



***PT Universal Service and its
Financing***

Working Group Economics



CERP

WORKING GROUP
PT Universal Service and its
Financing

Final report – Second step
Calculating the
burden/benefits of the USO

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1 INTRODUCTION	3
1.1 BACKGROUND.....	3
1.2 CONTEXT	3
2 FINDINGS.....	4
2.1 HAS YOUR COUNTRY ESTIMATED THE BURDEN / BENEFITS ASSOCIATED WITH THE PROVISION OF THE USO? IF "YES" WHO UNDERTOOK THE WORK, USP/NRA/MINISTRY WITH OWN STAFF OR A CONSULTANT?.....	4
<i>Conclusions</i>	5
2.2 IF THE BURDEN / BENEFITS OF THE USO HAVE BEEN CALCULATED WHICH METHOD(S) WERE APPLIED?.....	5
<i>Conclusions</i>	7
2.3 IF ESTIMATIONS OF THE BURDEN / BENEFITS OF THE USO HAVEN'T BEEN MADE, THEN WHY?	8
2.3.a <i>Reserved area</i>	8
2.3.b <i>Compensation fund</i>	9
2.3.c <i>Subsidies</i>	9
2.3.d <i>Geographical cross subsidisation</i>	10
2.3.e <i>Other cross subsidisation</i>	11
<i>Conclusions</i>	11
2.4 HOW COULD AN ESTIMATION OF THE BURDEN / BENEFITS OF THE USO BE MADE (OTHER THAN METHODS IDENTIFIED IN QUESTION 2 ABOVE) AND HOW FREQUENTLY?	12
2.4.1 <i>Frequency</i>	12
2.4.2 <i>Method</i>	12
<i>Conclusions</i>	13
2.5 WHAT VARIABLES WOULD BE IMPORTANT IN AN ESTIMATION OF THE BURDEN / BENEFITS OF THE USO?.....	13
2.6 WHO SHOULD DO THE ESTIMATION OF THE BURDEN / BENEFITS OF THE USO?.....	15
2.7 IF YOU HAVE ANSWERED THE USP IN QUESTION 6, WHO SHOULD SCRUTINISE THE ESTIMATION?	16
2.8 WHAT WOULD BE AN INCENTIVE FOR THE USP TO ESTIMATE THE BURDEN / BENEFITS OF THE USO?.....	16
3 OVERALL CONCLUSIONS.....	17

1 Introduction

1.1 Background

At the WG Economics meeting in Zürich on the 25th of September 2005 the Project Team Universal Service and its Financing was established. The project team shall deal with the issues whether the existing means to finance the universal service (US) are efficient and to what extent they are used. As a first step the PT conducted a general survey based on a questionnaire addressed to all member countries. The survey made it possible to describe the situation in all CERP member countries regarding whether there is an extra cost for providing the universal service and how the service is financed. Some of the main findings where:

- Only a limited number of CERP member countries has made calculations of the need to finance the universal services.
- One basic condition for calculating the burden/benefit of the USO is that the USP has a well developed cost accounting system.
- A market opening does not eliminate the need for a regulatory regime and an independent NRA.
- Common basic principles for calculating the burden/profit of the USO should facilitate the work of the NRA.
- If the USP calculates that the USO is a burden it should also be able to defend the reasons for it being a cost.
- It's not until an actual cost of providing a USO is proven that different means of financing it should be discussed.

Based on these conclusions the PT found it essential to study more thoroughly which estimations of the burden/benefits associated with the USO have been made in the CERP countries, who has made them, if they haven't been made why, how often they should be made and by whom etc. A questionnaire was put together with questions which would reflect these issues. The questionnaire was sent to all CERP members the 28th December 2006. At the end of February 29 countries (six ministries and 23 NRAs) had answered.

1.2 Context

The report should be seen as a presentation of the actual situation in the CERP countries at the beginning of 2007. There is, as stated in the earlier report, a variety of different means of financing the USO in the member countries. The most common mean is though the reserved area. When deciding the size of it a reference is generally made to the maximum price and weight limits indicated in the Postal Directive 97/67 EC. It seems to be some uncertainty among the EU member states

if they have to calculate the necessary size of the reserved area. A plausible explanation could be the rather vague formulation in Article 7.1 in the Postal Directive which states that member states may reserve services for the USP to the extent necessary to ensure the maintenance of US. As the date for the liberalisation of the European postal market comes nearer the question of calculating the burden/benefit of the USO becomes more topical. This report could therefore be said to reflect the beginning of the discussion of calculating the net cost of the USO.

