Application to Commission for Communications Regulation to increase prices for Reserved domestic services

12 August 2005

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Introduction and Summary

Having traded profitably without interruption since 1992, An Post recorded operating losses in 2001 and 2002. In 2003 it recorded an operating loss of €42.9m, its highest ever loss. There were a number of reasons for the deterioration in the company's performance, the primary one being the fact that standard postal prices had been frozen for over a decade while the same period saw continuous growth in wage costs resulting from the series of Social Partnership agreements. Labour costs represent over 70% of total An Post costs. Accordingly, pay inflation is the primary driver of An Post cost growth. Pay inflation from 1 January 1991 to 31 December 2003 was 64%, excluding Sustaining Progress. To put it in other terms: in 2003, the company incurred an additional cost of approximately €190m arising from national pay agreements in the period 1991-2003. The impact of wage inflation, the price freeze, and the emergence of a decline in mail volumes combined to create a financial crisis in An Post, the full extent of which emerged in the second half of 2003.

At the instigation of the Minister for Communications, Marine, and Natural Resources, the Board and Management of the company prepared a Strategic Recovery Plan which was submitted to the Minister on 30 September 2003. While the Strategic Recovery Plan incorporated a comprehensive programme to address the performance of the company, it was founded on a number of key dimensions:

- the implementation of major change programmes throughout the company's operation with clear cost reduction targets;
- generation of additional revenue through increases in postal prices and business development initiatives;
- the achievement of improved quality performance and customer service.

The delay in progressing negotiations with the largest trade union led to the prospect of the non-achievement of targeted pay savings in 2003/2004. In these circumstances, the company was required to avail of the inability-to-pay clauses of the current Social Partnership Agreement, although it did so reluctantly.

Following the implementation of emergency measures (in particular the non-payment of Sustaining Progress) and with the successful control of pay and non-pay cost, the 2004 outturn was better than originally projected in the Strategic Recovery Plan. However, the fundamental difficulties facing An Post carried forward into 2005, in particular the continuing delays in the implementation of the change programmes at the heart of the Strategic Recovery Plan.

In July 2005, the Labour Court issued recommendations concerning the extent of and payment for change and the payment of Sustaining Progress. With regard to the change proposals, the Labour Court stated that it believes the proposals `provide the best possible approach to achieving the necessary modernisation and change which An Post must attain so as to deliver an efficient and viable service'. With regard to the payment of Sustaining Progress, the Court found that the remaining element of Sustaining Progress could be paid if there was agreement on the draft change programme. These recommendations provide clarity for An Post on the future wage bill and on the extent of cost savings that can be achieved from current programmes. The full payment of the wage increases provided for under Sustaining Progress will increase the An Post cost base by approximately €60m in 2006, which is approximately 8% of 2004 turnover. By contrast, the maximum cost reductions which can be achieved by the implementation of the proposed change programmes (net of productivity payments) as recommended by the Labour Court is in the region of €30m.

The price application which has been submitted to ComReg relates to the Reserved domestic business. This business segment was heavily loss-making in 2003, recovered somewhat in 2004 due to the implementation of emergency measures, and will again be heavily loss-making going forward unless the price application is approved. In the absence of the price increase sought, the loss will be of the order of €40m in 2006, a result that would fundamentally undermine the viability of the business and the provision of the Universal Service Obligation. With the proposed price increases, the Reserved domestic business would break-even in 2006.

The headline price increases proposed are the following:

Service	Current Price, €	Proposed price, €
Letter <100g stamp	0.48	0.60
Letter <100g meter	0.48	0.55
Letter <100 g bulk	0.48	0.54
Flat <100g	0.60	0.90
Packet <100g	0.96	2.00

The prices proposed are based on a continuation of the restructuring of prices along format-based lines. The introduction of an automatic discount for meter and bulk posters of letters <100g is an important innovation, which reflects the relative processing cost for the different payment methods and will stimulate the meter and bulk markets.

The proposed increases in postal prices must be seen in the context that postal prices remained constant or fell in the 12 years from 1990 to 2002. In the period from 1990 to 2004, consumer price inflation (CPI) was 47%, CPI services inflation was 73%, while inflation in the price of the basic stamp was 26%. In short, other services have passed on to the customer increases in wage costs, while An Post has not. The strong growth in demand for mail services throughout the 1990s enabled An Post to carry this increasing cost without incurring losses. However the current conditions of stagnating or falling volumes render such an approach completely unsustainable now. These demand conditions are replicated throughout developed economies and are predicted to continue.

In international terms, with the proposed price increase An Post maintains one of the cheapest rates in Europe for letters at the 50g and 100g weight-steps and moves to just below the EU-15 average for letters from 0-100g overall. This is before consideration is given to the significant payment-method discounts for meter and bulk.

In conclusion, substantial progress has been made in the implementation of the Strategic Recovery Plan since 2003.

- Following a detailed independent end-to-end audit of quality of service performance, An Post has a plan in place to meet ComReg's quality of service targets. Although the task ahead is considerable, improvements in quality of service have already been registered by the independent monitors of both An Post and ComReg. The latest figures from the ComReg monitor (Q1 2005) show a 6 percentage point improvement over the corresponding period in 2004.
- Following a process of almost two years of focussed and sustained engagement, the Labour Court Recommendations (12 July 2005) show a clear way forward for the delivery of change and efficiency and provide a clear quantification of the future wage bill.
- Significant cost reductions have already been achieved through tight management of non-pay expenditure and the implementation of other change programmes. This has resulted in: reductions in non-pay spend from €209m in 2003 to a forecast figure of €196m in 2005; labour costs have reduced from €480m in 2003 to a forecast figure of €454m in 2005 (for comparison purposes this excludes impact of Sustaining Progress in 2005); a reduction in staffing of approximately 700 full-time equivalents.
- Significant progress has been made in Non-USO revenue generation, including the disposal of business assets at market-leading prices, which will fund the cost of voluntary redundancies through the change programme.

Progress on all of these fronts is necessary but not sufficient to the achievement of the Strategic Recovery Plan. A further domestic price increase in 2005 was always a fundamental component of this Plan in order to achieve financial viability for the USO and this remains the case.

Context: Why the present price increase is required; An Post financial performance and projections, 2000-2006

Rapid deterioration in financial position, 2000 to 2003

Table 1: An Post financial operating performance, 2000 to 2004, €m

	2004	2003	2002	2001	2000
Turnover	750.2	709.2	683.7	624.9	572.9
Operating costs	748.4	752.1	701.1	631.6	563.1
Group operating profit/(loss)	1.8	(42.9)	(17.4)	(6.7)	9.8

Having traded profitably without interruption since 1992, An Post recorded operating losses in 2001 and 2002. In 2003 it recorded an operating loss of €42.9m, its highest ever loss. There are a number of reasons for this performance, in particular the following:

- As outlined below, standard postal prices remained at the same level for over a decade, i.e. there was no increase in the price of a basic letter either within Ireland or to the UK between 1991 and 2002. The emerging situation in 2001/2002 would have required a rapid substantial price increase, but as a regulated company An Post did not have this flexibility.

- The same period saw continuous growth in wage costs as determined by the series of Social Partnership agreements. Labour costs represent over 70% of total An Post costs. Accordingly, pay inflation is the primary driver of An Post cost growth. Pay inflation from 1 January 1991 to 31 December 2003 was 64%, excluding Sustaining Progress. To put it in other terms: in 2003, the company incurred an additional cost of approximately €190m arising from national pay agreements in the period 1991-2003.

