Policy implications from USP sustainability reliance on growth in parcel market

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The views and findings expressed herein are those of the authors.

Introduction

- We look at recent volume trends in light of 2022 findings that parcel volume growth is helping USP’s sustain the USO

- We review our 2022 analysis of USP profitability for the case that parcel growth is slowing

- We then look at potential implications for postal regulation and wider sector policies

Our previous paper found that USPs revenues / profits from parcels can be vital for sustaining the USO

SCENARIO	MAIL VOLUME [MN]	LETTER [MN]	PARCEL [MN]	MARGIN
Base case	3,750	3,375	375	5.0%
A: 20% letter decrease and 30% parcel increase	3,187	2,700	487	5.8%
B: 20% letter decrease and 16% parcel increase	3,135	2,700	435	2.4%
C: 40% letter decrease and 16% parcel increase	2,460	2,025	435	-4.8%

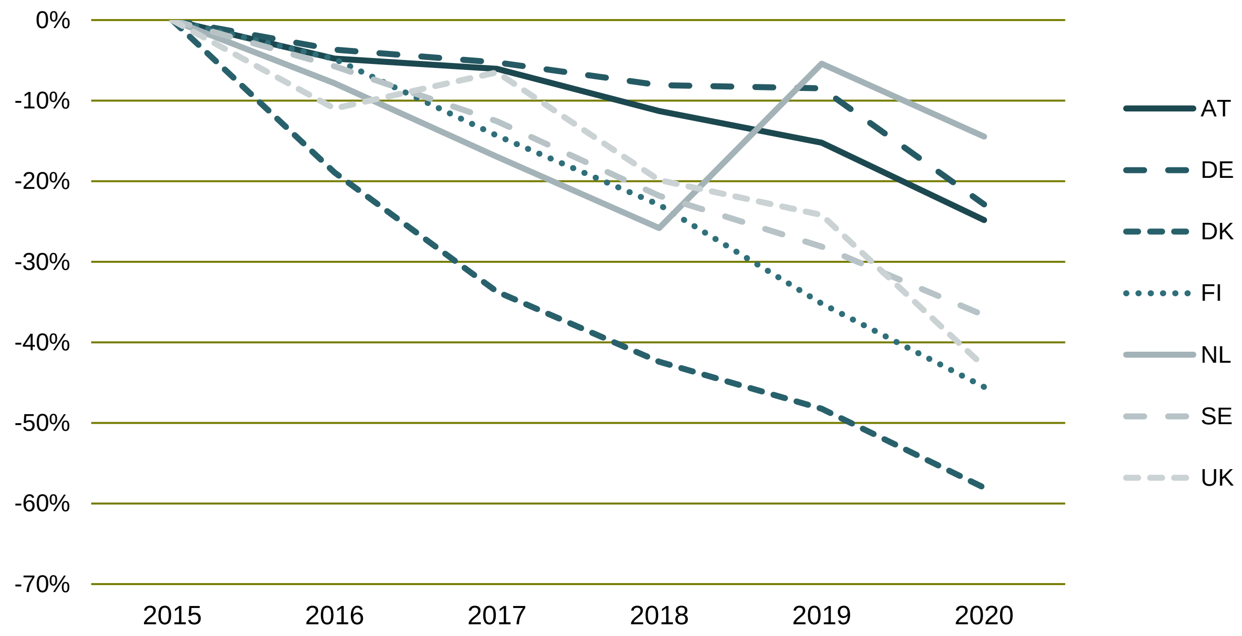
Modelling an average European USP

Calibrated to 5:1 Parcel:Letter price levels

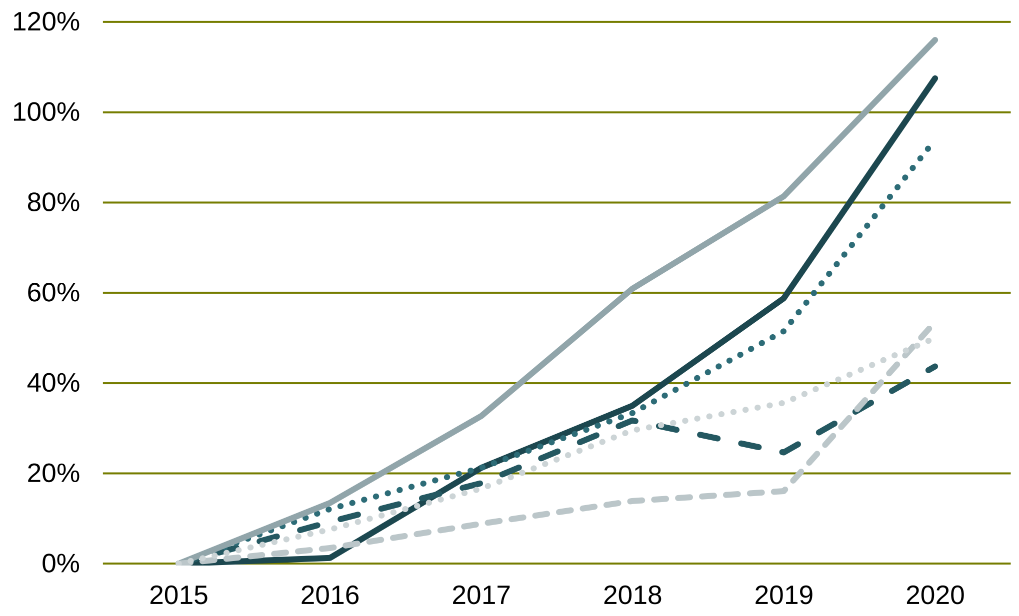
Generating a profit margin of 5% in the base case

