcomm recognises this. However, there is a residual risk that the outturn differs from the forecast, and could in theory lead to an over-recovery by Royal Mail. In this scenario, Postcomm would be able to determine whether a new pricing structure enabled Royal Mail to earn higher revenue than that allowed by its Licence, for which a penalty is applied through the price control (as being the primary mechanism for such an adjustment).

Royal Mail therefore believes that it is in the interests of regulatory certainty for Postcomm to adhere in the present case to the principles it has established.

### b. Transitional period

Given the revenue neutrality test is for the year of implementation only it would naturally be expected to be consistent with the conditions applicable in that year. The Licence makes no mention of transition periods and Postcomm's assertion that the revenue neutrality should be assessed when the change has occurred and in a steady state has not been justified to Royal Mail.

Royal Mail believes that inclusion of the transition period in the revenue neutrality test should be allowed for two reasons:

- The Price Control remains the main mechanism through which Postcomm controls the revenue Royal Mail is allowed to earn. These requirements are



determined in the Licence and consequently it is neither necessary nor proportionate for Postcomm to intervene further since revenue is already controlled.

- Postcomm's suggested approach (of not including the transition period) would be revenue diluting and therefore if Postcomm were to enforce this position it would remove any incentive to offer the transition period, and indeed would penalise Royal Mail if it were to continue to offer it.<sup>43</sup>

Royal Mail continues to believe that the transitional period should properly be included in its revenue neutrality calculations. This is because to exclude this period would depend on estimating volumes further into the future, when they are less predictable. However, Royal Mail welcomes Postcomm's conclusion that the impact of the transition period on revenue neutrality is small relative to overall revenues and therefore this issue does not negate the conclusion of overall revenue neutrality.

### c. Inclusion of market share effect

As stated above, Postcomm' recognises that the debate regarding the inclusion of a market share effect in the modelling does not affect the assessment that Royal Mail's proposed pricing structure is revenue neutral.

Postcomm has suggested that Royal Mail could "improve" its modelling by including the effect of market share. Royal Mail believes that this approach would be unreasonable. There are three reasons why the revenue neutrality test cannot include a market share effect:

- The Price Control remains the main mechanism through which Postcomm controls the revenue that Royal Mail is allowed to earn. The Licence states "*The Licensee shall take all reasonable steps to ensure that in each Formula Year... " the forecast revenue does not exceed allowed revenue. It is not necessary or proportionate for the regulator to intervene further than is already in the Licence.*
- The calculation of revenue-neutral pricing depends on volume forecasts. Market share estimates (i.e. volume forecasts) in turn depend on pricing assumptions. Thus Postcomm's suggestion would require several iterations of price and volume effects and this would entail a considerable additional level of complexity in the modelling.
- Improving cost-reflectivity is a key requirement for Royal Mail to compete in a liberalised market. Postcomm itself recognises this fact in its Proposals and welcomes this move. In short, it will allow Royal Mail to charge prices more reflective of its costs and compete on the merits of its prices and quality of service. Condition 21(19)(a) is intended to ensure that in doing so, Royal Mail does not increase prices above the overall price constraint even though it can

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<sup>43</sup> The provision of a 6 month transition recognises that there are three main changes customers will need to develop, a software change, a print change and a requirement for some customers to adopt our electronic transaction interface (E-pro / OBA) and leave paper based transaction recording behind. In setting the six month transition period we reviewed customers' experience in upgrading from the 2003 Mailsort database to the 2005 Mailsort database and the change to PPI indicia.

redistribute its revenue. By suggesting that any consequential changes in Royal Mail's market share be included in its revenue neutrality calculation, Postcomm undermines the basis for introducing a more cost reflective price structure (i.e. Royal Mail would be penalised for becoming more competitive).

For completeness, Royal Mail also notes that a change in the methodology used to calculate revenue neutrality to factor in potential changes in market share would have represented a significant departure from, and be inconsistent with, Postcomm's past practice. For example, Postcomm's approach to PiP excluded consideration of products outside of those within the application when assessing revenue neutrality while Postcomm proposes that they are included for its assessment of the RZA.

Nevertheless Royal Mail is pleased that Postcomm is able to conclude that the RZA would be revenue-neutral to within a small margin or error inherent in such calculations (based as they are on a number of assumptions).

