PUBLIC EXPENDITURE EVALUATION 2018

PROJECT 7 (CORREOS)

STUDY

REPORT ON THE EVALUATION OF SOCIEDAD ESTATAL CORREOS Y TELÉGRAFOS, AND PROVISION OF THE UNIVERSAL POSTAL SERVICE

AIReF
Independent Authority for Fiscal Responsibility

Autoridad Independiente de Responsabilidad Fiscal

The Independent Authority for Fiscal Responsibility (AIReF by its Spanish acronym) was created with the mission of ensuring strict compliance with the principles of budgetary stability and financial sustainability set out in article 135 of the Spanish Constitution.

AIReF Contact

C./ José Abascal, 2, 2.ª planta 28003 Madrid
Tel. +34 910 100 599
Email: info@airef.es Web: www.airef.es

CONCLUSION OF THE EVALUATION

In the context of the Spending Review carried out by AIReF in 2018, the provision of the Universal Postal Service –UPS UPS) by *Sociedad Estatal Correos y Telégrafos, SA* (hereinafter referred to as *Correos*) has been evaluated. The UPS is the set of postal services subject to public service obligations (PSO) and that must be provided permanently throughout the national territory and at an affordable price for all users. The State has entrusted *Correos* with the provision of this service for the period from 2011 to 2026. *Correos* receives compensation for the financial burden borne from providing this service.

This study analyses the strategy and procedure for determining the public cost and conditions for the provision of the UPSUPS in the 2011-2020 period. In addition, the efficiency of the designated operator is also studied, as the amount of compensation depends on this.

Currently, the service delivery plan implemented by the current Postal Law (2010) is pending approval and the UPS is compensated by instalment payments. For the 2011-2020 period this amounts to approximately 1,450 million euros.

The main conclusions of AIReF's analysis are as follows: 1) the net cost of the UPS in Spain is high compared with other countries; 2) there is a delay of nine years in the approval of the service delivery plan that creates legal uncertainty and does not allow the cost of this service to be calculated; 3) the service delivery plan being prepared does not facilitate a future reduction in the public cost, adaptation to a growing demand, nor rationalisation and simplification of the net cost calculation without relying on the operator and introducing efficiency incentives; 4) the operator has room to improve its efficiency in both revenue and expenditure; and 5) without a strategic reorientation the operator will continue generating losses. The following table summarises the major findings:

Strategy and procedure evaluation of the public cost	Compensating the service with public funds is not the norm in other countries. The cost of the UPS in Spain is comparatively high	*Correos* presents a negative operating deficit and higher than the rest of operators in the postal sector	The cost of the UPS is practically the same using several proposed methods	The two studied service delivery plans do not have enough efficiency incentives
Operator efficiency evaluation: strategic uncertainty and higher future costs.	The discounts offered by *Correos* are higher than those of the neighbouring countries	On the cost side, *Correos* has adjusted less than other countries in spite of the fact that demand has fallen more *Correos* has not explored strategies for diversification and outsourcing	The volume of letters is decreasing and is partially offset with the increase in parcel services The parcel market is more competitive and with lower margins	There are three different networks with limited synergies between them

As a result, AIReF proposes:

Regarding compensation

1. The *Ministerio de Fomento* (Ministry of Public Works), in collaboration with the *Ministerio de Hacienda* (Ministry of Finance), should take responsibility for defining the new calculation methodology and make the public service obligations more flexible to reduce the cost of the UPS.

2. The compensation should be simplified and focused on the territorial deployment of the network, including exclusively rural areas or areas where volumes are low and do not allow an adequate return.

Regarding operator efficiency

1. Support the transition of a company focused on the conventional sector towards
2. different and very competitive markets such as urgent parcel services.

3. Make an efficiency plan to reduce the current costs, based on an analysis of the different phases of its value chain, and increase synergies among the three current operational models to adapt the volumes of each of the networks to the capacity and staff available.
4. Continue efforts towards automation, simplification of the organisational structure, study of activities that could be outsourced and reduction of the time dedicated to lower value-added activities.

5. Review the revenue and discounts policy of large clients.

6. Promote new sources of revenue based on different paths for diversification. Consider the possibility of taking advantage of the network deployment to provide other public services to citizens.

1

SUMMARY OF THE EVALUATION

1.1. Background

Project 7 evaluates the provision of the Universal Postal Service - UPS by *Sociedad Estatal Correos y Telégrafos, SA* (hereinafter referred to as *Correos*). The UPS is the set of postal services subject to public service obligations (PSO) and that must be provided permanently throughout the national territory and at an affordable price for all users[1]. The State has entrusted[2] *Correos* with the provision of this service for the period from 2011 to 2026.

The regulation of the UPS corresponds to the Government and the *Ministerio de Fomento* (Ministry of Development), which is also responsible for funding this service for support under its budget. Moreover, the *Comisión Nacional de los Mercados y la Competencia* (National Commission on Markets and Competition - CNMC)[3] holds the functions of supervision and control of the postal market.

