LETTERS GROUP

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18 July 2008

Mr Anthony Wing
General Manager – Transport and Prices Oversight
Australian Competition and Consumer Commission
Level 35 / 360 Elizabeth St
MELBOURNE VIC 3000

Dear Mr Wing

Notification of Changes to Domestic Reserved Letter Service

The purpose of this correspondence is to formally notify the Australian Competition and Consumer Commission (ACCC), in accordance with part VIIA of the Trade Practices Act 1974 (TP Act), of proposed changes to Australia Post's domestic reserved letter service which include the introduction of two new letter categories.

The proposed prices in this notification are the same as those included in Australia Post's draft notification (February 2008) and which were not objected to in the ACCC's Preliminary View (June 2008). The major elements of the price changes, which are proposed to take effect from 15 September 2008, are:

- a 5 cent increase to the basic postage rate (BPR);
- increases to other Ordinary Letter prices (Large, seasonal greeting cards etc) to maintain appropriate relativities to the BPR;
- increases to PreSort Letters by an average of 2.5 cents (GST exclusive);
    - Small PreSort by an average of 2.4 cents (GST exclusive); and
    - Large PreSort by an average of 3.2 cents (GST exclusive).

Additionally, Australia Post is proposing the introduction of two new letter categories:

- Metered / Imprint – provides a moderate discount for full rate letters where postage has been paid using a postage meter or by an Australia Post charge account; and
- Acquisition Mail – a geographically targeted, non personalised saturation delivery service.

The proposed price changes represent the first general increase to PreSort prices since 1992 and to Ordinary Letters, including the BPR, since 2003. Overall prices will increase by an average of 8.1 per cent compared with the Consumer Price Index which is estimated to increase by over 15 per cent from January 2003 to July 2008.

The primary objective of the price changes is to provide for a Letters business profitability that is considered acceptable by the ACCC.

The proposed prices:

- improve the profitability of the domestic reserved letters business in an environment of declining volume growth (compounded average growth of 0.3% since 2002) and reduced potential for ongoing productivity improvements;

- avoid significant "upfront" price increases, which can exacerbate unfavourable volume trends;

- as far as practicable, simplify Ordinary 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 and Australia Post's Community Service Obligations, better reflect the differences in costs, within and between, Ordinary Letters and Bulk Letters.

Australia Post's formal notification is provided in Attachment 1. Supporting information to the notification is included at Attachment 2.

Australia Post wishes to assist the ACCC in its consideration of this Notification and toward prompt resolution of any issues that may arise. Accordingly, please do not hesitate to contact Mark Pollock, Manager Letters Strategy & Planning Unit, on 9204 7578 if you have any questions regarding this Notification.

Yours sincerely

Allan Robinson
Group Manager, Letters

Attachment 1

NOTIFICATION AND DETAILS OF PRICES PROPOSED BY THE AUSTRALIAN POSTAL CORPORATION FOR ITS DOMESTIC RESERVED LETTER SERVICE

Notification of prices pursuant to section 95Z of the Trade Practices Act, 1974

Name of Declared Person: Australian Postal Corporation

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 and terms and conditions indicated, effective from 15 September 2008.

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, Clean Mail, Reply Paid, Postage Prepaid Envelopes, Local Delivery Letters, PreSort Letters (including Charity Mail, Impact Mail and Acquisition Mail) at prices as detailed in Schedule 1 of this Attachment.

Reasons for the proposed price changes:

- improve the profitability of the domestic reserved letters business in an environment of declining volume growth and reduced potential for ongoing productivity improvement;

- as far as practicable, simplify Ordinary Letter prices, for customer convenience, by selecting prices in multiples of 5 cents, and in multiples of the Basic Postage Rate (BPR) for relevant products; and

- Subject to the letter pricing principles and the need to fund Australia Post's Community Service Obligation (as outlined under section 27 of the Australian Postal Corporation Act, 1989), to better reflect the differences in costs, within and between, Ordinary Letters and Bulk Letters.

Consideration having regard to section 95G(7) of the Trade Practices Act, 1974

Australia Post asserts that the proposed price changes would not result in revenues in excess of revenues based on efficient costs and a reasonable rate of return and are consistent with the requirements of section 95G(7) of the Trade Practices Act, 1974

Date: 18 July 2008 Signature: Allan Robinson
Group Manager, Letters

Schedule 1

Proposed Price Structure

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

Ordinary Letters

	Current	Proposed Prices Amount	Proposed Prices % Change
Small Letters			
Ordinary - General (eg. Stamp)	$ 0.50	$ 0.55	10.0%
Ordinary - Imprint/Metered (new)	$ 0.50	$ 0.54	8.0%
Clean Mail	$ 0.45	$ 0.48	6.7%
Seasonal Greeting	$ 0.45	$ 0.50	11.1%
Barcoded and Metered	$ 0.48	$ 0.54	12.5%
Large Letters			
Seasonal Greeting Cards			
Up to 125g	$ 0.90	$ 1.00	11.1%
Ordinary Letters - General			
Up to 125g	$ 1.00	$ 1.10	10.0%
Over 125 up to 250g	$ 1.45	$ 1.65	13.8%
Ordinary Large - Imprint/Metered (new)			
Up to 125g	$ 1.00	$ 1.08	8.0%
Over 125 up to 250g	$ 1.45	$ 1.62	11.7%
Ordinary Letters Barcoded and Metered			
Up to 125g	$ 0.95	$ 1.08	13.7%
Over 125 up to 250g	$ 1.40	$ 1.62	15.7%
Clean Mail			
Small Plus Size			
Up to 125g	$ 0.70	$ 0.75	7.1%

Notes/Comments: Ordinary Letters

Small, 50 to 55; Large rounded to multiples of 55c

Introduction of new price category for items that are paid for by a charge account or postage meter. Large Letter prices are also multiples of the 54c price

Prices for Barcoded AND Metered have been aligned with the new category

Local Delivery (only available in specified postcodes)

	Current	Proposed Prices Amount	Proposed Prices % Change
Small Letters			
Up to 125g	$ 0.46	$ 0.51	10.9%
Medium Letters			
Up to 125 grams	$ 0.60	$ 0.70	16.7%
Over 125 up to 250g	$ 0.85	$ 0.95	11.8%
Large Letters			
Up to 125 grams	$ 0.85	$ 0.90	5.9%
Over 125 up to 250g	$ 1.20	$ 1.30	8.3%

Notes: Local Delivery

Local Delivery postcodes to be reviewed

Reply Paid

	Current	Proposed Prices Amount	Proposed Prices % Change
Small			
Barcoded	$ 0.40	$ 0.42	5.0%
Unbarcoded	$ 0.60	$ 0.63	5.0%
Annual Fee	$ 60.00	$ 65.00	8.3%
Large			
Up to 125g	$ 1.10	$ 1.20	9.1%
Over 125 up to 250g	$ 1.55	$ 1.75	12.9%

Noets: Reply Paid

Per item prices for Large are based on Ordinary Large Letter prices plus a 10c administration fee

PrePaid Envelopes

	Current Prices Single	Current Prices 1-4 Packs of 10	Current Prices 5+ Packs of 10	Proposed Prices Single	Proposed Prices 1-4 Packs of 10	Proposed Prices 5+ Packs of 10	% Change Single	% Change 1-4 Packs of 10	% Change 5+ Packs of 10
Plain Envelopes									
Small (DL and C6)	$ 0.60	$ 5.85	$ 5.70	$ 0.65	$ 6.34	$ 6.18	8.3%	8.3%	8.3%
C5 Size	$ 1.20	$ 11.70	$ 11.40	$ 1.30	$ 12.68	$ 12.35	8.3%	8.3%	8.3%
C4 Size	$ 2.35	$ 22.91	$ 22.33	$ 2.50	$ 24.38	$ 23.75	6.4%	6.4%	6.4%
B4 Size	$ 2.70	$ 26.33	$ 25.65	$ 2.90	$ 28.28	$ 27.55	7.4%	7.4%	7.4%
One Rate to the World Postcard	$ 1.20	NA	NA	$ 1.50	NA	NA	25.0%	NA	NA
Window Faced		Pk of 50	Bx of 500		Pk of 50	Bx of 500		Pk of 50	Bx of 500
Small (DL and C6)	NA	$ 29.70	$ 286.00	NA	$ 32.20	$ 309.50	NA	8.4%	8.2%

Notes/Comments - PrePaid Envelopes

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

Large Letter prices increased slightly, to reflect change to Ordinary prices, with rounding to five cent multiples.

One Rate to the World Postcard price reflects first increase since circa 2000

Barcode PreSort Letters

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

Regular Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
Size / Weight	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var
Small Letters												
Up to 125g	$ 0.374	$ 0.399	6.7%	$ 0.385	$ 0.410	6.5%	$ 0.424	$ 0.449	5.9%	$ 0.450	$ 0.480	6.7%
Charity Mail	$ 0.312	$ 0.344	10.3%	$ 0.323	$ 0.355	9.9%	$ 0.356	$ 0.394	10.7%	$ 0.450	$ 0.480	6.7%
Small Plus												
Up to 125g	$ 0.473	$ 0.509	7.6%	$ 0.495	$ 0.531	7.3%	$ 0.572	$ 0.619	8.2%	$ 0.700	$ 0.750	7.1%
Medium												
Up to 125g	$ 0.561	$ 0.630	12.3%	$ 0.594	$ 0.674	13.5%	$ 0.671	$ 0.768	14.5%	$ 0.803	$ 0.905	12.7%
Over 125 up to 250g	$ 0.724	$ 0.823	13.7%	$ 0.779	$ 0.911	16.9%	$ 0.889	$ 1.015	14.2%	$ 1.034	$ 1.158	12.0%
Large												
Up to 125g	$ 0.770	$ 0.773	0.4%	$ 0.825	$ 0.817	-1.0%	$ 0.935	$ 0.938	0.3%	$ 0.980	$ 0.982	0.2%
Over 125 up to 250g	$ 1.111	$ 1.103	-0.7%	$ 1.221	$ 1.191	-2.5%	$ 1.331	$ 1.323	-0.6%	$ 1.430	$ 1.433	0.2%

Off Peak Delivery	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
Size / Weight	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current*	Amount	% Var
Small Letters												
Up to 125g	$ 0.363	$ 0.388	6.9%	$ 0.374	$ 0.399	6.7%	$ 0.402	$ 0.432	7.5%	$ 0.435	$ 0.465	6.9%
Charity Mail	$ 0.296	$ 0.328	10.8%	$ 0.301	$ 0.339	12.6%	$ 0.340	$ 0.372	9.4%	$ 0.435	$ 0.465	6.9%
Small Plus												
Up to 125g	$ 0.451	$ 0.498	10.4%	$ 0.473	$ 0.520	9.9%	$ 0.550	$ 0.608	10.5%	$ 0.671	$ 0.720	7.3%
Medium												
Up to 125g	$ 0.528	$ 0.597	13.1%	$ 0.534	$ 0.630	18.0%	$ 0.638	$ 0.729	14.3%	$ 0.759	$ 0.850	12.0%
Over 125 up to 250g	$ 0.653	$ 0.757	15.9%	$ 0.669	$ 0.801	19.7%	$ 0.818	$ 0.949	16.0%	$ 0.946	$ 1.059	11.9%
Large												
Up to 125g	$ 0.748	$ 0.751	0.4%	$ 0.792	$ 0.784	-1.0%	$ 0.902	$ 0.905	0.3%	$ 0.957	$ 0.960	0.3%
Over 125 up to 250g	$ 1.045	$ 1.026	-1.8%	$ 1.111	$ 1.092	-1.7%	$ 1.254	$ 1.235	-1.5%	$ 1.353	$ 1.334	-1.4%

Impact Mail	Postcode Direct Tray			Area Tray			Residue		
		Proposed Price			Proposed Price			Proposed Price	
	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var
Small - up to 125g									
Same State	$ 0.550	$ 0.600	9.1%	$ 0.590	$ 0.640	8.5%	$ 0.660	$ 0.700	6.1%
Other State	$ 0.560	$ 0.610	8.9%	$ 0.600	$ 0.650	8.3%	$ 0.670	$ 0.710	6.0%
Small Plus - up to 125g									
Same State	$ 0.800	$ 0.850	6.3%	$ 0.850	$ 0.900	5.9%	$ 0.950	$ 1.000	5.3%
Other State	$ 0.810	$ 0.860	6.2%	$ 0.860	$ 0.910	5.8%	$ 0.960	$ 1.010	5.2%

Acquisition Mail	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
		Amount	% Var		Amount	% Var		Amount	% Var		Amount	% Var
Off Peak Delivery												
Small - Up to 125g		$ 0.280			$ 0.300			$ 0.432			$ 0.465	
Small Plus - up to 125g		$ 0.390			$ 0.410			$ 0.608			$ 0.720	

Notes/Comments - PreSort Letters

Small PreSort

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

Acquisition Mail

New category; Barcode Residue and Unbarcoded Residue are per the Off Peak price structure

Attachment 2

Supporting Information to Australia Post's Notification of Change to Domestic Reserved Letter Service

18 July 2008

Tables

Figures

Executive Summary

Pursuant to Declaration 75, Australia Post is a declared person under section 95X of the Trade Practices Act, 1974 (TP Act) and Australia Post's reserved letter services are notified services for the purposes of the TP Act. Consequently, to comply with the TP Act, Australia Post must notify the Australian Competition and Consumer Commission (ACCC) of any proposed change to reserved letter services.

This Notification covers price changes to domestic reserved letter services (eg Ordinary and PreSort up to 250g) effective 15 September 2008. The financial impact of these price changes are modelled over 2008/09 – the first financial year that the proposed prices would apply.

The major elements of the proposed prices (with a comparison to current prices) are shown in Schedule 1 of Attachment 1. The major elements are as follows:

- Increase of five cents to the basic postage rate (BPR)
- Increases to other Ordinary Letter prices (eg Large, Seasonal Greeting cards etc.) to maintain relativity to the BPR; and
- Increases to PreSort Letters by an average of 2.5c (GST exclusive);
    - Small PreSort, by an average of 2.4c (GST exclusive), and
    - Large PreSort, by an average of 3.2c (GST exclusive).

The proposed increases are the first for the BPR and other Ordinary Letters since January 2003 and the first general increase to PreSort Letters since January 1992: overall they represent an average increase of 8.1%.

Considering the Consumer Price Index (CPI) is estimated to have increased by over 15% (over the period January 2003 to June 2008), the proposed prices represent a real reduction of around 6%.

The primary objective of the proposed price increase is to provide for an appropriate return to the reserved letters business in the context of market and regulatory expectations, as follows:

- in the context of market expectations, proposed prices have been set to:
    - limit the risk of price increases having an adverse impact on demand;
    - optimise revenue management through lodgement conditions; and
    - maximise volumes of machine efficient mail.
- in the context of regulatory expectations, an appropriate return will be a return that is deemed by the ACCC as being 'reasonable':
    - Australia Post has modelled the proposed prices using the Post Tax Revenue Model (PTRM) used by the ACCC in Australia Post's 2002 Notification; and
    - under the PTRM, revenue from proposed prices is marginally less than the revenue that the PTRM calculates as being required.

