



Commission for  
**Communications Regulation**

# **Response to Consultation and ComReg's determination on the form and manner of any net cost request by the universal postal service provider under section 35 of the 2011 Act**

## **Response to Consultation and Determination**

**Reference:** ComReg 13/69 and  
D09/13

**Date:** 25 July 2013

**An Coimisiún um Rialáil Cumarsáide**

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# 1 Introduction

- 1 Arising from the Communications Regulation (Postal Services) Act 2011 ("2011 Act"), the current designated universal postal service provider ("USP"), An Post, may submit a request for funding in respect of what it submits is the net cost of providing the universal postal service, after the end of the first financial year following its designation as universal postal service provider. Consequently, from 1 January 2013, An Post can submit such a claim for funding in respect of the universal postal service for the financial period ending 31 December 2012. However, as noted by ComReg in its Postal Strategy Statement 2012 – 2014<sup>1</sup> and in Consultation 13/48<sup>2</sup>, any such claim must be audited and a claim for 2012 could not be made until the external audit of An Post's 2012 financial and regulatory accounts has been completed. The external audit of An Post's 2012 regulatory accounts was completed on 30 May 2013.
- 2 Furthermore, the 2011 Act requires that a request by An Post for funding of the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines and must be accompanied by any such information as may be reasonably required by ComReg.
- 3 ComReg set out its preliminary views on the form and manner of any net cost submission by An Post in Consultation 13/48, having had regard to the applicable provisions of the 2011 Act, Annex 1 of the Postal Services Directive<sup>3</sup>, and the recommendations made by ComReg's independent consultants, Frontier Economics.<sup>4</sup> Consultation 13/48 also provided guidance on the information that would be required to support a net cost submission.
- 4 There were two responses to Consultation 13/48<sup>5</sup> (from An Post and Nightline). Having considered those two responses, this document sets out ComReg's determination and guidance in order to ensure that any net cost submission made by An Post is evidence based and is consistent with section 35 and Schedule 4 of the 2011 Act. This should also facilitate any future audit and/or determination by ComReg in respect of any net cost submission made to it by An Post under the 2011 Act.

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<sup>1</sup> ComReg Document No. 12/116 dated 30 October 2012

<sup>2</sup> 'Consultation on ComReg's draft determination on the form and manner of any net cost request by the universal postal service provider' dated 20 May 2013

<sup>3</sup> Directive 2008/6/EC

<sup>4</sup> ComReg Document No. 13/48a published 20 May 2013

<sup>5</sup> See ComReg Document No. 13/60 dated 21 June 2013

- 5 This document does not concern the manner in which ComReg would determine whether the net costs (if any) of the universal postal service represent an unfair financial burden on An Post or how any such net cost, if it was deemed to be an unfair financial burden, would be apportioned among other providers of postal services within the scope of the universal postal service. As set out in ComReg's Postal Strategy Statement<sup>1</sup> and in Consultation 13/48<sup>2</sup>, these issues will be addressed by a separate consultation which ComReg will commence later in 2013.
  
- 6 Under section 17(1) of the 2011 An Post is designated as the as the sole universal postal service provider in the State for a period of 12 years, commencing 2 August 2011, subject to review by ComReg after the first 7 years. Consequently, and for the sake of brevity, this paper refers wherever possible to "An Post" rather than to the "universal postal service provider" or the "USP". All such references to An Post should be read as references to An Post in its capacity as the sole universal postal service provider, unless the context suggests otherwise.

## 2 Executive Summary

- 7 Arising from the 2011 Act, any request by An Post for funding of the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines and must be accompanied by such information as may be reasonably required by ComReg.
- 8 In Consultation 13/48, ComReg sought views on the form and manner of any such net cost submission by An Post, including the information that should be included with any such application. Responses to Consultation 13/48 were received from An Post and Nightline and both responses generally agree with ComReg's preliminary views as set out in Consultation 13/48.
- 9 Having considered the views of the two respondents to Consultation 13/48, and the recommendations of its independent expert advisors<sup>6</sup>, this Response to Consultation sets out ComReg's determination on the form and manner of any request by An Post for funding for what it submits is the net cost of providing the universal postal service. This document also sets out ComReg's guidance on the information required to support such a request. This is being done in order to provide An Post with as much guidance as possible and to ensure that any application by An Post is evidence based and is consistent with the applicable provisions of the 2011 Act. In accordance with the 2011 Act, ComReg will ultimately determine whether provision of the universal postal service represents a net cost to An Post and, if it does, whether that net cost represents an unfair financial burden on An Post. In order to make such a determination, which will include having to audit or verify the calculation of the net cost, ComReg will require detailed evidence based information from An Post and the 2011 Act empowers ComReg to obtain such information from An Post where it has not been provided.

### 2.1 Background

- 10 In accordance with section 35(1) of the 2011 Act, An Post may submit a request in writing to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service. According to Schedule 4 of the 2011 Act, the net cost of the universal service obligation ("USO") is any cost related to and necessary for the operation of the universal service provision. Schedule 4 further provides that the net cost of the USO is to be calculated as the difference between the net cost for a designated universal service provider of operating with the USO, and the same postal service provider operating without the USO.

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<sup>6</sup> Report by Frontier Economics @ ComReg Document No. 13/69a

- 11 Section 35(2) of the 2011 Act provides that such a request for funding for the net costs (if any), made under section 35(1), shall be in such form and manner as ComReg determines and shall be accompanied by such supporting information as may be reasonably required by ComReg.
- 12 This document sets out ComReg's determination on the form and manner of any request for funding for the net costs (if any) made under the 2011 Act.

## 2.2 Form and manner of any net cost submission

- 13 Having considered the views of respondents to Consultation 13/48, together with the views of ComReg's independent expert advisors, Frontier Economics, the following summarises ComReg's determination on the form and manner of any request for funding for the net costs (if any) made by An Post, under section 35 of the 2011 Act:

a) The Profitability Cost (PC) approach will be used to calculate the net costs (if any) of providing the universal postal service, for the following reasons:

- The PC approach can capture the full complexity of a reference scenario.
- The PC approach can take account of all changes arising from modifying the USO.
- The PC approach takes better account of efficiency.
- The PC approach is an established methodology which has been widely used by the postal industry in Europe.

b) An Post defines the reference scenario:

The "reference scenario" is key to the PC approach. Its development requires an assessment of how a USP would re-optimize its whole operation in the absence of the USO – i.e. it seeks to identify the changes to services that a USP would make if it operated on an unconstrained commercial basis. An Post, as the USP, should develop such a reference scenario as it is important that the reference scenario be informed by An Post's commercial knowledge and reflects how An Post would seek to reorganise its operations, absent the current USO, so as to maximise profits. Also, and as required by the 2011 Act, in order to ensure that only the efficient net costs of the USO are calculated An Post must ensure that its estimate of the cost differences between the baseline and reference scenarios is on a "like-for-like" basis, reflecting only differences associated with any changes in the service specification.

- c) The reference scenario is assumed to be a reduced USO under section 16(1)(a) of the 2011 Act:

In order to minimise the complexity for An Post in setting its reference scenario, ComReg assumes that a reference scenario would be a reduced USO requested by An Post, in accordance with section 16(1)(a) of the 2011 Act. Section 16(1)(a) defines the “universal postal service” as meaning that there shall be at least one clearance and one delivery to the home or premises of every person in the State on every working day, except in such circumstances or geographical conditions as ComReg considers to be exceptional. (For ComReg to consider whether particular circumstances or geographical conditions are “exceptional”, such that the USO under section 16(1)(a) may be reduced in some manner, would require an application made to it by An Post to include sufficient supporting information.)

- d) Use of bottom-up model based on LRIC if An Post’s reference scenario departs significantly from the current USO:

If the reference scenario presented by An Post should depart significantly from the current USO, it would then be necessary for An Post to develop a “bottom-up model” in order to estimate the costs in its reference scenario as it would be difficult to estimate the applicable costs based solely on historic accounting data.

The PC approach seeks to identify costs that could be avoided if changes to the USO were made. Therefore, Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO, as the concept of avoidable cost is more closely related to the use of LRIC. Consequently, if a bottom-up operational model is required, it should be based on LRIC.

## **2.3 Guidance on information required with net cost submission**

- 14 Section 35(3) of the 2011 Act provides that ComReg may require, in writing, that the USP shall provide such additional information as ComReg specifies, relating to any request by the USP under section 35(1) for funding in respect of the universal service. ComReg considers it useful, and to the benefit of An Post as the current sole universal postal service provider, to provide guidance on the information that ComReg is likely to require in order to determine if the universal postal service does represent a net cost to the USP, though ComReg fully reserves its right to make all such information requests as it considers necessary, under section 35(3) of the 2011 Act.



