Recommendations on a net cost unfair burden assessment and sharing mechanism to fund any unfair burden

A REPORT PREPARED FOR COMREG

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Executive Summary

An Post, as the designated "universal service provider" ("USP"), is required to provide a universal postal service of a specified scope and quality. The Communications Regulation (Postal Services) Act 2011 ("2011 Act") provides that An Post may seek funding for the net costs (if any) of providing a universal postal service[1].

Once ComReg receives an application for funding by the USP, it must determine whether the provision of a universal postal service by the USP concerned:

- represents a net cost, taking into account any market benefits which accrue to the USP; and
- is an unfair burden to the USP.

If ComReg finds that a net cost represents an unfair financial burden on the USP, it shall apportion the net cost among providers of postal services, within the scope of the universal postal service, according to a sharing mechanism.

Frontier's terms of reference are to prepare a report, having due regard to the Communications Regulation (Postal Services) Act 2011 and Directive 97/67/EC (in particular Annex 1), as amended, setting out in detail, recommendations in relation to:

1. the form and manner that a net cost submission should be made by the USP including detailed guidance on "the reference scenario" that should be utilised by the USP;
2. how ComReg could assess whether a net cost is an unfair burden; and
3. how ComReg should set the sharing mechanism to fund any unfair burden

Frontier's previous report *"Recommendations on the form and manner that a net cost submission should be made by the universal service provider"* set out its recommendations in relation to the first of these three elements of the terms of reference. This report addresses the second and third elements.

Background

Before developing a methodology for ComReg to assess whether any net cost associated with the provision of a USO by the USP represents an unfair financial

1 Provision of the universal postal service is referred to in this paper as the "universal service obligation", or "USO", while references to the "USP" should be read as being references to An Post, unless otherwise specified.

burden to the USP, and the appropriate apportionment of such a net cost amongst other providers of postal services within the scope of the universal postal service by means of a sharing mechanism, it is important to take utmost account of:

- Chapter 5 of the 2011 Act, which covers financial support for the USO and consists of two sections:
  - Section 35 - Net cost of provision of universal postal service; and
  - Section 36 - Financing of provision of universal postal service; and
- Article 7 and Annex 1 of Directive 97/67/EC.

The former specifies that if it is determined that the net cost is an unfair burden, it shall be apportioned among providers of postal services within the scope of the universal postal service. There are currently two authorised postal service providers, in addition to An Post, who offer services within the scope of the universal postal service, and who could therefore be subject to any sharing mechanism:

- DX Ireland – who offer one service that is within the scope of the universal postal service; and
- Eirpost – who intend to offer one service that is within the scope of the universal postal service.

Unfair burden assessment

Following submission of a funding request from the USP for the net costs (if any) of providing a universal postal service, ComReg must determine whether the provision of a universal postal service by the USP does represent a net cost.

If ComReg is satisfied that either the net cost has not been verified or that the net cost is outweighed by benefits accruing to the USP that are associated with the USO, then there should be no need to proceed further in an assessment of whether the USO represents an 'unfair financial burden'. If, on the other hand, ComReg is satisfied that a positive net cost is associated with the USO then, pursuant to Section 35(4) of the 2011 Act, it must determine whether that net cost reflects an unfair financial burden to the USP.

Although Section 35(4) of the 2011 Act specifies that ComReg shall determine whether any net cost represents an unfair financial burden on the USP, it does not explicitly define the term 'unfair financial burden'. Similarly, Annex 1 of the Directive 97/67/EC, as also set out in Schedule 4 of the 2011 Act, also does not specify what constitutes an unfair financial burden, or how to identify it.

ComReg would therefore appear to have a degree of discretion in specifying the general and objective criteria it would use to identify what constitutes an "unfair financial burden" for the purposes of section 35(4). In order to determine the appropriate set of criteria to use in the context of the Irish postal market, Frontier has drawn on three key sources of information:

- the approaches discussed by the ERGP in its 2011 paper - *Net Cost Calculation and Evaluation of a Reference Scenario;*
- academic literature and legal precedent relating to the postal sector, as set out in Frontier Economics' 2013 study for the European Commission; and
- the approach used in the Irish telecommunications market.

The criteria recommended by the literature and other NRAs, or used in practice, as part of an unfair burden assessment, fall into three distinct areas.

1. **Absolute net cost of the USO** - A consideration of the absolute positive net cost of the USO to assess whether it is material compared to the potential administrative costs associated with establishing and implemented a sharing mechanism.
2. **Impact of the net cost on the profitability of USP** - An assessment of whether or not this positive net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed in the prevailing market conditions.
3. **Impact of the net cost on the competitiveness of the USP** – An assessment of whether or not this net cost has a material negative impact on the competitiveness of the USP. This will be strongly linked to the impact that any positive net cost has on the profitability of the USP. More specifically, it is unlikely that any net cost could be considered to cause a significant competitive disadvantage unless it also materially undermines the USP's profitability and/or ability to earn a fair return on the capital employed in the prevailing market conditions.

We recommend that ComReg follows this approach, and that it should assess the net cost in relation to each of the above areas as a cumulative test in determining whether any net cost of the USO represents an unfair financial burden on the USP. It is also important that the second and third criteria should only be applied if it is found that the positive net cost is material compared to the potential administrative costs associated with any sharing mechanism.

We note that if ComReg determines that the net cost of the USO represents an unfair financial burden on the USP, based on the three cumulative criteria outlined above, the next step, pursuant to section 36 of the 2011 Act, is to design a sharing mechanism to apportion the net cost among providers of postal services within the scope of the universal service.

Sharing mechanism

Where ComReg determines that there is a net cost of provision of the universal postal service and that this net cost represents an unfair financial burden on the USP, the next step is to determine how this should be financed.

Section 36 of the 2011 Act is prescriptive about the option that should be used to finance the net cost. It requires the net cost to be apportioned among providers of postal services within the scope of the universal service. ComReg must therefore determine how such a sharing mechanism should be implemented and operated.

Frontier's approach

In order to design a sharing mechanism, it is important to first determine a set of criteria against which the potential options should be judged. This includes:

- criteria required by legislation; and
- additional criteria that it would be appropriate to use.

Legislative requirements

Section 36(5) of the 2011 Act and Annex 1 of the Directive 97/67/EC provide some high level requirements for such a sharing mechanism. It is therefore appropriate for these requirements to form the first set of criteria against which the potential options should be judged. In particular, the sharing mechanism must operate:

- in an objective, proportionate and transparent manner;
- in a manner that does not involve or tend to give rise to any undue discrimination against:
  - particular postal service *providers* or a particular class or description of postal service *providers*; or
  - particular postal service *users* or a particular class or description of postal service *users*; and
- in a way that avoids a double imposition of contributions falling on both outputs and inputs of undertakings.

In addition, pursuant to section 12(1) of the Communications Regulation Act 2002, in designing the sharing mechanism, ComReg take utmost account of its responsibilities to:

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

- 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.

