Australian Competition & Consumer Commission

Australia Post price notification for its 'ordinary' letter service February 2014

ACCC Decision

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

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Glossary

ABC	Activity Based Costing
ACCC	Australian Competition and Consumer Commission
Australia Post	Australian Postal Corporation
APCA	*Australian Postal Corporation Act 1989*
BPR	Basic Postage Rate, which is the price of posting an ‘ordinary’ small letter
Capital costs	The sum of a return on capital commensurate with the risks faced by the business plus the depreciation of the regulatory capital base
CCA	*Competition and Consumer Act 2010*
CPI	Consumer Price Index
CSO	Community Service Obligation
MAR	Maximum allowable revenue—the amount of revenue a regulated firm should receive that recovers all efficient costs plus a reasonable return on its capital
Operating costs	Non-capital costs
PTRM	Post tax revenue model—this is the form of the financial model used by the ACCC to model the cash flows of a regulated firm
Return of capital	Depreciation
Return on capital	The amount of revenue that an investor would require as compensation for the opportunity cost of funding its capital base, calculated by multiplying the WACC by the depreciated regulatory capital base
WACC	Weighted average cost of capital, which is the reasonable rate of return allowed, given the relative level of risk associated with the capital base, averaged across debt and equity funding

Summary

ACCC's decision

The Australian Competition and Consumer Commission (ACCC) has decided to **not object** to Australia Post's proposed price increases for 'ordinary' letter services, including an increase in the basic postage rate from 60 cents to 70 cents.

On 31 January 2014, the Australian Postal Corporation (Australia Post) provided the ACCC with a price notification proposing to increase the prices of its 'ordinary' letter services, with the key change being a 10 cent increase in the price of posting a small letter (the Basic Postage Rate, or BPR), from 60 cents to 70 cents, from 31 March 2014.[1] The last time the BPR was increased was June 2010. The proposed price increases are outlined at Appendix A.

Australia Post has also informed the ACCC that it is introducing a concessional stamp rate for Australian Government concession card holders, set at 60 cents. However, the ACCC does not consider the concessional stamp rate to be a 'notified service' pursuant to *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2011*, and as such it is not subject to the price notification provisions in section 95Z of the *Competition and Consumer Act 2010* (CCA).

Under Part VIIA of the CCA, Australia Post is required to formally notify the ACCC of proposed increases to charges for its 'ordinary' reserved services.[2] Under the CCA, the ACCC has 21 days to assess the proposal. While in the past Australia Post has generally submitted draft price notifications to the ACCC, allowing the ACCC to consult on and assess price increase proposals over a longer time frame, Australia Post has not provided a draft price notification to the ACCC in this instance. In these circumstances, the ACCC has undertaken a high level review of the proposal within the statutory 21-day period, to assess whether the proposed price increases are likely to result in Australia Post recovering more than an efficient level of costs and return.

Australia Post submits that a combination of declining letter volumes and fixed costs from its community service obligations (CSOs) is resulting in growing losses incurred by its domestic reserved letter service. Australia Post submits that the proposed price increases will temporarily reduce the size of these losses, but that even with the price

[1] Australia Post's submission is available on the ACCC's website, at http://accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2014/notification-lodged.

[2] In 2011, the Australian Government limited prices surveillance of Australia Post's letter services from all of Australia Post's reserved services to its reserved 'ordinary' letter service. Reserved 'ordinary' letter services are currently offered at three postage rates – currently 60c for small letters (the basic postage rate), $1.20 for large letters up to 125 grams and $1.80 for large letters over 125 grams and up to 250 grams. The other services currently reserved to Australia Post are no longer 'notified' (refer *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2011*).

increases, Australia Post is forecasting an under recovery of approximately $313 million for the domestic reserved letter service in 2014-15.[3]

As part of its high level review, the ACCC has undertaken sensitivity testing based on Australia Post's submitted financial model.

The ACCC has restricted its consideration of the price increases to the likely effects on Australia Post's levels of cost recovery in 2013-14 and 2014-15. In other circumstances, it may be appropriate to take a longer-term view. However, the approach adopted takes into account the uncertainty surrounding longer-term letter volume forecasts (including the difficulty in estimating the impacts of price and electronic substitution on future letter volumes) and Australia Post's submission that the proposed price increases are just one part of a broader strategy to improve productivity and provide a sustainable letter service.

Australia Post has forecast an average annual volume decline of 6.7 per cent for its reserved services over the two years to 2014-15. Australia Post's demand forecasts take into account the expected downward impact on letter volumes of Australia Post's proposed price increases. However, this impact is less than the impact of electronic substitution on letter volumes. For the purposes of its sensitivity testing, the ACCC has modelled Australia Post's revenues on the 2013-14 and 2014-15 reserved services volume forecasts, which are contained in its supporting submission and Corporate Plan, given that they are broadly consistent with recent trends.

While the ACCC accepts Australia Post's claim that the proposed price increases are still likely to result in Australia Post under recovering its costs, Australia Post's estimates may overstate the extent of the under recovery of efficient costs. In the limited time available, the ACCC has not been able to form a view on the efficiency of Australia Post's cost base as part of its assessment.

Australia Post expects its costs for reserved services to increase by 3.9 per cent and 1.2 per cent in 2013-14 and 2014-15 respectively. As demonstrated by the ACCC's sensitivity analysis, Australia Post's under recovery would still be over $200 million in 2013-14 and 2014-15[4] (after the proposed price increases) under alternative assumptions regarding the appropriate contribution of shared costs to reserved services and the rate of return. Even under these alternative assumptions, Australia Post's operating costs would need to fall in real terms by around 15 per cent from 2012-13 to 2014-15 in order for domestic reserved services to break even.

Given the magnitude of the forecast under recovery of reserved services costs, the ACCC considers Australia Post is unlikely to recover more than an efficient level of

[3] This estimate of under recovery is based on Australia Post's submitted Post Tax Revenue Model (PTRM), which is an economic financial model (which includes capital costs) that is used by the ACCC to assess the extent to which Australia Post's proposed price increases are expected to recover efficient costs. This financial information from the PTRM differs from some other estimates provided by Australia Post, which are based on operating costs only. The ACCC has used the PTRM throughout this decision when making comments about the level of under recovery that is being forecast for Australia Post's reserved services. Further details about the ACCC's assessment of Australia Post's PTRM are detailed in Chapter 6 of the ACCC's decision.

[4] Australia Post is forecasting reserved services under recoveries of $289 million and $313 million in the respective years (refer Chapter 6), prior to the ACCC's sensitivity testing. The testing involves (i) an alternate WACC and also (ii) a lower attribution of shared costs to reserved services.

costs and return. As such, the ACCC has decided to not object to the proposed price increases to ‘ordinary’ reserved letters. The ACCC’s reasons and its analysis of the proposal are contained in this decision.

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

1 Introduction

On 31 January 2014, the Australian Postal Corporation (Australia Post) provided the Australian Competition and Consumer Commission (ACCC) with a price notification proposing a 16.7 per cent increase in its 'ordinary' letter service, effective 31 March 2014. The key price change proposed is a 10 cent increase in the 'ordinary' small letter price (the basic postage rate - BPR) from 60 cents to 70 cents.

Australia Post has also submitted that with the introduction of the price change it is introducing a 60 cent stamp to Australian Government concession card holders which will be held at this level until 2017 to protect disadvantaged members of the community from the proposed increase to 'ordinary' letter prices. However, the ACCC does not consider the latter to be a 'notified service', pursuant to *Price Notification Declaration (Australia Post Letter Services (No. 2) 2011)* and as such it is not subject to the price notification provisions in section 95Z of the CCA.

The ACCC takes a consultative approach to its assessment of price notifications, and on 31 January 2014 through a document posted on its website sought the views of industry and consumer stakeholders on Australia Post's 2014 price notification proposal.

The ACCC received 658 submissions from major mail users (including Printing Industries Association of Australia and Mailing House), Licensed Post Offices (LPOs), other businesses and members of the public. These submissions include around 650 submissions from LPOs, almost all of which used a standard form submission. The submissions are available on the ACCC's website. The ACCC has considered these submissions in its assessment of Australia Post's 2014 price notification.

1.1 Australia Post's 2014 price notification

The particular services affected by Australia Post's proposal are its reserved 'ordinary' letter services.[5] 'Reserved' services are those services in respect of which Australia Post has a legislated monopoly. The price increase proposal includes the BPR and two large letter prices. The price increases are set out in Table 1.1.1 below:

Table 1.1.1 Australia Post's proposed prices

	Current Price	Proposed Price	Increase %
'ordinary' small letter	$0.60	$0.70	16.7%
'ordinary' large letter			
- Up to 125g	$1.20	$1.40	16.7%
- Over 125g up to 250g	$1.80	$2.10	16.7%

[5] Australia Post has also indicated it is proposing to increase the price of its non-reserved 'ordinary' large letters over 250 grams and up to 500 grams which are not subject to price notification requirements under Part VIIA of the CCA.

