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

LECG Report

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LECG Ltd
Davidson Building, 5 Southampton Street, London WC2E 7HA, United Kingdom
main +44 (0)20 7632 5000 fax +44 (0)20 7632 5050 www.lecg.com

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Glossary

The following abbreviations are used in this report:

Access regulations	Set of prices and conditions for users and operators to input mail into the USP's postal network – see also REIMS agreements, Terminal dues
BT	British Telecom
Bulk mail	Mail that is input into the postal pipeline in high quantities. Typically includes direct and statement mail. Often identical
ComReg	Commission for Communications Regulation, the NRA for postal, electronic communications and spectrum services in Ireland
Consignia	Former name for Royal Mail
CPI-X	Price control formula based on the Consumer Price Index, "CPI" and an efficiency factor, "X"; analogous to RPI-X
Deutsche Post AG	USP for the postal market in Germany
DHL	Deutsche Post AG subsidiary operating in express and logistics market
Direct mail	Advertising material sent through the postal system
Downstream access	Access to the postal network of the USP on a wholesale basis close to the final delivery point
End-to-end	Complete postal pipeline service, from collection to delivery
Postal Directive	Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2002 amending Directive 97/67/EC with regard to the further opening to competition of Community postal services
Ex-ante	Regulatory control before the event, based on predicted results
Ex-post	Regulatory control based on analysis of past performance
FMO	Full Market Opening
Forfas	Forfás is Ireland's national policy and advisory board for enterprise, trade, science, technology and innovation. It operates under the auspices of the Department of Enterprise, Trade and Employment

GDP	Gross Domestic Product; measure of level of economic activity
La Poste	USP for the postal market in France
De Post/La Poste	USP for the postal market in Belgium
Mailing house	A company that prints, binds and sorts bulk mail items
NAC	Net Avoidable Cost method of calculating the net cost of USO, which has been advocated by some stakeholders
NRA	National Regulatory Authority
Ofgem	Office of Gas and Electricity Markets, the NRA for the gas and electricity markets in the UK
Oftel	Office of Telecommunications, the former NRA for telecommunications services in the UK (replaced by Ofcom in 2003)
Operator, the	An Post
Postal Regulatory Commission	US postal regulator (formerly known as the Postal Rate Commission)
Postcode address file	Database that links street addresses with postcodes, often used by bulk mailers and mailing houses
Postcomm	Postal Services Commission, the NRA for postal services in the UK
Posten AB	USP for the postal market in Sweden
PTS	Post & Telestyrelsen, the NRA for postal and electronic communications services in Sweden
Regulations, the	European Communities (Postal Services) Regulations, 2002. S.I. No. 616 of 2002 – Irish secondary legislation transposing the Postal Directive
Regulator, the	ComReg, the NRA in Ireland
REIMS agreements	A series of agreements between most USPs in Europe concerning access conditions for cross-border mail
Reserved area	Part or all of the market for postal services where a postal service provider has exclusive (monopoly) rights and where competitive services are prohibited
Royal Mail	Licensed USP for the postal market in the UK

RPI-X	Price control formula based on the Retail Price Index, “RPI” and an efficiency factor, “X”; analogous to CPI-X
Single piece mail	Postal services for which the tariff is set in the general terms and conditions of universal service providers for individual postal items, typically used by individuals or SME
SKR	Swedish Krona
SME	Small and Medium-sized Enterprises
Social mail	Mail sent by individuals, as opposed to businesses
Sortation	The sorting process within the postal pipeline
Tariff principles	Principles set out in Article 12 of the Postal Directive that must be complied with in respect of all services forming part of universal service
Terminal dues	The remuneration of universal service providers for the distribution of incoming cross-border mail from another Member State or a third country
Terminal dues principles	Principles set out in Article 13 of the Postal Directive concerning terminal dues agreements for intra-Community cross-border mail
Third Directive	The Presidency Compromise proposal for a Directive of the European Parliament and of the Council amending Directive 97/67/EC concerning the full accomplishment of the internal market of Community postal service. Council document 13114/07 25 September 2007 (see Postal Directive)
TNT	USP for the postal market in the Netherlands with overseas mails operations
UNI Postal	Union Network International
USO	Universal Service Obligation
USP	Universal Service Provider; In Ireland, An Post has been designated as the USP

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1 Executive summary

Introduction

1.1 In October 2006, the European Commission published its proposal for the full accomplishment of the internal market for Community postal services (i.e. full market opening or "FMO") from 1 January 2009. The Third Directive, which was agreed by the Council of the European Union on 1 October 2007, however, set the deadline for FMO at 31 December 2010, and allowed 11 Member States[1], a further two years derogation if necessary. The Third Directive establishes common rules for European Communities concerning:

- the conditions governing the provision of postal services;
- the safeguarding of a universal service for all users at an affordable price;
- tariff principles and transparency of accounts for universal service provision;
- the setting of quality standards for universal service provision and the setting up of a system to ensure compliance with those standards;
- the harmonisation of technical standards; and
- the creation of independent national regulatory authorities.

1.2 In accordance with the principles of proportionality and subsidiarity, the Third Directive provides a range of choices for Member States as to how these choices should best be achieved. It is, therefore, for Member States (perhaps in conjunction with their existing national regulatory authorities) to identify the appropriate choices to make.

1.3 In that context, ComReg, the existing national regulatory authority ("NRA") for the postal sector in Ireland, has commissioned this study to address the overall question of how best to ensure that consumers benefit from the opening of the Irish postal market to competition. That general question in turn has been broken down into three key issues:

[1] Greece, Luxembourg, Hungary, Lithuania, Poland, Latvia, Slovakia, Czech Republic, Romania, Malta, Cyprus.

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- 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; and
- what steps, if any, need to be taken to secure the provision of the universal service?

Price regulation

1.4 The Postal and Telecommunications Services Act, 1983, which established An Post as a state owned limited liability company, set the principle that the company could not increase the prices it charged for services covered by its statutory monopoly without the prior ("ex-ante") approval of the Minster. The Regulations transposing the Postal Directive into Irish Law transferred this control to ComReg, and provided for ex-post enforcement of the tariff principles in respect of services for which An Post no longer had an exclusive right in the form of a reserved area. Once the market has been fully opened to competition, the requirement for ex-ante approval will therefore - absent any new primary legislation - lapse.

1.5 Transposition of the Third Directive provides an opportunity to consider the need for such legislation. Consideration of the issues set out above is therefore timely. Our views on each, which have been informed by economic principles, stakeholder discussions, and comparative studies, are set out in summary form below, and more fully within the body of this report.

1.6 The requirement for continuing regulation of prices is set out explicitly in Article 12 of the Third Directive:

- *"prices must be affordable and must be such that all users, independent of geographical location, and, in light of specific national conditions, have access to the services provided. Member States may maintain or introduce the provision of a free postal service for the use of blind and partially-sighted persons,*
- *"prices must be cost-oriented and give incentives for an efficient universal service provision. Whenever necessary for reasons relating to the public interest, Member States may decide that a uniform tariff should be applied throughout their national territory*

and/or crossborder, to services provided at single piece tariff and to other postal items,

- *“the application of a uniform tariff does not exclude the right of the universal service provider(s) to conclude individual agreements on prices with users,*

- *“tariffs must be transparent and non-discriminatory,*

- *“whenever universal service providers apply special tariffs, for example for services for businesses, bulk mailers or consolidators of mail from different users, they shall apply the principles of transparency and non-discrimination with regard both to the tariffs and to the associated conditions. The tariffs, together with the associated conditions, shall apply equally both as between different third parties and as between third parties and universal service providers supplying equivalent services. Any such tariffs shall also be available to users, in particular individual users and small and medium-sized enterprises (“SME”s), who post under similar conditions.”*

1.7 Economic theory is clear that in circumstances where an incumbent is dominant and has market power, and where there are significant barriers to entry, the safeguarding of effective competition will require monitoring of the price (and quality) parameters deployed by the incumbent. This is because in principle, these factors can be used to deter competitive entry, and, therefore, to protect an incumbent position in ways which are disadvantageous to consumer interests.

1.8 Absent regulatory oversight, it is, for example, open to an incumbent to reduce prices in potentially competitive areas of business, and to raise prices in those areas less potentially competitive, in order to finance any resulting deficit. On similar principles, it is open to an incumbent to increase quality in potentially competitive areas, and to reduce quality in areas that are less potentially competitive. In both cases, the outcome is to deter entry in potentially competitive areas, and to disadvantage customers in areas that are less competitive. This reduces the effectiveness of competition and denies to customers the benefits that would otherwise flow from the opening of postal markets to competition.

1.9 These issues arise not just in markets that are protected (or reserved) but also in markets in which competition has yet to develop fully. The question that then arises is whether the monitoring process there envisaged should best be carried out by a specific regulatory body, or whether the monitoring can effectively be carried out by the competition authorities, which oversee markets generally.

1.10 In discussions, An Post argued that these regulatory functions could be carried out effectively on an ex-post basis by the competition authorities. The Irish Competition Authority itself, however, were inclined to believe that a specific industry regulatory body setting prices and quality standards on an ex-ante basis would be preferable; as were potential new entrants.

1.11 This view was confirmed by PTS, the Swedish regulator, in March 2007:

> *"The Swedish Competition Act, which is the implementation of the EC rules on competition, 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"*[2].

1.12 The balance of views is unsurprising: experience elsewhere is strongly suggestive that ex-ante vigilance is more effective than ex-post investigation. In Sweden, by way of example, Posten (the incumbent USP) has been investigated over 100 times by the competition authorities, and has been found to have abused its market power many times, since the market was opened in 1993. Posten, however, has been successful in retaining some 91% of the total letters market over that period[3].

1.13 There are sufficient barriers to entry in Ireland (including the lack of postcodes and the VAT exemption enjoyed by An Post) to provide reasons to believe that the effectiveness of potential competition will be fragile. In these circumstances,

[2] PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007. Page 2.

[3] PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007.

there appear to us to be considerable grounds for believing that ex-ante regulation will be preferable in Ireland.

1.14 Ex-ante regulation of prices and associated quality parameters has generally been the preferred solution in liberalised postal markets in other countries. It has also been the preferred solution in other liberalised sectors within Ireland (including telecoms and electricity, for example). Ex-ante regulation also has better theoretical economic properties, particularly in encouraging incumbents to generate continuous gains in both the costs (and quality) of their operations (i.e. by setting targets, which can be outperformed, rather than ex-post imposition of prices based on actual costs). This appears to be anticipated by the Third Directive in its reference to the principle *"that prices must … give incentives for efficient universal service provision*"[4].

Quality

1.15 The ambit of quality regulation goes beyond the oversight of quality standards deployed by the incumbent in the less competitive areas of the market. In particular, the regulation of quality provided by the incumbent to new entrants seeking access to their network is valuable to entrants (in ensuring that the quality that they can offer to their customers is not compromised). Similarly, the regulation of the quality of service provided by the entrants themselves is valuable for entrants collectively (in ensuring that the market perception of entrants collectively is not tarnished, to the detriment of the market generally).

1.16 On the former point, discussions with potential entrants highlighted a fear that access conditions imposed by An Post might compromise their ability to provide a competitive service in circumstances where they rely on An Post for final delivery. Since the absence of postcode structures in Ireland makes the emergence of end-to-end competition less likely, this is an important concern. Other stakeholders were equally concerned about the potential harm to the development of the postal market generally that could be caused by low quality entry.

1.17 Ireland's mail volumes per capita (and per '000 GDP) are low in comparison to other European countries. There is some evidence to suggest that service quality

4 Third Directive. Presidency Compromise Proposal. 25 September 2007, Article 12, second indented point.

affects mail volumes. Union representatives in particular believed that volume growth was possible, but might be jeopardised either by low quality entry or by a failure on the part of An Post to improve on quality standards that are generally recognised (not least by the company itself) to be low. As the Presidency Compromise Proposal for the Third Directive notes:

> *"Increased competitiveness should furthermore enable the postal sector to be integrated with alternative methods of communication and allow the quality of the service provided to evermore demanding users to be improved.*[5]

> *"The provision of high-quality postal services contributes significantly to attaining the objective of social and territorial cohesion. E-commerce, in particular, offers new opportunities for remote and sparsely populated areas to participate in economic life for which the provision of good postal services is an important precondition."*[6]

Universal service

1.18 The conventional fear in respect of universal service provision is that competitive entry will progressively eliminate the profitability of activities that support the loss making activities required to deliver on the obligation to provide services on a universal basis. This was the fear expressed by union representatives at the recent conference in Ireland on the impact of liberalisation:

> *"Mr John Pedersen, Assistant General Secretary, UNI Postal, Union Network International, spoke about the inherent contradictions in the Commission's proposals to open the market... The two objectives; to open the market and maintain the universal service obligation do not sit well with each other and UNI believes these two objectives are contradictory."*[7]

1.19 The Third Directive recognises the tension between its twin objectives, and indeed provides for a variety of financing mechanisms, should these prove necessary. It also, however, incorporates the statement that:

"The prospective study states that the basic aim of safeguarding the sustainable provision of a universal service matching the standard of quality defined by the Member States in accordance with Directive 97/67/EC, can be secured throughout the Community by 2009 without the need for a reserved area."[8]

1.20 Discussions with An Post confirmed a similar belief, consistent with the comments made at the same conference by Mr Donal Connell, An Post's Chief Executive, who:

"presented a vision of An Post delivering USO on a commercial basis in a fully liberalised market without subvention, which is currently the case."[9]

1.21 In our opinion, and based on our experience, the circumstances in which competitive entry could threaten the provision of the universal service would be rare. In particular, any costs associated with the universal service appear to be widely distributed across delivery density and distance parameters. They are therefore not easily avoided by entrants, whose primary strategy is, in general, to concentrate on bulk mailers with broadly ubiquitous delivery requirements. The empirical evidence from studies in other countries is also that the net costs, if any, associated with the provision of the universal service provision are low[10].

1.22 Universal service requirements in Ireland are not, in relative terms, onerous; and are unlikely to be significantly increased given that they are compatible with the minimum standards set out in the Third Directive. The scope of the universal service has recently been the subject of extensive consultation by ComReg, and there was general agreement among those responding that the scope should be kept under review.

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5 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 13.

6 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 14b.

7 Fitzpatrick, S. "Proposed EU Directive on Postal Liberalisation and the Future of the Irish Postal Service". Conference Report. March 2007.

8 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 8.

9 Fitzpatrick, S. "Proposed EU Directive on Postal Liberalisation and the Future of the Irish Postal Service". Conference Report. March 2007.

10 NERA's 1998 study for the European Commission, by way of example, calculated the cost of the USO in Ireland at between 0.3% and 5.4% of turnover, before allowing for associated benefits.

1.23 We believe that problems with the financing of the universal service are unlikely to emerge; but if they do, they will emerge only relatively slowly. In these circumstances, we believe that it will be sufficient for ComReg to consider the scope of, and any burden imposed by, the universal service. This is consistent with the Third Directive which states:

> *"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive, in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service. They may also be charged with ensuring compliance with competition rules in the postal sector."*[11]

Conclusions

1.24 We believe that consumers will benefit most from the opening of the postal market to competition if the activities of the incumbent, An Post, are subject to ex-ante regulation by a dedicated industry specific regulator that has adequate and appropriate enforcement powers. That is not only the view offered by economic theory, but also the view of potential entrants and of the Irish Competition Authority themselves. We understand that achieving this will require amending legislation, perhaps as part of the process by which the Third Directive is implemented into Irish law.

1.25 Similarly, we believe that it will benefit the development of the postal industry if the activities of new entrants are overseen in similar fashion. Poor quality entry risks undermining the competitive effect of entrants generally and thereby the development of the industry as a whole. We believe that credible regulation of entrants may require ComReg to conduct a licensing rather than an authorisation process, since the threat of potential licence removal may be more effective in securing sustained quality levels. However, whilst this is our preference, the merits of a licensing regime in an Irish context should be considered further.

1.26 We believe that the risks to the provision of the universal service posed by FMO 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.

[11] Third Directive. Presidency Compromise Proposal. 25 September 2007. Article 22(2).

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1.27 Finally, we believe that competition is critical to ensure a well functioning postal services market. This view is shared by Postcomm, the UK NRA, who recently concluded:

> *"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".*[12]

1.28 However, competition will not happen by itself and there will be a need for adequate monitoring by a regulator who has appropriate enforcement powers. This view is supported in a report from the Commission to the Council of European Union and the European Parliament, which stated:

> *"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."*[13]

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

13 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.

2 Background

Introduction

2.1 In this section, we provide a background to ComReg's regulatory framework, our terms of reference and give a brief overview of our experience, relevant to this project.

Overview of current regulatory framework

2.2 ComReg is the national regulatory authority ("NRA") for the Irish postal industry. An Post was designated as the universal service provider ("USP") by the Minister for Communications under the European Communities (Postal Services) Regulations 2002 ("the regulations"), S.I. No. 616 of 2002.

2.3 ComReg currently has certain regulatory duties. For example, ComReg regulates An Post's prices. Under the Postal and Telecommunications Services Act, 1983 (as amended), An Post is required to secure ComReg's ex-ante approval before increasing prices for postal services falling within An Post's reserved area. An Post is also required to comply with the key elements of the regulations concerning the provision of universal service, including the *tariff principles*, *terminal dues principles*, quality standards and the universal service obligations ("USO")[14].

2.4 An Post's universal service prices are required to be affordable, transparent, geared to costs and non-discriminatory. ComReg has a statutory obligation to monitor compliance with these regulations.

2.5 ComReg also monitors An Post's quality of service. The regulations require ComReg to monitor the transit time of cross-border mail, to monitor and publish quality performance standards for universal service mail and to monitor universal service mail end-to-end transit times within the State. ComReg cannot penalise An Post for failure to meet its quality targets. ComReg has set quality of service targets for An Post. These currently require that 94% of domestic mail should arrive the day after posting ("D+1")[15] and that 99.5% of domestic mail should

[14] In particular, those set out in Regulation 4.

[15] ComReg monitors three D+1 transit times: "anywhere to anywhere", "Dublin County to anywhere" and "Outside Dublin County to anywhere". The target for each of these transit times is identical at 94%. There is one D+3 transit time target for mail sent and received anywhere in the State.

arrive on or before the third day after posting ("D+3")[16]. ComReg publishes An Post's performance against these targets on an annual basis with quarterly "progress reports".

2.6 The current regulations are based on the Postal Directive. This provided a timetable for Member States to liberalise the industry, by reducing the reserved area to single items weighing less than 50 grams and postage costing up to 2.5 times the standard mail price, from 1 January 2006[17]. Ireland has complied with this timetable for market opening.

Future regulatory framework

2.7 In October 2006, the European Commission published its proposed Third Directive. In October 2007, the Council of the European Union reached political agreement to set the deadline for full market opening ("FMO") as at 31 December 2010. It is expected that the final text of the Third Directive will not be finalised before June 2008.

2.8 We understand that the main provisions relating to pricing (and accounting), quality, NRAs and the universal service are agreed as part of the Council's agreement. We provide below some examples of key aspects to the regulatory framework. Further details are provided in the following sections.

2.9 In relation to prices, the proposed Third Directive continues the requirement from earlier versions that prices of universal services must be affordable, transparent and non-discriminatory[18]. The proposed changes that will be affected by the Third Directive include, amongst other things, the requirement for postal prices to be "*cost-oriented and give incentives for an efficient universal service provision"* instead of simply "*geared to cost*". The Third Directive is not prescriptive about how prices should be regulated to ensure compliance with tariff rules.

2.10 In relation to quality, Member States must ensure that quality of service standards are set and published in relation to the universal service in order to guarantee a

16 ODTR. "Regulation of Universal Postal Services - Quality of Service Standards to be achieved by An Post: Decision Notice and Report on Consultation". September 2001. Annex 1.

17 European Commission. "Postal Services Directive (2002/39/EC)". 2002.

18 Third Directive, Presidency Compromise Proposal. 25 September 2007. Article 12.

postal service of good quality. These provisions are unchanged. For example, Article 6 requires:

> *"Member States shall take steps to ensure that users and postal service providers are regularly given sufficiently detailed and up-to-date information by the universal service provider(s) regarding the particular features of the universal service offered, with special reference to the general conditions of access to these services as well as to prices and quality standard levels".*

2.11 Article 9 states that:

> *"1. For services which are outside the scope of the universal service, Member States may introduce general authorisations to the extent necessary in order to guarantee compliance with the essential requirements.*
>
> *"2. For services which are within the scope of the universal service, Member States may introduce authorisation procedures, including individual licences, to the extent necessary in order to guarantee compliance with the essential requirements and to safeguard the universal service."*

2.12 Finally, Articles 16 requires:

> *"Member States shall ensure that quality-of-service standards are set and published in relation to universal service in order to guarantee a postal service of good quality.*
>
> *"Quality standards shall focus, in particular, on routing times and on the regularity and reliability of services."*

2.13 The Third Directive does not propose a change to the definition of the minimum universal service[19]. Following the removal of the reserved area, alternative financial safeguards *may* be required to ensure that the universal service can be maintained. The European Commission proposes to allow Member States some flexibility in determining these safeguards, with the restriction that they should

19 The definition of the USO is provided in 6.66.

respect certain principles (e.g. objectivity, transparency, non-discrimination, proportionality and least market distortion).

