The Impact on Universal Service of the Full Market Accomplishment of the Postal Internal Market in 2009

Final Report
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The views and opinions expressed in this study are those of the authors and do not necessarily reflect the position of the European Commission.
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Executive Summary

The Postal Directive (Directive 97/67/EC as amended by Directive 2002/39/EC) envisages the full opening of the EU postal market to competition by 1 January 2009. This provision of the European Directive constitutes in fact the “last mile” of the long journey the European Union is undertaking in creating a liberalised internal market for postal services.

In order to allow the European Commission to make an informed assessment of the impact of ‘full market opening’ (FMO) on the Universal Service and to provide a framework for a proposal it will present by end 2006, the Commission has commissioned PricewaterhouseCoopers (PwC) to undertake a prospective study on the sustainability of the postal Universal Service in each Member State and on how competition may impact the future provision of this universal service once the market is fully liberalised. PwC has carried out this study between November 2005 and May 2006, involving a large variety of stakeholders in the 25 EU Member States, as well as from Romania, Bulgaria, Norway, Iceland and Lichtenstein.

In order to obtain a correct positioning of the main objectives, approach and outcomes of the study, we begin with a summary of the broader context of the changes that have been occurring in postal markets that have led to this study.

The provision of postal services: history, myths and reality

Postal services are one of the oldest and most widely spread forms of communication. The Universal Service Obligation (USO) has been an integral feature of postal service for many years. Its origins can be traced back to 1840 with the implementation of the reforms of Rowland Hill in the form of the Penny Post in the United Kingdom. Prepayment by means of a stamp was a significant innovation in 1840. For the price of a stamp, delivery anywhere in the country was provided. Thus, the twin notions of ubiquitous delivery and uniform price inherent in the USO evolved, and these have remained an integral part of the USO ever since.

These twin notions made mail services affordable, easy and transparent to the user, and allowed the provider of postal services to reduce transaction costs and to benefit from economies of scale as this easy way of communication showed a considerable growth in volumes of the last 150 years. The features of uniformity of price for nationwide delivery continue to be valued by individual mailers and supported by governments. Over the years, the clear and perceived value of these aspects of modern postal service resulted in the establishment of important nationwide state owned postal operators (national postal operators (PO)).

However, while there are obvious benefits to the dramatically reduced transaction costs resulting from ubiquitous delivery at a uniform price, these benefits come at the cost of decoupling the direct relationship between
value, the cost to offer this value (service) and the price paid for it. As a result, postage price does not necessarily reflect the actual cost of delivery between two points since high-cost areas are being priced below cost and low-cost areas being priced above cost (‘cross subsidy’). This, indeed, has been the source of the “obligation” in the USO debate, as decoupling of price and cost leads to a number of problems, especially when competition is allowed.

While ubiquity of service and uniformity of price are the foundation of the USO they are not the only constituents of the USO. It also calls for some uniformity in service standards, an obligation not only to collect letters but also to collect and deliver parcels, an obligation to provide postal counters and other “proximity services” of general interest to the public. Needless to say these are major reasons for the continued support for the USO by the general public.

The system of cross subsidy has traditionally been maintained by restricting entry to the postal market by means of a “reserved area” (RA). The reserved area was traditionally defined in terms of weight or value thresholds. The prohibition of entry in the reserved area prevents entrants from “cream skimming” by entering the low-cost markets and undercutting the PO. On the other hand, in many cases this resulted in Universal Service Providers (USPs, incumbent PO), supported by their national governments, becoming less agile, focusing more on their internal organisation and “indirect” objectives (employment, public services,…..), failing to connect to the needs of their end customers and to the final integrated market demands for communication services.

During the last 15 years or so, some important changes have occurred and have initiated in several European countries as well as at the level of European Commission a debate about the sense, the benefits and shortcomings of the postal market ‘model’ of a USO provided by a USP under regulation of national authorities. Several elements are at the origin of this debate:

- On the communications market, other forms of communication have seen great technological advances (telecom, mobile telecom and internet);
- Consumption patterns are shifting at the level of corporations as well as households and Small and Medium sized Businesses: this results in an increased need for refined market and product segmentation with corresponding pricing policies and service performance;
- Improved and new technologies allow the POs, but also other actors in the postal market such as large mailers and consolidators, to increase dramatically the efficiency of their logistics processes, leading to higher flexibility, more capacity to treat large volumes, and improved performance at lower costs;
- Due to budgetary restrictions, EU Member State governments have become much less willing to finance (to a large extent) the deficits some national Postal Operators are facing. So, increasingly, policy
makers are feeling the need to review (and perhaps adapt) the principles of the postal market model.

In the process of the creation of the single European market, awareness and consensus has been growing on the need to create a single open market for postal services, as is the case for other segments of the global communications market. Most of the debate has been, and still is, not whether such a reform of the postal market is needed, but more about the extent and the timing of such a reform. A large spectrum of political positions can be observed in this debate, and this primarily for 3 reasons:

- Amongst the 25 EU Member States, the characteristics of the postal markets vary to a quite large extent: size and density of population (urban vs. rural), degree of maturity of the postal services market (expressed as level of mail scale), cultural differences;

- Over the last decades, national legislation regulating the USO and its provision by the USP, remained very diverse. It is not so easy to find a ‘common denominator’ that could apply for the whole EU on all aspects of the USO. Even the Second Postal Directive did not provide much ground for this. In many countries, still, national regulations focus not only on guaranteeing the rights of the customer, but (implicitly) serve also other goals which are more of a political nature or oriented towards the protection of the incumbent PO;

- In some countries, over the last 10 to 15 years, a new dynamic has evolved, in the beginning initiated by policy makers, but gradually taken over and acted on by the management of the main national postal operator. This new dynamic focused on professionalisation in the provision of Universal Services, developing and pursuing a commercial strategy aiming at restoring or improving where possible the link between price, value (service) and cost. In most cases, it has resulted in much improved services and value to the customers and some of the “common and necessary” universal services being increasingly provided by the market (i.e. the incumbent PO and new entrants). An important “side effect” has been improvements in the performance of Postal Operators, some of which are almost ready to face competition within their postal market and which contribute to maintaining the competitive position of postal services against other forms of communication.

As a consequence, the current debate about the full accomplishment of the internal market for postal services remains a very complex and diverse one whereby many arguments building on the above mentioned 3 aspects are bundled into a single “melting pot” which is then positioned to defend or promote one or another point of view. Given these complexities, and the size of the sector and the number of people whose lives are affected by this, the impetus provided by the Commission to this project was to try to understand the common ground that might lead to continued progress in European postal markets. With this in mind, this project focused on the following main issues:
The sustainability of the postal universal service in each Member State and the extent to which competition would contribute to this sustainability in terms of service quality, end user prices, and changes in the value proposition offered to various consumer segments;

The risks and opportunities that a full opening of the postal market may give rise to, with regard to the elements mentioned just above, as well as with respect to the impact on the USP;

The factors that will contribute to create a positive dynamic in the market place between all actors (including users, Universal Service Providers, regulatory authorities) so as to ensure that these opportunities can be captured and risks are mitigated;

The mechanisms that will ensure a level playing field between the incumbent PO and its competitors in national markets, since the respective positions of the USP and New Entrants can be quite asymmetric, both on the national as well as the European scale.

Therefore one of the underlying objectives of this study is to make a clear distinction between the various drivers and components of the postal sector reform:

- The Universal Service as part of the postal services market, including all aspects of normal market forces;
- The position of the Universal Service Provider and its competitors;
- The regulatory environment, both national and at EU level.

It is clear that in the end, the purpose of any further step in postal reforms should aim at unlocking more economic benefits and welfare for all actors and stakeholders. The results presented here show already a rich set of innovations undertaken by various actors in the European postal sector in anticipation of Full Market Opening (FMO). Hoping that one by-product of this study will be a greater appreciation for the progress that has already been accomplished in liberalizing European postal markets.

**Main Task and Objectives of the Study**

In the context described above, the present study responds to the requirement of the 2nd European Postal Directive (2002/39) that the European Commission conduct a prospective study to assess the impact on Universal Service of complete liberalization in 2009 for each Member State. Given these challenges, and the overall objectives of the study noted above, three basic tasks were delineated for the study:

- To survey and assess the current status of the USO, national regulatory authorities and Universal Service Providers in the postal market across the Member States of the EU, and to develop more
detailed studies of selected core issues likely to be significant in judging the impact of FMO on the USO in Member States:

- On the basis of the survey and assessment, and of the potential evolution of the postal sector derived from the current status, to determine and evaluate the key factors underlying the design of effective policies to achieve accomplishment of an internal market for postal services with a sustainable USO across all EU Member States;

- To the extent that financial or other barriers represent significant problems for some Member States in achieving FMO, to suggest measures that might be considered with the objective of enabling these Member States to participate in FMO with minimal delay or negative effects.

**Approach and methods used to examine these questions**

An important aspect of the methodology applied for this study, is the fact that the entire process was conceived as the mutual enrichment of two approaches: a conceptual or deductive one and an empirical or inductive one for each of the 25 EU Member States and 5 additional countries:

- As for the inductive approach is concerned, at the beginning of the project survey questionnaires were built on our conceptual and theoretical framework, derived from the postal economics literature, and refined through the usual pre-testing of the survey with selected stakeholders. These questionnaires were specifically designed to address during mostly face-to-face interviews the concerns of the main stakeholders of the postal sector namely the postal operators, the national regulatory authorities, the competitors, the customers (both large mailers and household customers) represented by professional associations and the unions;

- After the Member States were visited, the results of the survey were confronted with the results arising from the analytical framework, a deductive comparison that generated questions within and across countries, leading to our conclusions and qualifications to these conclusions.

This methodology, though quite effort intensive and in several cases hampered by the limited availability of important data elements, provided the benefits of being able to test various factors and outcomes, to build common deep understanding between the PwC team and the stakeholders interviewed, and to distinguish the various ‘components’ of the process towards full market opening and the resulting impacts.

Through this cross-country modelling and scenario-based interviewing framework, the outcome of the main drivers interacting with the postal market (volumes, prices,…), the provider of the USO (financial viability, employment
level,…) and the regulatory regimes (access regimes, affordability,…) were examined and assessed on a comparative basis across countries (Chapter 2 and Annex A of the Report). The possible use of certain measures to balance opportunities and risks related to FMO were examined as to their impact on key outcomes such as the financial state of the USP, employment levels and the ability to establish workable competition (Chapter 3 of the Report). Finally, even with the large variety of actual situations that exist in the European postal market, the ‘lessons learned’ demonstrated clearly that there a limited number of key issues that need to be addressed both at EU level and national level, and three of these were examined in detail: access pricing, definition and funding of the USO and restructuring of USPs (Chapter 4 of the Report).

**Main Findings of the Study: Impact of FMO**

The present study has been ambitious in its scope and reach with hundreds of affected stakeholders and organizations in the European Postal Sector. In stating the summary findings from this study, PwC is mindful of the conflicting points of view that are represented in this sector. PwC is also aware of the fact that investigating the impact of FMO on the USO encompassed entering into somewhat unchartered territory.

The balancing act between the known and the unknown is, of course, at the centre of any innovation, including the policy innovation of FMO in the postal sector. What makes this ambitious policy endeavour worth the effort are the continuing pressures which the developing communications market and electronic substitution are placing on the postal sector. These pressures make it imperative to move toward market-based solutions to provide an effective means for the European Postal Sector to continue to adapt to its own internal dynamic as well as to the broader external forces impinging on it.

As the impact of full market opening itself is concerned, the following can be noted:

- As has been demonstrated in recent years, FMO in itself, but certainly also the pressure of simply the fact that FMO will become reality in the coming years, embodies considerable advantages as a source of discipline and process innovation for USPs and of value for all participants in European postal markets:
  - To an increasing extent and for business customers, postal services, which are today considered as Universal Service, will be provided by the market, i.e. through both competitors and incumbent national Postal Operators. Postal providers, including national POs, are beginning to understand better the quality preferences of different customers segments, the cost and profit consequences of alternative methods of serving these, and the FMO should promote a better alignment over time between the costs of providing services,
including those understood to be a part of the USO, and the price paid for them;

- Hence, there will be great pressures on national POs as USPs to become more commercial, more market-oriented, and to restructure their own products and processes to achieve this;

- Third, there will be changes for postal customers, with greater attention to market-driven needs. This may lead to a re-alignment of the scope and characteristics of the Universal Services with these market-driven needs.

- The debate about FMO should underestimate neither the complexities nor the potential benefits of FMO. The opening of the postal market is probably more complex than any other market opening introduced in the course of the previous two decades in Europe. In fact, several factors make the postal sector restructuring unique compared to other network based industries:
  - Several postal/logistic networks have faced competition for some time now, and they will continue to compete;
  - The postal market is not likely to continue to expand significantly;
  - The postal sector is less technologically intensive and consequently more labour intensive;
  - The USPs were and are still to a large extent publicly owned undertakings, imbued historically with important public roles as well as their increasing role as a participant in communications markets.

- In general, FMO seems feasible for the European Postal Sector. But, there are large differences across the EU Member States in terms of the current status and the likely consequences of FMO on consumer well being, on the sustainability of the historical USO, and on the ability of the USP to sustain FMO without external support or restrictions on the speed and scope of introduction of FMO. Therefore several countries may require assistance in the form of specific flanking measures. The significance of these interventions depends on both demographic and socio-cultural factors as well as on factors that are under the direct control of national governments, regulators and the USPs.

- Key drivers of the financial impact of FMO on USPs include cost differences between the USP and likely entrants, the level and stability of USP demand, and structural factors that underlie postal costs. These structural factors are related to the country demographic and geographic characteristics, as these interact with postal demand.

Main Findings of the Study: Key factors to achieve FMO
As far as the key factors to achieve FMO are concerned, the following can be noted:

- To garner the benefits and reduce risks, will surely require a shared commitment between all stakeholders in the postal market, from USP management and employees, to national regulators and governments to postal customers. Maintaining and shaping the continuing commitment to FMO embodied in the First and Second Postal Directives must remain an important element of the on-going debate on FMO.

- This commitment to a timely introduction of FMO should be combined with an appropriately defined “New Regulatory Model” (per WIK, 2005) as regulation is a key enabling and disabling force under FMO. The New Regulatory Model at EU level should assure:
  - non-uniform prices for bulk mails;
  - appropriately designed price-cap regulation as an element of stable price and profit regulation for the USP;
  - transparent and non-discriminatory negotiated access regime to the Public Postal Network.

- The ‘preparedness’ of the USP for FMO, can be noted as key internal or endogenous factor affecting the outcomes of FMO in a significant way. The USP should have the means (at corporate as well as at political level) to be(come) an agile actor on the postal market through implementing strategies of product and service offerings diversification and increased ‘yield management’, increased flexibility to change its offerings and its logistics infrastructure. These factors will contribute to a sustainable and viable competitive scene in terms of an “equal” share of benefits and costs among all market players.

- In case markets and operators are most prepared and FMO ready, measures need to be worked out that would further reduce the barriers to entry to the postal markets whenever they are present, for instance regulated open access to PO Boxes, letterboxes and addresses databases. Like for the previous point, these measures will contribute to a sustainable and balanced competitive scene.

**Main Findings of the Study: Suggested measures to mitigate risks of FMO**

As the suggested measures to mitigate risks of FMO are concerned, the following can be noted:

- **Access and pricing regulation** will be of central importance under FMO, especially in the early stages of entry, both for the New Entrant as for the USP. Hence access regulation will be an important element in channelling the evolution towards FMO. The regulation of access prices is discussed in detail in Chapter 4. On the basis of case studies.
and previous work in postal economics, 3 critical features concerned with access pricing under FMO are discussed:

- Negotiated versus mandated access provision: In the initial stages of FMO, it will be efficient to promote upstream access to encourage the development of mail preparation infrastructure and to capture the obvious benefits of joint preparation and worksharing of mail. Because of the complexities of downstream access under bypass (i.e., under FMO), country-specific solutions should dominate the regulation of downstream access.

- Non-discriminatory treatment between the PO’s own customers and its competitors: As long as incumbents enjoy a market dominant position, non-discriminatory treatment of the PO’s customers and entrants will be important to mitigate anti-competitive behaviour.

- Zonal or non-uniform access pricing: Under FMO, the wide-scale practice of charging uniform prices, based on avoided cost principles, should give way to zonal pricing of access, at least to the extent that there are large differences in cost between different zones in a country.

- **Restructuring of the USP** is a key leverage to reduce the overall cost gap with new entrants. Experience demonstrates clearly that endogenous factors driven by restructuring can, if properly addressed, significantly improve outcomes the competitive positioning of the USP in postal markets. Some of these endogenous leverages are:
  - level of automation, process innovation and network optimisation;
  - counter franchising, partnerships, customer management and marketing strategy as key elements to product/market segment innovation and diversification;
  - management of the labour cost differential, the degree of labour flexibility, a transparent and fair settlement of historical liabilities such as pension liabilities.

- **Review of the ‘general’ obligations** imposed on the USP as “public” missions that go in fact beyond what of those services would be undertaken, without obligation, commercially or under the principle of Postal Universal Services. This kind of services could be funded through direct and specific subsidies, in accordance with the principle of public services tendering.

**Main Findings of the Study: General observations**

Throughout this Study, it has been reconfirmed that the USO is still considered an entitlement by the public across all Member States, particularly for households and other single-piece letter users. However, it also has become clear that there should be an **evolution of the USO after FMO** towards
expecting the “market” to be the ultimate provider of Universal Services for business customers rather than imposing this as an obligation on the current USP. Here some related aspects require special attention:

- As the prices of all services, including USO services, become more aligned with cost and quality through the forces of competition, smaller customers may see increases in price. Larger customers can expect, for similar reasons, to see increases in product variety and decreases in price;
- This increased flexibility in pricing and product variety however may raise concerns over the exercise of predatory pricing by the USP against entrants. One approach to limiting predatory pricing will likely be to have a publicly regulated access tariff, at least during the transition phase until workable competition is established;
- Although smaller customers devote a very small part of their overall budget to postal services, pricing stability remains important as to keep increases in prices within the boundaries of “affordability”;
- Under FMO, instead of financing the USO by reliance on a Reserved Area, funding will be provided by means of a variety of new mechanisms, including increased efficiency and adding revenues from new services. Additional funding from compensation funds or direct subsidies could supplement these normal market sources of funding in exceptional circumstances;
- Under FMO, the role of competition authorities and postal regulators will be critical. The regulator will be obliged to determine whether Universal Services are being properly provided by the market, and when they are not, to define and regulate their provision by a form of Obligation imposed upon the market or a specific Postal Operator.

The approach taken at the EU level aim to achieve FMO at minimal risk and so should focus on establishing a level playing field for all participants in the market and on the definition of a minimal USO. Level playing field arguments will be very important in assuring that entry which does occur is efficient. These arguments include abolition of the Value Added Tax (VAT) exemption for all providers in the postal market, pricing flexibility for incumbents, as well as transparent and non-discriminatory access conditions to leverage the incumbent PO’s network.

FMO is not without risks to the USO and to the financial viability of some POs. Where the USO is threatened, the initial approach should be to increase the commercial freedom of the PO and to adapt the scope of the USO to market conditions, including increased use of franchised operations and better alignment of price and cost of USO services. Thereafter, there is a rich set of flanking measures, both general and specific, that can be used during the
transition period to move the market and national POs to FMO with minimal delay.

The provision of specific measures applicable in particular cases or countries, implies, subject to a clear definition and EU-wide implementation of FMO itself, that *subsidiarity* should continue to dominate in the definition of the USO in individual Member States. This will allow individual Member States to align the costs and benefits of their definition of the USO going forward, including the means to pay for it as discussed under the options for funding the USO in this Report. Thus, to avoid disillusionment with the policies of FMO in the postal sector, expectations of differential costs and benefits for different stakeholders should be understood from the start and left, in large part, to individual Member States to resolve through their definition of the USO and the regulatory policies on pricing and access that are implemented in each Member State.

The findings presented are at once a reflection of the long history of the postal sector that has preceded this study, and a launching point for the vision of what is to come under FMO. The history of the sector makes plain that the USO has continued to serve an essential purpose in national communications, and it will continue to do for some time to come. At the same time, adapting to the changes in the technology and uses of communication products presents a continuing set of challenges for renewal and integration. The confluence of the historical value of the USO with the engine of markets to power the required renewal and integration is the centre piece of the challenges of implementing FMO while maintaining the value and stability of the postal USO. This report aims to provide an assessment of the current state of accomplishment of this process from the varied perspectives of EU Member States.
Chapter 1  Introduction and Methodology
1.1 Introduction

The Postal Directive (Directive 97/67/EC as amended by Directive 2002/39/EC) envisages the full opening of the EU postal market to competition by 1 January 2009. Article 7 (3) of the Postal Directive requires the Commission to “finalise a prospective study which will assess, for each Member State, the impact on universal service of the full accomplishment of the postal internal market in 2009. Based on the study's conclusions, the Commission shall submit by 31 December 2006 a report to the European Parliament and the Council accompanied by a proposal confirming, if appropriate, the date of 2009 for the full accomplishment of the postal internal market or determining any other step in the light of the study's conclusions.”

To support this key assessment in the evolution of the postal market, the Commission ordered an external study. The resulting project was awarded to PricewaterhouseCoopers and was undertaken between November, 2005 and May, 2006. This is the Final Report of the project.

The objectives and methodology of this study were spelled out in the Terms of Reference for the Project, and amplified further in the initial stakeholder meeting that took place at the Commission on December 5, 2005. The agreed objectives of the study are:

- To assess whether the Universal Service Obligations (USOs) as laid down currently will still be relevant and appropriate in an open market;
- To evaluate risks and opportunities for the current universal service model and any proposed changes to the USO that might result from or be desirable under liberalisation;
- To assess how universal service can be safeguarded in an (open) internal market and assess whether any flanking measures would be considered appropriate.

In order to provide a reasoned assessment to inform policy choice underlying these objectives, a survey instrument was designed to gather necessary data on the scope of the USO in various Member States (as well as other interdependent States such as EEA and EU-candidate states), on the specifics of each country concerning the readiness of the Universal Service Provider (USP) and the National Regulatory Authority (NRA) for full market opening (FMO) as well as on the views of the different stakeholders.

An important aspect of the applied methodology is the fact that the entire process was conceived as the interaction of two approaches: a conceptual or deductive one and an empirical or inductive one. At the beginning of the project the survey questionnaire was built on the conceptual and theoretical framework, derived from the postal economics literature and refined through the usual pre-testing of the survey with selected stakeholders.

After the Member States were visited, the results of the survey were compared with the results arising from the analytical framework, a comparison that
generated questions within and across countries, leading to the conclusions and qualifications to these conclusions. This approach is illustrated in the figure below:

*Figure 1: Project approach summary illustration*

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<tr>
<th>Conceptual approach</th>
<th>Empirical approach</th>
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<tbody>
<tr>
<td>Identifying and establishing contacts with stakeholders</td>
<td>Assessing model requirements</td>
</tr>
<tr>
<td>• USPs</td>
<td>Developing and testing model</td>
</tr>
<tr>
<td>• NRAs</td>
<td>Gathering model input information/data</td>
</tr>
<tr>
<td>• New Entrants, Large Mailers, Households and SME, Trade unions</td>
<td>Producing model results</td>
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<tr>
<td>Designing questionnaire to ensure uniformity of interviews</td>
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<tr>
<td>Sending questionnaires to stakeholders</td>
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<tr>
<td>• USPs: Part A to prepare interview</td>
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<tr>
<td>• NRAs and others: separate interview instruments</td>
<td></td>
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<tr>
<td>Conducting interviews with postal stakeholders</td>
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From a practical point of view, for the organisation of the country visits, the study progressed as if two parallel study processes of the introduction of FMO in each Member State had been undertaken: the model-based process, implemented by a Conceptual Team and the inductive one, implemented by a Country Team.

Both processes considered that FMO is introduced in the country and that a base case or benchmark option for the USO is imposed, but, apart from this common starting point, those two processes do their work and generate outputs through different paths.

In fact, the empirical approach is simply based on the interview and questionnaire data obtained from each respondent, while the deductive approach is the anticipated outcome in each Member State (or clusters of similar states) based on theoretical and conceptual developments derived from the postal economics literature.

The survey instrument was based, in part, on a model-based assessment of the impact of FMO on each respective country, where the model involved was an elaboration and refinement of d’Alcantara and Amerlynck. The model was intended to provide both insights on individual countries as well as a tool for comparative assessment across Member States.
This introductory Chapter describes the background of this study and the issues underlying its objectives. It also describes the methodology employed to design the survey instrument and provide comparative results on the impact of FMO on the postal market and USPs in Member States.

Chapter 2 presents the assessment of the impact of FMO across Member States. It considers the current status of the postal market development and of the preparedness of the USPs in the Member States, based essentially on the extensive interviews undertaken during this study and on desk research. The status of USPs and of postal markets in Member States shows a variety of differing approaches to the USO and to steps undertaken in anticipation of FMO. Examples of new entrants and competition are presented, and different regulatory policies analysed.

The comparative results of a set of model runs addressing key issues arising from individual country assessments are summarised, and reported in country clusters to protect confidential data. They provide basic information on the likely impact of FMO across Member States and, in particular, on the ability of USPs to sustain the USO under alternative scenarios on the form of regulation (Annex A).

Chapter 3 reports on "flanking measures" that may be applied by some Member States in the transition period immediately following FMO. These include both direct measures to improve USP efficiency as well as regulatory measures that may be useful in the short term to assist USPs to adjust to the new realities of the market under FMO.

Chapter 4 reports on case studies on specific flanking measures: access regimes and worksharing, USO scope and funding, and USP restructuring

Chapter 5 summarizes the findings and recommendations of the study
It is important to acknowledge with gratitude the contributions of a large number of respondents to interviews. These included the national postal organizations in Member States and other countries, national regulatory agencies, competitors, consumer and labour representatives, and many others who have taken the time to meet with the study team to share their thoughts and recommendations about the future of the postal sector in the European Union and beyond.

The study team deeply appreciates the time and commitment of these organizations and individuals. Without their input and participation this study clearly would not have been possible.
1.2 Background

The debate on liberalization and market opening in the postal sector, which has been taking place for several years, has centred on how to garner the benefits of competition and continue to provide Universal Service without undermining the financial viability of the incumbent Postal Operator (PO).

The present study responds to the requirement of the 2nd European Postal Directive (2002/39) that the European Commission conduct a prospective study to assess the impact on universal service of complete liberalization in 2009 for each Member State. This study occurs at a time when several Member States have already entered a very clear path leading to full liberalization ahead of this date, while others are just at the beginning of the liberalization process.

Besides the challenges presented by an uneven opening of the market across the European Union, there are significant uncertainties associated with individual national markets in terms of the ability to sustain the Universal Service Obligation (USO) of traditional scope.

In addition, there are large differences in the demography, size of market and historical contexts of the POs of Member States. These differences suggest some degree of non-uniformity in policies directed at reaching full liberalization, but non-uniformity can be a source of regulatory problems as well as non-technical barriers to competition.

Given these challenges, and the overall objectives of the study noted above, three basic tasks were delineated for the study:

- Survey and assess the current status of the USO, national regulatory agencies, universal service providers and consumers in the postal market across the Member States of the EU, and to develop more detailed studies of selected core issues likely to be significant in judging the impact of FMO on the USO in Member States.

- On the basis of the survey and assessment, and of the potential evolution of the postal sector derived from the current status, determine and evaluate the key factors underlying the design of effective policies to achieve completion of market liberalization with a sustainable USO across all EU Member States.

- To the extent that financial or other barriers represent significant problems for some Member States in achieving FMO, to suggest measures that might be considered with the objective of enabling these Member States to participate in FMO with minimal delay.

The USO is the obligation to deliver letters and parcels ubiquitously and at an affordable price. In addition, there is an obligation to provide some uniformity in service quality, including access to common and necessary postal services via readily accessible counters. Traditionally, the USO, once defined, has been
understood to be the responsibility of the national PO, otherwise known as the Universal Service Provider (USP).

As USPs, the essence of the problem faced by POs in Member States in meeting the full liberalization objective of the 2nd European Postal Directive is to balance the scope of the USO, its obligation, against the enabling factors that will allow the PO to maintain financial viability. In terms of the scope of the USO, this is defined in terms of products covered, the price levels allowed under the notion of affordable price, and the required or expected levels of service quality (including access to collection facilities and counter services) in the USO.

In terms of the enabling factors, as discussed in more detail below, these include the size of the reserved area, market and demand conditions, regulatory requirements, and the commercial freedom and pricing flexibility accorded the PO in the conduct of its business. The greater the scope of the obligations and inherent costs of the USO, the greater must be the quality of the enabling factors to allow the PO to achieve a balance between the scope of the USO and its cost and value to the country in question.

Traditionally, the noted balance has been achieved through granting to POs a reserved area, a weight or price limit below which, they are the only legal providers. Absent the obligation of the uniform price and some service uniformity, the ubiquity requirement could be satisfied without a reserved area, as the PO would only need to increase price or reduce service quality to a level that drove demand to zero in any area it did not wish to serve. Such a state of affairs would not be compatible with what has come to be understood as a viable USO; thus, the tension that is the centrepiece of this study.

The presence of the two forces of technological change and liberalization policies promoting competitive entry raises several issues concerning the traditional USO and the tension just described.

First, technological competition has provided substitutes for and reduced demand for letter mail in general, and for products covered by the traditional USO in particular. This results in a potential increase in a PO’s unit costs if it loses some of the benefit of scale economics because of the lower output. The same changes may also reduce the value of the USO to postal consumers, as available substitutes may be adequate to meet many of the previous needs covered by the USO.

Second, changes that eliminate or significantly reduce the POs’ reserved area, as envisaged under FMO, take away the primary means through which the USO...
has been funded to date. Both of these changes suggest the need to assess the interaction between FMO and the USO and the logic for determining the scope of the USO under FMO.

These twin changes will require changes not only in the way POs operate but may require further changes in the legal framework to assure the continuing ability of POs to fund their USO. Absent a reserved area for letter mail, entrants could price below the incumbent in the low cost markets. The incumbent would then raise its (uniform) prices making a larger market more attractive to the entrants.

As many papers in postal economics have argued, the resulting process may not converge to a viable solution. Something must then be done to restore the equilibrium between the USP and the USO. Under FMO, a variety of approaches to restoring this equilibrium are available and already in evidence in various Member States. Such approaches include internal restructuring to achieve greater productivity for the USP and regulatory relief in terms of greater flexibility in pricing and greater freedom for the USP in the pursuit of its commercial objectives. Direct subsidies or compensation funds can also be used to finance the USO, and such direct supports are already in evidence in several Member States.

It is important to note that FMO brings not just risks, but also significant potential benefits. Thus, the discipline of competition can be expected to provide significant benefits in promoting a better alignment of price, cost and value for postal services across Member States. This fundamental consequence of FMO should make the provision of universal services a more self-supporting activity after the market is opened. For example, uniformity constraints on business-originating mail, which is imposed in the USO by various Member States, would be expected to be removed after FMO. Such uniformity constraints normally impede the development of markets and certainly impede the ability of the USP to finance its operations. With the removal of such constraints, and under the general discipline of competition, one would expect customers to be better served as new products are developed and service quality dimensions are customized to meet their needs. These benefits could lead to significant mitigation of concerns in financing the USO after FMO.

In this regard, a key benefit of FMO in the European Union will certainly be USP restructuring, including corporatisation, innovative marketing and labour-relations strategies. All organisations facing competition have to seek continuously to improve their efficiency and effectiveness. While several USP restructuring initiatives had started prior to the introduction of market opening in the European Union, it is clear that EU-driven market opening has provided a further impetus to the restructuring of the European USPs. This restructuring is essential to the success of the postal market opening in the European Union and is often a prerequisite for the success of the USPs in this liberalised postal market. The various restructuring programmes that have been implemented in the previous 15 years have demonstrated that suitable solutions can be developed to address many of the challenges confronting USPs under FMO.
Thus, USP restructuring is both emblematic of the launch of FMO and a foundation for achieving its benefits.

In addition to adapting the USO and the USP to market conditions\(^2\), there are several other elements associated with postal liberalization that need to be understood in order to provide an efficient balance between the benefits of the USO and the benefits of liberalization. These include continuing regulation of the USP and entrants, including the design of policies related to determining the terms of access offered to entrants. Pricing and contracting will become much more competitive and access policy will have to take into account increasingly important competitive concerns with the revenue required to maintain its USO. Finding a workable solution to these problems is critical since if inappropriate policy choices are made, the changes that are then ushered in could be extremely expensive to undo.

The central issues here, as posed in the Terms of Reference for this study and clarified with stakeholders over the course of the study, are to determine the appropriate scope of the USO to balance the risks and benefits it offers, and where necessary to propose alternative ways of financing the remaining USO burden, if any, after FMO has been launched.

The empirical survey and assessment undertaken in this study focused directly on the conditions in different Member States that could affect the design of efficient and equitable approaches to achieving the necessary balance between the scope of the USO and liberalization. Let us briefly note some of the options considered, both in the survey and by various stakeholders interviewed, for achieving this balance.

The feasible options for financing the USO burden in the face of entry begin with increased internal efficiency and greater commercial freedom for the PO/USP, with the increased commercial operations and competition implied by this. Beyond this, it is important to also see the adaptation of the USO itself as many of the “obligations” currently imposed under national USO definitions would not have to be imposed at all, as the market would naturally provide incentives for either the current USP and new entrants to provide these services as a part of their commercial objectives. What is required is a balance between greater commercial freedom for the USP and strong monitoring of market conditions to assure a level playing field for entrants, especially in the early stage of FMO where USPs maintain a dominant market position. This balance

\(^2\) We use the term “adapting the USO to market conditions” to mean generally achieving a better alignment of price, cost and value for USO services. This might include, for example, using postal employees to provide services in rural areas as part of their routes rather than at fixed counters, increased use of franchised operations, increasing the stamp price, and eliminating uniformity requirements on business-originated mail. Adapting the USO could also mean changing the constraints on accessibility for counters and collection services as populations and demand for postal services change over time.
on the one hand allows the continued assurance of the ability of the USP to finance remaining “obligations” imposed on it under the USO, and on the other hand the ability to harvest the benefits of competition that will be promoted by a more level playing field for entrants.

The approaches underway, and the results achieved, in Member States are reviewed in chapter 2 of this study. Not surprisingly, predicted benefits from increased commercial operations differ across Member States and must be assessed against the current efficiency of the PO, labour costs and staffing levels, and the regulatory framework employed.

Chapter 3 explores a number of the interrelated conditions that will act as enabling features in establishing workable competition under FMO, while continuing to assure the viability of the USP to meet any remaining obligations imposed on it under the USO that it would view as burdens, i.e., that it would not already elect to provide as part of its commercial objectives. These conditions begin with removing unnecessary constraints on business products, such as pricing uniformity for both end-to-end products and access products. The report also explores a number of flanking measures that could be used to rebalance the costs and benefits of the USO with the USP’s ability to support these. These include changes in the national definitions of the USO, more flexible labour arrangements, internal restructuring of USPs, and various types of subsidies that would recognize specific historical burdens that prevent, during a transition period, the USP from meeting the obligations imposed on it by under the USO. The balance between the general supporting and enabling factors, that are recommended for all Member States to consider, and the specific additional measures needed in some Member States, will obviously required extended dialog among all stakeholders to achieve consensus.

In parallel with the undertaking of the country interviews and modelling, PwC identified three critical issues that are likely to be central to the debate about postal policy alternatives going forward. The major issues identified concern (1) access policies, (2) the definition and financing of the USO, and (3) restructuring challenges facing USPs under FMO. These major themes are treated in chapter 4 in detail. For each of these major themes, relevant experience in Member States are discussed, as well as the relationship of each of these themes to the consequences of FMO on the USO and the effects of alternative EU and national policies regarding these themes on key metrics such as the survival and efficiency of the USP, and the vitality of competition, in different Member States.

The above discussion suggests the background against which this study was conducted. The key issue addressed was to understand the consequences of FMO on the USO. This requires understanding the balance between the obligations (and value) of the USO against the ability of the PO (with other market participants) to sustain this USO under liberalization. This balance may well differ across countries and over time. Understanding the nature of this balance and the factors driving it gave rise to the necessity for a structured
empirical assessment of the impact of FMO under alternative approaches to the USO. The approach to this empirical assessment is now described.
1.3 Methodology and Approach Employed

Given the expected variation across Member States related to the impacts of FMO, PwC developed and executed an approach that combined comparative modelling results, executed on common scenarios, with structured and formal interviews of key stakeholders. The basic approach pursued encompasses the following major features:

- The approach was based on the economic analysis of the USO/FMO debate developed over the past few years, including previous studies undertaken for the European Commission. This approach provides transparency on the limitations in PwC's current knowledge, as documented in the debate surrounding the USO/FMO issue in the postal economics literature.

- The approach was designed to rely on real data from USPs and other stakeholders in postal liberalization. While PwC brought its own perspectives and experience to this matter, a central objective of the study was to obtain as objective a current assessment as possible as to the scope and value of the USO and the expected consequences of FMO in various Member States.

- The approach was designed to provide policy-relevant information responding to the study objectives in a manner that makes plain commonalities and differences arising from the geographic and demographic drivers of the USO/FMO outcomes across the EU Member States.

- The approach needed to safeguard sensitive data through appropriate security and technical safeguards, and through the use of clustering and normalization techniques for reporting results.

- In order to provide a solid basis for comparative assessment and to enable continuing debate on the meaning and validity of the results of this study, the PwC Team proposed from the very beginning the use of a model-based assessment, with generic scenarios that would allow structured comparisons across countries.

Based on supporting theory and evidence from previous work, PwC followed a joint modelling and survey approach. That is, data were gathered for an expanded version of the d’Alcantara and Amerlynck model and a set of survey instruments were designed for USPs, for National Regulatory Agencies (NRAs), for new entrants (NEs), and for various other stakeholder groups (customers, competitors, labour representatives being the most important of these). Let us briefly consider the approach taken to both the comparative modelling and the surveys of key stakeholders.

As noted, the model developed was an extension of that published as d’Alcantara and Amerlynck (2006). The model is a single country model. It
considers a liberalized competitive postal market that has one Universal Service Obligation (USO) provider, the incumbent, and one or more entrants.

The model takes into account the existence of economies of scale in their collection and delivery activities, and the results in Chapter 2 show some of the impacts of economies of scale on the postal market in various countries, as measured by mail delivery scale (defined as the number of postal items delivered per person, per year).

Delivery technologies of operators in markets of different sizes are considered, measured by both these criteria. Variable and fixed costs in the collection and delivery activities are estimated by a structural cost model, which has the same form for the incumbent as for the entrant. In this latter model delivery technology parameters allow calibration to a particular country, based on the number of delivery points per route stop.

