



International **Post**
Corporation

How to regulate the postal industry an economic approach

A study prepared by

International **Post**
Corporation

in cooperation with

The logo for DIW BERLIN, featuring a green square with a white diagonal line on the left side, followed by the text "DIW BERLIN" in a bold, green, sans-serif font.

the German Institute for Economic Research

Company profile IPC

The International Post Corporation was founded in 1989. We are a cooperative association of 24 member postal operators in Europe, North America, and Asia-Pacific. Together our members deliver more than 330 billion letters a year; that is to say almost 80% of the world's total mail volume.

Members recognise IPC as the natural partner and industry organisation for improving service quality, promoting cooperation and interoperability and for providing informed analysis on the postal and adjacent markets.

Our mission statement leads to our strategy which we have called *IPC Strategy 2007-2012 - Towards an Industry Organisation*. Both in timing and title it underlines the transformation phase our industry is in. The strategy is supported by six strategic pillars: providing platforms, broadening the membership base, upgrading quality, managing inter-company pricing, creating intelligence and striving for service excellence.

Herbert-Michael Zapf

President and Chief Executive Officer

Herbert-Michael Zapf is leading IPC into a new stage of development. He became president and chief executive officer in May 2006, joining IPC from Germany's privatised postal operator, Deutsche Post World Net (DPWN), where he spent 10 years in senior management positions.

Dr. Zapf is an economist and strategic development expert. He is building on IPC's expertise in quality measurement, operations upgrading, and inter-company pricing to create an industry organisation that translates providing platforms and creating intelligence for postal operators.

At DPWN, Herbert-Michael was executive vice-president and divisional board member with responsibility for import and export mail, international marketing, international relations, and commercial relationships with other postal operators. Prior to joining DPWN, he was head of department at Deutsche Telecommunications Consulting (DETECON) working on international strategy, regulation and the organisation of postal and telecommunication companies. He also worked in Latin America for the United Nations/International Labour Organisation, and in Luxembourg for the European Parliament.

Herbert-Michael studied economics and political science at the universities of Mannheim, Hamburg and the London School of Economics. He graduated from the University of Paris IX Dauphine and earned his doctorate at the University of Kassel, where his studies focused on the role of institutions in the development process.

Company profile DIW Berlin

The DIW Berlin - German Institute for Economic Research was founded in 1925 and is Germany's leading economic research institute. Its strength is based on its active engagement in both research and policy advice and its independent status as a non-partisan and non-profit organization. DIW Berlin has established work areas with a well elaborated focus and world-wide coverage. It is internationally renowned as an important location of policy relevant competitive academic research. Since 2000 DIW Berlin has been chaired by the President Prof. Dr. Klaus Zimmermann.

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In addition to permanent staff, many research professors and affiliates contribute to the activities of the institute. DIW Berlin is active in many of international research networks and co-operations.

About half of DIW Berlin's annual budget of 18 Million Euros consists of public grants provided as research funding in equals shares by the State of Berlin and the German Federal Government. These funds are supplemented with revenues from projects and commissioned work.

Furthermore, in 2007 DIW Berlin has set up a subsidiary consulting company – the DIW econ GmbH. The profit-oriented consulting company serves the growing demand for economic consulting by corporate and international clients.

Dr. Christian Wey

Dr. Christian Wey is head of the Department and Professor of Economics at the Technische Universität Berlin. His research interests are in the area of industrial organization with a special focus on those models which are suited to examine the competitive interdependencies between input market and final product market structures. His recent research deals with buyer power in the retail industry, the competitiveness of collective wage-setting regimes, and the emergence of effective competition in telecommunication markets. **PD Dr. Pio Baake** is a senior researcher of the Department. His main fields of research include competition theory, regulation and public economics.

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Executive Summary

In recent years, the postal market has undergone a widespread change process. Competition is increasing, first among the different postal providers, including today's incumbents and new market entrants, second through the developments in the e-sector, and third through logistics, publishing and mail order companies entering the postal market. On the political side there are discussions and negotiations to liberalize postal markets and often to introduce new laws and regulations.

At the same time National Regulatory Authorities (NRAs) accumulate more and more power and exert it on the postal providers, in particular on today's universal service providers. Due to the changing market realities it becomes obvious that many laws and regulatory concepts contradict the requirements of a fair, balanced, and functioning market environment.

The following study shows where deficiencies in today's regulatory approaches lie and give an overview of the characteristics of the postal industry. They show why today's regulatory approach is often incorrect and based on a lack of understanding of the postal markets. However, the effects of erroneous regulatory rules and measures can have a significant impact on one of the most important industries – in economic and organizational terms – in the world.

The postal industry and its impact on world and European economy

The postal industry is a sector contributing a big share to world economy. Estimates show that traditional postal operators, the incumbents, represent roughly one percent of the Gross Domestic Product (GDP) and roughly one percent of the labor force. In total figures, it is estimated that national postal operators worldwide account for over USD 250 billion in revenue and employ five million people. Those are merely the directly attributable figures, not including competitors or other sectors and industries depending on the mailing industry. In the United States, the Envelope Manufacturers Association Foundation found that, including those sectors, the entire mailing industry in the United States accounts for eleven million employees alone.

In Europe, in particular due to the plans to liberalise the markets, there exist several studies dealing with the direct and indirect impact of the postal industry on the economy.

A recent study (by WIK, 2006), commissioned by the European Commission reveals that postal services in the EU earned about 90 billion EUR in 2004 or 0.9 percent of the gross domestic product (GDP). The postal sector makes a significant direct contribution to the EU

economy. It is estimated that direct contribution to EU GDP is about 37 billion EUR or 0.4 percent. Postal services employed about 1.6 million persons, accounting for 0.8 percent of all jobs in the European Union.

Another study (by the Postal User's Group, 2006), underlines that although there are one million people employed in the letter mail businesses of Europe's postal service providers alone, there are further four million jobs dependent on a growing mailing service sector. Following this reasoning, the postal sector as a whole contributes 203 billion EUR in revenue to the European economy. Indirect jobs and revenues are created by internal and outsourced services, technology and equipment, investments in infrastructure, and as an example, in cooperation with mail order companies on the basis of e-commerce.

