



Australian  
Competition &  
Consumer  
Commission

**ACCC decision on  
Australian Postal Corporation  
2015 price notification**

December 2015

Australian Competition and Consumer Commission  
23 Marcus Clarke Street, Canberra, Australian Capital Territory, 2601

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## ACCC decision

On 30 November 2015, Australia Post provided the ACCC with a price notification (“locality notice”) informing the ACCC of its intention to increase the prices of its ordinary (i.e. stamped) letter services from 4 January 2016.<sup>1</sup> The ACCC’s decision under section 95Z of the *Competition and Consumer Act 2010* (CCA) is that it does **not object** to the proposed price increases outlined in Australia Post’s price notification.

Australia Post is proposing to introduce a basic postage rate (BPR) of \$1 for letters delivered at a new regular timetable, which allows an extra 2 business days for delivery to occur compared to the current timetable. Postage stamps for letters delivered at the current timetable cost 70 cents. Australia Post’s proposal also includes price increases for the delivery of stamped large letters. The proposed prices are set out in Schedule 1 of Australia Post’s price notification and would apply from 4 January 2016.

The proposed prices in Australia Post’s price notification and Australia Post’s supporting submission are consistent with Australia Post’s draft price notification submitted to the ACCC on 20 August 2015. The price notification is at Attachment B and the ACCC’s view on the draft notification is at Attachment A. The ACCC’s consideration of the draft price notification and its view not to object are set out in the ACCC’s view published on 27 November 2015. It stated that the ACCC expected to soon receive a formal price notification from Australia Post and issue its final decision consistent with the view document.

In considering Australia Post’s draft price notification the ACCC carried out an extensive public consultation process, which is outlined in the attached ACCC view (Attachment A). The ACCC also engaged independent consultant WIK Consult (Wik) to review Australia Post’s cost allocation model and benchmark Australia Post’s business reform program against overseas postal operators that have experienced declining mail volumes. The ACCC has published executive summaries of Wik’s reports on the ACCC website.

In addition to the proposed price changes, Australia Post is introducing a new two-speed consumer letter service which will distinguish between letters delivered by Australia Post on a priority and regular timetable. The two-speed service will be provided under amended performance standards governing Australia Post’s speed of mail delivery.<sup>2</sup> Australia Post has stated that its new regular service will be delivered up to two business days slower than the current ordinary letter timetable. However, the amended performance standards provide an additional third business day for Australia Post to deliver regular letters between states. The changes to the performance standards are not subject to ACCC assessment. The new priority letter service will be provided at the same speed as the current ordinary letter timetable. The ACCC has not assessed prices for letters delivered at the priority timetable.<sup>3</sup>

In addition to the ACCC’s assessment, Australia Post must give written notice to the Minister for Communications of its intent to vary the BPR. Under Section 33 of the *Australian Postal Corporation Act 1989* Australia Post may increase the BPR only if the Minister for Communications does not disapprove the proposed increase within 30 days of receiving notification from Australia Post.<sup>4</sup>

In its supporting submission for its price notification, Australia Post acknowledges the comments by the ACCC and Wik regarding its draft price notification and commits to working with the ACCC in the lead up to any future price notification, in particular in relation to Australia Post’s:

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<sup>1</sup> A locality notice is a written notice given to the ACCC, pursuant to s 95Z(5) of the CCA, stating that the declared person proposes to supply goods or services in a particular locality on specified terms and conditions at a specified price.

<sup>2</sup> *Australian Postal Corporation (Performance Standards) Regulations 1998*, as amended by the *Australian Postal Corporation (Performance Standards) Amendment (Speed of Mail Delivery) Regulation 2015*.

<sup>3</sup> The price of stamped letters carried at the priority timetable is subject to price notification provisions if it exceeds 150 per cent of the ordinary rate. The prices of Australia Post’s other services, such as parcels, express post, bulk business letters, concession stamps and seasonal greeting cards are not subject to the ACCC’s assessment.

<sup>4</sup> The instruments relevant to the ACCC’s assessment of price notifications are available on the ACCC website.

- Cost allocation model – regarding the accurate reflection of regular and priority cost differences
- Letter volume forecasts – baseline forecasts and augmentation; and
- Reform our Letter Service (RoLS) program – demonstrated progress in achieving operational efficiencies and cost reductions.

## Legislative framework

The ACCC's role in the prices oversight of Australia Post's notified letter services is provided under Part VIIA of the CCA. Australia Post's reserved ordinary letter services carried at the regular timetable have been declared by the relevant Minister to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the CCA.<sup>5</sup> This Declaration means that in accordance with section 95Z of the CCA, Australia Post must notify the ACCC if it proposes to increase the price of a notified service, or if it proposes to supply a notified service on particular terms and conditions and it has not supplied the service on the same or substantially similar terms and conditions in the past 12 months.

Before increasing the prices of ordinary letters, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a price notification. The ACCC will then assess the proposed increases and decide to either:

- not object to the price increase
- not object to a price that is less than that proposed, or
- object to the price increase.

Subsection 95G(7) of the CCA provides that in assessing price notifications the ACCC must have particular regard to:

- the need to maintain investment and employment, including the influence of profitability on investment and employment
- the need to discourage a person who is in a position to substantially influence a market for goods and services from taking advantage of that power in setting prices
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC's approach to interpreting subsection 95G(7) of the CCA is outlined in detail in its *Statement of regulatory approach to assessing price notifications*.<sup>6</sup> The ACCC's approach to applying subsection 95G(7) of the CCA for its assessment of this price notification is consistent with the approach outlined in this guide.

Broadly, the ACCC considers that the matters in subsection 95G(7) guide the ACCC towards an assessment of the efficiency of Australia Post's cost base and the rate of return that it is seeking. Prices are then assessed having regard to the firm's ability to recover revenue sufficient to cover the efficient cost of providing a service, including a rate of return commensurate with the risks faced by the firm, without achieving excessive or monopoly profits. The ACCC's assessment of Australia Post's financial model is described in detail in the attached ACCC view document.

A general direction given to the ACCC by the Government in 1988 under s.20 of the *Prices Surveillance Act 1983*, provides that the ACCC must give special consideration to the Government's policy that increases in executive remuneration in excess of those permitted

<sup>5</sup> The current declaration applying to Australia Post's reserved ordinary letters is *Price Notification Declaration (Australia Post Letter Services) (No 2) 2015*.

<sup>6</sup> The guide is available on the ACCC's website, <http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications>.

under wage fixing principles should generally not be accepted as a basis for price increases.<sup>7</sup> The ACCC has considered the issue of executive remuneration within the context of Australia Post's labour costs. The ACCC notes that executive remuneration does not form a material proportion of Australia Post's labour costs given the size of its overall labour force, and thus is unlikely to have a material impact on Australia Post's cost forecasts.

Direction 11, made under s.20 of the *Prices Surveillance Act 1983*, provides that the ACCC must give special consideration to:

- Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35–41 of the *Australian Postal Corporation Act 1989* and in particular the pricing targets contained in Australia Post's corporate plan
- the functions and obligations of Australia Post as set out in sections 14–16 and 25–28 of the *Australian Postal Corporations Act 1989* and to such directions or notifications given to Australia Post by the Minister under that Act.

The ACCC has considered Direction 11 as part of its assessment of Australia Post's cost and revenue forecasts, which are based on Australia Post's 2015-18 Corporate Plan.

The ACCC's decision under section 95Z of the CCA is therefore consistent with the Ministerial directions and the legislative requirements under the CCA.

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<sup>7</sup> Section 45 of the *Trade Practices Legislation Amendment Act 2003* allows a direction made under s 20 of the *Prices Surveillance Act 1983* to continue in effect as if it were given under subsection 95ZH(1) of the *Competition and Consumer Act 2010*.

**Attachment A ACCC view on Australia Post's draft price notification**



Australian  
Competition &  
Consumer  
Commission

## **ACCC's view on Australia Post's draft price notification**

November 2015

Australian Competition and Consumer Commission  
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## Glossary

ABC	Activity Based Costing
ACCC	Australian Competition and Consumer Commission
Australia Post	Australian Postal Corporation
APCA	<i>Australian Postal Corporation Act 1989</i>
BPR	Basic Postage Rate, which refers to the price of carriage within Australia of a standard postal article by ordinary post. This will be the price of posting an ordinary small letter (according to Australia Post's new regular timetable).
Capital costs	The sum of a return on capital commensurate with the risks faced by the business plus the depreciation of the regulatory capital base
CAM	Cost allocation model
CCA	<i>Competition and Consumer Act 2010</i>
CPI	Consumer Price Index
CSO	Community Service Obligation
Declaration	The current declaration applying to Australia Post's ordinary letters is <i>Price Notification Declaration (Australia Post Letter Services) (No 2) 2015</i> .
Declared person	Under section 95X of the CCA, the Minister may declare a person to be, in relation to certain goods or services, a declared person for the purposes of Part VIIA of the CCA. Australia Post is a declared person in relation to certain ordinary letter services.
Draft price notification	Under section 95ZB of the CCA, the applicable period for the ACCC's assessment of a price notification is 21 days. However, a declared person is able to submit to the ACCC a draft price notification, which allows the ACCC to conduct a preliminary assessment prior to the lodgement of a formal price notification.
LPO	Licensed Post Office
Notified services	Under section 95X of the CCA, the Minister may declare goods or services to be notified goods or services for the purposes of Part VIIA of the CCA. The introduction of a new notified service, or a price increase for an existing notified service, is subject to the ACCC's assessment. For example, Australia Post's reserved ordinary letters are notified services.
Ordinary letters	Ordinary letters refers to postal articles carried by Australia Post by ordinary post. The main component of ordinary letters is stamped letters. Small and large ordinary letters (weighing up to 250 grams), including the BPR, are notified services.
Operating costs	Non-capital costs
Performance	Australia Post's current performance standards, including minimum

standards Amended performance standards	delivery standards, are set out in <i>Australian Postal Corporation (Performance Standards) Regulations 1998</i> .  <i>Australia Post Corporation (Performance Standards) Amendment (Speed of Mail Delivery) Regulation 2015</i> specifies Australia Post's minimum delivery standards for its new regular and priority letter services.
PreSort letters (including Charity mail and Acquisition mail)	Australia Post's PreSort letters service offers discounted postage rates for customers lodging more than 300 machine-addressed articles that are barcoded and sorted. PreSort services are not notified services.
Price notification (locality notice)	A price notification refers to a locality notice under section 95Z of the CCA. Where a declared person proposes to increase the price of a notified service, it is required to give the ACCC a written locality notice.
Priority letters / priority letter service	Letters carried at the priority timetable. The priority letter service will be delivered at the same speed as the current ordinary letter timetable. The price of stamped letters carried at the priority timetable is only subject to price notification provisions if it exceeds 150 per cent of the ordinary rate.
PTRM	Post tax revenue model—this is the form of the financial model used by the ACCC to model the maximum allowable revenue (MAR) of a regulated firm
Regular timetable / regular letter services	Australia Post proposes to deliver ordinary letters at a new regular timetable from 4 January 2016. Under this timetable, ordinary letters will be delivered up to two business days slower than the current timetable.
Reserved services	Under section 29 of the APCA, Australia Post has exclusive rights over the provision of reserved services. These services include the domestic carriage of letters weighing less than 250 grams and the issue of postage stamps.
Return of capital	Depreciation of fixed assets
Return on capital	The amount of revenue that an investor would require as compensation for the opportunity cost of funding its capital base, calculated by multiplying the WACC by the depreciated regulatory capital base.
RoLS	Reform our Letter Service
WACC	Weighted average cost of capital, which is the rate of return on assets allowed, given the relative level of risk associated with the capital base, averaged across debt and equity funding.

## ACCC view on Australia Post's 2015 draft price notification

The ACCC's view is to not object to the proposed price changes in Australia Post's draft price notification for notified postal services provided to the ACCC on 20 August 2015.

Australia Post's proposal comprises a significant price increase for its notified letter services (reserved ordinary letters) accompanied by a decline in service levels in the form of a new slower delivery timetable. Postage stamps for letters delivered at the current timetable cost 70 cents. Australia Post is proposing to introduce a basic postage rate (BPR) of \$1 in January 2016 for letters delivered at a new regular timetable, which allows an extra 2 business days for delivery to occur compared to the current timetable.<sup>8</sup> Australia Post's proposal also includes price increases for the delivery of large letters.

Australia Post has been making losses on its letter business for some years. Australia Post's application for an increase in the BPR is based on its claim that it is necessary to raise revenue to offset continuing losses as letter volumes decline. That is, in an environment of declining volumes with relatively fixed network costs, Australia Post's letter business is not recovering its costs and will experience further losses in the absence of price increases and efficiency reforms to its business practices.

The ACCC has considered Australia Post's forecasts for letter volumes, its allocation of costs to its reserved letter services, the efficiency of its costs and its proposed business reform program (Reform our Letter Service (RoLS)) to assess whether the proposed price increase will lead to an over recovery of Australia Post's costs for its letter services.

Having considered these factors and submissions on Australia Post's proposal, the ACCC has come to the view that Australia Post will not likely recover revenue in excess of its costs for reserved and notified postal services over the period to 2017-18 even with an increase in the BPR to \$1.