Given a definition of the USO, assumptions about demand behaviour, and the opening of the market to the entrant, the calibrated model computes the impact of entry on volumes, tariffs, market shares and the cumulative balance the entrant needs in order to finance the delivery network. The model also measures the effects of economies of scale on the financial requirement of the incumbent in charge of the USO, for the case that tariffs remain at the constant pre-competition level, considered as an approximation of affordable price.

The existence of economies of scale has been widely recognized in the postal economics literature, notably in the delivery function and, to a lesser extent, in other activities in the postal value chain. Among other evaluations, PwC examined the impact of these economies of scale on the postal market in various countries.

When the market opens and there are economies of scale, a number of questions arise, whose answer is likely to differ country by country:

- What are the long-term impacts of alternative regulatory regimes on tariffs, volumes and market shares?
- How do economies of scale affect the levels of the tariff differentials between both operators?
- What is the end result in each country when scale obviously decreases for the incumbent with the entry of the competitor?
- Who benefits both from increasing scale and from relatively denser delivery zones, lost by the incumbent?
- Which parameters are crucial for the financial requirements of the entrant, who wants to invest in a delivery network, and for the incumbent in charge of the USO, when tariffs are kept unchanged, i.e. at affordable levels?

Various types of model solutions were examined and compared on the basis of this model, including the examination of breakeven operations (allowing the incumbent to vary their price as needed) versus price constraints that require the
incumbent to maintain stable prices over time, perhaps giving rise to financial losses that may need to be financed.

This evaluation was carried out for those countries whose USP provided us sufficient data to calibrate the model. For other countries, where data was missing or too sensitive to be provided to PwC, best available public data were used.

The model considers four product groups (1st and 2nd Class Letter Mail, Bulk Mail, Periodicals and Newspapers, and Parcels), two customer segments served by postal service providers (household and business customers) and two delivery zones (rural or urban). The model was run across a number of scenarios described in more detail in Chapter 2. These scenarios distinguished themselves along the following dimensions for four product groups (1st and 2nd Class Letter Mail, Bulk Mail, Periodicals and Newspapers, and Parcels):

- The nature of access pricing and bypass allowed (fundamental characteristics of how FMO itself is defined);
- Assumptions about internal efficiency gains likely to be achieved by the USP before and after FMO, including franchising of counters, changes in automation and other aspects of postal operations;
- The nature of demand and demand shifting between the USP and entrants;
- The nature and scope of the USO, including delivery frequency in urban and rural zones, changes allowing a reduction in total routes serviced, and counter and collection density.
- The uniformity of price for letter mail and for bulk mail.

Based on data obtained from USPs and public sources, model runs were undertaken for each country prior to on-site interviews. On-site interviews were conducted with the USP, the NRA and various other stakeholders (see Annex D) for a list of organizations interviewed in this study. The interview itself was a structured process, following a detailed survey instrument.

The information obtained was then summarized for each Member State in a Country Assessment Report (CAR), and these CARs, combined with the minutes of interviews and desk research, then formed the basis for the study's findings in Chapter 2.

In parallel with its undertaking of the country interviews, PwC identified critical issues that stakeholders believed were likely to drive the impact of FMO and policy choices going forward. These issues suggested an important number of issues that needed to be examined further. This was done through three thematic case studies focused on the following questions:

- Impact on FMO of PPN access conditions, including delivery bypass prohibition and worksharing
- The scope, the characteristics and the funding of the USO
- USP restructuring: corporatisation, efficiency management and marketing strategies,

The case studies addressed the specific topic in terms relevant to the Study’s overall objectives with a deeper illustration drawn from one or two countries in the sample (and using the postal economics literature where appropriate to provide contrasting perspectives in theory and practice from other countries not in the interview sample).
1.4 Outline of the Remainder of the Report

The remainder of the report is structured as follows.

Chapter 2 presents the major lessons that can be drawn from the review of the Country Assessment Reports (CAR), interviews, model runs and desk research that were performed during the project. Firstly considered are the key factors that drive the impact that the introduction of FMO will have in Member States. These factors include demographic and social factors, as well as fundamental descriptors of the postal markets. The identification of these factors then allows constructing some representative countries that capture the characteristics of postal markets, USPs and demography. These countries represent countries and markets that will face only minor impacts from FMO to those that show average impacts across the EU, to countries that are likely to exhibit significant impacts from FMO. Using a model-based approach, both several basic scenarios are analysed for these representative countries as well as the sensitivity of key outcomes such as market share of entrants, financial situation of the incumbent USP, and net changes in employment levels in the postal sector.

From the comparative analysis in Chapter 2, as grounded in the detailed country assessments in Annex A, it is argued that the following four basic themes or dimensions will fundamentally influence the impact of introducing FMO across the European Union:

- Market and demographic conditions, including fundamental determinants demand and delivery costs;
- Preparedness of the USP for FMO;
- Regulatory and legal framework: scope and fit with FMO;
- Definition and cost/scope of the USO;

In the individual country assessments, an assessment of how each Member State fares on these four dimensions is provided. In situations where a Member State or its USP have a confluence of negative factors on these dimensions, it may be that mitigation or flanking measures are required in order to accommodate FMO with minimal delay. Chapter 3 discusses this important topic. Follows a presentation of the flanking measures that are considered as necessary to grasp the benefits and opportunities that are associated with FMO, while minimising the potential difficulties and risks associated with its introduction. Some of these are “necessary features” to support FMO; others may be required in particular countries and not in others. The aim is to capture as many of the opportunities available as possible, while mitigating as many of the risks as possible:

- *Promoting Efficient Competition:* assure a level playing field for entrants and incumbents;
- *Promoting Efficient Co-operation:* leveraging the USP’s network for efficient entry through proper access arrangements;
- **Promoting Efficient Universal Service Provision**: adapting the US at the national level to the FMO context, including relaxing the obligation to provide such services to the extent that these are provided by the market;

- **Promoting Efficient and Viable USPs**: restructuring – aligning the incentives for USPs to restructure and removing the impediments for them to do so – including increased commercial freedom, pricing flexibility;

- **Promoting Efficient Postal Services for Small Consumers**: safeguarding availability of "common and necessary" postal services at affordable prices for households and SMEs;

- **Promoting Efficient Postal Services for Large Consumers**: allowing the USP to face the discipline of competition and respond to it with the required flexibility and freedom.

Chapter 3 presents, in turn, the benefits associated with FMO and, in a second stage, the “generic” measures that are considered as prerequisites to the introduction of FMO or may be considered as a more refined definition of the regulatory arrangements that may be associated with FMO. In a third stage, a second category of flanking measures is presented which application may vary on a country-by-country basis and which are more of a temporary nature. These flanking measures are illustrated with examples from various Member States.

Chapter 4 is concerned with a deeper analysis of three critical issues that are likely to drive the debate about postal policy alternatives going forward. The major issues identified concern:

- Access policies and efficient leveraging of the USP’s network for FMO;
- The definition and funding of USO under FMO;
- Restructuring challenges facing USPs under FMO.

  - For each of these major themes, relevant examples in Member States are discussed, together with applicable theory and experience from the postal economics literature.

  - Chapter 5 pulls together the findings from Chapters 2 through 4 and summarizes these with respect to the key question addressed in this study: namely, the consequences of FMO on the USO in the form that it is expected to exist at the beginning of FMO, and on USPs and other stakeholders who will be affected by the fundamental changes likely to occur in European postal markets under FMO.
Chapter 2  Main Drivers of the Introduction of Full Market Opening (FMO) in the Postal Sector in the European Union
2.1 Introduction

This Chapter presents the major lessons that can be drawn from the review of the Country Assessment Reports (CAR), interviews, model runs and desk research that were performed during the project.

While assessing the potential impact of FMO in 2009 on the Universal Service Obligation (USO) of such an important number of different countries and markets, central recurring themes emerged. Indeed, underlying these themes a limited number of key factors, to a large extent, drive the impact that the introduction of FMO will have in a particular country.

While a detailed country-by-country review of the postal market is required to understand the specific market dynamics and constraints, it hardly allows for a comparative analysis of the impact of FMO across the European Union. Furthermore, considering contrasting and comparable effects across countries perhaps best elucidates the main mechanisms underlying the likely evolution of postal markets when confronted with FMO.

The market dynamic differs from country to country, as well as the current relative situation of the Universal Service Providers (USPs), competitors and customers. So the current state of the market participants and the expected future plays of the game will determine the future impact of FMO.

The constant interaction between experts’ views and the simulation based results is at the core of this study. Indeed, model-based results bring some objectivity to the debate, which in view of the often-contradictory opinions that are present is essential to allow further constructive evolution. The model – parameterised to correspond to each of the postal market and USP specifics – presents stylised quantified results associated with specific stylised scenarios. This also allows for comparisons between the various operators and postal markets covered.

It has to be stressed that a model simplifies the full complexity of any given postal market and that its results have to be carefully analysed taking into consideration the model characteristics, hence limitations. Moreover, while the pros and cons of introducing competition in the postal market(s) are still being debated, stakeholders can be expected to present views that are in line with the direct interests of the organisations, which they represent. This is exacerbated by the political and social dimensions of anticipated market reforms, where opinions expressed are often directly contradictory.

In other words, since neutrality of opinions expressed is difficult to attain, a key virtue of a model, despite its well-known limitations, is to force all stakeholders to confine themselves to a limited number of dimensions, with a view to providing a common ground for understanding the consequences of alternative policies. Additionally, there are today very few examples of full market opening (Sweden, New-Zealand) and, although some lessons can be learned from these experiences, their extrapolation to other markets has obvious limitations.
Themes, Drivers and Diversity

Consequently, to allow for a comparative and constructive presentation of the impact of introducing FMO in a broad range of countries, three themes (or dimensions) have emerged during the interviews and desk research:

- Market and FMO;
- Preparedness of the USP;
- Impact of Scope of USO;

These 3 themes along with the regulatory aspects are illustrated in the below figure:

*Figure 3: Recurring themes/dimensions when assessing the impact of FMO*

For each of these themes, the main factors are identified that will drive the impacts that the introduction of FMO will likely have in a given market and a summary of the main findings of the country assessments is presented. This summary will make plain that there are both common themes across countries as well as considerable diversity in terms of expected effects of FMO and country specificities.
**Figure 4: Themes, drivers and diversity of driver values**

<table>
<thead>
<tr>
<th>Themes</th>
<th>Drivers</th>
<th>...that influence the...</th>
<th>FMO impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>Postal scale, urbanisation, direct mail %, letter mail and bulk mail, postal density, ...</td>
<td></td>
<td>USP Financing needs</td>
</tr>
<tr>
<td>Preparedness of the USP</td>
<td>Labour cost, efficiency, ...</td>
<td></td>
<td>Workable competition achieved</td>
</tr>
<tr>
<td>Impact of scope and characteristics of USO</td>
<td>Counter density, frequency of delivery, ...</td>
<td></td>
<td>Where entry occurs</td>
</tr>
<tr>
<td>Regulatory policies</td>
<td>Licensing, pricing, access, ...</td>
<td></td>
<td>Employment impact</td>
</tr>
</tbody>
</table>

**Diversity of driver values across countries**

**Variety of impacts across countries**

**Sensitivity on Outcomes - FMO impacts**

A limited number of themes, associated drivers and key parameters were selected to provide insights on country specificities that are likely to drive the impact of introducing FMO under given circumstances. The key outcome variables are:

- **USP Financing Needs**, measured as the percentage of USP revenue needed to be financed following FMO in order to assure financial viability when USP tariffs are constrained by price capping (affordability);

- **Workable Competition Achieved**, measured as the total entrants’ market share following FMO;

- **Coverage of Entrants--Where Entry Occurs**, measured by the route coverage by the new entrants following FMO;

- **Employment Impact**, i.e. impact of introduction FMO in terms of level of employment with the USP, with new entrants, and for the sector as a whole;

- **Price Increase to Attain Breakeven**, measured as the price increase required for the USP to attain breakeven following FMO, hence *de facto* relaxing the usual constant price constraint.

The figure below illustrates the sensitivity analysis that relates drivers to outcomes of interest.
The indicated sensitivity analyses in the above figure was carried out for each of the key parameters identified while keeping all other parameters constant. Isolating the effects of a single parameter will allow for a better understanding of its influence on the consequences of FMO.

The sensitivity analyses have been run through the model by working with three representative national postal markets that have been designed using the range of parameters present in EU Member States. These three representative countries have been created to explain the impact of certain drivers on FMO outcomes. The representative countries have been created by choosing parameters for the national markets that represent low, average and high FMO impact countries (LoC – Low FMO impact Country, AvC – Average FMO impact Country and HiC – High FMO impact Country). The reader may think of these countries as representing a set of postal market conditions where FMO will have very little impact on either the USP or the market, the LoC case, or will have moderate or important impacts, the AvC and HiC cases.

The three representative countries were constructed by using extreme values observed for European Members States for the LoC and HiC countries and average values for the AvC country (see Table 1 below). This was done in a very careful way using as much as possible publicly available data, checked with data gathered in interviews with a large variety of stakeholders (data were cross-checked with member country postal USP’s, national regulators, existing and potential postal competitors, multinational companies selling sorting/sequencing machines, logistic companies (concerning contractual
agreements between operators), trade unions (about technical norms for postmen in terms of time needed for detailed postal task components), and local real estate agents). In all cases where data were considered to be non-robust or unreliable or where quantifications were not statistically “significant”, these data were not used to differentiate the three representative countries (though these uncertainties were controlled through sensitivity analyses as described further below).

The following specific sources were used:

- Country Market "Scale" data ("scale" is defined as the number of postal items distributed in the country market per inhabitant and per year), were determined using USP sources, when reliable data were available, and otherwise public sources;

- Urbanization "density" ratios ("density" is defined as the average number of post boxes per mail stop, a number which will depend on such features as the number of high-rise apartment buildings in the urban areas in a country) were extracted from published UN statistics (2003);

- Labour Cost Ratios between Self-employed workers (representing the cost of workers who might be hired by entrants) and Employees (representing the cost of workers who might work for the USP) were computed using Eurostat sources;

- Customer demand behaviour coefficients for C (Consumer) and B (Business) customers were derived from studies in the literature published by specialized researchers in Postal economics (market elasticities and shifting elasticities for 4 products); to allow comparisons across countries, and given the relative lack of any significant differential between these coefficients for each of the EU Member States, justifies the fact that per coefficient type the same value has been used for all three representative countries.

The market structures and key parameters defining the three representative countries are characterised by the following parameters in Table 1 (the demand elasticities are discussed separately and presented in Table 2):
<table>
<thead>
<tr>
<th>Name</th>
<th>Definition</th>
<th>LoC</th>
<th>AvC</th>
<th>HiC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scale</td>
<td>Mail items per person per year</td>
<td>500</td>
<td>200</td>
<td>10</td>
</tr>
<tr>
<td>Urbanisation rate</td>
<td>Percentage of population in urban area (UN standard)</td>
<td>45%</td>
<td>70%</td>
<td>95%</td>
</tr>
<tr>
<td>Labour cost ratio</td>
<td>Ratio of freelancer vs employee FTE cost (Eurostat)</td>
<td>90%</td>
<td>75%</td>
<td>60%</td>
</tr>
<tr>
<td>Shifting elasticity</td>
<td>Variation of 1% of volume associated to a 1% variation of price</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Automation % in sorting</td>
<td>Percentage of mail item automatically processed</td>
<td>90%</td>
<td>50%</td>
<td>10%</td>
</tr>
<tr>
<td>Automation % in sequencing</td>
<td>Percentage of mail item automatically processed</td>
<td>75%</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>Flexible USP workforce in</td>
<td>Percentage of freelancer FTE hired by USP in activity</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>collection</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible USP workforce in</td>
<td>Percentage of freelancer FTE hired by USP in activity</td>
<td>26%</td>
<td>6%</td>
<td>0%</td>
</tr>
<tr>
<td>sorting</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible USP workforce in</td>
<td>Percentage of freelancer FTE hired by USP in activity</td>
<td>57%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>transport</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible USP workforce in</td>
<td>Percentage of freelancer FTE hired by USP in activity</td>
<td>29%</td>
<td>8%</td>
<td>0%</td>
</tr>
<tr>
<td>delivery</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Franchised counters</td>
<td>Percentage of counters franchised</td>
<td>46%</td>
<td>28%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Moreover, the following characteristics were assumed as part of the definition of all the three representative USPs and countries:

- The number of letter mail items sorted per hour with machines equals 50% of that the bulk mail. This reflects the fact that the addressing of single piece letters is of a lower writing quality than that of administrative mail for example, and that bulk mail is often pre-sorted;

- When processed manually, letter mail and bulk mail are sorted and sequenced using the same capacity and the same average cost;

- USO counters costs represent half of the of the total counter costs, with the latter set at 15% of total costs of the USP;

- Franchised counter costs equals 40% of non-franchised counter costs;

- There is (required to be) one collecting box per 10 square kilometres and 1 counter per 5000 inhabitants;

The parameters in Table 1 above have been selected to provide both coherence and plausibility to the results. In particular, best practice technological coefficients were derived from the information received from the USPs and from public sources. AS noted earlier, the objective here is to provide insights on the range of possible effects of FMO on various outcomes of interest, based on favourable and unfavourable drivers.

Demand responsiveness variables are likely to be very important in determining the effects of FMO on the USP and on the viability of entrants. Two parameters are of special interest in this regard. First is the loyalty parameter describing the percent discount that entrants must offer in order to begin attracting business away from the incumbent USP. Second is the elasticity of shifting, once the
The loyalty factor has been exceeded, where elasticity is defined as the percent increase in demand for an entrant’s product for each percentage increase in the price of the incumbent’s product (beyond the initial loyalty discount). Clearly, the lower the loyalty and the higher the shifting elasticity, the easier it is for an entrant to establish viable operations in a country. The loyalty and shifting elasticities used are shown in the table below. The Medium case corresponds to the values acceptable in view of comparative studies from the literature: see for example Cazals, C. and Florens, J-P. (2002). The lack of any significant differential between these coefficients for each of the EU Member States, justifies the fact that per coefficient type the same value has been used for all three representative countries. (corresponding to the Medium case in Table 2).

<table>
<thead>
<tr>
<th>(Actual) Shifting elasticity</th>
<th>Loyalty</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B-originating</td>
</tr>
<tr>
<td>Low</td>
<td>-0.75</td>
</tr>
<tr>
<td>Medium</td>
<td>-1.0</td>
</tr>
<tr>
<td>High</td>
<td>-1.25</td>
</tr>
</tbody>
</table>

Best practice technological coefficients (e.g., for the LoC country impacts) were derived from the information received from the USPs and from public sources.

Two analyses were made: a comparative analysis across Member States as well as a sensitivity analysis of the three representative countries encompassing the range of effects that might occur under FMO. The former shows specific details for clusters of actual countries in the EU and the latter shows the impact of important factors, like Scale and Density, underlying the impact of FMO on these countries.

Note that while may vary one factor at a time in the sensitivity analysis., the final impact of introducing FMO in a market will be largely linked to the **combined impact** of various factors. The point here is that the situation facing any specific country may embody both positive factors as well as negative factors— for instance, a USP suffering from an important human resources cost ratio differential (compared to freelancers) operating in a market with scale factor that makes defending the market by the USP easier. While this does not present specific analytical difficulties to assess the impact of FMO, the simultaneous presence of positive and negative factors implies that considerable care must be exercised in drawing conclusions on the impact of FMO on the basis of single-factor sensitivity analysis.

These combined effects as well as the major results of country-specific assessment reports are described in Section 2.5 (CARs in Annex B).
2.2 Main Findings per Theme

2.2.1 Theme 1: The Market and FMO

2.2.1.1 Introduction

The intrinsic characteristics of the market are among the main factors that will determine the impact of introducing FMO. Some of these characteristics may have very significant impacts, differing from country to country, while others have a more progressive impact, more balanced from one country to the other.

Among the latter, the substitution for postal products of electronic communication products is probably the most often cited. However, current studies on electronic substitution support the notion that the effect of this substitution will be continuing erosion rather than an immediate rapid drop. Moreover, these effects are not likely to vary dramatically across countries. In general, items of correspondence are expected to show a moderate decline while other products such as magazines and catalogues are expected to remain stable, and may, in some countries, still show a potential for growth.

Despite the fact that the substitution of postal product by electronic products is likely to be a rather slow phenomenon, it is nevertheless important, since postal operators, independently from the expected impact of FMO, already have to address a static or declining market.

In saturated markets, competition for market share can be quite intense, especially where economies of scale and fixed costs are as dominant as they are in the postal sector. In the short run, a gradual decline in the postal market can therefore be expected to intensify competition, market shares lost to new entrants being added to market volumes lost because of the general market decline.

High mail volumes, per capita mail volumes, potential for growth in direct mail volumes, a high degree of urbanisation and population density may allow new entrants to secure sufficiently high volumes to build a sustainable business case. On the other hand some of these factors may also moderate the impact FMO will have on the USO since they mitigate the cost burden associated with providing the USO, e.g.:

- The USP will normally have important economies of scale that reduce the unit cost of providing the USO, as long as sufficient volumes can be maintained;

---

See, e.g., the Pitney Bowes studies on electronic substitution available at [http://www.postinsight.pb.com/](http://www.postinsight.pb.com/) As illustrated in these studies, the Internet not only results in substitution away from mail, but it also provides some opportunities for new mail products.

4 Fouad H. Nader, Adrenale Corporation, Mail trend, December 2004 (background paper for “Electronic Substitution for Mail: Models and Results; Myth and Reality”, Pitney Bowes, 2005)

5 Fouad H. Nader, Adrenale Corporation, Forecast, February 2005 (idem supra)
A high degree of urbanisation implies also that the relative cost of providing the USO in rural areas will be limited, and that, confronted with a price uniformity constraint, the difference between the uniform price and the cost of delivering mail in urban areas would be lower, limiting entrants’ ability to generate significant margins through cream skimming.

2.2.1.2 Main Findings, Diversity and Sensitivity

Considering the above, the following parameters are likely to be key drivers of the impact that FMO would have on USP financial viability and the extent of market entry for competitors. For each of these drivers, an overview is provided of the situation in the European market and the variation described in the values of the driver across this market.

Postal scale factor (mail items delivered per inhabitant)

Considering that the primary costs incurred by a postal operator are in the delivery process and that those costs are often considered to be essentially fixed costs, it follows that the higher the mail scale, the lower the unit cost of delivery will be. Consequently, entrants – even if more efficient or generally benefiting from lower labour costs than the incumbent – will be confronted with a USP that benefits from these economies of scale and will have difficulties matching the unit costs achieved by the incumbent operator. On the other hand, since the USP has the obligation to deliver every day everywhere on the territory, it follows it has a fixed cost which the entrants does not.

For this reason, most of the entrants use a different business model, delivering at a lower frequency bulk mail that is pre-sorted by the mailer itself, avoiding them to invest in expensive sorting centres. Next to this phenomenon, in a high mail scale market, market share lost by the USP to entrants increases the USP’s unit cost of delivery but to a lesser extent than in a low mail scale market.

The relation between the postal unit cost of an operator and the postal scale is inherent to the postal process itself. Indeed, the technical coefficients and hence the fixed costs are related to the postal delivery tour that the postman makes to reach households, SME, large companies, etc. The fixed costs relating to this delivery process are spread over the mail items volumes, which are dependent on the postal scale. In the case of a high postal scale environment, low unit costs provide an initial advantage to the historic operator. Nevertheless this advantage diminishes when its market share decreases. All the same, from the entrants’ perspective, the fixed cost differential is an initial disadvantage when his market share is small, but the fixed cost levels should improve when his share increases.

In other words, the higher the postal scale in a country, the lower the unit costs for both operators. To the contrary, the smaller the scale in a country, the higher the unit cost differentials between both operators, in favour of the historic
operator for whom it is a sort of barrier to entry. Mail scale thus has an impact on competition.

**Unit Costs as a function of the postal scale**

The USA has the largest sized postal operator, USPS, distributing 654 items per inhabitant and per year in 2004.

It is used as the starting point in the following figure, which shows on the vertical axis unit costs as a function of the number of postal items per inhabitant and per year on the horizontal axis. Unit costs are computed using best practice coefficients. For example, the unit cost for a postal scale of 100 (items per inhabitant) is almost double than that of the highest postal scale (654: the USPS standard). Likewise, for a scale of 30, the unit cost is more than quadrupled.

*Figure 6: Best practice computed unit costs as a function of scale*

Mail scale across countries in the EU vary widely from 14 (Bulgaria) to 489 (Luxembourg) mail items per inhabitant with an average of 195 and a median of 137.
The above shows that 37% of the countries show low mail scales (below 100 items per inhabitant per year) and 26% operate in a market that presents high postal scales (300 and more). Low postal scales (less that 150) is a characteristic of the market that may affect countries such as Italy, Greece, Spain, Latvia, Lithuania, Malta, Cyprus, Malta, Ireland, Germany, Romania and Bulgaria. In these countries, mail is often associated with administrative issues: in Italy for example 16% of the letter mail volume is registered mail.

On the other hand, the (relatively) high mail scale countries (mail scale higher than 300) include the Nordic countries, Estonia, the United Kingdom, France, Belgium, The Netherlands, and Luxemburg, which present a more attractive market for entrants and hence are more prone to attract new entrants.

**What drives Postal scale?**

High postal scale might be related to cultural aspects (predominance of the written document on the verb), but is also related to the development of bank and administrative transactions, of mail orders or e-commerce, and of direct mail. The examples of work sharing in the US and of upstream consolidation in France show that upstream liberalisation promotes the development of bulk mail.

Postal scale is a well-known key driver when assessing FMO impacts. Important volumes of mail provide the postal operator with significant economies of scale, hence with the ability to provide services at reduced prices compared to a new entrant suffering from initially low volumes.
However, the following figures also indicate that the country profile is particularly important when assessing the sensitivity of FMO impacts to variations in mail scale and that the combined effect of drivers may be particularly important.

In the following figure, illustrating the case where the constant pricing constraint is imposed, one can see that the impact of FMO on the USP balance to be financed depends on scale. The balance to finance is measured by the coverage of the revenues linked to USO products of the costs associated with USO provision. In order to compare results across different countries, the balance to finance is normalized by using the total postal revenues. The final (normalized) balance to finance equals the difference between revenues and costs associated to USO divided by total postal revenues. Small scale situations will require counterbalancing drivers against financing problems for the USP whereas large scale decreases the USP financing problem. In the AvC representative country for example, where impacts of FMO are average, the need to finance the USP decreases from important to limited when scale increases from 10 to 200.

*Figure 8: Sensitivity to postal scale of the balance to finance*
When assessing the impact of introducing FMO, what matters is not only the absolute order of magnitude of the impact, but also the relative impact associated to variations in a given driver. In this respect, the following figures indicate that a given variation of mail scale is likely to have a more significant impact:

- in low mail scale markets, and
- in average and high impact markets.

The following three figures will be analysed simultaneously. They indicate the modelled impact of FMO on the employment levels of the USP, the new entrant(s) (and the market for Universal Services in total) depending on the mail scale level of the markets considered.
Figure 10: Sensitivity to scale of the number of USP’s FTE

Figure 11: Sensitivity to scale of the number of new entrant’s FTE
The results indicate that even though the variation of USP employment levels can be important, the impact of introducing FMO on the total level of employment is to – a large extent – moderate. In fact, as indicated by the third graph, introducing FMO can lead to employment creation, in particular in low scale markets. Such employment creation must be analysed with care since it goes also in parallel in this case with a, sometimes significant, USP balance to finance.

It may be concluded here that low postal scale could represent a risk for the USP, but at the same time, upstream market opening contributes to generate more bulk mail volumes, particularly in direct mail.

**Population Density and Urbanisation Rate**

Price uniformity usually imposed on a USP implies that entrants will focus on less costly destinations, namely Urban Routes. Furthermore, a high proportion of Urban Routes implies that a large number of Urban Routes are used to generate a margin to finance deliveries on Rural Routes. Consequently, in markets with an important proportion of Rural Routes, losing even a limited market share in the Urban Area implies that a significant part of the de facto subsidy available to fund the Rural Area will be lost.

Because the USPs are using different definitions of rural/urban across countries, the Rural Routes proportions are estimated through the measurement of the urbanization rate of each country. For the sake of comparability of the data UN urbanisation data were used, which are recognized as being an effective proxy for Urban Routes estimation.
The figure above shows that distribution of the countries along the urbanization rate intervals is pretty much evenly distributed between 50% and 100% with a higher concentration in the range 60%-70% reflecting the particularities of urbanization rates.

Belgium, Luxemburg, the United Kingdom, Denmark, Germany, The Netherlands, Sweden and Malta are among the highly urbanized countries (>80%) whereas Ireland, Finland, Portugal, Romania, Lithuania and Greece are among the least urbanised (<65%).

The figure below illustrates in a matrix both postal scale and urbanisation measurements (expressed as postal items per inhabitants and the urbanisation rate as estimated by the United Nations) and shows 4 clusters of countries constructed according to these 2 drivers whose variability can have huge effects on the impacts of FMO.
The division of the clusters is based on the average values of the drivers, that is to say that in the table countries such as Belgium, Denmark, France, Germany, Luxemburg, Norway, Sweden and the United Kingdom all show higher than average urbanization rates and scale. In contrast, Greece, Ireland, Latvia, Lithuania, Poland, Portugal and Romania - among others - prove to be characterised by values below average for both drivers.

According to these elements and the rationale outlined above, it may be deduced for example that, for countries in quadrant II, the impacts of FMO would be mitigated as (i) their high postal scale allows them to drive their unit costs down making them more competitive and (ii) their high urbanisation rate puts the USPs less at risk as they tend to have less expensive rural routes to support. This conclusion may be counterbalanced by the attractiveness for entrants of such high urbanisation and high postal scale environments and must be considered mainly in conjunction with the efficiency level of the USP.

The sensitivity analysis for urbanisation rate shows that it drives the relative part of the Universal Service market that is initially targeted by new entrants. new entrants’ participation is furthermore facilitated by the other parameters characterising each of the three representative market profiles.
Relative importance of Bulk Mail volume

The rationale for considering this indicator is the following: Letter Mail is less likely to be captured by entrants as the interest of the entrants lies mainly in the Bulk Mail (Transaction Mail + Direct Mail) which:

- can be easily collected and sorted / sequenced by the mailer himself,
- is produced by large mailers who are more cost conscious,
- can be delivered less rapidly, time being saved/planned at the production stage, but time certain,

The figure below shows a classification of the countries according to their Letter Mail/Bulk Mail ratio. The higher the value of the ratio, the less is the relative Bulk Mail volume.
This ratio is heavily triggered by the ratio of Direct Mail to total mail: in Italy for example a small proportion of mail - that is 19% - is composed of Direct Mail whereas in Germany the same proportion reaches 62%.

Direct Mail is usually considered as one the few and probably the main potential growth areas in the postal sector. Consequently, this market segment is likely to be one of the main targets for entrants since it exhibits characteristics that suit entrants’ strategies. Direct mail constitutes one of the central focuses of new entrants like Sandd in the Netherlands, Redmail in Austria, UK mail, Adrexo in France. On the other hand, an important absolute Direct Mail volume implies also an important scale factor that would imply low unit costs making it more difficult to compete.

**Perceived likely competition following FMO-demand elasticity**

A final indicator to take into account the potentially important combined effect of several drivers and/or the neutralisation effect of opposing factors drivers is the assessment of the likely loss of market share by the USP following the introduction of FMO. This loss is related to customer’s behaviour of switching to the new postal entrants. This assessment is based on the combined judgments of survey respondents from USPs and NRAs.
This indicator does not prejudge the costs or benefits of the expected market share loss, but rather points only to the predictions of respondents of the market share loss. A majority of USPs (64%) estimate that the new entrant(s) will not capture more than 22% market share in their respective countries which is representative of a perception that the FMO will be successful in terms of market opening and the establishment of workable competition.

Demand elasticity is the percentage change in quantity demanded divided by the percentage change in price. The sensitivity of FMO introduction to demand elasticity is particularly high, but uncertain, and hard to predict. The assumption of high elasticity shows a dramatic impact, particularly on HiC and AvC. But no one has clear estimates of the real demand that he will obtain, given that these will involve in many countries new entrants with new business models, offering new services and covering just part of the territory, while most of the bulk mailers have to send mail to the entire population, specifically in transaction mail. The liberalisation examples of Sweden and New Zealand show strong competition in the cities, but only limited competition at national level.

Some USPs have extrapolated the potential penetration rate of CityMail in Stockholm to calculate the eventual elasticities in their countries, but this approach remains quite uncertain as it is based on a single, specific example.

However, considering the entire set of market drivers, the demand elasticity, like the postal scale, but unlike the urbanisation rate, is a driver that can be influenced by operators and, in particular, the USP. In other words, securing customer satisfaction and loyalty can drastically reduce, in all cases, the impact of introducing FMO in a market. Hence, USPs can influence the final impact of introducing FMO by developing more customer-orientated strategies and
services that would strengthen the loyalty of their customer base and decrease price sensitivity in the business segments through segment-specific products. This recommendation is clearly observable from the following 5 figures.

**Figure 18: Sensitivity to demand elasticity of the balance to finance**

![Figure 18](image1.png)

**Figure 19: Sensitivity to demand elasticity of the new entrant's market share to demand elasticity**

![Figure 19](image2.png)
The following figure illustrates one of the consequences of introducing FMO in markets where the USP continues to be financed in order to provide the required Universal Services. In this case, not surprisingly, the employment level in the sector increases with the customer sensitivity, in particular in HiC type markets.
Indeed, in these markets, the importance of new entrants’ coverage of rural areas, together with the associated network duplication and the smaller employment impacts on the USP (driven by the fixed costs – hence employment levels - associated with its network) implies a net increase of the employment level of the postal sector considered.

2.2.1.3 Conclusions

- **The different market drivers induce a different impact of FMO on USO.** Postal scale is a key driver. A minimal postal scale, particularly in bulk mail and including direct mail, is required in order to get the expected economies of scale. This can normally be achieved in all Member States, if and when the economy is developing and the USO provides the requested quality of service.

- **Obviously, high urbanisation is an advantage.** Urbanisation rate can hardly be influenced, but appears not to have a major influence on USO, when other drivers are favourable.

- **Market and customer loyalty.** The key driver is fidelity and elasticity, though estimations about the value of these two parameters remain quite uncertain. The few examples of Sweden and New-Zealand show that FMO has triggered the USPs to offer higher quality services and new services.

The challenge will be to all USPs to improve their service in such a way that they keep their main customers. Isn’t it this the value of competition?
2.2.2 Theme 2: Preparedness of the USP

2.2.2.1 Introduction

After having assessed the exogenous market characteristics and how they could impact the different FMO impact indicators (outcomes), this section describes in this section the overall state of preparedness of the USPs by evaluating several drivers that measure directly or indirectly this level of preparedness.

The USP preparedness drivers which interact with the FMO impact indicators (outcomes) fall into to 3 categories, namely: the commercial freedom or allowed flexibility of the operator and its ability to engage in efficiency improvement exercises and targeted pricing, the efficiency levels attained or expected to be attained in the medium term and finally the labour-related conditions including eventual social liabilities, resulting from the historical status of state administration of the USPs.

These three dimensions are related to the overall USP capacity to operate in an efficient manner and they cover the constraints (liberty of action, labour conditions) as well as the objectives or the expected results (efficiency levels).

In general, it can be assumed that an operator presenting overall high levels of efficiency is more likely to take advantage of new (or increased) competition following FMO, innovating in new products and services. In a context of high efficiency, the optimized cost structure and processes in place will translate to relatively lower unit costs that will make it more challenging for the new entrant to align to the highly efficient operator.

Indeed, the new entrant will most probably follow a low-cost strategy, compete on price in order to capture sufficient market share necessary to absorb its fixed costs. This commercial strategy will only be possible - in terms of preservation of margins - if the new entrant can operate in a highly efficient manner, actually more efficiently that the USP. It already can be observed most of the new entrants follow a different business model, allowing them to offer competitive prices, but also time certain services, corresponding to clients expectations. They focus on delivery, part of the sorting being done by the mailer itself, without requesting daily frequency of delivery.

In contrast, a postal market with a less efficient USP will be an easier target as a market for a highly efficient new entrant.

The efficiency levels attained are strongly correlated to the ability of the management to engage in improvement exercises or restructuring without political influence. Commercial freedom allowed to the USP, performance accountability of the USP management and the USP capacity to undertake efficiency improvements are the critical factors. The same goes for the labour conditions which are also a constraint originating in general from specific collective labour agreements or more simply from the special status (mostly) of USP postal workers.
In view of these observations, it is important to assess the overall level of preparedness of the USP so as to understand how the specific situation of the USP can or will affect the impact of the FMO on the country. The following sub-sections discuss the preparedness levels of the USP in the Member States.

### 2.2.2.2 Main Findings, Diversity and Sensitivity

Many drivers are likely to affect the preparedness of the USP to the FMO. These parameters allow for an assessment of the relative positioning of the USP with regards to its preparedness level and ability to react positively to FMO.

Each of these drivers is shortly described, with the overall situation in Europe and an overview on the main trends that have come out of the assessment and analysis of the sector. This outline will be illustrated with specific examples.

**Labour cost ratio (Freelance versus postal employees) and flexible workforce**

The labour cost ratio is measured by the relative cost of the freelance workforce relative to the average USP labour cost. Many new entrants, or potential new entrants, are active in the express/parcels business, or unaddressed mail, or newspapers/periodicals distribution. They apply other wage conditions, or use free-lancers, or pay per piece delivered.

The figure below is based on estimates Eurostat data and outline the distribution of the labour cost ratios.

#### Figure 23: Distribution of countries across cost of labour ratio ranges

![Figure 23: Distribution of countries across cost of labour ratio ranges](image)

In some countries such as Poland the labour cost ratio is higher than 1, in other words the freelance labour costs are higher than that of the USP. This atypical
situation will make it difficult for the NE to compete while not particularly encouraging the USP to realize efficiency gains in labour.

Also, it must be noted that the USPs of these countries charge relatively high prices for the first class letter mail (measured in purchasing power parity and compared with other European countries) hence making it a rather comfortable environment for the USPs to do business.

Nevertheless, these countries have also had less time to transpose the *acquis communautaire* and for some of them the overall efficiency levels remain very low.

By contrast, in two thirds of the countries the new entrants potentially benefit from favourable labour cost ratios of 80% or less, that is the cost of freelance labour at a cost of 80% or less than that of the USP. This cost differential is most advantageous to the new entrants in countries such as Sweden (74%), Norway (75%), Italy (72%), Greece (69%), France (73%) and Belgium (68%). Needless to say, this ratio is also an indirect indicator of the USP’s labour cost.