[1] The service includes the collection, admission, sorting, transport, distribution and delivery of national and cross-border shipments in the ordinary scheme for letters and postcards of up to 2 kilograms and parcels of up to 20 kilograms.

[2] First additional provision of Law 43/2010, of 30 December, on the universal postal service, the rights of users and the postal market.

[3] The CNMC holds the function of resolving disputes between economic operator through the Law 3/2013, which defined that, with the constitution of the CNMC, the Comisión Nacional del Sector Postal (National Commission of the Postal Sector) was extinguished, defined as a body for such purpose in Law 43/2010.

The postal service was liberalised in Spain between 1997 and 2010 by the transposition of several European Directives. This process ended with the Postal Law of 2010[4] (in force today) that transposed Directive 2008/6/EC. The service delivery plan, which should include the specific conditions for provision of the UPS and the methodology for calculating the net cost and financial burden, and the regulating Contract implemented by this law have not yet been approved. Pending the adoption of the new regulations, *Correos* is managing the service with the previous delivery plan, which dates back to 2000[5].

Correos must determine the net cost of the PSO and submit the cost to the CNMC for verification and for the calculation of the financial burden. In the absence of a new Plan and a new contract, CNMC is not carrying out any of these functions. As a consequence, payments to *Correos* for the UPS are being made via instalment payments. The *Ministerio de Fomento* is in charge of incorporating these amounts into its budget. The instalments paid amount to some 1,450 million euros for the 2011-2020 period and are largely conditioned by the budgetary needs of the Administración General del Estado (Central State Administration - AGE).

A working group has been operating over the past two years with the participation of the *Ministerio de Fomento* and *Correos* to develop a new service delivery plan. The draft plan was sent to Brussels in 2018 for approval. At the date of preparing this report there was no definitive version, therefore the latest draft submitted was studied.

1.2. Overview and methodology

Sociedad Estatal Correos y Telégrafos, Sociedad Anónima, was founded in 1716 and is the parent company of the *Correos* group and acts as the designated operator for the provision of the UPS. *Correos* manages both the postal service and the network structure, which is deployed throughout the territory. Some of the most important characteristics of *Correos* are as follows[6]:

[4] Law 43/2010, of 30 December, on the Universal Postal Service, the rights of users and the Postal.
[5] Decree 1829/1999, of 3 December, approving the Regulation regulating the provision of postal services, implementing the provisions of Law 24/1998, of 13 July, on the Universal Postal Service and Liberalisation of Postal Services.
[6] Source: *Correos* 2017 Annual Report.

CORREOS IN FIGURES[7] (2017)

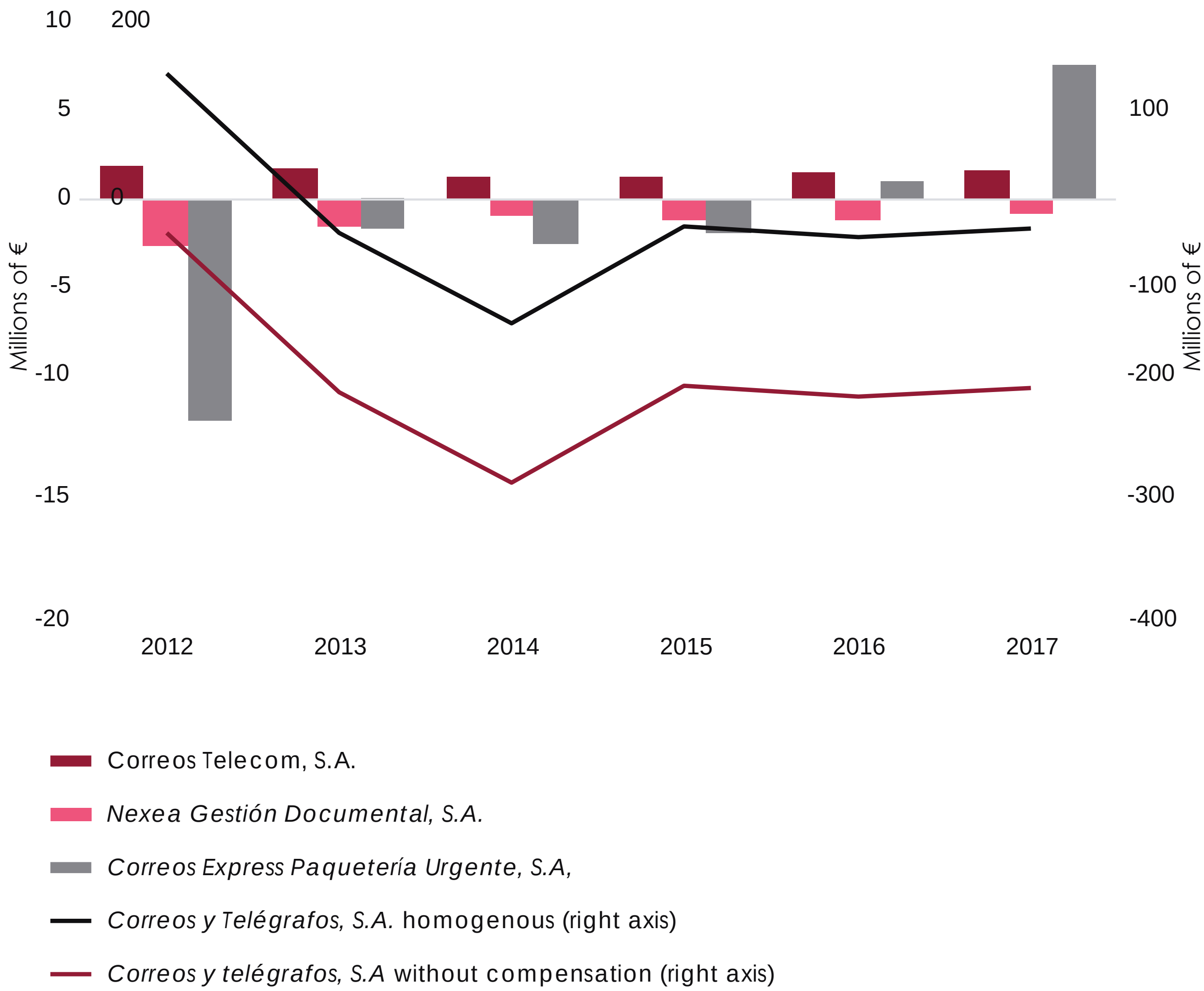
Source: Operator's 2017 annual report and report *Analysis of the postal sector and the dispatching and parcel service sector. 2017*.

