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INDEPENDENT COMMUNICATIONS AUTHORITY OF SOUTH AFRICA

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FINDINGS REPORT ON THE REVIEW OF THE SOUTH AFRICAN POSTAL OFFICE (SAPO) PRICE CAP REGULATIONS

1. On 23 August 2019, the Independent Communications Authority of South Africa ("ICASA or the Authority") published a notice[1] in the Government Gazette, along with a Questionnaire on its website, regarding its intention to review the Price Cap Regulations for Reserved Postal Services, 2013 ("the Regulations") in terms of sections 2 (a), 8(a) and 30 of the Postal Services Act 124 of the 1998 ("PSA") and regulation 10 of the Regulations.

2. The Questionnaire requested the public to respond within 30 working days of the date of publication, with the deadline being 7 October 2019. The Authority received responses from two stakeholders.

[1] Government Gazette No. 42657.

3. The Authority hereby publishes the Findings Report on the Review of the South African Postal Office ("SAPO") Price Cap Regulations, pursuant to the consideration of the submissions received.

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Date: 03/03/2020

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1. Introduction

1.1. Background

The Independent Communications Authority of South Africa ("ICASA/ the Authority") is mandated to regulate postal services in terms of section 2(bA) of the Independent Communications Authority of South Africa Act, 2000 (Act No. 13 of 2000) read with section 8 of the Postal Services Act, 1988 (Act No. 124 of the 1998) ("PSA"). An aspect of postal services regulated by ICASA is that of price controls in the reserved postal sector through the Price Cap Regulations for Reserved Postal Services, 2013[2] ("the Regulations"). Regulation 10 of the Regulations requires that the Regulations be reviewed at least every three (3) years, ICASA has thus conducted a review of same.

This review of the Regulations was preceded by the Regulatory Impact Assessment ("RIA")[3] on the Regulations which determined that a new regulatory framework is urgently needed. One of the observations made from the said RIA is that the current price control obligation is no longer effective or proportionate. It should be noted that a RIA is not a requirement in terms of the PSA but is viewed as regulatory best practice.

Additionally, an assessment on existing legislation and regulations of the postal sector in SADC by the Communications Regulators' Association of Southern Africa (CRASA), found that while South Africa has a clear legal mandate in the law to support postal market reforms, its regulations were not adequate in fostering effective and efficient delivery of postal services.[4] The Authority deems that the review of the Regulations will contribute to creating an environment that promotes and encourages reliable postal services.

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[2] Published under GG 37010

[3] Publicly available at ICASA's library.

[4] Assessment Report of Existing Legislations and Regulations for Reforms of The Postal Sector In SADC, 2013

1.2. Purpose

The purpose of this Findings Report ("Report") is to establish the Authority's findings with respect to required changes to the current Regulations. The need for these changes has arisen out of the review process outlined later in this document (i.e. Section 2: An Outline of the Review Process). The review was undertaken to ensure that the regulation of Reserved Postal Services remains appropriate and sufficient to enable the efficient and financially sustainable provision of reserved postal services.

This Report is based on responses received from stakeholders to the Authority's Questionnaire published on its website on 23 August 2019.[5] The Questionnaire solicited input from stakeholders on the imposition of price control regulation on Reserved Postal Services offered by SAPO. The Questionnaire also obtained information from relevant stakeholders on the general regulation of the Reserved Postal Services. The information focused on themes such as SAPO's financial sustainability and efficiency, competition in the parcels and letters segments and the appropriateness of past as well as proposed regulatory conditions.

1.3. Report Outline

The Report begins with the reason why the Regulations are being reviewed and the purpose of this Findings Report. This is followed by an outline of the review process and the applicable legislative framework. Thereafter, it summarises key features of the submissions received by ICASA on the Questionnaire.

This is followed by a discussion on SAPO's postal service performance under the Regulations' Consumer Price Index (CPI)-based price cap approach, with reference to specific themes of financial stability, price cap formulation, mail volumes and structural market changes.

Finally, the Authority identifies the way forward in the review process in light of the findings from the submissions.

[5] Questionnaire to stakeholders on the review of the review of the price cap regulations: https://www.icasa.org.za/legislation-and-regulations/regulations-underway/price-cap-regulations-for-reserved-postal-services

2. An outline of the review process

Phase 1: Commencement of the review and publication of questionnaire

On Friday 23 August 2019, the Authority published its Intention to Review the Price Cap Regulations Notice in Government Gazette No. 42657 ("the Notice"). The Notice was also published on ICASA's website alongside a Questionnaire requesting information and opinions from stakeholders or interested parties. Stakeholders were invited to submit written responses to the Questionnaire within thirty (30) working days from the date of publication of the Notice, the closing date for submissions was Monday 07 October 2019.

The information and opinions obtained from stakeholders covers a number of issues including, but not limited to, SAPO's financial sustainability and efficiency; competition in the parcels and letters segments; and the appropriateness of past and proposed regulatory conditions.

Phase 2 (Findings Report in terms of regulation 10 of the Regulations)

On 07 October 2019, the Authority received responses to Phase I (the Questionnaire) from the following two (2) stakeholders:

1. South African Express Parcel Association ("SAEPA"); and
2. South African Post office ("SAPO").

In conjunction with responses received to the Questionnaire, the Authority has developed the Findings Report on the Review of the SAPO Price Cap Regulations.