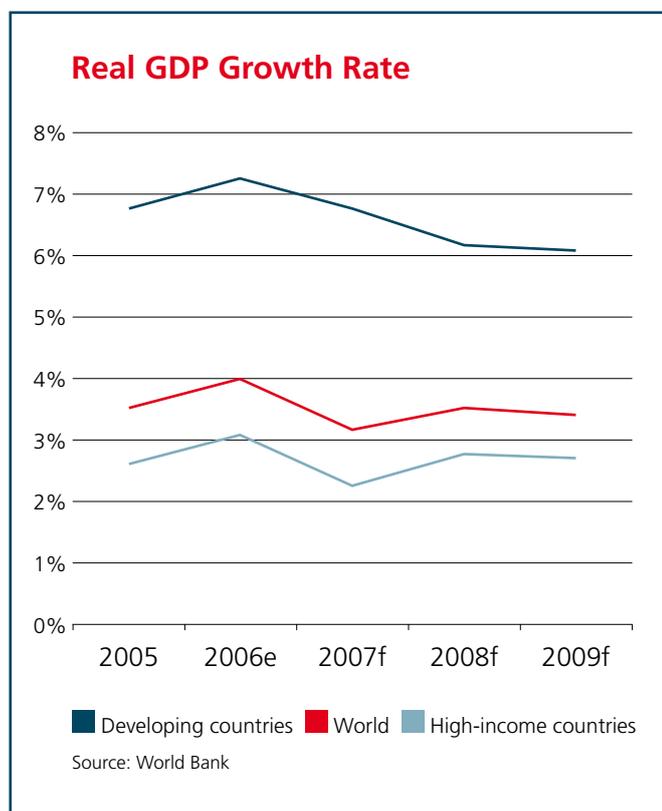
These figures show very clearly that a well functioning postal industry is essential for the future health and dynamism of the European economy. To guarantee that the postal industry will remain a healthy and important element of the economy, it is indispensable that law makers and NRAs act with responsibility and abide by the basic principles that characterize the postal industry.

The changing face of the postal markets

Global economic trends

The year 2006 was marked by strong growth in the global economy as world GDP climbed to 4 percent, up from 3.5 percent in 2005. Much of the growth in 2006 can be attributed to developing countries as their economies grew by 7.3 percent for that period, which is more than double the 3.1 percent growth posted by high-income countries. China and India played a significant role in the strong outcome in 2006, as it reached GDP growth rates of 10.7 percent and 9.2 percent, respectively. But the growth was broadly based, with all developing regions expanding by more than 5 percent.

Prospects for Europe appear to be robust due to strong domestic demand growth, combined with the continued integration of new member states into the European Union, which is expected to boost exports. In Japan, very low interest rates are projected to sustain growth in investment and industrial production. The United States, on the other hand, is expected to slow down in the medium-term as the sharp decline in the housing sector activity has already reduced investment in other sectors. For developing countries, the trend is expected to continue, with China and India contributing the biggest growth.



The postal industry in relation to global economic developments

Although the recent years have shown a strong GDP growth, the growth of letter post is much weaker or even diminishing. Economic growth does not guarantee a growth of letter volumes or the postal industry as a whole.

“Times have changed and with it the markets, the consumer behavior and the technical alternatives. When those changes are neglected the postal industry and the general economic growth will suffer.”

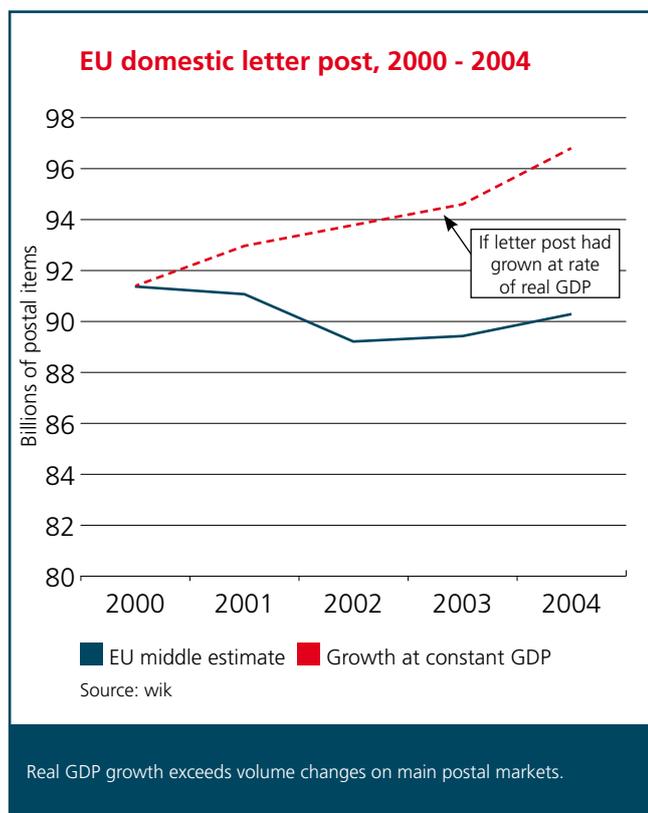
Companies in every sector try to increase their profits and revenues. When they are profitable this does not mean that they automatically increase their expenditure on mail. With increasing means of communication those businesses seek the best, most flexible, and least expensive method of communication with their customers. The internet and broadband are the basis for those new means of communication. They open up fresh possibilities for advertisers or companies in their communication with their customers. Those technological developments, and the new means of communication create strong competition for the postal industry. Thus

the postal industry is, as the study reveals, not a self-contained industry, but one that is connected to, and in competition with, many other industries offering alternative channels of communicating, advertising or delivering information.

Moreover, the demands of customers and the market have evolved considerably over the recent years. The postal industry is moving away from a two-way communications market to a one-way distribution market. The majority of mail is sent by businesses (87.5 percent), that tend to optimize their communication expenses. Also consumers change their habits. Holiday and new year wishes are often sent by e-mail or SMS rather than the traditional card sent by mail operators. On the other hand, the internet also provides new possibilities for postal companies considering the boom

of internet shopping that leads to sending and shipping the ordered goods home to the consumer, thus growing the market size - also in the interest of new market entrants. But the postal service providers will need the necessary flexibility in order to respond to new market trends and customer demands.

The study shows that today's regulatory approaches do not reflect those market realities. Times have changed and with it the markets, the consumer behavior and the technical alternatives. When those changes are neglected the postal industry and the general economic growth will suffer. Therefore, it is indispensable that the ten assertions presented in this study are the guideline for any legal or regulatory decision.



1. Investments in the postal industry are neither extremely high, nor predominantly sunk costs. There is no indication for a natural monopoly based on an essential facility. Therefore, the postal industry is no classical network industry.