In addition, Australia Post has submitted that with the introduction of the price change it is introducing a 60 cent stamp to Australian Government concession card holders which will be held at this level until 2017 to protect disadvantaged members of the community from the proposed increase to 'ordinary' letter prices. The ACCC does not consider the concessional stamp rate to be a 'notified' service and as such is not subject to the price notification provisions in section 95Z of the CCA. Australia Post has also identified a number of price changes it is proposing for its 'PreSort' and 'other' reserved services. These letter services (generally used by business, government agencies and not-for-profit organisations) are offered at prices lower than the equivalent 'ordinary' letter services and are not subject to ACCC prices surveillance.

According to Australia Post, the proposed price changes for its reserved 'ordinary' letter services will generate around an additional $95 million in 2014-15 in revenue, which will partially offset the under recovery on its 'ordinary' letter services.[6] However, in 2014-15 Australia Post is still forecasting an under recovery on its reserved letter services of $313 million even with the proposed price increases.[7]

This estimate of under recovery is based on Australia Post's submitted Post Tax Revenue Model (PTRM) which is an economic financial model (which includes capital costs) that is used by the ACCC to assess the extent to which Australia Post's proposed price increases are expected to recover efficient costs.[8]

In addition to the proposed price increases, Australia Post's price notification provides information about its plan to improve the delivery timetable for some of its business letter services (PreSort 'surface' mail).[9]

1.2 The ACCC's approach to assessing Australia Post's price notification

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

Australia Post's 'ordinary' letter services have been declared by the Minister (Treasurer) to be 'notified services' and Australia Post to be a 'declared person' in relation to those notified services pursuant to section 95X of the CCA.[10] As a result of this declaration, before increasing the prices of 'ordinary' letters, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a locality

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[6] Australia Post, *Supporting Statement: Changes to Australia Post's Ordinary Letter Service 31 January 2014* (Australia Post's supporting submission), p. 11.

[7] Refer Table 6.1.1.

[8] This financial information from the PTRM differs from some other estimates provided by Australia Post, which is based on operating costs only. The ACCC has used the PTRM throughout this decision when making comments about the level of under recovery that is being forecast for Australia Post's reserved services. Further details about the ACCC's assessment of Australia Post PTRM are detailed in Chapter 6 of the ACCC's decision.

[9] Australia Post's supporting submission, pp. 13, 33.

[10] Refer to the *Price Notification Declaration (Australia Post Letter Services) (No.2) 2011*, made under section 95X of the CCA.

notice.[11] The ACCC will then assess the proposed increases and decide whether to object or not object to the proposed charges.

The operation of the legislative framework and the ACCC's approach to assessing price notifications are outlined in Chapter 2. A more detailed explanation is contained in the ACCC's *Statement of Regulatory Approach to Assessing Price Notifications, June 2009*, which is available on the ACCC's website at http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications.

The ACCC customarily adopts a cost-based approach to assessing prices notifications under Part VIIA of the CCA. The appropriateness of proposed prices is considered by assessing the extent to which they are forecast to recover efficient costs, including an appropriate rate of return.

1.2.1 Submissions

In reaching its decision on Australia Post's price notification, the ACCC has carried out a public consultation process. On 31 January 2014, through a document posted on its website, the ACCC sought the views of industry and consumer stakeholders on Australia Post's 2014 price notification proposal. The ACCC received 658[12] submissions from mail users (including Printing Industries Association of Australia and Mailing House), LPOs, other businesses and members of the public. The ACCC has taken these submissions into account in its assessment of Australia Post's price notification.

A number of these submissions identified that in the past Australia Post has submitted a draft price notification to the ACCC, allowing the ACCC to consult on and assess price increase proposals over a longer time frame. Australia Post has not provided a draft price notification to the ACCC in this instance. In these circumstances, the ACCC has undertaken a high level review of the proposal within the statutory 21-day period, in order to assess whether the proposed price increases are likely to result in Australia Post recovering more than an efficient level of costs and return on capital.

1.3 Confidentiality

During the course of the ACCC's assessment of Australia Post's price notification, Australia Post has provided the ACCC with supporting information that it considers to be commercial-in-confidence. The ACCC has had regard to this information in conducting its assessment and there are aspects of the ACCC's decision which refer to this information to support its views regarding elements of Australia Post's proposal.

1.4 Structure of the ACCC's decision

The legislative framework and the approach undertaken by the ACCC in applying the legislative criteria are outlined in Chapter 2—Legislative Framework and Regulatory Approach.

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

[12] These submissions include around 650 submissions from LPOs, almost all of which used a standard form submission.

The reasons for the ACCC's decision are outlined in Chapters 3–7 and include:

- **Chapter 3 – Cost allocation**
- **Chapter 4 – Operating costs**
- **Chapter 5 – Demand**
- **Chapter 6 – Financial model**
- **Chapter 7 – ACCC's decision**

2 Legislative framework and regulatory approach

This section outlines the legislative framework relevant to the ACCC's assessment of Australia Post's price notifications, and the ACCC's approach in applying the legislative framework to its assessment of Australia Post's price notifications.

The relevant legislative instruments are attached at Appendix B.

2.1 The ACCC's role in the regulation of postal services

The ACCC has three specific responsibilities in the regulation of postal services. These are:

- monitoring for the presence of cross subsidies between Australia Post's reserved and non-reserved services[13]
- assessing proposed price increases for Australia Post's notified reserved services (assessing price notifications)[14]
- inquiring into certain disputes regarding the terms and conditions under which Australia Post supplies bulk mail services**.**[15]

2.1.1 The ACCC's role in assessing price notifications

The price notification provisions are contained in Part VIIA of the CCA and apply only to 'notified services' and 'declared persons'.

On 18 October 2011, the Treasurer made the *Price Notification Declaration (Australia Post Letter Services) (No.2) (2011)* (the current declaration) under section 95X of the CCA.[16] The purpose of the current declaration was to limit notified services to the basic postage rate and certain letter services (such as 'ordinary' letters), and to exclude business letter services (such as 'PreSort' and certain 'other' letters).[17] Under the current declaration, Australia Post is a declared person.[18]

Under previous declarations, prices surveillance applied to all letter services reserved to Australia Post under Division 2 of Part 3 of the *Australia Postal Corporation Act 1989*.[19]

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[13] This cross subsidy monitoring is undertaken through the use of information provided pursuant to a record keeping rule issued by the ACCC under Section 50H (2) of the *Australian Postal Corporation Act 1989.*

[14] Sections 95X and 95Z of the CCA.

[15] Paragraph 32B(1)(a)(i) of the *Australian Postal Corporation Act 1989*.

[16] The declaration came into effect on 2 November 2011 and ceases to have effect on 1 August 2016, unless revoked earlier.

[17] Explanatory Statement to the *Price Notification Declaration (Australia Post Letter Services) (No.2) 2011*.

[18] Clause 5(4) of the *Price Notification Declaration (Australia Post Letter Services) (No.2) 2011*.

[19] In 1992, Australia Post's reserved services were declared by the Treasurer to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the *Prices Surveillance Act 1983*. The declaration prior to the current declaration, *Price Notification for*

Prior to increasing the prices of notified services, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a locality notice notifying of the proposed price increase and the terms and conditions of supply. As set out in section 95ZB of the CCA, there is an 'applicable period' (also known as the price-freeze period) of initially 21 days within which the ACCC is to make its assessment, starting on the day on which the locality notice was lodged.[20] The price-freeze period ceases when:

- the ACCC advises it does not object to the proposed price increase; or
- Australia Post agrees to implement a lower price specified by the ACCC; or
- the 'applicable period' expires.

However, in order to enable the ACCC to form a view on price notifications taking account of the views of industry stakeholders and interested parties, the ACCC usually conducts an informal assessment of a draft price notification proposal lodged by a declared person prior to the lodgement of a locality notice.

Section 95ZH of the CCA enables the Minister to direct the ACCC to give special consideration to specified matters in performing its functions under Part VIIA of the CCA. In 1990, the Minister issued Direction 11[21] requiring the ACCC to give special consideration to, amongst other things:

> Australia Post's obligation to pursue a financial policy in accordance with its corporate plans…and in particular the pricing targets and Government endorsed financial targets contained in Australia Post's corporate plan; and
>
> The functions and obligations of Australia Post as set out in sections 14-16 and 25-28 of the Australian Postal Corporation Act 1989 and to such directions or notifications given to Australia Post by the Minister for Transport and Communications under that Act as may from time to time be in force;

The functions and obligations of Australia Post referred to above include its Community Services Obligations (CSOs).

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

Appendix B of this ACCC decision provides the current Declaration and Ministerial Directions that the ACCC must consider in assessing Australia Post's price notifications.[22]

Australia Post's reserved services (which came into effect in February 2011 and was revoked on 2 November 2011), was of similar effect to the 1992 declaration.

[20] Pursuant to subsection 95ZB(2) of the CCA, the ACCC may specify a longer price-freeze period with the consent of the declared person. In circumstances where the ACCC has given a response under subsection 95Z(6)(c), the period is also extended by 14 days.

