26 October 2015

Mr Robert Wright
General Manager—Water and Wire line Markets
Australian Competition and Consumer Commission
GPO Box 520
MELBOURNE VIC 3001

postalservices@accc.gov.au

Printing Industries Association of Australia

ABN 84 720 646 451

25 South Parade
Auburn NSW 2144
Australia

PO Box 234
Auburn NSW 1835
Australia

Telephone
+61 2 8789 7300
Fax
+61 2 8789 7387
Email
info@printnet.com.au
WWW
http://www.printnet.com.au

Dear Mr Wright,

Review of Australia Post's (AP) Draft Price Notification

Introduction

This submission is provided to the ACCC review of Australia Post (AP) Draft Price Notification by the Printing Industries Association of Australia *(Printing Industries)* on behalf of a range of businesses that operate in the Australian Mailing Industry. These include mailing houses, paper and envelop suppliers, equipment companies, printers, designers and a range of businesses that use mail for essential transactional and promotional activities. The submission has been prepared in consultation with the Association for Data Driven Marketing and Advertising (ADMA). ADMA will be providing its own submission. Our organisations share similar concerns with the implications of the proposed price increases.

The submission is in two parts. This paper provides feedback on the questions asked in the Discussion Paper. The second is a paper prepared by economic consulting firm ACIL Allen which provides a summary of issues arising from AP August 2015 Draft Price Notification to the ACCC. Unfortunately this has not been able to be updated to take account of the revised submission provide by AP on Friday, 17 October.

We understand that the ACCC seeks to consider the extent to which the proposed price increases are required for the recovery of efficient costs for the provision of letter services. The ACCC is therefore seeking submissions on relevant issues such as AP:

- proposed prices;
- forecasts of letter demand and revenues,
- business reform and cost reduction program,
- AP cost allocation methodology, and
- proposed return on assets (weighted average cost of capital or WACC).

We believe the ACCC's task in reviewing AP price increases goes beyond its role in the regulation of postal services. Its needs to consider its broader obligations set out in s.95E of the Competition and Consumer Act which provides for prices surveillance applied only "in those markets where, in the view of the Minister, competitive pressures are not sufficient to achieve efficient prices and protect consumers".

The ACCC should always seek to enhance the welfare of Australians by promoting competition. It is not to satisfy the Government's desire for a stable revenue source.

We note that the ACCC will consider a building block model for all of AP total reserved services when assessing revenue required for ordinary letter services and that it is acknowledged that Ordinary letter services are a subset of Reserved Services.

We welcome this acknowledgement and the indication that the review will look at this broader area. There is a view in the industry that an increase in the price of a stamp to $1 would not be a major issue. However, this accounts for only about 14% of reserved letter volumes.

However, the industry has legitimate concerns about the ramifications the proposed 42% price increase to ordinary letter services will have across all reserved letter categories. This will be on top of the significant price increases in business mail that have occurred since ACCC oversight was removed from this area in 2011.

A summary of price increases is found at Attachment 1.

Australia Post and the Australian Mailing Industry

A study undertaken by ACIL Allen found that the industry employs conservatively 131,000 people and generated $14.1 Billion in gross value added. (Copy provided to ACCC Review team)

Around 25 per cent of this activity and contribution is made directly by AP, with the remainder made by other businesses including the Licensed Post Offices.

There are therefore a large number of other businesses as well as consumers that are affected by AP prices and a significant part of Australia's economic product depends on it.

The ACCC's consideration of AP prices is therefore important and should be given due consideration.

The Senate Inquiry

A recent Senate Environment and Communications Legislation Committee Inquiry into the Performance, Importance and Role of Australia Post in Australian communities and its operations in relation to licensed post offices ("**LPOs**") recognised that the future of postal services in Australia was at a crossroads, and raised concerns that AP is making changes without involving stakeholders and most importantly indicated that:

"it must be recognised that AP is not a private business: its shareholders are the entire Australian Community and the postal network is woven through the fabric of Australian life. Significant changes to AP and its network will have a commensurate effect"

The operations of AP have always been dictated by its obligation to provide a commercial rate of return to Government. In the decade ending June, 2013 the organisation has paid $2,397 billion in dividends to Treasury.

We accept that the industry is faced with significant challenges. Structural adjustment in any major industry requires a holistic strategy. This has been recognised by Government in other areas of the economy such as the car and steel industries.

We therefore welcomed the Senate Committee's report and believe that it is time for the key stakeholders to work together to develop a blueprint for the industry that minimises the impact of changes and identifies and implements opportunities to reduce costs or increase revenue.

However, the approval of the current application without a formal restructuring blueprint will lead to a piecemeal approach which fails to take account of the economic significance and level of employment of the broader industry.

We note that AP has proposed the development of a working group which includes *Printing Industries* and other postal and related customer organisations (eg. ADMA),which will meet regularly to discuss, on a confidential basis future price changes and product initiatives. We believe this has the potential to a develop adjustment plan for the broader industry.

The 2014/15 Financial Performance of Australia Post
It has been difficult to determine the current trading position of Australia Post. The 2014/14 Annual Report was only released on the day before the formal closing date for submission (15/10/2015). A revised draft price notification was submitted at the same time. However, based on the limited time available to review the Accounts we believe that ACCC needs to undertake extensive research to establish the true financial position of the organisation. We make the following observations:

In summary:

- The profit result comes from two major decisions to write down/impair assets and to provide for restructuring costs.
- The large reduction in profit is not reflected in a similar reduction in operating cash flows.
- The poorest performing segment, year on year, appears to be the Parcels Service.
- The digital assets are not treated separately and appear to be lumped in with Retail and Agency. This would indicate they may have not reached revenues that would warrant separate disclosure.
- The numbers do not obviously support the narrative that letters are in terminal decline. In addition to issues in the Mail Service, other parts of the business do not appear to be thriving.
- There is no aggressive costs out strategy evident, no overall reduction in staff numbers, staff costs or operating costs in any segment.

Reported result
The 2015 results are significantly affected by an increase in restructuring costs and asset write offs and impairments. The results include:

1. a $200.1m provision to pay for restructuring costs. This is $110m greater than in 2014.

2. There is also a $214.1m asset write off and impairments. This is $201.0m greater than in 2014. The impairment is (perhaps unusually) not allocated to a segment and could suggest it is not associated with the impairment of Mail Services assets.

Cash Flow statement
Despite the marked deterioration in profit (A reduction of $337.90m, year on year), cash generated solely from operations deteriorated by only $66.80m and, on the face of the segment reporting, much of this can be attributed to the decline in the Parcels result.

Principles underpinning the Review Process

The key principles of better economic regulation are:

1. economic regulation should be incentive based wherever possible;
2. necessary and efficient investment should be encouraged and the return on investment should balance predictability with the need to take into account changing market conditions,
3. economic regulation should be coupled with a strong consumer engagement framework.

The impact of the proposed price changes needs to be carefully considered within these three principles.

This will ensure that AP is treated consistently with other regulated monopoly businesses, whether they are Government owned or privately owned. This also ensures that AP customers and other stakeholders can be assured that the prices they are paying are developed in line with best practice and are scrutinised appropriately. Scrutiny must be applied and must also be seen to be applied.

