ACCC view on Australia Post's draft price notification

November 2022

Contents

Executive summary

The ACCC does not object to Australia Post's proposed price increase for its reserved ordinary letter service,[1] as described in its draft price notification provided to the ACCC on 11 August 2022.

Australia Post is proposing to increase the price for reserved ordinary small letters delivered to the regular timetable by 9.1% (from $1.10 to $1.20).[2] It also proposes to increase the prices for the delivery of reserved ordinary large letters delivered to the regular timetable by 9.1% (from $2.20 to $2.40 for letters less than 125 grams, and from $3.30 to $3.60 for letters between 125 and 250 grams).

Australia Post's proposed price increase does not affect the price of concession stamps (60 cents).[3] Stamps for seasonal greeting cards (65 cents) will also remain unchanged.

The last time the ACCC considered a price notification to Australia Post's notified letter services was in 2019. Following an assessment process, the ACCC did not object to a 10% increase in the price of the notified services. In this 2022 draft price notification, Australia Post has taken a similar approach to key elements underpinning its proposal, such as its cost allocation methodology and approach to forecasting letter volumes.

However, other factors have changed that are significant to our assessment of this draft price notification. These include a further decline in letter volumes, an increase in delivery points across the country, the impact of COVID-19 on Australia Post's service delivery, and the current economic climate, including rising inflation.

In 2019 the ACCC noted that Australia Post had exceeded the efficiency targets it set for its monopoly letter services in 2015 but had not made efficiency gains in its delivery operations.[4] Due to the challenges caused by COVID-19 since early 2020, we have not focused on assessing Australia Post's efficiency outcomes since 2019 but intend to review the outcomes of their business efficiency program in future price notifications.

The ACCC has considered Australia Post's draft price notification and the submissions received through public consultation. The ACCC has come to the view that Australia Post is not likely to recover revenue in excess of efficient costs for reserved and notified postal services over the period to 2022–24 if the proposed 9.1% increase in the price of notified services is implemented.

Process

Australia Post's reserved ordinary letter services are part of the services for which Australia Post has a statutory monopoly and are declared as 'notified services' for the purposes of section 95Z of Part VIIA of the *Competition and Consumer Act 2010* (CCA).

As the reserved ordinary letter services are 'notified services',[5] Australia Post cannot increase its prices without notifying the ACCC and the Minister for Communications of its intentions.

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1. Australia Post's reserved ordinary letter services are reserved letter services which do not involve the supply by Australia Post of a specified special services for which a special charge or additional fee is payable.
2. This report refers to prices in nominal terms unless otherwise specified.
3. Sold in booklets of 5 for $3.
4. ACCC, *ACCC view on Australia Post's draft price notification,* November 2019, pp 20-22.
5. If the price of priority stamped letters is more than 1.5 times the price for an equivalent ordinary letter, it also falls into the scope of notified letter services. At this time the price of priority stamped letters is less than 1.5 times the price for an equivalent ordinary letter, and therefore priority stamped letters are not currently notified letter services.

Australia Post's obligations in this regard relate only to its notified services. Australia Post is not subject to any obligation to notify the ACCC in relation to a decision to increase the price of any non-notified service, such as parcel services.

The ACCC must consider Australia Post's proposal to increase the price of the notified services and decide to:

- not object to the price increase
- not object to a price that is less than that proposed
- object to the price increase.

Australia Post is not permitted to increase the price of the notified services until:

- 21 days have elapsed since the notification to the ACCC, or the ACCC has decided to not object
- 30 days have elapsed since the notification to the Minister and the Minister does not disapprove the proposed increase.

The ACCC now expects to receive a formal price notification[6] from Australia Post. If this formal notification is in the same form as the draft price notification, the ACCC intends to issue a final decision consistent with the view expressed in this report – to not object to the proposed price increase for the reserved ordinary letter services.

Australia Post intends to implement the proposed price increase in January 2023 subject to the Minister not disapproving the increase.

[6] Also referred to as a 'locality notice' under s 95Z(5) of the CCA.

Findings

The ACCC does not object to Australia Post's proposed price increase for its notified services.

As detailed in part 2 of this report, the ACCC considers that:

- Australia Post's ordinary letter prices remain lower than most international comparators
- the proposed prices are likely to remain affordable for most consumers and small businesses
- Australia Post is proposing to maintain current service delivery standards.

The ACCC has found that Australia Post is unlikely to earn revenue in excess of efficient costs for reserved services with the proposed increase in prices. This is because:

- since the last assessment, the number of new delivery addresses has increased by around 400,000 and the annual volume of domestic addressed letters delivered by Australia Post has declined by around 280 million[7]
- letter volumes are expected to continue to decline by 9.3% per annum through to 2023-24 (part 3)
- Australia Post has adopted efficiency measures that are in line with international best practice (part 4)
- while there is potentially more Australia Post could do to further improve efficiency, any further cost savings are not likely to compensate for the fall in letter volume (parts 4 and 5)
- Australia Post is expected to continue to under-recover its efficient costs for its reserved letter segment under scenarios where alternative values for key inputs, such as cost of capital, are adopted (parts 6 and 7).

[7] Australia Post, *Draft price notification*, August 2022, p 7.

1. Introduction

1.1. Australia Post's draft price notification

On 11 August 2022, Australia Post submitted a draft price notification to the ACCC proposing to increase the prices charged for delivering reserved ordinary small and large letter services to its regular timetable by 9.1% from January 2023.[8]

Australia Post's proposal would raise the price of delivery of:

- small letters from $1.10 to $1.20
- large letters up to 125 grams from $2.20 to $2.40
- large letters between 125 grams and 250 grams from $3.30 to $3.60.[9]

1.2. Australia Post's legislative obligations

1.2.1. Reserved and notified services

Under s 29 of the *Australian Postal Corporation Act 1989* (Cth) (the Postal Act), Australia Post has exclusive rights over the provision of 'reserved services'. These services include the domestic carriage of letters weighing no more than 250 grams and the issue of postage stamps.

Australia Post's reserved letter services for ordinary letters are 'notified services' under the CCA (the notified letter services).[10] Where Australia Post proposes to increase the price of a notified letter service, it must notify the ACCC of the proposal.

Australia Post is not permitted to increase its prices until 21 days have elapsed since the notification or the ACCC has decided to not object to the proposal.

In addition to the ACCC's assessment, Australia Post must give written notice to the Minister for Communications of its intent to vary the postage rate for reserved ordinary letters. Australia Post may increase the rates only if the Minister does not disapprove the proposed rates within 30 days of receiving notification from Australia Post.[11]

Parcel services and ordinary large letters weighing more than 250 grams are not reserved or notified, and their prices are not subject to ACCC review.

1.2.2. Community service obligation and delivery standards

Australia Post is subject to a range of obligations under the Postal Act and the Australian Postal Corporation (Performance Standards) Regulations 2019 (the Postal Regulations).

Key to the delivery of ordinary letters, under s 27(4) of the Postal Act, Australia Post must ensure:

8 Australia Post, *Draft price notification*, August 2022, p 12.

9 Australia Post, *Draft price notification*, August 2022, p 12.

10 Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015. Letter services which involve the supply by Australia Post of a special service for which a special charge or additional fee is payable (as described in the Price Notification Declaration) or letters services under an incoming mail service to which a convention applies are not notifiable services.

11 Section 33 of the Postal Act.

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

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

The obligation under s 27(4)(a) to provide a service that is reasonably accessible to all people is also referred to as Australia Post's community service obligation. 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.[12]

The Postal Regulations set out a number of performance standards Australia Post must meet, such as delivery timeframes. For example, under s 7(1) of the Postal Regulations, Australia Post must service:

a) 98% of all delivery points daily (except on weekends or public holidays)

b) 99.7% of all delivery points at least 2 days each week.

Section 8 of the Postal Regulations sets out the time for expected delivery of reserved service letters at different types of addresses, distinguishing between priority and non-priority mail.

1.3. Operating environment

Since Australia Post's most recent price notification in 2019, the Australian economic landscape has shifted, particularly due to the impacts of the COVID-19 pandemic.

COVID-19 had a significant effect on Australia Post's ability to fulfil its obligations. As a result, on 21 April 2020, the Australian Government announced temporary adjustments to Australia Post's performance standards. These changes applied from May 2020 until 30 June 2021.[13]

Under the temporary changes, the priority letter service was suspended, and a temporary alternative priority timetable was introduced for some business letter services. Changes to the regular delivery service included an extension to the delivery timeframes for letters, and a reduction in delivery frequency in metropolitan areas to every second business day. Delivery into regional, rural and remote areas did not change.[14]

At the expiration of the temporary regulatory relief on 1 July 2021, facilities and delivery rounds operating under the alternative delivery model were progressively rolled back to 5 day per week delivery, and the priority service was reinstated to those products which previously had this option available.[15]

In addition to the impacts of COVID-19, the ACCC acknowledges the current inflationary environment and cost-of-living pressures faced by Australian consumers. The ACCC notes

12 Steering Committee on National Performance Monitoring of Government Trading Enterprises, 1994, p 8.

13 Media Release, Minister for Finance and Minister for Communications, 'Supporting Australia Post throughout COVID-19', 21 April 2020, https://www.financeminister.gov.au/media-release/2020/04/21/supporting-australia-post-throughout-covid-19.

14 Australia Post, *Draft price notification*, August 2022, p 49.

15 Australia Post, *Draft price notification*, August 2022, p 49.

that the consumer price index (CPI) rose 7.3% over the 12 months to September 2022, with significant rises in housing, fuel, and food prices contributing to this increase.[16]

While postal services account for a small share of the goods and services that make up the CPI[17] and will often be considered a relatively small expense, in light of the current economic climate we have considered the affordability impacts of the proposed price increase on consumers and small businesses.

1.4. ACCC approach to assessment

Australia Post's provision of letter services for carriage of reserved ordinary letters at the regular timetable have been declared as a notified service under Part VIIA of the CCA.[18]

In response to a price increase notification for a notified service, the ACCC must consider the proposal and decide to:

- not object to the price increase
- not object to a price that is less than that proposed
- object to the price increase.[19]

In considering whether or not to object to a proposed price increase for Australia Post's notified letter services, the ACCC must have particular regard to:[20]

- the need to maintain investment and employment, including the influence of profitability on investment and employment
- the need to discourage a person who is in a position to substantially influence a market for goods and services from taking advantage of that power in setting prices
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.[21]

The ACCC's approach to interpreting s 95G(7) of the CCA is set out in our *Statement of regulatory approach to assessing price notifications under Part VIIA of the CCA*.[22]

Broadly, the ACCC considers that the matters in s 95G(7) require an assessment of the efficiency of a regulated firm's cost base and the rate of return that it is seeking. The proposed price increase is then assessed having regard to the firm's ability to recover revenue sufficient to cover the efficient cost of providing a service, including a rate of return commensurate with the risks faced by the firm, without generating excessive or monopoly profits.

In accordance with ministerial directions issued under s 95ZH of the CCA,[23] the ACCC must also give special consideration to the functions and obligations of Australia Post as set out in

[16] Australian Bureau of Statistics, '6401.0 Consumer Price Index, Australia', September quarter 2022.

[17] Postal services account for 0.11 per cent of the 'all group' CPI basket. (Australian Bureau of Statistics 'Annual weight update of the CPI and Living Cost Indexes', reference period 2021, released 17 December 2021.)

[18] Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015. https://www.legislation.gov.au/Details/F2015L01429.

[19] Section 95Z of the CCA.

[20] Subsection 95G(7) of the CCA.

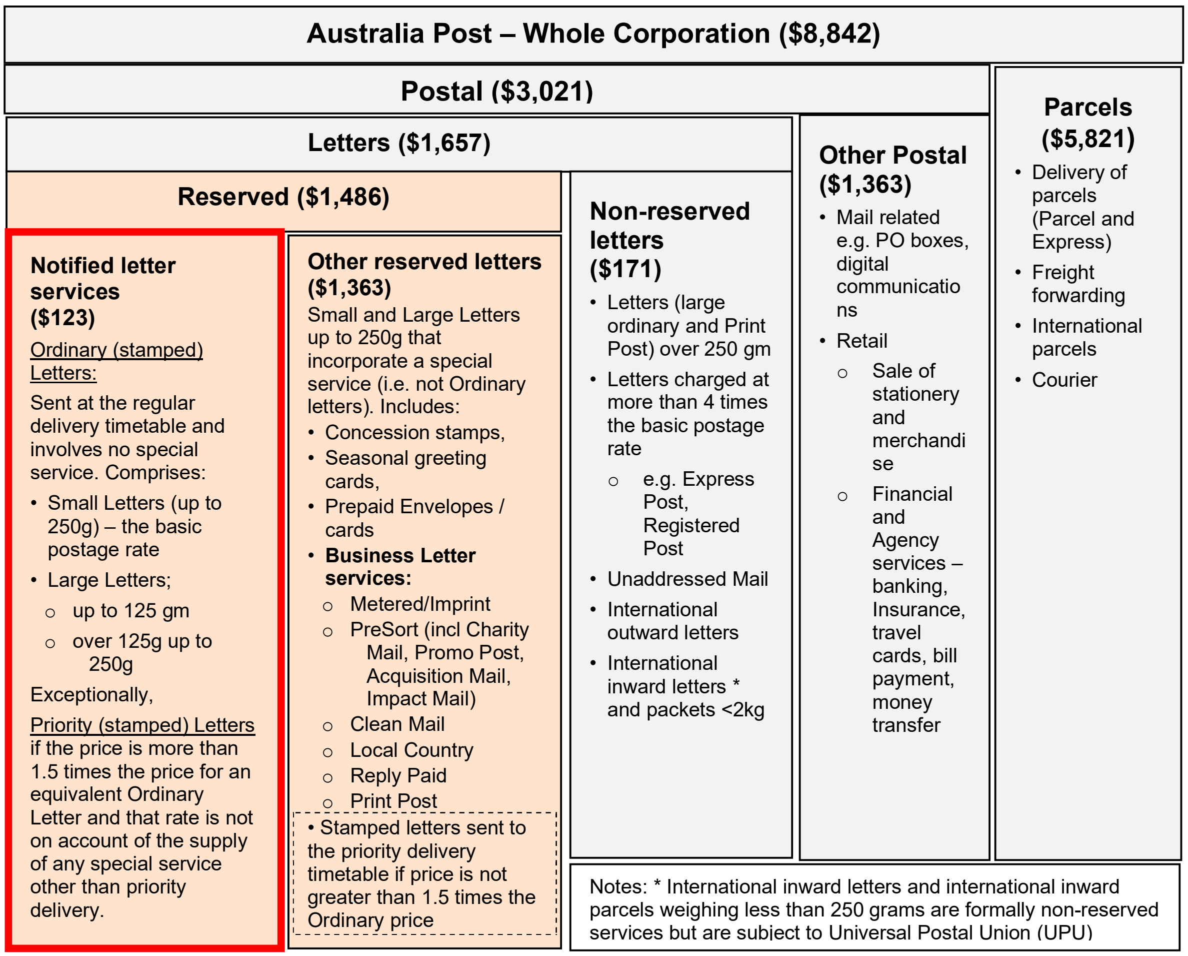
[21] As set out in our *Statement of regulatory approach to assessing price notifications under Part VIIA of the CCA*, The ACCC considers the third criterion is now less relevant to its consideration of price notifications given there has been a movement away from centralised wage fixing to agreements negotiated at the enterprise level.