[21] Dated 14 September 1990, made under section 20 of the *Prices Surveillance Act 1983*.

[22] Declarations and other instruments made under the *Prices Surveillance Act 1983* have been carried over to have effect as if made under the corresponding section of the TPA and subsequently the CCA (see *Trade Practices Legislation Amendment Act 2003*).

2.2 Regulatory approach

The ACCC has considered the relevant legislative criteria contained in subsection 95G(7) of the CCA, and Direction 11 in assessing this price notification. Subsection 95G(7) provides the ACCC must have regard to the following matters:

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

The ACCC has had regard to these matters insofar as they are relevant to the current price notification. The ACCC notes Australia Post did not provide information in its submission to address these matters.

The ACCC considers subsection 95G(7) and Direction 11 steer it towards an assessment of the efficiency of Australia Post's cost base, and of the rate of return it is seeking. Prices have then been assessed on their ability to achieve total revenue sufficient to recover the total cost of providing an efficient service, including a rate of return commensurate with the risks faced by Australia Post, without achieving excessive or monopoly profits.

The cost-based approach typically used by the ACCC to inform its price assessments is the building block model, under which the total required revenue for the efficient service is based on the following formula:

required revenue = *operating costs + capital costs + tax*

where:

capital costs = *a return on capital + depreciation of the regulatory capital base*

and:

return on capital = *rate of return on capital commensurate with the risks faced by the business * regulatory capital base*

The ACCC generally applies a building block model of the post-tax revenue form (PTRM) to inform its view on whether or not the proposed price increases are expected to recover the efficient costs of providing the declared services.

The PTRM is applied in the context of Part VIIA of the CCA. Given the PTRM's specificity, it is not identical to that applied in other industries. In particular, while the formulation of the model is similar, the lack of a fixed regulatory period under Part VIIA of the CCA means that efficiency benefit sharing schemes are difficult to implement.

2.2.1 Different regulatory approaches to assessing pricing for reserved services

For a firm that provides non-regulated services in addition to its regulated services, the efficient cost base for providing the regulated services may be influenced by the concurrent provision of non-regulated services. The sharing of some costs jointly incurred in the provision by Australia Post of both reserved and non-reserved services introduces considerations about the application of the building block model and how these costs should be recovered through prices under a cost-based approach.

The ACCC has historically applied a 'dual-till' regulatory pricing approach for Australia Post. In assessing Australia Post's 2002 price notification the ACCC decided to adopt a 'dual-till' approach to assessing Australia Post's reserved services prices. This approach was maintained by the ACCC in assessing Australia Post's 2008, 2010 and 2011 price notifications.

Under this approach, Australia Post's shared costs must be separated into the portion used in providing the reserved services and the portion used in providing the non-reserved services. This allows the building block model to be applied specifically to the reserved component of Australia Post's business.

If a 'single-till' approach is to be applied, no such separation is made, and the building block model is applied using costs incurred in the provision of both reserved and non-reserved services. The appropriateness of the regulated prices would then be assessed by reference to the extent to which the regulated business can recover its total costs of both reserved and non-reserved services.

2.2.2 ACCC's regulatory approach for assessing the 2014 price notification

The ACCC in its decision on Australia Post's 2010 price notification noted that an environment of declining demand for letter services raises questions as to what the appropriate approach to the pricing of Australia Post's reserved services should be.[23] The ACCC and Australia Post also agreed in 2011 that the current approach to assessing prices needs to be re-examined before considering another major price notification.[24] Such a re-examination would include a consideration of whether to maintain the current dual-till approach or move towards a single-till approach.[25]

In 2013-14, notified services[26] (i.e. 'ordinary' letters) are forecast to account for only around 12 per cent of Australia Post's revenue, while the broader category of reserved services are forecast to account for around 27 per cent of Australia Post's total forecast revenue.[27]

As such, a significant proportion of Australia Post's services are provided in markets where competitive pressure on Australia Post may already exist, and in markets that are not subject to Australia Post's statutory monopoly (i.e. non-reserved services). To the extent that these markets are competitive, market forces should already constrain Australia Post from incurring costs inefficiently in many (non-reserved) areas in which it operates. Further, given that under a single-till approach declared services prices would be based on Australia Post's overall profitability, such an approach would have

[23] ACCC, Decision on Australia Post's 2010 price notification, p. 4.
[24] ACCC, Decision on Australia Post's 2011 bulk mail price notification, p. 5.
[25] ACCC, Decision on Australia Post's 2010 price notification, p. 104.
[26] Those services subject to the price notification requirements.
[27] Calculation based on Table 13 and Appendix 3 of Australia Post's supporting submission.

the effect of penalising Australia Post for high profitability in non-regulated (including competitive) areas, and this may distort Australia Post's incentives.

Therefore the ACCC is assessing this price notification based on a 'dual-till' regulatory pricing approach, whereby the appropriateness of the proposed prices is assessed with reference to a building block model applied to the costs and revenues of overall reserved services.[28]

[28] Reserved services include business mail services that are not notified services but are provided at a discount to the notified 'ordinary' letter services prices. Accordingly, these services are implicitly subject to some price regulation – under the ACCC's 'dual-till' pricing approach, the costs and revenues of overall reserved services determine Australia Post's maximum allowable revenue (MAR). In addition, to the extent that some of these services are provided at a discount to the notified 'ordinary' letter services prices, the prices of the notified services should form an upper limit on the prices of business services.

3 Cost allocation

Key points

- The ACCC has recently completed a limited review of Australia Post's cost allocation methodology (CAM), which focused on the allocation of non-operational (indirect) costs to reserved services. This review did not identify any systematic bias in Australia Post's CAM that would likely lead to an inappropriate allocation of non-operational costs to reserved services.
- After considering the results of recent ACCC reviews of Australia Post's CAM (which also included a 2009 review focussed on direct costs) the ACCC has used the financial information produced by Australia Post's CAM in its consideration of this price notification.

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

As outlined earlier in section 2.2.2, the allocation of costs between Australia Post's reserved and non-reserved services is relevant to the ACCC's 'dual-till' assessment of Australia Post's price notification. The assessment involves determining if an appropriate separation has been made between the costs of providing reserved and non-reserved services for the purpose of comparing the forecast revenues from the proposed prices with the efficient costs of providing reserved services. The allocation of Australia Post's costs between its various services is performed by applying its cost allocation methodology (CAM).

3.1 Consideration of cost allocation issues in recent ACCC decisions

The ACCC has considered Australia Post's CAM in a number of recent price notification decisions.

In its assessment of Australia Post's 2008 price notification, the ACCC engaged WIK Consult to assess Australia Post's CAM. In its report, WIK Consult expressed some concerns about Australia Post's methodology.[29] In light of these concerns, the ACCC decided that Australia Post's CAM required a review before Australia Post provided the ACCC with any further price notifications.

The ACCC undertook a review of Australia Post's CAM in 2008-09. As a result of this review, which was primarily focused on Australia Post's direct costs, there has been an

[29] WIK Consult. '*Assessing Australia Post's allocation of costs between (and within) reserved and non-reserved services, non-confidential summary', May 2008* available at http://www.accc.gov.au/system/files/20080529_wik_AustraliaPost_CostAllocation_Summary.pdf

improvement in the transparency of Australia Post's regulatory accounts.[30] Australia Post has also addressed a number of the ACCC's concerns about the application of its CAM.

3.1.1 Australia Post's submission

Australia Post submits that its CAM is a fully absorbed costing model that allocates costs to products and services via the following main principles: [31]

- All products and services are charged appropriately with the costs of the enterprise
- Activity based costing is used as the appropriate cost allocation methodology. Resources (cost inputs) perform activities (the doing things). Activities are used by products and services
- Direct attribution of costs to products is conducted, wherever possible
- Sound allocation rules based on the best available data are employed where direct attribution is not possible.

Australia Post submits that its CAM is robust and relevant and that product volume is the dominant cost driver in the model. Australia Post submits that its CAM inherently increases the cost burden for products experiencing volume growth and lessens the burden for products in decline. According to Australia Post, under a 'dual till' regulatory model this ensures that as reserved services letter volumes decline an increasing proportion of Australia Post's total costs are borne by its non-reserved services that are subject to competition. [32]

According to Australia Post, the CAM has safeguards to avoid over-costing declining products with reserved service letter products bearing less of the fixed cost burden of the network over time. [33]

Australia Post has also advised the ACCC that it now (since 2010) uses its ABC (activity-based costing) system and CAM for its own management decision making and financial reporting, as well as for the ACCC's regulatory purposes i.e. for price notification assessments and to produce annual regulatory accounts for cross subsidy monitoring purposes. Previously, the ABC system and CAM were predominantly used for ACCC regulatory purposes.[34]

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[30] Australia Post submits annual regulatory accounts to the ACCC which it uses in its role of monitoring for the presence of cross subsidies between Australia Post's reserved and non-reserved services. This occurs under the Record Keeping Rules establishing a regulatory accounting framework for Australia Post issued under s 50H of the *Australian Postal Corporation Act 1989,* 30 March 2005.