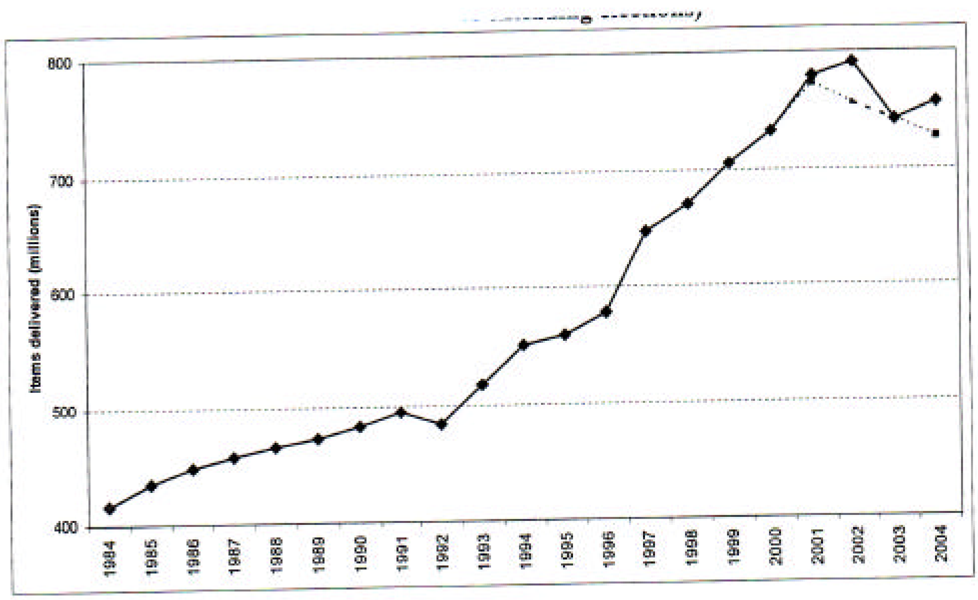
- The combination of the above factors with a rapid fall in volume growth after 2001 pushed An Post into a situation where it was recording substantial losses. Mail volume growth had been strong throughout the 1990s: measured in terms of the number of items delivered, mail volume grew by 5% per annum on average between 1992 and 2002. Since then there has been a marked downturn in mail volumes, as shown in Table 2 below.

While there were other contributory factors, including losses on inbound international mail (which itself was due primarily to low domestic tariffs, given the terms of the REIMS Agreement which fixes terminal dues as a proportion of domestic tariffs), the above are the principal factors explaining the rapid deterioration in the An Post financial position from 2000 to 2003. An Post is a network business with high fixed costs. Strong volume growth, driven by national economic performance, allowed An Post to absorb cost increases throughout the 1990s without passing them on to the consumer in terms of higher prices. When volume growth weakened, this was no longer sustainable.

Table 2: Volume growth rates, 2001-2004

	%o change, . 2001-2002	% change 2002-2003	% change 2003-2004
Items-delivered[1]	1.4%	-6.1%	2.0%
Items (excl.election)	-2.2%	-1.9%	-2.1%°
Total item	2.2%	-5.5%	2.3%
Total items (excl.election)	-I.2%	-1.6%	-1:4%

Figure 1: Volume of mail items delivered 1984 to 2004, including elections (Note: Dashed line 2001-2004 show volumes excluding elections)



Implementation of Strategic Recovery Plan

The enormity of the financial difficulties facing An Post emerged fully during 2003. Under newly-appointed management, in mid-2003 the company immediately set about developing the Strategic Recovery Plan, which was approved by the Board in September 2003 and subsequently submitted to the Minister for Communications, Marine and Natural Resources. The detail of the Plan was communicated extensively to staff and trade union representatives. The Plan fully confronted the crisis situation in which An Post found itself and required the implementation of a substantial change programme, involving the introduction of new arrangements for collection and delivery, a significant reduction in staff numbers through voluntary measures, and the

[1] This measurement of mail volume excludes outbound international mail, which is not delivered by An Post.

achievement of savings from the investment in automation. The objective of the Plan was to return the company to break-even in 2005.

The delay in progressing negotiations with the largest trade union on collection and delivery arrangements led to the prospect of the non-achievement of targeted pay savings in 2003/2004. In those circumstances, and given a claim from the trade unions that the company should pay the wage increase under the first phase of Sustaining Progress, the company had no option but to inform the trade unions in January 2004 that it would be availing, reluctantly, of the inability-to-pay clauses of the current Social Partnership Agreement. The company indicated that it wished to pay these increases but that it could only do so where there was a clear path towards achieving financial stability, a key element of which would be provided by a successful outcome to the change negotiations.

Financial progress in 2004, following implementation of exceptional measures

Following the implementation of emergency measures (in particular the non-payment of Sustaining Progress) and with strict management of pay and non-pay cost, the 2004 outturn was better than originally projected in the Strategic Recovery Plan. In some respects, the result for 2004 was encouraging and provided evidence that full implementation of the Strategic Recovery Plan could lead to a stabilisation of the An Post finances, including the ability to deliver the Universal Service Obligation (USO) on a financially viable basis going forward. However, the fundamental difficulties facing An Post carried forward into 2005, in particular, the continuing delays in the implementation of the change programmes at the heart of the Strategic Recovery Plan.

Recommendations of the Labour Court in July 2005

In 2005, the company has continued to push for the implementation of the change programmes. In February 2005, the Labour Court recommended the establishment of a Technical Group to assist in `identifying and reaching agreement on the best means of achieving the degree of change and cost savings needed to ensure the continued viability of the company'. Also in February 2005, the Labour Court recommended the appointment of independent assessors to report on the economic, commercial, and employment circumstances of An Post, assessing the ability to pay Sustaining Progress.

The assessors concluded in May 2005 that the company could not, in the absence of rationalisation and restructuring, meet the Sustaining Progress pay costs `in full or substantially', but that `in the light of management efforts to date to get cost and profitability disciplines into the company' S% of Sustaining Progress could be paid with effect from 1 January 2005. The company implemented this recommendation in June 2005.

In July 2005, the Labour Court issued its recommendations in relation to the reports of both the assessors and the Technical Group. In reporting to the Court, the Technical Group set out in the form of a draft agreement ‘the terms on which work practice change should be introduced'. The Labour Court has recommended that this draft agreement be accepted, stating that it believes the proposals `provide the best possible approach to achieving the necessary modernisation and change which An

Post must attain so as to deliver an efficient and viable service'. With regard to the assessors' report on the payment of Sustaining Progress, the Court accepted the assessors' conclusions and proceeded to find that Sustaining Progress could be paid if there was agreement on the draft change programme put forward by the Technical Group, i.e. that this agreement would meet the requirement for rationalisation and restructuring. The Court accepted that an increase in postal tariffs is 'an essential element of the company's overall recovery plan'.

Cost implications of national wage agreements

Post is a uniquely labour-intensive utility business in modern economies. The effect of centrally-determined wage increases on the economics of the business is enormous. The full payment of the wage increases provided for under Sustaining Progress will increase the An Post cost base by approximately €60m per annum in 2006, which is approximately 8% of 2004 turnover. By contrast, the maximum efficiency saving which can be achieved by the proposed change programmes (net of productivity payments) is in the region of €30m. In other labour-intensive service industries, the rising cost of labour has been passed on to the consumer in the form of higher price increases, whereas the real price of postal services has remained artificially low, which makes the business unviable and also represents a barrier to competition.