In extension to the labour cost ratio, it would also be appropriate to consider other aspects of labour efficiency, e.g. the measurement of the proportion of the ‘flexible’ labour force\(^6\) working for an operator. Luxemburg, Romania and Germany appear to be working with flexible workforce at this point. TNT has replaced 9000 fix contracts with part-time mail deliverers, following natural attrition, and the automation of sequencing, which changes the requested mail deliverer profile. At the same time, Royal Mail is motivating its postmen through giving them back 218m GBP, and paying them up 25 % since 2002.

One can observe a high sensitivity of the competitiveness to the labour cost ratio, according to the model-based analysis. A low ratio allows the new entrant an easy market penetration; a high one is forcing him to find alternative competitive advantages. Without any labour cost differential, the model doesn’t show any market penetration by the new entrant. This labour cost related competitive disadvantage can be countered by introducing flexibility in the USP, or to the contrary by imposing the same collective conventions to the NE (as it is the case for example in Switzerland).

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\(^6\) Flexible workforce comprises labour force subcontracted, outsourced or paid per unit of volume.
A higher value of the labour cost ratio unsurprisingly reduces the competitive advantage of the new entrant towards the USP. Nevertheless, as from a given value (80% in this model) even in the HiC environment (characterised among other things by a low mail density) a significant drop of the competitive advantage of the new entrant leads to a marginalisation of the competition (very limited market share). The reason for this is the combination of high population density and a sufficiently low level of postal scale.

In that case, few Rural Routes need to be financed by the USP inducing a reduced discrepancy between USP’s uniform tariff and his Urban Route’s unit cost. Cream skimming does not offer a large tariff advantage to the entrant.
When the labour cost advantage of the entrant diminishes while its scale is reduced (and the USP’s increases), causing his unit distribution costs to increase, the entrant looses his advantage in terms of unit cost. This is caused by the nonlinear relation between the unit cost and the postal scale. This shows that the specifics of postal economics are in the combination of the density factor with the scale factors under uniformity.

This means that if the HiC environment is potentially less favourable to the USP, it is also an environment in which pro market entry flanking measures may be envisaged in order to foster competition.

**Labour Productivity**

Fully-fledged efficiency measurements have always represented a major challenge in the sense that they are extremely complex and time-and-material consuming. In view of this very high investment, these studies typically focus on limited processes oriented on a specific improvement but, more importantly, their strategic nature makes them highly confidential.

In view of this constraint, the efficiency levels attained or in the process of being attained by the postal operators is approximated by measuring the labour productivity ratio which is calculated as the total number of mail items per year processed per USP FTE staff (allocated to USO).

This representation provides an indication only of the efficiency levels. Indeed, it must be stressed that the measure of labour productivity does not take into account country specificities such as, for example, the country geography and population density, the postal scale or the bulk mail relative volumes, which - among others - can have an effect of labour productivity in the sense that they can impose 'less efficient' operational processes.

The figure below presents the different countries grouped by (i) the proxy measurement for the efficiency that is the labour productivity ratio (measured today) and (ii) by the expected date of attainment of best practice levels which approximates the readiness of the USP and/or its capability to reach best practice level within a determined time frame. This assessment is based on current improvement and/or restructuring plans, and on the date as of which the USP expects to have reached enough efficiency to be able to be confronted with competition.
The countries are split into the quadrants according to best practice level attainment (before or after 2009) and to labour productivity ratio (below or above European average). A high productivity of the USP leaves less room to the NE to provide services at significantly lower prices than the USP. If the USP is highly productive and cost efficient, the NE will struggle to position itself with a competitive edge.

The figure below provides some details of the labour productivity that can be observed in Europe. Again, it must be stressed that these data do not include country specificities (geography, densities, and USO scope).
Some of the various initiatives that can be put in place in order to increase efficiency within the USP are listed in the table below.

**Table 3: Efficiency measures observed**

<table>
<thead>
<tr>
<th>Efficiency measures</th>
<th>Potential expected effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sorting automation and/or rationalization of transport and sorting networks</td>
<td>increase in productivity</td>
</tr>
<tr>
<td>Centralized sorting centres</td>
<td>increase in productivity and cost reduction</td>
</tr>
<tr>
<td>Counter franchising</td>
<td>reduction of fixed cost base but still a variable cost in most cases</td>
</tr>
<tr>
<td>Diversification of products and services at counters</td>
<td></td>
</tr>
<tr>
<td>Modernising and automating the counter network</td>
<td></td>
</tr>
<tr>
<td>Postal counter front-office automation (front office IT)</td>
<td>increase in productivity and quality of service</td>
</tr>
<tr>
<td>Replacement of counters with mobile counters</td>
<td>reduction of fixed cost</td>
</tr>
<tr>
<td>Counter density reduction</td>
<td>reduction of fixed cost base</td>
</tr>
<tr>
<td>Reduction of mail boxes</td>
<td>reduction of fixed cost base</td>
</tr>
<tr>
<td>Redeployment of mail boxes</td>
<td>reduction of fixed cost and</td>
</tr>
<tr>
<td>Walk sequencing and/or walk routes optimization</td>
<td>increase in productivity</td>
</tr>
<tr>
<td>Increase in the motorized delivery in order to increase delivery speed</td>
<td>increase in productivity and quality of service</td>
</tr>
<tr>
<td>Management and staff incentives</td>
<td>increase in productivity</td>
</tr>
<tr>
<td>Outsourcing of transportation activities</td>
<td>cost reduction</td>
</tr>
<tr>
<td>Contractual workforce, replacing civil servants contracts</td>
<td></td>
</tr>
<tr>
<td>Hiring self employed, or part-time workforce</td>
<td>cost reduction and flexibility</td>
</tr>
<tr>
<td>Cost accounting implementation</td>
<td>improvement of management decision</td>
</tr>
<tr>
<td>Management Information Systems implementations</td>
<td>improvement of management decision</td>
</tr>
<tr>
<td>Reduction of central /regional overheads</td>
<td></td>
</tr>
</tbody>
</table>
Although all USPs can or will follow a similar efficiency path, not all USPs can engage in specific initiatives. For example, the (further) automation of the sorting process in countries where labour costs are relatively low (Poland, Hungary, Czech republic) is not always economically sound because the return on investment remains negative due to the relatively high cost of implementation and sorting and sequencing activities maybe not yet possible due to market organisation (deliveries, post codes, etc).

Some initiatives are driven directly by the USP whereas in some cases the NRA itself triggers many efficiency improvement initiatives. For example, the Danish competition authority has encouraged Post Denmark to further outsource its post offices.

A good example of a restructuring in difficult conditions is the Italian case. Despite operating in a context unfavourable to restructuring efforts, as from the start of the gradual liberalisation process that started in 1993, Poste Italiane has radically improved its efficiency and the overall quality of its services. Among the several initiatives, the redesign of the overall delivery processes can be outlined, the ongoing reduction in the number of sorting centres, the outsourcing of the delivery of both parcels and registered mail; all leading to an overall employment reduction from 220 000 to 150 000.

These last years (2002-2004) have also witnessed the first profits in 50 years and comfortable EBIT margins that tend to demonstrate that the efficiency improvement efforts of the last decade are bearing their fruits.

The automation of the sorting process is one of the principal efficiency improvements that can be put in place in order to streamline a postal operation.
The impact of the automation driver has much larger effects on the LoC and AvC countries than on the HiC. This indicates that for the HiC, the other parameters defining its vulnerability are more important (postal scale, postal density, labour cost ratio, population density …).

**Proportion of civil servants working for the USP presently**

The USPs that have been able to reduce the relative number of civil servants are likely to suffer less from “social rigidity” in case restructuring would be
required following FMO. Furthermore, these USPs are likely to have lower labour cost.

Figure 28: Distribution of countries across civil servant ratio ranges

Outsourced postal counter ratio

The outsourced (or franchised) level of postal counters may also be considered as an indicator or as a proxy for a measure of efficiency. The higher the proportion of outsourced postal counters the lower the fixed costs borne by the USP.
This table however doesn’t take into account other ways the USPs have to reduce the fix costs of their counter network. Italy has succeeded to have most of these paid by the development of their financial services while France is maintaining counters in remote areas through a system of local taxes alleviation.

In the model based sensitivity analysis, the counter franchising levels are made to vary from 0% to 50% of the total number of USP counters. The table below provides the sensitivity data for each of the representative countries (LoC, AvC and HiC). Some of these results are illustrated and commented in the figures below.
The (further) franchising of the counters shows relatively small effects on the representative countries LoC and AvC because these countries are already (assumed to be) partly covered by franchised counters.

**Development of new products by the USP ((subjective) assessment of the efforts and success of the USP in developing new products):**

An innovative USP looking towards the future is more likely:

- To be able to seize future opportunities,
To reduce the impact of FMO through the development and diversification of products,

To accompany rather than oppose the evolution towards FMO in order to be more prepared than others,

The announcement of FMO alone and the threat posed by substitution services and products has already encouraged the creation of new products, such as hybrid mail, tracking, etc. The same goes for the implementation of efficiency measures. The FMO is not required to foster new product development but it certainly stimulates the management team and tickles the shareholder.

Relative RA margin (subsidy) to total cost of USO

Theoretically, the value of this driver is very close to zero. Indeed, the assumption is that the cost of the USO is balanced by the Reserved Area revenues/subsidy. The more the USO is presently benefiting from RA subsidy (in relative terms), the more the USP is likely to suffer following FMO.

Despite the obligation prescribed by the First Postal Directive related to keeping separate accounts (that allow for distinction of reserved area and non-reserved area, itself separated into universal service related services and other services) and to the supplying of detailed accounting information in confidence to the Commission, most USPs were unable to provide the requested information. The reasons invoked for not supplying the data mainly relate to confidentiality or availability issues.

Taking this incompleteness of data into consideration, it should be nonetheless clear that the abolition of the Reserved Area will be a greater hardship for those USPs that have larger revenues and larger margins on single-piece mail and on transactions mail benchmarked to single-price prices. Model results below illustrate this intuitive point.

Allocation of postal counter costs to activities (total (postal) counters costs associated to financial, logistics, retail and other non-postal activities / total counters costs):

A further driver of a USP’s ability to prosper under FMO is the extent to which the USP is positioned to capture network economies of scope from offering products, such as financial services, through its counters. Such complementary services would then the share of counter (fixed) costs associated with the USO and provide synergies within the counter activity.

It should be very clear that an extended product line, whether in financial services or in logistics or other areas, could provide both a source of additional cash flows as well as diversification and opportunities for employment flexibility.
Management ability to restructure

The rationale behind this measurement implies that if USP management is dependent on the State, then they will likely be forced to take into account elements that go beyond purely financial and economic factors. A management with tied hands is also less likely to adapt to FMO, the USP being therefore more vulnerable to FMO.

While considering the positioning of a USP in terms of its ability to restructure, the ownership structure provides a proxy by which it is possible to assess whether the management team of the USP is constrained or not by eventual agendas dictated by political reasoning as opposed to profitability and other commercial objectives.

Nevertheless, ownership alone does not delineate the accountability of the management of the USP as it must be assumed that state ownership will not consistently hinder commercial restructuring processes.

Commercial freedom and management's ability to restructure

From the observations deriving from both the desk research and interviews with the postal operators, it appears that there are 3 levels of commercial freedom in USP management across operators, and these levels are not directly related to the ownership structure. These 3 levels can be described as follows:

Limited margin of manoeuvrability within a state controlled structure. The management team will not be in a position to take the often-necessary measures in order to improve the efficiency of the operator. Nevertheless, the state can pursue other objectives through its postal operator, like maintaining employment, social cohesion and territorial cohesion.

Commercial freedom within a state controlled structure presents a degree of liberty sufficient to allow for some latitude in restructuring efforts. This management latitude is more likely to cause restructuring resistance because of the potential social implications of such a restructuring.

Full autonomy of management, theoretically offers the easiest environment for restructuring the operator. Needless to say, social partners, namely the unions, may still have a strong influence on potential restructuring processes, but this is not likely to be as strong as that of the public shareholder.

In the European postal landscape, a vast majority of operators are to be categorized within the first type of ownership, namely with only a limited accountability.

(…)

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With the exception of Austria (IPO ongoing), Belgium, Denmark, Germany, Netherlands, Italy and Malta, all postal operators considered in this study are fully owned by their respective States either directly or via financial vehicles such as public investment companies.

Out of this group of 6 countries whose postal operators are owned conjointly by public and private shareholders only 2 countries are majority controlled by a private shareholder, namely Germany and The Netherlands.

As mentioned above, the ownership structure must be considered conjointly with the willingness and/or ability and/or political freedom of the government to engage in restructuring processes. Indeed the ownership structure should be regarded along the political positioning of the government and the prevailing social environment. Also, it is needless to mention here that the alignment of both the management's vision and the willingness of the policy maker can grandly contribute to the success of any improvement endeavours that would be launched.

To illustrate this point, there appears to be considerable variation in the attitude towards restructuring across countries. For example, Norway Post has gone through a very successful cost-savings program and numerous efficiency improvement initiatives. A further interesting example is Swedish Posten AB, which engaged in restructuring efforts focusing on its mail business that were met with strong resistance from the Swedish national union of postal workers. Despite this tense environment, the management team carried forward and engaged in the restructuring with the support of the government (whose coalition has remained in place for the last 30 years). This particular case demonstrates that political willingness can overcome resistance and hurdles.

The Swedish case to some extent contradicts the commonly held belief that says that a public ownership ties management hands and therefore hinders restructuring efforts. Indeed, one can note a general tendency in recent years toward an interest in improving the efficiency of public services as more demanding public consumers look for better quality and prices from their public providers, just as they do from privately provided goods and services.

In the context of the overall European internal market development and its associated liberalization initiatives and efforts, this trend will most probably persist and it clearly comes out of the interviews that the liberalization process - if not the only trigger to efficiency improvements - has certainly played a major role in the stimulation of said improvements within the postal operators.
Political willingness to modify USO characteristics

In continuation of the above, this evaluation aims at assessing the perception of the willingness of the policy makers regarding the eventual reduction of Universal Service levels in terms of:

- number and reach of counters: reduction of the level of fixed costs is important, where not supported by demand or other activities, but this may be prohibited by political barriers

- quality of service: reduction of the level of costs incurred through peak loads and night shifts to assure historical levels of service quality may be important, but may be prohibited by political or labour union barriers

- product scope: reduction of the level of costs in providing all services at all counters or at uniform levels of service across all delivery areas may be dictated by low demand and willingness to pay conditions, but may be opposed politically

One of the characteristics of the USO that has been assessed separately in country interviews concerned the price capping (affordability) of tariffs. Figure 21 positions the countries in terms of political willingness, both in reducing USO levels and in increasing USO product tariffs. It should be emphasized that these represent the views of a variety of respondents from each country, including labour representatives, NRAs, USPs and competitors, but they are not the result of a public referendum or a poll of members of parliament in these countries. The latter could well yield rather different outcomes.
increases in USO tariffs may provide a solution in case of FMO (cfr. Swedish case briefly described below), but it requires political willingness to decide to do so. Note that these increases are more than likely to fall on the household and SME sector and not on major mailers, who would tend to see decreases in tariffs.

For example, changing the minimum service level requirements would clearly have some effect in reducing the magnitude of the cost of the USO, effectively by lowering the cost of service in high-cost areas. Similarly, modifying the range of services would impact the burden of the USO, as for example in the Netherlands where bulk mail (direct mail) is not part of the USO.

Another alteration in the USO that could be implemented concerns the transit time. The quality of service required by different customers differs widely, for instance the household and the SME consumers tend to be less sensitive to transit times. As an example, First-Class (overnight) mail in Sweden is cited: today the USO covers overnight mail and the price thereof is capped. The cost of operations linked to overnight processing is the highest cost driver for the Swedish post although this service’s demand is in decline. The speed of delivery linked to the USO could be reduced in order to lower costs. Another option with
similar effects would be to extract the overnight mail from the USO and hence allow price adjustments. Both options would allow the USP to either reduce cost of operations or increase revenue. Depending on the financial needs required for the rest of the USO, this margin could be allocated to the remaining USO.

The effect of this increase in tariffs must be tempered by the relative low size of the basket of postal service. As an example, in the Netherlands, the average size of the basket of postal services is around 22 euros per year.

**USP Efficiency Level and Triggers for efficiency improvement initiatives**

Efficiency improvements can be prompted by several signals among which the most obvious is the profitability erosion. The following are the main triggers that were identified through the analysis:

- **Decreasing volumes:** additionally to the loss in revenues, decreasing volumes drive unit costs up by affecting fixed cost distribution on volumes. This decrease in volume is caused by either substitution products and/or services or by market share loss due to increased competition from other operators. (Nevertheless, in countries such as Greece the volumes have increased by 30% in the last 6 years.)

- **Productivity increase potential:** historically less efficient operators may be hampered by heavy and costly processes as well as with inherent inefficiencies that can be removed by way of improving processes and/or technologies

- **Profitability constraint:** some operators may not be profitable at all in which case efficiency improvements are to be envisaged were the operator (and the underlying owner) wanting to return to profitability

- **Upcoming FMO:** in view of the anticipated FMO most postal operators have taken measures in order to cope with the potential threat of the market opening and the subsequent future intensified competition

- **New technology:** the conception of new and more cost efficient technologies may of course be adopted hence improving overall efficiency

- **Quality of service:** increased expectations in terms of quality of service (date certain delivery, value added services,....) and demand characteristics can trigger efficiency improvements

Ultimately, the decision to initiate an efficiency improvement exercise is always a direct or indirect reaction to a profitability erosion issue whether it is pre-existing or expected. The observations indicate that a majority of USPs invoke the upcoming FMO as the major trigger for the launch of their efficiency efforts.
2.2.2.3 Conclusions

FMO as an efficiency trigger. The announced FMO already has triggered most Member States and their USPs in transforming their Postal Operators into efficient incorporated companies, offering better and customer oriented services. Given the employment size of the postal operators, the investments required in new distribution and counters networks and the emotional/political impact attached to postal counters and postmen, this change process is taking many years. Quality of service improved, while at the same time profitability increased, allowing IPO’s (Germany, Netherlands, Austria in process).

The social impact of this evolution is generally positive for the global employment in the sector, but the job qualifications and the contractual conditions also move from more generalist civil servant positions to more specialised functions, from management to sales and flexible delivery. The most advanced USPs are already progressively introducing these new forms of flexible contracts in delivery, those who are not there yet will face though competition from new entrants, particularly in the attractive areas.

(see Sections 4.4 and 5.2.3.3 for more details)
2.2.3 Theme 3: The Impact of the Universal Service Obligation (USO)

2.2.3.1 Introduction

Defining the scope of the USO remains one of the most complex questions when assessing the impact of the FMO. The USO is the result of the right of postal users to benefit from postal services in a context where postal traffic still constitutes an essential channel of communication.

Originally, the main objectives when defining USO were to ensure provision of postal services at a predefined quality level, accessible to all throughout the EU territory on a permanent, transparent and non-discriminatory basis, under the control of an independent authority and at an affordable price.

For the last 20 years, the European Commission has worked on the regulatory framework of the postal sector with more recently a view to the Full Accomplishment of the Internal Market for Postal Services. The first stage of the development of the European Postal policy was the Green Paper published in 1992. The First Postal Directive (97/67/EC) that followed in 1997 outlined the basis of the Universal Postal Services. This Directive has been amended in 2002 by the Second Postal Directive (2002/39/EC).

This Second Postal Directive did not bring any modifications to the scope or characteristics of the Universal Postal Services, except regarding the progressive reduction of the reserved area. The reserved area, as defined in the last Directive, is limited to items of correspondence that weigh less than 50 grams and cost less than 2.5 times the basic tariff as from 1st January 2006 and does not concern upstream activities.

2.2.3.2 Main findings, Diversity and Sensitivity

Defining the USO scope - Products under the USO scope

As per the Directive, the USO scope covers postal items, registered and insured items, which covers wide range products from letter items to parcels through newspapers and periodicals. As observed during the interviews, the products scope of USO varies from country to country, but there is a general trend towards a global move tending to reduce the USO scope.

When assessing postal products covered by the USO, the definition of postal items does not always cover the same items as those outlined in the Second Directive. For example, the definition of postal items up to 2 kg may be interpreted in a more restrictive manner namely as items of correspondence or to the contrary as the full range of items that is addressed mail, catalogues, brochures, newspapers and periodicals.

The latitude allowed by the Directive concerning the upward weight limit for parcels allows countries to set up limits on their internal market that differ from other countries. However, the upper weight limit among all countries for
inbound cross-border mail should be equal to 20 kg, as part of the UPU obligation of acceptance for inbound cross-border postal items.

The adaptation of the USO product scope could be more desirable in the context of a more detailed customer segmentation (C2C, C2B, B2C, B2B). USO's prime objective is to ensure that every user can benefit from a permanent provision of postal services at a defined quality, at affordable prices and throughout the entire territory, but different segments may benefit from different adaptations.

The specific case of newspapers and periodicals delivery is worth mentioning. The inclusion or not in the USO product scope varies widely from country to country. Indeed, countries such as France, Italy, Finland, Germany, Denmark, have included newspapers and periodicals in the scope of the USO and in some cases, an important state subsidy is foreseen to cover the associated costs (as it is the case in France, Italy and Belgium)

**Frequency of delivery**

It appears that delivery frequency is a very sensitive aspect of the USO in the European Union. Most of the USO related literature focuses on the delivery dimension of access to the postal services (receiving) although it includes both receiving and sending mail. One of the reasons provided to justify this focus is that delivery constitutes a large part of postal operators' costs.

Although the minimum required by the Directive is one delivery per working day (equivalent to 5 deliveries per week), the national regulations of a large number of countries impose on their operators 6 deliveries per week.

On one hand, requiring 5 day frequency delivery per week, considering the uniformity principle, participates to the burden on postal operators, as certain countries have uncommon particularities that directly affect postal services, like geography in Greece.

Consequently, maintaining or increasing the current delivery frequency level would increase the likelihood that the costs of the USO will not be fully covered (balance to finance). According to a study\(^7\) realised by K. Bergum on the cost calculation of the USO burden, the main costs generated by the USO are due to the combination of uniformity and costs associated with delivery frequency.

On the other hand, from an economical point of view, any reduction of delivery frequency will have a huge impact on the business plan of USO operators, which remains partially unpredictable. The balance has to be made consequently to such frequency delivery reduction. Considering the rotation cycle as being potentially reduced remains a critical issue as the associated costs could not be decreased on the same manner. Balance has to be found between over-costs generated in high level delivery frequency and a lower one.

\(^7\) K. Bergum, “The Universal Service Obligation: a Strategic Perspective on Service Level and Cost Calculating the Burden of the USO – The Norwegian Experience” (2002)
Views on the delivery frequency

The interviews of the different postal stakeholders also show us that a high delivery frequency service is not always required. Indeed, the direct marketing and distant selling businesses which mainly send direct mail (non-transactional mail) do not view high delivery frequency (5-6 deliveries per week) as a must.

This category of mailers values highly date certain delivery for some of the mail they issue (e.g. distant selling catalogues that should preferably be delivered on a Friday or a Saturday). On the other side, some NRA fear discrimination will occur between people living in densely populated areas and those in sparsely populated areas.

This particular need of the direct mailers market segment represents a good opportunity for the new entrants to penetrate the market with specific products and higher quality standards. Most large mailers interviewed would seriously consider a change of postal services provider if the quality of the delivery would be improved. Despite what is generally claimed when considering the market opening, the eventual lower price of the new provider does certainly not constitute the main shifting criteria.

Also, due to the further development of speedy substitution services (email, telecoms…), for some customers the high delivery frequency does not bring any additional value anymore.

In countries like France, delivery includes newspapers that have to be delivered 6 times a week.

The Directive also imposes one clearance and one delivery rotation every working day, not less than 5 days a week. After assessing the situation in European countries, deliveries per week varies from 5 to 6 rotations per week.

One argument playing in favour of 6 deliveries per week is that it is considered as a competitive advantage since mail can be distributed to households when people are free and available.
In some particular remote areas in Finland and Norway, due to specific geographical characteristics, frequency has been exceptionally reduced. Such cases remain marginal.

A general comment can be drawn from the interviews with the USPs in the sense that it is not clear that an eventual reduction of the number of weekly deliveries would lighten the overall cost of distribution. On top of that, in the case of a frequency reduction, the quality of service standards linked to the delivery timing could not be reached anymore.

A reduction of the delivery frequency in rural area is one of the options considered. A reduction in delivery frequency from 6 to 3 in rural area would reduce the balance to be financed for each type of countries (LoC, AvC, HiC) as it will reduce high costs generated in rural area. In the case of the incumbents providing US, it should help him to counterbalance the loss of market share in urban area.

However, the impact in HiC is more consequent due to low volume of rural area in such countries which generate an increased differential cost between urban and rural area. Delivery frequency in rural area constitutes the main driver in terms of USO balance cost that has to be financed.
Figure 33: Sensitivity of the balance to finance and of the number of USP’s FTE to the rural delivery frequency

Accessibility and Density of Counters

As defined in the Directive, accessibility to the Universal Service has to take into account the needs of the users. In a fully competitive market, such considerations are normally directly integrated. However, the current European situation shows numerous biases in the use of such concepts. The main difficulty is to guarantee a balance between the accessibility and the profitability of the network.
On a European level, it can be observed that many USPs are decreasing their network costs by reducing the number of classical access points (public letter boxes and classical post offices). On the opposite, new solutions are developed in order to maintain a certain coverage level through franchising, developing postal points, etc.

**Financing counters: the French alternative**

As for the financing of the counters, the French example is worth mentioning: the recent law on the regulation of the postal services states that the national Postal Operator (La Poste) contributes via its post office network to the regional territory development. The French authority therefore confers on La Poste a role in maintaining and developing the regions both socially and economically.

This subset of the USO is financed by a special fund supplied for the State and the municipalities. Such an alternative financing and separation in the objectives of the USO would clearly separate the role of the post office network as social and economic cement in rural regions from its operational role as an access point to the postal network.

The definition of the postal counter access standards differs from one country to the other. However, it can be observed that the frequency of collection and delivery, the post office geographical accessibility (minimum postal network density, franchising operation level, etc) and time accessibility (opening hours) seem to be the critical characteristics when assessing the scope of the USO.

Some restrictions have also been set on the franchised percentage of the counters. For example, the minimum number of counters that should be operated by Deutsche Post AG staff is equivalent to 5,000 fixed locations. France is preparing rules regarding minimum number of counters based on population coverage, maximum distance standards and types of settlement/municipality (France).
For example, in Sweden, postal services are offered in numerous stores, supermarkets and petrol stations. Nevertheless, the quality of service is well perceived by its customers. The postal network is considered as a competitive advantage for the USP, more than as a liability.

**Pricing**

Because it is subject to interpretation, price capping (affordability) has been interpreted very widely across European countries. These impose price
uniformity, which is different, and at the same time regulate the stamp rate for single letter mail.

It is expected that prices of postal products, due to a market liberalisation, will be more directly correlated to their underlying costs to several postal stakeholders and to the value to the various customer segments.

Moreover, prices of product segments, where the competition is supposed to be important, are expected to decrease due to the competitive pressure. On the other hand, prices, applicable in product segments where there is a low competition level, will probably not go down and a possible increase is not excluded.

Consequently, suppression of the price uniformity will probably affect a particular area of products, namely high quality consumers’ mail and individual business mail. Bulk mail should not be concerned by such prices movements, but would remain stable or come down, depending on the competitive pressure. The example of liberalisation in Sweden shows price increases of 90% for single letter mail, VAT effect included, but the resulting rates are still at European average. By contrast, bulk mail volumes have decreased by 40%.

Today, pricing modification often require the agreement of the National Regulatory Authority. Currently, almost each Member State has its own definition of what affordable prices means to postal users. The following table provides the letter price adjusted for purchasing power parity.

Assuming “standard” physical network characteristics (i.e. standard unit production cost), “standard” USO constraints and the fact that the USP balances its accounts (taking into account the RA subsidy) through an average regulated tariff (with the price of the first step as proxy), the below rate of the first step is also a proxy to measure the efficiency of the USP.
The Impact on Universal Service of the Full Market Accomplishment of the Postal Internal Market in 2009 - Final Report

Figure 36: Letter price adjusted for purchasing power parity

<table>
<thead>
<tr>
<th>Country</th>
<th>Price in PPP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.85</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.71</td>
</tr>
<tr>
<td>Italy</td>
<td>0.68</td>
</tr>
<tr>
<td>Greece</td>
<td>0.67</td>
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<tr>
<td>Lithuania</td>
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<td>Portugal</td>
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</tr>
<tr>
<td>Finland</td>
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<tr>
<td>Norway</td>
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<tr>
<td>Austria</td>
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</tr>
<tr>
<td>France</td>
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</tr>
<tr>
<td>Sweden</td>
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</tr>
<tr>
<td>Germany</td>
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</tr>
<tr>
<td>Belgium</td>
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</tr>
<tr>
<td>Latvia</td>
<td>0.54</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.53</td>
</tr>
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<td>Czech Republic</td>
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<tr>
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<td>Switzerland</td>
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<tr>
<td>Luxembourg</td>
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<td>United Kingdom</td>
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<td>Ireland</td>
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<tr>
<td>Cyprus</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>Spain</td>
<td>0.35</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.3</td>
</tr>
<tr>
<td>Malta</td>
<td>0.26</td>
</tr>
<tr>
<td>Average (New Member States Excluded)</td>
<td>0.54</td>
</tr>
<tr>
<td>Average (New Member States Included)</td>
<td>0.55</td>
</tr>
</tbody>
</table>

The prices adjusted for Purchasing power parity are a fair indicator of price levels across countries.

Uniformity principle is not required by European Directives. According to European regulation, uniform pricing might be imposed in case of national authorities assumed this is necessary measure at a national level for keeping market equilibrium. It can observed that almost all USPs apply the same national tariff for letter mail (first class and second class), and many of them do the same for mail and parcels as well. National legislation does not always exist in each country about uniformity or be restricted. The 2005 postal law in France limits the uniformity obligation to the single piece mail in the reserved area.

Because affordability (price capping) is a constraint with a large impact on the USP balance to finance, it is simulated that the USP is allowed to increase its tariffs so as to cover its costs: first only for the Business customers group (large

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8 "Letter prices in Europe", Deutsche Post World Net (2005)
companies and governmental agencies), and then for all customers of types B and C. Considering the outcome of the balance to finance with constant tariffs under FMO, the following graph shows that allowing commercial freedom for segment B in the market would have different impacts depending on the group of countries discussed, growing from LoC to HiC clusters. Effects will remain negligible for LoC countries, and will remain limited for AvC. On the other hand, a significant impact can be expected on countries with characteristics similar to the HiC country. For HiC countries, price increases for both B and C market segments would result in a significant reduction of the balance to be financed and (as shown below) also to significant price increases in the affected segments.

**Figure 37: Sensitivity of the balance to finance to a relaxation of the fixed price constraints**

![Graph showing sensitivity of balance to finance](image)

Price increases should allow USPs to reach financial equilibrium but not when doing so only on B customers.

To complete previous observations, this would clearly contribute to increase the market share of new entrants, exception made of new entrant market share in rural area for LoC countries.
In case of relaxing the constant price constraint for both on B and C customers segments, USP is anticipated to react with a strong increase of its prices in both segments in the HiC type of country. In comparison, required price increases for breakeven operations for LoC and AvC would be more moderate according to the model.
When assuming relaxing the constant price constraint for B customers, it is noted that such relaxation will have a significant impact on USP price B customers, as relaxing the constant price constraint on B and C customers will have a lower impact on USP prices for B customers, since the USP will absorb the negative financial balance through increasing prices for C customers.

Finally, following the model results, the constant pricing constraint (affordability) suppression will allow the development of an alternative network in rural areas in each representative country.

The uniformity of pricing is, with frequency of delivery, a critical factor in the postal business process. It can seriously hinder the full market opening.
Differentiation has to be made between the single-piece mail and bulk mail. Relaxing the uniformity is critical for bulk mail, allowing price differences for urban and rural, depending upon the distance. Furthermore, relaxing pricing uniformity will increase the importance of other general pricing principles such as transparency and non-discriminatory principles.

Concerning the singe-letter mail, on a theoretical view, a suppression of the uniformity would allow postal operators to develop further their pricing, based on distance or geographic area for instance. But, on a practical view, a suppression of the uniformity would also generate some supplementary costs, in term of education and enforcement. Another possibility could be the instauration of different rates based on routes profitability level. However, such implementation would significantly increase the complexity of postal services and would probably extend postal systems enforcements. At this point, it is not clear if additional revenues will or will not be offset by the additional transaction costs that a uniformity modification will produce.

Suppression on the uniformity on B and C customers segments will generate higher USP prices for B customers in rural area and lower prices for B customers in urban area. Funding postal services in rural area through urban area will not be required anymore. Urban area will be less impacted by the new entrants due to the facts that USPs will be more competitive. Total impact will be positively correlated to the urban area size.

**Quality of service**

Practically, all the countries have standards of quality that are based on the intra-community cross-border quality standards. In some case, incumbents have some difficulties to respect the standards incorporated in each Member State’s regulation. It is also the responsibility of each Member State to arrange independent monitoring of Universal Service quality standards and for the publication of the results.

Quality has a huge impact on costs, particularly for delivery in remote areas, but the requested automation to achieve these targets have been implemented, or are in the process to be implemented, both to avoid substitution and in view of the FMO.

Regarding the quality of the services and the customer satisfaction, several measures have been taken to handle this key issue. On a customer satisfaction view basis, national regulators have constrained their postal operators to take into consideration the consumers issues by an active monitoring of their customers relations. This has been done by a more general assessment of the services provided by postal operators in the USO context and is generally included in the management contracts of postal operators.
2.2.3.3 Conclusions

- **USO as a guaranteed quality.** The USO as defined in the Directives had so far a positive effect on quality of service. Member States sometimes get exception to these rules, for example for delivery frequency in remote areas, like in Greece. But most Member States implemented USO with broader definition than defined in the EU Directive, particularly on issues like counters, delivery frequency, and uniformity of tariffs. This was often justified by a tradition of public administration, and numerous civil servants.

- **USO as an adaptation to customer needs.** In an open market environment, USO should be defined looking at customer (both sender and receiver) expectations, and at economic costs. There is in fact no need for an obligation, when the market is providing the expected service, but this obligation has a cost in principle. Some argue that USO also represents a competitive advantage, with its network and delivery frequency.

- **USO versus commercial freedom.** Member States should be very careful in reducing USO, but should leave the biggest commercial freedom to USP in how to implement USO. Counters need to be accessible, this can be achieved outsourcing them or sharing them with financial services. Uniformity of tariff could be preserved for single letter mail, for practical reasons, but should be suppressed for bulk mail.
2.3 Competitors and New Entrants

In several countries, competition has already been present for some time on different segments of the postal market. The main segments of the postal market that have attracted the interest of the competition include the newspapers and press delivery, the bulk mail in general (above reserved area limits and the direct mail in countries where it isn’t reserved area), the date certain delivery products, and of course the non-addressed mail (although it is not perceived as being part of the postal market).

One may note that the entry strategies differ widely from country to country. The origin of the development of the competition ranges from the logistics business that diversified in the mail business (e.g. BD in Belgium) to the pure new entrant (e.g. Sandd in the Netherlands) or to the development from a press group (e.g. Adrexo in France). All these actors were attracted into the postal market while identifying opportunities. The outspoken strategy of Sandd is to "penetrate the cash-cow segment of the market" whereas another operator wants to by an "end-to-end postal operator providing integral service" that is from design and printing to final delivery.

In a context of overall decreasing mail volumes and slightly increasing direct mail volumes (depending on the market of course), the existing market players rely for their development on the growth of the direct mail as an advertisement medium and on the capture of market shares from the incumbent. Some competitors claim they could still thrive in a zero growth market by simply gaining market share from the USP.

The typical market for the competitors is the bulk mail (pre-sorted or not) delivered in the urban zones or intercity. Of course un-addressed mail remains well represented in the product offered as well as the newspapers distribution.

On top of the obvious suppression of the reserved area, most of the competitors sounded through the interviews mention the following main barriers to entry to the postal market:

- Insufficiently regulated access to PPN;
- Dumping on prices by the incumbent operator;
- VAT exemption of postal operators;
- Access to addresses database (change of address, re-expedition, PO box access);
- Letter boxes access (digital codes or keys);
- Standards (sorting, addressing);
- Constraining licensing schemes;
- Access to Terminal Dues agreements conditions (Reims III);

It is worth mentioning that a vast majority of competitors foresee that the FMO will be an opportunity to create employment in the postal sector. This optimism
contrasts with the common perception that the USPs will suffer from both the overall reduction in mail volumes and the capture of market shares by the new entrants.

Competitors in the postal sector adapt rapidly to the customer needs. For example, following a market survey, CityMail in Sweden adjusted its offer and reduced the product scope by eliminating the distinction between First (overnight) and Second Class mail.

Some characteristics of the USO such as the delivery frequency are not considered by most competitors as essential to the postal service. Indeed, these operators put more emphasis on the date certain delivery rather than on the frequency. This alternative product feature allows their customers to better target their audiences (e.g. mail delivered on the last day of the week to ensure attention during week-end) and to better plan within their organisations (e.g. customer services availability in the mail order business).

Most new entrants/competitors also differentiate themselves from the incumbent postal operators by proposing more attractive pricing, but using advanced addresses databases.

On the side of the customers, the vast majority of Large Mailer customers interviewed are looking forward to the opening of the postal market as they are all convinced that FMO will induce a decrease in prices and an improvement in quality.

This perception is not shared by Household customer's representatives as they seem to be more cautious when assessing quality of service modifications.
2.4 Regulatory Policies

An exhaustive assessment of the drivers impacting the introduction of FMO also requires addressing a broader range of issues dealing with Regulatory Policies and USP Strategies, as they can be developed in anticipation or following the introduction of FMO.  

In fact, assessing the impact of FMO involves assessing both how the market actors, USP and new entrants, evolve to adapt themselves to FMO, to enter a new market or protect their markets as well as how the regulatory environment sets the scene for this competition.

An example of how regulatory policies may affect the level playing field can be found in countries where, as opposed to the neighbouring countries, no plans for deregulating the market have been put in place. This will constitute a considerable advantage for the said national operator since it will prevent entry in the domestic market while at the same time allowing the operator compete in neighbouring countries already open to competition. Potentially, this time edge could allow the said national operator to better prepare in view of the opening of its domestic market.

Regulatory Policies can potentially raise significant barriers to entry to the postal markets at stake. Among those, the main ones that can be listed are the following:

**VAT exemption of USP**

On the basis of the 6th VAT Directive and depending on national circumstances, USPs are totally or partially VAT exempt regarding Universal Services. Consequently, depending on the applicable VAT rates, VAT exempted operations of the USPs benefit from a price differential for all customers that are also VAT exempt directly related to the VAT rate applicable to non-exempted postal activities and operators. On the other hand, new entrants do not benefit from the same VAT advantage.

