



Commission for
Communications Regulation

Consultation on ComReg's draft determination on the form and manner of any net cost request by the universal postal service provider under section 35 of the 2011 Act

Consultation and draft Determination

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1 Introduction

- 1 Arising from the Communications Regulation (Postal Services) Act 2011 ("2011 Act"), the current designated universal postal service provider, An Post, can submit a request for funding for the net costs of providing a universal postal service after the end of the first financial year following its designation as universal postal service provider. Consequently, from 1 January 2013, An Post can claim for funding of the net costs (if any) of providing a universal postal service for the financial period ending 31 December 2012. However, as noted by ComReg in its Postal Strategy Statement 2012 – 2014¹, given that any such claim for net costs must be audited, it is likely that any such claim for 2012 could not be made before June 2013, after the external audit of An Post's 2012 financial and regulatory accounts has been completed.
- 2 Furthermore, the 2011 Act requires that a request by An Post for funding of the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines and must be accompanied by any such information as may be reasonably required by ComReg.
- 3 Therefore, having regard to the applicable provisions of the 2011 Act, Annex 1 of the Postal Services Directive², and the recommendations made by ComReg's independent consultants, Frontier Economics, in its supporting report³, this consultation sets out ComReg's preliminary views on the form and manner of any net cost submission by An Post. The consultation also provides guidance on the information that would be required to support a net cost submission. The proposals and guidance are being made to ensure that any net cost submission made by An Post is evidence based and consistent with section 35 and Schedule 4 of the 2011 Act. It will also facilitate and enable ComReg's audit, verification and determination of any net cost submission by An Post as required by the 2011 Act.
- 4 This consultation does not concern how ComReg will determine whether the net costs (if any) represents an unfair burden or how any net cost, if an unfair burden, will be apportioned among postal service providers of postal services within the scope of the universal postal service. As set out in ComReg's Postal Strategy Statement¹, these will be addressed by a separate consultation which ComReg will issue later this year.

¹ ComReg Document No. 12/116 dated 30 October 2012

² Directive 2008/6/EC

³ ComReg Document No. 13/48a

2 Executive Summary

- 5 Arising from the 2011 Act, any request by An Post for funding of the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines and must be accompanied by such information as may be reasonably required by ComReg.
- 6 In this consultation, ComReg sets out its preliminary views on the form and manner of any request to seek to receive funding for the net cost (if any) of providing the universal postal service in accordance with section 35(2)(a) of the 2011 Act.
- 7 ComReg has also set out its proposed guidance with regards to the information that would be required to support a net cost submission. This is being done in order to provide the universal postal service provider, An Post, with as much guidance as possible to assist it in submitting any net cost application and to ensure any such application is evidence based and consistent with the 2011 Act as in accordance with the 2011 Act it is ComReg that will audit, verify, and determine whether there is a net cost if a claim for net cost is made by An Post. In order to make that audit, verification, and determination, ComReg will require detailed evidence based information from An Post and the 2011 Act empowers ComReg to obtain such information from An Post where it is not provided.

2.1 Background

- 8 In accordance with section 35(1) of the 2011 Act, a universal postal service provider may submit a request in writing to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service. According to Schedule 4 of the 2011 Act, the net cost of the universal service obligation (“USO”) is any cost related to and necessary for the operation of the universal service provision. Schedule 4 of the 2011 Act further provides that the net cost of the USO is to be calculated as the difference between the net cost for a designated universal service provider of operating with the USO, and the same postal service provider operating without the USO.
- 9 A request under section 35(2) of the 2011 Act must be such form and manner as ComReg determines and must be accompanied by such supporting information as may be reasonably required by ComReg.
- 10 This consultation sets out ComReg’s preliminary views on the form and manner of any net cost submission by An Post, made under section 35(2) of the 2011 Act.

2.2 Preliminary views on the form and manner of any net cost submission

11 Subject to the views of respondents to this consultation, the following are ComReg's preliminary views on the appropriate form and manner of any net cost submission made under section 35(2) of the 2011 Act:

a) The Profitability Cost (PC) approach is the appropriate methodology to calculate the net costs (if any) of providing the universal postal service as:

- The PC approach can capture the full complexity of a reference scenario.
- The PC approach can take account of all changes arising from modifying the USO.
- The PC approach is better at taking account of efficiency.
- The PC approach is an established methodology which has been widely used in Europe.

b) An Post defines the reference scenario:

The "reference scenario" is the key aspect of the PC method. Its development requires an assessment of how the universal postal service provider ("USP") would re-optimize its whole operation in the absence of the USO – i.e. it seeks to identify the changes to the current service provision that an USP would make if it were operating on an unconstrained commercial basis. ComReg proposes that An Post should develop the reference scenario as it is important that the reference scenario be informed by An Post's commercial knowledge and reflects how An Post would seek to reorganise its operations, absent the current USO, so as to maximise its profits. Also, as required by the 2011 Act, to ensure that only the efficient net costs of the USO are calculated, An Post must ensure that its estimate of the cost differences between the baseline and reference scenarios is on a like-for-like basis reflecting only differences associated with any changes in the service specification.

- c) The reference scenario is assumed to be a reduced USO under section 16(1)(a) of the 2011 Act:

In order to minimise the complexity for An Post in setting its reference scenario, ComReg proposes that the reference scenario set by An Post is assumed to be a reduced USO requested by An Post under section 16(1)(a) of the 2011 Act. Section 16(1)(a) goes towards the definition of the “universal postal service” as meaning that there shall be at least one clearance and one delivery to the home or premises of every person in the State, on every working day, except in such circumstances or geographical conditions as ComReg considers to be exceptional. For ComReg to consider whether exceptional circumstances or geographical conditions apply, for the purposes of section 16(1)(a), would require an application made to it by An Post.

- d) Use of bottom-up model based on LRIC if reference scenario departs significantly from the current USO:

If the reference scenario departs significantly from the current USO, ComReg proposes that it will be necessary for An Post to develop a “bottom-up model” in order to estimate the costs in the reference scenario as it would be difficult to estimate the applicable costs based solely on historic accounting data.

Also, as the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification, ComReg proposes that the cost concept of Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO as the concept of avoidable cost is more closely related to the cost concept of LRIC. This is a result of the fact that LRIC excludes fixed and common costs associated with an increment of output. In reality, the universal service provider would still need to pay such costs even if volumes fell as a result of a move to the reference scenario. Consequently, if a bottom-up operational model is required, it should be based on LRIC and ComReg, by this consultation, is proposing this as a requirement.

2.3 Proposed guidance on information required with net cost submission

- 12 Section 35(3) of the 2011 Act provides that ComReg may require, in writing, that the USP shall provide such additional information as ComReg specifies, relating to any request by the USP under section 35(1) for funding in respect of the universal service. ComReg considers it useful, and to the benefit of An Post, to provide guidance on the information that it is likely to require in order to determine if the universal postal service does represent a net cost to the USP, though ComReg reserves its right to make such additional information requests as it considers necessary, under section 35(3) of the 2011 Act.
- 13 Subject to the views of respondents to this consultation, Annexes 1 to 3 set out guidance that An Post should be cognisant of, in submitting a request for funding under section 35(1) of the 2011 Act. The proposed guidance covers:
- Guidance to An Post in setting its reference scenario
 - Guidance to An Post on measuring the revenues foregone and costs avoided by modification of the universal service
 - Guidance to An Post on taking intangible and market benefits into account

2.4 Conclusion

- 14 ComReg's determination on the form, manner and content of any submission made under section 35(1) of the 2011 Act, should facilitate and enable ComReg's audit and verification of any such submission made by An Post, as required by section 35(5)(b) of the 2011 Act. In accordance with the 2011 Act, ComReg shall determine whether the provision of a universal postal service by a USP represents a net cost.
- 15 In making its final determination on the form, manner and content of any submission made under section 35(1) of the 2011 Act, ComReg will carefully consider the information and views submitted by all respondents to this consultation. As noted in ComReg's published Consultation guidelines⁴, the purpose of a public consultation is to allow ComReg to consider the views of interested parties in reaching a decision. It should, however, be noted that the consultation process is not equivalent to a voting exercise and ComReg alone will form the final decision, or decisions, having had regard to all relevant information before it.

