7 October 2002

Ms Margaret Arblaster
General Manager – Transport and Prices Oversight
Australian Competition and Consumer Commission
Level 35 / 360 Elizabeth St
MELBOURNE VIC 3000

Dear Ms Arblaster

Notification of Changes to Letter Prices

The purpose of this letter is to formally notify the ACCC of proposed prices for reserved letter services in accordance with the Prices Surveillance Act 1983 and following the ACCC's Preliminary View of Australia Post's draft pricing proposals submitted in April 2002.

The proposed prices in this notification are broadly in line with the ACCC's Preliminary View. The main price changes, which are proposed to take effect from 13 January 2003, are:

- a 5 cent increase to the Basic Postage Rate (BPR) to 50 cents and increases to Ordinary Large Letters, Local Delivery Letters, Seasonal Greetings and Prepaid envelope rates to maintain appropriate relativities to the BPR;

- removal of the '90/10 barcoding rule' (requiring 90% of barcoded PreSort lodgements to be barcoded) and its replacement with specific residue rates for letters that cannot be barcoded through the AMAS (Address Matching Approval System) process;

- introduction of a new PreSort Medium 5mm Letter category to align with Post's Small Letter processing capabilities;

- introduction of a Clean Mail service for lodgements of 300 or more machine addressed Small and Medium 5mm sized letters; and

- combination of existing 0-50g and 50-125g weight categories into a single 0-125g category for PreSort Medium and Large letters.

Post's formal notification is provided in Attachment 1. Supporting information to the notification is included in Attachments 2 and 3.

Overall, the price changes represent weighted average increases of 7.6% to Ordinary letters and 0.3% to Bulk letters, equating to an average price increase of 3.0%.

The objectives that the proposed price changes are designed to achieve are:

- to improve profitability of the letters business in the context of falling volume growth and declining opportunities for productivity improvements;

- to simplify the weight and size categories for Bulk letters to facilitate more cost effective lodgements;

- as far as practicable, to simplify letter prices, for customer convenience, by selecting prices in multiples of 5 cents; and

- subject to the letter pricing principles and the need to fund Community Service Obligations, to realign letter prices to better reflect the differences in costs between Ordinary letters and Bulk letters.

In its Preliminary View, the ACCC objected to some of the proposed price increases contained in Post's draft notification of April 2002 on the basis that, in the ACCC's view, the proposed prices appeared to result in Post earning excessive returns over the medium term. The ACCC proposed to accept certain prices which would result in acceptable returns and invited Post to submit restructured prices providing that such prices did not breach overall price levels or deter competition in closely related markets.

This proposal includes a number of changes to Post's draft proposals so that the prices overall are broadly in line with the Preliminary View. The proposed prices embody a return that is marginally lower than the reasonable return determined by the ACCC. In submitting proposed prices developed on the basis of the Preliminary View, Post does not necessarily accept that the prices provide an appropriate return to the letters business. As noted in our response to the Preliminary View, Post wishes to work with the ACCC to develop a regulatory model that is more appropriate for the postal industry which could be used to assess future notifications.

Post wishes to assist the ACCC in its consideration of this notification and toward prompt resolution of any issues which may arise.

Please do not hesitate to contact me if you wish to discuss any issue regarding this notification.

Yours sincerely,

Gary Lee
Group Manager Letters

Attachment 1

NOTIFICATION AND DETAILS OF CHARGES PROPOSED BY THE AUSTRALIAN POSTAL CORPORATION

Prices Surveillance Act 1983

Notification of prices pursuant to section 22(2)(a)

Australian Postal Corporation
(Name of Declared Person)

whose address is: 321 Exhibition Street, MELBOURNE VIC 3000
(Postal address: GPO Box 1777, MELBOURNE VIC 3001)

hereby gives notice that it proposes to supply the goods or services described below at the prices terms and conditions indicated, effective from 13 January 2003.

Description	Locality, Proposed Prices, Terms and Conditions

The services which are the subject of this notification provide for the carriage by post within Australia, of Ordinary Letters and the Bulk Mail categories of Local Delivery Letters, PreSort Letters and Clean Mail (new category), at proposed prices as detailed in Schedule 1.

Reasons for the Proposed Prices

To improve profitability of the letters business in the context of falling volume growth and declining opportunities for productivity improvements.

To simplify the weight and size categories for Bulk letters to facilitate more cost effective lodgements.

As far as practicable, to simplify letter prices, for customer convenience, by selecting prices in multiples of 5 cents.

Subject to the letter pricing principles and the need to fund Community Service Obligations, to realign letter prices to better reflect the differences in costs between Ordinary letters and Bulk letters.

Consideration Having Regard to section 17(3)

Australia Post believes that the proposed prices would not result in revenues in excess of revenues based on efficient costs and a reasonable rate of return. Australia Post considers that the proposed prices are consistent with the requirements of section 17(3) of the PS Act.

Date: **7 October 2002** **Signature:** **G Lee**
Group Manager Letters

Schedule 1

Details of Proposed Prices

Proposed Price Structure - January 2003

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

Ordinary Letters

	Current	Propsoed Prices Revised	% Change
Small Letters			
Ordinary	$ 0.45	$ 0.50	11.1%
Clean Mail	$ 0.45	$ 0.45	0.0%
Seasonal Greeting	$ 0.40	$ 0.45	12.5%
Barcoded and Metered	$ 0.43	$ 0.48	11.6%
Large Letters			
Seasonal Greeting Cards			
Up to 125g	$ 0.98	$ 0.90	-8.2%
Ordinary Letters			
Up to 125g	$ 0.98	$ 1.00	2.0%
Over 125 up to 250g	$ 1.47	$ 1.45	-1.4%
Over 250 up to 500g	$ 2.45	$ 2.45	0.0%
Ordinary Letters Barcoded and Metered			
Up to 125g	$ 0.94	$ 0.95	1.1%
Over 125 up to 250g	$ 1.41	$ 1.40	-0.7%
Over 250 up to 500g	$ 2.36	$ 2.35	-0.4%
Clean Mail			
Medium Size - 5mm max thick			
Up to 125g	$ 0.98	$ 0.70	-28.6%

Notes/Comments: Ordinary Letters

Small, 45 to 50; Large rounded to multiples of 5c

Introduction of "clean" mail price for unbarcoded letters (Small and Medium 5mm) - minimum 300 per lodgement subject to compliance with Clean Mail

Introduction of "Large" seasonal greeting card rate

For External Territories: the current GST free prices that apply to Ordinary Large Letters are 90c, $1.35 and $2.25. Under the proposed prices, the GST free price for External Territories will be the same as the GST Inclusive price shown above.

Local Delivery (only available in specified postcodes)

	Current	Proposed Prices Revised	% Change
Small Letters			
Up to 125g	$ 0.41	$ 0.46	12.2%
Medium Letters *			
Up to 50g	$ 0.54	$ 0.60	11.1%
Over 50 up to 125g	$ 0.65		-7.7%
Over 125 up to 250g	$ 0.87	$ 0.85	-2.3%
Large Letters			
Up to 50g	$ 0.76	$ 0.85	11.8%
Over 50 up to 125g	$ 0.93		-8.6%
Over 125 up to 250g	$ 1.20	$ 1.20	0.0%
Over 250 up to 500g	$ 1.31	$ 1.30	-0.8%

Notes/Comments - Local Delivery

Small price increased to remain 4c lower than full rate (50c)

0 to 50g and 50 to 125g prices combined into a 0 to 125g price.

* Medium Letter stays at up to 20mm thickness and 250g in weight.

For External Territories; the Current GST free price that applies to Local Delivery is the current price shown above, less 9%. Under the proposed prices, the GST free price will be the same as the GST Inclusive price shown above.

PrePaid Envelopes

	Current Prices			Proposed Prices			% Change		
	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10	Single	1-4 Packs of 10	5+ Packs of 10
Plain Envelopes									
Small (DL and C6)	$ 0.54	$ 5.13	$ 4.86	$ 0.60	$ 5.85	$ 5.70	11.1%	14.0%	17.3%
C5 Size	$ 1.19	$ 11.31	$ 10.71	$ 1.20	$ 11.70	$ 11.40	0.8%	3.5%	6.4%
C4 Size	$ 2.37	$ 22.52	$ 21.33	$ 2.35	$ 22.91	$ 22.33	-0.8%	1.8%	4.7%
B4 Size	$ 2.70	$ 25.65	$ 24.30	$ 2.70	$ 26.33	$ 25.65	0.0%	2.6%	5.6%
Window Faced		Pk of 50	Bx of 500		Pk of 50	Bx of 500		Pk of 50	Bx of 500
Small (DL and C6)		$ 25.55	$ 244.50		$ 29.70	$ 286.00		16.2%	17.0%

Notes/Comments - PrePaid Envelopes

Small Letter prices increased in line with BPR and to reflect increased stationary costs

Large Letter prices rounded to nearest multiple of 5c.