The proposed increases are necessary to ensure that Australia Post's domestic reserved letter service generates a reasonable rate of return. They reflect an environment where:

- volume growth for domestic reserved letters has been low at around 0.3% per annum (since 2001/02): this is in stark contrast to the 1990s where volume growth averaged almost 4.5% per annum. The major feature being flat to declining transactional mail (78% of domestic letter volumes), which is under pressure from electronic substitution and the consolidation & rationalisation initiatives of business senders. The pressure on transactional mail is evident in postal organisations of other developed countries; many of which have already begun experiencing declines in overall letter volumes;
- there is reduced potential for ongoing productivity improvement within Australia Post; and
- Australia Post is required to continue to fund its Community Service Obligations (CSO) and meet its regulated performance standards.

In its Statement of Regulatory Approach to Assessing Price Notifications of July 2005 (Statement of Approach) the ACCC considers that the criteria in section 95G(7) of the TP Act can generally be met by economically efficient prices which reflect:

- an efficient cost base; and
- a reasonable rate of return on capital.

Australia Post believes that the cost base for the domestic reserved letters business is efficient. As the ACCC stated in their Decision of October 2002 in respect to Australia Post's 2002 price notification (Decision of October 2002)"… the current level of operating and maintenance costs are a reasonable starting point for an analysis of Australia Post's profitability".

In assessing Australia Post's productivity performance since 2002, Australia Post has commissioned Meyrick and Associates to update their 2002 study which they undertook on behalf of the ACCC. The 2007 review by Meyrick and Associates covered Australia Post's aggregate and reserved service productivity performance. A copy of the report has been made available to the ACCC. As noted in the 2007 Meyrick report,

> "Both Australia Post's TFP indexes have outperformed the market sector multifactor productivity (MFP) index over both the last 11 years and the last five years. Given that Australia Post's reserved service output has essentially been flat since 2001, being able to outperform the productivity performance of the economy as a whole has been an impressive achievement".

The proposed prices provide for a rate of return that is below the reasonable rate of return that was determined by the ACCC in their June 2008 Preliminary View. The rate of return applied is in the form of a Weighted Average Cost of Capital (WACC). The WACC formulations used by Australia Post are those specified by the ACCC in section 18 of the Record Keeping Rules (RKR). In terms of the pre-tax nominal WACC formulation in section 18(3) of the RKR, Australia Post's pre-tax nominal WACC for the reserved letter service is 11%.

1. Introduction

This Notification sets out Australia Post's evidence and arguments supporting the allowance for an increase to the domestic reserved letter prices – including the BPR. In lodging this Notification Australia Post asserts that the proposed price changes:

- recover the efficient forward costs of providing the domestic reserved letter service (incorporating the effects of continuing productivity improvements);
- embody a rate of return that is below that considered reasonable when applied to an efficient capital base for the services; and
- reflect the pursuance of pricing, and financial targets, embodied within Australia Post's corporate plan.

2. Duration of this Notification

The proposed prices in this Notification have been modelled over the 2008/09 financial year (the first financial year that proposed prices would apply). This is a shorter period than modelled in Australia Post's 2002 Notification – which covered a five year period.

As noted by ACCC in its paper titled 'Statement of Regulatory Approach to Assessing Price Notifications' of July 2005 (Statement of Approach):

> "The ACCC's experience in assessing price notifications has led it to adopt a flexible approach to assessment which reflects the individual characteristics of each price notification. For example, the complexity of issues raised, the length of the pricing period and the number of goods and services covered will affect how the ACCC approaches an assessment."

Further, as observed in the ACCC's Decision of October 2002[1]:

> "There is no fixed regulatory period for assessments under the PS Act. However, 5 years is a common period for regulatory horizons in industries such as gas and electricity…"

In modelling proposed prices and the resulting rate of return over a longer period, as was the case in Australia Post's 2002 Notification, the actual rate of return varies on a year-to-year basis. In the 2002 Notification, the effect of constant prices over the period combined with an underlying trend of increasing costs meant that over-recovery occurred in the initial years and under-recovery in the later years of the period.

For Australia Post's 2002 Notification, the five year period was appropriate, where the average price increase under the 2002 Notification initially resulted in a rate of return above a normal economic return, but the rate gradually declined, providing a reasonable, economic rate of return, when taken over the five year period.

However, for a number of reasons detailed below, a five year price period is not appropriate or desirable for this Notification:

- in contrast to the higher profitability in 2001/02, domestic reserved letter service profitability in the 2007/08 will be negligible. Therefore, a long period is not required to achieve an average profitability in line with the required rate of return; and
- to bring about average returns over a number of years would require a significant upfront price increase. Australia Post believes that significant price increases should be avoided, as experience with customers who use other non-reserved letter products (eg Print Post and Unaddressed Mail) indicates that there has been a distinct preference for modest price adjustments at more frequent intervals as opposed to significant increases at infrequent intervals.

[1] Page 50 & 51, ACCC Decision of October 2002 in respect of Australia Post's 2002 price notification

Australia Post does not disagree with the ACCC's comments in its Decision of October 2002 that:

> "The appropriate regulatory period is a balance between competing demands. A short period, such as one year, generates excessive costs for frequent notifications and regulatory inquiries, and perhaps administrative costs for adjustment of prices."

However, as indicated above, this Notification models the financial outcomes for a one-year period only. Any longer than this would either:

- require price rises that may be too large in view of the maturity of the letter market; or
- result in an inadequate profit for the domestic reserved letter service.

While not specific to this Notification, Australia Post believes that the combination of ongoing rises in labour and other costs (eg contractors, accommodation, fuel), modest future productivity growth and weak volume outlook wholly support the need for frequent, lower price rises in the future. This would enable a steady level of reserved service profitability to be maintained rather than the commercially undesirable volatility of the past five years. Such incremental price changes, which would result in a more constant rate of return from domestic reserved letters, is considered to be more consistent with the outcomes of the competitive market (where reflection of the outcomes of a competitive market could be considered to be an underlying objective of the prices surveillance regime for notified services).

As noted in Australia Post's response to the ACCC's June 2008 Preliminary View, Australia Post looks forward to working with the ACCC to discuss various matters, including the time period modelled, and reach an agreed position that can be followed /observed in future price notifications submitted by Australia Post.

3. Proposed Prices

Schedule 1 of Attachment 1, details the proposed change in unit prices under this Notification. However, a summary of the major elements of the pricing proposal is as follows:

- increase of 5 cents to the BPR;
- increases to other Ordinary Letter prices (eg Large, Seasonal Greeting) to maintain relativity to the BPR; and
- Increases to Bulk Letter prices:
  - Small PreSort an average increase of 2.4 cents (GST Exclusive); and
  - Large PreSort an average increase of 3.2 cents (GST Exclusive).

The proposed prices represent the first general increase to PreSort prices since 1992 and to Ordinary Letters, including the BPR, since 13 January 2003. Overall, the proposed prices represent an average variation on 2003 prices of 8.1% (and include 10% increase to the BPR). Furthermore, considering the Consumer Price Index will have increased by over 15%[2] over the period (January 2003 to June 2008), the proposed prices represent a real reduction of around 6% on the 2003 prices.

3.1. Grounds for Proposed Prices

The proposed price changes have been developed pursuant to Australia Post's Letter Pricing Principles (Appendix 1) and have been modelled in an environment where:

- addressed letter volume growth is declining with a compound average growth of only 0.3% since 2002 (section 8);
- there is reduced potential for ongoing productivity improvement (section 10); and
- Australia Post is required to continue to fund Community Service Obligations (CSO) (7.6).

Australia Post believes these prices better reflect the differences in costs within, and between, Ordinary Letters and Bulk Letters and, as far as practicable, simplify Ordinary Letter prices for customer convenience by selecting prices in multiples of five cents and in multiples of the BPR for relevant products.

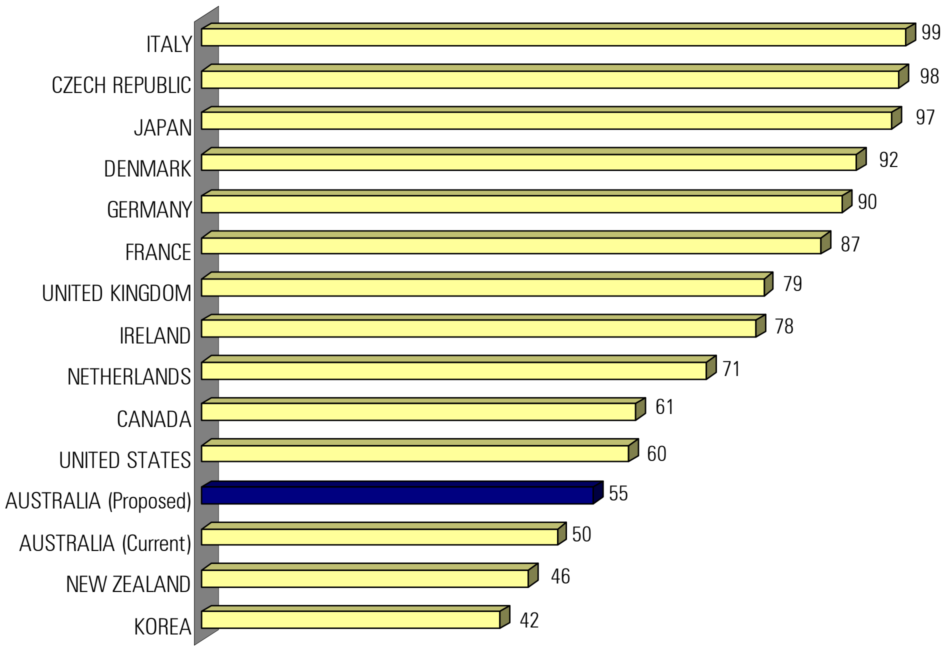
3.2. Price Comparison

Australia Post's letter prices compare favourably with letter prices in other OECD (Organisation for Economic Co-operation and Development) countries. At 55 cents, Australia Post's proposed BPR would still be the third lowest in the developed world as illustrated in Figure 1.

Many European countries do not apply their VAT (GST) to domestic postage. When comparisons between Australia's BPR and overseas rates are made on a like-with-like basis, the reasonableness of the proposed BPR is even more evident. Appendix 2 details this.

[2] Actual December 2007 and Access Economics forecasts of CPI rises thereafter

Figure 1 – Standard Letter Price Comparison (Purchasing Power Parity[3])



[3] Source OECD and Australia Post – Prices in other countries as at June 2008

4. Regulatory Overview

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

4.1. Declaration 75

Declaration 75 was made under section 21 of the Prices Surveillance Act 1983 (PS Act) on 5 February 1992. The PS Act was repealed on 1 March 2004 and the relevant provisions of the Act incorporated into the TP Act, under Part VIIA Prices Surveillance. Declarations and other instruments made under the PS Act are carried over to have effect as if made under the corresponding section of the TP Act, pursuant to the Trade Practices Amendment Act 2003 (TPA Act).

Pursuant to Declaration 75 made by the Minister, Australia Post is a declared person under section 95X of the TP Act. Furthermore, letter services reserved to Australia Post under Division 2 of Part 3 of the Australian Postal Corporation Act 1989 (APC Act) are notified services.

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

- increase the price of a notified service (ie a reserved letter service); or
- introduce a new service that would fall within the definition of a reserved letter service; or
- provide an existing reserved letter service under terms and conditions that are not the same or substantially similar to the existing terms and conditions of that service.

4.2. APC Act

Section 38 of the APC Act sets out financial and cost recovery requirements that Australia Post will have regard to in preparing or revising a financial target for inclusion in a corporate plan under section 17 of the Commonwealth Authorities and Companies Act 1997. The matters the Australia Post Board are to have regard to include:

- the expectation of the Commonwealth that Australia Post will pay a reasonable dividend (section 38(c));
- the need to maintain Australia Post’s financial viability (section 38(d));
- the need to maintain a reasonable level of reserves (section 38(e)); and
- the cost of carrying out Australia Post’s CSOs (section 38(g)).

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

5. Approach to Assessment of this Notification

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

- the need to maintain investment and employment, including the influence of profitability on investment and employment (section 95G(7)(a));
- the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices (section 95G(7)(b));
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals (section 95G(7)(c).

In the Statement of Approach, the ACCC considers that the criteria in section 95G(7) of the TP Act can generally be met by economically efficient prices, which reflect:

- an efficient cost base; and
- a reasonable rate of return on capital.

Additionally, Direction 11 (made by the Minister under section 20 of the PS Act on 19 September 1990 (and given effect in terms of the TP Act pursuant to 'carry over' provisions of the TPA Act)) directs the ACCC to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35 to 41 of the APC Act[4], particularly the pricing and financial targets.

Accordingly, the approach adopted by Australia Post is that the evidence and arguments contained within this Notification will provide the supporting information required to demonstrate:

- the efficiency of Australia Post's cost base;
- that the rate of return is reasonable; and
- that proposed prices reflect Australia Post's obligations to operate in a manner consistent with sound commercial practice.

Australia Post will work with the ACCC to assist it in its consideration of this Notification and toward the prompt resolution of any issues which may arise.

[4] Sections 35, 36, 37, 39 and 41 of the APC Act were repealed in 1997 and their subject matter incorporated into section 17 of the Commonwealth Authorities and Companies Act 1997

6. Consultation

Australia Post has undertaken stakeholder consultation in relation to the proposed price changes under this Notification. During January 2008, Australia Post commenced confidential discussions with the Major Mail Users Association (MMUA) and the Australian Direct Marketing Association (ADMA) in accordance with agreed consultation protocols with each of those organisations.

The purpose of the consultation process is to ensure an exchange of information and better mutual understanding of the perspectives of Australia Post and these stakeholders before any price proposals are finalised.

During the consultation process with the MMUA and ADMA, Australia Post has responded to several queries and requests for further information. As part of the consultation process, Australia Post also seeks to understand whether the proposed prices will result in a significant disadvantage to a particular member or market segment. The consultation process did not identify any such impacts.

7. Australia Post

7.1. Nature of Australia Post

Australia Post is one of Australia's oldest (commercial) organisations. It is a Government Business Enterprise and is wholly owned by the Commonwealth Government.

Aside from its ownership and a number of specific legal obligations, Australia Post is clearly recognisable as a leading Australian corporation. It is a self-funding business managed by a Board of Directors. It is subject to all applicable Commonwealth, State and local government laws. It pays all rates and taxes at normal rates to all three levels of government. It is subject to Australian accounting standards. It pays dividends to the owner on normal financial principles.

