Consultation on price cap control for universal postal services

Consultation and draft Decision

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1 Introduction

1 Section 30(2) of the Communications Regulation (Postal Services) Act 2011 ("2011 Act") provides that where ComReg is of the opinion that there is no effective competition in the market for the supply of postal services within the scope of universal postal service by the universal postal service provider[1] ("USP") then it shall, following a public consultation, make a decision in which it shall specify a "price cap" in respect of one or more than one "basket of postal services". In ComReg Decision D13/13[2], ComReg formed the opinion that there is no effective competition for the universal postal services and therefore the universal postal services[3] should be subject to a price cap control.

2 Section 30(1) of the 2011 Act defines a "price cap" as meaning an overall limit on the annual percentage change in charges that can be imposed for any basket of postal services calculated by the formula: overall limit = (Δ CPI) — X, where "(Δ CPI)" is the annual percentage change in the consumer price index and "X" is the adjustment specified by ComReg to provide incentives for efficient provision of the services concerned.

3 Section 30(3) of the 2011 Act further provides that for the purposes of making a price cap decision ComReg shall:

(a) have regard to the requirements relating to tariffs specified in section 28(1);

(b) ensure that the price cap provides incentives for efficient universal postal services provision, and;

(c) have regard to its statutory objectives, in particular the protection of the interests of postal service users and those of small and medium-sized enterprises ("SMEs").

4 This consultation builds on ComReg Decision 13/13 and sets out ComReg's preliminary views on setting a price cap control. This will be the first time that An Post has been subject to a price cap control. Once in place, it should enable An Post to manage and adjust its universal postal service prices and thereby make a reasonable return on the efficient provision of the universal postal service. As envisaged by the 2011 Act, the price cap control should also underpin the continued provision of the universal postal service to all postal service users, over the period in which it is effect.

[1] Section 17 of the 2011 Act designated An Post as universal postal service provider
[2] ComReg Document No. 13/82 dated 6 September 2013
[3] Except for four universal postal services that did not require to be price controlled

5 Section 16(1) of the 2011 Act provides that the “universal postal service” means that on every working day (i.e. Monday – Friday, excluding national public holidays), except in such circumstances or geographical conditions as ComReg considers to be exceptional, there is at least one clearance and one delivery to the home or premises of every person in the State. Section 16(1) further specifies that the following universal postal services be provided:

- the clearance, sorting, transport and distribution of postal packets up to 2kg and parcels up to 20kg (subject to the 20kg weight limit being reviewed)
- a registered items service
- an insured items service
- postal services, free of charge, to blind and partially-sighted persons.

6 In addition, Section 16(9) of the 2011 Act requires that ComReg shall make regulations specifying the services to be provided by a 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 users. ComReg made such regulations in July 2012, following public consultation (the Communications Regulation (Universal Postal Service) Regulations 2012 (S.I. 280 of 2012) - see ComReg Document No. 12/81).

7 An Post is the sole designated “universal postal service provider” under section 17(1) of the 2011 Act. In addition to providing the universal postal service, An Post also provides various other commercial products and services, often through the post offices which form part of its postal network. These include, by way of examples, various financial and social welfare services. An Post also provides a range of postal services which are not universal postal services. ComReg has no role to regulate An Post in its capacity as a provider of various non-postal products and services.

8 The purpose of this public consultation is to allow interested parties to submit their views, which ComReg will carefully consider prior to making any final decision. This paper sets out ComReg’s various preliminary views and/or proposals, which are subject to consideration of all responses to the consultation.

9 Please note that references herein to An Post are generally references to An Post in its capacity as the current sole designated universal postal service provider, under section 17 of the 2011 Act, unless the context indicates otherwise.

1.1 Structure of this document

10 This document is structured as follows:

- Chapter 2 provides an Executive Summary
- Chapter 3 provides a background to making the price cap decision
- Chapter 4 sets out ComReg's preliminary views on the design of the price cap control
- Chapter 5 sets out ComReg's preliminary views on the key model inputs for the calculation of the CPI-X% price cap
- Chapter 6 sets out, given ComReg's preliminary views expressed in Chapters 4 and 5, the key price cap model outputs and resultant X factors in the CPI-X% price cap
- Chapter 7 sets out ComReg's preliminary views on how compliance with the price cap decision and 2011 Act will be assessed
- Chapter 8 provides ComReg's draft decision on the price cap
- Chapter 9 sets out ComReg's preliminary views on considerations for the next price cap control review
- Chapter 10 provides ComReg's draft Regulatory Impact Assessment ("RIA")
- Chapters 11 and 12 conclude this consultation
- Annex 1 sets out the legal basis for the price cap decision

2 Executive Summary

11 This public consultation sets out ComReg's preliminary views regarding a proposed price cap decision, made under section 30(2) of the 2011 Act.

12 In making these preliminary views, ComReg has had regard to:

1. its statutory objectives, functions and duties;
2. the 2011 Act (particularly sections 28(1) and 30); and
3. the report and advice of its expert consultants, Frontier Economics[4].

2.1 Background

13 In proposing its price cap decision, ComReg is cognisant of its statutory function to ensure the provision of a universal postal service[5] that meets the reasonable needs of postal service users.

14 ComReg is of the view that a price cap decision, when made, should bring the price-controlled universal postal services back to profitability (all other things being equal), provided that An Post meets or betters the efficiency target which form part of the proposed price cap decision. If An Post does meet the efficiency target then, based on current data, it should make a profit of c. €46 million from provision of the universal postal service over the 5-year period of the proposed price cap, thereby underpinning and strengthening the provision by An Post of the universal postal service. ComReg, in setting the efficiency target, will endeavour to ensure that it is achievable by An Post.

15 Following ComReg Decision D13/13, the proposed price cap decision only relates to the universal postal service. It is for An Post to ensure that its other postal services and business activities, such as its International Inbound service[6], are financially viable.

[4] Frontier Economics has provided advice on the setting the price cap control published at ComReg Document No. 14/30a

[5] As set out at section 16 of the Communications Regulation (Postal Services) Act 2011

[6] The pricing of International Inbound is mainly by bi-lateral agreements between An Post and foreign postal service providers. According to An Post, the loss on the provision of International Inbound was €11.3m in 2012 (see http://www.anpost.ie/NR/rdonlyres/3159FB69-BA77-4453-9AC6-F19055F8CADA/0/AnPostRegulatoryAccounts2012Summary.pdf)

2.2 Design of the price cap control

16 Section 30 of the 2011 Act provides that in making a price cap decision ComReg shall:

(a) have regard to the tariff requirements specified in section 28(1) (which in summary are that tariffs for universal postal services shall be affordable, cost-oriented, uniform[7], transparent, and non-discriminatory);

(b) ensure that the price cap provides incentives for efficient universal postal services provision; and

(c) have regard to its statutory objectives, in particular to promote the interests of postal service users and small and medium-sized enterprises ("SMEs").

17 As market conditions change, An Post may wish to adjust its prices within the constraints of the proposed price cap - i.e., to increase some prices and/or decrease others such that the average price changes would comply with the overall price cap. ComReg believes that such pricing flexibility is important for An Post. However, ComReg must also assess the possible impact of such price adjustments, having particular regard to the tariff requirements and its objective to promote the availability of a universal postal service at an affordable price for the benefit of all postal service users. In addition, ComReg notes that in setting any of its prices, An Post is at all times subject to the ex post rules on competition, enforced by The Competition Authority.

18 For the reasons set out in Chapter 4 and contained in the draft RIA, ComReg's preliminary views on the design of the price cap are as follows:

- One basket should be used with a sub-control on the pricing of letters (stamp, meter, and label).
- A basket with fixed weights should be used; in particular, the fixed weights should be a proportion of base year volumes.
- An Post should be provided with a 'buffer', through the margin on opex in the cash-flow methodology, to cover it for the risk of non-manageable risks (e.g. greater volume declines than forecast in the price cap model).

[7] For universal postal services provided at single piece tariff

- Though section 30(5) provides for possible revision of a price cap decision after 3 years, ComReg considers that this should only be undertaken in relation to non-manageable risks that are not covered by the ‘buffer’ mechanism.
- A different X-factor should be set for the first year of the price control.

2.3 Key inputs into the calculation of CPI-X% price cap

19 Based on the high level design features of the price cap control outlined in Chapter 4, Chapter 5 focuses on the actual calculation of the CPI-X% price cap. It provides, insofar as possible given the confidential inputs to the price cap, a detailed explanation of each of the key inputs in calculating the CPI-X% price cap.

20 ComReg’s preliminary views on the key inputs in the calculation of the CPI-X% price cap are as follows:

Key model input	ComReg’s preliminary view
Year-on-year volume growth	An Post’s central scenario
Take up[8] of Downstream Access (“DSA”) and direct customer agreements	5% in 2014/15 and 5% in 2015/16
Price elasticity of demand	-0.22
Cost marginality	36%
Efficiency target	2.75% p.a. for total 13% over 5 year period of this price cap control
Proportion of An Post’s capex forecasts allowed	70%
Sub-control on Standard Letter (Stamp, Label, Meter)	Maximum annual price increase of 10% in 2014/15 and 3% in 2015/16 – 2018/19
Profit margin	1% in 2014/15 and 3% for 2015/16 – 2018/19

[8] As a percentage of the universal postal service, Discount 6 bulk mail

21 ComReg considers that its proposed year-on-year efficiency target, which if met would result in a 13% improvement in efficiency in universal postal service provision over the 5-year period of the price cap control, is a conservative figure, for the following reasons:

- it is based on internal benchmarking work which has not considered, for this proposed first price control, other possible factors, including, for example, how levels of remuneration at delivery units fare against those of comparable occupations in other sectors; and

- many of the lower bound estimates are based on samples where a large number of delivery units are deemed to be outliers and are hence excluded.

22 ComReg considers the proposed sub-caps to be appropriate given the requirement, specified in section 30(3)(c) of the 2011 Act, to protect the interests of postal service users and those of SMEs. ComReg's preliminary view on the quantum of these proposed sub-caps mean, and subject to An Post making the maximum allowed price increases under the sub-cap, that the price of a Domestic Stamped Letter would increase from 60 cents to c.75 cents over the 5-year period of the price cap control.

2.4 Key model outputs and resultant "X" in CPI-X% price cap

23 Based on the inputs above, the key output of the draft price cap model is as follows:

	2014/15	2015/16	2016/17	2017/18	2018/19
Revenues	€317,085,618	€299,321,131	€293,298,799	€288,243,244	€283,662,573
CAPEX	€4,548,416	€4,425,372	€4,363,841	€4,295,669	€4,224,902
OPEX	€309,442,774	€293,403,316	€281,599,235	€270,279,626	€259,372,310
Profit	€3,094,428	€1,492,443	€7,335,722	€13,667,949	€20,065,362

24 This results in preliminary "X%"s as follows for the CPI – X% price cap:

- X% for 2014/15: -10.11%; and

- X% for 2015/16- 2018/19: 1.71%.

25 This means, drawing on the key model inputs and given that the price cap formula is CPI-X, that on average, for those universal postal services which would not be subject to a sub-cap, prices would need to increase by approximately 11.13% in 2014/15 in order for An Post to recover its efficient costs (if it is assumed that An Post will increase its prices for Standard Post – Stamp and Label (Letters) and Standard Post - Meter (Letters) by the maximum 10% in 2014/15, in line with the recommended sub-cap).

26 The proposed preliminary X-factor for the period 2015/16 to 2018/19 is 1.71%. This means that for An Post to be compliant with the price cap control, the prices of its products which would not be subject to the proposed sub-cap prices would need to need to remain flat if out-turn CPI is in line with IMF's forecast (and if it is assumed that An Post will increase its prices for Standard Post – Stamp and Label (Letters) and Standard Post - Meter (Letters) by the maximum allowed of 3% in 2015/16 – 2018/19, in line with the recommended sub-cap).

27 However, it is worth noting that the proposed price cap would only set a maximum ceiling for An Post's prices and An Post could set its prices below the cap. Consequently, given information asymmetries, it would be for An Post to assess whether any price increase would be likely to have an adverse effect on profitability, due to resultant greater decline in mail volume.

2.5 Compliance with tariff requirements

28 Section 30(3) of the 2011 Act requires that ComReg, in determining a price cap, must have regard to the tariff requirements specified in section 28(1) of the 2011 Act, which in summary are that tariffs for universal postal services shall be affordable, cost-oriented, uniform[9], transparent, and non-discriminatory. Below is a summary of how the proposed price cap would have regard to each of the tariff requirements. An Post, in setting any future prices within the parameters of a price cap, would also have to ensure that those prices comply with the tariff requirements.

Affordability

29 As noted by ComReg in Document 12/138, affordability is assessed separately by ComReg for residential postal service users and businesses / SMEs. This is because price increases are unlikely to cause affordability issues for residential postal service users, who generally send relatively low volumes of post. However, ComReg and An Post need to ensure that the universal postal service remains affordable for businesses / SMEs, who generally send higher volumes of post.

30 For businesses / SMEs, ComReg is of the preliminary view that affordability would be ensured in part by an overall price cap and would be further ensured by additional sub-caps on Standard Letter Post – Stamp, Label, and Meter.

[9] For universal postal services provided at single piece tariff

Cost orientation

31 The 2011 Act does not require or empower ComReg to set exact prices for universal postal services, but only to set maximum prices. ComReg is of the view that An Post shall be responsible for ensuring that its prices for any of its universal postal services, within the parameters of a price cap, are cost orientated.

Transparency

32 Section 24(7) of the 2011 Act requires An Post to publish notice of any price changes with respect to the universal service provision on its website, and by any such other means as ComReg may direct. The price changes cannot come into effect until at least 14 days after the date of publication. As only certain universal postal service products are subject to the price cap control, ComReg is of the preliminary view that this statutory requirement will ensure sufficient transparency of tariffs set under the price cap.

Non-discrimination

33 In relation to non-discrimination, ComReg is of the preliminary view that the design features of the proposed price control, namely one basket with sub-controls on Standard Letter Post – Stamp, Label and Meter, should be sufficient to minimise the risk of An Post setting discriminatory tariffs for the universal postal services within the price cap control.

2.6 Compliance with price cap decision

34 To ensure compliance with the X-factor proposed by ComReg, An Post would be required to set prices such that, across all price controlled products, the total weighted average price increase in each year of the price control would not exceed the annual percentage change in CPI, minus X.

3 Background

3.1 ComReg Decision D13/13 – scope and form of the price cap

35 This is the second of two planned consultations. In the first consultation[10], ComReg consulted on two key high-level design features of the price control, namely (1) the scope and (2) the form.

36 This chapter summarises the decisions made on foot of the first consultation. This chapter also describes the financial challenges currently facing An Post.

Scope of the products under the price control

37 Pursuant to the 2011 Act, for a postal service within the scope of universal postal service to be subject to price cap control, ComReg must be of the opinion that there is no effective competition in the market for the supply of that service. Following Consultation 13/68, ComReg formed the opinion (Decision D13/13[11]) that "*the universal postal services specified in the Communications Regulation (Universal Postal Service) Regulations, 2012 form one market in which there is no effective competition. That market shall therefore be subject to price control, save for the following specific services which fall within that market but which do not require price control, for the reasons set out below:*

- *Postal services to blind and partially sighted, as this service must be offered for free in accordance with both the 2011 Act and SI 280 of 2012;*
- *Poste Restante, as this universal postal service must be offered for free in accordance with SI 280 of 2012;*
- *A service for the sorting, transport and distribution of postal packets deposited with a USP at an Office of Exchange within the State by the designated operator of a signatory to the Universal Postal Convention as An Post does not control the pricing of this International Inbound postal service; and*
- *Business Reply, as the universal postal service Freepost acts as a cap on the price for this universal postal service*."

