Australia Post's Draft 2009 Price Notification

ACCC View

Public version

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Contents

Glossary

A-IFRS	Australian accounting standards equivalent to International Financial Reporting Standards which apply to all Australian corporations.
Acquisition mail	Acquisition mail is a mail service that enables customers to deliver semi addressed letters (i.e. no name) to a proportion of addresses in defined geographic areas. This service enables customers to exclude addresses from the letters sent to these geographic locations.
ANI/ePLA	The integrated Advanced Network Integration and Electronic Pre Lodgement Advice system.
APCA	*Australian Postal Corporation Act 1989.*
Australia Post	Australian Postal Corporation.
BMP	Bulk Mail Partner
BPR	Basic Postage Rate.
Capital markets	The market for securities where companies and governments can raise funds.
Capital structure	The mix of debt and equity used to finance a company.
CIP	Capital Investment Plan. A one-year budget of capital requirements approved by the Australia Post Board annually.
CSO	Community service obligation.
Cost of capital	Represents the minimum return an investment should generate to meet the cost of financing the project, or the minimum return required to earn the cash flow out of which investors can be paid their return. It is a weighted average of the cost of equity and debt.
CPI – X	An incentive regulation under which the overall output price is capped at consumer price index minus an X factor for a target level of productivity gains.

DEA	Data envelopment analysis. DEA uses linear programming techniques to construct a non-parametric frontier.
Default risk	Also known as credit risk. The risk that a company is unable to meet its debt obligations.
DORC	Depreciated optimised replacement cost.
EBITDA	Earnings before interest, tax, depreciation and amortisation.
Effective tax rate	The actual tax rate a company pays after all tax offsets are applied.
Financial distress costs	The costs incurred by the company when it cannot meet, or has difficulty meeting, its debt obligations.
Fixed assets	Physical assets (e.g. land, buildings, plant and equipment) employed by a firm in the provision of goods and/or services.
Franked dividend	A dividend that has imputation credits attached.
Frontier analysis	A method for estimating best-practice frontier under which firm-level efficiency and productivity can be measured. A commonly adopted frontier analysis method is DEA.
FTE	Full time equivalent.
GBE	Government business enterprise.
Imputation tax credits	Also known as franking credits. A credit that represents a share of the tax paid by the company in the distribution of dividends or similar distributions.
Imputation tax system	A corporate tax system whereby profits distributed by companies to investors are not taxed twice, but at the investor's marginal tax rate.
Inflation risk	The risk that the real value of the asset will decline due to inflation.
Interest rate risk	The risk of interest rate variation during the life of an interest bearing asset.

Interest tax shield	A reduction in income taxes as the result of an allowable deduction in taxable income.
KPI	Key performance indicator.
Liquidity risk	The risk associated with holding an asset that cannot be easily traded.
LPO	Licensed Post Office.
MAR	Maximum allowable revenue. The amount of revenue a regulated firm should receive that recovers all costs plus an efficient and reasonable return on its capital.
Market imperfections	Deviations from a perfectly competitive model. An example of a market imperfection is taxes.
MFP	Multifactor productivity. MFP is measured as the ratio of an index of output to a combined index of two or more inputs, typically labour and capital.
Par yield	The yield of a security such that the price of the security remains at par.
PIM	Perpetual inventory method.
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.
Publications	Addressed periodicals and publications delivered by Australia Post throughout Australia at reduced postal rates.
RAB	Regulatory asset base.
RKR	Record Keeping Rule. The ACCC has issued one RKR, which established a regulatory accounting framework for Australia Post.
Standard errors	A method to measure the standard deviation of measurement error.
Statutory tax rate	The corporate tax rate that is applied to companies in Australia. It is currently 30 per cent.

TPA	*Trade Practices Act 1974.*
TFP	Total factor productivity. TFP is measured as proportional change in total outputs relative to proportional change in total inputs.
Time value of money	The value of money at different periods of time. The general concept is that money today is of a greater value than money in the future.
Unaddressed letter	Unaddressed advertising items, including envelopes, postcards, catalogues, brochures and so on, to be delivered to delivery points and letter boxes within a specified geographic area at low prices.
ULD	Unit load device – metal cage used by Australia Post for mail handling and transport
WACC	Weighted average cost of capital.

Executive summary

On 24 July 2009 Australia Post provided the ACCC with a draft price notification seeking increases in the prices of the letter services over which it has a statutory monopoly. Australia Post proposes to increase the basic postage rate from 55 cents to 60 cents, and increase the prices of large Ordinary Letters, small Ordinary Letters and large PreSort letters in early 2010.

Australia Post also identified that a further price increase may be required in 2011-12, but that this would be subject to an assessment of the market environment before any further proposals were finalised.[1]

The ACCC has established a process for the assessment of price notifications under Part VIIA of the *Trade Practices Act 1974* (TPA), whereby declared firms submit detailed proposals for ACCC consideration prior to providing the ACCC with a formal price notification.[2] This process provides the ACCC with additional time beyond the period of 21 days provided under Part VIIA of the TPA to consider the proposal, and enables the ACCC to conduct a consultation process with stakeholders.

On 20 August 2009 the ACCC released an issues paper seeking submissions from interested parties on the proposed price increases and on the matters raised by Australia Post's in support of its proposal. The ACCC received a total of 23 submissions in response to its issues paper from mail users, other businesses, industry associations, and the public. The ACCC has considered these submissions in its assessment of Australia Post's draft price notification.

The ACCC adopts a cost-based approach to assessing the prices notifications under Part VIIA of the TPA.[3] The appropriateness of proposed prices is considered by assessing the extent to which they are forecast to recover the efficient costs of providing reserved letter services.

The key issue overshadowing Australia Post's 2009 draft price notification is the significant fall in Australia Post's reserved letter volumes between the 2007-08 and 2008-09 financial years, and Australia Post's expectation of declining letter volumes into the future.

The ACCC considers that Australia Post's 2009 draft price notification does not demonstrate that Australia Post has fully exhausted cost-based responses to its expectation of declining letter volumes.

In assessing the efficiency of the cost base the ACCC assumes that Australia Post would continue to be obliged to comply with its community service obligations and meet its performance standards.

The ACCC recognises that some of Australia Post's costs are fixed. However, it would be expected that its overall costs would respond as demand declines. As a result the ACCC has

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1 Australia Post, *Australia Post's Response to Issues Paper*, 18 September 2009, p. 4.

2 see ACCC, *Statement of Regulatory Approach to Assessing Price Notifications*, July 2009.

3 see ACCC, *Statement of Regulatory Approach to Assessing Price Notifications*, July 2009.

significant concerns about the efficiency of Australia Post's forecast costs for the period 2008-09 to 2011-12.

Australia Post is at a critical point where it will need to re-examine its cost structure, and the approach it takes to meeting the delivery obligations required by government into the future. In the ACCC's view, funding the maintenance of Australia Post's existing cost structure through regular price increases as the letter business declines is not a sustainable strategy.

The ACCC also has concerns about the lack of transparency in Australia Post's approach to forecasting demand for its letter services. The ACCC considers that reliable demand forecasts are critical component of an assessment of whether a business is responding appropriately to volume declines and of the ACCC's profitability analysis. The ACCC therefore cannot rely on Australia Post's forecasts of demand for its letter services.

The ACCC's view is to object to Australia Post's proposal to increase the prices of its reserved letter services.

The ACCC considers that there are a number of issues of Australia Post's 2009 draft price notification that Australia Post needs to address before it submits any further draft price notifications ACCC consideration.

1 Introduction

1.1 Australia Post's draft price notification

On 24 July 2009, Australia Post provided the Australian Competition and Consumer Commission (ACCC) with its complete draft price notification, which outlined Australia Post's intention to increase the prices of a number of its reserved postal services. Australia Post also provided the ACCC with a supporting submission setting out a detailed explanation of the price changes.[4]

The draft notification process as outlined in the ACCC's Statement of Regulatory Approach to Assessing Price Notifications[5] provides the opportunity for the ACCC to consider Australia Post's proposal in detail prior to the submission of a formal price notification under section 95Z of the *Trade Practices Act 1974* (TPA). A detailed outline of the ACCC's process of assessing draft price notifications is outlined in section 1.3.

Australia Post's 2009 draft price notification details Australia Post's proposal to increase the prices of its reserved services (services over which Australia Post has a statutory monopoly – a detailed description of Australia Post's reserved services is contained in Chapter 2). Australia Post's reserved services extend to:

- the collection, within Australia, of letters for delivery within Australia; and
- the delivery of letters within Australia.[6]

In its draft price notification, Australia Post proposes the following changes to prices:

- an increase of 5 cents to the basic postal rate (BPR) (to 60 cents);
- an increase to other Ordinary Letter prices (e.g. Large letters, Seasonal greeting cards, etc.) to maintain relativity to the BPR; and
- an increase to PreSort letters by an average of 2.8 cents (GST exclusive):
  - Small PreSort by an average of 2.6 cents (GST exclusive); and
  - Large PreSort by an average of 5.0 cents (GST exclusive).[7]

A complete list of Australia Post's proposed price changes is set out in Appendix 1 of its 2009 draft price notification, and is attached to this ACCC View document at Appendix A.[8]

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4 Australia Post, *Draft Notification – Change in Domestic Reserved Letter Pricing - Detailed Explanation of Price Changes* – July 2009 (Australia Post's 2009 draft price notification).

5 ACCC, *Statement of Regulatory Approach to Assessing Price Notifications,* June 2009.

6 *Australian Postal Corporation Act 1989* (APCA), section 29.

7 Australia Post's 2009 draft price notification, p. 8.

8 Australia Post's 2009 draft price notification, pp. 68-69.

There are a number of exceptions to Australia Post's reserved services, including letters weighing more than 250 grams and letters that are carried for a charge of more than four times the BPR.[9]

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 maximum allowable revenue (MAR).

Australia Post's supporting submission includes a number of reports and commentaries commissioned by Australia Post in support of its draft price notification.[10] These include:

- Diversified Specifics, *Domestic Large Letter Segment Volume Demand –1995/96 to 2007/08*;
- Diversified Specifics, *Domestic Small Letter Segment Volume Demand, Addendum, 1996 to 2008*;
- Diversified Specifics, *The Impact of Economic Downturns on Income Elasticity of Demand – PreSort Barcoded Small Letters*;
- Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 Update*;
- Economic Insights, *International Benchmarking of Postal Service Productivity*;
- Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*; and
- Value Adviser Associates, *Regulatory WACC for Australia Post (Draft).*

In its supporting submission, Australia Post notes that its '…domestic reserved letter service is forecast to make a loss of around $143m in 2009/10'.[11] 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'.[12] The draft price notification also notes that Australia Post's proposed 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;

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9 APCA, section 30.

10 Australia Post's supporting submission and public versions of the reports it commissioned in support of its draft price notification are available on the ACCC's website, http://www.accc.gov.au., under Regulated Industries and Postal Services.

11 Australia Post's 2009 draft price notification, p. 6.

12 Australia Post's 2009 draft price notification, p. 6.

- 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.[13]

Australia Post has identified that further price increases to 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% to reserved letter prices (4.5% for PreSort letters, and 8.1% for Other Letters).[14]

Further price increases for 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.[15]

Australia Post has cited a number of factors as grounds for the proposed price increase. In particular:

- delivery points are increasing by around 2% (200,000) per annum;

- letter volumes are forecast to decline by an average of 2.3% per annum over the next three years;

- Australia Post is required to continue to fund its CSOs and meet its regulated performance standards; and

- there is a reduced potential for significant productivity improvements.[16, 17]

Australia Post's key arguments in relation to each of these factors are examined briefly below.

1.1.1 Delivery points growth

Australia Post submits that the area it has to service (i.e. number of delivery points) is growing on average by around 2 per cent per annum.[18] Australia Post, which had to service 10.5 million delivery points at 30 June 2008, expects this growth rate to continue over the next three years.[19] Further, Australia Post submits that there is a high dependency upon the requirement for posties to cover the geographic area regardless of volume of letters to be

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13 Australia Post's 2009 draft price notification, p. 6.

14 Australia Post's 2009 draft price notification, p. 13.

15 Australia Post's 2009 draft price notification, p. 13.

16 Regulations made under section 28C of the APCA detail the prescribed performance standards that Australia Post is required to meet.

17 Australia Post's 2009 draft price notification, p. 6.

18 Australia Post's 2009 draft price notification, p. 6.

19 Australia Post's 2009 draft price notification, p. 47.

delivered[20] – it must service 98% of the delivery points 5 days a week and 99.7% of the delivery points at least twice a week.[21]

1.1.2 Letter volumes

Australia Post submits that, compared to an average annual growth rate in the 1990s of around 4 – 5%, domestic letter volume growth in the 2000s slowed to an average of around 0.3% per annum up to 2007-08.[22]

Australia Post expects domestic letter volumes to decline by 3.8% in 2008-09.[23] The 2008-09 forecast reflects a relatively strong result in 2007-08 (growth of 1.8%) where volumes were positively influenced by the general economic environment (including business and consumer confidence) and activity related to the 2007 Federal Election.[24] Australia Post submits that, in addition to the long term trend decline in some letter uses (for example, social mail and payments), the recent decline has been exacerbated by the impact of the global economic and financial crisis, which has had a negative impact on domestic letter volumes among other postal authorities.[25]

Over the next three years, Australia Post expects domestic reserved letter volumes to decline by an average of 2.3% per annum.[26]

1.1.3 Community service obligations

Under section 27 of the APCA, Australia Post is required to supply a letter service which extends to both reserved and non-reserved letters.

Key requirements of the letter service are that:

- it includes a single uniform rate of postage for the carriage within Australia, by ordinary post, of letters that are standard postal articles (i.e. the BPR);
- 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 business; and
- the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community. [27]

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[20] Australia Post's 2009 draft price notification, p. 34.

[21] Australia Post's 2009 draft price notification, p. 75.

[22] Australia Post's 2009 draft price notification, p. 25.

[23] Australia Post's 2009 draft price notification, p. 26.

[24] Australia Post's 2009 draft price notification, p. 26.

[25] Australia Post's 2009 draft price notification, p. 26.

[26] Australia Post's 2009 draft price notification, p. 26.

[27] APCA, section 27 as cited in Australia Post's 2009 draft price notification at p. 16.

Compared with a fully commercial operation, Australia Post claims that CSOs impose a cost structure that is higher than would otherwise be the case.[28] It contends that the net cost of Australia Post providing the CSOs (calculated on an avoidable cost methodology) for 2008-09 is estimated to have been $122.3 million.[29]

1.1.4 Productivit y growth

Productivity growth is growth in output per unit of growth in input, with both output and input measured on a real rather than nominal basis. Total factor productivity (TFP) measures output growth compared with the change in all inputs.

Australia Post's benchmarking study[30], which compared postal authorities in Australia, Canada, Denmark, Italy, Japan, New Zealand, and the USA over the 2002-2009 period, found that:

- on an unadjusted basis Australia Post was ranked third in terms of TFP levels;
- Australia Post was the only postal authority to show steady, consistent improvement in TFP, while the TFP of three other postal authorities deteriorated over the period;
- when the raw results were adjusted for mail density, Australia Post moved from third to second in the rankings; and
- when the data was adjusted for both mail density and customer density Australia Post moved from second to first in the rankings.[31, 32]

Australia Post submits that the results should provide reassurance to the ACCC that Australia Post is operating at a very high level of performance in the postal world.[33]

In the three years covered by this draft notification Australia Post forecasts:

- TFP for the total of Australia Post to fall slightly, with an overall fall in output volumes and a small rise in inputs;
- letter volumes to fall over the three years;
- inputs into the reserved letter service to fall over the next three years; and

28 Australia Post's 2009 draft price notification, p. 16.

29 Australia Post, *2009 Annual Report*, p. 110.

30 Economic Insights, *International Benchmarking of Postal Service Productivity,* June 2009,

31 The authors of the benchmarking study, Denis Lawrence and John Fallon, note at page 26 of their study that this adjustment is likely to be conservative as Australia Post has not included route length associated with rural deliveries by roadside mail contractors in its route length data supplied. Australia Post believes that this further adjustment would strengthen the result further as stated in its 2009 draft price notification at p. 56.

32 Australia Post's 2009 draft price notification, pp. 55-56.

33 Australia Post's 2009 draft price notification, p. 56.

- as a consequence, TFP for the reserved letter service to fall (by about 1% per annum).[34]

Australia Post submits that the forecast declines in TFP in the reserved letter service reflect the fact that Australia Post's network is required to provide a letter service to mandated service and access standards.[35] Australia Post points out that these standards do not vary downwards with declining letter volumes, and in fact have effectively become more demanding because of the 'inexorable rise' in the number of delivery points each year.[36] In Australia Post's view, the contributions of fixed service standards, increasing delivery points and declining volumes does not indicate decreasing efficiency in Australia Post's cost base.[37] Australia Post submits that it has managed its cost base over time to maximise profitability while not availing itself of the maximum revenue allowed in the ACCC's pricing formula.[38]

1.2 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.

To assist in undertaking these roles, the ACCC can issue record-keeping rules (RKRs) 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.

1.3 The ACCC's approach to assessing price notifications

In 1992, Australia Post's reserved letter services were 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 TPA. As a result of this declaration, to increase the

[34] Australia Post's 2009 draft price notification, p. 57.

[35] Australia Post's 2009 draft price notification, p. 57.

[36] Australia Post's 2009 draft price notification, p. 57.

[37] Australia Post's 2009 draft price notification, p. 57.

[38] Australia Post's 2009 draft price notification, p. 57.

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 does not object to the price increases or to price increases lower than Australia Post's proposed price increases.

Section 95ZH of the TPA enables the Minister (Treasurer) 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 (Treasurer) issued Direction 11 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

- Australia Post's functions and obligations (including its CSOs).

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.[39]

As outlined in that document, the formal price notification process described in subsection 95ZB(1) of the TPA does not provide sufficient time for the ACCC to give proper consideration to the complex issues presented in the assessment of a proposal to increase the prices of a firm with a high degree of market power.

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 its lodgement of a locality notice.

To adequately consider the issues raised, the ACCC usually adopts an approach whereby the declared firm lodges a draft notification with a supporting submission. After undertaking a preliminary review of the draft notification, the ACCC releases an issues paper seeking comments from interested parties on key issues. Although the timeframe for assessment will vary depending on the price notification, more complex proposals usually require a period of around six months.

In the case of Australia Post's proposed price notification, the ACCC's assessment involves careful consideration of econometric analysis of past and estimated future productivity improvements, theoretical financial analysis of the balance sheet components on which a return should be provided, the approach used to allocate costs to reserved and non-reserved services (and to particular letter services), and each of the components of the financial model supporting the proposed price increases.

In reaching its view on the draft price notification from Australia Post, the ACCC has carried out a public consultation process. On 20 August 2009, the ACCC released an issues paper

[39] ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009.

seeking submissions from interested parties on the proposed price increases by Australia Post. In addition to Australia Post's submissions, the ACCC received a total of 23 submissions from mail users, other businesses and members of the public. The ACCC has taken submissions provided by interested parties into account in its assessment of Australia Post's draft price notification.

1.4 Confidentiality

During the course of the ACCC's assessment of Australia Post's draft 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.

Information considered to be commercial-in-confidence is denoted by "✂" in this document.

Australia Post retains the discretion to release information that it considers to be commercial-in-confidence. Interested parties should approach Australia Post to seek access to this information.

2 Legislative framework and regulatory approach

This chapter outlines the legislative framework relevant to the ACCC's assessment of Australia Post's price notifications. While the formal price notification process has not been invoked at this stage, in forming a view on Australia Post's draft price notification, the ACCC has had regard to those matters it would be required to consider under the legislative framework if it had received a formal price notification (locality notice) from Australia Post. Relevant legislative instruments are attached at **Appendix C**.

2.1 ACCC's prices oversight role

The ACCC's role in the prices oversight of Australia Post's reserved letter services falls within the scope of Part VIIA of the TPA. In particular, under section 95X of the TPA, the Minister, or the ACCC with the approval of the Minister may:

- declare goods or services to be 'notified' goods or services;
- declare a person to be, in relation to goods or services of a specified description, a 'declared person' for the purposes of Part VIIA of the TPA.

Declaration 75 (made on 5 February 1992) provides that Australia Post is a declared person, and the provision of reserved letter services and the carriage within Australia of registered publications are notified services for the purposes of Part VIIA of the TPA.

This declaration means that in accordance with section 95Z of the TPA Australia Post must notify the ACCC if it proposes to:

- increase the price of a notified service; or
- introduce a new service that would fall within the definition of notified services; or
- provide an existing notified service under terms and conditions that are not the same or substantially similar to the existing terms and conditions of that service.

The ACCC must review price notifications and take such action, in accordance with Part VIIA of the TPA, as it considers appropriate.[40] In performing its functions in relation to Australia Post's price notifications, the ACCC:

- gives special consideration to the matters outlined in Ministerial directions, such as Direction 8 and Direction 11, and
- has particular regard to matters outlined in subsection 95G(7) of the TPA.

[40] Subsection 95G(5) of the TPA.

2.2 Ministerial directions (Direction 8 and Direction 11)

There are two ministerial directions relevant to the ACCC's assessment of Australia Post's price notification — Direction 8 and Direction 11. Consideration of the criteria under subsection 95G(7) of the TPA is subject to these directions.

As detailed in the ACCC's *Statement of regulatory approach to assessing price notifications*[41], Direction No. 8 is a general direction given to the ACCC by the Government under section 20 of the *Prices Surveillance Act* on 22 April 1988. Direction 8 provides that the ACCC must give special consideration to:

> The Government's policy that increases in executive remuneration in excess of those conferred under wage fixing principles should generally not be accepted as a basis for price increases.

Of primary importance to the ACCC assessment of Australia Post's price notification is Direction 11, made on 14 September 1990. Direction 11 states:

> (i) In exercising its powers and performing its functions under the Act in relation to prices charged by the Australian Postal Corporation (Australia Post) in respect of the transmission within Australia by ordinary post of standard postal articles and registered publications, to give special consideration to the following matters:
>
> - Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35-41 of the *Australian Postal Corporation Act 1989* and in particular the pricing targets and Government endorsed financial targets contained in Australia Post's corporate plan;
>
> - 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;
>
> (ii) To provide, where appropriate in confidence, advice to the Government on the appropriateness of pricing targets to be included in Australia Post's future corporate plans. Such advice should be given in the context of the financial targets contained in the corporate plan.

Australia Post's obligation to pursue a financial policy, pricing targets and Government endorsed financial targets

The ACCC must give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plan. While Direction 11 refers to sections 31–41 of the APCA, only sections 38 and 40 of the APCA remain operative.

Section 38 specifies the matters that Australia Post must have regard to in preparing or revising a financial target in its corporate plan. In particular, section 38 of the APCA provides:

> In preparing or revising a financial target for inclusion in a corporate plan under section 17 of the *Commonwealth Authorities and Companies Act 1997*, the Board shall have regard to:

[41] ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009, p. 14.

(a) the need to earn a reasonable rate of return on Australia Post's assets;

(b) the need to maintain the extent of the Commonwealth's equity in Australia Post;

(c) the expectation of the Commonwealth that Australia Post will pay a reasonable dividend;

(d) the need to maintain Australia Post's financial viability;

(e) the need to maintain a reasonable level of reserves, especially to make provision for:

  (i) any estimated future demand for postal services; and

  (ii) any need to improve the accessibility of, and performance standards for, the letter service;

(f) any other commercial matters the Board considers appropriate;

(g) the cost of carrying out Australia Post's community service obligations;

(h) the cost of performing Australia Post's functions in a manner consistent with the general policies of the Commonwealth Government of which the directors are notified under section 28 of the *Commonwealth Authorities and Companies Act 1997*;

(j) the cost of implementing any directions given by the Minister under section 49; and

(k) the cost of any other obligations of Australia Post under this or any other Act that require it to act otherwise than in accordance with normal commercial practice.

Section 40 of the APCA enables the Minister to within 60 days of receiving Australia Post's corporate plan and after consultation with the Board of Australia Post direct it to vary the financial target in its plan and/or the statement included in the plan of the strategies and policies under which Australia Post proposes to carry out its CSOs.

Australia Post's functions and obligations

The ACCC must give special consideration to Australia Post's functions set out in sections 14 to 16 of the APCA and also sections 26 to 28 of the APCA which detail Australia Post's commercial, community service, and general governmental obligations.

Section 14 of the APCA details Australia Post's principal function:

> The principal function of Australia Post is to supply postal services within Australia and between Australia and places outside Australia.

Section 15 of the APCA provides Australia Post's subsidiary function:

> A subsidiary function of Australia Post is to carry on, outside Australia, any business or activity relating to postal services.

Section 16 provides that Australia Post's functions also include the carrying on, within or outside of Australia, of any business or activity that is incidental to Australia Post's primary and subsidiary functions.

Section 25 of the APCA identifies that Australia Post has three obligations – its commercial obligation, its community service obligation, and its general governmental obligation.

Section 26 of the APCA provides Australia Post's commercial obligation:

> Australia Post shall, as far as practicable, perform its functions in a manner consistent with sound commercial practice.

Section 27 of the APCA provides Australia Post's community service obligation:

> (1) Australia Post shall supply a letter service.
>
> (2) The principal purpose of the letter service is, by physical means:
>
> (a) to carry, within Australia, letters that Australia Post has the exclusive right to carry; and
>
> (b) to carry letters between Australia and places outside Australia.
>
> (3) Australia Post shall 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.
>
> (4) Australia Post shall ensure:
>
> (a) that, 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 business; and
>
> (b) that the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community.
>
> (5) In this section:
>
> ***Australia*** includes Christmas Island and Cocos (Keeling) Islands, but does not include any other external Territory to which this Act extends.

Section 28 of the APCA provides Australia Post's general governmental obligation:

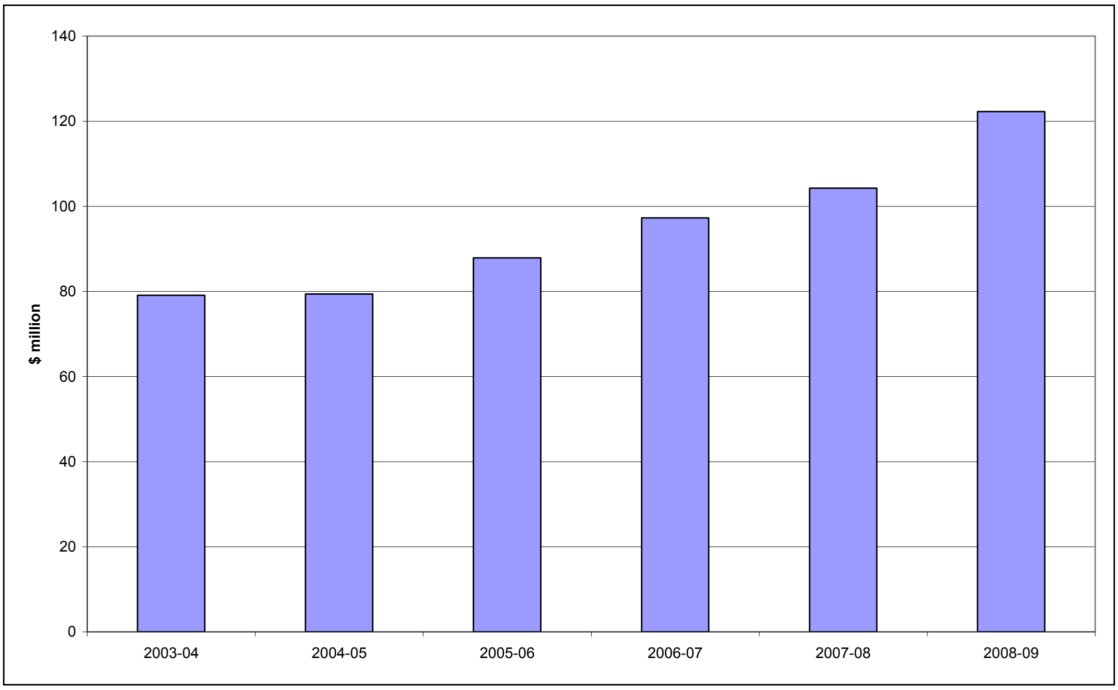
> Australia Post shall perform its functions in a way consistent with:
>
> (a) any general policies of the Commonwealth Government of which the directors are notified under section 28 of the *Commonwealth Authorities and Companies Act 1997*;
>
> (b) any directions given by the Minister under section 49; and
>
> (c) Australia's obligations under any convention.

Australia Post's community service obligations and performance standards

Australia Post regularly reports on the cost of complying with its CSO in its annual reports. Australia Post estimates the costs of complying with its CSO using an avoidable cost methodology. As outlined in Australia Post's 2007-08 annual report, the financial cost associated with meeting its CSO '…arises when the charge made for any mandated service does not recover the cost of its delivery.'[42] Australia Post notes that '[t]he cost is measured on a net basis, i.e. after reduction of related revenue, and is funded by an internal cross subsidy within the letter service.'[43]

Figure 2.1 shows Australia Post's costs of complying with its CSOs for the period 2003-04 to 2008-09 and also shows that the avoidable cost of meeting its CSO has been steadily increasing over time.

Figure 2.1: Australia Post's annual CSO cost 2003–04 to 2008–09 $ million



Source: Australia Post annual reports: 2003-04, 2004-05, 2005-06, 2006-07, 2007-08, and 2008-09

In addition to the general requirements of the CSO under paragraph 27(4)(a) of the APCA regarding accessibility and under paragraph 27(4)(b) regarding performance standards (including delivery standards), Australia Post must also comply with prescribed performance standards specified in regulations made pursuant to section 28C of the APCA — *Australian Postal Corporation (Performance Standards) Regulations 1998* (the Regulations).

The prescribed performance standards (outlined in detail in Appendix D), place specific requirements on Australia Post in relation to mail delivery (Part 2) and in relation to the accessibility of services (Part 3). In particular:

- regulation 5 prescribes the frequency of delivery;
- regulation 6 details the accuracy and speed of delivery (for reserved services);

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42 Australia Post, *2008-09 Annual report*, p. 110.

43 Australia Post, *2008-09 Annual report*, p. 110.

- regulation 8 specifies the mail lodgement points for articles other than bulk mail; and
- regulation 9 imposes requirements on Australia Post in relation to the number and location of its retail outlets.

It is important to note that unlike the CSO set out in section 27 of the APCA, not all of the performance standards in the Regulations relate specifically to the provision of the letter service. In fact, only regulation 6, which deals with accuracy and speed of delivery relates to a particular service — namely reserved services letters. Thus, Australia Post' obligations prescribed under the Regulations in relation to the frequency of delivery, retail outlets and collection points relate to all of Australia Post's delivery operations.

Australia Post's compliance with the prescribed performance standards specified in the Regulations is assessed by the auditor-general.[44] Australia Post reports on its compliance with the performance standards in its annual report.

Table 2.1 below shows Australia Post's compliance with the prescribed performance standards for the period 2003-04 to 2008-09. Australia Post has historically met its performance standards. Indeed, Australia Post has exceeded some performance standards (such as number of street posting boxes and retail outlets) by a large margin.

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44 Section 28D, *Australian Postal Corporation (Performance Standards) Regulations 1998.*

Table 2.1 Australia Post's required versus actual performance standards 2003-04 to 2008–09

Standard	*Required performance*	*Australia Post's actual performance*					
		2003-04	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
Number of street post boxes	**10 000**	15 238	15 425	15 436	15 606	15 878	16 055
Delivery timetable	**Maintained**	Maintained	Maintained	Maintained	Maintained	Maintained	Maintained
On time delivery of non bulk letters	**94%**	95.5%	94.9%	95.6%	96.3%	95.9%	95.5%
Points to receive delivery 5 days per week	**98%**	98.8%	98.7%	98.7%	98.7%	98.8%	98.8%
Points to receive delivery no less than twice	**99.7%**	99.9%	99.9%	99.9%	99.9%	99.9%	99.9%
Retail outlets	**4 000**	4 477	4 474	4 462	4 449	4 453	4 433

Source: Australia Post annual reports: 2003-04, 2004-05, 2005-06, 2006-07, 2007-08, and 2008-09

2.3 Subsection 95G(7) of the TPA

Subsection 95G(7) of the TPA provides:

> In exercising its powers and performing its functions under this Part, the Commission must, subject to any directions given under section 95ZH, have particular regard to the following:
>
> (a) the need to maintain investment and employment, including the influence of profitability on investment and employment
>
> (b) the need to discourage a person who is in a position to substantially influence a market for goods and services from taking advantage of that power in setting prices
>
> (c) the need to discourage cost increases arising from increases in wages and changes in the conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC's approach to interpreting subsection 95G(7) of the TPA is outlined in detail in its *Statement of regulatory approach to assessing price notifications* — which was updated and sent to key stakeholders (including Australia Post) in June 2009.[45] The ACCC's approach to applying subsection 95G(7) of the TPA for its assessment of Australia Post's draft price notification is consistent with the approach outlined in this guide (reproduced below).

45 ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009, pp. 12-14, 15-18.

Investment, employment and market power – paragraphs 95G(7)(a) and (b)

A declared firm may possess monopoly or market power which allows it to charge excessive prices through having either costs above efficient levels, or profit margins above competitive levels.[46]

An important consideration relevant to the first two criteria in subsection 95G(7) is that in an open and competitive market economy efficient provision of services underpins investment and employment opportunities. Further, investment and employment in the national economy will be promoted when firms produce goods or services efficiently and price them competitively.

Pricing decisions by a declared firm may involve conflict between the investment and employment interests of the declared firm on the one hand, and the interests of users and other groups in the economy on the other. To obtain an appropriate balance, the ACCC has interpreted the criterion in paragraphs 95G(7)(a) and (b) as seeking to promote economically efficient investment and employment throughout the economy. This is broadly consistent with the objectives outlined by the Government for pricing infrastructure services under the national access regime under Part IIIA of the TPA[47] and also consistent with the object of prices surveillance, as set out in section 95E of the TPA.

Economic efficiency encompasses the following elements:

- *productive efficiency*, which is achieved when firms have the appropriate incentives to produce goods or services at least cost, and production activities are distributed between firms in a manner that minimises industry-wide costs;
- *allocative efficiency*, which is achieved when firms employ resources to produce goods and services that provide the maximum benefit to society;
- *dynamic efficiency*, which is achieved when firms have appropriate incentives to invest, innovate and improve the range and quality of goods and services, increase productivity and reduce costs over time.

In an open and competitive economy, the efficient provision of services underpins investment and employment opportunities. Welfare enhancing investment and employment in the national economy will be promoted when firms produce goods or services at least cost and charge prices that correspond as closely as possible to competitive levels. Although a competitive benchmark may be lacking in industries subject to prices surveillance, economically efficient prices would, as in competitive areas, reflect least-cost production and

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46 Australia Post and Airservices Australia are both statutory monopoly providers of particular services and the Productivity Commission found that Sydney airport has a high degree of market power in domestic markets (Price regulation of airport services—Inquiry report, 23 January 2002).

47 See Commonwealth Government, *Government response to Productivity Commission report on the review of the National Access Regime*, Canberra, September 2002.

include profit margins reflecting a return on capital commensurate with the risks faced by the firm.

Prices above efficient levels result in a loss of allocative efficiency as they discourage some marginal purchases which would have had a value to the purchaser above the cost of supply. As excessive prices are passed on in higher costs for other industries using the services, they lead to lower profits and potentially a loss of investment and employment opportunity in the competitive sectors of the economy.

Accordingly, the ACCC considers that the criteria in subsection 95G(7) will generally be met by economically efficient prices which reflect:

- an efficient cost base; and
- a reasonable rate of return on capital.

Including a reasonable rate of return on capital employed in prices for goods and services addresses the criterion in paragraph 95G(7)(a) in relation to the declared firm's industry by providing incentives to maintain profitable investment. At the same time, a declared firm which may have substantial influence in a market for notified goods and services is discouraged from charging prices based on profits above that reasonable rate of return addressing the criterion in paragraph 95G(7)(b).

Wages & conditions of employment

The ACCC considers paragraph 95G(7)(c) is less relevant to its consideration of price notifications following changes to industrial relations legislation in 1996 which led to a movement away from centralised wage fixing to agreements negotiated at the enterprise level. The object of the *Workplace Relations Act 1996* was to give 'primary responsibility for industrial relations and agreement making to employers and employees at the enterprise and workplace levels'.[48]

Enterprise bargaining has remained central to enabling an enterprise to negotiate the types of terms and conditions and work practices that allow an enterprise to retain good staff and make productivity gains that ultimately promote the future profitability of that enterprise. This type of remuneration is intended to boost the capacity of the enterprise to attract investment and provide future employment.

Consistent with the current wage determination framework, the ACCC is more likely to not object to price increases based on wage increases where such wage increases are associated with improvements in productivity and/or wage levels are at market levels. However, in monopolies or industries with highly concentrated market power, there may be less pressure for wage and labour agreements to be kept within the bounds of conditions across the economy generally. In assessing a price notification the ACCC will usually treat the level of wages and conditions as part of the broader issue of an efficient cost base.

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[48] Commonwealth Department of Industrial Relations, *Changes in federal workplace relations law - legislation guide*, Dec. 1996, p. 1.

2.4 Approach to considering Direction 11 and subsection 95G(7) of the TPA

Australia Post's view

In its 2009 draft price notification, Australia Post acknowledges the approach taken by the ACCC in applying subsection 95G(7) of the TPA as set out in the ACCC's *Statement of Regulatory Approach to Assessing Price Notifications*.[49] However, Australia Post submits that while the ACCC's approach may apply in general, the ACCC has acknowledged that a flexible approach is required to reflect the individual characteristics of each price notification.[50] One factor that Australia Post sees as necessitating a flexible approach is section 95ZH of the TPA which provides for the Minister to direct the ACCC to give special consideration to a specified matter or matters in performing its functions under Part VIIA.[51]

In support of its submission, Australia Post relies on the Explanatory Memorandum to the *Trade Practices Legislation Amendment Bill 2003*.[52] Australia Post submits that the Explanatory Memorandum to the *Trade Practices Legislation Amendment Bill 2003* reinforces the importance of the obligation on the ACCC to give special consideration to matters that the ACCC is directed by the Minister to consider under section 95ZH of the TPA, in this case Direction 11.[53]

The Explanatory Memorandum states in regard to section 95G of the TPA that:

> …In exercising its powers and performing its functions under Part VIIA, the Commission must, subject to any directions given under s95ZH (which would become the paramount factors to be considered by the Commission), have particular regard to the three other factors described in s95G(7)(a),(b) and (c).[54]

Further, it states in regard to section 9ZH of the TPA that:

> …The purpose of the provision is to ensure that the operations of the Commission remain within the framework of Government policy (95ZH special considerations are to be paramount; for example, they are to be more important considerations than the particular factors specified in 95G).[55]

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49 Australia Post's 2009 draft price notification, p. 10.

50 Australia Post's 2009 draft price notification, p. 10.

51 Australia Post's 2009 draft price notification, p. 10.

52 Australia Post's 2009 draft price notification, p. 10.

53 Australia Post's 2009 draft price notification, p. 10.

54 *Trade Practices Legislation Amendment Bill* 2003 Explanatory Memorandum, accessed on 25 November 2009 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html.

55 *Trade Practices Legislation Amendment Bill* 2003 Explanatory Memorandum, accessed on 25 November 2009 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html.

For the purposes of Direction 11, Australia Post notes that its corporate plan does not identify a particular item as being a 'financial target', but does include targets for the following financial measures:

- revenue;
- profit, both before tax and after tax;
- dividends paid;
- shareholder value; and
- rates of return, on operating assets, on revenue and on equity.[56]

Australia Post also notes that its corporate plan includes a reference to its capital investment program.[57] Australia Post submits that its capital investment program is '…considered necessary to achieve the revenue and expense projections in the plan and to underpin the longer-term viability and growth of Australia Post.'[58] Australia Post submits that '[t]he capital investment program is integral to each corporate plan, and receives its own more detailed account. Australia Post's capital investment program forms as important an element of Australia Post's overall "financial policy" as any of the factors chosen as "financial targets"'.[59]

In addition, noting the specific reference to the pricing targets and government endorsed financial targets in Australia Post's corporate plans in Direction 11, Australia Post submits that the separate identification of these items in Direction 11 suggests that they require separate consideration.[60] In particular, Australia Post notes that '…in considering these two items, pricing targets would need to be considered separately to the government endorsed financial targets and it would not be consistent with Direction 11 to consider alternative options to maintain a financial target if a pricing target is varied.'[61]

ACCC's view

The Explanatory Memorandum of the *Trade Practices Legislation Amendment Bill 2003* clarifies that matters specified in Ministerial directions are more important considerations than the factors specified in section 95G of the TPA.[62]

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56 Australia Post's 2009 draft price notification, p. 12.

57 Australia Post's 2009 draft price notification, p. 12.

58 Australia Post's 2009 draft price notification, p. 12.

59 Australia Post's 2009 draft price notification, p. 12.

60 Australia Post's 2009 draft price notification, p. 11.

61 Australia Post's 2009 draft price notification, p. 11.

62 *Trade Practices Legislation Amendment Bill* 2003 Explanatory Memorandum, accessed on 25 November 2009 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html.

While the ACCC acknowledges that it must give special consideration to the matters in Direction 11, it continues to also be obliged to have particular regard to the factors specified in section 95G of the TPA.

It is the ACCC's view that the approach it takes in giving special consideration to the matters set out in Direction 11 such as Australia Post's functions and obligations, its obligation to pursue a financial policy, pricing targets and Government endorsed financial targets does not conflict with the approach that it takes in having particular regard to the factors specified in section 95G.

In addition, the ACCC considers the matters raised in Direction 8 in a similar way to that of paragraph 95G(7)(c). The issues raised in Direction 8 and 95G(7)(c) are less relevant now than in 1998 in light of the movement away from centralised wage fixing to agreements negotiated at the enterprise level. Nevertheless, the ACCC treats the level of wages and executive remuneration as part of its broader concern related to the efficiency of the cost base.

Australia Post's functions and obligations

Australia Post is under a commercial obligation to, as far as practicable, perform its functions in a manner consistent with sound commercial practice. In the ACCC's opinion this would entail charging prices that reflect the efficient costs of production and include profit margins reflecting a return commensurate with the risks faced by the firm. In a commercial setting, seeking price increases above efficient cost levels would put a firm at a competitive disadvantage and would not be commercially sound.

Australia Post itself acknowledges the link between cost efficiency and its commercial obligation. In its draft price notification Australia Post submits that:

> 'Cost control is vital for Australia Post if it is to meet its commercial obligation to make a satisfactory rate of return. Specific to the domestic reserved letter service, there are two key points that underpin Australia Post's assertion that it has, and will continue to pursue, an efficient cost base. They are:
>
> - the domestic reserved letter service is provided from a joint cost base. Ensuring competitiveness across all products that are provided from this joint cost base requires ongoing efforts and the establishment of performance management targets that focus on ensuring efficiencies are pursued and realised; and
>
> - in the context of this draft notification, in which a commercial market volume and price concerns prevent a recovery of maximum allowable revenue (circumstances which are likely to persist beyond the three year price window), achieving an acceptable rate of return is dependent upon minimising costs rather than on price increases compensating for an inefficient cost base.'[63]

Australia Post's CSOs (and prescribed performance standards) mean that the costs associated with the provision of Australia Post's standard letter service are greater than what would be incurred if the letter service was not subject to the CSO (and prescribed performance standards). In addition, the CSO requires a uniform price structure for the standard letter service. However, (particularly in light of the expectation of declining volumes for letter services as set out in this price notification) Australia Post's ability to continue to meet its

[63] Australia Post's 2009 draft price notification, p. 36.

CSO on an ongoing basis also requires prices to be set at efficient costs (accounting for Australia Post's CSO and prescribed performance standards) and include profit margins that reflect a return commensurate with the risks faced by the firm. Levying prices above this level would deter consumption of Australia Post's reserved services and impact the financing of Australia Post's CSOs.

The ACCC is not aware of (nor has Australia Post identified) any general governmental obligations imposed on Australia Post under section 28 of the APCA, or any directions or notifications under the APCA that are relevant to the ACCC's assessment of Australia Post's draft price notification which are required to be considered under Direction 11.

Australia Post's obligation to pursue a financial policy, pricing targets and Government endorsed financial targets

In support of its draft price notification, Australia Post has provided the ACCC with its 2009-10 corporate plan which has been submitted to the Government. Australia Post's draft price notification (including the financial model used to support its proposed price increases) is based on information in Australia Post's corporate plan. Australia Post submits that '[t]his draft notification is supported by information on volumes, revenues and costs and is modelled over the 2009-10 – 2011-12 financial years. This financial data is consistent with Australia Post's corporate plan'.[64]

The ACCC notes that a cost based approach to considering Australia Post's price notification — where an assessment is made of the extent to which the additional revenue from the proposed price increases will enable the recovery of efficient costs including profit margins reflecting a return commensurate with the risks faced by the firm — facilitates the ACCC in providing special consideration to the pricing targets and government endorsed financial targets in Australia Post's corporate plan.

The ACCC notes that the corporate plan identifies a number of strategies designed by Australia Post to achieve the financial targets outlined in the corporate plan. While an increase in prices of reserved services is one strategy that may result in Australia Post meeting its financial targets, this is not necessarily the only strategy that enables Australia Post to achieve those targets.

The ACCC disagrees with Australia Post's view that the pricing targets and government endorsed financial targets in Australia Post's corporate plan should be considered separately, and that it would inconsistent with Direction 11 to consider alternative options to maintain a financial target if a pricing target were varied. Pricing targets and financial targets are interrelated, and the ACCC considers that it should not ignore alternative strategies that Australia Post could implement to reach the financial targets as set out in its corporate plan, such as restructuring its prices, increasing productivity and/or reducing its costs.

Therefore, in the context of Direction 11 and subsection 95G(7) of the TPA, the ACCC considers that its assessment of Australia Post's 2009 draft price notification should be guided by the following:

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64 Australia Post's 2009 draft price notification, p. 7.

- whether the cost base, including a rate of return, underlying the proposed price increases is efficient;

- whether proposed price increases will provide Australia Post with economically efficient investment incentives;

- whether the proposed price increases will provide consumers with economically efficient signals for the consumption of Australia Post's services; and

- whether the proposed price increases are sufficient to enable Australia Post to meet the costs of its CSOs but do not reflect monopoly rents.

2.5 ACCC's advisory role under Direction 11

In addition to identifying a number of matters which the ACCC must give special consideration to in assessing a price notification from Australia Post, Direction 11 enables the ACCC to provide confidential advice to Government on the appropriateness of pricing targets in Australia Post's corporate plan. In particular, Direction 11 states:

> …
>
> (ii) To provide, where appropriate in confidence, advice to the Government on the appropriateness of pricing targets to be included in Australia Post's future corporate plans. Such advice should be given in the context of the financial targets contained in the corporate plan.

2.6 Regulatory approach to assessing Australia Post's draft price notification

Australia Post's view

In its 2009 draft price notification, Australia Post signalled its expectation that the ACCC would take a similar approach to assessing this notification as was taken by the ACCC in assessing its 2008 price notification. Australia Post submits that:

> Australia Post's 2009/10 – 2011/12 corporate plan sets out the most recent expectations for the business. In that plan, profit targets and pricing expectations for the domestic reserved letter service were formed on the assumption that the ACCC's pricing model continued to apply to reserved services. That is:
>
> - the efficiency of the asset and cost base would be assessed by the ACCC;
> - a reasonable economic return equal to the WACC multiplied by the asset base would form part of the allowed revenue by the ACCC; and
> - allowable revenue for the reserved letters service is determined at a total package level, rather than on individual product category.
>
> These assumptions reflect the practice of the ACCC as applied in the 2008 price notification. In other words:
>
> - if the ACCC maintains its financial model used in the 2008 price notification and in the regulatory accounting process; and

- Australia Post's efficient costs and rate of return in this draft notification are accepted as the basis of domestic reserved letter service required revenues and thus prices; then
- Australia Post does not expect that this would create any tensions in terms of Direction 11, which requires the ACCC to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plan.'[65]

ACCC's view

The ACCC provided extensive guidance in its 2008 decision regarding information that should be provided to the ACCC by Australia Post to support future price notifications. For example, the ACCC requested that:

> '…the ACCC requires 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 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 this period.
>
> The ACCC also expects Australia Post to address the concerns that have been identified with its cost allocation methodology…'.[66]

The ACCC also identified that an international benchmarking study could assist Australia Post to demonstrate the efficiency of its operations to the ACCC. [67]

The ACCC has two specific concerns in relation to Australia Post's views on the ACCC's regulatory approach to Australia Post's 2009 draft price notification and in relation to whether the ACCC's regulatory approach is consistent with Direction 11.

First, Australia Post submits that it assumed that '[a]llowable revenue would be determined at a total package level, rather than on individual product category'.[68] This assumption is inconsistent with the guidance provided by the ACCC to Australia Post in its 2008 price notification on this issue. In its assessment of Australia Post's 2008 draft price notification, the ACCC stated that the determination of allowable revenue on an individual product category was '…relevant to its assessment of the proposed price increases in reserved

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65 Australia Post's 2009 draft price notification, p. 63

66 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 184.

67 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 140.

68 Australia Post's 2009 draft price notification, p. 63.

services'.[69] Indeed, the ACCC requested that Australia Post provide a disaggregated three year model in future price notifications.[70]

Second, Australia Post submits that if the ACCC accepts Australia Post's efficient costs and rate of return in this draft notification, then Australia Post does not consider that this will create tensions with Direction 11.[71] The ACCC does not consider that merely accepting Australia Post's estimate of its efficient costs would be consistent with Direction 11. If Australia Post's estimate of its forward looking efficient costs is too high (i.e. in excess of relevant efficient costs) the ACCC's acceptance of this estimate would be inconsistent with the matters in Direction 11 — particularly in regard to Australia Post's commercial obligation and community service obligation.

As outlined in sections 2.2 and 2.4 above, the ACCC considers that subsection 95G(7) and Direction 11 steer the ACCC towards an assessment of the efficiency of Australia Post's cost base, and of the rate of return it is seeking.

As outlined in the ACCC's *Statement of regulatory approach to assessing price notifications*, 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 TPA. 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 TPA means that efficiency benefit sharing schemes are difficult to implement. The difficulty of implementation may impact on the incentives for cost efficiency for both the period of analysis and for the duration of the proposed price increases.

Non-declared services

Where a firm provides non-declared services in addition to its declared services, these services may be relevant to the ACCC's assessment of price levels of the declared services. In particular, where a dual till approach to regulation is applied, a separation needs to be made between the costs of providing the declared and non declared services where those costs are jointly incurred.

The approach to separating the costs of providing Australia Post's reserved and non-reserved services was an issue of concern in the ACCC's assessment of Australia Post's 2008 price notification.[72] Since then the ACCC has conducted a review of Australia Post's cost allocation methodology — see Chapter 4.

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[69] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 184.

[70] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 187.

