Independent Communications Authority of South Africa
Pinmill Farm, 164 Katherine Street, Sandton

Private Bag X10002, Sandton, 2146

# RESEARCH REPORT ON THE ECONOMIC REGULATORY FRAMEWORK FOR RESERVED POSTAL SERVICES

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# 1 Introduction

This report represents the results of a study undertaken by the Independent Communications Authority of South Africa ("**the Authority**") to develop an Economic Regulatory Framework ("**ERF**") to monitor and regulate reserved postal services tariffs in the Republic of South Africa. Currently, the South African Post Office ("**SAPO**") is licensed to provide reserved postal services. Among the terms and conditions of its licence SAPO is required to submit, to the Authority for approval, annual tariff adjustments/price increases for its reserved postal services.

In terms of Section 30 of the Postal Services Act of 1998 ("**the Act**"), as amended, and Section 8 of the ICASA Amendment Act of 2006, the Authority has the mandate to determine fees and charges for reserved postal services. Currently, tariff determinations are made without detailed financial information on individual product and service segments within the reserved areas. More importantly, tariff reviews are conducted without the benefit of acquiring a conclusive understanding of potential cross subsidies that might exist between business segments, and more specifically between reserved and unreserved postal services. Accordingly, in order for the Authority to more effectively exercise its responsibilities, there is a need for an Economic Regulatory Framework ("**ERF**") that comprises both the Price Cap Regulations and Accounting Separations Regulations.

This report discusses the key issues that were brought to bear in the development of the economic framework proposed for reserved postal services. The conclusions and proposed regulation of reserved postal services are based on findings from the review of up to seven (7) international jurisdictions, the review of the legal framework under which.

## 1.1 Approach and Methodology

Regulatory Financial Reporting coupled with a Price Cap Regime is a conventional form of *Financial Regulation* for telecommunications and public utility services companies. Both mechanisms apply financial analysis to monitor and influence operators' market behaviour. Competition Law and associated commercial legislation, along with licensing conditions, are indeed the primary regulatory mechanisms; however in lieu of micro-managing operators, financial regulatory reporting allows regulators to assume a non-interventionist approach towards operators while working from the same base of information as those operators for purposes of regulatory decision making. The extent to which these mechanisms are relevant for reserved postal services needs to be determined in the context of market conditions and competitive pressures that currently exist within South Africa. This report sets our findings in these matters and prescribes the ERF for reserved postal services in South Africa.

The study began with a review of local practices, regulatory mechanisms and postal sector performance to determine the regulatory decision issues and regulatory economic framework that the Authority requires to exercise its responsibilities. A critical input to this review included a scan on international developments in postal services and postal regulation to gain insight into how other jurisdictions oversee and monitor their respective postal agencies. Interviews were conducted with SAPO personnel to understand their business strategy, potential regulatory issues and their existing reporting practices. The following figure illustrates overall approach and steps that were completed for this study.

### 1.2 Document Structure

In addition to the introduction in section 1 above, the report is structured as follows:

- **Sections 2: An Economic Regulatory Framework** sets out the elements of the framework proposed for South Africa and the rationale to support the regulations proposed for the sector;
- **Section 3: International Perspectives on Reserved Postal Services** sets out a summary of findings on international regulatory practices in regard to postal services;
- **Section 4: Current Regulation of Reserved Postal Services** sets out a proposed framework and compares this to the current legal framework in place. Present financial highlights of the industry before proceeding to detailed operator reviews;
- **Sections 5: The South African Post Office** presents financial highlights of SAPO's financial performance and identifies additional issues that need to be reflected in the implementation of the Economic Regulatory Framework;

## 2 ECONOMIC REGULATORY FRAMEWORK FOR POSTAL SERVICES

The Act specifies that the regulation and control of postal services is in the public interest and sets out several objectives that are very similar to regulatory objectives in other jurisdictions and market sectors.[1] These objectives, along with specific licence conditions set out in the licence granted to SAPO form the basis of determining the crucial decision issues the Authority needs to regulate and monitor the sector[2]. However, only a subset of these decisions will require financial information as inputs. The scope of the ERF is limited to the financial regulatory mechanism that

[1] Section 2, Objects of the Act, The Postal Services Act, 1998.
[2] Licence, No. 2008/005477/06, Granted to the South African Post Office Limited For the Provision of Reserved Postal Services, Issued by the Independent Communications Authority of South Africa, 20 October 2008.

should be used. To some extent the ERF will prescribe some non-financial or statistical regulatory reporting but this will only be issued to provide context to the Regulatory Financial Statements ("**RFS**") and Tariff Applications ("**TA**") - it will not be inclusive of all non-financial reporting that will be required of a licensed postal operator. Such additional requirements must be specified in a separate regulation or in the next iteration of a postal licence that is issued to an operator.

The Authority's legal mandate is set out in Section 8, of the Act, entitled General Functions of the Regulator. As well, the Authority draws its legal mandate to request regulatory financial information through its Licence granted. Specifically, section 15(2) requires a licensee to comply with the obligations set out in its licence, which specifically state that Operators are required to "furnish the Authority with the following information on request:

a) the cost structures of the Licensee;
b) steps taken by the Licensee during the preceding period to reduce costs;
c) capital expenditure the Licensee intends to deploy in any one financial period;
d) any profit the Licensee may have generated from the reserved postal services;
e) the proposed pricing for new products forming part of reserved postal services to be introduced by the Licensee including a detailed analysis of the proper costing for such new products; and
f) any other information that the Authority may require the Licensee to provide.[3]

## 2.1 Policy Objectives

The Authority's objectives, inter alia, are to monitor and regulate reserved and unreserved postal services. "The primary object of this Act is to provide for the regulation and control of postal services in the public interest"[4]. Below, are key regulatory objectives that have been articulated in the Act. These objectives drive the measurement objectives for the ERF accordingly.

[3] Licence No. 2008/005477/06 Granted to the South African Post Office for the Provision of Postal Services, Section 7.6.6.
[4] The Postal Services Act, 1998, as amended, S(2).

**Figure 2**
**Implications of Policy Objectives on Measurement**

| Policy Objectives (per Section 8 of the Act) | Postal Accounting Manual Requirements / Objectives | Rate Regime Requirements / Objectives |
|---|---|---|
| a. Promote the universal and affordable provision of postal services | • Monitor economic profits of reserved postal services.<br>• Monitor the effect of price controls on provision of quality of service, roll-out and innovation. | • Maintain price increases of reserved postal services within prescribed guidelines. |
| b. Promote the provision of a wide range of postal services in the interest of the economic growth and development of the Republic | • Monitor roll-out and effect on achievement of universal service targets.<br>• Permit cross-subsidies of postal services within "baskets" of reserved services. | • Maintain price increases of reserved postal services within prescribed guidelines.<br>• Permit cross-subsidies of postal services within "baskets" of reserved services. |
| c. Make progress towards the universal provision of postal services | • Monitor impact of roll-out obligations on licensed operator's profit performance. | • Ensure price controls reflect roll-out obligations. |
| d. Encourage investment and innovation in the postal industry | • Monitor impact of capital investment on licensed operator's profit performance. | • Establish price controls that enable licensed operator to earn a sufficient rate of return. |
| e. Promote the development of postal services that are responsive to the needs of users and consumers | • Monitor roll-out and effect on the efficient achievement of universal service targets. | • Maintain price increases of reserved postal services within prescribed guidelines. |
| f. Ensure greater access to basic services through the achievement of universal postal service, by providing an acceptable level of effective and regular postal services to all areas including rural areas and small towns where post offices are not sustainable | • Monitor roll-out and effect on the efficient achievement of universal service targets. | • Maintain price increases of reserved postal services within prescribed guidelines; possibly create sub-basket of price controls for reserved services provided in new, un-served areas or uneconomic areas. |

**Figure 2**
**Implications of Policy Objectives on Measurement**

| Policy Objectives (per Section 8 of the Act) | Postal Accounting Manual Requirements / Objectives | Rate Regime Requirements / Objectives |
|---|---|---|
| g. Develop greater equity in respect of the distribution of services, particularly within the areas of the historically disadvantaged communities, including rural areas | • Monitor roll-out and effect on the efficient achievement of universal service targets. | • None. Other non-economic regulatory mechanisms required. |
| h. Promote stability in the postal industry | • Monitor financial performance of the licensed operator.<br>• Monitor cross-subsidies between reserved and unreserved services; between postal and Postbank services.<br>• Monitor potential for anti-competitive behaviour on the part of the licensed operator – in particular – excessive pricing. | • Monitor potential for anti-competitive behaviour on the part of the licensed operator – in particular - discriminatory, collusive and predatory practices.<br>• Monitor possibility of predatory pricing of unreserved services. |
| i. Ensure fair competition within the postal industry | • Monitor potential for anti-competitive behaviour on the part of the licensed operator.<br>• Monitor cross-subsidies between reserved and unreserved services; between Postal and Postbank services. | • Monitor potential for anti-competitive behaviour on the part of the licensed operator.<br>• Monitor possibility of predatory pricing of unreserved services. |
| j. Protect the interests of postal users and consumers | • Monitor potential for anti-competitive behaviour on the part of the licensed operator – in particular – excessive pricing. | • Monitor potential for anti-competitive behaviour on the part of the licensed operator – in particular - discriminatory, collusive and predatory practices.<br>• Evaluate affordability of services within the context of essential services provided by other sectors. |

**Figure 2**
**Implications of Policy Objectives on Measurement**

| Policy Objectives (per Section 8 of the Act) | Postal Accounting Manual Requirements / Objectives | Rate Regime Requirements / Objectives |
|---|---|---|
| k. Promote the effective maintenance of an efficient system of collecting, sorting, and delivering mail nationwide, in a manner responsive to the needs of all categories of mail users | • Monitor cost structures of the licensed operator to observe productivity. | • Establish controls that promote efficient use of resources in the provision of reserved postal services. |

## 2.2 Rate Regime Objectives

The primary objective of the Price Cap regime is to control the level of retail tariffs. In the absence of any meaningful competition for reserved postal services, in particular, the Price Cap regime aims to emulate a competitive market where operators are price takers and are likely to increase prices in response to inflationary pressures on their input costs. Establishing such a regime is crucial in the case of South African postal services where the operator has an extensive roll-out target, has a natural monopoly and can potentially undercut pricing of competitive services. A Price Cap regime coupled with accounting separations reporting can provide transparency in tariff reporting as well as observe where operating inefficiencies are occurring – particularly in universal service provision where an operator can blame poor productivity on its universal service obligation. Ideally, the regime should reward operators for productivity improvement.

### 2.2.1 Key Principles

The following principles were considered in the development of the Postal Price Cap Regime Regulation:

- **Relevance** - The rate regime must align to the Act in terms of its segregation of reserved and unreserved postal services. The classifications of reserved products must therefore correspond to those defined in the Act.
- **Transparency** – Tariff applications must provide transparency on both reserved and unreserved services and therefore include detailed reporting for all products and services. SAPO through its scale and advantages of natural monopoly can potentially engage in anti-competitive behaviour unless it is aware that the Authority is monitoring its activities closely. Furthermore, the tariff reporting when

coupled with regulatory financial statements will illustrate whether the operator is subsidising its competitive and unregulated services.

