Attachment 3

AUSTRALIA POST

# Draft Notification

# Change in Domestic Reserved Letter Pricing

## Detailed Explanation

## of Price Changes

## July 2009

## Glossary

| | |
|---|---|
| AASB | Australian Accounting Standards Board |
| ABS | Australian Bureau of Statistics |
| ACCC | Australian Competition and Consumer Commission |
| AER | Australian Energy Regulator |
| AIRC | Australian Industrial Relations Commission |
| AMAS | Address Matching Approval System |
| APC Act | Australian Postal Corporation Act, 1989 |
| Australia Post | Australian Postal Corporation |
| APSS | Australia Post Superannuation Scheme |
| BCS | barcode sorter machine |
| BPR | basic postage rate |
| CAC Act | Commonwealth Authorities and Companies Act, 1997 |
| CEPU | Communications Electrical Plumbing Union (Communications Division) |
| CFC | culler facer canceller machine |
| CIP | Capital investment plan |
| CPA | community postal agency |
| CPI | consumer price index |
| CSO(s) | community service obligation(s) |
| CPSU | Community and Public Sector Union |
| DC | delivery centre |
| DPID | delivery point identifier – is a unique number associated with a delivery point |
| EBA | Enterprise Bargaining Agreement |
| FDD | (Australia Post's) Future Delivery Design |
| FMOCR | flat mail optical character reader machine |
| FTE | full time equivalent (standardised labour unit) |
| GDP | gross domestic product |
| GIS | geospatial information system |
| GST | goods and services tax |
| LPO | licensed post office |
| LSE | load shifting equipment |
| LTIFR | Lost Time Injury Frequency Rate |
| M&ND | (Australia Post's) Mail and Networks Division |
| MAR | maximum allowable revenue |
| MC | mail centre |
| MFP | multi factor productivity |
| MLOCR | multi line optical character reader machine |
| MRP | Market Risk Premium |
| OCR | optical character recognition |
| OECD | Organisation for Economic Co-operation and Development |
| OH&S | Occupational Health & Safety |
| Postie | Postal delivery officer |
| PTRM | Post Tax Revenue Model |
| PS Act | Prices Surveillance Act, 1983 |
| RFID | radio frequency identification |
| RKR | The Record Keeping Rules, made by the ACCC under section 50H of the APC Act |
| SPB | street posting box |
| Statement of Approach | ACCC's *Statement of regulatory approach to assessing price notification*s June 2009 |
| TFP | total factor productivity |
| TP Act | Trade Practices Act, 1974 |
| ULD | unit load device – metal cage used by Australia Post for mail handling and transport |
| USPS | United States Postal Service |
| VAT | Value Added Tax |
| WACC | weighted average cost of capital |

## Executive Summary

This draft notification proposes price changes to Australia Post's domestic reserved letter service (eg Ordinary and PreSort Letters up to, and including, 250 grams) effective January 2010. The full detail of the proposed changes with a comparison to current prices is at Appendix 1, with the major elements as follows:

- increase of five cents to the BPR; and
- average increase of 2.8c (GST exclusive) to PreSort prices.

The primary objective of the proposed prices is to provide for an appropriate level of revenue from Australia Post's domestic reserved letter service within the context of market and regulatory expectations. This approach is consistent with Australia Post's 2008 price notification where prices were set to provide a level of revenue below that which the ACCC's modelling determined as being the amount required (ie the MAR) to recover the efficient forward costs of providing the domestic reserved letter service (incorporating the effects of continuing productivity improvements).

The proposed prices have been modelled in an environment where:

- delivery points continue to increase by around 2% (200,000) per annum;
- there is reduced potential for significant productivity improvements;
- letter volumes are forecast to decline by an average of 2.3% per annum over the next three years; and
- Australia Post is required to fund its CSOs and meet its regulated performance standards[1].

Australia Post believes that the proposed changes to domestic reserved letter prices in January 2010 are both appropriate and necessary. This draft notification sets out Australia Post's evidence and supporting arguments demonstrating that:

- Australia Post's costs are efficient and cost movements over the period of this draft notification reflect an aggressive and sustained pursuit of efficiency and productivity opportunities:
- although the revenue from the proposed prices does not fully recover the sum of efficient costs of providing the domestic reserved letter service plus an appropriate rate of return, it is reasonable in the current circumstances and reflective of the current global economic environment: and
- pricing:
    - is consistent with Australia Post's position of proposing smaller more frequent increases as opposed to a larger upfront increase - thereby minimising any adverse impact upon demand;
    - reflects Australia Post's obligations to operate in a manner consistent with sound commercial practice; and
    - reflects the pursuit of pricing and financial targets that are embodied within Australia Post's corporate plan.

As noted above, the primary objective of the proposed prices is to provide for an appropriate level of revenue from Australia Post's domestic reserved letter service within the context of market and regulatory expectations. Under the PTRM used by the ACCC in Australia Post's 2002 and 2008 price notifications, even with the January 2010 price changes, Australia Post's domestic reserved letter service is forecast to make a loss of around $143m in 2009/10. Despite this, Australia Post contends that, the level of return is appropriate given the current global economic environment and the need to avoid large upfront pricing which could lead to demand shocks.

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[1] Regulations made under section 28C of the APC Act detail the prescribed performance standards that Australia Post is required to meet.

This draft notification is supported by information on volumes, revenues and costs and is modelled over the 2009/10 – 2011/12 financial years. This financial data is consistent with Australia Post's corporate plan[2].

References to historical information and statistics are based on extracts from the Australia Post Annual Report 2007/08. Data for 2008/09 will not be finalised and made publicly available until later this year (eg the annual report is normally released around October), however, where possible the most recent forecast data for 2008/09 has been used.

[2] Australia Post's 2009/10 – 2011/12 corporate plan – endorsed by the Australia Post Board and forwarded to the Shareholder for consideration

## 1. Proposed prices

*This section:*

- *summarises the proposed January 2010 price changes; and*
- *sets out the principles adopted in forming the pricing proposal.*

Australia Post's pricing proposal is detailed at Appendix 1. A summary of the major elements of the pricing proposal is as follows:

- increase of 5 cents to the BPR (to 60c);
- increase to other Ordinary Letter prices (eg large, seasonal greeting) to maintain relativity to the BPR; and
- increase to PreSort Letter prices of an average of 2.8c (GST Exclusive);
  - Small PreSort an average increase of 2.6 cents (GST Exclusive); and
  - Large PreSort an average increase of 5.0 cents (GST Exclusive).

The proposed prices, which reflect an average variation on 2008 prices of 7.6%, represent:

- the third increase to the BPR since 1992; and
- the second general increase to PreSort prices since 1992.

The pricing proposal has been developed pursuant to Australia Post's Letter Pricing Principles (Appendix 2) and Australia Post believes that the proposed prices:

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

# 2. Regulatory overview

*This section details how:*

- *for the purposes of prices surveillance by the ACCC, Australia Post's domestic reserved letters are notified services, and Australia Post is a declared person;*

- *these factors require Australia Post to notify the ACCC of proposed increases in the prices of the services concerned; and*

- *this draft notification is made on the expectation that, subject to any particular valid directions, the ACCC in its review of the proposed prices will have regard to the efficiency of Australia Post's cost base and the reasonableness of the rate of return being sought in this notification.*

## 2.1. Australia Post services subject to ACCC prices surveillance

Under section 95X of the TP Act, the (relevant) Minister, or the ACCC with the approval of the Minister, may declare a person to be a declared person for the purposes of Part VIIA of the TP Act relating to prices surveillance, and may declare goods or services of a specified description to be notified goods or services for those purposes.

Declaration 75 made by the Minister under section 21 of the PS Act[3] on 5 February 1992 declares that letter services reserved to Australia Post under Division 2 of Part 3 of the APC Act are notified services, and that Australia Post in relation to those services is a declared person. A copy of Declaration 75 is at Appendix 3.

The effect of Declaration 75 is that to comply with section 95Z of the TP Act, Australia Post must notify the ACCC if it proposes to:

- increase the price of a notified service (ie a reserved letter service); or

- introduce a new service that would fall within the definition of a reserved letter service; or

- provide an existing reserved letter service under terms and conditions that are not the same or substantially similar to the existing terms and conditions of that service.

## 2.2. Australia Post reserved letter services

Australia Post's reserved letter service is defined under section 29 of the APC Act, which states that:

> 'Subject to section 30, Australia Post has the exclusive right to carry letters for delivery within Australia, whether the letters originated within or outside of Australia.'

Exceptions to this right are detailed under section 30 of the APC Act, the most notable of which are:

- letters that are carried for a fee or charge that is at least 4 times the rate of postage of the carriage within Australia of a standard postal article by ordinary post (ie the BPR); and

- letters that weigh more than 250 grams.

Domestic letter services that provide for the carriage of reserved letters are listed in Appendix 4.

[3] The PS Act was repealed and replaced by Part VIIA of the TP Act in 2004. Transitional arrangements provide that a declaration made pursuant to the PS Act has effect as though it was made under s95X of the TP Act.

## 2.3. Approach to assessing price notifications

The ACCC's *Statement of Approach* outlines the approach that the ACCC is likely to take when assessing a price notification and reaching a final decision. In particular, the *Statement of Approach* indicates how the ACCC intends to make the requirements of section 95G (7) of the TP Act operational.

Section 95G(7) of the TP Act provides that, in exercising its powers and performing its functions under Part VIIA the ACCC must, subject to any directions given under section 95ZH, have particular regard to the following;

a) the need to maintain investment and employment, including the influence of profitability on investment and employment;

b) the need to discourage a person who is in a position to substantially influence a market for goods and services from taking advantage of that power in setting prices; and

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

In its Statement of Approach, the ACCC considers that the criteria of section 95G(7) of the TP Act can generally be met by assessing price notifications using a cost-based approach with particular attention to;

- the efficiency of the cost base; and

- the reasonableness of the rate of return that is being sought.

While this approach may apply in general, the ACCC has acknowledged that a flexible approach is required to reflect the individual characteristics of each price notification.

One factor that necessitates this flexible approach is section 95ZH of the TP Act which provides for the Minister to direct the ACCC to give special consideration to a specified matter or matters in performing its functions under Part VIIA. In the Explanatory Memorandum to the Trade Practices Legislation Amendment Bill 2003 (when the PS Act was repealed and replaced by the TP Act) the importance of these special considerations was reinforced in two parts:

- when referencing the ACCC's functions under Part VIIA (a reference to section 95G of the TP Act) it is noted that any direction under section 95ZH "…would become the paramount factors to be considered…"; and

- when referencing section 95ZH (Division 6 – Other Provisions) of the TP Act which empowers the Minister to direct the ACCC to give special consideration to particular matters in performing its functions under Part VIIA of the TP Act, it is noted that "… special considerations are to be paramount; for example, they are to be more important considerations than the particular factors specified in 95G".

These special considerations (directions) can be general or related to specific firms. In relation to Australia Post, Direction 11[4] applies to the assessment of any price notifications from Australia Post. Direction 11 is discussed below.

[4] Made by the Minister under section 20 of the PS Act on 19 September 1990 and given effect in terms of the TP Act pursuant to 'carry over' provisions of the TP Act.

## 2.4. Direction 11

Direction 11 in terms of its (then) coverage of price notifications for standard postal articles and registered publications, requires the ACCC (in having regard to the criteria under section 95G (7)) to give special consideration to the following matters:

- "Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35-41 of the Australian Postal Corporation Act 1989 and in particular the pricing targets and Government endorsed financial targets contained in Australia Post's corporate plan;

- The functions and obligations of Australia Post as set out in sections 14-16 and 25-28 of the Australian Postal Corporation Act 1989 and to such directions or notifications given to Australia Post by the Minister for Transport and Communications under that Act as may from time to time be in force;"

The functions and obligations of Australia Post in the second matter are discussed in section 4 of this draft notification.

In relation to the first matter, as sections 35, 36, 37, 39 and 41 of the APC Act were repealed in 1997 and their subject matter incorporated into section 17 of the CAC Act only sections 38 and 40 of the APC Act and section 17 of the CAC Act are discussed below.

- Section 17 of the CAC Act, requires Australia Post to prepare a corporate plan.

- Section 38 of the APC Act sets out matters that the Australia Post Board shall have regard to in preparing or revising a financial target for inclusion in a corporate plan under section 17 of the CAC Act. These include:

  - the expectation of the Commonwealth that Australia Post will pay a reasonable dividend (section 38(c));

  - the need to maintain Australia Post's financial viability (section 38(d));

  - the need to maintain a reasonable level of reserves – especially to make provision for any need to improve the accessibility of, and performance standards for, the letter service (section 38(e)(ii)); and

  - the cost of carrying out Australia Post's CSOs (section 38(g)).

- Section 40 of the APC Act sets out the powers of the (relevant) Minister to direct certain variations to Australia Post's corporate plan. In exercising the powers under this section, the Minister is to have regard to the matters in section 38 (other than 38(f)) and any other matters the Minister considers appropriate.

In noting Australia Post's obligations to pursue a financial policy in accordance with its corporate plans, Direction 11 makes a specific reference to the consideration of two items:

- the pricing targets; and

- government endorsed financial targets.

It is Australia Post's submission, that the separate identification of these two items – which form part of Australia Post's overall financial policy – suggests that each item requires separate consideration independent from the other. This is irrespective of the fact that a pricing target may contribute to the achievement of a financial target.

Therefore, in considering these two items, pricing targets would need to be considered separately to the government endorsed financial targets and it would not be consistent with Direction 11 to consider alternative options to maintain a financial target if a pricing target is varied.

In relation to pricing targets, Australia Post's 2009 corporate plan is consistent with this draft notification that proposes changes to domestic reserved letter prices from January 2010.

In relation to financial targets, while Australia Post's corporate plan does not identify a particular item as being a 'financial target', it does include targets for the following financial measures:

- Revenue;
- Profit, both before tax and after tax;
- Dividends paid;
- Shareholder value; and
- Rates of return, on operating assets, on revenue, and on equity.

The corporate plan also includes a reference to the capital investment program considered necessary to achieve the revenue and expense projections in the plan and to underpin the longer-term viability and growth of Australia Post. The capital investment program is integral to each corporate plan, and receives its own more detailed account. Australia Post's capital investment program forms as important an element of Australia Post's overall 'financial policy' as any of the factors chosen as 'financial targets'.

## 3. Duration and scope of notification

*This section details that this draft notification:*

- *proposes price changes effective January 2010;*
- *is supported by financial data for the period 2009/10 to 2011/12; and*
- *flags that any price changes beyond the scope of this draft notification will be the subject of a separate notification, if required.*

In the ACCC's decision to not object to Australia Post's 2008 price notification, the ACCC requested that future price notifications from Australia Post be supported by:

- a forward-looking disaggregated financial model covering at least a three year period;
- information on how prices for reserved services will change over that period; and
- information on the revenues and costs of those non-reserved services that share the same costs as reserved services over this period.

Noting this request, this draft notification is modelled over the 2009/10 – 2011/12 financial years and is supported by:

- disaggregated financial details (volume, revenue and cost) at product and category level;
- detailed (by price point) information on the proposed January 2010 price changes; and
- information on the revenue and costs forecasts of other Australia Post areas at an aggregate or summary level (this information has been provided separately to the ACCC).

In complying with the ACCC's request to supply financial details over the three years, Australia Post has identified that further price changes may be necessary in the third year (2011/12). Overall, these further price changes would result in an average increase of 6.3% (4.5% for PreSort Letters and 8.1% for Other Letters). However, Australia Post believes that any further price changes beyond January 2010 would firstly require Australia Post, closer to the time of any proposed future change, to undertake an appropriate robust assessment that takes into consideration relevant factors within the market environment. Such a review would also consider the relevant issues related to individual product categories and the impact that any price change would have upon particular customer and market segments. This would be particularly prudent noting the current environment within which Australia Post's domestic reserved letters service operates.

Noting this, the scope of this draft notification is the proposed price changes in January 2010. In the event that Australia Post, after an appropriate robust assessment, believes price changes beyond January 2010 (and in 2011/12) are necessary Australia Post would undertake consultation with key customers and stakeholders and lodge a separate notification (closer to the actual date) containing full details of the proposed prices.

Australia Post anticipates that such a notification would be based on the same financial forecast data as this draft notification – with any significant variations identified, including the reason for such variation. Where appropriate, in such a notification, Australia Post would replace forecast data with actual numbers where available.

# 4. Australia Post

*This section provides:*

- *an overview of Australia Post and its main areas of operation; and*
- *an outline of Australia Post's commercial obligations, community service obligations, and general government obligations which govern the way that the business operates.*

Australia Post is one of Australia's oldest (commercial) organisations. It is a Government Business Enterprise and is wholly owned by the Government of the Commonwealth of Australia. Australia Post is a self funding business managed by a Board of Directors and is subject to all applicable Commonwealth, state and local government laws.

Australia Post is recognised as a leading Australian corporation. Australia Post is rated AAA by Standard & Poor's[5], which is the highest level of corporate credit rating assigned by that organisation. Australia Post is one of only two Australian corporations rated AAA, and the only postal service rated by Standard & Poor's to currently hold this level of rating. Australia Post has maintained its AAA rating continuously since the initial rating was issued in 1995[6].

Australia Post complies with Australian accounting standards, pays dividends to the owner on normal financial principles and makes a major contribution to Australia's economic prosperity and development. In 2007/08, Australia Post (to the nearest $m):

- achieved revenue of $4,959m and profit after tax of $432m, from which a dividend declared to the shareholder was $446m;
- paid rates and taxes to all levels of government (commonwealth, state and local) totalling $548m;
- provided over 36,000 jobs to staff in Australia Post and its subsidiary companies, including permanent and fixed term staff, casuals and agency employees;
- supported over 7,000 small businesses directly (including almost 5,000 in regional and remote areas of Australia) as licensed or franchised post offices, or as mail contractors, and a further 1,000 engaged as owner-drivers;
- provided a retail network of 4,453 outlets, with 2,561 in rural and remote areas; and
- delivered to 10.5m addresses across Australia.

Appendix 5 provides further detail on Australia Post's financial contribution to economic development.

## 4.1. Australia Post's functions

Sections 14 – 16 of the APC Act provide that Australia Post's functions are:

- the supply of postal services within Australia and between Australia and places outside Australia (the principal function, as specified in section 14 of the Act);
- to carry on, outside Australia, any business or activity relating to postal services (the subsidiary function specified in section 15); and

[5] As noted by Standard & Poor's "Ratings are subject to change. For the latest ratings information please visit www.standardandpoors.com.au. Credit ratings issued by Standard & Poor's Ratings Service are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions."

[6] On 30 June 2009 Australia Post was placed on CreditWatch Negative status by Standard & Poor's prior to review of the corporation's existing AAA rating under a new ratings assessment system involving all government-related entities.

- the carrying on of any business or activity that is incidental to the principal and subsidiary functions (from section 16).

## 4.2. Markets in which Australia Post operates

Australia Post has three main business portfolios:

- Letters & Associated Services, which operates in the Australian and international communications market. All of the letter services reserved to Australia Post lie within this portfolio. In 2007/08, the Letters & Associated Services portfolio generated $2,731m of revenue and $149m EBIT;

- Parcels & Logistics, which operates in the Australian and international parcel and logistics markets. In 2007/08, the Parcels & Logistics portfolio generated $1,315m of revenue and $224m EBIT; and

- Agency Services & Retail Merchandise, which operates in the Australian retail merchandise, financial services and identity verification markets. In 2007/08, the Agency Services & Retail Merchandise portfolio generated $713m of revenue and $87m of EBIT.

Appendix 6 provides an overview of services and products within each of these business portfolios.

In addition to Australia Post's continuing efforts to pursue all reasonable cost savings, it is important for the long-term viability of Australia Post that new sources of revenue be found. While such efforts are focussed across all portfolios there has been a specific focus to develop new revenue streams beyond the traditional mail services.

Systematic development of new revenue streams in the latter two portfolio businesses commenced early in the life of the corporation, ie after 1989, although some non-mail services were offered prior to 1989. This reflected Australia Post's decision to pursue economies of scope in addition to economies of scale, thereby spreading fixed network costs both across a wider range of goods and services and also away from non traditional letter and parcel services. The success of this revenue diversification is reflected by the change in trading revenue mix as shown in Table 1.

Table 1 – Trading revenue mix[7]

| Revenue shares | Letters / Parcels | Other services / products | Total |
|---|---|---|---|
| 1989 / 90 | 85% | 15% | 100% |
| 1993 / 94 | 85% | 15% | 100% |
| 1998 / 99 | 79% | 21% | 100% |
| 2003 / 04 | 73% | 27% | 100% |
| 2008 / 09 | 69% | 31% | 100% |

## 4.3. Australia Post's obligations

Under the APC Act, Australia Post has commercial, community service and general governmental obligations. Each of these is discussed below.

### 4.3.1. Commercial obligation

Australia Post is required to, as far as practicable, perform its functions in a manner consistent with sound commercial practice. Australia Post has interpreted its obligation in its widest sense. Australia Post is not aware of any areas where competitive neutrality does not occur. For example, Australia Post:

[7] Note that the letters and parcels data are for the traditional domestic and international mail services only. They do not include all services within their respective portfolio – in particular services introduced since 1990.

- seeks acceptable rates of return and these form part of the range of financial targets included in Australia Post's corporate plans;

- pays dividends to the shareholder at commercially benchmarked rates (currently benchmarked at 75% of profit after tax);

- borrows in capital markets under ordinary conditions with no government guarantee and with credit ratings assessed annually by Standard & Poor's;

- has vigorously pursued productivity gains through economies of scale and economies of scope rather than relying on price rises to ameliorate the impact of establishing and maintaining a relatively fixed cost network required to meet performance standards; and

- sets and determines prices for products and services (including domestic reserved letters) in each market with regard to the market environment, including the capacity for customers to afford any change. This is particularly evident in the current draft notification within which Australia Post has proposed domestic reserved letter prices below that which would be considered the 'maximum allowable' revenue.

### 4.3.2. Community service obligations

Australia Post's CSOs are outlined under section 27 of the APC Act, which requires Australia Post to supply a letter service and which extends to both reserved and non-reserved letters. Key requirements of the letter service are that:

- it includes a single uniform rate of postage for the carriage within Australia, by ordinary post, of letters that are standard postal articles (ie the BPR);

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

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

Compared with a fully commercial operation, the CSOs impose a cost structure that is higher than would otherwise be the case. The CSO cost occurs when the charge for the prescribed service does not recover the cost of delivering the service. In costing the CSOs, Australia Post's approach has been to identify those activities which a commercial enterprise, motivated by the pursuit of its own commercial interest, would not carry out to the same extent or under the same conditions. Australia Post's CSO net cost (calculated on an avoidable cost methodology) for 2007/08 is estimated to have been $104.3m.

### 4.3.3. General governmental obligations

Section 28 of the APC Act requires Australia Post to perform its functions in a way consistent with:

- any general polices of the Commonwealth Government of which the Directors are notified under section 28 of the CAC Act;

- any directions given by the Minister under section 49 of the APC Act; and

- Australia Post's obligations under any convention.

There are currently no obligations under this section that have material impact upon the provision of the domestic reserved letter service.

# 5. Service standards and performance

*This section:*

- *provides an overview of Australia Post's CSO and associated prescribed performance standards which, to ensure ongoing performance, necessitates a high fixed cost network; and*

- *provides an international postal perspective on geographic size, number of delivery points, mail density, service standards and basic postage rates.*

Geographically, Australia is the sixth largest country in the world with a highly dispersed population and a relatively low mail density. Notwithstanding this, Australia Post's service performance ranks among the best in the world and, in a recent survey of a number of OECD postal authorities, Australia Post was ranked first in terms of the total factor productivity level attained (see section 11 of this draft notification).

Australia Post provides the domestic reserved letter service in accordance with a number of performance standards. These standards include those prescribed, pursuant to section 28C of the APC Act, by the Regulations which detail particular standards (the prescribed performance standards) Australia Post is required to meet. Prescribed performance standards must relate to:

- the frequency, speed or accuracy of mail delivery; and

- the availability or accessibility of mail lodgement points or Australia Post offices (or other places) from which Australia Post products and services may be purchased.

Without exception, the CSO requirements and their associated prescribed performance standards of the APC Act, impose a relatively high fixed cost structure on Australia Post that varies marginally with a change in letter volume. Examples include:

- requiring at least 4,000 retail outlets, with a specific rural and remote minimum of 2,500 outlets. The number of outlets is not related to mail or any other volumes. The location of outlets must meet certain geographic coverage requirements that do not provide for any discretion based on an individual outlets' commercial viability. This is so regardless of whether an outlet is staffed by Australia Post employees (corporate) or not eg licensed or franchised;

- the requirement to meet specific delivery accuracy and speed standards requires an ongoing capability across Australia Post's network. The network must perform to these standards irrespective of any variability in volumes, on a daily, weekly or seasonal basis; and

- the requirement to meet prescribed delivery frequency standards – delivery to 98% of delivery points five days per week - means that the outdoor delivery cost, which is the single largest cost item in Australia Post's network, is largely determined by delivery points rather than mail volumes. In the current environment, where delivery points are growing but mail volumes per point are falling, this generally fixed cost results in an increase in average unit costs and a negative impact upon productivity.

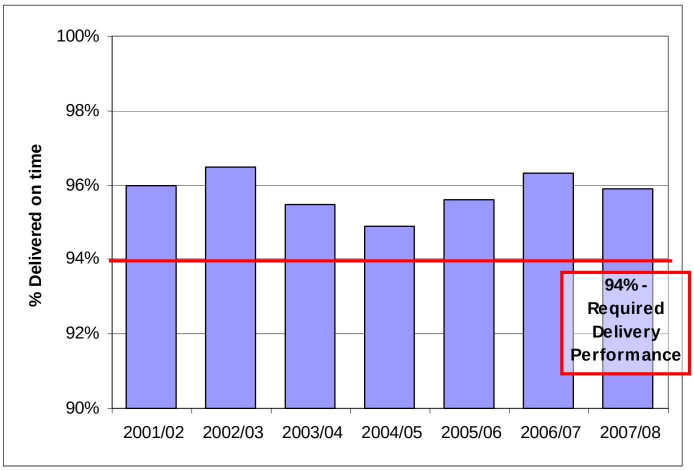
Appendix 7 provides further detail on Australia Post's performance standards.

Performance against these standards is subject to independent audit by the Australian National Audit Office. As detailed in Table 2, Australia Post continued to meet its regulated performance standards in 2007/08. Furthermore, as indicated in Figure 1, for the last seven years, Australia Post's delivery performance standard has continued to exceed the minimum required.

Table 2 – Performance standards 2007/08[8]

| Standard | Required Performance | Actual Performance |
|---|---|---|
| Number of street posting boxes | 10,000 | 15,878 |
| Delivery timetables | Maintained | Maintained |
| On time delivery of non bulk letters | 94% | 95.9% |
| Points to receive deliveries five days per week | 98% | 98.8% |
| Points to receive deliveries no less than twice a week | 99.7% | 99.9% |
| Retail outlets | 4,000 (2,500 in rural and remote areas) | 4,453 (2,561 in rural and remote areas) |

Figure 1 – Delivery performance over time – non bulk letters 2000/01 – 2007/08




## 5.1. International comparison

Comparisons are often drawn between Australia Post and its major peer postal organisations, especially in the United States of America (USPS), United Kingdom (Royal Mail), Canada and, because of its geographic closeness, New Zealand.

It is difficult to draw reasonable comparisons with the USPS and Royal Mail as both have significantly higher population densities than Australia which gives these postal authorities considerably greater economies of scale in postal delivery.

[8] Australia Post Annual Report, Financial and Statutory Reports, page 120

Notwithstanding that there may also be other points of difference (eg centralised or decentralised processing, costs per letter processed, scale factors, delivery standards and lodgement times), Table 3 below provides a snapshot of several countries' postal organisations showing that, even with generally lower mail densities, leading to potentially lower economies of scale, Australia Post generally provides a higher standard of delivery while maintaining a low basic postage rate. International benchmarking of productivity of postal operations is discussed at section 11.1.1.

