Australia Post draft price notification for bulk letter services

Preliminary view

May 2011

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Glossary

ACCC	Australian Competition and Consumer Commission
Australia Post	Australian Postal Corporation
APCA	*Australian Postal Corporation Act 1989*
Capital costs	The sum of a return on capital commensurate with the risks faced by the business plus the depreciation of the regulatory capital base
CPI	Consumer Price Index
MAR	Maximum allowable revenue—the amount of revenue a regulated firm should receive that recovers all efficient costs plus a reasonable return on its capital
Operating costs	Non-capital costs
PTRM	Post tax revenue model—this is the form of the financial model used by the ACCC to model the cash flows of a regulated firm
Required revenue	Maximum allowable revenue (see MAR above)
Return of capital	Depreciation
Return on capital	The amount of revenue that an investor would require as compensation for the opportunity cost of funding its capital base, calculated by multiplying the WACC by the depreciated regulatory capital base
ABC	Activity-based costing
SBD	Separate bundle delivery
VOP	Value Optimisation Program
CCA	*Competition and Consumer Act 2010*
WACC	Weighted average cost of capital, which is the reasonable rate of return allowed, given the relative level of risk associated with the capital base, averaged across debt and equity funding

Executive summary

ACCC's preliminary view

The Australian Competition and Consumer Commission's preliminary view is to **not object** to Australia Post's revised proposal to increase charges for PreSort letter services, as well as Clean Mail letters and the annual fee for its Reply Paid Mail service.

Under Part VIIA of the *Competition and Consumer Act 2010* (CCA), Australian Postal Corporation (Australia Post) is required to notify the Australian Competition and Consumer Commission (ACCC) of proposed increases to charges for letter services that are exclusively reserved to it by its statutory monopoly ('reserved services'). The ACCC must then assess the proposed increases and decide whether to object or not object to the proposed charges.

On 25 January 2011, Australia Post provided the ACCC with a draft price notification proposing an increase in charges for bulk mail. The proposal entailed an average increase of 6.6 per cent for Regular PreSort letters, and 3.0 per cent for Off Peak PreSort. Price increases for Clean Mail and the annual fee for Reply Paid are also proposed.

Subsequently, on 16 May, Australia Post provided a revised proposal which reduced the size of the proposed price increases for certain Off Peak services, so that the average price increase for Off Peak would be only 2.1 per cent.

The draft price notification (and the revised draft price notification) does not include any increases to the 60 cent basic postage rate.

This paper represents the ACCC's preliminary view on Australia Post's proposal. The ACCC will make a final decision after Australia Post submits a price notification (locality notice) to the ACCC.

The ACCC expects to release its final decision in June 2011 and is now seeking submissions in response to its preliminary view. Submissions should be provided to the ACCC no later than close of business 14 June 2011.

The ACCC will accept submissions by email or by post. Submissions should be addressed to:

> Mr Anthony Wing
> General Manager—Transport and General Prices Oversight
> Australian Competition and Consumer Commission
> GPO Box 520
> MELBOURNE VIC 3001
> By email: postalservices@accc.gov.au

Australia Post's proposed price restructure is potentially efficiency-enhancing

A key objective of Australia Post's proposal is to encourage the use of the Off Peak PreSort letter service by:

- re-positioning Off Peak as a more attractive option
- increasing the price difference between Off Peak and the Regular PreSort letter service.

Australia Post proposes changes to its Off Peak PreSort letter services to make these services more attractive to its bulk mail customers. Services provided to users of Off Peak products will be improved from the current delivery window of four business days to a delivery window of two business days. These changes increase the certainty of Off Peak services.

In the short-term, Australia Post expects to realise some cost savings for interstate transport as a result of migration from Regular to Off Peak. In the longer term, customer migration to Off Peak services potentially gives rise to greater network flexibility.

There is uncertainty surrounding the level of migration that would occur. Australia Post faces significant information problems in predicting any future cost-saving opportunities that may arise from migration to Off Peak services—especially given the level of doubt surrounding future mail volumes. Submissions from interested parties suggest migration will not occur to the extent Australia Post expects.

However, the ACCC considers the objective of Australia Post's proposal is a step in the right direction to reduce costs. Migration from Regular to Off Peak will potentially give rise to cost-saving opportunities to Australia Post and, therefore, may be efficiency-enhancing.

In response to the ACCC's concerns about the expected level of migration to Off Peak, Australia Post reduced the size of the proposed price increase in the original draft price notification for Off Peak Barcoded Direct Tray prices by over 50 per cent. The revised draft price notification, with its larger gap between Regular and Off Peak, should increase any efficiency gains by increasing the relative attractiveness of Off Peak.

Nevertheless, Australia Post's proposal results in an average increase to domestic reserved letter prices. In order to properly assess the draft price notification, the ACCC has undertaken an assessment of Australia Post's overall costs, revenues, and levels of cost-recovery. Additionally, if the gap between PreSort and Ordinary prices narrows, any concerns about adverse effects on competition need to be examined. Finally, Australia Post's pricing proposal raises questions about the approach to determining the appropriate contribution towards shared costs by reserved services.

Australia Post is under-recovering on costs for reserved services

Australia Post submits that it is continuing to make losses on reserved services and, therefore, it requires price increases to recover costs. Similar to recent price notifications, information provided to the ACCC by Australia Post indicates there is significant pressure on Australia Post's reserved service revenue streams, resulting in a substantial forecast under-recovery for reserved services—based on current cost allocations.

Financial information submitted by Australia Post that includes additional revenue from the proposed price increases indicates Australia Post would under-recover across reserved services as a whole by \$195 million in 2011-12 and by \$✂ million in 2012-13. On the PreSort letter services alone, Australia Post submits that it would be making an operating loss of \$33 million in 2011-12 even after the proposed price increases are implemented.

Although the ACCC accepts Australia Post's claim that it is under-recovering using current cost allocations, Australia Post's estimates may overstate the under-recovery of efficient costs. The ACCC's sensitivity analysis shows that Australia Post's under-recovery for reserved services could be closer to \$21 million in 2011-12 and \$✂ million in 2012-13 under alternative assumptions regarding the WACC, efficient costs, volume mix between Regular and Off Peak, and price elasticity of demand.

Australia Post's current proposal appears to be an outstanding element of the 2010 price notification, which sought price increases to the basic postage rate and bulk mail. The ACCC's 2010 decision was to not object on the basis that Australia Post is forecast to incur substantial losses for reserved services. Australia Post's current proposal for bulk mail only removes some of the losses.

Further, Australia Post submits that the key price for Australia Post's PreSort letter service has only increased by 1.5 per cent (0.6 cents) since 1992 (excluding the impact of the GST). Over the same period, the Consumer Price Index increased by over 60 per cent. Australia Post's revised proposal would increase prices for PreSort letters (including Acquisition Mail and Charity Mail) by 3.4 per cent—that is, an average of 1.4 cents (GST exclusive). Indeed, the Major Mail Users of Australia, whose customers account for roughly 86 per cent of bulk mail volumes, does not object to Australia Post's proposal.

Is Australia Post's proposed structure of prices likely to result in adverse effects on competition?

Bulk mail service users can be thought of as wholesale customers, who may in some sense compete with Australia Post in elements of the mail collection and processing functions—such as sorting and barcoding—required in the broader postal market.

An increase in the prices of PreSort letters without a corresponding increase in the retail price of Ordinary letters reduces the margins available to bulk mailing competitors to Australia Post. If the resulting margin is less than the difference in efficient costs between the two services, this may be regarded as a price squeeze with anti-competitive effects.

Australia Post provided confidential evidence indicating that the average price differences between Ordinary and PreSort are greater than the savings in processing costs.

Based on the limited information available, the ACCC accepts that the proposed price restructure is not likely to result in a price squeeze. Significantly, submissions received by the ACCC did not raise this issue as a concern.

ACCC's preliminary view

The ACCC's preliminary view is to **not object** to Australia Post's revised proposal to increase charges for PreSort letter services, as well as Clean Mail letters and the annual fee for its Reply Paid Mail service.

The ACCC and Australia Post have agreed there needs to be a review of pricing principles prior to the next price notification

There are significant questions about the approach to assessing Australia Post's future pricing proposals, especially given the environment of declining demand for traditional letter services.

The ACCC and Australia Post agree that the current approach to assessing prices, including the allocation of costs, needs to be re-examined—consistent with statements made by the ACCC in its 2010 decision. For example, such a review would include consideration of whether or not it is appropriate to move away from a dual-till approach to promote economically efficient prices and provision of services.

The ACCC and Australia Post have agreed that this needs to occur before another major price notification.

1 Introduction

On 25 January 2011, Australian Postal Corporation (Australia Post) provided the Australian Competition and Consumer Commission (ACCC) with a draft price notification proposing to increase the prices of a number of the letter services that are exclusively reserved to it by its statutory monopoly (‘reserved services’).

Australia Post’s proposal outlines increases in the prices of a number of its reserved services—including its wholesale PreSort letter services, as well as Clean Mail letters and the annual fee for its Reply Paid Mail service. Australia Post also proposes product design improvements for its Off Peak PreSort letter services.

The ACCC takes a consultative approach to its assessment of price notifications, and on 25 February 2011 released an issues paper seeking the views of industry and consumer stakeholders on Australia Post’s 2011 draft price notification proposal.

The ACCC received seven submissions from users (including Major Mail Users of Australia, Australian Direct Marketing Association and Printing Industries Association of Australia), industry associations, and other businesses. The submissions are available on the ACCC website. The ACCC has considered these submissions in its assessment of Australia Post’s 2011 draft price notification.

On 16 May 2011, Australia Post provided a revised proposal under which the price increases for Off Peak Barcoded Direct Tray services would be lower than previously submitted.[1] Price increases for Regular and other Off Peak PreSort services would remain as in the original draft price notification. The effects on average letter prices are noted in section 1.1 below.

1.1 Australia Post’s draft price notification

The particular reserved services affected by Australia Post’s proposal are PreSort letters, Clean Mail and Reply Paid. The draft price notification also details Australia Post’s proposed product design changes for its Off Peak PreSort letter services.

The wholesale PreSort letter service, which accounts for over half of the domestic reserved letter volumes, provides discounted prices for business customers that barcode and sort their letters prior to lodgement. The service offers reduced prices to those customers that sort letters into a particular order, place them into appropriately labelled trays, complete documentation prior to posting at a designated postal outlet, and comply with relevant mailing conditions such as barcoding.

Clean Mail is an ‘end-to-end’ product offered by Australia Post for companies sending more than 300 machine-addressed letters that are not pre-processed. Hence, it is essentially the same as unbarcoded residue letters (unsorted) within a larger delivery for PreSort.

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1 Letter from Mr Ahmed Fahour, Managing Director and Chief Executive Officer of Australia Post, to Commissioner Dimasi, ACCC, 16 May 2011.

The key price changes of Australia Post's proposal are:

- an average increase of 2.8 cents (GST Exclusive) (or 6.6 per cent) for Regular PreSort
- an average increase of 0.9 cents (GST Exclusive) (or 2.1 per cent) for Off Peak PreSort, as submitted in the revised proposal of 16 May
  - compared with an average increase of 1.3 cents (GST Exclusive) or 3.0 per cent in the original draft notification of 25 January
- as part of the increase to PreSort mail prices, Australia Post is also proposing to increase the prices of Acquisition Mail and Charity Mail
- an increase to Other letter services:
  - an average increase of 2.3 cents (or 4.9 per cent) (GST exclusive) for Clean Mail prices
  - an increase to the Reply Paid annual fee from $65 to $80.

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

For example, Australia Post is proposing the following overall basic letter prices:

- Ordinary letter prices are unchanged at 60 cents
- small Clean Mail letter prices increase from 51 cents to 53.5 cents (4.9 per cent)
- small (PreSort) Regular barcoded direct tray (BDT) (delivered in the state of lodgement) letter prices increase from 42.7 cents to 45.7 cents (7.0 per cent)
- small (PreSort) Off Peak BDT letter (delivered in the state of lodgement) prices increase from 41.6 cents to 41.9 cents (0.7 per cent)
  - compared with the original proposal for an increase to 42.4 cents (1.9 per cent).

The key difference between the above four products is the level of costs saved by the customer for Australia Post. The PreSort (Off Peak and Regular) products are bulk interconnection services, and thus the difference between these prices and the prices of Ordinary letters (e.g. Ordinary, Clean letters) should include avoided transport and processing costs.

Australia Post, to encourage more efficient and flexible use of its postal network, also proposes an improvement in the delivery standards for Off Peak: Australia Post submits that it will now provide a delivery window of two days, compared to the current arrangements of delivery occurring over a possible four day window (Regular PreSort plus three days). Australia Post's proposed Off Peak delivery timeframe is based on a 6pm lodgement and utilises surface/road transport.