2 Findings

2.1 Has your country estimated the burden / benefits associated with the provision of the USO? If "yes" who undertook the work, USP/NRA/Ministry with own staff or a consultant?

In total 29 countries have answered this question (23 regulators and 6 ministries). Eight countries (three ministries and five NRAs) say the burden/benefits with the provision of their USO have been estimated. The estimation has been made by the USPs in five countries, in two by the NRAs and in one by an external consultant chosen by the ministry. 21 countries have answered no to this question.

Estimations by the USP

Three respondents (two ministries and one regulator) say that the USP's estimations are based on the accounting system and that they are certified by an external auditor. Another ministry has answered that the USP has developed the model which has been examined by two different external consultancy firms on behalf of the Ministry. The USP does the yearly calculations of the USO-burdens. The calculations are controlled and confirmed by an external auditor. The fifth respondent hasn't mentioned how their estimation has been done.

Estimations by the NRA

One of the NRAs tells us that they made some calculations in 2001, and they are carrying further work into understanding the underlying profits and loss of the USO. The other NRA hasn't mentioned what calculation that has been done.

Estimations by an external consultant

In one country estimations have been made by an external consultant on the behalf of the Ministry.

Other comments

Two other regulators have answered that the USP shall, within the scope of the cost accounting system, demonstrate the costs and revenues associated with the provision of the universal service. Until now the burden and benefits associated with the provision of the USO haven't been estimated.

Another regulator says that the net burden of the USO hasn't yet been calculated. Their USP has to calculate the cost and the revenue of the USO (regulatory accounting), which has to be audited by an external competent body each year. But that has in their opinion no direct link to the estimation of the burden of the USO. One regulator states that until now the US has been profitable, but that the USP prepare to calculate the burden. The work will be supervised by the NRA with cooperation of the USP (data necessary) by own staff.

Conclusions

The overall conclusion is that the issue calculating the burden/benefits of USO has been initiated recently and the process, to the extent it has started, is till in a phase of slow development. There are a few exceptions to this providing examples of fixed models and methods. The major part of the participating countries appears to be in an explorative process searching for models, methods and good examples. When carrying out these estimations the USP seems to have a crucial role. The majority of the countries where estimations have been made indicate that the USP has actually made these estimations. It seems however to be a process where the Ministry or the NRA are involved either by indicating the standards or the model to be applied or by scrutinising the results. The latter is often carried out by an external auditor or consultant.

2.2 If the burden / benefits of the USO have been calculated which method(s) were applied?

The eight countries that have made calculations have mentioned following methods:

- Fully Distributed Cost (FDC model) (one NRA)
- Cost accounting system
- The deficit between revenues and costs (one USP)
- Activity Based Cost (ABC-model) (one USPs)
- Net avoided cost (one USP and one NRA)
- Entry pricing model (this NRA has also NAC – see above)
- Direct and indirect costs assigned to each service within the reserved area (one USP)
- Additional costs and benefits (external consultant)

Fully Distributed Cost (FDC)

Total losses of the US minus profits of profitable reserved services.

Cost accounting system

The calculation is based on a cost accounting system approved by the NRA, which provides for the:

- a. non-realisation of cross-subsidies (unless foreseen by the law - i.e. reserved area).
- b. exact cost calculation of the cost of the US
- c. definition of cost-oriented prices

The deficit between revenues and costs

The burden of the USO is calculated by the USP and certified by an external auditor. This is an independent body which, according to the national society law, audits the USP's balance sheet. The benefits are not yet calculated according to this ministry.

Net Avoided Cost (NAC)

The calculation of the extra costs of performing the US includes:

- (i) a prognosis on expected future profit from the reserved area minus
- (ii) the calculated costs of the USO. The costs of the USO-burden
- (iii) are calculated by first setting the service level that the USP will perform if there was no USO. The main difference between this hypothetical level and the USO level in lower frequency of delivery in sparsely populated areas.

Entry pricing model

The regulators study in 2001 was based on the Net Avoided Cost (NAC) methodology. The current study is using both the NAC approach and also the Entry Pricing methodology. The Entry Pricing equates the cost of the universal service to the difference between the incumbent's profit level before the advent of competition and the incumbent's predicted profit level after the loss of mail volumes in the profitable parts of the network to competitors.