2.14 The Third Directive provides some guidance about how these services and obligations should be provided. The Third Directive provides a number of options, as outlined in Recital 15 of the Presidency Compromise proposal for the Third Directive, for example:

> *"Directive 97/67/EC established a preference for the provision of the universal service through the designation of universal service providers. Member States may require that the universal service is provided for the whole of the national territory. The development of greater competition and choice means that Member States should have further flexibility to determine the most efficient and appropriate mechanism to guarantee the availability of the universal service, while respecting the principles of objectivity, transparency, non discrimination, proportionality and least market distortion necessary to ensure the free provision of postal services in the internal market. Member States may apply one or a combination of the following: provision of the universal service by market forces, designation of one or several undertakings to provide different elements of universal service or to cover different parts of the territory and public procurement of services."*

2.15 Article 7(3) also introduces the concept of funding mechanisms as follows:

> *"Where a Member State determines that the universal service obligations, as provided for by this Directive, entail a net cost, calculated taking into account Annex I, and represent an unfair financial burden for the universal service provider(s) it may:*
>
> *(a) Introduce a mechanism to compensate the undertaking(s) concerned from public funds;*
>
> *(b) Introduce a mechanism for the sharing of the net cost of universal service obligations between providers of services and/or users."*

2.16 The role and independence of NRAs has been reinforced in the Presidency Compromise Third Directive. Article 22 requires that:

> *"Each Member State shall designate one or more national regulatory authorities for the postal sector that are legally separate from and operationally independent of the postal operators. Member States that retain ownership or control of postal service providers shall ensure effective structural separation of the regulatory functions from activities associated with ownership or control.*
>
> *"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive, in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service."*[20]

2.17 The proposed Third Directive does not prevent earlier FMO. Markets are already opened in Sweden, Britain and Finland. Germany and the Netherlands are currently proposing to open their markets in January 2008. The Irish Government decided in February 2007 that market opening by January 2009 was acceptable, but time will be needed to adopt new legislation.

Terms of reference

2.18 In accordance with the principles of proportionality and subsidiarity, the Third Directive provides a range of choices for Member States as to how these choices should best be achieved. It is, therefore, for Member States (perhaps in conjunction with their existing national regulatory authorities) to identify the appropriate choices to make.

2.19 In that context, ComReg, the existing NRA for the postal sector in Ireland, has commissioned this study to address the overall question of how best to ensure that consumers benefit from the opening of the Irish postal market to competition. That general question in turn has been broken down into three key issues:

- what is the most appropriate form of price regulation for the Irish market following FMO;

[20] European Commission. "Postal Services Directive (proposed amendments for Third Directive)". October 2006. Article 22.

- how should quality standards for universal service be defined, set and regulated; and
- what steps, if any, need to be taken to secure the provision of the universal service?

2.20 The Postal and Telecommunications Services Act, 1983, which established An Post as a state owned limited liability company, set the principle that the company could not increase the prices it charged for services covered by its statutory monopoly without the prior (ex-ante) approval of the Minster. The Regulations transposing the Postal Directive into Irish Law transferred this control to ComReg, and provided for ex-post enforcement of the tariff principles in respect of services for which no longer had an exclusive right in the form of a reserved area. Once the market has been fully opened to competition, the requirement for ex-ante approval will therefore - absent any new primary legislation - lapse.

2.21 Transposition of the Third Directive provides an opportunity to consider the need for such legislation. Consideration of the issues set out above is therefore timely. Our views on each, which have been informed by economic principles, stakeholder discussions, and comparative studies, are set out within the body of this report.

2.22 We outline in further detail below the nature of the issues we have been asked to consider. Our formal terms of reference are set out in Appendix 1.

Prices

2.23 The Third Directive requires Member States to ensure that prices for universal services are affordable, cost-oriented, transparent and non-discriminatory, while giving incentives for efficient universal service provision and complying with competition law. Given FMO, the specific nature of the Irish market, and the requirements of the Third Directive, we were asked to consider the most appropriate form of price regulation for the Irish market following FMO. In developing our recommendations to ComReg we have considered the following, *inter alia:*

- whether An Post is likely to retain a dominant position for the foreseeable future;
- whether the Third Directive allows for ex-ante price regulation after FMO;

- whether ex-post enforcement works sufficiently well, whether by competition law or by ex-post regulatory powers; and
- whether ex-ante forms of control are otherwise preferable over ex-post forms of control.

Quality

2.24 The setting of high quality standards for universal services is mandatory under the Third Directive and necessary to meet users' needs. We were asked to consider how quality standards for universal service should be defined, set and regulated. In developing our recommendations to ComReg we have considered the following, *inter alia:*

- the nature of the available trade off between price and quality;
- the benefits conferred on the market generally through the regulation of quality;
- the views of relevant stakeholders; and
- should quality thresholds be set for new entrants? If so, how should it be done?

Universal service

2.25 The Third Directive does not propose a change to the definition of the minimum universal service. The Postal Directive is based on the premise that historically, monopoly profits from the reserved area have supported the additional costs, if any, incurred by some USPs in fulfilling the universal service. Following the removal of the reserved area, alternative financial safeguards *may* be required to ensure that the universal service can be maintained. The European Commission proposes to allow Member States some flexibility in determining these safeguards, with the restriction that they should respect certain principles (e.g. objectivity, transparency, non-discrimination, proportionality and least market distortion). The conventional fear in respect of universal service provision is that competitive entry will progressively eliminate the profitability of activities that support the loss making activities required to deliver on the obligation to provide services on a universal basis.

2.26 We were asked to consider what would be required to secure the provision of universal service after FMO. In developing our recommendations to ComReg we have considered the following, *inter alia:*

- An Post's natural incentives to continue to provide the universal service;
- the circumstances under which the universal service would be a net cost to the USP; and
- the factors that might limit An Post's ability to self-finance the universal service in the future?

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2.27 LECG is a global economics and consulting firm, which provides independent and objective advice and analysis on matters of economics, finance, and strategy, to law firms, businesses, regulators, and governments. Founded in 1988, LECG has 1,000 professional staff, including over 375 experts, operating in 36 offices in Europe, the Americas and Asia-Pacific.

3 Approach

Introduction

3.1 A number of issues need to be considered before the Third Directive can be transposed into Irish law. As a first step, we confirmed these issues with ComReg. We then considered the economic theory surrounding these issues and developed hypotheses, which were subsequently tested though stakeholder interviews, case studies and a review of regulatory precedent. Based on the available evidence, we then evaluated the regulatory options available to Ireland. We provide further details on our approach below.

Confirmation of issues

3.2 We met with ComReg to agree our approach and deliverables. Through a series of workshops, we agreed the key issues and structure of our analysis. We agreed to focus on the following key questions:

- the nature of any requirement for the regulation of prices once the market has been fully opened to competition;
- the nature of any requirement for the regulation of quality once the market has been fully opened to competition; and
- what steps, if any, need to be taken to secure the provision of the universal service?

Theoretical analysis

3.3 Our first step was to consider each of the key questions from a theoretical perspective. In performing our work, we performed a detailed review of the abundant theoretical and policy-oriented literature. From this, we performed an initial evaluation of the available regulatory options. 6.66 summarises the information we have relied on.

3.4 We used hypothesis (or logic) trees to allow us to structure the issues into a set of discrete questions. This helped to guide focused analysis. We tested the hypotheses using evidence provided by stakeholder interviews, case studies and regulatory precedent.

Stakeholder interviews and case studies

3.5 We consulted with stakeholders (i.e. operators, state bodies and organisations, business and consumer representatives and large mailers) and informed parties in other postal markets. We generated a structured interview template to obtain the views of stakeholders. The interviews were used to help evaluate a range of regulatory options. In general, views were provided on a confidential basis. Therefore, responses have been aggregated and anonymised in this report. The interview questionnaire is provided in Appendix 3.

3.6 We interviewed the following existing operators:

- An Post;
- DX Ireland;
- the Irish Association of International Express Carriers ("IAIEC"), which represents the large express carriers in Ireland such as DHL Express (Ireland) Ltd., TNT, UPS;
- Interlink Ireland, Interlink Express;
- Nightline; and
- Door2Door Services Ltd.

3.7 We interviewed the following business and consumer representatives and large mailers:

- Irish Business and Employers Confederation ("IBEC");
- Consumer Association of Ireland;
- Irish Small and Medium Enterprise Association ("ISME")
- TiCo Postal Services Ltd; and
- Vodafone.

3.8 We interviewed the following state bodies and organisations:

- ComReg;
- the Department of Communications, Energy and Natural Resources;
- the An Post Group of Trade Unions;

- the Competition Authority;
- Muintir na Tíre (a national organisation for the promotion of community development in Ireland); and
- Forfás (Ireland's national policy and advisory board for enterprise, trade, science, technology and innovation).

3.9 We interviewed the following international bodies:

- Postcomm (the UK NRA);
- UK Mail, a new entrant in the UK postal market;
- the Swedish NRA, the National Post and Telecom Agency ("PTS");
- New Zealand Post;
- New Zealand Treasury; and
- Sandd, an entrant in the Dutch market.

3.10 We gathered and interpreted information on the development of regulatory regimes following the introduction of full competition in other countries and sectors. Competition has progressively been introduced to a range of sectors across Europe and more widely internationally. In general, we considered evidence across Member States. Specifically, within the postal sector, we looked at three relevant precedents in more detail. These were:

- **UK** - Postcomm, the UK postal NRA, has considered in depth the form of price control to apply in the UK following FMO (1 January 2006), the scope of products to be price controlled, quality regulation, and universal service issues. Postcomm has recently consulted on its future strategy, where many of these issues were covered;
- **Sweden** - FMO took place in 1993[21]. We understand that experience in Sweden has influenced many of the approaches taken by the European Commission in forming the Postal Services Directives. We interviewed PTS, the Swedish NRA, to investigate the progress of competition and its impact on key regulatory issues; and

[21] www.pts.se.

- **New Zealand** – some stakeholders thought New Zealand would set a relevant precedent for Irish postal regulation. New Zealand's geography is similar to Ireland, with a combination of urban and rural delivery walks. In addition, the postal market was liberalised through a 1998 Act of Parliament[22].

3.11 We reviewed ComReg (and Postcomm's) recent consultation documents and their responses to understand the views of customers and new entrants.

22 www.nzpost.co.nz/Cultures/en-NZ/AboutUs/OurHistory/TheArrivalofCompetition/TheArrivalofCompetition.htm. Accessed October 2007.

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4 Price regulation

Introduction

4.1 Member States are responsible for overseeing the postal industry in their territories, as well as ensuring the continued provision of the universal service, under the Third Directive[23]. The Third Directive will not come into force until June 2008, at the earliest, but main provisions are settled. The proposed Third Directive continues the requirement from earlier versions that prices of universal services must be affordable, transparent and non-discriminatory[24]. The proposed changes that will be brought in by the Third Directive include, amongst other things, the requirement for postal prices to be "*cost-oriented and give incentives for an efficient universal service provision"* instead of simply "*geared to cost*". The Third Directive is not prescriptive about how prices should be regulated to ensure compliance with tariff rules[25].

4.2 The Postal and Telecommunications Services Act, 1983, which established An Post as a state owned limited liability company, sets the principle that the company could not increase the prices it charges for services covered by its statutory monopoly without the prior (ex-ante) approval of the Minster. The Regulations transposing the Postal Directive into Irish Law transferred this control to ComReg, and provided for ex-post enforcement of the tariff principles in respect of services for which An Post no longer had an exclusive right in the form of a reserved area. Once the market has been fully opened to competition after 31 December 2010, the requirement for ex-ante approval will therefore - absent any new primary legislation - lapse. An Post suggested to us during the interview process that after the removal of the reserved area, prices for universal services would only need to be monitored on an ex-post basis, perhaps by the Competition Authority.

4.3 We believe, however, that there is likely to be a continuing need for price regulation after FMO and that an ex-ante price control would be the most effective

23 Article 22 of the Third Directive.

24 Tariff principles in Article 12 of the Third Directive.

25 Member States have implemented the Postal Directive in different ways. Across Member States, there is a mix of ex-ante and ex-post, and price cap and rate of return forms of regulation. The proposed Third Directive retains this flexibility.

tool to ensure compliance with the tariff principles and to stimulate efficiency gains. This belief is based on the following findings:

- the requirement for continuing regulation is recognised implicitly within the Third Directive;
- economic theory suggests that companies with dominant market power will need to be regulated until competition is fully developed;
- An Post has a dominant position in the Irish postal market and is likely to retain it in the medium term after FMO;
- competition may be inhibited due to the existence of significant barriers to entry in the Irish postal services market;
- there is evidence in other postal markets that dominant positions have allowed USPs to exercise control over prices and service conditions, adversely impacting or deterring potential competitors;
- relevant stakeholders agree that ex-ante price regulation is required; and
- ex-ante forms of price control have better incentive properties than ex-post forms of regulation and have been used widely in other liberalised markets.

4.4 Each of these points is discussed in more detail below. At this stage, we have not been asked to make recommendations on the precise form of ex-ante regulation. Further consultation would be needed to determine the relative merits of different mechanisms (e.g. price caps, baskets, a CPI index etc).

Third Directive envisages continuing price regulation

4.5 ComReg's pre-approval powers over An Post's prices for products in the reserved area are derived from:

> *"the Postal and Telecommunications Services Act, 1983, as amended by Regulation 4(1), which transfers the power to the Director and restricts its scope to reserved services. No objectives other than compliance with the tariff principles are set for the Director in deciding whether to approve a proposed price increase for a reserved service"*[26].

[26] ComReg (2001), Regulation of Postal Services Approach to Monitoring Compliance with Universal Service Tariff Principles

4.6 The Irish government, through this legislation, transferred some ex-ante price approval powers to the ODTR (now ComReg) in the reserved area, because An Post had a monopoly in this area. It would appear that the primary legislation in Ireland explicitly allows ex-ante price regulatory powers over a company with a dominant or monopoly position, such as An Post. This legislation suggests that ComReg should no longer have ex-ante price control powers post FMO, as the reserved area would disappear. However, this position may not be acceptable to other stakeholders.

4.7 However, the proposed Third Directive still requires an Irish NRA to function and oversee the market (including compliance with tariff principles). For example, the Third Directive requires:

> *"In a fully competitive environment, Member States must conduct the delicate exercise of providing sufficient freedom to universal service providers to adapt to competition and at the same time, ensure adequate monitoring of the behaviour of the likely dominant operator in order to safeguard effective competition.[27]"*

4.8 The Presidency Compromise proposal for the Third Directive also states that:

> *"[T]he role of national regulatory authorities is likely to remain crucial, in particular in those Member States where the transition to competition still needs to be completed.[28]"*

4.9 The Third Directive requires that an independent NRA should be responsible for overseeing the postal market and ensuring compliance with the tariff principles after FMO. The Third Directive, however, does not stipulate how prices should be regulated - just that they should.

Economic theory

4.10 Economic theory views regulation as a mechanism designed primarily to control natural monopolies. The purpose of regulation is to ensure socially optimal outcomes when the invisible hand of competition cannot be relied upon to produce reasonable prices and profits.

[27] Third Directive. Presidency Compromise proposal. Paragraph 3.3.3.

[28] Third Directive. Presidency Compromise proposal. 25 September 2007. Article 29.

> *"Regulation, it is said, is a substitute for competition. Hence its objective should be to compel a regulated enterprise... to charge rates approximating those which it would charge if free from regulation but subject to the market forces of competition."*[29]

4.11 It is clear that, in circumstances where an incumbent is dominant and has market power, and where there are significant barriers to entry, the safeguarding of effective competition will require the regulation of the incumbent's prices, since these can in principle be used to deter competitive entry.

4.12 In economic terms, a dominant firm can take advantage of its market power to "extract" rents from customers that could not have been obtained by a non-dominant operator. Absent regulatory oversight, it is open to an incumbent to reduce prices in potentially competitive areas of business, and to raise prices in those areas less competitive. These issues arise not just in markets that are protected (or reserved) but also in markets in which competition has yet to develop fully.

4.13 The question, which then arises, is whether the monitoring process envisaged should best be carried out by a specific regulatory body, or whether the monitoring can effectively be carried out by the competition authorities that oversee markets generally.

4.14 We show below that there are sufficient barriers to entry in Ireland that the effectiveness of potential competition will be constrained. In these circumstances, we believe that some form of ex-ante regulation will be necessary in Ireland. Once competition is more effectively established and certain of the barriers to entry have been addressed it may be possible for regulation to be relaxed and perhaps even replaced by more general competition policy.

An Post's dominant position in the Irish postal market

4.15 Until 2006, An Post had monopoly rights over a reserved area that included items of ordinary correspondence, incoming cross border mail, addressed direct mail and addressed bulk mail weighing less than 100g and priced at less than three times the standard tariff. All other postal and delivery services were open to competition.

[29] Bonbright. 1966. Page 93.

4.16 At the beginning of 2006, the scope of the reserved area was reduced by the Irish Government in line with the Postal Directive's market FMO timetable. An Post currently retains monopoly rights over national and inbound international postal items weighing less than 50g and with postage costing less than €1.375. We understand from stakeholders that in excess of three quarters of An Post's domestic mail volumes are in the reserved area.

4.17 To date only 20% (by volume) of the market for universal services has been opened to competition. Since 2004, postal service providers with turnover in excess of 500,000 Euro have had to apply for a "postal service authorisation". ComReg has now authorised 30 postal operators[30]. We understand that this has been primarily to established operators rather than new entrants. Many of these operators are niche market players.

4.18 Generally, it appears that operators have yet to change their business models to take account of current market opportunities. In part, this is because only a small part of the market has been opened and customers want to give all of their business to an operator, this applies to weight as much as geographical coverage. Clearly, there are constraints to doing this until FMO. Some of the stakeholders we interviewed suggested that they were considering options to enter the universal service market, but only after FMO and perhaps only in niche markets.

4.19 Against this background, An Post has maintained a total mail market share, generally considered to be well in excess of 95%. We also note that An Post uses its delivery network to compete with other companies who deliver unaddressed advertising media. Even in this market, An Post has about 50% market share[31].

4.20 Given the slowness of market entry to date, we believe that An Post is likely to remain the dominant operator in the Irish market for some time. This belief is supported by evidence in other liberalised postal and utility markets. The evidence suggests that incumbent operators typically enjoy dominant market

[30] ComReg. "Authorised Operators Postal Register". ComReg's website. Accessed 1 October 2007.

[31] Market share relating to unaddressed advertising in 2004. Ecorys. "Development of competition in the European postal sector". European Commission. 2005. We have been unable to source more up to date estimates of unaddressed market shares.

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shares for long periods after FMO. The table below presents a summary of relevant international evidence in the other liberalised postal sectors.

Table 1: International postal sector market shares 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 for correspondence and addressed direct mail	2004	92.0%
			Addressed mail	2003	92.9%
			Total letter market	2007	91.0%
Finland	1994	Ongoing	Domestic correspondence and addressed direct mail	2003	99.7%
New Zealand	1998	2001	Basic letter market	2007	>80.0%
UK	2006	Ongoing	Regulated letter and packet	2007	96.0%

Note: Market shares are in terms of volume. Source: Wik-Consult (2006), Ecorys (2005), www.pts.se, LECG New Zealand, PIQUE (2007).

4.21 The table below illustrates some relevant international evidence in the telecommunications sector.

Table 2: Market share data after FMO in the telecoms sector

Country	Year of FMO	Sub-market	Market share of former incumbent in medium term after FMO	
			Year	Market share
Ireland	1998	Overall fixed line revenues	2001	80.0%
			2007	68.0%
Germany	1998	Overall fixed call volumes	2005	47.2%
France	1998	Overall fixed call volumes	2005	65.2%
Spain	1998	Overall fixed call volumes	2005	66.5%
United Kingdom	1991	Retail fixed voice call volumes (excluding NTS voice calls)	2004	55.4%
			2006	48.0%

Source: www.comreg.ie, 'Competition in European Telecom Markets' (2006), Ofcom - The Communications Market 2007 (August). We recognise that the table above mixes different markets and is incomplete, and that in some telecommunications markets competition has progressed more quickly. However, the table is illustrative, and is designed to show that in some important markets, competition has been slow to develop.

4.22 The experience in telecoms suggests that competition has been slow to develop after FMO. In part, this is because new entrants need to build competing networks. In addition, however, it is recognised that the incumbent has a number of competitive advantages – such as ubiquity of network and service offering, ability, brand strength and consumer trust. These advantages are also present in the postal sector.

4.23 The experience in the UK is particularly interesting. Over a 20-year period, Oftel/Ofcom has experimented with various forms of regulatory intervention to improve the level of competition. In November 2003, Ofcom launched a strategic review and looked at structural and operational separation options for BT. Ofcom's view was that BT's access network remained an enduring bottleneck and that as a result, competition in the fixed line telecoms was stifled. This view was supported by a significant number of complaints raised by BT's wholesale customers. In September 2005, Ofcom accepted legally binding undertakings from BT. This involved operational separation of BT's Access Services Division (now named Openreach) and the requirement for BT to provide Equivalence of Input (i.e. same product, price, and processes) to other telecoms providers.