Further criteria

In addition, we have developed a further set of criteria in line with those used for the unfair burden assessment. In particular, the following questions should be asked:

- Would the proposed sharing mechanism create significant administrative costs?
- Would there be an adverse effect on competition?

Recommended approach to designing the sharing mechanism

Based on the criteria against which the options were judged and regulatory precedent in other European jurisdictions, we recommend that a pro-rated contribution based sharing mechanism should be used, based on revenues from postal services within the scope of the universal postal service. We also recommend that the sharing mechanism includes a mechanism to cap the proportion of revenues that small operators or new entrants must contribute. This will provide protection for smaller providers, reducing the risk that the sharing mechanism may have an adverse effect on competition in the market for the provision of postal services within the scope of the universal service. This will allow ComReg to ensure it meets its obligation set out in section 12(1) of the Communications Regulation Act 2002, to facilitate the development of competition and innovation in the market for postal service provision, subject to promoting the availability of a universal postal service.

Note, prior to the implementation of the sharing mechanism designed by ComReg, we recommend that a final step is carried out – ComReg should assess whether the contributions collected from other providers through the designed sharing mechanism is greater than the potential administrative costs associated with establishing and implementing this sharing mechanism. We recommend that ComReg should only implement the sharing mechanism if the administrative costs are likely to be less than the contributions collected from other operators.

1 Introduction

The Communications Regulation (Postal Services) Act 2011 ("2011 Act") designates the Commission for Communications Regulation ("ComReg") as the "national regulatory authority" ("NRA") for the postal sector. It also designates An Post as the sole "universal service provider" ("USP") in the State for the period of 12 years, commencing on 2 August 2011.

An Post, as the designated USP, is required to provide a universal postal service of a specified scope and quality. The 2011 Act also provides that An Post may seek funding for the net costs (if any) of providing a universal postal service[2].

Under the 2011 Act, a request for funding by the USP shall be:

- made in a form and manner as ComReg determines;
- submitted after the financial year ending 31 December 2012 for the year of designation and for each year after that no later than six months after the accounts for the financial year concerned have been audited (unless ComReg agrees otherwise); and
- accompanied by any such supporting information as may reasonably be required by ComReg.

Once ComReg receives such an application, it must determine whether the provision of a universal postal service by the USP concerned:

- represents a net cost, taking into account any market benefits which accrue to the USP; and
- is an unfair burden to the USP.

If ComReg finds that a net cost represents an unfair financial burden on the USP, it shall apportion the net cost among providers of postal services, within the scope of the universal postal service, according to a sharing mechanism.

Frontier Economics has been commissioned to assist ComReg in developing a methodology for assessing whether the universal service obligation (USO) represents a net cost and unfair financial burden on the USP, before any such claim for funding in respect of the USO is made by the USP. It has also been commissioned to provide guidance on how to set a sharing mechanism if a net cost is found and this is deemed to represent an unfair financial burden to the USP.

2 Provision of the universal postal service is referred to in this paper as the "universal service obligation", or "USO", while references to the "USP" should be read as being references to An Post, unless otherwise specified.

Frontier's terms of reference are to prepare a report, having due regard to the Communications Regulation (Postal Services) Act 2011 and Directive 97/67/EC (in particular Annex 1), as amended, setting out in detail, recommendations in relation to:

1. the form and manner that a net cost submission should be made by the USP including detailed guidance on "the reference scenario" that should be utilised by the USP;
2. how ComReg could assess whether a net cost is an unfair burden; and
3. how ComReg should set the sharing mechanism to fund any unfair burden

Frontier's previous report *"Recommendations on the form and manner that a net cost submission should be made by the universal service provider"* set out its recommendations in relation to the first of these three elements of the terms of reference. This report addresses the second and third elements. It is structured as follows:

- Chapter 2 sets out background to the study in terms of the relevant legislation and regulations, highlighting in particular those elements to which Frontier has had due regard in the preparation of this report. It also provides information on the other authorised postal service providers operating in the Irish postal market;
- Chapter 3 sets out Frontier's recommendations on how to assess whether any net cost can be considered to be an unfair burden to An Post; and
- Chapter 4 sets out Frontier's recommendations as to how, upon finding that a net cost constitutes an unfair burden to An Post, ComReg could set a sharing mechanism to apportion this net cost among providers of postal services within the scope of the universal postal service.

2 Background

Before developing a methodology for ComReg to assess whether any net cost associated with the provision of a USO by the USP represents an unfair financial burden to the USP, and the appropriate apportionment of such a net cost amongst other providers of postal services within the scope of the universal postal service by means of a sharing mechanism, it is first important to understand:

- the relevant legislation that needs to be adhered to in relation to both exercises; and
- the characteristics of the authorised postal service providers in Ireland.

This section provides background on each of the above.

2.1 Relevant legislation

Frontier's terms of reference require it to have due regard to both:

- the Communications Regulation (Postal Services) Act 2011; and
- Directive 97/67/EC, as amended (in particular Annex 1).

In particular, it is essential that attention is paid to certain sections of the above. These sections are highlighted below.

2.1.1 Communications Regulation (Postal Services) Act 2011

Chapter 5 of the 2011 Act provides for possible financial support for the USP. It consists of two sections:

- Section 35 - Net cost of provision of universal postal service*;* and
- Section 36 - Financing of provision of universal postal service.

In assessing whether any net cost, as calculated, is an unfair burden to the USP, particular attention should be paid to Section 35(4) of the 2011 Act. This specifies that upon receipt of an application for funding of the net costs (if any), ComReg must determine whether the provision of a universal postal service by the USP:

- represents a net cost to the USP, taking into account any market benefits which accrue to the USP; and
- represents an unfair financial burden on the USP.

Where ComReg determines that the net cost does represent an unfair financial burden on the USP, section 36 (1) of the 2011 Act provides that ComReg shall apportion that net cost among the providers of postal services within the scope of the universal postal service and such providers shall make a contribution, in accordance with the cost apportioned to each of them, for the purposes of meeting that burden.

Pursuant to section 36(2) of the 2011 Act, this should be done by means of a sharing mechanism provided for in regulations made by ComReg. Section 36(5) provides that, in making such regulations, ComReg shall ensure that the sharing mechanism operates:

(a) in an objective, proportionate and transparent manner; and

(b) in a manner that does not involve or tend to give rise to any undue discrimination against:

(i) particular postal service providers or a particular class or description of postal service providers; or

(ii) particular postal service users or a particular class or description of postal service users.

All contributions collected through the sharing mechanism shall be paid into a fund and distributed to the USP in accordance with the sharing mechanism.

2.1.2 Directive 97/67/EC

Article 7(3) of the Directive specifies that, where a Member State determines that the USO entails a net cost and represents an unfair financial burden on the USP(s), it may introduce:

- a mechanism to compensate the undertaking(s) concerned from public funds; or
- a mechanism for the sharing of the net cost of the USO between providers of services and/or users.

