Australian
Competition &
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Commission

AUSTRALIAN POSTAL CORPORATION

Pricing Proposal

Preliminary View

September 2002

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Glossary

90/10 rule	As part of the phasing in of barcoding, not all of a barcoded PreSort lodgement had to be barcoded. From 1 July 2001 to 30 June 2002, at least 90% of barcoded PreSort lodgements were required to be barcoded to attract the barcode rate. Unbarcoded letters lodged under the 90/10 rule had to be presented in Unbarcoded Residue trays and were charged at the same rate as Barcoded Residue.
90/10 allowance[1]	Although the 90/10 rule was to cease to have effect after 30 June 2002, Australia Post has extended the 90/10 rule given that it would be logical to continue the concession in light of the proposed introduction of Clean Mail/Unbarcoded Residue prices in Jan 2003.
ACCC	Australian Competition and Consumer Commission
ADMA	Australian Direct Marketing Association
AMAS	Address Matching Approval System
Australia Post	Australian Postal Corporation
APC Act	*Australian Postal Corporation Act 1989*
Barcode	Each postal address in Australia has a unique delivery point identifier number which can be applied to an envelope as a barcode which enables machine sorting of letters. In cases of bulk mail, the sender or a mail aggregator may apply the barcode to the letter and presort prior to lodgement thus earning a discount rate of postage.
Barcode Direct Trays	A PreSort category. Barcode Direct Trays attract the lowest rates. However, a minimum of 300 letters, all barcoded and all with addresses belonging to a single sort plan number (postcode range) is required to qualify for this level of charges.
Barcode residue	A PreSort category. Barcoded letters that cannot be sorted into Barcode Direct Trays are lodged in barcode residue trays. The charge for these letters is higher than for those letters lodged in a Barcode Direct Tray.
Basic postage rate	See BPR
BPR	Basic Postal Rate – the rate that applies to the universal service (i.e. the full rate small letter service). It is the price of ordinary small letters,

[1] The Commission understands that this is an interim measure that will become obsolete if the proposals in the draft notification come into effect in January 2003.

	currently 45 cents.
Clean Mail	A new category proposed in the draft notification for 300 or more machine addressed, unbarcoded and minimally sorted letters which can be mailed at the proposed "Clean Mail" rate. Clean Mail is further divided into small, medium and large letter categories.
CPI	Consumer Price Index
CSO	Community Service Obligation. This is the description given to services provided for the good of the community and not for economic gain. CSOs are often provided at a loss and must be funded either directly by Government subsidy, by the provider forgoing profits or by raising prices on other services to cover the loss on the CSO (cross-subsidy). In the case of Australia Post, the CSO is the provision of mail services at a uniform cost even though in some areas, the cost of providing the service is well in excess of the income received.
DORC or ODRC	Optimised Depreciated Replacement Cost
DPID	Delivery Point Identifier. A unique eight digit code allocated to each delivery point (address to which Australia Post delivers). The DPID is necessary for barcoding.
Draft statement	Australian Competition and Consumer Commission, *Draft Statement of Regulatory Approach to Price Notifications*, April 1998.
DRP	Australian Competition and Consumer Commission, *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999.
Full rate letters	Letters that do not attract a discount
Future Post program	Barcoding and multi line optical character reading technology
GDP	Gross Domestic Product
Large letter	Weighs up to 500 gms; no larger than 260mm x 360mm, no thicker than 20 mm.
Letters business	That part of Australia Post's operations covering the delivery of letters within Australia. Other business units include Parcels, Retail, Financial Services and Logistics.
Local mail	This is a discount rate on letters sent and delivered within a defined local area. It is only available in certain areas.
Medium letter	A category for bulk mail defined by dimensions. Used for large transactional mailings and promotional mailings to help distinguish them from other mail.
MMUA	Major Mail Users Association
MRP	Market Risk Premium
NCC	National Competition Council

Notification	When a declared body gives notice to the Commission of its intention to raise prices, it is said to have given notification of the increase.
NPV	Net Present Value
ODRC or DORC	Optimised Depreciated Replacement Cost
Off peak	A lower rate for non-time critical mail. Off peak allows Australia Post to deliver letters up to 3 days beyond Regular Delivery.
Optical character reading technology	Technology that can "read" the addresses on letters and sort these letters mechanically.
PAF	Postal Address File. This contains all the addresses to which Australia Post delivers and their associated DPID.
PreSort	Australia Post offers reduced charges to bulk mail customers who sort small, medium and large letters according to specified requirements before lodgement. Applies only to a lodgement containing a minimum of 300 letters. Since 1 July 2002 PreSort letters can be further classified into three categories: Barcode Direct Trays; Barcode Residue Trays; and Unbarcode Residue Trays. Different rates also apply to PreSort letters sent for regular delivery or off peak delivery. Prior to 1 July 2002 PreSort letters could be classified into a wider range of categories enabling lodgements of unbarcoded bulk mail. As these categories no longer exist, unbarcoded bulk mail is ineligible for any discounts unless it can be lodged under the 90/10 allowance.
Print Post	Service for authorised periodical publications within Australia. Not part of the reserved service.
PS Act	*Prices Surveillance Act (Commonwealth) 1983*
PSA	Prices Surveillance Authority
RBA	Reserve Bank of Australia
Regular Delivery	Australia Post's normal delivery time for letters.
Reserved	Refers to postal services reserved to Australia Post under legislation i.e. no other entity can provide these services. Reserved services include the delivery of letters within Australia (excluding certain types of services as specified in legislation) and the issuing of postage stamps.
Small letter	No larger than 130mm x 240 mm, no thicker than 5mm, no heavier than 125 gm and no smaller than 88mm x 138mm.
The Commission	The Australian Competition and Consumer Commission
TLMS	Tray labelling management software (TLMS) which allows bulk mail customers to create mail tray labels, subject to licensing conditions. Tray labels identify the final destination and contents of each tray. Different labels are needed for different products and tray sizes. Label

	stock is free. Order forms must be completed for pre-printed labels.
UK	United Kingdom
Unbarcoded PreSort	A discontinued bulk mail category where the letters were not barcoded but could qualify for PreSort discounts. Up to 1 July 2002, bulk unbarcoded letters could be lodged in their own right and sorted into trays or bundles for further discounts. A minimum of 300 also applied. This service is not available beyond 1 July 2002 and unbarcoded letters that cannot be lodged as “unbarcoded residue” must be lodged as ordinary mail at the BPR.
Unbarcoded residue	Prior to 1 July 2002 this category described unbarcoded letters lodged as unbarcoded PreSort letters but not sorted into direct trays or direct bundles. Currently this grouping refers to the PreSort category introduced after 1 July 2002[2]. Unbarcoded letters lodged as part of a barcode PreSort lodgement are eligible for access to the Barcode Residue pricing under the 90/10 allowance but must be lodged in a separate tray. The charge for letters in this category is the same as for the barcoded residue. The draft notification proposes the introduction of another new definition of “unbarcoded residue”. Under this definition, unbarcoded letters can be lodged as part of a barcoded PreSort lodgement without the restriction on numbers that applies under the 90/10 allowance (or applied under the 90/10 rule). However, only letters to addresses which do not have a DPID can be lodged in this category. The rate for unbarcoded residue letters is proposed to be increased to 45 cents, the same as for Clean Mail but above the proposed barcode residue rate.
Universal service obligation	This means that Australia Post must carry and deliver standard letters at a uniform postage rate – currently 45c - to anywhere in Australia.
US	United States
USPS	United States Postal Service
WACC	Weighted Average Cost of Capital

[2] As with the 90/10 allowance, the Commission understands that this is an interim measure that will become obsolete if the proposals in the draft notification come into effect in January 2003. The definition enables a new discount on unbarcoded letters which Australia Post can revoke as long as the requirements of the PS Act are observed.

Executive summary

The Commission's preliminary view

In April 2002 the Australian Postal Corporation (Australia Post) submitted a Draft Pricing Proposal (the draft proposal) to the Australian Competition and Consumer Commission (the Commission) to increase a range of postal charges. As well as raising the basic postage rate (BPR) from 45c to 50c, increases are proposed for large letters, pre-sorted mail, greeting cards and prepaid envelopes. The changes are proposed to take effect from 13 January 2003. In addition, Australia Post proposes to alter the requirements for some categories of business mail, including introducing a new mail category, 'Clean Mail'.

In its draft notification, Australia Post argues that the profitability of providing letter services is declining as a result of falling volume growth and fewer opportunities for improving productivity. It also points to the fact that its Community Service Obligations (CSO) impose a significant annual cost, and the ongoing need to earn a commercial rate of return.

The Commission's preliminary view is to not object to the increase to the basic postal rate or the introduction of Clean Mail and unbarcoded residue rates; but to object to the other proposed increases including bulk PreSort rates, large letters and some local delivery services. The decision is expected to add around $53 million to Australia Post's revenue in 2003/04, the first full year in which the increased charges will apply, which is slightly more than half of the $91m sought by Australia Post.

The Commission's preliminary view is that the prices not objected to should provide Australia Post with a reasonable return over the five year period to 2006/07. Maintaining a price freeze (at these approved levels) provides Australia Post continued incentives to reduce costs and grow volumes. In addition it provides price certainty to Australia Post's customers and facilitates business planning.

The Commission's preliminary view recognises that some price increase may be warranted given expectations of slower volume growth and general increases in the cost of inputs. However, the Commission has some concerns about the rate of return Australia Post is seeking from its regulated services. The Commission also notes that Australia Post's forecast volume growth may be somewhat conservative. While slower rates of volume growth may inhibit the rate of future productivity growth, as Australia Post suggests, the Commission considers that there may be some scope for Australia Post to explore cost savings beyond 2004/05.

The preliminary view implies a price structure between bulk and non-bulk mail that is different to that proposed by Australia Post. However, the case for price increases is stronger in relation to the BPR than for other rates, as ordinary letters appear to be currently priced below cost. In contrast, PreSort mail appears to be very profitable. As a result, there is a cross-subsidy from bulk mail users to ordinary mail users.

The Commission has some concerns about this current low margin between the BPR and bulk prices. Maintaining a narrow differential, as proposed by Australia Post, limits the scope for effective competition to Australia Post in providing some services. For example, the potential for mail aggregation businesses to develop, as has occurred in overseas markets such as the US, would be hampered.

An increase to the BPR may also increase the potential for Australia Post to extend the retail distribution of stamps through parties such as newsagents. This could provide increased convenience and accessibility to consumers.

The Commission sees some merit in introducing the Clean Mail product and the unbarcoded residue rates, as these shield some users from the proposed increase to the BPR. However, these new products also have the potential to limit the scope for mail aggregation if there is insufficient margin over the price of PreSort mail. This effect may be avoided if the Commission objects to increases in PreSort rates.

The Commission's process

In reaching its preliminary view on the draft proposal the Commission has carried out an extensive public consultation process. In May it released an issues paper seeking submissions. The Commission received a total of 26 submissions from major mail users, other businesses and members of the public. In June the Commission held a series of public forums around Australia, and in July a technical discussion forum in Melbourne. Public forums were held in Brisbane, Townsville, Sydney, Adelaide, Perth, Hobart, Melbourne, Tamworth, Canberra and Darwin.

The Commission also obtained advice from the following external consultants:

- Professor Kevin Davis, on cost of capital; and
- Meyrick & Associates, on Australia Post's productivity.

These reports are available on the Commission's website at http://www.accc.gov.au.

The Commission is now seeking submissions in response to its preliminary view. These should be provided by close of business 27th September 2002. It aims to release a final decision in late October.

Submissions should be forwarded to the following address by COB Friday 27th September 2002:

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Australia Post's proposal

Australia Post provided its estimate of the average price changes as summarised in Table A below. The average price increase proposed is around 5 per cent.

Table A: Current and proposed postal charges*

Service	Average rate per unit – current prices	Average rate per unit – proposed prices	Change
Ordinary letters			
Small	$0.45	$0.50	11.2%
Large	$1.19	$1.21	1.9%
Average – ordinary letters	*$0.57*	*$0.62*	*7.9%*
Bulk letters			
PreSort	$0.41	$0.43	5.0%
Clean Mail	$0.45	$0.45	0.0%
Local delivery	$0.42	$0.47	11.9%
Average – bulk letters	*$0.42*	*$0.44*	*3.5%*
Total Letter Services	**$0.47**	**$0.49**	**5.1%**

*Prices are GST-inclusive

An overview of Australia Post's approach is provided in Chapter 1. A full list of all the proposed price changes is provided in Appendix A.

Submissions from interested parties

The Commission has received submissions from mail user associations such as the Major Mail Users Association (MMUA) and Australian Direct Marketing Association (ADMA); businesses including mail houses, newsagents, printers, mail aggregators and retailers, and individuals. (see Appendix B for full list and summary of submissions received. The submissions are also available from the Commission's website at http://www.accc.gov.au.)

Most, but not all, submissions oppose the proposed increases. It was suggested in some submissions supporting the proposal that increased prices were necessary to improve licensees' margins and to enable existing networks to be maintained.

However, the majority of submissions are against the proposal. Reasons given include the lack of information transparency of Australia Post's figures; questions regarding the forecast decline in volumes; perceived opportunities for further productivity improvements; current problems with quality of service; and issues surrounding Australia Post's CSOs. A number of concerns about the potential impact on mail users - both individuals and businesses - were also raised. These comments noted the effects of the removal of Adpost and the phasing out of discounts for unbarcoded mail.

A number of retailers also raised issues with Australia Post. In particular, these focussed on the extent to which Australia Post's retail services are cross-subsidised by its monopoly activities, and the lack of commission paid by Australia Post for the retailing of stamps. Other submissions also raised concerns about cross-subsidisation.

Regulatory framework

'Reserved' postal services are defined under section 29 of the *Australian Postal Corporation Act 1989* (APC Act), which gives Australia Post the exclusive right to deliver letters and perform other functions related to their delivery within Australia whether they originate in Australia or overseas. Reserved services are declared under section 21 of the PS Act and Australia Post must notify the Commission if it wants to increase prices.

Other services provided by Australia Post are not reserved, and are open to competition from other businesses. Such exceptions include letters weighing more than 250g and letters that are carried for a charge more than four times the basic postage rate, as well as non-mail services such as retailing and financial services. The prices of these services are not subject to the provisions of the PS Act.

In assessing price notifications submitted to it, the Commission is required to meet certain statutory obligations under the provisions of subsection 17(3) of the PS Act. The Commission applies this legal framework according to the concepts and procedures outlined in the *Draft Statement of Regulatory Approach to Price Notifications*.

Within this legal framework, the Commission broadly aims to ensure the proposed prices are consistent with the following principles:

- the cost base underlying the proposed charges is efficient;
- the service provider faces appropriate signals for new investment decisions;
- service users receive appropriate signals for the efficient use of declared services; and
- the provider earns a reasonable rate of return which does not reflect monopoly rents.

Section 20 of the PS Act provides that the Minister may direct the Commission to give special consideration to certain other matters. Direction 11, made under this provision, requires the Commission to give consideration to:

- Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in the Australian Postal Corporation Act 1989 (APC Act); and
- The functions and obligations of Australia Post as set out in the APC Act and under any directions or notifications given to Australia Post by the Minister.

Application of the regulatory framework

The Commission generally attempts to assess the efficiency of the declared firm's cost base and the rate of return[3] the company is seeking. In other words, the Commission will balance Australia Post's desire to increase profits with the need to ensure that it does not increase prices over and above a level that is economically efficient.

In order to assess the efficiency of the cost base, the Commission will usually undertake a detailed analysis of the declared firm's costs. However, Australia Post's initial submission did not provide sufficient information to properly assess these issues and, instead, provided information about changes in activity levels and productivity growth which it claimed would affect its future costs. The Commission considers that these factors are not, in themselves, sufficient to justify a price increase especially if the company is already earning sufficiently high returns.

The Commission has therefore undertaken its own analysis of the profitability of providing reserved services. In doing so, it has separated costs and profits relating to reserved services and other Australia Post services. The analysis seeks to estimate how much revenue Australia Post needed to earn a high enough rate of return to enable it to continue to provide the services.

This profitability analysis draws together the various factors considered elsewhere in this document. These include: the demand for postal services, costs – both capital and operating – and Australia Post's CSOs.

Demand for postal services

A key element of Australia Post's case for price increases is its argument that growth in mail is slowing over the next 5-10 years, with its overall estimate representing an average growth rate of 0.2% per annum from 2001/02 until 2006/07. Australia Post claims that letter volumes will become increasingly affected by substitution, consolidation and rationalisation[4] over coming years. The Commission's preliminary view is that such developments are possible, and that Australia Post's predictions appear to be supported by international experience.

However, several submissions argue that this is a pessimistic view, and that the forecast decline is likely to be related to the price increases currently proposed.

The Commission has reached the preliminary conclusion that demand for reserved services is likely to be relatively price inelastic. That is, a price increase is unlikely to result in a significant reduction in user demand. Of the three letter segments identified by Australia Post

[3] Rate of return means return on investment. That is, the profit as a percentage of assets or capital. It does not mean profit overall.

[4] Substitution means that instead of post, other methods, particularly electronic methods of communication will be used. Consolidation and rationalisation includes methods used to reduce the volume of mail such as including more information in one letter or reducing the frequency with which bills or invoices are mailed out.

– social, transactional and promotional – the Commission expects that the price elasticity of demand for social and transactional mail will be relatively low over the range of prices under consideration. The Commission is of the view, however, that promotional mail users will be more price sensitive.

For the purposes of this preliminary view, the Commission has accepted Australia Post's forecasts and assumes that they already reflect the anticipated effect of the proposed price increases. Furthermore, while it is possible the increases may lead to some short-term effects, an expected decline in real prices over the medium-term will mitigate the extent to which volume reduction is a concern.

Productivity

Another key reason cited by Australia Post for an increase in prices is the projected decline in productivity growth to levels below those achieved in recent years. Australia Post claims that throughout the 1990s it achieved superior productivity gains through the introduction of new technology, rationalisation of labour and changes in employment practices. Australia Post contends that it will be unable to sustain these growth rates particularly given its forecast decline in letter volumes and reduced opportunities for labour and capital productivity improvements.

Australia Post's submission focussed on labour productivity. However, this is a partial measure only, and if labour use has been reduced as a result of increased use of capital, it may overstate actual productivity performance. The Commission has therefore looked also at measures of total factor productivity, with the aid of independent consulting advice from Meyrick & Associates. This analysis has informed its assessment of the reasonableness of Australia Post's current and projected operating costs.

With regard to past productivity growth, the Commission's view is that Australia Post has achieved significant productivity gains over the 1990s. The Meyrick study found that Australia Post (as a whole) has improved total factor productivity (TFP) by an average 3.5% p.a. over the past ten years. In focussing on just the reserved services, a similar result is obtained. This suggests that the current level of operating and maintenance costs are a reasonable starting point for an analysis of Australia Post's profitability.

The Meyrick results suggest that a significant substitution of capital for labour has occurred in recent years, a result that would be expected given the implementation of the FuturePost program. This substitution explains the lower rate of growth in TFP compared to labour productivity.

The historical results also show that a significant driver of past productivity growth has been growth in output. It follows that forecasts of lower volume growth also suggest lower rates of productivity growth. Looking at the extent to which Australia Post is factoring in productivity gains in the future, it appears that this is in fact the case. A reasonable reduction in inputs is forecast, but anticipated volume growth is much lower. That said, it is not clear that Australia Post has fully explored the potential for cost reduction in the years beyond 2004/05.

Rather than prescribing a reasonable level of projected operating and maintenance costs, however, the Commission's emphasis is to encourage Australia Post to continue to seek out possible cost reductions by providing it with suitable incentives. The previous price freeze for the basic stamp (prevailing from 1992) appears to have been successful in providing Australia Post with the incentive to reduce costs and pursue productivity gains. The Commission considers that such an incentive could be replicated if Australia Post adopted a similar pricing policy over the medium-term.

Community Service Obligation

The statutory requirement that Australia Post collect and deliver "standard postal articles" at a uniform rate throughout Australia means that it cannot operate in a purely commercial manner. Australia Post also has a requirement to provide a reasonably accessible and equitable service to all people in Australia. These requirements give rise to community service obligations (CSOs).

The Commission acknowledges that the imposition of these CSOs mean that Australia Post's costs will be higher than those that would be found in a purely commercial service provider. Similarly, it accepts that the policy of providing services at a uniform rate throughout Australia means that there will be some cross-subsidisation from profitable mail routes to those routes on which the cost of providing services is greater than the price charged. The costs associated with CSOs have therefore been incorporated into the Commission's profitability analysis.

Cost allocation

A number of submissions expressed concern about the possibility that Australia Post's reserved services cross-subsidise competitive services, thereby providing Australia Post a considerable advantage in the provision of the latter. The concern arises because Australia Post incurs a range of costs which are common to the provision of both groups of services.

For the purposes of its profitability modelling, the Commission sought to identify costs relevant only to reserved services, including the allocation of common costs between reserved and non-reserved services. Addressing this issue necessitated an examination of the manner by which Australia Post allocates costs between the two categories.

Australia Post uses a complex activity based costing system to allocate costs to its different products. This is referred to as its product costing system (PCS). Essentially the system is a form of fully distributed costing, which ensures that all operating and depreciation costs are allocated. The system does not, however, allocate financing or tax costs.

Products in the PCS are not separated to the same level of detail as Australia Post's separate pricing categories. However, the product categories in the system clearly distinguish those that are reserved from those that are not. Consequently, while the separation between reserved and non-reserved services is reasonably well-defined, the separation of costs between separate reserved services is less precise.

The Commission's preliminary view is that the *principles* of activity based costing are reasonable for the purposes of assessing an appropriate level of prices across reserved services as a whole.

Given that the principles of Australia Post's costing methodology are acceptable, a critical question arises as to how they are implemented. In the limited time available for its assessment, it was not feasible for the Commission to examine in detail the quantification for all the cost drivers that are used to implement these principles.

The Commission has, however, undertaken some sampling of Australia Post's cost allocation model. No significant problems became apparent through this process.

Accordingly, for the purposes of assessing the draft notification, the Commission has adopted the cost allocations provided by Australia Post.

Asset valuation

Part of the Commission's profitability analysis entails an examination of the value of assets employed in providing reserved services.

The valuation of assets is important in two respects. First, it is the basis for determining the amount of revenue that an investor in Australia Post would require to recover its investment in the assets required to provide the regulated services. This amount, the return *of* capital, is commonly thought of as the depreciation component of regulatory pricing models. Secondly, a rate of return measure is applied to the depreciated asset value to determine an amount of revenue that Australia Post requires in order to compensate it for the opportunity cost of funding those assets, given its relative level of risk.

Two distinguishing features of Australia Post's asset base are:

- the generally non-specialised nature of its assets; and
- the generally non-sunk nature of its assets.

These characteristics suggest that the issue of asset valuation is less problematic for Australia Post than in other regulatory contexts. The Commission's preliminary view is therefore to adopt the asset values provided by Australia Post as the basis for assessing its proposed prices.

Australia Post allocates assets to particular business sections rather than specific products which means that assets allocated to the letters business are likely to be used for some unreserved large letter services. The profitability analysis takes this into account by reducing the amount of revenue to be recovered through prices for the reserved services.

As at 30 June 2002, the value of fixed assets for the letters business was $1203m.

Weighted Average Cost of Capital

The return on capital component of the Commission's profitability analysis also requires an estimate of the required rate of return on capital. The Commission estimates parameters to determine both the cost of debt and the cost of equity capital. It then weights these according to the capital structure to determine the Weighted Average Cost of Capital (WACC). The analysis aims to ensure that an investor in the regulated business earns an adequate post-tax return on equity.

On the basis of the parameters proposed by Australia Post, its post-tax nominal WACC would be 9.4%.[5] This is the equivalent to a post tax nominal return on equity of 10.8%. The Commission, however, took a different view of the appropriate values for the risk-free rate, the market risk premium and imputation credit parameters. As a consequence, the Commission's view is that the appropriate nominal WACC is the lower value of 8.7%, which corresponds to a post tax nominal return on equity of 9.9%.

Financial modelling

The Commission has modelled the amount of revenue required to cover the total costs of providing reserved letter services. The model takes into account operating and maintenance costs; depreciation on fixed assets; return on capital; other capital charges; and income tax. While the PS Act provides no fixed rule about the period of time that should be considered in pricing decisions, the Commission considers that in this case, it was appropriate that the model should cover a 5 year period.

The Commission invited Australia Post to provide its own financial model - showing how the proposed prices reflected costs, volumes, efficiency and required rates of return - to support the arguments raised in its initial submission. Although Australia Post did not provide such a model, it did provide data showing forecasted levels of volumes, asset values, operating costs, revenues and profits for the 5 years to 2006/07.

The Commission has applied Australia Post's own cost data in the financial model, together with the WACC considered by the Commission to be more appropriate. It concludes that Australia Post's proposed price increases would raise more revenue than is necessary to cover its costs (over the five year period considered).

The following tables show the comparison between modelled costs and the revenues that would be generated from Australia Post's proposed pricing over the period 2002/03 to 2006/07.

[5] The measure referred to here represents the nominal vanilla WACC. For a more detailed discussion, refer to Chapter 9.

Table (i): ACCC financial modelling results

[$m]	2002/03	2003/04	2004/05	2005/06	2006/07
Volume (million letters)	**4,163**	**4,189**	**4,205**	**4,205**	**4,184**
Average Assets	$1,216	$1,208	$1,192	$1,194	$1,184
Return on capital	$75	$74	$73	$73	$73
Depreciation (current prices)	$119	$126	$129	$132	$133
Total capital charge	$193	$200	$202	$205	$206
Operating costs	$1,536	$1,579	$1,600	$1,649	$1,707
Total Costs	*$1,729*	*$1,778*	*$1,802*	*$1,854*	*$1,912*
Plus Tax Liability	$19	$20	$21	$22	$23
Less Dividend Imputation Credit	-$9	-$10	-$10	-$11	-$11
Required Revenue	**$1,739**	**$1,788**	**$1,813**	**$1,865**	**$1,923**
Revenue at existing prices	$1,767	$1,778	$1,785	$1,785	$1,776
Revenue at AP proposed prices	$1,807	$1,869	$1,870	$1,864	$1,849
Existing *less* required revenue	$28	-$10	-$28	-$80	-$147
Proposed *less* required revenue	$68	$80	$57	-$1	-$75
Unit revenue - required ($)	$0.418	$0.427	$0.431	$0.443	$0.460
Unit revenue - existing prices ($)	$0.424	$0.424	$0.423	$0.422	$0.420
Unit revenue - AP proposed prices ($)	$0.434	$0.446	$0.445	$0.443	$0.442

In light of the findings from this financial analysis, the Commission has considered several alternative options available under the PS Act.

Pricing options

In considering what prices might bring Australia Post's prospective revenues to a more appropriate level, the Commission has examined the following options general:

- object to some of the proposed increases but not others;
- object to all proposed increases but not object to lesser increases;
- recommend Australia Post delay the introduction of some of the proposed increases; or
- a combination of the above.

This requires some consideration of the feasibility of certain options. For example, as the 5 cent coin is the smallest denomination in the Australian currency, it is more practical that the cost of stamps be a multiple of 5 cents. The proposed increase of the basic postal rate from 45c to 50c is therefore the most practical even if a cost increase to 47c is easier to justify.

The Commission's analysis also suggests that the margin between full rate post and PreSort rates is, if anything, insufficient. Australia Post recovers a relatively low return in relation to costs on ordinary full rate services and a relatively high return on PreSort services. On this basis it would represent a reduction in efficiency to further narrow the gap between these classes of services. Indeed, by *increasing* the current margin between full rate and bulk mail, more competition between mail aggregators – and hence more efficient outcomes - might be fostered.

The Commission's preliminary view is that it would be more economically efficient if the price for ordinary small letters is increased (basic postal rate) but the prices for bulk mail (PreSort) remains unchanged. The Commission also considers the introduction of Clean Mail and unbarcode residue rates acceptable.

This response would create a better alignment between costs and revenues than is currently the case. It may also minimise any welfare losses caused from price increases due to the lower degree of demand sensitivity of full rate mail. Further it may encourage longer term dynamic efficiency by lending greater confidence to those considering investing in markets related to, and dependent upon, the services reserved to Australia Post.

Preliminary view

The Commission considers that Australia Post's proposed price increases would appear to result in Australia Post earning excessive revenues in the immediate future and that this is contrary to the requirements of the PS Act.

The Commission's preliminary view is that it does not object to the proposed increase in the basic postage rate, but that it does object to the proposed increases in Barcode PreSort, large letter and some local delivery rates. It has also formed the preliminary view that it would not object to the proposed increase relating to Clean Mail and the unbarcoded residue rates.

The Commission's preliminary view is to not object to the postal charges proposed by Australia Post for the services set out in Table (ii).

The Commission's preliminary view is to object to all the other **increases** in postal charges for reserved services proposed by Australia Post.[6] A full set of Australia Post's proposed prices is contained in Appendix A.

A number of the price changes proposed by Australia Post represent price **decreases**. Australia Post has no requirement to notify these changes and as such, the Commission does not object to them.

In light of the preliminary views expressed here, the Commission notes that Australia Post may wish to re-consider its proposed pricing and structure, in particular, for barcoded pre-sort letters. The Commission is prepared to consider such proposals, but emphasises its concerns regarding overall price levels and the extent to which re-structuring might deter mail aggregation. In general, Australia Post should demonstrate that the re-structure would not lead to increases in average prices beyond those represented in this preliminary view.

While not all of Australia Post's increases were approved, the increases that would be allowed should provide sufficient returns to Australia Post over a 5 year period. This will provide positive incentive effects in relation to investment, stimulus to volume growth and an incentive for Australia Post to continue to reduce costs through productivity improvements.

[6] A number of the price changes proposed by Australia Post relate to services not reserved to Australia Post, and thus not declared for the purposes of the PS Act. These comprise large letters weighing more than 250g. Australia Post has no requirement to notify these changes and as such, the Commission does not object to them.

Table (ii): Commission preliminary view – postal charges not objected[1]

Service	Current price[3]	Proposed price
Small letter – ordinary	$0.45	**$0.50**
Small letter – Clean Mail	-	**$0.45**
Small letter – seasonal greeting	$0.40	**$0.45**
Small letter – barcoded and metered	$0.43	**$0.48**
Local delivery – small letter up to 125g	$0.41	**$0.46**
Prepaid Envelopes		
Small (DL & C6)		
Single	$0.54	**$0.60**
1-4 Packs of 10	$5.13	**$5.85**
5+ Packs of 10	$4.86	**$5.70**
Small Window Faced (DL & C6)		
Pack of 50	$25.55	**$29.70**
Pack of 500	$244.50	**$286.00**
Clean Mail		
Medium Letters – 5mm Max[2]		
Up to 125g	-	**$0.70**
Large Letters		
Up to 125g	-	**$0.98**
Over 125 up to 250g	-	**$1.43**
Over 250 up to 500g	-	**$1.98**

1. GST-inclusive
2. Provided Australia Post elects to offer this pricing category.
3. Where no current price is specified (because the service does not currently exist), the appropriate comparator is the full rate price that would apply in the event the new price was not approved.

Table (ii) (cont.): Commission preliminary view – postal charges not objected[1]

Service	Current price[3]	Proposed price
Unbarcoded Residue Rates – Regular Delivery		
Small Letters		
Up to 125g	-	**$0.450**
Charity Mail	-	**$0.450**
Medium Letters - 5mm Max[2]		
Up to 50g	-	**$0.700**
Over 50 up to 125g	-	**$0.700**
Medium Letters - 20mm Max		
Up to 50g	-	**$0.803**
Over 50 up to 125g	-	**$0.803**
Over 125 up to 250g	-	**$1.034**
Large Letters		
Up to 50g	-	**$0.980**
Over 50 up to 125g	-	**$0.980**
Over 125 up to 250g	-	**$1.430**
Over 250 up to 500g	-	**$1.980**
Unbarcoded Residue Rates – Off-Peak Delivery		
Small Letters		
Up to 125g	-	**$0.435**
Charity Mail	-	**$0.435**
Medium Letters - 5mm Max[2]		
Up to 50g	-	**$0.671**
Over 50 up to 125g	-	**$0.671**
Medium Letters - 20mm Max		
Up to 50g	-	**$0.759**
Over 50 up to 125g	-	**$0.759**
Over 125 up to 250g	-	**$0.946**
Large Letters		
Up to 50g	-	**$0.957**
Over 50 up to 125g	-	**$0.957**
Over 125 up to 250g	-	**$1.353**
Over 250 up to 500g	-	**$1.815**

1. GST-inclusive
2. Provided Australia Post elects to offer this pricing category.
3. Where no current price is specified (because the service does not currently exist), the appropriate comparator is the full rate price that would apply in the event the new price was not approved.

1 Introduction

1.1 Australia Post

Australia Post is a business enterprise fully owned by the Commonwealth Government. It was corporatised in 1989 and its activities and responsibilities are set out by the *Australian Postal Corporation Act 1989* (the APC Act).

Australia Post's obligations are defined by sections 25-28 of the APC Act. Firstly, Australia Post has an obligation to, as far as is practicable, perform its functions in a manner consistent with sound commercial practice.

Secondly, Australia Post has a universal service obligation. This means that it must carry and deliver standard letters at a uniform postage rate - currently 45c - to anywhere in Australia. This obligation is known as the Community Service Obligation (CSO) and reflects the social importance of the letter service. Under this obligation, Australia Post is required to ensure that the service is reasonably accessible to all Australians on an equitable basis, irrespective of where they reside. Furthermore, Australia Post must ensure that the performance standards for the letter service reasonably meet the social, industrial and commercial needs of the Australian community.

Finally, Australia Post is required to pay heed to general government obligations (including obligations under conventions to which Australia is a signatory), any directions given by the Minister, and any general policies of the Federal government of which the directors are notified under the *Commonwealth Authorities and Companies Act 1997*.

In 1998, the NCC described Australia Post as follows:

> Australia Post is one of Australia's largest companies. It has outlets in almost every suburb and town in Australia and is very likely to be used by every Australian. There are over 20,000 posting facilities and Australia Post services nearly eight million delivery points. … it ranks among Australia's largest businesses in terms of revenue, profit and employment.[7]

The NCC described Australia Post as operating within the Communications Services Market as this market includes postal services and telecommunications[8]. However, Australia Post identifies five major "markets" in which it operates[9]. These services may or

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[7] National Competition Council (NCC), *Review of the Australian Postal Corporation Act, Final Report, Volume 2*, 1998, p. 51.

[8] NCC 1998, p. 7.

[9] Australia Post Annual Report 2000/01, p. 8.

may not be provided in a competitive environment and are not all within the communications market. They are:

- Letters: collection, processing and distribution of letters to the whole Australian community and between Australia and overseas;
- Parcels: providing an Australia-wide parcel service including a number of categories of parcel post;
- Logistics: providing an integrated business logistics service which provides end-to-end services including warehousing, inventory management, order picking, assembly and consolidation, kitting, scan packing, returns management and delivery;
- Financial services: providing access to a wide range of financial services through its retail and electronic networks, for example Billpay, giroPost and money orders; and
- Retail: offering a range of products that are complementary to postal services through the post office network.

It also offers other services including customised services such as Messenger Post; delivery of Coles Online groceries, courier services, and other Mailroom Solutions.

Under the APC Act, certain postal services are 'reserved' to Australia Post. This means that Australia Post has the exclusive right to provide these services. In particular, Australia Post has an exclusive right to deliver letters within Australia and an exclusive right to issue postage stamps.

There are a number of exceptions to the reserved services. Most notably, letters weighing more than 250g are not reserved, nor are letters that are carried for a charge more than four times the basic postage rate. Since the current postage rate is 45c, this means that letters carried for a fee of over $1.80 are not reserved. Other services which are not reserved include services include parcel delivery, outgoing international mail, mail holding or mail re-direction, logistics, financial services and retail services.

1.2 Market for postal services

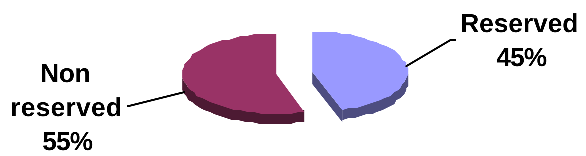
Size of the market

Australia Post reported $3,732.6 million in revenue in the year ending 30 June 2001[10] and $274.5 million in profits after tax. Reserved mail services represent a significant component of the services provided by Australia Post in terms of revenue (see Figure 1-1) but a small

10 Australia Post Annual Report 2000/01, p. 7.

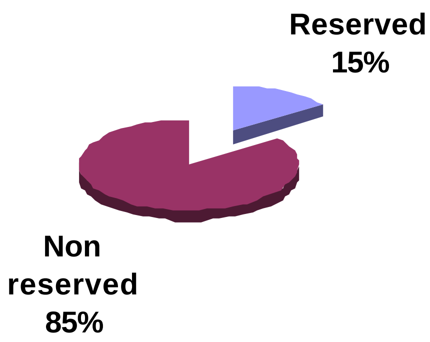
proportion of Australia Post's profits (see Figure 1-2). On the basis of these figures, reserved mail services generated $1680m revenue and $41m profit after tax in that year.

Figure 1-1: Proportion of Revenue Received from Reserved Services 2000/01



Source: Australia Post *Annual Report* 2000/01 p.8

Figure 1-2: Proportion of Profit Received from Reserved Services 2000/01



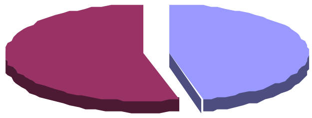
Source: Australia Post *Annual Report* 2000/01 p.8

The letters business

Reserved mail services come within Australia Post 'letters business'. The letters business comprises that part of Australia Post's operations covering the delivery of addressed letters within Australia. The letters business includes large letters (letters greater than 250g are not reserved to Australia Post) but not publications (Print Post) or unaddressed letters. Other business units in Australia Post include Parcels, Retail, Financial Services and Logistics. Figure 1-3 compares the size of the letters business relative to Australia Post's other businesses.

'Letters market' is a more generic term used to refer to the domestic addressed letters market (including letters up to 500g) and includes letters delivered by other carriers. The Commission is only required to assess price changes to reserved letters. However, it should be noted that Australia Post's submission discusses the characteristics of the letters market as a whole rather than the reserved letters market or those segments of the reserved letters market which will be affected by the proposed price increases.

Figure 1-3: Letters Business Share of Revenue 2000/2001



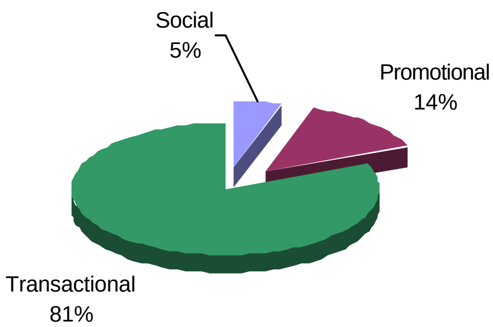
Source: Australia Post *Draft Notification of Change in Letter Pricing – Basic Postage Rate and Associated Services*, (Revised on 28 May 2002), p.5.

The non-reserved letters component of the letters business mainly comprises ordinary and bulk letters in the 250g to 500g category. Non-reserved letters represent approximately 1% of total letters business volume and approximately 4% of total letters business revenue. Incoming international letters are reserved letters but are not the subject of the current draft notification. Outgoing international letters are not reserved.

For pricing purposes, Australia Post distinguishes between ordinary letters and bulk mail (whether reserved or unreserved) which includes local delivery, barcode PreSort letters and Clean Mail. Each of these segments are further divided into different 'price points'. For example, ordinary letters includes the small letters sent by ordinary post service which attracts the BPR, exceptionally small letters and seasonal greeting cards which are charged below the BPR and large letters which are charged higher than the BPR. Similarly, PreSort offers to customers who have at least 300 letters to send and who sort and barcode their letters before lodgement different charges based on the level of pre-lodgement sorting and whether the letter is to be sent by regular delivery or by off-peak delivery.

Australia Post also makes a distinction between social, transactional and promotional mail. This grouping reflects the reason the letter is being sent. Social mail includes household to household mail. Transactional mail includes mail from business to households, from households to business and from business to business. Promotional mail consists of direct mail and includes promotional mail, brochures and other addressed promotional mail that satisfies the small letter category size and weight requirements. Social mail is typically sent at ordinary rates whereas mail emanating from businesses may be sent at ordinary rates or may qualify for discounts available to bulk mailings such as PreSort. Demand for postal services in each of these categories is affected by different factors and is explored more fully in Chapter 4. The relative importance of these categories is represented in Figure 1-4.

