# RECENT DEVELOPMENTS IN THE POSTAL SECTOR IN EUROPE

## 1. The new scenario

Dramatic changes have occurred in the postal sector over the last three years. The implementation of the 97/67 Directive of the European Commission on postal sector reduced the monopoly threshold to 350 grams or 5 times the basic stamp price in all Member States. Moreover, a new Directive is expected by the first quarter of 2000, probably lowering the threshold to 50 grams and 2.5 times the basic rate. All European Public Postal Operators (PPOs) are aware that a full liberalization policy could be decided by the European Parliament within 5 - 7 years.

This liberalization perspective put enormous pressure on both private and public operators. It gave the former a strong incentive to increase efficiency and prepare to enter the profitable part of the ordinary postal market (business to business and business to consumers segments), and the latter, real pressure to remain financially viable while continuing to supply universal service.

Acquisition fever is an indicator of these changes. Apart from TNT and DHL, now owned or controlled by Dutch and Deutsche Posts respectively, today's acquisitions mainly relate to small to medium national-based private firms, operating in freight/parcel/express courier and logistic services. In the future, however, the acquisition strategy is expected to involve Public Postal Operators (PPO) not only as predators but also as prey. Some observers believe that in the next 3 years the European Market will be run by no more than 3 or 4 operators, either vertically integrated into a single company or allied in-groups.

In Europe, almost all PPOs were transformed into a corporate company. Corporatization implies:

1) A clear distinction between productive and regulatory tasks, the latter performed by an independent public body (Authority, Ministry, a Commission), but the former not performed exclusively anymore by the national PPO. The PPO is not allowed, unlike in the United States, to check and fine private firms that breach antitrust laws. If mail is still reserved, monopoly enforcement becomes a critical point. The European

experience shows that if it is poorly performed, serious risks of de facto liberalization of some postal markets are very likely to arise.

2) A reduction of hidden subsidies; hereto, granted to particular constituencies (newspaper and magazine publishing firms, nonprofit organizations).
3) A clear cost accounting system of the PPO, usually adopting ABC (activity based costing) methods.
4) Implementing careful revisions to costs and benefits of Universal Service Obligations. In some Member States, the PPO is allowed to franchise unprofitable post offices (90 percent of which are already supplied under the franchising regime in the UK, the Netherlands and, beginning next year, Sweden).
5) New incentive schemes for labor can be introduced.
6) The crucial strategy of variabilizing costs as much as possible is made easier.

The large PPOs are preparing themselves for this liberalized scenario and for the information technology challenge (e-mail, telefax, mobile phone and cross-related telecommunication services) with a transformation into global players. This strategy requires each postal organization to strengthen its logistic/delivery network, both at home and abroad. The small or unprofitable PPOs limit this strategy to their national market. In both cases the ultimate goal is to significantly increase the traffic of goods and services passing through the postal network, in order to maintain its financial viability.

There are at least two main consequences of this unexpected scenario. The first consequence is that the boundaries between postal and closely related markets (logistics, freight and express courier, e-commerce), and between genuine private and public operators in Europe, tend to fade away. The second consequence is that markets tend to be distinct according to both specific postal products (e.g., letter traffic as respect to direct mail) and geographic areas. This implies that a postal uniform pricing policy, as far as competition grows only in selective markets, tends to become incompatible with the break-even target of the PPOs.

## 2. Some lessons from postal competition national experiences

In Sweden, Finland, Italy, Spain and Germany, PPOs are facing competition not only with private couriers, but also with new entrant firms. Some of them are owned by other PPOs (Royal Mail owns 25 percent of City Mail in Sweden, TPG-TNT owns 100 percent of Rinaldi, an urban delivery firm in Milan). For a single PPO to expand or at least to hold its national market position is already a daily challenge.

Sweden and Finland are the only Member States that opted, since 1994, for a fully liberalized market. Sweden Post competes with many small, locally based postal firms on bulk mail, but still holds a strong dominant position in the national market. Observed results of competition in this country are: the end of geographically uniform price; and both a reduction of price for bulk mail, and an increase for single piece-mail, because only the PPO is able to serve and to break-even in such a market.

In Finland, however, no significant new entries are observed, because the national law requires the new firms operating in the universal service postal market to pay a tax which is proportional to the population density of the geographic area to be served.

In both Spain and Italy, the Post Office runs a huge, but gradually reducing deficit. The two main reasons for this are both a very low per capita mail volume collected and delivered in low income regions (as the Mezzogiorno in Italy, accounting roughly for a third of the national population). And competition in urban delivery markets facing local licensees were in the past allowed by national legislation to fully adopt a cream skimming strategy. In Italy, local licenses in the reserved areas were abolished in 1999. They were considered incompatible with the 97/67 EC Directive principle of proportionality ("the reserved area in postal services, if needed, should be set equal and not greater to the extra cost for fulfilling the universal service obligations"). On the contrary, in the new Spanish law implementing the EC Directive, such local licensed firms were allowed to operate and a de facto liberalization in urban markets arose.