[10] ComReg Document No. 13/68 dated 11 July 2013
[11] ComReg Document No. 13/82 dated 6 September 2013

38 The scope of the proposed price control does not contain all of An Post's services that fall within the scope of the universal postal service. It is therefore essential that An Post should correctly apportion all of its cost, revenue and volume data, as between its price-controlled services and its non price-controlled services. Only those costs, revenues and volumes that apply to price-controlled services should feed into the price cap model.

Form of the price control

39 Decision D13/13 also addressed the form of the price control. On foot of Consultation 13/68, ComReg formed the decision that a cash-flow model is the most appropriate model to use for the price cap control.

3.2 Financial challenges facing An Post

40 In reviewing An Post's last price application[12], ComReg noted a number of financial challenges facing An Post, namely:

- The significant declines in mail volumes
- The deteriorating cash position and high cash-burn rate of An Post

41 ComReg stated its views as follows:

"*ComReg remains of the view that An Post faces a very challenging financial situation and An Post management must address An Post's cash outflow as a matter of utmost urgency, in order to ensure the continued provision of the universal postal service by An Post at an affordable price for all its postal service users*."

42 ComReg has updated its review of the financial challenges facing An Post and how the proposed price cap mechanism should form *part* of a solution to address these.

[12] ComReg Document 12/138 dated 20 December 2012 and ComReg Document No. 13/21 dated 1 March 2013

Challenge for An Post: The significant declines in mail volumes

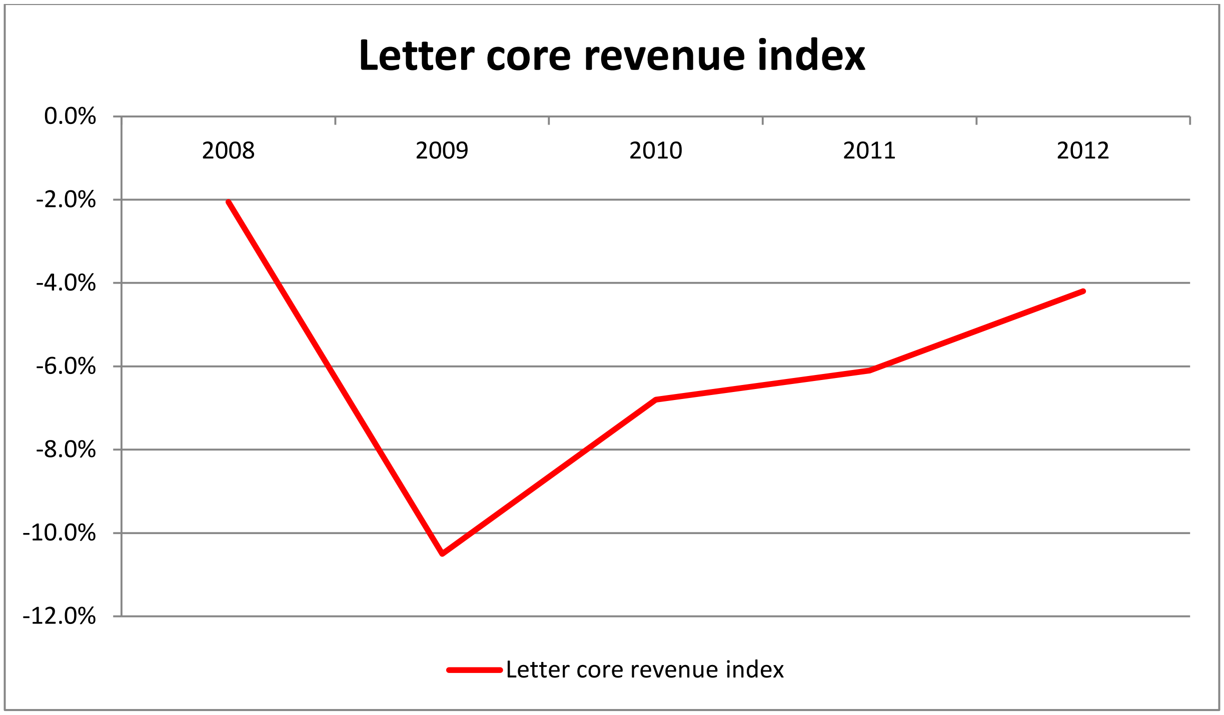
43 As previously noted by ComReg[12], traditional mail volumes are in decline, mainly due to replacement by electronic substitutes (”e-substitution”) and the challenging global economic environment. As noted in ComReg's Postal Strategy Statement[13], business postal service users account for over 80% of mail transactions and many of these users are seeking cheaper alternatives, often electronic, to deliver their communications. Therefore, it would appear that the greatest threat to An Post’s postal business does not come from other providers of postal services but lies outside of the postal sector – i.e. substitutable electronic methods of communication.

44 Furthermore, once a portion of mail business has been lost to an electronic substitute it is likely to be a permanent loss, as business customers would likely have to re-engineer their internal processes to take account of the switch to an electronic substitute.

45 The significant recent decline in mail volumes for An Post’s core letters business can be seen in the Figure 1 below[14]. This shows that though letter mail volume declines continue, the size of this decline is reducing to c. 4% per annum. This degree of decline is also reflected internationally and in other EU member states[15].

[13] ComReg Document No. 12/116
[14] Based on An Post's "letter core revenue index" published in its audited annual reports.
[15] See, for example, slide 3 in http://www.wik.org/fileadmin/Konferenzbeitraege/2013/14th_Koenigswinter_seminar/S1_1_Niederpruem.pdf

Figure 1: Decline in An Post's letter volumes



Source data: An Post annual reports

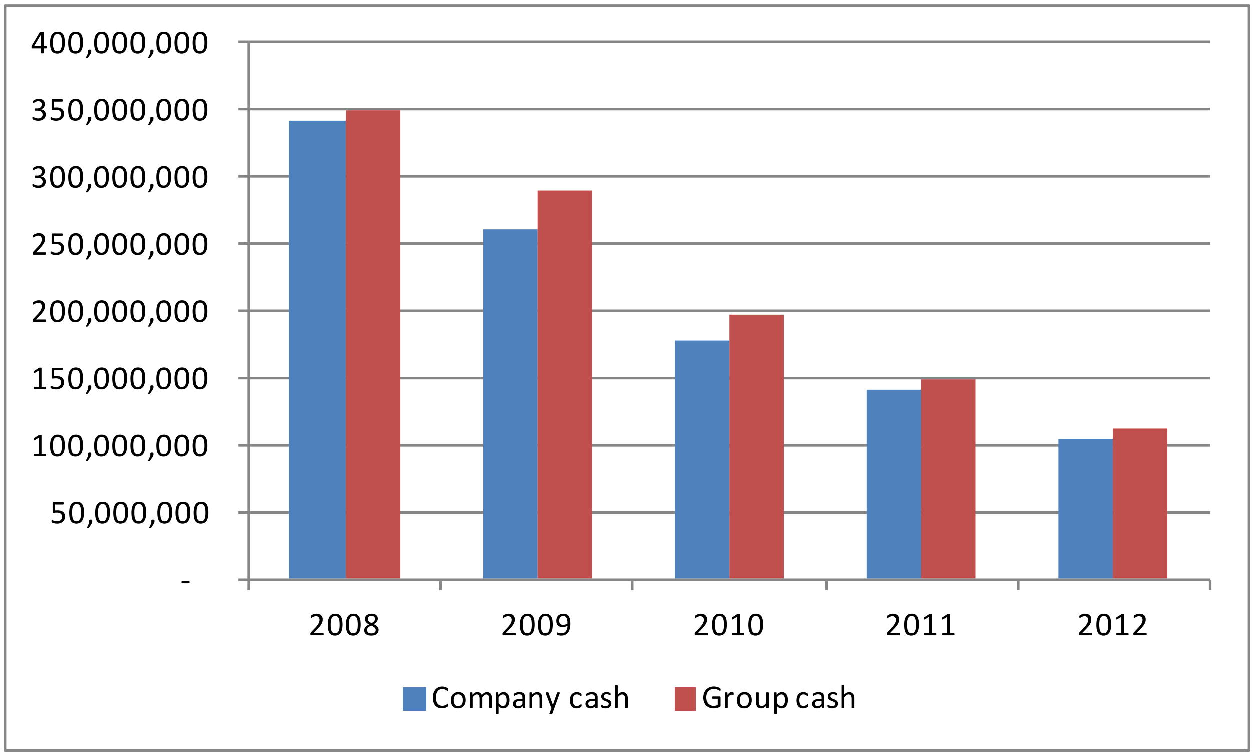
46 ComReg previously noted its view that any further significant decline in An Post's mail volumes, absent any commensurate reduction in its costs, would significantly increase An Post's costs per unit, thereby possibly placing the financial viability of the universal postal service provider at risk. It is highly questionable whether price increases could ever fully compensate for such a significant increase in per unit costs, as significant price increases could drive postal service users to switch to substitutable electronic services. A downward spiral could potentially occur in which a decline in mail volumes leads to an increase in per unit costs, leading to an increase in prices, leading to a further decline in mail volumes, leading to a further increase in per unit costs, leading to a further increase in prices, leading to a further decline in mail volumes, etc.

47 Therefore, the proposed price cap decision takes into account the likely price elasticity of demand effect of possible large price increases that may be made by An Post in 2014, as discussed later in this consultation. However, notwithstanding this and given information asymmetries, it is for An Post, as the USP, to assess whether any significant price increases under the price cap control would have an adverse effect on profitability, due to a resultant decline in mail volume. In this respect, it is worth remembering that a price cap sets a maximum ceiling and An Post, as the USP, has the discretion to price below the maximum ceiling.

Challenge for An Post: The deteriorating cash position of An Post

48 An Post is the current sole designated USP while ComReg's statutory remit is to ensure the provision of an affordable universal postal service that meets the reasonable needs of all postal service users. ComReg therefore remains concerned by An Post's deteriorating company and group cash position as this could have a negative impact on the continued provision of the universal postal service.

Figure 2: Decline in An Post's cash



Source: An Post's annual reports

49 As can be seen from the table above, cash reserves for the entire An Post group have been declining at a rate of c. €50-90m per annum. As noted by ComReg previously, the reduction in cash reserves in the period 2008 – 2011 was c.€200 million, of which c.76%[16] was capital expenditure such as purchase of new automated sorting machines while c.24% was cash paid for voluntary staff exit[17].

[16] Also, for information, according to An Post's audited annual reports, cash expenditure on Tangible Fixed Assets was c.€317m in the period 2002 – 2011 which was mainly expenditure on Operating Equipment and Buildings.

[17] Also, for information, according to An Post's audited annual reports, cash paid for Voluntary Severance / Voluntary Early Retirement was c.€93m in the period 2005 – 2011.

50 Furthermore, this general downward trend of c. €50m per annum persists despite the investment in new automated sorting machines, for the most part, being complete. Therefore, given a cash balance of c. €110m at the end of 2012[18], and absent any other changes, ComReg remains of the view that An Post faces a very challenging financial situation if its cash balance continues to reduce at the rate seen to date. Furthermore, ComReg considers that this situation, if not addressed by An Post, could impact on the provision of the universal postal service.

51 As noted above, ComReg's statutory remit is to ensure the provision of an affordable universal postal service that meets the reasonable needs of all postal service users. ComReg has a limited statutory remit to regulate An Post's postal services which are not universal postal services, while ComReg has no role to regulate An Post in its capacity as a provider of various non-postal products and services.

52 ComReg, acting in accordance with the 2011 Act, will endeavour to ensure the continuing provision of the universal postal service by setting a price cap that would enable An Post, as the USP, to recover its efficient costs and return its universal postal service to a maintained state of profitability. However, returning the universal postal service to a maintained state of profitability would also be subject to An Post meeting or exceeding the year-on-year efficiency target, as factored into the proposed price cap decision. ComReg considers that the proposed efficiency target should incentivise An Post to an appropriate extent, while also being achievable.

53 Also, for the avoidance of doubt, the proposed price cap would only apply to the universal postal services specified in Decision D13/13. The profitability or otherwise of other parts of An Post's mail and other businesses are for An Post itself to address.

[18] An Post's annual report for 2013 is expected April 2014

4 Design of the price cap control

54 Decision D13/13 sets out the opinion, formed by ComReg, that "*the universal postal services specified in the Communications Regulation (Universal Postal Service) Regulations, 2012 form one market in which there is no effective competition [and that] market shall therefore be subject to price control*". This opinion excludes four universal postal services which do not require price control. This consultation paper sets out ComReg's preliminary views on the price cap control. These preliminary views are made following consideration of the recommendations of Frontier Economics.

55 In making a decision as to the number, characteristics and form of the price control basket(s), two important design questions need to be considered:

- how much tariff rebalancing freedom to afford An Post relating to the number of baskets and the inclusion of any sub-controls; and
- how to weight the products in each basket.

56 Both questions are important as they will be key determinants as to the extent of pricing freedom that An Post will have.

4.1 Number of baskets and sub-controls

57 In order to determine the number, characteristics and form of the basket(s), a balance is required between allowing An Post sufficient commercial freedom to rebalance its prices, while also ensuring that competition is not foreclosed:

- An Post requires sufficient commercial freedom to rebalance prices in order to:
  - achieve cost orientation and non-discrimination between products; and/or
  - react to competitive market constraints; and
- ComReg must ensure that actual or prospective competition is not foreclosed (for example, through predatory pricing) and postal service users are protected from excessive prices. Although tariff rebalancing carried out within a basket by the universal service provider could be expected to be efficient, it raises two potential concerns:
  - possible distortion of competition faced by some services; and
  - different effects on different types of postal service users.

58 For the reasons set out in the draft RIA, and having considered the recommendation of Frontier Economics, ComReg is of the preliminary view that a single basket of postal services, with additional safeguards, should be put in place. ComReg considers that this would allow An Post an appropriate degree of commercial freedom to price the universal postal services in question while also ensuring the continued provision of the universal postal service, and that the interests of postal service users would be protected.

59 ComReg is further of the preliminary view that having a single basket of postal services should be combined with placing limits on the degree of pricing freedom afforded to An Post, in setting its prices for certain services within the basket. ComReg proposes to achieve this by setting a sub-control which would set annual maximum limits on the percentage change in price allowed for letters paid for by stamps, labels, and meter. ComReg considers that this measure would be in accordance with the statutory objective of protecting the interests of postal services users, including SMEs.

4.2 Weighting products in each basket

60 For the reasons set out in the draft RIA, and having considered the recommendation of Frontier Economics, ComReg is of the preliminary view that a tariff basket with fixed weights should be used; in particular, the fixed weights should be a proportion of base year volumes. ComReg considers that this would be in the best interests of stakeholders as a tariff basket approach can converge on optimum pricing decisions. In addition, as the tariff basket control uses fixed weights it has more certainty associated with it.

4.3 The treatment of uncertainty and risk

61 *Ex ante* price controls are, by their nature, forward-looking and are therefore based on certain assumptions about future costs and volumes. There will, inevitably, be some degree of uncertainty in making these forecasts, which may result in differences between projected values and actual values, over the 5-year period of a price cap.

62 These uncertainties can be classified as to whether they constitute manageable or non-manageable risks for An Post. Manageable risks are those which mainly fall within the control of An Post - for example, control of its operating costs. Unmanageable risks are those which mainly fall outside the control of An Post - for example, significant and unexpected changes in mail volumes.