This positive effect that benefits exempted activities of USPs is negatively compensated by the limited possibility of VAT exempted USPs to reclaim VAT on their inputs.

However, in view of the labour intensive nature of the postal sector, this second negative effect is usually considered as being less important than the former positive effect. Indeed, VAT exempt customers\(^\text{10}\) can represent a significant part of the USP mail volumes since they often include: public bodies, insurance companies, banks, healthcare institutions, charitable institutions and final consumers (as well as sometimes specific SMEs).

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9 We note the extensive review of the impact of regulatory policies on European postal services presented in WIK (2005) to which the reader is referred for additional and extensive discussions about the role of postal regulation before and after FMO.

10 See VAT 6th Directive for a full list of VAT exempt services.
Thus in general, the broader the VAT exemption of USP and the higher the VAT rates, the higher the competitive advantage benefiting the USP for VAT exempted customers.

Postcomm estimates\textsuperscript{11} for instance that the price advantage of Royal Mail, which is VAT exempted for all its activities, is in the range of 13% for VAT exempted customers.

The presence of USPs that are VAT exempted for only some of their products and are therefore required to levy VAT on other products may lead to even more complicated and more biased cases. Indeed, depending on the cases, such a USP can be exempted from levying VAT on some of its products, the advantages towards exempted customers being maintained, while at the same time the USP can reclaim VAT on all or part of its inputs, the disadvantage towards non-exempted VAT customers disappearing.

Finally, one should also stress that the VAT exemption of an USP will also potentially affect USP activities that are outsourced, since outsourcing can also affect its capacity to reclaim VAT.

\textit{Constraining licensing regime}

Despite the full opening of the Finnish postal market, Suomen Posti still virtually holds the totality of the market (circa 99%). The licensing scheme imposes indeed a full geographical coverage on candidate new entrants. The costs of setting up the network that would allow such coverage are literally prohibitive and indirectly prevent any entry in the market. A similar licensing scheme is also in place in Estonia.

On the other hand, entry barriers in the Netherlands are relatively low as new entrants are not required to obtain a license in this country. Although the market is already partially opened, TNT expects that upon FMO most of the entry will happen in the 2 days delivery direct mail segment.

\textit{Access to letterboxes and other typical postal assets}

The Austrian locked letter box is a good example of a barrier to entry that prevents a level playing field. Around 60\% of the letter boxes in Austria are closed and accessible only to the incumbent who holds the so-called Z-keys needed to access the letter boxes. Today the competitor needs to place the mail in a plastic bag and hang it on the front door of each individual household that is being delivered.

Recent regulation (Postgesetz) foresees that access to closed letter boxes will be given to private postal operators before 1 July 2006. The cost incurred for the necessary modification of the letter boxes (estimated in the range of 40 EUR per letter box) in order to allow access by several postal operators will be borne by either the Austrian Post (for buildings built before 1972) or the owner of the building.

\textsuperscript{11} Postcomm, Competitive Market Review, November 2005
The impossibility of access to letterboxes by entrants may drive additional disadvantages for competition. Such disadvantages arise, for example, from the fact that Austrian Post delivers un-addressed mail in the closed letterboxes (with a higher impact than that of un-addressed mail delivered in a plastic bag-readily disposable).

So far, such disadvantages have not been recognized as a breach to competition law. However, the Austrian government recognizing the unbalanced situation, is currently investigating a new postal regulation that would restrict delivery to closed letter boxes to addressed mail only.

Next to the typical and obvious restriction of access to the letterboxes presented above, other access restrictions preventing or limiting the entry of new entrants are also often mentioned, such as the ones shown in the figure below12.

**Figure 40: Barriers to entry**

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12 Ecorys 2005
2.5 Combined Effect Analysis on Representative Countries

As indicated in Section 2.1, the impact of introducing FMO in the three Representative Countries as defined in Table 1 differs significantly depending on their profiles.

Following the description in the previous section of the main drivers impacting the introduction of FMO, this section focuses on the combined effect of the various drivers characterising simultaneously each postal market and USP.

The important diversity among postal markets is, as indicated previously, one of the main elements to be taken into account when assessing the impact of introducing FMO.

The below figure illustrates the sensitivity of each of the countries, when changing the value of one of the key parameter characterising a Representative Country (e.g. HiC) to the value of the same parameter associated to another Representative Country (e.g. LoC), these 3 key parameters are:

- Labour ratio,
- Postal Scale, and
- Urbanisation rate (Density).

The following figure indicates the path followed while changing successively each of these three key parameters that characterise a Representative Country, when it is confronted with FMO and with a price capping (affordability) constraint, defined in these examples as a cap to the unit product tariffs imposed to the USPs.
The following figure complements the previous one. It indicates the same relation between the three Representative Countries envisaged, these countries being this time confronted with FMO with commercial freedom. In other words, in this case, the USP is by definition free to set tariffs at cost levels: its Balance to finance being consequently is reduced to zero and replaced by a tariff increase compared to the pre-FMO tariffs.
The following comments can be made:

- **Impact of postal scale**: potentially very important impact of the postal scale for the most sensitive countries (HiV), the impact of the same driver appearing much less important at average to high Postal Scale. Consequently, particular care should be taken of market with low to very low Postal scale. All efforts should be made to develop these markets, which will benefit the customers and the market of postal services in general.

- **Impact of Labour cost ratio and postal Density (Urbanisation rate)**: for both these parameters, the sensitivity appears similar moving from HiC country to AvC countries and from AvC countries to LoC countries. Furthermore, the “cumulative” effect associated with reducing the Labour cost ratio from HiC to LoC – which, conversely to the Urbanisation rate (Density) is an endogenous factor – allows to reduce significantly the USP market share loss as well as, though to a lesser extent, its balance to finance. In other words, one can consider that USPs characterised by a unfavourable high Urbanisation rate and a high Labour cost ratio (important differential labour cost between the USP and the new entrant) would actually not be significantly worth off than an USP benefiting from a favourable Urbanisation rate and an
unfavourably low Labour cost ratio. In any case, actions are needed to have similar employment conditions for all market players

- **Combined effect:** while, with the exception of the Mail scale, the variation in Urbanisation and Labour Cost Ratio have independently moderate impacts, the combination/addition of those variations may lead to significant variation in the impact of FMO.

- **The relaxation of the constant price constraint** (which, when it is imposed is replaced by a Balance to finance in the modelled situation, hence a subsidy of one form of another) exacerbates the influence of the postal scale.

In conclusion, actions on postal scale and labour cost alignment transform high impact countries into average impact ones, the handicap of low urbanisation having a relatively low impact.
2.6 Scenarios Analysis

The figures reproduced in the previous section are associated with representative countries confronted with FMO, both with and without imposing on the USP a constant price constraint.

Depending on the cases, the introduction of FMO will trigger successive reactions from the market participants: USP, authorities, entrants and clients. Depending on its final impact – possibly on a market-by-market basis – the FMO, as initially defined for the purpose of this project, will need to be adapted to mitigate the impact of its introduction.

In summary, following the introduction of FMO in postal markets, one can expect that:

- USP will continue to improve their operations so as to get the gain of FMO, such a process having been already initiated in most if not all USPs – but at different paces – triggered among others by the previous partial postal market openings;
- Authorities will reflect upon the actual users’ need in term of US. This may lead to some adjustments of the USO, for instance in terms of US uniformity, US affordability, US product scope, US service levels under specific circumstances, US services quality under specific circumstances, etc.;
- … and of course,
- Entrants will seek to gain market share whenever they can generate a positive margin; and
- Clients will switch towards the postal providers that best suit their needs.

The introduction of FMO in the various markets considered is mapped below with the modelled evolutions of Representative Countries going through the following cumulative situations, called Scenarios. Moving from one Scenario to the next one, all Scenario characteristics remain unchanged, unless the new Scenario specifies otherwise. The successive Scenarios are presented in the following diagram.
2.6.1 Definition of the Scenarios

The successive Scenarios that have been defined can be summarised as follows. Each Representative Country is determined by a given set of parameters, among which:

- “market parameters” such as the postal scale, postal density, urbanisation, etc., and
- “scenario parameters” associated to either regulatory and efficiency changes, in particular: level of automation, presence of a price uniformity constraint, ratio of counters franchised, reduction of counters (compared to initial situation), presence of a price capping (affordability) constraint.

Thus taking for each of the three Representative Countries described at the beginning of this Chapter and taking the initial USO constraints, the Scenarios are associated to successive and cumulative changes of the above “scenario parameters”:

- **Scenario 1: USO + FMO**: this presents, for each of the three Representative Countries, the impact of introducing FMO in a market, and thus on a USP, that is subject to the current USO, including the price capping (affordability) constraint. FMO is characterised as follows:
  - Full suppression of any reserved area;
• Provision of a negotiated access to the PPN;
• Initial efficiency (estimated through a rate of automation) associated to the Representative Country case.

- **Scenario 2**: USO + FMO + Internal efficiency measures: in the second stage, technological and organizational efficiency improvements and counters franchising are implemented by the USP:
  
  - Franchising of a minimum of 20% of the counters – this therefore “forces” the HiC country to increase its franchising rate from 0% to 20%, but does not affect the AvC and LoC cases that had already reached respectively 28% and 46% of franchising prior to FMO;
  
  - Automation of 90% (for the sorting and 75% for the sequencing activities respectively), this change impacting therefore both the HiC and AvC countries (that come from a 10%-10% and a 50%-25% automation rates respectively) but not the LoC country that already achieved a reduction of the manual sorting and sequencing to 10% prior to FMO.

- **Scenario 3**: Scenario 2 with a relaxation of the uniformity constraint imposed on the USP for B-originating products. In fact, this corresponds to the suppression of the uniformity constraint, both for E2E (end-to-end) traffic and access tariffs for B customers and for all non-Letter Mail products.

- **Scenario 4**: Scenario 3 with a relaxation of the constant price constraint imposed on the USP. Finally the price capping (affordability) constraint is relaxed and tariffs are fixed by the USP in order to balance his current account: if any, this change absorbs the USP deficit that is associated to the USO.

Two additional scenarios are also introduced for countries that may deem necessary to adapt the level of the US. These two scenarios start from Scenario 3 and are associated to:

- **Scenario 3-bis**: Scenario 3 with a reduction of the number of counters by 20%.
- **Scenario 3-ter**: Scenario 3-bis with an additional relaxation of the USO rural coverage modelled as a reduced frequency in rural area (from 6 to 3 deliveries a week in rural area only) combined with a reduction of the delivery coverage of the rural area of 20%.
- **Scenario 4-bis**: Scenario 3-ter with a relaxation of the price capping (affordability) constraint imposed until now to the USP.

### 2.6.2 Results for Representative Countries for Various Scenarios

The following figures illustrates the evolution of the balance to finance and the new entrant market share while progressing from Scenario 1 (USO+FMO) to Scenario 5 (relaxation of the affordability or constant tariff level constraint).
Following initial conclusions can be drawn:

- First, efficiency improvements may have significant impacts and, in effect, allow for an important reduction of the USP balance to be financed, except in the case of HiC markets. This first result is key since it demonstrates that efficiency gains are crucial and that for most countries, these would significantly reduce the impact of FMO and allow efficient USPs to provide Universal Services without difficulty. The important of embarking on restructuring programmes and securing efficiency gains ahead of FMO to allow USPs to protect their market share and continue providing Universal Services appears again as a key element of the reform.

- Second, under the AvC case, i.e. under average market conditions, the combined effects of the both efficiency gains and the suppression of the uniformity constraint for B-originating products suffices to nearly reach break even. The following relaxation of the price capping constraint induced consequently a limited tariffs increase and hence a limited further market share reduction of the USP.

- Third, in the HiC case, the effect of the relaxation of the uniformity constraint allows the USP to significantly reduce its Balance to finance. However, it apparently does not suffice to reach levels of Balances to finance that are of the same range of in AvC countries. In these
countries, flanking measures are needed, for playing on the labour cost, or on the market development. Higher quality could also generate a lower demand elasticity than the one used in the model. In between, compensation funds or state subsidy might be required.

- Fourth, in LoC country, it appears that the impact of introduction FMO can be effectively mitigated by both efficiency gains and the suppression of the uniformity constraint. This further confirms that FMO is possible and that under several circumstances, USP benefiting from natural economic barriers such as their economies of scale and scope do not need market protection to keep their market share.

In conclusion, low impact countries can maintain their USO financially viable, with limited market share to the new entrants. The same applies for average impact countries, with a higher market share to new entrants.

High impact countries only will be able to maintain financial sustainability of USO through increased efficiency of the USP, non-uniform pricing and price increases, but this will be lead to very high market shares to the new-entrant. Flanking measures will be needed to avoid this evolution, amongst which increasing the fidelity of bulk mailers offering them better service, and avoiding social competition imposing similar labour conditions to USP and new entrants.
2.7 Country Readiness Scorecard

During the project, while assessing the country specific FMO impact, each country expert gathered objective data and produced subjective assessments associated to 4 dimensions that are considered illustrative of the country readiness to be confronted with FMO. These 4 dimensions cover the themes previously described in this chapter and will allow for an evaluation of each country on each of these dimensions:

- Market Characteristics Favourable to Efficiency Gains and to the Establishment of Workable Competition under FMO.
- Current Status and Market Orientation of Postal Regulatory Institutions
- USP Preparedness and Adaptability for FMO.
- Market Alignment of the USO.

Within each of these dimensions several indicators are used to evaluate the readiness to FMO of the country. These indicators are listed in Annex A, which also outlines the calculation and consolidation methods that led to the rating per dimension.

The ratings must be interpreted along the scale on which the value 1 represents a low FMO orientation. A country showing for a specific dimension - e.g. 'Market' - a value nearer to 1 (minimum value) would present a situation in which the conditions would not be highly favourable to FMO with for example a relative low postal scale, a relative low ability of entrants to maintain or gain market share.

To the contrary a rating value of 5 (maximum value) represents high readiness, orientation, adaptation or alignment accordingly.

It must be noted that each synthetic dimension rating is calculated with indicators that can be based on either objective data or PwC assessments.
### Table 4: FMO Readiness by Dimension

<table>
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<th>Country</th>
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<th>Regulatory</th>
<th>USP</th>
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These 4 dimension ratings were then processed in a second stage in order to compute a Country FMO Readiness Index. A weighting was applied to the 4 dimensions of respectively 1, 2, 2 and 1 in order to incorporate the relative estimated importance of each of the dimensions. Indeed, the orientation towards FMO of the regulatory institutions and the USP preparedness and adaptability have a greater effect on the overall state of the readiness of a country.

The data was normalized with the purpose to represent the data around an average value of 100.

The results of the Country FMO Readiness Indices are presented in the figure below. They represent the synthetic view of all 4 dimensions discussed above.
Figure 45: Overall FMO Readiness Index
2.8 Summary: Key Issues, Key Drivers, Key Findings

Several lessons can be drawn from the studies and analysis carried out in the course of this project and that have been outlined in the previous sections.

First, assessing the impact of FMO in postal markets is a very delicate exercise mainly because of the important number of parameters to be taken into account and the important variability of values of those parameters. Furthermore, by definition, the study is to look across a wide range of countries and can therefore not focus solely or develop a particular approach for each of those markets.

In fact, when considering so many postal markets, those are such complex “systems” that considering exhaustively all parameters that may have an impact in each market would lead quickly to the conclusion that each situation is unique and hence impossible to be compared with other situations. This difficulty is even worsened when gathering information among market actors’ representatives which have – by nature – private interests and therefore perceive and present their views of the anticipated reform and its impact.

To address this situation, an empirical approach and a conceptual approach were combined.

The confrontation of both approaches has demonstrated that the conceptual and the empirical approaches concur in term of trends: the experts’ judgments and model estimates indicate similar trends;

… but experts’ judgments are usually not able to “size” the impact of the introduction of FMO – the conceptual approach being therefore inescapable: consequently, experts’ judgment is difficult to “reconcile” amongst countries, a comparison of the FMO introduction impacts across countries being therefore not feasible if based solely on experts’ judgment;

… and the conceptual approach benefited from the exchanges of views and was consequently fine tuned during the project: while confronting the model results with numerous practical cases, several improvements and fine tuning were introduced in the model recognising the complexity of the situations but keep a single model for all situations, adapting the model through parameters;

… but the conceptual approach, which complements and moderates the experts’ view, cannot provide the final answer: indeed, any model seeking to map such complex system as a postal market has limitations. Furthermore, key parameters – despite the number and importance of the postal studies and literature, in particular the market demand (elasticities and loyalties) parameters remain largely unknown, while their impact on an open market is and will be key.
Nevertheless and despite these difficulties, following the interviews and production of the model runs made during the project:

**FMO can be introduced without impacting the Universal Services.** However, this requires an understanding that market will be complementing and replacing the functions of the traditional Universal Service Provider for business customers and that pricing uniformity requirements and other market-impeding restrictions on business products be relaxed; this will allow the full development of competition in the business segment, with the positive effects already observable on innovation, new products and services. Where possible, new entrants show they serve specific market requirements, particularly in direct mail, with a new business model. This might generate more traffic for the incumbent, if downstream access is promoted and used. This competition also has a stimulating effect on the USP, forcing him to innovate and to adapt quality to customer’s expectations.

**Wide variety of country specific situations (diversity) and some situations may lead to potentially sizeable impacts from introducing FMO.** While practical cases demonstrate the feasibility of FMO, recent progress achieved following the previous gradual market openings of the postal markets indicates that postal markets and USP can adapt to a large extent ahead of them and that FMO can be introduced in most markets without significant adverse consequences.

However, in countries confronted with the combined effect of several unfavourable conditions (such as low operational efficiency levels, low postal scales and population densities), introducing FMO may prove difficult and a funding mechanism or other flanking measures may be provisionally required (these will be described in Chapter 3); this should allow the Member States to progress in the restructuring of their ex-postal administrations in efficient enterprises, able to compete in an open market. A key condition here is to put in place similar working conditions for all operators in the postal market, to avoid social competition.

**Both exogenous parameters and endogenous parameters are to be considered.** And addressing the endogenous factors can have significant positive effects in conjunction with FMO: exogenous factors such as population density and other geographic factors differ among countries and lead to different FMO potential impacts. Those have been very much debated. But endogenous factors – such as level of automation, management of the labour cost differential, the degree of labour flexibility, network optimisation, partnerships/diversification, counter franchising, customer management, etc. – have also a very important impact and, if properly addressed, can significantly improve the outcomes in the postal markets in conjunction with FMO.
This confirms that one of the key differences between postal markets in terms of their ability to garner the benefits of FMO is the level of operators’ preparedness. This key endogenous factor can contribute as much as actual exogenous market factors in adapting to and benefiting from the introduction of FMO. There is therefore a need to maintain restructuring momentum in the postal industry.

Finally, an important parameter – postal scale – can be considered to some extent both as exogenous and endogenous. Indeed, postal scale can be linked to historical postal patterns and cultural habits, but several operators have also sought and appear to have succeeded in increasing the intensity of use of mail per inhabitant (i.e., in increasing their scale), hence influencing the market so as to improve the nature of the confluence between the market, the USP and the impending FMO.
Chapter 3  Introducing FMO: Flanking Measures
3.1 Introduction

*Flanking measures (mitigation and enhancement measures): measures which may enhance opportunities of a proposed regulatory reform and significantly reduce the potentially negative impacts that result from the same anticipated reform.*

This Chapter presents the flanking measures considered necessary to grasp the benefits and opportunities that are associated to FMO, while minimising the potential difficulties and risks associated to its introduction.

The aim is to capture as many of the opportunities available as possible, while mitigating as many of the risks as possible:

- **Promoting Efficient Competition**: assure a level playing field for entrants and incumbents;
- **Promoting Efficient Co-operation**: leveraging the USP’s network for efficient entry through proper access arrangements;
- **Promoting Efficient Universal Service Provision**: adapting the US at the national level to the FMO context, including relaxing the obligation to provide such services to the extent that these are provided by the market;
- **Promoting Efficient and Viable USPs**: restructuring – aligning the incentives for USPs to restructure and removing the impediments for them to do so – including increased commercial freedom, pricing flexibility;
- **Promoting Efficient Postal Services for Small Consumers**: safeguarding availability of "common and necessary" postal services at affordable prices for households and SMEs;
- **Promoting Efficient Postal Services for Large Consumers**: allowing the USP to face the discipline of competition and respond to it with the required flexibility and freedom.
The following sections present in turn, the benefits associated to the FMO and, in a second stage, the “generic” measures that shall be considered as prerequisites to the introduction of FMO or may be considered as a more refined definition of the regulatory arrangements that shall be associated to the FMO.

In a third stage, a second category of flanking measures is presented which application may vary on a country-by-country basis and which are more of a temporary nature, their implementation being bond to last.

Finally, several arrangements are presented that are found in several postal markets and that are usually represent additional barrier to entry for the new entrants. Reducing the impact of those arrangements may represent, for markets and USPs that are already well prepared to be confronted to FMO, additional opportunity to have both USPs and new entrants further progressing towards increased efficiency and customers’ orientations.
3.2 Guarding the Benefits of FMO

Reforms of services of general economic interest (SGEI), such as telecommunications, air transport and postal services, have produced clear benefits for European consumers in terms of lower prices, choice and better services a European Commission report shows\textsuperscript{13}.

Looking at the postal sector more specifically, one can summarise the impacts of the progressive opening of the postal market on a selected number of performance measures, in particular: prices, productivity and service quality:

- The **evolution of prices** for mail services over the EU15 over the period 1998-2001 indicates that prices remain stable in real term or have followed an initial increase to follow reducing trend in a second stage to finally reach their 1998 levels. Furthermore, there seems to be, among the Members States, a correlation between postal market opening and falling prices.

- The **productivity of the USP**, measured as the number of letters per USP employee, seems to have increased over the period 1990-1999. This tendency seems more important in Members States that have embarked on a rapid or extensive market opening, while reluctant Members States have only experience moderated and mixed improvements of their productivity over the same period.

- Regarding **quality of postal services** provided by USP, several measures can be analysed. Concerning the **share of international mail delivered on time**, the analysis shows that most Member States slightly improved their quality performances during the period 1998-2002. This positive trend does not seem to be depending on the speed of opening of the postal market in the various Member States. Looking at the evolution of national mail, the analysis indicates that the Members States investigated maintained there quality levels and that there seems to be a slight tendency of Members States favouring postal market opening to score better than the other ones. Concerning the **accessibility of letter boxes and post offices**\textsuperscript{14}, the analyses provides results very much differing among Members States. Comparing the **density letter boxes** between 1996 and 2000, one observes, depending on the countries, in most cases limited changes or a slight tendency to increase density, while in one case, Finland, a significant reduction of the density of letter boxes is observed. Regarding the **density of post offices**, comparing these densities between 1995 and 2000 indicates a general tendency to reduce the density of post offices, in particular in highly urbanised areas, to the exception of Spain and Greece. One should however note that such results shall be interpreted with due

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\textsuperscript{13} Market Opening in Network Industries, Copenhagen Economics, September 2005,

\textsuperscript{14} See Commission staff working paper - Horizontal evaluation of the performance of network industries providing services of general economic interest, 2004 report (23/6/2004),
care, since in the mean time the scope of services provided by post offices may have changed at difference pace in the various Members States.

Regarding transit time targets for domestic priority mail (D+1)\(^{15}\), the review of the performance reached indicated that the criteria set in all Members States, to the exception of Malta and Spain, have been met. Furthermore, one observes that more Member States set higher domestic priority mail target in 2004 than in 2003.

In general, comparing the 2002 and 2003 data, one observes that priority domestic mail transit time was reduce across Members States, to the some countries such as Portugal, Czech Republic, United Kingdom, Ireland, Hungary and France.

Furthermore, **market opening has also fostered USP to increase their customers’ orientation.** In particular, USP have:

- Introduced **increasingly flexible pricing**, rewarding and incentivising mailers to prepare their mails to better suit the USP operation, hence optimising the interaction between the USP and their clients hence the cost of the entire supply chain;

- Developed and introduced **new postal products**, driven both by competition and new technological developments, such as: Direct mail services (such as loyalty and bulk mails management), Track & Trace services, Electronic hybrid mail, National and international parcels services, etc.

- **Adapted their organisation to customer needs**, e.g. introducing working schedule better tailored to their clients needs, developing points of sales in addition to the traditional post offices, developing new products to broaden the range of products offered to clients, etc.

- **Diversified their activities** both with a view to share their fixed costs on a broader ranges of products, as well as to increase their clients satisfaction, both measures allowing USPs to **provide more and more adapted services at maintained or reduced prices**. Among those diversifications, one can list, in particular the development of financial services (retail banking, insurance, etc.), the development of electronic services (e-mail and portal hosting; document management; data warehousing; e-government development; hosting and management; electronic certification and secure messaging; etc.).

In summary and as anticipated, one observes that the introduction of a partial and gradual postal market opening in the postal sector has put incentives on USP and the postal market in general that have allowed for an improvement of the services provided to the market.

Anticipating a full market opening, one shall make sure that those improvements are consolidated and that potential negative impacts or risks associated to the full opening are fully mitigated through the introduction of “flanking measures”.
3.3 Fine Tuning FMO: Generic Flanking Measures

As reminded in the previous section, the benefits associated to the gradual opening of the European postal markets are comforted by the observation of the recent trends in the European postal industry. In the context of the anticipated full market opening, these benefits need to be consolidated and, if possible, to be enhanced.

Furthermore, the review of the likely impacts of introducing FMO in the various markets investigated has indicated that FMO can, under specific circumstances, lead to undesirable effects. Those effects are at the root of the postal economy as implemented on the basis of historical and traditional regulatory arrangements.

With a view to enhance positive impacts and significantly reduce the potentially negative impacts associated to FMO, the postal market opening shall be introduced together with:

- A guaranteed freedom of USP to apply non-uniform prices for bulk mails\(^{16}\). Indeed, the historical uniformity constraint\(^{17}\) imposed on several USPs has resulted in uneven competitive pressure supported by USPs.

The significant impact of the density of population on the unit cost of delivering mail items is well known. While protected by a Reserved Area, the USP does not feel directly the competitive ability of new entrants to seize market share in low cost areas (typically urban areas). It leaves the USP with high cost areas (typically rural areas), hence reducing the ability of the USP to subsidised high cost areas with profit generated in low cost areas, as it was the case historically and still is under a Reserved Area regime. Thus, the suppression of the Reserved Area shall be linked with the suppression of the traditional uniform price requirement.

Even though this requirement is not, per se, a part of the Universal Services as defined in the Directive, it is important to recognise that uniform prices are considered as an important feature by most mailers of single piece letter mail. On the same time, it is unlikely that, because of transaction costs associated to the relaxation of the uniformity constraint on letter mail products, the USP would introduce non uniform prices for such product.

Consequently, preventing any imposition of a uniformity constraint by Member States on USP or limiting this prevention to bulk mail product is likely to have the same effect on the market, while being perceived differently by the market stakeholders. It seems therefore advisable

\(^{16}\) i.e. Direct mail and Transaction mail

\(^{17}\) i.e. the imposition of a uniform price for a given product across a relatively large and varied territory
to guarantee freedom of USP to apply non-uniform prices for bulk mail only, keeping therefore price for single piece letter mail uniform, as may be the case in the various Member States.

- A guaranteed freedom of USP to apply a transparent and non-discriminatory negotiated access regime to the PPN\textsuperscript{18}. The presence of competing postal and logistic networks is a key characteristic of the postal market opening.

Indeed, unlike most network industries providing services of general interests, with which the postal sector is often associated, new entrants often seek to build their own network rather than providing their own products through the infrastructure of the historical incumbent. In this respect, the postal market opening is in fact only comparable to the mobile telecommunication sector. However, this comparison shall also consider a key difference between these two sectors: the important capital costs associated to the mobile telecommunication network (and very limited labour intensity) and the extreme labour intensity associated to the postal network operation.

Building on the presentation of the access and worksharing theme in the following Chapter, it seems advisable to allow USP to apply transparent and non-discriminatory negotiated access regime to the PPN.

- A guarantee that all “public” missions entrusted to the USPs are adequately funded. Often for historical reasons, USPs may be required to provide a variety of public services going beyond the Universal Services as defined in the EU Directive. These can for instance include “public” missions (i) to deliver nation-wide the newspapers daily before a specific hour in the day, (ii) to pay pensions, (iii) to provide “free” financial services under specific circumstances (as a “last resort and minimal” service), etc.

The “extension” of the Universal Services is to a large extent left to the subsidiary of the Members States (density of counters “taking into account the needs of users”, delivery to the home or premises of every natural or legal person “save in circumstances deemed exceptional by the national regulatory authorities”). While this freedom is left to the Members States, the Directive imposes a separation of accounts associated to the Universal Services and the Reserved Area\textsuperscript{19}, and therefore imposes that the burden of the Universal Services is made transparent and taken into account.

\textsuperscript{18} Public Postal Network

\textsuperscript{19} The Directive imposes a separation of costs and revenues between the Reserved Area and the Non-Reserved Area as well as between the part of the Non-Reserved Area that is part of the Universal Service versus the remaining part of the Non-Reserved Area. This accounts separation provides a first reference to assess whether the Reserved Area is required to fund the burden associated to the provision of the Universal Services.
In order to avoid that public service missions would increase the burden imposed upon the USP, similar accounts separations shall apply to all public services with a view to ensure that both the Universal Services as any additional public service are properly funded.

In other words, USPs shall be given the guarantee that any “public” missions – included or not in the Universal Services defined by the Directive – shall be properly funded.
3.4 Enabling FMO: Specific Flanking Measures

While generic flanking measures, as described above, accompanying FMO will enhance the generation of positive effects, FMO still can remain problematic to introduce in some markets.

In their restructuring efforts to address the increasing competitive pressure following FMO, USPs benefit from economies of scale and scope that protect them to some extent from competition. However, this protection can, in some cases, not suffice, in particular when the USPs are confronted with other constraints such as:

- *High human resource costs compared to new entrants:* USPs are, or were not so long ago, public companies relying on public employment contracts that in most cases were more rigid and more costly than the working conditions offered by new entrants.

Consequently, whenever competition enters the market, the USP – provided that the economies of scale and scope do not suffice – will need to reduce labour cost to remain competitive. The sensitivity of the FMO impact to a variation of the labour cost ratio as well as the labour cost ratio diversity has been described in the previous Chapter. New entrants could have it very hard to penetrate if they have to pay the same wages as the incumbent.

Another factor affecting the cost of labour is associated to the capitalisation of pension liabilities by USP. Depending on the case, pension funds have not been constituted in due time by the USP because there historic situation did not include this requirement. Following there incorporation, in some case, USP are confronted with significant financial provisions to fund their pension fund at an accelerated pace, hence impact the required level of profitability those USPs need generated until their pension fund is fully financed.

There are several ways to address the above difficulties, in particular:

- The most obvious and the most used in practice is to **embark on restructuring programmes** that generate new employment opportunities as well as incorporate market based employment conditions for any new staff recruited following a given date. This can also be strengthened by an increased recourse to franchising, partnering or outsourcing techniques.

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20 Larger product volumes allowing the provider to allocate fixed costs over a larger number of products hence reducing the average unit cost of producing a given unit of product
21 Wider range of products (e.g. postal, logistic and financial products) allowing the provider to allocate fixed costs over a wider range of products, hence reducing the share of costs borne be each range of products, hence the average unit cost of producing a given unit of product
22 Detailed evidence and experience on the restructuring is provided in Section 4.4
Another way to circumvent the difference in terms of labour cost supported by the USP and the new entrants is to impose common collective conventions to both the USP and the new entrants active in the postal sector. This imposition suppresses de facto any bias between the USP and the new entrant but can only be envisaged whenever the USP collective convention provides conditions that are close to the relevant labour market conditions in the country. But on the other hand, such collective conventions if imposed might hinder the capability of potential competitors to enter and establish workable competition.

Finally, one should address stranded liabilities that increase the labour cost ratio of USP such as the unfunded pension funds. Ideally, the financing of (partially) unfunded pension funds shall be financed true a lump sum payment limited to the historically unfunded pension liabilities. Such financing allows to restore a level playing field among competitors, does not distort competition and forces the USPs to secure funding of all its present and future social liabilities.

Low degree of restructuring and productivity: USP confronted with FMO can also suffer from low productivity, which – combined or not with an unfavourable cost of labour – decrease their ability to provide postal services at competitive prices.

Sometimes in advance of the Directive agendas and systematically following its introduction, USPs addressed their sometimes low productivity, though a various speed. Furthermore, USPs started initiating their restructuring efforts at various points in time. Consequently, USPs have reached at present various stages of their restructuring plans.

The implementation of such restructuring plans – integrating increased automation, development and implementation of new processes and organisation, introduction of new employee contractual and incentive schemes, etc. – can take several years before providing actual results and may require significant financial means.

Consequently, USPs that delay restructuring will need to embark on rapid restructuring to be prepared to face the discipline of competition. While it may take some time to establish workable competition following FMO in 2009, it will also take time to implement restructuring.

Low scale (low number of mail items per inhabitant per year): in countries such as Poland, Italy, Ireland and Greece, where the postal scale is low, the USP benefit from less important economies of scale. Those USPs are therefore more likely to be sensitive to other negative drivers such as unfavourable total cost of labour. However, low scale should not be considered as a fixed variable. Indeed, several postal
operators, recognising the importance of the mail scale, have successfully sought to develop the direct mail in their market.

This postal scale effect is worsened whenever the issuance of mail is concentrated in the hands of a limited number of large bulk mailers, which have therefore a stronger bargaining power whenever negotiating commercial conditions with postal services providers.

Though important to mention, it is also important to stress that this negative effect is shared by all market participants, including the new entrants.

The origin of the diversity on terms of postal scale across Members States seems difficult to explain. Though some postal operators claim they have been very active in promoting direct marketing with a view to maintain or increase mail volumes, other factors such as the cultures, varied usages of other competing (direct) media for marketing purpose (newspapers, television, etc.) and legal privacy protections present in the various Members States may also explain part of the observed diversity.

While the funding of the USO under FMO would normally be provided through revenues generated by the USP from its operations, it may be the case during a transition period that additional funding will be required from a “compensation fund” or direct subsidies from general tax revenues. In such cases, and only on exceptional, and fully economically justified grounds, temporary funding may be required to allow USPs to continue to provide the USO under FMO.

Such exceptional funding should be focused solely on the funding of the USO, with its level determined as part of an overall consideration of other opportunities for financing the USO, from internal means available to the USP, or from the market, including adapting the USO to market needs and the willingness of market participants to pay for USO services.
3.5 Beyond FMO: Implementing a Competitive Postal Market

Assessing the impact of a full market opening of postal markets is particularly delicate because of:

- the “natural” factors protecting the USP market share, in particular, its ubiquitous market presence and its economies of scale;
- the variety of market situations structures as determined by market parameters such as postal scale and urbanisation rates, as well as the differential competitive position of the new entrants compared with the USPs, for instance regarding the relative labour cost ratio of both types of organisations.

While the progressive introduction of FMO, accompanied by the above flanking measures, in postal markets should lead to more efficient operators and enhanced services, market arrangements need to continue to be reviewed with a view to seeking further efficiency whenever possible. In particular, alongside increased efficiency of the USPs, a real market “level playing field” should be progressively introduced.

In this context, a critical review of several factors traditionally favouring the USPs needs to be carried out and the associated changes introduced in markets where the USPs have already reached a sufficient degree of efficiency.

Those changes include:

- **Suppressing USPs VAT exemption**: on the basis of the 6th VAT Directive and depending on national circumstances, USP are totally or partially VAT exempted. Such system may create market distortions and, as indicated by a Baker and McKenzie\(^2\) study, a diversity of situation may be observed in the European Union which can be regrouped in three main types: VAT exemption limited to a license holder for US only with narrow spectrum for US (such as in The Netherlands), VAT exemption limited to a license holder for US only (including reserved area), VAT exemption covering all post related activities of a certain company appointed by law (most of the Members States).

Suppressing the VAT exemptions should be a long term objective to implement a truly level playing field in the postal sector. However such market distortion is often also counterbalanced by other market distortions such as labour costs differential and can be therefore considered as a transition measure, the exemption being first suppressed for the most efficient postal operators;

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- **Addressing “traditional” postal barriers to entry:** several postal markets are characterised by “traditional” barriers to entry that should be addressed to enhance the ability of new entrants to compete with the USPs. These include typically: the access to letterboxes, the notification of address changes, the access to PO boxes, etc.

- **Introducing fair licensing regimes:** in several postal markets, the licensing regimes imposed on new entrants are very important requirements to be entitled to operate in the postal market. While such requirements provide an opportunity to monitor the qualifications of new entrants, they also present barriers to entry. Such requirements can lead de facto to “cosmetic” market opening when for instance, new entrants providing services belonging to the Universal Services area are required to provide all Universal Services, or to provide ubiquitous delivery for a particular service;

- **Introducing public tendering for public/government originating mail:** public originating mail may represent an important part of the postal market. This type of mails exhibits, in several cases, the characteristics of bulk mail. Consequently, in many cases these mail streams would be among the market segments initially targeted by new entrants. However, in most countries, public originating mail items are systematically managed by the USP, this market segment being de facto a captive market for the USPs.

Consequently, a truly opened postal market should also introduce public procurement for this kind of mail items.
3.6 Conclusions

Liberalising a sector shall not be “une fin en soi”. It is first and foremost a way to improve the way a sector is functioning with a view to optimise the services provided to customers or citizens. The challenge is to translate this broad vision into practical regulatory proposals that would ensure that Europe’s postal market makes its contribution to the modernisation and future growth of the European economies.

Uniqueness of the postal market. The opening of the postal market is probably more complex and delicate to address than most of the market openings introduced in others in the course of the previous two decades in Europe. In fact, several factors make the postal sector restructuring unique:

- First, unlike usual network based industries, several postal/logistic networks have almost always and will continue to compete;
- Second, again unlike most network based industries, the postal market is shrinking rather than expanding;
- Third, the postal sector is less technologically intensive than most network based industries and consequently more labour intensive;
- Fourth, more than in most network based industries, the USPs were and are still to a large extent publicly owned undertakings.

As presented in this Chapter, a fine-tuned definition of FMO and the introduction of temporary flanking measures seem required to ensure that the benefits associated with FMO are optimised and the potential difficulties and risks associated with FMO are minimised.
Figure 47: Regulation: FMO definition and its implementation

A timely introduction of FMO – combined with properly defined flanking measures – is required to create the sense of urgency and commitment that remains necessary in numerous Member States to drive changes throughout postal organisations and societies as a whole.

FMO shall therefore be associated with the following Flanking Measures:

- Systematically, entitling USPs to:
  - Apply non-uniform prices for bulk mails;
  - Apply a transparent and non-discriminatory negotiated access regime to the PPN;
  - Perform “public” missions provided the associated funding is foreseen.