- **Productivity Offset** - An offset is intended to contain revenues and in the event of rising input costs, motivated a licensed operator to improve operating performance through cost reduction initiatives and technological innovation. Gains are thus passed on to customers in the form of lower prices.
- **Flexibility -** Price-controlled Baskets should allow the operator to rebalance tariffs where it deems appropriate – particularly where tariffs do not adequately cover the provisioning cost of the service. The regime allows operators some flexibility in pricing while still maintaining its overall price increase within the framework's limits.
- **Periodic review** - In most cases, the Price Cap regime regulation undergoes a review every three to five years – the time period often being dictated by the extent to which products, services and market structures have changed during the rate regime term. At the end of each term, "X-factor" is normally adjusted to ensure that operators pass a portion of their productivity gains to consumers. Information from profit/loss reporting imposed by Accounting Separations is often used to evaluate the effectiveness of price controls.

### 2.2.2 Rate Base Regulations

Rate base regulation allows an entity with the opportunity to earn a fair rate of return.

A fair rate of return should:

- Allow the entity to earn commensurate return to investments of similar risk (i.e. similar returns to businesses which bear similar risks as postal services businesses),
- Provide the operator with the assurance of financial integrity (i.e. allow the operator to recover its costs, provided those costs are incurred efficiently); and
- It must be sufficient to attract the necessary capital to ensure organizational stability.

Rate Base Regulation essentially determines a "revenue requirement" based on the entity's costs (including asset base). The regulated entity is required to provide extensive information on its operations and costs and the burden is placed on the regulator to deem whether such costs not only are deemed necessary but have been incurred using efficient processes and practices. Theoretically a regulator would have the power to *reduce* selected costs from the operator's application and determine a lower revenue requirement than the operator applies for. Ideally, the revenue requirement approved by the regulator allows the entity to recover its costs going forward but this cannot be guaranteed since rates are derived from a combination of the revenue requirement and demand projections.

The main advantage of rate base regulation is that an entity is unlikely to earn an excessive rate of return – however, there is little incentive for efficiency. License operators are known to overstate their cost bases and understate their demand projections in order maximize their revenue requirement. In a declining or saturating market a licensed operator must have an orientation toward improving efficiency. Furthermore, as in the case of SAPO, where there is a requirement to expand postal services and incur large costs in doing so, this form of regulation would do little to ensure that expansion is pursued efficiently.

In a rate base regulatory regime, the regulator must review the prospective budget and capital investment program and subsequently approve the revenue requirement and resulting tariffs. The process involves an intensive study, where the regulator assumes the responsibility of:

- Evaluating the capital asset program for the upcoming year and assess whether the full application requirement is appropriate and does not contain any excessive spending;
- Evaluating the net working capital requirement the operator has reported and assessing the extent to which the requested amount does not contain any excessive working capital requirements;
- Evaluate the reasonableness of the cost of capital to be applied by the operator and the ultimate cost of capital charges that will factor into the total costs the utility will expect to earn;
- Reviewing on a detailed basis the forecasted cost of service and ensure there is no excessive spending; and
- Based on accumulated analysis of assets and costs approve the revenue requirement and the resulting tariffs.

The administrative burden of rate base regulation is high since the regulator would need to have an intimate knowledge and understanding of the operational costs and demand profiles of the regulated entity to determine the appropriate cost base and then to determine revenues and set tariffs based on demand projections. In addition the regulator must also review and determine the appropriate cost of capital that an entity should be permitted to earn. The process is time consuming and could severely restrict the licensed operator's flexibility to respond to market changes. For the arguments noted above, an incentive-based form of regulation would be more appropriate in the South African context.

### 2.2.3 Price Cap Regulation

Price Cap Regulation is a form of pre-emptive, ex-ante, incentive regulation that allows the operator to change its price level according to an inflation index that is adjusted for a productivity offset, namely the "X-factor" which effectively moderates any sharp price increases to the end consumer. The key advantages to the price cap system include the following features:

- The mechanism allows the postal operator to share the productivity improvements it makes with the consumers. By the x-factor from inflation, the "real" price of a stamp falls year-over-year.
- Administratively, this system is less cumbersome from a regulatory perspective as the regulator is not constantly required to review the legitimacy of costs incurred by the operator to ensure that there is no "over-sizing" of the postal network which is included in the costs associated with the price of services. Instead, it is the responsibility of the operator to ensure that they are conducting business in the most efficient manner possible.
- Tariff changes can be implemented within a shorter review time providing operators with some measure of agility in the marketplace.

This regime is considered superior to traditional rate based regimes where, formerly, retail tariffs were set on a "cost plus" basis – operators essentially justified their capital and operating costs to the regulators and were then allowed to set tariffs that would enable them to earn a pre-determined, agreed upon, cost of capital. In the case of other industries, rate base regulation had no effect on controlling costs, particularly during the highly inflationary periods of the seventies and eighties or when economies experienced rapid demand growth – consumers were forced to bear the cost of "gold plated network facilities" with potentially excessive network capacity. Consequently regulators, noting the limitations behind the rate-base regimes turned to price control regimes to pre-empt excessive tariff increases while providing operators with the opportunity to retain profits earned through improved operating efficiencies.

### 2.2.4 Proposed Price Cap Regime Regulation for Postal Services

In view of its successful application to postal services in South Africa and its widely recognised applicability to the postal sector in other jurisdictions, it is recommended that the current rate regime regulation be continued for SAPO with refinements to existing regulatory practices.

The following general formula should be used for the Rate Regime regulation. Essentially, the formula stipulates that any change in revenue, resulting from price increases, should be lower than CPI minus X.

**Formula (1)** $(RR_t \div RR_{t-1}) \times 100 \leq CPI_{t-1} - X_t$
**Formula (2)** $X_t = 3\%$

Where --

*t:* is the current year in the price control period;

*t-1*: is the preceding year;

$X_t$: is the productivity factor in the price control period "*t.*"

The Consumer Price Index ("**CPI**"), published by South African Statistics, should correspond to the most recent financial year. Although forecast CPI may vary, the measured CPI is more objective and verifiable. It is important to recognise that inflation will always fluctuate. The effect of these movements will offset each other over time. Any price control regime must be coupled with a detailed rate-based type of review of assets, costs and tariffs on a periodic basis (every 3 to 5 years) to evaluate the effectiveness of price controls. The detailed rate based review would occur periodically to measure productivity improvements and determine the extent to which the "X-factor" needs to be adjusted upwards or downwards. The rate-based review would use the financial regulatory reports prepared in accordance with the Accounting Separations Regulation and would involve a review of trends in revenues, profits, costs, inputs (head count, outlets, transport miles, etc.) and outputs (volumes, addressable deliveries, etc.) to evaluate productivity improvements. Meaningful analysis of such would require reliable data that is audited over a period of time (such as 3 to 5 years) to adjust for fluctuations or extraordinary events that may affect postal operation profitability.

## 2.3 Postal Accounting Separations Reporting

The Postal Accounting Separations Reporting ("Postal Accounting Reporting") sets out a structured accounting and regulatory reporting framework for licensed postal services operators who fall within the regulatory jurisdiction of the Authority. The Accounting Regulations sets out the guidelines for preparing Regulatory Financial Statements ("**RFS**") which regulated postal operators are required to submit to the Authority on a pre-defined schedule. The RFS are intended to convey information to the Authority to allow it to monitor and regulate products and services set out in the Postal Services Act.

The Postal Accounting Manual prescribes the framework, methodology and format in which licensed operators are required to report financial information to the Authority. Regulatory financial reporting aims to reduce the *informational asymmetry*[5] regulated companies have over policy-makers and regulators. Unless it is legally compelled to do so, a licensed operator is unlikely to share its internal knowledge of its

[5] In the context of regulation, the operator has information that is unavailable to the regulator. (Baldwin, Robert and Martin Cave, Understanding Regulation: Theory, Strategy, and Practice; Oxford: Oxford University Press, 1999, Chapters 2-3.)

customers' buying patterns, structure of internal costs and use of resources, quality of service and product/service profitability. As the operator responds to internal resource demands and external opportunities and threats, it will seek to maximise its profits through its management, pricing, selling, and marketing practices. Guarding against potential anti-competitive behaviour is the purview of the regulator – an operator's profit maximisation must not be achieved at the expense of public welfare.

The purpose of this reporting is to enable the Authority to monitor a licensed operator's business activities and to evaluate the effectiveness of other existing regulatory mechanisms such as licensing and price controls. Without intervening directly in a licensed operator's business decision making processes, the Authority requires the submissions of detailed financial information, compiled in accordance with the Postal Accounting Regulations. The Regulations sets out to balance an operator's need for privacy and prescribing standardised regulatory financial reporting requirements that meet regulatory monitoring requirements. A standardised regulatory accounting framework prescribes rules and procedures for reporting financial information to ICASA – effectively disclosing information on the business activities and marketing intentions of operators. Regulatory financial reports are to be submitted in confidence and are not available for public scrutiny.

### 2.3.1 Measurement Objectives

The measurement objectives of the Postal Accounting Manual are to:

- Monitor financial performance and more importantly --
  - the extent of economic profits earned by a licensed operator in the provision of reserved postal services,
  - the impact of capital investment on profit performance and service innovation,
  - the financial impact of roll-out obligations on profit performance, and
  - cost structures of the licensed operator to observe productivity;
- Monitor potential for anti-competitive behaviour on the part of the licensed reserved postal services operator, in particular
  - Cross-subsidies between reserved and unreserved services,
  - Unfair discriminatory practices, and
- Monitor the effect of price controls on provision of quality of service, roll-out and innovation.

### 2.3.2 Design Principles

The following principles were considered in the development of the Postal Accounting Manual:

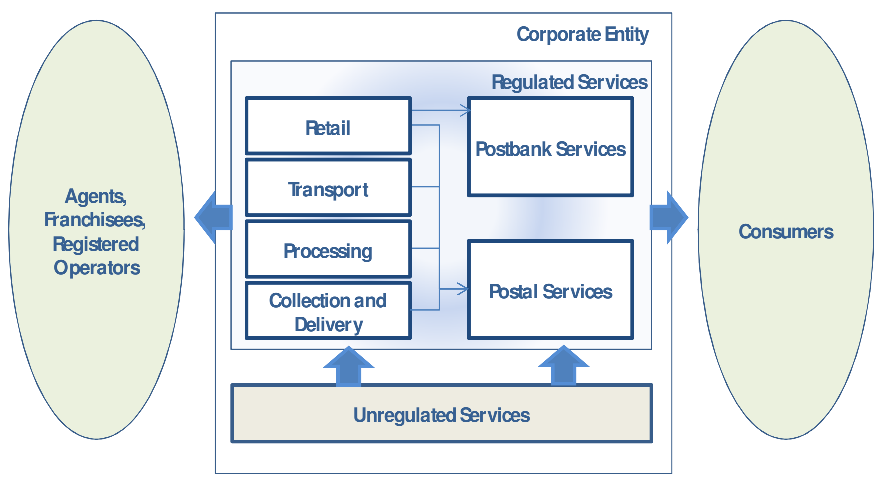
- **Relevance** - The Reporting Requirements must be aligned to the Authority's regulatory mandate, and therefore be limited to providing only that information that the Authority requires to monitor and regulate services, in accordance with the objectives set out in section 2.1 of this Report entitled 'Measurement Objectives', only. Furthermore, the information reported should be aggregated – special studies into more detailed information need only be requested if anomalies or key indicators suggest the need for regulatory intervention.
- **Applicability** - The Postal Accounting Manual should only apply to licensed postal operators who have the exclusive privilege to provide reserved postal services. However, these operators should be required to report on all aspects of their business (which may include provision of unlicensed services or unreserved postal services) to understand the extent to which there are any cross-subsidies between reserved services and other segments of the licensed operator's business areas.
- The Postal Accounting Manual regulation must be evolutionary and should contain provisions for periodic revisions in the event of:
  - Changes in postal services technologies; and
  - Changes in licensed operator's business;
- **Confidentiality** – The information presented is private and confidential and must not be available for public consumption. In many cases, the licensed postal operator will object to providing the detailed regulatory financial information citing confidentiality – particularly since it will highlight sensitive commercial information. The concern must be sufficiently alleviated in the regulation.
- **Auditability and Flexibility** – The licensed postal operator should have the discretion to meet the objectives of the regulation by applying the relevant methodologies and statistical analysis that best reflects its unique operating circumstances. Therefore, specific methodological calculations on how to conduct statistical surveys, construct activity lists, compile costs along intermediate cost pools, etc. should not be prescribed in the regulation. Rather, licensed postal operators should be required to demonstrate how they have satisfied the regulatory requirements in an Operators Procedures Manual ("OPM") which the Authority must review and approve. Furthermore, all results must be compiled in accordance with the approved OPM and the reports must only be accepted once they have been independently audited by the licensed operator.