4.24 Even in markets where competition should be able to develop more quickly, we find that competition has been slow to develop. In the UK, for example, just over

60% of domestic gas and electricity customers remained with their incumbent suppliers some five years after FMO. In 2003, Ofgem investigated why such a large proportion of customers had chosen not to switch, given the monetary savings that were available[32]. Ofgem found that important non-price factors explained why customers did not switch. For example, some customers perceived their supply to be functionally different from – perhaps less reliable or less well supported with emergency service than – that of other suppliers. Search and switching costs also explained non-switching behaviour.

Significant barriers to entry

4.25 It might be hoped that the possibility of competitive entry would be enough to constrain the behaviour of an incumbent. Where there are significant barriers to entry, however, any resulting constraints will be weak.

4.26 First, Post has many of the classic features of a natural monopoly. There is a vast economic literature relating to postal markets commenting on natural monopoly elements of the network. There is consensus amongst authors that there are significant economies of scale, density and scope in the delivery function (at least), which may act as a barrier to entry. Natural monopolies are an extreme competition case because the cost structure is such that costs are minimised with one supplier only. In this situation, direct regulation of the monopolist (or dominant firm) may be the only solution.

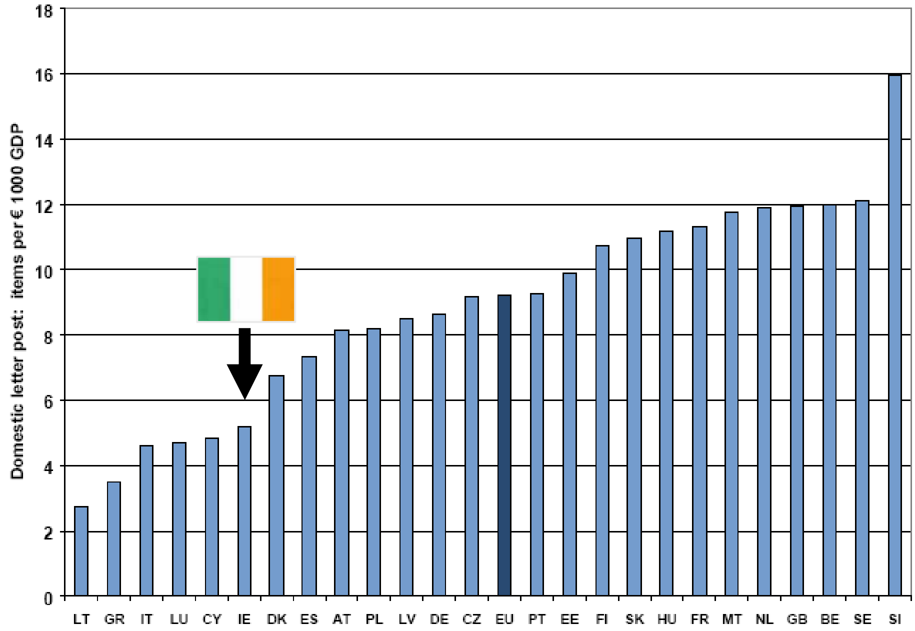
4.27 Second, in Ireland there are a number of additional factors, which create additional barriers to entry, which are likely to hinder the development of competition in the Irish postal market. These include: i) the size of the Irish market; ii) An Post's brand loyalty and customer inertia; iii) the lack of postcodes; iv) below cost terminal dues; and v) An Post's VAT exemption. We discuss each barrier in turn below.

Scale of operations

4.28 The Irish postal market is characterised by low volumes of mail and an underdeveloped market for addressed direct mail, in comparison with other European countries. Ireland had the sixth lowest letter mail volume per GDP in the EU in 2002, as shown in the figure below:

32 For example, savings of up to £62 per annum in gas and up to £55 in electricity were available for customers who switched from the incumbent supplier in 2003. Source: Ofgem.

Figure 1: Letter post volume per GDP in EU Member States (2002 data)



Source: WIK-Consult. "Main Developments in the European Postal Sector". 2004.

4.29 This position tends to lead to high *unit* costs in Ireland, which makes it unattractive for potential new entrants to develop competing postal networks as the payback on their investment is seen as being too low and risky. Discussions with potential entrants in the Irish market confirmed this point.

An Post's brand loyalty and customer inertia

4.30 An Post has a strong brand that is linked to providing the universal service. This is recognised in a report written for the An Post Group of Unions:

> *"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[33]"*

4.31 Providing the universal service increases customer confidence, and this may be a competitive advantage, providing signals to new entrants that competition will not prevent An Post from occupying a significant share of the market. Additionally, certain business customers may value a single provider and prefer to enter into bulk contracts with An Post to be certain of reaching all members of society.

33 Walley P.; An Post Group of Unions. "An Post – A New Vision". May 2005.

There is evidence in other markets that the brand of incumbent postal monopolists is strong. In the UK Government's White Paper on Post Office Reform, market research is cited suggesting that "The Post Office" is the second most widely recognised brand in the UK after Coca-Cola[34].

4.32 Stakeholders agreed that An Post was a trusted and respected organisation. This brand positioning has been derived from its long history of operation, its ubiquitous network and service offering and its ability to offer end-to-end mail solutions. This has been recognised by the An Post Group of Unions that has stated that An Post is "*highly respected throughout the country as the organiser and provider of postal services, and as a social service and community bonding force*"[35].

4.33 New entrants both in Ireland and in other European markets commented that securing the trust of customers was critical to developing their businesses. They stated that many national customers preferred and required services from operators that could offer a nationally ubiquitous coverage. The need to replicate An Post's level of customer trust was seen as a significant barrier to entry by potential new entrants.

Lack of postcodes and a postcode address file

4.34 Ireland is the only country in the EU without a postal code system. Albania is the only other country in Europe without such a system. The lack of postcodes, together with the high level of non-unique addresses, increases the complexity of rural delivery. Stakeholders claimed that rural delivery requires local knowledge. This was seen as a significant barrier to entry.

Low terminal dues take volume from the Irish market

4.35 An Post is a signatory to the REIMS agreements. These are a series of agreements defining the payments ("Terminal Dues") and other conditions that Member States make to each other for the delivery of inbound cross-border mail[36]. We have been told that the price that An Post receives for inbound

34 UK Department for Trade and Industry. "Post Office Reform: A world class service for the 21st century". July 1999. Page 14.

35 Walley P.; An Post Group of Unions. "An Post – A New Vision". May 2005. Page 68.

36 In addition to the Reims agreement, An Post has bilateral agreements with USPs in other countries (for example with Royal Mail), which set the price that An Post receives for inbound international mail. We understand that these bilateral agreements are influenced by the Reims agreement.

international mail is potentially below cost. The An Post Group of Unions supports this, stating, "*An Post is losing money on each piece of cross border mail it delivers and has been in effect subsidising postal operators in other states*"[37].

4.36 This again acts as a barrier to potential domestic entrants. The inbound international mail segment accounts for around 30% of the total mail delivered in Ireland[38] (which is more than in the UK or Germany for example). Below cost terminal dues makes it artificially cheaper for mail to be sent to Ireland from other countries, compared with producing and sending the mail from within Ireland. This denies competitors the opportunity to compete for these volumes and distorts competition in the mail preparation market.

An Post's VAT exemption

4.37 An Post is exempt from charging VAT on its postal services because it provides the *public postal service*, as defined in the European VAT Directive. Other postal operators do not have this exemption, and are required to add VAT to their prices. An Post's prices therefore have a 21% built-in price advantage over competitors. This is not normally a problem, as most businesses claim back the VAT paid, from the tax authorities. However, VAT-exempt customers such as banks and charities cannot claim back VAT charged by suppliers, and these customers represent a large proportion of mail volumes.

4.38 VAT exempt customers therefore enjoy a considerable price advantage using An Post over its competitors. Once again, the price advantage acts as a barrier for competitors trying to win VAT exempt customers. In the UK, where a similar problem exists, Postcomm estimated that "*approximately 50% of customers by value cannot reclaim all the VAT charged to them*" and noted, *"it is apparent that Royal Mail's VAT exemption significantly distorts competition*"[39].

An Post's dominant position could allow it to exercise significant control over prices and service conditions

4.39 Economic theory is clear that in circumstances where an incumbent has a dominant position, and where there are significant barriers to entry, it will need to

[37] Walley P.; An Post Group of Unions. "An Post – A New Vision". May 2005. Page 48.

[38] Stakeholders and ComReg. "Terminal dues agreement" Document 03/40. April 2003. Page 11.

[39] Postcomm. "Competitive Market Review". 2004. Page 13.

be regulated. As noted elsewhere, absent regulatory oversight, the incumbent is open to reduce prices in potentially competitive areas of business, and to raise prices in those areas less potentially competitive, in order to finance any resulting deficit.

4.40 In the postal market, it could be argued that electronic substitutes for postal products might constrain market power. We understand, for example, that banks and utilities[40] are already incentivising customers to receive e-bills and e-statements, instead of receiving paper statements in Ireland. However, it is not clear that this substitution will reduce overall mail volumes, and hence constrain market power. In addition, it is unlikely that electronic substitutes provide a credible alternative to postal products for SME's[41].

4.41 The WIK report for the European Commission concluded that the:

> *"substitution of physical mail takes place much slower than forecasted…It is possible though that future generations will use electronic services much more intense[ly] than former generations. Currently, it appears that electronic and paper-based mail services were used simultaneously and complementarily."*[42]

4.42 The WIK report also comments that direct advertising (addressed and unaddressed) mail to consumers has grown considerably in most Member States and has compensated for the decline or slow growth of letter post.

4.43 The An Post Group of Unions has similar beliefs:

> *"An Post's third assumption is that the Internet is a substitute communications technology for mail and has led to decline in volume of mail in Ireland. This assumption is questionable."*[43]

4.44 International evidence also suggests that a dominant position is sustained after FMO. There have been several competition cases in EU Member States. For

[40] We understand that constraint for utilities in Ireland is that this practice may only add value if customers are on direct debit payment plans. We understand that Ireland has a relatively high unbanked population.

[41] e-commerce is dependent on postal services for fulfilment, the return of signed documents, etc.

[42] WIK-Consult. "Main Developments in the Postal Sector (2004-2006)". 2006. Page 208.

[43] Walley P.; An Post Group of Unions. "An Post – A New Vision". May 2005. Page 22.

example, since FMO in 1993, Posten AB, the Swedish incumbent operator, was found to have used its market power to exclude competitors from the market on a number of occasions. More than 100 cases have been dealt with by the Swedish Competition Authority between 1993 and 1999 alone[44]. Illustrative examples are summarised below:

- engaged in predatory pricing by lowering the price for magazine distribution in three urban areas where its main competitor, CityMail, was active, thereby seeking to exclude the competitor from this market segment;
- offered fidelity rebates to customers that bought all of their mail delivery from Posten. Customers using alternative operators were charged substantially higher prices for their deliveries on the Posten network. Posten could do this because CityMail did not have a ubiquitous network; and
- provided CityMail with unfavourable access conditions. These were resolved in 1999 through an amendment of the Postal Services Act[45].

4.45 A report by PTS, in March 2007[46] concluded that:

> *"The Swedish Competition Act, which is the implementation of the EC rules on competition, 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".*

4.46 In the UK, Postcomm has also investigated alleged anticompetitive behaviour as follows[47]:

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44 In Sweden, prices of postal products, other than single piece items weighing less than 500g, are subject to ex-post review.

45 Ecorys. "Development of Competition in the European Postal Sector". 2005 and PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007.

46 PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007. Page 2.

47 www.psc.gov.uk.

- in 2003, Postcomm investigated complaints against Royal Mail's treatment of Mailsort workshare customers. Postcomm asked Royal Mail to communicate more effectively with customers of its Mailsort business;
- in 2005, Postcomm received complaints from another operator, against the introduction of Royal Mail's specialised catalogue and advertising mail promotion scheme. The schemes were designed by Royal Mail to encourage customers to use mail as part of their marketing activities. The complainant alleged that, in encouraging customers to switch to Royal Mail, the company was intending to remove competition from the market. Postcomm concluded that Royal Mail appeared to have contravened two conditions in its licence designed to facilitate competition. As a result, the company gave several undertakings to Postcomm on the way it will in future conduct any promotional offers and special deals with non standard terms;
- in 2005, a postal operator complained that a new Royal Mail bulk mail product for heavy items, which was priced based on capacity in the incumbent's network, was unfairly priced because it took advantage of spare capacity in a partially monopolised operation. Postcomm found evidence of anticompetitive behaviour; and
- in 2006, Postcomm imposed a fine of £1m on Royal Mail for failing to ensure that it did not gain an upstream commercial advantage, using information about competitors gathered through its downstream access operations. Royal Mail undertook a management separation between its retail and wholesale businesses, to ensure operational discretion between its internal functions.

4.47 Further examples of market abuse (alleged and actual) in other Member States are provided in Appendix 8.

4.48 In Ireland, some stakeholders questioned whether An Post had already used its dominant position to price excessively. In the last three years, there have been two reductions in the scope of the reserved area in Ireland. First, on 1 January 2004 outbound international services were removed. On the same date An Post increased tariffs by up to 57%. A year previously, ComReg had approved prices increases for the same services by 29.7% to Britain, by 15.9% to Europe while reducing prices to the Rest of the World by 14.2%. From 1 January 2006 the remaining reserved area was reduced from 100g to 50g. In the latter half of 2005 An Post had sought ComReg's concurrence to increase the price for a letter weighing up to 100g from 48 cents to 60 cents. ComReg refused to concur, but An Post nevertheless went ahead in February 2006 and increased the price of a letter weighing between 50g and 100g to 60 cents despite having claimed previously that there was no difference in cost of handling letters weighing less than 100g. Eventually these tariff changes were reversed, but some stakeholders suggested to us that in these cases, the possibility of competition was insufficient to constrain prices outside the reserved area, and the ex-post enforcement powers available to ComReg were slow and ineffective. While eventually the price increase were partially reversed there was no redress for consumers who had to pay the higher price for 12 months or longer.

4.49 Postcomm recognises that there will still need to be price control in place from 2010 in the UK, some 4 years after FMO. It recognises that some controls can be relaxed, but that it would still need to control those areas where competition was not well developed.

> *"Regulation would be focused on the economic 'bottlenecks' and regulated universal service products where users' interests require continued protection. We would, in so doing, acknowledge that controls on a smaller number of products can indirectly continue to influence a larger number of other products' prices because the price controlled products are, to a considerable extent, substitutes for other products"*[48].

4.50 Postcomm also recognised that competition could not develop successfully without regulatory intervention on an ex-ante basis. It stressed that it was important to remove barriers to entry and market distortions in order to promote effective competition; however, it did not believe that it should *"tilt the playing field"* in favour of either the new entrants or the incumbent. Postcomm has therefore decided that it needs to consider a range of policies to ensure that competition continues to develop. These include:

- ensuring greater transparency of Royal Mail's costs;

48 Postcomm. "Strategy Review, The Postal Market 2010 and Beyond". August 2007. Page 32.

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- ensuring that certain Royal Mail pipeline activities that competitors rely on are appropriately ‘ring-fenced’ from other Royal Mail functions in order to prevent possible anticompetitive behaviour;
- implementing some form of separation, either between the network infrastructure and customer facing sales and marketing functions or between the upstream and downstream activities if the “final mile” is considered as a natural monopoly;
- introducing an Access Code to address potential concerns regarding non-price discrimination for access users; and
- imposing “wholesale equivalence” through licence conditions.

Stakeholders agree that ex-ante regulation is required

4.51 In this section, we consider the views of relevant stakeholders on the most appropriate form of price regulation in the Irish market following FMO (i.e. whether regulation should be on an ex-ante or ex-post basis).

The Competition Authority recognises the need for specialist ex-ante regulatory bodies

4.52 We interviewed the Competition Authority. It has not yet considered in detail competition issues relating to the Irish postal market. However, in general the Competition Authority suggested that wherever there is a strong incumbent operator, there would be competition problems as the market liberalises.

4.53 The Competition Authority suggested that a NRA is generally required to prepare the market for effective liberalisation (i.e. to define the “rules of engagement”) and to monitor the market so that the market develops in an orderly manner. The Competition Authority suggested that addressing issues of price and non-price discrimination would require detailed market knowledge, which an industry-specific regulator might be better equipped to handle.

4.54 The Competition Authority appeared to be inclined to believe that a specific industry regulatory body setting prices and quality standards on an ex-ante basis might be sensible, until competition emerged. A similar view is shared by Postcomm:

> *“[I]n the early phase of market liberalisation it was necessary for us to control Royal Mail prices and service quality across a wide*

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spectrum of products to ensure the protection of customers, because there was little competition...It is becoming clear that some customers believe that competition and innovation are now more effective tools than regulation for securing a healthy future for the mail market and protecting customer interests in the long term. We believe that this can best be achieved by reducing the scope of regulatory controls in a carefully phased way[49]*".*

4.55 This view is supported in a report from the Commission to the Council of European Union and the European Parliament, which stated:

"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."[50]

4.56 As competition emerges, it might be important to consider whether ComReg should have concurrent powers with the Competition Authority as envisioned by Article 22(2) of the Third Directive, which states:

"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive, in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service. They may also be charged with ensuring compliance with competition rules in the postal sector."

4.57 A number, but not all, of the specialist economic regulators have concurrent powers to apply the competition rules in relation to their own sectors in the UK[51]. We understand that ComReg recently received concurrent competition powers to assist in addressing outstanding Local Loop Unbundling challenges in the Irish

[49] Postcomm. "Strategy Review, The Postal Market 2010 and Beyond". August 2007. Page 32.

[50] 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.

[51] The list of concurrent regulators in the UK is as follows: Ofcom (which has concurrent powers in relation to electronic communications); ORR (railway services); Ofgem (electricity and gas sectors); CAA (in relation to NATS, but not airports); Ofwat (water sector in England and Wales); and Ofreg (in relation to electricity and gas sectors in Northern Ireland). WICS, as the water regulator in Scotland, does not have concurrent powers.

Telecom market. Irrespective of whichever body is ultimately responsible there will be a need for active and regular consultation between such bodies:

> *"Due to the frequent involvement of different national bodies in the exercise of regulatory functions, it is appropriate to introduce transparency in the allocation of tasks and require the different responsible bodies in charge of sector regulation, the application of competition rules and consumer issues to cooperate in order to ensure the effective accomplishment of their tasks."*[52]

Potential entrants and consumers agree that ex-ante regulation is preferable over ex-post regulation

4.58 A few stakeholders questioned the benefit of a separate NRA for the postal sector and expressed the view that the Competition Authority was probably adequate to oversee discriminatory behaviour in the postal market. However, most stakeholders were of the opinion that the ex-ante regulation of prices by an industry-specific regulator would be beneficial to the development of competition and for the protection of consumers.

4.59 New entrants believed that without regulation, the incumbent operator could keep prices low in competitive areas, with higher prices in less competitive areas. They believed that ex-ante price control with suitable measures to control against abusive forms of cross-subsidisation would be beneficial. Whilst below cost prices in contestable areas were one concern, ensuring that access prices were not excessive was another. New entrants also expressed the need for ex-ante regulation over downstream access conditions, to ensure they obtained equivalence of access with all other customers, including An Post itself, universal service providers in other countries and the commercial operations of REIMS signatories.

4.60 A report by PTS[53] raised the same concern for access conditions and states that:

> *"Many competition problems on liberalised markets can be traced to the former monopolist's control over an infrastructure that competitors need access to so that they can run their*

52 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 30.

53 PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007. Page 2.

businesses…Competition rules are not necessarily the most proper tool for determining the terms of access".

4.61 The Third Directive requires Member States to guarantee access to the postal infrastructure in Article 11(a) which is justified in the following terms:

> *"In an environment where several postal undertakings provide services within the universal service area, it is appropriate to require all Member States to assess whether some elements of the postal infrastructure or certain services generally provided by universal service providers should be made accessible to other operators providing similar services, in order to promote effective competition, and/or protect all users by ensuring the overall quality of the postal service.*

> *"Where several universal service providers with regional postal networks exist, Member States should also assess and, where necessary, ensure their interoperability in order to prevent impediments to the prompt transport of postal items. As the legal and market situation of these elements or services is different in Member States it is appropriate to only require Member States to adopt an informed decision on the need, extent and choice of the regulatory instrument, including where appropriate on cost sharing. This provision is without prejudice to the right of Member States to adopt measures to ensure access to the postal network under conditions of transparency and non discrimination."* [54]

4.62 The ex-ante approval of prices for a period of at least five years was also thought by potential entrants to provide a degree of transparency and stability, allowing competitors to develop their future business strategies with some degree of certainty over pricing conditions in the market.

Regulators recognise the benefits of ex-ante regulation

4.63 Ex-ante forms of regulation are widely recognised as having better economic properties than ex-post forms of regulation. There are several forms of ex-ante price regulation available. It is also widely argued that price controls based on

[54] Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 22.

price caps[55] are more effective that rate of return form of ex-ante regulation. A summary of the key forms of regulation is provided in Appendix 9.