- On a case by case basis, providing exceptional and limited in time, a form of funding/financial compensation to USPs to allow them to address:
  - the differential of their human resource costs with new entrants through the, introduction of restructuring plans, outsourcing schemes, collective working agreements and the final settlement of historical liabilities such as pension liabilities;
  - their low degree of restructuring and productivity;
  - the low level of postal scale of their markets, if and when this mail scale can effectively be improved while, even in those markets,
maintaining the momentum of the postal market opening, going ahead with the introduction of FMO.

- For the most prepared and FMO ready markets and operators, introduce **measures that would further reduce the barrier to entry to the postal markets** whenever they are present, for instance: termination of the VAT exemption (but this probably implies consensus at Member States level), regulated open access to PO Boxes, letterboxes and addresses databases, etc.
Chapter 4  Thematic Case Studies / Key Topics
4.1 Introduction

In parallel with the undertaking of the country interviews, PwC identified critical issues that are likely to drive the debate about postal policy alternatives going forward. The major issues identified concern access policies, the USO itself, and restructuring challenges facing USPs under FMO. These major themes are treated in this chapter in detail. For each of these major themes, relevant experience in Member States are discussed, as well as the relationship of each of these themes to the two fundamental questions underlying the entire project, viz.:

- What would be the consequences of FMO on the USO in the form that it is expected to exist at the beginning of FMO?
- What would the effects be of alternative EU and national policies (concerning the scope of regulation, the USO and the definition of FMO) on key metrics such as the survival and efficiency of the USP, and the vitality of competition, in different Member States?

The specific questions to be addressed in these case studies were identified based on discussions with the Commission, public stakeholder meetings, and the results of the PwC country assessments. This process led to the following three issues as deserving a deeper analysis through case studies:

- **Impact on FMO of PPN access conditions**, including both upstream (worksharing) and downstream access. Access and worksharing arrangements will drive the ability of the USP to continue leveraging its network and they may also support the financing of the USO as well as the development of efficient new entrants’ business models. On the other hand, if done improperly, access arrangements can undermine efficiency of the entire postal market. This is therefore a key theme when assessing the impact of FMO in postal markets.

- **Adapting the scope and regulation of the USO to FMO**, including alternative approaches aligning the cost, price and value of USO services to meet the needs of postal customers and the funding of the USO. Universal Services are those postal services that are understood to be common and necessary, and these can be expected to evolve. Postal services are a part of a broader communication market and the provision of postal services needs to be considered in this perspective. Electronic communication markets have dramatically evolved over the last 20 years and represent nowadays the bulk of the market, while the presently used definition of the postal universal services is still based on days when postal services were virtually the only mean of communication. Furthermore, postal and logistic markets have also dramatically evolved during the last 15 years, with various competing offers and products being introduced. These “new” offers often complement or effectively replace “traditional” universal services whose provision is still imposed on the USPs. All of these changes call for a critical review of what now constitute “common and necessary”
postal services that should be provided under the umbrella of the USO, as well as efficient approaches to ensure the provision of these services in the market-driven environment to be launched with FMO.

- **USP restructuring**, including corporatisation, and innovative marketing and labour-relations strategies. All organisations facing competition have to seek continuously to improve their efficiency and effectiveness. While several USP restructuring initiatives have started prior to the introduction of market opening in the European Union, it is clear that EU-driven market opening has provided a further impetus to the restructuring of the European USPs. This restructuring is essential to the success of the postal market opening in the European Union and is often a prerequisite for the success of the USPs in this liberalised postal market. The various restructuring programmes that have been implemented in the previous 15 years have demonstrated that suitable solutions can be developed to address many of the challenges confronting USPs under FMO. Thus, USP restructuring is both emblematic of the launch of FMO and a foundation for achieving its benefits. Conversely, the introduction of FMO will make plain the level of readiness of various USPs to face the rigors of competition. This theme is clearly a central issue for all stakeholders in the emerging European postal market.

Each of these issues is addressed in detail in the following three sections. Both the background theory and developments in practice that underlie each of these key issues are described, followed by a review of the range of practices uncovered across Member States in PwC interviews and some selected examples illustrating these practices. Each of the thematic case studies is concluded with the assessment of relevant policy implications for FMO and its impact on the USO and on USPs.
4.2 Access and Worksharing: Leveraging the Incumbent PO’s Network under Entry

This case study will review the issue of access pricing and the role of access under FMO. Section 4.2.1 is by way of background. It provides a general introduction to access pricing including some brief discussion of access in fixed network industries. Section 4.2.2 provides a brief introduction to the practice of access in the postal sector including the different types of access. Two types of access are distinguished – worksharing (which may be thought of as upstream access) and downstream access. Sections 4.2.3 and 4.2.4 describe the experience with upstream (worksharing) and downstream access in the United States, France and United Kingdom. Section 4.2.5 summarizes the key lessons for policy in a liberalized postal market of worksharing and access in leveraging the existing PO’s network to promote efficient competition.

4.2.1 Background

The last twenty years have seen the entry of competitors into what had formerly been regulated monopolies. Along with this entry the regulated incumbents have been allowed to diversify into other industries and to expand the commercial freedom of their operations. This process has given rise to some concern that the incumbent might employ its regulated monopoly to the disadvantage of competitors.

Specifically, where competitors require access to monopoly or essential facilities, there has been a concern that incumbents might overprice this access or increase the costs of competitors through the terms under which access is provided. In telecommunications and energy this has been a major issue for much of the period and has resulted in various actions by regulatory commissions.

In the postal sector, which is still heavily dominated by state-owned national post offices (POs), there has been less actual opening up of markets to competition and consequently less diversification by POs into competitive industries. However, the postal sector worldwide is facing pressure to open up its traditional monopoly markets to competitors. With the consequent increase in POs’ desires to enter competitive markets, such issues are now a salient area of concern for the future of the postal sector as well.

In situations other than regulated monopoly, firms normally do not offer access to their facilities to competitors at all. This arises for a number of reasons including the very nature of a firm. As Nobel Laureate Ronald Coase argued in

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24 There are several ways in which an incumbent providing access to an essential facility, or having some residual monopoly power, could engage in behaviour to the disadvantage of competitors. A survey of the underlying theory is provided in Armstrong (2002), which also provides a comprehensive review of applications to telecommunications and an extensive list of references.
1937, a firm exists to perform a set of transactions that can be performed more economically by means of a hierarchy rather than through the market. Coase viewed the firm as “a device that supersedes the market.” So, allowing outsiders to enter this hierarchy may result in disruptions to and loss of the synergies, scale and scope economies and the like that arise from the use of a hierarchy rather than the market.

Where effective competition exists, forcing access to facilities by regulatory fiat is going to provide disincentives for efficiency. If a firm is forced to share its facilities and technologies with competitors by giving them access to its facilities, the edge to innovate will be blunted, as the firm cannot retain all benefits of innovation for itself. So forcing access in such cases may be inefficient both in a Coasian and a Schumpeterian sense. In the former case this arises because of the loss of synergies and therefore reducing internal or operational efficiency and, in the latter case, because of its adverse impact on dynamic efficiency and innovation.25

Where a regulated monopoly exists and where a decision is made to introduce competition, different considerations arise and the incumbent may be required by the industry regulator to provide access to its facilities on terms and at such prices as the regulator may determine. This is the case in electricity, telecommunications and gas, for example. The reason for requiring access is that the incumbent controls a bottleneck, what is known in regulatory economics and law as an “essential facility”.

An obvious example of an essential facility is a bridge – it is the only feasible way of getting across the river! The essential facility doctrine at its simplest would require that access be provided to such essential facilities on reasonable and non-discriminatory terms. This doctrine is commonly thought to apply to electric transmission and distribution networks, gas pipelines and distribution systems and to local exchange networks in telecommunications.

Alfred Kahn has proposed that the notion of essential facility should be broadened in scope in the case of incumbent network industries. “…in the context of the introduction of competition into public utility industries…an incumbent company not only will control some facilities truly ‘essential’ to its rivals but will enjoy economies of scale and scope…merely because of a franchised monopoly…, requiring it to share the benefit of those facilities with rivals at a compensatory price would therefore not entail penalizing successful competitive efforts.” (2001, p18) Kahn’s suggested extension of the notion of essential facilities should be taken seriously, given his experience and stature in regulatory economics.

25 It may be that the effect of allowing entry is to foster a different kind of innovation as well as lowering some prices as a result of competition. However, unless there is good reason to believe that this is the case and that such gains will outweigh the losses from a less innovative incumbent, then caution about forcing access is warranted.
The implication is that an incumbent enjoying a market dominant position could reasonably be required at the early stages of competition to provide access to its facilities.

Despite these considerations and proposals, the success in opening up networks to competition has been of limited success. In the gas distribution industry this has happened because of the nature of the commodity and the clear distinction between the commodity, gas, and the service of transporting it.

Many gas distribution companies provide transportation services only to large customers, like electric utilities and major industrial facilities. However, this practice is not widespread among residential and small commercial customers. In electricity, there is even less competition for retail customers. What were effectively experiments in the U.S. and Europe turned out only to be viable when entrants were provided with, in effect, subsidies or other incentives.

In telecommunications such issues have been and continue to be aired extensively. The Telecommunications Act of 1996 in the U.S. was a major landmark in opening up the incumbent’s market by requiring the RBOCs to provide access. However, this failed in a mass of litigation with the issue largely being resolved in favour of the incumbent Regional Bell Operating Companies (RBOCs).

Although the postal sector differs in some fundamental respects from fixed network industries, failures to promote access in other network sectors by means of subsidies, command and control and other measures to jump-start competition provide a lesson to the postal sector about the difficulties of implementing efficient access policies. With this in mind, the next section examines some of the specific features of the postal sector that shape access policies there.

### 4.2.2 Access in the Postal Sector

Access to the postal network can occur at multiple stages. Access is termed either upstream or downstream access. The latter refers to access to the local delivery network. All other types of access are deemed upstream access. Upstream access activities in the postal sector are often referred to as “worksharing”, which include activities like collection, consolidation and franking undertaken by customers or mail preparation companies in advance of tendering the mail to a postal operator.

This type of preparatory work, in effect, substitutes some of the upstream work that would otherwise have to be undertaken by the postal operator. Thus, mail may be delivered at a processing facility and it may, if it is barcoded, go straight to a barcoder, saving the PO the expense of reading and barcoding. There is a

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26 With USTA vs USA the prospect of widespread access was dealt a major or even fatal blow. The acquisition in 2005 of the largest competitors by RBOCs, viz., AT&T by SBC and MCI by Verizon, effectively ended the issue of RBOCs’ obligation to provide widespread access. The most recent further proposed acquisition by AT&T of Bell South can be expected to solidify this “no access obligation” in the US telecommunications sector.
long tradition of worksharing discounts, which is most highly developed in the case of the United States Postal Service (USPS), but is widespread also in other countries. For this kind of worksharing (upstream) access to postal facilities, Kahn’s extension of the essential facilities doctrine does not apply. Such upstream facilities are not in any sense essential to an entrant, as illustrated by the entrant using his own equipment to perform barcoding.

Concerning access to the use of the PO’s automated processing equipment, and perhaps other facility-based access, the arguments are a bit more complicated, as granting access would generally have greater impacts on the PO’s internal operations. This is not to say that a PO would or should deny access to such upstream facilities to rival entrants.

It may, in some instances, be very good business to allow such access. In cases where a PO’s processing equipment is under-utilized during parts of the day or night, entrants who could make use of these off-peak hours would benefit as could the PO.

Thus, if an entrant were able to have its mail processed only during these periods, it may be possible to do so at attractive rates. However, it should be clear that any such access should take place under a freely negotiated arrangement between the PO and entrants, rather than under a regulatory mandate.

While it is very difficult to make a convincing argument that upstream access is an essential facility, it could be argued that downstream access has some of the features of an essential facility. In a fixed network industry, for example, telecommunications or electricity, the claim of an essential facility arises from the sunk nature of the investment that has to be undertaken in these industries.

Often the investment is literally sunk – the pipes in the ground for gas – but the economic meaning of sunk in economics is that it has a much lower value, possibly even negative, in an alternative use. In the case of downstream access in the postal sector, very few costs are sunk and for this reason an entrant could replicate a PO’s delivery network much more easily than it would be for an entrant to replicate a gas distribution company’s network. Thus, the argument that a PO’s delivery network is an essential facility is rather weak.

Upstream access is likely to be highly beneficial when there are technologies available to entrants that are much lower cost than using the existing postal technology. These technologies might be as simple as mailroom activities on a customer’s premises to accomplish barcoding and presorting of mail at the time when the mail is printed and prepared for mailing.

Downstream access in the early stages of competition provides the means of allowing an entrant to use the PO’s network for some delivery zones (those for which the entrant has not yet developed full service) while bypassing the PO’s network partially or completely for other zones. As it is difficult to mount a compelling argument that downstream access is an essential facility, some have

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27 The experience of USPS and La Poste in worksharing is reviewed in more detail below.
argued that it should be unregulated and therefore subject to the normal process of business negotiations (de Bijl et al., 2006).

Despite these considerations, downstream access has some features that may mean that regulators may, after FMO, determine that some regulation is appropriate, for a number of reasons. These include possible concerns over anticompetitive behaviour by the market dominant incumbent PO, as well as the desire to promote universal coverage by entrants through mandated access.

A further reason is that mandated access geared to cost is a protection against predation, which is further strengthened if the regulator monitors and requires the non-discriminatory application of access tariffs. As seen in the discussion of the United Kingdom, reasons such as these suggest that regulation of access prices will likely continue for the foreseeable future.

The basic economic efficiency principle underlying access pricing is that incentives should be aligned in such a way that the producer with the highest quality/cost ratio of producing certain services, whether it is the PO or an entrant, should be the producer that actually provides them. Downstream access is likely to be a large part of a POs business under competitive entry, and the regulator needs to be concerned as to whether the terms and conditions of access undermine the PO’s ability to maintain the USO.

Generally, the approach involves unbundling, and separately pricing, the various components of the value chain. The following access approaches can all be expected to occur during the evolution to FMO:

- Entrants hand selected mail to the PO, after worksharing, which then provides end-to-end service for this mail (the upstream access or worksharing option);
- Entrants hand selected mail to the PO for local delivery by the PO (the downstream access option);
- Entrants provide end-to-end service for selected customers and perhaps for only a subset of their mail (the end-to-end service option).

Entrants, in this framework, would provide end-to-end service primarily on the lowest cost, highest profit routes. Other mail, especially mail destined for higher cost delivery areas, they would hand back to the PO. The current practice in many POs is to charge a uniform rate based only on the amount of upstream work embodied in the mail (e.g., the level of presorting performed).

However, this is not efficient. A better approach would be to develop pricing signals, which allow the incumbent, through publicly posted tariffs, to charge entrants for access as a function of the ultimate destination of their mail. The approach in the UK reviewed below has some of these features. The approach amounts to unbundling the option of downstream access and pricing it

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28 Panzar (2002) notes additional caveats about the problem of mandated unbundling and access to postal networks where a PO has a USO.
according to its cost. This enables entrants to access the PO network at two levels, either for delivery only or at the single piece rate (the latter accommodating, of course, whatever volume or upstream worksharing discounts are appropriate for the mail).

The basic idea, as proposed in Crew and Kleindorfer (2002), is captured in the term *Delivery-Area Access Pricing* or DAP, which charges higher access prices for downstream entry where such entry requires delivery to high-cost areas. Thus, the key is to charge entrants who by-pass upstream operations of the PO not according to the work they have by-passed, but according to the work yet to be performed in delivering the mail they repost with the PO.

This approach is more efficient than uniform access pricing - the usual approach adopted, following avoided cost rules that provide discounts equal to the average avoided cost of upstream activities bypassed/provided by the organization seeking access.³⁰

Let us consider in more detail the difference between three different types of access rules, currently in use in the EU or being discussed as possible rules to govern access pricing (Billette de Villemeur et al., 2006; Crew and Kleindorfer, 2002).

- **Avoided Cost Pricing (ACP):** Charge for access according to discounts off single-piece rates, based on the avoided cost of by-passed activities provided by the organization seeking access.

- **Delivery-Area Access Pricing (DAP):** Charge for access not according to the work that is by-passed, but according to the work yet to be performed in delivering the mail to be reposted and delivered by the PO.

- **Negotiated Access Pricing (NAP):** Essentially whatever price the PO and entrants agree on through their own negotiations is the outcome here. One would expect NAP to give rise to prices no lower than the average incremental cost of delivery that would result under DAP. Prices could be higher if entrants seeking access have higher costs in certain zones than the PO, and if the PO has some bargaining power.

Concerning ACP, as part of its USO, POs currently face a uniform pricing requirement for single-piece mail (possibly differentiated into 1st and 2nd class mail categories). Traditionally, POs have allowed discounts for worksharing, mainly bar-coding and presorting, off this single-piece rate. However, where entrants are allowed to deliver to the customers they choose and the PO still has

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²⁹ The reader with some background in postal lore will recognize immediately that this proposal enjoys a very long pedigree, going back at least to Rowland Hill who discussed similar ideas in coping with the vast differences in local delivery costs under a uniform tariff. Of course, Hill was not concerned with the problem of entrants at the time, but only with the viability of the incumbent under uniform pricing. For a discussion of Hill’s contributions and the form of his proposals, see Crew and Kleindorfer (1991).

³⁰ The avoided cost rule for access pricing also is known under the name of the Efficient Component Pricing Rule (ECPR).
a USO, this kind of avoided cost discount off the single-piece rate could lead to problems in funding the USO. A more responsive system of access pricing is required under which entrants make efficient choices as to whether to access the PO’s network or use their own networks.

Entrants’ costs are usually lowest for delivery in central city areas with banks, stock exchanges, insurance and law firms, a striking example being the City in London. A PO’s costs of delivery are usually lowest in such areas too. A PO would find that its delivery costs varied depending on where a letter was posted and where it was delivered. In practice, the variations in costs could be classified into a number of delivery zones or areas.

The key to designing efficient access prices is to have these depend on both the origin and destination of the mail for which access is being provided by the PO. Where an entrant transported the mail to the PO’s delivery unit, the origin would be the destination and a pure local delivery charge only would be levied. Additional charges would apply depending on where the mail entered the stream.

An example of an access tariff that has the required efficiency properties is given in the Table 5 (which shows tariffs for both downstream access and presort/worksharing access). For simplicity focus will be set on delivery costs. These costs and contributions to counter costs and other aspects of the USO are intended to be recovered in the mark-up. Areas are ranked according to delivery costs. Area A is lowest cost and can be accessed by entrants for 13c. If the entrant’s delivery costs are below 13c, he will deliver his customers’ mail. The same considerations apply in the case of Areas B and C. In all three cases the access price is less than or equal to the presort price. For Area D, however, a problem arises. Even though the entrant’s costs may be less than those of the PO if they exceed 20c, the price of the single-piece stamp, the entrant will not deliver here, as he will lose money. Similarly the PO will not give the entrant the presort price as this will increase the PO’s expenses under the USO.

<table>
<thead>
<tr>
<th>PO’s Marginal Cost</th>
<th>Access price</th>
<th>Single piece price</th>
<th>Presort Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Area A</td>
<td>10c</td>
<td>13c</td>
<td>20c</td>
</tr>
<tr>
<td>Area B</td>
<td>13c</td>
<td>17c</td>
<td>20c</td>
</tr>
<tr>
<td>Area C</td>
<td>14c</td>
<td>18c</td>
<td>20c</td>
</tr>
<tr>
<td>Area D</td>
<td>25c</td>
<td>20c</td>
<td>20c</td>
</tr>
</tbody>
</table>

Under the DAP structure it is essential that entrants not be given incentives to increase the burden of the USO. The access-pricing tariff must therefore send the right signals to them. From the entrant’s point of view for Area D, the fact

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31 Roy (1999), Kolin and Smith (1999) and d’Alcantara and Amerlynck (2006) have examined some of the factors that determine the costs of delivery.
that he does not receive payment for the worksharing that he has performed may seem unfair and inefficient. In fact, it is neither. It would be both unfair and inefficient were it not for the USO, the burden of which should not be increased by entrants. Under the USO the entrant not receiving payment for worksharing in Area D is not unfair if it is considered part of his share of meeting the USO.

In return for being able to access the high-cost areas at below cost because of the USO, he must pay a price of entry, namely forego the value of any worksharing since the value of the subsidy he is receiving exceeds the value of the worksharing he is providing.

It is interesting to contrast this approach with the approach of ACP, frequently recommended for determining access prices. The standard approach to ACP essentially assumes a single-product world, with access then being priced at the avoided cost of any upstream operations performed by the entrant. The problem in the postal context is that this is not a single-product context. On the contrary, every delivery area constitutes a different product with different cost characteristics for fulfilment.

Thus, the simple logic of ACP breaks down. Consider Table 5 again. Assuming a constant markup of about one-third (which might be different from Ramsey markups) for each area, the access price paid by the entrant for downstream access and delivery to Area D under ACP, which would be around 31c (the marginal cost of delivery, 25c, plus the markup, 8c, less the pre-sort discount, 2c). Since 31c exceeds the single-piece price of 20c, the entrant has to be charged the single-piece rate, as the entrant would post the mail at the single-price rate if the access price exceeded this.

Note that this is certainly not the same rate as the simple avoided cost rule (ACP) in which the full (uniform) single-piece rate is discounted by the avoided cost of presort discount. Such a simple application of avoided cost logic would lead to a price of 18c for delivery to Area D, which would constitute a further subsidy beyond the 5c subsidy already contained in the single-piece rate for this area.

Put differently, the proper access-pricing rule is that the entrant be charged the single-piece rate if the work remaining to be performed after the worksharing exceeds the single-piece price. The simplest implementation of DAP would be to set the access charge for each delivery zone to be the maximum of the traditional avoided cost rule (ACP) and the average cost of delivery to that zone, truncated at the single-piece rate. This rule has a number of benefits, including

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32 For a discussion of the logic of this rule, see Crew and Kleindorfer (2002, p. 30) and Panzar (2002, p. 114). Note that DAP is sometimes confused with Long-run Incremental Cost (LRIC) access pricing, e.g., Armstrong (2002) as practiced in the telecommunications sector. In the postal sector, it would not be appropriate to charge less than avoided cost under DAP, even if LRIC is less than avoided cost. Of course, LRIC still serves as a floor for access costs, but is not itself the proper benchmark for prices themselves. The reason is that all products, including access products, should make a contribution toward covering the fixed costs of the USO. Thus, the indicated rule above is the proper one, namely the maximum of the avoided cost and average incremental cost of remaining work to be accomplished following access (truncated at the
simplicity and better alignment of cost with pricing and in avoiding subsidies to entrants that encourage inefficient entry. Importantly, it recognizes that while averaging of prices might be in the interest of efficiency for single-piece rates, there is no reason to maintain such averaging across delivery zones in pricing unbundled access.

In completing the discussion of access pricing, it is important to discuss two additional issues: 1) customer heterogeneity, responsiveness and efficiency, and 2) price regulation and access.

The above discussion on DAP has emphasized the importance of delivery zone cost heterogeneity. A further concern analyzed in the postal economics literature has been with heterogeneity in customers. An early model to treat this matter in the postal context was Crew and Kleindorfer (2001), who examined the dynamics of entry at the customer level, noting that large customers would clearly be the major target of new entrants. They model the interaction of access pricing for differentiated customer classes and illustrate the complexity of Ramsey pricing when customers can choose either entrants or the incumbent USP as their service provider.

Those customers will be most attractive to entrants who have large volumes of mail destined for low-cost areas. Just where the line will be drawn by entrants in attracting customers away from the incumbent USP depends directly also on the access price for mail which will determine, in part, the mail entrants wish to deliver themselves versus tendering this to the USP. The interaction of customer heterogeneity, uniform pricing and entry in the face of breakeven constraints for the USP gives rise to worksharing prices that can differ significantly (either above or below) those determined by the ACP rule.

Work on customer heterogeneity and worksharing discounts was further advanced in the work of Billette de Villemeur et al. (2002, 2006). These authors model customer heterogeneity in terms of the costs of those customers to engage in worksharing. They provide a detailed analysis of the resulting market demand for both workshared products and end-to-end (i.e., non-workshared) products, and they demonstrate under plausible conditions that the discounts for worksharing can be either greater or less than those specified by the ACP rule, with smaller discounts resulting in particular if a significantly higher weight is placed in the welfare analysis on benefits to households (and other single-piece mail customers) than on benefits to business customers (who would be the only recipients of worksharing discounts).

The Billette de Villemeur et al. model has been further refined (to account for some aspects of simultaneous worksharing and bypass) and calibrated for the French market. Coupled with the earlier work on DAP access rules noted above, this work shows that, in general, the ACP rule captures neither the essential characteristics for promoting efficient upstream/worksharing discounts nor downstream access prices.

single-piece rate). More sophisticated demand-related adjustments, e.g., de Villemeur et al. (2002, 2006), also allow for Ramsey effects to further refine these DAP prices.
A final important point worth mentioning here concerns the regulation of access prices. Several approaches to this are possible, roughly characterized by the degree of discretion left to the incumbent USP. Under FMO, it is important that sufficient flexibility be granted the USP so that customization of products to individual customer segments can be achieved without interference by the regulator.

On the other hand, given the market dominant position that incumbent POs will have at the beginning of FMO, it is also important that prices and conditions of access be offered on a non-discriminatory basis to both customers of the USP as well as to competitors seeking access to the USP’s network. Moreover, it is reasonable to expect the level of prices for access products to be regulated while the UPS is market dominant.

The appropriate approach capturing both price limitations and flexibility is to subject access products to price-cap regulation. This can be done by including a weighted average of all access products in (one of the baskets regulated by) the traditional price-cap formula.

Alternatively, only a few products such as basic downstream access and the single-piece letter rate could be included in the price-cap formula, with then the requirement that the prices for all other access products be subject to the floor and ceiling prices of the single-piece rate and the (possible zone-specific) applicable delivery zone rate, leaving otherwise the determination of pricing for all intermediate forms of access entirely to the discretion of the incumbent.\footnote{Both of these forms of access price regulation have been discussed in the literature, and the inclusion of access prices in the price cap formula has come to be known as “global price cap regulation”. For details, see Crew and Kleindorfer (1994) and Billette de Villemeur et al. (2003).}

This latter regime is essentially what is described above under Negotiated Access Pricing (NAP). Both of these regimes could be further bolstered by posted generic access terms and rates available to all comers and by governing regulatory principles, for example those embodied in the DAP regime described above.

The more inclusive the regulator is of the details of access prices in the price-cap formula, the greater the control the regulator would have over access prices, but also the greater the rigidity of the resulting access regimes in responding to market conditions. Subject to the non-discrimination requirement, the greater the degree of workable competition and entry in the access market, the greater the degree of flexibility would be desirable for the incumbent USP.

4.2.3 Examples of Experience in Pricing and Facilitating Worksharing

4.2.3.1 Worksharing and Upstream Access at United States Postal Service (USPS)

USPS is a recognized pioneer in worksharing. Introduced in 1976 (see Postal Service Staff Study, 1976), there were two expectations associated with having large mailers and consolidators presort their mail prior to tendering it to USPS.
First was the general belief that this could be done efficiently at the time the mail was prepared by printing and mail preparation houses. Second was the expectation that, because of the increase in quality of mail preparation resulting from worksharing, the efficiency of USPS itself might improve. As explained in Cohen et al. (2006), both of these effects did occur, with some lag between the introduction of worksharing and productivity effects. The magnitude of worksharing in USPS is evident in the following table, which shows that the % of total volumes workshared for had grown by 2004 to nearly 73% across all major product groups.

Table 6: 2004 Worksharing Total Avoidable Costs and the Total Value of Worksharing Discounts (Volumes and $'s in Millions) (From Cohen et al., 2006)

<table>
<thead>
<tr>
<th>Class of Mail</th>
<th>Volume</th>
<th>Workshared</th>
<th>Total USPS</th>
<th>Value of Discounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>First-Class Mail</td>
<td>97,926</td>
<td>50,239</td>
<td>51%</td>
<td>3,466</td>
</tr>
<tr>
<td>Periodicals</td>
<td>9,135</td>
<td>8,731</td>
<td>96%</td>
<td>1,485</td>
</tr>
<tr>
<td>Advertising Mail</td>
<td>95,564</td>
<td>89,762</td>
<td>94%</td>
<td>9,297</td>
</tr>
<tr>
<td>Package Services</td>
<td>1,132</td>
<td>826</td>
<td>73%</td>
<td>151</td>
</tr>
<tr>
<td>Other</td>
<td>2,349</td>
<td>-</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>206,106</td>
<td>149,559</td>
<td>73%</td>
<td>14,399</td>
</tr>
</tbody>
</table>

The worksharing activities shown here resulted in $14 billion in discounts or rebates to worksharing organizations, and reflect some $14 billion in avoided costs for the USPS. Cohen et al. (2006) estimate that these activities were undertaken at a fraction of that cost by the third parties who undertook worksharing, leading to an overall economy-wide savings of some $11 billion.

In addition to these significant cost savings, there are also substantial demand effects resulting from the price decreases associated with operating a less expensive postal value chain for business customers.

Pearsall (2005) estimated the demand stimulus effect of worksharing by separating out in his econometric model the secular and pricing effects of demand growth from the effects associated with various worksharing innovations. His conclusions are that over the period 1976 through 2003, postal volumes were increased by 37% by worksharing and postal revenues were increased by 26% relative to what they would have been absent the worksharing innovations.

Pearsall and Cohen et al. conclude that these effects are likely the result of the synergies between mail preparation, collection and overall convenience of worksharing organizations who have, in effect, brought new services to the market place through their specialized activities that allow their business clients
to use postal products conveniently while reaping cost savings from the worksharing discounts provided by USPS.

Pricing of worksharing products in USPS is based upon avoided cost (ACP) principles. Thus, workshared products in USPS are priced at the respective End-to-End Price of the Product minus Avoided Cost to USPS for Worksharing (i.e., the cost avoided by the USPS for the work undertaken by the worksharing organization). The efficiency losses of the ACP approach are mitigated in the USPS context by the fact that no by-pass (i.e., no delivery competition) is currently allowed.

There are continuing questions raised as to whether the avoided costs used are too narrowly construed and reflect actual costs avoided (see, e.g., Haldi and Olsen, 2004), but generally the methodology used for ACP implementation and the arguments underlying it are understood by those involved. The success of the USPS worksharing program clearly illustrates the effectiveness of upstream access in leveraging an incumbent PO’s network.

4.2.3.2 Worksharing and Upstream Access at La Poste

Interestingly, La Poste has an even longer history of worksharing than USPS, with its roots dating to significant increases in parcels and direct mail in the 1960s. This led La Poste in 1967 to seek third-party assistance for the collection, sorting and preparing of parcels, which were then tendered to La Poste for ultimate delivery.

Encouraged by the additional flexibility evident in this arrangement, La Poste extended this to direct mail products in 1969, thereby encouraging major mailers to presort their mail and to undertake other activities that led to cost savings for La Poste.

During the 1970s, stimulated somewhat by a significant strike in 1973, this process led to the further development of worksharing in La Poste, and this has continued to grow to this date. Contributing to this was the elaboration of the theoretical foundations underlying the design of worksharing discounts in La Poste (see Billette de Villemeur, 2002, 2006).

Several types of contract govern worksharing arrangements between La Poste and providers of worksharing services (large mailers and consolidators).

The standard contract is “product-based” and covers direct mail, parcels or transactions mail, specifying the general access conditions and service quality standards for the product in question and the discounts (or rebates) for various levels of worksharing.

The second type of contract governing worksharing is referred to as “technical contract” (“contrat technique”) and covers specific additional matters such as time windows to tender mail, additional refinements in sortation, and other matters for which La Poste wishes to provide incentives to mailers and consolidators because of the cost implications of these activities.
Finally, there are “commercial contracts” that specify total periodic rebates based on total volumes provided by a commercial client. A typical example would be a 5% annual rebate of total mailing costs provided by La Poste to a financial institution based on the total volume of that institution tendered to La Poste for delivery. Interestingly, rebates on commercial contracts are computed on the basis of total volume ultimately delivered by La Poste, whether this is tendered directly to La Poste by the client or arrives to La Poste via a consolidator/worksharing organization that might prepare the client’s mail.

Given the product focus of worksharing contracts, the intent is to build prices on the basis of specific accounting information on costs for each product class (transactions mail, direct mail, etc.). The current methodology for pricing of workshared products at La Poste is based on avoided costs, but not rigidly so. The intent is to capture for each product class and each technical feature for access appropriate incentives to promote efficiency in the value chain between mail generation and receipt of the mail in a La Poste facility.

As can be seen in Table 7 and Table 8, worksharing is an important feature of the French market. From Table 7, it can be observed that more than 9.3 billion mail items are affected, representing some 1b€ in worksharing discounts in 2004. For the same period, mailing houses and consolidators (some 200 in total) processed more than half of the bulk mail, including 75% of the direct mail and 30% of total transaction mail. These 200 small and medium businesses are either subsidiaries of international groups (DPWN, Belgian Post, Bertelsmann, Wegener, Quebecor) or of advertising companies or routing companies previously owned by the banking sector for their transaction mail. They access the postal network at negotiated rates, identical for large mailers and consolidators.

Market studies on the French postal sector show that both markets – Transaction Mail consolidation and Direct Mail consolidation – have significantly evolved in the last 15 years. Once composed of many fragile SME’s, with unskilled employees and limited automation, these markets are now dominated by significant players, subsidiaries of international groups.

There are two drivers for this evolution: the development of the transaction mail consolidation market and the increase in quality in the Direct mail consolidation market.

- First, the transaction mail consolidation market is of relatively recent vintage: main mailers have long been reluctant to externalize the preparation of their transaction mail, considering confidentiality and security attached to this type of mail (invoices, banknotes, etc). In the 90’s, transaction mail mailers increased their use of third-party consolidators, but with stringent pre-qualification and monitoring requirements, hence the quality level of the main players in the consolidation market increased(automation level, quality control, workforce qualification).
Secondly, the Direct Mail market, active and competitive from the end of the 60’s, experienced some major changes in adapting to changing client needs. Direct mailers have increased the quality of their mailing in the last decades, with a focus on targeting, paper quality and diversification. Consolidators in this market have then invested significantly in automation and workforce capabilities to allow tailor-made service for direct mailers.

Table 7: Workshared Volumes at La Poste for 2005

<table>
<thead>
<tr>
<th>2005 Type of client</th>
<th>Number of items (millions of items)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Direct Bulk Mail</td>
<td>Mailer 900</td>
<td>19%</td>
</tr>
<tr>
<td></td>
<td>Consolidators 3,900</td>
<td>81%</td>
</tr>
<tr>
<td></td>
<td>TOTAL 4,800</td>
<td>100%</td>
</tr>
<tr>
<td>2005 Total transaction Mail*</td>
<td>Mailer 3,400</td>
<td>76%</td>
</tr>
<tr>
<td></td>
<td>Consolidators 1,100</td>
<td>24%</td>
</tr>
<tr>
<td></td>
<td>TOTAL 4,500</td>
<td>100%</td>
</tr>
<tr>
<td>2005 Total Bulk Mail**</td>
<td>Mailer 4,300</td>
<td>46%</td>
</tr>
<tr>
<td></td>
<td>Consolidators 5,000</td>
<td>54%</td>
</tr>
<tr>
<td></td>
<td>TOTAL 9,300</td>
<td>100%</td>
</tr>
</tbody>
</table>

NOTES:

These 2005 figures are unaudited estimates that are subject to revision.

* Transactions mailers have been more reluctant to externalize the preparation of their mail since the nature of mails is more sensitive (confidentiality for banks, invoices, etc). Nevertheless, there is a strong growth potential for transaction mail consolidators since modernisation of the consolidation market now allows transaction mailers to externalise this function. The level of transaction mail intermediation is growing rapidly and the overall part of mail treated by consolidators in the years to come is expected consequently to increase significantly.

** The “total bulk mail” category includes all types of mail that could be workshared, i.e. which could benefit from rebates in case of pre-sorting and handling preparations. Periodicals and magazines are not included in this table.
Table 8: Workshared Rebates Available at La Poste*

<table>
<thead>
<tr>
<th>Postal Product</th>
<th>Prices (in €)</th>
<th>Maximum Rebate**</th>
</tr>
</thead>
<tbody>
<tr>
<td>D+1/2 Transaction Mail</td>
<td>Single Piece mail</td>
<td>0.53</td>
</tr>
<tr>
<td></td>
<td>Workshared bulk mail</td>
<td>0.40</td>
</tr>
<tr>
<td>D+3/4 Transaction Mail</td>
<td>Single Piece mail</td>
<td>0.48</td>
</tr>
<tr>
<td></td>
<td>Workshared bulk mail</td>
<td>0.36</td>
</tr>
<tr>
<td>D+7 Direct Mail</td>
<td>Non workshared bulk mail</td>
<td>0.35</td>
</tr>
<tr>
<td></td>
<td>Workshared bulk mail</td>
<td>0.23</td>
</tr>
</tbody>
</table>

NOTES:
* The prices for workshared products shown here correspond to the maximum degree of pre-sorting and mail preparation, which differs according to the different products considered (Direct or Transaction mail, different type of Direct Mail, etc.). What is shown in this Table is the rebate for the workshared product indicated relative to a comparable “bundled” product. For example, for transaction mail, the bundled product benchmark (and the maximum rebate of 23.7% for D+1/2 Workshared Bulk Mail) is the single-piece rate. For Direct Mail, the benchmark product is the least demanding non-workshared bulk mail contract - in terms of volume and sorting preparation - since Direct Mail is a business product and there is therefore no specific private customer tariff for Direct Mail. The benchmark products used to illustrate the magnitude of worksharing rebates in this Table should not be confused with the actual process for obtaining the prices of workshared products. The actual process for deriving the price of each of the respective workshared products is, as indicated in the text, based on the logic of avoided cost, as derived from the workflow, costing and base tariff considerations appropriate to each class of workshared mail. For example, the price of Workshared Bulk Mail (shown as 0.40 €) was not obtained by applying avoided cost discounts to the price of single-piece mail. It was derived based on the avoided cost of the respective worksharing activities embodied in this type of mail. Consequently, the three comparisons shown in this Table (for D+1/2, D+3/4 and D+7) should be understood as comparisons to illustrate the magnitude of the discounts available for unbundled products relative to comparable bundled products, and not the actual process of computing these discounts.

** The “maximum rebate” indicated in the table includes the combined effects of three types of rebates available to La Poste customers:
1. Rebates related to “contrats produits” subject to volume and pre-sorting conditions (avoided costs in collecting and sorting)
2. Rebates related to “contrats techniques” subject to supplemental pre-sorting and mail preparation (avoided costs in collecting, sorting and handling of mail).
3. Rebates related to “contrats commerciaux” subject to total (e.g. annual) volume conditions (avoided costs in the distribution segment).

