

Regulation & Strategy under FMO and Electronic Competition

Paul R. Kleindorfer
INSEAD

ANACOM
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Outline of Discussion

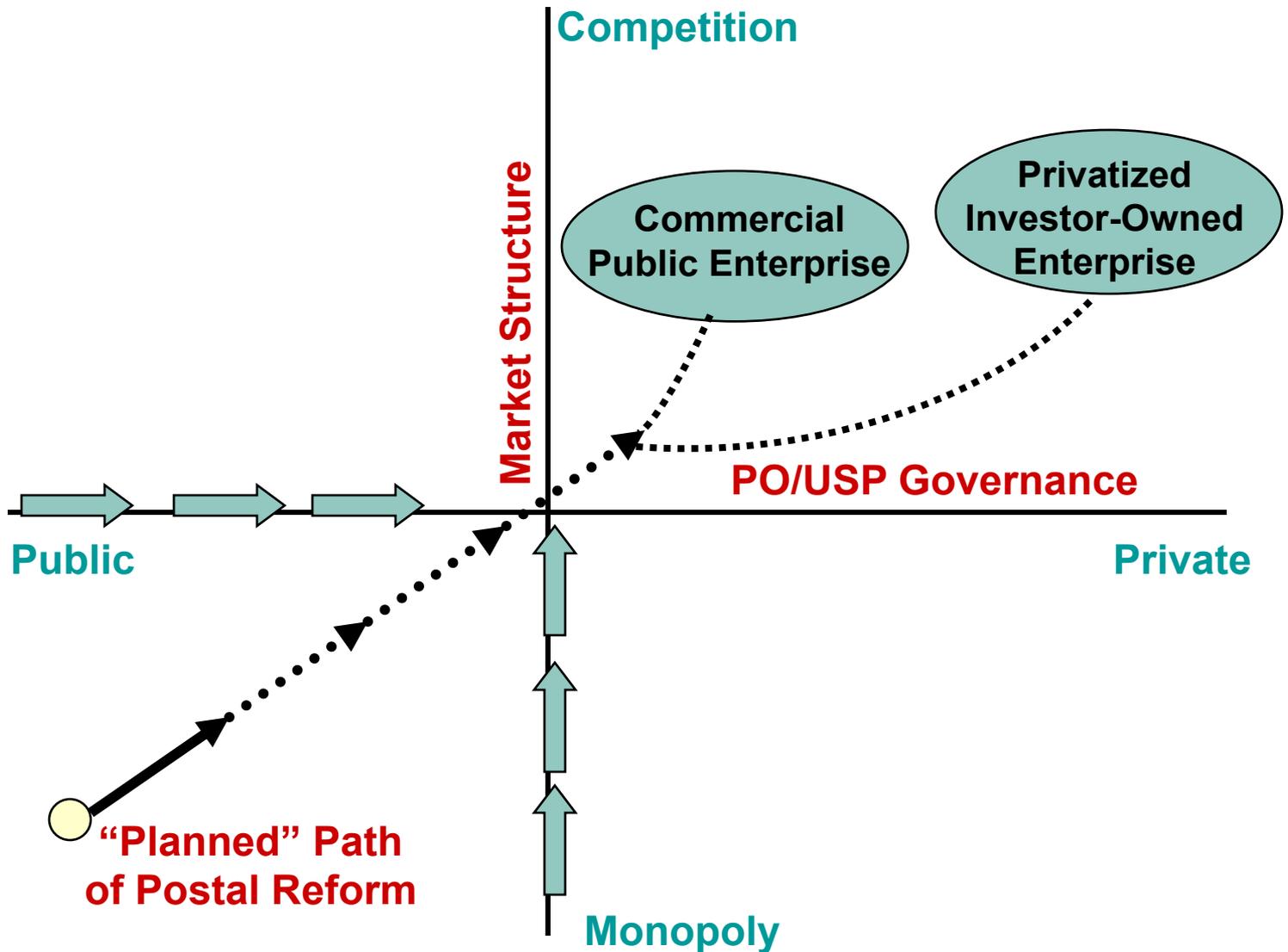
- Historical Overview on Drivers and Levers of Reform/Liberalization/Regulation
 - USO traditionally the main driver
 - Efficiency and cost drivers fundamental
 - Demand and intermodal competition
- Implications for regulation and strategy
 - Wholesale and retail themes
 - Cost and efficiency strategies
 - USO: costs and scope