[71] Australia Post's 2009 draft price notification, p. 63.

[72] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 68.

Pricing structure

In addition to using the PTRM to assess the extent to which the expected revenue from the proposed prices is in line with a firm's efficient costs, the ACCC will also consider the structure of the firm's prices. In assessing the structure of prices in a pricing proposal, the ACCC will, when relevant, consider the extent to which the firm's proposed pricing structure promotes the objectives of economic efficiency (outlined above) which are consistent with meeting the criteria set out in subsection 95G(7) and Direction 11 matters.

2.7 Structure of the ACCC View

The ACCC's consideration of Australia Post's proposed price increases involves an analysis of each of the components of the PTRM, an assessment of pricing structure, and a consideration of the implications of the decline in demand for letter services.

The application of the regulatory framework by the ACCC in the assessment of Australia Post's 2009 draft price notification will proceed as follows:

- assessment of the determinants of demand for Australia Post's services, including consideration of the approach taken by Australia Post to forecast demand for its letter services over the three year period to 2011-12 — Chapter 3, Demand;
- analysis of Australia Post's claim that its proposed costs are efficient, including consideration of studies commissioned by Australia Post regarding its productivity — Chapter 4, Costs;
- assessment of Australia Post's proposed return on capital estimated by Value Advisors Associates — Chapter 5, Return on Capital;
- consideration of the implications of the preceding assessments for the ACCC's view on the proposed price increases — Chapter 6, ACCC's view.

3 Demand

Forecasts of demand for Australia Post's services are required under a cost-based pricing methodology as they are relevant to the ACCC's assessment of the efficiency of Australia Post's costs (for the relationship between costs and volumes, and cost allocation – see Chapter 4). Forecasts of demand are also used to assess whether the proposed prices are expected to achieve revenue sufficient to recover these costs (without providing excessive returns). Demand forecasts are also used in calculating Australia Post's TFP and in the assessment of whether Australia Post is expected to make productivity improvements over the period 2008-09 to 2011-12 (see Chapter 4).

The ACCC engaged Frontier Economics to review Australia Post's forecast letter volumes and forecasting method, including the reports prepared by Diversified Specifics and used by Australia Post in forecasting letter volumes.

This chapter outlines Australia Post's volume forecasts, the findings from Frontier Economics' review, and the ACCC's assessment of demand for domestic reserved letter services.

3.1 Australia Post's forecast letter volumes

Figure 3.1 and Table 3.1 outline Australia Post's forecasts for domestic reserved letter volumes for 2008-09 to 2011-12 for the main service categories subject to its draft price notification.[73]

Australia Post's forecast volumes for its domestic reserved letter services over the period 2008-09 to 2011-12 indicate: [74]

- In total, volumes are expected to fall by 2.3 per cent from 4113 million letters to 3832 million letters.
- Small Other (including ordinary) letters are expected to decline by an annual average of 5.4 per cent.
- Small PreSort letters will remain relatively stable with an annual average decline of 0.1 per cent.
- Large Other (including ordinary) letters are expected to decline by an annual average of 3.4 per cent.
- Large PreSort letters are expected to decline by 0.3 per cent.

[73] That is, domestic reserved letter services.

[74] Source: Australia Post's 2009 draft price notification, p. 79.

Figure 3.1 — Australia Post's actual and forecast reserved letter volumes by service category for 2007-08 to 2011-12[75]

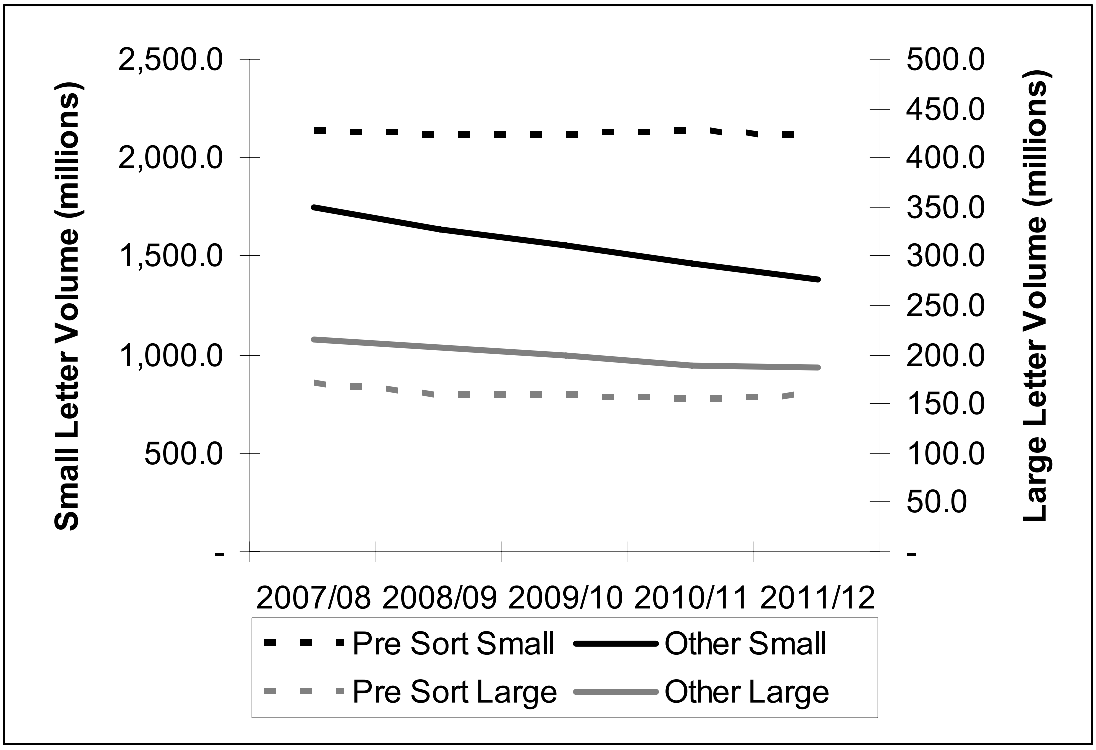

Table 3.1 — Australia Post's actual and forecast reserved letter volumes by service category for 2007-08 to 2011-12[76]

	2007-08	2008-09	2009-10	2010-11	2011-12
Total Domestic Reserved	4,273.2	4,113.0	4,018.1	3,939.5	3,832.3
Pre Sort Small	2,135.4	2,112.3	2,109.8	2,131.4	2,103.9
Pre Sort Large	169.9	159.1	159.5	154.0	157.9
Other Small	1,752.7	1,633.9	1,550.4	1,464.5	1,383.4
Other Large	215.3	207.6	198.5	189.6	187.0

Although not subject to the proposed price increases in the 2009 draft price notification, the forecast volumes of other non-reserved and reserved non-domestic services provided by

75 Source: Australia Post's 2009 draft price notification, p. 79.

76 2008-2012 Data Source: Australia Post's 2009 draft price notification, p. 79; 2007-08 Data Source: Data provided by Australia Post in support of its draft notification.

Australia Post are relevant to the ACCC's consideration of broader market developments in the other delivery services provided by Australia Post using its shared delivery network. While non-reserved and reserved non-domestic service volumes relate to non-declared services, they are also relevant to Australia Post's forecast allocation of common costs (i.e. costs incurred in producing a group of products that cannot be directly attributed to any one product or service) to the declared reserved letter services.

For its letters network, Australia Post's forecasts for non-reserved letters and reserved international letters volumes over the period 2008-09 to 2011-12 are as follows: [77]

- Non-reserved PreSort and Other Letter volumes (e.g. letters weighing in excess of 250 grams) are forecast to ✂✂✂✂ over the period by an annual average of ✂✂✂✂✂.
- Non-reserved publications volumes are forecast to ✂✂✂✂✂, with an annual average ✂✂✂✂✂.
- Non-reserved unaddressed mail volumes are forecast to ✂✂✂✂✂✂✂.
- International inwards letter (both non-reserved and reserved) volumes are forecast to ✂✂✂.
- International outwards letter volumes are forecast to ✂✂✂✂.
- Express post letter volumes are forecast to ✂✂✂✂✂✂✂✂✂✂✂✂.

In addition to letter services, Australia Post also provides parcels and logistics services using its mail network, and provides non-mail (retail and agency) services using its retail network. Forecasts for these services over the period 2008-09 to 2011-12 are as follows: [78]

- Parcel services volumes are forecast to ✂✂✂✂✂✂✂✂✂✂✂✂.
- Agency and financial services volumes are forecast to ✂✂✂✂✂✂✂✂✂✂✂✂.

3.1.1 Australia Post's forecasting method and considerations

Australia Post states that it uses information from a variety of sources in forecasting demand for its domestic reserved letter services, including:[79]

- analysis of market environment conditions;

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77 Source: Australia Post, information provided to Economic Insights for its 2009 international benchmarking of postal service productivity study. Non-reserved PreSort and Other Letter volumes data source: Australia Post, Letter volumes and revenue, information provided in support of 2009 draft price notification, July 2009.

78 Source: Australia Post, information provided to Economic Insights for its 2009 international benchmarking of postal service productivity study.

79 Australia Post's 2009 draft price notification, p. 25.

- input from national and state based sales areas (incorporating knowledge of customer behaviour); and
- knowledge derived from econometric modelling.

Australia Post states that its volume forecasts are primarily based on business intelligence due to limitations of econometric forecasting techniques for letter volumes: [80]

> Information from these data sources supports the development of volume forecasts that incorporate management assessments and judgements across Australia Post. These forecasts are used as a key input to the determination of corporate and divisional budget targets.
>
> The market environment analysis includes econometric analysis of historical volumes (demand analysis), … However forecasts are not exclusively based on econometric analysis because of the limitations of such analysis e.g. the impact of the consolidation, rationalisation and substitution of some mail which is driven by the behaviour of individual senders rather than any general tractable factor or driver.

Australia Post indicated that forecasts provided to the ACCC were derived via an iterative process between product group managers, sales managers and general management.[81] Australia Post was unable to provide documentation or quantitative associations to demonstrate the iterative process of incorporating management opinion and econometric modelling in volume forecasts.

In deriving its letter volume forecasts, Australia Post considers that there are three segments that account for the following (approximate) proportions of the total domestic letters market:[82]

- transactional mail 77 per cent
- promotional mail 19 per cent
- social mail 5 per cent

As these letter segments are separated by purpose, they may have more clearly delineated volume drivers than service categories based on price differentials (such as size or sort level). Table 3.2 illustrates the link between trends in these letter segments and trends in service categories (e.g. the proportion of transactional mail estimated to be sent using the small PreSort letter service). Australia Post estimates that social mail is predominately sent as small Other Letters, transactional mail is typically sent as small PreSort and small Other Letters, while promotional mail is predominately sent as small PreSort letters.[83]

80 Australia Post's 2009 draft price notification, p. 25.

81 Australia Post response to information request from Frontier Economics: see Frontier Economics, *Review of Australia Post's volume and input cost forecasts*, *A report prepared for the ACCC,* November 2009, p. 15.

82 Australia Post's 2009 draft price notification, p. 78.

83 Source: Australia Post response on 2 September 2009 to information request by Frontier Economics on 26 August 2009, p. 2.

Table 3.2 — Relationship between service categories and letter segments for Australia Post's 2009-10 forecast volumes [84]

2009-10 forecast	social (millions)	%	transactional (millions)	%	promotional (millions)	%	total (millions)
small PreSort	-	0%	1,410	67%	700	33%	**2,110**
large PreSort	-	0%	78	46%	90	54%	**168**
small Other	178	11%	1,372	89%	-	0%	**1,550**
large Other	2	1%	213	99%	-	0%	**215**
total small	178	5%	2,782	76%	700	19%	**3,660**
total large	2	1%	291	76%	90	23%	**383**
total PreSort	-	0%	1,488	65%	790	35%	**2,278**
total other	180	10%	1,585	90%	-	0%	**1,765**
Total	**180**	**4%**	**3,073**	**76%**	**790**	**20%**	**4,043**

Note: Includes non-reserved small and Large Letters over 250g (Draft notification, p. 26)

Figure 3.2 shows Australia Post's forecasts over the period 2008-09 to 2011-12 for the three letter segments. Australia Post expects transactional and social mail volumes to steadily decline over the period by 3.4 per cent and 4.1 per cent respectively. [85] Promotional mail volumes are expected to flatten initially before rising to grow over the period by 2.1 per cent.[86]

In support of its expected decline in overall letter volumes, Australia Post notes that electronic communication substitutes have been eroding letter volumes for many years, stating:[87]

> [T]he traditional letters market has been under pressure since 2000 as the range, availability and capability of new communication and messaging channels continues to grow. Compared to an average annual growth rate in the 1990s of around 4 – 5%, domestic letter volume growth in the 2000s slowed to an average of around 0.3% per annum up to 2007/08. Some specific parts of the market have shown even earlier impacts of changes in customer preferences. For example social mail has been in decline since the mid 1980s.

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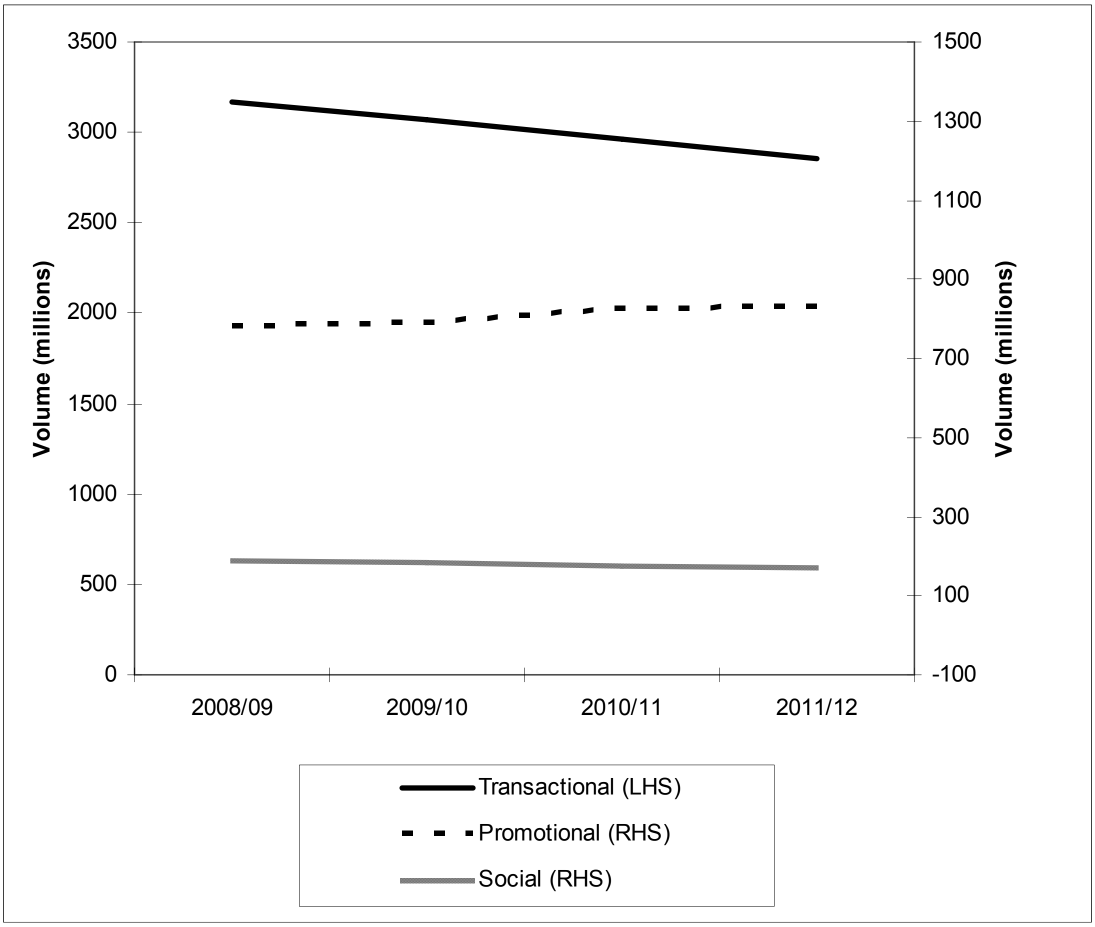
84 Data Source: Australia Post response on 2 September 2009 to information request by Frontier Economics on 26 August 2009, p. 3.

85 Australia Post's 2009 draft price notification, p. 27.

86 Australia Post's 2009 draft price notification, p. 27.

87 Australia Post's 2009 draft price notification, p. 25.

Figure 3.2 — Australia Post's forecast reserved letter volumes by letter segment for 2008-09 to 2011-12 [88]



Australia Post submits that expected decline in transactional mail is due to:[89]

- the move by all senders to use electronic/digital communication channels, (i.e. substitution), e.g.
  - from private consumers a reduction in cheque payments by mail, and
  - from business senders an uptake of email, fax streaming, electronic bill presentment, etc.; and
- the move by business senders to look at strategies that consolidate (e.g. a single bills covering gas & electricity, or a fixed line & mobile phone) or rationalise (e.g. moving from monthly to quarterly statements) their mailings.

Compounding this is a slow down in a number of volume drivers, such as take-up of (account based) mobile phones (e.g. movement to prepaid).

Australia Post submits that expected declines in social mail are attributable to: [90]

88 Source: Australia Post's 2009 draft price notification, p. 27.

89 Australia Post's 2009 draft price notification, p. 78.

the continued increase in electronic/digital communication options (eg phone, email, SMS, IM, etc.) and their uptake/utilisation by private consumers.

Australia Post submits that while growth in the promotional mail volumes has been relatively robust over the past three years, it expects this to flatten to around 2% which it contends reflects '…expectations within the broader advertising and marketing industry'.[91]

3.1.2 Diversified Specifics' reports

Prior to Australia Post's 2008 draft price notification, Australia Post commissioned Diversified Specifics to undertake a study on domestic Small Letter segment volume demand.[92] To assist Australia Post in forecasting letter volumes prior to its 2009 draft price notification, Australia Post commissioned Diversified Specifics to:

- provide a 2009 update on the 2007 domestic Small Letter segment volume demand study[93]
- undertake a study into domestic Large Letter segment volume demand;[94] and
- undertake a study into the impact of economic downturns on the income elasticity of demand for PreSort bar-coded Small Letter services.[95]

Diversified Specifics' studies into domestic Small Letter segment and domestic Large Letter segment volumes involved econometric analysis of the drivers of letter volumes for small PreSort, small Other, large PreSort and large Other Letter services over the period 1995-96 to 2007-08. The analysis was conducted by regressing, using ordinary least-squares techniques, relevant drivers of letter volumes using quarterly data and a model for letter volumes using the natural logarithm of both the dependent and explanatory variables, which allows for results to be interpreted as elasticities. Relevant volume drivers were selected for each letter category based on association testing, diagnostic tests and their common sense checks via an iterative regression process.

Table 3.3 outlines the estimated elasticity results from Diversified Specifics' models. For example, the results indicate that for a 1 per cent increase in non-farm GDP, large Other

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90 Australia Post's 2009 draft price notification, p. 78.

91 Australia Post's 2009 draft price notification, p. 78.

92 Diversified Specifics, *Domestic Small Letter Segment Volume Demand: 1995/96 to 2006/07,* December 2007.

93 Diversified Specifics, *Domestic Small Letter Segment Volume Demand: Addendum 1996 to 2008,* March 2009.

94 Diversified Specifics, *Domestic Large Letter Segment Volume Demand: 1995/96 to 2007/08,* February 2009.

95 Diversified Specifics, *Impact of Economic Downturns on Income Elasticity of Demand: Pre Sort Barcoded Small Letters*, May 2009.

Letter volumes are estimated to increase by 0.22 per cent, while small Other Letter volumes are not estimated to be significantly affected.

Table 3.3 — Elasticities estimated by Diversified Specifics [96]

Explanatory variables	Small PreSort letters	Small Other Letters	Large PreSort letters	Large Other Letters
Non-farm GDP [1]	0.99	NA	1.03	0.22
Advertising industry health measure [2]	0.12	NA	0.30	NA
Barcode introduction [3]	0.10	NA	0.16	NA
Credit card volume [1]	NA	-0.91	NA	NA
Real price of other Small Letters	NA	-0.65	NA	NA
Closure of unbarcoded PreSort service [4]	NA	0.11	NA	0.08

Notes: (1) Seasonally adjusted; (2) S&P/ASX 200 Consumer Discretionary Index used as a proxy variable; (3) Binary variable equal to zero before October 1999 and to one afterwards (4) Binary variable equal to zero before September 2002 and to one afterwards; NA – not included in the preferred model.

The findings from Diversified Specifics' small and Large Letter volume studies suggest that:

- Small Other and large Other Letter volumes are inelastic to changes in economic activity (non-farm GDP).

- Volumes for all letter categories are inelastic to changes in their respective prices, with small Other Letter volumes appearing to be the most elastic.

96 Source: Diversified Specifics, *Domestic Small Letter Segment Volume Demand: Addendum 1996 to 2008,* March 2009, pp. 9-10; Diversified Specifics, *Domestic Large Letter Segment Volume Demand: 1995/96 to 2007/08,* February 2009, pp. 45, 48.

- Variation in PreSort letter volumes can be explained by changes to advertising industry health. This is likely attributable to the use of PreSort mail for promotional purposes.

Diversified Specifics concludes from its findings from the Small Letter study that volume declines are explained by continuation of substitution to electronic communications, deteriorating economic activity and a depressed advertising industry. Diversified Specifics states: [97]

> Other Small Letter volumes have decreased at an increasing rate, attributable to a continuation of substitutive pressures in conjunction with an escalating real price. Additionally, deteriorating domestic economic activity has combined with a depressed advertising industry to suppress transactional and promotional PreSort Barcoded Small Letter volume growth rates.

Diversified Specifics concludes that economic activity has been a significant driver of Large Letter volume growth in the past, and that the recent economic downturn may be a threat to Large Letter volumes. Diversified Specifics states: [98]

> [T]he statistical results suggest solid rates of growth in the Australian economy over recent times has primarily driven letter volume growth throughout the 1995/96 to 2007/08 timeframe. These empirical findings suggest the global and domestic economic slowdown will be a major threat to Large Letter volume growth in the short term, should the strength of past associations be replicated in future periods.

However Diversified Specifics also finds that the past association between other Large Letter volumes and economic activity is weakening. Diversified Specifics states: [99]

> With respect to Other Large Letter volumes even though the level of economic activity (Non-farm) over the 2007/08 financial year (3.63%) was higher than the average annual growth rate experienced throughout recent years (3.51%) a declining rate of volume growth in 2007/08 is likely to be explained by underlying substitution effects factored out of the modelling process.

Diversified Specifics finds that the past association between PreSort Large Letter volumes and economic activity may be weakening, but that recent movements in PreSort Large Letter volumes may be explained by advertising industry health. Diversified Specifics states: [100]

> PreSort Barcoded Large Letter volumes also declined in 2007/08 despite strong rates of economic growth. The health of the advertising industry however registered a fall of 34.92% (far greater than the average annual decline of 4.28% over the 2000/01-2007/08 period) suggesting a lower promotional component within the PreSort Barcoded Large Letter volumes and possibly explaining the more pronounced decline. In addition the recent annual report changes are likely to have exerted further downward pressures on this Large Letter product stream.

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97 Diversified Specifics, *Domestic Small Letter Segment Volume Demand: Addendum 1996 to 2008,* March 2009, p. v.

98 Diversified Specifics, *Domestic Small Letter Segment Volume Demand: Addendum 1996 to 2008,* March 2009, p. 1.

99 Diversified Specifics, *Domestic Large Letter Segment Volume Demand: 1995/96 to 2007/08,* February 2009, p. 49.

100 Diversified Specifics, *Domestic Large Letter Segment Volume Demand: 1995/96 to 2007/08,* February 2009, p. 49.

Australia Post concurs with Diversified Specifics that the findings from Diversified Specifics' Small Letter volume studies suggest a weakening association between letter volumes and economic activity, stating the results: [101]

> suggests that the historically strong positive association between the level of economic activity and fluctuations in total domestic Small Letter volumes has weakened considerably in recent times due to the effects of factors such as electronic substitution.

Diversified Specifics' study into the impact of economic downturns on the income elasticity for PreSort barcoded Small Letter services involved splitting quarterly GDP measures[102] into low growth and non-low growth periods and re-calculating the regression for PreSort Small Letters used in its domestic Small Letter segment volume demand study separately for the low and non-low growth periods.

Table 3.4 outlines the main results from Diversified Specific's study into the impact of economic downturns on the income elasticity of PreSort Small Letter volumes.

Table 3.4 suggests that PreSort Small Letter volumes are more inelastic to changes in economic activity during periods of non-low growth than periods of low growth. Diversified Specifics interpreted its results by stating: [103]

> All else being equal, the negative impact of a given percentage decrease in economic growth on PreSort Barcoded Small Letter volumes was found to be greater than the stimulatory impact of an equivalent percentage increase in economic growth on PreSort Barcoded Small Letter volumes.

Table 3.4 — Pre sort Small Letter volume elasticities estimated by Diversified Specifics during periods of low and non-low economic growth[104]

	Low growth model	Non-low growth model
Quarterly GDP growth rates	Less than 0.5 per cent	Greater than or equal to 0.5 per cent
Income elasticity	1.179	0.806
Advertising industry health elasticity	0.096	0.179

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101 Australia Post's 2009 draft price notification, p. 27.

102 Total GDP rather than non-farm GDP was used in this instance by Diversified Specifics because 'this reflects the headline measure of economic activity upon which many business forecasts are based on' (Diversified Specifics, *Impact of economic downturns on the income elasticity of PreSort barcoded Small Letters*, May 2009, p. 12).

103 Diversified Specifics, *The impact of economic downturns on the income elasticity of demand: PreSort barcoded Small Letters,* May 2009, p. 14.

104 Source: Diversified Specifics, *The impact of economic downturns on the income elasticity of demand: PreSort barcoded Small Letters,* May 2009, p. 13.

Diversified Specifics considered that its results that income elasticity for PreSort Small Letter volumes is significantly different depending on the level of economic activity are statistically robust, stating that: [105]

> [T]he income elasticity estimate for the Low-growth model is not contained within the Non-low growth model's 95% confidence interval.
>
> Likewise, the income elasticity estimate of the Non-low growth model is not contained within the Low growth model's 95% confidence interval.
>
> This suggests that the income elasticity estimates for each model, differs to one another to a statistically significant degree at a 95% level of confidence.

3.2 Interested parties' views

A number of stakeholders commented on the price elasticity of demand for letter services and stakeholders submitted that a price rise is likely to result in a negative impact on letter volumes.

The Australian Direct Marketing Association (ADMA) submitted that: [106]

> members report that mail is an often preferred and effective method of communication but that there is some price sensitivity.
>
> The September 2008 price increase coincided almost exactly with the beginning of the global financial crisis. It is therefore impossible to discern to what extent these two significant events contributed to the 4% drop in volumes for Australia Post services in 2008/2009.

ADMA also stated that: [107]

> It is however clear that in a period of difficult trading conditions for many companies that an increase in postage prices will have the direct result of:
>
> a) reducing both transactional and promotional volumes
>
> b) forcing organisations to expedite plans to move cheaper electronic methods of communication.

The Printing Industry Association of Australia (PIAA) submitted that: [108]

> Australia Post projects falls in reserved letter volumes for the period 2009-10 to 2011-12. A valid question for Australia Post to answer is what proportion of the expected volume reduction is attributable to the excessive price increases it is seeking approval for.
>
> [PIAA] maintains that mail volume is price sensitive meaning that any price increase will have an adverse impact on volumes.

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105 Diversified Specifics, *The impact of economic downturns on the income elasticity of demand: PreSort barcoded Small Letters,* May 2009, p. 13.

106 Australia Direct Marketing Association, *Submission on ACCC issues paper,* 16 September 2009, p. 1.

107 Australia Direct Marketing Association, *Submission on ACCC issues paper,* 16 September 2009, p. 1.

108 Printing Industries Association of Australia, *Submission on ACCC issues paper,* 11 September 2009, p. 3.

…

> Any increases approved by the ACCC will prove detrimental to the paper-printing-mail house value chain and the compounding effect will result in product substitution with mail users switching to non-mail alternatives such as e-communications at the expense of paper based communication mediums.

Major Mail Users of Australia Limited (MMUA) submitted that: [109]

> …increasing the price of postage without offering any new services or inducements for its use will only hasten the company-by-company examination of the cost-effectiveness of papermail in comparison to other communication options are available.

B Such submitted that '…further price increases will discourage greater usage of Australia Post services',[110] and W Anderson submitted that '…if Australia Post wants to remain relevant as we become more accustomed to the numerous forms of electronic communication, it needs to do all it can to retain customers, not drive them away. Otherwise, we will not send a letter'.[111]

Some stakeholders also noted the income elasticity of demand for letters, and the impact of the current economic climate on letter volumes. Remington Direct submitted that: [112]

> In tough times many companies will look to reduce expenditure with marketing often one of the first casualties. A postal price rise only exacerbates the problem and many of these same companies will simply cease this activity all together.

ADMA submitted that: [113]

> Declines in economic activity does reduce the demand for Australia Post's reserved services. ADMA also submits that demand for Australia Post's reserved services will increase as the Australian economic activity increases.

Submissions generally agreed with Australia Post's views that letter volumes are facing pressures from trends towards substitution to electronic communications as well as mail consolidation and rationalisation.

The Post Office Agents' Association Limited (POAAL) submitted that: [114]

> Although the economy is already showing signs of returning to strength it is evident that all organisations that have survived the downturn have had a sharp look at costs and value in their operations. The trend to consolidation and re-evaluation of past practices and their impact will be part of those assessments.

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[109] Major Mail Users of Australia Limited, *Submission on ACCC issues paper,* 15 October 2009, p. 5.

[110] B Such, *Submission on ACCC issues paper,* 26 August 2009, p. 1.

[111] W Anderson, *Submission on ACCC issues paper,* 28 August 2009, p. 2.

[112] Remington Direct, *Submission on ACCC issues paper,* 18 September 2009, p. 1.

[113] Australia Direct Marketing Association, *Submission on ACCC issues paper,* 16 September 2009, p. 4.

[114] Post Office Agents Association Limited, *Submission on ACCC issues paper,* 18 September 2009, p. 4.

> This could further accelerate the move towards less expensive alternatives. This direction will be little influenced by a price increase in Australia Post reserved services.
>
> Even anecdotally it is clear that organisations are publishing annual reports on line rather than posting hard copy, and encouraging the receipt and payment of bills and accounts via email accompanied by financial incentives or penalties to help drive behaviour. The community is showing an increasing acceptance of these incentives because it suits the time-poor nature of their lifestyles. These changes are not temporary and have a material impact on Australia Post.

PIAA argued that trends for electronic substitution may also be affecting the price elasticity of demand, stating: [115]

> For an industry that faces competition from "other" mediums such as electronic mail, [PIAA] believes that the price elasticity of mail items will only increase over time and regular price increases will culminate in reduced volume.

MMUA submitted that: [116]

> Australia Post's forecasts are, in our opinion, like all such forecasts, neither to be accepted at this time of dramatic change in *communication* methodology nor to be rejected. We agree with the trend they have shown but the numbers will no doubt vary – we have, however, no alternative set of figures to suggest and the best we can offer is to say that all of our members are reporting great interest in finding e-alternatives to paper-mail and some are projecting being non users of paper-mail within the next 5-years.

Some stakeholders submitted that economic downturns may intensify electronic substitution, consolidation and rationalisation, such that the income elasticity of demand for letter volumes may be asymmetric.

PIAA submitted: [117]

> As one industry member clearly stated: "*The mailing industry is already facing reduced volumes. Raising prices during an economic downturn will simply push more businesses to reduce costs and move to electronic delivery of information. This mail will not return as the economic cycle improves*".

ADMA stated that: [118]

> ADMA believes that the long term inexorable trend towards consolidation, rationalization and substitution will be accelerated by the recent downturn in economic conditions and that this trend will also gain further impetus by increases in postage prices.
>
> …
>
> using the price lever alone will only accelerate the shift and set up a spiral from which it will be impossible to recover.

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115 Printing Industries Association of Australia, *Submission on ACCC issues paper,* 11 September 2009, p. 4.

116 Major Mail Users of Australia Limited, *Submission on ACCC issues paper,* 15 October 2009, p. 20.

117 Printing Industries Association of Australia, *Submission on ACCC issues paper,* 11 September 2009, p. 4.

118 Australia Direct Marketing Association, *Submission on ACCC issues paper,* 16 September 2009, p. 4.

MMUA stated that: [119]

> …what all who are in the mail industry agree is that for all practical purposes paper-mail lost to e-alternatives is lost forever.

3.3 Frontier Economics' review of Australia Post's forecast letter volumes

The ACCC engaged Frontier Economics to review Australia Post's forecast letter volumes. In doing so, Frontier Economics reviewed Australia Post's forecasting method and the factors taken into account by Australia Post, in particular the reports prepared by Diversified Specifics. Frontier Economics also provided analysis of historical trends in volumes for the main service categories and estimates of future letter volumes based on this analysis.

3.3.1 For ecasting method

Frontier Economics expressed serious reservations over Australia Post's forecasting method.

Frontier Economics expressed concerns about the lack of transparency around how Australia Post's volume forecasts were derived. As stated by Frontier Economics: [120]

> Australia Post's methodology is fundamentally not capable of being validated or critiqued by a third party. The forecasting process is not documented and is therefore essentially a 'black box'.

Frontier Economics went on to elaborate: [121]

> In simple terms, the analytical heart of any forecasting model comprises sets of inputs (data and assumptions), and the relationships imposed on those input elements which determine how the forecasts for the outputs are calculated. To evaluate a model or a modelling approach, a reviewer would need to assess the validity of each of these elements. This evaluation approach, however, cannot be applied to Australia Post's methodology as the data inputs, the assumptions and calculations that went into producing the forecasts are not documented.

Frontier Economics noted incentives for Australia Post to under forecast reserved letter volumes, stating that: [122]

> …within the context of a regulatory setting, where there are incentives to under-forecast, there is a burden on Australia Post to ensure that its demand forecasting methodology:
>
> - is well documented, so that it is clear how the forecasts have been derived (at a disaggregated level)

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[119] Major Mail Users of Australia Limited, *Submission on ACCC issues paper,* 15 October 2009, p. 12.

[120] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 20.

[121] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 28.

[122] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 19.

- explains how forecasts are related to historical trends – that is, there should be a recognition that expected divergences from historical trends will require explanation and documentation

- has some means of reconciling the statistical models to its actual forecasts.

Frontier Economics also noted the implications of the lack of transparency in Australia Post's forecasting method, stating: [123]

> …the lack of flexibility in Australia Post's model; in particular, the inability to conduct any type of sensitivity analysis in a transparent manner. The importance of conducting sensitivity analyses is apparent in the current economic environment where the projections of one of the drivers of letter volumes, GDP, have been revised significantly over the past year.

Australia Post identified a number of factors that were taken into account when setting its volume forecasts.[124] While it may be appropriate to consider these factors, the validity of the actual volume forecasts cannot be tested unless a direct relationship between the relevant factors and the actual volume forecasts is expressed. As stated by Frontier Economics: [125]

> …while the factors taken into account by Australia Post are appropriate, its actual approach adopted to deriving and documenting its forecasts is some distance from best practice in a regulatory setting

In addition, while Frontier Economics considered that the factors taken into account by Australia Post in determining letter volume forecasts were appropriate, Frontier Economics also considered that there were other factors that Australia Post should have also taken into account, stating: [126]

> The forecasts do not explicitly take into account the effect of the proposed price increases on expected volumes, although we understand that managers were provided with 'price guidance' in setting volume forecasts. If price elasticity was not taken into account in setting the volume forecasts, then this is a potentially significant flaw (which would tend to bias the forecasts upwards).

Frontier Economics considered a best-practice forecasting approach to involve both statistical analysis and business information in two stages, stating: [127]

> The first stage would be to:
>
> - estimate an econometric model taking account of:

[123] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 29.

[124] Australia Post's 2009 draft price notification, pp. 24-26, 78.

[125] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 18.

[126] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 75.

[127] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, pp. 39-40.

- o time series data issues, such as stationarity and correct specification of the cointegrating vector of explanatory variables
- o structural breaks in the data (i.e. perform formal tests for structural breaks which would then guide model specification)
- o the effect of price changes on demand (informative in the context of price notification)
- o economic activity (important for sensitivity analysis)
- o technological change
- o standard testing for robustness of the models

- use the estimated model to derive baseline forecasts.

The second stage would entail adjusting the baseline forecast to reflect Australia Post's specific knowledge of customer demand, and to incorporate anticipated behavioural changes that could not be captured in the econometric model. These adjustments should be documented and explanations provided for the quantitative significance of these.

3.3.2 Frontier Economics' review of Diversified Specifics' reports

Since Diversified Specific's demand modelling approach was fundamentally the same for both the Large and Small Letter studies,[128] Frontier Economics expressed similar concerns about the rigour of econometric techniques applied by Diversified Specifics in both reports.

Frontier Economics considered there to be some concerns about the model specifications in both studies, highlighting:

- Non-stationarity[129] of explanatory variables in both models which may have the potential to lead to spurious results: [130]

  Diversified Specifics did not provide any information on whether it tested for stationarity and cointegrating relations in the variables included in its preferred models.

- The sample period chosen within which to model demand for small Other Letters: [131]

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[128] That is, the modelling approaches were essentially the same with differences in selected variables.

[129] In analysing variables over time, a variable (either that which is attempted to be explained/forecasted, or that which has been selected as able to explain another) is non-stationary when its long-term mean and/or variance is not constant but rather changes over time.

Non-stationarity can cast doubt over the usefulness of the model for explaining letter volumes because since the explanatory (dependent) variable has not settled into equilibrium, its true association with the dependent (explanatory) variable cannot be estimated with confidence.

[130] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 34.

[131] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, pp. 35-36.

> Diversified Specifics does not provide a clear justification for truncating the modelling period for other Small Letters… Whatever the reason, our view is that it is better to test for structural breaks in the series, using methods such as the Chow test. Moreover, an occurrence of an event or behavioural change does not imply that one has to ignore earlier data. One can (and should) attempt to model the change, instead of ignoring a large amount of data.

- The method for accounting for technological change in modelling demand for Large Letter services: [132]

> The effect of technological change (i.e. substitution to electronic means of communication) on other Large Letter volumes was controlled for by arbitrarily truncating the time series.

- The method for accounting for the effect of the closure the PreSort service on other Large Letter volumes: [133]

> The trends…seem to suggest that the closure of the pre-sort service had a sizeable impact on the pre-sort large letter volumes (with pre-sort large letter users shifting to other large letters). Yet, a dummy variable characterising the closure event was included only in the model for the other large letters and not in the model for the pre-sort large letters.

In responding to questions from Frontier Economics, Diversified Specifics provided results of further analysis conducted in September 2009 for Small Letter categories.

This additional analysis concluded that:

- all continuous variables, including the dependant variables, are integrated of order 1 (i.e. they are non-stationary in levels but can be made stationary by taking first differences); and
- the variables were cointegrated,[134] with the elasticity estimates from the cointegrating equations similar in magnitude and statistical significance to the results presented in its March 2009 report.

However, the additional analysis from Diversified Specifics was only conducted for the Small Letters study and not for the Large Letters study.[135]

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[132] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 45.

[133] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 45.

[134] Cointegration means that although variables are non-stationary — have a mean or variance moving over time — the movements in mean or variance over time are such that they maintain their relationship with each other in the long-run. Cointegration allows non-stationary variables to regressed and results interpreted with confidence.

[135] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 45.

Although Frontier Economics' other concerns[136] remained, Frontier Economics considered that the studies by Diversified Specifics could be useful in informing the historical drivers of letter volumes, stating: [137]

> Our review suggests that Diversified Specifics' work has some value as a tool in understanding past trends, notwithstanding some methodological concerns.

3.3.3 Frontier Economics' historical trend forecasts

Frontier Economics assessed Australia Post's forecast letter volumes by comparing them to historical trends.

Frontier Economics noted that basing volume forecasts in a regulatory setting solely on historical trends would not be preferred, stating: [138]

> in principle, forecasts based on statistical analysis using historical data (such as econometric models) could be improved by the incorporation of information from outside a formal model, for at least three reasons:
>
> - New factors or drivers can emerge that were not present over the period that the model is estimated. These new drivers are anticipated, but cannot be captured in an econometric forecasting model that uses past data.
> - Some factors may already be included in the model, but their influence is expected to change significantly in the future. In other words, the elasticities estimated today are not necessarily the elasticities that will hold in the future.
> - Judgement about potential changes in the market may sometimes be required, for example if a large customer is known or is highly likely to change their usage patterns.

However, in light of the lack of transparency around Australia Post's volume forecasts, Frontier Economics concluded that historical trends are the only objective measure by which to assess Australia Post's forecasts, stating: [139]

> Our reason for making reference to historical trends is because this at least provides a baseline by which Australia Post's forecasts can be assessed.

Using historical letter volumes, Frontier Economics constructed a set of benchmark forecasts using:

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136 That is, concerns related to the sample periods chosen, the method for accounting for the effect of technological change on Large Letter services, and the method for accounting for the effect of PreSort service closure on Large Letter services.

137 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 36.

138 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, pp. 18-19.

139 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 20.

- A trend line fitted using a 'goodness of fit' criterion, which places equal emphasis on all data points. Frontier Economics found a polynomial trend line to be the best fit for PreSort Small, PreSort Large and other Small Letter service categories while no trend line represented a reasonable fit for the other Large Letter service category.

- Values derived through exponential smoothing, which places greater emphasis on more recent data points. Exponential smoothing calculates forecasts as a weighted average of past values, with the weights declining geometrically.[140]

Figures 3.3 to 3.6 show historical volumes, Australia Post's forecast volumes, polynomial trend forecasts[141] and exponential smoothing forecasts for the four main letter service categories.

It should be noted that Frontier Economics' analysis was conducted using volume data provided by Australia Post for the four main letter service categories that:

- include reserved and non-reserved services,[142] and

- include local rate letter volumes (both Small and Large) in PreSort categories whereas all other information provided by Australia Post in support of its draft price notification includes local rate letter volumes in the Other Letter categories.[143]

Therefore the reserved Large PreSort and Large Other volume data will be lower than that shown by Frontier Economics' analysis and in Figures 3.3 to 3.6.[144] The inclusion of non-reserved Large Letter volumes in the Large PreSort and Large Other categories is not expected to materially affect the historical trend analysis since non-reserved Large Letter services are expected to have the same volume drivers as Large reserved letter services.

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140 The smoothing method and the smoothing parameters were selected by minimising the sum of squared errors over the modelling period 1995 to 2008. Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 37.

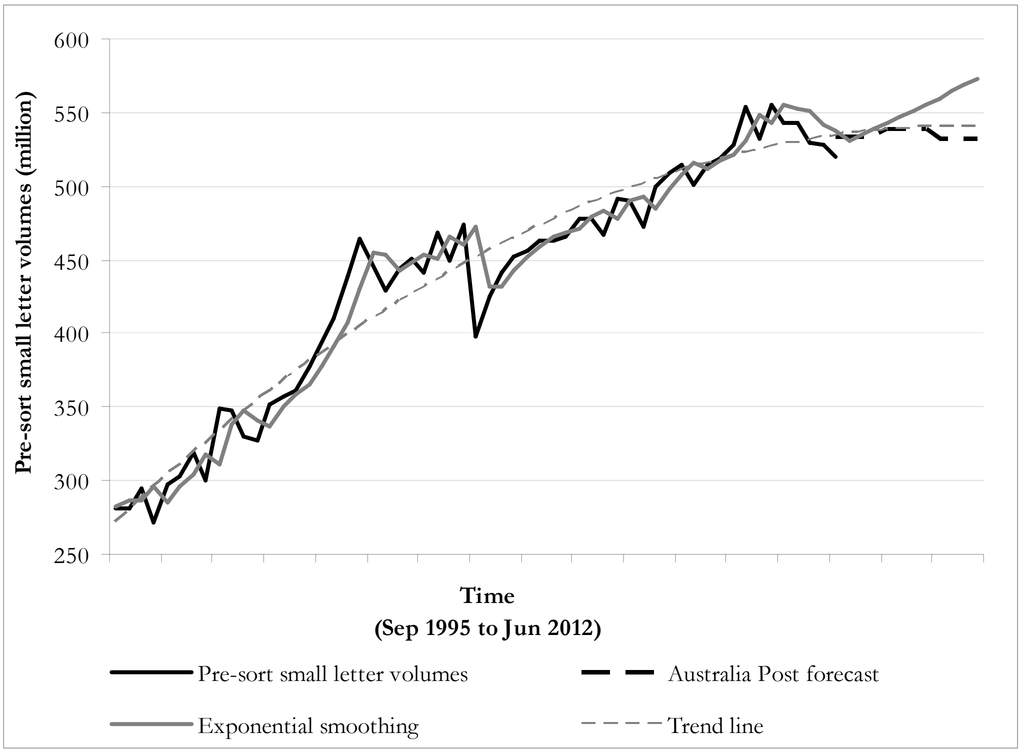
141 Polynomial trend forecasts were not included for other Large Letters since it did not sufficiently satisfy the 'goodness of fit' criteria for that service category.

142 In practice, only Large Letter service categories (both PreSort and other) include non-reserved services.

143 Australia Post, Response to ACCC request for information, 22 October 2009.

144 The shift of local rate volumes from Other Letter categories to PreSort letter categories will also result in Frontier Economics' analysis showing PreSort letter volumes higher and Other Letter volumes lower than those reported in Australia Post's draft price notification.

Figure 3.3 — Pre sort Small Letter volumes (historical and forecast) for 1995-96 to 2011-12 [145]

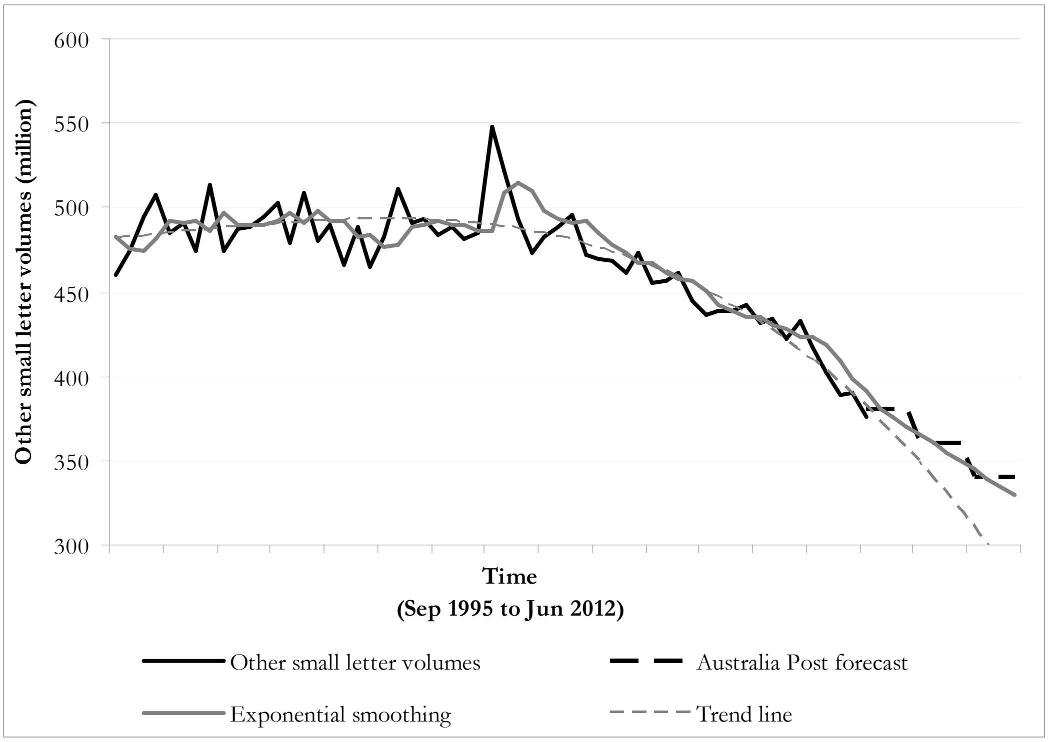


Notes: (1) Historical volume data are seasonally adjusted. (2) The Holt-Winters exponential smoothing method (which adjusts for the trend in the data series) was used. (3) 2nd order polynomial trend line was fitted. 2nd and 3rd order polynomial trend lines provided similar goodness-of-fit, with the former resulting in more conservative (i.e. lower estimates).

For Other Small Letter volumes, Australia Post's forecast is above the polynomial trend line, but tracks the exponential smoothing forecasts. For PreSort Small Letter and Large Other Letter volumes, Australia Post's forecasts are below the historical trends for each of the three forecast years. For PreSort Large Letter volumes, Australia Post's forecast for the 2009-10 year is above the exponential smoothing forecast and below the polynomial trend line, but falls below the historical trends in the following two years. Australia Post's forecasts of PreSort Small Letter volumes are relatively closer to the benchmark forecasts than the Large Letter volumes.

145 Source: Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 37. Data source: Australia Post.

Figure 3.4 — Other Small Letter volumes (historical and forecast) for 1995-96 to 2011-12 [146]



Notes: (1) Historical volume data are seasonally adjusted. (2) The Double exponential smoothing method (which adjusts for the trend in the data series) was used. (3) 3rd order polynomial trend line was fitted. (4) For the third quarter 2009 we present both the forecasted and the actual volumes.

Frontier Economics conducted sensitivity analysis to test the impact on Australia Post's revenues should future volumes be consistent with the historical trend forecasts rather than Australia Post's forecasts. The analysis was premised on Australia Post's proposed price increases occurring in 2009 and 2011-12. In such circumstances, Frontier Economics found that Australia Post would experience over the period 2008-09 to 2011-12 (depending on the use of trend line or exponential smoothing): [147]

- For PreSort Small Letter revenue, an annual average increase of between 1 and 3 per cent (which results in a less than 1 to 1 per cent increase in total domestic reserved revenue).
- For Other Small Letter revenue, an annual average decrease of between 1 and 6 per cent (which results in a less than 1 to 2 per cent decrease in total domestic revenue).

