

Estonian Competition Authority

**Methods for the cost assessment of the
universal postal service provider**

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1. Introduction

Pursuant to subsection 41¹ (1) of the Postal Act, a universal postal service provider may submit to the Estonian Competition Authority an application for compensation for the unreasonably burdensome costs related to the performance of the USO. The application must be submitted not later than on the tenth day of the month following the accounting quarter.

Pursuant to subsection 41¹ (2) of the Postal Act, upon assessment of the costs related to the performance of the USO, the Estonian Competition Authority verifies whether the specified costs are justified.

Pursuant to 41¹ (3) of the Postal Act, if, as a result of the assessment specified in subsection 41¹ (2) of the Postal Act, the Estonian Competition Authority finds that performance of the USO is unreasonably burdensome for a universal postal service provider, taking account of the revenue arising from performance of the specified obligation and any market benefit, the Estonian Competition Authority shall decide to compensate for the costs related to the USO to the extent provided for in subsection 41¹ (4) of the Postal Act.

Pursuant to subsection 41¹ (4) of the Postal Act, the costs specified in subsection 41¹ (3) of the Postal Act shall be compensated to a universal postal service provider only to the extent to which the price charged from users specified in section 6¹ of the Postal Act does not enable covering of the costs related to performance of the USO or ensure a reasonable profit.

Pursuant to subsection 3 (2) of the Regulation established on the basis of subsection 41¹ (6) of the Postal Act, if the audited costs and revenue of the universal postal service provider of the previous financial year differ from the data submitted in the previous financial year by reporting quarters, the Estonian Competition Authority has the right to change the amount of the compensation.

In accordance with subsection 41¹ (5) of the Postal Act, the Estonian Competition Authority has developed uniform methods based on the weighted average capital cost for the assessment of unreasonably burdensome costs related to the performance of the USO. The relevant methods are published on the website of the [Estonian Competition Authority](#).

2. Definitions

2.1. Reporting period – a period for which the justified costs are the basis for assessing the costs related to the performance of the USO. The reporting period is a quarter and the financial year of the undertaking.

2.2. Investments in regulated assets – one-off costs for the acquisition and improvement of regulated fixed assets.

2.3. Weighted average cost of capital; WACC) or rate of return – the price of total capital found on the basis of the capital structure (the ratio of own and external resources in total capital) and the price of debt and equity capital.

2.4. Non-UPS services – all services offered by a universal postal service provider in addition

to the universal postal service.

2.5. Reasonable profit – the operating profit earned for the provision of universal postal services, calculated as the product of the regulated assets and the reasonable rate of return.

2.6. Depreciation of fixed assets – the cost added to the prices of universal postal services, which is related to the acquisition of fixed assets.

2.7. Depreciation rate of fixed assets – the reciprocal of the time period which shows the addition of expenses incurred for the acquisition of fixed assets to the price of the universal postal service. The depreciation rate of fixed assets is determined based on the useful life of the fixed assets.

2.8. Reasonable operating costs – reasonable costs that do not include depreciation or financial costs. Operating costs can be influenced by the undertaking through its more efficient economic activities (e.g. labour costs, etc.).

2.9. Reasonable rate of return – the return on regulated assets that does not exceed the applicable weighted average cost of capital (WACC).

2.10. Regulated assets – fixed assets and working capital used in regulated activities (UPS).

2.11. Affordable price – a price charged to the user for universal postal services established by a regulation of the minister.

2.12. Universal postal service (UPS) – services specified in subsection 5 (2) of the Postal Act, which are the forwarding of items of correspondence weighing up to 2 kilograms as ordinary, registered, and insured items and the forwarding of postal parcels weighing up to 20 kilograms as registered and insured items as both international and domestic services.

2.13. UPS sales revenue – revenue from the sale of all universal postal services.

2.14. UPS provider – a postal service provider designated on the basis of a public competition who provides universal postal services.

2.15. Unfairly burdensome costs relating to the performance of the USO – difference between the costs incurred in the performance of the USO and the UPS sales revenue.

2.16. Costs relating to the performance of the USO – the sum of the reasonable UPS operating expenses, depreciation of fixed assets, and reasonable profit.