The proposed changes in Australia Post's pricing structure, whereby the prices of both Regular and Off Peak services are increasing, will result in additional revenue for Australia Post. Australia Post is expecting to generate an additional $29.2 million in PreSort reserved services revenue under its revised proposal. This represents a reduction of an estimated $4.0 million from its original proposal. The changes to its other letter services (i.e. those not relating to PreSort) are estimated to generate an additional $3.3 million in 2011-12, which would result in a total increase in revenue of $32.5 from the revised proposal in 2011-12.

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

The ACCC's role in the prices oversight of Australia Post's reserved letter services falls within the scope of Part VIIA of the *Competition and Consumer Act 2010* (CCA).

Australia Post's reserved letter services have been declared by the Minister (Treasurer) to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the CCA. As a result of this declaration, to increase the prices of its reserved services, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a locality notice. The ACCC will then assess the proposed increases and decide whether to object or not object to the proposed charges.

The operation of the legislative framework and the ACCC's approach to the assessing draft price notifications are outlined in section 2 and at Appendix B. A more detailed outline is contained in the ACCC's *Statement of Regulatory Approach to Assessing Price Notifications, June 2009,* which is available on the ACCC's website.

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

In reaching its preliminary view on the draft price notification from Australia Post, the ACCC has carried out a public consultation process. On 25 January 2011, the ACCC released an issues paper seeking submissions from interested parties on the proposed price increases by Australia Post. The ACCC received a total of seven submissions from mail users, businesses and members of the public. The ACCC has taken all submissions provided by interested parties into account in its assessment of Australia Post's draft price notification.

1.3 Next steps

The ACCC aims to release its final decision in June 2011 and is now seeking submissions in response to its preliminary view.

Submissions should be provided to the ACCC no later than close of business 14 June 2011.

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

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

Submissions should be addressed to:

Mr Anthony Wing
General Manager—Transport and General Prices Oversight
Australian Competition and Consumer Commission
GPO Box 520
MELBOURNE VIC 3001
By email: postalservices@accc.gov.au

If you have any further questions about the process, or about making a submission to the ACCC, please contact the ACCC's Infocentre on 1300 302 502, or send an email to postalservices@accc.gov.au.

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 and there are aspects of the ACCC's decision which refer to this information to support its views regarding elements of Australia Post's proposal.

Information considered to be commercial-in-confidence is denoted by "✂" or [information removed] 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.

1.5 Structure of the ACCC's preliminary view

The legislative framework and the approach undertaken by the ACCC in applying the legislative criteria are outlined in section 2—Legislative Framework and Regulatory Approach and in more detail at Appendix B.

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

- **section 3 — Australia Post's declining letter volumes**: assessment of the impact of the pricing proposal on PreSort mail volumes and the overall volume forecasts for domestic reserved letter services submitted by Australia Post

- **section 4 — Is Australia Post's cost base efficient?**: assessment of the impact of the pricing proposal on PreSort mail costs and analysis of Australia Post’s claim that its proposed costs are efficient

- **section 5 — Is Australia Post under-recovering?**: assessment of the extent to which Australia Post’s proposed price increases are expected to recover efficient costs using the ACCC’s Post Tax Revenue Model framework

- **section 6 — Would the price structure have anti-competitive effects?**: assessment of Australia Post’s proposed price structure and its impact on competition

- **section 7 — ACCC’s preliminary view**

2 Legislative framework and Regulatory Approach

This section outlines the legislative framework relevant to the ACCC’s assessment of Australia Post’s price notifications.

More detail and relevant legislative instruments are attached at Appendix B.

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

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

- monitoring for the presence of cross subsidies between Australia Post’s reserved and non-reserved services

- assessing proposed price increases for Australia Post’s reserved services (assessing price notifications)

- inquiring into certain disputes regarding the terms and conditions under which Australia Post supplies bulk mail services.

2.1.1 The ACCC is responsible for assessing Australia Post’s price notifications

Australia Post’s reserved letter services have been declared by the Minister (Treasurer) to be notified services and Australia Post to be a declared person in relation to those notified services pursuant to section 95X of the CCA. As a result of this declaration, to increase the prices of its reserved services, in accordance with section 95Z of the CCA, Australia Post must provide the ACCC with a locality notice. The ACCC will then assess the proposed increases and decide whether to object or not object to the proposed charges.

As set out in section 95ZB of the CCA, there is an ‘applicable period’ of initially 21 days within which the ACCC is to make its assessment starting on the day on which the notification was lodged. However, in order to enable the ACCC to form an informed view on price notifications taking account of the views of industry stakeholders and interested parties, the ACCC usually conducts an informal assessment of a draft price notification proposal lodged by a declared firm prior to the lodgement of a locality notice.

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

Appendix B of this preliminary view provides greater detail on the relevant legislative criteria and Ministerial Directions that the ACCC must consider in assessing Australia Post's price notifications.

2.2 Regulatory approach

The ACCC considers that the relevant legislative criteria contained in subsection 95G(7) of the CCA, 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. Prices are then assessed on their ability to achieve total revenue sufficient to recover the total cost of providing an efficient service, including a rate of return commensurate with the risks faced by Australia Post, without achieving excessive or monopoly profits.

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

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

where:

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

and:

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

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

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

2.2.1 Non-reserved services

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

More detail on the appropriate method of allocating Australia Post's costs is included in section 4.1.

2.3 Pricing structure

The building block model may be applied to the reserved services in aggregate, to partially disaggregated service groups or to individual services. Greater degrees of disaggregation within the building block model require higher levels of detail on the allocation of costs to the relevant services/service groups. Where a significant amount of the costs of providing the reserved services are common to multiple services, the allocation of costs among the services becomes less straight-forward. As a result, greater degrees of disaggregation within the building block model may provide little additional information on the efficiency of proposed prices, but rather reflect more on the chosen cost allocation approach.

Consequently, the ACCC does not look to prescribe too fine a level of detail when applying the building block model. In this case, the building block model informs the ACCC on the recovery of efficient costs by service groups – further discrete analysis on the appropriateness of the proposed prices at the individual service level is hence required.

In assessing the structure of prices in a pricing proposal, the ACCC will, where 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 matters set out in Direction 11 and subsection 95G(7) of the CCA. The ACCC will also consider the impact of a change in pricing structure on competition.

3 Australia Post's declining letter volumes

Key Points

- Australia Post has forecast an average annual volume decline of 3.4 per cent for its reserved services over the period 2009-10 to 2011-12.
- For the purposes of this draft price notification, the ACCC accepts the volume forecasts supplied by Australia Post as they appear more broadly consistent with recent trends than the econometric baseline forecasts.
  - The ACCC is particularly concerned that the econometric forecasts are likely to overstate demand as the econometric models do not include downside volume drivers to reflect recent trends towards consolidation, rationalisation and bill presentment substitution.
- Australia Post's assumption that the pricing proposal will lead to a significant migration from Regular to Off Peak PreSort letter services has been questioned. Some major customers of Australia Post do not consider that the product design changes to Off Peak and the price provide sufficient incentive to migrate from Regular to Off Peak services.
  - To encourage more businesses to migrate from Regular to Off Peak, Australia Post reduced the size of the proposed price increase in the original draft price notification for some Off Peak prices by 50 per cent.
- The ACCC considers there is some risk that the share of Off Peak in the PreSort mix may increase at a more modest rate than forecast by Australia Post. Therefore, the ACCC has undertaken some sensitivity analysis based on this assumption, which suggests Australia Post would generate around $16 million in additional revenue in 2011-12.
- On the other hand, Australia Post assumes that its proposed price increases will not lead to a reduction in aggregate letter volumes. The ACCC, however, considers that letter volumes may be responsive to price changes and has undertaken some sensitivity testing that suggests that Australia Post's profit could be around $8 million per annum lower as a result of elasticity effects on volumes and costs.

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 related to its reserved services. 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.

In support of its draft price notification, Australia Post has provided forecasts of volumes for reserved letter services for the period 2010-11 to 2011-12. The ACCC has also been provided, on a confidential basis, with volume estimates for 2012-13. Additionally, Australia Post submitted a consultancy report prepared by Diversified

Specifics titled '*Econometric Validations and Augmentation* January 2011' in support of its proposal. This report is available on the ACCC's website.

This section considers the impact of the pricing proposal on PreSort mail volumes (section 3.1) and the overall volume forecasts for domestic reserved letter services submitted by Australia Post (section 3.2).

3.1 Expected volume impact of PreSort proposal

Australia Post submits that a key objective of its proposal is to encourage the use of the Off Peak PreSort letter service by providing a new delivery timeframe for Off Peak and increasing the price difference between the Off Peak and the Regular PreSort letter services.

In its revised proposal, Australia Post has reduced the size of its proposed price increase for some Off Peak prices by 50 per cent to encourage more businesses to migrate from Regular to Off Peak. As an example, the differential between the prices for Regular and Off Peak small Same State Barcoded Direct Tray letters is currently 1.1 cents (42.7 minus 41.6). Under Australia Post's original notification, this differential would increase to 3.3 cents, while the revised proposal would further increase the price differential to 3.8 cents.

Australia Post submits that the current Off Peak delivery window is often viewed as an inhibitor to the use of Off Peak as it is difficult for customers to plan and co-ordinate other supporting or complimentary activities (e.g. call centre resourcing, alignment with other media channels, etc.).

Australia Post contends that, while the price changes will reduce the effective discount provided to users of the PreSort service relative to Ordinary letters, it is not expected to reduce the incentive for customers to access the PreSort letter service. Australia Post forecast no change to overall (i.e. aggregate) PreSort mail volumes as a result of the proposed prices and product design changes.

The current mix of Regular and Off Peak PreSort mail is 83 per cent Regular and 17 per cent Off Peak, but Australia Post is forecasting the new delivery timeframe for Off Peak and the increased price differential will result in a new mix of 51 per cent Regular and 49 per cent Off Peak.

3.1.1 Australia Post's view

Australia Post in its response to the ACCC Issues Paper noted that it has consulted with a broad selection of customers on the proposed price changes and improvements to product design prior to finalising the proposed changes in the draft price notification. Australia Post argues that its proposed changes to Off Peak PreSort incorporate comments that it had received from customers as part of its consultation process.

Australia Post states that it was aware that:

> … the uncertainty that the current Off Peak delivery window provides (i.e. delivery over a four day window) is one of the main inhibitors to customers using Off Peak. As such, Australia Post's proposal included a two day delivery window.[2]

Australia Post also submits that following consultation with its customers it changed its lodgement time from 12 noon to 6pm.

> The majority of customers consulted provided feedback and while there were three main areas of concern, the 12 noon lodgement time was the major one. In particular for mail houses, where production is generally geared to a 6pm lodgement time and changes to business processes and systems (e.g. separate files, impact on production schedule and service level agreements) would be costly.[3]

Australia Post also identified the process it had gone through to estimate migration from Regular to Off Peak. To estimate the level of migration, Australia Post indicated that it:

- undertook analysis at the customer/industry segment level to understand current behaviour and predict future behaviour
- made assumptions around the likelihood of whether Off Peak would be suitable for a particular letter type.

Australia Post also supplied the ACCC on a confidential basis with additional internal working documents outlining how it had estimated the migration to Off Peak.

3.1.2 Views of interested parties

The ACCC received seven submissions on Australia Post's draft price notification from major mail users, industry associations, and other businesses.

MMUA Submission

The Major Mail Users of Australia (MMUA), whose customers account for roughly 86 per cent of bulk mail volumes, does not object to Australia Post's proposal and has also noted that Australia Post is seeking to improve the Off Peak service.[4]

MMUA submits that Australia Post undertook significant consultation with MMUA. In particular, technical matters have been discussed between MMUA members and Australia Post, and concerns were addressed or explained to members' satisfaction.

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2 Australia Post, *Australia Post Response to ACCC Issues Paper*, 16 March 2011, p. 6.

3 Australia Post, *Australia Post Response to ACCC Issues Paper*, 16 March 2011, p. 6.

4 MMUA, *Submission to the ACCC Australia Post's 2011 Draft Price Notification Issues Paper*, 16 March 2011, p. 2.

MMUA notes that its members report that while price is an important factor in terms of users migrating from Regular to Off Peak mail, 'time sensitive mail is destined for Regular Mail as the over-riding deciding factor'.

According to MMUA, increases in postage prices will work to further drive Australia Post's high-volume mail customers across to the e-communications now available. MMUA also claims paper-mail volumes are being increasingly affected by adaptation of the e-alternatives on offer.