⁴ ComReg Document No. 11/34

3 Background

16 In forming its preliminary views on the form and manner of any net cost request made by the USP, ComReg has considered Annex 1 of the Postal Services Directive⁵ which provides guidance on calculating the net cost, if any, of the universal postal service and ComReg has also taken account of the relevant provisions of the 2011 Act. This is discussed further below.

3.1 Universal service obligations

17 In forming its preliminary views on the form and manner of any net cost request, ComReg first has to consider what has been set as a universal postal service. In this respect, the meaning of “universal postal service” is set out in section 16(1) of the 2011 Act, which provides, amongst other things, that “universal postal service” means that on every working day there is at least one clearance and one delivery to the home or premises of every person in the State except in such circumstances or geographical conditions as ComReg considers to be exceptional.

18 Section 16(1) also states that the universal postal service means providing the following services:

- i. The clearance, sorting, transport, and distribution of postal packets up to 2kg in weight
- ii. The clearance, sorting, transport, and distribution of parcels up to 20kg in weight
- iii. A registered items service
- iv. An insured items service
- v. Postal services, free of charge, to blind and partially-sighted persons.

19 Section 16(9) of the 2011 Act requires ComReg to make regulations specifying the services to be provided by the USP for the purposes of ensuring that the universal postal service develops in response to the technical, economic and social environment and to the reasonable needs of postal service users. Following public consultation, ComReg made and published the Communications Regulation (Universal Postal Service) Regulations 2012 in July 2012 ((SI 280 of 2012) (“the Regulations”) .

⁵ Which is included as Schedule 4 of the 2011 Act

20 In making the Regulations, ComReg specified a minimum set of universal postal services to meet the needs of postal service users, while also minimising the regulatory burden on An Post as the USP. For the most part, the set of universal postal services to be provided were the same as those previously set by ComReg in its working definition of universal postal services⁶. Furthermore, as can be seen in the summary below, the specified universal postal services are for the most part those services already required by section 16 of the 2011 Act:

- A single piece service involving the clearance, sorting, transport and distribution of letters, large envelopes, packets and parcels.
- Issuing free certificates of posting.
- A registered items (“proof of delivery”) service.
- An insured items service.
- A single piece service provided free of charge to the postal service user for the transmission of postal packets for the blind or partially sighted.
- A service for the clearance, transport and distribution of:
 - postal packets deposited in bulk “for delivery only”.
 - “foreign postal packets deposited in bulk” pre-sorted by country of destination.
 - “postal packets deposited in bulk” for “deferred delivery”.
- Business Reply.
- Freepost.
- A service for the clearance, transport and distribution of postal packets deposited with a universal postal service provider at an Office of Exchange within the State by the designated operator of a signatory to the Universal Postal Convention.
- The following special facilities for the delivery of postal packets are provided at the request of the addressee:
 - Private boxes and bags.
 - Redirection.
 - Poste restante.
 - Mailminder.

3.2 Calculation of net cost

21 In relation to calculating the net cost, if any, of the universal postal service, based on the guidance of the Postal Service Directive which is included as Schedule 4 to the 2011 Act and the relevant provisions of the 2011 Act, the following is relevant:

⁶ ComReg Document No. 05/85

Universal postal service must be provided in cost efficient manner

- 22 Schedule 4 of the 2011 Act states that National Regulatory Authorities (“NRAs”), such as ComReg, are to consider all means to ensure appropriate incentives for postal service providers (designated or not) to provide universal service obligations cost efficiently. This is reinforced by section 35(5)(ii) of the 2011 Act which requires ComReg to take into account, in its determination on any net cost submission, whether the universal postal service is being provided in a cost efficient manner.

Difference due to operating without the universal service obligations

- 23 Schedule 4 of the 2011 Act provides, the net cost of USO is any cost related to and necessary for the operation of the universal service provision. According to Schedule 4 of the 2011 Act, the net cost of USO is to be calculated, as the difference between the net cost for a designated universal service provider of operating with the USO and the same postal service provider operating without the USO.

Take into account all other relevant elements

- 24 According to Schedule 4 of the 2011 Act, the calculation of net cost shall take into account all other relevant elements, including any intangible and market benefits which accrue to a postal service provider designated to provide universal service, the entitlement to a reasonable profit and incentives for cost efficiency.

Correctly assess the costs that have chosen to be avoided

- 25 According to Schedule 4 of the 2011 Act, due attention is to be given to correctly assessing the net costs that any designated universal service provider would have chosen to avoid, had there been no USO. 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.
 - ii. Specific users or groups who, taking into account the cost of providing the specified service, the revenue generated and any uniform prices imposed, can only be served at a loss or under cost conditions falling outside normal commercial standards. This includes those users or group of users that would not be served by a commercial operator that did not have an obligation to provide universal service.

No double counting of costs and benefits

- 26 According to Schedule 4 of the 2011 Act, the calculation of the net cost of specific aspects of the USO is to be made separately so as to avoid the double counting of any direct or indirect benefits and costs.

ComReg verifies the net cost

- 27 According to Schedule 4 of the 2011 Act, the responsibility of verifying the net cost lies with the NRA. In this respect, section 35(4) of the 2011 Act confirms that ComReg, as the NRA for the regulation of the postal sector, determines whether the provision of a universal postal service by the universal postal service provider represents a net cost calculated in accordance with the guidance in Schedule 4 of the 2011 Act.

4 Preliminary views on the form and manner of any net cost submission

28 Taking account of the applicable provisions of the 2011 Act, the guidance given in the Postal Service Directive, and the recommendations⁷ made by ComReg's independent consultants, Frontier Economics, the following sets out ComReg's preliminary views on the form and manner of any net cost submission by the USP. In setting out its preliminary views, ComReg has also considered the practice of other European postal NRAs which was set out in Frontier Economics' study for the European Commission⁸ which documented how the net cost of the postal USO is calculated across Europe.

4.1 The appropriate methodology

29 Frontier Economics recently carried out a study for the European Commission which examined the current state of play in relation to the experience of USPs and NRAs in calculating the net cost of the USO in the postal sector.

30 The study identified that three main types of methodology have been used to calculate the costs of the USO in the postal sector:

- Deficit Approach with Fully Allocated Cost (DA);
- Net Avoided Cost (NAC); and
- Profitability Cost (PC).

31 Chapter 3 of the accompanying report by Frontier Economics for ComReg examines each of these possible methodologies and recommends the PC approach as the most appropriate methodology for any net cost submission by An Post. ComReg has assessed each of the possible methodologies in its draft Regulatory Impact Assessment (RIA) contained in this consultation and based on that draft RIA makes the following preliminary views.

⁷ See ComReg Document No. 13/48a

⁸ See http://ec.europa.eu/internal_market/post/doc/studies/2012-net-costs-uso-postal_en.pdf

Profitability Cost approach as the appropriate methodology

32 Having considered the recommendation of Frontier Economics, together with the applicable provisions of the 2011 Act, the guidance of the European Commission in its Postal Directive, the study conducted by Frontier Economics for the European Commission, and an assessment of the options as set out in the draft RIA of this consultation, ComReg is of the preliminary view that the PC approach is the methodology that An Post should use in any submission made by it under section 35 of the 2011 Act, for the following reasons:

- The PC approach can capture the full complexity of a reference scenario. This approach is not restricted by the status quo and allows for the modelling of a whole host of potential changes that an operator could make in the absence of the USO. The PC approach can model not only the potential withdrawal of certain USO products, but importantly it can also capture the effects of removing or relaxing specific elements of the USO.
- The PC approach can take account of all changes arising from modifying the USO. This includes direct effects on demand, costs, and market shares arising from changes in the USO.
- The PC approach is better at taking account of efficiency. This is important as the net cost calculation should not include the impact of inefficient operation in order to be in line with the Postal Directive and the 2011 Act.
- The PC approach is an established methodology which has been widely used in Europe to calculate the net costs (if any) of a postal USO, in some cases in the context of a funding application. This methodology has already been applied in practice in Denmark, UK, Norway, Slovakia, and the Netherlands.