Previously, volume trends seemed to suggest that the USO can be sustained by parcel growth despite loss in letter volumes

Letters



Parcels



Average annual decline ranged from approximately 4% to 12%	Average annual growth ranged from approximately 8% to 20%

Current USP volume trends (2022) seem less favourable on average albeit in wake of significant growth during COVID crisis

USP BY COUNTRY	PARCEL (2022)	PARCEL (2021)	ADDRESSED MAIL (2022)	ADDRESSED MAIL (2021)	MAIL (2022)	MAIL (2021)
Austria	-4%	9%	2%	-0.3%	-	-
Germany	-8%	13%	-	-	-1%	-0.3%
Denmark[1]	-6%	10%	-	-	-6%	-11%
Sweden[1]	-6%	10%	-	-	-14%	-8%
Finland[2]	-4%	11%	-4%	-8%	-	-
Netherlands	-10%	14%	-8%	0%	-	-
UK[3]	-21%	-13%	-9%	3%	-	-

[1] Post Nord is the USP for both Denmark and Sweden, and it did not split the change in parcel volumes between the two countries.
[2] Parcel figure for Finland includes parcels delivered in Finland and the Baltic countries.
[3] UK figure is for financial years ending in March.

USO sustainability depends on trends returning to long term averages and USPs being able to retain their market shares.

USP volumes underperforming as a result of deceleration in volume trends or loosing volumes to rivals could imply challenges in financing the USO

SCENARIO (ASSUMPTIONS BASED ON PREVIOUS TRENDS	MAIL VOLUME [MN]	LETTER [MN]	PARCEL [MN]	MARGIN
Base case	3,750	3,375	375	5.0%
A: 10% letter decrease	3,412	3,037	375	2.2%
B: 20% letter decrease	3,075	2,700	375	-0.7%
C: 40% letter decrease*	2,400	2,025	375	-7.0%

We look at three areas of sector regulation / policy that could be affected if parcel growth alone is not sufficient to sustain the USO

- USO costing / funding
- USP price regulation / approval
- Wider sector policies / interventions

*Can be considered the result of a multi-year continuation of a negative USP volume trends

The costs of the USO could be markedly different for a USP with significant parcel volumes

Considering a profitability costing approach → Estimating the cost of the USO from delivering 5 days a week → By assuming alternative delivery frequencies

NON-USO DELIVERY SCENARIO	4 DAYS	3 DAYS
Net USO Cost (relative to total costs)	7%	14%
Parcel demand response -5%	**4%**	12%
Parcel demand response -10%	1%	**9%**

- Assumed demand reduction based on service characteristic, not price.
- While a relatively high demand response is needed to counterbalance the change in costs, such reductions, given recent developments are not unprecedented and may be reasonable to expect unless delivery models change for the market as a whole.

- The drivers of the cost of the USO may also need to be more specifically related to other characteristics, e.g. QoS targets or related to the geographic dimensions of the delivery network (e.g. obligation to cover very remote areas)
- **A more extreme parcel demand response (as a result of changes in non-USO delivery characteristics) could imply no net USO costs, i.e. USO may not be binding.**

Regulators may also need to consider how price approval / regulation impacts USP's business

A reduction in letter volumes may justify a review of regulator's approach to price setting / tariff approval

- The presence of fixed and common costs means that service prices of a multiproduct firm can vary significantly depending on how prices are set to recover fixed and common costs
- USP tariff regulation or price approval often based on fully allocated costs, equi-proportionate mark-ups, etc.
  - Majority of regulators (e.g. UK, Bulgaria, Czechia, Croatia, Germany and Slovenia) use FAC as the cost standard, with most opting for an Activity-Based Costing top down model.
- **There could be a stronger case to consider an alternative approach taking account of price elasticities**
- We illustrate the differences in cost allocation principles below.

COST ALLOCATION PRINCIPLES	LETTERS	PARCELS
Fully allocated costs (allocation based on volume weight)	50%	50%
Allocation based on standalone costs	59%	41%

Wider sector policy may also need to be considered

For a number of USPs a key issue is differences in costs, especially labour costs

- For example, a review of costs in the UK shows significant differences in hourly costs.
- Other conditions, e.g. weekly work hours and other working conditions are likely to further contribute to cost differences

OCFOM REPORT TABLE	HOURLY RATE
Royal Mail	£12.95
Competitors (average)	£10.90

Source: Job portals, 2021, average of metropolitan and non-metropolitan rates

If USPs parcel growth were to slow, the ability of USP to compete with rivals could become more dependent on the labour contracts / arrangements in place, and hence more policy focus may be required in this area

Conclusions

- Current parcel volume trends, if persistent, may not be sufficient to offset revenue impact from letter volume decline and therefore may not be sufficient, on their own, to sustain the USO.

- The importance of parcel volumes for USPs means that:
  - parcel demand response (in light of more competitive markets compared to letters) can significantly affect the determination of the net cost of the USO;
  - regulators need to carefully consider the impact of price regulation on USPs ability to compete in parcel markets; and
  - policy makers need to ensure a level playing field for competition in parcel markets.