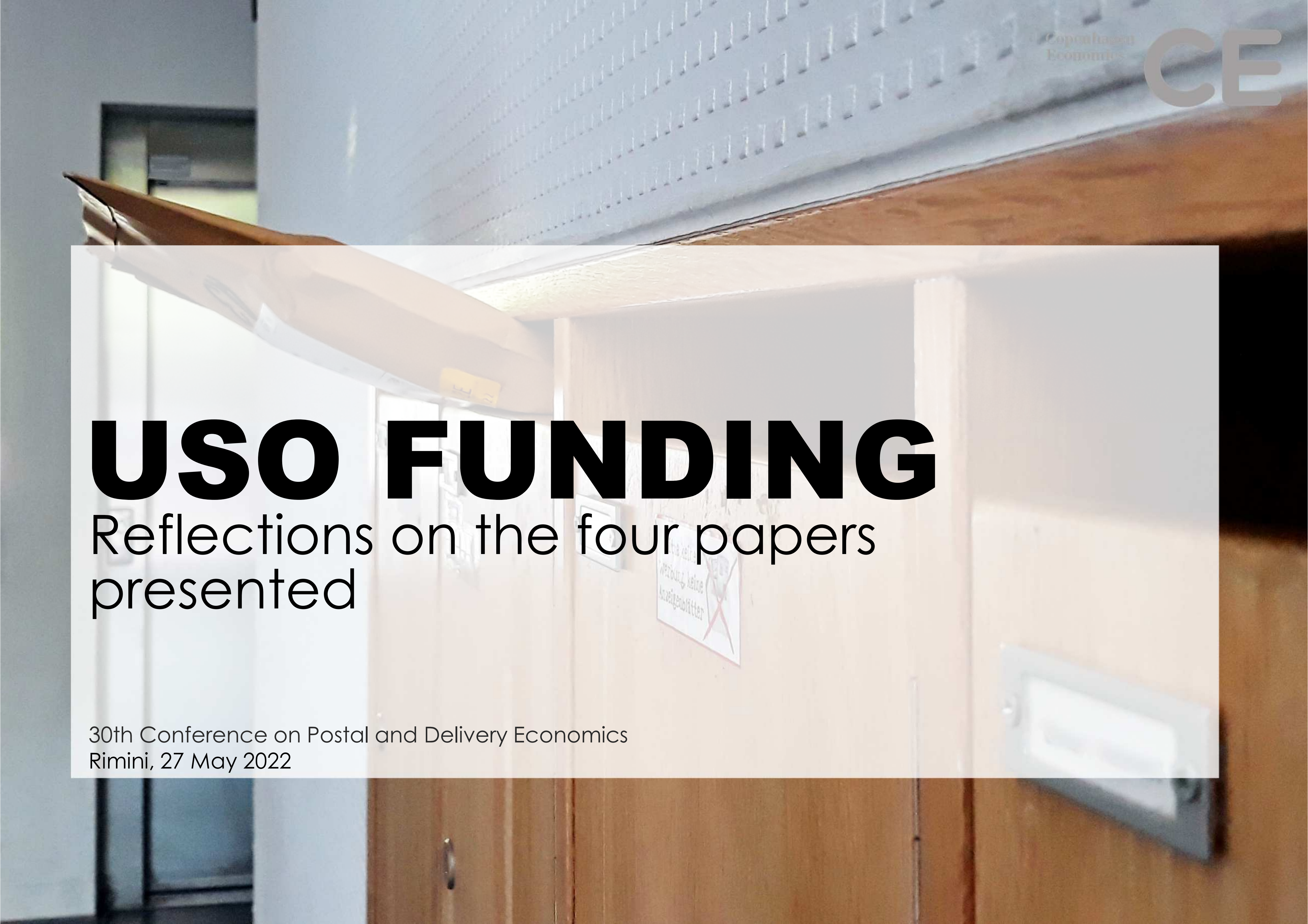

USO FUNDING

Reflections on the four papers presented

30th Conference on Postal and Delivery Economics
Rimini, 27 May 2022

Overall conclusions based on the four papers

Increased importance of parcel delivery for postal USPs create both opportunities and challenges linked to USO funding.

Getting the net cost calculation (and thereby compensation) right is of critical importance to ensure

- financially sustainable provision of postal services,
- efficiency incentives, and
- a level playing field.

Cost allocation and calculation of USO net costs are still perceived as complex exercises where more clarity and transparency is needed.

The Interplay of Public Funding and Industrial Synergies in the Evolving Postal Services Market: What Impact for the Calculation of the Net Cost of the USO?

Frezza (2022)

Investment synergies' impact on cost allocation – an old challenge in a new context

Perceived risk

- USPs rely on joint network/joint investments for delivery of letters and parcels
- This may give incentives to portray network and investment costs as fixed costs resulting from the USO status.

This may distort competition

1. More costs allocated to USO

→ USO perceived as more costly to provide

→ higher net cost compensation

→ higher prices to USO products

2. Less costs allocated to more competitive products

→ justifying lower (even predatory?) prices

- Not a new challenge (e.g. cases against several USPs almost 20 years ago).
- How is the current situation different from the past?

How will cost allocation affect USO net costs?