Q. 1 Do you agree or disagree that Profitability Cost is the appropriate methodology to assess the net costs (if any) of providing the universal postal service? Please explain your response.

4.2 Implementing the PC approach

33 As set out in the accompanying report by Frontier Economics and the draft RIA included in this consultation paper, the PC approach measures the difference between a USP's profit level with and without the USO in a liberalised market. If the USP is compensated for this difference, the USP achieves the same profit as it would in the postal market without obligations. The PC approach therefore provides an estimate of the net cost of the USO which, if fully compensated, would make the designated USP indifferent about whether to provide the USO or not in a liberalised market.

34 The PC approach consists of four steps:

- the first step of the PC method is to define a reference scenario where the USP faces no obligations regarding the services it offers. This step involves identifying the part of the USO services that would not be provided or would be modified by a (profit maximising) USP, not subject to the USO;
- the second step is to calculate the costs that the USP would avoid should it move to the reference scenario;
- the third step involves calculating the revenues that would be foregone under the reference scenario as the product offering is modified compared to the base case. Both direct and indirect demand effects are expected to impact revenue in this reference scenario. The direct effect is the demand loss for products which would no longer be provided. The indirect effect is the impact of a change in one service on the demand for the other products of the USP;
- the final step of the PC method is to calculate the USO net costs as the difference between the USP's profit level with and without the USO.

Step 1: Defining the reference scenario

35 The reference scenario is the key aspect of the PC method. Its development requires an assessment of how the USP would re-optimize its whole operation (USO and non-USO) in the absence of the current USO. In the following, ComReg makes a number of proposals and seeks the views of interested parties on these proposals.

Propose that An Post develops the reference scenario

36 ComReg proposes that An Post develops the reference scenario as it is important that the reference scenario be informed by An Post's commercial knowledge and that it reflects how An Post would seek to reorganise its operations absent the current USO, so as to maximise its profits.

- 37 The reference scenario should set out the realistic counterfactual service offering that An Post would continue to provide if the current USO constraint were to be removed. It implicitly acknowledges that even without the constraints currently imposed by the USO, An Post would continue to run a postal business, albeit one that possibly offers a different set of products and one possibly configured on a different basis.

Q. 2 Do you agree or disagree that An Post should develop the reference scenario? Please explain your response.

Propose that the reference scenario represents a reduced universal service obligation under section 16(1)(a) of the 2011 Act

- 38 In order to minimise the complexity for An Post in setting its reference scenario, ComReg proposes that the reference scenario set by An Post is assumed to be a reduced USO requested by An Post under section 16(1)(a) of the 2011 Act. Section 16(1)(a) of the 2011 Act states that there shall be at least one clearance and one delivery to the home or premises of every person in the State, on every working day, except in such circumstances or geographical conditions as ComReg considers to be exceptional. For ComReg to consider whether exceptional circumstances or geographical conditions apply for the purposes of section 16(1)(a) would require an application made to it by An Post.

VAT exemption on universal postal services

- 39 As it is proposed that the reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act, ComReg is of the preliminary view that An Post, in setting its reference scenario, should deal with the VAT exemption on universal postal services by assuming that a USO would apply in both the baseline scenario and in the reference scenario. This proposal means that An Post would not have the complexity of:
- calculating the market benefit of the VAT exemption that applies to universal postal services. In accordance with Schedule 4 of the 2011 Act, this market benefit would be taken into account to calculate the net costs (if any) of providing the current USO.
 - calculating the effect of demand if the VAT exemption that applies to universal postal services no longer applied in the reference scenario. This would require detailed economic modelling providing substantial sensitivity testing around:
 - demand assumptions and price elasticity of demand effects

- acceleration in e-substitution
- entry / expansion by competitors.

Changes to the structure of the pricing of universal postal services

40 As it is proposed that the reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act, An Post's reference scenario will be subject to the tariff requirements of section 28 of the 2011 Act for its universal postal services. This includes the requirement for uniform pricing of universal postal services unless, in its reference scenario, An Post assumes that it has sought and received consent from the Minister under section 28(2)(b) of the 2011 Act to not offer a uniform price throughout the State. However, as noted by Frontier Economics, a change to the price structure is such a fundamental change to the product offering that it is likely to lie outside the range of commercial strategies that a USP would consider to be feasible or profitable. It is also likely that such a move would lead to substantial customer disruption and could impose substantial additional costs on An Post. Therefore, ComReg proposes that An Post should not include changes to the structure of the pricing of the universal postal services in its reference scenario. If An Post were allowed to include changes to the structure of the pricing of universal postal services in its reference scenario, An Post would be required to provide evidence in relation to:

- the additional costs An Post would incur in moving away from uniform pricing;
- the potential customer disruption it would cause, and the likely loss of brand value to An Post;
- the likely impact on entry/expansion by competitors;
- the likely impact on demand for mail services where the move away from uniform pricing has led to a substantial increase in price;
- if the removal of the uniform pricing leads to more negotiated prices, the impact of the loss of the VAT exemption as such negotiated prices would not be universal postal services
- the impact on e-substitution and competition.

Changes to the level of the pricing of universal postal services

41 With respect to changes in the price level, this is something that An Post may wish to consider as part of the development of its reference scenario. However, in the event that An Post considers that sizeable increases in price formed part of the reference scenario, An Post will need to provide significant supporting analysis. This would include analysis that demonstrates An Post is only including efficient costs in both the current and reference scenarios. An Post would also need to take into account the impact of higher prices on:

- customer demand
- an acceleration in e-substitution
- an acceleration in entry/expansion by competitors
- its compliance with the tariff requirements under section 28 of the 2011 Act.

Guidance to An Post in developing the reference scenario

42 In making the proposal that An Post takes responsibility for developing the reference scenario, Annex 1 of this consultation proposes guidance as to how the reference scenario should be set and the information that should be provided by An Post to support any reference scenario it may submit, so that ComReg can properly audit, verify, and determine the net costs (if any). ComReg would welcome views on this proposed guidance.

Step 2 & 3: Measuring the revenues foregone, costs avoided and change in the value of indirect benefits that result from the modification of the universal service

43 Once the reference scenario has been developed by An Post, the next step for An Post will be to calculate the net cost of the USO for ComReg's determination as to whether there is a net cost⁹. The net cost seeks to measure:

- revenues foregone by modification of the universal service;
- costs avoided by modification of the universal service; and
- the change in the value of indirect benefits that result from the modification of the universal service.

⁹ In accordance with sections 35(4) and 35(5) of the 2011 Act

44 To measure the first two of these effects, it will be critical for An Post to understand how volumes, market shares and costs depend on service specification. Therefore, in Annex 2, ComReg has proposed guidance as to how these should be calculated. In Annex 3, ComReg also provides guidance on taking intangible and market benefits into account. An Post should be cognisant of this guidance when calculating its net costs (if any) of providing the universal postal service to facilitate ComReg's audit, verification, and determination of the net costs (if any). ComReg would welcome views on the proposed guidance.

Propose use of bottom-up model based on LRIC if reference scenario departs significantly from the current USO

45 If the reference scenario departs significantly from the current USO, ComReg proposes that it will be necessary for An Post to develop a bottom-up model to estimate the costs in the reference scenario as ComReg considers that it would be difficult to estimate the applicable costs based solely on historic accounting data. This is because accounting data is unlikely to be suitable as:

- it is likely that the accounting data is not designed to estimate the costs of running the business with and without the USO. This also applies to activity based costing models which are often used to describe the costs of undertaking each pipeline activity and which do not relate explicitly back to each USO component. It is likely the accounting models do not provide the comprehensive set of cost drivers across all meaningful components of the USO, and therefore limits the relevance of the estimates.
- the extent that the accounting models do estimate cost elasticities associated with modifying or removing the USO, these are likely to be short run in nature and do not encompass the effects of re-optimising operations without a USO. This would limit the accuracy of the estimates.
- even if the costs and processes are accurately modelled in the financial models the estimates may not represent the optimal level of operational efficiency (due, for example, to excessive use of inputs or if input prices are too high); and
- even if relevant, accurate and efficient elasticity estimates can be drawn from accounting information, these may still not be the basis for policy making because they simply describe the operational processes that the USO provider has in place at that time. Consequently, the accounting data would not reveal the fundamental cost drivers of the USO, simply the cost drivers deriving from the particular processes and activities chosen by the USO provider to meet its obligations.

