

Ensuring that consumers benefit from the opening of postal markets to competition

National Postal Conference Presentation

18 October 2007



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Changes to the European Postal Regulatory Framework

- Political agreement reached 1 October 2007 to set deadline for FMO of 31 December 2010. New Postal Directive will not come into force until June 2008 at the earliest but main provisions are settled.
- **Pricing (and accounting):** prices must “be cost-oriented and give incentives for an efficient universal service provision” rather than “geared to costs”.
- **Quality:** provisions remain generally unchanged. General authorisations (including licensing) to “safeguard universal service”.
- **Services:**
 - scope of universal service unchanged (considerable freedom for Member States to define)
 - financing mechanisms i) use public procurement rules, including competitive dialogue or negotiated procedures; ii) if universal service obligations entail a net cost and represent an unfair financial burden then can compensate from state funds or share net cost between all service providers and/or users; iii) market provision
- **NRA:**
 - independence reinforced
 - must establish monitoring and regulatory procedures to ensure the provision of universal service

Key issues and our terms of reference

- There are a number of potential issues that need to be considered before the proposed Directive is adopted into Irish law.
- Member States have considerable autonomy in how they transpose the proposed Directive into national law.
- ComReg has asked LECG to consider how best to ensure that all consumers benefit from the opening of the postal market to competition in Ireland.
- We have been asked to focus on the three key issues:
 - What is the most appropriate form of price regulation for the Irish market following liberalisation?
 - How should quality standards for universal service be defined, set and regulated?
 - What steps if any need to be taken to secure the provision of universal service?