This is due in large part to a continued forecast decline in letter volumes. A key issue for the ACCC in assessing Australia Post's draft price notification is the forecast rate of decline in Australia Post's reserved letter volumes. As part of its assessment the ACCC has undertaken a review of Australia Post's forecast letter volumes and its forecasting method. The ACCC has not accepted Australia Post's letter volume forecasts and considers that the decline forecast is overstated. However the ACCC recognises that volumes have declined and will continue to do so and has accepted a forecast for a lower decline in letter volumes.

In assessing the effectiveness of Australia Post's response to declining letter volumes, the ACCC has noted the findings of a report to the ACCC by WIK Consult (Wik) which benchmarks Australia Post's current business reform program against overseas postal operators that have experienced declining mail volumes. A finding of this report is that the efficiency of Australia Post's current letter operations lags international peers. However, Wik considered that Australia Post's RoLS program is an appropriate response to declining letter volumes based on overseas experience and will, if implemented successfully, enable Australia Post to 'catch up' to the level of efficiency achieved by overseas postal operators that have faced declining letter volumes.

The ACCC recognises that Australia Post's RoLS program is intended to allow it to change its cost structure to become more flexible and more responsive to volume declines in the future. The ACCC commends Australia Post's recognition of the need to improve its

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<sup>8</sup> Australia Post has stated that its new regular service will be delivered up to two business days slower than the current ordinary letter timetable. However, the two-speed service will be provided under amended performance standards governing Australia Post's speed of mail delivery. The amended performance standards provide an additional third business day for Australia Post to deliver regular letters between states.

operational efficiency and notes that some of the additional efficiencies identified by Wik may not be available to Australia Post in the Australian economic and legal environment. However, notwithstanding that Australia Post may face challenges in implementing its business reform program, the ACCC would expect that Australia Post will implement the program as proposed and achieve at least the efficiencies it is forecasting.

The ACCC engaged Wik to also review Australia Post's cost allocation model (CAM). This review did not identify any systematic bias in Australia Post's CAM regarding the over allocation of costs from non-reserved services (i.e. services supplied in a contestable market) to reserved or notified services. The ACCC is satisfied that the costs allocated to reserved and notified services are appropriate but agrees with Wik that Australia Post should implement a number of improvements to the CAM. Importantly this includes the provision of additional information so that in the future the CAM accurately reflects cost differences between ordinary and stamped priority letter services.

The ACCC notes that the cost reductions forecast by Australia Post over the next three years are largely the result of moving to a slower delivery timetable and accommodating lower mail volumes, rather than efficiency improvements per se. However, unless Australia Post achieves cost reductions in the order of 3 per cent per annum (real) beyond its current expectation, through potential efficiencies such as those identified in the Wik report, it is likely to remain in an under-recovery position on reserved services over the period to 2017-18 even with the introduction of the proposed prices in January 2016.<sup>9</sup>

The ACCC has also not accepted Australia Post's proposed Weighted Average Cost of Capital (WACC) of 7.29 per cent and has reduced the nominal WACC to 6.53 per cent. Adopting a lower WACC and not accepting Australia Post's demand forecast reduces its forecast level of under recovery for reserved services.

The ACCC considered an alternative to Australia Post's proposal to implement its price increase in one step, that is instead phasing in the increase through the introduction of a 90 cent BPR from January 2016 and a \$1 BPR in January 2017. This would reduce Australia Post's revenue by around \$134 million over the three years to 2017-18 compared to Australia Post's proposal to introduce a \$1 BPR in January 2016. However, when combined with the adjustments to WACC and mail volumes referred to above, Australia Post would need to increase its operational efficiency for reserved services by around 4 per cent (real) annually to deliver such a phased price increase and achieve cost recovery over the period to 2017-18.<sup>10</sup> The ACCC concluded that it would be difficult for Australia Post to reduce its costs to that extent and consequently phasing a price increase is not feasible at this time.

The ACCC considered a large number of submissions on Australia Post's proposals, a summary of which is available on the ACCC's website. Submissions were received from Licenced Post Offices, businesses, local councils and non-profit organisation. ACCC staff met with interested stakeholders including major business groups representing business mail users. Amongst the issues raised were concerns about the introduction of significant price increases for bulk mail midway during the financial year, and the level of consultation provided by Australia Post regarding its proposals. The business groups were also concerned that the price increases proposed will have an adverse impact on future mail volumes and the bulk mail, philatelic equipment, marketing and printing industries. The ACCC notes that it does not have a role in assessing bulk business mail prices under Part VIIA of the *Competition and Consumer Act 2010* (CCA). However, as discussed above, the ACCC considered phasing in a price increase for the stamp price as part of its assessment of the price notification.

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<sup>9</sup> Based on the ACCC's assumptions regarding alternative demand forecasts and WACC, outlined in this document.

<sup>10</sup> Estimates for alternative price phasing options were based on Diversified Specifics' equations for estimating volumes, and estimates of cost elasticities from Economic Insights' consultancy report for Australia Post.

Under the CCA, Australia Post is required to notify the ACCC of proposed price increases for its ordinary letter services delivered at the new regular timetable. The ACCC must then assess the proposed increases and decide whether to object or not object.

The ACCC adopts a cost-based approach to assessing price notifications under Part VIIA of the CCA. The appropriateness of proposed prices is considered by assessing the extent to which they are required to recover the efficient costs of Australia Post providing letter services. The ACCC has assessed Australia Post's proposed prices with reference to the costs and revenues of its notified (i.e. stamped letter services) and reserved letter (i.e. statutory monopoly) services.

After releasing this paper the ACCC expects to receive a formal price notification from Australia Post and intends to issue its final decision consistent with the view set out in this paper in December 2015.

In addition to the ACCC's assessment, pursuant to section 33 of the *Australian Postal Corporation Act 1989*, Australia Post must provide written notice to the Minister for Communications of a proposal to fix or vary certain rates of postage. Therefore, Australia Post may increase the BPR only if the Minister does not disapprove the proposed increases to the BPR within 30 days of receiving notice of the price increase from Australia Post.

# 1. Australia Post’s proposal and the ACCC’s role and assessment approach

## 1.1. Australia Post’s draft price notification

On 20 August 2015 Australia Post provided the ACCC with a draft price notification regarding proposed price changes for its monopoly letter services. Australia Post is proposing to introduce a basic postage rate (BPR) of \$1 for letters delivered at a new regular timetable, which allows an extra 2 business days for delivery to occur compared to the current timetable. Postage stamps for letters delivered at the current timetable cost 70 cents. Australia Post’s proposal also includes price increases for the delivery of large letters. The proposed prices are set out below and would apply from 4 January 2016.<sup>11</sup> Australia Post is not proposing to increase the prices of concession stamps or stamps for seasonal greeting cards.

**Table 1 – Prices for ordinary letters**

Letter service	Current Price (current ordinary timetable)	Proposed Price (new regular slower timetable)
Small letter (BPR)	\$0.70	\$1.00
Large letter up to 125g	\$1.40	\$2.00
Large letter over 125g up to 250g	\$2.10	\$3.00

In addition to the proposed price changes, Australia Post is introducing a new two-speed consumer letter service which will distinguish between letters delivered by Australia Post on a priority and regular timetable. The two-speed service will be provided under amended performance standards governing Australia Post’s speed of mail delivery.<sup>12</sup> Australia Post has stated that its new regular service will be delivered up to two business days slower than the current ordinary letter timetable. However, the amended performance standards provide an additional third business day for Australia Post to deliver regular letters between states. The new priority letter service (“priority letters”) will be provided at the same speed as the current ordinary letter timetable. The ACCC is not assessing prices for letters delivered at the priority timetable.

Australia Post’s draft price notification outlines that a key objective of its new two-speed consumer letter service is to enable greater flexibility and efficiency in its letter processing and delivery operations. Australia Post submits that the changes to the delivery timetable and prices are also intended to support Australia Post’s strategy of providing a more financially sustainable letter service. These initiatives are a response to the trend of declining letter volumes and letter business losses experienced by Australia Post in recent years.<sup>13</sup>

The proposed increase in the BPR would allow Australia Post greater flexibility in respect of its business mail prices, which are provided at a discount to the BPR. While the BPR is subject to ACCC prices oversight, business mail prices are not directly regulated. However, the BPR acts as a ceiling to business mail prices.

Figure 1 provides a categorisation of Australia Post’s products, showing the major business segments and the revenue generated by them in 2014-15.

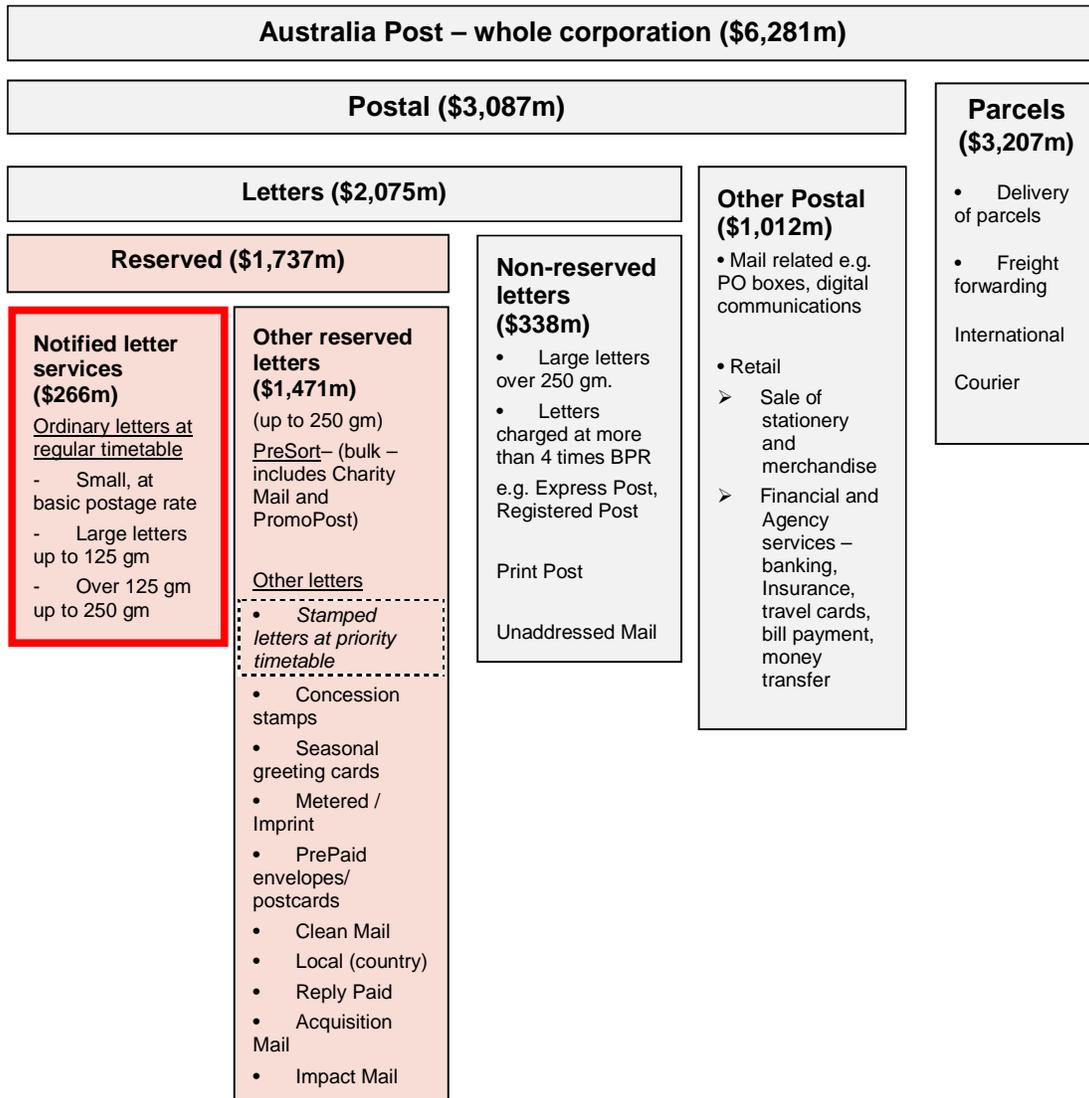
<sup>11</sup> Australia Post is proposing that the new prices would apply from 4 January 2016 until further notice.

<sup>12</sup> *Australian Postal Corporation (Performance Standards) Regulations 1998*, as amended by the *Australian Postal Corporation (Performance Standards) Amendment (Speed of Mail Delivery) Regulation 2015*.

<sup>13</sup> Australia Post’s annual reports note domestic reserved letter service losses in each year since 2008.

**Figure 1: Categorisation of Australia Post product groups and revenues**

Revenue in \$ millions, based on 2014-15.



**Key:**  Reserved letters     Notified letters (part of Reserved)

Sources:

Australia Post, Supplementary Information to Draft Price Notification, October 2015, table 5 (p.11) and table 15 (p.17).

Note: International inward letters and international inward parcels weighing less than 250grams are formally non-reserved services but are subject to Universal Postal Union (UPU) regulation.

Note: Ordinary letters at the priority timetable are a new service that was not provided in 2014-15.