[22] See: http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications.

ss 14–16, 25–26, 27(1), 27(3)–(5), and 28 of the Postal Act, and to directions or notifications given to Australia Post by the Minister under that Act. The ACCC considers these matters in its assessment of Australia Post's cost and revenue forecasts below.

As set out in figure 1, Australia Post's notified letter services are a subset of Australia Post's broader reserved letter services monopoly.

Figure 1. Categorisation of Australia Post product groups and revenues (revenue in $ millions, 2021–22)



Key: Notified letters (part of Reserved) – subject to price notification to ACCC

Reserved letters – overall cost recovery considered by ACCC in deciding whether to object to price increases for notified services

Source: Australia Post; ACCC.

Only the notified letter services are subject to ACCC review when a price increase is proposed. However, when assessing the appropriateness of the proposed price increase for

[23] The relevant ministerial directions are General Direction 8 and Direction 11 made under section 20 of the *Prices Surveillance Act 1983*. The *Prices Surveillance Act 1983* is no longer in force, but the directions under apply as directions given under subsection 95ZH(1) of the CCA by virtue of Schedule 2, Part 2, Item 45(2) of the *Trade Practices Legislation Amendment Act 2003*. A number of sections of the *Australian Postal Corporation Act 1989* that are referred to in Direction 11 have been repealed or amended.

the notified letter services, the ACCC also considers the forecast costs and revenues of all reserved letter services.[24] This is necessary as the notified letter services share most of the same processing and delivery facilities as other reserved letter services. Consequently, Australia Post's cost recovery for the notified letter services is affected by the amount of shared and direct costs allocated across reserved services (see part 5).

1.5. Consultation and review process

In considering Australia Post's draft price notification, the ACCC has carried out a public consultation process. The ACCC published a consultation paper on 25 August 2022 seeking stakeholder views in relation to the draft price notification.

The ACCC received submissions from 10 stakeholders in response to the consultation paper. The public versions of the submissions are available on the ACCC's website. In October 2022, Australia Post provided the ACCC with supplementary information in response to some of the submissions. This is also available on the ACCC's website.

Six submissions were from members of the public, whose personal details have not been disclosed publicly. The authors of these submissions are referred to as 'member of the public (#)' in this report.

We expect to receive Australia Post's formal price notification in late November 2022. We then intend to publish the ACCC's final decision in December 2022. Our anticipated timeline is outlined in table 1.

Table 1. Timeline for assessing the price notification

Date	Event
25 August 2022	Consultation paper released
23 September 2022	Consultation period closed
November 2022	ACCC view on draft price notification released
Late November 2022	Australia Post lodges formal price notification
December 2022	ACCC decision

24 Reserved services include all of Australia Post's statutory monopoly letter services under section 29 of the Postal Act, including business mail services that are not notified services but are provided at a discount to notified 'ordinary' letter services prices.

2. Australia Post's proposed price increase

2.1. Australia Post's proposal

As outlined in part 1.1, Australia Post proposes to increase the prices charged for the notified letter services delivered according to its regular timetable. Table 2 summarises the proposed price changes for the affected letter service.

Table 2. Prices of ordinary letter services ($ nominal)

Letter service	Current price	Proposed price	Increase
Small letters	1.10	1.20	9.1 %
Large letters up to 125 grams	2.20	2.40	9.1 %
Large letters >125 grams <250 grams	3.30	3.60	9.1 %

Source: Australia Post, *Draft price notification*, August 2022, table 1, p 12.

Australia Post proposes to implement the new prices from 3 January 2023.[25]

Australia Post is not proposing to increase the price of concession stamps ($3 for a booklet of 5) or seasonal greeting stamps (65 cents for a small letter).[26]

2.1.1. Affordability

Australia Post's draft price notification highlights that even upon increasing to $1.20, the basic postage rate[27] will be the second lowest in the OECD where choice of delivery speed for letters is offered, and fourth lowest overall.[28] Similarly, in a report commissioned by Australia Post, Diversified Specifics (a research and consulting firm) found that in an analysis of stamp prices across 33 countries, Australia was the 11th least expensive. And, in the last 5 years, Australia Post's postage rate has risen by only 10%, which ranks as the 6th lowest increase across the countries considered.[29]

Australia Post also emphasises that changes to the basic postage rate since 1975 have been well below the changes to the CPI and wage price index.[30]

2.2. Submissions received

The ACCC received 10 submissions in response to its August 2022 consultation paper.[31] Seven of these submissions opposed the price increase,[32] 2 were in support,[33] and one expressed neither support nor opposition.[34]

[25] Australia Post, *Draft price notification*, August 2022, p 12.

[26] Australia Post, *Draft price notification*, August 2022, p 7.

[27] That is, the price of carriage of a standard postal article by ordinary post.

[28] Australia Post, *Draft price notification*, August 2022, pp 13-14.

[29] Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, pp 4-5.

[30] Australia Post, *Draft price notification*, August 2022, p 13.

[31] ACCC, *Australia Post's draft price notification consultation paper*, August 2022.

[32] Submission from member of the public (1), August 2022, submission from member of the public (2), August 2022, submission from member of the public (3), August 2022, submission from member of the public (5), August 2022, submission from member of the public (6), September 2022, submission from Global Express, September 2022, submission from Ben Blackburn Racing, September 2022.

[33] Submission from Licensed Post Office Group, September 2022, submission from Post Office Agents Association Limited, September 2022.

Three submissions directly considered issues of affordability. Member of the public (5) considers that a price increase will particularly affect them, as they are a concession card holder who sends in excess of 70 letters per year. Due to the volume of letters sent, member of the public (5) is required to rely on ordinary letter prices for each letter sent in excess of the 50 concession stamps they are entitled to per annum.

Member of public (2) expresses concern that a price increase will affect their small business, by forcing them to pass on increased costs to consumers.[35] Ben Blackburn Racing considers that current ordinary letter prices should be maintained for the next 3 years, to mitigate cost of living pressures for Australian consumers.[36]

2.3. ACCC views

2.3.1. The basic postage rate remains lower than most international comparators

The ACCC considers that when compared to most international comparators, even with a 9.1% increase, Australia Post's basic postage rate remains relatively low, as illustrated by figure 2.[37]

We also agree that the basic postage rate has risen at a much slower rate than postage rates offered by most international comparators, as illustrated by table 3.[38]

The ACCC considers that Australia Post's basic postage rate will remain relatively low compared to international comparators after the proposed price increase.

34 Submission from member of the public (4), August 2022.

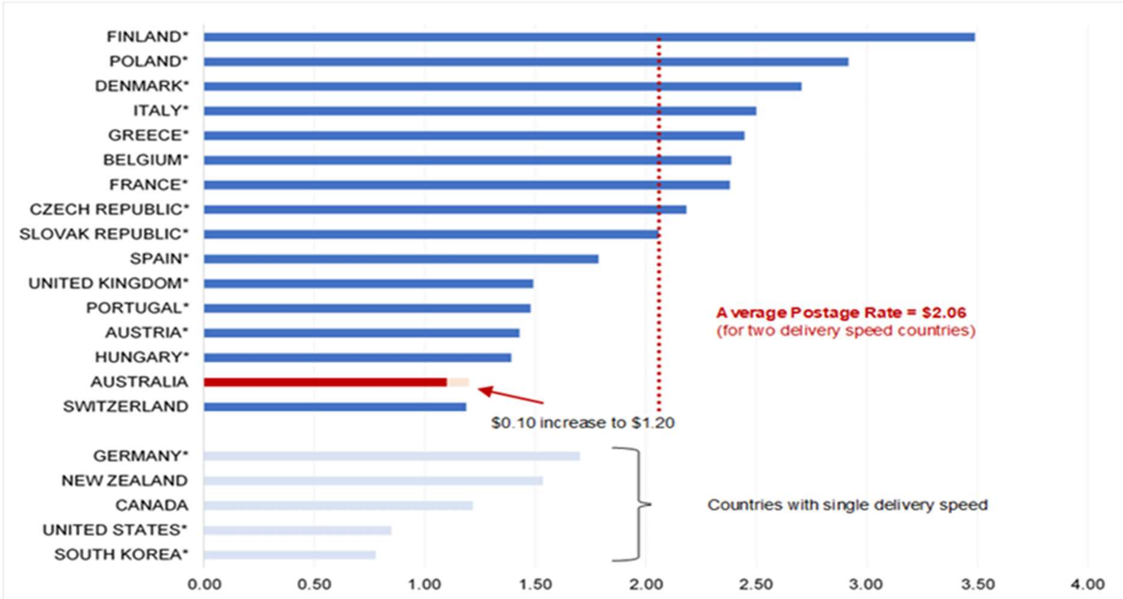
35 Submission from member of the public (2), August 2022, p 1.

36 Submission from Ben Blackburn Racing, September 2022, p 1.

37 Australia Post, *Draft price notification*, August 2022, pp 13-14; Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, pp 4-5.

38 Diversified Specifics, *Australia Post Letter Volume Demand Update,* August 2022, pp 4-5.

Figure 2. Basic postage rates in OECD countries with choice of delivery speeds



Source: Australia Post, *Draft price notification*, August 2022, p 14.

Table 3. Increases in basic postage rate by country for the period 2017 to 2022

Country	% change	Country	% change	Country	% change
Finland	165%	Slovakia	43%	Germany	21%
Greece	164%	UK	41%	Malta	15%
Romania	163%	Poland	36%	Luxembourg	14%
Belgium	139%	Bulgaria	30%	Hungary	12%
Estonia	131%	Portugal	28%	Switzerland	11%
Latvia	111%	Canada	26%	Australia	10%
Slovania	81%	Ireland	25%	Denmark	7%
Sweden	73%	Austria	25%	Iceland	2%
Czech Republic	71%	Netherlands	23%	Italy	0%
France	68%	United States	22%	Croatia	0%
Spain	50%	Lithuania	22%	Cyprus	0%

Source: Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 15.

2.3.2. Ordinary letter prices are likely to remain affordable for most consumers

The KPMG community sentiment research commissioned by Australia Post estimated that the average consumer sends around 15 letters per year, meaning the 10 cent stamp price increase would amount to a cost of around $1.50 per consumer per year.[39]

We acknowledge that the increase in ordinary letter prices is likely to disproportionally affect consumers who send larger volumes of mail, including older Australians. KPMG found that

39 KMPG Community Sentiment Research, *Exploring reactions to a potential stamp price increase*, July 2022, p 8; Australia Post, *Supplementary Information to Australia Post's draft price notification*, October 2022 indicated that while the average consumer sends 15 letters per year, the median number of letters sent per consumer is 6 per year.

Australians aged over 55 were more likely to buy stamps than younger Australians.[40] Affordability issues for older Australians and concession card holders are ameliorated by Australia Post's retention of current concession and seasonal greeting card stamp prices, which remain at $3 for 5 concession stamps and 65 cents for seasonal greeting card stamps. However, concession card holders are only entitled to purchase 50 concession stamps annually and the ACCC acknowledges that some concession card holders may send more than 50 letters per year.

The impact of the proposed ordinary letter price increase on existing concession entitlements is illustrated by the circumstances of member of the public (5), who sends in excess of 70 letters per year.[41] When compared to current prices, member of the public (5) will face an additional cost of $2 for sending 70 letters each year (that is, an extra 10 cents per letter for each letter in excess of their 50 concession stamps entitlement). However, the KPMG research provides some assurance that most consumers are unlikely to send letters in such quantities, and thus most concession card holders are unlikely to be affected by the 10 cent rise.

The ACCC considers that in most, but not all, cases the proposed stamp price increase is unlikely to make ordinary letter prices unaffordable for consumers.

2.3.3. Ordinary letter prices are likely to remain affordable for most small businesses

We acknowledge that many small businesses will be unable to utilise discounted bulk business mail services offered by Australia Post, which are only offered to businesses sending at least 300 letters per occasion.[42] In fact, the KPMG community sentiment research commissioned by Australia Post estimated that the average small business sends 68 letters per year,[43] which is vastly below the volume which is eligible to access bulk business rates. This also means that the 10 cent stamp price increase would amount to an average extra cost of $6.80 per small business per year.

For context, $6.80 is approximately one-third of the expense that a business would face from having a single employee on the minimum wage work an extra hour during the year,[44] and comprises approximately 0.05% of the median small business income of $13,000 per annum in Australia.[45]

We recognise there may be businesses who send larger quantities of letters, but still below the volume which would allow them to access bulk mail services. These businesses may also send large (up to 250 grams) rather than small letters, and in both cases the financial impact will be greater. For example, following the ordinary letter price increase, a small business that sends 295 small letters per year would face an additional annual cost of $29.50. For a small business who sends 295 large letters per year, the additional cost could be $88.50. A submission from member of the public (2) indicated that they would be required to pass on this price increase to their customers.[46]

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40 KPMG found that 62% of those aged over 55 bought stamps, 63% of retirees and pre-retirees bought stamps, and 51% of those holding a pensioner concession card bought stamps. In contrast, only 20% of those aged 16-24 bought stamps: KMPG Community Sentiment Research, *Exploring reactions to a potential stamp price increase*, July 2022, p 13.

41 Submission from member of the public (5), August 2022, p 1.

42 Australia Post, 'Bulk Mail Options' https://auspost.com.au/business/marketing-and-communications/business-letter-services/bulk-mail-options.

43 KMPG Community Sentiment Research, *Exploring reactions to a potential stamp price increase*, July 2022, p 8.

44 The national minimum wage is $21.83 per hour.

45 Australian Small Business and Family Enterprise Ombudsman, *Small Business Counts*, December 2020, p 17.

46 Submission from member of the public (2), August 2022, p 1.

In light of the above, the ACCC considers that in most, but not all, cases the proposed price increase is unlikely to make ordinary letter prices unaffordable for small businesses.

2.3.4. Australia Post is proposing to maintain current service delivery performance standards

Australia Post's draft price notification does not propose any amendments to its current service delivery standards.

As outlined in part 1.3, during the COVID-19 pandemic, Australia Post's service delivery standards were reduced by the Australian Government in recognition of the challenges of delivering to required timeframes within a pandemic environment. However, since 1 July 2021, Australia Post's performance standards have reverted to the usual standards prescribed under the Postal Regulations.

