



Australian  
Competition &  
Consumer  
Commission

# **Australia Post's draft price notification**

## **Issues paper**

August 2009



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# 1 Introduction

On 24 July 2009, Australia Post provided the ACCC with a draft price notification proposal<sup>1</sup> and supporting information, including a financial model and consultancy reports on the demand for letter services, Australia Post's productivity performance and Australia Post's return on capital.

Australia Post's 2009 draft price notification outlines Australia Post's proposal to increase the prices of those letter services over which it has a statutory monopoly. The services captured by this monopoly are generally referred to as 'reserved services'. In particular, Australia Post is proposing to increase the basic postage rate by 5c to 60c, and to increase the prices of its reserved letter services by an average variation of 7.6 per cent on 2008 reserved service prices in early 2010.

In order to increase the prices of its reserved letter services in accordance with the *Trade Practices Act 1974* (the TPA), Australia Post must provide the ACCC with a locality notice specifying the proposed price increases, and receive a response from the ACCC stating that it has no objection to the proposed price increases, or price increases that are less than those proposed by Australia Post.<sup>2</sup>

The ACCC takes a consultative approach to its assessment of price notifications, and is seeking the views of industry and consumer stakeholders on Australia Post's 2009 draft price notification proposal at this time.

The purpose of this issues paper is to outline important elements of Australia Post's 2009 draft price notification proposal, and identify those issues on which the ACCC would be assisted by the views of industry and consumer stakeholders.

In particular, as the ACCC will consider the extent to which the proposed price increases will enable it to recover the costs of providing reserved letter services, it would be assisted by comments on the demand for reserved letter services, and the drivers of Australia Post's costs and productivity. The ACCC also welcomes the views of industry and consumer stakeholders on any other issues related to Australia Post's 2009 draft price notification.

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<sup>1</sup> For convenience, Australia Post, *Draft Notification Change in Domestic Reserved Letter Pricing – Detailed Explanation of Price Changes*, 23 July 2009, will be referred to in this paper as 'Australia Post's 2009 draft price notification'.

<sup>2</sup> TPA, subsections 95Z(5) and (6).

Following this consultation process, the ACCC will release a preliminary view before it makes a final decision on Australia Post's proposed price increases.

Submissions should be addressed to:

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If you have any further questions about the process, or about making a submission to the ACCC, please contact the ACCC's infocentre on 1300 302 502, or send an email to [postalservices@acc.gov.au](mailto:postalservices@acc.gov.au).

## 2 Australia Post's 2009 draft price notification

Australia Post's 2009 draft price notification details Australia Post's proposal to increase the prices of those letter services over which it has a statutory monopoly — known as reserved services. Australia Post's reserved services extend to:

- the collection, within Australia, of letters for delivery within Australia
- the delivery of letters within Australia.<sup>3</sup>

There are a number of exceptions to Australia Post's reserved services, including letters weighing more than 250g and letters that are carried for a charge more than four times the basic postage rate.<sup>4</sup>

In particular, Australia Post summarises the major elements of its 2009 pricing proposal in its draft price notification as follows:

- increase of 5 cents to the basic postage rate (BPR) (to 60c);
- increase to other ordinary letter prices (e.g. large, seasonal greeting) to maintain relativity to the BPR; and
- increase to pre-sort letter prices of an average of 2.8c (GST exclusive):
  - small pre-sort an average increase of 2.6 cents (GST exclusive); and
  - large pre-sort an average increase of 5.0 cents (GST exclusive).<sup>5</sup>

A detailed table of Australia Post's proposed prices can be found in the Appendix.

In support of its draft price notification, Australia Post has provided the ACCC with a financial model that assesses the extent to which the proposed price increases will recover Australia Post's allowable revenue. Australia Post notes that its '*...domestic reserved letter service is forecast to make a loss of around \$143m in 2009/10*'.<sup>6</sup>

Australia Post notes that over the period 2009/10 to 2011/12 it expects that its costs will increase as a result of its community service obligations (CSOs) and increasing network size, and that letter volumes will be in decline. Australia Post states that:

*The proposed prices have been modelled in an environment where:*

- *delivery points continue to increase by around 2% (200,000) per annum;*
- *there is reduced potential for significant productivity improvements;*
- *letter volumes are forecast to decline by an average of 2.3% per annum over the next three years; and*

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<sup>3</sup> Australian Postal Corporation Act 1989 (APCA), section 29.

<sup>4</sup> APCA, section 30.

<sup>5</sup> Australia Post's 2009 draft price notification, p. 8.

<sup>6</sup> *ibid*, p. 6.

- *Australia Post is required [to] [sic] fund its CSOs and meet its regulated performance standards*.<sup>7,8</sup>

While Australia Post notes that the proposed price increases do not fully recover the sum of the efficient costs of providing the domestic reserved letter service plus an appropriate rate of return, its draft price notification contends that ‘...[this] is *reasonable in the current circumstances and reflective of the current global economic environment*’.<sup>9</sup> Australia Post’s 2009 draft price notification also notes that its pricing:

- *is consistent with Australia Post’s position of proposing smaller more frequent increases as opposed to a larger upfront increase – thereby minimising any adverse impact on demand;*
- *reflects Australia Post’s obligations to operate in a manner consistent with sound commercial practice; and*
- *reflects the pursuit of pricing and financial targets that are embodied within Australia Post’s corporate plan.*<sup>10</sup>

Australia Post has also identified that further increases to the prices of its reserved services may be necessary by 2011/12. Australia Post has stated that these further price changes would result in an average increase of 6.3 per cent (4.5 per cent for pre-sort letters, and 8.1 per cent for other letters).<sup>11</sup>

Further increases in the prices of Australia Post’s reserved services in 2011/12 would be subject to a further price notification assessment by the ACCC. Australia Post has noted that it will undertake further assessment of the need for these price increases closer to 2011/12.<sup>12</sup>

## **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;
- assessing proposed price increases for Australia Post’s reserved services; and
- inquiring into certain disputes regarding the terms and conditions under which Australia Post supplies bulk-mail services.

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<sup>7</sup> Regulations made under section 28C of the APCA detail the prescribed performance standards that Australia Post is required to meet.

<sup>8</sup> Australia Post’s 2009 draft price notification, p. 6.

<sup>9</sup> *ibid.*

<sup>10</sup> *ibid.*

<sup>11</sup> *ibid.*, p. 13.

<sup>12</sup> *ibid.*

To assist it in undertaking these roles, the ACCC can issue record-keeping rules (RKR) to Australia Post that require Australia Post to keep specified records and provide them to the ACCC.

The ACCC issued one RKR in March 2005 which established a regulatory accounting framework for Australia Post. The primary purpose of the RKR is to enable the ACCC to monitor for the presence of cross subsidy.