DRIVERS AND LEVERS OF REFORM/LIBERALIZATION & REGULATION

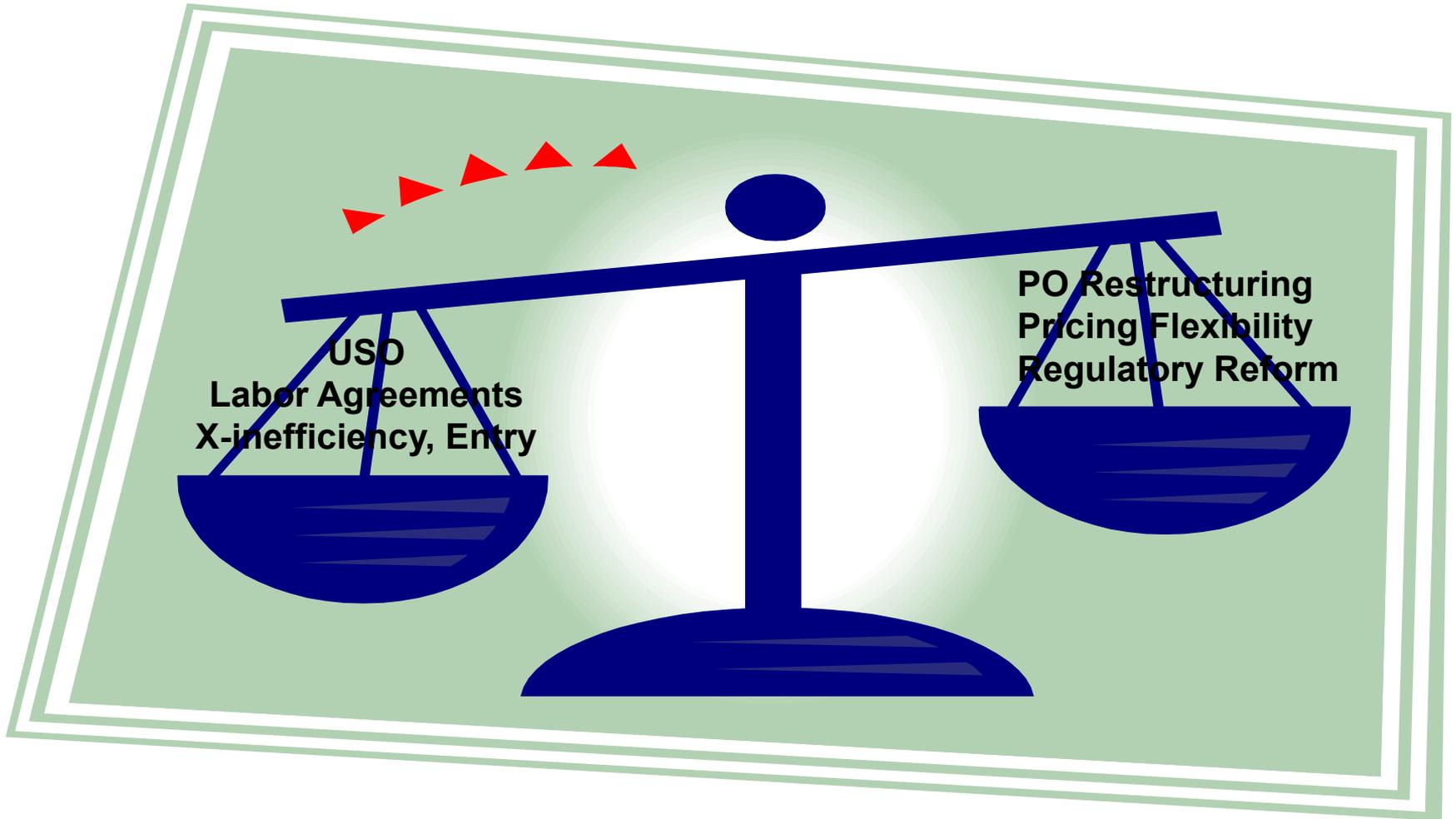
Drivers & Levers of Postal Reform

- Demand for and Cost of the USO
- Changing market structure in communications markets and related electronic substitution
- Health & pension benefits
- X-inefficiencies and dynamic efficiency
- Dysfunctional regulatory practices
- Research and “lessons” from other sectors