The most recent Auditor-General report on Australia Post's compliance with its service obligations found that for the period 2021-22, Australia Post did not meet the performance standards prescribed by ss 7 and 8 of the Postal Regulations.[47] Specifically:

- section 7(1)(a) requires Australia Post to service 98% of all postal delivery points daily (except on a Saturday, a Sunday or a public holiday). The Auditor-General found that Australia Post serviced less than 98% of all postal delivery points daily (except on a Saturday, a Sunday or a public holiday)[48]
- section 8 requires Australia Post to deliver at least 94% of reserved services letters to the indicated or appropriate address within the delivery time mentioned for the address according to the timetable prescribed in Regulation 8. The Auditor-General found that Australia Post delivered 93.5% of reserved services letters to the indicated or appropriate address within the delivery time mentioned for the address.

Australia Post has provided information to the ACCC explaining that these performance standards were not met due to residual COVID-19 challenges, particularly during the period July to December 2021, when strict close contact isolation rules and air freight constraints were in place. In contrast, Australia Post considers their performance during the January to June 2022 period to have achieved compliance with the regulated standards.[49]

Under s 28E of the Postal Act, if the Auditor-General reports that Australia Post has not met a prescribed performance standard, Australia Post must, unless the Minister determines by legislative instrument that it is unnecessary in the circumstances, prepare a service improvement plan to ensure it meets that prescribed performance standard as soon as practicable.

The ACCC considers that increasing ordinary letter prices in line with inflation may reduce the incentive for Australia Post to seek a reduction in their performance standards as a means of cutting costs and maintaining profitability. However, we are also mindful that increasing the price of postage stamps does not entirely alleviate this risk.

2.3.5. The proposed increase is broadly in line with inflation

Examining the size of a price change with reference to changes in the price of other goods can give insight into whether that service is becoming relatively more expensive. To this end,

[47] Australia Post, Annual Report 2022, p 150.

[48] Australia Post's 2022 Annual Report did not disclose their specific performance against this obligation.

[49] Australia Post, *Supplementary Information to Australia Post's draft price notification*, October 2022, p 4.

price changes that are in line with inflation suggest that the 'real price' of that good or service has not changed.

Between January 2020 (when the price of letters previously increased) and September 2022, the Australian Bureau of Statistics reported that the 'All Groups' CPI increased by 10.5%.[50] Over the same period, 'postal services'[51] recorded price growth of 10.7%.[52] With the price of reserved services fixed over this period, the real cost of reserved services has effectively fallen relative to other services since January 2020.

We also agree with Australia Post's submission that changes to the basic postage rate since 1975 have been well below the changes to the CPI and the wage price index.

As the monopoly provider of letter postage services, it is important to guard against the possibility of Australia Post taking advantage of its influence and power in the market in setting prices. However, in circumstances where the percentage by which Australia Post is proposing to increase ordinary letter prices is broadly in line with movements in the prices of other goods in the economy (many of which are constrained by competition), the ACCC considers that Australia Post's proposed pricing does not suggest it is taking advantage of its market power.

However, we note that an inflationary environment, in and of itself, is not a sufficient justification for a proposed price increase. While we recognise that Australia Post may face an increase in some of its costs because of inflation, we note that labour is the most significant driver of costs for Australia Post and wages have not been increasing at the same rate.[53]

3. Letter volumes

3.1. Draft price notification

Australia Post's letter demand forecast is used to assess whether its proposed price increase is expected to achieve sufficient revenue to recover costs, without providing excessive returns. This forecast is also relevant to assessing Australia Post's cost forecasts, as the volume of letters sent impacts on estimated future operational costs.

Australia Post's draft price notification indicates that the actual number of addressed letters sent in Australia has fallen by 65% since 2007-08, and that this decrease has accelerated over time. Since 2001, Australia Post has engaged Diversified Specifics to explain and project fluctuations in domestic letter volumes over time.[54] Australia Post refers to this as its econometric baseline. Australia Post then overlays this baseline projection with its own institutional intelligence to ensure the final letter volume forecasts are as accurate as possible.[55]

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50 This is calculated based on percentage change in the Australian Bureau of Statistics "All groups CPI" index between 2019 December quarter and 2022 September quarter.

51 'Postal services' cover a range of postal charges including those for standard letters, parcels in the most common sizes and international mail.

52 This is calculated based on percentage change in the Bureau of Statistics 6401.0 Consumer Price Index, Table 9. CPI: Group, Sub-group and Expenditure Class, Index Numbers by Capital City "Index Numbers; Postal services; Australia" between 2019 December quarter and 2022 September quarter.

53 Australian Bureau of Statistics, *Wage Price Index Australia,* June 2022.

54 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 9.

55 Australia Post, *Draft price notification*, August 2022, p 20.

From this analysis, Australia Post forecasts that the average annual letter volume for all letters will decline by 9.3% per annum each year through to 2023–24.[56] Table 4 provides Australia Post's forecasts for volume demand by key postal type segments.[57]

Table 4. Forecast volume demand by key segments – econometric baseline[58]

		2021–22	2022–23	2023–24	AAGR[59]
Ordinary/ Other small	Volume (m)	382	344	307	
	Change (%)		-10.1	-10.8	-10.5
PreSort small	Volume (m)	917	840	763	
	Change (%)		-8.4	-9.2	-8.8
Ordinary/ Other large	Volume (m)	59	52	48	
	Change (%)		-10.7	-8.2	-9.5
PreSort large	Volume (m)	45	39	35	
	Change (%)		-13.8	-8.9	-11.3
Print Post	Volume (m)	89	79	75	
	Change (%)		-11.6	-5.2	-8.4
Total domestic addressed letters	**Volume (m)**	**1,492**	**1,353**	**1,227**	
	Change (%)		**-9.3**	**-9.3**	**-9.3**

Source: Australia Post, *Draft price notification*, August 2022, tables 4 and 5, pp 21-22.

Modelling by Diversified Specifics found that the factors that have had the greatest impact on the decline in letter volumes over the January 2011 to December 2021 period include:[60]

- **E-substitution**: 'e-substitution' refers to the shift towards digital modes of communication and away from a physical letter item:[61] that is, the number of internet and mobile phone services in place have grown, providing greater access to email and voice/video calls, and it has become increasingly common for bills to be invoiced and paid electronically
- **Real own price** (the price of postage, adjusted for inflation):[62] this variable reflects changes to the nominal price of postage (for example, raising the price makes postage more expensive), and the impact of inflation during periods where the nominal price is unchanged (which makes postage cheaper in real terms)
- **Real cross price** (how expensive postage is compared to other goods, adjusting for inflation):[63] changes to the prices of alternative communication services impact the relative expense of the postal service. For example, more consumers may post letters if mobile phone plans increase in price, because the postal service will become relatively less expensive. To assess cross price effects, Diversified Specifics assessed a representative range of telecommunications services, as determined by the Australian Bureau of Statistics

56 Australia Post, *Draft price notification*, August 2022, p 21.
57 Australia Post, *Draft price notification*, August 2022, p 22.
58 Inclusive of proposed rate rises and COVID-19 impacts.
59 Average Annual Growth Rate is the average annualized return of an investment, portfolio, asset, or cash flow over time. AAGR is calculated by taking the simple arithmetic mean of a series of returns.
60 Diversified Specifics submit that these results were generated using a vector error correction modelling framework.
61 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 36.
62 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 37.
63 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 37.

- **COVID-19**: The pandemic had a significant impact on letter volumes, particularly on the volume of promotional materials sent through the Print Post service.[64] This decline was particularly significant in the March and June quarters of 2020, and continued throughout the remainder of 2020, resulting in a consistent gap between actual and expected post volumes for that period.

While Diversified Specifics identified several different factors that have influenced letter volumes over the previous 10 years, Australia Post considers the main driver to be intensifying e-substitution pressures as consumers move away from letters in favour of email, SMS, and web-based portals.[65]

However, Australia Post also agrees that COVID-19 had a substantial impact on letter volumes since 2020. According to Australia Post, the contraction in the level of economic activity in Australia caused by COVID-19 resulted in a reduction in the number of transactions within the Australian economy. The consequential fall in transactional mail was like that which occurred during the 2007-08 global financial crisis.[66] Table 5 shows Australia Post's estimates of COVID-19 impacts on the volume demand for letters for the period January 2020 to December 2021.

Table 5. Australia Post estimates of COVID-19 impact on letters volume demand

Segment	Total volume impact (m)	Volume impact as % of the total (%)
Ordinary / Other small	-57	-6.5
PreSort small	-131	-6.7
Ordinary / Other large	-6	-4.8
PreSort large	-7	-8.8
Print Post	-38	-20.4
Total letters	-239	-7.5

Source: Australia Post, *Draft price notification*, August 2022, table 3, p 21.

3.1.1. Demand for letters is price inelastic

Diversified Specifics' report estimated the price elasticity of demand for Australia Post's different letter segments. The price elasticity of demand measures how responsive consumers will be to a change in price when deciding how much of a good or service to purchase. It is expressed as the percentage change in volume associated with a 1% change in price.[67] In this context, it measures the change in Australia Post's domestic letter volume in response to a given change in postage rates, assuming all other factors are held constant.

Diversified Specifics estimated demand elasticities for postal services against impacts arising from e-substitution, the real price of letters, and cross prices (against substitutable services). Table 6 shows the associated percentage decrease in volume of each letter segment in response to a 1% increase in each of the 3 variables estimated by Diversified Specifics in its 2019 and 2022 reports.[68]

[64] Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 72.
[65] Australia Post, *Draft price notification*, August 2022, p 16.
[66] Australia Post, *Draft price notification*, August 2022, pp 16-17.
[67] Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 16.
[68] Diversified Specifics, *Australia Post Letter Volume Demand Update*, July 2019, pp 34, 41, 47, 53 and 62.

Table 6. Diversified Specific's elasticity of demand estimates (%)

Segment	e-substitution		Real price		**Cross-price**[69]
	2019	**2022**	**2019**	**2022**	**2022**
Ordinary / Other small	-0.56	-0.24	-0.42	-0.15	0.70
PreSort small	-0.06	-0.49	-0.24	-0.55	n/a
Ordinary / Other large	-0.09	-0.60	-0.60	-0.18	n/a
PreSort large	-0.40	-0.16	n/a[70]	-0.47	2.0
Print Post	-0.14	-0.52	-0.34	-0.06	n/a

Source: Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022.

Diversified Specifics found that all estimated price elasticities of demand for letters in 2019 and 2022 were inelastic.[71] That is, the percentage change in volume that results from a change in price is less than the rate of change in the price variable. This suggests that consumers are not sensitive to changes in price when deciding how many letters they will post.[72]

For ordinary/other small and large letters, price elasticities have further decreased since the 2019 estimates, suggesting that consumers have become less sensitive to price changes over time.

3.1.2. Letter volume demand is decreasing worldwide

Diversified Specifics found that declines in the volume of letters posted due to movements towards digital communication is a universal phenomenon impacting all major postal economies globally. Consequently, postal services worldwide have increased postage rates to assist with the sustainability of their letters division.[73]

Despite this, and as explored in part 2 of this report, Diversified Specifics highlights the comparatively low levels of basic postage rate increases in Australia over the past 5 years, and the comparatively low basic postage rate in Australia overall.[74]

3.2. Submissions received

Licensed Post Office Group Limited (LPO Group) and Post Office Agents Association Limited (POAAL) agree with Australia Post's position that letter volumes have been declining and will likely continue to do so.

LPO Group, which supports the proposed price changes, submits that it is apparent that letter volumes will inevitably decline with an increase in digital communications, and that a price increase could serve to hasten this decline. However, LPO Group also highlights that

69 Cross-price elasticity was not calculated by Diversified Specifics in 2019

70 Diversified Specifics 2019 estimates for real price elasticity of demand for PreSort large was insignificant and was not included in its report.

71 The ACCC notes that the price elasticity estimates produced in 2019 and 2022 may not be directly comparable due to some refinements in the modelling approach. For example, the inclusion of the prices of alternative technologies to capture the cross-price effect may change the estimated e-substitution effect.

72 If the absolute value of the calculated elasticity statistic is less than 1, then it is "price inelastic". It means the rate of change in volume is less than the rate of change in the price variable.

73 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 15.

74 Diversified Specifics, *Australia Post Letter Volume Demand Update,* August 2022, pp 14-15.

the increase will lead to increased revenue for licensed post offices and observes that the postal service may not be sustainable without such increases.[75]

POAAL, which also supports the price increase, considers Australia Post's forecast rate of letter volume decline to be realistic. POAAL submits that the downward trend in letter volumes is clear, it pre-dates Australia Post's current price notification, and it will continue regardless of any increase to letter prices.[76]

Member of the public (3) indicates that while demand for letters is declining, Australia Post's letter service is still frequently used by business customers.[77]

3.3. ACCC view

3.3.1. Overall, the variables used to forecast demand volumes are reasonable

The ACCC considers that most of the variables used by Diversified Specifics to forecast demand volumes are reasonable. The core methodology remains consistent with that used in Australia Post's price notifications since 2010, but has seen some improvements with each iteration.

To inform Diversified Specifics' analysis, Australia Post supplied letter volume and revenue data for the period July 1995 to March 2022 in the form of revenue-based volumes. Information on the proposed 9.1% price increases was also incorporated.

To facilitate the generation of econometric models and the associated testing, Diversified Specifics obtained variables from external sources. This included data from the Australian Bureau of Statistics, the Reserve Bank of Australia, the International Telecommunications Union, the ACCC website, and the Australian Electoral Commission. The model has also attempted to account for impacts of the COVID-19 pandemic.

3.3.2. Diversified Specifics has refined its analytical approach, but CPI projections and e-substitution parameters could be improved

We consider Diversified Specifics' analytical approach has improved since the ACCC last considered the methodology in 2019. For example, in 2019:

- we noted the mobile data traffic series used by Australia Post was measured for the Asia-Pacific region and may not be applicable to Australia.[78] In contrast, in 2022, each index used by Diversified Specifics utilises Australia-centric data and is reflective of the evolution of technological change that has facilitated the erosion of Australia Post's letter volumes
- we expressed reservations with the approach to variable selection and structural break testing.[79] In contrast, in 2022 Diversified Specifics tested each letter volume segment individually for a structural break.

The ACCC considers that the broad econometric modelling approach adopted by Diversified Specifics is appropriate and has been improved by the modelling refinements incorporated

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[75] Submission from LPO Group, August 2022, p 1.

[76] Submission from POAAL, August 2022, pp 8, 10.

[77] Submission from member of the public (3), August 2022, p 2.

[78] ACCC, *ACCC view on Australia Post's draft price notification*, November 2019, pp 15-16.

[79] The ACCC considered that it was not clear from Diversified Specifics' 2019 report that it has taken a structured approach to truncating the sample periods. We also considered that the application of structural-break testing used to identify the choice of estimation periods did not appear to be consistent across the segmented letter volume models.

since 2019.[80] However, further improvements could be implemented around the treatment of e-substitution and CPI forecasting.