The ACCC has released four reports monitoring the presence of cross subsidy, for the 2004/05, 2005/06, 2006/07 and 2007/08 financial years. These reports are available on the ACCC's website, [www.accc.gov.au](http://www.accc.gov.au).

## **2.2 The ACCC's approach to assessing price notifications**

In 1992, Australia Post's reserved letter services were declared by the Minister to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the TPA. This declaration means that to increase the prices of its reserved services, in accordance with section 95Z of the TPA, Australia Post must provide the ACCC with a locality notice, and receive a response to that locality notice from the ACCC stating that it has no objection to the price increases or no objection to price increases lower than the price increases proposed by Australia Post.

Section 95ZH of the TPA enables the Minister to direct the ACCC to give special consideration to specified matters in performing its functions under Part VIIA of the TPA. In 1990, the Minister issued Direction 11 requiring the ACCC (in having regard to the criteria under section 95G(7) 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
- Australia Post's functions and obligations (including its CSOs).

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 conducts an informal assessment of a draft price notification proposal lodged by a declared firm prior to the declared person's lodgement of a locality notice.

A detailed outline of the operation of the legislative framework and the ACCC's processes in assessing draft price notifications is contained in the ACCC's *Statement of Regulatory Approach to Assessing Price Notifications* June 2009, which is available on the ACCC's website.

Table 1 provides an indicative timeframe for the ACCC's assessment of Australia Post's 2009 draft price notification.



**Table 1 — Indicative timeframe for the ACCC assessment of Australia Post’s 2009 draft price notification**

<b>Date</b>	<i>Action</i>
20 August 2009	ACCC releases issues paper
18 September 2009	Closing date for submissions on the issues paper
End November 2009	ACCC releases draft decision and calls for comments
December/January 2010	Closing date for comments on the draft decision
<b>End January 2010</b>	ACCC makes its final decision

### **2.3 Making a submission to the ACCC**

To facilitate an informed, transparent and robust consultation process, the ACCC prefers that all submissions are publicly available. Accordingly, submissions will be treated as public documents and posted on the ACCC’s website, unless prior arrangements are made with the ACCC to treat the submission, or portions of it, as confidential.

**Submissions should to be provided to the ACCC by COB Friday 18 September 2009.**

The ACCC will accept submissions by email or by post. However, it is preferred that submissions be made by email. If submissions are provided in PDF format, parties are asked, for accessibility reasons, to also provide a copy in Microsoft word format.

Submissions should be addressed to:

Mr Anthony Wing  
General Manager—Transport and General Prices Oversight  
Australian Competition and Consumer Commission  
GPO Box 520  
MELBOURNE VIC 3001

By email: [postalservices@acc.gov.au](mailto:postalservices@acc.gov.au)

If you have any further questions about the process, or about making a submission to the ACCC, please contact the ACCC’s infocentre on 1300 302 502, or send an email to [postalservices@acc.gov.au](mailto:postalservices@acc.gov.au).

### 3 Issues on which ACCC is seeking comment

Industry and consumer stakeholders are invited to make submissions on the issues identified by the ACCC in this issues paper, and on any other issues relevant to the ACCC's assessment of Australia Post's 2009 draft price notification.

In considering the issues raised by the ACCC in regards to Australia Post's 2009 draft price notification, industry stakeholders and interested parties should review Australia Post's *'Draft Notification Change in Domestic Reserved Letter Pricing — Detailed Explanation of Price Changes'* document, and supporting consultancy reports on Australia Post's return on capital, productivity performance and forecast demand for Australia Post's letter services.

Australia Post's 2009 draft price notification and supporting documentation is available in the postal services section on the ACCC's website, [www.accc.gov.au](http://www.accc.gov.au).

#### 3.1 Prices oversight in a period of transition from traditional letter services

Australia Post proposes to notify the ACCC of an increase in the prices of its reserved letter services in 2010, and again in 2011. Two reoccurring themes supporting these increases in Australia Post's 2009 draft price notification are:

- Declining demand for domestic letter services — demand for domestic letters is forecast to decline in 2008/09 by 3.8 per cent and Australia Post expects demand to decline by an average of 2.3 per cent in the next three financial years<sup>13</sup>; and
- Increasing network size and costs of complying with CSOs — Australia Post forecasts that delivery points will continue to increase by around 2 per cent per annum<sup>14</sup>, and that *'...Australia Post's CSO and associated prescribed performance standards which, to ensure ongoing performance, necessitates a high fixed cost network...'*<sup>15</sup>

The ACCC considers that the reasons advanced in support of the proposed price increases raise broader questions about the appropriate funding of Australia Post's reserved letter operations in the context of its CSOs and performance standards.

While Australia Post is forecasting that demand for its reserved letter services will decline, the ACCC notes that the postal services industry (and Australia Post) has been in transition for some time.

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<sup>13</sup> *ibid*, p. 26.

<sup>14</sup> *ibid*, p. 6.

<sup>15</sup> *ibid*, p. 18.

There has been a substantial change in the nature of Australia Post's business operations over time — Australia Post itself notes that '*...it is important for the long term viability of Australia Post for new sources of revenue to be found. While such efforts are focused across all portfolios there has been a specific focus to develop new revenue streams beyond traditional mail services.*'<sup>16</sup> Australia Post also notes that it systematically developed new revenue streams in its Parcels & Logistics and Agency Services & Retail Merchandise portfolio business portfolios since corporatisation, and that '*This reflected Australia Post's decision to pursue economies of scope in addition to economies of scale, thereby spreading fixed network costs both across a wider range of goods and services and also away from non traditional letter and parcel services.*'<sup>17</sup>

This environment may raise broader regulatory policy questions about the appropriate approach to prices oversight of an industry in transition. The ACCC would appreciate the views of interested parties on this matter.

### **3.2 Scope and duration of Australia Post's 2009 draft price notification**

In its final decision on Australia Post's 2008 draft price notification<sup>18</sup>, the ACCC provided Australia Post with guidance on the content and scope of any further draft price notifications it intended to lodge with the ACCC. In particular, the ACCC stated that:

*... any future price notifications to be supported by a forward looking proposal that provides more certainty to customers about prices for a reasonable period of time.*

*Therefore any future price notifications submitted by Australia Post should provide:*

- *a disaggregated financial model over a at least a three year period;*
- *information on how prices for Australia Post's reserved services will change over this period; and*
- *information on the revenues and costs of those non-reserved services that share the same costs as reserved services over that period.*<sup>19</sup>

Australia Post's 2009 draft price notification notes this request, and is '*...modelled over the 2009/10 – 2011/12 financial years and is supported by:*

- *disaggregated financial details (volume, revenue and cost) at product and category level;*

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<sup>16</sup> Australia Post, 2009 draft price notification, p. 15.