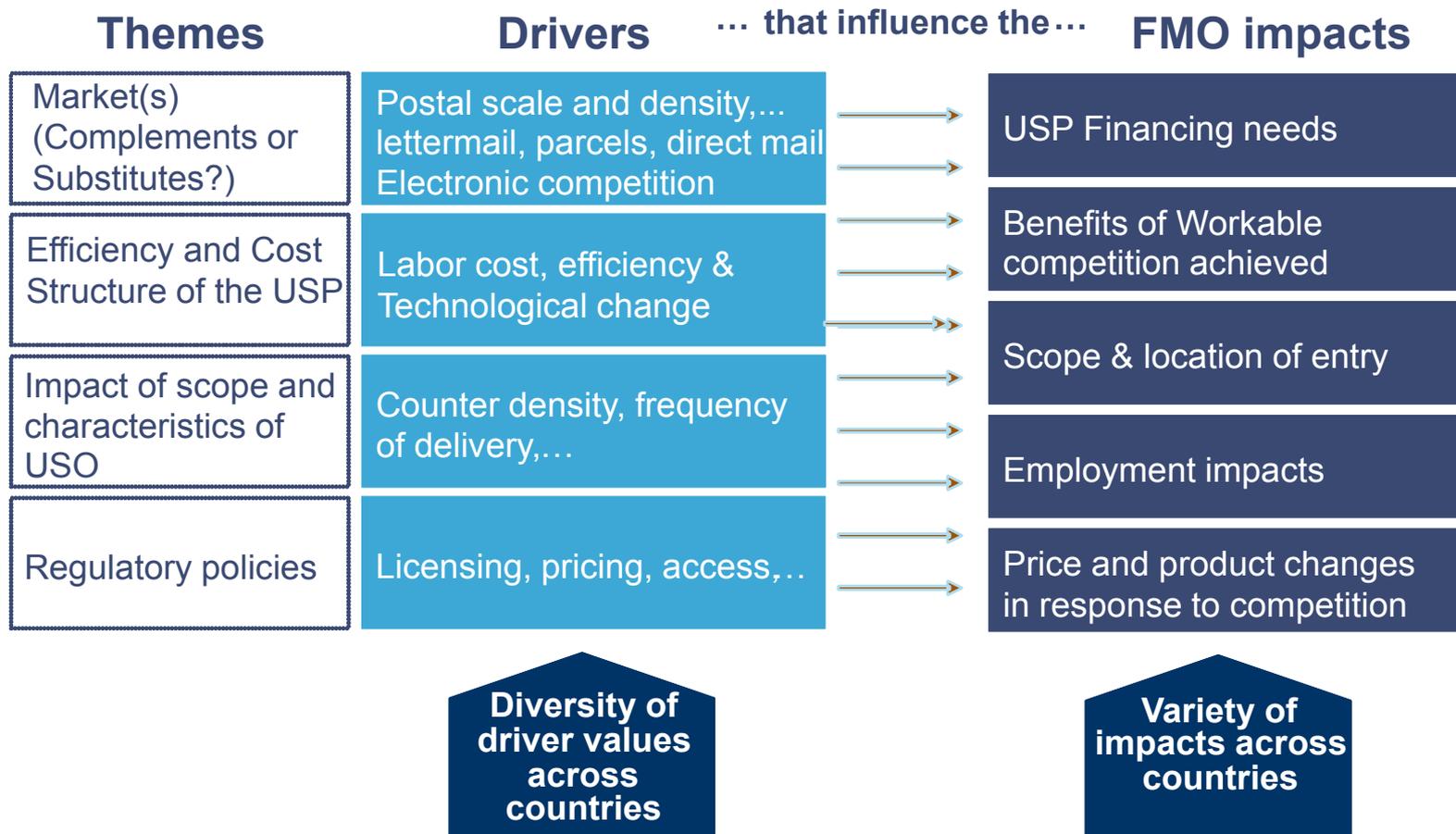
Path of Postal Reform



Country-specific Re-Balancing



Economic Analysis of USO under FMO: Many Studies in Crew-Kleindorfer Postal Volumes



Major Drivers of PO Profitability and Efficiency

- Many studies considered the interactions under entry/FMO of various factors driving PO profits and overall efficiency
- The interdependent factors include:
 - Postal scale and demand (including eSubstitution)
 - Cost structure (drivers of fixed vs. variable cost)
 - X-efficiency and Dynamic efficiency
 - Scope, cost and financing of the USO
 - Regulation and pricing flexibility/commercial freedom for the PO

Financing the USO under FMO

1. Scale and scope economies
2. Market dominance
3. Increase in the uniform price of single-piece mail.
4. Reducing the scope and therefore the obligation of the USO
5. Increases in X-efficiency and dynamic efficiency
6. Extent of pricing flexibility allowed by regulators

Role of Regulation

Regulation a critical element in determining outcomes under FMO

- USO scope and monitoring
- Licensing of new entrants
- Accounting separation and structure
- Price and profit regulation

Focus on price/profit regulation and the impact of this on funding of USO

Basic Model for PCR a private, for-profit firm, a residual claimant, extended as in Portugal to include QoS incentives

IMPLICATIONS FOR REGULATION AND PO STRATEGY

Key Points

Electronic competition and financial viability critical issues for POs

Necessary shift of attention to wholesale vs. retail markets

Access pricing as a fundamental issue for regulators in enabling viable wholesale markets

Shift in emphasis from internal cost cutting to external market drivers and innovation

Demand Side Strategy Issues: Electronic/Intermodal Competition

Competition from electronic media a serious threat to the viability of POs

The basic reason is that such competition erodes natural economies of scale in delivery

Retaining delivery volumes through improved access services increased importance