In Germany, more than 100 small private competitors are active in many local markets. Common features of private firms competing with the national PPOs are:

- small dimension, mainly locally based;
- in delivery, only high density urban areas are served;
- low capital intensity technology;
- intensive use of part time, cheap, labor;
- cream skimming behavior, e.g. to take both profitable customers and delivery routes, leaving the unprofitable ones to the PPOs.

## 3. The cost of Universal Service Obligations

Today, few European PPOs are ready for full liberalization. PPOs in favor of liberalization are those which started their reorganization in the early '90s, often through a corporatization. This allowed a more commercial strategy and a substantial use of contracting out schemes for unprofitable post offices. Crucial to the profitability of a PPO, among other factors, is the ratio between revenues, almost generated from reserved postal services, and operating costs. The latter varying greatly according to the cost of the universal service obligation (USO).

The following Table shows the two main variables affecting USOs. The higher the per capita mail volumes delivered by the network, and the more evenly spread population (few population density differences) across the country, the lower the USO costs. The density of population within each country is also important for measuring the potential for cream skimming. In the case of competition in a country with large differences in population density (often reflecting income; and therefore, demand differences), new entrants can easily select densely populated areas, leaving the others to the incumbent. On the contrary, in the case of an evenly spread population, entry will be more difficult because of fewer cream skimming opportunities (a "take all or leave all" strategy).

**TABLE 1**

| | **Evenly spread population** | **Concentrated population** |
|---|---|---|
| **High per capita Mail volume** | low USO costs<br>A | Intermediate USO costs<br>C |
| **Low per capita Mail volume** | Intermediate USO costs<br>B | high USO costs<br>D |

Following Table 1, we can distinguish among four types of countries:

1) *type A* countries, with evenly spread populations (e.g. few differences in population density areas) and high per capita volumes, exhibit small differences in postal delivery costs. Therefore, other things being equal, USO costs will be constantly low (main examples: the Netherlands, some German Lands and part of Sweden). PPOs belonging to type A countries, owing to the lack of cream skimming opportunities for competitors, will be in favor of liberalization everywhere because it means larger market opportunities for them.

2) *type B* countries, with evenly spread population but low per capita volumes, exhibit few differences in postal delivery costs; and therefore, low USO costs at present. However, PPOs belonging to this type are sensitive to a cream skimming strategy, since even a small market share taken by competitors will threaten their financial performance. Therefore, they are expected to be in favor of maintaining a small but stable reserved area.

3) Similar, but reversed, conditions apply to *type C* countries (concentrated population and high per capita volumes) that exhibit large differences in postal delivery costs that are diluted by high volumes. USO cost levels will be intermediate (France, the UK, part of Germany) but, there are opportunities for cream skimming in the high density/high volume areas. Generally speaking, these countries are expected to be in favor of a small reserved area, which is necessary in order to provide a sufficient level of cross subsidy between profitable and loss-making routes.

4) *type D* countries, with concentrated population and low per capita volumes, are in the worst condition. PPOs of this type exhibiting high USO costs (Austria, Italy, Portugal, Spain, Greece, and perhaps Ireland) are extremely vulnerable to cream skimming strategies. For them, the definition of a reserved area is crucial for their future financial sustainability. There is a risk that many areas of such countries – especially regions with low per capita income; and therefore, lowest per capita mail – will not be served anymore.

For all these reasons, the measure of the true USO cost for each national PPO is now an important political issue in Europe, which can delay or speed up full liberalization. There are several methodologies to implement this task, each one reflecting a slightly different approach:

1. Fully allocated cost: USO costs are equal to the sum of the losses faced by the PPO in unprofitable routes.
2. Net avoidable costs: USO costs are equal to the sum of the variable costs faced by the PPO in unprofitable routes, less the commercial benefits due to the availability of the postal network.
3. Entry pricing approach: USO costs are equal to the sum of the losses for the PPO on each of the routes where entry occurs, less the impact on the PPO's costs.

While the general goal of USO cost estimates is to allow the provider to finance the public component of the postal service, which no entrepreneur would perform unless fully compensated for it, the three methods differ with respect to the point of view from which they are analyzed. Method 1 provides the basic data framework needed to implement the calculation. Method 2 is appropriate for measuring the *actual* USO costs of PPOs, but not for evaluating its financial impact in a liberalized environment. Method 3 seems the most preferable from a policy standpoint.

