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Assessment of Australia Post's cost allocation methodology

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Executive Summary

1. Taking a top-down view on Australia Post's profitability, it shows that Australia Post as a company and in particular their reserved services have significantly lost profitability over the last years. The profits earned in all other services were not high enough to cover the losses of reserved services, so that Australia Post made a loss at the company level in FY2023.

2. Reserved letters are a loss-making service for Australia Post since FY2020. Losses increased year by year and are projected to achieve their maximum in FY2023 with over AUD 200 million.

3. Australia Post's profit margins are generally low. In the best of last years the margin at the company level did not exceed 2%. [redacted]

4. The development of revenues shows that Australia Post is progressively transforming itself from a mail delivery company to a parcel and express delivery company. Reserved services contributed still [redacted] to total revenues in 2019. This revenue share [redacted] on average (=CAGR) in this period. Parcel and express services on the other hand accounted for [redacted] of all revenues generated by Australia Post in FY2022. These revenues [redacted] on average since 2019.

5. The development of costs over time is relatively similar to the development of revenues. The cost shares of reserved services on the one hand and parcel and express services on the other hand is almost identical to the share of revenues of these service categories. This relative proportional development of revenues and costs indicates from a high-level top-down view that the way Australia Post's cost allocation model works, it generates a relatively "fair" allocation of costs to services. This overall view does not exclude that we have reservations how cost allocation works in detail.

6. Domestic reserved letter volumes have declined from FY2017 to FY2023 by an average rate of approx. 8% per year. A similar further decline is expected for the next years. Because a major part of Australia Post's network represents fixed costs, unit costs steadily increased over time from [redacted] in FY2017 to [redacted] in FY2022. A further increase to [redacted] is expected for FY2026. To cope with this trend of unit costs, Australia Post has to increase service prices to keep a certain level of profitability for reserved services.

7. While volumes for reserved letters declined by approx. 8% p.a., unit cost (only) increased by about [redacted] This observation indicates (if the model structure has not changed) that Australia Post realised relatively more efficiency gains in activities primarily used for reserved services, because scale disadvantages should be higher for reserved services.

8. In its updated forecast of November 2023, Australia Post presents a rather pessimistic and different view than in the initial forecast of August 2023 on the further business developments for parcel and express services. Although parcel and express volumes have steadily increased in the past (by about 12% p.a.) [redacted] As a consequence, Australia Post in total continues being loss-making during the forecast period from FY2024 to FY2026. Australia Post has made itself not clear why it drastically changed its business expectations for parcel and express services. In any case under the mechanics of the EPM, this leads to an increase of costs allocated to reserved services of [redacted] although the business expectations for these services did not change. A second reason for the increased cost allocated to reserved letter services is that the updated forecast does not include the cost effects of the implementation of the New Delivery Model. We could not further clarify the reasons and the prudency of this fundamental change of business expectations in Australia Post's newest corporate plan. Such a fundamental change can in our view only be explained by some disruptive developments which at least we could not identify yet. It has to become a major task for ACCC to properly assess Australia Post's newest business assumptions and its prudency with the particular emphasis on the major cost increase for reserved services.

9. Our analysis of unit costs showed that the unit cost of priority letters, regardless whether reserved or non-reserved increase, on average, more than the unit costs of regular letters.

10. Based on Australia Post's activity hierarchy cost breakdown, we analysed in detail the relative importance of the various activities. Compared to our 2019 analysis, delivery has further increased its relative importance as a cost component for reserved services. While the this activity represented a proportion of [redacted] of costs of reserved services in FY2019 this proportion increased to [redacted] in FY2023. For all services, the increase was from [redacted] to [redacted] over the same period. This has major implications for the cost structure, as the cost of delivery are more characterised as fixed costs and are less volume driven than the costs of other functions. This implies that further volume declines for reserved services will further increase their unit costs.

11. The structure of Australia Post's cost allocation model has basically remained unchanged since we analysed it in 2019. Production costs are allocated to products using the Activity Based Costing methodology. Different allocation rules are applied

for direct, attributable and unattributable costs. Costs of shared facilities or networks are allocated to services on the basis of various cost drivers.

12. Australia Post is continuously improving and updating the structure of the EPM. There is a general trend in developing the EPM to increase the number of products differentiated in the model. Between 2018 and 2023 one can observe this trend in the segments of international and parcel products as well as of agency services. Furthermore, at the activity level, particularly in the delivery function, the EPM 2023 differentiates between metro and regional activities, and StarTrack services are integrated in the model. We generally support the model development trend of differentiation and disaggregating services and activities in the model. The interpretation of model outputs becomes easier and more precise.