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

- the supply of postal services within Australia and between Australia and places outside Australia (the principal function, as specified in section 14 of the Act);
- to carry on, outside Australia, any business or activity relating to postal services (the subsidiary function specified in section 15); and
- the carrying on of any business or activity that is incidental to the principal and subsidiary functions (from section 16).

Further, section 25 of the APC Act states that Australia Post has commercial obligations under section 26, community service obligations under section 27, and general governmental obligations under section 28 of the Act.

Australia Post's financial and operational success is reflected in a number of recent achievements including:

- Australia Post is rated AAA by Standard & Poor's, which is the highest level of corporate credit rating assigned by that organization. Australia Post is the only Australian corporation rated AAA, and the only postal service rated by Standard & Poor's to currently hold this level of rating. Australia Post has maintained its AAA rating continuously since the initial rating was issued in 1994;
- World Mail Awards 2004 – Transformation; Australia Post won the Award for successfully transforming '…to an organisation that has achieved excellent results across the full range of key measures…on a sustained basis for over a decade, in service quality, prices and financial results.';
- World Mail Awards 2008 – Australia Post won the top award in the 'growth' category for successfully encouraging the use of mail as a promotional channel. Australia Post's entry highlighted the range of initiatives and industry collaboration undertaken to drive the growth of promotional mail volumes and industry growth in general; and
- through sustained productivity growth, at three times the national average since 1990, Australia Post has been able to reduce real prices, thus generating business growth without increasing the employment base.

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, introduction of new services and the operation of the postal network in a manner consistent with sound commercial practice.

7.2. Dimensions of Australia Post

Australia Post makes a major contribution to Australia's economic prosperity and development. In 2006/07 (with all financial data shown to the nearest $ million), Australia Post achieved:

- revenue of $4,678 million;
- profit after tax of $401 million, from which a dividend declared to the shareholder was $297 million;
- taxes paid to the three levels of government totalled $484 million;
- almost 35,000 jobs were provided directly to permanent staff, together with another 1,500 employed in various categories in subsidiary companies;
- almost 1,000 additional positions were filled by agency and casual operators;
- over 7,000 small businesses directly supported as licensed or franchised post offices, or as mail contractors;
    - including almost 5,000 small businesses in regional and remote areas of Australia;
- a retail network of 4,449 outlets
    - With 2,553 in rural and remote areas; and
- delivery to 10.3 million addresses across Australia.

Appendix 3 provides an overview of Australia Post's contribution to economic development.

7.3. Markets in which Australia Post Operates

Australia Post has three main business portfolios:

- Letters & Associated Services, which operates in the Australian communications market. In 2006/07 the Letters & Associated Services portfolio generated $2,679 million of revenue and $160 million EBIT. All of the letter services reserved to Australia Post lie within this portfolio;
- Retail Products & Agency Services, which operates in the Australian retail merchandise, financial services and emerging identity markets. In 2006/07 the Retail Products & Agency Services portfolio generated $681 million of revenue and $87 million of EBIT; and
- Parcels & Logistics, which operates in the Australian and International parcel and logistics markets. In 2006/07 the Parcels & Logistics portfolio generated $1,199 million of revenue and $223 million EBIT.

An overview of services and products within each of the three main business portfolios is provided at Appendix 4.

7.4. Service Standards

As illustrated in Table 1 below, Australia Post's service performance ranks among the best in the world despite Australia's large geographic size, highly dispersed population and relatively low mail density. Australia 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.

Table 1 - 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)	21.0[5]	33.2[6]	303.6[7]	60.8[8]	4.2[9]
Area (million sq kms)	7.7	9.2	9.2	.24	.27
Persons/sq km	2.7	3.6	32.7	253.3	15.2
Annual mail items per capita	241	348	663	334	unknown

Source: Postal Service Terms and Conditions (Various)
Note: na = not applicable

7.5. Reserved Service

Under section 29 of the APC Act, Australia Post has the exclusive right to carry letters for delivery within Australia, whether the letters originated within or outside of Australia. There are some exceptions to this right which are detailed in section 30 of the APC Act, the most notable of which are;

- letters that are carried for a fee or charge that is at least 4 times the rate of postage of the carriage within Australia of a standard postal article by ordinary post (i.e. the BPR); and
- letters that weigh more than 250 grams.

Letter services reserved to Australia Post are listed in Appendix 5.

7.6. Community Service Obligations

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

Key requirements of the letter service are that:

- it includes a single uniform rate of postage for the carriage within Australia by ordinary post of letters that are standard postal articles;
- in view of the social importance of the letter service, the service is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business; and
- the performance standards (including delivery times) for the letter service reasonably meet the social, industrial and commercial needs of the Australian community.

[5] ABS – as at December 2007
[6] Statistics Canada November 2007
[7] US Census Bureau December 2007
[8] CIA World Fact Book July 2007
[9] Statistics New Zealand December 2007

Compared with a fully commercial operation, the CSOs impose a cost structure that is higher than would otherwise be the case. The CSO cost occurs when the charge for the prescribed service does not recover the cost of delivering the service. In costing the CSOs, Australia Post's approach has been to identify those activities which a commercial enterprise, motivated by the pursuit of its own commercial interest, would not carry out to the same extent or under the same conditions. Australia Post's CSO net cost for 2006/07 is estimated to have been $97.3m

7.7. Performance Standards

Under section 28C of the APC Act, the regulations may prescribe performance standards that Australia Post is required to meet. The prescribed performance standards must relate to:

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

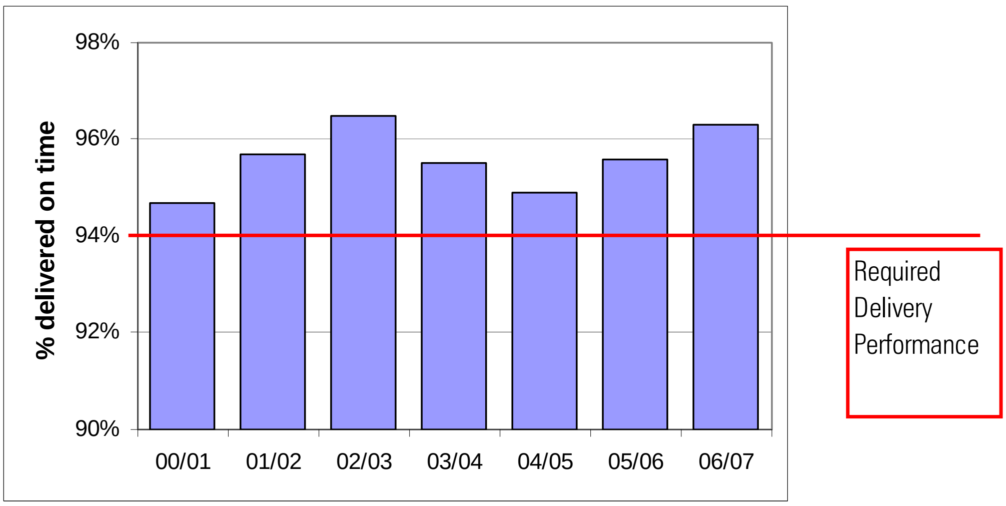
Performance against these standards is subject to independent audit by the Australian National Audit Office. As detailed in Table 2, Australia Post continued to meet its regulated performance standards in 2006/07.

Table 2 - Performance Standards 2006/07

Standard	Required Performance	Actual Performance
Number of Street Posting Boxes	10,000	15,606
Delivery Timetables	Maintained	Maintained
On time delivery of non Bulk Letters	94%	96.3%
Points to receive deliveries five days per week	98%	98.7%
Points to receive deliveries no less than twice a week	99.7%	99.9%
Retail Outlets	4,000 (2,500 in rural and remote areas)	4,449 (2,553 in rural and remote areas)

Figure 2 below shows the delivery performance for non-bulk letters since 2000/01.

Figure 2 – Delivery Performance – Non-Bulk Letters 2000/01 to 2006/07



8. Letter Volumes

In the early part of the 1990s domestic small letter volume growth tracked or exceeded Australian non-farm Gross Domestic Product (GDP) and achieved a compound annual growth of almost 4.5%. However, the letter volume growth rate has been in decline since 1994/95 with the exception of volumes in 1999/00 when a number of factors (introduction of the GST, a large number of public share offers and a federal referendum) drove extraordinary volume growth of 5.7%. Since 2002 letter volume growth has been low at an average of 0.3% p.a.

8.1. Australia Post's Domestic Letters Market

Australia Post's domestic letters market is represented by three letter segments: Transactional, Promotional and Social (an overview of each segment is provided at Appendix 6).

Transactional mail accounts for 78% of domestic letter volumes, promotional mail 18% and social mail 5% (percentages are rounded to the nearest percent) and while all segments of the domestic letters market are under threat, the impact is heightened for the transactional segment, with a 5% growth in promotional mail needed to offset each 1% decline in social and transactional mail.

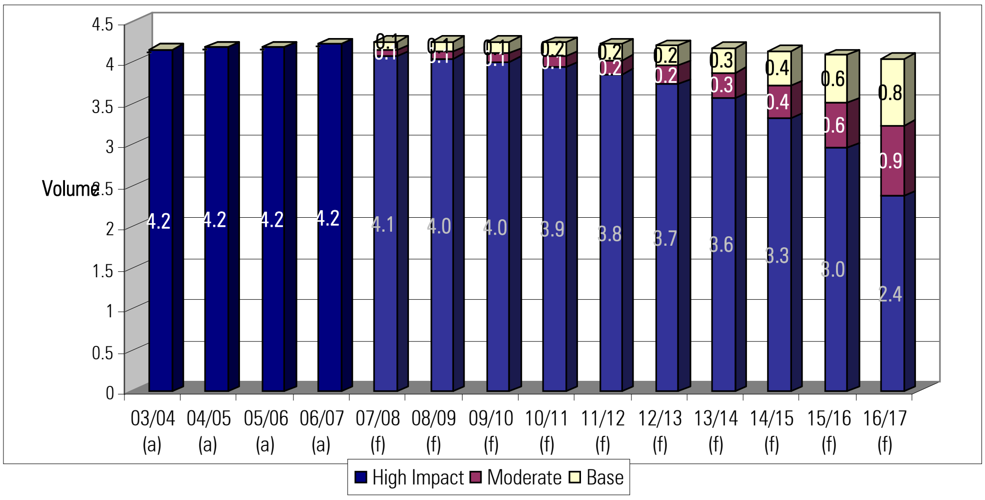
Australia Post continues to promote and encourage the use of paper-based communications through programs of work specific to each market segment. Achievements for 2007/08 include:

- developing individual strategies to retain customers identified as being most at risk of moving to electronic communications (transactional mail);
- a mail channel advertising campaign launched in May 2008 (promotional mail); and
- continuing to reaffirm the social niche by highlighting the personal connection value of paper mail and encouraging people to use mail for special occasions (social mail).

Figure 3 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 10 years based on both a moderate take-up and a high take-up scenario for each of the three impacts.

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

Figure 3 – Australia Post Letter Volume[10]



(a) = actual (f) = forecast

<u>Assumptions:</u>

Base	Underlying letters volume growth, -0.4% average growth per annum
Moderate Impact	An additional (to base case) 25% of Transactional, 5% of Promotional and 25% of Social mail will be lost to consolidation and substitution in the next 10 years
High Impact	An additional (to base case) 50% of Transactional, 15% of Promotional and 50% of Social mail will be lost to consolidation and substitution in the next 10 years

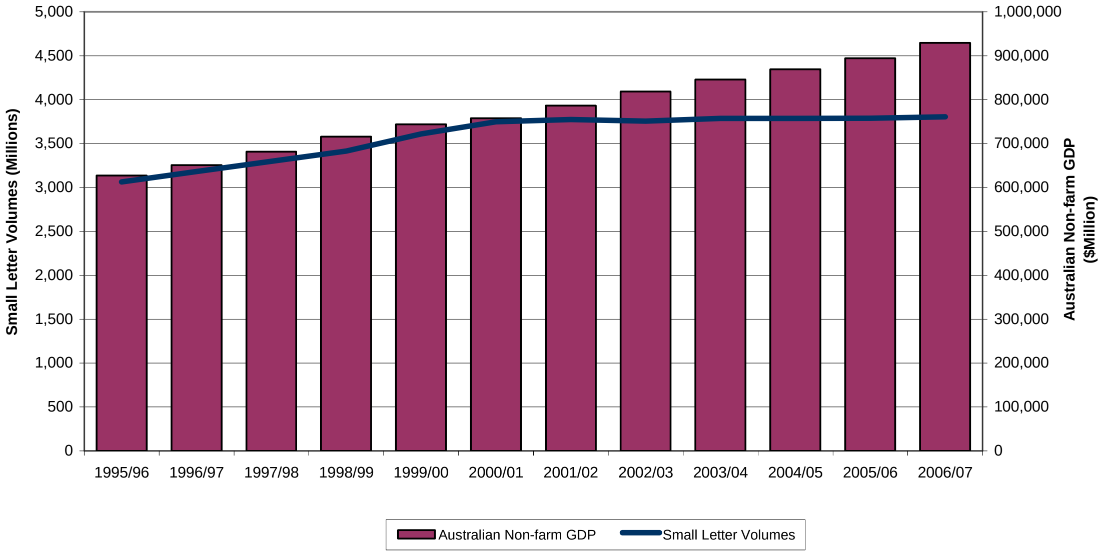
The volume forecasts included in this Notification are based on the "base" scenario and therefore do not anticipate any significant increase in the rates of substitution or consolidation in the period concerned.

8.2. Letter Volume Growth vs Non-farm GDP

Studies undertaken by Diversified Specifics, on behalf of Australia Post (and which include an allowance for moderate but increasing substitution, mail piece consolidation and rationalisation), since 2001/02 show that non-farm GDP is no longer the primary driver of letter volumes and that this divergence between non-farm economic activity and small letter volumes will continue at an increasing rate. This divergence is illustrated in Figure 4 below

[10] Source: Australia Post

Figure 4 – Letter Volume Growth vs GDP Growth



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

8.3. Price Elasticity

Within Australia, letter demand has historically been price inelastic for small price changes. Australia Post has recently commissioned Diversified Specifics to review price elasticity within Australia. A full version of the report which analyses letter demand within Australia has been provided to the ACCC, with the key findings from the report provided at Appendix 7.

The findings of the report indicate that, while letter volumes overall appear to have been inelastic to the low levels of price change experienced in the past decade or two, the elasticity does vary by the type of mail. Typically, social and transactional mail have a lower level of elasticity, whereas for promotional mail elasticity is higher.

This is consistent with behaviour overseas, as identified in a recent report by Direct Communications Group[11], which observed as follows:

- from a review of 45 studies that presented price elasticity estimates for postal operators in six countries only one estimated a price elasticity of greater than -1 (and that relates to a mail category that is unique to the US market); and
- price elasticity measures for postal products ranged between -0.2 and -0.8, with the price elasticity for promotional mail being higher than transactional mail.