ADMA Submission

Australian Direct Marketing Association (ADMA) submits that continued price increases will result in moves away from the PreSort products as many businesses will move to non-mail channels. ADMA states that:

> … there is a structural adjustment occurring in the economy away from mail towards other, mainly digital, channels … continued price increases will result in less volumes and significantly greater substitution of alternate marketing channels such as online advertising, email, telephone and social media.[5]

ADMA also suggests that the forecast of a slight improvement in volume forecasts if a price increase proceeds is optimistic. ADMA's view is that:

> … a smaller price increase than may be needed in the long term is a better alternative to perhaps lowering the volume forecast and putting prices too high and unnecessarily driving further volume decreases.[6]

According to ADMA, the changes to the design of the Off Peak service are not sufficient to prompt organisations to migrate from Regular to Off Peak PreSort services. ADMA submits the main reason for Off Peak PreSort services not suiting business is that:

- a greater change to Off Peak prices would need to be implemented to cover the costs incurred by organisations if they migrate to the new Off Peak service
- the lack of certainty in delivery times is a significant issue, particularly for direct marketers where timing is crucial to the success of campaigns (especially in rural and regional Australia)
- delays in incoming revenue generated by mail pieces are not offset by the decrease in mail price.

According to ADMA, unless these issues can be resolved with the Off Peak PreSort service 'it will not meet businesses' needs and will not be used because the price incentive is too small'.[7]

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5 ADMA, *Submission to the ACCC Australia Post's 2011 Draft Price Notification Issues Paper*, 6 April 2011, p. 4.

6 ADMA submission, 6 April 2011, p. 5.

ADMA argues that this means business will continue to use Regular mail services and 'volume increases will not transfer to Off Peak rather they will transfer to other non-mail channels'.[8]

According to ADMA, if Australia Post wants to make Off Peak more attractive then further amendments will be required to the design of the service. These would include:

- Australia Post providing greater certainty that mail will be delivered on a specific day
- introducing reporting on delivery times for each State and providing this to customers.

ADMA also submits that Australia Post should develop a pricing structure that provides discounts to high volume users as this would ensure that organisations that may be contemplating moving away from mail or reducing their volumes receive incentives to maintain their current volume of mail.

Centrelink Submission

Centrelink indicated its view was that it did not think that the increase in the price of Off Peak letter services and the proposed price differentials with Regular PreSort letter services was appropriate.[9]

Centrelink argues that in the short term it was not intending to migrate any of its mail from Regular PreSort to Off Peak PreSort letter services. This is because:

- the infrastructure that Centrelink would have to put in to enable mail to be 'sorted' from Regular to Off Peak within running jobs, would outweigh the savings
- the service changes to Off Peak will result in some mail paths having a longer delivery time, especially delivery from state-to-state
- Centrelink already uses Off Peak services for magazines as these are not time critical but this is only 1 per cent of Centrelink's output.

According to Centrelink, the price changes to PreSort mail will involve a considerable expense, with no improvement in service delivery.

Centrelink suggests that, rather than spending more taxpayers' money to fund more infrastructure to use Off Peak, it is likely to 'ramp up the work to reduce paper mail and

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7 ADMA submission, 6 April 2011, p. 5.

8 ADMA submission, 6 April 2011, p. 5.

9 Centrelink, *Submission to the ACCC Australia Post's 2011 Draft Price Notification Issues Paper*, 15 March 2011, p. 1.

provide customers with other forms of communication rather than mail. This in turn will reap a saving for Centrelink and the Government'.[10]

POAAL Submission

Post Office Agents Association Limited (POAAL) argues that Australia Post's proposed changes may lead to further migration from Regular PreSort mail. However, POAAL suggests 'for [migration to increase to] nearly half of the PreSort mail volume will take some time to achieve'.[11]

POAAL notes that feedback from its members suggests that the lack of certainty around mail delivery timetables is a disincentive for using the current Off Peak service, especially for organisations using the service for billing and marketing programs.

POAAL also considers that the 'Off Peak mail service is probably vulnerable to migration to electronic delivery formats' but the 'commitment to a more certain delivery standard will be a good incentive for organisations to migrate to the new Off Peak service'.

PIAA Submission

Printing Industries Association of Australia (PIAA) has suggested that Australia Post should aim to improve its Off Peak mail service. According to PIAA, Australia Post should 'reduce the cost of the Off Peak mail service, reduce the turn around from 3 to 2 days and keep [Regular] mail at the existing price'.[12]

PIAA also argues that as 'postage remains the main cost associated with mail house related jobs, any price increases will trigger adverse impacts such as further volume reductions'.[13]

PIAA suggests that as mail volumes continue to decrease, Australia Post is able to deliver envelopes in a shorter time span than before which 'weakens the case advanced by Australia Post to shift more mail volume from Regular towards Off Peak'.[14]

3.1.3 ACCC's view on the expected volume impact of PreSort proposal

On balance, the ACCC considers that Australia Post has provided a reasonable level of transparency about the assumptions underpinning its migration forecasts and accepts them for this pricing proposal.

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[10] Centrelink submission, 15 March 2011, p. 1.

[11] POAAL, *Submission to the ACCC Australia Post's 2011 Draft Price Notification Issues Paper*, 16 March 2011, p. 1.

[12] PIAA, *Submission to the ACCC Australia Post's 2011 Draft Price Notification Issues Paper*, 17 March 2011, p. 3.

[13] PIAA submission, 17 March 2011, p. 3.

[14] PIAA submission, 17 March 2011, p. 3.

The ACCC considers that there appears to be a level of support from some of Australia Post's customers for the proposed product design changes to Off Peak on the basis that they provide a more certain delivery window for users of this service.

However, some major customers of Australia Post do not consider that the price and product design changes to Off Peak provide sufficient incentive to migrate from Regular to Off Peak services.

The ACCC considers, based on comments from some of Australia Post's major customers, that there is some risk that Australia Post may not achieve the significant migration levels from Regular to Off Peak.

The ACCC has for example considered POAAL's suggestion that it may take some time for Australia Post to achieve the significant migration levels from Regular to Off Peak and that PreSort mail volumes are also vulnerable to migration to electronic delivery formats.

The ACCC notes Australia Post's assumption that any bulk mail customers that are intending to migrate to Off Peak will do so in the first year after its proposed price changes and product design changes are implemented.

The ACCC's view, based on comments from some Australia Post customers, is that this migration may take longer to occur and that some customers might not migrate from Regular to Off Peak and will instead choose another service such as electronic mail.

The ACCC considers that Australia Post's proposal for a smaller price increase for some Off Peak services will provide further encouragement for migration from Regular to Off Peak.

However, as noted above, the ACCC's assessment is that migration may proceed at a more modest rate than forecast by Australia Post. Accordingly, in sensitivity testing in its financial model, the ACCC has assumed that the share of Off Peak in the PreSort mix increases to 27 per cent (rather than 49 per cent) in 2011-12 and to 37 per cent in 2012-13, as outlined in section 5.2.3. This would result in around $16 million of additional revenue in 2011-12 above that forecast by Australia Post.

Given this situation the ACCC will need to consider information about the actual levels of migration from Regular to Off Peak as part of its assessment of any future pricing proposal from Australia Post.

3.2 Australia Post's forecast letter volumes

3.2.1 Australia Post's forecasts

Australia Post states that since the 2010 notification was prepared 'the level of volume decline has eased and the overall economic environment has improved. It is in this new environment that we have considered the proposed price changes'.[15]

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15 Letter from Mark Pollock, Australia Post to Anthony Wing, ACCC dated 18 February 2011

In support of its current pricing proposal Australia Post has provided the ACCC with forecasts of volumes for reserved letter services for the period 2009-10 to 2012-13.[16]

Australia Post's draft notification forecasts that reserved services letter volumes will fall by an average of 3.4 per cent per annum over the two years to 2011-12 and the three years to 2012-13. By comparison, Australia Post's 2010 price notification forecast an annual average fall in letter volumes of 3.5 per cent per annum or 0.1 per cent lower than the current forecast over the two years to 2011-12.[17]

Table 3.1 below contains a comparison between Australia Post's forecast reserved services letter volumes provided in the 2010 price notification and the current draft price notification.

Table 3.1 Australia Post's forecast reserved services letter volumes provided in 2010 and 2011 [18]

	2009-10	**2010-11**	**2011-12**	**2012-13**
Letter volume forecast (million) 2011 draft price notification	3 877	3 749	3 619	3 491
Letter volume forecast (million) 2010 price notification	3 865	3 730	3 599	NA

Chart 3.1 below provides a comparison between the volume forecasts provided by Australia Post as part of its 2011 draft price notification and its 2010 price notification for its four major reserved letter categories (PreSort small, PreSort large, Other small, Other large).

Australia Post's 2011 forecast volumes for its domestic reserved letter services over the period 2009-10 to 2011-12 indicate:

- small Other (including Ordinary) letter volumes are expected to decline by an annual average of 5.1 per cent
- small PreSort letters are expected to decline by an annual average of 2.0 per cent

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16 Australia Post's 2012-13 volume forecasts were supplied to the ACCC on a confidential basis in response to an ACCC information request.

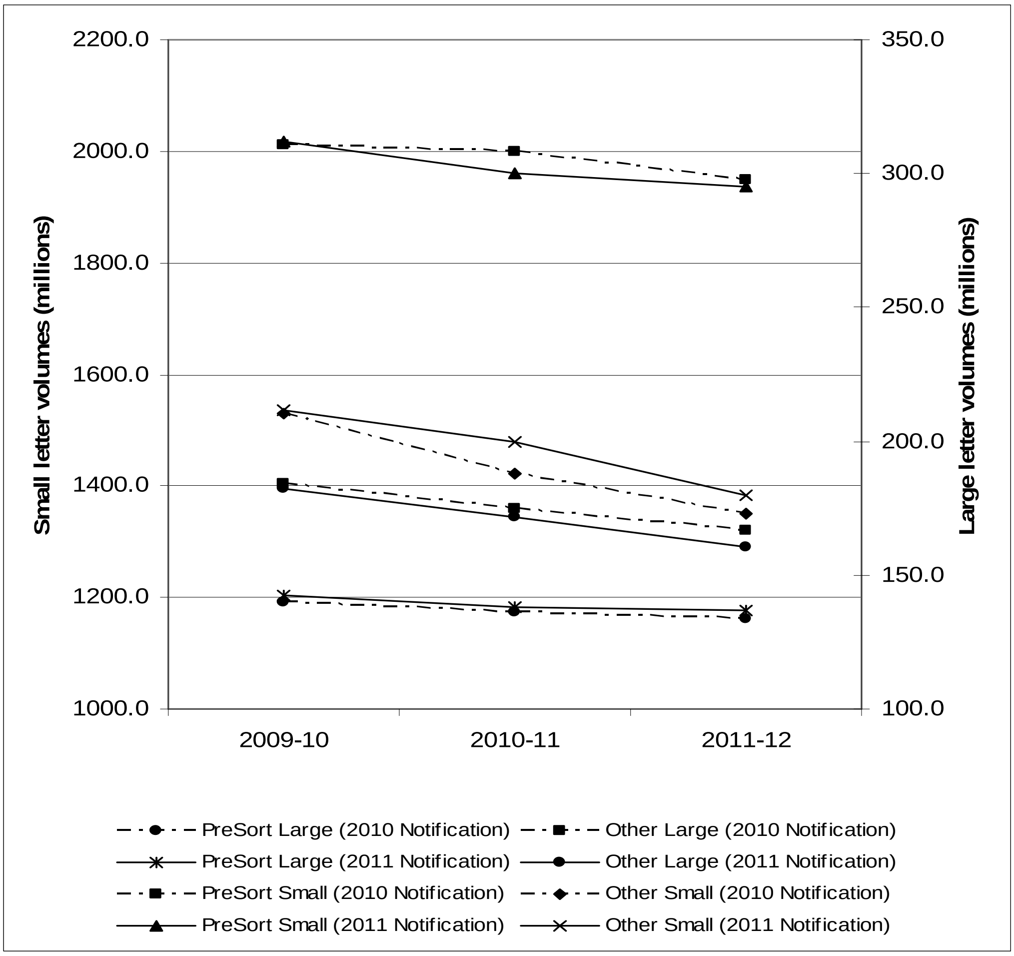
17 Australia Post's 2010 price notification included a forecast of 2009−10 reserved service letter volumes whereas its 2011 draft price notification contains actual 2009−10 reserved service letter volumes.

18 Source: Australia Post's 2010 price notification, p. 34 and 2011 draft price notification, p. 40.

- large Other (including Ordinary) letters are expected to decline by an annual average of 6.1 per cent

- large PreSort letters are expected to decline by an annual average of 2.0 per cent.

Chart 3.1 Comparison between Australia Post's forecasts provided in 2010 and 2011[19]



Australia Post has also provided forecast volumes for each of its domestic letter segments (transactional, promotional, and social) over the period 2009-10 to 2011-12. These forecasts indicate that transactional and social mail volumes are expected to decrease while promotional mail volumes are anticipated to increase.

3.2.2 Australia Post's forecasting methodology

Australia Post has broadly described its methodology for forecasting volumes as a two part process involving:

- econometric models providing baseline volume forecasts

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19 Source: Australia Post's 2010 price notification p. 34. & 2011 draft price notification, p. 40.

