Trade and Competition Issues Raised by the Liberalization of State-Owned Monopolies: The Example of Deutsche Post’s Cross-Subsidization of Its Express Delivery Operations

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Executive Summary

The liberalization of state-owned monopolies has important implications for trade and competition. Because state-owned monopolies exist in a number of industries, the way they are handled in trade negotiations warrants detailed study and proactive approaches.

Such monopolies exist in the financial services, broadcasting, transportation, telecommunications, energy and postal industries. Deutsche Post, for example, the German postal monopoly, presents a case where a monopoly is stretching the limits of the current trade and competition environment, raising unprecedented – indeed, uncharted – issues for policymakers in the United States and Europe. Deutsche Post has launched a major

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effort to become an integrated global express delivery firm through a large number of acquisitions, including international market leader DHL and Airborne Express. Recent financial analysis suggests that Deutsche Post is likely to command the resources to accelerate its move into international markets largely because of its continuing monopoly over regulated mail delivery in Germany and its de facto monopoly over many parts of the liberalized mail market.

European regulators have recognized this problem and attempted to deal with it by penalizing Deutsche Post for anticompetitive behavior, but European regulations are not well-designed to handle the problem in a broader international context, meaning that Deutsche Post's actions could continue undeterred.

This Economic Strategy Institute (ESI) analysis is one of several studies of express delivery services. Our analysis begins with this case study of Deutsche Post's impact on current competitive conditions facing U.S.-based express delivery services in global markets and U.S. markets. We found that Deutsche Post appears to be using its monopoly status in the postal services area to cross-subsidize its effort to enter new areas of business, such as express delivery, and to pose a competitive threat to U.S. companies, such as FedEx and UPS.

Deutsche Post is one of the most profitable express delivery firms in Europe, and mail proceeds accounted for 28 percent of the firm’s revenues but 72 percent of its profits in 2001. In 2002, fully 68 percent of the mail
division’s income came from the reserved sector, where Deutsche Post continues to enjoy a monopoly. The Economic Strategy Institute examined forecasts for Deutsche Post’s income and earnings from a variety of sources, and these projections expect that Deutsche Post will rely heavily upon its monopoly mail income to fund its investments through 2005.

ESI noted that the European Commission has begun to address anticompetitive behavior within the European Union – even levying a substantial fine against Deutsche Post for actions that contravene EU rules. The Commission’s recent decisions have been courageous, and they establish a framework for future action within the Union. Nevertheless, the European Commission has not committed to expand this regional action into a global framework.

This ESI study raises the concern that, if there is no agreement on setting an international framework for dealing with problems like those in express delivery services in GATS and/or other fora, the negative consequences for U.S. express delivery firms will be serious. The potential threat is that U.S. firms will face competitors from Europe or other nations that will use their monopoly positions in domestic markets to cross-subsidize their operations in the United States and around the globe.

In addition, we have underscored recent economic analysis by Sappington and Sidak and that identifies the unique incentives that state-owned monopolies have to
act anti-competitively. These include incentives to raise their own revenue and output by raising their rival’s production costs. This means that policymakers need to pay special attention to the economics of such state-owned monopolies, particularly in international markets.

There are few examples in trade law to address anticompetitive behavior in global markets outside of Article 8\(^1\) of the GATS, which is vaguely worded and

\(^1\) Article VIII of the General Agreement on Trade in Services is part of the World Trade Agreement of 1994 that established the World Trade Organization and included the GATT Uruguay Round. The main provisions of Article VIII on Monopolies and Exclusive Service Suppliers are included in Annex 1b of the GATT. Article VIII states that “1. Each Member shall ensure that any monopoly supplier of a service in its territory does not, in the supply of the monopoly service in the relevant market, act in a manner inconsistent with that Member's obligations under Article II and specific commitments. 2. Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments. The Council for Trade in Services may, at the request of a Member which has a reason to believe that a monopoly supplier of a service of any other Member is acting in a manner inconsistent with paragraph 1 or 2 above, request the Member establishing, maintaining or authorizing such supplier to provide specific information concerning the relevant operations. 4. If, after the entry into force of the Agreement Establishing the WTO, a Member grants monopoly rights regarding the supply of a service covered by its specific commitments, that Member shall make such notification to the Council for Trade in Services no later than three months before the intended implementation of the grant of monopoly rights and the provisions of paragraphs 2, 3 and 4 of Article XXI shall apply. 5. The provisions of this Article shall also apply to cases of exclusive service suppliers, where a Member, formally or in effect, (a) authorizes or establishes a small number of service suppliers and (b) substantially prevents competition among those suppliers in its territory.” See World Trade Organization, “Article VIII of the GATT 1994 – Scope And Application,” G/C/W/391, July 9, 2002. Cited at http://www.wto.org/english/tratop_e/tradfa_e/tradfa_overview2002_e.htm
untested. In addition, other nations' trade negotiators and U.S. trade negotiators have not included provisions to address anticompetitive behavior in their offers on GATS for express delivery. This makes the GATS an inadequate tool for addressing trade disputes.

The ESI analysis suggests additional steps that can be taken by the U.S. government, including an investigation by the International Trade Commission into the trade and competition implications of liberalizing state-owned monopolies, such as postal monopolies that are extending their operations into express delivery services. The U.S. Trade Representative and the Department of Justice could also act in concert with their counterparts in the European Commission to establish international protocols for addressing the trade and competition issues raised by the liberalization of monopoly markets.