3. Separation of costs

3.1. Pursuant to subsection 40 (1) of the Postal Act, a universal postal service provider shall keep separate revenue and cost accounting:

- 1) regarding postal services belonging to the set of the universal postal service;
- 2) regarding each service for the provision of which common resources with postal services belonging to the set of the universal postal service are used.

3.2. Pursuant to subsection 40 (2) of the Postal Act, a universal postal service provider shall apply activity-based cost accounting.

3.3. Pursuant to subsection 40 (3) of the Postal Act, the revenue and cost accounting of a universal postal service provider shall be based on the process of provision of universal postal service and clearly specify the resources, activities, and services necessary therefor.

3.4. Pursuant to subsection 40 (4) of the Postal Act, the universal postal service shall be provided in compliance with the principle of cost-effectiveness.

3.5. Pursuant to subsection 40 (5) of the Postal Act, the revenue and cost accounting of a universal postal service provider shall comply with the following principles:

- 1) causal relationship – costs must be related to the activities or services which cause the costs;
- 2) objectiveness – the allocation of costs must be based on objective bases and shall not bring about unjustified profit or loss for the universal postal service provider.

3.6. Pursuant to subsection 40 (6) of the Postal Act, a universal postal service provider shall differentiate the revenue and cost of different services in accordance with the requirements established by the Regulation of the Minister of Economic Affairs and Communications ‘Requirements for revenue and cost accounting of universal postal service provider’ (hereinafter Regulation).

3.7. The universal postal service provider submits data to the Estonian Competition Authority together with the application for compensation for unreasonably burdensome costs in accordance with the form provided in Annex 1 to the methods. The data is provided for the reporting period on which the application is based.

3.8. In order to assess the costs related to the performance of the USO, the Estonian Competition Authority may request data from previous reporting periods, including previous financial years.

4. Assessment and analysis of the costs relating to USO

4.1. The assessment of the costs related to USO includes an analysis of the economic activities of the UPS provider to assess the reasonableness of the costs on the basis of which cost-based prices of the universal postal service are formed.

4.2. When setting the prices of the universal postal service, cross-subsidisation of activities must be avoided. When using the resources rationally, the cost-based prices of the universal postal service ensure:

- 1) coverage of the reasonable operating costs and the depreciation of fixed assets necessary for the provision of the service;
- 2) the investments necessary for the performance of the USO and investments in development;
- 3) a reasonable profit on the regulated assets.

4.3. In the course of the analysis of the assessment of the costs related to the performance of USO, the operating costs of the undertaking are divided as follows:

- 1) direct costs;
- 2) indirect costs;
- 3) unspecified costs.

In accordance with subsection 2 (2) of the Regulation, direct costs are costs, the reason for which is directly related to the service provided.

In accordance with subsection 2 (3) of the Regulation, indirect costs are costs, the reason for which is indirectly related to the service provided, but the amount of which can be measured from the total costs of the respective service.

In accordance with subsection 2 (4) of the Regulation, unspecified costs are costs, the cause of which is not directly or indirectly related to the service provided and the share of which in the respective service cannot be accurately measured.

4.4. The costs related to the performance of USO include the following expenditure items:

- 1) justified operating costs;
- 2) depreciation of fixed assets;
- 3) reasonable profit.

4.5. The following expenditure items are not to be included in the justified operating costs related to the performance of the USO:

- 1) the cost of doubtful receivables;
- 2) sponsorship, gifts, and donations;
- 3) costs not related to the provision of the universal postal service;
- 4) change in the value of assets (change in inventories, write-down of current assets, impairment of fixed assets, loss from the sale and liquidation of tangible and intangible fixed assets, etc.);
- 5) financial expenses;
- 6) fines and default interest imposed on the undertaking under legislation;
- 7) special benefit costs;

- 8) income tax expenses pursuant to sections 48–52 of the Income Tax Act;
- 9) other unjustified costs identified in the economic analysis.

4.6. The Estonian Competition Authority analyses the allocation of costs between UPS and non-UPS services and verifies whether cross-subsidising between areas of activity is avoided with the sold goods and services, whether costs are related to the specific activity which causes the cost, and whether the costs are allocated on objective grounds that does not bring about unjustified profit or loss for the UPS provider.

