



Bulletin

Water
 Energy
 Retailing
 Transport
 Financial services
 Healthcare
 Telecoms
 Media
 → Post
 Competition policy
 Policy analysis and design
 Regulation
 Strategy
 Contract design and evaluation
 Dispute support services
 Market design and auctions

JULY 2002

Message in a model

MANAGING COMPETITION IN POSTAL SERVICES

The European Commission has decided to liberalise the postal sector gradually, rather than sparking off a "big bang" with a competitive free-for-all. This cautious approach, also adopted in the UK, reflects the view that existing postal operators may not be able to maintain a universal service at a uniform price in the face of sudden competition. In a paper presented at a postal conference in Potsdam, Germany, Frontier staff have developed a model of the economics of entry into the postal sector, and used it to help identify the conditions under which it may be possible for rival operators and incumbents to co-exist, without the latter facing financial meltdown.

Until recently, in most countries there was only one, national postal organisation that could deliver your mail. Such "post offices" had been granted a legal monopoly. In return, they were required to deliver mail to all addresses in the country at a single tariff – the same whether this was cheap to do (e.g., delivering to a city centre apartment) or expensive (e.g., delivering to a remote island farm). This requirement of national →

delivery coverage on a daily basis at a uniform tariff is called the "universal service obligation" or USO.

Because the price is the same, but costs differ, the profitability of different services obviously varies greatly. Postal operators use their profitable operations to subsidise the unprofitable ones, thus covering the fixed costs associated with this USO.

However, the onset of more competition in this sector – at the behest of the European Commission and national postal regulators – will disturb the status quo. Existing postal operators, providing a universal service (which we will call "incumbents" to distinguish them from new entrants) are warning that they may not be able to continue to meet the USO.

Their argument is simple: new postal competitors will target the more profitable areas, where the uniform tariff (the price of the stamp) is well above the cost of handling mail. By "cherry-picking" this low-cost business, they could undercut the incumbent's uniform tariff and poach customers. The incumbent would be left with fewer profitable services on which the margins can be used to subsidise expensive deliveries, which new postal competitors would have no interest in targeting. For the incumbent, the USO then becomes a real burden. Increasing its uniform tariff would only make matters worse - offering more opportunities for undercutting by rivals.

Competition is supposed to act as a spur to efficiency. But, incumbents argue, even the most efficient of them would struggle to carry the burden of the USO, when facing competition from cherry-pickers.

This is indeed a serious cause for concern. But incumbents do have a number of advantages, notably the power of their brands – which may make customers reluctant to switch – and the fact that the incumbents are well-established in the mainstream of customer demand. Economic analysis suggests that new entrants may well seek to avoid the head-to-head competition that would result from targeting the most profitable services. And indeed, in Sweden and New Zealand, where firms are free to set up new postal businesses, entrants have decided not to build their business model on cherry-picking strategies.

THE POWER OF THE BRAND

The belief that postal incumbents possess valuable brands is important to the argument. It means that they may be able to charge a higher price than unknown newcomers for the same service. Why should this be so? Three main reasons come to mind.

- First, mailers know by experience that their mail will get to its final destination in a given time (say, 90% by the next day) and that there is a relatively low chance it will be lost or stolen. Thus there is a *quality assurance* element to the brand.
- Secondly, letters handled by the incumbent are seen to benefit from a "recipe" that works, thanks to the know-how of the incumbent and its ability to organise a large-scale operation to deliver the mail on a daily basis. There is a *confidence* element springing from the USO itself.
- Thirdly, the incumbent postal organisation has "always" been there – there is a *longevity* element stemming from the history of a national institution behind the postal brand.

Brand image is likely to be more important in post than in, for example, electricity and gas (which saw rapid switching to new entrants once competition was introduced) because of the different risks associated with service provision. The 'lights go out' on an electricity customer if there is a system-wide failure rather than because its retailer has failed. Consequently, with service taken as given, switching in the energy sector was largely determined by price differentials. In the postal sector, if a customer's post is

Message in a model

undelivered, then this will not be due to a systemic failure, but will be entirely due to the individual operator serving the customer. Consequently, in post, switching will not just be driven by price but also by the confidence customers have in the ability of the new entrant to offer a reliable service.

So the incumbent's brand may translate into an ability to charge a premium, despite the offering of equivalent products by new entrants. Or, at least, the incumbent may find it easier to retain customers. Of course, the strength of the brand can be expected to vary by customer types. Large users of mail may perhaps be readier than private households to try alternative postal suppliers.