Where the latter mechanism is introduced, article 7(4) states that Member States may establish a compensation fund, which may be funded by service providers and/or users' fees, and administered for this purpose by a body independent of the beneficiary or beneficiaries.

Guidance on calculating any net cost of the universal service is also provided in Annex 1 of Directive 97/67/EC, which is also set out in full in Schedule 4 of the 2011 Act. In relation to this element of the work, particular attention should be paid to the guidance provided in relation to 'Part C: Recovery of any net costs of universal service obligations'.

This section of the guidelines specifies that the recovery or financing of any net costs of the USO may require designated USPs to be compensated for the services that they provide under non-commercial conditions. As such compensation involves financial transfers, Member States have to ensure that they are undertaken in an objective, transparent, non-discriminatory and proportionate manner. This means that distortion to competition and to user demand by these financial transfers is minimised as much as possible.

Annex 1 of Directive 97/67/EC also specifies that a sharing mechanism based on a fund referred to in Article 7(4), should use a transparent and neutral mechanism for collecting contributions. Such a mechanism should avoid a double imposition of contributions falling on both outputs and inputs if undertakings.

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

2.2 Authorised postal service providers in Ireland

As outlined above, section 36(1) of the 2011 Act requires that if the net cost of the USO is determined to be an unfair burden, it shall be apportioned among providers of postal services within the scope of the universal postal service. In addition, section 36(5)(b) specifies that a sharing mechanism must not operate in a manner that would involve or tend to give rise to any undue discrimination against particular postal service providers or postal service users. Therefore, it is also important to understand:

- which current providers of postal services would be included in such a mechanism; and
- the types of services that they offer.

This section provides details on each of the above.

2.2.1 Authorised postal service providers in Ireland

Section 38 of the 2011 Act requires persons who intend to provide a postal service in Ireland to make a notification to ComReg. Section 6 of the 2011 Act denotes "postal services" to mean services involving the clearance, sorting, transport and distribution of postal packets.

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.

Pursuant to section 38 (3)(f) and 38(6) of the 2011 Act, as part of a notification to ComReg, a provider shall include a short description of the postal service concerned and the geographical scope of that service. It shall also include a declaration which states whether the postal service concerned is, or is not, within the scope of the universal postal service. **Table 1** below illustrates the number of postal services that each of the above providers claim to provide in total, and the number of these that are within the scope of the universal postal service. Other than An Post, only DX Ireland and Eirpost provide services that are within the scope of the universal postal service and could therefore be part of any sharing mechanism.

Table 1. Register of Authorised Postal Service Providers

	Number of "Postal Services" Claimed	Number of "Postal Services" "within the scope of the universal postal service" claimed
An Post	38	35
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: ComReg website (www.ComReg.ie)

2.2.2 Product offering

As outlined above, there are two authorised postal service providers, in addition to An Post, who offer services within the scope of the universal postal service:

- DX Ireland; and
- Eirpost.

Below we summarise the product offering of each of these providers in turn.

DX Ireland

DX Ireland[3] offers one service that is within the scope of the universal postal service - 'DX Exchange – to the door service'. This is an exchange service for B2B mail between registered customers. It allows any DX Exchange member (across ROI) to send mail to access points within County Cork.

Eirpost

Eirpost[4] intends to offer one service that is within the scope of the universal service, a domestic mail service for businesses. In Eirpost's 2012 notification to ComReg, it explained that it was 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.

2.3 Summary

In developing a methodology to assess whether a net cost could be considered to be an unfair burden to the USP, and the resulting sharing mechanism that would apply if such a finding is made, it is important to take utmost account of:

- Chapter 5 of the 2011 Act, which covers financial support for the USO; and
- Article 7 and Annex 1 of Directive 97/67/EC.

The former specifies that if the net cost is determined to be an unfair burden, it shall be apportioned among providers of postal services within the scope of the universal postal service. There are currently two authorised postal service providers, in addition to An Post, who offer services within the scope of the universal postal service, and who could therefore be subject to any sharing mechanism:

- DX Ireland; and
- Eirpost.

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

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

3 Unfair burden assessment

Following submission of a funding request from the USP for the net costs (if any) of providing a universal postal service, ComReg must determine whether the provision of a universal postal service by the USP does represent a net cost.

The information and data included as part of such a funding request by the USP and ComReg's subsequent analysis of this information, will have informed ComReg of both:

- the extent to which there is a verifiable and verified direct net cost associated with the USO; and
- the extent to which any benefits of the USO outweigh the net cost (i.e. there is a positive net cost associated with the USO).

If ComReg is satisfied that either the net cost has not been verified or that the net cost is outweighed by benefits accruing to the USP that are associated with the USO, then there should be no need to proceed further in an assessment of whether the USO represents an 'unfair financial burden'.

If ComReg is satisfied that a positive net cost is associated with the USO then, pursuant to Section 35(4) of the 2011 Act, it must determine whether that net cost reflects an unfair financial burden to the USP.

Although Section 35(4) of the 2011 Act specifies that ComReg shall determine whether any net cost represents an unfair financial burden on the USP, it does not explicitly define the term 'unfair financial burden'. Similarly, Annex 1 of the Directive 97/67/EC, as also set out in Schedule 4 of the 2011 Act, also does not specify what constitutes an unfair financial burden, or how to identify it.

As highlighted by the European Regulators Group for Postal Services' (ERGP)[5] 2011 paper – *Net Cost Calculation and Evaluation of a Reference Scenario*, some guidance comes from legal precedent around the definition of an 'unfair burden'. In particular, ERGP (2011) highlights the EU Court of Justice's judgement in the

[5] The ERGP was established by a Commission Decision in 2010 and is composed of the heads (or in exceptional cases other representatives) of the 28 EU NRAs responsible for postal services. The Commission and the EFTA Surveillance Authority, EEA countries (Norway, Iceland and Liechtenstein) and two EU candidate countries (Turkey and the Former Yugoslav Republic of Macedonia) participate as permanent observers to the group. Other observers may also be invited. The ERGP serves as a body for reflection, discussion and advice to the Commission in the postal services field. It also aims to facilitate consultation, coordination and cooperation between the independent national regulatory authorities in the Member States, and between those authorities and the Commission, with a view to consolidating the internal market for postal services and ensuring the consistent application of the Postal Services Directive.

case of European Commission v Kingdom of Belgium[6]. This judgement declared that the Kingdom of Belgium had failed to fulfil its obligations under Articles 12 (1) and 13(1) of the Directive 2002/22/EC on *universal service and users' rights relating to electronic communication networks and services (Universal Service Directive)*[7].

The judgement defined unfair burden as *"a burden which, for each undertaking concerned, is excessive in view of the undertaking's ability to bear it, account being taken of all the undertaking's own characteristics, in particular the quality of its equipment, its economic and financial situation and its market share"*. However, it also states that *"it falls to the national regulatory authority to lay down general and objective criteria which make it possible to determine the threshold beyond which – taking account of the characteristics mentioned in the preceding paragraph – a burden may be regarded as unfair"*.

