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ERGP Secretariat
by email

Contribution to the draft ERGP report on USO net costs

Dear Madam or Sir,

Thank you very much for the opportunity to comment on your draft ERGP report on net cost calculation and evaluation of a reference scenario. Swiss Economics is an independent consultancy and think tank with in-depth knowledge of the postal sector and a broad experience in the calculation of the net cost of universal service obligations. Our involvement in this topic has resulted in a number of academic publications. This encourages us to respond to selected issues and questions in your document for public consultation.

We hope that our response may be useful for your work. Please do not hesitate to contact us if you have any questions.

Sincerely,



Christian Jaag, PhD
Managing Partner

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Question 1

We agree with the report's statement under 3.4.1.5 that the counterfactual scenario should be plausible and as simple as possible. However, from an economic point of view, assuming the same level of competition in both scenarios is oversimplifying. It is well established in the relevant literature that the Universal Service Obligation (USO) very much affects competition for various reasons:¹

- Price uniformity for USO products invites competition in low-cost market segments / regions and deters entry in high cost areas / regions.²
- A binding minimum number of access points or processing facilities results in inefficient processes which translate into excessive prices if there is no appropriate compensation. This invites inefficient entry by potential competitors.³
- The USO acts as a strategic device to signal the Universal Service Provider's (USP's) presence in a market segments and therefore forecloses entry.⁴
- VAT exemptions associated with the USO would not exist in the counterfactual scenario. These have important implications for competition, too.⁵

Therefore, in a reference scenario without USO it should be assumed that also the level of competition is different.

Question 3

Question 3 is related to our comments made in relation to Question 1 insofar as demand very much depends on the availability of alternative services which itself is a matter of the level of competition. An important aspect which is not mentioned in your document is the interaction between the net cost of the USO and its financing: If there is a compensation fund to which all operators contribute, then it will be USP who bears most of the cost due to its (presumably) largest market share. In market equilibrium this results in an undercompensation of the USP and excessive market entry by competitors. If there is a pay-or-play system with a fund to which only oper-

¹ Jaag, Christian, Urs Trinkner, John Lisle, Navin Waghe, Erik Van Der Merwe (2011). Practical approaches to USO costing and financing. *Competition and Regulation in Network Industries*, 12(2), 108-129.

² See e.g. Jaag, Christian (2007). Liberalization of the Swiss Letter Market and the Viability of Universal Service Obligations, *Swiss Journal of Economics and Statistics* 143(3), 261–282.

³ See e.g. Buser, Martin, Christian Jaag, Urs Trinkner (2008). Economics of Post Office Networks: Strategic Issues and the Impact on Mail Demand, in: *Handbook of Worldwide Postal Reform*, M. A. Crew, P. R. Kleindorfer und J. I. Campbell Jr. (Hrsg.), Cheltenham, UK and Northampton, MA, USA: Edward Elgar, 80-97.

⁴ See e.g. Jaag, Christian (2011). Entry Deterrence and the Calculation of the Net Cost of Universal Service Obligations, 2011, *Review of Network Economics* 10(1), Article 4.

⁵ See e.g. Dietl Helmut, Christian Jaag, Markus Lang, Martin Lutzenberger, Urs Trinkner (2011). Impact of VAT-Exemptions in the Postal Sector on Competition and Welfare. In: *Reinventing the Postal Sector in an Electronic Age*. Edited by M. Crew and P.R. Kleindorfer, Edward Elgar, 267-280 or, in a more general framework, Dietl Helmut, Christian Jaag, Markus Lang, Urs Trinkner (2011). Competition and Welfare Effects of VAT Exemptions, *The B.E. Journal of Economic Analysis & Policy* 11(1), Article 19.

ators who are not providing universal services contribute, this raises severe barriers to entry and results in an overcompensation of the USP.⁶

Question 15

We have studied the competitive effects of various notions of what an unfair burden might be.⁷

1. Universal service provision imposes an unfair burden if it significantly reduces the USP's profit compared to a situation without USO.
2. Universal service provision imposes an unfair burden if the USP's profit is negative.
3. Universal service provision imposes an unfair burden if the USP's profit is lower than his competitors'.
4. Universal service provision imposes an unfair burden if it reduces the USP's profit compared to a situation without USO by more than the competitors' profits are reduced due to contributions to USO funding.