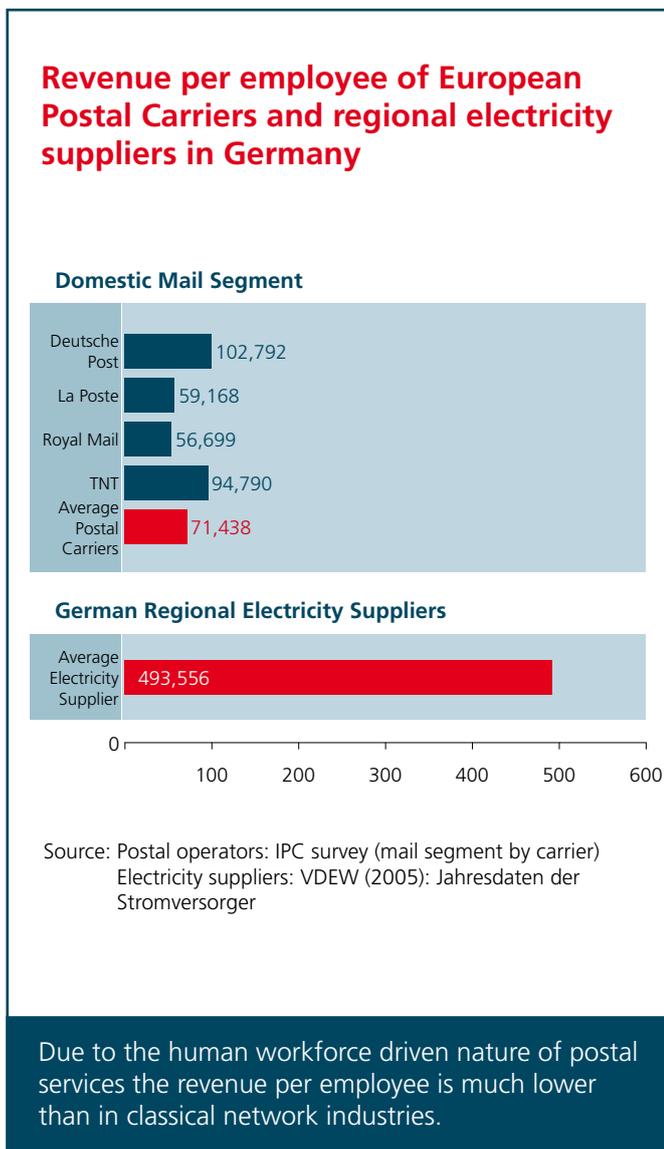
Classical network industries such as the gas, water or telecommunications industries are characterized by highly-specialized network infrastructures which channel a homogeneous good or service to the final consumer, as e.g., water, gas or telephone conversation. Infrastructures such as pipelines, ducts or cables are tailored to the specific characteristics of the goods and services to be supplied. These infrastructures typically require huge irreversible investments and exhibit the typical features of natural monopolies. Large economies of scale and scope imply that any duplication of infrastructures would be economically inefficient. Therefore, economic efficiency prescribes that the provision of goods and services of those highly specialized infrastructures should be based on the common use of existing networks.

“The postal industry is characterized by an infrastructure consisting mainly of human workforce and routes or means of transportation that are either publicly or competitively provided.”

The supply of postal services does not rely on comparable investments and infrastructures. The extent to which collection, sorting, transport, and delivery of postal services needs specific investments is very limited and comparable to other transport-intense industries such as retailing or airline services. As all transport services, the postal industry is characterized by an infrastructure consisting mainly of human workforce and routes or means of transportation that are either publicly or competitively provided. The postal service industry does not require sunk investments into network facilities at a scale which characterize classical network industries, as e.g., pipeline-bound gas or water networks, or cable-bound telephone and television networks.

Investments in logistic infrastructures and sorting centers may be partly sunk, but there is no indication that sunk costs are of outstanding importance when compared with other industries such as retailing where effective competition prevails. Similarly, the necessity to undertake large fixed costs due to indivisible investment requirements is largely absent as most fixed costs can be scaled in accordance to the local demand and supply conditions. This is true for all part of the postal value chain, including collection, transport, sorting and delivery of postal goods.

While economies of scale and scope may exist due to cost savings based on bundling collection and/or delivery services as well as combining transport services, the postal industry does not classify as a natural monopoly. Postal services are differentiated with respect to their qualities and the regions where they are supplied. Differentiated qualities, i.e. differentiations with respect to delivery time, service and reliability levels, lead to different routes or means of transportation. Economies of scope are thus limited and may only exist for a small subset of all postal services. The same reasoning applies to regional differentiation. While there are no economies

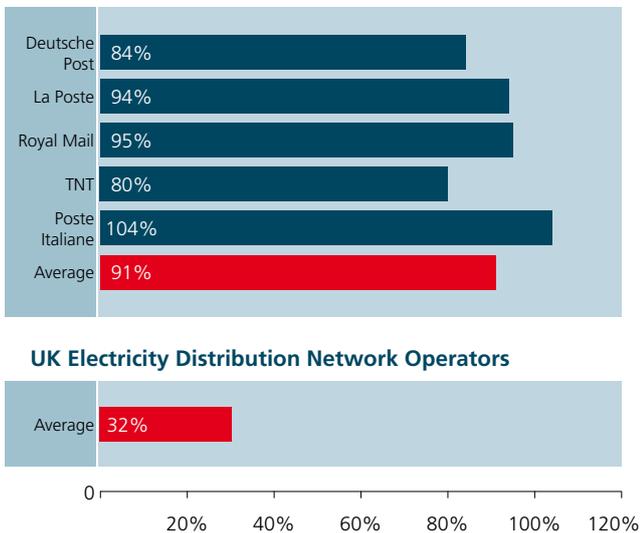


of scope between serving different regions, economies of scale may exist within specific regions for a specific service. The experience of the already liberalised postal product markets (parcels, express services, newspaper delivery etc.), however, has shown that competition is also developing in less populated rural areas.

The general presumption that regional collection and delivery services are natural monopolies is, therefore, certainly wrong.

Share of operating expenses in revenue between European Postal Carriers and UK Electricity Distribution Network Operators

Domestic Mail Segment



Source: Postal operators: IPC survey (mail segment by carrier)
 Electricity Distribution Network Operators:
 OFGEM: Electricity Distribution Cost Review 2005-2006
 (www.ofgem.com)

The postal industry infrastructure mainly consists of human workforce, having a direct impact on the share of operating expenses in revenue.

2. The role of postal market regulation is not to create competition, but rather to create a framework that allows for competition. Regulators that today set out to create a high level of competition within a short period of time have failed to understand the postal market correctly.

Unlike in classical network industries, barriers to entry do not exist in the postal industry. The possibility to duplicate postal infrastructures, the absence of large sunk costs as well as divisibility of necessary investments, allow market entry and competition to develop. This is shown in markets that have been liberalised so far (parcels, express, newspaper delivery).

“The possibility to duplicate postal infrastructures, the absence of large sunk costs as well as divisibility of necessary investments allow market entry and competition to develop.”

Furthermore, the technological characteristics and the implied cost structure in the postal industry imply that competitive equilibria are economically efficient. Market entry, product differentiation and innovations have to be driven by price-cost margins, consumer needs and expected profits from better or new services.

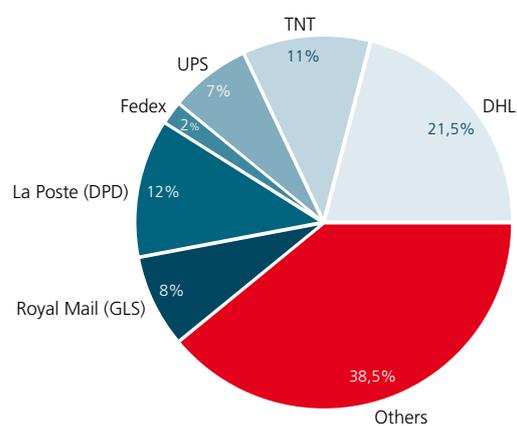
In contrast, regulatory interventions that foster market entry and aim to create competition can easily lead to inefficient market structures and allocations. Interventions limiting a firm's strategy space in order to enhance entry change relative prices and therefore the investment incentives of other players in the market. Entry decisions will not be based on prices reflecting true economic opportunity costs, but on investment opportunities opened up by regulation.

