Cost orientation in pricing - problem for the Czech Post

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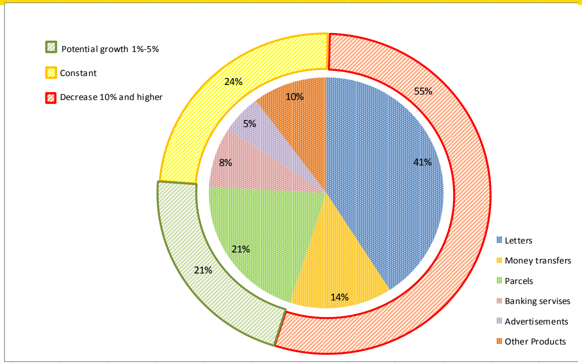
Purpose and goal of the presentation

- Basic definition remain unclear/wide, difficult to explain to authorities, strong penalty, return to strongest form of price regulation,…

- Are following problems more common throughout other postal operators?
- If yes:
  - Get a feedback
  - Get in touch with special departments responsible for agenda
  - Contribution to further discussion about the purpose of cost orientation

Brief Introduction of the Czech Post

- Main product trends
  - Decisive role of universal services
  - No real substitution in required size
  - No possibility to compensate in prices
  - Databoxes – really paid by CP



- Principals of separate evidence accounts
  - 20 years development from model to separate accounting module SAP
  - From cost centres (branches, delivery offices, sorting centers,…) to processes per standard working duties, from process to product per volumes x standard times (norms)
  - In principal equiproportional
- USO burden NAC
  - Number of branches (3200 x 691), D+1 for delivery
  - First pay in March 2018 (5 years delay), political limit without respect to real needs
- Regulation and P/L
  - Till 2012 price cap, since 2013 formally no price regulation x COP requirements
  - CP generates stabil profit for 20 years (until 2012), 2012 – now increasing loss

What is really cost orientation?

- Generic definition gives space x does not give specific know how
  - Regulator: „Cost orientation is only that price which covers fully proportionally alocated (historical) costs including costs of USO burden and creates reasonable profit“ – true or false?
  - Consequency: If priced below definition, compensation will be reduced
  - Subsequent questions:
    - Is USO burden to be covered with price?
    - What is the role of proportional alocation of shared costs – development in time?
    - Every single servis or universal services as a group – what is single servis?

Current regulatory attitude in Czech Rep. x CP

- Regulator:
  - the only space is in profit, CP can reduce rate of profit up to zero for group, not any of single products can be priced under FAC
- CP:
  - USO burden cannot be from principle covered (other competitors do not carry, compensation yes when covered by price, penalty when really needed, conflict with overcompensation principle
    - Regulator: compensation is to cover gap between plan and reality
    - CP: ???
  - USO burden cannot be alocated proportionaly (=direct cost of USO services)
    - Regulator: every single component of network is shared with all products coming through
    - CP: Proportional alocation in principal inadequate when portfolio development asymetric in the network and permanent total decrease identified
  - Group x individual product
    - Does not give any space for business reaction
    - Strongest form of regulation on liberalized market and formally not regulated prices
    - Non-market price liquidates universal product
    - Price represents value added for customer, cost progression is not identical (more flat)

Related – USO burden and separate accounts

- USO burden calculation – why it is important?
  - What is real size? When to reduce?
    - Number of branches
    - Matrix of losses
    - Workload increase limits
    - Real alternative scenario for deliveries
  - WACC – how in real time, get a link to separate acccounts,…
- Principals of separate evidence accounts
  - USO burden are direct costs (see Directive) – how technically implement into system?
  - How to avoid wrong cost information – fix proportion? Alternatives?
  - Link to financial accounting (underinvestments, gap in market wages,…)

What is the correct price?

- Hypothesis I: Cost oriented price is higher than avoidable/incremental market costs (without USO burden) plus minimal conribution margin and lower than FAC with USO burden plus reasonable profit. As orientation level, when starts the risk price could influence competition negatively, the data from separate evidence could be taken (costs of universal service without USO burden).
- Hypothesis II: the correct price is price which maximizes sources for covering shared fixed costs potentially including USO burden = maximizes contribution margin = minimizes compenzation from state

How the regulator could approve price level?

- Long term „price plan“?
- Price cap formula for minimum price increase? Based on structures and volumes of the first period? Only for retail segment?
- Marketing analysis of the CP? CP is primarily responsible for it´s business.
- Marketing analysis of some independent subject? Is there any qualified subject for such type of decision?
- Is that legitimate request from regulator? Other subjects responsible for control of predatory pricing, …
- Any alternatives?

Summary

- COP is every price inside certain interval, not exactly one figure.
- More important than space in profit is look at cost structure (which costs should/must or should not be included)
- COP and it´s control is possible only when USO burden and separate accounts are linked together (USO burden in correct sum is direct cost of universal service and this information is transferred into separate accounts).
- It is extremely difficult to find agreement on one optimal price between different subjects – primarily it is operator´s responsibility, regulatory authorities should focus on impact on competition (predatory pricing).
- The ability to contribute to cover part of USO burden with prices is on decreasing market only temporary.
- Liberalization and competitive environment but regulators insist on exactly same pricing like in monopoly.

Thank you for your attention

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