- augmentation of the baseline forecasts to incorporate management opinion and further market intelligence.

Australia Post notes that the econometric models that provide the baseline forecasts have been developed by Diversified Specifics and combine both short-run and long-run behaviour utilising Vector Error Correction Modelling (VECM) techniques.

Diversified Specifics generates four dynamic models that are then used to forecast the following letter segments individually:

- small letter PreSort
- large letter PreSort
- small letter Ordinary/Other
- large letter Ordinary/Other.

Each letter segment model has statistically significant volume drivers. Australia Post notes that for:

- small and large letter PreSort letters, domestic non-farm GDP and the health of the advertising industry index are statistically significant positive volume drivers
- small letter Ordinary/Other, cheque volumes (which capture the behavioural change in bill payment practices away from mail towards electronic alternatives) and price are negative volume drivers
- large letter Ordinary/Other, domestic non-farm GDP is a positive volume driver.

Australia Post's final forecasts are derived by augmenting the baseline econometric forecasts. This is necessary as according to Australia Post while the models themselves reflect worlds best practice, they do have limitations and do not incorporate some emerging trends known to be impacting letter volume demand.

Australia Post argues that:

> … with the exception of Small letter Ordinary/Other, the set of econometric models lack a sufficient number of downside drivers despite a widespread acceptance throughout the postal industry that letter volumes are in decline.[20]

Australia Post also notes that the econometric forecasts for 2009-10 over-estimated actual aggregate letter volumes by around 3 per cent.

Australia Post has provided some information to the ACCC on a confidential basis in relation to its augmentation of the baseline econometric letter volume forecasts. It also

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[20] Australia Post's 2011 draft price notification, p. 14.

notes that it ‘is working towards improving the transparency of the augmentation process in future forecasts’.[21]

Australia Post advises that it requested its consultant Diversified Specifics to prepare a report on the need for augmentation given a number of one-off events (such as the federal election) have recently occurred to directly impact the divergence between actual volumes and the econometric forecasts.

Diversified Specifics notes that for PreSort small letter volumes, which is the largest single major letter category, the econometric forecasts are based on historical associations and miss very recent trends towards consolidation, rationalisation and bill presentment substitution.[22]

Diversified Specifics also suggests that:

> … future letter volume fluctuations cannot be expected to mirror empirical movements across the forecast period as there may be a number of one-off events and emerging trends that will also have an impact on actual volumes.[23]

3.2.3 ACCC’s view on Australia Post’s forecasts and forecasting methods

In considering Australia Post’s 2010 price notification, the ACCC concluded that Australia Post had significantly improved the sophistication of its demand forecasting methods. However, it noted that some transparency issues remained in relation to Australia Post’s adjustments to econometric forecasts based on management opinion and market intelligence.

Notably, the reserved services volume forecasts submitted by Australia Post for this draft price notification are broadly similar to those it submitted as part of its 2010 price notification.

Australia Post’s approach to estimating letter volumes

For the purposes of this draft price notification, the ACCC accepts the volume forecast supplied by Australia Post as they appear more consistent with recent trends than the econometric baseline forecasts.

In its 2010 decision, the ACCC considered that the volume forecasts derived from Australia Post’s statistical model were appropriate. However, the ACCC assessed that Australia Post had not adequately explained the augmentation of its statistical letter volume forecasts using market intelligence and management insight. As a result, the ACCC took into account both adjusted and unadjusted forecasts when assessing if the proposed prices would achieve sufficient revenue to recover efficient costs.

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[21] Australia Post’s 2011 draft price notification, p. 14.

[22] Diversified Specifics, *Econometric Validations and Augmentation* January 2011, p. 2.

[23] Diversified Specifics, *Econometric Validations and Augmentation* January 2011, p. 4.

However, for the purposes of the current draft price notification, the ACCC considers there are some significant issues about using the unadjusted volume forecasts from the econometric model and therefore was not able to rely on them. For example:

- The econometric forecasts for PreSort mail assume continued volume growth for this category of mail in 2011-12. In contrast, the volume forecasts submitted by Australia Post, which suggest a continued decline in PreSort mail, appear to represent a more reliable forecast of letter demand, as they are more consistent with recent trends.

- The econometric forecasts are likely to overstate demand as the econometric models lack a sufficient number of downside volume drivers to reflect recent trends towards consolidation, rationalisation and bill presentment substitution.

The ACCC also considers that Diversified Specifics should investigate whether there are any other suitable new technology explanatory variables such as the number of internet connections that could be incorporated into future econometric modelling to reflect the impact of the internet on letter volumes.

Transparency

On the basis of the above, there is a need for augmentation of forecasts from the econometric model in order to produce meaningful letter volume forecasts. Australia Post provided the ACCC with some additional confidential information on augmentation adjustments to its PreSort and Other letter volume forecasts. Based on this information it seems that online billing/payments and consolidation are the main drivers of reductions in mail volumes.

Price elasticity

The ACCC notes Australia Post's assumption that its proposed price increases will not affect aggregate letter volumes. Australia Post argues that letters are inelastic to price[24] and that econometric modelling for PreSort letters has not identified real price as being statistically significant.[25] However, the views of a number of interested parties are that mail volumes are price sensitive and that regular price increases will culminate in reduced volumes and increasing rates of substitution away from the mail medium.

The ACCC considers that there is some support for the view that mail volumes are likely to be responsive to price changes. For example a recent study commissioned by the United States Postal Service Office of Inspector General implies a price elasticity of demand for the US Postal Service of 0.4.[26] A recent Finnish study suggests mail

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[24] Price elasticity of demand is a measure of the responsiveness or elasticity of the quantity demanded of a good or service to a change in its price. In general, the demand for a good is said to be inelastic when the price elasticity of demand is less than one (in absolute value) and changes in price have a less than proportional effect on the quantity of a good demanded.

[25] Australia Post, *Australia Post Response to ACCC Issues Paper*, 16 March 2011, p. 5.

[26] An average price elasticity of demand for the US Postal Service has been implied from: George Mason University School of Public Policy, *Implications of Declining Mail Volumes for the Financial Sustainability of the Postal Service*, September 29 2010, Table 3 p. 15.

volumes may be even more sensitive to price changes and in particular reports price elasticities for business to business mail of around 0.6 and business to consumer mail of around 1.8.[27] These results suggest that demand for mail is not perfectly price inelastic and a price increase is likely to result in a decline in mail volumes.

The ACCC considers that there is a possibility that the proposed price changes may reduce letters volumes. The ACCC's sensitivity analysis, based on an assumed price elasticity of 0.4, shows that Australia Post's profits could be around $8 million per annum lower than its forecasts as a result (outlined in section 5.2.4).

Overall assessment

For the purposes of this draft price notification, the ACCC accepts the volume forecasts supplied by Australia Post which appear broadly consistent with recent trends, but has carried out sensitivity testing which assumes a volume decrease as result of the proposed price increases. Australia Post has also made some progress towards improving the transparency of its demand forecasts. However, the ACCC expects any future price notification to be supported by revised econometric modelling, together with other information that would explain and quantify any augmentation that had been made to the econometric baseline volume forecasts.

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27 Nikali Heikki ,*"Does the Level of Price Elasticity Change with the Progression of Substitution?"* presented at the CRRI Conference on Postal Delivery Economics, Porvoo, Finland, June 2-5, 2010.

4 Is Australia Post's cost base efficient?

Key points

- The key objective of Australia Post's proposal is to encourage the use of the Off Peak PreSort letter services.
- The ACCC considers that migration from Regular to Off Peak is potentially efficiency-enhancing for Australia Post. However, the size of the cost-efficiencies and level of migration to Off Peak is uncertain. At least in the short term, the cost savings are likely to be small.
- As Australia Post's pricing proposal involves across-the-board price increases for reserved bulk letter services, it raises questions about overall revenue and cost-recovery.
- Overall, Australia Post estimates its reserved services operating costs (including depreciation) to be around $1 951 million in 2010-11 and $1 924 million in 2011-12, which are similar estimates to those it submitted in its 2010 price notification.
- However, Australia Post's cost forecasts may be higher than the costs of an efficient postal operator, as estimated by the ACCC. To estimate an efficient cost base, the ACCC made the following adjustments to Australia Post's costs:
  - The ACCC brought forward the savings associated with automated sequencing and separate bundle delivery.
  - The ACCC increased Australia Post's cost-volume variability from 0.14 (based on information provided by Australia Post) to 0.65 (based on international studies).
- After these adjustments, the ACCC estimates Australia Post's efficient reserved services operating costs (including depreciation) to be around $1 832 million in 2010-11 and $1 784 million in 2011-12.
- The ACCC and Australia Post agree that the current approach to assessing prices, including the allocation of costs, needs to be re-examined before another major price notification.

This section considers the efficiency of Australia Post's non-capital costs for its reserved letter services and the cost implications of Australia Post's PreSort proposal in particular.

4.1 The ACCC adopted a cost-based approach to assessing Australia Post's forecast costs

The ACCC has historically assessed price notifications under Part VIIA of the CCA by adopting a cost-based approach.[28] The appropriateness of proposed prices is assessed by the extent to which they are forecast to recover the efficient costs of providing reserved letter services. Prices that recover efficient costs of providing reserved services will typically ensure that Australia Post:

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

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

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

Since Australia Post's proposal results in an average increase to domestic reserved letter prices, the ACCC, in assessing the efficiency of Australia Post's operating costs for this draft price notification, considered:

- the composition of Australia Post's operating costs and changes in the components of these costs (Australia Post's operating cost estimates are summarised in section 4.2).
- the forecast impact of the PreSort proposal on Australia Post's operating costs and the flexibility of its cost base (section 4.3).
- Australia Post's efficiency initiatives and the relationship between costs and volumes (section 4.4).

4.1.1 Cost allocation

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

[28] ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009, p. 15.

Where a ‘dual-till’ approach to regulation is applied, a separation needs to be made to these shared costs into the portion used in providing the reserved services and the portion used in providing the non-reserved services. This allows the building block model to be applied specifically to the reserved component of Australia Post’s business.

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

In assessing Australia Post’s 2002 price notification the ACCC decided to adopt a dual-till approach to assessing Australia Post’s reserved services. The dual-till approach was maintained by the ACCC in assessing Australia Post’s 2008 price notification and 2010 price notification. The ACCC has maintained this approach for the purpose of the current draft price notification.

To meet the challenges of the current environment, Australia Post intends to diversify its business model. As stated by Australia Post in its 2009-10 annual report, to return the business to profit growth, Australia Post needs to develop new services so as to capitalise on its existing strengths—namely, Australia Post’s trusted brand, reliability, and retail and distribution networks unrivalled in Australia.

Australia Post is becoming increasingly reliant on parcel delivery and on other non-mail services. However, the sustainability and profitability of these services is to an extent dependent on the existence of Australia Post’s fixed mail network. Australia Post could have a competitive advantage in non-reserved services as a result of its reserved service business, and its established network and brand, which it has been able to develop due to its statutory monopoly.

In considering Australia Post price notifications, it may be appropriate for the ACCC to move away from a dual-till approach to promote economically efficient prices and provision of services. Australia Post has an incentive to maximise profits across its entire network. If Australia Post generates revenue in non-reserved services substantially above a competitive-market level because of its statutory monopoly in reserved services, it is possible that Australia Post may be earning monopoly rents overall. Revenue from both reserved and non-reserved services appears to have historically exceeded total costs, including ‘normal’ profits. Under this scenario, further increases in prices for reserved services may not be justified under a single-till approach.

Importantly, the ACCC and Australia Post agree that the current approach to assessing prices, including the allocation of costs, needs to be re-examined before another major price notification. A review of Australia Post’s allocation of costs would include a consideration of whether to maintain the current dual-till approach or move towards a single-till approach.

4.2 Australia Post's 2011 operating costs forecasts are not substantially different from the 2010 price notification

The forecasts provided by Australia Post in support of the current draft price notification do not differ substantially from the 2010 forecasts. The total forecast domestic reserved service operating costs for 2010-11 and 2011-12 are 0.5 per cent and 0.4 per cent respectively below the forecasts submitted in 2010. Australia Post provides information on its operating costs and full time equivalents (FTEs) in section 4 of its draft price notification.

4.2.1 Total operating costs

Australia Post does not expect its forecasts of total domestic reserved letter service operating costs (including depreciation) to change substantially from those that were submitted as part of its 2010 price notification.

Table 4.1 provides a comparison of domestic reserved letter service operating costs (including depreciation) submitted by Australia Post in its 2010 price notification and 2011 draft price notification over the period 2009-10 to 2012-13.