Fostering market entry ignores the fundamental tendency of competitive markets to secure that goods and services are provided at the lowest possible costs and to establish efficient market structures. Actual and potential competition lead firms to use efficient supply technologies and to exploit potential economies of scale and scope to an efficient extent. This holds with respect to the structural organization of collection, transport, sorting and delivery services as well as the number of firms operating in the respective markets. Endogenous market structures generally rely on relative prices and opportunity costs that reflect market valuations and are thus based on efficiency considerations. Inefficient market structures are not stable over time as they provide profitable entry or restructuring opportunities.

Moreover, the intensity of competition as well as the efficient provision of goods and services are generally not related to a high number of actual competitors. Potential entry effectively restricts the market power of firms being active in the market. Similarly, the intensity of competition depends on the degree of product differentiation and does not necessarily increase with the number of competitors. Furthermore, efficient provision of goods and services can also be ensured by competition for the market. Considering regional markets as well as dynamically efficient innovation incentives, competition for the market is an effective mechanism to ensure economically desirable allocations.

Overall, regulatory policies aimed at fostering market entry rely on the wrong perception that efficient market allocations can be only ensured if there is a high number of competing firms. This view neglects the efficiency of endogenous market structures as well as the importance of potential competition and competition for the markets.

Market shares in the European parcel and express market



Source: TNT (2004), Market statistics: Express and parcel services - intra-Europe: DPWN, Annual report 2005, European CEP market 2004 - market shares based on information from DE, ES, FR, IT, NL, and UK.

The European parcel and express market clearly shows that competition developed without much regulatory interference.

3. The objective of postal market regulation is not to divide up the postal market. The objective is to create an environment in which the market can grow.

In order to ensure that static and dynamic efficiency gains from competition can be realised, the regulation of the postal industry must contribute to an institutional framework that allows competition to work. Competitively driven incentives to enter markets, to supply new goods and services, and to use new production processes are the most efficient means to ensure efficient allocations.

“Regulatory interventions that aim at dividing up the postal market are based on wrong perception – often caused by the belief that the postal market is comparable to classical network industries as gas, railway or telecommunication.”

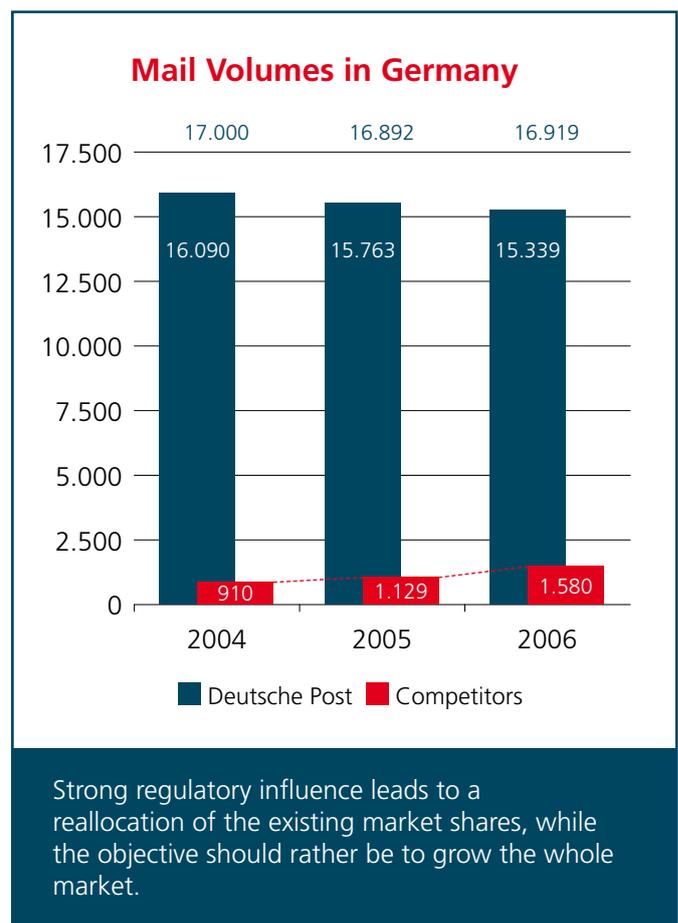
The best policy advice, therefore, is to tear down existing regulatory barriers so that unfettered competition can evolve where the market is already open. The postal market policy should focus on building a legal and institutional environment that allows firms to pursue competitive business strategies. Likewise, the avoidance of legal provisions that limit potential innovations and product differentiations is important in order to exploit the benefits of competition fully. At the same time, quality standards and requirements for all postal service providers may be necessary to guarantee an efficient development of postal markets.

Regulatory interventions that aim at dividing up the postal market are based on wrong perception – often caused by the belief that the postal market is comparable to classical network industries as gas, railway or telecommunication. Dividing up the value chain in order to implement some sort of cost-based access scheme by the regulatory authority is, however, counterproductive in the postal service industry. Sound economic consideration reveals that the postal service industry is neither a natural monopoly nor are entry costs prohibitively high and irreversible. Standard economic reasoning then concludes that a liberalised postal market should induce both efficient endogenous market structures and, with that, allocative efficiency. Regulatory interventions that divide up the postal market artificially, deprive firms’ from

desirable integration strategies which distorts the competitive mechanisms, and hence, must lead to inefficient market allocations.

“The best regulatory policy for the postal market, therefore, should focus on its overall growth.”

False comparisons with classical network industries typically build on the supposition that a monopolistic bottleneck also exists in the postal service industry and that this bottleneck is not replicable in the short run. Based on this assertion regulatory authorities then typically conclude that the incumbent firm will make use of its power to exclude competitors at large. Based on such a reasoning, regulators have imposed unbundling and access requirements, in particular in the telecommunications industry, in order to initiate competition. An “initialization” of competition is, however, completely unnecessary in postal service



markets where a non-replicable monopolistic bottleneck (as e.g., the local loop copper-line in telecommunications) does not exist. Even in the short run, competitors can enter highly populated areas easily and operate profitably. Over time, competitors can then expand their operations into other regions and product segments so that a division of the postal service industry is not necessary for competition to develop. Most importantly, a regulatory approach that divides up the postal value chain in order to implement a regulated access scheme will severely distort competitors' investment, entry and business strategies away from what efficient endogenous market structures in a liberalised postal market could achieve. The best regulatory policy for the postal market, therefore, should focus on its overall growth. In a fully liberalised and growing postal service industry efficient competition will develop rapidly.

