Attachment 2

Supporting Statement: Changes to Australia Post's Ordinary Letter Service

31 January 2014

Glossary of Terms

ACCC	Australian Competition and Consumer Commission
ADMA	Association for Data-driven Marketing & Advertising
AP	Australia Post
APC	Australian Postal Corporation
APSS	Australia Post Superannuation Scheme
ASX	Australian Stock Exchange
BPR	Basic Postage Rate
CAM	Cost Allocation Methodology
CAPM	Capital Asset Pricing Model
CPI	Consumer Price Index
CSO	Community Service Obligation
D/D+E	Debt over Debt plus Equity
FTE	Full Time Equivalent
GDP	Gross Domestic Product
GST	Goods and Services Tax
LPO	Licensed Post Office
LTE	Long Term Evolution
MRP	Market Risk Premium
OECD	Organisation for Economic Co-operation and Development
PDF	Portable Document Format
PPP	Purchasing Power Parity
PPS	Prescribed Performance Standards
Q1, 2, 3, 4	Quarter 1, 2, 3, 4.
RAPM	Regulatory Accounts Procedures Manual
RKR	Record Keeping Rules
SME	Small and Medium Enterprises
TFP	Total Factor Productivity
VECM	Vector Error Correction Model
WACC	Weighted Average Cost of Capital

Document Context

This document supports Australia Post’s proposal to increase Ordinary Letter prices effective 31 March 2014.

In addition to this document, Australia Post has provided supporting material by independent subject matter experts on volume demand and cost elasticities.

The scope of this document is the proposed 31 March changes. As such financial data is provided for the 2012/13 to 2014/15 financial years

To assist the ACCC in its assessment of the notification, this document has been prepared based on financial data used in Australia Post’s 2013/14 – 2016/17 Corporate Plan (2013 Corporate Plan), with the exception of the 2012/13 year which is an actual result.

1. Executive summary

This document supports Australia Post's proposal to increase prices for its Ordinary Letter service, effective 31 March 2014. Details of the proposed prices, with a comparison to current prices, are shown in section 4.

The key change is a 10 cent increase to the Ordinary Small Letter (the Basic Postage Rate – BPR).

The primary objective of the proposed price increases is to reduce the loss incurred in providing the Ordinary letter services. In 2012/13, the domestic reserved letter service lost $147.4m with reserved Ordinary letters losing $134.8m.

Increases to the BPR have lagged considerably behind the CPI for over 20 years, and the proposed increase is based on the need to recover the inflationary impact of input costs.

Reserved letter volumes have declined by over 23% in the past five years with accelerated rates of decline in the past two years. Ongoing acceleration is forecast as continued fixed line broadband growth leads to greater levels of digital substitution for bill payment and presentment.

Globally, many postal peers have increased prices substantially as a result of this to cover the cost of maintaining a largely fixed cost service.

With the increase to ordinary letter services, Australia Post will introduce a concession stamp for eligible Australians. Introduction of a concession stamp removes the impact of the changes as it continues to allow eligible Australians access to 60 cent postage for small letters.

While outside the scope of this price notification, there will also be changes to other domestic letter services including business letter services. One of the key changes is an improvement to the current (PreSort) Surface delivery timetable. All of the changes are part of our broader strategy to provide a sustainable letter service.

2. Introduction

The Australian Postal Corporation Act (APC Act) prescribes that Australia Post is required to supply a letter service that is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business.

In particular, the letter service must be available at a single uniform rate for standard letters carried by ordinary post ('the basic postage rate'). This requirement is part of Australia Post's Community Service Obligations (CSOs) section 27 of the APC Act.

Under the APC Act, Australia Post has the exclusive right to collect, carry and deliver letters within Australia that (subject to exceptions) weigh not more than 250 grams. These statutory monopoly services, along with the right to issue postage stamps, are termed Australia Post's 'reserved services'.

Australia Post was given this statutory monopoly so that revenue from its reserved services could fund the cost of meeting its CSOs. However, Australia Post must deliver its CSOs regardless of whether revenue from its reserved services is sufficient to cover the costs of the CSOs.

The APC Act also imposes commercial obligations on Australia Post. Section 26 of the APC Act imposes an obligation on Australia Post, as far as practicable, to perform its functions in a manner consistent with sound commercial practice.

The letters business operates in a complex and difficult market, where the current combination of rapid volume decline and fixed operating costs imposed by the existing regulatory framework (particularly the CSO-related Performance Standards, prescribed under section 28C of the Act) is leading, inevitably, to deteriorating financial results.

2.1. Australian letter volume decline

Australian domestic addressed letter volumes reached a peak in the 2007/08 financial year (4.6 billion items) and, in the five years since, have fallen by more than one billion items (22 per cent), as Australians have increasingly shifted to digital alternatives for communicating.

The trend of declining physical letter volumes is similar in industrialised nations all over the world. In fact, Australian declines have been relatively subdued and late (thus far), when compared to the volume declines experienced by postal administrations in Europe, Scandinavia, Korea, the United States and New Zealand. For example, the postal services of Denmark, Slovenia and Iceland all reached their letter volume peak by 2003 – and, in the decade since, the community's use of the letters service has halved.

The decline in the Australian community's use of the letters service over the past five years means that, in 2012/13, the total volume of domestic letters Australia Post delivered has already shrunk back to around the same level as in 1994/95 (approximately 3.6 billion items). We expect this decline to continue to accelerate until we reach similar levels to those of our international peers.

Over the past five years, the year-on-year decline in Australian domestic letter volumes has been gradually accelerating, as can be seen in the following Table:

Table 1 – Domestic addressed letter volume

Financial Year	Volume	Year-on-year decline
2008/09	4.4 billion	(4.0%)
2009/10	4.2 billion	(5.6%)
2010/11	4.0 billion	(3.7%)
2011/12	3.8 billion	(5.2%)
2012/13	3.6 billion	(6.0%)

2.2. Fixed operating costs related to the CSO performance standards

The cost involved in the transportation, processing and delivery of Australia's declining letter volume is largely fixed by the obligation to comply with the legislated Prescribed Performance Standards (under Section 28C of the APC Act), which outline the specific timetables, standards and accessibility required of Australia Post to meet the CSO.

For example, the delivery timetable sets a standard of next-day letter delivery within the same metropolitan area and there is a requirement that 94 per cent of non-bulk letters be delivered on time (against the delivery timetable). In addition, the Prescribed Performance Standards include a requirement that Australia Post delivers letters five-days-a-week to at least 98 per cent of all Australian delivery points. The work associated with meeting this 'delivery frequency' standard continues to grow, as population growth adds, on average, 135,000 new delivery points to Australia Post's network, each year.

Given that Australia Post is committed to meeting its community service obligation, in practice, these CSO-related standards effectively impose fixed costs on the letters sorting and delivery network.

As shown at Table 2 Australia Post exceeded all of its CSO-related performance standards in 2012/13, this is consistent with Australia Post's performance for over a decade.

Table 3 depicts the annual CSO costs borne by Australia Post over the past five years.

Table 2 – Performance standards 2012/13[1]

Standard	Required performance	Actual performance
Number of street posting boxes	10,000	15,927
Delivery timetables	Maintained	Maintained
On time delivery of non bulk letters	94%	95.5%
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)	4,429 (2,561 in rural and remote areas)

Table 3 – CSO costs

Financial Year	CSO costs
2008/09	\$113.8m
2009/10	\$147.7m
2010/11	\$144.7m
2011/12	\$165.9m
2012/13	\$177.5m (est)

While addressed letter volumes in 2012/13 were at around the same level as 1994/95, by comparison, the delivery footprint has increased by circa 46%.

[1] Results as at 30 June 2013 (Australia Post Annual Report, 2013)

2.3. The ‘Future Ready’ strategy

Given the impact of digital disruption on Australia Post’s core business, in early 2010 the corporation launched its business renewal program, under the title ‘Future Ready’.

The ‘Future Ready’ transformation program was created to guide the corporation’s strategic and operational response to the shift in customer behaviour being driven by the digital world.

The stated goal of Future Ready involves re-engineering Australia Post to be an enabler of the digital economy. The transformation is underpinned by three enterprise strategies relating directly to Australia Post’s three core activities – communications, retail and parcel delivery.

1. Build a sustainable communications business – both physically and digitally.
2. Offer government, business and financial trusted services for consumers – both physically and digitally.
3. Build a world-class parcels business, with excellence in service performance.

Furthermore, we have underpinned these business strategies with two vital platforms:

- embed the right culture and behaviours, build our capabilities and foster engagement; and
- drive for a productive, efficient and innovative organisation.

2.4. Building a sustainable communications business – physically and digitally

While it is incumbent on Australia Post (from a community service perspective) to continue delivering the nation’s physical letters service, it is also necessary (from a commercial perspective) to secure a sustainable delivery of this declining service, while also planning for growth in the rapidly growing substitute market (i.e. digital communications).