<sup>17</sup> *ibid*

<sup>18</sup> ACCC, *Australian Postal Corporation Price Notification Decision*, July 2008

<sup>19</sup> *ibid*, 189.

- *detailed (by price point) information on the proposed January 2010 price changes; and*
- *information on the revenue and costs forecasts of other Australia Post areas at an aggregate or summary level...'*<sup>20</sup>

Australia Post has also identified that further price changes may be required in 2011/12 — (an average increase of 6.3 per cent, with 4.5 per cent for pre-sort letters and 8.1 per cent for other letters). However, Australia Post states that:

- further price changes in 2011/12 would be dependent on a further assessment by Australia Post considering relevant factors in the market environment;
- Australia Post would undertake consultation with key customers and stakeholders on the 2011/12 price changes and would lodge a separate notification (closer to the actual date) containing full details of the proposed prices; and
- [The 2011/12 notification]... *would be based on the same financial forecast data as this draft notification – with any significant variances identified, including the reason for such variation. Where appropriate, Australia Post would replace forecast data with actual numbers where available.*<sup>21</sup>

The ACCC seeks comments on the scope and duration of Australia Post's 2009 draft price notification.

- Does the information about Australia Post's intention to increase the prices of its reserved letter services in 2011/12 provide certainty to customers about future prices for reserved services?
- One option available to the ACCC is to consider the need for price notifications over the period 2010/11 to 2011/12 in its assessment of Australia Post's 2009 proposal.

In light of this option, what are your views on:

- the appropriate sharing of volume risk (i.e. the extent to which reserved letter volumes vary from those forecast in this notification) between Australia Post and its key customers;
- whether Australia Post should be rewarded for reducing its costs below the ACCC's forecasts in future price notifications;
- if the 2009 model is used to assess future price notifications, how should variances between actuals and forecasts be treated?
- what would constitute a 'significant' variance?

<sup>20</sup> Australia Post's 2009 draft price notification, p. 13.

<sup>21</sup> *ibid.*

### 3.3 Australia Post’s forecast reserved letter volumes

Australia Post has provided the ACCC with forecasts of volumes for reserved letter services for the period 2009/10 to 2011/12. Australia Post’s volume forecasts will be used to calculate the revenue that Australia Post is expected to earn as a result of its proposed price increases, and in the calculation of the extent to which Australia Post is expected to make productivity improvements using total factor productivity (TFP) estimates over the period 2009/10 to 2011/12.

Australia Post states that it uses information from a variety of sources (analysis of market environment conditions, input from national and state based sales areas, and knowledge derived from econometric modelling) in forecasting demand for its reserved letter services.<sup>22</sup>

**Chart 1 — Australia Post’s actual and forecast reserved letter volumes for 2008/09 to 2011/12<sup>23</sup>**

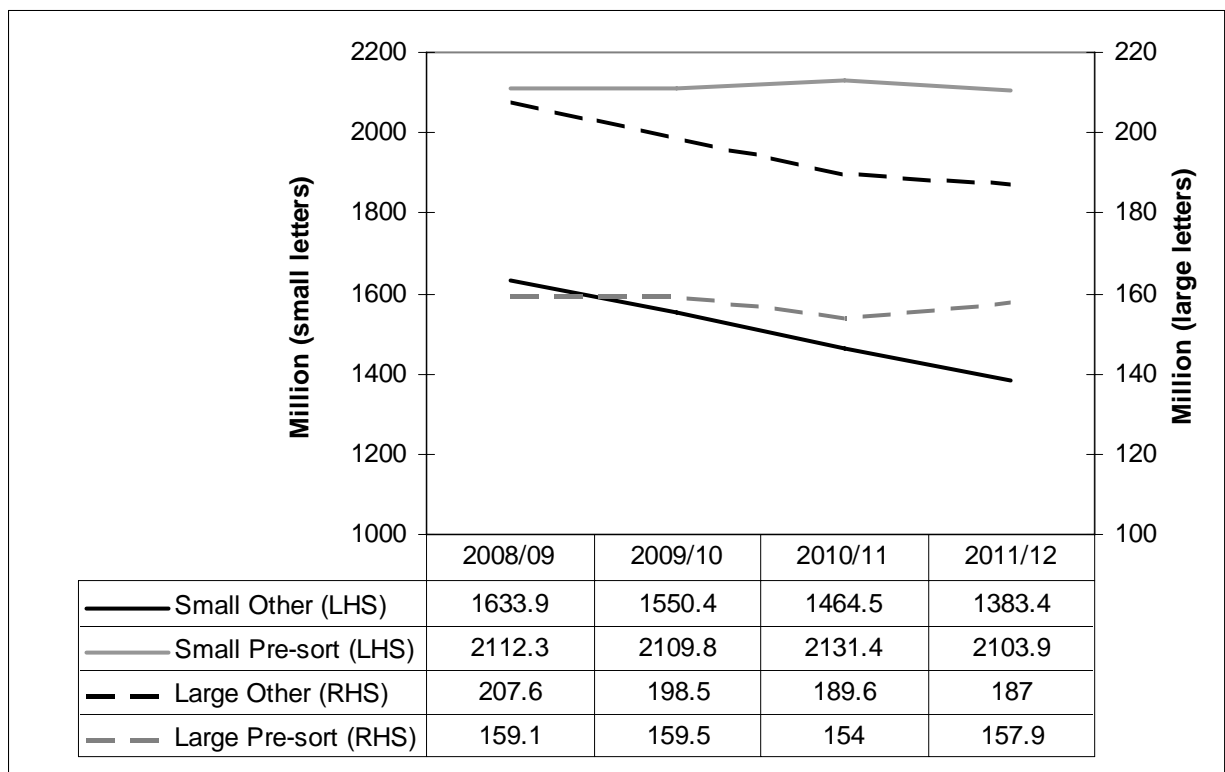


Chart 1 illustrates Australia Post’s actual and forecast reserved letter volumes for the period 2008/09 to 2011/12. Australia Post also provides a breakdown of its reserved letter volumes for the period 2007/08 to 2011/12 by transactional, promotional, and social segments for the same period in its draft notification.<sup>24</sup>

<sup>22</sup> *ibid.*, p. 26.

<sup>23</sup> Source: Australia Post’s 2009 draft price notification, p. 79.

<sup>24</sup> Australia Post’s 2009 draft price notification, p. 27.

