

# **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?

Emanuele Frezza

May 27, 2022

# Overview

- **Postal Services Market Trends**
- **Funding the USO**
  - *Regulatory Framework & Challenges for USO Net Cost Calculation*
  - *USO Compensation Scrutiny & Increasing Funding for USPs*
- **How USPs Innovate**
  - *Coping with Volume Shift and USO Challenges*
  - *Strategic Investments & Integration of Letter and Parcel Services*
  - *Joint Use of Technologies & Physical Infrastructures*
- **Conclusions**
  - **What Implications for the USO Net Cost Compensation?**
- **Recommendations**

# Postal Services Market Trends

- Continuous decrease of letter mail volumes due to increasing digitization of communications in the last decade (decline accelerated by Covid-19 crisis).
- Constant growth of the parcel delivery segment driven by the rise of e-commerce (parcel volumes growth accelerated by Covid-19 crisis)
- Overall volume ratio of letters to parcels has declined from 13:1 in 2005 to 4:1 in 2015 and is now expected to reach 1:1 parity by 2025 (*source: McKinsey & C.*)
- Stream of B2C parcel revenues has now become more important to sustain the overall operational activity and costs of USPs

*Incentives for USPs to **leverage their joint mail-parcel operations** to benefit from e-commerce opportunities but also need to **innovate and increase operational efficiency** to be competitive in the parcel delivery market (provide customer-oriented delivery solutions)*

# Funding the USO:

## *Regulatory Framework & Challenges for USO Net Cost Calculation*

- Long-term financial sustainability of the USO still a key priority but now more difficult for USPs to ensure it
- State aid as viable option to compensate USPs for the USO net cost burden
- However, need to consider difficulties around the calculation of the USO net cost:
  - Many EU MS not following EU Commission's guidance (counterfactual scenario)
  - Divergences in USO net cost calculations among EU MS may depend on differences in counterfactual scenarios developed by USPs due to:
    - *different estimations of costs and revenues because of respective accounting data available;*
    - *different definitions of the scope of the universal service;*
    - *different calculation methodologies applied (mainly NAC or PC)*
  - Burden of calculating USO net cost as additional effort for USPs cause developing counterfactual scenario not possible based on accounting data alone
  - Burden for NRAs due to effort needed to verify plausibility of data provided by USPs

# Funding the USO:

## *USO Compensation Scrutiny & Increasing Funding for USPs*

- State aid control of USO compensation as key to ensure calculation of USO net cost by EU MS and USPs is reliable (avoid risk of overcompensation or cross-subsidization or both).

EXAMPLE:

*State aid SA.57991 (2021/C) – Denmark: USO compensation for Post Danmark 2020*

*State aid SA.55918 (2020/FC) – Denmark: Alleged State aid for Post Danmark for USO in 2020*

- EU Commission concluded that USO compensation complies with many provisions of the SGEI Framework (i.e. genuine SGEI; limited in time; transparent) but raised two points:
  - (i) doubts on cost accounting methodology used by Post Danmark and on separation of accounts between USO and other services (lack of regulatory supervision and external validation);
  - (ii) likely underestimation of unit costs in the counterfactual scenario that would lead to undue profits increase and turn into undue inflation of the net cost and risk of overcompensation
- USPs receiving government compensation for their USO net cost are also recipient of public funds for other activities (regional presence, territorial cohesion, etc.), and are about to receive additional public support through the EU Recovery Fund and the EU Green Deal

# How USPs Innovate

## *Coping with Volume Shift and USO Challenges*

- Increased demand for parcels as opportunity for USPs to increase their profits but general recent trend marks profitability decline for many USPs in Europe
- Change in users' demand forces to identify where state intervention is required while avoiding to alter competition in the market (key objective)
- Intense debate around appropriate level of state intervention in the postal services market
- Parcel segment of the postal services market still highly competitive and in general no sign of market failure
- USPs try to become more efficient delivery providers by deepening integration of letter and parcel services (e.g. exploit economies of scale and scope)