The 2022 Diversified Specifics analysis has improved upon the range of e-substitution technologies captured by including cheque volume, direct debit volume, domestic broadband connections, mobile phone subscriptions, wholesale NBN connections and wireless broadband connections.[81] However, we remain concerned with Diversified Specifics' construction of the electronic substitution variables, particularly in relation to the source data used.[82] This includes whether they represent alternative e-communications technologies,[83] and whether the combined series, using principal component analysis, properly measure online connectivity for bill payment and presentation.[84]

It would also have been preferable for Australia Post and Diversified Specifics to base their CPI forecasts on the estimates provided by the Reserve Bank of Australia. To calculate baseline forecasts in demand modelling, Diversified Specifics has used the CPI projections from the IMF of 3.34% in 2022, 2.52% for 2023, and 2.47% for 2024,[85] which appear to be significantly lower than the RBA forecasts of 4.85% per annum (average of 6.2% for 2022–23 and 3.5% for 2023–24) and the annual inflation rate of 6.1% assumed in Australia Post's post tax revenue model ('the Revenue Model').[86] The ACCC considers that the RBA forecasts, last updated in August 2022, represent the best estimates.[87]

Differences in inflation factors will impact on volume demand in response to price changes to letters or their substitutes. The lower CPI values used in Diversified Specifics CPI projections result in higher forecast letter price changes in real terms, and lower demand forecasts than if the RBA forecasts are used. However, given the inelastic price elasticity estimates (see part 3.1.1) and relatively small impact of the proposed rate increases found (discussed below), the impact of changing the CPI measure on forecast letter volumes is immaterial.

Therefore, we consider any alternative forecasts from adjusting the inflation forecasts are unlikely to change the outcomes of the Revenue Model for the proposed increase in basic postage rate, given the extent of under-recovery in reserved letter services.

3.3.3. Price is not the main driver of declining letter volumes

As discussed in part 3.1.1, the price elasticity of demand for letters is inelastic, suggesting that consumers are not sensitive to changes in price when deciding how many letters they

80 Such as factoring in the impact of the COVID-19 pandemic, including a broad range of e-substitution variables for other small letters, using Australian data on e-substitution, testing for cross-price effects, and adopting a structured approach to structural break testing throughout the modelling process.

81 Diversified Specifics, *Australia Post Letter Volume Demand Update,* August 2022, pp 14-15.

82 We note that the source data series do not necessarily cover the full sample period used for constructing the e-substitution variables (March 2002 to March 2022) and Diversified Specifics has applied time series modelling to back casting and/or forecasting. Data splicing has also been used to generate a consistent time-series data. In cases where frequencies are different, interpolation is used to derive quarterly data.

83 For example, data series on wholesale NBN services do not account for the migration for DSL, overstating the growth of broadband connections in Australia.

84 Some data series represent technologies that are inter-related or overlapping. E.g., domestic broadband, wireless broadband, and NBN.

85 Note that these are based on IMF's April 2022 forecasts, which have since been updated in October 2022. The CPI forecasts in the updated version have been revised upward substantially to 6.50% in 2022, 4.80% in 2023 and 2.82% in 2024.

86 RBA, Forecast Table – August 2022, Statement on Monetary Policy, August 2022, available at: https://www.rba.gov.au/publications/smp/2022/aug/forecasts.html. Note that 6.1% is based on CPI change (year to quarter) in June quarter 2022.

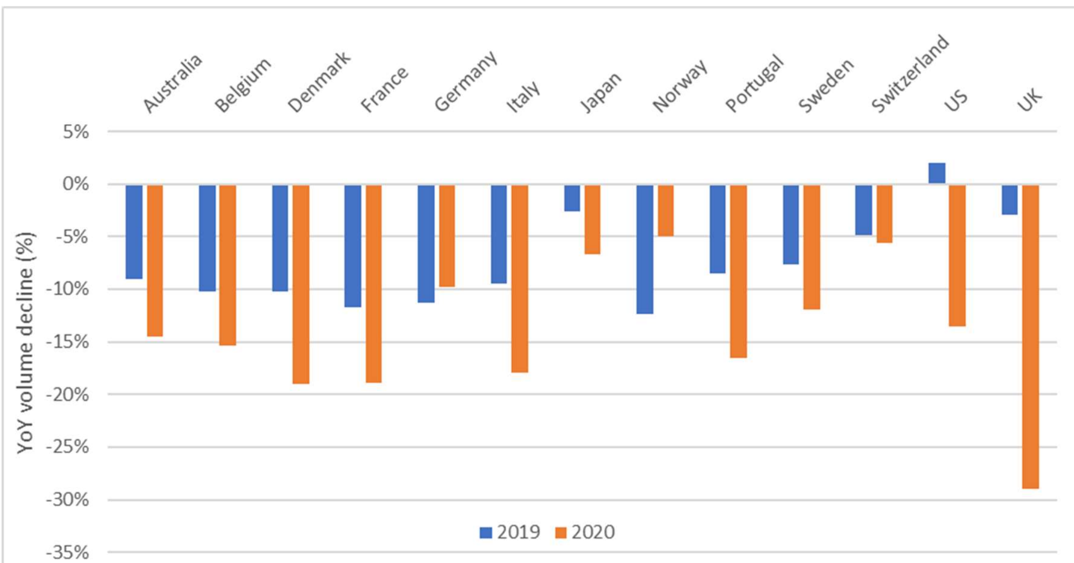
87 These figures were recently updated by the independent central bank in Australia who is responsible for conducting monetary policy to meet its medium-term inflation target.

will post. As a result, the proposed price increase on its own is not likely to drive a significant reduction in the volume of letters that will be sent.

The ACCC considers that Australia Post's basic postage rate is unlikely to be the main driver of declining letter volumes.[88] We agree with Diversified Specifics' finding that that decline in postal volumes for letters due to movements towards digital communication is a universal phenomenon impacting all major postal economies globally, a finding also made by McKinsey and Company.[89]

Figure 3 shows a comparison of decline in letter volumes across countries using data collected from the Universal Postal Union. All 13 high income countries in the figure experienced year on year decline in postal volumes in 2020 ranging from 5% (Norway) to almost 30% (UK). Most countries also experienced similar, although smaller, declines in 2019, with the United States being the only exception. We also refer to table 6 in part 3.1.1, which illustrates that volume demand appears to be most responsive to cross price and e-substitution factors rather than price.

Figure 3. Comparison of decline in letter volumes across countries[90]



Source: [Universal Postal Union website]

Consequently the ACCC does not expect the proposed increase in ordinary letter prices will cause substantial reductions in letter volumes.

3.3.4. The 2019 model over-forecasts demand for some letters and under-forecasts others

Figure 4 compares Australia Post's forecast demand volumes, as submitted under the 2019 Price Notification, to the volumes observed in the latest version of its Revenue Model to

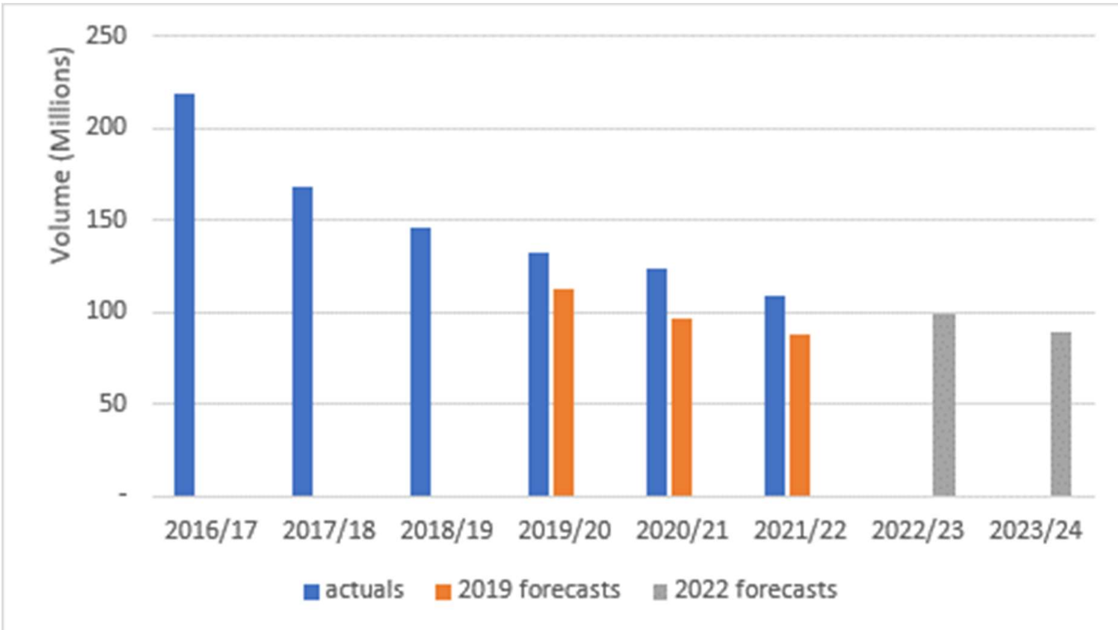
88 Diversified Specifics, *Australia Post Letter Volume Demand Update*, August 2022, p 15.

89 McKinsey & Company, *The endgame for postal networks: How to win in the age of e-commerce*, 2018, p 4.

90 Universal Postal Union website, 'Number of letter-post items, domestic service, High income countries' (GNI per capita above $9,205).

estimate the return required to recover its costs (discussed in part 7) for small-stamped letters, which is a key component of the notified letter service.[91]

Figure 4. Australia Post's volume forecast in 2019 for small-stamped letters[92]



Source: Australia Post 2019 and 2022 Revenue Models.

As shown in Figure 4, actual small-stamped letter volumes turned out to be higher than the 2019 forecasts by an average of 23 million letters per year between 2019-20 to 2021-22.

We also found that, as with the 2015 price notification, Australia Post continued to over-forecast for ordinary/other small letters and under-forecast for PreSort small letters in its 2019 price notification. Accounting for the impact of COVID-19, which was not foreseen under the 2019 forecasts, the ACCC considers:

- for PreSort small letters, the degree of under-forecasting by both Diversified Specifics and Australia Post is higher than it appears
- for other small letters, the degree of over-forecasting is less than it appears.

Overall, demand forecasts from the last price notification have been slightly pessimistic but reasonably close to an outcome without the pandemic. The finding of under-forecasting letter volumes for PreSort small letters is consistent with the ACCC's reservations with the volume forecasts for this letter segment under the 2019 Price Notification, specifically in relation to Diversified Specifics' approach to further augmenting e-substitution and Australia Post's off-model negative adjustment.[93]

However, Diversified Specifics has now implemented refinements to their methodology, as outlined in part 3.3.2. Under its more structured approach to volume modelling and

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91 The Revenue Model is a building block model used by Australia Post used to aggregate and forecast its costs The Revenue Model is discussed in detail in part 7.

92 Comparing the 2019 forecasts for 2019–20, 2020–21 and 2020-21 shows observed volumes for those year were 18–28% greater than those forecast in 2019.

93 ACCC, *ACCC view on Australia Post's draft price notification*, November 2019, pp 15-17.

forecasting, the construction of the e-substitution variable for PreSort small letters does not systematically differ from other segments. Nevertheless, the ACCC will continue to monitor the reliability of demand modelling and forecasts under its refined approach.

The ACCC acknowledges that letter volumes are likely to continue to decline significantly over the forecast period, based on domestic and international experience, as well as submissions received. Despite potential data and modelling issues, Diversified Specifics' baseline volume forecasts can serve as a reasonable estimate of volume declines for the purpose of revenue and cost modelling.

3.3.5. Australia Post's augmentation of Diversified Specific's results

Australia Post notes that the econometric forecasts represent a baseline upon which further intelligence may be overlaid to counter a lack of traceable empirical data on emerging threats to letter volumes.[94] As such, to derive the final volume forecasts, Australia Post has augmented the baseline forecasts provided by Diversified Specifics with its management and market insights that are derived from:

- input from the sales force, and account managers regarding customer behaviour
- market intelligence from participants in the mail value chain
- information in the public domain
- interpretation of qualitative and quantitative reports commissioned by Australia Post and external sources. [95]

Table 7 outlines Australia Post's augmentation on Diversified Specific's baseline volume forecasts. The largest difference between Australia Post's augmented volumes compared to the baseline forecasts is for Print Post letters, where Australia Post's augmented volume is 5.3% less than the baseline forecasts for 2023–24. Augmented small PreSort letter volume is also 2.6% smaller than the forecast estimates in 2022–23. However, the difference is smaller for ordinary/other letters (where the augmented volume is 0.8% smaller than the baseline in 2022–23, and 0.3% bigger than the baseline in 2023–24). It would be helpful if Australia Post could provide detailed explanations for its post-modelling adjustments.

94 Australia Post, *Draft price notification* 2022, p 63.

95 Australia Post has applied the same projected annual decline rates from Diversified Specifics econometric modelling to their own volume forecasts in the previous year to create the baseline forecast. Australia Post then applied further adjustments. Refer to Appendix 4 of Australia Post's draft price notification.

Table 7. Australia Post's augmentation from baseline forecasts, volume (m)

	2021–22	2022–23 baseline	2022–23 AP augmented	2023–24 baseline	2023–24 AP augmented
Ordinary/other small	386	347	345	307	309
Ordinary/other large	59	53	52	47	46
Total Ordinary/other	445	399	396	355	356
PreSort small	933	855	833	756	758
PreSort large	47	40	40	36	36
Total PreSort	980	895	872	792	794
Print Post	90	80	80	76	72
Large Member Associations*	19	17	17	17	17
Total Print Post	109	97	97	93	89
Total PreSort / Print Post	1,089	992	970	885	882
Total Addressed Mail	1,533	1,391	1,366	1,240	1,238

Source: Australia Post *Draft price notification* 2022, tables 38 and 39, pp 63-64.

Note: *Econometric Model growth/decline excludes volumes from large member association in generating its Baseline.

Broadly speaking, further ex-post modelling adjustments may be required if factors that are expected to materially affect future demand are not sufficiently accounted for in the econometric modelling of letter demand using historical data. To this end, the ACCC notes that there is no detailed analysis and documentation to detail the sources of differences underpinning the alternative sets of forecasts and considers it desirable for explanations about augmentation of the model to be provided.

The ACCC remains concerned about Australia Post's augmentation of Diversified Specifics forecast results because there is limited transparency and justification of these adjustments. However, the ACCC notes that the adjustments made are relatively small for this price notification, and are unlikely to have a material impact because the extent of the cost under-recovery is large.

4. Costs and operational efficiency

The ACCC has adopted a cost-based approach to assessing whether Australia Post's proposed price increase for its notified letter services is justified.

Under this approach, the ACCC seeks to compare the revenue earned by Australia Post through the proposed price increase with an efficient cost base. An efficient cost base in this context reflects those costs which would be incurred by a hypothetical efficient operator supplying letter services and operating to maximum efficiency in line with world's best practice.