### 2.3.3 Business Framework

Accounting separation involves analysing the Corporate Entity between Regulated and Unregulated Segments, separate Businesses (as defined below), and groups of services. Accounting separation involves disaggregating the total revenues and costs of the legal postal entity, referred to as the Corporate Entity, into sub-segments of the business.

The Corporate Entity is the legally incorporated organisation that holds the Licence to provide reserved postal service. The Regulated Entity includes all Postbank and Postal services, as defined in the Postal Services Act, and terms and conditions of licences issued to Operators. The legal entity may also provide other non-licensed services, such as real estate rental, consulting services, etc. and these need to be separated to establish a financial profile of the licensed operations. These services are partitioned into the Unregulated Segment which also includes subsidiaries or associates that are already regulated in their own right. Below is an illustration.

**Figure 3: Business Model**

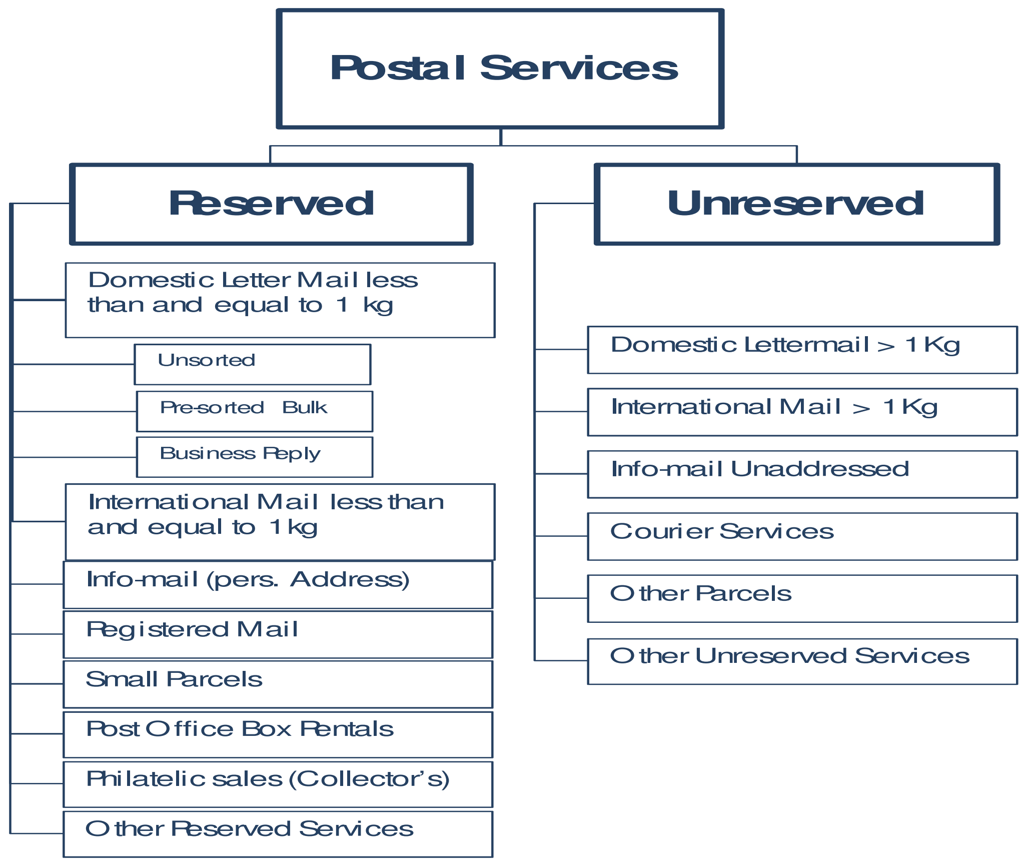



To establish a "level playing field" the Authority requires transparency on the cost of services that may be provided to other registered or licensed Operators, agents and franchises. These services may be in the form of "wholesale products and services" or work-sharing arrangements. Accordingly, the Authority proposes detailed cost reporting by four major cost classifications within the Regulated Entity: Retail Operations**;** Transport Operations**,** Processing Operations**;** and Collection and Delivery Operations**.** Costs in each of these categories will be allocated or attributed to individual product or service segments – therefore providing insight into the cost structure of reserved services as well as identify areas where cost improvements are being taken within the postal organisation. To further measure productivity, reports propose cost to be reported along two dimensions: Subject of expenditure (e.g. labour, materials, etc.) and Object of expenditure (e.g. activity cost such as collecting mail at retail counters.)

To evaluate tariff applications and pricing as well as measure any extent of cross subsidy between postal and Postbank service, the Authority also requires revenue and cost information on the following Business Segments which serve end consumers: the Postbank Services Business and the Postal Services Business. Income statements are required for these business units and their respective sub-segments. Furthermore, to determine the effect of any cross-subsidies, profit loss statements are proposed for the following major categories of services:

**Figure 4**

**Segmented Reporting**




The proposed listing of product and service segments allows the Authority to determine the extent to which potential price discrimination or cross-subsidies might exist between product and service segments.

- The separation of unreserved services into courier, other parcels, unaddressed mail and other unreserved services will identify if any of these segments are loss-making and the extent to which they are being subsidised by reserved services.

- The separation of domestic letter mail, international letter mail, small parcels, registered mail, letter box rentals and other reserved services is based on the expected differences in cost structure of these services, thereby providing transparency on their relative profitability.
- The separation of pre-sorted letter mail will allow ICASA to assess whether volume discounts offered to customers using this service correspond to the cost savings SAPO realises in this product. As well, this separation allows ICASA to determine if selected business customers are receiving preferential pricing that is potentially discriminatory and therefore anti-competitive.

### 2.3.4 Main Accounting Principles

Regulatory Financial Statements must employ the same accounting policies used for the preparation of statutory financial statements, together with the principles of accounting separation. All accounting policies and bases adopted by licensed operators in the preparation of Regulatory Financial Statements should be described in their Procedures Manuals. To the extent that licensed operators adopt accounting policies that differ from the above, licensed operators must prominently disclose the deviation from SA General Accepted Accounting Practice ("SA GAAP") or International Accounting Statements ("IAS"), and the reason for such deviation, in their Procedures Manuals.

#### 2.3.4.1 Measurement of Economic Profit

A critical component of the profit loss reporting is the concept of Economic Profit which calculates net income after reflecting an "opportunity cost" to shareholders. In calculating economic profit, opportunity costs are deducted from revenues earned. Opportunity costs are the alternative returns foregone by using the chosen inputs. As a result, it is possible for an operator to report a significant accounting profit while earning little or no economic profit. The "opportunity cost" to shareholders is referred to as the cost of capital. In practical terms, economic profit is measured by determining the residual wealth of a firm which is calculated by deducting cost of capital from its operating profit (adjusted for taxes on a cash basis). If the company earns above the profit, after accounting for the weighted average cost of capital, then it earns an economic profit.

Economic profit is objective and verifiable against company records; however the determination of cost of capital is subjective. This approach takes into account the risk that shareholders and debt holders are willing to take by their investment in the company. Although this point may be moot given SAPO's ownership by Government it is a useful measure to evaluate the company as if it were a stand-alone private enterprise.

The Accounting Separation Regulations proposed will measure "economic profit", but the cost of capital will be determined by the operators. This will require the Authority to be vigilant in understanding cost of capital charges and conducting its own independent evaluations of the licensed operator's RFS filings.

#### 2.3.4.2 Weighted Average Cost of Capital

The weighted average cost of capital ("**WACC**") represents the average cost to finance a Rand of investment. This cost includes the cost of equity, debt and any other source of financing such as preferred equity. For simplicity, only equity and debt are considered in what follows.

The appropriate calculation of WACC depends on how income taxes are recognized. In some cases, a pre-tax WACC is used where the cost of equity is grossed up to account for income taxes. The argument for using a pre-tax WACC is that income taxes are related to income (i.e., the return to equity) and therefore increase the cost of equity financing. However, complications can arise where there are deferred taxes, more than a single income tax rate or actual income differs from the cost of equity.

The simplest and most accurate approach to recognize an entity's income tax cost is to calculate WACC as if there were no income taxes and then to calculate income taxes separately[6]. With this approach, WACC is calculated as:

$$[k * E / (E + D)] + [d * D / (E + D)]$$

Where:
k = cost of equity
d = cost of debt
E = amount of equity
D = amount of debt

Therefore, WACC should be calculated in accordance with the above formula as if there were no income taxes, and the income tax cost should be calculated separately.

Determining WACC for postal services involves more than a simple mechanical calculation. Establishing the inputs to the calculation usually requires special studies that involve professional judgment. These studies require an understanding of the regulated operations, and therefore, the regulated entity is often in the best position to conduct them. Of course they should be subject to regulatory review and challenge.

[6] An after-tax WACC is often used as the discount rate in a present value calculation. In calculating this WACC, the cost of debt is reduced to recognize the deductibility of interest. However, the income taxes deducted in arriving at the cash flows for each period ignore the deduction for interest.

The cost of debt can reflect the current cost of debt or the embedded cost. The current cost is what the cost would be if the debt had been issued in the current period. The embedded cost is the actual cost of debt and would reflect the interest rates that the entity committed to in previous periods.

Consistent with the approach used to measure property plant and equipment (i.e., historical cost), the embedded cost of debt should be used. Current costs are more relevant for determining prices in a competitive market. However, the use of current costs does not necessarily benefit customers or the regulated entity. Changes in current costs are largely outside the control of a regulated entity and would result in unanticipated windfall gains and losses[7]. Such gains and losses would tend to average out but would increase the risk to the regulated entity and therefore the returns it should be allowed to earn. As a result, on average, it is expected that regulated rates would be higher. In addition, embedded and historical costs can usually be determined more objectively than current costs and usually with significantly less effort.

The cost of equity is usually considered to be a current cost. Unlike debt, there are not contractual arrangements that fix the return on equity.

Government owned regulated operations, such as SAPO, may have unusually high debt ratios that would not be sustainable on a stand-alone basis, at least not without a significant increase in the cost of debt. Such ratios can be maintained only because the debt is guaranteed by the owning government. In effect, much of the risk normally borne by the debt investors is be borne by the owning government through the debt guarantee. In addition, the higher debt ratio increases the equity risk and the appropriate cost of equity. Investors are normally compensated for bearing risk.