Broadly, we agree this implies the application of a building blocks approach to establish a regulated revenue over a regulatory period based on sound forecasts, a rigorous assessment of the efficient capital and operating costs and a two way consultation process with consumers to ensure that the benefits to consumers of the regulatory process are realised.

This is not explicitly required by the applicable legislation as it is, for example, by the National Electricity Rules. However, it is entirely consistent with the objective of the Competition and Consumer Act (CCA) and of the applicable provisions, which could be summarised as having the ACCC, as economic regulator, to apply regulatory pressure in lieu of competitive pressure.

More specific answers to the ACCC's six questions follow.

Question 1

If a price increase is required for Australia Post to help meet the cost of providing the slower ordinary letter service, should the increase be implemented in one step or over time? Is a longer-term approach to setting AP ordinary letter prices, such as a price path, more appropriate?

Before asking how price increases should be staged, the ACCC should satisfy itself that AP proposed expenditure is efficient and therefore that the price increases are permissible under the CCA. Therefore, the ACCC should consider how much an efficient, prudent entity would spend in AP position and set AP expenditure allowances to this amount(s).

We also note that the price rises has been linked to the negotiation of a package of reforms that are aimed to address the financial difficulties of LPOs. They receive 13.2% of the cost of a stamp. We understand that stamped addressed mail is provided at a significant loss to Australia Post.

We therefore believe it is important for the ACCC to establish the degree of any internal subsidy that exists between stamp and business mail given the flow on impact that a rise to the ordinary letter price has on all reserved letter categories.

Attachment 1 provides a summary of price increases for business mail since 2013 and analyses the current proposal. Our limited investigation has failed to identify any monopoly service provider that has been able to increase prices at the 42 per cent level proposed.

The industry recognises that changes are required to respond to rise of the digital economy. These changes however cannot continually focus on price increases.

If they occur they should be reasonable, occur in an agreed time frame, and be introduced in a way that reflects the needs of consumers including the whole mailing industry not just AP.

The Association would welcome the opportunity to work with AP to develop a structured price path linked to a broader long term industry strategy. It is consistent with other regulated industries for this price path to be set out over a five year timeframe rather than the annual/ ad hoc approach proposed by AP.

It is also possible that some of the costs AP will incur in the short term are transitional. These costs may be incurred 'once off' and then not incurred again.

Costs of this type should be recovered, but they should not cause prices to 'ratchet up' to higher levels in future after the transitional costs are gone.

Even if the cost profile is 'jagged', the price profile need not be. It would be more efficient for their recovery to be 'smoothed' over time rather than for prices to go up sharply to recover them quickly and then to come back down in future.

AP demand forecasts are a key input to the price setting process and, as is the case in other regulated sectors, they should be subjected to close scrutiny and review.

The price elasticity in particular should be subjected to scrutiny. The draft price notification provides no justification for the values other than saying that AP has elected to use different values than their adviser.

The ACCC should also enter into full consultation with users of the reserved mail services on the impact of any price increases on consumers with respect to both the magnitude of the increase and the timing of increases.

The initial draft notification refers to a range of consultative processes undertaken by AP but provides little feedback on the outcomes of these consultations. Much of this consultation involved AP telling people what it had already decided to do. The consultation the AER requires is before the fact and the businesses ask consumers what they want.

Question 2

AP s forecast savings in operational costs are largely dependent on around 80 per cent of addressed letter volumes being delivered at the slower timetable. Use of the slower timetable instead of the faster priority timetable would be encouraged by AP through a price difference between these services. Would a price difference between the regular and priority ordinary mail services encourage use of the slower regular service? If so, what level of price difference would encourage significantly greater use of the slower service?

The key issue is the need for efficient incentive based regulation of the price of the slower timetable service.

AP has advised that for proposed savings to be achieved then 80% of reserved mail volumes will need to go through the regular category. This system has been in place for business mail for 18 months and currently around 65% of mail is using the regular service.

We expect that there will be a component of mail that will always be required to be sent by Priority Mail. However, it is anticipated that as the new system comes into place there will be more reliance on the regular services as businesses seek to minimise the impact of any price increase.

Due to amendments to the regulations the priority rate is now notionally set at 150% of the Basic Postal Rate (BPR).

The appropriate price differential will also need to be considered in the light of the ACCCs independent investigation of the elasticity of demand.

Question 3
What are your views on AP proposed method of cost allocation? Are there any other cost allocation issues that the ACCC should be considering?

We note that when the 2011 draft price notification was under consideration the then Chairman of the ACCC, Graeme Samuel said that "Beyond this price notification, the current approach to setting prices, including the allocation of costs, needs to be re-examined given the environment of declining demand for traditional letter services. The ACCC and Australia Post have agreed to re-examine the current approach before any future major price notifications."

It would appear that this undertaking was not pursued in a formal way. There remains little if any transparency around the cost allocation process In addition the promise some four years ago to introduce a more consultative approach has not come to fruition.

AP expenditure proposal should be assessed on its own merits with regard to the efficient cost of providing those services. In assessing the expenditure proposal for letter services, the profitability of AP non-reserved businesses is not relevant. The guiding principles should be:

- efficiency - letter services should provide an efficient return to AP, but not more
- competitive neutrality – AP parcel business should not receive a competitive advantage by reason of its letter business.

We note that the ACCC has engaged an external firm, WIK Consult, to review AP CAM and that WIK specialises in regulatory economics and has extensive international experience in postal regulation.

We understand that the ACCC intends to publish WIK's report when the ACCC's response to AP draft price notification is released in November 2015.

There are concerns in the industry that the work undertaken by Wik has primarily been based on a desktop review of AP data and there has been no or only limited direct observation of AP operations in Australia. This would undermine the veracity of the findings if this is the case.

We note that it is suggested that 80% of planned "efficiency" gains are due to changes in service levels based o the introduction of the two speed arrangement. This is not efficiency but lower costs due to different service specifications. Efficiency should come from ongoing, day to day improvements in operations.

We expect that the CAM will include channel cost allocation. As mentioned earlier Prima facie there is big cross subsidy to the LPO, with the 13.2% and how this is addressed in the determination of pricing needs to be considered.

Finally there remains a concern about the lack of transparency about the way AP complies with Section 32A of the Postal Act in relation to how prices are determined for bulk interconnection services. This is where lower prices are calculated for bulk business letters reflecting in part lower costs incurred by Australia Post as a result of pre-sorting and bar coding of letters by business letter users.

The ACCC has a role under Part 3 of the *Australian Postal Corporation Regulations 1996* (APCR) to inquire into disputes about the terms and conditions on which AP provides or will provide a rate reduction for bulk interconnection services.

We believe the ACCC should review the process of establishing the interconnection discount as part of the current review of pricing to determine if this is reasonable in the context of the proposed price application.

Question 4

Is AP forecast improvement in operating efficiency over the next three years comparable with that which would be expected in the transport / logistics sector? What rate of improvement in AP s operating efficiency could reasonably be expected?

Benchmarking comparisons of relative rates of improvement may not necessarily be an indication of operating efficiency in AP. The efficiency of capital and operating costs of the reserved letter services should be examined in the light of service delivery requirements as well as in the light of comparisons with the transport and logistics sectors.

We believe that the application of any price rise should follow the achievement of available operational efficiencies.