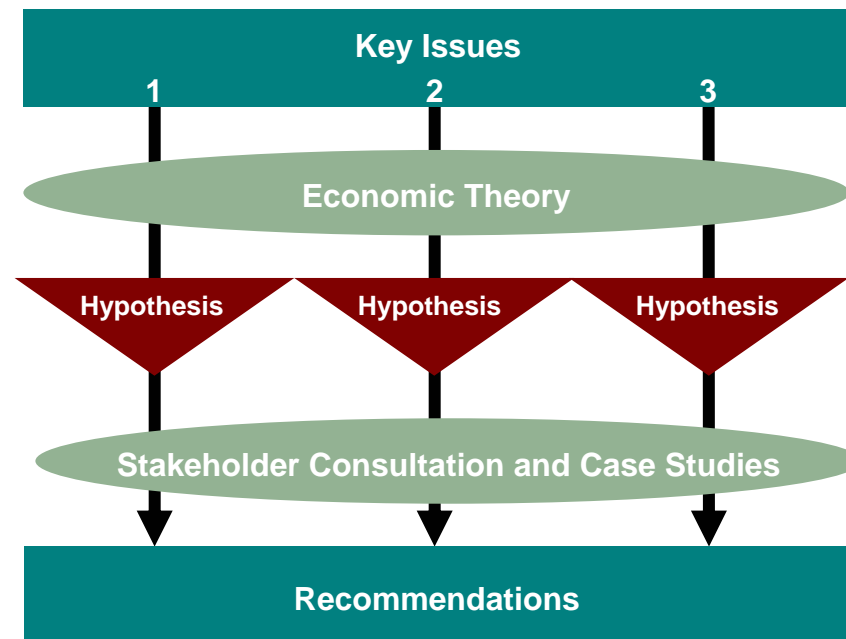


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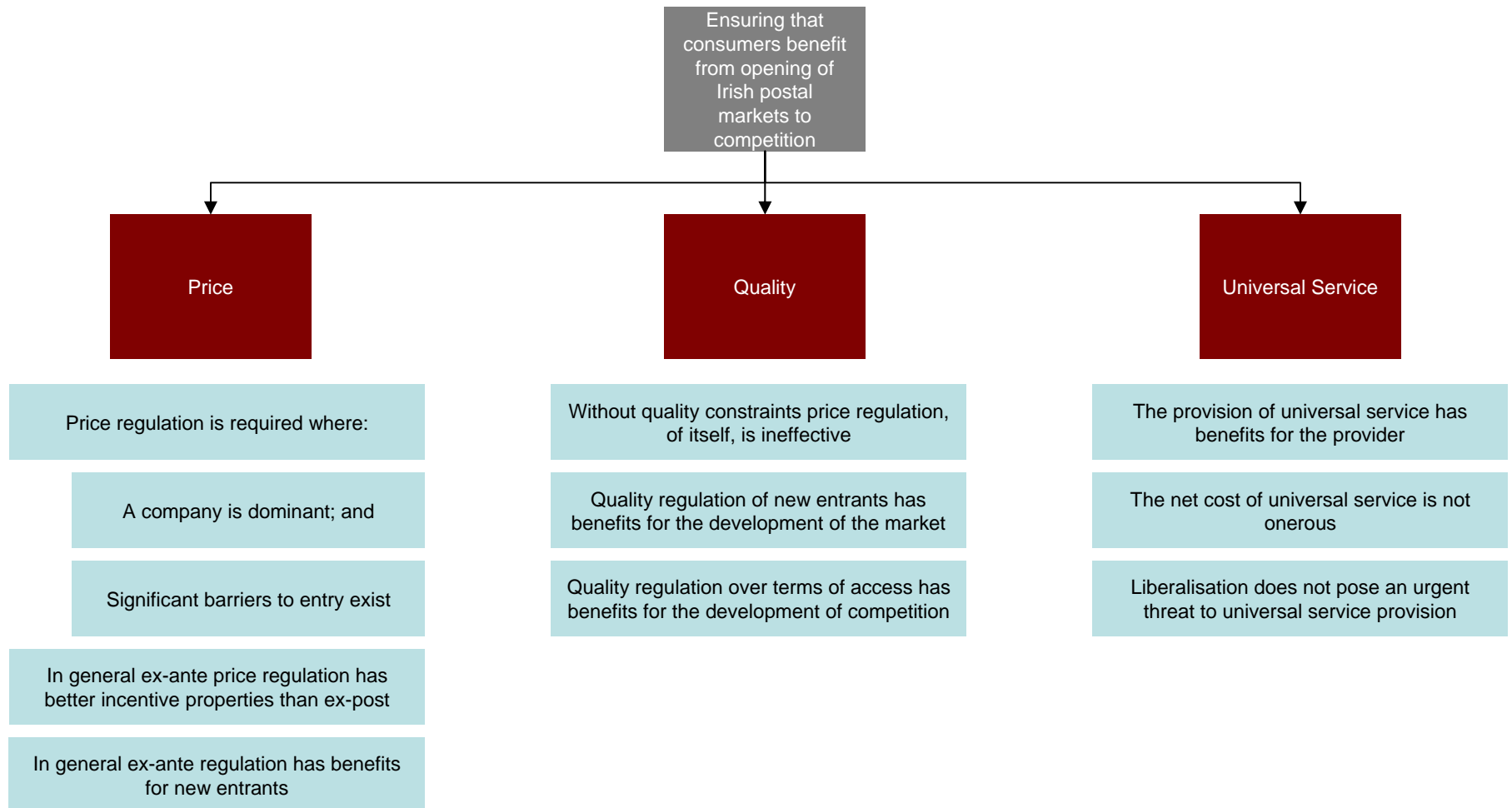
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Our approach

- We have adopted a five tiered approach to identify the key issues that might prevent consumers benefiting from the opening of the postal market to competition.
- The main stages in our approach are outlined below:

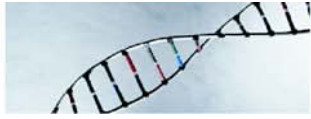


Economic theory leads to a number of basic hypotheses



Stakeholder consultation

Operators	State bodies and organisations
<ul style="list-style-type: none"> ▪ An Post ▪ DX Ireland ▪ DHL Express (Ireland) Ltd. via IAIEC ▪ Interlink Ireland, Interlink Express ▪ Nightline ▪ TiCo Postal Services Ltd ▪ Door2Door Services Ltd 	<ul style="list-style-type: none"> ▪ Department of Communications ▪ Competition Authority ▪ Forfas ▪ ComReg ▪ Muintir na Tire ▪ Trade unions (An Post Group of Unions)
Business and consumer representative groups and large consumers	International bodies
<ul style="list-style-type: none"> ▪ IBEC ▪ ISME ▪ Consumer Association of Ireland ▪ Vodafone ▪ MBNA 	<ul style="list-style-type: none"> ▪ Postcomm (UK regulator) ▪ PTS Sweden (Swedish regulator) ▪ Sandd ▪ UK Mail ▪ New Zealand Post ▪ New Zealand Treasury