In some cases the debt may be held directly by the owning government. However, the owning government bears the same risk as if the debt were issued to a third party and guaranteed by the owning government. In both cases, the owning government would bear the loss if the regulated entity defaulted.

The cost of debt may also be less than what a regulated operation would have to pay on a stand-alone basis, even if the entity had a normal capital structure. Again, this is often because of the debt guarantee.

In some cases, regulated operations do not seek compensation on behalf of their owner for the debt guarantee or for the higher equity risk. However, where they seek it, it would be unfair to deny compensation for risk that private investors are normally compensated for.

[7] In a competitive market, where future changes in current costs can be anticipated, the amortization and recovery of costs would tend to reflect the anticipated changes. As a result, to the extent that future changes in current costs could be anticipated, there would not be windfall gains and losses. Similarly, in a regulated environment, it could be argued that anticipated changes in future current costs should be reflected in the amortization and recovery of the costs; thereby avoiding the windfall gains or losses.

One approach to dealing with this issue is to use a deemed capital structure for government owned operations and a cost of debt[8] and equity that reflects this deemed capital structure. This capital structure would reflect what a stand-alone operation would require.

This approach is justified on the basis that it reflects the minimum cost of capital for the regulated operations on a stand-alone basis.[9] On the one hand, customers should not have to pay more because a regulated operation is government owned. On the other hand, governments should not be required to accept lower returns than those earned by a private investor. Indeed, many would argue that governments should be as prudent as a private investor in using taxpayer funds.[10]

#### 2.3.4.3 Related Party Transactions

The purpose of prescribing accounting treatment for Related Party Transactions is to ensure that licensed operators do not understate the economic profit of the licensed and regulated services. Related parties are defined as:

- Members of the same group of companies as the Corporate Entity, including subsidiaries, joint venture partners, joint venture companies and other similar arrangements, and the group's associated companies over which the Corporate Entity's ultimate shareholder (where the ultimate shareholder excludes the Government) can exert significant influence such as, in the case of SAPO, Postbank and other SAPO subsidiaries; and
- Companies outside the group of companies of which the Corporate Entity is a member, over which the Corporate Entity's ultimate shareholder (where the ultimate shareholder excludes the Government) can exert significant influence.

Transactions between the licensed corporate entity and related parties are identified, disclosed and treated at an arm's length value in the Notes to Audited Financial Statements submitted by an operator. However, transactions between the licensed entity and unregulated services are not explicitly dealt with through SA GAAP and the requirement to report such transactions between the regulated and unregulated segments of a postal union’s business operation must be explicitly prescribed in the Postal Accounting Manual.

Transactions in this category include:

8 The difference between the entity's cost of debt and what it would be on a stand alone basis may be treated as a debt guarantee fee.
9 There may be some downward adjustments to reflect economies of scale achievable as a result of raising funds through the government. This is consistent with the approach that is often taken where an entity is a subsidiary of a larger company.
10 Governments may have other objectives beyond those of a private investor, and these may be more important than financing costs. However, this does not mean governments should ignore financing costs.

- **Receipt and provision of services** which must be must be valued at the prevailing market price or in the absence of market price, the cost of such services including associated overheads
- **Asset transfers** which must be valued at fair market value or in the absence of market values, the asset's net book value based on historical cost accounting records.
- **Assets** which are shared between the licensed entity and the unregulated are charged to the licensed entity the basis actual usage or anticipated usage. Both periodic and capital costs are allocated to these entities.

#### 2.3.4.4 Accounting Separations Principles

For accounting separation purposes, accounts should be prepared on a fully allocated cost basis, whereby all the revenues, costs, assets and liabilities are allocated to segments according to the principles set out below. Licensed operators must ensure that their accounting separation methodology adheres to the key principles of:

- **Causality** where revenues, costs, assets and liabilities must be attributed to cost pools on the basis of how those cost pools cause the revenues to be earned, costs to be incurred or the assets to be acquired or liabilities to be incurred. Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution must be such as to reasonably present the revenues, costs, assets and liabilities accounted for by the segments, and to present a reasonable comparison between the segments
- **Objectivity** where attribution must be objective and not intended to benefit either the Operator or any other Operator, Business or service. The attribution must be objective and not intended to benefit either the Operator or any other Operator, Business or service.
- **Consistency** where operators must use the methodology consistently from year to year. Where there are material changes to the basis and method of revenue, cost, asset or liability attributions, the Operator must restate those parts of the previous year's Regulatory Financial Statements affected by the changes, to the extent that prior period financial and non-financial data is available.
- **Transparency** where attribution methods used must be transparent. Revenues, costs, assets and liabilities attributed to cost pools must be traceable back to their source in the Operators' accounting records.

#### 2.3.4.5 Measurement Issues

It is preferable that the accounting practices adopted by licensed operators for reporting to the Authority be the same and be applied consistently. However, for practical purposes the following measurement issues will arise, particularly where operators' records do not fully correspond to the reporting requirements of the Authority. Accordingly, the Postal Accounting Manual should explicitly address such issues.

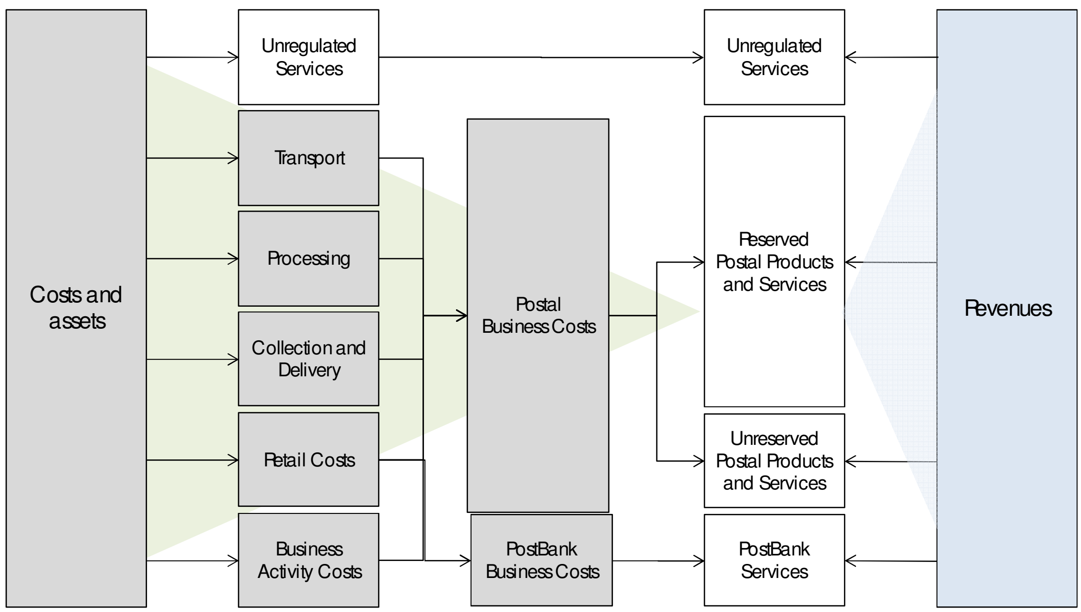
- The **historical cost basis** of accounting should be used for regulatory financial reporting practices since the most significant cost items are short-run in nature. Current cost accounting is impracticable for postal operations.
- **Materiality** issues occur where accurate identification of revenues and costs for a prescribed regulatory segment may be practicable because either revenues or costs are less than 5% of the total revenue or cost structure of a postal business. Where it may be impracticable for an operator to disaggregate costs, the Postal Accounting Manual should provide waivers to prescribed accounting practices.
- **Spare Capacity** may occur when the licensed operator provides for more retail outlets or suddenly expand operations to accommodate anticipated growth in operations. The cost of such spare capacity should be allocated to segments in the same proportion as used capacity.
- **Bundled Revenues** occur where single revenue is levied for a group of products and services (for example large business contracts, E-post etc). In such cases, where two services are combined into a packaged offering, at a bundled price, such pricing must be unbundled and allocated to the respective segments in relation to the costs associated with the individual elements comprising the bundled revenue stream.
- Where **sampling** is used to derive revenues and costs of a segment because the internal records of an operator are not at a sufficiently detailed level, such sampling should be based either on generally accepted statistical techniques or other methods that should result in the reasonable attribution of revenues, costs, assets and liabilities.

### 2.3.5 Accounting Separations Methodology

The methodology proposed is conventional to most accounting separations manuals where all revenues, costs and assets are attributed to businesses, cost centres and product / service segments on the basis of causality. Licensed Operator will have the flexibility to develop their own approaches provided they stay within the broad guidelines and furnish the information the Authority requires.

The attribution steps are illustrated in the figure following:

**Figure 5: Accounting Separations Process**




The broad attribution steps are as follows:

- All revenues, costs and assets, including the cost of capital, that are recorded in the operator's financial records are allocated to businesses and cost centres and then subsequently allocated to other cost pools on a common basis.
- Revenues are allocated or assigned to products and services based on accounting records or sampling.
- Support activity costs are indirectly attributed to cost centres, businesses and unregulated services using the most reasonable cost driver available. For example, human resource costs may be attributed

to primary activities using the number of staff performing each of the activities.

- Business and Cost centre activities are allocated to individual products and services using the most reasonable cost driver available. For example, collection costs may be attributed to postal services using mail collection volumes.
- Revenues and costs are accumulated by product/service to derive profit /loss statements by product/service.

The attribution approach is a tiered attribution process beginning with the identification of directly attributable costs and progressively attributing indirect costs on the basis of cost driver relationships.

### 2.3.6 Measurement of the Net Cost of Universal Service

The definition for universal service typically includes services to *uneconomic customers* and services to *uneconomic areas.* Uneconomic customers are customers who generate revenues that are lower than the cost of providing service to them. Uneconomic customers typically tend to be low volume users of postal services. Uneconomic areas comprise geographic areas that are unprofitable to serve.

The measurement of the net avoidable cost of universal service comprises the net cost of serving uneconomic areas. The measurement of the net cost of "uneconomic customers" per the theoretical definitions problematic since customer segmentation data is unlikely to be readily attainable for ongoing measurement purposes. The net avoidable cost of universal service comprises *costs that would be avoided and revenues that would be foregone if an operator did not have a universal service obligation*. Accordingly, the measurement of net costs would embody the following two elements must be measured for each geographic segment, as identified in SAPO's licence:

- Revenues and costs for *domestic outgoing mail and small parcels* which would be foregone if that area were to no longer exist; and
- Revenues and costs for *domestic incoming mail and small parcels* which would be foregone if that area were to no longer exist.

