



Royal Mail's response to Postcomm's consultation on Zonal Pricing

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1. Overview

- 1.1 The application and review preceding implementation of 'Pricing in Proportion'(PiP) in August 2006 took over 3 years to complete but set an important precedent for the way in which such applications should be processed. It also led to a belief within Royal Mail and Postcomm that the process for similar applications in the future could be completed within a significantly reduced timespan. Indeed, this led to Royal Mail's Licence specifying a 9 month period for a decision by Postcomm following receipt of "sufficient information of good quality" in relation to an application for zonal pricing. However, Postcomm has not attempted to define or explain the parameters of this term and has informed Royal Mail that it intends to process such applications on a case by case basis. This increases uncertainty and delay into the regulatory decision process and development of the market.
- 1.2 Royal Mail's retail zonal application is similar in many respects to the PiP application as the tests to be satisfied are the same. It is surprising that Postcomm should consult on how the application for retail zonal pricing should be assessed, given that there is already a precedent in the assessment of Royal Mail's PiP application. Indeed it is surprising that Postcomm's consultation document does not explain its experience of PiP nor develop its proposed approach much beyond that set out in the Licence.
- 1.3 While it has many similarities with the PiP application, Royal Mail's retail zonal application is different in three important respects. Firstly, the zonal pricing application is limited to bulk mail services. Secondly, it proposes a gentle introduction of zonal prices at the outset with those zonal prices then being adjusted during the period of the current price control, such that price distortions are minimised for the start of the next price control (scheduled in 2010). Thirdly, the speed of competitive entry for upstream business mail has been rapid and exceeded Postcomm's expectations in recent years; Royal Mail forecasts that by April 2008 Mailsort 2 will have dropped by 50%.
- 1.4 In many respects these are reasons why the regulatory review should take a significantly shorter time than for PiP. It is important that the regulator is able to demonstrate that it can process applications under the Licence quickly and efficiently and thereby enable Royal Mail to compete, in this instance in the market sector for zonal bulk mail services.

2. Introduction

- 1.5 In this response Royal Mail addresses the scope of the consultation, the proposed approach to the assessment of Royal Mail's zonal pricing application and the three questions raised in Postcomm's consultation:

(a) Is there anything in the application that respondents would like to bring to Postcomm's attention at this stage?

- (b) What are the factors to which you think Postcomm should give particular attention in applying the criteria set out in Royal Mail's licence?
- (c) How do you think the importance of these factors may change over time?

3. Scope of the consultation

- 1.6 We would like to clarify (in response to paragraph 3.6 of Postcomm's document) that Royal Mail is not proposing the introduction of new services and therefore there is no proposal to change the quality of service standards of the products to which the application relates. Furthermore, the only changes to terms and conditions are those directly related to the introduction of zonal pricing.
- 1.7 Royal Mail is surprised that Postcomm suggests at paragraph 3.8 that "stakeholders may wish to express views on zonal pricing issues that fall outside the scope of this consultation" as the consultation is supposed to be concerned with the proposed approach to assessing Royal Mail's application for retail zonal pricing. It would be inappropriate for Postcomm's consideration of that to be fettered by comments that may be made on other issues; Postcomm intends to consult on Royal Mail's application so any concerns proper to that can be raised at that time and through that process.

4. Postcomm's approach to the assessment

- 1.8 The criteria for assessment of the introduction of zonal pricing are clearly set out in paragraph 19 of Condition 21 of Royal Mail's Licence. Royal Mail concurs that the criteria for assessment of Royal Mail's application should be considered against the background of Postcomm's statutory duties, but these are expressed in broad terms. The interpretation of those duties should not be used to create additional criteria not set out in paragraph 19.
- 1.9 Paragraph 19(4) of Condition 21 of Royal Mail's Licence indirectly incorporates a requirement to comply with the pricing principles set out in the Postal Services Directive¹, to which the correct reference must be Article 12, as Postcomm notes. However, those pricing principles only apply in the circumstances in which the Directive requires them to do so. As the zonal pricing application only relates to non-USO services the pricing principles that apply to universal services only, ie of affordability and gearing to costs, are not applicable in this case and should not be used to assess Royal Mail's application under the heading of Condition 21(19)(e).

5. Review of the application

- 1.10 Postcomm's consultation replicates the requirements of the Licence and asks what factors warrant particular attention (Section 4). Royal Mail's application addresses the requirements set out in the Licence. However, in the context of Postcomm's consultation, Royal Mail focuses on three areas: the rationale for zonal pricing, the impact on customers and the change over the price control period. These are discussed in turn below.

¹ Directive 97/67/EC as amended by Directive 2002/39/EC

Rationale for zonal pricing

- 1.11 Several activities required for mail delivery have costs that are variable by geography. This is reflected in Royal Mail Wholesale's zonal access prices. Retail zonal pricing will allow Royal Mail's retail business to align its offering with that of competitors and Royal Mail's Wholesale users, and thereby compete effectively for bulk mail business. Customers will therefore be able to obtain the lowest cost source of supply. Also, by enabling Royal Mail to compete for bulk mail items retail zonal pricing better ensures the provision of the universal service (where retail zonal pricing does not apply).
- 1.12 Retail zonal pricing represents another step towards better cost reflectivity in pricing. Royal Mail's proposed zonal pricing focuses on local delivery cost drivers and demonstrates a self-evident improvement in cost reflectivity.
- 1.13 Retail zonal pricing also reduces cross subsidies and encourages efficient entry into the market. In the medium to long term inefficient entry will result in higher prices, lower volumes and higher unit costs – bad for most stakeholders, but particularly bad for competitors basing their entry strategies on unsustainable business models and distorted prices which will eventually have to be unwound.