15 Annexes 1 to 3 set out guidance that An Post should be cognisant of in submitting a request for funding under section 35(1) of the 2011 Act. The guidance covers:

- Guidance to An Post in setting its reference scenario
- Guidance to An Post on measuring the revenues foregone and costs avoided by modification of the universal service
- Guidance to An Post on taking intangible and market benefits into account

## 2.4 Conclusion

16 This determination by ComReg under section 35(2) of the 2011 Act on the form and manner of any request for funding for the net costs (if any) of the universal postal service, and as to the supporting information to be included with any such request, should facilitate ComReg in determining, in respect of any such future request, whether the provision of the universal postal service does represent a net cost to An Post, while taking into account the provisions set out in section 35(5) which include that ComReg shall audit or verify, or shall arrange for a suitable qualified person to audit or verify, the calculation of the net cost.

17 It is therefore critical that any application made by An Post for funding in respect of provision of the universal postal service is supported by sufficiently detailed and robust data, in order to facilitate ComReg's subsequent review and audit, and to inform ComReg's final determination. Similarly, if ComReg should determine that there is a net cost which also represents an unfair financial burden, and if An Post should seek funding from other sources in respect of that unfair financial burden (if the sharing mechanism provided for under the 2011 Act should prove to be insufficient) then it is likely that the same data would, at a minimum, be required in order to assess whether any such funding of An Post would be in accordance with other legislative and procedural regimes.

## 3 Background

18 In making its determination on the form and manner of any request for funding for the net costs (if any) of the universal postal service, and as to the supporting information to be included with any such request, ComReg has had regard to Annex 1 of the Postal Services Directive<sup>7</sup> which provides guidance on calculating the net cost, if any, of the universal postal service and ComReg has also taken account of all relevant provisions of the 2011 Act. This is discussed further below.

### 3.1 Universal service obligations

19 In making its determination on the form and manner of any request for funding for the net costs (if any) of the universal postal service, ComReg first considered what has been set as a universal postal service. Section 6 of the 2011 states that the term “universal postal service” shall be read in accordance with section 16 which provides, amongst other things, that “universal postal service” means that on every working day there is at least one clearance and one delivery to the home or premises of every person in the State, except in such circumstances or geographical conditions as ComReg considers to be exceptional.

20 Section 16(1) also states that the universal postal service means providing the following services:

- i. The clearance, sorting, transport, and distribution of postal packets up to 2kg in weight
- ii. The clearance, sorting, transport, and distribution of parcels up to 20kg in weight
- iii. A registered items service
- iv. An insured items service
- v. Postal services, free of charge, to blind and partially-sighted persons.

21 Section 16(9) of the 2011 Act requires ComReg to make regulations specifying the services to be provided by the universal service provider for the purposes of ensuring that the universal postal service develops in response to the technical, economic and social environment and to the reasonable needs of postal service users. Following a public consultation, ComReg made and published such regulations in July 2012, named the *Communications Regulation (Universal Postal Service) Regulations 2012* (S.I. 280 of 2012) (“the Regulations”).

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<sup>7</sup> Which is included as Schedule 4 of the 2011 Act

22 In making the Regulations, ComReg specified a minimum set of universal postal services to meet the needs of postal service users, while also minimising the regulatory burden on An Post as the USP. For the most part, the set of universal postal services to be provided were the same as those previously set by ComReg in its working definition of universal postal services:<sup>8</sup>

- A single piece service involving the clearance, sorting, transport and distribution of letters, large envelopes, packets and parcels.
- Issuing certificate of posting.
- A registered items (“proof of delivery”) service.
- An insured items service.
- A single piece service provided free of charge to the postal service user for the transmission of postal packets for the blind or partially sighted.
- A service for the clearance, transport and distribution of:
  - postal packets deposited in bulk “for delivery only”.
  - “foreign postal packets deposited in bulk” pre-sorted by country of destination.
  - “postal packets deposited in bulk” for “deferred delivery”.
- Business Reply.
- Freepost.
- A service for the clearance, 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.
- The following special facilities for the delivery of postal packets are provided at the request of the addressee:
  - Private boxes and bags.
  - Redirection.
  - Poste restante.
  - Mailminder.

## 3.2 Calculation of net cost

23 Section 35(4)(a) of the 2011 Act provides that ComReg shall, on the basis of the information given to it by An Post, determine whether the provision of a universal postal service by An Post represents a net cost to An Post in the relevant period, taking into account any market benefit which accrues to An Post, calculated in accordance with Annex I to the Directive, the text of which is set out in full in Schedule 4 of the 2011 Act and is set out below:

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<sup>8</sup> ComReg Document No. 05/85

**Part B: Calculation of net cost**

*National regulatory authorities are to consider all means to ensure appropriate incentives for postal service providers (designated or not) to provide universal service obligations cost efficiently.*

*The net cost of universal service obligations is any cost related to and necessary for the operation of the universal service provision. The net cost of universal service obligations is to be calculated, as the difference between the net cost for a designated universal service provider of operating with the universal service obligations and the same postal service provider operating without the universal service obligations.*

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

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

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

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

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

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

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

## 4 Form and manner of any net cost submission

24 Having taken into account the applicable provisions of the 2011 Act, guidance given in the Postal Service Directive, the recommendations<sup>9</sup> made by ComReg's independent consultants, Frontier Economics, and the two responses to Consultation 13/48, the following sets out ComReg's position on the form and manner of any request for funding for the net costs (if any) of the universal postal service, and as to the supporting information to be included with any such request. In making this determination, ComReg has also considered the practice of postal NRAs in other EU Member States as set out in Frontier Economics' study for the European Commission<sup>10</sup> which documented how the net cost of the postal USO is calculated across Europe.

### 4.1 Profitability Cost is the appropriate methodology

25 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 the EU in calculating the net cost of the USO in the postal sector.

26 The study identified that three main types of methodology have been used to calculate the costs of the USO in the postal sector:

- Deficit Approach with Fully Allocated Cost (DA);
- Net Avoided Cost (NAC); and
- Profitability Cost (PC).

27 Based on the draft Regulatory Impact Assessment ("RIA") in Consultation 13/48, ComReg set out its preliminary view that the PC approach is the appropriate methodology to adopt and ComReg sought the views of interested parties on this by asking the following question:

**Q.1 Do you agree or disagree that Profitability Cost is the appropriate methodology to assess the net costs (if any) of providing the universal postal service? Please explain your response.**

28 The key views raised by respondents and ComReg's corresponding response position are as follows.

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<sup>9</sup> See ComReg Document No. 13/69a

<sup>10</sup> See [http://ec.europa.eu/internal\\_market/post/doc/studies/2012-net-costs-uso-postal\\_en.pdf](http://ec.europa.eu/internal_market/post/doc/studies/2012-net-costs-uso-postal_en.pdf)

### Views of respondents:

- 29 **An Post** agrees that PC is the appropriate methodology to use in assessing the net cost of providing the universal postal service.
- 30 **Nightline** agrees that the PC approach is acceptable once it is subject to oversight and an appropriate level of regulatory rigour from ComReg.

### ComReg's position

- 31 In response to Nightline's comment, Section 35(4) of the 2011 Act provides that ComReg shall first determine whether the provision of a universal postal service represents a net cost to An Post, on the basis of the information provided by An Post and taking into account any market benefit which accrues to An Post. Section 35(5) provides that for the purpose of making such a determination under section 35(4), ComReg shall, amongst other things, audit or verify, or shall arrange for a suitably qualified person to audit or verify, the calculation of the net cost. The 2011 Act thus provides for, and indeed requires, thorough analysis by ComReg before any final decision may be made.
- 32 Having considered the recommendation of Frontier Economics, together with the applicable provisions of the 2011 Act, the guidance of the European Commission in its Postal Directive, the study conducted by Frontier Economics for the European Commission, the views of respondents to Consultation 13/48, and an assessment of the options as set out in the RIA, ComReg's determination is that the PC approach is the methodology that An Post should use in any submission made by it under section 35 of the 2011 Act.
- 33 The PC approach measures the difference between a USP's profit level with and without the USO, in a liberalised market. If the USP is compensated for this difference, an efficient USP achieves the same profit as it would in a postal market where it did not have specific universal postal service obligations.
- 34 ComReg's determination that the PC approach is the methodology that An Post should use in any submission made by it under section 35 of the 2011 Act is also supported by the following:
- The PC approach can capture the full complexity of a reference scenario. This approach is not restricted by the status quo and allows for the modelling of a whole host of potential changes that a USP could make in the absence of the USO. The PC approach can model not only the potential withdrawal of certain USO products, but importantly it can also capture the effects of removing or relaxing specific elements of the USO.
  - The PC approach can take account of all changes arising from modifying the USO, including direct effects on demand, costs, and market shares.