Phase 3 (amendment of the Regulations)

The Authority will amend the Price Cap Regulations in line with the provisions of sections 2(a), 8(a) and 30(2) of the PSA, regulation 10 of the Regulations read with section 4 of the Electronic Communications Act, 2005 (Act No. 36 of 2005).

Phase 4 (Publication of the Reasons Document)

After publishing the amended Regulations, the Authority will publish the reasons document in the Government Gazette to provide reasons regarding the effected amendments in the Regulations.

3. Legislative framework

ICASA is the regulatory Authority for postal services in terms of the PSA, as the Authority, in terms of section 8(1)(a) the PSA, ICASA is mandated to "... exercise regulatory functions in respect of the reserved and unreserved postal services".

Additionally, in terms of section 2 of the PSA, the primary objects of the PSA are to, among others:

- promote the universal and affordable provision of postal services;
- encourage investment and innovation in the postal industry;
- promote the development of postal services that are responsive to the needs of users and consumers;
- ensure fair competition within the postal industry;
- promote stability in the postal industry; and
- protect the interests of postal users and consumers.

ICASA, as the legislated regulator of reserved postal services, is required to regulate in accordance with the objectives of the PSA. In line with the above objects of the PSA, ICASA has embarked on this review of the Regulations with the view to promote the affordable use of postal services and innovation in the postal sector, by determining whether the current formula used for capping the price of reserved postal services is still relevant. This is in an effort to enhance stability and competition in the current state of reserved postal services.

Finally, in terms of section 30(1) of the PSA, ICASA has been empowered, through the approval of the Minister of Communications and Digital Technologies, and in consultation with SAPO, to determine the fees and charges in respect of reserved postal services.

4. Summary of Submissions

Section A: Questions for SAPO

1. **ICASA's Question:** Please provide SAPO's detailed broken down reserved postal services income statement for the prior 6 financial years (i.e. 2013/14, 2014/15, 2015/16, 2016/17, 2017/18, 2018/19).

   SAPO's Response: SAPO provided the Authority with the requested information. An analysis of this information will be dealt with in the findings section of this Report.

2. **ICASA's Question:** Given ICASA's view that a new regulatory framework is urgently needed, do you agree that the price control obligation imposed on the reserved market is no longer effective or proportionate? Please motivate your response by providing reasons and any supporting evidence that includes SAPO's volumes for reserved market.

   SAPO's Response: SAPO agreed that the current price control imposed on the reserved market is not effective or proportionate. The current regulation does not consider that key costs are increasing by more than CPI. It also does not consider the continuous decline in mail volumes. The methodology does not present SAPO the opportunity to recover the full costs of serving the reserved postal service area.

3. **ICASA's Question:** Should the revenue cap methodology of the Regulations be changed given the structural declining volumes? Please motivate your response by providing reasons and any supporting evidence data.

   SAPO's Response: It was SAPO's view that the scope and methodology of the Regulations should be changed. The decline in mail volumes results in lower revenues in the face of increasing costs. Additionally, the Regulations do not consider a number of factors such as above inflationary cost increases, fixed costs incurred in the short to medium term, and cost recovery of providing the Universal Service Obligation (USO) mandate.

4. **ICASA's Question:** Given the shortcomings of the current price control regulatory approach, do you agree with a new form of regulation based on a

new methodology be applied to SAPO's reserved activities? Are there any other issues that would be appropriate to consider as part of the review?

SAPO's Response: SAPO agreed that there should be a new form of regulation that ensures operational cost recovery and a profitable return.

5. **ICASA's Question:** Is the use of CPI an appropriate benchmark or closely linked to SAPO's costs? If not, what other alternatives can you provide to using the CPI as a benchmark in a price cap methodology? Please motivate your response by providing reasons and any supporting evidence data.

   SAPO's Response: SAPO observed that the CPI benchmark limits the company's ability to recover the costs incurred in rendering the services to customers. Staff, property and transport are SAPO's largest cost items and generally increase above the benchmarked CPI level annually.

6. **ICASA's Question:** How would a different methodology to the current price control regulatory approach ensure that the prices set by SAPO are not unduly high for consumers?

   SAPO's Response: According to SAPO, a review of uniform pricing and its compatibility to the South African economy will be necessary.

7. **ICASA's Question:** What was the impact, if any, of price controls on the financial sustainability of the provision of reserved postal services? Please motivate your response by providing reasons and any supporting evidence data.

   SAPO's Response: SAPO submitted that the Regulations do not fully consider the operational costs incurred in serving the customers or providing services. SAPO managed to provide evidence of its inability to recover operational costs in both the submission and referenced its Regulated Financial Statements (RFS) submissions to ICASA for further validation.

8. **ICASA's Question:** Does SAPO agree with the 2% productivity factor utilised in the current regulations, if not, provide reasons for your disagreement and a rate which SAPO believes is more closely related to its business activities.

SAPO's Response: SAPO indicated that it did not achieve the efficiency improvement target of 2% in the financial year 2014/15 as set out in the Regulations. SAPO's high numbers of employees accompanied by declining volumes make it impossible to meet the efficiency target.

9. **ICASA's Question:** What were the key reasons and drivers (both internal and external) behind SAPO's actual efficiency performance or lack thereof?

SAPO's Response: SAPO revealed that its cost structure is such that over 70% of the costs it incurs are fixed. The decline in revenue is a result of annually decreasing volumes. SAPO contends that there was an increase of 17.3% and 7% in costs for the reserved areas for the financial years 2014/15 and 2015/16 respectively, in the face of declining volumes.