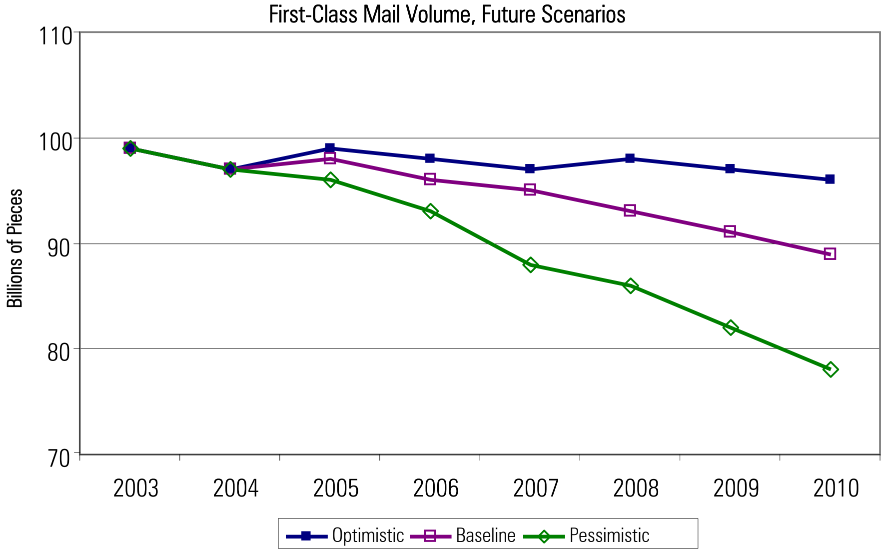
Although the modelling by its nature cannot demonstrate this at present, Australia Post believes that if regular, modest price adjustments are replaced by infrequent significant increases, then the elasticity effect would become more visible and pronounced as customers adopt an increased use of different communication channels / media.

8.4. International (US / Europe)

Similar to the Australian letter market, falling letter volume growth and actual letter volume reductions have been projected for the letters markets in the United States. Figure 5 below indicates the projected United States Postal Services (USPS) volume growth for first class mail (typically transactional mail); with the most optimistic scenario predicting moderate decline.

[11] A Review of Price Elasticity Models for Postal Products, Direct Communications Group, 2007

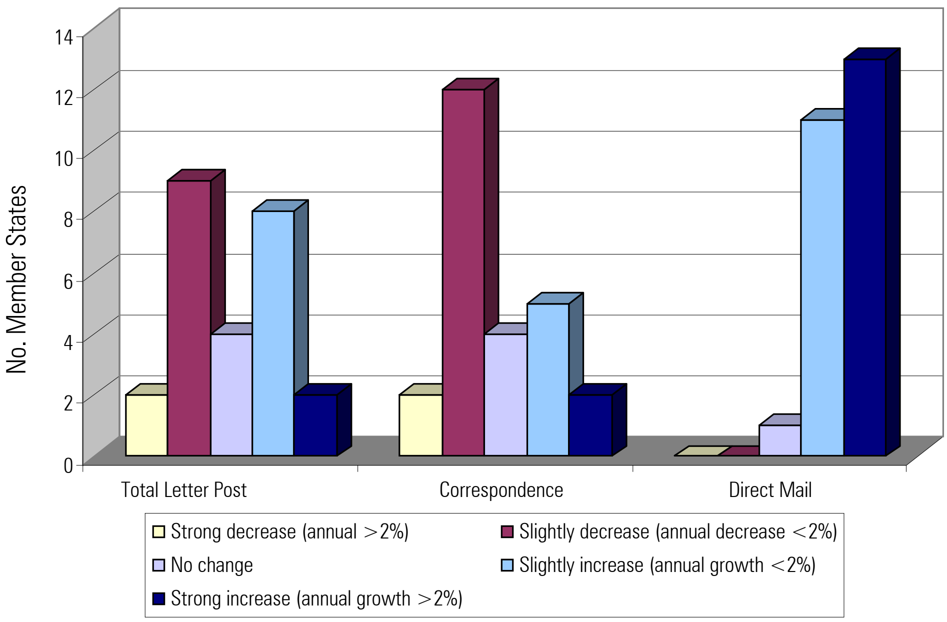
Figure 5 – USPS – Mail Volume Assumptions[12]



The latest USPS results[13] reported that in fiscal year 2007 first class mail volumes were down 1.8% on the prior year and in the first two quarters of fiscal year 2008 volumes were down 3.9% and 3.1%.

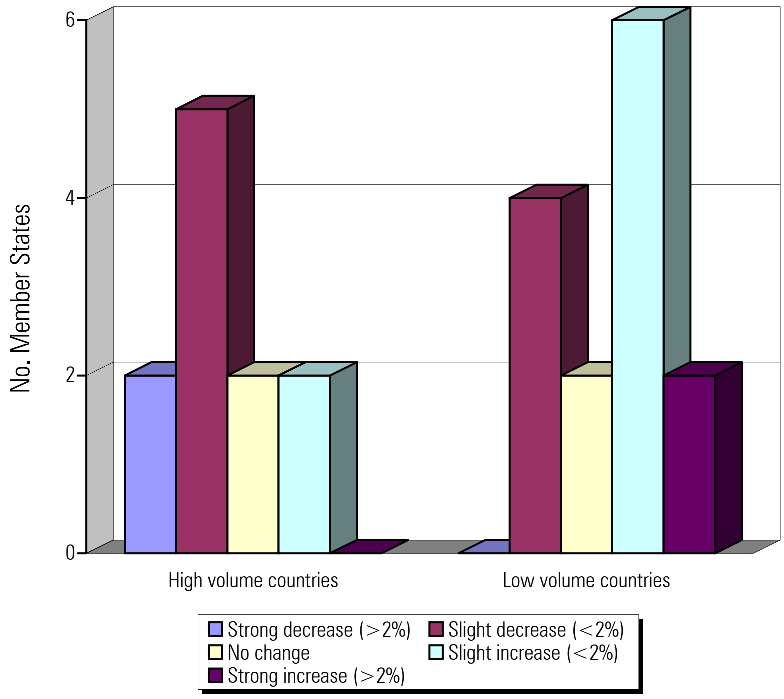
Figure 6 below summarises the expectation on future development of volumes in the European Union's 25[14] member countries; separately for total letter post, correspondence and direct mail. While decreases in letter post volumes are expected in eleven countries, four countries expect volumes to remain stable and ten expect increasing volumes. However, expectations are remarkably more optimistic in the less developed countries where volume per capita is relatively low, than in more developed postal markets where total letter post volumes are expected to decline rather than grow in most (Figure 7).

Figure 6 – European Letter Post Volume – Future Trends[15]



[12] USPS Strategic Transformation Plan 2006-2010
[13] USPS website – financial highlights
[14] Bulgaria and Romania joined the EU 1 January 2007 taking current EU membership to 27
[15] Source: wik Consult 'Main Developments in the Postal Sector (2004-2006)'

Figure 7 – European Total Letter Post Volume – Future Trends



8.5. Summary

As new mail growth events are not expected in the future, and as technology substitution and mail piece consolidation increase, the volume growth outlook in future years is flat with actual volume decline anticipated by 2010. In these circumstances, the volume-related productivity gains experienced in the last decade will not, and cannot, be expected to be repeated.

9. Cost Base

A key principle adopted by the ACCC in its Decision of October 2002 was that Australia Post's cost base had to be efficient if it was to provide a foundation for the ACCC's allowable revenue calculation.

In that case, the ACCC found that "… the current level of operating and maintenance costs are a reasonable starting point for an analysis of Australia Post's profitability".

Australia Post takes 2006/07 as the period appropriate to form the base year for this Notification. Consequently, this section will focus on cost movements in the five years since the last case to 2006/07.

As noted in the ACCC's Decision of October 2002, the purpose of examining cost changes over the five years since the last price rise is not to use those changes to seek compensating price rises, but instead to demonstrate that both the new cost base and the forward cost estimates are efficient.

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

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

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

This means, under the forward-looking price control approach applied based on the PTRM, that Australia Post's productivity performance in relation to the operating and maintenance costs (which are highly variable when compared to capital costs) is more crucial for its on-going profitability and ability to fund its operations. It also indicates that Australia Post faces higher risk in relation to non-capital cost variations over the future regulatory period, than a typical infrastructure-based enterprise.

For this reason, this section is focussed on non-capital costs i.e. operating and maintenance costs. Labour and labour related costs are particularly important, making up about 50% of total operating costs for Australia Post, and 70% of total costs for the domestic reserved letters business in 2006/07. The capital costs of providing the reserved letter services comprise depreciation charges, and the rate of return (section 11 of this Notification) applied to the efficient asset base for the services (refer section 12).

9.1. Australia Post's Cost Base

Excluding interest expenses, Australia Post's operating cost structure in 2006/07 was as shown in Table 3.

Table 3 – Operating Cost Structure 2006/07

	$ million	% of total
Labour and labour related	1,999	49
Contractors and Licensees	992	24
Accommodation	209	5
Depreciation	174	4
Payments to other postal authorities	95	2
Other expenses	647	16
Total operating expenses	4,116	100

All Australia Post operating divisions have Key Performance Indicators (KPIs) relating to productivity and cost control. For example, in recent years, the Mail and Networks Division (M&ND) has had a core performance target (endorsed by the Australia Post Board) to achieve operating cost savings of around $30 million p.a. (on average) over the relevant three year corporate plan period. Over the past five years, M&ND has achieved or bettered this target each year.

Figure 8 shows the four operating areas of sales & acceptance, mail processing, transport and delivery within Australia Post's mail value chain.

Figure 8 – Mail Value Chain

23,703 access points including:
4,449 retail outlets
15,606 street posting boxes

30 sorting hubs
9 metro Letter facilities
21 country Letter facilities
5 Parcel facilities
6 International Gateway facilities

20 Transport depots
120 prime movers
480 heavy rigid vehicles
1,200 vans

271 Delivery facilities
10,266,637 delivery points
5,296 mail contracts
7,300 motorcycles

Note: Bulk mail can also be lodged at most mail processing facilities

Note: Some parcel facilities are co-located with letter facilities and country facilities do some parcel processing

Note: Some contract transport, including air line haul, is used to move mail around Australia and to overseas destinations

Note: Mail contracts refers to the number of contracts not the number of people involved and not all of the contracts are for delivery

Handled 5,515.8 million articles (+1.8%) in 2006/07

9.2. Labour Costs

Labour costs represent by far the largest component of Australia Post's total cost base. As mentioned earlier, for the domestic reserved letter service, labour costs represent 70% of total costs whereas depreciation represents around 5%.

9.2.1. Wage and Salary Rates

Wages and salaries for award level staff are set within enterprise bargaining agreements (EBAs). These began in 1992, and have contained both salary increases and one-off cash bonuses dependent on the achievement of an agreed key performance indicator such as on-time delivery rates. The most recent EBA (EBA6) expired on 31 December 2006. A summary of Australia Post's EBA's since September 2002 is provided at Appendix 8.

As part of the negotiation for the replacement of EBA6 (which we refer to as EBA7), Australia Post has committed to salary increases. Payment of the first increase (4%) was made effective from August 2007, with the final payment (2%) scheduled for December 2010.

In addition to the salary increases, award level staff will be eligible for a performance bonus in September 2009.

History indicates that Australia Post's EBAs have been broadly in line with workforce expectations, business requirements and external market trends.

9.2.2. Labour Force Size

As detailed in Australia Post's Annual Reports over the relevant years, Australia Post's labour force has reduced from 36,877 in 2001/02 to 35,476 in 2006/07. In fact, Australia Post's workforce in 2006/07 was approximately 4,000, or 12%, less than its level a decade earlier. (This comparison includes part-time staff measured as 70% of a full-time equivalent (FTE)). Table 4 below shows the labour usage trends of the five years to 2006/07.

Table 4 – Labour Numbers

	Full-time	Part-time	Casual	Agency	Total	FTE Equivalent
30 June 2002	26,950	8,812	98	1017	**36,877**	**34,329**
30 June 2003	26,394	9,033	76	1042	**36,545**	**34,087**
30 June 2004	26,019	9,030	293	811	**36,153**	**33,753**
30 June 2005	25,851	8,953	220	950	**35,974**	**33,306**
30 June 2006	25,387	9,196	259	771	**35,613**	**33,075**
30 June 2007	25,026	9,498	208	744	**35,476**	**32,831**

This managed reduction in staffing needs to be seen in the context of growth in the business over the same period.

Although letter volume growth has been low over the five years to 2006/07 (an average of 0.3% per annum) delivery points have increased from 9.2 million in 2001/02 to 10.3 million 2006/07, an average of 2.2% p.a. Additionally, the parcels, express, financial services and merchandise areas of the business experienced volume growth over this time, in some cases (parcels, express) at significant levels.

Within Australia Post's four operating areas over the five years to 2006/07, FTEs fell from 6,060 in Retail to 5,822, from 8,269 in Mail Processing to 6,591; Transport FTE numbers were almost unchanged (2,551 to 2,552) and FTEs in Delivery rose from 12,381 to 12,569, well below the growth in delivery points.

Australia Post estimates that the labour FTEs[16] employed in the domestic reserved letter service fell from 21,250 in 2001/02 to 20,163 in 2006/07, that is 1,087 of the 1,498 labour FTE reductions made by Australia Post over the period 2001/02 to 2006/07 have been made in this area.

However, as not all of the labour gains are within the domestic reserved letter service, labour reductions affecting non-reserved items are also relevant to the ACCC, as they indicate that Australia Post has been pursuing and realising efficiency gains wherever they occur.

As discussed previously, one feature of the FTE numbers is the reducing opportunity for making savings – the Future Post investment has provided Australia Post with a mail network that uses some of the world's most technologically advanced processing equipment. This technology is typically developed in the US or Europe – countries that are experiencing low letter volume growth or decline. As a consequence demand within these countries for further advancement has reduced and there are no major technology innovations in sight that would generate the large scale labour savings that occurred with Future Post.

9.2.3. Labour Force Mix

Table 4 (above) shows the change in labour force mix. The increase in both part-time staff and casual employees demonstrates the increasing flexibility of the workforce and how Australia Post has better managed its labour cost through changes to its labour mix, i.e. greater use of part-time and casual staff to better match staff resources to demand.

At the corporate level, in 2001/02 the FTE proportions of full-time, overtime, and part-time & casual was 78:5:17. In 2006/07 the proportions were 75:5:20.

Retail has been a major beneficiary of this mix change. In 2001/02 its comparable proportions were 63:2:35. By 2006/07 that mix had changed to 54:1:45. In the other three operational areas (Mail Processing, Transport and Delivery), there has been an increased share of the more flexible labour categories against a reduction in full-time categories.

