



**Australia Post Response  
to ACCC Issues Paper**

16 March 2011

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## 1. Introduction

This document has been prepared by Australia Post in response to the Issues Paper released by the Australian Competition and Consumer Commission (ACCC) on 25 February 2011.

This document is provided for the benefit of the ACCC, in considering Australia Post's draft notification of January 2011; it reinforces and / or supplements information contained within the draft notification.

Australia Post will review the public submissions that the ACCC receive and may provide a further document to the ACCC that addresses any specific issues that are raised.

## 2. Will Australia Post's proposal encourage more efficient usage of Australia Post's services?

Australia Post's network is largely built around the need to perform to the Ordinary letter delivery standard, which encompasses prescribed performance standards<sup>1</sup>. Key features of the Ordinary letter delivery standard are delivery to:

- at least 98% of delivery points five days a week; and
- a timetable that includes next day delivery within the same metropolitan area.

Australia Post's PreSort letter service offers a Regular and an Off Peak delivery standard. The Regular PreSort letter service (Regular) delivery standard is aligned to the Ordinary letter delivery standard for market and operational reasons. The Off Peak PreSort letter service (Off Peak) delivery standard is Regular plus up to an additional three days (ie it provides a four day delivery window).

As around 90% of domestic reserved letter volumes are delivered to the Ordinary letter delivery standard there is limited opportunity to explore alternatives or variations to the current network arrangements. However, as the proportion of Off Peak increases (from around 10%) the opportunity to explore network variations increases.

Therefore, one objective of the proposed changes is to encourage greater use of Off Peak over Regular. Australia Post proposes to achieve this through changes to price and improvement to product design.

In not objecting to Australia Post's previous notification, where PreSort prices increased by an average of 2.8 cents (GST Ex), the ACCC:

- noted an average annual reduction in operating costs of 4.3%; and
- modelled an average annual loss of at least \$86.9 million (in real terms) over the period 2009/10 to 2011/12.

The revenue from those proposed prices was well below what the ACCC modelled as the 'maximum allowable' (an amount equal to the recovery of efficient costs plus a reasonable rate of return). As noted in Australia Post's previous notification, given the prevailing economic / environmental factors Australia Post considered the proposed prices appropriate.

Australia Post's previous notification also noted that continuing to provide the domestic reserved letter service in a future dominated by ongoing volume decline and increasing delivery points and input costs would present a challenge to the long term sustainability of the letter service. To address this challenge, Australia Post advised it was undertaking a fundamental review of its business model.

In July 2010 Australia Post launched Future Ready: a corporate wide transformation program. Future Ready included a review of Australia Post's strategic objectives and identified three key strategies, one of which is: *'Restore self-sustaining letters business.'*

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<sup>1</sup> Standards made under section 28C of the Australian Postal Corporation Act, 1989

The need to restore the letters business to self-sustaining is an essential point, as indefinitely continuing a service which does not generate a (reasonable) rate of return is inherently inefficient for Australia Post. By adjusting the pricing in the manner proposed, Australia Post can address both revenue and cost simultaneously.

- Customers who choose to remain with Regular will provide more revenue towards covering the efficient costs and achieving a reasonable rate of return.
- Customers who elect to use Off Peak will provide Australia Post with the opportunity to explore longer term benefits through variations to the current network.

## 2.1. Expected volume impact of PreSort proposal

The ACCC seeks comments on the impact the proposal is expected to have on demand for Australia Post's reserved services. In particular:

- Do you think that the increase in the price of Off Peak letter services and the proposed price differentials with Regular (PreSort) letter services are appropriate?
- To what extent do you expect the proposal to result in users migrating mail volumes from Regular to Off Peak mail? Would migration be due to:
  - The price differential?
  - The product design changes or
  - Both?
- Do you expect the proposed price changes to affect overall (i.e. aggregate) PreSort volumes?

The proposed changes are not expected to have an impact on overall demand for domestic reserved letter services<sup>2</sup>; they are however, expected to result in migration from Regular to Off Peak.