Table 3 - Service standards, demographics, and mail density

| | Australia | Canada | Germany | NZ | UK | USA |
|---|---|---|---|---|---|---|
| Population (m) | 21.7[9] | 33.4[10] | 82 | 4.2[11] | 60.9[12] | 305.9[13] |
| Total area (million sq kms )[14] | 7.7 | 9.9 | 0.35 | 0.27 | 0.24 | 9.8 |
| Population density (persons per sq km) | 3 | 3 | 234 | 16 | 253 | 31 |
| Number of delivery points (m) )[15] | 10.5 | 14.7 | 42 | 1.9 | 28 | 149 |
| Total annual mail volume (m) [16] | 5,206 | 11,620 | 21,000 | 1,033 | 24,000 | 202,703 |
| Annual mail items per delivery point [17] | 496 | 790 | 500 | 544 | 857 | 1,360 |
| Basic letter price (PPP)[18] | \$0.55 | \$0.67 | \$0.98 | \$0.48 | \$0.88 | \$0.66 |
| Mail closing time | 6pm | 5pm | Not available | 5-6pm | 5.30pm | 5pm |
| Intrastate delivery (days) | | | | | | |
| metro / metro | 1 | 2 | Not available | 1 | 1 | 1 |
| country / metro | 2 | 3 | Not available | 2-3 | 2 | 2 |
| country / country | 2 | 3 | Not available | 2-3 | 2 | 2 |
| Interstate delivery (days) | | | | | | |
| metro / metro | 2 | 4 | n/a | n/a | n/a | 2-3 |
| country / metro | 3 | 4 | n/a | n/a | n/a | 3 |

n/a = not applicable

As noted above, Australia Post offers a low basic postage rate. When Australia Post's proposed basic postage rate of 60c is compared with letter prices in other OECD countries it will remain the third lowest in the developed world as illustrated in Figure 2.

Moreover, additional European comparisons make Australia Post's strong service performance even more evident:

- the largest EU country, France, has a land area only 68% as large as New South Wales;
- domestic letter service standards within the EU are often next working day, but many only with a relatively low required reliability (eg Bulgaria 78%, Cyprus 90%, Czech Republic 90%, Estonia 90%, Finland

[9] Australian Bureau of Statistics website – accessed May 2009
[10] Statistics Canada website – accessed March 2009
[11] Statistics New Zealand website – accessed March 2009
[12] UK national statistics website – accessed March 2009
[13] US Census Bureau website – accessed March 2009
[14] CIA – The World Factbook website – accessed March 2009
[15] 2008 Annual Reports
[16] Volumes are derived from 2008 annual reports (with the exception of NZ Post where mail volumes have been derived from mail per capita and population statistics). 'Mail' may include all mail items delivered by that postal administration (eg letters, parcels and unaddressed mail).
[17] Calculated as total annual mail volume per year divided by number of delivery points
[18] PPP of basic letter price in A\$ - source OECD and Australia Post, prices in other countries as at 25 May 2009. Does not include the impact of VAT exemptions in some countries (see Table 4)

85%, France 85%, Germany 80%, Hungary 85%, Italy 89% for urban and 85% for provincial deliveries, Lithuania 85%, Malta 92%, Poland 82%, Romania 85%, Spain 93%, Sweden 85%, UK 93%;

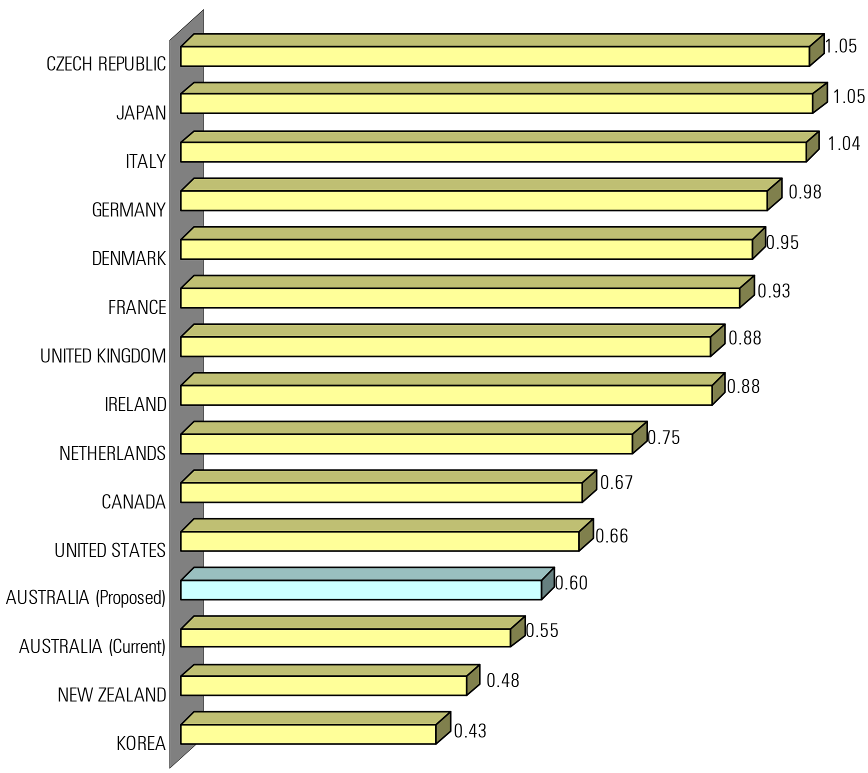
- for countries with a Day 1 standard but low reliability the remainder of domestic letters are generally required to be delivered by Day 2 or Day 3;

- cross-Europe delivery service standards are generally longer than domestic standards. For example, Royal Mail has a 3-5 day standard for delivery to Europe other than the UK;

- no EU country has a population density comparable to the low level in Australia (3 persons per sq km). Some examples are, 395 for the Netherlands, 340 for Belgium, 253 for the UK, and 234 for Germany. The lowest population density in the EU is Finland with 15, and the average across the EU is 113; and

- the most common delivery frequency required in the EU is five days a week, with a small number of EU countries still required to deliver 6 days a week. Not all addresses receive the standard delivery frequency.

Figure 2 – Standard Letter Price Comparison (Purchasing Power Parity)[19]




Furthermore, many countries (mainly European) where a VAT or GST exists do not subject their domestic letter price to VAT / GST. To enable a like-with-like comparison, Table 4 shows each country's basic letter rate 'As Is' and 'Adjusted to include VAT or GST'. When comparisons between Australia's BPR and overseas rates are made on a like-with-like basis the reasonableness of the proposed BPR is even more evident.

[19] Source OECD and Australia Post – prices in other countries as at 25 May 2009

The international price comparisons in Table 4 are basic postage rates. In view of the large size of Australia to which the basic postage rate applies, for countries in Europe it may also be relevant to compare prices for cross-Europe delivery. For example, in Germany the domestic basic postage rate is € 0.55 (A$0.98 or A$1.16 if adjusted for VAT/GST), with the rate from Germany to other European countries rising to € 0.70 (A$1.24/1.48).

Table 4 – Basic letter rates[20]

| | As Is | With VAT / GST |
|---|---|---|
| SLOVAK REPUBLIC | 1.35 | 1.61 |
| GREECE | 1.17 | 1.39 |
| POLAND | 1.11 | 1.35 |
| NORWAY | 1.27 | 1.27 |
| HUNGARY | 1.05 | 1.26 |
| PORTUGAL | 1.05 | 1.26 |
| ITALY | 1.04 | 1.25 |
| CZECH REPUBLIC | 1.05 | 1.25 |
| TURKEY | 1.21 | 1.21 |
| FINLAND | 1.21 | 1.21 |
| BELGIUM | 0.99 | 1.20 |
| MEXICO | 1.20 | 1.20 |
| DENMARK | 0.95 | 1.19 |
| GERMANY | 0.98 | 1.16 |
| AUSTRIA | 0.94 | 1.13 |
| FRANCE | 0.93 | 1.11 |
| IRELAND | 0.88 | 1.07 |
| JAPAN | 1.05 | 1.05 |
| UNITED KINGDOM | 0.88 | 1.01 |
| SWITZERLAND | 0.91 | 0.98 |
| SWEDEN | 0.97 | 0.97 |
| ICELAND | 0.75 | 0.94 |
| LUXEMBOURG | 0.80 | 0.92 |
| NETHERLANDS | 0.75 | 0.90 |
| SPAIN | 0.64 | 0.74 |
| CANADA | 0.67 | 0.67 |
| UNITED STATES | 0.66 | 0.66 |
| AUSTRALIA - PROPOSED | 0.60 | 0.60 |
| AUSTRALIA - CURRENT | 0.55 | 0.55 |
| NEW ZEALAND | 0.48 | 0.48 |
| KOREA | 0.43 | 0.47 |

[20] VAT-inclusive rate is the rate that would apply if national VAT exemptions were removed. Countries where the basic postage rate is exempt from VAT / GST are shaded

## 5.2. International postal themes and observations

A number of issues which affect this draft notification are common to many other postal authorities around the world, particularly in the OECD. These issues include:

- declining volumes, partly resulting from the global financial crisis but also as part of a longer-term trend; and
- increasing delivery obligations in countries where population levels are still growing.

The result for each postal authority is increasing costs from a combination of fixed CSOs and normal inflation rises in labour and other operating costs. Independent reports into two postal authorities, Canada Post and Royal Mail, have highlighted the commonality of these issues.

# 6. Consultation

*This section demonstrates that:*

- *prior to finalising this draft notification, Australia Post consulted widely with key customers and stakeholders; and*
- *the consultation process undertaken by Australia Post with its key customers and stakeholders, identified that no market segment would experience a significant disadvantage as a result of the proposed prices.*

Prior to finalising this draft notification, Australia Post undertook confidential consultation with a broad group of key customers and stakeholders. The intention of the consultation process was to:

- facilitate an exchange of information;
- facilitate mutual understanding of the perspectives of Australia Post and stakeholders; and
- understand whether the proposed prices would result in a significant disadvantage to a particular market segment.

The consultation process commenced in late April 2009 and was finalised in mid July 2009. Consistent with the scope of this draft notification the focus of the consultation was the proposed January 2010 price changes.

Consultation consisted of a presentation covering:

- Australia Post's domestic reserved letters business;
- the challenges facing the business; and
- the various responses by Australia Post to the challenges, including proposed price changes – which were discussed in detail.

As part of the discussions, Australia Post advised that supporting Australia Post's draft notification would be guidance on volumes, costs and revenue over a three year period (being the financial years 2009/10 to 2011/12).

Australia Post further advised that if after appropriate robust assessment price changes beyond January 2010 were necessary these prices would be the subject of a separate price notification – and that prior to finalising the prices in that notification, Australia Post would undertake broad consultation with key stakeholders and customers.

In addition to the opportunity to ask questions and provide feedback on the proposed price changes, participants were advised during the presentation that they were able to consider the information further, if necessary request further details, and, as appropriate, provide comments to Australia Post.

Customers and stakeholders who participated in the consultation process included the following with Appendix 8 providing a full list:

- key customers, including government departments and financial institutions;
- industry associations and representative bodies, including Australian Direct Marketing Association, Printing Industries Association of Australia, Fundraising Institute Australia, Publishers Australia and the Postal Services Consultative Council. Several opportunities for consultation were offered to the Major Mail Users of Australia, however, the invitations were declined; and
- industry partners and suppliers, including envelope manufacturers, AMAS providers, mail houses and postage meter suppliers.

As mentioned above, a key point that Australia Post sought from the consultation process was feedback to assist in understanding whether there were any perceptions that the impact from the proposed price changes would result in a significant disadvantage to a particular market segment. Overall the consultation process did not identify any such impact.

# 7. Letter volumes

*This section:*

- *provides an overview of Australia Post's domestic letters market, the work undertaken by Australia Post to promote the mail channel and forecast letter volumes over the period of this draft notification;*

- *presents an overview of, and the key findings from, several domestic letter demand studies undertaken by Diversified Specifics; and*

- *provides supporting data demonstrating that the traditional letters market of postal organisations globally is under pressure.*

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

The results of a recent Universal Postal Union survey (2 April 2009) conducted among 15 of the world's largest postal organisations and private courier companies show that domestic letter post is feeling the brunt of the global economic and financial crisis. In a year-over-year comparison, operators reported a 5.9% decrease in volumes in the last quarter of 2008, due in part to less direct mail being generated, coupled with less mail being generated by the financial sector. Where organisations have responded by shifting their customer communications to lower cost electronic media these letter volumes are unlikely to return, regardless of the resumption of economic growth. In Australia, domestic letter volumes were also impacted by the global economic and financial crisis, with domestic letter volumes down by 4% in 2008/09.

## 7.1. Australia Post's domestic letters market

Australia Post has a significant investment in the traditional mail market; one that it needs to protect and one which it needs to continue to manage on a commercial basis. Australia Post's domestic letters market is represented by three letter segments: Transactional (77%), Promotional (19%) and Social (5%). Appendix 9 provides an overview of each segment.

Australia Post has committed to a program of work to promote the mail channel to ensure it is seen as a relevant and contemporary part of the broader communications and messaging market. This includes responding to community and business expectations regarding the environment and the role it plays in the letter value chain. Specifically Australia Post:

- will continue to engage with major customers to enhance the value proposition of transactional mail – including through the promotion of 'transpromotional' letters;

- will continue to promote the mail channel for marketing communications, including via the *'Open Up To Mail'* mail channel advertising campaign (promotional mail);

- is developing and promoting new products and services across the letter value chain (data services, preparation, delivery and delivery management) that increase the value of the mail channel. This can involve developing new Australia Post products or identifying and promoting existing industry innovations; and

- will minimise volume decline for social mail and maximise the leverage of the positive brand association. The key message to the market is to remind our customers of the joy that 'keeping in touch' (by sending and receiving personal mail) provides over and above other newer types of social messaging.

Australia Post's efforts in promoting the mail channel have been recognised by the following Awards:

- Global Envelope Alliance's Global Achievement Award (January 2009) – Australia Post is the first postal organisation to ever receive an award from this industry. The award is in recognition of the 'the extraordinary job 'Australia Post is '…doing to grow direct mail and constantly promote the value of mail.'

- World Mail Awards 2008 – Australia Post won the award in the 'growth' category for successfully encouraging the use of mail as a promotional channel. Australia Post's entry highlighted the range of initiatives and industry collaboration undertaken to drive the growth of promotional mail volumes and industry growth in general, and

- Print On Demand Industry's Award – Global Best Practices Award for work done with ING – the award was given in the 'TransPromo' category for use of strategic segmentation and digital personalisation.

## 7.2. Letter volume forecasts

The volume forecasts used in this draft notification are the same as those included in Australia Post's 2009 corporate plan. In 2008/09, domestic letter volumes are forecast to decline by 3.8%. In addition to the long term trend decline in some letter uses, for example social mail and payments, decline was exacerbated by the impact of the global economic and financial crisis, which has had a negative impact on domestic letter volumes among other postal authorities. A comparison to other postal authorities' volumes is detailed in section 7.4. The 2008/09 result also reflected a relatively strong result in 2007/08 (growth of 1.8%) where volumes were positively influenced by the general economic environment (including business and consumer confidence) and activity related to the 2007 Federal election.

Over the next three years, domestic reserved letter volumes are forecast to decline by an average of 2.3% per annum. Volume forecasts by product category are shown in Appendix 10.

In determining volume forecasts Australia Post considers data from a number of sources, including;

- analysis of market environment conditions;

- input from national and state based sales areas (which incorporates specific knowledge of customer behaviour); and

- knowledge derived from econometric modelling of the association between historical volumes and potential drivers of demand.

Information from these data sources supports the development of volume forecasts that incorporate management assessments and judgements across Australia Post. These forecasts are used as a key input to the determination of corporate and divisional budget targets.

The market environment analysis includes econometric analysis of historical volumes (demand analysis), which is discussed at section 7.3 below. However forecasts are not exclusively based on econometric analysis because of the limitations of such analysis eg the impact of the consolidation, rationalisation and substitution of some mail which is driven by the behaviour of individual senders rather than any general tractable factor or driver.

A breakdown of volume forecasts by the three letter segments is shown in Table 5 along with the last full year results for 2007/08.

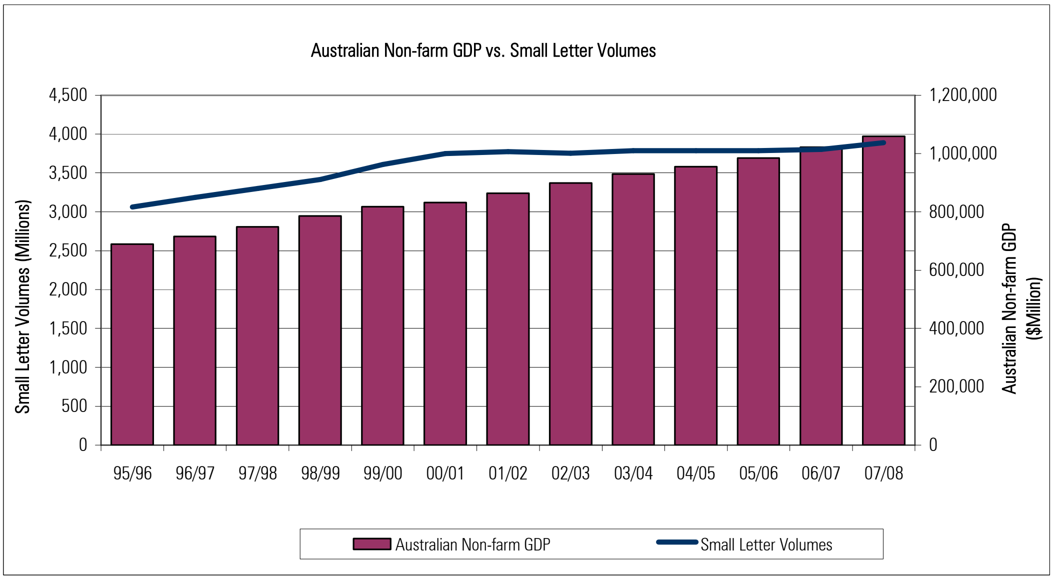
Table 5 – Domestic letter volumes by segment 2007/08 to 2011/12[21]

| | 2007/08 (actual) m | 2008/09 (forecast) m | 2009/10 (Year 1) m | 2010/11 (Year 2) m | 20011/12 (Year 3) m | Av Gr Rate 2009/10 to 2011/12 % |
|---|---|---|---|---|---|---|
| Transactional | 3,323 | 3,169 | 3,073 | 2,963 | 2,858 | (3.4%) |
| Promotional | 780 | 782 | 790 | 827 | 831 | 2.1% |
| Social | 198 | 188 | 180 | 173 | 166 | (4.1%) |
| Total | 4,302 | 4,139 | 4,043 | 3,963 | 3,856 | (2.3%) |

### 7.2.1. Letter volume growth vs non-farm GDP

Up until 2000/01, there appeared to be a reasonable correlation between growth in small letters and non-farm GDP. Since 2000/01, the impacts of mail consolidation and the increase in electronic substitution have become the determinate factors outweighing any positive GDP impacts – this divergence is shown in Figure 3 below.

Figure 3 – Letter volume growth vs GDP growth




Data Source - Australian Non-farm GDP: ABS 5206.0 Table 6 Gross Value Added by Industry, Australia, Chain volume measures
Data Source - Small Letter Volumes: Letters Group, Australia Post

In the future, the impact of consolidation and substitution is likely to increase, however, the volume forecasts used in this draft notification – which are also included in Australia Post's 2009 corporate plan – do not anticipate any radical increase in the rates of substitution or consolidation over the next three years (2009/10 to 2011/12).

[21] Includes addressed small and large letters up to 500grams

## 7.3. Demand analysis

To assist Australia Post in isolating trends, establishing demand drivers, estimating statistically significant market based demand elasticities and developing forecasting models, Australia Post commissioned Diversified Specifics to undertake the following work:

- provide an update on the December 2007, *Domestic Small Letter Segment Volume Demand* report; and
- analyse the degree to which prevailing income elasticity estimates for PreSort Barcoded Small Letter volumes hold for conflicting periods of economic growth; and
- conduct an econometric analysis of segmented large letter volumes over the 1995/96 – 2007/08 period.

The key findings of each study are detailed below:

### 7.3.1. Domestic small letter segment volume demand (update)

The major findings of the December 2007 report (based on the 1995/96 – 2006/07 period) were:

- Substitutive pressures have impacted volumes since the mid 1990's

Statistical evidence suggests that the historically strong positive association between the level of economic activity and fluctuations in total domestic small letter volumes has weakened considerably in recent times due to the effects of factors such as electronic substitution; and

- Volumes have become more income inelastic as rationalisation and consolidation trends intensify

There is evidence to suggest that the association between economic activity and PreSort Small Letter volumes (predominantly bill presentment and promotional mailings) is increasingly being threatened by mail rationalisation and consolidation behaviour by some of the major mailers.

The addendum to the December 2007 report extends the study to December 2008 and attempts to:

- identify more recent changes in segmented small letter volume trends, drivers and elasticities; and
- examine how perceptions relating to the short term economic outlook have impacted small letter volume projections for 2009 and 2010.

The recent trends in 'Other'[22] and PreSort small letter volumes point towards a deteriorating small letter landscape. Specifically:

- 'Other' small letter volumes declining at an increasing rate from factors including continued substitutive pressures.
  - volumes for the 12 months to December 2008 declined by 4.2% compared to a decline of 3.4% for the 12 months to June 2007.
- PreSort small letter volumes are suffering from the economic downturn.
  - volumes for the 12 months to December 2008 increased by 2.8% compared to an increase of 4.0% in the 12 months to June 2007
    - the non-farm real GDP for the 12 months to December 2008 was 1.8% compared to 3.9% for the 12 months to June 2007.

[22] Includes all letters other than PreSort letters

- given these changes in recent growth rates the robustness of the association between this segment and the level of economic activity is examined in greater detail within *The Impact of Economic Downturns on Income Elasticity of Demand*, study discussed below in section 7.3.2

The result of this extended study is that for total small letter volumes the outlook is more pessimistic than would have been projected six to twelve months ago as a result of the combined negative effects of the economic conditions, consolidation and substitution.

A copy of the *Domestic Small Letter Segment Volume Demand*, March 2009 Addendum has been provided to the ACCC.

### 7.3.2. Income elasticity of Small Letter PreSort volumes

From the September quarter 1995 to the December quarter 2008, the income elasticity of demand for Small Letter PreSort approximated 0.987.

Truncating the model timeframe however, revealed that the income elasticity of demand increased substantially over the last six months of 2008. Demand for Small Letter PreSort volumes has become increasingly income elastic as quarterly non-farm economic growth declined in the September and December quarters of 2008.

This suggested (at a preliminary level) that demand for PreSort barcoded small letter volumes might be increasingly elastic during periods of economic downturn.

To further test this hypothesis, the quarterly data used in developing the volumes model (data over the September 1995 to December 2008 quarters) was split into low growth and non low growth periods and separate income elasticities for each subset were estimated. The resultant statistical analysis concluded the income elasticity for the low-growth model was more elastic than the equivalent income elasticity obtained for the non-low growth model.

Specifically, the income elasticity for the low-growth model was 1.179 compared to 0.806 for the non-low growth model. Moreover, the income elasticity estimate for the low-growth model is not contained within the non-low growth model's 95% confidence interval and vice versa.

The implications of this study therefore suggest that Small Letter PreSort volumes:

> 'are more negatively impacted during an economic slowdown as compared to the upside effect on volume during more prosperous periods of economic growth.'

A copy of The Impact of Economic Downturns on Income Elasticity of Demand, May 2009 study has been provided to the ACCC.

### 7.3.3. Domestic large letter segment volume demand

The framework of the study is premised on the understanding that single piece 'Other' Large Letter[23] volumes have been prone to differing levels of electronic substitution over the study period which has resulted in successive downward shifts in the demand curve.

The analysis suggests the underlying demand for Other Large Letter volumes is positively associated with fluctuations in the level of domestic activity since July 2001.

In the PreSort barcoded[24] large letter volume segment, statistical results suggest solid rates of growth in the Australian economy over recent times have primarily driven letter volume growth over the period of this study.

[23] The 'Other' large letter segment consists of full rate mail up to a maximum size, weight and thickness of 360mmx260mm, 500grams and 20mm respectively

[24] The 'PreSort barcoded' large letter segment consists of bulk (300+) lodgements of large letter sized items that satisfies the relevant large letter category size, weight and thickness requirements

These findings highlight the importance of economic growth in driving large letter segment volumes, ie should the strength of past associations be replicated in future periods, the global economic slowdown will be a major threat to large letter volume growth in the short term.

A copy of the *Domestic Large Letter Segment Volume Demand,* February 2009 report has been provided to the ACCC.

### 7.4. International letter volumes

Internationally, letter volume growth rates have been declining since the mid to late 1990s with negative growth evident more recently. While the Internet has been touted as a major contributor[25], it is considered by Australia Post that businesses rationalising mailings (in their quest to decrease costs) has had a greater impact on letter volumes, while the more dramatic fall in volumes[26] recently is attributed predominantly to the global economic decline:

Table 6 – Mail volume changes

| Country | Year on year rate of decline % | Time period |
|---|---|---|
| Results incorporating 2009 activities | | |
| United States | -14.3 | Q2 2009 (Jan 1 – Mar 31) |
| Norway | -14.0 | Q1 2009 (Jan 1 – Mar 31) |
| Finland[27] | -10.0 | Q1 2009 (Jan 1 – Mar 31) |
| United Kingdom | -5.5 | FY 2009 (Apr 6 – Apr 5) |
| France | -5.0 | Q1 2009 (Jan 1 – Mar 31) |
| Germany | -5.0 | Q1 2009 (Jan 1 – Mar 31) |
| Netherlands | -4.7 | Q1 2009 (Jan 1 – Mar 31) |
| Austria | -4.3 | Q1 2009 (Jan 1 – Mar 31) |
| Australia [28] | -3.8 | FY 2008/09 (Jul 1 – Jun 30) |
| Switzerland[29] | -3.1 | Q1 2009 (Jan 1 – Mar 31) |
| Canada[30] | -2.0 | FY 2009 (Apr 1 – Mar 31) |
| Korea | -0.9 | Q1 2009 (Jan 1 – Mar 31) |
| | | |
| Results incorporating 2008 activities | | |
| New Zealand | -3.0 | FY 2008 (Jan 1 – Dec 31) |
| Sweden[31] | -2.8 | FY 2008 (Jan 1 – Dec 31) |
| Ireland | -2.0 | FY 2008 (Jan 1 – Dec 31) |
| Japan | -1.6 | FY 2008 (Apr 1 – Mar 31) |

[25] International Perspectives of Changing Regulatory Models in the Postal Sector; Internal Document, Crew & Kleindorfer; Sep 2008; p.4
[26] Figures relate to most recent fiscal year for each postal organisation
[27] First class mail only
[28] Addressed letters only – as per Australia Post's forecast
[29] Ibid
[30] Transaction mail only
[31] Priority, non-priority and unaddressed mail only

# 8. Australia Post's network

*This section:*

- *provides an overview of Australia Post's network, summarising the implications of Australia Post's performance standards upon the structure and operation of the letters network, including the high degree of fixed cost within that network; and*

- *highlights the strict time disciplines required to meet the service standards while coping with the inherent variability of letters*

As detailed in section 5, Australia Post's CSO (and the associated prescribed performance standards) require Australia Post's network to perform at a consistent dependable level irrespective of daily, weekly or seasonal changes in volumes. This volume volatility is considerable. As an example, on a Monday some DCs can receive up to double the volume of letters for delivery than on other days in that week. The prescribed performance standards are part of the broader performance standards (including delivery times) required to reasonably meet the social, industrial and commercial needs of the Australian community in supplying the letter service.

These standards are a major determinant of the network structure and operation, including:

- the function and timing of the sales and acceptance, processing, transport and delivery activities;

- the size and location of the sales and acceptance and network processing facilities;

- transport schedules that connect the sales and acceptance, processing, transport and final delivery points;

- the overall speed and accuracy of the end to end processes throughout the network to meet the prescribed delivery standards; and

- the network resourcing and internal arrangements required to meet prescribed performance standards despite significant variation in volumes on a daily and seasonal basis.