However, Royal Mail urges Postcomm to review the suggestions that the transition period should be excluded from this modelling and that estimated market share effects should be included. To do so would not only undermine the modelling itself, but would also undermine the regulatory certainty previously established by Postcomm in relation to the testing of revenue-neutrality. This lack of regulatory consistency would send a negative message to the market about the regulatory regime in which all of Postcomm's stakeholders are expected to conduct business.

## **6. Presstream**

The issues surrounding Presstream Profile and Presstream Premium are different. We address each in turn.

### **a. Presstream Profile**

Royal Mail's retail zonal pricing application concerns the replacement of two price structures. The geographically uniform tariff applicable to the majority of products and the geographic pricing structure that currently applies to Presstream Profile contracts.

In its terms of reference to its consultants Postcomm does not ask for any analysis of the alteration to these price structures, nor its effect on the market. Nor has Postcomm produced any evidence on which to base a conclusion to reject the RZA as it relates to Presstream Profile contracts.

### **b. Presstream Premium**

Postcomm proposes to reject Royal Mail's proposal to remove Presstream Premium as a standard product. Royal Mail is surprised by this conclusion.

The service currently provided allows customers to access to a number of Mail Centres with mail for delivery within the boundaries of the mail centre that morning. Royal Mail currently has only one customer for this service and the service has not attracted sufficient interest from other customers to continue to offer it as a standard product. Royal Mail therefore proposes to withdraw the product in its current form to new customers. Royal Mail will continue to provide the service to its existing customer and will make it available on a bespoke basis to others

Royal Mail believes that there is no rational justification for Postcomm to reject this element of the RZA.

## 7. Other issues raised by Postcomm

Royal Mail is disappointed to note that after over a year and a half of investigation, two consultations, two customer forums, a customer survey, much expert consultancy and many meetings with operators and associations, Postcomm is unable to conclude on some of the critical issues regarding zonal pricing. Not only is Postcomm unable to reach a conclusion, but it is also not able to suggest what analysis or evidence it would need to reach a conclusion. Postcomm's assessment of the likely effect on the development of a competitive market is an example of this. In the rest of this section we discuss these issues in turn.

### a. Impact of zonal pricing on Royal Mail's financial situation

In paragraph 9.16 of the Proposals Postcomm states that:

*"whilst Royal Mail indicated that retail zonal pricing is critical to its financial stability, it has submitted very limited evidence to support this view".*

In fact Royal Mail has provided both contribution data and supporting financial modelling. At paragraph 9.7 Postcomm itself notes that Royal Mail has shown how zonal pricing *"would lead to an increase in contribution towards its fixed costs of £25m per annum"*. Specifically, this additional contribution can be compared with Royal Mail's reported loss of £12m on the price controlled area for 2006/07.<sup>44</sup>

Postcomm does not provide any guidance on what further evidence it would need in addition to the contribution data and supporting financial modelling already provided nor, more importantly, does Postcomm state what level of improvement in contribution it would consider as being critical to financial stability.

Moreover, while Royal Mail believes that zonal pricing is critical to its financial stability, it is part of a wider range of revenue-led initiatives currently being proposed. What is critical is Royal Mail's ability to innovate and rebalance its prices (to be more closely aligned with its costs). Zonal pricing is therefore one of the most important initiatives in this respect, but not the only one.

### b. Competition assessment

Royal Mail finds it difficult to understand how, after reviewing Royal Mail's extensive modelling of zonal pricing and commissioning its own analysis to assess the market and competitive impact of zonal pricing, Postcomm remains unable to reach a decision on whether or not zonal pricing will have an appreciable effect on the development of competition. Postcomm's rather opaque conclusion on the competition assessment stated in paragraph 9.23 is:

*"For the purpose of Postcomm's proposed decision to reject Royal Mail's application we presently see no compelling evidence to suggest that competition reasons would warrant Postcomm's approval of an application which appears clearly to fail the licence tests."*

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<sup>44</sup> Regulatory Financial Statements 2006-07, Royal Mail Group, 31 July 2007

As stated in section 1 of this document, Postcomm's primary duty is to assess the RZA against the criteria in Condition 21(19). Subject to consistency with its statutory duties and the Directive, it should not introduce extraneous criteria into this exercise.