[31] Australia Post's supporting submission, p. 20.

[32] Australia Post's supporting submission, p. 21.

[33] Australia Post's supporting submission, p. 21.

[34] Information provided to ACCC staff at November 2013 cost allocation workshop convened by Australia Post

3.2 The ACCC's view on Australia Post's CAM

The ACCC in its decisions on Australia Post's 2010 and 2011 price notifications noted that an environment of declining demand for letter services raises questions as to what the appropriate contribution towards shared costs by reserved services needs to be.[35]

In light of these concerns, the ACCC has recently undertaken a limited review of Australia Post's CAM. The primary objective of this review was to consider whether the ACCC could rely on the financial information produced by Australia Post's CAM for the purposes of considering this price notification.

As part of the ACCC's review of Australia Post's CAM, Australia Post provided the ACCC with a number of detailed presentations on the operation of its CAM together with other supporting information provided to the ACCC on a commercial-in-confidence basis.

The ACCC notes that Australia Post now has sufficient confidence in its CAM to use it for internal budgeting and management decisions as well as for ACCC regulatory purposes.

Given that the ACCC had in 2009 undertaken a review primarily focussed on Australia Post's allocation of direct costs to reserved services, the ACCC's current review of Australia Post's CAM has mainly focused on Australia Post's allocation of non-operational (indirect costs) to reserved services.

Australia Post has forecast that in 2013-14 its non-operational costs will total around $1.4 billion, which represents around 23 per cent of Australia Post's total costs. The allocation of non-operational costs to reserved services will total $440 million.[36]

Overall, the ACCC's assessment, on the basis of the information provided by Australia Post about its non-operational costs, is that while Australia Post's CAM is continuing to improve there is still some capacity for further improvements in the use of cost drivers within the CAM. For example:

- Australia Post appears to effectively use the same approach to cost allocation for some direct and indirect activities. If the nature of cost incurrence is similar for both direct and indirect activities, such a practice may be appropriate. However, cost incurrence between direct and indirect activities is more likely to be different and therefore such a practice may not be cost reflective.
- For some of Australia Post's indirect activities, Australia Post currently allocates costs to reserved and non-reserved services based on the relative number of 'transactions' undertaken. However, if the time taken to perform each transaction is very different, an allocation based on the relative frequency of transactions may not be reflective of the actual costs that are attributable to reserved and non-reserved services.

Notwithstanding the above, the ACCC did not consider there was evidence of any systematic bias in Australia Post's CAM that would likely lead to an inappropriate allocation of non-operational costs to reserved services.

[35] ACCC, Decision on Australia Post's 2011 bulk mail price notification, p. 3.
[36] Australia Post's response to ACCC information request dated 12 November 2013.

In light of the above, and considering the results of the recent ACCC reviews of Australia Post's CAM, the ACCC has used the financial information produced by Australia Post's CAM in its consideration of this price notification. As a materiality check, the ACCC has undertaken some sensitivity testing based on a hypothetical assumption that improvements in the CAM, in particular the use of cost drivers may lead to a 10 per cent reduction in the allocation of non-operational costs to reserved services, which would lead Australia Post's reserved services costs to be over-stated by around $44 million in 2013-14 and 2014-15.

Given the level of losses forecast by Australia Post on its reserved services, such an adjustment would still suggest an under recovery of reserved services costs of over $200 million in 2013-14 and 2014-15.[37]

[37] The estimates of under recovery are based on ACCC calculations which include an adjustment for an alternative WACC which is discussed further in Chapter 6 of this decision.

4 Australia Post's operating costs

Key points

- Australia Post expects its costs for reserved services to increase by 3.9 per cent and 1.2 per cent in 2013-14 and 2014-15 respectively.
- In the limited time available, the ACCC has not been able to form a view on the efficiency of Australia Post's cost base as part of its assessment.
- As demonstrated by the ACCC's sensitivity analysis, even under alternative assumptions regarding the appropriate contribution of shared costs to reserved services and the rate of return (outlined in Chapter 6), Australia Post's operating costs would need to fall in real terms by around 15 per cent from 2012-13 to 2014-15 in order to break even. As such, given the magnitude of the forecasted under recovery of reserved services costs, Australia Post is unlikely to recover more than an efficient level of costs and return.

4.1 Background

4.1.1 The ACCC's approach to assessing Australia Post's costs

As outlined in section 2.2, the ACCC generally adopts a cost-based approach to assessing price notifications under Part VIIA of the CCA. Under this approach, prices that lead to a recovery of efficient costs of providing reserved services (but do not result in an over recovery) will typically ensure that Australia Post has:

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

The ACCC applies a building block model in conducting its assessment of Australia Post's forecast costs. The cost components of the building block methodology are:

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

This chapter outlines the ACCC's consideration of Australia Post's reserved services costs, and the sensitivity testing undertaken as part of the ACCC's high level review.

Australia Post's submitted reserved services operating costs account for over 90 per cent of Australia Post's reserved services cost base, and thus constitute the key component of Australia Post's maximum allowable revenue (MAR).[38]

The ACCC's sensitivity testing in relation to Australia Post's return on capital is outlined in section 6.2.1.

[38] Calculation based on Australia Post's submitted PTRM.

4.2 Australia Post's submission

4.2.1 Australia Post's submitted cost estimates

Australia Post's proposal contains forecasts of its operating costs for 2013-14 and 2014-15. This section provides a summary of that information.

Reserved services costs

Australia Post expects its costs for reserved services to increase by 3.9 per cent and 1.2 per cent in 2013-14 and 2014-15 respectively (see Table 4.2.1). This amounts to a forecast annual average increase of 2.5 per cent per annum over 2013-14 and 2014-15.[39]

Australia Post attributes these increases primarily to increases in labour costs (see below).

Table 4.2.1: Australia Post's cost forecasts – reserved letter service[40]

Category	2012-13 (actual) ($m)	2013-14 ($m)	2014-15 ($m)	Average annual change (%)
Sales / Acceptance		142	157	10.6
Processing ($m)		271	285	5.2
Transport ($m)		143	131	(8.4)
Delivery ($m)		927	939	1.3
Other ($m)		454	448	(1.3)
Total reserved costs ($m)	**1,864**	**1,936**	**1,960**	**2.5**
Annual change in total reserved costs (per cent)	**-**	**3.9**	**1.2**	**-**

Labour costs

Australia Post's forecasts indicate labour costs are the major component of Australia Post's forecast reserved services costs, accounting for around 66 per cent of those costs in 2013-14. Table 4.2.2 displays Australia Post's labour cost forecasts.

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[39] Figures based on information supplied on p. 23 of Australia Post's supporting submission.
[40] Figures based on information supplied by Australia Post to the ACCC in November 2013. The ACCC was not provided with breakdowns of 2012-13 reserved letter costs by category.

Table 4.2.2: Australia Post's labour cost forecasts – reserved letter service[41]

	2012-13 (actual) ($m)	2013-14 (forecast) ($m)	2014-15 (forecast) ($m)	Average annual change (%)
Labour costs	1,260	1,278	1,250	(0.4)
Annual change (%)	-	1.4	(2.2)	-

Superannuation

Australia Post has submitted that its superannuation expense is impacted as a result of changes to accounting standards from 1 July 2013 that affect its defined benefits superannuation scheme (which is now closed to new members).[42] Australia Post has advised that these accounting changes will increase reserved services superannuation expenses in 2013-14 and 2014-15.

'Fixed' costs of meeting CSOs

Australia Post submits that it faces 'fixed operating costs imposed by the existing regulatory framework'.[43] Australia Post submits that its costs are largely fixed due to its obligation to comply with legislated performance standards, which outline the specific timetables, standards and accessibility required of Australia Post. These requirements include, for example, that Australia Post provides next-day letter delivery within metropolitan areas and delivers letters five-days-a-week to at least 98 per cent of all Australian delivery points.[44] Australia Post maintains that the resources required to meet delivery standards continues to grow, as population growth adds up to around 135,000 new delivery points each year.[45] Australia Post submits that its CSO-related standards effectively impose fixed costs on the letters sorting and delivery network.[46]

Economic Insights study commissioned by Australia Post

Australia Post engaged Economic Insights to undertake an econometric analysis of the likely effects of declining mail volumes and declining mail density on Australia Post's future costs. This report[47] is available on the ACCC's website.