### 2.3.7 Reports

The reports proposed span the range of business activities of the postal organisation and ultimately allow the Authority to measure profitability by selected reserved services and unreserved services. Additional reports are prescribed to ensure RFS are verifiable and have integrity.

| Figure 6: Regulatory Financial Reports | |
|---|---|
| • Unconsolidated Financial Reports | • Requires the operator to ensure that it starts with its own accounts which reconcile to its audited and internal book keeping.<br>• The Unconsolidated Financial Statements must reconcile to Published Annual Financial Statements. Discrepancies must be itemised and addressed in reconciliation statements included in the RFRs.<br>• These reports also require the operator to separate company financials into postal services, Postbank services and unregulated services. |
| • Audited Financial Statements | • Verifies accuracy and reliability of information reported in accordance with regulatory accounting guidelines |
| • Cost of Capital Report | • Provides a detailed analysis of how the cost of capital was determined and the assumptions used.<br>• Assumptions can be validated and challenged by the regulator. |
| • Business and Cost Centre Report | • Provides an illustrative view of the cost structure of the organisation by major cost and business centre.<br>• The financial figures reported here must reconcile to the financial figures reported for postal operations on an unconsolidated basis.<br>• The report requires operators to separate postal and Postbank services as well as highlight were services along specific functions and shared across the businesses.<br>• This report provides a first indication of whether the operator is earning economic profits. |
| • Segment Report | • Can support the evaluation of tariff applications since rate filings will correspond to profit/loss segment categories. Calculates the economic profit earned by each service and customer segment.<br>• Calculates the cost of reserved and other postal services and the imputed transfer price of postal services to each retail and wholesale service.<br>• Calculates the net contribution of services offered through affiliate and non affiliated agencies. |
| • Universal Service Report | • Calculates the net cost of universal service. |
| • Reconciliation to Financial Statements | • Compares "Regulatory Reports" to Audited Reports and explains differences. |
| • Report from the Auditor | • Confirms that reports are prepared in accordance with regulatory reporting regulations. |

### 2.3.8 Level of disaggregation

- The Authority recognizes that each business segment and cost centre, within the Corporate Entity is not a separate, stand-alone business / cost centre and that the six units comprising Regulated Services, together, provide the full range of Postbank and postal services to end-users and customers.

- The disaggregation of the Corporate Entity into these components, hereafter referred to as "businesses or cost centres", is a notional separation for the purpose of providing transparency on revenues, costs and assets that are transferred to or from businesses and cost centres to each other.

- The Authority further recognizes that the total cost of providing products and services to the marketplace comprises a combination of retail, processing, collection and delivery costs, and sales and customer services.

- Unless otherwise specified by the Authority, unconsolidated financial statements for the Corporate Entity must be used as the starting point for accounting separation.

- The Corporate Entity is to be disaggregated into: Unregulated Services and Regulated Services.

  a) Unregulated services comprises all other products and services provided by the Corporate Entity and may include, but not limited to, such services as real estate rental, restaurant operations, etc. The Unregulated Segment also includes subsidiaries or associates that are already regulated in their own right.
  b) Regulated services include all Postal and Postbank services, as defined in the Postal Act 124 of 1998, as amended, and the terms and conditions of licences issued to the Licensed Operator.

# 3 INTERNATIONAL PERSPECTIVES ON POSTAL SERVICES REGULATION

The postal services sector is a market in flux. Developments in telecommunications and electronic communications have presented new challenges to the traditional postal market and threaten to erode the industry. Traditional mail is largely being replaced with email and text messaging among other methods of instant communication. Many businesses have adopted electronic invoice systems and now accept electronic payments rather than sending traditional paper invoices through the mail and receiving paper-based payments. It is highly important to understand that bills, invoices, notifications, and statements of business customers represent the bulk of most postal system volumes and these very mail usages are most susceptible to technological options offering cost, convenience, environmental, and speed advantages. These factors alone provide competitive pressures and challenges to the postal industry as a whole, forcing postal operators to develop efficient and innovative ways to provide their services to both business and the public.

Despite these challenges, the postal industry still has a relevant place in today's global marketplace. The Universal Postal Union ("**UPU**") states that despite the international trend towards electronic communication, there remain a limited number of major customers that generate the majority of volume upon which the global postal network operates. As such, the postal market can be viewed as moving away from social mail services, and towards business and corporate mail, albeit with consumers on the receiving end of those transactions.

Given the continued, though increasingly tenuous, importance of the traditional postal service, governments and regulators are faced with a complicated set of challenges. The challenges for a regulator in the postal market are multifaceted yet interwoven which can lead to complex and contentious decision-making. Primary among these challenges is to provide postal administrations an environment in which they can continue to grow despite these challenges, while ensuring that there is competitive behaviour within the sector.

While the postal market itself has experienced negligible growth in aggregate in recent years, it remains an important tool for communication as well as economic development domestically. For these reasons, it is crucial that regulators create an environment which is sustainable from the perspective of operators while maintaining affordability, a high quality of service and the greatest possible level of accessibility for consumers.

The countries examined in this section include Australia, Canada, Finland, Germany, Great Britain, Japan, Malaysia, Poland, Tanzania, Uganda, the United States and South Africa. This selection enables us to compare activities across countries with varying levels of economic development, geographic size and population densities. Moreover, this variance provides the backdrop to regulatory policies that may be effective given the contingent features of a specific country.

## 3.1 International Trends in Postal Services

The postal market has not experienced any meaningful growth in recent years, with volumes declining on average by 3.18% between 2005 and 2007 (Notably, this conclusion is based on the inclusion of Uganda's precipitous decline in volumes). With the proliferation of electronic mail, as well as other communication mediums, postal operators have argued that there is little opportunity for growth in the market. The critical issue for these operators is how to respond to these new technological challenges facing traditional letter-mail.

Figure 7
Average Percentage Growth in Domestic Letter Mail Volumes (2005-2007)

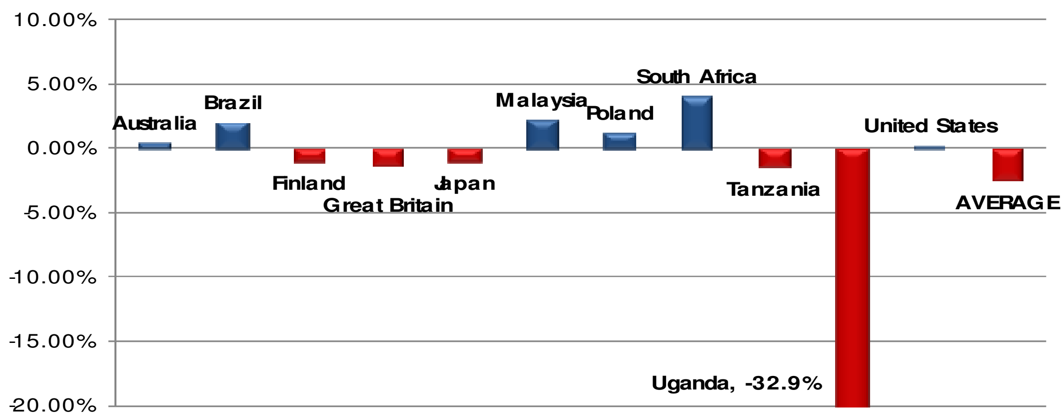
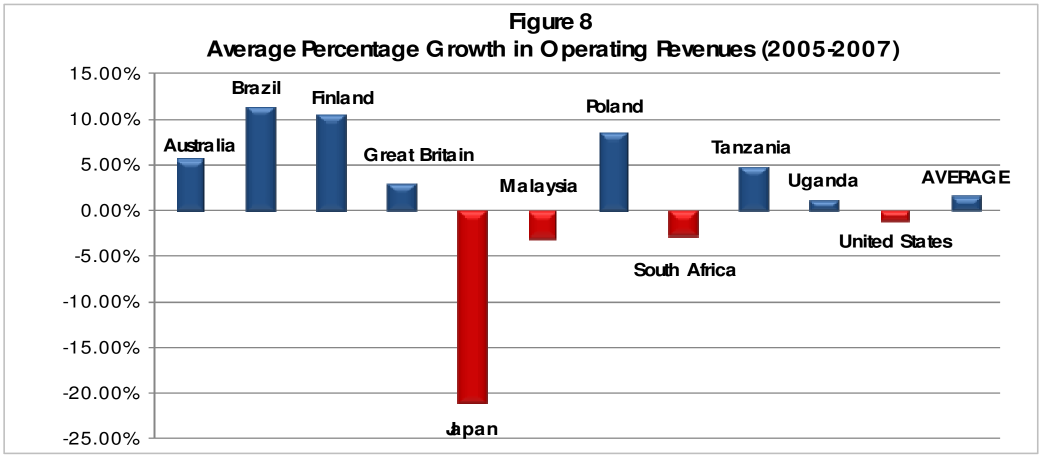
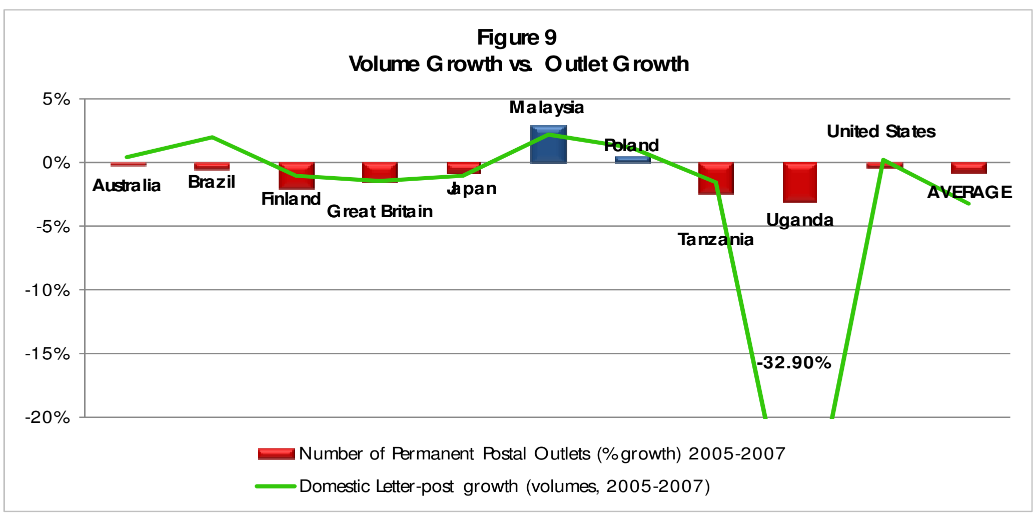



Figure 7 above demonstrates that in emerging countries, such as Malaysia and Brazil, there remains an opportunity for growth in the basic letter-mail segment. However, other African countries such as Uganda and Tanzania have struggled to achieve growth in this segment. By contrast, many developed nations are experiencing negligible growth, or even losses, in letter-mail volumes.

As growth in the volume of letter-mail has stalled, so too have postal revenues. Among the countries analysed, the average growth of mail revenues was a mere 1.54% over a three year period, as shown in figure 8 below. While some nations have experienced meaningful growth in postal revenues, others – even those with increasing volumes – have seen declining revenues in recent years. Given the apparent difficulties for postal operators in a technology-driven environment it is critical that regulators understand the need to create an environment which is sustainable for these postal operators. This environment would need to ensure that postal operators have the flexibility to stimulate revenue growth in related areas of their business, while remaining unfettered from a heavy regulatory obligation.




As demonstrated in figure 9 below, it is inconclusive whether there is a correlation between growth in postal outlets and growth in mail volumes.