However, Royal Mail is nevertheless concerned by this apparent lack of conclusion on the positive effects on competition. First, Postcomm states in Appendix 3 para A.3.11:

*"Royal Mail's forecasts are broadly consistent with the forecasts produced by Frontier which state that with Royal Mail's initial retail zonal prices there would be a limited impact on bypass volumes".*

But Postcomm goes on to say:

*"However, Postcomm thinks that Royal Mail's projections of their future mail volumes overestimate the likely growth in end-to-end competition, which is the key threat that its application is meant to address".*

What is unclear from these statements is the basis on which Postcomm has been able to reach a different conclusion from those of Frontier, nor, if Postcomm was not convinced by this analysis, why it did not instruct Frontier prepare forecasts based on its assumptions?

Postcomm concludes at paragraph A.3.15:

*"However, the extent of any offsetting impacts is almost impossible to predict".*

Postcomm appears to be saying that it is simply unable to carry out a competition assessment. Royal Mail believes that a proper competition assessment is perhaps the single most important aspect in analysing this and other pricing applications. Postcomm's refusal to reach a conclusion on this issue will have a chilling effect on the development of a fully competitive market.

### **c. Relevance of zonal pricing to protecting the USO and impact on rural areas**

It is apparent from Postcomm's Proposal that some stakeholders fear that the introduction of retail zonal pricing will compromise the provision of services to rural areas. Their fear is that higher prices for rural destinations would result in much lower volumes of mail for delivery in those places, and hence increased unit costs, resulting in a vicious circle of increasing costs and prices. We believe that these concerns are misplaced. Royal Mail believes that the RZA does not pose a threat to rural services for a number of reasons:

- Zonal pricing is limited to non-USO bulk mail services; universal services such as stamped and meter and USO bulk mail services mail are not affected.
- It is the mailer who pays the postage, not the recipient, so fears that individuals living in remote areas will have to pay more to post mail are unfounded.
- Rural customers are often very valuable to direct mailers and a modest price increase will not change this.

- The impact of Retail Zonal prices on volumes will be limited. For example, Royal Mail estimates that the volumes delivered by Royal Mail in zone D (the most rural zone) will fall by less than 2% relative to the forecast with the current uniform prices. It is difficult to see how this could threaten the survival of rural services.

Royal Mail's ability to fund the USO would be improved because the financial contribution which would be made through the deployment of zonal pricing would allow Royal Mail to compete on a more level playing field by offering products and services outside of the USO which are more cost-reflective.

Zonal pricing is a market-oriented innovation to pricing products. This seeks to make Royal Mail's products and services more attractive to business customers and ultimately allow Royal Mail to target its investment in infrastructure in such a way as to allow the more efficient provision of services outside the USO (both now and prospectively in the future).

It is critical to Royal Mail, as the universal services provider, that it is able to respond fairly and flexibly to competition in the non-USO service as a safeguard to its ability to finance its Licensed activities and further the provision of the USO services. This is consistent with the objectives of the Directive.

#### d. Changes to the price control

Postcomm raises two issues regarding the changes to the price control following the introduction of zonal pricing: setting the rebalancing criteria and calculating the access headroom. The fact that the Licence currently does not deal adequately with the impact of zonal pricing on the price control is not and should not be a valid reason for rejecting Royal Mail's application. Nevertheless, Royal Mail accepts that these issues do need to be addressed. Royal Mail tabled these issues as items for discussion with Postcomm but they were deferred by Postcomm. Royal Mail summarises its proposals below.

##### Setting the rebalancing criteria

The approach to forming the representative price has precedent within the operation of the Licence, both in terms of the introduction of channel pricing and Pricing in Proportion. Royal Mail believes the same approach should be applied for Retail Zonal prices and this is summarised below.