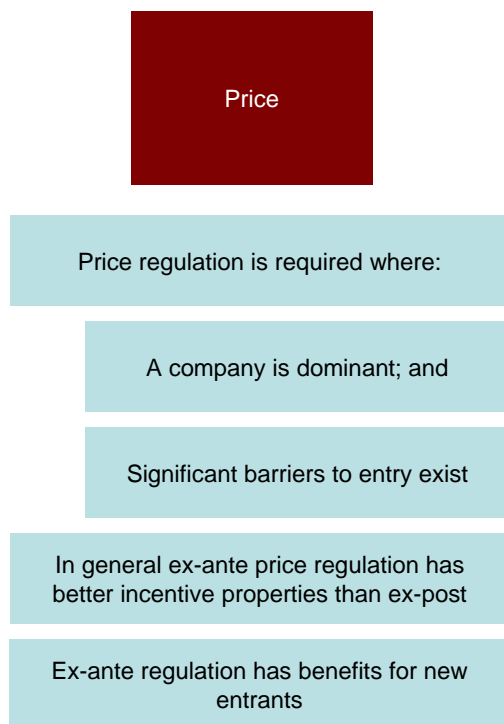


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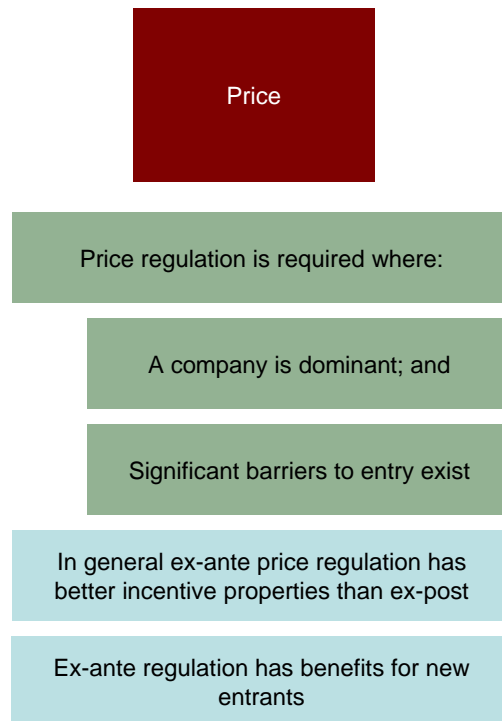


What is the most appropriate form of price regulation for the Irish market following liberalisation?



- An Post is, and is likely to remain, dominant.
- Significant barriers to entry exist for entrants in Ireland.
- Ex-ante price regulation does have better incentive properties than ex-post regulation.
- General consensus is that ex-ante regulation is preferable.

What is the most appropriate form of price regulation for the Irish market following liberalisation?



- An Post is a dominant supplier of postal services.
- In countries where the postal markets have been fully liberalised, the incumbent operator continues to have a dominant position up to ten years after FMO.
- Significant barriers to entry for new entrants in the Irish postal market means that An Post is likely to remain the dominant operator in the postal market post FMO.



An Post is still a dominant supplier of postal services

- To date only 20% (by volume) of universal services market has been opened to competition.
- Since 2004 postal service providers with turnover in excess of €500,000 have had to apply for a “postal service authorisation”. To date ComReg has granted 30 PSAs – mostly to established operators rather than new entrants.
- Some indication that operators are considering options to enter universal service market, but only after FMO and only in niche markets.
- Customers want to give all their business to a single operator, this applies to weight as much as geographical coverage.
- An Post uses it’s delivery network to compete with other companies who deliver unaddressed advertising media – An Post has about 50% market share. Need to ensure no impact on quality, cost or volumes of universal service.



Incumbent operators in fully liberalised postal markets continue to have significant market shares five to ten years after FMO

Country	Year of FMO	Year when price control ended	Market share of former incumbent in medium term after FMO		
			Sub-market	Year	Market share
Sweden	1993	Ongoing	Domestic End-to-End letter mail volume for correspondence and addressed direct mail	2004	92%
			Addressed mail	2003	92.9%
			Total letter market	2007	91.0%
New Zealand	1998	2001	Basic letter market	2007	>80%
United Kingdom	2006	Ongoing	Regulated letter and packet delivery sector	2007	96.0%

Source: wik-Consult (2006), www.pts.se, LECG New Zealand, PIQUE (2007)



Postal industries have natural monopoly characteristics

- An Post has many of the classic features of a natural monopoly.
- Economies of scale, density and scope in the delivery network.
- The investment in the infrastructure has been made over a long period and the incumbent has a significant advantage because of its legacy as the franchised monopoly - rather than the result of a superior business model.
- Natural monopolies are an extreme competition case because the cost structure is such that costs are minimised with one supplier only.
- Significant natural barriers to entry, giving the dominant firm market power.
- Widely acknowledged that natural monopolies need some form of regulatory control.
- It is in these exceptional circumstances where ex post regulation and ex post competition law have found it difficult to control pricing abuses.