The changes and trends noted above have led simultaneously to increased concentration in the sector and a presence of large international, investor-owned groups in the consolidation market, as the investments were particularly costly (IT, Sorting machines, printing machines). A 2002 study by La Poste summarized the main players in the Direct Mail and Transaction Mail consolidation markets in France (See Figures below).

In the Direct Mail consolidation market, the main players are Diffusion Plus, a French company quoted on Euronext with 20% of the market (in terms of mail volume). Next, EDMLS (Eurodirect) and Arvato have respectively 9% and 8% of the market and both are subsidiary of the German media giant, Bertelsmann.
Koba, a subsidiary of the German postal operator DPWN, had 5% of the market in 2002. La Poste is not active as a Direct Mail consolidator.

The concentration of the market is even greater for Transaction Mail consolidation. With a market share of 29% of the mail items, the leader of the industry in France is Asterion, a subsidiary of the Belgian Post. Aspheria is a subsidiary of French La Poste and, with 10%, represents the only involvement of La Poste in upstream consolidation markets. DPWN, through its subsidiary Koba, is also a major player in this market.

As with USPS, the details of worksharing contracts are sufficiently complex that this area has created some tension between consolidators and La Poste. In response to this, the French postal regulator ARCEP has set up a dispute
resolution procedure to allow the identification of sources of tensions in worksharing arrangements and resolution of these.

La Poste has stated that they are committed to the principle that worksharing organizations and La Poste share a common interest in growing mail volumes. In the interviews underlying this study, La Poste representatives noted that this principle will not change under FMO, since by now the upstream activities in the postal sector in France are firmly connected to a large network of workshared operations.

However, under FMO there may well be pricing changes in workshared products, moving from the current ACP approach to a zonal pricing approach along the lines of DAP. As in the case of the USPS, worksharing and upstream access represent a success story in France, promoting the leveraging of the incumbent PO’s network through incentives that motivate efficient preparation of mail and parcels.

4.2.4 Example of Experience in Pricing Access: Perspectives from the United Kingdom

As noted in de Bijl et al. (2006), access conditions vary considerably across the EU. In the UK, Royal Mail is required by its regulator (Postcomm) to provide access to any of its postal facilities (including, for example, its delivery network) by individual customers, consolidators and competitors. The terms under which access is provided are based usually on negotiated contracts between Royal Mail and parties seeking access, but Postcomm can impose a settlement in the event that the parties cannot agree.

In Germany, DPAG is obliged by law to offer downstream access services under terms and conditions that are largely determined by the National Regulatory Authority (BundesNetzAgentur). The Netherlands and Sweden also have Negotiated Access Pricing, largely determined by free negotiations between the USP and parties seeking access to the USP’s network. The UK framework and experience is now reviewed.

Evolution of access pricing in the UK

Access prices were originally agreed between the incumbent operator Royal Mail and UK Mail in February 2004. This was followed in April 2004 by similar downstream access agreements with TNT and Deutsche Post. All three companies are licensed by Postcomm (the postal regulator) to provide “consolidation” services, where mail is collected from customers or groups of customers and is then handed to Royal Mail for final delivery (while TNT and Deutsche Post were also licensed to provide delivery services for mailings of over 4,000 items).

Initially agreements for access were set on a geographically averaged cost recovery basis. This meant that licensed operators were required to present mail to Royal Mail in a form that reflected the overall letter volume of Royal Mail’s business, on the basis of individual postcode areas. Should volume vary from
Royal Mail’s by more than 7.5% but less than 15% in any ‘reference period’ (each such period being approximately three months) Royal Mail had the right to levy a surcharge. If volume in any outward postcode area varied from Royal Mail’s by more than 15% in any ‘reference period’ Royal Mail had the right to levy a higher surcharge, ask the customer to transfer to a zonal agreement or, if all else fails, terminate the agreement.\(^34\)

As of October 2004, Royal Mail added to its set of generic agreements (described above) access contracts based on geographically de-averaged access prices. These de-averaged access contracts are negotiated freely between Royal Mail and different operators and users, subject only to being offered on a non-discriminatory and non-preferential basis.

Once a contract is negotiated, then it is available to other customers if they meet the terms of the contract. If they want something different, then a new negotiation is initiated. Thus, the first contract negotiated was the one with UK Mail. That continues to be in place. A non-uniform price contract was negotiated with a different customer later in 2004 and that also is still in place. Furthermore, there is nothing preventing a customer from having two separate access agreements, one with a uniform price based on a national fall to earth and one with a non-uniform price, provided that they meet the terms for each contract.

Royal Mail published an explanatory note on geographically de-averaged pricing (which it calls “non-uniform” pricing)\(^35\). The note included the following comment:

- “In calculating a non-uniform access price, two of the most important cost drivers … are Delivery Point Density (DPD) and Business Density (BD); and
- DPD … determines the average travel distance between delivery points. BD is the proportion of delivery points that are registered as businesses”.

Royal Mail divides clusters of delivery points around the country into five bands, known as delivery zones, defined in terms of their major cost drivers (DPD and BD). Zone A is reported to have the cheapest delivery costs and hence the access price for zone A delivery points is the lowest. Access prices increase from zones B-E to reflect the cost differences of delivery to points in each zone.

In 2006, fourteen licensed operators competed with Royal Mail. In 2005, new operators carried more than 106 million items “End-to-End” (providing collection, sorting and delivery) and their revenue rose by 121 per cent to €44.6 million.\(^36\) UK Mail (among others) could offer End to End mail services, but to

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\(^{34}\) The Universal Service for Bulk Mailers: A Postcomm Decision Document”, 30 June 2005

\(^{35}\) Access to Royal Mail’s Postal Facilities, 15 October 2004

\(^{36}\) National Audit Office (2006), ‘Re-opening the Post: Postcomm and the Quality of Mail Services’ 22nd March
date the mail collected by UK Mail is ultimately delivered by Royal Mail. Although the UK postal market has been fully liberalised Royal Mail still has a dominant position. Royal Mail accounts for 97% of mail volumes in the regulated area in 2004-05\textsuperscript{37}, and it reported revenue growth over this period of 3.7%.

*Current state of access pricing in the UK*\textsuperscript{38}

Until 2006, geographically de-averaged access prices changed from year-to-year on the basis of a pre-determined formula (RPI-1%). The original access prices to which this clause applied were the negotiated prices, i.e. this formula was incorporated directly within the negotiated access agreements itself. The initial underlying prices (to which the RPI-1% per annum adjustment was applied) were roughly in line with avoided costs associated with a typical second-class\textsuperscript{39} item of mail.

Subsequently, the current (2006) regulatory review conducted by Postcomm has suggested an alternative pricing mechanism which simply preserves the headroom\textsuperscript{40} between access and retail prices over the next four years (2006 to 2010) as compared with an equivalent end-to-end product.\textsuperscript{41} This is expected to filter through to access agreements as they are renegotiated.

The requirement that access price meet the minimum price difference with its corresponding end-to-end product is checked as part of the audit conditions for the price-cap control, but only the end-to-end product is directly in the price cap formula. New access products are outside the control unless Postcomm determines that they are "substantially similar" to an existing product and hence would be treated the same as one of the existing price controlled access products. Hence, there is no allowed revenue calculation for access, only that access prices do not violate the headroom requirement.

This arrangement of allowing considerable flexibility to Royal Mail to price its access products, subject only non-discriminatory offering of access services to all parties and to the ceilings derived from the respective end-to-end products is very much in line with what was described earlier as Negotiated Access Pricing.

Postcomm requires that any access agreements entered into by Royal Mail are passed to the regulator as soon as practical for review and published on its website. As a result of a recent licence amendment, a grace period of one

\textsuperscript{37} Though these figures exclude Document Exchange mail which is not regulated and which accounts for approximately another 2% of addressed business mail, thus reducing Royal Mail’s market share to some 95%.

\textsuperscript{38} For a good description of the history and principles underlying access pricing in the UK, see Hill and Robinson (2006).

\textsuperscript{39} The precise benchmark for computing access prices is still under discussion, but Postcomm notes that the correct basis upon which avoided costs should in fact be calculated is that of a second-class mail item, since this is where access and competition primarily exist.

\textsuperscript{40} The "headroom" is a minimum. Access prices can be lower than required by this difference but not higher.

\textsuperscript{41} The possibility is foreseen in the access regulations of reviewing the current headroom minima and changing them after 2 years.
month is now required, before the arrangements can be implemented. Postcomm uses this period to assess the regulatory implications of the proposed arrangement and its competitive properties.

Paragraph 2 (Condition 9) of Royal Mail’s license says:

“If any person who is a postal operator or user seeks access to Royal Mail’s postal facilities, Royal Mail shall negotiate with that person in good faith with a view to agreeing with him terms for such access.”

As such, any prospective new entrant can simply approach Royal Mail and discuss access requirements. Terms are commercially negotiated and remain confidential until agreed. Most new entrants are likely to require a tailored access ‘product’. Ultimately, and subject to regulatory scrutiny, the access agreement can be enacted.

Changes following liberalisation

Following liberalisation, Postcomm have committed to preserve the ‘headroom’ between access and retail prices for the next four years to foster the development of competition through access. In the longer term, it is likely that the regulator will take a view as to whether downstream access arrangements are the most appropriate and efficient mechanism of fostering competition, or whether other regulatory mechanisms could be employed to provide incentives for end-to-end competition.

Should access be found over time to be the appropriate optimal means through which competition could be promoted, it is likely that continued downward pressure would be exerted by Postcomm on access prices. Royal Mail itself expects to see access volumes increasing significantly over the next five years, driven in part by the extent to which access prices are reduced in real terms. In this scenario, the company could be transformed into a ‘delivery-only’ monopoly, with growing volumes and increasing cost pressures up-stream.

Challenges to effective access

VAT exemption: The VAT exemption enjoyed by Royal Mail is cited by competitors as a barrier to effective competition given that new entrants and competitors must charge VAT on sales. Royal Mail disputes this claim; suggesting that the majority of customers served by its competitors are able to reclaim offset VAT against the VAT charged by sellers of postal services if the customer is rated for VAT purposes (since, as the name suggests, VAT is a tax only on value-added activities).

Overall, and viewed in this context, estimates reported by Postcomm suggest that the VAT exemption creates only slight price advantages for Royal Mail. 42

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There is, however, some uncertainty around the extent to which the VAT exemption will continue since the European Commission has launched proceedings against the UK Government on Royal Mail’s continued VAT exemption.43

Moreover, notwithstanding the outcome of this legal process, there is some current ambiguity concerning the extent to which companies acting under access agreements are themselves exempt from charging VAT by virtue of the fact that they are acting as ‘agents’ of Royal Mail. Ambiguity therefore arises from the way in which access arrangements are drawn up.

Theoretically however, and on the basis that Royal Mail’s VAT exemption remains, it might be possible for a new entrant to charge no VAT on the component of their overall tariff that represents the access price levied by Royal Mail. VAT would however be charged on the residual (the difference between the access price and the retail price).

Needless to say, these ambiguities need to be cleared up to assure transparent conditions for the access market. In any event, VAT does not appear to have played a role in the initial development of downstream access in the UK as most of the mail which has moved into downstream access so far has been mail generated by VAT-exempt financial services companies (e.g. RBSG, Lloyds, Barclays, etc.).

**Access prices per se.** The process through which mark-ups are determined in setting access prices’ (so as to make a reasonable contribution to Royal Mail’s fixed costs of running its network) is treated with some scepticism by new entrants and competitors. Commentators have suggested that this has allowed Royal Mail to load costs away from unregulated access products and onto price controlled customers without due consideration of the drivers and apportionment of these costs.

The tensions here are normal in moving to a more competitive market place, and have been seen in several other sectors as well (as discussed in Armstrong, 2002). Their resolution will require on-going discussion, evolution and further compromise.

Summarizing the experience to date, access pricing in the UK is viewed as one of the important instruments employed in leading to workable competition, both upstream (through worksharing) and downstream. Growth in use of access products has been significant44, and is expected to continue with the complete abolition of the Reserved Area as of January 1, 2006. Given the importance of


44 See [http://www.royalmailwholesale.com/c9_reports.cfm](http://www.royalmailwholesale.com/c9_reports.cfm). At the time of writing downstream access in the UK was at a level of approximately 40m items per week, with 14 access contracts in operation.
access for both consolidators and end-to-end competitors, pricing and terms of access are expected to remain a central focus of the UK regulator Postcomm.

4.2.5 Concluding Comments on Access Pricing

The background and general approach to upstream (worksharing) and downstream access in the postal sector were reviewed. As noted, access will be of central importance under FMO, especially in the early stages of entry. Properly structured access prices can contribute to funding the USO as well as promoting competition by leveraging the incumbent PO’s network.

Three approaches to access have been noted, either currently employed or under discussion in various Member States in the EU: Avoided Cost Pricing (ACP), Delivery-Zone Access Pricing (DAP) and Negotiated Access Pricing (NAP). The merits of each of these have been discussed, including enforcement and transactions costs. Some specific applications of these rules in USPS, La Poste and Royal Mail have also been described.

This section can be concluded with a few observations on 4 critical features and policy issues concerned with access pricing under FMO.

- **Negotiated versus mandated access provision.** In the initial stages of FMO, it will certainly be efficient to promote upstream access to encourage the development of mail preparation infrastructure and to capture the obvious benefits of joint preparation and worksharing of mail. While the principles of worksharing pricing and access might well be mandated to begin with, one would expect regulation of these to be withdrawn in favour of negotiated prices and conditions as workable competition is established. The USPS and La Poste cases illustrate the benefits of this approach.

- Downstream access under bypass (i.e., under FMO) is not a simple matter, and efficient conditions for pricing and access depend on a number of country-specific conditions. It would therefore be appropriate for country-specific solutions to dominate the regulation of downstream access, with a starting position being negotiated access pricing that allows the USP to contract freely with entrants on the terms of such access.

- **Non-discriminatory treatment between the PO’s own customers and its competitors.** As long as incumbents enjoy a market dominant position, non-discriminatory treatment of the PO’s customers and entrants will be important to mitigate anti-competitive behaviour. Such non-discriminatory treatment can be further enhanced by requirements for public posting of generic rates, as is the case in the UK and La Poste. The incumbent can and should, however, have the ability to depart from these generic rates in designing new products for specific customers, as long as these departures are governed by general principles that are applied in non-discriminatory fashion to all comers.
The actual form of the access pricing rule. The literature and practice of access pricing was reviewed in detail above. It should be emphasized that departures from efficient access pricing can have very negative consequences under FMO, consequences which would be masked in a monopoly setting by the ability to raise prices to cover inefficiencies. Under FMO, for example, the wide-scale practice of charging uniform prices, based on avoided cost principles, will naturally have to give way to zonal pricing of access, at least to the extent that there are large differences in cost between different zones in a country. Otherwise, the USP will find itself combating two problems of uniform pricing: the first from its single-piece letter rate and the inherent cream-skimming possibilities between low-cost and high-cost areas; and the second the compounded effects of providing subsidized access to its high-cost areas, while entrants deliver to the high-margin, low-cost areas.

Regulation of access pricing and conditions. Under FMO, upstream access should be subject to minimal regulation, requiring only that access prices and conditions be on non-discriminatory terms as between NEs and customers of the USP and bounded by delivery prices and the applicable single-piece rate (First-Class or Second-Class, depending on the service terms offered). Access to any provider’s actual facilities (e.g., for use of that provider’s equipment) should be left entirely to freely negotiated contracts. Pricing of upstream access is naturally intended for business mailers, with volumes above thresholds that make bulk handling and accounting economical. Even for consolidators, mandatory avoided cost rules, while simple in application, are likely to be inefficient and to attract a greater volume of mail destined for ultimate delivery in high-cost areas. DAP or NAP rules are therefore to be preferred, where one would expect NAP to approximate DAP since under competition, there would be pressures to align prices with costs. This is foreseen explicitly in DAP, and negotiated access (NAP) would be driven to the same result once workable competition is established.

From an antitrust perspective, the DAP approach with non-discriminatory and ex ante information provision has a number of advantages in that it may safeguard entrants from anticompetitive practices, for example, predation and safeguard POs from excessive antitrust litigation. The access price provides a floor price. Prima facie if the PO sets the price to its customers above the access floor, it may be considered not to be predatory. In the case of CityMail’s case against Sweden Post there was no equivalent floor established by the regulator. Where an access price is established by the regulator and made publicly available to all, the prices are transparent. A PO, where it competes with entrants, cannot charge below this price for its end-to-end services without making it rather easy for a competitor to charge predation. The issue of how much above this price the PO would have to charge is clearly debatable. However, by setting a floor for the biggest slice of the value chain, the regulator
has reduced significantly the money in contention providing the right incentives for both parties to steer away from anticompetitive practices and to avoid inflated claims of such practices.

In the early stages of FMO when the USP maintains a dominant market position, business products, including access, may still be subject to price and profit regulation. As discussed above, various forms of price-cap regulation can accommodate both DAP and NAP rules as part of an overall protective umbrella of price-cap regulation. One would expect such regulation of business mail products to gradually be withdrawn as workable competition is established.

Regulators are likely to require some regulation of downstream access, to assure that in the early stages of FMO that NEs can gradually develop their markets and leverage their initial entry on the USP’s network for high-cost areas. Given this, it is important that access prices be geared to cost, while still allowing access to make some contribution to overall USO costs, as would be the case under DAP. In terms of implementation, regulators might initially enforce DAP but gradually move to a monitoring role as workable competition is established, leaving then NAP as the preferred “light-handed” approach under FMO.

The regulator will clearly be vigilant, within the limits of the information asymmetries involved, to prevent monopoly pricing of access. Similarly, the regulator’s role will militate against unfair competitive practices, like predation. Finally, the regulator can also control the single-piece price. Price-caps and other incentive-based regulation can capture through global price caps incentives for promoting dynamic efficiency across both end-to-end services and access services. All of this is likely to be beneficial in promoting robust funding of the USO. The result is that the regulator will have a strong interest in overseeing increases in this rate but at the same time would see the consequences of such rates against the desired balance in funding the USO. These are not trivial tasks but, as regulators become better informed about the forces at work, it seems likely that they will be able to address them in a reasonable manner.
4.3 USO: Scope, Characteristics and Funding

This section examines the nature and origin of the Universal Service Obligation (USO) including how to fund it under FMO. It also provides a summary of the features of the USO in different Member States, and the expected evolution of universal postal services under FMO, as suggested by interviews and research conducted under this Study.

4.3.1 Background on the USO

The origins of ubiquitous delivery and uniform price

The USO has been an integral feature of postal service for many years. Its origins can be traced back to 1840 with the implementation of the reforms of Rowland Hill in the form of the Penny Post in the United Kingdom. Prepayment by means of a stamp was a significant innovation in 1840. It had the benefit of dramatically reducing transactions costs since the price was collected up-front from the sender by means of a prepaid stamp, rather than from the addressee on delivery. It made mail service affordable to the entire population. For the price of a stamp, delivery anywhere in the country was provided. Thus, the twin notions of ubiquitous delivery and uniform price inherent in the USO evolved, and these have remained an integral part of the USO ever since.

The uniform-nationwide prepaid price for the delivery of a letter reduced transactions costs dramatically in two ways. The prepayment meant that the postman no longer had to collect from the recipient, as had hitherto been the case. This was an expensive procedure because the recipient might not be willing or even able to pay, resulting in abortive and therefore costly deliveries in these cases. This reduction in transactions costs was significant and went a long way to making mail service affordable.

Mail service was also made affordable by the uniform price irrespective of where the letter was delivered. So the mailer just needed to buy the penny stamps and affix them for delivery anywhere in the land. This meant mailing was easy and therefore amounted to a further reduction in the implicit price paid as the mailer had to put minimum effort or thought into the process. The features of uniformity of price for nationwide delivery continue to be valued by individual mailers and supported by governments.

However, while there are obvious benefits of the dramatically reduced transaction costs resulting from ubiquitous delivery at a uniform price, these benefits come at the cost of decoupling the direct relationship between cost and price. As a result postage does not necessarily reflect the actual cost of delivery between two points. This, indeed, has been the source of the “obligation” in the USO debate, as decoupling price and cost leads to a number of problems, especially when competition is allowed, as discussed further below.
While ubiquity of service and uniformity of price are the foundation of the USO they are not the only constituents of the USO. It also calls for some uniformity in service standards, an obligation not only to collect letters but also to collect and deliver parcels, and an obligation to provide postal counters. While some countries do apply uniform parcel rates, the uniform price constraint does not necessarily apply to parcels. For example, in the European Union, the Second Directive allows non-uniform pricing for parcels, while maintaining the USO. Other countries, including the United States and Canada, apply zonal pricing: parcels mailed within a given zone will be subject to a uniform counter price. Regardless, there is an obligation to provide parcel service at a reasonable price.

In many countries, it would usually be too costly to apply the uniform service standard ubiquitously and in some countries dramatically so because of the large land mass and sparsely populated area, for example, Australia, Canada and the United States. Because of this concern to not to add further to the already high costs of servicing remote or rural areas, service standards are often allowed to be somewhat lower in rural areas than in dense urban areas.

The public policy expressed by the USO is transparent, easily understood and generally accepted. The uniform price of a stamp is well known and is monitored by industry regulators or the government to keep it reasonable. The simplicity, transparency and affordability of the ubiquitous service provided by national post offices (POs) are major reasons for the continued public support for the USO, and recognition of this support was reiterated across stakeholders in Member States interviewed in the course of this Study.

The benefits of the USO come at a cost and the cost is the inefficiency that results from the uniform price, which results in high-cost areas being priced below cost and low-cost areas being priced above cost. This is known as cross subsidy. The system of cross subsidy has traditionally been maintained by restricting entry to the postal market by means of a “reserved area” (RA). The reserved area was traditionally defined in terms of weight or value thresholds, e.g. restricted to letters of low weight e.g. 50 grams or by monetary amount, e.g. prices of less than 1 euro. This prevents entrants from entering the low-cost markets by undercutting the PO. (This is usually referred to as “cream skimming”.) This is a major concern of FMO: will cream-skimming entry so undermine a PO’s ability to fund its USO that its financial viability is threatened?

The USO is an extremely important distinguishing feature of POs. Unregulated carriers, or couriers, the competitors of POs, do not have such an obligation. After a century and half, the benefits of the USO remain highly valued. Governments continue to embrace the USO and, indeed, developing countries are generally seeking to attain its benefits. Even the severest critics of POs and strongest supporters of FMO argue for retaining the USO. As noted below in more detail, the character of the USO could well change under FMO, with some of the “common and necessary”: universal services provided under the current USO being increasingly provided by the market. This could also entail a change in the character of the USO, with no obligation imposed on any
particular organization to provide such services as are provided by the market. This feature of making the “O” part of the USO a responsibility of all market participants is foreseen in several country regulations, for example in the Postal Law in Germany.\footnote{See the attached Country Reports for details on this provision as well as other expected changes in particular countries in the USO under FMO.}

In addition to the USO for letters, POs usually have a USO in parcels in addition to the USO for letters. There are a number of differences between letters and parcels, the most important one being that usually there is no reserved area and no obligation of uniform pricing in parcels. So a PO may have an obligation to deliver ubiquitously parcels of up to, say, 30 kilograms but has no reserved area in parcels. This may be contrasted with the case of competitors in parcels. They may deliver wherever, whenever, and whatever they want. POs are required to deliver everywhere, up to some limit, typically five or six days a week, depending on the frequency imposed by the PO’s government as part of the USO.

As well as traditional letters and parcels, citizens of each country have traditionally received from their POs services that include the distribution of information in the form of publications, newspapers, and advertising mail. Further evolution in postal services took place and as a result a number of value-added features, such as registration, special delivery, insurance, etc., have also come to be associated with and perhaps integral to those services covered by the USO. Access to these value-added services will be an important element of the USO under FMO, and it may change as postal customers come to value these services differently in the future. In general, one would expect FMO to motivate a better alignment of value, price and cost of such services.

Generally, but with differences in emphasis across countries, access to retail counter services has been an important aspect of the USO in the past. The USO means having not just providing ubiquitous delivery but also having a ubiquitous network of post offices to provide retail services in the form of postage sales, parcel drop-off and pick-up and in some countries services such as cash disbursement and banking.

It is because of their USO that POs have many more outlets than they would in the absence of a USO. In France for example, around 13,000 outlets existed in 1914, 14,000 today. Most of them are in rural area, while in the same period, 80% of the population moved to urban areas. This rigidity is enforced by the new USO definitions, but could be just a consequence of administrative status.

Privately-owned companies that do not have a USO would have many fewer retails outlets than POs. One measure of a PO’s burden is the extra outlets it is obligated to operate. The presence of scope economies (i.e., economies in producing two or more services together, rather than independently) mitigates the cost of meeting this burden somewhat, but the provision of ubiquitous outlets clearly remains perceived as one of the burdens of the USO. Some USPs at the opposite consider their network of outlets as a competitive advantage, and...
just reduce the burden on USO franchising the outlets, or sharing them with financial services. Note, however, that some services, which are offered through the retail counter network, could be offered at fewer locations, lowering the cost of the USO but increasing the transactions costs of some customers in obtaining some services.

Summarizing, the USO has been an essential ingredient of postal services since their widespread diffusion following the innovation of the Penny Post. The general idea of the USO is similar to that of “default service obligations” in other network industries that provide services, which are thought to be common and necessary for all citizens. The USO specifies the set of services, which are to be accessible, more or less uniformly, by all citizens. The scope of such services often evolved in a somewhat haphazard fashion in different industries, including the postal sector, without much regard to the usual market dictates of value, price and cost alignment. This historical evolution inevitably gave rise to differences across countries in terms of universal services offered by national POs, and now embedded in the public’s expectations. As the European Union approaches the launch of FMO, it is helpful to keep in mind that markets have little respect for the status quo, but rather tend to put pressure on any misalignments of cost, value and price. Before examining what might be expected in terms of these pressures on the USO under FMO, let us take a closer look at the present state of the USO in Member States.

4.3.2 The Present State of the USO in Member States

The implementation of the USO has been determined by individual national governments. Traditionally, such governments have delegated most or all of the determination of the USO to their (publicly-owned) POs. In the European Union, minimum standards for the USO are set in the First and Second Postal Directives, but there is considerable variation across Member States in the setting of the USO (see Annex C for a summary of the current scope of the USO in Member States). Also the Universal Postal Union (UPU) has taken a greater interest in the USO with a view to establishing more uniform standards. As outlined in Leskinen (2004), Article 1 of the Universal Postal Convention of 1999 affirms the right of citizens of all member countries to universal postal service. The interpretation and implementation of the USO, which includes provisions on affordable prices and service quality, is recognized by the UPU as being within the sovereignty of the individual country. The EU Directive 97/67/EC, “the Postal Directive”, is much more specific and focused, placing definitive obligations on Member States by requiring minimum standards that are to be guaranteed by Member States. Article 3 of the Directive provides for “permanent provision of a postal service of specified quality at all points in their territory, at affordable prices for all users.” Table 9 summarizes the requirements of the First Postal Directive (Art. 3).
Table 9: Universal Postal Services as Defined in First Postal Directive (Art. 3)

<table>
<thead>
<tr>
<th>Scope of USO Services</th>
<th>Postal items up to 2 kg (correspondence, direct mail, books, catalogues, newspapers, and periodicals); Postal packages (parcels) up to 10 kg (20 kg). Services for registered and insured items.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accessibility</td>
<td>Density of points of contact and access (counters and letter boxes) according to the needs of users</td>
</tr>
<tr>
<td>Frequency of clearance and delivery</td>
<td>One clearance and one delivery every working day, and not less than 5 days per week.</td>
</tr>
<tr>
<td>Quality of service (end-to-end transit time)</td>
<td>In line with standards for intra-community cross-border mail (D+3 85%)</td>
</tr>
<tr>
<td>Prices</td>
<td>Affordable</td>
</tr>
</tbody>
</table>

Two recent surveys of the USO, Finger et al. (2005) and Ambrosini et al. (2006), provide helpful overviews of comparable features. Annex C reproduces the survey of Finger et al. (2005)\(^ {46}\). The following essential points from this survey can be noted.

Current scope: Typically weight limits (e.g., 2 kg for postal items and 20 kg for parcels) delineate the scope of products covered by the USO. Given the requirements of the First Postal Directive, registered and insured items are covered as well as newspapers and periodicals, although explicit recognition of these services varies considerably across Member States (see Annex C). Constraints on location and services offered at counters (postal outlets) and locations of letter boxes vary considerably across Member States. Quality and delivery frequency requirements associated with the USO also vary considerably across Member States.

Current commitment to USO: As noted earlier, there is expected to be a strong and continuing commitment to the USO, both before and after FMO. The general flavour of the USO is, however, expected to change somewhat as the market begins to assure services for business customers, leaving the USO primarily as an obligation to protect the provision of “common and necessary” postal services for households and small businesses, both as senders and receivers.

A further important, but somewhat ambiguous element, associated with the traditional USO has been the concept of “affordability”. The EU Postal Directives enshrine the notion that postal service should be affordable, and this concept is at least implicitly part of the USO in all Member States. Affordability is typically assured through capping of prices for single-piece letter mail (i.e., the First Class stamp for the first weight step).

Table 10 and Table 11 below are taken from the survey in Ambrosini et al. (2006) to summarize some of the differences in implementation of affordability

\(^{46}\) Thanks to Professor Finger and his co-authors for providing an updated version of the original survey published in Finger et al. (2005).
Again here considerable variability is seen in the implementation of the affordability criterion required under the First Postal Directive.

Table 10: Price controls in the selected countries from Ambrosini et al. (2006)

<table>
<thead>
<tr>
<th>Country</th>
<th>Price control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Price cap</td>
</tr>
<tr>
<td>Canada</td>
<td>Price cap for basic letters.</td>
</tr>
<tr>
<td>Denmark</td>
<td>Price cap for products of the reserved area, no constraint for universal service products outside the reserved area.</td>
</tr>
<tr>
<td>Finland</td>
<td><em>Ex-post controls</em></td>
</tr>
<tr>
<td>France</td>
<td>Global price cap for universal service products, possible split of the cap between single and bulk, price control for each product in the reserved area, notification to the regulator for the others universal service products.</td>
</tr>
<tr>
<td>Germany</td>
<td>Three baskets of price caps for letter mail items up to 1000 grams, other USO-products are subject to an <em>ex post</em> control (if prices are not in line with the principles of the Postal Act).</td>
</tr>
<tr>
<td>Ireland</td>
<td>Price control by the regulator for products in the reserved area.</td>
</tr>
<tr>
<td>Italy</td>
<td>Price cap for reserved products. The price cap system is applied every three years. The prices of universal non-reserved products are set “consistent” with the prices of reserved products.</td>
</tr>
<tr>
<td>Japan</td>
<td>Direct control for ordinary, special handling, and international mail.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Price increases for domestic universal services must not exceed the Dutch national wage index. Two price baskets for postal services: all domestic universal postal services and a small users’ basket.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>No controls (competition laws and market forces are seen as sufficient)</td>
</tr>
<tr>
<td>Norway</td>
<td>For assessing whether the tariffs are cost-based, and for detecting unlawful cross-subsidization, Norway Post keeps a product account. The regulator examines the product account.</td>
</tr>
<tr>
<td>Portugal</td>
<td>Price cap for products in the reserved area, <em>ex post</em> control for universal service products outside the reserved area.</td>
</tr>
<tr>
<td>Slovenia</td>
<td>The USP is obliged to receive price approval from the Post and Electronic Communications of the Republic of Slovenia.</td>
</tr>
<tr>
<td>Spain</td>
<td>Global price caps can be set (and are actually in place) by the government.</td>
</tr>
<tr>
<td>Sweden</td>
<td>Price cap for domestic priority mail up to 500 grams</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Subject to the control of the federal government.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Global price cap for all products where competition is not effective. Monitoring of access prices.</td>
</tr>
<tr>
<td>United States</td>
<td>To change rates, the USPS is required to obtain a recommended decision from the Postal Rate Commission. (Such decisions can be modified by a unanimous vote of USPS Board of Governors</td>
</tr>
</tbody>
</table>

47 The reader will note from Table 10 that the Ambrosini et al. survey also contains information on Australia (AT), Canada (CA), Japan (JA), New Zealand (NZ) and the United States (US), as well as a number of European countries.
**Table 11:** Ranking according to the existence of uniform price constraint for the reserved area from Ambrosini et al. (2006)

<table>
<thead>
<tr>
<th>No constraints</th>
<th>Constraints for some products</th>
<th>Constraints for all the products</th>
</tr>
</thead>
<tbody>
<tr>
<td>IE, IT</td>
<td>AT, US</td>
<td>CA, CH, DE, DK, FR, NL, NO, SI, SP, UK</td>
</tr>
</tbody>
</table>

**Table 12:** Ranking according to the existence of uniform price constraint for the products outside the reserved area from Ambrosini et al. (2006)

<table>
<thead>
<tr>
<th>No constraints</th>
<th>Constraints for some products</th>
<th>Constraints for all products</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA, CH, DE, FR, IE, IT, NO, NZ, PT, SP</td>
<td>AT, FI, JP, SW, US</td>
<td>DK, NL, SI, UK</td>
</tr>
</tbody>
</table>

### 4.3.3 The Evolution and Redefinition of the USO under FMO

FMO raises questions as to whether changes in postal markets should not dictate a re-examination of the nature of the USO. However, there is near-universal agreement on the issue of the existence of the USO. Almost all the architects of increased competition in the postal sector argue for the continued existence of some form of USO. For example, in the UK, where the British regulator Postcomm has undertaken a critical re-examination of the USO, there is no discussion of abandoning the basic principles of ubiquity and uniformity as integral to the concept. Indeed, the enabling legislation obligates the regulator to safeguard the viability of the USO.

Moreover, the figures in the previous section suggest broad agreement, perhaps driven by the requirements of the First Postal Directive, on the scope of the USO. However, it is interesting to note that where the EU Directive is less specific (in price controls and in accessibility requirements) is precisely where the widest variation in the national regulations adopted for the USO is seen. This undoubtedly reflects differences in value associated with various attributes of postal services, and (unless contravened by more stringent requirements in future EU Postal Directives) this variation can be expected to continue and to widen under FMO, since the essential character of markets is to provide a fit between value, service attributes, price and cost. Indeed, as Finger et al. (2005) point out, the First Postal Directive of 1997 “codified pre-existing national arrangements”, so that the variability noted is not of recent vintage, but reflects conditions and preferences of Member States going back some years.

Beyond the scope of products offered under the USO, there may be pressures under FMO on other aspects of the USO. Consider “affordability”. Under the current approach of ubiquity and price uniformity, the notion of affordability is transparent. When pricing and access conditions for postal services become more complex, as will almost certainly happen under FMO, affordability will also become less transparent, with the usual market test being the gold standard.
determining what prices and what services will be offered. However, the
country reports for this study echo the results of studies such as that of Finger et
al. (2005) in predicting that only a small portion of household budgets will
continue to be spent on postal products. Moreover, business customers should
face increased product offerings and choice under FMO, so the issue of
affordability will likely become less salient as market forces take hold.

Nonetheless, to the extent that cost drivers and value drivers of postal services
vary across Member States, it is natural to expect also variation in USO
requirements. This natural variation can be expected to be reinforced under
FMO. In judging where there may be pressures to adapt the USO in response
to changing market conditions ushered in by FMO, it is useful to consider a few of
the areas where one expects stability going forward, thereafter some areas
where increased variation or fundamental changes may be expected.

In terms of areas of stability going forward, all respondents in the PwC country
surveys anticipate continued uniformity in price and ubiquity of service for
single-piece letters, providing therewith both traditional transactions cost
savings to consumers as well as a measure of protection against price increases
through the transparency of the stamp value. Respondents also anticipate
stronger emphasis on service quality under market conditions to continue to
push for ubiquity of service for single-piece letters and high service quality
standards for both First-Class and (where offered) Second-Class letter service.

One might summarize this set of expectations by saying that the USO for
collecting and delivering mail for services to households and small businesses is
likely to continue for some time in roughly its current form, with possibly some
differences rooted in historical conditions across Member States. These same
expectations apply in most countries to the delivery of high-margin transactions
mail for business customers, as most of this mail is benchmarked and co-
mingled with single-piece services.

Where there is some disagreement or uncertainty about the desired scope of the
USO going forward, it has to do with the nature and uniformity of counter
services for smaller customers and the nature of end-to-end mandated services
for business customers. Let us consider each of these in turn.

On the issue of counter services, different countries have understandably
different concerns in this regard. Some are driven by local political pressures to
continue to see strong and ubiquitous counter services across the country.
These same pressures push in the direction of having full service counters
available in high density areas, and perhaps a uniformity requirement on the
services available at all counters (even though some of these services might be
used very infrequently in some areas). The question of financing these services
remains unsolved: in France, a system has been put in place to fund them
through local tax alleviation, the possibility was even considered to have the
municipalities supporting some of the costs (see above Section 2.2.3.2).
Other countries see the possibility of adjusting the scope of services somewhat over time to accord with the actual demand for these counter services.\footnote{This is certainly what one expects and what appears to happen in market-driven industries. For example, Cohen et al. (2006) review the location patterns of bank branches and pharmacies in the U.S. and Italy and they note that these are distributed roughly according to the population to be served. In the area of postal counters, other criteria are imposed and the location pattern of post offices may exhibit much lower correlation with population and other economic indicators.}

**Improved counter access**

For example, in Sweden, the number of full-service postal counters decreased dramatically after liberalization, with extensive franchising taking place. Similarly, in high-cost rural areas, there has been a replacement of many fixed counter services by rural postmen. These and other activities by the Swedish Post Office (Posten Sverige AB) have led to cost savings in meeting its country-wide USO.\footnote{Note that the USO itself in Sweden has not changed. These initiatives have therefore affected the cost of meeting the USO, without reducing its scope. For a recent discussion of the Swedish case, see Falkenhall & Kolmodin (2005).}

Moreover, many of the franchised postal counters are open at more convenient times than previous PO-operated counters, so accessibility for traditional postal services may have improved as a result of the substitution of franchises for PO-operated counters.

This same result on improved accessibility for franchised operations has been reported for other countries as well (e.g., Germany). Thus, reducing the cost of the USO does not necessarily translate into reduced scope or accessibility to postal services for the average customer. It does mean a better alignment of cost, value and prices for such services, as would generally be expected under competition.

