Price control format and scope

A REPORT PREPARED FOR COMREG

July 2013

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Executive Summary

Section 30 of the Communications Regulation (Postal Services) Act 2011 ("the 2011 Act") requires ComReg to regulate prices for An Post's postal services within the scope of universal postal service through a price cap in the form of CPI –X%.

Frontier has been commissioned to provide assistance to ComReg in setting such a price cap for the universal service provider's postal services within the scope of the universal postal service that are found to have no effective competition. The model is to be accompanied by a set of recommendations on how the price cap should be set.

A key first stage is to decide on the format and scope of the price control. There are three main design elements to the price control:

- the exact form of the price control;
- which of An Post's postal services within the scope of the universal service should be included in any price cap; and
- identifying the basket or baskets of postal services to be specified for any price cap.

In coming to decisions on each of the above design elements, it is essential to bear in mind:

- ComReg's responsibilities determined by the 2011 Act; and
- the An Post products within the scope of the universal postal service that could potentially be price controlled.

Form of price control

The first significant design decision that must be made in relation to the price control, is the form of the control. In practice, application of a CPI-X framework can be done in different ways and consideration must be must be given to a number of key issues:

- whether to implement a cashflow based or a Regulatory Asset Base (RAB) based price control;
- how to treat volume uncertainty and risk; and
- how to incorporate efficiency cost targets into the control.

We discuss each of these in turn below.

High level design

Within the CPI-X framework, there are two different methods for determining the revenues a regulated firm is allowed to earn.

- The cashflow approach sets allowed revenue in each year equal to the sum of operating expenditure, capital expenditure and a margin on turnover for that year.

- The Regulated Asset Base (RAB) approach sets allowed revenue in each year equal to the sum of operating expenditure, depreciation and a return on a regulatory asset base (RAB) for that year.

The key difference between the two models relates to their treatment of capital investment. Where capital investment is substantial, and in long-lived assets, the RAB model would appear to be more appropriate. Where capital investment is less significant as a proportion of total costs or revenues, a cash-based control is likely to be more appropriate. In post, we see that, relative to total expenditure, capital investment tends to be small (in the region of 10% or less of total expenditure). Furthermore, the asset lives of the capital investments used in the postal sector are, in general, short. Consequently, we recommend that the price control be set on a cashflow basis.

Volume uncertainty and risk

Price controls are forward-looking in nature and are therefore based on assumptions about future costs and volumes. There will, inevitably, be some uncertainty in the determination of these forecasts, resulting in differences between actual and expected values during the regulatory period.

Our previous analysis suggests that there may be significant volume risk and uncertainty for An Post over the planned price control period 2014 - 2018. Consequently, we recommend that, as part of the price control determination, ComReg give consideration to the introduction of mechanisms to manage volume risk and uncertainty.

Efficient costs

The 2011 Act Section 30.3.b states: "*ensure that the price cap provides incentives for efficient universal postal services provision.*" Pursuant to this section of the Act, the price control must therefore only reflect costs of efficient service provision. A key element of the price control will therefore be to consider what the current level of efficiency of An Post is and if any efficiency gains can be made.

We recommend that if An Post is deemed by the regulator not to be fully efficient at the start of the price control period, consideration should be given to the use of a glide path towards efficient costs to allow An Post sufficient time to align its cost base with an efficient level. This would ensure the sustainability of the USO while making sure consumers benefit as soon as possible from improved efficiency. The time period and trajectory of any such glide path can only be determined once the efficiency review has been undertaken and the level (if any) of any potential inefficiency identified, and estimates made of the time necessary to make adjustments to the cost base.

Scope of the products under the price control

Once the form of the price control has been determined, the next step of the price control process is to determine the products that will come under the scope of the price control. For a product to come under the scope of the price control, ComReg must determine that the product faces no effective competition in the market for its supply. The key question that must therefore be asked in assessing each of the products under consideration is:

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

In order to carry out such an assessment, three areas should be considered:

- **the extent of postal competition -** Each product under consideration can be judged against four assessment criteria to determine the extent of postal competition:
  - existence of barriers to entry;
  - scale and nature of competition;
  - customer awareness and behaviour; and
  - effectiveness of competition in postal services.
- **the extent of non-postal competition -** we also consider any evidence in relation to the degree of constraint exercised by non-postal alternatives; and
- **whether there are any benchmark universal service products provided by An Post that, if price controlled, would place sufficient constraint[1] on the price of the product under consideration** - There are two important factors to compare when assessing whether a potential benchmark product exists:
  - product characteristics; and

1 Throughout this report we use 'sufficient constraint' to mean as much constraint as is needed to prevent An Post engaging in excessive pricing behaviour in relation to the product under consideration.

- volume and price changes over time.

Based on the above competition assessment, **Table 1** summarises our recommendations on the products that should be included in the scope of the price control.

Table 1. Summary of Frontier's recommendations on the products that ComReg should include in the scope of the price control

An Post product under consideration	Recommendation
Standard Post – Stamp and Label (Letters, Flats, Packets and Parcels)	Standard Post – Stamp and Label (all formats) should be price controlled. An Post faces little postal competition and non-postal competition for this product. Existing competition is from courier and express service providers, predominantly limited to packet and parcel segments. However, large price differentials exist between An Post and competitors at weightsteps <2kg.
Standard Post – Meter (Letters, Flats, Packets and Parcels)	Standard Post – Meter (all formats) should be price controlled. As with Standard Post – Stamp and Label, An Post faces little postal and non-postal competition for the product. Further, Standard Post – Stamp and Label is unlikely to place sufficient constraint on the price of this product.
Certificate of Posting (Available with all Standard Post products)	Certificate of Posting should be price controlled. An Post is the only operator who can provide such a service for single piece universal postal services and no benchmark products are available.
Registered Post (Letters, Flats, Packets and Parcels)	All formats of both the Proof of Delivery service and the Insured service (currently combined as a Registered Post service) should be price controlled. Postal competition for this product is limited and in most cases customers use the service to send physical items, so non-postal alternatives aren't available. No potential benchmark products.
Postal services to blind and partially sighted (Letters, Flats and Packets to domestic and international destinations)	Postal services to the blind and partially sighted (all formats and destinations) should not be price controlled. Legislation requires this service to be provided free of charge.
Bulk Mail: Ceadúnas (License) – Fully paid and Discounted (Letters, Flats, and Packets where applicable)	Discount 6 – Deferred processing (presentation before noon 85%+ autosort), available for letters and flats, and Discount 9 – Presort (152 sorts) before 5:30pm, available for letters, flats and packets, should be price controlled. The remaining Ceadúnas variants should not be price controlled. Although An Post faces little postal and non-postal competition in relation to any Ceadúnas variants, our analysis suggests that price controlling discount 6 and

	discount 9 will place sufficient constraint on An Post's pricing of other discount variants. Standard Post – Meter will place sufficient constraint on An Post's pricing of the fully paid variant.
International Bulk Mail Service (IBMS) (Letters, Flats, and Packets where applicable)	Standard IBMS (all formats) should be price controlled, while IBMS Extra and IBMS DSA (UK Only) should not be price controlled. Postal and non-postal competition for IBMS is limited. However, it appears that Standard IBMS would act as an appropriate benchmark to sufficiently constrain An Post's pricing of the other IBMS variants.
PO Box	PO Box should be price controlled. We are not aware of any other postal, express or courier service providers who offer a similar service in Ireland and there is no non-postal competition given its physical nature.
Poste Restante	Post Restante should not be price controlled. Legislation requires this service to be provided free of charge.
Residential and Business Redirection	Residential and Business Redirections (of all durations) should be price controlled. An Post does not face any postal or non-postal competition for this product.
Mailminder	Mailminder should be price controlled. An Post is the only provider who can offer such a service due to the need to intercept mail at the delivery sorting office or delivery sorting unit level. No benchmark products to sufficiently constrain An Post's pricing of Mailminder.
Business Reply and Freepost	Business Reply should not be price controlled, while Freepost should be price controlled. An Post currently doesn't face postal competition for this products and non-postal alternatives provide limited constraint on An Post's pricing of these products. However, our analysis suggests that Freepost could act as a benchmark product for Business Reply.

Setting the basket or baskets of products

The 2011 Act allows for the price cap to be specified in respect of one, or more than one, baskets of the services that come within the scope of the price control. Although the use of more than one basket prevents An Post from re-balancing tariffs between baskets, it does not limit An Post's pricing freedom within each basket. Instead, this will be determined by the form of each basket. In relation to the form of the basket(s), there are two important design questions that need to be considered:

- **how to weight the products in each basket** – a firm's profit maximising pricing choices will differ depending on whether an average revenue or a tariff basket control is used; and
- **how much tariff re-balancing freedom to afford the operator**.

In relation to the second design decision, although tariff rebalancing carried out by an operator within each basket could be expected to be efficient, it also raises two concerns:

- possible distortion of competition faced by some services; and
- different effects on different types of customers.

As such, it may be appropriate to place some limits on the degree of rebalancing freedom afforded to An Post in relation to each of the defined baskets by introducing further constraints.

In order to determine the number, characteristics and form of the basket(s), a trade-off will be required between:

- allowing An Post sufficient commercial freedom to rebalance prices; and
- protecting customers.

We have identified a number of risks associated with allowing An Post too much pricing freedom. In particular, there is a risk that:

- the use of one basket would not protect residential customers from An Post's ability to exercise market power, thereby undermining a key objective of the price control; and
- there could possibly be a distortionary impact on competition if An Post were to exercise excessive rebalancing of prices, and reduce prices significantly on products that face more competition.

Equally, it is important not to unduly restrict An Post's commercial freedom to the extent that they themselves are left at a competitive disadvantage.

The reliance on an ex-post safeguard, such as the pricing requirements outlined in section 28 of the 2011 Act, does not appear to be attractive from a regulatory point of view. We therefore recommend that ComReg consider imposing some ex ante limitations on the pricing freedom that is afforded to An Post. In particular, we suggest that ComReg should consider either:

- using a single basket, along with limits on the degree of tariff rebalancing that An Post can undertake within a price control period; or
- using multiple baskets of products.

At this early stage of the price control process, we do not yet have the data on volumes, costs, revenues and market shares that would be needed to provide a definitive recommendation in relation to the choice between the options above. Instead, we recommend that this is reviewed and determined in conjunction with the decision on the overall price cap, when more information is available.

1 Introduction

Section 30 of the Communications Regulation (Postal Services) Act 2011 ("the 2011 Act") requires ComReg to regulate prices for An Post's postal services within the scope of universal postal service through a price cap in the form of CPI –X%. The forthcoming price control will be the first time that An Post has been subject to such a price control.

Frontier has been commissioned to provide assistance to ComReg in setting such a price cap for the universal service provider's postal services within the scope of the universal postal service that are found to have no effective competition. The model is to be accompanied by a set of recommendations on how the price cap should be set.

In carrying out this work, our terms of reference require us to carry out 5 key tasks:

- following a review of An Post's postal services within the scope of the universal service to ascertain if there is effective competition in the market for the supply of those postal services, set out which of those services should be in any price cap;
- set the basket or baskets of postal services to be specified for any price cap;
- provide detailed modelling to set the price cap, in particular on the X factor required in order to provide incentives for the efficient provision of the postal services concerned;
- review An Post's forecast volumes for the 5-year period that will apply for the price cap and report how this review has been considered in the price cap; and
- report how the recommended price cap:
  - has regard to the tariff requirements under section 28(1) of the 2011 Act. This will include making a recommendation as to how the tariff requirements should be specified;
  - provides incentives for efficient universal postal services provision;
  - has regard for ComReg's statutory objectives; and
  - protects the interests of postal service users, in particular businesses and Small and Medium Enterprises (SMEs).

It is vital that the first two of these key tasks are completed before the remainder of the price control process can take place. In order for this to happen, a decision must be made in relation to a third significant design element, the exact form of the price control.

This paper covers each of these three design elements and is structured as follows:

- chapter 2 provides background on the legislation and regulation behind the setting of a price cap and the products that can be considered for inclusion in the scope of the control;
- chapter 3 sets out our recommendations in relation to the form of price control; and
- chapter 4 provides a summary of our competition assessment of each candidate product and our subsequent recommendation in relation to the scope of the price control;
- chapter 5 outlines our recommendations in relation to the basket or baskets of postal services that should be specified for any price cap;
- chapter 6 concludes with a summary of our recommendations in relation to the above.

2 Background

In order to come to a decision on the three price control design elements covered by this paper, it is necessary to bear in mind:

- ComReg's responsibilities determined by the 2011 Act; and
- the An Post products within the scope of universal postal service that could potentially be price controlled.

This section provides further details on both of the above.

2.1 Overview of ComReg's responsibilities

Under section 30 of the Communications Regulation (Postal Services) Act 2011 ("the 2011 Act"), ComReg is required to, following a public consultation, specify a price cap in the form CPI –X%. This should be done in respect of basket(s) of postal services within the scope of the universal postal service provided by the universal postal service provider, where ComReg is of the opinion that there is no effective competition in the market for the supply of the postal services concerned.

The 2011 Act also sets out that the public consultation on the price cap must relate to:

- the services to be included in a basket of postal services[2]; and
- the proposed approach for setting the price cap for the basket of postal services under the CPI-X approach.

Pursuant to the 2011 Act, the price cap must apply for a period of five years, subject to a review by ComReg after three years.

The 2011 Act also specifies a number of requirements relating to the tariffs for each postal service or part of a postal service provided by the universal service provider in the provision of the universal postal service. Under section 28(1) of the Act, these tariffs must be:

- affordable and be such that all postal service users may avail of the services provided;
- cost-orientated, that is the prices shall take account of, and reflect the costs of, providing the postal service or part of the postal service concerned;

2 The 2011 Act defines "basket of postal services" as any postal service or group of such services, within the scope of the universal postal service, provided by a universal service provider, specified in the price cap decision.

- transparent; and
- non-discriminatory.

2.2 Price controlled products

The 2011 Act specifies that ComReg can only price control "*postal services within the scope of the universal postal service provided by the universal postal service provider*".

Section 17 designates An Post as the "*universal postal service provider*".

With regards to "*postal services within the scope of the universal postal service*", section 16 of the Communications Regulation (Postal Services) Act 2011 ("the 2011 Act") sets out a general description of the "universal postal service" that An Post as the designated "universal postal service provider" is required to provide. Section 16 (1) specifies the universal postal service to mean one clearance and one delivery every working day. It also specifies that the following services must be provided under the universal postal service:

- the clearance, sorting, transport and distribution of postal packets up to 2kg in weight;
- the clearance, sorting, transport and distribution of parcels up to 20kg, unless alternative weight threshold is specified by ComReg;
- the sorting, transportation and distribution of parcels from other Member States up to 20kg in weight;
- a registered item service;
- an insured item service within the State and to and from all countries which, as signatories to the Universal Postal Convention of the Universal Postal Union, declare their willingness to admit such items whether reciprocally or in one direction only; and
- postal services, free of charge, to blind and partially sighted persons.

Based on the requirements set out under section 16(1), ComReg is required by section 16(9) of the Act to "make regulations specifying the services to be provided by a universal postal service provider relating to the provision of a universal postal service". As a result, following public consultation, ComReg made the Communication Regulation (Universal Postal Service) Regulations 2012 in SI 280 of 2012. In making these Regulations, ComReg specified a "de minimis" set of universal postal services that meet the needs of postal service users, while also minimising the regulatory burden on An Post as the universal service provider. **Table 2** summarises the universal postal services that were specified, along with the An Post products that meet these requirements. All of these products can be price controlled if ComReg is of the opinion that there is no effective competition in the market for the supply of the postal services concerned.

In addition to the specific universal postal services outlined in SI 280 of 2012, there are a number of further products that are deemed by An Post to lie within the scope of the universal postal service:

- Fully paid Ceadúnas;
- Ceadúnas Discount A, 1-5, 7-8 and 10;
- IBMS Extra; and
- IBMS DSA (UK only)

These services may also be price controlled if ComReg is of the opinion that there is no effective competition in the market for the supply of the postal services concerned.

Table 2. Universal Postal Service products

Communications Regulation (Universal Postal Service) Regulations in SI 280 of 2012	Equivalent An Post Product
A single piece service involving the clearance, sorting, transport and distribution of letters	Standard Post (Stamp and Label), Letters Standard Post (Meter), Letters
A single piece service involving the clearance, sorting, transport and distribution of large envelopes	Standard Post (Stamp and Label), Flats Standard Post (Meter), Flats
A single piece service involving the clearance, sorting, transport and distribution of packets	Standard Post (Stamp and Label), Packets Standard Post (Meter), Packets
A single piece service for the clearance, sorting, transport and distribution of parcels	Standard Post (Stamp and Label), Parcels Standard Post (Meter), Parcels
Issuing free certificates of posting	Available with all Standard Post products on request when the postal packet is deposited at a post office
A registered items ("proof of delivery") service	An Post currently only offer a combined registered and insured service – Registered Post National. An Post will shortly offer separate services as required by the 2011 Act.
An insured items service	See above

A single piece service provided free of charge to the postal service user for the transmission of postal packets for the blind	Articles for the Blind
A service for the clearance, transport and distribution of "postal packets deposited in bulk" for "delivery only"	Ceadúnas Discount 9 (PreSort (151 Sorts) before 5:30pm)
A service for the clearance, transport and distribution of foreign postal packets deposited in bulk pre-sorted by country of destination	Standard International Bulk Mail Service (IBMS)
A service for the clearance, transport and distribution of "postal packets deposited in bulk" for "deferred delivery"	Ceadúnas Discount 6 (Deferred processing presentation before noon 85%+ autosort)
A service for the sorting, transport and distribution of postal packets deposited with a universal postal service provider at an Office of Exchange within the State by the designated operator of a signatory to the Universal Postal Convention	Inbound International Mail[3]
The following special facilities for the delivery of postal packets at the request of the addressee: • Private boxes and bags • Redirection	PO Box Redirection (Residential and Business) Poste Restante Mailminder

3 Although the costs and revenues of this product will be considered as part of the price control, it will not be explicitly included within any price cap(s). This is because the price for these products will be set by the designated operator of a signatory to the Universal Postal Convention (UPC). Payment to An Post will be in the form of terminal dues. For UPC signatories, these are determined by the Universal Postal Union (UPU) and are designed to cover costs incurred for the sorting, handling and distribution of postal packets from the sending country, within the receiving country.