Per pack discounts reduced from 5% for one to four packs and 10% for five or more packs, to 2.5% and 5% respectively

Barcode PreSort Letters

Regular Delivery	Same State BDT			Other State BDT			Barcode Residue			Unbarcoded Residue #		
Size / Weight	Current	Revised	% Var	Current	Revised	% Var	Current	Revised	% Var	Current*	Revised	% Var
Small Letters												
Up to 125g	$ 0.374	$ 0.374	0.0%	$ 0.385	$ 0.385	0.0%	$ 0.424	$ 0.424	0.0%	$ 0.424	$ 0.450	6.1%
Charity Mail	$ 0.312	$ 0.312	0.0%	$ 0.323	$ 0.323	0.0%	$ 0.356	$ 0.356	0.0%	$ 0.356	$ 0.450	26.4%
Medium Letters -5mm Maximum thickness												
Up to 50g	$ 0.461	$ 0.473	2.6%	$ 0.478	$ 0.495	3.6%	$ 0.614	$ 0.572	-6.8%	$ 0.614	$ 0.700	14.0%
Over 50 up to 125g	$ 0.565		-16.3%	$ 0.598		-17.2%	$ 0.724		-21.0%	$ 0.724		-3.3%
Medium Letters -20mm Maximum thickness												
Up to 50g	$ 0.461	$ 0.561	21.7%	$ 0.478	$ 0.594	24.3%	$ 0.614	$ 0.671	9.3%	$ 0.614	$ 0.803	30.8%
Over 50 up to 125g	$ 0.565		-0.7%	$ 0.598		-0.7%	$ 0.724		-7.3%	$ 0.724		10.9%
Over 125 up to 250g	$ 0.724	$ 0.724	0.0%	$ 0.779	$ 0.779	0.0%	$ 0.889	$ 0.889	0.0%	$ 0.889	$ 1.034	16.3%
Large Letters												
Up to 50g	$ 0.735	$ 0.770	4.8%	$ 0.790	$ 0.825	4.4%	$ 0.900	$ 0.935	3.9%	$ 0.900	$ 0.980	8.9%
Over 50 up to 125g	$ 0.790		-2.5%	$ 0.845		-2.4%	$ 0.933		0.2%	$ 0.933		5.0%
Over 125 up to 250g	$ 1.119	$ 1.111	-0.7%	$ 1.229	$ 1.221	-0.7%	$ 1.338	$ 1.331	-0.5%	$ 1.338	$ 1.430	6.9%
Over 250 up to 500g	$ 1.591	$ 1.584	-0.4%	$ 1.700	$ 1.694	-0.4%	$ 1.810	$ 1.804	-0.3%	$ 1.810	$ 1.980	9.4%

Off Peak Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue #		
Size / Weight	Current	Revised	% Var	Current	Revised	% Var	Current	Revised	% Var	Current*	Revised	% Var
Small Letters												
Up to 125g	$ 0.363	$ 0.363	0.0%	$ 0.374	$ 0.374	0.0%	$ 0.402	$ 0.402	0.0%	$ 0.402	$ 0.435	8.2%
Charity Mail	$ 0.296	$ 0.296	0.0%	$ 0.301	$ 0.301	0.0%	$ 0.340	$ 0.340	0.0%	$ 0.340	$ 0.435	27.9%
Medium Letters -5mm Maximum thickness												
Up to 50g	$ 0.434	$ 0.451	3.9%	$ 0.445	$ 0.473	6.3%	$ 0.587	$ 0.550	-6.3%	$ 0.587	$ 0.671	14.3%
Over 50 up to 125g	$ 0.516		-12.6%	$ 0.533		-11.3%	$ 0.675		-18.5%	$ 0.675		-0.6%
Medium Letters -20mm Maximum thickness												
Up to 50g	$ 0.434	$ 0.528	21.7%	$ 0.445	$ 0.534	20.0%	$ 0.587	$ 0.638	8.7%	$ 0.587	$ 0.759	29.3%
Over 50 up to 125g	$ 0.516		2.3%	$ 0.533		0.2%	$ 0.675		-5.5%	$ 0.675		12.4%
Over 125 up to 250g	$ 0.653	$ 0.653	0.0%	$ 0.669	$ 0.669	0.0%	$ 0.818	$ 0.818	0.0%	$ 0.818	$ 0.946	15.6%
Large Letters												
Up to 50g	$ 0.713	$ 0.748	4.9%	$ 0.757	$ 0.792	4.6%	$ 0.878	$ 0.902	2.7%	$ 0.878	$ 0.957	9.0%
Over 50 up to 125g	$ 0.768		-2.6%	$ 0.823		-3.8%	$ 0.911		-1.0%	$ 0.911		5.0%
Over 125 up to 250g	$ 1.048	$ 1.045	-0.3%	$ 1.119	$ 1.111	-0.7%	$ 1.268	$ 1.254	-1.1%	$ 1.268	$ 1.353	6.7%
Over 250 up to 500g	$ 1.300	$ 1.298	-0.2%	$ 1.372	$ 1.364	-0.6%	$ 1.569	$ 1.551	-1.1%	$ 1.569	$ 1.815	15.7%

Notes/Comments - PreSort Letters

Unbarcoded component to be eligible for an Unbarcoded Residue Price. Price consistent with clean mail, but enveloping and addressing requirements to be as per Barcode PreSort

* Current price shown for Unbarcoded Residue is the Barcode Residue price, eligible under the 90/10 rule. The Proposed price will apply to all Unbarcoded items in a barcoded lodgement.

Small PreSort

Introduction of unbarcoded residue category

Medium PreSort

Redefined into two segments.

First segment to be one weight step (up to 125g) and 5mm in thickness to align with MLOCR and BCS processing capabilities (current max dimensions; 250g and 20mm thick). The 0 to 125g price is set just above the old 0-50g price.

Second Segment to be in two weight steps, with the current 0-50g and 50-125g merged into a single up to 125g step. The new 0 to 125g price is set marginally above the previous 50 to 125g price. Virtually no change to 125g-250g price.

Large PreSort

0-50g and 50-125g merged to a 0 to 125g, price set in middle.

For External Territories; the Current GST free price that applies to PreSort Letters is the current price shown above, less 9%. Under the proposed prices, the GST free price will be the same as the GST Inclusive price shown above.

Attachment 2

Reasons For Proposed Price Changes

1. Introduction

This attachment provides information on the reasons for the proposed changes to prices for reserved letter services as set out in Attachment 1.

2. Scope

The proposed prices for reserved letter services are notifiable to the Australian Competition and Consumer Commission (ACCC) under section 22 of the Prices Surveillance Act 1983 (PS Act). Letter services reserved to Post under Division 2 of Part 3 of the Australian Postal Corporation Act 1989 (APC Act) are declared services under section 21 of the PS Act.

This notification is in relation to prices for Ordinary letters and Bulk letters to take effect from 13 January 2003. The key price changes are:

- for Ordinary letters, an increase of 5 cents in the Basic Postage Rate (BPR) to 50 cents; and
- for Bulk letters:
    - introduction of a Clean Mail service for lodgements of 300 or more machine addressed Small or Medium 5mm sized letters;
    - introduction of a new PreSort Medium 5mm letter category; and
    - combination of existing 0-50g and 50-125g weight categories into a single 0-125g category for PreSort Medium and Large Letter size categories.

Overall the price changes represent weighted average increases of 7.6% to Ordinary letters and 0.3% to Bulk letters, equating to an average price increase of 3.0%

Apart from the effects of the removal of the Ad Post discounts and the introduction of GST, the increases, if accepted, will represent the first general price increases in eleven years.

It is appropriate to note that the proposed prices set out in Attachment 1 include prices for letters weighing more than 250 grams and for the non-stamp component of PrePaid Envelopes, even though these are not notifiable services. Prices for these services are provided for information only. Revenues from these non-notifiable services represent approximately 4% of total revenues of the letters business and approximately 1% of total letters volume is attributable to such services.

Further, although part of the reserved service, incoming International letters are not part of this notification.

This notification is also separate to that in relation to the withdrawal of the Ad Post discounts in 2 stages (July 2002 and January 2003), which has already been accepted by the ACCC. Once the AdPost discounts have been withdrawn, customers using mail for advertising purposes will be subject to the same prices as other letter customers.

This notification has been developed to be broadly in line with the ACCC's Preliminary View of 6 September 2002 in relation to Post's draft notification submitted in April 2002 (Preliminary View). In particular, the proposed prices have been set so that the letters business revenue does not exceed the required revenue represented in the Preliminary View. This is shown in Schedule 2 of Attachment 3.

3. Background

3.1 Regulatory

Effect of APC Act

Since the introduction of the APC Act in 1989, Post has undergone significant reform resulting in major change to the business environment in which it operates. Greater empowerment and accountability to management and staff has fostered an environment that focuses on meeting specific profit targets, achieving commercial rates of return on its asset base and abiding by its social and commercial obligations. With the establishment of an external Board of Directors and the creation of a commercial structure, management has been given responsibility for initiatives such as business planning, product development and industrial relations with a focus on achieving best practice.

The introduction of the APC Act placed an obligation on Post to achieve a commercial rate of return on assets employed. In achieving this, Post must maintain an appropriate balance with its social obligation to provide an efficient, effective and accessible letter service and to apply a single uniform rate to standard letters carried by ordinary post. To assist in meeting these objectives, the reserved services of Post are declared under the PS Act. The effect of the declaration is that proposals to change prices or terms and conditions for such services are to be notified in advance to the ACCC.

Profit Target

Profit targets for the letters business are set within the context of Post's corporate plan. In determining Post's financial target for inclusion in the corporate plan, the Board is required under section 38 of the APC Act to have regard to a range of requirements, including:

- the need to earn a reasonable rate of return on assets;
- the expectation of a reasonable dividend return to the Commonwealth;
- the need to maintain a reasonable level of reserves; and
- the cost of Community Service Obligations (CSOs).

Under section 40 of the Act, the Minister either approves the financial target or has the power to vary the target. The target approved by the Minister for 2000/2001 was a return on assets of 14.1%.

Post believes that the shareholder Ministry will require a return of at least this magnitude in the future.

<u>Direction 11</u>

Section 20 of the PS Act provides that the Minister may direct the ACCC, in exercising its powers and performing its functions under the PS Act, to give special consideration to certain specified matters.

Direction 11, which was made under section 20 of the PS Act on 19 September 1990, directs the ACCC to give special consideration to Post's obligation to pursue a financial policy in accordance with its corporate plan. It also directs the ACCC to give special consideration to the functions and obligations of Post and to any Ministerial directions given to Post.

Direction 11 is considered to be directly relevant to any assessment by the ACCC of a rate of return for application to Post.

<u>PS Act Requirements</u>

In assessing a notification of proposed prices submitted under section 22 of the PS Act, the ACCC is to apply the criteria set out in section 17(3) of the Act. Those criteria relate to:

- the need to maintain investment and employment;
- the need to discourage persons in positions of market power from taking advantage of that power in setting prices; and
- the need discourage cost increases arising from wage increases.

In interpreting those provisions, the ACCC directs its attention to:

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

These interpretative rules are from the ACCC's Draft Statement of Regulatory Approach to Price Notifications.

As noted in section 2 above, the proposed prices reflect the Preliminary View outcomes, in that they have been set so that the letters business does not derive revenue in excess of the required revenue represented in the Preliminary View. The proposed prices can thus be considered to be consistent with the costs and rate of return determined by the ACCC in the

Preliminary View. Information on Post's costs and rate of return is provided in sections 6 to 8 below.