Table 4.1 Comparison of reserved services total operating cost estimates[29]

	2009-10 ($m)	**2010-11 ($m)**	**2011-12 ($m)**	**2012-13 ($m)**	**Average annual change (%)**[30]
2011 draft price notification	2 001[31]	1 951	1 924	✂	-1.9
2010 price notification	1 983	1 961	1 932	NA[32]	-1.3
Difference	+18	-10	-8		

Table 4.2 provides information on major expense categories of Australia Post's submitted operating costs over the period 2009-10 to 2012-13.

29 Source: *Australia Post's 2010 price notification,* Appendix 10*; Australia Post's 2011 draft price notification,* Appendix 2*; Australia Post response to ACCC information request number 3,* February 2011.

30 Calculated over 2009-10 to 2011-12.

31 Australia Post submitted that the PCS costs for 2009-10 were 1993 (0.4 per cent lower than PPM).

32 2012-13 forecasts were not available at the time of the 2010 price notification.

Table 4.2 Breakdown of reserved service costs ($m) 2009-10 to 2012-13[33]

Expense Category	2009-10	2010-11	2011-12	2012-13
Labour	✂	✂	✂	✂
Contract Mail and Licence	✂	✂	✂	✂
Accommodation	97	98	102	✂
Other	394	318	300	✂
Total	2 001	1 951	1 924	✂

4.2.2 Labour

Labour costs are Australia Post's major expense category, accounting for over 60 per cent of costs for its reserved services business. Table 4.2 shows that Australia Post forecasts these costs to decrease by $✂ million or ✂ per cent over the three year period to 2012-13.

Table 4.3 provides a comparison between Australia Post's FTE forecasts submitted as part of the 2010 price notification and the current draft price notification. This shows that Australia Post's FTE forecasts are substantially unchanged from the previous notification. [information removed]

Table 4.3 Australia Post's reserved services FTEs by network function ($m)[34]

[information removed]

4.3 Australia Post's PreSort proposal is expected to enhance efficiency

This section considers Australia Post's PreSort proposal and the impact it is expected to have on Australia Post's costs.

4.3.1 Australia Post's views

Australia Post submits that its proposal is part of an initiative of restoring a self-sustaining letter business, one of the three strategies identified as part of its Future Ready program.[35] Australia Post submits that the need to restore the letters business to self-sustaining level is essential, as indefinitely continuing a service that does not generate a (reasonable) rate of return is inherently inefficient for Australia Post.

33 Source: *Australia Post response to information request number 3*, February 2011.

34 Source: *Australia Post response to information request number 3*, February 2011.

35 Australia Post, *Response to ACCC Issues Paper, March 2011*, p. 4.

Australia Post submits that its proposed pricing restructure is efficient and is aimed at improving the flexibility of Australia Post's cost base in the longer term.

Australia Post's PreSort letter service offers a Regular and an Off Peak delivery standard. The Regular PreSort delivery standard is aligned to the Ordinary letter delivery standard for market and operational reasons. The current Off Peak PreSort delivery standard is Regular plus up to an additional three days (i.e. it provides a four day delivery window).

The key objective of the proposed changes is to encourage greater use of Off Peak over Regular PreSort letters. Australia Post proposes to achieve this through changes to price and improvement to product design.

Australia Post submits that, by adjusting the pricing in the manner proposed, it can address both revenue and cost issues simultaneously:

- Customers who choose to remain with Regular will provide more revenue towards covering the efficient costs and achieving a reasonable rate of return.
- Customers who elect to use Off Peak will provide Australia Post with the opportunity to explore longer term benefits through variations to the current network.

Australia Post suggests that, in 2011-12, it expects to realise some cost savings (for interstate transport) as a result of the migration from Regular to Off Peak (i.e. use of surface/road). For example, where a customer moves from Regular to Off Peak, this could mean mail is transported by surface transport rather than by air carriage.

Further, Australia Post submits that, as the use of Off Peak increases, it is expecting that there will be opportunities to explore variations to the current network arrangements. At a high level, Australia Post is expecting some future cost-saving opportunities to occur [information removed].

4.3.2 Views of interested parties

Submissions from interested parties have not raised major concerns with the efficiency impacts of the proposal, although there is some doubt about whether Australia Post's proposal will have the desired cost effects. In particular, stakeholders have expressed some scepticism about whether businesses will take up migration from Regular to Off Peak to the extent predicted by Australia Post (as discussed in section 3), and thus some of the efficiency impacts may not eventuate. Further, stakeholders have raised some concerns about whether these cost benefits will be realised even if the forecast rate of migration is indeed accurate.

In particular, Centrelink notes that any efficiencies would be dependant on mail generators migrating to the Off Peak service. Even if mail generators migrate their mail volumes, Centrelink is uncertain as to how Australia Post's proposal is going to result in cost savings or additional network flexibility and notes that:

> [Australia Post] are putting up their prices and delivering 'some' Off Peak mail in shorter time frames. The changes that mail generators are required to make far outweigh the network flexibility/cost savings that [Australia Post] is expecting.[36]

PIAA submits that it opposes the proposal, and notes that, in terms of Australia Post's costs flexibility:

> Australia Post's automated equipment and/or systems are designed to handle larger volumes of envelopes but as envelope volumes continue to decrease this means that Australia Post has the ability to deliver envelopes in an even shorter time span then before. The presence of this greater capacity for regular mail also weakens the case advanced by Australia Post to shift more mail volume from [Regular] towards [Off Peak].[37]

PIAA also suggests that Australia Post's proposal fails to compensate mail generators for helping improve the efficiency of Australia Post's transport, logistics and delivery networks by encouraging more mail to go through the 'quieter times'; in fact, PIAA submits that there is a general penalty in the form of the overall price increase.[38]

In respect of whether Australia Post will benefit from cost savings from the PreSort proposal, MMUA submits that it has outlined elements in its previous submissions where Australia Post may be able to achieve cost savings and notes that:

> [the] inability—or unwillingness—of [Australia Post] itself to enter into proper 'technical' exploration of these matters suggests to MMUA an entrenched 'we know best and don't need your help' attitude that permeates the organisation—and so, to answer this question we can only say … not on the basis of the post-BMP Launch experiences we have had with [Australia Post].[39]

However, the MMUA does not object to Australia Post's proposal and has also noted that Australia Post is seeking to improve the Off Peak service.

POAAL was of the view that the proposal is not likely to result in improved flexibility in managing volumes around peak and off-peak periods once mail has entered the mail sorting processes.[40]

In terms of Australia Post's cost base, POAAL suggested that the migration from Regular to Off Peak is likely to result in cost savings for Australia Post:

> [if], as suggested, more mail can be sent by rail or road rather than using the sharply increasing airline cargo costs this will benefit Australia Post.[41]

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[36] Centrelink, *Centrelink response to Postal Increases*, March 2011, p. 2.

[37] PIAA, *PIAA's feedback regarding Australia Post's draft price notification business letter pricing 2011*, March 2011, p. 3.

[38] PIAA submission, March 2011, p. 4.

[39] MMUA, *Comments on ACCC's issues paper*, March 2011, pp. 3-4.

[40] POAAL, *POAAL Submission – Australia Post Price Notification*, March 2011, p. 2.

[41] POAAL submission, *March 2011*, p. 2.

4.3.3 ACCC's view on Australia Post's PreSort proposal

Australia Post should have incentives to price efficiently to maximise the usage of its mail network and reduce its costs.[42] Further, Australia Post's letter services are increasingly being affected by electronic substitutes, and the erosion of volumes as a result of substitution places an additional incentive on Australia Post to ensure that it is utilising its mail network efficiently.

The ACCC accepts that migration from Regular to Off Peak may improve Australia Post's network flexibility in the longer term. Achieving this would be a more efficient outcome for Australia Post.

The ACCC also notes the difficulty faced by Australia Post in predicting any future cost-saving opportunities that may arise out of the migration. This difficulty is compounded by the uncertainty surrounding the level of migration that would occur and the potential impacts on overall PreSort volumes (discussed in section 3). However, it appears that the cost savings, at least in the short term, are likely to be relatively small.

As noted in section 3, for the purposes of this draft price notification, the ACCC accepts the volume forecasts supplied by Australia Post, which appear broadly consistent with recent trends. The ACCC is similarly prepared to accept that the proposed PreSort price differentials and product design changes appear to be efficiency-enhancing.

However, the ACCC will monitor Australia Post's progress in achieving any network flexibilities that arise as a result of the migration from Regular to Off Peak PreSort as part of any subsequent price notification.

4.4 The efficiency of Australia Post's cost base

The following section considers the efficiency of Australia Post's cost base. In particular, the ACCC considered the composition of Australia Post's operating costs, the relationship between Australia Post's costs and letter volumes, the changes in the components of these costs, and Australia Post's efficiency initiatives.

4.4.1 Australia Post's views

Australia Post has undertaken a fundamental review of its business model to ensure it is a sustainable business that can continue to meet its CSOs.[43] This review also considered Australia Post's strategic objectives and identified a key corporate strategy of restoring a self-sustaining letters business. As part of this strategy, Australia Post aims to:

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[42] There should be strong incentives to reduce non-reserved services costs as Australia Post's non-reserved business is subject to competition and not subject to regulatory oversight for pricing. While the cost reduction incentives for a regulated monopoly are likely to be weaker, a large proportion of Australia Post's network costs are shared by its reserved and non-reserved letter services—thus it may practically be unable to reduce its non-reserved mail costs without reducing its reserved costs.

[43] Australia Post, *Response to ACCC Issues Paper, March 2011*, p. 11.

- continue to seek efficiency improvements and reduce costs
- ensure our letter products continue to meet customer requirements
- seek moderate regular price increases.

Australia Post has undertaken two key efficiency initiatives—Future Delivery Design (FDD) and Value Optimisation Program (VOP).

In 2010, Australia Post expected forecast savings associated with its FDD program out to 2013-14 to be $69.8 million.[44] Australia Post now submits that the latest forecast savings, based on final approved business cases, are now $65.4 million. The key reason for the difference in forecasts is the decrease in forecast savings from separate bundle delivery (SBD) on motorcycles (see pp. 21–24 of Australia Post's current draft price notification).

Australia Post also advised in 2010 that the reduction in its labour usage was mainly being driven by its VOP.[45] Australia Post submitted that VOP is expected to be fully implemented by December 2011.[46] [information removed]

In its 2010 price notification a $✂ million redundancy provision relating to VOP was included in Australia Post's 2009-10 financial estimates for the business as a whole. This redundancy provision has been revised in the current pricing proposal. The 2009-10 accounts now show a redundancy expense of $150 million. This provision included $✂ million allocated to reserved services[47] (see p. 17 of the current draft price notification).

4.4.2 Views of interested parties

Centreforce submits, in respect of Australia Post's cost base, that it accepts that the cost of sending a letter has increased, but notes that:

> Australia Post like any other business must review its costs and reduce them in the face of reduced business. The simple solution of a price increase is not the answer.[48]

PIAA submits that Australia Post should consider savings from centralised delivery boxes in order to decrease its operating costs associated with delivery:

> Australia Post informs us one of the biggest costs is associated with the last hand delivery by the postman. A legitimate question would be what percentage of the delivery points are post boxes which require no such cost? … Also what proportion of the increase in delivery points over the last 10 years have been post boxes? … With Australia Post in the process of testing

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[44] Australia Post, *2011 draft price notification*, p. 21.

[45] ACCC, *Australian Postal Corporation 2010 Price Notification: Decision*, May 2010, p. 59.

[46] Australia Post, *2010 price notification confidential version*, p. 18.

[47] Information provided to the ACCC on a confidential basis.

[48] Centreforce, *Submission to ACCC issues paper*, March 2011.

> centralised delivery boxes at new housing estates – the question has to be asked if they have factored in any of the associated savings?[49]

MMUA submits that:

> We are … of the opinion that technical, production line opportunities to make [Australia Post's] own operations and [Australia Post's] interface with its Bulk Mail Partner accredited mailing houses remain untapped and of no interest to the powers-that-be within [Australia Post] responsible for such matters. …
>
> Rewarding [Australia Post] with yet another price increase under such circumstances is not good business practice in a shrinking market.[50]

ADMA submits that the ACCC should ensure:

> … that every avenue in terms of cost reduction has been pursued vigorously by Australia Post as an alternative to increasing the price of PreSort services.[51]

ADMA also notes that:

> Australia Post has pointed to the increase in multiple delivery points as a key factor necessitating an increase in prices. ADMA would like to see additional information and examination of whether these delivery points are more concentrated and the impact that this has on the cost of mail.[52]

POAAL suggests that the price increases are reasonable, in that 'this proposal simply starts to share more effectively the burden of increasing costs with business operators and the need to recover those costs over declining mail volumes'.[53]

4.4.3 ACCC's view on the efficiency of Australia Post's cost base

In the ACCC's assessment of Australia Post's cost base, the presence of an under-recovery of reserved services costs by Australia Post does not necessitate the need for price increases.