• Poste restante • Mailminder • Business Reply • Freepost	Business Reply Freepost

3 Form of price control

3.1 Legal framework

The 2011 Act specifies the high level features of the price control but is not prescriptive about the way in which the price cap should be designed. Section 30(1) of the 2011 Act specifies that:

- the price cap will be established after a public consultation and take the form CPI-X;
- a price cap can be specified in respect of one or more than one baskets of services;
- the length of the price control should be 5 years (subject to review after 3 years);
- the price cap will apply to postal services within the scope of the USO provided by the USP where there is no effective competition.

Specifically, according to the 2011 Act, the price cap must specify the maximum annual percentage change in charges that can be imposed for any basket of postal services. This must be calculated in accordance with the following formula:

$$\textit{Overall limit} = (\Delta\ CPI) - X$$

Where 'CPI' is the consumer price index number as compiled by the Central Statistics Office and 'ΔCPI' is the annual percentage change thereof. 'X' also known as the X-factor is the adjustment specified by ComReg to provide incentives for the efficient provision of postal services.

In determining the price cap ComReg must have regard to the tariff requirements of the 2011 Act[4] are:

- Affordability: such that all postal service users may avail of the services provided;
- Cost-orientation: prices shall take account of, and reflect the costs of, providing the postal service or part of the postal service concerned; and
- Transparency and non-discrimination.

The 2011 Act further specifies that the price cap must be set by ComReg in a way that:

- incentivises efficient operations; and

4 Furthermore, by the 2011 Act, An Post must ensure that its prices for its universal postal services are compliant with the tariff requirements of the 2011 Act

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

In relation to the first of these points, while it is clearly important to provide incentives to An Post, it is also important to ensure the sustainability of the USO and financeability of An Post, in line with ComReg's statutory duties.

To ensure compliance with the principles set out in the legislation outlined above it is essential that a price cap decision is supported by robust analysis and evidence.

3.2 Design of price control

At a general level, setting the level of a price control within the CPI-X framework requires an estimate of the revenue that would be needed to finance an efficient, well-run business. In practice the practical application of a CPI-X framework can be done in different ways and consideration must be must be given to a number of key issues:

- whether to implement a cashflow based or a Regulatory Asset Base (RAB) based price control;
- how to treat volume uncertainty and risk; and
- how to incorporate efficiency cost targets into the control.

We discuss these in detail in the following sections.

3.2.1 High level design

Within the CPI-X framework, there are different methods for determining the revenues a regulated firm is allowed to earn. A forward-looking price cap has to allow the regulated company to earn sufficient revenue to fund the expected efficient costs of providing the services covered by the control. Allowed revenue can be calculated in two ways, with the main difference arising in the treatment of capital expenditure.

- The cashflow approach sets allowed revenue in each year equal to the sum of operating expenditure, capital expenditure and a margin on turnover for that year. The margin on turnover is principally designed to cover the costs of financing working capital. Such an approach was used for the first Royal Mail price control.

- The Regulated Asset Base (RAB) approach sets allowed revenue in each year equal to the sum of operating expenditure, depreciation and a return on a regulatory asset base (RAB) for that year. This method has been commonly used in price controls for industries with long-lived assets, such as the energy network businesses.

Under both the cashflow and RAB approach, regulators set an opex allowance in a way that allows the regulated firm to recover an efficient level of day-to-day operational expenditure.

The advantages and disadvantages of each methodology are considered in the following section and a recommendation on the appropriate option to use for the calculation of An Post's price control is provided.

Cashflow approach

Under this approach the price control is based on the cash allowance a regulated firm needs to run its business efficiently. The building blocks of allowed revenue under this model are an opex allowance, a capex allowance and a margin on revenue (geared towards financing a working capital allowance and to provide a margin to compensate for the risk that the regulated company may face during the period). In principle, this approach could lead to volatility in allowed revenue from year to year if capex was large relative to the total cost base and varied significantly from year to year. In reality, capex makes up only a small proportion of An Post's expenditure so even if it varies from year to year it is unlikely to cause fluctuations in allowed revenues. Typically, if capex were large relative the the total cost base, this would be indicative that a RAB-type approach might be more appropriate.

Under the cashflow approach, customers fund expected operating expenditure and capital expenditure in the year that it is expected to be incurred at the time the price control is set. This has implications for investment incentives, prices and efficiency. We assess each of these factors in turn and then discuss practical considerations for calculating the price control using this approach.

Implications for investment

Because capital expenditure is funded when it is incurred – 'pay as you go' – a regulated company has certainty that the full cost of investment will be recouped, once it has been included within the regulator's estimation of allowed revenue. Therefore, providing the investment is included in the regulator's forecast of capital spend within a price control period, there is little residual risk that the asset will subsequently be stranded (i,e, the operator incurs the cost but subsequently prices are not sufficient to pay for the investment, as the prices immediately reflect the investment cost).

The cashflow approach finances expected efficient expenditure, rather than actual expenditure. As discussed below, this is to the company's benefit if expenditure is below expectations. However, if expenditure exceeds expectations the company bears the risk of the overspend. In particular, the cashflow approach has no clear mechanism within it for allowing the company to recover the cost of any expenditure that it may have incurred within a control period that was not forecast when the control was set. It would be possible to introduce specific mechanisms that trigger changes in the control to allow for unexpected investments to be funded (assuming they are considered to be efficient by the regulator).

Implication for prices

The impact of 'pay as you go' financing of capital expenditure on prices will depend on the scale and cyclicality of the investment programmes. If capital expenditure is a significant proportion of total costs (and hence allowed revenue), and if projects are lumpy in nature, this methodology can result in price volatility within a regulatory period and/or across regulatory periods. In contrast, if capital expenditure is a small proportion of allowed revenue and/or the level is similar from year-to-year, volatile prices are less likely to emerge.

Implications for efficiency

Incentives to improve cost efficiency are strong under the cashflow approach. If the company delivers a capital expenditure project for less than had been forecast, it gets to retain this benefit during the control period. This provides an incentive that is equivalent to any one-off opex efficiency saving. At the same time, it is important that actual outturn capital expenditure is monitored to ensure that planned investments remunerated through the price cap are actually delivered. If any discrepancies between planned and outturn capex are observed, capex allowances could be adjusted at the 3 year review and/or subsequent price caps.

Implications for returns

Since the regulated business does not need to raise funds (either equity or capital, other than working capital) to finance any investments, an explicit return on capital is not included in the price control formula. With the cashflow approach, the regulated business is provided with a margin on turnover. This provides the business with a return, or 'insurance', to compensate for the risks that it faces during the regulatory period. The risks relate to adverse shocks that the firm may experience within a control period that could lead to an increase in costs or reduced volumes and revenues in the case of An Post. The extent to which the regulated firm needs to be compensated for such risks will depend on the degree of exposure that it faces. The regulatory regime can, in part, manage this exposure. For example, volume adjustment mechanisms can be included in a price control to limit exposure to volume shocks (this is discussed in subsequent sections). While some of the volume risks can be mitigated, certain other risks may remain e.g. unexpected increases in opex or capex out of the control of the operator.

Practical implications

Calculating allowed revenue using the cashflow approach requires data on:

- annual efficient operating expenditure;
- annual efficient capital expenditure;
- annual turnover; and
- a margin on turnover.

In our view, compiling this data should not constitute an onerous requirement on An Post.

RAB control

With the RAB approach, operating expenditure is financed on a 'pay as you go' basis (identical to the cash flow approach) but capital expenditure is financed over the life of the assets that the investment relates to. For example, if there is an investment in a gas pipe that has a useful economic life of 50 years, the capital expenditure will be financed over 50 years. Under this approach, a business can expect to earn both a depreciation charge (return of) and a return on the investment (cost of capital times the RAB) for the life of the asset. The RAB is calculated as an opening asset value plus expected efficient new investment less depreciation of the asset base. At each price review, expected capital investment in the previous regulatory period is replaced with actual efficiently incurred investment.

The building blocks of RAB-based price cap regulation are the opex allowance, the RAB, the WACC, allowed Capex and depreciation. In order to implement a RAB-based control, a regulator needs to determine the value of the RAB in the first price control period. Thereafter, the RAB is rolled forward by indexing for inflation, removing depreciation, and adding new capital expenditure (capex). A number of issues need to be considered by regulators when determining the RAB and the return which can be earned on it including:

- How to value the RAB in the first price control. Valuing the RAB involves two steps:
  - 1) Determining which assets to include in the RAB – it is important that the RAB includes only those assets necessary to provide the regulated services; and
  - 2) Determining what method to use to value these assets – asset value can be based on actual incurred costs or current replacement value.

- What further investments are allowed to be included in the RAB - it is important that clear rules are set which provide incentives for efficient investment;

- What depreciation method to apply to the RAB – this can be straight-line depreciation where equal amounts of depreciation are allocated to each accounting period of the asset's life. Alternatively a declining-balance method can be applied where decreasing amounts of depreciation are allocated to each accounting period of the asset's life; and

- How to estimate the cost of capital. This is a crucial element of the RAB-based approach as it determines the allowed return on the RAB. The cost of capital is related to the systematic riskiness of a company's return. The standard way regulators calculate the cost of capital is through the Weighted Average Cost of Capital / Capital Asset Pricing Model (WACC-CAPM) approach.

The impact of this approach on investment incentives, prices, efficiency and shareholder return are discussed here.

Implications for investment

In theory, it could be considered that when investments are funded over the life of the asset, companies bear the risk that regulators will not provide the required funding in later years. However, in reality the RAB-based model has been associated with successfully incentivising large-scale investment in long-lived assets in a range of utility sectors, including gas, water and electricity. Consequently, one would not anticipate any negative implications for investment associated with choice of a RAB methodology.

Implications for prices

As noted above, prices under the cashflow approach will be volatile if capital investments are large and lumpy. The RAB approach reduces this volatility by providing companies with a smoothed return profile over the life of the asset. This is particularly important when the investment costs are large and lumpy.

Implications for efficiency

The incentives to reduce operating costs are similar under the cashflow and RAB approach. However, the incentives to reduce capital expenditure are likely to be different under the two approaches and the efficiency incentives of the RAB model will depend critically on how long a company is allowed to retain the benefits of efficient investment. Under the RAB methodology operating costs and capital investment are treated in different ways, which requires very careful application to ensure that input choices are not distorted. This is not the case under the cashflow approach where operating costs and capital expenditure are effectively treated in the same way.

Implications for returns

In principle, the company should recoup the full cost of the investment under the cashflow and RAB approaches (in net present value terms). However, with the RAB approach the regulated business faces cashflow costs during the investment programme. In particular, expenditure may exceed revenue in the early years, but will be lower towards the end of the asset's life. If a significant amount of expenditure is not financed through current year revenue (but through debt or equity) this is likely to be less problematic.

Practical implications

Calculating allowed revenue using the RAB approach requires data on:

- annual efficient operating expenditure;
- the RAB value at the start of the price control period (opening value) and
- the average economic life of assets;
- annual efficient capital expenditure; and
- the cost of capital.

Data on each parameter (apart from the cost of capital) needs to be available for the set of products included in the proposed price control.

The two key challenges here are the determination of the opening value of the RAB and the calculation of the appropriate cost of capital.

- Opening asset value – when a price control is first introduced, a decision must be made on the appropriate opening value of the asset base. A number of options have been used by regulators including the market value of assets (for listed companies), the book value of assets and the modern equivalent asset value. In addition, regulators must determine whether the asset lives used in a company's accounts are appropriate. If it is found that they are not, adjustments to the accounting value will be required to reflect alternative asset life assumptions.

- Cost of capital – regulators generally calculate the required cost of capital using the Capital Asset Pricing Model (CAPM). In many sectors, and jurisdictions, the value used is based on a review of regulatory precedent, particularly where stock market data is not available for the company concerned. The downside of such an approach is that comparisons will need to be made with companies that do not face identical risks.

Form of price control

Recommendation

As set out above, the key difference between the two models relates to their treatment of capital investment. Where capital investment is substantial, and in long-lived assets, the RAB model would appear to be more appropriate. Where capital investment is less significant as a proportion of total costs or revenues, a cash-based control is likely to be more appropriate. In particular, where capital investment is less significant over the duration of the price control period, a cash-based control avoids the need to create a RAB, identify remuneration arrangements in relation to capital investments and estimating a WACC.

In post, we see that, relative to total expenditure, capital investment tends to be small (in the region of 10% or less of total expenditure). For example, An Post's business plan shows projected capital expenditure for 2013 of €20m which accounts for 3% of total expenditure. Furthermore, the asset lives of the capital investments used in the postal sector are, in general, short. For example, many of the assets in the postal sector (e.g. IT, vans, etc.) have much shorter asset lives – in general around 5-7 years – compared to capital intensive industries such as energy, where a RAB based price control is often the norm.

Consequently, we recommend that the price control be based on a cash model rather than a RAB model.

3.2.2 Volume uncertainty and risk

Price controls are forward-looking in nature and are therefore based on assumptions about future costs and volumes. There will, inevitably, be some uncertainty in the determination of these forecasts, resulting in differences between actual and expected values during the regulatory period. This may result in prices and costs falling out of line during the regulatory control period for reasons other than because unforeseen efficiency savings have been achieved.

Specifically, if forecast volumes are higher than outturn volumes An Post would under-recover revenues. Conversely, if forecast volumes are lower than outturn volumes An Post would over recover revenues. Since volume deviations can have significant consequences on the profitability of An Post, it is important that volume forecasts are robust and accurate. Further, it is important that detailed scenario modelling is conducted at the start of the price control in order to gain a clear understanding of the potential impact of volume deviations. Finally, one needs to be clear on how much of the risk is borne by the customer (through higher prices, if volumes are under forecast) and how much by the regulated business (through lower prices and revenues if volumes are over forecast).

There are a number of measures that can be put in place in order to mitigate the risks associated with uncertain future volumes[5]. Any such measures would need to be consistent with the 2011 Act.

- Mechanisms could be put in place that allow for a price control to be reopened within the price control period if volumes deviate considerably from forecasts. A reopener would allow ComReg to review prices and ensure the financial sustainability of the USO is not jeopardised by unforeseen negative volume shocks.
- A shorter regulatory period can be used, so that volume and cost allowances can be adjusted to reflect actuals within a short space of time. A longer control may therefore need to be balanced with the introduction of additional regulatory mechanisms to balance the sharing of risks between the regulated business and customers. The 2011 Act already specifies that the price control is for five years but is subject to review after three years; following such a review ComReg may make a decision amending the basket(s) or the "X" of the price cap.
- The regulated business can be provided with a 'buffer' to cover them for the risk of unexpected exogenous shocks. The margin on turnover in the cashflow methodology can provide this insurance.
- Any shortfall (or excess) in revenue from a specific regulatory period, could be carried over into the subsequent price cap period.

The price control mechanism could include one or more of these options.

Recommendation

Our previous analysis suggests that there may be significant volume risk and uncertainty for An Post over the planned price control period 2014 - 2018. Consequently, we recommend that, as part of the price control determination, ComReg give consideration to the introduction of mechanisms to manage volume risk and uncertainty.

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5 At this early stage of the price control process, we do not yet have the data that would be needed to provide a definitive recommendation in relation to volume risk mitigation measures. Instead, we recommend that this is reviewed and determined in conjunction with the decision on the overall price cap, when more information is available.

3.2.3 Efficient costs

The 2011 Act Section 30.3.b states: "*ensure that the price cap provides incentives for efficient universal postal services provision*."

Both capex and opex efficiency needs to be incentivised. In order to incentivise efficiency, regulators set capex and opex allowances in a way that allows the regulated firm to recover an efficient level of capital and day-to-day operational expenditure. In principle, prices need to reward only efficiently incurred costs. If inefficiencies exist, this will feed through in the form of higher prices which are ultimately paid by customers.

Regulators can incentivise regulated businesses to increase their efficiency by setting cost allowances which ensure that the profitability of the business is linked to the efficiency improvements it makes – the more efficient the business becomes, the higher profits it is allowed to earn.

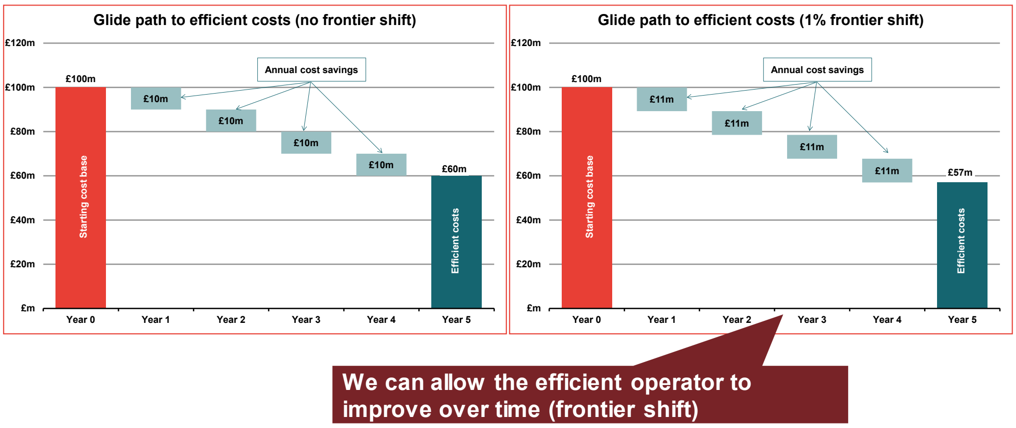
In determining these allowances, the regulator needs to balance the interest of consumers and the regulated business:

- setting aggressive targets to encourage fast efficiency improvements could jeopardise the sustainability of the USO, because the USP would have to find some way to finance the difference between their actual costs and efficient costs, if they could not reduce costs to the efficient level at the same rate as the efficiency adjustment; and
- setting more lenient cost allowances which cover part or all of the inefficient cost base leads to inefficiently high prices which harms consumers.