4.1. Draft price notification

4.1.1. Australia Post's costs are forecast to increase for reserved letter services

Australia Post forecasts that its costs for the reserved letter service will increase from $1.57 billion in 2020–21 to $1.60 billion in 2023–24 (a 1.7% increase), as outlined in table 8.[96] These costs are categorised as falling under:

- sales and acceptance
- processing
- transport
- delivery
- other.[97]

Between 2020–21 and 2023–24, trading costs for Australia Post's overall business are forecast to increase by 13.8%, from $8.1 billion to $9.2 billion, as outlined in table 8. These costs are categorised as falling under:

- labour and oncosts
- goods/services for sale
- accommodation
- depreciation
- other non-labour.[98]

Labour constitutes the most significant cost to the reserved letters business, comprising 62% of Australia Post's reserved letters operating costs.[99] These labour costs reflect the number of full-time equivalent employees (FTEs) and their wages.

We highlight that while the number of FTEs supporting Australia Post's reserved letter services fell by approximately 20% between 2018–19 and 2020–21, this decrease has now stabilised. The number of FTEs is forecast to remain relatively static over the 3-year period to June 2024, with Australia Post forecasting around 10,000 FTE for the period.[100]

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96 Australia Post, *Draft price notification*, August 2022, p 35.

97 Australia Post, *Draft price notification*, August 2022, p 36.

98 Australia Post, *Draft price notification*, August 2022, p 33.

99 Australia Post, *Draft price notification*, August 2022, pp 35, 48.

100 Australia Post, *Draft price notification*, August 2022, p 35.

Table 8. Costs ($m) of overall business and reserved letter services

	Actual 2020/21	Forecast 2021/22	Forecast 2022/23	Forecast 2023/24
Overall business	8,121	8,843	8,990	9,244
Reserved letter costs	1,570	1,595	1,628	1,597

Source: Australia Post, *Draft price notification*, August 2022, tables 10 and 16, pp 33 and 35.

4.1.2. Australia Post continues to implement operational efficiency measures

Australia Post's draft price notification outlines its changing letter delivery profile, which has impacts for the operational efficiency of its reserved services. For example, Australia Post forecasts that by 2025, Australians could receive almost one parcel for every 2 letters, up from one for every 5 in 2019.[101]

In response to this evolving delivery profile, Australia Post discusses several initiatives developed under their sustainable delivery model. These have been implemented, or are in the process of being implemented, to respond to changing circumstances and to achieve operational efficiencies in letter delivery, including:

- a change to the time of day that many street post boxes are cleared (from 2pm to 12pm), to allow posties to undertake box clearances during their normal working hours
- parcel gauge changes, to stream a larger volume of parcels to posties
- a reduction in corporate metropolitan delivery rounds
- the introduction of 3-wheeled electric delivery vehicles, which have a larger carrying capacity compared to traditional postie bikes
- deployment of small parcel sorting machines
- broader operational efficiencies in letter processing, including:
    - improvements to machine processing and mail movements within facilities
    - the consolidation of QLD metropolitan mail processing
    - the review of management and supervisory structures
    - shift alignment changes and management
    - reducing the size of mail processing centres.
- regional mail centre optimisation in NSW
- the implementation of an indoor planner, management and reporting system
- the roll out of an online booking system for unaddressed mail, allowing for scheduling of mail outs of bulk letters.[102]

Australia Post also refers to its organisation-wide business efficiency program, under which it has annual efficiency benefit targets over the coming years, encompassing retail, network operations, customer experience and digital technology support, and support functions. The

[101] Australia Post, *Draft price notification*, August 2022, p 50.
[102] Australia Post, *Draft price notification*, August 2022, pp 51-52.

totality of the efficiency benefit targets for the sum of these different areas for each upcoming financial year is outlined in table 9.

Table 9. Australia Post's Enterprise Efficiency Program targets

Financial year	2022/23	2023/24	2024/25	2025/26
Total efficiency benefit ($m)	216	253	189	160

Source: Australia Post, *Draft price notification*, August 2022, table 27, p 48.

4.1.3. Australia Post performs well on productivity measures

Australia Post commissioned a report by Quantonomics, an economics consultancy, to assess Australia Post's corporate and reserved service total factor productivity (TFP) – a measure of how much output can be generated from given inputs - building on data previously used by Economic Insights in a similar 2019 report.[103]

Quantonomics highlighted the declining letter volumes since around 2009, which accelerated from 2015 to 2022.[104] At the same time, Quantonomics noted that Australia Post has been required to make its network available to an increasing number of geographically dispersed customers which has increased broadly in line with population growth.[105]

Despite these changes, Quantonomics found that Australia Post's corporate TFP grew by an average of 1.5% per annum over the last 30 years, and their reserved service functional TFP grew at an average annual rate of 2.6% over the 25-year period from 1997 to 2022.[106]

Quantonomics found that the reserved services TFP growth of 2.6% has outperformed the ABS market sector productivity index,[107] which averaged an annual growth rate of 0.6% for the period from 1997 to 2021.[108]

Given that Australia Post's reserved services mail output has fallen substantially since 2008, Quantonomics considers that being able to outperform the productivity performance of the economy as a whole has been an impressive achievement.[109]

4.2. Submissions received

Two submissions address Australia Post's costs and operational efficiency.

Global Express submits that Australia Post has not taken sufficient steps to increase operational efficiency since the 2019 notification.[110] Global Express considers only 2 of the efficiency changes documented in Australia Post's price notification to be significant, namely the gradual replacement of posties' motorcycles with 3-wheel electric vehicles and a greater reliance on vans during the last 2 years.[111]

103 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, p 4.
104 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, p 4.
105 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, p 4.
106 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, pp 4-6.
107 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, p 6.
108 ABS 5260.0.55.002 'Estimates of Industry Multifactor Productivity, Australia', Table 2: Hours worked basis. https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5260.0.55.0022016-17?OpenDocument
109 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, p 6.
110 Submission from Global Express, September 2022, p 7.
111 Submission from Global Express, September 2022, p 7.

POAAL submits that there are several other cost reduction strategies open to Australia Post, including greater use of deep sorting (that is, sorting letters into delivery sequence), further combining letter and parcel delivery, converting corporate post offices to LPO operations, and further outsourcing mail carriage operations. However, POAAL concedes that these strategies would result in relatively small savings compared to the mounting losses in letters, such that these potential cost reduction strategies would be insufficient to justify the delaying or diminution of the quantum of Australia Post's proposed letter pricing increase.[112]

4.3. ACCC view

As noted above, in considering whether Australia Post's cost base is efficient, we ask whether Australia Post's costs reflect those which would be incurred by a hypothetical efficient operator supplying letter services and operating to maximum efficiency in line with world's best practice.

4.3.1. Estimates of mail contractors needs further consideration

The ACCC has some reservations about Quantonomics' use in its TFP analysis of the number of contracts as a measurement for the mail contractor input, which has showed declining trends for both corporate services and reserved services since 2002.[113] The ACCC considers this should be examined further, because using number of contracts as a measure fails to control for changes in size or composition of mail contracts over time.

The ACCC notes that mail contractor costs as a proportion of corporate non-capital costs increased by 5 times over the decade to 2022, while mail contractors relative to labour quantity rose marginally.[114]

This indicates that using number of contracts as a quantity measure of mail contractor input may under-estimate the increase in the use of mail contractors over time. As a result, the TFP growth described in part 4.1.3 is potentially over-estimated. However, given the relatively small cost share of the mail contractors input, the ACCC considers the extent of over-estimating TFP growth may be limited.

4.3.2. Australia Post has adopted some efficiency measures in line with international best practice

We refer to the previous international benchmarking studies of Australia Post, which were undertaken in 2009 and 2012 and which were outlined in the 2022 Quantonomics report.[115] Both benchmarking studies used post-modelling adjustment to Australia Post's measured TFP for operating environment differences. Australia Post ranked highly in both those studies. Nevertheless, we consider these are now significantly out of date. We also highlight the 2015 WIK Review, which found that Australia Post's efficiency in letter operations lagged behind the levels achieved by its international peers.[116]

In the absence of recent efficiency benchmarking studies, in assessing Australia Post's current efficiency measures we considered McKinsey's 2018 report detailing postal service efficiencies in the context of the global decline in mail volumes.[117] The efficiencies outlined

[112] Submission from Post Office Agents Association Limited, September 2022, pp 5-7.

[113] Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity,* 3 August 2022, p 37.

[114] Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity,* 3 August 2022, pp 28 and 37.

[115] Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, August 2022, pp 7-8.

[116] WIK Consult, *Review of Australia Post Efficiency Program in light of international benchmarks*, November 2015.

[117] McKinsey & Company, *The endgame for postal networks: How to win in the age of e-commerce*, 2018.

by McKinsey include a number that Australia Post has already implemented, or is in the process of implementing, including:

- standardised letter sorting machines/processes
- streaming small parcels
- moving from regional to central transport planning
- leveraging joint delivery of mail and parcels where possible
- introducing new delivery methods (e.g., e-bikes, e-trikes, motorbikes)
- overhauling planning processes (e.g., workforce planning, route and district redesign, vehicle administration)
- consolidating mail sorting centres/depots as well as access and delivery points.

We also highlight that a number of these initiatives address efficiency issues raised by WIK Consult in their 2019 report for the ACCC, which had raised, among other things:

- issues with indoor activities and planning
- a need to shift packet and parcel volume to posties, to make better use of existing delivery capacity
- issues with transport capacity, though the ACCC highlights that WIK Consult indicated that van delivery was preferable to electronic delivery vehicles due to the increased capacity of vans compared to other transport types.[118]

Overall, the ACCC considers that the range of initiatives Australia Post is undertaking under its sustainable delivery model will achieve efficiencies over the coming years. While we have not focused on assessing Australia Post's efficiency outcomes since 2019 due to the challenges caused by COVID-19 since early 2020, we will review the outcomes of the business efficiency program in Australia Post's future price notifications.

In forming this view, the ACCC has considered that Australia Post is limited in the extent of efficiency initiatives it can implement, due to its Postal Regulations obligation to deliver letters 5 days per week to at least 98% of all Australian delivery points, which are increasing each year in line with population growth.

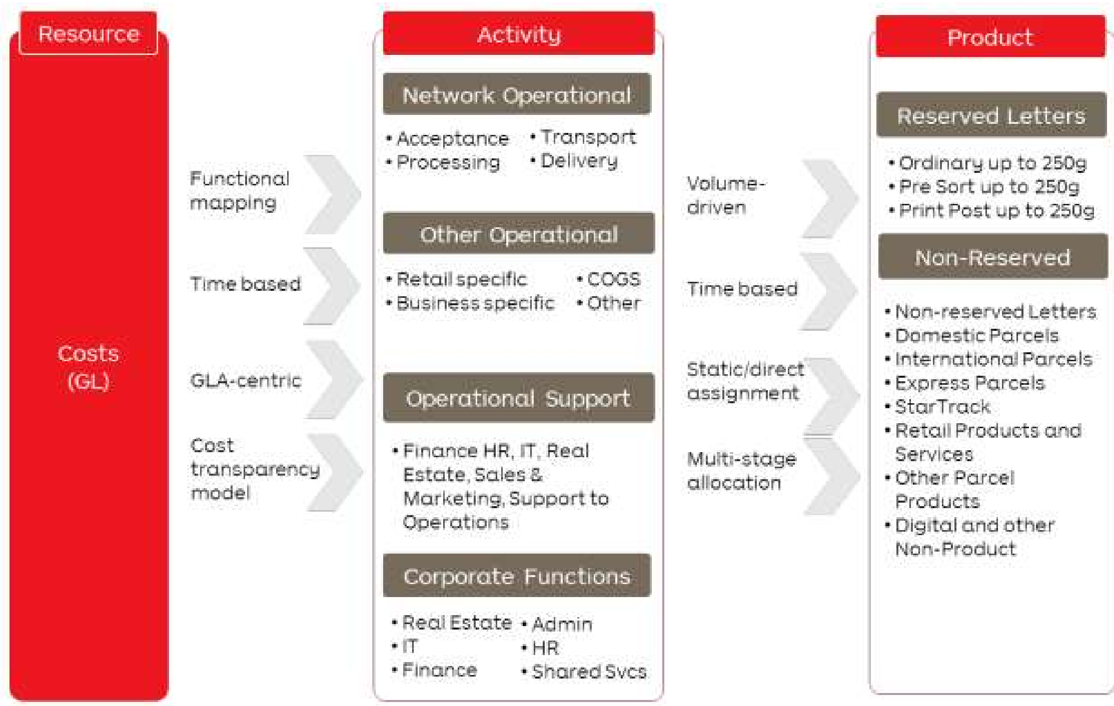
[118] WIK Consult, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, October 2019.

5. Cost allocation

5.1. Draft price notification

According to the draft price notification, Australia Post's costs are allocated using an 'Activity Based Costing' model. This approach identifies resource costs from the general ledger and assigns them to activities. These activities are then assigned to products and services primarily according to consumption. Wherever possible, costs are directly attributed to products.[119] Figure 5 provides a flow chart of Australia Post's Enterprise Profit Model.[120]

Figure 5. Australia Post's Enterprise Profit Model



Source: Australia Post, *Draft price notification*, August 2022, p 41.

According to the draft price notification, product and service volumes are the dominant cost driver in the model.[121] This means that increasing costs are allocated to products and services experiencing volume growth when compared with products and services experiencing a volume decline.

Consistent with previous price notifications, this cost allocation methodology reflects a "dual till" approach. Under this approach, Australia Post separates costs and revenues of its reserved services from its non-reserved services.

119 Australia Post, *Draft price notification*, August 2022, p 41.

120 Australia Post uses an Enterprise Profit Model to allocate costs, assess profitability and support commercial pricing decisions. This incorporates a Cost Allocation Model which allocates costs across the business between the various products and services and between reserved and non-reserved services. Asset values are allocated to products according to procedures specified in Australia Post's Regulatory Accounts Procedures Manual. This records the procedures to be followed within Australia Post in preparing the Regulatory Accounts and is also part of its Enterprise Profit Model.

121 Australia Post, *Draft price notification*, August 2022, p 42.

5.2. Submissions received

Two submissions comment on Australia Post's cost allocation methodology.

A submission from member of public (4) makes a general statement that allocation of costs between parcels and letters should be investigated,[122] while Global Express submits that it is not apparent from Australia Post's draft price notification that it has made an appropriate allocation of the common costs to the non-reserved services.[123]

5.3. ACCC view

5.3.1. Australia Post's cost allocation model was assessed in 2019

The ACCC engaged WIK Consult to review Australia Post's cost allocation methodology in 2015 and 2019.[124] In 2019, the ACCC noted that the cost allocation model, as it then stood, provided an adequate measure of Australia Post's historic costs for reserved letters, including the notified letter services.[125] As Australia Post has used the same cost allocation methodology in 2022, with some refinements, the ACCC did not engage a consultant to assess the cost allocation model as part of this 2022 draft price notification assessment.