3.2 Post's Performance

Post has achieved world's best practice in many aspects of its business and has a commitment to ongoing improvement:

- Post has one of the nation's largest, most advanced industrial relations environments – whose culture, since corporatisation, has changed from adversarial to participative;

- Through sustained productivity growth, at twice the national average, Post has been able to reduce real prices, thus generating business growth and maintaining relatively stable employment;

- Delivery performance has been enhanced substantially, from 91% on time delivery in 1992 to 96% in 2002;

- Profit and dividends have been consistent with Post's obligations under the APC Act; and

- Post has continued to meet the CSOs required by the APC Act and has generally continued to outperform the required performance standards associated with those obligations.

Key success factors underpinning these achievements include the stimulus of target setting and accountability provided for under the APC Act, the application of a customer-focussed culture, enhanced labour flexibility, network modernisation, the introduction of new services and the operation of the postal network in a manner consistent with sound commercial practice.

These factors, along with annual volume growth, have led to sustained profits from the letters business over the past decade, during which time Post's letter prices have generally remained unchanged.

As discussed below, future declines in letter volume growth and lower levels of productivity growth are expected for the letters business. These will have an adverse affect on the letters business profit and on the ability of the business to fund ongoing investment and meet statutory obligations.

4. Objectives of Price Changes

The objectives that the proposed price changes are designed to achieve are as follows:

- to improve profitability of the letters business in the context of falling volume growth and declining opportunities for productivity improvements;

- to simplify the weight and size categories for Bulk letters to facilitate more cost effective lodgements;

- as far as practicable, to simplify letter prices, for customer convenience, by selecting prices in multiples of 5 cents, and in multiples of the BPR for relevant products; and

- subject to the letter pricing principles (as set out in section 9) and the need to fund CSOs, to realign letter prices to better reflect the differences in costs between Ordinary letters and Bulk letters.

The primary objective is to improve letters profitability in the face of declining volume growth and reduced opportunities for productivity improvements.

It is emphasised that apart from the changes associated with the removal of the Ad Post discounts and the introduction of the GST, Post has not had a general price increase since 1992.

Appropriate profits have been maintained from the letters business through this extended period from a combination of productivity, volume increases, and customer work share. These results have been achieved through a period when Consumer Price Index increases of more than 27% have resulted in significant cost increases to Post. This freeze cannot be maintained and appropriate returns achieved as:

- <u>Post absorbed the GST on the Ordinary Small Letter (ie. the BPR)</u>. With the implementation of GST in July 2000, Post was required to maintain the 45 cent BPR by absorbing the GST. In order to maintain price incentives for barcoding, certain PreSort prices were also reduced at the same time. This has resulted in an annual cost to the letters business of around $90m – providing annual savings to businesses, able to claim the GST as an input tax credit, of approximately $75m pa.

- <u>Volume growth declines</u>. Through the 1990's mail volume growth tracked or exceeded Gross Domestic Product (GDP) and achieved a compound annual growth of 4.7%. Following a spectacular 6.3% growth in 2000, mail volumes declined in 2001. Analysis of the past decade has determined that while there has been a loose correlation between GDP growth and mail volume growth, the primary stimuli have been a series of one-off events such as the introduction of mobile and other telecommunications services, financial regulation changes, the implementation of GST and the impact of stock market activities. As these events are not expected to be repeated in this decade, and as technology substitution and mail piece consolidation increase, the volume growth outlook is subdued and actual decline is expected from 2006/2007, if not sooner. In these circumstances the volume-related productivity gains experienced in the last decade will not be repeated. Further information on reducing volume growth is provided in section 5 below.

- Productivity gains peak. During this same period (1991-2001) Post has achieved productivity gains of 67%, more than double the national average of 28.7%. These gains will peak with the completion of Future Post and related projects and, while Post will continue to pursue future improvements, the same rate of improvement cannot be maintained. Additional information in this regard is provided in section 5 below. Technological advances, such as were introduced under Future Post, have plateaued and significant future opportunities are unlikely.

The following section 5 provides information on the trend of falling volume growth and declining opportunities for productivity improvements for the letters business.

5. Letters Market

5.1 Letter Volume Trends

The letter volume growth rate has been in decline since 1994/1995 with the exception of 1999/2000 when the GST, a large number of public share offers and the referendum drove extraordinary volume growth of 6.3%.

Among the contributing factors to the downward growth trend is the recent decline in discretionary letter volumes (caused by a depressed advertising market) and a slowdown in a number of significant volume drivers such as the GST and take-up of mobile phone and credit cards/loyalty cards.

Moderate Volume Growth will turn to Annual Decline over the Next Five Years

The domestic economy is expected to strengthen over the coming years with GDP growth of between 2% and 4% pa (source: Access Economics).

However, the results of a recent analysis of letter volumes conducted by Diversified Specifics on behalf of Post, reveals that economic activity (measured by GDP) is no longer the primary driver of letter volumes and that major volume drivers differ between key letter segments ie. transactional, promotional and social letters.

The study suggests that the divergence between GDP and letter growth rates will continue. For example:

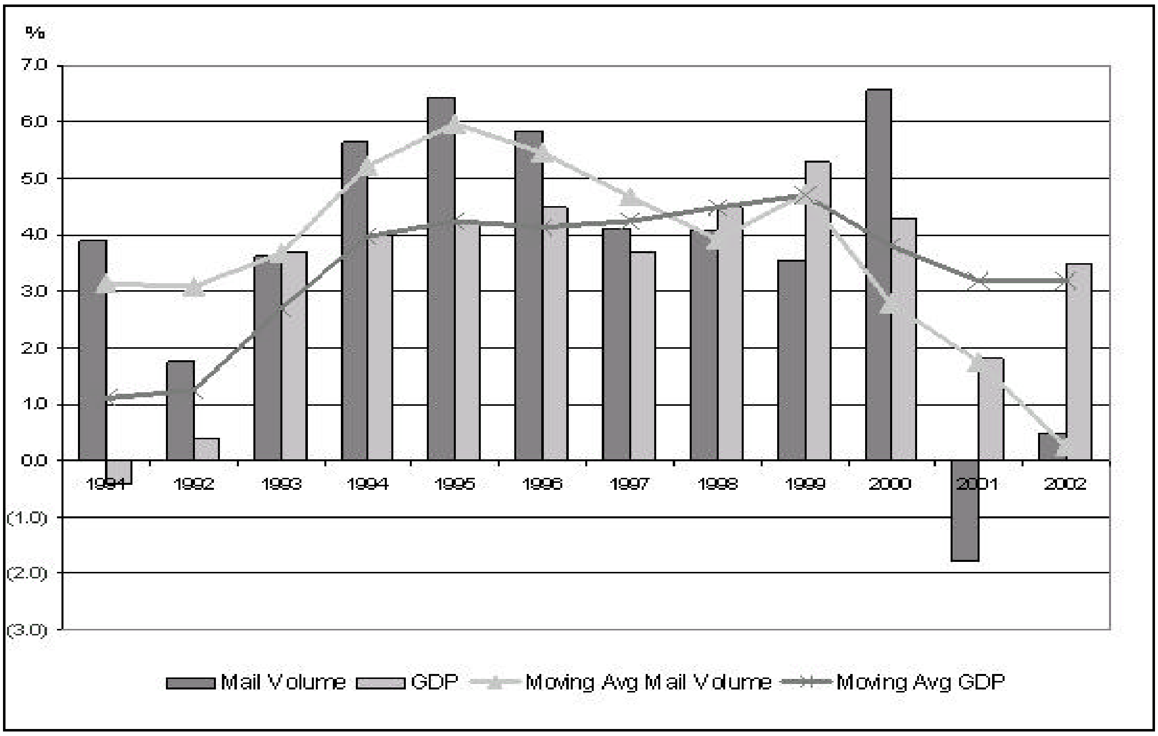
- PreSort Transactional letter volumes (typically mass produced bills, statements and other transactional correspondence from business) have been driven more by the significant expansion in the take-up of credit cards and loyalty cards, the introduction of the GST and the significant take-up of mobile phones, than by an increase in GDP. As these three drivers of past volume reach maturity, other drivers of mass-produced transactional mail need to emerge if the decline in growth rates is to be moderated. No such new growth sources are apparent at this stage.

- Ordinary Letters have been in decline due partly to a migration to PreSort (since the PreSort threshold was reduced to 300 letters per lodgement) and more fundamentally to a reduction in cheque payments by mail and business to business transactional mail (replaced by on-line communication and billing, fax streaming etc.).

- Promotional letter volumes growth has reduced significantly over the past two years, driven by significant reductions in major customer expenditure on Direct Mail and by a general downturn in the advertising market.

Figure 1 below illustrates the noticeable divergence between GDP and letter growth trends since 1991/1992.

Figure 1. Letter Volume Growth vs GDP* Growth



Source: Australia Post * GDP (non farm)

On the basis of the above, the combined outlook for the letters business is for a continued decline in letter volume growth rates leading to actual volume decline within the next five years.

Table 1. Five Year Growth Estimates – 2002/3 to 2006/07

	2002/03	2003/04	2004/05	2005/06	2006/07
GDP (non farm)*	**4.1%**	**3.4%**	**3.0%**	**2.2%**	**N/A**
Transactional Letters	0.5%	0.3%	(0.2%)	(0.7%)	(1.4%)
Promotional Letters	1.1%	3.3%	4.8%	4.8%	4.6%
Social Letters	(3.9%)	(3.1%)	(3.3%)	(3.4%)	(3.5%)
Total Letters	**0.4%**	**0.6%**	**0.4%**	**0.0%**	**(0.5%)**

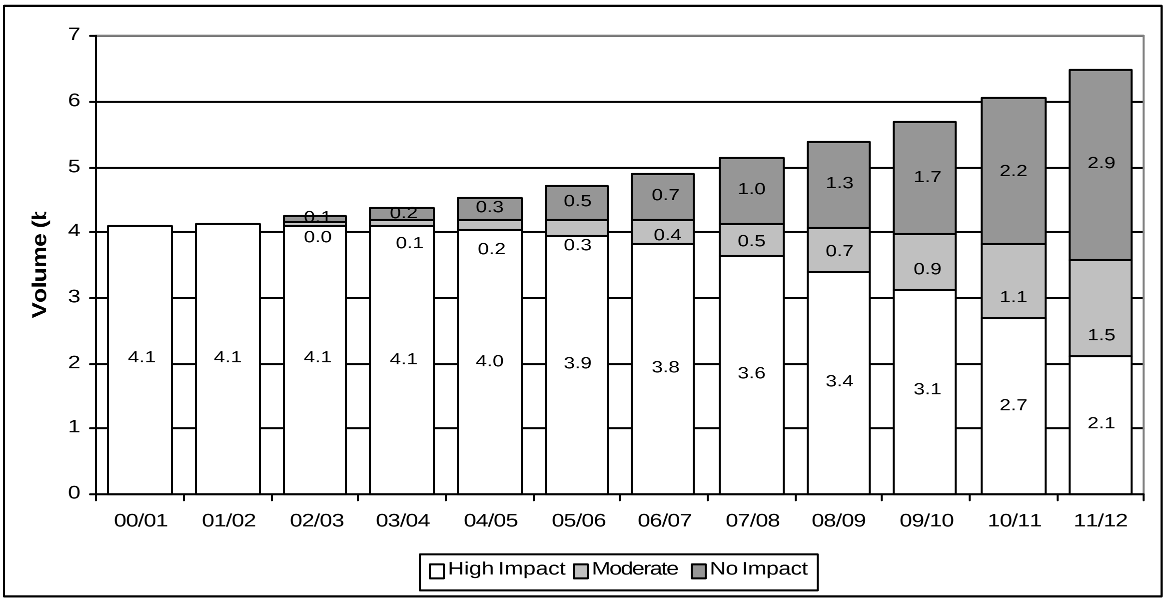
Source: Australia Post * Access Economics

These estimates include an allowance for moderate but increasing substitution, mail piece consolidation and rationalisation.