63 ComReg has the statutory function to ensure the provision of a universal postal service that meets the reasonable needs of postal service users. Having regard to this function, ComReg previously set out[19] its view that mechanisms to deal with non-manageable risks, which mainly fall outside the control of An Post, should be factored into the price cap. This should reduce the risk of An Post being left financially exposed by such risks, thereby reducing any risks to the continued provision of the universal postal service. ComReg considers that An Post should be provided with a 'buffer' to cover it in relation to such unmanageable risks, and that the margin on opex in the cash-flow methodology would provide this buffer.

64 To provide a further mechanism by which non-manageable risks can be reduced, ComReg proposes to include a provision by which An Post could request ComReg to review the price cap decision, in respect of the specified basket of postal services or the value of "X", or both. It must be noted, in this regard, that sub-sections 30(4) and 30(5) of the 2011 Act provide that a price cap shall apply for 5 years, subject to possible review by ComReg after 3 years following which ComReg may amend its original decision. ComReg proposes that that such a provision would only relate to non-manageable risks that are not covered through the 'buffer' mechanism. Such a provision should therefore only allow An Post to request a review if:

- volumes of price controlled services depart significantly from those forecast at the start of the price control period, such that the universal postal service would be threatened (and in circumstances where An Post has met efficiency targets and the other requirements of the price control); or
- An Post should experience other significant and unforeseen changes in circumstances that threaten the universal postal service.

65 If ComReg should decide to agree to any such request by An Post to conduct a review of its original decision, this would involve a new public consultation.

4.4 X-factor calculation

66 The final key design feature, of a price cap decision by ComReg, is a methodology for calculating the appropriate value(s) of "X", to be used in the prescribed formula "overall limit = (Δ CPI) – X".

67 There are two main options in setting the value(s) of "X":

- X is fixed and does not change for the 5 years of the price control (i.e. actual revenue is smoothed equally over the full price control revenue); or

[19] ComReg Document No. 13/68 dated 11 July 2013

- X is variable and does change over the 5 years of the price control.

68 Having regard to current forecast declines in mail volumes, ComReg expects that revenue from price-controlled services at the start of the price control period would be much greater than at the end of that period. This forecast divergence in revenue may be further affected by An Post's ability to meet the efficiency targets which would form part of the proposed price cap decision. Therefore, if the value of X-factor is fixed, such that expected actual revenue is smoothed over the full price control period, then An Post's price controlled services would be unlikely to return to profitability until the end of the price control period.

69 Consequently, ComReg considers that the value of X for 2014/15 should be set separately than for 2015/16 - 2018/19. This should ensure a faster return to an appropriate level of profitability for the price-controlled universal postal services. Under this design, the average annual expected revenue, for each year during the 2015/16 to 2018/19 period, should be such that An Post should remain at an appropriate level of profitability. Different year-on-year X-factors for 2015/16 to 2018/19 are therefore not considered necessary.

4.5 Summary preliminary views on design of price cap control

70 The following summarises the preliminary views of ComReg, as set out in this chapter:

- One price control basket should be used with a sub-control on the pricing of letters (stamp, meter, label).
- A tariff basket with fixed weights should be used; in particular, the fixed weights should be a proportion of base year volumes.
- The universal postal service provider is provided with a 'buffer', through the margin on opex in the cash-flow methodology, to cover it for the risk of non-manageable risks.
- The price cap can be reviewed after 3 years but it should also only be made in relation to non-manageable risks that are not covered through the 'buffer' mechanism.
- A different X-factor should be set for the first year of the price control.

Q. 1 Do you agree or disagree with ComReg's preliminary views on the design of the price cap control? Please explain your response.

5 Key inputs for the calculation of CPI-X% price cap

71 This chapter focuses on calculation of the proposed price cap. It sets out and explains each of the key inputs to the price cap model, which mainly consist of data and analysis provided by An Post. Some of this data is confidential to An Post and, where appropriate, such confidential data has been redacted from this consultation paper and from the published version of the report by Frontier Economics which accompanies this paper.

72 The key model inputs relate to:

- base year
- volume forecasts
- cost marginalities
- efficiency factors
- opex and capex forecasts
- profit margin and other key inputs

5.1 Base year

73 The starting point for the calculation of allowed revenue over the price control period is An Post's own data for the base year of the model. Given that the price control will run from 2014/15[20] - 2018/19, 2013 will be the base year. This is the year from which An Post's opex and capex in the period 2014/15 – 2018/19 will be forecast, in order to calculate allowed revenue.

74 The model requires base year data on volumes, opex, capex and revenues for each universal postal service subject to price cap control.

- Volumes and opex - 2012 is the last year for which actual data for volumes and opex is currently available from An Post[21]. In order to calculate the base year volumes and opex, this data has been projected forward to 2013.

[20] ComReg expects the price cap to commence July 2014
[21] ComReg has requested 2013 actual data from An Post. This should be available to ComReg before ComReg makes its final price cap decision which is expected by July 2014.

- Capex – The base year capex in the model is calculated by adjusting An Post's forecast for 2013.

- Revenues – The base year revenues are calculated by multiplying average weighted prices for the base year with base year volumes.

75 Figure 3 provides an overview of the base year An Post data[22] that feeds into the model. An Post's data shows a significant overall loss of €42 million for 2013 on the universal postal service products that will be subject to the price cap control.

Figure 3: Base year (2013) data[23]

Format	Product	Volumes	Weighted price	Revenues	Operating costs	CAPEX	Profit
Letters	Stamped	76,608,623	0.60	45,965,174	61,693,215	1,599,505	-17,327,546
Letters	Labels	188,595	0.59	111,271	163,415	9,862	-62,006
Letters	Metered	93,407,639	0.59	55,110,507	60,448,436	1,723,233	-7,061,163
Letters	Discount 6 Caedunas	173,827,423	0.45	78,222,340	89,732,491	1,823,651	-13,333,802
Letters	Discount 9 Caedunas	422,258	0.48	202,684	191,355	16,139	-4,810
Letters	Standard International Outbound	24,657,150	0.85	20,943,556	25,900,190	562,158	-5,518,792
Letters	Standard IBMS	2,102,016	0.59	1,234,084	1,671,969	40,327	-478,212
Flats	Stamped	3,953,420	1.27	5,009,027	6,026,078	144,350	-1,161,401
Flats	Labels	1,287,420	1.50	1,936,324	2,063,899	52,898	-180,473
Flats	Metered	7,863,435	1.28	10,090,026	9,995,616	244,767	-150,357
Flats	Discount 6 Caedunas	796,665	0.99	791,631	773,592	24,208	-6,169
Flats	Discount 9 Caedunas	26,815	1.16	31,045	47,460	13,449	-29,863
Flats	Standard International Outbound	2,327,078	2.49	5,782,871	5,413,122	118,349	251,399
Flats	Standard IBMS	571,428	1.63	929,357	743,797	17,699	167,861
Packets	Stamped	2,077,740	3.86	8,022,402	6,610,636	150,626	1,261,140
Packets	Labels	1,424,940	4.47	6,370,563	4,830,781	110,280	1,429,502
Packets	Metered	1,936,980	4.49	8,687,391	5,566,540	126,418	2,994,433
Packets	Registered (Note 2)	3,245,352	5.90	19,147,577	22,261,606	841,892	-3,955,921
Packets	Standard International Outbound	3,438,423	6.47	22,255,071	21,581,089	385,531	288,451
Packets	Standard IBMS	63,501	3.60	228,338	280,322	9,862	-61,846
Parcels	Domestic	479,949	7.73	3,708,786	3,268,408	172,144	268,234
Parcels	International Outbound	118,204	41.74	4,933,489	4,397,418	237,595	298,476
Total				**299,713,513**	**333,661,436**	**8,424,942**	**-42,372,866**

Source: Frontier Economics based on analysis of An Post data

5.2 Volume forecasts

76 As noted by Frontier Economics, in order to determine the appropriate volume forecasts to be used in the price cap model, there are three key assumptions to consider:

- year-on-year volume growth rates;

- expected take up of downstream access and direct customer agreements; and

[22] Cash based rather than accounting based

[23] We have requested An Post to provide 2013 data on costs allocated to the following universal postal services: Freepost, PO Box, Residential and Business Redirections, and Mailminder. However, according to An Post, this information is unavailable at this time.

- price elasticity of demand.

Year-on-year volume growth rates

77 The first key volume related assumption is the 2013-2018 year-on-year volume growth rates. Figure 4 details the volume growth rate assumptions provided by An Post. These assumptions were calculated through the application of high level average volume growth rates (letters, flats and packets) generated through econometric analysis undertaken by Deloitte on behalf of An Post. Figure 5 outlines the seven scenarios generated by Deloitte through this analysis. For each scenario, Deloitte made assumptions around the trends over the period for the following volume growth drivers, relating to:

- GDP growth;
- the increase in the price of An Post's USO products; and
- the rate of e-substitution.

Figure 4: An Post's volume growth rate assumptions

Letters

	2013	2014	2015	2016	2017	2018
Stamp	-4.75%	-4.50%	-4.00%	-4.40%	-4.40%	-4.40%
Meter	-5.95%	-4.50%	-4.20%	-4.60%	-4.50%	-4.60%
Bulk	-4.25%	-3.90%	-3.70%	-3.80%	-4.00%	-4.00%
Registered						
PO Box/Mailminder/Redirections	-0.95%	-0.90%	-0.65%	0.85%	1.00%	1.00%
Overall Domestic	**-4.70%**	**-4.13%**	**-3.86%**	**-4.07%**	**-4.17%**	**-4.19%**
Outbound International	**-3.40%**	**-4.10%**	**-3.80%**	**-4.10%**	**-4.20%**	**-4.20%**
Inbound International	**-8.20%**	**-4.00%**	**-4.00%**	**-4.00%**	**-4.25%**	**-4.25%**

Flats

	2013	2014	2015	2016	2017	2018
Stamp	-14.00%	-11.90%	-11.65%	-13.25%	-13.60%	-14.00%
Meter	-14.50%	-13.90%	-13.65%	-14.25%	-13.60%	-14.00%
Bulk	-13.50%	-13.00%	-12.65%	-12.25%	-13.00%	-13.00%
Registered						
PO Box/Mailminder/Redirections						
Overall Domestic	**-14.02%**	**-13.07%**	**-12.77%**	**-13.28%**	**-13.39%**	**-13.65%**
Outbound International	**-3.80%**	**-13.10%**	**-12.70%**	**-13.20%**	**-13.40%**	**-13.60%**
Inbound International	**-8.20%**	**-4.00%**	**-4.00%**	**-4.00%**	**-4.25%**	**-4.25%**

Packets

	2013	2014	2015	2016	2017	2018
Stamp	2.00%	3.30%	4.20%	3.90%	4.00%	3.00%
Meter	2.00%	3.60%	4.50%	3.85%	4.00%	4.00%
Bulk	1.00%	4.10%	4.35%	3.35%	3.50%	5.50%
Registered	-2.95%	-1.40%	-0.15%	0.35%	0.50%	0.50%
PO Box/Mailminder/Redirections						
Overall Domestic	**0.21%**	**1.93%**	**2.91%**	**2.73%**	**2.89%**	**2.81%**
Outbound International	**4.10%**	**3.60%**	**4.30%**	**3.90%**	**3.90%**	**3.90%**
Inbound International	**0.00%**	**3.00%**	**2.75%**	**2.75%**	**2.75%**	**2.75%**

Parcels

	2013	2014	2015	2016	2017	2018
Domestic and outbound international	**1.90%**	**3.60%**	**4.10%**	**3.90%**	**3.90%**	**3.90%**
Inbound International	**0.00%**	**3.00%**	**2.75%**	**2.75%**	**2.75%**	**2.75%**

Source: An Post data

Figure 5: An Post's advisors (Deloitte) volume forecast scenarios

		Average volume growth 2013-2018		
		Letters	Flats	Packets
1	GDP = IMF, Price increase=0%, E-substitution = 2010-2012 growth rate extrapolated	-4.2%	-13.3%	3.6%
2	GDP = IMF+20%, Price increase=0%, E-substitution = 2010-2012 growth rate extrapolated	-4.0%	-13.0%	4.0%
3	GDP = IMF-20%, Price increase=0%, E-substitution = 2010-2012 growth rate extrapolated	-4.4%	-13.7%	3.1%
4	GDP = IMF, Price increase=2%, E-substitution = 2010-2012 growth rate extrapolated	-4.4%	-14.1%	1.5%
5	GDP = IMF, Price increase=0%, E-substitution = 20% greater than 2010-2012 growth rate extrapolated	-4.8%	-14.8%	3.7%
6	GDP = IMF-20%, Price increase=0%, E-substitution = 20% greater than 2010-2012 growth rate extrapolated	-5.0%	-15.2%	3.2%
7	Exponential smoothing	-3.3%	-15.9%	-10.0%

Source: An Post / Deloitte (An Post's advisors) data

78 Having considered the recommendation of Frontier Economics, ComReg is of the preliminary view that it will utilise An Post's central volume forecasts in the price cap model. An Post's central volume forecast assumes that GDP grows in line with International Monetary Fund ("IMF") forecasts, that there will be no price increase for An Post's universal postal services, and e-substitution grows at the same rate as it did over 2010 – 2012. As noted by Frontier Economics, and as concurred with by ComReg, An Post's forecast seems reasonable based on:

- the available data on recent overall rates of e-substitution,
- the type of mail that has been affected,
- international comparisons,
- An Post's own data for latest actual volume trends,
- against An Post's 5 year plan for 2014 - 2018.

Downstream access and direct customer agreements

79 A key assumption in the price cap model is the forecast of mail volumes that will move to either:

- Downstream access ("DSA") which is a commercial agreement between An Post and a postal service provider[24], or
- Direct customer agreements which is a commercial agreement between An Post and its larger postal service customers (e.g. utilities).

80 This is a key assumption for volume forecasts in the price cap model, as the above commercial agreements are not universal postal services and therefore cannot be subject to price cap control.

81 In forecasting product-by-product volumes over the price control period, An Post has made the assumption that ✂% of its existing bulk mail volumes would move to DSA or direct customer agreements. As the universal postal service, Discount 6 product, accounts for the vast majority of this volume, this assumption is modelled as a ✂% decline in the Discount 6 product. An Post expects that ✂% of this decline will come from the take up of DSA and the other ✂% from the take up of direct customer agreements. In relation to timing, An Post forecasts that ✂% take up will occur in 2014 and the remaining ✂% in 2015.

82 A ✂% decrease in existing bulk mail volumes would represent a significant decline in mail volumes within the price cap control. Therefore, it is essential that a reasonable assumption as to the likely take up of such commercial agreements, by existing bulk mail customers, is included in the price cap model. If assumed take up is set too low then this may impact on the sustainability of the universal postal service. Conversely, if assumed take up is set too high then this may lead to over-recovery of revenues by An Post and may result in retail prices that are unnecessarily high for postal service users.

[24] The current list of authorised postal service providers is at http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html

83 According to An Post, the maximum discount that can be offered on these commercial agreements is ✂ cent per item, which represents the outward sorting costs per item. Even at this maximum discount, take up relies on DSA operators and large customers being able to undertake sorting (and collection where appropriate) for less than the maximum discount of ✂ cent per item. An Post would also be required to charge VAT on the postal services provided under these commercial agreements, as they would not be exempt universal postal services. An Post has provided analysis to suggest that c.50% of its bulk mail customers are VAT exempt. The ✂% take-up assumption therefore implies that c.✂% of An Post's bulk mail customers, who could move to a DSA product or a direct customer agreement, would do so.