As stated by the ACCC in 2010, a number of other considerations are relevant. For example, emphasising pre-existing cost forecasts in subsequent notifications provides incentives for Australia Post to reduce costs below forecasts and find innovative service provision solutions.[54] Creating the strongest economic incentives—in particular

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49 PIAA, *PIAA's feedback regarding Australia Post's draft price notification business letter pricing 2011*, March 2011, p. 4.

50 MMUA, *Comments on ACCC's issues paper*, March 2011, p. 3.

51 ADMA, *Submission to the ACCC on Australia Post's draft price notification issues paper*, March 2011, p. 2.

52 ADMA submission, March 2011, p. 6.

53 POAAL, *POAAL Submission – Australia Post Price Notification, March 2011*, p. 2.

54 ACCC, *Australian Postal Corporation 2010 Price Notification: Decision,* May 2010, p. 103.

efficiency and investment incentives—is an important task for the ACCC in assessing Australia Post's pricing proposals. This task is especially pertinent given:

- the difficulty for the ACCC of trying to ascertain with a level of confidence the efficiency and reliability of Australia Post's reserved services forecast costs, especially in light of transparency concerns

- the lack of a relevant benchmark (i.e. Australia Post is the only Australian monopoly postal operator, facing a different postal landscape to international postal operators)

- the bulk of Australia Post's mail network costs are utilised by both reserved and non-reserved services, and are allocated by Australia Post's activity-based costing (ABC) system.

The ACCC has in previous assessments expressed concerns about the efficiency of Australia Post's cost base. To estimate Australia Post's efficient costs, the ACCC has previously made certain adjustments to Australia Post's submitted model. For example, the ACCC brought forward savings associated with automated sequencing and SBD and assumed a higher cost-volume variability than implied in information submitted by Australia Post.

This section assesses the impacts of Australia Post's main costs reduction initiatives and the ACCC's cost-volume variability assumptions on the ACCC's modelling for the current draft price notification.

Australia Post's costs reduction initiatives: separate bundle delivery

Australia Post's current pricing proposal suggests that the efficient savings from the implementation of SBD out to 2013-14 are $✂ million, which is approximately $✂ million less than the $✂ million estimated by Australia Post in 2010.[55] The ACCC has made the relevant adjustment to account for this as part of its current modelling (see section 5.2.2, adjustment 2). In making this adjustment, the ACCC accepted Australia Post's claim that the savings from SBD are likely to be lower than initially forecast because additional outdoor delivery time is required to enable the motorcycle rider to complete their delivery duties.

The ACCC's 2010 view was that if Australia Post had previously invested in sufficient automated sequencing equipment (as a number of other countries had already done), all delivery rounds suitable for sequencing could already be sequenced.[56] If this had occurred Australia Post would already be benefiting from the forecast savings in operating costs, and it could be argued that these savings would include savings from the implementation of SBD across all sequenced mail rounds.

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[55] Australia Post, *2011 draft price notification, confidential version*, p. 27.

[56] ACCC, *Australian Postal Corporation 2010 Price Notification: Decision,* May 2010, p. 68.

Relationships between costs and volumes (cost-volume variability)

Consistent with the approach the ACCC adopted in its consideration of Australia Post's 2010 price notification, the ACCC has made an assessment about what it considers an efficient cost response to a decline in letter volumes.

The ACCC assessed what Australia Post's cost reduction would be, based on increasing Australia Post's volume variability of costs from 0.14 to 0.65, reflecting an average estimated volume-variability for overseas postal providers (i.e. for every 1 per cent reduction in volume, the ACCC estimates that Australia Post should achieve a 0.65 per cent reduction in operating costs) (see section 5.2.2, adjustment 2).

The relationship between Australia Post's costs and volumes is an important consideration for the ACCC, especially given the current environment of declining volumes. In particular, the ACCC is interested in whether Australia Post is undertaking adequate steps to ensure that its costs are responsive to volumes.

Australia Post provided updated information in its current draft price notification on the relationship between its costs and volumes. Specifically, this information is included in section 4.8 of the draft price notification and in a memo by Economic Insights provided in support.[57] Box 4.1 below provides a summary of information on cost-volume variability submitted by Australia Post.

Box 4.1: Cost-volume variability information provided by Australia Post

In its 2010 price notification, Australia Post provided information that suggested that its cost-volume variability is 0.14.[58] Australia Post argued that the variability of cost with respect to volume is of the order of 0.3 for delivery and 0.25 for processing (i.e. this suggests that Australia Post's cost-volume variability is 0.14). Thus, Australia Post's view was that costs do not vary significantly with volumes (i.e. a 1 per cent change in volumes is accompanied by a 0.14 per cent change in Australia Post's costs).

Australia Post submits that, for the purpose of the current draft price notification, it is retaining the cost-volume variability assumptions it advised in its April 2010 notification.[59] Australia Post also relies on a memo by Economic Insights, which responds to international studies cited by the ACCC's economic consultants Frontier Economics as part of Australia Post's 2010 price notification process. In particular, the memo notes potential issues in terms of reliability and comparability of the studies referred to by Frontier Economics in 2010.

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[57] Economic Insights, *Memorandum: review of US and UK studies quoted by ACCC and Frontier Economics*, p. 6, December 2010.

[58] Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, May 2010, p. 29.

[59] Australia Post, *2011 draft price notification*, p. 19.

In its 2010 Decision, the ACCC found that 0.14 was a low cost-volume variability compared to international studies, which have shown that overseas postal providers have estimated volume-variability of costs of between 0.6 and 0.7.[60]

Australia Post, which commenced an econometric assessment of its potential cost-volume variability elasticity prior to the 2010 price notification, has not yet finalised this work.

The ACCC notes that the memo provided by Economic Insights offers little in the way of new information. The ACCC recognises that some of Economics Insights' concerns about the individual international studies appear to be valid, and appreciates the reasons proposed for why Australia Post's cost-volume elasticities may be lower than those reported in those studies. However, for Australia Post to rely on claims that its cost-volume variability is 0.5 or even lower, it needs to undertake work to demonstrate reasons for its claims. As stated by Frontier in 2010, until 'this work is complete, it is difficult to comment on the validity of the cost-volume elasticities claimed' by Australia Post and Economic Insights.[61]

The ACCC notes stakeholders' comments suggesting that Australia Post has failed to take advantage of potential cost reduction opportunities (for example, technical, production line opportunities). The concerns of key Australia Post customers (including MMUA and ADMA) that Australia Post may not have pursued every avenue in terms of cost reduction reinforces the ACCC's concerns that Australia Post's actual cost-volume relationship (for example, 0.14 or similar) may be less from that of an efficient postal operator.

The ACCC also notes that Australia Post's latest forecasts indicate that its cost-volume variability may increasingly become a concern for Australia Post. In particular, Australia Post's reserved services volumes are forecast to decline by around 130 million letters per annum over the next three years, but costs are only expected to decline by $50 million, $27 million and $✂ million in the three years to 2012-13 respectively.[62]

A basic analysis of the latest cost and volume forecasts over the period 2009-10 to 2012-13 is provided in table 4.4 below.

60 ACCC, *Australian Postal Corporation 2010 Price Notification: Decision*, May 2010, p. 70.

61 Frontier Economics, *Review of Australia Post's volume and input cost forecasts - A Report Prepared for the ACCC*, May 2010, p. 29.

62 Source: *Australia Post, 2011 draft price notification, confidential version,* p. 45*; Australia Post, response to information request number 3*, February 2011.

Table 4.4: Australia Post's forecast cost-volume trends[63]

Network function	Forecast cost-volume trend
Sales & Acceptance	✂
Processing	✂
Transport	✂
Delivery	✂
Other	✂

Table 4.4 shows that, with the exception of the 'other' costs category, only sales & acceptance and processing costs are declining as volumes decline. The decline in 'other' costs could be largely non-volume related—it is likely to be impacted by a substantial amount of savings flowing out of Australia Post's VOP initiative. If Australia Post is unable to extract further non-volume related cost savings, a continuation of the forecast trends would result in long-term reserved services cost under-recoveries as volumes decline.

Summary of ACCC adjustments to Australia Post's costs

To estimate an efficient cost reduction, the ACCC has again assessed what Australia Post's cost reduction would be, based on:

- bringing forward the savings associated with automated sequencing and separate bundle delivery (as discussed in the previous section)

- increasing Australia Post's volume variability of costs from 0.14 to 0.65, reflecting an average estimated volume-variability for overseas postal providers (i.e. for every 1 per cent reduction in volume, the ACCC estimates that Australia Post should achieve a 0.65 per cent reduction in operating costs).

After the ACCC's two adjustments to Australia Post's forecasts, the ACCC estimates Australia Post's efficient reserved services operating costs (including depreciation) to be around $1 832 million in 2010-11 and $1 784 million in 2011-12.

These adjustments are outlined in section 5.2.2 (adjustment 2).

[63] Source: information provided by Australia Post to the ACCC on a confidential basis.

5 Is Australia Post under-recovering?

Key points

- Australia Post estimates that it will face an under-recovery of costs for reserved services of $195 million in 2011-12 and $✂ million in 2012-13, even after the proposed price increase.
- Although the ACCC accepts Australia Post's claim that it is under-recovering using current cost allocations, Australia Post's estimates may overstate the under-recovery of efficient costs.
- The ACCC's sensitivity analysis shows that Australia Post's under-recovery for reserved services could be closer to $22 million in 2011-12 and $✂ million in 2012-13 under alternative assumptions regarding the WACC, efficient costs, volume mix between Regular and Off Peak, and elasticity of demand.

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

The ACCC is generally more likely to object to proposed price increases if proposed revenue exceeds maximum allowable revenue.

Although the proposed prices increases are primarily for PreSort letters, the ACCC's PTRM assesses the effect on the whole of Australia Post's reserved services. As Australia Post's pricing proposal involves across-the-board price increases for reserved bulk letter services, it raises questions about overall revenue and cost-recovery. The reserved services all use a common infrastructure and have the same legal obligations and monopoly privileges.

Australia Post submitted a PTRM containing its own forecast data for costs and revenues up to 2011-12 (section 5.1). The model relies on assumptions about future variables which have a degree of uncertainty. Given that Australia Post may have an incentive to understate its potential profitability in the context of a price notification, the ACCC has explored a number of variations in order to test the sensitivity of the net result to a range of assumptions (section 5.2). The ACCC's conclusions are in section 5.3.

5.1 Australia Post forecasts

Table 5.1 illustrates the outputs from Australia Post's proposed financial model for domestic reserved services. This indicates continuing under-recoveries—that is, deficiency of proposed revenue required to cover costs. An under-recovery of $173 million in 2010-11 would increase to an under-recovery of $195 million in 2011-12, even after the proposed price increase in July 2011. [information removed].

Table 5.1 Australia Post's required and proposed revenue forecasts for total domestic reserved services ($ million)

	2009-10	2010-11	2011-12	2012-13
Required revenue	2 076	2 027	2 008	✂
Operating costs	1 906	1 841	1 814	✂
Return on capital	63	64	67	✂
Depreciation	95	110	114	✂
Tax	12	12	13	✂
Proposed revenue	1 783	1 853	1 813	✂
Over/under-recovery	**-293**	**-173**	**-195**	✂

The growing under-recovery arises mainly from the decline in proposed revenue due to declining volumes. Total letter volumes for reserved services are forecast to decline by 3.5 per cent in both 2011-12 and 2012-13. The proposed price increases generate an increase in revenue per unit of 3.4 per cent for PreSort letters, and 1.8 per cent across all reserved letters in 2011-12, which is a partial offset to the decline in volumes. As a result of these factors, revenues decline by 2.2 per cent in 2011-12 [information removed].

Costs are also decreasing in nominal terms as management programs to reduce costs are keeping ahead of inflationary effects on prices of labour and materials. Total costs (required revenue) decline by 0.9 per cent in 2011-12 [information removed]. However, as this rate of decline is smaller than for revenues, the under-recovery is growing, and represents 9.7 per cent of allowable revenue in 2011-12 [information removed]. Removal of the under-recovery would require either more stringent cost cutting than Australia Post has achieved so far, or greater reliance on price increases.

5.2 Sensitivity analysis

As uncertainty surrounds the forecast data for a number of components of the financial model, the ACCC has tested the sensitivity of the results to several key factors. The ACCC's PTRM model begins with the base data provided by Australia Post and then tests various alternative assumptions on WACC parameters (section 5.2.1), future operating costs (5.2.2) and volumes (5.2.3). The ACCC considers the following adjustments are necessary to accord with more efficient costs or likely demand scenarios.