10. **ICASA's Question:** To what extent did e-substitution impact on SAPO's reserved postal mail business? Please provide supporting evidence data.

SAPO's Response: SAPO argues that the impact of e-subsitution has resulted in the decline of traditional mail business volumes. The extent of this decline has been provided in the RFS submissions to ICASA.

11. **ICASA's Question:** How can the current tariff methodology, as applied in the Regulations, be adapted to consider changes in technology such as e-substitution?

SAPO's Response: According to SAPO, the regulatory review needs to introduce a formula that is realistic, relevant and user friendly for SAPO, particularly in context of the impact of digital technology. The current Regulations are spent, hence new regulations must take into consideration market forces that are in competition with SAPO market share.

12. **ICASA's Question:** To what extent do you consider SAPO's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as e-substitution?

SAPO's Response: SAPO's submitted that its pricing behaviour in the reserved market is not constrained in anyway by the other postal operators. SAPO pricing behaviour is only constrained by the applicable Regulations as SAPO is unable to recover the total costs to serve. The e-substitution has significant impact on SAPO's pricing and non-pricing behaviour. The costs to a SAPO customer to send an e-mail, SMS or MMS is far cheaper in comparison to the price of a letter. The direct competition to SAPO products costs a fraction of the price, therefore SAPO is unable to compete based on price.

13. **ICASA's Question:** What are the main future trends and developments (other than e-substitution) that could affect SAPO's reserved postal mail business? Please elaborate and provide examples where possible.

SAPO's Response: SAPO mentioned that the most relevant global trends most likely to impact SAPO are product innovation, product pricing, diversification of services, eCommerce, customer focus, effective operating models, digitisation, cost management and big data analytics. The impact on SAPO's business model by these trends is further compounded by the highly competitive postal industry that SAPO finds itself in competition. This industry is characterised by high fixed costs and low revenue margins as well as digital transformation that enables businesses in other industries to access the postal market without having to invest heavily in physical infrastructure.

14. **ICASA's Question:** To what extent do the competitive constraints faced by SAPO vary by different types of mail, e.g. for letter services, between advertising mail, transactional mail (mail sent following a consumer's interaction with a company), and publishing mail (such as newsletters and magazines); and for parcel services, between single-piece and bulk parcels?

SAPO Response: According to SAPO, the main competitive constraint is fulfilling the USO to commercially unviable areas. Furthermore, single pricing (flat rate) makes the delivery of parcels appear expensive in Metropolitan areas and also negatively affects international inbound prices, as SAPO is unable to recover service costs from their international partners in parcel delivery.

As SAPO considers itself a media platform owner, in the realm of direct mail it competes with media buyers such as SABC, Primedia, Multichoice etc. The constraint that direct mail faces, is the ability of other media like television and radio to pay commission (of approximately 12%) to media buyers. At best, direct mail can only offer pre-sorting rebates, which is not even 4%.

On letter service, the biggest competitive constraint is on pricing. SAPO can only increase its prices once a year. Whilst the Regulations limit SAPO to increase prices once a year, they also cap postage price increases at the CPI level of approximately 6% per annum. This is weighed against the postal costs inflation of greater than 14% per annum experienced by SAPO, resulting in costs rising at a rate faster than SAPO's annual price increase. Normally, salaries, rentals and fuel (which account for more than 65% of the cost of delivering letters) increase annually by 6%, 7% and 25%, respectively.

15. **ICASA's Question:** How can a new price cap regulatory framework assist SAPO in 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?

SAPO's Response: SAPO submmited that the new price cap regulatory framework will have to ensure that SAPO receives a return on investments made in the systems employed for collecting, sorting and delivering mail. SAPO will also have to recover the maintenance costs of the systems through the tariff.

16. **ICASA's Question:** Do you think price control regulation of the reserved postal services area is adequate to protect consumers, in promoting universal access and affordable prices? Please elaborate.

SAPO's Response: SAPO is of the view that with the current price control regulation the consumers are protected, and the current prices are affordable. However, the designated operator might not be able to fully recover the cost to serve those consumers as the Regulations do not cater for cost reflective prices.

17. **ICASA's Question:** Do you have any further comments or views (supported by evidence where available) on the issues identified in this questionnaire?

SAPO's Response: SAPO's view is that in general, the price control regulation is designed to protect consumers in a context where the provider of a service is a monopoly. It is assumed that market competition would ordinarily curb excessive pricing since an entity would price itself out of the market. But the assumption that SAPO actually enjoys a monopoly is open to some debate. There is currently a complaint awaiting an outcome from the Complaints and Compliance Committee (CCC) based on the view that in fact there are players in the market who are in direct competition with SAPO in the supposed reserved market. While the concept of price capping and productivity factors is an exercise in prudence where a monopoly exists, it will be important to establish if indeed a monopoly exists. If not, the price capping in our view then acts as a penalty rather than incentivizing the entity to be more efficient, especially in light of USOs that are not carried by the competition.

Section B: Questions for Other Stakeholders

SAEPA was the only respondent to this portion of the questionnaire. It did not respond to each question raised by the Authority, as its clients' knowledge of the efficacy of pricing regulation for the reserved postal service is extremely limited. As such, it has opted not to prescribe to SAPO how it should operate and allocate its resources at its disposal. As a result, SAEPA opted to only answer specific questions.

6. **ICASA's Question:** To what extent has e-substitution impacted the reserved and/or unreserved postal services in South Africa? Please provide supporting evidence data, if any.