Correos is the head of a business group composed of four companies: *Correos matriz* and its subsidiaries *Correos Express* (urgent parcel service), *Correos Nexea* (document management) and *Correos Telecom* (group telecommunications). The *Correos* group is 100% public and belongs to *Sociedad Estatal de Participaciones Industriales* (SEPI).

As seen in the following figure, *Correos matriz* has recorded losses since 2012, with a cyclical low in 2014, closely related to the fall in postal demand . In recent years, it has stabilised at a structural deficit that, without compensation for the UPS, would be around 220 million euros[8]. *Correos Express* and the other subsidiaries represent a very small part of the group's results.

[7] The data on the market share comes from the Traditional Postal Sector segment.
[8] The left axis shows the results of Correos Telecom, Nexea Gestión Documental and Correos Express Paquetería Urgente, while the right axis shows Correos y Telégrafos.

CONSOLIDATED PROFIT AFTER TAX OF *CORREOS* GROUP COMPANIES WITH AVERAGE COMPENSATION OF 180 M€[9]



Source: Annual reports of the designated operator.

This study focuses on analysing the strategy and procedure for determining the public cost and conditions for the provision of the UPS in the 2011-2020 period. The evaluation was based on an analysis of the instalment payments paid and planned for this period. In addition, to assess the model for determining the cost of the UPS the characteristics of both the regulations in use and the proposals pending approval were reviewed. This analysis includes an evaluation of the public cost at the international level.

[9] The result of *Correos y Telégrafos* described in the figure includes compensation for the UPS that has been homogenised, that is to say, the amount accounted for each year is deducted and an average compensation of 180 million euros is added.

In addition, in order to carry out a comprehensive analysis of the compensation, the efficiency of the designated operator is also studied, including a comparison of the strategy pursued regarding revenue and expenditure with those carried out in selected countries, a trend analysis of the operator's operating result, the opportunities for improving efficiency by studying the costs and the synergies between the operational models.

The evaluation of the UPS is based on international analysis and the review of accounting information provided by *Correos*[10]. The analytical accounting review covers the 2014-2017 period, and several analyses have been carried out: cost efficiency of each of the stages of the value chain; efficiency in revenue, based on the understanding of the model of discounts and tariffs and their rationality in relation to costs; the possible relaxation of the distribution models (ordinary, urgent and express network model); and, finally, an analysis of the method for calculating the net cost.

The benchmarking exercise has been carried out on three levels of evaluation. At the first level, the public cost of the UPS in 31 countries (26 EU countries plus Norway, Serbia[11], Switzerland[12] and two countries with federal structure, Australia and Canada[13]) was analysed. Subsequently, both the cost of the service and the profitability, strategy and market position of designated operators in eight countries[14], which were selected according to various indicators, were studied in greater depth. Finally, we selected six countries[15] to study best practices regarding the management model.

Interviews and meetings were held with agencies that have responsibilities in the regulation of the UPS. Meetings were held with the *Subdirección de Regulación Postal* (Sub-directorate for Postal Regulation) of the *Ministerio de Fomento*, as well as with various departments of the *Correos* group: *Dirección de Planificación y Finanzas* (Directorate of Planning and Finance) and Dirección de Operaciones (Directorate for Operations), as well as with the *Dirección de Transportes y del Sector Postal* (Directorate for Transport and the Postal Sector) of the CNMC. The work of the department of analytical accounting and cost model, which provided all the internal accounting information and that relating to the net cost, has been particularly remarkable.

