



Posten Norge

# Calculation and compensation of USO net costs in Norway

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12th Königswinter Seminar on Postal Economics

# Agenda

1. Background
2. USO-definition and financing in Norway
3. Net USO-cost models – The Norwegian experience
4. The Alternative Commercial Strategy (ACS) Model
5. Political choice
6. Practical and political experiences
7. Compatibility with EU-postal directive

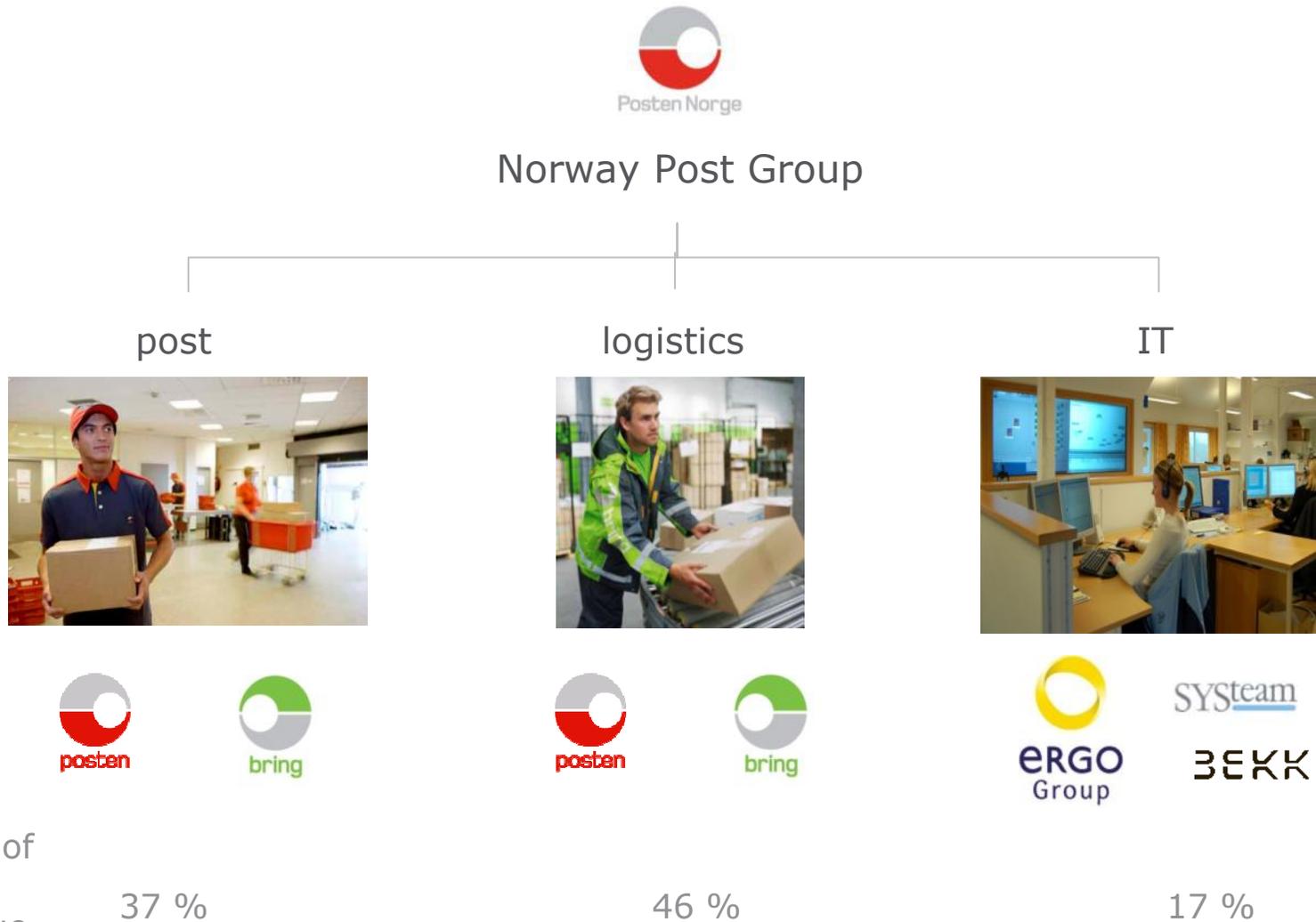
# Norway – in the high North-Western corner of Europe

- 4.8 mill. inhabitants
- 16 inhab. per km<sup>2</sup>
- 2/3 covered by mountains
- Long coastline interrupted by deep fjords
- Many populated islands
- Winter climate

One would expect the burden of the USO to be considerable



# Norway Post Group's business segments



Share of  
Group  
revenue  
2008:

## The Universal Service Obligation (USO) in Norway

- Norway Post is the one and only operator with universal service obligations
- The obligations are defined by law and a ministerial license granted to Norway Post
- Main elements of the USO:
  - At least one post office per local municipality (in reality the required structure and number of offices is much more demanding due to political approval in Ministry and Parliament)
  - Transit times quality requirements (minimum 85 % of national priority mail D+1, etc)
  - Delivery 6 days per week
  - Tariffs for basic postal services must be cost oriented, transparent, and non discriminatory
  - Tariffs for reserved services must be geographically uniform
  - Mail with special content for blind persons free of charge
  - Non-postal: Basic banking/financial services available at every stationary post offices and all rural area delivery routes

## Financing of the net USO-cost

- The financing mechanism is defined in Norway Post's licence
- Net cost of the USO is financed from two sources:
  - Primarily by the reserved area, - that is the superprofit from the reserved area
  - If reserved area monopoly profit is insufficient to finance net costs, the residual is to be compensated by the state
- Norway Post estimates monopoly profits and net costs of the USO in advance (forecast based on expected revenues and costs)
- From 2009 and onwards the estimates has to be revised/recalculated ex-post in connection with Norway Post's product accounts, to safeguard against overcompensation.

## How to define and calculate the net cost of the USO? - The Norwegian experience

- Net Avoidable Cost-model practiced some years until 2001:
  - Net costs increased proportionally with disaggregation of cost data
  - Failed to take account of network economies (i.a. closedown of one region had no impacts on demand for services in other regions etc)
  - Tended to overestimate the costs
  - Lack of transparency: Difficult to communicate what the state actually was paying for
  
- Growing concerns about the weaknesses of the model both on Norway Post's side and in the Ministry

## How to define and calculate the net cost of the USO? - The Norwegian experience cont.

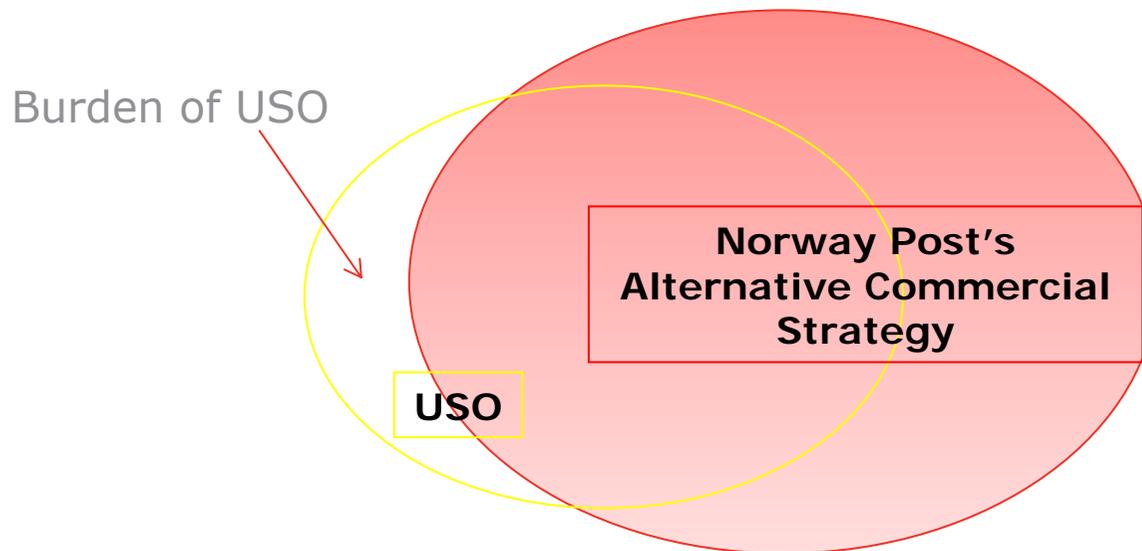
- New model introduced in 2002: The “Alternative Commercial Strategy Model” (ACS-model):
  - Modified Net Avoidable Cost Model
  - Based on a plausible definition of Norway Post’s strategy without USO (and reserved area) consistent with main elements of Norway Post’s current commercial strategies
  - The model defines the burden of the USO in terms of certain services and service-standards

In practice main elements of ACS cannot be amended without an express strategy decision by the Board of Norway Post. Such a change of strategy should be communicated appropriately and based on a credible commercial assessment. This gives credibility to the definition of the ACS.