In 2019, WIK Consult noted the following features of the cost allocation methodology:

- the model is consistent with Australia Post's financial accounts because its basic input data are derived from the General Ledger of the company
- the model fully absorbs all costs and guarantees a full cost coverage of Australia Post
- the model is not only (or primarily) used as a regulatory tool. It is mostly used as a management tool. This should give the ACCC confidence in the appropriate modelling and data input approach.[126]

Another feature of Australia Post's cost allocation model is that product volume is the dominant cost driver. Product volume is measured in each activity and in each geographic state, and costs are not allocated to products that are not serviced by an activity.

The use of volume as a key driver means the methodology employed by Australia Post inherently increases the cost burden for products experiencing volume growth and lessens the burden for products in decline.

5.3.2. Australia Post has refined its cost allocation model since 2019

In 2019, WIK Consult published some recommendations to further improve the cost allocation methodology. These included suggestions to:[127]

- identify unattributable cost, treat restructuring costs as unattributable costs, allocate them at a high level based on the Equi-Proportionate Mark Up[128] rule proportionally to attributable costs to all services

122 Submission from member of the public (4), p 1.

123 Submission from Global Express, 23 September 2022, p 3.

124 WIK Consult, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, November 2019.

125 ACCC, *ACCC view on Australia Post's draft price notification*, November 2019, pp 26-28.

126 WIK Consult, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, November 2019, p 5.

127 WIK Consult, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, November 2019, p 5.

128 Equi-Proportionate Mark Up means splitting the common cost in proportion of the volume or turnover of notified and other products delivered by the network. Australia Post's draft price notification notes that its cost allocation model achieves this as all activity cost is volume variable, regardless of whether the underlying resource used in the activity is fixed or variable.

- make the model capable of calculating the impact of parameter changes and for scenario calculations
- generate short-run and long-run incremental cost for loss making reserved services
- require a decomposition of cost changes in the future into major drivers at a service group level.

Australia Post has improved upon its 2019 model by including a:

- delivery time standard update - Australia Post undertook a field-based review of the time standards associated with the indoor and outdoor activities performed by postal delivery officers. This update was reflected in its enterprise profit model in 2019–20
- van operations national survey and allocation update - Australia Post undertook a review of its transport function. The impacts of the resulting updates to van operations and other transport (interstate linehaul and interstate air transport) resulted in a shift in costs away from reserved letters.

Australia Post also responded to WIK Consult's recommendation to generate short-run and long-run incremental costs by engaging Quantonomics to produce estimates of cost elasticities for delivery centres. Quantonomics estimated cost elasticities for both total cost and variable cost, which, according to Quantonomics, corresponds to long-run and short-run elasticities respectively.[129] This follows the adoption of recommendations made by WIK Consult in 2015, such as a greater level of disaggregation of some activities.

While the ACCC acknowledges that Australia Post has taken steps to improve its cost allocation model following WIK Consult's recommendations in both 2015 and 2019, there are some opportunities for further improvements.[130] We recommend Australia Post continue to refine the model, particularly its ability to calculate the impact of parameter changes to support better decision-making.

Nevertheless, the ACCC considers that the cost allocation methodology is adequate for the purposes of this assessment process.

5.3.3. Costs are allocated using a dual till approach

The ACCC would be concerned if there was evidence that Australia Post had been using, or in the future would be likely to use, its reserved services (over which it has a monopoly) to subsidise non-reserved services (for which it faces competition).

Australia Post's cost allocation model has safeguards in place to avoid over-costing declining products and under-costing growing products. The "dual till" approach adopted by Australia Post means that as demand for reserved letter services declines, an increasing proportion of Australia Post's total cost base is borne by non-reserved services. This provides some assurance that revenue from the reserved letter services, which are in decline, are not subsidising the cost to deliver non-reserved, or competitive services.

The model achieves this as all activity costs are determined by a volume-based variable, regardless of whether the underlying resource used in the activity is fixed or variable. In multi-product activities, product volume and the product consumption rate of activity resources determine the cost allocation to each product. If consumption rates remain relatively stable over time, then cost allocation is predominantly volume dependent.

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129 Quantonomics, *Australia Post's Delivery Centre Cost Elasticities*, 2 August 2022, p 5.

130 WIK Consult, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, November 2019, pp 4-5.

Products experiencing volume growth are deemed to be placing increasing demand on shared activity resources relative to products that are declining. All products that share an activity, such as letters and parcels delivered in the same postal run, bear the same proportional change in activity cost per unit. However, under Australia Post's cost allocation model, products experiencing volume growth will absorb a rising share of the total activity cost pool, and products in decline a decreasing share.

The ACCC's view in 2019 was that the parcel market is competitive, particularly in metropolitan areas, so that despite Australia Post's advantages, market forces constrain it from setting monopoly prices for parcel services. We consider that this remains the case in 2022.

Table 10 shows that the proportion of costs allocated to reserved letter services from the total cost pool remains relatively constant throughout the forecast period.

Table 10. Allocated cost to reserved letter service

	2020/21	2021/22	2022/23	2023/24
Reserved letter service costs ($m)	1,570	1,595	1,628	1,597
Total Australia Post costs ($m)[131]	8,121	8,843	8,990	9,244
Reserved letter service costs as % total Australia Post's costs	19.33%	18.04%	18.11%	17.28%

Source: Australia Post, *Draft price notification*, August 2022, tables 10 and 16, pp 33 and 35.

The ACCC is not aware of compelling evidence to suggest that Australia Post has been allocating costs in a way that subsidises its non-reserved section of the business to an extent that it would have a material impact on our findings.

131 This refers to the "Total trading expense" in table 10 of Australia Post's draft price notification. This is different to total costs in Australia Post's Post Tax Revenue Model, which adds a miscellaneous component with no product code to the trading costs.

6. Cost of capital

In assessing Australia Post's draft price notification, the ACCC has had regard to whether the estimated revenue generated is required to recover the efficient costs of providing its reserved services,[132] including a return on capital.

The weighted average cost of capital (WACC) is a commonly used approach for calculating the return on capital. It reflects the opportunity cost to investors of choosing to finance a firm's operations. The WACC estimates the expected rate of return on assets by combining the return on debt and equity weighted by the amount of debt and equity held by the firm.

To attract capital to fund activities, investors expect a business to earn at least a sufficient profit or cash flow to meet a required return in proportion to the risk of the business, while preserving the base capital provided.

While the WACC formula is simple to apply, the analysis that goes into determining each parameter can be contentious. Any assessment of WACC needs to consider the assumptions underlying the choice of values for key parameters, as they will impact the WACC calculation.

6.1. Draft price notification

Australia Post engaged Deloitte Financial Advisory Pty Ltd (Deloitte) to provide an independent assessment of the WACC for the Australia Post reserved letters business. Australia Post stated in its draft price notification that the WACC parameters have been assessed on a forward-looking basis, and Australia Post has adopted the mid-point of the assessed range.

Based on the report by Deloitte, which suggested that the WACC should be in the range between 9.25% to 9.75%, Australia Post has submitted that a nominal 'vanilla' WACC[133] of 9.55% should be applied for its return on capital.[134]

6.2. ACCC view

The ACCC has reviewed the parameters proposed by Australia Post and compared these with parameters that the ACCC considers more reasonable based on its historical approach to calculating WACC for Australia Post price notifications. The ACCC's reasoning for adjusting each of the parameters proposed by Australia Post is set out in Appendix A.

Table 11 compares the WACC input parameters proposed by Australia Post to the ACCC's view.

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[132] As set out in part 1.4, the ACCC considers Australia Post's cost recovery for all reserved services, as the notified letter services share most of the same processing and delivery facilities as other reserved letter services.

[133] The nominal, vanilla WACC is the weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity. In other words, it excludes all tax-related matters from the WACC calculation. A provision for the cost of taxation is made separately from the WACC, in the form of an estimate of the company tax that would be payable each year by the regulated entity.

[134] Deloitte, *Australian Postal Corporation – Assessment of WACC for Australia Post's Reserved Letters Business*, 1 August 2022. Available at: https://www.accc.gov.au/system/files/Deloitte%20report%20on%20assessment%20of%20WACC%20for%20Australia%20Post's%20Reserved%20Letters%20Business.pdf.

Table 11. Australia Post's weighted average cost of capital

WACC parameter	Australia Post proposal	ACCC view
Risk free rate	3.73%	3.80%
Market risk premium	5.75%	6.10%
Corporate tax rate	30.00%	30.00%
Gamma (imputation factor)	0.00	0.585
Asset beta (β_a)	1.00	0.63
Equity beta (β_e)	1.04	0.87
Debt beta (β_d)	0.00	0.00
Gearing ratio (D/V)	5.00%	28.30%
Cost of equity	9.69%	9.12%
Cost of debt	6.89%	5.58%
Nominal vanilla WACC	**9.55%**	**8.12%**

Source: Australia Post, ACCC analysis.

Based on the ACCC's adjusted parameters, the ACCC considers an alternative WACC of 8.12% is more appropriate than the 9.55% WACC proposed by Australia Post.

The impact on required revenue (discussed in part 7 of this report) when the ACCC's alternative parameters are used is a reduction of approximately:

- $19 million, $20 million and $20 million for reserved services in 2021–22, 2022–23 and 2023–24 respectively
- $2 million per annum for reserved ordinary letters.

The effect of this reduction in required revenue is relatively small and would not materially improve Australia Post's under-recovery for reserved services. This is because the return on capital accounts for approximately 1.5% of Australia Post's total required revenue for reserved services.

The most significant difference between the WACC parameters proposed by Australia Post and those suggested by the ACCC relate to market risk premium, the value of gamma, the cost of debt, the gearing ratio and the value of the asset and equity betas.[135] The ACCC's lower value of nominal vanilla WACC is the result of lower cost of debt and equity beta, and higher gearing ratio, offset by the higher market risk premium.

The ACCC notes that it sets the cost of capital in reference to an efficient comparable firm operating in Australia rather than the regulated business' actual financial statements. The ACCC considers that this approach balances the need for a firm to earn a competitive rate of return to encourage investment, but not lead to monopolistic pricing, and provides an incentive to improve overall performance.

[135] Each of these variables is explained and discussed in Appendix A.

7. Cost recovery

As outlined in part 1.4, the ACCC's key consideration in assessing the proposed price increases is whether revenue generated by the proposed increases is sufficient to allow Australia Post to recover its efficient costs, without generating excessive or monopoly profits.

The ACCC typically considers a building block model provided by Australia Post to aggregate its full costs. The cost components of the building block model are:

- operating costs
- return of capital, representing depreciation of fixed assets
- return on capital, representing the required rate of return on the asset base
- tax allowances.

The sum of these building block elements represents the 'required revenue' to recover the costs of providing letter services. Required revenue represents a return covering the full economic costs of providing the services, as distinct from Australia Post's operating costs (discussed in part 4 of this report), which are a subset of full economic costs.

The type of building block model provided by Australia Post is a Post-Tax Revenue Model (referred to in this paper as the Revenue Model), meaning that the corporate tax allowance is a separate cost block in the model, so the rate of return is the return required after tax has been paid.

7.1. Draft price notification

Australia Post has provided the ACCC with the latest version of its Revenue Model, which sets out its forecasts of costs, revenue and other inputs used to estimate its expected cost recovery and required revenue for the period 2022–23 to 2023–24.

Australia Post's draft price notification emphasises that, as a Government Business Enterprise, one of its principal objectives is to "add to its shareholder value, and to earn at least a commercial rate of return, which contemplates recovery of the full cost of the resources employed".[136] The revenue Australia Post will need to achieve this objective (i.e. "required revenue") for reserved ordinary letters, domestic reserved letters, and domestic letters are set out in table 12.

The revenue recovery figures in Australia Post's Revenue Model rely on assumptions about factors such as future letter volumes, costs, inflation, and what constitutes a reasonable rate of return.

[136] Australia Post, *Draft price notification*, August 2022, p 10.

Table 12. Australia Post's Revenue Model summary

Summary of PTRM outputs		2021/22 $m	2022/23 $m	2023/24 $m
Nominal Vanilla WACC	**9.55%**			
A: Ordinary reserved letters				
Required Revenue		$ 187	$ 195	$ 190
Present Value of Required Revenue		$ 176	$ 174	$ 159
Sum of PV over 2 years (2022/23 - 2023/24)				$ 333
Letters Revenue at proposed prices		$ 123	$ 116	$ 110
Present Value of Proposed Letters Revenue		$ 116	$ 103	$ 92
Sum of PV over 2 years (2022/23 - 2023/24)				$ 195
Deficiency of Letters Revenue to Required Revenue		$ 60	$ 70	$ 68
Sum of PV over 2 years (2022/23 - 2023/24)				$ 138
B: Domestic reserved letters				
Required Revenue		$ 1,628	$ 1,668	$ 1,641
Present Value of Required Revenue		$ 1,534	$ 1,481	$ 1,374
Sum of PV over 2 years (2022/23 - 2023/24)				$ 2,856
Letters Revenue at proposed prices		$ 1,486	$ 1,358	$ 1,278
Present Value of Proposed Letters Revenue		$ 1,401	$ 1,207	$ 1,070
Sum of PV over 2 years (2022/23 - 2023/24)				$ 2,276
Deficiency of Letters Revenue to Required Revenue		$ 134	$ 275	$ 305
Sum of PV over 2 years (2022/23 - 2023/24)				$ 579
C: Domestic letters				
Required Revenue		$ 1,927	$ 1,959	$ 1,926
Present Value of Required Revenue		$ 1,817	$ 1,740	$ 1,612
Sum of PV over 2 years (2022/23 - 2023/24)				$ 3,352
Letters Revenue at proposed prices		$ 1,657	$ 1,515	$ 1,425
Present Value of Proposed Letters Revenue		$ 1,562	$ 1,346	$ 1,193
Sum of PV over 2 years (2022/23 - 2023/24)				$ 2,539
Deficiency of Letters Revenue to Required Revenue		$ 255	$ 395	$ 419
Sum of PV over 2 years (2022/23 - 2023/24)				$ 813

Source: Australia Post, *Draft price notification*, August 2022, p 57.

The draft price notification asserts that under the Revenue Model, even with the proposed price changes, by 2023–24 Australia Post's:

- reserved ordinary letter service is forecast to generate $138m less than the required revenue
- reserved letter service is forecast to generate $579m less than the required revenue
- domestic letter service is forecast to generate $813m less than the required revenue.[137]

[137] Australia Post, *Draft price notification,* August 2022, p 8.

Underpinning these estimated revenue shortfalls is Australia Post’s calculation of the required revenue for each service. Table 13 summarises each of the building block components for Australia Post’s reserved letter services which inform the required revenue figures in table 12.