Australia Post’s draft price notification was supported by a Post Tax Revenue Model (PTRM) provided to the ACCC which was based on Australia Post’s 2014-2017 Corporate Plan.<sup>14</sup> The PTRM provided in August 2015 forecast that if new prices are introduced in January

<sup>14</sup> This financial information from the PTRM differs from some other estimates provided by Australia Post, which are based on an accounting concept of costs, that is, operating costs and depreciation at historical cost. The equivalent cost concept in the PTRM is ‘required revenue’ which includes the operating costs, depreciation at current cost, return on capital and tax allowance. The ACCC has used the PTRM throughout this decision when making comments about the level of under recovery that is being forecast for Australia Post’s reserved services. Further details about the ACCC’s assessment of Australia Post PTRM are in section 6.1 of this document.

2016 as proposed by Australia Post, under-recovery for its reserved letter services would be \$70 million in 2015-16, while an over-recovery of \$84 million was forecast for 2016-17.

In October 2015 Australia Post provided the ACCC with additional information on its forecasts, including an updated PTRM based on its 2015-18 Corporate Plan and updated financial information. This included:

- forecasts for an additional year to 2017-18
- updated forecast cost savings from the Reform our Letter Service (RoLS) program to 2018-19
- adjusted prices for reserved services, such as an increased discount for the business letter service Promo Post.

Based on Australia Post's updated forecasts, a \$1 BPR would reduce the losses on Australia Post's stamped and other monopoly letter services by 2017-18. However, Australia Post expects these services to still under-recover their costs over that period. Australia Post's revised forecasts indicated:

- lower reserved services revenue (compared with the 2014-17 Corporate Plan), largely due to different assumptions about the level of migration from the priority to the regular timetable, and the increased discount applicable to Promo Post
- reserved services costs for 2015-16 and 2016-17 would be higher than previously forecast (largely due to revised forecasts regarding labour costs and LPO commissions),
- under-recovery of reserved letter costs totalling \$126 million, \$72 million and \$108 million in 2015-16, 2016-17 and 2017-18 respectively.<sup>15</sup>

Therefore, while an over-recovery of \$14 million for reserved letter services over 2015-16 and 2016-17 was previously forecast by Australia Post, its revision forecast an under-recovery of \$198 million over this period.

## 1.2. The ACCC's role

### 1.2.1. Services subject to ACCC assessment

The ACCC's role in the prices oversight of Australia Post's notified letter services falls within the scope of Part VIIA of the CCA.

Australia Post's reserved ordinary letter services carried at the regular timetable have been declared by the Minister (Treasurer) to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the CCA. The price of ordinary letters carried at the priority timetable is subject to price notification provisions if it exceeds 150 per cent of the ordinary rate.<sup>16</sup> The prices of Australia Post's other services, such as parcels, express post, bulk business letters, concession stamps and seasonal greeting cards are not subject to the ACCC's assessment.

Before increasing the prices of ordinary letters, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a locality notice.<sup>17</sup> The ACCC will then assess the proposed increases and decide to either:

- not object to the price increase

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<sup>15</sup> Revenue, cost and recovery figures are presented in this document in nominal dollars unless otherwise specified.

<sup>16</sup> Refer to *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015*, Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015, <https://www.comlaw.gov.au/Details/F2015L01429>.

<sup>17</sup> A locality notice is a written notice given to the ACCC, pursuant to s 95Z(5) of the CCA, stating that the declared person proposes to supply goods or services in a particular locality on specified terms and conditions at a specified price.

- not object to a price that is less than that proposed, or
- object to the price increase.

There is an applicable period (also known as the price-freeze period) of 21 days within which the ACCC is to make its assessment, starting on the day on which the locality notice is lodged. In order to enable the ACCC to form a view on price notifications taking account of the views of industry stakeholders and interested parties, the ACCC usually conducts an informal assessment of a draft price notification proposal lodged by a declared person prior to the lodgement of a locality notice.

In addition to the ACCC's assessment, Australia Post must give written notice to the Minister for Communications of its intent to vary the BPR. Australia Post may increase the BPR only if the Minister for Communications does not disapprove the proposed increase within 30 days of receiving notification from Australia Post.<sup>18</sup>

### **1.2.2. ACCC approach to assessment**

The ACCC has adopted a cost-based approach to assessing Australia Post's draft price notification under Part VIIA of the CCA.<sup>19</sup> Under this approach, prices should reflect:

- a cost base that is efficient
- incentives for efficient investment.

The ACCC has applied a building block model to calculate the total revenue required to meet efficient costs. The model aggregates the following cost components:

- operating costs
- return of capital, representing depreciation costs
- return on capital, representing the required rate of return on the capital base.

In assessing Australia Post's draft price notification, the ACCC has considered whether the revenue from the price increases proposed will meet the revenue required for Australia Post to recover the efficient costs of providing letter services.

The ACCC has assessed the components of Australia Post's PTRM including the forecasts of costs, revenue and demand, and other factors included in the model. Australia Post's submitted PTRM is for the period to 2017-18. The ACCC has considered a building block model for Australia Post's total reserved services when assessing revenue required for ordinary letter services. Ordinary letter services are a subset of reserved services.

As discussed in more detail in this document, the ACCC's assessment has also involved consideration of:

- the impact of the two-speed letter service and other business reforms on Australia Post's costs, and how the reforms and cost savings compare to overseas postal operators undertaking similar reforms
- Australia Post's demand forecasts and the effect of the proposed price changes on forecast revenue
- Australia Post's proposed rate of return on capital (WACC)
- Australia Post's cost allocation model (CAM).

<sup>18</sup> The legislative instruments relevant to the ACCC's assessment of price notifications are available on the ACCC website.

<sup>19</sup> A more detailed explanation is contained in the ACCC's Statement of Regulatory Approach to Assessing Price Notifications, June 2009, which is available on the ACCC's website at <http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications>.

As part of its assessment the ACCC engaged Wik Consult to review Australia Post's CAM and benchmark Australia Post's business reform program against overseas postal operators that have experienced declining mail volumes. Wik specialises in regulatory economics and has extensive international experience in postal regulation. The ACCC has published public executive summaries of Wik's reports on the ACCC website.

### **1.2.3. Public consultation and review timeframe**

In considering Australia Post's draft price notification the ACCC has carried out a public consultation process. The ACCC published an Issues Paper on 7 September 2015 and sought the views of stakeholders. The ACCC considered a large number of submissions, including from Licenced Post Offices, businesses, local councils and non-profit organisations. A summary of these submissions is available on the ACCC's website. ACCC staff also met with interested stakeholders including major business groups representing business mail users and held a series of meetings with Australia Post.

Amongst the issues raised were concerns about the introduction of significant price increases for bulk mail midway during the financial year, and the level of consultation provided by Australia Post regarding its proposals. The business groups were also concerned that the price increases proposed will have an adverse impact on future mail volumes and the bulk mail, philatelic equipment, marketing and printing industries. The ACCC notes that it does not have a role in assessing bulk business mail prices under Part VIIA of the CCA. However the ACCC considered phasing in a price increase for the stamp price as part of its assessment of the price notification.

As discussed above, the ACCC will make a final decision after Australia Post submits a formal price notification (locality notice) to the ACCC. The ACCC expects to receive a locality notice after the release of this document. On this basis the ACCC would release its final decision in December 2015.

Table 2 provides a timetable for the ACCC's review process.

**Table 2 — Timetable for assessment of Australia Post's price notification**

<b>Date</b>	<b>Process</b>
<b>28 August 2015</b>	Australia Post's draft price notification and invitation for submissions released by the ACCC
<b>7 September 2015</b>	ACCC published issues paper
<b>14 October 2015</b>	Australia Post provides supplementary information to its draft price notification
<b>15 October 2015</b>	Closing date for submissions on draft price notification
<b>27 November 2015</b>	ACCC publishes its view on Australia Post's draft price notification
<b>December 2015</b>	Australia Post expected to submit formal price notification
<b>December 2015</b>	ACCC publishes Final Decision

## 2. Cost of providing letter services

### 2.1. ACCC view

The ACCC has adopted a cost-based approach to assessing Australia Post's draft price notification. Under this approach, prices should reflect a cost base that is efficient and provide incentives for efficient investment. The ACCC's assessment has involved a consideration of the impact of the two-speed letter service and other Reform Our Letter Service (RoLS) business reforms on Australia Post's costs. The ACCC engaged Wik Consult (Wik) to assess the efficiency of Australia Post letter operations compared with postal agencies overseas that have faced declining letter volumes over the past decade.<sup>20</sup>

Wik has found the efficiency of Australia Post's current letter operations lags behind the international peers considered. Notwithstanding this, Wik considered that Australia Post's RoLS program is an appropriate response to declining letter volumes based on overseas experience. Australia Post's RoLS program is intended to allow it to change its cost structure to become more flexible and more responsive to volume declines. As noted by Wik, other operators have modernised their operations in a way that provides them with greater flexibility to respond to declining mail volumes. Specifically, Wik found Australia Post's modernisation program had commenced later than the overseas operators considered, and that Australia Post required a long period to implement necessary cost savings and efficiency programs despite significant letter volume declines since 2008 and increasing losses in monopoly letter services.<sup>21</sup>

The ACCC recognises that Australia Post's RoLS program is intended to allow it to change its cost structure to become more flexible and more responsive to volume declines in the future. The ACCC commends Australia Post's recognition of the need to improve its operational efficiency and recognises that some of the additional efficiencies identified by Wik may not be available to Australia Post in the Australian economic and legal environment. However, notwithstanding that Australia Post may face challenges in implementing its business reform program, the ACCC would expect that Australia Post will implement the program as planned and achieve at least the efficiencies it is forecasting. In considering any proposals for price increases in the future, the ACCC will look closely at Australia Post's progress on achieving operational efficiencies and cost reductions, along with the improvements to its cost allocation model recommended by Wik (discussed in section 5 of this paper).

### 2.2. Australia Post's forecasts

#### 2.2.1. Cost forecasts

A key objective of Australia Post's two-speed letter service to be introduced in 2016 is to shift mail volumes to its new regular timetable. Australia Post submits that its major operational savings from the reform program are dependent on achieving significant levels of migration of letter volumes to the slower timetable. Migration will be encouraged through a price differential between regular and priority services.

Operational costs represent the majority of Australia Post's costs for provision of reserved letter services, around 90 per cent, with the balance being its capital costs (depreciation and return on assets) and tax expense. The bulk of Australia Post's operating costs are labour costs.

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<sup>20</sup> A public version of the executive summary of Wik's review of Australia Post's efficiency program is available on the ACCC website.

<sup>21</sup> Wik, *Review of Australia Post Efficiency Program in light of international benchmarks, Final report for ACCC*, November 2015, p. 2.

Australia Post forecasts total costs for reserved services to decrease by \$136 million over the three years to 2017-18 (a decline of around 2.3 per cent per annum in nominal terms). This is less than the cumulative RoLS savings of \$319 million over the same period (refer Table 4). This reflects that some of the RoLS savings relate to non-reserved letter services, but also reflects Australia Post's forecast increases in other costs, in particular due to:

- commissions paid to LPOs in line with the proposed increases in letter prices
- higher depreciation costs, in line with new sorting machines for greater automation
- an increase in the number of delivery points and distance of rounds
- higher input prices due to general inflation and wage rates based on its Enterprise Agreements.

These factors largely explain why Australia Post's costs are forecast to decline by less than the expected savings from RoLS. The ACCC understands that the forecast cost reductions due to the RoLS program also take account of the lower mail volumes expected.

As shown in Table 3 below, Australia Post expects its total costs (operating and capital costs) for reserved services to remain relatively constant over the two years to 2016-17 (in nominal terms). However, Australia Post is forecasting total reserved services costs (operating and capital costs) to decline in 2017-18 by around \$130 million (6.5 per cent reduction compared to 2016-17 in nominal terms).

Australia Post expects its notified services operating costs to decline by 4.5 per cent in 2015-16 and increase by 2.7 per cent in 2016-17 compared to the previous years (i.e. an average annual decline of around 1 per cent over two years in nominal terms).

**Table 3 – Australia Post's submitted cost forecasts**

(\$ million)	2014-15	2015-16	2016-17	2017-18	Average annual change in costs (nominal)	Average annual change in costs (real)
<b>Notified services</b>	353	337	346	334	-1.8%	-4.2%
<b>Reserved services</b>	1990	2000	1982	1854	-2.3%	-4.7%

Source: Australia Post, *Supplementary information to Draft Price Notification*, October 2015, p. 16-17; *Draft price notification*, August 2015, p. 53.

Note: Notified services costs are only operating costs. Reserved services also include capital costs. Costs are in nominal terms, including inflation at an assumed rate of 2.5 per cent per annum.

Australia Post's forecasts indicate that labour costs are the major component of its forecast reserved services costs, accounting for around 60 per cent of those costs. The operational changes being implemented by Australia Post and the introduction of a two-speed letter service will enable a reduction in the size of its labour force.