13. Australia Post has conducted major model revisions and updates since 2019. We analysed each of them in detail and assessed their outcomes. Furthermore, we make proposals for further updates or renewals of updates so that the model reflects the structure of Australia Post's business as it is today. Whenever structural changes in the business (products, volumes, procedures and resources) occur, the model has to be changed or updated to reflect effectively and prudently the structure of costs and the allocation of costs to services. It is, however, realistic to assume that the EPM usually lags (a bit) behind the development of the business. Resulting distortions in cost allocation may be negligible. If they are assumed to be more material, the need for update becomes obvious. We have highlighted some requirements for updates to be commenced in the near future.

14. The in-depth analysis of the process 'Corporate Outdoor Delivery' with emphasis on selected activities classified as 'fixed cost' and as 'variable cost' showed that the structural shift from letter to non-letter volumes had a visible impact on the cost allocation of those activities are consumed by both, domestic reserved letters and parcel and express services (joint production). This was made possible by Australia Post's progress made in modelling the delivery activities that can be categorised as fixed and variable costs. Between FY2019 and FY2023 basically two major changes/developments have affected the cost allocation to service categories: Firstly, the implementation of the delivery time standard update and secondly, opposite letter and parcel/express volume trends. The delivery time standard update resulted into a structural shift from variable to fixed costs. Declining letter volume further reinforced this shift for domestic letter services. As more than three quarter of the fixed cost were allocated to domestic reserved letters (before and after the update), this change resulted in a significant increase in activities' costs for domestic letters for the benefit of the other services (i.e. parcel & express services). The second development, declining letter volume, reduced the variable cost allocated to domestic (reserved) letters. Insofar, the EPM reacts properly to letter volume declines and parcel volume growth.

15. We also identified that between FY2019 and FY2023 the share of fixed cost allocated to parcel and express services has increased for the benefit of the letter services. However, this increase was too small to compensate for the structural shift following the delivery standard time update. This indicates once more, as we have already emphasized [redacted] that an update of the delivery time standards is necessary.

16. Overall, the share of fixed cost in delivery has increased between FY2019 and FY2023 and domestic reserved letters were particularly affected by this increase. The level of the fixed cost depends on the delivery frequency necessary for each of the service categories. The implementation of the new delivery model [redacted] would help to reduce the fixed cost in the staffed delivery network and would further shift fixed costs to priority letter services (that require daily delivery) as well as to parcel and express services (and other scannable products). On the other hand, fixed cost allocated to regular letter services that do not require daily delivery to meet the delivery time standard would decline.

17. Australia Post's cost allocation methodology in general and the EPM specifically has strengths and weaknesses. They are related to the EPM as a system and are not related to the way the model is structured in detail and operated by Australia Post. The EPM as such and the way Australia Post operates the model is conducted at highest professional standards.

18. The EPM is characterised by a number of strengths. Among them are the following ones:

    - The model is consistent with the Record Keeping Rules. That makes it stable and coherent over time. Additionally, the ACCC can further specify the details and output of the model.

    - The model is consistent with Australia Post's financial accounts because its basic input data are derived from the General Ledger of the company.

    - The model fully absorbs all costs and guarantees a full cost coverage of Australia Post.

    - The model is not only or not even primarily used as a regulatory tool. It is mostly used as a management tool. This should give the ACCC confidence in the appropriate modelling and data input approach.

19. Despite these major strengths, there are some main weaknesses of the model which are inherent in the conceptual methodology of the model. Among those are the following ones:

    - The model is based on actual and not (necessarily) efficient costs.

- The model presents an ex post cost allocation to products and services which are incurred at the corporation level.
- The model is not an integrated tool which would allow an external user for calculating the impact of parameter changes and scenario calculations.
- The model does not generate forward looking cost forecasts and is not integrated into a forecast model.
- The model does not provide the short-run or long-run incremental cost of a service.

20. The strengths and weaknesses of the model have implications where and how the model can support regulatory decisions of the ACCC. The model allows for directly identifying the profitability of services which supports a traditional cross-subsidy test. The model does neither generate forward looking nor efficient costs. It provides actual cost based on historic data. That gives some limitations in applying the strict economic efficiency view of costs. The mostly missing element is a coherent and consistent forecasting tool to properly assess forward looking costs which should be the basis for regulatory price decisions.

21. On the basis of our assessment of the model and in light of regulatory requirements to better support ACCC's decisions we have made following recommendations to improve the model and Australia Post's financial reporting for the ACCC.