In addition, the ESI study proposes that Congress support additional investigations and analyses to build upon the present one, hopefully leading to a better GATS “request-offer” negotiating process or a pro-competitive regulatory reference paper that would identify improved approaches to anticompetitive behavior in the express delivery industry. Such analyses might also suggest a framework for addressing similar issues in other markets that include state-owned monopolies.
I. Liberalization of State-Owned Monopolies and Deutsche Post’s Move into the U.S. Market

Deutsche Post’s foray into the U.S. express delivery market through its acquisition of industry leader DHL has raised two concerns. The first is that, although the European Union had begun gradually in the 1990s to liberalize postal services within the 15 member states, and did so under a framework of competition rules, it had not developed a remedy to address the use of monopoly status in anticompetitive pursuits. The second is that U.S. trade policy was unable to countermand such unfair behavior, especially when it included “former” state-owned monopolies.²

² We use the word “former” very cautiously. It is important to note that the Dutch and German Post Offices still have a legal monopoly. The German Post Office is still majority controlled by the German State (directly and indirectly through a state-owned bank). The Dutch Government has less than a 50 percent interest in Royal TPG Post, but has a "golden share" which gives it a veto power over certain strategic decisions.
This paper examines recent events in the express delivery sector to ascertain whether there is a need for the U.S. government and its trading partners to remain vigilant when “former” state-owned monopolies expand into competitive arenas. It also explores the important trade and competition issues raised by Deutsche Post’s operations in the U.S. market, as well as its global expansion.

A. Liberalization of State-owned Monopolies

In the late 1990s, the European Commission began its well-intentioned efforts to support the liberalization of state-owned monopolies, including postal services. The Commission considered means to address unjustified cross-subsidies that postal monopolies might use when they establish themselves in the private sector “primarily through acquisitions. Deutsche Post alone (including its Post Bank operation) is believed to have spent 10 billion Euros (U.S. $12.5 billion) on acquisitions during 1998-1999 (although acquisitions have continued through to 2002) in order to move aggressively into express delivery, logistics and the international market.”

Incumbent “postal monopolies raised their share of the

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3 The original Economic Strategy Institute study, “Dealing with Deutsche Post’s Well-Funded Foray into the U.S. Express Delivery Market,” Economic Strategy Institute, April 2001, estimated that this spending took place from 1998 to 1999. A re-examination of the statistics indicates that this spending most likely took place over the 1996-2003 period.

express delivery market from 5 percent to 40-50 percent, due to acquisitions.”

Unfortunately, the European approach did not work. The German government hoped to provide its postal monopoly with a long transition to a competitive domestic market. Accordingly, it let Deutsche Post charge high prices for domestic postal services, thus creating a “cash cow” to fund the monopoly’s acquisition of logistics and express delivery services firms.

The only countervailing force in Europe, the European Commission’s Competition Directorate, raised concerns about the postal monopoly’s intentions. It grew even more troubled when a number of European postal monopolies expanded into express delivery services. In a key ruling, the Competition Directorate found that “Deutsche Post had used profits from its state-granted monopoly in letter mail services to subsidize efforts to dominate the parcel delivery business in Germany by pricing below cost and undercutting competitors.” In other words, it had engaged in predatory pricing.

5 Ibid.
6 Some of the German government’s support of Deutsche Post may have been to improve the value of its shares. If share value rose, the government would gain more from the sale of any shares it held. The German government recently sold 30 percent of the shares in Deutsche Post to KfW, a bank that is owned by the German federal government and several state governments. This leaves the German government with 68 percent of the shares in Deutsche Post. “Germany Sells Shares of Deutsche Post,” Associated Press, November 11, 2003. http://www.ohio.com/ml/ohio2003/09/11/business/7235441.htm?template=contentModules/printstory.jsp
Other legal actions in European courts attempted to question whether former monopolies used revenues from reserved areas, such as postal services, to expand into new services, such as express delivery. In addition, the European Commission investigated “whether Deutsche Post’s activities violated EU rules on state aid – that is, whether it cross-subsidizes private sector activities with its postal monopoly profits.” Running counter to these investigations was the German government’s extension of Deutsche Post’s monopoly in the domestic letter market to 2007.

The U.S. government’s approach to trade agreements for service industries has not included any offers that address anticompetitive behavior, except in telecommunications. One reason for this is that most trade agreements deal with manufactured goods and rely upon long-established antitrust laws to penalize anticompetitive behavior. In the services sector, there is not a long tradition of antitrust laws, with the exception of laws adopted to deal with interconnection in the telecommunications services.

Even the first agreement for services, the General Agreement on Trade in Services (GATS), contained few mechanisms to address anticompetitive issues. Article 8 of the GATS addressed abuse of a monopoly position in services, but only applied to service industries where

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8 U.S. telecommunications firms pressed the government to include such provisions in the GATS because they were concerned that their foreign rivals might make interconnection difficult for their international networks.
signatories had made commitments. These commitments could be tailored to make it difficult for an injured party to bring a complaint. Article 8 also left the definition of an abuse vague. Thus, Article 8 is unclear about how to remedy a problematic situation that could lead to trade distortion and create impediments for competitors.