## 2.2.2. Savings forecast from RoLS

Australia Post estimated the following savings from its RoLS program:

**Table 4 – Savings forecast from RoLS program<sup>22</sup>**

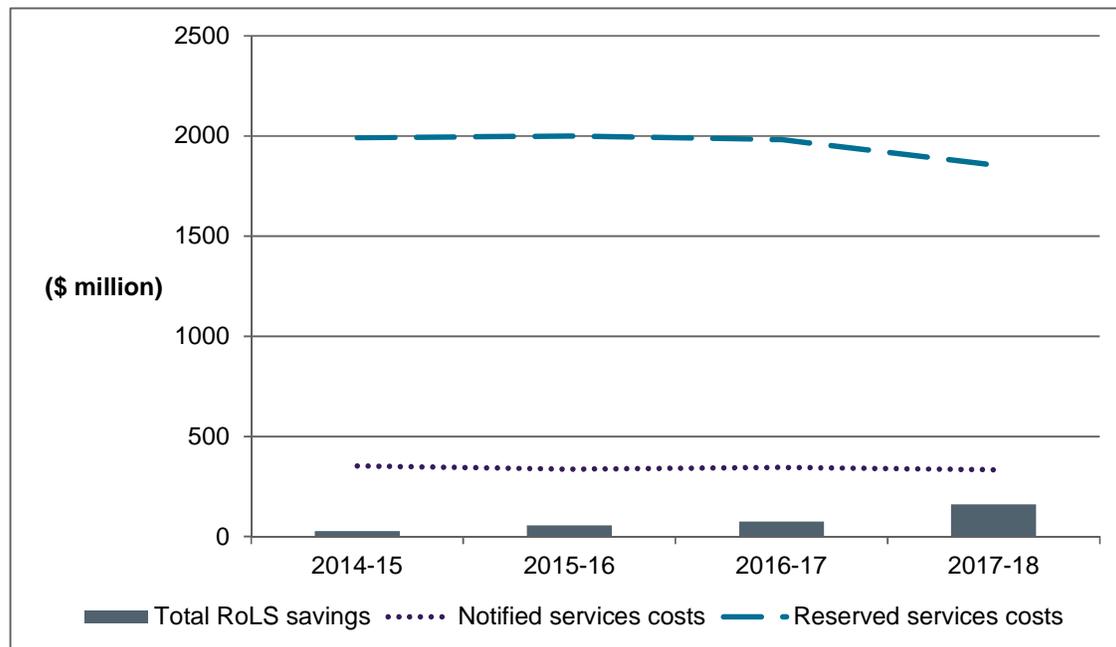
(\$ million)	2014-15	2015-16	2016-17	2017-18	Average annual change in costs due to ROLS (2014-15 to 2017-18)	
<b>Total RoLS savings (cumulative)</b>	27.2	83.3	158.2	319	Nominal -5.6%	Real 7.9%
<b>Incremental saving in costs over previous year</b>	27.2	56.1	74.9	160.8		

Source: Australia Post, *Supplementary information to Draft Price Notification*, October 2015; *Draft price notification*, August 2015, p. 16.

Note: Reserved services also include capital costs. Costs are in nominal terms.

The following chart illustrates the size of the RoLS savings relative to Australia Post's reserved and notified services cost levels.

**Figure 2 – Incremental RoLS savings relative to Australia Post's letter costs**



Source: *Supplementary information to Draft Price Notification*, October 2015 pp. 10, 16-17; *Draft price notification*, August 2015, pp. 53, 58,

The largest RoLS cost reductions are based on savings in labour costs. The labour savings are of two types:

- Reduction in full time equivalent (FTE) staff numbers - Australia Post proposes to reduce reserved services FTE numbers by around 3,370 by 2017-18. This would amount to a

<sup>22</sup> Australia Post, *Supplementary Information to Australia Post's Draft Price Notification*, October 2015, p.10. Some of the RoLS savings would relate to non-reserved letter services.

reduction of 22 per cent, or 8 per cent per annum, in FTEs from the level of 15,280 in 2014-15.<sup>23</sup>

- Reduction in penalty payments - The two-speed letter service will allow savings through a reductions in penalty payments. The longer daytime processing window provided by the regular timetable will allow most letters to be stored at mail centres overnight and be sorted/sequenced during the next day. This will attract a lower or no penalty rate and reduce the level of manual handling of letters (leading to a further reduction in labour costs).<sup>24</sup>

These operational savings are to a large extent made possible by the introduction of the slower delivery timetable for ordinary letters, which constitutes a reduction in service levels. Australia Post has stated that it requires around 80 per cent of total addressed letters to be delivered at the slower timetable in order to implement its operational savings. Australia Post was unable to forecast the savings from its reform program that can be attributed to efficiency and which are due to reductions in delivery speed and mail volumes.<sup>25</sup> Australia Post did not forecast improved efficiency in other areas of its letters business. As shown above, a substantial proportion of the RoLS savings was offset by increases in costs in other areas of its letters business.

### **2.3. Wik's key findings**

The ACCC engaged Wik to benchmark Australia Post's RoLS program and related business reforms against overseas postal operators that have experienced declining mail volumes. Wik's review focused on five major European postal operators: Deutsche Post (Germany), La Poste (France), PostNL (The Netherlands), PostNord Denmark and PostNord Sweden. These operators commenced significant operational reform programs over a decade ago which have allowed them to alter their cost structures in recognition of a structural break in demand for mail services that has occurred in their respective jurisdictions.

Wik reviewed Australia Post's current operations, past performance and projected progress in increasing the efficiency of its letter operations. Wik also compared Australia Post's operations and reform program to the overseas postal operators listed above.

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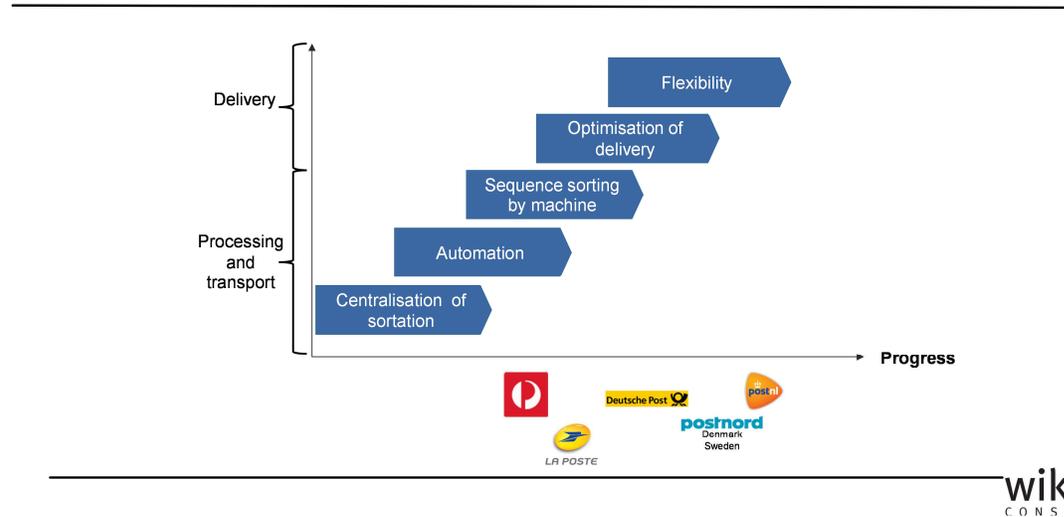
<sup>23</sup> Australia Post, *Supplementary Information to Australia Post's Draft Price Notification*, October 2015, p.12.

<sup>24</sup> Australia Post, *Draft price notification*, August 2015, p. 74.

<sup>25</sup> Australia Post, response to ACCC information request of 27 October 2015, Q.10, received 30 October 2015.

Wik has found the efficiency of Australia Post’s current letter operations lags behind the international peers considered. Figure 3 below illustrates Wik’s findings on Australia Post’s current level of modernisation relative to its international peers.

**Figure 3 – Modernising letter operations: Australia Post’s position before RoLS relative to international peers**

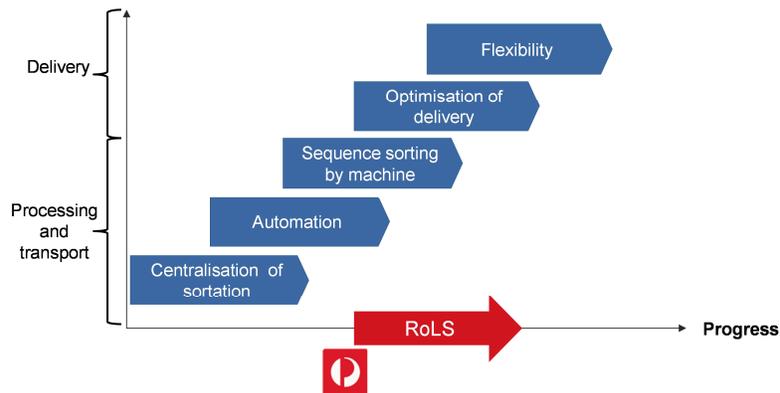


Source: Wik-Consult.

Wik considered that the RoLS program is an appropriate response to declining letter volumes based on overseas experience. Wik’s finding was that RoLS would be challenging to implement, but if implemented as planned will allow Australia Post to ‘catch up’ to the current level of modernisation achieved by its international peers. Wik considered that the program will have a substantial impact on Australia Post’s letter operations, because it plans to implement many different elements simultaneously, which would impact both processing and delivery operations.<sup>26</sup> Figure 4 illustrates Wik’s view of the position Australia Post would achieve in terms of modernisation if RoLS is successfully implemented.

<sup>26</sup> Wik, *Review of Australia Post Efficiency Program in light of international benchmarks*, p. 4.

**Figure 4 – Modernising letter operations: Australia Post before and after RoLS**



Source: Wik-Consult.

Assuming Australia Post is able to successfully implement its RoLS program, Wik considered that Australia Post’s forecast savings appeared conservative in light of the savings achieved by overseas operators experiencing similar levels of volume declines. On the other hand, Wik considered that given Australia Post’s progress to date in implementing reforms and realising cost savings, achieving all of the projected cost savings is likely to be challenging for Australia Post.<sup>27</sup> Australia Post maintains that Wik’s view is based on an incomplete assessment of its past performance and that Australia Post has achieved what has been possible given its operating environment.<sup>28</sup>

## 2.4. Submissions received

Most submissions did not directly consider Australia Post’s costs. However, at a general level, a number of submitters noted that the declines in mail volumes should also decrease the costs of distributing and sorting mail, and decrease general costs. As noted in section 2.5 below, Australia Post has historically had relatively fixed costs due to its prescribed service levels and performance standards, and a traditional postal delivery model utilising full-time postal delivery officers. The ACCC expects Australia Post’s reform programs to increase the downward flexibility of its costs, and considers this to be essential to an efficient response to the trend of declining letter volumes.

Submitters also expressed concerns that the price increases were being accompanied by a reduction in delivery standards. Submitters noted that a large price increase is usually accompanied by a justification of improving service standards. The ACCC considers that even with the implementation of a slower timetable Australia Post would not be able to recover the costs of providing letter services without price increases for its ordinary letters. This is because of the trend of declining letter volumes. The changes to the performance standards for Australia Post’s ordinary letter services are a matter for Australia Post and the Australian Government and are not subject to ACCC assessment. However, the ACCC notes that the proposed changes to delivery times are integral to Australia Post’s proposal for business reform and reducing costs in response to the sustained decline in letter volumes.

<sup>27</sup> Wik, *Review of Australia Post Efficiency Program in light of international benchmarks*, p. 4.

<sup>28</sup> Australia Post e-mail to ACCC staff 26 November 2015.

The ACCC received submissions in relation to Australia Post's executive remuneration levels, including the remuneration of its CEO. The ACCC has previously considered the issue of executive remuneration within the context of Australia Post's total labour costs for reserved and notified services. The ACCC notes that executive remuneration does not form a material proportion of Australia Post's labour costs given the size of its overall labour force, and thus is unlikely to have a material impact on Australia Post's cost forecasts.

Some submissions expressed concern that provision for staff redundancy costs in Australia Post's financial results for 2014-15<sup>29</sup> were inflating its losses. Australia Post has advised that it has not included costs for staff redundancy in its cost forecasts for 2015-16 and onwards because provision for these costs was made in its 2014-15 financial results (by way of a one-off adjustment).

The ACCC also received a large number of submissions from Licenced Post Office (LPO) operators, in addition to detailed submissions by the LPO Group and Post Office Association of Australia Limited (POAAL). The submissions expressed support for Australia Post's proposed increase in the BPR, noting that Australia Post's costs are increasing, and that the remuneration of LPO operators are linked to the level of the BPR. The LPOs submitted that granting an increase in the BPR and increasing the price of stamps by at least the CPI is necessary to allow the incomes of LPOs to keep pace with their increasing costs and to avoid price shocks in the future.

In contrast, other submitters noted that Australia Post needs to reform its business practices in relation to providing its CSOs (in particular that Australia Post was providing services in excess of its CSOs). Some submitters also noted that Australia Post is not making good economic retail use of its post offices, and that this is placing pressure on the costs of Australia Post's letters and parcels business. This is discussed further in section 5.2 of this document.

## **2.5. ACCC's view on Australia Post's costs forecasts**

Australia Post's application for an increase in the BPR is based on its claim that the increase is necessary to raise revenue to cover its costs and offset its losses as letter volumes decline. That is, in an environment of declining volumes with relatively fixed network costs, Australia Post would experience further losses in the absence of price increases.

The ACCC's assessment has involved consideration of the impact of the two-speed letter service and other RoLS business reforms on Australia Post's costs. As discussed above, the ACCC engaged Wik to assess the efficiency of Australia Post letter operations compared with postal agencies overseas that have also faced declining letter volumes.

