

Calculating the net cost, if any, of the Universal Service Obligation

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Introduction

Definition of USO Net Cost

- Key question:

Which services and service elements would a commercial postal service provider discontinue / which customer groups would the company stop serving without a USO compared to a postal service provider with a USO?

- Calculation: Comparison of profits in two scenarios

$$\begin{aligned} & (\text{Revenue} - \text{Costs})_{\text{with USO}} - (\text{Revenue} - \text{Costs})_{\text{without USO}} \\ & = \text{Costs of USO (net costs)} \end{aligned}$$

→ “Profitability cost approach” (Panzar/Crèmer)

Introduction

Third Postal Directive: Net cost of the USO

Why calculate?

Precondition for external funding

Who calculates?

Universal service provider?
NRA?

How?

Subject of this presentation

Who verifies?

NRA
(USP shall cooperate with NRA)

USO Costing Methodologies

Overview of Surveyed Approaches

- Belgium / BIPT
- Denmark / Danish Competition Authority (2007)
- Denmark / Copenhagen Economics (2007)
- France / La Poste
- Norway / Norway Post
- Switzerland / Swiss Post
- United Kingdom / Postcomm (2001)
- United Kingdom / Frontier Economics (2008)

USO Costing Methodologies

Belgium / BIPT

Purpose	<ul style="list-style-type: none"> • Legislation requires the regulator to calculate USO costs • Regulator IBPT has published a methodology paper (2006) • No results published to date • Results could be used to justify external funding (USF)
Services or service elements considered	<ul style="list-style-type: none"> • Product accounts for all universal service products • Approx. 700 products, e.g. 20g 1st class letter • USO net cost = (sum of all negative product accounts) minus (profits from accounts of reserved products)
Cost concept	<ul style="list-style-type: none"> • Fully distributed costs (from cost accounts of the Belgian Post)
Reference scenario without USO	<ul style="list-style-type: none"> • Not stated explicitly • Implicitly assumes all loss-making universal service products would be discontinued (e.g. 20g 1st class letter)
Cost & revenue effects	<ul style="list-style-type: none"> • Static approach: Only “first round” cost and revenue effects (of withdrawing individual products)
Result	<ul style="list-style-type: none"> • Not published

USO Costing Methodologies

Denmark / Danish Competition Authority (2007)

Purpose	<ul style="list-style-type: none"> • Inform postal policy (no legal mandate) • Calculation presented by the Danish Competition Authority in a one-off report on the postal market (2007) • No external funding
Services or service elements considered	<ul style="list-style-type: none"> • Product groups per delivery area (rural/urban) • 5 product groups (light letters, heavy letters, periodicals, dailies, parcels) • Free services to the blind
Cost concept	<ul style="list-style-type: none"> • Unclear
Reference scenario without USO	<ul style="list-style-type: none"> • Not stated explicitly • Implicitly assumes loss-making product groups would be discontinued in aggregated delivery areas (rural/urban)
Cost & revenue effects	<ul style="list-style-type: none"> • Static approach: Only “first round” revenue effects (of discontinuing “product groups” in/to certain areas)
Result (2005)	<ul style="list-style-type: none"> • DKK 700m (€ 94m) - approx. 7% of operating expenses • Competition Authority: Loss to be caused by uniform tariff – Authority called for more pricing flexibility (zonal prices)

USO Costing Methodologies

Denmark / Copenhagen Economics (2007) I

Purpose	<ul style="list-style-type: none"> • Inform postal policy (no legal mandate) • Model prepared for Danish Chamber of Commerce
Services or service elements considered	<ul style="list-style-type: none"> • Nationwide delivery • 6-day-delivery • Routing time targets, etc.
Cost concept	<ul style="list-style-type: none"> • Incremental costs (estimated bottom-up)
Reference scenario without USO	<ul style="list-style-type: none"> • Alternative business model of Post Danmark (absent the USO) <ul style="list-style-type: none"> - Delivery frequency down from 6 to 5 days per week - Free services for blind discontinued
Cost & revenue effects	<ul style="list-style-type: none"> • “First round” revenue effects only • Longer term effect supposedly considered in developing “realistic” alternative business model
Result (2005)	<ul style="list-style-type: none"> • DKK 150m (€ 20m) – approx. 1.5% of operating expenses • Report argues previous analysis by Competition Authority does not reflect a “commercially viable business model”