22. Due to its nature as an ex post cost allocation model the EPM is not coupled with a forecast model. The EPM (and the CAM as part of the EPM) itself is not used as a forecasting tool. It is rather used to allocate Australia Post's cost forecast, undertaken for each business unit in fully separated models, to products and services. Furthermore, the financial forecast is presented in a much more aggregated structure. Results are presented at the level of service groups and not individual products. This is a potential source of a mismatch between historic, actual and forecast data. When it comes to price notifications, the more important source for decision making is, however, the forecast data. Therefore, the reliability, prudency and transparency of the forecast methods and their results become a key factor to the ACCC. Therefore we recommend that the ACCC takes great attention on the prudency and reliability of the forecast data. Because of the uncertainties related to forecasts, forecasts are usually presented as scenarios. To better assess forecasts, Australia Post should provide the underlying assumptions of the forecast scenario which Australia Post presents to the ACCC. For business decisions usually various forecast scenarios are prepared to inform management decisions. We assume that Australia Post also is following this approach internally. We recommend that Australia Post is sharing the calculation of different forecast scenarios with ACCC if Australia Post usually

calculates different scenarios. This would enable ACCC to better deal with the uncertainties related to forecasts.

23. Australia Post includes intended prices changes into its forecast calculations. The draft notifications do, however, not isolate and calculate the financial impact of the proposed price changes. For properly assessing price notifications, the ACCC should know what the financial impact of not changing prices would be. Therefore, Australia Post should regularly calculate a scenario where prices remain unchanged. Such a calculation should be ceteris paribus. This means that not only revenue effects of stable prices have to be identified. The calculations should also show what the cost impact of volumes following from stable prices would be.

24. To better assess cost forecasts, we recommend that the ACCC requests a decomposition of cost changes in impacts related to input price changes, volume changes, economies of scale, changes in the production process (efficiency), more (or less) economies of scope. AP should present the absolute value of a cost change attributable to input price changes, volume changes, changes in economies of scale and scope and, finally, efficiency improvements. This decomposition of the drivers for change should be provided in a coherent and consistent way for major product groups such that the forecast data are consistent with the EPM data. This would be an extension of the decomposition of volume and price change effects which Australia Post provides for major cost input factors.

25. For (major) updates of the EPM Australia Post provides calculations of the financial impacts and profitability of the update on services. These calculations are usually provided for the (full) financial year before the update was implemented. Methodologically correct, Australia Post calculates the financial impact as the difference between a model run without the update and with the update for the full financial year without any other changes. We recommend that the ACCC requests from Australia Post to calculate the financial impact not only for the year before but also for the year of implementation. Such information would be more recent and it would ACCC enable to assess the validity and stability of the impact calculation.

26. Australia Post provides its financial impact calculations of model updates for four categories of reserved letter services (ordinary stamped, presort, print post and ordinary other), for non-reserved letters and for total domestic letters. Australia Post does not provide these data for parcel post, express services and StarTrack services. ACCC would get a more complete picture of the financial impact if it would also get the relevant values for these services. This would better enable ACCC to assess the coherence of the impact calculation. Therefore, we recommend that ACCC regularly requests a breakdown of the financial impact calculations of model updates for all service categories.

27. [redacted] Australia Post allocates unattributable costs at a deep level of activities. This allocation implies that unattributable costs influence the relative costs allocated to activities and to services. This can be identified at the mark-up of unattributable on direct and attributable costs. This mark-up varies by service [redacted] This is not efficient. Unattributable costs should not distort the relative costs of services. Therefore we recommend the allocation of these costs at a high level according to an equi-proportionate mark-up (EPMU) rule to products or service groups. In applying an EPMU rule each service cost (sum of direct and attributable costs) gets allocated the same mark-up for unattributables.

28. For good reason, Australia Post is in a permanent restructuring process and the implementation of new efficiency enhancing programs. Australia Post does not show the amount of restructuring costs in the EPM which may be salary or leave payments to redundant employees. Australia Post's financial statement of FY2023 show 'leave and other entitlements' expenses at an amount of AUD 309.1m which is an increase of 35% over FY2022 expense. These expenses are not explained but may represent restructuring costs. Restructuring costs economically are unattributable costs. The EPM, however, is treating them as attributable and does not have a specific allocation mechanism for them. We recommend that restructuring costs are separately identified, treated as unattributable costs and allocated by an EPMU rule.

29. The EPM as a system does not generate the short-run and long-run incremental cost of a service. Such information is necessary to make proper business decisions in certain circumstances. To assess the appropriateness of the (negative) profitability of certain services such costing information also is an important source for ACCC's assessment of the profitability of reserved services. Therefore, the ACCC should request Australia Post to provide the short-run and long-run incremental cost of certain loss making reserved services. This additional costing information should be calculated such that it is coherent with the EPM. By including incremental costing elements into the EPM methodology. Australia Post could improve and strengthen the appropriate allocation according to cost causation. We have demonstrated that for StarTrack's use of Australia Post's resources.