Wik has found the efficiency of Australia Post's current letter operations lags behind the international peers considered. That is, other operators have modernised their operations in a way that provides them with greater flexibility to respond to declining mail volumes. Australia Post has historically had a relatively large proportion of fixed costs due to its prescribed service levels and performance standards, and a traditional postal delivery model utilising full-time postal delivery officers.<sup>30</sup> A significant level of manual work is still undertaken by postal delivery officers at Australia Post compared to the comparator operators considered by Wik (for example, manual sorting and sequencing of letters at mail centres, and at delivery centres by postal delivery officers). This operational model has generally enabled Australia Post to recover its costs while letter volumes were increasing or stable. However, in an environment of declining volumes, the model results in continued high

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<sup>29</sup> Australia Post annual report 2014-15, p. 70.

<sup>30</sup> Boston Consulting Group (BCG) estimated that around 80% of the letters business's costs were currently fixed. This finding is consistent with that of Economic Insights.

fixed costs and therefore losses in the absence of price increases or improved operational efficiency.

As part of its assessment the ACCC also considered a report prepared by Economic Insights for Australia Post.<sup>31</sup> The report considered the likely effects of declining mail volumes and increasing delivery points on Australia Post's future costs. The ACCC considers that Economic Insights' report is useful in demonstrating the historic drivers of costs in processing and delivery, but does not assist in forecasting Australia Post's future costs where a transformation process with substantial impact on its letter operations is being undertaken.

The ACCC considers that the cost reductions forecast by Australia Post over the next three years are largely the result of moving to a lower standard of service (i.e. a reduction in delivery speed) and accommodating lower volumes, rather than efficiency improvements per se. Australia Post submitted that 'business-as-usual' efficiencies were incorporated in its cost forecasts. However, Australia Post has been unable to isolate general efficiency savings from those due to reductions in delivery speed and mail volumes.<sup>32</sup> While a specific target for improvement in operational efficiency has not been provided in Australia Post's forecasts the ACCC considers there are likely to be some savings unrelated to the reduction in delivery speed and letter volumes.

The ACCC agrees with Wik that RoLS is an important modernisation program for Australia Post. Australia Post is endeavouring to implement a step change in its cost structure through the RoLS program which will allow it to have a cost base that is more flexible and more responsive to volume declines. The ACCC commends Australia Post's recognition of the need to improve its operational efficiency and notes that some of the additional efficiencies identified by Wik may not be available to Australia Post in the Australian economic and legal environment. However, notwithstanding that Australia Post may face challenges in implementing its business reform program, the ACCC would expect that Australia Post will implement the program as proposed and achieve at least the efficiencies it is forecasting.

In considering any proposals for price increases in the future, the ACCC will look closely at Australia Post's progress in achieving operational efficiencies and cost reductions, along with the improvements to its cost allocation model recommended by Wik (discussed in section 5 of this paper).

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<sup>31</sup> Economic Insights, *Updated Estimates of Australia Post's Mail Centre and Delivery Centre Cost Elasticities* 14 May 2015, available at <https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2015/draft-price-notification>.

<sup>32</sup> Australia Post, response to ACCC information request of 27 October 2015, Q.10, received 30 October 2015.

## 3. Australia Post's demand forecast

### 3.1. ACCC View

Forecasts of letter demand are used to assess whether proposed prices are expected to achieve sufficient revenue to recover costs (without providing excessive returns). These forecasts are also relevant to assessing Australia Post's cost forecasts where volumes impact on operational costs. Australia Post submitted three-year demand forecasts in the supplementary information for its draft price notification, consistent with its 2015 Corporate Plan. Australia Post is forecasting an average rate of decline in reserved service letter volumes of 10.9 per cent per annum from 2014-15 to 2017-18 (see Table 5). In recent years (2011-12 to 2014-15), letter volumes have declined by an annual average of 5.8 per cent. Australia Post notes in its draft price notification that substitution, consolidation and rationalisation continue to place pressure on letter volumes, leading to an increasing rate of decline.<sup>33</sup>

The ACCC has undertaken a review of Australia Post's forecast letter volumes and its forecasting method, including the forecasts provided by its consultant Diversified Specifics. Australia Post's demand forecasts are based on augmentations it has made to Diversified Specifics' baseline forecast. After these augmentations, Australia Post's forecast rate of decline is higher than Diversified Specifics' forecast of an average 8.6 per cent decline annually over the three years from 2014-15.

A key concern for the ACCC is that Australia Post's forecasts appear to double count factors responsible for driving forecast letter volumes down that are already included in the modelling by Diversified Specifics. The ACCC has therefore not accepted Australia Post's augmentations to Diversified Specifics' demand forecasts.

The ACCC had some concerns with Diversified Specifics' baseline model. However, alternative scenario analysis performed by the ACCC showed that these issues were not material for the purpose of volume and revenue forecasts. Consequently, the ACCC has accepted Diversified Specifics baseline volume forecast. The ACCC has also accepted Diversified Specifics' estimated price elasticity of demand, which is higher than that assumed by Australia Post, for the purpose of forecasting the level of consumer response to the proposed price increase. In summary, the ACCC has applied Diversified Specifics' forecast volumes for the purposes of modelling Australia Post's revenue projections.

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<sup>33</sup> Australia Post states that "Emerging digital communication platforms are presently in various stages of development and are likely to exacerbate an already deteriorating situation for Australia Post's core letter volume segments in the immediate future." Australia Post's draft price notification, p. 24.

**Table 5 – Australia Post’s forecast volume rate of change (%) 2014-15 to 2017-18<sup>34</sup>**

	Actual volumes in 2014-15 (millions)	2014-15 <sup>35</sup> (%)	2015-16 (%)	2016-17 (%)	2017-18 (%)	CAGR <sup>36</sup> (%)	Forecast volumes in 2017-18 (millions)
Ordinary / Other small	1,045	-9.4	-13.1	-13.6	-7.5	-11.4	726
Ordinary / Other Large	135	-13.5	-15.5	-16.1	-9.0	-13.6	87
PreSort Small	1,672	-4.6	-12.2	-11.0	-7.8	-10.3	1,205
Presort Large	123	-4.5	-11.1	-14.0	-8.8	-11.3	86
Total Volumes	2,975	-6.8	-12.6	-12.2	-7.8	-10.9	2,104

Source: Australia Post supplementary information October 2015.

### 3.1.1. Australia Post’s forecasting method and considerations

Australia Post describes its methodology for forecasting mail volumes as a two-part process:

- Australia Post engaged Diversified Specifics to construct baseline volume forecasts for each of its key letter volume segments.
- Diversified Specifics’ forecasts were then subject to augmentation by Australia Post. Australia Post advised that this was necessary because Diversified Specifics’ models do not incorporate some emerging trends known to be influencing letter demand.<sup>37</sup>

### 3.1.2. Diversified Specifics’ baseline forecasts

Australia Post provided the ACCC with a report which details the econometric modelling undertaken by Diversified Specifics. Diversified Specifics employed a number of econometric techniques including tests for structural breaks, non-stationarity, co-integration and optimal lag structures. Diversified Specifics utilised Vector Error Correction Modelling as well as dynamic ordinary least squares methodologies to forecast demand for the four letter segments. The approach sought to isolate, explain and quantify the impact of a number of letter volume drivers with a primary focus on the forces of electronic substitution.<sup>38</sup>

Overall, Diversified Specifics forecast an average annual rate of decline in letter volumes of 8.6 per cent over the three years to 2017-18, which is a lower rate of decline than Australia Post forecast. Broadly, Diversified Specifics’ forecasts are within the range of a 2014 report on Australia Post by Boston Consulting Group commissioned by the Department of

<sup>34</sup> Volumes include non-reserved ordinary/other large letters and non-reserved PreSort large letters in order to remain consistent with Diversified Specifics’ forecasts.

<sup>35</sup> 2014-15 letter volumes are actual letters volumes. However, due to Diversified Specifics methodology and base year 2015-16, 2016-17 and 2017-18 letter volumes cannot be considered in isolation.

<sup>36</sup> Compound Annual Growth Rate (CAGR) from 2014-15 to 2017-18.

<sup>37</sup> Australia Post’s draft price notification, p. 24.

<sup>38</sup> For more information on the drivers of letter volumes and associated elasticities please see the relevant letter segment sections of Diversified Specifics’ 2015 Report published on the ACCC website, <http://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2015>.

Communications and the Department of Finance.<sup>39</sup> Diversified Specifics' forecasts for individual letter segments are set out below.

**Table 6 – Diversified Specifics forecast letter volume rate of change (%) 2014-15 to 2017-18<sup>40</sup>**

	Actual volumes in 2014-15 (millions)	2014-15 <sup>41</sup> (%)	2015-16 (%)	2016-17 (%)	2017-18 (%)	CAGR <sup>42</sup> (%)	Forecast volumes in 2017-18 (millions)
Ordinary / Other small	1,045	-11.7	-8.9	-17.2	-6.9	-11.1	734
Ordinary / Other Large	135	-4.8	-4.4	-21.2	-15.4	-14.0	86
PreSort Small	1,672	-5.5	-9.3	-8.3	-2.6	-6.8	1,355
Presort Large	123	-2.3	-3.9	-9.3	-12.4	-8.6	94
Total Volumes	2,975	-7.6	-8.7	-12.0	-5.0	-8.6	2,270

Source: Australia Post supplementary information October 2015.

### 3.1.3. Australia Post's augmentation of the baseline forecasts

Australia Post's demand forecasts are derived by augmenting the baseline forecasts by Diversified Specifics. Australia Post advised that it has used management and market intelligence to augment Diversified Specifics' forecasts. Generally, this intelligence is acquired through its own sales group by way of discussions with customers and participants in the mail value chain, and from publicly available reports. Australia Post provided an overview of the factors it considered in deriving the management augmentations in its draft price notification and provided further information in response to questions from ACCC staff.

Some specific augmentations made by Australia Post include the use of a 'conservative' price elasticity estimate of -0.25 for all letter categories (rather than the price elasticities derived by Diversified Specifics). The more conservative price elasticity estimate assumes that demand will be less responsive to the proposed letter price increases than Diversified Specifics' model. Australia Post also made negative volume adjustments based on management insight to account for electronic substitution and continued consolidation and rationalisation of letter volumes by businesses. Australia Post considered letter volume declines are driven primarily by business and government encouraging receivers of mail to transition to online interactions.

Australia Post's forecasts compared to the forecasts developed by Diversified Specifics are shown in the table below.

<sup>39</sup> BCG expected volumes to decline by 8 to 11 per cent per annum through to 2019-20. The BCG report is available at [https://www.communications.gov.au/sites/g/files/net301/f/BCG\\_Postal\\_Services\\_Background\\_Report.pdf](https://www.communications.gov.au/sites/g/files/net301/f/BCG_Postal_Services_Background_Report.pdf)

<sup>40</sup> Diversified Specifics volumes include non-reserved ordinary/other large letters and non-reserved PreSort large letters.

<sup>41</sup> Due to Diversified Specifics methodology and base year, 2015-16, 2016-17 and 2017-18 forecasts cannot be considered without considering 2014-15 letter volumes.

<sup>42</sup> Compound Annual Growth Rate (CAGR) from 2014-15 to 2017-18.

**Table 7 – Forecast rates of change in letter volumes: comparison between Diversified Specifics and Australia Post (%) 2014-15 to 2017-18**

	Ordinary / Other Diversified Specifics	Ordinary / Other Australia Post	PreSort Diversified Specifics	PreSort Australia Post	Domestic addressed Diversified Specifics	Domestic addressed Australia Post
2014-15	-10.9	-9.9	-5.3	-4.6	-7.6	-6.8
2015-16	-8.4	-13.4	-8.9	-12.1	-8.7	-12.6
2016-17	-17.7	-13.9	-8.4	-11.2	-12.0	-12.2
2017-18	-7.8	-7.7	-3.3	-7.9	-5.0	-7.8

Source: Australia Post supplementary information October 2015.

### 3.2. Assessment of Diversified Specifics' econometric model

Diversified Specifics has previously conducted econometric modelling of letter volumes for Australia Post. The general approach in Diversified Specifics' 2015 Report is the same as its 2010 and 2013 forecasts for Australia Post.

In 2010, Frontier Economics provided a review of the Diversified Specifics 2010 forecasts.<sup>43</sup> Frontier Economics observed that the econometric forecasts in the 2010 Report were 'based on best practice time series techniques for mail volume forecasting' but expressed some reservations about the application of the econometric modelling. Similarly, and based on analysis by ACCC staff, the ACCC notes that some aspects of Diversified Specifics modelling have the potential for downward bias in letter volume forecasts. For example, the shorter sample period in the presence of the structural breaks in each letter segment, the input variables selected and the way in which some of these variables were constructed and projected may potentially result in a downward bias. Further, it is not clear from Diversified Specifics' 2015 Report that it has taken a structured approach to truncating the sample periods. It is also unclear how Diversified Specifics narrowed down the large number of potential variables for letter demand modelling into the small set of long-run demand drivers used.

The ACCC is aware that Australia Post's proposed price increase is larger than any historical letter price increase. This creates some uncertainty around the level of consumer response to the price increase assumed by Australia Post and Diversified Specifics. However, the ACCC has insufficient evidence to conclude that the price elasticity is not linear or behaves differently at higher price points. The ACCC has therefore accepted Diversified Specifics' estimated price elasticity of demand when assessing consumers' and businesses' responsiveness to the price increase. This results in volumes declining further in response to the price increase compared to the lower price elasticity assumed by Australia Post.

