



Review and assessment of An Post's terminal dues agreements

A REPORT PREPARED FOR COMREG – EXTRACT FOR PUBLICATION

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Executive Summary

Frontier Economics has been commissioned by the Commission for Communications Regulation (“ComReg”) to review and assess whether An Post’s agreements on inbound terminal dues rates¹ comply with section 29 of the Communications Regulation (Postal Services) Act 2011 (“2011 Act”).

The Universal Service Obligation (USO) section of An Post’s regulatory accounts suggests that An Post has been incurring significant losses in relation to international inbound mail. In light of this, ComReg initiated this review to assess whether An Post is compliant with the requirements of section 29 of the 2011 Act.

Section 29(1) of the 2011 Act stipulates that An Post’s terminal dues agreements for intra-Community (i.e. between EU Member States) must comply with the following requirements:

- a) Terminal dues shall be fixed in relation to the costs of processing and delivering incoming cross-border mail.
- b) Levels of remuneration shall be related to the quality of service achieved.
- c) Terminal dues shall be transparent and non-discriminatory.

Our review and assessment has focussed on An Post’s agreements on terminal dues with other EU Member States. For information purposes, we have also considered An Post’s non intra-Community terminal dues agreements.

Terminal dues agreements

The system of terminal dues covering most countries in the world is Universal Postal Union (UPU), which includes 192 designated operator signatories. The UPU Treaty, of which An Post is a signatory, requires An Post to deliver all international inbound mail items.

The UPU provides for countries to enter into alternative multilateral or bilateral agreements on terminal dues. In cases where bilateral or multilateral arrangements have been agreed, the rates designated under such agreements supersede the UPU rates.

¹ Terminal dues are the rates paid by a postal operator to another for delivery of international inbound mail items

In Europe, the REIMS² agreement is an alternative multilateral terminal dues agreement. ✂ EU designated operators are signatories to REIMS, including An Post. An Post also has bilateral agreements in place with ✂, ✂ and ✂³. The agreement with ✂ is the most significant as ✂ accounts for about ✂ of Ireland's international inbound mail volumes.

As most EU designated operators are either signatories to REIMS or have entered a bilateral agreement with An Post, proportionally little intra-community inbound mail to Ireland is priced under the UPU agreement. The UPU rates only apply to intra-community mail from countries not signed up to REIMS, or from countries where An Post has not agreed bilateral terms with that country's designated operator. Nevertheless, the UPU rates are still relevant for intra-community terminal dues due to it being the default agreement, as described above.

The delivery of cross-border parcels is not covered under REIMS, An Post's bilateral terminal dues agreements or the UPU terminal dues agreement. Terminal dues rates for parcels are set by the Enhanced-Parcel Group (EPG), which An Post has been a member of since the EPG was established in 1996.

Table 1 below shows An Post's 2014 terminal dues rates under the different agreements.⁴ For each format, we illustrate the rate applicable to one representative weight step, for ease of comparison. The table shows that for most intra-community international inbound mail, An Post has multilateral or bilateral agreements with inbound rates above the UPU terminal dues rates.

² Remuneration for Exchanges of International Mails

³ The REIMS agreement allows signatories to opt-out for some cross borders connections and parties can engage in bilateral agreements outside REIMS.

⁴ Note that throughout this report we use 2014 data as that was the latest available at the time of the analysis.

Table 1. An Post's 2014 terminal dues rates in euro

	Weight	Priority letters (20g)	Priority flats (100g)	Priority packets (250g)	Registered item (20g letter)
UPU	Transition⁵	✗	✗	✗	✗
	Target 2010 and 2012⁶	✗	✗	✗	✗
	Target pre-2010	✗	✗	✗	✗
REIMS	Core Group	✗	✗	✗	✗
	✗	✗	✗	✗	✗
Bilaterals	✗	✗	✗	✗	✗
	✗	✗	✗	✗	✗
	✗	✗	✗	✗	✗

Source: Frontier Economics analysis of terminal dues agreements

We note that An Post is net importer of international mail, that is, more international mail comes into Ireland, than goes out. An Post is different to most EU countries in this respect. This an issue because if multilateral or bilateral terminal dues agreements set rates below cost, An Post would lose more on inbound mail volumes than it would gain on outbound mail volumes.

Overview of An Post's international inbound mail

We find that over 80% of An Post's international inbound USO mail volumes originate from within the EU. At a country level, around ✗ of An Post's international inbound USO mail originates from ✗, making An Post's bilateral agreement with ✗ of particular importance.

An Post presently makes significant losses on its international inbound USO mail. For example, according to its regulatory accounts, An Post made a loss from USO

⁵ These rates apply to ✗.