B. Efforts by Deutsche Post since 2001 to become a Global Express Delivery Firm: The Strategic Intent of Deutsche Post’s Acquisitions of Firms in the United States, including Airborne

To illustrate the concerns raised when “former” state monopolies expand into new business areas, ESI focused on the case of Deutsche Post. Deutsche Post has been moving into express delivery, an industry pioneered by several U.S. firms, such as FedEx and UPS. It has also acquired many U.S. firms, including Airborne, one of the three largest express delivery firms in the United States, and international market leader DHL. It paid over $1 billion for Airborne. Overnight, Deutsche Post attained about 28 percent of the U.S. express delivery market.¹⁰

Deutsche Post’s acquisition spree was part of a three-pronged strategy to turn the firm into a global mail, express and logistics leader.¹⁰ The first stage was to alter its internal structure. To prepare for future expansion,

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⁹ This includes DHL’s market share of 21 percent and Airborne’s share of 7 percent, according to data from the Air Cargo Management Group that analyzes the volume market shares of various competitors.
Deutsche Post changed its management structure and invested in express delivery and mail infrastructure. In the second stage, the “former” monopoly expanded its “geographic scope and capabilities.”\textsuperscript{11} It made major acquisitions, such as the purchase of “Danzas, a Swiss-based freight forwarding company that had its own global network. Danzas was used as a vehicle for many of its other logistics targets, which in Europe included Nedlloyd ETD and ASG. The global forwarder AEI was later acquired, which added to the air freight capabilities of Danzas and improved its USA coverage.”\textsuperscript{12}

To continue extending its geographical scope and capabilities, Deutsche Post built EuroExpress, a new European express parcels network. It created EuroExpress through acquisitions and partnerships or through joint ventures with domestic parcel and express delivery companies. The acquisition of Airborne was part of Deutsche Post’s expansionistic strategy, enlarging its presence in the U.S. market and providing it with the opportunity to create a globally integrated express delivery company.

The third and last stage in the strategy is to integrate all of Deutsche Post’s operations into a single global network, in order to exploit efficiencies of scale and scope. Deutsche Post plans to reorganize its older services under the DHL brand and implement STAR, an integration and efficiency program. STAR’s main goal is

\textsuperscript{11} Ibid.  
\textsuperscript{12} Ibid.
to increase Deutsche Post’s profitability by 40 percent, raising it to 3.1 billion Euros by 2005.\textsuperscript{13}

II. The Economics of Deutsche Post’s Operations

Deutsche Post appears to be using its monopoly status in the postal services area to cross-subsidize its efforts to enter new areas of business, such as express delivery, thus posing a competitive threat to FedEx and UPS. A recent study by NERA Economic Consulting (a Marsh and McLennan Company that is part of Mercer Management Consulting) analyzed Deutsche Post’s sources of funds in considerable detail. The NERA study tried to discern whether the profits from mail operations were higher than might be expected and if they might act as a “cash cow” to support Deutsche Post’s expansion.

A. NERA Study of the Profitability of Deutsche Post’s Mail Operations

The NERA study concluded that Deutsche Post is the most profitable postal service operating in Europe. NERA found that:

Profits in the Mail division, measured in terms of return on capital employed and based on Deutsche Post’s accounts, are substantially above the estimated cost of capital. This applies in particular during the years since 2000. For example, we estimate that in the year 2002, the return on capital employed in the Mail division was 50.4 per cent. By contrast, we estimate that the current cost of capital of the Mail division is between 9.0 and 10.6 per cent before tax.

Deutsche Post are protected from competition by means of their reserved sector so that they can meet their Universal Service Obligation to serve the whole of the domestic German mail market. However, this protection is only required so that they can earn sufficient revenue to cover the costs of serving this market. These costs include an adequate return on capital, but there is no need to earn more than this cost of capital – indeed, the evidence that NERA has found of excessive returns in the Mail Division implies that the company is afforded more protection than strictly necessary to meet their Universal Service Obligations – Article 7 of Directive 97/67/EC notes that postal services may be reserved “to the extent necessary to ensure the maintenance of universal service”.

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We do not regard it as likely that the current profit levels in the Mail division will come under pressure in the next few years, other than through the impact of the decision by the German regulator RegTP on Deutsche Post’s tariffs of July 2002. We expect that profits will remain substantially above our estimated cost of capital even when taking the impact of this decision into account.14 [Italics added]

The NERA study estimated (see Figure 1) that, while Deutsche Post’s mail division contributed 28 percent to the firm’s total revenues or sales in 2001, it accounted for 72 percent of the firm’s 2001 profits, estimated as earnings before interest and taxes (EBIT).15 Financial analysts use EBIT to measure profits. This means that the mail sector provides a disproportionate share of Deutsche Post’s profits.

Figure 1. The Importance of the Mail Division for Deutsche Post in Revenue and Profit (EBIT) Terms

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15 Dodgson et. al., p. 6.
NERA also analyzed how much of Deutsche Post’s profits are due to sales in the “protected” or monopoly part of its operations, which included licensed services. Using the annual report of the German regulatory agency, RegTp, NERA found that Deutsche Post obtains most of its profits from its regulated mail operations (see Figure 2).

Figure 2.
The left-hand column in Figure 2 shows the total 2002 turnover of Deutsche Post’s Mail division, approximately €11.7bn. Of this, around 68 per cent is derived from the reserved sector (i.e. the area where Deutsche Post enjoys a statutory monopoly), around 19 per cent from the non-reserved but licensed sector, and around 14 per cent from the non-licensed sector.
The right side of Figure 2 shows that Deutsche Post accounts for some 97 per cent of the total estimated turnover in the licensed sector of €10.4bn in 2002. In the licensed sector that is open to competition (the non-reserved but licensed sector), Deutsche Post’s 2002 share was around 87 per cent.”\textsuperscript{16}

Thus, at least 68 percent of Deutsche Post’s mail division earnings are based upon its monopoly status. \textit{These monopoly earnings provide at least 49 percent}\textsuperscript{17} of Deutsche Post’s profits that are the primary source of its funds for investing in overseas acquisitions, such as DHL and Airborne.