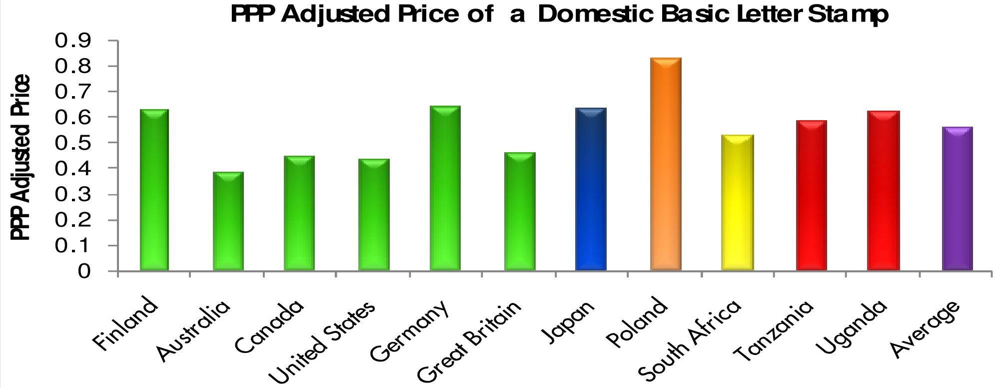



The most critical issue in postal regulation is the balance a regulator must strive to achieve between profitability of the postal operator and accessibility as well as affordability of postal services. In most cases, we have observed that as postal unions increase their points of presence, to other parts of their respective countries, they experience increases in mail volumes. However, the correlation between postal outlets and mail volume cannot be assumed as the policy makers impose an ambitious roll-out obligation on SAPO. Arguably, as the postal operator arrives at saturation points, there will be a need to moderate licence roll-out obligations or universal service obligations to ensure continued viability of the sector.

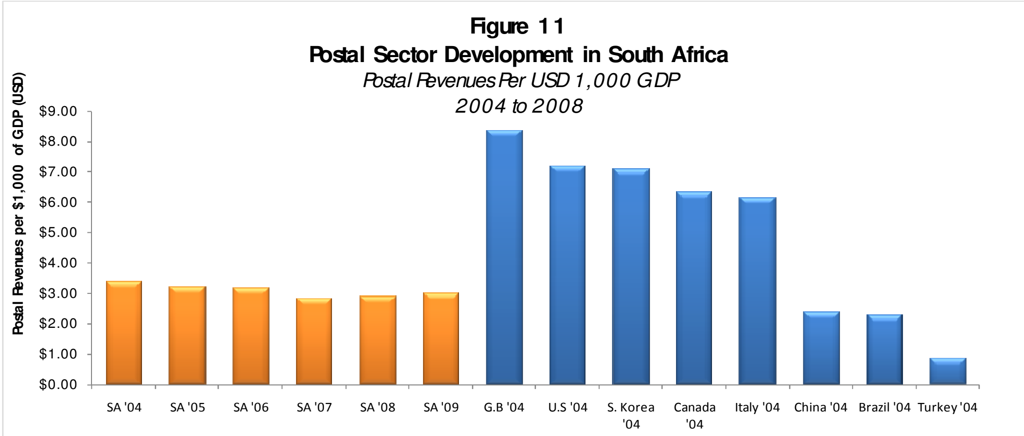
Furthermore, affordability is seen as one of the key elements of universal service – an objective of virtually all of the postal regulators studied. Lower prices for basic mail can have a positive impact on economic development by keeping communications costs low -- however costs that are too low may be reducing the funding pool for additional rural points of presence which is another key element of universal access. Consideration of alternative funding mechanisms may need to be on the agenda to ensure that the postal operator can comply with universal service obligations along with other possible policy objectives.

South Africa's tariffs appear to be on par with the average of the countries studied. The low price of basic letter-mail in South Africa has undoubtedly assisted in the provision of accessible postal service and looks to serve the country well in its economic development.

Figure 10
PPP Adjusted Price of a Domestic Basic Letter Stamp




When measuring the development impact of postal service, the Universal Postal Union uses a calculation of Postal Revenues per US$ 1,000 of GDP. This is meant to demonstrate the correlation between development and a strong postal sector.




South Africa compares favourably with other developing nations, earning revenues of US$ 3.38 per US $1,000 GDP in 2004. There remains, however, a significant disparity between South Africa and the world leaders in this area.

## 3.2 The Reserved Area

The concept of Reserved Area has evolved from the need to provide postal Universal Service Providers ("**USPs**") with the funds necessary to support their universal service requirements and in many countries it continues to serve this purpose. It recognises that the postal sector is commonly viewed as a natural monopoly and therefore, provides exclusive privileges to operators licensed to provide such services. However, this privilege comes at a cost – namely to assume a Universal Service Obligation ("**USO**") – and this cost needs to be measured to understand the effect of USO on the financial viability of an operator.

The provision of postal services for an entire country requires an extensive and costly network. Unlike telecommunications, this network is not constructed of wires and base stations but rather of people, outlets and delivery vehicles. Postal services consist of the pickup, conveyance and delivery of tangible goods. The need for this service will not disappear no matter how ubiquitous telecommunications services become. As such, these services rely heavily on a vast and substantially fixed network of postal workers, sorting centres and transport fleet to perform these functions -- suggesting that perhaps postal services may be viewed as, as many utilities are, a natural monopoly. As a consequence of this enormous network, economies of scale suggest that competition in the postal market, taken as a whole, is difficult. The UK regulator, Postcomm, stated that, "it is proving very hard for new operators to compete against Royal Mail's scale economies."[11] Rather than compete in end-to-end delivery, secondary entrants choose instead to "cherry-pick" profitable

[11] Postcomm *Strategy Review* (August 2007).

segments from the primary operator in lieu of competing in all service segments. Such "cherry-picking" can complicate universal service requirements as the profitable segments of the postal business are often critical to the funding of universal service, which often represents some cost to the USP. Naturally, there are varying means of recovering this funding; including reserved services, which preserves adequate profitable segments.

Liberalisation in the postal sector is a relatively new phenomenon and as such there is little information available on the subject. Most experience in this area has been experienced through forced liberalisation within the European Union, and this experience is therefore flavoured with intra-Union competitive dynamics that blur relevant experience for other global jurisdictions. However, there is some evidence to suggest that liberalizing postal markets has little effect on competition.

- **Germany**: As of 2004 nearly 33% of the German postal market had been opened to competition and yet Deutsche Post maintained a 95% market share.[12] While competitive market share has since increased, Deutsche Post remains highly dominant.
- **Great Britain:** In Great Britain less than 1% of addressed mail volumes are currently delivered end-to-end by Royal Mail's rival operators.[13]
- **New Zealand:** While the New Zealand market fully liberalised in 1998, only limited competition has taken hold in that small market.
- **Sweden:** Sweden has been liberalised since 1993. However, despite numerous attempts by challengers firms, the incumbent maintains over 90% market share.
- **Japan Post:** While liberalised, more to liberalise its banking operation than its postal services, there is virtually no competition thriving in Japanese postal services.

Based on a review of the jurisdictions selected, it would appear that the prospects for liberalisation may rely on increasingly liberal processes, such as enabling pre-sorted or partially pre-sorted volumes into sorting centers and delivery stations, rather than full end-to-end competition. Moreover, these figures lend credence to the argument that the postal sector represents a natural monopoly.

[12] Pique, *Liberalization, privatisation and regulation in the German postal services sector (2006).*
[13] Postcomm *Strategy Review* (August 2007).

### 3.2.1 International Definitions for Reserved Services

There is tremendous variance in the scope of reserved services in the postal sector. For example;

- **The United States**: In the United States the reserved area includes letters up to 70 lbs regardless of classification. This classification can be suspended if the letter is "extremely urgent" and meets the qualifications of a "loss-of-value" test or a simple cost test. Uniquely, the United States Postal Service ("**USPS**") has a monopoly on the use of mailboxes (even if they are owned and maintained by the houses to which they belong).
- **The European Market**: The European Commission has determined that the reserved area should no longer be the preferred method for funding universal service obligations. Directive 2008/6/EC of the European Parliament and the Council states that in an attempt to create an internal European Market that it is appropriate to end the use of the reserved area and of special privileges as a means of funding these obligations. As such the EC has incentivised the abolition of the reserved area by the end of 2012.

These definitions provide contrasting examples of the state of postal liberalization as it pertains to reserved services. On the one hand, the United States maintains a fairly rigid postal monopoly whereas the European Commission has determined that it is now appropriate to do away with the reserved area entirely. Below is a table outlining the definitions of reserved services adopted by several international jurisdictions.

**Figure 12: Alternative Definitions for Reserved Services**

| Country | Definition of Reserved Services |
|---|---|
| **Australia** | (i) Collection and delivery of letter-mail (standard letter service - max. 250g, with basic tariff within Australia (ii) issuance of postage stamps. |
| **Brazil** | (i) Letters, postcards, telegram and consignments and (ii) a monopoly on the production and issue of postage stamps and other means of postage prepayment. |
| **Germany** | No Definition. 2008 marked the end of the reserved area in Germany following a gradual liberalisation process. |
| **Great Britain** | No Definition. The market has been fully open to competition since 1 January 2006, though service providers still require a licence to provide postal services. |
| **Japan** | The "Law Concerning Correspondence Delivery provided by Private-Sector Operators" came into effect on 1 April 2003 and permits private-sector operators to engage in general correspondence delivery services. However, as of 1 April 2005, there was no private-sector operator |

| | |
|---|---|
| | licensed to provide the general correspondence delivery service with full national coverage though there are several operators licensed to provide high 'value-added' postal services. |
| **United States** | The reserved area includes letters up to 70 lbs regardless of classification. This classification can be suspended if the letter is "extremely urgent" and meets the qualifications of a "loss-of-value" test or a simple cost test. Moreover, USPS has a monopoly on the use of mailboxes (even if they are owned and maintained by the houses to which they belong). |

### 3.2.2 Accounting Separations

The reserved area provides a partial monopoly to selected postal operators. Therefore, it is critical that there exist stringent accounting separations requirements upon these operators in an attempt to ensure that there is no cross-subsidisation to unreserved products or services and other unregulated services. Some international examples of reporting requirements or objectives include;

- **Great Britain:** Currently, Postcomm requires product-based accounting separations with the intention to move towards a more detailed separation of accounts in order to determine the cost of "the last mile" as process-liberalisation begins taking hold in Great Britain.
- **The European Market:** The EC has been attempting to move its accounting separation requirements from high-level segment separation (i.e. reserved area, universal service, etc.) to more specific, product-based separations.[14]
- **Ireland:** The universal service provider is required to keep separate accounts for each service in the reserved sector and unreserved sector. These reports must be sufficiently detailed to conduct analysis on a "geographic or category of customer basis."[15] There is, however, no obligation to maintain management accounting systems.
- **Canada:** Canada Post Corporation discloses in its Annual Report audited revenue, cost, and margin separations based on product as well as regulatory classification.
- **Australia:** Australia Post is subject to annual financial reporting in which they must report on the extent to which Australia Post met its prescribed performance standards.
- **Uganda and Tanzania:** Ongoing reporting is not required. Licensees are required to furnish documents, accounts, financial data, estimates, returns, reports, or any other information, as the Authority may require.[16]

[14] Universal Postal Union, *Postal Regulation Principles and Orientation (2004)*.
[15] Commission for Communications Regulation, *Regulation of Universal Postal Services – Accounting Separations & Costing Methodology (2006)*.
[16] Uganda Communications Act, pg 51, Conditions of a Licence, Tanzania Postal Act, 2005 (23).

### 3.2.3 Price Regulation

As is most often the case with regulated monopolies, the regulation of price is an important issue in the postal sector.

Price control **(i.e. CPI +/- X)** is considered appropriate where pricing strategies are not intended to be reflective of costs (such as in instances where there is a universal service obligation as well as an obligation to maintain affordability within the service).