# How USPs Innovate

## *Key Investments and Integration of Letter and Parcel Services*

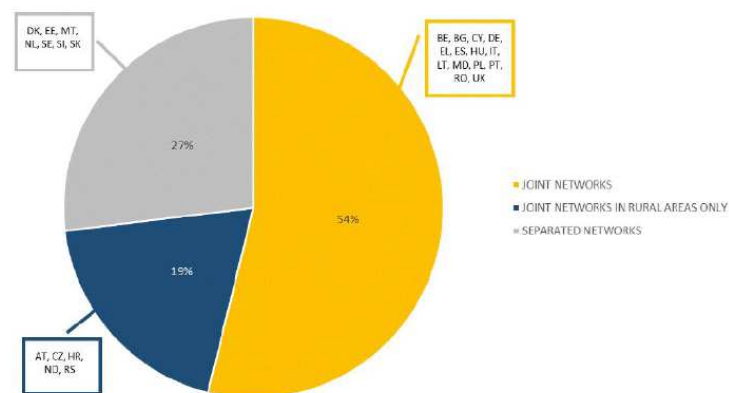
- How can USPs stay competitive in the evolving postal services market?
  - Parcel sorting facilities (automated conveyors, sortation system, scanning technology)
  - Last-mile delivery solutions (parcel lockers, proximity delivery points)
  - Digital shipping tools (track and trace, customers' notification)
  - Alternative fuel vehicles (electric/natural gas vehicles, e-bikes)
  - Energy efficiency for buildings (solar panels, power grids to charge electric vehicles)
- Investments are a response to the changed postal product mix of letters and parcels and may imply redesign of the postal logistics network
- One approach many USPs select is the integration of letters and parcels into one delivery stream to achieve efficiency gains

# How USPs Innovate

## *Joint Use of Technologies & Physical Infrastructures*

- In most European countries USPs are opting for a joint logistics network for the delivery of both letters and parcels
- Examples are the use of a unique sorting system for all postal items or the application of advanced IT and scanning systems to all postal items
- Benefits of a joint network can be:
  - operations and transport costs reduction
  - overhead costs minimization
  - avoiding duplication of other expenses
  - operational efficiency
  - operational flexibility

Graph 3: Use of a joint or separate network for the delivery of letter mail and parcels by USPs (%)



Source: ERGP Access regulation WG questionnaire 2019, based on the reply of 26 NRAs.



# Conclusions

## *What Implications for the USO Net Cost Compensation?*

- Calculation of the USO net cost burden becomes more complex when increasing funds are available to USPs and USPs' integration of letter and parcel services deepens:
  - Joint network and investment synergies can negatively impact cost allocation between USO and non-USO services by providing incentive for USPs to portray network and investment costs as fixed costs and allocate them to universal service provision
  - Allocation of less costs to more competitive products (parcels) may justify application of lower prices to them, while allocation of more costs to less competitive products (letters) may lead to consider USO as more expensive to provide and justify application of higher prices to USO products (*risk of competitive distortions due to predatory pricing and cross-subsidization*)
  - Excessive allocation of costs to letters may lead to overestimate profit in the counterfactual scenario and therefore inflate the USO net cost burden
  - Overestimation of USO net cost may lead USPs to advance requests for additional funding that do not reflect the true burden and this could result in competitive distortions (worrisome in a scenario where funds available to USPs increase and boundaries between USO and non-USO provision becomes more blurred)
  - Misallocation of costs may be incentivized when USPs are given significant operational and commercial flexibility by NRAs

# Recommendations

- NRAs play essential role in continuing to oversee how appropriate USO compensation can be preserved but not losing sight of their prerogative of promoting competition in the postal sector
- Carefully monitor correct cost allocation when government compensation is in play
- Maintain effective costs regulation at NRAs level to avoid risk of anticompetitive spillover effects
- Simplify existing methodologies for USO net cost calculation while ensuring that any methodology (and the consequential funding of the net cost) do not introduce competitive distortions
- Ensure that cost accounting transparency is guaranteed and that USPs closely cooperate with NRAs in providing full costs visibility (boost transparency)
- NRAs should conduct regular active reviews of USPs' implementation of cost allocation methodologies

Thank you for your attention

*Emanuele Frezza*  
EU Affairs Manager  
UPS Europe  
[efrezza@ups.com](mailto:efrezza@ups.com)