- The PC approach is considered to take better account of efficiency than the DA or NAC approaches. This is important as the net cost calculation should not include the impact of inefficient operation in order to be in line with the Postal Directive and the 2011 Act.
- The PC approach is an established methodology which has been widely used in other European jurisdictions to calculate the net costs (if any) of a postal USO, in some cases in the context of a funding application. This methodology has already been applied in practice in Denmark, UK, Norway, Slovakia, and the Netherlands.

## 4.2 Setting the reference scenario, implementing the PC approach, and guidance on information requirements

35 The PC approach consists of the following four steps:

- (1) define a reference scenario where the USP faces no obligations in respect of the services it offers. This step involves identifying the part of the USO that would not be provided or would be modified by a (profit maximising) USP, if it was not subject to the USO;
- (2) calculate the costs that the USP would avoid if it moved to the reference scenario, as defined in step 1;
- (3) calculate the revenues that the USP would forego under the reference scenario if its product offering was modified compared to the base case. Both direct and indirect demand effects are expected to impact revenue in this reference scenario. The direct effect is the demand loss for products which would no longer be provided. The indirect effect is the impact of a change in one service on the demand for the other products of the USP; and
- (4) calculate the USO net costs as the change in the USP's profits should it move to the counterfactual scenario without the USO.

36 By reference to the above four steps, ComReg, in Consultation 13/48, set out its preliminary views that An Post should set the reference scenario and that such a reference scenario should be assumed to be a reduced universal service obligation under section 16(1)(a) of the 2011 Act. In Consultation 13/48, ComReg also set out how the PC approach should be implemented and set out its proposed guidance on the information required to support any net cost submission. ComReg sought the views of interested parties on these by asking the following questions:

**Q.2 Do you agree or disagree that An Post should develop the reference scenario? Please explain your response.**

**Q.3 Do you agree or disagree with the proposals on the form and manner of any net cost submission? Do you have any views on the proposed guidance set out in Annex 1 – 3? Please explain your response.**

37 The key views raised by respondents and ComReg's corresponding response position are as follows.

**Views of respondents:**

38 **An Post** agrees that it should develop the reference scenario. An Post claims that it is in the best position to assess the commercial viability of amendments to the service level inherent in the reference scenario.

39 An Post agrees with the four required steps to calculate the net cost under the PC approach and makes two comments:

(1) The PC approach calculates the change in profit level

(2) It may be necessary to use a combination of accounting and LRIC in order to make the PC approach manageable for An Post

40 In relation to the guidance on setting the reference scenario, An Post notes that the proposed steps are in line with its understanding.

41 In relation to the guidance on measuring the revenues foregone and costs avoided, An Post notes that it has taken an approach that is consistent with ComReg's proposals. However, in relation to estimating the future demand of its large customers with regard to changes made in its reference scenario, An Post proposes to use its expert market knowledge as it claims a direct customer survey could, as a direct consequence, adversely impact the rate of e-substitution.

42 Also, An Post states that any efficiency adjustment made in its USO net cost submission should not be confused with achievable efficiencies and transition costs under the future price cap decision. Furthermore, An Post is of the opinion that an allowance for reasonable profit should be included and will provide detailed supporting information in any net cost submission it makes to support this.

43 In relation to the guidance on taking intangible market benefits into account, An Post states that it is important not to confuse USP ubiquity with other attributes and achievements of An Post. An Post also clarifies that it does not benefit from some of the legal privileges listed in the consultation such as An Post has no exemption from parking and stopping restrictions.



- 44 **Nightline** states that it would appear most practical for An Post to develop the reference model but stresses that ComReg needs to have a close involvement in any analysis of this scenario with detailed scrutiny. Nightline also states that the PC approach would appear to be the most practical.

### **ComReg's position**

- 45 Having considered the recommendation of Frontier Economics, together with the applicable provisions of the 2011 Act, the guidance of the European Commission in its Postal Directive, the study conducted by Frontier Economics for the European Commission, and the views of respondents to Consultation 13/48, ComReg position remains as that set out in Consultation 13/48. Consequently, ComReg's determinations are as follows:

#### **Determination: An Post to develop the reference scenario**

- 46 The reference scenario is the key aspect of the PC method. Its development requires an assessment of how the USP would re-optimize its entire operation (USO and non-USO) in the absence of the current USO.
- 47 All respondents to Consultation 13/48 agreed that An Post should develop the reference scenario. ComReg's position is that An Post, as the sole designated USP, should develop the reference scenario as it is important that the reference scenario be informed by An Post's commercial knowledge and that it reflects how An Post would seek to reorganise its operations absent the current USO, so as to maximise its profits.
- 48 The reference scenario should set out the realistic counterfactual service offering that An Post would continue to provide if the current USO constraint were removed. It implicitly acknowledges that even without the constraints currently imposed by the USO, An Post would continue to run a postal business but that business could possibly be based upon a different set of products and could be configured differently.

**Determination: The reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act**

49 In order to minimise the complexity for An Post in setting its reference scenario, ComReg assumes that a reference scenario would be a reduced USO requested by An Post, in accordance with section 16(1)(a) of the 2011 Act. No respondents to 13/48 disagreed with this or provided any alternative approaches for consideration. Section 16(1)(a) defines the “universal postal service” as meaning that there shall be at least one clearance and one delivery to the home or premises of every person in the State on every working day, except in such circumstances or geographical conditions as ComReg considers to be exceptional. (For ComReg to consider whether particular circumstances or geographical conditions are “exceptional”, such that the USO under section 16(1)(a) may be reduced in some manner, would require an application made to it by An Post to include sufficient supporting information.)

**VAT exemption on universal postal services**

50 As the reference scenario would be based upon a reduced USO under section 16(1)(a) of the 2011 Act, An Post, in setting its reference scenario, should deal with the VAT exemption on universal postal services by assuming that a USO would apply in both the baseline scenario and in the reference scenario. Again, no respondents to Consultation 13/48 raised any objection to this.

51 This approach, of basing the reference scenario on a reduced USO under section 16(1)(a) of the 2011 Act, means that An Post will not have to deal with the complexity of:

- calculating the market benefit of the VAT exemption that applies to universal postal services (in accordance with Schedule 4 of the 2011 Act, this market benefit would be taken into account to calculate the net costs (if any) of providing the current USO); and .
- calculating the effect of demand if the VAT exemption that applies to universal postal services no longer applied in the reference scenario. (This would require detailed economic modelling providing substantial sensitivity testing around:
  - demand assumptions and price elasticity of demand effects
  - acceleration in e-substitution
  - entry / expansion by competitors.)

### Changes to the structure of the pricing of universal postal services

52 As the reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act, any reference scenario put forward by An Post would be subject to the tariff requirements set out in section 28(1) of the 2011 Act, which include that pricing for single piece universal postal services shall be uniform. A change to the price structure, for example non-uniform pricing for single piece universal postal services, is such a fundamental change to the product offering that it is likely to lie outside the range of commercial strategies that a USP would consider to be feasible or profitable. It is also likely that such a change would lead to substantial customer disruption which could result in An Post incurring substantial additional costs. Therefore, An Post should not include changes to the structure of the pricing of the universal postal services in its reference scenario. No respondents to Consultation 13/48 raised any objection to this.

### Changes to the level of the pricing of universal postal services

53 An Post may wish to consider changes in price level when developing any reference scenario. However, if An Post considers that sizeable increases in price formed part of the reference scenario then it will need to provide significant supporting analysis. This would include analysis that demonstrates An Post is only including efficient costs in both the current and reference scenarios. An Post would also need to take into account the impact of higher prices on:

- customer demand;
- an acceleration in e-substitution;
- an acceleration in entry/expansion by competitors; and
- its compliance with the tariff requirements under section 28 of the 2011 Act.

No respondents to Consultation 13/48 raised any objection to this.

### Guidance to An Post in developing the reference scenario

54 Annex 1 of this document sets out guidance as to how any reference scenario should be set by An Post and the information that should be provided by An Post to support any such reference scenario as it may submit, in order that ComReg can determine whether provision of the universal postal service represents a net cost to An Post. Respondents to Consultation 13/48 generally agreed with this guidance.

**Guidance to An Post on measuring the revenues foregone, costs avoided and change in the value of indirect benefits that result from the modification of the universal service**

- 55 Once the reference scenario has been developed by An Post, the next step for An Post will be to calculate and present what it considers to be the net cost of the USO, in order that ComReg's may then determine whether there in fact such a net cost and whether it agrees with An Post's calculation of that net cost<sup>11</sup>. The net cost calculation seeks to measure:
- revenues foregone by modification of the universal service;
  - costs avoided by modification of the universal service; and
  - the change in the value of indirect benefits that result from the modification of the universal service.
- 56 To measure the first two of the above, it is critical for An Post to understand how volumes, market shares and costs depend on service specification. In Annex 2, ComReg provides guidance as to how these should be calculated and in general, respondents to Consultation 13/48 agreed with this guidance.
- 57 In response to An Post's claim that a direct customer survey of large mailers may not be appropriate to estimate the demand effect of any reference scenario, ComReg's position remains that the use of customer surveys as one type of evidence of stated preference is ranked second in the "pyramid approach" of alternative information sources, and therefore this approach remains in the guidance.
- 58 In response to An Post's statement on the efficiency adjustment, ComReg is of the view that the efficiency adjustment in any net cost submission should be similar to the efficiency adjustment set by ComReg as part of any price cap determination made under section 30(2) of the 2011 Act (as both are seeking to reflect the efficient costs associated with providing the current USO services), notwithstanding that any price cap determination which would apply for a 5 year period may allow a glide path to efficiency and such a glide path would not be applicable to a net cost submission as this is based on an assessment of costs in the one year under review.