## 8.1. Network overview

The network can be summarised into four core functions as shown below with further detail at Appendix 11:

Figure 4 – Australia Post's network[32]

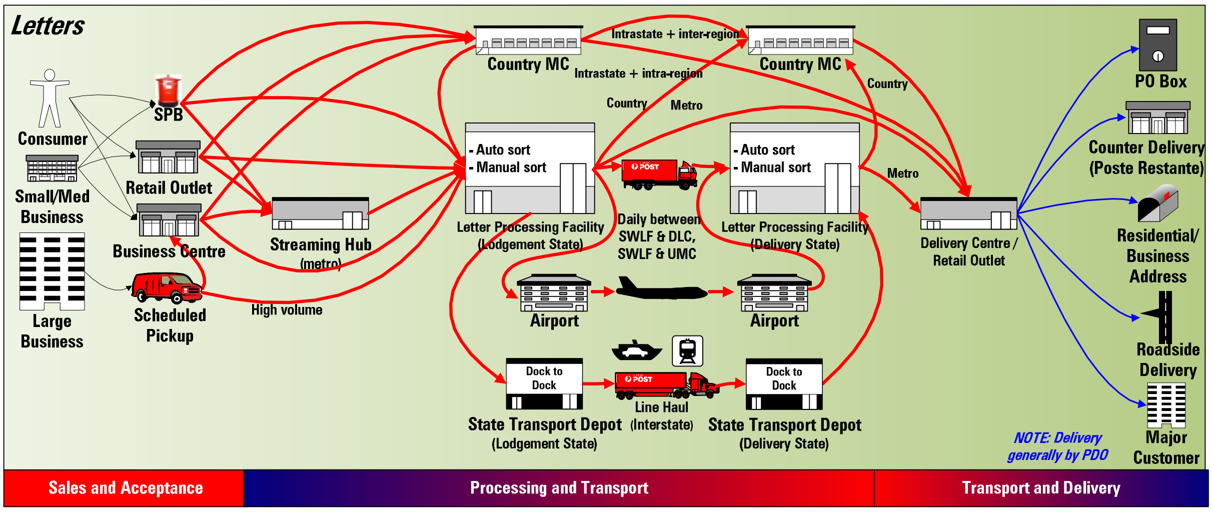

| | | | |
|---|---|---|---|
| 4,453 retail outlets<br>15,878 street posting boxes<br>105 community mail agents | 10 metro letter facilities<br>23 country letter facilities<br>5 parcel facilities<br>7 gateway facilities | 20 transport depots<br>125 prime movers<br>434 trucks<br>1,025 vans | 265 delivery facilities<br>7,500 motorcycles<br>12,938 FTEs<br>3,452 street and roadside delivery contractors<br>10,458,870 delivery points |
| Note: bulk mail can be lodged at mail centres | Note: some parcel facilities co-located with letter facilities | | |

[32] 2007/08 Australia Post Annual Report data

## 8.2. Network principles

Australia Post operates a time constrained national letter and parcel network that extends across the continent operating to prescribed performance standards. The performance standards impose a distinctive cost structure across the four core network functions: Sales & Acceptance, Processing, Transport and Delivery. These core functions of the network operate in a connected and integrated 'end to end' chain:

Figure 5 – Network overview




The principles governing this chain are illustrated by the example of a stamped letter, posted in a capital city SPB for delivery to a residential address in the same capital city. In this example the applicable delivery performance standard is 'same state, day 1, metro to metro'.

### Path of a letter

- the letter is collected from the SPB after 6.00pm and transported to a transport hub;
- at the hub, letters collected from a number of SPBs are consolidated and transported to the letter processing facility – typically by 8.00pm;
- at the letter processing facility, the letter is processed by a CFC machine, where the letter is faced up for further automated sorting and the stamp is cancelled;
    - the letter is then transferred for 'originating processing' at an MLOCR machine, which interprets the address via software recognition or video coding to apply a "DPID" barcode for sorting;
    - the letter is then transferred to a designated BCS machine to sort the letter to the appropriate delivery round for that DPID (and where applicable within delivery sequence);
    - from the BCS machine the letter is forwarded, in a tray with other letters, to the DC, according to critical transport despatch times;
- the letter is received at the DC (typically before 7.00am) and where required the tray of letters for the specific round is then sorted into the posties' street delivery sequence by around 9.00am; and
- the letter is then taken by the postie for delivery to the street address that day.

This simple example illustrates the sequence of activities that must be completed along the network chain and the handovers between the four core functions that must be executed within precise time windows if the overall service performance standard is to be met.

Other examples, which involve lodgements of large volumes, have significantly greater network complexity eg interstate mailings where articles must be first processed in the posting state (originating), then transported to the destination state for (terminating) processing. Linehaul transport can be either air or road, dependant on the delivery performance standard. However, in all examples it can be noted that:

- the network is relatively stable – network nodes and paths in the network are fixed and predetermined – with the main structural change from the expanding delivery footprint due to delivery point growth;
- the network operates from 'the few to the many' – in that there are almost 24,000 collection points compared to 10.5m delivery points; and
- it is only after all letters in a particular lodgement at a letter processing facility have completed 'originating processing' that the various destinations can be determined – with destination being anywhere across Australia (excluding international items) – and this determines the transportation modes used to meet the service standard commitment.

The core functions of the network are therefore organised according to strict internal operating time standards. The logic of the standards can be summarised as follows:

- service standards (from origin to destination) determine critical transport connections that must be met and the mode of transport (air or surface). This takes into account what further processing is required (and at what point) and what other critical transport connections must be made within the state of delivery;
- the critical transport connections determine critical departure times from facilities;
- the critical departure times from facilities determine when letters have to be fully processed and available for despatch;
- the processing window determines when the letters are required into the processing facility – taking into account processing capabilities in the facility, quantity and type of letter etc; and
- the required arrival times into the processing facilities determine the transport and resources necessary to collect, consolidate and transport letters to the next facility.

## 8.3. Network operational implications

A number of key implications arise from the operation of these network principles:

- each network function must operate to a level of reliability well above 94% to ensure that the overall prescribed performance standard for 94% on an end to end basis is achieved as a failure within a particular function will have a compounding impact along the network chain. Noting this, each function must have the capability to operate to a level of reliability up around 99%;
- processing operations differ from normal manufacturing operations where, in the latter, fluctuations in inventory serve as a buffer for shortfalls in machine capacity or labour resourcing. In letter processing – the prescribed performance standards effectively require domestic reserved service letters to be continuously cleared through the network to a fixed schedule regardless of volume;

In addition, the network has to cope with a high level of variability and unpredictability that is inherent to postal operations:

- unlike a typical manufacturing operation with strict controls on input quality, all letters must be accepted into the network despite a large variation in physical characteristics meaning their 'machineability' varies with humidity, size, shape and content. Further, Australia Post has a limited ability to enforce conditions on the specification for the creation or quality of lodgement of an 'ordinary small letter' (the BPR);
- transport disruptions due to accidents, floods, fire and the spreading of peak hour traffic congestion on metropolitan road networks; and equipment outages and other incidents.

There are other regulatory requirements that Australia Post must consider in its network design to ensure ongoing compliance. In particular this includes compliance with various transport regulations (for both air and road) where requirements have typically been strengthened in recent years. Some examples include Transport Chain of Responsibility legislation, Dangerous Goods legislation, Aviation security screening requirements and legislation governing contractors.

While these form part of the basic 'licence to operate' for any business of similar complexity, the trend towards escalating requirements in such areas has impacts on the time windows along the network chain, in addition to the costs involved eg in upgrading compliance systems and staff training.

As a consequence, the management of resourcing and cost levels in each of the network functions is a balancing act in managing the risks to service reliability against the need to ensure all processes operate efficiently

## 8.4. Network cost implications

The principal cost implications of the performance standards for the core network functions: sales and acceptance, processing, transport and delivery can be summarised as follows:

- Sales & Acceptance – this function is relatively stable in size and comprises around 24,000 lodgement points across Australia, with the costs largely determined by the distance and number of points from which letters must be collected on a daily basis;

- Processing – this function contains activities that are more variable with letter volumes but it operates within a fixed structure of a small number of large centres across Australia that are automated with low (variable) manual effort, and which currently achieve high technical efficiency;

- Transport – this function is relatively stable operating between nodes in the network with many runs fixed or set to ensure that connections between nodes to meet processing and delivery function commitments; and

- Delivery – the area to service (ie delivery points) is growing on average by around 2% per annum. There is a high dependency upon the requirement for posties to cover the geographic area regardless of volume of letters to be delivered. This includes the requirement that Australia Post service, five days per week, 98% of the 10.5m delivery points.

Appendix 11 explores in more detail these implications highlighting:

- the relatively high levels of fixed cost associated with performance standards in the sales and acceptance, transport and delivery functions; and

- the high efficiencies Australia Post is now achieving in the processing function arising from the Future Post infrastructure.

# 9. Costs

*This section:*

- *demonstrates that Australia Post has, and is maintaining, an efficient cost base, both for the purpose of this draft notification and more generally across the total business; noting that:*
    - *the domestic reserved letter service is provided from a cost base that provides both reserved and non-reserved services;*
    - *the costs for domestic reserved letters are determined by an allocation process that has been extensively examined by the ACCC and found to be appropriate for regulatory purposes; and*
    - *Australia Post manages the cost base collectively, not by its allocation between reserved and non-reserved services and products.*
- *illustrates how major cost areas have been successfully managed over time against the fact that Australia Post's cost base reflects the provision of resources to provide a letter service to the standards required and where most costs are not driven by, or vary only marginally with changes in volume.*

The ACCC uses a PTRM to determine the costs of services of the industries it regulates. The PTRM essentially determines the costs of regulated services from the three 'building block' cost elements below to arrive at efficient forward-looking required revenue for the regulated services:

- non-capital costs, representing operating and maintenance costs;
- return of capital, representing depreciation of the capital base; and
- return on capital, representing the application of a rate of return to the capital base.

In the case of infrastructure industries to which the PTRM is generally applied (eg the natural gas pipeline industry) the capital-related cost components typically constitute well over 50% of the total costs of service. However, in the case of the domestic reserved letter service, in the period covered by this draft notification, the capital-related cost component is less than 5% of total costs. This highlights a significant difference between Australia Post's cost structure and that of other typical regulated industries.

A principle adopted by the ACCC in Australia Post's 2002 and 2008 price notifications was that Australia Post's cost base had to be efficient if the cost base was to provide a foundation for the ACCC's allowable revenue calculation.

In the ACCC's Decision of October 2002[33], the ACCC found that:

> '… the current level of operating and maintenance costs are a reasonable starting point for an analysis of Australia Post's profitability.'

Although the ACCC did not formally determine a position on Australia Post's cost base in the 2008 price notification, implicitly it reaffirmed its 2002 conclusion by not objecting to Australia Post's 2008 proposed prices in full.

In Australia Post's 2008 price notification, the ACCC focused more on productivity growth than on costs as its efficiency indicator. Australia Post contends that this approach on its own is not appropriate when letter volumes are declining, as the inevitable resultant fall in productivity reflects the constraints imposed by maintaining a predominately fixed cost network required to meet certain standards and objectives rather than an inefficient cost base. Therefore, this section focuses on the major cost categories and their management.

[33] Appendix B Page 12

## 9.1. Australia Post's cost base

Cost control is vital for Australia Post if it is to meet its commercial obligation to make a satisfactory rate of return. Specific to the domestic reserved letter service, there are two key points that underpin Australia Post's assertion that it has, and will continue to pursue, an efficient cost base. They are:

- the domestic reserved letter service is provided from a joint cost base. Ensuring competitiveness across all products that are provided from this joint cost base requires ongoing efforts and the establishment of performance management targets that focus on ensuring efficiencies are pursued and realised; and

- in the context of this draft notification, in which commercial market volume and price concerns prevent a recovery of the maximum allowable revenue (circumstances which are likely to persist beyond the three year price window), achieving an acceptable rate of return is dependent upon minimising costs rather than on price increases compensating for an inefficient cost base.

Australia Post's forecast operating cost structure for 2008/09 is shown in the following Table.

Table 7 – Operating cost structure 2008/09

| | $ million | % of total |
|---|---|---|
| Labour | 2,214 | 48.4% |
| Contract services | 1,138 | 24.9% |
| Accommodation | 250 | 5.5% |
| Depreciation and Amortisation | 202 | 4.4% |
| Other | 772 | 16.9% |
| Total | 4,577 | 100.0% |

## 9.2. Labour costs

At around 48% of Australia Post's total costs in 2008/09, labour costs represent by far the largest single cost item. For domestic reserved letters, labour also makes up the largest component of the domestic reserved letter service total cost base, accounting for 68% of total costs in 2008/09.

Labour costs therefore have continuously been a primary focus for careful management. Changes in percentage of labour costs relative to other costs, since Australia Post became a corporation, are set out in the Table below.

Table 8 – Labour cost history – Australia Post

| Financial year | Labour cost as % of total costs[34] |
|---|---|
| Actual ratio | |
| 1987/88 | 71.1% |
| 1992/93 | 64.7% |
| 1997/98 | 57.7% |
| 2002/03 | 49.3% |
| 2007/08 | 47.4% |
| Forecast ratio | |
| 2008/09 | 48.4% |
| 2009/10 | 48.4% |
| 2010/11 | 48.2% |
| 2011/12 | 47.8% |

[34] Total costs exclude interest expense

The ratio of labour to non-labour costs has reduced steadily between 1987/88 and 2007/08. The forecast rise in the ratio of labour to non-labour costs in 2008/09 (which reduces in the following years) is due to a rise in the superannuation expense which, as explained below has increased significantly during 2008/09 due to external financial and property market factors that are beyond the control or influence of Australia Post.

Another factor which contributes to this increase concerns the impact of Commonwealth bond rate changes on non-wage labour costs (employee-related provisions including long service leave and workers' compensation etc). Bond rates are used in the discount factors when determining the provision to be made in the profit and loss statement for future long service leave and worker's compensation payments. The bond factor is highlighted below in the appropriate sections, but, in brief, its importance is as follows:

- Commonwealth bond rate rises (falls) reduce (increase) the relevant labour-related cost in the year of the rate change, after which the expense should settle back to its 'underlying' value; and

- a one percentage (100 basis) point decrease (increase) in longer-term bond rates is estimated to cause the total of the affected labour costs to rise (fall) by approximately $30m in the year of the bond rate change.

In 2008/09 the fall in the 10 year bond rate was 93 basis points. This fall followed a 19 basis point increase in 2007/08.

The ACCC will note that the pace of reduction in the labour cost ratio is slowing. The labour cost experience of the 1990s and early years of this decade reflected the succession of large structural changes within the Australia Post network, all of which contributed to the large growth of productivity during that period. Those technology based changes might be referred to as 'macro-initiatives'.

In the past few years, the productivity improvements have been the result of 'micro-initiatives', such as process improvements. Opportunities for micro-initiatives are more difficult to identify and implement, as they are less obvious. They are also becoming scarcer, and the forecast fall in productivity growth reflects this situation. Similarly, the likely slowing decline in the labour cost ratio also reflects the fact that Australia Post's network, which is designed to provide its CSO and meet the associated performance standards, has undergone continuous process improvement over a sustained period of time.

The ACCC will note that volume impacts on measured productivity are likely to be major, and both output and input influences on productivity outcomes are discussed in the Productivity section (section 11).

## 9.3. Wages

Wages form the largest component of Australia Post's total labour cost. In 2007/08, wages (including overtime) accounted for almost 82% of the total labour cost of $2,049m.

Consequently, although all aspects of labour costs will be covered in this section, particular attention will be given to wage setting processes and outcomes and to labour usage.

### 9.3.1. Wages and terms and conditions of employment

Australia Post operates within the Commonwealth industrial relations framework governed by the Fair Work Act 2009 (Cth). Implementation of relevant Commonwealth industrial relations legislation is the responsibility of Fair Work Australia. For the purposes of this draft notification (including its appendices) and in reference to the requirements of s. 95G (7) (c) of the TP Act, we will refer to Fair Work Australia and its predecessor bodies as 'the relevant industrial tribunal'.

Four Awards made by the relevant industrial tribunal govern the wages and terms and conditions of employment of Australia Post's employees. The Awards are:

- Australia Post General Conditions of Employment Award 1999;
- Australia Post Administrative Award 1999;
- Australia Post Technical Award 1999; and
- Australia Post Operations Award 1999.

Some additional terms and conditions of employment are contained in the Australia Post Principal Determination, which is a determination made in accordance with section 89(2) of the APC Act.

The other industrial instruments that govern wages and terms and conditions of employment are Australia Post's enterprise agreements. All enterprise agreements that have been negotiated and agreed between Australia Post and the relevant unions have been made in accordance with relevant industrial laws and certified by the relevant industrial tribunal.

The primary enterprise agreement that currently applies at Australia Post is EBA6 (the Australia Post Enterprise Agreement 2004). While EBA6 nominally expired in December 2006, it continues to operate while Australia Post attempts to finalise its next EBA (EBA7) with the relevant unions.

EBA7 was initially negotiated and agreed with the relevant unions in October 2007. The intended expiry date of that agreement was to be 31 December 2010. However, in early 2008 the unions walked away from the agreement reached on EBA7. Despite this, Australia Post has honoured the pay commitments made under EBA7, as Australia Post believes that staff would be unreasonably disadvantaged if the pay increases were held back over such a protracted period due to the actions by relevant unions.

In essence, Australia Post is effectively continuing to operate under the provisions of EBA6, but with the EBA7 pay increases, that were negotiated and agreed. Pay increases (and dates of effect) paid under the EBA7 (and EBA5 and EBA6) are set out at Appendix 12.

The other critical enterprise agreement is the Redundancy / Retraining / Redeployment Agreement which applies in circumstances where positions become redundant at Australia Post.

### 9.3.2. Wage outcomes

The appropriate official statistic for EBA wage comparison is the ABS's Labour Price Index[35]. From the end of EBA4, to the end of calendar 2008, (ie from the June quarter 2002 to December quarter 2008), the Labour Price Index rose by an average of 3.9% per annum. The pay increases provided under Australia Post's EBAs are in line with this Index.

The conclusion that Australia Post has continued to achieve responsible wage outcomes under its EBAs is not dependent on a particular choice of ABS benchmark. Australia Post's EBAs are in line with two other labour cost measures published regularly by the ABS and commonly used for comparison purposes. They are the Average Weekly Ordinary Time Earnings[36] and the national accounts-based Average Non-Farm Compensation per Employee[37].

In Section 8.3 of the ACCC's Preliminary View of June 2008, the ACCC stated that Australia Post employees would benefit from outperforming the productivity performance of the national economy. The rationale for this conclusion is that EBA7 wage projections averaged 4% per annum, compared with the Reserve Bank's forecast of annual inflation (CPI), at around 3%.

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[35] Catalogue 6345.0
[36] Catalogue 6302.0
[37] Catalogue 5206.0

In respect to this point, Australia Post notes two items:

- first, the ACCC was correct to assess that Australia Post's productivity performance was superior to that of the national economy for a long time. However, the correct conclusion to be drawn on the CPI comparison was that workers in the broader economy have benefited from wage rises considerably greater than those that would have reflected their productivity growth; and

- second, in contrast, Australia Post's EBA outcomes since 1991 have been consistently in line with national wage outcomes, indicating that Australia Post's EBAs have generated wage settlements that had proper regard to our productivity requirements and also had regard to the need to maintain labour market competitiveness. This latter factor is critical, as Australia Post faces the reality of having to attract and retain labour in local and regional labour markets where potential labour mobility is high.

In response to the impact of the economic slowdown on Australia Post's trading outcomes, the Managing Director has determined that the annual rise in base salaries for executives normally planned at this time will not now proceed. This freeze matches similar decisions at other Australian corporations such as Telstra, ANZ Bank and Wesfarmers.

In conclusion:

- Australia Post has observed the proper industrial relations processes in accordance with procedures laid down by the relevant authority, enabling the ACCC to assess the outcomes in accordance with section 95G(7)(c) of the TP Act; and

- the outcomes of these pay rises have been within the wider Australian economy norms as indicated by a range of official statistics available upon which suitable comparisons can be made.

## 9.4. Labour numbers

In Australia Post's 2008 price notification, the ACCC considered actual labour usage changes up to, and including, those for 2006/07. It also examined projected data for 2007/08 and later years. Consequently, the analysis in this draft notification will include 2006/07, as the last completed year already examined by the ACCC, but focus on 2007/08 and later years.

At 30 June 2008, Australia Post's workforce comprised 32,504 FTEs (this excludes 482 FTEs in operational areas unrelated to this draft notification). While this number is projected to fall steadily the trend reflects a slowing productivity potential, which is somewhat masked by the need to increase resources related to delivery point growth and new business activities. From a base of 2007/08, Annual FTE totals are projected to decline by an average of 0.5% per annum as follows:

- 2007/08 32,504
- 2008/09 32,329
- 2009/10 32,170
- 2010/11 31,960
- 2011/12 31,889

## 9.5. Other labour cost issues

### 9.5.1. Payroll Tax

As is the case for all Commonwealth, state and local government taxes, rates and charges, Australia Post pays all State and Territory payroll taxes at normal rates. Other than indirectly via wage and salary levels and labour usage, this is not a cost that can be managed by Australia Post.

### 9.5.2. Workers' compensation

Australia Post is a licence holder under the Safety, Rehabilitation and Compensation Act, 1988 (SRC Act). Australia Post self-insures its liability for workers' compensation. Claims are recognised in the statutory financial statements and measured by the discounted value of an annuity. Adequacy of the workers' compensation provision is established by reference to an independent actuary as at each balance date (ie 30 June each year). The ultimate amount recognised in the liability (and associated expense) takes into account pay rises, attrition rates, bond rates and the times over which claim settlements are projected to occur.

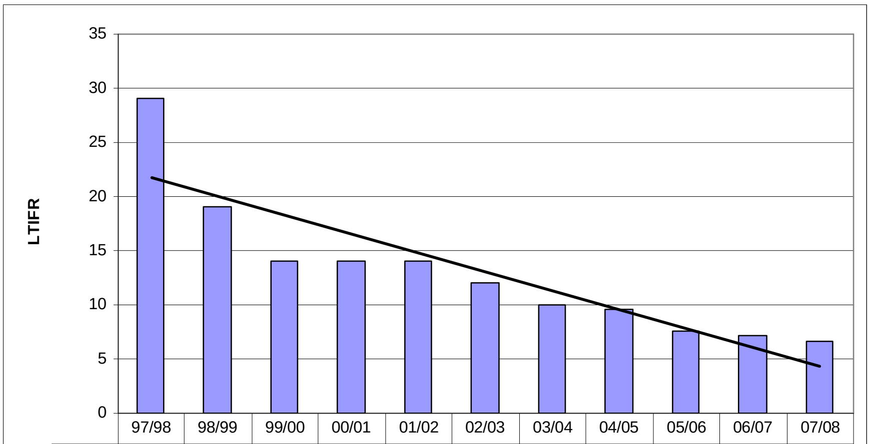
In accordance with its SRC Act licensing conditions, Australia Post has a bank guarantee to cover its outstanding actuarial claims liability. Australia Post also complies with a requirement to maintain reinsurance to limit its workers' compensation liabilities.

### 9.5.3. Results of management of workers' compensation

Workers' compensation is a labour item that is actively and continually managed by Australia Post to maximise employee welfare through OH&S programs. These programs have been aimed at reducing the Lost Time Injury Frequency rate (LTIFR) that underlies workers' compensation claims. The programs have been very successful, as shown in the LTIFR trend in Figure 6 below.

Large improvements in LTIFR have become harder to achieve in recent years, and this reflects the nature of transport and distribution operations inherent in providing a national mail service, including the high use of motorcycles in the delivery function. However, Australia Post remains committed to reducing further the LTIFR, and progress to that end is both monitored and reported at senior levels on a monthly basis.

Figure 6 – National Lost Time Injury Frequency Rate




| | 97/98 | 98/99 | 99/00 | 00/01 | 01/02 | 02/03 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| LTIFR | 29 | 19 | 14 | 14 | 14 | 12 | 10 | 9.6 | 7.6 | 7.2 | 6.6 |

AASB 119 governs the calculation of the liability for workers' compensation, and the associated expense. By the nature of the prescribed methodology of calculation contained in AASB 119, the liability exhibits volatility whenever Commonwealth bond rates move up or down. Similarly, in any year of bond rate change, the workers' compensation expense exhibits an associated volatility, which moves the actual expense for that year away from the expense inherent in the operational and usage patterns giving rise to the underlying expense.

Despite this annual unpredictability, the worker's compensation expense has trended down through this decade, and it is expected to continue to do so. The forecast $29m per annum expense for worker's compensation in the three forward years of this draft notification, ie 2009/10 to 2011/12 inclusive is lower than the average of the seven years to 2008/09 ($30m per annum), despite the last decade of wage rises approximating 4% per annum which feed directly into the liability (and expense) on a one-for-one basis.

To put Australia Post's excellent health and safety and resultant workers' compensation achievements into a longer-term perspective, Australia Post's workers' compensation liability for the last three completed financial years, ie at June 2007, June 2008, and June 2009 was $107m, $115m and $118m respectively. Each of these results is substantially below those of every year from 1991 to 1995 inclusive even without taking account of wage inflation. If the average liability for those early five years ($150.1m) were escalated into 2008/09 dollars using wage rises of 4% per annum, it would amount to over $280m compared with the average of $111m actually achieved for 2006/07, 2007/08 and 2008/09.

### 9.5.4. Superannuation

Australia Post is an employer sponsor of the APSS. Almost all employees of Australia Post are members of this scheme. APSS provides employer-financed defined benefits to all employees who are members, and member-financed accumulation benefits to members who elect to contribute.

Some of Australia Post's current and past employees are also entitled to benefits under the Commonwealth Superannuation Act, but Australia Post has no contribution obligation in respect of these benefits.

A small percentage of Australia Post employees have elected not to be members of APSS and are not entitled to benefits under the Superannuation Act. Australia Post pays the Superannuation Guarantee contribution to the nominated superannuation funds of these employees.

A non-current asset representing APSS is included in Australia Post's balance sheet each year. The amount recognised is essentially the fund's assets less its liabilities. At 30 June 2008, the fund had a net surplus (as measured by AASB 119) of $1.6b. Accounting for APSS in this way is a requirement of AASB 119; however, Australia Post does not control the fund's operation or its financial policy, and therefore does not control that asset in the same way that it does other assets in the balance sheet.

The superannuation expense largely reflects the APSS's entitlements and liabilities each year, and is advised by an independent actuary in accordance with the provisions of AASB 119. In any year, the superannuation expense depends to a relatively small degree on the cash contribution that Australia Post chooses to make to APSS. The dominant determinants of the expense in the short to medium terms are movements in the fund's assets and liabilities, and in Commonwealth bond rates.

The superannuation expense for 2008/09 was set by the actuary. The actual level for each year's expense is advised by the actuary each August. Actual expenses for recent years up to and including 2008/09, and forecasts for the three forward years, are as follows.

Table 9 – Superannuation expense[38]

| Financial year | Superannuation expense |
|---|---|
| Actual expense | |
| 2004/05 | $129.8m |
| 2005/06 | $100.9m |
| 2006/07 | $74.2m |
| 2007/08 | $36.0m |
| 2008/09 | $48.1m |
| Forecast expense | |
| 2009/10 | $111.0m |
| 2010/11 | $112.8m |
| 2011/12 | $115.3m |

[38] Data are shown for only for 2004/05 onwards, as the current relevant parts of AASB 119 only became operational on and from that year.

The ACCC will note that, as with other employee balance sheet items described elsewhere in this draft notification, changes in Commonwealth bond rates impart annual volatility into the calculations of the superannuation surplus and the annual expense. An additional source of volatility arises from rises or falls in the market value of assets in which APSS invests. Changes in the fund's surplus arising from both sources of volatility feed into the annual superannuation expense as advised by the actuary.

Movements in the APSS surplus and in the expense required of Australia Post are affected in the short to medium term only at the margin by the cash contributions which Australia Post chooses to make. For practical purposes, the ACCC should regard this expense as beyond the capacity of Australia Post to manage over the time period covered by this draft notification.

Financial details of Australia Post's superannuation obligations are contained in Note 12 to the 2007/08 statutory financial statements.

### 9.5.5. Long service leave

Long service leave is a statutory entitlement whose accounting treatment is governed by AASB 119.

The liability for long service leave is recognised as a balance sheet provision which is measured as the present value of expected future payments to be made in respect of services provided by employees up to the reporting date. The calculation is made by an independent actuary each year, and takes into account wage levels and expected rises, projected employee departures, and periods of service. Expected future payments are discounted to a present value using Commonwealth bond rates whose yield period most closely matches the expected timings of future cash payments.