84 An Post also provided data relating to its individual negotiations with other postal service providers and its large customers, including the expected mail volumes associated with each negotiation. As a result of these negotiations, ✂ Downstream Access ✂ is in place with ✂ postal service ✂ and ✂ Downstream Access ✂ has been reached in principle with ✂ postal service ✂. However, ✂ direct customer agreements are currently in place between An Post and its large customers. The volumes that An Post expects to move under its first Downstream Access agreement equates to only ✂% of Discount 6 volumes, with ✂% of Discount 6 volumes expected to move ✂. An Post expects a further ✂% of Discount 6 volumes to move under direct customer agreements. These figures, in total, equate to ✂% of Discount 6 volumes.

85 Given the low number of Downstream Access and/or direct customer agreements currently in place (or even in an advanced stage of negotiation) and the large degree of uncertainty surrounding take up of direct customer agreements, ComReg considers An Post's assumption of ✂% take-up to be unrealistic. Frontier Economics recommends that ComReg should assume take up of between 0-10% for the period 2014/15, and 0-10% for the period 2015/16.

86 Having considered the above, ComReg proposes that it will assume take up of 5% (from Discount 6 bulk mail volumes) for the period 2014/15, and a further 5% (from Discount 6 bulk mail volumes) for the period 2015/16. ComReg would welcome views on this, particularly from parties that are planning to enter into Downstream Access or direct customer agreements with An Post over the period of the price cap control.

Price elasticity of demand

87 As set out above, ComReg's proposes separate values of "X" for the periods 2014/15 and 2015/16 - 2018/19. This would likely result in a large initial price increase, followed by no changes/relatively minor price changes over the latter period (depending on whether the USP makes the maximum price increases allowed for letters paid by stamp, label, meter). To take account of the impact on mail volumes of the large initial price increase, Frontier Economics recommends that the price cap model should allow for the inclusion of an elasticity effect on 2015/16 volumes (in addition to the year-on-year growth rates outlined above).

88 Having considered the recommendation of Frontier Economics, ComReg considers that the elasticity estimates to be used in the model should be those submitted by An Post, through the 2012 report prepared by Indecon on its behalf. Based on a PCAIDS approach, Indecon estimated a price elasticity of demand of 0.22[25] for stamp, metered and bulk products. Having considered the recommendation of Frontier Economics, ComReg considers it appropriate to use this estimate for all universal postal services subject to price cap control. This approach is in line with ComReg's review of An Post's 2012 interim price application. An Post has not provided any evidence to suggest that these elasticities would have changed notably since this time.

5.3 Cost marginalities

89 Cost marginality measures the extent to which costs adjust as volumes decline. Given the fixed costs associated with the mail network, ComReg concurs with Frontier Economics that ComReg would not expect costs to decline one-to-one in line with volumes, i.e. a 1% decline in mail volumes should lead to a decline in costs of less than 1%.

90 In the context of expected continued decline in mail volumes, in order to produce robust opex forecasts over the price control period it is essential to include an assumption around An Post's cost marginality in the model.

[25] This means a price increase of 10% would reduced demand by 2.2%

91 An Post estimates that the weighted marginality associated with the provision of universal postal services is 36%, i.e. a 1% decline in mail volumes leads to a 0.36% reduction in costs. An Post estimates that this marginality saving takes around three years to materialise as it would not be possible for it to re-design all of its DSU/DSOs in one year. This suggests that the annual marginality factor is lower than 36%. However, recent mail volume declines are not significantly different from those forecast over the price control period and ComReg therefore concurs with Frontier Economics' view that annual marginality should average out around An Post's marginality estimate of 36%. This estimate also appears reasonable in a business where costs of a significant part of the mail pipeline are largely fixed (i.e. delivery).

92 Therefore, ComReg proposes that an annual cost marginality assumption of 36% be included in the price cap model.

5.4 Efficiency factors

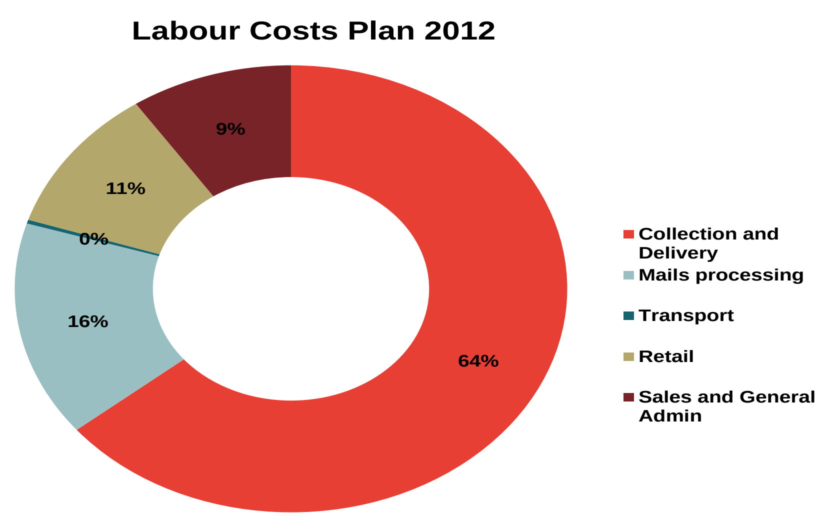
93 Section 30(3)(b) of the 2011 Act requires ComReg to ensure that the price cap provides incentives for efficient universal postal service provision. In Consultation Document 13/82, ComReg noted: "*if An Post is deemed by ComReg not to be fully efficient at the start of the price control period, consideration should be given to the use of a glide path towards efficient costs to allow An Post sufficient time to align its cost base with an efficient level. This would ensure the sustainability of the universal postal service while ensuring consumers benefit as soon as possible from improved efficiency.* "

94 A key consideration in setting a price cap will be the current level of efficiency of An Post and whether any efficiency gains can be made, including the appropriate timescales to achieve such gains. In carrying out this assessment it is essential to consider both:

- static efficiency gains (i.e. any efficiency improvements that may be required to bring An Post's current cost base in line with that of an efficient service provider); and
- dynamic efficiency gains (i.e. any further efficiency improvements that would be possible over the price control period).

95 Based on data provided by An Post, Frontier Economics has assessed An Post's efficiency for its universal postal service. As shown in Figure 6, the largest cost centre in An Post's business is collection and delivery. Therefore, for this first price control, collection and delivery has been the primary focus of the assessment. To complement this, some indicative efficiency analysis of An Post's mail centres was also conducted.

Figure 6: An Post's labour costs by business units



Source: An Post

96 Frontier Economics' overall approach in relation to assessing efficiency, which ComReg agrees with, has been to review the data provided by An Post and its advisors Deloitte.

Collection and delivery

97 As noted above, collection and delivery is the largest cost centre in An Post's pipeline. Its management, in the context of falling mail volumes, is therefore fundamentally important for An Post. In recent years, An Post has implemented a number of initiatives aimed at improving the productivity in this part of the pipeline. Among others, these initiatives have included the periodic redesign of delivery units to reflect the decline in mail volumes.

98 An Post has a network of delivery service units (DSUs) and delivery service offices (DSOs). These are primarily responsible for the delivery of mail and also carry out mail collection and sortation activities. DSUs are larger than DSOs and tend to cover more urban areas. Mail is distributed from the one of the four mail centres to a DSU, where it is sorted and delivered either to the addressee or to a DSO. DSOs, in turn, deliver mail to postal service users located in their assigned area. In recent years, An Post has reduced the number of DSOs, from 378 in 2008 to 305 in 2012, while instead concentrating its delivery operations in the larger DSUs. In 2012, there were 118 DSUs and 305 DSOs across Ireland. DSUs account for the vast majority of costs in delivery (c. 84%). ComReg has therefore focussed its assessment on the level of efficiency on this particular aspect of the delivery network.

99 An Post's advisors, Deloitte, undertook econometric benchmarking of An Post's DSUs, in order to measure the possible efficiency improvement that could be achieved if all DSUs were brought up to the same efficiency levels as the most efficient DSUs.

100 Deloitte used internal (econometric) benchmarking of An Post's delivery offices to estimate the scope for efficiency gains. This method identifies inefficiency by comparing the performance of different An Post delivery offices, while accounting for their characteristics[26]. Some differences in performance are attributed to inefficiency while others are assumed to be caused by other factors. Fundamentally, this method advisors measures relative inefficiency, by reference to An Post's best performing delivery units.

101 Deloitte's model compares differences in An Post staff costs between delivery units, controlling for:

- the number of delivery points;
- delivery point density;
- mail volumes per delivery point;
- the type of addresses served (% business addresses); and
- the number of DSOs served by each DSU.

[26] Such as volume, delivery point number, delivery point density etc

102 Deloitte's econometric benchmark model is estimated using the stochastic frontier analysis (SFA) approach[27].

103 Using the SFA approach recommended by An Post's advisors, Deloitte, a number of model versions and sensitivities were run. The average efficiency estimates are shown below:

Table 1: Adjusted USO capex forecast 2014-2018

	Base case 2 outliers[28]	Excluding standarised residual outliers	Excluding Cook's distance outliers
2012-2013	90.0%	93.0%	92.0%
2011-2013	85.4%	88.6%	87.1%
2010-2013	82.1%	84.9%	84.7%
2009-2013	77.9%	82.6%	82.1%

Source: Frontier Economics analysis based on An Post's advisors, Deloitte, model specification and An Post data

104 As Table 1 shows, the estimated average efficiency of DSUs ranges between 78% and 93%, depending on the sample used. In general, as noted by Frontier Economics, and perhaps not surprisingly, the model finds less inefficiency in smaller samples (i.e. covering smaller time periods) than in larger samples (i.e. covering longer time periods). Specifically, the 2012-2013 sample results in inefficiency estimates of between 7%-10%, while the 2009-13 sample results in inefficiency estimates of between 18%-22%.

[27] SFA is a commonly used technique for assessing technical inefficiencies which recognises that differences in cost performance across operation units can be due to random factors but also due to inefficiencies. As noted by Frontier Economics, for this reason SFA typically leads to lower estimates of inefficiency than alternative econometric techniques such as corrected ordinary least squares (COLS), for example.

[28] Outliers are data points which are not typical for the sample and have considerable impact on the estimates

105 An Post and Deloitte have submitted that more reliance should be placed on the results using the smallest sample (2012-2013: 7-11%) because they believe the more recent years to be more relevant for a forward looking price control, and because they feel there are econometric reasons[29] to prefer the estimates from the smallest sample to those from the largest sample. Frontier Economics is of the view that there is no econometric reason to consider the results from the 2012-13 sample to be more robust than the results from the longer samples. Frontier Economics is further of the view that the longer samples are based on more data[30] and therefore provide better estimates. Frontier Economics therefore recommends that the full range of estimates from the econometric benchmarking of DSUs of 7%-22% should be considered by ComReg when setting the efficiency target for the price control. ComReg agrees with this recommendation.

Mails processing

106 Mails processing is the second largest cost centre in An Post's pipeline, accounting for c. 16% of labour costs. An Post operates a network of four mail centres:

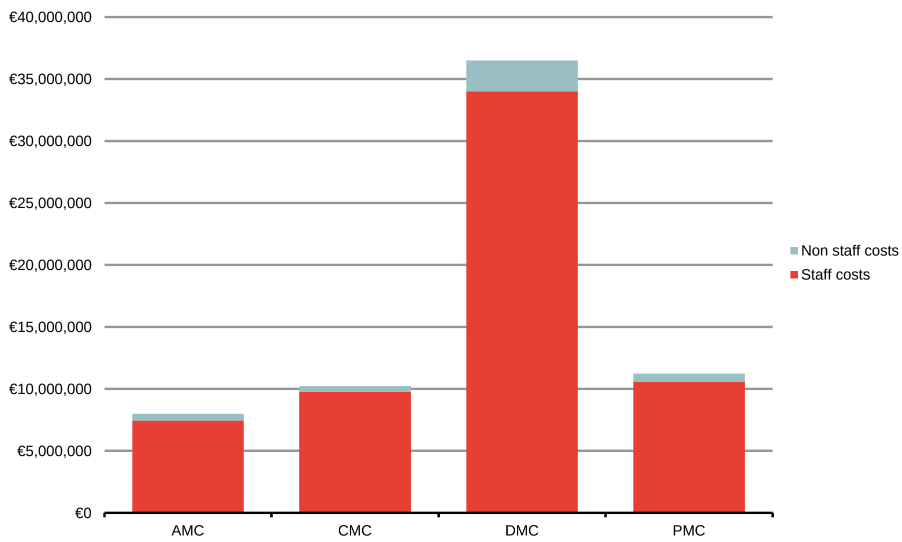
- Portaloise mail centre (PMC);
- Dublin mail centre (DMC);
- Cork mail centre (CMC); and
- Athlone mail centre (AMC).

107 All four mail centres are single floor buildings and were constructed relatively recently. The first mail centre, DMC, was built 20 years ago and it is the largest mail centre, processing more mail than the other three combined. Mail centre costs totalled c. €70m in 2012, mainly comprised of staff costs. More than half of mail centre costs are accounted for by the DMC, as shown in Figure 7.

[29] Deloitte have argued that heteroscedasticity may bias the results from the panel SFA using the 2009-2013 data

[30] Excluding 2009-2011 data reduces the sample by 55%.

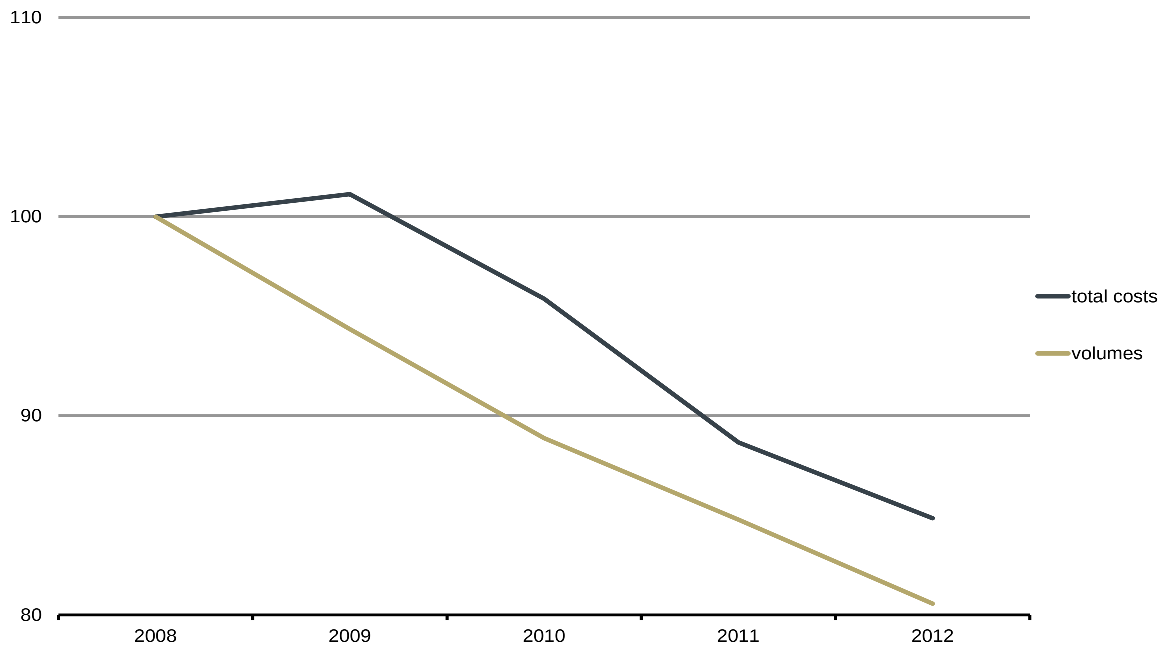
Figure 7: Mail centre costs 2012



Source: Frontier Economics analysis based on An Post data

108 As shown in Figure 8, the volumes of mail processed by the four mail centres have been declining over the past five years. Although costs of operating the mail centres have also fallen, they have not fallen in line with mail volumes. There have not been any changes in the number of mail centres in Ireland over the last decade.