⁶ These rates apply to ✗, ✗ and ✗.

international inbound mail of €13.4 million in 2013 and €14.8 million in 2014⁷. This is a significant ongoing loss, especially given An Post's low cash at bank and in hand balance (€49.9m at end 2015, €55.5m at end 2014).

The majority of those losses are from two formats: letters and registered items. Moreover, given that the majority of volumes fall under bilateral agreements, the majority of An Post's international inbound losses also arise from An Post's bilateral agreements, in particularly its agreement with \mathcal{K} .

Figure 1. An Post's 2014 USO international inbound profit and loss by format and agreement

\mathcal{K}

Source: An Post, 2014 Regulatory Accounts, An Post data file to ComReg, 14 October 2015

Our assessment of An Post's terminal dues

We assess An Post's terminal dues against the three criteria set out in section 29 of the Act as follows:

- Are An Post's terminal dues fixed in relation to the costs of processing and delivering incoming cross-border mail?
- Are the levels of remuneration related to the quality of service achieved?
- Are An Post's terminal dues transparent and non-discriminatory?

Criteria 1: Cost reflectivity

In order to assess whether An Post's intra-community terminal dues are "fixed in relation to the costs of processing and delivering incoming cross-border mail" we compare:

- the **relevant cost benchmarks** that An Post's terminal dues should be fixed against; and
- the actual level of An Post's **terminal dues rates** under the different agreements compared with the relevant cost benchmarks.

The relevant cost benchmark against which to compare terminal dues rates needs to be considered in relation to the wording of section 29(1)(a) of the Act and

⁷ We note that An Post continued to make a loss from USO international inbound Mail in 2015, with a loss of €13.2 million reported in their 2015 regulatory accounts. However the analysis in this report focused on data for year ending 2014, as this was the information available at the time of the review.

Article 13 of the Postal Directive, which both state the relevant costs are “the costs of processing and delivering incoming cross-border mail”.

The 2011 Act and the EU Postal Directive suggest that, in the context of terminal dues in Ireland, the most appropriate cost benchmark is An Post’s fully allocated costs (FAC). This includes all of the costs of processing and delivering incoming cross-border mail, including common costs that have been attributed to products according to a given allocation rule format using an (equi-proportionate) general allocator. In particular, as is typical in the postal sector, An Post has a large proportion of common costs which must be recovered via the appropriate users, rather than being cross-subsidised (for instance by domestic mailers).

We have also assessed two alternative cost benchmarks – attributable costs and retail-minus – which we use as a cross-check against our main findings. Note that our analysis uses 2014 data, as that was the latest available at the time of the analysis.

We find the following in relation to the cost-reflectivity of An Post’s inbound intra-Community terminal dues:

- REIMS:
 - We find that An Post’s terminal dues rates for letters and registered items under the REIMS agreement are below An Post’s fully allocated costs of processing and delivering incoming cross-border mail.
 - We find that terminal dues rates for REIMS packets appear to cover their FAC costs. As for flats, the terminal due rates cover their FAC at some weight steps but not at others.
- ✕ bilateral agreement:
 - We find that An Post’s terminal dues rates under the ✕ bilateral agreement for letters and registered items are below FAC costs. For flats and packets, their terminal dues rates are above FAC for some weight steps, but not for others.
- UPU:
 - We find that An Post’s terminal dues rates for UPU target 2010 and 2012 countries are below each cost benchmark across all four formats for most weight steps. It is worth stressing that these rates apply to only small proportions of intra-community mail handled by An Post.

These findings are summarised in Table 2.

Table 2. Summary of whether terminal dues cover An Post's fully allocated costs

Agreement	Cost benchmark	Letters	Flats	Packets	Registered items
UPU (target 2010 and 2012)	FAC	Red	Orange	Red	Red
REIMS (core group)	FAC	Red	Orange	Orange	Red
✕ bilateral agreement	FAC	Red	Orange	Orange	Red

Note: **Red** means terminal dues below cost benchmark at all weights; **orange** means terminal dues below cost benchmark for some weights, and **green** means terminal dues above cost benchmark for all weights

Criteria 2: Quality adjustment

Next we assess whether An Post's terminal dues levels of remuneration are related to the quality of service achieved.

We find that An Post's terminal dues levels of remuneration are related to the quality of service achieved for UPU, REIMS and ✕. Each agreement allows for the level of remuneration to be varied to take into account quality of service. Each agreement applies a quality of service incentive mechanism in practice.

Criteria 3: Transparency and non-discrimination

We consider transparency in relation to each of An Post's main terminal dues agreements.