Because of the nature of the discounting factor, ie bond rates, any movement in bond rates (in either direction) results in a commensurate change to the long service leave liabilities, and therefore to the long service leave expense in that year. In following periods, provided that bond rates do not continue to change materially, the annual long service leave expense reverts to the underlying level based on the internal actuarial factors, ie all factors that relate only to Australia Post.

### 9.5.6. Recreation leave

Liabilities for annual leave are recognised in balance sheet current provisions at the amounts expected to be paid when the liabilities are settled. (There is an exception where the corporation has an unconditional right to defer settlement of the liability for at least twelve months after the balance date).

By the provisions of AASB 119, both the balance sheet provisions and the associated labour expense for recreation leave are not affected by volatility derived from Commonwealth bond rate changes.

Recreation leave is prescribed by the General Conditions of Employment Award. Other than to ensure that employees actually utilise their leave entitlement, there is little that Australia Post can do to 'manage', ie minimise, this.

### 9.5.7. Separation and redundancy

A liability (and an associated expense) is recognised for separation and redundancy benefit payments for ongoing restructuring, only where the corporation is demonstrably committed to the restructuring and the cost can be reliably measured. Generally, such assessments do not exceed the certainty of initiatives planned for the following year. AASB 119 contains strict rules governing such liabilities.

Since the major network changes were completed and the process improvements wound down, the liability and expense for this labour item have become very small, and the projected levels for the years 2008/09 onwards are expected to change very little from the levels of the last two financial years.

Comparative recent data for the liability are contained in Note 20 to the 2007/08 statutory financial statements.

## 9.6. Non-labour costs

Non-labour costs include items such as contract services, payments to licensees, depreciation, accommodation, security services, vehicle costs etc. All such items have prices set in competitive markets, each with its own cost characteristic.

Covered below are payments to licensees, contract mail services and other contract services. Each demonstrates the degree to which Australia Post has reduced both the risk and size of its cost structure over time. If those functions had been retained by Australia Post as staffed activities, then the cost would have been higher and more fixed in nature.

These three areas of contract expenses jointly form the second most important category of expense after labour costs. In 2007/08 contract services of all kinds amounted to $1,079m, compared with the labour cost total of $2,044m. In other words, staffed labour and contract resources amounted to some 72% of the Australia Post's (non-interest) cost base.

### 9.6.1. Payments to Licensees, Franchisees and Community Postal Agents

At 30 June 2008 the retail network of 4,453 outlets comprised:

- 831 corporate outlets;
- 2977 licensees and franchisees; and
- 645 community postal agents (CPAs).

The heavy concentration on licensee (including franchise) outlets in part recognises the ability of such enterprises to offer postal and related services in conjunction with operating an independent business. Although some licensee outlets may be viable standalone businesses, the 'in-conjunction' nature of many licensees allows the required number of retail outlets to be maintained, and at a lower cost to Australia Post than would otherwise be the case.

CPAs provide a lower cost, but reduced service range, option in areas where even in-conjunction licensee enterprises would not be viable.

The retail (ie sales and acceptance) function is described in greater detail in Appendix 11.

### 9.6.2. Contract mail services

Australia Post uses contractors for mail services (ie transport and delivery) where contracting provides a more efficient, flexible, or more appropriate remuneration model, given the operational circumstances and risks involved; eg with variable or low mail volumes and wide mail dispersions.

Contract mail services include:

- Roadside mail delivery – associated with rural and remote delivery – where the delivery run can be long and mail volumes may be light (Australia Post's CSOs require delivery of a domestic letter service on reasonable access standards regardless of whether the service route is economic);
- Street mail delivery – although mainly undertaken by Australia Post employees, there are cases, for example in outer suburban fringe deliveries, where the number of delivery points might be too small to make up full delivery rounds that would justify a staffed service;
- Parcel service delivery – small parcel (generally under 500 grams) deliveries may be included as part of the staffed street delivery service by a postie. Larger parcels cannot, as they are too heavy or too large for a postie to carry in addition to a full letter load. Australia Post outsourced the large parcel delivery service many years ago for cost effectiveness reasons;

- **Intrastate and interstate road transport** – a mix of air and road transport is used for the movement of letters across Australia. Road transport is the preferred mode on a cost basis but there are mail paths (typically between interstate non adjacent capital cities) where the service standard and timing does not afford time for road transport, and higher cost air transport is used. Road contractors are used when Australia Post's existing vehicles are not available, or where capacity has to be augmented in periods of high demand and where it would be uneconomic to add to the permanent fleet capacity;

- **Air and sea transport** – air transport is needed for longer interstate routes to meet service standard requirements, and for international services. Some rural and remote deliveries require air transport because of the isolation of the sites and the distance to a town from which a delivery could be made. Sea transport is a small part of contract services; and

- **Mail collections** – in metropolitan and large country areas, mail collections from approximately 24,000 collection points is largely undertaken with Australia Post's vehicles, but in some country and remote areas, mail collection activities may be undertaken by contractors (eg as part of a mail delivery contract).

These services are delivered across regional areas (approximately 50% of contracts), remote locations (approximately 10%), and metropolitan areas (the remaining 40% of contracts).

#### 9.6.2.1. Administration of contract mail services

The majority of mail contractors are engaged under a standard contract, regardless of the type of material carried (ie parcels or letters, reserved or non-reserved letters). However, there are a number of contract versions in operation as each year the contract is reviewed. Past versions are rarely amended unless it makes commercial sense to do so. Australia Post has provided a copy of the standard contract to the ACCC separately.

The standard contract includes matters such as:

- definition and ABN of the contractor;

- nature of the services to be provided by the contractor, ie parcel delivery, roadside delivery, street mail delivery etc;

- the delivery area;

- contract fees and escalation factors;

- contract date of commencement, initial term and further periods;

- equipment and tools of trade; and

- insurance details.

Australia Post engages contractors via open public tender and therefore is subject to market conditions. In summary the current process is:

- when a service is to be tendered or re-tendered the delivery / contract manager undertakes a review of the service, which measures mail volumes, hours worked, distance travelled , delivery points etc. Note that at tender time there is an opportunity to review a contract;

- the data used to generate a specification are used by tenderers to estimate their tender costs. This document is specific to the service provided (ie roadside delivery, street delivery) ;

- tenders are submitted and assessed against cost and capability criteria;

- costs are compared with an internally-assessed price for the service;

- negotiation is undertaken with acceptable tenderers;
- the contract is then awarded;
- in certain circumstances, for example if there is only one supplier such as a ferry or air service, Australia Post might negotiate directly with that supplier.

The majority of contracts are tendered for 5 years but there are cases where, for example, there might be a scheduled relocation of a DC or a planned DC amalgamation that may require contracts to be specified for a shorter period before review. Only about 50% of contracts complete their full term.

In recent years, there has also been a small trend towards master contracts with parcel delivery contractors, but this is far less pronounced with street and roadside delivery contractors.

Contract escalation provisions are based on the Labour Price Index (source ABS Catalogue No. 6345.0), CPI (ABS Catalogue No. 6401.0) and a fuel price index (source FuelTrac). Contract fee adjustments based on these escalations are reviewed once a year with the exception of the fuel price escalation that is reviewed every three months and adjusted where the fuel price escalation exceeds a predetermined threshold.

##### 9.6.2.2. Contract costs

The work effort has been relatively stable for roadside mail delivery over time. However, with the growth in parcel volumes and delivery points the workload for parcel and street mail contractors has grown steadily. These growth factors feed directly into contract costs over time.

In addition, the ability of contractors to renegotiate contract payment rates, and even to terminate contracts early, has placed contract costs under extra pressure for some time.

In addition to volume and points growth factors, contract costs have significantly increased because of wages, fuel and other escalation factors against a background of the tightening labour market throughout most of this decade. Although particular states have been relatively more affected by contract rate pressures, the issue is widespread.

### 9.6.3. Other contract services

Australia Post has outsourced resourcing requirements across a number of areas. These include:

- operational activities in logistics and in courier and mailroom services, whose business models rely more on contractors (eg owner drivers) than on using Australia Post employees;
- IT specialists and other administrative roles; and
- a small number of operational personnel in MCs and DCs.

Usage of such contractor personnel was relatively steady in the early years of this century, at about 1,000 FTEs. The total peaked at about 1,200 FTEs in 2004/05 and has been steady at just over 1,100 FTEs per annum in the three years ending 2007/08. Total annual usage is forecast to decline steadily from 2007/08 to about 950 FTEs by 2011/12.

### 9.6.4. International Settlements

Mail settlements are the payments that Australia Post makes to other postal authorities around the world for delivery in those countries of letters and parcels mailed in Australia. Payment rates are set by the Universal Postal Union or direct negotiation between countries. All outward letter and parcel services to which this expense applies are non-reserved. These mail settlement costs are not relevant to this draft notification and they do not form part of the draft notification cost base.

### 9.6.5. Depreciation

Depreciable property, plant and equipment assets are written off to their estimated residual values over their estimated useful lives using the straight-line method of depreciation.

Depreciation and amortisation rates and methods are reviewed annually and necessary adjustments are recognised in the current reporting period, or current and future reporting periods, as appropriate.

Depreciation rates, useful lives and residual values used are generally those advised previously to the ACCC as part of Australia Post's 2008 price notification. (The one change involved a reduction in the useful life of some motor vehicles from 7 years to 5 years to address an issue of loss on disposal of the vehicles concerned). Australia Post's fixed asset lives and associated depreciation rates have not otherwise changed since the 2008 price notification. A summarised version of those asset lives is contained in note 1(s) to the statutory financial statements, at page 77 of Australia Post's 2008 annual report.

The depreciation expense is forecast to rise from $187m in 2007/08 to $202m in 2008/09, $217m in 2009/10, $229m in 2010/11, and $252m in 2011/12 (numbers shown to the nearest $m). This is higher than the depreciation charge of the four years prior to 2007/08, but is similar to the levels applicable in the early years of this decade, (ie $218m in 2001/02 and $232m in 2002/03).

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

The need to lift capital investment in total, and IT capital investment in particular, was stated in the 2008 price notification.

### 9.6.6. Other miscellaneous non-labour expenses

Other non-labour costs incurred by Australia Post include:

- staff-associated costs, such as training and travel;
- accommodation, including premises rent, cleaning, charges by utilities for gas, electricity, water etc;
- cost of goods sold;
- statutory and legal payments;
- motor vehicle costs;
- communications;
- bank fees and charges;
- general material purchases; and
- other miscellaneous expenses.

Australia Post is not aware of anything which is unusual or specific to Australia Post in this set of unrelated expenses. All products and services concerned are purchased from third party suppliers. These costs do not vary with letter volumes.

In total, expenses for these items are forecast to grow by an annual average of 3.0% per annum over the four years from 2007/08 to 2011/12. Some factors that are forecast to add to normal business and price growth impacts on expenses over the three years (of this draft notification) include increases in software licence fees (contractually required under current contracts) and communications and other costs that will rise with a planned growth in new financial services revenue over this time. The ACCC will note that, at 3.0% per annum, the average annual rate of increase of these miscellaneous items is within the forecast average inflation rate of 3.1% per annum (underlying CPI) as estimated by Access Economics for those four years[39]

Many of these expense items are set in usage terms by normal commercial or legal factors.

There is some discretion for cost management in areas such as staff-associated costs, and areas such as travel and travel-based accommodation are already tightly controlled. Because of the ongoing importance of labour resources in providing Australia Post's services, reductions in staff training are possible but counter-productive in all but the shortest of timeframes. Expense categories such as general materials and miscellaneous expenses generally involve local expenditure needs and decisions which are either too costly or physically impractical to manage centrally.

## 9.7. Cost forecasts

Future year costs rely on a number of planning assumptions. These are at three levels for the purpose of this draft notification: those that are economy wide assumptions; those that are relevant only to Australia Post, but that apply across all of the business; and those at a particular product level. The expected drivers of cost over the three years of this notification (2009/10 to 2011/12) are shown in the following Tables:

**Table 10 – External assumptions**

| | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|
| GDP growth (%) | (0.5) | 2.25 | 4.5 |
| CPI increase (%) | 3.0 | 2.5 | 2.5 |
| Bond rates | unchanged | unchanged | unchanged |
| A$ | 2.30 | 2.30 | 2.30 |

**Table 11 – General business assumptions**

| | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|
| Wage growth (%) | 4.0 | ✂ | ✂ |
| Delivery points | Continued growth of around 2% (200,000) per annum | | |
| Labour numbers | Annual FTE numbers are projected to decline by an average of 0.5% per annum | | |
| Portfolio growth (revenue) | | | |
| - Letters & Associated Services (%) | 2.1 | 1.7 | 3.2 |
| - Parcels & Logistics (%) | 5.5 | 6.4 | 7.9 |
| - Agency Services & Retail Merchandise (%) | 0.0 | 6.2 | 7.6 |

## 9.8. Cost allocation to products and services

Cost allocation to products and services in each year of this price application is made in accordance with sections 5-7 of Australia Post's Regulatory Accounts Procedures Manual (which has been provided to the ACCC as part of the RKR process). Allocation procedures have been subject to rigorous assessment by the ACCC in the course of its 2008/09 review of Australia Post's costing system.

[39] Business Outlook, March 2009

# 10. Asset base

*This section:*

- *demonstrates that Australia Post has an efficient asset base, both for the purpose of this draft notification and across Australia Post in general;*
- *demonstrates the nature of Australia Post's assets is such that valuation does not present the ACCC with difficult issues;*
- *provides an overview of Australia Post's comprehensive governance process embedded in its capital investment system, including Board endorsement of the capital investment projections that cover the three years of this draft notification; and*
- *demonstrates that because most of Australia Post's assets are shared by reserved and non-reserved services, asset allocation principles are needed for all of the asset base used in this draft notification. Asset allocation is consistent with cost allocation.*

In response to the ACCC's Decision of July 2008, the emphasis of this section is on fixed assets. This includes both the inherited fixed asset base and the incremental changes to it arising from the Australia Post's capital investment plans for the next three financial years.

## 10.1. Australia Post Balance Sheet[40]

Australia Post's balance sheet at 30 June 2008 comprised \$5,477m in assets, \$2,667m in liabilities, and \$2,810m in equity, or net assets. An abbreviated version of the asset section of the balance sheet is as follows:

**Table 12 – 30 June 2008 balance sheet – Assets**

| Assets | Value at 30 June 2008 ($m) |
|---|---:|
| Current Assets | |
| - Cash and cash equivalents | 710 |
| - Trade and other receivables | 358 |
| - Other current assets | 239 |
| **Total Current Assets** | **1,307** |
| Non-Current Assets | |
| - Investments in jointly controlled entities | 310 |
| - Superannuation asset | 1,595 |
| - Land and buildings | 777 |
| - Plant and equipment | 534 |
| - Intangible assets | 218 |
| - Investment properties | 238 |
| - Other non-current assets | 498 |
| **Total Non-Current Assets** | **4,170** |
| **Total Assets** | **5,477** |

[40] All financial data in this section are rounded to the nearest \$m unless indicated otherwise

## 10.2. Asset accounting policies and practices

Australia Post complies with all relevant Australian accounting standards, as well as with an extra set of financial accounting instructions issued by the Minister for Finance and Deregulation. These additional instructions do not supersede the accounting standards.

At 30 June 2008 Australia Post had about $2.5b of fixed assets (including land and buildings) recognised in the balance sheet or in notes to the accounts. (This total replaces the formal balance sheet total for land and buildings, which for statutory accounting purposes are valued now at cost, by their fair value as shown in Note 13 to the accounts). The $2.5b total excludes investments in jointly controlled entities, tax assets, the superannuation fund and loans to associated entities. It therefore includes the following items from the abbreviated balance sheet:

- land and buildings;
- plant and equipment; and
- intangible assets (mainly software).

These assets are grouped into approximately 500 asset classes. Depreciation rates are set asset by asset within each asset class level, and are reviewed annually. Asset stocktakes are also conducted annually and assets and their location are confirmed, transferred to a new work centre, or removed from the asset register if they can not be located or are no longer used. These practices are required for the annual statutory financial audit purposes to ensure that asset balances are not being maintained above their appropriate values.

Accounting details for fixed assets are summarised in Appendix 13.

Australia Post's fixed asset classes, together with asset depreciation rates, were supplied to the ACCC as part of Australia Post's 2008 price notification. This information has undergone two very minor changes since then. The changes involve two asset classes for vehicles – ZD06 (mail vans) and ZD20 (large trucks) – and involves a reduction in their residual values (10 percentage points for each class) in light of previous losses on disposal of these vehicles. The net financial impact of the two changes is small, and amounts to less than $2m per annum in increased depreciation once the transition year has passed.

Other than these minor changes to vehicle accounting policies, there has been no other asset accounting change since these were last reviewed by the ACCC in the 2008 price notification.

The revised asset class schedule has been provided to the ACCC together with a statement of the financial position for each class at 30 June 2008 and 31 March 2009.

Fixed asset data for the domestic reserved letter service is provided at Appendix 14.

## 10.3. ACCC views on Australia Post's fixed assets

Australia Post's fixed asset register was analysed by the ACCC in the 2002 and 2008 price notifications.

In its Decision of October 2002[41], the ACCC stated that;

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

[41] Page 14, Appendix B

That view was reaffirmed by the ACCC in its Decision of July 2008[42], when it concluded:

> 'The ACCC notes that there has been no material change to the nature of Australia Post's assets, although a number of accounting changes have been introduced as a result of the adoption of new accounting standards by Australian corporations generally.
>
> The valuation methods employed by Australia Post are consistent with accounting standards and guidelines for statutory reporting purposes. The allocation of fixed assets to reserved services is generally consistent with cost allocation procedures which are used in the RKR assessment.
>
> The ACCC therefore considers that Australia Post's fixed asset values are likely to be reasonable for the purposes of analysing the profitability of providing domestic reserved letter services.'

As stated above, since Australia Post's 2008 price notification there has been no material change to the nature of Australia Post's assets, and asset accounting changes have been rare and immaterial. The asset classes are very similar to the asset classes used by Australia Post in 2008. No infrastructure-type assets have been introduced. This is the case regardless of whether the asset base is that of Australia Post or of the domestic reserved letter service.

The June 2008 fixed asset allocation to the domestic reserved letter service was $973m, ie less than 40% of total fixed assets. In view of Australia Post's CSO to provide a letter service (of which the domestic reserved letter service is the dominant part), it could be argued that the allocation of shared network fixed assets according to product activity levels under-estimates the asset levels required to support the letter service on a standalone basis.

This view is analogous to the conclusion reached by the ACCC on cost allocation in its April 2008 RKR report, which said[43]:

> 'It seems that the fully distributed cost underestimates the cost of providing the reserved services and that it is necessary to add back some of the unattributable costs that were allocated to the non-reserved services. However, identifying the appropriate amount to be added back is problematic.'

However, as the ACCC notes, identifying the extra asset total, to be added, is problematic. Therefore, the fixed asset base included in this draft notification is restricted to the (lesser) total used in the RKR process, eg $973m at 30 June 2008 as adjusted by forecast capital investment additions, deletions and depreciation.

Therefore, the ACCC's conclusion reached above in relation to the 2008 price notification, ie that Australia Post's fixed asset values are likely to be reasonable for the price application purposes, was the appropriate judgement then, and remains the appropriate assessment in this case.

## 10.4. Capital investment

Australia Post's capital investment planning cycle is directed by detailed guidance set out in the Project and Capital Investment Program Policy and Procedures Manual. A copy of this manual has been provided to the ACCC.

The annual capital investment planning cycle commences each year in the December quarter. In this first stage of the process, business units both compile new possible capital investment opportunities and refine the assessment of opportunities that have been identified previously but have not yet proceeded through all required governance stages of the formal capital investment planning and approval process.

The period to which this first annual stage of the capital investment process applies is normally the following 'budget' year and the two following years which, together, form the three-year planning horizon of the corporate plan and supporting plans, such as the IT plan. For the purpose of this draft notification, the budget year is 2009/10 and the later plan years are 2010/11 and 2011/12.

[42] Page 108 – ACCC's view
[43] ACCC, Assessing Cross Subsidy in Australia Post 2006-07, April 2008, Section 4.3

Following the compilation and initial vetting of business proposals at divisional level, business units provide their draft capital investment proposals to the Australia Post Enterprise Investment Committee (EIC)[44].

The EIC will then review individual project selection to establish a balance of investments which will constitute Australia Post's capital investment plan. Once this is complete the EIC provides a recommendation to Australia Post's Executive Committee and ultimately the Australia Post Board for approval.

In 2008/09 the original capital investment plan approved by the Australia Post Board for the year involved $410m of outlays. At the March 2009 review of the full year capital investment outlays, this figure had been revised to $332m.

## 10.5. 2009 Capital investment plan

The 2009 capital investment plan which is included in the 2009 corporate plan covers the budget year (2009/10) and the two subsequent years. The 2009 capital investment planning process was influenced by the downturn in current economic conditions and by Australia Post's forecast profitability and cash flow positions for the planning period. The resulting capital investment program therefore reflects the prevailing financial environment and focuses on investment in activities considered core to Australia Post.

The 2009 approval program included a reduction in 'business as usual' projects. While the level is deemed to be sufficient to maintain core operations of Australia Post, there are some instances where replacement program capital investment outlays have been reduced in order to allow more strategic new initiatives to proceed. This reduction has been made with reference to the corresponding operating cost implications as well as management of acceptable operating risk levels.

The main capital expenditure items (by category) included in the current three-year capital investment plan are detailed in the following Table.

Table 13 – Capital investment outlays by category ($m)

| | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|---|
| Australia Post Network | | | | |
| - Sales and Acceptance | 36 | 24 | 33 | 31 |
| - Processing | 31 | 20 | 22 | 49 |
| - Delivery | 25 | 19 | 30 | 45 |
| Information technology | 120 | 176 | 162 | 118 |
| Motor vehicles | 41 | 28 | 46 | 49 |
| Other capital investment | 79 | 50 | 16 | 14 |
| Total capital investment | 332 | 316 | 308 | 307 |

Although the planned projections are built up on a project-by-project basis, capital spending data for the second half of the plan period are inherently more indicative than firm, as they involve preliminary expectations rather than projects for which there are well-developed business cases. Appendix 15 provides an overview of Australia Post's three year capital investment program.

[44] Introduced into the planning process in November 2008, the EIC is responsible for establishing and overseeing Australia Post's total investment portfolio.

## 10.6. Comparison with 2008 price notification capital investment outlook

Capital investment data used in the 2008 price notification were those of Australia Post's 2007 corporate plan. They were based on Australia Post total capital investment outlays approaching $400m per annum in each of 2008/09 and 2009/10 (that being the final year of that three year plan). The capital investment outlook from the 2007 corporate plan was maintained very closely in Australia Post's 2008 corporate plan, as is shown in Table 14 below.

Table 14 – Corporate plan capital investment requirements ($m)

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|---|---|---|
| 2007 – capital investment plan | 260 | 246 | 399 | 385 | | |
| 2008 – capital investment plan | | 286 | 412 | 404 | 372 | |
| 2009 – capital investment plan | | | 332 | 316 | 308 | 307 |

The key feature of the capital investment plan programs approved by the Australia Post Board in both 2007 and 2008 was the acceptance of the strategic need to increase investments in areas that had experienced a reduction in earlier years in the decade.

The 2009 corporate plan and its capital investment requirements, upon which this draft notification is based, continues to implement the regeneration of much of Australia Post's fixed asset base. However, it does so at annual capital investment levels that are lower than those contained in the previous two plans. The reason for this capital investment reduction in the current plan is not that programs have already been substantially implemented. Instead, it reflects the limitations placed on Australia Post's ability to fund its capital investment from free cash flows and from a reluctance to resort to seeking substantial new sources of debt in financial markets where that debt is now difficult to obtain and expensive.

In addition, to the cash flow and external financing constraints that have influenced the 2008/09 reduced capital investment outlays, the three-year program involves both a relatively small number of complex projects that will take a number of years to fully implement and a large number of smaller projects. All projects – large, complex or small – require project management to implement the capital investment and make it operational. Therefore, the three-year program will be set at levels that are within Australia Post's capability, and resourcing availability to execute it.

## 10.7. Domestic reserved letters capital investment

Most capital investment in any year is shared across a number of services, and also across Australia Post's three main business portfolios. Very little is dedicated solely to the domestic reserved letter service. For example, plant and equipment used for domestic reserved letters can be used also for domestic non-reserved letters or international letters (which can be a mixture of reserved and non-reserved items).

Capital investment totals for the domestic reserved letter service from 2008/09 onwards are included within asset numbers in Appendix 14.

## 10.8. Other investments

No allowance is made in this draft notification for external acquisitions in any of the three portfolios, including the Letters & Associated Services Portfolio in which the reserved letter service is contained.

## 10.9. Forecast asset base

### 10.9.1. Total forecast fixed assets

Fixed asset forecasts for Australia Post are as follows:

Table 15 – Forecast Australia Post total fixed assets ($m)

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 2,506 | 2,570 | 2,683 | 2,756 |
| Additions | 258 | 323 | 296 | 306 |
| Depreciation | (195) | (210) | (222) | (245) |
| Closing balance | 2,570 | 2,683 | 2,756 | 2,818 |

### 10.9.2. Forecast asset base – domestic reserved letter service

Consistent with the allocation of costs, asset values are allocated to products according to procedures specified in the Regulatory Accounts Procedures Manual (chapter 8), which has been provided to the ACCC in accordance with section 23 (6) of the RKR.

Forecast fixed asset data for the domestic reserved letter service for the pricing notification period are as follows.

Table 16 – Forecast domestic reserved letter service fixed assets ($m)

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 973 | 1,003 | 1,033 | 1,029 |
| Additions | 130 | 137 | 107 | 205 |
| Depreciation | (100) | (107) | (111) | (118) |
| Closing balance | 1,003 | 1,033 | 1,029 | 1,116 |

The ACCC will note that the allocation of capital investment and Assets Under Construction to products and services has been made under very conservative assumptions, which act to reduce allocated fixed asset balances below levels used in Australia Post's 2008 price notification. Those assumptions involve holding all new assets as unallocated until they are forecast to be completely installed and ready for use. As a result, a large total of new assets which could well become operational before the assumed dates are held for forecast purposes as unallocated Assets Under Construction until 2011/12.

## 10.10. Conclusion

The ACCC, in its Decision of October 2002 and July 2008, accepted Australia Post's fixed asset base as reasonable. No material change to the nature of those assets has occurred since then, and the accounting treatment is materially the same as in the 2008 case.

Across Australia Post, capital investment has been modest since the 2002 price notification. As mentioned earlier, in recent years Australia Post has been at the low end of its investment cycle.

However, certain infrastructure assets (eg IT) are scheduled for replacement and it is essential that Australia Post reinvests in these assets to ensure its continued competitiveness. This investment is likely to leave Australia Post with fixed asset efficiency higher in 2008 and 2009 than in 2002.

Fixed asset values in respect of the network are generally the result of an allocation process, as few of those assets are dedicated solely to particular products and services. The fixed asset and cost allocation procedures are consistent and are used in the RKR assessment.

# 11. Productivity

*This section:*

- *introduces total factor productivity (TFP) results for Australia Post, covering both recent history and projections for the pricing period;*
- *provides an overview of an international benchmarking study of a number of representative OECD postal authorities that compares Australia Post's TFP against those in the sample;*
- *shows that while TFP growth in Australia Post has been impressive, the forecast negative impact of declining mail volumes will reduce TFP within the period of this draft notification;*
- *shows that consumers have been the greatest beneficiaries of Australia Post's TFP growth over time; and*
- *demonstrates that although potential sources of new productivity growth are becoming harder to identify, a number of initiatives and programs are planned to deliver further efficiency gains during the pricing period.*

## 11.1. Total Factor Productivity

Productivity growth is basically output growth less input growth, with both output and input measured on a real rather than nominal basis.

Some versions of productivity growth employ a partial factor measure, which compares output growth with the change in just one factor of production. The most common version of this is labour productivity.

Single factor productivity measures provide relevant and useful information, but they can be affected by changes in other production factors, for example in capital or labour substitution or outsourcing previously staffed work to contractors.

Total factor productivity measures output growth compared with the change in all inputs. It overcomes the issues of interpretation that arise with single (ie partial) factor productivity results.