Figure 1-4: Letter Segments by Volume 2000/01



Source: Australia Post Public Submission "Impact of the Proposed Price Increases on Letter Volumes", July 2002, page 1.

1.3 Reserved services and related markets

The significance of having reserved services is that it allows Australia Post to operate the service as a regulated monopoly. This means that there is no direct competition in the supply of reserved services.

Australia Post's draft notification relies heavily for its justification on its assertion that growth in demand for reserved services is declining partially because of the availability of substitutes such as electronic mail. This claim is explored and partially confirmed in the NCC Report and, as evidenced by a World Bank report[11], is not confined to Australia.

However, it would be wrong to conclude from the availability and apparent growth of substitutes that the extent of Australia Post's monopoly is limited. Australia Post's market power is therefore kept in check by government regulation. In addition to prices surveillance, which is discussed in more detail below, these statutory constraints, which are more fully described in Chapter 2, generally have the effect of seeking to ensure that specific social objectives can be met. Of particular importance in this context is Australia Post's obligation to carry and deliver standard letters at a uniform postage rate – currently 45c - to anywhere in Australia.

Clearly, the letters service is a distinctive service and, while there may be other areas within the communications market that are increasing market share relative to letters, these are not perfect substitutes for the letters service.

Partially because of its market power and despite the presence of substitutes, the NCC recommended that the Australia Post's control over reserved services be substantially but not completely dismantled. It recommended that Australia Post still have a monopoly over household mail; that the uniform rate of postage be retained (but that Australia Post could

[11] Referred to in the NCC Report, p. 15.

lower the rate of postage below that rate); and that Australia Post should still meet the Universal Service Obligations regarding letter delivery[12].

The NCC's views remain current. In its annual assessment, the NCC further recommends that, in order "to maintain and, if possible, enhance the social obligation of Australia Post … [legislative reforms] should facilitate the emergence and growth of competing firms in the postal services industry in the interests of the Australian community."[13]

However, legislation to facilitate improved access Australia Post's network (introduced into Parliament in response to the NCC's findings[14]) was withdrawn in March 2001. The situation therefore remains one in which Australia Post is a monopoly provider of mail services, which may provide it with a competitive advantage in relation to related services.

Reserved postal services are declared under the *Prices Surveillance Act 1983* (PS Act). This means that, despite its market dominance, statutory constraints mean that Australia Post is not totally free to set prices. The regulatory framework is discussed in greater detail in Chapter 2.

Australia Post's monopoly over reserved services and its pricing policies has an effect on commercial users of Australia Post's services and on upstream and downstream markets within which other providers operate and in which Australia Post may or may not compete. Appendix F provides a list of the areas in which businesses interact, or even compete with, Australia Post.

The issue of the effect of Australia Post's pricing policies on upstream and downstream competitors was raised by the MMUA using the fate of GoMail, a mail aggregator, as an example. It claimed that Australia Post's ability to impose its own terms and conditions under section 32 of the APC Act led to the closure of GoMail and that this was an abuse of Australia Post's monopoly powers[15].

It was also raised in submissions from newsagents who are licensed to sell stamps. Australia Post pays a commission to post office licensees and agents and to Postpoint operators and restricts licences to other stamp vendors to protect those interests. Licensed stamp vendors do not receive a commission on the sale of stamps (the licence gives them the right to buy and sell stamps at face value) and are affected by restrictions on the number of licences available.

The way in which prices set by Australia Post can affect the ability of firms to enter and compete in these areas is discussed further in Chapter 11. However, the effect of other policies of Australia Post, such as the determination of terms and conditions for access to its reserved services, is outside the terms of this review.

[12] NCC 1998, p. 254.

[13] NCC, *Assessment of Governments' Progress in Implementing National Competition Policy and Related Reforms*, June 2001, p. 253.

[14] *Postal Services Legislation Amendment Bill 2000*.

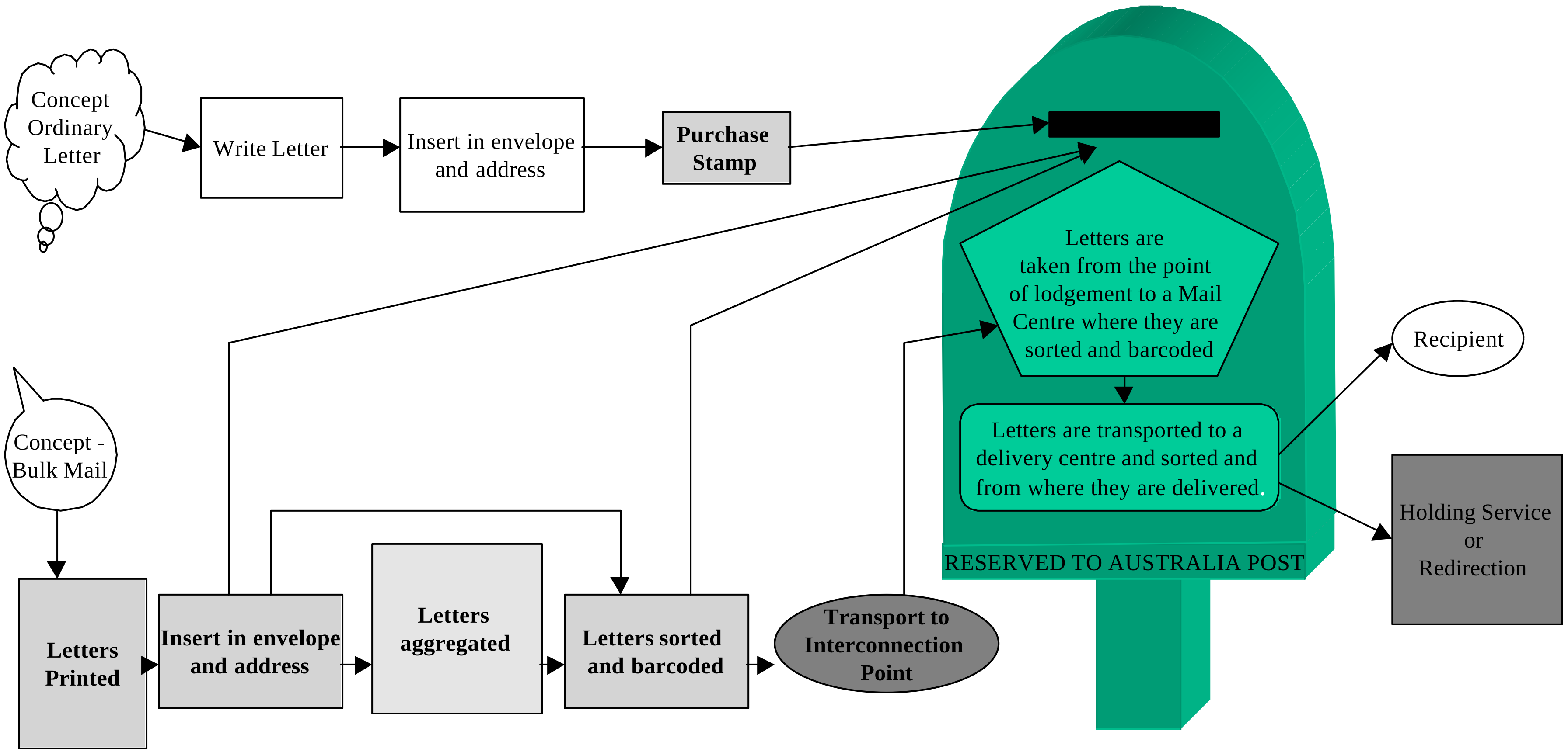
[15] ibid., pp. 13-14.

By way of summary, Figure 1-5 provides a schematic representation of some of the processes and activities associated with mail. It tracks the different stages a letter must pass through between its original conception by the originator or sender to the point at which it is delivered to the intended recipient. This Figure only tracks letters that are processed by Australia Post at some stage in their journey. It does not include letters which are delivered by competitors such as couriers or document exchange services[16].

Figure 1-5 also demonstrates the functions that can be provided by Australia Post or by an upstream or downstream competitor. Highlighted boxes on the figure represent areas where other firms operate or where bulk customers may perform certain functions themselves in order to obtain a discount. Australia Post itself operates in some of these areas.

[16] There is a specific exemption in the *Australian Postal Corporation Act 1989* for document exchange services at paragraph 30(1)(ma), and couriers may pick up and deliver letters under the exemption, at paragraph 30(1)(e) for cases where the charge is more than four times the cost of an ordinary letter. Similarly, other upstream and downstream competitors may also rely on exemptions under subsection 30(1).

Figure 1-5: Opportunities for competition in process of letter delivery from conception to delivery



Key:

- Function performed by origator/sender
- Function performed by originator or 3rd party (not Australia Post)
- Function performed by orginator, 3rd party or Australia Post
- Function performed by 3rd party or Australia Post

Source: ACCC.

Further description on some of these services is contained in Appendix F.

1.4 The current draft notification

On 30 April 2002 Australia Post provided the Commission with its *Draft Notification of Change in Letter Pricing – Basic Postage Rate and Associated Services*[17]. Australia Post intends to increase the price of assorted postal services, including the price of the basic postage stamp, pre-sorted mail, greeting cards and large letters, effective January 2003. In addition, Australia Post proposes to introduce a new bulk mail category, Clean Mail, priced at a discount to the basic postage rate. The individual price changes proposed are set out in Appendix A to this preliminary view.

The draft proposal relates to changes in both the price structure and levels of charges for reserved postal services.

Australia Post's proposed changes include:

- a 5 cent increase to the basic postage rate (increasing it from 45 cents to 50 cents) and increases to large letter, local, seasonal greetings and prepaid envelope rates to maintain appropriate relativities to the new basic postage rate;
- an increase to PreSort rates of around 2 cents per article;
- introduction of a Clean Mail service for lodgements of 300 or more machine addressed letters;
- the replacement of the '90/10 barcoding rule' (requiring 90% of PreSort lodgements to be barcoded), which expired at the end of June 2002, with specific residue rates for letters that cannot be barcoded through the Address Matching Approval System process;
- introduction of a new PreSort medium letter category to align with Australia Post's small letter processing capabilities; and
- a combination of the existing 0-50g and 50-125g weight categories into a single 0-125g category for PreSort medium and large letters.

The full details of proposed charges, and a comparison with existing charges, are set out in Appendix A.

Australia Post states that a number of factors have contributed to the need to increase prices. These include diminishing volume growth and diminishing opportunities for productivity gains. As a result of this, Australia Post argues that the profitability of providing letter services is declining and will continue to decrease.

[17] Australia Post, *Draft Notification of Change in Letter Pricing – Basic Postage Rate and Associated Services,* (revised on 28 May 2002), is available on the Commission's website at <http://www.accc.gov.au/post/post.html>.

Australia Post also claims that the proposed price changes will result in ongoing profitability and compliance with its statutory obligations to fund Australia Post's CSO and to generate commercial returns.

A more detailed summary of Australia Post's arguments follows:

Volume

Australia Post argues that the letter volume growth rate has been in decline since 1994/95, with the exception of 1999/2000 when additional mailings related to the introduction of the GST and a national referendum resulted in volume growth of 6.3%.

Australia Post claims that the major factors contributing to the decline in letter volume are:

- a decline in discretionary letter volumes (caused by a depressed advertising market);
- a decline in GST related matters;
- the take-up of mobile phones; and
- the take-up of credit cards/loyalty cards.

A study by Diversified Specifics for Australia Post suggests that economic activity is no longer a primary driver of letter volume and that the divergence between GDP (non-farm) and postal service growth rates is expected to continue.

Australia Post predicts a continued decline in letter volume growth leading to actual decline (in absolute terms) within the next five years.

Revenue

Australia Post argues that the average unit revenues from Australia Post's letters business has been declining.

Australia Post claims that factors contributing to this trend include:

- the price freeze on the basic postage rate since 1992;
- the absorption of GST since July 2000; and
- the growth in lower priced PreSort Letters.

Productivity

Australia Post claims that cumulative labour productivity growth between 1991 and 2001 was 67%, compared with the Australian average of 28.7%.

Australia Post argues that it has implemented a number of initiatives to enhance productivity. In particular, it has significantly invested in technology and implemented a range of labour reforms.

It should be noted that labour productivity is the only measure of productivity proposed by Australia Post in their submission.

Profitability

Australia Post argues that there is a declining growth trend in the letters business of Australia Post. Furthermore, it suggests that profitability has only been maintained in recent years due to significant productivity improvements and volume growth.

Australia Post claims that if the basic postage rate and PreSort rates remain at their current levels the profitability of the postal service business may decline with the likelihood of rising costs, moderate volume growth and a decline in productivity growth.

Service standards

Australia Post argues that it has significantly improved its letter delivery performance. In 1991, 91% of the letters were on time and in 2001, 94.1% of the letters were on time.

Australia Post argues that, despite Australia's large size and highly dispersed population, it ranks amongst the best postal services in the world. Australia Post claims that it has a high standard of delivery with opening hours and intrastate and interstate delivery times (days) that compare favourably with countries such as the United States(US), United Kingdom(UK), Canada and New Zealand (NZ). A comparison of Australia Post's standard of delivery with these countries is provided in Table 1.1.

Table 1.1: Service standards, demographics and mail density

	Australia	Canada	USA	UK	NZ
Closing time	6pm	5pm	5pm	5:30pm	5-6pm
Intrastate delivery (days):					
- metro/metro	1	2	1	1	1
- country/metro	2	3	2	2	2-3
- country/country	2	3	2	2	2-3
Interstate delivery (days):					
- metro/metro	2	4	2-3	N/A	N/A
- country/metro	3	4	3	N/A	N/A
Population (m)	19.4	31	285	60	3.9
Area (million square kms)	7.7	9.2	9.2	0.24	0.27
Persons/square kms	2.4	3.4	30.9	250	14.4
Annual mail items per capita	229	363	663	278	190

Source: Australia Post draft notification

1.5 Australia Post's consultation

Australia Post informed the Commission that in March and April of this year, it undertook stakeholder consultation in relation to the proposed price changes. Specifically it held discussions with the MMUA and the ADMA. The changes that occurred as a result of these discussions were:

- redefinition of the Medium Letter category to align with the Multi Line Optical Character Readers and Bar Code Sorters processing capabilities;
- introduction of Clean Mail rates for Large Letters; and
- introduction of unbarcoded residue rates for PreSort to effectively extend the concept of Clean Mail to unbarcoded components of barcoded PreSort lodgements which might not comply with the enveloping and addressing conditions of the Clean Mail service.

Australia Post states that these discussions have resulted in a reduction in the annual revenue impact of the proposed package from $94.0 million to $91.3 million.

1.6 The role of the Commission

Reserved postal services are declared under Declaration 75 made under subsection 21(1) the *Prices Surveillance Act 1973* (PS Act). This means that Australia Post must notify the Commission – which has the role of assessing the proposed price increases - before it can increase the prices of these services.

Section 17 of the PS Act gives the Commission responsibility for reviewing proposed price increases for declared services. The Commission can object to the proposed increase but not object to a lower, specified increase (which can also include no increase) or it can decide to not object to the proposed increases. Not all reserved services are covered by the draft notification: for example, incoming international letters are not affected by the proposed price increases.

It is important to note that many services provided by Australia Post are **not** regulated by the Commission. Non-regulated services include parcel delivery, outgoing international mail, mail holding or mail re-direction, financial services and retail services. Should Australia Post wish to increase the prices for any of these services, they could do so at any time without giving notice to the Commission. The regulatory framework is discussed in more detail in Chapter 2.

In addition to the Commission's role in assessing any proposed price rises to reserved services, Australia Post is also required (by the APC Act) to give the Minister for Communications, Information Technology and the Arts written notice of any intention to vary the price of the postage stamp. The Minister then has 30 days in which to give Australia Post written notice disapproving it.

1.7 The Commission's assessment process

In reaching this preliminary view, the Commission has consulted with major stakeholders of Australia Post and sought submissions from other parties and the public on Australia Post's proposals. The Commission received submissions from a number of parties including the Major Mail Users Association (MMUA), Readers Digest and the Australian Direct Marketing Association (ADMA). A summary list of individuals and organisations which contributed is provided in Appendix B. Copies of all submissions received by the Commission are available on the Commission's website at http://www.accc.gov.au.

In late June, the Commission conducted a series of Public Forums across the country under the chairmanship of Commissioner John Martin. These forums were attended by community groups and other interested parties and discussed the possible effect Australia Post's proposals might have on users of postal services. A further forum was held in Melbourne on 11 July 2001 to discuss technical issues associated with Australia Post's proposal, including issues relating to the demand for postal services, efficiency of Australia Post, and costs and cross-subsidies. Transcripts from these forums are available on the Commission's website at http://www.accc.gov.au.

Australia Post and other interested parties will be given an opportunity to respond to this initial view as part of the consultation process. Following the release of the Commission's initial view interested parties are encouraged to make submissions on the preliminary conclusions.

Submissions should be forwarded to the following address by COB Friday 27th September 2002:

Margaret Arblaster
General Manager
Transport and Prices Oversight
Australian Competition and Consumer Commission
PO Box 520J Melbourne, Victoria 3001
Fax 03 9663 3699
E-mail: margaret.arblaster@accc.gov.au
and richard.home@accc.gov.au

Unless a submission is marked confidential it will be made available to any person or organisation on request. Sections of submissions that are confidential should be clearly identified.

The Commission aims to assess the submissions and release its final decision by late October 2002.

Table 1.2 provides a summary of the Commission's assessment timetable.

Table 1.2: Commission's assessment timetable

Date	Process
30 April 2002	Australia Post lodged draft notification with the Commission.
10 May 2002	The Commission released an Issues Paper seeking comment from interested parties.
June 2002	Submissions on draft notification received.
17 June – 28 June 2002	Holding of Public Forums across Australia[18].
11 July 2002	A Technical Issues Forum held in Melbourne.
Early September 2002	Release of the Commission's Preliminary View and calls for comments.
27th September 2002	Closing date for comments on Preliminary View.
October 2002	Release of final decision.

[18] Full details of the Australia Post Forums are provided in Appendix E.

The Commission has also received advice from the following consultants in its assessment of Australia Post's proposal:

- Professor Kevin Davis, on issues relating to Australia Post's cost of capital;
- Meyrick & Associates, on measures of Australia Post's productivity.

Copies of the advice received are available on the Commission's website. The Commission has taken into account the consultancy reports, submissions from interested parties and the forum discussions in reaching its initial view.

1.8 Past notifications

In recent years, the Commission has received a number of notifications from Australia Post.

In 1997 Australia Post notified the Commission of its intention to introduce barcoded letters by October 1999, with the phasing out of unbarcoded letters (bulk PreSort) by October 2000. The Commission did not object to the proposal.[19]

In April 1999 Australia Post proposed to make changes to the lodgement requirements for bulk mail, reduce the AdPost discount in October 1999, increase the discount offered to metered letters and postpone the phasing out of non-barcoded bulk PreSort mail until the end of June 2002. The Commission did not object to the proposal, but did recommend that Australia Post postpone the reduction in the AdPost discount until October 2000.

In early March 2000, Australia Post notified the Commission of changes proposed within the declared postal services to accommodate the imposition of the New Tax System. In late March 2000, Australia Post submitted another notification to cover additional declared services such as Postage PrePaid envelopes and Reply Paid services. The notifications allowed for the Government requirement for Australia Post to absorb the cost of the GST on the 45 cent ordinary small letter. The Commission did not object to either of the proposed increases.

In November 2001, Australia Post notified the Commission of a two-stage process to phase out the AdPost discount. The first stage involved a 10% increase in AdPost prices from 1 July 2002 and the second stage involved the discontinuation of the AdPost service from 1 January 2003. The Commission did not object to the proposal.

[19] The phasing-out was subsequently deferred to 1 July 2002.

2 The regulatory framework

This chapter sets out the legislative framework and discusses the principles that guide the Commission's assessment of Australia Post's proposal. Copies of relevant legislative instruments are contained in Appendix C.

2.1 Legislation

The *Prices Surveillance Act 1983*

The PS Act provides that the Minister may declare goods or services to be 'notified' goods or services and declare a person to be a 'declared person' for the purposes of the Act (subsection 21(1)).

Under Declaration 75[20] certain postal services have been declared to be notified services, and Australia Post is a declared person in relation to the provision of those services. The notified services are[21]:

> 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.

As Australia Post is a declared person it must notify the Commission if it proposes to increase the price of a notified service. It must also notify the Commission if it proposes to introduce a new service which falls within Declaration 75.

The PS Act requires the Commission to consider notifications from declared persons in relation to the price of notified services and to take such action in accordance with the Act as it considers appropriate (paragraph 17(1)(a)). Upon receiving a notification, the Commission may:

- serve a notice stating it has no objection to the person supplying the relevant goods or services on the proposed terms at the proposed price;
- serve a notice stating it would have no objection to the person supplying the relevant goods or services on the proposed terms at a specified price, being a price that is lower than the proposed price; or
- not serve any notice.

[20] Declaration No. 75 made under *Prices Surveillance Act 1993*, section 21, 5 February 1992, published in the *Commonwealth of Australia Gazette* No. GN 6 of 12 February 1992.
[21] ibid., Declaration No. 75, paragraph 2(a).

The *Australian Postal Corporation Act 1989*

The APC Act empowers the board of Australia Post to determine the terms and conditions of postal services (section 32). However the Board's power is not unfettered. Subsection 32(5) provides:

> This section [empowering the Board to determine terms and conditions] has effect subject to section 33 of this Act and to the *Prices Surveillance Act 1983*.

Section 33 of the APC Act requires Australia Post to notify the Minister of any determination fixing or varying the rate of postage for the carriage within Australia of standard postal articles by ordinary post. The Minister may disapprove any such determination.

As noted above, the postal services declared for the purposes of section 21 of the PS Act include the provision of letter services reserved to Australia Post under Division 2 of Part 3 of the APC Act. Section 29 of the APC Act provides:

> **Services reserved to Australia Post etc.**
>
> (1) Subject to section 30, Australia Post has the exclusive right to carry letters within Australia, whether the letters originated within or outside Australia.
>
> (2) The reservation of services to Australia Post under subsection (1) extends to:
>
> (a) the collection, within Australia, of letters for delivery within Australia; and
>
> (b) the delivery of letters within Australia.
>
> (3) Australia Post also has the exclusive right to issue postage stamps within Australia.

The APC Act further provides that certain services that might otherwise fall within the section 29 definition are not reserved services. Section 30 provides:

> **Exceptions to reserved services**
>
> (1) The reserved services do not include any of the following:
>
> (a) the carriage of a letter weighing more than 250 grams unless the letter consists of an envelope, packet, parcel, container or wrapper containing 2 or more separate letters;
>
> (b) the carriage of a letter relating to goods that is sent and delivered with the goods;
>
> (c) the carriage of a newspaper, magazine, book, catalogue or leaflet, whether or not directed to a particular person or address and whether or not enclosed in any sort of cover;
>
> (d) the carriage of a letter otherwise than for reward;
>
> (e) the carriage of a letter within Australia for a charge or fee that is at least 4 times the then rate of postage for the carriage within Australia of a standard postal article by ordinary post;
>
> (g) the carriage of a letter by the sender or an officer or employee of the sender;

(ga) the carriage of a letter from an office of the individual or organisation sending the letter to another office of that individual or organisation;

(h) the carriage of a letter to or from:

(i) the nearest office of Australia Post;

(ii) another office of Australia Post authorised by it;

(ha) the carriage of a letter to an office of Australia Post where it is then lodged for delivery under a bulk interconnection service (within the meaning of section 32A);

(j) the carriage of a letter on behalf of Australia Post under an agreement with it;

(k) the carriage of a letter that, under the terms and conditions on which Australia Post supplies postal services, is not a postal article;

(m) the carriage of writs, warrants or other documents required or permitted to be served, given or sent under the practice and procedure of any court or tribunal;

(ma) the carriage of a letter, in the course of a document exchange centre:

(i) from one service centre of the service to another service centre of the service;

(ii) within a service centre of the service;

(n) the carriage of a letter solely by any electromagnetic or other non-physical means;

(p) the carriage of letters by or on behalf of a foreign country under a convention;

(q) any service that, under the regulations, is not reserved to Australia Post.

Relevant in the present context is the exclusion from the scope of the reserved services of letters weighing more than 250 grams (paragraph 30(1)(a)).

2.2 Principles

In performing its functions in relation to Australia Post's pricing proposal, the Commission must have 'particular regard' to the matters in subsection 17(3) of the PS Act and give 'special consideration' to any relevant directions issued by the Minister under section 20 of the PS Act. The Commission may take into account any other relevant matter.

Principles emerging from subsection 17(3) of the *Prices Surveillance Act 1973*

Subsection 17(3) of the PS Act provides:

In exercising its powers and performing its functions under this Act, the Commission shall, subject to any directions under section 20, have particular regard to:

(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 substantially to influence a market for goods or services from taking advantage of that power in setting prices; and

(c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The notion of 'particular regard' means the Commission must have regard to the factors in subsection 17(3) as a significant element of its reasoning.

The meaning and scope of these criteria are discussed at length elsewhere.[22] Briefly, the Commission considers that, in relation to the first two criteria, an important consideration is that, in an open and competitive economy, efficient provision of services underpins investment and employment opportunity. Investment and employment in the national economy will be promoted when firms produce goods or services efficiently and charge prices which correspond as closely as possible to competitive levels.

Monopoly suppliers do not necessarily produce goods or services at efficient cost levels or at competitive prices. If higher than efficient prices are passed on to the competitive part of the economy, there is a resultant loss in allocative efficiency and potentially a loss of investment and employment opportunity.

The Commission considers that encouraging efficient pricing outcomes in line with more competitive conditions implies that prices should stem from a cost base which is efficient and involve appropriate margins.

Thus the Commission considers it appropriate, when having regard to the matters referred to in subsection 17(3), to examine:

- the efficiency of the cost base the company is working from to earn a return; and
- the reasonableness of the rate of return the company is seeking.

The third criterion outlined in subsection 17(3) no longer appears to be directly relevant to price notifications because of changes to industrial relations legislation and wage determination practice.

Direction 11 issued under section 20 of the *Prices Surveillance Act 1973*

Section 20 of the PS Act provides that the Minister may direct the Commission to give special consideration, in exercising its powers and performing its functions under the PS Act, to certain specified matters. Direction 11, issued under section 20 of the PS Act, directs the Commission as follows[23]:

[22] ACCC, *Sydney Airports Corporation Ltd – Aeronautical Pricing Proposal: Decision*, May 2001, p.41-9; ACCC, *Draft Statement of Regulatory Approach to Price Notifications*, April 1998.

[23] Direction No. 11 made under PS Act section 20, 19 September 1990.

(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.

Financial targets

Direction 11 directs the Commission to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plans (made under section 17 of the *Commonwealth Authorities and Companies Act 1997*)[24] as set out in sections 35 to 41 of the APC Act, particularly the pricing and financial targets. Most of these provisions have been revoked, so that only sections 38 and 40 remain operative.

Section 38 directs Australia Post to have regard to certain matters when setting a financial target for inclusion in its corporate plan. These include:

- the need to earn a reasonable rate of return (section 38(a));
- the Commonwealth's expectation that Australia Post will pay a reasonable dividend (s 38(c));
- Australia Post's financial viability (section 38(d));
- the need to maintain a reasonable level of reserves (section 38(e);
- such commercial matters Australia Post considers appropriate (section 38(f)); and
- the cost of carrying out Australia Post's CSOs (section 38(g)).

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[24] Australia Post is a government business enterprise (*Commonwealth Authorities and Companies Regulations 1997*, reg 4) and must, under section 17 of the *Commonwealth Authorities and Companies Act 1997*, annually prepare a corporate plan and give it to the responsible Minister. The plan must include (among other things) details of financial targets and projections, CSOs and the authority's strategy for carrying out those obligations, and price control and quality control strategies for goods or services supplied by the authority under a monopoly.

Section 40 provides the Minister may direct Australia Post to vary the financial target in its corporate plan and the strategies and policies under which Australia Post proposes to carry out its CSOs.

Australia Post states:

> [Australia Post] has a financial target whose level is governed by legislation. The relevant Minister will either accept the rate of return proposed in each corporate plan, or replace it with an alternative.
>
> Australia Post understands that the ACCC has an established process and set of models for determining price notifications. However the existence of a financial rate of return target with legal underpinning does raise some question over the appropriateness of the application of these models to Australia Post.
>
> Based on the above financial requirement, Post considers that the ACCC does not have the same ability to apply a general all-purpose model to Post when there is Ministerial approval of a specific rate of return as applicable to the Corporation.[25]

In assessing Australia Post's draft notification, the Commission must give special consideration to the financial targets in Australia Post's corporate plan. However, it is also necessary to bear in mind the following matters:

- Although the Commission must give special consideration to these financial targets, it is not the sole consideration the Commission is required to, or may, take into account.
- The corporate plan is prepared by Australia Post, although the Minister may direct the Board to vary the plan (APC Act section 40). Australia Post must, in its Annual Report, include an assessment of its progress in achieving financial targets in the corporate plan (APC Act sections 43 and 44). Australia Post therefore has some influence over the target determined.
- Direction 11 envisages that the Commission will advise the Government on the appropriateness of the pricing targets included in the corporate plan. However the Commission has not had any input into the current corporate plan.
- The corporate plan refers to a 'return on average assets of 14.1 percent'. This is one of a number of financial targets. The target is for the whole of Australia Post's business and is not necessarily appropriate for assessing the rate of return for assets used to provide reserved services, over which Australia Post has a statutory monopoly.
- The target could be interpreted as being an incentive device for the management of Australia Post, rather than a measure which facilitates economically efficient pricing.
- Although the pricing proposal may lead to Australia Post achieving the return on assets target in the corporate plan it is not necessarily the only strategy by which Australia Post

[25] Australia Post, Information provided to ACCC on 12 June 2002, p. 18.

may attain that target. The Commission should not ignore the possibility of alternative means of attaining the desired level of return, such as restructuring prices or reducing costs.

Australia Post's functions and obligations

Direction 11 directs the Commission to give special consideration to the functions and obligations of Australia Post and to any Ministerial directions given to Australia Post. The primary function of Australia Post is to supply postal services within Australia and between Australia and places outside Australia (APC Act section 14). A subsidiary function is to carry on, outside Australia, any business or activity relating to postal services (APC Act section 15). Australia Post's functions also include the carrying on of businesses or activities that are incidental to its primary and secondary functions (APC Act section 16).

Australia Post's obligations are set out in sections 26 to 28 of the APC Act as follows:

26 Commercial obligation

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

27 Community service obligations

(1) Australia Post shall supply a letter service.

(2) The principal purpose of the letter service is, by physical means:

(a) to carry, within Australia, letters that Australia Post has the exclusive right to carry; and

(b) to carry letters between Australia and places outside Australia.

(3) Australia Post shall make the letter service available at a single uniform rate of postage for the carriage within Australia, by ordinary post, of letters that are standard postal articles.

(4) Australia Post shall ensure:

(a) that, in view of the social importance of the letter service, the service is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business; and

(b) that the performance standards (including delivery times) for the letter service reasonably meet the social industrial and commercial needs of the Australian community.

General governmental obligations

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;[26] and

(c) Australia's obligations under any convention.

Australia Post's obligation to act in a commercial manner (APC Act section 26) is consistent with the principles which fall from subsection 17(3) of the PS Act. The Commission considers proper commercial behaviour involves operating an efficient asset base and recovering a reasonable rate of return.

Australia Post's CSOs (APC Act section 27) do not conflict with subsection 17(3) of the PS Act. However the reference to these obligations in Direction 11 means the Commission should have regard to the fact that Australia Post is required to provide a letter service at a uniform rate which is reasonably accessible to all people in Australia on an equitable basis and which meets the social, industrial and commercial needs of the community.

The Commission is not aware of any general governmental obligations imposed on Australia Post under section 28 of the APC Act or directions or notifications under the APC Act that are relevant to the Commission's assessment of Australia Post's draft notification.

Other matters

In addition to the matters considered above, the Commission may have regard to any other relevant matters.

One such matter is the rationale underlying the regulatory oversight of certain Australia Post prices. As noted above, the Board's power to determine prices is subject to the PS Act and to Ministerial oversight under section 33 of the APC Act. The purpose of this provision was described in the explanatory memorandum as follows:

> These provisions are retained to allow appropriate scrutiny of the delivery of reserved services to ensure that it does not cross-subsidise the competitive elements of Australia Post's business.[27]

Commission's objectives

In light of the foregoing, the Commission considers that as far as possible its assessment of Australia Post's proposed price increases should be guided by the following principles:

- The cost base underlying the proposed charges should be efficient;
- Australia Post should face appropriate signals for efficient new investment decisions;

[26] Section 49 provides that the Minister may make such directions in relation to the performance of Australia Post's functions as appears necessary in the public interest but not directions in relation to the rates of postage or the amounts to be charged for services.

[27] Parliament of the Commonwealth of Australia House of Representatives *Australian Postal Corporations Bill 1989, Explanatory Memorandum*, p. 3.

- Users should receive appropriate signals for consumption of Australia Post's services; and

- Australia Post should earn a reasonable rate of return which is sufficient to enable it to meet its CSOs and does not reflect monopoly rents.

These objectives encourage the economically efficient use of and investment in Australia Post's infrastructure. They address the following elements of efficiency:

- Dynamic efficiency, which occurs when firms have appropriate incentives to invest and innovate over time;

- Productive efficiency, which occurs when firms have appropriate incentives to produce services at least cost; and

- Allocative efficiency, which occurs when firms employ resources to produce the goods and services that provide the maximum benefit to society.

3 Application of the regulatory framework

3.1 Australia Post's submission

As noted in the previous chapter, the Commission considers that in reviewing price notifications from monopoly companies, the criteria set out in paragraphs 17(3)(a) and (b) of the PS Act steer it towards an assessment of the efficiency of the declared company's cost base and the rate of return the declared company is seeking.

By contrast, Australia Post's draft notification contained little information on these issues. Rather, it focussed on the general arguments that volume and productivity growth rates were forecast to decline, and that price increases were therefore necessary to 'position the Letters Business for ongoing profitability and compliance with its statutory obligations'[28]. However, Australia Post provided little information on its profitability, either for the specific services under consideration or the business as a whole. The draft notification therefore provides only a partial analysis of the case for price increases.

It is generally the case, at least in part, that declared companies lodge price notifications because the higher prices are expected to increase profits. This is a commercial obligation that most declared companies have to their shareholders. However, these declared companies are not operating in competitive markets but are monopoly providers of the services subject to declaration. Accordingly, there is some tension between the incentive to maximise profits and the Commission's broader objectives of economic efficiency outlined in Chapter 2. Furthermore, the nature of the PS Act is such that the Commission has little role in assessing or reviewing prices in the intervening periods between such notifications. As a consequence, it may be the case that the declared company is earning *more* than sufficient profits at current price levels to provide sufficient incentives to invest in and grow its business. Such 'above normal' profits represent a potential abuse of market power.

In these circumstances, expected changes to activity levels and productivity are not in themselves sufficient arguments for price increases. Indeed, in previous decisions the Commission has noted that the extent to which price increases can be justified on the basis of a contraction in overall market demand depends significantly upon the expected duration, timing and size of that reduction in demand.[29]

Where existing prices are already providing a declared company with sufficiently high profits, price increases may have deleterious effects upon the broader economy. For example, users of the services in question will not face appropriate signals upon which they base their usage decisions.

[28] Australia Post, draft notification, p.3.

[29] Australian Competition and Consumer Commission, *Preliminary View: Airservices Australia Proposed Price Increase,* June 2002. This decision is available on the Commission's website at http://www.accc.gov.au.airport/airserv.html. Note that Airservices did not provide sufficient information to enable an assessment of efficiency.

This gives rise to allocative inefficiency, where resources are not directed towards the areas in which they provide the greatest value to society as a whole. Similarly, the monopoly provider may have incentives to *over*-invest in the provision of the regulated services. Such outcomes could be inconsistent with the criteria set out in subsection 17(3) of the PS Act.

So while Australia Post's arguments regarding forecast activity and productivity growth are relevant factors to consider in reviewing the proposed price increases, they should not be considered in isolation from an analysis of the profitability of providing reserved services. Indeed, Australia Post itself emphasises that profitability is a key factor underpinning the draft notification.

In this respect, the Commission's assessment of the proposal is frustrated by the fact that Australia Post has not provided a more holistic case to support its proposal; in particular, that the relationship between the proposed prices, volumes, productivity and profits has not been clearly demonstrated in its submission. In general, the Commission would expect such analysis to be provided for a notification of such significance. Furthermore, the analysis should be conducted over a time horizon similar to that over which the volume and productivity arguments apply; ie, around 3-5 years.

3.2 The Commission's assessment approach

In its assessment of Australia Post's proposal, the Commission has in the first instance considered the merits of Australia Post's claims regarding volume and productivity. These issues are discussed in more detail in Chapters 4 and 5.

The Commission has undertaken considerable additional work, however, to place these issues in a broader context, through a detailed examination of the costs and profitability of the services in question. Chapters 7 to 10 set out this analysis in more detail. This has also necessitated a significant number of requests to Australia Post for evidence and information, much of which might reasonably be expected to have been provided at the time of lodging the draft price notification. This information has been provided progressively over the course of the Commission's assessment process, much of it on a confidential basis.

The cost and profitability data have been tested by the Commission against a number of the economic cost principles established in previous regulatory decisions and, in particular, principles applied to other industries subject to prices surveillance under the PS Act. In making this assessment, certain factors specific to Australia Post, such as its CSOs, have been considered.[30]

In recent times, a number of significant price notifications under the PS Act have been assessed in the context of a detailed analysis of the declared company's costs. For example, in its price notification in October 2000, Sydney Airport presented the Commission with a highly integrated submission in support of its case for higher prices. Prior to the removal of prices surveillance of

[30] Note that Australia Post is not the only regulated business that has CSOs. Other GBEs are declared persons and, as such, have various CSOs imposed by their shareholder. Further, as noted by the Commission in the Airservices Australia decision, CSOs can be likened to externalities which are, more or less, imposed on business or voluntarily assumed.

airports, price regulated airports such as Brisbane Airport and Melbourne Airport used similar economic models to support price increases for necessary new investment.

More recently, in its decision relating to Airservices Australia, the Commission's assessment focussed on economic notions of cost in considering the proposed price increases.

These decisions have generally evaluated a reasonable level of profitability for declared services. The Commission's approach to measuring profitability is discussed in more detail below.

3.3 Analysing profitability

A forward-looking model

The Commission's preferred profitability/financial analysis calculates the amount of revenue required in future years to cover the total costs of an efficient service, based on the following formula:

$$RR = O\&M + D + ROC + T$$

Where: RR = required revenue

O&M = operating and maintenance expenditure (including administrative costs).

D = depreciation or return of capital

ROC = return on capital = WACC * WDV

WACC = weighted average cost of capital (post-tax);

WDV = written down (depreciated) average value of the asset base[31]

T = corporate tax, less benefit of dividend imputation

The return on capital covers both interest on external debt and return on equity. The WACC is a weighted average of the return on debt and equity, weighted by the proportions of debt and equity used to finance the asset base. By allowing the service provider a reasonable rate of return on capital employed, this addresses the first criterion of s17(3) of the PS Act of maintaining investment in the service provider's industry. At the same time, by discouraging prices based on returns above the WACC, it addresses the second criterion of s17(3) of discouraging the provider from taking advantage of its market power to make excessive profits and restrict supply at the expense of consumers and users.

Another way in which a provider could take advantage of its market power and lack of competition is by allowing costs to inflate to unnecessary or inefficient levels. Hence the analysis should be based where possible on an efficient cost-base, not necessarily the provider's actual costs.

[31] Average asset value over the year is (Opening value plus Closing value)/2.

Australia Post has suggested that:

> …such a theoretical exercise removed from the actual costs of the business being assessed is considered to be inappropriate for Australia Post. This is because Australia Post's business is subject to specific statutory obligations that require it to operate in a different manner than a purely commercial enterprise (for example, the CSO obligations and financial target requirements).[32]

The Commission disagrees with this view, and considers that these considerations can be incorporated into the above profitability analysis. Similar issues recently arose in the price notification submitted by Airservices Australia but did not preclude the application of a financial assessment.[33] The Commission's view in relation to Australia Post's financial targets – particularly in light of the requirements of Direction 11 – is discussed in Chapters 2 and 9. The Commission's views on Australia Post's CSOs and the impact this might be expected to have on incentives and costs is discussed further in Chapters 5 and 6.