Figure 8: Costs and volumes in mail centres (index, 2008=100)



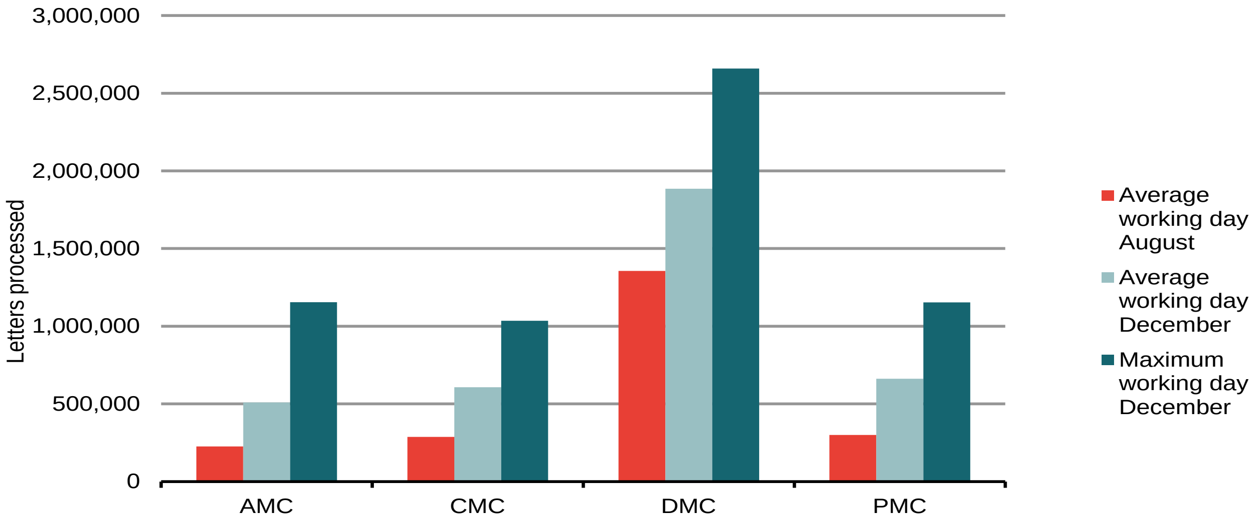
Source: Frontier Economics analysis of An Post data. Normalised costs (real 2008) and volumes

109 As noted by Frontier Economics, the efficiency of mail centres cannot be assessed using econometric techniques due to the small number of observations. However, a number of basic analyses provide a useful check to determine whether the levels of inefficiency estimated in delivery is also reflected in mail centres.

110 According to Frontier Economics, and based on information provided by An Post, there is evidence of spare capacity in An Post's mail centres. All mail centres operate well below capacity during certain periods of the year. If not addressed, it would seem clear that spare capacity in mail centres will increase over time, as mail volumes continue to decline. Figure 9 shows utilisation rates in the four mail centres in peak[31] and off-peak months[32] of the year.

[31] The month of December
[32] The month of August

Figure 9: Letters processed in peak and off-peak periods



Source: Frontier Economics analysis based on An Post data

Preliminary view on efficiency:

111 It is clear from the analysis presented by Frontier Economics, which is based on data provided by An Post, that there are inefficiencies in An Post's network. Econometric benchmarking of An Post's delivery network revealed inefficiencies in the range of 7% to 22%. Further analysis of the mail centres indicates that efficiency in this part of the network is not significantly different to that in delivery.

112 Frontier Economics notes that this estimated efficiency range is likely to be conservative because:

- it is based on internal benchmarking work which has not considered, for this proposed first price control, other possible factors, including, for example, how levels of remuneration at delivery units fare against those of comparable occupations in other sectors; and

- many of the lower bound estimates are based on samples where a large number of delivery units are deemed to be outliers and are hence excluded.

113 Notwithstanding this, the price cap must provide An Post with incentives for efficient provision of the universal postal service. Any efficiency targets which ComReg sets for An Post must be achievable within the price control period. This means that the targets must be set at a level and trajectory which will sufficiently balance the requirement to ensure the continued provision of the universal postal service against the requirement that universal postal services remain affordable.

114 Setting an efficiency target that aims to close the static efficiency gap in full is likely to be too challenging for An Post, especially in the first 5-year price control period. For example, setting an efficiency target that is set too ambitious could result in An Post under recovering revenues, which in turn could threaten the sustainability of the universal postal service.

115 Having considered Frontier Economics' recommendation, ComReg considers that there should be a glide path toward the efficiency target. Frontier Economics recommends that ComReg sets a static efficiency target towards the lower to mid end of the 7-22% range, for the 5-year price control period. Frontier Economics also recommends that the efficiency target should be split equally over each year of the price control period, in order to allow An Post time to remove inefficiencies. Frontier Economics' considers an annual efficiency target, in the lower to mid end of the 7-22% range, to be achievable. Further, such a target would seem to correlate with An Post's own 5 year business plan which projects cost savings of c. €✂m (or ✂% of costs) from initiatives over the 2014-2018 period with most of these initiatives relating to improvements in efficiency.

116 Given the size of the static inefficiency estimates, and ComReg's proposal to use a glide path towards this target, Frontier Economics recommends that no dynamic efficiency target should be applied in this first 5-year price control period. A dynamic efficiency target is often applied by regulators in order to reflect expected increases in input prices and ongoing improvements in productivity performance. Given the conservative treatment of static efficiency, the application of the glide-path to the efficiency target, and no setting of a dynamic efficiency target, ComReg agrees with Frontier Economics recommendation to not to include a modest inflation of input prices.

117 Therefore, ComReg proposes that a static efficiency target of 2.75% per annum ("p.a.") be included in the price cap control (13% over the 5-year duration of the price cap). ComReg further proposes that there is no dynamic efficiency target, but ComReg will give full consideration to dynamic efficiency targets for the subsequent price control periods.

118 ComReg's proposed means of ensuring that the price cap provides incentives for efficient universal postal services provision is to set an appropriate efficiency target, as described above. An Post's actual current level of inefficiency, based on information available to ComReg, is at least at the top of 7-22% range set out above. For the avoidance of doubt, ComReg would note that the proposed efficiency target for this first price cap control does not relate to any assessment of efficiency that would be required as part of any formal application by An Post for funding in respect of the net cost of the universal postal service. Section 35(5)(ii) of the 2011 Act provides that for the purpose of making a determination in respect of such an application, ComReg shall take into account the extent to which An Post is providing a universal postal service in a cost-efficient manner and that would be a separate assessment to be conducted by ComReg.

5.5 Opex and capex forecasts

119 The next key inputs to consider are the opex and capex forecasts for the 2014/15 – 2018/19 price control period. This section outlines the model assumptions with regards to the opex and capex forecasts, based on data provided by An Post.

Capex

120 The capex forecast used in the price cap model is based on An Post's nominal capex forecasts in respect of its universal service obligation ("USO"), for the period 2014 – 2018 inclusive. These forecasts have been adjusted to reflect only those universal postal services that will be subject to price cap control and to convert this expenditure into real terms, as shown in Table 2.

Table 2: Adjusted USO capex forecast 2014-2018

	2014	2015	2016	2017	2018
Adjusted USO capex	€4.5m	€4.4m	€4.4m	€4.3m	€4.2m

Source: Frontier Economics analysis of An Post data

121 In order to assess whether the full amount of An Post's forecast capex should be factored into the price cap calculation, ComReg must decide whether the forecast capex is justified and whether it would be efficiently incurred. An Post did provide a high level breakdown of the capex forecast for the whole postal business. However, An Post has not provided a list of the investments included in the aggregate USO capex figure, or detailed investment plans for ComReg's scrutiny.

122 Given this lack of information, ComReg cannot confidently conclude that all of forecast capex, shown in Table 2 above, is justified and would be efficiently incurred. Against this background, Frontier Economics recommends that ComReg allows 60-80% of An Post's forecast capex to be included in the price cap calculation, subject to An Post providing any more detailed investment plans which may justify inclusion of the full forecast capex.

123 Based on the information provided by An Post, ComReg proposes factoring 70% of An Post's forecast capex into the price cap calculation.

Opex

124 Starting with base year opex, the opex forecast used in the price cap model is calculated by making two key adjustments, on a year-on-year basis, in order to project efficient opex over 2014/15 – 2018/19. In particular, the previous year's opex is adjusted for:

- the cost marginality impact of the forecast volume declines (as described in section 5.3); and
- the impact of annual target efficiency savings set for An Post (as described in section 5.4).

5.6 Sub-controls

125 As set out in section 4.1 and in the draft RIA, ComReg proposes having a single basket of postal services and that this would be combined with placing limits on the degree of pricing freedom afforded to An Post, in setting its prices for certain services within that basket. ComReg proposes to achieve this by setting a sub-control which would set annual maximum limits on the percentage change in price allowed for letters paid for by stamps, labels, and meter. ComReg considers that this measure would be in accordance with the statutory objective of protecting the interests of postal services users, including SMEs.

Standard Letter Post - Stamp and label

126 In setting an appropriate limit on the annual percentage change in prices for Standard Letter Post - Stamp and Label, it is important to first consider the current fully allocated cost[33] of these products. Given the inherent link between the price of the Stamp and Label products, the focus is on the cost reflectivity of Stamps.

[33] Before any adjustment for inefficiency

127 Based on 2012 cost and volume data provided by An Post (i.e. the last year of data that is currently available[34]) it has been estimated that the 2012 weighted average unit cost[35] for Stamped letters was €0.82; which is the fully allocated cost and does not reflect efficient cost[36]. This compares to the current weighted average price of €0.60. Given the requirement under section 28(1) of the 2011 Act that tariffs be cost-oriented, it is important that any sub-controls do not unduly restrict An Post from correcting any efficient cost / price misalignment. However, it is also essential that these limits are set at a level which reflects the efficient cost of provision, and therefore takes account of the inefficiencies identified by the efficiency analysis, adjusting the €0.82 accordingly. At the same time, it is also essential to be cognisant of the ultimate aim of these sub-controls which is to prevent An Post from engaging in excessive tariff rebalancing, within the price cap period.

128 In order to strike this balance, Frontier Economics recommends that the sub-control on Standard Letters Post - Stamp and Label be set in the range of 2 – 4% for the period 2015/16 – 2018/19.

129 Having considered the recommendation of Frontier Economics, ComReg is of the preliminary view that the sub-control on Standard Letters Post - Stamp and Label should be set at 10%[37] for the period 2014/15, and 3% for the period 2015/16 - 2018/19. The setting of a different rate for 2014/15 is also in line ComReg's proposal to set different values of X for these same two periods. ComReg is of the preliminary view that 3% is a sufficient annual price increase for Standard Letters Post – Stamp and Label, particularly as it is considerably higher than forecast CPI. ComReg is also of the preliminary view that a 3% price increase p.a. should not raise affordability issues. The quantum of this sub-control, if An Post chooses to price at the maximum allowed, means that the price of a Domestic Stamped Letter will increase from 60 cents to c.75 cents over the 5-year period of the price cap control.

[34] We have requested 2013 data from An Post but it is unavailable at this time
[35] Which is the fully allocated cost and does not reflect efficient cost
[36] By way of example, if 13% is set as the target for efficiency, the resultant efficient cost would be c.72 cents
[37] This is also consistent with the overall X-factor for the first year, 2014/15

Standard Letter Post - Meter

130 In setting a sub-control limit on the annual percentage change in price for Standard Letter Post – Meter, it is important to consider the relationship between this universal postal service and Standard Letter Post - Stamp and Label. ComReg has previously stipulated to An Post that the discount offered by An Post for Standard Letter Post – Meter may only reflect the cost savings associated with this payment method, as compared against Standard Letter Post - Stamp and Label. Based on the information provided by An Post, there is nothing to suggest that this cost saving may change significantly over the price control period. Therefore, Frontier Economics recommends that the sub-control on Standard Letter Post – Meter be the same as the sub-control on Standard Letter Post – Stamp and Label. Having considered the recommendation of Frontier Economics, ComReg proposes that the sub-controls on Standard Letter Post-Meter be set at the same level as those on Standard Letter Post – Stamp and label, i.e. 10% in 2014/15 and 3% in 2015/16 - 2018/19. Again, this would be the maximum price increases allowed; An Post would be free to price its Standard Letter Post – Meter below this.

5.7 Profit margin and other key inputs

131 The final stages of calculating the price cap are to convert the opex and capex forecasts into allowed revenue for each year of the price control, and then calculate the resulting values of “X” for 2014/15 and 2015/16 – 2018/19. Related to this, there are a number of further model inputs for which ComReg needs to make decisions. In particular, the appropriate:

- profit margin on opex; and
- inflation forecast and interest rate.

Profit margin

132 ComReg is of the preliminary view that a profit margin on opex should be factored into the price cap, in order to provide a ‘buffer’ to cover An Post in the event of an unexpected exogenous shock occurring which would affect its provision of the universal postal service.

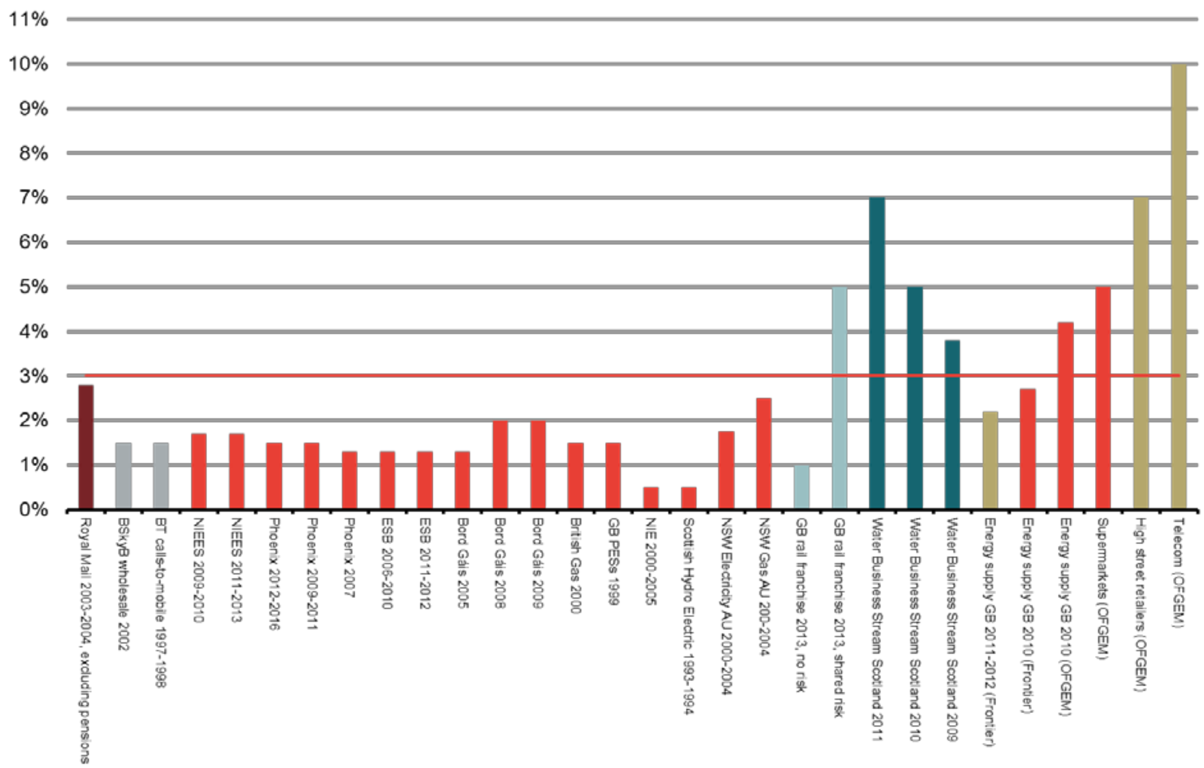
133 As noted by Frontier Economics, in order to determine the appropriate size of this profit margin, it is appropriate to consider:

- regulatory precedent in the postal sector;

- regulatory precedent in other regulated sectors; and
- the buffer required to account for volume risk in the provision of the universal postal service.