The representative price ( $P_R$ ) is calculated as  $P_R = \text{Sum of revenue} / \text{Sum of volume}$ . The sum of volume and revenue are derived in the following way:

|            |   |       |   |                |
|------------|---|-------|---|----------------|
| $V_U$      | X | $P_U$ | = | $R_U$          |
| $V_L$      | X | $P_L$ | = | $R_L$          |
| $V_A$      | X | $P_A$ | = | $R_A$          |
| $V_B$      | X | $P_B$ | = | $R_B$          |
| $V_C$      | X | $P_C$ | = | $R_C$          |
| $V_D$      | X | $P_D$ | = | $R_D$          |
| Sum Volume |   |       |   | Sum of revenue |

(where  $V_i$ ,  $P_i$  and  $R_i$  are the volume, price and revenue in zone  $i$  (with 'u' referring to the uniform price)). The volumes  $V$  are derived as per the Licence by reference to the relevant revenues and published prices.

#### Determination of access headroom

Notwithstanding Royal Mail's reservation on the access headroom as expressed in the access headroom application (March 2007) and its response to the Interim Review (October 2007), Royal Mail believes that there are two ways to apply the access headroom following the introduction of Retail Zonal pricing. In essence, there is a requirement to identify the relevant Access Reference Price to which to apply the given level of headroom. If the current level of access headroom was applied to a zone A Access Reference Price, the consequence of Retail Zonal would be to reduce the access price and further distort the market. Hence the Access Reference Price needs to be defined more appropriately than by reference to the zone with the lowest price. One way to proceed would be to assume a set of pre-determined weightings of the prices to form a single reference price. An alternative would be to use a weighted average of the five zonal prices using actual volumes. As Postcomm mentions in its Proposals, Royal Mail recommends using the latter approach which is consistent with the approach to forming the representative price as discussed above.

#### e. Use of Geoplan

Royal Mail has the following concerns regarding Postcomm's comments on the use of Geoplan:

- Royal Mail uses Geoplan as an "off-the-shelf" product, without modification. Geoplan is a commercially available spatial data product provided by an independent manufacturer which may be purchased by anyone. Many of Royal Mail's customers use this product for a variety of business purposes without any concerns of the type suggested by Postcomm: i.e. that there might be a risk of individual postcode sectors being allocated to the "wrong" zone.
- Postcomm's conclusions that the use of Geoplan is "*not perfect but neither are the options*" and that Royal Mail should "*consider how best to address it*" are unhelpful. Royal Mail believes that it is entirely sensible to adopt what it believes to be the most widely used software product, and that this approach is supported by the majority of its customers. Moreover, as stated below, Royal Mail has taken steps to address any potential errors.
- Postcomm paints only a partial picture of Royal Mail's proposal with respect to Geoplan. This is particularly disappointing since Royal Mail has discussed with Postcomm how any specific customer concerns will be addressed. Should a customer wish to query the allocation of a postcode sector, they can contact their account manager or Customer Services if they do not have an account manager. Royal Mail will then investigate and seek to resolve each query. However, Royal Mail does not anticipate this to be a significant concern. By way of illustration, none of Royal Mail's Wholesale customers on zonal contracts or the customers they represent have raised any issues regarding the allocation of postcode sectors to zones. Postcomm has not responded to Royal Mail's proposal.

Royal Mail remains of the view that the Geoplan software is the most widely used in the market. This reflects the fact that customers are familiar and comfortable with its methodology. Royal Mail also notes that it proposes to use Geoplan consistently for all zonal pricing decisions.

**f. Residue pricing**

Postcomm's comments on residue items (para 6.13) is misleading. Residue items are charged a discount or a surcharge depending on the zone they are delivered to, just as direct items. The majority of items falling into a residue selection do so because there is insufficient volume to form a direct selection. Only those residue items that have not been postcoded and therefore cannot be assigned to a zone will be charged at the highest zonal price.



## 8. Summary and Conclusions on Postcomm's Grounds for Rejecting the RZA

This document sets out Royal Mail's response to Postcomm's Consultation and Proposals on Royal Mail's application to introduce a zonal pricing structure for certain of its retail bulk mail services. All of the relevant services fall outside Royal Mail's universal service obligation.

