

The Net Avoided Cost (NAC) methodology applied to postal sector, a theoretical food for thought

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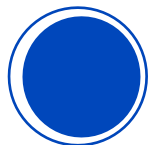
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AGENDA



Introduction



The Net Avoided Cost and Definitions



NAC in the European postal sector

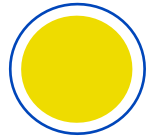


A more comprehensive approach



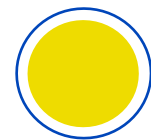
Conclusion and way forward

Introduction



In this paper we will address how **Net Avoided Cost (NAC) linked to Universal Service Obligations (USO) is applied in the postal sector**


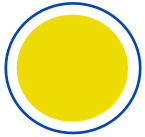
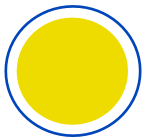
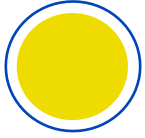
Postal sector is peculiar industry because compared to other Network industries (e.g. TELCO) is labor intensive industry versus the capital intensive nature of other industries



We will use a **theoretical approach** and present first the NAC applied to NIs with SGEI characteristics and after that, how it has been applied in the postal sector

We will conclude with a **“food for thought” proposal to address the NAC in the postal sector in the future, in view of the future regulatory architecture of the postal sector**

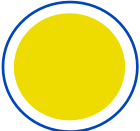
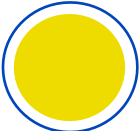
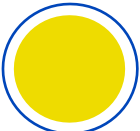
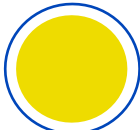
The Net Avoided Cost - NAC and Definitions

-  **NIs** are composed of complementary nodes. Services delivered require the use of two or more components. They tend to exhibit increasing returns to scale (network effects)
-  **Services of general Interest (SGIs)** are services that public authorities classify as subject to specific public service obligations. A subcategory of SGIs are **SGEIs**. They are carried out in return for payment and are subject to European competition rules
-  **Universal service obligations (USO)** refer to those obligations placed upon a service provider which concern the provision of a network and services throughout an area
-  EC states that the net cost of the US obligation is to be calculated as the difference between the **net cost for a designated undertaking operating with USO and operating without USO** (intangible benefits and reasonable profit)

The Net Avoided Cost - NAC - Three methods of calculation

- The **Deficit Approach (DA)** is calculated as the sum of the losses of the loss making services considered minus the profits of the profit making products included. It uses data present in the accounting system and no need of other calculation. The DA does not comply with the net cost definition as there is no reference scenario
- The **profitability cost approach (PC)** compares the profit of a USP with and without USO. The difference between the results of the two scenarios constitutes the net cost. Intangible benefits and a reasonable rate of return are also valued
- The **net avoided cost (NAC)** applied extensively in the TLC sector, foresees the construction of a reference scenario where the USP operates without USO. First identify the loss making services than to calculate the actual loss without the USO. The sum of the actual losses is the result of the calculation. In the scenario without USO unprofitable services would not be provided. Same as PC on Intangibles and rate of return

The Net Avoided Cost - NAC - Three methods of calculation - differences

-  The **PC and the NAC has the counterfactual scenario** (without USO). In the NAC the provision of unprofitable services is ceased and in the **PC it is even more flexible as the reference scenario provides also the possibility of changing the whole operations without USO**, maximizing profit.
-  The PC approach provides the most complex counterfactual scenario and as a consequence requires more data
-  The **NAC and the PC measure the difference in profits between the USP with or without USO** while the DA approach measures the result of the current provision of USO without a counterfactual scenario. Intangible benefits and reasonable rate of profits are valued
-  The DA method requires fully allocated costs while the NAC and the PC method are both **based on avoided costs**



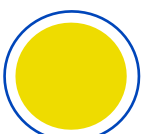
The NAC in the European postal sector

- The Communication (EC 2012/C 8/02) states the rules to avoid overcompensation not to threaten the competition. When a provider is entrusted of a SGEI it may need public financial support in case the revenues from the SGEI do not cover all the costs
- The Communication states that the **compensation “must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit”** . The net cost should be calculated using the **NAC methodology which “is calculated as the difference between the net cost for the provider of operating with the public service obligation or profit for the same provider of operating without that obligation”**
- The Communication refers to Annex I of the Postal Directive as a guidance for net cost calculation in the postal sector. Annex I:
 - *“the net cost of universal service obligations is any cost related to and necessary for the operation of the universal service provision”*
 - **net cost has to be calculated as the “difference between the net cost for a designated universal service provider of operating with the universal service obligations and the same postal service provider operating without the universal service obligations”**