[10] Previous analyses of the company carried out by the CNMC and the *Tribunal de Cuentas* (Court of Auditors) have served as a basis for the analysis.
[11] It includes Norway and Serbia, as a non-EU country, but analysed by the various reports of the European Regulators Group for Postal Services (ERPG).
[12] Switzerland is included in the analysis, as it has a designated postal operator which presents great diversification and positive financial results with regard to the postal services.
[13] It includes Australia and Canada, as they have expert judgement, with postal models of interest for comparative analysis in the benchmarking exercise.
[14] Australia, Belgium, Canada, Germany, France, Portugal, Switzerland and the United Kingdom.
[15] It has been decided to eliminate Canada and Belgium for the analysis of best practices, as the rest of the countries provide sufficient information.

AIReF has benefited from the collaboration of Deloitte[16] to carry out this project. In any case, the final content of the report is the exclusive responsibility of AIReF.

1.3. Findings and lessons learned

Strategy and procedure evaluation for determining the public cost of the compensation of the UPS

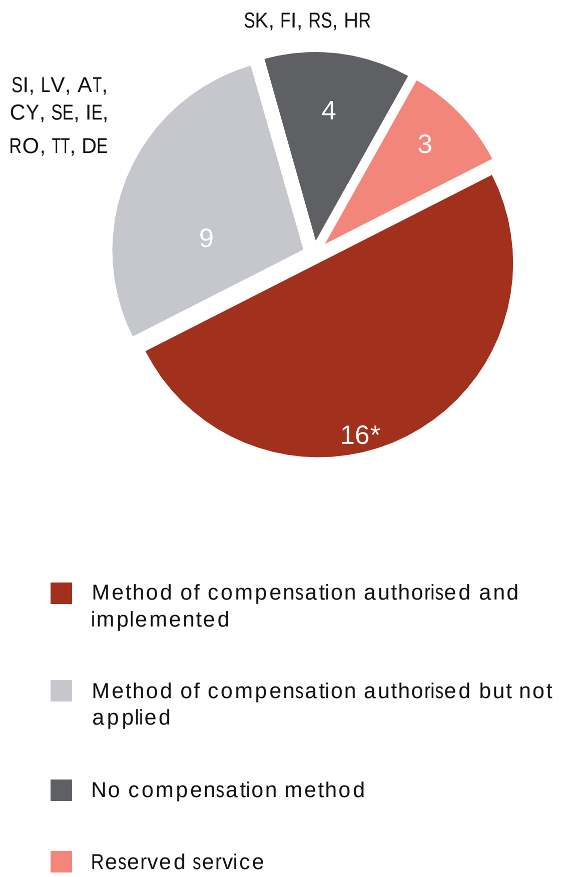
Public cost at the international level

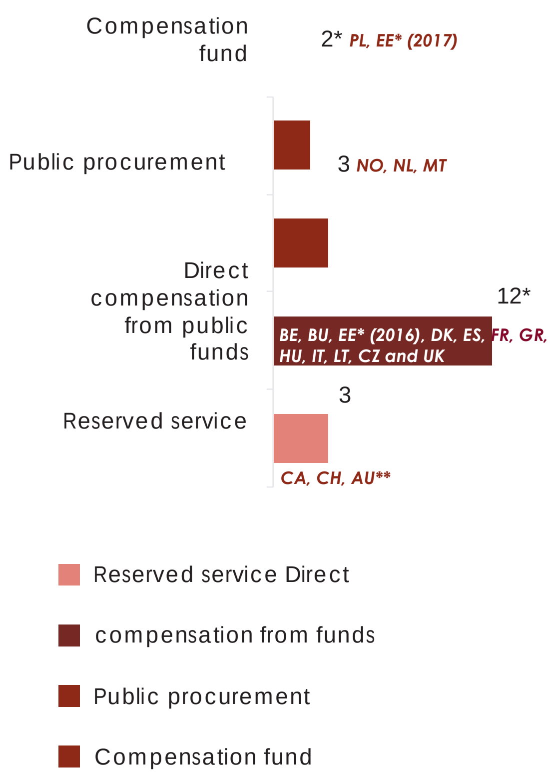
I. There are significant differences at the international level both in the configuration of services and in the form of compensation of the UPS. Although all countries must ensure the services listed by the postal Directive in force, there are differences with respect to products such as mass shipments or priority mail. Before the fall in postal demand, many countries have opted to modify the scope of the UPS to reduce the service costs.

II. Compensating with public funds is a minority option and is not inevitable. Of the 32 countries studied, - that is to say, the 31 referred to throughout the level 1 evaluation and Spain - only 12 directly compensated from public funds, as shown in the figure. However, it is true that 3 countries, Canada, Australia and Switzerland, reserve services for authorised entities, i.e., the State gives total control to the designated operators of any of the postal services.

[16] Company awarded the tender of the technical assistance contract.