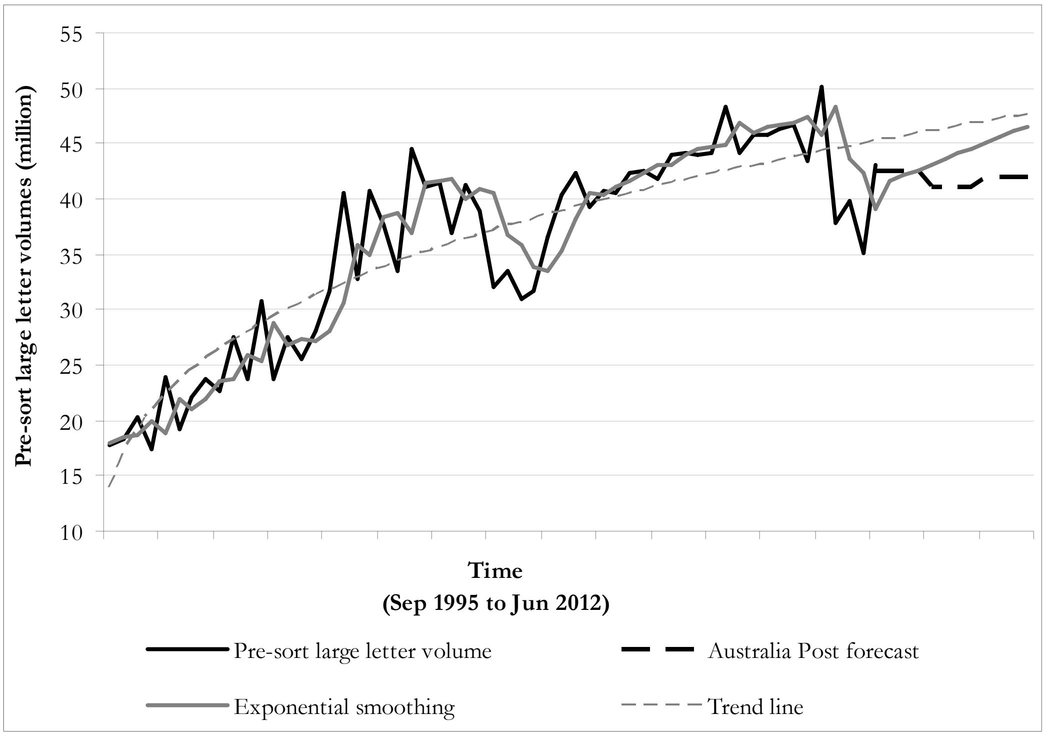
[146] Source: Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 38. Data source: Australia Post.

[147] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC, November 2009,* pp. 48-52. Note that for each main service category it was assumed that the other service category volumes and unit costs remain unchanged.

- For PreSort Large Letter revenue, an annual average increase of between 4 and 11 per cent (which results in a less than 1 to 1 per cent increase in total domestic reserved revenue).

- For Other Large Letter revenue, an annual average increase of 4 per cent (which results in a 1 per cent increase in total domestic reserved revenue).

Figure 3.5 — Pre sort Large Letter volumes (historical and forecast) for 1995-96 to 2011-12 [148]



Notes: (1) Historical volume data are seasonally adjusted. (2) The Holt-Winters exponential smoothing method was used. (3) Power trend line was fitted. (4) For the third quarter 2009 we present both the forecasted and the actual volumes.

In absolute terms, Frontier Economics found that Australia Post would experience over the period 2008-09 to 2011-12 (depending on the use of trend line or exponential smoothing): [149]

- For PreSort Small Letter revenue, an annual average increase of between \$6 million and \$25 million and a total (three-year) increase of between \$19 million and \$76 million.

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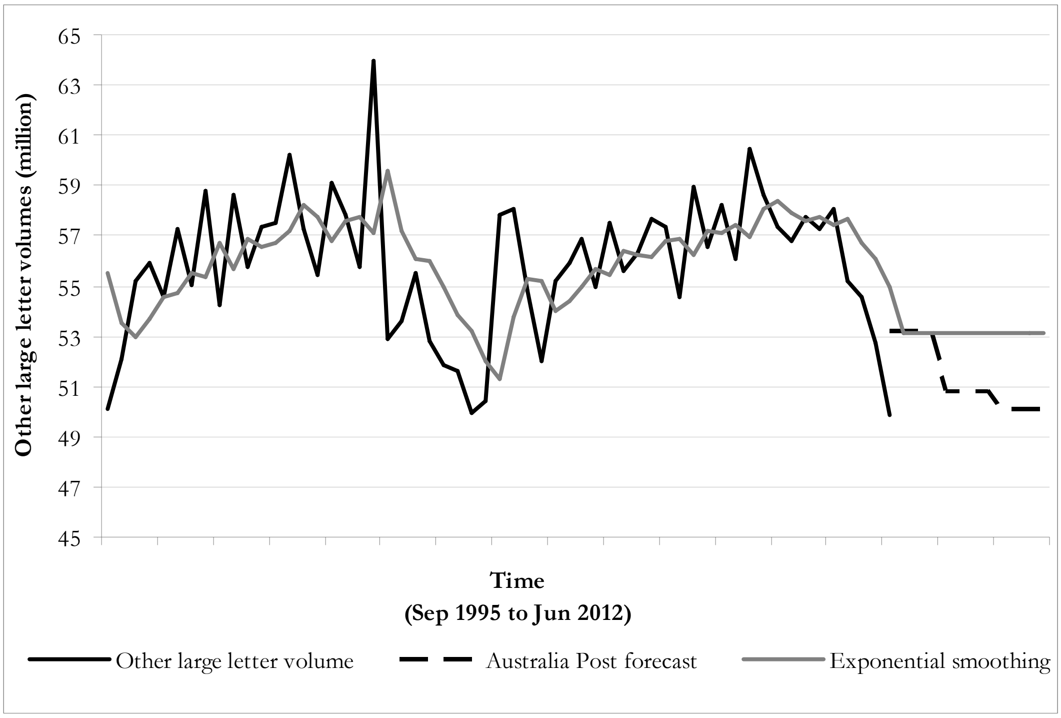
[148] Source: Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 46. Data source: Australia Post.

[149] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, pp. 48-52.

- For Other Small Letter revenue, an annual average decrease of between $6 million and $49 million and a total (three-year) decrease of between $17 million and $148 million.
- For PreSort Large Letter revenue, an annual average increase of between $5 million and $14 million and a total (three-year) increase of between $16 million and $41 million.
- For Other Large Letter revenue, an annual average increase of $10 million and a total (three-year) increase of $31 million.

Figure 3.6 — Other Large Letter volumes (historical and forecast) for 1995-96 to 2011-12 [150]



Notes: (1) Historical volume data are seasonally adjusted. (2) The Single exponential smoothing method was used. (3) Trend line not presented due to poor fit (i.e. R2 less than 0.1) (4) For the third quarter 2009 we present both the forecasted and the actual volumes.

3.4 ACCC's view

In its preliminary view on Australia Post's 2008 draft price notification the ACCC stated that: [151]

> While it engaged Diversified Specifics to advise it on small letters demand, Australia Post has not systematically used scientific methods in its demand forecasting. Australia Post has based its forecasts

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[150] Source: Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 48. Data source: Australia Post.

[151] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 89.

> primarily on management opinion, and has broadly been pessimistic in its outlook, especially for the growing product, large letters.

The ACCC acknowledges that Australia Post has provided additional analysis in its 2009 draft price notification, most notably the further Diversified Specifics analysis outlined in section 3.1.2. The ACCC also agrees with Frontier Economics that it would be appropriate when forecasting letter volumes to consider the factors that Australia Post lists as having been taken into account when determining its forecasts. However, Australia Post has not provided evidence that its volume forecasts are based on a robust methodology that incorporates these relevant factors and studies in an appropriate manner.

The ACCC agrees with Frontier Economics' view that Australia Post's method for determining volume forecasts is not best-practice, and specifically:

- The process for deriving volume forecasts from the relevant volume drivers and business intelligence, including quantitative links, need to be adequately documented. While Australia Post has identified the inputs used in deriving its volume forecasts, these inputs need to be more accurately defined and measured, and the relationships imposed on these inputs which determine how the forecasts have been derived need to be precisely documented.

- The process for deriving volume forecasts should make (or attempt to make) better use of accepted statistical methods for forecasting letter volumes, so that a stronger quantitative link between relevant drivers of letter volumes and volume forecasts can be generated which can be distanced from potentially debatable management opinion.

In addition, the ACCC is concerned that Australia Post has not demonstrated that it has adequately considered the impact of its proposed price rises on forecast demand. As recognised by Frontier Economics: [152]

> Australia Post suggested that it did not take into consideration the proposed price increase; however, it also stated that it did provide the budget guidelines (containing the information on the proposed price increase) to product groups and sales managers prior to the commencement of the forecasting process. Hence, it is possible that at least some managers may have taken into consideration the effect of the proposed price increase on the future volumes when preparing the initial volume forecasts.

The ACCC considers that Australia Post's view—supported by Diversified Specifics' studies—that letter volumes generally[153] are likely to be relatively inelastic to small changes in price (such as those observed in the sample periods in Diversified Specifics' studies) has some merit. Nevertheless, letter volumes are unlikely to be perfectly inelastic to price increases (i.e. some level of decline in volumes would be expected to result from a price rise

[152] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC,* November 2009, p. 30.

[153] Some individual letter services (for example, social mail) may indicate greater price elasticity of demand.

irrespective of its magnitude), and the frequency of price rises proposed by Australia Post[154] is greater than that experienced in the recently observed past.

Furthermore, that Australia Post cannot state for certain whether product groups and sales managers did or did not adjust volume forecasts in consideration of the effect of the proposed price increases exemplifies the ACCC's concerns over the transparency of Australia Post's forecasting method. For example, even if price elasticities of demand for Australia Post's letter service categories could be identified with confidence, Australia Post's volume forecasts could not be adjusted accordingly as it is unclear whether any contributing product group or sales managers had already adjusted individual volume forecasts.

Under a cost-based approach to assessing prices, forecast volumes are of fundamental importance for determining the level of prices that will efficiently recover Australia Post's costs. Where actual volumes exceed forecasts, Australia Post is able to earn greater revenue than that required to recover its efficient costs. In such a situation, economic efficiency is compromised as:

- Australia Post, unconstrained by competition for reserved services, is able to let its costs increase above an efficient level.

- Prices are higher than necessary and consumers will be inefficiently discouraged from consuming Australia Post's services.

Therefore, in assessing Australia Post's proposed price increases, volume forecasts should ideally be as accurate as practicable.

The lack of transparency around how Australia Post's volume forecasts have been derived creates a level of discomfort for the ACCC. This is particularly so considering that Australia Post's volume forecasts were generated at a time of general pessimism regarding future economic growth in the Australian economy. The lack of a transparent forecasting methodology means it is not possible to expose Australia Post's forecasts to sensitivity analysis regarding future economic growth.

While the ACCC applied the exponential smoothing method to assess Australia Post's demand forecasts in its assessment of Australia Post's 2008 price notification, the ACCC does not consider that it would be appropriate to rely on historical trends — particularly given the linkages between demand and costs, and the longer-term (three years) pricing proposal submitted by Australia Post (compared to the one year proposal in 2008). While such historical trend forecasts represent an improvement on the forecasts submitted by Australia Post—since the quantitative method of their derivation can at least be observed and scrutinised—forecasts based on historical trends are limited to the extent that the level of volume drivers in the past are unlikely to continue into the future. Limitations on the accuracy of forecasts provided by historical trends are likely to be of greater concern when a longer forecasting period is chosen (as divergences from trends can accumulate).

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[154] Australia Post's previous price rise occurred on 7 September 2008, and Australia Post's proposal is for a price rise in January 2010 with potentially another in 2011/12 (Australia Post's 2009 draft price notification, p. 13).

Statistical methods for forecasting volumes that measure associations between volumes and volume drivers may provide an improvement on forecasting based on historical trends, as the effect on volumes of changes in the future to the level of volume drivers can be estimated. Nonetheless, such statistical forecasting methods are also limited to the extent that past associations between volumes and volume drivers may not be maintained into the future.

Indeed, this point is acknowledged by Australia Post: [155]

> In a dynamic market, such as one that characterises Australian and international postal markets, it is more than reasonable to expect that marked deviations from historical trends may occur when one factors in:
>
> i. Sustained volume impacts resulting from changing electronic substitution behaviours;
>
> ii. Altered prevalence of letter mail rationalisation and consolidation practices of major mailers;
>
> iii. Other emerging and/or known industry-specific market intelligence e.g. the impact of the introduction of the Corporations Legislation Amendment (Simpler Regulatory System) Act 2007 – i.e. the annual report effect;
>
> iv. Exogenous impacts e.g. major political events (such as a Federal Election); and
>
> v. Consequences of fluctuations in the level of economic activity falling outside those bounds observed within the historical data investigated.

Therefore, while the ACCC encourages the use of statistical forecasting methods that can be subject to independent review, the ACCC also expects forecasts to be accompanied (where relevant) by documented augmentation based on management opinion and market intelligence.

The ACCC does not consider that it has before it reliable forecasts of demand for Australia Post's reserved letter services which could be used in the ACCC's financial analysis of the extent to which Australia Post's proposed prices are likely to meet Australia Post's efficient costs. Indeed, the ACCC considers that incorporating potentially unreliable demand forecasts in its financial analysis, and having regard to that financial analysis in forming a view on Australia Post's draft price notification would not be consistent with the matters identified in Directions 11, 8 and also the matters identified in section 95G(7) of the TPA (this is addressed in detail in Chapter 6).

The ACCC expects that Australia Post would provide letter volume forecasts estimated using a more robust and transparent forecasting method (taking into account the issues outlined in this chapter) in any future price notification.

[155] Australia Post, *Response to Frontier Economics draft report,* 19 October 2009, p. 12.

4 Cost s

4.1 Approach to assessing Australia Post's forecast costs

As outlined in Chapter 2, the ACCC informs its assessment of price notifications with consideration of the extent to which the proposed price increases will recover the efficient costs of providing the notified services.

The ACCC applies a building block methodology to conduct this assessment. The form of the building block model used by the ACCC is the post tax revenue model (PTRM) where taxation payments are explicitly modelled in the cash flows, and the cash flows are expressed in nominal terms.

The cost components of the building block methodology are:

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

This chapter considers the efficiency of the non-capital costs, and the determinants of the return of capital (i.e. the level of capital and capital expenditure) for Australia Post's reserved letter services. Chapter 5 presents the ACCC's analysis of Australia Post's return on capital.

In the ACCC's final decision on Australia Post's 2008 price notification, the ACCC raised concerns about a one year period building block model used to support Australia Post's price notification. In order to assess Australia Post's 2008 draft price notification, the ACCC constructed a disaggregated building block model[156] covering a three year period using data provided by Australia Post. In its final decision on Australia Post's 2008 price notification, the ACCC stated that any future price notifications provided by Australia Post should be supported by a forward-looking, disaggregated financial model covering a three year period. [157]

Australia Post has provided the ACCC with a disaggregated building block model covering a three year period in support of its 2009 draft price notification. Australia Post submits that the volume, revenue and cost information in its building block model is consistent with its 2009-10 – 2011-12 corporate plan.

However, the ACCC cannot simply accept Australia Post's forward-looking estimates of the costs of providing the domestic letter service contained in this model — even though the forecasts may be based on the pricing targets and government endorsed financial targets in Australia Post's corporate plan. One possible result of Australia Post's market power and the lack of competition in the market for reserved letter services would be to allow costs to

156 The ACCC disaggregated Australia Post's building block model to separate the allowable revenue for into four categories of reserved letter service — small ordinary, small PreSort, large ordinary, and large PreSort.

157 ACCC, *Australian Postal Corporation Price Notification, Decision*, July 2008, p. 8.

inflate to unnecessary or inefficient levels. The ACCC considers that basing prices on costs that were inflated in this way would be inconsistent with Australia Post's commercial obligation. Thus, the ACCC bases its assessment on the extent to which the proposed prices for Australia Post's reserved letter services are aligned with the efficient costs of providing those services.

The ACCC acknowledges that the forecast efficient costs of providing reserved letter services may not necessarily be the same as Australia Post's forecasts of its actual costs. Having said that, the ACCC's assessment of the efficient costs of providing reserved letter services is within the context of Australia Post's functions, obligations, and ministerial directions. For example, in assessing the efficiency of the cost base the ACCC assumes that Australia Post would continue to be obliged to comply with its CSOs and meet its performance standards.

Australia Post's view

Australia Post notes that the *Australian Postal Corporations Act 1989* (the APCA) obliges it to operate in a manner consistent with sound commercial practice. [158] In particular, Australia Post submits it '…has vigorously pursued productivity gains through economies of scale and scope rather than relying on price rises to ameliorate the impact of establishing and maintaining a relatively fixed cost network required to meet performance standards…'.[159]

Australia Post's contention that its proposed price increases are 'appropriate and necessary' is supported on its view that the forecast revenue generated from its reserved letter services at the proposed prices will be less than the efficient costs of providing those services. [160]

Australia Post submits that its draft price notification provides evidence and supporting arguments demonstrating that '…Australia Post's costs are efficient and cost movements over the period of this draft notification reflect an aggressive and sustained pursuit of efficiency and productivity opportunities…'[161] Australia Post also submits that '[t]his draft notification demonstrates Australia Post's efficiency in its cost and asset base — both in total and within that component allocated to the domestic reserved letter service'.[162]

In addition to a detailed description of the operating and capital costs that Australia Post forecasts that it will incur in providing its reserved letter services over the 2009-10 to 2011-12 financial years, Australia Post's draft price notification details the productivity and cost containment initiatives it anticipates it will undertake during the period. Australia Post's draft price notification also summarises its Future Delivery Design (FDD) program, the aim of which is to modernise the delivery of reserved letter services through the implementation of a number of linked projects, such as Optical Character Recognition (OCR) equipment upgrades and the automated sequencing of Small Letters.

[158] Australia Post's 2009 draft price notification, p. 16.

[159] Australia Post's 2009 draft price notification, p. 16.

[160] Australia Post's 2009 draft price notification, p. 6.

[161] Australia Post's 2009 draft price notification, p. 6.

[162] Australia Post's 2009 draft price notification, p. 67.

In the context of Australia Post's forecast declines in demand for reserved letter services, Australia Post's draft price notification includes a description of each of the components of its delivery network (sales and acceptance, processing, transport and delivery) and some analysis of the extent to which those costs are volume variable.

Australia Post also engaged economic consultants Economic Insights to prepare a number of reports which draw together the combined effect of Australia Post's productivity and cost containment initiatives into a single measure of Australia Post's productivity performance — known as total factor productivity (TFP). In particular, Australia Post has engaged Economic Insights to prepare separate reports benchmarking Australia Post's TFP performance against international postal operators, analysing Australia Post's past and forecast TFP performance, and looking at the extent to which Australia Post's 'productivity dividend' had been allocated between its stakeholders over time.

ACCC's view on the approach to assessing Australia Post's forecast costs

The ACCC considers that in submitting a price notification for ACCC assessment, the onus is on Australia Post to demonstrate the efficiency of the costs that it is seeking to recover through its proposed prices. Having said that, the ACCC does acknowledge that there are some difficulties associated with demonstrating the cost efficiency in the absence of readily available benchmarks.

When regulating a number of similar companies in the same industry, it is possible for the regulator to compare the relative performance of these businesses, and then use that information to inform the assessment of the efficiency of the costs that the regulated firm is seeking to recover through prices. Depending on the consistency and comparability of data regarding the performance of these firms, one option for the regulator would be to use data envelopment analysis (DEA) to identify the efficiency frontier for comparable firms, and then provide incentives for firms not currently at the frontier to reach it.

However, a key problem facing the ACCC 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 reserved letter services in Australia. The ACCC was aware of this difficulty in assessing the efficiency of Australia Post's 2008 pricing notification, and identified that an international benchmarking study would assist the ACCC in assessing Australia Post's efficiency. In particular, the ACCC noted that '[a]n international benchmarking study comparing the productivity performance of Australia Post with overseas postal service operators could provide insight into the relative efficiency of Australia Post compared with postal operators overseas'.[163] The ACCC also acknowledged that such a study would need to address issues associated with data comparability and also control for differences in the operating environment between Australia Post and the benchmarked postal operators.[164]

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[163] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 140.

[164] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, pp. 140-142.

While not determinative of the efficiency of Australia Post's cost base, there are a number of other indicative measures that can be used to inform an assessment of the efficiency of Australia Post's cost base. Examples of such indicative measures include a detailed assessment of the components of Australia Post's cost base (including consideration of Australia Post's proposed capital expenditure program), a comparison of factors used to escalate cost components into future years (such as labour costs) with relevant domestic benchmarks, and an assessment of the extent to which Australia Post's forecast costs respond to declines in volumes. In addition, in previous assessments of Australia Post's price notifications, the ACCC has had regard to the extent to which Australia Post had made productivity gains in the past in forming a view on the efficiency of Australia Post's forecast costs.

Therefore, instead of relying on a single measure to inform its view on the efficiency of Australia Post's costs, the ACCC intends to inform its view on the efficiency of Australia Post's cost base having regard to both 'top down' benchmarking information, and 'bottom up' reviews of Australia Post's operating practices and strategic plans. In particular, the ACCC's assessment of the efficiency of Australia Post's operating costs will involve:

- an assessment of the composition of Australia Post's operating costs and whether changes in components of those costs are consistent with relevant domestic benchmarks;
- the relationship between costs and volumes;
- Australia Post's capital expenditure and FDD program;
- the TFP of Australia Post's aggregate and reserved services;
- the impact of the distribution of productivity gains on efficiency incentives; and
- Australia Post's international benchmarking study.

4.2 Cost allocation

The allocation of costs between Australia Post's reserved and non-reserved services is relevant to the ACCC's assessment of Australia Post's draft 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 price increases with efficient the costs of providing reserved services.

Australia Post's view

Australia Post states that '[c]ost allocation to products and services in each year of this price application have been made in accordance with Australia Post's Regulatory Accounts

Procedures Manual'.[165] It also argues that its cost allocation procedures have been assessed by the ACCC as part of a 2008-09 review of Australia Post's cost allocation methodology.[166]

ACCC's view on cost allocation methodology

The ACCC, in its 2008 final decision on Australia Post's 2008 price notification, decided that Australia Post's cost allocation methodology (CAM) required a comprehensive review before Australia Post provided the ACCC with any further price notifications. [167]

The ACCC completed a review of Australia Post's CAM in June 2009.

The ACCC considered three assessment principles when reviewing Australia Post's CAM:

- at each stage of Australia Post's cost allocation, ensuring there was sufficient information and explanation of its CAM to enable the ACCC to 'replicate' the results of Australia Post's CAM;
- assessing whether the allocation procedures were consistent over time; and
- assessing whether the CAM was internally consistent—that is, there is consistency between Australia Post's descriptions of the allocation process and its allocation methodology, and there is consistency and traceability of cost allocation to different products.[168]

The ACCC raised a number of issues with Australia Post as a result of the CAM review which were satisfactorily addressed and therefore, as a result of the review and its outcomes, the ACCC was satisfied with Australia Post's CAM.[169]

In view of the above, the ACCC considers that Australia Post's CAM is appropriate for the purposes of its assessment of Australia Post's current draft price notification.

4.3 Operating costs

In contrast to capital expenditure, which is a one off sunk cost that is then distributed across the life of the asset, operating costs refer to the recurring expenses related to the operation of a business.

Chart 4.1 provides a breakdown of Australia Post's Operating Costs in 2008-09 for the business as a whole by cost category.

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165 Australia Post's 2009 draft price notification, p. 47.

166 Australia Post's 2009 draft price notification, p. 47.

167 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 68.

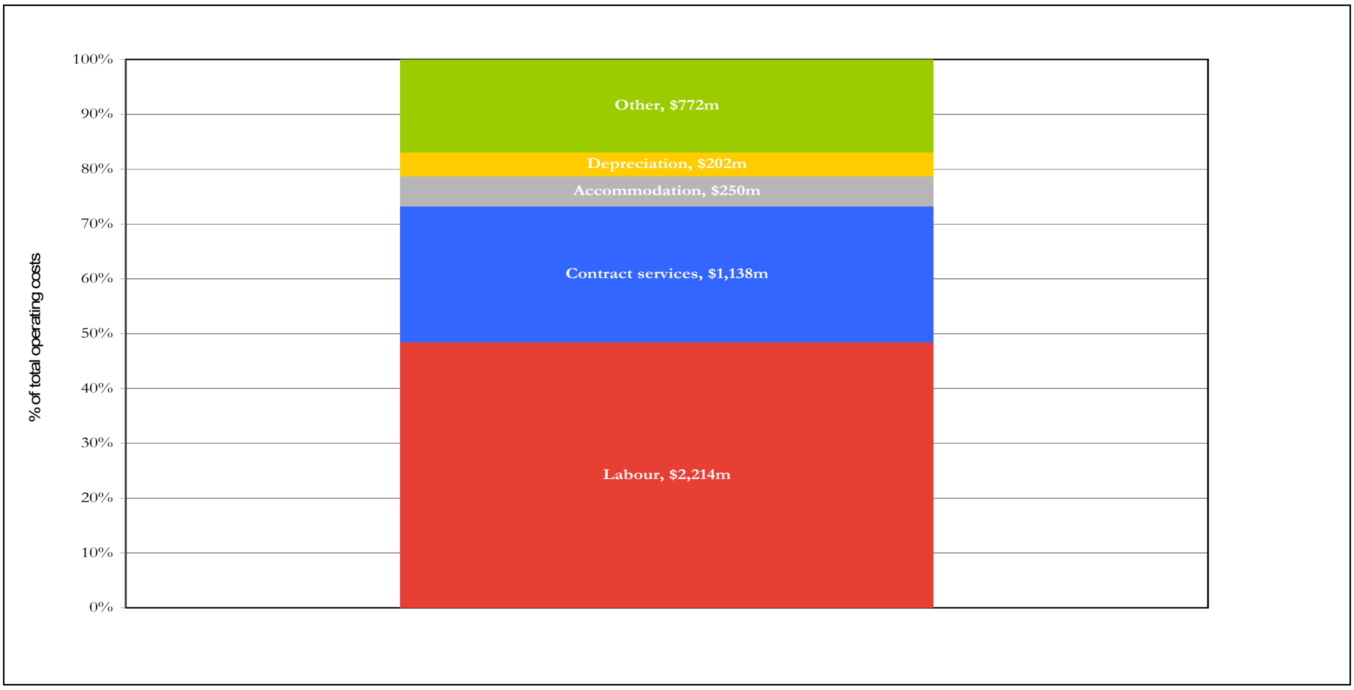
168 ACCC, *Assessing cross-subsidy in Australia Post 2007– 08 An ACCC report* July 2009, p. 9.

169 ACCC, *Assessing cross-subsidy in Australia Post 2007– 08 An ACCC report* July 2009, p. 9.

Labour costs account for the greatest proportion of Australia Post's operating costs. Other than labour and labour related costs, Australia Post's operating costs include:

- contractor and licensees;
- accommodation;
- depreciation;
- mail settlements; and
- other expenses.

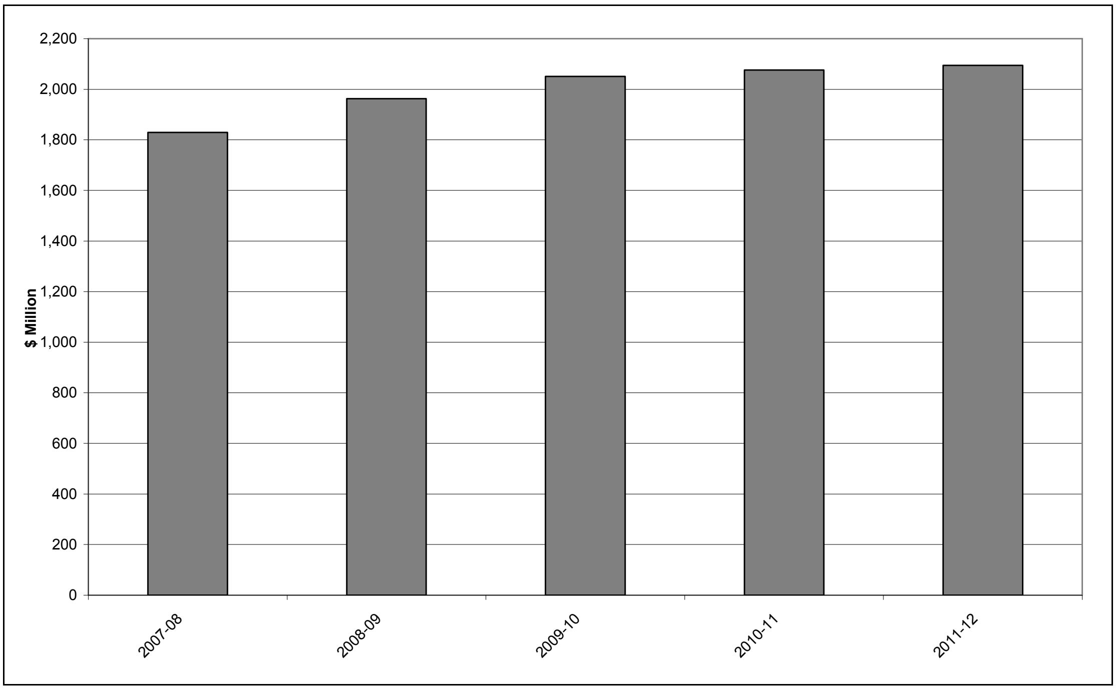
Chart 4.1: Australia Post Operating Costs 2008-09



Source: Australia Post, 2009 draft price notification p. 36.

Australia Post's domestic reserved letter service operating costs (including depreciation) increased significantly by 7.3 per cent in 2008-09 and are forecast to increase by 4.5 per cent in 2009-10 and then by around 1 per cent in both 2010-11 and 2011-12.

Chart 4.2: Australia Post's Domestic Reserved Letter Services Operating Costs 2007-08 to 2011-12



Source: Data provided by Australia Post in support of its draft price notification.

Australia Post's forecast operating costs

Labour and labour related costs

Labour and labour related costs includes costs incurred for wages as well as other labour cost items including payroll tax, workers compensation, superannuation, long service and recreation leave.

Australia Post's 2009 draft price notification provides a summary of its operating costs. 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.[170]

The high proportion of operating costs relative to the return on and of capital is in stark contrast to businesses ordinarily subject to price regulation where capital costs account for the greatest proportion of total costs. This is due to the large number of staff required for the operation of Australia Post's business. Australia Post's draft price notification identifies that over the four year period from 2007-08 to 2011-12 full time equivalent (FTE) staff for the business as a whole were estimated to decline by 615 FTEs or on average by 0.5 per cent per annum from 32,504 to 31,889.[171] Australia Post has also identified that over the four year

[170] Australia Post's 2009 draft price notification, p. 36.

[171] Australia Post's 2009 draft price notification, p. 39.

period to 2011-12 its reserved service FTEs were estimated to decline by 892 or on average by 1.1 per cent per annum from 19,923 to 19,031.[172]

Australia Post submits that the proportion of labour costs to total costs for the business as a whole has been declining over time.[173] In particular, Australia Post argues that the ratio of labour to non-labour costs has reduced steadily between 1987-88 and 2007-08 from 71.1 per cent to 47.4 per cent.[174] It also contends that the forecast rise in this ratio in 2008-09 to 48.4 per cent (Australia Post submits that the ratio subsequently reduces in future years) is due to a rise in the superannuation expense which is beyond the control or influence of Australia Post.[175]

Australia Post has advised of two main factors expected to result in a 5 per cent increase in labour and labour related costs for the business as a whole in the 2009-10 financial year. These two factors are:

- increased wages; and
- increased superannuation expense.[176]

Wages

Wages (including overtime) form the largest component of Australia Post's total labour cost, accounting for almost 82 per cent of the total labour cost for the business as whole.[177] Wages and salaries for non-contract staff are set within enterprise bargaining agreements (EBA).[178]

The most recent EBA (EBA 6) expired on 31 December 2006.[179] A summary of Australia Post's EBAs since September 2002 is provided at Appendix 12 of Australia Post's draft price notification.[180] Although EBA 7 has not been ratified by a required staff vote, Australia Post has continued to honour the pay commitments that it offered under EBA 7 because it believes that staff would be unreasonably disadvantaged if the pay increases were held back over such a protracted period due to the actions by the relevant unions.[181] Australia Post states that it is

172 Australia Post, *Australia Post's Response to Public Submissions,* 13 October 2009, p. 7.

173 Australia Post's 2009 draft price notification, p. 37.

174 Australia Post's 2009 draft price notification, p. 36.

175 Australia Post's 2009 draft price notification, p. 37.

176 Additional information provided by Australia Post to ACCC in cost breakdown spreadsheet dated 29 October 2009.

177 Australia Post's 2009 draft price notification, p. 37.

178 Australia Post's 2009 draft price notification, p. 38.

179 Australia Post's 2009 draft price notification, p. 38.

180 Australia Post's 2009 draft price notification, p. 87.

181 Australia Post's 2009 draft price notification, p. 38.

effectively continuing to operate under the provisions of EBA 6, but with the EBA 7 pay increases that were negotiated and agreed on.[182] Australia Post also contends that it has continued to achieve responsible wage outcomes as indicated by a range of '…official statistics available upon which suitable comparisons can be made'.[183]

Superannuation expenses

Australia Post has obligations to provide superannuation to its employees and its superannuation expense is determined based on advice provided by an independent actuary.[184] Australia Post suggests that the dominant determinants of its superannuation expense in the short to medium term are movements in the value of superannuation fund assets and liabilities and in Commonwealth bond rates.[185] Australia Post identifies a substantial increase in forecast superannuation expenses for the business as a whole from $48.1 million in 2008-09 to $111 million in 2009-10, $112.8 million in 2010-11 and $115.3 million in 2011-12.[186]

Employee-related provisions

Australia Post also states that non-wage labour costs such as employee-related provisions (including long service leave and workers' compensation) are also affected by Commonwealth bond rate changes which contributed to an increase in these costs in 2008-09.[187] Australia Post states that bond rates are used as a discount factor when determining the provision to be made in the profit and loss statement for future long service leave and worker's compensation payments.[188] Australia Post submits, in relation to long service leave that: 'Commonwealth bond rate rises (falls) reduce (increase) the relevant labour-related cost in the year of the rate change, after which the expense should settle back to its "underlying" value' provided the bond rates do not materially change.[189]

Contractor and licensees costs

Contractor and licensees costs are incurred for contract mail services, franchising/licensees and other contract services. Australia Post states if those functions now being performed by

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182 Australia Post's 2009 draft price notification, p. 38.

183 Australia Post's 2009 draft price notification, p. 38.

184 Australia Post's 2009 draft price notification, p. 41.

185 Australia Post's 2009 draft price notification, p. 41.

186 Australia Post's 2009 draft price notification, p. 41.

187 Australia Post's 2009 draft price notification, p. 37

188 Australia Post's 2009 draft price notification, p. 37.

189 Australia Post's 2009 draft price notification, p. 42.

contractors and licensees had been retained by Australia Post as staffed activities its costs would have been higher and more fixed in nature.[190]

Contract mail services

Australia Post indicates that it uses contractors for transport and delivery services where contracting provides a more efficient, flexible or more appropriate remuneration model.[191]

Contract mail services include:

- Roadside mail delivery;
- Street mail delivery;
- Parcel service delivery;
- Intrastate and interstate road transport;
- Air and seat transport; and
- Mail collections.[192]

Australia Post submits that it engages contractors through an open public tender and therefore is subject to market conditions in terms of the costs of obtaining these services.[193] It also notes that the majority of contracts are tendered for 5 years but only about 50 per cent complete their full term.[194] Contract escalation provisions are stated to be based on the Australian Bureau of Statistics Labour Price Index and Consumer Price Index and a fuel price index.[195]

Australia Post argues that 'in addition to volume and points growth factors, contract costs have significantly increased because of wages, fuel and other escalation factors against a background of the tightening labour market throughout most of this decade'.[196]

Franchising/Licensees

Australia Post, as a regulated requirement, maintains a retail network of at least 4,000 outlets, of which at least 2,500 must be in rural and remote areas.[197] This network is comprised of

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190 Australia Post's 2009 draft price notification, p. 43.

191 Australia Post's 2009 draft price notification, p. 43.

192 Australia Post's 2009 draft price notification, pp. 43-44.

193 Australia Post's 2009 draft price notification, p. 44.

194 Australia Post's 2009 draft price notification, p. 45.

195 Australia Post's 2009 draft price notification, p. 45.

196 Australia Post's 2009 draft price notification, p. 45.

corporately staffed outlets, licensed outlets, franchised outlets and community postal agents.[198]

As at 30 June 2008 Australia Post's retail network of 4,453 outlets comprised 831 corporate outlets, 2,977 licensees and franchisees and 645 community postal agents.[199]

Other contract services

Australia Post has outsourced resourcing requirements across a number of areas. Australia Post notes that these include:

- operational activities in logistics and in courier and mailroom services, whose business models rely more on contractors (e.g. owner drivers) than on using Australia Post employees;
- operational staff in mail centres and delivery centres (although contract staff form the minority); and
- IT specialists and other administrative roles. [200]

Depreciation

Australia Post submits that depreciable property, plant and equipment assets are written off to their estimated residual values over their estimated useful lives using the straight-line method of depreciation.[201]

Australia Post advised that depreciation rates, useful lives and residual values used are generally those provided previously to the ACCC as part of Australia Post's 2008 price notification. [202]

Australia Post's depreciation expense is forecast to rise from $187 million in 2007-08 to $252 million over the four years to 2011-12.[203] Australia Post notes this is higher than the depreciation charge of the four years prior to 2007-08, but is similar to the levels applicable to early years of this decade. [204]

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197 Australia Post's 2009 draft price notification, p. 75.

198 Australia Post's 2009 draft price notification, p. 43.

199 Australia Post's 2009 draft price notification, p. 43.

200 Australia Post's 2009 draft price notification, p. 45.

201 Australia Post's 2009 draft price notification, p. 46.

202 Australia Post's 2009 draft price notification, p. 46.

203 Australia Post's 2009 draft price notification, p. 46.

204 Australia Post's 2009 draft price notification, p. 46.

According to Australia Post, the rise in the depreciation expense reflects the resumption of significant capital investment by Australia Post at more commercially sustainable levels, including a large component of IT investment in that capital investment program.[205] Australia Post notes that IT investments normally are depreciated over 4-8 years, compared with around 15 years for some mail handling plant and equipment and 40-50 years for buildings. [206]

Other expenses

These include vehicle operating costs, statutory and legal payments, communications, accommodation expenses, bank fees, general materials and staff associated items such as travel and training. Australia Post forecasts these expenses to grow by an annual rate of 3 per cent over the four years to 2011-12. [207]

Views of other interested parties

MMUA noted that there was a question as to whether expectations of CSO could be re-examined in the interests of keeping costs down. The MMUA identified made a number of suggestions of cost saving opportunities available through a rationalisation of the CSO, including:

- ‘Removing roadside red mail boxes with all the associated Monday-Friday infrastructure needed to clear them within the 6pm deadline;
- Reduce the [where currently available] daily mail delivery to every second day delivery;
- Utilise different transport infrastructures for the bulk movement of mail, opening it to non-Post trucking by tender;
- Given the success of franchising the local post office, and parcel delivery contracting, open all areas of Australia Post’s monopoly operations to franchising or tendered business, changing the role of Australia Post from direct hands-on in as many areas as feasible to one of management – this could include street delivery where, were the venture to flourish, the move could introduce competition to the Print Post service delivery service as a side benefit’.[208]

MMUA argues that ‘Australia Post’s processing and delivery network has heavy fixed costs where every mailpiece going through the network reduces the per unit cost of processing’ and that it would ‘envisage that the technology-driven system changes … foreshadowed in the PIP2 discussions (moving the current Bulk Mail Partner Program into a new area of

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205 Australia Post’s 2009 draft price notification, p. 46.

206 Australia Post’s 2009 draft price notification, p. 46.

207 Australia Post’s 2009 draft price notification, pp. 46-47.

208 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post’s Draft Notification – Postal Pricing Increases*, p 22.

technology and systems) would be a suitable mandatory requirement to access the pricing structures needed'. [209]

MMUA also states that the ACCC should insist on Australia Post providing disclosure that it has:

- implemented a major cost reduction program in response to falling profits;
- either reduced its workforce consistent with the drop in volume or has plans to do so over the next 6 to 12 months;
- put a freeze on salaries and bonuses;
- examined whether it can relocate national, state and regional offices and operational sites to lower cost sites;
- examined whether or not Australia Post is better off selling its logistics business to a logistics company and outsourcing its mail freight operations; and
- identified underperforming assets and/or locations and put in place plans to exit.[210]

ADMA submits that the ACCC should continue to monitor and put pressure on Australia Post to continue to reduce its costs.[211] ADMA also supports the introduction of a reward structure for Australia Post for situations where it reduces its costs below the ACCC's forecasts in future price notifications, but it is unsure what form the rewards should take.[212]

Mr Bob Such MP opposes the proposal and suggests Australia Post might better use its retail component to help offset the costs of its basic services.[213]

Frontier Economics' view

As part of its assessment of the efficiency of Australia Post's operating costs the ACCC considered the views expressed in the Frontier Economics Report '*Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC* – November 2009'. This report included a review of all Australia Post's operating cost forecasts, but does not assess the implications of the FDD program on Australia Post's cost base, or Australia Post's proposed capital expenditure (which are considered separately by the ACCC in sections 4.5 and 4.6). A copy of this report is at Appendix E.

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209 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, p. 6.

210 Major Mail Users of Australia Limited, *Addendum to Submission in response the ACCC Issues Paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, p. 3.

211 Australian Direct Marketing Association, *Submission to the ACCC,* 16 September 2009, p. 2.

212 Australian Direct Marketing Association, *Submission to the ACCC,* 16 September 2009, p. 3.

213 Bob Such MP, *Submission*, 26 August 2009.

Frontier Economics notes that Australia Post's methodology for forecasting costs should meet certain standards. These forecasts should ideally:

- be clear in their derivation, with key assumptions documented (along with the basis for making them);
- bear some relationship to historical trends, and, where they do not, there should be a detailed explanation about the reasons for, and quantitative significance of, any expected deviations; and
- allow for some flexibility, so that sensitivity analysis can be conducted.[214]

Frontier Economics considers that Australia Post's input cost forecasts have not been derived using a statistically rigorous methodology. According to Frontier Economics, this has made it difficult to assess the forecasts, and it has consequently examined the forecasts primarily against historical trends.[215]

Total costs forecasts

Frontier Economics observed that changes to volume forecasts may influence both revenues and costs.[216] However, while the relationship between volumes and revenues is reasonably clear, it is less clear whether costs will change as volumes change. This will primarily depend on the nature of costs – that is, whether they are fixed in relation to demand, or whether they can be varied. This may differ across reserved services and other types of services. [217]

Frontier Economics also states that it expects that total cost forecasts in the PTRM would trend with volumes.[218] However it identifies that:

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214 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 54.

215 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 76.

216 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 58.

217 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 58.

218 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 58.

219 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 58.

According to Frontier Economics, the cost trends indicated in the PTRM are concerning as they suggest that there is a negligible relationship between costs and falling volumes.[220] Frontier Economics also argues that with falling volumes a static or rising cost base will lead to ever-increasing average costs, which may require higher prices which in turn may trigger an even greater reduction in volumes.[221] Frontier Economics argues that Australia Post will need to significantly reduce its cost base in the medium term. [222] It also contends that further analysis is required to understand whether Australia Post is adequately responding to the challenges of lower volumes by producing a plan that manages the cost base in the light of those market conditions. [223]

Frontier Economics analysed data provided by Australia Post to Economic Insights to examine the trends in costs across reserved and non-reserved services and how these related to changes in output volumes.[224] Chart 4.3 identifies that the outlook for volumes is negative relative to historical trends, but that the cost trends remain fairly constant. The declines in reserved service output relative to the aggregate are not matched by relative cost declines but rather increasing costs. [225]

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220 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 59.

221 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 59.

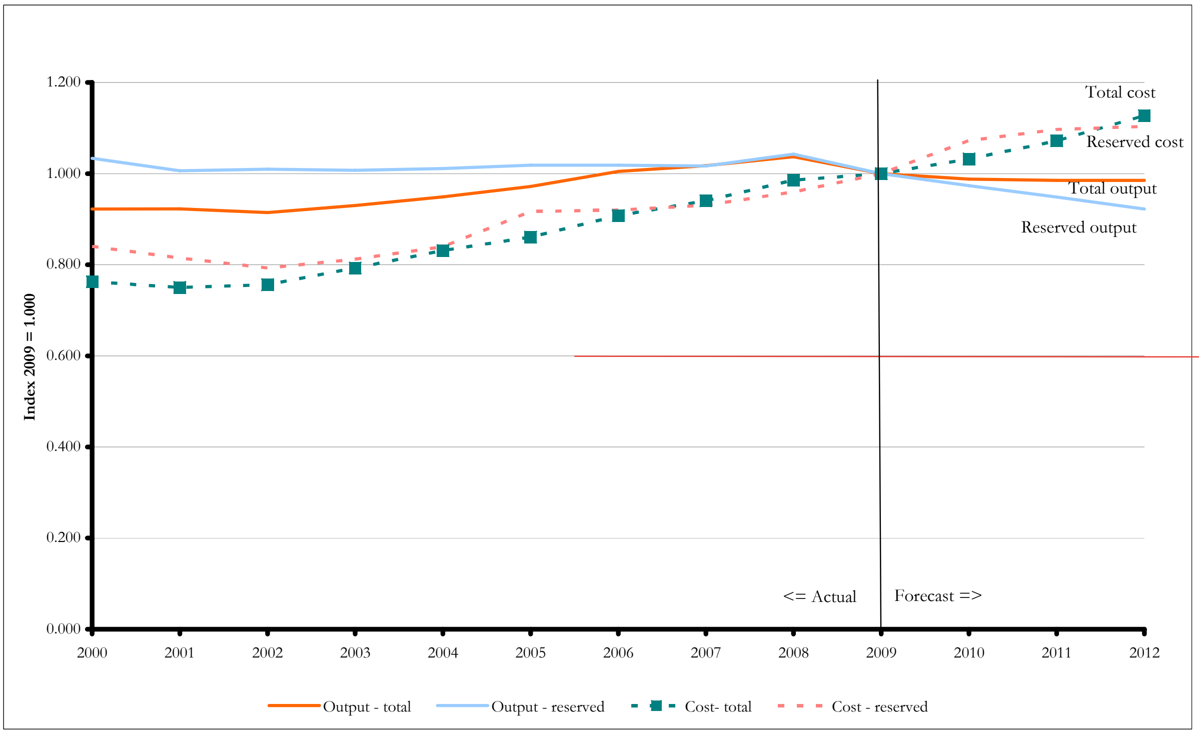
222 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 59.

223 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 59.

224 Australia Post have advised the ACCC that there are some inconsistencies in the reserved service cost data it provided to Economic Insights which Frontier Economics has analysed and cost data in the PTRM.

225 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 61.

Chart 4.3: Costs and output trends



Source: Frontier Economics Report p. 61.

Labour costs

Frontier Economics plotted the ABS Labour Price Index with historical values until June 2009 and compared these to the labour prices implied by the labour cost data for reserved services supplied to Economic Insights. According to Frontier Economics, this analysis illustrates that the historical growth in Australia Post's labour prices has been somewhat slower than the ABS benchmark, ✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂✂ ✂✂✂✂✂✂✂✂✂✂✂.[226] Frontier Economics states this may in part be attributable to its measurement of labour prices for Australia Post including non-wage factors (such as superannuation expenses) which are forecast to increase by $60 million in 2009-10. [227]

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[226] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 64.

[227] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 64.

Chart 4.4: Actual and forecast labour prices – reserved services

Source: Frontier Economics Report p. 65.

Contractors

In its draft report Frontier Economics observed that contractor costs appear to be consistent with historical trends, although contractor volumes appear to be levelling off relative to the trend.[228] It also noted that it would have expected contractor costs to have increased at about the rate of labour costs, but they seemed to be forecast to [redacted].[229]

Frontier Economics also notes that, in Australia Post's response to its draft report, it argues that Frontier Economics' expectation about [redacted] does not reflect Australia Post's experience with contractors.[230]

Frontier Economics' response to this was that it still had concerns [redacted].[231] Frontier Economics also stated that '[g]iven the general downturn in both the broader economy and in postal volumes, it seems this is a key area where cost restraint must be exercised'.[232]

Depreciation

Frontier Economics notes that depreciation costs are not a large part of Australia Post's cost base, accounting for around 5 per cent of annual costs.[233] In its draft report, Frontier Economics observed that depreciation is not a cash cost and there is an element of subjectivity as to how depreciation costs are represented in any one year.[234]

Frontier Economics noted that Australia Post responded to this by suggesting that under its accounting policies there is no subjectivity in relation to depreciation as it uses a straight-line

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228 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 66.

229 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 66.

230 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 67.

231 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, p. 67.

232 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC,* November 2009, pp. 67-68.

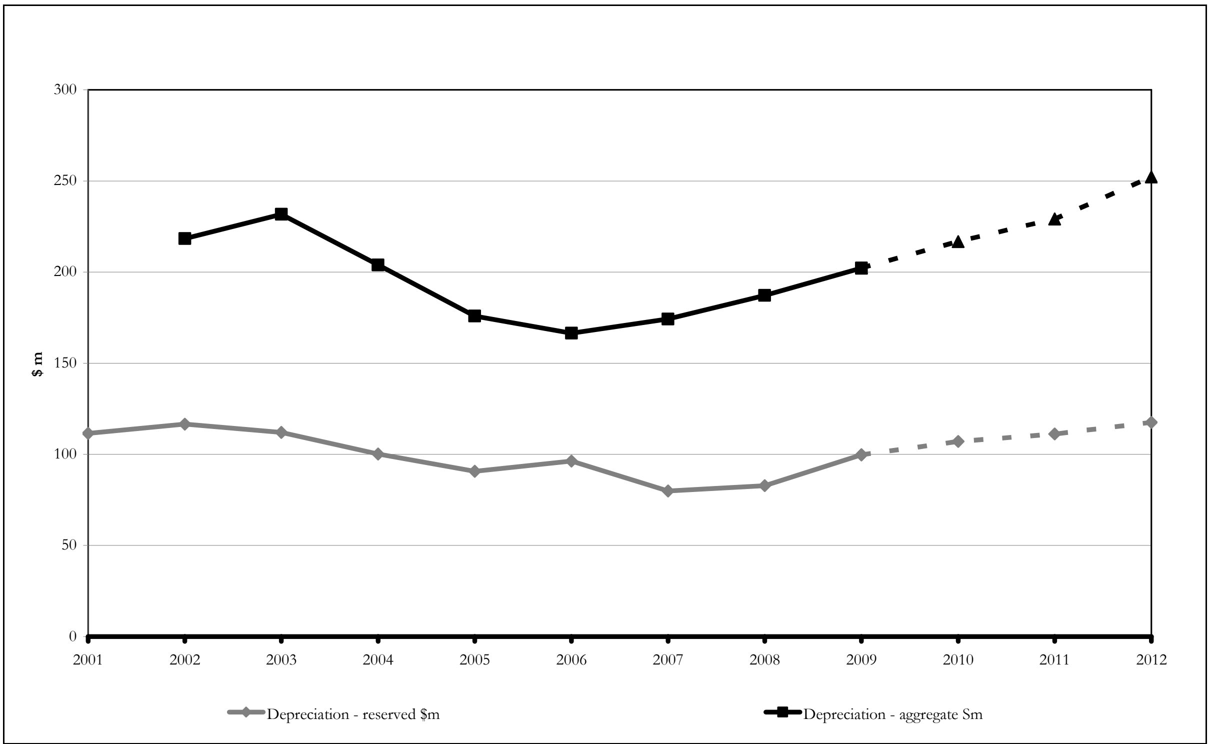
233 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

234 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

method of depreciation.[235] Further, Australia Post stated that it tests assumptions about asset lives and residual values annually, and that these are subject to independent scrutiny by its external auditors.[236]

Trends in depreciation are shown both at an aggregate level and for reserved services in Chart 4.5. Frontier Economics notes that the earlier periods in the series show a decline at both aggregate and reserved services level.[237] It also observes that since the 2006-07 financial year, the trends for both data sets have been clearly upwards and that the forecast levels do not appear to be out of line with these more recent trends. [238]

Chart 4.5: Depreciation – actual and forecast across reserved and aggregate services



Source: Frontier Economics Report p. 70.