The choice of a criterion is to be based on equity rather than on efficiency considerations. In general, each of the criteria results in a different distribution of profits. The choice of one among the others is therefore to be oriented on the goals to be reached by the compensation. It also depends on the available financing mechanism: If the net cost is compensated with external funds, criterion 2 is probably the most realistic one because tax payers would not accept financing a profitable USP. If competitors have to contribute to the funding of the USO, changes in their profit should be considered, too. Therefore, criterion 4 should be applied: It is closest to the concept of reciprocity which empirical evidence shows to be an important motive in social behavior.

Question 16

The competitive effect of asymmetric VAT exemptions has been studied theoretically.⁸ With a reasonable model calibration, the USP's VAT exemption positively affects the USP's profit and reduces the entrant's profit. Hence, it strengthens the incumbent's relative competitive position and results in an unlevel playing field. However, it has a positive effect on consumer surplus. Compared to no VAT exemption, it has a small but positive welfare effect in that the marginal tax rate is lower on average. The VAT regime also has an effect on the make-or-buy decisions of postal operators. VAT exempt operators have a higher incentive to employ their own workers instead of subcontractors.

⁶ See e.g. Jaag, Christian, Urs Trinkner (2011). "The Interaction between Universal Service Costing and Financing in the Postal Sector: A Calibrated Approach", *Journal of Regulatory Economics* 39(1), 89-110.

⁷ See Jaag, Christian (2011). "What is an Unfair Burden? Compensating the Net Cost of Universal Service Provision, 2011, *Review of Network Economics* 10(3), Article 7.

⁸ See e.g. Dietl Helmut, Christian Jaag, Markus Lang, Martin Lutzenberger, Urs Trinkner (2011). "Impact of VAT-Exemptions in the Postal Sector on Competition and Welfare". In: *Reinventing the Postal Sector in an Electronic Age*. Edited by M. Crew and P.R. Kleindorfer, Edward Elgar, 267-280 or, in a more general framework, Dietl Helmut, Christian Jaag, Markus Lang, Urs Trinkner (2011). "Competition and Welfare Effects of VAT Exemptions", *The B.E. Journal of Economic Analysis & Policy* 11(1), Article 19.

Section 4.3

In theory, under efficient market conditions, tendering of universal services allows for finding the most efficient provider for the required service at the minimum level of compensation. In practice, the design of auctions is complex and requires to solve several trade-offs. A first trade-off relates to the duration of the contract period. Contracts could range between three and ten years. The longer the contract, the larger are the investment incentives for the winning operator. However, the longer the contract the fewer are the possibilities to adapt the USO over time to the customers' needs. Therefore, although long time horizons might be needed for dynamic efficiency considerations (investments and innovation), they might result in higher compensation needs as the bidders will request considerable risk premia. A second problem is the determination of the optimal level of aggregation: Should the USO be tendered globally or divided up into various pieces and procured in smaller tenders? A global approach allows exploiting scale and scope economies. However, dividing the USO up into several pieces, for example various regions, enables yardstick competition which could result in a more transparent provision of the USO. Such a disaggregated approach involves complex practicability issues (e.g. the regulation of interconnection), and might not be able to sustain uniform prices and services. A third trade-off relates to the level of concreteness of the specific USO requirements. Tenders increase information asymmetries between governments and contractors compared to public provision. A detailed definition of the USO with respect to quality levels, accessibility criteria etc. increases both the operators' and regulator's legal certainty and provides a clear basis for any USO cost calculations. However, detailed contracts might hamper the commercial flexibility of the USO operator unnecessarily.

The use of subsidy auctions might also entail various political challenges for the regulator. First, tendering might require privatizing some of the activities that previously were provided by a state-owned incumbent monopoly. Otherwise, conflicts of interests are prevalent and a level playing field between the various USO candidates is not guaranteed. Hence, governments must assess whether they are ready and able to privatize their state-run undertakings. Second, USO tendering requires funds to pay the winning bid. In the absence of such funds, USO requirements should be redefined accordingly. Third, governments must be aware of the hold-up risk that is involved in tendering. In case the winner of the auction did underestimate the cost of the USO (winner's curse) or in case of bankruptcy, the government loses its invested compensation and is likely to be forced to enter into costly renegotiations of the concessions.

We conclude that tendering can be an option for procuring the provision of universal service obligations. The design of a tender should consider the relevant sector-specific aspects, such as the industry structure and changing consumer needs. In order to ensure the frictionless functioning of universal services in liberalized markets, these issues should be thoroughly assessed and resolved before a tender is introduced.⁹

⁹ Calzada, Joan, Christian Jaag, Urs Trinkner (2010). Universal Service Auctions in Liberalized Postal Markets. In: Heightening Competition in the Postal and Delivery Sector, edited by M.A. Crew and P.R. Kleindorfer. Cheltenham, UK: Edward Elgar.