134 Frontier Economics examined allowed margins in the postal sector and other regulated sectors. Figure 10 shows the margins allowed by regulators under price control decisions in a variety of regulated industries. The allowed margin in the previous postal sector decision (Royal Mail 2003-2004) was 2.8% and the average allowed margin across all previous decisions is 3%.

Figure 10: Allowed margins in the postal sector and other regulated sectors



Source: Frontier Economics

135 A further point to consider is the interaction of the choice of profit margin with the approach of setting a separate value of “X” in 2014/15. Ultimately, the profit margin is designed as a buffer to protect An Post against uncertainty in its provision of the universal postal service. This approach to setting the X-factor results in 2014/15 actual revenue being equal to 2014/15 allowed revenue, removing some of the risk to the USP for 2014/15. Combined with the fact that this is the first year of the price control and therefore there is inherently less uncertainty about volume outturns, ComReg is of the preliminary view that it is appropriate to set a lower profit margin for 2014/15.

136 Frontier Economics, recommends a profit margin of 2-4% for 2015/16 – 2018/19. For 2014/15, Frontier Economics recommends a lower profit margin of 0-2%. Frontier Economics also provides a sensitivity analysis to support this recommendation which shows that a profit margin of this size would provide a sufficient buffer in the event that volumes were in line with Deloitte’s worst case volume scenario or in the event of a greater take up of DSA and direct customer agreements.

137 Having considered the above, ComReg is of the preliminary view to set the profit margin at 3% for 2015/16 – 2018/19 as this is within the range recommended by Frontier Economics and is consistent with regulatory precedent. For 2014/15, ComReg is of the preliminary to set the profit margin at 1% as this is appropriate given the different (and larger) X for 2014/15 and that there is inherently less uncertainty about volume outturns.

Inflation rate and interest rate

138 The calculation of the final X-factor(s) is done such that, for each product, the price in each year is equal to the price in the previous year multiplied by (1+CPI-X). X is set at a level to ensure the sum of projected revenues equals the sum of allowed revenues in net present value (NPV) terms. Therefore, in order to undertake this calculation two additional inputs are needed:

- CPI forecast for 2014-2018; and
- interest rate for discounting.

139 ComReg is of the preliminary view to accept Frontier Economics' recommendation that the IMF CPI forecast[38] be used in this calculation, along with a nominal interest rate of 5.9% (adjusted for inflation)[39].

5.8 Summary preliminary views on the key inputs for the calculation of the CPI-X% price cap control

140 The following summarises ComReg's preliminary views in relation to the key inputs for the calculation of the CPI-X price cap control.

Key model input	ComReg's preliminary view
Year-on-year volume growth	An Post's central scenario
Take up[40] of DSA and direct customer agreements	5% in 2014/15 and 5% in 2015/16
Price elasticity of demand	-0.22
Cost marginality	36%
Efficiency target	2.75% p.a. for total 13% over 5 year period of this price cap control
Proportion of An Post's capex forecasts allowed	70%
Sub controls: Standard letter (stamp, label, meter)	Maximum annual price increase allowed of 10% in 2014/15 and 3% for 2015/16 – 2018/19
Profit margin	1% in 2014/15 and 3% for 2015/16 – 2018/19

Q. 2 Do you agree or disagree with ComReg's preliminary views on the key inputs for the calculation of the CPI-X% price cap control? Please explain your response.

[38] Latest IMF CPI forecast will be used before price cap model is finalised
[39] Short term (less than 10 years) discount rate recommended by The National Development Finance Agency (NDFA) for discounting cash flows – http://www.per.gov.ie/project-discount-inflation-rates/
[40] As a percentage of universal postal service, Discount 6 bulk mail

6 Key model outputs and the values of "X" in the CPI-X% price cap

141 Based on the key model inputs outlined in the previous chapter, this chapter sets out the key model outputs and the resulting values of "X" in the CPI-X% price cap.

6.1 Key model outputs

142 The following, given the key model inputs set out in the previous chapter, are the key model outputs of the draft price cap model.

Projected volumes

143 The output of the draft price cap model on volume projections is shown in Figure 11. This is based on:

- An Post's central volume forecast scenario for all products; and
- the impact on Discount 6 Ceadúnas volumes of the assumed take up of DSA and direct customer agreements in our central scenario.

Figure 11: Volume forecast output

Format	Product	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	% change 2013-2018
Letters	Stamped	80,429	76,609	73,161	68,625	65,606	62,719	59,959	-22%
Letters	Labels	198	189	180	169	162	154	148	-22%
Letters	Metered	99,317	93,408	89,204	83,495	79,654	76,070	72,571	-22%
Letters	Discount 6 Ceadunas	181,543	173,827	158,696	141,491	136,115	130,670	125,443	-28%
Letters	Discount 9 Ceadunas	441	422	406	381	366	352	338	-20%
Letters	PO Box (Note 3)	3,572	3,538	3,506	3,483	3,513	3,548	3,584	1%
Letters	Residential and business redirection (Note 3)	19,359	19,175	19,003	18,879	19,039	19,230	19,422	1%
Letters	Mailminder (Note 3)	4,749	4,704	4,662	4,631	4,671	4,717	4,764	1%
Letters	Freepost	8,449	8,090	7,774	7,487	7,202	6,914	6,638	-18%
Letters	Standard International Outbound	25,525	24,657	23,646	22,169	21,260	20,367	19,511	-21%
Letters	Standard IBMS	2,176	2,102	2,016	1,890	1,812	1,736	1,663	-21%
Flats	Stamped	4,597	3,953	3,483	2,992	2,595	2,243	1,929	-51%
Flats	Labels	1,497	1,287	1,134	974	845	730	628	-51%
Flats	Metered	9,197	7,863	6,770	5,680	4,871	4,209	3,619	-54%
Flats	Discount 6 Ceadunas	921	797	693	588	516	449	391	-51%
Flats	Discount 9 Ceadunas	31	27	23	20	17	15	13	-51%
Flats	Freepost	670	580	504	440	386	336	293	-50%
Flats	Standard International Outbound	2,419	2,327	2,022	1,716	1,489	1,290	1,114	-52%
Flats	Standard IBMS	594	571	497	421	366	317	274	-52%
Packets	Stamped	2,037	2,078	2,146	2,184	2,269	2,360	2,431	17%
Packets	Labels	1,397	1,425	1,472	1,498	1,556	1,618	1,667	17%
Packets	Metered	1,899	1,937	2,007	2,048	2,127	2,212	2,300	19%
Packets	Registered (Note 2)	3,344	3,245	3,200	3,117	3,128	3,143	3,159	-3%
Packets	Freepost	213	215	224	234	242	250	264	23%
Packets	Standard International Outbound	3,303	3,438	3,562	3,628	3,770	3,917	4,069	18%
Packets	Standard IBMS	61	64	66	67	70	72	75	18%
Parcels	Domestic	471	480	497	505	525	546	567	18%
Parcels	International Outbound	116	118	122	124	129	134	140	18%

Source: Frontier's draft price control model based on An Post data

Allowed revenues and profit margin

144 The output of the draft price cap model on volume projections is shown in Figure 12. In 2014/15, allowed revenues in the draft price cap model stand at €317m. By the end of the control in 2018/19 these allowed revenues decline by 14%. The decline is driven by several factors:

- a fall in revenue from Discount 6 Ceadúnas (due to the assumed customer switching to the DSA product and direct customer agreements);
- a fall in opex driven by the efficiency target; and
- a fall in opex due to volume declines estimated in An Post's central scenario.

145 Under this scenario, allowed opex declines by 16% but due to the allowed profit margin and lower declines in allowed capex, allowed revenues fall by 14% over the price control period.

146 As can be seen in Figure 12 below, the draft price cap model based on ComReg's preliminary views will afford An Post, as the universal postal service provider, with a total profit margin of c.€46m, subject to all other things being equal and An Post meeting the efficiency target set.

Figure 12: Profit margin under the price cap model

	2014/15	2015/16	2016/17	2017/18	2018/19
Revenues	€317,085,618	€299,321,131	€293,298,799	€288,243,244	€283,662,573
CAPEX	€4,548,416	€4,425,372	€4,363,841	€4,295,669	€4,224,902
OPEX	€309,442,774	€293,403,316	€281,599,235	€270,279,626	€259,372,310
Profit	€3,094,428	€1,492,443	€7,335,722	€13,667,949	€20,065,362

Source: Frontier Economics

147 For the avoidance of doubt, the price cap only relates to pricing and profitability of the universal postal service. In setting the price cap, ComReg does not take account of the profitability (or otherwise) of other postal services provided by An Post or of the non-regulated businesses operated by An Post. It is for An Post to ensure that such services and businesses are operated in a way that does not impair its ability to provide the universal postal service.

6.2 Preliminary X-factors

148 Based on the preliminary views expressed by ComReg in this consultation, the resultant “X” for the CPI-X% price cap are as follows:

- “X” for 2014/15: -10.11%; and
- “X” for 2015/16 - 2018/19: 1.71%.

149 Given that the price cap formula is CPI-X this implies that on average, for products which are not subject to a sub-cap, prices would need to increase by approximately 11.13% in 2014/15 to ensure An Post recovers its costs if for Standard Post – Stamp and Label (Letters) and Standard Post - Meter (Letters) the corresponding price increase in 2014/15 is 10%, in line with the recommended sub-cap.

150 The preliminary X-factor for the period 2015/16 to 2018/19 is 1.71%. This means that to be compliant with the control, the prices of products not subject to the sub-cap prices would need to remain flat if outturn CPI is in line with IMF’s forecast and if An Post chooses to price its Standard Post – Stamp and Label (Letters) and Standard Post - Meter (Letters) at the maximum price increase allowed of 3%.

151 For the avoidance of doubt, these are preliminary X-factors. If in making its final decision on the price cap, if ComReg decides on a different value input(s) from those preliminary value(s) presented in this consultation, the resultant X-factors will naturally be different.

6.3 Sensitivity analysis

152 Based on the preliminary X-factor(s) and accompanying sub-caps, Frontier Economics in its support report has also investigated the potential impact on An Post’s profitability of exogenous shocks on the volumes of price controlled products. In particular, Frontier Economics has run two types of scenarios:

- variation in the year-on-year volume growth rates included in the model; and
- variation in the take up of DSA and direct customer agreements.

153 In relation to the former, Frontier Economics has based its analysis on An Post’s advisor, Deloitte, other volume forecast scenarios. In relation to the latter, Frontier Economics has run scenarios based on the upper and lower end of the recommended ranges, and based on An Post’s assumption of ✂% of Discount 6 volumes split equally between 2014 and 2015.

154 This analysis, which ComReg concurs with, indicates that the profit margin that ComReg is minded to proceed with would provide An Post with adequate protection against non-manageable volume risk. Even in Deloitte's worst case volume scenario, An Post makes positive returns in all years except 2015/16. It also indicates that the greater the assumed level of take up for DSA and direct customer agreements, the greater An Post's profits from the provision of the universal postal service will be.

Q. 3 Do you have any comments on (1) the key outputs (2) the preliminary X-factors (3) the sensitivity analysis of the draft price cap model? Please explain your response.

7 Compliance

7.1 Section 28(1) Tariff Requirements

155 Section 30(3)(a) of the 2011 Act provides that in making a price cap decision ComReg shall have regard to the requirements relating to tariffs specified in section 28(1) of the 2011 Act. Section 28(1) states:

The tariffs for each postal service or part of a postal service provided by a universal postal service provider in the provision of a universal postal service shall comply with the following requirements:

(a) prices shall be affordable and be such that all postal service users may avail of the services provided;
(b) prices shall be cost-oriented, that is to say, the prices shall take account of, and reflect the costs of, providing the postal service or part of the postal service concerned;
(c) subject to any decision made by the Commission under paragraph (b) of subsection (2), prices shall comply with the uniform tariff referred to in that subsection;
(d) tariffs shall be transparent and non-discriminatory; and
(e) where postal service providers apply special tariffs, including special tariffs for postal services for businesses, bulk mailers or consolidators of mail from different postal service users, tariffs and associated conditions shall be transparent and non-discriminatory.

156 This section sets out how the proposed price cap has regard to each of the above tariff requirements. However, as An Post will set its own prices within the parameters of the price cap, it is for An Post to ensure that such prices are compliant with the above tariff requirements.

Affordability

157 There is no universally agreed measure of affordability, either in economic theory or regulatory practice.

158 However, as noted by ComReg in Document 12/138[41], affordability is assessed separately by ComReg for residential postal service users and business/SMEs. This is because price increases are unlikely to cause affordability issues for residential postal service users, who generally send relatively low volumes of post. However, ComReg and An Post need to ensure that the universal postal service remains affordable for businesses / SMEs who generally send higher volumes of post.

159 ComReg is of the preliminary view that the recommended sub-caps on Standard Letter Post – Stamp, Label, and Meter will provide an "affordability" protection for business/SMEs. ComReg would, in particular, welcome the views of businesses/SMEs on this.

160 For larger users of An Post's price controlled services, ComReg is of the preliminary view that affordability is ensured in part by the overall price cap and is further ensured by the sub-caps placed on Standard Letter Post – Stamp, Label, Meter. These sub-caps provide regulatory benchmark products that large users can switch to if required, thereby availing themselves of a universal postal service at an affordable price.

Cost-orientation

161 The design and form of the proposed price cap should ensure that prices for universal postal services are cost orientated. In particular, the price cap will be set using the cashflow approach, which calculates allowed revenue in each year by summing up An Post's forecast opex and capex. The 2011 Act also requires ComReg to ensure that the price cap incentivises efficient provision of universal postal services and the price cap sets an efficiency target for this purpose.

162 The 2011 Act does not require or empower ComReg to specify *exact* prices for individual universal postal services, or groups of universal postal services – ComReg can only place a maximum limit on such prices. The responsibility for ensuring that prices of universal postal services are cost-oriented at a more disaggregated level (e.g. on a product-by-product basis) lies with An Post. Consequently, in setting prices for its universal postal services that are subject to the price cap control, An Post must ensure that these prices are cost-orientated, as required by section 28(1) of the 2011 Act.

[41] Dated 20 December 2012

Transparency and non-discrimination

163 Section 28(1) of the 2011 Act also requires tariffs to also be transparent and non-discriminatory.

Transparency

164 Section 24(7) of the 2011 Act requires An Post to publish notice of any price changes with respect to the universal service provision on its website, and by any such other means as ComReg may direct. These changes cannot then come into effect until at least 14 days after the date of publication. As it is only certain universal postal service products that are subject to the price cap control, ComReg is of the preliminary view that this statutory requirement will ensure the transparency of tariffs set under the price cap.

Non-discrimination

165 In making its preliminary view on the appropriate number of baskets and sub-controls (if any), ComReg gave significant consideration to the required trade-off between:

- allowing An Post sufficient commercial freedom to rebalance prices in order to:
    - achieve cost orientation and non-discrimination between products; and/or
    - react to competitive market constraints; and
- ensuring that actual or prospective competition is not foreclosed (for example, through predatory pricing) and postal service users are protected from excessive prices (i.e. prices in excess of cost where there is no prospective competition).