For that reason, in March 2012, Australia Post announced plans to launch the Australia Post Digital MailBox – a free service that adult Australians can use as their own secure, online portal – for receiving and storing important documents, as well as making payments.

The Australia Post Digital MailBox became operational in April 2013 and it is available on any Internet-enabled device (smart-phone, tablet, or computer) – around-the-clock, anywhere in the world.

As at January 2014, Australia Post has signed 42 providers to the Australia Post Digital MailBox.

2.5. Operating environment

Given the ongoing decline of the Australian letters market, we are at a point where changes to the environment within which the letters service operates are necessary to ensure that this ‘physical’ communications service is financially sustainable, in the long-term interest of all Australians.

If these changes are not made, the losses incurred in Australia Post’s ‘Reserved Service’ letters business will become so substantial that they will overwhelm the profitable, non-regulated parts of the business.

To that end, the proposed changes to the Ordinary Letters service cannot be viewed in isolation and must be viewed as one part of a broader strategy to maintain the delivery of a sustainable letters service, of which the domestic reserved letter service is the predominant part. The increase for ordinary letters means the price is closer to the cost of providing the service, whereas the change to the slower delivery timetable for PreSort addresses an issue that we know was preventing some customers from exercising choice based upon their specific requirements and provides Australia Post with greater flexibility within the network.

This flexibility will enable Australia Post to improve its productivity which will assist in achieving a financially sustainable model for managing the on-going volume decline in the letters service.

3. Scope

Australia Post has historically provided information on its domestic reserved letter service in four product categories:

- small Ordinary /Other;
- large Ordinary / Other;
- small PreSort; and
- large PreSort.

In 2011, however, the Australian Government conducted a review of the prices surveillance arrangements of Australia Post's domestic reserved letter service. The review considered whether prices surveillance should focus on the Ordinary letter service and be discontinued for other reserved letter services which are priced below Ordinary letter services or for which specific conditions apply.

As a result of the review, the Australian Government issued a new Declaration which limited the ACCC's prices surveillance of Australia Post letter services to those letter services set out in clause 5 of the Declaration – Ordinary Letter Services.

While under the 2011 Declaration not all domestic reserved letter services are notified services, as the proposed Ordinary letter changes are the first since the change, Australia Post is providing, for information only, details on changes to domestic reserved letter services that are outside the scope of the Declaration.

Australia Post believes this will assist the ACCC in understanding the need for the increase to Ordinary letter prices as well as providing information regarding broader changes Australia Post is pursuing to achieve a more sustainable letter service.

4. Proposed Ordinary Letter service prices

Australia Post's Ordinary Letter service, which includes the basic postage rate (BPR), is provided through four price points:

- the uniform rate for an ordinary small letter (the BPR); and
- three large letter prices.

4.1. Proposed price changes

The proposed ordinary letter prices, effective 31 March 2014, are shown in the following Table. The prices for these letter services last changed in June 2010.

Table 4 – Proposed prices

	Current Price	Proposed Price	Increase %
Ordinary small letter	$0.60	$0.70	16.7%
Ordinary large letter			
- Up to 125g	$1.20	$1.40	16.7%
- Over 125g up to 250g	$1.80	$2.10	16.7%
- Over 250g up to 500g[2]	$3.00	$3.50	16.7%

Under the proposed prices, large letter prices have retained their relativity to the BPR (i.e. they are expressed in multiples of the BPR) to ensure the pricing structure remains simple and easily understood. In 2014/15 (the first full year of the price change) the proposed prices would increase revenue for the Ordinary / Other letter category by circa $95m

With the introduction of the price changes, Australia Post proposes to introduce a concession stamp to protect disadvantaged members of the Australian Community from the proposed increase to ordinary letter prices. At a high level:

- the concession stamp price of 60c will be held until 2017;
- it is available for holders of a Federal Government concession card;
- eligible Australians are able to purchase up to 50 concession stamps per year; and
- eligible Australians will receive five free stamps when they register for the Australia Post concession card.

The proposed prices, which are designed to ameliorate the loss on the ordinary letter service ($135.5m in 2012/13), will be accompanied by changes within other domestic letter services.

[2] Ordinary Large Letters Over 250g up to 500g are non-reserved

4.2. Impact of proposed price changes

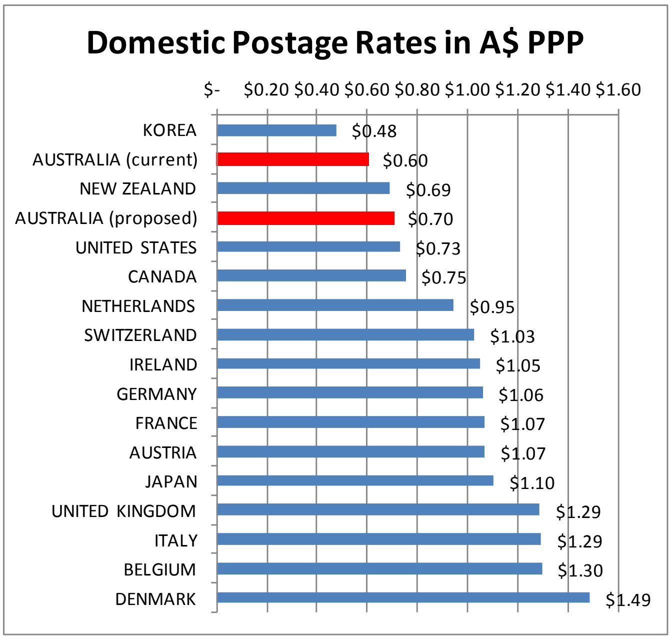
The proposed prices represent only the fourth increase to the BPR since January 1992. As shown in the table below between January 1992 and the latest figures, CPI has increased by more than 70% while the BPR has only increased by 21% (excluding GST)

Table 5 – Change in BPR to inflation

			GST Inclusive		GST Exclusive	
Date	**CPI**	**Change**	**BPR**	**Change**	**Rate**	**Change**
January 1992	59.9	NA	45c	NA	45c	NA
September 2013	104.0	73%	60c	33%	54.5c	21%
31 March 2014			70c	56%	63.6c	41%

A comparison of Australia's BPR against that of some other OECD countries is shown below[3]. Under the proposed price of 70c, Australia's BPR would be the third lowest in the OECD and considerably below that of many European countries.

Table 6 – Domestic postage rates



While Australia's BPR remains low by world standards, as shown in Table 7, the proposed increase of 10 cents is well below the level of increases that have occurred in other OECD countries (in particular European countries) since the end of 2010 and on par with New Zealand despite its considerably smaller size!

[3] PPP of basic letter price in A$ - source OECD and Australia Post, prices in other countries as at April 2013. Does not include the impact of VAT exemptions in some countries

Table 7 – Domestic postage rates, local currency

	Rate at 31 Dec 2010	Rate at April 2013	Change
Australia (current)	0.60	0.60	0.0%
AUSTRALIA (proposed)	0.60	0.70[4]	16.7%
NEW ZEALAND	0.60	0.70	16.7%
UNITED STATES	0.44	0.46	4.5%
CANADA	0.57	0.63	10.5%
NETHERLANDS	0.44	0.54	22.7%
IRELAND	0.55	0.60	9.1%
GERMANY	0.55	0.58	5.5%
FRANCE	0.58	0.63	8.6%
AUSTRIA	0.55	0.62	12.7%
UNITED KINGDOM	0.41	0.60	46.3%
ITALY	0.60	0.70	16.7%
BELGIUM	0.59	0.77	30.5%
DENMARK	5.50	8.00	45.5%

Australia Post estimates that the average household now sends around 20-40 letters per year. Based on this the average impact to a household from the proposed changes is $2 - $4 per annum.

Appendix 1 provides an overview of changes to the domestic letter service; Appendix 2 provides detail on the accompanying price changes and Appendix 3 details volume, revenue and cost data out to 2014/15.

4.3. Customer consultation and feedback

Australia Post undertakes consultation with customers to:

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

Traditionally Australia Post has focussed on the major users of Australia Post's domestic reserved letter services. Within this audience the most interest generally comes from changes that impact the business letter services (largely PreSort).

Therefore while the consultation can cover changes across letter services (including ordinary letter services) the consultation with major customers, mail houses, industry associations and envelope suppliers has included improvements to the current Surface delivery timetable.

The new timetable will be one to two days longer than the current Regular delivery timetable and will come into effect from 31 March 2014.

Potential use of this timetable will be driven by two major factors – the nature of the communication / time sensitivity of the content and the price differential between the timetables.

Generally customers support the improved delivery timetable and a number of mailers have noted their intent to migrate / use to this improved timetable, while others are waiting until we provide information on the proposed prices. Feedback specific to the change to Ordinary letter prices is minimal with no indication it would disadvantage a particular market segment.