4.64 Ex-ante regulation of prices has generally been the preferred solution in liberalised postal markets in other countries. It has also been the preferred solution in other liberalised sectors within Ireland (including telecoms and electricity, for example). Ex-ante regulation also has better theoretical economic properties, particularly in encouraging incumbents to generate continuous gains in both the costs and quality of their operations (i.e. by setting targets, which can be outperformed, rather than ex-post imposition of prices based on actual costs). This appears to be anticipated by the Third Directive in its reference to the principle *"that prices must … give incentives for efficient universal service provision"*[56].

4.65 Ex-post regulation, on the other hand, is associated with a number of problems, including:

- there are limited incentives for efficiency savings if competition pressures are low. Tariffs simply have to be cost oriented. The current Regulations do not explicitly make any provision for the regulator to incentivise efficiency;
- it is less transparent to entrants which might deter market entry. Entrants require certainty of pricing especially over the terms and conditions of access to the incumbent's network. Ex-post regulation cannot prevent price manipulation in the short term, and this might effectively prevent competition from entering the market; and
- it is harder to repeal price changes after they have happened. If an ex-post price assessment concludes that prices that have already been charged were in fact too high, then there is the difficult question of how damages to stakeholders should be paid[57].

55 Price cap regulation allows the USP to change prices provided they remain below a *pre-approved* level or formula. For example, a formula based on the Retail Price Index adjusted by some efficiency factor, X (know as RPI – X or CPI - X) may be used.

56 Third Directive. Article 12, seconded indented point.

57 Costs for the operator are also very high particularly in post where stamps, for example, are produced.

4.66 Ex-post regulation is comparable to any normal competition assessment and some believe that this is all that is required. We disagree for the reasons expressed in this section. Importantly, however, it is the case that generally competition authorities have found it difficult to determine where prices have been either excessive or predatory.

4.67 One of the reasons for this is that the competition authorities do not have access to the right kinds of information, and without effective regulation, companies do not normally collect the type of data that might be required for a competition investigation. Ex-ante regulation helps in this regard, as it ensures over time the right information is produced for pricing investigations. This is consistent with Recital 26 of the Third Directive:

> *"In view of the transition towards a fully competitive market, and in order to prevent cross subsidies from adversely affecting competition, it is appropriate to continue to require Member States to maintain the obligation on universal service providers of keeping separate and transparent accounts, subject to the necessary adaptations.*
>
> *"This obligation should provide national regulatory authorities, competition authorities and the Commission with the information necessary to adopt decisions related to the universal service and to monitor fair market conditions until competition becomes effective. Cooperation between national regulatory authorities in continuing to develop benchmarks and guidelines in this area, should contribute to the harmonised application of these rules.*
>
> *"This accounting separation and transparency should provide Member States and their national regulatory authorities with accounting information of sufficient detail to:*
>
> - *adopt decisions related to the universal service;*
> - *be used as an input when determining whether the universal service obligations imposed entail a net cost and represent an unfair financial burden for the universal service provider;*

- *ensure that the tariffs applied to the universal service comply with the tariff principles set out in Article 12;*

- *ensure compliance with the terminal dues principles set out in Article 13; and*

- *monitor fair market conditions until competition becomes effective."*

4.68 As noted above, there are different forms of ex-ante price regulation. Rate of return regulation focuses on the operating costs plus a return on capital employed. Incentive based CPI-X price caps regulation allows for cost inflation, but often subtracts an efficiency factor. An influential report by Stephen Littlechild[58] argued that price cap regulation has a number of advantages over rate of return regulation as follows:

- it provides strong incentives for cost reductions and productive efficiency and therefore the regulated firm is less vulnerable to cost inefficiencies, in particular, the 'over capitalisation' effect;
- it allows greater flexibility to the regulated firm in setting prices based on cost and demand condition forecasts, taking into account future market expectations;
- it can be applied selectively to the non-competitive segments of the regulated firms' industry, to substitute for competitive forces in captive markets, without over-burdening the incumbent where competitors already constrain prices; and
- it is more transparent to consumers, because prices are generally known in advance, thereby providing them with greater certainty.

4.69 We believe that the incentive effects are particularly important. Evidence from capital-intensive utilities' markets in the UK gives an indication of the incentive benefits of ex-ante (price cap) regulation. The scale of efficiency improvements

[58] Littlechild, S. Regulation of British Telecoms Profitability. London. 1983.

has been significant in the UK under RPI-X forms of regulation[59] as can be seen in the table below.

Table 3: Efficiency improvements in UK's capital intensive industries under RPI-X forms of price control

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.

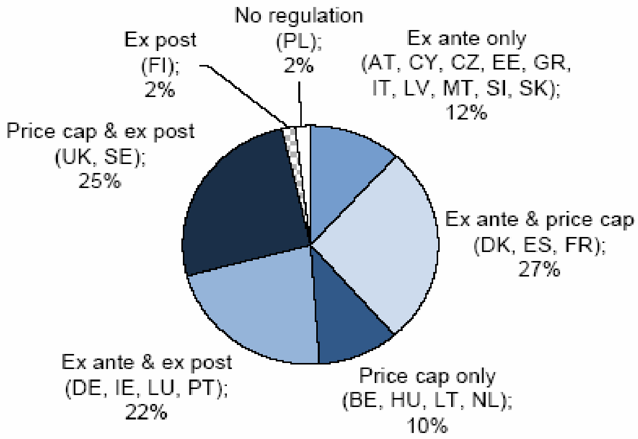
4.70 We note that the efficiency gains above relate to capital-intensive sectors. Postcomm, however, believes incentive based forms of regulation (i.e. RPI-X) can also stimulate significant efficiency gains in the postal sector. At the last price control, Postcomm set an efficiency target of 12% over a four-year period[60].

4.71 Price caps have been used in liberalised postal markets. The Third Directive does not require EU Member States to employ a particular form of price regulation, and to employ the same form for all universal services. Consequently, as shown in the figure below, many Member States have applied combinations of ex-ante and ex-post regulation.

59 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.

60 Efficiency target was set at 3% per annum measure in real unit operating cost terms, before volume and mix effects. Refer to Postcomm's final price control determination.

Figure 2: Methods of regulation used in EU Member States



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

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

4.72 The table below summarises the forms of price control used in certain liberalised postal markets around the world. We have also included Germany and Holland, which may provide helpful regulatory precedent (i.e. large markets and/or advanced regulations).

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Table 4: Price caps are commonly used in other key liberalised postal markets

Country	Type of price control after FMO	Description of price control system
Sweden	Ex-ante price cap and ex-post	Price cap system based on CPI (no productivity factor included) for single piece postal items of less than 500 g. Other universal service rates regulated ex-post. Prices of bulk mail lie outside PTS' supervision.
United Kingdom*	Ex-ante price cap and ex-post	Price cap system based on split baskets (captive and non-captive) and downstream access headroom maintenance. Ex-post ability to consider abuse of market position
New Zealand	Ex-ante price cap for transitional period (3 years) after FMO	Standard letter price (only for NZ Post) subject to transitional price cap set at 45 cents until February 2001 (transitional price cap) . No price regulation after that.
Germany	Ex-ante price cap and ex-post	Tariffs of incumbent under ex-ante regulation. 3 baskets of price caps for letter mail items up to 1000g, other USO products subject to ex-post control if prices not in line with principles of Postal Act.
Netherlands	Ex-ante price cap	Price increases for domestic US must not exceed the Dutch national wage index. Two price baskets for postal services: all domestic universal postal services and a small users' basket.
Finland	Ex-post	Ex-post review of prices by regulator.

Source: PwC (2006), PTS report (1999), Promoting competition in postal services (OECD, 1999), Ministerial Briefings, New Zealand (2002), WIK Consult (2006). * This information is provided by Postcomm.

4.73 Ex-ante forms of regulation (some based on CPI-X) are also used in the liberalised utility sectors in Ireland as shown in the table below.

Table 5: Price caps are commonly used in other regulated markets in Ireland

Sector	Type of price control after FMO	Description of price control system
Electricity	Ex-ante price cap	In the retail sector, an ex-ante CPI-X approach is used to regulate the tariffs of ESB PES, the incumbent supplier, after FMO over the period 2006 – 2010. The X is the efficiency factor set by the regulator.
Gas	Ex-ante price cap	The regulator sets tariffs prospectively to recover the total allowed revenues in the NDM (Non-Daily Metered)* market over the period 2007/08 - 2011/12. The price control has an inbuilt incentive sharing mechanism.
Telecommunications	Ex-ante price cap	From January 1997, a price cap of CPI-6% was set for eircom's tariffs. There were sub-caps set on individual services of CPI+2% and a cap on the Lower Quartile bill of CPI. A 2002 review set the price cap at CPI-0% to allow for line rental rebalancing. All sub-caps were removed as was the cap on the lower quartile bill, but it was replaced by a cap of CPI on the median Vulnerable User Scheme bill. The VUS was introduced to help address the needs of vulnerable social groups. In July 2007, ComReg consulted on the appropriate scope and structure of the retail price control and decided to retain the CPI-X form of price control with sub price caps for services.

Source: www.cer.ie, www.comreg.ie. * Domestic consumers that use less than 5.3 Gwh of gas per annum.

4.74 An important issue for any form of price control is whether An Post is willing and able to supply the information that the NRA would need to perform a review. We do not believe that the informational requirements are necessarily greater for ex-ante regulation than for ex-post. However, much would depend on the type of price control structure chosen. An Post's compliance with ComReg's revised 2006 Accounting Direction would be a good starting point to assess whether any further directions are needed for making the necessary information readily available.

4.75 If a price cap form of regulation was selected, then the form of price control would need to be properly evaluated (e.g. definition of baskets; period etc). We recommend that in developing a price control, ComReg would need to consider a sophisticated solution involving sub caps on key services.

Conclusions

4.76 The Postal and Telecommunications Services Act, 1983, which established An Post as a state owned limited liability company, set the principle that the company could not increase the prices it charged for services covered by its statutory monopoly without the prior (ex-ante) approval of the Minster. The Regulations transposing the Postal Directive into Irish Law transferred this control to ComReg, and provided for ex-post enforcement of the tariff principles in respect of services for which An Post no longer had an exclusive right in the form of a reserved area. Once the market has been fully opened to competition, the requirement for ex-ante approval will therefore - absent any new primary legislation - lapse.

4.77 Transposition of the Third Directive provides an opportunity to consider the need for such legislation. Consideration of the issues set out above is therefore timely. Our views on each, which have been informed by economic principles, stakeholder discussions, and comparative studies, are set out in summary form below, and more fully within the body of this report.

4.78 The requirement for continuing regulation of prices is set out explicitly in Article 12 of the Third Directive:

- *"prices must be affordable and must be such that all users, independent of geographical location, and, in light of specific national conditions, have access to the services provided. Member States may maintain or introduce the provision of a free postal service for the use of blind and partially-sighted persons,*

- *"prices must be cost-oriented and give incentives for an efficient universal service provision. Whenever necessary for reasons relating to the public interest, Member States may decide that a uniform tariff should be applied throughout their national territory and/or crossborder, to services provided at single piece tariff and to other postal items,*

- *"the application of a uniform tariff does not exclude the right of the universal service provider(s) to conclude individual agreements on prices with users,*

- *"tariffs must be transparent and non-discriminatory,*

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- *"whenever universal service providers apply special tariffs, for example for services for businesses, bulk mailers or consolidators of mail from different users, they shall apply the principles of transparency and non-discrimination with regard both to the tariffs and to the associated conditions. The tariffs, together with the associated conditions, shall apply equally both as between different third parties and as between third parties and universal service providers supplying equivalent services. Any such tariffs shall also be available to users, in particular individual users and small and medium-sized enterprises (SMEs), who post under similar conditions."*

4.79 Economic theory is clear that in circumstances where an incumbent is dominant and has market power, and where there are significant barriers to entry, the safeguarding of effective competition will require monitoring of the price (and quality) parameters deployed by the incumbent. This is because in principle, these factors can be used to deter competitive entry, and, therefore, to protect an incumbent position in ways which are disadvantageous to consumer interests.

4.80 Absent regulatory oversight, it is, for example, open to an incumbent to reduce prices in potentially competitive areas of business, and to raise prices in those areas less potentially competitive, in order to finance any resulting deficit. The outcome is to deter entry in potentially competitive areas, and to disadvantage customers in areas that are less competitive.

4.81 These issues arise not just in markets that are protected (or reserved) but also in markets in which competition has yet to develop fully. The question that then arises is whether the monitoring process there envisaged should best be carried out by a specific regulatory body, or whether the monitoring can effectively be carried out by the competition authorities, which oversee markets generally.

4.82 In discussions, An Post argued that these regulatory functions could be carried out effectively on an ex-post basis by the competition authorities. The Irish Competition Authorities themselves, however, were inclined to believe that a specific industry regulatory body setting prices and quality standards on an ex-ante basis would be preferable; as were potential new entrants.

4.83 This was view was confirmed by PTS, the Swedish regulator, in March 2007:

"The Swedish Competition Act, which is the implementation of the EC rules on competition, 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"[61].

4.84 The balance of views is unsurprising: experience elsewhere is strongly suggestive that ex-ante vigilance is more effective than ex-post investigation. In Sweden, by way of example, Posten (the incumbent USP) has been investigated over 100 times by the competition authorities, and has been found to have abused its market power many times, since the market was opened in 1993. Posten, however, has been successful in retaining some 91% of the total letters market over that period[62].

4.85 There are sufficient barriers to entry in Ireland (including the lack of postcodes and the VAT exemption enjoyed by An Post) to provide reasons to believe that the effectiveness of potential competition will be fragile. In these circumstances, there appear to us to be considerable grounds for believing that ex-ante regulation will be preferable in Ireland.

4.86 Ex-ante regulation of prices and associated quality parameters has generally been the preferred solution in liberalised postal markets in other countries. It has also been the preferred solution in other liberalised sectors within Ireland (including telecoms and electricity, for example). Ex-ante regulation also has better theoretical economic properties, particularly in encouraging incumbents to generate continuous gains in both the costs (and quality) of their operations (i.e. by setting targets, which can be outperformed, rather than ex-post imposition of prices based on actual costs). This appears to be anticipated by the Third Directive in its reference to the principle *"that prices must … give incentives for efficient universal service provision*"[63].

61 PTS. "The liberalised Swedish postal market – the situation 14 years after the abolition of the monopoly". 2007. Page 2.

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

63 Third Directive. Article 12, seconded indented point.

4.87 We believe that consumers will benefit most from the opening of the postal market to competition if the activities of the incumbent, An Post, are subject to ex-ante regulation by a dedicated industry specific regulator that has adequate and appropriate enforcement powers. That is not only the view offered by economic theory, but also the view of potential entrants and of the Irish Competition Authority themselves. We understand that achieving this will require amending legislation, perhaps as part of the process by which the Third Directive is implemented into Irish law.

5 Quality of service regulation

Introduction

5.1 ComReg is currently required to regulate An Post's quality of service. Article 16 of the Second Directive requires Member States to "ensure that quality-of-service standards are set and published in relation to universal service in order to guarantee a postal service of good quality". The Postal Directive also requires independent monitoring of transit time, at least once a year[64].

5.2 ComReg has complied with this requirement. Presently, ComReg has set An Post two targets. The first target was to ensure that 94% of mail should arrive the day after posting ("D+1")[65]. The second target was to ensure that 99.5% of mail should arrive the third day after posting ("D+3")[66]. ComReg publishes An Post's performance against these targets on a annual basis. ComReg does not have any specific enforcement powers if An Post for failing to meet targets. ComReg has no power to regulate the quality of service provided by other operators and new entrants.

5.3 In the context of FMO, ComReg has asked us to address the overall question of how best to ensure that consumers benefit from the opening of the Irish postal market to competition. In this section, we consider how quality standards for universal service should be defined, set and regulated.

5.4 Based on our review, we believe that universal service quality standards will continue to require regulatory oversight. This view is recognised within the Third Directive:

> *"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive,*

64 European Commission. "Postal Services Directive 2002/39/EC". 2002. Article 16.

65 ComReg monitors three D+1 transit times: "anywhere to anywhere", "Dublin County to anywhere" and "Outside Dublin County to anywhere". The target for each of these transit times is identical at 94%. There is one D+3 transit time target for mail sent and received anywhere in the State.

66 ODTR. "Regulation of Universal Postal Services - Quality of Service Standards to be achieved by An Post: Decision Notice and Report on Consultation". September 2001. Annex 1.

in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service."[67]

5.5 In addition, our conclusion is supported by the following findings:

- An Post's current quality of service is poor;
- regulatory pressure will be required to improve quality standards specifically for social and SME mail;
- regulatory pressure is required to improve delivery quality for downstream access absent financial penalties in access agreements;
- entrants need regulatory pressure to preserve customer trust in competition and the mail industry as a whole; and
- regulators in liberalised markets use a range of regulatory tools to improve quality of service performance.

5.6 We discuss each of these findings below.

An Post's current quality of service

5.7 An Post's current quality of service performance does not reach the target levels set by ComReg. The table below shows An Post's performance for the period January to June 2007 (the latest figures available):

Table 6: An Post's quality of service performance, Q1 and Q2 2007

Target category	An Post performance	Target
Next day delivery (D+1)		
From anywhere to anywhere	78%	94%
From Dublin County to anywhere	79%	94%
From outside Dublin County to anywhere	78%	94%
Delivery within three days (D+3)		
From anywhere to anywhere	98%	99.5%

Source: tnsMRBI. "Republic of Ireland Quality of Service Monitor – Interim Report". August 2007. Commissioned by ComReg.

[67] Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 22(2).

5.8 An Post's poor performance has attracted criticism from politicians, as reported in the press. Labour Party communications spokesperson Tommy Broughan highlighted that An Post appeared to be a "*long way away*" from achieving ComReg's targets. He stated, "*these figures confirm complaints that I receive on an ongoing basis from families and businesses about slow mail delivery times and unacceptable delays*". Deputy Broughan blamed what he said was the company's failure to provide proper holiday and illness cover for staff[68].

5.9 Complaints about An Post's quality of service are not new. In 2003, the Irish Independent reported that An Post has been criticised for "*poor customer service*" from Communications Minister Dermot Ahern:

> *"He has sent a strongly-worded letter to company chiefs pointing to "an increasing amount of complaints" received by himself and his department about the postal service. He says the complaints, from companies and the public, are based on "late delivery of mail, lack of information from An Post and poor quality of customer service." "*[69]

5.10 The stakeholders we interviewed as part of this study also expressed concerns. The Consumer Association of Ireland indicated that single piece mail performance was especially poor and that ordinary people did not know when or in fact whether their mail would arrive. Other stakeholders mentioned that while An Post retained popular support, continued poor quality of service, combined with price increases, threatened this support in the future.

5.11 Irish mail volume per GDP is low in comparison with other EU Member States, as shown in Figure 1, in the previous section[70]. In addition, An Post's quality of service has also been low. There is some evidence to suggest that service quality affects mail volume. The table below shows the lowest sixth Member States for mail volume per GDP, D+1 performance and D+1 performance against locally set targets. Ireland is within the lowest six Member States in each of the categories. Three of the other five Member States with the lowest mail volume

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68 Irish Times. "An Post service improving-regulator". June 2007.

69 Irish Independent. "Second class service from An Post". November 2003.

70 Subsequent year volume data was not released to the public domain for the European Commission's sector studies. WIK-Consult. "Main developments in the European postal sector". 2004. Page 136.

per GDP also fall within the lowest countries in both D+1 transit times and performance against quality of service targets.

Table 7: Lowest EU Member State mail volume and quality of service performance

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

Source: WIK-Consult. "Main Developments in the European Postal Sector (2004-2006)". Pages 236-237.

5.12 While more rigorous research would be needed before once could conclude that there is a strict causal link between these factors, it remains that case that An Post has poor quality when compared to other European USPs. However, this link has some support. Some stakeholders argued that there might be a link between mail volume growth and improved quality of service in the market. In particular, the An Post Group of Trade Unions identified poor quality of service, among other factors, as one of the drivers for the slowdown in growth of mail volumes[71].

5.13 Large mailer stakeholders confirmed that they would not accept continued poor service quality. Vodafone argued that there was a link between poor service quality and the migration of bulk mail to other communication media. It stated that it was reviewing the amount of mail that it sent through the An Post network because An Post could not guarantee the day on which it would arrive.

5.14 The link between quality of service and the growth in new sources of mail volume has been recognised within the revision of the Directive. The Presidency Compromise Proposal for the Third Directive notes:

[71] Walley, P; An Post Group of Unions. "An Post - A New Vision". May 2005. Page 22.

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"The provision of high-quality postal services contributes significantly to attaining the objective of social and territorial cohesion. E-commerce, in particular, offers new opportunities for remote and sparsely populated areas to participate in economic life for which the provision of good postal services is an important precondition."[72]

5.15 An Post recognises that it needs to improve quality standards. Donal Connell, Chief Executive has said:

"…our mails quality of service performance ranks as a source of disappointment and concern. Quality of service is a key area in which we need to achieve significant improvement"[73].

