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Agenda

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The USO in a liberalised postal sector: what are the options?

The European Commission would like to see a fully open postal market across Europe by 2009. At the same time, it considers it appropriate that the universal service be maintained in full. A number of mechanisms for financing the universal service have been proposed, but are they all relevant to the postal sector?

The European Postal Directive requires Member States to ensure that users of postal services enjoy the right to a universal service, involving the permanent provision of a postal service of specified quality at all points in their territory at affordable prices.[1] The Directive requires the universal service provider (USP) to guarantee one delivery of mail each working day, and one collection of mail at least five days per week. In addition, universal service obligations (USO) are commonly complemented with requirements to provide services at geographically uniform prices, irrespective of whether the mail is to be delivered in a city or a remote rural area.[2]

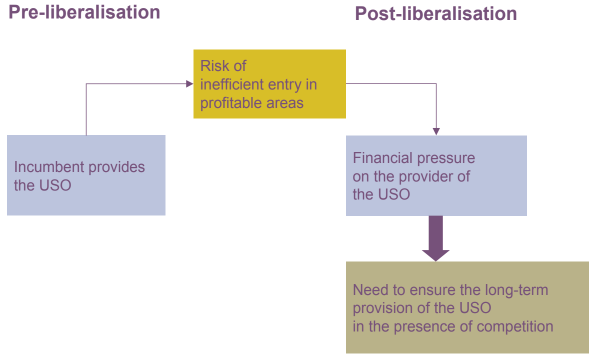
In the context of liberalising the postal market, the compatibility between competition and the provision of the universal service raises a number of regulatory policy issues. One of those key issues, which is generating significant debate, is how the provision of the universal service should be financed to ensure its sustainability.

While some stakeholders argue that the USO needs to be limited in order to be compatible with full market opening,[3] others are concerned that the current provision of the universal service might be put at risk.

To understand the consequences of a liberalised postal market, it is important to consider the implications for the USP. Traditionally, the USO in the European postal sector has been funded through a 'reserved area', which creates a legal monopoly in which the USP provides services to a number of routes. The reserved area currently applies to mail products weighing less than 50g. With the monopoly in place, the operator can set a geographically averaged price without the threat of competitive entry. Consequently, the reserved area—when properly designed—enables cross-subsidisation between low- and high-cost consumers, with the losses made on high-cost consumers offset by the profits made on low-cost consumers.

The issue of funding the USO under liberalisation is presented in Figure 1. Under full market opening, new postal operators that are not subject to the USO are most likely to enter the low-cost areas of the market (eg, larger cities) to compete with the incumbent's mail services. In such a context, inefficient entry may arise because companies that are less efficient than the incumbent would be able to exploit the price differential created by the affordability constraint.[4] This may lead to financial pressures for the USP, since it would be less able to offset its losses made on delivering mail to high-cost areas through its profits generated in low-cost areas. The European Commission has acknowledged that inefficient entry in profitable areas could have a negative impact on the USP.[5] It has therefore identified a number of flanking measures, which include, for

Figure 1 USO provision under full market liberalisation



Source: Oxera.

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example, increased pricing flexibility and a modification of the scope of the USO. In some markets, these flanking measures might reduce the burden of the USO such that further funding mechanisms would not be required; however, for many postal markets, such measures may still be insufficient to finance the costs of providing universal services.

In such cases, safeguarding the provision of these services would require regulators to implement a funding mechanism that ensures the financial viability of the USP. As explained below, such mechanisms may take the form of providing additional financial resources to the USP, or introducing a fair contribution scheme, which would require all market players to share the cost burden of the USOs.

Options for funding the USO

Were the scope of the USO to remain unchanged following market liberalisation, the fundamental objective of any funding mechanism would be to restore the financial viability of the USP such that it could continue to provide universal services at current levels. This could be broadly interpreted as saying that, after taking into account the net subsidy from the funding mechanism and any flanking measures, the USP's financial position post-liberalisation should ensure the full financing of the USO. There are, however, a number of alternative funding mechanisms, including the following.

– **Reserved area**—the traditional funding mechanism employed in the European postal sector. As discussed above, it creates a legally protected monopoly for particular services or products, which enables the USP to cross-subsidise between high- and low-cost areas. The cost burden of providing the USO is therefore indirectly funded with profits made on low-cost consumers.