While not incorporated into the consultation, the introduction of the concession stamp aligned to the date of the increase to ordinary letters, removes the impact of the changes to around 5.7m eligible Australians. Appendix 4 provides a list of customers who have taken part in the consultation process so far.

[4] Australia's rate is that proposed from April 2014

5. Letter volumes

The letter volume forecasts in this document are:

- the same as those in the 2013 Corporate Plan; and
- generated based upon the same methodology as that accepted by the ACCC in Australia Post's notification of 2011.

5.1. Situation

In 2012/13 domestic reserved letter volumes declined by 6.5%, exceeding the 4.2% decline forecast in Australia Post's 2012 Corporate Plan and represented the largest level of decline over the last five years. For ordinary / other letters the level of decline was greater 9.9%.

The Table below details the volume decline for domestic reserved letters and ordinary / other letters and shows the cumulative and average rate of decline since 2007/08.

Table 8 – Domestic reserved letter volumes

	2008/09	2009/10	2010/11	2011/12	2012/13	CAGR	Total (%)
Total	(3.9%)	(5.6%)	(3.6%)	(5.4%)	(6.5%)	(5.0%)	(22.6%)
Ordinary / Other letters	(6.6%)	(6.5%)	(5.8%)	(7.0%)	(8.6%)	(6.9%)	(30.1%)

- While the market challenges and opportunities facing Australia Post remain the same, their pace and magnitude have increased. As shown in Table 9 we are forecasting continued similar declines in 2013/14 and 2014/15.

Table 9 – Domestic reserved letter volumes

	2013/14	2014/15
Forecast	(6.6%)	(6.9%)

These forecast volume declines mean that the loss of $147m in 2012/13 will grow. In response to this situation, Australia Post will continue to promote the strategic value of the mail channel and pursue opportunities to reduce costs as letter volumes decline.

5.2. Ordinary letters – background

In the 1970s, 80s and early 90s aggregate letter volumes were essentially driven by a number of long run drivers that included real non-farm gross domestic product (GDP), population growth, delivery service performance and changes in real price of an individual letter item.

Of these variables, movement in the level of economic activity proved to be the primary long run driver of aggregated letter volume fluctuations which was unsurprising given a large proportion of mailings tended to be transactional in nature.

Although the importance of the transactional letter item still remains, a new era characterised by technological and behavioural change has resulted in significant threats to the demand for the traditional mail item.

Indeed, the combined forces of substitution, consolidation and rationalisation have substantially crowded out any linkage between movements in letter volumes and fluctuations in the level of Australian GDP.

To understand why this has occurred it's important to acknowledge the underlying mix within the transactional small letter segment.

The majority of transactional letters tend to be either bill presentments/statements (referred to in this document simply as presentments) or bill payments.

Since the mid to late nineties there are two fundamental changes that impact the econometric models:

- *Bill payments* – gradual substitution away from physical mail which commenced in the nineties and continues today due to the popularity of online bill payment platforms and the option of settling via direct debit.
- *Bill presentment* – following the global financial crisis, all segments of Australia Post's letter volumes began to register annual declines. While it was predicted that PreSort small letter volumes would decline, other small letter volumes have also experienced severe decline.

5.3. Summary

The most significant trend in recent times involves a sustained movement towards bill presentment substitution that has resulted in a series of annual declines in PreSort Barcoded small letter volumes whilst also accelerating the year on year declines in Other small letter volumes.

Despite strong recipient support still existing for the physical letter, the bill presentment declines are being driven by business strategies that aim to reduce transaction costs including the imposition of surcharges on the provision of a paper-based bill/statement and a tendency to not provide the option for a paper-based bill with new services.

As a result fluctuations in macro indicators such as the level of economic activity have diminished in their ability to explain and predict letter volume movements as income elasticities are being continually eroded.

Australia Post's letter segments are now entrenched within this new wave of electronic substitution as the propensity for invoice and statement presentments to migrate across from the traditional letter to an electronic alternative has never been greater.

5.4. Letter volume forecasts and methodologies – background

In the ACCC Decision of May 2010, in reference to the econometric baseline derived by Diversified Specifics the ACCC concluded.[5]

> *Australia Post has significantly improved the sophistication of its demand forecasting methods. The ACCC considers that the volume forecasts are appropriate for its assessment of the 2010 price notification.*

Moreover, Frontier Economics resolved*:*[6]

> *Diversified Specifics' econometric analysis was in line with internationally accepted leading practices in mail volume forecasting.*

And, that:[7]

> *Australia Post has adopted a more sophisticated approach to forecasting mail demand [and] Diversified Specifics has derived baseline econometric forecasts based on best practice time series technique for mail volume forecasting.*

The econometric forecasts were intended to represent a baseline over which further intelligence could be overlaid to deal with a lack of tractable empirical data on the emerging threats to letter volumes.

In further development of this approach we have worked with Diversified Specifics to develop a set of segmented letter volume forecasts that encompass both the econometric and some augmented components.

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[5] Australian Competition and Consumer Commission, Australian Postal Corporation 2010 Price Notification Decision Public version, May 2010, p.45

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

[7] Frontier Economics, Review of Australia Post's volume and input cost forecasts – a report prepared for the ACCC, May 2010, p. iii.

This has resulted in a set of forecasts that are premised upon:

- historical associations governing letter volume fluctuations – reflected in the econometric baseline that are derived utilising vector error correction modelling (VECM) techniques; and
- emerging threats to letter volumes – based upon research into recent technological and behavioural developments.

These forecasts from Diversified Specifics are subject to further augmentation by Australia Post before finalising.

5.5. Other small letter volume forecasts

In 2012/13 Other small letter volumes declined by 8.8%, a figure almost double the annual fall across the previous three years.

As shown at Table 10 accelerated Other small letter volume declines are projected as substitution is occurring on two fronts, bill payments and presentments.

Bill payment mailings have traditionally been characterised by a sustained decline over a 15 year period and have explained an average decline in the Other small letter volume segment of 3.3% over the 2000/01 to 2011/12 timeframe.

However, the SME bill presentment component of Other small letter volumes is now also under significant threat from online platforms which, with the proliferation of various mobile devices, now offer a greater variety of mediums when rendering an invoice.

Applying Australia Post management insight, Diversified Specifics have applied a factor of 25% to the total of Other small letter volumes, given that the remaining 75% is conservatively assumed to consist of other types of mailings.

Assuming 25% of Other small letter volumes are invoices and statements, then the rate at which they are being substituted towards electronic bill presentment platforms may be approximated by research that suggests that the estimated annual volume increase in electronic bills/invoices is anticipated to be 20%.[8]

To derive an approximation of the aforementioned quantity of SME invoicing volume substitution the world growth rate in electronic bills and invoices (20%) is then applied to the 25% proportion of Other small letter product segment volumes as given by the econometric forecasts.

In generating forecasts for the Other small letter volume segment the statistically significant volume drivers which are incorporated in baseline (econometric) forecasts over the 2002 Q4 to 2012 Q3 timeframe are:

- *Bill Payments Type Substitution* – cheque volumes (representative of bill payments sent via the mail) are hypothesised to be positively associated with Other small letter volumes. A reduction in cheque volumes therefore suggests a movement away from the physical mail item leading to declines in Other small letter volumes.

  A cheque volume decline of 13.07% is employed and given by the rolling 12 month September 2011 to September 2012 statistic in the absence of externally available projections on this variable;
- *Real Price* – the real cost (i.e. price adjusted for inflationary effects) of sending Other small letter mail is inversely related to demand. Price changes in the examined time frame have been significantly associated with demand responses in the contrary direction.

  CPI projections resulting in real price changes of negative 2.25% over 2013/14 and 2014/15 as given by the Commonwealth Budget have been utilised as proxies for 2013/14 to 2014/15 real price projections.[9]

[8] E-Invoicing E Billing - The catalyst for AR/AP Automation, Billentis, 2013, p.8
[9] Commonwealth 2013/14 Budget - 14 May 2013 p.45

For the second scenario a 16.7% from April 2014 nominal price increase has been incorporated.

- *The closure of the Unbarcoded PreSort service* – this resulted in migration towards the Other small letter volume segment and is captured in the modelling process by a dichotomous variable.

Table 10 – Other small letter volume forecast growth rate

	Econometric forecasts		Econometric forecasts augmented with additional intelligence
	Incorporating bill payments substitution and **no** nominal price rises	Scenario 2 - incorporating bill payments substitution with a nominal price rise of 16.7% in April 2014	Incorporating bill payments and presentments substitution with a nominal price rise of 16.7% in April 2014 and election related mailings
2013/14	(4.79%)	(4.79%)	(9.47%)
2014/15	(5.88%)	(10.16%)	(15.41%)

5.6. Other large letter volume forecasts

Other large letter volumes are also expected to be impacted significantly by substitutive pressures.