166 This was informed by the competition assessment of each universal postal service product that will be subject to the price cap control[42]. The results of Frontier Economics' analysis, which ComReg agrees with, suggest that one basket with sub controls on Standard Letter Post – Stamp, Label and Meter is sufficient to achieve this trade-off. This is complemented by the preliminary view that the price cap uses fixed weights within the tariff basket. Together, ComReg is of the preliminary view that these design features of the price control should be sufficient to minimise the risk of An Post setting discriminatory tariffs for the universal postal services within the price cap control.

[42] See ComReg Decision D13/13

7.2 Price cap decision

167 Under Section 30(7) of the 2011 Act, An Post is required to comply with any price cap decision for its 5-year price duration period; to include any amendments to that decision as may be made after 3 years. Section 30(13) provides that where ComReg is of the opinion that An Post is not complying, or has failed to comply with a price cap decision, it may give direction to An Post to ensure compliance with the decision concerned.

168 To ensure compliance with any the X-factor determined by ComReg, An Post will be required to set its prices such that, across all of the price-controlled universal postal services, the total weighted average price increase in each year of the price control does not exceed the annual percentage change in CPI, minus X. As stated earlier, ComReg's preliminary view is that the price increase associated with each universal postal service should be weighted by the base year volumes for each universal postal service. As is consistent with the calculation of the X-factor, ComReg is of the preliminary view that the most recent IMF CPI forecast is used for the year in question. For those universal postal services subject to a sub-cap, An Post must also ensure that the total price increase in each year of the price control does not exceed the limit set by the sub-cap in that year.

169 Section 24(8) of the 2011 Act requires that where An Post amends its charges in respect of any universal postal service, it shall publish notice of any such amendment on its website (and by any such other means as ComReg may direct) and as soon as practicable thereafter shall notify ComReg in writing of the amendment. The charges so amended cannot come into effect until at least 14 days after the date of publication of such a notice.

170 Having regard to section 24(8), but also with a view to promoting regulatory certainty, ComReg would welcome views of interested parties as to whether An Post should notify ComReg in advance of publishing any notice under section 24(8), in order that ComReg may engage with An Post and assess whether the price increases would comply with the tariff requirements. ComReg considers that such engagement, prior to the publication of any price amendments, would reduce the risk of any amended prices having to be "clawed-backed" from An Post, because they did not comply with the price cap decision or with one or more of the tariff requirements.

7.3 Competition law

171 An Post in setting its prices for its universal postal services under the price cap should ensure that such prices are in compliance with all applicable competition law. ComReg has no competition powers in the postal sector. However, in approving any price increases under the price cap, ComReg will endeavour to ensure, based on the information it posses, that such price increases do not conflict with competition law[43] and if there are matters of concern it would pass these onto The Competition Authority. Notwithstanding this, given information asymmetries, it is also for the USP to ensure its compliance with competition law requirements.

Q. 4 Do you agree or disagree with ComReg's preliminary views on assessing compliance by the universal postal service provider with the tariff requirements of the 2011 Act and with the price cap decision? Please explain your response.

[43] In accordance with Court of Justice of the European Union decision in Ahmed Saeed

8 Draft Decision

Q. 5 Do you have any comments on the draft Decision? Please explain your response and provide details of any amendments that should be considered by ComReg.

The Decision

1. The Commission for Communications Regulation ("**ComReg**") hereby makes the following decision under Section 30(2) of the Communications Regulation (Postal Services) Act 2011 ("**2011 Act**"), described herein as the "**Price Cap Decision**".

   (i). A price cap shall apply to a single basket of postal services comprised of all universal postal services specified in the *Communications Regulation (Universal Postal Service) Regulations 2012* (S.I. 280/2012) save for the four categories of services specifically excluded under ComReg Decision D13/13.

   (ii). With regard to the prescribed formula for calculating the annual percentage change in charges that can be imposed for the basket of postal services (overall limit = (Δ CPI - X) the following values of "X" shall apply in respect of the price cap:

   - -10.11% for the 12-month period [ ] July 2014 to [ ] July 2015

   - 1.71% for each 12-month period in the period commencing [ ] July 2015 to [ ] July 2019.

   (iii). Further to paragraph (ii), there shall be an additional sub-control on the maximum annual percentage change in charges that can be imposed for two categories of universal postal services, namely "Standard Letters – Stamp and Label" and "Standard Letters – Meter". For these two categories of universal postal services the maximum annual percentage change in charges that can be imposed shall be:

   - 10% for the 12-month period [ ] July 2014 to [ ] July 2015

   - 3% for each 12-month period in the period commencing [ ] July 2015 to [ ] July 2019.

Background

2. Section 30(2) of the 2011 Act provides that where ComReg is of the opinion that there is no effective competition in the market for the supply of the postal services concerned, ComReg shall, following a public consultation process in relation to the services to be included in a basket of postal services and, as ComReg considers appropriate, in relation to the adjustment referred to in the construction of "X" in the definition of "price cap" in section 30(1), make a decision specifying a price cap in respect of one or more than one basket of services ("price cap decision"). The terms "basket of postal services" and "price cap" are defined in Section 30(1) of the 2011 Act.

3. On 11 July 2013, ComReg commenced a public consultation which was stated to be the first of two planned consultations on setting a price cap control (Document 13/68). On 6 September 2013, ComReg published a Response to Consultation (Document 13/82) which included Decision D13/13. Decision D13/13 constituted the forming of the following opinion by ComReg pursuant to section 30(2) of the 2011 Act:

> *The Commission for Communications Regulation, pursuant to section 30(2) of the Communications Regulation (Postal Services) Act 2011 ("2011 Act"), is of the opinion that the universal postal services specified in the Communications Regulation (Universal Postal Service) Regulations, 2012 (S.I. 280 of 2012) constitute a separate market and that there is no effective competition in that market such that the Commission shall proceed to conducting a public consultation process under section 30(2) of the 2011 Act in relation to the postal services to be included in one or more baskets of postal services and, as the Commission considers appropriate, in relation to the adjustment referred to in the construction of "X" in the definition of "price cap" in section 30(1) of the 2011 Act, for the purposes of making a decision specifying a price cap in respect of one or more than one basket of services.*
>
> *The following specific universal postal services, which are included in the Communications Regulation (Universal Postal Service) Regulations, 2012, shall not form part of the consultation and shall not be subject to any price cap decision:*
>
> *(1) A single piece service provided free of charge to the postal service user for the transmission of "postal packets for the blind".*
> *(2) Poste Restante.*
> *(3) A service for the sorting, 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, acting as such.*
> *(4) Business Reply.*

This Opinion shall be construed together with ComReg's conclusions, reasoning, and analysis as set out in ComReg Decision D13/13 and ComReg Decision D08/12.

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

This Opinion shall remain in force until further notice.

4. On 15 April 2014, and following upon the above opinion, ComReg commenced its second public consultation (Consultation Document 14/30) which has resulted in the Price Cap Decision.

5. For the purposes of making the Price Cap Decision, and in accordance with section 30(3) of the 2011 Act, ComReg:

   - has had regard to the requirements relating to tariffs specified in section 28(1) of the 2011 Act

   - ensured that the price cap provides incentives for efficient universal postal service provision; and

   - had regard to its objectives set out in section 12(1)(c) of the Communcations Regulation Act 2002, in particular the protection of the interests of postal service users and those of small and medium-sized enterprises.

6. In accordance with section 30(4) of the 2011 Act, the price cap created hereunder shall apply for a period of 5 years from [XX] July 2014.

7. This Decision shall be construed together with ComReg's reasoning, and analysis as set out in Documents 13/68, 13/82, 14/30, and 14/XX.

8. Words and terms herein have the same meaning as in the 2011 Act, unless otherwise stated.

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

Commissioner

The Commission for Communications Regulation

Dated [ ] July 2014

9 Considerations for the next price control review

172 Pursuant to section 30(9) of the 2011 Act, before the end of the 5 year price control period, ComReg shall conduct a review of the price cap. Following such a review, for the purposes of protecting the interests of postal service users and of ensuring compliance with the tariff requirements set out in section 28(1) of the 2011 Act, ComReg may make a further price cap decision. The below sets outs ComReg's preliminary views on the considerations for the next price cap control review.

173 As noted in this consultation on the setting of the first price cap, there are a number of key considerations for ComReg in setting a price cap:

- the list of universal postal services subject to the price cap control;
- the assumptions around take-up of DSA and direct customer agreements;
- planned capex over the next price control period; and
- appropriate efficiency targets (if any).

9.1 Scope of the price cap control

174 The first key area for consideration by ComReg at the next price control is the scope of that price control. At that time, in 2018, it may be appropriate, if not already done, to reduce further the specification of the universal postal service and in turn the universal postal services subject to the price cap control.

175 Pursuant to the 2011 Act, for a product within the scope of universal postal service to subject to the price cap control, ComReg must be of the opinion that the product faces no effective competition in the market for its supply. The key question to ask at that time in respect of universal postal services is:

What constraints are there on An Post's pricing behaviour in relation to the postal service?

9.2 DSA and direct customer agreements

176 Following ComReg's review of the evidence provided by An Post regarding expected take up of DSA and direct customer agreements, it is clear that there is still a high degree of uncertainty around the take up of these commercial arrangements that may materialise over the price cap period. This is not surprising given the nascent liberalised postal market and that the implementation of the 2011 Act is recent. However, at the next price control review, there should be clearer information on the take-up of these non-universal postal service products and whether there will be any further take up.

9.3 Planned capex

177 In order to assess whether the full amount of An Post's planned capex over the price control period can be included in the price cap calculation, ComReg must come to a decision on whether this capex is well justified and is efficiently incurred. During this price cap setting process, An Post has not provided a list of the investments included in the aggregate USO capex figure, or detailed investment plans for ComReg's scrutiny. As a result, ComReg is of the preliminary view to only include a proportion of An Post's planned capex. Furthermore, An Post's forecast capital spend for the period of this price control is relatively low. However, this will not always be the case. At the next price control review, it is therefore essential that An Post provide well justified investment plans to accompany any planned capex over the next price control period.

9.4 Efficiency analysis

178 The final key consideration for the next price control period is the appropriate efficiency target (if any) for An Post. In order to comply with the 2011 Act, it is essential that the assessment of An Post's efficiency is an on-going process.

179 The efficiency analysis undertaken at this price control review focussed on internal benchmarking. Although internal benchmarking is one method for assessing efficiency, there are clearly others which have not been considered in this assessment but can form part of any efficiency reviews ComReg undertakes in subsequent price controls. Among others these include:

- external benchmarking:
    - with postal operators in other countries; and/or
    - with other regulated businesses in Ireland.

- comparing remuneration levels - benchmarking pay rates of postal workers with those of comparable occupations in other sectors; and
- examining individual investments and initiatives undertaken by An Post in detail to determine whether they achieve their planned objectives.

180 Further, the efficiency analysis undertaken in this price cap decision has focussed solely on assessing the static efficiency of An Post. Given the scale of the static inefficiency estimates, and the decision to use a glide path towards this target, ComReg's preliminary view is that no dynamic efficiency target is applied in this price control. On this basis, no dynamic efficiency analysis has been carried out at this stage. However, ComReg will give consideration to dynamic efficiency targets in subsequent price controls. In order to do this, consideration would be given to the dynamic efficiency improvements that businesses across Ireland may be expected to make in line with economy wide improvements in productivity.

Q. 6	Do you have any comments on the considerations for the next price cap review? Please explain your response.

10 Draft Regulatory Impact Assessment

181 ComReg's published Regulatory Impact Assessment ("RIA") Guidelines[44] (Doc 07/56a), in accordance with a policy direction to ComReg[45], 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 RIA 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.

182 In this draft RIA, ComReg examines the options open to it in relation to the following decisions to set a price cap control:

(1) Whether the price cap should be one basket or not

(2) Whether there should be an annual % price increase limit on letters (stamp, meter, label) to protect the interests of postal service users (in particular small and medium-sized enterprises ("SMEs")) or not

(3) Whether the weighting of products in each basket should be fixed weight or average revenue

(4) In the case of non-manageable risks, whether the price cap should include a 'buffer' in the margin on operating costs or allow a carry-over of any shortfall in turnover

(5) Whether a different X-factor is set for the first year of the price control or not

183 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 be considered. 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 ComReg's decision.

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

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

10.1 Steps involved

184 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

Step 4: determine the impacts on competition

Step 5: assess the impacts and choose the best option

Steps 1 & 2: Describe the policy issue and identify the objectives and options

185 In accordance with section 30(2) of the 2011 Act, where ComReg is of the opinion that there is no effective competition in the market for the for postal services within the scope of universal postal service as provided by a universal postal service provider, ComReg, shall, following a public consultation process in relation to the services to be included in a basket of postal services make a price cap decision specifying a CPI-X% in respect of more or more than one basket of services.

186 In accordance with section 30(3) of the 2011 Act, for the purposes of making a price cap decision, ComReg shall:

(a) have regard to the requirements relating to tariffs specified in section 28(1) of the 2011 Act

(b) ensure that the price cap provides incentives for efficient universal postal services provision, and

(c) have regard to its objectives set out in section 12(1)(c) of the Communications Regulation Act 2002 - 2011, in particular the protection of postal service users and those of SMEs.

187 ComReg is cognisant of these statutory obligations in determining, assessing, and choosing the best options below.

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

Option 1: Whether the price cap should be one basket or not

188 In Consultation 13/68, ComReg set out its initial thoughts on the number of basket(s) for the price control and, by that consultation, requested the views of interested parties on same.

189 In that Consultation (Document No. 13/68), ComReg noted that it could set multiple tariff baskets. Under this approach, the key criterion to use in selecting the appropriate number of baskets is the degree to which competition has developed for each universal postal service and how prospective competition is likely to develop. This criterion focuses on the supply side. There is also a demand side risk, in that there is a potential for arbitrage opportunities across sub-controls if products which are considered to be direct demand-side substitutes are included in separate sub-controls. For example, if product A and B were considered substitutes by a customer but were in different sub-controls, with a tighter control on the price of product A than product B, customers would choose the cheaper product (A). In this situation the relative prices of substitute products are affected by the decision on sub-controls and hence supply and demand decisions are potentially distorted.

190 A further criterion which focuses on demand side substitutability should therefore also be applied as a final check to ensure that this demand side risk does not arise. Applying this criterion, ComReg, at that time of Consultation 13/68, considered that an option could be three baskets:

(1) Basket A containing An Post’s non-parcel universal postal service products for residential customers

(2) Basket B containing An Post’s non-parcel universal postal service products for business customers

(3) Basket C containing An Post’s parcel universal postal service products for both residential and business customers.

However, ComReg concluded by noting that, at the time of making the consultation, ComReg did not yet have the data on volumes, costs, revenues and market shares that would be needed to provide a definitive recommendation in relation to the choice between multiple baskets and imposing limitations on tariff rebalancing during the price control process.

191 In response to Consultation 13/68, An Post was of the view that in order to give An Post the appropriate level of commercial freedom that there should only be one basket. According to An Post, having more than one basket will be unnecessarily complex particularly given the size of the country and the market. Furthermore, according to An Post:

- Having multiple baskets increases the burden on a volume adjustment mechanism by limiting the “within basket” rebalancing that is possible
- Multiple baskets are not consistent with trying to provide An Post with the agility to manage uncertain volumes
- Tariffs will remain subject to the tariff requirements set out in Section 28 of the 2011 Act, namely that prices should be affordable, cost oriented, transparent and non discriminatory. In addition, uniform tariffs should apply to postal services provided at single piece tariffs
- A single basket would be simpler, fairer and more likely to ensure a sustainable universal service into the future.