### 3.3. Assessment of Australia Post's augmentations

Australia Post has made augmentations to Diversified Specifics' baseline forecasts to account for emerging threats to letter volumes due to consolidation, rationalisation and electronic substitution.<sup>44</sup> Australia Post's total augmentations result in a net decline in volumes compared to the forecast by Diversified Specifics.

<sup>43</sup> Frontier Economics, *Review of Australia Post's Volume and Input Cost Forecasts: A Report prepared for the ACCC, May 2010*; Frontier Economics, *Review of Australia Post and Diversified Specifics Response Documents: A Report prepared for the ACCC, December 2010*.

<sup>44</sup> Australia Post's draft price notification Appendix 7, p. 62.

In previous decisions, the ACCC has accepted Australia Post's augmentations as Diversified Specifics' econometric models lacked sufficient downwards volume drivers and were likely to overstate demand.<sup>45</sup> However, the ACCC is of the view that Diversified Specifics has now included variables that are likely to capture the factors driving down letter volumes, such as electronic substitution. The ACCC is of the view that Australia Post's approach of making further augmentations (for factors already captured in the model developed by Diversified Specifics) is likely to result in double counting and consequently a lower forecast of future letter volumes than would otherwise be the case. In its draft price notification Australia Post noted that it made augmentations for changes in the mode of communication from traditional letters to online servicing, online payments and mobile. The ACCC considers that Diversified Specifics has already accounted for these electronic substitution effects in its baseline model. This issue was raised with Australia Post but it has not provided the ACCC with sufficient information to justify its augmentations. Based on the information available to it the ACCC has not accepted Australia Post's augmentations.

### 3.4. Submissions received

A number of stakeholders including the Communication Workers Union (CWU) and Association for Data-driven Marketing & Advertising (ADMA) commented that the price increase would have a more negative impact on demand for mail services than forecast by Australia Post because it would further accelerate substitution away from mail. The CWU noted that:

"price hikes in both the BPR and business mail of a minimum of 43% overnight, together with the delayed delivery standards, we believe will lead to greater volume declines than would otherwise happen."<sup>46</sup>

Consistent with this view, several local councils submitted that they would need to seek out alternative forms of communication due to the letter price increases.<sup>47</sup> The City of Salisbury noted that increasingly people are paying their bills online rather than over the counter or by mail.<sup>48</sup>

However, ACIL Allen's report commissioned by the Printing Industries Association of Australia (PIAA) commented that Australia Post's assumed price elasticity (i.e. -0.25) should be lower in magnitude noting that:

"a large portion of mail that can readily be converted from postal mail to electronic alternatives has already been converted. If this is so, the remaining 'sticky' mail may be much less price responsive than the mail that has already 'switched'.<sup>49</sup>

The CWU also submitted that the bulk of electronic substitution has already been realised noting that:

"the myGov agenda has already had an effect on mail volumes but the volumes that have migrated are the "low hanging fruit" and we do not believe that the initiative will have the drastic effect on the mail volumes that Australia Post assert in their submission"<sup>50</sup>

The ACCC has considered views in submissions about Australia Post's letter volume forecasts. Submissions contained a range of views, with some suggesting that volumes could be higher than forecast and others making the case that forecast volumes should be lower.

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<sup>45</sup> ACCC *Australia Post Price Notification Final Decision*, June 2011, p 24.

<sup>46</sup> CWU submission to the ACCC, p. 4.

<sup>47</sup> Break O'day Council submission to the ACCC, p. 2.

<sup>48</sup> City of Salisbury submission to the ACCC, p. 1.

<sup>49</sup> PIAA submission to the ACCC, p. 25.

<sup>50</sup> CWU submission to the ACCC p. 4.

ACCC staff conducted alternative scenario analysis to assess the materiality of issues discussed above in respect of Diversified Specifics' approach. The ACCC tested these issues by using alternative assumptions for projecting electronic substitution and the number of Initial Public Offerings (IPOs) in the forecast period.<sup>51</sup> On this basis, the ACCC considers that a reasonable alternative range is an annual decline of 6 to 8 per cent in letter volumes over the next three years. The ACCC then used these alternative forecast volumes to assess Australia Post's forecast revenue and costs for the purpose of assessing Australia Post's proposed price increases.

The ACCC notes that the difference between Diversified Specifics' forecast of volume decline (i.e. an average 8.6 per cent annually) and the top of the range derived from ACCC analysis (i.e. 8 per cent) is immaterial for the purposes of modelling revenue projections in Australia Post's draft price notification. In contrast the bottom of the range derived from the ACCC's analysis (i.e. 6 per cent) is materially different to the upper bound and is close to historical volume declines (i.e. 5.8 per cent). However, the significant increases in letter prices, including the 43 per cent increase in the BPR proposed by Australia Post is greater than any historical price increase. As this creates uncertainty around the level of consumer and business responsiveness, the ACCC has accepted Diversified Specifics higher forecast volume decline.

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<sup>51</sup> Diversified Specifics assumed IPO activity to be zero in the forecast period.

## 4. Cost of capital

### 4.1. ACCC view

In assessing Australia Post's draft price notification, the ACCC has had regard to whether the estimated revenue generated is required to recover the efficient costs of providing its reserved services, including a return on capital. Generally, a return on capital should reflect the opportunity cost to investors of choosing to finance a firm's operations. The return on capital is calculated as a weighted average of the opportunity cost of debt and equity, known as the weighted average cost of capital (WACC).

Australia Post has submitted that a nominal 'vanilla' WACC of 7.29 per cent should be applied for its return on capital, based on a report by Value Adviser Associates (VAA).<sup>52</sup> The ACCC's view is that Australia Post's proposed WACC is not appropriate and has derived an alternative WACC of 6.53 per cent. The WACC parameters proposed by Australia Post, and the parameters calculated by the ACCC, are set out below.

**Table 8 – Australia Post's proposed WACC parameters, ACCC view**

WACC parameter	Australia Post proposal	ACCC view
Risk free rate	2.96%	2.79%
Market risk premium	7.0%	6.0%
Asset beta ( $\beta_a$ )	0.60	0.56
Debt beta ( $\beta_d$ )	0.15	0.00
Gearing ratio	30%	30%
Gamma ( $\gamma$ )	0.0	0.4
Tax rate	30%	30%
Equity beta ( $\beta_e$ )	0.8	0.8
Cost of debt	4.35%	4.07%
<b>Nominal vanilla WACC</b>	<b>7.29%</b>	<b>6.53%</b>

Source: Australia Post draft price notification; ACCC analysis

The ACCC's approach to estimating individual WACC parameters leads, in most cases, to values that broadly align with those proposed by Australia Post. Most differences occur due to the averaging periods used. For example, to determine the risk free rate and cost of debt, the ACCC has used the most recent 20-day averaging period at the time of publication. The ACCC considers VAA's approach to estimating Australia Post's equity beta is appropriate.

The most significant differences between the WACC parameters proposed by Australia Post and the ACCC's view relate to the market risk premium (MRP) and the value of gamma. The ACCC's approach to these parameters is discussed below.

<sup>52</sup> Value Adviser Associates, *Assessment of WACC Parameters for Australia Post and its Reserved Letters Business as at 23 July 2015*, August 2015.

#### 4.1.1. Market risk premium

Australia Post has proposed, on the advice of VAA, an MRP of 7 per cent. VAA argued in its report that there is a large body of evidence supporting an MRP in the range of 6 to 8 per cent. VAA acknowledged that estimates of the historical Australian MRP have fallen over recent years but considers that an estimate of 6 per cent is too low. VAA considered that an estimate of 7 per cent is appropriate under 'normal' capital market conditions.<sup>53</sup>

The ACCC maintains its view that the MRP should be estimated based on evidence regarding historical returns above the risk free rate. The ACCC considers that the majority of evidence, including evidence other than historical returns, is consistent with an MRP of 6 per cent. This view is consistent with recent ACCC decisions. For example, in the ACCC's October 2015 fixed line services final decision, it cited a range of evidence in support of a 6 per cent MRP including historical excess returns, surveys of investor expectations, and recent decisions by the Australian Competition Tribunal.<sup>54</sup> This also accords with analysis by the AER, as reflected in recent decisions and its most recent rate of return guideline.<sup>55</sup>

Therefore, the ACCC's view is that an MRP estimate of 6 per cent should be applied in determining the nominal vanilla WACC.

#### 4.1.2. Gamma

In general, the ability of a listed company to pay imputation credits with dividends is taken into account in determining the WACC in order to avoid over-compensation of a regulated business. Since Australia Post's PTRM applies a vanilla WACC, gamma is used to capture all tax effects in the estimation of cash flows and tax liabilities. The revenue allowance to cover Australia Post's expected tax liability is reduced in a manner consistent with the value of gamma.

Australia Post has proposed, on the advice of VAA, that the value of gamma should be zero. VAA argued that since Australia Post, as a government-owned company, does not distribute franking credits and its shareholder does not claim them, a gamma of zero is appropriate.<sup>56</sup> The ACCC notes that Australia Post and VAA have held this position in previous price notifications. However, the ACCC has not accepted this position in the past on the basis that it sets gamma with reference to a benchmark for an efficient firm operating in Australia.

The ACCC maintains this view, and has adopted a value for gamma consistent with the approach taken in recent ACCC and AER decisions. For example, the AER's 2015 determination for the NSW government-owned electricity distributor Ausgrid adopted a gamma of 0.4, based on recent evidence and expert opinion which suggested that the value of imputation credits is between 0.3 and 0.5.<sup>57</sup> In the ACCC's recent fixed line services final decision, the ACCC had regard to this range in adopting a gamma of 0.45 for Telstra.<sup>58</sup>

The ACCC's view is that a gamma of 0.4 should be applied in estimating Australia Post's tax liabilities.

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<sup>53</sup> Value Adviser Associates, *Assessment of WACC Parameters for Australia Post and its Reserved Letters Business as at 23 July 2015*, August 2015, p. 13.

<sup>54</sup> ACCC, *Public inquiry into final access determinations for fixed line services: Final Decision*, October 2014, pp. 75-77.

<sup>55</sup> See, for example, AER, *JGN final decision – Cost of capital*, June 2015; AER, *Rate of Return Guidelines (appendices)*, December 2013, p. 92.

<sup>56</sup> Value Adviser Associates, *Assessment of WACC Parameters for Australia Post and its Reserved Letters Business as at 23 July 2015*, August 2015, p. 15.

<sup>57</sup> AER, *Final Decision – Ausgrid distribution determination 2015-16 to 2018-19*, April 2015, pp. 31-32.

<sup>58</sup> ACCC, *Public inquiry into final access determinations for fixed line services: Final Decision*, October 2014, p. 95.

## 5. Services considered to assess cost recovery

### 5.1. ACCC view

Australia Post's draft price notification covers its notified services (i.e. reserved ordinary letters) which are monopoly services and the only letter services that are declared under Section 95X of the CCA and subject to ACCC review for price increases.

In considering the justification for the proposed price increase, the ACCC has had regard to the revenue required to support Australia Post's notified letter services. However, the notified letter services are part of the wider segment of reserved letter monopoly services, which also includes business letter services.

The notified letter services share most of the same processing and delivery facilities as other reserved letter services, and cost recovery is affected by the amount of the shared costs allocated to them. The ACCC therefore has regard to the wider segment of reserved letters in considering Australia Post's proposal. That is, the ACCC has considered the forecast level of cost recovery of both Australia Post's reserved services and notified services as part of its assessment.

As part of the assessment of Australia Post's proposed prices the ACCC engaged an external consultant, WIK Consult (Wik), to review Australia Post's cost allocation model (CAM). This review did not identify any systematic bias in Australia Post's CAM regarding the over allocation of costs from non-reserved services (i.e. services supplied in a contestable market) to reserved or notified services.

Importantly, Wik noted that the cost allocation factors it examined were based on historical systems and Australia Post could not provide the allocation factors relevant to costing the new regular and priority letter services that are to be introduced in 2016. Wik also identified some areas where further improvements could be made to the CAM. This includes the provision of additional information so that in the future the CAM more accurately reflects cost differences between ordinary and stamped priority letter services.

### 5.2. ACCC's regulatory approach for assessing Australia Post's 2015 draft price notification

The ACCC has historically applied a 'dual-till' regulatory approach to assess price notifications from Australia Post and has adopted this approach for Australia Post's 2015 draft price notification. Under this approach the appropriateness of the proposed prices is assessed with reference to a building block model applied to the costs and revenues of reserved services.<sup>59</sup> If a 'single-till' approach is applied, no such separation is made, and the building block model is applied using costs incurred in the provision of both reserved and non-reserved services.<sup>60</sup> The appropriateness of the regulated prices would then be assessed by reference to the extent to which the regulated business can recover its total costs of both reserved and non-reserved services.

In considering its approach for this review, the ACCC recognised that the new ministerial price notification declaration issued has the effect of restricting Australia Post's notified services to reserved ordinary letters (including the BPR), and potentially stamped letters carried at the priority timetable.<sup>61</sup> In terms of the regulatory approach this means that there are fewer services subject to notification and fewer costs allocated to notified services.

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<sup>59</sup> Reserved services include all Australia Post's statutory monopoly letter services including business mail services that are not notified services but are provided at a discount to notified 'ordinary' letter services prices.

