

Assessing Australia Post's  
allocation of costs between  
(and within) reserved and  
non-reserved services

**NON-CONFIDENTIAL SUMMARY**

Authors:  
Alex Dieke  
Antonia Niederprüm

WIK-Consult GmbH  
Rhöndorfer Str. 68  
53604 Bad Honnef  
Germany

Bad Honnef, 29 May 2008

## 1 Background and objective

This report was prepared in April/May 2008 for the Australian Competition and Consumer Commission (ACCC).

The objective of this report is to assess the approach used by Australia Post to allocate its costs between different services, with particular attention to reserved (and notified) services. The ACCC's project specification limits the scope of this report to the allocation of "direct costs". These costs account for the largest proportion of those costs shared between the reserved and non-reserved services.

Unless stated otherwise, all financial information analysed for this report, and presented in the report, relates to financial year 2006/07.

## 2 Terminology and information contained in the RAPM

A first observation of this report is that the Australia Post's Regulatory Accounting Procedures Manual (RAPM) uses a terminology for cost categories (e.g. direct and indirect costs) that is quite different from the categories set out by the ACCC's Record Keeping Rules (RKR). In its annual regulatory accounts, Australia Post uses the categories set out by the RKR, but it is unclear how they are aligned to the categories described in the RAPM. This confusing use of different terminologies impedes transparency and we recommend a standardised terminology be established between the ACCC and Australia Post.

Another initial conclusion from the analysis of the RAPM is that the information provided in this manual is not sufficient to explain how the regulatory accounts have been drawn up. In particular, the RAPM does not explain how activities relate to individual services nor to reserved services on a summary level. It does not explain, on the level of activities, how activity costs are allocated to products.

However, such information is crucial for the ACCC to assess the allocation of shared costs to reserved services. We therefore recommend such information should regularly be included into the RAPM. This should include information on the factor values used to allocate activity costs to services, for both direct and indirect costs. We recommend such information be made available to the ACCC regularly as this would allow the Commission to scrutinise consistency of allocation factors over time.

### **3 Assessment of Australia Post's general approach to cost allocation**

Australia Post produces its regulatory accounts using a fully distributed cost methodology, and seeks to allocate shared costs according to the principle of cost causation (ABC: activity based costing). The approach to allocating shared cost is particularly important in postal services. The vast majority of total costs are shared costs, and most of them relate to reserved (and notified) services. We estimate that the amount of Australia Post's costs that are shared between reserved and other services is at least \$2.7 billion, or two thirds of the total cost of Australia Post.

In general, the ABC approach adopted by Australia Post is in line with cost allocation practices of other regulated postal companies. However, and with respect to producing relevant information to be provided to the ACCC, we see one important shortcoming in Australia Post's approach: activity costs are fully distributed to products without distinguishing between fixed or variable cost (with respect to variations in mail volume). This appears problematic because causal relationships between costs and volumes can be identified only for variable cost, not for fixed cost. Consequently, Australia Post's approach to cost allocation seems less appropriate – and less transparent than would be useful – for those activities that involve a high degree of fixed costs (e.g. parts of outdoor delivery).

While Australia Post's approach appears appropriate for many activities where costs are predominantly volume-variable, the methodology could be improved for those activities where a substantial portion of costs does not vary with volume. For those activities, a more explicit analysis of fixed costs should be used to determine Australia Post's factor values. In addition, more cost-reflective allocation would be possible for some activities if different "sub-activities" were analysed separately. This appears most important for outdoor delivery which is the activity that incurs the highest cost (17.8 per cent of all direct cost shared between reserved and non-reserved products).

### **4 Assessment of allocation of direct costs to services**

For (most) joint direct costs, Australia Post has provided information on the cost of each activity, and values of the factors used to allocate these costs to products, (this was agreed during a meeting held with Australia Post on 22 April 2008). More precisely, Australia Post made available detailed information about the allocation of joint direct cost to products for 73 activities. 56 of these activities are relevant to reserved services.

We have reviewed in detail the procedures Australia Post employs to allocate the costs of five selected activities to services. The direct costs of these five activities account for \$779 million, approximately 19 per cent of Australia Post's total costs.

Australia Post's general approach of combining volumes with factors that measure the relative hardship of processing different postal articles appears appropriate. However, a number of concerns emerge from this review:

- The documentation on the exact scope of activities for which costs are reported, as well as the considerations underlying the factors used for cost allocation in the RAPM, do not appear sufficiently informative in many instances.
- Related to the allocation of cost from set-up and sequencing (activity 1560) a minor concern is that express items appear not to be charged the cost for specific documentation (removal of barcodes). This could mean that other services, including reserved services are overcharged.
- The crucial factor for the allocation of the costs of outdoor mail delivery (activity 1630) is called GENWGT1. The values for this factor for small parcels (delivered with the mail), express "Platinum" products, and registered items appear rather low. It is conceivable that these concerns could be resolved if more substantiated information on Australia Post's operations was available.
- Activity 2550 (sorting of inward mail in licensed post offices) again uses the factor GENWGT1 for allocating costs to products. Our review raises important concerns about the appropriateness of the factor for this activity: Using the same factor for very different processes like processing and delivery cannot be cost-reflective.
- The factor GENWGT1 is used to allocate a total of \$490m, more than ten per cent of Australia Post's total cost. Further evidence to be presented by Australia Post is needed to provide reassurance about the adequacy of the values determined for this factor.
- In determining allocation factors for activity 6020 (contracted roadside delivery), Australia Post has sought to avoid "over costing" for one class of products: unaddressed. While we acknowledge the difficulty Australia Post faces in allocating the cost of an activity that is largely fixed, Australia Post has not presented any consistent approach to doing this. Overall, the allocation of the costs of this activity appears arbitrary; and this critical issue has not been addressed in the RAPM.
- Australia Post generally allocates the cost of interstate transport based on the weight of each product and this approach adequately reflects cost causation. However, it seems possible to allocate transport costs more cost-reflectively if the costs of different modes of transport (road, passenger aircraft and air freighter) were allocated separately in the accounts – which Australia Post (according to the RAPM) does not. The crucial factor for allocating the costs of domestic interstate air transport (activity 6140) is "AIRPR3\*". This factor aims at reflecting "the relative cost depending on the type of air service utilised". It needs to reflect simultaneously

many different product features, including 1) the extent to which a product is transported by each mode of transport; 2) the likelihood of products classified as “air mail” to require being transported by each mode of transport; and 3) the different cost of the three modes of transport. The factor appears unnecessarily complex and we consider the evidence presented by Australia Post to support determination of values for it inadequate. Given the large differences of per unit cost for transportation by road versus air freighter, and the presumption that express items use more expensive modes of transport, the factors for express items appear relatively low. This could mean reserved services are overcharged for the cost of air transport to the benefit of express services. In order to make sure reserved services do not contribute overly to the cost of interstate air transport, we recommend the ACCC should request further evidence to support factor values for AIRPR3\*.