MECHANISMS FOR COMPENSATION IN EACH OF THE COUNTRIES OBSERVED[17]



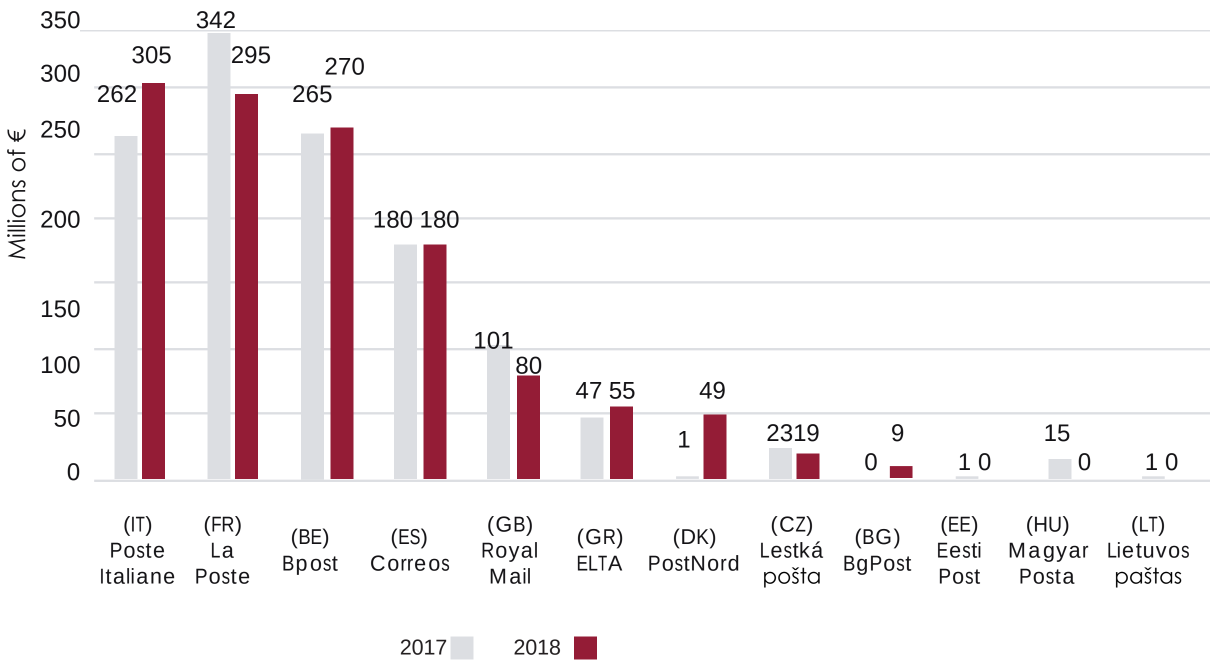


Source: Own calculations based on the Copenhagen Economics report *Main Developments in the Postal Sector (2013-2016)*, IPC report *Postal Regulatory Database: Country Directory 2017* and *ERGP Report on the outcome of the of the ERGP public consultation on the evolution of the Universal Service Obligation* and the annual accounts reports of each operator.

[17] It is worth noting the case of Estonia (EE), as it presented direct compensation in 2016, while in 2017 it established a compensation fund. Canada (CA), Switzerland (CH) and Australia (AU) have reserved area.

III. Compared with countries that compensate with public funds, Spain presents a high relative and absolute cost of the UPS. Of the 12 countries that receive direct compensation from their own public funds, the position of Spain stands out, which was the fourth country in absolute terms of average annual compensation in 2016 and 2017 (figures below). In relative terms, taking into account the unit cost (divided by the number of shipments of the conventional postal sector corrected by Purchasing Power Parity (PPP[18]), the Spanish compensation is also significant.

DIRECT COMPENSATION (M€) VIA PUBLIC FUNDS TO THE DESIGNATED OPERATOR (2016-2017)[19]



Source: Annual reports of the designated operators.

[18] The indicator used to measure the rate of purchasing power parity of the country is known as PPP.

[19] Data on direct compensation via public funds not available for Estonia, Hungary, Lithuania and Bulgaria. In the case of Spain the homogeneous compensation 180 million euros has been incorporated, corresponding to average instalment payments of the period 2010-2018. In 2016, the payment was 180 million euros, while in 2017 it was 58 million euros.

DIRECT COMPENSATION VIA PUBLIC FUNDS IN UNIT TERMS (2017)[20]