Figure 2 below illustrates the estimated impact on letter volumes of substitution (eg. electronic bill presentment and/or payment), consolidation (eg. combining multiple items into a single mail piece) and rationalisation (eg. reduction in billing cycles) over the coming ten years based on both a moderate take-up and a high take-up scenario.

Under both take-up scenarios, letter volumes will begin to trend downwards in the medium term as take-up rates begin to accelerate. Under both scenarios, letter volumes are predicted to be lower than current volumes within the next ten years.

Figure 2. Australia Post Letter Volume – Future Trends



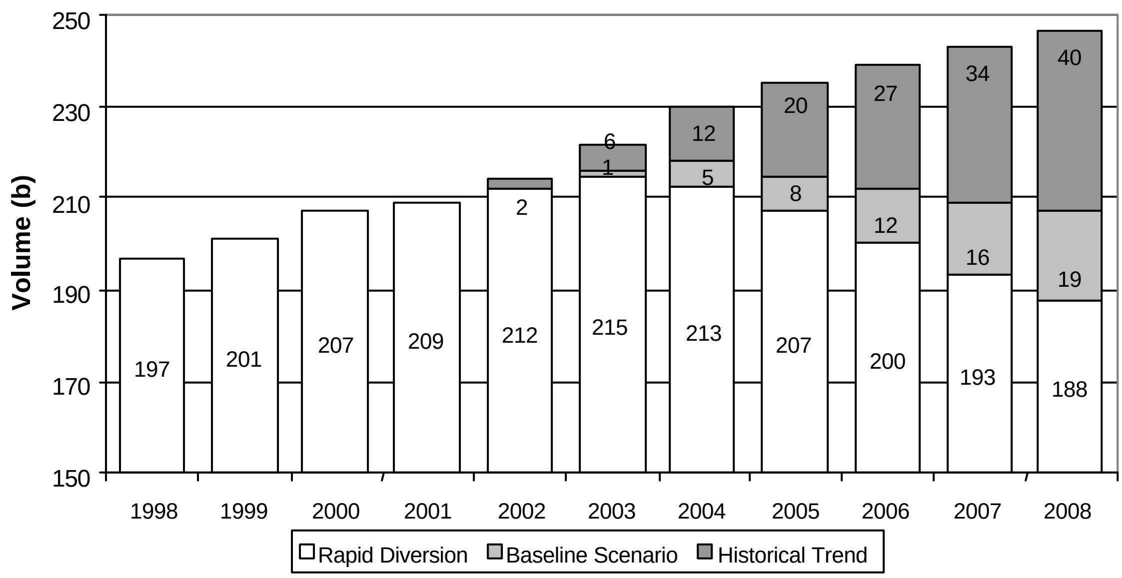
Source: Australia Post

Assumptions:

No Impact	Underlying letters volume growth is based on 2% average growth per annum
Moderate Impact	35% of Transactional, 5% of Promotional and 10% of Social mail will be lost to consolidation and substitution in the next 10 years
High Impact	70% of Transactional, 10% of Promotional and 20% of Social mail will be lost to consolidation and substitution in the next 10 years

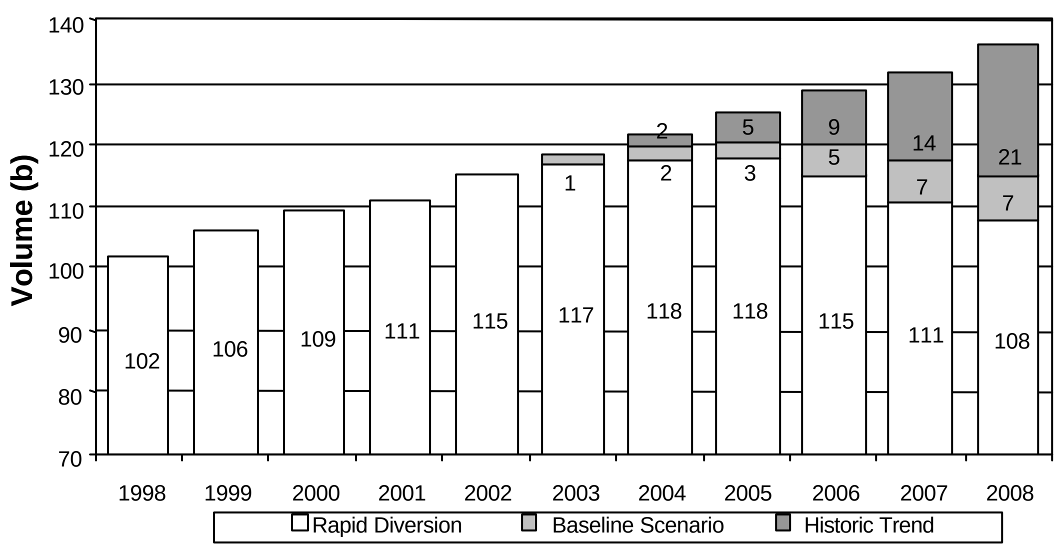
Similar to the Australian letter market, falling volume growth and actual volume reductions are also projected for the letters markets in the United States and Europe as illustrated below.

Figure 3. USPS Mail Volume Assumptions



Source: USPS Five Year Strategic Plan (FY 2001-2005)

Figure 4. Europe Letter Volume – Future Trends



Source: Industry Report on European Postal Companies (Jan 2001) conducted by Schroder Salomon Smith Barney

5.2 Letters Productivity

This section 5.2 explains Post's key productivity performance and trends. It shows that Post's significant historical labour productivity gains are not a simple result of factor substitution and sets out the basis for Post's expected decline in productivity. It also provides broadly based productivity information in support of the case that Post's reserved services are provided from an efficient cost base.

<u>Overview of Productivity Trends</u>

Productivity growth has been significant over the past decade, driven by a series of major productivity improvement initiatives (including the $520m Future Post program) and facilitated by solid volume and revenue growth.

Future productivity growth will decline with diminished opportunities for future productivity improvements and as volume and revenue growth decline. Post has adopted the best available mail processing technologies and processes in implementing its Future Post program. It has also rationalised its processing network as far as possible (subject to the completion of some current rationalisation in Victoria). The primary focus is on further labour productivity and completing other major improvement initiative currently in progress.

The exhaustive nature of the work that has been undertaken to optimise productivity can be illustrated by the following list of some of Post's major initiatives since 1991/1992:

- Introduction of first-generation Optical Character Reader technology from 1991/1992 to increase the proportion of mail that could be sorted using mechanised processes;

- Introduction of Multi Line Optical Character Readers and Bar Code Sorters, in association with the introduction of barcoded mail, through the Future Post program, involving an investment of approximately $520m over 1998/1999 to 2000/2001. Future Post was designed to ensure the Australian community benefited from the latest technology coming on stream and the more efficient network design this allowed Post to introduce;

- Negotiation and implementation of a series of Enterprise Bargaining Agreements (EBA 1 to 5), containing incentives for achievement of productivity targets, to create a new culture of cooperation to achieve best practice operations for our customers;

- A range of service quality initiatives from 1994/1995 designed to facilitate employee participation in the identification and application of process improvement ideas to all areas of Post's operations, from acceptance of mail through to its delivery; and

- A series of training programs to upgrade the management, technical and operator skills of the entire workforce, to support a significant investment in IT and mechanical processing equipment enabling the vast majority of small letters to be handled through automated processes.

Further investment in mechanical processing equipment and skilling of staff is planned, however there is less scope to achieve the very high productivity gains associated with the past initiatives as Post is now using some of the most advanced automated processing in the world.

Labour Productivity

Between 1991 and 2001, Post's cumulative labour productivity growth was 67% compared to the Australian average of 28.7%. Post has adopted new technologies that have significantly reduced labour costs. While the letter service is still relatively labour intensive with labour costs comprising 49.6% of total costs, this is down from 65.4% in 1992. In addition, Post's letter delivery performance (the percentage of small letters delivered within performance standards) has improved significantly since 1992, ie. from 91% on time in 1992 to 96% in 2002.

Letter volumes processed increased from 2.8b in 1991/1992 to 4.1b in 2001/2002, while the number of operational facilities and the staff employed in those facilities was reduced.

Another key feature of Post's labour policies of the past decade also captured in the productivity data is the better matching of workforce type to demand levels. Over the decade to 2000/2001, Post's use of part-time staff has doubled, from 12% of employees in 1990/1991 to 24% in 2000/2001. The substantial shift in labour usage has assisted in achieving the significant reductions in the cost base during that period.

Total Factor Productivity

As calculated in an independent study by Malcolm Abbott[1], Post's total factor productivity (TFP) increased by an average of 5.5% pa during the 1990s.

With labour productivity increasing at a similar rate (ie 5.25% pa) to TFP growth, productivity of non-labour inputs has also grown – so that the labour productivity growth outcome is not a simple result of factor substitution.

It is informative to also look at the earlier periods covered by Abbott's analysis. During the second half of the 1970s, Post's average TFP growth was around 3%, and during the 1980s it dropped back to around 2.5% pa.