Financial viability of the Reserved domestic area, 2000-2006

This price application which has been submitted to ComReg relates to the Reserved domestic business[2]. The turnover, expenditure and profit/loss for the Reserved domestic portion of the business from 2002 to 2004 are shown in Table 3 below. Table 3 indicates that the Reserved domestic services moved from a loss of €9m in 2002 to a loss of €28.3m in 2003. In 2004 the position improved to a loss of €7.9m, excluding the 2004 election (including the election, a loss of €1.5m was recorded). The improvement from 2003 to 2004 was primarily due - as per above - to the nonpayment of Sustaining Progress and tight restriction of non-pay expenditure. ComReg has been provided on a confidential basis with business forecasts for the Reserved area for 2005 to 2007. The key drivers of the forecasts are the projected increased wage bill of €80m in 2007, the projected efficiency savings, and the underlying volume trends in the market (see discussion below). The extent of the losses that would be recorded in the absence of the price increase would be of the order of €40m in 2006, which would fundamentally undermine the viability of the business and the provision of the Universal Service Obligation. With the proposed price increases, the Reserved domestic business would break-even in 2006.

Table 3: Financial details for An Post Reserved[3] domestic business, 2002-2004

[2] The Reserved area covers domestic items up to 100g and up to 3 times the basic tariff.
[3] Note that there was a change in the definition of the Reserved area from January 2003 and that the definition of the Reserved area will change again in January 2006. The figures in Table 3 show the Reserved area as in the period 2003-04.

	2002	2003	2004
Turnover €m	224.5	217.5	225
Expenditure €m	233.5	245.7	232.9
Profit/loss €m	(9.0)	(28.3)	(7.9)
Profit / loss %	(4.0%)	(13:0%)	(3.5%)

Price increases sought

Description of increases sought

An Post herewith formally applies to ComReg to increase prices in the domestic Reserved USO as set out in Appendix 1 and summarised below:

- The current retail price for a letter item up to 100g is 48 cent. The proposal is to increase this to 60 cent. An automatic discount of 5 cent per item will be applied to customers using meters. An automatic discount of 6 cent per item will be applied to Ceadunas[4] customers. These discounts reflect the fact that the end-to-end processing of meter and Ceadunas items are lower than the end-to-end processing of stamp mail. The current An Post proposal passes these cost savings onto customers.

- The current price of a `flat' item up to 100g is 60 cent. The proposal is to increases this to 90 cent.

- The current price for a `packet' item up to 100g is 96 cent. The proposal is to increase this to €2.

- The current prices for the Business Reply service up to 100g are 48 cent, 60 cent and 96 cent respectively for letter, flat and packet items. It is proposed to increase these prices to 54 cent, 90 cent, and €2 respectively.

- The current prices for letter items up to 100g under the Postaim service range from 28 cent to 38 cent. Under the proposed prices set out in Appendix 1, the range will be from 31 cent to 40 cent. The current prices for flat items up to 100g under the Postaim service range from 35 cent to 45 cent. Under the proposed prices set out in Appendix 1, the range will be from 40 cent to 48 cent. The current prices for packet items up to 100g under the Postaim service range from 60 cent to 70 cent. Under the proposed prices set out in Appendix l, the price for packets under the Postaim service will be €1.79.

[4] Ceadunas customers have an individual licence number which appears on the envelope in place of a stamp or meter frank.

Current proposal a progressive step in phased restructuring of postal prices

The current proposal continues the significant restructuring of postal prices that An Post has embarked on since 2002. The main features of this process so far can be summarised as follows:

- Phased increases of price levels to address the fact that the core services have been substantially under-priced.

- A switch from purely weight-based price structures to a format-based price structure, which has different prices for letter, flat and packet items, reflecting the fact that flats and packets cost more to process[5] than letters. Corresponding to this there has been a reduction in the number of weightsteps, with customers benefiting from price cuts in some cases.

- In tandem with the re-organisation of retail tariffs in its 2003 price changes, An Post completely revamped its service offering of discounts for bulk users. Previously there had been only 2 discount services. In September 2003, An Post introduced a range of 12 discounts (each covering letter, flat and packet items), designed to facilitate specific customer needs[6]. Discounts of up to 9 cent for letters up to 100g are currently available for bulk mail. Previously bulk discounts had been confined to Ceadunas customers posting a minimum of 2,000 items per posting. The new discount services are also available to meter customers meeting the volume requirement and 2 of the 12 services were specifically designed for meter customers, with a reduced volume threshold of 500 items.

The restructuring of prices has a number of objectives. The prime objective is to return the services under the An Post Universal Service Obligation (USO) to a financially viable footing. An Post prices must also be geared to cost in order to give the correct economic incentives to postal users and thereby to stimulate sustainable volume growth, mitigate the impact of e-substitution, and to compete effectively in the increasingly liberalised market.

Discussion of current proposals

The current proposals must be viewed in the light of these objectives. The key features of the proposals are as follows:

[5] For the purposes of this application, `process' refers to the end-to-end process from sale/collection to final delivery.

[6] As with retail prices, discount prices must reflect the economic cost to An Post of providing the services in question. Accordingly, the discounts offered are calculated on the basis of combining a number of factors that affect cost, namely: time of posting; whether delivery is `next day' or `deferred'; whether the mail is pre-sorted or not; whether the mail is machineable; and the extent to which machineable mail can be automatically sorted. (`Machineable' means that the mail can physically be processed by An Post's sortation equipment rather than requiring manual handling. The extent to which machineable mail can successfully be read by the sortation equipment depends on the clarity, positioning and accuracy of the address.)

- The 25% increase in the headline letter price from 48 cent to 60 cent is necessary in order to align the price with cost.

- Up to now, the price has been constant across all payment methods, i.e. stamp, meter and Ceadunas. However, the processing of meter and Ceadunas mail involves less cost than stamped mail. There has, in effect, been a crosssubsidy from meter and Ceadunas customers to stamp customers and the proposed discounts for meter and Ceadunas, relative to the headline retail rate, represent an important innovation which corrects this inherent cross-subsidy and gives a more accurate economic signal to the market. An Post believes that this proposal will be particularly beneficial to small businesses. While the increase for the stamped letter up to 100g will be 25%, the increase for the corresponding meter item will be 14.6% and the increase for the Ceadunas item 12.5%.

- The current proposal involves a substantial re-balancing of flat and particularly packet prices relative to letters. Flat and packet services up to 100g were heavily loss-making in 2004. The increases are necessary to gear prices to cost, as is required in the legislation. This rebalancing unavoidably requires large increases in the prices of these services. The headline rate for flats up to 100g will rise by 50% and the rate for a packet up to 100g will rise by 108.3%. (Full details of all price increases in percentage terms are given in Appendix 1.) The necessity for further rebalancing of flat and packet prices relative to letter prices has been clear since An Post first embarked on its reorganisation of postal prices. See further discussion below.

- As a consequence of the increase in the packet price up to 100g, the service at this price will no longer be reserved to An Post. Reducing the Reserved area represents an advance liberalisation of the market.

- The revised bulk discount services, introduced by An Post in September 2003, have been highly successful. The level of the bulk discounts will not be changed at this time. The discounts for the meter and Ceadunas payment methods will be in addition to existing bulk discounts. Accordingly, the final bulk discounted price will rise in each case by 6 cent for Ceadunas customers and 7 cent for meter customers.

- An Post does not intend to change the terms and conditions associated with bulk mail discounts at this time, except in the following respect. The threshold at which meter customers can avail of the discounts designed for small users will be reduced from 500 items to 350 items. This is specifically intended to stimulate demand among smaller volume customers. Take-up of bulk discounts by meter customers to date has been very low. One of the motivations in introducing the payment-method discount described above is to provide automatic cost-reflective discount to meter users, which should stimulate meter use.