SAEPA's Response: SAEPA's membership comprises of over 100 members of varying scale, each with its own specific target markets and strategic product priorities. It is therefore difficult to provide any meaningful response to this question as the effect of e-mail and e-substitution will vary from firm to firm depending on its service line priorities.

Also, while email and e-substitution may have had an adverse impact and disruptions to unreserved postal service providers in its earlier years, these disruptions have largely ceased. Unreserved postal service providers have indeed seen benefits from email and e-transacting as it has enabled markets to connect much easier, much faster and for much less cost leading to an increase in the flow of business for customers and an associated increase in demand for express courier services.

7. **ICASA's Question:** To what extent do you consider SAPO's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as e-substitution?

SAEPA's Response: It is SAEPA's view that while the unreserved postal service involves the transmission of the same postal articles as those reserved for SAPO, it comprises a completely different and distinct service to the transmission of postal articles by post.

What is apparent from international instruments is that the reserved postal service consists primarily of the transmission of parcels and letters for transmission by the national postal carrier by post using publicly funded infrastructure.

SAPO's behaviour in the market is also driven by other factors which do not apply to unreserved postal service providers, including the following:

- SAPO does not have any competitor in the reserved postal service market. Accordingly, an increase in price by SAPO or a failure to improve service levels or to innovate will not result in customer switches to an alternative supplier;
- SAPO is entitled to and receives state support and access to other public facilities which are not open to entities which operate within the private, competitive unreserved postal service space. It should be noted additionally that courier companies already pay taxes on their profits, and in doing so, already significantly contribute to the state support enjoyed by the reserved postal operator;
- SAPO has the ability to deliver domestic and foreign packages through international postal agreements facilitated and mandated by the Universal Postal Union (UPU) documents and instruments including all exemptions and privileges set out in the UPU. In addition, SAPO benefits from simplified customs clearance procedures, thus further lowering the cost of provision of universal postal service. In contrast, unreserved postal service operators do not derive any benefit from any such exemptions and privileges, but operate like any other private company that is driven by profits and the mechanisms of a liberalised and free market economy.

Accordingly, SAEPA submitted that unreserved postal service operators do not at all act as a competitive constraint on SAPO for the provision of reserved postal services. This being said, a supra-competitive increase without improved service levels or products may result in customer switches to a different type of (unreserved) service that offers value-add features.

9. **ICASA's Question:** What are the main future trends and developments (other than e-substitution) that could affect the reserved and/or unreserved postal services in South Africa? Please elaborate and provide examples where possible.

SAEPA's Response: SAEPA is of the view that the unreserved postal service is a highly dynamic, fast paced industry driven by competition between many participants, each of whom are always looking to differentiate their service through innovation and good customer service. Accordingly, the unreserved postal service or courier market is in a constant state of flux with new and innovative ways for customers to convey and receive their parcels. A recent example of innovations which can be anticipated to disrupt the unreserved postal service is the use of drones for parcel delivery.

The unreserved postal service market is likely to also see further interruption as a result of global trends towards greener business practices and so-called 4IR changes as the world moves towards automation. However, the above disruptions are likely to cause immediate disruptions to the unreserved postal service in South Africa in the medium to short-term.

This being said, statutory, administrative and cost restrictions in the express parcel industry continue to undermine and deter investment into the South African unreserved postal service and therefore delay innovation and product development. Furthermore, the African continent, in general, has seen a rise in uncommercial and restrictive conditions for private participants including:

- prohibitive licence fees and administrative costs;
- the imposition of universal service obligations on private operators;
- market access restrictions such as limits on package weight, size or value of conveyed goods, excessive conditions of service;
- prohibitive taxes and fees calculated as a proportion of revenue;
- overbearing conditions of service and carriage and other such measures against private express parcel delivery firms have led to a reduction in market entry, expansion and investment.

These conditions serve as a deterrent and deters growth and innovation in the market.