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[235] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

[236] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

[237] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, pp .69-70.

[238] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 70.

Other costs

Frontier Economics provided an assessment of Australia Post's other costs which include operating expenses not related to labour, contractors or depreciation. Frontier Economics analysed Australia Post's other cost data (compiled by Economic Insights from data provided to it by Australia Post) for reserved services and at an aggregate level.[239]

Chart 4.6 shows trends and forecasts in other costs for reserved services and in aggregate based on Economics Insights' methodology. Frontier Economics notes that Australia Post have forecast other expenses to grow at an annual average of ✂ per cent per annum for the business as a whole and this appears to be consistent with the results it derived at an aggregate level.[240] For reserved services, the forecast is for these costs to fall slightly.[241] Frontier Economics also notes that both of these forecasts appear consistent with the historical trends. [242]

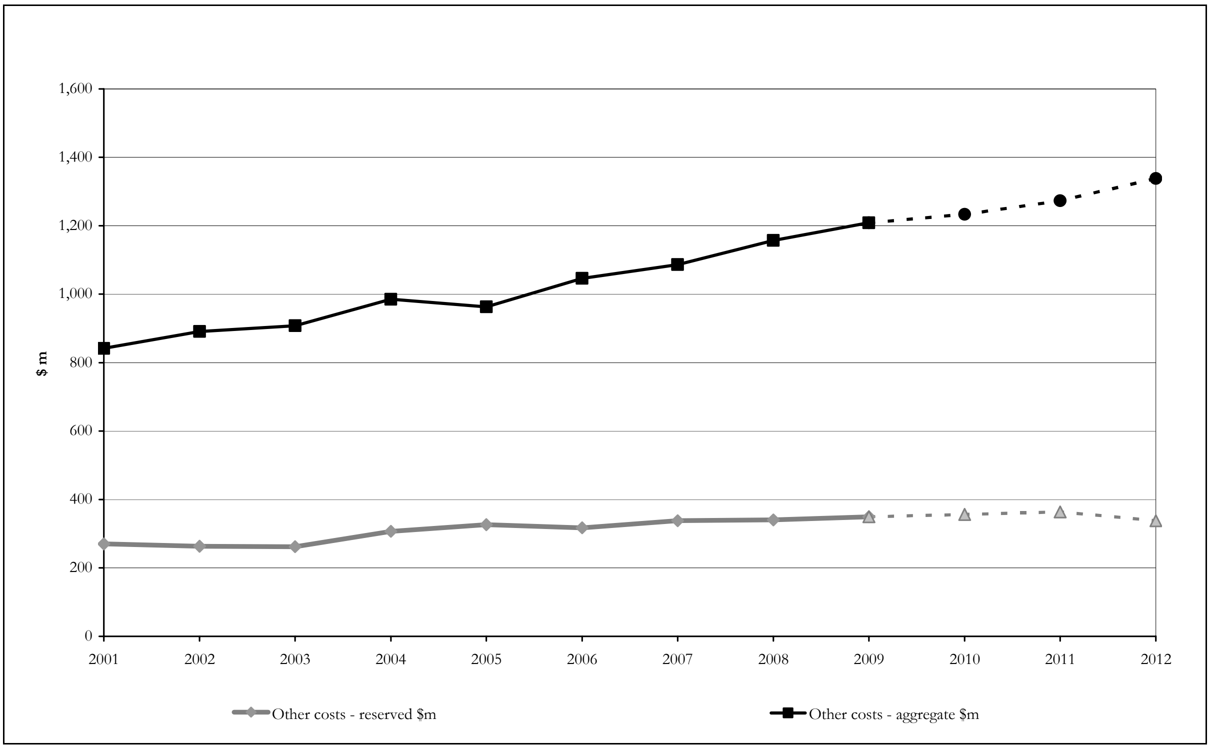
[239] Frontier Economics also observed that Economic Insights uses two different calculations to derive other costs for reserved services and at an aggregate level and these two calculations may not be entirely consistent and may not capture the same kinds of costs.

[240] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

[241] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

[242] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 69.

Chart 4.6 Other costs - reserved and aggregate



Source: Frontier Economics Report p. 69.

Australia Post view on input cost assessment

Frontier Economics notes that Australia Post, in commenting on its draft report, has suggested that it was unclear what Frontier Economics was proposing in its analysis of costs.[243]

Australia Post states that '[m]echanistic approaches to budgeting are probably rarely used in the commercial world, and they are not likely to be adopted by Australia Post. In our experience budgeting is a process of negotiation across all areas of the business, with work programmes rarely static enough to make simple extrapolation viable'.[244]

In response, Frontier Economics argues that 'for regulated businesses "mechanistic" approaches are preferable to subjective and non-transparent forecasts which cannot

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[243] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 70.

[244] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 70.

effectively be reviewed'.[245] Frontier Economics also argues that such processes are relatively standard in regulatory processes.[246]

ACCC's view on Australia Post's operating costs

The ACCC notes Frontier Economics' assessment that Australia Post's input cost forecasts have not been derived using a statistically rigorous methodology which has made it difficult to assess Australia Post's forecasts.

The ACCC notes (and agrees with) Frontier Economics' assessment that in broad terms, the cost forecasts supplied by Australia Post are in line with historical trends.

However the ACCC is concerned that one of the major drivers of cost increases over the period of the draft price notification is Australia Post's forecast of significant increases in its superannuation expenses. These cost increases would appear to be attributable to recent falls in the market valuations of the Australia Post Superannuation Scheme (APSS) assets, and to a more limited extent changes in Commonwealth bond rates. Changes in the value of assets in the APSS affect Australia Post's ongoing operations as Australia Post continues to offer employer-financed defined benefits to its employees. The ACCC notes that Australia Post's recent 2008-09 annual report identifies that Australia Post's net superannuation asset has declined from $1595 million in 2007-08 to $468 million in 2008-09, mainly attributable to a decline in the fair value of the plan's assets.[247]

The ACCC notes that, by offering defined benefits superannuation to all its employees Australia Post faces a higher financial risk than if it provided superannuation benefits through, for example, an accumulation scheme. This is because superannuation costs under a defined benefits scheme (unlike an accumulation scheme) are directly influenced by the asset management performance of the superannuation fund, which in turn is likely to be influenced by a number of factors including fluctuations in global financial markets. The ACCC also notes Australia Post's advice that at present it would incur a higher annual cost if it provided superannuation benefits under an accumulation scheme. [248] However, the ACCC is concerned about the longer term implications for Australia Post of continuing with its current defined benefits scheme.

In addition, a major concern for the ACCC is whether input costs should be increasing when volumes are declining. This issue will be discussed further in the next section.

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245 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 70.

246 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 70.

247 Australia Post, *Australia Post's Annual Report 2008-09*, Financial and statutory reports, p. 80.

248 Australia Post response to ACCC information request dated 2 November 2009 – Question 1.

4.4 Relationship between costs and volumes

Australia Post's Proposal

Appendix 11 of Australia Post's draft price notification describes its four core network functions — Sales and Acceptance, Processing, Transport and Delivery.[249]

Australia Post contends that it has relatively high levels of fixed costs associated with prescribed performance standards, principally in the sales and acceptance, transport and delivery functions of the network.[250] Australia Post also identifies some limits to cost adjustment in response to declining letter volume.[251]

The **sales and acceptance function** relates to the provision of the retail outlets and the acceptance and lodgement of mail at those outlets or at any lodgement point.[252] According to Australia Post, the maintenance of its retail outlets reflects the major cost component of this network function. [253]

Australia Post's views on the extent to which its costs will vary across different areas within its sales and acceptance function are as follows:

- Retail outlets – Australia Post states that 'the requirement to maintain a network of at least 4,000 retail outlets is becoming more challenging, particularly in rural and remote areas (where a minimum of 2,500 outlets must be maintained)'. [254]
- Collection costs – According to Australia Post 'while collection costs vary with distance travelled and the number of collection points, costs are largely independent of variations in letter volume and can also vary with changes in urban development, business location and population movements'.[255]
- Streaming – Australia Post submits that 'the cost drivers for the streaming activity are the mail volume, the mail mix and number of sort 'breaks' required specific to the streaming function at the retail outlet or transport hub'.[256]

[249] Australia Post's 2009 draft price notification, pp. 80-86.

[250] Australia Post's 2009 draft price notification, p. 80.

[251] Australia Post's 2009 draft price notification, p. 80.

[252] Australia Post's 2009 draft price notification, p. 80.

[253] Australia Post's 2009 draft price notification, p. 80.

[254] Australia Post's 2009 draft price notification, p. 81.

[255] Australia Post's 2009 draft price notification, p. 81.

[256] Australia Post's 2009 draft price notification, p. 81.

In conclusion, based on Australia Post's analysis of the sales and acceptance function, the costs associated with maintaining a fixed number of retail outlets and collection are volume invariant but streaming costs do vary with volumes.

Australia Post states that the design of its **processing function** enables a high level of automated sort efficiency[257] and that while declining volumes will generally translate into earlier process completion times, lower machine hour requirements and hence the potential for lower levels of labour resources, there are constraints to the amount of cost that can be reduced.[258] These constraints include:

- the requirement to collect from all lodgement points, regardless of volume, constrains the ability to commence processing earlier;
- labour resource reduction depends on the type of letter, e.g. a street post box (SPB) letter requires more processing steps and resources than PreSort Letters;
- volatility in the pattern of lodgements from businesses on a day by day basis, and it is not possible to fine tune rostered resources to match volume variations; and
- the level of cost savings that may be able to be achieved will vary depending on the type of mail processing equipment used. [259]

Australia Post also notes that an important element of the processing function is the ability to sort to sequence and that the automation of this element will achieve further efficiency, productivity and cost benefits within the processing function. [260]

Australia Post states that the **transport function** 'is built around the prescribed performance standards for letters, but is used as a shared infrastructure with non-reserved products where service standards and schedules permit'.[261]

Australia Post submits that transport costs are relatively fixed as there is a minimum fleet size to cover all transport routes to meet prescribed performance standards.[262] However, it also states that 'contractors charge on the basis of a rate per ULD per destination, the cost of the entire truck, or a rate per kilogram per kilometre in the case of air uplift'. [263]

Australia Post states that the key consideration in establishing the **delivery function** is the requirement that Australia Post must service 98 per cent of the 10.5 million Australia-wide

[257] Australia Post's 2009 draft price notification, p. 82.

[258] Australia Post's 2009 draft price notification, p. 84.

[259] Australia Post's 2009 draft price notification, p. 84.

[260] Australia Post's 2009 draft price notification, p. 84.

[261] Australia Post's 2009 draft price notification, p. 84.

[262] Australia Post's 2009 draft price notification, p. 85.

[263] Australia Post's 2009 draft price notification, p. 85.

delivery points five days per week.[264] Australia Post argues that from a cost driver perspective, the delivery function needs to be separated between the indoor and outdoor components. [265]

It states that the key cost driver in the indoor delivery function is the labour time and labour rate in:

- primary sorting of mail that needs to be manually sorted into delivery rounds (driven by the number of rounds and the mail volume); and
- time spent in manual street sequencing by posties on Vsort frames to separate the letters for a particular round into the street delivery sequence appropriate for that round. [266]

The key cost drivers in outdoor delivery are:

- delivery to post office boxes – the number of boxes and mail volume; and
- street delivery.[267]

Australia Post claims declining volumes will have a negligible impact on outdoor costs. [268]

Views of other interested parties

The MMUA has identified that over the past few years, as the digital technologies have encroached upon the traditional paper based mail/communication market, all of its members have reduced costs and reviewed and reduced overheads. [269]

However, according to the MMUA '…none of that standard approach to these matters can be evidenced in the material provided by Australia Post to justify its proposals' for postage price increases.[270]

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264 Australia Post's 2009 draft price notification, p. 85.

265 Australia Post's 2009 draft price notification, p. 85.

266 Australia Post's 2009 draft price notification, p. 85.

267 Australia Post's 2009 draft price notification, p. 86.

268 Australia Post's 2009 draft price notification, p. 86.

269 Major Mail Users of Australia Limited, *Addendum to Submission in response the ACCC Issues Paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, p. 2.

270 Major Mail Users of Australia Limited, *Addendum to Submission in response the ACCC Issues Paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, p. 2.

Frontier Economics View

Frontier Economics states that a key concern with Australia Post's 2009 draft price notification is that it forecasts declining volumes but Australia Post's forecast costs do not fall with volumes. [271] Frontier Economics identified that while Australia Post does have exacting service standards to meet, it expressed concerns that the scope for cost savings may have been underestimated.

Frontier Economics noted that there are several available international studies which derive relationships between costs and volumes for different postal functions. This relationship is captured in a 'cost-volume elasticity', which measures the percentage change in cost from a small percentage change in volume. Australia Post has effectively assumed a cost-volume elasticity of 0. However, the international studies on mail delivery functions conclude that while the cost-volume elasticity is likely to be less than 1.0, implying that there are 'economies of density' in mail delivery (that is, costs fall proportionally less than volumes), the cost-volume elasticity is significantly different from 0. [272]

Frontier Economics argues that processing of mail appears to be one area where lower volumes of mail should have a greater influence on cost. [273] This is because, where manual intervention in processing is necessary, lower volumes should reduce labour hours and therefore labour costs. [274] In particular it notes in the United States the Postal Rate Commission (PRC) continues to use variabilities close to 100 per cent based on an assumption that work hours vary mostly in proportion to volumes processed. [275]

Frontier Economics also notes a recent article by Bozzo, a US consultant for the United States Postal Service (USPS), which refers to econometric work that finds that: 'the traditional assumption [used by the PRC] that sorting costs will decline in direct proportion to processing volumes overstates the flexibility of USPS costs under stagnant or declining volumes'. While Bozzo finds that a cost-volume elasticity of 1.0 is too high, for all of the letter types he investigates, the cost volume elasticity is above 0.68. [276]

Further, an extensive study prepared for PostComm by the consulting firm LECG found that for the UK, cost-volume elasticities are over 1 (depending on the size of the mail centre).

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[271] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 71.

[272] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 71.

[273] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 72.

[274] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 72.

[275] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 72.

[276] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 72.

This means that costs change by a larger percentage as volumes change. This study used information on 70 mail centres across the UK and econometrically-estimated cost functions using independent variables such as volumes and mail destinations. [277]

Frontier Economics questions Australia Post's views about constraints on reductions in processing costs associated with volume reductions. In particular it notes that:

- It would have been preferable for Australia Post to demonstrate some of these points by pointing to its actual experience with changes in volumes. Frontier Economics notes econometric studies would provide more rigorous and quantifiable evidence of the relationships. There is also no sensitivity analysis applied to forecast what might happen in particular cost categories if such relationships do exist. According to Frontier Economics, as it stands, it is difficult to assess the statements that are made because they are not quantified.

- Australia Post makes no distinction between the short run and the long run. It is Frontier Economics' view that low cost-volume elasticities are plausible in the short run (implying relatively modest cost reductions), as it takes time to re-schedule operations and to re-deploy labour. However, low cost-volume elasticities become more difficult to justify as one moves towards the medium-to-longer term. In the medium-to-longer term, Australia Post could, for example, choose to invest in more scalable processing equipment. This is perhaps difficult to address within the context of a three-year forecast but is something that is clearly necessary to consider in the longer term. [278]

Frontier Economics also notes that, in a world of declining volumes and fixed costs, there are some doubts as to whether increasing prices to earn a return is a sustainable strategy. It argues that Australia Post may well need to significantly reduce its cost base in the medium term, but cost reductions are not yet evident in its cost forecasts. According to Frontier Economics, this will place a greater burden on any future attempts by Australia Post to lower costs in the longer term. [279]

ACCC's view on the relationship between Australia Post's costs and volumes

The ACCC is concerned that Australia Post's forecast declines in letter volumes appear to have had very little impact on its cost base.

This is particularly concerning given that overseas studies of postal delivery and sorting functions suggest that while there are economies of density (that is, costs fall proportionally less than volumes), lower volumes should be accompanied by some reduction in costs. The

[277] Frontier Economics - *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 72.

[278] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 73.

[279] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, November 2009, p. 73.

ACCC also agrees with Frontier Economics that the processing of mail is one area where lower volumes of mail should have a greater influence on cost than appears to be reflected in the cost forecasts provided by Australia Post.

The ACCC has also considered Australia Post's claims in relation to the impact of changing volumes on its cost base. The ACCC notes (and agrees with) Frontier Economics' view that many of the arguments presented by Australia Post cannot be easily tested and are not supported by quantifiable data.

The ACCC also notes (and agrees with) Frontier Economics' view that some cost savings are possible, particularly in the medium term. In light of the lack of quantitative analysis supporting Australia Post's contentions regarding the responsiveness of its cost base to volume declines and in light of overseas studies of postal delivery and sorting functions, the ACCC has concerns about the efficiency of Australia Post's cost base.

4.5 Future Delivery Design Program

The FDD Program is Australia Post's plan to modernise its approach to (predominantly) the delivery of reserved letters. The FDD Program includes a number of linked projects, including the substitution of manual sorting to automated sorting of letters at delivery centres, and in the long term, a move to remote commencement of delivery.

Australia Post's proposal

Australia Post has identified the delivery function as representing the core focus of network investment and process reengineering over the next 5 years.[280] Australia Post has submitted it has a delivery challenge to contain growth in its operating costs and to introduce greater cost flexibility, in light of declining letter volumes and revenues coupled with increasing delivery points (which equates to fewer letters being delivered to more delivery points).[281]

The FDD Program is Australia Post's response to this challenge. The FDD program can be separated into three elements:

Enhanced OCR recognition

- use enhanced OCR address recognition software to drive additional labour savings from existing barcoding processing equipment by significantly raising the proportion of Small Letters whose addresses can be read and sorted to the existing delivery round sort level (or round sections); [282]

Letter sequencing

[280] Australia Post's 2009 draft price notification, p. 95.

[281] Australia Post's 2009 draft price notification, p. 95.

[282] Australia Post's 2009 draft price notification, p. 96.

- extend automated Small Letter processing to delivery street sequence taking advantage of the enhanced OCR software platform to improve the economics of automated sorting of Small Letters to street delivery sequence; [283]

Reconfiguring the mail delivery network

- shift towards a more flexible workforce, and progressively introducing remote delivery rounds that commence and/or cease away from the delivery centre (DC) and which provide wider part time recruitment opportunities;

- deploy new delivery modes (power assisted bicycles and tricycles and walk buggies) to improve mail carrying capacity, broaden the potential outdoor delivery recruitment pool, apply improved round optimisation tools to realign the outdoor delivery task to the work required; and

- examine structural alternatives to Australia Post's regional DC network or other process changes to extract longer term value from the investments required.[284]

Australia Post also states that its overall approach is similar to the approach adopted by overseas postal authorities in response to delivery cost pressures, declining mail volumes and fixed delivery commitments, and that the design of FDD incorporates a number of features drawn from overseas experience. [285]

Enhanced OCR Recognition

Australia Post identifies the rollout of enhanced OCR address recognition software as the first element of the FDD Program.[286] According to Australia Post, OCR address recognition generates savings in its own right as well as being a key enabler for other FDD projects, including automated Small Letter sequencing.[287]

Australia Post states its short term goal is to deliver reduced costs by:

- improving the OCR performance in processing Small Letters to delivery round ;

- increasing the volume of mail whose addresses can be read to a delivery point level (i.e. DPID), hence enabling letters to be machine sorted into street delivery sequence; and

- reducing video coding and mail missorts. [288]

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283 Australia Post's 2009 draft price notification, p. 96.

284 Australia Post's 2009 draft price notification, p. 96.

285 Australia Post's 2009 draft price notification, p. 97.

286 Australia Post's 2009 draft price notification, p. 98.

287 Australia Post's 2009 draft price notification, p. 98.

288 Australia Post's 2009 draft price notification, p. 98.

Australia Post states that labour savings are immediately created by:

- reducing video coding in mail centres, as more letters are successfully read by the OCR on the sort machines; and

- reducing manual residue or primary sorting in DCs, by raising the proportion of letters sorted by machine to delivery round level.[289]

Other benefits that are claimed to arise from enhanced OCR include:

- an address learning capability in the software which enables continuous improvement in recognition performance;

- the use of open architecture facilitates the adoption of further address recognition enhancements into the future; and

- an ability to apply the enhanced OCR address recognition platform to other products such as Large Letters. [290]

Automated sequencing

Automated Small Letter sequencing

Australia Post has identified the progressive rollout of automated sequencing of Small Letters to delivery point street sequence as a central element of FDD.[291] Key aspects associated with Australia Post's plans for the implementation of Small Letter sequencing are as follows:

- Australia Post estimates that automated Small Letter sequencing will yield a net overall 30 minutes saving per round and its long run intention is to apply it to 5100 of the 5500 metropolitan delivery rounds;[292]

- Australia Post estimates average yearly labour savings of ✂✂✂✂✂✂✂✂✂✂ once automated Small Letter sequencing is implemented across metropolitan delivery rounds. This equates to an average yearly labour saving of ✂✂✂✂✂✂✂✂✂✂ if all 5100 metropolitan delivery rounds were sequenced;[293]

- Australia Post commenced the gradual rollout of automated Small Letter sequencing in 2008 using the capacity of its existing barcoding machines.[294] Using this

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[289] Australia Post's 2009 draft price notification, p. 98.

[290] Australia Post's 2009 draft price notification, p. 98.

[291] Australia Post's 2009 draft price notification, p. 96.

[292] Australia Post's 2009 draft price notification, pp. 98-99.

[293] *Future Delivery Design – ACCC Presentation*, 21 August 2009, p. 14.

[294] Australia Post's 2009 draft price notification, p. 98.

technology it is forecasting to rollout automated Small Letter sequencing across 1080 metropolitan rounds by 2009 and to expand this across a further 800 metropolitan rounds in 2010;[295]

- Australia Post is projecting to rollout automated sequenced mail to a further 1600 rounds by the end of 2012 with additional machine sequencing capacity.[296] This means that by 2012 it will have applied automated sequencing to 3480 of its metropolitan delivery rounds;[297]

- Australia Post's draft price notification includes capital expenditure of $21 million over the three years to 2011-12 to purchase additional sequencing equipment. This includes ✂ for automated sequencing machines and ✂ for merging trolleys;[298]

- Australia Post has advised that it would need to purchase ✂ sequencing machines to implement automated sequencing to all metropolitan delivery rounds;[299] and

- financial estimates provided by Australia Post suggest implementation costs of around ✂ to implement Small Letter sequencing nationally across its metropolitan delivery rounds. These costs relate to the establishment of dedicated implementation teams at the national and state level to introduce automated sequencing.[300]

The ACCC also sought further information from Australia Post on the reasons behind its strategic decision not to invest in automated sequencing at the same time as other postal operators overseas.[301] For instance, the USPS had implemented automatic sequencing in 2001 at the time when Australia Post implemented its FuturePOST program.[302]

Australia Post advised that there are some key differences between Australia Post and the USPS which led to this decision. These included the following factors:

- the average number of items per delivery point in Australia is less than 40 per cent of the US (496 items per annum compared to 1360);

- there is a significant quantity of large sized items in the US compared to Australia;

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[295] Australia Post's 2009 draft price notification, p. 100.

[296] Australia Post's 2009 draft price notification, p. 100.

[297] Australia Post's 2009 draft price notification, p. 100.

[298] Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 5.

[299] Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 6.

[300] The ACCC derived an estimate of an additional implementation cost of implementing sequencing across metropolitan delivery rounds based on information provided by Australia Post.

[301] ACCC Information Request dated 27 August 2009 – Question 2.

[302] ACCC Information Request dated 27 August 2009 – Question 2.

- the significant size difference of the network – the US network covers around 150 million delivery points, compared to around 10 million in Australia;[303] and
- differences in the points per round – the average 'postie' round in Australia covers around 1000 points compared to around 535 in the US. [304]

Australia Post also states that differences in scale, product mix, and business strategy inevitably drive differences in technology adoption. [305] Australia Post claims it does not have the economies of scale and density enjoyed by the USPS, nor does it have the leverage with equipment vendors to initiate major new technology design with overseas vendors.[306] However, Australia Post claims that it has a track record in adopting and tailoring overseas technology solutions to Australian conditions in a measured approach that has driven business benefit.[307]

The ACCC also sought further information from Australia Post on why automated sequencing was not implemented earlier in Australia and in particular why it had not been considered economic for at least metropolitan rounds in 2001 in Australia. [308]

Australia Post advised that a key requirement for the effective implementation of automated sequencing is a high proportion of letters with a unique delivery point identifier (DPID) – either generated by the sender or applied by the postal organisation through a mechanised process. [309] According to Australia Post, in 2001 OCR technology and customer database address accuracy were not at a level where DPID recognition rates supported viable automated sequencing.[310] Australia Post advised that barcode sorting rates to delivery round were around 60 per cent in 2001, had increased to 72 per cent when it started automated sequencing in 2008 and are currently approaching 80 per cent. This meant that in 2001 a costly manual mail merge would have been required as an additional process in DCs if automated sequencing had been implemented. [311]

Australia Post also advised that in 2001 there were very significant changes being made to its work processes as a result of the introduction of FuturePOST and given the finite limit in the network capacity to absorb major process change without threatening customer quality and

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303 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 15.

304 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

305 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 15.

306 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 15.

307 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 15.

308 ACCC Information Request dated 27 August 2009 – Question 2.

309 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

310 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

311 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

cost, a move to sequencing at that time was not contemplated and not envisaged in the FuturePOST planning.[312]

Australia Post also advised it was able to achieve a major share of Small Letter sequencing savings similar to savings achieved by other postal operators without buying sequencing equipment through:

- the use of barcode sort plans enabling Australia Post to sort to all rounds in one pass unlike USPS. The USPS zip code had 5 fields and sorting equipment cannot cover the 300,000 carrier routes in the USPS in one sorting process;
- introducing mechanised round sorting which reduced manual primary sorting by 60 per cent;
- the relatively low density of mail articles per delivery point in Australia which supported the viability of revised sorting frames in comparison to significant capital outlay for additional mechanised equipment; and
- implementing the VSort frame – this eliminated the 'streeting' process by combining both 'streeting' and 'sequencing' into the one sorting process in DCs and realised substantial (in excess of 500 work years) cost savings for a relatively low capital cost (around $50m). [313]

Australia Post has also indicated that current enhanced OCR software improvements are now at a level where DPID read rates have reduced volumes of manually sequenced Small Letters to levels where broad based automated sequencing can be viable. [314]

Australia Post has, however, also noted that industrial relations is one factor that has influenced the timing of automated sequencing but argues it is more a driver for how efficiency savings are to be realised, rather than what or when such initiatives are to be implemented. [315] According to Australia Post, the timing of sequencing has been determined by a convergence of new technology involving enhanced recognition software combined with the need to reduce dependence on motorcycle delivery and achieve a shift away from the traditional full time postie role. [316]

Automated Large Letter sequencing

The USPS began its initial deployment of large letter/flats sequencing machines in 2008 to sequence large letters, catalogues and periodicals into the order of delivery for carriers. According to the USPS, the flats sequencing system equipment are capable of sequencing

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312 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

313 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 2.

314 *Future Delivery Design – ACCC Presentation,* 21 August 2009, p. 18.

315 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 7.

316 Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 7.

280500 pieces of large mail items per day to more than 125000 delivery addresses.[317] Similar initiatives have also been identified by Royal Mail in its 2006 price control review.[318]

Australia Post states that Large Letters automated sequencing is not currently under consideration for a number of reasons including:

- current sequencing equipment cannot handle Large Letters and the existing barcode sorters capacity is fully committed to Small Letters;
- the low volume of Large Letters per delivery point (in contrast to overseas) and the considerable relative capital cost of Large Letter processing machines compared to Small Letter machines;
- the limited processing time within the Large Letter processing window; and
- the lower DPID OCR read rate for Large Letters, resulting in a poor sequencing rate.[319]

Reconfiguration of mail delivery network

Australia Post notes that the implementation of Small Letter sequencing in letter facilities reduces the indoor manual sequencing work by posties in DCs.[320] Australia Post also notes that the adjustments to work by posties in DCs provide flexibility in how the gains from automation are taken up[321], and provide an opportunity to increase flexibility away from Australia Post's traditional reliance on a full time postie role which encompasses both indoor sort activities and the outdoor motorcycle based functions.[322]

In particular, Australia Post states that the implementation of small letter sequencing opens up other opportunities, including:

- using other delivery modes (eg power assisted bicycles and tricycles, and walk buggies) to reduce dependence on motorcycles, thus eliminating travel time and the associated traffic risks of motorcycle delivery;
- redesigning the delivery rounds to better fit a part time role with round commencement and cessation remote from the DC; and

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[317] United States Postal Service, FSS delivers improved efficiency, service, MailPro May/June 2009, pp 4-5.

[318] LECG, *Future Efficient Costs of Royal Mail's Regulated Mail Activities – Bottom-up Review of Royal Mail's Strategic Plan: Final Conclusion*, February 2006.

[319] Australia Post's 2009 draft price notification, p. 99.

[320] Australia Post's 2009 draft price notification, p. 99.

[321] Australia Post's 2009 draft price notification, p. 100.

[322] Australia Post's 2009 draft price notification, p. 100.

- accordingly, recruiting from a wider labour pool by being able to offer part time work close to home without requiring a motorcycle licence.[323]

A move towards a remote commencement and cessation (RCC) delivery model is a significant change from Australia Post's existing delivery model where posties manually sort partially processed mail, travel from the DC to the rounds, and then deliver to the delivery points within the round. Under the RCC model, posties would not be involved in both the sorting and delivery of the mail.

Australia Post has advanced two main reasons for implementing this new delivery model:

- the need to reduce its reliance on motorcycle delivery — the current numbers of motorcycles are unsustainable given the availability of licensed riders; and

- the opportunity to recruit from a wider labour pool — by being able to offer delivery work on a part time basis close to home without needing a motorcycle licence.[324]

Australia Post is pursuing alternative modes of delivery that do not require a 'licensed' rider under its RCC delivery model. These include power assisted bicycles and tricycles and walk buggies that offer greater carrying capacity than motorcycles with options to use this form of delivery for other products while reducing the depot box network required with motorcycles.[325] RCC is currently being rolled out and as of July 2009 there were over 700 posties nationally who commenced and / or ceased work remotely. [326]

Australia Post is currently working through a number of regulatory matters associated with the design of power assisted pedal bicycles and tricycles to assess whether they can be used by unlicensed riders on footpaths.[327]

The RCC model also involves the establishment of small delivery depots where the power assisted bicycles and tricycles will be stored, and sorted mail can be dropped off from a larger delivery facility.[328]

Australia Post has advised that its current DC network is being reviewed with the overall intent to reduce the number of DCs (i.e. resulting in larger DCs that are fewer in number). [329]

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[323] Australia Post's 2009 draft price notification, p. 100.

[324] Australia Post's 2009 draft price notification, p. 100.

[325] Australia Post's 2009 draft price notification, p. 100.

[326] Australia Post Response to ACCC Information Request dated 28 August 2009 – Question 4.

[327] Advice provided to the ACCC by Australia Post at meeting dated 28 August 2009.

[328] Australia Post Response to ACCC Information Request dated 27 August 2009 – Question 8.

[329] Australia Post Response to ACCC Information Request dated 28 August 2009 – Question 8.

According to Australia Post, the consolidation of DCs does not generate significant savings in its own right but instead provides support for other changes in the delivery network. [330]

Views of other interested parties

The Post Office Agents Association Limited (POAAL), in referring to the two major initiatives for the future identified by Australia Post ─ enhanced OCR and letter sequencing ─ notes that it had understood these initiatives to be extensions of the current capability of existing letter sorting equipment rather than something requiring substantial additional investment. [331] POAAL noted that enhanced OCR and letter sequencing are well underway in other postal authorities.[332] According to POAAL, the application of this technology in Australia seemed not to be limited by the technical capability of the equipment but the industrial climate in which Australia Post is operating.[333]

MMUA argues that the FDD is not appropriate. According to MMUA, the FDD lacks ‘reference to MMUA’s suggestions from March 2007 for a more advanced network integration and use of e-PreLodgement Advice systems, as well as Australia Post’s own Alternative Lodgement Solutions (PIP2)’.[334] MMUA states ‘because of that omission of these two sophisticated proposals for use of modern day technology ... the FDD Program is incomplete and should be rejected by the ACCC’.[335]

MMUA also states that ‘a decade or so ago, Australia Post set itself upon a course of network renewal and innovative changes to the processing of mail – FuturePOST – but stopped short before all the potential areas…of productivity and cost effectiveness had been either sought or obtained’.[336] MMUA contends that, in its experience, since 2006 it has been frustrated in trying to deal with Australia Post in the areas of modification, improvement and advancing the processing of mail through new technologies. [337]

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330 Australia Post Response to ACCC Information Request dated 28 August 2009 – Question 8.

331 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 12.

332 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 12.

333 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 12.

334 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post’s Draft Notification – Postal Pricing Increases*, 15 October 2009, p. 25.

335 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post’s Draft Notification – Postal Pricing Increases*, 15 October 2009, p. 25.

336 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post’s Draft Notification – Postal Pricing Increases*, 15 October 2009, p. 12.

337 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post’s Draft Notification – Postal Pricing Increases*, 15 October 2009, pp. 12-13.

ACCC's view on the Future Delivery Design program

The FDD Program is highly relevant to the ACCC's assessment of the efficiency of the cost base Australia Post is seeking to recover through prices. The ACCC has assessed the three major elements of the FDD separately in terms of their effect on the efficiency of Australia Post's cost base.

Enhanced OCR Recognition

The ACCC notes that funds for the purchase of enhanced OCR recognition software and savings associated with its application are reflected in Australia Post's cost base. The ACCC considers this is appropriate given the importance of enhanced OCR recognition as an enabler to automated sequencing, which is another key element of the FDD. Therefore the ACCC considers Australia Post's treatment of the impact of OCR on costs to be appropriate.

Automated sequencing – international benchmarking

As has been previously noted, internationally some postal service operators have continuously and vigorously advanced mail sorting and sequencing automation technology in recent years. In contrast, Australia Post has made no major capital investment in its mail network since the completion of the FuturePOST program in the early 2000s.

In its consideration of Australia Post's 2008 draft price notification, the ACCC identified that Australia Post's planned deployment of automated sequencing was slow and small-scale. [338] The ACCC also assessed that Australia Post's projected savings from the deployment of automated sequencing appeared to be relatively low, compared with outcomes from implementations of this technology by overseas postal operators.[339]

In comparison to a number of international postal operators, Australia Post continues to appear to be slow in deploying automated sequencing. Automated sequencing has been used widely by overseas postal operators for many years on the basis that the technology is cost-effective in reducing processing and delivery time and improves the quality of processing and delivery.

For example, the USPS initiated its testing program in delivery point sequencing of standard letters in 1991 and started its implementation in 1993. By 2007, 86 per cent of standard-sized letters had been sequenced to the order of delivery point, with a target of 95 per cent by 2010.[340] The USPS estimated that sequencing would reduce in-office hours for processing mail by about 80 minutes per day.[341]

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[338] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 137.

[339] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 137.

[340] United States Postal Service, *2007 Comprehensive Statement on Postal Operation*, 2007, pp. 43-44.

[341] United States General Accounting Office, U.S. Postal Service: Progress Made in Implementing Automated Letter Sequencing, but Some Issues Remain, *Report to the Chairman, Sub-committee on the Postal Service, Committee on Government Reform and Oversight, House of Representatives*, GAO/GGD-98-73, April 1998., p. 14.

By 2004, Post Danmark (Denmark) had introduced automated sequencing to the extent that 76 per cent of all standard letters were delivered in the order of distribution.[342] By 2005, TNT (Netherlands) and Deutsche Post (Germany) had deployed automated sequencing to 40 and 80 per cent of all letters respectively.[343,344] Deutsche Post has now implemented fully automated sequencing of its letter mail.[345] Meanwhile, TNT had unrolled 286 sequence sorting machines in 2003-2005 as part of a major project that was completed in November 2005.[346]

Furthermore, Royal Mail (United Kingdom) and Canada Post, which have both recently undergone fundamental reviews, are implementing programs to introduce sequencing machines into their delivery networks as part of efficiency initiatives. Royal Mail recently installed the first walk sequencing machines in Bristol in preparation for a rollout to the rest of the delivery network.[347] The rollout will involve 900 sophisticated automation machines[348], including 530 walk sequencing machines[349], within 3 years, which would mean that Royal Mail will be able to sort 75 per cent of addressed letters to the exact door-to-door sequence.[350] Canada Post is also undertaking a number of efficiency initiatives, including the introduction of 'automating manual sequencing to facilitate … its ability to respond to attrition requirements and changes in market mix as well as improve productivity and efficiency of operations'[351]. Canada Post has stated that the majority of its anticipated savings from an investment in its 'Postal Transformation' program will be derived from 'synchronizing upcoming accelerated attrition with machine sequencing of the mail to each point of call thus minimizing reliance on manual work'.[352]

Australia Post has also identified that Deutsche Post announced in April 2009 that it was investing in 385 automated processing machines, including 97 Large Letters processing

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342 The Post Danmark Group, *Annual Report 2004,* p. 22.

343 LECG, *Future Efficient Costs of Royal Mail's Regulated Mail Activities*, 2 August 2005, p. 141.

344 Royal Mail, *Royal Mail's response to Postcomm's Strategy Review,* 2006, p. 22.

345 Canada Post, *A Blueprint for Change: Submission to the Strategic Review of Canada Post,* September 2008, p. 27.

346 TNT Group, *Annual Report and Form 20-F*, 2005, p. 30.

347 Royal Mail Group, News Release, *£120 Million Further Investment In Royal Mail Modernisation,* 21 July 2009, http://www.news.royalmailgroup.com/article.asp?id=2579&brand=royal_mail.

348 Royal Mail Group, News Release, *£120 Million Further Investment In Royal Mail Modernisation,* 21 July 2009, http://www.news.royalmailgroup.com/article.asp?id=2579&brand=royal_mail

349 Royal Mail Group, News Release, *£120 Million Further Investment In Royal Mail Modernisation,* 21 July 2009, http://www.news.royalmailgroup.com/article.asp?id=2579&brand=royal_mail.

350 Royal Mail Group, News Release, *£120 Million Further Investment In Royal Mail Modernisation,* 21 July 2009, http://www.news.royalmailgroup.com/article.asp?id=2579&brand=royal_mail.

351 Canada Post, *2008 Annual Report,* p. 38.

352 Canada Post, *2008 Annual Report,* p. 38.

machines, for a total cost of EUR 420 million in the 3 years to 2012. [353] In contrast, Australia Post's core processing equipment assets comprise 56 letter processing machines and 8 Large Letter processing machines.[354]

Automated Small Letter sequencing

The ACCC considers that while there may have been some case to support Australia Post's assertion that automated sequencing of Small Letters was not viable in Australia in 2001, this does not appear to be the case now. It would appear that Australia Post is now behind the world best-practice postal operation in terms of the deployment of automatic sorting and sequencing technology.

The ACCC does not consider that it is reasonable that in 2012, based on Australia Post's current implementation timetable, less than 70 per cent of metropolitan Small Letter delivery rounds will be sequenced.

The ACCC estimates, based on information supplied to it by Australia Post, that had Australia Post invested around ✂✂✂✂✂✂✂✂✂✂ on additional automated sequencing machines (and merging trolleys) it would now have the capacity to be sequencing all metropolitan delivery rounds. If this had occurred, Australia Post would now be benefiting from significant long term reductions in its operational expenses. This would suggest that Australia Post's current operating expenses are higher than what efficient labour costs might be for a postal operator in Australia that has the capacity to be sequencing all metropolitan delivery rounds. An efficient postal operator would have invested previously through its capital expenditure program to purchase sufficient automated Small Letter sequencing machines to enable the application of this technology to all metropolitan delivery rounds.

Thus, the above indicates that Australia Post does not appear to have an efficient cost base in this area and the ACCC considers that there should be a reduction in Australia Post's current and forecast operating expenses to better reflect efficient labour costs.

Automated Large Letter sequencing

The ACCC considers that there is some doubt as to whether Large Letter sequencing is currently viable in Australia given current Large Letter volumes but that Australia Post should continue to identify potential technological development which could lead to improved operational efficiency in this area. The ACCC also notes that the USPS in 2009 announced that it was revising its timelines for the national deployment of its Flats Sequencing System in the context of declining volumes.[355]

Therefore the ACCC considers that Australia Post's treatment of the impact of Large Letter sequencing on costs is appropriate.

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353 Australia Post's 2009 draft price notification, p. 93.

354 Australia Post's 2009 draft price notification, p. 93.

355 United States Postal Service, FSS delivers improved efficiency, service, MailPro May/June 2009, p 4.

Reconfiguration of mail delivery network

The ACCC notes that Australia Post has advised that it is not forecasting any savings associated with the reconfiguration of its mail network and the establishment of RCC as an outdoor delivery mechanism. Nonetheless, the ACCC considers that the rationalisation of the DC network and the implementation of RCC would seem to provide some potential for savings which could mean that Australia Post's current cost base may be higher than its cost base in the long term.

4.6 Capital expenditure

Australia Post's Proposal

Australia Post submits that its capital investment program is focussed on regeneration of its fixed asset base.[356,357] 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,[358] of which $153 million in 2008-09, $152 million in 2009-10, $124 million in 2010-11 and $150 million in 2011-12 has been allocated to the domestic letter service.[359]

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.[360] Australia Post claims 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. [361]

Table 4.1 identifies Australia Post's reserved service capital expenditure by category. This table shows that information technology and motor vehicles are the categories that have the highest proportion of reserved service capital expenditure (accounting for over 60 per cent of forecast capital expenditure over the three years to 2011-12). Appendix 15 of Australia Post's draft price notification also provides information on major projects by network function

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356 The ACCC has previously considered the value of assets employed by Australia Post in providing its reserved services. This matter was considered in detail by the ACCC in its July 2008 final decision on Australia Post's 2008 Price Notification where the ACCC then assessed that Australia Post's fixed asset values were likely to be reasonable for the purposes of analysing the profitability of providing domestic reserved letter services. The ACCC considers there has been no material change to the nature of Australia Post's assets or accounting policies since its 2008 decision and has therefore decided not to reconsider Australia Post's asset valuations in detail as part of Australia Post's current draft price notification.

357 Australia Post's 2009 draft price notification, p. 52.

358 Australia Post's 2009 draft price notification, p. 52.

359 Australia Post response to ACCC Information Request dated 19 October 2009 – Question 2 . This response also contained a revised reserved service capital expenditure figure for 2008-09 of $153 million.

360 Australia Post's 2009 draft price notification, p. 52.

361 Australia Post's 2009 draft price notification, p. 52.

included in the capital expenditure program for the business as whole over the three years to 2011-12. [362]

Table 4.1: Domestic Reserved Service – Capital expenditure by category ($ million)

Category	2008-09	2009-10	2010-11	2011-2
Sales & Acceptance	5	3	4	4
Processing	13	8	8	19
Delivery	15	13	24	34
Information Technology	65	75	58	55
Motor Vehicles	27	17	27	29
Other Capital Investment	28	36	3	10
Total	153	152	124	150

Source: Australia Post response to ACCC Information Request dated 19 October 2009

Australia Post submits that it traditionally funds the total capital expenditure outlay from its cash flows without resorting to external funding, a practice that it understands is the most common method of funding capital expenditure by corporations. [363]

Australia Post also states that its annual ratings review with Standard & Poor's has just commenced and it would need to wait for the outcome of that review before considering any change to standard funding practices as ratings outcomes can have a significant impact on capital market funding costs. [364]

Notwithstanding, Australia Post argues that if there was a clear need to make unavoidable investments not currently included in the three-year capital expenditure program, then it would examine all options to accommodate such investments.[365]

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[362] Australia Post's 2009 draft price notification, p. 91.

[363] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

[364] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

[365] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

South East Queensland Network Restructure Program

Australia Post advised that one of the capital expenditure projects it has deferred was its South East Queensland Network Restructure Program. [366] The project was estimated to cost $116 million and would have involved the establishment of a number of new mail facilities as well as the expansion and consolidation of a number of existing facilities.[367,368]

Australia Post has identified that South East Queensland is forecast to grow significantly in population and in delivery points and this is placing pressure on its existing network.[369] Specific South East Queensland network issues identified by Australia Post include:

- high parcel volume forecasts indicate that the Underwood Mail Centre is reaching its capacity; and

- forecast population growth indicates that 20 delivery centres over the next 5-10 years will reach capacity with no site expansion possible.[370]

Australia Post advised that there were a number of reasons for the project's deferral. These included the following:

- the project was not forecast to produce a positive financial return over a 10 year period;

- high expected project costs in a period of economic downturn and capital rationing;

- lower forecast parcel volume growth and production changes in parcel processing delaying capacity constraints in parcel sorting; and

- a series of workarounds for capacity management at DCs which will extend facility life for 3-5 years.[371]

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366 Additional information provided by Australia Post to the ACCC on its South East Queensland Network Restructure Program.

367 Additional information provided by Australia Post to the ACCC on its South East Queensland Network Restructure Program.

368 Australia Post has noted that, while the South East Queensland project has been deferred, some of the elements have been undertaken. In particular, one Delivery Centre consolidation (Heathwood DC), planned as part of the bigger restructure, did go ahead. This is in addition to the series of workarounds for capacity management at DCs which will extend facility life for 3-5 years.

369 Additional information provided by Australia Post to the ACCC on its South East Queensland Network Restructure Program.

370 Additional information provided by Australia Post to the ACCC on its South East Queensland Network Restructure Program.

371 Additional information provided by Australia Post to the ACCC on its South East Queensland Network Restructure Program.

Views of other interested parties

POAAL, in its submission, states that Australia Post's investment strategy seems to be based around renewal of existing infrastructure rather than investing in future revenue streams or cost reductions. [372] According to POAAL, it is debateable if this a sustainable investment approach. [373]

POAAL also states Australia Post is yet to reap the full potential and productivity from its major investment in mail sorting equipment. [374] For example, it argues that Australia Post's capacity to sort to delivery sequence or private boxes is unrealised. [375]

ACCC's view on Australia Post's capital expenditure

Australia Post is planning a large capital expenditure program over the next three years. Given the size and significance of the proposed capital expenditure program, it is important to ensure that the capital projects included are appropriate and that there is an efficient allocation of resources to the capital program.

In its assessment of Australia Post's 2008 pricing proposal, the ACCC considered the internal procedures used by Australia Post to assess capital expenditure projects. In this decision the ACCC arrived at the view that there were reasonable administrative processes established by Australia Post to internally assess capital expenditure projects. [376] In addition, the ACCC considered that there appeared to be sufficient controls in place for Australia Post to monitor and track deviations in project costs from original outlays estimates.[377] Given that there have been no significant changes in these procedures, the ACCC does not consider that there is a need to re-assess Australia Post's administrative processes in this area.

Notwithstanding, the ACCC is concerned that Australia Post has not previously allocated sufficient funds in its capital expenditure program for the purchase of automated Small Letter sequencing machines to service all metropolitan mail delivery rounds. As identified in the ACCC's assessment of the FDD, the ACCC's view is that if this expenditure had occurred Australia Post would currently be realising significant savings in operational costs.

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372 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 13.

373 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 13.

374 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 6.

375 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 6.

376 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 110.

377 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 110.

4.7 Total factor productivity of Australia Post's aggregate and reserved services

Australia Post's view

Australia Post contends that its '…costs are efficient, and reflect an aggressive and sustained pursuit of efficiency and productivity opportunities.'[378] In addition to providing detail on its capital expenditure incorporating its FDD program, Australia Post provided detail on its productivity and cost containment initiatives.

Australia Post states that it has undertaken a number of initiatives to promote cost containment and productivity targets across its core network functions of Sales and Acceptance, Processing, Transport and Delivery.[379]

Sales and Acceptance

Australia Post has identified some key initiatives associated with this function that it has undertaken or is intending to undertake to increase efficiency in the network. These include:

- converting corporate retail outlets to licensee or franchisee operations;
- application of a Resource Optimisation Model to better match labour resources to workload and restructuring its retail model to include a greater mix of part-time staff;
- a variety of measures to improve the operational efficiency of its network of retail offices; and
- application of technology improvements to support business growth as well as improve efficiency.[380]

Initiatives planned to further increase efficiency in the network include:

- further conversions of corporate retail outlets to licensee or franchised operations;
- continued evolution of the Resource Optimisation Model to align the changing requirements of the business;
- strengthened protocols to identify 'non compliant' lodgements which require more expensive processing to simplify customer lodgement and documentation and reduce compliance costs;
- route optimisation initiatives to reduce the costs of van collections from local area SPB networks and to improve the efficiency of intrastate and country truck schedules; and

378 Australia Post's 2009 draft price notification, p. 6.

379 Australia Post's 2009 draft price notification, p. 59.

380 Australia Post's 2009 draft price notification, pp. 59-60.

- contact centre optimisation and improved supply chain management. [381]

Processing

Australia Post claims that efficiency gains associated with the letters processing function will continue to be sourced from a wide range of localised process improvements across facilities, including:

- an intensive national focus on aligning labour resources to letter volumes as letter volumes decline;
- a continued focus on labour productivity issues in facilities including job rosters and shift alignments, attendance rates, requirements for weekend processing and management of flexible labour and overtime hours;
- further extension of the enhanced OCR address recognition platform from Small Letters to Large Letters, to secure efficiencies in Large Letter processing by improving the DPID read rates on automated equipment;
- savings from replacing aging 'Spectrum 10' machines that handle the more difficult to process Large Letters with more efficient equipment; and
- other technology refinements to improve materials handling and asset usage.[382]

Australia Post argues that while efficiency gains will continue to be pursued, major efficiency gains have already been extracted from letter processing operations and there are constraints to cost adjustment. These constraints include:

- structural options to reduce costs through facility consolidation are limited as with the exception of Brisbane, the metropolitan processing function is now centralised around one major facility;
- many of the automated and other processing operations within facilities have a fixed labour component that is required for the machine operation (e.g. machine set up and clear down) irrespective of volume if the machine is to operate;
- declining volumes introduce additional unpredictability in the timing and size of lodgements as large customers seek to merge and consolidate their mailouts; and
- potential labour savings arising from declining letter volumes are difficult to realise where the individual time savings are small and thinly spread.[383]

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381 Australia Post's 2009 draft price notification, p. 60.