- An Post believes that a Postal and Logistics Users' Group would be a progressive means of assisting An Post in delivering on its commitment to business and institutional users, and is in advanced discussions with IBEC about the establishment of such a group.

- In order to encourage further the take-up of bulk discounts by meter users, An Post is proposing to engage systematically and proactively with small businesses and small business representatives on a nationwide basis in order to better inform small business about the discounts that are available and how best to access discounts. The objectives will be to stimulate mail volume and generate business value.

- As discussed above, An Post prices have moved from a weight-based structure to a more format-based structure in the last price changes. This is continued in the present proposals. Over the course of the next year, An Post will be making a study of the weight basis of pricing within the flat and packet formats, and one further round of structural adjustment may follow from this.

Historical development of postal prices

The proposed increase in postal prices must be seen in the context that postal prices remained constant or fell over the previous 12 years. This is set out in Table 4 below.

Table 4: Prices of basic stamp, 1990-2005

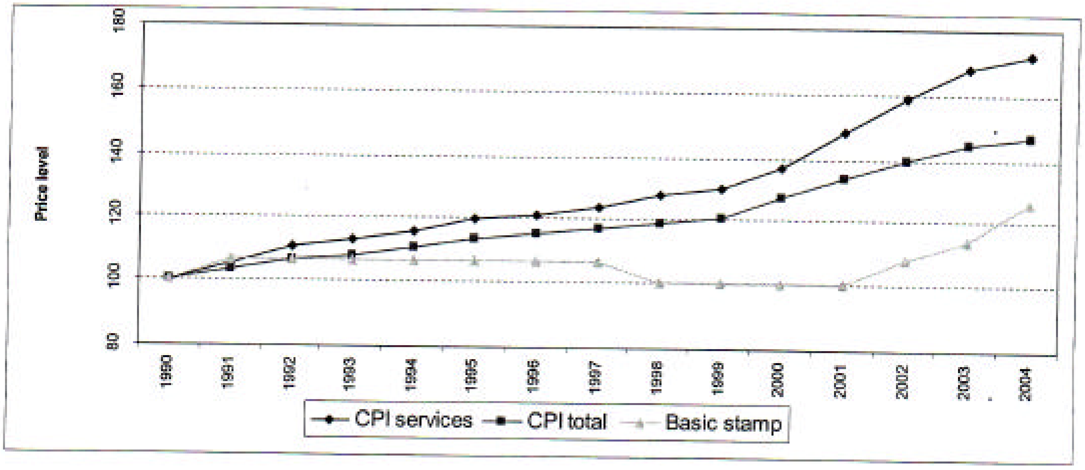
		1990	1991	1998	2000[1]	2002	2003[2]	2004	2005 (proposed)
(1)	Actual price in cent	38c	41c	38c	38c	41c	48c	48c	60c
(2)	Actual price in pence	30p	32p	30p	30p	-	-	-	-
(3)	Price of a basic stamp in real terms (1990 prices[3])	38c	39c	30c	28c	26c	29c	28c	33c

1: From April, 2002
2: From September 1, 2003
3. Based on CPI -services

Table 4 shows the historical development of basic postage stamp prices and how these prices have lagged inflation. Based on the CSO's CPI services index the price of a basic stamp has lagged inflation over the period 1990-2002 and has only started to catch up from 2003 onwards (row 3 above). With the current proposal basic postage remains cheaper than in 1990. In fact, basic postage would have to rise to over 65 cent in today's money to be on par with 1990.

Figure 2 below shows the price of the basic stamp, the total CSO Consumer Price Index (CPI), and the Services CPI from 1990 to 2004 in index form (1990=100). Over the period, the Services CPI index rose by 72.5%. This is a more appropriate comparator for postal prices than the total CPI, since postal services are highly labour intensive. Figure 2 shows that inflation in the services sector overall was almost 3 times higher than in postal services over the same period.

Figure 2: Price Level - CPI total, CPI services, Basic Stamp; 1990 to 2004; 1990=100



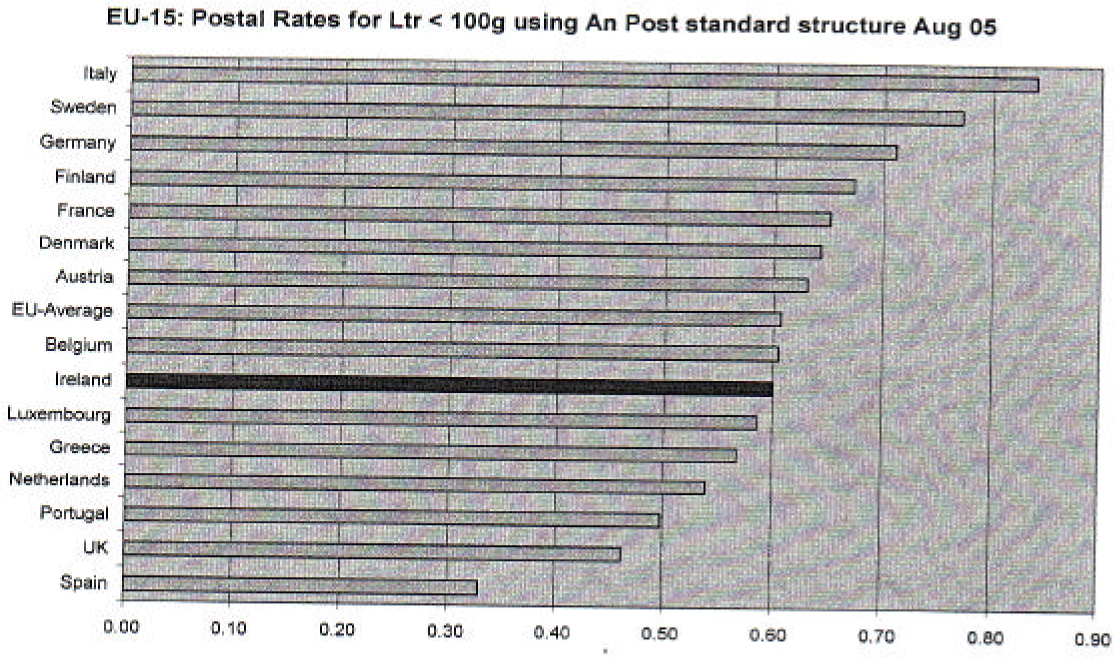
International benchmarking

Appendix 2 shows the proposed basic stamp price of 60 cent in comparison with corresponding prices for the EU-15 countries. (The new Member States are excluded given the generally large differential in national income and price levels between them and the previous 15 Members.) Ireland is the only country of the 15 in which the price of a basic stamp applies up to 100g, so comparisons are required at 20g, 50g and 100g.

- At 100g, the An Post proposed price of 60 cent is the 2°d cheapest in the EU15. It compares with top-end prices of €1.50 and €1.44 in Italy and Germany respectively and is only 59% of the EU-15 average of 96 cent. The UK price is 67 cent (May 2005 exchange rate).
- At 50g, 60 cent is the 3" cheapest price of the EU-15, comparing with prices of €1.40 and €1.20 in Italy and Sweden respectively and only 79% of the EU15 average price of 76 cent.
- At 20g, 60 cent is 15% above the EU-15 average, with Sweden, Italy, Finland and Denmark all having an equal or higher price.
- On a weighted average basis, covering all letters from 0-100g, Figure 3 shows that An Post's 60 cent is just below the EU-15 average of 61 cent. (The

weights are based on An Post composition of demand for three weight steps up to 100g.)