<sup>60</sup> Non-reserved services are services not subject to Australia Post's statutory monopoly (i.e. generally, services it provides in competition with other businesses). This includes some large letters, Express Post, parcels and other postal services such as PO boxes and in-shop merchandise sales.

<sup>61</sup> Refer to *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015*, Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015, <https://www.comlaw.gov.au/Details/F2015L01429>.

In 2015-16, notified services are forecast to account for around 12 per cent of letter revenue and 4 per cent of Australia Post's total revenue, while the broader category of reserved services are forecast to account for around 28 per cent of Australia Post's total revenue. However, the notified letter services share most of the same processing and delivery facilities as other reserved letters, and their cost recovery is affected by the amount of shared costs allocated to them. For this reason the ACCC has regard to the wider segment of reserved letters. In adopting this approach the ACCC is also recognising that:

- the appropriate allocation of shared costs between the various letter services is uncertain
- reliable data on demand and cost recovery is more readily available at the level of reserved services
- the reserved letter services are those over which Australia Post has a statutory monopoly, and the ACCC has regard to section 95G of the CCA in discouraging a monopolist from taking advantage of that monopoly power in setting prices.

The ACCC considers that both notified and reserved letter services are relevant to its assessment of this draft price notification. Accordingly, the ACCC is assessing Australia Post's proposed prices with reference to the costs and revenues of its notified and reserved letter services.

### **5.3. Australia Post's cost allocation model**

Australia Post has an extensive collection and delivery network which it uses to provide its mail services. Australia Post's reserved monopoly letter services are a subset of services Australia Post provides using its collection and delivery network. For example, non-reserved services provided by Australia Post, including express post and parcels, are also provided using elements of this network.

Australia Post applies a CAM to allocate shared costs across its business for reserved and non-reserved services. Within reserved services the CAM is also applied to help derive prices.

Australia Post submits that its CAM is a fully absorbed costing model that allocates costs to products and services applying the following principles:

- all products and services are charged with the costs of the business unit
- activity based costing is used as the cost allocation methodology. Resources (cost inputs) perform activities (i.e. the doing things). Activities are used by products and services.
- direct attribution of costs to products is conducted, wherever possible.

Australia Post submits that its CAM is robust and relevant and that product volume is the dominant cost driver in the model. It also submits that its CAM inherently increases the cost burden for products experiencing volume growth. For example, growth in parcels and decline in letters should lessen the costs allocated to letters. However, to some extent reductions in letter volumes also reduce economies of scale which affects unit costs.

#### **5.3.1. Wik review of Australia Post's CAM**

The ACCC engaged an external consultant with expertise in the postal industry, Wik, to review Australia Post's CAM. Wik previously reviewed Australia Post's CAM in 2008 and that review led to a number of improvements to the CAM.<sup>62</sup>

The current Wik review considered:

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<sup>62</sup> A non-confidential summary of the 2008 Wik review of Australia Post's CAM is available on the ACCC website at [http://www.accc.gov.au/system/files/20080529\\_wik\\_AustraliaPost\\_CostAllocation\\_Summary.pdf](http://www.accc.gov.au/system/files/20080529_wik_AustraliaPost_CostAllocation_Summary.pdf).

- the reasonableness of the allocation of Australia Post's direct and shared costs between reserved and non-reserved services including regular and priority letter services
- the appropriateness of the CAM given relevant accounting standards, the trend of declining letter volumes and increasing parcel volumes, and current and future cost differences in the delivery of regular and priority letter services
- the extent to which the CAM provides a reasonable model to derive efficient costs and prices for regular and priority letter services
- potential improvements that could be made to the CAM.

In undertaking this task Wik considered Australia Post's Regulatory Accounts for the 2013-14 financial year.<sup>63</sup> Wik also visited Australia in August 2015 to attend meetings with Australia Post and conduct site visits at Australia Post's letter processing and delivery centres.

Wik's review did not identify any systematic bias in Australia Post's CAM that would lead to an over allocation of costs to reserved services from non-reserved services but did identify some issues with the CAM. Wik's key findings include:<sup>64</sup>

#### *Strengths of Australia Post's CAM*

- Australia Post's CAM is based on actual costs which makes the model consistent with its financial accounting reporting.
  - Australia Post uses its CAM for its own management decision making and financial reporting, as well as for ACCC regulatory purposes.
- The inclusion of non-reserved services such as express post and parcel services in the CAM has resulted in a substantial fall in the share of total costs borne by reserved letters, with reserved letters' share of total costs dropping from 42 per cent in 2010-11 to a forecast 26 per cent in 2015-16.

#### *Recommendations for improvements to Australia Post's CAM*

- Wik found that there is a need for improved documentation about the CAM and more reasoning for factor value changes.
- Wik recommended that Australia Post further develop the CAM to include an integrated forecasting module which enables simulations and sensitivity analysis.
- Wik identified some concerns about using the same factor for different activities (like processing and delivery) and the extent to which the allocation of these activity costs to products are based on the principle of cost causality.
- Wik considered that there should be changes in the way unattributable costs are allocated to products.
- Wik also noted that the factor values of major factors had not changed since its 2008 review and that it would expect changes to be necessary due to changes in the composition of letter mail volumes and due to changes in the processing of mail.

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<sup>63</sup> Australia Post's 2013-14 Regulatory Accounts were the latest available at the time the Wik review was conducted. These accounts provide a separation of revenues and costs between Australia Post's reserved and non-reserved businesses and are used by the ACCC for monitoring the presence of cross subsidies between Australia Post's reserved and non-reserved services.

<sup>64</sup> The executive summary of Wik's review of Australia Post's CAM is available on the ACCC website, <http://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2015>.

### *Price notification assessments*

- Wik considered that for price notification assessments, the ACCC should consider all services sharing infrastructure and processes in the postal supply chain with the notified services. Wik has assisted the ACCC's assessment of this draft price notification by reviewing the cost allocation of all Australia Post's services that share facilities with the notified services.

### *Regular and priority Letters*

- Wik identified that Australia Post does not have accurate and reliable information about the cost of providing the regular and priority letter service. Australia Post's reform program is introducing substantial changes in its delivery and processing activities. Wik concluded that Australia Post's CAM can only show the cost differences between a regular and priority letter service once the service has been established and reliable cost data is available.
- Although Wik was unable to analyse differences in costs for the new regular and priority consumer letter service it was able to do this for the established regular and priority business mail services. According to Wik, differences in costs between regular and priority business mail services are mainly driven by different volumes and a higher share of transport costs. Overall, Wik's analysis only shows small cost differences between regular and priority mail services as they are currently provided.
- Wik considered that the cost differential between regular and priority letters will change significantly with the introduction of the new regular and priority letter services together with substantial changes in its delivery and processing activities.
- Wik recommended the provision of additional information so that in the future the CAM more accurately reflects cost differences between the ordinary priority and regular letter services.

### **5.3.2. Submissions received**

The ACCC sought submissions on Australia Post's cost allocation methodology in its Issues Paper on Australia Post's draft price notification.

PIAA<sup>65</sup> and ADMA<sup>66</sup> identified concerns that the Wik review would be a 'desktop' review with no or limited direct observations of Australia Post's operation in Australia.

The Supply Chain and Logistics Association of Australia<sup>67</sup> considered that Australia Post's retail outlets are not operating efficiently and this is placing pressure on the costs of Australia Post's letters and parcel business, resulting in letter and parcel price increases.

Submissions from Mr Brian Bolton and Mr Keith O'Brian also argued that the revenue from Australia Post's parcel business must be taken into consideration in determining if any price increase is justifiable.

These issues are discussed below.

### **5.3.3. ACCC view on Australia Post's cost allocation model**

The ACCC notes concern in some submissions that Wik may not have sufficient operational knowledge to effectively review Australia Post's CAM. However, the ACCC considers that Wik has significant international experience with other postal and non-postal services as well as previous experience in reviewing Australia Post's CAM. The ACCC also notes that as

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<sup>65</sup> PIAA submission, p. 6.

<sup>66</sup> ADMA submission, p. 9.

<sup>67</sup> SCLAA submission, p. 1.

part of this review Wik undertook site visits to Australia Post's letter processing and delivery centres, and attended meetings with Australia Post senior management and ACCC staff which provided Wik with a detailed understanding of how the CAM operates.

The ACCC considers that a key finding from Wik's review is that there is no evidence of systematic bias that would lead to a higher than appropriate allocation of costs from non-reserved to reserved or notified services. In addition, Australia Post's CAM separates costs allocated to reserved and non-reserved services, and the percentage of costs allocated to reserved services has fallen as non-reserved revenue and use of shared facilities has risen. Therefore the ACCC considers that the impact of increasing parcel use on Australia Post's network is already reflected in the CAM. Given this finding, and that Australia Post provides its parcel services in competition with other businesses, the ACCC does not consider it necessary (as was suggested in some submissions) for the costs and revenues of Australia Post's parcel businesses to be included in its assessment of this price notification.

The ACCC also notes concerns identified in some submissions about the efficiency of Australia Post's retail outlets and the potential impact this may have on postage prices. Within this context, the ACCC notes that Wik's review of Australia Post's CAM identifies that costs associated with its retail outlets only account for a small proportion of total reserved services costs. As such the ACCC does not consider that this issue is likely to have a material impact on reserved services prices.

The ACCC has also considered other recommendations from Wik including areas where further improvements could be made to the CAM. In particular the ACCC notes that the cost allocation factors Wik examined were based on historical data and did not provide allocation factors specifically relevant to the new regular and priority letter services. The ACCC agrees that the CAM requires further improvement so that in the future it more accurately reflects cost differences between the new regular and priority letter services.

## 6. Financial model

### 6.1. ACCC view

Australia Post provided a Post Tax Revenue Model (PTRM) which shows that revenue from its reserved services, at the proposed prices, would fail to recover their costs over each of the three years to 2017-18. Given the ACCC's views on WACC and Australia Post's demand forecast, several components affecting the PTRM were adjusted, specifically:

- Reducing the nominal WACC from 7.29 to 6.53 per cent
- Adopting the higher demand forecasts provided by Diversified Specifics.

The combined effect of these adjustments would reduce the under-recovery to a total of \$42 million over the three years to 2017-18 – an annual average of \$14 million, or 0.7 per cent of required revenue.

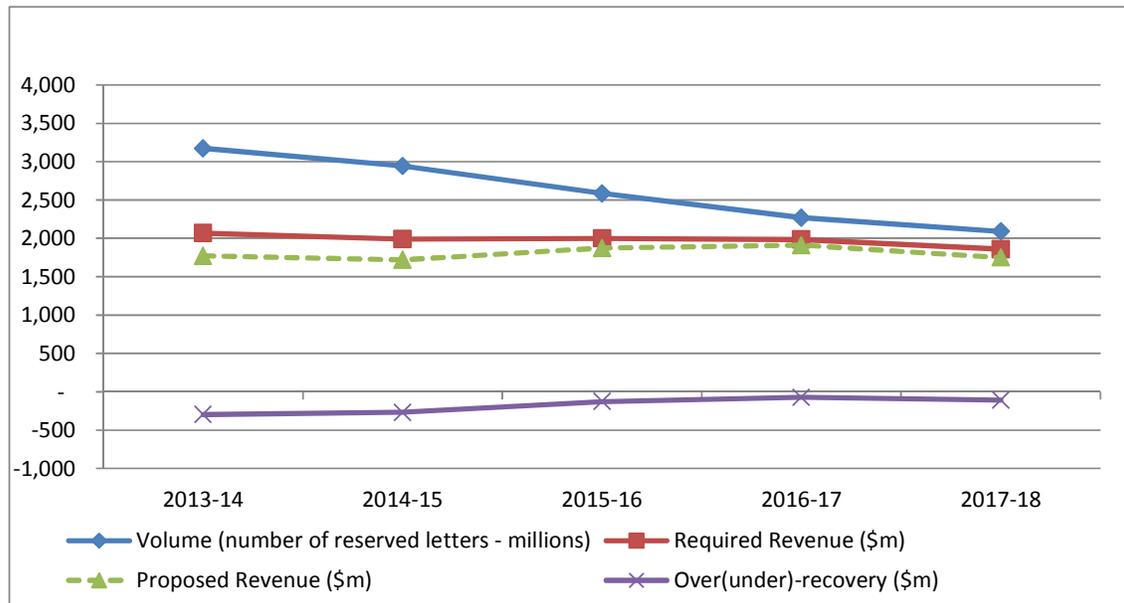
### 6.2. Overview of cost recovery forecasts

The ACCC uses a PTRM to assess the extent to which prices proposed by a regulated firm would provide sufficient revenue to recover the efficient costs of providing services.

Figure 5 below shows Australia Post's forecasts for key inputs to the PTRM, with actual data for recent years. The decline in letter volumes is reflected in the decreases in revenue in 2014-15 (actual) and 2017-18 (forecast). The increases in revenue in 2015-16 and 2016-17 reflect the proposed price increases in January 2016. Required revenue is relatively stable until cost savings from the RoLS program are reflected in the latter years of the forecasts, which reduces the required revenue.

Australia Post's data shows a large under-recovery of \$269 million for reserved services in 2014-15, which would be reduced to a forecast average of \$102 million per annum, or 5 per cent of required revenue, over the three years to 2017-18. The estimated under-recovery on notified services is much higher - averaging 22 per cent of required revenue over the period.