382 Australia Post's 2009 draft price notification, p. 60.

383 Australia Post's 2009 draft price notification, pp. 60-61.

Transport

Australia Post states that transport initiatives in recent years have focused on:

- switching interstate letter carriage from high cost air transport to road transport where there is a sufficient time window within the interstate service standard (e.g. Sydney – Melbourne and Sydney – Brisbane);
- ensuring that where air transport is unavoidable, carriage in lower cost passenger aircraft body space is maximised rather than using high cost air freighters;
- adjusting and optimising truck duties and driver rosters and schedules to ensure efficient labour costs ;
- route optimisation and outsourcing (e.g. where trip return loads are light) to maximise capacity usage; and
- improved vehicle fleet management efficiencies. [384]

Delivery

Australia Post has also identified a number of productivity and cost containment initiatives associated with the delivery function which are discussed in detail in section 4.5.

Economics Insights report

In addition to detailing the specific initiatives aimed at increasing productivity and cost containment, Australia Post provided the ACCC with a report prepared by consultants Economic Insights measuring Australia Post's past and forecast TFP for its aggregate and reserved services for the period 1990 to 2009. Unlike partial measures of productivity, such as the number of letters delivered per dollar of labour expenses, TFP measures output in the context of all inputs of production. TFP analysis provides a consolidated measure of the impact of the discrete productivity and cost containment measures presented in detail in Australia Post's draft price notification. A detailed outline of the TFP measure of productivity is contained in Box 4.1.

The Economic Insights report on Australia Post's reserved and aggregate service productivity is an updated version of the productivity report prepared for Australia Post to support its 2008 price notification. In addition to measuring Australia Post's past and expected TFP performance, this report addresses some of the concerns expressed by the ACCC regarding the TFP methodology in its decision on Australia Post's 2008 price notification.

Box 4.1 Total factor productivity

Australia Post uses multiple inputs such as labour, capital, and material to produce multiple outputs such as letters, parcels, and financial services.

384 Australia Post's 2009 draft price notification, p. 61.

Australia Post's productivity performance is best measured by TFP.

In order to calculate TFP, a TFP index is generally used. A TFP index is effectively a weighted average of output growth relative to a weighted average of input growth.

A TFP index reflects the overall productivity changes, which cannot be captured in a partial productivity index that measures the relationship between output and a single factor of production.

There are a number of index number methods that can be used to derive a TFP index and these calculate weighted average change in different ways.

Economic Insights has evaluated four index number methods and uses the Fisher ideal index in its *Australia Post's Aggregate and Reserved Service Productivity – 2009 Update* Report.[385]

Summary of Economic Insights report

Economic Insights' report examined Australia Post's aggregate and reserved services productivity performance for the years 1989–90 to 2008–09 using data on input, output and relevant prices. The report also forecast productivity performance through to 2011–12 based on Australia Post's forecasts of future output and input.

The main findings of this report are:[386]

- Australia Post exhibited strong TFP growth for both aggregate services and reserved services in the period to 2008-09.
    - Aggregate services experienced an annual rate of 1.8 per cent in TFP growth over the period from 1989-90 and 2008-09 and a slightly lower growth rate of 1.4 per cent from 1996-97 to 2008-09.
    - Reserved services experienced an annual rate of 1.7 per cent in TFP growth over the period from 1996-97 to 2008-09.
    - Both aggregate services and reserved services outperformed the overall market sector over both the last 13 years and the last 7 years.
- The strong TFP overall growth in aggregate services is attributable to the following factors:
    - output rose significantly up to 1999-2000;

385 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 5.

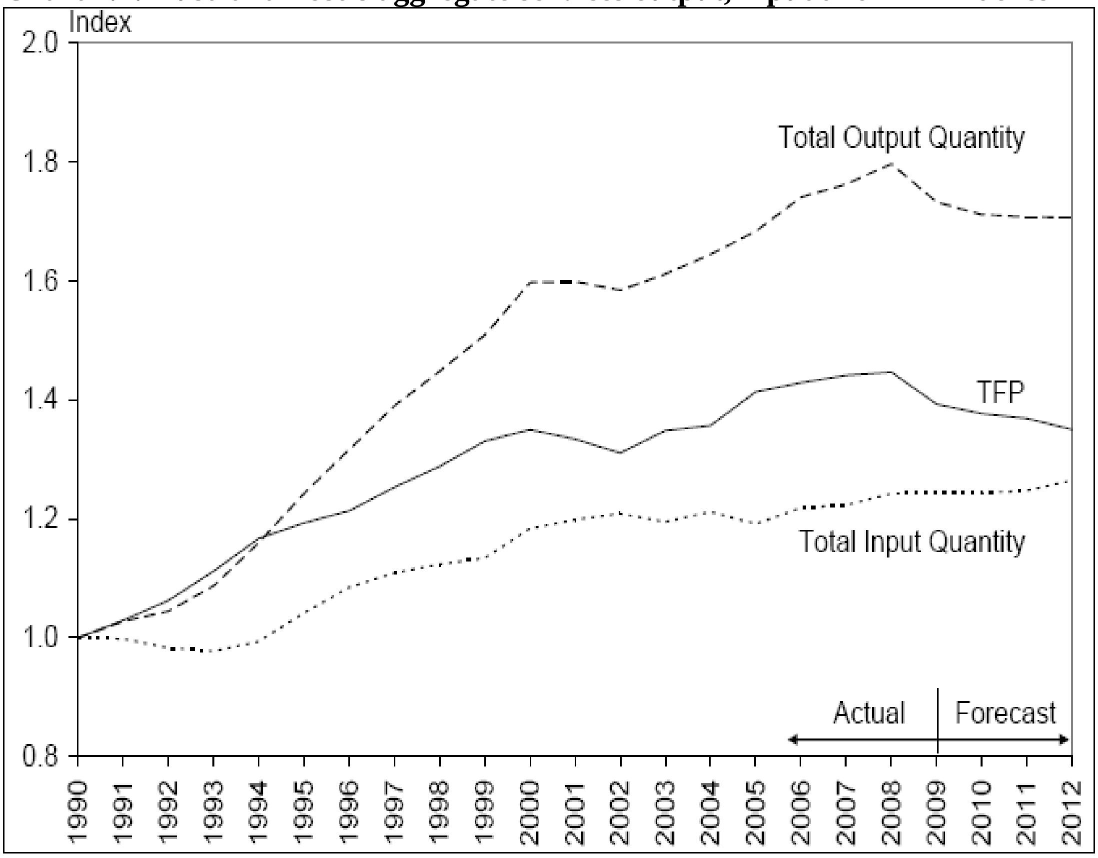
386 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, pp. ii, 15, 27, 29.

- output stalled in 2000-01 and 2001-02 and then increased at a smaller rate than before 1999-2000 up to 2007-08; and
- output fell significantly in 2008-09.

- The strong overall TFP growth in reserved services is attributable to the following factors:
  - output grew strongly up to 1999-2000 and then fluctuated around this level up to 2006-07 before increasing in 2007-08 and then decreasing significantly in 2008-09; and
  - input quantity declined during the period 1996-97 to 2008-09.
- TFP is predicted to decrease at an annual rate of 1.0 per cent for aggregate services and 1.3 per cent for reserved services over the period 2009-10 to 2011-12 mainly reflecting a reduction in the volume of letters.

Chart 4.7 presents Australia Post's estimated output quantity, input quantity and TFP indexes for aggregate services during the period 1989-90 to 2011-12.

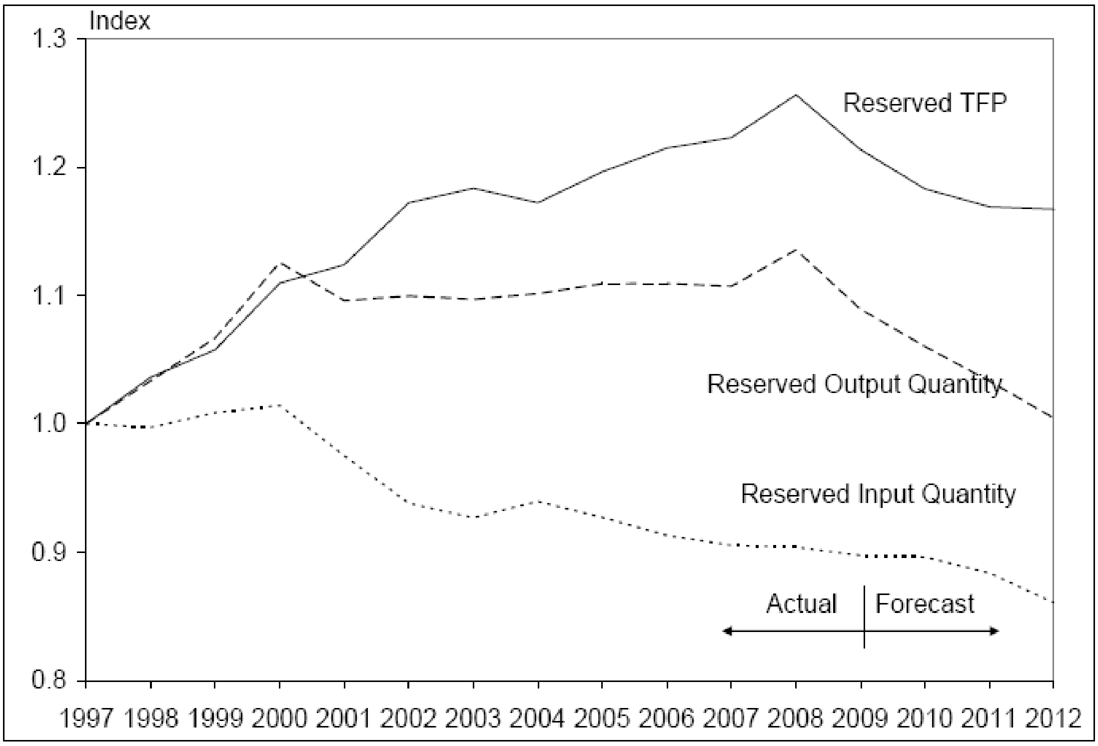
Chart 4.7: Australia Post's aggregate services output, input and TFP indexes



Source: Economic Insights – Australia Post's Aggregate and Reserved Service Productivity – 2009 update, 1 July 2009, p. 16.

Chart 4.8 presents Australia Post's estimated output quantity, input quantity and TFP indexes for reserved services during the period 1996-97 to 2011-12.

Chart 4.8: Australia Post's reserved services output, input and TFP indexes



Source: Economic Insights – Australia Post's Aggregate and Reserved Services Productivity – 2009 update, 1 July 2009, p. 26.

Issues in Economic Insights report

Economic Insights' response to the ACCC's comments on its TFP methodology in 2008

Economics Insights notes that the ACCC in its 2008 assessment of Australia Post's price notification suggested that higher declining balance depreciation rates should have been used for capital stock estimates as the depreciation rates used in Lawrence (2007) [387]were similar in magnitude to the straight–line depreciation rates used by Australia Post.[388]

Economics Insights has retained the depreciation rates used in Lawrence (2007) and justifies this on the following grounds:

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[387] Lawrence, Denis (2007), *Australia Post's Aggregate and Reserved Service Productivity Performance*, Report by Meyrick and Associates for Australia Post, Canberra, 22 November.

[388] Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 13.

- the depreciation rates used in Lawrence (2007) are generally higher but close to declining balance rates used by the ABS in constructing its multifactor productivity series;[389] and
- Economics Insights also undertook sensitivity analysis of the effects of using different parameters in constructing the capital input, including different depreciation rates. In particular Economics Insights noted that the use of higher depreciation rates 'produces implausible movements in capital stock'. [390]

Economic Insights' interpretation of Australia Post outperforming multifactor productivity (MFP) indexes

Economic Insights compared Australia Post's reserved services and aggregate services TFP indexes with the ABS's market sector 'multifactor' productivity for the period 1997-98 to 2008-09.

Economic Insights states that 'over the period 1997 to 2009 the reserved services TFP index has increased more than Australia Post's aggregate services TFP index with a trend growth rate of 1.7 per cent per annum compared to 1.4 per cent. Both indexes have increased more than the ABS market sector MFP index over the period up to 2008 which only had a trend growth rate of 0.9 per cent per annum.' [391]

Economic Insights also states that Australia Post's TFP indexes have outperformed the market sector MFP index over both the last 13 years and the last 7 years. According to Economic Insights, 'given that Australia Post's reserved services output has essentially been flat between 2001 and 2008, being able to outperform the productivity performance of the economy as a whole has been an impressive achievement'.[392]

Economic Insights however argues that 'the fall in Australia Post's output in 2009 and expected ongoing falls in output over the next three years will significantly reduce Australia Post's productivity performance going forward'. [393]

Australia Posts analysis of Economic Insights report

Australia Post's pricing proposal, in addition to providing a summary of the results of the Economic Insights report, also provided some additional analysis in relation to the TFP results for reserved letter services.

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389 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 34.

390 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 33.

391 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 29.

392 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 29.

393 Economic Insights, *Australia Post's Aggregate and Reserved Service Productivity – 2009 update*, 1 July 2009, p. 29.

According to Australia Post, the reserved services TFP result was very strong and achieved without a positive contribution from output growth and exceeded MFP growth in the economy. [394]

Australia Post submits that 'it is important that the ACCC draws the correct conclusion from these results'.[395] According to Australia Post, forecast declines in TFP for reserved letter services reflect the fact that Australia Post's network is required to provide a letter service to mandated service and access standards and that increasing delivery points and declining volumes does not indicate decreasing efficiency in Australia Post's cost base.[396]

Views of interested parties

POAAL submits that accommodation costs of licensees do not appear to have been included in the assessment of non-labour input factors. '[T]hese accommodation costs are obviously an element in the sale price of a Licensed Post Office' (LPO) and 'given the current sale prices of LPOs and the extensive number of them across the nation, these inputs would be material in a TFP calculation'.[397]

Economic Insights responded to the ACCC's question in its Issues Paper on how the TFP modelling should impact the ACCC's assessment of Australia Post's proposal. Economic Insights notes that under a productivity based approach to regulation where X is determined using the 'differential of a differential' form, all else being equal, if the regulated firm is experiencing lower TFP going forward than the rest of the economy as a whole, then there will be a case for price increases going forward.[398] Economic Insights also notes, all else being equal, that where a firm is facing input price growth which is higher than the economy as a whole then there will also be a case for a real price increase.[399]

In its submission in reply, Australia Post states that 'no matter how productivity is measured, e.g. on a total or partial factor basis, the measured productivity must arithmetically fall, even though the organisation has realised all of the cost savings available to it'. [400] Australia Post also argues that an additional non-volume factor in its TFP outlook is that certain infrastructure assets such as IT are scheduled for replacement. [401] Australia Post states that

394 Australia Post's 2009 draft price notification, p. 57.

395 Australia Post's 2009 draft price notification, p. 57.

396 Australia Post's 2009 draft price notification, p. 57.

397 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, pp. 10-11.

398 Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* Attachment 1 to Australia Post's Response to Issues Paper, p. 1.

399 Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* Attachment 1 to Australia Post's Response to Issues Paper, p. 2.

400 Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 8.

401 Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 8.

'combining this increased investment with the implementation of required network initiatives such as FDD means [Australia Post] will see an addition to the [its] capital resource levels'. [402]

ACCC's view on the total factor productivity of Australia Post's aggregate and reserved services

The ACCC notes Economic Insights' findings for aggregate and reserved services historical TFP performance. In particular, it is clear that Australia Post experienced strong growth at both aggregate and reserved services level until 2002-03. TFP continued to grow up to 2007-08 but at a lower rate than previously and then fell in 2008-09 mainly as a result of declines in letter volumes. The ACCC also notes the forecast decline in TFP over the three year period from 2008-09 to 2011-12. This decline would also appear to be driven by volume declines.

The ACCC has considered Economic Insights' assessment of alternative methods for calculating depreciation on Australia Post's capital stock and for this notification has decided to adopt the methodology applied by Economic Insights for calculating Australia Post's aggregate and reserved services TFP.

The ACCC notes Economic Insights' comments regarding Australia Post's productivity performance relative to the ABS market sector MFP index. The ACCC however considers TFP is a better productivity measure than MFP because it involves all of the factors of production whereas the ABS MFP only incorporates labour and capital.

4.8 The allocation of Australia Post's reserved services productivity dividend

Australia Post's view

Australia Post engaged Economic Insights to prepare a report which examines how Australia Post's 'productivity dividend' (defined below) had been distributed between its stakeholders (staff, contractors, consumers and Australia Post's shareholders).

According to Australia Post, the key insight drawn from this study by Australia Post is that consumers have been the main beneficiary from the productivity gains made by Australia Post over the period 1998-99 to 2008-09. [403]

Citing the results from the study, Australia Post noted that its shareholders had been left with a net negative return because most of the benefits from Australia Post's reserved service productivity improvements have been passed on to staff, contractors and consumers (Australia Post notes that the benefits transferred to its consumers, staff, and contractors exceeded the total productivity dividend).[404] Australia Post noted that '[i]n the seven years to

[402] Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 8.

[403] Australia Post's 2009 draft price notification, p. 58.

[404] Australia Post's 2009 draft price notification, p. 58.

2008-09 the total return to consumers was almost double the total available for all stakeholders combined. Again the shareholder was the net provider of the dividend.'[405]

Australia Post also noted Economic Insights' finding on how the allocation of the productivity dividend would impact on Australia Post's incentives to invest and make efficiency gains. Australia Post stated that '[t]he study concludes by noting that a more even share of the productivity dividend will be required in future if the distribution is to be sustainable, i.e. to provide Australia Post with suitable incentive to invest and seek further productivity gains'.'[406]

Economic Insights' report

Holding all else constant, Economic Insights defines the 'productivity dividend' as the difference between the gross return on capital resulting from changes in the size of the capital stock and the gross return to capital resulting from productivity improvements and changes in the size of the capital stock.

The gross return to capital is defined by Economic Insights as:

> '…the difference between revenue from outputs produced and the cost of the non–capital inputs of labour, contractors, and material and services). The gross return to capital has to cover the cost of depreciation and provide a residual return on the firm's assets.'[407]

Economic Insights notes that the size of the gross return to capital for Australia Post's reserved services is dependent on:

- growth in the size of the reserved asset base;
- growth in reserved service productivity;
- changes in average real prices for its reserved outputs; and
- changes in the average real price Australia Post pays for its reserved non-capital inputs. [408]

Economic Insights' report[409] separates and quantifies the effect that the above factors have had on Australia Post's gross return on capital over the 12 year period 1998-09 to 2008-09.

[405] Australia Post's 2009 draft price notification, p. 58.

[406] Australia Post's 2009 draft price notification, p. 58.

[407] Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 3.

[408] Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 7.

[409] Based on the following papers in Economics literature:

- Lawrence D., W.E. Diewert and K.J. Fox (2006), '*The Contribution of Productivity, Price Changes and Firm Size to Profitability*', Journal of Productivity Analysis, Vol. 26, pp. 1 – 13.

Economic Insights calculates a total productivity dividend of $694 million over the period 1998-99 to 2008-09, based on the difference between what Australia Post's gross return to capital would have been assuming growth in the capital stock only ($476m), and the gross return to capital assuming productivity gains and capital stock growth only ($1170m).[410]

Taking account of labour prices but holding contractor and output prices constant, Economic Insights estimated Australia Post's gross return on capital as $920 million.[411] When contractor prices were also allowed to vary, the gross return on capital was $601 million.[412] Finally, Economic Insights estimated that also taking into account changes in output prices, Australia Post's gross reserved return on capital was $107 million.[413] The difference between Australia Post's gross return on capital allowing only growth in the capital base and holding all else constant ($476 million) and Australia Post's return on capital taking account all factors ($107 million) was -$370 million. Thus, Economic Insights estimates that Australia Post's 'productivity dividend' over the period 1997-98 to 2008-09 was negative and represented a net transfer from shareholders to labour, contractors, and consumers.

The deterioration in the productivity dividend appears to have been driven by the costs of providing reserved services increasing faster than prices. As noted by Economic Insights '…our estimates of Australia Post's reserved services nominal non–capital input price changes have considerably exceeded estimated output price changes.'[414]

Australia Post's reserved service labour price index (which accounts for a large potion of the productivity dividend) '…increased by 10 percentage points more than the CPI over the period leading to an 8 per cent increase in the real price of labour'.[415] In addition, the real price of reserved service contractors '…has increased by nearly 100 percentage points more than the CPI over the 10 year period, leading to a 73 per cent increase in the real price of contractors.'[416] However, at the same time the prices of reserved services did not keep pace with inflation. Economic Insights noted that '[o]ver the same 12 year period, the consumer

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- Lawrence D., Richards, A. (2004), '*Distributing the Gains from Waterfront Productivity Improvements*', The Economic Record, Vol. 80, pp. 43 – 52.

410 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 11.

411 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 11.

412 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 12.

413 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 14.

414 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 5.

415 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 6.

416 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 6.

price index (CPI) increased by 35 per cent. This means that our estimate of the average real price of Australia Post's reserved services output – the overall price that it charges relative to the rate of inflation – has declined by 22 per cent over the last 12 years.'[417]

Economic Insights also looked at how Australia Post's productivity dividend has changed since the ACCC's consideration of Australia Post's 2002 price notification. Economic Insights found that Australia Post's position since 2002 has declined due to significant increases in its reserved labour and contractor costs, while prices for reserved services remained largely constant in nominal terms between 2004 and 2008.

Economic Insights expressed concerns about the impact that the recent distribution of Australia Post's productivity dividend between stakeholders would have on Australia Post's incentives to pursue productivity gains. Economic Insights notes that the uneven distribution of Australia Post's productivity gains:

> …reduces Australia Post's incentives to invest further in the reserved services business and meet future needs – or to commit the time and effort required to achieve further reforms and productivity improvements. Only by ensuring there is a more even distribution of benefits among stakeholders will a more sustainable position be maintained going forward.[418]

Views of interested parties

Interested parties expressed concerns about the finding in Economic Insights' study that Australia Post's shareholder (the Government) was worse off, in light of recent dividends and special dividends paid by Australia Post. Concerns were also raised about the efficiency of Australia Post's costs, and comments were made to the effect that Australia Post's forecast costs data should be independently reviewed.

POAAL questioned Australia Post's assertion that there had not been a reasonable sharing of productivity gains between consumers, stakeholders and staff. In particular, POAAL noted that '[i]t would seem to [POAAL] that the major beneficiary has been the owner. When taxes, statutory charges, dividends and special dividends are taken together the major beneficiary of Australia Post's past performance appears to be the Government'.[419] POAAL also considered that the credibility of the view that '…without more reward for Government, Australia Post will not be 'motivated' to make capital investments to sustain its statutory obligations' needed to be reviewed. [420]

POAAL identified that Economic Insights' study did not examine the question of the efficiency of Australia Post's costs. POAAL noted that '[s]ome would question whether one

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417 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 5.

418 Economic Insights, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*, 6 July 2009, p. 15.

419 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 7.

420 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

price sustained over many years indicates that significant inefficiency may have been in place when the fixed price regime commenced'.[421] POAAL also noted that some of Australia Post's contractors, such as post office licensees, have their rewards tied to the fixed price of postage, and that they had been compelled to undertake more of Australia Post's work for no additional reward. [422]

POAAL also queried whether the inference that the additional payments made to contractors meant that contractors reaped substantial benefits from Australia Post's productivity, and submitted that this view needed to be tested. [423] POAAL noted that Australia Post had been successful in transferring fuel price increases on to contractors in the past. [424] POAAL noted that '[a]lthough the competitive nature of the market has forced some increase in contractor costs these are very recent characteristics compared to the long term trends in the studies.'[425]

MMUA expressed the view that there remained untapped productivity gains from Australia Post's FuturePOST program and Bulk Mail Partner Program. [426] The MMUA also expressed the view that the ACCC should not rely on Australia Post productivity reports unless Australia Post's forecasts and data were independently validated.[427]

PIAA raised the concern that maintaining Australia Post's dividend payments to the government may have consequences for its operational efficiency. In particular, PIAA noted that '…if Australia Post needs to maintain a consistent dividend to the Australian Government, having a monopoly opportunity to increase postage charges on a regular basis, has the potential to camouflage poor management decisions, inefficient internal practices and other ineffective value-added services'.[428]

In its submission in reply, Australia Post clarified that it considered that the payments to contractors were fair and reasonable. [429] Australia Post also noted that it has specific

[421] Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

[422] Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

[423] Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

[424] Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

[425] Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009, p. 8.

[426] Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, 15 October 2009, p. 23.

[427] Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, 15 October 2009, p. 23.

[428] Printing Industries Association of Australia, *Submission to the ACCC's draft notification issues paper*, 11 September 2009, p. 5.

[429] Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 7.

requirements in relation to dividend obligations in the APCA and currently has a dividend payout ratio of 75 per cent of post tax profit, which was determined following a benchmarking exercise of large listed Australian companies.[430]

ACCC's view on the allocation of Australia Post's reserved services productivity dividend

Australia Post submitted the Economic Insights report '*Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend*' as part of the documents supporting its draft price notification. However, Australia Post was unable to provide the ACCC with the supporting data and calculations used to derive the findings in the report. In light of the considerable limitations on access to this information, the ability of the ACCC to give weight to the findings in the Economic Insights report is somewhat lessened as the ACCC has been unable to test this information.

From the available information, it appears that Economic Insights has constructed a productivity measure that allows the decomposition of profits earned by a firm (measured by gross operating surplus) into the effects of 'netput'[431] prices (where non-capital inputs are treated as being negative), productivity and capital stock.

The ACCC considers that the productivity index measured in Economic Insights' *Allocating Australia Post's Productivity Dividend* report (the Dividend report) is different from the productivity index used in Economic Insights' *Aggregate and Reserved Productivity – 2009 Update* report (the TFP report). In particular:

- In the TFP report, a Fisher index-based TFP index that measures all output growth net of all inputs, namely labour, mail contractors, capital, material and services, is used. It is the residuals from the overall output growth that cannot be explained by the overall input growth.

- In the Dividend report, the productivity index measures netput quantity growth relative to capital input growth. It is the change in the implicit 'netput' quantity index that cannot be explained by the change in capital stock employed.

As demonstrated by Balk (2003)[432], the gross output productivity index relates to the value-added productivity index by a ratio of the share of current price value-added in gross output; that is, the inverse of the so-called 'Domar factor' originally derived by Domar (1961).[433] As

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[430] Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 7.

[431] The term 'netput' denotes net output, which is measured here as output net of non-capital inputs. The netput productivity index measures net output quantity growth relative to capital input growth. In a net output production function where outputs are considered as positive while inputs are considered as negative, the technology is specified to show how inputs are used to produce output.

[432] Balk, B.M. (2003), 'On the Relationship between Gross-output and Value-added based Productivity Measures: the Importance of the Domar Factor', *Centre for Applied Economic Research Working Paper 2003/05*, Available at: www.caer.unsw.au/CAERpub.htm [accessed on 1 September 2009].

[433] Domar, E.D. (1961), 'On the Measurement of Technological Change', *The Economic Journal*, Vol. LXXI, pp. 709–29.

the revenue is higher than the value-added, the gross output productivity change is smaller than the value-added productivity change. In terms of the above two measures of productivity used by Economics Insights, the netput productivity index will be substantially higher than the TFP index as the share of profits in total revenue is small.

In particular, using the same set of input-output price and quantity data, the ACCC estimated that netput-based productivity indexes are larger than the estimated TFP indexes at a ratio ranging from 4.3 to 15. The ACCC is concerned that the use of this netput-based productivity index attributes all residuals to changes in a single input – capital stock – and therefore may overstate Australia Post's productivity changes.

The productivity measure also implicitly assumes that the price of other inputs has grown at CPI and therefore has had no contribution to the real gross capital return. If the price of other inputs has increased faster than the CPI, then the productivity growth is over-estimated and the share of Australia Post's owner (the Government) in the productivity gains is under-estimated.

Using the input-output price and quantity data submitted by Economic Insights in support of its TFP report, the ACCC has been able to replicate Economic Insights' decomposition of individual factors to changes in Australia Post's reserved services real gross return to capital. In conducting this exercise, the ACCC found:

- the size of the 'productivity dividend' measured is dependent on the specific productivity measure, adjusting for the change in capital stock;
- the size of the individual impact of other sources of change (i.e. price changes in outputs and non-capital inputs) on real gross return reported is dependent on what else has already been accounted for. As a result, the distribution of productivity dividend to labour, contractors and consumers is not uniquely determined;
- the productivity dividend decomposition into alternative sources is also not unique.

The ACCC is also concerned that the analysis in the Economic Insights report is based on the implicit assumption that the changes in Australia Post's input costs are efficient. One interpretation of Australia Post's experience of some productivity improvement, but a deterioration in the shareholder's position may be that Australia Post has become more efficient, but has made no excessive profits over time. Alternatively, it could be that the faster rise in the labour price than the CPI may demonstrate that Australia Post has failed to keep its costs at an efficient level and, as a result, other (labour or contractor) groups have benefitted substantially from productivity changes.

In conclusion, Economic Insights' decomposition of the Australia Post's reserved productivity dividend provides only limited assistance to the ACCC in its assessment of Australia Post's proposal, due to the lack of supporting information and the concerns outlined above about the higher productivity measure and non-unique decomposition.

4.9 International benchmarking of Australia Post's total factor productivity

Australia Post's view

Australia Post notes that the ACCC, in its final decision on Australia Post's 2008 price notification, commented on the scarcity of international benchmarking studies in the postal sector and the desirability of examining such information. [434] Australia Post states it commissioned Economic Insights to undertake an international benchmarking study on postal service productivity to provide that international perspective for the ACCC's consideration of Australia Post's 2009 draft price notification.[435]

Australia Post states that a key difference between this study and previous studies on Australia Post's TFP is that it 'enabled the absolute levels of productivity to be benchmarked in addition to providing the time series'. [436]

Australia Post also states that the results should 'provide reassurance to the ACCC that Australia Post is operating at a very high level of performance in the postal world'. [437]

Australia Post also refers to the international benchmarking study in Section 5 of its response to the ACCC Issues Paper and notes that it intends to update this study in the future. [438] Australia Post notes that benchmarking studies of this type can be difficult to undertake as participants typically report upon their business differently and may have specific reasons (e.g. confidentiality) why they may not wish to participate.[439]

Economic Insights' report

Economic Insights' *International Benchmarking of Postal Service Productivity report* benchmarks the productivity performance of postal services in seven countries – Australia, Canada, Denmark, Italy, Japan, New Zealand and the United States between 2002 and 2009 using TFP and partial productivity measures for four input and three output categories.[440]

Economic Insights states that the countries selected for the study were chosen because they were all developed economies with well established national postal systems, covering a range of small and large systems operating in different operating environments. Economic Insights

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[434] Australia Post's 2009 draft price notification, p. 54.

[435] Australia Post's 2009 draft price notification, p. 54.

[436] Australia Post's 2009 draft price notification, p. 54.

[437] Australia Post's 2009 draft price notification, p. 56.

[438] Australia Post, *Australia Post's Response to Issues Paper*, 13 October 2009, p. 11.

[439] Australia Post, *Australia Post's Response to Issues Paper*, 13 October 2009, p. 11.

[440] Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

states that it has put considerable effort into ensuring that confidential data collected by it from the surveyed operators and from which the report is compiled are comparable.[441]

Economic Insights also notes that a condition of participation by the postal services in its study was that data and results for each postal service remain confidential.[442] As a consequence, with the exception of Australia Post, no postal services results are directly identified by Economic Insights and instead other postal services are identified simply using the notation A, B, C etc.

The ACCC was also not provided with access to the data and regression analysis used by Economic Insights to produce its finding which significantly affected its ability to independently review Economic Insights methodology and findings.

Economic Insights identified a number of data issues that it had to deal with in compiling its report. These included the following:

- Data was requested for the 1997–2009 period at both the whole of business and reserved services levels. However, only two postal services were able to provide a complete data set for this period and for both the whole of business and reserves services levels. As a result, the benchmarking had to be undertaken at the whole of business postal services level;[443]

- Two of the postal services selected had important non-postal businesses, in particular banking services. One provided the information required to disaggregate the postal and banking activities but the other could not provide this information and so for this postal service the results relate to the whole of business including both postal activities and banking activities.[444]

Further, Economic Insights argues that like other network industries, postal service productivity performance is influenced by the operating environment conditions it faces.[445] Therefore to allow meaningful comparisons of performance, it is necessary to adjust for the most important operating environment conditions.[446]

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441 Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* Attachment 1 to Australia Post's Response to Issues Paper, p. 3.

442 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

443 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. 12.

444 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. 12.

445 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

446 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

Economic Insights states that for postal services two of the most important operating environment differences are mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length). [447] It argues that those postal services that have high mail density (i.e. a relatively large number of items delivered to each customer) and/or high customer density (i.e. a relatively large number of customers or delivery points per kilometre of route length) have a comparative advantage over those services with lower network densities.[448]

On the basis of this analysis, Economic Insights adjusted the TFP results for mail density and customer density differences for those countries that provided relevant data. Economic Insights notes that five postal services provided data that enabled adjustment for mail density only and four postal services provided data that enabled adjustment for both mail density and customer density. [449] It also notes that the density effects were found to be highly statistically significant and important in terms of their impacts on the relative rankings.[450]

Economic Insights presented adjusted and unadjusted results. For the unadjusted results Australia Post ranked third in terms of TFP and showed steady, consistent improvement over the sample period. [451] Three other postal services showed deterioration in TFP over the period, while the others showed some improvement but only one of these showed steady improvement. [452]

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447 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

448 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. ii.

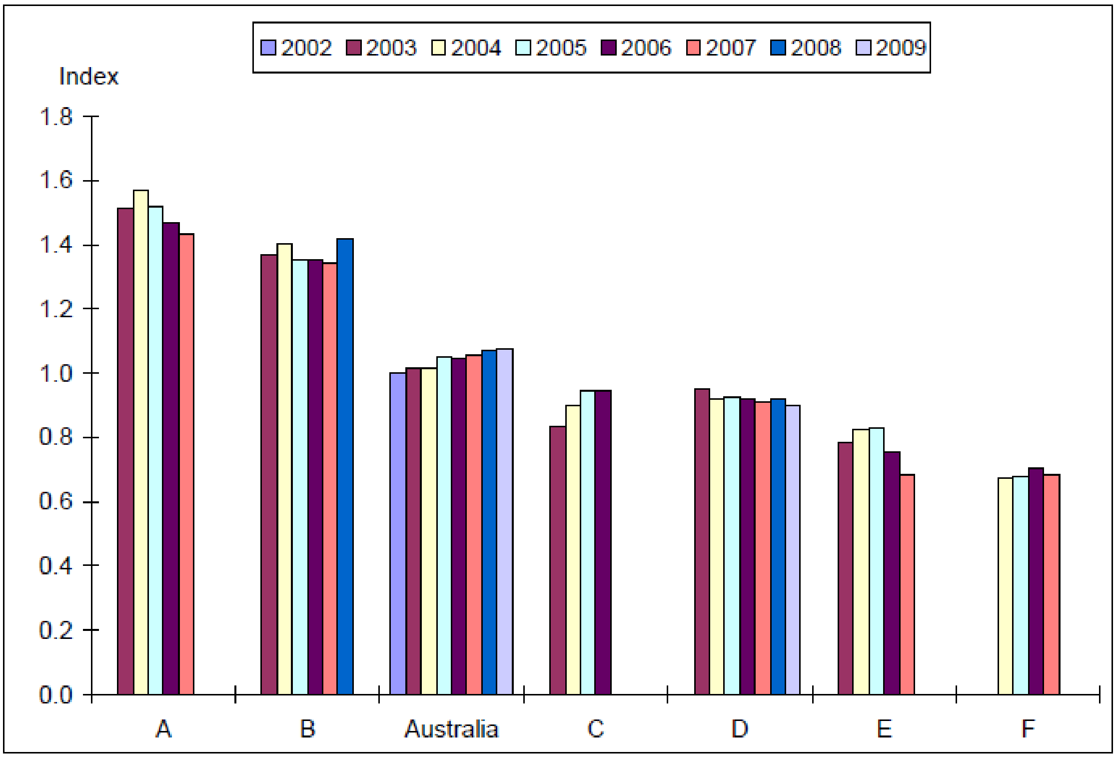
449 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iv.

450 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iv.

451 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iii.

452 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iii.

Chart 4.9: Total factor productivity for 7 postal services, 2002 to 2009



Source: Economic Insights, International Benchmarking of Postal Service Productivity, Report prepared for Australia Post, 5 June 2009, p. 18.

For the unadjusted partial productivity measures Australia Post was ranked as follows:

- third in terms of labour productivity;
- sixth in terms of the productivity of other operating expenditure;
- third in terms of the productivity of land and buildings; and
- fifth in terms of the productivity of other capital which comprises plant and equipment, motor vehicles and computer software.[453]

According to Economic Insights, as the cost shares for capital are relatively low, the productivity levels for land and buildings and other capital had little impact on the TFP rankings. [454]

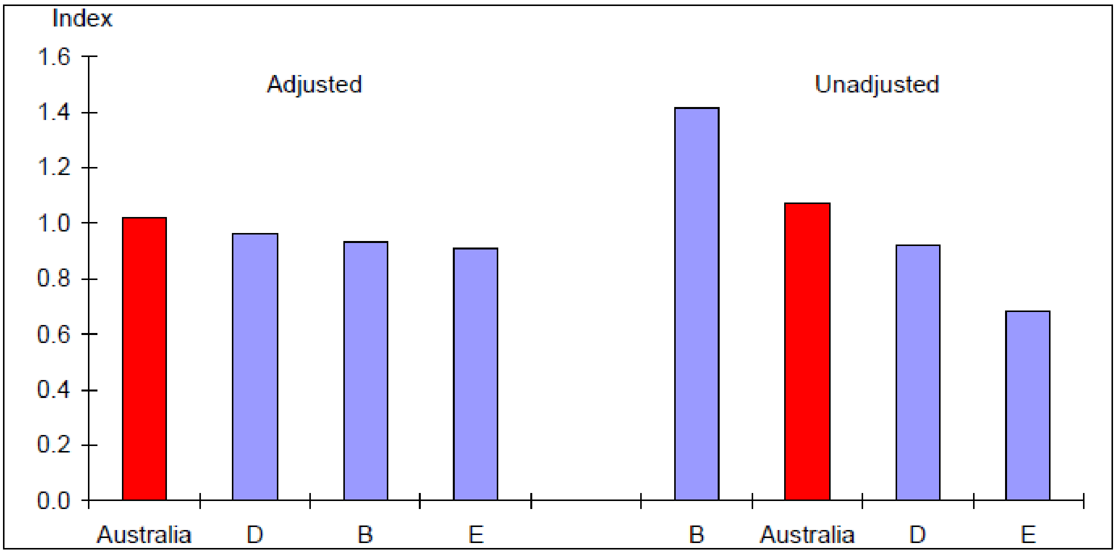
When the TFP estimates from the five postal services with relevant data were adjusted for mail density, Australia Post improved its relative position from third to second.[455] After the

[453] Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iii.

[454] Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iii.

TFP estimates for the four postal services with relevant data were adjusted for both mail density and customer density, Australia Post improved its relative ranking amongst the four postal services from second to first. [456] Economic Insights also notes that in the smaller sample of four postal services, the customer density influence was more important than the mail density influence on TFP.[457]

Chart 4.10:TFP adjusted for mail and customer density, 2008 or latest year



Source: Economic Insights, International Benchmarking of Postal Service Productivity, Report prepared for Australia Post, 5 June 2009, p. 26.

Views of interested parties

POAAL suggests that international benchmarking studies indicate sustained performance by Australia Post over a number of years with material improvements having been made when compared to other postal administrations. [458] POAAL suggests further that if other postal administrations have provided better improvements with labour productivity or are ahead of Australia Post in non-labour factors then Australia Post should target these better benchmarks.[459]

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455 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iv.

456 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iv.

457 Economic Insights, *International Benchmarking of Postal Service Productivity*, Report prepared for Australia Post, 5 June 2009, p. iv.

458 Post Office Agents Association Limited submission in response to ACCC Issues Papers, p. 10.

459 Post Office Agents Association Limited submission in response to ACCC Issues Papers, p. 10.

ACCC's view on the international benchmarking of Australia Post's total factor productivity

As outlined above, the ACCC, in its decision on Australia Post's 2008 draft price notification, identified that an international benchmarking study would enable it to verify some of the claims that Australia Post has made about its performance in comparison to overseas postal service operators. The ACCC therefore appreciates Australia Post commissioning Economic Insights to undertake an international benchmarking study.

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) due to confidentiality arrangements agreed to by Economic Insights. Thus, the ACCC has been limited in its ability to analyse this report in assessing Australia Post's 2009 draft price notification.

Notwithstanding the above, and within the limited confines available to it, the ACCC has undertaken a review of the Economic Insights' statistical processes and has identified some issues that may affect the results obtained by Economic Insights. These include the following:

- No sensitivity analysis appears to have been conducted by Economic Insights examining the robustness of its TFP results with respect to the input and output specifications.
- Without access to the data used in the benchmarking study, it is difficult to gauge whether the TFP results are robust. However, there are data consistency and comparability issues inherent in an international benchmarking study.
- Without access to the data used, it is difficult to gauge whether the regression results are reliable. However, the model specification and sample size seem to be severely constrained by the data availability.

The ACCC also notes that the countries sampled by Economic Insights are not obviously the world leaders in postal operations. Specifically, some of the highly innovative national postal operators from countries with a more liberalised and competitive postal market, including Sweden, the Netherlands and Germany, have been excluded from the study.

Nonetheless, the results of the international benchmarking study would appear to suggest that Australia Post has historically performed well among the sampled seven national postal operators over the sample period.

The ACCC does not, however, consider that Economic Insights' findings demonstrate that Australia Post has been and is presently one of the world's most productive postal operators. Therefore, it is the ACCC's view that the findings of the report cannot be used to support Australia Post's proposition that it is 'operating at a very high level of performance in the postal world' and 'the case for concluding that Australia Post's cost base is efficient is very strong'. [460] (The ACCC of course does not conclude that this is not the case; it is simply unproven.)

[460] Australia Post's 2009 draft price notification, p. 56.

4.10 ACCC's view

The ACCC undertakes, as part of its assessment of Australia Post's draft price notification, an assessment of the efficiency of Australia Post's cost base. The ACCC considers that in submitting a draft price notification for ACCC assessment, the onus is on Australia Post to demonstrate the efficiency of the costs that it is seeking to recover through its proposed prices.

In conducting its assessment of the efficiency of Australia Post's forecast costs, the ACCC has reviewed Australia Post's operating costs including the relationship between costs and volumes, its capital expenditure program and the FDD program. The ACCC has also considered Australia Post's productivity performance, including the result of an international benchmarking study on postal productivity commissioned by Australia Post. The ACCC also engaged Frontier Economics to assist in its assessment of Australia Post's forecast costs used in its PTRM and TFP models.

The ACCC notes that Australia Post's domestic reserved letter service operating costs increased significantly by 7.3 per cent in 2008-09 and are forecast to increase by 4.5 per cent in 2009-10 and then by around 1 per cent in both 2010-11 and 2011-12.

The ACCC also notes that labour and labour-related expenses account for approximately 68 per cent of the total costs of providing the domestic reserved letter services and that wages account for the largest component of labour costs. Frontier Economics found that, in broad terms, Australia Post's cost forecasts are in line with historical trends. Having said that, it also identified that '…the historical growth in Australia Post labour prices has been somewhat slower than the ABS benchmark, ✂✂✂✂✂✂✂✂✂✂✂✂✂✂.[461] Frontier Economics observed that ✂✂✂✂✂✂✂✂✂✂✂✂✂may be attributable to the inclusion of non-wage factors, such as superannuation expenses, in its measurement of labour prices.

Australia Post also submitted that one of the major drivers of cost increases over the period of the draft price notification is the increasing superannuation expense for its defined benefits superannuation scheme. The ACCC has noted its concerns about the longer term implications of Australia Post's current superannuation scheme for Australia Post.

The ACCC also considers that some cost savings are possible in the short-term. In particular, the ACCC is concerned that Australia Post has not previously invested in automated sequencing equipment. The ACCC's view is that Australia Post does not presently have an efficient cost base in this area.

Further, the ACCC is concerned that Australia Post's forecast declines in letter volumes appear to have had very little impact on its cost base. The ACCC recognises that some of Australia Post's costs are fixed. However, it would be expected that its overall costs would respond as demand declines. This is particularly concerning given that overseas studies of postal delivery and sorting functions suggest that while there are economies of density (that is, costs fall proportionally less than volumes), there should be some reduction in costs

461 Australia Post's 2009 draft price notification, p. 63.

associated with lower volumes. As a result the ACCC has significant concerns about the efficiency of Australia Post's forecast costs for the period 2008-09 to 2011-12.

The ACCC notes Economic Insights' historical finding for aggregate and reserved services TFP. In particular, it is clear that Australia Post previously experienced strong growth at an aggregate and reserved services level until 2002-03 and this continued up to 2007-08 but at a lower rate than previously. However, in 2008-09 TFP declined both at an aggregate and reserved service level, mainly as a result of declines in letter volumes. The ACCC also notes the forecast decline in TFP over the three year period from 2008-09 to 2011-12 which appears to be driven by the volume declines.

Furthermore, the ACCC considered an international benchmarking study undertaken by Economic Insights. However, the ACCC has not been able to independently verify the results of the TFP analysis due to confidentiality arrangements agreed to by Economic Insights. Thus, the ACCC has been limited in its ability to analyse this report in assessing Australia Post's 2009 draft price notification. Although the ACCC has not been able to independently verify the results of the study and has some concerns, in particular about the countries selected to be included in the survey, the results suggest Australia Post has historically performed well among the sampled postal operators over the sample period. The ACCC does not, however, consider that the findings of the report demonstrate that Australia Post has been, and is presently one of the world's most productive postal operators.

The ACCC also considered a study by Economic Insights on the decomposition of Australia Post's reserved service productivity dividend. However, this was of only limited assistance to the ACCC in its assessment of Australia Post's proposal, due to the lack of supporting information and a number of methodological concerns.

Overall in light of the above issues, the ACCC does not consider that Australia Post has demonstrated that its forecasts costs are efficient.

5 Return on capital

In assessing Australia Post's proposed price increases, the ACCC has regard to whether its revenue is sufficient to cover the efficient costs of providing mail services, including a return on capital. The provision for a return on capital compensates the firm for its operations in capital markets. The return on capital should reflect the opportunity cost to investors for choosing to finance the firm's operations.

Given that a firm can finance its operations using a combination of debt and equity, the return on capital represents a weighted average of the opportunity cost of debt and equity. This return on capital is known as a weighted average cost of capital (WACC).

5.1 Australia Post's proposal

Table 5.1 outlines Australia Post's proposed WACC, based on advice received from its consultants, Value Adviser Associates (VA Associates).

Table 5.1 Parameters of the WACC proposed by Australia Post[462]

WACC Parameter	*Value*
Risk-free rate	5.6%
Market risk premium	7.0%
Asset β	0.78
Gearing (debt/debt+equity)	20%
Imputation factor	0%
Equity β	0.93
Tax rate	30%
Debt β	0.15
Cost of debt	7.0%
Post-tax nominal WACC	**11.1%**

Australia Post has submitted different WACC parameters from those proposed in its 2008 price notification. Australia Post states that while its WACC reflects the '…systematic risks associated with delivering the domestic reserved letter service'[463], it also notes that '…the parameters for Australia Post's rate of return also recognise the need to cope with the

[462] Australia Post's 2009 draft price notification, p. 65.

[463] Australia Post's 2009 draft price notification, p. 63.

unusually high degrees of uncertainty and instability that currently exist in the global financial market at present'[464].

The parameters proposed by Australia Post for the 2009 draft price notification can be compared to the parameters proposed and accepted for the 2008 Australia Post price notification as seen in table 5.2

Table 5.2 Parameters of the WACC proposed by Australia Post and accepted by the ACCC for the 2008 price notification

	Australia Post's proposal	*ACCC's accepted value*
WACC Parameter	***Value***	
Risk-free rate	6.2%	6.2%
Market risk premium	6.0%	6.0%
Asset β	0.52	0.484
Gearing (debt/debt+equity)	25%	30%
Imputation factor	50%	50%
Equity β	0.66	0.66
Tax rate	30%	30%
Debt β	0.10	0.10
Cost of equity	10.2%	10.2%
Cost of debt	7.96%	7.96%
Post-tax nominal WACC	**9.6%**	**9.5%**

In comparison to the WACC proposed by Australia Post in its 2008 draft price notification, Australia Post's 2009 WACC proposal involves a lower risk free rate, cost of debt, imputation factor, and gearing, but a higher market risk premium, asset and equity beta. Overall, these changes result in a higher proposed post tax nominal WACC of 11.1 per cent for the 2009 draft price notification when compared to 9.6 per cent in Australia Post's 2008 price notification.

In its 2009 draft price notification, Australia Post has identified that it is aware of decisions made by other regulators — such as the Australian Energy Regulator (AER) — on WACC parameters in the context of the current market conditions. While Australia Post notes that consideration of recent AER decisions in other regulated industries regarding WACC parameters provide '…a useful context and guide for the development of a … rate of return

[464] Australia Post's 2009 draft price notification, p. 63.

for Australia Post',[465] it also points out that '…there are important factors which the AER is required to observe which are not also required of the ACCC in WACC matters'.[466]

5.2 ACCC's approach to assessing Australia Post's return on capital

Chapter 2 provides the ACCC's reasons for why a cost based approach to assessing Australia Post's 2009 price notification facilitates the ACCC in giving special consideration to the matters in Direction 11, and also in having particular regard to the matters outlined in subsection 95G(7) of the TPA.

Incorporating a return on capital in the financial model used to assess the proposed price increases in Australia Post's draft price notification ensures that prices will be sufficient to enable the firm to continue to finance its investment in assets necessary for its operations. At the same time, it ensures that the return on capital provided is commensurate with the risk associated with Australia Post's operations, and that the proposed price increases are not inflated and do not reflect the exercise of market power.

Although Direction 11 requires the ACCC to give special consideration to the financial targets in Australia Post's corporate plan, the rates of return in the corporate plan are expressed as an accounting rate of return. The overarching goal of the ACCC in assessing the rate of return is to provide for a rate of return that an efficient postal operator would require, based on the risks of Australia Post's operations.