Unlike its small letter counterpart, it is very difficult to definitively profile the contents of a typical Other large letter item.

As a result substitution effects pertaining to the Other large letter volume segment tend to reflect a general trend towards increasing usage of digital technology within the Business to Business and Business to Customer segments of the economy.

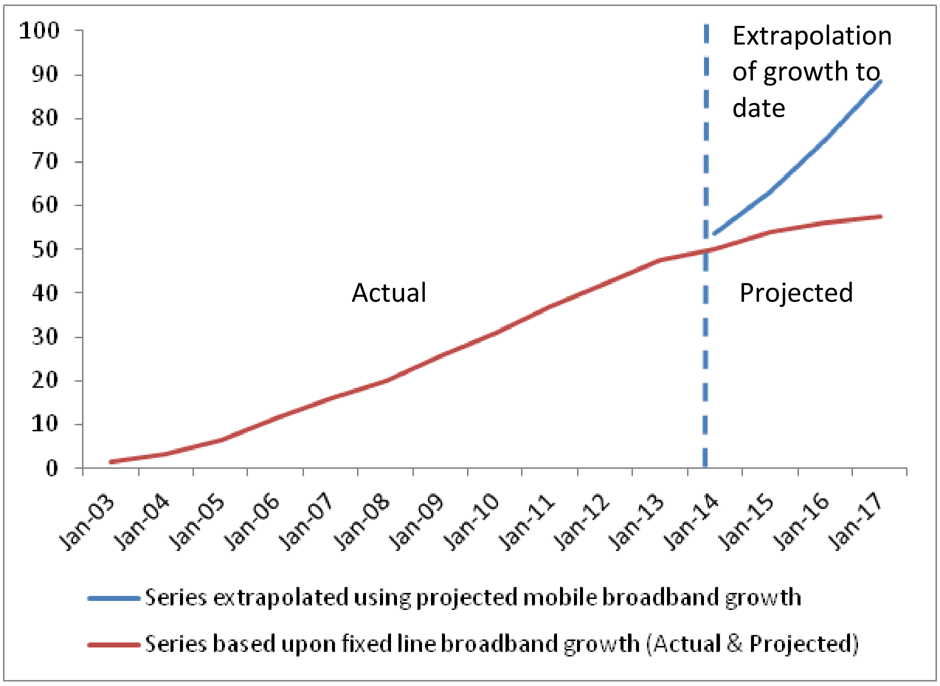
Fixed line broadband growth therefore acts as an effective proxy for capturing these substitutive pressures historically.

The underlying hypothesis suggests that as the number of broadband connections has increased substantially in recent years, electronic documentation such as PDFs and Microsoft word documents have now become viable alternatives to a physical mail item that previously would have resided in the Other large letter domain.

When constructing letter volume forecasts however a fixed line broadband penetration variable adds little utility if set equal to its anticipated growth rates.

This is due to fixed-line broadband growth approaching a saturation point, as illustrated in Chart 1 and this plateau does not reflect the continued movements away from the traditional Other large letter mail item that have been recently observed and are likely to be observed in the forecast period.

Chart 1 – Fixed line broadband growth index



Data Source for actuals is an index created by Diversified Specifics based upon original data from (1): Internet Activity, Australia, Dec 2010, Australian Bureau of Statistics; & (2): Snapshot of Broadband Deployment, Australian Competition and Consumer Commission with the projected values approximated by Diversified Specifics based upon recent declining trends in the index itself.

As shown at Table 11, anticipated growth is expected in LTE 4th generation technology (of which Australia is an early adopter), tablets and next generation smartphones.

Projections on each of these indicators suggest aggressive increases in the anticipated rates of mobile broadband traffic.

Such data is therefore deemed to be more appropriate as a proxy for capturing the next wave of Other large letter substitution given the elasticities generated via the econometric models are a direct function of similar growth rates for fixed-line broadband in its own period of exceptional growth.

Table 11 – Forecast growth on prior year in mobile technologies

	LTE Subscriber Growth*	Asia Pacific Mobile Data Traffic^
December 2013	122%	113%
December 2014	88%	90%
December 2015	61%	81%
December 2016	56%	74%
December 2017	50%	65%

* LTE (Long Term Evolution) subscriber growth forecast from 2012 to 2017, Informa Telecoms & Media
^ Cisco, 2012, p.24

The statistically significant Other large letter volume drivers over the 2008Q1 to 2012Q4 timeframe are:

- **Substitution** – in the Other large letter model, substitution is captured by the domestic broadband variable as being representative of the growth in EDI (electronic data interchange) technology, email transmission of larger documents and the proliferation of online form facilities.

Projections on the Broadband Connections growth rate are set to an approximation of the annual growth rate in mobile technologies based on a range of mobile broadband indicators; and

- **Domestic Non-farm Economic Activity** – Other Large Letter volumes are associated with movements in the general health of the economy.

Projections on GDP growth rates utilised were 2.75% (2013/14) and 3.00% (2014/15) as given by the Commonwealth Budget (Commonwealth 2013/14 Budget - 14 May 2013 p.45).

Other large letter ex-ante baseline forecasts are presented in the following Table.

Table 12 – Other large letter volume forecast

	Econometric forecasts
2013/14	(5.61%)
2014/15	(4.86%)

Letter volume forecasts for the key letter segments have been provided in an Excel Spreadsheet.

5.7. Promotion of the mail channel

Australia Post supports the promotional mail channel at both an industry level and a specific customer level.

Industry Support – Australia Post:

- sponsors relevant industry events (that provide an opportunity to promote the use of promotional mail to a wide audience of general marketers;
- undertakes regular research on the mail channel and promotes the findings via industry events and promotional campaigns; and
- recently formed a Working Group with ADMA to identify and develop further initiatives to support and encourage the use of direct mail – initiatives currently being assessed range from new products, to additional promotional activities and incentives for specific applications of direct mail e.g. Teaser / Reminder Campaigns.

Customer Support – Australia Post's:

- mail specialists work with individual customers to identify and support opportunities for ongoing or additional use of direct mail to meet their business objectives; and
- account team supports the mail production industry (mail houses) with any specific customer requests related to producing direct mail campaigns e.g. non standard envelope creative.

Lifestyle Direct Marketing:

- Our Australian Lifestyle Survey provides data and insight to help organisations acquire new customers and to enhance their marketing activity. With over 2.5 million customer records available for direct mail campaigns, organisations are able to select from over two hundred variables to identify lifestyle characteristics and profiles of consumers, supporting tailoring their copy and creative communications to achieve higher return on investment on marketing campaigns.

6. Costs

This section provides a breakdown of Australia Post's cost forecasts by major category and provides further information on those forecasts including the impact of changes in quantity (e.g. volume) and input costs on those cost forecasts.

The forecasts included in this section are the same as those in the 2013 Corporate Plan.

Table 13 – Financial overview

	Final result	**Forecast**	**Forecast**
$million	**2012/13**[10]	**2013/14**	**2014/15**
Trading Revenue			
- Communication Management Services	2,208	2,149	2,150
- Parcel and Express Services	2,651	3,308	3,550
- Retail Services	892	910	954
- Other	42	16	39
Total Trading Revenue	**5,794**	**6,383**	**6,693**
Trading Expenses (Cost)			
- Labour and Oncosts ./Contract Services	2,800	3,085	3,139
- Goods / Services for Sale	216	236	256
- Accommodation	301	355	370
- Depreciation	233	280	357
- Other Non-Labour	1,847	2,170	2,331
Total Trading Expenses	**5,397**	**6,126**	**6,454**
Trading Profit[11]	**397**	**257**	**238**

6.1. Cost allocation

Australia Post's cost allocation model is a fully absorbed costing model that allocates costs to products and services via the following main principles:

- All products and services are charged appropriately with the costs of the enterprise;
- Activity based costing is used as the appropriate cost allocation methodology. Resources (cost inputs) perform activities (the doing things). Activities are used by products and services;
- Direct attribution of costs to products is conducted, wherever possible; and
- Sound allocation rules based on the best available data are employed where direct attribution is not possible.

The cost allocation model is used as the key internal reporting tool, providing financial metrics for each business unit to ensure a sharp focus is maintained on costs.

Our cost allocation model also supports a number of external reporting requirements including:

- Record Keeping Rules (RKRs) requirements;
- Price notifications;
- Audited annual report (segment note); and
- Quarterly shareholder reports.

[10] In November 2012 Australia Post acquired the remaining half share of StarTrack
[11] Excludes all non-trading items

RKRs are a fundamental component of our external validation processes. The audit of the RKRs takes place over an intensive five week period each year.