5. Analysis of Submissions

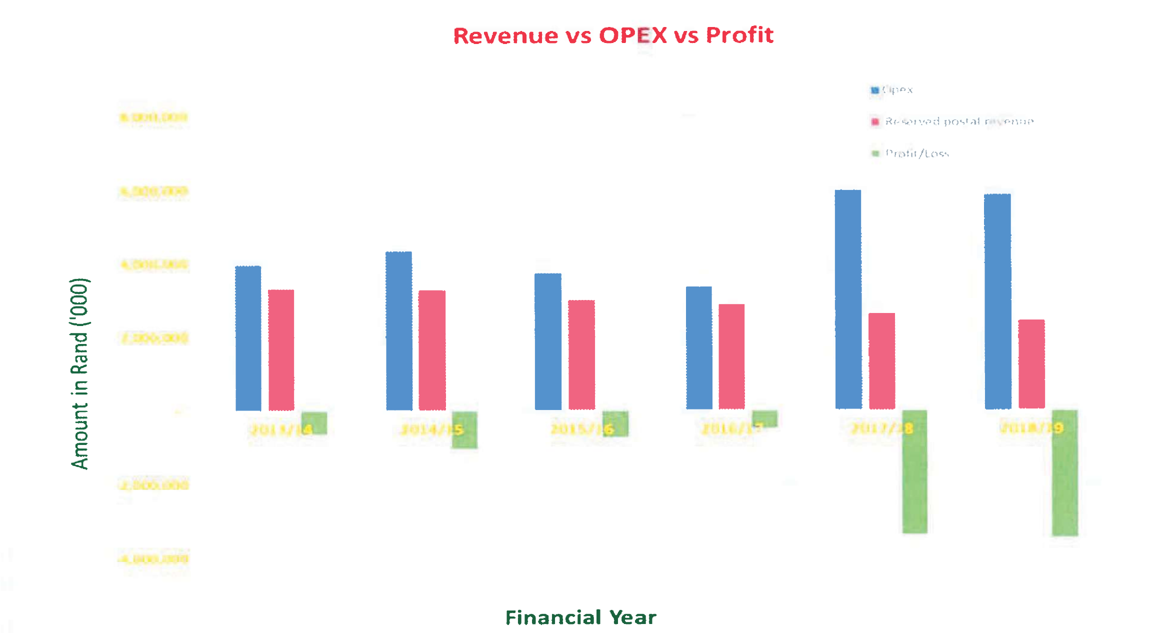
5.1. Financial Stability/Sustainability

From submissions received from SAPO there is evidence that it has incurred substantial financial losses over the last six (6) years (starting 2013/14 FY). Along with the Regulated Financial Statements (RFS) and tariff applications submitted to the Authority by SAPO over the years, there is mounting evidence showing that the form of rate regulation currently applied in the Regulations cannot create adequate revenues to maintain SAPO's financial stability or fund needed investments.

Revenue vs OPEX vs Profit (annual split)

Based on analysis of SAPO's submitted annual revenue, operational expenditure (OPEX) and profit figures, it can be seen that over the past six (6) years SAPO has been consistently incurring costs that exceed its revenues year on year (y-o-y). This has resulted in SAPO incurring annual operating losses in the reserved postal space as shown in Graph 1 below.

Graph 1: Revenue, OPEX, Profit



From the financials included in the submissions above, it is clear that SAPO is still battling in its postal operations as is evidenced by its declining revenue. Its inability to generate sufficient revenue to finance its high cost base negatively impacts its short-term operating efficiency and long-term financial sustainability. This sentiment is shared by SAPO wherein it states in its submission that a new form of regulation that ensures operational cost recovery and a profitable return is needed.

The adoption of the current price cap regulatory system was motivated by enforcing the PSA's objectives of promoting universal and affordable provision of postal services and protecting the interests of postal users and consumers.

In prioritising these two objectives, adopting a CPI-based price cap regulatory system made sense as it ensured rate stability. However, the prioritisation of these two objectives, against the backdrop of an evolving postal market, was ultimately to the detriment of other PSA objectives related to:

- encouraging investment and innovation in the postal industry;
- promoting the development of postal services that are responsive to the needs of users and consumers;
- ensuring fair competition within the postal industry; and
- promoting stability in the postal industry.

Furthermore, the Authority agrees with SAPO's view that whilst the current price regime protects consumers and offers affordable prices, it is deficient in its attempt to allow the designated operator to fully recover the costs associated in serving those customers.

SAPO is obligated to provide universal basic postal services at affordable uniform prices in the country. To do this effectively, SAPO previously received a government subsidy, the objective of such was to assist SAPO to cover a portion of its operating expenditure incurred as part of meeting its Universal Service Obligation (USO). SAPO's subsidy allocation for universal services funding was however withdrawn by the Department of Telecommunications and Postal Services (DTPS) in 2012 despite SAPO incurring losses of more than R400 million per annum. From 2013/14 to 2016/17 SAPO was overleveraged due to a combined result of under capitalisation and accumulated historical losses. In 2018/19 FY, R 1.5 billion was granted to SAPO to be used to fund the Public Service Mandate -Universal Service Obligation (USO). Of the R1.5 billion, R1 billion was used for the repayment of loans taken out in prior years. These capital injection commitments made by the Minister imply that there is greater focus on long term financing through equity as opposed to debt.

5.2. Price Cap Formula

The Authority finds that whilst the current CPI-based Regulations provide strong incentives to cut costs in the pursuit of increasing efficiency, they are silent on the matter of cost recovery and financial sustainability.

Evidence from SAPO, in its Questionnaire responses and in the submission of RFS to ICASA, has shown that it is unable to recover the total costs spent in providing reserved services under the current CPI based framework. This has led to a progressively deteriorating financial position with each passing year.