NERA also found that Deutsche Post continued to dominate many liberalized mail areas. Certain factors, such as Deutsche Post’s long history with German firms, make it likely that big customers will continue to use the postal firm’s deregulated mail services. NERA concluded that liberalization of the German domestic mail market would not reduce Deutsche Post’s dominance over the German mail market, although Deutsche Post priced its mail services far above costs. Other privileges offset these cost disadvantages, such as the ability to park

\textsuperscript{16} Dodgson et. al., p. 7. The data are from the German regulatory agency, Regulierungsbehörde für Telekommunikation und Post (2003) \textit{Jahresbericht} 2002.

\textsuperscript{17} This figure was estimated by taking the 68 percent of the mail division’s sales that are due to statutory monopoly and multiplying that by the 72 percent of profits (EBIT) that the mail division contributes to Deutsche Post. Although this estimate uses revenues from 2002 and profits for 2001, they are very close to the actual figures and give an estimate of the level of the profits due to the monopoly.
trucks in reserved areas to pick up both monopoly and licensed mail. In addition, the postal monopoly’s widespread presence and well-developed infrastructure mean that any competitor needs to make significant investments in order to match the service levels and geographical coverage that Deutsche Post can offer.

Thus, it appears unlikely that Deutsche Post will lose a substantial part of its mail operations to other competitors even when it must compete in non-reserved, but licensed sectors. In fact, there appears to be a very good likelihood that even after there is a complete liberalization of the regulation of mail in Germany and the European Union, Deutsche Post will continue to dominate domestic mail service for many decades.

B. Implications of Its Profitability for Deutsche Post’s Acquisitions – A “Cash Cow” Strategy

The majority of Deutsche Post’s profits\(^\text{18}\) come from its mail operations, which are a monopoly. Is there any evidence that these profits support the firm’s acquisitions? This section explores the relationship between profits from mail operations and Deutsche

\(^{18}\) Deutsche Post has also sold government-granted real estate to finance its acquisitions.
Post’s ability to purchase other firms. If this state monopoly uses its domestic mail operations as a “cash cow,” it may create an uneven playing field in the express delivery services. In large part, this would result from the vast profits its “cash cow” mail delivery services generate, profits that permit Deutsche Post to cross-subsidize its less profitable operations, as well as its expansion.

The higher margin assumptions that Morgan Stanley included in a recent forecast\(^\text{19}\) illustrate how Deutsche Post’s mail operations are such a significant contributor to profits. Table 1 demonstrates that mail operations account for 80 percent of profits\(^\text{20}\) in 2002, even after a large fall in mail revenues due to the decline in German economic growth. By 2004, mail operations are forecast to drop to 70 percent of profits, and by 2005, 65 percent of profits. These levels reflect Morgan Stanley’s expectation that Deutsche Post will need to spend aggressively (and squeeze more profits out of its postal operations) to establish its express operations in Europe. Morgan Stanley believes that Deutsche Post must create greater efficiencies in its express delivery services, similar to those already achieved by its main European competitor, Netherlands-based TPG. This will require new investment in Europe. If Deutsche Post intends to become a force in the U.S. express delivery market, it


\(^{20}\) In this analysts’ report, profits are measured as EBITA.
will also need to make large investments in U.S. infrastructure and services.

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<th>2002</th>
<th>2003</th>
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<tr>
<td>Mail Profits</td>
<td>80%</td>
<td>73%</td>
<td>70%</td>
<td>65%</td>
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<td>as Percent of Deutsche Post’s Total Profits</td>
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Note: Total Profits include Deutsche Post’s mail, express and logistics operations, excluding financial services. The figures for 2002-5 are forecasts. Source: Menno Sanderse, Martin Borghetto, Christian Kober, David Allchurch, Boniface Berthelot and Pablo Morales, “Deutsche Post: Targets Unchanged After Capital Markets Day,” Morgan Stanley Equity Research Europe, August 26, 2003, p.11.

What does this say about Deutsche Post’s capital spending? It indicates that mail operations will continue to account for a very substantial part of Deutsche Post’s operating profit. Forecasts\(^\text{21}\) of Deutsche Post’s cash from operations through 2004 expect profits to be very high,

and those profits – most of which come from the mail delivery business -- will be used by Deutsche Post use to make its capital expenditures. Without them, it would need to borrow nearly 2 billion Euros a year (about $2.5 billion). Clearly the mail operations of Deutsche Post underpin its ability to invest in the expansion of its acquisitions, particularly Airborne and DHL.