Economic Insights have estimated total cost and variable cost functions for Australia Post's key mail centres and its delivery centres. From these cost functions it has derived

[41] Figures based on information supplied to the ACCC by Australia Post in November 2013.
[42] Australia Post's supporting submission, p. 25.
[43] Australia Post's supporting submission, p. 7.
[44] Australia Post's supporting submission, p. 8.
[45] Australia Post's supporting submission, p. 8.
[46] Australia Post's supporting submission, p. 8.
[47] Economic Insights, *Memorandum: Australia Post's Mail and Delivery Centre Cost Elasticities*, February 2014.

cost output elasticities which show the percentage change in costs in response to a one per cent change in output.[48]

Based on Economic Insights' econometric analysis of Australia Post's processing and delivery functions (which it noted combined account for over 80 per cent of Australia Post's operational costs[49]), Economic Insights concluded that the output changes observed in 2011-12 and 2012-13 in isolation would have increased Australia Post's reserved services real operational costs by 0.2 per cent.[50]

International benchmarking studies

In support of its proposed price increases, Australia Post draws on two international benchmarking studies prepared by Economic Insights on behalf of Australia Post in 2009 and 2012.

In its proposal, Australia Post notes the conclusion from the 2009 study:

> 'Australia Post 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.'[51]

The 2012 study was commissioned by Australia Post to update and extend the 2009 results. Australia Post notes that it ranked second for TFP on an unadjusted basis, but when adjustments were made to take account of differences between postal service providers in mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length), Australia Post ranked first.[52]

The 2012 study also concluded that Australia Post showed improvement over the sample period for its unadjusted TFP measure compared with three of the five postal businesses.

4.3 Views of interested parties

The Printing Industries Association of Australia (PIAA) submits that while Australia Post has retained a statutory obligation to deliver letters this has often occurred with little commitment to driving productivity improvements. According to PIAA:

> 'it is a classic example of how a monopoly is able to avoid the implementation of more efficient systems and processes that are demanded under market competition.'[53]

PIAA submits that Australia Post's pricing proposal highlights drops in mail volumes without analysing what can be done to address the situation. PIAA also submits that it suspects that 'other reserved mail services' mail significantly subsidises 'ordinary' mail and that there is insufficient discount in bulk mail rates. PIAA notes, however, that

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[48] In particular, Economic Insights identifies four outputs of processing – culling-franking-cancelling, optimal character reading, bar code sorting and manual sorting; and three outputs of delivery – articles delivered, delivery points and distance covered.
[49] Economic Insights memorandum, *Australia Post's Mail and Delivery Centre Cost Elasticities,* p. 23
[50] Economic Insights memorandum, *Australia Post's Mail and Delivery Centre Cost Elasticities,* p. 23
[51] Australia Post's supporting submission, p. 26.
[52] Australia Post's supporting submission, p. 26.
[53] PIAA submission to the ACCC p. 6.

CSOs restrict some cost saving options and that it may be appropriate to reconsider issues including the frequency of deliveries. [54]

PIAA notes that the ACCC in its 2011 bulk mail decision suggested that Australia Post may have overstated its under recovery of efficient costs. PIAA states that close attention is therefore required to ensure any application for price increases reflects true costs. [55] PIAA also considers that Australia Post should be subject to benchmarks that lead to improved productivity, efficiency and customer focus rather than have an automatic right to recover increased costs. [56]

Mailing House submits that without significant insight into Australia Post's processing network and financial data, it is impossible to determine the true operating costs of running the monopoly letter business. It notes, however, that the mailing industry since 1998 has implemented a number of processes that makes the processing of bulk mail more efficient.[57]

According to Mailing House, Australia Post's focus should be broader than simply cost reduction. A more important consideration is about a realistic way to share the costs between 'ordinary' mail and bulk mail. Mailing House states that:

> 'business has been the easy target politically and from a legislative (ACCC) aspect in that it is no longer required to have the ACCC review applications to increase the business rate.'[58]

Mailing House submits that this increase in the BPR should be more towards 75 or 80 cents to reflect the true cost of sorting and delivering 'ordinary' mail.[59] In response to a question posed by the ACCC on the areas in which Australia Post might be able to reduce its costs, Mailing House's suggestions include:

- The BPR needs to rise to 70 cents with a target of $1, at least. Mailing House also does not support the introduction of a 60 cents concession stamp and can see 'a thriving black market in concession stamp usage to the detriment of Australia Post revenue. It's an unnecessary bureaucratic impost.'[60]
- Australia Post ceases competing with its customers in the mail house market.
- Australia Post charges Parcels and other Australia Post divisions a true inter-company fee for use of the 'poles and wires' created by traditional letter services.
- Increasing delivery sort sequencing, and thus further reducing manual sorting and cost.
- Delivery of mail every other day or Monday, Wednesday, Friday.[61]

The Communication Workers Union Postal & Telecommunications Branch Victoria (CWU) submits that Australia Post is considering downgrading its delivery standards.

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[54] PIAA submission to the ACCC p. 6.
[55] PIAA submission to the ACCC p. 6.
[56] PIAA submission to the ACCC p. 7.
[57] Mailing House submission to the ACCC p. 3.
[58] Mailing House submission to the ACCC p. 3.
[59] Mailing House submission to the ACCC p. 4.
[60] Mailing House submission to the ACCC p. 4.
[61] Mailing House submission to the ACCC p. 4.

Furthermore Australia Post should be required to maintain its current level of services if a price increase is approved. [62]

CWU also submits that attention should be paid to the remuneration of the CEO of Australia Post which is quoted as being $4.75 million in 2012-13. The CWU argues that the US Postmaster General has almost half a million employees, as opposed to Australia Post's 32,700 and receives a substantially lower remuneration when compared to Australia Post's CEO. The CWU also submits that the remuneration of Australia Post executives (excluding the CEO) has increased from $830,000 in 1996-97 to $8.23 million in 2012-13.[63]

The Post Office Agents Association Limited (POAAL) supports Australia Post's proposed price increases. POAAL notes that in an absence of letter volume growth, Australia Post needs price increases to offset its growing costs.[64]

POAAL indicates that the proposed price increases will support LPO revenue, noting that LPOs have mail payments linked to the price of postage. POAAL states that LPO operating costs have continued to rise since the last increase in the BPR.[65]

POAAL considers that Australia Post's main cost driver is the growing number of delivery points. POAAL notes that while the majority of these occur in urban areas, there are significant costs associated with regional and rural mail delivery. In particular, road infrastructure problems and low population densities in these areas drive higher costs.[66]

POAAL identifies some potential initiatives to reduce delivery costs (such as less frequent deliveries in low mail areas), but notes that reforms can be 'dependent on managing the community's current service expectations and the conservative attitudes of the community around changes to postal delivery and access to postal services'. Notwithstanding this, according to POAAL, Australia Post has been piloting some of these cost savings initiatives in new housing estates in Australia.[67]

The ACCC also received a number of submissions from LPOs. The submissions expressed support for Australia Post's proposed increase in the basic postage rate, noting that Australia Post's costs are increasing. The LPOs submit that granting an increase in the BPR will ensure that the incomes of LPOs increase to keep pace with increasing costs.[68]

4.4 ACCC view

This section outlines the ACCC's consideration of Australia Post's reserved services costs, and the sensitivity testing undertaken as part of the ACCC's high level review.

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[62] CWU submission to the ACCC, p. 1.
[63] CWU submission to the ACCC, p. 1.
[64] POAAL submission to the ACCC p. 2.
[65] POAAL submission to the ACCC, p. 2.
[66] POAAL submission to the ACCC p. 4.
[67] POAAL submission to the ACCC p. 4.
[68] Submissions from multiple Licensed Post Office operators, p. 1.

International benchmarking

Consistent with previous decisions, a key problem in assessing the efficiency of Australia Post's costs is that data against which Australia Post's performance can be compared is not readily available because Australia Post is the only firm providing mail services in Australia.

International benchmarking would potentially enable the ACCC to verify some of the claims that Australia Post has made about its performance in comparison to overseas postal service operators. The ACCC notes that Australia Post has referenced in its supporting submission a 2009 international benchmarking study undertaken by Economic Insights which was updated by Economic Insights in 2012.[69] However, the ACCC has not been able to independently verify the results of the TFP analysis (including the regression analysis conducted to adjust the TFP results) for either of the benchmarking studies due to confidentiality arrangements agreed to by Economic Insights. Thus, the ACCC has been limited in its ability to analyse these studies in assessing Australia Post's 2014 price notification.

Submissions

A number of submissions raised issues in relation to Australia Post's proposed price increases for business mail services.[70] The ACCC notes that Australia Post is no longer required to submit price notifications to the ACCC for changes in the prices of its business mail services.[71] However, regulations made under section 32B of the *Australian Postal Corporation Act 1989* allow the ACCC to inquire into disputes about the terms and conditions, including price of access to Australia Post's bulk mail services. Additionally, under the ACCC's 'dual-till' pricing approach, the costs and revenues of overall reserved services (which include bulk mail services) determine Australia Post's maximum allowable revenue (MAR).

The ACCC notes CWU's submission[72] in relation to Australia Post's executive remuneration levels. The ACCC has considered the issue of executive remuneration within the context of Australia Post's total reserved services labour costs. The ACCC notes that executive remuneration does not form a material proportion of Australia Post's labour costs given the size of its overall labour force, and thus is unlikely to have a material impact on Australia Post's cost forecasts.