4.7. The Estonian Competition Authority carries out systematic analysis of the costs of the universal postal service provider, using the following methods:

- 1) monitoring the dynamics of costs over time and comparing them with the dynamics of the consumer price index;
- 2) an in-depth analysis of the justification of the various cost components;
- 3) analysis of the depreciation of fixed assets, including depreciation rates;
- 4) investment analysis.

5. Regulated assets and depreciation

5.1. The purpose of depreciation of fixed assets is to recoup the expenses incurred for the acquisition of fixed assets necessary for the provision of the universal postal service through the price of universal postal services during the useful life of the fixed assets.

5.2. Depreciation of fixed assets is calculated based on regulated assets. Depreciation is calculated on depreciable fixed assets included in regulated assets.

5.3. Finding the value of regulated assets, i.e. the fixed asset related to the provision of the universal postal service, is necessary to calculate a reasonable depreciation and a reasonable profit.

5.4. Regulated assets include only reasonable investments actually made in accordance with clause 5.5 of the methods.

5.5. The Estonian Competition Authority does not accept the following costs for fixed assets as regulated assets and depreciation calculated therefrom:

- 1) long-term financial investments;
- 2) fixed assets acquired under non-repayable assistance (such as EU external assistance programmes) and depreciation calculated therefrom;
- 3) intangible assets (except computer software and program licences);
- 4) fixed assets not related to the provision of the universal postal service;
- 5) unjustified investments, i.e. fixed assets that the undertaking does not actually use in its

economic activities.

5.6. In determining the value of regulated assets, the book residual value of fixed assets at the beginning and end of the reporting period is used, taking into account the provisions of clause 5.5 of the methods. Depreciation is calculated using the depreciation recorded in the accounts, which is calculated on the regulated assets.

5.7. Regulated assets during the reporting period are found as follows:

$$AA = (AA_0 + AA_1) / 2 + WC$$

wherein

AA – regulated assets;

AA₀ – the residual value of the regulated fixed assets at the beginning of the reporting period;

AA₁ – the residual value of the regulated fixed assets at the end of the reporting period;

WC – working capital.

5.8. Working capital is calculated on the basis of 5% of the sales revenue of the universal postal service for the reporting period.

5.9. The residual value of regulated fixed assets at the end of the reporting period is calculated as follows:

$$AA_1 = AA_0 + I - A - S$$

wherein

AA₁ – the residual value of the regulated fixed assets at the end of the reporting period;

AA₀ – the residual value of the regulated fixed assets at the beginning of the reporting period;

I – investments in regulated fixed assets;

A – depreciation of fixed assets;

S – fixed assets sold or written off.

5.10. The accounting for regulated assets is consistent and will continue in all future reporting periods.

6. Calculation of a reasonable profit

6.1. Reasonable profit is calculated by applying a reasonable rate of return to the regulated assets.

6.2. Reasonable profit is calculated as the product of regulated assets and the reasonable rate of return based on the following formula:

$$RP = r \times AA$$

wherein

- RP – reasonable profit;
- r – reasonable rate of return (WACC);
- AA – regulated assets.

6.3. As applications for compensation are submitted on a quarterly basis, the reasonable profit calculated in accordance with the principles of clause 6.2 must be divided by four for the reporting period (quarter).

6.4. The reasonable rate of return is equal to the weighted average cost of capital, i.e.

$$r = WACC$$

wherein

WACC – weighted average cost of capital.

6.5. The weighted average cost of capital (WACC) is calculated with the following formula:

$$WACC = c_{equity} \times \left(\frac{EC}{DC + EC} \right) + c_{debt} \times \left(\frac{DC}{DC + EC} \right)$$

wherein

- WACC – weighted average cost of capital;
- c_{equity} – cost of equity capital;
- c_{debt} – cost of debt capital;
- DC – debt capital ratio;
- EC – equity capital ratio;

6.6. The weighted average cost of capital (WACC) is calculated using a capital structure of 50% debt capital and 50% equity capital.