Morgan Stanley’s cash flow analysis in Table 2 indicates that Deutsche Post will pursue an even more substantial investment strategy than Morgan Stanley had forecast earlier. In this analysis, Deutsche Post is expected to raise its capital expenditures to 1.9 billion Euros [about $2.4 billion] per year and to finance much of this investment from its earnings. This contrasts with 2001-2, when Deutsche Post relied upon sales of assets to raise funds for investments.

| Table 2. Deutsche Post World Net: Selected Cash Flow Statistics in Millions of Euros, 2000-2005 |
|---------------------------------------------------------------|---|---|---|---|---|
| Cash Flow from all of Deutsche Post’s Operations              |
| Cash Flow from all of Deutsche Post’s Operations              |
| Cash Flow from all of Deutsche Post’s Operations              |
| Cash Flow from all of Deutsche Post’s Operations              |
| Capital Spending                                              | 2000 | 2001 | 2002 | 2003 | 2004 |
| 1853 | 2228 | 1844 | 1960 | 1910 |
C. Unique Economic Incentives of Monopoly Public Enterprises to Act Anti-Competitively

David Sappington and J. Gregory Sidak’s economic analysis\(^{22}\) of state-owned enterprises and the incentives they have to act anti-competitively puts the behavior of Deutsche Post in an economic context. They note that monopolistic, state-owned enterprises (SOEs) can have goals that differ from a profit-maximizing firm, particularly when it comes to rivals in non-reserved, or non-monopoly, areas. Their analysis notes that, if an “SOE operates both in a reserved market (such as letter delivery services) served only by the SOE and a non-reserved market (such as parcel delivery services) served by the SOE and one or more rivals, then the SOE can exploit economies of scope (cost complementarities) between the two markets.”\(^{23}\) This would apply to cases, such as in Europe, where Deutsche Post has used fidelity agreements to block the growth of competitors in express delivery markets. According to Sappington and Sidak, this behavior means that consideration must be given to


the total effects of monopoly status and the economic power it confers, particularly in industries that include monopolies and competitive firms.

“The key conclusion here is that, in the non-reserved market, the SOE may derive from its statutory monopoly over the reserved product an incremental benefit in the form of both economies of scope and economies of scale in the non-reserved market. These combined effects, direct and indirect, are not the intended consequence of the government’s having granted the SOE a statutory monopoly in the reserved market. Both incremental effects flow causally from the statutory monopoly, and not from an inherent cost advantage that only the SOE has the skill or acumen to obtain.”

State-owned enterprises benefit from this ability to accrue economic benefits in their monopoly markets. According to Sappington and Sidak, they also have incentives to employ these gains to create barriers against potential competitors. As a consequence, special attention needs to be paid to monitoring such firms’ actions in the market. These concerns mirror the problems associated with Deutsche Post’s dominance over German mail delivery operations, and its ability to use this monopoly position to affect U.S. and other markets.

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These findings influence the optimal design of competition law as applied to public enterprises. Because an SOE may have greater incentive to engage in anticompetitive practices and circumvent antitrust laws than its private counterpart, particular vigilance in monitoring the market activities of SOEs may be warranted. It may also be appropriate to subject an SOE to more stringent competition laws and harsher penalties for violating them.25

In addition, Sappington and Sidak have used economic analysis to demonstrate that monopoly public enterprises have incentives to act more aggressively towards their competitors. As they note:

“We have shown how the diverse goals that a public enterprise faces may lead it to act more aggressively toward its rivals than a private enterprise. A reduced focus on profit can lead a public enterprise to price products below cost. It can also increase the public enterprise’s incentive to raise the costs of existing rivals, to erect entry barriers that serve to preclude entry by potential rivals, and to understate costs and adopt inefficient production technologies in order to circumvent regulations designed to foster competition. Each of these activities can preclude the operation of more

25 Sappington and Sidak, op.cit., p. 27.
efficient competitors, and thereby reduce social welfare.”26

Of special interest is their economic analysis that leads to the following conclusion:

“The public enterprise analyzed here will raise its rival’s cost more extensively than will a profit-maximizing firm ceteris paribus because the public enterprise is more eager than its profit-maximizing counterpart to expand revenue and output. An increase in the rival’s production cost induces the rival to reduce its output, which results in greater equilibrium output for the MPE [Monopoly Public Enterprise]. The increased output for the MPE increases both its revenue and its cost. But since the MPE effectively discounts the extra costs of expanded output, it perceives greater net gain than does a profit-maximizing firm from the expanded output that results from raising its rival’s costs. The higher relative valuation of increased operational scale leads the MPE to raise its rival’s costs more aggressively than does a profit-maximizing firm.

The finding that public enterprises can have expanded incentive to raise their rival’s costs takes on particular significance when it is recognized

that public enterprises may also have expanded *ability* to raise their rival’s costs relative to the corresponding ability of private enterprises. A public enterprise’s special position as a government entity can afford it power to set industry rules that raise rival’s costs directly. To illustrate, the United States Postal Service claims to have considerable discretion in defining the letter services that it is entitled to provide as a monopoly. By defining letter services broadly, the Postal Service can raise the operating costs of rival producers of non-letter services by limiting the economies of scale and scope that rivals can secure.

The postal Service is also able to deny competing suppliers of non-letter services access to the mail boxes in which the Postal Service places letters. Limited access to customers’ mail boxes can raise operating costs by necessitating multiple delivery attempts or by otherwise increasing the time required to deliver packages, as well as by increasing potential losses from theft of packages left in non-secure places.”

In the case we discuss here, Deutsche Post has not remained a classic Monopoly Public Enterprise because it is less than 100 percent owned by the government (in fact, the public ownership is closer to 32 percent).

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Nevertheless, it can continue to take advantage of the fact that it is publicly owned and retains a dominant role in the German market. As part of its continuing role as a public enterprise, it can use its position in the domestic market to lower its operating costs while creating important disincentives and increased operating costs for its competitors. In addition, as a result of its private ownership, it can act to maximize profits in new areas that are open to it.