Figure 3: International benchmarking results



As is clear from the above, with the proposed price increase An Post maintains one of the cheapest rates in Europe for letters at the SOg and 100g weight-steps and moves to just below the EU-15 average for letters from 0-100g overall. This is before consideration is given to the significant payment-method discounts for meter and Ceadunas.

It is important to note that consumer prices in general in Ireland are high by EU standards. The level of consumer prices in Ireland is currently estimated to be the most or second most expensive in the EU (see, for example, *Forfas Consumer Pricing Report 2003).* In this context postal prices remain extremely affordable for Irish consumers (see discussion of affordability below).

Compliance of proposed prices with tariff principles

Compliance of *proposed prices with geared-to-cost requirement*

A comprehensive dossier of cost, volume and revenue data has been supplied to ComReg on a confidential basis in support of the price application. The key points are summarised below:

- **Letters <100g**
  The stamp payment method is heavily loss-making. The increase to 60c will significantly correct this. The meter and Ceadunas services recorded small positive margins in 2004. The proposed increases are necessary to take account of forecast cost increases.

- **Flats <100g**
  The flat service is significantly loss-making. The increase to 90c will correct this.

- **Packets <100g**
  The packet service is heavily loss-making. The increase to €2 is necessary to correct this.

With regard to flat and packet prices, the need for the proposed increases has already been flagged by ComReg. Commenting on the current price levels, ComReg has previously stated: `We have concerns about the viability of the large envelopes and packets segment and there will need to be a further realignment in the future' *(An Post's Proposals to increase the price of Domestic Postal Services 2003,* Document No. 03/65R2, June 2003).

With regard to letter prices, though all payment methods currently face the same retail tariff, it is clear that the cost of handling meter and Ceadunas letters is significantly lower than the cost of handling stamp letters. Given the economic imperative in a competitive liberalising market that tariffs be geared to cost, An Post considers it important to introduce now a payment-method discount for meter and Ceadunas users. This will assist volume growth in both the meter and Ceadunas segments by giving the correct economic signal to the market with regard to the relative cost of the different service options. ComReg has been provided on a confidential basis with detailed explanation of the cost differential between, stamp, meter and Ceadunas letters.

Comment on inbound international mail

It has previously been argued by commentators that the domestic postal consumer is subsidising overseas posters into Ireland. In this context, it should be made clear that the proposed price increase for the Reserved domestic area is not required because of losses in relation to inbound international mail. It is required in order to bring and keep prices in the Reserved domestic area itself in line with costs. However, because of the terms of the REIMS II contract (which calculates terminal dues for inbound mail as a proportion of the domestic tariff), the domestic increase will significantly improve the profitability of traffic under REIMS terms from 2007 onward, bringing this segment close to break-even. (Losses for inbound mail under the UPU will continue. These losses represent pure USO cost, since the rates are determined under an inter-Governmental treaty signed by the Irish Government.)

Compliance of *proposed prices with affordability requirement*

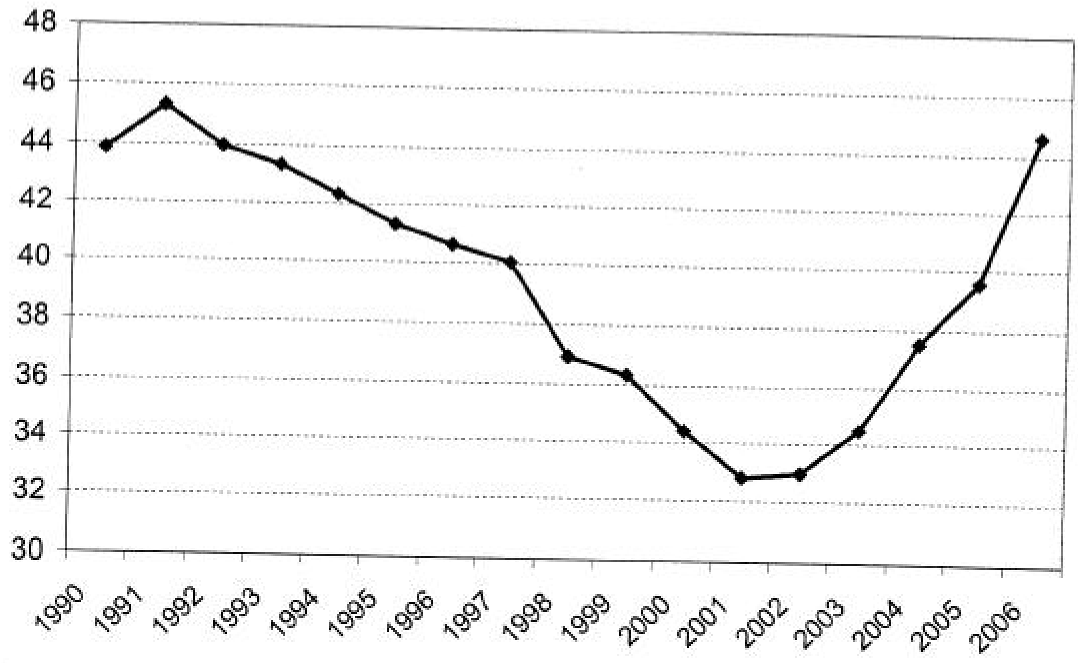
In addition to the requirement that they be geared to cost, which has been addressed above, legislation stipulates that An Post prices should be affordable. Affordability is related to:

- Price of the good/service in question relative to other prices.
- Proportion of household wealth spent on the good/service in question.

An Post is strongly of the view that the current and proposed prices for its Reserved domestic services are clearly affordable because the price is relatively low and makes up a very small proportion of household expenditures.

A starting point for this conclusion is to look at the real price of a basic stamp on an historical basis. Figure 4 shows that after years of falling real prices the current proposal returns the real price of a basic stamp in 2006 to slightly less than 1991 levels. In other words, basic postage with the current proposal will be cheaper than in 1991[7].

Figure 4: Real price of basic postage in 1996 cents



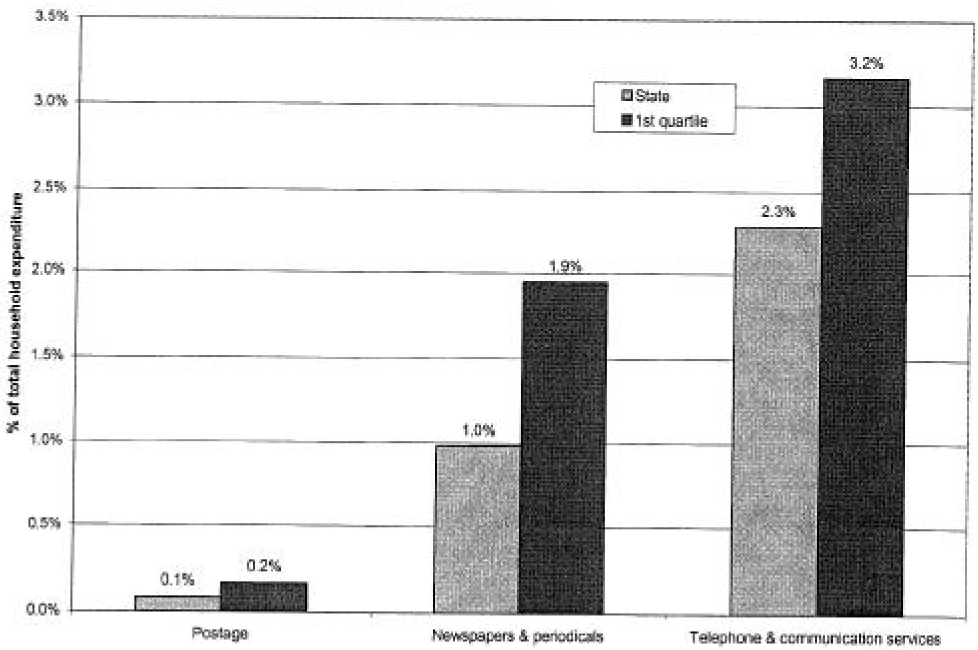
While the real price has declined substantially since 1991, two additional factors have dramatically improved affordability. First, the proportion of household income spent on basic postage is very small. Second, the price of postage for letters up to l 00g as a percentage of average hourly earnings in Ireland is much less than what is was in 1991.