Economic Insights study

As requested by the ACCC in its 2010 and 2011 price notification decisions, Australia Post has provided the ACCC with a consultancy report from Economic Insights that provides an econometric analysis of the likely effect of declining mail volumes and declining mail density on Australia Post's future costs.

The Economic Insights report rejects explanations of costs that rely principally on elasticities of cost to letter volumes. While the Economic Insights report is consistent

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[69] Australia Post's supporting submission, pp. 26-27.

[70] See, for example, the Mailing House and PIAA submissions.

[71] Due to the repeal of the previous declaration, the '*Price Notification for Australia post's Reserved Letter Services'* dated 23 February 2011.

[72] CWU submission to the ACCC, p. 1.

with the view that letter volumes are one important driver of costs, it demonstrates that another important driver of costs is the number of delivery points.

The major finding from the Economic Insights report is that the output changes in 2011-12 and 2012-13 would have increased Australia Post's real reserved costs by 0.2 per cent.[73] Economic Insights' study also identifies that an increasing number of delivery points and increases in the distance covered on postal delivery rounds are having a significant impact on Australia Post's operating costs.

The ACCC welcomes the econometric analysis undertaken by Economic Insights on the likely effect of declining mail volumes and declining mail density on Australia Post's future costs. The ACCC has only had a limited time to review the Economic Insights report, and thus is unable to analyse in any detail the data that forms the basis for the figures contained in the report. Subject to this qualification, Economic Insights report appears to be a relatively robust and transparent study of Australia Post's cost structures. The report suggests that Australia Post's present CSO-related standards have a material impact on its costs, particularly in relation to delivery costs, which in 2013-14 are forecast to account for around 48 per cent[74] of Australia Post's total reserved services costs.

However, the ACCC notes that while the Economic Insights report contains a convincing argument regarding how the ACCC should *not* calculate cost forecasts, it does not offer clear guidance as to how the ACCC *should* forecast costs. In particular, the report does not provide all the information necessary to make appropriate cost forecasts. The key pieces of information provided by the report are the elasticities of costs to seven types of output. But the report does not provide forecasts of these seven types of output, which the ACCC would need if it were to estimate the effect of changes in these outputs on future costs.

Sensitivity analysis

The ACCC notes the difficulty of making a specific assessment about the efficiency of Australia Post's operating cost base in the limited time available. A key problem in assessing the efficiency of Australia Post's costs is that data against which Australia Post's performance can be compared to is not readily available because Australia Post is the only firm providing mail services in Australia.

As such, the ACCC has conducted sensitivity analysis to assess how much Australia Post's costs would need to decrease by in 2013-14 and 2014-15 for it to break even on its reserved services business. This analysis assumes recent trends in the decline in letter volumes and the growth in delivery points continue. Based on Australia Post's cost forecasts (which have been adjusted to reflect alternative ACCC assumptions regarding the contribution of shared costs to reserved services and the rate of return – outlined in Chapter 6)[75], Australia Post's operating costs would need to fall in real terms by around 15 per cent from 2012-13 to 2014-15 in order to break even. Accordingly, Australia Post's operating costs would need to fall by a greater amount in order for Australia Post to over recover on its reserved services.

[73] Economic Insights memorandum, *Australia Post's Mail and Delivery Centre Cost Elasticities*, p. 23.
[74] This is based on information in Table 4.2.1
[75] These adjustments were applied cumulatively.

However, the results of the Economic Insights study suggest that Australia Post's costs are unlikely to fall by this magnitude. The ACCC notes Australia Post's submission that it is required to provide next-day letter delivery within metropolitan areas and deliver letters five-days-a-week to at least 98 per cent of all Australian delivery points,[76] which are increasing by around 135,000 delivery points each year.[77] Additionally there are other factors not included in Economic Insights' analysis that might affect future costs, such as changes in superannuation. Given these circumstances, the ACCC does not consider it likely that Australia Post would be able to recover the costs of its reserved services in 2013-14 and 2014-15 even with the proposed price increases in reserved services.

Given the limited time available to it, the ACCC has not been able to form a view on the efficiency of Australia Post's cost base as part of its assessment. However, as demonstrated by the ACCC's sensitivity analysis (set out above, and in Chapter 6), an over recovery of efficient reserved services costs would be unlikely.

[76] Australia Post's supporting submission, p. 8.
[77] Australia Post's supporting submission, p. 8.

5 Demand

> **Key points**
>
> - Australia Post has forecast an average annual volume decline of 6.7 per cent for its reserved services over the two years to 2014-15. Australia Post is forecasting the volume of its ‘other’ letter services to decrease by an average of 9.1 per cent per annum over the same period.
> - For the purposes of its sensitivity testing (in Chapter 6), the ACCC has modelled Australia Post’s revenues on the 2013-14 and 2014-15 reserved services volume forecasts, which are contained in its supporting submission and Corporate Plan. These forecasts incorporate the downward impact on letter volumes of Australia Post’s proposed price increases.

Forecasts of demand are used to assess whether the proposed prices are expected to achieve revenue sufficient to recover costs, without providing excessive returns. Forecasts of demand for Australia Post’s services are also required under a cost-based pricing methodology as they are relevant to the ACCC’s assessment of Australia Post’s costs related to its reserved services.

The ACCC has analysed Australia Post’s demand forecasts to determine whether they can be relied upon. The ACCC also considered supporting material provided by Australia Post including a consultancy report prepared by Diversified Specifics titled ‘*Domestic Other Letter Volume Demand Update – November 2013*’ (2013 report) in support of its proposal. This report is available on the ACCC’s website.

Australia Post’s submitted demand forecasts, which are consistent with its Corporate Plan, are based on Diversified Specifics’ econometric model, which is augmented for other factors that are not fully included in the model such as the impact of electronic substitution.

This section outlines Australia Post’s volume forecasts, and the ACCC’s assessment of demand for domestic reserved services.

5.1 Australia Post’s letter forecasts

Australia Post’s supporting submission

Australia Post engaged consulting firm Diversified Specifics to construct forecast baselines for each of its key letter volume segments. Australia Post has submitted that Diversified Specifics develops a set of segmented letter volume forecasts that encompass both econometric and some augmented components. This has resulted in Diversified Specifics producing a set of forecasts for its ‘other’ letters that are premised upon:

1. historical associations governing letter volume fluctuations – reflected in the econometric baseline that are derived utilising vector error correction modelling (VECM) techniques; and

2. emerging threats to letter volumes – based upon research into recent technological and behavioural developments.[78]

These forecasts from Diversified Specifics are subject to further augmentation by Australia Post before being finalised. These finalised forecasts also form the forecasts included in Australia Post's Corporate Plan.[79]

Australia Post's forecasts of changes in its reserved services volume forecasts are outlined in Table 5.1.1 below. These forecasts differ somewhat from the Diversified Specifics forecasts for the corresponding years reflecting further augmenting by Australia Post.

These demand forecasts identify an average annual reduction over the two years to 2014-15 of 6.7 per cent. These estimates are broadly consistent with recent trends. As shown in Table 5.1.2, over the five years to 2012-13 the average rate of decline in letter volumes was 5 per cent for reserved letters and 6.6 per cent for 'other' (including 'ordinary') letters per annum.

Table 5.1.1: Forecasts of changes in Australia Post's reserved services letter volumes[80]

	PreSort letters (Business Mail)	'Other' (including 'ordinary') letters	Total Reserved services
2013-14	(3.9%)	(10.4%)	(6.6%)
2014-15	(6.3%)	(7.9%)	(6.9%)
Average annual change	(5.1%)	(9.1%)	(6.7%)

Table 5.1.2: Historical domestic reserved letter volumes[81]

	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**Average**
Total reserved	(3.9%)	(5.6%)	(3.6%)	(5.4%)	(6.5%)	(5.0%)
'Other' (including 'ordinary') letters	(6.6%)	(6.5%)	(5.8%)	(7.0%)	(6.9%)	(6.6%)

5.2 Views of interested parties

Mailing House accepts Australia Post's volume forecasts, noting that based upon its business experience over the past five years, the forecasts were within anticipated parameters. [82]

[78] Australia Post's supporting submission, p. 16.
[79] Australia Post's supporting submission, p. 16.
[80] ACCC calculation based on Australia Post Appendix 3.
[81] Australia Post's supporting submission, p. 14.
[82] Mailing House submission to the ACCC p. 2.

Mailing House considers a 10 cent increase in the BPR will cause a drop in ordinary letters volume. In addition, it considers that the increased use of electronic communication by government, the ageing of the letter writing population and the adoption of electronic communication by the younger population, will see 'ordinary' letter volumes continue to drop. [83]

However, PIAA submits that Australia Post continues to ignore its own evidence that print will remain a key component of the emerging multi-channel communication. PIAA specifically refers to a consumer survey conducted by Australia Post in late 2012 which found that: [84]

- 85 per cent of people read their mail on the day received
- 98 per cent of people actually open their mail versus 20-25 per cent for email
- a preference for bills and statements to be sent by mail.