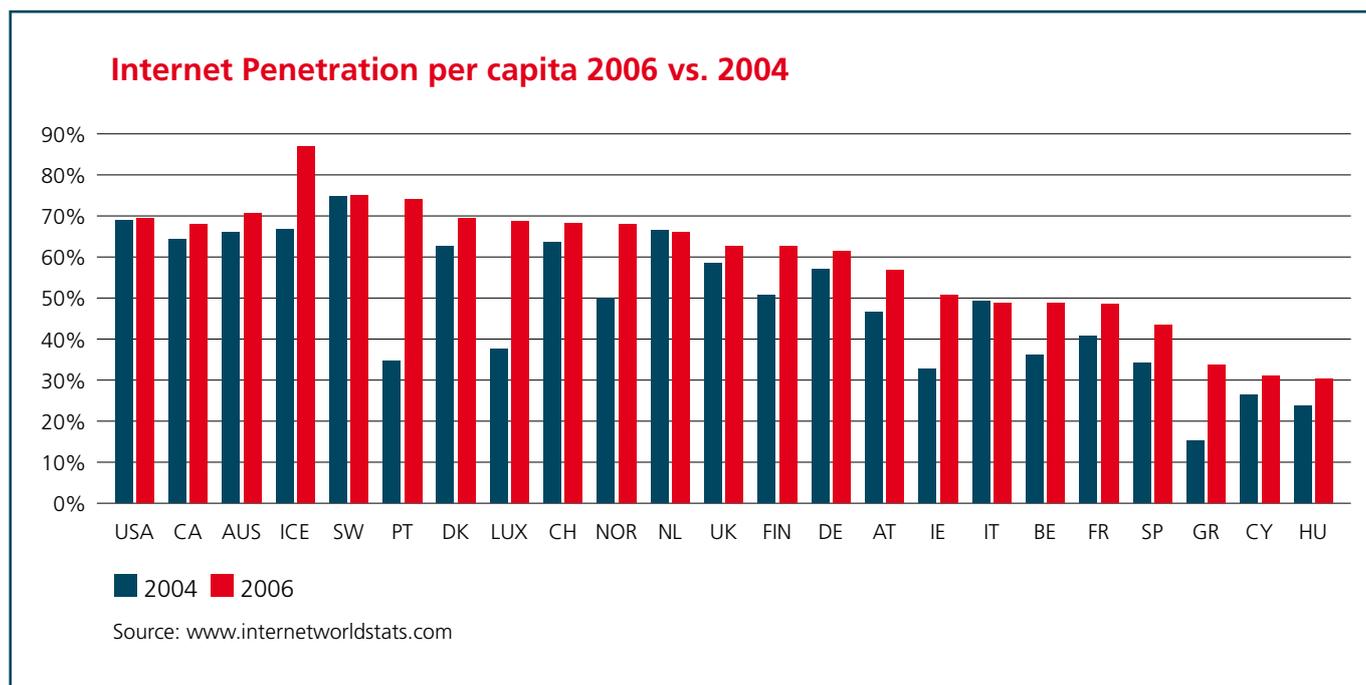
4. The postal market is neither a self-contained market, nor are there demand-side sources of entry barriers. Competitive interaction exists to a high degree with other industries such as electronic commerce and the logistics industries.

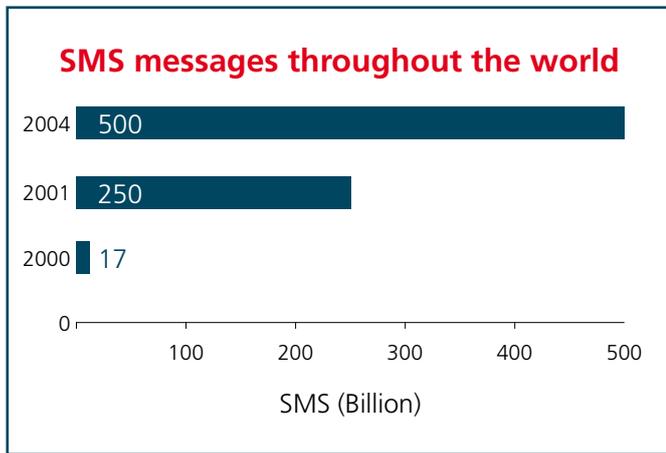
A necessary condition for regulatory intervention is the existence of market power. A firm's market power, in turn, critically depends on consumers' ability to substitute other products in case of price increases relative to the other products. If even a small relative price increase in the set of products under consideration induces consumers to switch their purchases towards other products, then raising prices significantly will not be profitable. The possibility of demand-side substitution, therefore, provides an immediate and effective disciplinary force on the suppliers. If consumers are in a position to switch to available substitute products or to begin sourcing their requirements from suppliers located in other areas, then it is unlikely that monopoly power in terms of prices above competitive levels can be sustained.

“The postal industry is competing with many other industries, as for instance, the transport business, media distribution systems, and electronic commerce.”

It is fair to say, that regulation in classical network industries typically ignores possible demand substitution effects. While in classical network industries such a

preoccupation with the technical features of the supply network maybe justified, (as for example, gas is only a poor substitute for electricity, and fixed-line services may be not fully substitutable by cable-based access), such an approach is completely misleading in case of postal services. The recent years have shown that the postal industry is competing with many other industries, for instance, the transport business, media distribution systems, and electronic commerce. Most importantly, new online services by banks, energy providers, or e-business platforms have created new options for consumers to send “mail” through the internet. As a result, e-commerce and online services have started to compete heavily with postal services. These new forms of increasing competition do not impose major challenges these days on the postal industry. More importantly, these developments show that the postal market is not isolated, but rather faces effective disciplinary forces from other industries. Moreover, in order to assess the competitive forces associated with the increasing substitutability of hardcopy and digital mail correctly, it is important to recognize that it is not necessary for all consumers to be willing to switch, only that enough would switch in response to a price increase. What matters are the marginal consumers, or in more technical jargon, the elasticity of demand. As digital “e-mail” is becoming an almost costless alternative for an increasing share of postal service customers, it follows that the

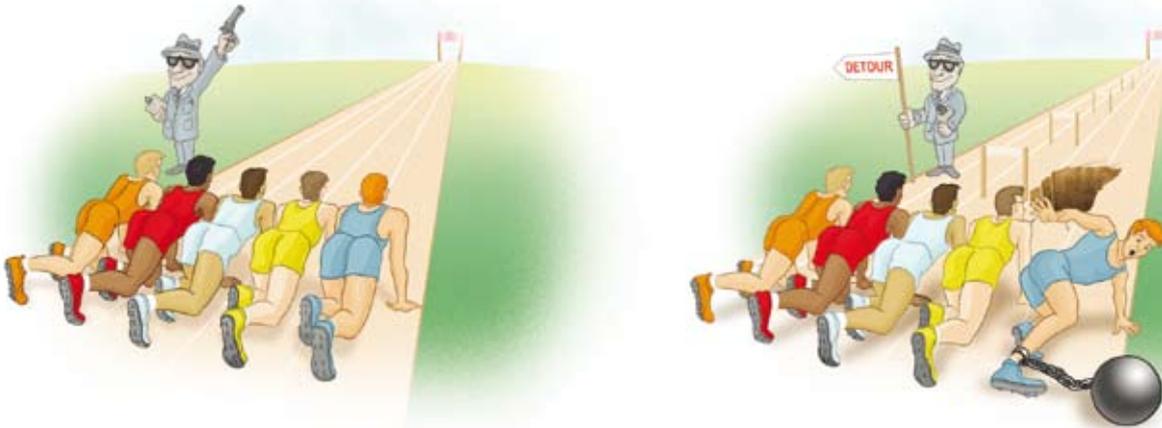




exercise of market power of postal service providers is effectively constrained by those non-postal market alternatives.