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<sup>11</sup> In accordance with sections 35(4) and 35(5) of the 2011 Act

- 59 In response to An Post's opinion that an allowance for reasonable profit should be included, ComReg's position, having further considered the view of its expert advisors, remains that under the PC methodology no adjustment is required to make allowance for a reasonable profit and ComReg has made this clearer in its guidance. Further details to support this position are provided in Annex 2 and in the supporting report by Frontier Economics. An Post, therefore, should make no adjustment for a reasonable profit when using the PC approach as no adjustment is required.
- 60 In Annex 3, ComReg provides guidance on taking into account any intangible and market benefits which accrue to a USP. In general, respondents to Consultation 13/48 agreed with the guidance set out in Annex 3. In relation to the possible benefits which may accrue to An Post, as a result of its being the USP, these were provided as general examples based on a European wide study. An Post, as part of any net cost submission that it may make, can clarify whether it considers that such benefits do or do not exist. In relation to An Post's claim that in relation to the guidance on taking intangible market benefits into account, it is important not to confuse USP ubiquity with other attributes and achievements of An Post, ComReg notes that any such a claim will need to be supported by detailed robust evidence in order to facilitate ComReg's audit, verification, and determination.
- 61 An Post should have proper regard to the guidance set out in the Annexes herein when calculating its net costs (if any) of providing the universal postal service, in order that ComReg may then consider the request for funding made by An Post and determine whether provision of the universal postal does represent a net cost to An Post. In response to Nightline's comment, ComReg again notes that the 2011 Act makes it clear that it is ComReg that will determine whether there is a net cost or not. In order to make determination, ComReg will require detailed evidence based information from An Post and the 2011 Act empowers ComReg to obtain such information from An Post where it is not provided.

**Determination: Use of bottom-up model based on LRIC if reference scenario departs significantly from the current USO**

- 62 If any reference scenario presented by An Post should depart significantly from the current USO, it will be necessary for An Post to develop a bottom-up model in order to estimate the costs in the reference scenario as ComReg considers that it would be difficult to estimate those costs based solely on historic accounting data. Historic accounting data is unlikely to be suitable for the following reasons:
- It is unlikely that accounting data would have been designed to estimate the costs of running the business with and without the USO. This also applies to

activity based costing models which are often used to describe the costs of undertaking each pipeline activity and which do not relate explicitly back to each USO component. It is unlikely that accounting models would provide the comprehensive set of cost drivers across all meaningful components of the USO, which limits the relevance of the estimates contained in such models.

- To the extent that any accounting models do included estimates of cost elasticities associated with modifying or removing the USO, these are likely to be short run in nature and do not encompass the effects of re-optimising operations without a USO. This would limit the accuracy of any such estimates.
- Even if costs and processes have been accurately modelled and/or estimated in the accounting data, the models or estimates may not represent the optimal level of operational efficiency (due, for example, to excessive use of inputs or if input prices are too high).
- Even if relevant, accurate and efficient elasticity estimates can be drawn from the accounting data, these may not provide a basis for policy making as they may simply describe the operational processes that the USO provider has in place at that time. Consequently, the accounting data may not reveal the fundamental cost drivers of the USO but may only reveal the cost drivers deriving from the particular processes and activities chosen by the USP in order to meet its obligations.

63 Also, as the PC approach seeks to identify the avoidable costs that would be saved as a result of making changes to the USO, Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO as the concept of avoidable cost is more closely related to the use of LRIC. In response to An Post's response that it may use a combination of accounting and LRIC in any net cost submission it makes, ComReg will assess the reasonableness of An Post's approach as part of any future consideration of the net cost. However, ComReg's position remains that LRIC should be used where the reference scenario departs significantly from the current USO.

**Determination: Cost differences between the baseline and reference scenarios must be on a like-for-like basis**

- 64 For the purpose of making a determination under section 35(4) of the 2011 Act as to whether the provision of the universal postal service represents a net cost and an unfair financial burden on the USP, section 35(5) requires that ComReg shall also take into account (i) the methodology used by the USP with respect to the information given to ComReg, (ii) the extent to which the USP is, in ComReg's opinion, complying with the statutory obligations imposed on it relating to the provision of a universal postal service in a cost-efficient manner, and (iii) any other information which ComReg considers relevant. The 2011 Act therefore requires that an assessment under section 35 should be based on the net costs of an efficient operator. Consequently, to the extent that any net cost identified is higher as a result of inefficiencies, that net cost should then be adjusted in order to take account of those inefficiencies.
- 65 For example, consider a scenario in which an efficient operator would utilise three rather than four mail centres in both the baseline and in the reference scenario. Use of accounting data for the baseline would show that four mail centres were being used. However, a bottom-up model would show that only three mail centres ought to be used and would attribute this to the move from the baseline to the reference scenario, when in fact an efficient operator would also have utilised three mail centres in the baseline. In consequence, the estimated cost of the USO might be substantially higher than the actual cost.
- 66 Therefore, to ensure that only the efficient net costs of the USO are calculated, it is critical that the estimate of the cost differences between the baseline and reference scenarios is on a like-for-like basis reflecting only differences associated with changes in the service specification. No respondents to Consultation 13/48 raised any objection to this.

**Calculating the net cost of the USO**

- 67 The net cost of the USO is calculated by:
- comparing revenues in the baseline year, at current prices, to modelled efficient costs in the baseline; and
  - comparing revenues in the reference scenario, which have been adjusted to reflect volume changes and market share effects, with modelled efficient costs in the reference scenario.
- 68 The net cost of the USO is the difference between the two figures.

69 As required by section 35 of the 2011 Act it is ComReg that determines whether there is a net cost and it is ComReg or a person appointed by ComReg that audit or verify the net cost.

### **4.3 Comments on the draft Regulatory Impact Assessment (RIA)**

70 In Consultation 13/48, ComReg asked the following question:

**Q.4 Do you have any views on this draft Regulatory Impact Assessment and are there other factors ComReg should consider in completing its Regulatory Impact Assessment? Please explain your response and provide details of any factors that should be considered by ComReg.**

#### **Views of respondents**

71 Other than the points it made in its responses to the other questions, An Post had no comments on the RIA.

72 In its response, Nightline requests that the consultation as to how unfair burden will be assessed should be completed as a matter of urgency.

#### **ComReg's position**

73 Having considered the responses to Consultation 13/48 ComReg considers that no changes are required to the RIA which was set out in draft form in Consultation 13/48. In response to Nightline's request, ComReg notes that that consultation on the unfair financial burden assessment will be issued in line with the indicative timeframe provided by ComReg in its Postal Strategy Statement<sup>12</sup>.

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<sup>12</sup> Document No. 12/116 published 30 October 2012



## 5 Regulatory Impact Assessment

- 74 ComReg's published RIA Guidelines<sup>13</sup> (Doc 07/56a), in accordance with a policy direction to ComReg<sup>14</sup>, state that ComReg will conduct a RIA in any process that may result in the imposition of a regulatory obligation, or the amendment of an existing obligation to a significant degree, or which may otherwise significantly impact on any relevant market or any stakeholders or consumers. However, the RIA Guidelines also note that in certain instances it may not be appropriate to conduct a RIA and, in particular, that a RIA is only considered mandatory or necessary in advance of a decision that could result in the imposition of an actual regulatory measure or obligation, and that where ComReg is merely charged with implementing a statutory obligation then it will assess each case individually and will determine whether a RIA is necessary and justified.
- 75 In accordance with section 35(2)(a) of the 2011 Act a request by the USP to seek funding for the net costs (if any) of providing the universal postal service must be made in such form and manner as ComReg determines. In this document, ComReg has made certain determinations on the form and manner for a USP's request to seek to receive funding for the net costs (if any) of providing a universal postal service. Therefore, ComReg has prepared a RIA in respect of these determinations as there were options open to ComReg in making these determinations.