The Commission also notes that there are well known incentive problems that may arise as a consequence of a regulator evaluating prices simply on the basis of actual costs of the regulated firm. In these circumstances the regulated firm effectively loses its incentive to provide services at the lowest possible cost, as any profits forgone as a result of cost increases can simply be recovered through higher prices and revenue.

Chapters 8 and 9 address two other key inputs to a profitability analysis; namely the valuation of assets and the appropriate rate of return to allow Australia Post to recover through its pricing of reserved services. In Chapter 10, the various elements of the Commission's assessment are brought together, and the preliminary results of the analysis are set out.

Separating reserved services

Given that the Commission considers profitability analysis an important consideration in its consideration of Australia Post's draft notification, an additional issue arises in its implementation. Two possible methods are the so-called 'single till' or 'dual till' approach. Under the single till approach an organisation is considered in its entirety and on this basis the inputs into required revenue calculations are the total assets and the total operating and maintenance costs required for the provision of all services. In contrast, a dual till approach separates regulated and non-regulated services. It then determines the required revenue for the regulated services by reference to those assets used for the provision of that service and costs directly attributable to the service, plus an allowance for joint costs.

Given its extensive non-regulated activities, the choice between a single till and a dual till approach is an important one in the case of Australia Post. Importantly, however, the scope of the regulated activities matches the legislated monopoly held by Australia Post over postal services. While the extent of Australia Post's market power may not precisely correspond with the definition of

[32] Australia Post, draft notification, p. 33.
[33] ACCC, *Preliminary View: Airservices Australia Proposed Price Increase*, June 2002.

reserved services, the non-regulated services such as parcels, financial services and transport are generally open to competition. Such a situation is similar to that of airports, which provide a range of contestable unregulated services, such as retailing.

The Commission considered the relative merits of the dual till and single till in its May 2001 decision on pricing at Sydney Airport.[34] That decision noted the superiority of the dual till approach in terms of economic efficiency, in particular on the incentives for new investment. For the reasons outlined in that decision, the Commission has adopted a dual till approach to evaluating Australia Post's profitability.[35] Thus the Commission has not analysed the profitability of unregulated services, but has examined the allocation of costs between Australia Post's regulated and non-regulated services. This issue is discussed in more detail in chapter 7.

Historical changes in costs

Some of Australia Post's evidence focused on movements in productivity, taxes and prices since earlier inquiries. In Prices Surveillance Authority decisions in earlier years, past movements in costs were commonly the basis for decisions. Allowing an increase in prices in line with cost increases since a particular date implies that the initial profit margin was appropriate, and that the original and subsequent cost increases were necessary.

However, such past movements are largely subsumed in the Commission's financial analysis, and do not need separate treatment. The analysis is basically forward-looking and starts with the cost base and appropriate rate of return in the current period. All past cost movements are implicitly reflected in the current cost base. Having established an acceptable current rate of return, future movements in costs beyond the regulatory period can in some circumstances be taken as an indicator of the need for future price changes. This is, however, subject to the desirability of incorporating incentives for cost control into the regime.

Notwithstanding the current base approach adopted, information on past cost and price movements may still provide useful checks on the reasons for how the current situation has developed, and as a guide to future trends.

Period of analysis

Adopting a forward looking analysis necessitates consideration of an appropriate horizon over which to consider prices. There is no fixed regulatory period for assessments under the PS Act. However, 5 years is a common period for regulatory horizons in industries such as gas and electricity, and recently was applied by the Commission in assessment of charges at Sydney airport.

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[34] Australian Competition and Consumer Commission, *Sydney Airports Corporation Ltd Aeronautical Pricing Proposal: Decision, May 2001*. This decision is available on the Commission's website at www.accc.gov.au.

[35] This is subject to some qualification in relation to the Commission's assessment of the profitability of non-reserved large letters and PrintPost services. See chapter 8 for some further discussion on this issue.

The appropriate regulatory period is a balance between competing demands. A short period, such as one year, generates excessive costs for frequent notifications and regulatory inquiries, and perhaps administrative costs for adjustment of prices. Further, if frequent assessments are held in which prices are adjusted for movements in the costs of the regulated company, perverse incentives can be established. Such a regime tends to pass cost inflation on to consumers automatically in higher prices, and provides little incentive for the regulated company to improve performance if cost increases are compensated by price increases. Hence in some other regulated industries, an incentive approach such as "CPI minus X"[36] price caps has been adopted which allow the company to keep part or all of the gains from cost reductions over a period of some years. This option is generally provided for under a specific government regulatory framework, however, and is not explicitly available under the PS Act in the case of Australia Post.

Too long a regulatory period, on the other hand, means that forecast data for the later years becomes increasingly uncertain. In some industries, a 5 year period may give an acceptable level of certainty. In the current assessment, however, the uncertainty of the forecasts beyond 3 years became apparent to the Commission through the course of the analysis, as is discussed in the chapters addressing forecast volume and productivity. Nevertheless, in the interests of a longer period of regulatory certainty, the Commission favours a 5-year horizon.

There are also specific reasons in this assessment for seeking a price outcome that remains viable over several years. Frequent price changes to the basic postage stamp are likely to be more costly in administrative terms than for most other industries. There are printing and distribution costs for stamps, and Ministerial approval is required. Furthermore, Australia Post's proposal would take the price of the basic postage stamp from 45 cents to 50 cents. Both amounts are round multiples of 5 cents which is the lowest denomination of coin now used in Australia. Although Australia Post did not submit this as a particular reason for the 5 cent increase in price, a price in 5-cent multiples has evident advantages in convenience for customers purchasing small numbers of stamps.

If stamp prices are kept as multiples of 5c, it dictates increases in steps of around 10% to a new level. Correspondingly, the incremental returns to Australia Post from such price rises may be unevenly distributed over future time periods. It is therefore useful to consider the likely returns from Australia Post's proposal over a number of years, rather than just a single period.

In light of the above, the Commission has found it useful to analyse likely costs and revenues for Australia Post over the next 5 years, while not being bound to approve prices for any particular period.

[36] CPI-X means that the price increase allowed is the rate of increase in the consumer price index, minus a target rate of productivity growth (X).

4 Demand for postal services

4.1 Introduction

In its draft notification, Australia Post has raised the issue of changes in the demand for letter services as a justification for price changes. “Letters” are defined as both reserved and non-reserved domestic letter services[37].

It is Australia Post’s contention that the letter volume growth *rate* has been in decline since 1994/95, with the exception of 1999/2000.[38] Australia Post predicts that declining volume growth will turn to absolute decline in letter volumes by 2006/07. The extent of volume growth will have implications for profitability.

For example, Australia Post submits that it has a high level of fixed costs. Current postal technology can involve significant lumpy capital costs (for example, discrete capacity jumps in processing equipment and buildings), and many of these are fixed in the short to medium term. Thus, to the extent that Australia Post’s costs include cost elements that are substantially fixed and indivisible, declines in volume may change unit costs and hence reduce Australia Post’s profitability. However, the Commission notes that the degree to which costs are truly fixed over the medium term calls for careful scrutiny.

In its draft notification, Australia Post submits that annual volume growth has been one of the factors assisting it to achieve sustained profit from the letters services over the past decade. Although not explicitly stated, the suggestion is that a decline in volume growth will make it more difficult to achieve the rapid productivity gains of the past decade, and lead to higher unit costs than would otherwise be the case.

This chapter discusses the market demand for letter services. The appropriateness of Australia Post’s volume forecasts and the sensitivity of the letter market to changes in price are also assessed.

4.2 Australia Post’s views

In its submission, Australia Post states it has estimated the impact on letter volumes of substitution (eg. electronic bill presentment and/or payment by telephone or internet), consolidation (eg. combining multiple items into a single mail piece), and rationalisation (eg. reduction in billing cycles) over the coming ten years based on market penetration and adoption rates for a moderate and a

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[37] This excludes Print Post and unaddressed mail, but includes non-reserved large letters. According to Australia Post’s draft notification to the Commission, approximately 1% of the letter business volumes are attributable to unreserved letter services.

[38] Volume in this context means number of letters or articles.

high take-up scenario. These forecasts estimate the impact on the three letter segments identified by Australia Post – social, transactional and promotional mail.

Social mail includes full-rate household to household mail. Transactional mail includes PreSort bulk mail from business, full-rate household to business mail and ordinary full rate mail that has been aggregated and presented as PreSort lodgements. Promotional mail consists of direct mail and includes promotional mail, brochures and other addressed promotional mail that satisfies the small letter category size and weight requirements. With the removal of the AdPost discount, effective 1 January 2003, promotional mail users are expected to migrate to PreSort bulk mail rates. As such, PreSort mail will consist of both transactional and promotional mail.

According to Australia Post's submission, under both high-take up and moderate take-up rates of substitution and mail piece consolidation and rationalisation, letter volumes will begin to trend downwards in absolute terms in 4-5 years, as take-up rates begin to accelerate. Relative to current levels, by 2006/07 volumes are forecast to be:

- 7 % lower in the high take-up scenario;
- 2 % higher in the medium take-up scenario; and
- 19 % higher in a no impact scenario.

However, Australia Post does acknowledge that accurately predicting future mail volumes will be difficult as the emerging trends are difficult to forecast. Australia Post also acknowledges that there will be a degree of uncertainty regarding the impact of AdPost's withdrawal on letter volumes. As such, the volume figures actually used by Australia Post in its revenue modelling appear to lie between the moderate and high-impact scenarios, showing an average 0.6% per annum increase from 2001/02 up to the year 2004/05, or an average 0.2% per annum increase over the five years to 2006/07. Within this relatively small change in total volume, Australia Post forecast an annual average fall of 2% in ordinary (full-rate) letter volumes with a 2.5% increase in bulk letter volumes.

In its response to the public submissions, Australia Post states that a recent study by Diversified Specifics was unable to identify any statistically significant price elasticity effect for letters.[39] That is, Australia Post does not expect that the proposed price increases will result in any volume reduction.

4.3 Submissions

The Commission has received a large number of submissions concerned with the effect any price changes may have on demand for postal services, as well as the accuracy of Australia Post's volume forecasts. Further comments have also been provided through the Public Forums held by the Commission during late June as well as the Technical Issues Forum in July. These submissions have raised a number of important points.

[39] Diversified Specifics, *Executive Summary: Small Letter Volume Forecasting Analysis*, report prepared for Australia Post, March 2002.

Whilst major issues raised by the submissions are discussed more fully in Section 4.4, with respect to market demand the submissions are most concerned with the:

- *accuracy of Australia Post's volume forecasts.* For example, the MMUA is concerned that whilst Australia Post has relied upon a report by Diversified Specifics, a copy of this report has not been provided for general review and comment. GoMail is also concerned about accepting unchallenged Australia Post's predictions of future volume decline;

- *appropriateness of increasing prices based on a long-term forecast of volume decline*. For example, the MMUA comments in its submission that it is concerned that Australia Post is requesting an increase in prices, in part due to forecast negative volume growth, when by its own estimates, total letters volume is not expected to experience negative growth until the financial year ending 30 June 2007, at which time, growth is expected to be –0.5%;

- *influence of Australia Post on demand for letter services*. Several submissions to the Commission, including submissions by Readers Digest and the MMUA, are concerned that Australia Post may be promoting their e.commerce alternatives at the expense of traditional mail;

- *effect of AdPost's removal on Promotional Mail volumes*. Submissions by ADMA, MMUA, Penfold Buscombe, Doubleday and the Printing Industry Association of Australia express concern about the impact that the phased removal of the AdPost discount, in combination with the proposed increases to bulk rates, will have on their direct mailing expenditure. The ACCC has previously approved the phasing out of AdPost, with an initial 10% increase to prices on 1 July 2002 and a final increase of 9% on 1 January 2003;

- *sensitivity of volume to price changes, the accuracy of Australia Post's statements to this effect, and effect on production*. The Commission has received a number of submissions, most particularly from direct mailers, who contend that the cost of postage to their core business is much greater than estimated by Australia Post. Direct mailers such as ADMA, Magnamail, Readers Digest and Doubleday suggest that any increase in prices will result in a reduction to production volume and frequency, with ensuing effects to downstream markets, as well as Australia Post. However, submissions by Action Words and Rapp Collins put a different view, and state that they do not believe a small increase in prices will result in reduced production.

These points will be expanded upon throughout the remainder of the chapter.

4.4 Discussion

As noted above, Australia Post has, in its draft notification, cited a predicted decline in the demand for letter services as a justification for an increase to letter prices. In support of this view, Australia Post has supplied the Commission with its estimates for future trends in the letters market, based on moderate and high impacts of consolidation, substitution and consolidation. More specifically, these scenarios look at both exogenous (external) and endogenous (price) factors on the three letter segments identified by Australia Post – social, transactional and promotional mail. These estimates raise a number of issues.

4.4.1 External influences on letter demand

According to Australia Post's draft notification, over the next five years there is unlikely to be an absolute fall in total letter volume, although the forecast rate of increase would be significantly slower than over the 1990s.

Several submissions to the Commission are reluctant to comment on Australia Post's volume predictions in the absence of more detailed information. For example, the Major Mail Users of Australia (MMUA) comment that whilst Australia Post has relied upon a report commissioned by Diversified Specifics, that this report has not been made public and hence "it is impossible for MMUA to comment on Australia Post's reliance on what is an assumption that mail volume growth rates will decline[40]".

The Commission has, however, received a significant number of submissions expressing concern that Australia Post is requesting a price increase based on a decline in absolute volumes not predicted until the mid to late part of this decade.

The Commission recognises this concern, but also recognises that changes in volume over time also relate to changes in profits, prices, and postal service requirements over time. If profit levels are insufficient, then it may be valid to raise prices if volume increases are not expected to be strong enough to allow Australia Post to realise a 'normal' level of profitability in future. If Australia Post is unable to earn an appropriate rate of return, this potentially undermines its incentive to invest. One of the Commission's primary functions under the PS Act is to have regard to the need to maintain investment and employment, including the influence of profitability on investment and employment. Thus forecast volumes must be considered in the context of other factors such as Australia Post's current level of profitability and future changes in cost, discussed elsewhere in this preliminary view.

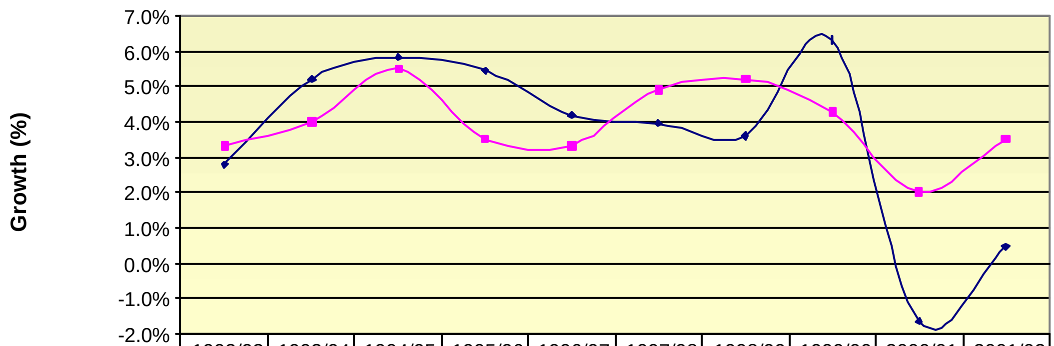
GoMail suggests in its submission to the Commission that giving credence to a price rise based on possible future events does not reflect "normal commercial practice that competitive organisations face"[41]. GoMail goes on to say that to justify such an increase on grounds of diminishing volume growth, Australia Post should be required to "demonstrate the rigours it has employed to maximise cost savings through elimination of waste or re-engineering process flows"[42]. The Commission points out, however, that Australia Post is not a commercial organisation, but rather a legislated and regulated monopoly. Whilst the Commission agrees that Australia Post should have an incentive to minimise costs, forecast activity will affect the Commission's assessment of acceptable prices.

[40] MMUA, submission to ACCC, p. 11.
[41] GoMail, submission to ACCC, p. 2.
[42] GoMail, submission, p. 9.

Australia Post's predictions of slowing volume growth do appear to be supported by international experience. For example, the United States Postal Service (USPS) and a number of European postal services are predicting falling volume growth and absolute decline over the coming decade. Indeed the USPS states, in its recently released Transformation Plan, that the rate of volume growth has been declining since 1997, with the rate of absolute volume declining in 2001, "following a general downturn in the economy"[43].

Historically, mail volumes have tended to move with changes in GDP (non-farm). Indeed, past Commission decisions relating to postal services (in this case conducted by the Commission's predecessor – the Prices Surveillance Authority) have found that a major factor in postal demand is the economy wide rate of economic growth. This point is demonstrated by Figure 4.4.1.

Figure 4.4.1. Letter Volume Growth vs GDP Growth



	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Letters	2.8%	5.2%	5.8%	5.4%	4.2%	4.0%	3.6%	6.3%	-1.7%	0.5%
GDP	3.3%	4.0%	5.5%	3.5%	3.3%	4.9%	5.2%	4.3%	2.0%	3.5%

Source: Australia Post, Response to Public Submissions, p21.

However, the independent Diversified Specifics report suggests economic activity (measured by GDP) is no longer the primary driver of total letter volumes and that major volume drivers differ between key segments of the letter market, namely transactional, promotional and social.

Whilst the Commission acknowledges the report's fundamental argument that there has been a 'structural break' in demand, it notes that the Diversified Specifics study was a short term study. Furthermore, the study found, when assessing individual letter segments, that GDP (non-farm) was still in fact a significant key volume driver of pre-sort mail volumes, the largest mail segment, comprising approximately 50% of letter volume.[44]

[43] United States Postal Service (USPS), *Transformation Plan*, 2002, p. 17.

[44] The Diversified Specifics report's definition of PreSort does not include Adpost volumes, as these are included in the 'promotional' category.

Whilst Australia's economy has been expanding for much of the last decade, following the international downturn in late 2001 there has been some slowing in the pace of Australia's economic growth. The Reserve Bank of Australia has noted in particular that in the face of potential economic downturn, many businesses will respond by curtailing discretionary spending, including advertising[45]. This could therefore explain some of the low growth in 2002, particularly in promotional mail volumes.

The Commission notes that economic growth in Australia is not completely in step with the world trend, with the US and several European economies currently in recession. Thus, the Commission cautions against depending too heavily on the predictions of volume decline made by the USPS and European postal services.

Notwithstanding these arguments, the Commission acknowledges Australia Post's concern that exogenous factors such as increasing penetration of electronic substitutes may be working to contract the demand schedule for letters and so reduce letter volumes. The Commission accepts that electronic substitutes pose a threat to letter volumes, but notes that some studies have suggested that the impact may be relatively slow.

For example, as part of its 1998 review of the Australian Postal Act, the National Competition Council (NCC) commissioned National Economic Research Associates (NERA) to undertake an analysis of possible future developments in the communications market over a 20 year period. This report concluded that its own projections suggested that even with high rates of penetration and use of electronic media, the volume of domestic letter traffic was unlikely to decline significantly over the next 20 years (1997 to 2017).

On balance, then, the evidence as to the extent to which the take-up of alternative communications channels will affect future mail volumes is somewhat mixed.

4.4.2 Price elasticity of demand for postal services

In considering Australia Post's proposal, the Commission has also considered the relationship between price and volume. Australia Post's proposal assumes that price elasticity of demand over the price range under consideration is approximately zero[46]. That is, the proposed increase in prices will not result in a change to demand for postal services, and mail volumes will be unaffected.

By contrast, some submissions have expressed concern that if price elasticity of demand is not zero, allowing a price increase may hasten a reduction in the volume of postal items. This point was raised by representatives of the MMUA at the Technical Issues Forum[47].

45 Reserve Bank of Australia, Economic issues and performance in 2002, *RBA Bulletin*, March 2002.
46 Australia Post, *Response to Public Submissions*, p. 53.
47 Transcript of proceedings, ACCC's Public Forum regarding Australia Post's Proposed Price Increases, pp. 20-21.

For the most part, studies assessed by the Commission suggest that whilst price elasticity of demand for postal services is not zero, it is typically inelastic**.** Diversified Specifics' report concluded that movements in (short run) real prices for full-rate and PreSort mail was not statistically significant, although it did register as a long run driver of aggregate small letter volumes[48].

Former decisions by the Commission's predecessor, the Prices Surveillance Authority, conclude that demand for postal services varies between user categories and products. However, inquiries by the PSA both in the 1980s and early 1990s found that the ordinary postal service would be significantly less price elastic than more competitive services.

In 1991, a Prices Surveillance Authority study found that the relative price elasticity of postal articles was approximately –0.55, indicating that an increase in Australia Post's real price index of 10 per cent would tend to be associated with a 5.5 per cent decrease in the total number of articles posted in Australia.

The Commission notes that since these studies were conducted, a number of substitutes, such as B-Pay and electronic communications, have become more readily accessible. As such the Commission acknowledges that demand may be less inelastic than it was in the 1980s and 1990s, although it notes Diversified Specifics contention that electronic communications are more likely to be substitutes for phone calls, faxes or other messages that would otherwise not be sent by mail. The Commission also notes that price elasticity measures changes in real prices. Any initial volume response resulting from a price increase could be mitigated if real prices fall over future years.

Therefore, the Commission considers that the demand for postal services in aggregate remains relatively inelastic over the price range currently being considered, and that Australia Post can increase prices (to a point) without suffering significant reductions in total volume.

The Commission also notes that any demand response may already have been factored into Australia Post's forecasts, so any objection to price increases may in fact be met by higher than expected volume figures.

Notwithstanding this preliminary view, the Commission's assessment of Australia Post's draft notification is somewhat complicated by the complexity of Australia Post's pricing structure as well as the effects of previous decisions with regards to barcoding and AdPost.

Furthermore, irrespective of the above assessment of demand elasticity for overall postal services, the Commission notes the logic of considering the social, transactional and promotional segments separately. These segments make use of different reserved services, and have distinct characteristics. Indeed, the Commission received a number of submissions questioning Australia Post's decision to base its need for price increases on *aggregate* demand for letter services, rather than individual letter segments.

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[48] Diversified Specifics 2002, p. 19, 24, 29.

For example, the MMUA claims that of the three letter segments, only one, social letters, is forecast to experience negative growth for the next 5 year period. Social letters make up approximately 5% of total letters volumes. Transactional letters, the largest of the letters segments, is not projected into negative growth until the year ending 30 June 2005, with forecast growth in that year of –0.2%. Promotional letters are forecast to be in growth over the five year period[49]. In light of these comments, the remainder of this section looks separately at the price sensitivity of each of the three letter segments.

Social Mail

With regards to ordinary full price mail, Australia Post states in its submission that:

> The proposed BPR (Basic Postage Rate) and associated price increases are not expected to have any significant impact on current volume trends given that customers are unlikely to change mailing behaviour in response to the proposed change[50].

Indeed where social mail is concerned, Australia Post estimates that a five cents increase in the cost of the basic postage stamp should have an annual impact of only $2.70 on households.

The Commission acknowledges that a number of alternatives to written communications now exist. However, for the most part, these substitutes do not offer significant cost savings, and hence are likely to be utilised for reasons of convenience rather than price sensitivity. Moreover, demand studies indicate that there is more substitution *among* electronic modes of communication (e.g., to email from phone and fax) than between post and these alternative modes.

The Commission therefore agrees that an increase in the price of the basic postage stamp appears unlikely to significantly alter the behaviour of individual consumers. Consequently, the Commission considers that social mail volumes are unlikely to materially change in response to the proposed price increase. Whilst the Commission received a small number of complaints from consumers about the proposed 5 cent increase in the basic postage rate, typically these submissions were more concerned with quality of service issues than the price *per se*. Quality of service issues are, however, better addressed through performance measures and Australia Post's community service obligations. These are discussed in more detail in Chapter 6.

Transactional Mail

The Commission's preliminary analysis is that transactional mail is also relatively price inelastic.

Transactional mail is typically made up of household to business mail, as well as mass produced bills, statements, and other transactional correspondence from business, often known as "essential mailings". These include credit card and bank statements, as well as utilities bills and statements (telephone, mobile, electricity and so on). Transactional mail includes both ordinary letter priced

[49] MMUA submission, p. 11.
[50] Australia Post, draft notification, p. 24.

items (ie full-rate) and PreSort bulk rate items. Transactional mail is the largest letter segment and makes up approximately 81% of the reserved letter service.

According to Australia Post's draft notification, transactional mail is expected to be the segment most affected by increasing availability of alternate communication channels. Possible substitutable services for transactional mail may include electronic bill presentment and payment, telephone bill-pay, direct debit, and counter payments. Consolidation and rationalisation of letter mail may include less frequent billing cycles and combined mailings. The Commission notes, however, that many of these trends are not price responses *per se*, but rather a general cost reduction strategy. However, the Commission also notes that whilst these factors might lead to volume changes without a price increase, their increasing substitutability may make this segment more price-elastic over time.

Against this, Mr Ashmore, Commonwealth Bank representative at the Commission's Technical Issues Forum, suggested adherence to industry codes of practice might reduce the impact of any price changes on the transactional sector, by dictating the regular mailing of bills and statements to customers. Furthermore it is likely that competitive forces, as well as custom and practice, may be driving the use of postal services in response to changing consumer preferences. The Commission considers that the move away from mail to other channels is likely to reflect changing consumer preferences across a wide range of prices.

Whilst the Commission acknowledges the increasing availability of substitutes, it is prepared to accept Australia Post's contention that transactional mail volumes are unlikely to change significantly in response to a price change. Evidence was presented at the Commission's Technical Issues Forum that major transactional mail users do not expect to reduce their production volumes in response to the proposed price increases. The Commission again notes that it expects Australia Post should have already factored any price response into its activity forecasts.

Promotional Mail

Promotional mail makes up approximately 14% of total mail volumes. Users of promotional mail are currently provided with a discount service called AdPost. The AdPost discount will be phased out effective 1 January 2003 and the Commission expects that AdPost users will migrate to PreSort bulk mail once the AdPost discount is removed.

The Commission has received a large number of submissions from direct mailers. These responses are somewhat mixed, with some questioning the need for an increase to PreSort rates and highlighting the potentially negative ramifications for their businesses, while others point to expected expansion of production.

A number of key themes emerging from these submissions are:

- the proportion of costs represented by postage;
- the effect the removal of AdPost's discount will have on cost; and
- the effect a further increase in PreSort rates will have on production decisions.

In its draft notification, Australia Post claims:

> (Given) that postage is only one element of the cost of sending a letter, it is unlikely that a 5% increase in postage will have a significant impact on the move to substitution, consolidation, or rationalisation. For example, if postage is 30% of the total cost, a 5% postage increase represents a 1.5% increase to the total cost of the mail piece[51].

Submissions by the MMUA, ADMA and Doubleday provide an alternative view.

ADMA suggests that a cost share for postage of 45% is closer to the industry average for bulk users, with Doubleday stating that "(p)ostage under the AdPost service presently accounts for as much as 58% of the total cost of a Doubleday recruitment direct mail pack". The MMUA also submits that the cost of postage is a highly significant proportion in comparison with other elements, such as printing.

Submissions by ADMA, MMUA and Doubleday also express concern about the impact that the phased removal of the AdPost discount might have on their direct mailing expenditure. The Commission has previously decided not to object to Australia Post's proposal to introduce the phasing out of the AdPost discount. In the current case, however, the Commission is primarily concerned with the effect of any *additional* price increases.

Furthermore, submissions to the Commission by ADMA, Magnamail and Readers Digest state that they expect that an increase in PreSort (in combination with the removal of the AdPost discount) rates will result in consolidation and rationalisation of mailing campaigns. For example, ADMA reports that its members are considering reducing their mailing campaigns from 6 to 5 times per annum. In addition, Magnamail is also considering a reduction in mailings per campaign. Readers Digest are currently reviewing their mailing list and expect to reduce mailing volumes by 15%. Some direct mailers, such as Doubleday, are considering relocating their printing businesses offshore. Speaking at the Commission's Technical Issues Forum, Australian Mailing's representative, Ms Raher, commented that "if you have got a marketing budget of $10 million, you have got a marketing budget of $10 million. It is not elastic[52]".

Suggestions by some direct mailers that they intend to reduce production volumes in response to any increase in bulk rates suggests some price sensitivity. The likely effect of any increase in the proportion of costs represented by postage may be to reduce direct mailers' profitability and lead organisations to seek out new ways to reduce costs, and pass some of the increase on to clients. Reducing costs by reducing production or moving production overseas might result in a reduction in income to downstream markets, and more importantly in the context of this assessment, to Australia Post.

In its *Response to Public Submissions* document, Australia Post comments that such claims imply that elasticity of demand for promotional services is near unity. That is, a price increase will be met

[51] Australia Post, draft notification.
[52] Ms Sally Raher, Australian Mailing and MMUA.

with a corresponding decrease in volumes which maintains unchanged revenue. Australia Post does not believe this to be the case.

Submissions by Action Words and Rapp Collins support Australia Post's contention. They suggest that direct marketing is structured in such a way that profitability is arrived at over time and that a small increase in the price of postage is unlikely to render a profitable campaign unprofitable. The Commission therefore accepts that the elasticity of promotional mail, while greater than for other mail segments, is still likely to be relatively low.

The Commission also notes that other submissions point to expected long term growth in the promotional mail market. For example, Doubleday comments that "we are expecting that a number of strategic changes planned for our business over the next few years will increase our letter activity".

Such contradictions make it difficult for the Commission to make any definitive statements as to the price elasticity of demand for promotional letter services. Furthermore, it is difficult for the Commission to distinguish from the submissions the effect AdPost's removal is expected to have from the effect the new prices proposed by Australia Post for PreSort rates will have on demand in the promotional segment. However, the Commission considers that the majority of comments made with regard to demand responses relate to the former.

Notwithstanding this, the Commission considers that the promotional segment is likely to be less inelastic than for social and transactional mail. However, the Commission notes that any demand response from both the removal of the AdPost discount, as well as the proposed changes, is likely to have been factored into Australia Post's forecast figures.

4.5 Conclusion

In its draft notification, Australia Post raises the issue of changes in demand for letter services as a justification for price changes. It is Australia Post's contention that letter volume growth has been in decline in recent years, and that letter volume growth will turn to absolute decline by 2006/07. Australia Post suggests that this decline is the result of increasing substitution of alternative communication channels, such as electronic mail, as well as increasing consolidation and rationalisation of mailouts.

The Commission received a number of submissions expressing concern that Australia Post has requested a price increase based on a decline in absolute volumes not predicted until the mid to late part of the decade. Whilst the Commission acknowledges this concern, Australia Post's predictions of slowing volume growth do appear to be supported by international experience.

In considering the proposal, the Commission has also considered the relationship between price and volumes. The Commission has reached the preliminary conclusion that demand for reserved services is likely to be relatively price inelastic. That is, a price increase is unlikely to result in a significant volume response, particularly if prices subsequently decline in real terms. Of the three letter segments identified by Australia Post – social, transactional and promotional – the Commission expects that the price elasticity of demand for social and transactional mail will be inelastic over the price ranges proposed. Combined, social and transactional mail make up approximately 86% of total mail volumes.

Promotional mail is the segment more likely to experience some volume response. However, as has been argued earlier in this chapter, it is difficult for the Commission to distinguish how much of this expected demand response is related to the removal of the AdPost discount, and how much relates to the additional increases to PreSort rates contained in the current proposal. The Commission considers, though, that it is likely that Australia Post would have incorporated these effects into its forecasts.

While anticipated volume levels are relevant to pricing considerations, the Commission is also mindful of the effect that short-term influences may have on demand. For example, volume decline may well be the result of a temporary slowdown in the growth of the economy. The Commission would also be hesitant to base prices upon forecasts that cover time periods some 5 to 10 years away. However, as discussed elsewhere in this preliminary view, there are merits in allowing prices that are maintained over a medium term horizon. These include incentives for cost reduction and market growth.

While there is some uncertainty regarding the future growth prospects for mail, and the possible volume effects of the proposed price rises, the Commission has accepted Australia Post's volume forecasts as a starting point for the Commission's profitability modelling. The Commission does note, however, that the volume forecasts appear to err on the conservative side, with Australia Post forecasting that the take-up rate of substitutes will be between medium and high levels. Furthermore, the Commission notes that should any proposed price increase be objected to, there is a reasonable chance that volume growth may be greater that predicted by Australia Post.

The Commission also stresses that Australia Post should bear a degree of risk associated with forecast volumes. If Australia Post's volume predictions are ultimately too conservative, Australia Post stands to make higher than expected profits. Conversely, should forecasts over-estimate future volumes, Australia Post should not be further compensated.

5 Australia Post's productivity

5.1 Introduction

In assessing price notifications, the Commission will, amongst other things, consider the efficiency of the cost base that a declared company is working from to earn a return. The importance of such a consideration, as noted in Chapter 2, lies in the recognition that monopoly suppliers do not necessarily produce goods or services at efficient cost levels which may in turn result in higher than efficient prices being passed on to consumers.

While this is a fundamental consideration for the Commission, establishing the precise current level and projected future levels of efficient operating costs is difficult in practice, requiring a thorough assessment of both the efficiency in which operating costs are incurred and inputs employed in the generation of output. Such an assessment would require one to consider the effect of a number of factors including:

- X inefficiencies;
- economies of scale and/or scope;
- technological innovation;
- productivity improvements; and
- the substitutability of inputs,

upon unit costs and in turn determine whether those unit costs are efficient.

Recognising the need to encourage the pursuit of technical efficiency, while also recognising the practical difficulties of assessing the absolute efficiency of the cost base, the Commission will assess whether the current and projected costs incurred by the regulated firm are reasonable. In making this assessment, the Commission in the first instance considers the current cost base, examining the effect of past technological innovation, productivity growth and the removal of previous inefficiencies upon unit costs. Once reaching a conclusion regarding the current cost base, the Commission then considers the effect of proposed technological innovation, projected productivity growth and the scope for further cost efficiencies in determining whether projected operating and maintenance costs are reasonable. These conclusions inform the Commission's profitability analysis.

In the case of Australia Post, the Commission has obtained advice from Meyrick and Associates on Australia Post's productivity. The results of this study are incorporated in the discussion in Section 5.6.

5.2 Australia Post's views

In its draft notification, Australia Post claims that over the period 1991-2001 it has achieved cumulative labour productivity growth equal to twice the national average (67% compared to the national average of 28.7%) and has reduced the ratio of labour costs to total costs from 65.4% in 1992 to 49.6% in 2001.

According to Australia Post, this growth in labour productivity and reduction in labour costs have primarily been a result of:

- the introduction of mechanised sorting processes ie Optical Character Readers and bar code sorters;
- investment in training programs to enhance the skills of its labour force;
- increased labour flexibility; and
- the introduction of performance related wage increases.

Australia Post argues that as a result of these productivity gains, it has been able to both reduce real prices and meet the growth in counter transactions, mail volumes and delivery points whilst maintaining a relatively flat labour force. Australia Post claims that this has been achieved with minimum industrial action.

Australia Post argues that while further investment in automated equipment and human capital is planned, "there is less scope to achieve the very high productivity gains associated with the past initiatives as Post is now using some of the most advanced automated processing in the world"[53]. Australia Post submits that combining this limitation on future productivity growth with the forecast fall in volumes "will have an adverse affect on Letters Business profit, its ability to fund ongoing investment and its ability to meet its statutory obligations"[54].

5.3 Submissions

Numerous comments have been made regarding Australia Post's contention that it is an efficient operator. These comments range from general comments on Australia Post's productivity, to the effect of past productivity initiatives upon users and the scope for future productivity improvements.

General comments

In response to Australia Post's claims of productivity improvements over the period 1991-2001, both GoMail and MMUA assert that the base upon which these improvements have been measured are misleading. GoMail argued that, "the origins of Australia Post and therefore the starting position

[53] Australia Post, d*raft notification*, p. 18.
[54] ibid., p. 6.

was a historically inefficient, lazy, over staffed, union dominated and heavily demarcated organisational structure as a base"[55].

MMUA adds:

> Australia Post states in its Draft Notification that it has been able to reduce labour costs from 65.4% in 1992 to 49.6% of total Letter Service costs, and compares its cumulative labour productivity growth of 67% to the Australian average 28.7%. We hold that the latter comparison is misleading in that it fails to acknowledge the very poor state of [Australia Post labour] affairs that existed at the beginning of the process [56].

The Post Office Agents Association Ltd (POAAL) concedes that some productivity gains have flowed through to the retail level through the Australia Post's introduction of point of sales systems. However, it argues that licensees that have borne the brunt of the real reduction in both volume and price and have had to generate significant productivity gains to "maintain a reasonable standard of living and to maintain a viable business"[57]. Further, the POAAL argues that much of the productivity gains to date have been a result of both the substitution of labour for capital and the increased use of contract services which have shifted labour costs.

Past productivity initiatives and scope for future productivity improvements

A number of submissions from large mail users refer to previous initiatives such as the implementation of FuturePOST which, through the introduction of bar-coded sorting, sought to:

- increase productivity;
- improve service delivery performance;
- reduce the cost of processing; and
- pass on cost reductions to consumers.

Each of these submissions argue that the introduction of bar coded sorting has shifted a portion of Australia Post's costs onto users, by requiring major mail users to invest in bar coding equipment. In addition, the parties argue that the reduction in costs and productivity improvements that were represented at the time of implementation have not been delivered.

Magnamail Pty Ltd argues that it has "incurred significant set up costs"[58] in implementing bar coding and is now unlikely to achieve a return on this investment over five years. The Printing Industries Association of Australia also refers to the significant investment mail houses have made in both capital and labour to implement the required changes.

Doubleday claims that:

[55] GoMail, submission, p. 9.
[56] MMUA, submission, p. 6.
[57] Post Office Agents Association Ltd, submission, p. 1.
[58] Magnamail Pty Ltd, letter dated 11 June 2002, p. 2.

> the introduction of bar coding was to assist Australia Post in increasing efficiency reducing costs and achieving better profits, however large customers of Australia Post, such as Doubleday, have invested significant amounts of money and resources to establish the bar coding infrastructure and contribute to Australia Post's productivity improvements and profitability[59].

Some parties such as GoMail and MMUA argue that the productivity gains and cost reductions originally projected for the implementation of FuturePOST have not been realised. GoMail suggests the Commission should "satisfy itself whether Australia Post has delivered on the cost savings and productivity improvements implicit in the original FuturePOST investment recommendation"[60].

MMUA maintains that "until Australia Post can show that all key elements within the Barcode Project included in the original plan which led to the approval of the $500 million budget have been exhausted then this is not an acceptable ground for postage price increases"[61]. Reader's Digest agrees with MMUA's comments and submits that it "does not believe that Australia Post has yet reached its full potential for productivity improvement"[62].

MMUA also questions the failure to achieve roundsorting, streeting and sequencing and queries whether union rather than technological influences have prevented this achievement. In addition, MMUA questions the extent to which changes in the workplace have "taken place to ensure that maximum efficiencies of mail processing automation have been delivered"[63].

Finally, the Australian Direct Marketing Association notes that "Australia Post's claim that opportunities for further productivity enhancements are not available suggests that in future, improvements in productivity will no longer be a priority"[64].

5.4 Australia Post's response

Following the receipt of public submissions, Australia Post sought to clarify its position on the issue of productivity and respond to the issues raised by interested parties.

Australia Post's position

In clarifying its position on the issue of productivity, Australia Post commences by stating that the growth in both labour and total factor productivity over the last decade had largely been a result of the implementation of productivity initiatives, combined with continued volume and revenue growth. Australia Post argues that while it had achieved growth in labour and total factor productivity of 5¼% p.a. and 5½% p.a. respectively over this time, the factors driving this growth were set to plateau and in some cases decline. That is, the implementation of productivity initiatives were

[59] Doubleday Australia, submission, 7 June 2002, p. 4.
[60] GoMail, op. cit., p. 9.
[61] MMUA, op. cit., p. 5.
[62] Reader's Digest, submission, 20 June 2002, p. 11.
[63] MMUA, op. cit., p. 10.
[64] Australian Direct Marketing Association, submission, 14 June 2002, p. 4.

nearing an end, which when combined with a projected fall in volume growth would result in "diminished opportunities for future productivity improvements"[65].