Another important feature of the postal service market is the absence of consumer lock-in which is often a problem in classical network markets. While the decision to subscribe to a service provider in a classical network industry is typically done once for a longer period of time, this is completely different in the postal service industry, where customers can choose the service provider for every single item anew. Consumers are not locked-in by means of long-term contracts or switching costs. As consumers are willing to switch to competitors immediately even when price differences are small, the competitive threat by alternative transport and distributions systems on the postal industry is significantly reinforced.

5. Postal market liberalisation must be symmetric. Common rules must apply to all operators — incumbents and competitors — in all markets, at least in one region.



In order to exploit the efficiencies of a competitive market process fully, firms should be able to compete head-to-head, each starting from the same initial position. It is straightforward that a level playing field is necessary to achieve efficient market outcomes. In classical network industries a level playing field often does not exist when the industry exhibits the features of a natural monopoly and sunk investments are large. Consumer lock-in often creates additional barriers to entry in classical industries. Overall, based on the assessment that incumbents in classical network industries control a network which is not replicable by competitors, national regulatory authorities have adopted a pro-active regulatory approach since liberalization to foster competition. The result is asymmetric regulation of the former monopolist by which access, interconnection, unbundling or resale obligations have been imposed on incumbent network operators in order to initiate competition at the service level and those elements of the network infrastructure which do not constitute a natural monopoly.

“Firms should be able to compete head to head each starting from the same initial position.”

Asymmetric regulation has been criticized on many grounds, for example, with regards to the telecommunications industry. Alleged foreclosure incentives are often absent or negligible, and more importantly, asymmetric regulations distort entrants' entry and investments incentives away from infrastructure investments. Therefore, asymmetric regulation jeopardizes the main goal of network liberalization; namely, to achieve effective infrastructure-based competition in network industries.

While asymmetric regulation is already highly questionable in more classical network industries, applying this regulatory approach to the postal industry would constitute a straight forward regulatory failure. First of all, essential facilities and barriers to entry do not exist in the postal industry. The possibility to duplicate postal infrastructures, the absence of large sunk costs and the divisibility of necessary investments allow market entry at various levels, and hence, allows competition to develop rapidly. Moreover, potential competition is a viable threat in postal markets as entry barriers are largely absent. Economies of scale and scope are rather limited so that entry deterring and predatory practices cannot be profitable for incumbent postal service operators. The technological characteristics and the implied cost structures in the postal industry imply that competitive equilibria are economically efficient. Hence, the most effective way to liberalise the postal service industry is to abolish existing regulatory barriers and burdens and to create a level-playing field where the rules of fair competition are applied to all providers symmetrically. This includes that all firms face similar opportunities with respect to their business strategies and employment decisions. Asymmetric burdens caused by fixed employment conditions (e.g., in the form of civil servants) distort competition and lead to inefficient entry. Such asymmetries can be avoided by easing existing employment obligations and balancing wage differentials through governmental actions and a system of financial transfers or by common employment and wage conditions in order to create a level playing field with regard to firms' employment strategies.

In order to create a level playing field among all postal service providers in Europe a symmetric competitive environment should be applied in all EU Member States.

6. Market conditions have changed significantly in recent years, therefore, the scope and financing of the USO needs scrutiny to prevent market distortion.

Traditional universal service obligations mainly build on policy goals such as equality of living conditions, public welfare issues, and securing the proper functioning of the legal and institutional system.

From an economic perspective, however, the imposition of universal service obligations can be justified only if market entry is unprofitable for firms while economic efficiency prescribes that markets should be served. This kind of market failure relies on the observation that consumers typically gain from market entry, so that overall economic rents are higher than firms' profits. Technically speaking, firms cannot extract all consumer surplus as perfect price discrimination is not possible.

“Prices have to reflect true economic costs and there must be a level playing field on which firms can compete according to their comparative advantages.”

Public welfare issues do not lead to well-founded reasons for universal service obligations. Redistribution of economic wealth and equality of living conditions can be established more efficiently by using direct income transfers. Altering prices that reflect true economic opportunity costs leads to inefficient distortions of market allocations and decreases overall efficiency.

Moreover, other industries have made significant developments and have become major competitors of the postal industry. Today, the telecommunication and the internet industry offer services that are close substitutes to the traditional mail services. Fax and e-mail services, electronic signatures and the increasing scope of internet applications such as electronic banking and e-government services decrease the dependency from traditional mail services.

These developments, however, have not led to an adjustment of existing universal service obligations. Most of the obligations are still built upon tradition, rather than the actual needs of the market players. Furthermore, existing pricing and financing systems have not been adapted to the changing environment and market structures.



To secure that liberalisation of postal markets and induced competition can lead to the expected efficiency gains and innovations, universal service obligations must not distort competition. Prices have to reflect true economic costs and there must be a level playing field on which firms can compete according to their comparative advantages.

Concepts for restructuring universal service obligations must follow an economic approach that builds on the needs of consumers and basic competitive incentives. Competition for the market and specifically adapted financing systems are key elements for efficiency based universal service obligations.

Furthermore, uniform prices and quality levels are not in accordance with basic economic reasoning. Price differentiations based on different cost and quality levels are perfectly accordable with efficient allocations. Different consumers' preferences, varying degrees of competition, and alternative services are factors that have a direct impact on the efficient extent of universal service obligations.

Senders and Receivers in the EU per segment



Legend: ■ Consumer ■ Business

Source: wik (2006),p.198

Almost nine in ten letters sent in the EU originate from business senders.

7. Where postal regulation remains, it must focus on end-to-end services; rule-setting for downstream access is an inadequate approach.

The postal value chain consists of collection, transport, sorting, and delivery of mails. Efficient provision of postal services requires that the overall costs along this value chain are minimized. Therefore, regulation of postal markets must not focus on specific levels within the value chain. In fact, regulation has to focus on the overall incentives of firms and the competitive forces along the whole value chain. Regulation of postal markets should therefore follow an end-to-end approach.