AP has allocated substantial funds to support restructuring and improved efficiency. We cannot see why any price increase can't be introduced after these efficiencies have been achieved or at least in lock/step with an implementation plan.

Question 5

AP rate of decline in its letter volumes has been around 5 to 6 per cent in most years since 2009 however it is currently forecasting that the annual rate of decline will more than double (i.e. Up to 13.9 per cent) in the coming three years. Is such an increase in the forecast rate decline of letter volumes realistic given the trend since 2009?

It appears that the factors that determine the proposed demand by AP reflect the current market situation particularly with respect to the assumption that the elasticities in the future are likely to reflect those in the past.

There is a view that the quantum of the proposed price increases is so large that any reliable prediction of the impact on demand is pure speculation. By definition elasticity is a non-linear concept. It cannot simply be assumed that the change that has been observed in response to (relatively small) historical price increases will be replicated in response to future increases.

Irrespective of this International experience suggests that the AP estimate of an elasticity of -0.2% is extremely low particularly for promotional mail.

The ACCC therefore needs to give close attention to this issue.

Question 6

Is the WACC proposed by Australia Post consistent with an efficient benchmark for its cost of capital?

ACIL Allen has dealt with this issue of page 16 of their report. The key question is can conservative adjustments be made to key financial benchmarks that would have a material impact on AP s trading Performance.

Financial gearing is one area that appears low compared with monopoly service providers in other areas. It may be appropriate for Australia Post to increase its debt levels to support cost reduction strategies thus avoiding the need for substantial and unpredictable price increases.

Assessment of AP draft price notification

We note that the ACCC is responsible under the CCA for assessing the proposed price increase and can make a decision 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.

The price of an ordinary letter is subject to this notification and assessment requirements.

The industry in general is not opposed to an increase to the ordinary letter (stamp) price to a $1. Regrettably we are forced not to support this increase because of the flow on impact to other categories of reserved letter services.

We therefore believe that the ACCC needs to apply regulatory best practice in assessing the application and justification of the proposed price increases.

We understand that the next step is for the ACCC to provide a draft response following which AP will prepare and submit a final application. The ACCC has 21 days to consider this.

The industry would like to work with Australia Post to establish an agreed way forward that provides fairness, sustainability and predictability to all parties. We ask the ACCC to explore how it might use its draft response to the application to enhance the protection of consumers and industry through the development of an agreed price path as was raised in the Discussion paper.

Yours sincerely

Bill Healey
Printing Industries Association of Australia

PreSort Letter Service price comparison table - 8 April 2013 to 4 January 2016 (proposed)

Priority delivery timetable (same state metro next day) - *Previously called Peak, then Regular*

Size	Weight		Barcoded direct tray															
	over	up to	Same state								Other state							
valid from date			8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013	8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013
Small	0	125g	0.486	0.590	0.630	0.648	0.960	52.38%	62.71%	97.53%	0.504	0.612	0.652	0.670	0.995	52.61%	62.58%	97.42%
Small Plus	0	125g	0.624	0.760	0.820	0.843	1.275	55.49%	67.76%	104.33%	0.651	0.793	0.855	0.879	1.330	55.56%	67.72%	104.30%
Large	0	125g	0.921	1.057	1.120	1.255	1.740	55.36%	64.62%	88.93%	0.965	1.106	1.175	1.315	1.845	57.02%	66.82%	91.19%
	125g	250g	1.273	1.442	1.528	1.710	2.350	53.80%	62.97%	84.60%	1.361	1.541	1.637	1.835	2.505	53.02%	62.56%	84.06%
	250g	500g	1.713	1.904	2.030	2.280	2.880	41.87%	51.26%	68.13%	1.850	2.080	2.220	2.485	3.080	38.74%	48.08%	66.49%

Size	Weight		Barcoded Residue								Unbarcoded Residue							
	over	up to																
valid from date			8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013	8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013
Small	0	125g	0.541	0.634	0.670	0.685	1.080	61.19%	70.35%	99.63%	0.565	0.660	0.675	0.690	1.125	66.67%	70.45%	99.12%
Small Plus	0	125g	0.745	0.892	0.950	0.977	1.473	55.05%	65.13%	97.72%	0.900	1.050	1.120	1.152	1.734	54.82%	65.14%	92.67%
Large	0	125g	1.097	1.244	1.305	1.380	2.125	62.84%	70.82%	93.71%	1.130	1.277	1.370	1.385	2.244	63.80%	75.72%	98.58%
	125g	250g	1.515	1.717	1.801	2.018	2.700	49.92%	57.25%	78.22%	1.603	1.794	1.925	2.080	2.850	48.05%	58.86%	77.79%
	250g	500g	1.955	2.234	2.370	2.660	3.390	43.04%	51.75%	73.40%	2.153	2.399	2.570	2.880	3.700	43.97%	54.23%	71.85%

Regular delivery timetable (same state metro 2-3 days) - *Previously called Off Peak, then Surface*

Size	Weight		Barcoded direct tray															
	over	up to	Same state								Other state							
valid from date			8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013	8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013
Small	0	125g	0.444	0.520	0.558	0.578	0.795	42.47%	52.88%	79.05%	0.457	0.538	0.576	0.596	0.820	42.36%	52.42%	79.43%
Small Plus	0	125g	0.582	0.657	0.705	0.730	1.000	41.84%	52.21%	71.82%	0.606	0.684	0.735	0.761	1.048	42.59%	53.22%	72.94%
Medium (now obselete)	0	125g	0.752	0.877	0.980*	1.080*	1.390*	41.84%	58.49%	84.84%	0.791	0.927	1.030*	1.135*	1.470*	42.72%	58.58%	85.84%
	125g	250g	0.994	1.146	1.300*	1.430*	1.850*	42.31%	61.43%	86.12%	1.060	1.229	1.410*	1.555*	2.010*	42.55%	63.55%	89.62%
Large	0	125g	0.846	0.943	0.980	1.080	1.390	41.84%	47.40%	64.30%	0.884	0.987	1.030	1.135	1.470	42.72%	48.94%	66.29%
	125g	250g	1.154	1.262	1.300	1.430	1.850	42.31%	46.59%	60.31%	1.225	1.350	1.410	1.555	2.010	42.55%	48.89%	64.08%
	250g	500g	1.418	1.559	1.670	1.840	2.380	42.51%	52.66%	67.84%	1.517	1.691	1.810	1.995	2.580	42.54%	52.57%	70.07%

Size	Weight		Barcoded Residue								Unbarcoded Residue							
	over	up to																
valid from date			8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013	8 Apr 2013	31 Mar 2014	2 Mar 2015	Oct 2015	proposed Jan 2016	increase fr Mar 2015	increase fr Mar 2014	increase fr Apr 2013
Small	0	125g	0.541	0.564	0.600	0.630	0.855	42.50%	51.60%	58.04%	0.565	0.600	0.630	0.660	0.900	42.86%	50.00%	59.29%
Small Plus	0	125g	0.745	0.858	0.910	0.943	1.300	42.86%	51.52%	74.50%	0.900	0.950	1.010	1.046	1.420	40.59%	49.47%	57.78%
Medium (now obselete)	0	125g	0.965	1.100	1.230*	1.330*	1.730*	40.65%	57.27%	79.27%	1.108	1.221	1.320*	1.335*	1.880*	42.42%	53.97%	69.68%
	125g	250g	1.295	1.436	1.600*	1.760*	2.280*	42.50%	58.77%	76.06%	1.432	1.639	1.700*	1.875*	2.420*	42.35%	47.65%	68.99%
Large	0	125g	1.097	1.166	1.230	1.330	1.730	40.65%	48.37%	57.70%	1.130	1.221	1.320	1.335	1.880	42.42%	53.97%	66.37%
	125g	250g	1.515	1.551	1.600	1.760	2.280	42.50%	47.00%	50.50%	1.603	1.639	1.700	1.875	2.420	42.35%	47.65%	50.97%
	250g	500g	1.955	1.903	2.030	2.225	2.900	42.86%	52.39%	48.34%	2.153	2.156	2.280	2.500	3.200	40.35%	48.42%	48.63%