### 5.1 Steps involved

- 76 In assessing the available regulatory options, ComReg's approach to RIA follows five steps as follows:
- Step 1: describe the policy issue and identify the objectives
  - Step 2: identify and describe the regulatory options
  - Step 3: determine the impacts on stakeholders
  - Step 4: determine the impacts on competition
  - Step 5: assess the impacts and choose the best option

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<sup>13</sup> Which have regard to the RIA Guidelines issued by the Department of An Taoiseach in June 2009

<sup>14</sup> Ministerial Policy Direction made by Dermot Ahern T.D. Minister for Communications, Marine and Natural Resources on 21 February, 2003

## **Step 1: Describe the policy issue and identify the objectives**

77 As required by the section 35(2)(a) of the 2011 Act, a request by the USP to seek to receive funding for the net costs (if any) of providing a universal postal service must be made in such form and manner as ComReg determines.

## **Step 2: Identify and describe the regulatory options**

78 In determining the form and manner of any request for funding the net costs (if any) of providing a universal postal service, a number of options were open to ComReg; these were:

- Option: Whether the Profitability Cost methodology should be used or not
- Option: Whether An Post should determine the reference scenario or not
- Option: Whether certain requirements for calculating the net costs should be set or not

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

### **Option: Whether the Profitability Cost methodology should be used or not**

79 There are three main types of methodology generally used to calculate the net costs (if any) of providing the universal postal service and they are as follows:

**Methods used in the estimation of the net cost of the USO**

Definition of the net cost of the USO	
<b>Deficit Approach (DA)</b>	The difference between the sum of the losses from individual loss making products, and the sum of the profits from individual profit making products, as reported in the universal service provider accounts.
<b>Net Avoidable Cost (NAC)</b>	The sum of the loss-making USO mail flows, where a mail flow in this context is made up of elements of products along a number of dimensions. (e.g. format, delivery zone, type of sender, class).
<b>Profitability Cost Approach (PC)</b>	The net cost of the USO is measured as the difference between a universal service provider's profit level with and without the USO, in a liberalised market. The Profitability Cost can also be expressed as the net avoidable costs – given by the sum of the change in incremental costs and the change in revenues.

Source: Frontier Economics

- 80 In making the determination that the Profitability Cost (PC) methodology should be used, ComReg has considered the analysis and recommendation of its independent consultants, Frontier Economics. ComReg has also considered the relevant provisions of the 2011 Act and Directive 97/67/EC on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended (the “Postal Directive”). ComReg has also considered the views of respondents to Consultation 13/48.
- 81 There are three key criteria to assess and compare the possible methodologies to calculate the net costs:
- (1) Ability of the methodology to deal with relatively complex changes to the service specification in the reference scenario
  - (2) Ability to take account of all changes arising from the USO and ability to take account of efficiency
  - (3) Precedent for use in other countries

**(1) Ability of the methodology to deal with relatively complex changes to the service specification in the reference scenario**

- 82 ComReg considers that it is important that the chosen methodology is able to take account of the likely complexity of the reference scenario. As part of any funding application, the net cost calculation is needed to understand the extent to which the obligations associated with the provision of the universal service imposes costs on An Post that it otherwise would not bear. It is therefore vital that the methodology used for such a calculation allows for the estimate of these costs to be as accurate as possible. As such, it must be based on a reference scenario which provides as accurate a reflection as possible of the service offering that An Post would provide in the absence of the constraints currently imposed by the USO.

83 In this respect, ComReg has considered and concurs with the advice of its independent consultants, Frontier Economics<sup>15</sup>. The possible different methodologies can be compared as follows:

**Table 1.** Behaviour of the universal service provider without the USO (counterfactual)

Features of methods	DA	NAC	PC
Remove whole of USO	Yes	No	No
Remove elements of USO products	N/A	Yes	Possible
Relax provision constraints for remaining services (e.g. delivery frequency)	N/A	No	Yes
Relax pricing constraints	N/A	No	Yes
Relax quality constraints	N/A	No	Yes
Changes in USP's operation and network (for instance re optimising the network)	N/A	No	Yes
Changes in demand for USP's "remaining" products	N/A	Not done to date but possible	Yes
Changes in market share of USP	N/A	No	Yes

Source: Frontier Economics

84 The DA approach differs from the other two in that there is no explicit reference scenario. There is no analytical exercise that defines what the USP would choose to do without the USO. However, it could be argued that the DA approach includes an implicit reference scenario that says absent the USO, the USP would stop providing all USO products whilst continuing to provide all non-USO products via an unchanged network.

85 In the case of the NAC approach as it has been applied in post to date, the counterfactual scenario can be interpreted as the USP ceasing to provide all loss-making USO "mail flows", and continuing to provide all non-USO products together with profitable USO mail flows via an unchanged network.

<sup>15</sup> ComReg Document No. 13/69a

- 86 The PC approach assumes that in a competitive market, the USP would seek to reorganise its operations absent the USO in a way to “maximise its profits”. This may include removing elements of USO products that are loss-making as under the NAC. But importantly, the USP would also be expected to seek further changes in its operations to minimise costs.
- 87 The NAC approach will produce higher estimates of the net cost of the USO than the DA, because where USO services as a whole are profitable, but are composed of losses and gains for individual services, the DA records no net cost. The NAC approach on the other hand simply aggregates the individual service losses as the net cost, so while USO services may be profitable as a whole, it may generate a net cost.
- 88 Under the PC approach, the USP puts in place a business model that seeks to maximise profits in a competitive environment. This may include removing elements of the USO that are loss making as under the NAC, however, the USP would also go further by reducing costs of all services down to an efficient level.

## **(2) Ability to take account of all changes arising from the USO and ability to take account of efficiency**

- 89 ComReg also considers it important that the methodology allows for all changes in costs and revenue that might arise as a result of the USO (in comparison to the reference scenario). This will include the impact on demand, seen through a change in volumes. In addition, section 35(5) of the 2011 Act requires ComReg, upon receipt of a funding application from An Post, to determine the extent to which the universal postal service is being provided in a cost-efficient manner. As such, it is essential that the chosen methodology allows for an adjustment to be made to costs and revenues to reflect the fact that current costs and revenues associated with the USO may not be equivalent to that of an efficient operator.
- 90 In this respect, ComReg has considered the advice of Frontier Economics and agrees with its comparison on the ability of the different methodologies to deal with all changes arising from the USO and ability to take account of efficiency.
- 91 The DA approach, as it is based on accounting costs, does not take into account the impact on existing demand flows if the USO services were no longer provided and initially assumes current efficiency levels. Under this approach, any efficiency adjustments would need to be carried out ex-post and would entail coming to a view on the proportion of the costs associated with delivering the USO that are inefficient.

- 92 The alternative approach, an ex-ante adjustment of costs for efficiency, could lead to misleading estimates of the net cost of the USO without an adjustment to revenues. This is because it would create artificial improvements in margins/profitability, which could not necessarily take place in a fully competitive market.
- 93 The methodology of the NAC approach, although based on the concept of avoidable costs, does not specify that this should be the costs avoided by an efficient operator. In fact, the actual application is based on accounting costs. Therefore, as with the DA approach; any efficiency adjustment would need to be made ex-post. Again, this would entail coming to a view on the proportion of the costs associated with delivering the USO that are inefficient.
- 94 The PC approach explicitly includes demand effects and efficiency adjustments. Efficiency adjustments can either be made ex-post, as with the DA or NAC approach, or ex-ante under the PC approach. An ex-ante adjustment can be made if bottom-up modelling is used. Such modelling can explicitly demonstrate the costs faced by an efficient operator under both the base case and reference scenario.

### **(3) Precedent for use in other countries**

- 95 The PC approach is the most commonly chosen approach to calculating the net cost of the USO in post by USPs and NRAs alike. It has been applied in practice in Denmark, UK, Norway, Slovakia, and the Netherlands.
- 96 Both the DA and NAC approaches have both been used in the past and replaced by other methods. For example, the USP in Norway has previously used the NAC approach and now uses the PC approach. In Norway, it was felt that general drawbacks of the NAC-model were that it did not take into account a realistic commercial counterfactual and that the final result depended on the chosen breakdown of data.
- 97 Likewise, the USPs in Italy and Belgium used the DA approach annually from 2002-2010. The calculations for 2011 are on hold and will be based on new methodologies following the transposition of the 3rd Postal Directive in Italy and Belgium.

### **Profitability Cost methodology should be used:**

- 98 ComReg's determination is that the most appropriate methodology for determining the net cost of the USO in Ireland is the PC approach. Respondents to Consultation 13/48 agreed with this position.

99 In particular, the PC methodology:

- can capture the full complexity of a reference scenario. This approach is not restricted by the status quo and allows for the modelling of a whole host of potential changes that an operator could make in the absence of the USO. The PC approach can model not only the potential withdrawal of certain USO products, but importantly can also capture the effects of removing or relaxing specific elements of the USO.
- can take account of all changes arising from modifying the USO. This includes direct effects on demand, costs and market shares arising from changes in the USO.
- is better at taking account of efficiency. This is important as the net cost calculation should not include the impact of inefficient operation in order to better comply with Annex 1 of the Postal Directive.
- is an established methodology which has been widely used in Europe to calculate the net cost of postal USO. This methodology has already been applied in practice in Denmark, UK, Norway, Slovakia, and the Netherlands.
- is the only methodology that applies the correct net cost definition as described in Annex 1 of the Third Postal Directive (which is included as Schedule 4 to the 2011 Act) by calculating the difference in profit with and without the current USO.