Australia Post has forecasted volumes for its reserved letter services to decline by 2.3 percent over the period 2009/10 to 2011/12.<sup>25</sup> Analysis of the volume forecasts in Appendix 10 of Australia Post's draft price notification indicates that Australia Post considers that the small other letters (including ordinary) will decline by an annual average of 5.4 percent over the period, with volumes expected to decline by 250.5 million letters to 1383.4 million in 2011/12. Australia Post has forecasted that small pre-sort letters will remain stable over the period, with an annual average decline of 0.1 per cent over the period. Large letters have also been forecasted to decline with large other letters (including ordinary) expected to fall by an annual average of 3.4 per cent, and large pre-sort letters expected to decline by 0.3 per cent over the period.

Australia Post cites a number of factors leading to support its forecasts of future reserved letter volumes in its draft price notification, including:

- previous strong growth in mail volumes of 1.8 per cent in 2007/08 attributable to the general economic environment and activity related to the 2007 federal election;
- a trend decline for some mail segments (such as social mail) exacerbated by the global financial crisis;
- recent declines in mail volumes of other postal operators overseas; and
- the impact of consolidation, rationalisation and substitution.<sup>26</sup>

Australia Post also cites the results of its consultants Diversified Specifics statistical analysis of determinants of demand for Australia Post's reserved letter services.<sup>27</sup> Australia Post summarises the key findings of these reports on pages 28 and 29 of its draft price notification.

The ACCC seeks comments on Australia Post's forecasts of reserved mail volumes for the period 2009/10 to 2011/12.

- Do you think Australia Post should seek price increases in the context of declining volumes? What impact do you consider increases in the price of domestic reserved letter services will have on the demand for those services.
- Do you agree with Australia Post's volume forecasts by category of reserved letter service? Are these forecasts reflective of the long-term trend of demand for Australia Post's mail services and your expectations about future usage?

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<sup>25</sup> *ibid.*, pp. 6 and 26.

<sup>26</sup> *Ibid.*, pp 25 and. 26.

<sup>27</sup> See the following Diversified Specifics reports: *Domestic Small Letter Segment Volume Demand 1996 to 2008*, March 2009; *The Impact of Economic Downturns on Income Elasticity of Demand – Pre-sorted Barcoded Small Letters*, May 2009; *Domestic Large Letter Segment Volume Demand 1995-96 to 2007-08*, February 2009.

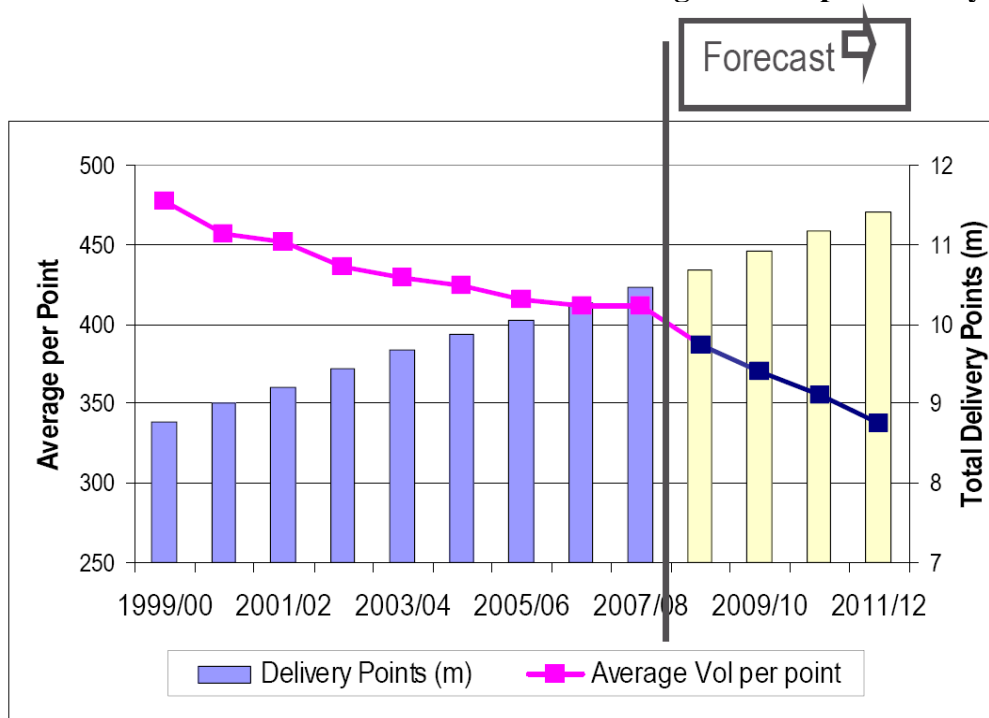
- What impact do you consider the decline in current economic activity will have on volumes of Australia Post’s reserved services? If there is an impact, how long do you expect that this will persist?
- Do you think that the long-term trend toward consolidation, rationalisation, and substitution will be affected by the recent downturn in economic conditions?

### 3.4 Community service obligations

Section 27 of the APCA specifies Australia Post’s CSOs, and obliges Australia Post to, amongst other things:

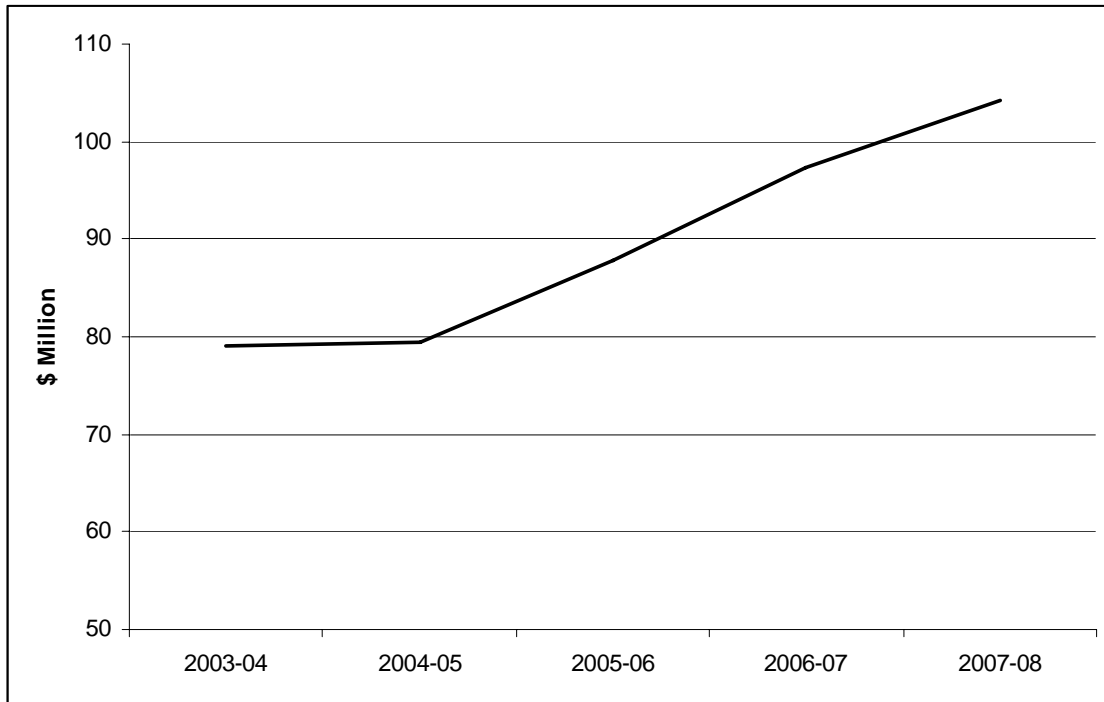
- make the letter service available at a single uniform rate of postage for the carriage within Australia, by ordinary post, of letters that are standard postal articles;
- ensure, in view of the social importance of the letter service, the service is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on a business
- ensure that the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community.