This section of the draft notification presents the results of a number of TFP studies commissioned by Australia Post for use in its 2009 price notification.

### 11.1.1. International benchmarking of productivity in postal operations

In its Decision of July 2008, the ACCC commented on the scarcity of international benchmarking studies in the postal sector and the desirability of examining such information.

Australia Post commissioned a benchmarking study to provide that international perspective to this draft notification. Independent productivity experts Economic Insights Pty Ltd were engaged to carry out the study, led by Denis Lawrence and John Fallon. A key difference between this study and studies on Australia Post's TFP carried out previously is that changes of TFP over time were measured, as in the previous studies, but the methodology also enabled the absolute levels of productivity to be benchmarked in addition to providing the time series.

A number of OECD postal authorities were invited by Australia Post to join the study, on the basis that:

- funding for the project was solely by Australia Post;
- data and other information would be supplied by each postal authority direct to Economic Insights;
- each country's data and information would be supplied on a confidential basis to Economic Insights, and each country's data would not be revealed to the other participants; and
- Economic Insights would provide a written report to each participant, with each country's own results identified to itself, with other participants' results also indicated, but with the identity of the other participants concealed.

Postal authorities participating in the study were:

- Australia;
- Canada;
- Denmark;
- Italy;
- Japan;
- New Zealand; and
- USA.

The decision to limit the sample to the number of countries was chosen partly on cost grounds, and partly to make the complicated issue of data collection manageable for Economic Insights. In doing so, Australia Post believed that there would be suitable insights in view of the representative nature of the countries invited: the countries selected provided a good cross-section in terms of country size and terrain, population, mail density etc. The UK and Spain were also invited to participate in the study, but declined to participate.

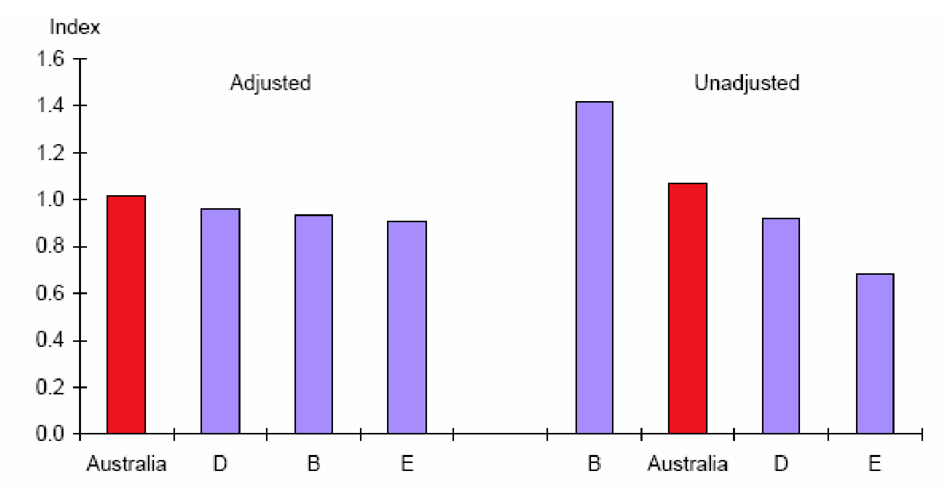
The study covered the period 2002 to 2009. Its main features were:

- three broad output categories were modelled – letters, parcels and 'other' outputs;
- four broad categories of inputs were included – labour, other operating expenditures, land and buildings, and all other plant and equipment, software and other capital; and
- to put all of the participating postal authorities on to a comparable operating base, raw data results were adjusted for differences in mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length).

The results of the study were as follows:

- on an unadjusted basis Australia Post was ranked third in terms of TFP levels;
- Australia Post was the only postal authority to show steady, consistent improvement in TFP, while the TFP of three other postal authorities deteriorated over the period;
- when the raw results were adjusted for mail density, Australia Post moved from third to second in the rankings; and
- when the data were adjusted for both mail density and customer density Australia Post moved from second to first in the rankings – as shown in Figure 7 below.

**Figure 7 – TFP adjusted for mail density and customer density, 2008 or latest year**



In commenting on this last result, Lawrence and Fallon stated:

> 'It should be noted that this adjustment is likely to be conservative as Australia Post has not included route length associated with rural deliveries by roadside mail contractors in its route length data supplied (but contract street deliveries are included). Including rural contractor route lengths could be expected to significantly reduce Australia Post's relative customer density and, hence, increase its relative TFP score when the adjustment is made.'

Australia Post believes that this adjustment would strengthen the result further. Of the countries selected for the study only Australia and Canada face the comparable conditions of a large and often hostile land mass, together with a relatively small population (ie rural and remote delivery points relatively few and far apart).

Australia Post believes that the results should provide reassurance to the ACCC that Australia Post is operating at a very high level of performance in the postal world. When the outstanding TFP result is considered beside the basic postage rate charged by Australia Post, the service standards and the distances to which these have to apply, the case for concluding that Australia Post's cost base is efficient is very strong.

A copy of the Economic Insights, June 2009, *International Benchmarking of Postal Service Productivity* study, has been provided separately to the ACCC.

### 11.1.2. Total Factor Productivity in Australia Post

As part of Australia Post's 2008 price notification Australia Post commissioned Meyrick and Associates to undertake a TFP assessment of Australia Post. This assessment resulted in the *Australia Post's Aggregate and Reserved Service Productivity Performance* report. For this draft notification, Australia Post commissioned Economic Insights Pty Ltd to update the report.

The main features of the modelling were:

- four output groups covering the domestic reserved letter service were included in the outputs. These were: small full-rate letters, small PreSort letters, large full-rate letters, and large PreSort letters;

- two other domestic letter groups and nineteen other output groups made up the remainder of the outputs;

- inputs were grouped into four aggregate categories: labour, contractors, capital, and other inputs; and

- results were calculated for both Australia Post as a whole and for the reserved letter service whose prices are the subject of this draft notification.

The main results were as follows.

- inputs into Australia Post's production processes have remained broadly stable in total throughout this decade;

- output rose in most years until last year, when it fell significantly because of declines in reserved service volumes and bill payments; and

- as a result, TFP growth was positive over the decade, but declined in 2008/09 with the lower output volumes.

For the reserved letter service:

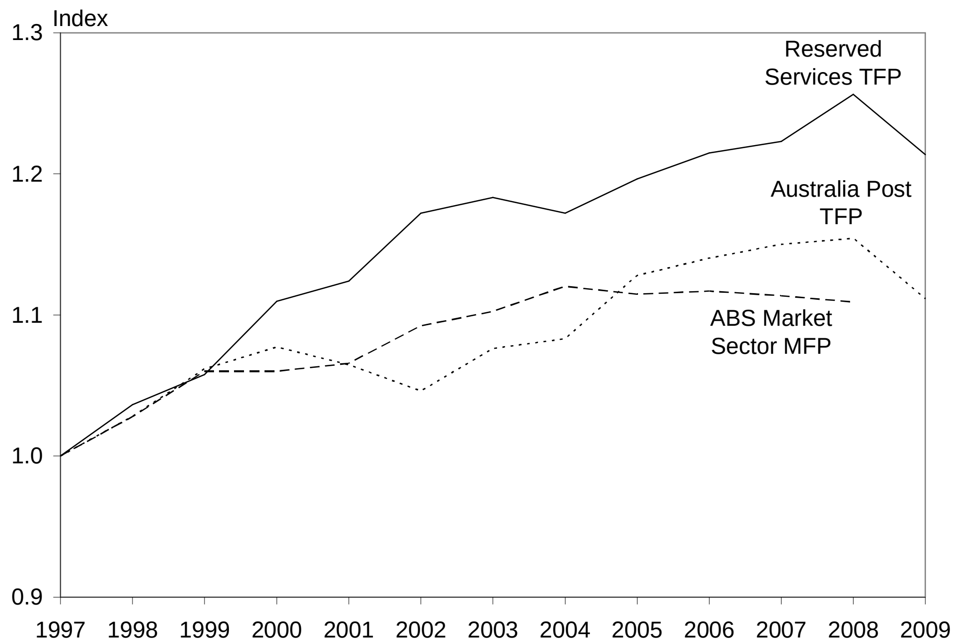
- output grew strongly between 1997 and 2000, increasing by 12 per cent before flattening out and fluctuating around this level through to 2008. It then fell markedly in 2008/09;

- the input quantity, on the other hand, has declined over the course of the decade; and

- as a result, TFP in the reserved letter service rose through the decade at an average annual rate of 1.0%, despite the fall in letter volumes in 2008/09.

The reserved service TFP result is very strong. It was achieved without a positive contribution from output growth, and exceeded multifactor productivity growth in the wider economy substantially. Figure 8 below summarises these results.

Figure 8 – Australia Post's TFP and Australian economy multifactor productivity




In the three years covered by this draft notification:

- TFP for the total of Australia Post is forecast to fall slightly, with an overall fall in output volumes and a small rise in inputs;

- letter volumes are forecast to fall over the three years;

- inputs into the reserved letter service are also forecast to fall over the next three years; and

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

It is important that the ACCC draws the correct conclusion from these results.

Forecast declines in TFP in the reserved letter service reflect the fact that Australia Post's network is required to provide a letter service to mandated service and access standards. These standards do not vary downwards with declining letter volumes, and in fact have effectively become more demanding because of the inexorable rise in delivery points each year. The contributions of fixed service standards, increasing delivery points and declining volumes does not indicate decreasing efficiency in Australia Post's cost base, and section 9 provides substantiated detail on how Australia Post has managed its cost base over time to maximise profitability while not availing itself of the maximum revenue allowed in the ACCC's pricing formula.

Results for the reserved letter service are considered to be equally valid for the domestic reserved letter service because of the relatively small volume of reserved international letters.

A copy of the Economic Insights, July 2009, *Australia Post's Aggregate and Reserved Service Productivity – 2009 Update* has been provided separately to the ACCC.

## 11.2. Productivity dividend

In addition to the two TFP performance studies referred to earlier in this section, Economic Insights Pty Ltd also carried out a study on how the benefits of TFP growth, ie the 'productivity dividend', have been distributed amongst the various stakeholders to the business. Stakeholders were defined in the study as:

- staff;
- contractors;
- consumers; and
- Australia Post's shareholders.

The main conclusion made in the study was that:

> 'Most of the benefits from Australia Post's reserved service productivity improvements over the past 12 years, and considerably more than all of the benefits over the last seven years, have been passed on to consumers in the form of real price reductions.'

The main results were:

- the total productivity dividend over the period 1998/99 to 2008/09 was approximately $700m;
- out of that total, staff and contractors have benefited by approximately $570m; and
- consumers have benefited by approximately $500m, leaving shareholders with a net negative return.

In the seven years to 2008/09, the total return to consumers was almost double the total available for all stakeholders combined. Again, the shareholder was a net provider of the dividend.

The study concludes by noting that a more even share of the productivity dividend will be required in future if the distribution is to be sustainable, ie to provide Australia Post with suitable incentive to invest and seek further productivity gains.

A copy of the Economic Insights, July 2009, *Measuring the Allocation of Australia Post's Reserved Service Productivity Dividend* report has been provided separately to the ACCC.

## 11.3. Productivity initiatives

A range of initiatives and programs support Australia Post's cost containment and productivity targets for the network. They cover a spectrum from:

- process efficiencies that are pursued on a localised basis throughout the network in order to achieve budget and plan targets: to

- major programs to re-engineer core network processes in order to extract cost, build flexibility, and create new network capabilities for future revenue growth.

Productivity initiatives aimed at cost containment need to be viewed in a strategic context:

- the aim is to drive out costs wherever possible; but without risking a failure to meet the service standards that the community has come to expect and which Australia Post is required to meet;

- major initiatives invariably have cross functional impacts and these are assessed against a strategic view of the future network requirements and a 'whole of network' architecture – to avoid cost shifting from one function to another – a risk in any network environment; and

- letters share a joint network infrastructure, and significant effort is being applied to strengthening the whole of Australia Post view and governance for systems infrastructure investments – replacing systems which in the past were tied to specific products with a common system servicing all relevant products – Australia Post's investment in a SAP based enterprise event management system is one example where shared enterprise functionality will reduce costs across multiple products.

Technology is a significant driver of productivity and cost containment, and the larger programs invariably contain technology and automation elements, but are by no means confined to such elements.

Appendix 16 summarises Australia Post's approach to technology adoption highlighting that while Australia Post has been an active adopter and adapter of technology and automation, it lacks the size and scale of the larger postal authorities to initiate and develop new technology solutions.

The following sections summarise productivity and cost containment initiatives extending across the four core network functions - Sales and Acceptance, Processing, Transport and Delivery.

### 11.3.1. Sales & Acceptance

Efficiency gains associated with the sales and acceptance function include the gains associated with the network of retail offices, customer and SPB collections and other acceptance activities which streamline the processing function. Key initiatives have included:

- converting corporate retail outlets to licensee or franchisee operations;

- application of a Resource Optimisation Model to match labour resources to workload and restructuring the retail model to include a greater mix of part-time staff – the proportion of part-time retail staff in the retail network will rise from 35% in 2001/02 to 47% (FTE basis) in the three years covered by this draft notification;

- changed preparation and streaming arrangements for letters lodged through larger retail outlets improving the flow of mail and reducing costs within the letter processing function;

- process improvement programs that have focused on removing redundant back-office functions from retail outlets;

- a range of performance management and incentive initiatives to enable benchmarking of retail outlet performance;

- a focus on simplifying counter transactions to reduce time per transaction; and
- application of technology improvements to support business growth as well as improve efficiency, for example introduction of the ID Wizard to support business growth and improve efficiencies in identity and verification services.

Initiatives planned to further increase efficiency in the network include:

- further conversions of corporate retail outlets to licensee or franchised operations;
- continued evolution of the Resource Optimisation Model to align the changing requirements of the business, with staff savings expected over each of the next three years to offset new staffing demands resulting from the planned expansion of identity and verification services;
- strengthened protocols to identify 'non compliant' lodgements which require more expensive processing to simplify customer lodgement and documentation and reduce compliance costs;
- route optimisation initiatives to reduce the costs of van collections from local area SPB networks and to improve the efficiency of intrastate and country truck schedules; and
- contact centre optimisation; and improved supply chain management.

### 11.3.2. Processing

Efficiency gains associated with the letters processing function over the draft notification period will continue to be sourced from a wide range of localised process improvements across facilities, including:

- an intensive national focus on the alignment of labour resources to letter volumes as letter volumes decline, supported by the standardised production management approach that has been introduced into the major processing facilities (letters and parcels);
- associated with the above, continued focus on labour productivity issues in facilities including job rosters and shift alignments, attendance rates, requirements for weekend processing and management of flexible labour and overtime hours;
- further extension of the enhanced OCR address recognition platform from small letters (described below in the Delivery section) to large letters, to secure efficiencies in large letter processing by improving the DPID read rates on automated equipment;
- savings from equipment replacement opportunities – eg replacing aging 'Spectrum 10' machines that handle the more difficult to process large letters with new cross belt sorting technology that can process more diverse products at lower cost and higher efficiency; and
- other technology refinements to improve materials handling and asset usage – eg management operating systems for load shifting equipment such as forklifts, mobile scanners to support equipment maintenance operations.

While opportunities for efficiency gains will continue to be pursued major efficiency gains have already been extracted from letter processing operations and there are constraints to cost adjustment eg:

- with the exception of Brisbane, the metropolitan processing function is now centralised around one major facility in each capital city, and further structural options to reduce costs through facility consolidation are very limited;
- many of the automated and other processing operations within facilities have a fixed labour component that is required for the machine operation (eg machine set up and clear down) and this applies irrespective of volume if the machine is to operate;

- declining volumes introduce additional unpredictability in the timing and size of lodgements as large customers seek to merge and consolidate their mailouts, creating further variability in addition to the intra- week fluctuations that must be resourced; and

- potential labour savings arising from declining letter volumes are difficult to realise where the individual time savings are small and thinly spread. For example it is difficult to convert to dollar cost savings a reduction in labour requirement of a few minutes per person as a result of a lower letter volume.

The FDD Program entailing the next phase of automated sequencing of small letters to street sequence level will have significant impacts on both the Processing and Delivery functions over the draft notification period and this is summarised below in the Delivery section and described in more detail in Appendix 17.

### 11.3.3. Transport

A significant element of letter transport efficiency is derived through the sharing of transport assets with parcel products. Transport initiatives in recent years have focused on:

- optimising the transport mode to reduce cost: eg switching interstate letter carriage from high cost air uplift to line haul road transport where there is a sufficient time window within the interstate service standard (eg Sydney – Melbourne and Sydney – Brisbane);

- ensuring that where air transport is unavoidable, carriage in lower cost passenger aircraft body space is maximised rather than using high cost air freighters;

- adjusting and optimising truck duties and driver rosters and schedules to ensure efficient labour costs;

- route optimisation and outsourcing (eg where trip return loads are light) to maximise capacity usage; and

- improved vehicle fleet efficiencies through:

  - centralised transport depots and outsourced vehicle maintenance regimes;

  - the procurement of newer and more fuel efficient vehicles and driver education – also an increasing priority in light of the Commonwealth carbon pollution reduction policy development; and

  - improved fleet management techniques.

Transport costs are relatively inflexible to letter volume variation but efficiencies will continue to be pursued through the above measures.

### 11.3.4. Delivery

The delivery function represents the core focus of network investment and process reengineering over the next 3-5 years. The delivery challenge is to contain the growth in operating cost and to introduce greater cost flexibility in the face of declining letter volumes coupled with increasing delivery points equating to fewer letters being delivered to more delivery points.

The FDD Program is the response to this challenge, and the key elements of the FDD Program are summarised below:

- implement an enhanced OCR recognition platform: use advances in address recognition software to increase the percentage of small letter addresses that can be read to DPID level, creating additional manual and video coding operational savings;

- rollout automated small letter sequencing: using the enhanced OCR recognition platform to improve the economics of automated sorting to street delivery sequence, implement the full rollout of a program of automated sorting of small letter processing to delivery street sequence level for all eligible delivery rounds;

- reconfigure indoor and outdoor delivery component; consistent with EBA commitments and staff attrition, reallocate indoor and outdoor resources to optimise overall delivery operations, enabling recruitment from a broader (part time) labour pool and reduced dependence on motorcycle delivery and the associated licensing and traffic risk issues; and

- review alternative outdoor delivery modes: deploy new delivery modes (power assisted bicycles and tricycles, and walk buggies) to improve mail carrying capacity, broaden the potential outdoor delivery recruitment pool, and apply improved round optimisation tools to realign the outdoor tasks to the work required (providing a delivery frequency to 98% of points 5 days a week).

Appendix 17 describes the FDD Program in more detail.

Other cost containment initiatives focused on the delivery function include improved production management system for DCs and enhancing contract administration of roadside and street delivery contractors.

# 12. Rate of return

*This section sets details that:*

- *as in previous price notifications, the rate of return proposed is a weighted average cost of capital (WACC) based on the capital asset pricing model; and*

- *a new study of Australia Post's WACC carried out by Officer and Bishop is used to update the WACC parameters provided to the ACCC as part of Australia Post's 2008 price notification.*

In achieving a reasonable rate of return on the efficient asset base used in providing reserved services, Australia Post must maintain an appropriate balance between its CSO to provide an efficient, effective and accessible letter service and its obligation to apply a single uniform rate to standard letters carried by ordinary post (Ordinary Small Letters). As noted in earlier sections of this draft notification, in setting financial targets for the domestic reserved letter service, Australia Post is required to consider a number of factors.

Australia Post's 2009/10 – 2001/12 corporate plan sets out the most recent expectations for the business. In that plan, profit targets and pricing expectations for the domestic reserved letter service were formed on the assumption that the ACCC's pricing model continued to apply to reserved services. That is:

- the efficiency of the asset and cost base would be assessed by the ACCC;

- a reasonable economic return equal to the WACC multiplied by the asset base would form part of the allowed revenue by the ACCC; and

- allowable revenue for the reserved letters service is determined at a total package level, rather than on individual product category.

These assumptions reflect the practice of the ACCC as applied in the 2008 price notification. In other words:

- if the ACCC maintains its financial model used in the 2008 price notification and in the regulatory accounting process; and

- Australia Post's efficient costs and rate of return in this draft notification are accepted as the basis of domestic reserved letter service required revenues and thus prices; then

- Australia Post does not expect that this would create any tensions in terms of Direction 11, which requires the ACCC to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plan.

Australia Post's proposed economic rate of return applied to the domestic reserved letter service asset base has been determined based on generally accepted financial market and regulatory practice, as based on current and established conditions in the markets for funds, and the systematic risks associated with delivering the domestic reserved letter service.

However, the parameters proposed for Australia Post's rate of return also recognise the need to cope with the unusually high degrees of uncertainty and instability that currently exist in the global financial market at present. The proposed parameters are reasonable for Australia Post's situation, but may differ from those applicable to other regulated corporations for a number of reasons such as those evident in section 12.2.

## 12.1. Capital Asset Pricing Model

The rate of return applied is in the form of a WACC reflecting the weighted costs of the different sources of funds. The proposed WACC parameters (and assumptions behind the derivation and estimation) for Australia Post are set out in Appendix 18. In this WACC model, the cost of equity funds is determined based on the generally accepted Capital Asset Pricing Model methodology, as has also been the case in previous price notifications and in the regulatory accounts process applicable to Australia Post.

## 12.2. The Australian Energy Regulator approach to WACC setting

Australia Post expects that the ACCC's analysis of Australia Post's WACC proposals will include a review of the recent analysis and decisions determined for the wholesale electricity industry by the AER. This draft notification addresses conclusions reached separately and previously by both the ACCC and the AER because:

- the ACCC is the determining organisation for Australia Post's use of the WACC in regulatory applications; but

- the AER is established under the TP Act as an independent legal entity but also, simultaneously, as a constituent part of the ACCC with a degree of commonality of both direct staffing and direct involvement between both entities.

Recent AER decisions in relation to other regulated industries may be considered to provide a useful context and guide for the development of a rate of return for Australia Post in this price notification. However, there are important factors which the AER is required to observe which are not required also of the ACCC in WACC matters. These include:

- the form of the WACC used (with implications for the matching cash flows);

- the need for the rate of return to be both forward-looking and commensurate with prevailing current conditions in financial markets, regardless of how unstable or unusual those prevailing conditions might appear to be;

- the need for the cost of debt to reflect the current borrowing cost, and not that expected to prevail over the period of the price case 'window'; and

- restrictions on the use of particular credit ratings.

In contrast, the ACCC is free to exercise discretion over all of these matters, without necessarily providing any precedents that might apply in AER proceedings. Australia Post will address a number of the AER's legislated restrictions as they might relate to this draft notification in Appendix 18.

## 12.3. WACC for Australia Post

Australia Post commissioned a 2009 report on a number of WACC issues facing Australia Post. These issues affect both Australia Post's own internal use of the WACC, ie for capital investment business cases, and the use of the WACC in regulatory applications. Value Adviser Associates Pty Ltd carried out the 2009 assessment, led by Professor R.R Officer and Dr S. Bishop.

Proposed key Capital Asset Pricing Model and WACC parameters are set out below in Table 17.

A number of the WACC parameters are inter-related, and as a result values for those items can not be set in isolation from those of the related factors. Such inter-related factors include the choice of the risk-free rate and the matching market risk premium ('MRP'), the MRP and the imputation factor, the equity beta and gearing, and the risk-free rate and cost of debt. For example, assuming that the asset beta is unchanged at 0.78, the associated equity beta is calculated to be 0.93 at a gearing level of 20% (proposed below) but 1.04 at a gearing level of 30% (ie the gearing level adopted by the ACCC in the 2008 price notification).

If the ACCC determined factors that differed from those proposed below, then the consequential adjustments would also need to be made to the inter-related factors.

Table 17 – Domestic reserved letter service WACC – input and output values

| WACC Parameter | Value |
|---|---|
| *rf* nominal risk-free rate-of-return | 5.6% |
| *rm-rf* market risk premium | 7.0% |
| *Tc* corporate tax rate | 30.0% |
| $\gamma$ imputation factor | 0.0% |
| Cost of debt | 7.0% |
| *D/V* Australia Post's gearing ratio | 20.0% |
| $\beta a$ asset beta | 0.78 |
| $\beta d$ debt beta | 0.15 |
| $\beta e$ equity beta | 0.93 |
| | |
| WACC Result | |
| Nominal vanilla WACC | 11.1% |
| Pre-tax nominal WACC | 15.3% |

In terms of the pre-tax nominal WACC formulation in section 18(3) of the RKR, Australia Post's pre-tax nominal WACC, including the domestic reserved letter service, is 15.3%.

A copy of the Value Adviser Associates Pty Ltd, June 2009, *Regulatory WACC for Australia Post* report has been provided separately to the ACCC.

# 13. Post Tax Revenue Model

Australia Post has modelled the proposed prices using the PTRM adopted by the ACCC in the 2002 and 2008 price notifications. The PTRM identifies the revenue required for Australia Post to receive a reasonable rate of return on an efficient asset base and with efficient costs.

The required revenue is calculated as the sum of:

- efficient operating costs;
- depreciation;
- tax (adjusted for imputation credits, if these are available and can be used); and
- return on capital which is a reasonable rate of return using the WACC previously discussed in the Rate of Return section.

The revenue at the proposed prices is below that identified by the PTRM as being 'required'.

A comparison of the proposed and allowable revenues over the 2009/10 – 20011/12 financial years is as follows:

Table 18 – Post Tax Revenue Model summary 2009/10 – 2011/12

| | | 2009/10 $m | 2010/11 $m | 2011/12 $m |
|---|---|---|---|---|
| Nominal Vanilla WACC | 11.1% | | | |
| Required Revenue | | $ 2,165 | $ 2,201 | $ 2,233 |
| Present Value of Required Revenue | | $ 1,949 | $ 1,783 | $ 1,628 |
| Sum of PV over 3 years | | $ 5,359 | | |
| Letters Revenue at proposed prices | | $ 1,908 | $ 1,934 | $ 1,991 |
| Present Value of Proposed Letters Revenue | | $ 1,717 | $ 1,567 | $ 1,452 |
| Sum of PV over 3 years | | $ 4,735 | | |
| Deficiency of Letters Revenue to Required Revenue | | $ 232 | $ 216 | $ 176 |
| Sum of PV over 3 years | | $ 624 | | |

# 14. Concluding comment

Australia Post has a strong record in delivering a high standard, reliable and low cost letter delivery service, which has supported essential business and private communications. This is evident by Australia Post's ongoing efforts to continue to meet its prescribed performance standards. The reliability, reputation and performance of Australia Post's domestic reserved letter service is recognised by business and the general public alike as an important contributor to the Australian community.

It is Australia Post's intention to maintain and build on this reputation and contribution, but this can only be achieved if Australia Post continues to achieve an appropriate level of revenue from the domestic reserved letter service to facilitate ongoing investment.

This draft notification demonstrates Australia Post's efficiency in its cost and asset base – both in total and within that component allocated to the domestic reserved letter service. As shown in Table 18 above, and based on the volume forecasts discussed in section 7, Australia Post's proposed prices (effective from January 2010) will result in revenue that is below that which the ACCC would consider as being the maximum required (to meet the efficient costs and provide for a reasonable rate of return).

## Proposed Prices - Effective January 2010

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

### Ordinary Letters

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

Notes/Comments: Ordinary Letters

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

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

Seasonal Greeting Card prices available during November and December

### Local Delivery (only available in specified postcodes)

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

### Reply Paid

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

### PrePaid Envelopes

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

Notes/Comments:

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

# PreSort Letters - Proposed from January 2010

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

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

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

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

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

Notes/Comments - PreSort Letters

Small PreSort

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

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

## Appendix 2 – Letter pricing principles

Australia Post's Letter Pricing Principles are as follows:

- the letters pricing structure will be as simple as possible;
- the letters pricing structure will reflect Australia Post's commercial, social and governmental obligations;
- the primary social obligation is to supply a letter service that is accessible, available equitably and meets community needs;
- letter prices will be set to enable Australia Post to meet its statutory requirement to provide an adequate commercial return and to fund the CSO;
- the BPR – the rate for the Ordinary Small Letter – is the keystone of the letter pricing structure;
- carriage of the Ordinary Small Letter at a uniform rate is central to the CSOs. Pricing of the BPR reflects the need to maintain an affordable rate. Consequently, the BPR may not always fully recover the costs of providing these services and as such, prices for other domestic reserved letter services may contain a cross subsidy to the BPR;
- subject to this need to cross subsidise letter products, letter prices have been set to achieve an appropriate aggregate rate of return for the letters business as a whole;
- price changes will be as infrequent as possible, but significant upfront price increases covering a long period should be avoided in preference for moderate price increases at more frequent intervals, with adequate notice and after appropriate consultation with stakeholders and customers;
- subject to meeting minimum agreed quantities and conditions, bulk interconnection prices will be applied uniformly regardless of volume;
- bulk interconnection prices will, in addition to, the requirements of section 32A(2) (c) of the APC Act, broadly reflect the level of work saved by Australia Post through work carried out by customers; and
- bulk interconnection prices will be applied uniformly for carriage within Australia subject to the point of lodgement (same/other state prices apply).