Additional costs and benefits

This assessment, coordinated by the ministry, was based on an analysis of the additional costs the USP had for the provision of universal service and the study was carried out by a well known consultant. However after having reduced these costs by considering basically the fact that the general service level could be commercially justified and

thus was not a burden and the advantages being the universal service provider only a minor sum – 10,000,000 Euro could be regarded as the net cost for providing universal service. Based on these calculations a commission appointed by the Government in 2005 concluded that the USO-obligation could not be considered as a burden for the USP.

Two of the above mentioned countries explicitly say that the calculation only is based on the cost accounting system (they have used the FDC model and ABC model in their calculations).

Other methods applicable mentioned by the other respondents (which haven't made any calculations) are:

Cost and benefits of the US

The NRA prescribed the main elements of the allocation system of costs and benefits of the US. Main elements are: fully allocated costs, historic costs and activity based costing. The allocation system and the outcomes are audited by a certified accountant each year.

Method described in the Postal Directive

(One ministry and one regulator)

One NRA proposes that the costs and revenues of the universal service reported in the cost accounting system could be an estimate of the burden and benefits of the USO. The method applied would be the one described in nr 2 and 3 of article 14 of the Postal Directive. According to another national regulation, the method applied to calculate the burden/benefits of the USO is consistent with the methodology developed for the European Commission, DGXIII relating to the UPS in the EC, by the National Economic Research Associates.

As we can see there is a general focus on the costs of the USO. Two countries have even understood the direction of separate accounts by the Postal Directive as guidance for estimating the burden of USO.

Conclusions

The answers provide a chart of different methods. In most cases these methods are those generally applied in business activities and focused on the costs, notably those indicated in the cost accounting systems. The benefits considered are almost exclusively the revenues for the services provided. Other benefits related to the provision of US seem to be considered only in a minority of the methods referred to.

The variety of methods illustrates the process and probably the lack of guidance in this matter. At the same time it highlights the fact that the methodology has

to be adapted to the specific conditions in each single country. In this perspective the application of uniform detailed principles for the calculations does not seem to be appropriate. On the other hand within the exchange of experiences between member states it appears to be relevant to achieve a common view on basic elements that ought to be considered in these estimations. The latter refers not least to the factors that are not reflected in the accounting systems.

2.3 If estimations of the burden / benefits of the USO haven't been made, then why?

If more than one alternative is applicable, please rank them.

12 countries (four ministries) out of 29 haven't answered this question. Seven of these have answered that they have made estimations in question 1, why it is natural that they haven't answered this question. Still the other five respondents haven't answered why they haven't made any estimation. The most common explanation to why estimations of the burden/benefits of the USO haven't been made is that there hasn't been an incentive to do so because the USP doesn't seek compensation. The second reason is that there is no legal obligation to estimate the burden/benefit. The third is that there is no sufficient method to estimate the burden/benefit of the USO and the fourth is that the USPs hasn't a sufficiently developed cost accounting system.

2.3.a Reserved area

If estimations of the reserved area required to finance the USO hasn't been made, then why? If more than one alternative is applicable, please rank them.

20 countries (four ministries) have answered the question. The most important reason, according to the respondents, why estimations haven't been made of the reserved area acquired to finance the USO is that a reference to the Postal Directive is considered sufficient. The second explanation is that there is no legal obligation to do estimations. The three other explanations are considered to be rather equal. No country has explicitly answered that the most important reason is that there is no sufficient accounting system.

Three regulators have mentioned other explanations to why no estimations have been made: that there is no necessity to do so when the USP doesn't seek compensation or that the US is profitable. In two of these countries there is a reserved area to finance the USO. The third

regulator says that some considerations have been made such as the necessity to ensure the maintenance of the US. Nine countries, two ministries and seven regulators, haven't answered the question though only four of these don't have reserved area as a mean to finance the USO.

2.3.b Compensation fund

19 countries have answered the question (two ministries). The most common explanation not to have estimated the size of the compensation fund is, according to the respondents, that there is no necessity to do so when the USP doesn't seek compensation. The second most common explanation is that there is no legal obligation to do estimations. A nearly as frequent answer is that there is no sufficient method to estimate the size of the compensation fund available. Five respondents (among these two ministries) have given other explanations such as that they have no operational compensation fund so far (two NRAs), that no estimations of the burden and benefits associated with the provision of the USO haven't been estimated (one NRA and one ministry) and that the compensation fund has not been considered to be an effective measure. Ten respondents (four ministries) haven't answered the question. None of these have an operational compensation fund. The only country which actually uses a compensation fund as a mean to finance their USO has explained that they don't have made any estimation as there is no sufficient method available.

