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"Structural Separation and Access Pricing in Postal Services, with applications to the UK"

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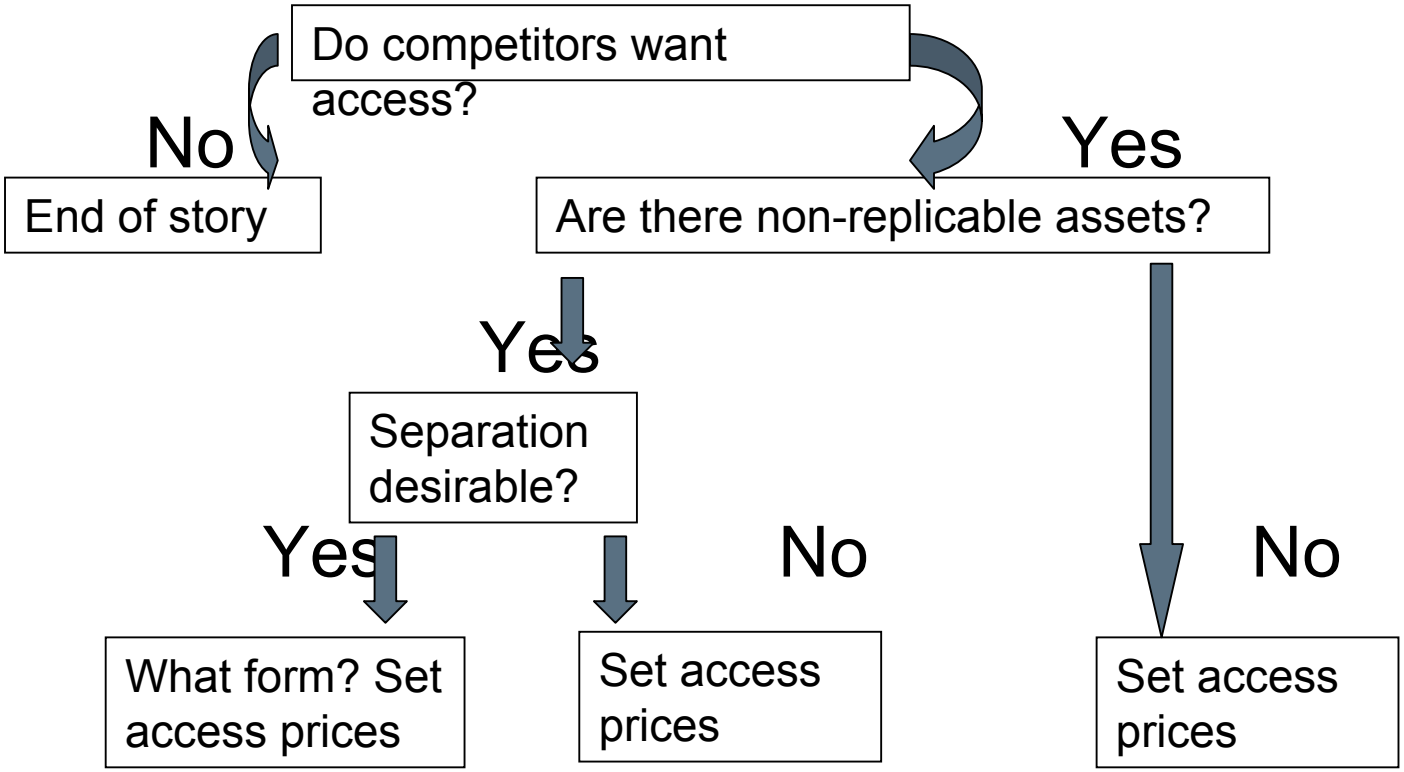
Part 1: General Discussion

Agenda



Mandating Access

Cost breakdown:

	%
Collection	5
Outward sorting	12
Transport	14
Inward sorting	14
Delivery	43
Support	12
	100%

Probably largest economies of scale

Tests for mandating access to delivery network

- Competition law/essential facilities
  - Costs not sunk
  - Bronner test not passed?
- Regulatory approach
  - Current structure distorted by historic and current reservations
  - Impact of USO on delivery costs
  - Promotion of competition via (possibly time-limited) access to encourage infrastructure build-out

➡ <u>Assume access is mandated</u>

Vertical separation and integration

Simple results – no regulation

- Static
  - Both stages competitive –no reason to intervene
  - Both stages monopolies – separation leads to double marginalisation
  - One stage persistent monopoly, the other competitive – structure chosen to minimise costs
- Dynamic
  - Monopolist may seek to gain market power in ‘competitive’ activity to protect monopoly.