COMMONWEALTH OF AUSTRALIA

Prices Surveillance Act 1983

DECLARATION (NO. 75)

I, PETER BALDWIN, Minister of State for Higher Education and Employment Services, acting for and on behalf of the Treasurer, in pursuance of section 21 of the Prices Surveillance Act 1983, hereby:

(1) revoke declaration No 53 of 18 April 1989 relating to the transmission of standard postal articles and registered publications by the Australian Postal Corporation published in the Commonwealth of Australia Gazette No. GN 16 of 3 May 1989; and

(2) declare:

  (a) the provision of letter services reserved to Australia Post under Division 2 of Part 3 of the *Australian Postal Corporation Act 1989*, and the carriage within Australia of registered publications, to be notified services for the purposes of the Act; and

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

Dated this FIFTH day of FEBRUARY 1992.

Peter Baldwin
Minister of State for Higher Education and Employment Services
acting for and on behalf of the Treasurer

## Appendix 4 – Domestic reserved letter services

Australia Post's domestic letter services are considered to provide for the carriage of reserved letters unless excluded by the conditions (or the circumstances) of the particular service, eg Print Post. Additionally, where a service has a weight step for letters weighing over 250 grams or the price charged is equal to or greater than four times the BPR (currently $2.20) those particular items will not be reserved because they fall within exceptions under section 30 of the APC Act.

Domestic Letter services that do provide for the carriage of reserved letters include the following:

- Ordinary Small letters (including seasonal greeting cards and small letter sized prepaid envelopes and postcards);
- Ordinary Large Letters (including C5 size prepaid envelopes)– where the weight step applies to letters weighing 250 grams or less;
- Clean Mail;
- Reply Paid – where the weight step applies to letters weighing 250 grams or less;
- Local Delivery Letters – where the weight step applies to letters weighing 250 grams or less;
- PreSort Small Letters (including Charity Mail);
- PreSort Large Letters – where the weight step applies to letters weighing 250 grams or less;
- Acquisition Mail (Small and Small Plus); and
- Impact Mail (Small and Small Plus).

A domestic letter would be non-reserved if the price charged was equal to or greater than four times the BPR (currently $2.20). None of the above services contain a price point for a letter weighing 250 grams or less that is above this amount.

Australia Post also categorises incoming international letters as reserved if:

- the item weighs 250 grams or less; or
- the price charged is less than four times the BPR (currently $2.20).

## Appendix 5 – Contribution to economic development

Australia Post's contribution to economic development is detailed as follows:

| | 2006/07 | 2007/08 |
|---|---|---|
| Revenue | **$4,711m** | **$4,959m** |
| - Australian | $4,561m | $4,806m |
| - Export | $150m | $153m |
| Direct employment in postal services | 35,476 | 35,845 |
| - full-time employees | 25,026 | 25,042 |
| - part-time employees | 9,498 | 9,936 |
| - agency staff | 744 | 589 |
| - casuals | 208 | 278 |
| Productivity growth | **1.4%** | **2.6%** |
| Payments: | | |
| - to employees | $1,978m | $2,021m |
| - to goods and services suppliers | $2,078m | $2,259m |
| - for capital assets & business acquisitions | $284m | $295m |
| Taxes and rates paid: | | |
| - Commonwealth | $356m | $424m |
| - State and local government | $119m | $124m |
| **Cost of community service obligations** | **$97m** | **$104m** |
| Small businesses directly supported | 7,127 | 7,074 |
| Licensed and franchise post offices | 2,969 | 2,977 |
| - metropolitan | 1,283 | 1,297 |
| - rural and remote areas | 1,686 | 1,680 |
| Mail contractors | 3,524 | 3,452 |
| - metropolitan | 723 | 758 |
| - rural and remote areas | 2,801 | 2,694 |
| Community postal agencies | 634 | 645 |
| - metropolitan | 35 | 32 |
| - rural and remote areas | 599 | 613 |
| Access to financial services: | | |
| - number of banks / financial institutions | 77 | 77 |
| **Outlets with on-line banking facilities:** | 3,291 | 3,305 |
| - metropolitan | 1,824 | 1,830 |
| - rural and remote areas | 1,467 | 1,475 |
| **Basic postage rate (ranking in OECD)** | **3rd lowest** | **3rd lowest** |
| Revenue foregone through Letter price restraint (compared with CPI): | | |
| - last 10 years | $2,672m | $3,341m |
| - last 5 years | $822m | $807m |
| **Delivery points (at 30 June)** | **10.3m** | **10.5m** |
| **Shareholder value** | | |
| - profit after tax | $401m | $432m |
| - dividends declared | $297m | $446m |

## Appendix 6 – Portfolio services and products

Overview of the services and products within each of Australia Post's three main business portfolios:

<u>Letters & Associated Services</u>

Letter Delivery Services:

- Domestic reserved Letter services, including:
  - PreSort Letters up to 250g, and
  - Ordinary, Clean Mail, Local Delivery Letters and Reply Paid
- Domestic non reserved Letters services, including:
  - Ordinary, Local Delivery, Reply Paid and PreSort Letters over 250g and up to 500g;
  - Print Post (publications);
  - Unaddressed Mail;
  - Express Post Letters; and
  - Registered Post
- International Letters;
  - Outward letters, and
  - Inward letters

Associated Services:

- Data services, including:
  - First Direct Solutions
- Mail Preparation, including:
  - eLetter Solutions, and
  - PrintSoft
- Delivery Management, including:
  - Post Office Box and Bag Rental;
  - Mail Redirection and Mail Holding, and
  - Mailroom Services

<u>Parcels & Logistics</u>

- Domestic Services include:
  - Parcel Post, Express Post Parcels, Messenger Post Couriers, Post eParcel, Post Logistics
- International Services Include:
  - Express Courier International, Express Post International, Air Mail (satchels / packets and parcels) and Sea Mail (satchels / packets and parcels)

<u>Agency Services & Retail Merchandise</u>

- Agency Services includes:
  - Banking, Money Orders and Transfers, Passport Interviews, Bill Payments
- Identity and Verification Services include:
  - Passport photographs and 100 point ID checks
- Merchandise including:
  - Collectable stamps, coins and associated products, postal packaging (Postpak), Stationery, Greeting Cards, Communications, General Merchandise

As noted in section 5 of this draft notification, Australia Post provides the domestic reserved letter service in accordance with a number of performance standards, including those prescribed, pursuant to section 28C of the APC Act (*the prescribed performance standards*).

The prescribed performance standards must relate to:

- the frequency, speed or accuracy of mail delivery; and
- the availability or accessibility of mail lodgement points or Australia Post offices (or other places) from which Australia Post products and services may be purchased.

Further information regarding these prescribed performance standards is detailed below:

## 1. Accuracy and speed of delivery

The prescribed performance standards state Australia Post must deliver at least 94% of domestic reserved letters[45] within the number of business days described in the following table.

Table 19 – Delivery times

| For delivery: | Same State | Other State |
|---|---|---|
| Within metropolitan areas of capital cities or within the same city or town and environs | 1 | NA |
| Between metropolitan areas of capital cities | NA | 2 |
| Between metropolitan areas of capital cities and country locations | 2 | 3 |
| Between country locations | 2 | 4 |

## 2. Frequency of delivery

Australia Post must service;

- Daily (except weekends and public holidays) 98% of all delivery points; and
- At least two days a week 99.7% of all delivery points

## 3. Mail lodgement points

Australia Post must maintain;

- Lodgement facilities at each of its retail outlets (which may be an SPB); and
- At least 10,000 SPBs

## 4. Retail outlets

Australia Post must maintain at least 4,000 retail outlets, with at least 50% - but not fewer than 2,500 – in rural and remote areas. Retail outlets must be located so that:

- in a metropolitan area, at least 90% of residences in the area are located within 2.5kms of a retail outlet; and
- in non-metropolitan zones, at least 85% of residences in the area are located within 7.5kms of a retail outlet.

[45] This time frame also applies to the PreSort Letter service (Regular Delivery).

In addition to prescribed performance standards, Australia Post is required under section 27 (4)(b) to ensure that, in providing a letter service, the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community.

One example of this is Australia Post's performance standard of 8am, 11am and 3pm. While not a prescribed standard it is an internal standard that Australia Post strives to achieve to meet the needs of the Australian community. This standard relates the delivery of letters to private boxes by 8am, business delivery points by 11am and all other delivery points by 3pm.

Another example is Australia Post's *Street Posting Box Policy.* The spirit of this policy is to express, in positive terms, the minimum standard for the provision of SPBs, which the community can rely on to meet their posting needs. The policy takes into account the general increased mobility of the population and Australia Post's commitment to provide reasonable postal network access for its customers.

The policy provides that:

- in capital city metropolitan areas and provincial cities, a street posting box facility will be provided at or near all postal outlets (a possible exception being outlets inside shopping centres that are not accessible after hours). In addition, street posting boxes will be provided to ensure that residents have access to a lodgement point within 2 kilometres.

- in rural towns and communities a street posting box facility will be provided at or near postal outlets.

And further to this, consideration will be given to the provision of street posting boxes in special cases to cater for the needs of concentrations of the aged and disabled people, including hospitals. The policy also covers the removal or relocation of SPBs, which involves extensive consultation with the affected community including its elected parliamentary representatives.

Customers and stakeholders who participated in the consultation process prior to finalisation of this draft notification were as follows:

## Customers:

- Westpac
- Commonwealth Bank
- Centrelink
- Australian Taxation Office
- Medicare
- Australian Electoral Office

## Industry associations and representative bodies:

- Australian Direct Marketing Association
- Printing Industries Association of Australia
- Fundraising Institute Australia
- Publishers Australia
- Postal Services Consultative Council (Stakeholder Council)

## Industry suppliers

- Mail Houses - (Salmat, Sema & Computershare)
- Postage meter suppliers – (Francotyp, GBC Australia, Frama & Pitney Bowes)
- Address Matching and Approval Software (AMAS) Suppliers
- Envelope Suppliers (Australian Envelopes & Candida)

Australia Post's domestic letters market is represented by three letter segments:

Transactional (77% of the domestic letters market) – typically mass produced bills, statements and other transactional correspondence from business. Transactional volumes are flat to declining and this is attributable to two factors:

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

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

The trend in Australia on transactional mail is consistent with what is occurring in countries overseas, with an independent UK report 'Modernise or decline'[46] noting that in the UK;

> "Transactional mail (such as bank statements) and social mail are in decline." (page 9)
> "In the long term, transactional mail seems very likely to be in decline". (page 42).

Promotional (19% of the domestic letters market) – typically advertising mailings between businesses, and between businesses and consumers, eg Direct Mail packs, brochures etc. While growth has been relatively robust over the past three years (average growth estimated at around 6%), driven by a number of factors including the Mail Marketing initiatives that Australia Post has developed, in the future Australia Post expects promotional growth to average around 2%. This reflects expectations within the broader advertising and marketing industry of more subdued growth in the coming years. As an indication of volume activity in overseas markets;

- 2008, the Read Group indicated direct mail volume in the U.K. declined by 8.5%[47]; and
- (Direct mail) 2008 in the U.S. pre-sorted first-class mail declined, a reflection of the general curtailment of advertising spending.[48]

Social (5% of the domestic letters market) – typically private letters, postcards, greeting cards and other correspondence sent between individuals. Social mail has been in decline since the 1980's, largely as a result of the continued increase in electronic/digital communication options (eg phone, email, SMS, IM, etc.) and their uptake/utilisation by private consumers.

Despite an increase in greeting card and postcard sales, Royal Mail estimates that personal mail communications have declined by around 5% between 2004 and 2007[49].

All segments of the domestic letters market are under threat. However, the impact is heightened for the transactional segment, which represents 77% of domestic letter volumes. As promotional mail accounts for around 19% of total volumes, a growth of more than 4% is needed to offset a 1% decline in social and transactional mail.

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[46] Modernise or decline – Policies to maintain the universal postal service in the United Kingdom, December 2008
[47] IPC Market Flash Issue 387, 11 March 2009; p.6
[48] USPS 2008 Comprehensive Statement on Postal Operations; p.5
[49] UK Postal Market,- Competitive Market Review 2008, Postcomm Report; p. 32

## Appendix 10 – Forecast volume, revenue and costs by product category

Details of forecast volume, revenue and cost by product category for the 2008/09 – 2011/12 financial years are as follows:

| | | PreSort Letters | | | Other (inc Ordinary) Letters | | | Total |
|---|---|---|---|---|---|---|---|---|
| | | Small | Large | Subtotal | Small | Large | Subtotal | Letters |
| **2008/09** | | | | | | | | |
| Volume | m | 2,112.3 | 159.1 | 2,271.4 | 1,633.9 | 207.6 | 1,841.6 | 4,113.0 |
| Revenue | $m | $ 777.8 | $ 102.5 | $ 880.3 | $ 777.9 | $ 216.2 | $ 994.1 | $ 1,874.4 |
| Total Cost | $m | ✂ | ✂ | $ 911.5 | ✂ | ✂ | $ 1,050.8 | $ 1,962.3 |
| Contribution | $m | ✂ | ✂ | ($ 31.1 ) | ✂ | ✂ | ($ 56.8 ) | ($ 87.9 ) |
| ROR | % | ✂ | ✂ | (3.5%) | ✂ | ✂ | (5.7%) | (4.7%) |
| **2009/10** | | | | | | | | |
| Volume | m | 2,109.8 | 159.5 | 2,269.3 | 1,550.4 | 198.5 | 1,748.8 | 4,018.1 |
| Revenue | $m | $ 807.6 | $ 106.3 | $ 913.9 | $ 776.2 | $ 217.8 | $ 994.0 | $ 1,907.9 |
| Total Cost | $m | ✂ | ✂ | $ 976.1 | ✂ | ✂ | $ 1,074.8 | $ 2,050.8 |
| Contribution | $m | ✂ | ✂ | ($ 62.2 ) | ✂ | ✂ | ($ 80.8 ) | ($ 143.0 ) |
| ROR | % | ✂ | ✂ | (6.8%) | ✂ | ✂ | (8.1%) | (7.5%) |
| **2010/11** | | | | | | | | |
| Volume | m | 2,131.4 | 154.0 | 2,285.4 | 1,464.5 | 189.6 | 1,654.1 | 3,939.5 |
| Revenue | $m | $ 843.4 | $ 106.4 | $ 949.7 | $ 767.4 | $ 217.1 | $ 984.5 | $ 1,934.3 |
| Total Cost | $m | ✂ | ✂ | $ 1,017.9 | ✂ | ✂ | $ 1,058.6 | $ 2,076.5 |
| Contribution | $m | ✂ | ✂ | ($ 68.2 ) | ✂ | ✂ | ($ 74.1 ) | ($ 142.3 ) |
| ROR | % | ✂ | ✂ | (7.2%) | ✂ | ✂ | (7.5%) | (7.4%) |
| **2011/12** | | | | | | | | |
| Volume | m | 2,103.9 | 157.9 | 2,261.8 | 1,383.4 | 187.0 | 1,570.4 | 3,832.3 |
| Revenue | $m | $ 862.3 | $ 114.1 | $ 976.4 | $ 782.6 | $ 232.2 | $ 1,014.9 | $ 1,991.3 |
| Total Cost | $m | ✂ | ✂ | $ 1,046.1 | ✂ | ✂ | $ 1,047.8 | $ 2,093.9 |
| Contribution | $m | ✂ | ✂ | ($ 69.7 ) | ✂ | ✂ | ($ 32.9 ) | ($ 102.6 ) |
| ROR | % | ✂ | ✂ | (7.1%) | ✂ | ✂ | (3.2%) | (5.2%) |

Note: costs shown are per Australia Post's Product Costing System – not per the PTRM

*This Appendix describes the cost drivers of the four core network functions (Sales & Acceptance; Processing; Transport and Delivery) highlighting:*

- *the relatively high levels of fixed cost associated with prescribed performance standards principally in the sales and acceptance, transport and delivery functions of the network;*
- *the limits to cost adjustment in response to declining letter volume; and*
- *the high efficiencies Australia Post is now achieving across the network arising from the Future Post infrastructure~~.~~*

## 1. Sales & Acceptance

The Sales & Acceptance function relates to the provision of the retail outlets and the acceptance and lodgement of mail at those outlets or at any lodgement point, including SPBs. The primary focus of this section is on retail outlets as they reflect the major cost component of this network function.

### Retail network

In overall terms, the number of retail outlets has remained relatively stable throughout the last 10 years, reflecting in part the prescribed performance standards relating to the number and location of retail points of presence that Australia Post is required to maintain.

While the prescribed performance standards detail the total number of retail outlets required, and within that total the number that must be maintained in rural and remote areas, the standards do not prescribe the mix between the corporate and 'other' (ie licensee, franchisee, or community postal agent) outlets.

Australia Post moved to the current retail 'model' during the 1990s, with corporate outlets comprising a small and diminishing minority of the overall number of retail outlets required as corporate outlets were converted[50] to licensee or other status. Table 20 shows the mix of corporate and other retail outlets since 2001/02.

Table 20 – Retail outlets

| Year | Corporate | Other | Total |
|---|---|---|---|
| 2001/02 | 882 | 3,615 | 4,497 |
| 2002/03 | 872 | 3,621 | 4,493 |
| 2003/04 | 862 | 3,615 | 4,477 |
| 2004/05 | 863 | 3,611 | 4,474 |
| 2005/06 | 857 | 3,605 | 4,462 |
| 2006/07 | 846 | 3,603 | 4,449 |
| 2007/08 | 831 | 3,622 | 4,453 |

The continuing increase of licensee (including franchisee and CPA) outlets demonstrates the ability of these retail outlets to offer postal and related services while (often), operating in conjunction with an independent business which in turn allows greater flexibility in hours of operation (eg weekends).

[50] Corporate outlets converted to licensee or other status have mainly been smaller outlets, eg with staff numbers fewer that 3 FTEs.

Although some licensee outlets may be viable as standalone businesses, the in-conjunction nature of many licensees allows the retail outlets to be maintained, and at a lower cost to Australia Post than would otherwise be the case. From the point of view of the licensees, the ability to offer postal and related services provides valuable economies of scope that enhance the viability of their businesses.

As shown in Table 20, the total number of retail outlets decreased marginally from 2001/02 to 2007/08, largely attributable to a decrease in the number of retail outlets in metropolitan areas, with rural and remote retail outlets largely unchanged.

### Future retail network changes

The requirement to maintain a network of at least 4,000 retail outlets is becoming more challenging, particularly in rural and remote areas (where a minimum of 2,500 outlets must be maintained). Maintaining the minimum number of 2,500 outlets requires Australia Post to provide 'top-up' payments to a number of the licensees to remain viable.

Network and outlet analysis indicates that there may be some benefits to be gained in terms of further outlet conversions to licensee (possible cost savings) or franchisee (possible extra revenue). Over the next three years, Australia Post is currently assessing 83 corporate outlets for conversion to either licensee or franchise operation.

### Cost drivers

**Collection** – to meet delivery times, retail outlets must be cleared by vans after 5.00pm (closing time), SPBs after 6.00pm while letters will be collected from major customers at agreed times (generally between 4-6.00 pm). Costs are largely determined by:

- the requirement to collect letters from SPBs in accordance with the advertised posting times; and
- pickups from retail outlets and customers determining the number of vans required in this window.

While collection costs vary with distance travelled and the number of collection points, costs are largely independent of variations in letter volume. Costs can also vary with changes in urban development, business location and population movement eg;

- inner urban development which may require additional SPBs or additional collections - incremental cost; or
- major new urban development which may require a significant step change to collection arrangements – and therein associated costs.

**Streaming** (presentation of letter products in a way that optimises machine usage, avoids double handling and maximises the processing window) – after collection, undertaken within retail outlets and transport hubs where letters are consolidated before being transported to the processing facility.

Key streaming requirements are:

- letters are separated from parcels;
- small letters are separated from large letters – a different process and location for small and large letters exists within the processing facility; and
- retail outlets with large volumes of letters separate 'machineable' from 'non machineable' letters to assist processing.

The cost drivers for the streaming activity are the mail volume, the mail mix and number of sort 'breaks' required specific to the streaming function at the retail outlet or transport hub.

## 2. Processing

The design of Australia Post's processing function enables a high level of automated sort efficiency via:

- a centralised network of automated metropolitan processing facilities;
- national configuration of automated MLOCR, video coding (VC) and BCS equipment; and
- a logical sorting hierarchy linking DPIDs to addresses, addresses to delivery rounds and delivery rounds to equipment sort plans.

This design provides a high level of operating efficiency capable of meeting the tight processing windows required for the prescribed delivery standards.

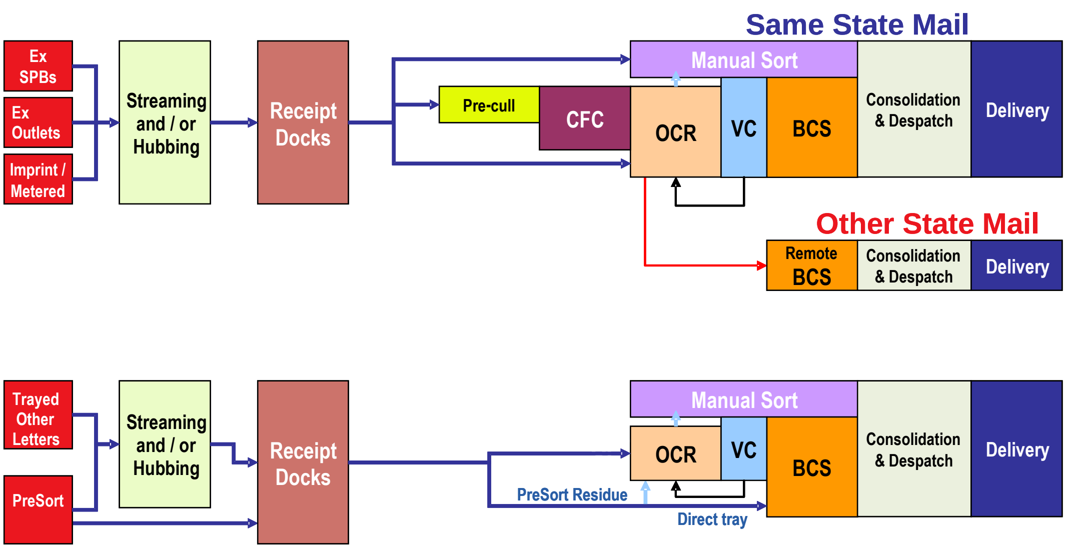
Within the processing function each process stream is uniquely matched to the work to be done – for example PreSort letters in a barcode direct tray are presented direct to a BCS for sorting to delivery round. Compare this to a stamped letter originating from an SPB which undergoes at least two prior processing streams before being presented to a BCS.

The design of the processing function minimises multiple handlings of the same letter between processing facilities, eg:

- a 'same state' letter originating in the state of delivery whose address is read and interpreted on an MLOCR machine, is directed onto a BCS machine in the same facility for sorting to delivery round (or street sequence) before being transported direct to the appropriate DC; and
- a letter destined for interstate delivery will be forwarded directly off the originating state MLOCR to a specific BCS in an interstate processing facility for final sorting to the interstate delivery round – ie a letter transits only one process even though part of that process may involve a BCS located in an interstate terminating facility

Figure 9 illustrates the separate process paths that are aligned to the different small letter products.

Figure 9 – Small letter products and processes



The design and strength of the architecture supporting Australia Post's processing function has facilitated progressive process and technology improvements which include:

- continued improvements to the proportion of letters processed in the automated streams (now averaging around 88% of all small letters, compared to around 70% in 2001) – reducing manual processing;
- continued improvements in machine performance metrics and address recognition rates and missort rates;
- reducing the number of process steps by directing letters to specific equipment related to the final delivery destination;
- improved video coding performance, and
- introducing a more disciplined approach to improving mail processing equipment usage, performance and reliability.

Incremental performance improvements to these processes continue to be made.

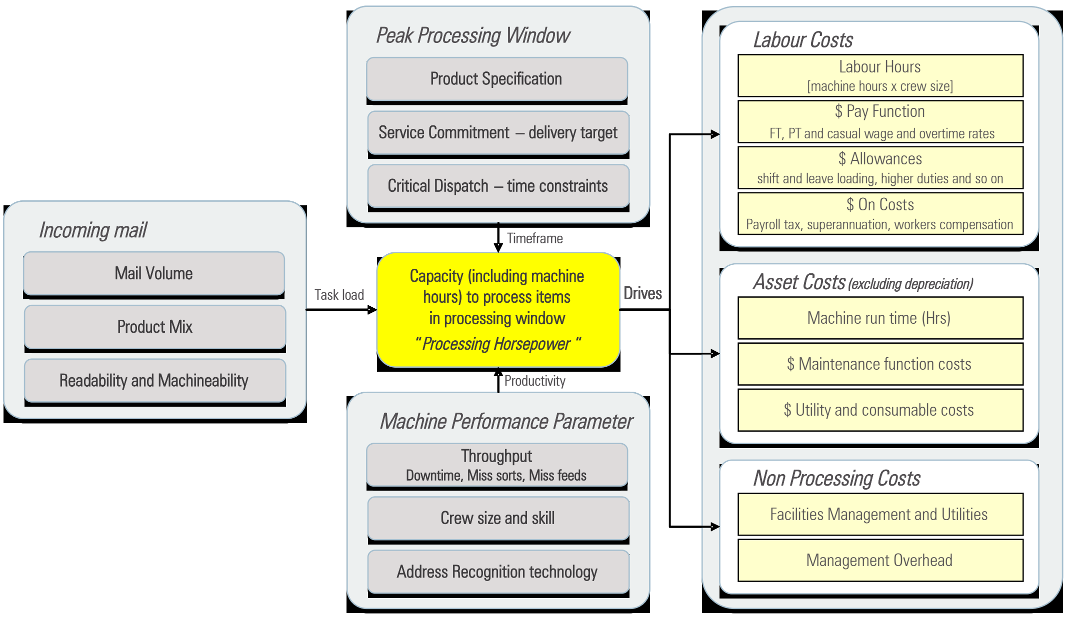
## 2.1. Cost drivers and processing variability

The main cost drivers in processing are;

- mail attributes – volume, product mix, readability and machineability;
- equipment performance – throughput rates, reading technology, etc;
- the processing window required to meet delivery standards;

This is described in Figure 10 below.

Figure 10 – Main processing cost drivers



While declining volumes will generally translate into earlier process completion times, lower machine hour requirements and hence the potential for lower levels of labour resources, there are constraints to the amount of cost that can be reduced:

- the requirement to collect from all lodgement points, regardless of volume, constrains the ability to commence processing earlier;
- labour resource reduction depends on the type of letter, eg an SPB letter requires more processing steps and resources than PreSort Letters;
- although letter volumes have declined there is still volatility in the pattern of lodgements from businesses on a day by day basis, and it is not possible to fine tune rostered resources to match volume variations; and
- type of mail processing equipment;
    - usage of CFCs and MLOCRs may reduce with declining volume, however:
        - equipment set up and clear down times are relatively fixed; and
        - equipment decommissioning opportunities require large and permanent volume decline.
    - usage of BCSs is far less variable with volume – there will be some reduction in run times, but all BCSs must be operated to the appropriate sort plan.

An important element of the processing function is the ability to sort to sequence. The automaton of this element will achieve further efficiency, productivity and cost benefits within the processing function. The rollout of automated sequencing is covered within Appendix 17 – Future Delivery Design (FDD) Program.

## 3. Transport

The transport function is built around the prescribed performance standards for letters, but is used as a shared infrastructure with non-reserved products where service standards and schedules permit.