If the regulated business is deemed to be inefficient, a glide path towards the efficient level can be used to allow the operator time to implement efficiency improvements and not threaten the sustainability of the USO. For each year, the regulator can set efficiency targets which if met would ensure that the regulated business covers its costs and makes a reasonable profit over the course of the price control.

The efficiency target can include static and dynamic elements. Static efficiency improvements are the gains a company can make if it was as efficient as it can be today. However, even the most efficient operator today can become more efficient over time. Technology advances provide opportunities for dynamic efficiency improvements which shifts the production frontier of the whole industry. Regulators can set a combination of static and dynamic efficiency targets. Including dynamic efficiency gains over time will make the glide path steeper, as illustrated in **Figure 1**. The red bar indicates the current cost level, while the dark blue bar shows the efficient level of costs. The light blue boxes illustrate the cost savings that would be required in order to reach the efficient level of costs. In the chart on the left, the level of efficient costs is based on static efficiency (the potential with current technology). In the right box the dark blue bar is lower, reflecting that new technologies will allow costs reductions over a five year span, even for the most efficient company at this moment.

Figure 1. Efficiency target example



Stylised example

Recommendation

In order to be compliant with the 2011 Act, the price control must only reflect costs of efficient service provision. A key element of the price control would therefore be to consider what the current level of efficiency of An Post is and if any efficiency gains can be made. The efficiency assessment should also capture the dynamic efficiency gains that will be possible over the price control period, independent of its current efficiency. Frontier Economics has been tasked to carry out an efficiency review of An Post's business as part of the price control.

We recommend that if An Post is deemed by the regulator not to be fully efficient at the start of the price control period, consideration should be given to the use of a glide path towards efficient costs to allow An Post sufficient time to align its cost base with an efficient level. This would ensure the sustainability of the USO while making sure consumers benefit as soon as possible from improved efficiency. The time period and trajectory of any such glide path can only be determined once the efficiency review has been undertaken and the level (if any) of any potential inefficiency identified, and estimates made of the time necessary to make adjustments to the cost base.

3.3 Summary of recommendations

Based on the analysis presented in sections 3.1 and 3.2 we have a number of recommendations.

Form of price control

- The price control be based on a cash model rather than a RAB model. In our view the cash model is better suited to the characteristics of the postal sector in Ireland than the RAB model for reasons discussed in section 3.2.1;

- As part of the price control determination, due consideration is given to the introduction of mechanisms to manage volume risk and uncertainty. This is necessary because in our view there is considerable volume uncertainty in the postal market in Ireland going forward.

- When determining the level of allowable 'efficient' costs, if An Post is found to be required to improve efficiency, consideration be given to the use of a glide path to allow An Post sufficient time to align its current cost base with an efficient level. A glide path ensures that the postal operator is incentivised to achieve efficiency improvements in a manageable manner.

4 Scope of the products under the price control

Once the form of the price control has been determined, the next step of the price control process is to determine the products that will come under the scope of the price control. Section 30(2) of the 2011 Act requires that where ComReg is of the opinion that there is no effective competition in the market for the supply of certain postal services within the scope of the universal postal service it shall, following a public consultation, specify a price cap in respect of one or more basket of the postal services concerned. Pursuant to this section of the Act, the scope of the price control is limited to, at most, those products that come within the scope of the universal postal service, as set out in section 2.2.

For a product to come under the scope of the price control, ComReg must demonstrate that the product faces no effective competition in the market for its supply. The key question that must therefore be asked in assessing each of the products under consideration is:

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

This chapter provides details of how we have approached this question in practice and the analysis we have carried out in doing so. It is structured as follows:

- section 4.1 outlines our approach to assessing each product;
- section 4.2 then sets out the general trends that can be seen across all products with regards to postal and non-postal competition;
- section 4.3 provides an assessment of each product, drawing on both the findings in section 4.2 and further product specific evidence; and
- section 4.4 summarises our recommendations on the products that should lie within the scope of the price control.

4.1 Our approach

It is essential that any assessment of whether An Post faces effective competition in the market for the supply of a product under consideration is based on a good understanding of its key product characteristics. This is because the extent of competition faced by a product is affected by these characteristics. In essence, entry is expected to be more profitable for some characteristics than others and, as a result, competition is more likely to develop for products that have these characteristics.

As such, there are two main steps to our approach:

- first, understanding the characteristics of each product under consideration; and
- second, undertaking a competition assessment of each product.

4.1.1 Product characteristics

An Post products vary across a number of dimensions. In particular, the characteristics of products differ depending on:

- the type of customer (i.e. business or household) who sends the mail items (the sender) and the type of customer who receives the mail items (the receivers);
- the geographic routes over which mail items are sent;
- the type of mail item which is being delivered (e.g. letter, flat, packet or parcel, weight);
- the timing of delivery;
- the number of items sent in a single mailing and the level of pre-sortation required from the customer;
- the networks which are used to get the product from sender to receiver (i.e. end-to-end or delivery only); and
- other aspects of service availability and constraints.

We briefly describe each of these below.

Type of sending and receiving customers

Mail items are sent and received by two types of customers: business and residential customers. Mail flows can therefore be categorised according to one of the following categories:

- business to business (B2B);
- business to consumer (B2C);
- consumer to business (C2B);
- consumer to consumer (C2C);
- government to consumer (G2C); or
- consumer to Government (C2G).

Businesses can also be further sub-divided into large businesses and small businesses, with the size of the business determining their volumes of mail.

The characteristics of an individual mail product is determined by the proportion of mail flows which fall into each of the above categories, and the size of businesses or Government departments included in the B2B, B2C, C2B, G2C and C2G categories.

Geographic routes

Mail flows can also be categorised according to the geographic nature of the start-point and end-point of the route (i.e. the collection and delivery points). Specifically, mail items can be collected and delivered within or across the following geographic areas:

- city centre;
- urban;
- suburban; or
- rural.

The geographic area could also be defined more widely than this. For example, mail items can be collected and delivered within or across cities or counties, both of which will contain a mixture of the above. This is important because the unit costs of collection and delivery are expected to vary by geographic route. The mix of geographic routes associated with a product may affect the feasibility and attractiveness of entry and thereby the degree of competition which develops.

Type of mail items

Customers can send a wide range of different postal items which vary by format, size, weight and shape. The costs and technologies required to deliver mail items vary across these attributes. Entrants may be expected to focus, at least initially on products which involve lower operating costs. They may also be expected to focus on mail market growth areas, such as packets and parcels.

Timing of delivery

The specified delivery time also varies within and across products. The ability to organise and optimise the costs of delivery routes may be better for longer specified delivery times. Entrants may therefore be attracted to these options.

Number of items in a mailing

Customers can send any number of mail items at the same time, from single piece mailings to large bulk mailings. A number of An Post products are focussed on mailings of more than 2,000 items while others are largely used for smaller mailings. An Post also offers different payment methods for customers which make it easier to send smaller bulk mailings (i.e. less than 2,000 items). Average operating costs are expected to decline the more items which are dealt with at any one time. Hence, larger bulk mailing may be more attractive to entrants.

Delivery network needed

Finally, the delivery of mail items from sender to receiver may involve an end-to-end or delivery-only network. Mail items only requiring a delivery-only network (i.e. those that are pre-sorted to delivery level) may be more attractive to entrants than those requiring an end-to-end network. Entrants may choose to operate their own delivery network or negotiate access arrangements to An Post's network.

Service availability and constraints

Products may have terms and conditions around service availability and constraints in addition to those associated with the characteristics already covered. For example, there may be constraints around the way a product is presented to An Post, including restrictions on timing of presentation and level of sortation required.

4.1.2 Competition assessment of each product

Based on the characteristics of each product under consideration, the next step is to determine whether An Post's pricing behaviour is constrained in the pricing of each universal service product, and therefore whether there is effective competition. In order to carry out such an assessment, three areas should be considered:

- the extent of postal competition;
- the extent of non-postal competition; and
- whether there are any benchmark universal service products, An Post products that, if price controlled, would place sufficient constraint[6] on the price of the product under consideration.

This assessment is primarily based on current available evidence and therefore reflects developments in competition to-date, rather than the potential further development. This is the most cautious assessment in the environment that exists today, where liberalisation has been implemented but actual competition has not yet actively established itself in relation to many of the services covered by the USO. Nevertheless, as well as undertaking an assessment of current levels of

6 Throughout this report we use 'sufficient constraint' to mean as much constraint as is needed to prevent An Post engaging in excessive pricing behaviour in relation to the product under consideration.

competition, we also provide a broad indication of how the level of competition faced by various products may evolve over the price control period.

This forward-looking analysis is intended to identify those products that are likely to face more competition over time, not for the purpose of informing the scope for the price control but to highlight the products that An Post may request be removed from the control during the regulatory period or which may require detailed investigation at the next price review.

We set out our approach to considering each of the above issues below.

Extent of postal competition

In assessing the extent of effective postal competition for each product under consideration, we ask the following question:

> **If An Post were to increase the price of the product, would there be sufficient demand and supply side substitution for this to be profitable?**

This can be summarised in the form of four assessment criteria. Each product under consideration can then be judged against these criteria to determine the extent of postal competition.

1. Existence of barriers to entry
2. Scale and nature of competition
3. Customer awareness and behaviour
4. Effectiveness of competition in postal services

If our assessment against these criteria finds that a particular product faces effective postal competition, then the resulting recommendation would be for that product to not be included in the scope of the price control.

Further detail on the application of each of these criteria is provided below.

Existence of barriers to entry

First we look at the existence of barriers to entry, these may be:

- legal, administrative (e.g. statutory limitations; special privileges that An Post receive – such as the VAT exemption on USO products; or simply the administrative burden or negotiations and agreeing access terms with An Post); or
- economic (e.g. economies of scale and scope or An Post's reputational advantages).

Any barriers to entry may apply in varying degrees to all products under consideration, a subset of these products or one particular product. If they are substantial then they may prevent An Post from facing effective competition in the market to supply the products concerned.

Scale and nature of competition

Linked to the above, we also look at the scale and nature of competition faced by each product under consideration. There are currently six authorised postal service providers in Ireland, including An Post. **Table 3** lists the five other postal services providers along with the number of postal services that they have told ComReg that they offer, and the number of these that are within the scope of the universal postal service.

Table 3. Other authorised postal service providers in Ireland

Postal service providers	Number of postal services claimed	Number of postal services within the scope of the universal postal service claimed
DX Ireland	7	1
Eirpost (Division of Nightline Logistics Group)	2	1
Fastway Couriers (Ireland)	11	0
Lettershop Postal	2	0
TICo Mail Works	4	0

Source: Register of Authorised Postal Service Providers - www.ComReg.ie

In assessing the scale and nature of competition posed by each of these other postal service providers, the following aspects should ideally be considered:

- market share – overall and on a product-by-product basis;
- size of each postal service provider and expected sustainability; and
- expected growth and innovation.

The final aspect listed above is helpful in identifying products that are likely to face more competition over time and therefore that An Post may request be removed from the control during the regulatory period or which may require detailed investigation at the next price review.

Customer awareness and behaviour

Customer awareness and behaviour should be considered in relation to An Post's other products and those offered by other postal service providers. This is linked to the demand side substitution aspect of whether a price increase could be profitable for An Post. Specifically, whether customers would switch away from the product under consideration if An Post were to increase its price, and if so, where demand would switch to. For example, if demand switches to another An Post product then An Post would still receive some revenue. In comparison, if demand switched to a product offered by another postal service provider then An Post would lose that revenue entirely.

In applying this third criterion, the following aspects should ideally be considered:

- evidence of switching and potential switching costs; and
- evidence of customer awareness of alternatives to An Post products.

Effectiveness of competition in postal services

Finally, if the application of the first three criteria suggests that there is potential for competition to develop, a fourth criterion should be applied. That is, a final consideration of whether other firms, in association with general competition law, would be effective at constraining An Post's pricing behaviour. It is used as a final check to ensure that, even where the potential for competition exists, the nature and scale of competition is expected to be effective at replacing the constraints imposed by a price cap.

Extent of non-postal competition

Substitution of mail for electronic alternatives is a key driver of the volume declines that have been seen in international mail markets. For these non-postal alternatives to constrain An Post's pricing behaviour, it would need to be considered that there would be enough of a shift in demand to such alternatives to make a price increase unprofitable. In assessing the extent of non-postal competition, we therefore look at any evidence in relation to the degree of constraint exercised by non-postal alternatives.

Availability of benchmark products

Finally, we will consider the availability of any benchmark products that lie within the scope of the USO. By benchmark product we mean a product that would sufficiently constrain An Post's pricing of the product under consideration if it were to be included within the scope of the price control.

There are two important things to compare when assessing whether a potential benchmark product exists:

- **product characteristics** – to assess whether the potential benchmark and the product under consideration are sufficiently similar for demand side substitution to occur; and

- **volume and price changes over time** – to assess price and volume differentials between the potential benchmark and the product under consideration, and how these have evolved over time. If, for example, the price differential has widened over time, this suggests that the constraint imposed on An Post's pricing by the potential benchmark product may be weaker.

4.2 General trends with regards to postal and non-postal competition

There are a number of trends with regards to postal and non-postal competition that apply more generally across all products under consideration, or sub-set of these products. In particular, we see general trends with respect to:

- barriers to entry; and
- scale and nature of competition, and customer awareness and behaviour in relation to such competition.

This section sets out each of these trends in turn and considers what these may mean for our assessment of the postal and non-postal competition faced by the products under consideration.

4.2.1 Barriers to entry

There are two types of barriers to entry that are relevant to the competition assessment of the products under consideration:

- legal and administrative; and
- economic.

These barriers exist in relation to all products under consideration, although they may be more significant for particular products, or groups of products. In the case of both types, the barrier that exists may make it more difficult and less profitable for a sufficient number of operators to enter the market to act as a constraint on An Post's behaviour. The extent to which the barriers deter entry depends not only on whether that particular barrier is relevant for the product under consideration, but also whether it is expected to be removed in the future.

Legal and administrative

With regards to legal and administrative barriers to entry, there are two possible barriers that should be considered here:

- An Post's VAT exempt status for USO products; and

- administrative barriers relating to negotiating and agreeing access to An Post's network.

We consider each in turn.

VAT exemption

An Post's customers do not have to pay VAT when purchasing universal service products as these products are VAT exempt. We understand that a similar VAT exemption currently also applies to An Post products that lie within the scope of the USO, but are not universal service products. However, the VAT status of these products is currently under review.

In contrast, other postal service providers have to charge VAT at a rate of 23% on the postal products that they sell. Even if these providers were able to offer equivalent prices to An Post excluding VAT, a proportion of their customers would not be able to reclaim the VAT paid and would therefore effectively face higher prices. More specifically, the following customer groups would not be able to reclaim the VAT paid:

- VAT exempt organisations (such as financial services, charities and government departments); and
- residential customers.

The importance of this barrier at a product level depends on the size of the proportion of customers that are not able to reclaim the VAT paid. An Post, in its response to ComReg 12/38, suggests that VAT exempt organisations account for approximately 50% of bulk mail volumes, with bulk mail volumes making up 53% of An Post's total USO volumes. Residential customers on the other hand, will mainly be buying stamp products. Stamp volumes make up 19% of An Post's total USO volumes.

This suggests that the VAT exemption could potentially be a significant barrier to entry.

Administrative barriers

As discussed in section 4.1.1, the degree of competition for some products may be restricted if access to An Post's network is required. This is primarily because of the difficulties that may arise in negotiating acceptable access terms with An Post, particularly the length of time that negotiated access takes. There may therefore be an administrative barrier associated with products that require access arrangements for competition to develop (i.e. any products for which customers require access to a comprehensive nationwide network).

ComReg and The Competition Authority respectively should be able to directly address this barrier through their respective functions in relation to access to An

Post's network. As a result, we do not consider it relevant to include this barrier in our competition assessment.

Economic barriers

With regards to economic barriers to entry, there are three possible barriers that should be considered here:

- economies of scale;
- economies of scope; and
- An Post's reputational advantages associated with being the universal service provider.

We consider each in turn.

Economies of scale

Economies of scale arise when unit costs decrease as volume increases. In the postal sector these economies are most likely to arise in delivery, suggesting that the delivery of large volume delivery routes provide an operator with a cost advantage relative to others with lower volume delivery routes. Further, delivery costs, for a given volume level, are expected to be lower in densely populated areas than in rural areas and economies of scale may be less significant in urban areas. This suggests that economies of scale may be less of an issue for such deliveries because the unit costs are lower, although it would still be the case these could be reduced further with higher volumes. Entrants may therefore avoid supplying products for which it would be difficult to reach required levels of scale and/or which require deliveries in primarily non-urban areas.

Based on this, we can draw the following conclusions in respect of economies of scale:

- economies of scale will be a significant barrier for products that require delivery to household customers (unless access arrangements are in place with An Post), and to rural businesses (unless designated pick up points, or similar, are established for such businesses, at no detriment to the sender);
- consequently, bulk mail services for business customers are expected to be the main focus for entrants as these will allow for any economies of scale that exist to be exploited. Niche services, involving sufficient loads in local urban areas, may also be attractive to entrants (e.g. business to business services in Dublin);
- entrants are expected to undertake upstream activities that do not exhibit economies of scale, but may require access to An Post's network

to be able to assure customers that mail items will be delivered to all required destinations;

- entrants may be unlikely to provide delivery services to rural areas and will tend to focus on urban and potentially suburban routes where they may be better placed to exploit economies of scale that exist; and
- entrants may seek to provide services that do not require immediate or next day delivery and they may offer a service which limits the number of delivery days per week, allowing them to plan routes and delivery schedules which maximise loads and hence take advantage of economies of scale.