Australia Post claims that the growth in labour productivity has been in part a result of the:

- decline in total full-time equivalent employees;
- increased use of part-time staff; and
- the introduction of performance related wage bonuses.

According to Australia Post, these achievements have in a sense been counteracted by the increase in the number of delivery points, which have required a further 250 full-time equivalent staff per annum.

Australia Post submits that if volumes decline and the number of delivery points further increases, then "future labour productivity growth must come from labour reductions and/or further gains in capital productivity"[66]. However, Australia Post argues that it has already reduced its labour force and thus opportunities for extracting further savings from this area are limited. Similarly, Australia Post argues that future capital productivity improvements are limited although it concedes that the effect of a number of capital and labour productivity initiatives are still to be realised. Australia Post claims that the effect of these initiatives have been incorporated into its operating cost projections and will be fully realised by 2004/05.

Reference is also made by Australia Post to other cost minimisation initiatives adopted including:

- the contracting process used to contract labour which requires the provision of services at the lowest cost; and
- the reduction in property holdings and centralisation of property contract management.

Australia Post contends that these factors demonstrate that it is operating from an efficient cost base. In addition, Australia Post argues that its use of a relatively low level of labour cost inflation in projecting labour costs for the period 2002-2004 is further evidence that projected costs are not excessive.

Response to public submissions

In response to claims that factor substitution has been the principal factor driving labour productivity gains, Australia Post directs attention to total factor productivity. Australia Post contends that Malcolm Abbott's[67] estimate of an average 5½% increase in total factor productivity over the 1990s

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[65] ibid.
[66] ibid, p. 6.
[67] Abbott M., An Economic Evaluation of the *Australian Postal Corporation Act 1989*, Economic Papers 19(3), 2000.

combined with similar growth in labour productivity suggests that labour productivity growth has not been solely a result of factor substitution.

Australia Post also refutes the claim that contracting has resulted in artificial productivity increases. Australia Post maintains that it adjusts labour to the extent of outsourcing to remove any effect of substitution between labour and contractors upon productivity.

Australia Post similarly rejects claims that the productivity improvement it has referred to do "not simply reflect the low base at 1991"[68]. Australia Post argues that total factor productivity data over the more extended period of 1975-1999, illustrates that productivity has been improving over a longer period.

In response to issues raised regarding FuturePOST, Australia Post submits that while it will "capture all of the benefits anticipated from FuturePOST at the outset"[69] all of the projected cost reductions have been "factored into the financial projections that underpin the case for letter price increases"[70].

In addition Australia Post argues that:

- streeting and sequencing were not part of the original FuturePOST business plan;
- work practices have been altered to accommodate FuturePOST;
- benefits from the small letters component of FuturePOST have been achieved; and
- benefits from the large letter component of FuturePOST (which requires further labour reductions) are yet to be realised but are incorporated into projections of operating costs.

Australia Post argues that FuturePOST has "contributed to significant improvements in both labour productivity and total factor productivity through more efficient use of land, buildings, equipment and transport assets"[71]. In addition Australia Post argues that the investment in FuturePOST has achieved all of its targets, including the reduction in full-time equivalent employees.

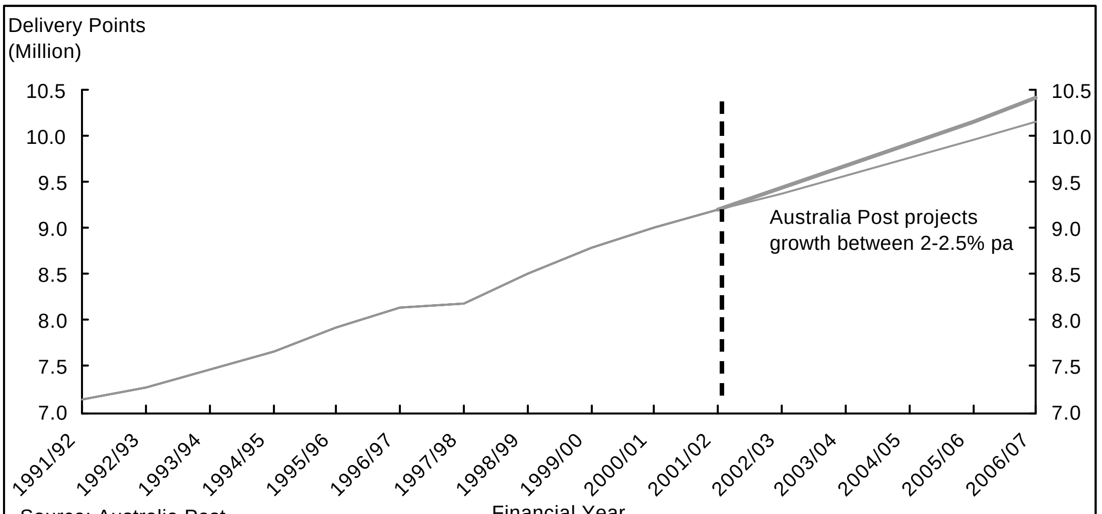
While Australia Post claims that it will not be able to sustain the rate of productivity growth it achieved over the last decade and expects only "marginal gains"[72] from technological innovation, it rejects the contention that future productivity improvements will not be a priority. Australia Post maintains that "its critical focus is on strategies to maximise the capabilities of FuturePOST network"[73], such as further network consolidation and selective deep sorting and sequencing.

Finally, Australia Post contends that future productivity growth will be constrained by the growth in delivery points which it is required to service under its universal service obligation. Australia Post

[68] Australia Post, Response to Public Submissions, July 2002, p. 7.
[69] ibid., p. 10.
[70] ibid.
[71] ibid., p. 12.
[72] ibid., p. 17.
[73] ibid., p. 16.

states that “delivery points are likely to grow at an annual rate of around 2-2.5% p.a.”[74] (see chart below), and argues that a 1% growth in delivery points requires 90 full-time equivalent resources which must be “met by on-going productivity improvements”[75].

Figure 5-1: Growth in delivery points



Source: Australia Post

5.5 Discussion

As outlined in the introduction to this chapter, determining the efficient level of operating costs is difficult in practice leading the Commission to utilise indicators such as past and projected productivity growth to assist in its assessment of whether current and projected costs are reasonable. The Commission has examined each of these indicators giving consideration to the information provided by Australia Post and the concerns raised by interested parties and will address each of them in turn.

Definitions

At its most basic, productivity measures the rate at which output is produced per unit of input. Growth in productivity over time is equal to output growth less input growth, which will depend on factors affecting output growth relative to input growth.

Productivity can be measured on a:

- partial factor basis, which relates output produced to one factor of production, for example labour productivity measures the output produced per unit of labour;

[74] ibid., p. 17.
[75] ibid.

- multi-factor basis, which relates output produced to more than one factor of production, for example it may measure output produced per combined unit of labour and capital input; and

- total factor basis, which relates output produced to all factors of production.

While partial measures such as labour productivity are often quoted as indicators of improved efficiency, the actual measure is influenced by a number of other factors including input substitution and the introduction of new technologies. That is, changes in the productivity of one input may come at the expense of the productivity of other inputs.

A more appropriate indicator of efficiency, then is total factor productivity (TFP). Estimates of TFP involve the construction of an aggregate output index and an aggregate input index. The ratio of the two indices provides the TFP measure that includes the impact of technical progress, economies of scale or of scope and managerial improvements[76].

Past productivity growth

External assessment

Australia Post's productivity performance has been considered in a study completed by Meyrick and Associates (Meyrick Report) on behalf of the Commission[77]. It has also been considered in two reports written in the last four years, one by Malcolm Abbott entitled *An Economic Evaluation of the Postal Corporation Act 1989*[78], and another by the National Competition Council (NCC) entitled *Review of the Australian Postal Corporation Act*[79].

Total Factor Productivity – Australia Post as a whole[80]

The Meyrick Report indicates that total factor productivity of Australia Post's operations has increased by 3.5% for the period 1992-2002. This increase in total factor productivity was somewhat less than the increase suggested by Abbott of 5.5% for the period 1989/90-1998/99. The major difference between the Meyrick Report and Abbott's study is the calculation of the user cost of capital[81]. Other differences include:

- the difference in the base years for the analysis and the differences the methodology used to calculate the TFP indices and growth rates;

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[76] ACCC, Review of Price Control arrangements - Telecommunications, February 2001, p. 56.

[77] Meyrick and Associates, *Australia Post – Past and Forecast Productivity Growth*, August 2002. A copy of this report is available on the Commission's website at http://www.accc.gov.au

[78] Abbott 2000, op. cit.

[79] NCC, *Review of the Australian Postal Corporation Act*, Final Report, February 1998.

[80] These estimates of total factor productivity cover Australia Post's full range of activities, not just regulated services.

[81] For more information regarding how the user cost of capital is calculated refer to p. 8. of the Meyrick report.

- a Fischer index is used in the Meyrick Report to calculate total factor productivity where as the Abbott study uses a Tornqvuist index method; and

- the growth rates calculated in the Meyrick Report are trend growth rates.

The increase in total factor productivity calculated in the Meyrick Report, for the period 1992-2002, was largely due to increases in letter volumes. Over this period, the output index increased at a trend growth rate of 5.7% and the input index increased at a trend growth rate of 2.2%. Table 5-1 below provides a summary of Australia Post's aggregate output and input quantity and TFP trend growth rates.

Table 5-1: Australia Post's aggregate output and input quantity and TFP trend growth rates, 1976–2002

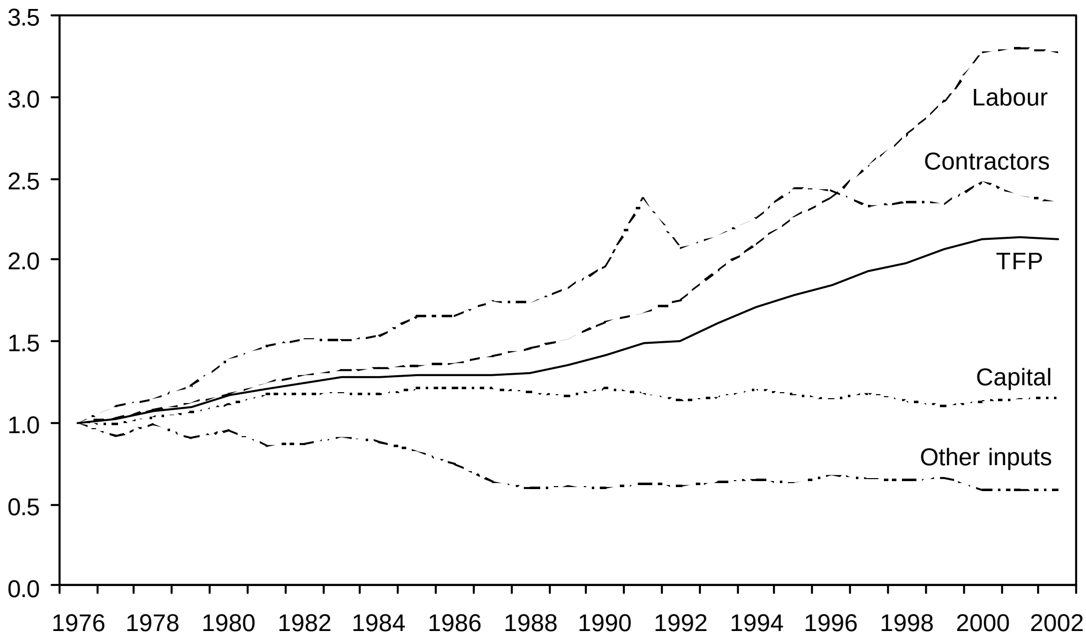
Variable	*1976–2002 % p.a.*	*1976–1991 % p.a.*	*1992–2002 % p.a.*
Output quantity	4.49	3.78	5.66
Input quantity	1.51	1.51	2.15
Total factor productivity	2.98	2.27	3.51

Source: *M&A estimates*

The Meyrick Report indicates that with the implementation of FuturePOST capital has been substituted for labour as the partial productivity indices of the two inputs, labour and contractors, increased at a much higher rate than capital, and hence total factor, productivity since 1996[82]. Figure 5-1 below shows the partial productivity indexes of the four inputs and total factor productivity over the period 1976-2002.

[82] Meyrick and Associates 2002, p. 10.

Figure 5-1 Australia Post's aggregate partial productivity and TFP indexes, 1976–2002



Source: Meyrick and Associates

Reserved services

The Meyrick Report also assessed the past and future productivity gains of Australia Post's reserved services operations. Table 5-2 provides a summary of the Meyrick results for Australia Post's reserved services output and input quantity and TFP trend growth rates for the period 1997-2007.

Table 5-2: Australia Post's reserved service output and input quantity and TFP trend growth rates, 1997–2007

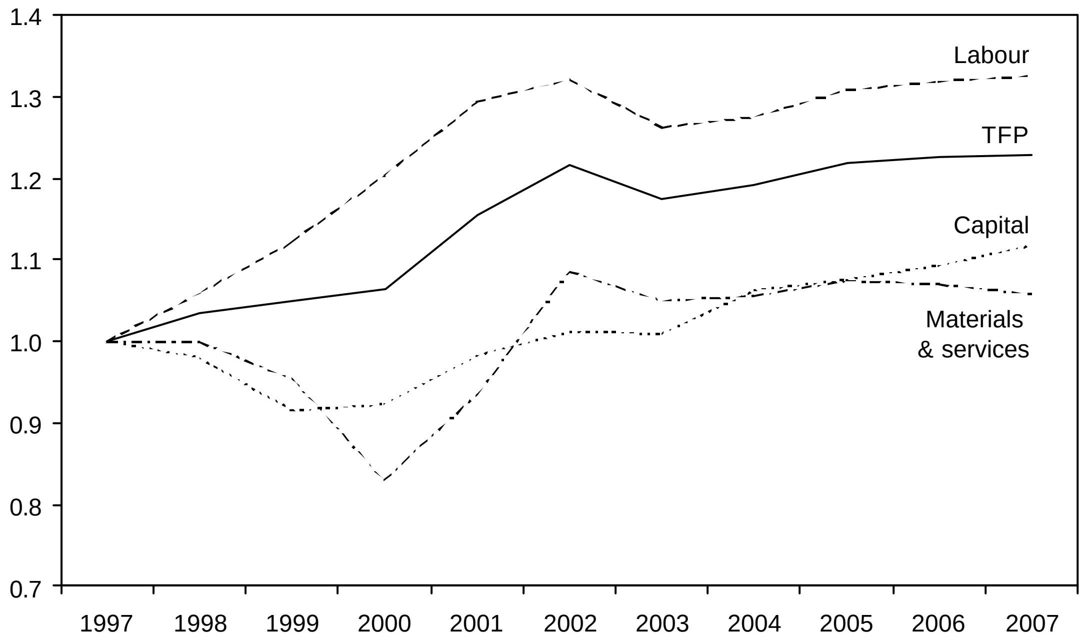
Variable	*1997–2007* *% p.a.*	*1997–2002* *% p.a.*	*2003–2007* *% p.a.*
Output quantity	1.76	3.68	0.14
Input quantity	–0.42	–0.11	–1.05
Total factor productivity	2.18	3.79	1.19

Source: *M&A estimates*

The key driver for productivity gains during the last five years for Australia Post for both the total and reserved service operations appears to have been Australia Post's ability to meet increased demand while keeping input usage relatively stable. The Meyrick and Associates study found that for the period 1997-2002 that reserved services output and input indices and total factor productivity trend growth rates were 3.7%, -0.1 %, and 3.8%, per annum respectively.

The Meyrick Report also indicates that the trends in partial productivity measures for Australia Post's reserved services operations and the entire business are similar. The partial productivities of the three inputs for reserved services, as well as the TFP index, are presented in figure 5-2. Figure 5-2 shows Australia Post's reserved service partial productivity and TFP indices for the period 1997-2007.

Figure 5-2 Australia Post's reserved service partial productivity and TFP indices, 1997–2007



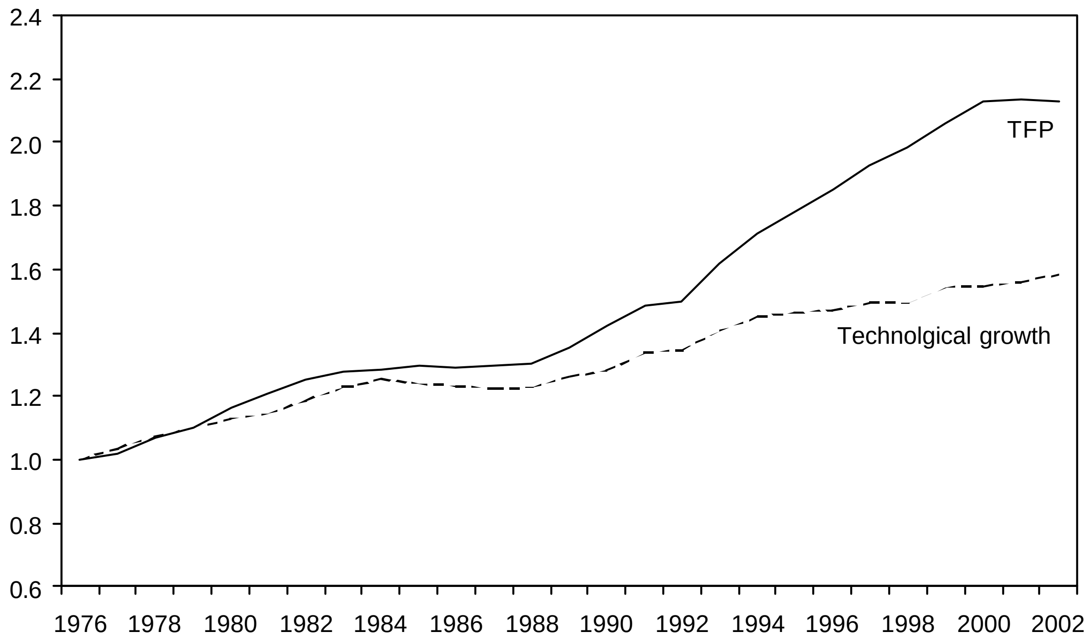
Source: Meyrick and Associates

Figure 5-2 shows labour productivity increasing at a faster rate than TFP, which has increased at a faster than capital productivity. Meyrick and Associates conclude that this reflects substitution of capital for labour over the period.

Decomposition of productivity gains - Australia Post as a whole

The Meyrick Report also includes an econometric decomposition of total factor productivity growth, as productivity improvements measured by TFP can result from a number of different factors. The study found that after adjusting for output and network size, Australia Post recorded significant technological improvement over the study period. The chart below provides Australia Post's total factor productivity and technological growth for the period 1976-2002.

Figure 5-4 Australia Post's total factor productivity and technological growth



Source: Meyrick and Associates

The Meyrick Report concludes that TFP increased significantly after 1992 due to increased volume growth, as output per delivery point increased by approximately 50% during the period 1992-2002. The Meyrick Report also suggests that the major determinants of for future productivity gains for Australia Post are:

- expected output growth;
- growth in the network; and
- underlying rate of technological process.

The Abbott study and the NCC report

The report written by Abbott examined trends in Australia Post's productivity over the period 1975-1999, considering both partial (output per unit of labour, contractor and capital) and total measures of productivity. In examining the partial measures, Abbott found that each of the measures had been steadily rising over the period, however, the less pronounced growth in the productivity of capital relative to labour demonstrated "the greater investment that Australia Post has put into replacing labour with capital"[83]. Abbott concluded that in cases where such substitution occurs, partial measures of productivity, such as labour productivity would "inaccurately portray the total

[83] Abbott , 2000, op. cit., p. 5.

change in productivity”[84]. That is, labour productivity would tend to overstate productivity improvements, while capital productivity would tend to understate productivity improvements. The Commission notes that Meyrick Report was critical of certain aspects of this study, although the broad trends in each study are not dissimilar.

A more limited study of Australia Post’s productivity was also conducted by the NCC. The NCC’s examination of labour costs and productivity over the period 1992-1997 found that labour productivity outstripped growth in the consumer price index over that period. The NCC concluded that labour productivity had improved as a result of:

- union and award rationalisation;
- the linking of wages and bonuses to performance;
- increased labour flexibility (that is a greater use of part-time and casual employment); and
- the introduction of automated mail processing.

Overall the NCC report concluded:

> Australia Post performs very well against its corporate objectives and against comparable organisations including overseas postal services and similar corporations. It has also been able to consistently improve its internal efficiency, provide large dividend payouts, capital investments, and has been able to make significant investments it its network primarily from internal sources[85].

Commission’s assessment

The difficulty in relying wholly on the NCC and Abbott reports is that a number of years have elapsed since the studies, during which time FuturePOST has been introduced. In light of these problems the Commission has given more weight to the total factor productivity study by Meyrick and Associates.

While noting the problems in relying on partial productivity measures, the Commission considers that Australia Post has derived significant cost savings and productivity improvements over the last decade as a result of labour rationalisation and changes in employment practices. Overall Australia Post’s labour force, including contractors, fell by 12% over the period 1990/91 – 2001/02, with full-time employment falling by 23% over the same period. The greatest fall in full-time employees occurred over the period 1991-1993 and 1997-2000, in line with the introduction of the first generation Optical Character Reader, the Multi Line Optical Character Reader and FuturePOST. This suggests that labour has been substituted for capital, particularly in the processing area, which has resulted in an increase in labour productivity.

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[84] ibid.

[85] NCC 1998, p. 130.

As mentioned previously the Meyrick Report also concludes that capital has been substituted for labour. The report notes that:

> …labour and contractor partial productivities have increased at a faster rate than TFP which has in turn increased faster than the capital and other inputs partial productivities. This reflects a substitution of capital and other inputs for labour and contractors over the period.[86]

The Meyrick Report also indicates that over the period 1976-2002 labour usage declined by 10 %, contractor usage increased by 30 % and capital usage increased by 160%. [87]

Changes in employment practices have also been a source of productivity improvements and labour cost reduction. One such change has been the growth in outsourcing over the last decade, which has occurred through the use of a greater number of contractors on some sections of Australia Post's delivery network. This has reduced costs since most of the contract cost is simply labour cost. Another source of change has been the change in the composition of the workforce, in particular the greater use of part-time and casual employees (with part-time employees representing 25% of employees in 2001/02 compared to 11% in 1990/91). This change in composition has accorded Australia Post some flexibility to adjust to changes in demand for its services over periods such as Christmas.

These changes in employment practices have resulted in a more flexible workplace, which when combined with the introduction of performance related wage bonuses and changes in the labour capital input mix have lead to an increase in labour productivity.

As noted previously, changes in the mix of inputs will affect partial measures of productivity so a more robust approach is to consider total factor productivity. The independent advice regarding Australia Post's total factor productivity for reserved services focuses primarily upon the period since the introduction of FuturePOST, and compares the increases in labour productivity with increases in total factor productivity. As mentioned previously, the Meyrick Report indicates that for the period 1997-2002 reserved service total factor productivity trend growth was 3.8% p.a.

Commission's conclusion

In light of the results of the Meyrick Report, the Commission considers that up to 2002 Australia Post both pursued and achieved significant labour and total factor productivity gains resulting in a cost base that was more efficient than had previously been the case. It does appear, however, that labour productivity estimates overstate the gains in total productivity, particularly over the last five years as capital has been substituted for labour since the introduction of FuturePOST.

Meyrick and Associates conclude that:

> Australia Post as a whole has exhibited strong TFP growth during the 1990s with a trend TFP increase of 3.5 per cent per annum between 1992 and 2002. This resulted from strong output

[86] Meyrick and Associates 2002, op. cit., p. 10.
[87] Ibid., p. 11.

> growth, particularly in the non–reserved output categories of other revenue, other addressed mail, agency services and unaddressed mail, combined with modest increases in the quantity of total inputs… Although more limited data is available for Australia Post's reserved service operations….a similar picture emerges for reserved services.[88]

The evidence available to the Commission suggests that Australia Post has, over the last decade, consistently achieved productivity gains and in turn generated cost savings leading to a more efficient cost base than had previously existed. The Commission will therefore accept, in the Preliminary View, that the current level of operating and maintenance costs are reasonable and has used these as the starting point for its profitability analysis.

The Commission also notes the importance of the effective price cap on the basic stamp, in providing Australia Post with the incentive to pursue productivity gains and cost reductions over the last decade. In the absence of competition, this has imposed some pressure on Australia Post to actively pursue productive efficiency, which may otherwise not have been achieved.

Forecast Productivity Growth

One of the principal reasons cited by Australia Post for an increase in price has been the projected decline in productivity growth. While forecast productivity growth data was not provided in its submission, Australia Post subsequently provided the Commission with labour productivity forecasts to 2006/07. These forecasts are based on Australia Post's latest corporate plan and focus primarily upon the three years to 2004/05. The information provided relates to labour productivity and projects growth in labour productivity of an average 2.5% p.a. over five years, which implies a decline in labour productivity growth rate to levels below the 5¼% p.a. achieved over the last decade. Australia Post contends that this is primarily a result of declining growth in output and reduced opportunities for labour and capital productivity improvements.

Declining growth in output and opportunities for productivity growth

As set out previously, productivity growth may be defined as the growth in output less growth in inputs. In line with this definition, if output is forecast to fall then productivity will be influenced by the ability of an organisation to reduce input usage relative to the reduction in output. This will in turn depend on the prevalence of fixed costs.

Australia Post argues that one of the principal contributory factors to the significant growth in productivity over the 1990s has been growth in volumes, and that this growth is set to plateau and decline in the coming years. As already noted, the Meyrick Report supports the view that volume growth has been a key driver of productivity improvements by Australia Post. Looking forward, Australia Post claims that over the period 2002/03 – 2006/07 overall volumes will slow to an average growth rate of 0.1% p.a. There is, however, likely to be some compositional change. In the case of full rate letters, Australia Post expects volumes will decline by an average 3.3% p.a over the period, while bulk rate letter volumes are expected to increase by an average 3.6% p.a.

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[88] ibid., pp.18-19.

The Meyrick Report notes that the decline in the reserved services TFP growth from 3.8% p.a during the period 1997-2002 to 1.2% p.a during the period 2003-2007 is a result of the flattening out of forecast output levels and to a lesser extent, reduced input usage (see table 5-2). It further notes that for the period 1997-2007 labour usage is estimated to decline by 10%, capital usage increases by 7% and materials and services usage increases by 13 %. The decline in labour usage and increased capital utilisation continues during the forecast period of 2002-2007 but at a slightly lower level due to the reduction in capital investment opportunities.

Australia Post contends that it is limited in its ability to reduce input usage with the forecast reduction in output because of the growth in delivery points, which must be serviced in accordance with the universal service obligation. Australia Post claims that delivery points have grown by 29% since 1992/93 (averaging 2.6% p.a. over the period) and estimates future growth of 2-2.5% p.a.

Section 27(4) of the *Australian Postal Corporations Act 1989* requires Australia Post to ensure that the letter service is "reasonably accessible to all Australians on an equitable basis, wherever they reside or carry on business". Further, they are required to ensure "that the performance (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community".

As discussed in Chapter 6, the Commission acknowledges that the universal service obligation operates as a constraint upon Australia Post's ability to adapt downstream delivery labour requirements to changes in letter volumes and that further rationalisation in this area will be limited (although the use of contractors may reduce the cost of servicing this growth). The Commission therefore accepts that the universal service obligation in effect reduces the scope for productivity growth which could be attained in the absence of such an obligation.

While the Commission accepts that this obligation in part restricts Australia Post's ability to adapt input usage to the forecast decline in full rate services, it also recognises that delivery is not the only area in which input use can be rationalised. In terms of aligning labour use to declining volumes, further rationalisation or restructuring could occur across areas such as processing, retail and administration. Rationalisation of capital inputs, particularly those used in full rate services, may also be required over time. The Commission acknowledges that some rationalisation has already occurred and more is planned across the network (particularly in Sydney and Melbourne) and in line with the implementation of FuturePOST. However, the Commission notes that this rationalisation has primarily been concentrated within the sorting area.

It may be possible for Australia Post to adapt to declining volumes over a sustained period. In the short run the cost base is comprised of both fixed (ie. overheads, salaries, rent and lease payments for plant and equipment) and variable costs (ie. hourly labour rates and raw materials), which can be distinguished by their relationship with output. That is, fixed costs will not vary with output while variable costs will vary directly with output. Over a longer period of time, however, it may be possible to change the scale of operations rendering a greater proportion of inputs and in turn costs variable.

According to Australia Post fixed costs currently represent between 65-75% of total costs. This does, however, appear to be based on a view of fixed input restrictions over a short run period. That is, limited consideration appears to have been given to the extent to which inputs currently defined as fixed could become variable over the medium term. In failing to fully consider this aspect, Australia Post's estimate of the extent of its fixed costs may be relatively high, which when spread over Australia Post's projected long-term decline in letter volumes, will result in rising unit costs.

The Commission notes that the extent to which costs currently defined as fixed are truly fixed over the period 2002/03 – 2006/07 might therefore be open to some debate.

In particular, the Commission notes that Australia Post's forecasts have been largely drawn from its latest corporate plan, which has a time horizon of three years. Within this framework Australia Post has focused primarily upon the years to 2004/05 giving only limited consideration to potential productivity gains for years four and five. The forecasts that have been provided to the Commission are relatively conservative and factor in a steady decline in labour productivity growth over the five years to 2006/07. In light of this limited consideration, the Commission considers that further productivity gains could be factored into years four and five, which would in turn affect projected operating and maintenance costs for these later years.

Opportunities for capital productivity growth

Australia Post claims that it is currently utilising the most advanced technology available and that it expects only limited gains from technological innovation in the near future. The Commission is not in a position to determine the likelihood of technological advancement and the effect this may have on the sorting process. However, the Commission does consider that further gains, which could flow from previous initiatives, such as FuturePOST, could be actively pursued. This is a point which Australia Post itself has acknowledged:

> "there will be some further scope to realise additional benefits from the technology as our knowledge of its capability increases"[89].

Again, the Commission notes that Australia Post has focused largely upon the opportunities for productivity growth up to 2004/05 and that investment and capital productivity improvements beyond this period have not been fully considered.

Incorporating projected productivity growth into the cost base

Australia Post claims that all projected labour productivity growth has been incorporated into its projected operating and maintenance costs. The Commission sought to examine this claim by carrying out its own analysis of labour costs over the period 2003-07, that is by comparing projected output per full-time equivalent employee to the real labour cost derived productivity.

Australia Post provided the Commission with data including:

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[89] Australia Post, Information provided to the ACCC by Australia Post on 12 June 2002, p. 7.

- the number of full-time equivalent employees per work year;
- projected letter volumes across the four product categories including: small full rate; small bulk rate; large full rate; and large bulk rate services;
- projected direct costs across the four product categories which were broken down into labour and related costs, contractor and related costs, licensee and related costs and other miscellaneous costs;
- indirect and allocated costs across the four product categories; and
- projected wage inflation.

The Commission acknowledges that there is a problem in comparing the cost derived productivity measure to the real input derived measure. The problem in this instance is that the cost data provided by Australia Post contained other labour related costs including redundancy payments and provision for workers compensation. These additional costs abstract from simple labour costs and make the transition from productivity projections to labour costs less transparent. The Commission acknowledges the potential distortionary effect of labour related costs and notes its wariness in relying solely on these calculations.

Having said that, the Commission did undertake an examination of the data provided by Australia Post. Projections for labour productivity were calculated using the first two elements of the above data, leading to output per full-time equivalent employee. These direct estimates of productivity were then compared with an estimate of implicit productivity derived by:

1. deflating labour and related costs for the period 2002/03– 2006/07 by projected wage inflation to determine real labour and labour related inputs;
2. indexing the real labour and labour related input series and the projected output series to 2002; and
3. calculating the ratio of output to real labour and labour related inputs.

This method was also applied across the four product categories. The results of this calculation for total labour and related costs demonstrated that some productivity growth had been factored into costs although the growth in the implicit cost-derived measure was less than Australia Post's direct estimate of productivity.

Across the four product categories the results were varied. These results demonstrated that the extent to which productivity improvements had been incorporated into labour and related costs was greater across the small and large bulk rate services than across the full rate services. Further, it appears that the projected productivity improvements are most concentrated within the large bulk rate service. These results may suggest that the expected growth in bulk rate letter volumes (forecast increase of an average 3.6% p.a. over the period 2002/03 - 2006/07) combined with the continued advancement of the benefits of FuturePOST have been incorporated into Australia Post's projections..

Total factor productivity

The Meyrick Report indicates that over the next five years (2002-2007), Australia Post's productivity of its reserved service operations will continue to improve by an average of 1.2% p.a. However, this increase in productivity is less than what has occurred in the previous five years (1997-2002) of 3.8% resulting from the flattening out in output growth and, to a lesser extent, Australia Post's continued marginal reduction in input usage.

The key driver of Australia Post's productivity gains over the last five years has been increased output growth, which is expected to be lower over the forecast period 2002-07. Input usage is also expected to decline over the next five years mainly due to site rationalisation and changes in employment practices. These reductions appear reasonable in comparison with past performance. The Commission therefore considers Australia Post's projected costs do not appear unreasonable.

5.6 Conclusion

Productivity

The Meyrick Report indicates that the productivity of Australia Post as a whole has increased significantly in the past decade. Furthermore, these gains also appear to have been realised in the provision of reserved services. On this basis, the Commission considers that Australia Post's current costs appear to be reasonable.

From the analysis the Commission has been able to carry out on projected operating and maintenance costs and the results contained in the Meyrick Report, it appears that Australia Post has, to some extent, factored in expected productivity gains. However, the Commission notes that only limited consideration has been given to potential productivity gains beyond 2004/05.

Although more limited data is available for Australia Post's reserved service operations, the Meyrick Report concludes, that the reduction in total factor productivity growth in reserved services over the next five years compared to the previous five years is the result of 'a levelling off in reserved service outputs after 2001 and ongoing modest reductions in total input use.[90]'

Therefore while the Commission considers that there may be some scope for further reduction in projected operating and maintenance costs, particularly over 2005/06-2006/07, Australia Post's forecast costs do not appear unreasonable.

[90] Meyrick and Associates 2002, op. cit., p. 15.

Incentives

Rather than prescribing a certain level or range within which projected operating and maintenance costs may be considered reasonable, however, the Commission considers it more beneficial to encourage Australia Post to continue to seek out efficiency gains and cost reductions by putting in place the necessary incentives.

The Commission notes the success of the price freeze on the basic stamp (prevailing from 1992) in providing such an incentive and suggests that such an incentive could be put in place once again. That is if prices are held constant over the medium-term, then in effect a CPI-X[91] price cap is put in place with the value of X set equal to the CPI. The operation of such a price cap would provide Australia Post with an incentive to seek out productivity gains.

The Commission therefore considers that if Australia Post were to adopt a constant price policy over a reasonable period of time, this would best address users' concerns regarding projected operating and maintenance costs.

[91] CPI-X means that the price increase allowed is the rate of increase in the consumer price index, minus a target rate of productivity, X.

6 Community service obligation

6.1 Introduction

Under section 27 of the APC Act, Australia Post is required to collect and deliver ‘standard postal articles’[92] to all but the most remote parts of Australia, even if the costs exceed the revenues. This obligation to collect and deliver letters around the country is known as Australia Post’s Universal Service Obligation (USO).

Australia Post could potentially earn higher profits if it was able to charge more than the uniform rate to deliver some letters. When other companies would charge a higher rate or not provide the service at all, Australia Post is performing a CSO.

The National Competition Council (NCC) in its *Review of the Australian Postal Corporation Act* defines a CSO as:

> A community service obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices[93].

This chapter begins by outlining the comments made in submissions by Australia Post and interested parties regarding Australia Post’s CSO. Subsequently, an explanation of the legislative basis of Australia Post’s CSOs and a discussion of key issues such as CSO costing, funding and performance standards are provided. Finally, the Commission’s views on the impact of the CSOs on the assessment of Australia Post’s proposed price changes are expressed.

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[92] A standard postal article is defined in the APC Act as an article that weighs less than 250g, has dimensions not exceeding 5mm thick by 122mm broad by 237mm long and where the length is at least 1.414 times the breadth of the article.

[93] National Competition Council, *Review of the Australian Postal Corporation Act: Final Report, Volume Two, February 1998*, p. 181. Alternative definitions are possible. For example, a recent survey of academics and representatives of government business enterprises recently identified the following as the most preferred definition: “A CSO arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices”. Baird, Kevin, “What is a Community Service Obligation (CSO)? An Analysis of the Issues Involved in Identifying and Accounting for CSOs Within Public Sector Organisations”, *Australian Journal of Public Administration*, 69(4) 2001, p. 58.

6.2 Australia Post's views

In its draft notification, Australia Post states that it must provide a letter service at a uniform rate around Australia and must also provide a reasonably accessible service to all people in Australia on an equitable basis.

According to Australia Post's submission, it has outperformed the required performance standards associated with these obligations. The actual and the required performance standards, as set out in Commonwealth Regulations, are illustrated in Table 6.1.

Table 6.1: Required versus actual performance standards

Standard	Required performance	Australia Post performance
Number of street post boxes	10,000	15,386
Delivery timetable	Maintained	Maintained
On time delivery of non bulk letters	94% on time	94.1% on time
Points to receive delivery 5 days per week	98%	98.6%
Points to receive delivery no less than twice per week	99.7%	99.9%
Retail outlets	4,000	4,491

Source: Australia Post draft notification

Australia Post states that although it has satisfactorily met its CSO, it has done so at a significant annual cost which has adversely impacted on its financial performance. In 2000/01 Australia Post estimated its CSO net cost at $86.3 million.

Australia Post also claims that its CSO costs are subject to change and in recent years have significantly risen. Australia Post suggests that the cost of its CSO has increased for two reasons, namely:

- the increase in the number of routes Australia Post is required to deliver to and collect from; and
- the increase in the number of unprofitable routes since the introduction of the GST.

6.3 Submissions

The Commission has received a number of submissions on Australia Post's pricing proposal, with many commenting on Australia Post's CSO. In particular, GoMail, Charleville Newsagency, Newsagents Association of South Australia, Queensland Retail Traders and Shopkeepers

Association, Queensland Newsagents Federation and several private citizens have expressed concerns about Australia Post's CSO.

The primary issues brought to the Commissions attention, in both the written submissions and the Public and Technical Issues Forum, were:

- *Relevance of the CSOs to the Commission's assessment.*

For example, GoMail states that:

> Australia Post very cleverly uses the argument of the cost of maintaining CSOs to suit its own political argument – driven more on fear and implied threat than economic substance. There is a cost of meeting those universal obligations, but such a cost obligation should be seen as part of the premia for its privileged monopoly status[94].

- *Transparency in Australia Post's CSO operations*. For example, GoMail states that:

> The real issue is to determine the true cost of maintaining the CSO, excluding the cost of maintaining historic old buildings and other such costs. Only upon full and open disclosure will the industry be informed as to the relevance of Australia Post's statement that it constrains its financial position[95].

- *Level of Australia Post's CSO cost*. Mr Terry Daly, a representative of HPA and MMUA, at the Technical Issues Forum expressed the view that:

> …it is just this community service obligation and the cost of that going up continually. I have always believed that that obligation, the way the process worked has never been put out to tender. Therefore, Australia Post can be as uncompetitive as it likes in that particular area and have a 92 or a 67 million-dollar community service obligation. To put that out to tender may be a real way to found out what that cost of is in the distribution system within the country areas[96].

- *Australia Post's poor CSO performance standards.* For example, the Queensland Newsagents Federation states that:

> Retailers would not participate in postage stamp resale if there wasn't a considerable customer demand which is currently not being satisfactorily attended by Australia Post. Micro-business retailers participate in resale of postage stamps to provide customer service[97].

Likewise, the Queensland Retail Traders and Shopkeepers Association comment that "retailers generally only take on the selling of stamps as a community service due to the lack of outlets/service by Australia Post"[98].

[94] GoMail submission, p. 10.
[95] GoMail submission, p. 10.
[96] ACCC, Australia Post Technical Issues Forum transcript, p 58.
[97] Queensland Newsagents Federation submission, p. 2.
[98] Queensland Retail Traders and Shopkeepers Association submission, p. 1.

These issues, raised in the written submission and also during the Public and Technical Issues Forums, are discussed in greater detail in section 6.5.