Implication: increased importance of wholesale side of PO's business in the years ahead

Rationale for Emphasizing Wholesale

Preserve economies of scale in delivery crucial

Access customers: lower costs in mail preparation upstream

Smaller companies, likely more innovative in designing products competing with electronic

Delivery – POs' comparative advantage

Innovation and customer focus remain fundamental

Access also applies to Retail Outlets— change of culture

Many POs face serious problems with uneconomic post offices

Extending franchise operations part of the same shift to wholesale operations

Leveraging POs “core competency” in delivery and in postal outlets a major culture change

Selling competitor’s products in postal outlets

Business innovations in hybrid mail, differentiated delivery quality and other areas

Key Role of Access Regulation

FMO is a reality

E2E competition likely to remain fairly restricted unless inefficient access policies enacted

POs have strong incentives to provide access at prices entrants cannot beat

Minimal regulation should be the rule, subject to:

- Access prices above Marginal Cost
- Transparent and Non-discriminatory
- Zonal rather than uniform (e.g. retail-minus) access prices
- Pricing innovations (e.g., non-linear pricing)

PO/Regulator Strategic Challenges I

- Cost and Risk
 - Efficiency
 - Restructuring: Fixed cost reductions
 - Diversification
 - Definition, scope and execution of the USO
- Customer Focus
 - Traditionally weak area
 - Refined and driven by strategic necessities
 - Spectre of FMO
 - Electronic competition

PO/Regulator Strategic Challenges II

- “Competing on Analytics”
 - Marketing science driven
 - Supply chain optimization
 - Product Innovation and Technology
- Core Competencies
 - Wholesale and Access
 - Agility and synergies in the postal network
 - Trust and connectivity to customers

Conclusions

Volume declines from electronic competition are serious

Some relief from increased parcel business, but not much

Access and wholesale services are therefore a critical element of the future of POs