**Option: Whether An Post should determine the reference scenario or not**

100 The most important element in assessing the net costs (if any) of providing the universal postal service is the development of the reference scenario. The reference scenario should set out the realistic counterfactual service offering that An Post would continue to provide if the current USO constraint were to be removed. It implicitly acknowledges that even without the constraints currently imposed by the USO, An Post would continue to run a postal business, albeit one that possibly offers a different set of products and one configured on a different basis.

101 The possible options here are whether ComReg should allow An Post to set the reference scenario or whether ComReg should specify the reference scenario.

102 ComReg's determination is that An Post is best placed to determine the reference scenario as it is important that the reference scenario is informed by An Post's commercial knowledge of its business, and that it is important that it reflects how An Post would seek to reorganise its operations absent the current USO in a way to maximise its profits. Respondents to Consultation 13/48 agreed with this position.

### **Option: Whether certain requirements for calculating the net costs should be set or not**

103 Though An Post will determine the reference scenario, there are certain requirements that ComReg considers must be placed with the use of the PC approach to ensure that the calculation of the net cost (if any) associated with the USO is evidence based and consistent with the requirements of the 2011 Act. These requirements are:

- 1) That the reference scenario represents a reduced universal postal service obligation under section 16(1)(a) of the 2011 Act

In order to minimise the complexity for An Post in setting its reference scenario, ComReg's determination is that the reference scenario set by An Post is assumed to be a reduced USO requested by An Post under section 16(1)(a) of the 2011 Act. Section 16(1)(a) of the 2011 Act enables An Post, in exceptional circumstances, to seek to reduce the delivery and clearance requirements of the universal postal service.

This determination makes it easier to account for the VAT exemption of universal postal services by assuming that a USO would apply in both the baseline scenario and the reference scenario. This will benefit An Post when it sets the reference scenario as it limits complexities that arise if the reference scenario does not represent a reduced universal postal service obligation.

No respondents to 13/48 disagreed with this or provided any alternative approaches for consideration.



2) That changes to the structure of the pricing of universal postal services should not form part of the reference scenario

As the reference scenario represents a reduced USO under section 16(1)(a) of the 2011 Act, An Post's reference scenario will be subject to the tariff requirements of section 28 of the 2011 Act for its universal postal services. This includes the requirement for uniform pricing of single piece universal postal services. A change to the price structure, such as single piece universal postal services no longer being offered at uniform prices, is such a fundamental change to the product offering that it is likely to lie outside the range of commercial strategies than a USP would consider to be feasible or profitable. It is also likely that such a move would lead to substantial customer disruption and could impose substantial additional costs on An Post. No respondents to 13/48 disagreed with this.

With respect to changes in the price level, this is something that An Post may wish to consider as part of the development of its reference scenario. However, in the event that An Post considers that sizeable increases in price formed part of the reference scenario, An Post will need to provide significant supporting analysis to demonstrate that such an increase would in fact be profitable and compliant with the tariff requirements under section 28 of the 2011 Act. No respondents to 13/48 disagreed with this.

3) That a bottom-up model based on LRIC is used if the reference scenario departs significantly from the current USO

If the reference scenario departs significantly from the current USO, it will be necessary for An Post to develop a bottom-up model to estimate the costs in the reference scenario as it would be difficult to estimate the applicable costs based solely on historic accounting data.

Also, as the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification, Long Run Incremental Cost (LRIC) should be used where the reference scenario departs significantly from the current USO.

Generally, no respondents to 13/48 disagreed with this. This will be relatively more data intensive for An Post but it is made in the context of ensuring that any net cost calculation is evidence based and in accordance with the requirements of the 2011 Act.

## 6 Determination

The Commission for Communications Regulation, pursuant to section 35(2)(a) of the Communications Regulation (Postal Services) Act 2011 (“2011 Act”) and having had regard to sections 16, 28, 35 and Schedule 4 of the 2011 Act, hereby makes the following determination as to the form and manner of any request for funding for the net costs (if any) of providing a universal postal service, submitted to the Commission under section 35(1) of the 2011 Act, by any universal postal service provider designated under section 17 or 18 of the 2011 Act:

1. That in respect of any such submitted request for funding, the Profitability Cost methodology shall be used by the universal postal service provider making the submission in order to calculate the net costs (if any) of providing the universal postal service.
2. That the universal postal service provider submitting the request for funding shall set the reference scenario used to calculate the net costs (if any) of providing the universal postal service, and in doing so, shall:
  - a. assume that the reference scenario represents a reduced universal postal service obligation, based on a determination by the Commission under section 16(1)(a) of the 2011 Act that exceptional circumstances or geographic conditions exist which warrant that there shall not be one clearance and one delivery on every working day to the home or premises of every person in the State (such determination having been made on foot of an application made to the Commission by a universal postal service provider);
  - b. not make any changes to the structure of the pricing of its universal postal services in its reference scenario; and
  - c. utilise a bottom-up model based on the Long Run Incremental Cost methodology if the reference scenario should depart significantly from the existing universal service obligation, as of the date on which the submission under section 35(1) of the 2011 Act is first made.

3. That the universal postal service provider's calculation of the net costs (if any) of providing the universal postal service shall be guided by Annex 1 – 3 of ComReg Document No. 13/69 (though the Commission also notes that any guidance provided by it should not be considered exhaustive of all matters that may arise in the course of reviewing any submission made to it under section 35(1) of the 2011 Act, and the Commission reserves its right to deviate from any guidance provided where it considers it reasonable to do so and the Commission further reserves its right to request such additional information of a universal postal service provider as it may require in respect of any submission made to it under section 35(1) of the 2011 Act, in accordance with section 35(3) of the 2011 Act).

This Determination shall be construed together with ComReg's conclusions, reasoning, and analysis as set out in ComReg Document No. 13/69.

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

This Determination shall remain in force until further notice.

Kevin O'Brien

Commissioner

The Commission for Communications Regulation

Dated 25 July 2013

## 7 Conclusion

104 Having considered the recommendations of Frontier Economics, together with the applicable provisions of the 2011 Act, the guidance of the European Commission in its Postal Directive, the study conducted by Frontier Economics for the European Commission, the views of respondents to Consultation 13/48, and an assessment of the options as set out in the RIA, ComReg has set out its determination on the form and manner of any request by An Post, or any other designated universal postal service provider, seeking to receive funding for the net cost (if any) of providing the universal postal service in accordance with section 35(2)(a) of the 2011 Act.

105 In accordance with section 35(4) of the 2011 Act, ComReg, on foot of any request for funding made by An Post, shall determine whether provision of the universal postal service does represent a net cost to An Post. For the purpose of making any such determination, ComReg shall take into account the factors set out in section 35(5)(a) and ComReg shall audit or verify, or shall appoint some suitably-qualified person to audit or verify, the calculation of the net cost of providing the universal postal service under section 35(4).

106 In order to carry out the work which may result in a determination under section 35(4), ComReg will require detailed evidence based information from An Post and the annexes to this document set out guidance on the nature and type of information that An Post should provide at the outset, as part of any request for funding. However, ComReg may have further information requirements, which could not be envisaged by this consultation, and ComReg therefore reserves its right to require An Post to provide any such additional information, pursuant to section 35(3) of the 2011 Act.

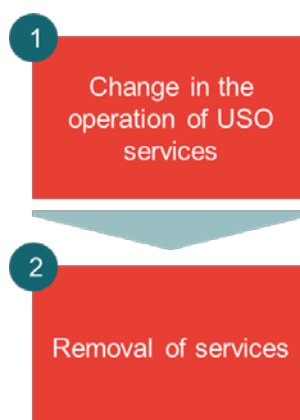
107 It is therefore critical that any application made by An Post for funding in respect of provision of the universal postal service is supported by sufficiently detailed and robust data, in order to facilitate ComReg's subsequent review and audit, and to inform ComReg's final determination. Similarly, if ComReg should determine that there is a net cost which also represents an unfair financial burden, and if An Post should seek funding from other sources in respect of that unfair financial burden (if the sharing mechanism provided for under the 2011 Act should prove to be insufficient) then it is likely that the same data would, at a minimum, be required in order to assess whether any such funding of An Post would be in accordance with other legislative and procedural regimes.

## Annex: 1 Guidance to An Post in setting its reference scenario

A 1.1 An Post should consider this guidance when setting its reference scenario in order to facilitate ComReg's subsequent audit, verification, and determination of the net costs (if any).