**Chart 2 — Australia Post’s actual and forecast average volume per delivery point**



Source: Australia Post’s 2009 Draft Price Notification, p. 95.

**Chart 3 — Australia Post’s annual CSO cost 2003-04 to 2007-08**



Source: Australia Post annual reports, 2003/04, 2004/05, 2005/06, 2006/07, 2007/08

Chart 2 illustrates Australia Post’s actual and forecast volume per delivery point for the period 1999/00 to 2011/12, while chart 3 shows Australia Post’s annual CSO cost (estimated using an avoidable cost methodology) for the period 2003/04 to 2007/08. These charts show that Australia Post’s cost of complying with its CSOs has increased over time, and could increase in the future as the size of Australia Post’s delivery network increases.

Australia Post notes that the combination of declining volumes and increasing delivery obligations resulting in increasing costs is a theme common to other postal operators around the world, and that these factors had been cited in two independent reports on Canada Post and Royal Mail.<sup>28</sup>

Australia Post further submits that it is inappropriate to focus on productivity growth as an indicator of efficiency as falling productivity in the context of falling volumes ‘...reflects the constraints imposed by maintaining a predominantly fixed cost network required to meet certain standards and objectives rather than an inefficient cost base.’<sup>29</sup>

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<sup>28</sup> Australia Post’s 2009 Draft Price Notification, p. 23.

<sup>29</sup> Ibid, p. 35.



The ACCC seeks comments on the impact of Australia Post's CSOs on the costs of providing its reserved letter services.

- What are the key growth areas in Australia Post's delivery network? Do you agree with Australia Post's forecast increase in delivery points?
- To what extent do you consider that the costs of providing Australia Post's letter services are predominantly fixed and invariant to volume declines?

Does this vary with changes in volume depend on the particular network function, i.e. sales and acceptance, processing, transport and delivery? Are there elements of these functions where costs are more variant with changes in volumes?

### 3.5 Productivity

Partial productivity indexes, such as mail volume per employee, measure the relationship between a single output and factor of production. In practice, Australia Post combines multiple inputs – labour, capital, materials and so on – to produce multiple outputs such as letter delivery, parcel delivery, and financial services.

Australia Post's productivity performance can also be measured by total factor productivity (TFP) – a measure of total output produced per unit of total input.

Australia Post has provided the ACCC with three reports relating to Australia Post's TFP:

- a report measuring Australia Post's past aggregate and reserved service TFP, and forecasting Australia Post's TFP for the period 2009 to 2012<sup>30</sup>;
- a report benchmarking Australia Post's TFP against six OECD countries, including Canada, Denmark, Italy, Japan, New Zealand, and USA<sup>31</sup>; and
- a report examining how the productivity improvements made by Australia Post over the past 12 years have been allocated between its staff, contractors, Australia Post's shareholders, and consumers.<sup>32</sup>

#### ***Australia Post's past and forecast productivity performance***

Australia Post summarises the results of its aggregate and reserved TFP in section 11.1.2 of its draft price notification. The results of Australia Post's TFP modelling indicate that Australia Post's reserved services have experienced positive TFP growth over the period 1997 to 2009, despite falls in letter volumes in 2008/09.

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<sup>30</sup> Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity — 2009 Update*, Canberra, 1 July 2009.

<sup>31</sup> Economic Insights, *International Benchmarking of Postal Service Productivity*, Canberra, 5 June 2009.

<sup>32</sup> Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, Canberra, 6 July 2009.

However, for the three year forecast period for Australia Post's 2009 draft price notification, TFP is forecast to decline for Australia Post's aggregate and reserved services. Australia Post notes that its reserved letter service TFP is forecast to decline by 1 percent per annum.<sup>33</sup>

Australia Post notes that the forecast declines in its TFP are attributable to its forecast decline in letter volumes and its mandated service and access standards.<sup>34</sup> Australia Post contends:

*These standards do not vary downwards with declining letter volumes, and in fact have effectively become more demanding because of the inexorable rise in delivery points each year. The contributions of fixed service standards, increasing delivery points and declining volumes does not indicate decreasing efficiency in Australia Post's cost base...*<sup>35</sup>

### **Australia Post's international benchmarking report**

In its final decision on Australia Post's 2008 price notification, the ACCC identified that '*...an international benchmarking study comparing the productivity performance of Australia Post with other overseas postal operators could provide some insight into the relative efficiency of Australia Post compared with postal operators overseas.*'<sup>36</sup>

Australia Post has benchmarked its productivity performance against six other OCED postal operators for the period 2002 to 2009. The results of this study indicate that:

- on an unadjusted basis Australia Post has the third highest TFP for the period 2002 to 2009; and
- when the results were adjusted for mail density and customer density, Australia Post has the highest TFP for the period 2002 to 2009.<sup>37</sup>

Australia Post submits that the ACCC should take account of the TFP benchmarking in considering the efficiency of Australia Post's costs. Australia Post notes that the results of the benchmarking study suggest that it is '*...operating at a very high level of performance in the postal world*'<sup>38</sup> and that '*...the case for concluding that Australia Post's cost base is efficient is very strong.*'<sup>39</sup>

### **Allocation of Australia Post's productivity dividend**

Australia Post commissioned a study of how the productivity improvements it has made over the 12 year period from 1998 to 2009 had been distributed between the key

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<sup>33</sup> Australia Post's 2009 draft price notification, p. 57.

<sup>34</sup> *ibid.*

<sup>35</sup> *ibid.*

<sup>36</sup> ACCC, *Australia Post Price Notification Decision*, July 2008, p. 141.

<sup>37</sup> Australia Post's 2009 draft price notification, p. 55.

<sup>38</sup> *ibid.*, p.56.

<sup>39</sup> *ibid.*

stakeholders of its business — staff, contractors, consumers and Australia Post’s shareholders.