[1] Article published in 2000 in the Economic Papers, An Economic Evaluation of the Australian Postal Corporation Act 1989. The article was not commissioned by, or initiated by, Australia Post, nor does Post fully endorse the analysis and findings presented in the article.

To put Post’s TFP record into wider perspective, the following data reveal the extent of Post’s sustained gains compared with those in the economy generally.

Total Factor Productivity Growth	Post	Australia % pa average
1975/76 to 1980/81	3.0	1.1
1981/82 to 1987/88	2.4	0.6
1989/90 to 1998/99	5.5	1.3

<u>Future Productivity</u>

Financial projections incorporate residual Future Post benefits from the small letters network restructure, planned benefits from large letters investments, and the benefits from further consolidation of the Sydney and Melbourne networks and other on going productivity improvements.

Post’s focus is on strategies to maximise the capabilities of the new Future Post network. Where such performance improvement measures can be reliably scoped and quantified, they have been included in the forward financial projections.

Sequencing

Part of the potential benefits from street sequencing have been gained through process changes in delivery centres, effectively combining the streeting and sequencing of letters into one process. As potential gains from automating the sequencing of mail upstream in mail centres are reduced, Post will instead focus on selective deep sorting and sequencing to maximise the utilisation of its existing infrastructure.

Further Network Consolidation

Given the expected decline in volumes, Post is aggressively rationalising the Sydney and Melbourne networks to provide a basis for productivity improvement over the coming three years. This will produce a single site network in Melbourne and a two site network in Sydney, leaving little scope for further savings from consolidation.

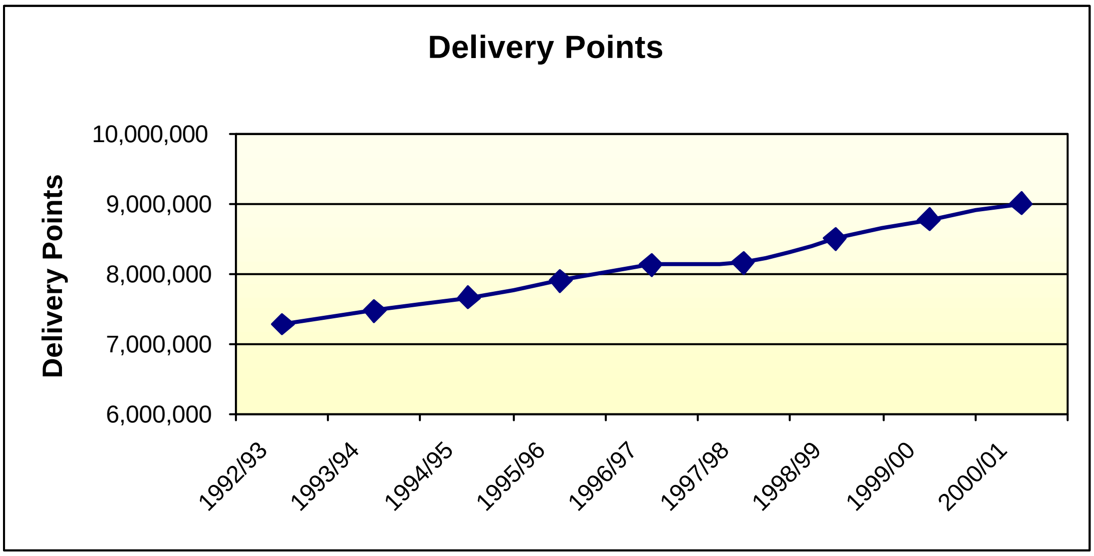
Future Technology Potential

While there may be some potential left in improvements in software to successfully read addresses, the scope for improvements is marginal.

In the face of financial difficulties experienced by the USPS, UK Royal Mail and other advanced postal administrations, there is no substantial world investment occurring in R&D on letter automation. Current expectations are that only marginal gains are likely from technology innovation by equipment suppliers in the foreseeable future.

Delivery Points Growth

Delivery points have grown some 29% since the last increase in the basic postage rate. This is shown in the graph below.



Delivery points are likely to grow at an annual rate of around 2-2.5% pa. Under Post's service obligations, such growth injects an ongoing delivery requirement into the network on a day to day basis, which cannot be avoided. This additional resource requirement must be met by on-going productivity improvements. It should be noted that a 1% growth in delivery points represents an additional resource requirement of around 90 full time equivalent resources, or $4m pa.

Most of the benefits from the future productivity initiatives will be fully realised by 2004/2005 and are incorporated into Post's financial projections.

6. Post's Cost Base

Post's reserved services are provided from an efficient cost base. Five year forecasts for volume, revenue and costs by letters category are set out in Schedule 1 of Attachment 3. The volume and cost trends reflect figures from the 2002/2003 Financial Operating Plan (FOP) and associated official planning numbers for the following two years based on bottom up calculations consistent with the FOP process. Cost numbers for the final two years are based on Access Economics estimates of wages escalation and general inflation.

The volume and cost data provided is as per the data used by the ACCC in its Preliminary View. The revenues and resultant profit information is based on the proposed prices that are the subject of this notification. The derived letters business revenue does not exceed the required revenue represented in the Preliminary View. This is shown in Schedule 2 of Attachment 3.

While the cost data was used in the Preliminary View, Post wishes to emphasise the effects on its costs arising from Australia's large size and dispersed population and from the need for it to fund CSOs. These matters distinguish Post from companies to which it may be compared and are discussed in section 6.1 and 6.2 below.

6.1 Service Challenges in Australia

Post's performance ranks amongst the best in the world despite Australia's large size and highly dispersed population. Post generally provides a higher standard of delivery (notwithstanding generally lower mail densities, leading to potentially lower economies of scale) than the countries it is often compared against. This is shown in Table 2 below.

Table 2. Service Standards, Demographics and Mail Density

	Australia	Canada	USA	UK	NZ
Closing time	6pm	5pm	5pm	5.30pm	5-6pm
Intrastate delivery (days)					
- metro/metro	1	2	1	1	1
- country/metro	2	3	2	2	2-3
- country/country	2	3	2	2	2-3
Interstate delivery (days)					
- metro/metro	2	4	2-3	Na	na
- country/metro	3	4	3	Na	na
Population (m)	19.4	31	285	60	3.9
Area (million sq kms)	7.7	9.2	9.2	.24	.27
Persons/sq km	2.4	3.4	30.9	250	14.4
Annual mail items per capita	229	363	663	278	190

Source: Postal Service Terms and Conditions (Various)

In addition to the service attributes above, Post's prices compare favourably with postal charges in other countries. At 50 cents, Post's proposed BPR would still be one of the lowest in the developed world. Using a price parity comparison, Canada's basic stamp costs the equivalent of 56 cents, France 62 cents, Germany 76 cents, Italy 96 cents, Japan 75 cents, New Zealand 37 cents, UK 56 cents and the US 51 cents (source: 2001 purchasing power parity estimates from Australia Post).

6.2 Community Service Obligations

Section 27 of the APC Act requires Post to provide a letter service and, in addition to meeting performance standards which meet the needs of the Australian community, to ensure that:

- standard postal articles carried by ordinary post within Australia are subject to a single uniform rate; and
- the letter service is to be reasonably accessible to all people in Australia on an equitable basis wherever they reside or carry on business.

Post has continued to meet the CSOs required by the APC Act and has generally continued to outperform the required performance standards associated with those obligations. Table 3 below shows that Post exceeded its required performance standards for the 2000/2001 financial year as set out in Commonwealth Regulations.

Table 3. 2000/2001 Required vs Actual Performance

Standard	Required Performance	Australia Post Performance 2000/2001
Number of Street Post Boxes	10,000	15,386
Delivery Timetables	Maintained	Maintained
On time delivery of non Bulk Letters	94% on time	94.1% on time
Points to receive Delivery 5 days per week	98%	98.6%
Points to receive delivery no less than twice per week	99.7%	99.9%
Retail Outlets	4,000	4,491

Source: Australia Post

Compared to a fully commercial operation, the CSO imposes 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 its CSO, 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. Post's CSO net cost for 2000/2001 is $86.3m.

7. Asset Base

This section 7 provides information on Post's approach to asset valuation. The approach adopted by Post is based on principles that are designed to arrive at an efficient cost of assets.

In addition to complying with approved Australian Accounting Standards, Post is required to comply with financial valuation and reporting guidelines issued by the Department of Finance and Administration. These guidelines are set out in the annual release of “Requirements and Guidance for the Preparation of Financial Statements of Commonwealth Agencies and Authorities” by the Department. Instructions for fixed assets are as follows.

> “8.1 Land, buildings, infrastructure, plant and equipment must:
>
> (a) initially be recorded at cost of acquisition, in accordance with Australian Accounting Standard 21 (AAS21); and
> (b) be revalued progressively every three years in accordance with the deprival method of valuation, so that land, buildings, infrastructure, plant and equipment have values which are no greater than three years old.”

The Australian National Audit Office gave an unqualified audit opinion in the closing of the 2000/2001 accounts of the Corporation. That included the agreement that the Statement of Financial Position (ie. the balance sheet and its components) gave a true and fair view in accordance with the statutory reporting requirements stated above.

In addition, Post removes from its capital base assets that cease to contribute to the provision of services.

Post’s deprival value methodology essentially arrives at forward-looking valuations for Post’s lands and buildings. In this context, deprival value methodologies are designed to arrive at a value consistent with that embodied in prices in a competitive market. Deprival valuation methodologies are based on the following principles:

- where an entity would replace the service potential embodied in an asset if deprived of it, the asset is measured at the current cost;
- where an entity would not replace an asset if deprived of it, the asset is measured at the greater of its market value and the present value of future net cash inflows; and
- where the asset is surplus to requirements the asset is measured at its market value.

In practice, Optimised Deprival Value (ODV) is generally calculated as the lesser of:

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

The ODV approach has been endorsed by the Council of Australian Governments as the preferred approach for valuing assets for reporting purposes and has been adopted as the valuation approach in decisions by state jurisdictional regulators (eg decisions in relation to the NSW water supply industry by the Independent Pricing and Regulatory Tribunal).

Letters business asset values, by asset category, from 2001 to 2007 are set out in Schedule 8 of Attachment 3.

8. Rate of Return

As commented in section 2 above, the proposed prices in this notification reflect the Preliminary View outcomes, in that they have been set so that the letters business does not derive revenue in excess of the required revenue represented in the Preliminary View. The proposed prices can thus be considered to embody a rate of return considered reasonable by the ACCC (in fact, as can be determined from Schedule 2 of Attachment 3, the proposed prices embody a return that is marginally lower than the reasonable return determined by the ACCC).