According to PIAA transactional and direct mail will continue to have a significant role into the foreseeable future. PIAA also argues that there is evidence that advertising agencies are starting to question the effectiveness of digital media and are returning to traditional areas of advertising. [85]

Similarly, Mailing House notes there are threats to electronic communications caused by, for example, electronic eavesdropping, data and identity theft and privacy issues posed by social media that could result a significant flow back to physical mail. [86]

Mailing House also considers that physical mail is a very effective method of promoting goods and services but continual bulk price increases are speeding up its demise. [87]

POAAL notes that while it is difficult to predict the size of any decline, it appears certain that Australia Post's letter volumes will continue to fall. [88]

POAAL identifies the impact of increasing electronic substitution on letter volume declines, noting it is the 'delivery efficiency of hard copy mail, rather than price of the postal service, that is the principle determinate in exercising choice about the use of alternatives. Electronic substitutes are exponentially less expensive and faster than the postal service'.[89]

5.3 ACCC view on Australia Post's forecast letter volumes

In contrast to previous years, the 2013 Diversified Specifics report does not provide forecasts for PreSort (i.e. bulk mail) letter segments, which are forecast by Australia Post to account for around 60 per cent of total reserved services volumes and 55 per cent of total reserved services revenue.[90]

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[83] Mailing House submission to the ACCC p. 2.
[84] PIAA submission to the ACCC p. 5.
[85] PIAA submission to the ACCC p. 5.
[86] Mailing House submission to the ACCC p. 2.
[87] Mailing House submission to the ACCC p. 3.
[88] POAAL submission to the ACCC p.3.
[89] POAAL submission to the ACCC p.3.
[90] ACCC calculation based on Australia Post supporting submission Appendix 3.

Although the ACCC’s prices surveillance of reserved services is limited to ‘ordinary’ letter services, such as the assessment of increases in the basic postage rate, the ACCC’s PTRM assesses the impact of the pricing proposal on the whole of Australia Post’s reserved services, which all use a common infrastructure and processes, and are all affected by certain legal obligations and monopoly privileges.

As such, the 2013 Diversified Specifics report, which provides econometric forecasts for only ‘other’ letters for a period of four years to 2016-17, does not explain Australia Post’s reserved letter forecasts. The ACCC is also concerned about relying on longer term forecasts of letter volumes, given the difficulties involved in predicting the impact of electronic substitution on letter volumes.

The ACCC also notes that submissions did not raise any significant issues with the 2013-14 and 2014-15 volume forecasts provided by Australia Post for this price notification but some submissions did argue that there was likely to be a significant role for physical mail in the foreseeable future.

The ACCC has therefore considered it appropriate, for the purpose of its sensitivity testing (outlined in Chapter 6), to model Australia Post’s revenues on the 2013-14 and 2014-15 reserved services volume forecasts, which are contained in its supporting submission. These forecasts incorporate the downward impact on letter volumes of Australia Post’s proposed price increases. However, this impact is less than the impact of electronic substitution on letter volumes.

Australia Post is forecasting an average annual volume decline of 6.7 per cent for its reserved services over the two years to 2014-15. Australia Post is forecasting the volume of its ‘other’ letter services to decrease by an average of 9.1 per cent per annum over the same period. These forecasts, which are also reflected in Australia Post’s 2013 Corporate Plan, are broadly consistent with recent trends in letter volumes.

6 Financial model

Key points

- Australia Post estimates that it will face a growing under recovery of costs for reserved services of $289 million in 2013-14 and $313 million in 2014-15, even after the proposed price increases.
- Although the ACCC accepts Australia Post's claim that the proposed price increases are still likely to result in Australia Post under recovering its costs, the ACCC considers Australia Post's estimates may overstate the extent of under recovery of efficient costs.
- The ACCC's sensitivity analysis shows that Australia Post's under recovery for reserved services could be closer to $220 million in 2013-14 and $245 million in 2014-15 under alternative assumptions regarding the appropriate contribution of shared costs to reserved services and the rate of return.

The ACCC customarily uses the building block model to assess the extent to which the prices proposed by a regulated firm are commensurate with the efficient costs of providing those services. The version of the building block model used is known as the post-tax revenue model (PTRM). All costs including operating costs, depreciation, return on capital and tax are aggregated to derive maximum allowable revenue. The return on capital is based on a weighted average cost of capital (WACC) which is correspondingly an after-tax cost of capital—that is, the required return after tax and other expenses have been paid.

In assessing proposed price increases, the ACCC considers whether the revenue generated by the proposed prices would exceed maximum allowable revenue.

Although the ACCC is only required to assess 'ordinary' letter prices[91], the ACCC's PTRM assesses the effect of Australia Post's price increases on the whole of Australia Post's reserved services, which all use a common infrastructure and processes, and are all affected by certain legal obligations and monopoly privileges.

Australia Post submitted a PTRM containing its own forecast data for costs and revenues up to 2014-15. The model relies on assumptions about future variables which have a degree of uncertainty. However, Australia Post may have an incentive to understate the potential level of its cost recovery in respect of reserved services in the context of a price notification. In the limited time available to the ACCC, it has explored a number of variations to the assumptions underlying Australia Post's PTRM in order to test the sensitivity of the net result (section 6.2). The ACCC's conclusions are in section 6.3.

[91] Under the *Price Notification Declaration (Australia Post Letter Services) (No.2) (2011)*, the price notification provisions apply only to 'notified services', which include the BPR and 'ordinary' letter services, but not business letter services such as PreSort mail.

6.1. Australia Post's PTRM

Table 6.1.1 illustrates the outputs from Australia Post's proposed financial model for domestic reserved services. This indicates continuing under recoveries—that is, deficiency of proposed revenue required to cover costs. An under recovery of $289 million in 2013-14 would increase to an under recovery of $313 million in 2014-15, even after the proposed price increases in March 2014.

Table 6.1.1: Australia Post's required and proposed revenue forecasts for total domestic reserved services ($ million)[92]

	2013-14	2014-15
Nominal Vanilla WACC	9.14%	9.14%
Required revenue	2,000	2,027
Operating costs	1,838	1,835
Return on capital	49	47
Depreciation	101	132
Tax	12	13
Proposed revenue	1,712	1,714
Over/under recovery	(289)	(313)

The forecast growing under recovery arises from continuing declines in letter volumes and increasing costs from 2012-13 levels.

Total domestic reserved services letter volumes are forecast to decline by an average of 6.7 per cent per cent in 2013-14 and 2014-15.[93] Australia Post's proposed changes to the domestic reserved letter prices generate an increase in revenue, which is forecast to partially offset the declines in volumes. As a result of these factors, revenues are forecast by Australia Post to remain close to 2012-13 levels ($1,716 million) in 2013-14 and 2014-15.[94] Reserved services operating costs, however, are forecast by Australia Post to increase in 2013-14 and 2014-15 from 2012-13 levels ($1,767 million)[95] by 3.8 per cent over the two years. As revenues are forecast to remain constant, Australia Post's domestic reserved services under recovery will increase to $289 million in 2013-14 and $313 million in 2014-15.

[92] The ACCC's financial modelling is based on Australia Post's submitted PTRM, including its submitted WACC. The ACCC's under recovery calculation is presented in nominal terms, whereas Australia Post's supporting submission (p. 32) presents the under recovery in present value terms.
[93] Australia Post supporting submission, Appendix 3.
[94] Australia Post supporting submission, Appendix 3.
[95] Australia Post's PTRM submitted to the ACCC in support of its price notification.

6.2 Sensitivity analysis

As uncertainty surrounds the forecast data for a number of components of the financial model, in the limited time available to the ACCC to assess this proposal, the ACCC has tested the sensitivity of the results to several key factors.

The ACCC's PTRM model begins with the base data provided by Australia Post and then tests the sensitivity of the results to:

- an alternative WACC (section 6.2.1), and,
- an alternative assumption[96] regarding the allocation of shared costs (section 6.2.2).

6.2.1 Adjustment 1 — Alternative WACC

As part of the ACCC's sensitivity analysis, the ACCC has assumed an alternative WACC and also made minor changes to accord with the ACCC's usual methodology for the calculation of tax.[97]

Australia Post submitted a nominal 'vanilla' WACC of 9.14 per cent, based on a consultancy report by Value Adviser Associates titled '*Assessments of Weighted Average Cost of Capital for Australia Post & Star Track Express as at 30 June 2013 – Final Report*, *August 2013'*. The ACCC does not accept Australia Post's proposed WACC as appropriate for this assessment, and as part of its analysis, has assumed an alternative WACC of 7.02 per cent.[98] The impact of this adjustment is shown below at Table 6.2.1.

Applying this alternative WACC would lower Australia Post's cost base. However, the impact of a reduction in the WACC is relatively small, because for Australia Post the return on capital is a relatively small fraction of revenue (compared to, for example, energy infrastructure businesses, for which the return on capital is often as much as half the allowed revenue). As such, the impact of the difference between Australia Post's submitted WACC and the ACCC's estimate is in the order of 1-2 per cent of revenue.

