

# **Net Cost of the Universal Postal Service and Financing Options Experiences from Europe**

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# Who is WIK-Consult?

- WIK ('Scientific institute for infrastructure and communication services')
  - Independent research institute, owned by the German government
  - ~ 40 consultants/researchers
  - 25 years of experience with economic regulation and sector policies
  - Telecommunications, postal and energy markets
- WIK-Consult is a 100% subsidiary of WIK
  - Consultancy specialised in regulated industries, founded in 2001
  - ~ 60% of revenue from customers outside Germany

# Contents of Presentation

**What are  
USO net costs?**

**Review of net  
cost calculations in  
Europe**

**Options for  
financing USO net  
costs (if any)**

# What are USO Net Costs?

- Cost of universal service ('gross cost')
  - Total expenditure for operating universal postal services (as per financial regulatory accounts)
  - ➔ This cost is normally covered by revenues from customers
- Net cost of universal service (= cost of universal service obligation)
  - Theoretical concept, cannot be observed directly
  - Net cost is additional cost (or lost profit), that results from the USO
  - Net cost is not the loss/profit reported for US in financial accounts
  - ➔ This cost is created by legislative requirements, and may be compensated

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?

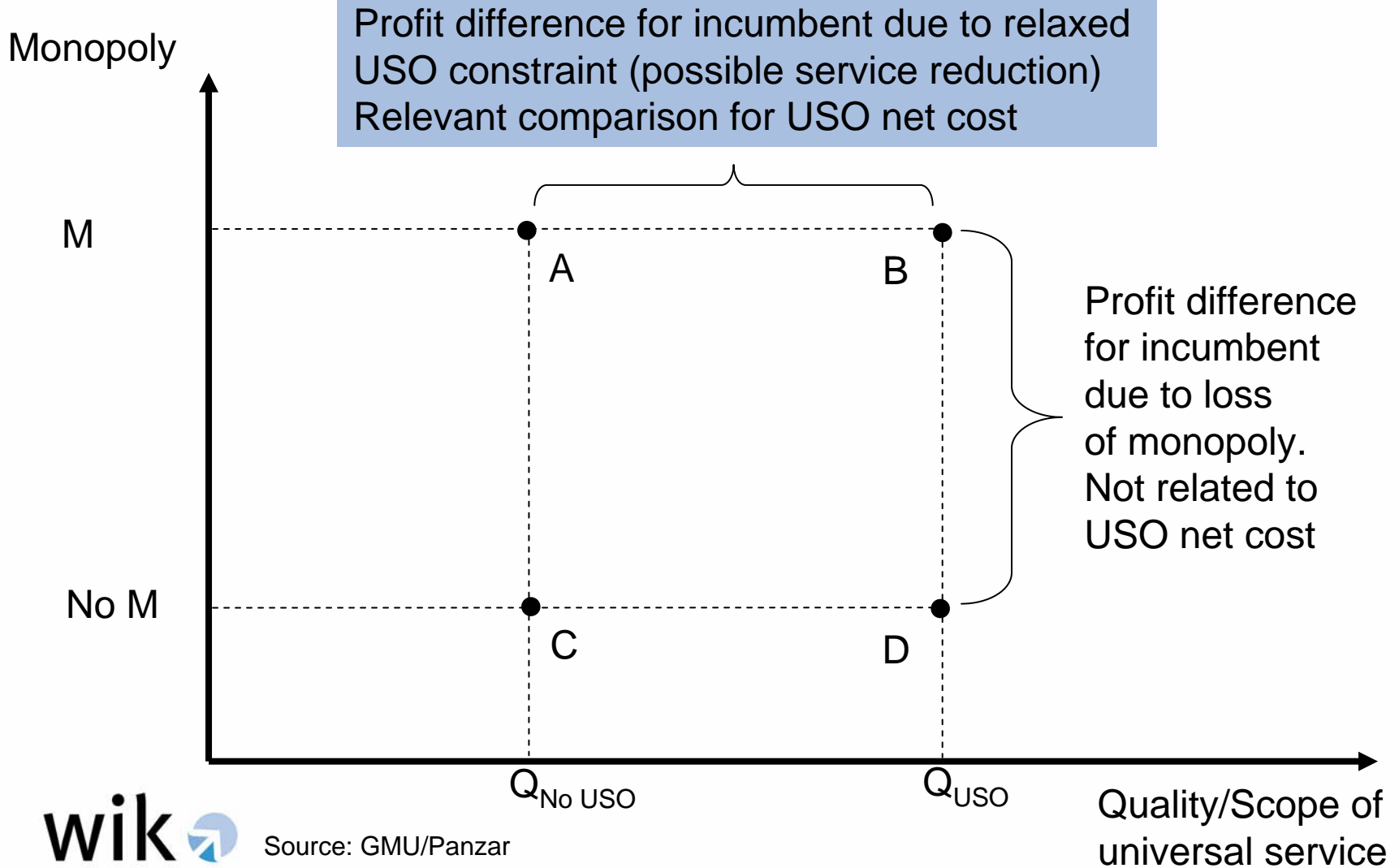
- Calculation: Comparison of profits in two scenarios