The annual compilation of the Regulatory Accounting Procedure Manual enables an annual checkpoint of policies. The Regulatory Accounting Procedure Manual is reviewed both by external audit and the ACCC prior to its finalisation.

Each year since 2004/05 the ACCC produces an annual report '*Assessing cross subsidy in Australia Post*'. Each year as part of preparing this report, the ACCC scrutinises Australia Post's cost allocation methodology.

6.1.1. Methodology

Australia Post's cost allocation methodology is robust and relevant.

- product volume is the dominant cost driver in the model;
- product volume is measured in each activity (providing activity specific volume) and in each geographic state (state originating and terminating volumes); and
- products do not receive activity cost if there is no volume of product in the activity.

The Full Cost Allocation Methodology employed in Australia Post inherently increases the cost burden for products experiencing volume growth and lessens the burden for products in structural decline.

In relation to reserved service costing under a 'dual till' regulatory approach, this ensures that as demand for reserved service letters declines, an increasing proportion of Australia Post's total cost base is borne by products open to competition.

While the principles underpinning our cost allocation model are unchanged, we continue to refine and update the model to reflect changes in the business. Examples of this include:

- the addition of new non reserved products – Express Post articles >5kg and Parcel Post Plus;
- increasing the volume of international packets < 2kg through the postal delivery officer stream (more volume added to existing non barcoded small packets); and
- changes to our business structure necessitating increased focus on resource mapping. With total indirect cost pools having been rebuilt more of our costs are charged directly to products.

Extending the range of non reserved services that can use the network has helped to limit the loss of scale in the network from declining reserved letter volume.

6.1.2. Safeguards

An increasing proportion of Australia Post's cost base relates to non-letter activities, which follows the growth trend of the business (i.e. the business has invested in dedicated parcels infrastructure, both owned and contracted)

The cost allocation model has safeguards to avoid over-costing declining products – reserved service letter products bear less of the fixed cost burden of the network over time.

The model achieves this as all activity cost is volume variable, regardless of whether the underlying resource used in the activity is fixed or variable.

In multi-product activities, product volume and the product consumption rate of activity resources, determine the cost allocation to each product. If consumption rates remain relatively stable over time, then cost allocation is predominantly volume dependent.

As the volume of reserved service letter products structurally decline over time, the economic cost per unit of all products in multi-product network activities increases proportionately.

Within Australia Post's volume variable economic model, products that are experiencing volume growth are deemed to be placing greater demand on shared activity resources than those that are declining. A consequence of the long term structural decline of reserved service letter products is rising activity cost per unit through diseconomies of scale, coupled with rising factor input costs due to wage inflation and CPI in a predominantly labour intensive industry.

In the absence of productivity improvement, activity cost per unit of throughput (measured as standard article equivalent) will proportionately increase or decrease by the % change in throughput and % change in factor prices.

All products in the shared activity therefore bear the same proportional change in activity cost per unit, however, products experiencing volume growth will absorb a greater share of the total activity cost pool, while products in decline absorb a lower share.

6.1.3. Influence of cost driver changes

Product volumes are updated in the model monthly and activity throughput is assessed annually. Changes are reflected in the model if there are material changes identified in mail flows across the network.

Consumption rates (time, weight, mass, repetitions) are reviewed when activity costs deviate from expected tolerances (i.e. activity unit costs increase / decrease sharply)

The increasing rate of losses in the reserved service is a function of regulated prices and declining volume combining to generate insufficient revenue to cover rising unit costs through diseconomies of scale and rising factor prices.

Productivity improvements are necessary to limit increases in the unit cost of products that share activities with reserved service letter products in order to maximise profit margins at competitive market prices.

6.2. FTE usage

As shown in Table 14, the number of Full Time Equivalents (FTEs) is forecast to decline slightly in 2014/15.

Table 14 – Total FTEs by function

Activity / Area	Forecast	
	2013/14	**2014/15**
Sales / Acceptance	3,055	3,053
Processing	6,679	7,040
Transport	2,195	2,134
Delivery	14,327	14,209
Other areas	5,539	5,080
Total	**31,795**	**31,516**

A breakdown of these FTEs by full time, overtime and part time is shown in Table 15.

Table 15 – Total FTEs by type

Type	Forecast	
	2013/14	2014/15
Full time	23,706	23,632
Overtime	1,647	1,654
Part time / casual	6,442	6,230
Total	**31,795**	**31,516**

6.3. Domestic reserved letter service

Table 16 details 2012/13 final result data and the latest forecasts for the domestic reserved letter service. Note: the information in this section is based on the 2013 Corporate Plan. The revenue impact of the proposed prices is at Appendix 3.

Table 16 – Domestic reserved letter service

	Final result	Forecast	
	2012/13	2013/14	2014/15
Volume (m)	3,306	3,089	2,875
Revenue ($m)	1,716	1,659	1,654
Cost ($m)	1,864	1,936	1,960
Profit ($m)	**(147)**	**(277)**	**(306)**

6.4. Relationship between costs and volumes – cost elasticity

Australia Post engaged Economic Insights Pty Ltd to undertake an econometric analysis of the likely effects of declining mail volumes and declining mail density on Australia Post's future costs.

This is done by econometrically estimating cost elasticities which show the percentage change in costs in response to a one per cent change in output. A cost elasticity of one would indicate that costs change by exactly the same percentage as output while a cost elasticity of zero would indicate that costs are totally independent of output changes.

This study provides information on postal cost elasticities specifically for Australia and using recent data from the period of secularly declining mail volumes. It also uses flexible functional forms for the estimated cost function and covers all inputs whereas earlier studies have tended to use simple functional forms and only cover labour data.

A copy of the report will be provided to the ACCC.

Based on their econometric analysis of Australia Post's processing and delivery functions (which they noted combined account for over 80% of Australia Post's operational costs), Economic Insights Pty Ltd concluded that the output changes observed in 2012/13 in isolation would have *increased* Australia Post's reserved service real operational costs by 0.2 per cent.

6.5. Superannuation

This section details how for the ten years ended 2012/13, providing defined benefits through the APSS has materially reduced the Australia Post's superannuation expense and cash superannuation contributions

6.5.1. Defined benefit scheme

Since 1991, Australia Post has provided employee members of the APSS with retirement benefits equal to 14.3% of their final average salary for each year of service. At 30 September 2013 the APSS defined benefit component held $3,537m in assets, representing a $2m surplus over the $3,535m of vested employee liabilities.

Although the nominal benefit rate of 14.3% provided to employees is greater than legislated Superannuation Guarantee obligations, these benefits are largely funded from the returns on existing APSS investments as well as company contributions to the scheme.

Based on independent actuarial assumptions, funding the defined benefit obligations of all existing APSS members will require annual employer contributions equal to 9.5% of employee salaries. This contribution rate is lower than the equivalent superannuation guarantee contributions.

For the ten years ended 2012/13, providing defined benefits through the APSS has materially reduced the corporation's superannuation expense and cash superannuation contributions. Over this period the APSS has provided expense savings of $768m and cash savings of $749m.

6.5.2. APSS Cost Management

Although still favourable, the financial benefits derived by Australia Post from sponsoring the APSS have reduced since the global financial crisis and are no longer considered adequate to compensate for the risk of exposure to movements in the $3.5bn of funds invested.

To actively manage the growth superannuation liabilities and superannuation expense, the scheme was closed to new members in July 2012. Current projections show the total benefit liability will peak in 2016/17 and decline thereafter. In addition, operational efficiency gains in 2012/13 delivered $0.5m of savings with another $0.5m being targeted in 2013/14.

6.5.3. Change in Accounting Standards

In financial reporting periods up to 2012/13, calculation of Australia Post's defined superannuation benefit expense assumed that investments within the APSS would generate market returns of 7.25% to 8.30%, as determined by the fund's independent actuary. These returns acted to reduce Australia Post's superannuation expense.

From 1 July 2013, new international and Australian accounting standards require calculation of the defined benefit expense to assume all investments will generate returns equal to the long term government bond rate. At 30 June 2013, this rate was 3.76%. This change significantly reduces subsidisation of superannuation expense previously provide by investment returns and is projected to increase the enterprise superannuation expense from 2013/14 onwards.

6.6. Depreciation

Australia Post's capital plan was updated as part of the 2013 Corporate Plan. Table 17 details the depreciation expense through to 2014/15.

Table 17 – Depreciation expense, domestic reserved letter service

	Forecast	
	2013/14	**2014/15**
Buildings and Fitout	18	22
Plant and equipment	23	24
Computer software	35	56
Motor vehicles	23	23
Total	**99**	**125**

7. Productivity

Australia Post's cost containment and productivity targets for the network 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.