2.3.c Subsidies

If estimations of the size of the subsidies required to finance the USO over the governmental budget hasn't been made, then why? If more than one alternative is applicable, please rank them.

20 countries have answered this question (three ministries). The most common explanation to why no estimation has been made is that the USP doesn't seek compensation. Five respondents have indicated that it is the most important reason why. A bit contradictory is that three of these countries have in the earlier survey answered that their USP receives state subsidies for some services. The services mentioned are subsidy to the USP for the distribution of newspapers, magazines and periodicals and government funding and grants for the post office network.

The second most common explanation is that there is no legal obligation to estimate the subsidies required to finance the US. Nine

countries (three ministries) haven't answered the question though two of these finance their US with subsidies over the governmental budget. Six respondents have answered that they haven't made any estimations because of other reasons. Two of these say that they don't give state subsidies to the USP and the other four haven't explained why.

2.3.d Geographical cross subsidisation

If estimations to determine the degree of cross subsidisation required to finance the USO hasn't been made, then why? If more than one alternative is applicable, please rank them.

22 countries have answered the question (three ministries). 13 respondents (two ministries) have indicated that their USP doesn't seek compensation why there is no necessity to estimate the degree of geographical cross subsidisation. One could though question whether these countries' USP doesn't use, for example, uniform tariffs for parts of their universal services? The second most common reason why estimations of the degree of cross subsidisation necessary to finance the USO haven't been made is that there is a lack of pressure through legislation. The third explanation is that the USP lacks a sufficient accounting system.

Five countries (all of them NRAs) have referred to other explanations, but only one of these has mentioned an estimation. This estimation is based on an international study with the average cost of a letter for the three zones - national, Europe and the rest of the world. In accordance with this the USP introduces consistent tariffs for all geographical zones. Another regulator states that their USP applies uniform tariffs though it doesn't have a legal obligation to do so. The decision is based on the uniform technological processing of postal items. Furthermore, the uniform tariffs seem to be the most appropriate solution regarding affordable prices and the financing of the US. The respondent thinks that the alternative not to use uniform tariffs would trigger additional costs and would be a backspace for the USP.

A third regulator has answered that geographical cross subsidisation shouldn't be considered a mean to finance universal services. Uniform tariffs basically reflect the principle of access to postal services in all parts of the country on equal terms and conditions. An example of when the NRA has scrutinised the USP's cost calculations is when the USP has applied zonal pricing (urban and not urban) for bulk mail sendings and therefore deviates from the national uniform tariffs. The NRAs task is to state whether prices in such cases are geared to cost. The aim is to prevent that geographical cross subsidisation is used as a mean to create barriers to market entry for local competitors.

Seven countries haven't answered to the question, three of these are ministries.

2.3.e Other cross subsidisation

If estimations to determine the degree of cross subsidisation required to finance the USO hasn't been made, then why? If more than one alternative is applicable, please rank them.

21 countries have answered the question (three ministries). The most important/one of the most important reasons to why no estimations have been made is that the USP doesn't seek compensation, according to 12 countries (two ministries). The second most frequent reason is that the USP lacks of pressure through legislation. Quite as many think that one reason could be that the USP hasn't got the sufficient accounting system to do the estimations.

Two regulators have stated that their accounting system should prevent cross subsidisation and ensure the USP to comply with the obligations. Two other regulators refer to the Postal Directive when saying there is no legal possibility to apply other form of cross subsidisation than uniform tariffs why estimations haven't been made. According to another NRA cross subsidisation could exceptionally be authorized by them.

One NRA has answered that there is no legal option to cross subsidise exclusively with the aim to finance USO. There are inevitably elements of cross subsidisation in all systems where pricing is not unique, i.e. based on cost calculations for each service provided to every single customer. Pricing based on weight limits is an example of potential cross subsidisation within a defined service. Scrutinising the cost calculations for such services with the aim to state whether prices are geared to cost is the closest the NRA gets to the issue estimating the degree of cross subsidisation.

8 countries haven't answered to the question, among them three ministries.

Conclusions

Even though a majority of the participating countries states that there is no need to estimate the burden/benefits of USO, the size of the compensation fund etc, because the USP doesn't seek compensation, there seems to be different views concerning whether or when estimations are required. With reference to the European Directive it appears that there is a need for clarification at least

for countries being members of the European Union. This is underlined by the fact that reference to the Directive is considered sufficient when deciding the size of the reserved area according to a number of answers. One possible explanation is that only pecuniary transactions are regarded as means to finance USO and that reserved areas, cross subsidies etc. consequently are regarded as something else.