A common argument of those who deny the relevance of USOs in the supply of postal services is that differences in their costs only reflect hidden overstaffing. If this is true, one should observe a positive correlation between USO costs and some indicator of postal staffing. Data presented in Table 2 shows that this argument is negligible, because the number of employees of PPOs has to be matched with the number of dropping points to be served. Italy scores the best performance of this variable.

**TABLE 2**

**POSTAL USO PERFORMANCES IN SELECTED EUROPEAN COUNTRIES**

**- fiscal year 1998 -**

| | ITALY | FRANCE | UNITED KINGDOM | GERMANY | THE NETHERLANDS |
|---|---|---|---|---|---|
| Square km per employee | 1.7 | 2.4 | 1.2 | 1.3 | 0.5 |
| Dropping points per employee | 183 | 125 | 129 | 165 | 91 |
| Inhabitants per employee | 318 | 260 | 297 | 306 | 199 |
| Population density | 190 | 106 | 240 | 229 | 379 |

source: NERA (1998), Annual Reports of Postal Operators (1998)

There is a strong belief, far from being solved both practically and theoretically, that competition and universal service obligations (USO) are incompatible with each other. Despite a specific European Commission Notice in 1998, stating the extent to which competition law should be applied to the postal sector, problems were found in the following cases.

i) Liberalization often implies to differentiate ordinary postal prices in selected areas. Such differentiation is hard to prove to be strictly related to cost differentials; i.e. Swedish Antitrust case, where Sweden Post charged different prices in different cities.

ii) If postal delivery is not strictly reserved to the PPO, as in the United States, but other competitors are allowed to operate in the market, should the postal network be defined as an essential facility? An example would be an Italian Antitrust POSTEL case, where Poste Italiane was charged for abuse of dominant position by supplying its Hybrid Mail Service.

iii) As in the telecommunication sector, is the cream skimming strategy of a PPO's competitor to be considered irrelevant? (Refer again to POSTEL case)

## 4. Comparing postal liberalization paths in Europe and the United States

The liberalization paths of the postal sectors in Europe and the United States have crucial differences.

The American model implies:

1) full liberalization of postal markets upstream to delivery;
2) monopoly strictly enforced only in delivery;
3) access pricing system;
4) gradual reduction of remaining monopoly limited only in the long run;
5) strong pressure for creating efficient upstream markets.

The European model implies instead:

1) Harmonization of the criteria of Member States legislation in the monopoly definition (97/67 EC Directive);
2) Gradual reduction of the weight/price threshold, and also possible selective liberalization of direct or cross-border mail - both inbound and outbound. While the majority of European PPOs are in favor of the former, some proposals, both from the private sector and the PPOs ready for full competition, support the latter.
3) In the transitory regime, monopoly limits should be set equal to, and not greater than, the cost of the universal service;
4) Competition rules would apply to the postal sector. PPO monopolies are supposed to be in a dominant position in their home market with clearance, sorting, transport and delivery to be considered as distinct relevant markets;
5) A compensation fund as a possible solution for making USO compatible with competition.

Main problems in implementing the European Model

- Harmonization of national laws implies, in some cases, a redefinition of the national monopoly boundaries: the full adoption of weight/price threshold could imply either an increase or a reduction of the previous monopoly limit;