Regulatory pressure will be required to improve quality standards specifically for social and SME mail

5.16 In this subsection, we consider whether ComReg's current quality of service regulatory powers will be sufficient to protect individuals and SMEs within a fully liberalised market.

5.17 Absent effective regulatory controls, it will be open to an incumbent to increase quality in potentially competitive areas, and to reduce quality in areas that are less potentially competitive. The outcome would be to deter entry in potentially competitive areas, and to disadvantage customers in areas that are less competitive. This reduces the effectiveness of competition, and denies to customers the benefits that would otherwise flow from the opening of postal markets to competition.

5.18 It is generally held that An Post retains a dominant market share. Once the market is open, other operators will be able to transport the lightest ordinary postal items (both bulk and single piece mail). Experience from other fully liberalised postal markets shows that the first category of mail that will be switched from the USP to competitors after FMO will be bulk mail[74]. Bulk mail accounts for a high percentage of An Post's total volumes and accordingly, in the absence of any other controls, there would be a strong incentive for An Post to

72 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 14b.

73 An Post. "Annual Report". 2006. Page 11.

74 WIK-Consult. "Main developments in the European Postal Sector (2004-2006)". 2006.

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increase the quality of these mail items at the expense of quality of service for personal and SME mail.

5.19 An Post has recognised that it needs to improve customers' quality of service stating "*we are falling short of the level of quality that our customers are entitled to expect from us as a matter of routine*"[75].

5.20 Whether An Post's quality of service improves is yet to be seen. However, customer stakeholders remain sceptical. During the interview process, we found that there were concerns that An Post might focus efforts on the quality of service provided to bulk mail customers, while saving costs by lowering the quality of service to social and SME mail consumers, who are likely to face little, if any, choice of service provider for some time.

5.21 Stakeholders have already experienced higher quality of service in bulk mail, compared with social and SME single piece mail[76]. For example:

- a bulk mailer claimed to be receiving near 100% next day delivery nationally, in comparison with an overall 78% performance level shown in ComReg's second quarter 2007 quality report[77];
- An Post confirmed that the quality of service for bulk mail was superior to that for single piece mail, during a meeting held during September 2007;
- one stakeholder claimed that a greater proportion of social and SME mail was redirected from the local delivery office and sent back to a Dublin centre to be resorted. This typically delayed single piece items, increasing their transit times and thereby lowering the quality of service. Bulk mail had a greater chance of being delivered correctly at the first attempt. While this was partially caused by poor addressing, the stakeholder claimed that An Post's processes were suboptimal in dealing with single piece mail; and

75 An Post. "Annual Report". 2006. Page 11.

76 A stakeholder indicated to us that inbound international mail is also currently prioritised compared with single piece mail. Under the Reims agreements, An Post's transit times for mail sent from abroad are monitored and the penalties for low quality of service can result in a significant loss of revenue. We understand that An Post has a strong financial incentive to fulfil its transit time obligations, potentially at the expense of other mail types.

77 tnsMRBI. "Republic of Ireland Quality of Service Monitor – Interim Report". August 2007. Commissioned by ComReg.

- the An Post Group of Unions confirmed the company had evolved special arrangements to facilitate higher quality of service for larger customers' mail.

5.22 Competitive pressure for bulk mail customers could continue this quality imbalance between bulk and single piece mail, and potentially worsen the quality offered to customers without a competitive alternative.

5.23 It is evident that An Post is able to deliver improved quality in competitive areas. However, without competitive pressure to increase quality of service for single piece mail, we believe that An Post may require regulatory incentives.

5.24 However, we believe ComReg's lack of enforcement powers will be insufficient in a fully liberalised market. The current regulatory regime *names and shames* An Post for poor performance, but it does not result in a financial impact on the USP (i.e. a fine, or a lower allowed revenue). In a competitive market, An Post may be prepared to accept a degree of negative publicity, if it can reduce costs through falling quality, thereby placing it in a better competitive position, and stopping greater loss of revenue to competitors.

5.25 We believe, therefore, that ComReg's quality regulatory powers may need to be reviewed and potentially increased, given FMO. We discuss the potential options in detail below.

Regulatory pressure is required to provide high quality of service for downstream access

5.26 Downstream access may become an important medium for the development of competition in the Irish postal market. Access operators will depend on An Post's quality of service for their own performance offered to customers. Operators who use downstream access will be offering a service that will collect customers' mail and input it into An Post's final mile delivery network. The access operator's successful quality of service in the early processing stages could be countermanded by poor quality of service in the later stages of the delivery.

5.27 As mentioned above, quality of service has been an important factor in developing new entrants' businesses in fully liberalised settings. UK Mail, an access operator in the UK, was required to prove good service quality before customers would trust its operations. The operator stated that it risked not earning this trust and good service quality, if Royal Mail had not delivered its mail on time. Moreover, since Royal Mail's upstream operations were in direct competition with UK Mail, the USP would have benefited if it discriminated against the entrant and offered it a poorer quality.

5.28 We believe that there is a case for regulatory controls over the USP's downstream access quality of service. As in the UK case, An Post could have an incentive to discriminate against access operators in the downstream, in order to prevent the switching of mail in the upstream. Therefore, we believe that it could be important for the development of competition, that there are effective procedures in place to prevent potential discrimination against between operators, domestic and international and including An Post itself, who use the postal network operated by An Post to deliver some or all of their mail.

Entrants need regulatory pressure to preserve customer trust in competition and the mail industry as a whole

5.29 The ambit of quality regulation goes beyond the oversight of quality standards deployed by the incumbent in the less competitive areas of the market. Similarly, the regulation of the quality of service provided by the entrants themselves is valuable for entrants collectively (in ensuring that the market perception of entrants collectively is not tarnished, to the detriment of the market generally).

5.30 UK Mail, the British bulk mail entrant, told us that trust is one of the most significant barriers to customer switching (i.e. in the entrant's quality). UK Mail mentioned that it had to prove its quality of service to prospective customers before they would switch from Royal Mail. It is clear that entrants in Ireland will also have to prove and maintain a high level of quality.

5.31 In a well functioning market, each entrant will face this pressure to prove and maintain its quality of service to retain customers for the long term. An Post will face competitive pressure on quality, from entrants who manage to achieve customer confidence. In this scenario, regulatory pressure over bulk mail quality may not be required.

5.32 However, we believe that regulatory pressure may still be required to maintain market confidence. Many of the Irish stakeholders interviewed expressed concern that poor quality operators could damage the reputation of all new

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entrants, and the whole industry. Such operators would not necessarily be seeking to develop a long term business, but to generate opportunist revenues, from a low cost, low quality service. DX Ireland wanted ComReg to have "*policing powers for the market*", to ensure that such poor quality operators do not dump mail and damage the reputation of all entrants. Postcomm also saw that this mail integrity was a "*key point in maintaining customer confidence in the postal sector as a whole*"[78]. Stakeholders mentioned that falling trust in the postal market would result in customers switching to alternative methods of communication.

5.33 In the UK, entrants are required to inform Postcomm of their service performance. Postcomm is able to publish these figures, or take legal action, if licensees do not fulfil the terms of their contracts with customers. After FMO, Postcomm reviewed its regulatory constraints on operators. It decided to retain entrant quality regulation. It was concerned that regulation should "*encourage entry to the market, while providing sufficient safeguards to protect customers' interests*"[79]. Despite the fact that Postcomm did not want to place an unwarranted regulatory burden on operators, its objectives were to:

> *"balance freedom of entry to, and exit from, the market; with provision of sufficient safeguards to prevent the system being abused to the detriment of customers; while providing some assurance for customers who use new licensees; and ensuring provision of sufficient information for the market to function properly."*

5.34 These objectives were "*widely supported by respondents*" to Postcomm's consultation[80]. In providing safeguards and assurance for the market, Postcomm was attempting to exclude operators with poor quality standards.

5.35 Operator stakeholders, including An Post, believed that information on the service quality levels achieved by all operators should be accessible to customers. This should potentially include transit times and other customer focused performance

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78 Postcomm. "Licences under the Postal Services Act 2000: Licensing framework in a fully open market". May 2005. Page 2.

79 Postcomm. "Licences under the Postal Services Act 2000: Licensing framework in a fully open market". May 2005. Page 2.

80 Postcomm. "Licences under the Postal Services Act 2000: Licensing framework in a fully open market". May 2005. Page 9.

statistics, such as the number of complaints, service failures etc[81]. However, Forfas doubted the need for quality regulation. It stated that the cost of regulation should be balanced against the potential benefits. Its view was that the costs of quality regulation could outweigh the limited benefit for competition, given the fixed nature of regulatory compliance costs and the limited scale of the Irish market.

5.36 We believe that some form of quality regulation is required for new entrants in the market, as well as for An Post. Clearly, ComReg should consider the costs and benefits of any proposed quality regulatory regime (examples of which are provided below).

Regulatory tools

5.37 In this subsection, we highlight the mechanisms used in other European postal markets to regulate quality. Postcomm in the UK appears to have the most developed set of tools. We believe that ComReg should consider the merits of each mechanism described below. In doing so, it will need to consider any specific legal constraints in the Irish market.

Codes of conduct

5.38 Where operators self-regulate, and commit to service standards; the code is monitored and there are penalties for breaking the code. In the UK, Postcomm facilitated the development of the Mail Integrity Code and the Common Operational Procedures Code. Both codes were established by the industry and feature service standards for screening of staff and training, and the identification of mail, within a multi-operator market[82]. Codes of conduct can be used to establish self-regulation over different service standards. In Ireland, both the Security and Taxi industries have statutory vetting of staff.

Licensing/authorisation

5.39 Under Article 9 of the Second Directive, Member States are able to operate some form of authorisation regime for operators carrying mail items within the *scope of*

[81] We believe that ComReg should consult on the amount and type of information that would be useful for customers and practical for operators to measure.

[82] The codes are monitored through licensees' statements of compliance, submitted to Postcomm and Postwatch. www.psc.gov.uk. Accessed October 2007.

the universal service[83]. Within this regime, Member States are able to choose between using an individual licence or a general authorisation. Typically, individual licences, can be tailored by the licensing authority (potentially the regulator) to the individual firm or class of firms[84], whereas general authorisations are typically non-unique to operators[85].

5.40 Licensing can allow for more flexible regulation, focused on individual operators or groups of operators. However, there are advantages and disadvantages in using a licensing system. Typically, licences are controlled and can be changed by the licensing authority[86]. However, the costs incurred in complying with licences could form a regulatory burden on entrants, and in the extreme case, could act as a barrier to entry – something that regulators, especially Irish regulators usually try to avoid.

5.41 Choosing an individual licence system over a general authorisation for mail within the scope of the universal service requires an assessment of the likely benefits brought through the flexibility for the regulator to be able to control individual operator behaviour, balanced against the potential regulatory burden.

5.42 Both licence and general authorisation systems can be tailored using *conditions*. These conditions can be used to control the behaviour of operators. Article 9 states that the authorisation regime can "*impose requirements concerning the quality, availability and performance of the relevant services*". As such, they form the necessary foundation for many of the regulatory instruments mentioned in this report.

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83 Most USPs (including An Post) are *designated* by Member States to operate the universal service. A one-off designation can result in inflexible regulation, as well as the potential for the USP to claim compensation from the unilaterally imposed obligation. In this subsection, we highlight the further abilities of different forms of authorisation as tools for regulating the USP.

84 The European Directive defines individual licences as "*an authorisation which is granted by a national regulatory authority and which gives an undertaking specific rights, or which subjects that undertaking's operations to specific obligations supplementing the general authorisation where applicable, where the undertaking is not entitled to exercise the rights concerned until it has received the decision by the national regulatory authority*". European Directive. Article 2.

85 The European Directive defines general authorisations as "*an authorisation, regardless of whether it is regulated by a 'class licence` or under general law and regardless of whether such regulation requires registration or declaration procedures, which does not require the undertaking concerned to obtain an explicit decision by the national regulatory authority before exercising the rights stemming from the authorisation*". European Directive. Article 2.

86 In the UK, Postcomm reviewed its licensing regime between 2005 and 2006. This resulted in a new licences for each postal operator.

5.43 ComReg currently uses a general authorisation system for operators that carry mail within the scope of the universal service. As part of its review of its regulatory regime, we believe that ComReg should reconsider the conditions within its authorisation system. Similarly, ComReg should consider whether the flexibility enabled through individual licences outweigh the potential regulatory burden, and hence whether it should change to an individual licence regime.

5.44 Under Article 9 of the Second Directive, Member States can only use a general authorisation for operators who carry items *outside* the scope of the universal service.

Name and shame

5.45 Operator behaviour could be monitored, (potentially against set targets), with the regulator highlighting poor performance to customers. In the UK, operator licences require the disclosure of performance information to Postcomm for all operators. Postcomm is then able to reveal poor performance, although we understand that this has not yet occurred. We understand that a similar regime operates in Portugal[87].

Customer compensation scheme

5.46 Operators are free to establish their own compensation schemes for poor performance. Regulations could also mandate the operator to put a scheme in place. In the UK, Postcomm took powers over Royal Mail's compensation schemes as part of the 2006-10 price control[88]. By making Royal Mail's self-regulated schemes compulsory within a licence condition, Postcomm was able to ensure continued provision of compensation for poor performance.

Fines

5.47 With the appropriate powers, regulators could fine operators for poor performance. In the UK, Postcomm has fined Royal Mail for poor performance. In December 2003, Postcomm fined Royal Mail £7.5m for being 6% below target on first class business mail products[89]; in April 2006, Postcomm fined Royal Mail £271,000 for poor performance in the London area[90]; and in August 2006,

87 WIK-Consult. "Main Developments in the Postal Sector (2004-2006)". Page 103.

88 Postcomm. "Royal Mail's Compensation Schemes for Delay and Loss and Damage". November 2006. Page 2.

89 Postcomm. "Postcomm confirms £7.5 million penalty on Royal Mail". December 2003.

90 Postcomm. "Postcomm confirms postcode penalty of £271,000". April 2006.

Postcomm imposed a financial penalty of £9.62m on Royal Mail for breeching its licence condition dealing with mail integrity – in 2004/05 "*around 14.6 million letters, packets and parcels in its care were lost, stolen, damaged or interfered with*"[91].

Quality penalties within the price cap

5.48 Some European regulators have adopted mechanisms for reducing allowable revenue within USP price caps, because of poor performance: "*Portugal applies this type of price/quality control since 1995, UK has implemented this in the course of the first price control, and Belgium introduced a quality-related price cap formula mid of 2005*[92]".

5.49 The latest Postcomm price control over Royal Mail includes a quality factor that directly affects future prices. The "C" factor is directly affected by performance against quality of service targets. Poor quality results in a reduction in allowable revenue for Royal Mail's basket of captive products[93].

Enforcement orders

5.50 While most regulatory tools are aimed at incentivising good performance, by fining, reducing revenue or highlighting failures to customers, direct legal action could be used against operators. In the UK, Postcomm is currently consulting on its ability to investigate licence breaches, including poor performance. Postcomm has the ability to issue legally binding orders, which include legal sanctions requiring the licence holder to change its behaviour and the imposition of financial penalties. Failure to abide by the order could result in Postcomm's civil legal action, which would also allow for damages to be sought by affected parties[94].

5.51 There may be constraints to the implementation of different quality regulation options given the right for all legal and natural persons to have their case

[91] Postcomm. "Postcomm imposes penalty on Royal Mail for failing to protect mail". August 2006.

[92] WIK-Consult. "Main Developments in the Postal Sector (2004-2006)". Page 103.

[93] Postcomm. "Royal Mail's Price and Service Quality Review 2006-2010: Licence Modifications". Page 53.

[94] "*If a licence holder fails to comply with an enforcement order it may be enforced by civil proceedings brought by Postcomm. It is possible for any person affected by a licence holder's failure to comply with such an order to bring an action against the licence holder if he or she has suffered loss or damage as a result of that failure*." Postcomm. "Enforcement Guidance for considering and investigating complaints in relation to licence contraventions". August 2007. Page 24.

determined by a Court of Law. The merits of each option would need to be balanced against the difficulties involved in their implementation.

Conclusions

5.52 The requirement for continuing regulation of the quality of service is recognised unconditionally within the Third Directive:

> *"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive, in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service. They may also be charged with ensuring compliance with competition rules in the postal sector."*[95]

5.53 In the last section, we argued that economic theory is clear that in circumstances where an incumbent has a dominant position and market power, and where there are significant barriers to entry, the safeguarding of effective competition will require the monitoring of the price and quality parameters.

5.54 We also concluded that ex-ante regulation of prices and associated quality parameters has generally been the preferred solution in liberalised postal markets in other countries and in other liberalised sectors within Ireland. Ex-ante regulation has better theoretical economic properties, particularly in encouraging incumbents to generate continuous gains in both the costs and quality of their operations (i.e. by setting targets, which can be outperformed).

5.55 The ambit of quality regulation goes beyond the oversight of quality standards deployed by the incumbent in the less competitive areas of the market. In particular, the regulation of quality provided by the incumbent to new entrants seeking access to their network is valuable to entrants (in ensuring that the quality that they can offer to their customers is not compromised). Similarly, the regulation of the quality of service provided by the entrants themselves is valuable for entrants collectively (in ensuring that the market perception of entrants collectively is not tarnished, to the detriment of the market generally).

5.56 On the former point, discussions with potential entrants highlighted a fear that access conditions imposed by An Post might compromise their ability to provide a

95 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 22(2).

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competitive service in circumstances where they rely on An Post for final delivery. Since the absence of postcode structures in Ireland makes the emergence of end-to-end competition less likely, this is an important concern. Other stakeholders were equally concerned about the potential harm to the development of the postal market generally that could be caused by low quality entry.

5.57 Ireland's mail volumes per capita (and per '000 GDP) are low in comparison to other European countries. There is some evidence to suggest that service quality affects mail volumes. Union representatives in particular believed that volume growth was possible, but might be jeopardised either by low quality entry or by a failure on the part of An Post to improve on quality standards that are generally recognised (not least by the company itself) to be low. As the Presidency Compromise Proposal for the Third Directive notes:

> *"Increased competitiveness should furthermore enable the postal sector to be integrated with alternative methods of communication and allow the quality of the service provided to evermore demanding users to be improved."*[96]
>
> *"The provision of high-quality postal services contributes significantly to attaining the objective of social and territorial cohesion. E-commerce, in particular, offers new opportunities for remote and sparsely populated areas to participate in economic life for which the provision of good postal services is an important precondition."*[97]

5.58 Similarly, we believe that it will benefit the development of the postal industry if the activities of new entrants are overseen in similar fashion. Poor quality entry risks undermining the competitive affect of entrants generally and thereby the development of the industry as a whole. Based on our view and our own experience, we believe that the credible regulation of entrants may require ComReg to conduct a licensing rather than an authorisation process, since the threat of potential licence removal may be more effective in securing sustained quality levels. The merit of this conclusion, however, will need to be considered further in the context of the Irish market.

96 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 13.

97 Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 14b.

6 Universal service

Introduction

6.1 The Third Directive does not propose a change to the definition of the minimum universal service[98]. The Postal Directive is based on the premise that historically, monopoly profits from the reserved area have supported the additional costs, if any, incurred by some USPs in fulfilling the universal service. Following the removal of the reserved area, alternative financial safeguards *may* be required to ensure that the universal service can be maintained. The European Commission proposes to allow Member States some flexibility in determining these safeguards, with the restriction that they should respect certain principles (e.g. objectivity, transparency, non-discrimination, proportionality and least market distortion).

6.2 The conventional fear in respect of universal service provision is that competitive entry will progressively eliminate the profitability of activities that support the loss making activities required to deliver on the obligation to provide services on a universal basis. This was the fear expressed by trade union representatives at the recent conference in Ireland on the impact of liberalisation:

> *"Mr John Pedersen, Assistant General Secretary, UNI Postal, Union Network International, spoke about the inherent contradictions in the Commission's proposals to open the market... The two objectives; to open the market and maintain the universal service obligation do not sit well with each other and UNI believes these two objectives are contradictory."*[99]

6.3 The Third Directive recognises the tension between its twin objectives, and indeed provides for a variety of financing mechanisms, should these prove necessary. It also, however, incorporates the statement that:

> *"The prospective study states that the basic aim of safeguarding the sustainable provision of a universal service matching the standard of quality defined by the Member States in accordance with Directive*

[98] The definition of the USO is provided in 6.66.

[99] Fitzpatrick, S. "Proposed EU Directive on Postal Liberalisation and the Future of the Irish Postal Service". Conference Report. March 2007.

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97/67/EC, can be secured throughout the Community by 2009 without the need for a reserved area."[100]

6.4 Discussions with An Post confirmed a similar belief, consistent with the comments made at the same conference by Mr Donal Connell, An Post's Chief Executive, who:

> *"presented a vision of An Post delivering USO on a commercial basis in a fully liberalised market without subvention, which is currently the case."*[101]

6.5 In our opinion, and based on our considerable experience, we believe that the circumstances in which competitive entry could threaten the provision of the universal service would be rare. In this section, we explain why this is the case. In the context of FMO, we do think it will be important for the NRA to establish the scope of the universal service and any non-commercial obligations that may need to be provided. In addition, we believe that the NRA will need to verify if there is a net cost to providing the universal service, and if there is, whether this cost represents an unfair financial burden.