A general hypothesis however is that a number of concurrent factors – uncertainty about the need to make estimations, lack of legal pressure, lack of methodology and good examples etc – are part of the explanation to why so few estimations have been made.

2.4 How could an estimation of the burden / benefits of the USO be made (other than methods identified in question 2 above) and how frequently?

21 countries (six ministries) have answered the question.

2.4.1 Frequency

Six countries (one ministry) have answered that the estimation should be made once a year. One regulator state that they receive regulatory accounts from their USP on a quarterly basis, though they haven't said that they do the estimation quarterly. Another regulator thinks that estimations should be made whenever the USP requests that any special means to finance US should be applied. The estimations should in the first place be revised if the need for financing changes. This could be the case when the USP requests that any kind of compensation for providing US should be adjusted or if any significant changes in the scope of USO or in the way to provide these services have been made.

2.4.2 Method

Four regulators think that estimation should be based on the USPs accounting system and separate accounts. Three other countries (two ministries) share the same view when they refer to the methodology developed for the European Commission and that the European framework should assess the method for estimation.

Other methods mentioned are cost orientation of the USP's accounting system (one regulator) net cost of US (one ministry), net avoided cost (four regulators). One regulator mentions that they use a prescribed allocation system which seems rather similar to an ABC-model which another ministry has mentioned. One regulator also says that the estimation should consider welfare economics for the operators and the

consumers and loss of profits for an effective operator in a liberalised market.

Two regulators points at the necessity of a precise definition of what the USP is required to do and which for commercial reasons it would not otherwise do. An assessment of the costs and probably benefits associated with such services should then be made, as well as a measurement of the efficiency of the USP.

One NRA refers to the earlier mentioned method to estimate additional costs of the USP minus the advantages being the USP. Most important is to apply a wide approach, thus taking into account even the highly important factors that are not reflected in the accounting systems of the USP. When applying such an approach it is important not to stick at the difficulties estimating the value of these factors in economic terms.

Two countries (one ministry) say that they don't know, one that the question isn't applicable to their country and eight haven't answered the question at all.

Conclusions

Apparently a number of methods are preferred by the participating countries. Concerning the frequency a majority of the participating countries have indicated a yearly estimation. One single country suggests that calculations should be made whenever there is change in the need to finance USO. At the same time one regulator indicates that estimations are given in four times a year. This raises the question how frequent thorough analysis of the costs and benefits could be carried out. How the estimations should be taken care of by the NRA, what measures should be taken by the NRA etc seems to be crucial when deciding the frequency. If estimations are given in frequently to the NRA several times a year the ambitions probably have to be adjusted accordingly.

2.5 What variables would be important in an estimation of the burden / benefits of the USO?

When applicable the answer can include both factors reflected and not reflected in the accounts (for example goodwill).

Below we have just referred to the answers as the respondents have put them. Nine countries have not answered the question (one ministry).

Revenues

Immaterial

2 Non tangible assets

3 Compensation

2 Benefits of the US obligation

Average profit for a fully processed postal item

5 Goodwill/Brand recognition

- Benefits from value added services provides on the top of the US
- Benefits from increased efficiency resulting from the US provision.
- Economies of scale (delivery)
- Objektive benefits
- Avoided costs when providing other postal and non postal services simultaneously with US that enables to use the postal network fully and efficiently.
- 2 Revenue structure with and without the USO
 - Profit of the USP
 - Profit from the US en bloc
 - Profit from each US
 - Nationwide coverage
 - Core business commercially justified

Costs

- Cost of capital
- Proportion of overhead
- Increase or decrease
- All costing pools mail related or not
- Fully distributed cost model
- Inefficiencies of the USP
- Unit cost for delivery and clearance
- Cost for transportation
- 2 Cost per post office or postal contact point
 - Net cost of maintaining unprofitable post offices
- 2 Average cost for a fully processed postal item
 - Objective costs
 - Operational and financial costs
 - Cost of provision of US in non-profitable areas
- 2 Cost structure with and without the USO
 - Cost function and cost drivers of each operational stage (sorting, collection/clearance, transport, delivery, etc.)
 - Elasticities of cost with respect to output.
 - Loss of the USP
 - Loss from the US en bloc
 - Loss from each service
 - Cost of delivery items in rural areas
 - Core business not commercially justified