On the issue of end-to-end mandated services for business customers, if FMO is able to deliver on expectations, then business customers will have many alternatives available to them. It would then seem hardly in keeping with “market-oriented” principles to impose universal service requirements on any operator in the case of business customers. As workable competition is established, the services to business will change as a result of market forces. As long as regulators impose a USO to benefit small customers, it will have an impact on the service provided as a result of these market forces. However, since the USO is indivisible and non-excludable, it is not possible to offer the USO to small customers without making it available to all. As long as there is any vestige of a USO, it is going to impact the services provided to both large and small customers. These interdependencies imply that FMO will also have an impact on small customers and may, at least indirectly, bring market forces to bear on the nature of the USO for small customers. A number of possible
scenarios could result. With small customers covering the cost of the USO and possibly subsidizing the use by large customers of the USO, the single piece price is likely to rise in real terms, possibly significantly. This could lead to the recognition that the USO was not worth the price paid and would be reduced accordingly. So, under FMO, everything is affected. The impact of price increases in single piece may face resistance from national regulators and their governments if they misguidedly attempt to keep the price too low or try to stick to a USO that is not viewed as being worth the price.

The concern here is how to transition to this market-driven solution. Until workable competition, both upstream and end-to-end, is present, it is likely to be the case that national regulators will continue to impose ubiquitous delivery requirements, for both letter mail and bulk mail, on a USP, giving rise to a host of questions about how to finance the ensuing burden that is thus imposed on the USP. One approach might be to require a PO or some other organization to offer specific services considered necessary (i.e., “universal”) only if they are not provided by the market. This very provision is, in fact, foreseen in some postal laws already (e.g., the German Postal Law). These questions concerning the funding of the USO under FMO, especially during the early phases of FMO, are likely to be at the core of the political and economic debate going forward concerning the definition of the USO, the level of discretion left to national authorities to influence the conditions governing FMO, and ultimately the flanking measures that may be needed to cope with remaining exceptional conditions. These issues are now addressed.

4.3.4 Funding of the USO under FMO

It is widely-recognized (e.g., Cohen et al., 2002) that some countries face a greater burden of coping with the USO than others because of demographic, geographic and economic factors idiosyncratic to each country and network. The varied impacts of demographic and geographic factors are apparent across Member States in the results reported in Chapters 2-3 above. Of the primary dimensions defining the scope of the USO--letters, parcels and retail outlets or counters--the obligation for letter mail usually receives most attention in the economics and postal policy literature. Nevertheless, the obligation to provide ubiquitous counter service and the USO in parcels can also be a significant burden for some USPs.

The USO raises costs for POs because it requires them to undertake non-remunerative activities not imposed on other unregulated carriers. Therefore, POs are required to operate differently from the manner in which unregulated carriers operate. To fund the USO the traditional approach has been to set up a RA from which the bulk of the funding for the USO was derived. Uniform pricing, as required by the USO, then gives rise to cross subsidies within each product class. The surplus achieved from low cost routes is used to fund the losses from the high cost routes. This is a form of cross subsidy by location rather than the traditional form of cross subsidy by product. With each product class, the cross subsidy is dependent on where delivery occurs. Generally, rural
letters are cross-subsidized by urban letters. This cross-subsidisation will face pressure under FMO since cross-subsidization runs the risk of cream skimming and associated revenue loss. Even if a PO moves to zonal pricing for bulk mail, cross-subsidisation would remain for single-piece mail, of which the price is capped, and the volumes are low.

Taking all the above factors into account, national POs will face potential burdens under FMO that they will need to finance in one way or another. The key issue to recognize is that the magnitude of this burden depends on the interaction of several factors as we have examined in earlier chapters. These include the nature of the specific postal market in question, the eternal efficiency of the PO, the nature of the regulation imposed on the PO including the commercial freedom it is allowed, and the scope of the USO itself. The general approach that has emerged from stakeholders interviewed in this study, and from existing successful examples of FMO in various network industries, suggests the following three-prong approach to funding the USO. First, national POs must commit to the process of FMO. Second, through restructuring of its operations, together with increased commercial freedom allowed to the PO after FMO, the PO should normally provide the necessary funding to support the continued provision of USO services until these are provided adequately by the market itself. Third, USO services that would not be provided for commercial reasons by the PO should be identified together with an appropriate funding mechanism to allow the PO, or some other qualified organization, to offer these services.

The key to the three-prong approach just noted is the set of alternatives available to achieve a balance between the burdens imposed by the USO and the means available to finance these. Neglecting changes to the USO itself, these alternatives include principally the following:

- Restructuring of internal operations to improve efficiency of the PO in its initial role as USP;

- Enhancing the revenue generation capabilities of the PO by taking advantage of scope economies leveraged on its ubiquitous network;

- Implementing more flexible pricing and service quality standards for business products, including access, which will be the focus of competition;

- Increasing the single-piece price;

- Providing targeted subsidies to support specific USO requirements that would not otherwise be provided for commercial reasons (we describe below the pros and cons of a variety of funding mechanisms that have been proposed for this purpose).
Given the importance of restructuring of POs, the subject of restructuring is reviewed below as the third thematic case study. We discuss each of the other four alternatives listed above in sequence.

(i) Taking advantage of scope economies by selling competitive services

Although POs have provided competitive services, notably parcels, for many years, defining standards of conduct when a USP does introduce competitive services is not straightforward. Use of the same infrastructure to provide USO and competitive products is likely to lead to claims of unfair pricing practices, unless competitive products are required to make a contribution to the costs of the infrastructure. However, the infrastructure would still be required to meet the USO whether or not such competitive services were offered. The further use of this infrastructure by competitive products paying at least their own incremental cost would generally be efficiency enhancing and could make significant contributions to the viability of the national post office and the ability to fund the USO. Moreover, the cases of Germany and the Netherlands (see section 4.4 below) illustrate the expansion of activities into related products offer advantages to a USP in addressing labour restructuring in a more flexible manner.

A further critical element in the funding of the USO is that the PO may be able to take advantage of economies of scope and scale across the various services it offers. In the case of a multi-product firm a scope economy occurs where, in the case of two or more products, the cost of producing these two products in one firm is lower than if two firms produce them separately. In any individual firm, economies of scale occur where as output increases, unit or average costs decrease. The idea is to spread fixed costs over a greater volume.

Except in rather unusual cases, for example, strongly complementary products if a firm has economies of scope and it decides to add a product, it will be better off if the price it charges is greater than its average incremental cost. The same result is achieved if the incremental revenue from the product exceeds the incremental cost of the product. Using this approach and taking advantage of economies of scope, it is possible to achieve efficiency improvements.
Taking advantage of the economies of scope

The point may be demonstrated by a simple example, recognizing however that in reality the issue is much more complicated. Suppose a PO produces one product, letters. It has fixed costs of €200, with unit costs constant at €2 per letter, and a total demand of 100 units. Its total (stand-alone) costs for letters are therefore €400. Now consider the market for parcel delivery. Assuming a total demand of 50 units, fixed costs of €200 and unit costs of €4/parcel, if a separate firm were to deliver parcels, it would have total (stand-alone) costs for parcel delivery of €400. The total cost between the two companies is therefore €800. Suppose the PO produced both letters and parcels without changing the nature or extent of its network, so that its fixed costs remain €200, with its total variable costs also remaining €200 each for letters and parcels. The total of €600 results in a savings of €200. To break even, separate organizations would have to charge €4 and €8 respectively for letters and parcels. However, if the PO produced both, it could charge, for example, €3 and €6 respectively. The PO would still break even, and both letter and parcel customers would be better off. Moreover, at prices €3 and €6, both products would be making a contribution to covering the fixed cost of the network.

To what extent can competitive services provide funding for the USO? Traditionally, economic theory has demonstrated that competition puts pressure on profits. The contribution from such services stems from economies of scope that are inherent in POs’ operations. Research in this area (e.g. Crew and Kleindorfer 2004) has illustrated the benefits of parcels and other competitive products in contributing to the funding of the reserved area. However, under FMO all products will face competitive pressure, so the ability to a PO to employ scale and scope economies to make a contribution to the successful funding of the USO is limited.

(ii) More flexible and responsive pricing and service quality standards

In Section 3.3, it was already shown that the first general flanking measure to accommodate FMO should be to suppress uniformity of pricing bulk mail, while maintaining uniformity for single letter mail, just for ease of simplicity. The case study above, on access pricing and worksharing, showed the interest of DAP in an open market

The same allocative inefficiencies apply to uniform service quality standards. Here the uniformity has to do with 1) delivery frequency, and 2) scope of products offered at various counters (e.g., requiring that all counters offer all services), 3) reliability standards for delivery, 4) other specific quality standards such as “day-certain delivery” and bundled services such as addressing services. The point here is that “uniformity” hinders product and service innovations by reducing everything to a common denominator, especially when coupled with
regulation that focuses on a few “uniform” products. Of course, Member States should have clear quality standards, including delivery frequency, for products covered by the USO, including standards for D+1 single-piece mail. However, from a regulatory perspective, such quality standards should be confined as narrowly as possible to core USO products, leaving to the market the discipline of assuring service quality across all products. Much of modern marketing has been concerned with product design and pricing that is responsive to differences in customer willingness-to-pay across different consumer segments. The pre-liberalization mindset of “uniformity” masks customer valuation and value-based pricing, and thereby blunts market-driven or customer-focused approaches to service design and delivery. Misplaced notions of equity and quality uniformity needlessly sacrifice the benefits of competition in promoting increased product differentiation and innovation.

(iii) Raising the single-piece price

The single-piece price will likely have to be increased to help fund the USO after FMO. Regulators will have a delicate balancing act of not conferring too great an advantage on the PO by allowing the single-piece rate to rise to near the monopoly level as POs will still have an effective monopoly on single-piece mail. Competition/FMO will drive the price of services to their cost and, when there is some market power to do so, to increase those prices for products which are less elastic. Both of these tendencies will exert upward pressure on the single-piece price and downward pressure on the prices of business products. The postal sector is not the first network sector to have experienced entry, and these effects have been seen in other sectors, from energy to telecommunications. There is no reason to believe that one will not see the same effects in the postal sector after FMO.

(iv) Compensation funds and explicit subsidies to the PO.

It was concluded in Chapter 3, Section 3.4 on Specific Flanking Measures that some high impact countries could be in a situation where some elements of the USO represents an unfunded cost under FMO, even after restructuring and other possible flanking measures have been implemented. This could be exacerbated in the transition period after FMO, where development of mail volumes and positive effects of restructuring have not yet taken place. In this case, a provisional state subsidy could be envisaged.

A number of Member States in the EU have passed postal legislation that explicitly foresees the use of compensation funds or targeted subsidies to support the USO. Several approaches have been analyzed for such funding, including explicit subsidies from general tax revenues and excise taxes placed on entrants’ postal revenues. The key concern with any subsidy scheme is that it typically motivates the recipient to devote significant resources to the unproductive business of protecting and increasing the subsidy instead of

50 These include Belgium, Cyprus, France, Germany, Greece, Italy, Portugal, Slovenia and Spain.
becoming market oriented and seeking efficiency improvements from more innovative operations and service offerings. To counter this natural defect of any subsidy scheme, we argue that such subsidies be for small amounts, targeted to specifically identified aspects of the USO, and monitored carefully to assure that these subsidies are spent as intended.

Two general sources of subsidy are available to support the USO: general tax revenues or compensation funds deriving revenues from an excise tax on selected postal and courier products. If the subsidy comes from general tax revenues, funding would impose deadweight losses on the economy through the tax system. On the positive side, such a subsidy would have the benefit of putting real pressure on the USP to prove that the funding it requires to support the USO is absolutely required. In particular, from a political point of view, raising additional taxes for this purpose would be difficult if a recognized and effective mechanism for providing the services through the market were in operation.

Instead of general tax revenues, one could also use a compensation fund which would be funded via an excise tax on selected postal and courier products.51 The usual proposal (e.g., in Belgium and Italy, see the Country Assessments for these countries in Annex C) is to collect funds equal to the projected USO burden imposed on the USP from all licensed operators offering certain postal products, with the tax burden proportional to their revenues in the selected postal products. Such a fund might, for example, be levied as a per unit surcharge on every mail item delivered by all licensed carriers. On the positive side, this sort of fund would keep the pressure on all parties in the postal business to carefully measure the scope of the USO and to propose alternatives ways of meeting it through the market. On the negative side, compensation funds based on taxes on either products or gross revenues have not worked well in practice as they generate high transaction costs in tracking and monitoring the selected products and in collecting the tax.

Let us consider a few concrete examples of subsidy schemes based on existing programs and legislation as reported in the PwC country interviews. We structure these examples on funding of the USO under a set of key principles that derive from the postal economics literature.

**Principle: To collect money is more difficult than to distribute it.**

Consider the example of Italy, where there is a requirement for licensees who deliver “USO products” to pay 3% of their turn-over to a compensation fund. “The compensation fund only generated 104k€ in 2004. One explanation for this low value of receipts was that operators declared only a very small fraction of their mail as being a “USO product”. The Italian example illustrates two problems with compensation funds. One is that they present difficulties in monitoring receipts and assuring that everyone pays their fair share. Second, the

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51 WIK (2005), chapter 5, provides a detailed set of prescriptions and model regulatory language for the design of compensation funds, as well as a discussion of some of the pros and cons of alternative ways of setting up such funds.
problem of assuring that the fund raises a specified amount of money to finance some targeted obligation is an additional challenge.

**Principle: Funding should be market-oriented and specific.**

Open-ended subsidies are a recipe for inefficiency on the part of the recipient. Thus, from whatever source, subsidies must be specific in their intent, their measurement and their temporal scope. If such subsidies are intended to finance the burden of the USO, then the USO and the resulting burden must both be properly defined and measured (see De Donder et al. (2002) for a discussion of this important point).

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**Proper definition and measurement of the burden of USO in Germany**

The case in Germany is a good illustration. The Postal Act, as amended in 2002, provides detailed guidance for licensing, regulation and universal service. As long as Deutsche Post (DPAG) is granted a reserved area, it is explicitly obliged by the Postal Act to provide the universal service as described in detail in the universal postal service ordinance (PUDLV).

The Postal Act provides that once the market is liberalised (currently scheduled for 1 January 2008) the “obligation” to provide universal postal services should be understood as a requirement on all licensed providers of such services, and not just on a single USP.

The Postal Act (and the associated regulatory ordinance, known as PUDLV) defines the process for assuring the provision of universal services in the event that the market as a whole does not provide these. This process includes designating any enterprise that has a market dominant position in the relevant postal services market (this would be the DPAG at this point) as the USP, as well as allowing this USP to claim additional costs (if demonstrated) for the obligation, to allow a competitive auction to determine which organizations would then provide those universal services which the designated USP wishes to eliminate or to have subsidized, and other elements that are important for the continuing definition, monitoring and financing of universal services. Notwithstanding these detailed provisions, it is anticipated that DPAG will continue to be the USP in Germany for the foreseeable future.\(^{52}\)

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\(^{52}\) Part of the reason for this is that DPAG will naturally continue to provide ubiquitous coverage as a part of their overall mission and value proposition to business customers. Moreover, the Postal Act foresees paying for any public tender of a USO service on the basis of total market shares in USO postal products, so at least for the time being DPAG would end up with the lion’s share of the cost, whoever provides these services. In the end, it might as well be DPAG.
A further case in point is the French Law, recently revised in May, 2005, that provides specific state funding for some of its 17,000 counters, at least one per municipality, in France. The network in France, as elsewhere, has evolved historically and is not always adapted to the level of postal activity, with proportionally too many offices in rural zones, and not enough in new urban or commercial zones. Some forms of franchising have been introduced to alleviate this problem. In addition, a subsidy from general tax revenues (with the current level of the subsidy at around 150m€ per year) partially supports the cost of counters in municipalities with low demand (but the remaining burden of these counters is still estimated by La Poste to be more than twice the current subsidy level). The general thought here is that the presence of these counters may be demanded by municipalities even though they are not be required to assure accessibility linked with the USO. If the government accedes to these wishes for such additional counters, the French Law also recognizes the responsibility to finance their cost.53

Norway Post has similar provisions to those of the German case noted above that specify financial support (the nature of which is defined more clearly below) for services that are required (by the USO) to exceed service levels that would normally be performed on a commercial basis (i.e. without imposing an “obligation”). As part of their assessment of the “Burden of the USO”, Norway Post initially identified the following parts of the USO as not likely to be offered without the USO obligation (see Bergum, 2002):

- 15% of the households would receive mail five and not six days per week
- Another 5% would receive mail only twice a week
- The mobile post office-services would be halved compared to the present situation
- The uniform price would not apply to mail and parcels sent to and from Spitzbergen (an archipelago far north at a long distance from mainland Norway)
- Services to the blind would be payable
- Some extra services related to insured and registered mail would not be offered at all post offices

Norway Post computes the cost of these specific activities, which are then audited. After approval by the Ministry of Transport and Communications, then a subsidy for these costs is provided to the extent that the surplus from the Reserved Area does not cover these costs. The definition of the required subsidy is specific and transparent, and places the scope of the USO and its financing in a clear fashion before political decision makers. In the case of Norway, the

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53 The possibility is also offered to municipalities wishing to keep existing counters to finance them.
above list of services was estimated to have total costs of approximately 2% of Norway Post’s total costs (Bergum, 2002). While 2% of total costs is not insignificant, it is seems unlikely to cause grave distortions of the incentives for the enterprise to pursue operational efficiencies and product innovations.

**Principle: Subsidies should be predictable, capped, and limited in time.**

The idea of a never-ending guaranteed subsidy promotes the wrong kind of thinking. Rather, USPs should be provided with a predictable level of subsidy, based on well-identified areas to be covered (see the “principles” above), and should be motivated to improve its performance so as to obviate the need for continued subsidy.

This principle implies on the one hand a temporal limitation, or a periodic reauthorization, of any subsidy. It also suggests the expectation of continuous improvement in areas that are subsidized.

**A subsidy capping mechanism: Poste Italiane**

As a case in point, part of the USO burden for Poste Italiane is currently covered by a state subsidy. A subsidy capping mechanism is implemented, which anticipates planned efficiency gains (3.6% per year) and accounts also for inflation (just as in the standard price-cap mechanism). The required subsidy in this case is explained by the low scale of mail in Italy, combined with high fixed delivery costs and significant amounts of rural delivery. The interesting point here is that subsidies are not only identified and connected to specific USO services, they are also capped in a manner that encourages innovation and improvements by the USP over time.

The above principles can be summarized as follows. If explicit subsidies are provided, it will be important to specify these in understandable terms for those responsible for granting the subsidies (so that they can understand what they are paying for), and that these subsidies be predictable and small relative to the size of the recipient, and that they be for a definite and limited period of time.

When these subsidies purportedly arise as a part of the USO, this means that a proper definition and assessment procedure must also be used to define the burden of the USO. While this will inevitably be fraught with uncertainties and some controversy, it is important to promote clarity about the burden and the subsidies provided in order to encourage a more intelligent political choice and sense of shared responsibility about the nature and value of the USO and the appropriate way of financing it.
4.3.5 Summary

The above discussion and the underlying research and interviews conducted in this study and reviewed earlier lead to the following conclusions concerning the impact of FMO on the USO and on its future sustainability going forward.

- The USO is still considered an entitlement by the public across all Member States, particularly for households and other single-piece letter senders, and for households as receivers. However, there may be some evolution after FMO towards expecting the “market” to be the ultimate provider of USO services for business customers rather than imposing this as obligation on the current USP. This evolution has been experienced in other network industries, and might be expected in the postal sector as well.

- The changes under FMO for USO services and other services will vary as the USO is adapted to market conditions. Smaller customers may see increases in price as the prices of all services, including USO services, become more aligned with cost and quality through the forces of competition. Larger customers can expect, for similar reasons, to see increases in product variety and decreases in price.

- Under FMO a number of modifications should take place in the allowed flexibility to USPs in their pricing and product mix, at least for bulk mail and possibly for access rates and worksharing discounts. Pricing flexibility may raise concerns over the exercise of predatory pricing by the USP against entrants. One approach to limiting predatory pricing will likely be to have a publicly regulated access tariff, at least during the transition phase until workable competition is established. Access pricing, if properly designed, can be a central driver of the financial well being of the USP under FMO, promoting efficient entry as well as providing support for the USO.

- Smaller customers, including households, devote a very small part of their overall budget to postal services. Notwithstanding this fact, postal services in general and the USO in particular remain important elements of the overall communications market. Therefore, continuing stability of prices for small customers is likely to remain an important element of “affordability” discussions concerning the USO and other postal products.

- Little research is available on the actual costs and benefits of service quality, counter and collection services or delivery frequency. Thus, little guidance is available to inform policy design or regulation on the question of

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54 This is in line with experience of deregulation in utilities in the U.S. where large customers have more purchasing options and obtain lower prices. The ability of regulation to keep prices low for residential customers is reduced under deregulation as it will be under FMO.
the impact of price increases or decreases on small businesses and households in return for maintaining or increasing the scope or quality of USO services, including the value of changes in delivery frequency or in accessibility to particular services for rural areas. This suggests that before NRAs approve proposals to maintain or increase the historical scope of the USO after FMO, they should require an appropriate cost-benefit analysis of both the desirability of the proposed USO and the reason why the market itself would not provide the products or services in the expanded USO proposal.

The impact of FMO is likely to be that both competitors and incumbent national POs will begin to understand better the true quality preferences of customers of various sizes, the cost and profit consequences of alternative methods of serving these, and there will be a better alignment over time between the costs of providing services, including those understood to be a part of the USO, and the price paid for them. To the extent that some customers are currently receiving some services at a subsidized level as part of the USO, this implies continuing tensions to either increase these prices or decrease the costs and scope of the USO to achieve the indicated alignment.

Under FMO, instead of financing the USO by reliance on a Reserved Area, complemented by scale and scope economies of the USP, a mix of adapting the USO to changing market needs and new funding methods for the residual burden posed by the USO are needed. These methods could include rents arising from continued market dominance of the incumbent USP, efficiency gains from restructuring of the USP, increased use of scope economies from diversified services, raising the single piece letter price, and more flexible and responsive bulk mail pricing, including improved access pricing.

Direct subsidies should be avoided in most Member States. Direct subsidies, if used, should be limited, transparent and specific to allow those policy makers, public officials and competitors who provide such subsidies to understand exactly what they are paying for and to promote a healthy debate on whether the value of the services thereby guaranteed is worth the cost of the subsidy. Any subsidy scheme for the USO, whether from general tax revenues or compensation funds, must provide answers to the following questions: 1. What specific services or elements of the USO are being supported by the subsidy? 2. Who is paying the subsidy, who is receiving the benefits of it, and why would subsidized services not be provided by the market absent the subsidies? 3. How large will the subsidy need to be to assure the provision of these services? 4. What is the structure of monitoring and auditing functions to assure that subsidies provided are spent properly and that the services supported therewith are delivered as expected?

Under FMO, the role of competition authorities and postal regulators will be critical for some time to come, as the regulator will be obliged to determine
whether Universal Services are being properly provided by the market, and when they are not to define and regulate the provision of required services not provided by the market in the more complicated environment of FMO.

The above findings and conclusions, together with the evident and continuing diversity in the initial market conditions and the definitions of historical USOs in various Member States suggest that continuity of the previous EU Directive constraints specifying the USO may be the best way to proceed after FMO, allowing individual countries the option to adjust the USO to meet country-specific conditions. However, it will be desirable to establish additional clarity on when market provision of universal services may be deemed to have substituted for an appointed Universal Service Provider, especially in the area of business products where competition can be expected to take root first. A central issue for national and EU regulators will be to strike the proper balance, given the variations across countries at the start of FMO, in achieving the benefits of FMO and an appropriately defined USO without subjecting the market to inefficiencies or the USP to undue risks of financial distress.
4.4 USP Restructuring and Efficiency Improvement

Following the gradual introduction of competition in the European postal sector, USPs have been incentivised to introduce various restructuring programmes with a view to improving their efficiency, retaining their share of the postal markets and developing activities in new markets such as the financial and logistic sectors. Such programmes will be increasingly important under FMO, as a direct contributing factor in assuring the financial health of the USP itself and as an indirect but important element in assuring that the benefits of the USO will continue to be available to every citizen in every Member State.

Initially, two main groups of countries could be distinguished: the proactive ones, initiating often reforms in advance of the European agenda, and reactive ones, that implemented reforms triggered by the new European challenges ahead of them. In the first category are countries such as Sweden, United Kingdom, The Netherlands and Germany.

Nowadays, it can be observed however that all countries have embarked on restructuring programmes, the most advanced ones being progressively followed and imitated. However, despite a European wide transformation of the sector, differences can be noticed in terms of the depth of restructuring achieved by USPs to date in the various Members States.

Introducing restructuring programmes is not straightforward as it is often confronted with several opposing forces representing stakeholders for whom change is perceived as difficult or against their interests. To mitigate the impact of this inherent difficulty, one should stress the important gains achieved in the most advanced markets, which suggests that – even if sometimes difficult – the changes achieved are worth the efforts the have been devoted to the task.

Restructuring an organisation, to adapt to an increasingly competitive environment, has basically two dimensions:

- reducing the level of costs while maintaining the required level of outputs and maintaining or increasing the level of output quality,
- increasing the level of revenues, while maintaining the level of costs.

To increase revenues and seize one of their key advantages, postal operators have often diversified their operations, developing financial services or international logistic activities.

To reduce their level of costs, postal operators have embarked on traditional restructuring programmes aimed at increasing organisational efficiency through the introduction of more adaptive and flexible structures and increasing organisational effectiveness through the introduction of quality measurements and improvements programmes.

Doing so, the most proactive postal operators have to date managed to achieve considerable success, which demonstrates that such efforts pay off and should be judged on the ultimate improvements that are likely to be obtained for all stakeholders: the postal organisations’ workers, clients and shareholders.
4.4.1 Diversification

In seeking to increase their profitability, USPs are naturally induced to consider reducing costs and hence potentially rationalising their networks. This rationalisation can, in some cases, lead to a network coverage reduction or to the perception by the public at large of a reduction in network coverage.

However, even if justifiable, network rationalisation is often confronted by resistance, individual interests being always difficult to balance with the public interest. Furthermore, network coverage is often associated with an obligation and can therefore only be implemented to a limited extent. Consequently, even when network rationalisation is necessary and has demonstrable benefits in improving the financial standing of USPs, it is unlikely to suffice.

Hence, taking these factors into account, many USPs have been naturally induced to diversify their portfolio of activities to further exploit their key strength: a ubiquitous presence over their respective countries, both in terms of counters and delivery.

Diversification allows USPs to increase revenues without (or with very marginal) increases in their costs. It can occur through the development of new products belonging to the “traditional” postal market or through the introduction of new products such as financial services, administrative support, travel services, etc.

Several postal operators, such as TNT and DPWN, have successfully managed to diversify in logistic and transport activities through the acquisition of worldwide logistic operators. Others, such as La Poste (FR), have developed their own internal logistic activities.

Diversification into financial services has been one of the most important diversifications that has been implemented by postal operators and it was also probably to the most obvious to exploit since it allows the postal operator to leverage on their:

- brand,
- customer base,
- network of counters, and
- existing experience in terms of support to or management of transactions between public authorities and citizens (tax bill payments, social benefit distribution, etc.).

The following figure shows the relative importance of financial services in the total services for a selected number of postal operators that have diversified their activities to financial activities.
This figure clearly indicates the importance of financial services in the postal operators, this diversification being therefore a key mean for postal operator to dilute their fixed network costs over a broader range of activities, and to reduce the burden associated with their coverage obligation.

Such diversifications can take several forms, depending on the financial means of the postal operators and on the market conditions at stake. The most common are briefly described below:

- **Development of fully or majority owned bank**: directly owned banks are developed as separate entities of postal operators. They are in possession of their own banking licences and have concluded an agreement for using the distribution network of the postal operator, generally through an internal transfer fee payment. DPWN and Deutsche Postbank, as well as La Poste and La Banque Postale are typical examples of such type of diversification.

- **Development of banking joint venture**: another possibility is to establish a joint venture with pre-existing banks. In Belgium, Fortis provides management services, back office and asset management services of financial product to a joint venture with La Poste/De Post. The joint venture pays a fee to La Poste/De Post for the utilisation of its postal network. This case is similar to the previous one, to the exception that risks are shared between the postal operators and existing banks. This option is generally privileged in highly developed banking markets such as Belgium. Similar arrangements are implemented between the UK Post Office and Bank of Ireland and An Post and Fortis.

- **Integration of financial services**: integrators are postal operators who distribute financial products under “white label” or co-branding from different financial services providers. In such cases, the postal operators control the product offers, are in charge of marketing and

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55 Figure prepared by La Poste / De Post on the basis of annual report, Vienne conference March 20-21, 2006
manage the clients’ database. Poste Italiane can be considered as an integrator. Its Banco Posta operates as a business unit without banking licence, and is nonetheless the largest banking retail network in Italy. Similar arrangements are implemented for instance by Swiss Post.

- **Distributor of financial services**: postal operators can also simply conclude distribution agreement with one partner. In this case they often distribute an entire family of financial products, the partner controlling often the product offer and the product marketing. The responsibility of the postal operator is therefore very much limited to the distribution of the financial products. Such arrangements are for instance in force between Correos Spain and Deutsche Bank, or between Posten Norge and DnB.

- **Shared network**: another form of diversification / association, more symmetric and that exemplifies the value of a network of branches, can finally be listed. In this case, both the postal operator and a bank own a network in the form of a joint venture. Each partner pays fees based on volumes of sales associated to each partner. TNT and ING provide an example such a shared network model.

Diversification can also apply to other products besides financial products. In the United Kingdom, for instance, post offices are not “simple” post offices anymore but real centres of services, postal services being part of the portfolio of services that are offered to customers. This diversification was implemented through a large franchising initiative which began already in 1989. Services that are commonly provided in post offices include: postal services, travel services (passport support services, social support services, travel assurances, exchange office, etc), licence (driver licences, television licences, fishing licences, etc), telecom services (phone cards and prepaid cards for mobile phones) and financial services.

### 4.4.2 Increasing the organisational efficiency and effectiveness: Examples

#### 4.4.2.1 Deutsche Post

The German postal market is an on-going case study of market opening and commercialization of the national postal operator, Deutsche Post AG (DPAG), which is a publicly traded for-profit company. Deutsche Post World Net (DPWN) is the trade name for the group formed by DPAG and its subsidiaries. The group operates in four corporate divisions: MAIL, EXPRESS, LOGISTICS and FINANCE, where EXPRESS includes parcels and express delivery services. Started in 1990, the restructuring of the Federal Postal Administration (Postdienst) is a work in progress, with the capital of DPWN now more than 58% in the hands of private investors, and with the stated intention of eventual complete withdrawal of government ownership. The restructuring process at DPAG can be described in terms of the following main phases:
Corporatisation (1990 to 1995): Merging of the two former national post offices into the Deutsche Post, with separation of posts, telecommunications and financial operations, and spin-off of telecommunications into the separate company Deutsche Telekom, and financial services into Deutsche Postbank (now a majority owned subsidiary of DPAG).

Privatisation (beginning in 1995): Foundation of the stock corporation DPAG, takeover of major pension obligations by the German Federal Government, Universal Service guaranteed by the Constitution, restructuring of labour agreements so that new employees would no longer have civil servant status, and so that there would be a clear recognition of pension and health obligations to present and future employees.

Privatisation also saw other elements of a high-performance organization developed in DPWN, including enterprise-wide accounting and information systems, separation and restructuring of parcel and letter networks, and the development of a strong profit orientation in all of its lines of business (Mail, Express, Logistics and Financial Services).

During this period, Deutsche Post pursued a strategy of internal productivity improvement and external growth via numerous acquisitions. During the period 1990 to the present DPWN has increased its revenues (from all its lines of business, excluding telecommunications) from 9.3 €bn to 44.6 €bn in 2005.

The table below outlines the main initiatives put in place and illustrates the fact that DPWN concentrated on restructuring in the years following the incorporation and afterwards ensured integration of the businesses acquired in the context of its aggressive external growth and diversification strategy.
Table 14: Restructuring and process improvement initiatives at DPWN

<table>
<thead>
<tr>
<th>Year</th>
<th>Initiative</th>
</tr>
</thead>
</table>
| 1997 | transport network streamlined  
number of transport routes reduced  
sorting processes extensively automated  
opening of Direct Marketing Centers  
reorganisation of sales activities for Freight Mail  
counter employee training program |
| 1998 | hybrid mail development  
collective wage agreement |
| 1999 | further international expansion  
network integration (following acquisitions) |
| 2000 | cost-cutting, overhead streamlining efforts |
| 2001 | cost-cutting, overhead streamlining efforts |
| 2002 | integration of national and international activities of cross-border networks  
improvement of sorting databases and reading techniques (coding) |
| 2003 | reporting structure modification  
tracking system (IT) for quality measurement  
joint delivery system in rural areas  
transport optimisation (air to road shift) |
| 2004 | new sorting machines  
improved processes for special services  
improved sorting procedures for Direct Mail (delocalized) |

**Liberalisation** (1998 and continuing): DPWN has continued to expand its operations, developing significant strategic competencies in logistics services through mergers and acquisitions (with around 40 significant completed M&A activities recorded for investor information purposes on their website), and interlinking these competencies with a strategy for global expansion of its operations.

Besides its global presence in express mail through DHL, DPWN.DPAG has also developed its competitive capabilities in letter mail, and has launched new entrants in the Dutch market and the UK market. In turn, DPAG faces competition in its home market from new entrants for business customers (EuroPost AG, PIN AG, and others as noted below), delivering both direct mail as well as periodicals and newspapers.

**Social and Labour Restructuring**: As shown in Error! Not a valid bookmark self-reference. below, DPAG/EPWN has decreased its employment levels in postal operations while adding significant headcount to its other operations (and these figures do not account for the further significant increases in headcount absorbed in 1990 as a result of the integration of former East German Postal employees into the Bundespost, the forerunner of DPAG). These changes represent a sign of success for investors in DPAG as well as a symbol of the increased opportunities for employees of DPAG over the years. As part of its privatisation in 1995, DPAG undertook also a legal restructuring of employment relations, including the determination of contributions of DPAG to finance pension obligations to establish a clear recognition of pension and health obligations to present and future employees.
Table 15: Comparing DPAG Postal Employment Figures 1989 & 2005*

<table>
<thead>
<tr>
<th>Employment figures (Full time equivalents, average of the year)</th>
<th>1989</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employment</td>
<td>272,491&lt;sup&gt;56&lt;/sup&gt;</td>
<td>347,607</td>
</tr>
<tr>
<td>Employment in postal operations</td>
<td>232,985</td>
<td>129,200</td>
</tr>
<tr>
<td>Employment in other operations</td>
<td>39,506&lt;sup&gt;1&lt;/sup&gt;</td>
<td>218,407</td>
</tr>
</tbody>
</table>

*Note: in 1989 Deutsche Post also provided telecommunications services. However, all figures given here exclude telecommunications services. Note that the figures in 1989 do not include the additional 86,000 employees from the former East German Post Office that were absorbed after reunification in 1990. The fact that the impact of absorbing these additional employees is represented in the figures in 2005 makes the restructuring represented in the above figures even more profound.

Sources: Deutsche Bundespost, Annual Report 1989; DPWN, Annual Report 2005

Its letter mail and parcel business activities have been restructured to decrease significantly the number of sorting centres and to improve service quality (now in excess of 95% for D+1 mail and 99% for D+2 mail).

Retail outlets have gone from nearly 30,000 in 1990 to around 13,000 currently (more than half of which are franchised agencies).

4.4.2.2 The metamorphosis of Koninklijke PTT into TNT

In 1989, the Netherlands was the first country to engage on the path of the reform of the postal sector by transforming the public enterprise PPT into the KPN NV corporation whose management was given full independence from the shareholder (the Dutch state). The next steps were in 1994 and 1995, the opening of the capital, in 1996 the acquisition of TNT and finally the separation of the telecom and postal activities in 1998 and the subsequent IPO of TPG.

This early metamorphosis was accompanied by ambitious and precocious restructuring programs that appear to have born fruits. By leading the way and being innovative in the resolution of what seem to be complex restructuring problems, TNT is today in a strong position to compete on its domestic market.

The table below lists the main initiatives that have allowed TNT to reach its efficiency levels.

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<sup>56</sup> Please note: in 1989 Deutsche Post also provided telecommunications services. However, all figures given here exclude telecommunications services.
Table 16: Main restructuring and process improvement initiatives at TPG

<table>
<thead>
<tr>
<th>Year</th>
<th>Initiative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>overall productivity improvement programme (Briefpost 2000)</td>
</tr>
<tr>
<td>1997-2000</td>
<td>new sorting centres</td>
</tr>
<tr>
<td></td>
<td>transport mode switch (rail to road)</td>
</tr>
<tr>
<td></td>
<td>sorting automation updated</td>
</tr>
<tr>
<td></td>
<td>restructuring of the mail depot structure</td>
</tr>
<tr>
<td>2001-2003</td>
<td>labour cost flexibility programme negotiated with work councils</td>
</tr>
<tr>
<td></td>
<td>sequence sorting automation</td>
</tr>
<tr>
<td></td>
<td>improve code reading rates</td>
</tr>
<tr>
<td></td>
<td>introduction of mail deliverer position 'bezorger'</td>
</tr>
<tr>
<td>2004</td>
<td>overhead reduction programme</td>
</tr>
<tr>
<td>2005</td>
<td>redesign of the management structure</td>
</tr>
<tr>
<td></td>
<td>review of the sorting system</td>
</tr>
</tbody>
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During the period 1995-2000, the number of sorting machines rose 771% inducing a reduction in staff number that was nevertheless partially compensated by new jobs creation in new services (addresses database management for Direct Mail, corporate internal mail rooms,…).

Labour restructuring has also been a major element in TPG’s evolution to becoming a market-oriented organization. Today, all employees of TPG have private sector labour contracts. The shift from civil servant status to common social law employee status happened smoothly thanks to the pre-existing corporate pension fund. The new collective agreement of TPG took over the previous conditions included in the particular Dutch civil servant agreements which are now submitted to regular negotiations.

There were no salary decreases, and only few privileges linked to the civil servant status were transferred to the corporation structure, mainly in the field of pensions. The creation of the part-time flexible contracts ('bezorgers') allowed for further reduction in staff costs while ensuring flexibility.

Table 17 below shows a comparison of TPG’s postal operations between 1989 and 2005, indicating the significant increases in employment in their postal operations as a result of their restructuring activities.

Table 17: Comparing TNT Postal Employment Figures 1989 & 2005

<table>
<thead>
<tr>
<th></th>
<th>1989 (=PTT Post)</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employment*</td>
<td>59,300</td>
<td>128,307</td>
</tr>
<tr>
<td>Employment in Postal Operations</td>
<td>59,300</td>
<td>77,447</td>
</tr>
<tr>
<td>Employment in Express and Courier Services</td>
<td>NA</td>
<td>50,860</td>
</tr>
</tbody>
</table>

* The employment figures here do not reflect the additional 35,007 employees who are part of the TNT Logistics Group. According to the TNT Annual Report 2005, the TNT Logistics Group is being divested in order for TNT to focus entirely on its core delivery network businesses, for both mail and parcels. Employment figures for the Logistics Group are therefore excluded from this Table. Similarly,

57 PTT, Annual Report 1989 (PTT Post only); TNT, Annual Report 2005
telecommunications activities were included in KPN in 1989, and these figures have also been excluded in the above Table.