The transport function is designed to minimise cost whilst achieving the required schedules to meet the overall delivery standards. These delivery standards govern the vehicle types, transport duties and schedules, as well as the transport mode – air or road as required.

The primary function of the transport function is the collection of letters from lodgement points and the subsequent transportation of letters to processing and delivery facilities. This is achieved via:

- operation and management of over 1,000 vans, 125 linehaul prime movers and over 400 trucks of varying size – operating between the letter and parcel processing nodes within, and between, states;
- use of external providers on an ongoing basis, particularly on long haul sectors eg Sydney to Perth, and on an as-needs-basis to cope with uneven distribution of mail between capital cities;
- air uplift for interstate destinations (where required);
- use of contractors (air and road) particularly in rural and remote areas to meet Australia Post's CSO; and
- use of delivery contractors in fringe metropolitan areas.

Transport schedules are set in relation to product service requirements and the number of network origins and destinations.

### Cost drivers

Transport costs are relatively fixed as there is a minimum fleet size to cover all transport routes in line with the prescribed performance standard ie:

- current transport duties operate to tight schedules within the existing operational arrangements and costs therefore are largely driven by ULD numbers and distance; and
- contractors charge on the basis of a rate per ULD per destination, the cost of the entire truck, or a rate per kilogram per kilometre in the case of air uplift.

Notwithstanding this, Australia Post continues to pursue a wide range of transport cost containment and productivity measures as set down in the productivity initiatives section.

## 4. Delivery

The key consideration in establishing the delivery function is the requirement that Australia Post must service 98% of the 10.5m Australia-wide delivery points five days per week. This requirement explains the:

- large scale of resourcing – over 12,000 FTEs – determined by the density and geographic reach of the network;
- location and structure of the DC network (265 DCs nationally) necessary to complete the preparation of letters for delivery in order to deliver to recipient address within the designated time standard;
  - predominant role of motorcycle delivery (over 80% of rounds) within that decentralised DC structure, separate to walk and bicycle rounds;
  - cost dynamics, with a high level of fixed cost in the outdoor street delivery component; and
  - specific challenges and risks to productivity where the network must expand to meet an average growth in delivery points (around 2% per annum) in an environment of forecast volume decline.

Australia Post's response to these challenges is the FDD Program which is detailed within Appendix 17.

### Cost drivers

From a cost driver perspective, the delivery function needs to be separated between the indoor and outdoor components:

- indoor – processing in the DC completes the sort undertaken in letter facilities, typically undertaken from around midnight after the first transport drop off from the letter processing facility; and
- outdoor – final delivery according to Australia Post's internal standards – delivery into post office boxes by 8.00am, delivery to business addresses by 11.00am, and delivery to street residential addresses by 3.00pm.

### 4.1. Indoor delivery components

Key activities within the indoor component of delivery operations include:

- a primary sort to delivery round for any residual mail arriving at the DC that is not already sorted to an individual round (eg letters that had to be manually sorted in the processing facility);
- a street sequencing function undertaken by posties on Vsort frames to separate the letters for a particular round into the street delivery sequence appropriate for that round;

- the removal of any redirections before the sequenced mail is ready for outdoor delivery; and

- other activities such as filling depot bags (used to store and access part of the mail on a round at various points along the route taken) in preparation for delivery.

The key cost driver in the indoor delivery function is the labour time and labour rate in:

- primary sorting of mail that needs to be manually sorted into delivery rounds (driven by the number of rounds and the mail volume); and

- time spent in the Vsort manual sequencing process – driven by the volume and number of delivery rounds to be sequenced and the number of points per round (around 1000 – 1200 points per delivery round).

Declining letter volumes will impact the manual activities associated with the primary and Vsort activities, but the resource impact will be limited in the short term.

### 4.2. Outdoor delivery components

Key activities within the outdoor component of delivery include:

- major activity of physical delivery to residential and business addresses (around 1000 – 1200 points per delivery round) by various modes of transport including motorcycle, bicycle, van or walking. This activity may also entail accessing a group of letter boxes installed at a particular location such as a secure residential building or estate or business premises;

- obtaining signatures from addressees for signature items (eg Registered Post items);

- carding of items in instances of non-attendance for signature items, or where there is insufficient capacity of the letter box to secure other items for delivery; and

- stopping at, or returning to, a re-supply point eg depot box or post office, for mail items unable to be taken at the commencement of the delivery round due to either weight or capacity restrictions (eg on motorcycles) of the mode of transport.

The key cost drivers in outdoor delivery are:

- delivery to post office boxes – the number of boxes and mail volume; and

- street delivery – distance to be covered from the DC, over the designated round and back to the DC upon completion, the number of delivery points at which the postie must stop, and the carrying capacity of the technology used – be it walk trolley, bicycle or motorcycle – that will determine the need for depot boxes to be located along the route to replenish the load.

Declining volume will have a negligible impact on outdoor costs.

### 4.3. Impact of automated sequencing on the delivery function

The gains Australia Post has realised to date from the efficiency of automated round sortation and from the implementation of Vsort frames means that the rollout of automated sequencing has to be calibrated to the specific location to ensure there are realisable net savings achieved.

The rollout of automated sequencing of small letters is described in more detail within Appendix 17.

# Appendix 12 – Wage rises and bonus payments under EBA5, EBA6 and EBA7

| | Date | Amount |
|---|---|---|
| EBA5 | September 2002 | $300 cash performance bonus |
| | 24 April 2003 | 3.0% |
| | 18 December 2003 | 2.5% |
| EBA6 | 9 August 2004 | 4.0% |
| | 30 June 2005 | 2.0% |
| | 9 March 2006 | 2.0% |
| | 22 March 2006 | $400 cash performance bonus |
| | 2 November 2006 | 2.0% |
| EBA7 | 23 August 2007 | 4.0% |
| | August 2008 | 4.0% |
| | August 2009 | 4.0% |
| | September 2009 | $500 cash performance bonus |
| | August 2010 | 2.0% |
| | December 2010 | 2.0% |

**Asset Register structure** – Australia Post's fixed assets are grouped into approximately 500 asset classes.

An asset class is broadly descriptive of the nature of the assets contained within that class rather than by each asset's accounting treatment. For example, the buildings asset class (asset class no. ZB00) comprises administrative buildings, post offices, depots, mail centres etc.

Assets within a class do not necessarily have the same accounting treatment. Within class ZB00, for example, there are three different service lives – 40 years, 50 years and 70 years – depending on the type of building. Other asset classes similarly can have a range of service lives and/or residual values.

Within SAP, asset classes are grouped by type into one of 22 Asset Groups, as follows:

- land
- buildings
- leaseholds
- mail handling plant
- motor vehicles
- workshops / laboratory equipment
- furniture and office equipment
- stores handling equipment
- staff amenities equipment
- office machines
- other plant and equipment
- electronic mail equipment
- electronic counter services equipment
- computer software
- computer equipment
- data communications equipment
- voice communications equipment
- assets under construction
- bulk purchases
- FuturePost equipment
- pooled assets
- asset class – equipment reference

**Land, Buildings and Fitout** – prior to 2005/06, Australia Post's land and buildings were valued in the statutory accounts at fair value. Valuations were obtained from independent expert valuers. This continued to be the case until the 2005/6 accounts.

After discussion with the ACCC in 2006, Australia Post changed its accounting treatment of property assets. Instead of being held at market values in the accounts, Australia Post restated land and building assets to cost in the 2006 statutory accounts. However, it was recognised that the ACCC would require those assets to be counted at market value for regulatory accounting and other regulatory purposes, such as domestic reserved letter service price notifications. Therefore, Australia Post still has its properties assessed at market values, with the amounts recognised in a note to the accounts (Note 13).

At 30 June 2002 Australia Post had 577 owned properties, down from 1311 a decade earlier. By 30 June 2008 that number had fallen further to 511.

The 30 June 2008 asset values which form a foundation for this draft notification include land and building assets at market value. Its total at 30 June 2008 was $1,579.5m, compared with the book value of $777m shown on the face of the balance sheet. Valuations for the 30 June 2008 accounts were carried out by Savills Pty Ltd for properties in all states and territories. All properties are revalued annually.

**Investment Properties** – as part of the transition to AIFRS accounting standards, Australia Post introduced a new asset class in its 2006 balance sheet entitled Investment Property. This asset class concerns properties held for rental income or capital gain rather than for use in Australia Post's operations. It can include whole properties or parts of properties.

At 30 June 2008 the value of properties covered by this asset class was $238.4m. This amount is not allocated to products and services, and is not part of the asset base on which this draft notification is based. The impact of the introduction of this class is to reduce by the $238.4m the value of Australia Post's operational properties compared with the outcome if the previous accounting treatment had been maintained.

Investment properties are measured initially at cost. Subsequently they are stated at fair value.

**Plant and Equipment & Other** – are stated at cost less accumulated depreciation and less any impairment losses. Information technology assets and vehicles are also stated at cost less accumulated depreciation.

**Asset Lives** – a high level summary of asset lives is shown in Note 1 to the statutory accounts and is as follows:

| | |
|---|---|
| - Buildings – GPOs | 70 years |
| - Buildings – other facilities | 40 – 50 years |
| - Leasehold Improvements | Lower of lease term and 10 years |
| - Motor Vehicles | 3 – 10 years |
| - Specialised plant / equipment | 10 – 20 years |
| - Other plant / equipment | 3 – 10 years |

Appendix 14 – Fixed asset forecasts ($m)

Table 21 – Domestic reserved letter service – Small full rate letters

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 432 | 452 | 455 | 447 |
| Additions | 65 | 50 | 41 | 90 |
| Depreciation | (45) | (48) | (49) | (53) |
| Closing balance | 452 | 455 | 447 | 484 |

Table 22 – Domestic reserved letter service – Small PreSort letters

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 368 | 374 | 402 | 415 |
| Additions | 42 | 69 | 56 | 82 |
| Depreciation | (37) | (41) | (43) | (45) |
| Closing balance | 374 | 402 | 415 | 451 |

Table 23 – Domestic reserved letter service – Large full rate letters

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 113 | 116 | 116 | 110 |
| Additions | 15 | 12 | 6 | 22 |
| Depreciation | (12) | (12) | (12) | (13) |
| Closing balance | 116 | 116 | 110 | 119 |

Table 24 – Domestic reserved letter service – Large PreSort letters

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 59 | 60 | 60 | 58 |
| Additions | 8 | 6 | 4 | 11 |
| Depreciation | (6) | (6) | (6) | (7) |
| Closing balance | 60 | 60 | 58 | 62 |

Table 25 – Domestic reserved letter service – all domestic reserved letters

| June | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Opening balance | 973 | 1,003 | 1,033 | 1,029 |
| Additions | 130 | 138 | 107 | 205 |
| Depreciation | (100) | (107) | (111) | (118) |
| Closing balance | 1,003 | 1,033 | 1,029 | 1,116 |

## Appendix 15 – Capital investment program

Australia Post's three year, capital investment program includes the following:

Sales and Acceptance – major priority is the national retail fitout program. There are 186 projects with a total projected outlay across the three future years of $87m. Cyclical refurbishment of retail outlets accounts for over 80% of the $87m, as the refurbishment fitout cycle for retail outlets averages 5-6 years;

Processing – major priorities are: phase 2 of the Enhanced Open OCR project, management operating system implementation to improve productivity for load shifting equipment in processing facilities, evaluation of multiproduct sorters for the major letter facilities in Sydney and Melbourne, and Voice / OCR process improvements in parcels, plus a range of plant and equipment replacements which together total $91m across the three years.

Delivery –major priority is the Future Delivery Design Program including some $21m for additional small letter sequencing equipment capacity. There are some 90 projects, totalling $94m over the three years. Many projects involve property, including land and buildings for new or relocated DCs, and fitout for new and refurbished DCs. Some projects also reflect the ongoing need to ensure continued compliance with building and other OH&S standards. Plant and equipment investment includes replacement of items for assets at the end of their useful lives;

Information Technology – 80 projects planned

- Commercial and product business systems
    - Channel enablement point of sale system
    - New product framework for communications
    - Identification and Verification
    - Integrated customer lodgement (letters, parcels)
    - Retail supply chain optimisation
    - Single view of customer
- Corporate business systems
    - HR enabled – release 1, 2 and 3
    - SAP finance project
- Mail and logistics business systems
    - PostMaster Program
    - Recognition engine
- Infrastructure / application integration services
    - SAP Enterprise Licence Agreement V2
- Cyclical replacement of PCs and associated software

Vehicles – virtually all capital investment is cyclical replacement. As at 30 April 2009 the acquisition cost of the entire vehicle fleet was $220m. With an average useful life across the fleet of about 6 years, the annual average annual capital investment replacement cost for the fleet is approximately $40m.

Miscellaneous – 114 projects in all other areas - most capital investment items are classified as 'minor pools'.

# Appendix 16 – Technology and automation

*This appendix summarises:*

- *the context for the creation of efficiency improvements and other business value from technology and automation; and*

- *Australia Post's approach to technology adoption which is determined by its relatively small size and purchasing power with international equipment vendors.*

Postal technologies are heavily driven by the demand and needs of the large North American and European postal and logistic operators and, more recently, how postal operators have responded to the global recession and financial crisis. The global environment for postal operators has seen:

- major letter volume declines in overseas markets from the impact of recession and the effects of electronic substitution and mail consolidation resulting in intensified pressures for cost management and internal funding constraints in response to pressures on profit margins;

- heightened competitive threats in parcels markets amongst the international operators and local providers;

- continued development of carbon reduction and environment initiatives and reporting; and

- demand for more add-on services relating to traceability and security, but the markets' willingness to pay for such enhancements appears more limited with letters than with express or parcel products.

## Technology trends

Key technologies applicable to the postal business include:

- image processing and OCR;

- automated equipment and letter processing technologies;

- materials handling and robotic technologies;

- management reporting, diagnostics and optimisation technologies, including data management and communication;

- transport technologies; and

- energy efficiency and environmental technologies.

Many such technologies are subject to significant change and development, hence a key feature of Australia Post's approach to technology investment has been to ensure a specific technology solution does not pre-empt or lock Australia Post out of further technology advances. The open architecture strategy for the enhanced OCR platform is an example of this approach to ensure that Australia Post is able to readily incorporate future advances in OCR performance.

Australia Post maintains a wide range of international contacts with vendors, other postal organisations, and professional contacts in order to identify and evaluate emerging technology trends and efficiency opportunities. The portfolio of efficiency initiatives in the Commercial and Mail & Network Divisions invariably contain a range of technology and automation ideas subject to regular review and assessment.

## Automation and business value

Technology and automation remains a key driver of business efficiency and business value. However the successful realisation of efficiency gains is dependent on a number of enabling conditions including:

- complementary change to the network processes, business systems and structure in order to extract value from the automation;

- the levels of staff training, and competencies to operate and maintain the equipment;

- alignment with customer requirements –does automation provide a capability that customers want and are prepared to pay for?;

- alignment with network requirements – does automation tackle the key cost, constraint or capacity requirements in the network?;

- 'end to end' network performance;– does automation improve overall network performance, or just part of the process?; and

- can theoretical benefits be realised in practice? - eg resource benefits created as many small time savings in manual activities spread across a network may not be readily converted into cost savings to the bottom line.

This cautions against simple comparisons between postal organisations on the basis of their apparent 'technology maturity' – the key issue is the extent to which technology and automation solutions produce realisable business benefit.

In the major technology programs that Australia Post has undertaken, considerable management effort has been expended to ensure that the above enabling conditions can be met and that the benefits from automation are actually realised through the governance of program implementation.

## Technology Adoption - Australia Post Vs other adopters

A large proportion of the letter sorting machine development by vendors over the last 20 years has been driven by large scale investments by the USPS and European postal authorities – for example Deutsche Post DHL announced in April 2009 that it was investing in some 385 automated processing machines, including 97 large letters processing machines, for a total cost of EUR 420m in the 3 years to 2012.

By contrast, Australia Post's core processing equipment assets comprise 56 letter processing machines of a given type (MLOCRs and BCSs) and 8 FMOCR large letters processing machines.

Being a comparatively small customer for most postal technology vendors, Australia Post has limited influence on technology development.

There is a threshold beyond which the cost of Australia Post developing new technology will not be recoverable unless amortised over more equipment than Australia Post purchases or applied to more mail volume than Australia Post processes.

While technology investments by the larger postal authorities lower the cost barrier for smaller postal authorities such as Australia Post, the equipment must still be customised for Australian conditions, and the smaller market can drive costs to the point where the investment is still not feasible.

## Procurement principles

Australia Post's approach to technology and automation procurement is in keeping with best practice standards, including the Commonwealth Government Procurement Guidelines. The approach reflects the unique requirements for the network – in terms of customer service and CSOs, geographic footprint, mail volume, population density and dispersion, and the physical attributes of Australian letter products versus those overseas.

Where there is business value in doing so, Australia Post will influence the market for postal technology through the development of unique equipment and more frequently through adaptations of international equipment to better meet Australia Post's network requirements.

Australia Post's procurement principles involve:

- a preference to adapt and modify established technologies to Australian conditions (an approach repeatedly proven by the results), to reduce risk exposure;

- seeking to extract maximum value from existing assets (eg AEG small letter sorting equipment is over 25 years old but still serves a valuable niche role, particularly in Country MCs);

- seeking vendor support arrangements that manage technical obsolescence and the associated risks eg availability of software upgrades, spare parts;

- undertaking technology assessments on a life cycle, total cost of ownership basis; and

- seeking to avoid:
    - procuring new technologies that are not market tested, to minimise threats to service performance, cost, and supportability; and
    - closed proprietary arrangements, which tie Australia Post exclusively to a particular vendor for upgrades and long term support.

## Automation and asset management

Australia Post's asset management approach complements the approach to automaton. This approach involves the complete management of the asset from idea to disposal such that overall life cycle costs are minimised and the operating capability of assets to meet performance standards is maintained throughout their life.

Australia Post's asset management strategy is modelled on the *International Infrastructure Management Manual*[51] which is widely recognised as the definitive work on the management of public infrastructure assets.

The strategy requires the development of automation plans which cover the network functions. This strategy is complemented by a Supportability Plan for existing processing equipment that is used to manage anticipated obsolescence and supportability issues over a 10 year horizon.

Where existing equipment meets demand at costs comparable to the market alternatives, existing equipment will be retained unless new equipment reveals significant lifecycle cost advantage, or a step change in performance or functionality.

Given the letters growth outlook, Australia Post expects its processing equipment to remain in service for full life, subject to remediation opportunities and supportability assessments.

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[51] Originally developed by the National Asset Management Steering Committee, New Zealand and since adopted by the Institute of Public Works Engineers, Australia

*This appendix describes:*

- *the strategic challenge to contain delivery costs whilst meeting Australia Post's prescribed performance standards;*
- *the Future Delivery Design (FDD) Program response; and*
- *the components of the FDD Program and their complementary relationship in generating efficiency gains.*

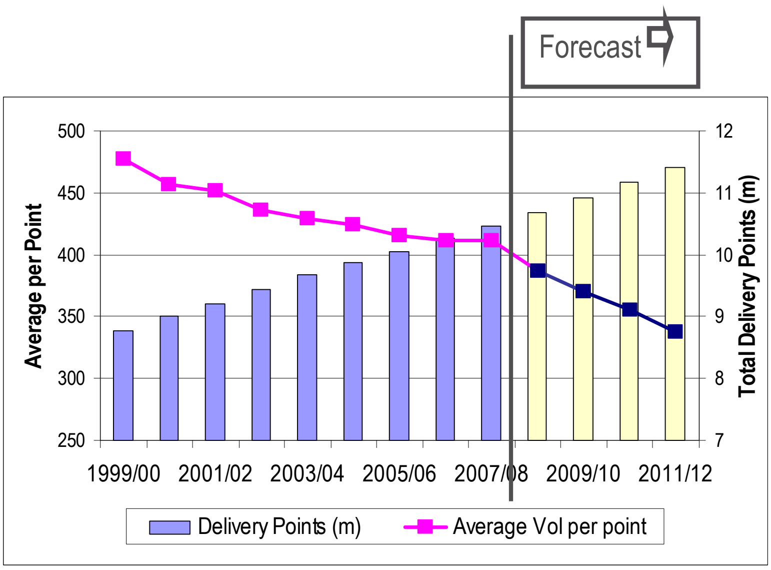
## Australia Post's delivery challenge

The Delivery function represents the core focus of investment and process reengineering in the network over the next 5 years. The challenge is to contain the growth in operating cost and to introduce greater cost flexibility in the face of declining revenues and a thinning in network volumes as fewer letters are delivered to more delivery points.

The imperatives driving this strategic challenge are:

- the size of the delivery resource base – over 12,000 FTEs, and operating expense, with the escalation in delivery costs each year largely attributable to labour rate escalation and delivery point growth;
- high fixed costs in outdoor delivery – determined by the 5 day delivery service to at least 98% of all delivery points;
- declining letter volumes per delivery point combined with the delivery frequency;
- the need to reduce dependence on motorcycles as an outdoor delivery mode due to a combination of factors including limits on the carrying capacity and changes in the mix of mail, accident and OH&S factors and the availability and cost of licensed riders;
- continued growth in delivery points, requiring servicing. Growth in delivery points has consistently averaged around 2.0% per annum, requiring additional resources each year (about 175 work years at around 1,000 to 1,200 delivery points per round); and
- difficulties, in converting relatively small time savings per postie, spread across many DCs and staff, into realisable resource savings to Australia Post's bottom line.

Figure 11 – Average volume per delivery point



## The strategic response

The specific objectives of the FDD Program are to:

- use enhanced OCR address recognition software to drive additional labour savings from existing MLOCR and BCS processing equipment by significantly raising the proportion of small letters whose addresses can be read and sorted to the existing delivery round sort level (or round sections);

- extend automated small letter processing to delivery street sequence taking advantage of the enhanced OCR software platform to improve the economics of automated sorting of small letters to street delivery sequence;

- extract savings from the above changes by shifting towards a more flexible workforce, and progressively introduce remote delivery rounds that commence and/or cease away from the delivery centre and which provide wider part time recruitment opportunities;

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

- examine structural alternatives to the DC network or other process changes to extract longer term value from the investments required.

The progressive rollout of automated processing of small letters to delivery point street sequence is a central element of FDD but all elements are interdependent and are integral to the realisation of savings and cost flexibility benefits.

### Sorting of small letters to delivery street sequence

Future Post yielded major productivity benefits through progressive 'capital deepening' – replacing the manual sort function in MCs and DCs with an automated process involving the:

- introduction of automated equipment from 1999 enabling small letters to be sorted to delivery round level for the first time (previously only to postcode or delivery centre level);

- elimination of one significant part of the manual sequencing operation undertaken by posties in DCs with the introduction of Vsort frames , as part of the Future Post Program; and

- implementation of work sharing arrangements for bulk customers under which letters prepared according to PreSort lodgement conditions received discounted rates reflecting the savings from the work share effort.

The current rollout of automated sequencing of small letters with FDD provides:

- a further step in extracting productivity from the existing network asset base;

- an investment path for new sequencing capacity and delivery modes to contain cost growth over the next 5 years; and

- a longer term positioning for network options that provide greater flexibility in response to major uncertainties around the future for various letter segments.

The current rollout is being phased to target high yield rounds first and to ensure that the lessons learned from the initial pilot rollouts through 2008 are built into the subsequent transition across the network.

## International comparisons

Key elements of the FDD Program are in line with the responses in a number of overseas postal organisations. The design of the FDD Program has been informed by this overseas experience, site visits and discussions and regular contact with overseas postal organisations, equipment vendors and the Universal Postal Union.

All postal authorities potentially have available similar opportunities from advances in address recognition software and processing technologies. They are also facing a similar problem of how to maintain and improve service and contain costs whilst delivery points grow and mail volumes decrease. For example The Netherlands (TNT), Sweden, Norway and Germany are implementing a combination of automated sequencing and delivery process changes including:

- mechanised sequencing (mostly using small sequencing machines);
- increasing workforce flexibility with part time delivery only;
- decentralising and separating mail delivery from mail preparation (separation of indoor and outdoor components);
- alternative technologies to support the postie's outdoor delivery task (eg large capacity electric vehicles);
- application of computer based delivery route optimisation tools; and
- reducing the processing nodes and centralising delivery preparation operations (fewer, larger DCs).

However, there are a number of contrasts in the Australian context and these include:

- the geographic reach of the Australian network, exceeding anything in Europe, which constrains internal operating standards across the network;
- substantially lower mail densities (per point) and significantly lower advertising and promotional mail; and
- heavy reliance on motorcycles (currently around 84% of all metropolitan rounds) as the mode of transport for the outdoor delivery component.

Motorcycle delivery was one of the outstanding productivity drivers of network performance when introduced in the 1980s. However, reduced reliance on motorcycle delivery is now an important objective of the FDD Program due to issues including:

- diminishing availability of recruits with motorcycle licenses;
- limited (eg 25kg) carrying capacity of the motorcycles in the face of a changing mail mix towards bulkier items (and the consequential need for a depot box network to support motorcycle delivery);
- the ageing profile of existing posties and the rider weight limits of the motorcycle – further limiting carrying capacity;
- time lost in travelling to and from the start and finish of delivery rounds and time lost in stopping and replenishing the load from depot bins due to the carrying limits of motorcycles; and
- OH&S requirements and the accident risk in current metropolitan traffic conditions.

A brief overview of the separate, but dependent, components of FDD is provided below and the final section lays out the current parameters for the rollout of small letters automated sequencing:

- enhanced OCR recognition upgrade and open architecture platform;
- automated small letter sequencing;
- reconfiguring indoor and outdoor delivery operations; and
- optimising outdoor delivery rounds

## Enhanced OCR Recognition

The rollout of enhanced OCR address recognition software is the first element of the FDD Program. It generates savings in its own right as well as being a key enabler for the other FDD projects, including automated small letter sequencing.

The short term goal is to deliver reduced costs by:

- improving the OCR performance in processing small letters to delivery round (which prior to the introduction of machine sequencing was the target sort level);
- increasing the volume of mail whose addresses can be read to a delivery point level (ie DPID), hence enabling letters to be machine sorted into street delivery sequence; and
- reducing video coding and mail missorts.

Labour savings are immediately created by:

- reducing video coding in MCs, as more letters are successfully read by the OCR on the sort machines; and
- reducing manual residue or primary sorting in DCs, by raising the proportion of letters sorted by machine to delivery round level.

In addition, other benefits arise from enhanced OCR:

- an address learning capability in the software enables continuous improvement in recognition performance;
- the use of open architecture, (ie not tied to the intellectual property of a particular software vendor), facilitates the adoption of further address recognition enhancements into the future; and
- an ability to apply the enhanced OCR address recognition platform to other products such as large letters.

Stage 1 of this project is scheduled to enter full rollout by September 2009 and the productivity benefits are incorporated into Australia Post's 2009/10 financial projections.

## Automated small letter sequencing

Automated sequencing of small letters is the second key element of the FDD Program and comprises:

- the rollout of automated sequenced mail using the capacity of the existing MLOCR and BCS machines, which, on current estimates, will sustain the rollout to 2010 and likely involve over 1880 delivery rounds; and
- the rollout of automated sequenced mail up to end 2012 with additional machine sequencing capacity, to approximately 1600 additional delivery rounds (ie a total of nearly 50% of all delivery rounds which currently total around 7600) with expectations to eventually sequence to 5100 of the 5500 metro delivery rounds.

Australia Post has not adopted a blanket approach to automated sequencing of rounds.

Automated sequencing adds cost and time to the processing operation in letter facilities – some 15 minutes per round as a broad benchmark, including transport impacts. However, this is offset by time savings (45 minutes indicative) in the manual Vsort operation in the DC – to provide a net overall 30 minutes saving per round allowing for the need to merge the remaining manually sequenced letters with the automated sequenced mail prior to outdoor delivery.

Case by case examination of local delivery networks highlights areas of high savings potential and other areas where there is very limited potential (eg areas where there are high volumes of large letters such as magazines. This is due in part to the efficiency of current processes.

As address readability improves in the MC, the volume of letters to be hand sorted in the DC will fall. However, this is offset by the growth in the number of delivery points nationally.