Regulation of access should be minimal

Under FMO, POs need to focus on the core-competence of POs in delivery and on integration with eCommerce

USO Backup Slides

Scale and Scope economies, Market dominance

- Retaining scale economies in low cost areas
- Scope economies rest on success in B2B and B2C and in leveraging the network in offering other products (e.g., financial services)
- Market dominance now transparent
- Source of USO funding and profit
- Regulatory and antitrust concerns

Increase in the Uniform Price(s) of Single-piece Mail

- Major component of reducing benefit of USO
- Small customers pay more in both low cost and high cost areas
- Face a monopoly except for electronic substitution

Reducing the Scope of USO

- Therefore the obligation/cost of the USO
- PO closures
- Adaptation of scope of services offered at selected POs and other changes in accessibility conditions
- Reduced frequency of delivery in high cost areas
- Elimination/relaxation of uniformity requirements for business mail products
- Several tradeoffs must be struck to achieve a balance between financial viability and loss of benefits from reduced USO.

Increased X-/dynamic efficiency

- Primary raison d'être for FMO
- Entry and efficiency
- New products along with greater customer orientation
- Will this work under continued public enterprise? – next section
- Requires increased pricing flexibility if better price-cost-value alignment is to be attained

Pricing Flexibility and Regulation

- Complete pricing flexibility unlikely while POs occupy dominant market position
- Regulators partially immunize against antitrust claims
- But most POs would prefer the antitrust risks to detailed regulatory controls
- Regulatory constraints reduce PO's ability to compete
- Pricing flexibility critical in determining success of FMO in postal markets

PCR Backup Slides

Implementing PCR with QoS

Each Product Basket s.t. PCR Formula

$$\frac{\sum_{i=1}^n P_{it+1} Q_{it}}{\sum_{i=1}^n P_{it} Q_{it}} \leq [1 + \Delta \text{CPI}_t - X(z)] + Y$$

ΔCPI_t = Change in CPI in period t

$X = X(z) = X$ -Factor (set as a function of achieved QoS “z” relative to benchmarks)

Y = Accounting for Exogenous Changes

Key regulatory choices: P_{i0} and $X(z)$

Designing $X(z)$ and USO

- Design of USO constraints on counter density and other objectively observable QoS indicators based on empirical studies of net benefits
- Less observable QoS indicators left largely to discretion of PO, with lower bounds set by regulator and with incentives for improvement set to balance incremental allowed revenue under PCR-QoS with net surplus generated from QoS improvements

Anacom (Portuguese Postal Regulator)

Quality of Service Indicators

Minimum, Targets, Objectives, Weight*

Quality of Service Indicators (QSI)				
N.º	Description	weight (%)	2006-07	
			Minimum	Target
QSI1	Conveyance time for Non-Priority Letter Mail (% in D+3)	45,0%	95,5%	96,3%
QSI2	Conveyance time for Priority Letter Mail (% in D+1) - Mainland	15,0%	93,5%	94,5%
QSI3	Conveyance time for Priority Letter Mail (% in D+2) - Continent; Azores; Madeira	4,0%	84,0%	87,0%
QSI4	Non-Priority Letter Mail not delivered within 15 working days (per 1000 letters)	5,0%	2,3‰	1,4‰
QSI5	Priority Letter Mail not delivered within 10 working days (per 1000 letters)	3,0%	2,5‰	1,5‰
QSI6	Conveyance time for Newspapers and Periodical Publications (% in D+3)	11,0%	95,5%	96,3%
QSI7	Conveyance time for Intra-community Cross-border mail (% in D+3)	3,5%	85,0%	88,0%
QSI8	Conveyance time for Intra-community Cross-border mail (% in D+5)	3,5%	95,0%	97,0%
QSI9	Conveyance time for Non-Priority Parcels (% in D+3)	5,0%	90,5%	92,0%
QSI10	Waiting time in a queue (% of observations ≤ 10 minutes)	5,0%	75,0%	85,0%

*From J. Castro & A. Franco (2009), "Price and Quality of Service Regulation in Portugal."