According to the *Household Budget Survey 1999-2000* (CSO, 2001), average weekly household expenditure on postage was 50 cent in 1999-2000, which was 0.1% of total household expenditure[8]. Similarly, the base expenditure weight assigned to postage in the typical `basket of goods' making up the CSO's *Consumer Price Index is* currently 0.08%[9].

[7] Figures are weighted averages for intra-year price changes.
[8] As of May 2005 this is the most recent Household Budget Survey completed. However, it is estimated that this figure fell to approximately 0.080% by 2003, given that the price of the basic stamp has grown by less than average earnings since the survey was conducted.
[9] See *Consumer Price Index: Introduction of Updated Series* (CSO, 2002).

For further illustration of the relatively small weight of postage expenditures, Figure 5 below compares the share of Irish household expenditure on postage, newspapers and telephony in 1999/2000. Postage makes up a smaller proportion of household expenditures than other communications goods such as newspapers and telephony that are purchased on a daily basis. Figure 5 also shows the share for the lowest expenditure quartile of the economy (i.e. the quarter of households that spend the least). For this quartile, expenditure on postage accounted for 0.2% of total expenditure.

Figure 5: % of Household Expenditure Accounted for by Three Services, Averages for the State and Lowest Expenditure Quartile, 1999-2000

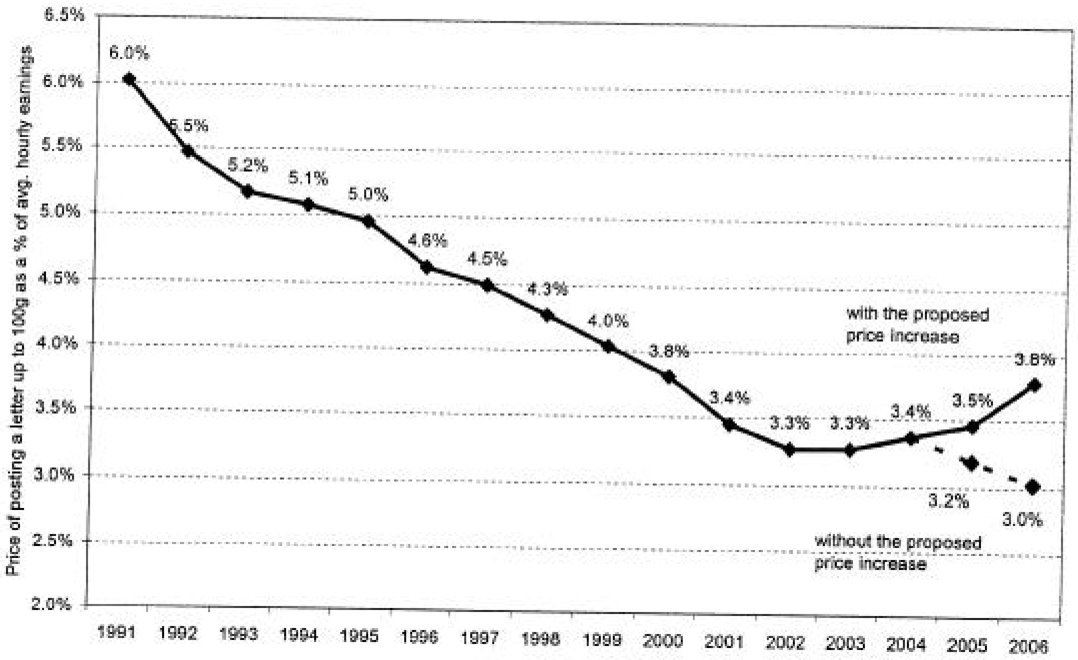


Source: Analysis of CSO Household Budget Survey, 1999-2000

Figure 6 below shows the price of postage for letters up to 100g as a percentage of average hourly earnings from 1991 to 2006. For the years prior to 2003, the price used is the weighted average price up to 100g based on 2001 volume weights. The earnings figures used are the average hourly industrial earnings for all industries from 1991-2003 from CSO Statistical Bulletins. For 2004 to 2006 earnings growth is based on the average earnings growth over the 1991-2003 period (+5.5% p.a.).

As per Figure 6, without the current proposal the price of standard postage would decline to 3.2% and 3.0% of average hourly earning in 2005 and 2006 respectively. With the current proposal those percentages are 3.5% and 3.8%. By comparison, the figure is 6.0% in 1991.

Figure 6: Price of postage for letters up to 100g as a % of average hourly earnings in Ireland, 1991-2006



Source: Analysis of CSO and An Post data.

In summary, with the current proposal:

- The real price of basic postage remains less than in 1991.
- Basic postage makes up a very small share of household expenditure, even for the poorest of households.
- Workers on the average industrial wage will require 3.8% of an hour's salary in 2006 to pay for basic postage versus 6.0% in 1991.

Finally, it is useful to consider affordability in the international context. Considering the affordability of standard postage in Ireland relative to the EU-15 (as discussed above), the price level for postage up to 1 00g would be just below the EU-15 average with the proposed increase. Noting that consumer prices in Ireland are among the highest in the EU-15, this indicates that postage is relatively more affordable in comparative international terms than other Irish consumer goods.

Discussion of volume trends

Mail volumes are declining internationally

Published information and expert analysis point irrefutably to declining core mail volumes in modern economies. UPU[10] figures show that industrialised nations have experienced static or declining volumes from 1999-2003 with further decline forecast for 2004-2008. Similarly, mails volumes in Europe have been static or declining since 2001 and are predicted to continue to decline between 2004 and 2009 as per a

[10] Postal Market 2004 - Review and Outlook, UPU, September 2004

2004 report undertaken for the European Commission[11]. This does not mean that there will not be instances of positive performance. Indeed, overall An Post volumes in 2004 were marginally up on 2003, while core volumes were down. However, such outturns do not negate the reality of the underlying international trend that faces public postal operators. France, Germany, Netherlands, Norway, New Zealand, and Switzerland all recorded negative growth in 2004 as per their official Annual Reports[12].

It is useful to cite the view of the European Commission on this matter in its March 2005 report to the European Parliament and Council. It concluded that `it is now clear that we are seeing the end of guaranteed future volume growth which had been a feature in the sector for the last 30 years. Postal operators can no longer anticipate the volume of mail that will enter their network every day and they need more flexibility to adapt their operations accordingly'[13].

Link between economic growth and mail volume growth now broken

Economic growth was previously regarded as a driver of mail growth. However, recent evidence and commentary by international experts[14] suggests that this link is now broken in developed countries. Domestic figures support this observation: although economic growth was buoyant in 2004, core mail volumes fell. Indeed, the effect of mail alternatives is likely to accelerate. IPC pinpoints e-substitution as the major reason for the decline in Dutch and Nordic mail volumes. Across Europe, the share of mail as a medium of communication is diminishing. Possible growth sectors, such as direct mail and the growth in the number of domestic delivery points, will not generate the income to offset decline.