- **UPU:** UPU terminal dues rates and methodology are published and publicly available, and therefore we consider that they are transparent.⁸
- **REIMS:** REIMS terminal dues rates are not published, but to the extent that EU designated operators can become signatories to REIMS, these rates are transparent to them. In relation to non-designated operators within the EU, we understand that REIMS rates are required to be made available to these operators. As such, An Post should continue to provide the details of these rates to these operators on request.

⁸ For example, see <http://www.upu.int/en/activities/terminal-dues-and-transit-charges/2014-2017-cycle.html>

- **✕ bilateral agreement:** This is a commercial negotiation between An Post and ✕, with ✕ being the largest originator of international inbound mail.

As the details of An Post's bilateral agreements are not publicly available, we recommend that An Post make publicly available the principles upon which it sets its terminal dues rates.

In relation to non-discrimination, we consider that non-discrimination means that terminal dues rates, and the associated conditions, apply equally to all users who post similar items under similar conditions. Therefore, we recommend that terminal dues rates should be non-discriminatory rates in relation to:

- **Designated and non-designated operators:** In order to limit the potential for competitive distortions, and thereby promote efficient outcomes for Irish consumers, terminal dues rates should be available to non-designated operators. This would mean that these operators would be better able to compete with designated operators for outbound mail to Ireland.
- **Cross-border and domestic:** Postage rates for cross-border inbound terminal dues should also be non-discriminatory and not be more favourable to international delivery operators than to domestic access seekers.

We find that the evidence suggests An Post's terminal dues do not discriminate between designated and non-designated operators, nor between inbound mail and domestic access seekers.

Conclusions

As can be seen from the analysis above, the majority of the compliance issues in respect of An Post's terminal dues are in relation to the cost-orientation requirements. **An Post incurs considerable losses on international inbound mail, which accounts for almost 40% of losses on provision of universal postal service.** Without action this percentage will likely increase over time. This is because, over time, the price cap decision should bring domestic universal postal service to profitability, assuming An Post meet its efficiency and volume projections, and therefore the losses on universal postal service are likely to be only in relation to international inbound.

Any assessment of An Post's ability to achieve compliance in the future must be cognisant of the fact that **An Post has a limited ability to negotiate terminal dues upwards.** This is because UPU is essentially the default terminal dues tariff which applies in the absence of an alternative multilateral or bilateral agreement. The UPU rates are below REIMS, and below the bilateral rates that An Post has negotiated with X , X and X . So to the extent that UPU rates are insufficiently reflective of the costs incurred by the delivery operator and are default rates, it is difficult for An Post to bring its termination rates closer to costs under the other two agreements of REIMS and bilateral. Moreover, there is an absolute requirement under UPU for An Post to deliver inbound mail. Even if An Post considered it advisable to do so, for commercial reasons, as a designated operator it could not refuse to deliver inbound international mail.

Under the REIMS agreement, there is a restriction on the scope for annual terminal dues increases. While terminal dues are linked to domestic prices, under REIMS terminal dues rates can increase by a maximum of $\text{X}\%$ per annum – and so not necessarily as fast as increases in domestic prices. This is an issue in the case of An Post. Its domestic prices increased significantly in July 2014 and by more than $\text{X}\%$. If An Post were to continue to increase its domestic price in line with the maximum allowed under the current price cap, then **it will therefore take a number of years for domestic price increases to be fully reflected in REIMS terminal dues rates.** We note that there are no equivalent automatic price adjustment mechanisms in any of the bilateral agreements negotiated by An Post.

An alternative means of achieving compliance would be for An Post to reduce the cost of processing and delivering incoming cross-border mail. In this regard, we note that An Post's price control included efficiency gains of 10% over the period 2014 to 2019.⁹

⁹ ComReg, 2014, Response to Consultation and Decision on price cap control for universal postal services

If An Post's efficiency gains were to be achieved, the gap between An Post's current terminal dues and its costs would therefore narrow substantially. We note that the benchmarking analysis undertaken as part of An Post's price control found that the efficiency gap was up to 22%,¹⁰ and therefore there is potentially even greater scope for efficiencies to close the gap between terminal dues and costs.

Table 3 shows the potential closing of the gap for REIMS priority letter rates between 2014 and 2019, which corresponds to An Post's current price control period. The gap between costs and terminal dues potentially closes due to a combination of decreasing costs resulting from an assumed 10% efficiency gain and rising terminal dues as over time terminal dues are increased (subject to the 5% per annum cap) to fully reflect 5%¹¹ of the domestic stamp prices. If we assume that An Post's terminal dues rates with 5% move on the same relative basis as REIMS, then there is the potential for terminal dues losses to significantly reduce over time.