Monopoly stage regulated

- Profits shifted to unregulated activity
- Possible motive for
  - A price squeeze
  - Quality discrimination/sabotage
- Greater incentive for sabotage
  - The lower regulation keeps monopoly profits
  - The lower is product differentiation
  - The more efficient is the integrated firm's 'competitive' activity

Adjustment needed for retail price control

How detectable is sabotage?

<u>Possible benefits of separation</u>

Benefits of vertical integration

- Better co-ordination
- Overcomes hold-up problems
- Internalises externalities
- Risk sharing

Addressing the benefits of integration in posts, between delivery and upstream activities.

Where is optimal point of separation? Will it move?

How complex are the contracts?

Co-ordinating operational activities

Co-ordinating investment activities

<u>Needs preliminary quantification</u>

Other forms of separation

- Accounting
  - Non-discrimination condition
  - Exposes origins of profits
  - Helps to expose margin squeeze
  - ➡ Does it work?

Legal

separate legal entities, separate arrangements, separate incentives

➡ How real are ‘separated’ incentives?

Access Pricing

- How should access prices be set?
- Main candidates:
  - Incremental cost (plus mark up)
  - Retail minus/ECPR (possibly modified)
  - Ramsey prices

(Note retail minus affected by separated structure)

An example

Service	**Incremental cost**		**Price**
Collection and inward sorting	6		
Trunking	7		
Outward sorting and delivery	15		
Retail	2		
Total incremental cost	30		30
Common costs		6	
-			
Contribution	-		10
Total cost/price	**36**		**40**

Incremental cost (plus mark up) = 18
Retail minus (unmodified) = 25

Access Pricing Objectives

	IC	R-	Ramsey
Promotion of competition	✓	X	
Efficient retail prices		X	✓
Cross-subsidised retail prices		X	✓
Cost-minimisation		✓	
Avoidance of inefficient bypas	s	✓	X

table reflects difficulty in using one instrument to achieve multiple objectives

What are the retail pricing objectives in postal services?

- Product to product cross-subsidies – probably not
- Universal service/postalised prices- yes
- How costly are these?
  - On net avoided cost basis (before benefit) 1-5% of relevant revenues
- Can the pricing objective be achieved, consistently with efficient input prices?
  - Via output tax/universal service fund

Tentative conclusions

- Mandate Access?
  - Justified in short/medium term
- Separation?
  - Investigate further
  - Accounting separation of delivery simple fast step
- Access pricing?
  - Incremental cost with USO fund dominates alternative pricing rules

Part 2: UK Postal Environment

Independent regulator since 2000- Postal Services Commission – Postcomm

Market opening

- 30% of market (customers with 4000 identical items) opened up on 1 January 2003
- Second stage 1 April 2005 (further 30%)
- Process to be complete by 1 April 2007
- UK goes further than required by EU

Postal Directive (liberalisation based on weight)

- By 2007, markets to be liberalised in Finland, Germany, Netherlands, Norway, Sweden and UK.

Performance of Royal Mail

Financial crisis in 2002

Recovery under new management

Serious attack on cost base

Failure to meet quality targets (all 15 of them in 2003/4)

Markets and market shares

Growth of 2-3% p.a. over 10 years

£6 billion turnover in regulated market

Customers generally unaware of liberalisation process

Royal Mail's market share still >99%

Regulation

Price control via price cap from 2003-2006

(RPI + 3 in first year, then RPI-1)

Maintaining Universal Service first duty of regulator

RM Licence contains provisions for access pricing

RM seeking to move to size based pricing (from weight based pricing)

RM (unlike competitors) exempt from VAT.

Separation

Little discussion in UK

No evidence of any trend towards anti-competitiveconduct in provision of access to delivery network

Obvious difficulties in choosing where to separate – e.g. same equipment used for inward and outward sorting.

Can expect greater use of accounting separation/ ring fencing

Access Pricing

Dispute between RM and PostComm over pricing principle (R- vs. IC)

Agreement reached between RM and 3 postal operators at rate close to IC for ‘nationwide’ portfolio of delivery

PostComm can introduce a price control on access

Debate about whether access prices should be geographically de-averaged.

Overview

Painfully slow development of competition.

Rigorous retail price control can injure competitors – need to cater for their needs.

Access in its infancy – needs more transparency.

Desirable to have Universal Service Fund in place.