9.2.4. Other Labour Cost Issues

In addition to actual wage and salary costs, Australia Post has indirect labour cost items comprising recreation leave, long service leave, superannuation, payroll tax and workers compensation. Each of these costs is paid according to the relevant Award/Agreement, Commonwealth or State legislation. Two of these five labour cost items have changed significantly in the five years to 2006/07:

- Superannuation: Australia Post's main superannuation fund is a defined benefit plan. Australia Post has complied continuously with its statutory obligations to the fund, with the annual superannuation expense calculated by an independent actuary. The expense will vary with changes to the fund's assets and liabilities. In addition, the practice is to make cash payments into the fund to match the expense calculated by the actuary;
- Workers compensation: this is a labour item that Australia Post has been managing actively. In 2001/02 Australia Post's Lost Time Injury Frequency Rate was 14. That rate was reduced progressively over the last five years to 7 in 2006/07.

[16] Number includes only the four operating areas and therefore excludes any administration numbers

9.3. Non-Labour Costs

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

The first three non-labour items covered below are contract mail services, franchising/licensees, and other contract services. They reflect the degree to which Australia Post has reduced both the risk and size of its cost structure over time. If these functions had been retained by Australia Post as staffed activities, then the cost would have been higher and more fixed in nature.

9.3.1. Contract mail services

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

Contract mail services include:

- Roadside mail delivery – associated with rural and remote delivery – where the delivery run can be long and mail volumes may be light (Australia Post's CSOs require delivery of a domestic letter service on reasonable access standards regardless of whether the service route is economic);
- Street mail delivery – although mainly undertaken by Australia Post staff, there are cases, for example in outer suburban fringe deliveries, where the number of delivery points might be too small to make up full delivery rounds that would justify a staffed service;
- Parcel service delivery - small parcel (generally under 500 grams) deliveries can be included as part of the staffed street delivery service by a postal delivery officer. Larger parcels cannot, as they are too heavy / large for a postal delivery officer to carry in addition to a full letter load. Australia Post outsourced the large parcel delivery service many years ago for cost effectiveness reasons;
- Intrastate and interstate road transport – a mix of air and road transport is used for the movement of letters across Australia. Road transport is the preferred mode on a cost basis but there are mail paths (typically between interstate non adjacent capital cities) where the advertised service standard and timing does not afford time for road transport, and higher cost air transport is used. Savings through optimising road / air modal choice have been actively pursued in the period to 2006/7. Road contractors are used when Australia Post's existing vehicles are not available, or where capacity has to be augmented in periods of high demand and where it would be uneconomic to add to the permanent fleet capacity;
- Air and sea transport – air transport is needed for longer interstate routes to meet of service standard requirements, and for international services. Some rural and remote deliveries require air transport because of the isolation of the sites and the distance to a town from which a delivery could be made. Sea transport is a small part of contract services; and
- Mail collections – in metropolitan and large country areas, mail collections from Street Posting Boxes are largely undertaken with Australia Post's vehicles, but in some country and remote areas, mail collection activities may be undertaken by contractors (eg as part of a mail delivery contract).

9.3.2. Franchising / Licensees

It is a regulated requirement of Australia Post to maintain a retail network of at least 4,000 outlets, of which at least 2,500 must be in rural and remote areas.

During the five years since 2001/02, Australia Post has continued to optimise its retail network both within the regulated requirement and in accordance with agreements with staff and other representative organisations. The network comprises corporately staffed outlets, licensed outlets, franchised outlets, and community postal agents.

The licensed business model was established in 1993. It moved a number of key costs (labour, accommodation) from fixed to variable. About half of the licensees operate the postal service in conjunction with another business,

such as a general store, pharmacy or newsagency. This provides a viable business for the licensee and enables a lower-cost postal service to be maintained by Australia Post.

A franchised model was introduced a few years ago and is gradually being implemented where appropriate. This format retains the variable cost components of the licensed model however it provides tighter control over brand, image and product offering.

Community postal agents represent Australia Post in circumstances where it is not viable to operate any other type outlet and typically are located in rural and remote regions of Australia. This model is a low cost operation that provides a limited postal acceptance service and an over-the-counter delivery service. Community postal agents do not provide any banking or other agency services.

The number in each outlet category is set out in Table 5 below.

Table 5 – Retail Facilities

	2002	2003	2004	2005	2006	2007
Staffed	882	872	862	863	857	833
Licensees/ Franchisees	2,979	2,981	2,982	2,979	2,975	2,969
Community postal agents	636	640	633	630	630	635
Total outlets	**4,497**	**4,493**	**4,477**	**4,474**	**4,462**	**4,437**

9.3.3. Other Contract Services

Australia Post has outsourced staffing needs across a number of areas. These include:

- operational staff in Logistics and in Courier and Mailroom Services, whose business models rely more on contractors (eg owner drivers) than on using Australia Post staff;
- operational staff in mail centres and delivery centres (although contract staff form the minority); and
- IT specialists.

9.3.4. Mail Settlements

Mail settlements are the payments that Australia Post makes to other postal authorities around the world for delivery in those countries of letters and parcels mailed in Australia. Payment rates are set either by the Universal Postal Union (UPU) or by direct negotiation between countries. Mail settlement costs are not relevant to this Notification and they do not form part of the Notification cost base.

9.3.5. Accommodation

Australia Post has been managing down its property portfolio throughout the current decade and in the 1990s before it.

As shown in Australia Post's Annual Report the total number of owned properties fell from 577 in 2001/02 to 519 in 2006/07. At the same time, the number of leased properties rose, from 715 in 2001/02 to 760 in 2006/07. The overall total of owned and leased properties fell slightly from 1,292 at 30 June 2002 to 1,279 at 30 June 2007.

The vast majority (95%) of either owned or leased properties are industrial or retail sites located in areas where a good level of market demand exists.

In addition to rental, the accommodation expense includes gas, water and electricity, whose rates are set by the utilities concerned, land tax and local government rates, repairs and maintenance, cleaning, waste disposal etc.

In April 2006 Australia Post outsourced all property management responsibility to a specialist property management firm (5D) in order to achieve property management cost savings.

9.3.6. Depreciation

Depreciation expense has fallen since 2002/03, as Australia Post held down its levels of capital expenditure, particularly in areas of IT and retail property. From $231 million in 2002/03 depreciation expense decreased to $162 million in 2005/06.

Deprecation expense will increase in the upcoming years in line with the investment programme approved by the Australia Post Board in 2007.

9.3.7. Goods for Sale

Cost of goods sold is one element of the cost base of stamped letters. However, the cost is very low and immaterial.

9.3.8. Other Non-Labour Expenses

These include vehicle operating costs, statutory and legal payments, communications, promotional spending, bank fees, security costs, equipment (repairs and maintenance, software licence fees and equipment that is not or cannot be capitalised), general materials, and staff associated items such as travel and training.

In the five years from 2001/02 to 2006/07, this group of miscellaneous expenses grew at an average annual rate of 3.0%. For comparative purposes, the CPI rose by an average annual rate of 2.8% over the same period.

In Australia Post's view, this is a very efficient outcome for these cost items. Australia Post has held cost rises in this category to about the rate of general inflation, despite five years of business volume growth and higher rises in energy prices. The ACCC will note that Australia Post has a vehicle fleet of over 10,000 vehicles and can hedge its fuel exposure only one year ahead before further hedging is deemed to be speculation rather than risk management.

9.4. Corporate Key Performance Indicators

The Australia Post Board sets corporate KPIs to measure the performance of the business across a number of areas: Customers, Internal Process, Business Regeneration and Financial.

Together, the KPIs form a balanced scorecard with process management and cost control a key component, along with customer service, and generation of revenue by both the sales process itself and the introduction of new products and services.

9.5. Cost Allocation to Products

Cost allocation to products in 2006/07 and in 2007/08 is made in accordance with sections 5-7 of the Regulatory Accounting Procedures Manual (RAPM) which has been provided to the ACCC in accordance with section 23 (6) of the Record Keeping Rules (RKR[17]).

Allocations for the pricing year 2008/09 are extrapolations from the 2007/08 data using similar allocation principles.

9.6. Cost Forecasts

Future year costs rely on a number of planning assumptions. These are at three levels for the purpose of this Notification: economy-wide assumptions, assumptions relevant only to Australia Post, but that apply across all of the business, and assumptions at product level. The expected drivers of costs in the 2007/08 and 2008/09 years are as follows:

[17] The Record Keeping Rules, made by the ACCC under section 50H of the APC Act

9.6.1. External Assumptions[18]

GDP growth	Average 4 % pa
CPI Inflation	Average 3% pa
Wage Inflation	Average 4½% pa
Bond rates	Unchanged (no impact on employee provisions/costs)
A$	Unchanged

9.6.2. General Business Assumptions[19]

<u>Inflation</u>

Labour costs	In line with EBA7 (Appendix 8)
Contractor costs	✂
LPO payments	✂
Non-labour costs	Other than for depreciation and terminal dues, prices generally rise in line with CPI
Diesel prices	Rise by 7½% pa

<u>Other</u>

Delivery points	continued growth of 2% pa

<u>Labour numbers</u>

Reductions in FTE numbers in the retail and mail networks are assumed to continue to be achieved to the end of 2008/09 (and beyond).

<u>Portfolio growth assumptions (2007/08 to 2008/09)</u>

Letters & Associated Services - Domestic letters:

- Small full rate volumes fall by about 2% pa
- Small PreSort volumes up by about 2½% pa
- Large Letter volumes steady to 2008/09

Parcels & Logistics - strong volume growth is expected across most segments. This has the effect of moving shared costs away from the domestic reserved letter service in the forecasts.

Retail & Agency Services - modest growth is expected.

[18] GDP, CPI and wage assumptions are based on forecasts by Access Economics. Wage inflation is as measure by the labour price index. GDP and external wages do not directly affect the financial forecasts for any forward year.
GDP and its components' growth affect some forecasts indirectly, through influencing product volume forecasts. This is the case for parcel volumes but any correlation between GDP growth and letter volumes ceased to be evident a decade ago.

[19] Mail and parcel contractor rates are rising strongly fuelled by generally low unemployment rates and the very tight labour markets in the resource states. Australia Post is unable to fill some contracts due to lack of availability of suppliers and/or the contract price that needs to be offered. The contractor escalation rate assumptions shown above are those used in the corporate plan. Delivery points in Australia have been rising at an annual average rate of 2.2% pa over the past five years.

9.7. Conclusion re Cost Efficiency

This section summarises the main cost components of Australia Post's cost base as well as the recent trends in these components to highlight that:

- despite a moderate growth in letter volumes and continued growth in delivery points, Australia Post has continued to reduce labour usage in the five years since 2001/02 and adjust the workforce composition to improve flexibility;
- in a context of slowing volume growth in domestic reserved letters and limited technology opportunity, the trend of labour costs in recent years is reflective of strong cost management performance;
- non labour costs are also determined in competitive markets and such costs are reflective of the steps by Australia Post in ensuring that some internal services are more appropriately provided through franchise or outsourced providers where there has been an efficiency benefit; and
- in most parts of the retail and mail networks resources are shared between reserved and non reserved services. While cost management is important for reserved services it is equally important for non reserved services for Australia Post to maintain its competitiveness.

10. Australia Post's Productivity Growth

10.1. Background

A major section of the ACCC's Decision of October 2002 comprised an assessment of productivity growth in Australia Post in the period leading up to the 2002 Notification and in the years immediately following it. The ACCC concluded that:

> "The key driver of Australia Post's productivity gains over the last five years has been increased output growth, which is expected to be lower over the forecast period 2002-2007. Input usage is also expected to decline over the next five years mainly due to site rationalisation and changes in employment practices. These reductions appear reasonable in comparison with past performance. The Commission therefore considers Australia Post's projected costs do not appear unreasonable".

In forming that conclusion the ACCC obtained advice from Meyrick and Associates who were commissioned to undertake a study on Australia Post's productivity for the purposes of the ACCC's consideration of the 2002 Notification. For this Notification, Australia Post commissioned Meyrick and Associates to update and extend its 2002 study.

The 2007 review by Meyrick and Associates comprises an update of the 2002 work. This covers both total factor productivity (TFP) and partial factor productivity over the five years since 2002 and over the future years to 2010/11. A substantially greater level of disaggregation of key data was provided for this work, and the 2007 paper includes a revision of productivity results from 1990 onwards. The revisions do not materially alter the conclusions of the 2002 Meyrick study.

This section presents the main findings of the Meyrick review which is provided separately to the ACCC.

10.2. Total Factor Productivity Measurement

Productivity growth is basically output growth over input growth, with both output and input measured on a real, rather than nominal, basis. Productivity growth can be represented by a partial factor measure, which compares output growth with the change in just one factor of production. The most common version of this is labour productivity.

Such partial, or single, factor productivity measures provide relevant and useful information. However, a firm's productivity performance can be affected by changes in other production factors, for example in capital/labour substitution or outsourcing previously staffed work to contractors.

TFP measures output growth compared with the change in all inputs. It overcomes the issues of interpretation that arise with partial factor productivity results.

Both the 2002 Meyrick study and the 2007 Meyrick review assess productivity growth on both a TFP basis and on a number of partial factor bases. These partial productivity measures include labour, contractors, capital, and other inputs.

The 2007 review repeats the approach of the 2002 study in that:

- productivity is measured for Australia Post as a whole and for the reserved letter service which is the subject of this Notification; and
- actual data for the five years since the 2002 review are provided, as well as forecast data for a number of future years (2007/08 to 2010/11).

In addition, Australia Post's TFP results will be compared with actual and forecast comparable data for the Australian economy as a whole.

Significant data improvements have been made in the 2007 review including the number of output categories, which has increased from seven to twenty five for the aggregate Australia Post analysis, and from one to five for the reserved letter service. This enables greater accuracy and robustness of the productivity results. A number of other data enhancements were also introduced in the 2007 review, and these are set out in section 1.2 of the Meyrick report.

10.2.1. Delivery point growth and measurement of output

The Meyrick analysis has focused on estimation of productivity as calculated in the 2007 study. Productivity outputs were volume-based, and did not include either the achievement of high levels of service performance or the servicing of an additional 210,000 delivery points each year (an average annual growth from 2001/02 to 2006/07 or 2.2%). They must be appropriately serviced regardless of whether overall volumes have risen or not and clearly amount to a delivery output. Their omission from the Meyrick calculation was not for relevance reasons, but because of technical difficulties in bringing them into the Meyrick model without introducing a degree of subjectivity.

10.3. Total Factor Productivity - History

TFP growth in Australia Post in the 1990s was very strong. Its average annual compound growth rate was almost 3½ %. This compares with the average annual multifactor productivity (MFP) growth for the entire economy of just over 1¼ % for the same period. (Note that this latter figure is derived from unpublished data estimated by Access Economics).