Table 3. Potential change in terminal dues and costs per unit over time for REIMS priority letters

	2014	2019
Terminal dues rate¹²	€0.5	€0.5
FAC	€0.5	€0.5
Difference	€0.5	€0.5

Source: Frontier Economics' analysis

While the gap between terminal dues and costs can be expected to close over time, registered items can be expected to continue make significant losses on a per unit basis. This is because the additional premiums over priority items to derive a registered terminal dues are insufficient to cover the additional costs of handling a registered item. Such a gap is potentially best addressed in upcoming negotiations.

¹⁰ ComReg, 2014, Response to Consultation and Decision on price cap control for universal postal services

¹¹ The REIMS agreement bases An Post's terminal dues off 5% of its domestic prices.

¹² We note that terminal dues rates are also impacted by exchange rate fluctuations. For 2019, we have assumed a euro-equivalent rate of 5% of the domestic stamp rate.

Recommendations

We find that **losses on An Post's international inbound universal postal service will continue to occur unless action is taken** by An Post and in the upcoming negotiations of terminal dues agreements. As discussed below, there may be a role for the State in these negotiations. An Post's international inbound losses are primarily in respect of letters and registered items, as packets and parcels are largely covering the cost of providing those services. We consider that it will be critical to keep An Post's terminal dues under review as losses on international inbound are major component of losses on universal postal service and are of concern, especially given concerns over An Post's financial position.

We note that there are upcoming terminal dues negotiations. We consider that **action can be taken by An Post and the State¹³ to ameliorate future international inbound losses.**

- **UPU:** UPU is significant factor in losses on international inbound. Losses. UPU is causing significant losses on international inbound registered letters. UPU rates also set a floor for other international inbound terminal dues rates. UPU is a treaty level agreement, and therefore there is a role in the negotiation for the State (and An Post as the designated operator) to increase UPU rates for Ireland as the rates do not currently cover cost. The 2012 UPU agreement on terminal dues is effective from the beginning of 2014 until the end of 2017. The next round of negotiation is due to be discussed at the next UPU Congress in Istanbul, Turkey in 2016. Our view is that consideration should be given as to how Ireland's interest can be best represented at the upcoming multi-lateral negotiations given the current losses on international inbound and that Ireland will likely continue to be a net importer of international mail.
- **European agreement:** As An Post noted, the upcoming European negotiations are likely to focus on the Interconnect (eCIP) agreement, as a replacement to REIMS. An Post advised that these negotiations are likely to conclude within the next two years. Our view is that consideration should be given as to how Ireland's interest can be best represented at the upcoming multi-lateral negotiations. That is, how should representatives of the State and An Post negotiate for Ireland? Rates for intra-community mail to Ireland under REIMS, and potentially under eCIP in the future, need to be increased as those rates are not currently covering the costs of providing those services.

¹³ Such as representations from the Department of Communications.

REIMS also currently has a 3% maximum per annum price increase. This is impacting An Post, as due to the large 2014 domestic stamp price increases, it will take up to 3 years for domestic price increases to fully flow through to REIMS terminal dues rates. Negotiation in relation to REIMS or eCIP should ideally remove this maximum per annum price increase.

- **3 bilateral:** We understand that An Post is currently in negotiations with 3. The rates An Post has negotiated with 3 for inbound mail are currently insufficient to cover An Post's cost. Our view is that An Post should share with ComReg the outcome of its future bilateral negotiations. This would enable ComReg to continue to monitor An Post's compliance with the Act.

We also recognise that **An Post could become more efficient in relation to costs**. As noted, ComReg's price cap decision notes that An Post is up to 22% inefficient. As An Post becomes more efficient over time, An Post's cost base should reduce thereby reducing losses on international inbound mail.

On the basis of the above assessment of An Post's terminal dues, we make the following specific recommendations:

1. An Post's on-going compliance with section 29 of the Act should be monitored, given significant losses in international inbound mail being incurred.
2. Consideration should be given as to how Ireland's interest can be best represented at the upcoming multi-lateral negotiations. That is, there may be a role for the State and An Post in negotiating future agreements, as current terminal dues rates are insufficient to cover An Post's costs, and therefore do not comply with section 29 of the Act.
3. An Post should share with ComReg the outcome of its bilateral negotiations to enable ComReg to monitor An Post's compliance with the Act as its current rates are not sufficient to cover its costs of providing international inbound services.
4. ComReg should monitor An Post's performance against its efficiency targets. A large component of the gap between terminal dues rates and An Post's costs can be closed if An Post meets its efficiency targets as set out in the price cap decision.
5. The 3% cap on terminal dues increases in REIMS (or, in the future, eCIP) should ideally be removed, or significantly increased. This would allow terminal dues to be better aligned with An Post's costs.
6. To improve transparency, in particular for non-designated operators, the principles which An Post uses to set terminal due rates should be made publicly available.

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