Significant additional barriers to entry exist for new entrants in Ireland

Scale in the Irish market

- Ireland has the sixth lowest mail per GDP in the European Union and a high proportion of its population live in rural areas.
- New entrants indicated that the density of delivery points was a potential barrier to end-to end competition.

Low terminal dues stripping volume from Irish market

- Around 30% of mail delivered in Ireland originates from abroad (more than in the UK or Germany).
- Pre-agreed prices for inbound international are “below cost” denying competitors the opportunity to compete for these volumes and distorting competition in the mail preparation market.

An Post’s brand loyalty and customer inertia

- Stakeholders confirmed that An Post’s brand was trusted by the public and business and that customer inertia had been experienced in other liberalised Irish utility markets.



Significant additional barriers to entry - continued

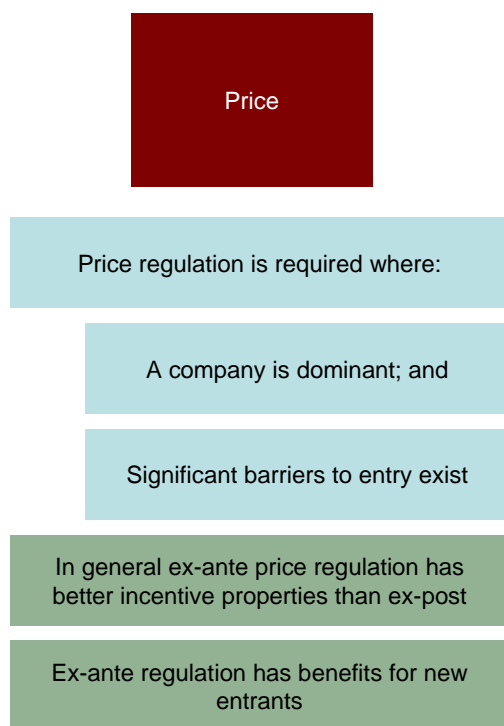
Lack of postcodes and a postcode address file (“PAF”) – complexity of rural delivery

- Stakeholders claimed that rural delivery requires local knowledge and access to postcodes and PAF would help entrants to develop a rural delivery network.
- An Post Group of Trade Unions recognised that Direct Mail volumes could benefit from the use of postcodes and claimed that postcodes would reduce An Post’s profits and affect its ability to fund the provision of universal services.

An Post’s VAT exemption

- An Post does not charge VAT. VAT exempt customers (i.e. banks, charities etc) cannot claim back.
- VAT charged by suppliers and these customers represent a large proportion of volumes.

General consensus that ex-ante regulation is preferable to ex-post regulation



- The Third Directive anticipates the need for continued regulation.
- Competition authorities generally recognise the need for a sectoral regulator.
- Stakeholders indicated that ex-post regulation by itself may not be enough, and that an industry-specific regulator is needed.
- New entrants believe that ex-ante regulation improves regulatory certainty.
- Regulatory precedent in a number of European markets suggests that ex-ante price regulation can incentivise efficiency and is commonly used in European countries where markets are liberalising.



The Directive anticipates the need for continued regulation

- Ex-ante price control over reserved (monopoly) services introduced by 1983 Act.
- This statutory price control will end when markets are fully opened to competition.
- An Post has a legitimate expectation that ComReg will no longer have ex-ante price control powers.
- This position may not be acceptable to other stakeholders.
- The proposed Third Directive still requires an Irish NRA to function and oversee the market (including compliance with tariff principles).
- However, the Directive is not prescriptive about how an NRA should enforce these obligations.
- Transcribing the Third Directive into Irish Regulations gives the State an opportunity to review the success/failure of the current regime, and plan for the future.



Competition Authorities recognise the need for specialist ex-ante sectoral regulatory bodies

- Unconstrained, incumbent operators can keep prices low in competitive areas. By:
 - keeping prices high in less competitive areas; thereby
 - deterring entry; and
 - securing their own position.
- Ex-post policing of such behaviour is too slow and ineffective.
- The Competition Authority in Ireland commented to us that although they had not done a specific study of the Irish Postal industry and therefore did not have an official view, in their experience, wherever there was a strong incumbency, this usually led to competition issues as that sector liberalised.
- This was confirmed by PTS, the Swedish postal regulator:

“The Swedish Competition Act...does not appear to be well suited for a transition from monopoly to a market solution.