- 46 Also, as the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification, ComReg proposes that the cost concept of Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO as the concept of avoidable cost is more closely related to the cost concept of LRIC.

Cost differences between the baseline and reference scenarios must be on a like-for-like basis

- 47 For the purpose of making a determination under section 35(4) of the 2011 Act as to whether the provision of the universal postal service represents a net cost to the USP and an unfair financial burden on the USP, section 35(5) requires that ComReg take into account (i) the methodology used by the USP with respect to the information given to ComReg, (ii) the extent to which the USP is, in ComReg's opinion, complying with the statutory obligations imposed on it relating to the provision of a universal postal service in a cost-efficient manner, and (iii) any other information which ComReg considers relevant. The 2011 Act therefore requires that an assessment under section 35 should be based on the net costs of an efficient operator. Consequently, to the extent that any net cost identified is higher as a result of inefficiencies, the net cost should be adjusted to take account of those inefficiencies.
- 48 For example, consider a scenario in which an efficient operator would utilise three rather than four mail centres in both the baseline and in the reference scenario. Use of accounting data for the baseline would show the use of four mail centres. However, a bottom-up model would show the use of three mail centres and would attribute this to the move from the baseline to the reference scenario, when in fact an efficient operator would also have utilised three mail centres in the baseline. In consequence, the estimate of the cost of the USO might substantially over-state the true cost.
- 49 Therefore, to ensure that only the efficient net costs of the USO are calculated, it is critical that the estimate of the cost differences between the baseline and reference scenarios is on a like-for-like basis reflecting only differences associated with changes in the service specification.

Step 4: Calculating the net cost of the USO

- 50 The final step is to calculate the net cost of the USO by:
- comparing revenues in the baseline year, at current prices, to modelled efficient costs in the baseline

- comparing revenues in the reference scenario, which have been adjusted to reflect volume changes and market share effects, with modelled efficient costs in the reference scenario.

51 The net cost of the USO is the difference between the two figures.

52 As required by section 35 of the 2011 Act it is ComReg that determines whether there is a net cost and it is ComReg or a person appointed by ComReg that audit or verify the net cost.

Q. 3 Do you agree or disagree with the proposals on the form and manner of any net cost submission? Do you have any views on the proposed guidance set out in Annex 1 – 3? Please explain your response.

5 Draft Regulatory Impact Assessment

- 53 ComReg's published RIA Guidelines¹⁰ (Doc 07/56a), in accordance with a policy direction to ComReg¹¹, state that ComReg will conduct a RIA in any process that may result in the imposition of a regulatory obligation, or the amendment of an existing obligation to a significant degree, or which may otherwise significantly impact on any relevant market or any stakeholders or consumers. However, the Guidelines also note that in certain instances it may not be appropriate to conduct a RIA and, in particular, that a RIA is only considered mandatory or necessary in advance of a decision that could result in the imposition of an actual regulatory measure or obligation, and that where ComReg is merely charged with implementing a statutory obligation then it will assess each case individually and will determine whether a RIA is necessary and justified.
- 54 In accordance with section 35(2)(a) of the 2011 Act a request by the USP to seek funding for the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines. In this consultation, ComReg has made certain proposals on the form and manner for a USP's request to seek to receive funding for the net costs (if any) of providing a universal postal service. Therefore, ComReg has prepared a draft RIA in respect of these proposals as there were options open to ComReg in making these proposals.
- 55 ComReg invites interested parties to review this draft RIA and to submit any comments or information which they believe ComReg has not considered and should consider in finalising its determination on the form and manner of any net cost submission. Subject to respondents' views and consideration of any other evidence, this draft RIA will be finalised in ComReg's consultation response and which will in turn inform its determination.

5.1 Steps involved

- 56 In assessing the available regulatory options, ComReg's approach to RIA follows five steps as follows:

Step 1: describe the policy issue and identify the objectives

Step 2: identify and describe the regulatory options

Step 3: determine the impacts on stakeholders

¹⁰ Which have regard to the RIA Guidelines issued by the Department of An Taoiseach in June 2009

¹¹ Ministerial Policy Direction made by Dermot Ahern T.D. Minister for Communications, Marine and Natural Resources on 21 February, 2003

Step 4: determine the impacts on competition

Step 5: assess the impacts and choose the best option

Step 1: Describe the policy issue and identify the objectives

57 As required by the section 35(2)(a) of the 2011 Act, a request by the USP to seek to receive funding for the net costs (if any) of providing a universal postal service must be made in such form and manner as ComReg determines. The objective of this consultation is to seek the views of interested parties on ComReg's draft determination in this respect.

Step 2: Identify and describe the regulatory options

58 In proposing the draft form and manner of any request for funding the net costs (if any) of providing a universal postal service, a number of options were open to ComReg; these were:

- Option: Whether the Profitability Cost methodology should be used or not
- Option: Whether An Post should determine the reference scenario or not
- Option: Whether certain requirements for calculating the net costs should be set or not

Steps 3, 4 and 5: Determine and assess the impacts on stakeholders and competition and choose the best option

Option: Whether the Profitability Cost methodology should be used or not

59 There are three main types of methodology generally used to calculate the net costs (if any) of providing the universal postal service and they are as follows:

Methods used in the estimation of the net cost of the USO

| Definition of the net cost of the USO | |
|---|--|
| Deficit Approach (DA) | The difference between the sum of the losses from individual loss making products, and the sum of the profits from individual profit making products, as reported in the universal service provider accounts. |
| Net Avoidable Cost (NAC) | The sum of the loss-making USO mail flows, where a mail flow in this context is made up of elements of products along a number of dimensions. (e.g. format, delivery zone, type of sender, class). |
| Profitability Cost Approach (PC) | The net cost of the USO is measured as the difference between a universal service provider’s profit level with and without the USO, in a liberalised market. The Profitability Cost can also be expressed as the net avoidable costs – given by the sum of the change in incremental costs and the change in revenues. |

Source: Frontier Economics

- 60 In making the preliminary view that the Profitability Cost (PC) methodology should be used, ComReg has considered the analysis and recommendation of its independent consultants, Frontier Economics, set out in Chapter 3 of its supporting report¹². ComReg has also considered the relevant provisions of the 2011 Act and Directive 97/67/EC on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended (the “Postal Directive”).
- 61 With this in mind, and as noted by Frontier Economics, there are three key criteria to assess and compare the possible methodologies to calculate the net costs:
- (1) Ability of the methodology to deal with relatively complex changes to the service specification in the reference scenario
 - (2) Ability to take account of all changes arising from the USO and ability to take account of efficiency
 - (3) Precedent for use in other countries

¹² Document No. 13/48a

(1) Ability of the methodology to deal with relatively complex changes to the service specification in the reference scenario

- 62 ComReg considers that it is important that the chosen methodology is able to take account of the likely complexity of the reference scenario. As part of any funding application, the net cost calculation is needed to understand the extent to which the obligations associated with the provision of the universal service imposes costs on An Post that it otherwise would not bear. It is therefore vital that the methodology used for such a calculation allows for the estimate of these costs to be as accurate as possible. As such, it must be based on a reference scenario which provides as accurate a reflection as possible of the service offering that An Post would provide in the absence of the constraints currently imposed by the USO.
- 63 In this respect, ComReg has considered and agrees with the advice of its independent consultants, Frontier Economics. The possible different methodologies can be compared as follows:

Table 1. Behaviour of the universal service provider without the USO (counterfactual)

| Features of methods | DA | NAC | PC |
|---|-----|-------------------------------|----------|
| Remove whole of USO | Yes | No | No |
| Remove elements of USO products | N/A | Yes | Possible |
| Relax provision constraints for remaining services (e.g. delivery frequency) | N/A | No | Yes |
| Relax pricing constraints | N/A | No | Yes |
| Relax quality constraints | N/A | No | Yes |
| Changes in USP’s operation and network (for instance re optimising the network) | N/A | No | Yes |
| Changes in demand for USP’s “remaining” products | N/A | Not done to date but possible | Yes |
| Changes in market share of USP | N/A | No | Yes |