**Figure 5 – Australia Post’s forecasts of key financial data for reserved services, 2015-16 to 2017-18, with actual 2013-14 to 2014-15<sup>68</sup>**



Source: Australia Post supplementary information, and Post Tax Revenue Model, October 2015.

### 6.3. Adjustments

The adjustments made by the ACCC to the inputs in Australia Post’s PTRM are outlined below.

#### Volumes

The ACCC adopted the letter volume forecasts based on Diversified Specifics’ demand forecasts, that is, excluding the augmentations made by Australia Post. The reasons for adopting Diversified Specifics’ forecasts are set out in section 3 of this document. Compared to Australia Post’s forecasts, Diversified Specifics’ volume estimates show lower rates of decline due to electronic substitution, partially offset by a greater assumed decline due to its estimate for price elasticity of demand. Overall Diversified Specifics’ volume estimates are higher than Australia Post’s forecasts, by around 5.5 per cent over the three year period.

The higher volumes increase proposed revenue proportionately, and also affect costs to a smaller extent.<sup>69</sup>

#### WACC

A number of the WACC input parameters were adjusted for the reasons set out in section 4 of this document. This reduced the nominal WACC to 6.53 per cent, resulting in a decrease in required revenue through the return on capital and tax components. The impact on required revenue is around \$12 million per annum for reserved services for the combined

<sup>68</sup> Proposed revenue is revenue at prices proposed (price times estimated volume, summed for all products). Required revenue is the sum of efficient costs, including costs of capital and company tax, from the building block model. Over(under)-recovery is Proposed revenue minus Required revenue (positive for over-recovery; negative for under-recovery).

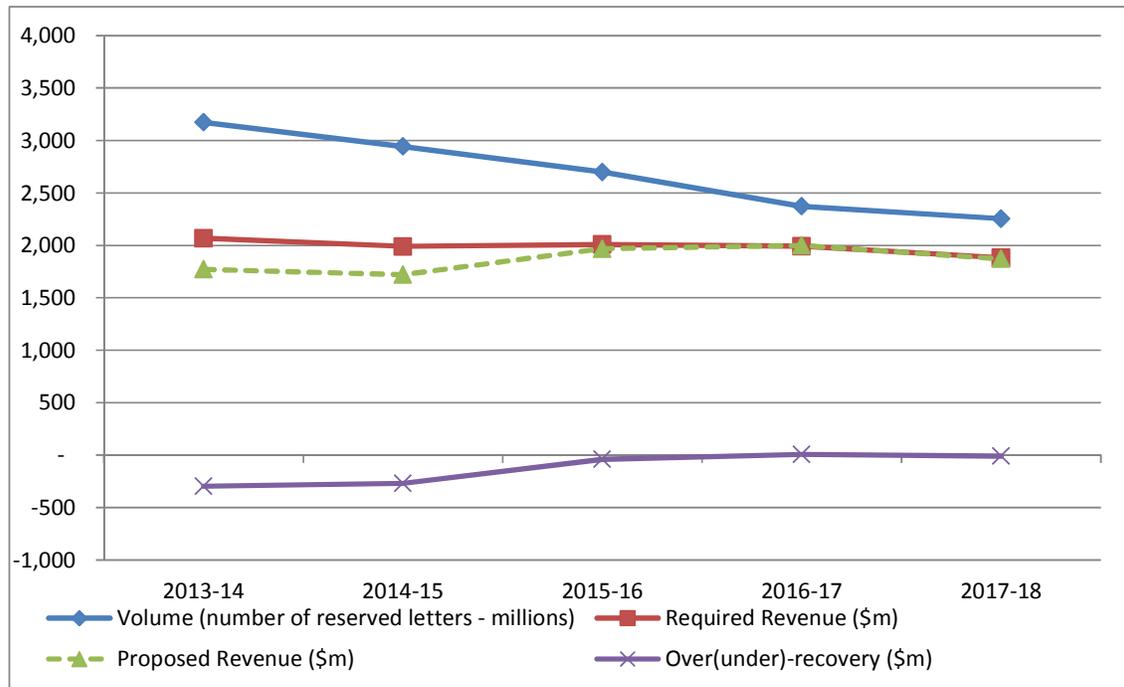
<sup>69</sup> The effect on volume changes on costs is based on cost elasticities estimated by Economic Insights in a study for Australia Post.

change in the parameters. The effect is relatively small as Australia Post's operations are labour-intensive rather than capital intensive.<sup>70</sup>

### Overall recovery

The ACCC estimated that the combined effect of these adjustments would reduce the under-recovery to an annual average of \$14 million over the three years to 2017-18. Figure 6 shows the revenues and required revenues which would result from Australia Post's proposed price increases in January 2016 with the ACCC's adjustments to volumes and WACC.

**Figure 6 – Australia Post key financial data for reserved services, with ACCC adjustments to volumes and WACC, 2013-14 to 2017-18**



Source: ACCC analysis on Australia Post base forecasts, with ACCC's adjustments to volumes & WACC.

Note: 2013-14 and 2014-15 are actual data; later years are forecasts.

The ACCC notes that with its adjustments to volumes and WACC, Australia Post would require an additional reduction in costs of around 3 per cent (real)<sup>71</sup> beyond its current forecasts each year to recover its costs for reserved and notified postal services – that is, to remove the under-recovery over this period even with an increase in the BPR to \$1.<sup>72</sup> The ACCC considers that it is unlikely Australia Post would achieve an additional 3 per cent (real) annual cost reduction or recover revenue in excess of its costs over the period to 2017-18.

The ACCC considered an alternative to Australia Post's proposal to implement its price increase in one step that is instead phasing in the increase through the introduction of a 90 cent BPR from January 2016 and a \$1 BPR in January 2017. This would reduce Australia Post's revenue by around \$134 million over the three years to 2017-18 compared to Australia Post's proposal to introduce a \$1 BPR in January 2016. However, when combined

<sup>70</sup> The opening value of Australia Post's fixed assets for reserved services for 2015-16 was \$677 million (Australia Post, Supplementary information, October 2015, table 13 (p.15).

<sup>71</sup> This is equivalent to a reduction in nominal costs of 0.4 per cent per year, assuming an inflation rate of 2.5 per cent.

<sup>72</sup> The percentage efficiency gain is calculated to reduce required revenue by the same proportion.

with the adjustments to WACC and letter volumes referred to above, Australia Post would need to increase its operational efficiency for reserved services by around 4 per cent (real) annually to deliver such a phased price increase and achieve cost recovery over the period to 2017-18.<sup>73</sup> The ACCC concluded that it would be difficult for Australia Post to reduce its costs to that extent and consequently phasing a price increase is not feasible at this time.

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<sup>73</sup> A different price is assumed to affect volumes according to Diversified Specifics' model (incorporating price elasticity effect), and accordingly affects revenue through both the changed price and volumes. It also affects required revenue according to the volume change and cost elasticity.

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## Attachment B Price notification



AHMED FAHOUR  
Managing Director and  
Chief Executive Officer

GPO Box 1777  
MELBOURNE VIC 3001

111 Bourke Street  
MELBOURNE VIC 3000

Telephone: +61 3 9106 6758  
Facsimile: +61 3 9206 4152

auspost.com.au

30 November 2015

Mr Rod Sims  
Chairman  
Australian Competition and Consumer Commission  
GPO Box 520  
MELBOURNE VIC 3001

Dear Mr Sims,

A handwritten signature in blue ink, appearing to read 'Rod', written over the text 'Dear Mr Sims,'.

**Notification of changes to Australia Post's  
reserved ordinary letter service**

I am writing to formally notify the Australian Competition and Consumer Commission (ACCC) of proposed price changes within Australia Post's reserved ordinary letter service.

The key change is a 30-cent increase to the Ordinary Small Letter (the Basic Postage Rate or BPR) from 70 cents to \$1.00. Large letter prices will continue to be set relative to the BPR (i.e. they are expressed in multiples of the BPR) to ensure the pricing structure remains consistent and simple to understand.

As you would be aware I'm very conscious of the need to maintain an accessible and affordable letters service for all Australians. As such:

- The concession stamp will continue to be offered to eligible Australians at 60 cents; and
- The seasonal greeting rate will continue to be offered at 65 cents for a small letter.

I am also pleased to confirm my commitment to continuing to support the mailing industry by increasing the discount for Promo Post from 14% to 25%.

We are planning to make these price changes effective from 4 January 2016. At the same time, consistent with the announcement by the Australian Government in March 2015, we will introduce a broad based, two speed letter service that provides all Australians with a choice of a 'Priority' or a 'Regular' letter service.

As you are aware, the combination of volume decline and the fixed-cost nature of our letter-sorting and delivery operations are leading to Australia Post incurring growing losses on the domestic reserved letter service.

Over the past three years, this loss has grown as follows:

- FY2012/13: (\$198.0m)
- FY2013/14: (\$242.6m)
- FY2014/15: (\$283.4m)

The proposed 30 cent BPR increase, coupled with the introduction of the Priority and Regular delivery timetables, will assist in reducing the size of the loss that we incur in providing the nation's letters service.

Our formal notification is provided at [Attachment 1](#). Supporting information to the formal notification is at [Attachment 2](#).

Australia Post wishes to assist the ACCC in its consideration of this notification and to promptly resolve any issues that may arise during the course of those considerations. Accordingly, please do not hesitate to contact Mark Pollock, General Manager, Mail Products on (03) 9106 7578 if you have any questions.

Yours sincerely,



**Ahmed Fahour**  
**Managing Director and Group Chief Executive Officer**

**Attachment 1**

**NOTIFICATION AND DETAILS OF CHANGES PROPOSED BY THE AUSTRALIAN  
POSTAL CORPORATION FOR ITS RESERVED ORDINARY LETTER SERVICE**

Notification of changes pursuant to section 95Z of the Competition and Consumer Act, 2010

Name of Declared Person: Australian Postal Corporation (Australia Post)  
Whose address is: 111 Bourke Street, MELBOURNE VIC 3000  
(Postal address:  
GPO Box 1777, MELBOURNE VIC 3001)

Hereby gives notice that it proposes to supply the goods or services described below at the prices and terms and conditions indicated, effective from 4 January 2016.

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Description: Locality, Proposed Prices, Terms and Conditions

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The services, which are the subject of this notification, are detailed in Schedule 1 of this Attachment.

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### Context:

Australian domestic addressed letter volumes reached a peak in 2007/08 (4.6b letters). By 2017/18, Australia Post expects volumes to be less than half of that peak (2.1b letters).

On 3 March 2015 a joint release by the Hon Malcolm Turnbull MP, then Minister for Communications and Senator the Hon Mathias Cormann, Minister for Finance announced that to support a more sustainable letter service, with the aim of breaking even, the Australian Government had approved Australia Post's request to introduce a two-speed letters service (Regular and Priority) and that the price of Regular letters would be overseen by the Australian Competition and Consumer Commission (ACCC).

The release also noted:

- The introduction of this service would be 'no earlier than September 2015';
- To support the sustainability of the letter service, Australia Post would apply to the ACCC to increase the regular stamp price from \$0.70 to \$1.00;
- Australia Post would continue to deliver mail five days a week to 98% of addresses;
- The concession stamp (available to 5.7 million Australians) would be frozen at 60 cents; and
- The seasonal greeting card rate would be frozen at 65 cents.

Consistent with this announcement, in August 2015, Australia Post provided the ACCC with a draft notification proposing an increase to Ordinary Letter Services (including the basic postage rate) effective 4 January 2016.

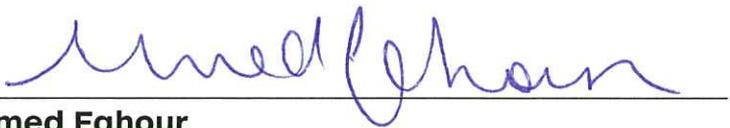
The draft notification also noted that as part supporting the sustainability of the letters service, product changes to give all Australians a choice between a 'Priority' letter service (delivered according to the existing delivery timetable) and a 'Regular' letter service to be delivered to a slower delivery timetable would be introduced at the same time.

To ensure the ACCC has the most recent and relevant information upon which to consider Australia Post's proposal, in October 2015, Australia Post provided the ACCC with a Supplementary Information document.

This document, based on Australia Post's 2015 Corporate Plan, contains an additional year of forecast data (out to 2017/18), updated volume and revenue forecasts as a result of the increased discount for Promo Post and updated information on the increased benefit from Australia Post's major reform Program 'Reform our Letters Service – RoLS' (from \$262m to \$323.8m)

Consideration having regard to section 95G(7) of the Competition and Consumer Act, 2010

Australia Post asserts that the proposed price changes do not result in revenues in excess of revenues based on efficient costs and a reasonable rate of return and are consistent with the requirements of section 95G(7) of the Competition and Consumer Act, 2010.

**Signature:**   
**Ahmed Fahour**  
**Managing Director and Group Chief Executive Officer**

**Date:** **30 November 2015**

**Schedule 1**

<b>Product</b>	<b>Current Price</b>	<b>Proposed Price</b>
Ordinary Small	70c	\$1.00
Ordinary Large Letters		
Up to 125 grams	\$1.40	\$2.00
Over 125 grams up to 250 grams	\$2.10	\$3.00