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# Determining the correct compensation for Services of General Economic Interest

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# Overview

- Part I** Preliminary remarks
- Part II** Overview of the approach to construct the counterfactual
- Part III** Implications for future state aid assessments
- Part IV** Concluding remarks

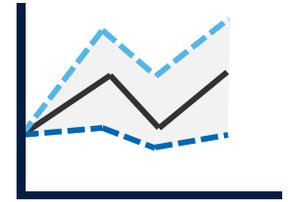
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**Part I**

**Preliminary remarks**

# Constructing the counterfactual scenario

## Preliminary remarks



- to an extent, competitive constraints have previously been taken into account in order to construct the counterfactual scenario
  - in the 2016 bpost decision, the Belgian authorities recognised that higher prices to distribute newspapers and periodicals would result in a decline in demand<sup>1</sup>
- however, in the recent La Poste press distribution decision<sup>2</sup>, the Commission has highlighted in detail the wide range of potential sources of competitive constraints in formulating pricing strategies in the counterfactual scenario
  - La Poste's press delivery services, considered to be a SGEI, could compete with other delivery companies, newspaper stands as well as tablets (i.e. e-delivery)



Is it feasible to do adopt this methodology for USO decisions? Does the approach provide a more precise estimate of USO compensation?

<sup>1</sup> European Commission (2016), 'State aid SA.42366 (2016/N) – Belgium State compensation to bpost for the delivery of public services over 2016-2020', 3 June, paras. 211 and 212. <sup>2</sup> European Commission (2019), 'Aide d'Etat SA.48883 (2018/N) – France Compensation de la mission de service public relative au transport et à la distribution de la presse pour la période 2018-2022', 24 January. SGEI denotes Services of General Economic Interest.

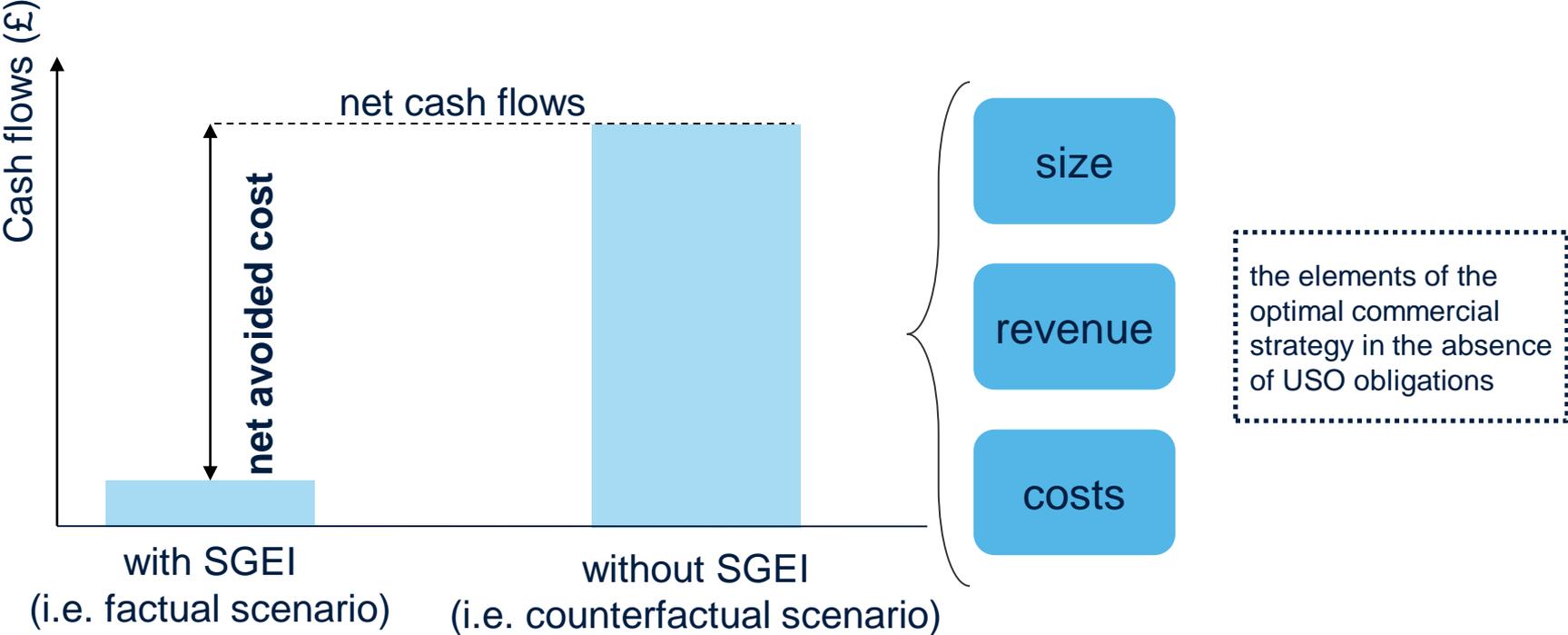
## Part II

# Overview of the approach to construct the counterfactual

# Overcompensation assessment

## The net avoided cost (NAC) methodology

- it is common in the postal sector to use the net avoided cost (NAC) methodology



# Defining the counterfactual (I)

## Case study: Czech Post

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1. What elements would change in the absence of USO funding?

