



# Europe Economics Postal Executive Briefing

September 2005

## The net cost of universal postal service in the new postal market

*In the third of our Executive Briefs before the EU postal negotiations, we argue that the industry needs not only to update assessments of the net cost of universal postal services (uso) but also to undertake a regulatory impact assessment of the uso.*

### Introduction

Much of the debate over postal liberalisation has focused upon the ability of the national post (USP) to fund its universal service provision in a competitive market. Under the Treaty (reflected in Article 7 of the Amended Postal Directive) any special rights for the USP are only allowable “to the extent necessary to ensure the maintenance of universal service”.<sup>1</sup> However, in practice, although Article 7 has applied to all the EU Member States since 1998, only in the UK has the regulator made and published any serious attempt to measure universal service costs. Moreover, approaches to universal service costing have become entangled with the wider debate over the de-regulation of postal services and this has hindered the emergence of consensus on this issue.

### The different approaches to measuring universal service costs

The first major study undertaken to measure universal service costs in the EU Member States was for the European Commission in 1998. This considered the net costs of the universal service to be “when a postal administration is obliged by the government to supply customers or services in

circumstances where the overall revenues generated from doing so are less than the costs of supply, taking into account any revenue benefits from providing the universal service.”<sup>2</sup> This was termed the Net Avoided Cost approach, which looked to assess the revenue gain or loss that the USP may have if it was not obliged to provide the universal service. This could be estimated by adding together losses made by the USP on services where revenues did not meet incremental (or avoidable) costs and netting off these losses against the financial benefits of universal service provision. The study estimated the costs of the universal service as ranging from 8 per cent of delivery costs in Austria to zero in France, Greece, Denmark and Finland.

However, in the discussion surrounding the next steps of Community regulation such findings proved controversial. In particular USPs were concerned that under this static analysis, the losses they might incur as a result of the universal service obligation (uso) under different steps of postal market opening would not be clear. Royal Mail’s economists, therefore, developed their own technique for identifying universal service costs in a competitive market, known as the

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<sup>1</sup> Article 7 of the Amended Postal Directive.

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<sup>2</sup> NERA; “Costing & financing of universal services in the postal sector in the European Union”. 1998



Entry Pricing model. This approach used a spreadsheet model to measure the impact of the use (in particular the geographically averaged uniform tariff) on the USP's finances by seeking to assess where they would lose revenues to competitors in a competitive environment.<sup>3</sup> Here the cost of the universal service was defined as the reduction in profit levels caused by universal service obligations under different scenarios of weight and direct mail liberalisation.

This approach has subsequently been refined further, notably at the IDEI at Toulouse University, to include additional analyses of the effects of the pressure on the uniform tariff and the potential welfare implications of competition.<sup>4</sup> American economists have also applied entry pricing models to simulate the potential effects of competition on the United States Postal Service, deriving what has become known as the 'graveyard scenario'. This occurs where a USP increases its prices to offset revenue losses and as a result increased average unit costs due to loss of economies of scale, thereby generating increased future switching<sup>5</sup>. Further refinements of this type of modelling have been made by economists working with Poste Italiane, to consider the potential for a graveyard spiral in EU posts.<sup>6</sup>

## The findings of these approaches

In theory the NAC method and the entry pricing methodology might produce similar results. However, in practice, given that the

NAC method uses estimates of incremental costs and that there are difficulties in fully establishing the advantages to the USP of providing the universal service and the likely scale and impact of competitive entry, it is unsurprising that their results have often proved widely different. For example, the UK regulator, Postcomm, used consultants who undertook a Net Avoided Cost analysis of Royal Mail's service provision. Their conclusion was that the Net Avoided Cost was, in context not a substantial burden.<sup>7</sup> Meanwhile, based on a similar data set, Royal Mail's entry pricing model predicted that if the weight defining the protected mail market was reduced to 50g and direct mail was liberalised the USP could lose all their 'normalised' profit.

## The impact of changing market and regulatory conditions

Current approaches are coming under increasing challenge as market dynamism and the effects of actual competition in the market appear to put their assumptions and structure under question.<sup>8</sup> In this respect it may be necessary to update views of what constitute universal service costs and benefits in the changing market, and of how best to model their impact.

## A fuller analysis of universal service burdens and benefits is needed

### Costs

It can be argued that the methodologies and models developed thus far do not fully

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<sup>3</sup> Examples of this approach include Hill, Robinson and Rodriguez: "Estimates of the Cost of the Universal Service Obligation using the Entry Pricing Approach."

<sup>4</sup> For example, see Helmut Cremer, Andre Grimaud, Jean-Jacque Laffont: "Le coût du service universel dans le secteur postal in Joelle Toledano (eds) Economica 2004.

<sup>5</sup> See Michael Crew and Paul Kleindorfer: "Liberalisation and the Universal Service Obligation in postal service."