## Deviations from USO in the "Alternative Commercial Strategy" (ACS) define the net cost elements of USO

USO-element	Deviation in ACS	Comments on deviation
Universal coverage of postal services	No	
Delivery frequency 6 d/week	Yes	ACS more differentiated in high cost delivery routes/areas
Post office network	Yes	Overall the same number and distribution of post offices, although a higher proportion run by third parties (daily food shops, supermarkets, petrol stations etc)
Basic bank/financial services	Yes	Excluded from ACS, not a core business for Norway Post
Postal products	No	Some minor modifications in availability which the regulator eventually has accepted to be compatible with the USO
Mail to blind persons free of charge	Yes	Fully charged

This means Norway Post's strategies overlap with most of the USO...



- ..which is mirrored in the net USO-cost as a relatively small share of revenues
- Yet, with decreasing revenues from USO-services due to electronic substitution, the USO will become heavier to carry and may lead to changes in the ACS

Net USO cost Year 2008 as:	% of total USO market revenue	% of total revenue post segment	% of total revenue Norway Post Group
	8,3 %	5,5 %	2 %

## The net costs amounts to 497 MNOK (approx. 57 mill Euro) in 2010

- Mainly made up of delivery frequency obligations and of the post office structure combined with bank services obligation:

USO-element	Net costs*	Alternative Commercial Strategy	Comments
6 days delivery per week:		Differentiated service:	Assumes insignificant revenue impacts of differentiated service
+ 1 day to 15 % of the households	12	5 days weekly	
+ 4 days to 5 % of the households	29	2 days weekly	
Suboptimal post office structure, partly due to bank services obligation	15	Higher proportion of third party run offices, no bank services	Cost efficiency gains, assumes no significant volume effects on postal services, loss of all revenues from bank services
Other elements	1		Minor adjustments
<b>Net costs in total</b>	<b>57</b>		

\*In mill Euro. 1 Euro=8,73 NOK (2009 average rate)

## The model gives Government a political choice

- The net costs are relatively small compared to total revenues of Norway Post
- However, this does not mean that the costs are insignificant to Norway Post, nor to the Government which has to comply with tight budget constraints.
- Menu for political choice: *Is the USO worth the extra costs? If considered they are not, the Government can adjust the USO more in line with Norway Post's alternative commercial strategy:*
  - Reduce delivery frequency obligation to 5 days weekly:  
Net cost reduction of 20 mill Euro
  - More flexible post office obligations and abolish bank service obligation:  
Net cost reduction of 15 mill Euro
- For comparison: In 2008 state funds to support commercially non-viable (i) broadband investments in rural areas and (ii) regional aviation services, amounted to 16 mill and 61 mill Euros respectively

## Practical and political experiences

- Cost efficiency gains and monopoly profits reduce the state compensation bill:
  - This is to some extent a disincentive, but is balanced by Norway Post's own interest in minimizing reliance on state compensation and reserved area.
  - Ex-post calculation of net costs and monopoly profits from 2009 and onwards to safeguard against overcompensation. This is mainly due to variations in monopoly profits, not in the net cost estimates.
- The Government is reluctant to pay the bill or to change USO:
  - In 2008 approx 35 mill Euro of the USO net cost was not compensated
  - Explicitly expects profits from other business in Norway Post Group to cover the USO net cost. This is in conflict with the basic principles of the licence and unrealistic in highly competitive markets.
- An independent consultant's appraisal of net cost calculations and method on behalf of the Ministry in 2005, confirmed the amount as reasonable.
- The Ministry recently ordered another consultancy appraisal of the net costs and impacts of liberalization on the need for state compensation and/or on the USO-definition. (To be delivered by early summer 2010)

# The model is in line with the EU postal directive Annex on calculation of net USO-cost

## Basic principles in the Annex:

- The net cost of universal service obligations is to be calculated, as the difference between the net cost for a designated universal service provider of operating with the universal service obligations and the same postal service provider operating without the universal service obligations.
- The net cost calculation should assess the benefits, including intangible benefits, to the universal service operator.
- The calculation is to be based upon the costs attributable to:
  - (i) elements of the identified services which can only be provided at a loss or provided under cost conditions falling outside normal commercial standards.

## Compatibility with the principles:

- ✓ Net cost calculation based on a defined alternative commercial strategy consistent with Norway Post's current strategies
- ✓ The net-cost services are specified and net costs calculated in line with NAC-principles.
- ✓ Norway Post 's benefits from the USO are implicitly taken into account in the definition of the ACS.
- ✓ An argument against could be that the ACS is defined by the USO-operator itself and as such is "subjective". An indisputable ACS is hard to estimate, though, in a dynamic environment.
- ✓ A practical example of how to adopt the principles in the directive in a manner which also provides a menu for political choice.