Source: Frontier Economics

- 64 The DA approach differs from the other two in that there is no explicit reference scenario. There is no analytical exercise that defines what the USP would choose to do without the USO. However, it could be argued that the DA approach includes an implicit reference scenario that says absent the USO, the USP would stop providing all USO products whilst continuing to provide all non-USO products via an unchanged network.
- 65 In the case of the NAC approach as it has been applied in post to date, the counterfactual scenario can be interpreted as the USP ceasing to provide all loss-making USO “mail flows”, and continuing to provide all non-USO products together with profitable USO mail flows via an unchanged network.
- 66 The PC approach assumes that in a competitive market, the USP would seek to reorganise its operations absent the USO in a way to “maximise its profits”. This may include removing elements of USO products that are loss-making as under the NAC. But importantly, the USP would also be expected to seek further changes in its operations to minimise costs.
- 67 The NAC approach will produce higher estimates of the net cost of the USO than the DA, because where USO services as a whole are profitable, but are composed of losses and gains for individual services, the DA records no net cost. The NAC approach on the other hand simply aggregates the individual service losses as the net cost, so while USO services may be profitable as a whole, it may generate a net cost.
- 68 Under the PC approach, the USP puts in place a business model that seeks to maximise profits in a competitive environment. This may include removing elements of the USO that are loss making as under the NAC, however, the USP would also go further by reducing costs of all services down to an efficient level.

(2) Ability to take account of all changes arising from the USO and ability to take account of efficiency

- 69 ComReg also considers it important that the methodology allows for all changes in costs and revenue that might arise as a result of the USO (in comparison to the reference scenario). This will include the impact on demand, seen through a change in volumes. In addition, section 35(5) of the 2011 Act requires ComReg, upon receipt of a funding application from An Post, to determine the extent to which the universal postal service is being provided in a cost-efficient manner. As such, it is essential that the chosen methodology allows for an adjustment to be made to costs and revenues to reflect the fact that current costs and revenues associated with the USO may not be equivalent to that of an efficient operator.
- 70 In this respect, ComReg has considered the advice of Frontier Economics and agrees with its comparison on the ability of the different methodologies to deal with all changes arising from the USO and ability to take account of efficiency.

- 71 The DA approach, as it is based on accounting costs, does not take into account the impact on existing demand flows if the USO services were no longer provided and initially assumes current efficiency levels. Under this approach, any efficiency adjustments would need to be carried out ex-post and would entail coming to a view on the proportion of the costs associated with delivering the USO that are inefficient.
- 72 The alternative approach, an ex-ante adjustment of costs for efficiency, could lead to misleading estimates of the net cost of the USO without an adjustment to revenues. This is because it would create artificial improvements in margins/profitability, which could not necessarily take place in a fully competitive market.
- 73 The methodology of the NAC approach, although based on the concept of avoidable costs, does not specify that this should be the costs avoided by an efficient operator. In fact, the actual application is based on accounting costs. Therefore, as with the DA approach; any efficiency adjustment would need to be made ex-post. Again, this would entail coming to a view on the proportion of the costs associated with delivering the USO that are inefficient.
- 74 The PC approach explicitly includes demand effects and efficiency adjustments. Efficiency adjustments can either be made ex-post, as with the DA or NAC approach, or ex-ante under the PC approach. An ex-ante adjustment can be made if bottom-up modelling is used. Such modelling can explicitly demonstrate the costs faced by an efficient operator under both the base case and reference scenario.

(3) Precedent for use in other countries

- 75 The PC approach is the most commonly chosen approach to calculating the net cost of the USO in post by USPs and NRAs alike. It has been applied in practice in Denmark, UK, Norway, Slovakia and the Netherlands.
- 76 Both the DA and NAC approaches have both been used in the past and replaced by other methods. For example, the USP in Norway has previously used the NAC approach and now uses the PC approach. In Norway, it was felt that general drawbacks of the NAC-model were that it did not take into account a realistic commercial counterfactual and that the final result depended on the chosen breakdown of data.
- 77 Likewise, the USPs in Italy and Belgium used the DA approach annually from 2002-2010. The calculations for 2011 are on hold and will be based on new methodologies following the transposition of the 3rd Postal Directive in Italy and Belgium.

Profitability Cost methodology should be used:

78 ComReg is of the preliminary view that the most appropriate methodology for determining the net cost of the USO in Ireland is the PC approach. In particular, the PC methodology:

- can capture the full complexity of a reference scenario. This approach is not restricted by the status quo and allows for the modelling of a whole host of potential changes that an operator could make in the absence of the USO. The PC approach can model not only the potential withdrawal of certain USO products, but importantly can also capture the effects of removing or relaxing specific elements of the USO.
- can take account of all changes arising from modifying the USO. This includes direct effects on demand, costs and market shares arising from changes in the USO.
- is better at taking account of efficiency. This is important as the net cost calculation should not include the impact of inefficient operation in order to better comply with Annex 1 of the Postal Directive.
- is an established methodology which has been widely used in Europe to calculate the net cost of postal USO. This methodology has already been applied in practice in Denmark, UK, Norway, Slovakia and the Netherlands.
- is the only methodology that applies the correct net cost definition as described in Annex 1 of the Third Postal Directive (which is included as Schedule 4 to the 2011 Act) by calculating the difference in profit with and without the current USO.

Option: Whether An Post should determine the reference scenario or not

79 The most important element in assessing the net costs (if any) of providing the universal postal service is the development of the reference scenario. The reference scenario should set out the realistic counterfactual service offering that An Post would continue to provide if the current USO constraint were to be removed. It implicitly acknowledges that even without the constraints currently imposed by the USO, An Post would continue to run a postal business, albeit one that possibly offers a different set of products and one configured on a different basis.

80 The possible options here are whether ComReg should allow An Post to set the reference scenario or whether ComReg should specify the reference scenario.

81 ComReg is of the preliminary view that An Post is best placed to determine the reference scenario as it is important that the reference scenario is informed by An Post's commercial knowledge of its business, and that it is important that it reflects how An Post would seek to reorganise its operations absent the current USO in a way to maximise its profits.

Option: Whether certain requirements for calculating the net costs should be set or not

82 Though An Post will determine the reference scenario, there are certain requirements that ComReg considers must be placed with the use of the PC approach to ensure that the calculation of the net cost (if any) associated with the USO is evidence based and consistent with the requirements of the 2011 Act. These proposed requirements are:

- 1) That the reference scenario represents a reduced universal postal service obligation under section 16(1)(a) of the 2011 Act

In order to minimise the complexity for An Post in setting its reference scenario, ComReg proposes that the reference scenario set by An Post is assumed to be a reduced USO requested by An Post under section 16(1)(a) of the 2011 Act. Section 16(1)(a) of the 2011 Act enables An Post, in exceptional circumstances, to seek to reduce the delivery and clearance requirements of the universal postal service.

This proposal makes it easier to account for the VAT exemption of universal postal services by assuming that a USO would apply in both the baseline scenario and the reference scenario. This will benefit An Post when it determines the reference scenario as it limits complexities that arise if the reference scenario does not represent a reduced universal postal service obligation.

- 2) That changes to the structure of the pricing of universal postal services should not form part of the reference scenario

As it is proposed that the reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act, An Post's reference scenario will be subject to the tariff requirements of section 28 of the 2011 Act for its universal postal services. This includes the requirement for uniform pricing of universal postal services unless in its reference scenario An Post assumes it has sought and received consent from the Minister under section 28(2)(b) of the 2011 Act to not offer a uniform price throughout the State.

However, as noted by Frontier Economics, a change to the price structure is such a fundamental change to the product offering that it is likely to lie outside the range of commercial strategies than a USP would consider to be feasible or profitable. It is also likely that such a move would lead to substantial customer disruption and could impose substantial additional costs on An Post.