Parameters in prioritising rounds for automated sequencing using available capacity on existing equipment include the:

- percentage of small letters which can be sorted to round level on the automated equipment (eg greater than 75% round sort);
- proportions of large letters that must be manually merged into a single bundle for a motorcycle (less than 15% large letters);
- proportion of mail for delivery to high rise apartments (where automated address recognition is substantially less accurate); and
- time to transport sequenced mail from the BCS in the processing facility to the DC because of the time to complete the indoor delivery functions and still meet the 8.00am, 11.00am and 3.00pm internal standards for post office boxes, business mail and residential delivery respectively.

Large letters automated sequencing is not currently under consideration. There are a number of compelling reasons for not contemplating automated large letter sequencing at this stage and these include:

- current BCS sequencing equipment cannot handle the large letter product spectrum and the existing BCS capacity is fully committed to small letters;
- the low volume of large letters per delivery point (in contrast to overseas), the relative capital cost of large letter FMOCR processing machines up to 8 times that of a small letter MLOCR at 2001/2 prices) and the limited processing time within the large letter processing window; and
- the lower DPID OCR read rate for large letters, resulting in a poor sequencing rate.

### Reconfiguring indoor and outdoor delivery operations

The third major element of FDD involves the reconfiguring of indoor and outdoor delivery operations.

Automated sequencing in letter facilities reduces the indoor manual sequencing work by the postie in DCs. Savings from the shrinkage in indoor labour can be realised through a variety of adjustments:

- reduced overtime, part time hours or natural attrition;
- earlier shift starts – recruit to shifts that start later in the morning which commence before 6.30am and which attract a 15% shift penalty, are becoming less relevant since the introduction of automated round sorting and sequencing;
- re-balance full time indoor work – eg a full time postie prepares two or more rounds for delivery, then delivers one with other rounds assigned to a 'delivery only' postie;

- reallocate additional outdoor delivery hours – eg extend the hours allocated for outdoor delivery as a result of the reduced indoor manual processing now performed by automated address sequencing; and

- longer term, facilitated, transition to retirement for ageing posties.

These adjustments provide flexibility in how the gains from automation are taken up. They provide an opportunity to increase flexibility away from Australia Post's traditional reliance on a full time postie role which encompasses both indoor sort activities and the outdoor motorcycle based functions.

It also opens up other opportunities:

- using other delivery modes (eg power assisted bicycles and tricycles, and walk buggies) to reduce dependence on motorcycles, thus eliminating travel time and the associated traffic risks of motorcycle delivery;

- redesigning the delivery rounds to better fit a part time role with round commencement and cessation remote from the DC; and

- accordingly, recruiting from a wider labour pool by being able to offer part time work closer to home without requiring a motorcycle licence.

## Optimising outdoor delivery rounds

The costs of outdoor delivery continue to be dominated by the need to provide a 5 day a week delivery service to at least 98% of all delivery points.

The shift towards a dedicated outdoor delivery workforce with remote commencement rounds is not a universal solution. However, it does provide scope, when combined with the new modes of delivery, to address issues with motorcycle delivery whilst creating other opportunities:

- power assisted bicycles and tricycles and walk buggies offer greater carrying capacity than motorcycles, with options to use this form of delivery for other products while reducing the depot box network required with motorcycles; and

- greater flexibility in reconfiguring delivery rounds (with appropriate optimisation tools) to adjust to fluctuations in volume or other demands on the local network arising from changing customer requirements or patterns of urban development.

## Current parameters for the rollout of automated small letter sequencing

Table 26 summarises the current planning[52] baseline for the rounds to be sequenced by 2012 from existing and new sequencing capacity from a total of around 7,600 delivery rounds nationally.

Table 26 – FDD baseline – rounds to be sequenced

| Rounds sequenced | 2008 | 2009 | 2010 | 2011 | 2012 | Total |
|---|---|---|---|---|---|---|
| Existing capacity | 400 | 680 | 800 | | | 1,880 |
| New capacity | | | | 800 | 800 | 1,600 |
| Total | | | | | | 3,480 |

[52] Based on 2009 March Review data, which is the basis for the three year forecasts

Given an estimated investment in new sequencing capacity of $21.4m over the three years to 2011/12, the following Table details net savings over the next three years:

Table 27 – Net savings (3 years only)

| Net savings $m | 2009/10 | | 2010/11 | | 2011/12 | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2010 | 2011 | 2011 | 2012 |
| Sequencing 2009 – 680 rounds | (0.75) | 0.88 | 1.12 | 1.09 | 1.16 | 1.14 |
| Sequencing 2010 – 800 rounds | | (1.19) | 0.18 | 1.60 | 1.70 | 1.66 |
| Sequencing 2011 – 800 rounds | | | | (1.24) | 0.16 | 1.66 |
| Sequencing 2012 – 800 rounds | | | | | | (1.24) |
| | (0.75) | (0.32) | 1.30 | 1.46 | 3.03 | 3.23 |

Australia Post's WACC was discussed in some detail by the ACCC in the 2008 price notification decision.

Since that notification, Australia Post commissioned a new review of its WACC by independent financial experts Value Adviser Associates Pty Ltd, represented by Professor R.R Officer and Dr Steven Bishop. That review was completed in the June quarter of 2009, and its recommendations have been adopted by Australia Post in this 2009 price notification.

The WACC is calculated according to standard finance practice. It includes a cost of equity derived from the Capital Asset Pricing Model and a cost of debt containing a corporate risk premium over the risk-free rate.

Australia Post's WACC in this draft notification is calculated according to the formula set out by the ACCC in section 18 of the RKR. The following Table contains a summary of the main parameters.

Table 28 – WACC parameter values

| WACC Parameter | Value |
|---|---|
| Risk-free rate | 5.6% |
| Market Risk Premium | 7.0[53]% |
| Asset β | 0.78 |
| Imputation Credits Value | 0.0% |
| Equity β | 0.93 |
| Tax Rate | 30.0% |
| Debt β | 0.15 |
| Cost of debt | 7.0% |
| Gearing (D/D+E) | 20.0% |

The application of the methodology and the parameters above yields a nominal vanilla WACC of 11.1%. Commentary on the WACC parameters set out above is as follows.

### Choice of WACC Parameters

There are three generic options available for setting WACC parameters:

- choose both a risk-free bond rate and a matching market risk premium that reflect the current conditions in financial markets;
- choose long-term standard settings for both the risk-free rate and its associated MRP; or
- choose a current market rate for the risk-free rate but a long-term standard for the MRP.

[53] The market risk premium of 7% depends on acceptance of a 10-year Commonwealth bond as providing the risk-free rate. If a 5-year bond is used, then the market premium needs to be increased by 30 basis points to 7.4%; if a 3-year bond is used, then the premium needs to be increased by 100 basis points to 8% (spreads as at end-June 2009).

The first option is the one recommended by Value Adviser Associates and is the option chosen by Australia Post in this draft notification. It has two advantages: it has matching consistent data for both the risk-free rate and the MRP, and it alone of the three options reflects the pricing of risk inherent in current market settings. It will be the highest of the three in terms of a WACC result, as current market conditions reflect the corrections to risk pricing that have occurred as a result of the global financial crisis.

The second option is also internally consistent, but does not capture current market conditions relating to risk pricing. It might be appropriate if there is a valid and reasonable expectation that market conditions will quickly revert to long-term standard settings for WACC parameters. Australia Post does not believe that this expectation can be justified.

The third option will understate the WACC to levels that do not provide adequate returns to shareholders. The research provided by Value Adviser Associates indicates that that understatement is likely to be material. This option appears to be close to the position finally adopted by the AER.

### Risk Free Rate

In the 2008 price notification Australia Post proposed use of the 10-year Commonwealth bond rate as the risk-free rate. Australia Post understand that that choice is standard practice, and that it is the bond rate chosen normally by independent experts in calculating an MRP.

For capital investment and acquisition purposes Australia Post uses that Commonwealth 10-year bond rate as the risk-free rate. This reflects the longevity of Australia Post's capital base.

However, the ACCC in the 2008 price notification preferred a 5-year rate on the basis of a match to a regulatory period. A 5-year rate was also initially proposed by the AER in its preliminary 2008 review, but the AER's final choice was to reaffirm the 10-year rate as the risk-free rate. That choice appears to have been appropriate for the energy utilities, in view of the longevity of their asset base, and the choice is equally appropriate for Australia Post for the same reason.

Value Adviser Associates also recommend the 10-year bond as the most appropriate risk-free rate. They note that this is the accepted practice in the absence of regulation. This is an important additional point. There does not actually appear to be a problem here that a different regulatory approach needs to solve.

In the 2008 price notification the choice mattered very little, in practice, as the average yields on 5-year and 10-year bonds were virtually identical over the averaging base period of 14 April 2008 to 16 May 2008 which was used in that notification. On this occasion the choice does matter in practice, as the spreads on Commonwealth bonds at the end of June 2009 were approximately 30 basis points for the 5-10 year spread and 100 basis points for the 3-10 year spread.

Therefore, if the ACCC continues with a 5-year bond as its preferred risk-free rate, or if it uses any other bond other than a 10-year bond, then it will need to add the appropriate bond spread.

The test for this to have been done correctly will be that for an entity with a beta of 1 the combination of risk-free rate and MRP will be the same regardless of which bond rate has been adopted as the risk-free rate. If the ACCC chooses an option other than a 10-year rate and makes the compensating risk premium adjustment, then it will note that there is little difference in the outcomes the if the beta is close to 1 and for bond rate spreads up to 100 basis points or so. This point is made on page 18 of the Value Adviser Associates report.

It is important for the ACCC to set the risk-free rate and MRP jointly. In the 2008 price notification it was not clear on what period was applied. As indicated above, that practice had little distorting impact in the 2008 case because of the small size of the bond spread at that time. However, it makes a material difference when the yield curve is upward-sloping, as it would usually be expected. That difference is even more material now, when the bond spreads are well above their longer-term averages.

The average rate for the period 1 June 2009 to 30 June 2009 has been used in this draft notification to enable calculations to be made. However, if conditions and/or rates in financial markets change materially then Australia Post will consult the ACCC over whether the notification should adopt a more appropriate time frame closer to the point of decision by the ACCC.

### Market Risk Premium

Australia Post understands that a 6% MRP has been regarded as a long-term standard within the finance industry. That MRP was recommended for use in Australia Post in the 2005 Capital Partners review of our WACC, and it was the rate accepted by the ACCC for use in the 2008 price notification.

As a more precise statement of this understanding, Australia Post understands that a MRP of 6% has been based on a 10 year Commonwealth bond rate as the risk-free rate to which the market premium is to apply. This was also the basis on which Capital Partners recommended a 6% premium. If the term structure of interest rates is normal, ie upward sloping, then choice of a shorter term bond would require a compensating and consistent rise in the market premium to reflect the same level of market returns.

The issue of which risk-free rate should be used is also relevant to the MRP in this draft notification. Preliminary views by the AER in 2008 that the risk-free rate period should match the regulatory price duration would definitely have affected Australia Post's submission, as a long-term MRP of 6% consistent with a 10-year bond rate foundation would not be consistent with a risk-free rate of 5 years (in the energy utilities' case) or 3 years (to match the regulatory price period of this draft notification).

Value Adviser Associates have calculated that use of a 3-year risk-free rate rather than the preferred 10-year rate would require the MRP to be increased by about 50 basis points just to match the interest rate gap between the two bond rate terms. This is a longer-term relationship found by Value Adviser Associates. If prevailing conditions in financial markets are to be used instead, as is required of the AER, then the current and recent gap between 3-year and 10-year bond yields is approximately 100 basis points, not 50, and that would provide the more appropriate adjustment factor.

Value Adviser Associates have recalculated the MRP for both historical returns and prospective returns. They calculate that, depending on the imputation adjustments that might be appropriate, a long-term MRP of 6.1% to 7.2% is indicated.

The issue over which risk-free rate should be used to set the MRP may have subsided, as the AER in its Decision of May 2009 reversed its initial suggested move away from a 10-year risk-free bond rate and reaffirmed that 10-year rate as the cornerstone of the WACC to apply to the energy utilities.

This does not settle the issue of what MRP should apply to regulated price and other regulatory applications in future.

The WACC that should be applied to estimate future required returns needs to be a forward-looking WACC. Both the AER and Value Adviser Associates have examined the MRP impact of the instability and disequilibrium in financial markets. Both agree that forward-looking MRP calculations indicate an MRP well above 6% at present. Value Adviser Associates estimate that the current MRP could be up to 14%.

For energy regulation purposes, the AER has raised the MRP from 6% to 6.5%, but with no particular justification. Value Adviser Associates have a stronger case in recommending that 7% be used instead. This is:

- 6.5% is not even the midpoint of the MRP range (6.1% to 7.2%) estimated to be the long-term historical position;

- current forward-looking MRP rates are well above historical levels, possibly up to 14% rather than 6-7%; and

- a forward-looking rate in these circumstances needs to be above the historical rates.

Value Adviser Associates are still conservative in recommending that an MRP of 7% be used rather than one in double digits, but their advice is reasonable. Australia Post notes that the MRP advised by PwC approximately ten years ago was 7%, not 6%.

Consequently, Australia Post proposes that the MRP of 7% be applied on the assumption that the risk-free rate also selected is the 10-year bond rate rather than one of shorter maturity. 10 years is also a better reflection on the life of Australia Post's asset base. If a shorter maturity bond rate is used, then Australia Post propose adding 50 to 100 basis points to the MRP to compensate. The exact adjustment would depend on the choice by the ACCC of the specification of the WACC estimating period.

### Asset β

Australia Post's asset beta was assessed by Value Adviser Associates Pty Ltd in April 2009 to be 0.78.

In forming the benchmark group, Value Advisers used essentially the same group of companies used by Capital Partners in the 2005 study carried out for Australia Post. In the 2008 price notification, the ACCC carried out its own assessment of the asset beta, and arrived at a value close to that derived in the Capital Partners study.

Using a 30% indicative gearing ratio, this asset beta equates to an equity beta of approximately 1. The new asset beta outcome appears intuitively reasonable when compared with the 0.8 equity beta determined in May 2009 by the AER to apply to electricity utilities. All markets in which Australia Post operates are affected by the state of the economy, and all face short-term and long-term competitive pressures which would indicate higher operating risks than those faced by utilities.

### Imputation Credits

The latest WACC advice provided to Australia Post by Value Adviser Associates uses a non-zero imputation factor solely to calculate the MRP. A non-zero factor is valid for such a WACC purpose, as imputation credits are certainly both available and used by domestic investors in forming views on required rates of return.

However, imputation adjustments to the tax factor in the WACC and / or the associated cash flows used in the PTRM are not recommended by Value Adviser Associates. This is because imputation credits are not available for use by Australia Post's shareholders, and therefore have no value to them. Australia Post does maintain a franking account register, but it is not used in view of our current ownership and tax status.

In line with the most recent expert advice, ie from Value Adviser Associates, this draft notification therefore proposes that an imputation factor of zero be used for Australia Post for both the WACC formula and/or associated PTRM cash flows.

As indicated by the ACCC in its Decision of July 2008, this appears to be a WACC area where there is much disagreement on the correct imputation credit treatment even amongst independent experts. However, this disagreement appears to concern the extent of imputation usage by those able to utilise imputation credits. In Australia Post's case, where imputation credit is not available to our shareholder as a source of value, all of the return required by our shareholders must flow from the WACC and its cash flows.

Previous expert advice to Australia Post on this issue (ie from Capital Partners in 2005) recommended a general imputation factor of 0.5. We are also aware that the AER has decided to use an imputation factor of 0.65 in its regulatory matters. Our request for advice from Value Adviser Associates did not require a recommendation on the extent to which imputation credit is used by those shareholders to whom it applies.

Use of an imputation factor of 50% as adopted by the ACCC in the 2008 price notification reduces the pre-tax WACC from 15.3% to 12.8%. If the ACCC adopted the AER rate then the WACC would fall to 12.3%.

### Equity β

The equity beta is calculated according to the formula in the RKR. Value Adviser Associates Pty Ltd assess that beta as approximately 1.0, assuming an indicative gearing level of 30%.

On the basis of an updated view of gearing proposed in this draft notification, ie 20% gearing, the equity beta falls slightly to 0.93.

A 2008 independent review of Royal Mail provided support for the higher equity beta proposed for postal authorities. In December 2008 the independent committee provided its report 'Modernise or decline – Policies to maintain the universal postal service in the United Kingdom'. A key conclusion of that report was as follows[54].

> 'Water and rail networks are natural monopolies, operating in stable markets with low levels of risk, with long-term investment needs funded by significant debt positions. Since Royal Mail is facing much higher risks to its business driven by structural market change and increasing competition, the level of debt funding it could bear is unlikely to be sufficient to meet its capital requirements.'

### Tax Rate

Australia Post pays all Commonwealth, State and Local taxes on the same terms as any other corporation.

This submission proposes that the statutory company tax rate of 30% be used in the WACC calculation for Australia Post. This was the rate proposed by Australia Post in the previous case, and it was the rate accepted by the ACCC for WACC purposes in that case.

The ACCC will note that the average effective company tax rate for Australia Post has been marginally below the statutory rate in the three years to 2007/08. However, the gap is not material, and adoption of the average effective tax rate for those past three years would have resulted in a WACC change of only one decimal point. There are no taxation items included in Australia Post's current corporate plan (2009/10 to 2011/12) that result in a plan tax rate other than the statutory 30%, and other than to allow for minor rounding, 30% has been applied in that corporate plan for all three forward years.

### Debt β

Value Adviser Associates include a debt beta of 0.15 in their 2009 study for Australia Post. This compares with 0.10 recommended previously by Capital Partners and which was used in the 2008 price notification.

Australia Post proposes that the more recently recommended value of 0.15 be used in this draft notification.

We note that a change of debt beta from 0.1 to 0.15 reduces the nominal vanilla WACC by 10 basis points or less at gearing ratios of 20% - 30%.

### Cost of Debt

The cost of debt for Australia Post is affected by both the general increase in the pricing of risk in financial markets since the onset of the global financial crisis and by Australia Post's particular credit rating.

Australia Post's credit rating is reviewed annually by Standard and Poor's. A rating of AAA has been issued for Australia Post each year since the initial assessment, the most recent issue occurring in 2008.

Because of the speed with which economic events and their impacts on corporate profitability are unfolding, Australia Post asked Value Adviser Associates to include a current credit rating assessment of Australia Post in its latest advice. That assessment was that Australia Post's current rating was likely to be in the range AA to AAA based on the range of rating ratios considered key by Value Adviser Associates, but might fall within the range A to AA on the basis of a wider set of rating ratios.

[54] 'Modernise or decline, page 83

Australia Post's profit outlook for the next three years will be tempered by the fact that this draft notification does not seek to obtain the maximum short-term profitability that would be associated with applying the ACCC's maximum allowable revenue formula. Australia Post's approach is aimed instead at preserving longer-term viability of the domestic reserved letter service rather than seeking shorter term gains which could jeopardise that longer term viability aim.

Without attempting to guess the outcome of the next formal Standard and Poor's assessment, it therefore seems prudent to consider one or more of the lesser ratings advised by Value Adviser Associates in addition to the AAA still applicable at the draft notification date.

Australia Post proposes that an interest rate calculated on the basis of the average of June 2009 daily rates is reasonable for this draft notification. Average June rates are:

- AAA 10 year rate 6.9%
- AA 7 year rate 6.6%
- A 10 year rate 8.0%

For the purposes of this draft notification, an interest rate of 7.0% is proposed. This is close to the prevailing AAA rate, and has some regard to the AA and A rates.

The ACCC will note that the rate proposed appears to be well within a ceiling suggested by Reserve Bank data on capital market yields, which for May 2009 showed spreads for corporate bonds over Commonwealth bonds of 200-270 basis points for AA bonds and 420-460 basis points for A-rated bonds.

## Gearing

Australia Post proposes that the gearing rate for WACC calculation purposes be set at 20% for each of the three forward years.

This rate compares with a gearing rate of 25% proposed by Australia Post in the 2008 price notification and 30% as finally determined by the ACCC.

The rationale for the proposed rate is identical to that used by Australia Post in the last price notification. That rationale is as follows.

In the 2008 price notification Australia Post indicated that the balance sheet for Australia Post required adjustment before it could give meaningful gearing data for WACC calculation purposes. Two separate factors distinguished Australia Post's balance sheet from those applicable to most other corporations subject to the same accounting standards. Those factors were both material. One factor had the impact of 'inflating' the corporation's equity value in the balance sheet, while the other had no impact on the accounting value of equity, but would have added to equity had market values for property assets been used instead of cost-based values. The two factors are as follows:

- Australia Post's balance sheet now shows a significant superannuation asset and associated deferred tax liability. At June 2008 these added $1,116m to equity. The superannuation net asset entered the balance sheet under the AIFRS accounting standards (AASB 119) applicable since 2004/05, but in fact it is not an asset which either is controlled by Australia Post or which is used in Australia Post's operations. Its impact on equity needs to be removed to determine underlying gearing. Note that most other corporations do not face such a significant issue, as it concerns only defined benefit schemes. The scheme to which Australia Post belongs has a large asset surplus which creates the asset in Australia Post's balance sheet; and

- property assets are measured at cost in Australia Post's balance sheet. For ACCC purposes these assets need to be restated to market value, as has been done in the regulatory accounts process. The impact at 30 June 2008 would be an increase in property assets of $803m. Market values are provided by independent expert valuers and shown in the notes to the statutory financial statements (Note 13 in the 2008 annual report).

Australia Post's forecast levels of debt and equity contained in the latest corporate plan are set out below. Equity adjusted for the superannuation and property value factors is also shown, together with the resultant raw and adjusted gearing ratios.

Table 29 – Debt, Equity and Gearing

| | Debt | Equity | Adjusted Equity | Gearing | Adjusted Gearing |
|---|---|---|---|---|---|
| June 2007 | $531m | $2,812m | $2,275m | 16% | 19% |
| June 2008 | $531m | $2,810m | $2,496m | 16% | 18% |
| June 2009 | $556m | $2,618m | $2,298m | 18% | 19% |
| June 2010 | $556m | $2,664m | $2,344m | 17% | 19% |
| June 2011 | $556m | $2,724m | $2,401m | 17% | 19% |
| June 2012 | $556m | $2,797m | $2,470m | 17% | 18% |

The average adjusted gearing for the three years covered by this draft notification is 18%. This draft notification proposes to round that projection to 20%, but does not object to using the actual average if that is preferred by the ACCC.

In the previous price notification, the ACCC discussed Australia Post's forecast gearing from two different points of view.

The first was the optimal level of gearing for Australia Post. The ACCC did not produce any model or evidence to support any conclusion on what an 'optimal' level of gearing might be for Australia Post, and we presume that such an approach again is not practicable in this draft notification.

The second approach used by the ACCC was benchmarking the proposed gearing against the recent gearing achieved by a number of related firms chosen by the ACCC. In doing so, it did not indicate why the gearing for those firms was more appropriate than the target proposed by Australia Post. In practice, the ACCC did not even then accept its own calculation (ie 22.9% gearing) for those companies, instead arbitrarily choosing a 30% gearing for Australia Post that did not approximate Australia Post's own gearing, that of any of the seven benchmark firms (including Toll, to which the ACCC gave special attention), or the average gearing of those seven.

It is also noteworthy that the 22.9% gearing result was heavily biased by the Deutsche Post gearing of 86.5%. If that result were to be excluded, then the average gearing for the remaining six firms was just over 12%. Australia Post's proposed gearing of 20% in this draft notification in fact appears closer to that of the ACCC's benchmark group than the rate finally adopted by the ACCC.

The figure proposed by Australia Post comes from the most recent corporate plan endorsed by the Australia Post Board, and it is the appropriate factor to use in this case. Australia Post note that the proposed figure is also close to the 'benchmark' calculated by the ACCC in the last price notification.

In the last price notification, the ACCC also referred to the 60% gearing adopted by the AER for the energy utilities. Australia Post's position is simply that we are not an energy utility. Australia Post faces long-term demand risk in both its reserved and non-reserved operations that utilities do not appear to face to the same degree. A substantially lower level of gearing than 60% is clearly appropriate for Australia Post. Our shareholders clearly have approved Australia Post's gearing proposals by their continued acceptance of Australia Post's corporate plans throughout this decade.

One additional factor cited by the ACCC in support of its gearing choice in the 2008 price notification was that a statutory monopoly over reserved services provides more stability for Australia Post's income stream. Whatever the validity of that assertion was in 2008, it has little relevance to this and subsequent price notifications:

- the reserved service markets (in Australia and other countries) are facing long-term decline, not stability;
- the reserved service markets are affected by the state of the economy, as indicated by current revenue weakness; and
- Australia Post is not proposing to insulate itself, ie maximise 'stability' of income, by seeking a MAR close to that determined by the PTRM. This draft notification accepts the commercial reality that market conditions and longer-term expectations for those conditions do not support price settings that fully take advantage of the ACCC's price formula.

In the course of the 2008 price notification, the ACCC put forward the following question:

> "Could Australia Post please outline why it (and other comparable firms) choose to maintain gearing of between 25 to 30 per cent rather than the higher levels observed in utilities such as electricity and gas?"

Australia Post's response remains valid now (although some interest costs will have changed since then). It was as follows:

> "We cannot comment on other individual firms' financial strategies. However, as a general proposition we are unable to identify any desirability in exposing organisations or individuals to high debt exposures. We are also not aware of any compelling academic evidence that would support such an outcome.
>
> From the second half of last year, direct corporate access to capital markets has shrivelled, as noted by the Governor of the Reserve Bank in a speech on 27 March 2008. He went on to note that "the most highly rated corporate names can still access capital markets", but that businesses are largely now having to seek bank funding for new or rollover funding. Many such corporations, as the ACCC will be aware, are facing difficulties in getting debt rolled over, and some may face the prospect of asset firesales to survive.
>
> In Australia Post's case we see great merit in having a strong balance sheet for prudential reasons. The gearing ratio is one factor in Australia Post possessing a AAA rating from Standard & Poor's, a result which results in lower interest rates.
>
> Standard & Poor's rates corporations according to a large number of operating, regulatory and financial criteria. It gives broad guidance for a number of main financial key performance indicators in terms of their contribution to a particular rating.
>
> A Standard & Poor's rating of AAA is its highest. Decreasingly lower ratings of AA, A and BBB are still regarded as of investment quality, while BB, B, C and D (the lowest rating) are regarded as having 'significant speculative qualities' and may extend to prospective bankruptcy.

For industrial companies such as Australia Post, the Standard & Poor's indicator benchmarks for the debt/capital ratio are as follows:

- AAA 13%
- AA 28%
- A 34%
- BBB 43%
- BB 57%
- B 70%
- C 69%

(Note that this ratio is for long-term debt only. All of Australia Post's debt is long-term).

Although BBB is rated as investment quality, it represents a rating level that Post would find unattractive, and this may explain why many corporations in Australia would have gearing ratios in the range covered by A to AAA ratings as indicated above. Standard & Poor's define BBB as follows:

> "An obligation rated "BBB" exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation."

Clearly corporations will find it desirable to have their paper rated as of investment grade if they wish to obtain satisfactory funding. Quite apart from the physical availability of funding, higher ratings attract increasingly attractive interest costs. Lending rates as at 25 March for various corporate ratings were as follows:

- AAA 7.3%
- AA 8.0%
- A 8.6%
- BBB 9.4%

(Note that the AA interest rate was estimated by Australia Post by back filling between the AAA and A ratings, as no AA rate was available to us on that date).

It is possible that some utilities might have sufficiently stable or predictable market conditions to justify higher gearing levels, but this is not the case for Australia Post. The domestic reserved service is facing inevitable volume decline, while in 2006/07 60% of Australia Post's revenue, and 95% of pre-tax profit arose in fully contested markets. In our view neither of these factors supports a large rise in gearing.

Standard & Poor's also issue ratings to utilities, and they do have higher allowable debt/capital rates at each rating level than those of industrial corporations. Utilities are generally defined as those that offer water, electricity, gas or sewerage services. As these have no effective foreseeable lifecycle or competitive pressures, higher gearing may be affordable for such enterprises. However, the issues of physical funds availability and the cost of funds still apply.

The ACCC will note that commentary and data from Standard & poor's are extracts from that organisation's publication "Corporate Ratings Criteria".

To give some guidance on the impact on the WACC of assuming different gearing levels, we estimate that each 5 percentage point change in gearing up to a maximum gearing of 30% changes the pre tax nominal WACC by about 13 basis points.