The emergence of Deutsche Post in such a mixed position creates an important quandary for international antitrust policy and for how international trade agreements address the economic role of former monopoly public enterprises.

III. The European Commission’s Reaction to Deutsche Post’s Move into Express Delivery

Have there been any signs that the European Commission recognizes the economic problems mentioned above? As noted below, the Commission has been very critical of Deutsche Post’s use of its monopoly power in European markets. At the same time, the Commission has promoted the liberalization of service sectors that include state-owned enterprises. In Germany, Parliament has set a faster schedule for liberalization than the European Commission has. These plans foresee the complete
liberalization of the German market by 2008 and the European market by 2009.\textsuperscript{28}

The state of European liberalization in 2003 illustrates that the process has been rather plodding, thus permitting a number of countries to provide “near monopoly” conditions for their former state enterprises. In some cases, as in Germany, governments still hold stock in these enterprises and hope to sell stock in them to ameliorate budgetary problems. As a consequence, the pace of liberalization has been slow.

The European Commission has adopted measures to open mail markets to competition, but has exempted a number of countries from its directives. In legislation – for instance, Directive 2002/39 EC\textsuperscript{29} – member states were required to adopt the liberalization provisions as national laws by January 1, 2003. Most member states have adopted these provisions, although The Commission permitted a number of states to slow the liberalization schedule. For instance the Directive permits Greece, Spain, Italy, Portugal, and Luxembourg to close cross-

\textsuperscript{28} Studies and new consultations that will begin in 2006 will determine whether the European Commission will retain the goal of complete liberalization by 2009.

\textsuperscript{29} According to one of the main provisions of this Directive, Article 7, 2002/39 EC, “The weight limit shall be 100 grams from 1 January 2003 and 50 grams from 1 January 2006. These weight limits shall not apply as from 1 January 2003 if the price is equal to, or more than, three times the public tariff for an item of correspondence in the first weight step of the fastest category, and, as from 1 January 2006, if the price is equal to, or more than, two and a half times this tariff.” See The European Express Association, “Guide to Fair Competition & Implementation of the Postal Directives,” August 2003, p. 3.
border mail to competition. It lets Ireland open cross-border mail to competition in 2004.

Other member governments have created their own agendas for liberalizing mail delivery. France has been somewhat protective, not requiring that the delivery of standard letters (weighing less than 350 grams) be open to competition (see Figure 3 below). The Netherlands and Spain have fully liberalized delivery for all direct mail and standard letters weighing over 100 grams. Spain has also liberalized local letter delivery. The United Kingdom is not as open to competition in mail delivery as Spain and the Netherlands, but it has liberalized large mailings and consolidations, in addition to providing for competition in the delivery of letters weighing more than 100 grams. In letter direct mail, Germany and the United Kingdom are somewhat closer to liberalization than other nations. Although Germany has provided for competition in the delivery of direct mail that weighs more than 50 grams, this only liberalizes less than 10% of the total mail market, a small difference with the United Kingdom. 30

Still, large percentages of the population in countries where mail monopolies exist habitually use the monopoly postal services, and the slow pace of liberalization means that de facto monopolies remain and can fund new operations in unregulated areas. Thus, there is an

30 In addition, the German government has done little to change Deutsche Post’s ability to benefit from having its workforce deliver both mail and express packages. Germany’s Monopolies Commission has underscored the impact of this issue on competition in mail delivery. See Germany, Monopolies Commission, “Special Report on the Postal Market,” 2003, p. 116.
apparent need for oversight and analysis of the economic impacts of these players. It is to be hoped that the European Commission will build on its initial efforts to oppose anticompetitive behavior, in order to ensure an open playing field for all competitors.

Figure 3.

**Liberalised areas for mail delivery in selected European countries**

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<th>United Kingdom</th>
<th>The Netherlands</th>
<th>France</th>
<th>Spain</th>
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<td>&gt; 100g</td>
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<tr>
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A. Findings and Actions of the European Commission’s Competitiveness Directorate with Regard to Cross-Subsidization

Deutsche Post and other “former” European state-owned postal services began an acquisition spree in the mid-1990s. Most entered express delivery services and logistics markets. Deutsche Post and the Netherlands’ TPG led the European effort to form integrated delivery
service companies that can compete with U.S. express delivery firms, such as FedEx and UPS. UPS reacted to Deutsche Post’s unfair practices by bringing a series of cases against Deutsche Post in Europe.

These cases prompted the European courts to make two decisions about Deutsche Post’s behavior. In the first case, Deutsche Post was accused of abusing its dominant position in the market (monopoly power) by underpricing its services in European markets. On March 20\textsuperscript{th}, 2001, the European Commission issued a decision under Article 82 of the EC Treaty that, with respect to Deutsche Post, the

“Commission finds that fidelity rebates, sometimes combined with below service-specific-cost prices, affect the development of trade to an extent contrary to the interests of the Community. As stated above, this conduct completely seals off the German mail-order parcel services market. This walling-off of a national market affects the development of trade to an extent highly inimical to the Community's interests.”\textsuperscript{31}

This decision criticized Deutsche Post for abusing its dominant position by granting fidelity rebates, and also concluded that Deutsche Post had engaged in predatory pricing. As a result, Deutsche Post agreed to create a

separate entity for business parcel services. The remedy in this case required a clear separation of the monopoly mail-delivery side of Deutsche Post’s business from its non-monopoly side, so that there would not be any opportunity for cross-subsidization to support what could be interpreted as “predatory” pricing. There was also a fine of $24 million levied in this case.