USO Costing Methodologies

Denmark / Copenhagen Economics (2007) II

Indicators used for developing alternative business model	Interpretation
Does the incumbent provide a higher service level than required by USO?	If the service level is higher than required, the restriction is not binding.
Do competitors provide higher service level than what the USO demands from the incumbent?	If competitors without USO provide higher service level, the restriction is not binding. High service is commercially viable. The market will provide universal service.
Do incumbents in other countries with lower USO provide the service?	If incumbents in other countries with lower USO requirements provide the service voluntarily, it is not likely to be a burden – conditional on differences in postal markets.
Will the incumbent be restricted by the competition law?	The incumbent will remain dominant in many postal markets and thus be restricted by the general competition law. Only additional USO requirements should be considered.
Other pros and cons	...

USO Costing Methodologies

France / La Poste

Purpose	<ul style="list-style-type: none"> • Allocation of costs of "réseau grand public" (retail outlets) to "Accessibilité" (USO) and "CRAT" (Contribution du Réseau à l'Aménagement du Territoire) • Reporting required by ARCEP
Services or service elements considered	<ul style="list-style-type: none"> • Branch network (retail outlets) • Separate analysis for "postal USO" and "regional planning requirements"
Cost concept	<ul style="list-style-type: none"> • Incremental costs
Reference scenario without USO	<ul style="list-style-type: none"> • Branch network of a profit-maximizing company – # of retail outlets reflects maximum (global) contribution to profit • "Commercial" network determined using cost & revenue data, econometric modeling
Cost & revenue effects	<ul style="list-style-type: none"> • Cost comparison. Objective: Difference between cost of "commercial network" and current network • Revenue effects are taken into account in determining the reference scenario
Result	<ul style="list-style-type: none"> • Not published

USO Costing Methodologies

Norway / Norway Post

Purpose	<ul style="list-style-type: none"> • Determine subsidies from state budget (discontinued in 2006)
Services or service elements considered	<ul style="list-style-type: none"> • Frequency of delivery (by area) • Retail network • Free services to the blind • Non-uniform tariff / surcharge to Spitsbergen (remote island)
Cost concept	<ul style="list-style-type: none"> • Incremental costs
Reference scenario without USO	<ul style="list-style-type: none"> • “Commercial business model” determined by Norway Post <ul style="list-style-type: none"> - Delivery frequency down to 5 days for 15 % of population and down to 2 days for 5 % of population - “Mobile post offices” reduced by half - Introduce charges for services for the blind - Surcharge for mail to and from Spitsbergen
Cost & revenue effects	<ul style="list-style-type: none"> • Revenue effects are taken into account in determining the reference scenario
Result (2006)	<ul style="list-style-type: none"> • NOK 253m (€ 32m) / 2.3 % of operating expenses

USO Costing Methodologies

Switzerland / Swiss Post

Purpose	<ul style="list-style-type: none"> • Legislation requires report of “infrastructure contribution” • No external funding
Services or service elements considered	<ul style="list-style-type: none"> • Branch network: mail acceptance and sales, including financial services • Mail transportation • Delivery
Cost concept	<ul style="list-style-type: none"> • Branch network and transport: Incremental costs • Delivery: Difference between average delivery costs in “high-density” areas (per household) and actual delivery costs in “low-density” areas
Reference scenario without USO	<ul style="list-style-type: none"> • Branch network and transportation: # of retail outlets from 2,500 to 600 (benchmark: bank counters) • Delivery: Coverage from 100% of households to 70% (benchmark: private newspaper delivery)
Cost & revenue effects	<ul style="list-style-type: none"> • Static approach: First round cost effects ; • Revenue effects not considered
Result (2007)	<ul style="list-style-type: none"> • ~ CHF 500m (€ 315m) / 7.8% of operating expenses

USO Costing Methodologies

United Kingdom / Postcomm (2001)