If the brand strength of the existing postal operator makes it difficult for new entrants to succeed by offering a more or less identical product, they may prefer to attack on another front.

TRY ANOTHER TACK

Economists (led by the work of Harold Hotelling) have developed tools for analysing the choices faced by new entrants seeking to win market share. On the one hand, they can offer similar products to their rivals, but at lower prices. On the other, they can attempt to differentiate their products, set higher prices, and target a niche market and – by coming into the market with some kind of differentiated product offering. The Hotelling model helps to determine what degree of product differentiation will be the most profitable for the entrant.

Frontier Economics has built such a model to examine how entry might occur in the postal market. In the simplified model, two postal operators, National Post (the incumbent) and NewPost (the entrant) each offer a special postal service for business customers, which can choose freely between them. National Post delivers throughout the country (in both rural and urban areas). NewPost delivers only to urban areas and relies on access to National Post for rural delivery of its mail.

National Post was first in the market with its business mail product, and this partly explains the brand loyalty it enjoys, which is incorporated into the model. However, National Post's product may not perfectly match all customer needs: some of its features may be over-specified for some customers, or under-specified for others. What NewPost has to do is decide its own product position relative to that of National Post – and choose how many new features are required to differentiate its product sufficiently to win market share.

For different profiles of National Post – that is, its price and product position and the strength of its brand - the model helps to determine the best position for NewPost, i.e., the one that will maximise profit. The model can then be used to calculate the market share that the entrant could expect to capture, which is then translated into profits for both the incumbent and the entrant – using parameters whose values reflect the actual cost features of the postal sector. These include the high fixed costs for the incumbent, because of the USO, and marginal costs for both operators.

THE MODEL'S RESULTS

The model suggests that, to maximise profits, a new entrant should usually seek to differentiate its product as much as possible from that of the incumbent, especially if the incumbent has a strong brand. Competing with a similar product to the incumbent's at a cheaper price would be difficult, because the entrant would have to undercut prices significantly to win over the incumbent's loyal customers. Furthermore, a niche product may encounter less fierce price competition from the incumbent than an attempt to go "head to head" for a core market is likely to provoke. This suggests that the threat to the financial viability of the incumbent may be less significant than many incumbents fear.

Existing postal services may, therefore, be able to continue to meet the USO under

competition. The strength of brand and the product position are, of course, all-important. But challenging an incumbent that enjoys a strong brand with a good product range may not prove as easy as it looks. Indeed, under some assumptions about the incumbent's brand and position, a would-be competitor may not even find an entry strategy that is worth pursuing, especially if the incumbent is cost-efficient.

THE MESSAGE

Such models are, of course, useful not only to would-be entrants but also to incumbents and regulators. They help to clarify the conditions under which competition is likely to result in difficulties for existing postal operators. The following points summarise the message from each perspective.

- For *new entrants*, the key question is the strength of the incumbent's brand. The greater this is, the more likely it is that success will depend on product differentiation. The stronger the existing brand, the harder entry will be without a "niche" product. A second message is the importance, to entrants, of building their own brands, as a countervailing force, in this service-sensitive market.
- For *the incumbent*, the model also highlights the importance of the brand, emphasising the importance of doing nothing to undermine a strong one and everything to boost a weak one. It also indicates that the incumbent should seek to enlarge its product variety – reducing the niche territory available to the entrant. In other words, the incumbent should get into the entrants' backyard!
- For *the regulator*, the model illustrates the interplay of actions by both incumbent and entrants. While being aware of the burdens on incumbents following from the USO, they may also need to be aware of their competitive strengths – and may need to regulate the incumbent's expansion of its product range if liberalisation is to result in genuine choice.

Introducing competition into the postal market requires an understanding of the key drivers of market outcomes – the relative costs of incumbents and new entrants, the existing product range, the brand value of incumbents and so on. With these drivers in mind, it is possible to identify those national incumbents that are at greater financial threat than others from market liberalisation – regulatory authorities can then develop tailored remedies that are appropriate for their specific case.

CONTACT	Phil Burns philip.burns@frontier-economics.com
	Frontier Economics, 150 Holborn, London, EC1N 2NS UK
	BOSTON LONDON MELBOURNE
	www.frontier-economics.com