The results indicate that consumers, staff and contractors have been the main beneficiaries of the productivity gains made by Australia Post over the period 1998 to 2009, with Australia Post’s shareholders receiving a net negative share of the available productivity dividend.

The report states that the implication of this share of Australia Post’s productivity improvements has a negative impact on Australia Post’s incentives to invest and pursue productivity gains. In particular, the report notes:

*This uneven distribution of Australia Post’s reserved productivity dividend over the last 12 years in particular reduces Australia Post’s incentives to invest further in the reserved service business and meet future needs – or to commit the time and effort required to achieve further reforms and efficiency improvements. Only by ensuring there is a more even distribution of benefits among stakeholders will a more sustainable position be maintained going forward.<sup>40</sup>*

The ACCC seeks comments on Australia Post’s forecasted productivity performance, its international benchmarking study and its views on the allocation of its past productivity gains between its stakeholders.

- To what extent should the ACCC have regard to Australia Post’s past and forecast productivity performance in assessing the efficiency of the costs that it is seeking to recover from consumers through prices?
- Are the postal operators which Australia Post’s productivity has been benchmarked against appropriate, or are there substantial differences in the nature of the selected postal operators operations? Should other international postal operators have been included in Australia Post’s benchmarking study? If so, on what basis?
- Are the adjustments made to the international benchmarking study to account for mail density and customer density appropriate? Are there any other significant differences between the identified international postal operators that should be incorporated into the study?
- Australia Post’s productivity dividend study indicates that the productivity gains that it has made over the period 1998 to 2009 have been captured by consumers and labour (contractors and staff). Do you think that this is appropriate?

### **3.6 Australia Post’s financial model**

For this draft notification, Australia Post has provided the ACCC with a financial model that forecasts that Australia Post will under recover its allowable revenues in

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<sup>40</sup> Economic Insights, *Measuring the Allocation of Australia Post’s Reserved Service Productivity Dividend*, Canberra, 6 July 2009, p. 15.

2009/10 even with the additional revenues generated by the implementation of the proposed price increases.

The ACCC had regard to the extent to which the revenue from Australia Post's proposed price increases was consistent with the forward looking costs of providing Australia Post's reserved letter services in forming a view on Australia Post's 2008 draft price notification. A detailed outline of this financial model is contained on page 174 of the ACCC's final decision Australia Post's 2008 draft price notification.

In accordance with previous practice, the ACCC intends to carefully scrutinise the components of Australia Post's financial model covering the period 2009/10 to 2011/12.

### **3.6.1 Operating expenditure**

Operating expenditure refers to the day-to-day expenses that Australia Post incurs in providing its reserved and non-reserved services, such as wages, maintenance costs, contractor fees and depreciation.

Australia Post's 2009 draft price notification provides a detailed outline of the operating costs for Australia Post's operations as a whole. Australia Post submits that labour and labour-related expenses account for approximately 68 per cent of the total costs of providing the domestic reserved letter services.<sup>41</sup>

Australia Post reviews the key components of its operating costs on pages 35 to 47 of its 2009 draft price notification.

The ACCC seeks comments on the efficiency of the operating costs outlined by Australia Post in its draft price notification.

- What are your views on the efficiency of Australia Post's operating costs (including labour costs, contractor costs, accommodation and depreciation)?
- What factors do you consider will affect Australia Post's cost structure over time?

### **3.6.2 Future Delivery Design program**

Australia Post has submitted it has a delivery challenge to contain growth in its operating costs and to introduce greater cost flexibility in the face of declining letter volumes coupled with increasing delivery points equating to fewer letters being delivered to more delivery points.<sup>42</sup>

The Future Delivery Design (FDD) Program is Australia Post's response to this challenge. The main features of the FDD Program (identified in Appendix 17 of Australia Post's 2009 draft price notification) are to:

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<sup>41</sup> Australia Post's 2009 draft price notification, p. 36

<sup>42</sup> *ibid.*, p. 95.

- use enhanced optical character recognition (OCR) software to drive additional labour savings by raising the proportion of small letters whose addresses can be read and sorted to a delivery point
- extend automated sequencing of small letters
- shift towards a more flexible workforce, and progressively introducing remote delivery rounds that commence and/or cease away from the delivery centre and which provide wider part time recruitment opportunities
- deploy new delivery modes (power assisted bicycles and tricycles and walk buggies).<sup>43</sup>

The ACCC seeks comments on Australia Post's proposed FDD program.

- Are the key elements of Australia Post's FDD program appropriate? Are there other projects that Australia Post could implement to reduce its costs and improve the efficiency by which it provides reserved letter services?
- Do you consider the pace of Australia Post's implementation of technological changes (such as enhanced OCR software and small letters sequencing) is consistent with other postal operators overseas?
- Will the FDD be effective in constraining growth in Australia Post's operating expenditure over time?

### 3.6.3 Capital expenditure

Australia Post submits that its capital investment program is focussed on regeneration of its fixed asset base.<sup>44</sup> Australia Post's board has approved a capital expenditure program for 2008/09 of \$332 million, for 2009/10 of \$316 million, for 2010/11 of \$308 million and for 2011/12 of \$307 million. Of which \$109 million in 2008/09, \$152 million in 2009/10, \$124 million in 2010/11 and \$150 million in 2011/12 are allocated to the domestic letter service.<sup>45</sup>

The capital expenditure levels for 2008-09 and 2009-10 in Australia Post's 2009 capital investment plan are lower than those in its 2007 and 2008 capital investment plans. Australia Post notes that the reduction in proposed capital expenditure '*...reflects the limitations placed on Australia Post's ability to fund its capital investment from free cash flows and from a reluctance to resort to seeking substantial new sources of debt in financial markets where that debt is now difficult to obtain and expensive.*'<sup>46</sup>

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<sup>43</sup> *ibid.*, p. 96.

<sup>44</sup> *ibid.*, p. 52.

<sup>45</sup> The difference between the domestic letter service capex and the additions data in Appendix 14 of Australia Post's draft price notification is that some of the capex outlays held against the domestic reserved service do not immediately go into operation but instead go to Assets Under Construction, where it is held unallocated until operational.

<sup>46</sup> *ibid.*, p. 52.

Australia Post's 2009 draft price notification provides a detailed overview of Australia Post's capital expenditure. Major capital projects identified in the proposal to be undertaken over the period to 2011-12 include a national retail fit out program, phase 2 of the enhanced Open OCR project and other projects associated with the Future Delivery Design Program.

The ACCC seeks comments on Australia Post's proposed asset base and capital expenditure.

- The ACCC would appreciate views on the level and composition of proposed capital expenditure for the domestic reserved letter service
- Is Australia Post's approach to funding its forecast capital expenditure appropriate?