### 3.2.4 International Perspectives on Postal Services Regulation

By contrast a **"rate of return"** system accounts for costs and then adds a reasonable margin or return to these costs and sets prices based on these figures. This model is considerably "heavier" from a regulatory perspective as it requires strict and persistent monitoring of costs. Moreover, from the perspective of price-setting in the postal sector, there is a possibility that setting the prices of certain products in this way (particularly those which are universal service obligations) can distort markets and lead to higher than optimum prices as it incentivises excessive investment in infrastructure as all costs of providing services can be fully recovered.

Among the jurisdictions studied, price-control regulation is the most prevalent. In this regard, each jurisdiction applies these controls to reflect their respective market conditions:

- **Great Britain:** Price regulation in Great Britain is currently based on an RPI-X framework and the use of this model was extended by Postcomm in April 2009. This model is applied to all licensed products. Postcomm has expressed some concern that this model may not adequately promote increased efficiency as the postal sector is not technology-driven as most markets that use this model for price regulation are. However, this argument cannot be substantiated and presumes that postal unions have no margin for productivity improvement – which is unlikely.
- **France**: France has a regulator-imposed price cap on services which fall under the purview of universal service. Thus, services which are deemed to meet universal service requirements may not exceed this regulator-imposed price while competitive or non-essential services may be priced by the postal operators themselves.
- **Germany**: Germany has a price cap which uses three separate baskets; one pertaining to bulk mail, one to individual letters and one to work sharing arrangements. The model for this price cap is based on the RPI-X framework.
- **Portugal**: Portugal's price regime states that the weighted average price variation of reserved postal services cannot exceed (CPI+CPIAF)

- 0.3% in nominal terms. CPIAF is an adjustment factor which corresponds to the difference between the inflation value and the level of inflation officially expected.

- **Netherlands**: The Netherlands has two price cap baskets; the first pertaining to global universal service and the second to private customers and small businesses in universal service.
- **Canada**: Canada has a maximum increase for core letter mail products only where the increase is equal to two-thirds of inflation year-over-year (CPI -1/3). Other services are monitored only through disclosure and government approval. In light of current economic and volumetric trends, however, this mechanism is changing to provide substantially higher flexibility to price-setting

## 4 CURRENT REGULATION OF RESERVED POSTAL SERVICES

Postal Services in South Africa are overseen by the Department of Communications ("**DOC**") and the Independent Communications Authority of South Africa. The Act outlines the policy objectives and regulation associated with postal services in South Africa. The stated objectives of the Act are the promotion of modern, accessible, affordable and universal postal services throughout South Africa and stability and competition within the South African postal sector. The Act details the scope of reserved services and provides broadly-defined policy regarding regulatory oversight, pricing procedures and service obligations for postal and financial operations. The licence issued to SAPO by ICASA (most recently Licence No. 2008/005477/06) provides more detailed information regarding the USO, the determination of tariffs and regulatory reporting procedures and delivery and retail point rollout targets for SAPO.

SAPO holds a monopoly over reserved services, as outlined in the Act. Reserved services include "all letters, postcards, printed matter, small parcels and other postal articles subject to the mass size limitations (length 458 mm, width 324 mm, thickness 100 mm and a mass of up to one kilogram; cylinders must have a maximum length of 458 mm and 100 mm thickness and a mass of up to one kilogram) [and the] issuing of postage stamps and the provision of roadside collection and address boxes". All other postal services not listed as reserved services in the Act are open to competition, including courier services and the delivery of newspapers and other periodicals. However, Section 20 of the Act requires that operators of unreserved services hold a registration certificate issued by ICASA. This definition of reserved services implies that postal service liberalisation in South Africa has progressed similarly to comparable jurisdictions like Australia and Brazil.

At present, the current Act makes no specific mention of the requirement of the licensed postal operator to adhere to an Economic Regulatory

Framework for reserved postal services. Rather such requirements are implied in the operator's licence.

## 4.1 Price Controls and Tariff Applications

With respect to tariffs for reserved services, the licence issued to SAPO dictates that ICASA has the authority to determine a price cap which may include allowances for USO-related capital expenditure and/or a productivity factor ("x"-factor) to encourage operator efficiency. However, at present neither the licence nor the Act prescribes a specific method for determining such a price cap. The Act further stipulates that tariffs for reserved services may be differentiated from those that are unreserved (courier services are exempt from the aforementioned regulations) and that tariff changes must be published in the government Gazette sixty days in advance of taking effect.

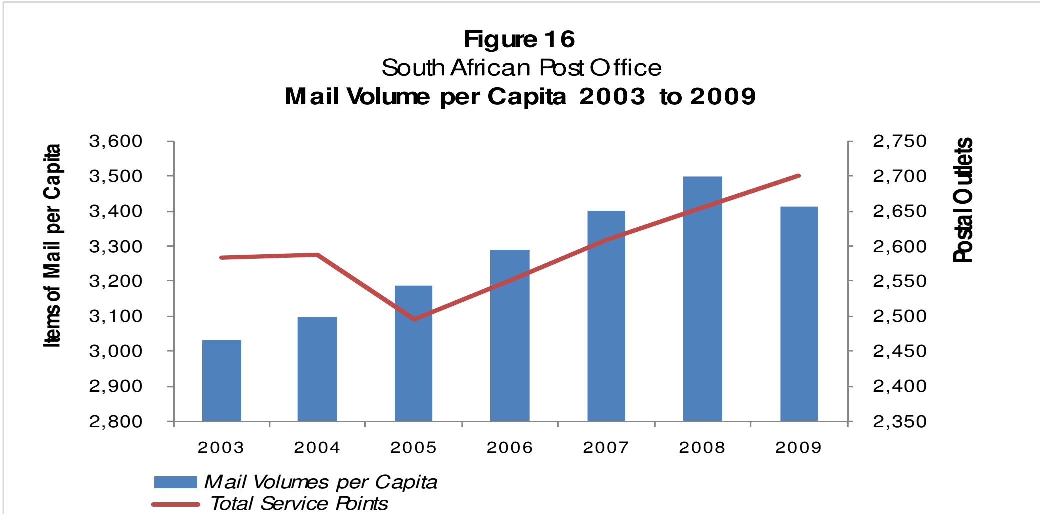
## 4.2 Accounting Separations

For the purposes of tariff determination, ICASA requires that SAPO provide information regarding cost structure and cost reduction, capital expenditure and profits are to be included in annual tariff proposals. Furthermore, SAPO is forbidden to use profits from reserved services to cross-subsidise unreserved services (although it may use profits from unreserved services to finance reserved services). To this end, SAPO is required to prepare separate, audited financial statements for both reserved and unreserved services within six months of the end of each financial year. Notably, the EC and Great Britain have progressed from the type of segment-based accounting separations used in South Africa towards more specific product-based accounting separations in order to better determine the incremental costs of service provision.

# 5 THE SOUTH AFRICAN POST OFFICE LTD

The South African Post Office Ltd. ("**SAPO**") was officially established on October 1st, 1991 and is wholly owned by the Government of South Africa ("Government"). Although government-owned, SAPO operates independently and is expected to be profitable. However, SAPO faces several challenges, foremost of which is the vast service area the size of France, Germany and the UK combined (1.2 million km²), much of it remote and sparsely populated. Consequently, universal service obligations ("**USO**") are substantial, and SAPO did not realise an operating profit until 2004.

As of March 2007, SAPO operated 2,650 postal outlets throughout South Africa, equal to a density of one outlet per 14,043 residents (excluding children) -- superior to comparable figures in China (one outlet per 22,283 residents) but approximately half the postal density in India and almost a fifth of that in Russia (one outlet per 6,649 and 3,383 residents respectively). SAPO has also seen an increase in their mail volumes per capita, though this number appears to have levelled off in recent years.




## 5.1 Corporate Structure

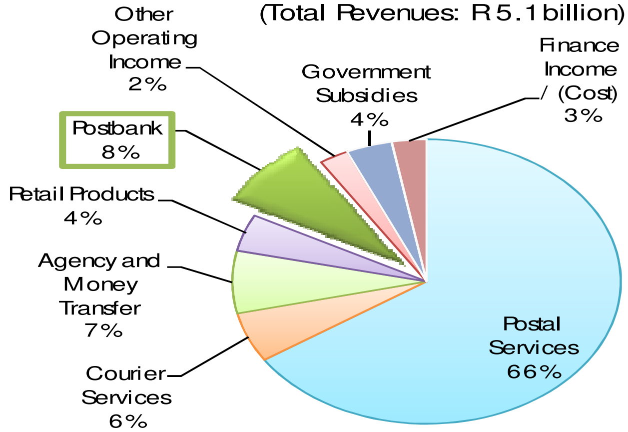
In addition to postal services, SAPO Group includes several subsidiaries. The foremost is Postbank, the largest financial institution in South Africa in terms of service area. Currently operating as a part of SAPO Company, Postbank is expected to become a separate corporation within the SAPO Group of companies by 2011. As of November 2007, SAPO Group's other retail subsidiaries were organised into the Logistics (which includes courier and document services) and Information and Communications Technology ("ICT") divisions. Following a market survey in 2008, SAPO announced plans to develop a new "brand architecture" during the 2009 fiscal year.

## 5.2 Financial Profile

### 5.2.1 Revenue, Profit and Asset Profile

As seen below, SAPO's revenues are mostly derived from Postal Services which generated 66% of the company's total revenues for the 2008 fiscal year.

**Figure 17**
South African Post Office
**Revenue Profile as of March 31 2008**
(Total Revenues: R 5.1 billion)



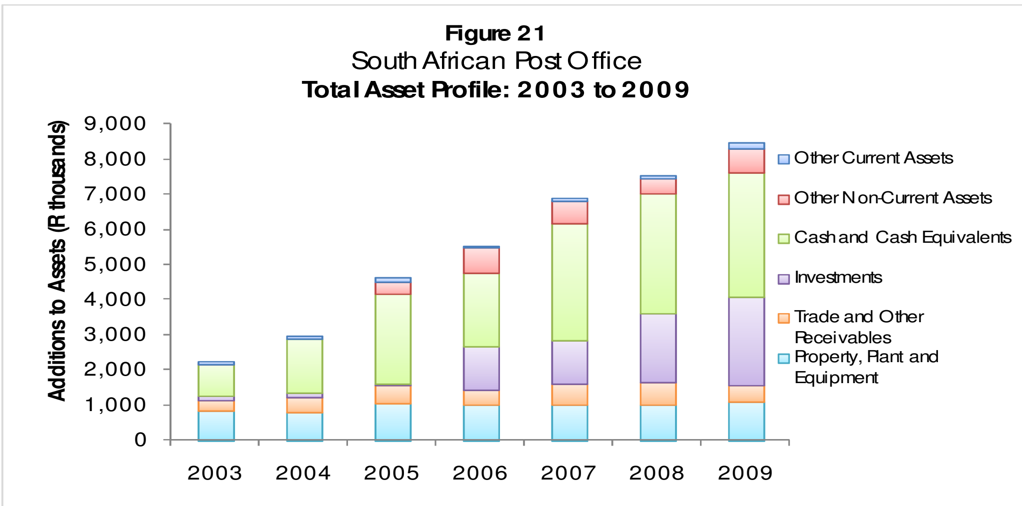

Current reporting by SAPO does not necessarily delineate reserved postal services from unreserved postal services. Accordingly, if ICASA is to review tariffs for reserved services, such information is a pre-requisite for monitoring. The Accounting Separations regulation proposes to prescribe more detailed revenue reporting of reserved and unreserved services to enable ICASA conduct more thorough analysis of revenues and tariffs, accordingly.