Purpose	<ul style="list-style-type: none">• Inform postal policy• Regulator reviewed a calculation of Royal Mail
Services or service elements considered	<ul style="list-style-type: none">• “Mail paths”: combination of product, origin and destination• Total: ~ 20,000 “mail paths”
Cost concept	<ul style="list-style-type: none">• Long-run marginal cost (as a proxy for avoidable cost)
Reference scenario without USO	<ul style="list-style-type: none">• Not stated explicitly• Implicitly assumes all loss-making “mail paths” be discontinued
Cost & revenue effects	<ul style="list-style-type: none">• Static approach: Only “first round” revenue effects (of discontinuing “mail paths”)
Result (FY1999/2000)	<ul style="list-style-type: none">• GBP 91m (€ 112m) / approx. 1.5 % of operating expenses

USO Costing Methodologies

United Kingdom / Frontier Economics (2008)

Purpose	<ul style="list-style-type: none"> • Inform postal policy
Services or service elements considered	<ul style="list-style-type: none"> • First Class transit time (reduce transit time target) • Frequency of service (stop Saturday service) • Reduce transit time target (from 93% to 78-85% J+1) • Single class of mail (only two day service)
Cost concept	<ul style="list-style-type: none"> • Long-run incremental cost / net avoided cost (NAC)
Reference scenario without USO	<ul style="list-style-type: none"> • Separate calculations for various changes of service levels • Alternative universal service requirements under three different base scenarios
Cost & revenue effects	<ul style="list-style-type: none"> • First round (non-price) cost and revenue effects including revenue losses due to competition • Second round (price) effects on cost and demand
Result (FY2006/2007)	<ul style="list-style-type: none"> • NAC of Saturday service: GBP 271m (€ 335m) / 4% of operating expenses • NAC of lower transit time targets: GBP 76m (€ 94m) / 1% of op. ex. • No cost to other elements of universal service

USO Costing Methodologies

Conclusions

- Two categories of approaches
 - Related to “product” accounts without explicit reference scenario
 - Related to elements of the USO with explicit reference scenario
- Consensus in recent models: Profitability cost approach
 - Calculate change in incumbent profits due to relaxing the USO
 - Key question: How would the incumbent change service levels if the USO was relaxed?
- Most important areas for service degradations (without a USO)
 1. Reduced frequency of delivery (possibly in rural areas only)
 2. Post office closures and conversion to contracted agencies
 3. Remove “social prices”, e.g. free service for the blind

Conclusions

Key Elements of Third Postal Directive (Annex 1)

Purpose	<ul style="list-style-type: none">• Precondition for external funding• Article 7 (3):“Where a Member State determines that <u>the USO [...] entail a net cost</u>, and represent <u>an unfair financial burden</u> on the USP [...]”
Services or service elements considered	<ul style="list-style-type: none">• Elements of services provided at loss or under cost conditions falling outside normal commercial standards• Specific users or groups of users served at loss or ... (revenues not cost-covering due to social, uniform, or affordable tariffs)• Calculation made separately and under avoidance of double counting per aspect (element or user group) of USO
Cost concept	<ul style="list-style-type: none">• Avoided cost
Reference scenario without USO	<ul style="list-style-type: none">• Same postal operator without USO
Cost & revenue effects	<ul style="list-style-type: none">• Assessment of “net cost“ effects and of benefits (“intangible and market benefits“) to the USP
Result	<ul style="list-style-type: none">• Shall be verified by NRA (USP shall cooperate)• Publication not required

Conclusions

USO Costing Methodologies in Light of the Third Postal Directive

Key elements of Annex 1	BE	DK 1	DK 2	FR	NO	CH	UK 1	UK 2
Services or service elements of USO?	No	Yes	Yes	Yes	Yes	Yes	No	Yes
Avoided cost?	No	No	Yes	Yes	Yes	Partly	Yes	Yes
Reference scenario without USO?	No	No	Yes	Yes	Yes	Yes	No	No
Further benefits?	No	No	Partly	No	Partly	No	No	No

Tentative conclusions by WIK-Consult

No: not consistent with Annex 1 of the Third Postal Directive

Yes: consistent with Annex 1 of the Third Postal Directive



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