The weighted average cost of capital is calculated in accordance with common practice in the WACC using the regulatory debt-to-equity capital ratio (50/50) and the same ratio is used for all other regulated undertakings providing a similar service (i.e. a vital service provided by an undertaking in a dominant position) (electricity, gas, district heating, water). These are a fairly large number of regulated undertakings with different capital structures, ranging from 100% equity capital to high gearing ratio. The use of regulatory debt and equity capital ratios ensures equal treatment for both undertakings and consumers. It is important to note here that the cost of debt capital is usually lower than the cost of equity capital. Therefore, the balance sheet figures of a particular undertaking are not used to determine the debt-to-equity capital ratio. This debt-to-equity capital ratio (50/50) ensures a balanced financing of the undertaking and reduces excessive financial risk.

6.7. The risk-free rate of return is the average interest rate of a German 10-year bond for the last five years, plus the Estonian country risk premium. In the case of Estonian government bonds, the interest rate of the government bond may be used as the risk-free rate of return.

As Estonia does not have long-term government bonds traded on the secondary market, it is not possible to provide a direct quantitative assessment of the country risk of Estonia. This can only be done indirectly by comparing Estonia with countries that have issued government bonds. The Ministry of Finance has recommended that the Estonian Competition Authority proceed from the average yield of approximately 10-year bonds of European countries with a credit rating similar to the credit rating given to Estonia by rating agencies (S&P/Moody's/Fitch), which can be used to assess Estonian long-term government bond yields.

6.8. The cost of debt capital is the sum of the risk-free rate of return, the Estonian country risk premium, and the risk premium of the debt capital of the undertaking.

6.9. The cost of equity capital is calculated using the CAPM (capital asset pricing model)

$$R_e = R_f + \beta \times R_m$$

wherein

R_e – cost of equity capital;
 R_f – risk-free rate of return;
 β – beta coefficient;
 R_m – market risk premium.

6.10. The risk-free rate of return is the interest rate (5-year average) on a euro area bond (a 10-year German bond) plus the country risk premium.

6.11. The beta coefficient is taken from the indicators of similar European and US undertakings, using data from other regulators and databases.

6.12. The market risk premium is calculated on the basis of the long-term market risk premium of European and/or US undertakings.

6.13. The WACC is calculated annually by the Estonian Competition Authority and published on the website www.konkurentsiamet.ee. The published document contains both the methodology for calculating the WACC and the weighted average cost of capital values for the various activities in the year of validity.

7. Calculation of unreasonably burdensome costs

7.1. The sales revenue of the universal postal service is formed by adding the actual prices for the universal postal services and the sales volumes of the respective services.

7.2. Pursuant to subsection 26 (3) of the Postal Act, a postal service provider may apply a discount for postal charges if the cost of forwarding the postal item is smaller than the cost of provision of the basic service.

In the case of cost-based discounts, the sales revenue is calculated as the product of the discounted service and the sales volume of the discounted service.

7.3. The costs related to the performance of the USO is calculated with the following formula:

$$C_{total} = C_{operating} + A + RP$$

wherein

C_{total} – total sum of costs related to the performance of the USO;

$C_{operating}$ – justified operating costs;

A – depreciation of fixed assets; RP – reasonable profit.

7.4. The unreasonably burdensome costs related to the performance of the USO is calculated with the following formula:

$$U = C_{total} - R$$

wherein

U – unreasonably burdensome costs related to the performance of universal postal service;

C_{total} – total sum of costs related to the performance of USO;

R – sales revenue from the universal postal service

7.5. If the sales revenue from the universal postal service (R) is less than the sum of the costs related to the performance of the USO for the same reporting period (C_{total}), this difference is considered an unreasonably burdensome cost related to the performance of the USO and the UPS provider has the right to submit an application to the Estonian Competition Authority for compensation in the amount calculated on the basis of the formula provided in clause 7.4 of the methods.

7.6. If the revenues and costs of the universal postal service provider for the financial year have been audited, the UPS provider will submit the data on the financial year to the Estonian Competition Authority in the form provided in Annex 1 to the methods. Based on the audited costs and revenues that were actually related to the performance of the universal postal service, the Estonian Competition Authority has the right to adjust the amount of compensation found on the basis of the data of the reporting quarters (subsection 3 (2) of the Regulation established on the basis of subsection 41¹ (6) of the Postal Act). When calculating the amount of

compensation, the Estonian Competition Authority proceeds from the provisions of subsection 41¹ (4) of the Postal Act, taking into account (as the period) the audited data of the financial year.

Annex 1 Compensation application form for the universal postal service