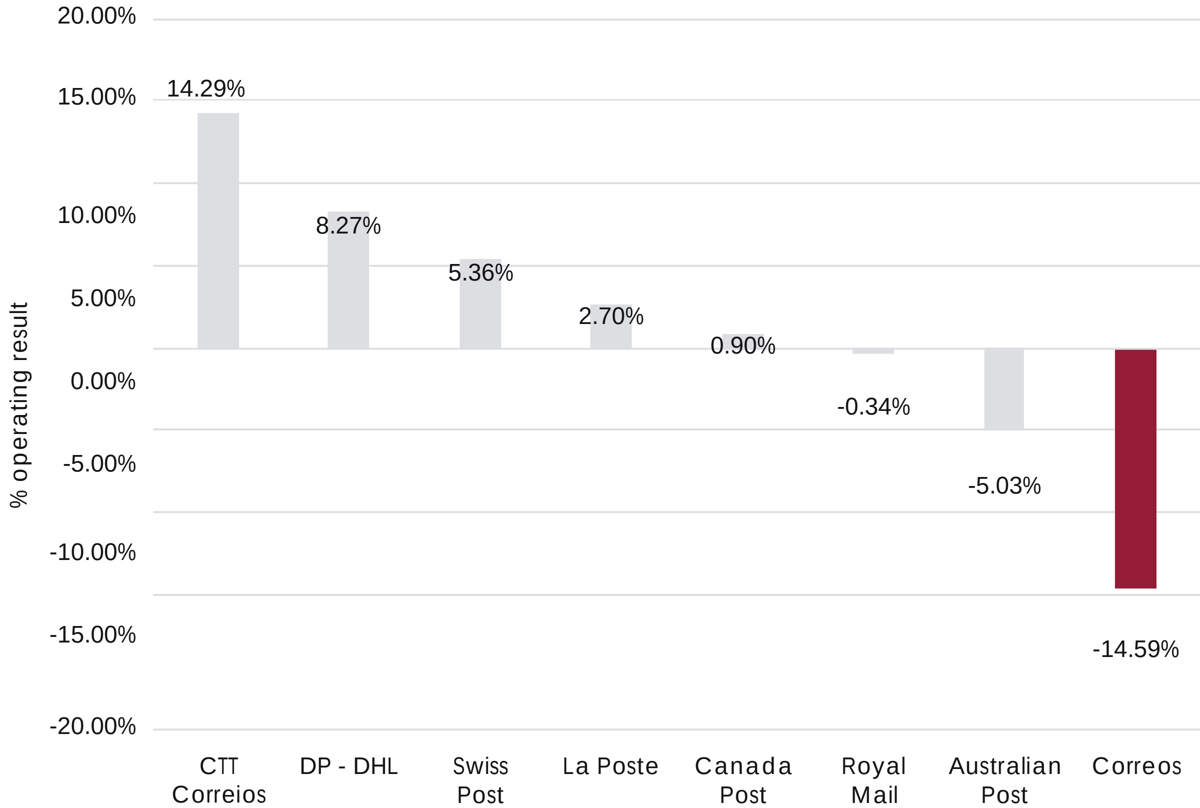
	Unit public cost adjusted for PPP
(BE) - Bpost	0.15
(IT) - Poste Italiane	0.13
(DK) - PostNord	0.09
(ES) - Correos	0.07
(FR) - La Poste	0.019
(GB) - Royal Mail	0.004

Source: Annual reports of the designated operators.

IV. In the conventional postal segment and before any type of compensation received, *Correos* presents a negative operating deficit over the past five years. In addition, this operational deficit is far higher than in the rest of operators[21].

[20] Does not include information on Bulgaria, Estonia, Lithuania, Hungary, Greece and Czech Republic due to lack of information in some of the calculation variables.
[21] With respect to 2018, *Correos* expects to experience a slight improvement primarily motivated by obtaining a greater market share following the abolition of Unipost.

OPERATING RESULT OVER TURNOVER NET OF COMPENSATION (OPERATORS OF LEVEL 2 EVALUATION) 2017



Source: Annual reports of the designated operators (2017)

Evaluation of the model for determining the cost of the UPS

V. Since 2011 there has not been a legal model adopted for calculating the net cost of the UPS and compensation is paid by instalments. Due to the lack of a model, *Correos* continues to carry out the calculations using the historical method called Net Avoided Cost (NAC). With this method, the losses recorded by all UPS products in the *Centros de Costes* (Cost Centres - CeCos), where the average unit costs exceed the average unit revenue, are added up.

VI. The NAC model concentrates losses and presents no incentives for efficiency.

VII. *Correos* commissioned a consultancy company to develop a new methodology that would follow the Profitability Cost (PC) approach. The PC method is based on a counterfactual model and for its calculation it is assumed that the operator ceases to provide the service under the same conditions as it would if it had a PSO, for example resulting in a decrease in delivery days. This new calculation system generates practically the same results than the NAC method.

VIII. The draft of the new service delivery plan sent to Brussels, which includes this new proposal for calculating the cost, presents no incentives for efficiency and is much more rigid than the previous plan. Unlike in other European countries, such as Italy or France, where there is a fixed number of offices or mailboxes, Spain's previous plan of was significantly more flexible, while the new plan is a step backward and a restriction in the face of future trade.