ComReg would therefore appear to have a degree of discretion in specifying the general and objective criteria it would use to identify what constitutes an "unfair financial burden" for the purposes of section 35(4). This section provides recommendations to ComReg on how this should be done, and it is structured as follows:

- section 3.1 sets out the possible approaches to an unfair burden assessment that have been discussed in the literature and the regulatory precedence in this area; and, based on this
- section 3.2 provides Frontier's recommendations as to how ComReg should carry out an unfair burden assessment within the context of the Irish postal market.

6 *Judgement of the EU Court of Justice of 6 October 2010, on case C-222/08* - Page 43, ERGP(August 2012) Net Cost Calculation and Evaluation of a Reference Scenario.

7 The Court of Justice concluded that the Kingdom of Belgium had:

- failed to take into consideration, in the calculation of the net cost of provision of the social component of universal service, the market benefits, including intangible benefits, accruing to the undertakings responsible; and
- made a general finding on the basis of the calculation of the net costs of the erstwhile sole provider of universal service that all undertakings now responsible for the provision of universal service are in fact subject to an unfair burden on account of that provision and by having done so without carrying out a specific assessment both of the net cost which the provision of universal service represents for each operator concerned and of all the characteristics particular to each operator, including the quality of its equipment or its economic and financial situation.

3.1 Possible approaches to an unfair financial burden assessment

When determining the appropriate set of criteria to use in the context of the Irish postal market, there are three key sources of information that can be drawn on:

- the approaches discussed by the ERGP in its 2011 paper - *Net Cost Calculation and Evaluation of a Reference Scenario;*
- academic literature and legal precedent relating to the postal sector, as set out in Frontier Economics' 2013 study for the European Commission; and
- the approach used in the Irish telecommunications market.

Each of these sources is discussed in more detail below.

3.1.1 ERGP - *Net Cost Calculation and Evaluation of a Reference Scenario*

In 2011, the ERGP published a paper on net cost calculation and evaluation of a reference scenario. Chapter 5 of this paper*, The assessment of whether the net cost constitutes an unfair financial burden,* states that in order "*for the net cost to be an unfair burden, a number of conditions need to be met:*

- *there must be a verifiable direct net cost;*
- *there must be a positive net cost; and*
- *the positive net cost must be material compared to the potential administrative costs of establishing and implementing a sharing mechanism.*[8]"

Once these conditions have been met, ERGP proposes that NRAs should analyse a number of factors that broadly relate to market conditions and the degree of competition in the market in order to determine whether an unfair financial burden exists. In particular, ERGP proposes that the following factors could be analysed:

- *"Financial position of the USP:*
  - *NRAs should assess if positive net cost significantly affects a USP's profitability and ability to earn a fair rate of return on capital employed;*
  - *Changes in profitability (the burden is unfair if the USP's market power is not sufficient to counterbalance the weight of the USO to maintain a reasonable profit);*

[8] Page 44, ERGP(August 2012) Net Cost Calculation and Evaluation of a Reference Scenario.

- *Significant difference in competitors profit level (Universal services provision imposes an unfair burden if the USP's profit is lower than its competitors);*
- *Changes in accounting profits and related financial measures analysis (for example EBITDA margins obtained by USP significantly decreases);*

- *The level of postal services usage (recently the demand for and usage of postal services are permanently declining because of Electronic substitution. The declining levels of usage of postal services will automatically reduce the revenue of USP and possibly can be a factor increasing the level of unfairness. Although fixed costs do not vary with changes in production or sales volume. In such a situation the fixed cost of universal service infrastructure usually remain constant and relatively high. For this reason the USP may face economic difficulties);*
- *Costs and revenues of USP, as well as ratio between net costs and revenues;*
- *Market shares – in case that USP is able to maintain sustained high market shares, USP will not represent an unfair burden resulting from the US provision. (In the European practice in Electronic Communications sector market shares in revenues above 80% are used in several countries to assess non-existence of unfair burden);*
- *Other criteria set by NRAs.*[9]"

3.1.2 Academic literature and regulatory precedent in the postal sector

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

The study reviewed the possible criteria that have been mentioned in the literature in relation to determining whether a net cost of the USO represents an unfair financial burden. In particular it highlighted a number of criteria that have been mentioned in the literature:

- absolute net cost of the USO;
- absolute level of the USP's profits;
- absolute net cost of the USO relative to USP's size;
- USP's absolute profit relative to competitor's profit; and
- relative difference to competitors' profit levels.

[9] Page 44, ERGP(August 2012) Net Cost Calculation and Evaluation of a Reference Scenario.

The study also looked at which of these criteria seemed to be favoured prospectively or in practice by USP's and NRA's. No recommendations were made by the study as to which of these criteria were the most appropriate to use.

Further detail is provided on each criterion below and its use in practice.

Absolute net cost of the USO

This criterion is used to determine whether an unfair financial burden exists based on whether the USO reduces the USP's profit compared to a situation without the USO[10]. Therefore any positive net cost of the USO is to be qualified as "unfair". However, the ERGP rejected this criterion following its 2011 consultation on the draft 'Net Cost Calculation and Evaluation of a Reference Scenario' paper, on the basis that it was not in line with the Court of Justice's position - that account should be taken of all of the USP's characteristics.

A possible variant of this criterion is to impose a threshold above which the net cost of the USO can be considered to be an unfair burden. This is in line with ERGP (2011)'s criterion, that "the positive net cost must be material compared to the potential administrative costs of establishing and implementing a sharing mechanism." That is, the benefits, through a transfer of funds to the USP, of establishing and implementing a sharing mechanism must be greater than the costs of such a mechanism.

Absolute level of the USP's profits

This criterion is used to determine whether an unfair financial burden exists based on whether the USP's profit (with the USO) is negative whereas the USP absent the USO would make normal economic profit. This criterion would seem to imply that the USO cannot negatively affect the financial performance of the USP to the extent that investors do not recover the opportunity cost of capital invested in the USP. In this setting, if the USP cannot sustain the provision of the USO, it is making an economic loss. Boldren et al. (2009) concludes that "*the burden is unfair if the USP's market power is not sufficient to counterbalance the weight of the USO to maintain a reasonable profit*[11]".

As outlined by Boldren et al. (2009), a possible variant of this criterion is to say that the USO imposes an unfair financial burden, under two specific circumstances, as described below, if it reduces the USP's profit (to a non-negative value) compared to a situation without the USO.

10 As stated by Jaag (2011).

11 Page 68, Boldren, F et al. (2009), *A dynamic and endogenous approach to financing the USO in a liberalised environment*.

- **Circumstance 1:** Where, although liberalised, the market is not effectively competitive, the financial burden imposed by the USO is determined to be fair and sustainable if USP profits have not been eroded to below a competitive level.

- **Circumstance 2:** Where the market is more competitive and the USP is still financially viable, the financial burden imposed by the USO becomes "more unfair" if competitors' level of profits are "clearly disproportionately better", and once it is established, that differences in profits are not attributable to differences in efficiency.