192 Frontier Economics[46] recommends the use of one basket with appropriate additional pricing safeguards. According to Frontier Economics, which ComReg concurs with, in order to set multiple baskets to be specified for any price cap, it is essential that a robust allocation of cost, revenue and volume data between these baskets (in line with the products in each basket) could be carried out. Having reviewed the information provided by An Post since the publication of Decision D13/13, it is not clear that such a robust allocation would be possible at this stage based on the information provided by An Post. Further, there is still uncertainty around the degree of prospective competition that may develop in relation to the universal postal services subject to the price cap control and the form that this prospective competition would take over the price control period.

193 Further, multiple baskets do not provide any additional benefits for competition. A one basket price control allows competition to continue for postal services outside of the control while ensuring that postal service users would not be subject to unjustified price increases for those services that currently do not benefit from effective competition.

[46] ComReg Document No. 14/30a

194 Finally, services that face the most prospective competition over the course of this price control period such as parcel and packets could be removed from the price control in the second price control period if effective competition is deemed to exist for those services. Any such services would therefore be subject to the normal forces of a competitive market.

195 Therefore, having considered the above, ComReg is of the preliminary view that best option is that the price cap should be one cap with additional safeguards (see option 2 of this draft RIA). ComReg is of the preliminary view that this is in the best interests of stakeholders as it allows An Post appropriate commercial freedom to price its universal postal services while ensuring (1) the continued provision of the universal postal service (2) that the interests of postal service users are protected.

Option 2: Whether there should be an ex-ante price increase limit on letters (stamp, meter, label) to protect the interests of postal service users (in particular SMEs) or not

196 Having just one basket will provide An Post with freedom to set its prices for its universal postal services. However, without appropriate ex-ante safeguards, there is a risk that significant prices increases for certain products, well beyond the % price increases allowed under the price cap, could be put on those postal service users that cannot access or have limited access to alternative postal service providers. Such postal users tend to use stamped letters are their predominant product. Furthermore, in setting the price cap, ComReg has a statutory obligation to ensure that the interests of SMEs are protected[47]. SMEs predominately use stamped and metered letters.

197 ComReg recognises that section 28(1) of the 2011 Act does provide a ex-post safeguard in this respect. However, there is a risk that this safeguard might not limit An Post's pricing behaviour and protect postal users to the desired extent as it is an ex-post safeguard. Specifically, this is because such an approach:

- requires substantial on-going monitoring of compliance with this section of the 2011 Act by ComReg;
- may result in postal service users and postal service providers being negatively impacted for at least a short period of time until potential non-compliance is identified, investigated and rectified;

[47] In accordance with section 30(3)(c) of the 2011 Act

- introduces a degree of regulatory uncertainty;
- introduces uncertainty for postal service users if non-compliant prices require subsequent amendment to be compliant;
- introduces unnecessary costs for the USP if non-compliant prices require subsequent amendment to be compliant.

198 Therefore, without an appropriate ex-ante safeguard, there is a real risk of damage to the interests of postal service users if significant price increases that are not compliant with section 28(1) of the 2011 Act took effect. An appropriate ex-ante safeguard would also benefit the USP as it would, for these universal postal services, minimise the risk of it being found non-compliant with section 28(1) of the 2011 Act.

199 In assessing the options on the universal postal service products that An Post should face limits on the annual percentage change in price, ComReg has drawn on the results of demand side and supply side analysis outlined in ComReg's Consultation Document 13/68. This analysis was used to identify the potential baskets under a multiple basket price control, and was based on:

- the degree of competition that has developed (or may develop over the price control period) for each product; and
- a consideration of any arbitrage opportunities that could arise if direct demand-side substitutes are included in separate sub-controls.

200 Table 3 summarises the resulting suggested product groupings, in ascending order of the degree of competition that has developed for each universal postal service product (or may develop over the price control period):

- Group A: non-parcel universal postal service products for residential customers;
- Group B: non-parcel universal postal service products for business customers; and
- Group C: parcel universal postal service products for both residential and business customers.

Table 3: Product groupings proposed in ComReg's Consultation Document 13/68

Group A: Standard Post – Stamp and Label (Letter and Flat) Registered Post (Letter and Flat) PO Box Residential Redirections and Business Redirections Certificate of Posting Freepost Mailminder	**Group C:** Standard Post – Stamp and Label (Packet and Parcel) Standard Post – Meter (Packet and Parcel) Registered Post (Packet and Parcel)
Group B: Standard Post – Meter (Letter and Flat) Ceadúnas – Discount 6 and 9 IBMS	

201 Although none of these products currently face any effective competition, those products in group C may face the most prospective competition over the price control period. Annual percentage change limits on prices may therefore be most appropriate for products in groups A and B. In order to determine which group A and B products should face such price limits, it is also important to consider two further factors:

- ComReg's statutory requirement to have regard to its objectives set out in section 12(1)(c) of the Communications Regulation Act 2002, in particular the protection of the interests of postal service users and those of SMEs; and
- the current volumes of each product.

202 The latter factor should be considered in the context of reducing regulatory burden on An Post. Regulation may not be considered proportionate if price limits were imposed on low volume products.

203 Therefore, and having considered the recommendation of Frontier Economics in this respect, ComReg is of the preliminary view that the following high volume group A and B products face annual price increase limits:

- Standard Letter Post – Stamp and labels; and
- Standard Letter Post – Meter.

204 These products are both widely used by SMEs. Such limits are therefore also in line with ComReg's statutory duty to protect the interests of these postal service users.

Option 2a: If there is an ex-ante price increase limit on letters (stamp, meter, label), whether this should be a limit on the annual percentage change in price allowed or a set maximum price

205 If there is an ex-ante price increase limit on letters (stamp, meter, label) as recommended under Option 2, the options are then whether to:

- set a limit on the annual percentage change in price allowed
- set a maximum price that cannot be exceeded

206 ComReg considers that setting a limit on the annual percentage change in price allowed provides additional protection to postal service users over the setting of a maximum price, as it not only restricts the overall price increase over the price control period, but also protects postal service users from significant year-on-year price increases which could occur if only a maximum price was set and there is a significant difference between current price and the maximum price.

207 Therefore, having considered the above, ComReg is of the preliminary view that an annual percentage change limit on prices for letters (stamp, metered, labels) is used.

Option 3: Whether the weighting of products in each basket should be fixed weight or average revenue

208 Setting an appropriate weighting of each of the products within a basket is important as it may drive An Post's profit maximising pricing choices. In particular these choices are likely to differ depending on whether a tariff based or average revenue control is used. In the below, ComReg assesses each of these options:

- A tariff basket with fixed weights[48]: Under this type of control, fixed weights would be assigned to each product for the duration of the price control.

- An average revenue control[49]: This type of control applies to the movement in the observed average revenue over time, and so, compared to the tariff basket approach, the weights on each product relate to the share of revenue for that product in that particular year.

209 As noted by Frontier Economics, which ComReg concurs with, an average revenue control can lead to excessive re-balancing, whilst a tariff basket approach can converge on optimum pricing decisions. In addition, as the tariff basket control uses fixed weights it has more certainty associated with it and postal service users would also be subject to lower price volatility over the course of the price control period.

210 Therefore, having considered the above, ComReg is of the preliminary that the best option is a tariff basket control with fixed weights; in particular that the fixed weights should be a proportion of base year volumes.

Option 4: In the case on non-manageable risks, whether the price cap should include a 'buffer' in the margin on operating costs or allow a carry-over of any shortfall in turnover

211 There are two options for this mechanism:

(1) a 'buffer' to cover the universal service provider for the risk of non-manageable risks, which could take the form of the margin on opex; or

(2) carrying over any shortfall (or excess) in revenue from a specific regulatory period into the subsequent price cap period.

212 Under the second option, An Post's financial exposure to non-manageable risks would still be present over the short term until an adjustment to revenue could be made which pending that adjustment could risk the continued provision on the universal postal service.

[48] For example, in a tariff basket for two products the total revenue from product 1 and product 2 under current prices and quantities must be less than or equal to the total revenue from product 1 and product 2 under current prices and period 0 quantities multiplied by 1+cpi-X.

[49] Average revenue in the current period must be less than or equal to average revenue from the previous period multiplied by 1+cpi-X

213 Furthermore, a buffer in the form of a margin would also provide the USP with additional incentives to achieve its efficiency targets since in the absence of an exogenous shock the USP would be able to capture any margin. If the USP achieves its efficiency targets, this would be to the benefit of postal service users and competition generally through the sustainable provision of a more efficient universal postal service.

214 Given this, and having considered the recommendation of Frontier Economics, ComReg is of the preliminary view that the best option is that a buffer is included in the margin on opex to cover the universal postal service provider for the risk of non-manageable risks.

Option 5: Whether a different X-factor is set for the first year of the price cap control or not

215 In the context of declining volumes, the allowed revenue at the start of the price control period is expected to be much greater than that by the end of the period. This trend is amplified by any efficiency targets that are set for An Post. Therefore, if the X-factor is set such that expected actual revenue is smoothed equally over the full price control period, An Post's price controlled products would be unlikely to return to profitability until the end of the price control period.

216 A different X-factor in the first year allows for An Post to potentially implement a larger price increase for certain products in year one and raises questions about the affordability of such a measure.

217 ComReg, however, is of the preliminary view that the likely large price increases in year one should not raise any affordability issues. Also, An Post has to adjust its prices within the constraints of the overall price cap. This may involve both price increases and decreases such that the average price changes would comply with the overall price cap. Further, postal service users would be subject to lower price volatility in the years following year one and may benefit from price decreases for certain products as a result of a different X-factor for the remaining 4 years of the price control.

218 Therefore, having considered the recommendation by Frontier Economics, ComReg is of the preliminary view that a different X is set for the first year of the price cap control to ensure a faster return to an appropriate level of profitability for An Post's price controlled universal postal service products. Furthermore, ComReg considers that this option ensures that ComReg meets its statutory obligation to ensure the provision of a universal postal service.

Q. 7 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.

11 Conclusion

219 This consultation builds on the matters explored in ComReg Decision 13/13 and sets out ComReg's preliminary views on making a price cap decision pursuant to section 30(2) of the 2011 Act.

220 Following this public consultation, ComReg will make its final decision on the price cap having regard to:

- its statutory objectives, functions and duties;
- sections 28(1) and 30 of the 2011 Act; and
- advice of its expert consultants, Frontier Economics[50].
- the information and views submitted by all respondents to this consultation.

221 As noted in ComReg's published Consultation guidelines[51], the purpose of a public consultation is to allow ComReg to consider the views of interested parties in reaching a decision and ComReg will carefully consider the information and views submitted by all respondents to this consultation. 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.

[50] ComReg Document No. 14/30a
[51] ComReg Document No. 11/34

12 Submitting comments

222 The consultation period will run until 5pm on 13 May 2014, during which time ComReg welcomes written comments on any of the issues raised in this consultation.

223 It is requested that comments be referenced to the relevant question numbers and/or 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.

224 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.

225 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.

226 All responses to this consultation should be clearly marked:- "Reference: Consultation 14/30", and sent by post, facsimile, or e-mail to arrive on or before 5pm, 13 May 2014, to:

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Questions

Section Page

Annex: 1 Legal basis

A 1.1 The Communications Regulation (Postal Services) Act 2011 ("2011 Act") became law on 2nd August 2011 and established a new framework for the regulation of postal services in the State. The 2011 Act also gives effect in Irish law to the European Postal Directive creates a harmonised framework for the regulation of postal services in all Member States (Directive 97/67/EC, as amended by Directives 2002/39/EC and 2008/6/EC).

A 1.2 Section 10 of the 2011 Act sets out ComReg's two *functions* in relation to postal services:

• *to ensure the provision of a universal postal service that meets the reasonable needs of postal service users,*

• *to monitor and ensure compliance by postal service providers with the obligations imposed on them by or under the Communications Regulation Acts 2002 to 2011*

A 1.3 Section 12 of the 2011 Act sets out ComReg's *objectives*, in exercising the above functions:

(i). to promote the development of the postal sector and, in particular, the availability of a universal postal service within, to and from the State at an affordable price for the benefit of all postal service users,

(ii). to promote the interests of postal service users within the Community, and

(iii). subject to subparagraph (i), to facilitate the development of competition and innovation in the market for postal service provision.

A 1.4 Section 13 of the 2011 Act designates ComReg as "*the national regulatory authority for the purposes of the Directive*" while Section 17 designates An Post as the sole universal postal service provider ("USP") in the State for the first 12 years of the Act, subject to review by ComReg after the first 7 years.

A 1.5 Section 16(1) of the 2011 Act defines the "*universal postal service*" to a large extent, setting out that it entails at least one clearance and one delivery to the home or premises of every person in the State on every working day (i.e. Monday – Friday, excluding national public holidays) except in such circumstances or geographical conditions as the Commission considers to be exceptional. Section 16(1) further specifies that the following services fall within the universal postal service:

• the clearance, sorting, transport and distribution of postal packets up to 2kg and parcels up to 20kg (the 20kg figure may be adjusted by ComReg)

• a registered items service

• an insured items service

• free of charge postal services for to blind and partially- sighted persons.

A 1.6 Section 16(9) of the 2011 Act requires that ComReg shall make regulations specifying the services to be provided by a 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 users. ComReg made such regulations in July 2012, following public consultation (the Communications Regulation (Universal Postal Service) Regulations 2012 (S.I. 280 of 2012) - see ComReg Document No. 12/81).

A 1.7 Section 28 of the 2011 Act sets out the "tariff requirements" that apply to each universal postal service. The price of each universal postal service is required to be:

(a) affordable, such that all users may avail of the service;

(b) cost-oriented – i.e. reflect the actual cost of providing the service;

(c) uniform throughout the State where provided at a single-piece tariff, (unless ComReg should decide otherwise); and

(d) transparent and non-discriminatory.

A 1.8 In accordance with the section 30(2) of the 2011 Act, where ComReg is of the opinion that there is no effective competition in the market for the supply of An Post's postal services within the scope of universal postal service, ComReg shall, following a public consultation process in relation to the services to be included in a basket of postal services and, as ComReg considers appropriate, in relation to the adjustment referred to in the construction of "X" in the CPI – X% price cap, make a decision specifying a price cap in respect of one or more than one basket of An Post's postal services within the scope of the universal postal service.

A 1.9 In accordance with section 30(3) of the 2011 Act, for the purposes of making a price cap decision the Commission shall:

- have regard to the requirements relating to tariffs specified in section 28(1) of the 2011 Act,
- ensure that the price cap provides incentives for efficient universal postal services provision, and
- have regard to its objectives set out in section 12(1)(c) of the Communications Regulation Act 2002 - 2011, in particular the protection of the interests of postal service users and those of small and medium-sized enterprises.

A 1.10 In accordance with section 30(4) of the 2011 Act, the price cap shall apply for a period of 5 years.

A 1.11 In accordance with section 30(5) of the 2011 Act, on or after the expiration of 3 years from the date specified in the price cap decision as the date from which the price cap is to apply, ComReg may conduct a review of the price cap and following such a review, the Commission may make a decision amending the price cap decision as regards any basket of postal services specified in the price cap decision or the adjustment referred to in the construction of “X” in the CPI – X% price cap, or both.

A 1.12 In accordance with section 30(7) of the 2011 Act, a universal postal service provider shall comply with a price cap decision and any decision made under amending a price cap decision. In accordance with section 30(8) of the 2011 Act, ComReg shall, as soon as practicable, publish a price cap decision.