Economies of scope

Economies of scope arise when the unit costs of production per product decline the more products a firm provides. In the postal sector, the existence of economies of scope is expected to be linked to the existence of economies of scale in delivery. In particular the unit costs of delivering an additional product are expected to be lower once a network has been established. Further, the more products that are delivered along the same route, the more likely it is that scale economies will be exploited as volumes will have increased.

However, if an entrant is offering a single service it is potentially as likely as An Post to benefit from the introduction of a second service as this will increase the scale of its operations and thereby allow it to exploit any economies that exist. In this sense, it is the existence of economies of scale that are expected to be the more significant barrier for entry.

Further, entrants may benefit from scope economies by combining mail services with other products already sold to customers. In this sense, while economies of scope may provide An Post with some cost advantages – and thereby create a barrier to entry – the potential may exist for other operators to also exploit these economies through the design of their business model.

However, we have not seen any evidence in relation to the extent of economies of scope in post, we therefore cannot conclude whether they are likely to pose a barrier to entry.

An Post's reputational advantage due to its USP status

While the USO may place costs on An Post, its USP status may also provide beneficial effects, particularly because of the historical nature of this status. In particular, the USO may enhance An Post's reputation as a reliable and ubiquitous service provider which new entrants may not be able to match (particularly in the early years of starting an operation). Evidence of An Post's strong reputation comes from the RepTrak™ Ireland 2013 Study[7], which measures the reputations of 100 firms in Ireland, where An Post ranked 3rd overall and 1st in the semi-state category.

The ability to reach all residential consumers will be important to many businesses and this is a service which entrants will find difficult to offer. However, access arrangements may alleviate this constraint. Further, operators providing niche services in specific areas may be able to reach all the residential consumers required by the business customer, particularly if the entrant has its own network. Over time, therefore, competitors may develop their own networks or enter into access arrangements with An Post, and from there build up their own reputation and associated brand.

In the short term, however, An Post's USP status is expected to be a significant barrier to entry. This barrier to entry is not only relevant for USO products, as all product sales benefit from the existence of an ubiquitous network and the quality associated with An Post's brand[8]. Entrants who have a developed reputation in other sectors may be able to leverage their brand image in the postal sector and will therefore be in a better position than other potential entrants to overcome this barrier.

4.2.2 Current competition, customer awareness and behaviour

The second general trend to consider is the scale and nature of competition faced by An Post in relation to the products under consideration. It is vital to also consider customer awareness and use in relation to this competition.

Here we look at two types of competition:

- postal; and
- non-postal.

Postal competition

Section 38 of the 2011 Act requires persons who intend to provide a postal service in Ireland to make a notification to ComReg. The 2011 Act denotes "postal services" to mean services involving the clearance, sorting, transport and distribution of postal packets. This does not include document exchange, express or courier services.

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7 Corporate Reputations' RepTrak™ Ireland 2013 Study (http://www.corporatereputations.ie/page.php?title=News&news_id=376)

8 The significance of brand advantage is further evidenced by the CER review of the non-daily metered retail gas market decision paper, which concluded that the brand of an incumbent provides a significant advantage.

In addition to An Post, there are currently five other authorised postal service providers in Ireland:

- DX Ireland;
- Eirpost;
- Fastway Couriers;
- Letterpost; and
- TICo Mail Works.

Below is a summary[9] of each provider and the postal services it provides or intends to provide according to their notification to ComReg.

- DX Ireland[10] currently offers 7 postal services in total. This includes a number of exchange services for B2B mail between registered customers, one of which, 'DX Exchange – to the door service', is within scope of the universal postal service. This allows any DX Exchange member (across ROI) to send mail to access points within County Cork. DX Ireland also offer a B2B courier service, a product for the delivery of internal mail and a parcel exchange locker system for businesses to collect and deliver parcels from 500 lockers all over Ireland.

- Eirpost[11] offer two products, again aimed at businesses. They pick up from anywhere on the island of Ireland, with customers needing to book a pick-up online. The first product is a standard international mail service. The second product, which is within the scope of the universal service, is a domestic mail service for businesses. In Eirpost's 2012 notification to ComReg, they explained that they were awaiting DSA arrangements for this product. Eirpost's website indicates that Eirpost intends this to be a second class mail service to the island of Ireland in a 3 day delivery timeframe.

- Fastway couriers[12] a franchise company in Ireland, offer 11 postal services, parcel and satchel delivery, to Ireland and the UK. This service includes full parcel tracking and €400 liability cover. They offer next day delivery in

9 As at May 2013

10 DX Ireland website (http://www.thedx.ie/) and DX Irelands notification to ComReg (http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html)

11 Eirpost website (http://www.eirpost.com/) and Eirpost's notification to ComReg (http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html)

12 Fastway couriers website (http://www.fastway.ie/) and Fastway Couriers' notification to ComReg (http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html)

Ireland and 3-day delivery in GB. Prepaid and frequent user discounts are available.

- Lettershop[13] offers two postal services to businesses, in addition to offering printing services. Both services offer hand delivery to Dublin and parts of county Dublin.

- Finally, TICo Mail Works[14] offers mail fulfilment services, including 4 postal services, with the provision of printing, packing and mailing activities for large businesses.

It is our understanding that there are currently no access arrangements in place between An Post and any postal service providers. All postal competition that currently exists is therefore mainly through a provider's own end-to-end network, with some use of An Post Ceadúnas products. However, An Post anticipates that 2 or 3 access arrangements will be in place with other postal service providers by the end of 2013.

Document Exchange, express and courier services competition

Section 37 of the 2011 Act, specifies that document exchange, express and courier services are not classed as postal services within the scope of the universal postal service. No providers of these services have notified ComReg of their provision or intended provision of postal services in Ireland. In addition to the courier services offered by Fastway and DX set out above, providers of document exchange or express or courier services include:

- DHL Express (Ireland);
- UPS;
- FedEx Express;
- TNT Express; and
- DPD/Interlink.

[redacted]

13 Lettershop website (http://www.lettershop.ie/) and Lettershop's notification to ComReg (http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html)

14 TICo Mail Works website (http://www.ticomailworks.ie/) and TICo Mail Works' notification to ComReg (http://www.comreg.ie/postal/regulation_of_authorised_providers.545.html)

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Customer awareness of alternative providers and use of services

Other postal service providers and express/courier service providers offer products with some similarity to some of those An Post products under consideration. However, we need to determine whether the services provided by other postal service providers or express/courier service providers offer effective competition. In order to do this, it is vital to consider both customer awareness and use of these products offered by alternative providers. While customer awareness of alternative providers is an important indicator of the potential for competition to develop, in the absence of evidence of significant usage of alternative products by customers, one would find it hard to conclude that effective competition is evident.

Here, customer surveys are particularly important. In particular we can draw on the following surveys that were carried out by Ipsos MRBI for ComReg in 2013[15]:

- Consumer Postal Users Survey 2013; and
- SMEs Postal Users Survey Survey 2013.

An Post was first choice for sending letters or packets/parcels for 92% of residential customers, with only 7% preferring other service providers. When asked which providers they had ever used for sending letters or parcels/packets, 98% of residential customer had previously used An Post, with less than 4% of residential customers having used other service providers. One of the key

15 ComReg Document Nos. 13/67a and 13/67b

messages from this survey was that awareness of other service providers has yet to translate into significant levels of usage among residential users.

The most cited reason for residential customers never having used other providers was that An Post was nearby or more convenient. However, reputation and lack of awareness of other options were also given as key reasons. This suggests that brand awareness does not automatically result in awareness of the services provided or how to access them.

With regards to residential use of parcel services specifically, the 2010 report by The Research Perspective[16], *Findings from qualitative research into the national need for communication and distribution services*, provides some additional useful findings[17].

- Customers in mature residential areas were happier with An Post's parcel services than those in recently developed areas (in particular those in apartments). The core perception was that insufficient effort is made to deliver parcels. This is compounded by difficulties associated with collecting parcels from the An Post collection points due to accessibility of the location and opening hours. In contrast, the delivery service provided by courier and express operators is perceived to be superior. This includes a perception that they make greater efforts to complete delivery.

- In relation to high value goods, courier delivery is considered to be more secure.

For business customers (SMEs), An Post is used almost universally as the main postal service provider. Although 90% of business customers (SMEs) were aware of at least one other provider, just over a third of these customers actively used an alternative provider. DX Ireland and Fastway were the most commonly used alternatives, with most business customers (SMEs) not being aware of Eirpost, Lettershop or TICo Mail Works.

The most cited reason for business customers (SMEs) not using other providers was that they trusted An Post. However, there were also many other reasons, including:

  - convenience;
  - suitability of products; and
  - no reason to change.

16 Document No. 10/102

17 Although this study was carried out in 2010 and may not provide a full picture of the current situation, it provides a useful indication of customer behaviour that can aid our analysis.

A further key message that came from this survey was that 79% of business (SMEs) customers were quite unlikely or very unlikely to use a provider other than An Post for the sending or delivery of postal items within the next 12 months.

As with residential use of parcel services specifically, the 2010 report by The Research Perspective also provides some additional useful findings on business use of parcel services.

Among SME customers, the perception was that An Post's parcel service had deteriorated, both in comparison with courier and express operators providing parcel services, and in comparison to previously provided services. There are two main issues that were highlighted in relation to parcel services:

- *lack of service availability for a customer's product category, both from An Post and alternative service providers* – Organisations recognised that there is an apparent high level of competition (as measured by the number of postal service providers). However, they perceived a lack of competition for many categories of product. Many categories of product have specialist packaging requirements which are met by only a few service providers; and

- *access to the service* – The current An Post service offering requires items to be deposited at a post office during opening hours, or requires pre-registering and pre-booking of collection.

Non-postal competition

Mail volumes in Ireland, and in many other mail markets internationally, have been on a downward trajectory. In addition to the negative economic growth that has been seen in recent years, a key driver of this decline is e-substitution of mail - a significant trend that appears set to continue.

As mail continues to lose volumes to non-postal alternatives, our competition assessment needs to consider the extent to which these alternatives constrain An Post's pricing of the proposed products. Again, the 2010 report by The Research Perspective provides some interesting insights in this area.

The trend away from letter post is continuing among **residential customers** with an increasing proportion that do not send post except in response to specific incoming communication. **SMEs** are, in many cases, following the same pattern of transition to predominantly electronic communication. Three key reasons were identified for this trend towards e-substitution:

- increasing range and availability of electronic communication options as well as the efficiency, cost and speed of delivery benefits;

- managers with responsibility for these decisions are likely to be entirely comfortable with electronic communications and will use them as their own default communication services; and
- the current economic environment focuses organisations on cost reduction.

Larger commercial organisations, government bodies and non-government organisations (which rely on postal services for fund raising and donor communications) continue to rely on letter post. There are a number of general barriers to e-substitution:

- a lack of access to electronic communications services among these organisations' customer base:
  - For larger commercial and government organisations, a pre-requisite for the transition to exclusively electronic communication is the ability to service the entire population.
  - Although a large proportion of the population have access to the internet, organisations are also finding that these online services are not reaching the levels of take-up that might be expected given the level of internet penetration.
- legal and contractual requirements to postal delivery – either explicit or implicit within regulatory frameworks or statutes (relevant to government organisations and businesses in regulated industries);
- cost reasons relating to the need to replace existing infrastructure that supports the use of postal services, with infrastructure capable of supporting electronic communication; and
- the value of physical delivery as a premium communications service – compared to electronic communications it offers the perception of additional effort, can have a superior impact on the recipient, and offers controllability of both the visual and the tactile form.

As part of *Public Service Reform Plan* launched in November 2011, the Irish Government developed an 'e-Government 2012-2015' strategy. One the key principles of this strategy is that 'Public bodies should work to ensure that the online channel is the most attractive option for customers.[18]' We might therefore expect the reliance of government bodies on letter post to have started to decrease in response to this strategy and to continue to decrease over the price control period.

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[18] Page 6, 'Supporting Public Service Reform – eGovernment 2012 – 2015' (http://egovstrategy.gov.ie/wp-content/uploads/2012/04/eGovernment-2012-2015.pdf)

Interestingly, the SMEs Postal User Survey 2013 revealed that speed (cited by 56% of respondents) is the number one reason for businesses (SMEs) choosing alternative communications media over postal service, with cost savings (cited by 38% of respondents) the second most important reason. In addition, the Consumer Postal Survey 2013 revealed that despite most companies offering online billing, 68% of respondents preferred receiving bills and statements in the post.

E-substitution of mail does not appear to be driven primarily by price. Instead it seems largely driven by other trends, such as those outlined above. This is further evidenced by the current price differential between mail and electronic alternatives to mail. For example, it would effectively be free to send an email to a customer, whereas a letter <100g would cost €0.45 to send using An Post's cheapest bulk mail product.

However, that is not to say that significant price increases in the mail market could not give rise to an acceleration of the rate of e-substitution. A key issue when considering whether non-postal competition acts as an effective constraint on An Post's pricing, is whether this potential acceleration of e-substitution would make such a price increase unprofitable.

Our assessment suggests that for moderate price increases, it is unlikely that competition from non-postal alternatives would be sufficient to constrain An Post's pricing. For example, in their 2012 price application, An Post themselves did not consider e-substitution to pose a risk to profitability, even with proposed price increases above 10% on average across products requiring prior consent by ComReg. However, we recommend that e-substitution rates are kept under review for the duration of the price control to assess whether these conclusions are likely to change significantly. This is particularly true in light of the aims of the 'e-Government 2012-2015' strategy and the impact that this may have on e-substitution by public bodies.

Further insights come from Postcomm's March 2011 report – *The building blocks for a sustainable postal service, Analysis of Markets*. Although this is an analysis in the context of the UK market, it provides some useful insights into the possible extent of non-postal competition on the basis of content type. **Table 4** summarises the report's conclusions in relation to the likely supply side substitution and indirect substitution (final consumers switching away from post) for each mail content type.

Table 4. Summary of the competition posed by non-postal alternatives in the UK market

Mail content type	Supply side substitution	Indirect substitution (Final customers switching away from post)
Transactional	Difficult for mailers to switch away from post as have to offer customers' preferred means of communication - strong preference for receiving transactional communications by post.	Limited – mailers generally do not charge consumers directly for receiving mail and in most cases consumers unaware of postal costs of service. Number of customers who have switched away from mail remains small.
Advertising	Campaign objectives and target audiences are main drivers when deciding which advertising medium to use. Direct mail often used in conjunction with other advertising media. Demand for advertising mail more price elastic than other content types, but significantly lower than level required to constrain Royal Mail's pricing behaviour.	
Publications	Publishers have strong preference for the development of postal subscriptions over alternative distribution methods – enhances customer loyalty and more attractive for advertisers. Newsstand can substitute, but retail space scarcity, uncertainty of demand and suitability makes substitution possibilities limited. Digital versions used to complement rather than substitute.	Limited – customers generally not aware of postal price rises and consumers have a strong preference for receiving physical over electronic versions of publications.
Social	Consumer awareness of stamp prices low. Also a strong preference for post for more personal communications such as greeting cards and legal documents. Use of alternative forms of communication rather than post, appears to be due to change in consumer preference and non-price factors.	

Fulfilment	Potential substitutes vary considerably by product, e.g. train ticket could be sent electronically, but credit cards and SIM cards could not.	Limited – postal prices may be passed on to consumers but they account for a relatively small proportion of the price of the good and therefore unlikely to change behaviour.

Source: Postcomm (March 2011), The building blocks for a sustainable postal service, Analysis of Markets

4.2.3 Summary

We have identified a number of general trends that exist with regards to postal and non-postal competition. In particular, we see trends with respect to both:

- barriers to entry; and
- scale and nature of competition, and
- customer awareness and behaviour in relation to such competition.

With regards to barriers to entry, it is likely that the VAT exemption is a barrier in relation to competition for business from residential customers and VAT exempt organisations, which together make up around 46% of An Post's current USO volumes. It is also likely that An Post enjoys an element of scale economies that a new entrant would find difficult to match. As such, entrants may avoid supplying products for which it would be difficult to reach required levels of scale and/or which require deliveries in primarily non-urban areas.

With regards to the scale and nature of postal competition, the evidence suggests that An Post currently faces different levels of postal competition in relation to residential and business customers. In particular:

- residential customers – An Post faces little competition from other providers, which is largely in relation to parcel products ; and
- business customers – An Post faces more competition from other providers, but this is still limited and it is not clear whether the service offered by these providers is equivalent to that offered by An Post. The evidence also suggests strong regional differences in usage levels of products provided by other service providers.

So, in the residential segment of the market, there are likely to be large barriers to entry and little competition. In the business segment of the market, although barriers to entry may be smaller, they are likely still to be significant, and An Post faces limited competition from other providers.

With regards to the scale and nature of non-postal competition, the evidence suggests that e-substitution is unlikely to constrain An Post's pricing behaviour in relation to moderate price increases.

Scope of the products under the price control

4.3 Assessment of individual products

This section of the report assesses the products within the scope of the universal service products, listed in section 2.2, on a product-by-product basis to assess the constraints on An Post's pricing behaviour in each case. This assessment is carried out in line with the three main areas of consideration:

- the extent of postal competition;
- the extent of non-postal competition; and
- the availability of benchmark products.

At the end of each section, we provide a recommendation as to whether the product should be price controlled.

4.3.1 Standard Post – Stamp and Label

Standard post paid for by stamp or label is familiar to most consumers. Stamps can be bought at post offices and other outlets, while labels are only available over post office counters. The exact value of the stamps or labels required for an item depends on the weight and format of the item. Most stamped mail can be sent through An Post post boxes, but some will be sent via post office counters. Most labelled mail will be sent via post office counters following payment of postage.