Australia Post's TFP growth in the decade or so up to the 2002 Notification featured both strong volume growth and very moderate input growth. Many revenue streams grew strongly in that period. In particular, addressed domestic letters, most of which form the majority of the reserved letter service, were a key driver of aggregate corporate volume growth during the 1990s. Growth in those letter volumes in the decade to 1999/00 averaged almost 4½% pa. In overall terms, the average annual output growth in that decade was over 5%.

Despite the strong volume growth, the volume of inputs was constrained. Labour usage declined, with greater use being made of contractors, capital and other resources. In overall terms, the annual average rise in input volumes during the 1990s was just over 1½% pa.

In contrast to the earlier strong volume growth, in the five years to 2006/07, overall corporate volumes rose by only 1.3% pa. The comparable average annual letter volume growth was even less. Other strong growth drivers of the 1990s, such as over-the-counter bill payments and banking, also began to decline during those five years. In compensation, overall input growth was slightly negative in the five years to 2006/07.

As a result of these lower output and input growth rates, Australia Post's aggregate TFP growth was slower (1.7% pa) in the last five years. Over the same period, Access Economics estimates that multifactor productivity (MFP) levels for the entire economy actually fell slightly (unpublished data).

Table 6 below sets out summarised results for the period since 1989/90, broken into slightly different periods which match the years of this recent study and the previous one.

Table 6 – Productivity Growth, Australia (TFP)[20] and National Economy (MFP)[21]

	Output % growth pa	Inputs % growth pa	TFP % growth pa	MFP for Australia % growth pa
1990 - 2007	3.7	1.3	2.4	0.7
1990 - 2002	4.9	1.9	3.0	1.2
2002 – 2007	1.3	-0.4	1.7	-0.4

These results confirm the conclusions on Australia Post's productivity drivers reached by the ACCC in their Decision of October 2002, as quoted at the start of this section. Those conclusions were set out in the context of reserved service TFP expectations, but they apply also to the aggregate TFP results:

- output growth is a critical driver of TFP growth;
- output growth was expected to slow in the five years to 2006/07; and
- input usage was expected to fall in the five years to 2006/07.

TFP growth for the reserved letter service for the five years to 2001/02 has been re-estimated in the 2007 Meyrick report. It is lower at 2.9% p.a. compared with 3.7% p.a. in the 2002 report. However, both rates of growth compare favourably with Access Economics' MFP growth estimate for the entire economy, i.e. less than 1¼ % pa for those five years.

The forecast trends in the drivers of reserved letter service TFP that were accepted by the ACCC as reasonable in that previous case materialised in the 2002-2007 period. Output growth did slow markedly, and input usage fell over the five years. Summary productivity results for the reserved service are set out in Table 7 below.

Table 7 – Productivity Growth, Australia Post's Reserved Letter Service (TFP)[22] and National Economy (MFP)[23]

	Output % growth pa	Inputs % growth pa	TFP % growth pa	MFP for Australia % growth pa
1997-2007	0.7	-1.2	1.9	0.7
1997-2002	1.8	-1.1	2.9	1.2
2002–2007	0.3	-0.4	0.7	-0.4

10.4. Total Factor Productivity Forecasts

TFP for Australia Post for the forecast four years to 2010/11 has been estimated by Meyrick and Associates from data extracted from the 2007 corporate plan, with minor updates to the plan forecasts arising from a new 2007/08 base (based on one quarter of actual results for 2007/08 and three quarters of forecasts).

[20] Meyrick and Associates 'Aggregate and Reserved Service Productivity'
[21] Access Economics (unpublished data)
[22] Meyrick and Associates Aggregate and Reserved Service Productivity'
[23] Access Economics (unpublished data)

Output growth for the forward years is forecast to be a little stronger than in the five years to 2007. Strong volume growth is expected in most Parcels & Logistics services. Weak reserved letter service volumes are expected to slow the growth in aggregate volumes for Australia Post as a whole. In view of declines already seen in some overseas letter markets, the risk to the output forecasts for the next four years is downwards, although this Notification does not assume a rapid erosion of letter volumes in Australia.

Input growth for Australia Post is expected to be positive, but small, over the forecast four year period.

Regrowth in the capital base is necessary and has been approved by the Australia Post Board. In recent years Australia Post has been at the low end of its investment cycle. However, certain infrastructure assets (eg Information Technology) are scheduled for replacement and it is essential that Australia Post reinvests in these assets to ensure continued competitiveness.

This capital expenditure is a source of growth in inputs. In contrast, further labour savings will be sought in the mail network, additionally the number of contractors is expected to be below the levels of recent years.

Table 8 below contains summary data for Australia Post, for the reserved letter service, and for the Australian economy (the latter data are Access Economics unpublished estimates for national MFP).

Table 8 – Productivity Forecasts 2007/11, Australia Post's Reserved Letter Service (TFP)[24] and National Economy (MFP)[25]

	Output % growth pa	Inputs % growth pa	TFP % growth pa	MFP for Australia % growth pa
Australia Post	1.9	0.3	1.6	-0.1
Reserved Service	-0.2	-1.5	1.3	-0.1

One feature of the TFP record has not yet been introduced. That concerns the convergence of its growth back to national averages.

In 2006/07 Australia Post obtained 60% of its revenue, and 95% of its profit, from its non-reserved operations. These operations take place in competitive markets, and are subject to the same wage, technology and purchasing factors that exist in other competitive markets. This being the case, as noted in the Meyrick report, it is reasonable to expect that, once any inherited inefficiencies had been removed, there would be a degree of convergence of Australia Post's historically higher TFP growth back to national benchmarks. Nineteen years on since corporatisation, and needing to be competitive in openly contested markets, suggests that Australia Post's aggregate productivity gains will start to trend toward the same performance levels of the overall Australian economy.

Australia Post has reached the stage in its development where material productivity gains are becoming increasingly difficult to orchestrate and obtain. In the reserved service, the combination of CSOs, absence of volume stimulus to productivity, and reduced potential gains from technology change, are expected to constrain future TFP growth. Nevertheless, the forecasts in this Notification of ongoing TFP growth, particularly in the reserved service, reflect Australia Post's position that ongoing, but increasingly difficult, productivity gains will continue to be vigorously pursued.

[24] Meyrick and Associates 'Aggregate and Reserved Service Productivity'

[25] Access Economics (unpublished data). Strong growth in the capital stock and employment at the national level amid the China boom of recent years has exacerbated a slowing in MFP arising from the fading effects of earlier economic reforms in Australia. That combination explains the estimated fall in MFP at the national level over five years to 2007, as well as the flat outcome forecast by Access Economics in the four years to 2011.

10.5. Productivity Growth – Partial Productivity Measures

Partial productivity growth rates since 1989/90, and for the forward years to 2010/11, are shown in Table 9 below. Each is calculated as the output increase, relative to the change in volume of the single input. All other inputs are eliminated from the calculation, although they can, and will, influence the results of the other input productivities over time. In simplified terms, the TFP outcome in this case is a weighted average of the four partial productivity series.

Table 9 – Annual Productivity Growth % - Aggregate Australia Post Results

	Labour	Contractors	Capital	Other Costs
1990-2000	5.7	1.9	1.3	-0.6
2000-2007	1.4	1.0	1.6	0.2
1997-2002	3.8	-0.4	0.9	-3.5
2002-2007	2.0	2.6	1.5	1.5
2007-2011	2.7	2.0	-0.7	0.8

'Labour' productivity growth has been positive for all but one year since 1989/90. It is forecast to rise each year to 2010/11. Australia Post's labour productivity record is discussed in this Notification.

'Contractors' productivity growth has not shown the same consistency. Australia Post converted staffed operations to contract and licensee status at a high rate during the 1990s. This boosted labour productivity as measured in the Meyrick studies, but contractor productivity slipped as a consequence for several years. The Meyrick calculations indicate contractor productivity rising each year from 2001/02.

'Capital' productivity also shows periods of rise and fall since 1989/90. This is as expected. Since corporatisation in 1989 Australia Post has invested heavily in its retail and mail networks, with the introduction of Post shops, delivery centres, and the modernisation of mail and parcel processing systems under the Future Post project. Capital productivity slipped a little in only two of the years since 1996/97.

With the reinvestment capital spending programme approved by the Australia Post Board in the 2007 corporate plan, capital productivity is likely to peak in 2008 in line with planned replacement of key infrastructure.

"Other Costs" productivity does not yield readily to logical analysis. This group of inputs is a residual collection of hundreds of general ledger expense accounts with no obvious relationship across accounts and, in most cases, across account groupings. All items concerned are bought in commercial markets at commercial prices. Meyrick calculations show this productivity rising and falling over time.

No analysis of 'Other Costs' productivity is attempted in this Notification. However, in normal commercial practice a corporation growing in real terms would expect to consume a greater volume of their costs quite apart from general inflation. The impact of this growth on the measured partial productivity measure is not obvious, as inflation for the items concerned need not match general inflation, such as a consumer price index. In Australia Post's case, growth of newer businesses such as Logistics, Messenger Post and Decipha are almost certainly the major influence on this productivity measure, as these businesses either did not exist prior to 1999/00 or were very small at that stage.

The 'Other Costs' productivity results do provide some comfort to the ACCC, in two ways:

- this productivity measure has risen since the 2002 Notification to 2006/07; and
- the Meyrick calculations show this productivity measure rising each year from 2006/07 to 2010/11.

Partial productivity results for the reserved letter service are very similar to those for Australia Post as a whole. A major difference between the reserved letter service and aggregate Australia Post results arise from the volume impact. Unlike the aggregate numbers, volume in the reserved letter service has little impact on the productivity results up to 2007/08, and actually has a negative impact thereafter. The arithmetic results are shown below in Table 10.

Table 10 – Annual Productivity Growth % - Reserved Letter Service Results

	Labour	Contractors	Capital	Other Costs
2000-2007	1.3	0.9	1.3	1.9
1997-2002	4.0	-1.7	1.4	3.6
2002-2007	1.3	3.2	1.8	-2.8
2007-2011	0.6	2.7	-1.5	3.5

10.6. Productivity in Australia Post

The following summarises the programs and actions which have contributed to Australia Post's productivity performance over the period 2001/02 – 2006/07 as well as the constraints to on-going productivity growth with fixed CSO service commitments and low letter volume growth. It also provides a context for the key efficiency initiatives being pursued in 2008/9 and beyond.

The scope for productivity growth in the letters network is governed by letter volumes and growth, service requirements (creating fixed cost), and the opportunities for process improvement or labour substitution.

Pursuit of productivity and cost efficiency has to be viewed in a context of customer expectations and market requirements. For example, customers may place significant value on the ease of access, service quality or reliability. These values could be threatened by narrowly focused cost reduction programs.

Australia Post's record of total and partial productivity measures in the previous section highlights that in the period to 2006/07, Australia Post has been able to sustain productivity growth while delivering high service performance and continuing to service the sustained growth in delivery points.

Importantly, Australia Post has achieved these outcomes in an environment of low letter volume growth (an impediment to productivity growth with significant network fixed cost), while continuing to improve the quality of its service performance as well as its performance against a range of internal employee related KPIs (eg lost time injury frequency rate and attendance).

However, sustaining this productivity growth in a future period of flat to declining volume growth will be challenging. Nevertheless, Australia Post will continue to pursue additional efficiency improvements in 2008/9 and beyond, and such improvements are incorporated in the financial projections.

Australia Post's two main operating divisions, Commercial Division and M&ND, are principally responsible for operations involving the reserved letter service. Total workyears in the two divisions have been driven down since 2001/02, with total workyears reducing from 32,438 in 2001/02 to 31,080 in 2006/07, a reduction of 1,358 (4.2%), while the volume of total postal articles handled by the workforce has increased by 4.4%.

Efficiency initiatives cover a wide range of actions varying from day to day performance management of the business, to more fundamental changes to operational arrangements and network structure. Such actions have made a critical contribution to containing escalation in the cost base due to such factors as higher labour rates and fuel prices, the need to extend the letters network to service additional delivery points and to continue to meet CSO requirements, as well as increased regulatory requirements.

Efficiency initiatives are guided by a number of considerations to:

- better match labour resources to traffic loads in retail and mail networks through roster change and by developing more flexible staffing arrangements through changes to staff mix;
- standardise processes in order to measure and target cost performance, and to minimise variation and missorts in mail processes;
- strengthen national mail performance reporting;
- leverage automation investments by maximising the flow of product onto machines rather than through manual processes;
- develop integrated systems for end to end network management and eliminate local system solutions; and
- optimise transport and distribution tasks within cost / service constraints.

A balance has to be maintained between the pursuit of efficiency and service quality. The mail network must retain sufficient resource to be able to flexibly respond to variations in letter volumes (or poor quality letters that cannot be handled by automated equipment). A failure to respond with sufficient staffing to handle a surge in letter volume for example, may mean that letters are delayed and service quality damaged.

The implementation of efficiency programs over an extended period means that the balance between efficiency initiatives and service quality becomes more finely tuned.

To mitigate such risks, Australia Post works closely with major customers in the preparation / planning of large mailings, and by mail volume forecasting recognising that the mail network must retain the flexibility to react to unanticipated volume and product mix variations.

10.6.1. Productivity and Efficiency Programs to 2006/07

While the main productivity enablers over the past five years are broadly in line with the outlook provided in the 2002 Notification, there has been a shift in the drivers of productivity growth, from a phase of major network and automation investment, to a phase of sustained process improvement that inevitably encounters “the law of diminishing returns”.

The period from 2001/02 marked a consolidation phase for productivity enablement in the letters network following the significant investment in the Future Post network restructure and automation of small letter processing (small letter phase completed 2000/01).

The period also incorporated a range of other technology and network-related change including:

- implementation of new automated large letter processing equipment ($✂ million capital expenditure) in all states since 2004/05;
- expanded use of V-sort frames in delivery centres, combining two significant manual indoor postal delivery officer operations (“streeting” and “sequencing”) into a single manual operation;
- consolidation of the remaining metropolitan letter processing facilities eg Melbourne Mail Centre into Dandenong (Processing) Letter Centre (April 2003), consolidation of St Leonards (2003) and (more recently) Alexandria Mail Centre into Sydney West Letter Facility (2006); and
- consolidation of smaller delivery centres in local delivery networks to reduce administrative overhead, reduce high fixed lease and rental costs (eg in metropolitan Sydney), and improve facility utilisation and work flow management.

The combined savings from these and other initiatives are included in the data underpinning the productivity estimates of the preceding section.