SAPO's profits and return on assets have been modest. Profits declined sharply from 2006 to 2007 before recovering slightly in 2008. This is consistent with declining government subsidies, which fell sharply from ZAR 164.9 million in 2005 to ZAR 86.7 million in 2006 and ZAR 72.9 million in 2007, and rising costs.

Return on assets have improved significantly, reaching a peak of over 25% in 2005, between 2003 to 2009 and now appear to be stabilising at 5% to 6% per year.

SAPO's profits and return on assets have been modest. Profits declined sharply from 2006 to 2007 before recovering slightly in 2008. This is consistent with rising costs and declining government subsidies, which fell sharply from ZAR 164.9 million in 2005 to ZAR 86.7 million in 2006 and ZAR 72.9 million in 2007.

However, SAPO continues to earn comparable returns when these assets are also included in the analysis. The Accounting Separations Regulations will continue to require SAPO to provide transparent reporting on all its assets as this will have a bearing on cost of capital determinations.




Furthermore, both 2008 and 2009 saw the greatest capital investment of any year, almost ZAR 243 million and ZAR 259, respectively. These net additions include assets funded through government subsidies. In keeping with SAPO's stated objective of increasing service accessibility and modernizing operations, 70% of aggregate investment from 2006 to 2009 was in land, buildings, leasehold improvements and data-processing equipment - over ZAR 237 million. SAPO's asset turnover ratio increased from 75% to over 155 over the period from 2003 to 2009, possibly reflecting increased efficiency in asset utilization in addition to a decrease in total assets and increased revenues. In obtaining accounting separations information from SAPO, ICASA will be able to monitor the extent to which government subsidies have contributed to capital investment as well as where increased efficiency in asset utilization has occurred. In cases where there is a decrease in total assets, ICASA will be better able to monitor where these decreases are taking place, thereby ensuring funds intended for social objectives, such as the provision of universal service, are not being diverted to competitive services such as courier services.

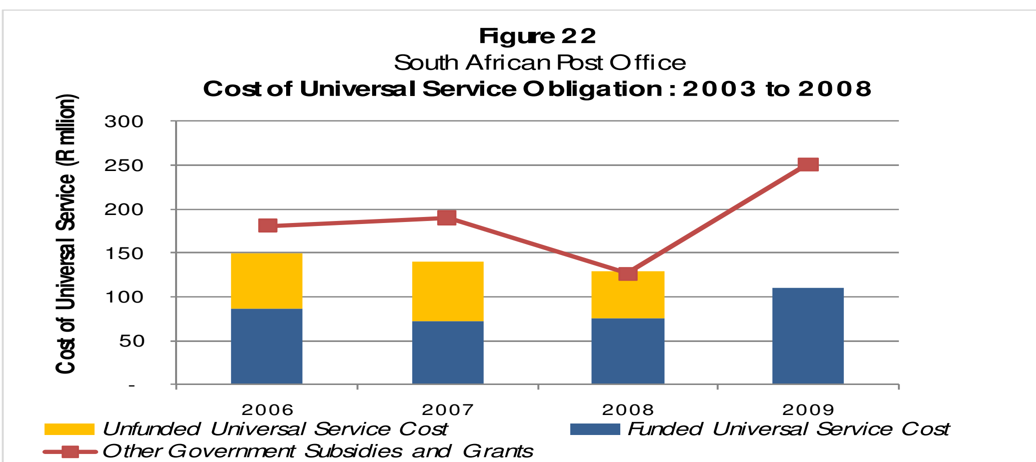
Total Assets (excluding those funded (through government subsidies) declined steadily from 2006 to 2009, from a total of 7.5 billion in 2006 to approximately ZAR 5.6 billion. SAPO held relatively few fixed assets -- property, plant and equipment and other non-current assets comprised less than a third of total assets in each year. Cash, cash equivalents and investments comprised a considerable majority of total assets (between 58-65%). The review was completed with SAPO's published annual reports where financial results are not posted separately for postal and Postbank operations. By obtaining SAPO's accounting separation reports, ICASA will be able to conduct detailed and thorough reviews of SAPO's assets, investment and return on assets in order to ensure the greatest possible level of market welfare.

### 5.2.2 Universal Service Obligation

SAPO reports that its cost of providing USO, according to these terms, was projected as follows:

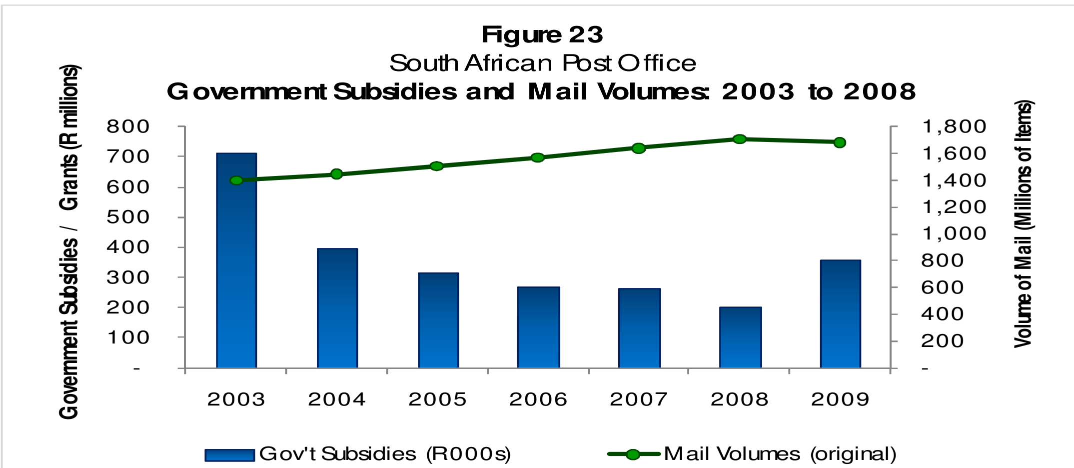
| Year | Projection Per Tariff Application |
|---|---|
| **2006** | R 150 million |
| **2007** | R 140 million |
| **2008** | R 130 million |
| **2009** | R 110 million |

Source: SAPO Tariff Filings for periods ending 2007, 2008, 2009, 2010.




This valuation was difficult to confirm in the absence of access to the underlying methodologies and cost calculations and verified statements from auditors. No reference on the cost of this obligation was explicitly mentioned in the Annual Audited Financial Statements. With detailed accounting separation information, these figures will be easier to accurately assess and SAPO's methodologies will be increasingly transparent.

Furthermore while SAPO reported that the USO might have been underfunded, they enjoyed other government subsidies.




As ICASA begins gathering accounting separations information, it will become increasingly apparent where government subsidies are meeting, exceeding or falling short of the cost of providing universal service. This information will prove invaluable as it will ensure that there is transparency around the costs of providing universal service as well as the government funds SAPO receives to provide these services.

### 5.2.3 Tariffs

South African postal tariffs are among the lowest in the world. Despite sharply rising fuel costs, the tariff increases requested by SAPO from 2005 to 2008 were, on average, consistent with increases in CPIX and below increases in CPIX for regulated prices. The effective increases in the price of a basic letter stamp over the same period increased at about half the rate of the increases in CPIX and PPI. SAPO tariff increases are applied "across the board" without any noticeable product differentiation or tariff rebalancing.

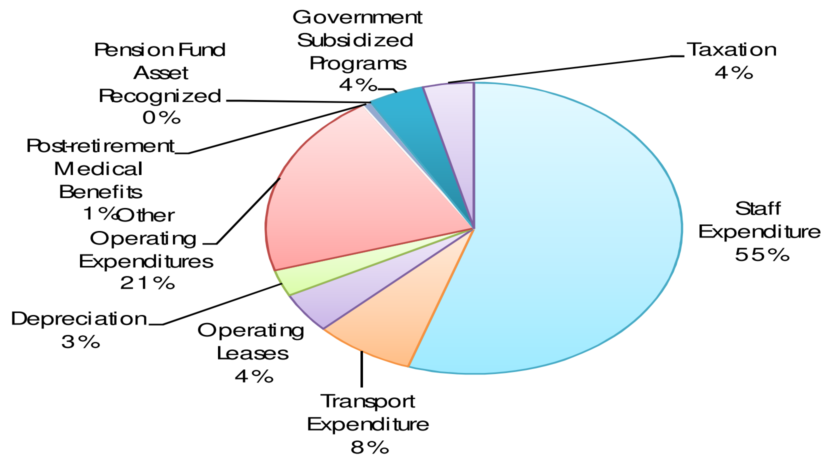
**Figure 24**
**Comparison of Tariff Changes to Other Indexes**

| | 2005 | 2006 | 2007 | 2008 | Average Annual Increase |
|---|---|---|---|---|---|
| PPI (2000=100) | 131.0 | 138.7 | 157.0 | 182.7 | 8.7% |
| PP! – Transport (Vehicles); (2000=100) | 126.0 | 130.2 | 132.9 | 135.2 | 1.8 |
| Crude Oil Prices ($US / Barrel) | 50.04 | 58.30 | 64.20 | 91.48 | 16.3% |
| CPIX (2000=100) | ND | 140.8 | 150.1 | 166.8 | 5.8% |
| CPIX for Regulated Prices (2000=100) | ND | 139.0 | 150.1 | 177.4 | 8.5% |
| **Request for Tariff Increase** | **5.9%** | **6.5%** | **5.5%** | **7.0%** | **5.8%** |
| **ICASA Approved Tariff Increase** | **4.3%** | **4.0%** | **4.0%** | **4.1%** | **4.1%** |
| Basic Letter Price | 1.77 | 1.85 | 1.93 | 2.07 | 4.0% |

So far, although the licence permits it, an "X" factor has not been applied to the "CPI – X" price cap. To a large extent, the existing price controls have managed to contain SAPO's retail prices. The new price cap regulation will provide SAPO with a greater degree of certainty as it pertains to their future rate increases thereby allowing them to make their business decisions with a more complete understanding of the environment in which they will be operating.

### 5.2.4 Cost Structure and Productivity Improvements

**Figure 25**
South African Post Office
**Cost Profile as of March 31 2008**
(Total Costs: R4.6 billion)




Current cost reporting by SAPO does not delineate reserved postal services from unreserved postal services. The regulatory reporting, prescribed in the Accounting Regulations, will permit ICASA to determine the extent to which there are cross-subsidies between reserved and unreserved services and whether the rate regime should be modified if needed.

## 5.3 Implications for Economic Regulatory Framework for Postal Services

Tariff increases since 2005 have been modest - approximately equal to or below inflation indicating that existing regulatory framework have effectively curtailed high retail tariff increases. However, it is important to review the existing framework in line with the changing environment to ensure that it is sustainable in the long-term to avoid adverse impact on customers and SAPO. This is in view of the fact that SAPO faces numerous challenges operating in a volatile and dynamic industry and unique market environment.

# 6 CONCLUSION

It is clear that the Postal Sector face numerous challenges owing to developments in the postal market which have been accelerated to a large extend by technological developments over the past decade. It is therefore imperative that with these challenges and developments in mind, the Authority should develop tools and measurements which would enhance the effectiveness of the regulation of the postal sector. The Price Cap Regulations and the Accounting Separation Regulations will therefore enhance the regulatory role of the Authority to ensure long term sustainability of the sector.