6.4 Legislative basis of CSO

6.4.1 The *Australian Postal Corporation Act 1989*

The functions and obligations of Australia Post are set out in the APC Act. Specifically, section 27 of the APC Act sets out Australia Post's CSO and states that:

> (1) Australia Post shall supply a letter service
>
> (2) The principal purpose of the letter service is, by physical means:
>
> > a) to carry, within Australia, letters that Australia Post has the exclusive right to carry; and
> >
> > b) to carry letters between Australia and places outside Australia.
>
> (3) Australia Post shall make the letter service available at a single uniform rate of postage for the carriage within Australia, by ordinary post, of letters that are standard postal articles.
>
> (4) Australia Post shall ensure:
>
> > a) that, in view of the social importance of the letter service, the service is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business; and
> >
> > b) that the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community[99].

Although section 27 broadly outlines Australia Post's CSOs, the specifics of these obligations are subject to interpretation. The following paragraphs set out the Commission's understanding of these obligations.

Subsection 27(3) requires Australia Post to "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". Australia Post currently satisfies this component of the definition by charging 45 cents for the delivery, to all areas of Australia, of all standard postal articles.

Paragraph 27(4)(a) states that Australia Post must ensure 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".

In particular, the specific activities incorporated in the term 'letter service' need to be spelt out and also the meaning of the term 'reasonably accessible' needs to be explained. A broad interpretation of paragraph 27(4)(a) may require Australia Post to provide a more extensive range of services and/or make these services more accessible.

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[99] *Australian Postal Corporation Act 1989*, section 27.

To the Commission's understanding, the 'letter service' incorporated in Australia Post's CSO includes the delivery and collection of letters as well as the provision of stamps. Australia Post's obligations do not cover other services people have come to associate with the provision of postal services such as reasonable access to post offices. As NCC report states:

> Under the letter delivery USO, Australia Post is required to provide a letter service that is reasonably accessible to the community. However, this does not mean that Australia Post must provide the community with reasonable accessibility to post offices. Instead, the commitment is measured in terms of accessibility to stamps and a posting point[100].

Paragraph 27(4)(b) states that Australia Post must meet the performance standards (including delivery times) for the letter service to reasonably meet the social, industrial and commercial needs of the Australian community.

The Commission interprets paragraph 27(4)(b) as being satisfied if Australia Post meets performance standards specified in the regulators pursuant to subsection 28(c). The prescribed performance standards relate to:

> (1) the frequency, speed or accuracy of mail delivery; or
>
> (2) the availability or accessibility of:
>
> (i) post-boxes or other mail lodgement points; or
>
> (ii) offices of Australia Post or other places from which Australia Post products or services may be purchased[101].

According to Australia Post's 2000/01 annual report and public submission, it is currently meeting its required performance standards. For example, the performance standards require that 98% of delivery points receive deliveries five days a week. In 2000/01 Australia Post managed to ensure that 98.6% of delivery points received deliveries five days a week. Performance against these standards is subject to independent audit by the Australian National Audit Office.

6.4.2 Direction 11

Under section 20 of the PS Act, the Minister may direct the Commission to give 'special consideration', in exercising its powers and performing its functions under the PS Act, to certain specified matters.

Direction 11 requires the Commission to give special consideration, in its assessment of Australia Post's pricing proposal, to:

- Australia Post's obligations to pursue a financial policy in accordance with its corporate plans as set out in sections 35-41 of the APC Act; and

[100] NCC 1998, p. 173.
[101] APC Act, section 28C(2).

- Australia Post's functions and obligations as set out in sections 14-16 and 25-28 of the APC Act.

Therefore, while the Commission pays particular regard to the efficiency of the cost base and the reasonableness of the rate of return that company is seeking, it must also give special consideration to the functions and obligations of Australia Post. Essentially, this means that Australia Post's costs will be higher than would be the case in the absence of its CSOs and the Commission must take this into account in its assessment.

6.5 Discussion

6.5.1 CSO funding

In order to assist Australia Post to fund the CSO, the Commonwealth Government has effectively forbidden parties from competing with it in some letter delivery services. That is, certain postal services are 'reserved' to Australia Post. These services are defined by section 29 of the APC Act and include letters not weighing more than 250g, or costing more than four times the standard postal rate.

Australia Post uses the profits it generates from delivering letters on routes where the costs are lower than the uniform rate to subsidise the losses sustained delivering letters on the routes where costs exceed the uniform rate. This method of using profits to fund CSOs is known as **cross-subsidisation**[102].

Australia Post contends that the cross subsidy arrangements are easy to administer and facilitate a uniform rate of postage across Australia, which fulfils equity considerations and simplifies assessment of postal charges.

However, the National Competition Council report notes that the cross subsidy arrangements require extensive restrictions on competition, they are not transparent, they require some users to pay significantly more than the cost of delivering their mail and they create tensions between commercial objectives and CSOs.

As mentioned above, submissions have questioned the cross-subsidy arrangement used by Australia Post to fund the CSO and in turn, have suggested that Australia Post be more transparent in its operations.

In response, Australia Post states in its *Response to the Public Submissions* that:

[102] This form of cross-subsidisation refers to cross-subsidisation between different **routes**, as opposed to the cross subsidisation between **services** such as reserved and non-reserved services.

> …..the integration of CSOs into Australia Post's business operation, and payment of their cost by cross-subsidy, periodically raises claims that reserved service profits are diverted to subsidise our commercial activities. This is not our practice[103].

More generally, Australia Post argues that it complies with all general accounting standards and reports detailed information on revenues, costs and assets in its annual report.

The cost information that Australia Post has provided to the Commission is based on its detailed Product Costing System (PCS). The PCS matches the revenues and expenditures of all of Australia Post's activities to products and services. Notably, CSO costs are incorporated in the system. Australia Post also estimates the cost of the CSO as a separate exercise, but it is only undertaken periodically for reporting purposes. Accordingly, the Commission has not separately included the cost of CSOs in its profitability analysis.

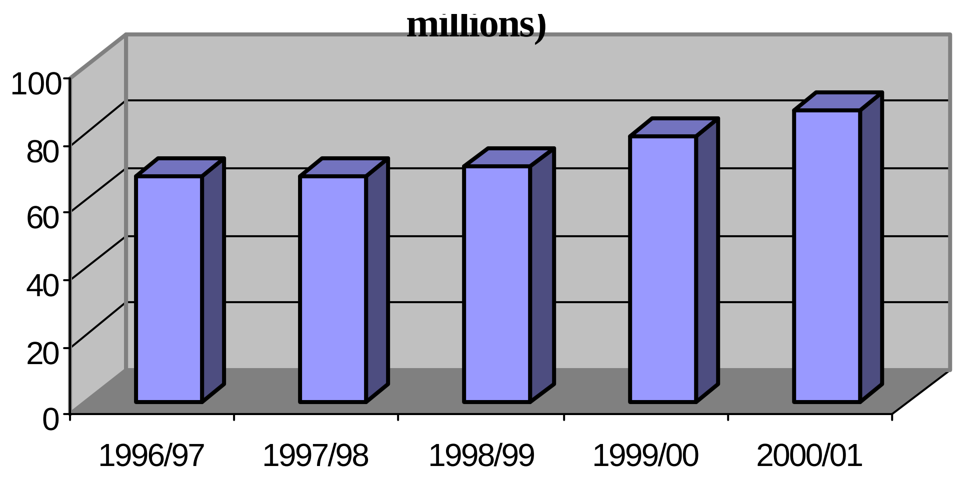
A detailed discussion of cost allocation can be found in chapter 7. In general, however, the Commission regards Australia Post's CSOs as a constraint on Australia Post's profits rather than an opportunity to subsidise its commercial activities. Further analysis of Australia Post's profitability is provided in chapter 10.

The Commission emphasises that it is not its role to recommend an appropriate method of funding the CSO. Rather, the Commission must accept the uniform rate of postage as a constraint upon Australia Post's discretion in pricing.

6.5.2 CSO costing

Australia Post calculates the size of the letter delivery CSO using an **avoidable cost methodology**. Under the methodology, the cost of a CSO is the net cost that could be avoided over the long term if the service was not supplied. The net cost is the cost avoided less the revenue earned on the service (the revenue must be less than the cost avoided if the service is to be a CSO). Figure 6.1 illustrates Australia Post's CSO costs over the last five years.

Figure 6.1: Australia Post annual CSO cost ($ millions)



[103] Aus

Source: Australia Post annual reports

Australia Post has previously argued that the avoidable cost methodology underestimates the true costs of providing the CSO and argues that the CSO costs should be measured using a methodology based on fully distributed or stand-alone costs. Fully distributed costs measure the separately attributable cost of an activity plus a proportion of the common costs which are not directly attributable to any particular activity. Stand-alone costs measure the costs as if the activity was provided in isolation from other activities.

The problem with a fully distributed cost methodology or a stand-alone cost methodology to calculate CSO costs in the postal industry is that they include a number of costs that Australia Post would have incurred even if it was not required to deliver the CSO.

Nevertheless, GoMail states in its public submission that:

> …the real issue is to determine the true cost of maintaining the CSO…only upon full and open disclosure will the industry be informed as to the relevance of Australia Post's statement that it constrains its financial performance[104].

However, it should be noted that it is not the role of the Commission to assess the alternative methods of costing the CSO. Under Direction 11, the Commission is required to give special consideration to the functions and obligations of Australia Post. The Commission must take Australia Post's CSO cost into account when assessing the proposed price changes. As already noted, Australia Post's CSO costs are incorporated through its PCS.

6.5.3 CSO performance standards

As mentioned above, many submissions have expressed concern about Australia Post's inadequate provision of its CSO.

It should be noted, however, that in considering proposed prices, the Commission is not in a position to, nor is it appropriate to, assess the quality of service in detail for all services. Nonetheless, quality is a relevant issue in that the Commission would be concerned if Australia Post was adjusting to price restraints by allowing quality of service to deteriorate. To this end, it is appropriate to look at aggregate measures of performance.

According to Australia Post's 2000/01 annual report and public submission, it is currently meeting, and generally outperforming, its required performance standards. For example, the performance standards require that 98% of delivery points receive deliveries five days a week. In 2000/01, Australia Post managed to ensure that 98.6% of delivery points received deliveries five days a week.

[104] GoMail submission, p. 10.

The Commission notes that performance against the standards is subject to independent audit, and accepts that Australia Post is reasonably meeting its performance standards. Further discussion of quality of service is contained in Appendix D.

In addition to private customers of Australia Post, several businesses and associations also suggest that Australia Post is failing to meet its CSO. In both written submissions and during the forums, several newsagent representatives (in particular) claimed that they were providing postal services as a community service as Australia Post was failing to meet the needs of the community.

The Commission notes that Australia Post appears to have significant discretion over which third parties may sell stamps. In this respect, there is potential for consumer welfare to be lessened through the loss of convenience that might be associated with a greater number of sales points and longer trading hours. This may have some implications for competition between newsagents, Australia Post and licensed post offices.

The Commission does note that newsagents are not required to sell stamps and other postal products and that their choice to do so reflects a commercial decision. Although newsagents do not receive a margin on the sale of stamps, provision of the service is likely to be worthwhile, as a customer purchasing stamps/postal products may also purchase other non-postal products. That said, there appears to be some scope for Australia Post to facilitate broader distribution of postal products through third parties.

6.6 Conclusion

In assessing Australia Post's draft notification, the Commission has taken into consideration the impact of the CSO on the efficiency of Australia Post's cost base in accordance with the Commission's interpretation of section 17(3) of the PS Act. The Commission has also given special consideration to the functions and obligations of Australia Post in its assessment of the pricing proposal in line with the requirements of Direction 11.

According to information provided to the Commission by Australia Post, Australia Post appears to be adequately meeting its CSO, albeit at a significant annual cost. The Commission agrees with the comments made by Australia Post that "compared to a fully commercial operation, the CSO imposes a cost structure which is higher than would otherwise be the case.[105]" In other words, the Commission accepts that Australia Post's CSOs prevent Australia Post from having complete control over its costs.

Nevertheless, the Commission expects Australia Post to provide its CSO in a productively efficient manner. Although Australia Post's CSOs are clearly set out in section 27 of the APC Act, Australia Post does have some discretion over the way in which it meets these obligations. For example, Australia Post is able to choose the technology it deems appropriate to provide its CSOs.

[105] Australia Post draft notification, p. 12.

The Commission understands that the cost of Australia Post's CSOs are subsumed into the cost base of its letters business, and are thus covered by the required revenues in the financial analysis for this assessment. The Commission has not considered it necessary to make a separate estimate of the cost of the CSOs.

7 Cost allocation

7.1 Introduction

Australia Post's reserved letter services, which are declared under the PS Act and covered by the current price notification, constitute only part of the range of Australia Post's diversified services. Many of Australia Post's resources or costs contribute to the production of both the reserved and non-reserved services. The non-reserved services include retailing, logistics and financial services as well as other mail products such as parcels and large letters.

The costs included in Australia Post's accounts include operating costs such as labour and contract payments, accommodation, vehicle operating expenses, cost of goods sold, maintenance, and depreciation, but exclude interest, tax and return on equity. Many of these costs are shared; that is, they simultaneously serve more than one of these products or services. They are joint or common costs in economic terminology[106]. For example, resources such as post office buildings and counter staff serve both reserved and non-reserved products, while postal delivery serves a range of letter and other mail products which are not regulated. Other costs such as manual sorting may be confined to ordinary letters – small or large.

For the purposes of this inquiry, it is necessary to identify the costs relating only to the reserved services and also an acceptable allocation of the shared costs, at a broad level, between Australia Post's reserved and non-reserved products. There is also an issue as to how shared costs are allocated between the numerous separately priced products, as a basis for the price structure in Australia Post's schedule.

In this chapter, issues raised in users' submissions are first summarised, followed by discussion on the appropriate methodology for cost allocation and an outline of Australia Post's costing systems, and then the Commission's assessment.

7.2 Submissions

Several submissions express concern about the relationship between Australia Post's reserved and non-reserved services, raising the issues of cross subsidisation and cost allocation. For example, the Queensland Newsagents Federation submits that:

> We understand that Australia Post operate central purchasing for most of their retail product and distribute it via their exclusive and reserved practices with mail distribution.

[106] These terms are discussed later in this chapter.

> Also the postal system which has protection allows Australia Post officers to distribute promotional brochures to households which would normally be a cost to other competitive retailers.
>
> Serious question must be raised on the manner by which the labour of Australia Post, their operating overheads and costs are apportioned between protected activities and competitive retailing operations?
>
> ……..
> We question whether there is sufficient separation and reporting on the various elements which comprise the activities of Australia Post to ensure that the cross-subsidisation practices are appropriately revealed.[107]

The Newsagents of South Australia Limited and QRTSA make similar claims about cross-subsidisation of Australia Post's retail activities by its reserved activities.

Reader's Digest's submission raises the issues of marginal costing and cross-subsidisation:

> The ability of Australia Post to carry reserved and non-reserved service postal items throughout their national system therefore marginalizing the cost base to operate the network prohibits competition in being able to set up an alternative structure and operation to deliver to residential addresses in metropolitan, rural and remote locations. [108]
>
> ……..
>
> Whilst we congratulate Australia Post on their ability to offer choice to the bill presenter and consumer the question should be asked are these proposed increases paying for these alternative services?[109]

GoMail argues as follows:

> ….However this does not give Australia Post unchallenged licence to continue with its present aggressive practice of using monopoly profits derived from its reserved services to actively drive its e commerce initiatives within the non reserved services sector.
>
> …………
>
> .. rather Australia Post's strategy is to establish itself as the dominant industry player within the competitive electronic commerce sector. This is an admirable strategy except for the fact that it competes within this contestable industry segment with the privilege of unchallenged monopoly profits derived from its reserved services funding such investment. Taken to its logical conclusion such market advantage will lead to the loss of competitive alternatives within this emerging sector due to the (mis)use of monopoly profits to unfairly fund such initiatives.[110]

The Major Mail Users' Association states in regard to the relationship between reserved and non-reserved:

> … for the Australian mail industry the inter-relationship of Australia Post's various mail and mail-related products (Reserved and Non-Reserved) makes it important that the price review should embrace all elements of Australia Post's core business: mail.[111]

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[107] Queensland Newsagents Federation submission, p. 2.
[108] Reader's Digest submission, p. 9.
[109] Reader's Digest submission, p. 12.
[110] GoMail submission, p. 3.
[111] Major Mail Users' Association submission, p. 4

> ….We question whether the intention of the monopoly was also intended to be used for the development of the other business activities, competing in the marketplace with companies that do not have the benefit of a monopoly-provided "core competency and infrastructure" from which to lever.
>
> 55. We acknowledge that that point is not an argument in this matter, nevertheless arising from the more specific issue of the use by Australia Post of its Reserved Services revenues, core competencies and infrastructures:
>
> 55.1. We hold that for accounting (and pricing increase) purposes they should be dedicated to Reserve Services products - any other use of them to be properly accounted for and Reserved Services credited for such use;
>
> 55.2. We suggest to the ACCC that in this current pricing increase proposal, segmented accounting reporting requirements should be placed upon Australia Post to account for the degree of dependency and inter-dependency between Reserved Services and the Non-Reserved Services, e.business and other business activities.[112]

Issues raised in those submissions are considered below.

7.3 Costing principles

7.3.1 Cross-subsidisation

Testing the above claims requires investigation of factors such as the extent of monopoly profit in Australia Post's reserved business, whether the non-reserved services operate at a loss, and whether costs properly attributable to its non-reserved business have been charged to the reserved side.

Australia Post's profitability in its non-reserved business has been considerably greater overall than in its reserved business – the return on assets on non-reserved was 21.7% compared with only 4.2% on reserved in 2000-01[113]. This result is at first surprising if Australia Post's non-reserved businesses are engaged in competitive areas of the economy where rates of return are generally much lower than 20%. However, these figures do not show differences in profit or loss for individual segments of Australia Post's business, and are dependent on the way in which joint and common costs are allocated between them. They may also be impacted by the extent to which Australia Post's statutory monopoly on standard letters may carry over to provide a competitive advantage in closely related non-reserved services.

The Commission's primary interest is in the level of prices for Australia Post's notified letter services. This does not involve direct investigation of costing and pricing of non-reserved services, but does involve the issue of whether the cost base submitted for reserved services is attributable strictly to those services or whether it includes any costs more properly attributable to non-reserved services.

[112] Major Mail Users' Association submission, p. 15.
[113] Australia Post, Annual Report 2000/01, p. 88.

7.3.2 Broad principles

The Commission has considered the issue of cost allocation in a number of inquiries, including in airports and telecommunications. Where a company has both regulated and non-regulated sides to its business, and a cost-based approach to regulated prices is applied, the company may have an incentive to over-estimate the proportion of its cost-base serving the regulated activities. The company could derive two types of advantage:

i) costs and prices could be higher in the area with greater market power, resulting in a greater exploitation of market power at the expense of consumers;

ii) non-regulated products can be effectively subsidised, allowing the company an advantage in competing with other firms[114].

These issues were implied in the users' submissions outlined earlier. The Commission is therefore concerned in the current case to check that the prices of reserved services are subsidy-free and consistent with economic efficiency[115]. The following principles provide a starting point for considering efficient prices:

- revenues generated by any subset of services provided should not exceed those based on cost for sole provision of that set of services (that is, stand alone costs); and

- total revenues for any subset of services should not be less than the incremental cost of providing those services.

This indicates a minimum price based on incremental costs, and a maximum price based on stand-alone costs. In practice the gap between incremental and stand alone costs can be substantial. The gap is due to the costs of shared resources – joint or common costs, which are of particular significance in the case of Australia Post as many of its resources such as labour, vehicles, buildings and senior management and administrative staff contribute to both reserved and non-reserved services. There is no widely agreed economic principle for setting appropriate prices within that range, but commonly used principles are discussed further below.

The **incremental** cost is the cost that is directly attributable to, and avoidable with, the provision of the service; that is, it is the extra cost that is incurred by providing that service over and above costs that would have been necessary in any case for other purposes. If a company sets prices lower than

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[114] In the extreme case, this could be predatory pricing. In a notable recent example, the European Commission decided in 2001 that Deutsche Post had abused its monopoly power by pricing its parcel services in the competitive sector below the incremental cost. In another case, the Swedish Competition Authority found that Sweden Post's announced prices for the distribution of periodical publications for 1996 in Stockholm did not cover the costs for such distribution and that the purpose was to eliminate CityMail and other potential competitors. The Competition Authority considered it as predatory pricing and an abuse of a dominant position.

[115] See similar approach in ACCC, *Sydney Airports Corporation Ltd Aeronautical Pricing Proposal Decision*, May 2001, p.157. This document is available from the Commission's website at http://www.accc.gov.au/airport/fs-air.htm

this, it is inefficient in that it will make a loss and thereby use resources poorly, and discourage other firms who could have supplied the service at lower cost than the first company, but not as low as the price actually set.

Similarly, prices that generate revenue above stand-alone costs (including a market rate of return on assets required) will result in a loss of economic welfare as they discourage marginal demand whose value to users would have exceeded the cost of supply. Other businesses could potentially supply the service at the lower stand-alone cost, if they were not prevented by government regulations.

The incremental cost for pricing decisions is generally viewed over the **long-run** when all resources can be replaced[116]. If a particular service were to cease, many of the assets and resources it uses might not be readily transformed or sold, but in the long run, far more costs are avoidable; eg. even building size is variable, and the long run incremental cost for one service such as Express Mail would include the incremental cost of the building size needed to accommodate that extra activity.

As one extreme possibility, Australia Post's non-reserved services could be priced at incremental cost with no share of common costs that have to be borne even without the non-reserved services. This would give Australia Post an advantage over other competitors that had to produce the services on a stand-alone basis. Nevertheless, it could constitute an efficient use of its existing facilities.

However, if all the services individually are costed at their incremental cost, the sum will not cover all costs in a multi-product business, because it will omit the joint and common costs which are used by more than one service and thus are not incremental to any particular one. By contrast, stand-alone costs include such joint and common costs, but the sum of stand-alone costs for different products would exceed the actual total cost. Hence neither of these methods is acceptable for pricing **all** services in a multi-service firm, as they would result in either under or over-recovery of total costs.

Usage of the terms joint and common costs varies considerably but for the purposes of this report, the term **common cost** is used to describe any of the costs that are not incurred exclusively for one service, so are shared in providing more than one service[117]. These include management overheads,

[116] This is essentially the TSLRIC+ approach used by the ACCC in decisions on telecommunications access pricing. TSLRIC is Total Service Long Run Incremental Cost, where the + indicates that a contribution to common costs is added. The long-run incremental cost is averaged across all the output of a particular service, and in that sense is an average cost rather than a marginal cost of an extra unit.

[117] For example, as in ACCC, *Sydney Airports Corporation Ltd Aeronautical Pricing Proposal: Decision,* May 2001. Similarly, in the ACCC's *Supplementary Submission to Productivity Commission Review of Telecommunications Specific Competition Regulation*, November 2000, Attachment A2: 'The ACCC's use of TSLRIC as a basis for determining efficient access prices', it is stated: "In addition to these attributable costs there may be costs of facilities that are shared between two or more services and are therefore 'unallocable" to a particular service or are "common" to more than one service" …

Academic texts typically describe costs as joint when they are required to produce "joint products" which are produced in fixed proportions (such as wool and meat from sheep), while common costs include those where the same equipment can be used to produce A or B, and when producing one uses capacity that could have been used to produce the other. (AE Kahn, *The Economics of Regulation: Principles and Institutions,* MIT 1988, p.78-9). Under this definition, the shared costs in postal services appear to be mostly common rather than joint.

general marketing, and post office buildings. In some circumstances the bulk of transport costs could be common, such as in the delivery in rural areas where indivisibility in capacity allows several services (such as letter and parcel delivery) to be provided simultaneously. Once the delivery vehicle and driver are made available for letter delivery, they are available with little additional cost for parcel delivery. The term joint cost may also be used to distinguish the costs that are strictly unallocable between products.

Allocation of common costs

Economic theory provides no unique rule for allocation of common (strictly joint) costs. However, for a multi-product business to fully recover all of its costs, these costs need to be allocated, implicitly or explicitly, across products. Two quite different approaches are:

i. Inverse elasticity or Ramsey pricing[118]

ii. Full distribution of costs in line with cost drivers

Inverse elasticity pricing involves charging higher mark-ups (to cover the common costs) on those products for which demand is least responsive to price increases. The result is that the method causes equal proportionate reductions in quantity purchased for each product. This is theoretically the method which recovers common costs with the least overall burden to economic efficiency. In practice it is usually impracticable to obtain elasticity information for all products. Nevertheless, it is an approach that is often appealed to in some form as it approximates the idea of charging mark-ups according to what the market will bear and supports profit maximisation. Pricing to maximise profits may involve unacceptable exploitation in a monopoly case. However, relativities between prices of different products that capture broad differences in demand responsiveness, within an acceptable overall rate of return, can be consistent with an efficient approach.

The use of various **cost drivers** to fully distribute costs is an alternative approach, especially where the mix of common and joint costs in practical terms is blurred. It is used by Australia Post as described below, and is commonly accepted as reasonable for regulatory purposes involving multiple products[119]. It may be noted that many costs are considered to be common because the cost ledger and accounting systems do not provide sufficient disaggregation to enable ready attribution to individual services; for example, counter staff costs involved in retail sales at post offices. However, it may be logically possible to attribute portions of their time to particular products. Cost drivers such as volume of transactions on different products and representative time per transaction can be used to achieve such attribution and may approximate cost causality for many shared costs.

[118] Strictly, the Ramsey approach applies to joint costs while the use of "cost drivers" applies to a ready means of attributing common costs. In practice, with a blurred mix of joint and common cost elements, both approaches are drawn upon.

[119] For example, the ACCC has developed the Regulatory Accounting Framework for the telecommunications industry which includes rules for allocating different kinds of expenses in line with particular factors.

Even if common costs cannot be strictly attributed to different services, they can be allocated in line with a cost driver which appears to be reasonably related to it. For example, Human Resources section costs might be allocated in proportion to direct labour cost of different products.

Australia Post's evidence on its costing system is considered in section 7.4.

7.4 Australia Post's costing system

Australia Post's primary submission provided data only for the domestic letters business, the great majority of which relates to reserved postal articles. Australia Post estimates that only 1% of the volume (number) of letters are non-reserved, those being a portion of the Large Letters category that account for 4% of the revenue.

Australia Post provided no data on costs in its public submission. Its own accounting for costs was, however, implicit in the estimates of future rates of return on assets in the letters business provided in section 8.3.5 of its submission. Australia Post subsequently provided more detailed data on costs to the Commission through the course of the inquiry.

Data on expenses and rates of return at a broad level are also available in Australia Post's annual reports, comparing the reserved and non-reserved businesses.

7.4.1 Activity Based Costing system

Australia Post initially provided the Commission with a summary description of its product costing system, and in July, a manual providing a more detailed view of its composition and logic of operation, with examples of how costs were allocated for a number of cost categories. Besides information on the methodology, Australia Post also provided output tables showing how the expected dollar amounts of various cost pools would be allocated to different product groups for 2002-03.

Australia Post's costing system involves two main components:

i. Product Costing System (PCS) for "direct" expenses in operational areas – including operational labour and accommodation, contract mail payments and transport, cost of goods sold - that Australia Post considers to require dynamic cost drivers.

ii. Activity Based Costing (ABC) system for indirect overhead expenses, including management, material and transport and accommodation in non-operational areas, and depreciation.

Both of these are applications of the general activity-based costing **methodology**, but the latter is referred to as the ABC **system**.

Product Costing System – direct expenses

Australia Post states that its PCS matches the revenue and expenditure of all of its products and services, including mail, counter and agency services. The PCS is a computer model of Australia Post's operations designed to reflect the impact of cost pools, volume and operational practice on products and services.

> The actual revenues and expenditures recorded in the General Ledger (GL) are allocated to products and services by the PCS on predetermined bases which are continually under review, together with internally generated allocation bases reflecting volume, revenue and cost changes.
>
> Full absorption costing is employed in the PCS. This means that all products and services are charged appropriately with the overheads of the enterprise.
>
> The PCS is an average cost system and, in many processes, joint costs are involved. Costs are joint when they relate to more than one product and/or service and cannot be readily separated, for example:
>
> - Post office counter costs involve both mail and non mail products;
> - Sorting costs often relate to both letters, small and large, and parcels; and
> - Transport costs can involve the entire mail product range.
>
> …
>
> The costing approach adopted, therefore, is to use data from established accounting, statistical and management information systems supplemented as necessary by special costing studies. Process costing techniques are considered to be most to the postal network. This involves looking at the successive processes or activities involved, determine the costs applicable to each service in a process (through an activity based costing methodology), and transfer the service through further processes to finality at accumulated cost.
>
> In Activity Base Costing (ABC), resources – labour, materials, contractor payments, etc, are associated/allocated to activities/processes – selling stamps, sorting mail, delivering parcels, etc, and these activities are subsequently consumed by (allocated to) products and services.
>
> ………
>
> Distribution of activity costs to products and services using the ABC methodology requires the identification and application of cost drivers. Cost drivers reflect the consumption rate of activity costs by each product. Following is a non-exhaustive list of cost drivers which are used singularly or in combination:
>
> - Volume
> - Sales value; ie revenue per piece
> - Average transaction value
> - Average mass
> - Total mass – a function of volume and average mass
> - Average bag /tray content
> - Average distance conveyed
> - Average processing/transaction time
> - Handling difficulty
> - Number of transactions

- Turnover
- Total revenue – a function of volume and sales value
- Conveyance rate
- Various probability factors.[120]

Partly because of the complexity of the system, Australia Post did not hold documentation in a convenient form for external review, and in the context of this assessment, it was not feasible for the Commission to examine the system at the most detailed level; i.e. the numerical values applied to the hundreds of cost drivers.

> Allocation of resource/cost pools to product groups (and further to product categories) by cost driver is a complex procedure performed within Australia Post's Product Costing System (PCS). It is impractical to provide the ACCC with copies of all cost pool allocations in this regard. This is because of the significant number of activities that are mapped by the PCS. The resource/cost pools comprise more than 100 resource centres, times 6 (each State and National), times 5 major cost classifications (labour, overtime, on-costs, accommodation, motor vehicle operating and other non-labour expense). These inputs are ultimately driven to almost 180 activities, times 6 (each State and National).[121]

These activity costs are subsequently driven to at least 100 products. In view of the complexity, Australia Post therefore provided only examples for several of these cost centres showing how the total costs for a particular State are allocated between 50 mail products in accordance with the cost drivers. For example, for outdoor postal delivery labour, costs are allocated between letter types in proportion to the arithmetic product of several factors – number of letters, handling factors, and percentage delivered by delivery officers.

Australia Post's costs allocation manual provides a list of the drivers used to allocate costs for each of the hundreds of other cost centres. Australia Post also holds very detailed data on the derivation of cost drivers such as handling factors and transaction times from operational 'engineering' studies.

Indirect expenses

In Australia Post's ABC system as applied to overhead expenses, groups of expenses are allocated first to activities or cost pools, and then to products in line with drivers, except in cases where product-specific activities have been identified. The allocations are based on interviews with each overhead cost area to determine the activities undertaken, apportionment of costs to activities, cost drivers and products impacted. Typical default drivers are labour cost (eg. for many types of depreciation, supplies and administrative and personnel costs) and, in the case of general management, revenue[122].

[120] Australia Post, *Product Profitability and Costing in Australia Post*, 2002.

[121] Australia Post, *Data to Support Australia Post's Price Notification*, 21 May 2002.

[122] Australia Post's use of demand side factors, such as revenue, is limited largely to joint costs, especially senior management, to the extent that time-based allocation by effort to products is not practical.

Australia Post notes that its system is used for its own cost and performance management and internal transfer pricing, as well as national pricing, and it is in the interests of its own managers to ensure that they are not bearing costs that are attributable to other sections.

7.4.2 Relative costs of letter products

Australia Post's draft notification involves separate prices for 125 letters products[123] (listed in Appendix A). However, Australia Post's product costing system is not designed for pricing at the level of the products listed. Those products have been grouped into only 12 product categories in Australia Post's product costing system. They are:

- Small letters – Ordinary;
- Small letters – Local rate;
- Small letters – PreSort Off-peak AdPost[124];
- Small letters – PreSort Off-peak Not AdPost;
- Small letters – PreSort Regular AdPost;
- Small letters – PreSort Regular Not AdPost;
- Large letters – Ordinary;
- Large letters – Local rate;
- Large letters – PreSort Off-peak AdPost;
- Large letters – PreSort Off-peak Not AdPost;
- Large letters – PreSort Regular AdPost;
- Large letters – PreSort Regular Not AdPost.

The PCS therefore provides guidance on relative costs for the above broad categories, but not explicitly between, for example, large letters of different weights, cards and letters, or PreSort categories such as Same state, Other state and Barcode residue.

Australia Post provided supplementary confidential data at the level of 4 broad categories of letter (Small full rate, Small bulk, Large full rate, Large bulk), where "full-rate" is synonymous with "ordinary". Further data was at a level of 6 broad categories including a break-down of bulk mail into Regular and Off-peak.

[123] After combining several price points (involving some medium and large letters), 99 would remain separate after the proposed price changes in January 2003.

[124] AdPost, which has been subject to special discounts, is scheduled to be withdrawn in January 2003.

7.5 Commission's views

7.5.1 Reserved and non-reserved services

Australia Post's system for product costing, outlined above, involves fully distributing common costs by a variety of cost drivers considered most appropriate to each cost. These include estimates of transaction time needed for each service (based on sampled operational studies), handling factors reflecting the amount of time needed to handle different types letters, floor space occupied by products, and revenue.

In the Commission's assessment, the basic **principles** of activity-based costing and the nature of Australia Post's typical cost drivers provide a theoretically reasonable basis for cost allocation and price setting under regulation. The accounting system appears to rely on a principle of causation to attribute costs to services as far as practicable. Since the system fully distributes all costs, all parts of the business should be allocated their directly attributable costs plus a share of common costs. Provided that the values of specific drivers are appropriate, products should be costed above their incremental cost. It also appears that the cost of reserved services should not exceed their stand-alone cost, since any extraneous costs more properly attributable to other services should be excluded.

Hence, if Australia Post's fully distributed costs, plus a return on capital, are used as the basis for setting allowable prices, as under the Commission's approach to profitability analysis, the resultant prices should be free of the problems of subsidisation or excessive cost-loading referred to earlier.

Because of the complexity and voluminous nature of Australia Post's costing system, however, it has not been feasible for the Commission to assess the detailed application and data used in the time available for this assessment. Hence the actual values applied to each individual cost driver (such as handling factors and transaction times) could not be confirmed as appropriate. The Commission's acceptance is therefore based on the general methodology rather than the precise numbers, although some limited "sampling" was undertaken with qualitative assessment of the shares of common costs (such as those based on floor space proportions) allocated to reserved services to gauge their reasonableness.

The Commission also notes that Australia Post periodically makes changes to the rules underpinning its costing system, and that its assessment of the present system would therefore not necessarily apply following future changes. The Commission has also not examined whether any individual non-reserved services are priced below cost, as this is considered beyond the scope of the present assessment.

Several user submissions raised the issue of separation of accounts. In some other regulated industries such as telecommunications, and some overseas postal services, there are provisions for separation of accounts between regulated and non-regulated parts of the business. However, such provisions are not in place for Australia Post, and are beyond the scope of the current assessment.

7.5.2 Relative price structure

The Commission's predominant concern is normally with the overall level of pricing for regulated services rather than the structure of relative prices for individual products, especially where there are numerous products as with Australia Post. It is concerned that market power is not taken advantage of by charging excessive prices to consumers and business users at a broad level. However, market power of regulated companies can also be reflected in inefficient or predatory pricing structures. If there were evidence that significant inefficiencies could result from the relative price structure, the Commission would also be concerned.

The same principles for efficient pricing apply to relative prices as discussed above in relation to reserved and non-reserved services. Incremental cost should set a floor for prices, but elasticity or demand factors may play a role in the recovery of common costs.

Given the Commission's views on the methodology of Australia Post's product costing system, its accepts for the purpose of this assessment that the cost data submitted provide a reasonable basis for pricing decisions at the broad 4 or 6 category levels. This data allows some broad conclusions regarding the efficiency of Australia Post's price structure to be drawn. These are discussed further in Chapter 11.

Australia Post did not provide and does not appear to record costs at the level of the 125 individually priced items. The Commission therefore could not form a judgement as to whether the relative prices at this level of disaggregation appropriately reflect costs and are conducive to efficiency.

However, the issue of one particular product - Clean Mail - was raised by GoMail's and several other submissions. No cost data were provided relating specifically to the Clean Mail category which has not yet been introduced, but is expected to be an important component of mail under the proposed price structure (22% of total letters revenue). Pricing for Clean Mail is also discussed further in Chapter 11 on price options.

8 Asset valuation

8.1 Introduction

As noted in chapter 3, in evaluating the appropriateness of the proposed price increases the Commission has undertaken an analysis of the costs and profitability of providing reserved services. Part of such analysis entails an examination of the value of assets employed in providing these services.

The valuation of assets is important in two respects. First, it is the basis for determining the amount of revenue that an investor in Australia Post would require to recover its investment in the assets required to provide the regulated services. This amount, the return *of* capital, is commonly thought of as the depreciation component of regulatory pricing models.[125] Secondly, a rate of return measure is applied to the depreciated asset value to determine an amount of revenue that Australia Post requires in order to compensate it for the opportunity cost of funding those assets, given its relative level of risk. The rate of return is discussed further in chapter 9.

Allowing prices which generate revenues sufficient to recover these capital costs is consistent with the Commission's objective of allowing prices which provide Australia Post with efficient signals for investment. If Australia Post cannot earn a return on its investment in the letters business, then it will have little incentive to undertake capital expenditure to expand the business and/or improve the quality of its service to customers.

This chapter considers the value of assets to which the rate of return measure should be applied in determining the cost of capital and the related depreciation charges. It examines the general principles by which Australia Post values its assets and the allocation of those assets to the services which are the subject of the current draft notification.

8.2 Australia Post's views

In its original draft notification to the Commission, Australia Post provided only indicative information on the assets employed in the provision of reserved letter services. The Commission subsequently sought further details on Australia Post's method of valuing assets, the valuation amounts, associated depreciation rates and the allocation of assets specifically to the reserved letters services. Australia Post responded to these requests on a largely confidential basis. The Commission has taken the information provided by Australia Post into account in this preliminary view.

[125] The term 'depreciation' can have different applications in different regulatory models – care should be taken in interpretation.

Australia Post is required to comply with financial valuation and reporting guidelines issued by the Department of Finance and Administration. These guidelines are set out in the annual release of *Requirement and Guidance for the Preparation of Financial Statements on Commonwealth Agencies and Authorities*[126] by the Department. Most particularly, these guidelines require Australia Post to value fixed assets initially at the cost of acquisition, but that assets be revalued every three years "in accordance with the deprival method of valuation"[127].

Australia Post contends that the deprival value methodology essentially arrives at forward looking asset valuations. In this context Australia Post suggests that deprival methodologies have been established to arrive at a value that would be consistent with the value embodied in prices in a competitive market. Australia Post's deprival value methodology is based on the principles outlined below:

- where an entity would replace the service potential embodied in an asset if deprived of it, the asset is measured at the current cost;
- where an entity would replace an asset if deprived of it, the asset is measured at the greater of its market value and the present value of future net cash flows; and
- where the asset is surplus to requirements the asset is measured at its market value.

Australia Post also states that it optimises its asset base; that is, it removes from the capital base assets that cease to contribute to the provision of services. Australia Post states that in practice its estimate of optimised deprival value is generally calculated as the lesser of:

- Depreciated Optimised Replacement Cost (DORC); and
- the higher of NPV and Net Realisable Value (NRV or market value).

Australia Post identifies four main asset categories. A brief description of the methodology used to value each category of assets is provided below.

Land, buildings and fit-out

The majority of Australia Post's assets are property assets. Valuations for those assets are the market valuations provided by independent valuers. Australia Post's property portfolio, including all land, buildings and fitout, is revalued on a three-year rolling cycle. Each property is revalued at least once within any three-year period.

Australia Post states that:

> The property valuations included in the balance sheet at 30 June 2001 are made up of:

[126] Available at http://www.dofa.gov.au/corporategovernance/ace/docs/fmos.doc

[127] Department of Finance and Administration, *Requirement and Guidance for the Preparation of Financial Statements on Commonwealth Agencies and Authorities*, p. 18.