In recent years, (i.e. 2005/06 and 2006/07), efficiency improvements based around process standardisation and benchmarking have been the significant productivity enablers. Such activities have included:

- increased use of part-time staff and a reduction in full-time staff numbers, particularly in the retail network (part of this FTE reduction was due to the conversion of staffed post shops to licensed or franchised status – Australia Post allows for outsourcing in calculating labour productivity changes);
- the application of optimisation methodologies to align staff resources to the work required in retail and letter facilities (eg in retail the use of the MODular Arrangement of Predetermined Time standards, time and motion studies provide an ability to align outlet customer / transaction volumes to staffing requirements);
- better streaming and presentation of letters into the network eg from retail shops, business centres, reducing downstream processing costs in letter facilities;
- improved operation of network interfaces and letter handover points between transport hubs to letter facilities, or between interstate letter facilities;
- improved performance of manual sort operations and video coding operations in letter facilities and increased letter flows to automated equipment;
- higher capital productivity by improving the efficiency and effectiveness of Australia Post's large processing equipment fleet (eg by improved equipment maintenance regimes); and through automated systems to replace labour intensive audit functions in the retail network;
- complementary policies applied to Australia Post's vehicle transport fleet, including fewer transport depots, better maintenance arrangements and vehicle route optimisation; and
- significant investments to reduce cost and improve the quality of information by consolidating the applications, data and support systems for managing the letters network, and decommissioning legacy and local systems.

10.6.2. Future Challenges to Productivity Growth

Productivity growth will continue to be a priority to limit escalation in the cost base for the retail and mail networks. However, the big labour gains achieved through projects such as Future Post have been completed. With letter volume growth at low levels and expected to decline in the future, productivity growth is becoming more difficult, a point noted in the Meyrick report.

The period from 2007/08 presents a number of challenges in sustaining productivity growth in the letters network, including:

- labour availability – this is currently a high priority issue impacting delivery productivity in the resource boom areas of Western Australia and Queensland, with significant recruitment and staff turnover issues likely to continue over the next few years.

  Broader labour market and productivity risks arise from workforce aging and the difficulty of replacing experienced retail and operational staff over the forecast period;
- limits to process improvement – Australia Post has been extracting process savings over an extended period, and with fixed service standards, diminishing returns limit the potential for future productivity gains;
- network consolidation – with the exception of the parcels facility development and the letter delivery centre consolidation in South East Queensland, the main letter facility consolidations are complete with the related productivity benefits realised. These consolidations complete the transition from a decentralised letter processing network of some 35 metropolitan facilities prior to Future Post, leaving one major metropolitan letter processing facility in each capital city;
- productivity from technology investment – in the short term, opportunities from additional automation and technology investment are limited. While savings from such investments are incremental and realisable only in the longer term the forward projections do incorporate a level of savings from such sources in 2009/10, to anticipate opportunities emerging by that time;

- continued growth in delivery points (i.e. street addresses; PO Boxes / locked bags; private and community bags; roadside delivery and counter delivery) – reflecting demographic and urban growth and migratory movement to areas such as South East Queensland. From a 2001/02 base, growth has averaged 2.2% pa to 2006/07. Each 1% growth in delivery points adds some $4 million to cost; and
- continued growth in cost from general regulatory change that is not offset by revenue eg Chain of Responsibility legislation for transport fleet operators, the Transport Security Program, Dangerous Goods compliance with changes to the Civil Aviation Act.

Notwithstanding the challenges above, a range of cost containment programs will continue to be pursued to deliver productivity benefits in 2007/08 and beyond.

10.6.3. Future Productivity and Efficiency Programs

Productivity growth and cost efficiency will continue to be driven through day to day management of the retail and letter networks against defined cost and service targets. These targets are incorporated into Australia Post's performance management reporting systems, including the Performance Management Appraisal process.

The day to day management of operations against cost and service KPIs is being supported by improved production management approaches and tools. These have been implemented in major letter facilities, and a similar approach is being developed for delivery centres, country mail centres and transport operations.

Improved operating procedures and reporting tools provide the capability to better identify in real time, misalignments in staff rosters, resourcing and work loads at more local levels of process operation, and are linked to a range of on-going initiatives to improve the flow and presentation of letters through the network.

Productivity benefits are progressive and the financial projections for 2008/9 include an estimate of savings from these types of efficiency improvements.

In addition, a number of strategic programs are being implemented that reduce cost and contribute to other benefits (eg reduced cycle times). Key programs are outlined below.

10.6.4. Machine Sequencing of Small Letters

Australia Post's Future Post investment in automating the sortation of small letters to delivery rounds can be extended to the automated sorting of small letters to street section and street delivery sequence.

Most small letters arriving in delivery facilities have been sorted to delivery round level and have to be manually sorted into the street and address sequence of a delivery round prior to the delivery officer leaving the delivery facility. Automated deep sorting and sequencing of this process enables the postal delivery officers to focus on the outdoor delivery task. It also has the potential for more flexible work arrangements for both the sorting (indoor) and final delivery (outdoor) tasks associated with delivery facilities, and it can offset some of the cost pressures from delivery point growth and the reduced availability of labour for outdoor delivery activities.

However, the economics of automated sequencing of letters require evaluation at a delivery facility and round level because it can involve higher net costs – for example unless machine address recognition and sequencing rates are high, automated sequencing can entail net additional costs within the delivery facility in having to physically merge machine sequenced mail and other mail for the delivery round before the delivery officer can commence the outdoor delivery task.

Trials of deep sorting and sequencing, using existing Multi Line Optical Character Readers (MLOCRs) and Barcode Sorters (BCSs), are currently in progress to explore the network scope and parameters for cost effective automated sequencing of small letters.

Relatively minor savings from automated small letters sequencing are anticipated in 2008/09 and this has been included in the cost base for 2008/09 on an indicative basis.

10.6.5. Further Network Expansion

Mail network investment must continue to meet the demands of population growth and to ensure that Australia Post's processing, transport and delivery networks keep pace with customer service requirements eg through urban development.

In response to the sustained high population growth in South East Queensland, the letters and parcels processing and delivery network in the region (covering a large geographic area from Noosa in the north to Toowoomba in the west and Tweed Heads in the south) is currently the focus of a major ($100m) mail network restructure. This will provide a long term solution to capacity pressures in the region and ensure service standards are maintained.

As part of the restructure, a major new parcel processing facility will be developed at Yatala (target opening early 2010), with the existing letter and parcel processing facilities at Northgate and Underwood being modified to change their network roles. Additionally, a large consolidation of the delivery centres is planned.

Savings from the major South East Queensland network restructure are largely in terms of cost and service disruption avoided. However the forward estimates for the 2008/09 cost base contain additional expenses associated with the restructure, separate to the substantial capital expenditure involved.

10.6.6. Other Process and Technology Related Initiatives

Australia Post is using advanced small and large letter automated processing technology and has made major progress in establishing an integrated data and reporting infrastructure for performance management.

A range of additional initiatives are being developed to drive the efficiency of small and large letter processes such as:

- implementation of enhanced address recognition software to raise the percentage of small letter addresses that can be read to round (currently reading in excess of 70%) or street level. Additionally, adoption of this software in an "open architecture" enables Australia Post to further upgrade recognition capabilities for multiple products without being tied to a particular vendor; and
- application of strong company wide architectural disciplines to guide Australia Post's system investments, with benefits in lower support costs, and improved flexibility and scalability.

Australia Post is also evaluating replacements and upgrades for aging equipment and address platforms, which may result in further labour substitution. While none of these developments is on a scale of the Future Post investment, each will assist in further network cost containment.

10.6.7. Other Initiatives

A wide range of other initiatives will continue to be pursued across Australia Post's mail network in the forecast period to extract further network efficiencies. These are incremental and ongoing at many points across the network and include:

- restructuring of transport schedules and delivery rounds to optimise resource use;
- the commencement of a programme of work to replace Australia Post's retail systems, end to end. The first phase is a project to replace the point of sale and associated back end systems. It is envisaged that this will provide the opportunity to shorten processing times and reduce levels of rework as well as to integrate channel options (including more online capability); and
- upgrading systems to improve management of network assets – eg Australia Post's transport and equipment fleets, load shifting equipment, ULDs and trays.

10.7. Proposed Technological and Other Cost Efficiencies 2007/08

Forecasts of volume, revenue and costs by product category are set out in Appendix 9. The forecast volume and cost trends reflect figures from Australia Post's 2007/08 Financial Operating Plan (FOP) and associated draft official planning numbers for the following year based on bottom up calculations consistent with the FOP process.

The forecast revenues and resultant profit information is based on the proposed prices that are the subject of this Notification. As shown in Appendix 9, the forecast revenue from domestic reserved letter service does not exceed the forecast required revenue for these services as based on efficient costs and a reasonable rate of return.

11. Rate of Return

In achieving a reasonable rate of return on the efficient asset base used in providing reserved services, Australia Post must maintain an appropriate balance between its CSO to provide an efficient, effective and accessible letter service and its obligation to apply a single uniform rate to standard letters carried by ordinary post (Ordinary Small Letters). In setting financial targets for the domestic reserved letter service, Australia Post is required to consider a number of factors (as stated in section 4).

The 2007 corporate plan provided in June 2007 to the shareholders sets out the most recent expectations for the business. In that plan, profit targets and pricing expectations for the domestic reserved letter service were formed on the assumption that the ACCC's pricing model continued to apply to reserved services. That is:

- efficiency of the asset and cost base would be assessed by the ACCC;
- a reasonable economic return equal to the weighted average cost of capital (WACC) multiplied by the asset base would form part of allowed revenue by the ACCC; and
- allowed revenue for the reserved letters service is determined at a total package level, rather than on a product by product basis.

In other words:

- if the ACCC maintains its financial model used in the 2002 Notification and, more recently, in the regulatory accounting process; and
- Australia Post's efficient costs and rate of return in this Notification are accepted as the basis of domestic reserved letter service required revenues and thus prices; then
- Australia Post does not expect that this would create any tensions in terms of Direction 11, which requires the ACCC to give special consideration to Australia Post's obligation to pursue a financial policy in accordance with its corporate plan.

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

The rate of return applied is in the form of a WACC (provided at Appendix 10), reflecting the weighted costs of the different sources of funds. The cost of equity funds in the model is determined based on the generally accepted Capital Asset Pricing Model (CAPM) methodology.

The WACC formulations used by Australia Post are those specified by the ACCC in section 18 of the RKR.

In terms of the pre-tax nominal WACC formulation in section 18(3) of the RKR, Australia Post's pre-tax nominal WACC for the reserved letter service is 11.0%.

The domestic reserved letter service WACC parameter input, and key output, values are detailed in Table 11.

Table 11 – Reserved Letter Service WACC – Input and Output Values

WACC Parameter	Value
rf nominal risk-free rate-of-return	6.2%
rm-rf market risk premium	6%
Tc corporate tax rate	30%
γ imputation factor	50%
Cost of debt	8.0%
D/V Australia Post's gearing ratio	25%
βa asset beta	0.52
βd debt beta	0.10
βe equity beta	0.66
WACC Analysis	
Post-tax nom return on equity (pre-imputation)	10.2%
Nominal Vanilla WACC	9.6%
Pre-tax nominal WACC	11.0%

Appendix 10 sets out full details of:

- the pre-tax nominal WACC estimate of 11.0%;
- the assumptions underlying the estimations and derivation of parameter input values; and
- the specific WACC calculations.

Based on Australia Post's methodologies and procedures, as set out in Appendix 10, the derived WACC reflects conditions in the market for funds and the systematic risks associated with the reserved letter service. The WACC value is also consistent with the regulatory precedent and regulatory requirements in the forms of the RKR.

12. Asset Base

This section provides information on Australia Post's asset accounting policy, practices and values. It also presents a case for a widening of the asset base to include current assets in the total asset base in the PTRM, and thereby inclusion in the asset base on which an allowable return is calculated.

12.1. Outline of Australia Post's Asset Accounting Policies and Practices

12.1.1. Fixed Assets

Australia Post is required to comply with all relevant Australian accounting standards, as well as having an extra set of financial accounting instructions issued by the Minister for Finance and Deregulation.

At 30 June 2007 Australia Post had about $2.3 billion of fixed assets (including land and buildings) recognised in the balance sheet and notes to the accounts. (This total replaces the balance sheet total for land and buildings, which for statutory accounting purposes are valued now at cost, by their fair value as shown in Note 13 to the accounts). This total excludes investments in jointly controlled entities, tax assets, the superannuation fund and loans to associated entities.

These assets are grouped into approximately 500 asset classes. Depreciation rates are set asset by asset within each asset class level, and are reviewed annually. Asset stocktakes are also conducted annually: and assets and their location are confirmed, transferred to a new work centre, or removed from the asset register if they can not be located or are no longer used.

Australia Post's fixed asset classes, together with asset depreciation rates, will be supplied to the ACCC. Asset and capital investment data for the domestic reserved letter service are provided at Appendix 11.

The June 2007 fixed asset allocation to the domestic reserved letter service was $937 million, i.e. less than 40% of total fixed assets. In view of the fact that Australia Post's statutory primary purpose is to provide a letter service, it could be argued that the allocation of shared retail and mail network fixed assets according to product activity levels under-estimates the asset levels required to support the letter service on a standalone basis.

This view is analogous to the conclusion reached by the ACCC on cost allocation in its March 2007 RKR report, which said (in section 4.3 of that report):

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

A similar conclusion is valid for the domestic reserved letter service asset base, as the asset allocation process must tightly match the cost allocation process for compatibility reasons. However, as the ACCC notes, identifying the extra asset total, to be added, is problematic. Therefore, the fixed asset base included in this Notification is restricted to the (lesser) total used in the RKR process, ie $937 million at 30 June 2007 as adjusted by forecast capital investment additions, deletions and depreciation.

12.2. ACCC Views on Australia Post's Fixed Assets

Two features of Australia Post's fixed assets distinguish it clearly from many utilities subject to regulatory scrutiny. These are:

- that the assets are purchased or constructed in open markets; and particularly
- that assets, even specialised mail handling equipment, can generally be sold in open markets in Australia or overseas.

In its Decision of October 2002[26], the ACCC stated that;

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

Since that case there has been no material change to the nature of Australia Post's assets, although a number of accounting changes have been introduced as a result of the adoption of new accounting standards applicable to Australian corporations generally. The asset classes are very similar to the asset classes used in 2002. No infrastructure-type assets have been introduced. This is the case whether the asset base is that of Australia Post or of the domestic reserved letter service.

12.3. Capital Investment

A major part of Australia Post's capital expenditure involves items which are cyclical or replacement in nature. Essentially this is aimed at maintaining or supporting Australia Post's operational infrastructure. It is usually shared across the three business portfolios.

All of Australia Post's capital expenditure is classified according to its purpose. A strategic review of likely capital expenditure requirements extending over the next 3-4 years concluded that the capital expenditure profile by investment purpose would be as follows:

- replacement 38%;
- cost reduction 26%;
- growth 20%;
- infrastructure 7%; and
- other factors 9%.

Australia Post's average annual capital expenditure spending since 1999/00 is $212 million. In contrast, the average annual capital expenditure in the five years to 1999/00 was $304 million. Capital expenditure reached a low point in 2001/02, at $142 million which was the lowest annual capital expenditure since 1987/88.