7.1. International benchmarking study

The ACCC, in its Preliminary View of June 2008[12], noted 'There is only a limited amount of research on international benchmarking of postal service performance in the academic literature.' Then stated that 'An international benchmarking study comparing the productivity performance of Australia Post with other overseas postal service operators could provide insight into the relative efficiency of Australia Post compared with postal operators overseas.'[13]

Consequently, to provide an international perspective, Australia Post, in late 2008, commissioned Economic Insights to undertake an international benchmarking study, the outcome of which would be provided as part of a future price notification.

A key requirement for participants was the use of an independent expert to undertake the study (Economic Insights) and the need for the data provided to the independent expert to be kept confidential.

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).

A key requirement for participants was the use of an independent expert to undertake the study (Economic Insights) and the need for the data provided to the independent expert to be kept confidential.

The study concluded that:

> 'Australia Post has shown the most consistent improvement in total factor productivity (TFP) of the seven postal services reviewed. Importantly, Australia Post improved its ranking when formal, statistically based adjustments were made for differences in mail and customer density with its TFP level being ranked first or second after the adjustments were made.'[14]

In participating in the study a key requirement for participants was the use of an independent expert to undertake the study (Economic Insights) and the need for the data provided to the independent expert to be kept confidential.

In late 2011 Australia Post commissioned Economic Insights to update and extend the 2009 study. Additional postal services were invited to participate however, not all were able to accept the invitation.

As with the previous study, a condition of participation by the participants was that data and results for each service remain confidential.

To maintain this confidentiality each participating postal service received a report that identified its own performance only relative to the other services labelled as A, B, C, etc.

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[12] Page 138
[13] Page 139
[14] Page iv, International Benchmarking of Postal Service Productivity, Economic Insights, 5 June 2009

The output and input categories were the same as in the 2009 study.

As productivity performance is influenced by the operating environment conditions to allow like–with–like comparisons of performance, it is necessary to adjust for the most important operating environment conditions to put the services on a relatively even footing.

For postal services two of the most important operating environment differences are mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length).

On an unadjusted basis, Australia Post ranked second in terms of TFP. When the adjustment was made to take account of both mail and customer density differences however, Australia Post improved its relative position from second to first.

The study concluded that:

- Australia Post showed improvement over the sample period for its unadjusted TFP measure compared with three of the five postal businesses; and
- while another postal business, which was the highest ranked postal service for the unadjusted TFP measure, showed a slightly better performance over the sample period, Australia Post improved its ranking to first for its TFP level when formal, statistically based adjustments were made for differences in mail density and customer density.

8. Asset base

This section focuses on Australia Post's fixed asset base and includes both the inherited fixed asset base and the incremental changes to it arising from the Australia Post's capital investment plans out to 2016/17.

8.1. Australia Post's balance sheet

As at 30 June 2013[15] Australia Post's balance sheet comprised $4,402m in total assets, $2,720m in liabilities, and $1,682m in equity, or net assets. Table 18 shows the current and non-current (fixed) assets as per the balance sheet (Appendix 5).

Trade and other receivables includes: loans to controlled and jointly controlled entities, and provision for impairment of loans to controlled and jointly controlled entities.

Table 18 – Australia Post total assets

Assets	**Value $million**
Current assets	
- Cash and cash equivalents	293
- Trade and other receivables (including accrued revenues)	594
- Inventories	49
- Other current assets	304
Total current assets	**1,240**
Non-current assets	
- Trade and other receivables	99
- Investments in jointly controlled entities	3
- Superannuation asset	0
- Land and buildings	797
- Plant and equipment (including motor vehicles)	647
- Intangible assets (including software)	1,123
- Investment property	173
- Deferred income tax assets	304
- Other non-current assets	17
Total non-current assets	**3,162**
Total assets	**4,402**

[15] Australia Post Annual Report 2012/13, Financial and Statutory Reports, page 54

8.2. Asset accounting policies and practices

As show in Table 18, at 30 June 2013 Australia Post had $3,162m of non-current assets recognised in the balance sheet.

Fixed 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 cannot 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.

Appendix 6 provides further detail on Australia Post's fixed assets.

8.3. Capital investment plan

Australia Post prepares a capital investment plan each year as part of the annual planning process. The current capital investment plan was updated as part of the 2013 Corporate Plan. As such forecast data provided is consistent with the 2013 Corporate Plan.

Table 19 – Capital investment plan

$million	2012/13	2013/14	2014/15
2012 Capital investment plan	**400**	**400**	**400**
2013 Capital investment plan	**391**	**473**	**400**

Table 20 details capital investment outlays by category. As above, data within this Table is consistent with the 2013 Corporate Plan.

Table 20 – Capital investment outlays by category

$million	2012/13	2013/14	2014/15
Total Strategic	**264**	**376**	**279**
Asset Replacement	**127**	**97**	**121**
Total	**391**	**473**	**400**

8.4. Forecast asset base

Table 21 details Australia Post's total fixed assets out to 2014/15. Data is consistent with the Record Keeping Rules schedules (the allocation of costs, asset values are allocated to products according to procedures specified in the Regulatory Accounts Procedures Manual (RAPM), which has been provided to the ACCC in accordance with section 23 (6) of the RKR).

Investment Property and Land and Buildings are measured at Fair Value, whereas Plant and Equipment and Intangible Assets are measured at cost, net of any accumulated depreciation/amortisation and/or impairment losses. Fixed asset opening and closing balances include assets under construction and agree to the RKR schedules.

Table 21 – Australia Post total fixed assets and intangibles

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	2,438	3,351	3,460
Net Additions	1,160	409	400
Depreciation	(247)	(300)	(377)
Closing balance	3,351	3,460	3,483

Table 22 details the domestic reserved letter service total fixed assets including assets under construction. Appendix 7 provides a breakdown of Table 22 by each letter category

Table 22 – Domestic reserved letter service fixed assets and intangibles

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	893	788	753
Net Additions	(9)	64	62
Depreciation	(97)	(99)	(125)
Closing balance	788	753	690

Additions in 12/13 and 13/14 are for asset replacement including; transport, delivery centre relocations, mail centre air-conditioning and other building and system upgrades. Out year forecasts are also for asset replacement.

9. Rate of return

This section 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 (CAPM); and*
- *Australia Post has sought independent advice regarding the corporation's WACC.*

The 2013 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.

9.1. Australia Post Corporation WACC

Australia Post has recently engaged Value Adviser Associates to undertake an independent assessment, and provide estimates, of certain parameters used to derive Australia Post's weighted average cost of capital ('WACC').

Table 23 details the parameters used to derive Australia Post's WACC submitted as part of this notification, following the independent assessment from Value Adviser Associates. Appendix 8 provides further detail regarding these parameters.

Table 23 – Australia Post Corporation WACC

WACC Parameter	Based on latest advice
rf nominal risk-free rate-of-return	4.22%
rm-rf market risk premium	6.50%
Tc corporate tax rate	30.00%
γ imputation factor	0.2
Cost of debt	5.72%
D/V Australia Post's gearing ratio	30.0%
βa asset beta	0.75
βd debt beta	0.2
βe equity beta	1.0
Nominal vanilla WACC	**9.14%**

10.Post Tax Revenue Model Summary

Australia Post is proposing that the price changes take effect from 31 March 2014. A comparison of the proposed and allowable revenues over the 2013/14 to 2014/15 financial years is shown in Table 24

Table 24 – Post Tax Revenue Model summary 2013/14 to 2014/15

Post Tax Revenue Model - Summary

		2013/14 $m	2014/15 $m
Nominal Vanilla WACC	9.14%		
Required Revenue		$ 2,000	$ 2,027
Present Value of Required Revenue		$ 1,948	$ 1,922
Sum of PV over 2 years		$ 3,870	
Letters Revenue at proposed prices		$ 1,712	$ 1,714
Present Value of Proposed Letters Revenue		$ 1,667	$ 1,625
Sum of PV over 2 years		$ 3,292	
Deficiency of Letters Revenue to Required Revenue		$ 281	$ 297
Sum of PV over 2 years		$ 578	

Note: PV calculations are future values discounted by inflation

Appendix 1 – Changes to the domestic reserved letter service

Australia Post is required to manage dual objectives of earning a commercial rate of return and meeting its Community Service Obligations (CSO).

With the rise of digital communication, accelerated letter volume decline and continued growth in delivery points, meeting these objectives is becoming increasingly difficult.

As noted earlier Australian domestic addressed letter volumes reached a peak in the 2007/08 financial year (4.6 billion items) and, in the five years since, have fallen by more than one billion items (22 per cent), as Australians have increasingly shifted to digital alternatives for communicating.

Complicating the matter is the fact, like other network businesses, to ensure we maintain the required capability our network costs remain largely fixed.

While challenging, the challenges we face are similar to most posts. As noted in a BCG report, '…it is an illusion to think that growth in non-mail areas can reduce the need for rigorous restructuring in mail.'