$$\text{USO net cost} = (\text{Revenue} - \text{Costs})_{\text{with USO}} - (\text{Revenue} - \text{Costs})_{\text{without USO}}$$

→ 'Profitability cost approach' (Panzar/Crèmer)

# USO Net Cost

## “Commercial Scenario”: Liberalization and Quality of USO



# USO Net Cost

## Role of USO Net Cost in European Postal Law

### Why calculate?

Precondition for external funding

### Who calculates?

Universal service provider?  
Regulator?

### How?

(No generally accepted  
practice to date)

### Who verifies?

Regulator! (USP shall cooperate)

(State aid control by  
European Commission)

## How Calculate? Requirements of 2008/6/EC, Annex 1

Purpose	<ul style="list-style-type: none"><li>• Precondition for external funding</li><li>• 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 [...]”</li></ul>
Services or service elements considered	<ul style="list-style-type: none"><li>• Elements of services provided at loss or under cost conditions falling outside normal commercial standards</li><li>• Specific users or groups of users served at loss or ... (revenues not cost-covering due to social, uniform, or affordable tariffs)</li><li>• Calculation to be made separately and must avoid double counting of same aspect (element or user group)</li></ul>
Cost concept	<ul style="list-style-type: none"><li>• Avoided cost</li></ul>
Reference scenario (no USO)	<ul style="list-style-type: none"><li>• Same postal operator without a USO</li></ul>
Cost & revenue effects	<ul style="list-style-type: none"><li>• Assessment of ‘net cost’ effects and of benefits to the USP (‘intangible and market benefits’)</li></ul>



# USO Net Cost

## Survey of USO Costing Methodologies

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

Discussed in this presentation

# USO Costing Methodologies

## Danish Chamber of Commerce (2007)

Purpose	<ul style="list-style-type: none"> <li>• Inform postal policy (no legal mandate)</li> <li>• Model prepared by Copenhagen Economics for the Danish Chamber of Commerce</li> </ul>
Services or service elements considered	<ul style="list-style-type: none"> <li>• Nationwide delivery</li> <li>• 6-day-delivery</li> <li>• Routing time targets, etc.</li> </ul>
Cost concept	<ul style="list-style-type: none"> <li>• Incremental costs (estimated bottom-up)</li> </ul>
Reference scenario without USO	<ul style="list-style-type: none"> <li>• Alternative business model of Post Danmark (absent the USO) <ul style="list-style-type: none"> <li>- Delivery frequency down from 6 to 5 days per week</li> <li>- Free services for blind discontinued</li> </ul> </li> </ul>
Cost & revenue effects	<ul style="list-style-type: none"> <li>• “First round” revenue effects only</li> <li>• Longer term effect supposedly considered in developing “realistic” alternative business model</li> </ul>
Result (2005)	<ul style="list-style-type: none"> <li>• DKK 150m (US\$ 32m) – approx. 1.5% of operating expenses</li> <li>• Report argues previous analysis by Competition Authority does not reflect a “commercially viable business model”</li> </ul>