To give the proposed changes the greatest chance of success, Australia Post consulted with a broad selection of customers on the proposed price changes and improvements to product design prior to finalising the proposed changes in the draft notification. This enabled, where possible, concerns or identified impediments to Off Peak usage to be addressed. The price changes and improvements to product design are discussed below.

*Price changes* – the proposed price changes to the PreSort letter service represent only the third general increase since 1992. A comparison of the key PreSort price in 2010 to that in 1992 shows an increase of just 1.5% whereas CPI has increased by over 60% over the same period.

Overall the proposed prices represent an average increase to PreSort letter prices of 1.6c (GST Ex), within this overall increase there are some structural changes which include:

- increasing the price difference between Regular and Off Peak;
- aligning the Regular and Off Peak residue and unbarcoded residue prices; and
- increasing the price difference between same state and other state.

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<sup>2</sup> This is supported by letter demand analysis which identifies that letters are inelastic to price. Specifically for PreSort letters, the econometric modelling did not identify real price as being statistically significant.

Under the proposed changes, as a further incentive, for letters in barcode direct trays a customer can save a minimum of 0.3 cents, on what they currently pay, by migrating from Regular to Off Peak.

*Improvement to product design* – in developing the proposal that would form the basis of the customer consultation, Australia Post, based on previous customer feedback, knew that the uncertainty that the current Off Peak delivery window provides (ie delivery over a four day window) is one of the main inhibitors to customers using Off Peak. As such, Australia Post's proposal included a two day delivery window based on a 12 noon lodgement time.

The majority of customers consulted provided feedback and while there were three main areas of concern, the 12 noon lodgement time was the major one. In particular for mail houses, where production is generally geared to a 6pm lodgement time and changes to business processes and systems (eg separate files, impact on production schedule and service level agreements) would be costly.

As a direct result of this feedback, Australia Post amended its proposal to maintain the current lodgement time of 6pm. While this required a change to some of the delivery times, the benefit of delivery over a two day window remains. Customer feedback on the 6pm lodgement time has been extremely positive and Australia Post is working to ameliorate the other areas of concern (which relate to the use of the Off Peak imprint and reliability of delivery performance).

Australia Post asserts that the proposed prices are appropriate and expects that coupled with an improved delivery window the use of Off Peak will increase. An increase in the proportion of Off Peak will provide an increase in the level of network flexibility. As the level of Off Peak usage increases, Australia Post will analyse the operational impact to identify opportunities for change.

Feedback from the customer consultation process reinforced Australia Post's expectation that the proposed changes will lead to migration from Regular to Off Peak.

To estimate the level of migration, Australia Post undertook analysis at the customer / industry segment level to understand:

- current behaviour – to what degree is Off Peak used today? does behaviour within the segments vary? what insight can the Australia Post account managers offer? etc; and
- the type of letters sent by segment (eg promotional, bills, statements, terms and conditions, etc).

Australia Post then included assumptions around the likelihood of whether Off Peak would be suitable for a particular letter type. For example, within transactional letters the assumption was made that the longer the cycle time the greater the likelihood of change.

Based on this analysis Australia Post expects that with the proposed price and product design changes, the mix between Regular and Off Peak will shift from around 81% and 19% to 51% and 49%, but as mentioned earlier is not expected to have an impact on overall demand.

As noted in the draft notification, volume forecasts are aligned to Australia Post's 2010 corporate plan. Any variation between these volume forecasts and those in the previous notification are as a result of the finalisation of the forecasts in the 2010 corporate plan.

## 2.2. Expected costs impact of PreSort proposal

The ACCC seeks comments on the impact the proposal is expected to have on demand for Australia Post's costs.

- Do you expect Australia Post to benefit from cost savings as a result of its proposal?
- Do you expect the proposal (i.e. product design changes, migration of volumes from Regular to Off Peak) to impact Australia Post's costs structure over time?
- To what extent do you expect Australia Post to benefit from greater network flexibility as a result of the proposal?