Is the universal service clearly defined?

6.6 NRAs must establish the scope of universal service and any non-commercial obligations. The Postal Directive allowed flexibility in how the universal service should be implemented by Member States, who have considerable discretion as to the nature of the universal service imposed.

6.7 There are significant differences between Member States with regard to the scope of the universal services. For example, addressees in 12 Member States receive deliveries of mail on six days a week, compared with the minimum of five deliveries a week that is set out in the Third Directive. The remaining Member States have five deliveries a week[102]. In addition we find that newspaper, magazine, and periodical deliveries are included in the scope of the universal

[100] Third Directive. Presidency Compromise Proposal. 25 September 2007. Recital 8.

[101] Fitzpatrick, S. "Proposed EU Directive on Postal Liberalisation and the Future of the Irish Postal Service". Conference Report. March 2007.

[102] WIK-Consult. "Main Developments in the Postal Sector (2004-2006)". May 2006. Table 3.2.3.

service in about half of Member States and there is a constant debate as to whether or not bulk mail services should be included in the universal service.

6.8 In Ireland, the universal service has been clearly defined through an extensive consultation process[103]. ComReg was obliged to monitor the provision of universal service and needed a precise definition of what An Post should provide. It was advised to prepare a working definition of the universal service based on customer demand, in order to protect postal customers and to help ensure that ComReg safeguarded the services that postal customers needed. This is consistent with the Postal Directive's requirement that universal service provision should evolve in response to "*the needs of users*"[104].

6.9 The consultation document discussed a wide range of services and comments were invited on whether individual services should be included in the working definition. Having considered the views of all respondents, ComReg formulated a working definition of the universal service, describing the basic package of postal services, which must remain available to everyone in Ireland, at an affordable price.

6.10 Defining the universal service is an important first step, but the definition will need to be monitored over time. ComReg recognised that as the postal market develops after FMO, the scope of the universal service would need to evolve. ComReg has stated in the consultation that it would review the requirements of the universal service periodically[105]. It is clear that with the advent of many alternative means of communication, the needs of postal users are changing. Again this is consistent with the Postal Directive's requirement that the universal service should evolve in "*response to the technical, economic and social environment*"[106].

6.11 Postcomm has also adopted this approach in the UK. In its recent strategy document it concluded:

[103] ComReg. "The Universal Postal Service. A working definition." (Response to Consultation) Doc. No. 05/85. November 2005.

[104] Postal Directive. Article 5. (These words are unchanged between 1997, 2002 and proposed 2007 Directives).

[105] ComReg. "The Universal Postal Service. A working definition." (Response to Consultation) Doc. No. 05/85. November 2005

[106] European Directive. Article 5. (These words are unchanged between 1997, 2002 and proposed 2007 Directives).

> *"We are keen to facilitate a debate about how the universal service should change, in terms of its product coverage and service specification, in the medium to long term. We need to ensure the service remains aligned with changing customer needs and the economic costs of providing it. We will not be proposing any changes without extensive public debate nor will we take initiatives that could threaten the long term health of the mail market.*
>
> *"We believe therefore that between now and 2010 it is necessary for us to decide whether – and if so how – the current scope and service specification of the universal service should in due course be changed to meet the evolving needs of postal users."*[107]

6.12 Stakeholders also agree with this approach. For example, the European Postal Users Group, which represents companies such as publishers, distance sellers, advertisers, envelope manufacturers and paper producers, have indicated:

> *"The USO should evolve to guarantee just the core need for sustaining reliable, predictable and sustainable final and universal delivery networks for letter post. This will enable complete market liberalisation, the entry of new players into the market, and the provision of meaningful choice to users through effective competition in practice."*[108]

6.13 It is also recognised that changing scope and/or service specification, might be a regulatory tool to help ensure the universal service remains self-financing. Before proposing any changes to the universal service specification there is a need to understand more clearly the cost savings to An Post and the costs that would be incurred by other stakeholders. In particular, it would be necessary to establish the extent to which lower delivery costs, for example, could be reflected in mail prices and, therefore, the improved sustainability which might be associated with a different service specification. It would also be necessary to consider whether these factors are outweighed either by the detriment to some users or by such a

107 www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/postcomm-s-strategic-review/2007-08_Strategy_Review_Emerging_Themes.pdf. Pages 4, 23.

108 www.euractiv.com/en/transport/financing-universal-service-mail-delivery/article-164698. Accessed October 2007.

large reduction in the value experienced by mail users that any cost savings are more than countered by a lower usage of mail.

6.14 In conclusion, we believe that the universal service will need to be reviewed and allowed to evolve in a dynamic way to reflect the effects of changes in social, technological and economic factors on the needs of users of universal postal services. We believe that ComReg should monitor these changing needs on a periodic basis, and should be responsible for advising on the scope of universal services. In doing so, it should consult widely, taking into account the views of all stakeholders.

How should services and obligations be provided?

6.15 It will need to be decided how these services and obligations should be provided. The Third Directive provides a number of options, as outlined in Recital 15 for example:

> *"Directive 97/67/EC established a preference for the provision of the universal service through the designation of universal service providers. Member States may require that the universal service is provided for the whole of the national territory. The development of greater competition and choice means that Member States should have further flexibility to determine the most efficient and appropriate mechanism to guarantee the availability of the universal service, while respecting the principles of objectivity, transparency, non discrimination, proportionality and least market distortion necessary to ensure the free provision of postal services in the internal market. Member States may apply one or a combination of the following: provision of the universal service by market forces, designation of one or several undertakings to provide different elements of universal service or to cover different parts of the territory and public procurement of services."*

6.16 For example, Ireland could designate (and licence) one or more operators to provide the universal service. Ireland could use public procurement methods to select a USP(s). A limitation of this option in the postal sector, currently, is a shortage of credible tenderers, other than the incumbent operator. The alternative is to let the market decide what services it is willing to provide and then consider whether this is sufficient to meet users' requirements or whether it is necessary for the NRA to secure the provision of additional services, through alternative means. An advantage of this approach is that it determines in a straightforward and simple manner what the incumbent is able to provide on a commercial basis.

6.17 Currently, An Post is designated as the USP by the Minister under the regulations. All Member States have designated the public postal operator (successor to the former postal administration) as the USP. However, a WIK-Consult report notes that once fully liberalised, the Netherlands and Germany may abolish the ex-ante obligation on one specific postal operator, based on the expectation that the market will voluntarily provide a universal service. In Germany, if the market does not provide the services and the service level wished by the society (i.e. defined by postal legislation), German postal law foresees that the NRA has the power to tender the respective service or to oblige a market dominant postal operator to provide the service[109].

6.18 Some operator stakeholders indicated that they would be willing to provide the universal service, or parts of it, suggesting that there might be some merit in changing the current arrangements. However, most acknowledged they did not currently have the scale actually to provide all the universal services that Member States must ensure are provided.

6.19 There does not appear to be any immediate need to change current arrangements, as effective competition has yet to emerge. However, the provision of the universal service is dynamic, and as competition develops and as customer demands change, there may be a need to reconsider this aspect. In fact, An Post in the future may decide that it does not want to provide aspects of the universal service. If this was to happen then Ireland could seek to contract out, or franchise, parts of the service through a process of competitive tendering[110].

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[109] WIK-Consult. "Main developments in the European postal industry (2004-2006)". May 2006. Pages 47-48.

[110] There are many examples internationally of how the contracting out or tendering approach has been applied successfully. For example, in Australia and New Zealand, the majority of rural collections and deliveries are contracted out to third parties.

Is there a net cost to be funded?

6.20 Irrespective of who provides the universal service, a key consideration is whether there is a net cost to providing the service, and whether this presents the provider with an unfair financial burden. The Third Directive provides guidance on how to calculate whether there is a net cost. It states:

> *"The net cost of universal service obligation is any cost related to and necessary for the operation of the postal universal service provision. The net cost of universal service obligations is to be calculated, as the difference between the net cost for a designated universal service provider of operating with the universal service obligations and the same postal service provider operating without the universal service obligations.*
>
> *"The calculation shall take into account all other relevant elements, including any intangible and market benefits which accrue to a postal service provider designated to provide universal service, the entitlement to a reasonable profit and incentives for cost efficiency."*[111]

6.21 It is widely recognised that calculating the net cost of the universal service is complex. Many different methods have been employed to estimate the cost. One approach, which is partially consistent with the guidance above, is the net avoidable cost ("NAC") methodology[112]. The logic of this approach can be explained as follows. The universal service forces the USP to provide some mail routes or products that are loss making. Without the universal service, a profit-maximising operator might withdraw some or all of the services for which avoidable costs exceed price[113]. A practical interpretation of the cost of the universal service might be the "losses" that arise from the provision of certain loss

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[111] Annex I to the Third Directive (as attached to Presidency Compromise Proposal dated 25 September 2007). See Appendix 6 to this report for the full guidance. This guidance is consistent with a recent judgment made by the European Parliament and Council (refer to Appendix 3).

[112] There is academic argument and case law to support that the method set out in the Annex to the Third Directive is the only way to calculate the net cost of universal service obligations. Some operators and their advisors have advocated other methods, such as the NAC. It can be argued that these approaches are measuring the cost of other things (e.g. the impact of liberalisation rather than the net cost of universal service obligations).

[113] A USP might seek to increase the price of loss making services, although it may be constrained from doing so, by universal pricing or the transaction costs of changing prices for specific services, in isolation from most services.

making services. "Losses" in this context occur when avoidable costs are higher than prices[114].

6.22 The NAC has been used by various European postal and other industry regulators. Arthur Andersen used the NAC approach for Postcomm's 2001 assessment of the cost of Royal Mail's USO. NERA used a similar approach in 1998 to estimate the financial impact of the USO in the EU. Additionally, Oftel used the NAC approach as one estimate of the cost of the universal service in UK telecommunications[115].

6.23 In the USA, the Postal Regulatory Commission estimated that the cost of the universal service represented 5% of revenues. It was found that in order to remove this obligation, the USP would have to cease deliveries to approximately 47% of addresses. It has been argued that no commercially focussed operator would cease to service about half the routes in the country, simply to reduce costs by such a small amount. In practice, an unconstrained USP may not cease loss-making services. Separating such services from other operations may generate a greater cost (either one-off or ongoing) than the avoided losses. A profit-maximising firm would therefore continue to offer such loss making services, accepting the losses. Any NAC calculation should therefore take into account only the services that a profit-maximising firm would actually cease if it were unconstrained by regulation.

6.24 It is important to recognise that set against the potential costs of loss-making services are the potential commercial benefits arising from providing the universal service. The guidance mentioned above requires that such benefits should be taken into account. An overview of the potential benefits is provided in Appendix 5.

6.25 In estimating the cost of the universal service, a stepped approach is required. The first step is to consider whether absent the obligation, the USP would continue to provide the universal service. If the USP continues to provide the service on commercial grounds, then there can be no net cost. If the USP would

114 The formula for calculating the NAC can be stated as follows: NAC of the USO = USO revenues – USO LRMC + Benefits of the USO.

115 Postcomm. "An assessment of the costs and benefits of Consignia's current Universal Service Provision". June 2001. Page 24.

choose to reduce its service, this might suggest that there is a net cost to providing the universal service.

Would the USP provide the same or more than the obligation?

6.26 In the current market, An Post might decide to continue to provide the same universal service, even if it was not constrained to do so by the obligation. In our meetings with An Post, it indicated that it saw the universal service as an "asset". 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.

> *"He presented a vision of An Post delivering [the] USO on a commercial basis in a fully liberalized market without subvention, which is currently the case. He recognized that the USO imposes costs which other operators do not carry. However An Post has a network which no one else has to deliver this service. This gives it a major social as well as a commercial role".*[116]

6.27 Others have acknowledged that it is important to consider the benefits of the universal service. For example, the EU Internal Market Commissioner, Charlie McCreevy stated that, although the financing issue is important, there is a:

> *"…temptation to over-emphasise [the net cost of the USO]… Many of us tend also to forget that the universal service may in several respects be judged more an asset than a burden."*[117]

6.28 PTS has also recently noted that:

> *"there has been a debate also in Sweden concerning the costs of the assumed extra burdens imposed by the universal service obligation. A number of investigations have tried to estimate those costs and the Swedish Government has, since the monopoly was abolished, on two occasions considered the creation of a compensation mechanism for the universal service.*

"it was already noted in a Governmental investigation in 1991 that the possession of such a system together with the ability to provide the customers with a one-stop-shop for all kind of postal services was a considerable asset. It was stated that Posten AB, or by then the Postal Administration, being the only operator capable of offering this kind of complete services, had a great competitive advantage in this respect. This is to a large extent the reason why Sweden doesn't find it necessary to create a compensation mechanism for the universal service besides the particular subsidies for some social services.

"Accordingly, the benefits for the universal service provider should always be taken into account when there is an attempt to estimate the extra costs of universal delivery."[118]

6.29 The An Post Group of Unions also acknowledges that the universal service is an asset.

"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"[119].

6.30 It has been recognised that the benefits that accrue from the ubiquity of geographical coverage make it unlikely that any USP would propose to withdraw service from many specifically high cost areas, although cost reduction measures such as a reduced number of deliveries may be proposed. It has been observed in the United States that, "*because the value of the network is positively correlated with the number of points served, few customers would think it*

116 An Post Group of Unions. "Proposed EU Directive on Postal Liberalisation and the Future of the Irish Postal Service". Conference Report. Page 9.

117 Charlie McCreevy, European Commissioner for Internal Market and Services. "Completing the last mile of the Single Market for Postal Services Conference – Delivering Postal Liberalisation on Time". Brussels. 17 October 2006.

118 PTS. "The liberalised Swedish Postal Market the situation 14 years after the abolition of the monopoly". March 2007.

119 Walley, P.; An Post Group of Unions. "An Post – A New Vision". May 2005. Page 40.

worthwhile to trade a rate reduction of this small magnitude for the inability to reach 45 percent of the population"[120].

6.31 There is other evidence to support the argument that An Post would provide the universal service absent the obligation. 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. An Post's memorandum of association, for example, sets out its objectives as:

> *"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,…"*

6.32 We understand that the amended memorandum and articles were dated 15 December 1983, which precedes the First Directive, which was introduced on 15 December 1997. We also understand that, apart from seeking to curtail deliveries to premises where there is no access or health and safety risks to employees and not to deliver daily to certain islands off the coast (less than 0.1% of addressees), An Post has never made a formal application to change either the scope or the specification of the universal service. We can only conclude therefore, that An Post does not object to the scope of the current universal service, and in fact embraces it as the foundation of its raison d'etre.

6.33 This argument is also supported by the fact that An Post currently provides services in excess of the minimum requirements set out in the working universal service definition. For example, An Post provides postboxes/access points in

[120] Cohen, R., Matthew Robinson, John Waller and Spyros Xenakis. Postal Rate Commission, USA. "The Cost of Universal Service in the U.S. and its impact on Competition". Washington, DC. 2002.

excess of the universal service requirement of Direction 1 in ComReg Doc 03/50[121].

6.34 Evidence from Sweden suggests the incumbent operator will provide what is sensibly required. However, if there is a shortfall in service provision, the NRA can always seek to find a niche operator prepared to provide services in a limited geographical area.

What is the cost of the universal service?

6.35 If there is a net cost to the universal service, current evidence suggests that it is likely to be small. There have been a number of estimates of the cost of the universal service across Member States. While different methodologies have been used, each approach takes into account those postal activities, which would not be undertaken using normal commercial logic – because they are uneconomic or loss making, but which, nevertheless are socially desirable[122]. By way of illustration, the following estimates of the uneconomic costs of universal service have been observed[123]:

- in Norway, the postal operator receives a small income (equivalent to approximately 2% of the costs) from the government as a proxy for the uneconomic costs;
- in Portugal, a study by the national operator suggested that between 4-6% of its €15.9m loss could be ascribed to the requirements of the USO;
- in Sweden the obligation was recently estimated at 100 million SKR a year (€10.3m) or about 4% of the operator's group-wide revenue; and
- in the USA, the Postal Regulatory Commission estimated that the cost of the equivalent of the USO represented around 5% of revenues.

6.36 There have been a number of other studies. Postcomm used the NAC approach and estimated that the cost of Royal Mail's universal service provision was about £81m, representing about 1.7% of its revenues from its mails business.

121 An Post. "Annual Report". 2006. Page 23.

122 For example, different methods include the Net Avoided Cost approach, the Long Run Incremental Cost approach, the Entry Pricing approach etc.

123 "Commission staff working document - Accompanying document to the Proposal for a Directive of the European Parliament and of the Council amending Directive 97/67/EC. concerning the full accomplishment of the internal market of Community postal services - Impact Assessment". October 2006. Pages 10-11.

Postcomm concluded that the overall cost was low, noting that its estimates excluded the quantification of any associated benefits. In addition, it was based on actual rather than efficient costs[124]. Some work performed by LECG in 2007 suggests, that the net cost to Royal Mail could be lower.

6.37 In 1998, NERA conducted a study of the cost of providing nationwide postal services in eight EU countries (Austria, Denmark, Finland, France, Greece, Ireland, Portugal and the UK) based on figures for 1997. According to NERA, the added cost of the universal service was less than 0.5% of the sales for the postal operators[125]. As part of this NERA performed a study for Ireland, which concluded:

> *"Although there have not been any direct attempts to estimate the costs of the USO in Ireland, An Post believes that by far the largest cost is incurred from deliveries to sparse postal areas for both letter post and for parcels, followed by the cost of letter and parcel collections from these areas. This is particularly significant in the light of Ireland's demographic structure which is characterised by a high population density in Dublin and a very low density outside the capital.*
>
> *"Under these assumptions, our model estimated the cost of the USO for letter mail in the Republic of Ireland, on a fully distributed cost basis, as Ir£ 11.9 million in 1997, and, on an avoidable cost basis, of only Ir£ 0.6 million. The latter figure represents the amount over the price of the services that would be saved if the "unprofitable" part of the service were withdrawn. It is clearly sensitive to the particular avoidability assumption made. Our estimate of Ir£ 11.9 million for the USO cost on a fully-allocated basis represents 5.4 per cent of An Post's letter mail turnover in 1997."*[126]

124 www.psc.gov.uk/universal-service/cost-of-the-universal-service.html. Accessed October 2007.

125 NERA. "Costing and Financing of Universal Service Obligations in the Postal Sector in the European Union". Final Report for EC DG XIII. 1998. The exception to the above range was Austria, where the cost was no less than 8 percent of the sales. NERA commented that this might be due to uncertain data.

126 NERA. "Costing and Financing of Universal Service Obligations in the Postal Sector in the European Union". Final Report for EC DG XIII. 1998.

6.38 In summary, the evidence suggests that net universal service costs are currently low even before the calculation of any associated benefits. Of course, in a fully liberalised market, these estimates might change, suggesting that the cost estimates will need to be revised from time to time.

Is there an unfair burden?

6.39 If a net cost is found to exist, then the next question is whether it represents an "*unfair financial burden*"[127]. A number of regulators believe that the universal service can be internally financed, through prices that cover efficient costs. Any financial burden can be mitigated by continuous improvements in efficiency to reduce costs. Ex-ante price regulation (e.g., in the form of CPI-X) can used to ensure prices cover the costs of providing the universal service, and to incentivise greater efficiency. Postcomm concluded in its Strategic Review:

> *"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. What is needed urgently is for Royal Mail to place a far greater focus on efficiency and customers accepting the need to pay a fair price for postal services. We do not consider external financing is needed; this could potentially lead to serious distortions and perverse incentives on Royal Mail's efficiency."*

6.40 The self-financing path has been successfully followed in Sweden, Germany and the Netherlands where the national operators have been able to maintain a high specification universal service despite having lost volumes to end-to-end competitors. In Germany and the Netherlands, 10% and 14%, respectively, of end-to-end volumes have substituted from the national operator, compared to less than 1% in the UK and in Ireland. In Sweden, which has had a fully liberalised mail market since 1994, the national operator has been significantly challenged by an end-to-end operator – CityMail – that now serves over 40% of delivery points nationally and plans to increase coverage to 65%. However, because significant cost reductions have been made every year since Swedish Post was exposed to competition, the universal service remains of a high quality

[127] The Third Directive requires a Member State to determine that there is firstly, a net USO cost and secondly, that this is an "unfair financial burden". Third Directive. Article 7.

and is self-financed. In all three instances, the national operators regard the universal service as an asset[128].

6.41 Other European postal regulators and stakeholders support the view that the universal service can be internally financed in a competitive market. A brief summary of views supporting self-financing can be found in Appendix 7.