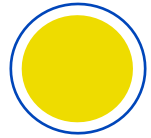
A more comprehensive approach (1/5)

- Concerning the postal sector in the past few decades it has faced dramatic changes due to digitalization which has impacted negatively on volumes and on USO financing
- The **Annex I and The Communication (2012/C 8/02) do not provide detailed rules** but just general principles so that their implementation shows different solutions
- The issue is which costs and revenues must be considered in the calculation (*“the net cost of universal service obligations is any cost related to and necessary for the operation of the universal service provision”*) Annex 1. Two possibilities:
 - 1. consider only costs and revenues strictly linked to the universal services**
 - 2. consider all the costs & revenues coming from the postal network subject to USO**

A more comprehensive approach (2/5)

-  USP needs to be compensated for **“the net cost of discharging the public service obligations”** Communication (2012/C 8/02) clearly **all the obligations not a part of them**
-  USP should be compensated for loss of profitability linked to the entitlement of USP. The obligations impact the whole postal network not the single services
-  In postal companies there is just one postal network which carries the burden on which single services are provided. Hence, **not considering as US burden the net cost linked to the whole postal network mislead the calculation**

A more comprehensive approach (3/5)

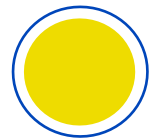


From our **theoretical analysis the cost method which best fits the net cost calculation in the postal sector seems to be the NAC adapted to the postal sector which would be also very similar to the (PC) method**

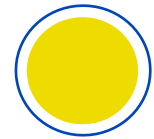
- USPs have diversified their business, due to huge drop of mail volumes, the chance of changing the whole operations may not fit anymore as some parts of the postal infrastructure are nowadays the main infrastructure of the other business
- On the other hand, the costs of these parts of infrastructure are to be considered in the net calculation as the infrastructure originates and is shaped by the postal burden

A more comprehensive approach (4/5)

PC method - Evidence from studies





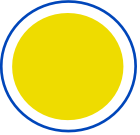
Copenhagen Economics (2018), states that this **“method estimates the total commercial effect of discontinuing a given USO element in form of both cost and revenue effects”** and implies that all services linked to the postal network which is affected by USO should be considered in the calculation



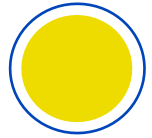
Frontier Economics (2013), principles used to calculate the net costs of USO, observes that **PC “is focused on both the operational and product implications of having to meet the universal service obligations (rather than providing the USO products or business per se). It also considers the USP as a whole (i.e. the net costs of the USO can be calculated as the difference in profits from operating with and without the USO)”**

A more comprehensive approach (5/5)

Evidence from NRAs

-  **Ofcom** (2012), on the new regulatory framework, securing financial sustainable universal service, **states that the purpose of sustainable universal service is in line with a net cost calculation that considers all costs and revenues which are linked to the US network**
-  Belgian NRA, "Communication du conseil de l'ibpt du 21 mai 2014 concernant la vérification du calcul du coût net du service universel postal en belgique" **states that the net cost calculation should value all processes linked to the universal service network**
-  **Anacom** (2014), Portuguese NRA, in the Decision on the methodology for calculating the net cost of the universal postal service (CLSU) **observes that all services, not only universal services, should be considered in the net cost calculation**

Conclusion and way forward (1/2)



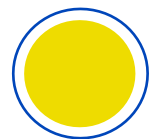
The different evolution of the strategy of postal operators signals that **in each member state the concept of postal network differs**

Differences depend from the two intertwined main strategic decision of USPs:

1- diversification away from the traditional postal services (letter and parcel)

2- the ubiquity and the range of control of the Post Office network

Conclusion and way forward (2/2)



These strategic decisions impact on the calculation of the net cost

The issue is which method should be applied to do the calculations, we think that:

- **Annex 1** of the directive **should evolve to incorporate the evolution in the past decades on SGEIs**
- In this evolution the **new Net Cost to be applied to the postal sector (NCP) should go beyond the NAC** used in the TELCOs
- The postal network is a seamless network labor intensive and the NAC used in TELCOs is not flexible enough to re-modulate the network (e.g. delivery days). The **NCP should evolve from the NAC methodology and merge with PC**

THE DEBATE IS OPEN

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