- Properties valued to market on 30 June 2001 (one third of the portfolio);
- Properties valued the previous year, for which one year's depreciation and disposal adjustments would be made (one third of the portfolio); and
- Properties valued two years ago, for which one year's depreciation and disposal adjustments would be made (the remaining third).

Motor vehicles

The market value of motor vehicles is currently used as it is lower than the current written down book value.

Major specialised plant and equipment

Major specialised plant and equipment is valued using the lesser of the current replacement cost and current reproduction cost of that service.[128]

Other plant and equipment

Australia Post states that the market value and the written down book value of these assets are similar and as a result the written down book values of the assets are used.

8.3 Submissions

In its Issues Paper, the Commission sought comments on Australia Post's approach to asset valuation, and the relationship between asset valuation and pricing of reserved services.

The MMUA considers that Australia Post should be held accountable for the $500m investment in mail handling, processing and delivery capability. In particular, the MMUA suggests that the draft notification should have provided full disclosure on the link between the investment decision and the proposed price increases. The MMUA calls upon the Commission to review the financial impacts of the FuturePOST investment program.

Other submissions made few comments relating to asset valuation issues.

8.4 Discussion

In a number of regulatory decisions in recent years the Commission has generally adopted an Optimised Depreciated Replacement Cost (ODRC/DORC) methodology for the valuation of assets. For example, in its decision on Australian Rail Track Corporation's (ARTC) access undertaking, the Commission accepted ARTC's proposal to value assets in this way.

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[128] The ACCC understands that, in practice, the current replacement cost is not materially different from the historic cost of these assets and that Australia Post accordingly uses the historic book value.

In its *Draft Statement of Principles for the Regulation of Transmission Revenues* (DRP), the Commission notes:

> The main economic principle for assessing the economic value of any assets is that their value to investors is equal to the net present value of the expected future cash flows generated by those assets. The practical difficulty in making this assessment for regulated monopoly businesses is that the future revenue derived from the assets is itself determined by the regulator – hence the issue of circularity associated with the use of ODV as a methodology to value sunk assets.
>
> This potential circularity is eliminated by the use of DORC.[129]

In the context of the current draft notification, the circularity referred to above potentially arises given that Australia Post is required to value its assets on a deprival value basis. In practice, however, Australia Post has indicated that only the Sydney GPO building is valued on an expected cash flow basis. Furthermore, this asset is not included in the asset base allocated to letters.

In a practical sense, then, Australia Post's fixed assets (with the exception of property) are valued at the lower of depreciated historic cost or market value. As noted above, property assets are valued on a market value basis that is progressively updated throughout the course of a three-year cycle.

In considering which assets should be incorporated into the capital base for pricing purposes, the Commission is primarily concerned with the assets required to provide the services in question; in this case, the carriage of reserved domestic letters. The Commission has therefore examined both the valuation of Australia Post's assets, and the allocation of assets to the regulated services which are the subject of this price notification.

8.4.1 Current assets

Australia Post provided to the Commission an allocation of both current and fixed assets to the letters business. Australia Post suggests that analysis of return on assets requires all assets, not just fixed assets, to be included in the capital base.

The Commission notes that a return on assets measure that includes current as well as fixed assets may be useful for certain purposes. For example, a potential lender to Australia Post may use this measure as an indication of the extent to which interest-bearing debt can be used to finance operations. However, the Commission notes that current liabilities provide a significant proportion of the funding for current assets. Furthermore, to the extent that current assets exceed current liabilities[130], the Commission is unclear as to the justification for allowing an additional return to a firm for this excess.[131]

[129] Australian Competition and Consumer Commission, *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999, p. 39.

[130] Current assets minus current liabilities is also known as working capital.

[131] The Commission notes that these considerations can be thought of as a question regarding the timing of cash flows within each period in the model being used – in this case each year. It is not clear that such considerations lend support to the argument that an allowance for working capital be made.

The WACC applied by the Commission (discussed in Chapter 9) represents the opportunity cost of the capital held in assets that are relatively long-lived. Such an approach aims to ensure a regulated entity has sufficient incentives to invest capital into the fixed assets necessary to provide those services, and maintain the assets over time, such that the services can continue to be provided to an appropriate quality standard. Such assets would not normally include current assets.

As noted above, the valuation of fixed assets is relevant in a regulator's assessment of the future cash flows required to compensate the regulated entity for holding those assets. Yet current assets *are* cash, or are assets that are expected to be converted to cash in the current reporting period. It is therefore not clear as to whether there is any significant opportunity cost in holding them. There is therefore no apparent need for revenues – and thus cash flows - over *future* periods to compensate the regulated firm for holding such assets.

The Commission's profitability analysis is designed to calculate revenues which provide a return on and of the capital invested in the fixed assets necessary to provide regulated services. The Commission does not generally incorporate current assets into such analysis, and notes that Australia Post has not provided any particular reason why it should do so in this case. The Commission has therefore not included current assets in the asset base.

8.4.2 Valuation of fixed assets

Unlike other regulated industries such as gas, rail or airports, a postal network is not characterised by large sunk investments in specialised assets.[132] That said, different asset categories do have some distinct characteristics, and it is therefore useful to consider some of these separately.

Land, buildings and fit-out

The single most significant category within Australia Post's asset base is property (which comprises land, buildings and fitout). The property category incorporates its post office network, mail and delivery centres and corporate offices. At 30 June 2002, these assets represented around \$1000m out of Australia Post's total fixed assets of around \$1743m[133]. Of the \$1000m total, around \$678m is allocated to the letters business segment. Australia Post's property values have grown by an average annual rate of around 2.5% over the past four years - in real terms, this represents very little, even negative growth.

In the event that Australia Post chooses to dispose of a particular property, it could readily be converted to an alternative use. In such circumstances, market based valuations are likely to reflect the opportunity cost of holding these assets. Such valuations are also likely to be largely independent of Australia Post's own decisions to hold or dispose of the property. That is, given the dispersed nature of the property portfolio, spanning many different locations, it is also unlikely that the

[132] It should also be noted that in post, capital costs (depreciation and return on capital) are a much smaller share of total cost than is the case for other regulated industries.
[133] Fixed assets covers property, plant and equipment. It does not include other financial or intangible assets.

opportunity cost of these types of property would materially change in the event that Australia Post makes a decision to divest itself of them.

Australia Post regularly acquires and disposes of property assets, and through this process, its valuations could be expected to be tested for accuracy within the market. Were Australia Post to systematically over-value its property assets, it would be expected to regularly record losses on disposal. The Commission is not aware of any evidence of significant losses on disposal; particularly losses that might represent a *systematic* undervaluation of property values.

Accordingly, the Commission considers Australia Post's market-based valuation of property assets to be reasonable for regulatory purposes. Changes over time are likely to be gradual, and thus the risk of price shocks on the basis of changes in the value of these assets should be minimal.

Motor vehicles

The second category of assets to be considered is that of motor vehicles, which represented some $122m at 30 June 2002, of which around $81m is allocated to the letters segment. As with land assets, it could be expected that the market value of such assets could be reasonably estimated. Indeed, as noted above, Australia Post has indicated that vehicles are valued at market value since losses on disposal were being recorded over a period of several years. Australia Post has accordingly written down the value of these assets. This has the result of lowering the return on capital for these assets. However, it should be noted that Australia Post has made a corresponding increase to the depreciation rate on motor vehicles in response to this trend, thus increasing the return of capital in each period. While the depreciation effect is likely to outweigh the return on capital, the Commission does not consider these adjustments unreasonable. The Commission is satisfied that the valuation of motor vehicles represents a reasonable approximation of the opportunity cost of those assets.

The remainder of Australia Post's fixed assets which are allocated to the letters business are essentially valued at written down historic cost.[134] In examining the appropriateness of these valuations, it is useful to consider the more specialised FuturePOST assets separately from other, more easily transferable assets.

FuturePOST assets

Australia Post's FuturePOST assets category includes multi-line optical character readers, barcode sorters and tray management system assets found in Australia Post's mail sorting centres. They represent a significant proportion (around 13%) of the total letters assets, with a total book value of $164m as at 30 June 2002. While these assets are technically classified as a finance lease, the treatment of the assets is essentially the same, with the asset value being depreciated over the economic life of the assets in question.

[134] The one qualification to this statement is that some FuturePOST assets have been subject to a cross-border lease arrangement. This has the effect of lowering the book value of those assets, which are then depreciated using the normal economic lives.

The FuturePOST assets appear to be the only significant assets that might be thought of as being 'specialised'. They are specifically designed for the sorting of mail, and could not be readily transferred to alternative uses. This degree of specialisation suggests that, unlike property and motor vehicles, market value is not immediately observable. That is, should Australia Post choose to dispose of these assets, a liquid secondary market is not straightforward to find.

That said, there is still an important distinction between these assets and those in other regulated industries in that the degree to which the assets are 'sunk' is less clear. That is, the investment is not necessarily irreversible. While significant capital expenditures have been made in the assets, there may be *some* scope to find a purchaser for redundant assets. Such purchasers might include overseas postal providers and/or customers of Australia Post who may be able to use such assets to meet Australia Post's own barcoding requirements.

As already noted, however, such a market is not highly liquid, nor are market values for these assets readily observable. Accordingly, Australia Post's approach – comparing the written down book value with the replacement cost of the assets is a reasonable starting point in considering their valuation. Australia Post has indicated, however, that in practice, differences between replacement cost and historic cost are largely driven by changes in the exchange rate (since the assets were purchased in the United States) rather than changes in the purchase price of the assets *per se*. Accordingly, it adopts the written down historical cost for its reporting purposes. The Commission has reviewed Australia Post's estimates of the replacement cost, and considers that historic cost is, in these circumstances, likely to be a suitable measure for regulatory purposes.

Other fixed assets

The vast majority of other assets used by Australia Post are likely to have alternative uses. Much of the plant and equipment required to provide retail services, office equipment and other assorted assets could be expected to be used in a variety of industries. Accordingly, disposal values should be readily observable and hence depreciation rates are likely to result in asset valuations that closely reflect the remaining service potential of the assets. The Commission therefore accepts Australia Post's contention that the market value of these assets would be similar to the written down book value. Any differences between the two are unlikely to be material.

In summary, then, the Commission considers that, in the case of Australia Post, the book values of its assets are not inappropriate for regulatory purposes. This is a consequence of:

- the generally non-specialised nature of its assets;
- the generally non-sunk nature of its assets; and
- the deprival value reporting requirements currently imposed upon it by the Department of Finance.

The issue of asset valuation for Australia Post thus seems significantly less problematic than in other regulatory contexts.

8.4.3 Depreciation

The points raised above regarding the non-specialised and non-sunk nature of many of Australia Post's assets has implications for the robustness of its estimates of depreciation. Since market values for many assets can be approximated with a reasonable degree of certainty, and since at any point in time Australia Post's asset base will contain a mix of assets of various vintages, systematic deviations from market value upon disposal are likely to become apparent readily quickly. Indeed, such a deviation led Australia Post to write-down the value of its motor vehicles, and slightly increase the depreciation rate applied to them.

It follows that the depreciation rates adopted should be closely related to the economic lives of the assets. Accordingly, the Commission's preliminary view is that Australia Post's depreciation charges are reasonable for the purposes of its profitability assessment.

8.4.4 Optimisation

The above discussion has not considered the issue of optimisation of Australia Post's asset base. However, the notion of optimisation is an important element of the ODRC methodology already referred to. 'Optimisation' of the asset base is a process which attempts to ensure that a regulated entity is not rewarded for holding assets which cease to contribute to the provision of services. These assets are normally excluded from consideration in profitability analysis. As noted above, Australia Post has stated that it is required to optimise its asset base for the purposes of its financial reporting.

There are, however, many degrees of optimisation. For example, a regulator may adopt an approach which bases the valuation on an 'optimised' network configuration, as well as assuming that each particular facility in that network has an optimal configuration of assets. Another approach might be to accept the existing network configuration as a given and concentrate only on ensuring that the network assets do not include any that are unnecessary to support that configuration.

In other industries, the Commission has generally adopted an approach more in keeping with the latter characterisation. For example, in considering access to Telstra's public switched telephone network (PSTN), the Commission uses a 'scorched node' approach, which assumes that existing switch sites and links between them are maintained but the equipment is optimised. Similarly, in the case of Sydney Airport, the Commission accepted an approach which assumed that the existing location of the airport and the configuration of the facilities on that site were optimal.

In the case of Australia Post, the case for accepting its existing network is strengthened by the fact that the existing configuration is heavily influenced by its CSOs. Australia Post is required to meet certain performance standards in terms of accessibility to its services and frequency of collection and delivery. Its post office and transport network has developed over time in response to these requirements. Accordingly, the Commission sees no reason to require further optimisation of its existing network configuration.

For Australia Post, then, the question of optimisation relates mainly to whether its asset base contains assets that are not necessary to maintain its existing network. On this question, Australia Post is again likely to be somewhat a different case to other regulated industries. As noted in the preceding discussion, most of the assets used by Australia Post to provide reserved postal services are not sunk, and could be transferred into other uses at relatively little cost.

The issue thus centres on whether Australia Post has sufficient incentives to dispose of redundant assets. On this point, the Commission notes that Australia Post's performance targets are based on return on operating assets measures. This might be expected to provide some incentive for Australia Post to sell assets that are no longer required and use the funds to make investments with higher expected returns.

The Commission notes that this optimisation argument is less persuasive in relation to more specialised FuturePOST assets. Nonetheless, given the relatively small proportion of the asset base that these assets represent, and the fact that the investment is still quite recent, the Commission's preliminary view is that optimisation would lead to negligible, if any, reductions in the value of those assets. Accordingly, the Commission considers that Australia Post's asset valuations are unlikely to incorporate much in the way of redundant assets.

8.4.5 Allocation of fixed assets to reserved services

As noted in Chapter 3, the Commission has essentially adopted a 'dual till' approach to assessing Australia Post's proposed prices. This means that the Commission has focussed on the costs of providing the regulated services, while largely ignoring the revenues and profitability of non-regulated services. The Commission considers that a dual till approach has advantages over the so-called 'single till' methodology that has been used by regulators in the past.[135] The Commission's decision on pricing at Sydney Airport sets these out in more detail.[136] In particular, the dual till approach provides more appropriate incentives for new investment.

Adopting a dual till approach, however, necessitates allocation of costs (including capital costs) between the regulated and non-regulated services. Accordingly, in considering Australia Post's asset valuation, it is also necessary to consider the allocation of assets to the regulated services.

Australia Post's fixed asset allocations do not include any receivables, investments or future income tax benefits. The Commission considers it appropriate that these assets remain excluded from the asset base for current purposes, as they do not specifically relate to the provision of reserved letter services. Furthermore, tax is explicitly factored into the Commission's profitability analysis as a cash flow. The treatment of tax is discussed further in Chapter 10.

Australia Post has indicated that most fixed assets are allocated to the letters business through its Activity Based Costing (ABC) system. Essentially, this means that fixed assets are allocated to

[135] The regulation of airports, for example, has until recently been frequently based on a single-till approach.
[136] Australian Competition and Consumer Commission, *Sydney Airports Corporation Ltd – Aeronautical Pricing Proposal: Decision*, May 2001.

products on the same basis as the associated depreciation charges. In the case of land, which does not depreciate, it is allocated on a matching basis to the associated buildings allocations. The Commission's views on Australia Post's activity based costing are discussed in more detail in Chapter 7.

Australia Post also states, however, that some assets are directly matched to product groups. In particular, major FuturePOST processing assets such as multi-line optical character readers, barcode sorters and tray management systems are directly classed as letters assets.

The Commission understands, therefore, that Australia Post's focus in the allocation of assets is to allocate to particular business segments rather than specific products.[137] Assets allocated to its letters business segment are therefore likely to be used in the provision not only of the reserved services subject to this notification, but other non-reserved services managed through the letters business segment. These other services include non-reserved large letters, as well as Printpost and, to a lesser extent, unaddressed letters.[138] The assets allocated to the letters business should, however, exclude amounts that apply to international mail.[139]

In relation to the letters assets, Australia Post argues that although they are used to process some non-reserved services (ie large letters over 250g, Printpost and unaddressed letters), no capital costs would be avoided if the non-reserved component of the service was not provided. Australia Post therefore suggests that the full value of the assets should be allocated to the letters business for the purposes of assessing its pricing proposal.

The Commission takes a somewhat different view on this issue. Where assets are necessary to provide a regulated service but are also used to provide other services, it is reasonable to expect that some of the capital costs associated with holding the asset are recovered through profits on the non-regulated services. Indeed, this is one justification for the use by regulators of the single till methodology discussed above.[140]

An alternative approach would be for Australia Post to separately identify the proportion of the value of letters assets that would properly be allocated to the non-reserved letter services. Australia Post suggests that this is inappropriate since there would be no reduction in the level of assets required to provide reserved letter services if the non-reserved services were not offered. Essentially this is an avoidable cost argument. The Commission notes, however, that this argument is somewhat

[137] This contrasts with its allocation of operating costs (including depreciation) which are allocated down to specific products.

[138] Unaddressed letters are likely to utilise fewer assets than either large letters or Printpost since they would not incur sorting costs. However, assets such as vehicles might be expected to be used in the delivery of these articles, so some allocation might be expected.

[139] The Commission understands that the letters business segment does not incorporate international mail. Thus the allocation of assets between the letters business segment and the international business segment should be appropriate. A similar issue might arise in examining the proportion of the assets allocated between reserved incoming international letters and non-reserved outgoing international letters; however, these are not relevant to the current notification.

[140] The single till here referred to would generally be applied across an entire company's business activities. The concept can, however, be thought of as applying more narrowly.

inconsistent with Australia Post's approach to allocation of operating costs and depreciation, which represents a fully distributed cost allocation methodology. It would therefore seem more appropriate to allocate some portion of the letters assets to those non-reserved letter services.

On this point, Australia Post argues that the non-reserved letters place only a small demand on the network's assets. This may be the case, however, it has not provided the Commission with a quantification of this argument. Given that assets are broadly allocated on the basis of the depreciation allocations, it would seem that it is possible for this additional allocation of the assets to be undertaken. However, Australia Post appears to be suggesting that there are no compelling commercial reasons for it to do so. Accordingly, the Commission has considered the possibility of a slightly modified 'till' for letters services.

Since Australia Post does not allocate the letters assets *between* all the services that require those assets for their provision, the Commission's preliminary view is that a narrower form of single till could be applied to determine an appropriate level of returns from the regulated services. That is, the 'till' can be thought of as applying across the letters business segment.

This would necessitate the incorporation of the costs, revenues and assets attributed to non-reserved large letters services, Printpost and unaddressed letters. Since no assets are separately allocated to these products, this means that the profits generated from these services could be subtracted from the required revenues from reserved services.[141]

That said, Australia Post has provided the Commission with information regarding the profitability of these separate product categories. Effectively, Printpost and unaddressed letters appear to approximately break-even; ie revenues only just cover the costs of these services. Accordingly, incorporating the costs and revenues for these products into the Commission's profitability analysis would have negligible impact. The Commission notes, however, that non-reserved large letters appear to make a not insignificant contribution to recovering the capital costs of the letters assets.[142]

The Commission also notes that, to the extent that assets are 'over-allocated' to the reserved services, the reported returns on these assets may be understated and the returns on non-reserved services overstated. This may in part explain the apparent discrepancy between these reported measures.[143]

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[141] 'Profits' here refers to the excess of revenues over operating and maintenance costs and depreciation (since depreciation is allocated to products). These profits essentially represent a contribution to the return *on* capital for the assets in question (but not return of capital, since this is already included in the costs allocated to particular products).

[142] These letters generate around 1% of total letter volumes and 4% of total letter revenues.

[143] For example, in 2000/01, Australia Post reported a return on assets for non-reserved services of 21.7%, compared to 4.2% for reserved services. It should be noted, however, that Australia Post's method for allocating assets has significantly developed in the last year. Accordingly, return on asset measures reported in the 2000/01 annual report will not reflect the new approach.

In other respects, the Commission considers that Australia Post's allocation of assets through the use of its activity based costing system is acceptable for the purposes of this preliminary view, in light of the views expressed on the issue of cost allocation in Chapter 7.

8.4.6 Conclusion

In light of the above discussion, the Commission considers that Australia Post's fixed asset values are likely to be reasonable for the purposes of analysing the profitability of providing domestic reserved letter services. The value of fixed assets for the letters business was $1203m as at 30 June 2002. Similarly, the depreciation charges associated with these asset valuations are likely to be reasonable.

The one qualification to this view, however, relates to the allocation of these assets to the reserved services. That is, the Commission has some concern that some of the return on capital required on these assets may be recovered through non-reserved letter services. To address this concern, the Commission has incorporated the costs and revenues from non-reserved large letters into its profitability analysis. The details of this analysis are contained in Chapter 10.

9 Weighted average cost of capital (WACC)

9.1 Introduction

The return on capital is another essential component of the financial modelling used to assess Australia Post's price proposal. The return on capital used in the model allows for both debt and equity holders to be rewarded with a rate of return that reflects the opportunity cost of capital.

In calculating this required rate of return, the financial model estimates a number of parameters to determine both the cost of debt and the cost of equity capital. It then weights these costs in accordance with the capital structure to determine the Weighted Average Cost of Capital (WACC). Professor Kevin Davis has provided advice to the Commission on the appropriate weighted average cost of capital for Australia Post, which is available on the Commission's website at http//www.accc.gov.au/post/post.html.

The Commission considers that a weighted average cost of capital is the most appropriate measure of the opportunity cost of capital. However, in Australia Post's case the issue is more complicated due to Direction 11 which directs the Commission to have regard for pricing targets that have been agreed to by Australia Post and the relevant Minister. Accordingly, this chapter also considers Direction 11 and its relevance to the Commission's profitability analysis.

9.2 WACC formulation

In regulated applications, there are several alternative approaches to incorporating a WACC in a project's expected costs. Whilst many methods are theoretically sound, the guiding principles should be that the chosen WACC will most accurately provide the true expected after-tax rate of return over the life of the project and be consistent with the corresponding cash flows.

Australia Post's position

Australia Post proposes a post-tax nominal WACC formulation which is shown below (Equation 9.1). This is equivalent to the classical post-tax WACC, as noted in Professor Davis's consultancy report.

Equation 9.1

$$\boxed{WACC = \frac{E}{D+E}K_e + \frac{D}{D+E}K_d(1-t_c)}$$

where:

- K_d is the pre tax cost of debt;
- K_e is the post tax cost of equity[144];
- D is the market value of debt;
- E is the market value of equity; and
- t_c is the corporate tax rate.

9.2.1 Commission's preliminary assessment and analysis

The Commission considers that a real "vanilla" WACC is appropriate for use in its financial modelling. A vanilla form of WACC refers to the equity and debt weightings being applied to a *post-tax* cost of equity and a *pre-tax* cost of debt. This approach is appropriate when applying the rate of return to post-tax cash-flows as done in the Commission's financial analysis. Taxes are treated like costs in the expected cash flows, rather than accounted for in a higher return. It reflects the fact that debt-holders are compensated before payment of company tax, whereas equity holders receive compensation after company tax has been paid.

The vanilla WACC formula is:

Equation 9.2

$$\boxed{WACC = \frac{E}{D+E}K_e + \frac{D}{D+E}K_d}$$

A real value of WACC is applied as forecast operating and maintenance costs have already been inflated. However, this is equivalent to applying a nominal WACC to uninflated costs.

The real rate, $WACC_r$, is derived from the nominal rate, $WACC_n$ by the Fisher equation as follows:

$$(1+WACC_r) = (1+WACC_n)/(1+p)$$

where p is the expected inflation rate.

For ease of understanding, however, the discussion in this chapter focuses on nominal measures.

Tax and imputation factors

An alternative formulation of WACC, known as the Officer WACC, incorporates the dividend imputation factor. This was included in Professor Davis's report and is shown in Equation 9.3.

[144] This is a rate of return after company tax but before the impact of dividend imputation.

Equation 9.3

$$\boxed{WACC = \frac{1-t_c}{1-t_c(1-g)}\frac{E}{D+E}K_e + \frac{D}{D+E}K_d(1-t_c)}$$

where gamma (γ) = average degree of utilisation of franking credits by shareholders.

The dividend imputation system operates to compensate shareholders for the tax paid out of company earnings through the distribution of franking credits. In effect the system recognises that tax paid by the company represents a pre-payment of personal income tax on dividends thereby providing some value to shareholders. This value may in turn result in the actual after-tax return required by shareholders, as calculated through CAPM, being overstated.

Thus the post-tax nominal WACC formulation is modified in the Officer version to incorporate the value of gamma into the required return on equity. Gamma could range from 0 to 1 with a gamma of 0 signifying the absence of any utilisation while a gamma of 1 signifies full utilisation. It may be noted that, where gamma is 0, the Officer formula collapes to the classical formula (Equation 9.1).

The Commission prefers to incorporate the tax and imputation factors directly into the cash-flows in its financial analysis, to which the vanilla rather than Officer formulation of WACC is applied. A higher imputation factor thereby has an equivalent effect in reducing required revenues, but operates through reducing the net tax payable by shareholders rather than reducing WACC. The tax and imputation factors nevertheless have a small direct effect on WACC through their effect on the equity beta, discussed later in this chapter.

Tax rate

Australia Post uses a corporate tax rate of 30 per cent. This is the statutory rate of company tax and is accepted by the Commission for this assessment.

Imputation factor

Australia Post suggests that it is appropriate to use an imputation tax credit value (gamma) of 0.30.

Professor Davis notes that although Australia Post proposes a gamma of 0.30, its calculation of the nominal WACC formula does not appear to incorporate the imputation tax credit parameter. If the imputation tax credit value of 30 per cent is incorporated, and assuming that all other parameters are the same as the ones used by Australia Post, then for any increase in gamma the WACC would decrease, assuming the WACC formulation is the one that incorporates gamma (for example, Equation 9.3)[145]

[145] If gamma is assumed to be zero, then the WACC that incorporates the imputation factor is 9.1%. If gamma is assumed to be 0.3, then WACC decreases to 8.2%. If gamma increases to 0.5, then the WACC is 7.7%.

The Commission has in previous decisions adopted a gamma of 0.50. In the *Sydney Airports Aeronautical Pricing Decision*[146], the Commission noted that there is considerable evidence pointing towards a higher gamma. Nevertheless, while still prepared to alter its position for future decisions if a clearer trend or consensus on this issue emerges, the Commission maintains a gamma of 0.50 for this assessment.

9.3 Australia Post's financial target and Direction 11

9.3.1 Australia Post's position

In its draft price notification Australia Post argues that:

> While some regulatory analysis may apply forward-looking, benchmark economic costs (including a rate of return on capital) to determine the relevant rates of return, such a theoretical exercise removed from the actual costs of the business being assessed is considered to be inappropriate for Australia Post. This is because Australia Post's business is subject to specific statutory obligations that require it to operate in a different manner than a purely commercial enterprise (for example, the CSO obligations and financial target requirements).[147]

9.3.2 Direction 11

Direction 11 directs the Commission to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plans[148] as set out in sections 35 to 41 of the *Australian Postal Corporation (APC)* Act, particularly the pricing and financial targets. Most of these provisions have been revoked, so that only sections 38 and 40 remain operative. Further information regarding the legislative framework that Australia Post is subject to can be found in Chapter 2.

The target approved by the Minister for 2001/02 was a return on operating assets of 14.1%. In additional information provided by Australia Post regarding its draft price notification, Australia Post outlines how the financial target applies to the organisation. Australia Post states that it uses a pre-tax nominal WACC of 13% as an internal hurdle rate for investment evaluations. Australia Post also contends that the financial target (the required rate of return on operating assets), is analogous to a pre-tax WACC in other circumstances. The Commission's views on the appropriateness of using a return on assets measure to assess pricing is discussed in section 9.3.3 below.

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[146] ACCC, *Sydney Airports Corporation Ltd Aeronautical Pricing Proposal: Decision*, May 2001, p. 199.
[147] Australia Post, Draft Price Notification (Revised 17 July 2002), p. 32.
[148] Australia Post is a government business enterprise (*Commonwealth Authorities and Companies Regulations 1997*, reg 4) and must, under section 17 of the *Commonwealth Authorities and Companies Act 1997*, annually prepare a corporate plan and give it to the responsible Minister. The plan must include (among other things) details of financial targets and projections, community service obligations and the authority's strategy for carrying out those obligations, and price control and quality control strategies for goods or services supplied by the authority under a monopoly.

9.3.3 Commission's preliminary assessment framework

In its *Draft Statement of Regulatory Approach to Price Notifications*, the Commission outlined the framework in which it will assess price notifications and the focus it will place on assessing the "reasonableness of the rate of return that the declared company is seeking"[149] in accordance with section 17(3)(a) of the *Prices Surveillance Act 1983*. Central to this assessment is the recognition that to encourage efficient investment, a declared organisation needs to be able to earn a reasonable rate of return on its assets.

As set out in the *Draft Statement of Principles for the Regulation of Transmission Revenues*[150], it is important that the regulator sets the rate of return at a level which reflects a commercial return for the regulated businesses. Setting a rate of return below the cost of funds in the market could make continued investment in developing the network difficult or unattractive for the owner. Conversely, allowing a rate of return in excess of the market-based cost of capital would distort price signals to consumers and investors, resulting in a misallocation of resources and sub-optimal economic outcomes.

The Commission assesses the reasonableness of the rate of return being generated by comparing the economic rate of return with the cost of capital. The Commission's rejection of accounting based measures of return for this assessment and for decisions relating to investment and pricing stems from the recognition that these returns are vulnerable to bias stemming from the techniques used to value assets, measure accounting income and depreciation. The issue has also been discussed at length by authors such as Brealey and Myers who state, "unfortunately book income and return on investment are often seriously biased measures of true profitability and thus should not be compared to the opportunity cost of capital" [151].

Return on assets based on accounting book values cannot be directly compared to the economic measure of the cost of capital. An economic rate of return, in contrast, is based on the discounted cash flow model and thus incorporates the opportunity cost of capital and risk. Within this framework the Commission will then compare both the economic return on equity and economic return on assets to the relevant cost of capital. The relevant cost of equity capital is estimated

[149] Australian Competition and Consumer Commission, *Draft Statement of Regulatory Approach to Price Notifications*, 1998, p. 4.

[150] Australian Competition and Consumer Commission, *Draft Statement of Principles for the Regulation of Transmission Revenues,* May 1999, p. xii.

[151] R. Brealey & S. Myers *Principles of Corporate Finance,* 1996, p. 312.

Brealey and Myers went on to note that: "Book measures of profitability can be wrong or misleading because:

- Errors occur at different stages of project life. When true depreciation is decelerated, book measures are likely to understate true profitability for new projects and overstate it for old ones.
- Errors also occur when firms or divisions have a balanced mix of old and new projects.
- Errors occur because of inflation, basically because inflation shows up in revenue faster than it shows up in costs.
- Book measures are often confused by "creative accounting". Some firms pick and choose among available accounting procedures, or even invent new ones, in order to make their income statements and balance sheets look good."

through the Capital Asset Pricing Model and the relevant return on assets is derived through the post-tax nominal WACC.

The weighted average cost of capital measures the opportunity cost of capital borne by the service provider, including both the cost of debt and the cost of equity, weighted by its proportion in the company's financial structure. The WACC is set on the basis of financial market benchmarks, taking into account the level of commercial risk involved in the relevant business. In the context of assessing Australia Post's pricing targets, the Commission focuses on whether prices are based on an efficient cost base, including this opportunity cost. Accordingly the Commission regards the weighted average cost of capital as an appropriate measure of a reasonable rate of return in its assessment of Australia Post's pricing proposal.

Although the Commission is to have regard for the financial target agreed to by the relevant Minister and Australia Post, this is expressed as an accounting rate of return on assets. By contrast, the Commission must also assess the current price notification on the grounds of economic efficiency. This process may in turn have an effect on the accounting rate of return of Australia Post. For this reason the Commission has not employed Australia Post's explicit financial target in its profitability analysis.

This course is further suggested by the fact that the target applies to Australia Post as a whole (rather than just its reserved services) and also that the Commission has not provided advice on pricing targets as the Direction apparently envisages. A further consideration is that the financial target is agreed by the Minister in relation to a particular year, whereas the Commission seeks to estimate the cost of capital over a longer term corresponding to the period of analysis.

In the following section there is a discussion of the underlying WACC parameters proposed by Australia Post and the Commission's views on these parameters. Table 9.2 at the end of the chapter compares Australia Post's proposed values and the parameters used to estimate the WACC by the Commission in this decision.

9.4 Gearing ratio

Australia Post's position

Australia Post points to advice received from Price Waterhouse Coopers regarding the gearing ratio and considers that a debt equity ratio of 30:70 to 40:60 per cent is appropriate.

Commission's preliminary assessment and analysis

In previous decisions regarding capital structure the Commission has tended to adopt a benchmark debt to equity ratio of 60 per cent on the basis that such a ratio operates as an incentive for regulated firms to efficiently structure their capital such that the cost of capital is minimised. However, the Commission has noted that, as a result of offsetting channels such as equity (levered) beta and treatment of tax, any variation on this benchmark will have only a limited impact on the post-tax nominal WACC. Given its relative immateriality, therefore, the Commission has adopted Australia Post's suggested debt to equity ratio of 30:70.

9.5 Cost of debt

9.5.1 Introduction

The cost of debt in the WACC formulation is the expected return to debt holders on debt capital invested and is calculated as the sum of the nominal risk free rate and the cost of debt margin. That is:

$$\boxed{K_d = Rf + dm.}$$

where:

- Rf is the nominal risk free rate; and
- dm is the cost of debt margin; that is, the excess of the market return on debt over the risk free rate.

9.5.2 Risk free rate

Australia Post's position

Australia Post in supplementary information to its draft price notification, provides information regarding the appropriate measure to determine the risk free rate. Australia Post uses a ten year Commonwealth government bond rate. Australia Post is of the view that the 10 year rate reflects the longevity of its capital base and, in particular, the composition of capital expenditure in recent years eg. property and mail handling plant and equipment. The ten year bond rate was 6.27% on 5 June 2002. For the purposes of comparison with the Commission's calculations, a more recent figure of 5.7% is included in Table 9.2.

Commission's preliminary assessment and analysis

The Commission generally adopts estimates of the risk-free rate which correspond with the length of the regulatory period under consideration. The use of the nominal and real bond yields with terms that correspond to the regulatory period is the appropriate estimate of the risk free rate of return for the following reasons.

Firstly, the use of such bond yields will ensure that rates that asset owners are expected to be subject to through the course of regulatory period will exactly correspond with estimated rates. In a previous consultation paper for the Commission, Professor Kevin Davis supported this argument. Professor Davis suggested that the use of yields commensurate with the regulatory period ensures that service providers do not 'charge prices that incorporate a premium for bearing long term interest rate risk which is not in fact being borne'[152].

Secondly, the use of yields commensurate with the regulatory period is appropriate under the CAPM framework. The CAPM framework is a one period model, thus it is more appropriate to estimate the rate for one regulatory period, rather than over the course of numerous regulatory periods.

Although the PS Act does not define regulatory periods, the Commission considers that an assessment over a five-year term may be more appropriate in the case of Australia Post's pricing proposal. This is discussed further in Chapter 3. In this preliminary view, the Commission therefore uses five-year rates to calculate the risk-free rate. The 40-day moving average of nominal Commonwealth government 5-year bond rates up to 29 August 2002 was 5.5% per annum. The equivalent rate for indexed bonds was 3.0%, implying an expected inflation rate of 2.4%.

9.5.3 Debt Margin

An integral element of the cost of debt formulation is the debt margin, which is a function of an organisation's credit rating. An organisation's credit rating is a measure of the potential default risk of a company. Standard and Poor's incorporates the level of gearing as a parameter in determining the overall rating[153].

Australia Post's position

Australia Post contends that a debt risk premium 0.3% to 0.4% above the risk free rate is appropriate as it reflects the corporation's AAA credit rating and relatively low gearing. In its calculations, Australia Post used a debt margin of 0.3%.

Commission's preliminary assessment and analysis

The Commission agrees that credit ratings and gearing ratios are factors relevant to the debt margin. In its July 2000 decision relating to Telstra, which has an AA credit rating, the Commission concluded:

> …that given Telstra had both an excellent credit rating and a very low gearing ratio, a small debt premium was appropriate[154].

In that context, the Commission decided to use a 0.8% debt margin for Telstra's PSTN.

[152] K Davis, *The Weighted Average Cost of Capital for the Gas Industry – Report Prepared for the ACCC*, 1998, p. 15.
[153] Standard and Poor's *Corporate Rating Methodology*, p.17.
[154] ACCC, *Report on the assessment of Telstra's Undertaking for the Domestic Public Switched Telephone Network (PSTN) Originating and Terminating Access services*, July 2000, pp. 92-3.

In light of Australia Post's credit rating of AAA and gearing ratio of around 30%, the Commission considers that Australia Post's proposed debt margin of 0.3% is appropriate.

9.6 Cost of equity

9.6.1 Introduction

The cost of equity capital is the rate of return required by equity holders given the opportunity cost of investing in the market, the volatility of the market and the systematic risk of holding equity in a particular organisation. It is estimated using the Capital Asset Pricing Model, that is:

$$\boxed{Ke = Rf + \beta e(Rm-Rf)}$$

where:

- Rf is the risk free rate of return
- (Rm-Rf) is the market risk premium; and
- βe is the relative systematic risk of an organisation's equity.

9.6.2 Equity and Asset Beta

Since the equity beta depends on the capital structure of an organisation, it is unique to an organisation and thus cannot be used as a proxy unless the effect of financial gearing is allowed for.

An alternative measure to be used when establishing a proxy is the asset beta[155]. The asset beta is the beta that would prevail if an organisation were wholly financed by equity. It therefore measures the risk associated with an asset's cash flows and controls for the risk arising from an organisation's capital structure. Two possible methods by which a proxy asset beta can be established are:

- through the use of a comparable organisation's asset beta; and
- through an estimate of the income elasticity of demand for the organisation's products.

The first of these methods requires consideration of the operating environment in which the organisation exists and then identifying listed companies with similar or identical business segments.

[155] An estimate of the equity beta is derived from the asset beta using the formula:

$$\beta e = \beta a\ [1 + (1- T\ (1-\gamma))(\ D / E)\ ] - \beta d\ (D/V)$$

Australia Post's position

Australia Post has adopted, on advice from Price Waterhouse Coopers (PWC), an asset beta of 0.55. This asset beta is based on a comparative study performed by PWC of similar regulated organisations. Australia Post also argues that the asset beta could possibly be higher due to the volatility of the advertising market.

Commission's preliminary assessment and analysis

Professor Kevin Davis in his advice to the Commission regarding the weighted average cost of capital states that:

> …it would appear that this estimate (β=0.55) is based on using electricity, gas and water utilities as comparable companies, and the suggestion is given that UK data was seen as particularly relevant to (rather than that of the US).[156]

Professor Davis suggests that the choice of comparative organisations could be based on observed similarities in the relevant industries such as: operating leverage, covariance of industry demand with aggregate demand or stock market returns, longevity of assets and forecast cash flow patterns, regulatory framework and growth opportunities.

Australia Post suggests that there are reasons for believing that the asset beta might be somewhat higher than this estimate. One reason given is the volatility of the advertising market, where it is suggested that the beta of any industry dependent upon it will be higher. Professor Davis points out that 'this argument appears to equate volatility and systematic risk, whereas the latter is determined by covariance with market returns rather than volatility *per se*. It is difficult to assess this argument without further information'[157].

Although as Professor Davis suggests, there are companies which Australia Post could be compared to, these companies are involved in some activities that are different from Australia Post. The difficulty arises due to the fact that the activities of such companies, and that of Australia Post, span several business segments. Professor Davis notes that if there is no systematic risk difference across those segments, an estimate of a company level beta is appropriate. However, if there are significant differences across business segments, it would be appropriate (if feasible) to estimate separate betas for each segment.

Professor Davis provided the information contained in Table 9.1. It provides relevant information on a number of companies, which might be thought comparable, to some degree, to Australia Post. Professor Davis notes that the data in Table 9.1 is, at best, indicative.

[156] K Davis, *Report on asset beta and cost of capital for Australia Post, prepared for ACCC*, July 2002, p. 6.
[157] Davis 2002, p. 6.