### 3.6.4 Weighted average cost of capital

The financial model applied by the ACCC in assessing Australia Post's draft price notifications applies a weighted average cost of capital (WACC) to determine the return on capital to be included in the revenue allowance used to assess the extent to which the proposed price increases will recover the costs of providing Australia Post's reserved letter services.

A detailed outline of the parameters used to generate Australia Post's return on capital is contained in Appendix 18 of Australia Post's 2009 draft price notification.

**Table 2 — Parameters of Australia Post's return on capital proposed in its 2008 and 2009 price notification**

<b>Parameter</b>	<b>2008</b>	<b>2009</b>
Risk free rate	6.20%	5.60%
Market risk premium	6.00%	7.00%
Asset beta	0.484	0.78
Equity Beta	0.66	0.93
Gamma (Imputation factor)	0.50	0.0
Tax rate	30%	30.0%
Debt beta	0.10	0.15
Cost of debt	7.96%	7.0%
Gearing	30%	20.0%
<i>Nominal vanilla WACC</i>	<i>9.5%</i>	<i>11.1%</i>
<i>Pre-tax nominal WACC</i>	<i>10.8%</i>	<i>15.2%</i>

The ACCC seeks comments on Australia Post's return on capital.

- Are Australia Post's WACC parameters appropriate?
- A benchmarking approach is ordinarily taken in estimating the equity beta parameter. Which domestic and international firms are most comparable to Australia Post's operations and should be used in benchmarking this parameter?

### 3.7 Structure of Australia Post's proposed price increases

The financial modelling conducted to estimate the extent to which Australia Post is likely to meet the allowed revenue ceiling for its reserved letter services has been disaggregated into four categories — Other (inc Ordinary) small letters, Other (inc Ordinary) large letters, PreSort small letters, and PreSort large letters. However, as detailed in the Appendix to this issues paper, there are a large number of prices and services within these categories.

Australia Post's 2009 draft price notification provides some guidance on how Australia Post has adjusted the individual prices within these categories. Guidance on the issues that Australia Post has considered in doing this is contained in its letter pricing principles in Appendix 2 of its draft price notification. Australia Post states that it '*...believes the proposed prices;*

- *provide increases that are appropriately balanced across all letter price points to ensure, given the current market environment and circumstances, an appropriate level of revenue from Australia Post's domestic reserved letter service;*
- *better reflect the differences in cost within, and between Ordinary Letters and PreSort Letters;*
- *maintain a simple letter pricing structure for Ordinary Letters;*
  - *including maintaining large letter prices in multiples of the small letter price to provide a convenient and simple assessment process for senders; and*
  - *where appropriate selecting prices in multiples of five cents.*
- *provide appropriate incentives for customers to adopt efficient lodgement and payment channels; and*
- *maximise volumes of machine efficient letters.*<sup>47</sup>

The ACCC seeks comments on the structure of Australia Post's proposed price increases.

- Are the letter pricing principles that Australia Post has had regard to in proposing price increases appropriate?
- Are the margins proposed by Australia Post between its PreSort and other reserved letters sufficient?

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<sup>47</sup> *ibid*, p. 8.

# Appendix — Australia Post's current and proposed prices

## Ordinary Letters

	Current	Proposed Prices	
		Amount	%Change
<b>Small Letters</b>			
Ordinary - (eg Stamped)	\$ 0.55	\$ 0.60	9.1%
Metered / Imprint	\$ 0.54	\$ 0.58	7.4%
Clean Mail (up to 125g)	\$ 0.48	\$ 0.51	6.3%
Seasonal Greeting Cards	\$ 0.50	\$ 0.55	10.0%
<b>Large Letters</b>			
Seasonal Greeting Cards			
Up to 125g	\$ 1.00	\$ 1.10	10.0%
Ordinary Letters			
Up to 125g	\$ 1.10	\$ 1.20	9.1%
Over 125 up to 250g	\$ 1.65	\$ 1.80	9.1%
Over 250 up to 500g	\$ 2.75	\$ 3.00	9.1%
Metered / Imprint			
Up to 125g	\$ 1.08	\$ 1.16	7.4%
Over 125 up to 250g	\$ 1.62	\$ 1.74	7.4%
Over 250 up to 500g	\$ 2.70	\$ 2.90	7.4%
Clean Mail			
Small Plus Size			
Up to 125g	\$ 0.75	\$ 0.80	6.7%

### Notes/Comments: Ordinary Letters

Small, 55c to 60c; Large in multiples of 60c

Metered / Imprint from 54c to 58c, with Large rounded to multiples of 58c

Seasonal Greeting Card prices available during November and December

## Local Delivery (only available in specified postcodes)

	Current	Proposed Prices	
		Amount	%Change
Small Letters			
Up to 125g	\$ 0.51	\$ 0.56	9.8%
Medium Letters			
Up to 125g	\$ 0.70	\$ 0.80	14.3%
Over 125 up to 250g	\$ 0.95	\$ 1.10	15.8%
Large Letters			
Up to 125 g	\$ 0.90	\$ 1.00	11.1%
Over 125 up to 250g	\$ 1.30	\$ 1.45	11.5%
Over 250 up to 500g	\$ 1.45	\$ 1.60	10.3%

## Reply Paid

	Current	Proposed Prices	
		Amount	%Change
Small			
Barcoded	\$ 0.42	\$ 0.43	2.4%
Unbarcoded	\$ 0.63	\$ 0.65	3.2%
Annual Fee	\$ 65.00	\$ 65.00	0.0%
Large			
Up to 125g	\$ 1.20	\$ 1.30	8.3%
Over 125 up to 250g	\$ 1.75	\$ 1.90	8.6%
Over 250 up to 500g	\$ 2.85	\$ 3.10	8.8%

## PrePaid Envelopes

	Current Prices			Proposed Prices			%Change		
	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10
<b>Plain Envelopes</b>									
Small (DL and C6)	\$ 0.65	\$ 6.34	\$ 6.18	\$ 0.70	\$ 6.83	\$ 6.65	7.7%	7.7%	7.7%
C5 Size	\$ 1.30	\$ 12.68	\$ 12.35	\$ 1.40	\$ 13.65	\$ 13.30	7.7%	7.7%	7.7%
C4 Size	\$ 2.50	\$ 24.38	\$ 23.75	\$ 2.70	\$ 26.33	\$ 25.65	8.0%	8.0%	8.0%
B4 Size	\$ 2.90	\$ 28.28	\$ 27.55	\$ 3.20	\$ 31.20	\$ 30.40	10.3%	10.3%	10.3%
One Rate to the World Postcard									
	\$ 1.50	NA	NA	\$ 1.60	NA	NA	6.7%	NA	NA
Window Faced									
Small (DL and C6)	NA	Pk of 50 \$ 32.20	Ex of 500 \$ 309.50	NA	Pk of 50 \$ 34.70	Ex of 500 \$ 333.50	NA	Pk of 50 7.8%	Ex of 500 7.8%

### Notes/Comments:

Non-reserved products (over 250g or more than four times the BFR) are shaded

All prices are GST Inclusive, except for External Territories where they are as stated but GST free.