Mail volumes per capita in Ireland

Irish mail volumes per capita fall slightly short of the EU average.WiK classified Ireland in the `medium' group of EU nations with regard to mail volumes per capita. (The `low' are mostly Eastern European countries. Other countries in the `medium' group include Spain, Portugal, and Italy, all of which have lower volumes than Ireland.) Our relatively lower level of mail volume per capita has been cited as evidence in itself of potential for significant growth, particularly in the direct mail sector. This is a very superficial observation. Demand for mail is a function of a range of social and economic factors, which vary from country to country. For example, mail volume per head in France is approximately 30% higher than the level in Germany, although the countries are similar in many respects, including economic income. This does not mean that per capita mail volumes in Germany can readily be increased by 30%. Similarly, levels in the US are almost double the levels in the

[11] Main Developments in the European Postal Sector - Study for the European Commission, DG Internal Market, July 2004.

[12] In the case of France, the source is a La Poste press release of 21 April 2005. Danish volume growth in 2004 was zero.

[13] Commission Staff Working Paper - Annex to the Report on the application of the Postal Directive 23.3.05, Section 4.3.

[14] WiK report for the European Commission `Developments in the European Postal Market', July 2004; IPC `Strategic Perspectives on the Postal Market 2005-2007', 2005; Nader for Pitney Bowes `Mail Trends', Dec 2004

Netherlands, but this cannot be taken to mean that there is scope in the Netherlands for a doubling of per capita mail volumes.

An Post campaign to stimulate postal volumes

An Post believes that there are segments of the market where demand can grow, including Direct Mail. Wherever there is such potential for revenue generation, the company is actively pursuing it. For example, An Post has made considerable and successful efforts to stimulate the bulk mail market through the introduction of a new range of innovative discounts. These discounts cater for a range of customers, from low-volume posters of ordinary mail to high-volume posters of high-quality mail achieving a high degree of automatic sortation. Following the introduction of bulk mail discounts, bulk mail volumes in 2004 were 10% higher than bulk mail volumes in 2003, with revenues up 15%. However, these gains have not been sufficient to offset losses elsewhere due to e-substitution.

Notwithstanding the underlying market dynamics, An Post is working to increase mail volumes. Initiatives currently in place include the following:

- working with bulk mailers to optimise their use of bulk mail discounts, e.g. through improved databases and improved presentation of mail;
- working with individual businesses to customise postal service offerings to support internal business processes
- promotion of bar-coded products such as Registered, parcel, SwiftPost, and SwiftPost Plus, targeting in particular key sectors that can deliver growth, including telecommunications, pharmaceuticals, ticketing, and travel agents;
- developing a new product portfolio for over-the-counter customers, which will remove duplication and promote clarity and ease of use; continuing roll out of the Autolynk product, which ensures that these services can be used more easily and more quickly;
- particular focus on direct mail as a significant opportunity for sustained volume growth; initiatives include
    - influencing decision-makers in Irish marketing agencies to shift from above-the-line investment to direct mail
    - countrywide educational seminars aimed at the SME sector facilitating easier access to creative fulfilment and distribution
    - actively working with major direct mail users to fine-tune products that will generate incremental volume
    - development of a retail agency agreement with SNAP;
- working with the home shopping industry to develop this sector in the Irish market, with particular focus on catalogue mailing and fulfilment; active development programmes with a number of key businesses in this sector.

Price elasticity effects

Detailed independent analysis of the effect of price changes on postal volumes has been supplied to ComReg on a confidential basis. Given the company's extremely difficult financial position and the international trends in mail volume demand, it is important that An Post takes a prudent view in relation to the effect on customer behaviour of price increases.

An Post successfully diversifying to offset effects of mail volume decline

As mail volumes fall, postal administrations are forced to seek revenue opportunities elsewhere as efficiency gains fail to make up the shortfall. For example, throughout Europe postal operators are attempting to leverage additional value-added from their retail networks.

For An Post, maximising revenue forms an important part of the Strategic Plan. An Post is now the country's single biggest provider of bill payment services through its network of post offices, bill payment retailers and agents with the total number of billpay transactions growing to 17 million during 2004 - over 20% of all post office transactions. Most encouragingly the service for bill payment has brought thousands of younger customers into increasing contact with their local post office and is helping to change substantially the age profile of postal retail customers.

In 2002, An Post started offering a range of banking services to AIB personal customers. AIB recently announced their intention to renew this alliance, labelling it ‘a big success’[15] with volumes doubling in the last year. Currently, 15% of AIB customers are estimated to have used this service. In 2004, An Post concluded new agreements providing for motor fines to be paid through outlets; selling Gift Vouchers; and trialling a motor tax express renewal service. An Post is exploring other business development and partnership opportunities such as ticketing opportunities, mobile phone services, and services to facilitate e-commerce.

An Post is currently reviewing its financial services strategy, to build on the success of our retail network and our subsidiary One Direct. This provides a range of insurance and financial services products to over 100,000 customers and primarily operates over the telephone and the Internet. The excellent technology platform in the An Post retail network provides an opportunity for future expansion and increased business through the development of a strong financial services portfolio.

An Post commitment to improved customer service

Quality of service target for single piece priority mail

In June 2004, ComReg set the quality-of-service standard for priority single-piece domestic mail at 94% next-day delivery (ComReg Document 04/56). In response to this, An Post submitted an updated internal performance-improvement plan and also committed to undertaking an operational end-to-end audit of performance to identify the failings in the network and to indicate the steps that need to be taken to achieve ComReg's target.

[15] AIB moves to expand on lucrative four year distribution deal with An Post' Sunday Tribune, 1 May 2005

The operational audit was undertaken by PA Consulting (PA). The principal tools were multiple site visits to points at each stage in the network, assessment of An Post operations against international best practice, detailed analysis of An Post management information and end-to-end / diagnostic results from quality monitoring, and the customisation and population of a network simulation model. PA also looked at customer issues and quality monitoring. An independent economic consultancy firm, Indecon, undertook an econometric analysis of quality success / failure as a function of process inputs and mail characteristics, updating the work previously undertaken and submitted to ComReg in 2002.

The exercise was a necessary one, and the findings validate the decision to undertake it. The output from the PA exercise was submitted to the An Post Board in April 2005 and shortly afterwards forwarded to ComReg. The following are some of the key points which have emerged:

- In order to achieve 94% on a consistent basis, there needs to be a fundamental re-organisation of how the network is operated at each stage in the pipeline. Failings have been identified in all elements of the pipeline.
- Although there are cost implications in the programme of improvement now to be implemented, the key point is that the changes needed for the next step relate to organisation rather than increasing resources per se. However, in characterising the changes as organisational, An Post does not underestimate the enormity of the task it faces. An Post needs to take a fundamentally different approach to quality of service, and the technical and cultural changes will take time to implement.
- An Post in conjunction with PA has developed a detailed implementation plan, which has been approved by the An Post Board and forwarded to ComReg.