Table 9.1

Indicative Asset Beta Estimates			
Company	**Equity Beta**	**Gearing**	**Asset Beta**
UPS	0.64	0.32	0.43
Fed Ex	1.04	0.26	0.77
TP	0.8	0.42	0.46
DPW	0.6	0.3	0.42
Consignia			0.842

Source: Professor Kevin Davis, *Advice to the Commission on Australia Post's Weighted Average Cost of Capital*, p. 3.

Professor Davis concludes that 'on the basis of this, admittedly, highly imperfect information, the assumption of an asset beta of 0.55 made by Australia Post does not appear to be unreasonable'[158].

The Commission also notes that the estimate is not out of line with asset betas for other regulated businesses in Australia. For the purposes of this preliminary assessment, therefore, the Commission has adopted the asset beta proposed by Australia Post.

9.6.3 Market Risk Premium

Introduction

The market risk premium represents the additional expected return for investing in the market as a whole over investing in the risk free instruments such as government bonds. The MRP is a parameter in the CAPM, which together with the risk free rate and firm specific beta, determines the expected return on equity in the business - that is, the level of compensation required for investors to assume the risk of the market (exclusive of franking credits).

Australia Post's position

Australia Post suggests that an appropriate market risk premium (MRP) would be 7 per cent and also suggests that the adoption of a single rate of 6 per cent for the MRP is inappropriate.

[158] Davis 2002, p. 8.

The *Draft Statement of Principles for the Regulation of Transmission Revenues* discusses the Commission's consideration of the appropriate market risk premium. It notes that:

> Theoretically the market risk premium is an ex-ante premium based on a forward view of the market. However, for practical reasons much of the analysis of its value has relied on the premium historically achieved, as a proxy measure. Historical estimates are contentious as, for example, the more stable inflationary environment now prevailing may mean that the relevant market risk premium is less than has been observed over recent years.…Conventional market wisdom favoured by many financial analysts indicates the market risk premium lies in the region of six to seven per cent under a classical tax system. The Commission will use its judgement in setting the market risk premium, noting the views of market participants as to its value are just as important as its statistically determined value. [159]

In past regulatory decisions the Commission has adopted a MRP of 6 per cent. It should also be noted that despite several arguments to the contrary since September 11 the Commission has continued to use a market risk premium of 6 per cent. While the Commission acknowledges the various complexities and uncertainties involved in the estimation of this parameter, the market risk premium is a parameter that does not vary according to the company in question. Since Australia Post has not provided any particular arguments to support its claim for a higher figure, the Commission has not departed from its standard 6% value in this case.

9.7 Conclusion

The Commission concludes that an appropriate post-tax nominal return on equity is 9.9% given the parameters outlined above. This is lower than the post-tax nominal return on equity calculated using parameters proposed by Australia Post, primarily due to the difference in the market risk premium.

The resulting post-tax nominal vanilla WACC is 8.7%, and the equivalent real WACC is 6.1%.

A comparison of Australia Post's proposed parameters, and the Commission's preferred values, is contained in Table 9.2. The table also shows the corresponding estimate of the WACC and return on equity.

[159] ACCC, *Statement of Principles for the Regulation of Transmission Revenues*, 27 May 1999, pp. 78-9.

Table 9.2

WACC Parameter	Australia Post value	Commission's initial view
Risk free rate (Rf)	5.7 %	5.5 %
Market risk premium	7.0 %	6.0 %
Asset beta	0.55	0.55
Cost of Debt Margin (over Rf)	0.30%	0.30%
Imputation credits (g)	30 %	50 %
Equity beta	0.72	0.74
CorporateTax Rate	30 %	30 %
Debt beta	0.04	0.05
Gearing	30 %	30%
Nominal Vanilla WACC	9.4%	8.7%
Post tax nominal return on equity	10.8%	9.9%

10 Financial modelling

10.1 Introduction

As discussed in Chapter 3, two key criteria which the Commission must have regard to under Subsection 17(3) of the PS Act in deciding whether to object to notified price increases are:

> (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;

The Commission's financial analysis provides a way of quantifying the level of prices satisfying these criteria. A spreadsheet-based model is used to calculate the amount of revenue required in any year to cover the total costs of an efficient service, based on the following formula[160]:

RR = O&M + D + ROC + T

where RR = required revenue

O&M = operating and maintenance expenditure (including administrative costs).

D = depreciation or return of capital

ROC = return on capital = WACC * WDV

WACC = weighted average cost of capital (post-tax);

WDV = written down (depreciated) average value of the asset base[161]

T = corporate tax, less benefit of dividend imputation

The return on capital covers both (i) interest on external debt and (ii) return on equity. The WACC is a weighted average of the return on debt and equity, weighted by the proportions of debt and equity used to finance the asset base. WACC is estimated as the rate sufficient to continue to attract capital into the industry without an excessive return, based on normal returns in the capital market and the particular risks of the industry under investigation (as discussed in Chapter 9). By allowing the service provider a reasonable rate of return on capital employed, this addresses the first criterion of maintaining investment in the service provider's industry. At the same time, by discouraging prices based on returns above the WACC, it addresses the second criterion of discouraging the

[160] This approach has been further developed by the ACCC in the context of the electricity and gas industries, and recently accepted by the ACCC as the basis for the decision on Sydney Airport in 2001.

[161] Average asset value over the year is (Opening value plus Closing value)/2.

provider from taking advantage of its market power to make excessive profits and restrict supply at the expense of consumers and users.

Another way in which a provider could take advantage of its market power and lack of competition is by allowing costs to inflate to unnecessary or inefficient levels. Hence the analysis should be based where possible on an efficient cost-base rather than the provider's actual costs. Australia Post's efficiency is discussed further in Chapter 5.

10.2 Discussion

Period of analysis

For the reasons set out in Chapter 3, the financial analysis spans the five year period up until 2006/07.

Australia Post's data

The Commission invited Australia Post to provide a financial model which supported its claims by demonstrating how the proposed prices reflect costs, volumes, efficiency and required rates of return. Australia Post did not provide a model showing such relationships, but provided (confidential) data tables showing forecast volumes, asset values, costs, revenues at proposed prices, and profits for the 5 years up to 2006/07.

The cost and revenue data were provided on two bases:

i. Domestic letters, including certain large letters which are not reserved, split by 6 broad categories of letter[162];

ii. Reserved domestic letters only, split by 4 broad categories of letter[163].

The difference relates to non-reserved large letters (over 250 gm), which account for only about 1% of total domestic letters by volume, although they contribute a larger share of revenue and profit. The services declared under the PS Act exclude these non-reserved letters. However, Australia Post presented price changes for all letters as an integrated proposal, and provided asset data only on a total letters basis. Hence, as discussed in Chapter 8, the Commission considers that it is appropriate to undertake the financial analysis on the basis of all domestic letters.

Australia Post's accounting costs included depreciation, but excluded interest, income tax, GST and return on capital[164]. Table 10.1 below shows Australia Post's forecast data, assuming the proposed

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[162] These were: Small Ordinary, Small PreSort – Regular, Small PreSort – Off-peak, Large Ordinary, Large PreSort – Regular, and Large PreSort – Off-peak.

[163] Small Full-rate (Ordinary), Small Bulk (PreSort), Large Full-rate, Large Bulk; that is, the PreSort categories of Regular and Off-peak are combined.

[164] Deducting costs on that basis from revenue gives Earnings Before Interest and Tax (EBIT).

prices apply from 13 January 2003 and remain constant thereafter, while costs increase. As a result, projected profit declines from $152m in 2002/03 to $21m in 2006/07.

Table 10.1: Australia Post forecasts, domestic letters

	2002/03	2003/04	2004/05	2005/06	2006/07
Volume (million letters)	4163	4189	4205	4205	4184
Revenue ($m)	1,807	1,869	1,870	1,864	1,849
Costs ($m)	1,655	1,701	1,723	1,772	1,827
Profit ($m)	152	167	146	92	21

Australia Post also provided limited cost data for 2000/01 and 2001/02 to help show the link between actual and forecast data.

Australia Post did not attempt to trace the relation between its costs, prices and required rates of return. However, the Commission tested the basic cost data provided in its own financial model, combining it with the Commission's estimated parameters for cost of capital and tax.

Costs

The postal service is relatively labour-intensive compared with several other major regulated public utilities such as gas, electricity and telecom, and a higher proportion of its costs are operating and maintenance rather than capital. Employee expenses constitute 50% of total costs across the whole of Australia Post[165]. Depreciation is only about 7% of costs as submitted by Australia Post, and when a return on capital is added, total capital charges are only 11% of total costs. The remaining 89% are operating costs. Hence the main uncertainties affecting allowable prices concern operating costs rather than capital charges.

Inflation

It is expected that the prices set by Australia Post may have to endure for several years, as discussed above, and hence need to give an appropriate rate of return over several years in the light of general cost inflation over that period. The Commission does not propose to adjust future prices to reflect any difference between actual and expected inflation.

The Commission's analysis is in terms of nominal prices for future years, incorporating constant nominal postage prices but an allowance for expected future rates of inflation in input costs. Australia Post's estimates of future costs incorporate assumed inflation rates (approximating 3.25% pa when averaged over labour and other input goods). These appear to be consistent with independent forecasts used for the economy generally in Australia, but the Commission notes that the assumed inflation rate for non-labour inputs appears to be at the high end of market

[165] Australia Post Annual Report 2000/2001, p. 48.

expectations. For consistency, asset values in the analysis are in nominal (inflated) terms for future years, as noted below.

Assets

Asset values were provided by Australia Post as the basis for deriving a return on fixed assets employed. The asset values were shown on a rolling 5-year basis; that is, opening and closing values each year are linked through depreciation, additions, revaluations, sales and internal transfers. The return on capital in the model was based only on the value of fixed assets, excluding current assets, as discussed in Chapter 8 on asset valuation.

The asset data related to the total letters business and were split by asset type (land, vehicles, equipment, buildings, land etc) rather than by product type, due to the high degree of commonality discussed earlier in Chapter 7 on cost allocation and Chapter 8. Hence the Commission considered it appropriate to apply rates of return and estimate required revenue for the letters business as a whole.

Australia Post states that its assets are valued by Deprival Value, in accordance with Department of Finance guidelines for financial reporting for government agencies and authorities. As discussed in Chapter 8, the Commission accepts the valuation methodology as being an acceptable approximation of the optimised replacement cost approach it generally uses.

Australia Post's asset values are understood to be in current cost terms at the time they were supplied, except that property values were adjusted for expected CPI inflation from 2004 onwards. Other assets appear not to have been revalued after 30 June 2002. Since the Commission has adopted a current cost approach for its analysis, it has revalued the non-property assets for years following 2002/03, by applying the expected inflation rate, derived from the difference between nominal and indexed bond rates. This is the same inflation rate as is used to estimate the real value of WACC, and is currently 2.4% pa.

Depreciation

Australia Post also provided data for depreciation of fixed assets. Property, plant and equipment assets owned by Australia Post are depreciated over their estimated useful lives using the straight-line method[166] which is common in business accounts, and is accepted by the Commission for application in its financial analysis (as discussed in Chapter 8 on asset valuation)[167]. However, the Commission revalued depreciation amounts in future years by the expected inflation rate, as for asset values.

This regulatory depreciation differs from depreciation for income tax purposes in that tax depreciation is based on the historic cost of assets. Hence the tax calculations in the Commission's

[166] Australia Post Annual Report 2000/2001, p. 54.
[167] Other methods of depreciation may be acceptable in other circumstances.

model use the original depreciation data supplied by Australia Post, without adjusting for inflation, whereas the regulatory depreciation used in the model as a component of costs is inflated to future price levels.

Cost of capital

The full costs estimated in the Commission's model include a return on capital, equal to the weighted average cost of capital (WACC) times the asset base. Since the WACC is applied to inflated asset values each year, a real WACC is appropriate to avoid double-counting inflation[168]. The parameters suggested by Australia Post generate a nominal "vanilla" WACC of 9.6%, equivalent to a WACC of 6.5% on a real basis. As discussed in Chapter 9 on WACC, using the parameters considered more appropriate by the Commission, the nominal "vanilla" WACC is 8.7%, or 6.1% pa in real terms.

Prices & revenue

Australia Post provided confidential data to show how its forecast revenues are derived from the proposed prices for the 125 products in the proposed schedule. This is based on estimates of the volume (number) of letters in each price category, with weighted averages calculated to show expected revenues per unit for the broad letter categories that match the cost data provided.

As the new prices are proposed to apply from 13 January 2003, Australia Post's revenue forecasts for 2002/03 reflect the current prices applying for the first part of the year, and the new prices for the second part. The first full year with revenue at the proposed rates is 2003/04.

Forecast revenue per unit declines slightly from year to year, even at fixed prices, because of a shift in composition from higher-priced ordinary mail to lower-priced bulk mail. The decline in the weighted average revenue per unit is about 0.4 cents by the end of 2006-07.

Taxes

Australia Post's accounts since 1 July 2000 are affected by the introduction of Australia's Goods and Services Tax (GST). Retail prices as quoted in Attachment 1 of Australia Post's submission include GST. That is, from its revenue at those prices, Australia Post must pay the Australian Tax Office its GST liability which is 10% of the GST-exclusive price. It can offset (against this liability) credits from GST it pays on input.

Hence, in calculating the revenue effectively received by Australia Post, one-eleventh is deducted from retail prices to arrive at GST-exclusive revenue. Australia Post accounts show both costs and revenues exclusive of the GST. Indirect taxes other than GST are treated as costs.

[168] Note, however, that when discounting future (nominal) revenues to a present value, it is appropriate to use a nominal WACC.

Income tax is calculated separately in the model using standard benchmark rates for corporate tax and franking credits, as if it were an extra cost. The rates applied are discussed in Chapter 9. Correspondingly, the WACC applied to derive the cost of capital incorporates a post-tax return on equity.

10.3 Commission's modelling results

Required revenue

As a starting point, the Commission's calculations used Australia Post's own cost data for the domestic letters business within the model described earlier. To fit the data into the Commission's framework of analysis, fixed asset values and depreciation were inflated, and a real return on capital (based on a real WACC of 6.1%) and standard income tax were added. The model generated **required revenue** which could be compared with:

- revenue at existing prices; and
- revenue expected by Australia Post at its proposed new prices.

The main components of the analysis are shown in Table 10.2 below:

Table 10.2: Financial modelling results.

[$m]	2002/03	2003/04	2004/05	2005/06	2006/07
Volume (million letters)	**4,163**	**4,189**	**4,205**	**4,205**	**4,184**
Average Assets	$1,216	$1,208	$1,192	$1,194	$1,184
Return on capital	$75	$74	$73	$73	$73
Depreciation (current prices)	$119	$126	$129	$132	$133
Total capital charge	$193	$200	$202	$205	$206
Operating costs	$1,536	$1,579	$1,600	$1,649	$1,707
Total Costs	*$1,729*	*$1,778*	*$1,802*	*$1,854*	*$1,912*
Plus Tax Liability	$19	$20	$21	$22	$23
Less Dividend Imputation Credit	-$9	-$10	-$10	-$11	-$11
Required Revenue	**$1,739**	**$1,788**	**$1,813**	**$1,865**	**$1,923**
Revenue at existing prices	$1,767	$1,778	$1,785	$1,785	$1,776
Revenue at AP proposed prices	$1,807	$1,869	$1,870	$1,864	$1,849
Existing *less* required revenue	$28	-$10	-$28	-$80	-$147
Proposed *less* required revenue	$68	$80	$57	-$1	-$75
Unit revenue - required ($)	$0.418	$0.427	$0.431	$0.443	$0.460

Unit revenue - existing prices ($)	$0.424	$0.424	$0.423	$0.422	$0.420
Unit revenue - AP proposed prices ($)	$0.434	$0.446	$0.445	$0.443	$0.442

Revenue at existing prices

Under the above assumptions, revenue at existing prices would be $28m (or 1.6%) in excess of required revenue in 2002/03, as shown in Table 10.2. This would change to a deficit of $10m in the following year 2003/04, and the deficit would increase to $148m or 9% by 2006/07, due to the assumed increase in costs.

One way of gauging the overall appropriateness of a particular set of prices is to measure the difference between revenue at that set of prices and the required revenues in each year of the period studied, and take the discounted total value of the differences in all years.

Using this approach, the discounted value of the difference between revenues at existing and required prices over the first 3 year period would be a **deficit (**or **under-recovery** of costs) of $5m in present value terms. Over a 5-year period the deficit would grow to $173m, which is 2.2% of the discounted value of required revenue.

Revenue at Australia Post's proposed prices

At Australia Post's proposed prices and forecast costs, revenue would exceed required revenue by $68m in 2002/03, and would not fall below required revenue until 2005/06. Over the first 3-year period, the present value of the differences is a **surplus** or over-recovery of $190m, and there is still a surplus of $136m over a 5-year period (or 1.7% of revenue).

The return on capital is based a real post-tax (vanilla) WACC of 6.1%, as discussed in Chapter 9. Changing the WACC to 6.5% pa, the value derived from Australia Post's suggested parameters, results in the required return on capital being increased by $5m.

The change in WACC value does not alter the broad implications that:

- existing prices are adequate now but may result in under-recovery from 2003/04, with a slight under-recovery over the first 3 years as a whole, and a significant under-recovery over 5 years;
- Australia Post's proposed price increase in 2003 would be expected to result in over-recovery over a 3-year and even 5-year horizons.

In light of these results, alternative "intermediate" approaches were considered for testing in the financial model, namely:

- increases of a lesser size;
- delaying the proposed price;
- increases over a more limited range of products.

Smaller increases

As discussed in Chapter 3, there are advantages in maintaining the price of the basic postage stamp in 5 cent multiples. Further, the accuracy of the data available does not support finely judged annual increases of a smaller size.

For bulk mail rates, there is little need to maintain round amounts, and they can be adjusted at more frequent intervals with little loss of efficiency. However, the increases in bulk rates proposed by Australia Post are significantly smaller than the basic postal rate – averaging only about 2.2 cents. Therefore there is little scope for reducing the size of the bulk increases while allowing increases that are administratively worthwhile.

Therefore the Commission is reluctant to recommend price increases of a smaller size for either the basic rate or bulk mail, and no such options were tested in the financial model.

Deferral

On the above cost data, AP's proposed increase could be delayed for 2 years, and if applied and maintained for the following 3 years, a broadly neutral result would be obtained. That is, the present value of the difference between required and proposed revenues would be small (at a surplus of $13m) over a full 5-year period.

Increases over a limited range of products

The broad product groups in Australia Post's data show some contrasting features. Small ordinary letters incur a small percentage loss currently, while large letters and bulk mail have comfortable profit margins. This difference would be magnified over future years, in the case of small letters, for which volumes at full rate are forecast to fall by 12%, while those at bulk rates rise by 15%. These have corresponding inverse effects on their unit costs. That is, the fall in volume of small full rate letters causes an increase in their unit costs and therefore greater losses, while the rise in volume of bulk letters causes a fall in their unit costs and a rise in unit profits. Partly on account of this (combined with inflation and other factors), unit cost of small full rate letters is expected by Australia Post to increase by 23% while unit cost for small bulk letters increases by only 1% over the next 5 years.

Given the wide and growing disparity in profits per unit between different types of letter, there is a case on economic efficiency grounds for restructuring prices to increase the profit contribution from ordinary small letters, and bring price and unit cost more in line. One simple mechanism would be an increase in the basic postal rate without the rises for other letters proposed by Australia Post.

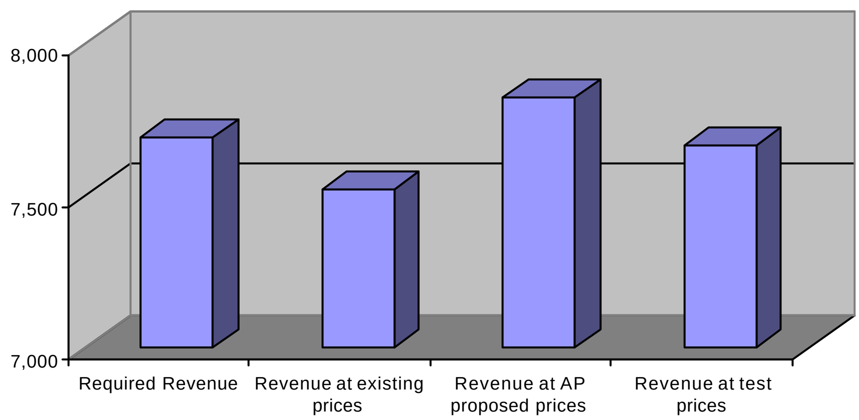
The rationale for differential increases in the price structure is discussed further in Chapter 11, but the broad implications have been tested in the financial model and are reported here. The test investigates the option of restricting the price rise to small ordinary letters (the basic postage stamp), and related services such as seasonal greeting cards, barcoded and metered, and local delivery, while holding large letters and bulk letters at their existing prices. It is assumed that the Clean Mail category is introduced, with the price left at 45c, and the rates for PreSort unbarcoded residue are set at Australia Post's proposed rates, to align with Clean Mail.

This scenario increases estimated revenue in the first full year, 2003/04, by about $53m which is about 58% of the increase sought by Australia Post. This increase would apply to small ordinary letters (excluding Clean Mail) accounting for about 26% of total letters, but the size of the increase at 5 cents per letter is larger than the average proposed increase for bulk mail of around 2.2 cents.

Accepting Australia Post's costs as given, the scenario would result in more than adequate returns over the first 3 years (over-recovery of $110m over the period in present value terms). The result would be near neutral over the 5 year period.

A broad comparison of the different price scenarios is shown in Figure 10-1.

Figure 10-1: Present value of revenues over 5 years under various price options



10.4 Conclusion

On the Commission's analysis, the scenarios for future costs and volumes submitted by Australia Post, combined with the WACC considered reasonable by the Commission, would not justify all the proposed price rises. Increases of the size proposed by Australia Post in January 2003 would result in over-recovery of costs over a 5-year horizon.

On the other hand, maintenance of the existing level of prices could lead to under-recovery of costs by 2003-04, increasing over a 5-year period on the basis of Australia Post's assumptions of deteriorating growth in volumes and productivity. There may therefore be some justification for an increase. The Commission has considered the following basic alternatives to the proposed increases:

- objecting to all of the proposed price increases, but not to lesser price increases; and
- objecting to some of the proposed price increases but not others;
- recommending that Australia Post delay the introduction of some or all of the proposed increases.

The Commission is reluctant to recommend a smaller increase in the basic postage rate so that it is no longer a round multiple of 5 cents. There is no such constraint regarding bulk mail rates, but the increases proposed by Australia Post were already relatively small. There appears to be little scope for reducing the size of the bulk increases while making increases that are administratively worthwhile. Further, the accuracy of the data available does not support finely judged annual increases of a smaller size. Hence, the Commission did not pursue modelling results for smaller increases.

The effects of delaying the introduction of Australia Post's proposed set of price increases were also tested. This indicated that a delay of 2 years, with maintenance of the new price levels for the following 3 years, would yield a broadly neutral result over a 5-year period to 2006-07 on the above costs scenarios.

A third option tested was for a price increase only for small ordinary letters – the basic postage stamp, and related products such as seasonal greeting cards and local delivery, while holding large letters, bulk letters and Clean Mail at their existing prices. Accepting Australia Post's costs as given, the scenario would yield a near-neutral result over a 5 year period.

The merits of these various options are explored further in Chapter 11.

11 Pricing options

11.1 Introduction

The earlier chapters build up a model from Australia Post's information to calculate a required revenue for Australia Post's reserved services. The approach followed these steps:

- taking Australia Post's estimate of the capital base used to produce the reserved service. This involved taking Australia Post's estimates of both the value of the assets and the portion of the assets that should be allocated to the reserved services;

- calculating a return on the capital base. The WACC used to calculate this is slightly lower than Australia Post's proposed WACC;

- calculating an allowance for depreciation of the capital base used to provide the reserved services;

- calculating Australia Post's operating and maintenance costs associated with supplying the reserved services. Again, this involved accepting Australia Post's allocation of costs between reserved and non-reserved services.

Following this process, the Commission provisionally finds that the proposed increases would lead to Australia Post earning excessive returns.

The current chapter takes the analysis to the next step of examining Australia Post's proposed mechanisms for recovering a reasonable amount of revenue. In other words the focus now shifts from '*how much* revenue should Australia Post earn to '*how* is Australia Post to earn this revenue'.

11.2 Options

The Commission's role is to look at proposed price changes and either object to the proposed increases or serve a notice saying it objects but would not object to a lesser price increase.

Australia Post's proposal covers 125 separate prices. Having provisionally found the full proposal would result in Australia Post earning excessive returns, the Commission must consider how to bring Australia Post's prospective revenues to an appropriate level. In a broad sense the Commission's options are:

- to object to some of the proposed price increases but not others;

- to object to all of the proposed price increases, but not object to lesser price increases; and

- to recommend Australia Post delay the introduction of some or all of the proposed increases.

The regulatory framework does not unambiguously point to a particular solution. The Commission has considerable discretion in formulating its response to the proposed price increases. It is relevant to consider the principles to which the Commission must have regard when exercising its powers under the PS Act. As discussed in Chapter 2, the Commission seeks to formulate a response which promotes the following objectives:

- the cost base underlying the proposed charges should be efficient;
- Australia Post should face appropriate signals for investment decisions;
- users should receive appropriate signals for consumption of Australia Post's services; and
- Australia Post should earn a reasonable rate of return which is sufficient to enable it to meet its community service obligations and does not reflect monopoly rents.

11.3 Relationship between price and cost

In the present context the Commission considers these objectives are best advanced if prices are set at efficient levels. As discussed in Chapter 7, prices are consistent with economic efficiency if:

- The revenue derived from any subset of services is more than the incremental cost of providing the services and less than the stand alone cost of providing the services; and
- Shared costs are appropriately allocated among the various subsets of services.

In a general sense the Commission is hesitant to prescribe prices at too fine a level of analysis. It is not feasible or desirable, for example, to simply reduce each of the proposed prices by a proportion to bring total revenues into line with total costs. This approach would be insufficiently subtle to accommodate the commercial judgements which must take place at a micro level.

For example, this approach might point to the basic postal rate being increased to, say, 47 cents. In this scenario a customer purchasing a single stamp for cash would pay 45 cents due to rounding, whereas a customer purchasing 10 stamps would pay $4.70. This outcome appears unsatisfactory.

To some extent, the different types of mail services provided by Australia Post represent different stages in the postal market. Full rate mail could be thought of as involving a degree of retail servicing, while users of bulk mail services might be thought of as wholesale customers, who may in some sense compete with Australia Post in elements of the mail processing required in the broader postal market.

In any case, as discussed in Chapter 7, Australia Post has not provided sufficient information to enable the Commission to determine Australia Post's costs at the level of individual products. Australia Post's product costing system ("PCS") breaks costs down to 12 product groupings. The data indicate the discounts offered by Australia Post for bulk mail are generally less than the cost savings it achieves through this group of services. This could lead to allocative inefficiency as bulk services are likely to be under utilised relative to full-rate mail, resulting in both Australia Post and mail users forgoing savings.

The PCS data also suggests Australia Post's returns from ordinary small letters do not fully meet the costs of providing these services. The uniform price requirements means there is inevitably a degree of cross-subsidisation between high and low density routes within this service. However the ordinary small letters service is also cross-subsidised by other product groups such as large letters and bulk mail.

The existence of these cross-subsidies between different product groups leads the Commission to provisionally conclude that pricing efficiency will be enhanced if the price for ordinary small letters is increased while the price for bulk mail services is maintained at its current level. This approach would better align costs to revenues as between the different product groups identifiable within Australia Post's PCS.

11.4 Relationship between price and demand

When considering what level of prices should attach to particular services or groups of services, it is relevant to consider the likely effect upon demand of any increase in price. As discussed in Chapter 7, inverse elasticity pricing involves levying higher charges for those products for which demand is least responsive to charges. This leads to the recovery of common costs in a manner which minimises the loss of transactions which would have made both parties better off.

Studies which evaluate the elasticity of each of the individual services covered by Australia Post's proposal are not available. The finest level of resolution is in the analysis described in Chapter 4, which discusses the elasticity of three market segments, namely:

- social mail, consisting of household to household mail;
- transactional mail, including such mailings as bank statements, bills and cheque payments; and
- promotional mail, including addressed advertising mail and brochures.

The analysis in Chapter 4 suggests that demand sensitivity to price is lowest in relation to social mail and highest in relation to promotional mail. The analysis also suggests there may be a degree of price sensitivity in relation to transactional mail.

These market segments do not relate directly to individual Australia Post service offerings. However it is possible to draw the following loose connections:

- ordinary full rate letters are likely to fall within the social mail and transactional mail categories;

- PreSort letters are likely to fall within the transactional or promotional category;
- AdPost items currently fall in the promotional category. Many of these items may be sent as PreSort items when AdPost is no longer offered.

These connections lend support to the Commission not objecting to an increase in the price of ordinary full rate letters via the basic postal rate, as the demand for services affected by this increase appears to be less sensitive to price changes. This also lends support to the Commission objecting to increases in PreSort prices, as the demand for these services appears to be relatively more sensitive to price changes.

11.5 Competition in related markets

In considering price structure issues it is relevant for the Commission to have regard to the likely effect of the proposed prices on competition in markets related to the markets in which Australia Post holds a monopoly.

Mail aggregation

GoMail expresses concern at the combined effect of the introduction of Clean Mail and the increase in PreSort rates. GoMail argues the introduction of Clean Mail is at odds with Australia Post's policy of requiring bulk mail users to bar code mail. GoMail states:

> Australia Post's $500M FuturePOST investment strategy set forth the future vision of Australia Post to the mailing industry – with mail processing automation via the introduction of barcoding as a key element. Put more succinctly, no barcoding, no discount. The mailing industry was given forward notice of the changes allowing the industry to organise itself and make the requisite investment in parallel processes, consistent with FuturePOST's direction.
>
> The emergence of the aggregation sector in 2000 was a positive example of how the industry invested behind the industry's blueprint for the future.
>
> […]
>
> Australia Post's current price justification announcement evidenced by the proposal to introduce the new mail product "Clean Mail" demonstrates a complete contradiction and inconsistency in Australia Post's previously applauded commitment to the principles underpinning FuturePOST's direction.
>
> Australia Post has broken its duty of care obligation by compromising on one of the foundation premises of FuturePOST – a commitment to barcoding as the industry blueprint. It is a statement of fact that right up until the proposed introduction of Clean Mail as announced in April 2002, Australia Post had been reinforcing its consistent message of barcode compliance as the only means to continue to enjoy bulk mail discounts. As recent as March 2002 the Australia Post customer awareness marketing program/publication 'Barcoding July 2002 - A Way of Life', reinforced the FuturePOST commitment.
>
> […]
>
> Via the proposed introduction of Clean Mail, Australia Post has displayed a disregard for the significant investment made by the mailing industry in barcode technology. As from July 2002, under the principles of FuturePOST, any mailer unable to meet the 90/10 barcode compliance either through its own investment in barcode technology or utilising the services of aggregation would

> have no choice other than to pay full rate for all mail sendings. The proposed introduction of CleanMail effective January 2003 provides nil incentive to seek barcoding as the price of postage will remain at 45 cents.[169]

GoMail also argues Australia Post's proposal critically reduces the margin in which it must operate. It states:

> The mail aggregation sector is dependent on the bulk mail presort pricing schedule released by Australia Post for its top line margin.
>
> [..]
>
> The Clean Mail proposal in its present form completely undermines the value proposition of the mail aggregation sector. Increasing the base presort discount price and at the same time creating a new maximum price point for unbarcoded mail volumes (target market for aggregation) represents an adverse "double whammy" effect and renders aggregation as uncompetitive.
>
> The maximum pricing differential between barcode pricing and full rate was 7.6 cents (45 cents – 37.4 cents). After Clean Mail the differential has been narrowed to 5.4 cents (45 cents – 39.6 cents). [Further,] the weighted average gross margin over postage (taking into account typical mail mix) available to the aggregation sector reduces from 5.7 cents to 3.7 cents before operating costs and margin sharing with customers.[170]

GoMail goes on to suggest that the introduction of Clean Mail represents a deliberate attempt by Australia Post to curb the growth of the aggregation sector. GoMail submits that the price of Clean Mail should be increased to 47 cents to maintain the necessary relativities.

In its response to GoMail's submission, Australia Post argues the margin for operators such as GoMail are largely unaffected by the proposed changes. Australia Post provides a diagram showing the price differential between PreSort (barcoded and unbarcoded) and the basic postal rate (including the new Clean Mail and unbarcoded residue rates[171]) based on a weighted average price for each service. The diagram is reproduced on the following page.

Australia Post notes that, based on the weightings used for the diagram, the current differential between Barcoded PreSort and Unbarcoded PreSort is 3.8 cents[172]. The proposed differential between Barcoded PreSort and Clean Mail is 3.6 cents. Australia Post submits that the example illustrates the introduction of Clean Mail will not have a detrimental impact on margins and that the proposed price is therefore appropriate.

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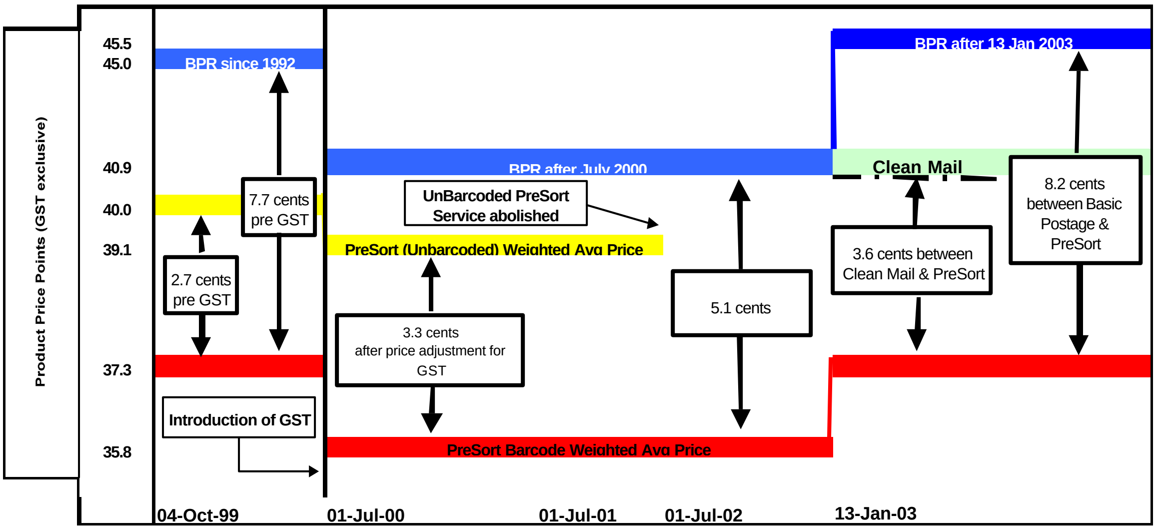
[169] GoMail submission, June 2002, pp. 4-5.

[170] GoMail submission, June 2002, p. 6.

[171] 'Clean Mail' would be a new service for customers lodging at least 300 letters which are machine addressed, minimally sorted but not barcoded. 'Unbarcoded residue' would be redefined to apply to letters which are not barcoded but lodged as part of a barcode PreSort lodgement and: a) could not be matched against a barcode in the Postal Address File (maintained by Australia Post); and b) are lodged in separate unbarcoded residue trays. While the threshold for a barcode PreSort lodgement is 300, there is no restriction on the unbarcoded residue component of that lodgement. The proposed pricing for Clean Mail and unbarcoded residue is the same, as are the addressing, envelope and sorting conditions.

[172] Note that the table puts the differential at 3.3 cents rather than 3.8 cents. The key point, however, appears to be that the difference is trivial.

Price Variation Comparison between PreSort (Barcode) Weighted Average Price vs PreSort (unbarcoded) / Clean Mail / BPR



Assumes dispersion of 60 % Same State, 40% Other State, Depth of Sort 90% Direct Tray, 10% Residue, DPID Assignment of 84%, 10,000 articles

Source: Australia Post, *Response to Public Submissions*, p. 69.

Australia Post's comparison does not address the point that, until recently, Australia Post had signalled to the industry that the unbarcoded PreSort service was to be phased out. Referring again to Australia Post's diagram, the Commission considers it likely that operators such as GoMail would anticipate and invest on the basis that after July 2002 mailers would have to barcode in order to get any discount at all. That is, mail aggregators would reasonably have expected to face the 5.1c margin between barcoded PreSort mail and the BPR (rather than the 3.3c margin between barcoded and unbarcoded PreSort mail) beyond this date.

The Commission provisionally accepts GoMail's submission that Australia Post's decision to introduce Clean Mail and increase PreSort rates narrows the margin upon which mail aggregation firms anticipated they might operate. Australia Post has actively encouraged the industry to invest in barcoding technologies. The Commission is concerned that by narrowing the margin Australia Post may generate uncertainty in the industry. This may lead to innovative operators being less likely to commit to Australia Post's directions in future, having negative implications for dynamic efficiency.

Against that, it is possible that the proposed price changes could allow for more efficient outcomes, to the extent that the new price structure is more closely aligned with the differences in the cost of providing the different services. For example, consider the following hypothetical situation.

Simplified Hypothetical

Assume Australia Post's ordinary rate exactly matches the average cost for that service. Further assume Australia Post saves an average of 1c per item from mail received as part of a barcode PreSort lodgement (compared to ordinary mail), the barcode PreSort rate is 5c below the ordinary rate, and a mail aggregator is prepared to operate for a price of 3c (which reflects the costs, including its own profit margin, of providing aggregation). A mail originator will have an incentive to use the mail aggregator, as it will be able to offer a price 2c below Australia Post's ordinary rate (5c discount from Australia Post less the 3c for aggregation). The mail originator receives a benefit of 2c, however, Australia Post incurs a loss of 4c on that item (since it receives a price 5c less than the ordinary rate, yet only saves 1c of cost). Consequently, there is a net welfare loss of 2c on the transaction. In these circumstances, any reduction in the PreSort discount (provided the discount is at least 1c) would improve efficiency by: a) reducing the number of transactions which generate the loss and b) lowering the loss per transaction. If the discount is exactly 1c, no efficiency loss should eventuate.

It follows that if the margin within which mail aggregators *currently* operate (ie, the 5c in the hypothetical above) is too broad, then maintaining the current price structure might encourage inefficient entry in this aggregation market.

However, the Commission's analysis suggests that the opposite argument applies in the case of Australia Post's price structure. That is, the margin between full rate mail and PreSort rates is, if anything, insufficient. In the earlier part of this chapter it was noted that Australia Post recovers a relatively low return in relation to costs on ordinary full rate services and a relatively high return on PreSort services. On this basis it would represent a step away from efficiency to further narrow the gap between these classes of services. Indeed, Australia Post has itself made this point.

> Pricing of the standard postal article, that is the basic postage rate, will reflect the need to maintain an affordable rate and as a result of this, the basic postage rate is not expected to fully recover the cost of providing these services. Consequently, prices for other letter services will contain a cross-subsidy to the standard postal article. That is a very important point for the forum, that in our pricing, as a result of this, the need to cross-subsidise letter prices will be set to achieve an appropriate aggregate rate of return for the letters business as a whole and that is central to our pricing principles.[173]

It follows that by *increasing* the current margin between full rate and bulk mail, more competition between mail aggregators – and hence more efficient outcomes - might be fostered.[174]

The Commission must be conscious of the effect of any price changes on the potential state of competition in markets which are related to the market for the reserved services. This is because competition is generally instrumental in promoting efficiency, which as discussed is one of the chief objectives the Commission seeks to promote when considering a price notification. The

[173] Mr Gary Lee, Australia Post, *ACCC's Technical Issues Forum*, 11 July 2002. A transcript of this forum is available at www.accc.gov.au.

[174] It should be noted that an increase in the BPR of 5c would significantly improve the profitability of ordinary mail.

Commission considers there is a reasonable case that, by introducing Clean Mail at the same time as increasing the PreSort rates, Australia Post is narrowing the margin otherwise available to operators such as GoMail. This is likely to render the conditions for competitive entry in this sector less favourable than would be the case if Australia Post either did not introduce Clean Mail or did not increase its PreSort rates.

Retailing

As noted in Chapter 6, a concern expressed by newsagents relates to the absence of a profit margin available to many retailers of postage stamps. For example, the Queensland Newsagents Federation remarks that the sale of stamps "is on the basis of cash up front purchase and at no margin to the retailer"[175]. By contrast, licensed post offices receive a discount price for products purchased from Australia Post. Australia Post also appears to have discretion over which outlets are authorised to actually sell its products.