Table 13. Revenue Model cost components for reserved letter services ($m)

3. PTRM analysis						
Year		**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Financial year		2021	2022	2023	2024	2025
Year number		0	1	2	3	4
Total domestic reserved letters						
Real Vanilla WACC	3.25%					
Return on Asset			$24	$24	$24	$24
- Return on Equity	3.39%		$24	$23	$23	$24
- Return on Debt	0.74%		$0	$0	$0	$0
Depreciation (Current Cost Accounting)			$90	$97	$110	-
Operation & Maintenance Cost			$1,505	$1,536	$1,495	-
Revenue Component for Tax Calc			*$1,619*	*$1,656*	*$1,629*	*$24*
Tax Payable			$9	$11	$12	$9
Less Value of Imputation Credits	0.00%		-	-	-	-
Total domestic reserved letters - MAR Component	calculated		**$1,628**	**$1,668**	**$1,641**	**$33**

Source: Australia Post Revenue Model, August 2022.

Table 13 shows that the operation and maintenance costs incurred by Australia Post comprise the most significant cost component in its reserved letter services by far. This is different to many other infrastructure providers such as energy, telecommunications, transport and water, which, in comparison, have far higher capital costs. As a result, the required revenue is less sensitive to changes in WACC than may be observed in some other regulated industries.

7.2. Submissions received

LPO Group submits that Australia Post’s community services obligation places it in the “awkward position” of being obligated to act commercially, but also to operate an extensive post office network when there would be no commercial imperative to do so otherwise.[138] LPO Group considers that revenues must increase in line with unavoidable but reasonable cost increases, so that Australia Post can continue to provide a corporate and privately owned footprint of postal service access to the nation.[139]

According to LPO Group, the proposed postage increase should allow Australia Post to partially offset the increasing costs both for the provision of the letter service and the maintenance of the privately-owned licensed post office network, where digital disruption continues to encroach on the viability of community post offices.[140]

POAAL submits that one of the principles of the basic postage rate is that the letters service is self-funding and not reliant on any other financial support, either from the Government or via internal cross-subsidy.[141] POAAL’s submission notes that the regular letter service is a ‘safety net’ service priced to recover the efficient cost of providing the service. POAAL states

138 Submission from LPO Group, August 2022, p 2.
139 Submission from LPO Group, August 2022, p 2.
140 Submission from LPO Group, August 2022, p 2.
141 Submission from POAAL, August 2022, p 3.

that under the principle of cost recovery, Australia Post must set the price of postage stamps such that the costs of delivering the basic letter service are covered.[142]

7.3. ACCC view

7.3.1. The forecast under-recovery depends on parameters in the Revenue Model

The under-recoveries forecast by Australia Post's Revenue Model reflect assumptions on key factors made by Australia Post. The ACCC has discussed the key factors in the preceding parts of this report, namely: letter volumes (part 3), costs (parts 4 and 5) and a return on capital (part 6). The ACCC considers that Australia Post has generally suggested reasonable values for these parameters, but in some instances the ACCC considers alternative values may be more appropriate.

To test the Revenue Model's conclusion, that Australia Post will continue to under-recover revenue if its proposed pricing is implemented, the ACCC has considered how alternative assumptions would affect the extent of cost recovery for reserved services. That is, we have considered whether under-recovery is still likely to occur, assuming the proposed price increases are accepted, on the basis of reasonable alternative assumptions.

Time horizon

One factor that will significantly impact cost recovery is the future time horizon. Australia Post has provided public estimates of its Revenue Model up to 2023–24 – effectively a time horizon of less than 2 years.

The ACCC has tested forecasts generated by the Revenue Model with alternative realistic parameter values for each of the key factors discussed above. In each of these calculations the shortfall between expected revenue and required revenue has increased year on year between 2021–22 and 2023–24.

While the gap between expected revenue and required revenue widens over time in the timeframe modelled, the ACCC is mindful that the shortfall could narrow or close over a longer period. In circumstances where letter volume demand is a key driver of revenue (and is expected to continue its decline into the future), while cost reductions are unlikely to keep pace, we would not expect the gap between expected revenue and required revenue to narrow over a longer time horizon while prices are held constant.

Volumes

As discussed in part 3, while the ACCC considers the letter volume forecasting approach adopted by Diversified Specifics is generally reasonable, we have reservations over the electronic substitution variables constructed, the CPI projections used, and Australia Post's off-modelling augmentation.

The ACCC has compared actual volumes to the forecasts Australia Post provided for its 2019 price notification. We found Australia Post overestimated the extent to which postal volumes would decline for ordinary small stamped letters, one of the major components of notified services, as well as for pre-sort small letters. And, the overall letter volume is marginally under-forecasted, after accounting for the differences associated with COVID-19 induced impact.

[142] Submission from POAAL, August 2022, p 3.

However, the ACCC considers that addressing these modelling and forecasting issues is unlikely to result in an alternative set of volume forecasts that are materially higher. Therefore, improved volume forecasts, in combination with changes to other parameters, are not likely to substantially improve the under-recovery.

Costs

In part 4, the ACCC considers the efficiency of operational costs forecast by Australia Post. According to Quantonomics, Australia Post achieved significant productivity growth for both corporate services and reserved services over the period 1997 to 2022, as well as during the most recent period 2015 to 2022. Australia Post's productivity growth, as measured, outperformed the productivity performance in the market sector.[143] While the ACCC has some reservations about the input measure for mail contractors, this generally indicates that Australia Post has become more efficient over time. The ACCC also notes Australia Post has, and continues to, put in place efficiency measures consistent with international best practice.

ACCC analysis of the Revenue Model indicates that Australia Post would require an average reduction in operations and maintenance costs of 9% in 2021–22, 20% in 2022–23 and 24% in 2024–25 per year compared to the current forecasts by Australia Post, across all reserved letters, to break even in each year.

While there is potentially more that Australia Post could do to improve efficiency, these measures are unlikely to result in a scenario where Australia Post would be able to recover the costs of its reserved services in the period 2022–23 to 2023–24, even with the proposed price increases.

WACC

For the reasons set out in part 6 and Appendix A, the ACCC has adjusted a number of the WACC input parameters proposed by Australia Post. The combined effect of adjusting the parameters is to reduce the nominal WACC from Australia Post's proposed 9.55% to 8.12%. This results in a decrease in required revenue through the return on capital component.

The impact on required revenue is around $19 million, $20 million, and $20 million for reserved services in 2021–22, 2022–23, and 2023–24 respectively. It is approximately $2 million per annum for reserved ordinary services. The effect is relatively small, as the return on capital accounts for approximately 1.5% of Australia Post's total required revenue for its reserved letters and would not substantially affect the under-recovery.[144]

Inflation

The ACCC has also examined the 'inflation factor', a parameter that estimates the rate of inflation in future years, applied by Australia Post. As discussed in part 3.3.2, the inflation factor applied by Australia Post in the Revenue Model to estimate inflation up to financial year 2022–23 (6.1%) was higher than the average rates estimated by the Reserve Bank (5.3%) or the International Monetary Fund used in Diversified Specifics' report (2.8%)[145].

Australia Post's Revenue Model utilises an inflation factor in 3 ways. First, it is used for indexing the value of Australia Post's regulated asset base (that is, the value of the assets for which it is seeking a return) and for converting depreciation from a historic cost basis to a

143 Quantonomics, *Australia Post's Corporate and Reserved Service Total Factor Productivity*, 3 August 2022, p 6.

144 The ACCC has also conducted sensitivity analysis on some of the individual WACC parameters to observe the difference in PTRM outputs.

145 Note that IMF has revised its inflations rates upward in October 2022.

current cost basis. Second, inflation is used as an input to calculate the real WACC (discussed in part 6 and Appendix A). Third, inflation is used as the discount factor to calculate present value of revenues and costs.

In relation to the first and third factors, adjusting for inflation to calculate present value will cancel out the indexing for inflation in the regulatory asset base and depreciation. As long as a consistent inflation rate is applied for depreciation and cost of capital calculations, changes to the inflation rate should not have an impact on these calculations.[146]

Changes to the inflation factor will primarily have an impact in relation to the second factor, real WACC. A higher projected inflation factor will lower real WACC and thus reduce the calculated return on capital and ultimately the required revenue. In circumstances where the WACC has a rather limited impact on the required revenue (discussed above), we consider discrepancies between the inflation rate used by Australia Post compared to the ACCC's preferred RBA rates will not change the ultimate finding of the Revenue Model – that an under-recovery is likely to result.

7.3.2. Using the ACCC's recommended parameters results in a smaller shortfall

The ACCC has examined how results from the Revenue Model would change when each of the key WACC parameters are set at more appropriate values, as presented in Table 11. The combined effect of adjusting the parameters is to reduce the nominal WACC from Australia Post's proposed 9.55% to 8.12%. This results in a decrease in required revenue through the return on capital component.

Table 14 summarises the forecast costs and revenues for domestic reserved letters in Australia Post's Revenue Model using the WACC parameters provided by Australia Post and the ACCC alternative.

Table 14. Effect of alternative parameters on forecast costs and revenues for domestic reserved letters ($m)

	2021–22 ($)	2022–23 ($)	2023–24 ($)
Australia Post's Proposed WACC parameters			
Return on Asset	24	24	24
Depreciation (Current Cost Accounting)	90	97	110
Operation and Maintenance Cost	1,505	1,536	1,495
Tax payable	9	11	12
Required Revenue	**1,628**	**1,668**	**1,641**
Letters Revenue at proposed prices	1,486	1,358	1,278
Deficiency	-142	-310	-363
ACCC recommended WACC parameters			
Return on Asset	14	14	14
Depreciation (Current Cost Accounting)	90	97	110
Operation and Maintenance Cost	1,505	1,536	1,495

146 The Revenue Model provided by Australia Post used inflation rates (5.1% in 2022-23 and 2.3% in 2023-24) for indexing regulatory asset base and depreciation, which are different from 6.1% used for deriving real WACC for discounting. Nevertheless, the data inconsistency does not appear to have a material impact on the Revenue Model results.

Tax payable	1	3	5
Less Value of Imputation Credits	-1	-2	-3
Required Revenue	**1,609**	**1,648**	**1,621**
Letters Revenue at proposed prices	1,486	1,358	1,278
Deficiency	-123	-290	-343

It is significant to note that even when all the ACCC's alternative parameters are used, the model continues to predict a material under-recovery in revenue for Australia Post's reserved services in the future under its proposed pricing.

7.3.3. Australia Post is profitable, but its letter services run at a loss[147]

The ACCC considers that although Australia Post is a profitable business overall, its letter segment has continuously incurred losses due to declining volumes and increasing delivery points. Without a price increase, the losses will be even greater in the forecast period.

Table 15 presents an extract from Australia Post's annual report for the 2021–22 financial year, showing its business performance in the last 5 years.

Although Australia Post's revenue for its non-letter segment has increased continuously over those 5 years, its letters segment revenue has continuously declined, with letter revenue in 2021–22 27% lower than in 2017–18. Non-letter revenues have increased by over 60% in the same period. Australia Post's expenditure over the period has also increased each year, with expenditures in 2021–22 having increased by 9% since 2020–21, and now standing more than 30% above 2017–18 levels.

[147] All references to profits and costs in this part 7.33 refer to accounting profit and loss, not economic profit and loss.

Table 15. Australia Post's business performance trends from financial years 2018 to 2022

Five-year trends	2018	2019	2020	2021	2022
Revenue - letters ($m)	2,433.7	2,216.3	1,996.4	1,794.4	**1,783.1**
Revenue - non-letters ($m)	4,443.3	4,773.5	5,502.8	6,479.3	**7,190.8**
Expenditure ($m)	6,757.6	6,950.3	7,447.5	8,174.4	**8,918.7**
Profit before tax ($m)	125.7	41.1	53.6	100.7	**55.3**
Profit after tax ($m)	134.2	40.6	42.9	69.6	**49.5**
Total assets ($m)	5,589.1	5,542.7	6,785.3	7,064.9	**6,903.1**
Shareholder return on equity (%)	6.0	1.7	1.9	3.0	**2.0**
Return on average operating assets (%)	3.3	1.6	2.1	2.6	**1.6**
Debt to debt plus equity (%)	22.9	23.6	24.6	15.7	**12.0**
Dividends declared ($m)	83.1	25.4	27.9	44.3	**32.1**
Dividends paid ($m)	78.5	42.2	21.0	46.2	**36.3**
Estimated cost of Community Service Obligations ($m)	403.5	392.2	393.3	348.3	**348.5**
Total taxes and government charges ($m)	540.2	529.4	480.6	571.0	**660.6**
Capital expenditure ($m)	310.2	423.9	316.1	450.0	**427.2**
Basic Postage Rate[1] (BPR) and consumer price index (CPI)	**2018**	**2019**	**2020**	**2021**	**2022**
BPR (cents)	100	100	110	110	**110**
Concession (cents)	60	60	60	60	**60**
CPI all groups 8 capitals base 2011-12=100	113.0	114.8	114.4	118.8	**126.1**
Year on year change in BPR (%)	0.0	0.0	10.0	0.0	**0.0**

Source: Australia Post Annual Report 2022, p 17.

Table 15 shows that overall profit (excluding capital costs) for Australia Post has been positive throughout the 4 years to 2021–22, with the majority of revenue accruing from the non-letter segment of the business.

Table 16 presents a comparison between Australia Post's letter and non-letter services. It shows that the letter segment contribution to overall revenue and expenditure for Australia Post has declined in 2022 (19.9% and 23% respectively) compared to 2021 (21.7% and 24.6% respectively).

Reported as profit before tax, finance costs for the non-letter segment have fallen slightly from $350.3 million in FY 2020–21, to $348.8 million in 2021–22, while the letter segment's loss increased from $205.7 million in 2020–21, to $255.7 million in 2021–22.

As shown by table 16, increased losses in 2021–22 for the letter segment of the business from 2020–21 to 2021–22 was the result of reduced revenue (falling from $1,794.4 million to $1,783.1 million), and increased expenditure (rising from $2,000.1 million to $2,038.8 million).

Table 16. Comparison between Australia Post's letters and non-letter services

	Letters[1]		Non-Letters		Total	
2022	**$m**	**%**	**$m**	**%**	**$m**	**%**
Revenue	1,783.1	19.9%	7,190.8	80.1%	8,973.9	100.0%
Expenditure	2,038.8	23.0%	6,842.0	77.0%	8,880.8	100.0%
Profit/(loss) before income tax, finance costs and share of net profits of equity-accounted investees	**(255.7)**	**(274.7%)**	**348.8**	**374.7%**	**93.1**	**100.0%**
Finance costs					(37.9)	
Share of net profits of equity-accounted investees					0.1	
Profit before income tax					**55.3**	
Income tax (expense)/benefit					(5.8)	
Net profit for the year					**49.5**	

	Letters[1]		Non-Letters		Total	
2021	**$m**	**%**	**$m**	**%**	**$m**	**%**
Revenue	1,794.4	21.7%	6,479.3	78.3%	8,273.7	100.0%
Expenditure	2,000.1	24.6%	6,129.0	75.4%	8,129.1	100.0%
Profit/(loss) before income tax, finance costs and share of net profits of equity-accounted investees	**(205.7)**	**(142.3%)**	**350.3**	**242.3%**	**144.6**	**100.0%**
Finance costs					(45.3)	
Share of net profits of equity-accounted investees					1.4	
Profit before income tax					**100.7**	
Income tax (expense)/benefit					(31.1)	
Net profit for the year					**69.6**	

1. Letters includes reserved letters (Revenue $1.5 billion (2021: $1.5 billion) and loss before income tax expense and share of net profits of equity-accounted investees of $95.8 million (2021: loss before income tax expense and share of net profits of equity-accounted investees of $60.3 million)), non-reserved letters (including unaddressed mail), international letters and small packets (i.e. regulated packets less than 2kg).