6.42 Others have asserted that the removal of the reserved area will increase the net cost of the universal service, requiring some form of funding mechanism. The President of France's La Poste insists that the universal service must be "correctly" financed if the current monopoly is to be abolished. He favours a 'pay or play' mechanism where new market entrants would either have to take on a share of public-service provision proportional to their financing capacity and their size, or contribute to a fund. He states "*as for saying that we have to finance the universal service through productivity efforts, this is out of the question!*"[129]

6.43 The An Post Group of Unions does not believe that the universal service can be financed in a fully liberalised market[130]. They point to what academics, Michael Crew and Paul Kleindorfer have described as the "graveyard spiral". This theory is based on the assertion that delivery costs vary between routes. If prices are uniform, the lower cost delivery routes are more profitable and vice versa. Within a single operator, profitable delivery routes cross-subsidise unprofitable ones. New operators are attracted by making profits, and so cherry pick the profitable routes by offering customers prices that are lower than the USP's uniform price, but still high enough to make a profit. Once profits on these routes are lost to the entrant, the USP may be forced to raise prices because its average unit cost has increased and it needs additional revenue to maintain its level of profit (breakeven or otherwise). This could lead to a continuous cycle of higher average unit costs, lost profits and forced price increases[131]. The result could be a graveyard decline of the company and an undermining of the universal service provision.

128 www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/postcomm-s-strategic-review/2007-08_Strategy_Review_Emerging_Themes.pdf. Pages 26-27.

129 www.euractiv.com/en/transport/financing-universal-service-mail-delivery/article-164698. Accessed October 2007.

130 Walley, P.; An Post Group of Unions. "An Post – A New Vision". May 2005.

131 Crew, M.A., and P.R. Kleindorfer. "Whither the USO under Competitive Entry: A Microstructure Approach". 2001.

6.44 This is an extreme situation, which depends on a number of factors. First, it depends on how quickly competition will enter the market, and the type of the competition that will emerge (e.g. end-to-end versus downstream access). We have argued elsewhere that competition is likely to develop slowly in Ireland. On this basis, there is unlikely to be an immediate threat to the provision of the universal service.

6.45 It will also depend on how competition develops. If end-to-end competition develops successfully, then this could, all other things being equal, put pressure on An Post's ability to finance the universal service. We have argued elsewhere that we do not think that full end-to-end competition will develop quickly in Ireland. This has been the experience in the UK:

> *"Less than 1% of addressed mail volumes are currently delivered end-to-end by rival operators. We do not expect Royal Mail's dominance over the final mile to reduce materially over the medium term because it is proving very hard for new operators to compete against Royal Mail's scale economies, the sunk costs of its existing network, and its unique privilege of VAT exemption."*[132]

6.46 If downstream access competition dominates, then An Post will not see a reduction in volumes over the final mile. It is in this area where the cost of the universal service is thought to be highest, especially in rural areas. The An Post Group of Unions notes:

> *"USP obligations in Ireland are particularly onerous in comparison to most other member states as the population is very dispersed – 40% of the population live in rural areas in comparison to 5-10% in most other member states."*[133]

6.47 If downstream access competition develops, An Post would not lose revenues attributed to this key area, and this would help to ensure the universal service remains self-financing. Again, this is the experience in the UK. Postcomm recently concluded:

[132] www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/postcomm-s-strategic-review/2007-08_Strategy_Review_Emerging_Themes.pdf. Page 10.

[133] Walley, P.; An Post Group of Unions. "An Post – A New Vision". May 2005. Page 19.

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"Under access competition, more than 70% of the total mailing revenue is still retained by Royal Mail and there is no associated reduction in the volumes that it carries over the final mile. It is in final delivery where Royal Mail says that its fixed costs are highest and where a significant reduction in mail volumes would most challenge the business."[134]

6.48 It is too early, however, to conclude with any certainty how competition will develop in Ireland. Our interviews with stakeholders provide mixed views on how competition will develop, how quickly this will happen and whether end-to-end or downstream access will be more prevalent.

6.49 The graveyard spiral scenario also assumes that prices are uniform, with no ability to rebalance prices. This is unlikely to be true. In the UK, cross-subsidies are unwinding with the introduction of zonal pricing and weight based charges. In Ireland, uniform pricing has never been set as an obligation. We understand that An Post has chosen to charge uniform prices. Theoretically, therefore, An Post could develop non-uniform prices if cherry picking became a serious threat to the provision of the universal service.

6.50 The graveyard spiral also assumes, in addition to uniform prices, that competitors can easily identify opportunities to cherry pick. We have performed some work for Postcomm (unpublished) that indicated that 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.

6.51 Costs associated with the universal service appear to be widely distributed across delivery density and distance parameters. Data published by Postcomm showed that deliveries within Greater London are the most expensive – on average 12% more than average. They are therefore not easily avoided by entrants, whose

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134 www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/postcomm-s-strategic-review/2007-08_Strategy_Review_Emerging_Themes.pdf. Page 9.

primary strategy is, in general, to concentrate on bulk mailers with broadly ubiquitous delivery requirements.

6.52 ComReg can play a role to ensure that the universal service is financed, using appropriate price control mechanisms. A regulatory price control can contain a number of mechanisms to provide assurance for the financing of the universal service. For example, Postcomm allows revenues to be adjusted if delivered mail volumes are lower than expected when the price control was set. ComReg would also be able to set prices at subsequent reviews, to ensure that average prices covered average costs. Furthermore, price control with built in efficiency incentives, would help to mitigate upward price through continuous improvements in efficiency to reduce costs.

6.53 If the universal service was found to entail a net cost and to represent an unfair financial burden, then the Third Directive is clear that ComReg would need to play a role in verifying the calculations. This comes from places in the Third Directive. First Article 22 requires:

> *"The national regulatory authorities shall have as a particular task ensuring compliance with the obligations arising from this Directive, in particular by establishing monitoring and regulatory procedures to ensure the provision of the universal service"*

6.54 Second Annex 1, Part B, of the Third Directive states:

> *The responsibility for verifying the net cost lies with the national regulatory authority. The universal service provider(s) shall cooperate with the national regulatory authority to enable it to verify the net cost.*

6.55 From this, it is clear that ComReg has a role to verify any calculation of the net cost of the universal service.

6.56 A final point, is that An Post is currently designated as the USP by the Irish Government and not subject to authorisation by ComReg. Of itself, this could perhaps lead to a claim that as universal service provision was imposed upon An Post, rather than being something it freely entered into for commercial purposes, some degree of compensation should be provided. Further, and perhaps more importantly, designation of this nature may deprive Ireland of the flexibility necessary in an evolving postal market to ensure that consumer needs continue to be met.

6.57 As Recital 22 of the Third Directive recognises, it is appropriate that Members States should have further options to secure the provision of universal services. We believe that in a changing industry, with the introduction of competition and the changing composition of mail volumes, the regulator should be able to re-specify the universal service, and thereby the work of the USP. Therefore, the continued use of designation may not be the best option for facilitating the provision of the universal service.

Funding the universal service

6.58 If there is a net cost to the universal service, and it is found to provide an unfair financial burden, then Ireland would need to consider the most appropriate form of funding. The relative strengths of the alternative forms of funding would need to be considered. It will be important that any measure adopted should not distort competition or An Post's behaviour and should seek to maximise efficiency.

Conclusion

6.59 In Ireland, the universal service has been clearly defined through an extensive consultation process[135]. The scope and specification of the universal service, however, will need to be reviewed and allowed to evolve in a dynamic way to reflect the effects of changes in social, technological and economic factors on the needs of users of universal postal services. The NRA should monitor these changes on a periodic basis, and should be responsible for determining the scope and specification of the universal service. In doing so, it should consult widely, taking into account the views of all stakeholders.

6.60 Ireland will need to decide how universal services and obligations should be provided. Currently, An Post is designated as the USP. There does not appear to be any immediate need to change current arrangements, as effective competition has yet to emerge. However, as competition develops and as customer demands change, there may be a need to reconsider who provides aspects of the universal service.

[135] ComReg. "The Universal Postal Service. A working definition." (Response to Consultation) Doc. No. 05/85. November 2005.

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6.61 Ireland will need to consider whether there is a net cost for An Post in providing the universal service. It is quite clear that incumbent operators have significant advantages such as name recognition, an established infrastructure, economies of scale, density and scope, ubiquity of geographical coverage and frequency of service provided. Indeed, An Post acknowledged to us that the universal service is an asset. These benefits would need to be included into the assessment of net costs.

6.62 We are not aware of any evidence that An Post would not continue to provide the same universal service, even if it was not constrained to do so by the obligation. Currently, An Post provides more than the minimum requirement. We must assume that it chooses to do this on commercial grounds.

6.63 Across Europe, the evidence suggests that net universal service costs are low even before the calculation of any associated benefits. Of course, in a fully liberalised market, the cost of providing the universal service might change. Therefore, it will be important for cost estimates to be performed from time to time. ComReg should have a role to verify any calculation that is performed of the net cost of the universal service.

6.64 Even if a net cost is found to exist, then the next question is whether it represents an "*unfair financial burden*"[136]. A number of regulators believe that the universal service can be internally financed, through prices that are properly regulated to cover efficient costs.

6.65 There is strong evidence from international comparisons that competition and a strong internally financed universal service can co-exist. The early experience in the UK is that competition has strengthened the universal service.

6.66 We believe that the risks to the provision of the universal service posed by FMO 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.

136 The Third Directive requires a Member State to determine that there is firstly, a net USO cost and secondly, that this is an "unfair financial burden". Third Directive. 2007. Article 7.

Appendix 1: Terms of reference

To advise ComReg how best to ensure that all postal consumers benefit from the opening of postal markets to competition, with particular reference to:

Prices: optimal approaches to ensure that An Post, as the Universal Service Provider (USP), complies with competition law and the specific requirements of the Postal Directives, taking into account data requirements and the potential scope and nature of competition in the short term (i.e. the first five years following market opening), and to ensure that consumers are protected from any market power that may exist in the sector, and that any dominant firm is prevented from charging excessive prices to postal consumers.

Quality: optimal approaches to ensure that the universal services provided by An Post or any other designated universal service provider are of the specified quality, and how should that quality be determined.

Services: anticipating the evolution of postal services in terms of the range and nature of services provided and the most important customer groups, reflecting the convergence between express and traditional postal services, and between postal and electronic communications; and other innovations, and in the light of such an assessment advising on:

- the scope of the universal services to be provided in Ireland in the short term (i.e. the first five years following market opening), distinguishing between upstream and downstream activities.
- the most appropriate means[137] of ensuring that such services are provided at least cost to consumers and by extension the state and with the least distortion

[137] For example: Public Procurement, Licensing, Designation by Government or ComReg, State ownership of operator (An Post)

Appendix 2: Information sources

In performing our work, we performed a detailed review of the abundant theoretical and policy-oriented literature. We provide examples of the literature reviewed below:

- Oxera, "*Funding universal service obligations in the postal sector*", January 2007;
- ComReg. "*Regulation of Postal Services - Universal Service Obligation, Tariff Principles and miscellaneous issues*". Dublin. Nov 2002;
- ComReg. "*The Universal Postal Service – Formulating a Working Definition*". Dublin. March 2005;
- CTcon. "*Study on the conditions governing access to universal postal services and networks*". European Commission. July 2001;
- Ecorys. "*Development of competition in the European postal sector*". European Commission. July 2005;
- Hearn, J. "*The Accounting and Economic Implications of the EU's New Postal Directive*". Presentation to 15th Conference on Postal and Delivery Economics, CRRI, Rutgers University. June 2007;
- NERA. "*Costing and Financing of Universal Service Obligations in the Postal Sector in the European Union*". European Commission, DG XIII. November 1998;
- NERA. "*Study about the Economics of the Postal Sector*". European Commission. July 2004;
- Walley, P. "*An Post – A New Vision*". An Post Group of Unions. May 2005;
- Postal Technology International. "*USO Focus*". Dorking, UK. June 2005 Edition;
- Postcomm (UK). "*The Universal Service for Bulk Mailers: A Decision Document*". London. June 2005;
- PTS (Sweden). "*Implementing a price regulation in a deregulated letter mail market – The Swedish experience in brief*". August 1999;

- PTS (Sweden). "*The liberalised Swedish postal market: the situation 14 years after the abolition of the monopoly*". March 2007;
- PWC. "*The Impact on Universal Service of the Full Market Accomplishment of the Postal Internal Market in 2009*", final report, May 2006;
- WIK. "*Main Developments in the European Postal Sector*". European Commission. July 2004;
- WIK. "*Survey on some main aspects of postal networks in EU adhesion candidate countries*". European Commission. August 2003; and
- WIK. "*Main Developments in the Postal Sector (2004-2006)*". European Commission. May 2006;

Further reports and academic articles were reviewed. For brevity, we do not list them here. However, where relied on directly in the report, we provide the appropriate source.

Appendix 3: Interview questionnaire

Introduction

In this appendix, we provide an example of the interview questionnaire we sent to stakeholders prior to being interviewed. The form of the questions changed slightly depending on the stakeholder, so what follows is illustrative.

Context

ComReg is currently reviewing the future of its regulatory strategy in the light of proposed revisions in the Third Directive and the debate happening around Europe between those in favour and those against FMO.

ComReg has asked LECG to review its approach to regulation and to contribute to the debate within the country and within government about the future of the postal industry. As part of this review, we are consulting stakeholders, to understand your requirements from postal regulation and the form of market you need in the future.

We would welcome your thoughts and evidence within each of the areas below:

1. FMO

The Third Directive requires FMO for postal services within each Member State by 1 Jan 2009, although this is being challenged by some stakeholders at the European level. In broad terms, how is An Post preparing for FMO, both financially and operationally?

2. Competition

Do you believe that competition will develop? Which parts of your service do you expect will be affected by FMO and the development of competition? Do you believe that downstream access will develop in Ireland? How soon/to what degree of magnitude do you expect competition to develop?

3. Price regulation

Do you believe that ComReg should continue to be able to pre-approve An Post's price increases after FMO? Do you believe that there is sufficient pressure to constrain your prices after FMO? If it were decided that there needed to be a form of price control, what form would you support? Would the UK approach be appropriate? If not, why not? Is there any other country/industry where you think other forms of control/no control have been successful?

4. Quality regulation

Do you believe that the current form of quality of service measurement is appropriate to customers? If not, how should that change? Do you think there needs to be any form of quality regulation? Do you think it is appropriate for ComReg to continue to regulate quality?

5. Universal service

Does the current USO places a net cost on An Post? If so, how? Does An Post benefit from the USO? How have you calculated the cost of the USO? If you would like to change the USO definition, what effect would that have on the net cost of the USO? Do you think that FMO with affect your ability to finance the USO? If so, over what time period do you believe competition will influence the USO?

5. Universal service definition

Do you think the USO definition should change? If so, how? Could the USO definition be changed to allow for a sustainable USO provision, after FMO? If so, how? Does the USO definition need to be flexible, to respond to the challenges of FMO? What implications would this have for your annual costs and revenues?

Appendix 4: Definition of universal service in Third Directive

In this Appendix, we summarise the definition of the universal service, as defined in Article 3 of the Third Directive.

"1. Member States shall ensure that users enjoy the right to a universal service involving the permanent provision of a postal service of specified quality at all points in their territory at affordable prices for all users.

2. To this end, Member States shall take steps to ensure that the density of the points of contact and of the access points takes account of the needs of users.

3. They shall take steps to ensure that the universal service is guaranteed not less than five working days a week, save in circumstances or geographical conditions deemed exceptional, and that it includes as a minimum:

- *one clearance,*
- *one delivery to the home or premises of every natural or legal person or, by way of derogation, under conditions at the discretion of the national regulatory authority, one delivery to appropriate installations.*

Any exception or derogation granted by a national regulatory authority in accordance with this paragraph must be communicated to the Commission and to all national regulatory authorities.

4. Each Member State shall adopt the measures necessary to ensure that the universal service includes the following minimum facilities:

- *the clearance, sorting, transport and distribution of postal items up to two kilograms,*

- *the clearance, sorting, transport and distribution of postal parcels up to 10 kilograms,*

- *services for registered items and insured items.*

5. *The national regulatory authorities may increase the weight limit of universal service coverage for postal parcels to any weight not exceeding 20 kilograms and may lay down special arrangements for the door-to-door delivery of such parcels. Notwithstanding the weight limit of universal service coverage for postal parcels established by a given Member State, Member States shall ensure that postal parcels received from other Member States and weighing up to 20 kilograms are delivered within their territories.*

6. *The minimum and maximum dimensions for the postal items in question shall be those laid down in the relevant provisions adopted by the Universal Postal Union.*

7. *The universal service as defined in this Article shall cover both national and cross-border services."*

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Appendix 5: Benefits of universal service

Introduction

In this appendix, we provide an overview of the potential benefits of the universal service. We summarise each benefit and provide a qualitative assessment of how each benefit might affect an incumbent monopolists profits.

Any calculation of the net cost from universal service provision needs to consider a range of benefits. These benefits might include the ownership of a legacy network established with state funding over centuries, which no competitor could aspire to establish, and which can be used for universal and other services.

The benefits also include:

- brand enhancement and corporate reputation benefits;
- special privileges such as VAT exemptions;
- avoidance of customer transaction costs;
- ubiquity of service; and
- customer life cycle benefits.

We discuss each benefit below.

Brand enhancement and corporate reputation benefits

Benefits might accrue to a USP from the effect that serving uneconomic areas and customers has upon the operator's brand image and corporate reputation, and hence upon its overall current and future profitability. Providing the universal service may also increase customer confidence, and this may be a competitive advantage, providing signals to new entrants that competition will not prevent An Post from occupying a significant niche in the market.

Additionally, certain business customers may value a single provider and prefer to enter into bulk contracts with USPs to be certain of reaching all members of society. This preference casts doubt upon the genuine "avoidability" of "loss-making" elements within the provision of these postal products. Withdrawing from certain universal service activities might damage An Post's corporate reputation.

There is evidence in other markets that the brand of incumbent postal monopolists is strong. In the UK Government's White Paper on Post Office Reform, market research is cited suggesting that "The Post Office" is the second most widely recognised brand in the UK after Coca-Cola[138]. Some of this benefit may be derived from its provision of the universal service.

The quantification of brand or corporate reputation benefits that may relate to the provision of the universal service is complex. One means of valuing the benefit might be to equate it to a proportion of An Post's annual marketing and advertising spending. This approach was adopted by Oftel in its initial review of the costs of the UK telecommunications universal service. Oftel equated this benefit to approximately 20% of BT's marketing and advertising spends. This approach probably has some merit, and is certainly worth exploring if only because it has been accepted before. Whether it is the primary approach or a crosscheck probably depends on the other options available.

A key question is what drives An Post's brand strength. Clearly, there are at least two contributory factors: the universal service and its monopoly position. The key challenge is how to separate the two elements. Many companies have high brand awareness. It might be argued that the power of these brands is in their longevity and their association in the market place with a single or a small number of long standing products, even if these products are not necessarily the major part of the business. In many cases, the brands with power were first to market and had/have de-facto monopolies in their respective niches.

A further point to be considered is with whom does the brand have resonance? If the brand has resonance with individuals but these do not contribute very much in terms of revenue/profitability (e.g. social mailers) it could it be argued that the brand has little value. If the brand has positive connotations in the mind of the large mailers, which represent the major portion of value of mail services, then the brand has a higher value.

Further work would need to be performed to understand the overall drivers of An Post's brand. It is clear, however, that the universal service will contribute to the value of An Post's brand. As such, it will benefit from commercial benefits arising from the provision of the universal service.

138 UK Department for Trade and Industry. "Post Office Reform: A world class service for the

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Special privileges such as VAT exemptions

An Post is exempt from paying VAT. Some have argued that this gives An Post a competitive advantage over rival operators that do not benefit from similar exemptions. VAT charged by private operators may be offset against other expenditure allowing business customers to reclaim VAT paid. Financial institutions, charities and residential customers, however, are not able to reclaim VAT. In any event, the process of claiming money back adds transaction costs to customers and competitors in a way that An Post as the USP can avoid. If An Post did not have this VAT exemption, its prices might increase for VAT exempt customers and it might lose volumes to alternative postal operators and other means of communication.

These special privileges provide An Post with an advantage over competitors, however they apply to both universal service and non-universal service services. It might be argued that this is not specifically a benefit of the universal service, but a benefit to An Post as a whole. In theory, these benefits should only be included if the privileges are provided because of the requirement to provide the universal service. If that was the case, these benefits could be material.

Avoidance of customer transaction costs

Lower transaction costs are often cited as a benefit of providing a universal service at a uniform tariff. Certain customers may not want to invest time in determining the correct rate for low value items. Consequently, the uniform tariff saves transaction costs of both customers and the USP. Therefore, although moving to non-uniform prices may be cost reflective, it might not be the most cost-effective option for a USP. For example, extra costs could be incurred from customer confusion and the generation of more enquiries and call centre traffic.

Most European USOs are priced on a geographically uniform tariff and it is argued that this uniformity has an associated benefit. If rebalancing is allowed, it seems logical that the USP would seek to avoid the losses by making prices cost reflective. It would then be a separate decision for USP to decide if uniform or semi-uniform prices were the correct solution, given the additional transaction costs that may be associated with highly granular cost-reflective prices as well as the revenue impacts.

21st century". July 1999. Page 14.

It should be noted that uniform prices are not only a characteristic of USOs. Many unconstrained businesses with single tariffs operate geographically uniform prices, despite potential cost variation (e.g. electricity and gas supply, sales of new cars, supermarket prices for grocery, household goods etc). It does not follow, therefore, that removing the USO would necessarily introduce non-uniform prices and face increased costs. Uniform pricing is a commercial strategy used by many firms, who would have to deal with transaction costs If they changed to geographically non-uniform prices.