In developing its corporate plan, Australia Post was aware that the ACCC would be applying a WACC to determine the rate of return that would be applied to its reserved letter service asset base in its pricing model. In its 2009 draft price notification, Australia Post notes that it had based its profit and pricing expectations for the domestic reserved letter service on the assumption that the ACCC's pricing model would continue to apply to the domestic reserved letter service.[467] In this respect, Australia Post submitted that '…a reasonable economic return equal to the WACC multiplied by the asset base would form part of the allowed revenue by the ACCC.'[468] The ACCC considers that in its approach to assessing the WACC proposed by Australia Post, the WACC used should be reflective of the risks of Australia Post's operations to ensure that it is set at the long term rate of return that an efficient postal operator would require.

Finally, the ACCC is aware that it has to apply a different legislative framework in assessing Australia Post's 2009 draft price notification compared to that applied by the AER for energy businesses, or indeed by the ACCC in assessing the WACC for regulated businesses in other industries. However, this does not mean that the ACCC should ignore relevant research and

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465 Australia Post's 2009 draft price notification, p. 64.

466 Australia Post's 2009 draft price notification, p. 64.

467 Australia Post's 2009 draft price notification, p. 63.

468 Australia Post's 2009 draft price notification, p. 63.

empirical analysis in relation to the WACC — particularly where it relates to parameters that are not industry-specific.

5.3 Interested parties' views

The submissions provided by interested parties did not express any specific views on particular WACC parameters.

PIAA expressed some general comments on the reasonableness of Australia Post earning an appropriate return on capital. PIAA noted that:

> Australia Post uses the appropriate return on capital argument to justify price increases. It would be great if we were all able to achieve a reasonable or appropriate return on capital simply by increasing prices – most can not. Australia Post can because it is a monopolist.
>
> [PIAA] is of the view that any consideration of what constitutes "appropriate return on capital" has to take into account the economic business cycle. If the majority of businesses in Australia are facing pressures on margins then it would be reasonable to expect Australia Post's profit results to reflect this lowering rate of return.[469]

POAAL stated that '…while these issues are not the prime expertise of POAAL it would seem reasonable to follow earlier reviews by the Commission including the current parameters.'[470]

Australia Post also made some general comments on its proposed WACC in its submissions. It submitted that:

> Australia Post always seeks independent expert advice in settings its weighted average cost of capital.
>
> The most recent advice was obtained in June 2009 from Value Adviser Associates and this independent advice was adopted in full in the draft notification…[471]

In addition, Australia Post submitted in its addendum that:

> The rate of return applied is in the form of a WACC reflecting the weighted costs of different sources of funds. As noted in the draft notification, [Australia Post] expect[s] that the ACCC's analysis of the proposed WACC will include a review of the recent analysis and decisions determined for the wholesale electricity industry by the Australian Energy Regulatory. Further, [Australia Post] also commissioned a new review of its WACC by independent financial experts Value Adviser Associates Pty Ltd.[472]

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[469] Printing Industries Association of Australia, *Submission to the ACCC's Australia Post's Draft Price Notification Issues Paper,* 11 September 2009, p. 4.

[470] Post Office Agents Associated Limited, *Submission to the Australian Competition and Consumer Commission – Australia Post draft price notification issues paper,* September 2009, p. 13.

[471] Australia Post, *Australia Post's response to issues paper,* 18 September 2009, p. 18.

[472] Australia Post, *Addendum to Australia Post's Response to Public Submissions,* 2 November 2009, p. 26.

5.4 Form of the WACC

The WACC can be expressed in a number of different forms (i.e. real or nominal, and with or without tax and imputation credits). While the choice of the form of the WACC modifies the WACC value applied, this choice is arbitrary as long as the way in which cash flows are expressed in the financial model used to calculate the MAR matches. The most important consideration is ensuring that all relevant parameters are incorporated and treated consistently either in the WACC or the cash flows, and that there is no double counting.

Australia Post has proposed a post-tax nominal vanilla WACC, which implies that the financial model will calculate a real MAR. However, the asset values used in Australia Post's financial model are expressed in nominal terms. If a post-tax nominal vanilla WACC is applied to nominal asset values, inflation would be double counted in the MAR. Therefore, to accurately calculate the MAR, the asset figures should either be adjusted to their real values, or alternatively a post-tax real form of the WACC should be applied.

It is the ACCC's preference to use a post-tax real vanilla WACC. The ACCC models the MAR using a post-tax revenue model, which models inflation and taxes in the calculation of the MAR. Therefore, to ensure that there is no double counting, a post-tax real vanilla WACC is used. It is shown in equation 5.1

Eq 5.1

$$WACC = \frac{E}{D+E}k_e + \frac{D}{D+E}k_d$$

where:

- E is the value of the firm's equity;
- D is the value of the firm's debt;
- k_e is the return on equity; and
- k_d is the return on debt.

5.5 Cost of equity

The return required by equity investors for investing in the firm is known as the cost of equity. The cost of equity can be estimated in a number of ways; however, the approach generally applied by the ACCC involves the use of the capital asset pricing model (CAPM). The CAPM assumes that the expected return demanded by investors on a risky asset depends on the risk-free rate (RFR), the expected return on the 'market portfolio'[473], the variance of the return on the 'market portfolio' and the covariance of the return on the risky asset with the market portfolio's return.[474,475] The CAPM implies that equity investors should be

[473] The 'market portfolio' is defined as the portfolio of all risky assets, weighted according to their market capitalisation

[474] This is also known as the equity beta. The equity beta is a measure of the standardised correlation of the return of the asset compared with the return of the market portfolio.

compensated only for the amount of systematic risk[476] the firm's equity investors faces. The CAPM formula is shown by equation Eq. 5.2

Eq. 5.2 $$E(r_e) = r_f + \beta(E(r_m) - r_f)$$

where:

- $E(r_e)$ is the expected return on equity;
- r_f is the RFR;
- $E(r_m)$ is the expected return of the market portfolio;
- β is the standardised correlation of the return of the asset relative to the return of the market portfolio.[477] In this case, the operations of the firm to the market portfolio.

Choice of parameter estimation

In its 2009 draft price notification, Australia Post expressed the view that:

> There are three generic options available for setting WACC parameters:
>
> - choose both a risk-free bond rate and a matching market risk premium that reflect the current conditions in financial markets;
> - choose long-term standard settings for both the risk-free rate and its associated MRP; or
> - choose a current market rate for the risk-free rate but a long-term standard for the MRP. [478]

Australia Post and its consultants VA Associates presented a number of arguments[479,480] in favour of the first option (where the risk free rate and the MRP reflect current market rates). In particular, Australia Post stated that '[the first option] has two advantages: it has matching

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475 G. Peirson, R. Brown, S. Easton, P. Howard, *Business Finance 8th Edition*, McGraw Hill, p. 220.

476 Systematic risk refers to market risk that cannot be diversified away. This can be viewed as risk that all companies face in the same market and is compared to unsystematic risk specific to the company.

477 $\beta = \dfrac{\rho(a,m)SD(m)}{SD(a)}$ where $\rho(a,m)$ refers to the correlation of the return of asset 'a' to the return of the market portfolio 'm', and $SD(a)$ and $SD(m)$ refer to the standard deviation of the return of asset 'a' and market portfolio 'm' respectively.

478 Australia Post's 2009 draft price notification, p. 102.

479 Australia Post's 2009 draft price notification, pp. 102 – 110.

480 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 7–19.

consistent data for both the risk free rate and the MRP, and it alone of the three options reflects the pricing of risk inherent in current market settings.'[481]

Risk free rate

The RFR is the rate of return an investor will receive from holding an asset over a given amount of time with a promised repayment amount and no risk of default. The RFR compensates investors for the opportunity cost of not being able to invest in the next best 'riskless' investment. This can include compensation for the time value of money, inflation, as well as bearing interest rate risk, and liquidity risk.

While the RFR should be based on the return of an asset that promises a given return assuming no risk of default, there is no such asset in the Australian market. Therefore, an appropriate proxy is selected to estimate the RFR. The proxy selected should reflect an average investor's forward-looking expectation of the RFR to ensure consistency with the CAPM.

Australia Post's position

Australia Post contends that Commonwealth 10 year bonds should be selected as the RFR proxy, as it '…reflects the longevity of Australia Post's capital base'[482], and is '…standard practice, and … it is the bond rate chosen normally by independent experts in calculating a market risk premium'.[483]

Australia Post notes that the ACCC adopted a 5 year bond rate in its 2008 price notification '…on the basis of a match to a regulatory period', and that while this '…was also initially proposed by the AER in its preliminary 2008 review, the AER's final choice was to reaffirm the 10 year rate as the risk free rate'. [484,485] Australia Post contends that the AER's choice was made on the basis of the longevity of energy business' asset base, and that '…the choice is equally appropriate for Australia Post for the same reason.'[486]

VA Associates note that matching the length of the financing maturity with the life of the assets is consistent with the notion that '…the appropriate period is the price setter's horizon' and that '…there is usually an implicit assumption of a match between the asset life and the investor's planning horizon'. [487,488] VA Associates state that '…since Australia Post's asset base is largely long term then we deduce that the cost of capital should also be long term'.[489]

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481 Australia Post's 2009 draft price notification, p. 103.

482 Australia Post's 2009 draft price notification, p. 103.

483 Australia Post's 2009 draft price notification, p. 103.

484 Australia Post's 2009 draft price notification, p. 103.

485 Australia Post's 2009 draft price notification, p. 103.

486 Australia Post's 2009 draft price notification, p. 103.

487 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

VA Associates point out that matching the investor's horizon with the asset horizon minimises roll over risk, transaction costs associated with raising capital, and interest rate charges.

However, VA Associates cite Davis and Lally, and acknowledge that '…the use of the 10 year rate in regulatory hearings provides a reward for risk (the difference between the yield of a 5 and 10 year maturing CGS) that regulated firms do not bear'.[490] VA Associates contend that '…there is a need for consistency in the way that the MRP is measured and the way the risk free rate is measured', and that '[f]or assets with asset betas close to 1, any difference [in the WACC under a 10 year or 5 year RFR] is immaterial'. [491,492] VA Associates present analysis indicating that any difference in the WACC would be immaterial for a change in the term of the RFR from 10 to 3 years.

In addition, VA Associates claim that the move to select the term of the RFR to match the regulatory period requires the view that there are active markets for the RFR at the regulatory period, there are low transaction costs, roll over risk is comparatively low, the MRP can be reliably estimated over the regulatory period and that the yield curve for government bonds are upward sloping.[493]

VA Associates note that '…given the long term nature of the underlying assets and the relative depth and liquidity of the ten year market, we support the use of a ten year maturing bond proxy for the risk free rate.'[494]

Finally, Australia Post states that the rate it proposes is the average value of the 10-year Commonwealth bond calculated for period 1 June 2009 to 30 June 2009. However Australia Post has also proposed that the rate that would be applied would be the average rate estimated in October 2009 in response to a request by the ACCC.[495]

ACCC's view on the risk free rate

There are four issues that need to be considered when estimating the RFR. These are:

- the choice of the proxy for the risk free asset;

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488 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

489 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

490 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

491 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

492 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

493 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

494 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

495 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 18.

- the term of the RFR proxy;
- the length of the averaging period used to estimate the risk free rate proxy; and
- the date of the averaging period used to estimate the risk free rate proxy.

Choice of the RFR proxy

The asset used to estimate the RFR should represent a security that has no systematic risk. Since no true risk free assets are observable, a proxy must be used to estimate the RFR.

The best RFR proxies are assets that have the lowest systematic risk. In general, central Government securities are assets with the lowest possible risk; therefore such securities would be the most appropriate RFR proxy. In Australia, central Government securities are Commonwealth Government Securities (CGS) and therefore the most appropriate RFR proxy would be CGS.

Term of the RFR proxy

The term of the RFR should result in fair compensation to investors for investments of similar risk and length. The RFR provides investors a return for the opportunity cost of not being able to invest in the next best equivalent 'riskless' investment.

In general, the term of the RFR should be the relevant investment period. Theoretically, the relevant investment period should be the regulatory period in the context of a pricing decision for a regulated firm. Each time a regulatory pricing decision is made, the regulator re-determines the appropriate RFR, effectively resetting the risk of the regulated firm. If the risk of the regulated firm is reset at each regulatory period, this would imply that the period a regulated firm faces business risk is the length of the regulatory period. Since a firm should only be compensated for the length of time it faces risk, choosing a term that does not attempt to match the regulatory period could result in inappropriate compensation of risk.

In the 2008 price notification, the ACCC considered that the appropriate term was five years. In reaching this conclusion, the ACCC noted that there was uncertainty about the duration of the regulatory period given Australia Post's one year draft price notification, and that the legislative framework under Division 4 of Part VIIA of the TPA provides for a declared firm to seek increases in the prices of notified services at any point in time. In light of the uncertainty of the timing between Australia Post's price notifications and thus the appropriate regulatory period, the ACCC chose a period consistent with the time elapsed since the 2002 pricing proposal — five years.

For the current price notification, Australia Post has provided a forward looking three year financial model and also signalled its pricing intentions over that period, indicating a three year regulatory period. VA Associates have also indicated that the regulatory period is three years, noting that the term of the RFR could '…be changed to 3 years for Australia Post to match the regulatory period'.[496]

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[496] Australia Post, *5 October 2009 – Questions regarding period of averaging for RFR and debt premium for WACC and volumes discrepancy,* 8 October 2009, p. 1.

The ACCC has more certainty over the duration of the regulatory period in assessing Australia Post's 2009 draft price notification, as compared to when it was considering Australia Post's 2008 draft price notification. In the 2008 draft price notification process, the ACCC lacked guidance as to the appropriate regulatory period and selected a term that it approximated to be the appropriate regulatory period. For the 2009 draft price notification, Australia Post has provided a stronger indication of the appropriate regulatory period. Therefore, the ACCC's assessment process is no longer one of approximating an appropriate regulatory period, but one involving the weighing up the merits of a three year or a ten year term for the RFR.

It is true that, assuming an upward sloping yield curve, selecting a term of the RFR longer than the regulatory period would over-compensate Australia Post. However there are other issues that must be considered. The first is that moving towards a three year RFR would, as argued by VA Associates, also require a move towards calculating a three year historical estimate of the MRP. Since the historical MRP is calculated as the difference between the market yield and the RFR, if the three year RFR is lower than the ten year rate, then there should be an upward adjustment to any historical MRP estimates. However, due to the interaction of the RFR with the MRP, the final effect on the WACC using historical MRPs is relatively negligible.

It is also difficult to reliably and robustly estimate the historical MRP using the return of a three–year CGS. According to the Reserve Bank of Australia (RBA), three year Commonwealth Government Bonds began trading in June 1992[497], a much later date than ten year Commonwealth government bonds. This means that there are fewer observations on which to estimate a historical MRP. In general, the number of observations can affect the accuracy of parameter estimates and therefore an estimate based on a high number of observations is generally preferred to one that is based on a low number.

Finally, selecting a three year regulatory period for a company that issues long-term debt is likely to expose the regulated firm to higher debt roll-over risk and transaction costs. By selecting a RFR term of three years, for consistent application of the WACC, a debt term of three years must also be used. Therefore, to compensate the regulated firm for these costs, these risks and costs must be factored into either the cost of debt, or the cash flows. While it is possible to calculate these costs (an example of which is in a study into transaction costs by the Allen Consulting Group (2004)[498]) these studies only provide an indicative range. Actual transaction costs are highly dependant on factors such as underwriting and legal fees, as well as the rates Australia Post could obtain in rolling over its debt. Due to the fully distributed nature of Australia Post's cost allocation methodology, any contribution to transaction costs (to the extent that it is related to the provision of reserved services) associated with Australia Post's existing debt is already contained in the cash flows in Australia Post's financial model. Having said that, the ACCC does not have actual estimates of the additional transaction costs associated with a three-year cost of debt.

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497 RBA, *Commonwealth Treasury Bonds - Capital Market Yields – Government Bonds Monthly,* viewed 30 October 2009, www.rba.gov.au: see e.g. http://www.rba.gov.au/Statistics/Bulletin/F02hist.xls.

498 Allen Consulting Group, *Debt and Equity Raising Transaction Costs,* December 2004.

Taking all relevant factors into consideration, the ACCC has decided to adopt a 10 year CGS for the RFR in estimating the MAR in this price notification.

Length of averaging period used to estimate the RFR proxy

As outlined above, Australia Post proposed that the average daily 10 year Commonwealth Treasury bond yields for 1 June 2009 to 30 June 2009 should be used to estimate its WACC. Taking an average of bond yields for a specific time period will help contain the noise driven by market volatility. However, using too long an averaging period will risk the inclusion of old information, while using too short an averaging period may introduce market volatility driven errors. Therefore, in selecting an appropriate averaging period, a balance must be struck between errors due to stale information and errors caused by short term volatility. The ACCC considers that Australia Post's approach of using the average yield over a month is a reasonable approach.

Date of the averaging period used to estimate the RFR proxy

The final consideration is the date of the averaging period used to estimate the RFR. This is especially important since the choice of the date directly affects the return on equity.

For the correct application of the CAPM, the period should be as close as possible to the regulatory period because it best reflects market expectations. However in regulatory pricing decisions, this is not necessarily practical. The financial modelling assessment of a price notification is dependant on a certain set of assumed values, one of which is the estimate of the RFR. While ideally this estimate would be close to the date of when the price increase comes into effect, due to timing discrepancies between when the analysis is done and when decisions are made, in practice such an approach could result in uncertainty as to whether a sufficient return is provided.

Regulatory practice, as applied by the ACCC in its assessment of Australia Post's 2008 price notification, provides the regulated firm with an opportunity to nominate a specific period (that is, a specific period in the future before the regulatory period begins) to estimate the RFR. This provides certainty to both the regulated firm and the regulator, while avoiding data-mining issues that could occur if the regulated firm was allowed to nominate a period in the past. In addition, allowing the firm to nominate a period provides an opportunity for the regulated firm to hedge the RFR.

However, the ACCC must also be wary of the possibility of regulatory 'gaming' by the regulated firm. Providing the regulated firm the opportunity to nominate a period to estimate the RFR also provides the opportunity to allow the regulated firm to select a period that maximises its RFR estimate. This could occur because the regulated firm is able to select a historical estimation period that results in the highest possible RFR estimate. Therefore, in order to prevent this form of 'gaming', the ACCC will accept an average period proposed by the regulated firm in the future that is as close as practically possible to the start of the regulatory period.

Australia Post has elected to estimate the RFR from 1 October 2009 to 31 October 2009.[499] For the purposes of the 2009 draft price notification, the ACCC finds this to be an acceptable date; however, the ACCC notes that this figure will be updated for the final decision.

The ACCC's view is to apply a monthly average of the daily 10 year Commonwealth Treasury bond. For the period 1 October 2009 to 31 October 2009, this is estimated to be 5.6 per cent.

Market Risk Premium ($E(r_m) - r_f$)

The MRP is the minimum premium an investor requires over the RFR such that they will invest in a market portfolio. The market portfolio is defined as the value weighted portfolio of all risky assets in the market.[500] The MRP is estimated by subtracting the RFR from the market portfolio.

Australia Post's position

Australia Post has proposed a MRP of 7.0 per cent on the advice of VA Associates. Australia Post argues that '[t]he WACC that should be applied to estimate future required returns needs to be a forward-looking WACC. Both the AER and Value Adviser Associates have examined the MRP…[and] [b]oth agree that forward looking MRP calculations indicate an MRP well above 6% at present.'[501] In addition, Australia Post submits that:

> Australia Post proposes that the MRP of 7% be applied on the assumption that the risk-free rate also selected is the 10-year bond rate rather than one of shorter maturity. 10 years is also a better reflection on the life of Australia Post's asset base. If a shorter maturity bond is used, then we propose adding 50 to 100 basis points to the MRP to compensate.[502]

VA Associates have recommended a MRP of 7.0 per cent based on a combination of historical and forward looking MRP estimates. It calculated a range of historical MRP, depending on imputation adjustments, to be between 6.1 per cent and 7.2 per cent.[503] It has also advanced three arguments for a higher MRP using forward looking models, including a dividend discount model, an implied volatility methodology on options of the share price index, and the implied MRP from debt spreads.[504] Citing this analysis, VA Associates have argued for a higher MRP.

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499 Australia Post, *5 October 2009 – Questions regarding period of averaging for RFR and debt premium for WACC and volumes discrepancy,* 8 October 2009, p. 1.

500 The market refers to the market portfolio. The market portfolio consists of all risky assets.

501 Australia Post's 2009 draft price notification, p. 104.

502 Australia Post's 2009 draft price notification, p. 105.

503 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 10.

504 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 7–16.

VA Associates used a dividend discount model to determine the implied return on equity, which was then used to deduce the expected MRP. VA Associates has proposed that a forward looking MRP, as calculated by Competition Economics Group (CEG) and Bloomberg, be applied[505]. Using a dividend discount model, and recent 2009 data, CEG '…estimate the MRP to be around 12 per cent. CEG consider this is a long term estimate of the MRP.'[506] Table 5.3 shows estimates of the MRP calculated using a dividend discount model using Bloomberg.[507]

Table 5.3 Bloomberg forward based estimates of MRP.

Country	Market Risk Premium					
	2004	2006	2008	July 2008	Jan 2009	April 2009
Australia	4.5	4.9	7.9	8.6	8.0	5.4
Canada	6.6	6.6	7.8	6.8	9.8	8.2
United Kingdom	5.0	5.2	6.3	6.7	7.9	8.0
USA	5.1	4.5	6.8	6.9	8.7	7.5

VA Associates state that '…[they] interpret the forward assessment by CEG and the trends in the Bloomberg assessments as signalling that the current forward looking MRP is above the long term historical MRP.'[508]

VA Associates have also estimated a forward measure of the MRP from forward markets on options on the Share Price Index.[509] By applying the relationship established by JF Capital Partners between volatility and MRP, and using estimates of implied volatility, VA Associates propose that the MRP '…falls in the range 13 – 15% compared to the 6 – 7 % long term average range.'[510] VA Associates also say that 'while [they] are not advocating this approach to estimating an MRP at this time, [they] make the point that the 6.0% widely used by regulators in the past, and also the 6.5% determined by the AER recently, is clearly below the prevailing shorter term and medium term forward MRP.'[511]

505 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 10–12.

506 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

507 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 12.

508 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 12.

509 The Share Price Index is a futures product traded on the Sydney Futures Exchange. Its value is based on the S&P/ASX200 index.

510 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 15.

511 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 16.

The final argument VA Associates make for the use of a higher MRP is based on an examination of yields in the corporate bond markets. VA Associates state that the current credit spreads for Standard & Poors' BBB rated corporate bonds have increased from an average spread in the data to December 2006 of 122 basis points to a spread at the end of May 2009 of 319 basis points.[512] VA Associates argue that for the MRP to remain around 6 to 7 per cent when the debt spread has increased from 122 to 319 basis points implies that the debt beta must increase from a range of 0.17-0.2 to 0.46-0.53.[513] VA Associates state that '…[they] would not expect the beta of debt to have more than doubled so an increase in the MRP can be expected…'[514]

ACCC's analysis and view on the Market Risk Premium

Two issues need to be considered in analysing the MRP proposal by Australia Post — the term and value of the MRP.

Term of the MRP

For the calculation of historical MRPs and the correct application of the CAPM, the term of the MRP should be consistent with the term of the RFR. The ACCC's view is to use ten year Commonwealth Treasury bonds as the RFR proxy, and therefore the term for the calculation of historical MRP should be ten years.

Value of the MRP

The value of the MRP should be based on the most appropriate and robust representation of the long term expected forward looking MRP. In general, this has been estimated using historical data; however, given the current investment climate, the ACCC must have some regard to the state of the economy currently faced by regulated firms.

The value proposed by Australia Post based on the recommendation by VA Associates is justified by a combination of historical and forward looking estimates of the MRP. Both methodologies need to be considered to determine the weighting that the ACCC should place on each. In addition, the ACCC considers that some weight should also be placed on the value that is used by practitioners[515] as the value of the MRP should represent the long term market expectation.

Historical MRP

The ACCC agrees with the view expressed by VA Associates that an adjustment in yield is required for the value of imputation credits in the calculation of the MRP. That is, there should be an increase in yield for the imputation credits attached to dividends distributed,

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512 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 16.

513 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 16.

514 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 16.

515 'Practitioners' refers to people who work in commerce that use the CAPM model to determine the cost or required return on equity.

pending the assumed distribution rate and imputation credit utilisation rate. Based on these adjustments, VA Associates propose a historical MRP range of 6.1 per cent to 7.2 per cent using a variety of assumptions of gamma.

The ACCC also agrees with VA Associates usage of Brailsford et al[516] for data before 1958, and Officer's own data post 1958.[517] This approach is reflective of the data corrections by Brailsford et al to Officer's original data since it was considered to overstate actual historical returns[518]. The same data set was considered acceptable by the Joint Industry Associations[519] in the AER's recent WACC review[520].

However, estimates of the historical MRP are sensitive to the period selected, and larger data sets tend to produce more robust and reliable estimates. VA Associates produced estimates of MRP using data from 1883 to 2007, 1958 to 2007, as well as 1883 to 2008 and 1958 to 2008, with upper values of the range for the historical MRP being based on the periods from 1883 to 2007 and 1958 to 2007. However, for the periods from 1883 to 2008, and 1958 to 2008, the values range from 6.0 to 6.4 per cent, consistent with the estimates produced by Handley (2009).[521] Handley (2009) estimated a MRP of 6.1 per cent assuming a gamma of 0.5 and 0.65 using data from 1883 to 2008, and 6.1 and 6.2 per cent assuming a gamma of 0.5 and 0.65 respectively using data from 1958 to 2008.[522]

Forward looking MRP

The forward looking MRP estimates, whilst are theoretically valid, in general do not produce robust estimates of the MRP.

The dividend discount model has been used in a number of studies to estimate the MRP. The dividend discount model can be explained as a model determining the price of an asset by discounting future dividends. For example, a single period in perpetuity dividend discount model can be explained as follows:

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[516] Brailsford T, J Handley & K Maheswaran, "*Re-examination of the historical equity risk premium in Australia,*" Accounting and Finance, 48, (2008) pp. 73-97.

[517] Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 9–10.

[518] Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 9–10.

[519] The Joint Industry Associations is a group that represents the electricity network providers of Australia, as well as other interested groups in energy regulation.

[520] Australian Energy Regulator, *Review of the weighted average cost of capital (WACC) parameters,* May 2009, p. 194.

[521] J.C Handley, *Further comments on the historical equity risk premium – Report prepared for the AER*, 14 April 2009, p. 9.

[522] J.C Handley, *Further comments on the historical equity risk premium – Report prepared for the AER*, 14 April 2009, pp. 8, 9.

$$p_t = \frac{D_{t+1}}{k_e - g}$$

where :
p_t is the share price at time t
D_{t+1} is the dividends expected at time t + 1
k_e is the return on equity
g is the expected growth rate of dividends

This model is used to implicitly determine the market return by assuming a certain asset price, dividend, as well as dividend growth rate. Therefore, while the asset price is readily observable, MRP estimates using a dividend growth model are sensitive to assumptions on the next period's dividend as well as dividend growth rate.

As outlined in VA Associates' submission[523], the dividend discount model has produced ranges from AMP capital's estimate (2006) of 4.5 to 5.0 per cent[524], Grey's (2003) estimate of 5.6 to 5.9 per cent[525], Lally's (2002) estimate of 4 to 5.7 per cent[526] and Davis' (1998) estimate of 4.5 to 7.0 per cent[527]. VA Associates also note that consultants CEG, in a report for ETSA,[528] attempted to calculate the MRP using the dividend discount model under current market conditions and produced a value of 12 per cent.[529]

These examples demonstrate that a dividend discount model is quite sensitive to the inputs in estimating an MRP. Stock prices, as well as assumed dividend growth rates are volatile in nature, and could vary from one week to another. Since the dividend growth model is sensitive to its inputs, and the inputs to the model are stock prices and the assumed growth rate, it stands to reason that the MRP estimates derived from the dividend growth model are volatile as well.

523 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

524 AMP Capital Investors *The equity risk premium – is it enough?,* May 2006, Oliver Insights, ed.13. as referenced in Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

525 S. Grey, J. Hall, *Issues in Cost of Capital Estimation,* September 2003, p. 25. as referenced in Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

526 M. Lally, *The cost of capital under dividend imputation*, 2002 pp. 29-34. as referenced in Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

527 K. Davis, *The weighted average cost of capital for the gas industry*, 18 March 1998, pp. 15-16. as referenced in Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

528 ETSA is South Australia's primary electricity distributor.

529 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 11.

Using implied volatility of options on the share price index to determine the MRP is not consistent with the assumptions underpinning the CAPM. The CAPM requires that the estimates of the WACC parameters be obtained from normal distributions. While using estimates of means (such as a historical average MRP values) is consistent with the CAPM, using volatility figures to estimate the MRP estimates is not. According to Poon and Granger (2003), '[t]here is now widely documented empirical evidence that risky financial asset returns have leptokurtic[530] tails'[531]; therefore, the volatility estimates of options would not be representative of volatility estimates of a normal distribution, and this is inconsistent with the CAPM.

In addition, the implied volatility value determined via option pricing theory is also sensitive to its assumptions. The Black-Scholes model is the standard model used to price options, of which is dependant on time to maturity, current underlying asset price, asset strike price, the RFR and volatility of the option. Therefore, volatility can be calculated from the option price, time to maturity, current and strike price of the asset and the RFR. However, because volatility estimates are sensitive to these five factors, any change in one of those factors can dramatically change the volatility estimate, which impacts the MRP estimate. Due to the erratic nature of implied volatility estimates, option pricing theory cannot be used to reliably and robustly estimate a MRP.

Finally, the ACCC agrees with VA Associates' view that an increase in the debt yield spread indicates an increase to the MRP, beta or a combination of both. In general, an increase in the yield spread of the debt market signifies an increase in overall risk of the debt market. Since an overall increase in risk in the debt market indicates an overall increase in business risk, it stands to reason that there would also be a subsequent increase in equity risk as well. While there is not substantive empirical evidence indicating whether the increase in risk signifies an increase in the beta or the MRP, it is possible that the MRP would increase to some degree.

Practitioners' opinion of the MRP

The CAPM is a forward looking model of the expected return on equity. Since it is based on market expectations of the future required rate of return on equity, the ACCC considers that some weight should be placed on Australian market practitioners' expectations of the MRP.

There has been a recent study into the MRP used by market participants. The study by Truong, Partington and Peat (2008)[532], as part of a larger study on cost of capital estimation, surveyed 38 companies listed on the Australian Securities Exchange (ASX), and found that 47 per cent of the respondents use 6 per cent as the MRP. In addition, the average of the MRPs adopted by the 38 surveyed companies is 5.94 per cent. More recently, in September

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530 Leptokurtic tails refer to the shape of a probability distribution with excess kurtosis. Kurtosis is a measure of the how high the peak the probably distribution shape is. If a distribution is leptokurtic, it means that compared to a normal distribution, there is a higher probability of observing the mean, or extreme deviations from the mean.

531 S.H Poon, C.W.J. Granger., *Forecasting Volatility in Financial Markets: A Review,* Journal of Economic Literature, Vol 41, No.2, June 2003, pp. 478-539.

532 G. Truong, G. Partington, M. Peat *"Cost of capital estimation and capital budgeting practices in Australia",* Australian Journal of Management, Vol. 33, No. 1, June 2008 p. 155.

2009 KPMG released an independent expert report on the valuation of Macquarie Airports, which stated that:

> The market risk premium is generally determined with reference to market observations over a long period of time, and is therefore relatively stable. A market risk premium of 6.3 percent for the Australian market is regarded as appropriate by KPMG. [533]

However, it must be noted that, whilst KPMG identified that a MRP of 6.3 per cent would be appropriate, it adopted a MRP of 6.0 per cent for that report.

Current investment climate

Australia Post is correct to point out that '...the WACC that should be applied to estimate future required returns needs to be a forward-looking WACC'[534] As such, the ACCC's consideration of an appropriate WACC should account for the current expectations of the future investment climate.

Subsequently to VA Associates providing advice to Australia Post, and Australia Post providing its 2009 draft price notification, the investment climate has changed. Current market expectations can be viewed in a Reserve Bank of Australia's (RBA) statement on monetary policy from November 2009[535]:

> Economic conditions in Australia have also been stronger than expected. In contrast to other developed economics, the Australian economy is estimated to have expanded, albeit modestly, over the first half of the year and recent data suggest that this expansion has continued into the second half. Confidence has improved and spending has been supported by stimulatory settings for both monetary and fiscal policy. The Australian Economy has also benefitted from the strong bounce-back in Asia, particularly China, with export volumes remaining broadly unchanged during a period in which global trade fell markedly.
>
> Given the resilience of the economy, GDP is now expected to increase by a little more than 2 per cent over the year to Mid 2010, a considerably better outcome than thought likely earlier in the year…
>
> Conditions in the global and Australian economics are significantly better than was expected when the Board lowered the cash rate to 3 per cent earlier in the year…

The ACCC has attempted to replicate and update the Bloomberg MRP estimates that VA Associates submitted. The following table displays the results.

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533 KPMG, *Independent expert report & Financial services guide*, 4 September 2009, p. 37.

534 Australia Post's 2009 draft price notification, p. 104.

535 RBA, *Statement on monetary policy*, Statement, 6 November 2009, pp. 1-3.

Table 5.4 Bloomberg estimates of the MRP[536]

2009	Market Risk Premium								
Country	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**
USA	8.69	8.57	8.98	8.39	7.54	6.92	7.12	6.66	6.69
UK	7.39	7.22	8.20	8.21	8.09	7.81	7.67	6.78	6.34
Canada	9.70	10.03	9.64	8.98	8.21	7.79	7.85	7.42	7.48
Australia	8.10	8.03	7.46	6.36	5.55	4.85	5.02	5.02	5.66
Average	8.47	8.46	8.57	7.99	7.35	6.84	6.91	6.47	6.54

While the ACCC could not exactly replicate the figures produced by VA Associates[537], Table 5.4 shows a clear downward trend in the MRP from January to September 2009. The average of the four countries' monthly MRP decreased from 8.47 to 6.54.

The RBA statement and the Bloomberg estimates of the MRP indicate that the economy is showing improvement since the downturn late last year. These are both signals that the downturn is likely to be over and that the financial market is on the road to improvement.

Conclusion

The ACCC believes that a MRP of 6.5 per cent is a more appropriate value, based on current market conditions, compared to the 7 per cent MRP proposed by Australia Post. The ACCC notes that recent evidence of market practitioners' opinion on MRP and the improvements in the financial economy together suggest that a MRP of 6.0 per cent is not an unreasonable value. Thus, the ACCC is of the view that a MRP is 6.5 per cent is considered conservative.

Gearing

Gearing refers to the proportion of debt relative to the combined total of debt and equity used by a firm to finance investments. This is usually expressed as the debt to equity ratio or, in the ACCC's assessment, the amount of debt as a proportion of equity and debt. Gearing is used in the WACC to determine the appropriate weighting for the return to equity and the return to debt, as well as the levering and de-levering of the asset beta to estimate the equity beta in any benchmarking approach.

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536 Obtained from the Bloomberg data service via the Country Risk Premium function. The risk free rate used was the local 10 year treasury bond, and the market return is calculated as a capital weighted average of the internal rates of return earned by the members of the country's major index.

537 While the figures are similar, it is unclear why the figures are not exactly the same as the values proposed by VA Associates. In VA Associates' report, they indicated that they estimated Bloomberg MRP, of which the ACCC has estimated.

Australia Post's position

Australia Post has proposed a gearing of '…20% for each of the three forward years'[538], representing a five per cent reduction to the proposal provided in its 2008 price notification. Australia Post's gearing proposal is based on its own balance sheet, after adjusting for equity. Australia Post states that '…averaged adjusted gearing for the three years covered by this draft notification is 18%. This draft notification proposes to round that projection to 20%...'[539]

Australia Post also criticised the methodology applied by the ACCC in assessing Australia Post's proposed gearing for its 2008 price notification. It states that the optimal level of gearing approach is '…not practicable in this draft notification.'[540] In addition, Australia Post criticised the benchmarking approach used by the ACCC for its previous price notification, stating that the ACCC '…did not indicate why the gearing for those [benchmarked] firms was more appropriate than the target proposed by Australia Post.'[541]

Australia Post adopts the view it expressed in its 2008 price notification, where it stated that it is '…unable to identify any desirability in exposing organisations or individuals to high debt exposures. [Australia Post is] also not aware of any compelling academic evidence that would support such an outcome.'[542] Australia Post states that '…[it] see[s] great merit in having a strong balance sheet for prudential reasons' and that '[t]he gearing ratio is one factor in Australia Post possessing a AAA rating from Standard & Poor's…'[543]

Australia Post has identified that the current market conditions that it faces are more volatile than for other regulated industries, and that this volatility means that it should not change its gearing. In particular, Australia Post submits:

> It is possible that some utilities might have sufficiently stable or predictable market conditions to justify higher gearing levels, but this is not the case for Australia Post. The domestic reserved service is facing inevitable volume decline, while in 2006/07 60% of Australia Post's revenue, and 95% of pre-tax profit arose in fully contested markets. In our view neither of these factors supports a large rise in gearing.'[544]

ACCC's analysis and view on Australia Post's gearing

The role of the ACCC in assessing the gearing of a regulated firm is to gauge whether the proposed level of gearing balances the taxation benefits of debt with the expected financial distress costs. In other words, the ACCC assesses whether the proposed level of gearing

538 Australia Post's 2009 draft price notification, p. 107.

539 Australia Post's 2009 draft price notification, p. 108.

540 Australia Post's 2009 draft price notification, p. 108.

541 Australia Post's 2009 draft price notification, p. 108.

542 Australia Post's 2009 draft price notification, p. 109.

543 Australia Post's 2009 draft price notification, p. 109.

544 Australia Post's 2009 draft price notification, p. 110.

would minimise the cost of capital. A firm that is financed purely by equity is not preferred because of the taxation benefits, reductions in transaction costs and agency costs associated with debt financing. [545] However, a firm financed purely by debt is not preferred either due to the large costs of financial distress. To assess the gearing, the ACCC follows the *generalised theory of transaction costs*, which suggests that the optimal level of gearing involves balancing the taxation and administrative advantages of debt against the present value costs of financial distress.

The ACCC, however, acknowledges the two propositions by Modigliani and Miller (M&M). In the M&M theorem (1958)[546], two propositions were made in relation to capital structure. The first proposition states that the market value of any company is independent of its capital structure ─ this is known as the 'conservation of value'. The second proposition states that the company's cost of capital is not affected by its gearing ─ this proposition is known as the 'conservation of risk'. However, the ACCC considers that whilst this theory holds true in M&M's world of a perfect capital market[547], it does not hold in the real world with market imperfections.[548] This implies that in the real world, the two M&M propositions do not necessarily hold. As such, an ideal capital structure can be achieved where the cost of capital varies according to gearing.

According to the *generalised theory of transaction costs*, the choice of the appropriate level of gearing for the regulated firm depends on the level of business risk of the regulated firm. Generally, the higher the business risk, the lower the amount of debt a firm can maintain before the costs of financial distress outweigh the benefits of debt. Australia Post has argued that it is '…unable to identify any desirability in exposing organisations or individuals to high debt exposures.'[549] This submission would be correct if the level of debt exposure was excessively high. However, as long as increasing the debt levels results in an increase in firm value through a reduction in the WACC, there is desirability to rely on more debt financing.

In Australia Post's case, the ACCC has to consider its current and forecasted capital structure in light of it being a Government Business Enterprise (GBE). The Government earns its revenue from GBEs from either the net profits, or through taxation. As such, GBEs may not have the same incentives as other corporations to utilise debt for the purposes of reducing their taxation liabilities. The ACCC's assessment of Australia Post's gearing is based on characteristics of an efficient firm that minimises its cost of capital. Since Australia Post is a GBE, it is unlikely that the proposed level of gearing is optimal. Therefore, the ACCC will

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545 Agency costs occur when the interests of the investor and the agent are mis-aligned. In the Australia Post price notification case, it occurs when the interests of equity investors and the management of Australia Post are misaligned. This occurs when one party has more information than the other about its business operations.

546 F. Modigliani, M.H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment,* American Economic Review, 48: 261-97, June 1958.

547 A perfect capital market refers to perfect information, no transaction costs and no taxes. A separate definition of a perfect capital market is the absence of any arbitrage opportunities.

548 Market imperfections refer to any deviation from a perfect capital market.

549 Australia Post's 2009 draft price notification, p. 109.

utilise an approach that allows it to estimate the level of gearing an efficient firm would choose.

To assess the level of gearing Australia Post has proposed, the ACCC will use a benchmarking approach. The benchmarking approach is the most appropriate method because it allows the ACCC to measure the level of gearing a comparable efficient competitive firm would use. This approach allows the ACCC to assess whether the proposed level of gearing is one Australia Post would employ if its reserved services side of its business were efficiently operating in a competitive environment.

The benchmarking approach assesses Australia Post's proposed gearing by comparing the level of gearing of firms similar to Australia Post. As with the benchmarking approach to estimating the equity beta, if there are no firms in the same regulated industry, the ACCC would use firms that have similar regulatory regimes or operating environment as Australia Post. For example, the ACCC could use logistics companies to provide guidance on the efficient level of gearing for Australia Post.

Selecting comparable firms will depend on the type and level of business risk that they face compared to Australia Post. Ideally, the selected comparators would be in the same market as well as the same line of business as Australia Post, however due to the monopoly nature of Australia Post's reserved letter services, the ACCC will also seek guidance from international or firms in a similar line of business.

The ACCC has selected four listed international postal operators to benchmark Australia Post's gearing. These firms are Deutsche Post, TNT, Singapore Post and Oesterreichische (Austria) Post. The ACCC has also selected five listed Australian logistics companies to serve as a check on the reasonableness of the benchmarked gearing figures. These firms are Toll Holdings, CTI Logistics, K&S Corporation, Wridgways and Lindsay Australia. As discussed further in the section on equity beta below, these firms have been selected based on data availability and industry relevance. The ACCC notes that eight of the nine firms are comparators used by VA Associates in its benchmarking exercise.[550]

Table 5.4 International postal operators' gearing values[551]

Company	Gearing
Deutsche Post	78.74%
TNT	15.56%
Singapore Post	14.77%

[550] Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 30.

[551] Gearing is calculated as the book value of debt divided by the current market value of equity from values obtained from the Bloomberg data service.

Oesterreichische Post	7.48%
Average	**29.13%**

Source: Monthly figures from October 1999 to October 2009 obtained from the Bloomberg data service

Table 5.5 Australian logistic company's gearing values[552]

Company	Gearing
Toll Holdings	15.89%
CTI Logistics	31.67%
K&S Corporation	23.09%
Wridgways	4.01%
Lindsay Australia	63.83%
Average	**27.70%**

Source: Monthly figures from October 1999 to October 2009 obtained from the Bloomberg data service

Table 5.4 shows that the average leverage of the benchmark postal operators is 29.13 per cent. Table 5.5 shows that the average leverage of the benchmarked Australian logistics companies is 27.70 per cent, which is not significantly different to the average benchmarked postal operators' gearing.[553]

While the benchmarked figures show that on average, comparable postal operators are leveraged at 29.13 per cent, the ACCC must also consider that, similar to Australia Post, these firms also provide a wide range of services in a competitive environment. For example, Deutsche Post provides domestic and international mail services within Germany, as well as

552 Gearing is calculated as the book value of debt divided by the current market value of equity from values obtained from the Bloomberg data service.

553 The gearing is measured using data obtained from the Bloomberg data service. It is calculated as the average of monthly observations of the value of short term and long term debt divided by the average monthly market capitalisation, starting from October 1999 to October 2009. The average is calculated as an arithmetic average of the relevant firms.

express mail services, retail services and freighting [554], similar to Singapore Post[555], TNT[556] and Oesterreichische Post[557].

The ACCC has taken into consideration Australia Post's desire to maintain an AAA credit rating. The ACCC takes the view that notwithstanding a significant increase in gearing, it is unlikely that Australia Post will not receive an AAA debt rating for its reserved services, given that it has a statutory monopoly in providing that service. The ACCC understands that Australia Post's reserved letter services are facing an environment of volume decline; however there is uncertainty as to whether the declines currently observed are the result of a fundamental change in letter usage, or rather a symptom of the economic downturn. The ACCC will benchmark a long term efficient level of gearing, which is influenced by fundamental changes in business risk. Based on the uncertainty in the drivers of the mail volume decline, it is unlikely that this would cause a long term shift in gearing.

Further, the ACCC notes that gearing is not a main consideration in the determination of a credit rating. Credit ratings represent an assessment of the business' ability to service its debt obligations. Although gearing does have an indirect impact – through higher debt levels – other factors such as management ability and cash flow risk have a more immediate impact on the credit ratings. Finally, the ACCC notes that Australia Post's consultants VA Associates assumed a target gearing of 30 per cent in estimating Australia Post's equity beta. VA Associates' report states that '[t]he equity beta was assessed by re-levering the asset beta at a target gearing of 30%'.[558]

In its 2009 draft price notification, Australia Post criticised the inclusion of Deutsche Post as a comparator in the 2008 price notification. Australia Post states that the use of Deutsche Post heavily biased the resulting benchmarked figure and that if it had been excluded from the assessment of the 2008 draft price notification, a much lower benchmarked gearing value would have resulted.[559] While the ACCC does acknowledge that Deutsche Post has a higher level of gearing than the other firms in the pool of comparators, the ACCC considers that the pool of comparators was selected based on the comparators' similarity to Australia Post's operations. In the ACCC's view, the process of removing the estimate itself introduces selection bias into the figure, whereby observations are removed because it does not achieve a desired result, rather than lack of relevance. The ACCC believes it is appropriate to retain Deutsche Post as a relevant comparator — particularly given that it is used by VA Associates as a relevant listed postal operator in its beta calculation.[560]

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554 Deutsche Post, last updated 11 May 2009, viewed 30 October 2009, http://investors.dp-dhl.de/en/investoren/segmente/brief/index.html.

555 Singapore Post, created 2005, viewed 30 October 2009, http://singpost.com/singpost_06about.htm.

556 TNT Post, created 2008, viewed 30 October 2009, http://www.tntpost.co.uk/About_Us/.

557 Osterreichische Post, viewed 30 October 2009, http://www.post.at/en/15.php.

558 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 26.

559 Australia Post's 2009 draft price notification, p. 108.

560 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 30.

While a benchmarked gearing of 29.13 per cent for postal operators is determined through the benchmarking analysis, and a gearing of 30 per cent was used by Capital Partners in the assessment of Australia Post's WACC, the ACCC notes that there is a possibility for Australia Post to further substitute equity for debt. In past energy decisions on the WACC, the ACCC and the AER have applied a gearing of 60 per cent, which was originally calculated using various empirical studies as well as regulatory precedent in the ACCC's statement of principles for the regulation of electricity transmission revenues (2004)[561]; this level of gearing was recently applied in ElectraNet transmission determination[562]. In the case of the 2008 Australian Rail Track Corporation access undertaking, the ACCC accepted a 50 per cent gearing level[563], whilst the ACCC's recent review of telecommunication fixed line wholesale services pricing set a gearing level of 40 per cent.[564] While Australia Post is not considered a traditional infrastructure business, it does maintain a statutory monopoly over its reserved services. This is likely to provide Australia Post with a much more stable income stream than comparable mail companies that operate in a competitive environment, and as such Australia Post should be able to take on more debt than comparable companies to minimise its tax expenses.

Based on the benchmarking analysis, the ACCC considers that there is insufficient evidence to suggest a departure from a capital structure of 30 per cent debt and 70 per cent equity.

Equity beta

The equity beta measures the level of systematic risk of an asset relative to the market portfolio. The equity beta contains the underlying systematic risk of the asset[565], and implicitly financial risk from debt[566]. This is because as the company takes on more debt, equity holders will require a higher rate of return to compensate them for the higher costs of financial distress. Thus, the higher the level of debt relative to the level of equity, the greater the financial risk and therefore the greater the equity beta. This implies that the equity beta of a certain asset implicitly reflects a certain capital structure.

The market portfolio is, as defined above, the weighted average of all risky assets in the market. This means that if the equity beta is positive, the returns from the asset move in the same direction as the market portfolio, and vice versa.

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561 ACCC, *Statement of principles for the regulation of electricity transmission revenues – background paper*, December 2004, pp. 114-116.

562 AER, *ElectraNet transmission determination 2008-09 to 2012-13, Final decision,* 11 April 2008.

563 ACCC, *Draft Decision – Access Undertaking – Interstate rail network – Australian Rail Track Corporation,* April 2008, pp. 158-160.

564 ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN, OTA, ULLS, LSS,* August 2009, p. 72.

565 Systematic risk refers to market risk that cannot be diversified away using other assets. It reflects the risk the whole economy contains.

566 Financial risk from debt refers to the higher rate of return equity investors require to invest in the asset. This is because as debt increases, the risk of financial distress increases as well.

The equity beta is used in the CAPM to measure an asset's systematic risk. The CAPM framework assumes that an investor should only be compensated for the amount of systematic risk an asset bears. This is because any unsystematic risk can be diversified away by holding a portfolio of assets/investments. Therefore, the equity beta measures the additional compensation an investor would require in excess of the RFR for investing in an asset that contains systematic risk.

The equity beta can be estimated by measuring the standardised correlation of the asset's return against the return of the market portfolio. This is commonly achieved by regressing the asset's return with the market return using historical data. This form of empirical estimation of the equity beta relies on two key assumptions about the capital markets:[567]

- the required rate of return for equity increases linearly in direct proportion to the equity beta; and
- investors, when pricing an asset, are concerned exclusively with systematic risk.

In addition to the equity beta, the asset beta and debt beta are used in the benchmarking approach to estimating the equity beta applying the Monkhouse formula.[568] The asset beta is a concept that represents only the fundamental business risk associated with an asset, and is equal to the equity beta if the firm is financed with 100 per cent equity. Since the asset beta does not include financial risk from debt, the estimated value will lie below the equity beta with debt in the capital structure, assuming the asset beta is greater than zero and the debt beta is less than the equity beta. The debt beta reflects the covariance between the return of a particular debt instrument and the market portfolio.

Whilst the debt beta could theoretically be used to determine the cost of debt, the ACCC does not adopt this approach. As indicated in the Section 5.6, it is the ACCC's view that the cost of debt is more reliably estimated through a benchmarking approach. For the purposes of the ACCC's estimation of the WACC, debt beta is only used as an input in the process of levering and un-levering the asset beta to estimate the equity beta.

Australia Post's position

Australia Post has proposed a consolidated asset beta of 0.78, which re-levered to a gearing of 20 per cent results in an equity beta of 0.93.[569] This proposal is based on advice provided by VA Associates, who conducted a benchmarking exercise to determine Australia Post's beta[570].

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567 There are also additional assumptions. For details, see W. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk,* Journal of Finance, Vol 19, pp. 425-442.

568 The Monkhouse formula was developed by Peter Monkhouse to re-lever or de-lever beta estimates. A more thorough discussion can be read at P. H.L. Monkhouse, *Adapting the APV valuation methodology and the beta gearing formula to the dividend imputation tax system.* Accounting and Finance, 37: 69 – 88. 1997.