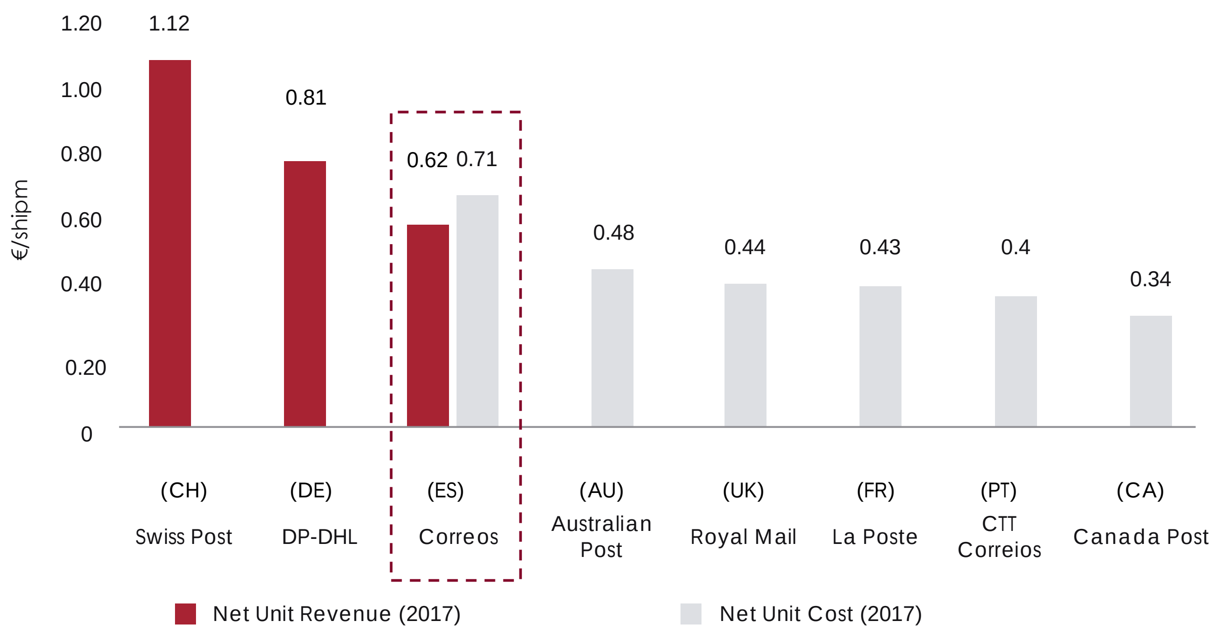
Operator efficiency evaluation[22]

Indeterminate positioning in both revenue and costs

I. *Correos* holds a position of strategic uncertainty in revenues and costs because, although it is close to the average, their revenue is insufficient with respect to markets with lower rate of digital replacement and higher postal "tradition" and their costs are higher than those of operators who have opted for a cost reduction strategy, as shown in the following figure:

[22] Throughout this section, the analysis has been undertaken with respect to the eight countries selected for the level 2 international comparison.

INTERMEDIATE POSITION OF CORREOS (2017)



Source: Annual reports of the postal operators.

II. *Correos* competes in a market with little postal tradition, with a high *digital replacement* and also has few sources of income that are not diversified. The highest unit revenue levels tend to occur in countries where demand is the most deep-rooted due to socio-cultural circumstances (in Switzerland, due to its peculiar direct political system, per capita shipments reached 236 in 2017 compared to 57 in Spain). In addition, Spain is one of the countries with the highest penetration of the digitalisation due to the Digital Administration and large companies' cost reduction strategy. For this reason, Spain is the country where postal demand has fallen the most in recent years with a decrease in shipments of 31% in 2012-2017 compared to an average of 18%.

III. Tariff increases reflect a defence of the market for large customers, who benefit from substantial discounts in comparison with small customers that pay the full tariff. In recent years, *Correos* has increased the tariff of its main postal products in a manner similar to some of the more profitable countries, but this has not had all the expected effects due to the discounts model that it applies. In addition, the discounts offered in Spain are above the rest of the countries.

IV. The discounts are much more aggressive at different levels of the volume scale than those that would result from a model based on total costs.

V. The postal operators evaluated have been more decisive than Correos in the reduction of costs in relation to the decline in volumes. Correos has reduced its workforce by 9% to cope with a 31% drop in volume in the 2012-2017 period compared to an 11% average reduction in the workforce against a decline of 18%.

VI. Most of the operators have opted for automation processes to improve productivity. Among the practices applied, it is possible to observe processes for the centralisation and automation of sorting or the minimisation of mail preparation. In this case, *Correos* has implemented various initiatives to improve efficiency, but with less depth than other operators such as the Portuguese operator, which has carried out strategies based on reorganising, redesigning and rationalising the resources of its postal network. In this way, it is shown that in order to obtain greater cost efficiency new recruitment models or policies to improve productivity should be adopted. Many operators have initiated strategies for the diversification and outsourcing of the postal network, but this has not been the case for *Correos*.

Transition to markets with high competition, with base scenario of greater public cost

VII. To cope with the fall in demand for postal shipments, *Correos* is focusing on the parcel service market, which is a market with high volume and that is in a growth phase, but also has strong competition.

VIII. If postal volumes continue to fall at a rate similar to the current rate and there are no significant gains in efficiency, it is likely that Correos will have lower operating results and a higher public cost in coming years.

Opportunities to improve efficiency

IX. *Correos* is a complex organisation with significant differences in productivity between its various centres. The analysis carried out is based on a theoretical valuation of gains in cost efficiency through a top-down approach

X. It is noted that economies of scale are limited and that the dispersion in efficiency is significant between different offices, therefore there is scope for savings. There are also potential efficiency gains to be had in the central services of the organisation.