### PreSort Letters

**Note: all prices are GST Inclusive, except for External Territories where they are as stated but GST free.**

Regular Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
	Current	Proposed Price		Current	Proposed Price		Current	Proposed Price		Current	Proposed Price	
		Amount	%Var		Amount	%Var		Amount	%Var		Amount	%Var
Size / Weight												
Small Letters												
Up to 125g	\$ 0.399	\$ 0.427	7.0%	\$ 0.410	\$ 0.438	6.8%	\$ 0.449	\$ 0.477	6.2%	\$ 0.480	\$ 0.510	6.3%
Charity Mail	\$ 0.344	\$ 0.372	8.1%	\$ 0.355	\$ 0.383	7.9%	\$ 0.394	\$ 0.422	7.1%	\$ 0.480	\$ 0.510	6.3%
Small Plus												
Up to 125g	\$ 0.509	\$ 0.550	8.1%	\$ 0.531	\$ 0.572	7.7%	\$ 0.619	\$ 0.660	6.6%	\$ 0.750	\$ 0.800	6.7%
Medium												
Up to 125g	\$ 0.630	\$ 0.693	10.0%	\$ 0.674	\$ 0.737	9.3%	\$ 0.768	\$ 0.831	8.2%	\$ 0.905	\$ 0.968	7.0%
Over 125 up to 250g	\$ 0.823	\$ 0.913	10.9%	\$ 0.911	\$ 1.001	9.9%	\$ 1.015	\$ 1.106	9.0%	\$ 1.158	\$ 1.249	7.9%
Large												
Up to 125g	\$ 0.773	\$ 0.825	6.7%	\$ 0.817	\$ 0.869	6.4%	\$ 0.938	\$ 0.990	5.5%	\$ 0.982	\$ 1.034	5.3%
Over 125 up to 250g	\$ 1.103	\$ 1.155	4.7%	\$ 1.191	\$ 1.243	4.4%	\$ 1.323	\$ 1.375	3.9%	\$ 1.433	\$ 1.485	3.6%
Over 250 up to 500g	\$ 1.543	\$ 1.595	3.4%	\$ 1.675	\$ 1.727	3.1%	\$ 1.763	\$ 1.815	2.9%	\$ 1.983	\$ 2.035	2.6%

Off Peak Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
	Current	Proposed Price		Current	Proposed Price		Current	Proposed Price		Current*	Proposed Price	
		Amount	%Var		Amount	%Var		Amount	%Var		Amount	%Var
Size / Weight												
Small Letters												
Up to 125g	\$ 0.388	\$ 0.416	7.2%	\$ 0.399	\$ 0.427	7.0%	\$ 0.432	\$ 0.465	7.6%	\$ 0.465	\$ 0.505	8.6%
Charity Mail	\$ 0.328	\$ 0.356	8.5%	\$ 0.339	\$ 0.367	8.3%	\$ 0.372	\$ 0.405	8.9%	\$ 0.465	\$ 0.505	8.6%
Small Plus												
Up to 125g	\$ 0.498	\$ 0.539	8.2%	\$ 0.520	\$ 0.561	7.9%	\$ 0.608	\$ 0.649	6.7%	\$ 0.720	\$ 0.795	10.4%
Medium												
Up to 125g	\$ 0.597	\$ 0.671	12.4%	\$ 0.630	\$ 0.704	11.7%	\$ 0.729	\$ 0.820	12.5%	\$ 0.850	\$ 0.963	13.3%
Over 125 up to 250g	\$ 0.757	\$ 0.875	15.6%	\$ 0.801	\$ 0.919	14.7%	\$ 0.949	\$ 1.084	14.2%	\$ 1.059	\$ 1.238	16.9%
Large												
Up to 125g	\$ 0.751	\$ 0.803	6.9%	\$ 0.784	\$ 0.836	6.6%	\$ 0.905	\$ 0.979	8.2%	\$ 0.960	\$ 1.029	7.2%
Over 125 up to 250g	\$ 1.026	\$ 1.089	6.1%	\$ 1.092	\$ 1.155	5.8%	\$ 1.235	\$ 1.331	7.8%	\$ 1.334	\$ 1.474	10.5%
Over 250 up to 500g	\$ 1.301	\$ 1.375	5.7%	\$ 1.389	\$ 1.463	5.3%	\$ 1.521	\$ 1.650	8.5%	\$ 1.741	\$ 1.925	10.6%

Impact Mail	Postcode Direct Tray			Area Tray			Residue		
	Current	Proposed Price		Current	Proposed Price		Current	Proposed Price	
		Amount	%Var		Amount	%Var		Amount	%Var
Small - up to 125g									
Same State	\$ 0.600	\$ 0.640	6.7%	\$ 0.640	\$ 0.680	6.3%	\$ 0.700	\$ 0.740	5.7%
Other State	\$ 0.610	\$ 0.650	6.6%	\$ 0.650	\$ 0.690	6.2%	\$ 0.710	\$ 0.750	5.6%
Small Plus - up to 125g									
Same State	\$ 0.850	\$ 0.900	5.9%	\$ 0.900	\$ 0.950	5.6%	\$ 1.000	\$ 1.050	5.0%
Other State	\$ 0.860	\$ 0.910	5.8%	\$ 0.910	\$ 0.960	5.5%	\$ 1.010	\$ 1.060	5.0%

Acquisition Mail	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
	Current	Proposed Price		Current	Proposed Price		Current	Proposed Price		Current	Proposed Price	
		Amount	%Var		Amount	%Var		Amount	%Var		Amount	%Var
Off Peak Delivery												
Small - up to 125g	\$ 0.280	\$ 0.300	7.1%	\$ 0.300	\$ 0.320	6.7%	\$ 0.432	\$ 0.465	7.6%	\$ 0.465	\$ 0.505	8.6%
Small Plus - up to 125g	\$ 0.390	\$ 0.415	6.4%	\$ 0.410	\$ 0.435	6.1%	\$ 0.608	\$ 0.649	6.7%	\$ 0.720	\$ 0.795	10.4%

**Notes/Comments - PreSort Letters**

**Small PreSort**

Charity Mail prices for Barcoded items set at a specific cent reduction from "non-charity" small PreSort (Regular 5.5c and Off Peak 6c)

Non-reserved products (over 250g or more than four times the BFR) are shaded