Applying a WACC of 7.02 per cent would have the effect of reducing the return on capital and hence allowable revenue, which in turn reduces the extent of under recovery by around $25 million per annum. The forecast under recovery becomes $264 million in 2013-14, and $289 million in 2014-15, as shown in Table 6.2.1.

The ACCC does not endorse either Australia Post's proposed WACC or the WACC tested in this scenario as the appropriate values for future price notifications. The WACC may nevertheless be of more importance in a future price notification and, in light of the methodological issues raised by the Value Adviser Associates[99] consultancy

[96] This assumption is cumulative to the adjustment made to the submitted WACC.

[97] In its calculations of maximum allowable revenue, the ACCC calculates tax costs on the basis of actual interest paid by Australia Post rather than benchmark interest rates, and uses a lower tax imputation factor.

[98] The WACC tested for under this scenario is based on alternative values to Australia Post's for the market risk premium, gamma, and asset and equity betas.

[99] Value Adviser Associates, *Assessments of Weighted Average Cost of Capital for Australia Post & Star Track Express as at 30 June 2013*, Final Report, August 2013.

report, the ACCC may in future work further with Australia Post in determining the appropriate methodology and parameters.

Table 6.2.1: ACCC's assessment of required and proposed revenue forecasts for total domestic reserved services based on an alternative WACC ($million)

	2013-14	**2014-15**
Required revenue	1,976	2,003
Proposed revenue	1,712	1,714
Over/under recovery	(264)	(289)

6.2.2 Adjustment 2 (cumulative) — Different assumption regarding the allocation of shared costs

As noted in section 3.2, the ACCC has undertaken a limited review of Australia Post's CAM (cost allocation methodology). The primary objective of this review was to consider whether the ACCC should continue to rely on the financial information produced by Australia Post's CAM for the purposes of considering this price notification.

Overall, the ACCC's assessment of the information provided by Australia Post about its non-operational costs is that while Australia Post's CAM is continuing to improve there was still some capacity for further improvements in the CAM, in particular the use of cost drivers within the CAM. Although the ACCC did not consider there was evidence of any systematic bias in Australia Post's CAM that would likely lead to a higher allocation of non-operational costs to reserved services, the ACCC has undertaken some sensitivity testing based on an assumption that improvements in the use of cost drivers may lead to a 10 per cent reduction in the allocation of non-operational costs to reserved services.

The results of the ACCC's sensitivity analysis suggest that if such an over allocation of non-operational costs had occurred, Australia Post's reserved costs could be over stated by around $44 million in 2013-14 and 2014-15. However, given the level of losses forecast by Australia Post on its reserved services, even assuming the alternative WACC of 7.02, such an adjustment would still lead to a substantial under recovery of reserved services costs ($220 million in 2013-14 and $245 million in 2014-15, as shown in Table 6.2.2 below).

Table 6.2.2: ACCC's assessment of required and proposed revenue forecasts for total domestic reserved services based on adjustments to the WACC and alternative assumptions on the allocation of costs ($million)

	2013-14	2014-15
Required revenue	1,932	1,959
Proposed revenue	1,712	1,714
Over/under recovery	(220)	(245)

6.3 ACCC's view

Given the potential for Australia Post's forecasts to overstate its losses, in the limited time available to the ACCC, the ACCC has made two cumulative adjustments to Australia Post's base data in order to test the sensitivity of the net result to certain assumptions. These adjustments comprise an alternative WACC and a different assumption regarding shared cost allocations.

The ACCC's analysis shows that Australia Post's under recovery for reserved services could be closer to $220 million in 2013-14 and $245 million in 2014-15 under these alternative assumptions.

Even with these two adjustments to Australia Post's financial model, the most likely outcome is an under recovery of reserved services costs, albeit by less than that estimated by Australia Post.

7 ACCC decision

The ACCC's decision pursuant to section 95Z of the CCA is that it does **not object** to the proposed price increases outlined in Australia Post's price notification. The ACCC also considers that its decision is consistent with the matters set out in Direction 11. The prices are set out at Appendix A of this decision.

Australia Post submitted a price notification to the ACCC on 31 January 2014 proposing a 16.7 per cent increase in its 'ordinary' letter service, effective 31 March 2014. The key price change proposed is a 10 cent increase in the 'ordinary' small letter price (the basic postage rate - BPR) from 60 cents to 70 cents. The proposed price increases are outlined at Appendix A.

Australia Post has also informed the ACCC that it is introducing a 60 cent stamp to Australian Government concession card holders. However, the ACCC does not consider the concessional stamp rate to be a 'notified' service pursuant to *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2011*, and as such it is not subject to the price notification provisions in section 95Z of the CCA.

Under Part VIIA of the CCA, Australia Post is required to notify the ACCC of proposed increases to charges for its 'ordinary' reserved services.[100] The ACCC must then assess the proposed increases and take action in accordance with Part VIIA, which ordinarily includes a decision to object or not object to the proposed increases.

Under the CCA, the ACCC has 21 days to assess the proposal. While in the past Australia Post has generally submitted draft price notifications to the ACCC, allowing the ACCC to consult on and assess price increase proposals over a longer time frame, Australia Post has not provided a draft price notification to the ACCC on this occasion. In these circumstances, the ACCC has undertaken a high level review of the proposal within the statutory 21-day period, to assess whether the proposed price increases are likely to result in Australia Post recovering more than an efficient level of costs and return.

As part of its high level review, the ACCC has undertaken sensitivity testing based on Australia Post's submitted financial model. The ACCC also considered Australia Post's submission, including supporting reports by external consultants, and the views of interested parties.

The ACCC has restricted its consideration of the price increases to the likely effects on Australia Post's financial performance in 2013-14 and 2014-15. In other circumstances, it may be appropriate to take a longer-term view. However, the approach adopted takes into account the uncertainty surrounding longer-term letter volume forecasts (including

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[100] In 2011, the Australian Government limited prices surveillance of Australia Post's letter services from all of Australia Post's reserved services to its reserved 'ordinary' letter service. Reserved 'ordinary' letter services are currently offered at three postage rates − currently 60c for small letters (the basic postage rate), $1.20 for large letters up to 125 grams and $1.80 for large letters over 125 grams and up to 250 grams. The other services currently reserved to Australia Post are no longer 'notified' (refer *Price Notification Declaration (Australia Post Letter Services) (No. 2) 2011*).

the difficulty in estimating the impacts of price and electronic substitution on future letter volumes) and Australia Post's submission that the proposed price increases are just one part of a broader strategy to improve productivity and provide a sustainable letter service.

Australia Post has forecast an average annual volume decline of 6.7 per cent for its reserved services over the two years to 2014-15. For the purposes of considering this price notification, the ACCC has used Australia Post's volume forecasts (based on its supporting submission and its Corporate Plan) for the two years to 2014-15 in its consideration, given that they are broadly consistent with recent trends in letter volumes. Australia Post's volume forecasts take into account the expected downward impact on letter volumes of Australia Post's proposed price increases. However, this impact is less than the impact of electronic substitution on letter volumes.

While the ACCC accepts Australia Post's claim that the proposed price increases are still likely to result in Australia Post under recovering its costs, Australia Post's estimates may overstate the extent of under recovery of efficient costs. In the limited time available, the ACCC has not been able to form a view on the efficiency of Australia Post's cost base as part of its assessment.

Australia Post expects its costs for reserved services to increase by 3.9 per cent and 1.2 per cent in 2013-14 and 2014-15 respectively. The ACCC's sensitivity analysis shows that Australia Post's under recovery for reserved services would still be over $200 million in 2013-14 and 2014-15[101] (after the proposed price increases) under alternative assumptions regarding the appropriate contribution of shared costs to reserved services and the rate of return. Even under these alternative assumptions, Australia Post's operating costs would need to fall in real terms by around 15 per cent from 2012-13 to 2014-15 in order for the domestic reserved services to break even.

Given the magnitude of the forecast under recovery of reserved services costs, the ACCC is of the view that Australia Post is unlikely to recover more than an efficient level of costs and return as a result of the proposed price increases.

As such, the ACCC's decision pursuant to section 95Z of the CCA is that it does not object to the proposed price increases to 'ordinary' letters outlined in Australia Post's price notification. The ACCC also considers that its decision is consistent with the matters set out in Direction 11. The prices are set out at Appendix A of this decision.

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

[101] Australia Post is forecasting reserved services under recoveries of $289 million and $313 million in the respective years (refer Chapter 6), prior to the ACCC's sensitivity testing. The testing involves (i) an alternate WACC and also (ii) a lower attribution of shared costs to reserved services.

APPENDIX A —Australia Post's proposed prices

	Current Price	Proposed Price	Increase %
'ordinary' small letter	$0.60	$0.70	16.7%
'ordinary' large letter			
- Up to 125g	$1.20	$1.40	16.7%
- Over 125g up to 250g	$1.80	$2.10	16.7%