569 Australia Post's 2009 draft price notification, pp. 105, 106.

570 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, pp. 26–27.

In its 2009 draft price notification, Australia Post notes that in conducting the benchmarking exercise, '[VA Associates] used essentially the same group of companies used by Capital Partners in the 2005 study carried out for Australia Post.'[571]

In relation to their approach of estimating beta, VA Associates state:

> To maintain consistency with the process of estimating betas in the past, [Value Associates] have essentially replicated the process followed by Capital Partners in 2005 to estimate a cost of capital for Australia Post. This involved estimating an asset beta from the equity beta of comparable companies for each major business unit and determining a weighted average of these assets for Australia Post as a whole. The equity beta was assessed by re-levering the asset beta at a target gearing of 30%.[572]
>
> …
>
> The comparable list was updated from the initial Capital Partners work in conjunction with Australia Post…it is a wide ranging list of comparables that reflects the diversity of business activities undertaken.[573]

VA Associates also state that they changed the Capital Partners process of estimating the equity beta slightly. That is:

> [VA Associates] have modified the process in one respect as guided by Australia Post. Rather than estimate a beta for each business unit and weight them to obtain an overall beta the comparables were grouped in total to form one overall beta.'[574]

ACCC's analysis and view on the equity beta

The traditional way of estimating an equity beta involves directly measuring the company's return on investment against the market return on investment. In Australia Post's case, this would mean regressing the Australia Post's returns against the returns of an appropriate market index, such as the All Ordinaries index. This form of direct measurement is based on two assumptions:

- that the company is a publicly listed company on a stock exchange; and
- that the regulated business is the primary business of the regulated firm, or has the same systematic risk as the business as a whole.

Since Australia Post is not a publicly listed company on the ASX, the ACCC must use alternative methodologies to assess the proposed beta estimates.

It should be noted that Australia Post, as with the 2008 price notification, appears to have proposed a beta for the whole of its business, rather than for the reserved element of its business. This means that some of the comparators in the list used will not be reflective of

571 Australia Post's 2009 draft price notification, p. 105.

572 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 26.

573 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 26.

574 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 26.

Australia Post's reserved business activities. The ACCC believes that from the list of comparators, the firms that are most relevant to Australia Post's reserved letter service are those within the listed postal operators group.[575] If the consideration of Australia Post's proposed asset beta was restricted strictly to listed postal services group, the proposed asset beta would be 0.53 according to VA Associates' analysis, as compared to 0.78. However, the ACCC considers that Australia Post's reserved business activities should also be measured using firms that are of a comparable line of business.

Therefore, in estimating the equity beta for Australia Post, the ACCC will consider:

- benchmarking Australia Post using relevant domestic firms; and
- benchmarking Australia Post using relevant international postal operators.

Benchmarking

The ACCC's approach involves a combination of international and domestic benchmarking.

International benchmarking

International benchmarking involves selecting international firms in the same industry as the regulated firm to determine the appropriate equity beta. Firms are selected based on businesses that best resemble the regulatory firm. The advantage of this methodology, as compared to domestic benchmarking, is that the ACCC is able to select businesses that are in the same industry as the regulated firm. This means that the estimates should more accurately reflect the systematic risks faced by the regulated firm.

A difficulty with using international benchmarks is that the comparator firms operate in a different market to the domestic regulated firm, and therefore may face different market conditions. For example, the firms may face a different taxation system, form of regulatory regime and macroeconomic risks. Introducing an equity beta estimated for a different market as compared to the other WACC parameters means that the ACCC is not strictly applying the domestic CAPM. However, in situations where data is limited, internationally benchmarked equity beta estimates still provide guidance as to the appropriate asset beta.

Domestic benchmarking

Domestic benchmarking involves selecting a sample of Australian firms which are expected to have similar levels of systematic risk to the regulated firm. In selecting comparators it is important to consider whether the firm's revenues are regulated or not and its line of business. A distinct advantage of this approach compared to international benchmarking is that the sample firms are operating in the same market as the regulated firm. In addition, the pool of investors, the level of systematic risk, the regulatory regime and the taxation system are all similar to the domestic regulated firm.

However, this approach relies on the existence of comparable domestic firms. In Australia Post's case, there are no other firms that operate in the reserved letters market. Therefore, the

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[575] The group comprised of TNT NV, Deutsche Post AG, Singapore Post Ltd and Oesterreichische Post AG.

domestic comparators selected for Australia Post are firms that operate in a similar line of business, such as logistics companies.

ACCC's choice of comparators

Since there are no domestic firms that are directly comparable to Australia Post, the ACCC selected a sample of publicly listed international postal operators. These are Deutsche Post, TNT, Singapore Post and Oesterreichische Post. These firms were selected because they are the primary mail operators in their respective countries, operating in a developed and free market economy. It is expected that the economies in which these postal operators conduct their business are relatively stable, with similar systematic risk as compared with Australia Post's reserved services.

The ACCC has also selected a range of Australian logistics firms as domestic comparators. These are CTI Logistics, K&S Corporation, Wridgways and Lindsay Australia. Whilst these businesses would not face precisely the same business risk as Australia Post's reserved services, Australian logistics firms do provide some guidance as to Australia Post's level of systematic risk. The logistics firms serve as a check as to the reasonableness of the beta estimates derived from the four international postal operators.

The ACCC notes that eight of the nine firms selected by the ACCC had been chosen by VA Associates in its benchmarking exercise.[576] The ACCC also added a further Australian logistics company into the list of comparators, Lindsay Australia. Lindsay Australia is a transport and logistics company similar to K&S Corporation and CTI Logistics, and as such is considered to be an appropriate firm for the benchmarking exercise.

The ACCC also notes that the list of comparators used for the assessment of the 2009 draft price notification is different to the list of comparators used in the 2008 price notification. The ACCC conducted a review of the comparators used in the previous price notification and decided that it should expand the list of listed international postal operators to include Oesterreichische Post to increase the sample size. In addition, the ACCC believed that it was more appropriate in the CAPM framework to use domestic logistics operators such as CTI Logistics, rather than international counterparts such as UPS.

ACCC's estimate of Australia Post's Beta

Using the benchmarking approach outlined above, of which involves the nine international and domestic benchmarked firms, the ACCC has generated the following asset beta estimates set out in Tables 5.6 and 5.7 using relevant international and domestic benchmarked firms.

576 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 30.

Table 5.6 Asset beta estimates of international postal operators[577]

Company	Equity beta	Leverage	Asset beta
Deutsche Post	0.782	78.74%	0.168
TNT	0.791	15.56%	0.669
Singapore Post	0.338	14.77%	0.288
Oesterreichische Post	0.171	7.48%	0.158
Average	**0.521**	**29.13%**	**0.321**

Table 5.7 Asset beta estimates of listed Australian logistics companies[578]

Company	Equity beta	Leverage	Asset beta
Toll Holdings	0.928	15.89%	0.782
CTI Logistics	0.304	31.67%	0.209
K&S Corporation	0.467	23.09%	0.407
Wridgways	0.497	4.01%	0.477
Lindsay Australia	0.193	63.83%	0.071
Average	0.478	27.70%	0.389

The ACCC estimates an average asset beta of 0.321 from the four international listed postal operators, taking account of the different corporate tax rates of the international firms. The ACCC also estimates an average asset beta of 0.389 from the five Australian logistics companies.

577 These values were obtained from the Bloomberg data service. TNT was measured against the Amsterdam Index, Deutsche Post was measured against the DAX index, Singapore Post was measured against the Straits Times index, Oesterreichische Post was measured against the Austrian Index. These values represent an average of weekly beta estimates over the period 31 October 1999 to 31 October 2009.

578 These values were obtained from the Bloomberg data service. Toll Holdings, CTI Logistics, K&S Corporation, Wridgways and Lindsay Australia is measured against the All Ordinaries index. These values represent an average of weekly beta estimates over the period 31 October 1999 to 31 October 2009.

In absolute terms, there is a small difference in beta estimates; However in relative terms, the beta estimate of the Australian logistics companies is 21 per cent higher than the international postal operators. This discrepancy could be due to differences in operating environment, regulatory regime or other factors that influence systematic risk of similar businesses in different countries. Due to this discrepancy, the ACCC believes a midpoint of the estimates should be used to place weight on the estimate on the asset betas for the Australian logistics companies, as well as the international postal operators.

The ACCC's asset beta estimates are different to the value estimated by VA Associates for Australia Post. As mentioned above, the value Australia Post has proposed has been calculated using comparators that represent the entire range of reserved and non-reserved services provided by Australia Post. This range of products includes higher risk products such as its money order services, as well as parcel and logistics services. Since the task currently before the ACCC is to assess the return on capital for Australia Post's reserved letter services, the ACCC considers that the most relevant figures would be the postal service comparators, as well as Australian logistics firms used in VA Associates' analysis. The asset betas of postal services and Australian logistics comparators are calculated to be 0.53 and 0.64 respectively by VA Associates[579]. Whilst these estimates are different to the ACCC's estimates, this difference is due to the updated sample set used by the ACCC.

In the 2008 price notification, the ACCC did not object to Australia Post's beta proposal. The beta that the ACCC calculated was similar to the value Australia Post calculated for its whole of business beta. While the ACCC did object to the list of comparators used to calculate Australia Post's beta, since the value itself was not dissimilar to the beta estimated by the ACCC, the ACCC raised no objection to its use in the cost of capital calculation. However, in relation to the beta assessment in the context of the 2009 draft price notification, the asset betas the ACCC calculated are approximately 39 and 39 per cent lower than the value VA Associates proposed for postal services and Australian logistics companies respectively.

The ACCC is of the view is that an asset beta of 0.355, representing the midpoint of the asset betas generated by the ACCC for international postal operators and Australian logistics companies, should be used to estimate Australia Post's equity beta, and WACC.

5.6 Cost of debt

The cost of debt in the WACC is the expected cost a firm would face to raise the required amount of debt capital over the regulatory period. This amount includes the value the regulated firm expects to pay to its debt capital providers and, in addition, all expected transaction costs associated with raising the debt capital may be included. To fairly compensate a firm for the actual cost of its debt capital, the cost of debt should be estimated based on a forward looking expected cost of debt to the firm.

In the ACCC's view, the expected cost for a regulated firm to raise its debt capital over the regulatory period can be expressed by Eq 5.4:

Eq 5.4 $$E(r_d) = YTM + DIC$$

579 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 30.

Where:

- $E(r_d)$ is the (maximum) expected cost of debt of the regulated firm;

- YTM is the yield on debt of the firm over the regulatory period and is the expected return to investors on the debt capital of the firm assuming no default risk. Currently, the Bloomberg data service is used to estimate this and it reports par yield;

- DIC is the expected debt issuance costs annualised over the regulatory period.[580]

To assess the proposed cost of debt, five factors should be considered. These are the:

- appropriate yield on debt;
- correct term of the debt;
- length of the averaging period of which the cost of debt is estimated;
- date of the averaging period of which the cost of debt is estimated; and
- debt issuance cost.

Australia Post's position

Australia Post has proposed a rate of 7.0 per cent, because '...this is close to the prevailing AAA rate, and has some regard to the AA and A rates.'[581]

Australia Post has said that its 'credit rating is reviewed annually by Standard and Poor's. A rating of AAA has been issued for Australia Post each year since the initial assessment'.[582] It has also submitted that:

> Because of the speed with which economic events and their impacts on corporate profitability are unfolding, Australia Post asked Value Adviser Associates to include a current credit rating assessment of Australia Post in its latest advice. That assessment was that Australia Post's current rating was likely to be in the range AA to AAA based on the range of rating ratios considered key by Value Adviser Associates, but might fall within the range A to AA on the basis of a wider set of rating ratios.[583]

Australia Post states that:

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[580] This ignores other capital costs such as ongoing legal and administrative costs that are compensated for in allowed operating expenses.

[581] Australia Post's 2009 draft price notification, p. 107.

[582] Australia Post's 2009 draft price notification, p. 106.

[583] Australia Post's 2009 draft price notification, p. 106.

> Without attempting to guess the outcome of the next formal Standard and Poor's assessment, it therefore seems prudent to consider one or more of the lesser ratings advised by Value Adviser Associates in additional [sic] to the AAA still applicable at the draft notification date.[584]

ACCC's analysis and view on Australia Post's cost of debt

The cost of debt capital should be the compensation that debt investors expect to receive as a component of their opportunity cost of the investment over the regulatory period. This compensation includes the time value of money in real dollar terms, inflation, a risk premium for inflation and other systematic risks, and the expected cost of default. In addition, arguably the regulated firm should receive compensation for transaction costs incurred through debt raising activities.

With the exception of debt issuance costs, the cost of debt should not compensate the regulated firm for risks that debt providers themselves do not bear. This is because any risks, to the extent that they are systematic risks that are not borne by debt holders, are borne by equity holders.

Yield on debt

To correctly estimate the yield of the debt, the ability of an efficient firm with similar risks to the regulated firm to meet its debt obligations should be considered. This means that the choice of the optimal yield of debt should depend on both the level of debt the regulated firm carries, as well as the riskiness of the regulated firm's revenue stream. In general, the higher the level of debt, or the higher the risk of the firm's revenue stream, the higher the yield debt holders would require to issue capital to this firm. Since the ACCC benchmarked Australia Post's beta as well as gearing, for consistency it is appropriate to also benchmark Australia Post's yield on debt.

The ACCC undertakes a benchmarking approach in the calculation of the WACC, and therefore it is appropriate to also benchmark the yield on debt. While Australia Post has received an AAA credit rating for its business, it would be inconsistent, for the purposes of benchmarking a WACC, for the ACCC to use actual Australia Post credit rating data, yet benchmark gearing and the asset beta for calculating its WACC. Therefore, the ACCC will attempt to benchmark an efficient cost of debt for a firm that can be comparable to Australia Post's reserved letter services business.

The ACCC has compared the ratings of the nine benchmarked firms used in the gearing and asset beta analysis against Australia Post's own credit rating. Since only Deutsche Post, TNT and Singapore Post had current credit rating data available, the ACCC is limited to using these three comparators. Notwithstanding the limited information, Deutsche Post and TNT both have a BBB+ rating, and Singapore Post has an AA- credit rating. This suggests that Australia Post's yield on debt should be between the yield of BBB+ and AA- corporate bond yields.

As discussed earlier in the gearing and equity beta sections, the information on the benchmarked firms that is available to the ACCC takes into account a range of services

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[584] Australia Post's 2009 draft price notification, p. 107.

including non-mail services, and these services will have a range of different business risks. The task currently before the ACCC is to regulate Australia Post's reserved mail services, which are expected to be less risky than its competitive non-reserved mail services due to its legislated monopoly. Therefore, for the purposes of benchmarking Australia Post's yield on debt, the ACCC considers that the benchmarked Australia Post's yield on debt for reserved services is likely to be AA- rated rather than BBB+ rated.

A further consideration is the current credit rating issued for Australia Post. Australia Post has stated that it was issued a AAA rating in Standard & Poor's most recent 2008 assessment of Australia Post.[585] While Australia Post did not explicitly indicate which line of business this rating was based on, credit rating information from Standard and Poors indicates that the AAA credit rating was issued for the Australian Postal Corporation's total portfolio of debt.[586] Since Australia Post's reserved mail services are, in general, of lower business risk than its non-reserved services, it is reasonable to consider that Australia Post will maintain a strong credit rating for its reserved services.

Overall, the ACCC considers that using a cost of yield calculated using AA as well as A rated debt gives appropriate weighting to both the benchmarked credit ratings, as well as Australia Post's own strong balance sheet assessed by Standard & Poors.

Term of the debt

As noted in the RFR section of this chapter, the choice of the term should arguably depend on the term of the risk borne by investors; in this situation, the term of the risk borne by the debt holders. However, measuring three year debt to match the regulatory period could be inconsistent with the CAPM. In addition, in the current climate of an upward sloping debt yield curve, it would insufficiently compensate Australia Post for its long-term debt. Therefore, as with the RFR, the ACCC believes a 10 year term is appropriate in current circumstances.

Length of averaging period of the cost of debt

As with the RFR, the ACCC needs to consider the averaging period over which the cost of debt is estimated. Like the RFR, taking too short or too long an averaging period may introduce market driven volatility or stale information respectively. Therefore, a balance must be struck between volatility errors and old information errors. The ACCC's view is to accept Australia Post's proposal to take a monthly average of corporate bond rates to assess Australia Post's notification.

Date of averaging period of the cost of debt

As with the RFR, the ACCC will need to consider the date of the averaging period for the estimation of the cost of debt. Again, as identified in the RFR discussion above, the ACCC

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585 Australia Post's 2009 draft price notification, p. 106.

586 Australia Post credit rating, Standard & Poors, created 2009, viewed on 30 October 2009, http://www2.standardandpoors.com/portal/site/sp/en/au/page.ratingssearch/ratings_search/2,1,1,5,0,0,0,0,0,0,0,0,0,0,0,0.html?cspage=or&SearchValue=129031.

should estimate the cost of debt rate as close as practically possible to the start of the regulatory period. Like the RFR, the ACCC will allow Australia Post to nominate a period in the future close to the beginning of the regulatory period for the estimation of the cost of debt.

Australia Post has elected to estimate the cost of debt from 1 October 2009 to 31 October 2009. The ACCC's view is that this is an acceptable timeframe for the purposes of the draft price notification, noting that this will be re-estimated for the final decision.

Debt issuance cost

Debt issuance costs depend on the level of debt the regulated firm carries. This is because the higher the amount of required debt, the more it costs to raise that capital. As such, the debt issuance costs of comparable firms will be used to assess whether the cost of debt proposed by Australia Post is reasonable.

ACCC's calculated cost of debt

The ACCC has calculated the yield on seven year AA rated corporate bond average from 1 October 2009 to 31 October 2009 to be 6.72 per cent with the ten year A rated bonds yielding 7.38 per cent. The ACCC notes that, although the longest term AA rated bonds are eight year bonds, the ACCC has chosen the seven year bond because it represents the longest term actively traded AA rated corporate bond. As the purpose of this analysis is to use the most appropriate long-term debt, the seven year AA rated bonds were selected. Based on the data provided by Australia Post, it currently has \$318 million in debt[587]. The debt issuance cost of \$318 million in debt is calculated to be 0.097 per cent.

Based on these figures, the ACCC has benchmarked a cost of debt of 7.15 per cent for Australia Post. The ACCC considers that this figure considers both the benchmarked AA and A rated corporate bond rates, as well as the debt issuance costs.

5.7 Imputation factor

The imputation factor is the market value of every dollar of tax credit that is distributed and utilised as a franked dividend to shareholders. This is denoted by the parameter gamma (γ) in the WACC, and also commonly known as the 'gamma'. These tax credits, known as franking credits, are utilised by shareholders, which prevents the double taxation of company profits. The value of the franking credits is dependant on whether the shareholder is able to utilise the credit. These credits can only be used if the shareholder is under an imputation tax system. If the investor is based on a classical tax system, the franking credit is of no value to the shareholder.

Monkhouse (1997) [588] defines γ as Eq 1.5:

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587 This is calculated by multiplying the gearing with the proposed asset base.

588 P .Monkhouse, *Adapting the APV Valuation Methodology and the Beta Gearing Formula to the Dividend Imputation Tax System*, Accounting and Finance, 37, Vol 1, 1997, pp. 69-88.

Eq 1.5. $\gamma = \alpha.\theta$

Where:

- α is the imputation credit payout ratio.[589] This is defined to be the value of imputation credits obtained by shareholders divided by the amount of imputation credits generated in the CAPM period.[590]

- θ is the utilisation factor of distributed imputation credits. That is, \$1 of imputation credits distributed via a dividend is assumed to be valued at \$ θ by the market.

Australia Post's position

Australia Post states that 'in line with the most recent expert advice, i.e. from Value Adviser Associates, this draft notification therefore proposes that an imputation factor of zero be used for Australia Post for both the WACC formula and/or associated PTRM cash flows.'[591]

The reason for Australia Post's proposal of a gamma of zero is as follows:

> …imputation adjustments to the tax factor in the WACC and/or associated cash flows used in the PTRM are not recommended by Value Adviser Associates. This is because imputation credits are not available for use by Australia Post's shareholders, and therefore have no value to them. Australia Post

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589 This is defined mathematically by Monkhouse as:

$$\alpha = D.t_f / \{[E(X) - P - r_d L].T\}$$

where;

$E(X)$ is the expected company's cash flow before interest and (Australian) tax.

$D = d/(1-t_f)$. The grossed up dividend paid by the company. It is equal to the cash dividend plus the imputation credits distributed.

P is an adjustment to allow for the fact that the actual Australian corporate tax rate is not the same as the statutory tax rate due to factors such as depreciation for example. See Monkhouse pp 74 for more details.

L is the principal outstanding at the beginning of the period and repaid at the end of the period. Monkhouse assumes the outstanding debt is constant between periods. For further details see section 4 of his paper.

T is the statutory corporate tax rate

r_d is the cost of debt

t_f Indicates the level of franking of a dividend. $t_f = 0$ under a "classical" tax system or if the dividends are unfranked and t_f is the current statutory corporate tax rate (maximum) if the Australian dividends are fully franked.

590 For the purposes of this assessment, the CAPM period is defined as ten years.

591 Australia Post's 2009 draft price notification, p. 105.

> does maintain a franking account register, but it is not used in view of our current ownership and tax status.[592]

Australia Post also argues that '[i]n Australia Post's case, where imputation credits are not available to our shareholder as a source of value, all of the return required by our shareholders must flow from the WACC and its cash flows.'[593]

In VA Associates' advice to Australia Post, it argued that:

> Unlike the privately owned Distribution and Transmission businesses falling under the AER jurisdiction, Australia Post does not distribute imputation credits along with dividends and the shareholders do not claim imputation tax benefits as a personal tax rebate. Thus there is no imputation tax benefit for shareholders and the effective corporate tax rate is generally the statutory rate. Consequently both F and theta are zero for Australia Post therefore gamma is also zero.'[594]

In addition, in the advice VA Associates provided to Australia Post, Australia Post '…did not require a recommendation on the extent to which imputation credit is used by those shareholders to whom it applies.'[595]

ACCC's analysis and view on the imputation factor

To assess the proposed imputation factor, the ACCC needs to consider two factors. As illustrated in Eq 1.5, these are the imputation credit:

- payout ratio (α); and
- utilisation factor (θ).

The imputation credit payout ratio of 1.0 is considered appropriate for a regulated firm. The breadth of discussion involved a consideration of what practitioners used, as well as estimating the payout ratio. In a study by Lonergan (2001)[596], a list of conceptual grounds was cited for not adjusting for imputation credits in mergers. Whilst the study states that market practitioners in general do not apply a gamma, it is not because it is inappropriate to do so but rather because there is no general consensus what the value of gamma should be. Similar themes were evident in a 2005 KPMG study of imputation credits, in which it is acknowledged that imputation credits are valuable[597]. Notwithstanding these difficulties, there have been several studies attempting to estimate the value of gamma. Hathaway and Officer

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592 Australia Post's 2009 draft price notification, p. 105.

593 Australia Post's 2009 draft price notification, p. 105.

594 Value Adviser Associates, *Regulatory WACC for Australia Post — Commentary*, June 2009, Draft, p. 25.

595 Australia Post's 2009 draft price notification, p. 105.

596 Lonergan, W. *The Disappearing Returns: Why imputation has not reduced the cost of capital,* 2001, JASSA, Autumn 1, pp. 1-17.

597 KPMG, *Cost of capital – Market practice in relation to imputation credits,* August 2005.

(2004)[598] measured it to be approximately 0.71, whereas Handley (2008)[599] adopted a payout ratio of 1.0. The ACCC believes there is theoretical merit in the view that a firm that possesses imputation credits should pay them out. Whilst Australia Post does not pay out imputation credits, an efficient, privately owned firm would. The ACCC's considers that an efficient privately owned firm would attempt to maximise the return to the shareholder. Since an efficient firm is likely to pay out all its imputation credits, the ACCC is of the view that the payout ratio should be 1.0.

To determine the appropriate franking credit utilisation rate (θ), the most common method is dividend drop-off analysis. Dividend drop-off analysis measures θ by comparing cum-dividend share prices with ex-dividend share prices, where the difference in value theoretically represents the value of the dividend distributed, and as such a drop greater than the cash value of the dividend would represent the value of the franking credit. There have been many empirical studies undertaken on the optimal method to measure the value of θ, however the ACCC highlights two recent Australian studies into the imputation factor. The first is a comprehensive study of Australian dividend drop-offs by Beggs and Skeels (2006) [600], and the second is a study into the efficacy of the Australian imputation tax system by Handley and Maheswaran (2008)[601].

Beggs and Skeels use regression analysis to estimate θ. The analysis factors the current taxation regime and attempts to correct for multi-collinearity as much as possible, representing the most appropriate and rigorous study into the utilisation of franking credits. Beggs and Skeels have concluded that a value of 0.572 is the most appropriate value.

While Handley and Maheswaran's study focuses on the efficacy of the imputation taxation system in Australia, it measures the credit utilisation rate as well. In the study, a credit utilisation rate is obtained by estimating the aggregate amount of imputation credits used as a proportion of the aggregate amount of imputation credits received by investors. This is estimated over the period 1988 to 2004. Handley and Maheswaran conclude that the average credit utilisation rate has increased from 0.67 in 1990–00 to 0.81 in 2001–04.

The main basis for Australia Post's argument that the gamma should be zero is that '…imputation credits are not available for use by Australia Post's shareholders, and therefore have no value to them.'[602] This argument however is incomplete because Australian Government ownership actually implies that the gamma should be one. Australia Post is entirely owned by the Australian Government and therefore the shareholder receives the same revenue irrespective of the taxation obligations of Australia Post. However, it is

598 Hathaway, N., R.R. Officer, *The value of imputation tax credits – Update,* 2004, Capital Research Pty. Ltd. 2 Melbourne, 2 November.

599 J.C Handley *A note on the valuation of imputation credits* 12 November 2008.

600 D. Beggs and C. Skeels. *The Market Arbitrage of Cash Dividends and Franking Credits*, The Economic Record ,vol 82 no 258, September 2006.

601 J.H. Handley and K. Maheswaran *A Measure of the Efficacy of the Australian Imputation Tax System,* The Economics Record, vol 84, no.264, March 2008.

602 Australia Post's 2009 draft price notification, p. 105.

inaccurate to state that Australia Post's invariance to tax or profit revenue implies that imputation credits have no value. Australia Post's ownership structure actually implies that Australia Post is entirely owned by Australians. Since it is owned entirely by Australians, the appropriate imputation credit utilisation rate for Australia Post is one, rather than zero.

In addition, as indicated in the ACCC's statement of regulatory approach to assessing price notifications, the overarching principle in the assessment of Australia Post's reserved price increases is considering what would occur '…in an open and competitive market economy [for the] efficient provision of services…'[603]. That is, the guiding principle for the ACCC in setting the gamma for Australia Post is benchmarking a gamma for an efficient firm operating in Australia.

Based on the studies cited above, an efficient profit maximising firm would pay out all its imputation credits, with a credit utilisation factor ranging between 0.572 and 0.81. The ACCC therefore considers that a gamma of 0.65 should be used in calculating Australia Post's WACC.

5.8 Taxation

Taxation plays an important role in the determination of the WACC. It is particularly important in determining the maximum revenue or price of a regulated firm. Therefore, regulators must take into account the taxation costs that regulated firms incur in running their businesses. In addition, the taxation liabilities of the regulated firm also influence the capital structure of the firm. This is because a major consideration in the capital structure is the size of the interest tax shield[604] available to the regulated firm.

The ACCC employs a post-tax nominal WACC. This suggests that the WACC estimated utilises post-tax cash flows, rather than pre-tax cash flows. The taxation component of the regulated firm is accounted via tax modelling, and as such in the PTRM rather than the WACC.

Australia Post's position

Australia Post has proposed a tax rate of 30 per cent. Australia Post has stated that '…this was the rate proposed by Australia Post in its previous case, and it was the rate accepted by the ACCC for WACC purposes in that case.'[605] It also submits that '[t]he ACCC will note that the average effective company tax rate for Australia Post has been marginally below the statutory rate in the three years to 2007-08, and adoption of the average effective tax rate for those past three years would have resulted in a WACC change of only one decimal point.'[606]

[603] ACCC, *Statement of regulatory approach to assessing price notifications,* June 2009, p. 12.

[604] A tax shield is the reduction in income taxes that result from taking an allowable deduction from taxable income. The value of any tax shield will depend on a number of factors including: whether the firm is in a tax paying position; the type of personal taxes faced by the marginal investor and the costs of financial distress from excessive leverage.

[605] Australia Post's 2009 draft price notification, p. 106.

[606] Australia Post's 2009 draft price notification, p. 106.

Australia Post submits that '[t]here are no taxation items included in Australia Post's current corporate plan (2009-10 to 2011-12) that result in a plan tax rate other than statutory 30%, and other than to allow for minor rounding, 30% has been applied in the corporate plan for all three forward years.'[607]

ACCC's analysis and view on taxation

To assess Australia Post's proposed tax rate, the ACCC should estimate the effective tax rate of the regulated firm from its forecasted cash flows. The effective tax rate is the actual tax rate Australia Post faces because it takes into account any tax offsets incurred by the regulated firm from depreciation, or through other devices to defer or offset taxation payments.

Application of too high or too low a tax rate would result in inappropriate compensation of a firm's efficient expected cost. Applying an incorrect tax rate affects not only the cash flows of the firm, but also distorts the optimal capital structure as well as the levering and de-levering of the asset beta. Therefore, it is important in pricing decisions to set the tax rate as the actual effective tax rate a firm faces in a competitive environment.

In the context of Australia Post's price notification, calculating and applying an effective tax rate is likely to have a negligible effect on the final MAR calculation. For example, a one per cent change in the tax rate has a 0.06 per cent change in the final MAR calculation for the 2008-09 financial year, accounting for the impact it has on the benchmarked beta calculation as well as on the taxation compensation component of the MAR.

While it is appropriate to use the effective tax rate that a regulated entity faces, and this is the position of the ACCC and the AER, in Australia Post's case the effect this has is considered negligible. Due to the minimal impact, the ACCC accepts Australia Post's proposal of using 30 per cent as the tax rate.

The ACCC's view is to accept Australia Post's proposal to use a tax rate of 30 per cent.

5.9 ACCC's view

The ACCC concludes that an appropriate post tax-nominal return on capital is 8.82 per cent, given the parameters the ACCC has discussed and estimated. This is 2.29 per cent lower than Australia Post's proposed value due to the differences in gearing, benchmarked firms, gamma, MRP as well as the cost of debt.

The ACCC notes that some of the WACC parameters Australia Post has provided are for Australia Post's whole business, rather than its reserved services. As the scope of this price notification is limited to Australia Post's reserved services, any parameters that are proposed for Australia Post's whole business are of limited use. The ACCC will however, refer to any material provided if it is of relevance.

For comparison purposes, the ACCC has listed the values Australia Post has proposed and the values the ACCC has estimated.

607 Australia Post's 2009 draft price notification, p. 106.

Table 9.5 WACC Parameters

	Australia Post's proposed value	ACCC's estimated value
WACC Parameter	**Value**	
Risk-free rate	5.6%	5.6%
Market risk premium	7.0%	6.5%
Asset β	0.78	0.355
Gearing (debt/debt+equity)	0.20	0.30
Imputation credits value	0.0	0.65
Equity β	0.93	0.463
Tax rate	30%	30%
Cost of equity	12.14%	8.61%
Cost of debt	7.00%	8.31%
Post-tax nominal WACC	**11.11%**	**8.52%**

6 ACCC' s view

As described in Chapter 2, in forming a view on a price notification the ACCC generally has regard to the extent to which the proposed price increases will recover the efficient costs of providing the declared services. However, the ACCC has been unable to conduct this assessment to its satisfaction using the information provided by Australia Post in support of its 2009 draft price notification.

Chapter 3 of the ACCC View document outlines the ACCC's assessment of Australia Post's forecasts of demand for its reserved letter services for the period 2008-09 to 2011-12. The ACCC engaged a third party, Frontier Economics, to conduct a review of these forecasts (see Appendix E). However, Frontier Economics considered that Australia Post's demand forecasts were not capable of being independently reviewed as the process for deriving these forecasts had not been documented. Frontier Economics notes that:

> …Australia Post's methodology is fundamentally not capable of being validated or critiqued by a third party. The forecasting process is not documented and is therefore essentially a 'black box'. In the context of a regulatory setting where Australia Post has incentives to under-forecast, our view is that this is not a desirable or best practice approach.[608]

The ACCC had previously identified similar difficulties with Australia Post's demand forecasts in its assessment of Australia Post's 2008 price notification. In particular, the ACCC noted that:

> …While it engaged Diversified Specifics to advise on small letters demand, Australia Post has not systematically used scientific methods in its demand forecasting. Australia Post has based its forecasts primarily on management opinion, and broadly has been pessimistic in its outlook, especially for the growing product, large letters.[609]

While the ACCC relied on historical trends in its 2008 assessment of Australia Post's price notification, the ACCC does not consider that it can rely on historical trends in its assessment of Australia Post's 2009 draft price notification given the important links between Australia Post's costs and volumes, and the limitations of forecasts based on historical trends. The limitations of forecasts based on historical trends were also identified by Australia Post in its response to Frontier Economics' draft report.[610]

Chapter 4 of the ACCC View document outlines the ACCC's assessment of Australia Post's forecast costs over the period 2008-09 to 2011-12. To support its claim that '…Australia Post's costs are efficient and cost movements over the period of this draft notification reflect an aggressive and sustained pursuit of efficiency and productivity opportunities…'[611], Australia Post provided the ACCC with a description of its costs forecasts, productivity initiatives, capital investment program, FDD program and approach to technology adoption,

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[608] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 20.

[609] ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 89.

[610] Australia Post, Response to Frontier Economics draft report, 19 October 2009, p. 12.

[611] Australia Post's 2009 draft price notification, p. 6.

as well as three commissioned studies on Australia Post's TFP from Economic Insights. The ACCC also engaged Frontier Economics to assist in its assessment of Australia Post's forecast costs used in its PTRM and TFP models. Frontier Economics expressed the view that its ability to assess Australia Post's cost forecasts was similarly constrained as its assessment of Australia Post's demand forecasts:

> Similar to its demand forecasts, the input cost forecasts (usually consisting of a quantity variable and possibly a price variable, such as FTEs and wages to derive labour costs) are not derived using a statistically rigorous methodology. This has made it difficult to assess the forecasts, and we have consequently examined the forecasts primarily against historical trends.[612]

The ACCC previously identified concerns with Australia Post's forecast data for TFP analysis in its assessment of Australia Post's 2008 price notification. The ACCC noted that '[w]hile some measurement issues that may systematically affect historical and forecast TFP estimates have been identified, the largest area of concern is over the robustness of Australia Post's forward-looking data for the period 2007-08 to 2011-12'.[613]

Frontier Economics found that in broad terms, Australia Post's cost forecasts are in line with historical trends. Having said that, it did identify that '…the historical growth in Australia Post's labour prices has been somewhat slower than the ABS benchmark, [redacted]…'[614] Frontier Economics identified that [redacted] may be attributable to the inclusion of non-wage factors, such as superannuation expenses, in its measurement of labour prices.[615]

Australia Post's forecast of significant increases in its superannuation expenses over the period of the price notification appear to be attributable to recent falls in the market valuations of the Australia Post Superannuation Scheme (APSS) assets, and to a more limited extent changes in Commonwealth bond rates. Changes in the value of assets in the APSS affect Australia Post's ongoing operations as Australia Post continues to offer employer financed defined benefits to its employees. The ACCC notes that Australia Post's recent 2008-09 annual report identifies that Australia Post's net superannuation asset has declined from $1594 million in 2007-08 to $468 million in 2008-09, which is mainly attributable to a decline in the fair value of the plan's assets.[616]

As outlined in Chapter 4, the ACCC notes the longer term implications for Australia Post of its superannuation scheme.

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612 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 76.

613 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 132.

614 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 64.

615 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 64.

616 Australia Post, *Australia Post's Annual Report 2008-09*, Financial and statutory reports, p. 80.

Frontier Economics considered that its finding that Australia Post's cost forecasts were in line with historical trends is problematic for Australia Post given that it is at the same time forecasting demand for its reserved letter services to decline — as it implies little to no relationship between the forecast lower volumes and Australia Post's costs .[617] Frontier Economics stated that:

> Such an outcome would only be plausible if costs were completely inelastic to volume, and our reading of Australia Post's statements is that while much of the network cost is fixed due to the need to maintain regulated delivery standards, some cost savings are possible, particularly in the medium term. Overseas studies of delivery and sorting functions also indicate that while there are economies of density (that is, costs fall proportionally less than volumes), there should be some reduction in costs from lower volumes.[618]

The ACCC also reviewed Australia Post's FDD program and the TFP studies commissioned by Economic Insights. The ACCC has examined Australia Post's FDD program in detail, and considers that when compared to postal operators overseas, Australia Post appears to be behind world best-practice postal operation in terms of the deployment of automatic sorting and sequencing technology.

The ACCC had already identified the implementation of Small Letter sequencing as an area for future productivity growth for Australia Post in its assessment of Australia Post's 2008 price notification. In particular, the ACCC noted that:

> Despite its initial small scale, the scheduled deployment of deep sequencing by Australia Post requires little capital investment, and would bring significant labour savings in this traditionally labour-intensive manual sequencing activity. Utilisation of this technology could also help improve quality in sequencing to street level and make Australia Post better prepared for the fast growing delivery network.[619]

Australia Post considers that an international benchmarking study into postal operator productivity conducted by Economic Insights '…should provide reassurance to the ACCC that Australia Post is operating at a very high performance in the postal world'.[620] In principle, the ACCC considers that comparative performance benchmarking can provide insight into the efficiency of Australia Post compared with postal operators overseas — the ACCC identified this in its assessment of Australia Post's 2008 price notification.[621]

However, due to confidentiality arrangements entered into with other postal operators, Australia Post was unable to provide the ACCC with the data used to generate this study and therefore the data remains untested. The ability of the ACCC to have regard to this report in

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617 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 76.

618 Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 76.

619 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 137.

620 Australia Post's 2009 draft price notification, p. 56.

621 ACCC, *Australia Post's draft price notification, Preliminary view, Public version*, June 2008, p. 139.

forming a view on the efficiency of Australia Post's forecast costs was limited due to the ACCC's inability to independently review the study.

The ACCC does not consider that it can rely on the cost forecasts provided by Australia Post in support of its 2009 draft price notification. Of the issues identified above, the lack of a relationship between costs and volumes is of particular concern to the ACCC, and raises concerns about the efficiency of its forecast costs. As identified by Frontier Economics:

> …in a world of falling volumes and fixed costs, higher prices will be required for Australia Post to earn a return but there is some doubt as to whether this is a sustainable strategy. Australia Post may well need to significantly reduce its cost base in the medium term, but cost reductions are not yet evident in its cost forecasts. This will place a greater burden on any future attempts by Australia Post to lower costs in the longer term.[622]

In assessing the efficiency of the cost base the ACCC assumes that Australia Post would continue to be obliged to comply with its CSOs and meet its performance standards.

The ACCC recognises that some of Australia Post's costs are fixed. However, it would be expected that its overall costs would respond as demand declines. The ACCC does not consider that Australia Post's 2009 draft price notification has adequately addressed the linkages between prices, volumes and costs. This is particularly evident given that uncertainty still remains about whether Australia Post accounted for the impact of the proposed price increases in constructing its demand forecasts — as noted by Frontier Economics:

> The forecasts do not explicitly take into account the effect of the proposed price increases on expected volumes, although we understand that managers were provided with "price guidance" in setting volume forecasts. If price elasticity was not taken into account in setting the volume forecasts, then this is a potentially significant flaw (which would tend to bias the forecasts upwards).[623]

Australia Post's proposal suggests that the letters side of its operations is in decline. Australia Post is at a critical point where it will need to re-examine its cost structure, and the approach it takes to meeting the delivery obligations required by government into the future. In the ACCC's view, funding the maintenance of Australia Post's existing cost structure through regular price increases as the letter business declines is not a sustainable strategy.

The ACCC has formed a view regarding the appropriate rate of return for Australia Post. Chapter 5 of the ACCC View document provides the ACCC's assessment and view on Australia Post's appropriate rate of return.

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[622] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 73.

[623] Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009, p. 75.

ACCC's view on the consistency of Australia Post's proposed price increases with the legislative framework

Australia Post forecasts (with its proposed price increases) a substantial under-recovery of allowable revenue over the three year period 2009-10 to 2011-12 at an approximate annual average of over $208 million.[624] It could be argued that such a magnitude of under-recovery of allowable revenue is likely to outweigh the ACCC's concerns over the reliability of volume forecasts and the efficiency of forecast costs.

However, the ACCC notes that views about the magnitude of under-recovery are based on Australia Post's forecast cost and demand data. For the reasons summarised above, and outlined in detail in Chapters 3 and 4 of the ACCC View document, the ACCC does not consider that Australia Post's demand forecasts are reliable, and has serious concerns about the efficiency of its forecasted costs.

In the event the ACCC decided not to object to proposed price increases in the circumstance where it had serious concerns about the efficiency of Australia Post's costs, Australia Post's incentives to contain its costs and pursue productivity gains over time would be reduced.

Even if Australia Post's reserved services were likely to under-recover costs in the short-term, the ACCC does not consider that short term under-recoveries provides a sufficient basis for the ACCC to make informed decisions on proposed price increases under Part VIIA of the TPA. In addition to the ACCC's concerns regarding Australia Post's demand and cost forecasts, the price notification regime under Part VIIA of the TPA is asymmetric in price setting as regulatory oversight is required for upward movements in prices but is not available for downward movements in prices.

The consequence of this asymmetry is that it becomes even more important for the ACCC to avoid basing pricing decisions on short-term results. Events in the (foreseeable) longer-term may counteract current circumstances and mitigate the necessity of price rises. Australia Post may be able to benefit from favourable short-term changes to costs without fear of detriment from unfavourable events in the longer-term.

Robust forecasts of demand and costs are required to establish future pricing targets. The ACCC identified that these were needed to provide greater incentives for the regulated firm to make productivity gains and cost savings over time in its assessment of Australia Post's 2008 notification.[625] Indeed, the ACCC requested:

> …that any future price notifications 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 at least a three year period;

[624] Australia Post's 2009 draft price notification, p. 66.

[625] ACCC, Australia Post's 2008 draft price notification, Public version, June 2008, p. 182.

- Information on how prices for Australia Post's reserved services will change over this period…[626]

The ACCC considers that where there is a material degree of uncertainty around Australia Post's proposed price increases, Direction 11 and subsection 95G(7) of the TPA require it to object to the proposed increases.

In particular, Direction 11 requires that the ACCC must give special consideration to Australia Post's functions and obligations. Australia Post's obligations include its commercial obligation, CSO and governmental obligation. In light of the unverified demand and cost forecasts, it is unclear to the ACCC whether the proposed price increases would be consistent with sound commercial practice.

Not objecting to price increases in circumstances where there are concerns about the efficiency of Australia Post's forecast costs could risk further reducing demand for letter services and hasten substitution away from Australia Post's reserved letter services. Were it to inefficiently increase substitution away from reserved letter services, it could risk making it more difficult for Australia Post to fund and meet its CSO in the future.

Direction 11 also requires the ACCC to give special consideration to 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. The ACCC notes that section 38 of the APCA specifies the matters that Australia Post must have regard to in setting its financial targets for inclusion in preparing its corporate plan. In particular, paragraph 38(d) of the APCA requires the need to maintain Australia Post's financial viability. Again, the ACCC considers that not objecting to proposed price increases based on demand forecasts that are not fully documented, that cannot be independently verified and on costs which are not necessarily efficient, inappropriately increases the risk of inefficiently increasing substitution away from Australia Post's reserved letter services.

Given its concerns with the volume and cost forecasts, the ACCC's view is that making pricing decisions based on them would not be consistent with the relevant criteria. In light of requirements in the legislative criteria, the ACCC is unable to not object to price increases using volume and cost forecasts, where there is a lack of clarity whether the price increases will assist Australia Post in meeting its legislated functions and obligations.

Chapter 2 identifies that, in addition to providing special consideration to the matters identified in Directions 11 and 8, the ACCC must also have regard to the matters in subsection 95G(7) of the TPA. The ACCC considers that the criteria in subsection 95G(7) of the TPA will generally be met by economically efficient prices which reflect:

- an efficient cost base; and
- a reasonable return on capital.

[626] ACCC, Australia Post's 2008 draft price notification, Public version, June 2008, p. 187.

It is difficult to form a view on the extent to which Australia Post's proposed prices reflect an efficient cost base and a reasonable return on capital due to the lack of reliable and independently verifiable forecasts for the demand of Australia Post's reserved letter services. Even if the ACCC did have reliable demand forecasts, the ACCC would still have serious concerns about the efficiency of Australia Post's cost base.

In addition, the ACCC's view is that price assessments should be conducted with reference to longer-term considerations. In its *Statement of approach to assessing price notifications*, the ACCC indicated that it prefers draft price notifications to be supported by information on future prices. The ACCC stated that it will generally consider the efficiency properties of longer-term price assessments in line with Direction 11 and subsection 95G(7) (see Chapter 2).[627] The ACCC is currently not in a position to identify forecast targets of efficient costs or prices due to its concerns regarding the efficiency of Australia Post's cost base. The inability to identify forward looking pricing or cost targets will have a deleterious effect on Australia Post's incentives to improve productivity or pursue cost improvements over time.

The ACCC's view is that it would be inconsistent with Direction 11 and subsection 95G(7) of the TPA to approve the price increases in Australia Post's 2009 draft price notification and therefore, objects to any such increase.

Way forward

The ACCC considers that there are key areas of Australia Post's 2009 draft price notification that need to be revisited before any further draft price notification.

Throughout the ACCC View document, the ACCC has identified a number of deficiencies with Australia Post's demand and cost forecasts. Most of the ACCC's concerns have arisen due to a lack of transparency (either through lack of supporting information, or confidentiality concerns) which means that data or information on which Australia Post is seeking the ACCC to rely cannot be subjected to review by third parties or lead to fully informed decision making. The ACCC would expect that its concerns would be addressed in any future price notifications from Australia Post.

In particular, Australia Post needs to adopt an independently verifiable approach to forecasting demand for its reserved letter services that can be exposed to sensitivity analysis around key economic assumptions. The ACCC considers that Australia Post could consider an approach similar to that identified in the Frontier Economics report, which also provides examples of forecasting approaches used in other regulated industries.[628]

In relation to addressing the ACCC's concerns regarding the efficiency of Australia Post's forecast costs, it is of primary importance for Australia Post to address the relationship between its forecast costs and volumes. The ACCC shares Frontier Economics' concerns about the sustainability of a situation where '[i]n a world of falling volumes, a static or rising

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[627] ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009, pp. 17-18.

[628] see p. 17 – 21 of Frontier Economics, *Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC*, November 2009.

cost base will lead to ever increasing average costs, which may require higher prices which in turn may trigger an even greater reduction in volumes.'[629]

The ACCC does not consider that Australia Post's draft price notification has adequately addressed the linkages between volumes, costs and prices. This is particularly evident given that there remains uncertainty about whether Australia Post accounted for the impact of the proposed price increases in constructing its demand forecasts. In addition to incorporating the impact of price changes into its demand forecasts, the ACCC considers that Australia Post could better address the linkages between volumes, costs and prices by, as suggested by Frontier Economics[630], producing a plan that manages the cost base in light of market conditions. This plan should outline how Australia Post proposes to optimise its cost base over the forecasting period in response to forecast volume declines.

The ACCC considers that Australia Post needs to be able to provide rigorous and quantifiable evidence of the relationships between volumes and costs by network function to support its views regarding the volume variability of its costs. One approach to providing evidence of these relationships would be to conduct empirical analysis of the relationship between costs and volumes by network segment similar to that conducted in international studies. Anecdotal evidence augmenting any empirical analysis should be in a form that can be independently verified and its suggested effect of volume variability on costs able to be quantified.

Statistical analysis of the relationship between volumes and costs will be of assistance in assessing the appropriateness of Australia Post's costs forecasts; however such analysis may be influenced by the historical configuration of Australia Post's network. Australia Post's plan to manage its cost base over the forecasting period should provide a bridge between the statistical analysis of the relationship between volumes and costs, and the impact on this relationship of any identified changes to network configuration (such as the FDD program) that may be implemented over the forecasting period.

The ACCC notes that Australia Post has provided an international benchmarking study and appreciates this. The ACCC notes Australia Post's view that it intends to update its international benchmarking study in the future, and the difficulties Australia Post encountered in this undertaking. As noted by Australia Post these studies '…can be difficult to undertake as participants typically report upon their business differently and may have specific reasons (e.g., confidentiality) why they may not wish to participate.'[631]

However, in order for the ACCC to be able to place more reliance on Australia Post's international benchmarking analysis, it requires some ability to scrutinise the construction of the study, which would be managed within the standard ACCC confidentiality provisions. The inclusion of postal operators that have been found to be high performing in existing TFP

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[629] Frontier Economics, Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC, November 2009, p. 59.

[630] Frontier Economics, Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC, November 2009, p. 74.

[631] Australia Post, *Australia Post's response to public submissions*, 13 October 2009, p. 7.

studies[632] or postal operators in countries where postal liberalisation has taken place and competition has been introduced (such as Sweden, Germany and the Netherlands) would also provide better information on the relative efficiency of Australia Post's operations.

To supplement such a study (given that there would be a need to adjust for differences in operating environment across countries in international benchmarking) Australia Post could also consider internal benchmarking[633] of the efficiency of its own operations — which would avoid issues associated with obtaining information from other postal operators. Internal benchmarking could involve the relative performance of different parts of its network segments (for example, its delivery and sorting centres) across its delivery network.

The ACCC has identified a number of issues within Australia Post's draft price notification that need to be addressed in order for the ACCC to make an informed decision on the appropriateness of the proposed price increases for the domestic reserved letter services. While the ACCC signalled in its issues paper that it would consult on its view before making a final decision in January 2010, in light of the concerns the ACCC has with Australia Post's proposal it does not consider that this is an appropriate way forward. The ACCC will provide guidance to Australia Post and industry stakeholders on the timing of its consideration of any future price notifications when Australia Post addresses the above concerns.

632 For example, Sweden has been found to out-perform other EU countries in two reports — see Frontier Economics, *Impact of Liberalisation on Efficiency: A Survey – A Report for Postcomm*, January 2002, and LECG Ltd., *Future Efficient Costs of Royal Mail's Regulated Mail Activities*, 2 August 2005.

633 Postcomm used internal benchmarking in addition to international benchmarking in making a decision on the efficiency of Royal Mail in its 2005 price control review for the period 2006 – 2010.