Supporters of that decision remain concerned that the European Commission’s Competition Directorate has limited numbers of staff and may be unable to oversee whether Deutsche Post complies with the decision.

The second decision addressed whether Deutsche Post had unfairly used state aid to cross-subsidize the services it was offering in other parts of Europe.

“On June 19th, 2002, the European Commission concluded that the DPAG used 572 million Euro, received to fund its public service mission, to finance an aggressive pricing policy, intended to undercut private rivals in the parcel sector between 1994-1998. This behavior breaches the principle that companies that receive state funding for services of general interest cannot use these resources to subsidize activities open to competition. The European Commission ordered DPAG to repay this amount plus interest.”

32 One complaint is that Deutsche Post re-branded much of its parcel business under DHL, thus undermining the intent of this agreement.
In this decision, there was no specific structural remedy for Deutsche Post’s improper use of state aid. The European Commission did impose a fine of nearly $1 billion on Deutsche Post that was paid in the second quarter of 2003.

B. Current Outlook for Effective European Remedies against Deutsche Post’s Behavior

By pursuing Deutsche Post in two cases concluded in 2001 and 2002, the European Commission showed a good deal of creativity and courage in pressing for an end to anticompetitive behavior. In addition, as the Commission has demonstrated in the recent Alstom case, it can exert pressure on individual companies to come to agreements that meet most of the Commission’s competition goals.

What has been missing is a consideration of how the liberalization of formerly monopolized industries in Europe might impact Europe’s trading partners. To date, with the exception of telecommunications, there is not even the barest framework to deal with abusive practices such as cross-subsidization in global services markets.

34 In this case, the European Union’s Competitiveness Commissioner, Mario Monti, blocked a large bailout of Alstom by the French government and forced it to devise a rescue plan that kept within the guidelines for government assistance to private firms that the European Commission had adopted. See Paul Meller, “EU and France set bailout for Alstom,” International Herald Tribune, September 19, 2003. http://www.iht.com/articles/110543.html
This means that Deutsche Post might use its dominant position in the German market to grant fidelity rebates or engage in predatory pricing, go on an acquisition spree, or engage in other monopoly abuses in the U.S. market. This would harm its international competitors, UPS and FedEx, in their home market and make it more difficult for them to compete against Deutsche Post in Germany, the rest of Europe, and the rest of the world. The U.S. government would not be able to seek relief from the WTO because WTO rules against such practices as cross-subsidies by state-owned monopolies are not yet sufficiently well developed.

Deutsche Post might also use its monopoly power or other arrangements with business partners (airlines or logistics services) to affect the way U.S. express delivery firms can do business in other foreign markets, such as Asia or Latin America. This could diminish U.S. firms’ efforts to help customers build supply chains and to offer competitive prices to current or potential customers in these markets. The end result might be to make it more difficult for some of America’s more competitive firms, such as its computer and electronics giants, to develop the kind of global supplier networks that keep prices down at home and make their goods competitive in global markets.

In its submission to WTO on GATS rules for postal and courier services, Europe has pressed for a fair and level playing field in mail and express delivery operations.35

35 WTO, Council for Trade in Services Special Session, “Communication From The European Communities and Their Member States: GATS 2000:
The United States is also committed to trade liberalization of this sector, but that will take time, and the problems caused by Deutsche Post are immediate. Current trends suggest that Deutsche Post will have little difficulty maintaining its dominance in Germany’s domestic mail market. The new competition it will face in liberalized mail markets will probably be quite small, with only an additional 4 percent of the total market open to competitors in 2003 and another 4.7 percent of the market open in 2006 (see Figure 4). Thus, it seems unlikely that even additional postal liberalization will affect Deutsche Post’s dominant position in this market, meaning that it can behave very much like the monopolistic enterprise that it was in the past.

If that scenario unfolds, the question is whether the European Commission will be able to ensure that Deutsche Post does not distort European markets or create an uneven playing field in global markets.

In addition, the European Commission should be aware that Deutsche Post could easily subvert the Commission’s efforts to stop anticompetitive behavior. Deutsche Post could pay its fines and temporarily set up a separate business entity for mail operations, in order to meet the requirements of previous court decisions, but still adopt policy and operational procedures that permit it to take advantage of the synergies offered by combining mail and express delivery operations.

This past August, Klaus Knappik of Deutsche Post World Net’s Divisional Board described the synergies that
existed in the process chain for mail and express deliveries (see Figure 5). This would be the way Deutsche Post would integrate its mail and express delivery sides to reduce costs and achieve better economies of scale. If the requirement to offer parcel services in a separate entity required by the 2001 European court ruling were followed to the letter, it might be difficult for Deutsche Post to exploit these synergies until the German market is completely liberalized. It is not clear how the Commission may react to such a strategic move.

Figure 5. The Creation of Synergies between Deutsche Post’s Mail and DHL’s Delivery Operations
IV. The Policy Challenge Posed by Deutsche Post’s Expansion into the U.S. Market via DHL and Airborne Express

A. European Remedies Will Not Constrain Deutsche Post’s Global Operations

The European Commission has begun to take steps to address anticompetitive behavior within the European Union. Its recent decisions have been courageous and
have set a framework for future action. Nevertheless, the European Commission cannot be expected to expand this regional action into a global framework.