Royal Mail believes that the introduction of zonal pricing is critical to its move towards more cost-reflective pricing. This in turn is a necessary step in its drive towards greater efficiency and flexibility to respond to an open and competitive market.<sup>45</sup> Zonal Pricing will also benefit customers, who will reap the rewards both of increased competition and reduced cross-subsidisation between the services they buy. Postcomm recognises these benefits and states that it "*is generally supportive of pricing structures that are more reflective of costs*".<sup>46</sup>

In general, densely populated areas have lower delivery costs per unit than less densely populated areas. Thus a system of geographically uniform prices results in wide variations between cost and price in different locations. These differences can be recognised in the prices charged to customers by Royal Mail's competitors, who are not constrained by geographically uniform pricing. They are able to target deliveries to areas with a high density of delivery points, ignoring high cost deliveries to low areas.

This results in a unique impediment on Royal Mail, which impacts on the financing of Royal Mail Group. Postcomm accepts that the introduction of zonal pricing would lead to an increased contribution towards Royal Mail's fixed costs of £25m per year. This compares with Royal Mail's reported loss of £12m on the price controlled area for 2006/07.<sup>47</sup> The benefits of zonal pricing are therefore clear and Postcomm has an opportunity to allow Royal Mail Group to improve its financial position. This is consistent with its statutory duty to have regard to the need to ensure that licence holders are able to finance their licensed activities.

In Royal Mail's view, all of the relevant Licence criteria set out in Condition 21(19) are satisfied by its proposal. In spite of this, Postcomm is proposing to reach a decision to reject Royal Mail's application. As set out in detail in this response, Royal Mail believes that the grounds on which Postcomm is proposing to reach this decision are flawed.

### Postcomm's grounds for rejecting the proposal

Royal Mail's Licence allows it to apply to Postcomm with a proposal to price its non-USO retail services on a basis which is not geographically uniform. The relevant test for assessing Royal Mail's application is set out in Condition 21(19). This states that Royal Mail is permitted to introduce more cost-reflective pricing (in place of its current geographically uniform pricing), but that Postcomm may reject Royal Mail's application if it not satisfied that the five criteria set out in that Condition are met.

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<sup>45</sup> It is estimated that upstream mail volumes handled by Royal Mail's competitors will reach 4 billion items in 2007, some 60% higher than Postcomm's forecast.

<sup>46</sup> Paragraph S.11 of Postcomm's Consultation and Proposals.

<sup>47</sup> Regulatory Financial Statements 2006-07, Royal Mail Group, 31 July 2007

In its published Proposals, Postcomm concludes that Royal Mail's application fails to satisfy two of these criteria, but that the remaining three are satisfied. The two in question are:

- (i) whether the changes would lead to a failure to provide services priced in a manner referred to in the Postal Services Directive (paragraph e of Condition 21(19)); and
- (ii) whether the changes would not be introduced in a manner that avoids unreasonable changes for users of the service (paragraph c).

As Royal Mail demonstrates in this response, none of the reasons given by Postcomm for reaching these conclusions are justified. Nevertheless, recognising these issues, Royal Mail now proposes to make some modifications to the operational requirements of its application, also set out below, to address two of Postcomm's particular concerns in relation to paragraph (c).

#### Paragraph (e) - Discrimination Issues

Postcomm's principal reason for proposing to reject Royal Mail's application is on the grounds that Retail Zonal Pricing would result in Royal Mail failing to provide services in a manner referred to in the Postal Services Directive. In particular, Postcomm states that Retail Zonal Pricing would result in undue discrimination and therefore fall foul of Article 12 of the Directive.

In fact this conclusion cannot be supported, for two reasons. First, Article 12 of the Directive clearly, and expressly, applies only to universal services. As stated above, all of the bulk mail services affected by Royal Mail's proposal fall outside its universal service obligation. Postcomm is therefore misapplying this provision and seeking to import an additional criterion into Condition 21(19).

Secondly, there is no evidence that Royal Mail's pricing would be discriminatory (nor would it be). Postcomm has carried out no legal or economic assessment of whether undue discrimination would result, nor has it produced any evidence of a potential anticompetitive effect. Its approach is therefore inconsistent with the principles of EU and UK competition law.