An Post has informed us that payment method is a good indicator of customer type. In particular, stamp customers are comprised of both SMEs and residential customers. This product is characterised by low volumes per customer mailing.

Postal competition and non-postal competition

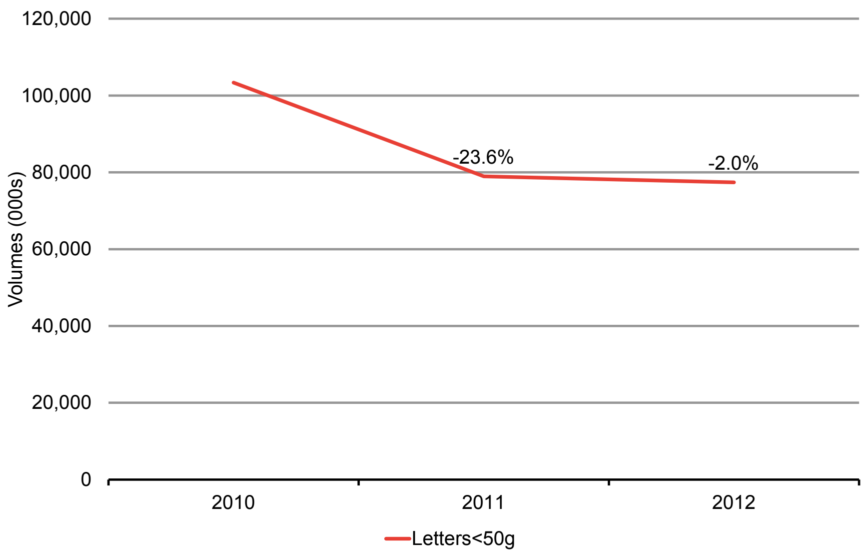
As discussed in section 4.2.2, An Post currently faces little competition from other postal providers in relation to mail sent by residential customers, such as Standard Post – Stamp or Label. Where competition does exist, it is in the form of parcel services offered by express and courier service providers. It is also likely that there are significant barriers to entry in relation to the residential segment of the market.

With regards to non-postal competition, we have not seen any evidence to suggest that this has been constraining An Post's pricing of the Standard Post – Stamp and Label product. In particular, we see very substantial price differentials between An Post's products and electronic alternatives, e.g. email and post.

Volume and Price trends

Stamps are mainly used for letter mail under 50g. In line with overall trends in mail volumes, the volumes for this product segment decreased considerably over 2010 to 2012, as shown in **Figure 2**.

Figure 2. 2010-2012* volumes of Standard Post – Stamped, Letters <50g

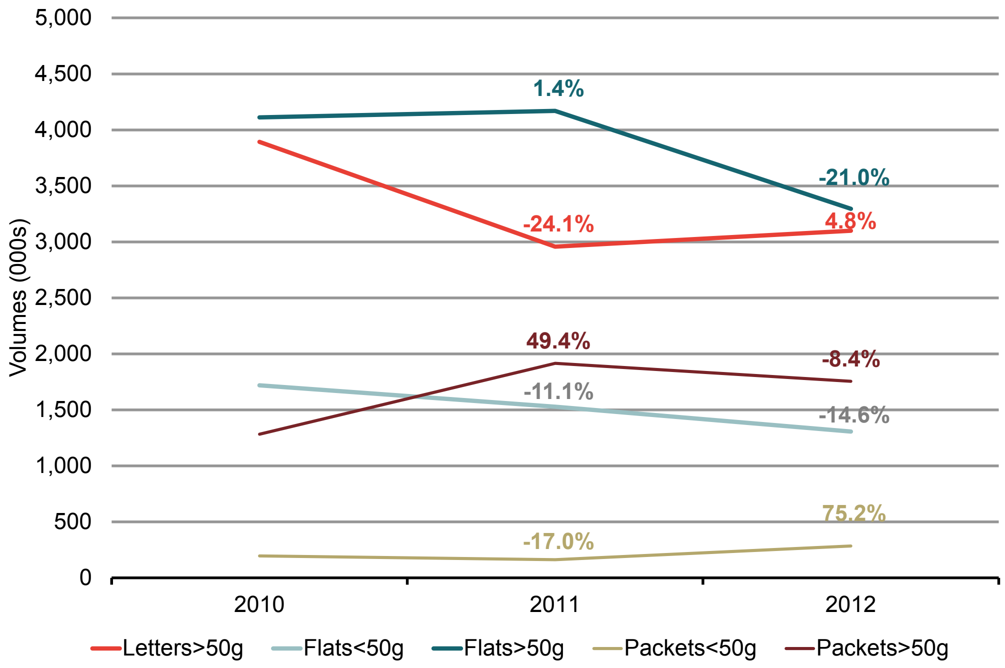


Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

Over the same period, the volumes of Standard Post - Stamp for other formats and weight steps were significantly lower. As shown in **Figure 3**, these volumes also fell over 2010 to 2012 for all but packets above 50g.

Figure 3. 2010-2012* volumes of other formats and weight steps of Standard Post – Stamp Mail



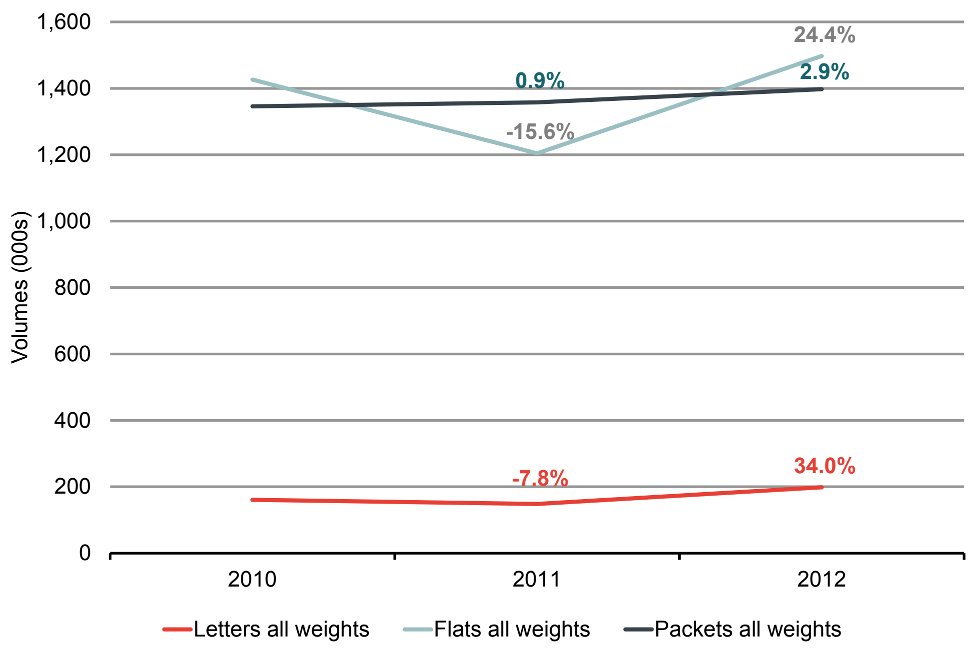
Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

Labelled mail volumes are significantly lower than stamped mail volumes (96% lower in 2012). They have also been variable over recent years, with an 8% overall decline between 2010 and 2011 and a 14% overall increase between 2011 and 2012. In contrast with stamped mail, the majority (90% in 2012) of labelled mail volumes come from mail items >50g.

Figure 4 below illustrates the split of Standard Post - Label volumes by format and how this evolved over 2010 to 2012. It is clear that majority of volumes come from flats and packets, with letters only contributing a small proportion (6% in 2012).

Figure 4. Standard Post - Label volumes 2010-2012*



Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

An Post has only provided parcel volumes for 2010. These are not broken down by product, but even aggregate domestic parcel volumes are low, at only [redacted] mail items.

As a result of the current price regulation of An Post, the price of Standard Post – Stamp and Label letter <50g has been stable in recent history. In 2006 the price was €0.48, which was increased to €0.55 in 2007. The price stayed at this level until April 2013, when the new price was set at €0.60 (an increase of 9%).

The price of Standard Post – Stamp and Label letter >50g has been subject to slightly more change. In 2006, the price was €0.60, it then fell to €0.55 (equal to <50g) for the 2007-2011 period. In 2012, An Post increased the price of this weight step to €0.65, to then reduce it to €0.60 in 2013 (again, equal to <50g). The prices of Standard Post – Stamp and Label flats and packets for different weightsteps over 2011 to 2013 are shown in Table 2. Flats and packets <50g increased in price in 2013 by 10.5% and 9.1% respectively. The price increases for all other weight steps occurred in 2012, except for packets greater than 1kg.

Scope of the products under the price control

Table 5. 2011-2013 prices of Standard Post – Stamped flats and packets

Weight	Flats 2011	Flats 2012	Flats 2013	Packets 2011	Packets 2012	Packets 2013
0-50g	€ 0.95	€ 0.95	€ 1.05	€ 2.20	€ 2.20	€ 2.40
51-100g	€ 0.95	€ 1.05	€ 1.05	€ 2.20	€ 2.40	€ 2.40
101-250 g	€ 1.35	€ 1.50	€ 1.50	€ 2.70	€ 3.00	€ 3.00
251-500g	€ 1.90	€ 2.10	€ 2.10	€ 3.85	€ 4.00	€ 4.00
501-1000g	€ 3.00	€ 3.20		€ 6.00	€ 6.50	€ 6.50
1001-1500 g				€ 7.50	€ 7.50	€ 7.50
1501-2000 g				€ 7.50	€ 7.50	€ 7.50

Source: Frontier Economics based on information from An Post

The price increases seen in 2013 for Standard Post- Stamp and Label mail <50g are the result of a price application process between An Post and ComReg in 2012. As part of this process, An Post initially requested the following price increases:

- 18.2% for letters;
- 10.5% for large letters; and
- 9.1% for packets.

A request for price increases of this magnitude suggests, particularly for letters, that An Post does not face sufficient constraints on the pricing of Standard Post – Stamp and Label mail for this weight step.

Although parcel volumes are only available for 2010, and even then only on an aggregate basis, Standard Post-Stamp and Label parcel prices are available and can provide some insights, as shown in **Table 6**. Prices for parcels <1kg and 1-2kg have remained constant over the last six years at €6.50 and €7.50 respectively. Prices for heavier parcels were increased in 2008 and 2012. The price increases seen in 2012 for heavier parcels varied by weightstep, but were between 2% and 4.5%. However, An Post did reduce prices for parcels >5kg in 2012 by removing the additional charge of €1 per kilo. An Post's 2012 prices for Standard Post stamped and labelled packets are the same as parcel prices for the 1kg to 2kg limit. Similarly, parcels <1kg are priced at the same level as 500g-1kg packets, with lower prices offered for packets at lower weightsteps.

Table 6. Standard Post – Stamp and Label parcel prices

Weight	An Post
<1 kg	€ 6.50
1 kg - 2.5 kg	€ 7.50
2.5 kg – 3 kg	€ 9.00
3 kg - 3.5 kg	€ 10.00
3.5 kg – 4 kg	€ 11.50
4 kg - 4.5 kg	€ 12.50
4.5 kg – 5 kg	€ 13.50
5 kg +	€ 14.50

Source: An Post

Comparing these packet and parcel prices to those of competitors, suggests that An Post's current prices for Standard Post stamped and labelled packets and parcels are significantly lower than competitors' at lower weightsteps. For example, Fastway Couriers' Post Plus service, for which items are collected from any location and delivered the next working day, offers the following weight steps and prices:

- up to 2kg: €8.60;
- 2.1kg to 5kg: €12.95;
- 5.1 kg to 15kg: €16.25; and
- 15.1kg to 30kg: €21.55.

The prices they offer are therefore 32% higher for packets weighing between 500g and 1kg and parcels <1kg, and 15% higher for packets and parcels weighing between 1kg and 2kg. The price differential between An Post's Standard Post – Stamp and Label and Fastway Couriers' Post Plus service, is even larger for packets <500g. Although for non VAT exempt customers, who are able to claim back VAT costs on their inputs, the price differential will effectively be reduced.

Benchmark products

The closest universal service product to Standard Post - Stamp and Label is Standard Post - Meter. However, this product requires the hire of a meter machine, as discussed in more detail in section 4.3.2 below. As such, Stamped

Post - Meter is highly unlikely to be available for the vast majority of residential customers and SMEs, and therefore are unlikely to place sufficient constraint on the price of Standard Post – Stamp and Label.

Recommendation

Our recommendation is that Standard Post – Stamp and Label mail (letters, flats, packets and parcels) should be price controlled.

An Post faces little postal and non-postal competition for this product and, as such, has a near 100% market share. The competition that does exist comes from courier and express service providers and is predominantly limited to the packet and parcel segments, with some competition for heavy or valuable letters and flats. However, our analysis of volume information for this product illustrates that 89% of 2012 letter, flat and packet volumes[19] came from letter mail <50g, with only 2% from packets >50g. Parcel volumes for Standard Post – Stamp are unknown, but even aggregate parcel volumes are low. Further, An Post's current prices for Standard-Post stamped and labelled packets and parcels appear to be significantly lower than competitors' at lower weightsteps. For example, prices for Fastway Couriers' Post Plus service are 32% higher for packets weighing between 500g and 1kg and parcels <1kg, and 15% higher for packets and parcels weighing between 1kg and 2kg. The price differential between An Post's Standard Post – Stamp and Label and Fastway Couriers' Post Plus service, is even larger for packets <500g. Such a large price differential, all other things equal, would suggest that services at weightsteps less than 2kg are unlikely to impose a sufficient competitive constraint on An Post. It would be surprising to observe such a large price differential as an outcome of a competitive process.

4.3.2 Standard Post – Meter

The final alternative payment method under Standard Post is Meter. Under this method, the customer is required to purchase or lease a franking machine from one of three authorised suppliers – CASS Limited, Neopost Ireland Limited and Pitney Bowes (Irl) Limited. The machine can be credited by telephone or via a modem and mail is then franked by the customer. The frank can include company logos and/or a return address. Generally, meter mail must be posted at a mail centre or acceptance office in the pouches or bags provided. However, in certain cities meter mail can also be posted into meter post boxes. Delivery targets are the same as for regular stamped post, although business can also opt for deferred delivery.

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19 Note: 2012 volumes are draft volumes that are still to be reviewed and audited.

Postal competition and non-postal competition

An Post have informed us that meter customers tend to be SMEs, although some meter customers may be large business customers. An Post data on average meter spend per user in 2011 shows that 97% of Standard Post – Meter customers spend €107 per week on average. However, An Post have also informed us that [redacted] meter customers account for c.€[redacted] million in spend.

Our analysis of postal competition in section 4.2.2 suggested that there may be some limited competition in the business customer segment of the market from rival postal service providers. In particular, Lettershop offer the following two products:

- postal delivery service in Dublin and Cork area with a 1-7 day delivery timeframe; and
- domestic postal delivery service for mail over 1kg with a 1-2 day delivery timeframe.

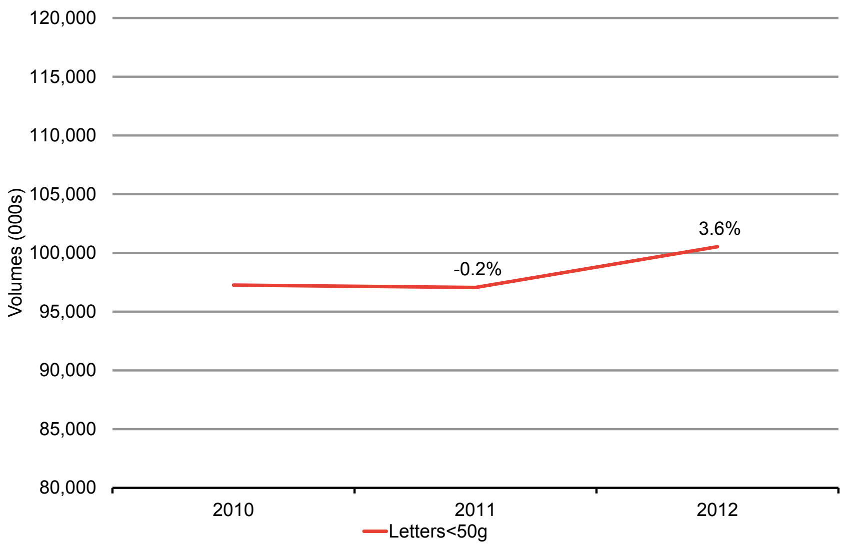
However, these products would appear to target only a narrow part of the business customer market. As such, Standard Post – Meter cannot be considered to face significant postal competition.

Again, with regards to non-postal competition, we have not seen any evidence to suggest that this has been constraining An Post's pricing of the Standard Post - Meter product. In particular, we see very substantial price differentials between An Post's products and electronic alternatives, e.g. email and post. We have also seen insufficient evidence to suggest that this will change over the price control period.

Volume and Price trends

A large proportion of Standard Post - Meter volumes consist of letters <50g (87% in 2012). **Figure 5** shows that these volumes decreased by 0.2% between 2010 and 2011, and then increased by 3.6% between 2011 and 2012.