Source: Australia Post Annual Report 2022, p 159.

7.3.4. The proposed price increases are unlikely to generate excessive revenue

The ACCC considers that based on past trends, the letter segment of Australia Post is likely to continue to incur losses in the next 2 years. In forming this view, the ACCC considers:

- although the letter volumes are decreasing, the delivery points have continuously increased over the years (see part 3 on volume demand)
- due to the substantial decline in letter volume and resulting revenue, Australia Post is unlikely to recover its cost for this segment, even though it has reduced its expenditure for its letter segments in recent years (see parts 4 and 5). Australia Post's allocation of costs to ordinary/other letter segments from the total cost pool are forecast to continuously decline in the next 2 years
- the CPI in 2022 has increased significantly compared to past years and RBA forecasts for 2023 and 2024 remain on the high side.

In light of these factors, the ACCC considers that, even with alternative reasonable assumptions to the forecasts of letter volumes, costs, and WACC, a break-even of costs and revenue is unlikely to arise for reserved services. This is the case even if Australia Post is permitted to increase its prices as it has proposed. The ACCC is also mindful that it would be undesirable for reduced profitability in the business as a whole or increased losses for letter services to reach a level that leads to reduced employment.

Appendix A: ACCC approach to cost of capital parameters

Risk free rate

Deloitte use the 5-day average of the 10-year Australian Government Bond yield as the proxy for the risk-free rate. Deloitte calculate the risk-free rate to be 3.73% as at 30 June 2022.[148]

The ACCC agrees that a 10-year Australian Government Bond yield is a good proxy for the risk-free rate. However, the ACCC uses a 20-day average to calculate the risk-free rate as at 30 September 2022. The risk-free rate is 3.80%.[149]

Market risk premium

The market risk premium (MRP) is the expected return over the risk-free rate that investors require to invest in a well-diversified portfolio of assets. It represents the risk premium that investors can expect to earn for bearing only non-diversifiable (systematic) risk.

The MRP is common to all businesses in the economy and is not specific to an individual business or industry.

Australia Post has proposed, on the advice of Deloitte, an MRP of 5.75%. Deloitte notes that their estimate is based upon analysis of both historic and prospective estimates of the MRP. However, they note that they have placed more weight on current and prospective approaches:[150]

> We are of the view since the unveiling of the global financial crisis in mid-2007 and the subsequent periods of increased volatility in equity and debt instruments, the relevance of historical observations and long-term average measures for the estimate of the equity market risk premium (EMRP) has substantially weakened.
>
> As a result, Deloitte has increasingly placed more weight on current and prospective approaches to assess the EMRP. In particular, we estimate the EMRP based on current share market values and assumptions regarding future dividends and growth. This analysis involves the setting of several variables and can only be considered indicative. As a result, we therefore also use other market indicators to support our estimate of the prospective EMRP, which include the spreads observed on domestic and foreign corporate bonds and equity market volatility.

The ACCC agrees with Deloitte that there are different approaches to estimating the MRP, including analysing historical excess returns, dividend growth models, survey evidence and using conditional variables.

The ACCC, however, has historically favoured using historical excess returns to estimate the MRP as there is difficulty in estimating the conditional MRP.[151] As such, the ACCC considers that the MRP should be estimated based on evidence regarding historical excess returns, with less weight given to other methods. The ACCC considers that historical excess returns provide the better estimate of MRP because they are directly observable, easily replicable and transparent.

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148 Deloitte, *Australian Postal Corporation – Assessment of WACC for Australia Post's Reserved Letters Business*, 1 August 2022, p 7.

149 Using Bloomberg ticker BV100127.

150 Deloitte, *Australian Postal Corporation – Assessment of WACC for Australia Post's Reserved Letters Business*, 1 August 2022, pp 7-8.

151 MRPs informed or conditional on information from the time of the estimate.

The ACCC's and Australian Energy Regulator's (AER's) MRP estimates typically range between 6 and 6.8.[152]

Given the ACCC's and AER's previous estimates of the MRP, the ACCC's view is that an MRP estimate of 6.1 per cent should be applied in determining the nominal vanilla WACC. This is consistent with using a 10-year term for the risk-free rate.

Gamma

In general, the ability of a listed company to pay imputation credits with dividends is taken into account in determining the WACC in order to avoid over-compensation of a regulated business.

Since Australia Post's Revenue Model applies a vanilla WACC, gamma is used to capture all tax effects in the estimation of cash flows and tax liabilities. The revenue allowance to cover Australia Post's expected tax liability is reduced in a manner consistent with the value of gamma.

Deloitte, on behalf of Australia Post, has not included a value for gamma or any evidence or analysis. Hence it is assumed that Deloitte propose a gamma value of zero.

As noted in previous price notification assessments, the ACCC has historically set gamma with reference to a benchmark for an efficient firm operating in Australia rather than the regulated business' actual financial statements. This is on the premise that the cost of capital should be independent of the regulated firm's ownership structure, and it should instead reflect a competitive capital market that is supporting investment in real assets. The ACCC considers that this approach allows the firm to earn a competitive rate of return to encourage investment but not lead to monopolistic pricing while providing an incentive to improve overall performance.

The ACCC has adopted a value for gamma consistent with the approach taken in recent ACCC and AER decisions. For example, the ACCC's final report on the access determination for the Domestic Mobile Terminating Access Service adopted a gamma of 0.585.[153] The AER proposes to continue to use this value in its 2022 Draft Rate of Return Instrument.[154] The AER's decision took an economy-wide approach to calculating the value of gamma, determined as a function of:

- the proportion of imputation credits generated by a regulated firm operating efficiently in Australia that is expected to be distributed to investors
- the extent to which an Australian investor is able to use imputation credits to reduce their personal tax (or receive a refund).

The ACCC's view is that a gamma of 0.585 be applied in estimating Australia Post's tax liabilities.[155]

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152 See ACCC, *Public inquiry on the access determination for the Domestic Mobile Terminating Access Service – Final Report*, October 2020, p 82; AER, *2018 Rate of Return Instrument – Explanatory Statement*, December 2018; AER*, 2022 Draft Rate of Return Instrument – Explanatory Statement*, June 2022.

153 ACCC, *Public inquiry on the access determination for the Domestic Mobile Terminating Access Service – Final Report*, October 2020, p 82.

154 AER*, Draft Rate of Return Instrument – Explanatory Statement*, June 2022, p 243.

155 This is based on an estimate of the distribution rate relying on financial statement data from the Top 50 ASX firms of 0.90 and an estimate of theta based on the proportion of Australian equity owned by domestic investors of 0.65.

Equity beta

The equity beta measures the 'riskiness' of a firm's returns compared with that of the market as a whole. Equity beta measures how sensitive a firm might be to the systematic risk that affects the overall market. A firm's exposure to these risks depends on its activities and level of financial leverage.

Australia Post, based on advice from Deloitte, propose an equity beta of 1.04. Deloitte states that it has estimated the equity beta with reference to betas for comparable listed companies that collectively reflect the range of operations of Australia Post. Deloitte notes that in estimating an appropriate beta for the Letters Business, they considered the betas of listed comparable companies operating in the postal and logistics industries. They calculated the betas based on weekly and monthly returns, over a 2- and 4-year period, compared to the relevant domestic index.[156]

Comparable companies

Deloitte includes eight international postal companies: Deutsche Post, Royal Mail, PostNL, Bpost, Osterreichische Post, Singapore Post, CTT Portugal and Pos Malaysia. The ACCC accepts these companies as comparable.

Deloitte also includes the following logistics/transport providers: CTI, Freightways Limited, Forward Air Corporation, Yamato Holdings, Mainfreight Limited, XPO Logistics, Fed Ex, UPS. The ACCC accepts these additional comparables as they are predominantly engaged in transportation and logistics services.[157] The ACCC has, however, included 3 other Australian logistics companies: K&S, Lindsay and Qube. As transport and logistics are estimated to consist of only 5%[158] of the reserved services' operating cost, in calculating the average beta of comparable companies, the ACCC adjusts the weight on the Australian logistics group accordingly.

The ACCC considers several aspects of Deloitte's approach to estimating Australia Post's equity beta to be inappropriate. This includes the approach to estimating the equity and asset betas (and associated gearing assumptions) to arrive at a final estimate. The ACCC does not accept Deloitte's argument for using adjusted equity betas over raw equity betas.[159]

The ACCC gives weight to empirical estimates from comparable listed companies to construct a benchmark beta for Australia Post's reserved services. The ACCC sources an average of weekly equity betas over a 5-year time period. The ACCC considers that this approach represents a trade-off between a shorter period with most recent data that is reflective of current systematic risk and a longer period with more data that improves accuracy of estimates.

The ACCC has also identified concerns with Deloitte's approach of using a 'mean of means'[160] for selection of a total reserved services beta, noting that this approach attributes

[156] Deloitte, *Australian Post Corporation – Assessment of WACC for Australia Post's Reserved Letter Business*, 1 August 2022, pp 11-13.

[157] The logistics companies have business segments which are similar to Australia Post's parcel and courier services but are not entirely comparable to Australia Post's reserved letter business. However, for the purposes of estimating the beta, they have been included.

[158] From Australia Post's Revenue Model.

[159] The raw equity beta measures the 'riskiness' of a firm's returns compared with that of the market as a whole and compares the historical returns of the firm against that of the overall market. The adjusted beta is derived from historical data but modified by the assumption that a security's beta moves toward the market average of one over time (i.e., the Blume adjustment).

[160] The 'mean of means' approach uses a simple average within each group, and then a further simple average across the 2 groups.

equal weights to each of the comparable sectors. As noted above, the transport and logistics sector reflect a relatively low share of the reserved service's total operating cost. The ACCC therefore applies a weighted average across the 2 groups to more accurately reflect the comparable companies' contribution to the reserved services' cost structure. The ACCC assigns a weight ratio of 0.95:0.05 to the international postal group and logistics group.[161] Having regard to the analysis above, the ACCC's view is that an equity beta of 0.87 should be applied to Australia Post's reserved services.

Gearing

Gearing is the proportion of capital funding sourced through debt as opposed to equity. The gearing level weights the return on equity and cost of debt in the WACC formula. Where the firm is highly geared (that is, the firm has a high level of debt) and holding all else equal, this implies greater financial risk for the firm and therefore a greater required rate of return for equity holders.

Australia Post, based on the advice of Deloitte, has proposed a gearing ratio of between and 10%. Deloitte has noted the following in determining this range.[162]

In selecting an appropriate level of gearing for the Letters Business, Deloitte considered the following:[163]

- the gearing of the companies comparable to the Letters Business, on a pre-IFRS 16 basis, are observed to have an average and median of 15.1% and 9.5%, respectively
- the gearing of the companies comparable to the broader Australia Post group, on a pre-IFRS 16 basis, are observed to have an average and median of 16.2% and 9.8%, respectively
- the operations of the comparable companies, and more specifically, the level of operating leverage
- the capital structure of Australia Post, which as at 30 June 2021, was in a net cash position
- in a report prepared by the Auditor General in 2017, it was found that on a stand-alone, benchmark basis, it seemed unlikely that the Letters Business would be able to sustain any debt in its capital structure, absent of government subsidies. We understand this observation was made with reference to the secular decline in the volume of letter delivery services, as well as the service nature of the business, whose asset base predominantly comprises of assets of an intangible nature and net working capital.

The ACCC considers it is the long-term gearing that an efficient firm in the industry would target.[164] The ACCC has adopted a gearing ratio of 28.3 by observing comparable companies' gearing. We consider that the gearing ratios of the comparable listed companies will most closely reflect the range of operations of Australia Post.

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161 From Australia Post's Revenue Model.

162 Deloitte, *Australian Post Corporation – Assessment of WACC for Australia Post's Reserved Letter Business*, 1 August 2022, pp 13-14.

163 Deloitte, Australian Post Corporation – *Assessment of WACC for Australia Post's Reserved Letter Business*, 1 August 2022, pp 13-14.

164 Using a firm specific gearing exposes the possibility of firms manipulating their leverage levels to improve their allowed revenues or prices (for example, raising its leverage to increase its allowed revenues or prices). The ACCC considers that a benchmarking approach incentivises a firm to efficiently finance its operations.

Cost of debt

Australia Post proposes, based on the advice of Deloitte, a cost of debt of 6.89%. Deloitte has employed this value based on:

- Australia Post's weighted average cost of debt of 3.84%. Deloitte notes that this includes 2 fixed term notes with weighted average interest of 4.74%
- the borrowing capacity of the Letter Business on a standalone basis. Deloitte consider the yield on 10-year non-financial BBB-rated corporate bonds as at 30 June 2022.[165]

The ACCC holds the view that the cost of debt should be estimated based on a forward-looking expected cost of debt to the firm, with the cost of debt set with reference to a benchmark business facing similar risks to Australia Post's reserved services. The ACCC considers Deloitte's method of using an actual cost of debt to be inconsistent with this approach.

Australia Post is currently rated A+ by S&P.[166] S&P does not separately rate individual component businesses, therefore Australia Post's overall credit rating extends to Australia Post's reserved services. As such, we have estimated the cost of debt using yields on A rated Australian corporate bonds.[167] The ACCC has adopted a 10-year A rated bond yield over a 20-trading day averaging period. The ACCC considers that 10 years represents a trade-off between the long asset lives of regulated assets and better quality of available data for shorter maturities. On this basis, the ACCC considers a cost of debt of 5.58% is appropriate for Australia Post's reserved services.

[165] Deloitte consider a 10-year maturity of the observed corporate bonds appropriate notwithstanding the shorter duration of the Regulatory Period, on the basis that a commercial enterprise would not seek to refinance its entire debt portfolio every 2 years, rather would rationally seek to refinance a portion of its debt every year.

[166] S&P Global Ratings Direct, *Australian Postal Corp – Full analysis,* 9 September 2022.

[167] The ACCC has obtained its corporate bond yield data from Bloomberg's 10-year Corporate A Bloomberg Fair Value Curve. This curve includes bonds rated A+, A or A- by S&P, Moody's, Fitch and/or DBRS. There is no equivalent curve for bonds rated A+ only.