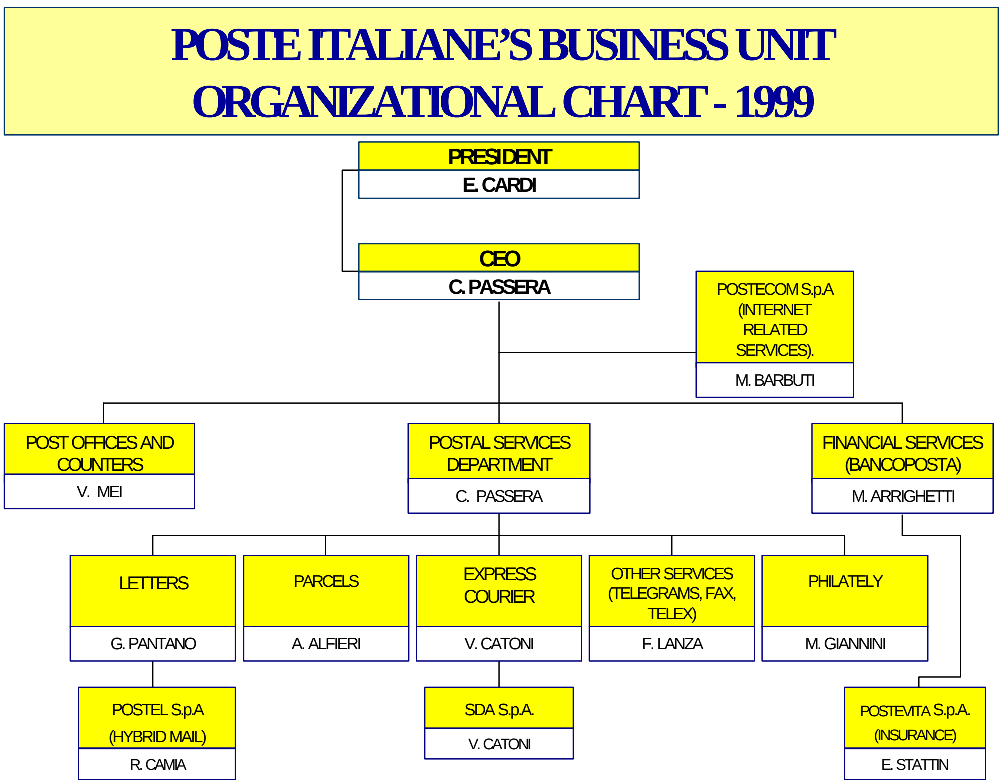
- Despite the legal definition of distinct relevant markets, there are no incentives to increase efficiency in the upstream activities;
- Access pricing policy becomes very difficult to implement because it entails different criteria if delivery is reserved or not;
- USO costs, mail per capita volumes, real monopoly limits, operating results and net profits vary greatly between national PPOs; therefore, the rule stating that monopoly limits should be set equal to, and not greater than the cost of the universal service is not enforced, leaving room for illegal cross-subsidies;
- Because relevant markets are mainly defined on a geographical (national) basis, PPOs looking for business opportunities in other Member State's markets are de facto free to use monopoly profits enjoyed at home to shop around Europe;
- The compensation fund is practically intractable. It implies a very high transaction cost for implementation. Data on revenues and volumes of mail subject to USOs of all the operators of the market can be strategically manipulated. The fund is also too sensitive in its width: useless if USO costs are low, inevitable market biasing if USO costs are high.

## 5. Poste Italiane's recent reform

For PPOs suffering from historical inefficiencies, as Poste Italiane, corporatization is a useful tool for speeding up change. A new CEO, Mr. Passera, who formerly held the same position at Olivetti, runs the new share-limited corporation. He decided to put new blood into the organization with new management, most of which he recruited from private sector businesses. Because of the huge operating deficit (roughly equal to 1.3 billion dollars in fiscal year 1998), a Business Plan 1999-2002 was promptly set up with the following aims:

- to increase the quality of the services, hereto one of the lowest in Europe;
- to break-even by 2002, with both a significant increase of revenues and cost reduction;
- to make Poste Italiane eligible for privatization at that date.

The first successful action of Poste Italiane was the dramatic increase of the quality in postal services. Thanks to the introduction of the new First Class Mail service in October 1999, 85 percent of the letters were delivered in D+1. Also, second class mail scored 83 percent of letters delivered in D+3. The reaching of such levels, allowed Poste Italiane to enter, by January 1, 2000, the REIMS agreement established between European countries for terminal dues compensation (terminal dues are defined as receiving a fixed share of stamp prices only if certain quality standards are met).




An effective cost accounting framework was introduced, with an internal transfer price system between Business Units, in order to carefully monitor, and correctly assign to them, both cost reduction and productivity improvements. This procedure is particularly helpful and effective by showing in a technically neutral way were the residual inefficiencies arise for all PPOs, such as Poste Italiane, which produce many different products and services exchanged between Business Units.

The figure above shows the new organizational chart of the Business Units of Poste Italiane, each of which are potentially eligible for future privatization. At the moment, most of them are unprofitable or just entering into new businesses, but in the future each is expected to become a significant revenue source.

A second action was to quickly set up an effective electronic network between all 14,000 post offices around the country. Computer Associates Inc., well known in the postal world as a software supplier to the U. S. Postal Service, accepted the challenge of becoming a minority partner in the consortium, Pegasus, 51 percent of which is owned by Poste Italiane. They share the costs and benefits of the ambitious goal of building a network of both postal and non-postal (e-commerce and other communication services) businesses.

In the first year, the number of employees of Poste Italiane was reduced by 4.7 percent between June 1998 and June 1999, averaging in November 175,000 units (on a full time equivalent basis). The labor costs to revenues ratio was reduced from 87 percent to 82 percent. The target of the Business Plan is to reach 70 percent by 2002 thanks to both further cost reductions and significant increases in revenue. Most of these revenues will come from the development of the following new businesses: 1.) Hybrid Mail, run by Postel SpA, 2.) Express courier (Poste Italiane today holds only 14 percent of national market share (Postacelere + SDA), but is expected to increase this figure), 3.) E-commerce run by Postecom SpA, a subsidiary created for Internet related services, and 4.) Financial services, through a complete integration with the banking system, whose products will be sold in all main post offices.