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

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Contents of Presentation

- Introduction
- USO Costing Methodologies
- Conclusions in the Light of the Third Postal Directive
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

\[(\text{Revenue} - \text{Costs})_{\text{with USO}} - (\text{Revenue} - \text{Costs})_{\text{without USO}} = \text{Costs of USO (net costs)}\]

→ “Profitability cost approach” (Panzar/Crèmer)
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 | • 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 | • 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 | • Fully distributed costs (from cost accounts of the Belgian Post) |
| Reference scenario without USO | • Not stated explicitly  
• Implicitly assumes all loss-making universal service products would be discontinued (e.g. 20g 1st class letter) |
| Cost & revenue effects | • Static approach: Only “first round” cost and revenue effects (of withdrawing individual products) |
| Result | • Not published |
### USO Costing Methodologies
**Denmark / Danish Competition Authority (2007)**

| Purpose |  
| --- | ---  
| **•** Inform postal policy (no legal mandate)  
**•** Calculation presented by the Danish Competiton Authority in a one-off report on the postal market (2007)  
**•** No external funding |  
| Services or service elements considered |  
| **•** Product groups per delivery area (rural/urban)  
**•** 5 product groups (light letters, heavy letters, periodicals, dailies, parcels)  
**•** Free services to the blind |  
| Cost concept |  
| **•** Unclear |  
| Reference scenario without USO |  
| **•** Not stated explicitly  
**•** Implicitly assumes loss-making product groups would be discontinued in aggregated delivery areas (rural/urban) |  
| Cost & revenue effects |  
| **•** Static approach: Only “first round” revenue effects (of discontinuing “product groups” in/to certain areas) |  
| Result (2005) |  
| **•** 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                                      | • Inform postal policy (no legal mandate)  
|                                             | • Model prepared for Danish Chamber of Commerce |
| Services or service elements considered     | • Nationwide delivery  
|                                             | • 6-day-delivery  
|                                             | • Routing time targets, etc. |
| Cost concept                                | • Incremental costs (estimated bottom-up) |
| Reference scenario without USO              | • Alternative business model of Post Danmark (absent the USO)  
|                                             |   - Delivery frequency down from 6 to 5 days per week  
|                                             |   - Free services for blind discontinued |
| Cost & revenue effects                      | • “First round” revenue effects only  
|                                             | • Longer term effect supposedly considered in developing “realistic” alternative business model |
| Result (2005)                               | • DKK 150m (€ 20m) – approx. 1.5% of operating expenses  
<p>|                                             | • Report argues previous analysis by Competition Authority does not reflect a “commercially viable business model” |</p>
<table>
<thead>
<tr>
<th>Indicators used for developing alternative business model</th>
<th>Interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the incumbent provide a higher service level than required by USO?</td>
<td>If the service level is higher than required, the restriction is not binding.</td>
</tr>
<tr>
<td>Do competitors provide higher service level that what the USO demands from the incumbent?</td>
<td>If competitors without USO provide higher service level, the restriction is not binding. High service is commercially viable. The market will provide universal service.</td>
</tr>
<tr>
<td>Do incumbents in other countries with lower USO provide the service?</td>
<td>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.</td>
</tr>
<tr>
<td>Will the incumbent be restricted by the competition law?</td>
<td>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.</td>
</tr>
<tr>
<td>Other pros and cons</td>
<td>…</td>
</tr>
</tbody>
</table>
## Purpose
- 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
- Branch network (retail outlets)
- Separate analysis for “postal USO” and “regional planning requirements”

## Cost concept
- Incremental costs

## Reference scenario without USO
- 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
- Cost comparison. Objective: Difference between cost of “commercial network” and current network
- Revenue effects are taken into account in determining the reference scenario

## Result
- Not published
### USO Costing Methodologies
#### Norway / Norway Post

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Determine subsidies from state budget (discontinued in 2006)</th>
</tr>
</thead>
</table>
| **Services or service elements considered** | • Frequency of delivery (by area)  
• Retail network  
• Free services to the blind  
• Non-uniform tariff / surcharge to Spitsbergen (remote island) |
| **Cost concept** | Incremental costs |
| **Reference scenario without USO** | “Commercial business model” determined by Norway Post  
- 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** | Revenue effects are taken into account in determining the reference scenario |
| **Result (2006)** | NOK 253m (€ 32m) / 2.3 % of operating expenses |
### Purpose
- Legislation requires report of “infrastructure contribution”
- No external funding

### Services or service elements considered
- Branch network: mail acceptance and sales, including financial services
- Mail transportation
- Delivery

### Cost concept
- 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
- 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
- Static approach: First round cost effects
- Revenue effects not considered

### Result (2007)
- ~ CHF 500m (€ 315m) / 7.8% of operating expenses
### USO Costing Methodologies
**United Kingdom / Postcomm (2001)**

| Purpose                                      | • Inform postal policy  
|                                             | • Regulator reviewed a calculation of Royal Mail |
| Services or service elements considered      | • “Mail paths”: combination of product, origin and destination  
|                                             | • Total: ~ 20,000 “mail paths” |
| Cost concept                                 | • Long-run marginal cost (as a proxy for avoidable cost) |
| Reference scenario without USO               | • Not stated explicitly  
|                                             | • Implicitly assumes all loss-making “mail paths” be discontinued |
| Cost & revenue effects                       | • Static approach: Only “first round” revenue effects (of discontinuing “mail paths”) |
| Result (FY1999/2000)                         | • GBP 91m (€ 112m) / approx. 1.5 % of operating expenses |
### USO Costing Methodologies
United Kingdom / Frontier Economics (2008)

<table>
<thead>
<tr>
<th>Purpose</th>
<th>• Inform postal policy</th>
</tr>
</thead>
</table>
| Services or service elements considered | • 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 | • Long-run incremental cost / net avoided cost (NAC) |
| Reference scenario without USO | • Separate calculations for various changes of service levels  
• Alternative universal service requirements under three different base scenarios |
| Cost & revenue effects | • 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) | • 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                                                                 | • Precondition for external funding  
|• Article 7 (3):“Where a Member State determines that the USO [...] entail a net cost, and represent an unfair financial burden on the USP […]” |
| Services or service elements considered                                 | • 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                                                            | • Avoided cost |
| Reference scenario without USO                                           | • Same postal operator without USO |
| Cost & revenue effects                                                  | • Assessment of “net cost“ effects and of benefits (“intangible and market benefits”) to the USP |
| Result                                                                  | • 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

<table>
<thead>
<tr>
<th>Services or service elements of USO?</th>
<th>BE</th>
<th>DK 1</th>
<th>DK 2</th>
<th>FR</th>
<th>NO</th>
<th>CH</th>
<th>UK 1</th>
<th>UK 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Avoided cost?</th>
<th>No</th>
<th>No</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>Partly</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Reference scenario without USO?</th>
<th>No</th>
<th>No</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>No</th>
<th>No</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Further benefits?</th>
<th>No</th>
<th>No</th>
<th>Partly</th>
<th>No</th>
<th>Partly</th>
<th>No</th>
<th>No</th>
<th>No</th>
</tr>
</thead>
</table>

#### 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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