In Post's view the ACCC's required rate of return, in the form of a real vanilla WACC of 6.1%, does not represent an adequate rate of return for the letters business.

In using an economic rate of return measure (in contrast to the accounting-based return on asset measure used as the target in the corporate plan) Post applies a weighted average cost of capital (WACC) approach using the Capital Asset Pricing Model (CAPM) for project appraisals. The parameters of the WACC calculation were adopted without amendment by the Board in February 1998, following expert independent advice by the then Price Waterhouse.

Capital expenditure proposals involving outlays greater than a minimum threshold level are subject to a hurdle rate test using the corporate WACC value. This is one of the ways that Post ensures that it establishes a prudent and efficient asset base. The derivation of a 13% pre tax nominal WACC used by Post as a hurdle rate for investment evaluation is set out in Schedule 3 to Attachment 3.

As noted in section 3.1, Post has a financial target that is governed by legislation. The relevant Minister may either accept the rate of return proposed in each corporate plan, or replace it with an alternative. That required return on operating assets, analogous to a pre-tax WACC in other circumstances, was established at 14.1% for 2000/2001 (rounded to 14%). The Corporation believes that shareholder Ministers will require a return at least of that magnitude in future.

9. Proposed Prices

9.1 Introduction

Post has held the BPR constant since 1992 representing a 21% reduction to the BPR in real terms during this period.

Even with the proposed 5 cent increase, the BPR will have reduced 12.5% in real terms since 1992.

Bulk letter prices have evidenced real, and in many cases nominal, reductions since 1992.

As discussed above, into the future, Post's operating environment will experience declines in letter volume and lower levels of productivity growth. This will have an adverse effect on the profitability of the letters business, resulting in a negative impact on the ability of the letters business to fund ongoing investment and meet statutory obligations on a continuing basis.

9.2 Letter Pricing Principles

The objectives that the proposed price changes have been designed to achieve have been developed pursuant to Post's letter pricing principles, which are as follows:

- The BPR – the rate for the standard letter by ordinary post – is the keystone of the pricing structure.

- Carriage of the Standard Postal Article by Ordinary Post at a uniform rate is central to the Community Service Obligation. Pricing of the Standard Postal Article (ie the BPR) will reflect the need to maintain an affordable rate. As a result the BPR is not expected to fully recover the costs of providing these services.

- Consequently prices for other letter services will contain a cross subsidy to the Standard Postal Article.

- Subject to this need to cross subsidise, letter prices will be set to achieve an appropriate aggregate rate of return for the letters business as a whole.

- Bulk inter connection prices will, in addition to the requirements of section 32A(2)(c) of the APC Act, broadly reflect the level of work saved by Post through work carried out by customers.

- Bulk interconnection prices will be applied uniformly for carriage within Australia subject to the point of lodgement (Inter/Intra state prices apply).

- Subject to meeting minimum agreed quantities and conditions, bulk interconnection prices will be applied uniformly regardless of volume.

- The pricing structure will reflect 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.

- The pricing structure will be as simple as possible.

- Prices will be set to enable Post to meet its statutory requirement to provide an adequate commercial return and to fund the CSO.

- Price changes will be made as infrequently as possible, with adequate notice and after appropriate consultation with stakeholders.

The context provided by the letter pricing principles above is particularly important in the case of the objective that, subject to the principles and the need to fund CSOs, letter prices are to be aligned to better reflect the differences in costs between Ordinary letters and Bulk letters.

9.3 Summary of Price Changes

The following is a summary of the proposed price changes to take effect from 13 January 2003:

- a 5 cent increase to the BPR (taking it from 45 cents to 50 cents) and increases to Ordinary Large Letters, Local Delivery Letters, Seasonal Greetings and Prepaid envelope rates to maintain appropriate relativities to the BPR;

- removal of the '90/10 barcoding rule' (requiring 90% of barcoded PreSort lodgements to be barcoded) and its replacement with specific residue rates for letters that cannot be barcoded through an AMAS (Address Matching Approval System) process;

- introduction of a new PreSort Medium 5mm letter category that aligns with Post's small letter processing capabilities;

- introduction of a Clean Mail service for lodgements of 300 or more machine addressed Small or Medium 5mm sized letters; and

- combination of the existing 0-50g and 50-125g weight categories into a single 0-125g category for PreSort Medium and Large sized letters.

Details of all proposed price changes are provided in Attachment 1. The weighted average change in prices is detailed in Table 4 below.

Table 4. Change in Unit Prices – Proposed Letter Prices

Letter Service	% Volume	Current Price	Proposed Price	% Increase
Ordinary Letters				
Small	82.8%	$0.45	$0.50	11.2%
Large	17.2%	$1.19	$1.20	1.0%
Total Ordinary Letters	30.4%	$0.57	$0.61	7.6%
Bulk Letters				
PreSort				
Small	61.9%	$0.38	$0.38	0.3%
Medium	2.6%	$0.55	$0.54	(2.0%)
Large	2.9%	$1.07	$1.07	0.2%
Total PreSort	67.3%	$0.41	$0.41	0.2%
Clean Mail	31.0%	$0.45	$0.45	0.0%
Local Delivery	1.6%	$0.42	$0.47	11.4%
Total Bulk Letters	69.6%	$0.42	$0.43	0.3%
Total Letter Services	**100.0%**	**$0.47**	**$0.48**	**3.0%**

Source: Australia Post

Information on the rationale and effects of the individual price changes is provided in Schedule 4 of Attachment 3.

10. Concluding Comment

Australia Post delivers high standard, reliable services which have supported essential business communications.

The reliability, reputation and performance of Australia Post's letter service is recognised by business and the general public alike as an important contributor to the Australian community.

It is Post's intention to maintain and to build on this reputation and contribution, but this can only be achieved if the business is able to continue to achieve adequate returns to facilitate ongoing investment.

The proposed prices would not result in revenues in excess of revenues based on efficient costs and a reasonable rate of return.

Attachment 3

Supporting Information

This purpose of this attachment is to provide supporting information to the reasons for the proposed price changes, and the other matters in relation to the price changes, as discussed in Attachment 2.

The supporting information in this attachment is contained in the following schedules:

Schedule 1. Five Year Forecast - Volumes and Revenues by Product Category
Schedule 2. Compliance with Preliminary View
Schedule 3. Weighted Average Cost of Capital
Schedule 4. Explanation of Individual Price Changes
Schedule 5. Letter Lodgement Conditions
Schedule 6. Letter Size Conditions
Schedule 7. Major Changes to Letters Conditions since 1992
Schedule 8. Letters Business Asset Values

Schedule 1

Five Year Forecast - Volume and Revenue Data by Product Category (2002/2003 to 2006/2007)

		Small Ordinary	Small PreSort Regular	Small PreSort Off Peak	Subtotal Small	Large Ordinary	Large PreSort Regular	Large PreSort Off Peak	Subtotal Large	Total Letter Product
2002/03										
Volume	m	Commercial in Confidence								4,163.3
Revenue	$m									$1,791.4
Total Cost	$m									$1,654.8
Contribution	$m									$136.5
ROR	%									7.6%
2003/04										
Volume	m									4,188.5
Revenue	$m									$1,831.5
Total Cost	$m									$1,701.4
Contribution	$m									$130.1
ROR	%									7.1%
2004/05										
Volume	m									4,205.0
Revenue	$m									$1,831.9
Total Cost	$m									$1,723.4
Contribution	$m									$108.5
ROR	%									5.9%
2005/06										
Volume	m									4,205.0
Revenue	$m									$1,825.1
Total Cost	$m									$1,771.6
Contribution	$m									$53.5
ROR	%									2.9%
2006/07										
Volume	m									4,184.0
Revenue	$m									$1,809.4
Total Cost	$m									$1,827.4
Contribution	$m									($18.0)
ROR	%									-1.0%

Schedule 2

Compliance with Preliminary View

The proposed prices have been set so that the letters business revenue does not exceed the required revenue represented in the ACCC's Preliminary View. This is shown below.

	02/03	03/04	04/05 $M	05/06	06/07
Nominal Vanilla WACC *8.7%* *Table 9.2, Preliminary View*					
Required Revenue *Table 10.2, Preliminary View*	1,739	1,788	1,813	1,865	1,923
Present Value of Required Revenue	1,739	1,645	1,534	1,452	1,377
Sum of Present Values	7,748				
Letters Revenue at Proposed Prices 7 October 2002 *Schedule 1, Attachment 3*	1,791	1,832	1,832	1,825	1,809
Present Value of Letters Revenue	1,791	1,685	1,550	1,421	1,296
Sum of Present Values	7,744				
Deficiency of Letters Revenue to Required Revenue	4				

Schedule 3

Weighted Average Cost of Capital

Post's WACC used as a hurdle rate for investment evaluation purposes was the subject of expert external advice by Price Waterhouse in December 1997. It includes a cost of equity derived from the CAPM and a cost of debt containing a corporate risk premium over the risk-free rate.

The Price Waterhouse recommendations were adopted without amendment by Post's Board in February 1998 and reaffirmed by the Board in August 2001.

The WACC is used as the foundation for capex business case analysis. Business cases above a low threshold level of capex must return a positive net present value using the WACC. The threshold is $50,000 for all projects other than IT development, for which the threshold is zero.

Post's WACC methodology in this context involves applying the post tax WACC formula below:

$$\text{WACC} = \frac{E}{D+E}K_e + \frac{D}{D+E}K_d(1-t_c)$$

The WACC parameters applied by Post in its investment evaluation framework are set out in the table below.

WACC Parameter	Value
Risk-free rate	6%
Market Risk Premium	7%
Asset β	0.55
Imputation Credits Value	30%
Equity β	0.72
Tax Rate	30%
Debt β	0.04
Gearing (D/D+E)	30%

The application of the methodology and the parameters above yields a post tax WACC of 9.06% (rounded to 9%) and an equivalent pre-tax WACC of 12.94% (rounded to 13%).

The ACCC will observe that some of the WACC parameters in the table above, in particular, the gearing and market risk premium, are different from those typically used by the ACCC's in its regulatory decisions. Some detailed commentary is provided on those, and notes provided for remaining items.