Article size and weight

	Small	Small Plus	Medium*	Large
Maximum weight	125g	125g	125g or 250g	125g, 250g or 500g
Minimum size	88 x 138mm	88 x 138mm	—	—
Maximum size	130 x 240mm	162 x 240mm	180 x 260mm	260 x 360mm
Maximum thickness	5mm	5mm	20mm	20mm
Common examples	DL, C6	C5	B5	C4, B4

* with the removal of Medium, the above figures are based on the relevant Large sized letter which is now applicable

The above is provided as information to assist in calculating postage prices based on the published changes effective October 2015 and the proposed changes effective January 2016 as released by Australia Post.

Please refer to the Australia Post website for more detailed information.

Published September 2015

ACIL ALLEN CONSULTING

A REPORT TO

AUSTRALIAN PRINTING INDUSTRIES ASSOCIATION ASSOCIATION OF DATA DRIVEN MARKETING AND ADVERTISING

26 OCTOBER 2015

AUSTRALIA POST

DRAFT PRICE NOTIFICATION

A SUMMARY OF ISSUES ARISING FROM AUSTRALIA POST'S AUGUST 2015 DRAFT PRICE NOTIFICATION TO THE ACCC

ACIL ALLEN CONSULTING PTY LTD
ABN 68 102 652 148

61 WAKEFIELD STREET
ADELAIDE SA 5000
AUSTRALIA
T +61 (0)412 089 043

LEVEL FIFTEEN
127 CREEK STREET
BRISBANE QLD 4000
AUSTRALIA
T+61 7 3009 8700
F+61 7 3009 8799

LEVEL TWO
33 AINSLIE PLACE
CANBERRA ACT 2600
AUSTRALIA
T+61 2 6103 8200
F+61 2 6103 8233

LEVEL NINE
60 COLLINS STREET
MELBOURNE VIC 3000
AUSTRALIA
T+61 3 8650 6000
F+61 3 9654 6363

LEVEL ONE
50 PITT STREET
SYDNEY NSW 2000
AUSTRALIA
T+61 2 8272 5100
F+61 2 9247 2455

LEVEL TWELVE, BGC CENTRE
28 THE ESPLANADE
PERTH WA 6000
AUSTRALIA
T+61 8 9449 9600
F+61 8 9322 3955

ACILALLEN.COM.AU

C O N T E N T S

EXECUTIVE SUMMARY

BOX ES 1 KEY POINTS

A significant proportion of the mailing industry relies on services from Australia Post. Around 75 per cent of the mailing industries value add and employment exists outside Australia Post's activities.

Australia Post's notification of its intention to increase prices represents the first stage in an economic regulatory review process. It would seem logical that this regulatory review process should adopt best practice regulation as enunciated in recent policy issues from the Australian Economic Regulator. That is that economic regulation should be:

- incentive based
- designed to encourage necessary and efficient investment
- coupled with a strong consumer engagement framework.

These goals place a number of obligations on Regulator in reviewing Australia Post's notification. The following issues are identified:

- Australia Post's proposed expenditure should be scrutinised along with the examination of the cost attribution model to ensure that it is efficient
- the elasticity of demand may not be linear over a 40 per cent price rise and it is possible that demand would be more inelastic at the proposed higher price level than assumed by Australia Post
- the draft price allocation should be assessed on its own merits with regard to the efficient cost of supplying the relevant services
- the WACC parameters should be reviewed against what an efficient operator in a competitive market would expect:
  - in particular the assumption of a zero gamma should be reviewed in the light of contemporary regulatory practice
- there has been limited information on the underlying costs of reserved services made available to consumers
  - given the magnitude of the proposed price increase, consumers in the mailing industry would have advocated a slower smoother glide path to a new price level. There has been little opportunity for consultation on this matter.

The ACCC raised six questions in the issues paper. The submission from *Printing Industries* and related industry bodies might approach these questions by firstly outlining the key principles of better economic regulation, which are:

1. economic regulation should be incentive based wherever possible
2. necessary and efficient investment should be encouraged and the return on investment should balance predictability with the need to take into account changing market conditions
3. economic regulation should be coupled with a strong consumer engagement framework.

The submission should note that the direct activities of Australia Post represent only about 25 per cent of the total value added by the mailing industry and 25 per cent of the employment in the mailing industry. The impact of the proposed price changes needs to be carefully considered within these three principles.

With respect to the six questions posed in the issues paper, the submission would make the overriding point that the ACCC should examine the draft pricing proposal for the reserved letter services in a manner that is consistent with these principles. This will ensure that Australia Post is treated consistently with other regulated monopoly businesses, whether they are Government owned or privately owned. This also ensures that Australia Post's customers and other stakeholders can be assured that the prices they are paying are developed in line with best practice and are scrutinised appropriately. Scrutiny must be applied and must also be seen to be applied.

Broadly, this implies the application of a building blocks approach to establish a regulated revenue over a regulatory period based on sound forecasts, a rigorous assessment of the efficient capital and operating costs and a two way consultation process with consumers to ensure that the benefits to consumers of the regulatory process are realised. This is not explicitly required by the applicable legislation. However, it is entirely consistent with its intent, which is for the ACCC, as economic regulator, to apply regulatory pressure in lieu of competitive pressure.

More specific answers to the ACCC's six questions follow.

Question 1

If a price increase is required for Australia Post to help meet the cost of providing the slower ordinary letter service, should the increase be implemented in one step or over time? Is a longer-term approach to setting Australia Post's ordinary letter prices, such as a price path, more appropriate?

Before asking how price increases should be staged, the ACCC should satisfy itself that Australia Post's proposed expenditure is efficient. Therefore, the ACCC should consider how much an efficient prudent entity would spend in Australia Post's position and set Australia Post's expenditure allowances to this amount(s).

Consistent with this, a building blocks approach to estimation of an efficient revenue and hence price should be adopted based on the reserved services component of the business.

It is possible that some of the costs Australia Post will incur in the short term are transitional. Those costs may be incurred 'once off' and then not incurred again. Costs of this type should be recovered, but they should not cause prices to 'ratchet up' to higher levels in future after the transitional costs are gone. Even if the cost profile is 'jagged', the price profile need not be. It would be more efficient for their recovery to be 'smoothed' over time rather than for prices to go up sharply to recover them quickly and then to come back down in future. The ACCC should examine the extent to which Australia Post's immediate costs are once off, for example the extent to which they are staff separation costs, and apply this approach.