– **Compensation fund**—the burden of the USO is funded through taxes imposed on operators in the market or directly on consumers.[6] Compensation funds can take several forms, depending on the definition of the taxable base. A tax rate can be applied to the revenues, profits, or the number of units sold by companies; alternatively, operators can be required to contribute a fixed amount towards the fund (ie, lump-sum taxes).[7]

– **State funding**—financing the USO through (direct or indirect) government transfers.

– **Pay-or-play**—under this mechanism, operators that deliver only in low-cost areas pay into some form of compensation fund. However, in contrast to a standard compensation fund, more than one company can decide to 'play' in the high-cost area. As a result of 'playing', the requirement on the company to 'pay' into the fund is then reduced. Two main versions of this funding mechanism can be envisaged. In a 'discrete' version, the choice of whether to pay or play is absolute. If entrants decide to play, they must play entirely (eg, deliver mail to every high-cost region in the country). In a more 'continuous' version of the model, the extent to which an entrant decides to 'play' determines the extent to which it is required to 'pay' into the fund.[8]

– **Access charge uplift**—this mechanism works by imposing a tax on the wholesale access charge that entrants would pay the incumbent for using its network to deliver mail.

– **Competitive tendering**—an alternative policy whereby the designation of the USP becomes part of the funding mechanism is competitive tendering or franchise bidding. The mechanism could be designed to reflect the 'reverse auction' model, which means that operators bid for a subsidy in order to fulfil the USO.[9]

What influences the choice of funding mechanism?

Figure 2 illustrates the conceptual framework used to assess the relevance of the different funding mechanisms to the postal sector. The choice of the most appropriate mechanism depends on a range of attributes or criteria, including whether the mechanism promotes efficiency, ensures fair competition, is proportional and transparent, and can be implemented in practice. While it is important to ensure that funding mechanisms are assessed against such criteria, it is also important to consider whether they are applicable to the particular market and country.

There are a number of characteristics in the postal sector that are not necessarily present in industries such as telecoms. For example, postal networks are more labour-intensive—as a result, it is less likely that technological innovations would help USO funding issues to any great extent. In addition, differences in the geographic and population characteristics of a country can influence the choice of funding mechanism. These differences across industries and countries suggest that it is crucial to test the potential effects of such variation on the applicability of a given funding mechanism to the postal sector.

As discussed above, each funding mechanism needs to be assessed against a set of criteria such as efficiency, fair competition, certainty or practicability when

Figure 2 Conceptual framework

Postal- and market-specific characteristics
- supply and demand characteristics of the postal sector
- scale of operation
- population and geographic characteristics

Criteria
- efficiency
- competitive neutrality
- social equity
- compatibility with state aid rules
- transparency
- practicability
- proportionality
- certainty

Funding mechanisms
- reserved area
- compensation fund
- state funding
- pay-or-play
- access charge uplift
- competitive tendering

Source: Oxera.

establishing whether it is the most appropriate. Funding mechanisms should, for example, minimise distortions to economic efficiency, and, where possible, improve it.[10] Furthermore, contributions that need to be raised to compensate for the net costs of providing universal services should avoid (or at least minimise) distortions to competition in the relevant market and ensure the provision of the USO in the long run. The mechanism should guarantee that the funding arrangements are sustainable over time, and it should be relatively straightforward to implement in practice.

Figure 3 There is no 'one-size-fits-all' mechanism

If regulatory authority is concerned with ...	then ...
Economic efficiency Competitive neutrality/ fair competition	• some types of compensation fund and pay-or-play mechanisms can address these concerns • reserved area (including final delivery) could be less likely
Practicability (eg, ease of implementation)	• reserved area, state funding or access charge uplift would score highly • competitive tendering and some types of compensation fund are less likely to score well against this criterion
Certainty	• reserved area could provide an answer to this concern • some types of compensation fund, access charge uplifts and competitive tendering might not result in sustainable solutions

Source: Oxera.

In selecting the most appropriate funding mechanisms, regulators in each Member State will face trade-offs between different objectives and criteria such as competitive neutrality, efficiency or practicability (see Figure 3). Mechanisms that score well against fair competition, for example, may not necessarily guarantee sustainable arrangements in the long term. The relevance of a given mechanism would require the different criteria to be weighted (eg, by taking the regulatory authorities' objectives into account). Some regulators whose main duty is the promotion of competition may place more weight on the performance of a mechanism against the criteria of efficiency and competitive neutrality, while a regulator whose main duty is to preserve the financial viability of the USP may place more weight on the proportionality and certainty criteria.