The Commission notes that allowing an increase in the BPR may increase the potential for Australia Post to provide a margin to retailers selling stamps, and so extend the distribution of stamps through a variety of third parties. This could provide increased convenience and accessibility to consumers.

11.6 Delaying price increases

An option available to the Commission is to recommend Australia Post delays its proposed price increases. While this approach may mitigate the likelihood of Australia Post earning excessive profits, it does not address the concerns noted above regarding the efficiency of the proposed pricing structure. Specifically, adopting this option would not diminish the possibility of margin contraction in the mail aggregation market.

Furthermore, the Commission's financial modelling suggests that the period of delay would need to be substantial; ie in the order of two or more years. This creates some risk of regulatory gaming in the interim, thereby undermining the efficiency incentives the Commission is keen to sustain. Accordingly, delaying the proposed price increases is not considered a desirable option.

11.7 Conclusion

Applying the objectives derived from the relevant criteria, the Commission provisionally finds Australia Post's proposal is more defensible in relation to the proposed increase in the basic rate of postage and less defensible in relation to the proposed increase in bulk postal rates.

Accordingly, the Commission's initial view is that it should not object to the proposed increase in the basic postal rate but should object to the proposed increase in bulk postal rates.

[175] Queensland Newsagents Federation, submission, p. 1.

This approach does, however, involve some further complications. An important element of the Commission's preliminary view is the proposed introduction of Clean Mail and unbarcoded residue rates. These new services appear to have merit, in that they offer discounts that reflect the fact that mail lodged in this way provides a cost saving to Australia Post. This should prevent inefficient use of full rate mail. In particular, it protects mail users from the proposed increase in the basic postage rate for those mail items which might not be lodged in a barcode PreSort lodgement, or are part of a barcode lodgement but cannot be matched to a barcode through the Postal Address File (PAF).[176] That is, were these new services not offered by Australia Post, much of this mail would be charged the full rate. These services may also have some attraction to businesses that would otherwise pay the full postage rate. For these reasons, the Commission sees merit in not objecting to the proposed rates for these services.

The Commission considers this response would create a better alignment between costs and revenues than is currently the case. It may also minimise any welfare losses caused by price increases due to the slightly lower degree of demand sensitivity of social mail. Further it may encourage longer term dynamic efficiency by lending greater confidence to those considering investing in markets related to and dependent upon the services reserved to Australia Post.

[176] 'Unbarcoded residue', as defined in the draft notification, has a slightly different meaning to its current definition (as outlined in Australia Post's *PreSort Letters Guide*, July 2002) or to the definition which applied prior to 1 July 2002. The Commission has previously agreed to the discount on unbarcoded mail being removed on 1 July 2002. Australia Post could therefore remove the current definition/discount were the Commission to object to the proposed rates for the 'new' unbarcode residue service. Accordingly, the Commission has considered the unbarcoded residue category as a 'new' service, akin to Clean Mail.

12 Preliminary view

As noted earlier, this paper is an initial view. The Commission encourages Australia Post and mail users affected by this preliminary view to respond to this paper and address the preliminary conclusions it contains. The Commission will publish its final decision on the basis of responses to its preliminary conclusions.

In Chapter 10, the Commission's analysis of the profitability of providing reserved services under a number of alternative pricing scenarios was discussed. It was noted there that endorsing all of Australia Post's proposed price increases would appear to result in Australia Post earning excessive returns over the medium term. Such an outcome is inconsistent with the Commission's obligations under the PS Act.

In light of these concerns over the returns Australia Post might generate, Chapter 11 canvassed some of the choices available to the Commission. It was noted there that the Commission generally prefers to leave questions of price structure to the regulated business, providing the overall level of prices does not seem excessive.

In the case of Australia Post, however, the Commission's concern over the general level of prices proposed, and how this concern should be addressed, has led to the question of price structure being considered in a little more depth than might otherwise be the case. This is also suggested by the differing characteristics of bulk mail users and retail customers.

With the large number of postal products and prices covered by the draft notification, there are many possible approaches the Commission could adopt. However, each of these has advantages and disadvantages. Chapter 11 concluded that, on balance, the Commission should not object to the proposed increase in the basic postal rate but should object to the proposed increase in rates for barcoded PreSort letters. It also noted the benefits of the proposed introduction of Clean Mail and unbarcoded residue rates.

There may, however, be some undesirable effects from the introduction of Clean Mail. This is one reason the Commission considers it should object to the proposed bulk rate increases. The Commission's objection essentially applies collectively to the proposed increases to barcode pre-sort rates, although unbarcoded residue rates are the exception for the reasons outlined above.

For similar reasons, the Commission's preliminary view is to not object to the related prices for small seasonal greeting cards, small (non-bulk) barcoded and metered letters, small local delivery letters, small prepaid envelopes (both plain and window-faced) or Clean Mail prices for medium and large envelopes.

The Commission's objection does, however, extend to the proposed increases in prices for ordinary large letters, and related local delivery and prepaid letters.[177]

It should also be noted that the Commission considers that the level of prices to which it has not objected should provide Australia Post with sufficient returns over a medium term time horizon of 5 years. The Commission is mindful of the positive incentive effects that can result from establishing a level of prices to apply for a reasonable period of time. It allows for price reductions in real terms over the next 5 years. This could provide some continued stimulus to volume growth, and should provide Australia Post with continued incentives to reduce costs. At the same time, it allows a reasonable level of certainty to mail users, which can assist them in making efficient investment decisions.

In this context, the Commission would also expect Australia Post to face the risk associated with forecast volume growth and cost savings. The failure of these to materialise as anticipated should not in itself provide a case for further price increases in the intervening period.

The Commission's preliminary view is to not object to the postal charges proposed by Australia Post for the services set out in **Table 12.1**.

The Commission's preliminary view is to object to all the other **increases** in postal charges for reserved services proposed by Australia Post.[178]

The Commission notes that a number of the price changes proposed by Australia Post represent price **decreases**. Australia Post has no requirement to notify these changes and as such, the Commission does not object to them.

In light of the preliminary views expressed here, the Commission notes that Australia Post may wish to re-consider its proposed pricing and structure, in particular, for barcoded PreSort letters. The Commission is prepared to consider such proposals, but emphasises its concerns regarding overall price levels and the extent to which re-structuring might deter competition in closely related markets. In general, Australia Post should demonstrate that the re-structure would not lead to increases in average prices beyond those represented in this preliminary view.

[177] The Commission's objection (to these and to barcode PreSort rates) does not extend to those products within this list that are specifically excluded from the definition of reserved services, since Australia Post does not have to formally notify the Commission of increases in these charges.

[178] A number of the price changes proposed by Australia Post relate to services not reserved to Australia Post, and thus not declared for the purposes of the PS Act. These comprise large letters weighing more than 250g. Australia Post has no requirement to notify these changes and as such, the Commission does not object to them.

Table 12.1: Commission preliminary view – endorsed postal charges[1]

Service	Current price[3]	Proposed price
Small letter – ordinary	$0.45	**$0.50**
Small letter – Clean Mail	-	**$0.45**
Small letter – seasonal greeting	$0.40	**$0.45**
Small letter – barcoded and metered	$0.43	**$0.48**
Local delivery – small letter up to 125g	$0.41	**$0.46**
Prepaid Envelopes		
Small (DL & C6)		
Single	$0.54	**$0.60**
1-4 Packs of 10	$5.13	**$5.85**
5+ Packs of 10	$4.86	**$5.70**
Small Window Faced (DL & C6)		
Pack of 50	$25.55	**$29.70**
Pack of 500	$244.50	**$286.00**
Clean Mail		
Medium Letters - 5mm Max[2]		
Up to 125g	-	**$0.70**
Large Letters		
Up to 125g	-	**$0.98**
Over 125 up to 250g	-	**$1.43**
Over 250 up to 500g	-	**$1.98**

1. GST-inclusive
2. Provided Australia Post elects to offer this pricing category.
3. Where no current price is specified (because the service does not currently exist), the appropriate comparator is the full rate price that would apply in the event the new price was not approved.

Table 12.1 (contd.): Commission preliminary view – endorsed postal charges[1]

Service	Current price[3]	Proposed price
Unbarcoded Residue Rates – Regular Delivery		
Small Letters		
Up to 125g	-	**$0.450**
Charity Mail	-	**$0.450**
Medium Letters - 5mm Max[2]		
*Up to 50g	-	**$0.700**
Over 50 up to 125g	-	**$0.700**
Medium Letters - 20mm Max		
Up to 50g	-	**$0.803**
Over 50 up to 125g	-	**$0.803**
Over 125 up to 250g	-	**$1.034**
Large Letters		
Up to 50g	-	**$0.980**
Over 50 up to 125g	-	**$0.980**
Over 125 up to 250g	-	**$1.430**
Over 250 up to 500g	-	**$1.980**
Unbarcoded Residue Rates – Off-Peak Delivery		
Small Letters		
Up to 125g	-	**$0.435**
Charity Mail	-	**$0.435**
Medium Letters - 5mm Max[2]		
Up to 50g	-	**$0.671**
Over 50 up to 125g	-	**$0.671**
Medium Letters - 20mm Max		
Up to 50g	-	**$0.759**
Over 50 up to 125g	-	**$0.759**
Over 125 up to 250g	-	**$0.946**
Large Letters		
Up to 50g	-	**$0.957**
Over 50 up to 125g	-	**$0.957**
Over 125 up to 250g	-	**$1.353**
Over 250 up to 500g	-	**$1.815**

1. GST-inclusive
2. Provided Australia Post elects to offer this pricing category.
3. Where no current price is specified (because the service does not currently exist), the appropriate comparator is the full rate price that would apply in the event the new price was not approved.

Appendix A Proposed prices

Proposed Price Structure - January 2003

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

Ordinary Letters

	Current	Proposed	% Change
Small Letters			
Ordinary	$ 0.45	$ 0.50	11.1%
Clean Mail	$ 0.45	$ 0.45	0.0%
Seasonal Greeting	$ 0.40	$ 0.45	12.5%
Barcoded and Metered	$ 0.43	$ 0.48	11.6%
Large Letters			
Seasonal Greeting Cards			
Up to 125g	$ 0.98	$ 0.90	-8.2%
Ordinary Letters			
Up to 125g	$ 0.98	$ 1.00	2.0%
Over 125 up to 250g	$ 1.47	$ 1.50	2.0%
Over 250 up to 500g	$ 2.45	$ 2.50	2.0%
Ordinary Letters Barcoded and Metered			
Up to 125g	$ 0.94	$ 0.96	2.1%
Over 125 up to 250g	$ 1.41	$ 1.44	2.1%
Over 250 up to 500g	$ 2.36	$ 2.41	2.1%
Clean Mail			
Medium Size - 5mm max thick			
Up to 125g	$ 0.98	$ 0.70	-28.6%
Large Size			
Up to 125g	$ 0.98	$ 0.98	0.0%
Over 125 up to 250g	$ 1.47	$ 1.43	-2.7%
Over 250 up to 500g	$ 2.45	$ 1.98	-19.2%

Notes/Comments: Ordinary Letters
Small, 45 to 50; Large rounded to multiples of 50c

Introduction of "clean" mail price for unbarcoded letters - minimum 300 per lodgement subject to compliance with Clean Mail conditions of service (tba)
Introduction of "Large" seasonal greeting card rate

Local Delivery

	Current	Proposed	% Change
Small Letters			
Up to 125g	$ 0.41	$ 0.46	12.2%
Medium Letters *			
Up to 50g	$ 0.54	$ 0.60	11.1%
Over 50 up to 125g	$ 0.65		-7.7%
Over 125 up to 250g	$ 0.87	$ 0.90	3.4%
Large Letters			
Up to 50g	$ 0.76	$ 0.85	11.8%
Over 50 up to 125g	$ 0.93		-8.6%
Over 125 up to 250g	$ 1.20	$ 1.20	0.0%
Over 250 up to 500g	$ 1.31	$ 1.35	3.1%

Notes/Comments - Local Delivery
Small price increased to remain 4c lower than full rate and similar to clean mail
0 to 50g and 50 to 125g prices combined into a 0 to 125g price.
* Medium Letter stays at up to 20mm thickness and 250g in weight.

PrePaid Envelopes

	Current Prices			Proposed Prices			% Change		
	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10
Plain Envelopes									
Small (DL and C6)	$ 0.54	$ 5.13	$ 4.86	$ 0.60	$ 5.85	$ 5.70	11.1%	14.0%	17.3%
C5 Size	$ 1.19	$ 11.31	$ 10.71	$ 1.20	$ 11.70	$ 11.40	0.8%	3.5%	6.4%
C4 Size	$ 2.37	$ 22.52	$ 21.33	$ 2.40	$ 23.40	$ 22.80	1.3%	3.9%	6.9%
B4 Size	$ 2.70	$ 25.65	$ 24.30	$ 2.80	$ 27.30	$ 26.60	3.7%	6.4%	9.5%
Window Faced		Pk of 50	Bx of 500		Pk of 50	Bx of 500		Pk of 50	Bx of 500
Small (DL and C6)		$ 25.65	$ 244.50		$ 29.70	$ 286.00		16.2%	17.0%

Notes/Comments - PrePaid Envelopes

Small Letter prices increased in line with BPR and to reflect increased stationary costs

Large Letter prices increased slightly, to reflect change to Ordinary prices, with rounding to five cent multiples.

Per pack discounts reduced from 5% for one to four packs and 10% for five or more packs, to 2.5% and 5% respectively

Barcode PreSort Letters

Regular Delivery	Same State BDT			Other State BDT			Barcode Residue			Unbarcoded Residue #		
Size / Weight	Current	Proposed	% Var	Current	Proposed	% Var	Current	Proposed	% Var	Current*	Proposed	% Var
Small Letters												
Up to 125g	$ 0.374	$ 0.396	5.9%	$ 0.385	$ 0.407	5.7%	$ 0.424	$ 0.429	1.2%	$ 0.424	$ 0.450	6.1%
Charity Mail	$ 0.312	$ 0.334	7.1%	$ 0.323	$ 0.345	6.8%	$ 0.356	$ 0.380	6.7%	$ 0.356	$ 0.450	26.4%
Medium Letters -5mm Maximum thickness												
Up to 50g	$ 0.461	$ 0.484	5.0%	$ 0.478	$ 0.506	5.9%	$ 0.614	$ 0.572	-6.8%	$ 0.614	$ 0.700	14.0%
Over 50 up to 125g	$ 0.565		-14.3%	$ 0.598		-15.4%	$ 0.724		-21.0%	$ 0.724		-3.3%
Medium Letters -20mm Maximum thickness												
Up to 50g	$ 0.461	$ 0.572	24.1%	$ 0.478	$ 0.594	24.3%	$ 0.614	$ 0.671	9.3%	$ 0.614	$ 0.803	30.8%
Over 50 up to 125g	$ 0.565		1.2%	$ 0.598		-0.7%	$ 0.724		-7.3%	$ 0.724		10.9%
Over 125 up to 250g	$ 0.724	$ 0.759	4.8%	$ 0.779	$ 0.792	1.7%	$ 0.889	$ 0.902	1.5%	$ 0.889	$ 1.034	16.3%
Large Letters												
Up to 50g	$ 0.735	$ 0.770	4.8%	$ 0.790	$ 0.825	4.4%	$ 0.900	$ 0.935	3.9%	$ 0.900	$ 0.980	8.9%
Over 50 up to 125g	$ 0.790		-2.5%	$ 0.845		-2.4%	$ 0.933		0.2%	$ 0.933		5.0%
Over 125 up to 250g	$ 1.119	$ 1.144	2.2%	$ 1.229	$ 1.254	2.0%	$ 1.338	$ 1.364	1.9%	$ 1.338	$ 1.430	6.9%
Over 250 up to 500g	$ 1.591	$ 1.595	0.3%	$ 1.700	$ 1.705	0.3%	$ 1.810	$ 1.815	0.3%	$ 1.810	$ 1.980	9.4%

Off Peak Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue #		
Size / Weight	Current	Proposed	% Var	Current	Proposed	% Var	Current	Proposed	% Var	Current*	Proposed	% Var
Small Letters												
Up to 125g	$ 0.363	$ 0.385	6.1%	$ 0.374	$ 0.396	5.9%	$ 0.402	$ 0.418	4.0%	$ 0.402	$ 0.435	8.2%
Charity Mail	$ 0.296	$ 0.319	7.8%	$ 0.301	$ 0.325	8.0%	$ 0.340	$ 0.363	6.8%	$ 0.340	$ 0.435	27.9%
Medium Letters -5mm Maximum thickness												
Up to 50g	$ 0.434	$ 0.462	6.5%	$ 0.445	$ 0.484	8.8%	$ 0.587	$ 0.550	-6.3%	$ 0.587	$ 0.671	14.3%
Over 50 up to 125g	$ 0.516		-10.5%	$ 0.533		-9.2%	$ 0.675		-18.5%	$ 0.675		-0.6%
Medium Letters -20mm Maximum thickness												
Up to 50g	$ 0.434	$ 0.528	21.7%	$ 0.445	$ 0.545	22.5%	$ 0.587	$ 0.638	8.7%	$ 0.587	$ 0.759	29.3%
Over 50 up to 125g	$ 0.516		2.3%	$ 0.533		2.3%	$ 0.675		-5.5%	$ 0.675		12.4%
Over 125 up to 250g	$ 0.653	$ 0.682	4.4%	$ 0.669	$ 0.704	5.2%	$ 0.818	$ 0.830	1.5%	$ 0.818	$ 0.946	15.6%
Large Letters												
Up to 50g	$ 0.713	$ 0.759	6.5%	$ 0.757	$ 0.803	6.1%	$ 0.878	$ 0.913	4.0%	$ 0.878	$ 0.957	9.0%
Over 50 up to 125g	$ 0.768		-1.2%	$ 0.823		-2.4%	$ 0.911		0.2%	$ 0.911		5.0%
Over 125 up to 250g	$ 1.048	$ 1.067	1.8%	$ 1.119	$ 1.144	2.2%	$ 1.268	$ 1.280	0.9%	$ 1.268	$ 1.353	6.7%
Over 250 up to 500g	$ 1.300	$ 1.320	1.5%	$ 1.372	$ 1.397	1.8%	$ 1.569	$ 1.650	5.2%	$ 1.569	$ 1.815	15.7%

Notes/Comments - PreSort Letters

\# Unbarcoded component to be eligible for an Unbarcoded Residue Price. Price consistent with clean mail, but enveloping and addressing requirements to be as per Barcode PreSort

* Current price shown for Unbarcoded Residue is the Barcode Residue price, eligible under the 90/10 rule. The Proposed price will apply to all Unbarcoded items in a barcoded lodgement.

Small PreSort

Prices increased by around 2c (GST exclusive) across the board

Medium PreSort

Redefined into two segments.

First segment to be one weight step (up to 125g) and 5mm in thickness to align with MLOCR and BCS processing capabilities (current max dimensions; 250g and 20mm thick). The 0 to 125g price is set just above the old 0-50g price plus an additional 2c.

Second Segment to be two weight steps, with the current 0-50g and 50-125g merged into a single up to 125g step. The new 0 to 125g price is set marginally above the previous 50 to 125g price.

Large PreSort

0-50g and 50-125g merged to a 0 to 125g, price set in middle, plus add 2c

Appendix B Summary of submissions

The following is a brief summary of the main points made in the submissions received in response to the Commission's initial view on Australia Post's pricing proposal.

Major Mail Users Association

The MMUA makes the following comments:

- MMUA is opposed to the proposed increase in the basic postage rate from 45 cents to 50 cents.
- As yet, Australia Post has not captured all of the potential productivity gains that can be achieved within the 'FuturePOST' project.
- Australia Post has contributed to the decline in the volume of paper-based forms of communication by concentrating on promoting non paper-based forms of communication.
- Australia Post has opted for the easy way out by asking for a price increase in an uncertain market, a luxury that commercial enterprises do not have in a competitive marketplace.
- Australia Post should be subject to more stringent monitoring and transparency requirements.
- A broader analysis of Australia Post's proposal is necessary. In particular, the combined impact of the present notification and past notifications should be considered. Additionally, it is important to consider the impact of the proposed price change on both reserved and unreserved postal services.
- With regards to mail aggregation, duty of care should be upheld and the reasoning behind the introduction of 'Clean Mail' should be further investigated.

Australian Direct Marketing Association (ADMA)

In its submission, ADMA raises a number of issues:

- The withdrawal of the AdPost service and the proposed price changes will significantly increase prices.
- Australia Post's mailing conditions have become more restrictive.
- The increase in the postal address file (PAF) pass rate requirement from 90% to 100% is unrealistic.

- Time and money was invested in software and systems development to ensure compliance with the new barcoding lodgement process set out by Australia Post and Australia Post has diminished the value of this investment by introducing Clean Mail.

- The Clean Mail service is welcomed in principle. However, ADMA acknowledges that significant investment has been made to accommodate the barcoding and that the service eliminates competitors such as GoMail.

GoMail

GoMail's submission expresses concerns with regards to claims made by Australia Post. They are that Australia Post has:

- Underestimated the impact on users of the proposed price increases.

- With the introduction of Clean Mail, Australia Post is deliberately attempting to curb the growth of the aggregation sector in the major mail segment of the market.

- With regard to efficiency of Australia Post's operations, GoMail suggests that Australia Post has improved over the last decade but there is still room for improvement.

- Overestimated the decline in mail volume growth over the next five years and will contribute to the decline in mail volume growth.

- With regard to its CSO, made claims regarding the cost of maintaining its CSO's that are driven more on fear and implied threat than economic substance. GoMail explains that there is a cost of meeting those universal obligations, but such a cost obligation should be seen as part of the premia for its privileged monopoly status.

Reader's Digest

Reader's Digest opposes Australia Post's proposed price changes and makes the following claims:

- Australia Post underestimates the impact of the proposed price increases.

- The Clean Mail service is a promising discount service, however use of the service is subject to highly specific lodgement criteria.

- Australia Post overestimates the potential decline in mail volume growth and will contribute to the decline in mail volume growth with the proposed increase in prices.

- Australia Post has not reached its full potential for productivity improvement.

- The introduction of a new pre-sort medium letter category to align with Australia Post's small letter processing capabilities is a positive move.

- Reader’s Digest, on several occasions, also expresses its support for the concerns and issues raised in the MMUA and ADMA submissions.

Printing Industries Association of Australia (PIAA)

PIAA opposes the proposed price notification submitted to the Commission. It states that the additional price rises combined with the elimination of the AdPost service and the introduction of barcoding will have a significant effect on printers and mailing houses. It also notes that significant investment was made to accommodate Australia Post’s introduction of mail sorting equipment on the proviso of keeping costs down and other benefits such as generating more efficient mailing lists. Finally, PIAA expresses a concern about Australia Post’s inflexible attitude towards requirements for discounted mail.

Subsequent submissions from the Printing Industries Association of Australia

PIAA made the following comments in response to Australia Post’s response to public submissions:

- PIAA claims that Australia Post inadequately addresses the issue of offshore printing mailing.
- Specifically, PIAA states that Australia Post’s price increases and restrictive limitations on shapes and sizes of mail have disadvantaged Australian printing companies.
- PIAA stresses that Australia Post’s proposed changes will have a significant impact, especially with advertising substitutes such as email and the internet available.
- PIAA argues that the combination of the proposed changes, the withdrawal of the AdPost service and the introduction of barcodes will have a serious and detrimental effect on the printing industry.
- PIAA concludes that it opposes the proposed notification of price changes submitted by Australia Post.

Penfold Buscombe Limited (PB)

The Commission received correspondence from PB expressing concern about Australia Post’s proposal. The primary issue brought to the Commission’s attention concerned the proposed price increases potential to impact dramatically on the printing industry, particularly after the withdrawal of the AdPost service.

Subsequent submissions from Penfold Buscombe Limited

PB submitted the following comments to the Commission after attending the Technical Issues Forum and reading Australia Post’s response to public submissions:

- PB argues that, similar to the newsagencies, it bears significant costs to accommodate Australia Post for which it sees little in return.
- PB claims that Australia Post has restrictive mail formatting and barcoding conditions compared with other postal services around the world.
- PB refutes Australia Post's comments that it will not deliver mail printed overseas, arguing that under international agreements Australia Post is required to deliver this mail.
- PB stresses the importance of comments made by large representative associations such as MMUA, ADMA and PIA.
- PB suggests that Australia Post should completely open all services to competition, if it performing so well.
- PB strongly disagrees with Australia Post's comments that "the proposed changes proposed will have any significant impact on the use of mail as an advertising medium".
- PB suggests that the AdPost decision should be reconsidered in light of this application for a further price rise in barcoded mail costs, when the impact of the July increase can be determined.
- PB does not object to the increase in the retail stamp as that would appear to be justified following the introduction of the GST by the Government.
- PB concludes that it opposes any increase to business for cost of postage.

Queensland Newsagents Federation (QNF)

The QNF expresses concerns on these matters:

- The terms under which Australia Post allows access to postage stamps and other postal products.
- The cross-subsidisation of retail activities by reserved activities of Australia Post.
- The lack of transparency in Australia Post's operations between reserved activities and other competitive retail activities.

Queensland Retail Traders & Shopkeepers Association (QRTSA)

The QRTSA states that it fully supports the QNF submission. In particular, the QRTSA expresses concern about the lack of margin on stamps and Australia Post's use of cross-subsidisation.

Newsagents Association of South Australia Limited (NASA)

NASA raises three concerns in its submission:

- Australia Post's failure to provide access to postal stamps and other postal products. It argues that retailers are helping Australia Post meet its CSO.
- Australia Post's commercial activities are being subsidised by its reserved activities.
- The transparency in Australia Post's financial reports. It suggests that Australia Post's clearly break down its commercial operations and its reserved activities in its financial reports.

Post Office Agents Association Limited (POAA)

The POAA supports Australia Post's proposal to increase prices. It claims that the profitability of licencees has declined, with real decreases in both volume and price and limited opportunities to achieve productivity gains. It states that the proposal to increase the standard rate of postage will translate directly into revenue for licencees and help to maintain the existing retail network.

National Farmers Federation (NFF)

The NFF suggests that the publicly available information provided by Australia Post does not enable it to make a fully informed decision on whether the postage price rise is needed. It claims that Australia Post does not explain whether the price increase is needed to maintain existing rates of return, or whether the increase will actually add to profit levels. In addition, Australia Post is unclear on whether the funds from the increase will be used to bolster profit and dividends or will they go to maintaining and enhancing its present service and infrastructure.

Magnamail Pty Limited

In its submission, Magnamail argues that the impact of the proposed price changes will be so significant that it will force Magnamail to adopt alternative strategies. Magnamail is a privately owned mail order company that distributes catalogues nationally throughout Australia and New Zealand. Magnamail also questions the restrictiveness of Australia Post's barcoding match rates.

DoubleDay Australia Pty Limited

Doubleday strongly disagrees with the changes proposed in Australia Post's price draft notification. It argues that the proposed price changes will have a significant negative impact on the operations of its business. (Doubleday is a direct marketing company of book and music products in Australia.) In addition, Doubleday feels that it has borne significant costs to accommodate Australia Post's introduction of barcodes and had accepted the withdrawal of AdPost, factors that should have been taken into consideration.

Action Words

Action Words, as a copywriting business specialising in writing for direct marketing, claims that while all direct marketers want to avoid cost, a small increase in postage, in itself, is unlikely to force traders to walk away from direct mail. It stresses that when assessing the likely effects of any individual increase in costs of direct mail, it is necessary to take into account the full costs of direct mail promotions. Where 'lifetime true value[179]' is considered it is unlikely that a small increase in postage is likely to make profitable promotions unprofitable.

Rapp Collins Australia

Rapp Collins Australia, a direct marketing agency, claims that a small increase to the price of postage is in this instance more than justified. It states that when you look at the proposed increases as a proportion of the total campaign spend, the effect is minimal. In addition, its suggests that Australia Post's attempts to provide value added services and its support of the Direct Marketing Industry be taken into consideration.

R.A. Sorrenti & Co

R. A Sorrenti, a small accounting practice, opposes the proposed price increases of Australia Post. R.A. Sorrenti claims that customers have endured significant increases in costs and that Australia Post has benefited from the introduction of the GST.

Wynnum Plaza Post Office (WPPO)

WWPO supports Australia Post's proposed price increases on the terms that the licensees' commission on postage continues to be based on the full value of standard postage and not on that amount less the GST.

Charleville Newsagency

This submission states that it fully endorses the submission of the Queensland Newsagents Federation. In particular, it argues that as small newsagents are largely offering to sell postal products as a community service they should be able to compete equitably with Australia Post.

ALP East Lake Macquarie Branch

The East Lake Macquarie Branch opposes Australia Post's proposed increases in price. It states that parcel charges have increased substantially and the branch questions the reasons behind Australia Post' proposed price increases.

[179] Action Words states that the principle of 'lifetime true value' is that traders make money from customers they win, over the longer term – or over the lifetime of the customer.

Australian Commercial Galleries Association (ACGA)

ACGA stresses that the proposed changes will contribute to the increased cost of postage already experienced following the removal of the AdPost concessions. It also states that as the new PreSort letter service only applies to barcoded envelopes, for which equipment is required, galleries will incur further cost increases. Therefore, ACGA expresses considerable concern about the proposed increase of 5 cents in the cost of the basic letter postage rate.

Tamworth and District Chamber of Commerce and Industry

The Tamworth and District Chamber of Commerce and Industry is concerned that the increases proposed by Australia Post could have a negative effect on small business and the non-profit service industry in the Tamworth area.

KU Children's Services

KU Children's Services comments that it finds the services offered by Australia Post's unreliable and restrictive.

Mr R. Cook

Mr Cook expressed his view that price of postal services should not increase as Australia Post has not improved its service.

Mrs A. Potts

Mrs Potts stresses that the proposed price increases will have a negative impact on senior citizens as many do not have access to alternative communication facilities and have limited incomes.

Mrs M. Chipper

Mrs M. Chipper expresses her dissatisfaction with the service provided by Australia and argues that there is no justification for price increases.

Ms V. Breen

Ms Breen opposes Australia Post's proposed price changes. She states that prices are already high and that the service of Australia Post has not improved.

J. Clark

J. Clark advocates Australia Post maintaining its current prices, as this provides a valuable service to the community and Australia Post makes profits on its other services.

Mr K. Carr

Mr Carr questions the amount of profit that Australia Post makes on the letter service and asks how much is needed and why.

Mr A. Miles

Mr Miles comments that he does not oppose an increase in the price of the 45 cent stamp. He does however believe that the price of stamps for large letters should be an exact multiple of the new basic postage rate.

Dr P. Colebatch

Dr Colebatch expresses the view that the price of stamps should not be allowed to increase as it will reduce the incentive to write letters.

Mr D. Lardner

Mr Lardner believes that an increase in the price of stamps should only be allowed if Australia Post increases the frequency and improves the quality of its service. Mr Lardner also believes that Australia Post's legislated monopoly rights need to be re-assessed.

Appendix C Relevant legislative instruments

COMMONWEALTH OF AUSTRALIA

Prices Surveillance Act 1983

DECLARATION NO 75

I, PETER BALDWIN, Minister of State for Higher Education and Employment Services, acting for and on behalf of the Treasurer, in pursuance of section 21 of the Prices Surveillance Act 1983, hereby:

(1) revoke declaration No 53 of 18 April 1989 relating to the transmission of standard postal articles and registered publications by the Australian Postal Corporation published in the Commonwealth of Australia Gazette No. GN 16 of 3 May 1989; and

(2) declare:

(a) the provision of letter services reserved to Australia Post under Division 2 of Part 3 of the *Australian Postal Corporation Act 1989*, and the carriage within Australia of registered publications, to be notified services for the purposes of the Act; and

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

Dated this fifth day of February 1992.

Peter Baldwin

Minister of State for Higher Education and Employment Services

acting for and on behalf of the Treasurer

COMMONWEALTH OF AUSTRALIA

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 14th day of September 1990.

Simon Crean
Minister of State for Science and Technology
Acting for and on behalf of the Treasurer

Appendix D Quality of postal services

Service performance is an important consideration in any assessment of Australia Post's prices. Deteriorating service performance at an unchanged price is seen by many consumers as being tantamount to an effective price increase, as customers are getting less for what they pay. Whilst assessing previous notifications, the Commission's predecessor, the Prices Surveillance Authority, expressed concern about Australia Post's quality of service levels.

Section 27 of the *Australian Postal Corporation Act 1989* (the Act), requires that, as part of its community service obligation (CSO), Australia Post's performance standards for the letter service must reasonably meet the social, industrial and commercial needs of the Australian Community.

The *Australian Postal Corporation Amendment Act 1994* (No. 142) introduced a new division to the Act, related to performance standards and audits. Included in the amended Act, section 28C states that regulations may prescribe performance standards to be met by Australia Post. These standards must relate to:

1. The frequency, speed or accuracy of mail delivery; or

2. The availability or accessibility of:

    a) postboxes or other mail lodgement points; or

    b) offices of Australia Post or other places from which Australia Post products and services may be purchased.

The Act does not specify Australia Post's obligations beyond section 28C and therefore Australia Post has had the task of translating its CSO requirements into an operating policy. Notwithstanding this, section 49 of the Act stipulates that, in consultation with the Australia Post Board, the Minister may give to the board written directions in relation to the performance of Australia Post's functions as he/she sees fit.

As with the Prices Surveillance Authority, the National Competition Commission (NCC), in its 1998 *Review of the Australian Postal Corporation Act*, also acknowledged that Australia Post had in the past provided lower than required levels of service. However the NCC found that at the time of the report's publication, Australia Post was providing a reasonable level of performance, although the NCC did remain concerned that Australia Post was responsible for defining the scope of the CSOs. The NCC was concerned that Australia Post might concentrate on its commercial objectives at the expense of its CSOs.

Following the NCC's report, in 1998 the Minister released Australia Post's inaugural Service Charter. The charter sets out the standards which to be expected from Australia Post, including delivery and posting times, lodgement points, the price and availability of stamps and complaint handling procedures. The Service Charter is underpinned by a set of minimum performance standards developed under the regulations to the Act.

These standards require Australia Post to:

- provide a daily weekday delivery service to 98 per cent of all delivery points in Australia and at least a twice weekly delivery service to 99.7 per cent of all delivery points;

- to deliver 94 per cent of all reserved letters within the time specified in Australia Post's schedule of delivery times;

- to maintain 10,000 street posting boxes in addition to providing lodgement facilities at each of its retail outlets; and

- maintain at least 4,000 postal outlets of which at least 50 per cent of the total number or a minimum of 2,500 (whichever is the greater) must be located in rural or remote areas.

As stipulated by section 28D of the Act, the Auditor General is required to report on compliance with the performance standards. The Australian National Audit Office is required to report annually to the Minister on the extent to which Australia Post has complied with these regulations. This report, together with a breakdown of the actual performance achieved, is included in Australia Post's Annual Report. Results for the last four (reported) financial years are as follows:

Requirement	1997/1998	1998/1999	1999/2000	2000/01
98% of delivery points to receive deliveries 5 days/week	98%	98.10%	98.2%	98.6%
99.7% of delivery points to receive deliveries no less than twice a week	100.0%	100.0%	99.9%	99.9%
94% of reserved letters delivered on time	94.2%	94.4%	91.6%	94.1%
10,000 street posting boxes	11,980	14,444	15,288	15,386
4,000 postal outlets (2,500 in rural or remote areas	4,481 (2,580 rural and remote)	4,425 (2,527 rural and remote)	4,479 (2,569 in rural and remote)	4,491 (2,580 in rural and remote areas)

These results show that Australia Post has almost always met the minimum standards set by the regulations. Furthermore, Australia Post has increased its supply of street posting boxes as well as postal outlets, and improved on its requirement to make deliveries 5 days a week to at least 98% of delivery points. Australia Post's on-time delivery for reserved services has decreased slightly but remains high and above minimum requirements, with the exception of 1999/00. Similarly, whilst Australia Post's performance in delivering mail to at least 99.7% of delivery points no less than twice a week has fallen slightly, it remains very high and above minimum standards.

In addition to the National Audit Office's role, Australia Post currently has a contract with KPMG to independently audit the performance of Australia Post's domestic letter service. In March 2002, KPMG released a quarterly audit report summarising findings over the previous 69 months. This report measures Australia Post's overall letter service performance against its delivery undertakings. KPMG's analysis suggests an overall increase in letter delivery performance over time.

Appendix E Details on ACCC Public Forums

To assist in the review of the submission, the Commission held Public Forums at a number of locations around the country. The Public Forums were scheduled as follows:

City	Date	Location
Brisbane	Monday 17 June, 9:30am	ACCC Office, Level 3, AAMI Building, 500 Queen Street, Brisbane
Townsville	Tuesday 18 June, 10am	Plaza Hotel Cnr Flinders and Stanley Street, Townsville
Sydney	Wednesday 19 June, 1:30pm	Sheraton on the Park 161 Elizabeth Street, Sydney
Adelaide	Thursday 20 June, 9:30am	ACCC Office, Level 14, ANZ House 13 Grenfell Street, Adelaide
Perth	Friday 21 June, 9am	Boardroom at Novotel Langley Perth Hotel 221 Adelaide Terrace, Perth
Hobart	Monday 24 June, 10am	Hobart Function and Conference Centre, Elizabeth Street Pier, Hobart
Melbourne	Tuesday 25 June, 10am	ACCC Office, Level 35, The Tower, 360 Elizabeth Street, Melbourne
Tamworth	Thursday 27 June, 9:30am	Tamworth Town Hall, Fitzroy Street, Tamworth
Canberra	Friday 28 June, 2:30pm	ACCC Office, Level 7 470 Northbourne Avenue, Dickson
Darwin	Friday 28 June, 2pm (linked to Canberra forum by VCU)	ACCC Office, Level 8 9-11 Cavenagh Street, Darwin

Appendix F Post related markets

SERVICE	Current competition	DESCRIPTION	COMMENTS
Retail sale of stamps	✓	Outlets, such as newsagencies, which are Licensed Stamp Vendors (LSVs) can sell stamps but provide no other postal services. What the community sees as Post Offices are operated under a range of arrangements: small businesses own and operate Licensed Post Offices (LPOs), Community Postal Agencies (CPA) and Postpoints (PPs). Australia Post itself operates and owns corporate offices including post offices, retail shops and business centres.	While they are licensed to sell stamps at face value, LSVs receive no commission whereas LPOs, CPAs and PPs receive a commission for the sale of stamps. The number of sales points are restricted to protect returns to vendors.
Printing	✓	The sender may provide an electronic or hard copy of the material to be mailed which is then reproduced/printed in large quantities. For example, an electronic record of billings is provided to the printing service.	Australia Post also provides this service. It may achieve a competitive advantage arising from the reservation of the collection and carriage of mail. Service also provided by Mail Houses as well as printers.
Packaging (inserting materials into envelopes or other covers for mailing) and addressing	✓	Businesses with large volume mailings may outsource this service. This step may be incorporated into the printing step.	Australia Post also provides this service. It may achieve a competitive advantage arising from the reservation of the collection and carriage of mail. Service also provided by Mail Houses.

Mail aggregation		Aggregates and sorts the bulk mail of small businesses, which would not on their own qualify for bulk mail discounts.	Australia Post is in a position to determine the terms and conditions of access to its network as well as prices which can impact on the ability of competitors to enter and operate in this market.
Sorting and barcoding	✓	Bulk mail letters may be sorted and barcoded by the sender or by a third party. If not sorted or barcoded, this function is performed by Australia Post after lodgement.	This can be performed by sender or by a third party.
Collection service		Picks up mail from sender.	A service offered by Australia Post
Transport to interconnection point	✓	Carries bulk mail from one state to another to obtain same state discounts.	This can be performed by sender.
Sorting after lodgement. Transport to delivery centres. Sorting and delivery.		The processes followed after lodgement of mail at a post office until delivery to the recipient.	Reserved to Australia Post.
Mail holding		When the mail is not delivered directly to the addressee but is held either for a certain period of time or for collection.	Service offered by Australia Post.
Mail redirection		Where mail is redirected to another address e.g. if addressee has moved.	Service offered by Australia Post.
Courier services	✓	Letters are carried from door to door.	An alternative to Australia Post as long as the price is more than 4 times the BPR.
Document exchange (DX)	✓	Letters collection and delivery service provided on a	An alternative to Australia Post under a specific

		B2B (business to business) basis, member to member.	exemption.