In 2011, to achieve a sustainable letter service Australia Post introduced changes which were designed to improve the positioning of our slower PreSort service (currently called PreSort Surface). At that time we improved the delivery timetable by providing delivery over a two day window rather than a four day window. We also increased the price differential between the Regular and Surface products.

The changes proposed to take effect from 31 March 2014 continue to build on this approach. From 31 March 2014 we will:

- increase the basic postage rate (BPR) to 70 cents with flow on increases to ordinary large letters to remain priced in multiples of the BPR;
  - At 70 cents, the BPR would still be affordable, representing an average additional cost of $2 - $4 per annum to the average household.
- introduce a concession stamp. A concession stamp removes the impact of the increase to ordinary letter services as it continues to allow eligible Australians access to 60c postage for small letters; and
- improve the current PreSort 'surface' delivery timetable.

While in itself migration to the slower PreSort delivery timetable does not provide Australia Post with a significant cost saving opportunity, Australia Post believes there is a longer term benefit (greater network flexibility) from encouraging this migration.

Australia Post's current network design is largely built around the need to perform to the ordinary letter delivery timetable (to which Regular is aligned) – this includes the requirement for overnight processing and delivery to at least 98% of delivery points five days a week. The majority of letters are carried in accordance with this timetable.

As the proportion of letters sent at the slower speed increases, Australia Post will analyse the impact upon the current network design to identify where opportunities for changes may arise

To that end, the proposed changes to ordinary letters cannot be viewed in isolation and must be viewed as one part of a broader strategy to maintain the delivery of a sustainable letters service, of which the domestic reserved letter service is the predominant part. The increase for ordinary letters means the price is closer to the cost of providing the service, whereas the change to the slower delivery timetable for PreSort addresses an issue that we know was preventing some customers from exercising choice based upon their specific requirements and provides Australia Post with greater flexibility within the network.

This flexibility will enable Australia Post to improve its productivity which will assist in achieving a financially sustainable model for managing the on-going volume decline in the letters service.

Appendix 2 – Price changes

While under the 2011 Declaration only Ordinary letter services are notified services, Australia Post is providing, for information only, detail on price changes to domestic letter services outside the scope of the Declaration.

Ordinary / Other Prices - GST Inclusive

	Current $	Proposed Price $	Increase %
Small			
Stamped	$ 0.60	$ 0.70	16.7%
Concession (NEW)	NA	$ 0.60	NA
Metered/Imprint	$ 0.60	$ 0.68	13.3%
Local (Country)	$ 0.583	$ 0.68	16.6%
Seasonal Greeting	$ 0.55	$ 0.65	18.2%
Clean Mail	$ 0.583	$ 0.66	13.2%
Reply Paid			
Barcoded	$ 0.46	$ 0.49	6.5%
Unbarcoded	$ 0.75	$ 0.85	13.3%
Large			
Seasonal Greeting			
Up to 125	$ 1.10	$ 1.30	18.2%
Stamped			
Up to 125	$ 1.20	$ 1.40	16.7%
Over 125 up to 250g	$ 1.80	$ 2.10	16.7%
Over 250 up to 500g	$ 3.00	$ 3.50	16.7%
Metered/Imprint			
Up to 125	$ 1.20	$ 1.36	13.3%
Over 125 up to 250g	$ 1.80	$ 2.04	13.3%
Over 250 up to 500g	$ 3.00	$ 3.40	13.3%
Local (Country)			
Medium			
Up to 125	$ 0.85	$ 1.20	41.2%
Over 125 up to 250g	$ 1.15	$ 1.60	39.1%
Large			
Up to 125	$ 1.05	$ 1.20	14.3%
Over 125 up to 250g	$ 1.50	$ 1.60	6.7%
Over 250 up to 500g	$ 1.65	$ 1.80	9.1%
Clean Mail			
Small Plus up to 125	$ 0.95	$ 1.05	10.5%
Reply Paid			
Up to 125	$ 1.35	$ 1.55	14.8%
Over 125 up to 250g	$ 1.95	$ 2.25	15.4%
Over 250 up to 500g	$ 3.15	$ 3.65	15.9%

Proposed PreSort Prices - GST Inclusive

Regular Size / Weight	Barcode Dir Tray Same $	Other $	Bcode Residue $	Unbc Residue $
Small Letters				
Up to 125g	$ 0.590	$ 0.612	$ 0.634	$ 0.660
Charity Mail	$ 0.507	$ 0.529	$ 0.551	$ 0.660
Small Plus				
Up to 125g	$ 0.760	$ 0.793	$ 0.892	$ 1.050
Medium				
Up to 125g	$ 1.057	$ 1.106	$ 1.244	$ 1.277
Over 125 up to 250g	$ 1.442	$ 1.541	$ 1.717	$ 1.794
Large				
Up to 125g	$ 1.057	$ 1.106	$ 1.244	$ 1.277
Over 125 up to 250g	$ 1.442	$ 1.541	$ 1.717	$ 1.794
Over 250 up to 500g	$ 1.904	$ 2.080	$ 2.234	$ 2.399

Surface Size / Weight	Barcode Dir Tray Same $	Other $	Bcode Residue $	Unbc Residue $
Small Letters				
Up to 125g	$ 0.520	$ 0.538	$ 0.564	$ 0.600
Charity Mail	$ 0.421	$ 0.439	$ 0.465	$ 0.600
Small Plus				
Up to 125g	$ 0.657	$ 0.684	$ 0.858	$ 0.950
Medium				
Up to 125g	$ 0.943	$ 0.987	$ 1.166	$ 1.221
Over 125 up to 250g	$ 1.262	$ 1.350	$ 1.551	$ 1.639
Large				
Up to 125g	$ 0.943	$ 0.987	$ 1.166	$ 1.221
Over 125 up to 250g	$ 1.262	$ 1.350	$ 1.551	$ 1.639
Over 250 up to 500g	$ 1.559	$ 1.691	$ 1.903	$ 2.156

Acquisition Mail	Barcode Dir Tray Same $	Other $	Bcode Residue $	Unbc Residue $
Off Peak Delivery				
Small - up to 125g	$ 0.410	$ 0.428	$ 0.564	$ 0.600
Small Plus - up to 125g	$ 0.547	$ 0.574	$ 0.858	$ 0.950

Impact Mail	Pcode Direct $	Area Tray $	Residue $
Small - up to 125g			
Same State	$ 0.720	$ 0.760	$ 0.820
Other State	$ 0.740	$ 0.780	$ 0.840
Small Plus - up to 125g			
Same State	$ 1.050	$ 1.100	$ 1.200
Other State	$ 1.070	$ 1.120	$ 1.220

Notes:

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

Non reserved prices

Medium size category is being withdrawn (proposed price shown is for Large)

Appendix 3 – Financial data

Table 25 shows the revenue impact of the 31 March 2014 domestic reserved letter price changes and introduction of a 60 cent concessional stamp.

Table 25 – Domestic reserved letter service

		PreSort Letters			Other (inc Ordinary) Letters			Total
		Small	Large	Subtotal	Small	Large	Subtotal	Letters
2012/13								
Volume	m	1,800	130	1,930	1,224	151	1,375	3,306
Revenue	$m	$ 795	$ 97	$ 892	$ 647	$ 177	$ 825	$ 1,716
Total Cost	$m	✂	✂	$ 934	✂	✂	$ 930	$ 1,864
Contribution	$m	✂	✂	($ 42)	✂	✂	($ 105)	($ 147)
ROR	%	✂	✂	(4.8%)	✂	✂	(12.7%)	(8.6%)
2013/14								
Volume	m	1,729	127	1,856	1,103	130	1,233	3,089
Revenue	$m	$ 831	$ 106	$ 937	$ 615	$ 160	$ 775	$ 1,712
Total Cost	$m	✂	✂	$ 1,014	✂	✂	$ 922	$ 1,936
Contribution	$m	✂	✂	($ 78)	✂	✂	($ 147)	($ 225)
ROR	%	✂	✂	(8.3%)	✂	✂	(19.0%)	(13.1%)
2014/15								
Volume	m	1,621	119	1,739	1,020	115	1,135	2,875
Revenue	$m	$ 830	$ 107	$ 936	$ 620	$ 158	$ 778	$ 1,714
Total Cost	$m	✂	✂	$ 1,021	✂	✂	$ 939	$ 1,960
Contribution	$m	✂	✂	($ 85)	✂	✂	($ 161)	($ 246)
ROR	%	✂	✂	(9.0%)	✂	✂	(20.7%)	(14.3%)

Appendix 4 – Consultation

Customers and stakeholders who have participated in confidential consultation are as follows:

Customers

- Commonwealth Bank
- ANZ
- NAB
- Westpac
- GE Capital
- Citigroup
- Centrelink
- Australian Taxation Office
- Medicare
- Australian Electoral Office
- Optus
- Telstra
- Vodaphone
- AGL
- Origin Energy
- Energy Australia
- Superpartners
- BUPA
- Citigroup Pty Ltd
- AMP
- Insurance Australia Group
- Medibank Private
- Tenix
- Suncorp Metway

Industry associations and representative bodies:

- Australian Direct Marketing Association
- Printing Industries Association of Australia
- Fundraising Institute of Australia

Industry suppliers:

- Mail Houses
- Postage meter suppliers
- Envelope manufacturers and suppliers

Australia Post Consolidated Group as at 30 June 2013.