<sup>6</sup> See Robert Cohen, Matthew Robinson, Renee Sheehy, John Waller and Spyros Xenakis: "An Empirical Analysis of the Graveyard Spiral."

<sup>7</sup> See Postcomm and Arthur Andersen: "An Assessment of the Costs and Benefits of Conisgnia's universal service provision" which estimated the cost at about £80m on a NAC basis.

<sup>8</sup> See David Stubbs: "The Birth of the New European Postal market." available at [www.europe-economics.com](http://www.europe-economics.com)



capture potential universal service costs in the developing market. Depending upon how they are defined universal service obligations appear to impose the following burdens on the USPs:

- The requirements for access and clearance facilities and daily collection and delivery (five days a week) may not only require the USP to maintain a more costly postal infrastructure than that which an unconstrained profit-seeking operator would provide, but also impede network re-optimisation.
- Universal service obligations which impose particular forms of service provision, pricing, or time-frame may also affect USPs' ability to serve customer requirements in the market where customers are increasingly seeking tailored services.

Whilst such burdens are partially considered by existing models, new technological opportunities to provide customer solutions may be increasing the ways in which universal service requirements hinder the USP from making an optimum competitive response. It is for example likely to be more difficult to tailor services where mail is injected into the universal service channel, with a daily delivery and volume-handling process which is geared to meet speed-of-transit quality of service targets.

As the mail volume-mix continues to change towards direct mail items and heavier postal items, it can be argued that the impact of these restrictions is likely to grow. The effects of infrastructure requirements also now need closer analysis as universal service requirements may prevent the USP from benefiting from new possibilities for greater optimisation and efficiency.

## Benefits

Likewise existing models may not now fully capture the benefits deriving from universal service provision. The universal service national distribution network may provide USPs with significant competitive advantages, for example:

- They can retain key customer groups including Business to Consumer mailers who may require national or comprehensive regional coverage.
- They can use 'slack' in the national network to provide non-postal services such as unaddressed mail.
- They can use their competence in national distribution to expand into ancillary markets.
- They can gain synergies between universal and non universal postal products (economies of scope) as well as economies of scale.
- They can lever non-postal revenues from their postal customers (served through the national distribution network) with upstream and downstream services such as IT services, invoice printing and data management service and mail room services. The broad customer base provided by the universal service obligation is an advantage in developing such services.
- They can use the postal retail networks to build presence in the financial services market.



- They can use their post-coding database to provide tailored marketing services.

Changing market dynamics also suggest some structural adjustments may need to be made to entry price modelling. Closed models based solely on revenues and costs for mail and parcels services will not capture the full benefits that USPs derive from their universal service provision outside postal services. Current analyses may also underplay the importance of large customer contracts. Further the scope for geographic cream-skimming against a uniform tariff may be more limited where contracts are negotiated on a discounted national basis and where USP scale or other incumbent advantages may outweigh geographic cost differences.

### **Moving towards a regulatory impact assessment**

As we move towards de-regulation, the industry and regulators will need a deeper consideration of universal service costs and benefits. As has been predicted, the pressure to reduce universal service definitions will increase in a competitive market. To take just one example, if bulk mail services are withdrawn from the universal service definition and USPs provide these services through discrete (non universal service) channels, then the scope for such services 'funding' the universal service infrastructure may contract.<sup>9</sup> In such a situation the apparent net cost of the universal service (for those services and infrastructure which remain) may rise significantly, presenting a real challenge to regulators. In this context universal service

obligations may become increasingly controversial and may only be justifiable following a thorough regulatory impact assessment.<sup>10</sup> Such an assessment of universal service obligations starts in looking at the purpose of the obligations (customer and consumer needs). The different obligations would then be compared to other regulatory approaches and to the counterfactual. Having understood the different costs and benefits of these obligations to stakeholders, the industry and its regulators could then assess which was the most appropriate universal service obligation, and then have a firm basis for compensating the USP for its provision, if this was necessary.

### **Conclusions**

Postal economists have provided useful evidence of the burdens which may be imposed by different universal service obligations. However, as customer requirements develop and the market is de-regulated this analysis needs to be updated and put in the context of a broader regulatory impact assessment of universal service obligations.

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For further information, please contact David Stubbs:  
[david.stubbs@europe-economics.com](mailto:david.stubbs@europe-economics.com)

For general enquiries contact: Samantha McCarron at:  
Europe Economics, Chancery House, 53-64 Chancery Lane,  
London WC2A 1QU

Tel: (+44) (0) 20 7831 4717 Fax: (+44) (0) 20 7831 4515  
e-mail: [enquiries@europe-economics.com](mailto:enquiries@europe-economics.com)

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<sup>9</sup> This would occur as the universal services would not now share common costs with bulk mail services and would therefore have a significantly higher average unit cost.

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<sup>10</sup> See our Handbook on Impact Assessment at [www.europe-economics.com](http://www.europe-economics.com)