RISK FREE RATE

The Commonwealth 10-year bond rate is chosen as the risk-free rate. This reflects the longevity of the Corporation’s capital base and, in particular, the composition of capex in recent years eg property and mail handling plant and equipment.

A significant proportion of capex is assets with shorter economic lives, eg software and fitout. To test whether choice of a long-term risk-free rate materially affects the cost of equity, the impact of substituting shorter-term risk-free rates has been tested by the Corporation. Risk-free rates from 1 to 10 years have been used, with appropriate amendments to the market risk premium. (Those amendments do not offset the change to the risk-free rate on a 1-for-1 basis because of the term structure of interest rates.)

Results of the testing indicated that the cost of equity remained within a range about ½% wide. In view of the underlying uncertainty inherent in any CAPM assessment, this was not considered a material difference to warrant different WACCs for shorter-life assets.

The 10-year bond rate applied by Post is 6.27%.

MARKET RISK PREMIUM

The ACCC uses a standard 6% market risk premium (MRP).

Based on both Australian and overseas studies, the Steering Committee on National Performance Monitoring of Government Trading Enterprises in 1996 recommended use of a 7% forward-looking MRP

Price Waterhouse advice to Post in 1997 was that Australian research indicated a long-term MRP between 6% and 8%. It also drew on work by Neville Hathaway of the Melbourne Business School which estimated a 7% MRP for the USA and a 6.6% MRP for Australia. The final Price Waterhouse recommendation was an expected value of 7% for the MRP.

The Price Waterhouse advice confirmed that it was relevant to look at overseas MRP levels. MRPs would be set more by integrated international capital markets, with national factors such as introduction of dividend imputation having a very minor impact on MRP levels.

Consequently, Post’s Board approved a cost of capital for the Corporation using a 7% MRP.

Post suggests that adoption of a single rate of 6% for the MRP is inappropriate. It is at the lowest end of the range of reasonable estimates, which imparts a downward bias to regulated rates of return.

Given the imprecision of estimating MRPs, it is suggested that a more appropriate treatment is to accept a MRP value within the range of respected research and which is also used for internal purposes by the organisation concerned.

If a single, uniformly applicable rate for the MRP is to be adopted by the ACCC, it is more appropriate that it be 7%, as the midpoint of the recommended Australian range. This would have the benefit of imparting neither an upward nor a downward bias to regulated rates of return.

ASSET β

Price Waterhouse examined the asset risk of utilities of a number of countries, using a de-levering process to move from observed equity β rates. UK rates were regarded as closer counterparts than US rates, because of the differing regulatory regimes in those two countries.

The utilities covered electricity, gas and water industries.

In addition, factors specific to Post were considered. These included:

- Possible/likely deregulation trends;
- Ease of access to Post's markets (ie low capital barriers to entry);
- The strength of Post's brand.

Applying its balanced judgment, Price Waterhouse recommended an asset β of 0.55, ie the midpoint of the estimated reasonable range of 0.50 to 0.60.

This is a part of the advice that Post may have rejected. The utility areas concerned appear to have no technological or direct competition, and are little affected by discretionary spending. That is certainly not the case for Post – either for its letters business or any other of its businesses. In particular, the advertising market is highly volatile, and will lift the asset β of any industry highly dependent on it. For Post, the direct marketing sector is regarded as the critical driver of growth in the letters business, with declining volumes forecast for transactions-based mail.

It is very likely that Post's asset β is quite higher than the 0.55 adopted for each of its businesses.

However, there was an advantage for Post to be gained first from seeking independent expert advice, and then by accepting its package as a whole.

It is an approach that would be reasonable for the ACCC to also adopt in view of the independence and expertise of the source adviser.

IMPUTATION CREDITS

Factors that affected the recommendation in this area were:

- The desirability of a competitive neutrality outcome rather than one based on government ownership;
- "typical" franking credit values; and
- dividend payout ratios.

EQUITY β

Monkhouse formulae have been used to de-lever observed equity β's to determine Post's asset β - and to re-lever the derived asset β value using the gearing ratio discussed below to determine Post's equity β.

TAX RATE

Post pays all Commonwealth, State and Local taxes on the same terms as any other corporation. Its effective company tax rate has been a little under the statutory rate in recent years, but the gap is not material when the impacts of property sales are eliminated. For the purpose of WACC estimates, the statutory company tax rate has been assumed.

DEBT β

The debt β was derived from an assumed risk premium of 0.3% to 0.4% above the risk-free rate. This premium reflected a continuation of Post's AAA investment rating. Although the debt risk premium would be expected to rise over time with likely increased riskiness of the Corporation's various cash flows, the contribution of the debt items to the WACC has been maintained at their conservative, low value for the time being.

GEARING

Australian Companies

It is noted that the ACCC generally adopts a 60% debt (D) to debt plus equity (E), ie D:D+E ratio in its utility decisions.

Theory suggests that an optimum gearing ratio does exist, but there is no obvious way to make the theory operational. What can be observed from Australian corporate experience is that the ACCC's model ratio is extremely high, and does not reflect corporate practice.

Post benchmarked a number of financial policies adopted by Australia's top 50 corporations during the second half of the 1990s. Those corporations were then grouped into three categories according to Standard & Poor's ratings. The categories were:

- AA- or better;
- A- to A+; and
- BBB- to BBB+.

Companies with ratings below BBB- were not considered, as those lower ratings are not investment-class.

The sample was small in the highest class, because a number of banks made the gearing averages less relevant. However, the average gearing (D/D+E) for each of the three categories was approximately 35%.

An independent study released by Ian Huntley late in 2001 measured a number of indicators of financial health for Australia's top 500 companies from 1998 to 2000. These include gearing trends. The main outcomes were:

- The median gearing ratio was 29% in 2000;
- As a general guide, a prudentially sound gearing level was limited to 40%; and
- Gearing ratios dropped by about 2% each year from 1998 to 2000.

Australia Post

Post's gearing ratios have hovered around 30% for a number of years, in line with Board policy.

Post has a AAA rating from Standard & Poor's.

Although there is no firm policy in place, it is unlikely that the Corporation would gear its balance sheet in such a way that its implicit stand-alone rating would fall below A+. This would limit further gearing, probably to below 40%.

Advice received from Price Waterhouse in 1997 suggested that Post's optimal gearing would be in the range 20% to 40%, with a recommended level of 30%. This advice was based on previous and forecast cash flow volatility, market gearing of comparable companies, and on the Corporation's investment rating.

Both the market and Post do not regard a 60% gearing level as generally commercially sound. While a 60% gearing ratio may be acceptable for some companies, it is not so for Post. This is because:

- Half of its revenues are now in fully competitive markets;
- The Letter business is facing continual technological substitution and becoming more risky over time; and
- A further review of Post's regulatory arrangements is due in 2003.

These factors point to Post's systematic risk rising over time. Any additional financial risk arising from higher gearing would be very carefully judged.

Measured on an accounting basis, a benchmark gearing level for Australian enterprise appears to be around 30% rather than 60%. To the extent that market book values are greater than 1, the ratio for WACC purposes will be even lower.

Post has consistently aimed for a ratio around 30%, and this accords with commercial good practice in industry generally.

Schedule 4

Explanation of Individual Price Changes

1 A 5 cent increase to the BPR (and increases to Ordinary Large Letters, Local Delivery Letters, Seasonal Greetings and Prepaid envelope rates to maintain appropriate relativities to the BPR)

a. Background

- The BPR is the rate that applies to the universal service (ie. the Ordinary Small Letter).
- The increase to the BPR is the first increase to this rate since January 1992. When the GST was introduced on 1 July 2000, it was absorbed into the BPR which reduced Post's revenue to 40.9 cents per article.
- Since the BPR was last increased in 1992, CPI has increased by 27%. If the BPR had increased in line with CPI it would be 57 cents.
- For business customers, who do not bear the GST, the increase from 45 cents in 1992 to the (GST exclusive) price of 45.45 cents represents a nominal increase of 1%.
- Ordinary Large Letter, Local Delivery, Seasonal Greetings and Prepaid envelope rates are all set relative to the BPR.

b. The Market / Volumes

- Ordinary Small Letter volumes have been in decline over recent years due to:

  - a migration of full rate letters to PreSort as part of Post's strategy to increase the proportion of machine-efficient mail and to share these benefits with customers (eg. significant reduction in the volume threshold for PreSort, simplification of sorting breaks and introduction of commercial aggregation enabling smaller mailers to access bulk mail discounts); and
  - the increased take-up of substitutes including alternate bill presentment and payment channels.

- The volume decline has been from the most profitable segments of full rate mail eg. business full rate migrating to PreSort and bill payments sent to central metropolitan addresses.
- The volume decline in full rate letters is expected to continue as substitution increases and as migration to PreSort continues. This will result in a profitability decline for this service given that the declines will primarily come from the most profitable segments of full rate mail.
- The proposed BPR and associated price increases are not expected to have any significant impact on current volume trends.

c. Customer Impact

- The introduction of a Clean Mail service and unbarcoded residue rates will effectively quarantine unbarcoded PreSort and full rate letter mail (in lodgements of 300 or more) from the BPR increases.
- The BPR and associated increases are expected to have very little financial impact on consumers and small businesses as shown below:

Customer	Annual Usage*	Annual Impact
Private Household	56 letters pa	$ 2.67
Small Business	733 full rate letters pa	$33.70

* assumptions of annual usage based on average postage expenditure per household and small/medium business customer respectively.

2. Introduction of residue rates for PreSort letters that remain unbarcoded following the application of the AMAS process (this will replace the 90/10 rule, which is scheduled to be withdrawn);

AND

Introduction of a "Clean Mail" service for lodgements of 300 or more machine addressed letters.

a. Background

- The introduction of unbarcoded residue rates and the Clean Mail service will quarantine bulk full rate mail lodgements (ie. 300 or more including residue from PreSort lodgements) from the BPR increase.
- The creation of this service recognises the different processing costs associated with bulk full rate business letters compared to other full rate letters.
- The new letter lodgement conditions are set out in Schedule 5.

b. Market / Volume

- The business full rate segment is currently in decline due partly to the ongoing migration of full rate mail to PreSort (including through commercial aggregation services) and partly to the diversion of some of this mail to electronic substitutes (eg. B2B emails, fax-streaming etc.).

c. Customer Impact

- Introduction of unbarcoded residue rates will address industry concerns about the removal of the ‘90/10 rule’ for barcoded lodgements (ie. at least 90% of letters in a barcoded lodgement must be barcoded).
- Introduction of unbarcoded residue rates and Clean mail will quarantine many business mailings from the BPR increase.