# USO Costing Methodologies

## Norway: Norway Post

Purpose	<ul style="list-style-type: none"> <li>• Determine subsidies from state budget (discontinued in 2006, re-introduced in 2009)</li> </ul>
Services or service elements considered	<ul style="list-style-type: none"> <li>• Frequency of delivery (by area)</li> <li>• Retail network</li> <li>• Free services to the blind</li> <li>• Non-uniform tariff / surcharge to Spitsbergen (remote island)</li> </ul>
Cost concept	<ul style="list-style-type: none"> <li>• Incremental costs</li> </ul>
Reference scenario without USO	<ul style="list-style-type: none"> <li>• “Commercial business model” determined by Norway Post               <ul style="list-style-type: none"> <li>- Delivery frequency down to 5 days for 15 % of population and down to 2 days for 5 % of population</li> <li>- “Mobile post offices” reduced by half (approx. 2,000)</li> <li>- Introduce charges for services for the blind</li> <li>- Surcharge fro mail to and from Spitsbergen</li> </ul> </li> </ul>
Cost & revenue effects	<ul style="list-style-type: none"> <li>• Revenue effects are taken into account in determining the reference scenario</li> </ul>
Result (2006)	<ul style="list-style-type: none"> <li>• NOK 253m (US\$ 50m) / 2.3 % of operating expenses</li> </ul>

# USO Costing Methodologies

## Switzerland: Swiss Post

Purpose	<ul style="list-style-type: none"> <li>• Legislation requires report of “infrastructure contribution”</li> <li>• No external funding</li> </ul>
Services or service elements considered	<ul style="list-style-type: none"> <li>• Branch network: mail acceptance and sales, including financial services</li> <li>• Mail transportation</li> <li>• Delivery</li> </ul>
Cost concept	<ul style="list-style-type: none"> <li>• Branch network and transport: Incremental costs</li> <li>• Delivery: Difference between average delivery costs in “high-density” areas (per household) and actual delivery costs in “low-density” areas</li> </ul>
Reference scenario without USO	<ul style="list-style-type: none"> <li>• Branch network and transportation: # of retail outlets from 2,500 to 600 (benchmark: bank counters)</li> <li>• Delivery: Coverage from 100% of households to 70% (benchmark: private newspaper delivery)</li> </ul>
Cost & revenue effects	<ul style="list-style-type: none"> <li>• Not considered</li> </ul>
Result (2007)	<ul style="list-style-type: none"> <li>• ~ CHF 500m (US\$ 501m) / 7.8% of operating expenses</li> </ul>

# USO Costing Methodologies

## Lessons from Practice in Europe

- Two categories of approaches
  - Older approaches relate to “product” accounts, (= no explicit reference scenario)
  - More recent approaches relate to elements of the USO (= explicit reference scenario)
- Consensus in recent models: Profitability cost approach
  - Calculate change in incumbent profits due to relaxing the USO
  - How would the USP change service levels if 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

# USO Financing in European

- Original Postal Directive (1997)
    - Member State allowed to preserve monopolies “to the extent necessary to ensure the maintenance of universal service”, plus maximum weight and price limits
  - 2011 (Third Postal Directive)
    - “Where a Member State determines that the universal service obligations, as provided for in this Directive, entail a net cost [...] and represent an unfair financial burden on the universal service provider(s), it may introduce:
      - (a) a mechanism to compensate the undertaking(s) concerned from public funds; or
      - (b) a mechanism for the sharing of the net cost of the universal service obligations between providers of services and/or users.”
- (Article 7.3, Directive 2008/6/EC)

# USO Financing Options

- USO Funding necessarily is a second step
- First step must be to prove that there is a USO net cost at all

## Monopoly

- Pro
  - No change needed
- Con
  - Difficult to balance value to need
  - May not raise sufficient funds
  - No incentives for USP to reform
  - Difficult and costly to police

## Compensation fund

- Pro
  - All customers contribute according to their demand
- Con
  - Costly to operate
  - May not raise substantial funds
  - Violates 'tax incidence rule': Senders pay what government has 'ordered'

## State budget

- Pro
  - Accords to 'tax incidence rule': Government set rules, and pays for outcome
  - Least transaction cost
- Con
  - Adds to public spending, may increase deficits

- USO net costs provide sound conceptual basis for safeguarding universal service in a liberalised market
- Emerging consensus on methodology for USO net cost in Europe (and the USA) – but complex technical exercise!
- If any ,unfair‘ USO net cost exists, direct subsidies appear superior to compensation funds





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