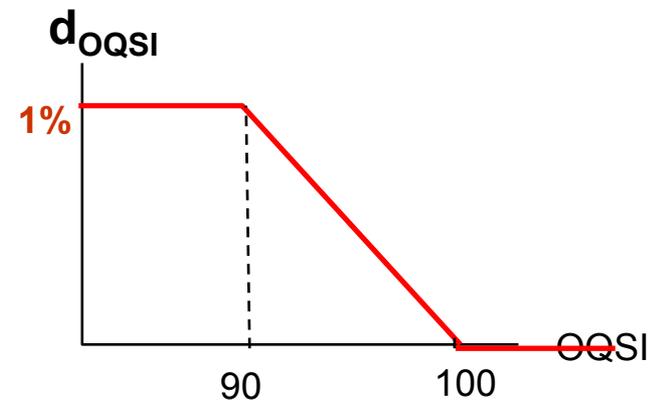
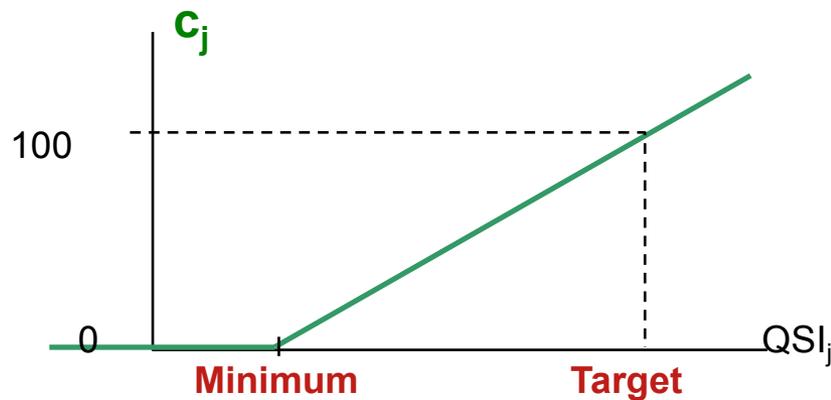
Anacom

Calculation of the Deduction Factor

- For a given QSI its contribution to the Overall Quality of service indicator is c_j

$$OQSI = \sum c_j * w_j$$

- w_j is the weight of QSI_j;
- C_j is the unweighted contribution of QSI_j for OQSI:

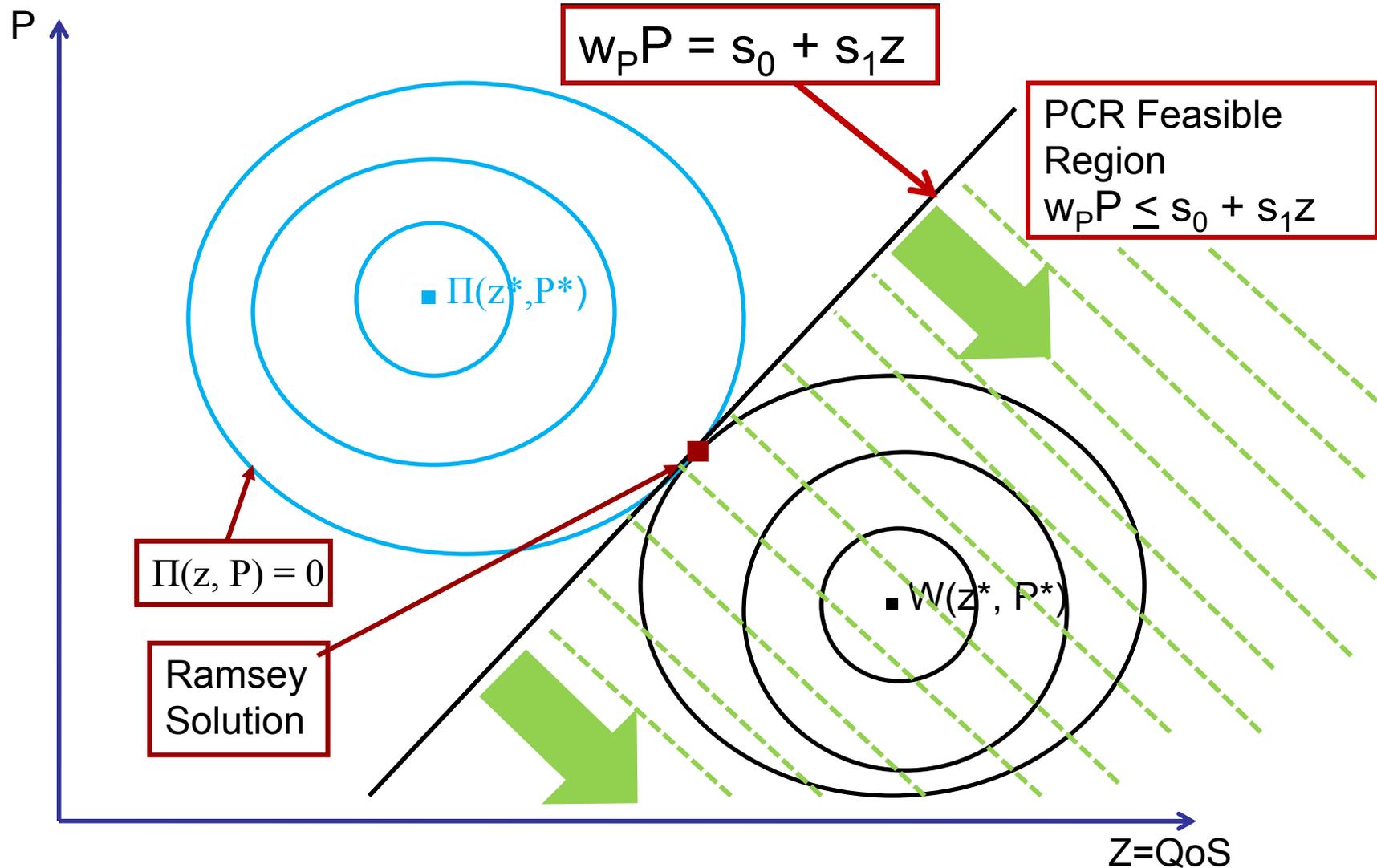


- Determination of the Quality factor (d):

$$d = d_{\min} + d_{OQSI}, \text{ d capped at 1\%}$$

where $d_{\min} = 1\% * w_j$ if QSI is below minimum

Quasi-Decentralized Implementation



Competition and Sustainability Backup Slides

Introduction

- Bypass of considerable importance with full market opening in 2011/13 (FMO)
- FMO already here for some e.g. Sweden, Germany, Netherlands and the UK
- Rapid growth in downstream Access
- Theory of downstream access and bypass has focused primarily on upstream worksharing or has assumed constant returns downstream operations

The Elephant in the Room

- Insufficient attention paid to electronic competition
- All attention given to allowing head-to-head competition through FMO
- USO continues
- USPS problems with no FMO
- Problem is clearly with economies of scale in delivery driven by large fixed cost of delivery under current USO

Efficient Access Pricing under FMO

- Consider a single zone with fixed E2E price P^I for the incumbent PO/USP and with access Price A
- Competitive market upstream... a single potential entrant in delivery
- Delivery is “contestable” so that the price charged by the entrant E is the minimum of E 's cost under access and under bypass.

$$P^E = \text{MIN} \left[C_u^E + A, C_u^E + C_d^E + \frac{F^E}{D^E(P^E, P^I)} \right]$$

Bypass very difficult for Entrants if the Incumbent has freedom to set A

- Theorem: If Entrant's AC of Delivery exceeds MC of Delivery for the Incumbent, then it is both efficient and profitable for I to set A so as to discourage bypass (with $A \geq MC^I$).
- Corollary: If the fraction of E's total delivery cost which is fixed is ϕ , then unless E's AC of Delivery is less than $(1 - \phi)$ times I's MC of Delivery, bypass is not efficient and would be discouraged by a profit-maximizing Incumbent.

Illustrating the Bypass Theorem