30. In the meantime the StarTrack business is integrated within the EPM in two different tracks. StarTrack firstly forms a separate product group within the EPM. Secondly, StarTrack services are integrated in the main body of the EPM for activities which share common resources. Resources of the letter and parcel networks consumed by StarTrack are then allocated in a transfer price regime to StarTrack ex post. We are not arguing that this cost allocation system is strategically distorted. It provides, however, flexibility to distort allocation in favour of StarTrack to support its competitive position in the market. An arm's length relationship to its subsidiary is better demonstrated by a transfer price system which is specified contractually and which specifies ex ante transfer prices for StarTrack to pay for using Australia Post network resources. This transfer price system may be adopted from time to time where the

updates may be informed by the allocation results of the EPM as it is structured today. A contractually specified transfer price system better enables the ACCC to control for competitive distortions.

31. The EPM allocates all subsidies paid by Australia Post to LPOs to reserved services only. This allocation is correct under the assumption that non-reserved services have no direct or indirect benefits from the larger number of PO outlets generated by subsidization. If non-reserved services receive direct and indirect benefits from the larger number of POs beyond the costs these services get allocated for using LPO services, it would be appropriate that non-reserved services also carry a certain share of these subsidies. Therefore, we recommend that ACCC initiates a process with Australia Post to check whether there are direct and indirect benefits for non-reserved services from a larger PO outlet network.

32. In 2020, Australia Post conducted a delivery time standard update within the EPM. The field research for the update was conducted in a pre-COVID period. This gives reason to assume that the findings of the survey are no longer valid for the post-COVID period. Volumes and processes have changed significantly in the meantime. Furthermore we have doubts that the survey has been representative [redacted] Therefore, we recommend that Australia Post conducts a new time delivery standard survey to update its delivery model. This holds in particular as Australia Post has been switching from motorcycles to eDVs and is going to implement a NDM.

33. As PDOs deliver increasing volumes of parcels, Australia Post changed the delivery modes significantly. Australia Post is more and more using eDVs for delivering parcels and letters. eDVs are substituting motorcycles. eDVs cause higher fixed costs for delivery than motorcycles. Different to motorcycles eDVs are not based at the delivery centres. Thus, PDOs have to carry them there first. Average travel time is [redacted] more for eDVs. The same holds for average stop time without delivery. Furthermore, the extensive use of eDVs for delivery increased the number of rounds [redacted] According to operational round planning using eDVs made mixed letter/parcel delivery [redacted] less productive, whereby the actual impact on specific rounds can vary based on local factors such as the proximity of letter boxes to the footpath. Australia Post operates currently approx. 3,500 eDV rounds. This represents an approximate increase of 500 rounds. The EPM spreads this increase in fixed cost to letter and to parcel delivery although the increase is caused by parcels (only). Introducing incremental cost allocation elements would better allocate cost according to cost causation. Therefore, we recommend that Australia Post takes better care of incremental cost in cost causation and allocation in particular regarding eDVs.

34. The way in which the EPM allocates costs to StarTrack demonstrates that the EPM is not sufficiently allocating costs according to cost causation. StarTrack uses Australia Post's parcel and letter networks for delivering its peak demand, for

resilience and in case of incidents. Such streams tend to use peak capacity and not average capacity of Australia Post's networks. Peak capacity costs are higher than average capacity costs. Therefore Australia Post should implement more incremental cost elements to determine appropriate transfer prices for StarTrack's use of Australia Post's networks. Allocating more peak capacity costs to StarTrack would also better reflect the cost savings which StarTrack has in stand-alone costs when using Australia Post's networks.

35. Our analysis of Australia Post's cost allocation has identified some approaches where we doubt the reasonableness of the cost allocation benchmarked against efficiency criteria and proper cost causation. These include

- the allocation of unattributable costs;
- the sharing of the additional fixed cost of eDV delivery between letter and parcel services;
- the allocation of linehaul cost;
- the allocation of LPO subsidies only to reserved services;
- the transfer prices, StarTrack has to pay for using Australia Post's network.

These approaches indicate that reserved services get more costs allocated than would be appropriate under efficient cost causation principles. Because the EPM does not allow an external user of the model to simulate the financial impact of such structural changes on the cost allocated to a particular service (group), we were not able to quantify the impact of these distortions on the overall costs of reserved services. Nevertheless, we have doubts that correcting for these distortions would make reserved services profitable (without the intended price changes).