As an illustration, an assessment of the compensation fund provides further insights into how regulators would need to trade off these different criteria when implementing a funding mechanism. Some types of compensation fund could provide less competitive distortion to the market than other funding mechanisms, because they do not impose undue barriers to efficient entry per se. When taxes are designed to maintain a level playing field, the mechanism can achieve efficiency gains. However, defining the correct tax rate and tax base are challenging tasks.[11] Thus a compensation fund may score well against criteria such as efficiency and fair competition, but be relatively impractical to implement and might not guarantee the provision of universal services in the long run.

Conclusion

A range of funding mechanisms may be implemented to ensure the financial viability of the USP before further market liberalisation takes place. However, no single approach is ideal, and there is always a trade-off between the negative and positive features of each. The weight given to each of the assessment criteria is likely to vary across Member States, depending on the objectives and statutory duties of the regulatory authorities; furthermore, the fact that some funding mechanisms have worked well in other sectors does not necessarily mean that they would be equally applicable to the postal sector.

The absence of a one-size-fits-all solution means that significant challenges lie ahead for the postal industry in Europe as it prepares to embrace full liberalisation.

[1] Directive 97/67/EC OJ L15/14, January 21st 1998 amended by Directive 2002/39/EC OJ L176/1, July 7th 2002.
[2] In Sweden, for example, the USO applies to all letters and other addressed mail weighing up to 20kg. The USP is obligated to collect the mail at least five times per week.
Source: Post- och telestyrelsen (2005), http://www.pts.se/Archive/Documents/EN/Postmarknad_forandring_eng_sammanf_jan_05.pdf.
[3] Source: http://www.euractiv.com/en/innovation/member-states-prepare-mail-battle/article-158899, http://www.ft.com/cms/s/6a1078d4-5e20-11db-82d4-0000779e2340,dwp_uuid=70662e7c-3027-11da-ba9f-00000e2511c8.html.
[4] Bernard, S., Cohen, R., Robinson, M., Roy, B., Toledano, J., Waller, J. and Xenakis, S. (2002), *Delivery Cost Heterogeneity and Vulnerability to Entry*, Boston, MA: Kluwer Academic Publishers.
[5] European Commission (2006), 'Proposal for a Directive of the European Parliament and of the Council amending Directive 97/67/EC, concerning the full accomplishment of the internal market of Community postal services', October 18th.
[6] Taxes imposed on operators are usually passed through to consumers to varying extents. Final customers therefore contribute to the fund either directly or indirectly.
[7] For example, in the French telecoms sector, all fixed, mobile, Internet, cable and data transport service providers are required to pay a share of approximately 0.5% of their total telecoms revenue to a compensation fund. The USP, which provides ubiquitous access to standard telephony services, directory enquiry services, and public payphones, receives an annual lump-sum subsidy in return. Source: Autorité de Régulation des Télécommunications (2004), 'Annual Report'.
[8] A version of pay-or-play has been adopted in the Finnish postal sector. Under the scheme, the 'pay' element entails postal service providers without a USO being liable to pay a fee to the tax office. The fee applies to new entrants with a restricted licence that provide postal services in areas where the average population density is above a given threshold. The tax fee varies in relation to the population density in their concession areas. If the operator decides to play, it will not be obliged to pay a fee, and will be entitled to receive government funds. Thus far, the incumbent operator, Finland Post Corporation, has been the only USP providing services in remote areas. Sources: Finland Post Corporation (2005), 'Annual Report', and Finland Post Corporation (2006), 'Postal Service Act', presentation at the seminar on legal and regulatory postal issues, September 22nd.
[9] In Norway, the provision of air services covering the routes in more remote areas is tendered and then funded through the budget of the Ministry of Transport and Communications. The service was auctioned in three bidding rounds between 1998 and 2006. The tender favoured the incumbent, Wonderoe, which won most of the tendered routes. Source: OECD (2003), 'Regulatory Reform in Norway: Marketisation of Government Services—State-Owned Enterprises'.
[10] Three central aspects underpin the efficiency concept: allocative efficiency (the USP is able to charge prices that reflect the cost of delivering the service); productive efficiency (the services are delivered at the lowest possible cost); and dynamic efficiency (having incentives to innovate).
[11] The compensation fund in the US telecoms sector illustrates the risk of the taxable base being too narrowly defined to generate sufficient funds. See United States General Accounting Office (2002), 'Federal and State Universal Service Programs and Challenges to Funding', report to the Ranking Minority Member, Subcommittee on Telecommunications and the Internet, Committee on Energy and Commerce, House of Representatives; and Congressional Budget Office (2005), 'Financing Universal Telephone Service', a CBO paper, March.