Absolute net cost of the USO relative to USP's size

This criterion is used to determine whether an unfair financial burden exists based on the extent to which the USP might be able to bear the net cost given the turnover made by the USP. The literature highlights that in order for it to be put into practice, there would need to be some determination as to what ratio of net cost of the USO to USP turnover is judged to be too high to warrant a conclusion that the net cost of the USO is an unfair financial burden. It also highlights that there would also need to be a determination as to what turnover measure should be used, i.e. the turnover of the individual USO services, the total USO or the entire company.

An example of the use of this criterion comes from the Finnish Postal Act (415/2011). This specifies four criteria with regards to determining what constitutes "an unreasonable financial burden":

- the size of undertakings;
- the type of business activities;
- the turnover of the undertaking's activities; and
- other similar elements.

Examples of "other similar elements" are the undertaking's market position or its profitability and ability to distribute dividends to shareholders.

Absolute USP's profit relative to competitor's profits

This criterion is used to determine whether an unfair financial burden exists based on whether the USP's absolute profit is lower than its competitors. Given that there are many other reasons that may explain profit differences, Jaag (2011) dismisses this criterion as a potential candidate for an unfair burden assessment.

Relative differences to competitors' profit levels

This criterion is used to determine whether an unfair financial burden exists based on whether any net cost reduces the USP's profit compared to a situation without the USO by more than the competitor's profit would be reduced due to its contribution to USO funding. Frontier (2013) found no example of this criterion being used.

Use in practice

Boldren et al. (2009) argues that in order to determine whether the USO does represent an unfair financial burden, it is necessary to consider different criteria, depending on the specific national situation. In practice, Frontier (2013) found that NRAs and postal legislation in different jurisdictions seem to opt for an assessment based on some combination of the above criteria (and additional ones).

As discussed in the previous section, ERGP (2011) proposes the use of a combination of criteria and advises NRAs to look at a variety of factors:

- a number of these factors relate to some of the individual criteria discussed above, e.g:
  - a variant of absolute net cost of the USO – ERGP advise that positive net cost must be material compared to the potential administrative costs of establishing and implementing a sharing mechanism; and
  - absolute level of the USP's profits – ERGP advise that NRAs could look at the financial position of the USP in determining whether an unfair burden exists, in particular whether a positive net cost significantly affects USPs profits and ability to earn a fair rate of return;
- some other factors are indicators that may support one criterion or another. For example, the analysis of the USP's market share level, as advised by ERGP, may support:
  - a variant of absolute level of USPs profits in which the conclusion differs based on the degree of competition in the market; or
  - the relative difference to competitors' profit level; and
- a new factor, the level of postal services usage, which relates to the rate of decline in total market demand for mail.

A further example of the use of a combination of criteria comes from Slovakia. A decree states that the net costs shall contain only provable and economically justified costs (direct and indirect costs spent on provision of the USO) and the existence of an unfair financial burden will be judged against the following indicators:

- the difference between net costs and intangible assets shall be positive;
- the absolute level of USP's profits;
- the absolute level of USP's profits relative to competitors' profit levels;
- the level of USO utilisation, its evolution, financial result and impact on the USP's economic situation; and
- the absolute level of net cost of the USO relative to USP's revenues.

3.1.3 Approach used in the Irish telecommunications market

In May 2011, ComReg published a decision paper on the principles and methodologies of costing the USO in the Irish telecommunications sector.

ComReg came to the decision that for an unfair burden on a USP, 3 cumulative conditions must be met:

1. There must be a verifiable and verified direct net cost.
2. The benefits of the USO must not outweigh the net cost (i.e. there is a positive net cost).
3. This positive net cost:
   a. is material compared to administrative costs of a sharing mechanism; and
   b. causes a significant competitive disadvantage for a USP.

Once the first two criteria have been met, the next step in determining whether the positive net cost identified is an unfair burden on the USP should be determined by the size of the positive net cost.

If the positive net cost is relatively small, ComReg will determine, on the basis of audited costs of the USO, whether USO financing is or is not justified, taking into account the administrative costs of <u>establishing</u> and <u>operating</u> a sharing mechanism (compared to the positive net cost of the USO) and taking into account whether these costs are disproportionate to any net transfers to a USP.

If the positive net cost is not relatively small, ComReg will assess whether or not this net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed. ComReg highlights that if there is a significant positive net cost, it is probable that a cross-subsidy would be required, meaning it may represent a call on a USP's profits. If the positive net cost significantly affects a USP's profitability, ComReg will assess whether or not such a net cost materially impacts a USP's ability to compete on equal terms with competitors going forward. ComReg will use the following criteria, statically and dynamically, to determine whether or not a net cost burden is actually unfair:

- changes in profitability – including an understanding of where a USP generates most of its profits over time;
- changes in accounting profits and related financial measures – e.g. earnings before interest, tax, depreciation and amortisation (EBITDA) analysis;
- changes in direct USO net cost, if any, over time;
- estimates of average level of cross-subsidy between classes of more or less separately accounted for services, and changes in these over time;
- changes in prices over time;
- changes in market share and/or changes in related markets; and
- market entry barriers.

3.2 Recommended approach to an unfair burden assessment

Once ComReg has determined whether the provision of a universal postal service by the USP represents a positive net cost, ComReg must then determine whether this net cost also represents an unfair financial burden to the USP. As outlined in the previous section, there are a number of approaches, and associated criteria, which can be used to carry out an unfair burden assessment. The 2011 ComReg decision in the Irish telecommunications market uses a combination of criteria. Frontier (2013) also found that this was common practice amongst NRAs and Postal Acts.

Drawing on all sources of information presented in the previous section, the criteria recommended by the literature and other NRAs, or used in practice, as part of an unfair burden assessment, fall into three distinct areas.

1. **Absolute net cost of the USO** - A consideration of the absolute positive net cost of the USO to assess whether it is material compared to the potential administrative costs associated with establishing and implemented a sharing mechanism.
2. **Impact of the net cost on the profitability of USP** - An assessment of whether or not this positive net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed.

3. **Impact of the net cost on the competitiveness of the USP** – An assessment of whether or not this net cost has a material negative impact on the competitiveness of the USP.

We recommend that ComReg follows this cumulative test approach, and that it should assess the net cost in relation to each of the above areas in determining whether any net cost of the USO represents an unfair financial burden on the USP. It is also important that the second and third criteria should only be applied if it is found that the positive net cost is material compared to the potential administrative costs associated with any sharing mechanism.

Below we provide more detail on how each of these criteria should be applied. We also discuss a final consideration that we recommend ComReg to make.

3.2.1 Administrative costs

The first criterion that should be applied as part of an unfair burden assessment is a consideration of whether the net cost is material compared to the costs that would be incurred if a sharing mechanism were to be introduced. In doing so, we recommend that the following costs should be considered:

- the establishment costs of a sharing mechanism; and
- the on-going administrative costs.

If the assessment suggests that the net cost is smaller than the costs associated with a sharing mechanism, we recommend that the assessment concludes that the net cost does not represent an unfair burden on the USP.