A comparison of the costs in Australia Post's previous notification to those in the draft notification shows lower costs are forecast. This largely reflects Australia Post's continued pursuit of cost reduction rather than being driven by the proposed changes to PreSort.

Notwithstanding this, in 2011/12, Australia Post does expect to realise some cost savings (for interstate transport) as a result of the migration from Regular to Off Peak (ie use of surface / road) and has included these savings in the financial modelling.

However, as noted previously, as the use of Off Peak increases Australia Post expects that there will be opportunities to explore variations to the current network arrangements which are largely built around the need to perform to the Ordinary letter delivery standard.

### 3. Is Australia Post's proposed structure of prices likely to result in adverse effects on competition?

Australia Post's Letter Pricing Principles provide a balanced approach to the determination of letter prices. They recognise Australia Post's Community Service Obligations, but also the need to ensure the pricing structure reflects commercial and market needs – which include the recognition that bulk interconnection prices, in addition to requirements of the Australian Postal Corporation Act, 1989, reflect the level of work saved by Australia Post through work carried out by customers.

#### 3.1. Structure of Australia Post's proposed PreSort prices

The ACCC seeks comment on the effects, including competition effects, of the changes to the structure of Australia Post's prices. In particular:

- Are the price differentials proposed by Australia Post between its PreSort and Other (e.g. Ordinary, Clean Mail) reserved letter prices appropriate?
  - In particular, do the price differentials reflect the costs avoided by Australia Post (in other words, the work saved) due to the pre-processing services (e.g. barcoding, sorting and delivery of bulk mail to a specified post office) performed by customers?
- Do you expect the proposed prices to impact Australia Post's competitors in related markets for non-reserved services, including competition in the provision of mail pre-processing services?

Australia Post believes that the price differences are appropriate and that PreSort prices reflect the lower processing costs incurred by Australia Post as a result of the work undertaken by the customer. PreSort prices also encourage the adoption of machine efficient formats

For PreSort letters, the level of work saved by Australia Post through work carried out by customers largely involves the application of a delivery point identifier (DPID), in a four state barcode, to each letter. Application of this DPID enables the letter(s) to bypass one step (address character recognition via the MLOCR) within the processing function.

There is no impact on the other network functions (acceptance, transport and delivery) from the pre-work (for PreSort letters) undertaken by the customer.

The table below provides an average unit cost comparison (by network function) for the four domestic reserved letter product categories based on the average characteristics of a letter in that category. As the letter characteristics within each product category vary (eg ordinary small letters can vary from the single hand written letter lodged in a street posting box to a tray of 300 machine addressed letters) a large part of the variation between product categories will be attributable to this difference.

It is important to note this when comparing the average unit costs for Ordinary and PreSort for both small and large, as a comparison between Ordinary and PreSort should be based on a lodgement of letters with similar characteristics (eg same lodgement quantity, machine addressed, etc.) to provide a realistic comparison. If this fact is not accounted for in a comparison between Ordinary and PreSort, the difference between the average unit cost will be overstated.



Notwithstanding this qualification, the table below does illustrate that even with this bias against Ordinary letters the variation between average processing costs (for Ordinary and PreSort) is less than the average price difference.

### Domestic Reserved Letters – Average Unit Cost and Revenue – 2009/10



While the average price differences (between Ordinary and PreSort) are greater than the processing costs, they are considered appropriate to ensure they continue to encourage machine efficient formats and the adoption of quality tools (eg database accuracy and maintenance).

Given this, Australia Post does not expect that the proposed changes will have any impact on the provision of mail pre-processing services (eg the application of a DPID barcode by customer prior to lodgement).

### 3.2. Other proposed price changes

The ACCC seeks comment on whether the proposed price charges for Acquisition Mail, Charity Mail, Clean Mail and the Reply Paid annual fee are appropriate and justified.

While the proposed changes are largely focussed upon PreSort letters there are relationships within the existing letter price structure that, where appropriate, have been maintained.