5.2.1 Adjustment 1 — Reduction in WACC

In Adjustment 1, the only changes are a reduction in WACC and minor changes to accord with the ACCC's methodology for the calculation of tax.[64] Australia Post submitted a nominal 'vanilla' WACC of 10.3 per cent, based on a consultancy report by Value Adviser Associates.[65] The ACCC does not accept Australia Post's proposed WACC as appropriate for this assessment, and in testing for Adjustment 1, the ACCC has reduced the WACC to 8.6 per cent, in accordance with its views on WACC parameters in its 2010 decision.

These changes reduce the return on capital and hence allowable revenue, reducing the extent of under-recovery by around $23 million per annum. The under-recovery becomes $172 million in 2011-12, and $✂ million in 2012-13, as shown in table 5.2.

Table 5.2 ACCC's assessment of required and proposed revenue forecasts for total domestic reserved services based on an adjustment to the WACC ($million)

	2009-10	2010-11	2011-12	2012-13
Required revenue	2 055	2 005	1 985	✂
Proposed revenue	1 783	1 853	1 813	✂
Over/under-recovery	**-272**	**-152**	**-172**	✂

The change due to the WACC is relatively small, and as is concluded further below, using the lower WACC tested by the ACCC does not have a material effect on the ACCC's conclusions. The ACCC does not endorse either Australia Post's proposed WACC or the WACC tested in this scenario as the appropriate values for future price notifications. In the context of this draft price notification, however, the ACCC does not consider it necessary to determine a more exact WACC.

5.2.2 Adjustment 2 — Efficient cost levels

The ACCC considers that the operating costs in the financial model should not be based solely on Australia Post's own forecasts, but at a level closer to an efficient cost base. This is consistent with the views of customers who were concerned that Australia Post had not taken sufficient advantage of opportunities for cost reduction. In Adjustment 2, in addition to the changes in Adjustment 1, operating costs are reduced to what the ACCC considers to be an efficient level, as outlined in section 4.4.3, by:

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

65 Value Adviser Associates Pty Ltd, 'Betas and other CAPM parameters for Australia Post's Reserved Letter Business', November 2010.

- bringing forward the savings associated with automated sequencing and separate bundle delivery
- assuming greater responsiveness of costs to volume changes, based on overseas studies of cost variability.

The adjustments for cost efficiencies reduce allowable revenue by $143 million in 2011-12, and thereby reduce the extent of under-recovery to $29 million in 2011-12, and to $✂ million in 2012-13, as shown in table 5.3.

Table 5.3 ACCC’s assessment of required and proposed revenue forecasts for total domestic reserved services based on adjustments to the WACC and efficient costs ($million)

	2009-10	2010-11	2011-12	2012-13
Required revenue	1 967	1 886	1 842	✂
Proposed revenue	1 783	1 853	1 813	✂
Over/under-recovery	**-184**	**-32**	**-29**	✂

5.2.3 Adjustment 3 — More limited change in volume mix

In the ACCC’s 2010 decision, a further adjustment was made to align the volume forecasts with the ‘baseline’ estimates provided by Australia Post’s consultant’s econometric model, by removing the management augmentations. This had the effect of increasing proposed revenues and substantially reducing the extent of under-recovery. However, as outlined in section 3.2.3, the ACCC accepts the augmented forecasts for the purposes of the current notification, which assume a decline in total letter volumes for reserved services of 3.5 per cent in both 2011-12 and 2012-13. Therefore, no adjustment for volume trends has been made.

A new source of uncertainty in the volume forecasts for the current assessment relates to the mix of PreSort Regular and Off Peak mail, as discussed in section 3.1.3. Adjustments 1 and 2 above follow Australia Post’s assumption that the price restructure would cause a shift in the current mix from 83 per cent Regular and 17 per cent Off Peak, towards a mix of 51 per cent Regular and 49 per cent Off Peak.

On the other hand, submissions from some customer groups suggest that there would be little shift towards Off Peak.[66] The ACCC considers that the change in volume mix is likely to be smaller than that forecast by Australia Post. Hence an adjustment was made to forecast volumes assuming that the share of Off Peak in the PreSort mix would increase at a more modest rate, to 27 per cent in 2011-12 and 37 per cent in 2012-13.

[66] For example, ADMA submission, pp. 5–6; MMUA submission, p. 3.

Under these assumptions there would be a greater proportion of the higher-priced Regular mail compared with Australia Post's assumptions, and the increase in average price across all PreSort letters is estimated to be 5.1 per cent in 2011-12 and 4.4 per cent in 2012-13, compared with Australia Post's assumption of 3.4 per cent. This generates an increase of $44 million in PreSort revenue in 2011-12, compared with $29 million under Australia Post's assumed volume mix. The effect of the adjustment is to increase proposed revenues and increase net profit by $16 million in 2011-12, and hence reduce the under-recovery by this amount. Thus in Adjustment 3, which superimposes the volume mix change on Adjustment 2, the under-recovery for 2011-12 would be reduced to $13 million and for 2012-13 to $✂ million, as shown in table 5.4 below.

Table 5.4 ACCC's assessment of required and proposed revenue forecasts for total domestic reserved services based on adjustments to the WACC, efficient costs and volume mix ($million)

	2009-10	2010-11	2011-12	2012-13
Required revenue	1 967	1 886	1 842	✂
Proposed revenue	1 783	1 853	1 828	✂
Over/under-recovery	**-184**	**-32**	**-13**	✂

This set of assumptions may be viewed as an upper bound for Australia Post's profitability. Nevertheless, it can be seen that under-recovery of efficient costs is still predicted by the ACCC's model.

5.2.4 Adjustment 4 — Increase in price elasticity

The price elasticity of demand for the letter service is another factor on which the ACCC received differing views. In contrast to Adjustments 1 to 3, alternative assumptions on price elasticity would generate an increase in the level of under-recovery.

Australia Post's forecasts were based on its view that total demand for PreSort would not be affected by the proposed price increases (although demand within PreSort categories would be quite responsive). Customer groups, however, argued that the price increases would accelerate the existing trends to substitution away from postal mail. This implies that there is some responsiveness of demand to price, although no quantitative estimates were submitted.

The ACCC is concerned that some allowance should be made for a likely volume response. From overseas evidence, price elasticities for business to consumer mail could be as high as 1.8, and for business-to-business mail 0.6, as outlined in section

3.2.3.[67] For the purpose of this assessment, however, the ACCC has tested the effect on the financial model of a mid-range value for elasticity of 0.4.

Given the average 5.1 per cent increase in PreSort prices in 2011-12 under the assumed volume mix in Adjustment 3, a price elasticity of 0.4 reduces PreSort volumes by 2.0 per cent. The effect of this volume change on revenue is partially offset by the associated reduction in costs according to the cost elasticities previously discussed. The net result is a reduction in profit of $8 million relative to the cumulative adjustments above. In summary, the original impact of the price increase is to increase PreSort revenues by $44 million, but elasticity effects could result in the net increase in profit being only $36 million. Superimposed on previous adjustments, the combined effect of the changes in Adjustment 4 is to generate an under-recovery for 2011-12 of $21 million and $✂ million in 2012-13, as shown in table 5.5.

Table 5.5 ACCC's assessment of required and proposed revenue forecasts for total domestic reserved services based on adjustments to the WACC, efficient costs, volume mix and price elasticity ($million)

	2009-10	2010-11	2011-12	2012-13
Required revenue	1 967	1 886	1 831	✂
Proposed revenue	1 783	1 853	1 810	✂
Over/under-recovery	**-184**	**-32**	**-21**	✂

5.3 ACCC's view

As Australia Post's forecasts potentially overstate its losses, the ACCC has made several adjustments in order to test the effect on the broad conclusions. These adjustments comprise a more appropriate WACC, more efficient costs, and more likely PreSort volume mix and price elasticity of demand. The ACCC's analysis shows that Australia Post's under-recovery for reserved services could be closer to $21 million in 2011-12 and $✂ million in 2012-13 under these alternative assumptions.

Therefore, the ACCC finds that the most likely outcome is an under-recovery of efficient costs, albeit less than that estimated by Australia Post. Given that it is unlikely to impact the conclusion, the ACCC does not consider it necessary to develop any more accurate a view of the financial factors that drive the model.

Whilst the ACCC does not accept the WACC proposed by Australia Post, in the context of this draft price notification the WACC is not crucial to the ACCC's decision, and thus it is not necessary to determine a precise WACC or views on individual

[67] Note that the price elasticity of demand is generally negative, but the absolute values are given here in line with common convention.

parameters. The WACC may nevertheless be of more importance in a future price notification and, in the light of the methodological issues raised by the consultancy report, the ACCC may work further with Australia Post in determining the appropriate methodology and parameters.

6 Would the price structure have anti-competitive effects?

Key points

- There is potential for an anti-competitive price squeeze when the discount for PreSort letters relative to Ordinary letters is narrowed, as it provides less opportunity for private operators to compete with Australia Post in the area of pre-processing of bulk mail.
- The ACCC has assessed the possibility of a price squeeze by comparing the price and cost differentials between small PreSort and Clean Mail. Clean Mail provides a reasonable proxy for Ordinary mail.
- The price discounts would be around 3 to 12 cents to users after the proposed price increases based on data supplied by Australia Post. By comparison, the cost saving to Australia Post from presorting of letters is less than ✂ cents.
- The ACCC accepts evidence provided by Australia Post that the price discount is higher than the cost saving to Australia Post and, therefore, it is unlikely that the proposed price increases would result in an anti-competitive price squeeze.

An important aspect of this draft price notification is the proposed restructuring of prices whereby the prices of Regular PreSort mail are raised by more than the prices of Off Peak PreSort, while Other/Ordinary mail prices are not changed at all.

The change in price relativities may have several effects:

- encourage a shift from Regular to Off Peak PreSort—which is the primary aim submitted by Australia Post
- discourage the use of PreSort, with customers either sending less mail, or sending mail as Ordinary rather than pre-sorted, due to either:
  - customers being deterred by the higher price, or
  - the price margin between Ordinary and PreSort being reduced, thereby reducing the scope for private pre-processors of bulk mail to operate profitably.

The potential shift from Regular towards Off Peak has been considered in section 3.1.3 insofar as it affects the mix of volumes and hence revenues expected, and also in section 4.4.3 in relation to costs. The effect of the price increase on overall PreSort volumes has been considered in section 3.2.3.

However, there are separate issues insofar as the demand for PreSort is affected by the size of the price discount, as outlined below in section 6.1. In section 6.2, the ACCC assesses the appropriateness of the discounts by comparing the differentials between prices and costs for PreSort and Ordinary letters.

6.1 Potential for anti-competitive effects

If the discount given by Australia Post for pre-processed letters is less than the cost savings it enjoys through receiving pre-processed letters, it could be considered a 'price squeeze', resulting in both inefficiencies and anti-competitive effects on private mail processors. The pre-processing can comprise barcoding of letters and sorting by location into trays, thereby saving Australia Post certain steps in the processing chain. In some circumstances there could also be savings in transport with bulk lodgements at an office of Australia Post.[68]

The inefficiencies could arise if private handlers are deterred from pre-processing because of the small discount, and Australia Post's processing operations are more costly than those that the private operators would have employed.

At the same time this would have anti-competitive effects through the deterrent to private mail processors who could have effectively competed with Australia Post in this part of the mail chain.

The pre-processing could be done by the firm generating the mail, but is most commonly done by specialist mail houses that also perform other database management and printing operations for mail generators. The mail houses assist Australia Post by providing mail in a more efficient format, but in a sense compete with Australia Post in limited areas, mainly transport, barcoding and sorting.

The ACCC's Issues Paper invited responses on whether the PreSort discount appropriately reflects the efficient cost savings to Australia Post, or whether the proposed prices would impact Australia Post's competitors.

While submissions by several stakeholders expressed concern about the increased cost of the PreSort service, they did not raise specific concerns about a squeeze on price margins and competition.

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68 It should be noted that certain aspects of bulk letter carriage are exempted from Australia Post's broad monopoly on carriage of letters. An exception is provided under subsection 30(1)ha of the APCA for the carriage of a letter to an office of Australia Post where it is then lodged for delivery under a bulk interconnection service, and under subsection 30(1)hb for the carriage of a letter to the provider of an aggregation service, for the purposes of aggregation in order to use a bulk interconnection service. Section 32A defines a bulk interconnection service as a service supplied by Australia Post under which bulk quantities of letters are delivered within Australia at reduced rates under certain conditions regarding lodgement at an office of Australia Post and pre-sorting. Further, section 32A provides for the rate reduction for such bulk mail to include a component that is Australia Post's estimate of the average transport costs per letter avoided by Australia Post. Section 32B provides for the ACCC to inquire into disputes between Australia Post and a person who wishes to obtain a rate reduction for the bulk letters.