The ACCC has commissioned independent expert advice to review Australia Post's cost allocation model. The same scrutiny should be applied to its proposed expenditure.

Australia Post's demand forecasts are a key input to the price setting process and, as is the case in other regulated sectors, they should be subjected to close scrutiny and review.

The price elasticity assumptions in particular should be subjected to scrutiny. The draft price notification provides no justification for the values other than saying that Australia has elected to use different values than those estimated by Diversified Specifics.

The ACCC should also require Australia Post to enter into full consultation with users of the reserved mail services on the impact of any price increases on consumers with respect to both the magnitude of the increase and the timing of increases.

Question 2

Australia Post's forecast savings in operational costs are largely dependent on around 80 per cent of addressed letter volumes being delivered at the slower timetable. Use of the slower timetable instead of the faster priority timetable would be encouraged by Australia Post through a price difference between these services.

Would a price difference between the regular and priority ordinary mail services encourage use of the slower regular service? If so, what level of price difference would encourage significantly greater use of the slower service?

The key issue is the need for efficient incentive based regulation of the price of the slower timetable service. The appropriate price differential should be considered in the light of the ACCCs independent investigation of the elasticities of demand.

Question 3

What are your views on Australia Post's proposed method of cost allocation? Are there any other cost allocation issues that the ACCC should be considering?

Australia Post's expenditure proposal should be assessed on its own merits with regard to the efficient cost of providing those services. In assessing the expenditure proposal for letter services, the profitability of Australia Post's non-reserved businesses is not relevant. The guiding principles should be:

— efficiency - letter services should provide an efficient return to Australia post, but not more
— competitive neutrality – Australia Post's parcel business should not receive a competitive advantage by reason of its letter business.

The cost allocation model should be examined closely in the light of the proposed report to be commissioned by the ACCC on this matter. Costs to be allocated should include both capital and operating costs.

Question 4

Is Australia Post's forecast improvement in operating efficiency over the next three years comparable with that which would be expected in the transport / logistics sector? What rate of improvement in Australia Post's operating efficiency could reasonably be expected?

Benchmarking comparisons of relative rates of improvement over time may not necessarily be an indication of operating efficiency in Australia Post. The efficiency of capital and operating costs of the reserved letter services should be examined in the light of service delivery requirements as well as in light of comparisons with the transport and logistics sectors.

The question is not whether Australia Post *today* is more efficient than it was *yesterday.* Rather, the question is whether Australia Post's proposal for the future is as efficient as it could be.

Question 5

Australia post's rate of decline in its letter volumes has been around 5 to 6 per cent in most years since 2009 however it is currently forecasting that the annual rate of decline will more than double (i.e. Up to 13.9 per cent) in the coming three years. Is such an increase in the forecast rate decline of letter volumes realistic given the trend since 2009?

It is not clear that the assumptions on the factors that drive demand proposed by Australia Post in its pricing proposal reflect the current market situation particularly with respect to the assumption that the elasticities in the future are likely to reflect those in the past. Considerable substitution of electronic services has already occurred and it is possible that the remaining market is less price responsive. The ACCC's examination of price elasticities should explore this issue.

Question 6

Is the WACC proposed by Australia Post consistent with an efficient benchmark for its cost of capital?

The ACCC should closely scrutinise the proposed WACC and ensure that it is consistent with the WACC allowed for other regulated business, whether Government or privately owned. We note, in particular, that the proposed gamma does not appear to be consistent with contemporary regulatory practice.

1 INTRODUCTION AND OVERVIEW

1.1 Why is Australia post submitting a price notification

Australia Post is a substantial Government owned business. According to the issues paper released by the Australian Competition and Consumer Commission (ACCC) in relation to its draft price notification, Australia Post earned more than $6 billion in revenue in 2013/14. Of this, slightly less than half was in the 'parcel' business, in which Australia Post competes with numerous other businesses[1] (ACCC, September 2015).

The remaining (just over) half of Australia's revenue came from its postal business. More than half of this, or about 28 per cent of Australia Post's revenue is in the 'reserved' services, which are essentially standard letters weighing no more than 250 grams.

Insofar as it is a provider of reserved services, Australia Post is a statutory monopoly. It has this segment of the market to itself. As a statutory monopoly, Australia post is subject to economic regulation.

Several forms of economic regulation are employed in Australia. In Australia Post's case the applicable regulation is set out in the provisions of what used to be the *Prices Surveillance Act,* but is now section95Z, Part VIIA of the Competition and Consumer Act (2010) (CCA).

In very simple terms, the economic regulatory framework applying to Australia Post prohibits it from increasing the price of reserved services above their current level (as that may be from time to time) unless two conditions are met:

1. Australia Post has notified the ACCC of its intention to increase prices
2. ACCC has endorsed that notification.[2]

If the ACCC does not endorse Australia Post's proposed price increase, it must state a price to which it would not object.

Therefore, Australia Post's price notification is the first 'move' in an economic regulatory process. It has submitted a price notification so that it may be scrutinised by the ACCC to ensure that it meets the requirements of the CCA.

1.2 What are the requirements of the CCA?

The reason that Australia Post's pricing is subject to this process is set out in s.95E of the CCA. It is that, in this market, competitive pressure is not sufficient to deliver efficient prices and to protect consumers. The broader objective of the CCA is also relevant. This is to: [3]

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[1] ACCC, Australia Post draft price notification – issues paper
[2] Another option is that the ACCC does not respond to the price notification. Clearly that is unlikely in this case.
[3] CCA, s.2

Enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.

Competition is not an end in itself. Competition is pursued in markets not for its own sake, but because when goods and services are supplied under competitive pressure they will tend to match consumer preferences more closely and be priced more efficiently than if there was no such pressure. As the degree of competition increases, market outcomes will tend to be more efficient.

It follows that the ACCC's role in its dealings with Australia Post is to ensure that Australia Post's prices are similar to those that would prevail if there was competitive pressure for reserved services. The ACCC's role is to apply *regulatory* pressure in lieu of *competitive* pressure to deliver efficient outcomes.

1.3 The principles of better regulation should apply to Australia Post

As noted above, Australia is not the only business in Australia with a monopoly. Nor is it the only business subject to economic regulation.

Economic regulation has been the subject of considerable development and attention in Australia. The most recent example was the Australian Energy Regulator's (AER) *Better Regulation Review*, which was conducted in 2013. The AER operates under the CCA and the principles it developed under this review are equally relevant to the ACCC's administration of economic regulation as to the AER's.

Following that review, the AER arrived at a set of three key principles for better economic regulation.[4]

The first principle is that economic regulation should be *incentive based wherever possible*. The incentives it creates should be designed to encourage regulated businesses to spend efficiently and should be supported by a robust approach to assessing expenditure forecasts.

The second principle is that "*necessary and efficient investment should be encouraged*" and that the rate at which regulated businesses earn a return on investment should "*balance predictability with the need to take into account changing market conditions*."

The third key principle is that economic regulation should be coupled with a *strong consumer engagement framework*. This will encourage greater involvement and communication between regulated businesses and their customers.

We note, of course, that the legal framework applying to Australia Post is different to that applying to the energy networks the AER regulates. However, the underlying objective and purpose of economic regulation is the same regardless of which legal avenue is used to apply it. In our view these three key principles are equally applicable to Australia Post as they are to energy networks and other regulated businesses.