This criterion is one of the conditions highlighted by the ERGP for the net cost to be an unfair burden. Likewise, in the telecommunications market ComReg has specified that "*if the positive net cost is relatively small, ComReg will determine, on the basis of audited costs of the USO, whether USO financing is or is not justified, taking into account the administrative costs of establishing and operating a sharing mechanism (compared to the positive net costs of the USO).*[12]"

As highlighted in ComReg's decision paper on the thresholds and criteria that should be used to determine an unfair burden, in the telecommunications sector, the application of such a criterion is also consistent with the regulatory best-practice principles of proportionality and practicality.

3.2.2 Profitability of the USP

If it is decided that the net cost is material compared to the administrative costs of a sharing mechanism, the second and third criteria should be applied in order

12 Page 63, ComReg 11/42 – Report on Consultation and Decision on the Costing of Universal Service Obligations Principles and Methodologies.

to come to a determination as to whether the net cost represents an unfair financial burden on the USP. The next step is to therefore carry out an assessment of whether the net cost significantly affects the USP's profitability and/or ability to earn a fair return on the capital employed in the prevailing market conditions. As highlighted in ComReg (2011), this analysis takes account of a USP's ability to bear a net cost. Jaag (2010) outlines a number of possible levels at which the impact of net cost on the profitability of the USP could be assessed, including:

- individual products within the scope of universal services;
- universal services as a whole;
- business units providing universal services; or
- the entire company.

As highlighted in ComReg's decision in relation to the Irish telecommunications market, if there is a significant net cost, it is probable that a cross-subsidy would be required, meaning it may represent a call on a USP's profits. It is therefore important that a profitability assessment ascertains the extent of cross-subsidisation that a USP is required to undertake as a result of any net cost. Such detail would be lost, if an unfair burden assessment were to only look at profits at the level of business units providing universal services or the entire company. Given the likely interdependence between universal services, it would also appear to be inappropriate to only look at the profitability of individual products within the scope of universal services. We therefore recommend that such a profitability assessment should be carried out at the level of universal services as a whole.

Frontier's previous report, *"Recommendations on the form and manner that a net cost submission should be made by the universal service provider"*, recommended that the PC methodology should be used to calculate the net cost of the USO, and that this should be based on efficient costs. Under this methodology, the net cost is the difference in operating profits with and without the USO[13]. Effectively, the profitability assessment should therefore be a comparison of the net cost of the USO with the operating profits of the company with the USO, as used in the net cost calculation.

As presented by ERGP (2011) and, in line with ComReg's approach in the telecommunications sector, such a profitability assessment could look at a combination of profit and related financial measures, including:

- accounting profits;

13 This assumes that operating profits aren't adjusted to take account of any movement in capital costs, and therefore "reasonable profits".

- EBITDA; and
- return on capital employed.

A key issue to take into account at this stage, is the interaction between the unfair burden assessment and the determination of An Post's price control. Section 30 the 2011 Act requires ComReg to regulate prices for the USP's postal services within the scope of universal postal service, where ComReg is of the opinion that there is no effective competition in the market for the supply of these services, through a price cap in the form of CPI –X%[14].

Setting the level of the price control within the CPI-X framework requires an estimate of the revenue that would be needed to finance an efficient, well-run business. Therefore, at the time that the price control settlement is put in place, the price control should cover the efficient cost of providing the USO, leaving no net cost for the USP. However, over the course of the settlement period, a net cost to the USP could arise if:

- there is sufficient entry or expansion in the market for postal services within the scope of universal postal service to result in a significant erosion of the USP's market share, hence resulting in the USP being unable to achieve the level of revenues envisaged in the price control settlement, and being unable to reduce costs proportionately due to the requirements of the USO; or
- there are significant external shocks to the USP's provision of universal postal services (for example, unanticipated volume declines) that result in the level of the price control no longer being sufficient to cover the efficient costs of USO provision.

3.2.3 Competitiveness of the USP

The final area that should be considered as part of an unfair burden assessment is whether any net cost causes a significant competitive disadvantage for the USP. This will be strongly linked to the impact that any positive net cost has on the profitability of the USP. More specifically, it is unlikely that any net cost could be considered to cause a significant competitive disadvantage unless it also materially undermines the USP's profitability and/or ability to earn a fair return on the capital employed in the prevailing market conditions.

Nevertheless, given ComReg's statutory duty to facilitate competition in the market for postal service provision, it is important to ensure that any unfair burden test considers whether the USP is placed at a significant competitive

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

disadvantage. In this regard, we consider it appropriate to consider similar factors to those looked at by ERGP (2011) and those considered by ComReg in the telecommunications market in order to apply this criterion. In particular, we recommend that the following factors are considered:

- changes in the USP's prices relative to competitors – if the USP lowers prices in order to compete for low cost customers, the uniform pricing requirement of the USO may leave them at a significant competitive disadvantage if the loss made on high cost customers increases as a result of the price reduction and they are unable to cross-subsidise these customers;
- changes in market share of the USP – if the USP is able to maintain high market shares in relation to the provision of postal services within the scope of the universal postal service, it is unlikely that the USP is being placed at a competitive disadvantage by any positive net cost; and
- market entry barriers – in the presence of large market entry barriers, it is unlikely that the USP is being placed at a competitive disadvantage by any positive net cost.

We note that under the 2011 Act, the USP is entitled to make an annual net cost funding request. Any unfair burden assessment as a result of such a funding request, should therefore relate only to the same period as the funding request. As such, ComReg need only to consider whether any net cost causes a significant competitive disadvantage for the USP in that particular period, and ComReg does not therefore need to forecast potential future impacts that may arise.

We note that if ComReg determines that the net cost of the USO represents an unfair financial burden on the USP, based on the three criteria outlined above, the next step, pursuant to section 36 of the 2011 Act, is to design a sharing mechanism to apportion the net cost among providers of postal services within the scope of the universal service. Section 4 discusses, in detail, Frontier's recommendations on how the sharing mechanism should be set.

4 Sharing mechanism

Where ComReg determines that there is a net cost of provision of the universal postal service and that this net cost represents an unfair financial burden on the USP, the next step is to determine how this should be financed.

Section 36 of the 2011 Act is prescriptive about the option that should be used to finance the net cost. It requires the net cost to be apportioned among providers of postal services within the scope of the universal service. ComReg must therefore determine how such a sharing mechanism should be implemented and operated.

This section is structured as follows:

- section 4.1 describes Frontier's approach to setting the sharing mechanism and possible options for the form that the mechanism should take; and
- section 4.2 provides Frontier's recommendations on the form that the sharing mechanism should take.

4.1 Frontier's approach

In designing the sharing mechanism, there are two areas that should be considered:

- the set of criteria that should be used to design the sharing mechanism; and
- the characteristics of sharing mechanisms used in other European postal sectors.

Each area is discussed in turn below.