“The Swedish experiences indicate that, in order for a liberalisation to have a stronger impact, a sector specific legislation should be considered. In particular, rules on the incumbent's freedom to set its tariffs”.

PTS. “The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly”. 2007.



The behaviour of Posten AB, the Swedish incumbent operator, is illustrative

- Since 1993, Posten has been found to have abused its market power many times. More than 100 cases have been dealt with by the Swedish Competition Authority between 1993 and 1999 alone. For example, Posten:
 - substantially raised prices for customers who switched to CityMail for their deliveries on the Posten network (customers did not have choice for nationwide delivery);
 - engaged in predatory pricing by lowering the price for magazine distribution in 3 urban areas where its main competitor, CityMail, was active;
 - used discount policies and zonal pricing to hinder competition;
 - offered fidelity rebates to customers that bought all of their mail delivery from Posten. Customers using alternative operators were punished and discriminated against;
 - exploited a loophole in the price cap to raise prices for single letters by roughly 30%; and
 - had disputes with CityMail about unfavourable access conditions. Resolved in 1999 through an amendment of the Postal Services Act.
- Posten still has 91% of the total letter market in 2007, 14 years after FMO.



Both potential new entrants and regulators recognise the benefits of ex-ante regulation

Potential new entrants

- Potential new entrants commented that they would welcome ex-ante price regulation, especially the regulation of access prices.
- Stakeholders would like prices monitored so that they are cost oriented and not below cost.

Regulators

- Better incentive properties and commonly used.
- Countries that have fully liberalised postal, electricity and telecoms markets have commonly used some form of price cap (ex-ante) regulation.
- The Directive states that “*prices must be cost-oriented and give incentives for an efficient universal service provision...*”.
- Price cap (or “RPI-X” or “CPI-X”) regulation has better economic properties than rate of return regulation and evidence from the electricity, gas and telecoms markets in UK and elsewhere supports this.



Ex-ante (Price cap) regulation can incentivise efficiency – examples from UK capital intensive industries

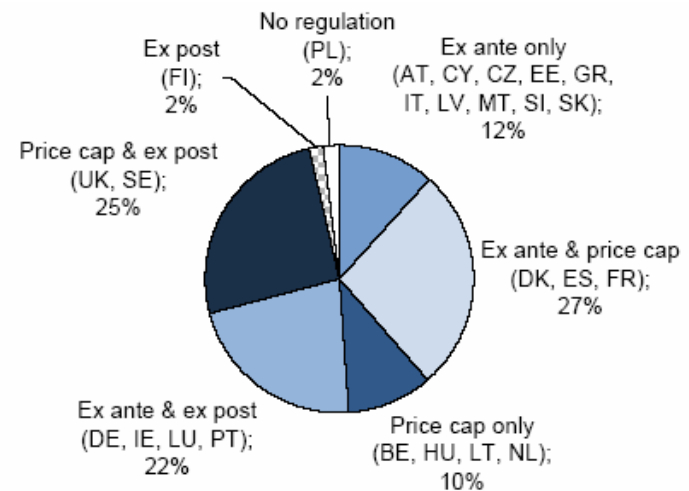
- Scale of efficiency improvements have been significant in the UK under RPI-X forms of regulation.
- There are many different ways of estimating historical cost savings – and one must ensure consistency between comparables - but on any basis, savings have been substantial.

Sector	Real unit operating cost savings
Electricity transmission	>50%
Electricity distribution	>45%
Telecoms (exchange lines)	>40%
Water	>35%
Rail	>20%
British Airport Authority	>20%

Source: LECG, Ofgem, CAA and NAO Report "Pipes & Wires" - April 2002. Efficiencies measured between start of regulation or privatisation to 2002

Price caps are commonly used in other key liberalised postal markets

- Ex-ante regulation is commonly used in EU Member States.
- Price caps are a popular form of ex-ante regulation.
- 9 Member States (accounting for 62% of the European market by domestic letter post volume) use price caps.
- The UK uses a form of RPI-X regulation.



Notes: MSs weighted by domestic letter post volume in 2004.

Source: WIK Consult. "Main Developments in the Postal Sector (2004-2006)."



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How should quality standards for universal service be defined, set and regulated?

Quality

Without quality constraints price regulation is in principle ineffective

Quality regulation of new entrants has benefits for the development of the market

Quality regulation over terms of access has benefits for the development of competition

- Quality is low and there is a recognised need for improvement.
- Relevant stakeholders agree that regulation of quality is desirable.
- Continued low quality will jeopardise volume growth.