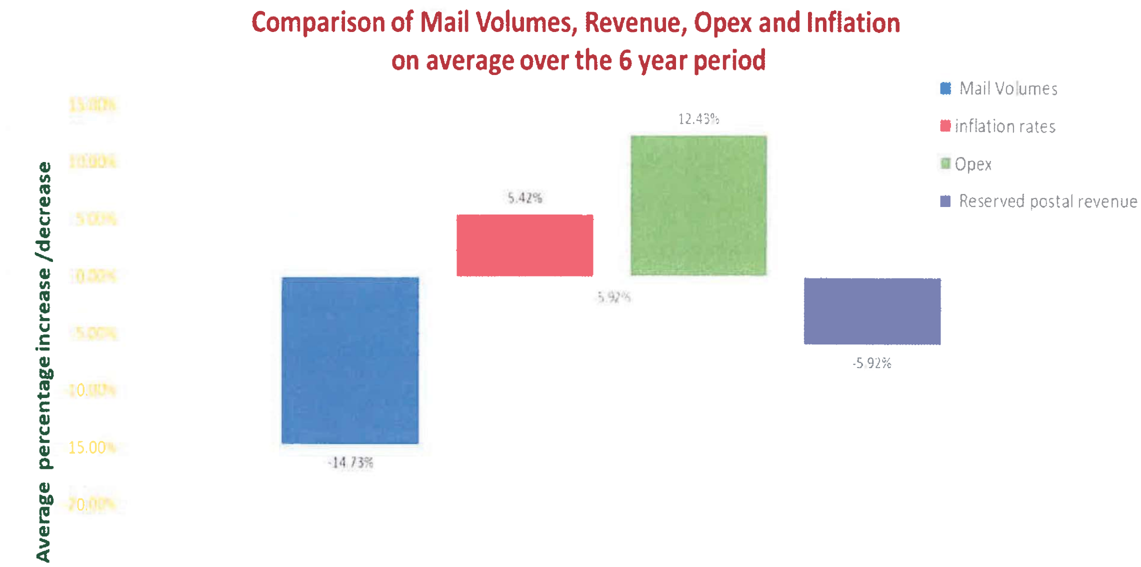
In its submission, SAPO states that the use of CPI as a benchmark in the price cap methodology limits its ability to recover the costs it incurs in rendering its services to customers. Additionally, the price control limits SAPO to being able to increase its prices once a year. As such, SAPO considers the current price control imposed on the reserved market as both ineffective and disproportionate.

Mail Volumes vs Revenue vs OPEX vs Inflation Comparison

An overall analysis (as shown in Graph 2 below) of SAPO's revenue, operational expenditure (OPEX) and mail volumes against inflation over the past 6 years show that SAPO's:

- mail volumes decreased by an average of 14.73% year on year,
- revenue decreased by an average of 5.92% year on year,
- OPEX increased by a disproportionate average of 12.43% year on year.

Graph 2: Mail Volumes, Revenue, OPEX vs Inflation Comparison



Given that South Africa's average y-o-y average CPI over the same period is 5.42%, the Authority finds that SAPO's OPEX generally tends to rise in excess of the prevailing yearly inflation rate thereby making the Price Cap formula (as espoused in the current Price Cap Regulations) ineffective as the price cap or ceiling is CPI-based. The inclusion of the productivity factor further curtails SAPO of the ability to pass through any prudently incurred costs that are in excess of inflation. This jeopardises SAPO's long term sustainability and negatively impacts its mandate of providing a reliable postal service to South African citizens.

The price cap formula does not consider above inflationary cost increases of key operational costs, fixed costs incurred in the short to medium term, and the cost recovery of providing the USO mandate, especially to commercially unviable areas. Furthermore, single pricing (flat rate) makes the delivery of parcels appear expensive in Metropolitan areas and also negatively affects international inbound prices, as SAPO is unable to recover service costs from their international partners in parcel delivery.

SAPO has further managed to provide evidence of its inability to recover operational costs through the annual submission of the RFS to ICASA. These indicate that SAPO's largest cost items of staff expenses, property and transport all generally increase above the CPI for the period. This is further proof that the price cap formula does not fully take into account the operational costs incurred in serving the customers or providing postal service and evidence that a review to this uniform pricing approach is necessary.

Further evidence on the ineffectiveness of the Regulations is provided by SAPO wherein it states that it was unable to achieve the efficiency improvement targets as set out in the Regulations. Whilst the CPI based price control provides strong incentives to cut costs in the pursuit of increasing efficiency, it is does not consider SAPO's cost structure and may lead to under recovery of costs. Therefore, an appropriate and effective tariff methodology should enable SAPO to recover its prudently and efficiently incurred costs whilst earning a return commensurate with risk.

SAPO further motivates that the current formula is not realistic, relevant and user friendly for SAPO, particularly in context of the impact of digital technology. The postal industry is characterised by high fixed costs and low revenue margins as well as digital transformation that enables businesses in other industries to access the postal market without having to invest heavily in physical infrastructure.

SAPO contends that the current price controls, limit its ability to effectively react to global trends such as product innovation, product pricing, diversification of services, eCommerce, customer focus, effective operating models, digitisation, cost management, and big data analytics.

