

PostNL's contribution to the draft ERGP Report on common cost allocation

Allocation of common cost for USO providers in a liberalized postal market

PostNL appreciates the opportunity to contribute to the draft report covering the important topic of how article 14 should be implemented.

PostNL would like to emphasise three points in this contribution:

1. Postal operators need to maintain flexibility in their pricing strategies in order to secure the universal service provision in a situation with declining mail volumes. To ensure this, it is important that the costs allocation principles reflect the economic realities for the postal operator.
2. To reflect economic reality in the cost allocation the principle of cost causation is the primary principle to be used. This principle is consistent with the prescriptions of art 14 in the Postal Directive.
3. Simple application of EPMU principles has important shortcomings. Like prescribed in the Postal Directive this method should only be used when no analysis of the origin of the costs can be made.

1. An economic approach to allocation of cost is needed

The USO provider: A multi-product firm in a liberalized postal market

Postal operators are multi product firms: they produce different categories of services, both USO and non-USO, in one organisational postal network. In a liberalized postal market those services compete in different markets or market segments with services of other operators or are under pressure of potential market entry.

A stand alone production of USO services will be more expensive because with separate production synergies will be lost, therefore USO-customers benefit from this integrated production of services. The continuation of this integrated production of USO and non-USO services in a liberalized market is therefore desirable. Cost allocation systems should reflect this.

Cost allocation for postal operators

Cost allocation rules should be objective and concur with economic reality to avoid distorting price signals and attract inefficient entry. At the same time the provision of the universal service should be ensured. Obviously in those accounting rules, limits set by competition law should be respected.

Some costs in the postal system can be easily identified and traced back to individual services or category of services and assigned to those services. A substantial part of the cost however cannot be directly assigned to a specific category of services; these are *common cost*. An appropriate approach for allocating those costs is therefore necessary. Art 14 of the Postal Directive implies that the principles used shall be objectively justifiable and consistently applied. External auditors can verify on a yearly basis whether cost allocation principles are consistently applied across all postal activities of the USO provider.

2. Cost causality is the primary principle to be used in an economic approach

A key question in the allocation of common costs is whether costs should be allocated according to use of inputs or according to cost causality. Use of input would for example be number of USO and non-USO letters in a mailbox, whereas cost causality would imply an analysis of whether the mere existence of a mail box is caused by USO or non-USO products.

Allocation of common cost is often based on *use* of the inputs. However, cost allocation of common cost based on *use* of inputs fails to reflect the factors driving the *causality* of costs.

Example: Suppose that the USO requires 100 mail boxes in a district, but that in absence of the USO, the operator would only have chosen to have 20 mail boxes. In this example, 80 mail boxes are not necessary for Non-USO products. These 80 mailboxes are caused by the USO. However, a cost allocation based on input use, would allocate costs according to the number of USO versus non-USO letters in the mail boxes. This neglects the causality, and may very well lead to an allocation of the costs assigned to the Non-USO products that exceeds their standalone costs. The flipside of this is that the USO products will be assigned costs below their incremental costs.

In a liberalized market a more economic approach is necessary based on this causality of cost.

This is in line with the Postal Services Directive. *Whenever possible, common costs shall be allocated on the basis of direct analysis of the origin of the costs themselves.* In case of USO with a small scope cost allocation to the USO should only be limited to the USO as a whole and not to individual products. In a postal sector allocation of common costs to individual services within a small USO is meaningless and cannot generate useful information for price setting.

Stand alone costs and incremental cost

Based on this causality the *maximum of common cost* attributable to a service or a set of services can be established based on a stand alone approach.

Total cost assigned to a specific service or category of services can not exceed the cost in a stand alone situation. If this were the case the company would be inclined to splitting the production in different organisations.

Stand alone costs minus volume variable cost of those category of services gives the upper boundary of the common cost that could be assigned to that category of services. Such a method can be seen as an analysis of the origin of those costs. No more common costs are allocated than the difference of the stand alone cost and direct attributable costs allows.

Allocation of more common cost to a category of services will force operators to switch to stand alone production of that category of services with detrimental effects for USO services.

Allocating only incremental or volume variable cost to services or categories of services means that no contribution is made to common costs. Contribution of common cost above this minimum will support the postal network and will support to ensure the provision of the USO.

3. Simple application of EPMU has important shortcomings

Equi-Proportional Mark-Up (EPMU) is another method of allocating common costs. EPMU means splitting the common costs in proportion of the volume or turnover of USO and non-USO products delivered by the network.

This method does not provide an adequate allocation of costs because:

First, this method ignores the fact that some of the requirements and thus costs of the USO concern the quality of the network and not only the type of products delivered.

The *design of the network* based on the obligations of offering USO-services is not taken in to account as an origin of the costs in an appropriate manner.

Second, this ignores the requirement of the directive to seek a *more direct connection between the origin of the cost and the cost itself*. A general allocator is only the allocation method of last resort and, wherever possible, a more direct cost analysis should be applied.