With respect to changes in the price level, this is something that An Post may wish to consider as part of the development of its reference scenario. However, in the event that An Post considers that sizeable increases in price formed part of the reference scenario, An Post will need to provide significant supporting analysis to demonstrate that such an increase would in fact be profitable and compliant with the tariff requirements under section 28 of the 2011 Act.

3) That a bottom-up model based on LRIC is used if the reference scenario departs significantly from the current USO

If the reference scenario departs significantly from the current USO, ComReg proposes that it will be necessary for An Post to develop a bottom-up model to estimate the costs in the reference scenario as it would be difficult to estimate the applicable costs based solely on historic accounting data.

Also, as the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification, the cost concept of Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO.

This proposal will be relatively more data intensive for An Post but it is made in the context of ensuring that any net cost calculation is evidence based and in accordance with the requirements of the 2011 Act.

Q. 4 Do you have any views on this draft Regulatory Impact Assessment and are there other factors ComReg should consider in completing its Regulatory Impact Assessment? Please explain your response and provide details of any factors that should be considered by ComReg.

6 Draft Determination

The Commission for Communications Regulation, pursuant to section 35(2)(a) of the Communications Regulation (Postal Services) Act 2011 (“2011 Act”) and having regard to sections 16, 28, 35 and Schedule 4 of the 2011 Act, hereby makes the following determination as to the form and manner of any submission made to it under section 35(1) of the 2011 Act by a universal postal service provider, designated under section 17 or 18 of the 2011 Act, seeking funding for the net costs (if any) of providing a universal postal service:

1. That in respect of any such submission, the Profitability Cost methodology shall be used by the universal postal service provider to calculate the net costs (if any) of providing the universal postal service.
2. That the universal postal service provider shall set the reference scenario used to calculate the net costs (if any) of providing the universal postal service, and doing so, the universal service provider shall:
 - a. assume that the reference scenario represents a reduced universal postal service obligation, based on a determination by the Commission under section 16(1)(a) of the 2011 Act that exceptional circumstances or geographic conditions exist which warrant that there shall not be one clearance and one delivery on every working day to the home or premises of every person in the State (such determination having been made on foot of an application made to the Commission by a universal postal service provider);
 - b. not make any changes to the structure of the pricing of its universal postal services in its reference scenario; and
 - c. use a bottom-up model based on Long Run Incremental Cost if the reference scenario departs significantly from its existing universal service obligation as of the date on which the submission under section 35(1) of the 2011 Act is first made.

3. That the universal postal service provider's calculation of the net costs (if any) of providing the universal postal service shall be guided by Annex 1 – 3 of [], though the Commission also notes that any guidance provided by it should not be considered exhaustive of all matters that may arise in the course of reviewing any submission made to it under section 35(1) of the 2011 Act, and the Commission reserves its right to deviate from any guidance provided where it considers it reasonable to do so and the Commission further reserves its right to request such additional information of a universal postal service provider as it may require in respect of any submission made to it under section 35(1) of the 2011 Act, in accordance with section 35(3) of the 2011 Act.

This Determination shall be construed together with ComReg's conclusions, reasoning, and analysis as set out in [].

For the avoidance of doubt, nothing in this Determination shall operate to limit the Commission in the exercise and performance of its statutory powers or duties.

This Determination shall remain in force until further notice.

[]

Commissioner

The Commission for Communications Regulation

Dated [2013]

7 Conclusion

- 83 In this consultation, ComReg has set out its preliminary views on the form and manner of any request by An Post to seek to receive funding for the net cost (if any) of providing the universal postal service in accordance with section 35(2)(a) of the 2011 Act. In accordance with the 2011 Act it is ComReg that will audit, verify, and determine whether there is a net cost if a claim for net cost is made by An Post. In order to make that audit, verification, and determination, ComReg will require detailed evidence based information from An Post and the 2011 Act empowers ComReg to obtain such information from An Post where it is not provided.
- 84 As annexes to this consultation, ComReg has set its proposed guidance on the information it is likely to require from An Post to ensure that any net cost calculation is evidence based and in accordance with the 2011 Act. This is being done in the expectation that An Post will be cognisant of this guidance in submitting any net cost application so as to facilitate ComReg's audit, verification, and determination of the net costs (if any) as required by section 35(5) of the 2011 Act. However, depending on what is contained in any actual net cost application by An Post, there may be further information requirements that could not be envisaged by this consultation and this is provided for by section 35(3) of the 2011 Act.
- 85 ComReg will consider all submissions to this consultation, together with any other relevant evidence, in finalising its determination on the form and manner of any net cost submission under section 35(2)(a) of the 2011 Act and setting its guidance on the information that should be provided with any net cost submission.

Annex: 1 Proposed guidance to An Post in setting its reference scenario

A 1.1 ComReg would welcome any views on the proposed guidance below. It is proposed that An Post should consider this guidance when setting its reference scenario in order to facilitate ComReg’s subsequent audit, verification, and determination of the net costs (if any).

Possible variations to An Post’s current service offering

A 1.2 As recommended by Frontier Economics, ComReg is of the preliminary view that the possible variations open to An Post in developing its reference scenario can be grouped into two steps which should be considered sequentially in the order illustrated below.



Source: Frontier Economics

Step 1: Change in the operation of the universal postal services

A 1.3 In this first step in developing the reference scenario, ComReg is of the preliminary view that An Post should consider what changes could be made to the operation of USO services that would increase the profitability of those services currently deemed by An Post to be unprofitable.

A 1.4 ComReg proposes that An Post in developing and setting its reference scenario makes an assumption that the reference scenario is a reduced USO sought under section 16(1)(a) of the 2011 Act. Consequently, under this step, the reference scenario may assume reduced USO as follows:

- changes in the number of collections and deliveries per week;
- changes to the number of access points for collecting mail; or

- changes to the points at which the mail is delivered.

A 1.5 These changes may vary on a geographic basis. For example, An Post may decide to vary the number of collections and deliveries per week by area of the country, making reductions in more rural areas of the country that are currently unprofitable to deliver to.

A 1.6 Under this step, An Post’s reference scenario plan will specify what changes, if any, it would make in relation to each of the above. It will also highlight any geographic differentiation that would be introduced. For each service element that An Post proposes to alter under the reference scenario, it should provide a high level commercial rationale to support the alteration. The table below provides a template for the format that this rationale might take and the areas that should be covered.

Template for required high level rationale for each service element alteration under the proposed reference scenario

| Service element | Current provision | Proposed alteration | Commercial rationale |
|--|-------------------|---------------------|----------------------|
| e.g. Collections and deliveries per week | Five days | | |
| e.g. Class of mail | First class (D+1) | | |

Source: Frontier Economics

Step 2: Removal of services

A 1.7 In this second step in developing the reference scenario, ComReg is of the preliminary view that if An Post finds it is not possible to make a profitable service offering based on changes to the operation of USO services at step 1, then An Post may then want to consider the removal of services altogether as step 2.

A 1.8 Under this step, the reference scenario may assume, for instance that:

- a particular service currently provided as part of the USO (or group of services) would be removed from the service offering entirely;
- the delivery of selected USO services would not be provided in specific geographic areas;
- the delivery of any USO service would not be provided in specific geographic areas; or

- there would be no delivery of any postal service in a given geographic area.

A 1.9 If An Post seeks to remove services on a geographic basis, An Post should demonstrate that making less radical alterations to the service would still be unprofitable. For example, if An Post were to suggest that it would not serve a particular geography at all, it would be important that it demonstrate that even a reduced service (e.g. one delivery and collection per week) to that particular geography would still be unprofitable.

A 1.10 If An Post develops its reference scenario under this step, An Post’s reference scenario plan will specify which services, if any, it would remove from its service offering. It will also highlight any geographic differentiation that would be introduced. An Post should also provide a commercial rationale for each service removal that it proposes to make under the reference scenario. The table below provides a template for the format that this rationale might take and the areas that should be covered.