Impact on customers

- 1.14 Royal Mail's proposition mitigates the impact on customers by proposing to introduce retail zonal pricing gently into the bulk mail market. It includes a 6 month transition period during which customers can move from uniform to zonal prices; the maximum price change in the first year will be only a few percentage points (7.3%) above the uniform price and other prices fall (some by 4.6%) to maintain revenue neutrality. Bulk mail senders will have access to software that enables them to undertake price comparisons to facilitate their planning and decision making.
- 1.15 The concept of destination distinct pricing is not new. 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.
- 1.16 In summary, Royal Mail's application pays particular attention to a gentle introduction of retail zonal prices for bulk mail customers. Indeed, this is perhaps the main distinction between the retail zonal application and that of PiP.

Change over the price control period

- 1.17 Postcomm's consultation also asks how the importance of the requirements of Condition 21(19) may change over time. Royal Mail reads this as indirectly asking the degree to which zonal prices should be cost reflective over the price control period.². In this regards Royal Mail considers it essential, having had the market opened to competition since January 2006, to ensure that pricing distortions and cross-subsidies are minimised from the outset of the next price control (2010). This will encourage efficient entry and robust entry models that will benefit customers.

² Revenue neutrality is addressed though the current Licence.

- 1.18 Postcomm's consultation draws some similarities between the zonal pricing application and Royal Mail's application that led to the introduction of PiP (see paragraph 3.6 of the consultation document). While the same Licence requirements apply to the zonal application as applied to the application for PiP, Royal Mail's approach to the introduction of zonal pricing proposes a phased price change over the current price control period, rather than a major once-off change. This is to help customers to become familiar with the operation of zonal pricing with limited initial price changes. However, it also means that the cost reflectivity of introducing zonal pricing into the market will improve over the period of the price control. Royal Mail is nevertheless not satisfied that Condition 21(19) requires that the tests set out within it are to be considered over a period of time, as that paragraph refers only to "the change".
- 1.19 As further comments, in paragraph 2.8 Postcomm states "*Royal Mail has so far given no clear indication of how it would phase the transition from the initial prices to the final '2010 prices'.*". It is not a requirement of the Licence for Royal Mail to set out how prices will move through the current price control period. However, our application sets out the need for Postcomm to set sub-caps sufficient to ensure pricing distortions and cross-subsidies are minimised by the end of the current price control period. This may be simplest if, following the introduction of the initial zonal prices, the sub-caps are increased by a specified equal amount each year of the remaining control to facilitate reaching the level of the "final '2010 prices'".
- 1.20 Paragraph 4.10 of Postcomm's consultation document appears to suggest the introduction of a cost reflectivity test for zonal pricing for each year of the current price control. This would add a further degree of complexity to an already complex price setting procedure. It also appears to be contrary to the current Licence where prices are subject only to meeting an overall pricing constraint and individual price caps. Therefore, the need to amend the setting of subcaps was anticipated in Royal Mail's application.

6. Review of the process

- 1.21 the Licence states that the process for Postcomm reaching a decision will be up to 9 months following receipt of "sufficient information of good quality to consider the application". Postcomm has not defined this term and has advised that, rather than seek to clarify it, it wishes to proceed with each application under Condition 21(19) on a case by case basis. However, Postcomm appears to have been surprised to have received the retail zonal pricing application shortly after completion of the licence modifications in May and appears to have had no process prepared or in place to address the application.
- 1.22 In September, at the time of writing its consultation paper (more than 3 months after sight of a draft application), Postcomm had neither defined its data requirements nor the analysis that it wished to carry out. In November 2006, Postcomm defined its data requirements and in December Postcomm has outlined the analysis to be undertaken, together with some additional data requirements and clarifications. At the time of this response, Royal Mail has provided Postcomm with the data requested. Postcomm has not yet confirmed that this is sufficient information of

good quality in order for it to be able to consider the application. Royal Mail has separately sought clarity of the process going forward and in particular what further information requirements Postcomm could have in order to enable it to consider the application. Royal Mail considers it unrealistic to expect (and unnecessary) that all potential questions could be identified by Postcomm and answered in advance of the assessment of Royal Mail's application. Royal Mail notes that Postcomm has the ability to ask for supplementary information should it decide this is necessary once the 9 month time period has commenced.

- 1.23 Separately in November, Postcomm asked Royal Mail to present at a workshop held on 30 November prior to the end of this consultation. In response to Postcomm's request, Royal Mail presented its application at that workshop. Royal Mail has concerns over the process for Postcomm's invitations to this workshop and whether the original invitations were accessible to all in sufficient time to ensure industry wide representation. As discussed above, Royal Mail has replied to Postcomm in response to its requests for data and in addition will shortly post on its website a response to discussion points raised at the meeting.

7. Concluding remarks

- 1.24 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.
- 1.25 We look forward to Postcomm's consultation on our application and clarification into the market place of Postcomm's expected timespan for processing this application.