From 1998 to 2003, the number of postal counter was reduced from 2600 to 2100 (-19%) but 1300 additional service points were put in place (petrol stations, supermarkets) during the same period. The net effect of these changes has been an improvement in quality of service to end customers while reducing the number of counters.

4.4.2.3 Austria: getting ready for the IPO

The Austrian Post is a medium sized European player that has successfully undertaken a complete restructuring that has now put it in a good position to profit from further liberalization of the postal market.

For 2005, total revenues of Austrian Post were 1,702 million euros. Mail currently constitutes its main activities with an internal revenue share of more than 70% and 15,367 employees directly related to mail activities.

At the beginning of 2006, the Austrian Government has given instructions to organise the privatisation of Austrian Post.

Like many postal operators, Austrian Post was spun off the federal government in 1996 together with the Telecom activities from which it ultimately separated in 1999 to become a state-owned stock company.

In 1999, a new management was put in place and Austrian Post started a major restructuring effort. Austrian Post then focused its improvement process on the further development of the value chain, through structural, process, labour and performance dimensions.

At that time Austrian Post was confronted with a costly and dense network of postal counters. In order to mitigate the costs of this burden the network was restructured by:

- relocating postal counters in order to optimize coverage and returns,
- outsourcing others counters,
- streamlining the range of retail offers,
- implementing a new front office IT system
- training of the counter staff in order to develop selling skills (important sales of non postal products such as telephones and other retail products followed).

By restructuring its network of postal counters, Austrian Post reduced the number of its post offices from 2,285 in 2001 to 1,338 today while at the same time putting in place alternatives solutions such as franchised counters, service points and mobile offices: in 2005, Austrian Post provided services through 191 franchised offices and through 421 services points. When closing an outlet, Austrian Post made sure that an alternative solution was provided such as
mobile post offices, service points or postal services provided by the postman (beyond the distribution of mail)

In the field of the sorting and transport among the initiatives implemented alongside the professional cost management that permitted a reduction of transport costs and the overall productivity improvement the following specific initiatives can be cited:

- Reduction and automation of the sorting centres, from 39 to 6 equipped with state of the art machines (total investment of 200 million euros);
- Introduction of labour flexibility;
- Improvement of the transport process by outsourcing part of it;
- Separation of letters and parcels in transportation between sorting centres;
- Switch from rail to road transportation.

Following the restructuring of the sorting and transportation processes, the total costs associated to these processes have decreased despite the increase in volumes.

Concerning the distribution process, the following initiatives have been put in place in order to improve overall efficiency:

- Reduction of the number of delivery centres from 1,880 to 400;
- Improvement of the internal structure (delivery groups organisation);
- Redesign of distribution routes;
- Introduction of innovative delivery service solutions (pick-up points, automatic parcels depots (planned), “house wife delivery” (planned))

During the last three years, several additional measures have been taken in order to bring forward the restructuring plan. More attention was focused on the optimisation of Austrian Post value chain and consequently EBIT has increased from 16.5 million euros in 2003 to 103 million euros in 2005, while on the other side, average headcount was reduced by almost 10% for the same period. All divisions of Austrian Post were profitable in 2005. In addition to this, new services like hybrid mail and mailroom management services were put in place to respond to new customers demands.

Moreover, Austrian Post is developing eastward in several neighbouring countries by being present in particular products segments in Slovakia, Croatia, Hungary, and elsewhere.

Having successfully carried out these restructuring efforts, the next step of the evolution of the Austrian Post is due this year with the initial public offering (IPO) of its shares on the road to its full privatisation.
4.4.2.4 Posten Norge

In the face of downward trends in the Norwegian postal market for traditional postal products, Posten Norge has been involved in several restructuring actions. Restructuring actions vary from cost reduction programmes to product diversification initiatives.

Posten Norgen remains by far the largest postal operators in most areas of the country for unregistered mail items and has an important position in other areas.

Posten Norge began implementing cost reduction programs since the beginning of the nineties. As a result of these cost cutting initiatives and of process restructuring, the number of employees expressed in terms of FTEs dropped from 26,822 in 2000 to 21,222 in 2004. At the same time Posten Norge hired staff from the private sector and outsourced some of its process such as the transportation and the delivery for certain special routes.

Regarding the upstream delivery process, Norway has undertaken an ongoing process of modernisation/automation and centralisation of mail sorting terminals for the last ten years. Serious improvements have also been made in the sequencing processes. Amount of sorting centres for letters and parcels has considerably been reduced respectively from 30 to 13 units and from 20 to 12 units.

Posten Norge also completed by the end of 2002 the entire restructuring of its distribution network. The postal office network was redesigned and outlets were relocated in order to meet customer needs better. Postal outlets and business centres units are the basis of the commercial redeployment strategy which also foresees that partners run postal outlets with the agreement and support of Posten Norge.

Today, 80% of postal outlets/counters are franchised. Cooperation with petrol stations, chain of supermarket perfectly depicts the development of this new strategy. From 2000 to 2004, the number of postal outlets grew 40% to reach 1201 counters in 2004.

Business centres offer postal and logistics services, with added extra services aimed at responding to specific business client’s needs. The increasing importance of the business centres also illustrates the adaptation of Posten Norge to its new environment.

On the other hand, the number of traditional post offices decreased from 875 in 2000 to 328 in 2004. Nevertheless, despite this strong reduction in outlets, the network modification has allowed Posten Norge to increase household coverage up to 99.96%.

The operator has also diversified its product offering by developing electronic products such as on-line payments, self-secure ID and email services. Posten Norge continues to expand itself through acquisitions like that of CityMail, which was acquired in a two phase plan (2002 and 2006).
4.4.3 Conclusions: Restructuring as both signal and outcome of FMO

To reduce their level of costs, postal operators have embarked on traditional restructuring programmes aimed at increasing organisational efficiency through the introduction of more adaptive and flexible structures and increasing organisational effectiveness through the introduction of quality measurements and improvements programmes. Doing so, the most proactive postal operators have achieved remarkable accomplishments. These include not just increased profitability but also gains for other stakeholders, including the postal organisations’ workers and customers.

Several important conclusions can be drawn from the above examples of restructuring. These include:

- **Restructuring has already made significant inroads in the postal sector in the European Union.** This observation is extremely important as the experience of others in restructuring is important in creating credibility for its benefits. In the postal sector, the experience of privatized as well as corporatised operators has been reviewed, noting the fundamental changes in culture, financial performance and market orientation of restructured postal organizations.

- **Restructuring is fundamental in achieving the benefits of FMO and reducing its risks.** Exogenous factors such as population density and other geographic factors differ among countries and lead to different potential impacts from FMO. These have been very much debated in the literature and in policy circles. But endogenous factors driven by restructuring – such as level of automation, management of the labour cost differential, the degree of labour flexibility, network optimisation, partnerships/diversification, counter franchising, customer management and marketing strategy, and general restructuring activities – have also a very important impact and, if properly addressed, can significantly improve outcomes in postal markets in conjunction with FMO. Finally, an important parameter – mail density – can be considered to some extent both as exogenous and endogenous. Indeed, mail density can be linked to traditional uses and cultural habits, but several operators have also sought and appear to have succeeded in improving mail density through applying (for the postal sector) new tools of marketing research to understand customer needs and to respond to them with targeting advertising and new products.

- **Similarly, the impact of investor pressures for privatized and partially privatized postal operators can be expected to have a strong effect on improving the commercial culture and market orientation of these operators.**
It can be seen from the examples here that FMO is already having strong effects in the European postal sector as it provides incentives for operators to restructure their organisations, in terms of operations, marketing and financial systems, to assure a reasonable confluence with the opening of the market.
4.5 Conclusions

The three case studies have shown that:

- **Access.** Access pricing based on Delivery access areas (DAP) is an innovative replacement for existing access pricing mechanisms, and will promote a better alignment of price and cost in the FMO context, promoting both efficient entry, increased financial viability of the USP, and reducing the cost of providing Universal Services themselves.

- **Funding.** A variety of means is available for funding the USO under FMO. These include leveraging the economies of scope of the USP’s existing network, adapting the USO itself to changing market needs, and restructuring to improve the ability of the USP to respond to market forces. Targeted, temporary and well-defined subsidy programmes could also be used in the transition phase for Member States in unfavourable conditions.

- **Restructuring.** FMO will continue to trigger Member States to improve the efficiency of their USPs, contributing to the development of the market, and to its improved quality and value of services provided to customers.
Chapter 5  Findings and Recommendations
5.1 Introduction

This chapter summarizes the results of the study, draws together detailed findings presented in various parts of the study and, based on these, presents some summary conclusions and recommendations.

The objectives guiding the study from the outset were the following:

- To assess whether the Universal Service Obligations (USO) as they are laid down currently will still be relevant and appropriate in an open market;
- To evaluate risks and opportunities for the current universal service model and any proposed changes to the USO that might result from or be desirable under liberalisation;
- To assess how universal service can be safeguarded in an (open) internal market and whether any additional safeguarding measures would be considered appropriate and if so, which and for which Member States.

To accomplish these objectives, PwC undertook the following tasks:

- Survey and assess the current status of the USO, National Regulatory Agencies and Universal Service Providers in the postal market across the Member States of the EU and closely allied other countries, and to develop more detailed studies of selected core issues likely to be significant in judging the impact of FMO on the USO in Member States.

- On the basis of the survey and assessment, and considering the potential evolution of the postal sector derived from the current status, determine and evaluate the key factors underlying the design of effective policies to achieve completion of market liberalization with a sustainable USO across all EU Member States.

- To the extent that financial or other barriers represent significant problems for some Member States in achieving FMO, to develop, with input from all stakeholders, appropriate measures that might be considered to mitigate the problems so that all Member States can participate in FMO with minimal delay.

In undertaking the above tasks, the PwC study team developed a cross-country modelling and scenario-based interviewing framework. This approach was taken in order to generate comparable results that would allow insights on the factors determining the level of risks and benefits associated with FMO across Member States. What follows are detailed findings, which bring together in summary form the findings previously reported in earlier chapters. Thereafter, the implications are drawn from these in terms of general recommendations and conclusions.
5.2 Detailed Findings

5.2.1 Factors Underlying the Impact of FMO on the USP and the Market

Chapter 2 of this Report considered the results of country-assessment reports and modelling of the outcomes of various scenarios. These were concerned primarily with determining the opportunities and risks associated with meeting a USO of particular scope, either through the market or through an assigned USP, and with the demographic, economic and regulatory factors that determine the impact of FMO on the current USP, the ability of the market to sustain workable competition, and the consequences of FMO on key outcomes such as prices and employment levels. Several lessons were drawn from the analyses reported in Chapter 2.

**FMO can be introduced without impacting the Universal Services.** However, this requires an understanding that the market will be complementing and replacing the functions of the traditional Universal Service Provider for business customers and that pricing, uniformity requirements and other market-impeding restrictions on business products will be relaxed. These changes will allow the full development of competition in the business segment, with positive effects on innovation, new products and services. For example, where allowed, new entrants are beginning already to develop new products, particularly in direct mail, along with new business models. To the extent that these have a better fit with the needs and willingness-to-pay of business customers, these services can also generate additional traffic and revenue for the incumbent if upstream and downstream access are promoted and used properly.

**Downside risks of FMO can be significantly reduced or eliminated in most countries without the need for external subsidies:** Both the model-based exercises conducted as part of this study and the more detailed interviews indicate that postal markets and USPs can adapt to a large extent ahead of FMO, with the consequence that the risks of downside consequences of FMO can be significantly mitigated. However, in countries confronted with the combined effect of several unfavourable conditions, introducing FMO may prove difficult and a funding mechanism or other flanking measures may be provisionally required. These should be directed at promoting the restructuring of postal administrations into efficient market-oriented enterprises. Besides providing the right incentives and regulatory governance for USPs to allow them to compete, a key condition here is to put in place similar working conditions for all operators in the postal market, to avoid social competition.

**Neither the complexities nor the potential benefits of FMO should be underestimated:** The opening of the postal market is probably more complex than other market openings introduced in the course of the previous two decades in Europe. In fact, several factors make the postal sector restructuring unique:

- First, unlike other network based industries, several postal/logistic networks have faced competition for some time now, and they will continue to compete;
Second, again unlike most other network based industries, the postal market is not likely to continue to expand significantly;

Third, the postal sector is less technologically intensive than most network based industries and consequently more labour intensive;

Fourth, more than in most network based industries, the USPs were and are still to a large extent publicly owned undertakings, imbued historically with important public roles as well as their increasing role as a participant in communications markets.

These factors, together, spell out both interesting challenges as well as the potential benefits of a market-oriented solution. The challenges have been underlined repeatedly in this study. But it is as important to see that there are real potential benefits from creating a better confluence of market forces with the postal and logistics sector going forward. Absent such a confluence, as embodied in FMO, and it difficult to imagine how the adaptation and innovation required will take place to assure that postal products fill their effective role in the expanding global communications marketplace. What is needed to allow and facilitate such adaptation and innovation are the decentralized forces of the market finding their clear pathways into the visions, strategies and operations of postal organizations. Enabling this process to occur in a smooth and fair fashion is both the promise and the challenge of FMO.

5.2.2 Introducing FMO: Flanking Measures

Chapter 3 of this Report discussed the nature of temporary flanking measures that may be required to ensure that the benefits associated with FMO are achieved and that the potential difficulties and risks associated to FMO are minimised.

Flanking measures begin with promoting readiness of USPs and NRAs for FMO: Possible Flanking Measures considered in this report begin with the fundamental proposition that USPs themselves must be enabled to compete and to the extent possible to meet the obligations they face. Simultaneously, USPs must face appropriate regulatory regimes that promote rather than hinder competitive response and innovation.

This proposition implies a number of things considered as basic ingredients required to set the stage for garnering the benefits of FMO, including:

- Commitment to a timely introduction of FMO, combined with an appropriately defined “New Regulatory Model” (per WIK, 2005) that assures that the USP is allowed:
  - to apply non-uniform prices for bulk mails;
  - to face stable price and profit regulation, such as implied by appropriately designed price-cap regulation;
  - to apply a transparent and non-discriminatory negotiated access regime to the PPN;
to generate through its operations, or through direct and specific subsidies, funding to pay for any imposed “public” missions that go beyond what those services or attributes of services that would be commercially undertaken without obligation.

On a case by case basis, USPs, NRAs and governments of Member States must work together to address, motivate and improve:

- the **differential in the human resource costs between USPs and new entrants**, for example through the introduction of restructuring plans, outsourcing schemes, collective working agreements and a transparent and fair settlement of historical liabilities such as pension liabilities;
- the **productivity and product marketing of USPs** to allow them to promote the full market potential of postal products, including improving the low level of mail scale in their markets.

**Flanking measures are also required for new entrants**: For the most prepared and FMO ready markets and operators, introduce measures that would further reduce the barriers to entry to the postal markets whenever they are present, for instance regulated open access to PO Boxes, letterboxes and addresses databases.

### 5.2.3 Findings from Thematic Case Studies

Chapter 4 considered three thematic case studies on themes that will be central to the continuing policy and regulatory debate about FMO:

- Access Pricing
- The Scope and Financing of the USO
- Restructuring of USPs

#### 5.2.3.1 Access Pricing

The background and general approach to upstream (worksharing) and downstream access in the postal sector was reviewed. As noted, access will be of central importance under FMO, especially in the early stages of entry. Three approaches to access have been observed, currently employed or under discussion in various Member States in the EU: Avoided Cost Pricing (ACP), Delivery-Zone Access Pricing (DAP) and Negotiated Access Pricing (NAP). The four critical features and policy issues concerned with access pricing under FMO are:

**Negotiated versus mandated access provision.** In the initial stages of FMO, it is efficient to promote upstream access to encourage the development of mail preparation infrastructure and to capture the obvious benefits of joint preparation and worksharing of mail. While the principles of worksharing pricing and access might well be mandated to begin with, one would expect regulation of these to be withdrawn in favour of negotiated prices and conditions as workable competition is established.
Downstream access under bypass (i.e., under FMO) is not a simple matter, and efficient conditions for pricing and access depend on a number of country-specific conditions. It would therefore be appropriate for country-specific solutions to dominate the regulation of downstream access, with a starting position being negotiated access pricing that allows the USP to contract freely with entrants on the terms of such access.

**Non-discriminatory treatment between the PO’s own customers and its competitors.** As long as incumbents enjoy a market dominant position, non-discriminatory treatment of the PO’s customers and entrants will be important to mitigate anti-competitive behaviour. Such non-discriminatory treatment can be further enhanced by requirements for public posting of generic rates, as is the case in the UK and France. The incumbent can and should, however, have the ability to depart from these generic rates in designing new products for specific customers, as long as these departures are governed by general principles that are applied in non-discriminatory fashion to all comers.

**The access pricing rule.** Departures from efficient access pricing can have very unfortunate consequences under FMO, consequences which would be masked in a monopoly setting by the ability to raise prices to cover inefficiencies. Under FMO, for example, the wide-scale practice of charging uniform prices, based on avoided cost principles, will naturally have to give way to zonal pricing of access, at least to the extent that there are large differences in cost between different zones in a country. Otherwise, the USP will find itself combating two problems of uniform pricing: the first from its single-piece letter rate and the inherent cream-skimming possibilities between low-cost and high-cost areas; and the second the compounded effects of providing subsidized access to its high-cost areas, while entrants deliver to the high-margin, low-cost areas.

**Regulation of Access Pricing and Conditions.** Under FMO, upstream access should be subject to minimal regulation, requiring only that access prices and conditions be on non-discriminatory terms as between NEs and customers of the USP and bounded by delivery prices and the applicable single-piece rate (First-Class or Second-Class, depending on the service terms offered). Access to any provider’s actual facilities (e.g., for use of that provider’s equipment) should be left entirely to freely negotiated contracts. Pricing of upstream access is naturally intended for business mailers, with volumes above thresholds that make bulk handling and accounting economical. Even for consolidators, mandatory avoided cost rules, while simple in application, are likely to be inefficient and to attract a greater volume of mail destined for ultimate delivery in high-cost areas. Zonal and negotiated access pricing rules are therefore to be preferred, the details of which are laid out in Chapter 4 and associated references.

Regulators are likely to require some regulation of downstream access, to assure that in the early stages of FMO that NEs can gradually develop their markets and leverage their initial entry on the USP’s network for high-cost areas. Given this, it is important that access prices be geared to cost, while still allowing
access to make some contribution to overall USO costs, as would be the case under zonal or negotiated access pricing. In terms of implementation, regulators might initially enforce zonal access pricing, but gradually move to a monitoring role as workable competition is established, leaving then fully Negotiated Access Pricing as the preferred “light-handed” approach under FMO.

5.2.3.2 The Scope and Financing of the USO

The USO is still considered an entitlement by the public across all Member States, particularly for households and other single-piece letter users. However, there should be an evolution after FMO towards expecting the “market” to be the ultimate provider of USO services for business customers rather than imposing this as an obligation on the current USP. This evolution has been experienced in other network industries, and is to be expected in the postal sector as well. Given this overall finding, other key findings associated with the USO include the following:

Adapting the USO to the Market. The changes under FMO for USO services and other services will vary as the USO is adapted to market conditions. Changes in the manner in which universal services are provided, such as increased use of combined delivery and counter services, and increased franchising, are examples of such adaptations. Smaller customers may see increases in price as the prices of all services, including USO services, become more aligned with cost and value through the forces of competition. Larger customers can expect, for similar reasons, to see increases in product variety and decreases in price.

Pricing flexibility for business products should be encouraged. Given the expected increase in product innovation under FMO, especially for business customers, the USP should be allowed greater price flexibility, at least for bulk mail and, in parallel with establishing workable competition, also for access rates and worksharing discounts. Pricing flexibility may raise concerns over the exercise of predatory pricing by the USP against entrants. One approach to limiting predatory pricing will likely be to have a publicly regulated access tariff, at least during the transition phase until workable competition is established.

Pricing stability for smaller customers remains important. Smaller customers, including households, devote a very small part of their overall budget to postal services. Notwithstanding this fact, postal services in general and the USO in particular remain important elements of the overall communications market. Therefore, continuing stability of prices for small customers is likely to remain an important element of “affordability” discussions concerning the USO and other postal products.

Funding the USO. Under FMO, instead of financing the USO by reliance on a Reserved Area, funding will be provided by means of a variety of new mechanisms, including increasing the efficiency of service providers and adding revenues from new services. Additional funding from compensation funds or
Direct subsidies could supplement these normal market sources of funding in exceptional circumstances.

**Direct subsidies should be avoided in most Member States.** If USPs succeed in developing their market and improving their efficiency, and if competition remains fair in labour conditions. Direct subsidies, if used, should be limited, transparent and specific to allow those policy makers, public officials and competitors who provide such subsidies to understand exactly what they are paying for and to promote a healthy debate on whether the value of the services thereby guaranteed is worth the cost of the subsidy.

**Regulating and assuring the USO.** Under FMO, the role of competition authorities and postal regulators will be critical for some time to come, as the regulator will be obliged to determine whether Universal Services are being properly provided by the market, and when they are not to define and regulate the provision of required services not provided by the market in the more complicated environment of FMO.

### 5.2.3.3 Restructuring of Universal Service Providers

Restructuring an organisation to adapt to an increasingly competitive environment has basically two dimensions:

- reducing the level of costs while maintaining the required level of outputs and maintaining or increasing the level of output quality;
- increasing the level of revenues, while maintaining the level of costs.

To increase revenues and seize one of their key advantages, postal operators have often diversified their operations, developing financial services or logistic activities.

To reduce their level of costs, postal operators have embarked on traditional restructuring programmes aimed at increasing organisational efficiency through the introduction of more adaptative and flexible structures and increasing organisational effectiveness through the introduction of quality measurements and improvements programmes. Doing so, the most proactive postal operators have achieved remarkable accomplishments. These include not just increased profitability but also gains for other stakeholders, including the postal organisations’ workers and customers. The study has drawn important conclusions from the review of restructuring, in general, and for postal organizations in particular. These include:

**Restructuring has already made significant inroads in the postal sector.** This observation is extremely important as the experience of others in restructuring is important in creating credibility for its benefits. In the postal sector, the experience of privatized as well as corporatised operators was reviewed, noting the fundamental changes in culture, financial performance and market orientation of restructured postal organizations.

**Restructuring is fundamental in achieving the benefits of FMO and reducing its risks.** Exogenous factors such as population density and other
geographic factors differ among countries and lead to different FMO potential impacts. These have been very much debated in the literature and in policy circles. But endogenous factors driven by restructuring – such as level of automation, management of the labour cost differential, the degree of labour flexibility, network optimisation, partnerships/diversification, counter franchising, customer management and marketing strategy, and general restructuring activities – have also a very important impact and, if properly addressed, can significantly improve outcomes in postal markets in conjunction with FMO. Finally, an important parameter – mail scale – can be considered to some extent both as exogenous and endogenous. Indeed, mail scale can be linked to traditional uses and cultural habits, but several operators have also sought and appear to have succeeded in improving mail scale, hence improving the nature of the confluence between the market, the USP and the impending FMO.

5.3 Summary Findings

This study has been ambitious in its scope, enabling us to speak with hundreds of affected stakeholders and organizations in the European Postal Sector. In stating the summary findings from this study, PwC is mindful of the conflicting points of view that are represented in this Sector. PwC is also mindful of the limitations in its current knowledge and available data.

The balancing act between the known and the unknown is, of course, at the centre of any new innovation, including the policy innovation of FMO in the postal sector. What makes this ambitious policy endeavour worth the effort are the continuing pressures which the developing communications market and electronic substitution are placing on the postal sector. These pressures make it imperative to move toward market-based solutions to provide an effective means for the European Postal Sector to continue to adapt to its own internal dynamic as well as to the broader external forces impinging on it.

The figure below shows the main forces centered on the USO and FMO. At the top are the key forces that will be unleashed through FMO, which will usher in an era in which market forces, and not regulators, will begin to dictate what products are offered at what prices and quality levels. At the heart of such market forces are user/client needs, which can be met both traditional postal products as well as from substitutes.

A second critical area of importance is the current national PO, which also acts in all Member States as the current USP. What happens to these POs is not just an abstract matter to be calculated on a spreadsheet. These POs embody broad historical mandates that have served their publics well over a long period of time. It is obviously important to ensure that these POs have the opportunity and the motivation to remain viable and to prosper in the new market environment.

The third key set of actors and balancing forces in the figure are regulators (both national and EU level). Their policies will help to determine the nature of the
interaction between new entrants, the USP and customers, and they will structure the incentives and the means by which participants in these markets interact and the cash flows that they pay or receive.

How should the interactions among these three main forces in the new era of FMO be structured so as to assure that the USO, adapted to market conditions, can continue to be guaranteed to all citizens in every Member State?

Based on the above “Detailed Findings” of the previous section, the most important general findings of this study concerning this basic question are the following.

- First and foremost, **FMO embodies considerable advantages as a source of discipline and innovation for USPs and as a source of new value for other participants in European postal markets.** The study has also pointed to some risks from FMO, and these will require constant vigilance as well as internal and external flanking measures to ensure that FMO can occur on schedule and can generate its full benefits. To garner the benefits of FMO and reduce its risks will surely require a shared commitment between all stakeholders in this market, from USP management and employees, to national regulators and governments to postal customers. Maintaining and shaping the continuing commitment to FMO embodied in the First and Second Postal Directives must remain an important element of the on-going debate on FMO.

- The impacts of FMO will be three-fold. First, there will be **natural alignment of price, value and cost of postal products** and significant pressures wherever
there is mis-alignment in these attributes, including for USO products. Second, there will be great pressures on national POs as USPs to become more commercial, more market-oriented, and to restructure their own products and processes to achieve this. Third, there will be changes for postal customers, with greater attention to market-driven needs.

In considering these impacts, the following important general findings are noted:

➤ There are large differences across the EU Member States in terms of the current status and the likely consequences of FMO on consumer well-being, on the sustainability of the historical USO, and on the ability of the USP to sustain FMO without external support or restrictions on the speed and scope of introduction of FMO.

➤ There are also large commonalities across Member States, and these include the necessity to implement a sensible New Regulatory Model compatible with FMO, and not anchored in the past pre-FMO vision, which focused on a single USP rather than on the overall efficiency of the postal market. Several important characteristics of this New Regulatory Model were noted. Regulation is a key enabling and disabling force under FMO.

➤ Key drivers of the financial impact of FMO on USPs include cost differences between the USP and likely entrants, the level and stability of USP demand, and structural factors that underlie postal costs. The structural factors are related to the country demographic and geographic characteristics, as these interact with postal demand. There are also key internal or endogenous factors, driven by the preparedness of the USP for FMO, that will affect the outcomes of FMO in significant ways and that may dictate the necessity of using one or more of the flanking measures discussed in this report.

➤ There are complex interactions between cost, demand and structural factors in terms of their impact on key outcomes of interest, including financial consequences for the USP, price changes for various market segments likely to follow FMO, and the possibility that workable competition will follow FMO for particular Member States and, more broadly, across the EU.

➤ USPs and national regulatory agencies in different Member States are at various levels of preparedness for FMO. Some began preparing for FMO more than a decade ago. Some have barely begun. There are, nonetheless, some generally applicable principles related to pricing and access regulation that can be recommended across Member States that will allow a smoother and
more efficient confluence with FMO. These include the pricing flexibility and incentives associated with price-cap regulation and the efficiency benefits of cost-based and negotiated access pricing. In particular:

- **Restructuring of USPs**, directly driven by the anticipation of competition under FMO, is likely to be one of the major benefits arising from FMO in terms of productivity, efficiency and consumer benefits in the European postal sector.

- Given the experience in other network industries, and general economic principles, it is to be expected that the costs and benefits of FMO will fall differently on different market segments and stakeholders in the postal market, in line with the general alignment of cost, price and value/willingness-to-pay of different segments for different services.

- The impact of FMO is likely to be that both competitors and incumbent national POs will begin to understand better the true quality preferences of customers of various sizes, the cost and profit consequences of alternative methods of serving these, and there will be a better alignment over time between the costs of providing services, including those understood to be a part of the USO, and the prices paid for them.

- This implies that to the extent that some customers are currently receiving some services at a subsidized level as part of the USO, there will be continuing tensions to either increase these prices or decrease the costs and scope of those elements of the USO until the indicated alignment is achieved.

- The approach taken at the EU level to assure FMO should focus on establishing a level playing field for all participants in the market and on a minimal definition of the USO itself. Level playing field arguments will be very important in assuring that entry which does occur is efficient. These arguments include abolition of the VAT exemption for all providers in the postal market, pricing flexibility for incumbents, as well as transparent and non-discriminatory access conditions to leverage the incumbent PO’s network. This implies the following:

- Subject to a clear definition and EU-wide implementation of FMO itself, subsidiarity should continue to dominate in the definition of the USO in individual Member States. This will allow individual Member States to align the costs and benefits of their definition of the USO going forward, including the means to pay for it as discussed under the options for funding the USO in this Report.
5.4 Concluding Comment

As the era of FMO is entered, it is worth noting that liberalising the postal sector should not be “une fin en soi”. It is first and foremost a way to improve the way the sector is functioning with a view to optimising the services provided to customers and citizens and the long-run value created by both postal organizations and other communication service providers with whom they compete. The challenge is to translate this broad vision into practical regulatory and policy proposals that will help to ensure that Europe’s postal markets make a contribution to the modernisation and future growth of the European economies.

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References


Wik, 2003, Antonia Niederprüm, Andreas Hense, Dr. Gabriele Kulenkampff and Alex Kalevi Dieke, “Quality of Service Objectives, Performance and Measurement in Relation to Community Universal Postal Service”, WIK Consult, Bad Honnef, Germany, August 2003.


## Glossary

<table>
<thead>
<tr>
<th>Technical term</th>
<th>Definitions</th>
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</thead>
<tbody>
<tr>
<td>Affordability</td>
<td>As per Postal Directive, prices should remain affordable for all users. It means that prices have to be determined so that each type of users has the sufficient financial means to face the cost of the service.</td>
</tr>
<tr>
<td>Automation level</td>
<td>The automation level measures the use of automatic equipment instead of manual labour. The automation percentage represents the percentage of mail automatically processed (overall, that is letter and bulk mail).</td>
</tr>
<tr>
<td>Avoided cost (Access price based on)</td>
<td>Avoided cost methodology (sometimes also referred to as Efficient Component Pricing) computes the price for a service that is less than end-to-end by subtracting from the full end-to-end price the cost of those elements of the end-to-end service that have been provided by the client. For example, avoided cost pricing for pre-sort discounts would provide a discount to those mailers who pre-sort that equals the average avoided cost saved by the incumbent USP by not having to sort the mail (and this discount could vary as a function of the depth of the pre-sort, its accuracy, the volumes involved, and other cost drivers).</td>
</tr>
<tr>
<td>Balance to finance</td>
<td>The balance to finance is measured by the coverage of the revenues linked to USO products of the costs associated with USO provision. In order to compare results across different countries, the balance to finance is normalized by using the total postal revenues. The final (normalized) balance to finance equals the difference between revenues and costs associated to USO divided by total postal revenues.</td>
</tr>
<tr>
<td>Bulk Mail</td>
<td>Addressed Bulk mail is mail that is potentially subject to volume discounts. They include Transaction mail and Direct mail.</td>
</tr>
<tr>
<td>By-pass</td>
<td>It is both technologically and economically feasible for entrants to build their own network and consequently to “by-pass” incumbent’s postal network.</td>
</tr>
<tr>
<td>Collection</td>
<td>This activity consists in the clearance of postal items deposited at access points throughout the territory, as per Postal Directive.</td>
</tr>
<tr>
<td>Competitive bottleneck</td>
<td>Markets are competitive for subscribers but access providers have a monopoly position with regard to their subscribers.</td>
</tr>
<tr>
<td>Cream-skimming competition</td>
<td>When an incumbent is forbidden by law to post cost-reflective prices (as a result of uniform pricing or universal service constraints), competitors enter in the markets where incumbent’s prices are above cost and leave the deficit making markets to the incumbent.</td>
</tr>
<tr>
<td>Delivery</td>
<td>This activity consists in the process from manual sequencing at the local distribution centre to delivery of postal items to their addressees.</td>
</tr>
<tr>
<td>Direct mail</td>
<td>As per Postal Directive</td>
</tr>
<tr>
<td>Flanking measures</td>
<td>“Flanking measures (mitigation and enhancement measures): measures which may enhance opportunities of a proposed regulatory reform and significantly reduce the potentially negative impacts that result from the same anticipated reform”. (Source: ???)</td>
</tr>
<tr>
<td>Franchised counters</td>
<td>Percentage of franchised counters versus counters directly owned by USP.</td>
</tr>
<tr>
<td>Freelancer</td>
<td>Self-employed.</td>
</tr>
<tr>
<td>Full Market Opening (FMO)</td>
<td>TO BE CONF</td>
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<tr>
<td>Global price cap</td>
<td>Price cap which incorporates intermediate goods (such as access to network) as well as final, retail, goods or services.</td>
</tr>
<tr>
<td>Incremental cost (Access price based on)</td>
<td>Incremental cost methodology for a particular service is the additional cost of providing a given increment in output of a given service during a particular period. The usual specifications for incremental cost would be the cost of providing all units of a particular service at a specific output level for a given year. In the context of the product “access”, incremental cost methodology would set access price as the average incremental cost (computed on an annual basis) of work to be undertaken to provide the access in question. Such incremental cost prices can themselves be averaged across products, e.g., incremental access cost could be the average cost of access for all geographic zones or it could be de-averaged and charged as the average incremental cost in a zone-specific manner.</td>
</tr>
<tr>
<td>Labour cost ratio</td>
<td>Measurement of the cost differential between postal workers and freelance workers. It is calculated as the relative cost of freelancers relative to that of the postal workers.</td>
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<tr>
<td>Letter Mail</td>
<td>Regular single-piece mail that is not subject to volume discounts applicable to Bulk Mail. This includes both 1st class mail (regular single-piece Letter Mail) and 2nd class mail (single-piece Letter Mail that has a lower service quality standard than 1st class, and as a result is subject to a discount relative to 1st class single-piece Letter Mail. Not all countries have 2nd class mail service)</td>
</tr>
<tr>
<td>Market elasticity</td>
<td>Market elasticity is defined as the percentage change of a product market demand resulting from the behaviour of the customer group reacting to a percentage change of the market tariff of that product.</td>
</tr>
<tr>
<td>Negotiated price - Access price based on</td>
<td>Negotiated prices are determined based on the bargaining power of the parties involved in the negotiation. In reality, this means that either party to the negotiation is free to take or leave the offered prices. In models of negotiated pricing, the outcome is determined by a specific formula that allocates the gains to trade between negotiating partners according to their bargaining power. Negotiated access prices would, for example, consider the average incremental costs of the incumbent USP and an entrant considering desiring access services from the incumbent, and would allocate the difference between the average incremental costs of these two bargaining partners according to some formula that recognized the (assumed) bargaining power of each partner.</td>
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<tr>
<td>Parcels</td>
<td>Parcels under the USO limits (weight and size).</td>
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<tr>
<td>Periodicals and newspapers</td>
<td>Periodicals and newspapers.</td>
</tr>
<tr>
<td>Price cap</td>
<td>Maximum average price that a bundle of incumbent’s good can not overshoot. The set of goods concerned and the weights used are two crucial elements of the price cap formula. Typically, such a formula would restrict weighted price increases to be no more than (some measure of) inflation minus a fixed amount (the “X” factor) that is expected to be made up by productivity increases or product innovations.</td>
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<tr>
<td>Postal scale</td>
<td>Measures the average number of postal items delivered annually per inhabitant</td>
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<tr>
<td>Product</td>
<td>A postal service available from either the incumbent or entrants under specified conditions</td>
</tr>
<tr>
<td>Public Postal Network (PPN)</td>
<td>The set of access points, including collection points and counter services, and delivery infrastructure that define the points at which customers or recipients of mail interact with the USP</td>
</tr>
<tr>
<td>Rural Route Delivery Zone</td>
<td>A route (or zone) located in a rural area, is defined by default using the United Nations definitions (see <a href="http://unstats.un.org/unsd/demographic/concerns/densurb/densurbmethods.htm">http://unstats.un.org/unsd/demographic/concerns/densurb/densurbmethods.htm</a>). But if the PO already has classified his routes or zones using different definitions, these should be used (indicate to the interviewer the criteria used to do the classification into rural and urban routes or zones)</td>
</tr>
<tr>
<td>Shifting elasticity</td>
<td>When the total market volume is known, the allocation of customer’s demand over the two Operators is made as a function of price/quality comparison: for the same product at the same quality, a relative price change between Operators will lead to a shift in demand from the one to the other or a shift in their market shares.</td>
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<tr>
<td>Sorting</td>
<td>This activity consists in the sortation (automated or manual) of mail items consolidated at regional sorting centre. The mail items originate from the collection network or from other regional sorting centres. The automated sequencing activity (ordering of mail item in sequence of delivery round) is processed at this stage.</td>
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<tr>
<td>Transactions mail</td>
<td>Transaction mail consists of bills, invoices, financial statements and other bulk mail originated by business/government organizations with receiver-specific content.</td>
</tr>
<tr>
<td>Transport</td>
<td>This activity consists in the transport of mail items between regional sorting centres and the transport of mail items from regional sorting centres to local distribution centres.</td>
</tr>
<tr>
<td>Uniform pricing</td>
<td>Postal products prices do not depend of the geographical characteristics of a country.</td>
</tr>
<tr>
<td><strong>Universal Service Obligation (USO)</strong></td>
<td>As per Postal Directive.</td>
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<tr>
<td><strong>Universal Service Provider (USP)</strong></td>
<td>Providers of the USO. In most of the European countries, USPs are historical national postal operators.</td>
</tr>
<tr>
<td><strong>Urbanisation rate</strong></td>
<td>Percentage of population living in urban areas (as per UN standards).</td>
</tr>
<tr>
<td><strong>Urban Route Delivery zone</strong></td>
<td>A route (or zone) located in an urban area, is defined by default using the United Nations definitions <a href="http://unstats.un.org/unsd/demographic/sconcerns/densurb/densurbmethods.htm">see http://unstats.un.org/unsd/demographic/sconcerns/densurb/densurbmethods.htm</a>. But if the PO already has classified his routes or zones using different definitions, these should be used (indicate to the interviewer the criteria used to do the classification into rural and urban routes or zones).</td>
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