3. Introduction of a New PreSort Medium letter category to align with the Small Letter Processing Network (Dimensions: “240mm (W) x 162mm (H) x 5mm (D) and up to125g”).

a. Background

- The current Medium letter category dimensions exceed the capabilities of Post’s small letter processing network. Current pricing for this category is set to cover the mix between higher and lower cost mailings.
- The introduction of a new Medium letter category aligning with the capabilities of the small letter processing network will enable better delineation between lower and higher cost letters leading to better alignment of prices to costs.
- The new letter size conditions are set out in Schedule 6.

b. Market / Volume

- Medium sized letters are used for large transactional mailings and for promotional mailings to help distinguish them from other mail.
- The current cyclical downturn in advertising expenditure has led to a decline in promotional mailings over the past two years.

c. Customer Impact

- The proposed new Medium PreSort letter category will provide significant reduction in average price for compliant Medium letters.
- This should provide a significant pricing incentive for direct mail users who want to use Medium letters to distinguish their letters from other mail.
- Customers sending Medium letters over 5mm in thickness will receive a marginal price increase, recognising the higher costs associated with processing these items.

4. Combination of the existing 0-50g and 50-125g weight categories into a single 0-125g category for Medium and Large PreSort letters

a. Background

- Customer pricing and lodgement processes can be simplified by broadbanding 0-50g and 50-125g PreSort letter categories.

b. Customer Impact

- Prices for the broadbanded weight category have generally been set at the midpoint between the two existing weight breaks for Large Letters.
- Prices for Medium Letters have been to the higher weight break (ie. 50-125g) given that the vast majority of 0-50g Medium letters will qualify for the new Medium (max 5mm) PreSort Letter category.
- Introduction of a broadbanded weight category will simplify bulk lodgement processes by enabling customers to lodge a broader range of letters under the same price and weight break.

Schedule 5

Letter Lodgement Conditions

Unbarcoded Residue (New Category)

Definition	Unbarcoded letters lodged as part of a Barcoded PreSort lodgement.
Scope	To apply to all PreSort Letter size categories and service standards (Regular and Off Peak).
Eligibility	No minimum volume to apply to this component of the lodgement (ie. each lodgement must still contain at least 300 barcoded letters of the same size and weight step). It is not intended to introduce a minimum barcode component for each lodgement. Currently, the Barcoded PreSort letter service requires that the database must be checked against the latest version of the PAF. Post will reserve the right to request customers to support a lodgement with an Address Matching Process Summary Report, which is generated by AMAS software. Also, unbarcoded letters that are part of the same job, but currently lodged separately, will be eligible to access the applicable unbarcoded letter price.
Presentation Requirements	Addressing and envelope conditions that currently apply to barcoded PreSort letters lodged as residue.
Lodgement Requirements	Unbarcoded letters to be lodged in separate trays (not to be mixed with barcoded residue letters). Volumes of 2,000 or more unbarcoded letters to be separated by state and territory (8 destinations).
Documentation	Volumes to be recorded on PreSort Letters – Lodgement Document (8835114). The manifest is also to record the volume of unbarcoded letters.

Clean Mail ***(New Category)***

Definition	Service for customers who undertake minimal sort activity and can present good quality machine addressed letters.
Scope	To apply to Small and the new Medium 5mm category.
Eligibility	Minimum of 300 letters.
Presentation Requirements	To reflect the addressing and envelope conditions that previously applied to Unbarcoded PreSort letters presented as residue. Additionally, small letters will require to keep clear a 20mm strip along the back of the envelope.
Lodgement Requirements	It is recommended that volumes of 2,000 or more Clean Mail letters be separated by state and territory (8 destinations).
Documentation	Lodgement document to be developed for Clean Mail.

Schedule 6

Letter Size Conditions

Letter Dimensions (applicable to PreSort and Clean Mail)

Small Letters	Weight:	Up to 125gms
	Size	No larger than 130mm x 240mm and no small than 88mm x 138mm
	Thickness	No thicker than 5mm
	Shape	Oblong
	Plastic	Yes* – Barcoded letters in Direct Trays No – Barcoded letters in Residue Trays and unbarcoded letters No – Clean Mail
Medium Letters (5mm)	Weight:	Up to 125gms
	Size	No larger than 162mm x 240mm and no small than 88mm x 138mm
	Thickness	No thicker than 5mm
	Shape	Oblong
	Plastic	Yes* – Barcoded letters in Direct Trays No – Barcoded letters in Residue Trays and unbarcoded letters No – Clean Mail
Medium Letters (20mm)	Weight:	Up to 250gms
	Size	No larger than 180mm x 260mm
	Thickness	No thicker than 20mm
	Shape	Rectangular
	Plastic	Yes* – Barcoded letters and Unbarcoded letters
Large Letters	Weight:	Up to 500gms
	Size	No larger than 260mm x 360mm
	Thickness	No thicker than 20mm
	Shape	Rectangular
	Plastic	Yes* – Barcoded letters and Unbarcoded letters

* Subject to conditions

Schedule 7

Major Changes to Letters Conditions since 1992

February 1995

- Introduction of specific price points replacing percentage discounts off full rate postage prices.
- Introduction of interconnection permitting customers to arrange their own interstate transport to interconnect at designated facilities to obtain ‘same state’ prices.

October 1999

- The introduction of a Barcoded PreSort service as part of Future Post (minimum proportion of barcoded letters per lodgement of 75%).
- The reduction of the PreSort threshold from 2,500 articles per lodgement to 300.

4 April 2000

- Withdrawal of the 6.5% AdPost Reply Paid Discount.

1 July 2000

- The introduction of mail piece aggregation permitting the aggregation of mail from various senders to be lodged as a single PreSort lodgement (subject to a minimum lodgement volume of 10,000 and to the lodgement being processed through approved postage meters).
- Minimum proportion of barcoded letters per lodgement of Barcoded PreSort increased from 75% to 80%.

1 July 2001

- Minimum proportion of barcoded letters per lodgement of Barcoded PreSort increased from 80% to 90%.

1 July 2002

- The withdrawal of the unbarcoded PreSort service on 1 July 2002.
- 1st Stage of AdPost Withdrawal (ie. 10% increase to AdPost pricing to halve the AdPost discount off PreSort rates).

1 January 2003

- Withdrawal of AdPost.

Schedule 8

Letters Business Asset Values

	2001	2002	2003	2004 $M	2005	2006	2007
LETTERS BUSINESS							
Letters Working Capital	322.0	365.0	380.0	398.2	404.1	413.4	420.7
Letters Fixed Assets	1233.4	1203.3	1213.6	1157.9	1150.4	1133.8	1105.5
Total Letters Assets	1555.4	1568.3	1593.6	1556.1	1554.5	1547.2	1526.2
Letters Depreciation		112.9	118.9	122.7	123.0	123.0	120.9

WORKING DATA

Fixed Assets

	2001	2002	2003	2004	2005	2006	2007
Vehicles							
- Opening Balance	72.3	74.0	81.2	87.2	90.4	94.1	95.4
- Additions	20.2	22.9	25.4	26.7	28.0	26.7	25.4
- Depreciation	13.3	12.7	14.0	17.6	18.2	18.7	18.9
- Sales	5.3	3.0	5.3	6.0	6.0	6.7	6.7
- Internal Transfers	0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Closing Balance	74.0	81.2	87.2	90.4	94.1	95.4	95.2
Software							
- Opening Balance	56.9	58.2	52.5	43.4	52.6	53.6	54.2
- Additions	18.4	14.4	10.8	26.2	19.6	19.6	18.0
- Depreciation	17.3	20.1	19.9	16.9	18.7	19.0	19.0
- Sales	0.4	0.0	0.0	0.0	0.0	0.0	0.0
- Internal Transfers	0.6	0.0	0.0	0.0	0.0	0.0	0.0
- Closing Balance	58.2	52.5	43.4	52.6	53.6	54.2	53.2
Land							
- Opening Balance		259.6	249.3	241.5	230.7	238.6	246.9
- Additions			8.8	8.2	7.9	8.3	7.4
- Sales		10.4	16.6	19.0			
- Internal Transfers							
- Closing Balance	259.6	249.3	241.5	230.7	238.6	246.9	254.3
Buildings							
- Opening Balance		365.5	364.7	342.5	309.0	305.4	298.9
- Additions		21.0	21.0	12.0	11.9	8.7	8.5
- Depreciation		18.3	18.2	17.1	15.4	15.3	14.9
- Sales		3.5	25.0	28.4	0.0	0.0	0.0
- Internal Transfers							
- Closing Balance	365.5	364.7	342.5	309.0	305.4	298.9	292.4
Fitout							
- Opening Balance		32.5	40.2	47.3	55.0	58.8	61.6
- Additions		17.5	19.6	22.3	20.0	20.0	15.0
- Depreciation		9.8	12.4	14.6	16.3	17.2	17.3
- Sales		0.0	0.0	0.0	0.0	0.0	0.0
- Internal Transfers		0.0	0.0	0.0	0.0	0.0	0.0
- Closing Balance	32.5	40.2	47.3	55.0	58.8	61.6	59.3

Plant & Equipment	2001	2002	2003	2004 $M	2005	2006	2007
General							
- Opening Balance		276.3	259.8	307.7	287.9	279.2	267.7
- Additions		24.0	90.6	25.0	34.0	29.7	25.0
- Depreciation		40.4	42.7	44.8	42.7	41.2	39.2
- Sales		0.2					
- Revaluation		0.0	0.0	0.0	0.0	0.0	0.0
- Internal Transfers		0.0	0.0	0.0	0.0	0.0	0.0
- Closing Balance	276.337	259.8	307.7	287.9	279.2	267.7	253.5
Small Letter FuturePost Processing Assets							
- Opening Balance	79.2	167.2	155.5	143.9	132.3	120.7	109.1
- Additions	99.3	0	0	0	0	0	0
- Amortisation	11.4	11.619	11.6	11.6	11.6	11.6	11.6
- Write off	0.0	0	0	0	0	0	0
- Revaluation	0.0	0	0	0	0	0	0
- Closing Balance	167.2	155.5	143.9	132.3	120.7	109.1	97.5
Working Capital							
Total	322	365	380	398	404	413	421