An Post's overall quality of service is low

Quality

Without quality constraints price regulation is in principle ineffective

Quality regulation of new entrants has benefits for the development of the market

Quality regulation over terms of access has benefits for the development of competition

- The last An Post annual report stated: “*our mails quality of service performance ranks as a source of disappointment and concern*”.
- Between January and June 2007:
 - 78% was delivered within 1 day (target 94%); and
 - 98% was delivered within 3 days (target 99.5%).
- An Post's performance has improved slightly in recent months.
- Stakeholders were concerned however that An Post might promote quality in competitive products at the expense of single piece mail.



Stakeholders agree that regulation of quality is desirable

Consumer Association of Ireland

- Highlighted that single piece mail quality was poor.
- Single piece mail products are important to residential consumers and small businesses, who are unlikely to have alternative suppliers in the early stages of liberalisation.

Unions

- Concern that low quality from either An Post or new entrants will jeopardise volume growth.

Operators/potential new entrants

- Concern that their offering will be compromised by poor An Post quality if they have to rely on access to the An Post network to fulfil their delivery requirements.
- Concern that An Post could make entry more difficult by promoting quality in competitive products.
- UK Mail, the British market bulk mail entrant, told us that one of the most significant barriers to customer switching was trust in entrant quality.

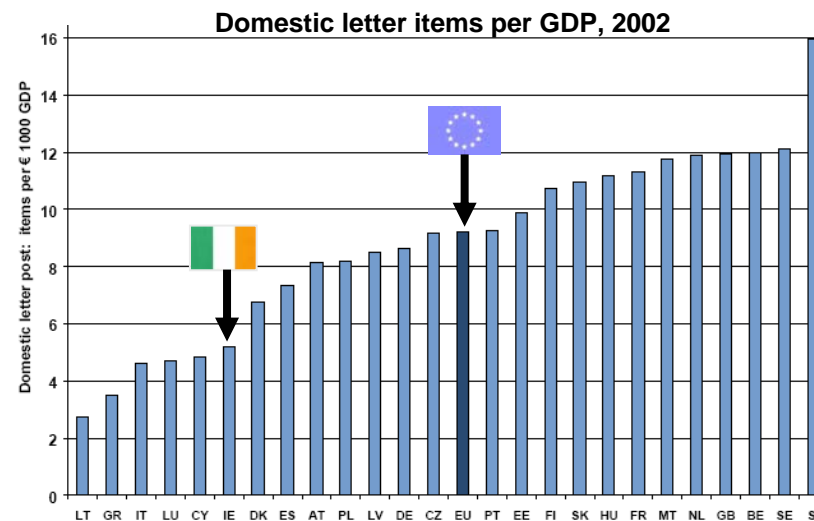
Bulk mail stakeholders

- Reported significantly better quality, compared to An Post's overall figures.



Continued low quality could jeopardise volume growth

- Mail volumes in Ireland are low.
- Quality of service performance in Ireland is also low.
- This pattern is seen across other Member States:
 - *Volumes*: only 5 Member States with volumes lower than Ireland.
 - *D+1 performance*: only 3 Member States with performance lower than Ireland.
 - *D+1 performance against targets*: only 1 Member State with performance against targets lower than Ireland.



Source: WIK-Consult, 2004

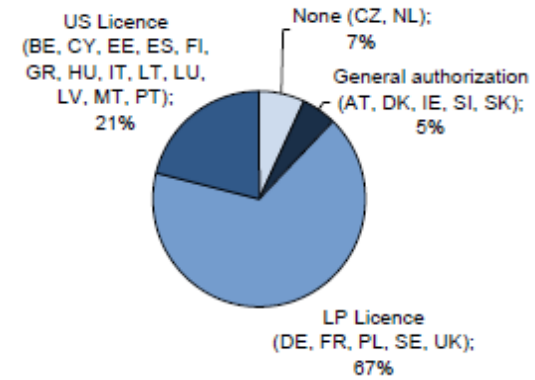
	Lowest volume, per GDP, 2002	Lowest D+1 performance, 2005	Lowest D+1 performance against targets, 2005
<i>Lowest</i>	Lithuania	Cyprus	Cyprus
	Greece	Greece	Ireland
	Italy	Lithuania	Greece
	Luxembourg	Ireland	Lithuania
	Cyprus	France	Slovenia
6th lowest	Ireland	Latvia	France