Appendix 1

Appendix 1 (a): Price Increases Sought

Published Tariff Weight up to 100g	Current Tariff	Proposed Tariff	Proposed Discount	Net Tariff	% Increase
Letters					
- Stamped	0.48	0.60	-	0.60	25.0%
- Metered	0.48	0.60	0.05	0.55	14.6%
- Bulk	0.48	0.60	0.06	0.54	12.5%
Flats					
- Stamped	0.60	0.90	-	0.90	50.0%
- Metered	0.60	0.90	-	0.90	50.0%
- Bulk	0.60	0.90	-	0.90	50.0%
Packets 1					
- Stamped	0.96	2.00	-	2.00	108.3%
- Metered	0.96	2.00	-	2.00	108.3%
- Bulk	0.96	2.00	-	2.00	108.3%

1 These now become non reserved

Appendix 1 (b): Price Increases Sought

Business Reply Weight up to 100g	Current Tariff	Proposed Tariff	% Increase
- Letter	0.48	0.54	12.5%
- Flat	0.60	0.90	50.0%
- Packet	0.96	2.00	108.3%

Appendix 1 (c): Price Increases Sought

Postaim Letters	Volume Band							
	2-75k		75-250k		250-500k		500k+	
	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed
<10g (Postaim Lite)	0.32	0.34	0.30	0.32	0.29	0.31	0.28	0.31
<50g	0.34	0.40	0.32	0.38	0.30	0.36	0.29	0.36
50-100g	0.38	0.43	0.36	0.41	0.34	0.38	0.33	0.38

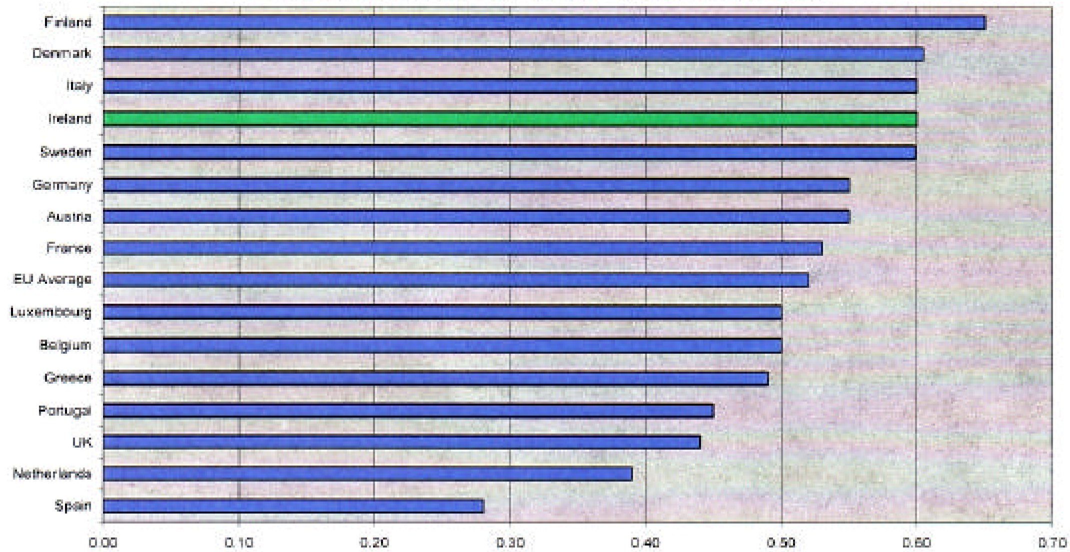
Postaim Flats	Volume Band							
	2-75k		75-250k		250-500k		500k+	
	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed
<50g	0.40	0.60	0.38	0.58	0.36	0.56	0.35	0.56
50-100g	0.45	0.65	0.42	0.62	0.39	0.60	0.38	0.60

Postaim Packets	Volume Band							
	2-75k		75-250k		250-500k		500k+	
	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed
0-100g	0.70	1.89	0.64	1.89	0.62	1.89	0.60	1.89

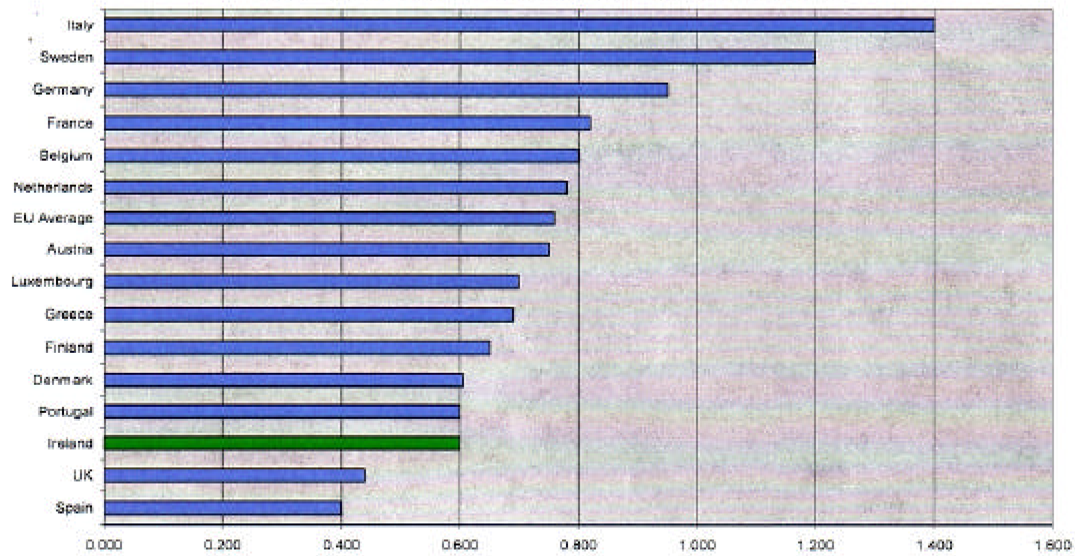
Postaim packets service is now charged at the full bulk packet price less the appropriate pre sort before noon discount

Appendix 2

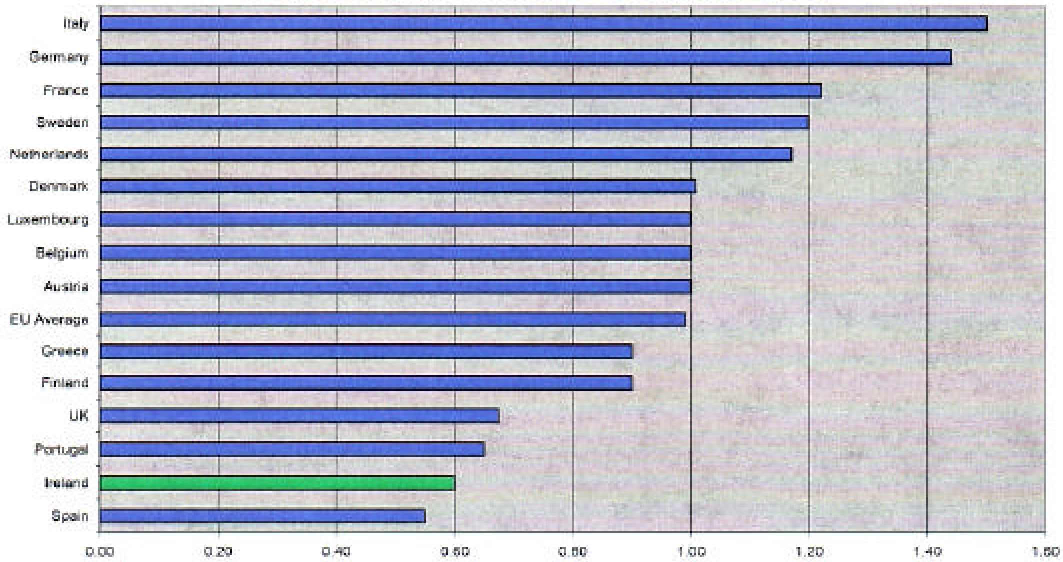
EU-15: Postal Rates for Letter - 20g (August 2005)



EU-15: Postal Rates for Letters - 50g (August 2005)



EU-15: Postal Rates for Letters - 100g (August 2005)



EU-15: Postal Rates for Ltr < 100g using An Post standard structure Aug 05