Therefore, it is our view that the ACCC should allow these three key principles to guide its assessment of Australia Post's price notification, both now at the draft stage and, in due course, when it is submitted formally.

1.4 Structure of this report

Chapter 2 of this report provides background information in relation to the Australian Postal industry to place consideration of Australia Post's draft price notification into context. In summary, that section shows that the Australian Postal industry is substantial, contributing approximately

- $14.1 billion to the Australian economy in 2013-14
- And employing at least 131,000 (FTE) Australians.

Around 25 per cent of this activity and contribution is made directly by Australia Post, with the remainder made by other businesses including the franchises. There is therefore a large number of other businesses as well as consumers that are affected by Australia Post's prices and a significant part of Australia's economic product depends on it. The ACCC's consideration of Australia Post's prices is important and should be given due consideration.

4 AER, Overview of the Better Regulation reform package, April 2014, p. 4, available from www.accc.gov.au, retrieved 30 September 2015.

Against that background we turn to the *Better Regulation* principles set out above. In the following three chapters we take the principles one at a time and apply them to Australia Post's draft price notification. Accordingly:

— Chapter 3 discusses the incentives that apply to Australia Post
— Chapter 4 considers whether the draft price notification encourages 'necessary and efficient investment' and whether the proposed rate of return strikes the appropriate balance
— Chapter 5 relates to consumer engagement.

2 THE AUSTRALIAN POSTAL INDUSTRY

Modelling and economic analysis that ACIL Allen conducted for *Printing Industries* in 2015 shows that Australia's mailing industry is substantial.[5]

It should be noted that there are activities that are undertaken, but which were omitted from this modelling and analysis. In large part this is because, like the tourism industry, the 'mailing industry' is not represented as a single sector in the traditional ABS national accounts. Therefore, while parts of the industry have been quantified, other parts are 'mixed' with other industries in the national accounts. The contribution of those 'other' parts of the mailing industry has not been quantified.

This omission makes the analysis presented here a conservative estimate of the contribution the mailing industry makes to Australia's economy. The true impact would be greater, though we cannot say confidently how much greater.

The mailing industry includes, but is not limited to, three groups of activities that were quantified, namely:

— direct mail services, which include postal and courier services
— mail management services in other businesses
— mail advertising services such as catalogues and other direct marketing material.

Between them, ACIL Allen estimates that, in 2013-14, these three groups made a total value add to the Australian economy of approximately $14.1 billion. This represents 0.9% of Australia's Gross Domestic Product.

Further, the businesses in these groups employ a large number of Australians, including a large number in regional areas. Across the three groups we estimate that employment in the mailing industry is more than 131,000 FTE.

This accounts for approximately 1.4% of employment in Australia in 2013-14.

Of these 131,000 jobs, approximately:

— 75 per cent, or 98,000 FTE, were in direct mail services
— 17 per cent, or 23,000 FTE were in mail management services
— 8 per cent, or 10,000 FTE were in mail advertising services.

More detailed information in relation to the three identified groups of activities in the mailing industry is provided in the following sections.

[5] ACIL Allen, The economic contribution of the Australian Mailing Industry, August 2015

The value added from Australia Post's direct activities in 2013-14 was $3.5 billion which represents around 25 per cent of all mail industry activities. A substantial part of Australia's mailing industry (including the franchises) exists outside Australia Post. However, those parts of the industry are all reliant on, or influenced by, Australia Post's direct activities in some way. There is therefore a case for the ACCC to give careful consideration to the implications for the broader mailing industry of Australia Post's pricing as it considers its response to Australia Post's price notification.

3

THE INCENTIVE FRAMEWORK

The first of the three guiding principles for *Better Regulation* is that Australia Post should be subject to incentive based regulation to the extent that this is possible.

This chapter begins by describing incentive based regulation briefly. It then compares it with the alternative, 'cost of service regulation', which is widely accepted to be inferior.[6]

Then we discuss the application of incentive based regulation to Australia Post's draft price notification. There are three key areas on which we encourage the ACCC to focus to ensure that Australia Post's incentives are set appropriately.

3.1 What is incentive based regulation

Incentive based regulation is a form of regulation where the regulator 'locks in' expenditure allowances for a period of time at the beginning of a regulatory period. The regulator chooses those allowances by considering the amount of expenditure that the business would need to make to meet its (pre-defined) service targets. It is then up to the business to spend those allowances as it sees fit, subject to an obligation to meet those service targets.

The key difference between incentive based regulation and cost of service regulation is that the business will not be compensated if its *actual* expenditure exceeds its expenditure allowances. On the other hand, if the business spends less than its expenditure allowances, it will keep the additional revenue and earn additional profit for a time.

The advantage of incentive based regulation over the alternatives is that it the business has a profit based incentive to seek out and implement more efficient ways of providing its service. With cost of service regulation the incentive is greatly diminished because the business will earn the same profit whether it becomes more efficient or not.

In practice, incentive based regulation is implemented using the building blocks model. The regulator analyses calculates the total revenue that a business will require based on the three 'blocks', namely:

1. operating expenditure
2. return of investment (depreciation) and tax
3. return on investment.

When the regulator has determined the required *revenue* it determines the appropriate *price*. Broadly, this is done by dividing revenue by a forecast of the volume that will be sold.

The regulator may enhance this basic model by applying features such as an efficiency benefit sharing scheme or incentives to use non-traditional approaches to meeting service targets.

[6] See, for example, AER, *Overview of the Better Regulation reform package*, April 2014. p. 5

A crucial feature of incentive based regulation is that allowances are *locked in*. When the regulator has determined the level of the building blocks, they are not reconsidered. If the business fails to meet the targets with the allowed levels of expenditure this is, simply put, bad luck. It is crucial that this is the case because, if it is not, the incentive to chase efficiencies is gone.

Further, incentive based regulation is a forward looking process. There is no place in incentive based regulation for a business to be compensated for losses made in the past.

3.2 Applying incentive based regulation to Australia Post

There are two aspects of Australia Post's draft price notification and the ACCC's issues paper that 'touch on' incentive based regulation, namely:

— Australia Post's proposed expenditure

— Australia Post's demand forecasts and, in particular, its estimates of price elasticity of demand.

These issues are discussed in turn below.

3.2.1 Proposed Expenditure

The information that has been published in support of Australia Post's draft price notification does not appear to set out proposed capital and operating expenditure allowances as such.[7]

There are numerous references to Australia Post's 'Reform our Letter Service' program (RoLS). From those references it certainly appears that the proposed operating expenditure is less than operating expenditure has been in recent years. It is possible, but we cannot say for sure, that Australia Post has submitted more detailed proposals to the ACCC in confidence.

Broadly, the ACCC should satisfy itself that Australia Post's proposed expenditure is efficient. Therefore, the ACCC should consider how much an efficient prudent entity would spend in Australia Post's position and set Australia Post's expenditure allowances to this amount(s).

Australia Post's argument that its expenditure is efficient appears to revolve around an efficiency benchmark study that was commissioned in 2008 and completed in 2009.[8]

While we have not reviewed the study itself, we note that Australia Post's reference to it in the draft price notification appears not to be on point. Australia Post quotes the study's conclusion that it has:

*shown the most consistent improvement in total factor productivity (**TFP**) of the seven postal services reviewed. Importantly, Australia Post improved its ranking when formal, statistically based adjustments were made for differences in mail and customer density with its TFP level being ranked first or second after the adjustments were made.*

In other words, between 2002 and 2009, Australia Post's productivity improved more quickly than postal services overseas.