An overview of these relationships is;

- Clean Mail (delivered according to the Ordinary delivery timeframe): is currently priced at the Regular unbarcoded residue price. This has been maintained to ensure the price incentive for PreSort is not reduced.
- Acquisition Mail (delivered according to the Off Peak delivery timeframe): is currently priced below the Off Peak price for barcode direct trays with residue prices aligned to the Off Peak residue price. A similar price differential has been maintained for barcode direct trays. Residue prices remain aligned to Off Peak residue.
- Charity Mail: The proposed prices for Charity Mail maintain the 5.5 cents (for Regular) and 6.0 cents (for Off Peak) reduction off the (non-charity) PreSort small letter barcode direct tray prices. In addition to the provision of Charity Mail, Australia Post takes its responsibilities as a corporate citizen very seriously and in 2009/10 delivered results that underscore its commitment to long-term sustainability founded on responsible business practice.

For Reply Paid, the proposed change to the annual fee follows a review that Australia Post recently undertook of its Reply Paid service. The review highlighted that costs associated with managing the Reply Paid accounts had increased and Australia Post believes that the proposed increase to the annual fee (which equates to of just \$1.25 per month) provides a more appropriate contribution to the administration and maintenance of the service. The Reply paid annual fee last increased in 2008.

The proposed changes also include some changes within PreSort:

- Alignment of Regular and Off Peak residue prices: barcode residue and unbarcoded residue prices for Regular and Off Peak have been aligned. This change reflects the fact that only barcode direct trays can be readily managed in the network to the Off Peak delivery time frame.
- For Regular the price difference between same and other state has been increased. The increase ensures that Australia Post provides a price difference that at least reflects the average transport cost avoided.

#### 4. What is the impact of the proposed price increase on Australia Post's recovery of allowable revenue?

While Australia Post's previous notification did not seek to fully recover the allowable revenue in 2010/11 (the ACCC's own modelling concurred with this point) the level of return was considered appropriate given the then prevailing global economic environment and a preference, based on customer feedback, to avoid large upfront price increases. As a result, as modelled in Australia Post's previous notification the domestic reserved letter service was forecast to under recover by \$202 million.

However, the environment in which the previous notification was prepared has changed. While still forecast to decline, our domestic letter volume growth rates out to 2011/12 show a three year average decline of 4.1% rather than 4.3% and the overall economic environment has improved.

As mentioned earlier, Australia Post has undertaken a fundamental review of its business model to ensure it is a sustainable business that can continue to meet its Community Service Obligations. This review also considered Australia Post's strategic objectives and identified a key corporate strategy of restoring a self-sustaining letters business.

To achieve a self sustaining letters business Australia Post will:

- continue to seek efficiency improvements and reduce costs;
- ensure our letter products continue to meet customer requirements; and
- seek moderate regular price increases.

The proposed changes in the draft notification are aligned with this strategy.

##### 4.1. Australia Post's proposed revenue

The ACCC seeks comment on whether it is appropriate for Australia Post's proposal to result in additional reserved services revenue.

The ACCC generally adopts a cost based 'building block' approach to assessing price notifications. This building block approach calculates the 'allowable revenue' which is the amount of revenue required to cover the total costs of an efficient service plus provide an appropriate rate of return.

Using this building block approach, the financial modelling within Australia Post's draft notification shows that even with the revenue from the prices proposed to take effect from 4 July 2011, Australia Post's domestic reserved letter service will under recover by \$180m in 2011/12.

This means that in 2011/12 (even with the full year impact of the price changes), Australia Post will not make any profit from the domestic reserved letter service; but instead will incur a loss of around \$108 million.

## 4.2. Australia Post's cost of capital

The ACCC seeks comment on Australia Post's return on capital and on whether Australia Post's proposed WACC parameters are appropriate?

In determining the appropriate weighted average cost of capital (WACC) parameters for its domestic reserved letters business, Australia Post sought independent expert advice from Value Adviser Associates.

Australia Post adopted in full the outcome from this advice in its draft notification of January 2011.