Figure 5. 2010-2012* volumes for Standard Post - Meter <50g

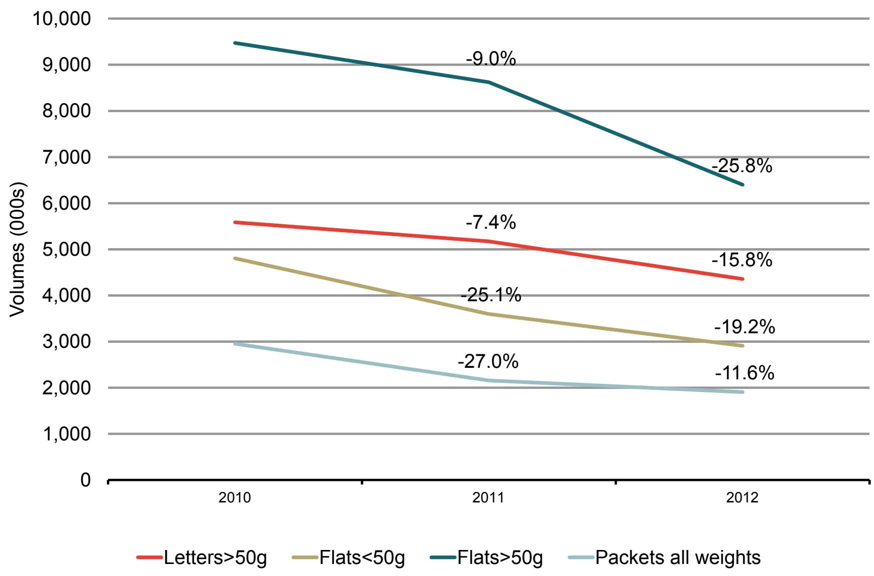


Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

Volumes for other Standard Post - Meter mail items, on the other hand, have decreased significantly over the same period, as shown in **Figure 6**.

Figure 6. 2010-2012* volumes of other formats and weight steps of Standard Post - Metered Mail



Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

Since 2007 to 2013, An Post has priced Standard Post - Meter letter mail at €0.01 below the price of the Standard Post – Stamp and Label letter mail.

An Post offer further discounts to Standard Post - Meter customers who post over 200 items[20] in a single posting and opt for deferred delivery. Such volumes make up a low proportion of total Standard Post - Meter volumes. For example, in 2012, 5.4% of the total Standard Post - Meter letter mail volumes <50g consisted of discounted items. Three sets of prices are available related to whether the mail items can be processed by automated equipment or not and the degree of automatic sortation:

1. **Discount A:** Deferred Manual Processing Before Noon – currently €0.52 for letter mail, a €0.07 discount.
2. **Discount B:** Deferred Automated Processing Before Noon 85%+ Autosort – currently €0.45 for letter mail, a €0.14 discount.
3. **Discount B:** Deferred Automated Processing Before Noon– currently €0.49 for letter mail, a €0.10 discount.

[20] Note: Prior to 2013, the volume requirement for the discounted Standard Post – Meter products was 350 items. We would expect that the proportion of Standard Post – Meter discounted volumes will increase as a result.

Benchmark products

The closest universal service products to Standard Post - Meter are Standard Post – Stamp and Label. Both of these payment methods are available to Meter customers, but neither offers the discount that Meter offers. The key question is whether stamp and label would constrain the price of meter mail in the absence of a price control. It appears that the stamped/labelled and metered customer groups are very different, and that it is unlikely that meter customers would switch to stamp or label mail in the event of a price increase.

For those large customers who currently use Standard Post – Meter, An Post's bulk mail product (Ceadúnas) may also act as a benchmark. However, these customers only make up a small proportion of customers and therefore the Ceadúnas product would not place sufficient constraint on the price of the product under consideration.

Recommendation

Our recommendation is that Standard Post – Meter (letters, flats, packets and parcels) should be price controlled. An Post faces very little postal and non-postal competition for this product. Further, although Standard Post – Stamp and Label are potential benchmark products, they are unlikely to place sufficient constraint on the price of Standard Post – Meter.

4.3.3 Certificate of posting

A customer can obtain a certificate of posting as proof that an item has been posted. This product is mainly aimed at residential customers and is available free of charge on request when an item is deposited at a post office. SI 280 of 2012 requires An Post to provide such a product with its single piece universal postal services.

Postal competition and non-postal competition

Given the nature of the service, we can conclude that An Post, as the designated USP, is the only operator that can provide a certificate of posting for single piece universal postal services.

Recommendation

Our recommendation is that certificate of posting should be price controlled. Although it is currently provided free of charge by An Post, SI 280 of 2012 does not explicitly specify that the product has to be provided free of charge. An Post, as the designated USP, is the only operator who can provide such a service for single piece universal postal services and no benchmark products are available.

4.3.4 Registered Post

An Post's Registered Post product offers a "proof of delivery facility" for the sender. Additional insurance services can be added with a compensation limit of either €1,500 or €2,000. This product can only be bought at post offices, where customers can pick up a Registered Post label. Items are handled with priority and the sender receives a proof of posting and a tracking number, which allows the sender to monitor the delivery of the item. The recipient of the item will be required to sign for collection, and the sender is able to view this signature online.

This is currently a combined "proof of delivery" and insurance product. However, both the 2011 Act and SI280 of 2012 requires An Post to introduce two separate products, which An Post will do later this year.

Postal competition and non-postal competition

Postal competition for An Post's Registered Post product is limited, with the only competition coming from products offered by express and courier service providers.

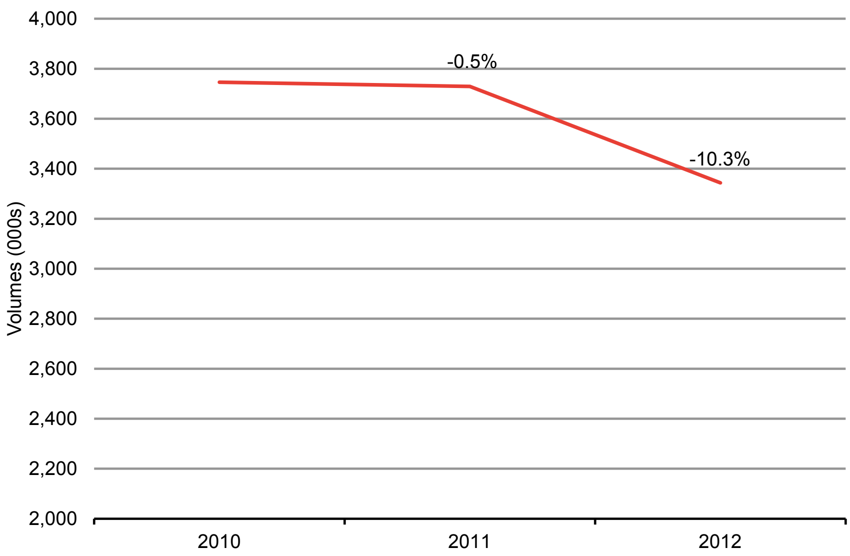
Non-postal competition would not appear to be relevant as in most cases, since customers use this service as they need to send a physical item.

Volume and Price trends

Registered Post volumes have fallen over recent years, as shown in **Figure 7**. The largest decrease was seen between 2010 and 2012. Majority of these volumes are letter mail, with the split in 2010 as follows:

- 54% letters;
- 25% flats; and
- 21% packets.

Figure 7. Domestic Registered Post volumes 2010-2012* (excluding parcels)



Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

An Post has informed us that the majority of customers using the current services are looking for proof of delivery rather than insurance. As such, it expects that the majority of Registered Post volumes will move to the "proof of delivery" service rather than the insurance service when the Registered Post product is separated out.

An Post charges the same price for letters, flats and packets sent via Registered Post within Ireland & Northern Ireland. As with other products, this price varies by weightstep, as shown in **Table 7** for 2013 prices.

Table 7. Registered Post – 2013 Prices

Weight	Price
<50g.	€ 5.25
51-100g	€ 5.50
101-250g	€ 6.00
251-500g	€ 7.00
501-1000g	€ 10.00
1001-1500g	€ 12.50

Scope of the products under the price control

1501-2000g	€ 12.50

Source: An Post

For parcels sent through Registered Post, An Post charges €10.50 for 0-1.5kg, €12.50 for 1.5-2.5kg, €13.50 for 2.5-3kg, €14.50 for 3-3.5kg, €16 for 3.5-4kg and then an additional €1 per 0.5kg for 4-5kg, with all 5kg+ parcels charged at €19.00. Comparing these prices to those offered by Fastway (as detailed in section 4.3.1), shows that Fastway prices are actually lower than An Post's prices for parcels sent through Registered Post for all weightsteps, further suggesting that customer awareness and use of alternative providers is low. For packets sent through Registered Post, Fastway prices are only cheaper for weightsteps from 500g to the 2kg limit.

Benchmark products

The closest alternative An Post product is Courier Post. However, this product lies outside the scope of the USO and therefore cannot be price controlled.

Recommendation

Our recommendation is that both the Proof of Delivery service and the Insured Service (currently combined as a Registered Post service) (letters, flats, packets and parcels) should be price controlled. Postal competition for An Post's Registered Post product is very limited. Further, in most cases, customers use the service to send physical items, so non-postal alternatives aren't available, and there are no potential benchmark An Post products.

4.3.5 Postal services to blind and partially sighted

An Post offer a free single-piece service for posting items to the blind and partially sighted. These items can be sent to domestic or international addressed. There is a weight restriction of 7kgs and also a restriction on the type of item that can be sent, e.g. packages to domestic addresses can only contain literature and articles adapted for the blind. Items should be clearly marked as items for the blind and postal clerks should be able to verify the content of the item.

Recommendation

Our recommendation is that postal services to the blind and partially sighted should not be price controlled. The 2011 Act and the Communication Regulation (Universal Postal Service) Regulations 2012 in SI 280 of 2012 specify that postal services to the blind and partially sighted must be provided free of charge. As such, no price regulation is required in relation to this product.

4.3.6 Bulk Mail: Ceadúnas (License) – Fully paid and Discounted

An Post offers a discounted mail product for customers posting large volumes of mail within the Republic of Ireland. To qualify for the service, customers must meet the following minimum volume requirements per posting:

- letters: 2,000 items;
- flats: 500 items; and
- packets: 100 items.

Ceadúnas customers have an approved Ceadúnas logo (which denotes payment of postage) printed on their envelopes. Mail is delivered by the customer to one of the 4 mail or 39 mail acceptance offices. An Post offers 13 variants of the Ceadúnas product, one fully paid (priced at the same level as Standard Post – Meter) and 10 variants that offer different levels of discount. The discounts available depend on six characteristics:

- **time** at which the mail is presented to An Post;
- **timing of delivery**: customers can choose for the mail be delivered the next working day, or opt for deferred processing, in which case delivery will take two working days;
- **automated processing**: whether items are within prescribed dimensions such that An Post can process the mail with automated equipment;
- **automated sorting**: whether items are such that An Post's equipment is able to sort at least 85% of the items automatically. Clear addresses are needed for this. Note that not all items that can be auto-processed can be auto-sorted;
- **pre-sorting before presentation to An Post**: level of pre-sorting (according to An Post's standards) done by customers before they present the mail to An Post;
- **location of presentation**: most discounts only apply when the mail is delivered to the four mail centres, others also apply when the mail is presented to the 39 acceptance offices

In the following table (**Table 8**) we categorise each Ceadúnas variant according to these six characteristics.

Table 8. Characteristics of Ceadúnas variants

	Timing of presentation (before ...)	Working days between presentation and delivery	Automated processing	Automated sorting	Pre-sorting	Mail centres only
Discount 1	noon	1	Yes	No	-	Yes
Discount 3 (2013 Discount 2)	noon	2	Yes	No	-	Yes
Discount 4 (2013 Discount 3)	noon	1	Yes	Yes	-	Yes
Discount 5 (2013 Discount 4)	3 pm	1	Yes	Yes	-	Yes
Discount 6	noon	2	Yes	Yes	-	Yes
Discount 7 (2013 Discount 5)	3pm	1	No	-	-	Yes
Discount 9	5.30 pm	1	-	-	Yes	No
Discount 10 (2013 Discount 8)	noon	1	-	-	Yes	No
Discount 11 (2013 Discount 7)	noon	2	No	-	-	No
Discount 12 (2013 Discount 10)	noon	2	Yes	No	-	No

Source: Website An Post: http://www.anpost.ie/NR/rdonlyres/B5774F94-F37B-429C-8ED0-8583E63DB288/5515/BulkMailBlueA4WWW1.pdf

Note: Labelling of each product in the table above corresponds to pre-2013 classification when 12 variants were available. Discount 2 and Discount 8 were withdrawn in 2013. New names in parentheses.

Postal competition and non-postal competition

Our analysis of postal competition in section 4.2.2 suggested that there may be some limited competition in the business customer segment of the market from rival postal service providers. However, it appears that the products offered by these providers only target a very narrow part of the business customer market. Ceadúnas therefore does not appear to face significant postal competition.

Scope of the products under the price control

With regards to non-postal competition, to date there has been no evidence that this has been constraining An Post's pricing of the Ceadúnas product (see below). There is also insufficient evidence to suggest that this will change over the price control period.

Volume and Price trends

In line with the overall volume trends that have been seen in the mail market as a whole, total Ceadúnas USO volumes have fallen over recent years. Between 2010 and 2011 volumes fell by 2% and between 2011 and 2012[21] volumes fell by 2%.

In 2012, Ceadúnas USO volumes were just over half of total USO volumes, 77% of which were letter mail <50g and a further 20% were letter mail >50g. Only 2.6% were flats mail and 0.4% packet mail. Analysis of the breakdown of volumes between the different variants of Ceadúnas for 2012 provides some further important insights. In 2012, 85% of Ceadúnas volumes were made up of the discounted variants. Of these volumes, **Table 9** shows the split between the different variants. The majority of these volumes are sent using Discount 6, with a further 14.1% sent using Discount 4.

21 Note: 2012 volumes are draft volumes that are still to be reviewed and audited.

Table 9. 2012** split of the discount variants of Ceadunas

	Proportion of discounted Ceadunas volumes
Discount 1: Presentation before noon auto processing	2.7%
Discount 2*: Presentation before 3pm auto-processing	0.3%
Discount 3: Deferred processing before noon auto-processing	1.1%
Discount 4: Presentation before noon +85% autosort	14.1%
Discount 5: Presentation before 3pm +85% autosort	3.7%
Discount 6: Deferred processing (presentation before noon +85% autosort)	73.8%
Discount 7: Presentation before 3pm	1.3%
Discount 8*: Deferred Processing before noon	2.0%
Discount 9: PreSort (152 Sorts) before 5.30pm	0.2%
Discount 10: PreSorted (152 Sorts) before noon	0.4%
Discount 11: Deferred Processing before Noon	0.1%
Discount 12: Deferred Processing before noon auto-processing	0.3%

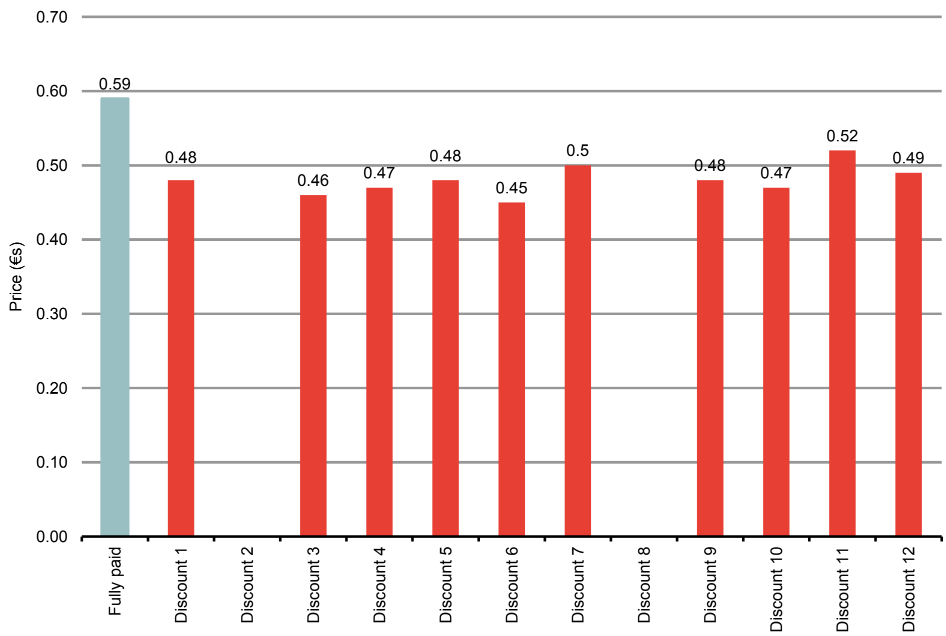
Source: An Post 'Volumes & Revenue 2012 Ceadunas Standard & Discounted'

Note: Labelling of each product in the table above corresponds to pre-2013 classification when 12 variants were available. *Discount 2 and Discount 8 were withdrawn in 2013. ** 2012 volumes are draft volumes that are still to be reviewed and audited.

An Post's pricing of each Ceadúnas variant depends on format and the cost saving characteristics of each variant for An Post. As an example of the prices offered by An Post for the different Ceadúnas variant, **Figure 8** shows the 2013 price of each variant for a letter <50g. The largest discount available is for discount 6 (deferred processing, presentation before noon +85% autosort), which is €0.15 cheaper than Standard Post – Stamp for the same item and €0.07 cheaper than the most expensive discount variant, discount 11 (deferred processing before noon).

Scope of the products under the price control

Figure 8. 2013 Prices for Ceadunas variants - Letters <50g



Source: An Post Bulk Discounts For Mailers 2013

Benchmark products

Given the similarities between the Ceadúnas variants and extent of the price differentials between them, there is clear potential for a limited number of Ceadúnas variants to act as benchmark products.

As set out in section 2.2, in 2012 ComReg specified a "de minimis" set of universal postal services that meet the needs of postal service users, while also minimising the regulatory burden on An Post as the universal service provider. In doing so, it considered whether to include all Ceadúnas variants or not. It was concluded that an extensive range might deprive customers of the ability to negotiate terms and conditions that suit their particular requirements. At the same time exclusion of Ceadúnas from the universal postal service altogether would run the risk that some users would not have sufficient bargaining power to secure the provision of the postal services that they require. As such, SI280 included two universal service bulk mail products:

- a service for the clearance, transport and distribution of "postal packets deposited in bulk" for "deferred delivery" – equivalent to Discount 6; and
- a service for the clearance, transport and distribution of "postal packets deposited in bulk" for "delivery only" – equivalent to Discount 9.