Access regulation in traditional network industries such as the electricity and telecommunication industries, builds on the natural monopoly characteristics of the respective physical networks. Duplication of these infrastructures or bypass is in most cases inefficient. Access regulation is thus necessary for enabling market entry and establishing downstream competition.

“Regulated access decreases the firms’ incentives to invest in product and process innovations. Binding access obligations distort the relative prices and can thus imply that otherwise profitable innovations are not undertaken.”

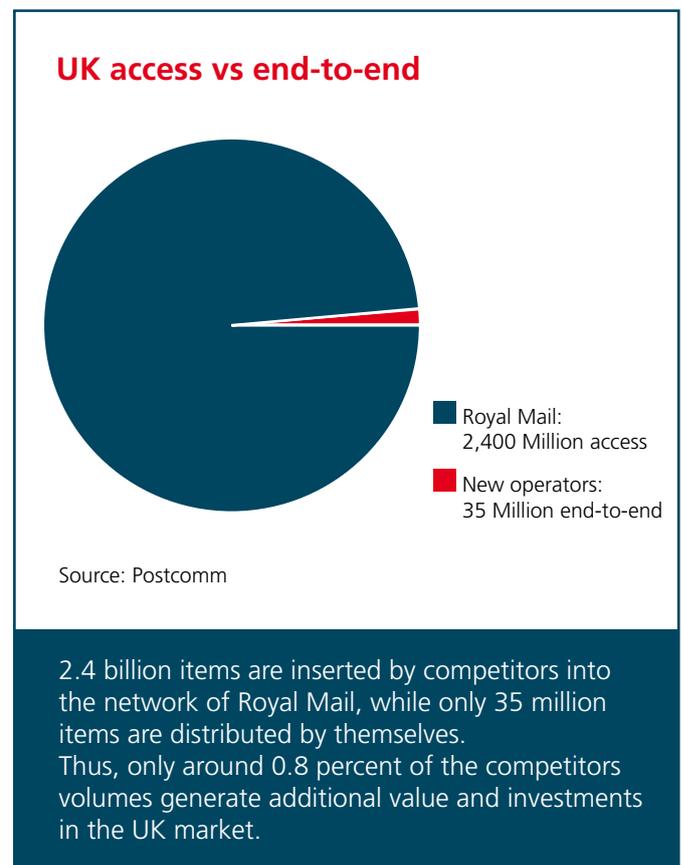
Applying this reasoning to the postal industry would neglect the basic observation that postal infrastructures are duplicable and that market entry is possible on all levels of the value chain. Furthermore, access regulation does not take endogenous market solutions into account and generally implies distortions with respect to firms’ investment incentives because of the following reasons:

- Potential or actual competition on upstream markets leads to competition for providing access, efficient access agreements, and efficient overall market structures. Strategic denial of access cannot be sustained if market entry on upstream markets is possible.
- Regulated access decreases the firms’ incentives to invest in product and process innovations. Binding access obligations distort the relative prices and can imply that otherwise profitable innovations are not

undertaken. This reasoning applies to investments in already existing infrastructures and to investment in new infrastructures. Cost orientated access regulation is generally based on static efficiency considerations and neglects dynamic efficiency gains from product or process innovations.

Taken together, these arguments clearly indicate that downstream access is not a proper regulatory approach for the postal industry. Access regulation offers new entrants the possibility to enter downstream markets without investing in own (upstream) infrastructure. While this can be seen as fostering market entry and hence competition, overall efficiency tends to be reduced.

Where postal regulation remains, it should instead build on an end-to-end approach. Focusing on consumer prices does not distort innovation incentives and allows potentially more efficient market solutions on upstream markets. Furthermore, end-to-end regulation can be more easily adapted to specific markets where competition should not function properly. Finally, end-to-end regulation is in line with general competition law.



8. Big discrepancies between the size and resources of national regulators in different countries are an indication of widespread inefficiencies that must be resolved.

Ideally, regulatory authorities and more generally public decision makers, should not be guided by their self-interests but rather by the interests of the general public. However, monitoring of political decision makers by the general public is only indirect and incomplete. It would be, therefore, naïve to assume that governmental agencies abstain from operating in their self-interest and only try to maximize general welfare. Indeed, it is conventional wisdom that growth and prosperity critically depend on building robust public institutions which align public agencies' incentives with the general public's welfare.

The positive theory of public regulation has identified several sources of governmental failures which all build on the fact that the general public cannot monitor the public agencies perfectly. Most importantly, agents working in a national regulatory authority have strong incentives to favor actions which make them indispensable. In addition, self-interested bureaucrats prefer to work in a growing agency which will offer them better chances for promotion. As a consequence, governmental agencies tend to overstaff and create strong incentives to expand the agency's competencies. It is, therefore, not surprising that many national regulatory authorities (NRAs) resemble huge administrative machines, disposing of high budgets and many employees. Backed with huge administrative personnel regulatory bodies, they tend to implement procedures and bureaucracy that is often in contradiction to a healthy economic development. Regulatory intervention then becomes excessive, for example, by implementing ex ante

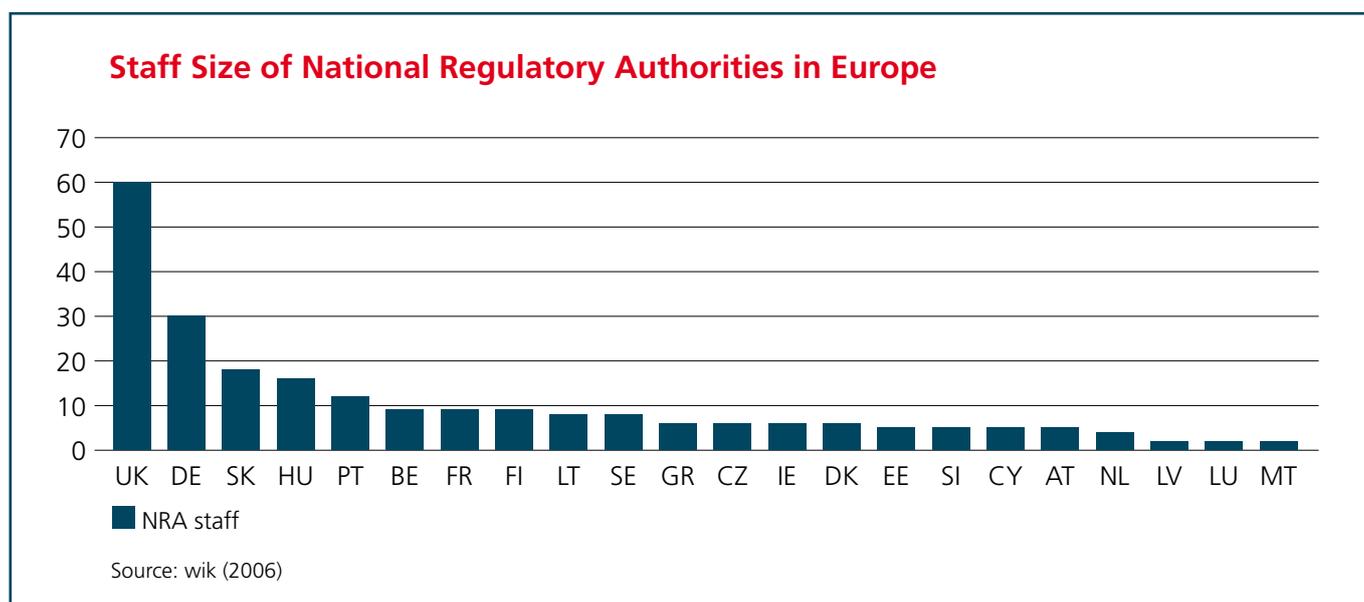
regulations in postal markets. Clearly, the core competency of the national regulatory authorities is to deal with uncontested market power caused by natural monopolies and large irreversible investments. It is quite obvious that national regulatory authorities act in their self-interest by expanding their sphere of influence on other industries. From a bureaucrat's perspective working in a national regulatory authority, the ideal world is a world of natural monopolies and essential facilities.