Template for required high level rationale for the removal of services under the proposed reference scenario

| Current provision | Proposed alteration | Commercial rationale |
|--|---------------------|----------------------|
| Two universal bulk mail services: ‘delivery only’ for mail sorted by delivery office, and ‘deferred delivery’. The remainder of bulk mail services fall within the scope of the USO. | | |
| Postal items up to 2kg | | |
| Postal packages up to 20kg | | |

Source: Frontier Economics

Annex: 2 Proposed guidance to An Post on measuring the revenues foregone and costs avoided by modification of the universal service

A 2.1 Once the reference scenario has been developed, the next step for An Post will be to calculate the net cost of the USO¹³ by measuring the revenues foregone and costs avoided by modification of the universal service. To measure these effects, it will be critical for An Post to understand how volumes, market shares and costs depend on service specification. In the below, ComReg sets out its proposed guidance on this. It is proposed that An Post should consider this guidance in order to facilitate ComReg's subsequent audit, verification, and determination of the net costs (if any).

Volume effects

A 2.2 Having developed the reference scenario, An Post will have to estimate the impact of changes in volumes because:

- it will impact directly on the revenues An Post can expect to generate;
- it will also likely impact on the costs An Post will incur.

A 2.3 In order to estimate the likely volume effects, the analysis will need to:

- Step 1: establish what volumes are in the base case; and
- Step 2: set out how volumes might be expected to change as a result of moving to the reference scenario.

Sub-step 1: Base case volumes

A 2.4 To establish the base case volumes, actual volume data from the financial year to which the funding request applies should be used. Ideally, this would be on as disaggregated a basis as possible. At the very least, this information should be broken down by:

- product;
- format e.g. letter, flat, packet or parcel;

¹³ Notwithstanding that in accordance with section 35(4)(a) it is ComReg that determines whether there is a net cost or not

- weight step; and
- some form of geographical measure, whether this be geographical area or zones based on population density characteristics.

A 2.5 All volume information should be presented in a way that allows it to be mapped to the key parts of the pipeline: collections, mail centres and transport, and delivery. Volumes should also be broken down by day of the week.

Step 2: Volumes in the reference scenario

A 2.6 Once the base case has been established, the next step is to estimate what would happen to volumes and costs under a move to the reference scenario.

A 2.7 The aim of this step is to identify the likely demand response of customers to the changes in service specification. In estimating the volume effects associated with a move to the reference scenario, it is recognised that there will be a reasonable level of uncertainty associated with the estimates. The level of accuracy of the estimation is likely to be particularly affected by the fact that the service offering under the reference scenario will not have been experienced before in Ireland, and there is therefore no directly relevant historical information that can be used to estimate demand effects. In this context, it will be particularly important to ensure that appropriate scenario analysis and sensitivity testing is undertaken by An Post to assess the robustness of the results.

A 2.8 Consequently, An Post should combine information from a range of sources. This should be guided by a “pyramid approach” which ranks alternative information sources:

- direct evidence of revealed preference, e.g. econometric or other statistical evidence which estimates demand elasticities, should be given a strong weighting.
- evidence of stated preference, e.g. survey data on customer preferences for postal products and switching between or for particular elements of the USO, should be ranked second. An Post should seek to develop survey evidence to measure customer preferences for postal products. The purpose of such evidence is to identify the elements of the universal service that are more important than others from a customer perspective, and to understand the extent to which different types of customer place a different value on various service features.

- qualitative evidence, e.g. from interviews with mail users, should be ranked third. An Post may wish to carry out interviews to develop a more qualitative understanding of how mailers could react to changes in service specification. For example, for large customers in particular, a key issue could be to understand the extent to which changes in the service specification could lead to an acceleration of e-substitution.

A 2.9 Finally, it is likely that there will be a level of uncertainty about the demand estimates An Post derive. Consequently, An Post should run a set of scenarios around the central estimates to assess the sensitivity of results to different assumptions.

Market share effects

A 2.10 In addition to estimating the demand effects associated with changes in service specification, it is also important to take into account any potential market share effects. For example, if demand for a particular product switches in response to a modification of the universal service, then the new mail product may be more or less contestable than the mail product the customer was originally using. Consequently, An Post would face not only a direct demand effect, but also potentially a market share effect.

A 2.11 It is also important to consider the possibility that some universal service modifications may cause a more profound effect upon An Post's position in the market.

A 2.12 This might be characterised either as:

- major changes that fundamentally alters the perception of An Post relative to competitors; or
- changes that disproportionately affect An Post's service quality relative to rivals.

A 2.13 ComReg suggest that a qualitative analysis be undertaken which:

- assesses the extent to which the move to the reference scenario makes market entry and/or customer switching more likely; and
- assesses case study evidence on the evolution of competition in other markets to identify the potential magnitude of such effects.

A 2.14 On the basis of the above qualitative analysis, it is recommend that scenario analysis is developed by An Post to estimate the potential impact of market share effects on volumes across streams.

Costs

A 2.15 The third key element associated with estimating net cost is the estimation of costs in the base and in the reference scenarios.

A 2.16 When considering the estimation of costs, there are two key points to note:

- (1) That the purpose of the assessment is to pick up only those changes in cost that are associated with the USO – in particular changes in cost that might be categorised as ‘efficiencies’ which could arise in the absence of changes to the USO should not be captured; and
- (2) When considering the net cost of the USO, the 2011 Act is clear that the assessment should be based on the net costs of an efficient operator. So to the extent that any net cost identified is higher as a result of inefficiencies, the net cost should be adjusted to take account of those inefficiencies.

A 2.17 To ensure that only the net costs of the USO are calculated, it is critical that the estimate of cost differences between the baseline and reference scenarios is on a like-for-like basis reflecting only differences associated with changes in the service specification.

A 2.18 In developing cost estimates, there are three critical decisions to be taken:

- (1) whether the analysis is based on a model, accounting data or a mix of both;
- (2) if a model is required, the relevant coverage for the model; and
- (3) if a model is required, the relevant cost standard for the modelling (i.e. whether it should be undertaken on a LRIC or FAC basis).

(1) Should the analysis be based on a model, accounting data or a mix?

A 2.19 In principle there are two options to estimate the costs of providing the USO:

- the use of cost accounting information; and
- the construction of a bottom-up model to estimate the costs of providing the USO by a hypothetical efficient operator.

A 2.20 In considering which option is the more appropriate for the particular reference scenario set by An Post, An Post should consider the type of costs change that will arise from the move from the baseline to the reference scenario as the choice of accounting data or bottom-up model will depend largely on the extent to which reference scenario departs from current USO. The more significant the departure, the more likely that there would be a step change in costs (e.g. significant re-design of mail flows, delivery network, mail centre network) and the more difficult it would be to estimate costs based solely on historic accounting data.

A 2.21 Consequently, if the reference scenario is likely to lead to a step change in costs, then it will be necessary to develop a bottom-up model to estimate the costs in the reference scenario and ComReg in this consultation has made that proposal.

A 2.22 This does not mean that the accounting data will be redundant. Rather, it will be an important input into the bottom-up cost models, and ComReg considers that a key element of the calibration of the bottom-up model will rely upon comparison of modelled and actual cost.

(2) If a model is required, the relevant coverage for the model

A 2.23 If a model is required, ComReg considers it important that the model provides enough granularity to reflect the cost impact of moving from the current USO baseline to the reference scenario. In this regard, the model (if required) should be able to:

- estimate the cost changes associated with changing postal volumes;
and
- estimate step changes in costs arising from changes in service specification.

A 2.24 Given the likely changes that An Post may identify as part of the reference scenario, and in order to be able to estimate cost step changes An Post should develop (or adapt, if An Post already has such a model in place) a bottom-up operational cost model, containing at least the following modules for different parts of the pipeline (although the modules are linked by volumes and other operational constraints):

- Collections: changes in the universal service potentially affect the timing of collections, the number of collection rounds per day and the number of collections per week. The constraints may be direct (e.g. at least one collection per day) or indirect (e.g. collections are required throughout the day to enable smooth workflows at mail centres).