Sources: WIK-Consult, 2004 & 2006

Options for the regulatory regime for implementation of price and quality regulation

- The EU Directive provides for two types of general authorisation in order to guarantee:
 - “*compliance with the essential requirements*” for all postal services; and
 - “*compliance with the essential requirements and to safeguard the universal service*” for universal services only.
- The authorisation obligations can be specific and can include a licensing regime.
- An Post is a state-owned enterprise and currently is designated as the universal service provider by the Minister; and is not subject to any authorisation from ComReg.
- Designation has disadvantages. It imposes an *obligation* – easier for the USP to claim compensation. It is inflexible and does not allow the regulator to change the USP’s rights and responsibilities.
- Precedent in the EU shows that a licensing regime is more widely used in practice. A majority of EU Member States have adopted some form of licensing regime. Only 5 States have a general authorisation regime without licensing.

Evaluation of authorization systems in universal service area



Note: Member states weighted by domestic letter volume in 2004. Source: WIK-Consult (2006)



Regulatory incentives are needed to ensure that quality standards are met

- Operators should respond to competitive incentives to improve quality.
- Some quality monitoring will be inevitable - the new proposed European Directive maintains the NRA's responsibility to monitor universal service quality (Article 16).
- Generally, stakeholders wanted quality monitoring and support ComReg having regulatory powers to incentivise quality.
- Different tools within quality regulation are used in different countries.

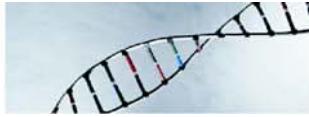
Quality Regulatory Tools

1. Codes of conduct – forms of self regulation (Postcomm developed the Mail Integrity and Common Operational Procedure codes with the industry – covering operational service standards)
2. Licensing – enables regulation of quality (18 MS licence universal service mail, from which 5 MS licence non-universal service mail)
3. “Name and Shame” – USPs forced to highlight poor performance to consumers (22 Member States); all licensee quality information disclosed to Postcomm in the UK
4. Customer compensation schemes (UK operates an agreed scheme)
5. Fines (Postcomm has fined Royal Mail for poor quality performance)
6. Quality penalties in price cap (Belgium, Portugal, UK)
7. Enforcement orders – legal action (UK)



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What steps, if any, need to be taken to secure the provision of the universal service?

Universal Service

The provision of universal service has benefits for the provider

The net cost of universal service is not onerous

Liberalisation does not pose an urgent threat to universal service provision

- An Post, along with other operators, recognises the benefits of universal service provision, describing the universal service as “an asset”.
- It is unlikely that the net cost, if any, is onerous.
- Stakeholders agree that the scope of universal services should be kept under review.



An Post's purpose is to provide a universal service

- An Post's memorandum and articles of association define the company's principle objects as being in essence to provide a universal postal service in Ireland. The memorandum of association defines the following principal objects of the company:

“to provide a national postal service within the State and between the State and places outside the State,

“to meet the industrial, commercial, social and household needs of the State for comprehensive and efficient postal services and, so far as the company considers reasonably practicable, to satisfy all reasonable demands for such services throughout the State,

“to provide counter services for the company's own and Government business and, provided that they are compatible with those services and with the other principal objects set out in this subsection, for others as the company thinks fit,...”.

- At the recent conference hosted by the An Post Group of Unions, Donal Connell, CEO, An Post, presented a vision of An Post delivering a universal service on a commercial basis in a fully liberalised market without subvention.



There are benefits to providing the universal service

- USPs in fully liberalised postal markets have tended to maintain high quality standards and provide universal services even after the FMO.
 - Sweden Post ranks as one of the most efficient USPs with high quality;
 - NZ Post still provides services in excess of the regulated minimum;
 - UK, USA, Sweden and NZ all self funding; and
 - Swedish and UK regulators believes that the provision of universal services is an asset.
- ComReg's working definition of the universal service is relatively minimal and currently An Post provides services in excess of the minimum requirements (which suggests that there are commercial benefits to do so):
 - it provides more access points and more clearance from these access points; and
 - it delivers daily to over 99% of the delivery points - some European operators only deliver daily to 95% of delivery points.
- Stakeholders stated that they believed provision of the universal service provides a number of market advantages to An Post – such as ubiquity of network and service offering, ability to offer a turnkey mail solution end-to-end, brand reinforcement, consumer trust.
- *“An Post has been a nationally known and very respected **brand** which has been built over many years by dedicated people. It is a core asset of the company and also part of the social capital of the community in Ireland”* – Paddy Walley for the An Post Group of Unions.