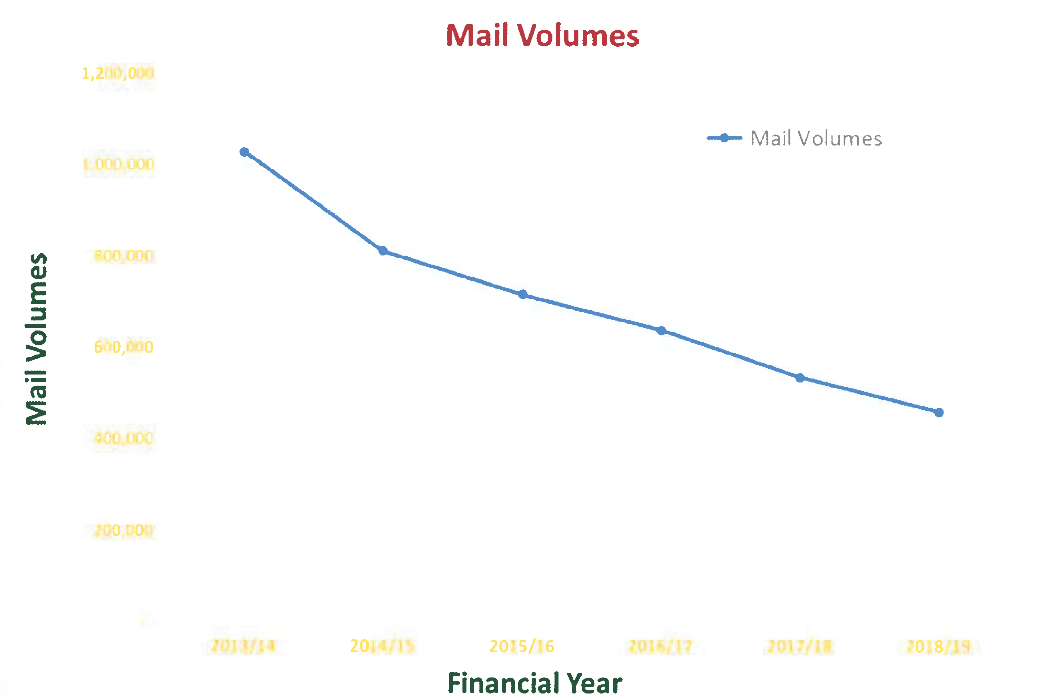
SAPO's stalled modernisation efforts in the realm of transformation and diversification are apparent. Transformation relates to efficiency and reduction of cost of providing postal services to remain relevant and competitive. This involves the restructuring of the postal network to ensure that it is configured to meet demands for postal services in the most efficient way. This process requires investment in automation of its postal operations. Diversification involves finding new sources of revenue by providing related products or expanding to cover a wider geographic area. As core mail volumes are declining, post offices around the world are looking to grow and diversify revenues via expansion of existing operations, or by acquisitions, joint ventures and partnerships.[6]

5.3. Mail Volumes

Globally, research indicates that traditional mail volumes, revenues and ultimately profitability of postal organisations are declining. SAPO is no exception.

As can be seen in the graph below, mail volumes have been continuously decreasing over the past 6 years. Given that revenue is a function of both volumes and price charged, such a deterioration will negatively impact SAPO's revenue generation capabilities. This has been confirmed by SAPO's tariff application and RFS submissions to the Authority over the same period. They conclusively show that despite being afforded revenue (and therefore price) increases, SAPO has not been able to generate sufficient revenue due to debilitating volumes decline.

Graph 3: Mail Volumes



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[6] https://www.accenture.com/us-en/_acnmedia/accenture/conversion-assets/dotcom/documents/global/pdf/industries_7/accenture-achieving-high-performance-postal-industry-2014.pdf

The volumes decline is partly due to structural changes experienced in the postal market. The growth of e-commerce worldwide over the last decade has resulted in postal service providers adopting and growing their e-commerce capabilities through the development and commercialisation of digital products and services. This is done to drive revenue, and ultimately to increase or maintain market share.

Impact of volumes on revenue and investment efforts

In an attempt to modernise as its counterparts, SAPO has introduced new services to take advantage of growth in the e-commerce ecosystem. The benefits of these new services[7] have yet to be fully realised as they have been onboarded at a much slower pace due to minimal investment funding. SAPO's RFS and tariff applications confirm that it has been investing progressively less (declining capital expenditure or CAPEX), if at all, due to lack of profitability. This has further cemented its inability to borrow from the markets.

Given that most of SAPO's costs are fixed costs as opposed to variable costs, the implication is that SAPO has a shrinking annual revenue base from which to fund its growing expenditure. This annual under-recovery of full costs has contributed to SAPO's progressively deteriorating financial position.

SAPO states that the scope and methodology of the Regulations should be changed to accommodate and recognise the aspect of mail volumes and their impact on SAPO's operations. The decline in mail volumes results in lower revenues. As SAPO's cost structure is such that over 70% of its costs are fixed, it effectively faces increasing costs in the face of declining revenue (as a result of decreasing volumes).

This reliance on mail volumes is compounded by the impact of e-substitution, which has contributed to the further decline in traditional mail business volumes. The extent of this decline has been provided in the RFS submissions to ICASA.

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[7] Hybrid mail, Virtual post office, Electronic bill presentment and payment system, SAPO WASP and SAPO Trust Centre.

Historically, the South African postal market's performance has had close correlation to the performance of the economy. For instance, until around 2008/2009 there was a correlation between economic growth and the growth in letter volumes (i.e. people sent more mail in response to increased economic activity and lesser when economic activity shrunk). After 2011, this relationship was undermined by the increased usage of the Internet, which provided alternative ways to people to communicate with each other and how businesses could carry out transactions and advertise their services.

The dramatic change over the last decade due to digitisation has altered how people communicate. For example, smartphones have become an essential part of everyday life when compared to about ten years ago. It should be noted that this trend is expected to continue as more people adopt the electronic and internet-based means of communication.

While SAPO evidently faces declining mail volumes, SAEPA stresses the distinction of services between the unreserved and reserved postal services. SAEPA argues that the transmission of parcels and letters in the reserved realm is done through the national postal carrier by post using publicly funded infrastructure.

Since SAPO is the only operator in the reserved postal services market, an increase in price by SAPO or a failure to improve service levels or to innovate will not result in customer switches to an alternative supplier. However, continual poor service delivery level, tariff increases or lack of improved products may result in customers opting for a different type of (unreserved) service that offers value-add features.

SAEPA submits that while email and e-substitution may have had an adverse impact and disruptions to unreserved postal service providers in the earlier years, these disruptions have largely ceased with benefits being experienced by unreserved postal service providers. Through email and e-transacting, markets have been enabled to connect much easier, much faster and for much less cost leading to an increase in the flow of business for customers and a concomitant increase in demand for express courier services.