### Possible variations to An Post's current service offering

A 1.2 The possible variations open to An Post in developing its reference scenario can be grouped into two steps which should be considered sequentially in the order illustrated below.



Source: Frontier Economics

### Step 1: Change in the operation of the universal postal services

A 1.3 In this first step in developing the reference scenario, An Post should consider what changes could be made to the operation of USO services that would increase the profitability of those services currently deemed by An Post to be unprofitable.

A 1.4 An Post in developing and setting its reference scenario makes an assumption that the reference scenario is a reduced USO sought under section 16(1)(a) of the 2011 Act. Consequently, under this step, the reference scenario may assume reduced USO as follows:

- changes in the number of collections and deliveries per week;
- changes to the number of access points for collecting mail; or
- changes to the points at which the mail is delivered.

A 1.5 These changes may vary on a geographic basis. For example, An Post may decide to vary the number of collections and deliveries per week by area of the country, making reductions in more rural areas of the country that are currently unprofitable to deliver to.

A 1.6 Under this step, An Post's reference scenario plan will specify what changes, if any, it would make in relation to each of the above. It will also highlight any geographic differentiation that would be introduced. For each service element that An Post proposes to alter under the reference scenario, it should provide a high level commercial rationale to support the alteration. The table below provides a template for the format that this rationale might take and the areas that should be covered.

### Template for required high level rationale for each service element alteration under the proposed reference scenario

Service element	Current provision	Proposed alteration	Commercial rationale
e.g. Collections and deliveries per week	Five days		
e.g. Class of mail	First class (D+1)		

Source: Frontier Economics

## Step 2: Removal of services

A 1.7 In this second step in developing the reference scenario, if An Post finds it is not possible to make a profitable service offering based on changes to the operation of USO services at step 1, then An Post may then want to consider the removal of services altogether as step 2.

A 1.8 Under this step, the reference scenario may assume, for instance that:

- a particular service currently provided as part of the USO (or group of services) would be removed from the service offering entirely;
- the delivery of selected USO services would not be provided in specific geographic areas;
- the delivery of any USO service would not be provided in specific geographic areas; or
- there would be no delivery of any postal service in a given geographic area.

A 1.9 If An Post seeks to remove services on a geographic basis, An Post should demonstrate that making less radical alterations to the service would still be unprofitable. For example, if An Post were to suggest that it would not serve a particular geography at all, it would be important that it demonstrate that even a reduced service (e.g. one delivery and collection per week) to that particular geography would still be unprofitable.

A 1.10 If An Post develops its reference scenario under this step, An Post’s reference scenario plan will specify which services, if any, it would remove from its service offering. It will also highlight any geographic differentiation that would be introduced. An Post should also provide a commercial rationale for each service removal that it proposes to make under the reference scenario. The table below provides a template for the format that this rationale might take and the areas that should be covered.

**Template for required high level rationale for the removal of services under the proposed reference scenario**

Current provision	Proposed alteration	Commercial rationale
Two universal bulk mail services: ‘delivery only’ for mail sorted by delivery office, and ‘deferred delivery’. The remainder of bulk mail services fall within the scope of the USO.		
Postal items up to 2kg Postal packages up to 20kg		

Source: Frontier Economics

## **Annex: 2 Guidance to An Post on measuring the revenues foregone and costs avoided by modification of the universal service**

A 2.1 Once the reference scenario has been developed, the next step for An Post will be to calculate the net cost of the USO<sup>16</sup> by measuring the revenues foregone and costs avoided by modification of the universal service. To measure these effects, it will be critical for An Post to understand how volumes, market shares and costs depend on service specification. An Post should consider this guidance in order to facilitate ComReg's subsequent audit, verification, and determination of the net costs (if any).

### **Volume effects**

A 2.2 Having developed the reference scenario, An Post will have to estimate the impact of changes in volumes because:

- it will impact directly on the revenues An Post can expect to generate;
- it will also likely impact on the costs An Post will incur.

A 2.3 In order to estimate the likely volume effects, the analysis will need to:

- Step 1: establish what volumes are in the base case; and
- Step 2: set out how volumes might be expected to change as a result of moving to the reference scenario.

### **Sub-step 1: Base case volumes**

A 2.4 To establish the base case volumes, actual volume data from the financial year to which the funding request applies should be used. Ideally, this would be on as disaggregated a basis as possible. At the very least, this information should be broken down by:

- product;
- format e.g. letter, flat, packet or parcel;

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<sup>16</sup> Notwithstanding that in accordance with section 35(4)(a) it is ComReg that determines whether there is a net cost or not



- weight step; and
- some form of geographical measure, whether this be geographical area or zones based on population density characteristics.

A 2.5 All volume information should be presented in a way that allows it to be mapped to the key parts of the pipeline: collections, mail centres and transport, and delivery. Volumes should also be broken down by day of the week.

### **Step 2: Volumes in the reference scenario**

A 2.6 Once the base case has been established, the next step is to estimate what would happen to volumes and costs under a move to the reference scenario.

A 2.7 The aim of this step is to identify the likely demand response of customers to the changes in service specification. In estimating the volume effects associated with a move to the reference scenario, it is recognised that there will be a reasonable level of uncertainty associated with the estimates. The level of accuracy of the estimation is likely to be particularly affected by the fact that the service offering under the reference scenario will not have been experienced before in Ireland, and there is therefore no directly relevant historical information that can be used to estimate demand effects. In this context, it will be particularly important to ensure that appropriate scenario analysis and sensitivity testing is undertaken by An Post to assess the robustness of the results.

A 2.8 Consequently, An Post should combine information from a range of sources. This should be guided by a “pyramid approach” which ranks alternative information sources:

- direct evidence of revealed preference, e.g. econometric or other statistical evidence which estimates demand elasticities, should be given a strong weighting.
- evidence of stated preference, e.g. survey data on customer preferences for postal products and switching between or for particular elements of the USO, should be ranked second. An Post should seek to develop survey evidence to measure customer preferences for postal products. The purpose of such evidence is to identify the elements of the universal service that are more important than others from a customer perspective, and to understand the extent to which different types of customer place a different value on various service features.

- qualitative evidence, e.g. from interviews with mail users, should be ranked third. An Post may wish to carry out interviews to develop a more qualitative understanding of how mailers could react to changes in service specification. For example, for large customers in particular, a key issue could be to understand the extent to which changes in the service specification could lead to an acceleration of e-substitution.

A 2.9 Finally, it is likely that there will be a level of uncertainty about the demand estimates An Post derive. Consequently, An Post should run a set of scenarios around the central estimates to assess the sensitivity of results to different assumptions.

## **Market share effects**

A 2.10 In addition to estimating the demand effects associated with changes in service specification, it is also important to take into account any potential market share effects. For example, if demand for a particular product switches in response to a modification of the universal service, then the new mail product may be more or less contestable than the mail product the customer was originally using. Consequently, An Post would face not only a direct demand effect, but also potentially a market share effect.

A 2.11 It is also important to consider the possibility that some universal service modifications may cause a more profound effect upon An Post's position in the market.

A 2.12 This might be characterised either as:

- major changes that fundamentally alters the perception of An Post relative to competitors; or
- changes that disproportionately affect An Post's service quality relative to rivals.

A 2.13 ComReg suggests that a qualitative analysis be undertaken which:

- assesses the extent to which the move to the reference scenario makes market entry and/or customer switching more likely; and
- assesses case study evidence on the evolution of competition in other markets to identify the potential magnitude of such effects.

A 2.14 On the basis of the above qualitative analysis, it is recommended that scenario analysis is developed by An Post to estimate the potential impact of market share effects on volumes across streams.

## Costs

A 2.15 The third key element associated with estimating net cost is the estimation of costs in the base and in the reference scenarios.

A 2.16 When considering the estimation of costs, there are two key points to note:

- (1) That the purpose of the assessment is to pick up only those changes in cost that are associated with the USO – in particular changes in cost that might be categorised as ‘efficiencies’ which could arise in the absence of changes to the USO should not be captured; and
- (2) When considering the net cost of the USO, the 2011 Act is clear that the assessment should be based on the net costs of an efficient operator. So to the extent that any net cost identified is higher as a result of inefficiencies, the net cost should be adjusted to take account of those inefficiencies.

A 2.17 To ensure that only the net costs of the USO are calculated, it is critical that the estimate of cost differences between the baseline and reference scenarios is on a like-for-like basis reflecting only differences associated with changes in the service specification.

A 2.18 In developing cost estimates, there are three critical decisions to be taken:

- (1) whether the analysis is based on a model, accounting data or a mix of both;
- (2) if a model is required, the relevant coverage for the model; and
- (3) if a model is required, the relevant cost standard for the modelling (i.e. whether it should be undertaken on a LRIC or FAC basis).

### **(1) Should the analysis be based on a model, accounting data or a mix?**

A 2.19 In principle there are two options to estimate the costs of providing the USO:

- the use of cost accounting information; and
- the construction of a bottom-up model to estimate the costs of providing the USO by a hypothetical efficient operator.