It is unlikely that there is an onerous net cost

- Difficult to calculate the net cost, if any, of the universal services obligation. Most calculations exclude the value of benefits.
- Calculations generally show that the cost is not onerous:
 - NERA's study for the European Commission (1998) calculated the net cost of the Irish universal service between 0.3% and 5.4% of An Post's 1997 turnover;
 - Postcomm' study of Royal Mail suggested an NAC of between 0% and 1% of turnover;
 - in Portugal a study by the national operator suggested that between 4% and 6% of the €15.9m losses could be ascribed to the requirements of the universal service;
 - in the USA, the Postal Rate Commission estimated that the cost of the universal service represented 5% of revenues. In order to remove this obligation, the USP would have to cease deliveries to approximately 47% of addresses;
 - in Sweden, the most recent estimate is €10.3m or 4% of the operator's group wide revenues. According to the Government, provision of the universal service can be considered an asset because ability to offer a full service is a competitive advantage (very expensive for competitors to build a parallel nationwide delivery network); and
 - in Norway, estimated at 2% of Posten Norge's sales.



It is difficult for entrants to cherry pick profitable routes

- There is some evidence (UK) to suggest that it will be difficult for new entrants to cherry pick profitable routes because the costs of the universal service are not necessarily concentrated in intuitive places.
- In the UK:
 - loss-making services are evenly distributed across delivery density and distance;
 - delivery to Rural and Deep Rural areas are not loss-making activities in aggregate; and
 - in aggregate all delivery densities generate a similar level of unit contribution.
- There is strong evidence from international comparisons that competition and a strong internally financed universal service can co-exist.



Stakeholders agree what constitutes universal services in Ireland

- ComReg conducted a consultation in 2005 to formulate a working definition of what constitutes the universal postal service in terms of specific services.
- ComReg did not receive any significant dissenting views during the consultation.
- The working definition has been accepted by all stakeholders and An Post has been providing the universal services as set out in the working definition.
- As the postal market develops, the scope of the universal service will need to evolve. In its consultation, ComReg acknowledged this:
 - *“it will review the requirements of the universal service periodically and therefore the outcome of the current consultation should not be seen as permanently fixing the definition”.*
- Stakeholders believe that the universal service should be dynamic, reflecting underlying demand.
- The Postal Directive (Article 5) requires that the scope of the universal service is adjusted to changing consumer demands.
- There is a need to continue to monitor demand trends.



Conclusions



Conclusions

- We believe that the risks to the provision of the universal service posed by full market opening are low, and likely to emerge slowly, if at all. We believe that they can be addressed through the monitoring of universal service provision by ComReg.
- Consumers will benefit most from the opening of the postal market to competition if An Post, is subject to ex-ante regulation and if the NRA has adequate enforcement powers.
- The development of the postal industry will benefit from regulatory oversight of new entrants. Poor quality entry risks undermining the competitive impact of entrants generally, and thereby the development of the industry as a whole. We believe that there may be benefits to a licensing rather than an authorisation regime, since the threat of potential licence removal may help to secure sustained quality levels.
- This may require amending legislation, and there is a potential opportunity to incorporate this as part of the process by which the Third Directive is implemented into Irish law.



Competition is critical

“We also have a firm belief, and can point to significant evidence from international comparisons, that competition and a strong internally-financed universal service can co-exist. Indeed, the early experience in the UK is that competition has strengthened the universal service...”

It is also because evidence increasingly supports our contention that competition is absolutely critical to stimulating innovation and better service quality”.

Postcomm Strategy Review, The Postal Market 2010 and Beyond. August 2007



An Post's vision

“Transformation of An Post into a truly customer-focused business that will survive and thrive in the face of competition is at the core of [the New Strategic Plan]. Key elements include: maximising the growth opportunities available to the Company; providing consistent high quality of service that meets customers’ and stakeholders’ expectations; and the development of a new approach for ongoing engagement with employees and their unions, as well as our post office contractors, to create a stimulating and rewarding work environment.”

An Post 2006 Annual report



But competition will not happen by itself

“There is a risk that competition will not develop as anticipated and that the benefits of competition....are not met. Competition is fragile in the initial phase, and there will be a need for adequate monitoring by regulatory and competition authorities.”

**Report from the Commission to the Council of European Union and the European Parliament.
Prospective study on the impact on universal service of the full accomplishment of the postal
internal market in 2009.**