Ubiquity of service

The provision of a universal postal service might provide beneficial effects based on customer awareness that, even when they move to a new address, An Post will supply a service. At the new location, the customer may not know of potential competitors. Consequently, a proportion of customers will choose An Post over alternative suppliers, where they are available.

Another benefit arising from ubiquity derives from the likelihood that customers will choose to use An Post when sending mail to wide ranging or new addresses given that, by virtue of the universal service, they can be sure that An Post will deliver to all addresses. In this sense, ubiquity may also serve to reduce customer switching.

A key issue is to what extent ubiquity derives from the monopoly and customer awareness of the An Post brand, rather than the provision of the universal service. To the extent that the benefit is attached to the universal service, any assessment should consider whether this relates to the current universal service or the universal service as defined in previous years. To include the latter as a benefit for the current universal service might be inappropriate.

As competition develops and people become more aware of the actual capabilities of the new entrants, the ubiquity of service may prove to be of value only if competitors fail to be able to offer such a service. We could see a situation in which people switch and then return. If the key to returning to An Post was the ubiquity point, and this is due to universal service, it has some value assuming that the returning customers/volumes are profitable. Clearly, there is no value if they return on loss-making routes.

Customer life cycle benefits

The "loss-making" services that An Post might argue it must cross-subsidise with services that are more profitable, may include deliveries to addresses and customers that are likely to generate "outward" flows of mail that will be profitable. Hence, taken in the round, the delivery point/customer may indeed be profitable overall and if An Post chose not to deliver to the unprofitable elements, it would lose revenue from the profitable elements.

Depending on the volumes and the associated ratio of collection to delivery costs, it can be argued that if 'inward' flows of mail at a delivery point are loss-making, then 'outward' flows are also likely to be loss-making. Nevertheless, the quantification of the universal service burden should not be simply taken as cumulative loss making services. There may be valid reasons why An Post might not choose to remove a loss-making service, as this may affect customer choices in relation to profitable services.

Conclusion

It is difficult to quantify the potential benefits that An Post might receive by virtue of being the USP. However, such benefits would need to included in any calculation to provide a balanced judgment on the degree to which An Post might be (dis)advantaged by its obligation to ensure a universal service at an affordable tariff.

In deriving an appropriate quantification of any benefit, the NRA should consider the materiality of any benefit and whether it can be calculated with the necessary degree of rigour.

Appendix 6: Guidance on calculating the net cost of the USO

Guidance given in the Third Directive

This appendix provides guidance on how to calculate the net cost of the universal service. The starting point is Article 7(3), which states:

> *Where a Member State determines that the universal service obligations, as provided for by this Directive, entail a net cost, calculated taking into account Annex I, and represent an unfair financial burden for the universal service provider(s) it may:*
>
> *(a) Introduce a mechanism to compensate the undertaking(s) concerned from public funds;*
>
> *(b) Introduce a mechanism for the sharing of the net cost of universal service obligations between providers of services and/or users.*

Further guidance is then given in Recital 20, which states:

> *"The principles of transparency, non-discrimination and proportionality contained in Directive 97/67/EC must continue to be applied to any financing mechanism and any decision in this area be based on transparent, objective and verifiable criteria. In particular, the net cost of universal service is to be calculated, under the supervision of the national regulatory authority, as the difference between the net costs for a designated universal service provider operating with the universal service obligations and operating without the universal service obligations. The calculation shall take into account all other relevant elements, including any market benefits, which accrue to a postal service provider designated to provide universal service, the entitlement to a reasonable profit and incentives for cost efficiency."*

Guidance that is more detailed is given in Annex I to the Third Directive (as attached to Presidency Compromise Proposal dated 25 Sept 2007). It provides "*Guidance on calculating the net cost, if any, of universal service*" as follows:

> *"Part A: Definition of the universal service obligations*
>
> *Universal service obligations refer to the obligations, referred to in Article 3, placed upon a postal service provider by a Member State which concern the provision of a postal service throughout a specified geographical area, including, where required, uniform prices in that geographical area for the provision of that service or provision of certain free services for blind and partially sighted persons.*
>
> *Those obligations may include, among others, the following:*
>
> - *a number of days of delivery, superior to those set in this Directive;*
> - *accessibility to access points, in order to satisfy the universal service obligations,*
> - *the tariffs affordability of the universal service;*
> - *uniform prices for universal service;*
> - *The provision of certain free services for blind and partially sighted persons."*
>
> *"Part B: Calculation of net cost*
>
> *National regulatory authorities are to consider all means to ensure appropriate incentives for postal service providers (designated or not) to provide universal service obligations cost efficiently.*
>
> *The net cost of universal service obligation is any cost related to and necessary for the operation of the postal universal service provision. The net cost of universal service obligations is to be calculated, as the difference between the net cost for a designated universal service provider of operating with the universal service obligations*

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and the same postal service provider operating without the universal service obligations.

The calculation shall take into account all other relevant elements, including any intangible and market benefits which accrue to a postal service provider designated to provide universal service, the entitlement to a reasonable profit and incentives for cost efficiency;

Due attention is to be given to correctly assessing the costs that any designated universal service provider would have chosen to avoid, had there been no universal service obligation. The net cost calculation should assess the benefits, including intangible benefits, to the universal service operator.

The calculation is to be based upon the costs attributable to:

i) elements of the identified services which can only be provided at a loss or provided under cost conditions falling outside normal commercial standards. This category may include service elements such as the services defined in Part A.

(ii) specific users or groups of users who, taking into account the cost of providing the specified service, the revenue generated and any uniform prices imposed by the Member State, can only be served at a loss or under cost conditions falling outside normal commercial standards.

This category includes those users or groups of users that would not be served by a commercial operator that did not have an obligation to provide universal service.

The calculation of the net cost of specific aspects of universal service obligations is to be made separately and so as to avoid the double counting of any direct or indirect benefits and costs. The overall net cost of universal service obligations to any designated universal service provider is to be calculated as the sum of the net costs arising from the specific components of universal service obligations, taking account of any intangible benefits. The *responsibility for verifying the net cost lies with the national regulatory authority. The universal service provider(s) shall cooperate with the national regulatory authority to enable it to verify the net cost."*

"Part C: Recovery of any net costs of universal service obligations

The recovery or financing of any net costs of universal service obligations may require designated universal service providers to be compensated for the services that they provide under non-commercial conditions. As such a compensation involves financial transfers, Member States have to ensure that these are undertaken in an objective, transparent, non-discriminatory and proportionate manner. This means that the transfers result as far as possible in the least distortion to competition and to user demand.

A sharing mechanism based on a fund referred to in Article 7(4) should use a transparent and neutral mechanism for collecting contributions that avoids a double imposition of contributions falling on both outputs and inputs of undertakings.

The independent body administering the fund is to be responsible for collecting contributions from undertakings, which are assessed as liable to contribute to the net cost of universal service obligations in the Member State and is to oversee the transfer of sums due to the undertakings entitled to receive payments from the fund."

Guidance given by the European Parliament and Council

Further support for the calculation is given in the Judgement of the European Court of Justice, 6 December 2001, in Case C-146/00, Commission of the European Communities v French Republic.

The judgement relates to a telecommunication case as follows:

1. Declares that, by failing to comply with Article 4c of Commission Directive 90/388/EEC of 28 June 1990 on competition in the markets for telecommunications services, as amended by Commission Directive 96/19/EC of 13 March 1996, and by failing to comply with

> *Article 5(1), (3), (4) and (5) of Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in Telecommunications with regard to ensuring universal service and interoperability through application of the principles of Open Network Provision (ONP), the French Republic has failed to fulfil its obligations under those directives;"*

Annex III to Directive 97/33 states how the costs of universal voice telephony service obligations are calculated. The annex provides:

> *The cost of universal service obligations shall be calculated as the difference between the net cost for an organisation of operating with the universal service obligations and operating without the universal service obligations…*
>
> *…The calculation shall be based upon the costs attributable to:*
>
> *(i) elements of the identified services which can only be provided at a loss or provided under cost conditions falling outside normal commercial standards…*
>
> *(ii) specific end-users or groups of end-users who, taking into account the cost of providing the specified network and service, the revenue generated and any geographical averaging of prices imposed by the Member State, can only be served at a loss or under cost conditions falling outside normal commercial standards.*

Appendix 7: Can the universal service be self-financed after FMO

In this Appendix, we provide a brief summary of opinion on whether the universal service can be self-financed after FMO[139]. We concentrate on comments supporting self-financing. This list is illustrative and non-exhaustive.

According to a study commissioned in 2006 by nine universal service operators to the independent consultancy Oxera, none of the financing possibilities proposed by the Commission is fully satisfactory, in particular, as regards financial security and social equity. On the other hand, it finds that the reserved area provides a stable financial source, making it less likely that the ongoing provision of the universal service be put at risk.

Derek Holt, author of the study explained:

> *"There is a key trade-off being practicality and simplicity versus pure economic efficiency…For some member states, the most important consideration might be focusing on stimulating more innovation and efficiency...Whereas in others, the importance of preserving a universal service and avoiding a complicated financing mechanism might be the most important criteria – in which case, they are more likely to want to preserve their existing approach."*

According to Dr. Hans-Dieter Petram, member of Deutsche Post World Net's board of management, "*market forces will perfectly replace universal service regulation and will most probably do a better job*" for the 85 % of standard mail from business customers. Thus, he believes that the universal service should be confined to ensuring the provision of services to residential and smaller business users and that “reliable” financing mechanism, which "*have already been successfully employed in postal or electronic communications and elsewhere*, *are already at hand if needed. I emphasise 'if needed'; because if we look at Sweden, we find that universal service has been provided without any subsidies for more than ten years now.*"

[139] www.euractiv.com/en/transport/financing-universal-service-mail-delivery/article-164698. Accessed October 2007.

Nigel Stapleton, chairman of Postcomm has stated "*Competition is already benefiting large mailers through better services and competitive prices, and retail mail users through significant improvements in Royal Mail's quality of service. The Universal Service remains secure and despite some recent weakness in Royal Mail's revenues, the company continues to make a profit from providing it*," he stressed, adding that the decline in Royal Mail's profits is not due to competition from other postal operators but due to Royal Mail's "*inability to control its costs and its need to finance the growing pension fund deficit*".

In a report published in March 2007, PTS concluded, "*there is nothing in the Swedish experience that may indicate that competition in the entire postal market should be regarded as a problem*". The Agency criticises the "*old but erroneous argument*" that monopoly gains are needed to finance the universal service, saying that Sweden has survived perfectly well without any reserved areas whatsoever. "*Swedish legislation is founded on the notion that the universal service can be provided on a strictly commercial basis, which has proved to be correct.*"

UNI Postal, which represents trade unions in the postal sector insists that a reserved area is the only financing mechanism proven to guarantee universal services throughout the EU, and calls for it to be maintained until a satisfactory alternative is ensured.

The European Postal Users Group (PUG), which represents related companies such as publishers, distance sellers, advertisers, envelope manufacturers and paper producers, stresses that an excessive universal service encourages the cross-subsidisation of unprofitable services, thereby increasing the burden for postal customers. It states, "*A competitive market will require a more flexible definition of the USO…The USO should evolve to guarantee just the core need for sustaining reliable, predictable and sustainable final and universal delivery networks for letter post. This will enable complete market liberalisation, the entry of new players into the market, and the provision of meaningful choice to users through effective competition in practice*."

The Free & Fair Post Initiative (FFPI), which represents users and competitors of the public postal operators agrees: "*In light of the on-going transformation of the postal sector, the current definition of the Universal Service Obligation is no longer appropriate for the development of the market…It should be redefined in* *terms of the minimum level of service that is to be guaranteed to consumers.”* It adds: "*The necessity of maintaining a reserved area to finance the USO has not been proven; moreover it has often been used as an excuse to protect the USP monopolies*."

Appendix 8: Abuse in postal markets after FMO

Country	Price abuse	Non-price abuse
Sweden	Since 1993, numerous examples of price and non-price abuse of market power by Posten. More than 100 cases with the Competition Authority between 1993 and 1999 alone	Posten has disputed with CityMail about unfavourable access conditions
United Kingdom	Postcomm has investigated claims of predation and margin squeeze from market entrants	Royal Mail ("RM") has been subject to fines as the result of anti-competitive practices and failure to meet quality of service targets; New entrants concerned about non price discrimination: - allegations that RM has obtained unfair commercial advantage by using information gained through negotiations with operators to target customers likely to consider switching to those operators - allegations by competitors of discrimination in downstream access conditions
Belgium		The European Commission issued a decision in 2001 on the abuse of dominant position by De Post/La Poste. A preferential tariff in the general letter mail service was offered by De Post/ La Poste subject to acceptance of a supplementary contract covering a new business-to-business mail service
France	La Poste was accused of granting its subsidiaries price discounts and differential service conditions, which were not available to third parties. The ECJ ruled *"…the economic power which the holder of the exclusive right has over the other undertakings active on the upstream markets gives rise to a conflict of interest*". This was ruled as constituting an abuse	
Netherlands	The distribution of return mail first delivered by a competitor and inserted into the street letter collection boxes was charged to the clients of competitors at commercial prices (tariff for handling plus a fine). This caused a financial burden for the clients of the competitors and hindered switching of postal operators	The regulator has dealt with disputes regarding access conditions to the TNT's facilities (e.g. the time during which the competitors can access P.O. Boxes)
Germany	Access charges were a core element of a dispute between Deutsche Post AG and its competitors – there was disagreement about the charges payable and the Ruling Chamber had to set prices, which reflected efficient operator costs German courts have dealt with disputes related to alleged excessive pricing for letter mail	Complaints from competitors that DPAG denied them access to its P.O. box facilities. Similar disputes related to access for change of address information and redirection of found and wrongly addressed letters. There has been a DPAG practice of taking cases against other operators, mirrored by An Post taking DX to court. Some have suggest this is not to win, but used as a delay tactic.

Source: Ecorys (2005), "Liberalisation, privatisation and regulation of postal services in Europe – first international experiences in the run-up to new European Regulations" PIQUE (2007), "Promoting competition in postal services" OECD (1999), "The structure and effect of international postal reform" AEI (2003), WIK (2006), "Is competition policy working for European business?" European Government business relations council, WIK (2004).

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Appendix 9: Types of price control

Introduction

The optimal model of a regulatory control regime for a particular firm or industry depends on its cost and demand functions and the extent of competition. The Third Directive requires *"that prices must … give incentives for efficient universal service provision*"[140]. Therefore, this presents an additional consideration when selecting a form of price regulation in Ireland. This appendix gives a brief overview of different forms of control as well as their efficiency incentivising properties, with a focus on "RPI-X" price caps.

There are five key generic forms of regulatory control regime: i) rate of return regulation; ii) incentive plans; iii) fixed price control or the "CPI – X" price cap system; iv) cost plus control; and v) profit sharing.[141]

The first two types regulate the rate of return that the firm can earn while the last three are variations of the formula:

$_{Pt} = (1\text{-}a)\ c^*_t + ac_t$, where

- Pt is the price;
- c^*_t is expected unit cost;
- c_t is the actual unit cost; and
- *a* is the proportion of cost overruns borne by consumers.

A zero value of *a* implies a fixed price control; a value of *a* equal to one is consistent with a cost plus control; and the value of *a* other than zero or unity implies a profit sharing control.

Rate of return ("ROR") and incentive plans

Under ROR regulation, the firm is allowed to earn a "fair" rate of return on its regulatory value. This required rate of return is normally set to emulate the cost of capital required by the investors in the firm if it were to operate in a competitive market. The firm is free to choose its product prices, output level, and inputs as

140 Third Directive. Article 12, seconded indented point.

141 These forms of regulation may be subject to a *cost pass-through*, which is normally applied to a part of the regulated business rather than the total business. A cost pass-through is usually applied to services and products whose costs are outside the firm's control, and/or are uncertain during the period of the price control.

long as its rate of return stays within the limit. The ROR indirectly limits the overall level of output prices.

However, this approach lacks incentives to maximise cost efficiency and to innovate, because all cost savings (and hence also inefficiencies) are passed on to consumers. In fact, the regulated firm might undertake a number of actions that can lead to losses in economic efficiency, such as choosing to decrease output and charge higher prices, to substitute capital costs for operating costs (chiefly labour) to increase asset value or to produce in excess of demand to justify the expansion of its asset base.

"Incentive" schemes generally represent modifications of the traditional ROR and may be used to incentivise a firm to improve its performance in terms of cost efficiency, innovation, safety, quality of service and product standards. For example, incentive premiums in excess of the allowed rate of return may be granted as a reward for achieving single or multiple, specific, performance targets, general regulatory monitoring activities such as management audits and prudency investigations may be carried out or rates may be set to reflect average or benchmark costs of a basket of comparable firms, rather than firm-specific costs.

These approaches avoid some of the direct economic costs of traditional ROR and provide pricing flexibility. However, there are some limitations to these approaches, including the risk of targets being set arbitrarily, thereby distorting incentives.

Price control ("RPI-X" or "CPI-X")

Under a price control, a regulator sets a price cap on the firm's products or services. Profiling the allowed revenues period derives the level of prices at the beginning of the price control by an RPI-X formula (or CPI-X). The initial price is rolled forward annually over the period of the price control[142] by RPI-X (or CPI-X), where:

- RPI/CPI is a general inflation index (e.g. retail price index or consumer price index); and
- X is the so-called efficiency factor, which is meant to reflect the expected net gains or losses in productivity over the price control period.

[142] The price control is normally set for a period of five years.

The firm can set a price at or below the cap and retains all profits it generates for the period of the price control. Some RPI-X regimes have a correction mechanism (generally applied on an annual basis), which becomes effective if the firm generates returns in excess of the built-in return allowed by the regulator, and such excess returns occur for reasons other than improvements in efficiency.

The X factor in the RPI-X formula can be determined by benchmarking and using both quantitative analyses (e.g. cost and demand regressions and total factor productivity) and qualitative judgements. .

In case of a multi-product or multi-service firm, there are a number of price control options including (i) a cap on each of the firm's services and/or products (a revenue yield or cap on unit revenues); (ii) a cap on a weighted average of the prices (commensurable services/products only); and (iii) a tariff basket.

Incentive properties of RPI-X price caps

Incentives for efficiency are provided through the use of productivity targets, price indices, and some kind of profit-sharing mechanism. The firm retains gains in excess of the X factor over the period of the price control and the new price control will generally be set tighter, to reflect the higher than expected gains in efficiency. This is intended to emulate the correction that would be imposed by market forces. NERA has demonstrated that in the UK 71% of unanticipated gains from outperforming the efficiency target are passed on to consumers by way of lower prices following the periodic review[143].

The price cap mechanism also imposes a penalty for inefficiency. If the firm's costs increase by more than RPI-X, output prices will not cover the actual costs incurred by the company. This penalty is borne by the shareholders, and therefore the firm has a strong incentive to be cost-efficient.

There are a number of other benefits of RPI-X price caps:

- incentives for over-capitalisation essentially disappear, as there is no direct link between the rate of return and profitability;
- price caps also provide stability and predictability in prices;
- as compared with ROR, they also reduce the incentive for cross-subsidisation once the new price control period has started. The company has no incentive to shift costs from competitive services to monopoly

[143] Ivan Viehoff. "Evaluating RPI-X". NERA Topics 17. NERA.

services, as the actual level of costs in each business is only considered periodically (typically every five years) rather than on an annual or more frequent basis; and

- price caps are set only at the beginning of the price control period instead of annually and therefore avoid some of the direct regulatory costs associated with traditional ROR.

However, there are some drawbacks:

- price caps do not provide direct incentives for investment. However, this is usually overcome through capital expenditure monitoring by the regulator;
- the question of whether productivity increases can be attributed to the firm’s endogenous factors or exogenous, uncontrollable forces can become an area of contention between the regulator and the regulated company;
- there might possibly be a lack of concordance between the factor composition of the general inflation index used and the firm's actual inflation factor composition, leading to either over-recovery or under-recovery of real costs; and
- if the RPI-X approach is not accompanied by quality of service obligations, the regulated firm may seek to compromise on quality to beat the inflation and productivity indices.

Cost plus

The only incentive-free form of control is cost plus. Cost plus regulation ensures that the firm recovers all of the costs it incurs, disregarding the actual level of such costs.

Profit sharing

Profit sharing is effectively a compromise between RPI-X and ROR forms of control, and as such dilutes the incentive properties of the RPI-X mechanism. One example of a profit sharing mechanism is where earnings in excess of the benchmark are shared in a predetermined proportion (with no sharing of the losses) between shareholders and consumers, with no floor or ceiling on the return. When applied to public enterprises, profit sharing provides no real incentive for the management, in terms of personal gain or greater budget in future years, to maximise their share of profit.

Other forms of control

Other forms of control may be used to complement the major forms of control discussed above. These include the use of taxes to influence the behaviour of an industry, for example where it is believed that excess profits are being generated, and the use of social, environmental and other licence obligations. In addition, a system of franchise bidding can be used as an alternative to ROR and price cap regulation, whereby candidates bid for a franchise based on the unit price of the products/services that the franchisee would sell.