- a number of post offices would close
  - based on their internal accounting system, Czech Post estimated the profitability of each post office in its network, with unprofitable branches assumed to close
- some routes would have lower delivery frequencies
  - based on a nationwide monitoring exercise, Czech Post observed the frequency and number of letters delivered to individual points
- some administrative processes assigned only to the USO provider would end
  - such as recording and auditing of separate accounts for activities that receive state compensation

European Commission (2018), 'State Aid SA.45281 (2017/N) and State Aid SA.44859 (2016/FC) – Czech Republic – State compensations granted to Czech Post for the provision of the universal postal service over the period 2013-2017', 19 February.

# Defining the counterfactual (II)

## Case study: Czech Post

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2. Incorporating the financial impact of the changes in the counterfactual scenario

- expected loss of revenues due to post office closures estimated from internal accounting data and market surveys
  - Czech Post expected that some demand would migrate to other post offices; however, others would be lost to competition
    - as a result, some increase in capacity and costs expected at profitable post offices to accommodate the expected increase in demand
- lower frequency of delivery would reduce costs in the counterfactual scenario
  - avoidable costs include salary costs, fuel and vehicle costs
- lower administrative costs in the counterfactual scenario

European Commission (2018), 'State Aid SA.45281 (2017/N) and State Aid SA.44859 (2016/FC) – Czech Republic – State compensations granted to Czech Post for the provision of the universal postal service over the period 2013-2017', 19 February.

# Part III

## Implications for future state aid assessments

# Potential implications



- analysing competitive constraints in detail when constructing the counterfactual is likely to lead to increased use of empirical data (e.g. market surveys)
- deeper understanding of drivers of demand would be necessary, together with analysing the impact of other substitutable products and services on prices and demand in the counterfactual
  - although in the La Poste press delivery decision, the Commission identified press editors and readers as the two principal elements, this could be more complicated in other SGEI decisions
    - it would be crucial to identify suitable empirical evidence that could be used to support the various assumptions in the counterfactual scenario
- if there is limited empirical evidence, economic theories can be used to support key assumptions
  - identifying plausible conservative alternative methodologies and sensitivity testing of base case results remains important

European Commission (2019), 'Aide d'Etat SA.48883 (2018/N) – France Compensation de la mission de service public relative au transport et à la distribution de la presse pour la période 2018-2022', 24 January.

# Case study: UK Post Office Ltd (I)



UK Post Office Limited (POL) maintains two types of SGEI among its activities:

- **network SGEI**—maintains a network of offices beyond commercial size (universal service)
- **product SGEI**—process payments, provide access to banking facilities, etc.

## Notified measures in the 2018 decision

- compensation for the normal cost of delivering the Network SGEI
- exceptional investment costs



## Counterfactual scenario

optimal commercial strategy

income  
—  
cost  
—  
net profit

Need to construct a counterfactual scenario under the net avoided cost approach

Source: European Commission (2018), 'State aid SA. 48224 (2018/N) – United Kingdom. Compensation to Post Office Limited for costs incurred to provide SGEIs 2018-2021', 20 February.

# Case study: UK Post Office Ltd (II)

## Constructing the counterfactual scenario



### Approach used in the 2018 decision

- income from profitable branches is expected to be fully retained, i.e. no changes to the product SGEI
  - a branch is deemed profitable if revenue is greater than direct costs and an allocated portion of shared costs
  - unprofitable branches will be closed
- demand from branches that are closed in the counterfactual scenario would migrate to the profitable branches
  - retention rate of income generated at closed branches is estimated based on past experience at POL and for the top 15 products only



### Illustrative examples of potential changes?

- product SGEI could be assessed on a product-by-product basis
  - is it reasonable to assume that the price of each product would remain the same? how to determine the price elasticity of each product? how to quantify any cross elasticities or the effects of changing the pricing strategy of one product on other products?
  - who are the alternative providers for each product? who may be potential new entrants to the market?
  - how would the retention rate of demand at profitable branches and the migration rates from closed branches to profitable ones be affected?
- how could the above information be used to determine the maximum network size?

# Part VI

## Concluding remarks

# Concluding remarks

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- the construction of a counterfactual scenario requires an element of judgment
- the Commission's La Poste and Poste Italiane press decisions imply a greater role for economic analysis
  - in addition to the previous focus on an empirical approach, there is a greater role for insights from economic theory
  - economic theories could be used to tailor the results from empirical studies



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