B. Remedies in International Trade Agreements Are Insufficient to Address Deutsche Post’s Activities

In a review of express services and the WTO, Michael Nunes of the U.S. International Trade Commission noted that, during the Uruguay Round of trade negotiations, less than thirty percent of the WTO’s members had scheduled full or partial commitments on courier services. Even where they did make commitments, most nations did not choose to liberalize their markets. This has left a void in trade agreements, because they fail to address anticompetitive behavior and provide remedies for it.

C. Without Remedies, There Are Significant Future Impacts Likely for U.S. Express Delivery Firms


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If there is no agreement on setting an international framework for express delivery services in GATS, there will be serious negative consequences for U.S. express delivery firms. There is the potential threat that they will face competitors from Europe or other nations that will use their monopoly positions in domestic markets to cross-subsidize their operations in the United States. They may also create synergies between operations that are part of their domestic or regional operations and new operations in the United States. This could reduce the profitability of U.S. express delivery firms and lower their ability to invest in new operations in the U.S. market. As a consequence, these firms would create fewer jobs than they have in the past.

A competitor that limits the market access of U.S. express delivery firms could also have a significant impact on U.S. trade – both trade in express delivery services and trade in goods. The monopoly abuse described above would make it very difficult for U.S. express delivery service providers to enter markets in which the competitor with monopoly powers is operating. U.S. trade in goods could also be adversely affected, because U.S. manufacturing firms expect that U.S. express delivery firms will be able to extend express delivery to many overseas markets where U.S. manufacturers are establishing supply chains to provide less expensive parts and components. If these supply chains are not developed rapidly or can only provide limited support, it is possible that the ability of many U.S. manufacturers to compete in global markets will be reduced.
V. Steps the U.S. Government Should Consider to Evaluate the Impact of Deutsche Post’s Acquisitive Foray into American Markets

A. The USTR or Congress should examine the impact on U.S. express delivery suppliers when government-sponsored monopolies like Deutsche Post engage in anticompetitive practices, such as cross-subsidization. In particular, such a study should analyze the effects of monopoly abuse: (1) on the ability of U.S. express delivery services firms to enjoy fair market access abroad, and (2) on the domestic express delivery services market when such monopoly abuse is, in effect, exported to the United States through the acquisition of U.S. firms and an aggressive approach in the U.S. market.

B. The U.S. Trade Representative should increase efforts to obtain pro-competitive regulatory principles for the express delivery sector in all trade agreements along the lines of what exists for telecommunications services in the basic telecommunications agreement under the GATS.

C. The U.S. Trade Representative should broaden discussions with European and Asian nations on express delivery and GATS to include a
consideration of how liberalization would relate to the effort by express delivery firms to support supply chains that U.S. manufacturers and other multinational firms are establishing. Barriers to express delivery are likely to have significant negative impacts on the development of these supply chains, reducing trade flows and affecting the profitability of U.S. and other nations' express delivery firms.

D. Congress should analyze the impact of monopoly abuse in the express delivery industry on U.S. firms. Such an analysis could include a House and Senate Judiciary Committee analysis that would focus on the impact of anticompetitive behavior by national monopolies upon U.S. firms in the express delivery industry, such as Federal Express and UPS.

E. Congress and the administration should determine whether immediate, interim steps are necessary to address the problem of monopoly abuse and, if so, develop WTO-consistent approaches to that end.

VI. Conclusions

There are few trade policies to address the anti-competitive behavior of “former” state monopolies. This lacuna in trade policy is made even more problematic as a result of the heterogeneity of these former state
monopolies that exist with one foot in the competitive arena and another firmly planted in their old monopoly markets.

As a consequence, they can readily exploit the benefits of monopolies in one sphere, such as postal delivery services, to affect their operations in more competitive markets, such as express delivery services. This conundrum is made even more complex because such monopolies are not limited to the postal sector that this analysis addresses. They populate many industries that are in the process of being liberalized following the General Agreement on Trade in Services including the financial services, broadcasting, transportation, telecommunications, energy and postal services industries.

Conflicting goals in the liberalization process – with governments hoping to maximize the value of their shareholdings in such former monopolies – can slow liberalization. It can also create a situation where former monopolies can use their dominance over key domestic markets as an economic advantage, and permits them to distort trade or restrict market access by private companies.

This exploration of Deutsche Post’s recent behavior, including its acquisitions of new firms in the express delivery services, raises some thorny policy issues. Absent international trade rules to address problems of anticompetitive behavior, such as cross-subsidization and other forms of monopoly abuse in express delivery
services, Deutsche Post may be able to use profits obtained from its traditional monopoly in the German mail delivery market to expand into unregulated markets, such as express delivery in the United States.

This expansion poses important competitive challenges to the U.S. players, including UPS and FedEx. The U.S. government should investigate how Deutsche Post restricts trade and market access in foreign markets, as well as the effect of its actions in the U.S. market.

We conclude that while there was an initial “rush to judgment” among economists that liberalization of monopolized public service markets could create only greater efficiency, this is no longer the case. At least some economists have recognized that there are true incentives for anti-competitive behavior by state-owned monopoly enterprises once they enter competitive markets. What this analysis suggests is that in their latest evolution, such monopolies retain the ability to utilize the benefits of continuing monopoly power in home markets to act anti-competitively in competitive markets. This poses important challenges to economists and policymakers who are just beginning to understand that the old state owned monopolies pose a considerable challenge to important rivals, such as UPS and FedEx, in competitive markets as a consequence of their ability to act anti-competitively.