The remaining Ceadunas variants are claimed by An Post to be postal services within the scope of the universal postal service.

As Discount 6 makes up 70% of discounted Ceadúnas volumes and is currently the cheapest Ceadúnas product (and will therefore act as a price floor), this would be a sensible benchmark to choose. Discount 9 would also be an appropriate benchmark product as it will further protect those Ceadúnas customer who do not want to opt for deferred delivery.

Recommendation

Our recommendation is that Discount 6 - Deferred processing (presentation before noon 85%+ autosort), available for letters and flats, and Discount 9: PreSort (152 Sorts) before 5.30pm, available for letters, flats and packets, should be price controlled and the remaining variants to not be price controlled. Although it is clear that An Post does not face postal or non-postal competition in relation to these variants, a comparison across these variants suggests that price controlling discount 6 and discount 9 will place sufficient constraint on An Post's pricing of the other discount variants[22]. Further, Standard Post - Meter will place sufficient constraint on An Post's pricing of the fully paid variant.

4.3.7 International Bulk Mail Service (IBMS)

An Post also offers an International Bulk Mail Service (IBMS) for customers sending high volumes of mail to foreign destinations. There are three variants:

- Standard IBMS;
- IBMS Extra; and
- IBMS DSA (UK only).

A priority and non-priority service is available for all three variants.

For Standard IBMS, the following qualification criteria apply:

- sorted items:
  - Letters only – minimum 1kg or 50 items per country; and
  - Letters, flats and packets – minimum 3kg per country.
- unsorted items:
  - Letters only – minimum 2kg or 100 items per mailing; and
  - Letters, flats and packets – minimum 5kg or 50 items per mailing.

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22 This approach is consistent with the universal postal services specified in SI 280 of 2012. This subset of Ceadunas product is therefore VAT exempt. It also accounts for majority of volumes.

For IBMS Extra, the following qualification criteria apply:

- sorted items: letters, flats and packets – minimum 40kg or 2,000 items; and
- unsorted items: - letters, flats and packets – minimum 40kg or 2,000 items.

Finally, for IBMS DSA (UK only), the following qualification criteria apply:

- Letters only – minimum 10kg or 500 items; and
- Large letters – minimum 5kg or 250 items.

IBMS customers should sort the mail according to format, and use bags, tags and labels provided by An Post. The mail can either be presented by the customer to An Post, or collected by An Post from the customer. It will be treated as first class mail in the destination country. With the priority service, delivery to the UK and Western Europe takes place within 2-3 working days. Delivery to the rest of Europe takes 4-6 days and the rest of the world 5-7. The non-priority service will take an additional 4-5 working days.

Postal competition and non-postal competition

Our analysis of postal competition in section 4.2.2 suggested that there may be some limited competition from rival postal service providers in the business customer segment of the market for sending international mail. In particular:

- Eirpost offers a standard international mail service with a pick-up service. Delivery timeframes are 3-4 working days for delivery in Europe and 7-8 days for the rest of the world. The prices per item are lower than An Post's Standard Post - International, but Eirpost will charge a pick up fee and requires online registration; and
- Lettershop also provides an international mail service for business mailers, which involves them pre-sorting international mail items and sending them directly into a variety of other foreign postal providers and alternative delivery services. Collection is free in Dublin dependent on location and volume.

IBMS is only available to large international mail customers, and all of these customers should be able to avail of international mail products offered by Eirpost and Lettershop. However, the evidence suggests that Eirpost and Lettershop do not have a significant market share. Further, as these products are aimed at business mailers, it is not available to An Post's residential customers. In relation to these customers the evidence suggests that postal competition is limited, and constrained to the parcel segment of the market.

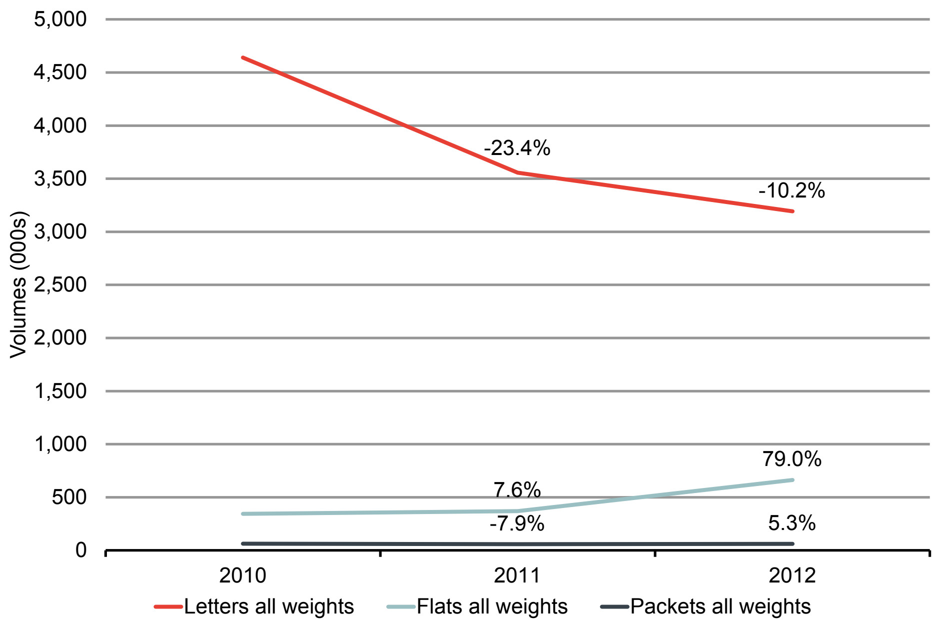
A further option for these large international mail customers may be to directly make use of bulk mail services offered by other postal providers. However, mail volumes to a particular country would have to be significant for this to be cost effective. We therefore conclude that this would not be a sufficient constraint on An Post's pricing of any variants of IBMS.

With regards to non-postal competition, we have not seen any evidence to suggest that this has been constraining An Post's pricing of any variants of IBMS. In particular, we see very substantial price differentials between An Post's products and electronic alternatives, e.g. email and post. We have also seen insufficient evidence to suggest that this will change over the price control period.

Volume and Price trends

IBMS volumes are dominated by letter mail. However, as illustrated in **Figure 9**, the volume of letters has fallen significantly in recent years, while there has been an increase in the volume of flats.

Figure 9. International Bulk Mail Service volumes 2010-2012*



Source: An Post

* 2012 volumes are draft volumes that are still to be reviewed and audited.

The price per item of mail sent via IBMS varies by country (apart from IBMS DSA, which can only be sent to the UK), and there is a special category for items weighing less than 25 gram. **Table 10** shows a selection of the 2013 prices for Standard IBMS letter mail. There is no distinct pattern between distance of a country from Ireland, and the prices charged. The same is true for IBMS Extra, which is priced at a lower level to reflect the higher volume threshold, as shown in **Table 11**. In comparison, IBMS DSA (UK Only) is priced at €0.387 for letters and €0.545 for flats up to 100g.

Table 10. Selection of Standard IBMS 2013 letter prices

	<25g	<50g	<100g
GB	€0.52	€0.59	€0.77
France	€0.70	€0.90	€0.90
Germany	€0.68	€0.90	€0.90
U.S.A.	€0.41	€0.51	€0.70

Source: An Post

Table 11. Selection of IBMS Extra 2013 letter prices

	<25g	<50g	<100g
GB	€0.48	€0.51	€0.66
France	€0.66	€0.90	€0.90
Germany	€0.63	€0.90	€0.90
U.S.A.	€0.39	€0.49	€0.67

Source: An Post

Benchmark products

Given the similarities between the IBMS variants and the price differentials between them, there is potential for at least one of them to act as a benchmark product for the others. In particular, it appears that Standard IBMS would be an appropriate benchmark product for IBMS Extra and IBMS DSA (UK Only) for a number of reasons:

- this approach is consistent with SI 280 of 2012 - Standard IBMS is currently the only IBMS variant that is specified as a universal service product, the other two are just within the scope of the USO;
- it is available for mailings to all countries that the other two variants can be used to mail to; and

- it is priced at a higher level than the other two variants and could therefore be expected to act as a price cap for these variants.

Recommendation

Our recommendation is that the Standard IBMS (all formats) should be price controlled. We also recommend that IBMS Extra and IBMS DSA (UK Only) are not price controlled. Postal competition for IBMS is limited. However, it appears that Standard IBMS would act as an appropriate benchmark to sufficiently constrain An Post's pricing of these variants.

4.3.8 PO Box

An Post offers PO Boxes (lockable boxes) for rental by residential or business customers. Instead of regular addresses, post can be send to these boxes. Customers can then either collect the post from their PO Box, or have it forwarded to their home or office.

Postal competition and non-postal competition

With regards to postal competition, we are not aware of any other postal, express or courier service providers who offer a similar service in Ireland. There is also no non-postal competition for this product given its physical nature.

Benchmark products

There is no close alternative to the PO Box.

Recommendation

Our recommendation is that PO Boxes should be price controlled.

4.3.9 Poste Restante

Poste Restante is an An Post service that allows customers to have their mail addressed to any specified Post Office in the state for three months. Mail will then be held for collection by the addressee at this Post Office for three months. The address on the mail item should include the name of the recipient, the address of the post office and the description "Poste Restante".

Recommendation

Our recommendation is that Poste Restante should not be price controlled. The Communication Regulation (Universal Postal Service) Regulations 2012 in SI 280 of 2012 specify that Poste Restante must be provided free of charge. As such, no price regulation is required in relation to this product.

4.3.10 Residential and Business Redirection

Redirection is a service provided by An Post that allows residential or business customers to forward mail to any other national or international address for up to three months, six months or one year. This is aimed at customers who are moving home or business.

Postal competition and non-postal competition

Given the nature of the redirection service, An Post is the only provider who can offer such a service. Redirection of mail takes place at delivery sorting office or delivery sorting unit level. An Post is therefore the only company who is able to intercept mail at this point and redirect it to the customer's chosen address.

There are also no non-postal alternatives that are available for this product.

Recommendation

Our recommendation is that Residential and Business Redirections (of all durations) should be price controlled. An Post do not face any postal or non-postal competition for this product.

4.3.11 Mailminder

Mailminder is a service which suspends delivery to an address for up to 12 weeks. All mail received during this suspension period will be delivered at the end of the period. This service can cover multiple addresses and is aimed at customers who are going to be away from their property during the pre-specified period of time.

Postal competition and non-postal competition

As with the redirection products, An Post is the only provider who can offer such a service due to the need to intercept mail at the delivery sorting office or delivery sorting unit level.

Again, there are no non-postal alternatives to this product.

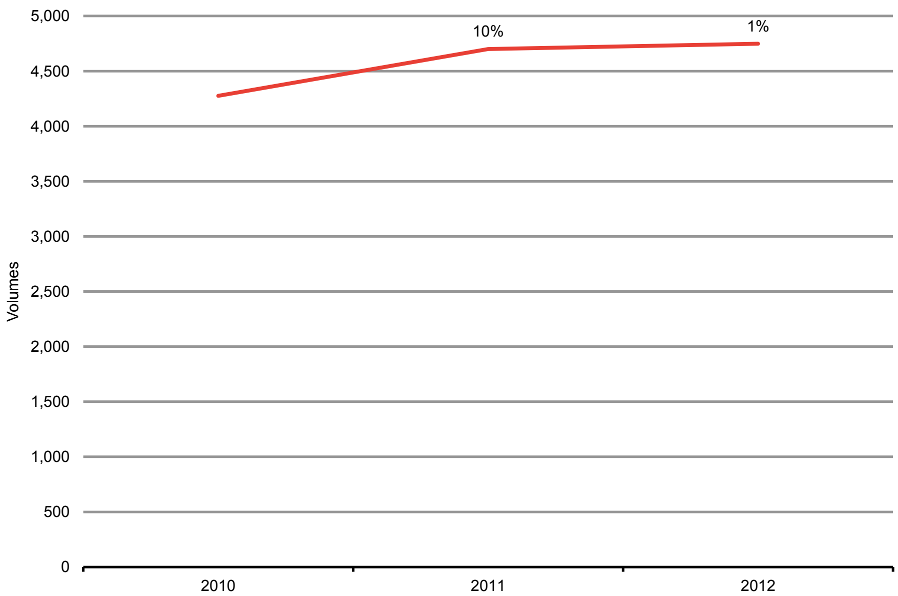
Benchmark products

The closest alternative to Mailminder is Poste Restante, a free service. However, with Poste Restante the senders of mail have to address the item to your chosen Post Office rather than your address (as with Mailminder).

Volume and Price trends

Mailminder is not a product that is used frequently by customers, as illustrated in **Figure 10**. Although volumes increased over the 2010 to 2012 period, they were still less than 4,800 by 2012.

Figure 10. Mailminder volumes 2010-2012*



Source: An Post

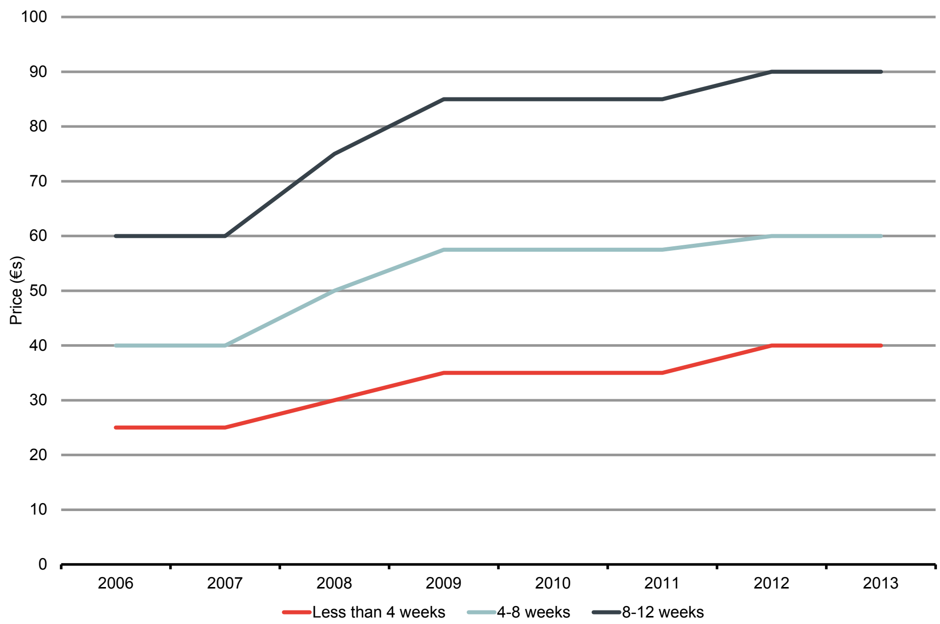
* 2012 volumes are draft volumes that are still to be reviewed and audited.

An Post offer three price steps for the Mailminder service:

- less than 4 weeks;
- 4 to 8 weeks; and
- 8 to 12 weeks.

The evolution of each of these prices over the 2006-2013 periods is shown in **Figure 11**. Price increases were seen across all options in 2008, 2009 and 2012. The price of the 'less than 4 weeks' variant increased by 14% in 2012, the '4 to 8' weeks' variant by 4% and the 8 to 12 weeks variant by 4%. The price difference between the '4-8 weeks' and '8-12 weeks' variants has consistently remained larger than that between the 'less than 4 weeks' and '4-8 weeks' variants over the 2006-2012 period.

Figure 11. Mailminder prices 2006-2013



Source: An Post guides to postal rates 2006-2013

Recommendation

Our recommendation is that Mailminder should be price controlled.

4.3.12 Business Reply and Freepost

Business Reply is a product that can be used by companies to maximise customer response, e.g. to speed up bill payments or collect information. An approved pre-paid, pre-printed envelope, card or label is supplied to customers, meaning that they can respond to the company at no cost. The company itself will only pay for the responses received.

Freepost is similar to business reply, but it instead offers businesses a Freepost address that customers can respond to. This therefore allows customers to respond free-of-charge without first receiving a pre-paid envelope, card or label. The business will then pay for all post it receives through this Freepost address.

Postal competition and non-postal competition

Provision of a response service, such as Business Reply or Freepost, requires national collection from, and delivery to, rural and urban areas. In addition, volumes sent via these services may not be significant, and there will be a degree of uncertainty attached as volumes will depend of how many households choose to send a response back to the business.

As such, it would be difficult for an alternative provider to develop the required national network to ensure national collection. It is therefore highly unlikely that other operators will provide an equivalent postal response service in the future.

Non–postal alternatives will provide limited constraint. The use of such alternatives by responding customers will depend largely on preference rather than price. It is likely that businesses will use business reply as part of a suite of options that customers can use to respond depending on their preference.

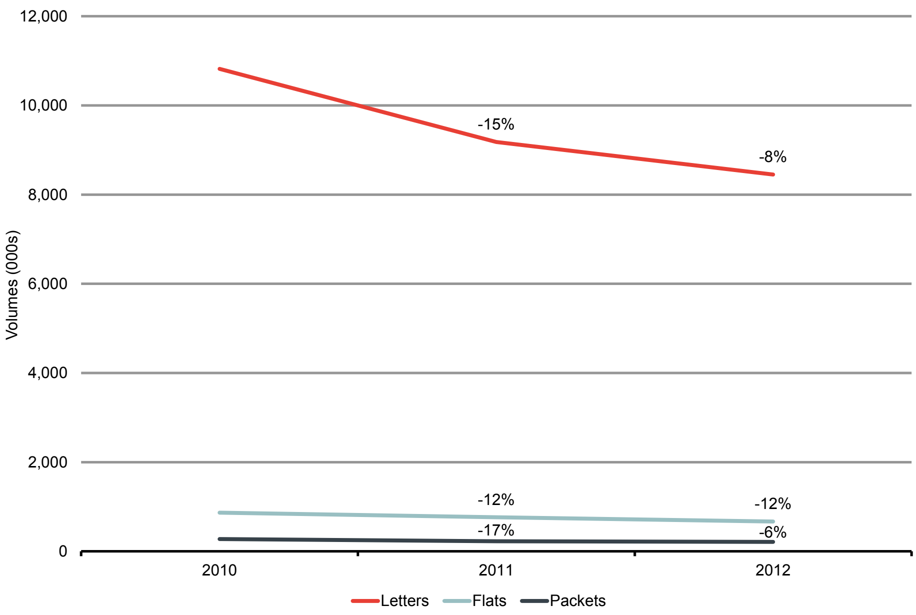
Benchmark products

Business Reply and Freepost could be potential benchmark products for each other. An Post classes these products as 'Business Response' services and currently charges the same prices for both. Given that Freepost does not require businesses to send out any pre-printed envelopes in order to receive responses from customers, this could be considered the superior service of the two. It might therefore be more appropriate for this to be the price controlled product, acting as a cap on the price that An Post could charge for Business Reply.