A 2.20 In considering which option is the more appropriate for the particular reference scenario set by An Post, An Post should consider the type of costs change that will arise from the move from the baseline to the reference scenario as the choice of accounting data or bottom-up model will depend largely on the extent to which reference scenario departs from current USO. The more significant the departure, the more likely that there would be a step change in costs (e.g. significant re-design of mail flows, delivery network, mail centre network) and the more difficult it would be to estimate costs based solely on historic accounting data.

A 2.21 Consequently, if the reference scenario is likely to lead to a step change in costs, then it will be necessary to develop a bottom-up model to estimate the costs in the reference scenario and ComReg has made this determination.

A 2.22 This does not mean that the accounting data will be redundant. Rather, it will be an important input into the bottom-up cost models, and a key element of the calibration of the bottom-up model will rely upon comparison of modelled and actual cost.

## **(2) If a model is required, the relevant coverage for the model**

A 2.23 If a model is required, it is important that the model provides enough granularity to reflect the cost impact of moving from the current USO baseline to the reference scenario. In this regard, the model (if required) should be able to:

- estimate the cost changes associated with changing postal volumes; and
- estimate step changes in costs arising from changes in service specification.

A 2.24 Given the likely changes that An Post may identify as part of the reference scenario, and in order to be able to estimate cost step changes An Post should develop (or adapt, if An Post already has such a model in place) a bottom-up operational cost model, containing at least the following modules for different parts of the pipeline (although the modules are linked by volumes and other operational constraints):

- Collections: changes in the universal service potentially affect the timing of collections, the number of collection rounds per day and the number of collections per week. The constraints may be direct (e.g. at least one collection per day) or indirect (e.g. collections are required throughout the day to enable smooth workflows at mail centres).

- Mail centres: the constraints of having to provide a D+1 service with a set quality of service may require An Post to have a larger number of mail centres than would otherwise be the case, while the universal service requirement for a five day delivery service affects the days on which the network needs to operate.
- Feeder services: these are connecting services between collection hubs (where collections are aggregated) and mail centres, or between mail centres and delivery offices. The cost of services will depend on the number of days that collections and deliveries take place.
- Deliveries: changes to the universal service determine the number of days on which deliveries operate and (indirectly) the number of delivery routes. Both these factors will affect indoor (i.e. mail preparation) and outdoor delivery costs. Timing constraints may also force shorter or more frequent delivery runs than An Post would wish.

A 2.25 To accompany the quantitative estimates of how costs could change in the reference scenario compared to the baseline, An Post should provide a qualitative analysis and detailed commentary which describes how operations and workplans could change in response to each element of change in the definition of the universal service in the reference scenario.

### **(3) If a model is required, the relevant cost standard for the modelling**

A 2.26 From a methodological point of view, the PC approach seeks to identify the avoidable costs that would be saved as a result of changes to the universal service specification. The concept of avoidable cost is more closely related to the concept of LRIC.

## **Under PC approach no adjustment is required for a reasonable profit**

A 2.27 Under the PC approach the USO net cost is determined by comparing the operating profits of the USP with the USO in place, assuming efficient costs, and the operating profits under a reference scenario where the operations of the USP are re-optimised assuming that the USO was removed, again assuming efficient costs. Taking “reasonable profits” into account requires the relevant appropriate capital costs to be deducted from the operating profit under the base case, and the operating profit under the counterfactual. This then becomes a comparison of net profits, rather than operating profits.

A 2.28 The PC methodology can in principle take into account movement in the capital employed and the Weighted Average Cost of Capital (WACC). However, this may not have a material impact on the level of the net cost of the USO. If the level of capital employed is not materially affected by the removal of the USO, and the WACC can also be considered to be largely unchanged, then the difference between the cost of capital under the base case and the counterfactual will not be significant.

A 2.29 Given the labour intensity of postal operations, it is likely that the reduction in capital employed following the removal of the USO would be relatively limited. Consequently, having considered the recommendation of Frontier Economics in this regard, under the PC methodology no adjustment is required to make allowance for a reasonable profit.

## Annex: 3 Guidance to An Post on taking intangible and market benefits into account

A 3.1 In accordance with the section 35(4) of the 2011 Act and in accordance with Annex 1 of the Postal Directive, a net cost must take into account any intangible and market benefit which accrues to the USP.

A 3.2 As noted by Frontier Economics in their supporting report<sup>17</sup>, there is no single definition of intangible or market benefits. According to a recent study<sup>18</sup> “a benefit is classified as ‘intangible’ when a universal service provider’s performance and cost accounting, and its calculation of the net cost of the universal service obligation does not (fully) reflect the impact on revenues and cost that result from the existence of this benefit. The definition is relevant insofar as the identification of such benefits becomes necessary only if they are not already included in the universal service provider’s net cost calculation.”

A 3.3 The key benefits of being designated as USP include:

- Brand value: higher sales due to positive impact of brand plus better customer retention and acquisition (ubiquity);
- Demand complementarity: higher sales of non-USO products as complement to the sale of USO products.

A 3.4 A number of other intangible and market benefits have been considered in relevant economic literature<sup>19</sup> and these are as follows:

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<sup>17</sup> ComReg Document No. 13/69a

<sup>18</sup> ARCEP, “Definition, classification and methodology for evaluating intangible benefits related to universal postal service”, from WIK consult, published 2010

<sup>19</sup> The literature covers a number of jurisdictions and therefore some of the benefits listed may not be relevant in the context of the Irish postal market.

Intangible/ market benefits	As a result of providing the USO, the USP may achieve...
<b><i>Most discussed in postal literature</i></b>	
1. Economies of scale and scope;	Lower average cost in providing several USO products and non-USO products
2. Enhancement of brand value;	Higher sales due to positive impact of brand (customer retention and acquisition)
3. Enhanced advertising effect	Higher sales due to more effective advertising thanks to higher visibility (better value for money)
4. VAT exemption	Higher sales to customers who cannot reclaim VAT back
5. Interest on prepaid postage	Earn interest on this revenue
6. Demand complementarities	Higher sales of other products (as complement to the sale of USO products)
<b><i>Discussed in postal literature</i></b>	
7. Ubiquity	Better customer retention and acquisition when mailers move address, better customer acquisition
8. Uniform price	Lower transaction costs for customers and therefore better customer acquisition
9. Customer life cycle effects	These are benefits arising from customers who are currently commercially non-viable and may at some future date become commercially viable. Such customers may, at this point, choose the USP over competitors (better customer retention)
10. Better bargaining position	Easier access to politicians than other operators and stronger influence on regulatory regime
11. Exclusive sale of stamps and monopoly over philately market	Additional revenues/ profits as some sold stamps are never used by users
12. Recipient database	Providing the universal service provides USPs with access to customer and demand information which can be used to market postal products (customer acquisition and retention)
<b><i>Legal privileges of USP/other</i></b>	
13. Parking and stopping exemptions	Lower costs as USP is exempt from parking restrictions
14. Exemptions from customs and excise legislation	Lower costs
15. Ownership of post office boxes	Great "visibility", brand recognition
16. Binding power of postmark	Higher sales as the postmark of USP's mail is a confirmation of date of dispatch
17. Exclusive right to use colour for mailboxes	Brand recognition
18. Right to hang mailboxes free of charge on public sector premises	Exempt from space neutral fee – lower cost

Source: Frontier Economics 2012 WIK (2010)



A 3.5 The current profitability of the USP (base case) reflects the intangible and market benefits attributable to the USO. As the USO changes under the reference scenario, consumers who value products provided under the USO banner may reduce their demand and/or choose alternative providers. The move from base case to reference scenario effectively reduces volumes and market shares.

A 3.6 Therefore, as part of the market share effect to calculate the net costs (if any), An Post should consider the extent to which:

- its brand and status as USP is likely to have a “chilling effect” on customer switching; and
- consider a market share scenario in which it was required to ‘rebrand’ and so would no longer have name recognition as the USP.

## Annex: 4 Legal basis

A 4.1 In accordance with the section 35(1) of the 2011 Act, a USP may submit a request in writing to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service.

A 4.2 However, any such request, in accordance with section 35(2) of the 2011 Act, must be:

- Must be made in such form and manner as ComReg determines
- Submitted no earlier than after the end of the financial year immediately following the designation as USP and thereafter no later than 6 months after the accounts for the financial year concerned have been audited, unless ComReg agrees otherwise
- Accompanied by such supporting information as may be reasonably required by ComReg to determine whether provision of the universal postal service by the USP represents a net cost and represents an unfair burden on the USP.

A 4.3 Furthermore, in accordance with section 35(3) of the 2011 Act, where the universal postal service makes a request to ComReg to seek to receive funding for the net costs (if any) of providing a universal postal service, it must provide any additional information as may be requested by ComReg.