- Mail centres: the constraints of having to provide a D+1 service with a set quality of service may require An Post to have a larger number of mail centres than would otherwise be the case, while the universal service requirement for a five day delivery service affects the days on which the network needs to operate.
- Feeder services: these are connecting services between collection hubs (where collections are aggregated) and mail centres, or between mail centres and delivery offices. The cost of services will depend on the number of days that collections and deliveries take place.
- Deliveries: changes to the universal service determine the number of days on which deliveries operate and (indirectly) the number of delivery routes. Both these factors will affect indoor (i.e. mail preparation) and outdoor delivery costs. Timing constraints may also force shorter or more frequent delivery runs than An Post would wish.

A 2.25 To accompany the quantitative estimates of how costs could change in the reference scenario compared to the baseline, An Post should provide a qualitative analysis and detailed commentary which describes how operations and workplans could change in response to each element of change in the definition of the universal service in the reference scenario.

(3) If a model is required, the relevant cost standard for the modelling

A 2.26 From a methodological point of view, the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification. ComReg considers that the concept of avoidable cost is more closely related to the concept of LRIC. This is a result of the fact that LRIC excludes fixed and common costs associated with an increment of output. In reality, the universal service provider would still need to pay such costs even if volumes fell as a result of a move to the reference scenario. Consequently, if a bottom-up operational model is required, it should be based on LRIC and ComReg, by this consultation, is proposing it as a requirement.

Propose that under PC approach no adjustment should be required for a reasonable profit

A 2.27 Under the PC approach the USO net cost is determined by comparing the operating profits of the USP with the USO in place, assuming efficient costs, and the operating profits under a reference scenario where the operations of the USP are re-optimised assuming that the USO was removed, again assuming efficient costs. Taking “reasonable profits” into account requires the relevant appropriate capital costs to be deducted from the operating profit under the base case, and the operating profit under the counterfactual. This then becomes a comparison of net profits, rather than operating profits.

A 2.28 The PC methodology can in principle take into account movement in the capital employed and the Weighted Average Cost of Capital (WACC). However, this may not have a material impact on the level of the net cost of the USO. If the level of capital employed is not materially affected by the removal of the USO, and the WACC can also be considered to be largely unchanged, then the difference between the cost of capital under the base case and the counterfactual will not be significant.

A 2.29 Given the labour intensity of postal operations, it is likely that the reduction in capital employed following the removal of the USO would be relatively limited. Consequently, having considered the recommendation of Frontier Economics in this regard, ComReg proposes that under the PC methodology no adjustment should be required to make allowance for a reasonable profit. If An Post does decide to make an allowance for reasonable profit, it should provide detailed supporting information setting out why and how it has made an allowance for reasonable profit.

Annex: 3 Proposed guidance to An Post on taking intangible and market benefits into account

A 3.1 In accordance with the section 35(4) of the 2011 Act and in accordance with Annex 1 of the Postal Directive, a net cost must take into account any intangible and market benefit which accrues to the USP.

A 3.2 As noted by Frontier Economics in their supporting report¹⁴, there is no single definition of intangible or market benefits. According to a recent study¹⁵ “a benefit is classified as ‘intangible’ when a universal service provider’s performance and cost accounting, and its calculation of the net cost of the universal service obligation does not (fully) reflect the impact on revenues and cost that result from the existence of this benefit. The definition is relevant insofar as the identification of such benefits becomes necessary only if they are not already included in the universal service provider’s net cost calculation.”

A 3.3 The key benefits of being designated as USP include:

- Brand value: higher sales due to positive impact of brand plus better customer retention and acquisition (ubiquity);
- Demand complementarity: higher sales of non-USO products as complement to the sale of USO products.

A 3.4 A number of other intangible and market benefits have been considered in relevant economic literature and these are as follows:

¹⁴ ComReg Document No. 13/48a

¹⁵ ARCEP, “Definition, classification and methodology for evaluating intangible benefits related to universal postal service”, from WIK consult, published 2010

| Intangible/ market benefits | As a result of providing the USO, the USP may achieve... |
|-----------------------------|--|
|-----------------------------|--|

Most discussed in postal literature

| | |
|----------------------------------|---|
| 1. Economies of scale and scope; | Lower average cost in providing several USO products and non-USO products |
| 2. Enhancement of brand value; | Higher sales due to positive impact of brand (customer retention and acquisition) |
| 3. Enhanced advertising effect | Higher sales due to more effective advertising thanks to higher visibility (better value for money) |
| 4. VAT exemption | Higher sales to customers who cannot reclaim VAT back |
| 5. Interest on prepaid postage | Earn interest on this revenue |
| 6. Demand complementarities | Higher sales of other products (as complement to the sale of USO products) |

Discussed in postal literature

| | |
|---|--|
| 7. Ubiquity | Better customer retention and acquisition when mailers move address, better customer acquisition |
| 8. Uniform price | Lower transaction costs for customers and therefore better customer acquisition |
| 9. Customer life cycle effects | These are benefits arising from customers who are currently commercially non-viable and may at some future date become commercially viable. Such customers may, at this point, choose the USP over competitors (better customer retention) |
| 10. Better bargaining position | Easier access to politicians than other operators and stronger influence on regulatory regime |
| 11. Exclusive sale of stamps and monopoly over philately market | Additional revenues/ profits as some sold stamps are never used by users |
| 12. Recipient database | Providing the universal service provides USPs with access to customer and demand information which can be used to market postal products (customer acquisition and retention) |

Legal privileges of USP/other

| | |
|--|--|
| 13. Parking and stopping exemptions | Lower costs as USP is exempt from parking restrictions |
| 14. Exemptions from customs and excise legislation | Lower costs |
| 15. Ownership of post office boxes | Great “visibility”, brand recognition |
| 16. Binding power of postmark | Higher sales as the postmark of USP’s mail is a confirmation of date of dispatch |
| 17. Exclusive right to use colour for mailboxes | Brand recognition |
| 18. Right to hang mailboxes free of charge on public sector premises | Exempt from space neutral fee – lower cost |

Source: Frontier Economics 2012 WIK (2010)

A 3.5 The current profitability of the USP (base case) reflects the intangible and market benefits attributable to the USO. As the USO changes under the reference scenario, consumers who value products provided under the USO banner may reduce their demand and/or choose alternative providers. The move from base case to reference scenario effectively reduces volumes and market shares.

A 3.6 Therefore, as part of the market share effect to calculate the net costs (if any), An Post should consider the extent to which:

- its brand and status as USP is likely to have a “chilling effect” on customer switching; and
- consider a market share scenario in which it was required to ‘rebrand’ and so would no longer have name recognition as the USP.

Annex: 4 Legal basis

A 4.1 In accordance with the section 35(1) of the 2011 Act, a USP may submit a request in writing to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service.

A 4.2 However, any such request, in accordance with section 35(2) of the 2011 Act, must be:

- Must be made in such form and manner as ComReg determines
- Submitted no earlier than after the end of the financial year immediately following the designation as USP and thereafter no later than 6 months after the accounts for the financial year concerned have been audited, unless ComReg agrees otherwise
- Accompanied by such supporting information as may be reasonably required by ComReg to determine whether provision of the universal postal service by the USP represents a net cost and represents an unfair burden on the USP.

A 4.3 Furthermore, in accordance with section 35(3) of the 2011 Act, where the universal postal service makes a request to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service, it must provide any additional information as may be requested by ComReg.

Submitting comments

The consultation period will run until 5pm on Tuesday 18 June 2013, during which time ComReg welcomes written comments on any of the issues raised in this consultation.

It is requested that comments be referenced to the relevant question numbers and paragraph numbers from this document. Where views are provided, please provide a supporting rationale for your comments, including if possible, an indication on the broader impact of any changes proposed.

As it is ComReg's policy to publish all responses in order to make them available for inspection, responses to consultations should be provided as non-confidential documents, with any information for which confidentiality is claimed (e.g. commercially sensitive information) supplied in a separate annex. In this respect, please refer to ComReg's Consultation Procedures - ComReg 11/34 and ComReg's guidelines on the Treatment of Confidential Information - ComReg 05/24.

We request that electronic submissions be submitted in an unprotected format so that they can be appended into the ComReg submissions document for publishing electronically.

All responses to this consultation should be clearly marked:- "Reference: Consultation 13/48", and sent by post, facsimile or e-mail to arrive on or before **5pm, Tuesday 18 June 2013**, to:

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Questions

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