Volume and Price trends

Between 2010 and 2012, Business Reply and Freepost volumes made up around 2% of USO volumes (excluding packets). This share of volumes has remained stable despite total volumes declining by 22% over the same period, as shown in **Figure 12** below. Similar percentage declines have been seen across all formats. Most of this decline occurred between 2010 and 2010 for letters and packets, whilst the decline in flats has been consistent at 12% per year.

Figure 12. Business Reply volumes 2010-2012*



Source: Frontier analysis of App 2 - Revenue and Volumes Model 2010-2014

* 2012 volumes are draft volumes that are still to be reviewed and audited.

The prices that An Post currently charges are the same for both products. Businesses that sign up to with service must pay an annual license fee[23] and then a per item charge based on weight and format. The annual license fee has remained constant at €145 since 2009, before this it increased by 5% on average year-by-year from 2006. The price for 50g letters, which made up 89% of 2012 Business Reply volumes, is currently 1c less than the Standard Post stamped product. This price differential has been maintained from that offered in the 2007-2012 period.

Recommendation

Our recommendation is that Business Reply should not be price controlled, while Freepost should be price controlled. An Post currently doesn't face any postal competition for these products. This is largely due to the fact that it would be difficult for an alternative provider to develop the required national network to ensure national collection. Non-postal alternatives also provide limited constraint. However, our analysis suggests that Freepost could act as a

23 The annual license fee operates until the end of the calendar year and will be pro-rated if bought after January. In addition to the annual license fee, a deposit related to anticipated volumes must also be paid (subject to a minimum deposit of €72.50).

benchmark product for Business reply, and therefore, only Freepost should be price controlled.

4.4 Recommendations

Based on our competition assessment of the products under consideration, we recommend that ComReg should include the following products in the scope of the price control:

- Standard Post – Stamp and Label;
- Standard Post – Meter;
- Certificate of Posting;
- Registered Post;
- Bulk Mail: Ceadúnas Discount 6 - Deferred processing (presentation before noon +85% autosort) and Ceadúnas Discount 9: PreSort (152 Sorts) before 5.30pm;
- Standard IBMS;
- PO Box;
- Residential and Business Redirections;
- Mailminder; and
- Freepost.

5 Setting the basket or baskets of products

The previous chapter set out our recommendations on the products to be included in the scope of the price control. The next step is to consider how to price control each of these products within the price control design framework outlined in section 3.

This stage of the price control process should determine whether all products will be subject to a single price cap (effectively a single basket control), or whether products should be grouped together into more than one basket, each with different price caps.

This chapter is structured as follows:

- section 5.1 highlights the main legislative requirements that govern this decision; and
- section 5.2 provides our recommendations on the appropriate number of baskets, the characteristics of these baskets and the form of each defined basket.

5.1 Legislative requirements

As highlighted in section 3.1, section 30(1) of the 2011 Act specifies that:

- the price cap will be established after a public consultation; and
- a price cap can be specified in respect of one, or more than one, basket of services.

This section of the 2011 Act also defines a price cap as *"an overall limit on the annual percentage change in charges that can be imposed for any basket of postal services which is calculated in accordance with the following formula:*

$$\textit{Overall limit} = (\Delta\ CPI) - X\text{''}$$

Where 'CPI' is the consumer price index number as compiled by the Central Statistics Office and 'ΔCPI' is the annual percentage change thereof. 'X' also known as the X-factor is the adjustment specified by ComReg to provide incentives for the efficient provision of postal services. If more than one basket of postal services is determined, a separate 'X' can be set for each basket.

In determining the number of baskets and the value of the 'X' for each basket, ComReg are required to act in accordance with the 2011 Act, and its statutory objectives, as set out in the Communications Regulation Act 2002. Particular attention should be paid to key sections of each Act.

- Pursuant to Section 12(1) of the Communications Regulation Act 2002, ComReg must:
  - promote the development of the postal sector and, in particular, the availability of a universal postal service within, to and from the State at an affordable price for the benefit of all postal service users;
  - promote the interests of postal service users within the Community; and
  - subject to promoting the availability of a universal postal service, facilitate the development of competition and innovation in the market for postal service provision.
- Pursuant to Section 28(1) of the 2011 Act, the tariffs for universal postal services must be:
  - affordable and be such that all postal service users may avail of the services provided;
  - cost-orientated, that is to say that, the prices shall take account of, and reflect the costs of, providing the postal service or part of the postal service concerned; and
  - transparent and non-discriminatory.

Further, in setting the product-by-product tariffs, based on ComReg's price control determinations, An Post must also pay utmost attention to the tariff requirements outlined in section 28 of the 2011 Act to ensure any of its pricing for its universal postal services are compliant with those tariff requirements.

5.2 Number, characteristics and form of baskets

The 2011 Act allows for the price cap to be specified in respect of one, or more than one, baskets of the services that come within the scope of the price control. Although the use of more than one basket prevents An Post from re-balancing tariffs between baskets, it does not limit An Post's pricing freedom within each basket. Instead, this will be determined by the form of each basket. In relation to the form of the basket(s), there are two important design questions that need to be considered:

- how to weight the products in each basket; and
- how much tariff re-balancing freedom to afford the operator.

The decision around how to weight the products in each basket is important as it influences a firm's profit-maximising pricing choices. In particular, these choices will differ depending on whether an average revenue or a tariff basket control is used.

Setting the basket or baskets of products

- *A tariff basket with fixed weights*[24]: Under this type of control, fixed weights would be assigned to each product for the duration of the price control.

- *An average revenue control*[25]: This type of control applies to the movement in the observed average revenue over time, and so, compared to the tariff basket approach, the weights on each product relate to the share of revenue for that product in that particular year. This means that the operator's pricing decisions will take account not only of the demand effect of the price change, but also the impact that the demand change will have on the share of revenue for that product which will determine the base weights for the basket for the following year.

In relation to the second design decision, although tariff rebalancing carried out within a basket by an operator could be expected to be efficient, it also raises two concerns:

- possible distortion of competition faced by some services; and
- different effects on different types of customers.

Both of which could contravene the statutory tariff requirements set out in the Act. As such, it may be appropriate to place some limits on the degree of rebalancing freedom afforded to An Post in relation to each of the defined baskets by introducing further constraints.

In order to determine the number, characteristics and form of the basket(s), a trade-off will be required between:

- allowing An Post sufficient commercial freedom to rebalance prices in order to:
  - achieve cost orientation and non-discrimination between products; and/or
  - react to competitive market constraints; and
- protecting customers.

24 **Tariff basket control formula for two products:**

$$p_{11}q_{10} + p_{21}q_{20} \leq (1 + cpi - X)p_{10}q_{10} + p_{20}q_{20}.$$

That is, the total revenue from product 1 and product 2 under current prices and period 0 quantities must be less than or equal to the total revenue from product 1 and product 2 under period 0 prices quantities multiplied by 1+cpi-X.

25 **Average revenue control formula:**

$$R_t/Q_t \leq (1 + cpi - X)R_{t-1}/Q_{t-1}$$

That is, average revenue in the current period must be less than or equal to average revenue from the previous period multiplied by 1+cpi-X.

This section covers:

- the risks associated with allowing An Post too much pricing freedom;
- the role that section 28 of the 2011 Act could play; and
- our recommendations on the number, characteristics and form of baskets.

5.2.1 Risks from allowing An Post too much pricing freedom

In considering the trade-off between providing An Post with appropriate commercial freedom, and protection competition and consumer interests, it is important to bear in mind that the reason products have been recommended for inclusion in the price control is that they do not face effective competition – i.e. An Post does not face sufficient constraint in relation to the pricing of these products.

However, our assessment of postal and non-postal competition carried out in section 4.2.2 also indicated that some products faced more postal competition than others[26]. In particular:

- postal competition for An Post parcel products (for both residential and business customers) is relatively well developed, with a range of express and courier service providers;
- postal competition for other products for business customers is still quite limited but is beginning to develop; and
- postal competition for other products for residential customers is yet to develop.

These differences indicate that residential non-parcel customers may be considerably more 'captive', than residential parcel customers and business customers. This has an important implication for the design of the price control and the decisions around basket(s) of products. In particular, if all of these products were to be included in one basket without any restrictions on the degree of rebalancing freedom afforded to An Post, the price cap would impose a weighted average price increase across all products. This could provide An Post with the incentive and ability to impose significant price increases for non-parcel products for residential customers, whilst keeping price increases low, or even reducing prices, for other products within the cap. There is therefore a risk that

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26 Our assessment of non-postal competition revealed nothing to suggest that non-postal competition would vary to the same degree across products.

the use of one basket would not protect residential customers from An Post's ability to exercise market power, thereby undermining a key objective of the price control.

A further consideration is the possible distortionary impact on competition that such pricing behaviour could create. If An Post were to exercise excessive rebalancing of prices, and reduce prices significantly on products that face more competition, it could have one of two effects:

- force existing competitors, who cannot compete with such significantly discounted prices, from the market; or
- prevent potential competitors from entering the market.

At the same time, it is important not to unduly restrict An Post's commercial freedom to the extent that they themselves are left at a competitive disadvantage. It is also important to ensure that An Post is provided with sufficient pricing flexibility to enable it to meet the tariff requirements as prescribed in the Act.

5.2.2 Role of section 28 of the 2011 Act

Section 28 of the 2011 Act provides ex-post safeguards against An Post's ability to exploit its market power. However, there is a risk that these safeguards might not limit An Post's pricing behaviour and protect postal users to the desired extent. This risk is centred first on the fact that the tariff requirements are not accompanied by detailed descriptions. For example, no definition of affordability is provided by the Act. Where ComReg is of the opinion that An Post is failing, or has failed, to comply with any of the requirements specified, section 28(5) of the 2011 Act allows ComReg to give a direction to An Post to ensure compliance with the requirement concerned. In doing so, it is therefore at the discretion of ComReg to define each of the relevant terms.

The reliance on such an ex-post safeguard does not appear to be attractive from a regulatory point of view. Specifically, this is because such an approach:

- requires substantial on-going monitoring of compliance with this section of the 2011 Act by ComReg;
- may result in customers and competitors being negatively impacted for at least a short period of time until potential non-compliance is identified, investigated and rectified; and
- introduces a degree of regulatory uncertainty.

5.2.3 Recommendations on the number, characteristics and form of the price control basket(s)

We recommend that Comreg consider imposing some ex ante limitations on the pricing freedom that is afforded to An Post. In particular, we suggest that ComReg should consider either:

- using a single basket, along with limits on the degree of tariff rebalancing that An Post can undertake within a price control period; or
- use multiple baskets of products.

Single basket with limits on the degree of tariff rebalancing

Under this option ComReg could set a single tariff basket. However, for certain categories of products (e.g. stamped mail), it could either:

- Set limits on the annual percentage change in price allowed for the product; or
- Set a maximum price that the product cannot exceed.

Under this option, the degree of pricing freedom afforded to An Post would depend upon the number of rebalancing limits and the 'tightness' of such limits. We suggest that any such limits or maximum prices would need to be set as part of the price control process, once ComReg has greater insight into the likely evolution of An Post's volumes and costs over the price control period.

Setting multiple baskets

Alternatively, ComReg could set multiple tariff baskets. Under this approach, we suggest that the key criterion to use in selecting the appropriate number of baskets is the degree to which competition has developed for each product. This criterion focuses on the supply side. There is also a demand side risk, in that there is a potential for arbitrage opportunities across sub-controls if products which are considered to be direct demand-side substitutes are included in separate sub-controls. For example, if product A and B were considered substitutes by a customer but were in different sub-controls, with a tighter control on the price of product A than product B, customers would choose the cheaper product (A). In this situation the relative prices of substitute products are affected by the decision on sub-controls and hence supply and demand decisions are potentially distorted. A further criterion which focuses on demand side substitutability should therefore also be applied as a final check to ensure that this demand side risk does not arise.

Applying the first criterion based on the differences in postal competition outlined above indicates that the use of three baskets might be appropriate under this option. A potential split of products between these baskets is shown in

Table 12. Basket A contains An Post's non-parcel products for residential customers, Basket B contains An Post's non-parcel products for business customers and Basket C contains An Post's parcel products for both residential and business customers.

Given the absence of product level information to establish the extent of substitution across products, we use information on product characteristics to apply the final criterion and assess whether customers have the option of using one product rather than another when delivering their mail items. This is also informed by the general information that An Post has provided on customer switching. In doing so, we find that no further adjustment is required to the three baskets shown in **Table 12**.

Table 12. Sub-controls based on the application of the degree of competition criterion

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

Source: Frontier Economics

Conclusion

At this early stage of the price control process, we do not yet have the data on volumes, costs, revenues and market shares that would be needed to provide a definitive recommendation in relation to the choice between multiple baskets and imposing limitations on tariff rebalancing during the price control process. Instead, we recommend that this is reviewed and determined in conjunction with the decision on the overall price cap, when more information is available.

Ultimately, the decision will depend upon the degree of uncertainty around volumes, costs, revenues and market shares that is likely to exist over the price control. The decision may also be usefully informed by the views of market participants through the consultation process.

Setting the basket or baskets of products

6 Summary of recommendations

Frontier has been commissioned to provide assistance to ComReg in setting a price cap for the universal service provider's postal services within the scope of the universal postal service that are found to have no effective competition, pursuant to section 30 of the 2011 Act. This report looks at the first key stage of this work, deciding on the format and scope of the price control.

We have set out our recommendations on three key issues:

- deciding on the exact form of the price control
- setting out which of An Post's postal services within the scope of the universal service should be in any price cap, following a review to ascertain if there is effective competition in the market for the supply of those postal services; and
- identifying the basket or baskets of postal services to be specified for any price cap.

Below we summarise our current recommendations in relation to each of the above

6.1 Form of price control

Based on the analysis presented in sections 3.1 and 3.2 we have a number of recommendations in relation to the form of the price control.

- The price control be based on a cash model rather than a RAB model. In our view the cash model is better suited to the characteristics of the postal sector in Ireland than the RAB model for reasons discussed in section 3.2.1.
- As part of the price control determination, due consideration should be given to the introduction of mechanisms to manage volume risk and uncertainty. This is necessary because in our view there is considerable volume uncertainty in the postal market in Ireland going forward.
- When determining the level of allowable 'efficient' costs, if An Post is found to be required to improve efficiency, consideration should be given to the use of a glide path to allow An Post sufficient time to align its current cost base with an efficient level. A glide path ensures that the postal operator is incentivised to achieve efficiency improvements in a manageable manner.

6.2 Scope of products under the price control

Based on our competition assessment of the products under consideration, we recommend that ComReg should include the following products in the scope of the price control:

- Standard Post – Stamp and Label;
- Standard Post – Meter;
- Certificate of Posting;
- Registered Post;
- Bulk Mail: Ceadúnas Discount 6 - Deferred processing (presentation before noon +85% autosort) and Ceadúnas Discount 9: PreSort (152 Sorts) before 5.30pm;
- Standard IBMS;
- PO Box;
- Residential and Business Redirections;
- Mailminder; and
- Freepost.

6.3 Summary of recommendations for setting the basket or baskets of products

The final chapter of this paper considers whether all products will be subject to a single price cap (effectively a single basket control), or whether products should be grouped together into more than one basket, each with different price caps.

Following our assessment, we come to the following conclusions in relation to the appropriate number of baskets, the characteristics of these baskets and the form of each defined basket:

- There are a number of risks associated with allowing An Post too much pricing freedom. In particular, there is a risk that:
  - the use of one basket would not protect residential customers from An Post's ability to exercise market power, thereby undermining a key objective of the price control; and
  - there could possibly be a distortionary impact on competition if An Post were to exercise excessive rebalancing of prices, and reduce prices significantly on products that face more competition.

- Equally, it is important not to unduly restrict An Post's commercial freedom to the extent that they themselves are left at a competitive disadvantage.

- Further, the reliance on an ex-post safeguard, such as the pricing requirements outlined in section 28 of the 2011 Act, does not appear to be attractive from a regulatory point of view. Specifically, this is because such an approach:
  - requires substantial on-going monitoring of compliance with this section of the 2011 Act by ComReg;
  - may result in customers and competitors being negatively impacted for at least a short period of time until potential non-compliance is identified, investigated and rectified; and
  - introduces a degree of regulatory uncertainty.

- We recommend that ComReg consider imposing some ex ante limitations on the pricing freedom that is afforded to An Post. In particular, we suggest that ComReg should consider either:
  - using a single basket, along with limits on the degree of tariff rebalancing that An Post can undertake within a price control period; or
  - using multiple baskets of products.

However, at this early stage of the price control process, we do not yet have the data on volumes, costs, revenues and market shares that would be needed to provide a definitive recommendation in relation to the choice between multiple baskets and imposing limitations on tariff rebalancing during the price control process. Instead, we recommend that this is reviewed and determined in conjunction with the decision on the overall price cap, when more information is available. Ultimately, the decision will depend upon the degree of uncertainty around volumes, costs, revenues and market shares that is likely to exist over the price control. The decision may also be usefully informed by the views of market participants through the consultation process.

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