It is no doubt laudable that Australia Post was able to increase its productivity faster than its overseas comparators. However, the issue for a regulator is whether the costs Australia Post proposes to incur are efficient. The fact that they have improved faster than others might indicate that they are efficient, or it might just mean that they were once much less efficient than others and they have caught up somewhat. We cannot say.

We note that the ACCC has commissioned independent expert advice to review Australia Post's cost allocation model. However, it is not clear that the same scrutiny is being applied to its proposed expenditure. In our view it would be appropriate, and consistent with the regulatory treatment of other similar businesses, for Australia Post's expenditure proposal to be scrutinised with a view to determining whether it is efficient.

[7] There is financial information in chapter 7 of the Draft Price Notification. However, it is not clear whether this applies to the whole business or, as would be necessary, just to the reserved services function. The text surrounding those tables indicates that they relate to the entire business. Therefore, we have assumed that they are not the relevant figures.

[8] Australia Post, Draft Price Notification, p.35

3.2.2 Demand forecasts

Demand forecasts are a key input to economic regulatory proposals. They are the 'denominator' that links revenue to price.

They are also a key input to the assessment of expenditure proposals, particularly capital expenditure.

In *Better Regulation*, the AER described a set of best practice principles for demand forecasting. According to these, demand forecasts should be:[9]

- accurate and unbiased
- transparent and repeatable
- based on key drivers
- produced from models that have been validated and tested
- based on the most recent information available
- reviewed regularly.

In the time available to us we have reviewed the demand forecasting methodology briefly. The forecasts were prepared using a Vector Error Correction Model, which is essentially a form of time series analysis based in which trends in postal volumes have been compared to trends in explanatory variables.

We raise several areas below where we feel that the demand forecasts should be considered further. Our key point, though, is that the demand forecasts are a key input to the price setting process and, as is the case in other regulated sectors, they should be subjected to close scrutiny and review. This is consistent with *Better Regulation*, in which the AER says that its review of capital expenditure proposals will include a "detailed consideration of the demand forecast and the timing, scope, scale and level of expenditure…"[10]

In this case, Australia Post has submitted a set of demand forecasts based on the work of an independent consultant, Diversified Specifics.[11] However, it has varied the forecasts to account for its own views of price elasticity and other factors.

In our view the price elasticity assumption in particular should be subjected to scrutiny. The draft price notification provides no justification for the values other than saying that Australia has elected to use different values. Aside from this, Australia Post refers to unspecified previous studies that have failed to produce a meaningful estimate of price elasticity at all.

It is clear that Australian letter volumes have declined rapidly in recent years. Presumably this is due to the rapid uptake of electronic, internet based alternatives to postal mail. In this context it is difficult to obtain a 'clean' estimate of price elasticity. In our view, it is at least arguable that price elasticity will now be very low, lower even than the -0.25 assumed by Australia post. This would be consistent with the view 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'.

We are also concerned that applying a simple linear elasticity may induce a spiral in the demand modelling where increasing prices induce falling demand, which induces increased prices etc.

As we say above, it is important that the ACCC considers these issues fully in its evaluation of the draft price notification. This may be underway, but it is not clear from the issue paper that this is the case.

In a separate issue, we note that a key driver of the future forecast decline in letter volumes is the projected uptake of broadband internet access.

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[9] There are other principles that are applicable to the electricity sector, which may not be applicable to post.
[10] AER, Better Regulation: Expenditure forecast assessment guideline, p. 2, available form www.aer.gov.au
[11] Diversified Specifics, *Australia Post Domestic Letter Volume Demand Update*, August 2015, available from www.accc.gov.au

Conceptually, we accept that this is likely to be a key driver of declining letter volumes. However, we note from the Diversified Specifics report that Australia Post's volume forecasts are based on the assumption that broadband uptake in Australia will match that in the Asia Pacific region.[12]

Diversified Specifics argues that this is consistent with the view that uptake will follow infrastructure condition. This may be correct, but intuitively it is difficult to accept that Australia, where uptake of broadband and mobile technology has traditionally been high, will follow the same forward trajectory as other countries where it has been slower to date. In our view this is a matter which should be scrutinised further by the ACCC.

[12] See Diversified Specifics' report, page 25 "the wireless mobile substitution variable developed in this study is based on a combination of [ABS data] and the set of global mobile traffic projections pertaining to the Asia Pacific region…".

4 NECESSARY AND EFFICIENT INVESTMENT

The second *Better Regulation* principle is that the regulatory regime should:

— encourage necessary and efficient investment, and, by corollary, discourage unnecessary and inefficient investment

— ensure that the rate of return is an appropriate balance between market conditions and predictability.

Two issues arise from our review of the draft price notification and the issues paper.

4.1 Cost allocation

The issues paper and the draft price notification both devote significant time to the question of allocating costs appropriately between Australia Posts two broad businesses, i.e. parcel and letter services.

In addition, the ACCC has dedicated significant effort in recent years to ensuring that Australia Post's parcel services are not cross subsidised by its regulated reserved services.

Cost allocation is an important issue for a business which is partly regulated. The key issue is that regulated businesses cannot be allowed to use their regulated status to gain a cost advantage over competitors in non-regulated sectors. In this context, Australia Post cannot be allowed to take advantage of its position as a statutory monopolist in respect of reserved services to compete unfairly in parcel services.

However, the reverse is true as well. In the draft price notification, Australia Post quotes work done by Boston Consulting Group in which it concludes that, without reform, Australia Post's losses from its letter business will soon exceed the profit of its parcel business. This may be true, but we do not see how it is relevant to the issue before the ACCC. That issue is the efficient level of revenue, and therefore price, for Australia Post's regulated letter business. The parcel business has previously been seen as an offset for letter losses, but this is no more than a happy coincidence.

Australia Post's draft price allocation should be assessed on its own merits, with regard had to the efficient cost of providing relevant services. The profitability of another of Australia Post's business units is simply not relevant.

We acknowledge, of course, that any shortfall Australia makes must be funded from somewhere. The implication in Australia Post's draft price notification is that if costs are not recovered from the parcel business they will become "a drain on the public purse": In our view this is not correct. Australia Post's letter business is just as much a drain on, or a contributor to, the public purse regardless of the performance of the parcel business. If the parcel business' profit is used to offset the losses made in the letter business, it is still unavailable to Australia Post's shareholder to use for other things.

4.2 Rate of return

The appropriate rate of return for a regulated business is a complex and controversial matter. A detailed discussion is beyond the scope of this paper.

However, we consider it important to note that Australia Post's rate of return is not being determined in a vacuum. On the contrary, the AER has recently completed an extensive process for determining the appropriate rate of return for energy networks. That process has made substantial changes to the way rate of return is set for those regulated businesses.

This process is not without controversy and, at the time of writing, the AER is in the midst of defending an appeal against its regulatory determination for the New South Wales electricity network businesses. A key part of that appeal pertains to the appropriate rate of return for those businesses.