- Other
- 2 Scope of the USO
 - Definition of the USO
 - Geographical conditions
 - Organisation of the public postal network
- 2 Services provided by the USP
 - Electronical substitution
- 3 Quality of service (delivery)
- 2 Numbers of delivery and collection/week
 - Number of delivered items/km²
 - Delivery to house or roadside letterbox
 - Uniform pricing
- 2 Customer loyalty
 - Ubiquity of service
- 2 Elements not accounted for in the accounts
- 3 Detailed information of volumes
- 2 Improvements
 - Density/coverage access points
 - Reserved area
 - Separate accounts (EU method)
 - Benchmarking data with other USP's or enterprises (efficiency argument)
 - Definition of the strategic level
 - Sound accounting system
 - Examples could be taken from the net cost calculation in the telecomsector.
 - Exchange of mail within the scope of UPU

2.6 Who should do the estimation of the burden/ benefits of the USO?

If more than one alternative is applicable, please rank them.

All 29 respondents have answered the question. According to the answers the parties could be placed in the following order:

1. The USP
2. The NRA
3. An independent auditor
4. The ministry
5. An independent auditor and the USP or an independent auditor with the ministry

Other aspects to consider:

- The independent auditor should be selected by the NRA
- It is important that the assessor have appropriate skills and knowledge to perform the task. External consultants could be a solution according to some respondents.
- The USP shall demonstrate the costs defrayed on providing the US and submit them to the approval of a committee made up of the NRA's and the USP's representatives.
- If the USP estimates the burden/benefits, the NRA should evolve the method and agree the amount of burden/benefits not, least as the basis for the estimations to a considerable extent includes external factors.
- Even though the studies are controlled by the NRA it is important to note that the main part of information reflecting internal conditions inevitably has to be provided by the USP.
- According to one national law it is the ministry through the NRA who should do the estimation.

All countries have answered the question.

2.7 If you have answered the USP in question 6, who should scrutinise the estimation?

If more than one alternative is applicable, please rank them.

The NRA is the most appropriate party to scrutinize the estimation, according to the answers. Second best is an independent auditor and in third place the ministry.

One suggestion mentioned is that the NRA should ask an independent auditor if necessary. Ten respondents (three ministries) haven't answered the question as they have answered that the estimation should be made by an independent auditor, the NRA or the ministry in question 6.

2.8 What would be an incentive for the USP to estimate the burden / benefits of the USO?

If several alternatives are applicable, please rank them by their joint importance.

27 countries have answered the question (four ministries). The answers have been compiled through weighting how many respondents that have found an incentive important and to what degree.

The best incentive for the USP to estimate the burden/benefits of the USO is if it identifies a need for compensation, according to the

respondents. The second best incentive is if the USP has to estimate the burden/benefits of the USO in compliance with legislation provisions.

The other incentives have been ranked as follows:

3. Identify a need to redefine the USO
4. Development of competition
5. Regulative measures
6. Improvements in the USP's accounting system
7. Development of methods

None of the respondents thinks that development of common standards would be an incentive for the USP to estimate the burden/benefits of the USO. Two countries (ministries) haven't answered the question at all.

3 Overall conclusions

The overall conclusion is that the issue calculating the burden/benefits of USO has been initiated recently and the process, to the extent it has started, is still in a phase of slow development. The majority of the responding countries appear to be in an explorative process searching for models, methods and good examples. The methods applied are those generally applied in business activities and focused on the costs indicated in the cost accounting systems. The benefits considered are almost exclusively the revenues for the services provided.

The process illustrates a lack of guidance. Within the exchange of experiences between member countries it appears to be relevant to achieve a common view on basic elements that ought to be considered in these estimations. The latter refers not least to the factors that are not reflected in the accounting systems.

There seems to be different views concerning whether or when estimations are required. With reference to the European Directive it appears that there is a need for clarification at least for countries being members of the European Union. This is underlined by the fact that reference to the Directive is considered sufficient according to a number of answers. A general hypothesis however is that a number of concurrent factors – uncertainty about the need to make estimations, lack of legal pressure, lack of methodology and good examples etc – are part of the explanation to why so few estimations have been made.

Based on these overall conclusions the project team decided to initiate a third step with the aim to provide guidance in this matter. As an introduction this third step shall start with a brain-storming session inviting members in the Working Group Economics.