“NRAs must be efficient and help rather than hinder the development of the market.”

As has been shown in the previous assertions, applying access regulation to the postal market (which maybe sensible in classical network industries), is based on the wrong conception that postal services constitute a natural monopoly and that there exist large sunk costs. Regulatory intervention based on this view must, therefore, inevitably create distortions, and hence, welfare losses.

In order to prevent agencies from an unduly expansion of their sphere of competence, the national regulatory authorities' size and budgets must be linked to their absolute necessary tasks.

Overall, NRAs must be efficient and help, rather than hinder the development of the market.



9. Regulation must be supervised and must not be an end in itself.

The assertion that regulatory authorities have strong motives to expand their sphere of influence excessively implies that some form of supervision is necessary to create an efficient regulatory environment. Supervision of the regulatory authority's activities should guarantee that the agency does not exert any power that is not absolutely necessary to fulfill its main task.

One sort of supervision can be provided by groups of experts which regularly review the regulatory authority's decisions and overall performance. Accurate information about the activities and capabilities of both incumbent suppliers and new operators is of great value when assessing the authority's performance. To ensure transparency and the timely availability of the information to supervise the NRA, it is important to establish data reporting requirements.

"It is extremely important to create a system of checks and balances which make commitments to regulatory withdrawal from network industries credible in the future."

In order to assess the importance for supervision of the national regulatory authority correctly, it is important to recall that the main goal of liberalising network industries was to achieve effective competition. While the transition period from monopoly to effective competition may very well differ among network industries depending, for instance, on irreversible investment made in the past and the course and speed of technical progress, the main reason to follow a liberalisation strategy in the first place was the conviction that many network industries can evolve towards effectively competitive structures. Such a vision is, however, detrimental to the self-interests of the national regulatory authority: it inevitably implies that the authority must wither away; a rather gloomy perspective for its employees.

National regulatory authorities have been quite successful to entrench themselves, so that the ultimate goal to create effective competitive structures appears to be not on the agency's agenda anymore. For example, in the telecommunications industry, access regulations and unbundling requirements are not withdrawn from

incumbent operators, while innovations and convergence of media networks have changed the industry dramatically and would make it possible to achieve effective competitive structures in the not too far future. To the contrary, it appears that asymmetric regulations have become the norm which are also applied to new and emerging markets in that industry.

These observations are particularly important when a policy of a gradual opening up of the postal market is adopted. Again, a gradual opening up of the postal market may lead the authority to conclude that some form of ex ante regulations is necessary to achieve competition in some liberalized segments of the postal industry. As should be clear from insights of the positive theory of public regulation, such a gradual opening of postal markets accompanied by asymmetric regulations sparks incentive to enshrine such regulations and to expand the regulator's sphere of influence in the postal area, rather than to follow the initially envisioned route of withdrawing regulations from that market.

Because of those regulatory hazards, it is extremely important to create a system of checks and balances which make commitments to regulatory withdrawal from network industries credible in the future. Regulatory defects might have detrimental effects on the postal markets. In an industry with such an importance for the whole economy and the labor market, any mistake from the regulatory side must be avoided.

10. There is no need for sector-specific regulation in the postal industry. Existing legal instruments, in particular competition law, can deal with any deficiencies that may arise.

All the previous assertions lead to the conclusion that the postal industry should not be subject to sector-specific regulation. The postal service industry is neither a natural monopoly, nor are significant irreversible investments necessary to enter postal service markets. Moreover, in the postal service industry there are no additional barriers to entry caused by locked-in customers. As a consequence, by de-regulating the postal industry it can be expected that competition will function not much differently than in related transport and logistic intense industries, as e.g., the retailing industry. Therefore, it is fair to assume that the postal market is well prepared for free, fair, and symmetric competition if the lawmakers and regulators understand and apply the basic principles characterizing the postal industry. Regulatory influence is likely to provoke more negative effects than possible positive ones. Hence, any regulatory influence distorting the market and its development must be avoided.

“Existing competition law rules can deal with any deficiencies of the postal market that may arise.”

Existing competition law rules can deal with any deficiencies of the postal market that may arise. Competition policy and regulatory policy differ in at least three fundamental respects: First, competition policy rules typically set guidelines that describe in broad terms acceptable behavior and outcomes. In contrast, regulation policy typically imposes a set of detailed rules on the incumbent operator that define precisely the limits on acceptable behavior and outcomes (as e.g. access prices). Second, having specified ex ante guidelines, competition policy typically entails ex post investigations of possible violations of the specified guidelines. In sharp contrast, regulation stipulates ex ante rules with ongoing industry oversight, rule refinement, and rule enforcement. Third, competition policy typically relies on edicts to discontinue anticompetitive and associated fines (e.g., in the form of damage payments to injured parties), while regulation often proscribes specific types of conduct and establishes detailed performance requirements and associated reward and penalty systems.

Based on our previous assertions, we can easily conclude that all those differences between competition policy and regulation policy highlight the relative merits of applying



competition law, rather than sector specific regulation to the postal industry. Any artificially imposed constraints on postal service operations caused by ex ante regulation harm economic efficiency. The very fact, that large irreversible investments do not play an important role in postal markets, implies that there are virtually no benefits from using an ex ante approach as anticompetitive practices can be cured effectively on an ex post basis by the application of the relevant competition law. Moreover, the regulatory hazards associated with building up a regulatory authority rise undue concerns about inefficient regulations.

Finally, competition policy is well developed in most EU member states and at the EU Commission. Competition laws prevent firms from engaging in anti-competitive behavior. Article 86 of the E.C. Treaty proscribes “any abuse by one or more undertakings of a dominant position within the common market”. Article 86 targets all kinds of abuse of dominance practices, in regards to excessive pricing, tying and bundling arrangements, price discrimination, and refusals to deal as well as essential facilities. A strict application of competition law to the postal industry will therefore suffice to assist the competitive process in postal industry effectively.

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