Australia Post submitted that the price differentials are appropriate and that PreSort prices reflect the lower processing costs incurred by Australia Post. Data provided by Australia Post showed that, for all small letters in 2009-10, unit revenue for PreSort mail is 11.1 cents less than for Ordinary, while unit costs of PreSort are ✂ cents lower than for Ordinary.[69] However, Australia Post argued that the only costs saved by presorting of bulk mail lie in the processing function, and the cost saving there is a maximum of ✂ cents. Australia Post concludes that the proposed changes will not have any impact on the provision of mail pre-processing services.

6.2 Comparing price and cost differentials

The ACCC has assessed the likelihood of a price squeeze by comparing the prices and costs of PreSort mail and comparable mail that does not qualify as PreSort. This involves the use of confidential data provided by Australia Post at a more disaggregated level than that referred to in section 6.1.

Business bulk mail is likely to be machine-addressed and lodged in large batches regardless of whether it is presorted or not. Hence, if it is not lodged as PreSort it is likely to qualify as Clean Mail, which is a category of Ordinary Mail carrying a price discount for batches of at least 300 machine-addressed letters. Clean Mail letters are not sorted or barcoded, which means that Australia Post must sort the mail to delivery round itself.

However, the costs incurred in processing Clean Mail are less than for Ordinary mail that is not machine-addressed. The other types of Ordinary mail, such as individual letters with hand-written addresses, are less relevant to compare with PreSort mail because their processing may involve extra difficulties (such as with address recognition) which are less likely with even unbarcoded bulk business mail.

6.2.1 Price differentials

At current prices, the Clean Mail price for small letters is currently 9 cents below the basic postage rate, while prices for various categories of PreSort mail are further below the Clean Mail price.[70] At the maximum discount, the price for Off Peak barcoded letters in direct trays destined for the same State as received in is 9.4 cents below that for Clean Mail, while the price for Regular barcoded residue is 3.3 cents below Clean Mail. For unbarcoded residue in PreSort batches, Australia Post has in recent years maintained the same price as for Clean Mail, as it requires similar processing steps.

At the new prices proposed by Australia Post, the price discount relative to Clean Mail would decrease for Regular PreSort, while increasing for Off Peak PreSort. For example, for Regular small letter Same State barcoded direct trays, the price discount would be reduced from 8.3 to 7.8 cents under the proposed prices. However, for Off Peak batches of the same kind, the price discount would increase from 9.4 to 11.6 cents.

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69 *Australia Post Response to ACCC Issues Paper*, 16 March 2011, pp. 8–9.

70 Price differentials are derived from prices in Appendix A.

On the basis of volume-weighted data provided by Australia Post, across all categories of PreSort small letters in 2011-12, the average price discount for Regular would be 5.9 cents, and for Off Peak 9.5 cents.

6.2.2 Cost differentials

On the basis of data provided by Australia Post, the unit costs of PreSort small letters are lower than those of Clean Mail by an average margin of less than ✂ cent for Regular and ✂ cents for Off Peak. (The actual cost figures are confidential to Australia Post.) This estimate of cost saving is based only on differences in processing, as Australia Post submits that no saving is made in transport, delivery or other stages.

The proposed price restructuring is expected to increase the proportion of PreSort received as Off Peak, which could slightly increase the average cost saving to Australia Post, due to the ability to handle it at off-peak times or transport it more cheaply.

6.3 ACCC's view

Data provided to the ACCC suggests that the price discount available for PreSort mail is higher than the cost savings to Australia Post from the reduction in processing work at present, and would remain so after the proposed price increases. Price discounts for PreSort small letters relative to Clean Mail would average around 6 to 10 cents, while cost savings would remain at less than ✂ cents. Given that the price discount is greater than the cost savings to Australia Post, the ACCC considers it is unlikely that the proposed price increases would result in an anti-competitive price squeeze.

7 ACCC's preliminary view

The ACCC's preliminary view is to **not object** to Australia Post's revised proposal to increase charges for PreSort letter services, as well as Clean Mail letters and the annual fee for its Reply Paid Mail service.

APPENDIX A — Australia Post's proposed prices

PreSort Letters

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	$ 0.427	$ 0.457	7.0%	$ 0.438	$ 0.473	8.0%	$ 0.477	$ 0.506	6.1%	$ 0.510	$ 0.535	4.9%
Charity Mail	$ 0.372	$ 0.402	8.1%	$ 0.383	$ 0.418	9.1%	$ 0.422	$ 0.451	6.9%	$ 0.510	$ 0.535	4.9%
Small Plus												
Up to 125g	$ 0.550	$ 0.578	5.1%	$ 0.572	$ 0.605	5.8%	$ 0.660	$ 0.688	4.2%	$ 0.800	$ 0.840	5.0%
Medium												
Up to 125g	$ 0.693	$ 0.732	5.6%	$ 0.737	$ 0.776	5.3%	$ 0.831	$ 0.869	4.6%	$ 0.968	$ 1.018	5.2%
Over 125 up to 250g	$ 0.913	$ 0.952	4.3%	$ 1.001	$ 1.040	3.9%	$ 1.106	$ 1.144	3.4%	$ 1.249	$ 1.287	3.0%
Large												
Up to 125g	$ 0.825	$ 0.853	3.4%	$ 0.869	$ 0.897	3.2%	$ 0.990	$ 1.018	2.8%	$ 1.034	$ 1.062	2.7%
Over 125 up to 250g	$ 1.155	$ 1.183	2.4%	$ 1.243	$ 1.271	2.3%	$ 1.375	$ 1.403	2.0%	$ 1.485	$ 1.513	1.9%
Over 250 up to 500g	$ 1.595	$ 1.623	1.8%	$ 1.727	$ 1.755	1.6%	$ 1.815	$ 1.843	1.5%	$ 2.035	$ 2.063	1.4%

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	$ 0.416	$ 0.419	0.7%	$ 0.427	$ 0.430	0.7%	$ 0.465	$ 0.506	8.8%	$ 0.505	$ 0.535	5.9%
Charity Mail	$ 0.356	$ 0.359	0.8%	$ 0.367	$ 0.370	0.8%	$ 0.405	$ 0.429	5.9%	$ 0.505	$ 0.535	5.9%
Small Plus												
Up to 125g	$ 0.539	$ 0.540	0.2%	$ 0.561	$ 0.562	0.2%	$ 0.649	$ 0.688	6.0%	$ 0.795	$ 0.840	5.7%
Medium												
Up to 125g	$ 0.671	$ 0.683	1.8%	$ 0.704	$ 0.716	1.7%	$ 0.820	$ 0.869	6.0%	$ 0.963	$ 1.018	5.7%
Over 125 up to 250g	$ 0.875	$ 0.887	1.4%	$ 0.919	$ 0.931	1.3%	$ 1.084	$ 1.144	5.5%	$ 1.238	$ 1.287	4.0%
Large												
Up to 125g	$ 0.803	$ 0.804	0.1%	$ 0.836	$ 0.837	0.1%	$ 0.979	$ 1.018	4.0%	$ 1.029	$ 1.062	3.2%
Over 125 up to 250g	$ 1.089	$ 1.090	0.1%	$ 1.155	$ 1.156	0.1%	$ 1.331	$ 1.403	5.4%	$ 1.474	$ 1.513	2.6%
Over 250 up to 500g	$ 1.375	$ 1.376	0.1%	$ 1.463	$ 1.464	0.1%	$ 1.650	$ 1.843	11.7%	$ 1.925	$ 2.063	7.2%

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	$ 0.300	$ 0.310	3.3%	$ 0.320	$ 0.330	3.1%	$ 0.465	$ 0.506	8.8%	$ 0.505	$ 0.535	5.9%
Small Plus - up to 125g	$ 0.415	$ 0.430	3.6%	$ 0.435	$ 0.450	3.4%	$ 0.649	$ 0.688	6.0%	$ 0.795	$ 0.840	5.7%

Other Letter Prices		Proposed Price	
	Current	Amount	% Var
Clean Mail			
Small	$ 0.510	$ 0.535	4.9%
Small Plus	$ 0.800	$ 0.840	5.0%
Reply Paid			
Annual Fee	$ 65.00	$ 80.00	23.1%

Notes/Comments

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

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

APPENDIX B — Legislative framework

B.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 *Competition and Consumer Act 2010* (CCA). In particular, under section 95X of the CCA, the Minister (Treasurer), or the ACCC with the approval of the Minister (Treasurer) 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 CCA.

On 23 February 2011, The Treasurer issued a new declaration that 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 CCA.

The new Declaration replaces the lapsed Declaration 75 (made in 1992 under section 21 of the *Prices Surveillance Act 1983*). The new Declaration ceases on 25 February 2016.

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

- increase the price of a notified service
- 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 CCA (subsection 95G(5)), as it considers appropriate. In performing its functions assessing Australia Post's price notifications, the ACCC:

- gives special consideration to the matters outlined in Ministerial directions, such as Direction 8 and Direction 11 (discussed in section B.2 below)
- has particular regard to matters outlined in subsection 95G(7) of the CCA.

B.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 statutory criteria under subsection 95G(7) of the CCA is subject to these Directions.

As detailed in the ACCC's *Statement of regulatory approach to assessing price notifications*, Direction 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's assessment of Australia Post's price notifications 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.

B.2.1 Australia Post's obligation to pursue a financial policy, pricing targets and Government endorsed financial targets

In accordance with Direction 11, 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 35–41 of the *Australian Postal Corporation Act 1989* (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. As stated under section 38 of the APCA, 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:

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

   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

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.

B.2.2 Australia Post's functions and obligations

The ACCC must give special consideration to Australia Post's functions set out in sections 14-16 of the APCA and also sections 25-28 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 outlines 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

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

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 outlines 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

c) Australia's obligations under any convention.

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 C), place specific requirements on Australia Post in relation to mail delivery and in relation to the accessibility of services. In particular:

- regulation 5 prescribes the frequency of delivery
- regulation 6 details the accuracy and speed of delivery (for reserved services)
- regulation 8 specifies the mail lodgement points for articles other than bulk mail
- regulation 9 imposes requirements on Australia Post in relation to the number and location of its retail outlets.

B.3 Subsection 95G(7) of the CCA

As stated under ss. 95G(7) of the CCA, 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 CCA is outlined in detail in its *Statement of regulatory approach to assessing price notifications*. The ACCC's approach to applying subsection 95G(7) of the CCA for its assessment of Australia Post's 2011 price notification is consistent with the approach outlined in this guide (key sections reproduced below).

B.3.1 Investment, employment and market power

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.[71]

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.

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 *Trade Practices Act 1974* (superseded by the CCA)[72] and also consistent with the object of prices surveillance, as set out in section 95E of the CCA.

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

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71 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 (Productivity Commission, *Price regulation of airport services*—Inquiry report, 23 January 2002).

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

- *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.

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 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
- 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).

B.3.2 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'.[73]

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

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

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.

B.4 ACCC's approach to considering Ministerial Directions and subsection 95G(7) of the CCA

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 CCA.[74]

The Explanatory Memorandum states in regard to section 95G of the CCA 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).[75]

Further, it states in regard to section 95ZH of the CCA 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).[76]

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 CCA.

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.

Additionally, 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

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[74] Trade Practices Legislation Amendment Bill 2003 Explanatory Memorandum, accessed on 24 May 2011 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html (see Division 2 - Commission's Functions).

[75] Trade Practices Legislation Amendment Bill 2003 Explanatory Memorandum, accessed on 24 May 2011 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html.

[76] Trade Practices Legislation Amendment Bill 2003 Explanatory Memorandum, accessed on 24 May 2011 at http://www.austlii.edu.au/au/legis/cth/bill_em/tplab2003351/memo1.html.

level of wages and executive remuneration as part of its broader concern related to the efficiency of the cost base.

B.4.1 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 Australia Post faces. In a commercial setting, seeking prices above efficient cost levels would put a firm at a competitive disadvantage and would not be commercially sound.

As a result of Australia Post's CSOs (and prescribed performance standards), 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 CSO on an ongoing basis also requires prices to be set to recover 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 Australia Post. Levying prices above this level would deter consumption of Australia Post's reserved services and thus impact the financing of Australia Post's CSOs.

B.4.2 Australia Post's obligation to pursue a financial policy, pricing targets and Government endorsed financial targets

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.

In the context of Direction 11 and subsection 95G(7) of the CCA, the ACCC considers that its assessment of Australia Post's current pricing proposal should be guided by the following:

- 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.

APPENDIX C — Legislative instruments

Commonwealth of Australia

Competition and Consumer Act 2010

PRICE NOTIFICATION FOR AUSTRALIA POST'S RESERVED LETTER SERVICES

I, WAYNE SWAN, Deputy Prime Minister and Treasurer, pursuant to section 95X of the *Competition and Consumer Act 2010* ('the Act'), hereby declare:

1. 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

2. the Australian Postal Corporation to be, in relation to those services, a declared person for the purposes of the Act.

This declaration is to cease to have effect on and from 25 February 2016, unless revoked earlier.

Dated this 23 day of February 2011.

Wayne Swan
Deputy Prime Minister and 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