Instead Postcomm has merely asserted discrimination on the basis that:

- (i) in one scenario (posting into London) a retail customer could be charged a different price from a wholesale customer, **despite** the differences between these two types of service and the ability of customers to switch between the two (Postcomm itself acknowledges that Royal Mail is under no obligation to implement parallel zonal structures for its retail and wholesale zonal structures<sup>48</sup>);
- (ii) in Postcomm's view the proposed London zone could be sub-divided into two zones, **despite** evidence supplied by Royal Mail demonstrating the commonality of costs; and

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<sup>48</sup> Paragraph 7.35

- (iii) Royal Mail's proposed prices for zones A and B are different without cost-justification, despite evidence supplied by Royal Mail demonstrating the difference between its costs for these two zones.

It should be noted that the differences between cost and price across different zones identified by Postcomm are insignificant compared with the differences which exist in the current position. Under geographically uniform pricing customers are charged the same price for each mail item regardless of its destination and therefore its underlying costs. Under zonal pricing, the price per item is more closely aligned with the costs incurred by Royal Mail of delivering that item. It is therefore difficult to understand why Postcomm is seeking to block Royal Mail's proposal to move away from geographically uniform pricing to more cost-reflective zonal pricing.

Given the evidence supplied by Royal Mail justifying its proposed pricing structure and Postcomm's failure to produce any evidence or analysis of how it would result in undue discrimination (beyond bald assertions), there can be no grounds for rejecting Royal Mail's proposal on the basis of paragraph (e).

#### Paragraph (c) - Introduction of the Changes

Postcomm's second reason for rejecting the application concerns whether the introduction of the proposed pricing would lead to unreasonable changes for users. It has identified three specific concerns in this area.

First, it has stated that Royal Mail would not have a sufficient mitigation scheme to assist that minority of bulk mail users who do not currently sort their mail mechanically using standard or upgradeable software.

Royal Mail recognises the importance of minimising the impact of non-price changes to its services to customers. It is, after all, in Royal Mail's own interests to provide a high quality service to customers, as they would otherwise switch provider. However, Royal Mail believes that it would be unreasonable if the pace at which it is permitted to innovate and improve its services were to be dictated by that small, unrepresentative, minority of customers.

Even so, Royal Mail has set out in this document further measures which it is prepared to adopt to accommodate those bulk mail customers for whom the change is complex.

Secondly, Postcomm has stated that it does not believe that Royal Mail has the commitment to develop and implement an effective communications plan to inform customers of the changes. Royal Mail doubts whether such a plan is formally required by Condition 21(19) (and is therefore required to form part of its application). Consistent with past practice Royal Mail will prepare a communications plan once the RZA has not been rejected by Postcomm. Royal Mail also draws Postcomm's attention to the experience of the successful communications plan it implemented when it introduced Pricing in Proportion.

Thirdly, Postcomm commented that it believed Royal Mail's proposed notice period was too short (nine months, including a six month transitional period). Postcomm felt that 12 months' notice was necessary. While Royal Mail doubts whether so long a notice

period is required by customers, it is prepared to amend its proposal to allow a 12 months notice period.

In conclusion, there can no longer be any grounds for Postcomm to reject Royal Mail's application on the basis of paragraph (c) of Condition 21(19).

#### Other issues

In addition to the points raised above, Postcomm makes a number of further observations on Royal Mail's application. Even though these points are not cited as reasons for proposing to reject the application (nor, in Royal Mail's view, could they be), each of these issues is also addressed in this response.

These include Royal Mail's response to Postcomm's comments on its modelling of cost reflectivity and revenue-neutrality, and to its comments on Royal Mail's use of Geoplan in order to determine zonal boundaries.

Royal Mail also addresses Postcomm's comments on Presstream Premium. Postcomm suggests that this product should be included within Royal Mail's retail zonal pricing. In fact this is a service which only one customer has purchased [and to whom Royal Mail has a contractual obligation to continue to supply]. No other customers have shown an interest in this service and, as a result, the service is being withdrawn.

#### Conclusion

For the reasons summarised above and set out more fully in this response Royal Mail believes that the grounds on which Postcomm proposes to reject Royal Mail's application are flawed, and that Postcomm should therefore approve the application when it reaches its final decision. Royal Mail notes that the purpose of issuing a "minded to" document is to test Postcomm's preliminary conclusions and do not fetter its discretion to reach a different ultimate conclusion taking account of the views and evidence put forward at this stage.