- The USO cannot be used as a cost driver – need to demonstrate causality:

"the ERGP considers that the USO cannot be regarded as a cost driver until proven otherwise by operators and formally acknowledged by the NRA."[1]

- Moreover, net cost calculations should not rely on cost allocation

"Although the Commission regards the ***net avoided cost methodology as the most accurate method*** *[…],* ***where duly justified****, the Commission can accept alternative methods for calculating the net cost necessary to discharge the public service obligations,* ***such as the methodology based on cost allocation."***[2]

- Investments that would have been implemented also without the USO (irrespective of cost allocation) should not contribute to USO net costs

- Still, the fact that the counterfactual is purely hypothetical imposes risks

→ Important for NRAs and the EC to scrutinize the calculations. Recent Post Danmark case is a good example.

→ Third party providers should continue to challenge the calculations provided by USPs to ensure calculations are sound

- And incorrect cost allocation may have serious impacts on pricing

1. ERGP (12) 28 Rev. 1 – Common Position on cost allocation rules // 2. European Union framework for State aid in the form of public service compensation (2011):

CAN PARCEL GROWTH SUPPORT THE SUSTAINABILITY OF THE USO?

Houpis et al. (2022)

Can the booming parcel market save the USO?

Modelling results: With traditional USO, normal increases in parcel volumes may be sufficient to compensate for declining letter mail volumes.

Reality check with annual reports: Many USPs still demonstrate increasing profits.
Conclusion: Profitability depends also on other factors (prices increases, cost cuts and network optimisation)

What other useful info in annual reports? Revenue development for letter vs. parcels/express segment?
Could one or two case studies shed some light on actual dynamics?

MDS 2016: Growth in the parcels and express segment did not outweigh letter revenue decline for two out of three USPs in Europe. Updated figures coming soon…

Future outlook: Increased demand for parcel delivery in rural areas could increase the margin for parcel delivery for USPs given a competitive advantage in these areas.

But what needs to be true? Uniform pricing might prevent margins from increasing. In fact, margins might be even lower due to high cost to serve in rural areas.

On the model…

Very little detail provided in the paper – an annex would have been helpful.

Model simulation results reported to depend critically on:
- ratio of parcel prices to letter prices
- assumption of constant prices

How do results change when these assumptions are varied?

It would also be interesting to better understand assumptions regarding
- Labour costs (normally a large cost driver)
- USO specification
- Operational model used (joint vs. separate delivery of letters and parcels)
- Product mix: To what extent are results robust for different letter/parcel ratios? Does the conclusion of similar parcel growth as letter decline hold for different starting points?

Compensation of net costs generated by SGEIs: Examples from different European network industries

Russo et al. (2022)

Compensation of SGEIs – lessons for the postal sector

The authors find that

- Similar application of the SGEI framework across different sectors at local and national level.
- Full financing of net cost and a small profit for investment purpose has been applied across sectors.

Three main conclusions are drawn

1	2	3
The SGEI framework helps to clarify the calculation of net cost compensation and should be the starting point also for sectorial regulation • *What type of sectoral regulation should be informed by this?* • *What is missing today?*	Net cost compensation should be full, taking into account also the investments needed to ensure sufficient quality of service and appropriate service levels • *Cost to maintain defined quality of service/service levels should be part of the net cost.* • *Is the problem the gap between net cost and actual compensation?*	State funding procedures should be simple, shorter, less burdensome and subject to possible different interpretations. • *Good for USPs, but entails a risk that USPs are over-compensated.* • *Important not to leave too much room for interpretation and to ensure sufficient scrutiny to maintain level playing field.*

A few more reflections…

Other aspects where lessons could be learned from SGEIs in other sectors:

- Public tendering of SGEIs (e.g. common in transport) – when does this make sense in the postal context, and when does it not?
- Incentive schemes for efficient service provision
- Consideration of costs of efficient service provision only

Scope for further research:

- Further elaboration on the additional aspects
- A more comprehensive overview of additional cases to verify conclusions

Incentives of Compensating USO net costs

Gottschalk et al. (2022)

How are incentives to grow and improve efficiency affected by net cost compensations?

Underlying economic rational: Financial compensation for the costs of providing a service might reduce the incentives to minimise costs since these are refunded by the State

Highly relevant to assess how different USO net cost compensation models affect incentives for efficiency improvements and growth

Two regulatory scenarios investigated (both assuming application of NAC/PC/CA):

- ex post compensation of actual net costs,
- ex ante compensation of anticipated net costs (before efficiency improvements)

The authors claim – in line with economic theory:
"efforts of USPs to increase efficiency might be deteriorated by lowering USO net costs, and similarly, growth in non-USO segments might lead to lower compensations"

Key question: How do efficiency improvements and growth on non-USO segments affect the amount of net cost compensation received?

A few reflections – and questions

Based on their modelling, the authors – inter alia – find that

1. Efficiency improvements mean lower net cost (i.e. less funding).
2. Ex post compensation <u>does not affect</u> efficiency/growth incentives
3. Ex ante compensation <u>increases</u> efficiency/growth incentives.
4. Compensating the USO net costs ensures, as foreseen in the postal directive Annex 1, "appropriate incentives" of efficient service provision.

What is meant by "appropriate incentives"?

- The postal directive requires "appropriate incentives" for efficient provision – <u>not indifference</u>
- *Do the findings imply then that ex ante compensation should be preferred to ex post regimes (which are standard in many countries)?*

An alternative interpretation of the requirement in the directive may challenges some of the conclusions

- A stricter interpretation of the PSD requirement on incentives for cost efficiency: USPs should not be compensated for inefficient service provision.
- If so, "inefficient costs" should never be part of net costs in the first place. Hence, implementation of efficiency improvements with the USO <u>should not reduce USO net costs</u> (and thus funding).
- If this is the case, ex post compensation **also** provides incentives for efficient service provision
- *Room for further research: How to assess whether the actual costs of the USP represent efficient service provision or not?*

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