5.4. Structural market changes

Aside from the impact that e-substitution has had on traditional mail business volumes, SAPO indicates that the most relevant global trends impacting it are product innovation, product pricing, diversification of services, e-commerce, customer focus, effective operating models, digitisation, cost management, and big data analytics.

The impact on SAPO's business model by these trends is compounded by its high fixed cost base and low revenue margins it earns. Digital transformation and convergence have also enabled other businesses in other industries to access the postal market without having to invest heavily in physical infrastructure.

As SAPO considers itself a media platform owner, in the realm of direct mail it competes with media buyers such as SABC, Primedia, Multichoice etc. The constraint that direct mail faces, is the ability of other media like television and radio to pay commission to media buyers.

The growth of e-commerce worldwide over the last decade has resulted in postal service providers adopting and growing their e-commerce capabilities through the development and commercialisation of digital products and services. This is done to drive revenue, and ultimately to increase or maintain market share.

Over the last decade technology has played and will continue to play a significant role in the future of postal organizations worldwide. Fresh streams of revenue procured from parcel volumes over e-commerce platforms are showing the potential to grow faster than traditional mail ever did. In fact, new purchasing models, driven by technological evolution, are now creating e-commerce opportunities beyond just delivering parcels.

Similar to the reserved market, SAEPA submits that the unreserved postal service is also impacted by structural market changes and global trends. According to SAEPA, the unreserved postal market is a highly dynamic, fast paced industry driven by competition between many participants, each of whom are always looking to differentiate their service through innovation and good customer service.

Furthermore, this market is in a constant state of flux with new and innovative ways of conveying and receiving of parcels which includes 4IR changes as the world moves towards automation as well as interruption as a result of global trends towards greener business practices. SAEPA is of the view that the above disruptions are likely to cause immediate impact to the unreserved postal service in South Africa in the medium to short term.

SAEPA has contended in its submissions that its members experience a unique impact of structural market dynamics due to e-substitution. However, the unreserved postal services space have realised benefits from e-substitution as it has enabled markets to connect easier, faster and at reduced costs, leading to an increase in the flow of business for customers and an associated increase in demand for express courier services.

Research shows, that e-commerce will reach an €8 trillion revenue mark by 2025 and online retail will exceed brick-and-mortar retail expansion by five times from 2016 to 2021 and account for 25% to 30% of total retail by 2030, in relation to the 9% retail share in 2019 (Dragendorf, et al; 2019)[8].

To meet the needs of customers today and in future, global capital expenditure (CAPEX) remained at a record high of 4.7%[9] in 2017, having increased by more than a quarter since 2012. Investments include facility and fleet upgrades, IT security, sorting automation and handheld devices to expanding the capacity and efficiency of parcel networks. The investment by incumbents also promoted business diversification countering the declining mail volumes. The PIC analysed 33 post offices in advanced economies between 2012-2017, who all delivered fewer letters and more parcels, yet achieved profitable growth; all became more diversified and most saw international revenue increase, often via acquisitions; and all have focused on resource efficiency, investing in IT, fleet upgrades and automation and increasing

[8] McKinsey & Company, 2019, The endgame for postal networks, <https://www.mckinsey.com/~/media/McKinsey/Industries/Travel%20Transport%20and%20Logistics/Our%20Insights/The%20endgame%20for%20postal%20networks%20How%20to%20win%20in%20the%20age%20of%20e%20commerce/The-Endgame-for-Postal-Networks.ashx> pg. 7

[9] IPC, 2018, *IPC Global Postal Industry Report Key Findings 2018*, <https://www.ipc.be/-/media/documents/public/markets/mi-products/ipc_gpir2018_key_findings.pdf?la=en&hash=C4413FA8AF161CC553240570A96CD6A1339C0CF2>, pg. 8

revenue per employee[10]. Just like its counterparts, SAPO has also introduced new services (to take advantage of growth in e-commerce), attempted to upgrade its infrastructure and focus on cost containment -albeit it at a much slower pace due to a less agile business model and insufficient funding.

6. Findings on SA Reserved Postal Service

Based on the above analysis, this is what is clear for the Authority:

- SAPO is not able to improve its efficiency as it is unable to reduce universal service and operational costs, thus the CPI-based Price Cap formula is no longer effective and proportionate as a regulatory tool;
- SAPO's declining mail volumes have resulted in declining revenues. The letter market is shrinking, which makes it difficult for SAPO to recover on its fixed costs; and
- SAPO's business model is less agile in the face of an evolving postal services market. This reduces the flexibility of SAPO to adapt to changes in the market and its operating environment.

In light of the above, the Regulations will be amended to:

- update the tariff formula so that it considers SAPO's cost structure such that it allows for recovery of prudently and efficiently incurred costs. This will address the shortcoming of the current Price Cap formula which restricts revenue increases to CPI despite SAPO incurring above inflationary cost increases; and
- update the tariff formula such that it allows SAPO to earn profit commensurate with risk as opposed to the current Price Cap formula which inadvertently causes SAPO to experience a shrinking profit margin annually.

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[10] IPC, 2018, *IPC Global Postal Industry Report Key Findings 2018*, <https://www.ipc.be/-/media/documents/public/markets/mi-products/ipc_gpir2018_key_findings.pdf?la=en&hash=C4413FA8AF161CC553240570A96CD6A1339C0CF2>, pg. 7