4.1.1 Criteria selection

In order to design a sharing mechanism, it is important to first determine a set of criteria against which the potential options should be judged. This includes:

- criteria required by legislation; and
- additional criteria that it would be appropriate to use.

Legislative requirements

Section 36(5) of the 2011 Act and Annex 1 of the Directive 97/67/EC provide some high level requirements for such a sharing mechanism. It is therefore appropriate for these requirements to form the first set of criteria against which the potential options should be judged. In particular, the sharing mechanism must operate:

- in an objective, proportionate and transparent manner;
- in a manner that does not involve or tend to give rise to any undue discrimination against:
  - particular postal service *providers* or a particular class or description of postal service *providers*; or
  - particular postal service *users* or a particular class or description of postal service *users*; and
- in a way that avoids a double imposition of contributions falling on both outputs and inputs of undertakings.

In addition, pursuant to section 12(1) of the Communications Regulation Act 2002, in designing the sharing mechanism, ComReg take utmost account of its responsibilities to:

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

Further criteria

In addition, we have developed a further set of criteria in line with those used for the unfair burden assessment. In particular, the following questions should be asked:

- Would the proposed sharing mechanism create significant administrative costs?
- Would there be an adverse effect on competition?

Administrative costs

The first question reflects the fact that the design of the sharing mechanism and the first stage of the unfair burden assessment set out in section 3.2, are very much interlinked. In particular, the unfair burden assessment looks at the:

> ***"Absolute positive net cost of the USO*** *- A consideration of the absolute positive net cost of the USO to assess whether it is material compared to*

the potential administrative costs associated with establishing and implemented a sharing mechanism."

In turn, the administrative costs are highly dependent on the complexity of the design of the sharing mechanism. It could also be argued that a sharing mechanism that incurs high administrative costs may not meet the 'proportionate' criterion, which is required by legislation. ComReg must therefore ensure that any sharing mechanism does not create significant administrative costs.

Potential impact on competition

The second question focusses on the impact of the sharing mechanism on competition. This is in line with the third area that the unfair burden assessment looks at, i.e. an analysis of whether the net cost causes a significant competitive disadvantage for the USP. It is critical that, in attempting to fund any net cost of the USO, the sharing mechanism is not designed in such a way that the costs imposed on providers of postal services either:

- puts existing providers at a significant competitive disadvantage; or
- prevents potential providers from entering the market through a significant reduction in their expected profits.

As highlighted by Boldren et al (2009), one of the key things to bear in mind when setting the sharing mechanism is that market structure, and therefore the net cost/burden of the USO, is endogenous to the sharing mechanism chosen. In line with this, they suggest that the proposed sharing mechanisms should be assessed by asking the following questions:

- What is the impact of the sharing mechanism on entry?
- What are the consequences for the evolution of the USO net cost with the resulting competition?
- Does the sharing mechanism generate distorted competition?
- Is there a risk for the sustainability of the USO at the end of the game, that is, at the resulting market equilibrium?

4.1.2 Regulatory precedent from other European jurisdictions

Compensation funds, based on sharing mechanisms, for the universal postal service, have been set up in both Italy and France.

Italy

As explained by Boldren et al (2009), a compensation fund was established by law in 1999. This fund is based on an individual license holder's revenue from universal postal services and the rate is fixed annually by the NRA (within a maximum of 10% of licensees' gross revenues from universal postal services). *"Until now, the ministry has always set the percentage at 3%, significantly below the maximum allowed."*

In 2005, the compensation fund contributions by operators other than the USP were only approximately 0.04% of the total USO burden, reflecting the market share of the USP.

France

In France, contributions are also made to a compensation fund by authorised postal service providers. As set out in the 2012 Post and Electronic Communications Code, contributions are pro-rated based on the volume of mail products within the universal postal service that a provider carries. Providers are required to keep a record of the relevant volumes. Any provider carrying fewer items than a threshold set by decree correspondence is exempt from contribution to the fund.

4.2 Recommended approach to setting the sharing mechanism

In order for ComReg to reach the point of designing and implementing a sharing mechanism, it must have determined that there is a net cost of provision of the universal postal service, and that this net cost represents an unfair financial burden on the USP. The 2011 Act requires that this net cost is apportioned among providers of postal services within the scope of the universal service.

In Frontier's view, there are essentially two methods that are available to ComReg to carry out this apportionment. Each provider of postal services within the scope of the universal service could pay either:

- a lump sum, i.e. dividing the net cost equally amongst operators; or
- a pro-rated amount of the net cost according to some measure of the size of that particular provider relative to other providers, e.g. market share.

In line with the criteria set out in the previous section, we suggest that it is also important that any sharing mechanism does not have an adverse effect on competition in the market. As such, it may be appropriate to include some measure of protection in the sharing mechanism for smaller existing providers or new entrants to the market. This is also in line with ComReg's responsibility, as outlined in section 12(1) of the Communications Regulation Act 2002, to facilitate the development of competition and innovation in the market for postal service provision.

Below we provide Frontier's recommendations on:

Sharing mechanism

- the method used for apportioning the net cost between providers within the scope of the universal service; and
- whether it is appropriate to build into the sharing mechanism some measure of protection for smaller existing providers or new entrants to the market.

4.2.1 Approach to apportioning net cost

The first decision in setting the sharing mechanism is whether it is more appropriate to apportion any net cost amongst providers using lump sums or pro-rated contributions. To make this decision, a comparison can be made in relation to how well each option meets the criteria set out in section 4.1.1. In particular, whether the mechanism:

- could operate in an objective, transparent and proportionate way;
- does not give rise to any undue discrimination;
- does not create significant administrative costs; and
- does not have an adverse effect on competition.

We discuss each in turn.

Both a lump sum and pro-rated contribution based mechanism could operate in an objective and transparent way. However, a lump sum contribution may not be considered proportionate as all providers would pay the same amount, regardless of their size or the proportion of relevant services they provide – so, a new entrant could be expected to contribute the same amount as An Post, an operator with USO revenues of c.€365 million.

In considering how well each option meets the non-discrimination criterion, it is important to bear in mind that for a mechanism to be truly non-discriminatory, providers with similar levels of provision of universal postal services would need to be contributing a similar amount. Therefore, a lump sum contribution could be considered to be discriminatory against particular providers.

Given the nature of a lump sum approach to apportioning any net cost, in comparison to pro-rating based on some measure of size, we would expect administrative costs to be higher under the latter approach. However, it is unlikely that such costs would be considered to be significant, and therefore both approaches should meet the criterion of not creating significant administrative costs.

In relation to the impact on competition, as the lump sum approach to apportioning net cost would lead to all providers contributing the same monetary amount, there is a significant risk that this approach could lead to an adverse effect on competition. This risk comes from the current structure of the market, in that there are extremely large variations in size between current providers of postal services within the scope of the universal service. Such an approach may therefore:

- put some smaller existing providers at a significant competitive disadvantage by weakening their financial position, possibly resulting in them ceasing provision of postal services within the scope of the USO (depending on the size of the net cost identified by ComReg);
- put upward pressure on prices charged by existing providers, as a lump sum, will act as a significant sunk cost which will be passed onto postal service users; and/or
- prevent potential providers from entering the market through a significant reduction in their expected profits (again, depending on the size of the net cost identified by ComReg).