Given that the rate of return is currently *sub judice* we have not conducted a thorough review of Australia Post's proposal. Nor have we attempted to parse the arguments in relation to each of the parameters - given its proximity to the AER, the ACCC will have far superior access to these issues than we could hope to have at this point.

As in other aspects of this paper, though, our point is that the way rate of return is determined for Australia Post should be consistent with the way it is determined for other regulated businesses.

It should be noted that consistency of approach will not necessarily lead to the same outcomes. For example, it is possible that Australia Post will be deemed to have a more risky business than electricity networks (for example) and that the parameters of the Weighted Average Cost of Capital (WACC) will differ to reflect this. This would be entirely possible in a model in which a given approach is applied consistently to different businesses.

In practical terms, we expect that Australia Post will be deemed to be more similar to a gas than an electricity distribution business. Therefore, in Table 4.1, we have compared Australia Post's proposed WACC parameters with the corresponding parameters determined by the AER for Jemena Gas Networks (in New South Wales).

TABLE 4.1 – **WACC PARAMETERS, JEMENA GAS NETWORKS AND AUSTRALIA POST**

	Date	Reg. period	Nominal risk free rate	Equity beta	MRP	Gearing ratio	Gamma	Nominal Vanilla WACC
Jemena Gas Networks	Jun-15	Applicable to 2015/16	2.53%	0.6	6.5	60%	0.4	5.41%
Australia Post	Aug-15	15/16 and 16/17	2.96%	0.8	7	30%	0	7.29%
Delta			**0.43%**	**0.2**	**0.5**	**-30%**	**-0.4**	**1.88%**

SOURCE: JGN –AER WEBSITE, JGN FINAL DETERMINATION
AUSTRALIA POST – DRAFT PRICE NOTIFICATION

Table 4.1 shows that there are differences in several of the WACC parameters, which may be due partly to timing and the process of estimating parameters. However, at least one difference is notable, namely the difference in the proposed 'Gamma' or the proportion of imputation credits that can be used by shareholders.

Gamma has a significant impact on the rate of return a regulated business is permitted to earn and, therefore, on Australia Post's revenue.

In the draft price notification, Australia Post proposes that Gamma should be zero. That is, it suggests that tax imputation credits are of no value to its shareholder. The reason is outlined in the supporting report from Value Advisers. To paraphrase, Value Advisers argues that:

1. the appropriate value of Gamma should reflect the individual circumstances of a company's shareholder(s)
2. Australia Post's shareholder is the Australian Government

3. the Australian Government does not pay tax
4. with no tax liability to offset, the Australian Government derives no value from tax credits, and therefore Gamma is zero.

Value advisers goes on to say that setting gamma to any value other than zero:

1. would threaten Australia Post's competitive position as it would not be able to enough revenue to cover tax payments
2. amounts to assuming that Australia Post's effective tax rate is less than 30%, which is not correct.

In our view, neither of these assertions is correct. The value of Gamma has no impact whatsoever on Australia Post's competitive position because it applies only to the parts of Australia Post's business where it is a statutory monopolist. In these parts of its business Australia has neither competitors nor a competitive position.

Contrary to Value Partner's assertion, setting gamma to a non-zero value does not amount to an assumption that Australia Post's effective tax rate is less than 30%. Rather, it amounts to an assumption that the *efficient* tax rate for a postal business is less than 30%. Value Partners may be right when it says that Australia Post's *actual* tax rate is 30%, but this is not relevant. As discussed above, in incentive based regulation the objective is to compensate *efficient* costs, not *actual* costs. This principle applies here as well.

The appropriate value of Gamma is a complex issue. We are aware of views in the literature that the appropriate value for Gamma is zero based on the notion that Gamma should be set for the *marginal* investor in the regulated business, rather than the *average* investor. There are also empirical studies which suggest that zero is the appropriate value.

Notwithstanding this, the ACCC has previously taken the view that the appropriate gamma for Australia Post should be the average gamma for Australian companies. Unsurprisingly, Value Partners rejects this view.

In contrast to Value Partner's argument, we note that the value of Gamma is an issue in the ongoing appeal in relation to New South Wales electricity distribution networks. In that appeal the debate is whether Gamma should be 0.25, as proposed by the businesses, or 0.4, as set by the AER. Neither party in that appeal has proposed that gamma should be zero, notwithstanding that the networks in question are Government owned.

5 CONSUMER ENGAGEMENT

The third *Better Regulation principle* is that economic regulation should be coupled with a strong consumer engagement framework. The objective of this is to better inform the business about customer preferences, which would be observed in a competitive market, but are more difficult to detect in a monopoly.

In this respect we note that Australia Post is conducting an "intensive stakeholder engagement program", which has been intensified further since the proposed reforms were announced. We understand that some of the results of that program have been provided to the ACCC, though we have not seen them.

Based on the information in the draft price notification, the stakeholder engagement program appears to have been conducted mainly *after* Australia Post formed its views as to the prices it would propose. Part of the focus in the write up of the engagement program is on how the proposed changes will be implemented. Another part of the focus is on Australia Post *telling* stakeholders what it is doing, rather than *asking* what stakeholders would like it to do. Consider, for example, Australia Post's description of its engagement website 'the National Conversation", which is "*a website dedicated to promoting community awareness about the future of the letter service.*"

Australia Post also sent letters to around 10 million Australians between March and May 2015 explaining what it had decided to propose.

Consumer engagement of this type is fine, but it is not what the AER had in mind in *Better Regulation*. Rather that *telling* customers, the purpose of consumer engagement in *Better Regulation* is to *ask.* In *Better Regulation* (with emphasis added) "(c)onsumer engagement is about working openly and collaboratively with consumers and providing opportunities for their views and preferences to be heard **and to influence service providers' decisions**."[13]

Our concern about the consumer engagement program Australia Post describes in its draft price notification is that it provided little or no opportunity for Stakeholders to influence its decisions. If it had, we understand that *Printing Industries* would have advocated for several differences from the current proposal.

One difference we understand that *Printing Industries* would have advocated for is a slower, smoother price path to transition to the new price levels. This would allow a balance between recovering revenue over time and allowing businesses time to adjust. The purpose of setting prices efficiently is to ensure that stakeholders make efficient choices. However, to a large extent choices have already been made so there is a need for time to adjust. The objective of efficiency will not be met if price changes are so rapid that they 'shock' downstream businesses too harshly.

[13] AER, *Better Regulation: Consumer engagement guideline for network service providers*, August 2013, available from www.accc.gov.au

A smoothed price path is entirely consistent with economic regulation in other sectors.[14] In fact a key principle of tariff setting in energy markets is the need for certainty and stability for customers.

Related to this, we note that Australia Post's proposal would see it over-recover revenue by a forecast $80 million in 2016-17. It is not clear why this over-recovery is necessary or that it is efficient. However, it appears to be a good opportunity for price smoothing. Prices could be set lower in the immediate term so that the present value of Australia Post's revenue is at the target level. Essentially the 2016/17 'over' could be used to offset an 'under' in the immediate term.[15]

[14] When price paths are smoothed the time value of money is brought into consideration to ensure that the regulated business does not lose as a result of the timing changes.

[15] The practicality of this depends on when the new prices take effect. However, the concept can be applied regardless.

ACIL ALLEN CONSULTING PTY LTD
ABN 68 102 652 148

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