Appendix A Australia Post's existing and proposed prices

Ordinary Letters

	Current	Proposed Prices Amount	Proposed Prices % Change
Small Letters			
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%
Large Letters			
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 post codes)

	Current	Proposed Prices Amount	Proposed Prices % 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	Proposed Prices % 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 Single	Current Prices 1-4 Packs of 10	Current Prices 5+ Packs of 10	Proposed Prices Single	Proposed Prices 1-4 Packs of 10	Proposed Prices 5+ Packs of 10	% Change Single	% Change 1-4 Packs of 10	% Change 5+ Packs of 10
Plain Envelopes									
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		Pk of 50	Bx of 500		Pk of 50	Bx of 500		Pk of 50	Bx of 500
Small (DL and C6)	NA	$ 32.20	$ 309.50	NA	$ 34.70	$ 333.50	NA	7.8%	7.8%

Notes/Comments:

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

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

PreSort Le tters

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		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
Size / Weight	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var
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		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
Size / Weight	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current*	Amount	% Var
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		
		Proposed Price			Proposed Price			Proposed Price	
	Current	Amount	% Var	Current	Amount	% Var	Current	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		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current	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 BPR) are shaded

Appendix B Summary of submissions in response to issues paper

The ACCC has received a total of 23 submissions to date from Australia Post, major mail users and businesses, small businesses, associations and private individuals. In addition to Australia Post, submissions were received from:

- Printing Industries Association of Australia (Printing Industries);
- Major Mail Users of Australia Limited (MMUA);
- Post Office Agents Association Limited (POAAL);
- Australian Direct Marketing Association (ADMA);
- Fundraising Institute Australia (FIA);
- 14 private individuals/associations/small businesses.

Australia Post – Initial submission[634]

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

While Australia Post provided modelling that indicated that further changes to the prices of the domestic letter services would be required in 2011-12, Australia Post considers that it would need to undertake an appropriate assessment of market conditions before finalising any further proposals.[635]

Australia Post states that the price increases substantially under-recover the efficient costs of providing the domestic reserved letter services, but proposing price increases at this level was reasonable in the current economic circumstances. Australia Post argues that under-recovery provides it with an incentive to pursue efficiencies.[636] As a result of the proposed under-recovery, Australia Post submits that it is not seeking to offset the impact of any volume decline through price increases.[637]

Australia Post's forecast reserved letter volumes

Australia Post's forecasts reflect an average rate of decline of 2.3% per annum over the next three years. This compares with an average growth of 0.3% since 2000 and a forecast decline

[634] Australia Post, *Australia Post's Response to Issues Paper*, 18 September 2009.

[635] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 4.

[636] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 4.

[637] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 5.

of 3.8% in 2008-09.[638] Australia Post submits that the volume forecasts are consistent with what other postal administrations are expecting.[639] Further, Australia Post submits that based on the conditions of the first two months of 2009-10 volumes are currently trading below the forecast level – closer to the declines experienced in the last six months of 2008-09.[640]

Community Service Obligations (CSOs)

Australia Post notes that delivery point growth forecast is based on an extrapolation of growth in delivery points over the last 20 years. Average annual growth rate has been 2.4% over the last 20 years and 2.5% over the last 10 years, but it has used 2% as a more conservative number (and as it is closer to the average over the past five years).[641]

The potential cost variability of Australia Post's letter services with changes in letter volumes depends on the network function and the activities within it.[642] Australia Post makes a number of comments specific to the potential cost variability of the following functions: *Sales and Acceptance, Processing, Transport* and *Delivery*.[643]

Productivity

Australia Post notes that its measured productivity must fall because volumes are expected to decline over the next three years and because CSOs and the associated prescribed performance standards further fix the resource base.[644]

Consultants Economic Insights were commissioned by Australia Post to respond to matters raised by the ACCC relating to productivity in its issues paper. In response to the ACCC's question on how TFP modelling should impact the ACCC's assessment of Australia Post's proposal, Economic Insights notes that under a productivity based approach to regulation where X is determined using the 'differential of a differential' form, all else equal, if the regulated firm is experiencing lower TFP going forward than the rest of the economy as a whole, then <u>there will be a case for allowing a real price increase for the firm</u>.[645] Economic Insights also notes that, all else equal, where the firm is facing input price growth which is higher than the economy as a whole then there will also be a case for a real price increase.[646]

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[638] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 5.

[639] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 5.

[640] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 5.

[641] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 6.

[642] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 7.

[643] Australia Post, *Response to Issues Paper*, 18 September 2009, pp. 7-9.

[644] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 10.

[645] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* Attachment 1 to Australia Post's Response to Issues Paper, p. 2.

[646] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 2.

However, Economic Insights notes that the above is based on two key assumptions. First, that Australia Post was earning the opportunity cost on its reserved services capital at the start of the next regulatory period and second, that Australia Post's reserved services are being operated at reasonable levels of efficiency given the operating environment it faces.[647]

In relation to the appropriateness of the comparators in its international benchmarking study, Economic Insights notes that: [648]

> 'Economic Insights (2009b) has adopted the targeted survey approach. It covers six overseas postal services and Australia Post which is a relatively ambitious undertaking for this type of study. The countries were chosen because they are all developed economies with well established national postal systems covering a range of small and large systems operating in a range of operating environments. Requests were also made to two other developed European postal systems but they were unwilling to participate because of concerns about data confidentiality.'

In relation to the basic data, Economic Insights states that considerable effort was made to ensure that the data were provided on a comparable basis.[649] It also notes that TFP estimates have been adjusted to take into account the most important operating environment differences — mail density and customer density.[650]

Economic Insights also notes that the uneven distribution of Australia Post's productivity dividend over time reduces the incentive to invest further in Australia Post's reserved services and meet future needs given the impact on profitability.[651]

Future Delivery Design (FDD) program

Australia Post notes that the major challenge in its delivery function is ensuring an ongoing delivery capability while containing costs and maintaining service performance standards in an environment of declining letter volumes, and where the delivery network continues to expand (by over 200,000 delivery points per annum).[652]

Australia Post submits that the 'key FDD elements entail technology, process and workforce changes to improve flexibility in the delivery network and create savings'.[653] Australia Post also submits that the FDD program 'provides an effective framework for extracting cost savings and efficiency gains across local delivery networks that have considerable variation in their geography, mail types, and staff mix, without threatening service quality'.[654] Australia

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[647] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 2.

[648] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 3.

[649] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 3.

[650] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 4.

[651] Economic Insights, *Response to ACCC Issues Paper Productivity Questions,* p. 6.

[652] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 13.

[653] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 13.

[654] Australia Post, *Response to Issues Paper*, 18 September 2009, p. 13.

Post also submits that the overall approach is similar to the approach adopted by overseas postal authorities in response to delivery cost pressures, declining mail volumes and fixed delivery commitments and the design of FDD incorporates a number of features drawn from overseas experience.[655]

Australia Post notes that over the period of the draft notification the FDD program will realise around 600 FTE savings (which is offset by delivery point growth).[656]

Capital expenditure

Australia Post submits that 'there are reserved and non-reserved components of its capex programme'.[657] Australia Post also notes that 'capex projects for some non-reserved products and services are clearly solely non-reserved in application, but all capex used by reserved services is also shared by non-reserved services and has to be allocated'.[658] Further, Australia Post submits that 'even the proposed future investment in sequencing machines (predominantly Small Letter sized items) will be shared between reserved and non-reserved letters'.[659] Australia Post also notes that traditionally it had 'funded total capex from its cash flows without resorting to external funding' as it understands that '…would be the most common method of funding capex by corporations'.[660]

Structure of Australia Post's proposed price increases

Australia Post submits that Australia Post's Letter Pricing Principles provide a balanced approach to the determination of letter prices.[661] Australia Post submits that the Letter Pricing Principles recognise Australia Post's community service obligation, but also the need to ensure the pricing structure reflects commercial and markets needs – which include the recognition that bulk interconnection prices, in addition to requirements of Australia Post's Act, reflect the level of work saved by Australia Post through work carried out by customers.[662]

Australia Post also submits that the price margins are appropriate and that PreSort prices encourage the adoption of machine efficient formats and reflect the lower processing costs,

655 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 14.

656 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 16.

657 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

658 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

659 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

660 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 17.

661 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 19.

662 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 19.

and, for the purposes of bulk interconnection, provide a price reduction for interstate movement that is greater than the avoidable costs.[663]

Australia Post – Response to public submissions[664]

Some areas of Australia Post's response to public submissions which have been included above in relation to Australia Post's original submission have been omitted.

Productivity

Australia Post notes that it intends to update its international benchmarking study in the future. Australia Post notes that benchmarking studies of this type can be difficult to undertake as participants typically report upon their business differently and may have specific reasons (e.g. confidentiality) why they may not wish to participate.[665]

In regards to the comment on shareholder dividend, Australia Post submits that it considers that the payment rates for licensees and contractors are 'fair and reasonable'.[666] Australia Post notes that 'as with all suppliers, payments to licensees and contractors take precedence over those to the shareholder' and that 'dividends to the shareholder and taxes paid to the Commonwealth depend on the profit remaining after all payments to suppliers have been accounted for'.[667]

Additionally, Australia Post provides graphs that:

- compare the growth in the number of delivery points and the change in the number of FTEs over time;
- show the change in labour costs as a percentage of total costs over time, and
- show the change in domestic reserved letter service labour numbers over time.[668]

In relation to the FDD program, Australia Post notes that the program is tailored to the strengths of its network and that there are difficulties of a comparison with overseas postal authorities.[669]

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663 Australia Post, *Response to Issues Paper*, 18 September 2009, p. 19.

664 Australia Post, *Australia Post's Response to Public Submissions*, 13 October 2009.

665 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 7.

666 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 7.

667 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 7.

668 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 8-9.

669 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 11.

Letter Pricing

Australia Post submits that the proposed increase represents only the third increase to Ordinary Letter prices and the second general increase to PreSort prices since 1992 and that the proposed prices were developed pursuant to Australia Post's Letter Pricing Principles.[670] Australia Post also supports this view with a comparison of proposed BPR to January 2003 BPR inflated by CPI and a comparison of standard basic letter prices with other OECD countries.[671]

Australia Post submits that, within Australia, letter demand has historically been price inelastic for small price changes and refers to the findings of Diversified Specifics' report, noting that the findings of the report are consistent with behaviour overseas, as identified in a recent report by the Direct Communications Group[672,673]

Australia Post notes the comments in submissions about hastening of transition to electronic alternatives and submits that this is a major reason why it believes that large upfront price increases should be avoided and why the proposed prices do not fully recover the sum of efficient costs of providing the domestic reserved letter service plus an appropriate level of return.[674]

Australia Post notes that it undertook consultation with a broad group of key customers and stakeholders from late April 2008 to gauge whether the proposed prices would result in a significant disadvantage to a particular market segment.[675]

Further, Australia Post submits that in the event that it believes that price changes beyond early 2010 are necessary, it would undertake consultation with key customers and stakeholders prior to a further price notification with full details of the proposed prices.[676]

Impact of Price Changes

Australia Post submits that it has a 'significant investment in the traditional mail market; one that it needs to protect and one which it needs to continue to manage on a commercial basis'.[677]

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670 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 17-18.

671 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 18-19.

672 Direct Communications Group, *Review of Price Elasticity Models for Postal Products*, 2007.

673 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 21.

674 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 21.

675 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 22.

676 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 23.

677 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 26.

Australia Post also submits that it continues to meet its regulated performance standards and that its customer service standards are 'higher than ever' (Australia Post also provides figures and tables which compare its performance with the standards).[678] Additionally, Australia Post provides information on how it is responding to community and business expectations and outlines the Awards that it has received.[679]

Rate of Return

Australia Post notes that 'the weighted average cost of capital (WACC) proposed and the previous version used in the last price case would appear to satisfy the PIAA's concerns, as both were set according to the long-term factors that are inherent in WACC parameters based on the Capital Asset Pricing Model'.[680]

Addendum to Australia Post's Response to Public Submissions[681]

Australia Post provided an addendum to its response to public submissions in order to respond to issues raised by the Major Mail Users of Australia Limited (MMUA).

The following summary does not attempt to cover all of the points made in Australia Post's addendum, but only those key points not included in previous Australia Post submissions or its draft notification (and independent reports).

In relation to MMUA's comments about Alternative Lodgement Solutions and the PIP2 Project, Australia Post notes that the Process Improvement Program (PIP) is an ongoing program that focuses on working with customers and industry suppliers (e.g. Mail Houses) to improve the acceptance process of mail, in particular PreSort letters.[682] Australia Post notes that its focus is on 'ensuring an efficient robust revenue collection process' and that 'as part of this program [Australia Post] will continue to investigate alternative lodgement & acceptance practices that improve the process for both parties'.[683]

Australia Post also submits that:

> [Australia Post] is currently working with two major mail houses and the MMUA in evaluating a specific initiative. At this point it is not clear what the potential benefits (and implementation costs) may be. The next stage in the evaluation is to continue a detailed analysis with the mail houses, with a view to scoping out a cost benefit analysis – from both the perspective of the mail houses and [Australia Post]. The MMUA's claim that [Australia Post] has allocated funding '…in the millions of dollars …' is incorrect. While [Australia Post] has engaged independent consultants to assist in the evaluation process, to date the spend is less than $50k. Consistent with standard [Australia Post]

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678 Australia Post, *Response to Public Submissions*, 13 October 2009, pp. 28-30.

679 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 26.

680 Australia Post, *Response to Public Submissions*, 13 October 2009, p. 32.

681 Australia Post, *Addendum to Australia Post's Response to Public Submissions*, 2 November 2009.

682 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 10.

683 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 10.

> practices, each stage of the evaluation requires justification for ongoing funding. It should be noted that [Australia Post]'s decision on continuing this initiative will be based on the potential positive impact across the letter value chain – not just on [Australia Post]'s acceptance costs. [684]
>
> AP notes the desire to improve lodgement quality and is constantly providing advice to customers through the operational acceptance staff and account managers. AP has national procedures and processes that underpin lodgement acceptance for mail.[685]

In relation to the Bulk Mail Partner program (BMP), Australia Post submits that the program consists of three major elements:

> -Customer Barcode Quality Assurance (CBQA) – a tool made available to the industry since 2000 that allows AP and customers to assess the accuracy of Delivery Point Identifier (DPID) assignment and barcode print quality (confirming eligibility for PreSort letter prices);
>
> -Process Improvement Program (PIP) – introduced in 2001 to improve the integrity of the volume reconciliation processes; and
>
> -Electronic Lodgement of Mailing Statements (eLMS) – commissioned in 2001 to enhance the lodgement and billing process. [686]

Australia Post submits that these three elements 'were linked together under the umbrella of BMP to provide a consistent national process, which includes the common reporting of identified issues via the Lodgement Quality System (LQS)'. [687]

Further, Australia Post provides a table comparing the difference (and effective discount) between the BPR and the key PreSort price over time.[688]

In relation to a proposal of a reintroduction of the 'AdPost' discount (A lower price that previously applied to promotional mail, Australia Post submits that it 'does not believe that the presence of a discount in itself provides an incentive to use mail as an advertising medium – when a discount has been in place for some time it becomes the price, not an incentive'. [689]

In relation to MMUA's comments regarding Australia Post's functions, markets and obligations, Australia Post submits that 'the MMUA's notion of what [Australia Post]'s principal and secondary function is, is incorrect' and refers to its functions as detailed in the APCA.[690]

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684 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 10.

685 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 10.

686 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 19.

687 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 19.

688 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 19, 20.

689 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 20.

690 Australia Post, *Addendum to Response to Public Submissions*, 2 November 2009, p. 23.

Australia Post's response to Freshwater Management's submission[691]

Australia Post identified that its compliance with its prescribed performance standards '…is independently monitored and, as with all prescribed performance standards, is subject to independent audit by the Australian National Audit Office'.[692] Australia Post provided information on its performance in regard to the prescribed performance standards for 2008-09. Australia Post also identified that it has exceeded the required delivery performance standard since 2000-01.[693]

Printing Industries Association of Australia (PIAA)[694]

PIAA is the peak advocate and support organisation for companies operating in the print, packaging and visual communication industry in Australia which represents around 2000 companies.[695]

PIAA submits that it is concerned about any proposed price increases having the effect of making the paper based communication medium relatively more expensive to end users.[696] PIAA also submits that the proposed new cost will have an adverse effect on the print and mailing house industry[697] and that, especially given the inflation outlook and the current and short term projected economic environment, the ACCC should reject the excessive price increases submitted by Australia Post.[698]

PIAA submits that a price increase will result in product substitution due to mail users switching to non-mail alternatives such as e-communications.[699] PIAA also submits that price rises should not be justified by an industry being in transition and that Australia Post should not be allowed to escape market disciplines. [700]

PIAA suggests that a proportion of Australia Post's projected falls in reserved letter volumes for the 2009-10 – 2011-12 period may be attributable to the proposed price increases,[701] noting that mail volume is price sensitive and the price increase will force the paper-printing-

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691 Australia Post, Response to *Freshwater Management Submission*, 6 November 2009.

692 Australia Post, Response to *Freshwater Management Submission*, 6 November 2009, p. 1.

693 Australia Post, *Response to Freshwater Management Submission,* 6 November 2009, p. 2.

694 Printing Industries Association of Australia*, Submission to the ACCC's Australia Post's Draft Notification Issus Paper*, 11 September 2009.

695 PIAA, *Submission,* 11 September 2009, p. 1.

696 PIAA, *Submission,* 11 September 2009, p. 1.

697 PIAA, *Submission,* 11 September 2009, p. 1.

698 PIAA, *Submission,* 11 September 2009, p. 2.

699 PIAA, *Submission,* 11 September 2009, p. 3.

700 PIAA, *Submission,* 11 September 2009, pp. 2, 3.

701 PIAA, *Submission,* 11 September 2009, p. 3.

mail house value chain to carry an extra financial burden.[702] PIAA argues that Australia Post uses the 'appropriate return on capital' argument to justify price.[703]

PIAA suggests that the industry would be able to better manage smaller phased price increases than larger upfront increases,[704] and that the bulk rebates offered to industry should compensate industry participants that incur greater costs by undertaking an increased share of tasks that had been previously performed by Australia Post.[705] PIAA also submits that industry participants suspect that business mail is relatively more expensive because of 'significant cross subsidisation' of ordinary household mail[706] and that Australia Post's monopoly can 'camouflage poor management decisions, inefficient internal practices and other ineffective value-added services'.[707] PIAA also submits that Australia Post has not truly consulted with the industry, but rather made presentations to comply with legislative requirements.[708]

Post Office Agents Association Limited (POAAL)[709]

POAAL is the independent industry membership organisation representing the business interests of owner/operators of Licensed Post Offices and mail contractors.[710]

Scope and duration of Australia Post's draft price notification

POAAL submits that Australia Post's forecasts of a price increase in 2011-12 without specifying its quantum at this stage are reasonable because of the rapidly-changing nature of the marketplace for hard copy mail and the reasonable size of Australia Post's past price increases.[711] POAAL also submits that the ACCC's suggested incentives and penalties appear complicated and unlikely to create any further pressure for improvements in productivity, and the current public assessment process provides a sufficient incentive to perform.[712] Incentives based on forecasts could encourage the process to become corrupt, decisions by Australia

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702 PIAA, *Submission,* 11 September 2009, p. 4.

703 PIAA, *Submission,* 11 September 2009, p. 4.

704 PIAA, *Submission,* 11 September 2009, p. 5.

705 PIAA, *Submission,* 11 September 2009, p. 5.

706 PIAA, *Submission,* 11 September 2009, p. 5.

707 PIAA, *Submission,* 11 September 2009, p. 5.

708 PIAA, *Submission,* 11 September 2009, p. 6.

709 Post Office Agents Association Limited, *Submission to the Australian Competition and Consumer Commission Australia Post Draft Price Notification Issues Paper,* 18 September 2009.

710 http://www.poaal.com.au/

711 POAAL, *Submission*, 8 September 2009, p. 1.

712 POAAL, *Submission*, 18 September 2009, p. 1.

Post and commercial entities using its services are unlikely to be linked in any risk sharing process, and events in the immediate future may disguise long-term demand trends for mail.[713]

POAAL argues that the delivery efficiency of hard copy mail, not the price, is the key determinant of demand for alternatives to hard copy mail.[714] POAAL supports more frequent postage price reviews because '…the relationship between GDP and the cost of substitutes is likely to change over the coming period as structural change to the communication sector makes its way through the economy'.[715]

POAAL suggests that the need to increase postage rates in increments of five cents could be tested – if Australia Post were to be encouraged to adopt a minimum sale quantity of five stamps, the postage rate could be increased in smaller increments.[716]

Australia Post's forecast reserved letter volumes

POAAL notes that 'the assessments of long-term growth forecasts commissioned by Australia Post appear reasonable' and 'as accurate as any forecast can be in the present climate'.[717] POAAL submits that, in the absence of volume growth, it is difficult for Australia Post not to seek price increases to offset its growing costs. POAAL submits that the expectation of an imminent price rise usually causes a 'short period of increased usage ahead of the price change followed by a short period of reduced sales before a return to 'normal' activity'.[718] POAAL also notes that 'the trend to consolidation and re-evaluation of past practices … could further accelerate the move towards less expensive alternatives' to hard mail, but this 'will be little influenced 'by the price increase'.[719]

Community Service Obligations

POAAL submits that 'it is reasonable to accept that Australia Post faithfully records the growth in delivery points that have occurred over the last few years'. However, POAAL submits that it is of the view that growth mainly occurred in urban areas (it submits that growth in costs of meeting growth in urban areas tends to be incremental in nature).[720]

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713 POAAL, *Submission*, 18 September 2009, pp. 1-2.

714 POAAL, *Submission*, 18 September 2009, p. 2.

715 POAAL, *Submission*, 18 September 2009, p. 2.

716 POAAL, *Submission*, 18 September 2009, p. 2.

717 POAAL, *Submission*, 18 September 2009, p. 4.

718 POAAL, *Submission*, 18 September 2009, p. 3.

719 POAAL, *Submission*, 18 September 2009, p. 4.

720 POAAL, *Submission*, 18 September 2009, p. 5.

POAAL also notes that details of Australia Post's proposals, including a more flexible workforce and the use of mechanised support for delivery staff, should be made available.[721]

Productivity

POAAL submits that 'of some concern is the lack of detail in the Australia Post forecast on future productivity improvements', and that although 'the means quoted by Australia Post to improve its future performance have all been listed before … [t]here remains no detail on the initiatives, their timing and impact'.[722] POAAL submits that there is no timetable for the completion of the FDD program.[723]

Further, POAAL notes that most of the Postal administrations compared in the Economic Insights' paper 'come from a similar government owned background'.[724] POAAL also suggests that 'future [benchmarking] comparisons might be better made against relevant commercial organisations in a disaggregated way'.[725]

POAAL also argues that the assertion that past productivity gains have been shared with consumers, contractors and staff needs to be examined (POAAL it is of the view that the 'major beneficiary has been … the Government').[726]

Australia Post's financial model

In relation to Australia Post's benchmarking study, POAAL notes that if other administrations implemented better improvements in labour productivity or are ahead of Australia Post in non-labour factors, then Australia Post should target these better benchmarks.[727] POAAL also submits that accommodation costs of Licensees appear not to have been included in the assessment of non-labour input factors, and that 'these inputs would be material in a TFP calculation'.[728]

Future Delivery Design program

POAAL submits that 'anecdotal evidence from visits by senior POAAL officers to other postal administrations or through attendance at international conferences indicates that [initiatives such as enhanced OCR and letter sequencing] are well underway in other postal

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[721] POAAL, *Submission*, 18 September 2009, pp. 5-6.

[722] POAAL, *Submission*, 18 September 2009, p. 7.

[723] POAAL, *Submission*, 18 September 2009, p. 8.

[724] POAAL, *Submission*, 18 September 2009, p. 9.

[725] POAAL, *Submission*, 18 September 2009, p. 9.

[726] POAAL, *Submission*, 18 September 2009, pp. 7-8.

[727] POAAL, *Submission*, 18 September 2009, p. 10.

[728] POAAL, *Submission*, 18 September 2009, pp. 10-11.

authorities'.[729] POAAL submits that these two initiatives for the future 'are understood to be extensions of the current capability of existing letter sorting equipment rather than requiring substantial additional investment' and that the initiatives 'seem not to be limited by the technical capability of the equipment but the industrial climate in which Australia Post is operating'.[730]

Capital expenditure

POAAL questions whether Australia Post's investment strategy, which appears to be based on renewal of its existing infrastructure, is a sustainable investment approach.[731]

Structure of Australia Post's proposed price increases

POAAL submits that the letter pricing principles and margins proposed by Australia Post seem reasonable on the basis of available information.[732]

Australian Direct Marketing Association (ADMA)[733]

ADMA is the peak body of the Australian direct marketing industry, which represents over 500 member organisations, many of which rely heavily on Australia Post's products for transactional and promotional communication.[734]

ADMA submits that an increase in postage prices 'will have the direct result of reducing both transactional and promotional volumes [and] forcing organisations to expedite plans to move to cheaper electronic methods of communication' and that the ACCC should continue to monitor and put pressure on Australia Post to continue to reduce its costs.[735] Further, ADMA submits that the increase in postage prices should be deferred indefinitely or at least until July 2010 to allow organisations to factor the increase into their budgets and that any increase should be in line with Consumer Price Index (CPI) changes only.[736] ADMA also notes that there should be no change to service standards that Australia Post must meet.[737]

Additionally, ADMA submits that Australia Post should not risk long term damage by employing a price increase (which is a 'blunt instrument') and that Australia Post 'should be

[729] POAAL, *Submission*, 18 September 2009, p. 12.

[730] POAAL, *Submission*, 18 September 2009, p. 12.

[731] POAAL, *Submission*, 18 September 2009, p. 13.

[732] POAAL, *Submission*, 18 September 2009, p. 14.

[733] Australian Direct Marketing Association, *Submission to the ACCC,* 16 September 2009.

[734] ADMA, *Submission to the ACCC,* 16 September 2009, p. 1.

[735] ADMA, *Submission to the ACCC,* 16 September 2009, pp. 1, 2.

[736] ADMA, *Submission to the ACCC,* 16 September 2009, p. 2.

[737] ADMA, *Submission to the ACCC,* 16 September 2009, p. 2.

encouraged to take a longer term view in relation to whether it should increase its prices and not overreact to the circumstances of the year just passed' given the 'extraordinary conditions that applied in the last year'.[738] ADMA explains that any increase in price will 'stymie any trend towards [economic] recovery' in a period when 'organisations are either still in difficult trading conditions or starting to see an increase in economic activity'[739] and that organisations 'had no way of knowing, nor expecting, that further price increases would occur so soon after September 2008' and 'it is totally unreasonable … to put a further cost impost [on businesses] half way through the current financial year'.[740] Further, ADMA submits that Australia Post should not seek further price increases beyond the CPI in the context of declining volumes because 'the scramble to retain margins and return on investment by using the price lever alone will only accelerate the shift [to alternative lower cost channels such as electronic mediums] and set up a spiral from which it will be impossible to recover'.[741]

ADMA argues that Australian business, which is bearing a 'significant amount of risk' because of the global financial crisis, should not be subject to additional risk with respect to a variation in volumes.[742] ADMA argues that the decline of economic activity will reduce the demand for Australia Post's reserved services, but a recovery will result in increased demand for Australia Post's reserved services.[743]

Additionally, ADMA states that it supports the introduction of a reward structure for Australia Post for situations where it reduces its costs below the ACCC's forecasts in future price notifications, but it is unsure what form the rewards should take.[744] ADMA further notes that it strongly supports the ACCC's 2008 decision that Australia Post should provide a disaggregated financial model over 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 other that period.[745] ADMA also submits that the letter pricing principles that Australia Post has had regard to in the proposed price increase are appropriate and the margins proposed by Australia Post between its PreSort and other reserved letters are sufficient.[746]

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738 ADMA, *Submission to the ACCC,* 16 September 2009, p. 2.

739 ADMA, *Submission to the ACCC,* 16 September 2009, p. 2.

740 ADMA, *Submission to the ACCC,* 16 September 2009, p. 3.

741 ADMA, *Submission to the ACCC,* 16 September 2009, p. 4.

742 ADMA, *Submission to the ACCC,* 16 September 2009, p. 3.

743 ADMA, *Submission to the ACCC,* 16 September 2009, p. 4.

744 ADMA, *Submission to the ACCC,* 16 September 2009, p. 3.

745 ADMA, *Submission to the ACCC,* 16 September 2009, pp. 5-6.

746 ADMA, *Submission to the ACCC,* 16 September 2009, pp. 6-7.

Fundraising Institute Australia (FIA)[747]

FIA, a charitable institution, is the national peak body for professional fundraising with a membership of approximately 1400 individuals and 50 organisations.[748]

FIA's strongly encourages the ACCC to consider retaining the current pricing regime for charity mail and recommends that Australia Post consider a pricing and eligibility structure enabling *all* nonprofit organisations to benefit from the charity mailing rate.[749, 750] FIA, which notes the increased cost burden caused by the price increases of charity mail on nonprofit organisations and charities, submits that the price increase, which follows a price increase in 2008, is highly inflationary, given the much smaller changes in the CPI.[751] FIA also notes that the proposed increase in mail pricing is a 'significant cost increase to one of the most popular methods for charities to communicate with their donors'[752] and that the 'proposed price increase will significantly adversely affect charitable organisations' donor acquisition, information channels, and most importantly, vital fundraising income streams'.[753] FIA submits that 'the impact of retaining current pricing for charity mail would be negligible as charity mail currently represents … less than 3% of Australia Post's services'.[754]

FIA notes the February 2008 submission by the Major Mail Users Australia (MMUA) to the ACCC which opposes any increase in the cost of charity mail.[755] FIA also notes the US postal system, which offers large discounts for charities.[756]

Major Mail Users of Australia Limited (MMUA) – initial submission[757]

MMUA, the association that represents major bulk mail users, notes that 'MMUA's member [Bulk Mail Partner]-accredited Mailing House members lodge some 86+ percent of all Bulk Mail lodgements in Australia'.[758]

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747 Fundraising Institute Australia, *FIA Submission on Australia Post's Draft Price Notification,* September 2009.

748 FIA, *Submission*, September 2009, p. 2.

749 FIA submits that at present less than 10% of nonprofit organisations in Australia are eligible for the charity mailing rate.

750 FIA, *Submission*, September 2009, p. 4.

751 FIA, *Submission*, September 2009, p. 2.

752 FIA, *Submission*, September 2009, p. 2.

753 FIA, *Submission*, September 2009, pp. 5-6.

754 FIA, *Submission*, September 2009, pp. 2-3.

755 FIA, *Submission*, September 2009, p. 3.

756 FIA, *Submission*, September 2009, p. 3.

757 Major Mail Users of Australia Limited, *Submission in response to the ACCC issues paper of August 2009: Australia Post's Draft Notification – Postal Pricing Increases*, 15 October 2009.

MMUA submits that there is a need for Reserved Services to have two distinct streams: Domestic Mail and Bulk PreSort Mail, and that for any pricing proposal these elements would need to be costed, analysed and dealt with separately.[759]

MMUA submits that Australia Post's pricing structure and Terms and Conditions for Bulk PreSort Mail are out of step with the industry to the extent that its pricing structure is not only not recognising the new driving forces but is working against encouraging greater use of paper-mail.[760] MMUA explains that 'postage pricing based on the size of the envelope belongs to yesterday: today the focus should be on the varying use of paper mail and to structure postage prices with a view to encourage increased use' which 'requires a change of attitude …that would be best achieved through a changed set of postal regulations'.[761]

Further, MMUA submits that given the work that is done pre-lodgement for Bulk PreSort Mail, and the extension in that area that could be done were Australia Post want to do so, the difference between Ordinary Letters pricing and that of Bulk PreSort Letters does not properly reflect the difference in costs to Australia Post for the handling of Ordinary Letters as opposed to handling Bulk PreSort Letters, the price of the Ordinary Letter should be much higher than either the existing 50 cents or the proposed 55 cents.[762] MMUA submits that access to the Bulk PreSort Mail discounts should be restricted to Mailing Houses and/or Mail Generators who hold quality assurance accreditation status under the Bulk Mail Partner Program (BMP), or alternatively, a sliding scale of discounts should apply depending on the degree to which the party lodging the mail has taken work away from Australia Post pre-lodgment, the greatest level of discount being available only to BMP-status.[763]

MMUA submits that Impact Mail is being priced too high (judging by marketplace comment) – if stakeholders had an input in structuring prices, initiatives such as Impact Mail would have greater value and greater use.[764]

In relation to the elasticity of PreSort Mail, MMUA contends that 'all of the participants report similarly that 'over the past decade there has been a quantum shift as to the impact of the postage cost: whereas 10 years ago it could be said that the PreSort Mail market was inelastic…with the introduction of the mass of e-alternatives now available the PreSort Mail [market] is very much price elastic'.[765]

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758 MMUA, *Submission,* 15 October 2009, p. 5.

759 MMUA, *Submission* ,15 October 2009, p. 7.

760 MMUA, *Submission* ,15 October 2009, p. 4.

761 MMUA, *Submission,* 15 October 2009, p. 4.

762 MMUA, *Submission,* 15 October 2009, p. 26.

763 MMUA, *Submission,* 15 October 2009, p. 8.

764 MMUA, *Submission,* 15 October 2009, p. 26.

765 MMUA, *Submission,* 15 October 2009, p. 26.

Additionally, MMUA refers to e-PreLodgment Advice systems and the Alternative Lodgment Solutions (PIP2) March 2007 proposal, noting that both were omitted from Australia Post's FDD Program. MMUA notes that 'Australia Post's processing and delivery network has heavy fixed costs where every mailpiece going through the network reduces the per unit cost of processing' and that it would 'envisage that the technology-driven system changes … foreshadowed in the PIP2 discussions (moving the current Bulk Mail Partner Program into a new area of technology and systems) would be a suitable mandatory requirement to access the pricing structures needed'.[766]

MMUA notes further that 'Australia Post has not followed through on all the potential cost savings that are available to it from the earlier FuturePOST project, nor has it been prepared to deal seriously with all the costs savings that MMUA proposed in 2007 through our Advanced Network Integration and e-Pre Lodgement Advice proposals, nor has it advanced appropriately its own 2007 proposals for Alternative Lodgement Solutions. Each of those proposals contain major cost savings…'.[767] MMUA also notes that the FDD Program is incomplete and should be rejected by the ACCC (because it does not incorporate e-PreLodgement Advice systems and the PIP2 proposal) until such time as 'the result of the PIP2 Project's investigations are determined and available in a public report'.[768]

In relation to the timing of the increase, MMUA submits that 'if there is to be an increase in postage prices, it should be timed for either 1 January or 1 July to match with industry's normal budgeting and financial reporting timings and the pricing changes should be known 12-months in advance of coming into effect'.[769]

In relation to the appropriate sharing of business risk, MMUA contends that its attitude is '**absolutely no sharing**', because businesses are unable to raise prices unilaterally in normal contractual relationships.[770] Further, MMUA notes that Australia Post could rationalise its CSOs in order to generate costs savings opportunities and notes a number of ways in which it could achieve this.[771]

Major Mail Users of Australia Limited (MMUA) – Addendum to submission[772]

MMUA provided an addendum to its submission in order to respond to issues raised by Australia Post in response to its initial submission.

766 MMUA, *Submission,* 15 October 2009, p. 6.

767 MMUA, *Submission,* 15 October 2009, p. 18.

768 MMUA, *Submission,* 15 October 2009, p. 25.

769 MMUA, *Submission,* 15 October 2009, p. 7.

770 MMUA, *Submission,* 15 October 2009, p. 18.

771 MMUA, *Submission,* 15 October 2009, p. 22

772 Major Mail Users of Australia Limited, *Addendum to Submission in response to the ACCC issues paper*, 9 November 2009.

MMUA states that its contention is that:

> [T]he ACCC should insist on Australia Post provided written **– open for public comment** – statements and detailed disclosure thereof covering the following points:
>
> 1. That it has implemented a major cost reduction program in response to falling profits;
>
> 2. That it has either reduced its workforce consistent with the drop in volume or has plans to do so over the next 6 to 12 months;
>
> 3. That it has put a freeze on salaries and bonuses;
>
> 4. That it has examined whether it can relocate national, state and regional offices and operational sites to lower cost sites;
>
> 5. That – in the light of its primary function being to provide the monopoly's Reserved Services for Community Service Obligation purposes - it has examined the financial and other aspects of advantage to the Corporation by such means as:
>
> - Whether or not the Corporation is better off selling its logistics business to a logistics company;
> - Whether or not the Corporation is better off outsourcing its mail freight operations;
> - Whether or not the Corporation has identified underperforming assets and/or locations and put in place plans to exit.
>
> A most important further element is related to a normal practice in the non-monopoly marketplace and that is that a supplier always works with its customer in times such as this to see if there are ways and means that changes can be made to keep prices under control: From the unique within the Australian mail industry advantage point that MMUA has of its BMP-Mailing House members supplying daily some 86+ percent of all Bulk Mail lodged, we can say that Australia Post has not done so and therefore we would make that a sixth point in this listing, viz:
>
> 6. That it demonstrate that it has worked with Bulk Mailers to explore all opportunities to reduce costs (and increase productivity) within their processes. Any response to this should be open for further public comment before the Preliminary Decision is made by the ACCC. [773]

Further, MMUA contends that:

> One option that has not been proposed – or even covered – is for a **price decrease** to hold or growth the paper-mail volumes and at the same time a fresh engagement with the Bulk Mail industry for the purpose of finding cheaper, more productive ways of preparation and lodgement of the mail.
>
> If the price were to be dropped; if the quality assurance accredited mailing houses were treated as professional partners instead of pesky agents of customers; if people who understood the day-to-day operational interface between Australia Post and the mailing house were the true primary contact, then and only then would it be possible to develop a joint approach to stemming the tidal flow from paper-mail to e.communications in ways that simply will not happen if the postage price increase is allowed.
>
> Such an approach would lead into a pricing structure for Bulk Mail based on a more appropriate linkage of "quality" mail to pricing levels – something that cannot be achieved while Australia Post continues its policy of non-consultative approaches to these matters. [774]

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[773] Major Mail Users of Australia Limited, *Addendum to Submission in response to the ACCC issues paper*, 9 November 2009, p. 3.

Additionally, MMUA suggests that 'within the context of cost saving potentials, a lessening of the Performance Standards requirements ought to be considered and commented upon by Australia Post – it has not been done so in this Draft Notification'.

Simon Remington (managing director of Remington – a direct marketing list brokerage)[775]

Mr Remington submits that many of the brokerage's clients, who use mail to help acquire new clients, are 'incensed' that their mailing costs could increase further, especially in light of the 2008 price increase. Mr Remington suggests that a postal price rise will only exacerbate the difficulties faced by many companies in the broader business community. Mr Remington, who warns that the flow-on effect throughout the multi-billion dollar direct marketing sector of a reduction in activity will be pronounced, urges the ACCC to thoroughly canvas the broader business community, suggesting that there is strong sentiment against the proposal.

Robert G. Richardson (Co-licensee Westbury Licensed Post office)[776]

Mr Richardson submits that payments to Australia Post licensees and delivery contractors have not kept pace with licensees' costs and reasonable expectations.[777] He emphasises the 'real need' to increase licensees' and contractors' compensation.[778]

Caled Containers Pty Ltd[779]

Caled Containers strongly objects to the proposed price increase and asks how Australia Post could justify two price rises in a short time span. Caled Containers argues that the price rise will have a negative impact on small business and notes that the price of postage had previously remained constant for many years.

Brian Dunphy (Freshwater Management Pty Ltd)[780]

Mr Dunphy makes a submission dealing with delay in delivery of normal postal articles, alleged frauds by post office franchisees; and the ability to operate customer accounts from different locations.[781]

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774 Major Mail Users of Australia Limited, Addendum to Submission *in response to the ACCC issues paper*, 9 November 2009, p. 4.

775 Simon Remington - Remington Direct, *Submission*, 18 September 2009.

776 Robert G. Richardson – co-licensee Westbury Licensed Post Office, *Submission*, 18 September 2009.

777 Robert G. Richardson, *Submission*, 18 September 2009, p. 3.

778 Robert G. Richardson, *Submission*, 18 September 2009, p. 3.

779 Caled Containers, *Submission*, 18 September 2009.

780 Brian Dunphy – Freshwater Management Pty Ltd, *Australia Post Submission*, 16 September 2009.

781 Brian Dunphy, *Submission*, 16 September 2009, p. 1.

Specifically, Mr Dunphy states that on many occasions mail sent by his business takes a number of days to be delivered.[782] In relation to the two reported cases of alleged fraud by Australia Post franchisees, Mr Dunphy asks 'How did they allow [frauds of multi-million dollar magnitude] to happen' and 'how many other undetected frauds are still being committed by franchisees and staff'? Mr Dunphy demands that Australia Post answers for its 'inefficiency of service' and its 'failure to safeguard the business from fraud'.[783] Mr Dunphy also submits that it is 'nothing short of ludicrous' that Australia Post's customer accounts can only be operated in a single location (i.e. that customers need to apply to have their account recognised at post offices other than their own).[784]

Wendy R. Anderson[785]

Ms Anderson submits that it is in the best interests of Australia Post and of every business and citizen that the proposed price rises do not occur in 2010. She submits that Australia Post will 'survive, and thrive, quite adequately for another year or two' without price rises at this time.[786] Ms Anderson also submits that postage price increases will have a detrimental flow-on effect on all businesses and consumers and that the price rise is excessive, especially given that it follows an increase in 2008.[787] Ms Anderson also argues that Australia Post is an essential service and a monopoly provider, and must remain affordable for all and that if Australia Post wants to remain relevant as consumers become more accustomed to the numerous forms of electronic communication, 'it needs to do all it can to retain customers, not drive them away'.[788]

Trevor Browning[789]

Mr Browning submits that he opposes the increase, emphasising the reliance of rural Australians on the service and the burden of any additional costs on residents. Mr Browning also submits that there are substantial delays in mail delivery in his area.

Alfred Grech (Public Officer for The Smithfield Stamp Club Inc)[790]

Mr Grech, in his submission on behalf of The Smithfield Stamp Club Inc, warns that the price increase will 'ultimately kill off the Philatelic Industry as a hobby'.[791] Mr Grech

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782 Brian Dunphy, *Submission*, 16 September 2009, p. 1.

783 Brian Dunphy, *Submission*, 16 September 2009, p. 2.

784 Brian Dunphy, *Australia Post Submission*, 16 September 2009. p. 2.

785 Wendy R. Anderson, *Submission*, 13 August 2009.

786 Wendy R. Anderson, *Submission*, 13 August 2009, p. 3.

787 Wendy R. Anderson, *Submission*, 13 August 2009, pp. 1, 2.

788 Wendy R. Anderson, *Submission*, 13 August 2009, pp. 2-3.

789 Trevor Browning, *Submission*, 23 August 2009.

790 Alfred Grech – Public Officer for The Smithfield Stamp Club, *Submission*, 24 August 2009.

submits that Australia Post should use its resources and avoid price increases until Australia overcomes the recession.[792] Mr Grech argues that the postage price should be decreasing, not increasing, in order to help ensure that the economy is going forwards.[793]

Nicholas[794]

Nicholas submits that he would support the price rise, but only if it would ensure the protection of jobs at Australia Post. He also submits that Australia Post's services would have to improve if the price increase is allowed.

Lesley T. Smith[795]

Mrs Smith strongly objects to the price increase, especially in light of the 5 cent price increase in 2008. She submits that there will be a proportion of the population who do not have access to substitutes to mail, and that people in such situations may not be able to afford the price increase.

Anonymous[796]

Anonymous strongly opposes Australia Post's proposed price increase, as well as *any and all* proposals to increase postage costs. Anonymous notes that 'some of us, like myself, live remotely, do not have a computer let alone the skills and ability to 'bank and pay bills online'. Anonymous submits that any price increases by Australia Post are 'outrageous'.

Benjamin Ho[797]

Mr Ho opposes the proposal, noting that Australia Post's service has not improved and that 'advances in technology should result in cheaper delivery of local mail'.

Mostyn B. Mills[798]

Mr Mills strongly objects to the proposal noting that he cannot see how Australia Post can justify the proposal to increase the price rate twice in twelve months.

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791 Alfred Grech, *Submission*, 24 August 2009, p. 1.

792 Alfred Grech, *Submission*, 24 August 2009, p. 1.

793 Alfred Grech, *Submission*, 24 August 2009, p. 2.

794 Nicholas, *Submission*, 25 August 2009.

795 Lesley T. Smith, *Submission*, 16 September 2009.

796 Anonymous, *Submission*, 26 August 2009.

797 Benjamin Ho, *Submission*, 28 August 2009.

798 Mostyn B. Mills, *Submission*, 17 September 2009.

Ann Heaneay[799]

Ms Heaneay objects to the increase, stating that a 20% increase in the cost of postage over a short period of time is unreasonable. Ms Heaneay sympathises with Australia Post's problems in the market place but notes that Australia Post has created more business in other areas to compensate.

Bob Such MP (Member for Fisher)[800]

Dr Such opposes the proposal and makes the following comments: [801]

- Postage was increased from 50 cents to 55 cents only recently in 2008.
- Further price increases will discourage greater use of Australia Post services.
- Fuel prices have come down significantly over the last year.
- Technology available to Australia Post should bring about cost savings.
- Australia Post is a monopoly and is therefore not subject to real competition.
- What efficiency gains has Australia Post made?
- Australia Post might better use its retail component to help offset the costs of its basic services.

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799 Ann Heaneay, *Submission*, 25 August 2009.

800 Bob Such MP, *Australia Post 2009 Draft Price Notification*, 26 August 2009.

801 Bob Such MP, *Australia Post 2009 Draft Price Notification*, 26 August 2009.

Appendix C   Relevant Legislative Instruments

COMMONWEALTH OF AUSTRALIA

Prices Surveillance Act 1983

DECLARATION (NO. 75)

I, PETER BALDWIN, Minister of State for Higher Education and Employment Services, acting for and on behalf of the Treasurer, in pursuance of section 21 of the Prices Surveillance Act 1983, hereby:

(1) revoke declaration No 53 of 18 April 1989 relating to the transmission of standard postal articles and registered publications by the Australian Postal Corporation published in the Commonwealth of Australia Gazette No. GN 16 of 3 May 1989; and

(2) declare:

  (a) the provision of letter services reserved to Australia Post under Division 2 of Part 3 of the *Australian Postal Corporation Act 1989*, and the carriage within Australia of registered publications, to be notified services for the purposes of the Act; and

  (b) the Australian Postal Corporation to be, in relation to those services, a declared person for the purposes of the Act.

Dated this FIFTH day of FEBRUARY 1992.

Peter Baldwin
Minister of State for Higher Education and Employment Services
acting for and on behalf of the Treasurer

PRICES SURVEILLANCE ACT 1983

DIRECTION (NO 11)

I, SIMON FINDLAY CREAN, Minister of State for Science and Technology, acting for and on behalf of the Treasurer, in pursuance of section 20 of the *Prices Surveillance Act 1983* hereby direct the Prices Surveillance Authority:

(i) In exercising its powers and performing its functions under the Act in relation to prices charged by the Australian Postal Corporation (Australia Post) in respect of the transmission within Australia by ordinary post of standard postal articles and registered publications, to give special consideration to the following matters:

- Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35-41 of the *Australian Postal Corporation Act 1989* and in particular the pricing targets and Government endorsed financial targets contained in Australia Post's corporate plan;

- 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;

(ii) To provide, where appropriate in confidence, advice to the Government on the appropriateness of pricing targets to be included in Australia Post's future corporate plans. Such advice should be given in the context of the financial targets contained in the corporate plan.

The matters set out in this direction are to replace those contained in the Treasurer's direction of 25 July 1984.

Dated this 19th day of September 1990.

Simon Crean
Minister of State for Science and Technology
Acting for and on behalf of the Treasurer

COMMONWEALTH OF AUSTRALIA

PRICES SURVEILLANCE ACT 1983

DIRECTION

I, Paul John KEATING, the Treasurer, in pursuance of section 20 of the Prices Surveillance Act 1983, hereby direct the Prices Surveillacne Authority to give special consideration, in exercising its powers and performing its functions under that Act, to the following matter in addition to the matters in paragraphs (a), (b) and (c) of sub-section 17(3) of the Act:

> the Government's policy that increases in executive remuneration in excess of those permitted under wage fixation principles and decisions announced by the Australian Conciliation and Arbitration Commission in National Wage Cases should generally not be accepted as a basis for prices increases.

Dated this 20th day of April 1988

P.J. KEATING
Treasurer

Appendix D Australia Post's performance standards

Sections 26 to 28 of the APCA combined with the *Australian Postal Corporation (Performance Standards) Regulations 1998* detail the obligations placed on Australia Post in the performance of its functions.

Performance standards — frequency of delivery

Statutory obligation	Legislative source of the obligation
Australia Post must service 98% of all delivery points daily (except on a Saturday, a Sunday or a public holiday in the place where the delivery point is located)	Regulation 5(1)(a) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
Australia Post must service 99.7% of all delivery points at least two days a week	Regulation 5(1)(b) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)

Performance standards — accuracy and speed of delivery

Australia Post must deliver 94% of all reserved service letters within the timeframes in the following table:	Regulation 6 of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)

Address of letter	Delivery time
Letters for delivery intraState:	
(a) within metropolitan area of capital city of lodgment	Next business day after day of posting
(b) within any other city or town of lodgment, or within adjacent town	Next business day after day of posting
(c) outside city or town of lodgment and adjacent towns	2 business days after day of posting
Letters for delivery interState:	
(a) within capital city metro-politan area if lodged in capital city metropolitan area of another State	2 business days after day of posting
(b) within capital city metro-politan area if lodged outside capital city metropolitan area of another State	3 business days after day of posting
(c) outside capital city metro-politan area if lodged in capital city metropolitan area of another State	3 business days after day of posting
(d) outside capital city metro-politan area if lodged outside capital city metropolitan area of another State	4 business days after day of posting

Performance standards — accessibility of services

Australia Post must maintain a lodgement point in Australia for postal articles other than bulk mail at each of its retail outlets	Regulation 8(1)(a) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
Australia Post must maintain at least 10,000 street posting boxes	Regulation 8(1)(b) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
Australia Post must maintain in Australia at least 4,000 retail outlets at which customers can purchase Australia Post products and services	Regulation 9(1) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
At any time, there must be located in places that, are in a rural or remote zone, at least 50% of all retail outlets in operation	Regulation 9(2) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
At any time, there must be located in places that, are in a rural or remote zone, no fewer than 2,500 retail outlets	Regulation 9(2) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
A retail outlet must be located such that in a metropolitan area, at least 90% of residences in the area are located within 2.5 kilometres of a retail outlet	Regulation 9(3)(a) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)
A retail outlet must be located such that in a non-metropolitan area, at least 85% of residences in the area are located within 7.5 kilometres of a retail outlet	Regulation 9(3)(b) of the *Australian Postal Corporation (Performance Standards) Regulations 1998* (Cth)