The ultimate impact on competition would depend upon the total size of the net cost, and therefore the size of the per provider contributions under this approach.

On balance, we recommend that a pro-rated contribution based approach should be used. This approach meets all of the desired criteria, whilst the lump sum contribution based approach may be considered discriminatory and may result in an adverse effect of competition given the large variations in size between current providers of postal services within the universal service. Such an approach has also been used by other national regulatory authorities in designing/implementing sharing mechanisms.

Based on this recommendation, a decision must also be made on which measure of a provider's size, relative to other providers of products within the scope of the universal service, that the net cost should be pro-rated on. The most commonly used measure of a company's size relative to other companies in the same market, is market share. We would therefore recommend that the same measure is used by ComReg as part of any sharing mechanism.

Market share can be determined based on volumes or revenues. Both variations could be considered to meet all of the required criteria, and both have been used in other European jurisdictions. However, as any net cost will have been calculated as a monetary amount, it is most practical to pro-rate this amount based on revenues as they are also measured as a monetary amount. For example, it is more practical to calculate a provider's contribution based on a % of their revenues, rather than calculating market shares based on volumes and then apportioning the total net cost between providers based on these shares. In addition, under section 39(d)(ii) of the 2011 Act, ComReg can require an authorised provider of postal services within the scope of the universal service to provide information relating to its revenues from the provision of services within the scope of the universal postal service.

4.2.2 Protection for smaller providers

It is important that any sharing mechanism does not have an adverse effect on competition. As set out above, the use of a pro-rated approach, based on share of market revenue, to apportion the net cost is preferable, particularly with respect to minimising the risk of such an effect.

However, for providers with a low turnover and high costs (actual or expected), such as those who have just entered (or are looking to enter) the market for provision of postal services within the scope of the universal service, this approach may still risk putting these providers at a competitive disadvantage, or even deterring entry completely. We would therefore recommend that some measure to protect smaller providers is included within the design of a sharing mechanism.

There are two options for a measure of this type:

- a revenue threshold below which an individual provider would not be required to contribute to any compensation fund ("threshold"); or
- a cap on the proportion of revenues that a provider must contribute if their revenues fall below a certain threshold ("cap").

We suggest that, as a point of principle, it is appropriate that all operators, including new entrants, should make some contribution to the net cost. We also note that the Act makes no provision for some operators to be excluded. Moreover, so long as the required contribution is at an appropriate level, it is unlikely to induce exit or deter entry.

However, we suggest that under the proposed mechanism a concern could arise due to the asymmetry in size between new entrants and the USP. For example, if the net cost identified by ComReg were large, then even if a new entrant were paying a small proportion of that net cost, it could be very significant compared to its total turnover.

We therefore suggest that, as a protection for small existing players or new entrants, the contribution they pay be capped at an appropriate percentage of turnover. It is difficult a priori to set any pre-determined rules for the level at which contributions should be capped, as it will largely depend on an assessment of the entrant's ability to pay and an assessment of the likely impact of the sharing mechanism on the development of competition in the sector. Similarly, setting an absolute market share threshold above which operator's would be expected to make a full contribution could act as a barrier to expansion.

Consequently, we recommend that ComReg, as part of the development of the sharing mechanism, should carry out a market assessment to determine the level at which contributions might be capped. The exercise would need to consider:

- the net cost of the USO to be recovered;
- the proportion to be recovered from non-USP operators;
- the impact of recoverability on the sustainability and profitability of non-USP operators; and
- the impact on the development of competition.

4.2.3 Final consideration

Prior to the implementation of the sharing mechanism designed by ComReg, we recommend that a final step is carried out – ComReg should assess whether the contributions collected from other providers through the designed sharing mechanism are greater than the potential administrative costs associated with establishing and implementing this sharing mechanism.

To illustrate the rationale for this recommendation, consider the following hypothetical example. The net cost has been found to be €5 million. The total net cost has been found to be greater than the administrative costs of setting up a sharing mechanism, and a mechanism has been designed to attribute the net cost to operators in proportion to their market share. Now assume An Post has a market share of 99.5%. In this case the element of net cost attributed to other operators would be €25,000 which might well be less than the administrative costs of the sharing mechanism. In such case, it would not make sense to implement such a sharing mechanism.

4.2.4 Summary

Based on the criteria against which the options were judged and regulatory precedent in other European jurisdictions, we recommend that a pro-rated contribution based sharing mechanism should be used, based on revenues. We also recommend that the sharing mechanism includes a mechanism to cap the proportion of revenues that small operators or new entrants must contribute. This will provide protection for smaller providers, reducing the risk that the sharing mechanism may have an adverse effect on competition in the market for the provision of postal services within the scope of the universal service. This will allow ComReg to ensure it meets its obligation set out in section 12(1) of the Communications Regulation Act 2002, to facilitate the development of competition and innovation in the market for postal service provision, subject to promoting the availability of a universal postal service.

Sharing mechanism

5 Summary

Following receipt of an application for funding from the USP, if ComReg determines that the provision of the universal postal service does represent a net cost to the USP, ComReg must then determine:

- whether this net cost is an unfair burden to the USP; and if so
- how it shall apportion the net cost among providers of postal service within the scope of the universal postal service according to a sharing mechanism.

In order to do this, we recommend that ComReg follow a number of steps. These steps should be followed sequentially.

1. **Assess whether the net cost is material compared to the costs that would be incurred if a sharing mechanism were to be introduced.** If the net cost is not material compared to the administrative costs of a sharing mechanism, then the assessment should end at this step. If it is material, then ComReg should move onto the second step of the overall assessment.

2. **Assess whether the net cost negatively impacts on the profitability and competitiveness of the USP.** If ComReg judges that the net cost does not significantly impact on the profitability and competitiveness of the USP, it should determine that the net cost is not an unfair burden to the USP and end the assessment at this step. If it is judged that there is a significant impact, then ComReg should determine that the net cost is an unfair burden to the USP, and move onto the third step of the overall assessment.

3. **Calculate the market share, based on revenues, of each provider of postal services within the scope of the universal postal service.**

4. **Determine, and consult on, the appropriate rate(s) at which to pro-rate the net cost and what caps (if any) on contributions should be introduced.**

5. **Apportion the net cost amongst providers of postal services within the scope of the universal postal service, based on the above decision.**

6. **Assess whether the contributions collected from providers of postal services within the scope of the universal service, other than An Post, would exceed the potential administrative costs associated with the sharing mechanism that has been designed.** If the contributions from other providers of postal services within the scope of the universal service would be smaller than the administrative costs of the sharing mechanism, then no mechanism should be implemented. If, however, the contributions are greater than the administrative costs, then the sharing mechanism should be implemented and the corresponding contributions collected from each provider.

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