XI. *Correos* has three operating models that are configured as independent units, with limited synergies and a need for convergence. The three current networks (ordinary, urgent and express) have different distribution areas and production chain phases.

XII. Maintaining three different distribution networks means losing economies of scale and scope. The market evolves and is oriented toward urgent and parcel service operating models, with high competition, so it is necessary to enhance the efficiency and integration of the networks. Correos seeks to place its

XIII. resources as efficiently as possible among each of the networks, owever, this reorganisation between models is not that simple, since both the urgent

XIV. delivery network and the *Correos Express* network require specific skills or certifications (such as motorcycle or van permit) and different legal agreements from those of the ordinary delivery network, therefore there is high degree of rigidity between the three models.

1.4. Summary of the analysis and proposals

Regarding the strategy and procedure relating to the model for determining the net cost and the conditions of provision of the UPS, the following conclusions have been reached:

There has been a delay of nine years in the approval of a new service delivery plan and the draft of this contains more rigid obligations than those included in the previous plan.

The calculation methodologies of the previous and future plan, NAC and PC respectively, are not problem-free.:

As a result, AIReF makes the following proposals:

1. The *Ministerio de Fomento* (Ministry of Public Works), in collaboration with the *Ministerio de Hacienda* (Ministry of Finance), should take responsibility for defining the new calculation methodology and make the public service obligations more flexible to reduce the cost of the UPS.

   Specifically, it proposes:

   - End the delay of almost a decade that generates legal uncertainty in public expenditure and the operator as soon as possible.
   - Independently establish a methodology for calculating the UPS that includes incentives for efficiency, is easy to check and obeys the logic of a UPS in a liberalised market.

- Make the public service obligations more flexible:
  - Reduce the number of days on which correspondence is delivered (as Italy has done, for example) as this does not appear to be a citizen demand.
  - Do not set the minimum number of offices for the provision of the service or the number of collection points.
  - Encourage the outsourcing of the network as occurs in countries such as France or the United Kingdom.
  - Include tiered prices: to introduce new products, such as the priority letter, and differentiate the terms and conditions of service of the normal letter and the urgent or priority letter.
  - Analyse the configuration of the products that make up the UPS so that some products can be eliminated or additional public services can be included, mainly in the network of offices covering the entire national territory.

2. The compensation should be simplified and focus on the compensation of the territorial deployment of the network. This would only include rural areas or areas where the volumes are low and do not allow for profitability.

   There are three possible compensation alternatives:

   - Only compensate for the deployment of the postal network in rural areas (less than 5,000 inhabitants
   - Compensate only those CeCos that concentrate a reduced volume of shipments and that may not be able to take advantage of economies of scale.
   - Compensate only those CeCos exceeding certain levels of efficiency, allowing to efficiency and volume criteria to be combined.

Regarding the company's efficiency, the following conclusions have been reached:

Regarding revenue, *Correos* is experiencing a sharp fall in total volumes, particularly significant in the universal products. To counter this effect on sales, in recent years *Correos* has opted to increase their effective price, but this increase has been offset in part by the discounts made to large customers.

It is therefore proposed to:

1. Review the revenue and discounts policy of large clients, in such a way that will make it possible to scale discounts by volume according to the costs reflected by the economies of scale and insularity.
2. Promote new sources of revenue based on different paths for diversification, with the aim of progressively reducing the percentage of turnover dependent on universal products. Study the possibility of taking advantage of the network deployment to provide other public administrative services to citizens (for example, at present, *Correos* manages some traffic services).

During the 2014-2017 period *Correos* has made an effort to reduce costs and has implemented measures such as sorting automation. However, there is still room for improvement in terms of efficiency, therefore it is proposed to:

1. Make an efficiency plan, mainly based on an analysis of the various stages of its value chain, in order to reduce current costs.

2. Continue efforts towards automation, simplification of the organisational structure, study of activities that could be outsourced and reduction of the time dedicated to lower value-added activities.

In relation to the operating model, the *Correos* group currently presents three different models and with apparent margin for flexibility and synergy between the three: ordinary delivery network, urgent delivery network and *Correos Express* network. The volume managed in each network evolves very differently so it is necessary to envisage a more integrated operating model. In this sense, it is proposed that *Correos*:

1. Support the transition of a company focused on the conventional sector towards different and very competitive markets such as urgent parcel services.
2. Carry out an assessment to identify potential synergies between each of the current operating models with the aim of adjusting the volume of each of the networks to the capacity and staff available. The plan should include:

   - The bases on which the market evolves and possible alternative operating models that maximise or better integrate the different networks.

   - The evaluation of the staff training of the ordinary delivery network in the skills necessary to be able to provide the services of urgent delivery networks.

   - The search for flexibility to promote the mobility of staff from one network to another, naturally absorbing the decline in the traditional market.

Independent Authority
for Fiscal Responsibility

José Abascal, nº 2 | 2.ª planta | 28003 Madrid
Tel. +34 910 100 599
Email: info@airef.es
Web: www.airef.es