	2013	2012
ASSETS		
Current assets		
- Cash and cash equivalents	293	776
- Held to maturity investments	-	59
- Trade and other receivables	594	435
- Inventories	49	55
- Accrued revenues	149	130
- Assets classified as held for sale	49	-
- Other current assets	106	81
Total current assets	**1,240**	**1,536**
Non-current assets		
- Trade and other receivables	99	228
- Investments in joint venture entities	3	285
- Land and buildings	797	736
- Plant and equipment	647	481
- Intangible assets	1,123	352
- Investment property	173	196
- Deferred tax assets	304	344
- Other non-current assets	17	19
Total non-current assets	**3,162**	**2,640**
Total assets	**4,402**	**4,176**
LIABILITIES		
Current liabilities		
- Trade and other payables	886	812
- Interest bearing liabilities	342	-
- Provisions	680	594
- Income tax payable	28	48
Total current liabilities	**1,936**	**1,455**
Non-current liabilities		
- Interest bearing liabilities	291	618
- Provisions	233	189
- Net superannuation liability	2	234
- Deferred tax liabilities	228	147
- Other non-current liabilities	31	28
Total non-current liabilities	**784**	**1,215**
Total liabilities	**2,720**	**2,670**
Net assets	**1,682**	**1,506**
EQUITY		
- Contributed equity	400	400
- Reserves	10	6
- Retained profits	1,272	1,100
Parent interest	**1,682**	**1,506**
- Non controlling interest	-	-
Total equity	**1,682**	**1,506**

Asset Register structure – Australia Post's fixed assets are grouped into approximately 500 asset classes each of which is a 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.

Land, Buildings and Fitout – at 30 June 2013 asset values which form a foundation for this notification include land and building assets at market value. Its total at 30 June 2013 was $1408m compared with the book value of $797m shown on the face of the balance sheet.

Valuations for the 30 June 2013 accounts were carried out by Savills Pty Ltd for properties in all states and territories. All properties are revalued annually.

Investment Properties – at 30 June 2013 the value of properties covered by this asset class was $173m. This amount is not allocated to products and services, and is not part of the asset base on which this notification is based.

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 – general post offices	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 7 – Domestic reserved letter service fixed assets

The following Tables provide a breakdown of the domestic reserved letter service fixed assets (shown at Table 22) by product category.

Table 26 – Small Ordinary / Other letters

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	391	337	324
Additions	(12)	28	25
Depreciation	(42)	(41)	(52)
Closing balance	337	324	297

Table 27 – Small PreSort letters

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	362	325	301
Additions	5	19	30
Depreciation	(42)	(43)	(55)
Closing balance	325	301	276

Table 28 – Large Ordinary / Other letters

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	96	82	84
Additions	(6)	11	4
Depreciation	(8)	(9)	(11)
Closing balance	82	84	77

Table 29 – Large PreSort letters

$million	Final result	Forecast	
	2012/13	2013/14	2014/15
Opening balance	45	44	44
Additions	4	6	3
Depreciation	(5)	(5)	(7)
Closing balance	44	44	41

Parameters and methodology of the WACC used in this notification.

Table 30 – WACC parameter values

WACC parameter	Value
Risk-free rate	4.22% [16]
Market Risk Premium	6.50%
Asset β	0.75
Imputation Credits Value γ	0.2 [17]
Equity β	1.0
Tax Rate	30.0%
Debt β	0.2
Cost of debt	5.72%
Gearing (D/D+E)	30.00%

Risk Free Rate

The nominal risk-free rate used is the 10-year Commonwealth Government bond yield, a widely-used proxy for the risk-free rate of return on investment, and the rate conventionally used in the capital asset pricing model. To avoid the impact of daily volatility, Australia Post has used a 30-day average 10-year Commonwealth bond yield to 28 January 2014.

Market Risk Premium ('MRP')

Recent independent advice from Value Adviser Associates is that a market risk premium of 6.50% is appropriate at the current time. This MRP is at a level in line with the long-term historical average of the Australian MRP (historical range of 6.0 - 7.0%).

We note the significant volatility in equity markets over recent years, and that an environment of market volatility can warrant an elevated short-term MRP. However, Value Advisors Associates has suggested that the volatility of the ASX200 has reverted to a level near its long-term average. Accordingly, we view a MRP of 6.50% as appropriate.

Asset β

Value Adviser Associates has independently estimated Australia Post's asset beta using a range of listed Australian and international postal companies and authorities. In estimating asset betas, Value Adviser Associates has used its standard practice of using 60 months (five years) of data observations.

Value Adviser Associates has cited research into the estimation period for regression analysis recommending five to seven years of monthly data observations, and has also cited that the Australian Energy Regulator has acknowledged that in estimating equity betas, an estimation period of five years of monthly observations is generally used.

[16] Reflects a 30-day average 10-year Commonwealth Government bond yield as at 28 January 2014

[17] As noted in Value Adviser Associates report, while 0.2 is an estimate for an average Australian company, Australia Post's actual imputation credit value is 0.0

Value Adviser Associates believe their analysis supports this approach, noting that monthly data reduces the ‘thin trading’ issue that is prevalent in weekly data.

Value Adviser Associates recommended an asset beta for Australia Post of 0.75.

Equity β

Adoption of an asset beta of 0.75 leads to a calculated equity beta of 0.99.

Imputation Credits

In assessing the appropriate imputation factor for Australia Post, a range of values have been considered.

An imputation factor of 50% would remove the bias of Government ownership and place AP in a similar position to businesses that distribute franking credits to shareholders.

Alternatively, an imputation factor of zero would reflect practical realities of Australia Post’s business, particularly:

- the fact that Australia Post does not distribute any franking tax benefits to its Government shareholder; and thus
- tax credits are not claimed by, and do not have a value, to Australia Post’s Government shareholder.

After consideration, Value Advisers Associates and Australia Post consider an imputation factor of 20% appropriate at the current time. According to Value Adviser Associates’ independent analysis, this is in line with current taxation statistics which show that 70% of tax paid by Australian companies is distributed to investors and that approximately 50% of this is redeemed by shareholders, which equates to an imputation factor of 35%.

Value Adviser Associates independent analysis also shows that an imputation factor of 20% is also in line with previous ‘mid-point’ estimates of a reasonable range of imputation factors of Australian companies, based on company franking credit distribution and redemption ratios.

Tax Rate

As accepted by the ACCC in previous price notifications, the statutory corporate tax rate of 30% is used.

Debt β

In estimating the appropriate debt beta for Australia Post, Value Adviser Associates has calculated the long-term average pre-GFC spread for 10-year BBB corporate bonds over the 10 year Commonwealth Government bond yield for the period from January 2002 to June 2007. Value Adviser Associates has then divided the long-term average spread over this period, being 1.21%, by the current estimated market risk premium of 6.5%, to calculate an appropriate debt beta for Australia Post of 0.19, which we have rounded to 0.20.

Cost of Debt

Value Adviser Associates has recently estimated that a margin of 150 basis points be added to the 10-year Australian Government Bond rate to arrive at an appropriate cost of debt for Australia Post. This margin has been derived by assessing the spread for longer-dated AA-rated corporate bonds over corresponding Australian Commonwealth Government yields.

Applying this methodology, we arrive at an estimated cost of debt for Australia Post of 5.72%.

Australia Post’s Treasury department has recently confirmed its comfort with this cost of debt estimate. Accordingly, we consider this an appropriate cost of debt for Australia Post.

Gearing

Australia Post's gearing (D/D+E) at 30 June 2013 was 27%, a level at which it remains after a minor adjustment of the balance sheet to account for the financial impact of the APSS superannuation fund which is not controlled by Australia Post. In recent years, Australia Post has consistently held a gearing (D/D+E) ratio in the range of 26% to 29%.

This gearing range is very close to the 30% ratio adopted by the ACCC for Australia Post in the previous price notification, and Australia Post has assumed that 30% is used again.

Table 31 – Debt, Equity and Gearing

$million	Debt	Equity	Adjusted Equity	Gearing (D/D+E)	Adjusted Gearing
June 2009	562	1845	1377	23%	29%
June 2010	559	1559	1387	26%	29%
June 2011	556	1804	1517	24%	27%
June 2012	618	1506	1740	29%	26%
June 2013	633	1682	1684	27%	27%