Prima facie, this might appear to reflect the cessation of the one-off capital expenditure demands that the Future Post network renewal programme involved. However, network renewal capital expenditure continued well into this decade, and the dramatic fall in capital expenditure reflected underlying falls in normal cyclical capital expenditure, particularly in IT and the retail network.

As shown in Table 12 below, the absolute levels of capital expenditure during this decade are largely consistent with those that prevailed in the first half of the 1990s before any expenditure on Future Post began and despite ten years of inflation.

Table 12 – Capital Spending Indicators

	Capex ($m)	Capex / Revenue %	Capex / Fixed Assets %
Av 1990/91 – 1994/95	202	8.3	15.2
Av 1995/06 – 1999/00	304	9.3	18.4
Av 2000/01 – 2004/05	194	4.9	10.8
Av 2005/06 – 2006/07	257	5.6	11.7
Av 2000/01 – 2006/07	212	5.1	11.1

[26] Page 14, Appendix B

In terms of providing sustainability guidance, the two capital expenditure ratios above provide some guidance to capital expenditure sustainability. In the absence of large shifts in lease/purchase preferences, it seems reasonable to suggest that a certain amount of ongoing investment is needed to sustain both revenue and fixed assets in a growing business.

In terms of then providing sustainability benchmarks, the results from 1995/96 to 1999/00 may be misleading, as that period included much of the Future Post investment phase. The ratios for the earlier period 1990/01 to 1995/96 might provide more robust guidance.

In the past two years, capital spending has started to rise again, reaching $284 million in 2006/07. However, the associated capital expenditure ratios still have not returned to the "benchmark" levels. In 2006/07 the revenue and fixed asset ratios had reached only 6.1% and 12.2% respectively.

In June 2007, the Australia Post Board approved the capital expenditure programme, with planned total spending of $246 million in 2007/08 and $399 million in 2008/09. Not all of this planned capital expenditure has undergone formal business case evaluation, and accordingly some might not eventuate. Nevertheless, all projects in the plan list for this year and next have been identified against the operating Division, asset class and investment reason parameters.

12.3.1. Forecast Asset Base – Domestic Reserved Letter Service

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

The components of Australia Post's capital expenditure allocated to the domestic reserved letter service are $114 million in 2007/08 and $122 million in 2008/09. For the domestic reserved letter service, none of the capital expenditure involves land purchases, but all other asset classes i.e. buildings, fitout, vehicles, hardware, software, plant and equipment – are included in the $114 million and $122 million. Forecast future levels of domestic reserved letter service assets are contained in Appendix 11. Appendix 12 provides an overview of Australia Post's major fixed assets.

12.4. Current Assets

12.4.1. 2002 Notification

In the 2002 Notification, Australia Post's estimated asset base included current assets as well as fixed assets. That inclusion reflected standard accounting practice, a practice which remains the norm today[27].

The ACCC however, did not allow the use of current assets in Australia Post's asset base in the 2002 Notification. A key influence in that decision may have been the provision to the ACCC of a study by the Allen Consulting Group (Working Capital, Relevance for the Assessment of Reference Tarrifs, March 2002), which recommended against including working capital in the relevant asset base for price setting purposes. That study focussed instead on biases involved in timing assumptions for revenue and expenses, and on their impacts on required revenue.

12.4.2. 2008 Notification

As in the 2002 case, this Notification proposes that the reasonable asset base should contain current assets and some non-current assets which are additional to fixed assets.

One element of current assets, i.e. cash, has its own special case for inclusion. This is not necessarily a statement capable of generalised application, but is valid in Australia Post's particular circumstances. Those circumstances involve Australia Post's requirement to provide a large retail network, within which a very large part of retail transactions involve cash.

[27] The segment note in the statutory accounts requires current assets to be assigned to each business segment in addition to fixed assets.

Additionally, Australia Post has sought expert, independent advice as to what should be included in an appropriate asset base for regulatory purposes. This advice confirms that cash and other working capital should be included in the asset base, for reasons that are generally applicable to any organisation.

The particular case for cash is presented first, to be followed by the more general asset model introduced in this Notification.

12.5. Cash

Australia Post's cash is held at three levels, all three of which are recognised and measured in separate groupings within Australia Post's general ledger in the 'cash total' grouping. The three cash categories are:

- Investment balances. These funds are held as investments in short term securities for the purpose of earning interest income. They are not used in any part of the operating business. Australia Post considers that these cash balances do not belong to the asset base on which this Notification should be based;
- Cash in bank accounts. These cash balances are available for immediate operational or capital expenditure applications, for example in paying agency creditors whose accounts are settled daily. In practice within Australia Post, these balances are normally assigned totally to agency and money order creditors. Australia Post considers that these cash balances do not belong to the asset base relevant to this Notification; and
- Cash in the field. This is the permanent cash float held at the retail outlets. This amount is not available for investment in interest-earning bank accounts or securities, as it is necessary to provide permanent liquidity to the retail network. Products sold by cash transactions within the retail network are not viable without it and as such, this cash asset is just as fixed as the 'fixed assets' that form the asset base currently accepted for regulatory purposes by the ACCC.

Australia Post believes it is appropriate that 'cash in the field' is included in the asset base for this (and future) Notification/s. In 2006/07 the amount of 'cash in the field' allocated to the domestic reserved letter service was $✂ million.

Forecast future levels of these domestic reserved letter service cash assets are contained with the other current asset and the non-current asset forecasts in Appendix 11.

12.5.1. Other Working Capital Items

All other working capital items either generate free cash to be used for any purpose, or use free cash to make payments that had been owed and recognised as liabilities in the financial statements. Normal accounting practice includes working capital in the asset base assigned to products and services, and on which a return has to be earned by those goods and services.

While the ACCC has previously denied such a return in Australia Post's case, this Notification reopens the working capital issue. It treats as working capital, all balance sheet items other than:

- fixed assets;
- investments in subsidiaries and joint ventures;
- securities;
- investment properties;
- defined benefit superannuation fund net asset;
- equity; and
- debt.

The treatment of remaining balance sheet items by regulatory authorities in Australia and overseas varies enormously. There is no consistency, even at the broadest level of definition. For regulatory authorities which do allow a return on working capital, there is no universal agreement on which items should be allowed, or even how working capital should be calculated. In many cases there does not appear to be a strong justification by the regulator of the basis on which its choice has been made.

The only issue involving working capital on which there appears to be some broad consistency is the inclusion of working capital that is a current asset / liability and not when it is a non-current asset / liability. Australia Post does not believe that distinction, which is regularly made in defining working capital, is appropriate.

A current asset (by accounting definition) is either cash or likely to be converted to cash in the twelve months following the balance date. A current liability is not always defined in the same way. For example, employee liabilities that are fully vested in the employees are defined as current liabilities under the IFRS accounting standards even though they might not be cashed in by the employee in the following twelve months.

An example of this is Australia Post's long service leave liability which is about $300 million. Most of that liability is owed to employees who have qualified fully for the leave, with only about $36 million accrued to employees who have not yet qualified by their length of service to actually use the accrued leave. Typically, only about $30 million of the long service leave liability is cashed in and used by employees in the year following the balance date. Under the pre-IFRS accounting standards, that $30 million or so would have been shown as a current liability in the statutory accounts, with the remaining majority of the liability shown as non-current. In contrast, under the IFRS standard the non-current liability is just the $36 million not yet vested.

A similar example exists with non-current assets; most of Australia Post's trade debtors pay their debts within twelve months, but some of the international debtors (i.e. some other postal authorities) take longer. Again, there is no difference in the character of the balance sheet item, just an arbitrary decision on reporting as current or non-current.

In practice, timing distinctions such as current or non-current are not meaningful, and have become even more confused by changes in accounting standards. There is no essential difference between a liability expected to be realised in six months time and an identical liability expected to be realised in eighteen months time.

Accordingly, Australia Post commissioned Professor Officer and Doctor Bishop to undertake a review of the issue of working capital in regulatory applications such as pricing cases (Officer /Bishop Report). The review studied the theory and principles that should be applied to working capital and as such provides a new working capital framework that Australia Post believes has not previously been considered by regulators.

12.6. The Officer / Bishop Report

The Officer / Bishop Report has been provided to the ACCC. The approach differs from that traditionally followed by regulators, which essentially takes fixed assets and then examines which working capital items could / should be added to them on a gross or net basis. Instead, the report focuses on the essence of a balance sheet. That is:

- one side of a balance sheet comprises the assets of the enterprise. That balance sheet compartment contains all of the enterprise's assets, and not just a selected subset. It might be split into current and non-current components, but such a distinction is not relevant to the Officer / Bishop framework and plays no further part in it; and
- the other side of the balance sheet comprises the claims on the assets. These include equity, debt and other liabilities. By necessity of double entry accounting, their sum is equal to the sum of the assets.

Officer / Bishop begin by taking all assets as potentially requiring a return. They then develop their framework by examining each of the liabilities to see whether any need to be deducted to give a reduced asset base requiring a return. The test applied is whether assets have to be held against the liability to provide future payment, and with no coverage already built into the expense associated with that liability. In Australia Post's case, trade credit is already covered in terms of payment to the creditors for the float involved. Trade credit therefore does not require an additional return to Australia Post's assets to reimburse it.

Other liabilities (other than debt or equity) are determined by the Officer / Bishop framework as being, in effect, charges against equity, that will later be realised as payments. These are not deducted to give a new, lower, adjusted asset base. The largest group of such liabilities for Australia Post comprises its provisions.

The adjusted asset base for Australia Post's domestic reserved letter service for 30 June 2007 is built up in this model as shown in Table 13 which also details estimated adjusted asset totals for 30 June 2008 and 30 June 2009.

Table 13 – Adjusted Domestic Reserved Letter Service Asset Base

	30 June 2007 ($m)	Estimated 30 June 2008 ($m)	Estimated 30 June 2009 ($m)
Fixed Assets	937[28]	964	991
Plus Operating Cash Float	✂	✂	✂
Adjusted Permanent Investment	✂	✂	✂
Plus Other current assets	✂	✂	✂
Plus Deferred Tax Asset	✂	✂	✂
Adjusted Total Assets	1322	1356	1405
Less Creditors	(23)[28]	(24)	(25)
Net Asset Base for Pricing	1,299	1,332	1,380

12.6.1. Conclusion

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

Across Australia Post, capital expenditure has been modest since the 2002 Notification. As mentioned earlier in recent years Australia Post has been at the low end of its investment cycle, however, certain infrastructure assets (eg Information Technology) are scheduled for replacement and it is essential that Australia Post reinvests in these assets to ensure its continued competitiveness. This investment is likely to leave Australia Post with a fixed asset efficiency higher in 2008 and 2009 than in 2002.

Fixed asset values in respect of the retail and mail networks are generally the result of an allocation process, as few of those assets are dedicated solely to particular products and services. The allocation process has been extensively developed over the past five years, is consistent with the requirements of the RKR and enables robust allocation to product level. Allocation to a product level was not possible in the 2002 Notification, and as a result, the ACCC found it necessary to include non-reserved revenues in the 2002 assessment, a practice which is therefore not required in this case.

Fixed asset and cost allocation procedures are consistent and are used in the RKR assessment. The major change in asset treatment contained in this Notification concerns current assets.

[28] Per 2007 Statutory Accounts

13. Post Tax Revenue Model

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

The required revenue is calculated as the sum of:

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

The revenue at the proposed prices is below that identified by the PTRM as being 'required'; a point noted in the ACCC's June 2008 Preliminary View.

A comparison of the proposed and allowable revenues (against different views of the regulatory asset base) in 2008/09 is as follows:

Table 14 – Post Tax Revenue Model Summary 2008/09

			2008/09
Nominal Vanilla WACC	9.6%		
Required Revenue			
Fixed Assets only		$	1,983
Present Value of Required Revenue			
Fixed Assets only		$	1,810
Letters Revenue at proposed prices		$	1,944
Present Value of Proposed Letters Revenue		$	1,774
Deficiency of Letters Revenue to Required Revenue			
Fixed Assets only		$	36

14. Concluding Comment

Australia Post delivers high standard, reliable and low cost letter delivery services which have supported essential business communications. The reliability, reputation and performance of Australia Post's domestic reserved letter service is recognised by business and the general public alike as an important contributor to the Australian community.

It is Australia Post's intention to maintain and 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.

This Notification demonstrates Australia Post's efficiency in both its cost and asset base for the corporation as a whole and within that the domestic reserved letter service. As shown in Table 14 above, and as based on the forecast volumes in section 8, Australia Post's proposed prices (as set out in this Notification) generate revenue that is below that determined by the ACCC in its June 2008 Preliminary View as being required (based on efficient costs and a reasonable rate of return).

Australia Post's Letter Pricing Principles are as follows:

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

	2008 Basic Letter Rate	
	As Is	+ VAT
AUSTRALIA	0.50	0.50
AUSTRIA	0.91	1.09
BELGIUM	0.87	1.05
CANADA	0.61	0.61
CZECH REPUBLIC	0.98	1.17
DENMARK	0.92	1.15
FINLAND	1.05	1.05
FRANCE	0.87	1.04
GERMANY	0.90	1.07
GREECE	1.04	1.24
HUNGARY	1.05	1.31
ICELAND	0.79	0.98
IRELAND	0.78	0.94
ITALY	0.99	1.19
JAPAN	0.97	0.97
KOREA	0.42	0.46
LUXEMBOURG	0.77	0.89
MEXICO	1.27	1.27
NETHERLANDS	0.71	0.85
NEW ZEALAND	0.46	0.46
NORWAY	1.13	1.13
POLAND	1.01	1.23
PORTUGAL	0.91	1.10
SLOVAK REPUBLIC	1.34	1.60
SPAIN	0.58	0.67
SWEDEN	0.85	0.85
SWITZERLAND	0.86	0.93
TURKEY	1.22	1.22
UNITED KINGDOM	0.79	0.92
UNITED STATES	0.60	0.60

Note: the VAT-inclusive rate is the rate that would apply if national VAT exemptions were removed.

Appendix 3 – Contribution to Economic Development

The following Table details Australia Post's contribution to economic development

	2005/06	2006/07
Revenue	$4,530m	$4,711m
▪ Australian	$4,386m	$4,561m
▪ Export	$144m	$150m
Direct employment in postal services	35,613	35,476
▪ Full-time employees	25,387	25,026
▪ Part-Time employees	9,196	9,498
▪ Agency staff	771	744
▪ Other employment	259	208
Labour productivity growth	3.7%	3.2%
Payments		
▪ To employees	$1,973m	$1,978m
▪ To goods and services suppliers	$1,937m	$2,070m
▪ For capital assets & business acquisitions	$238m	$284m
Taxes and rates paid		
▪ Commonwealth	$393m	$360m
▪ State and local government	$121m	$125m
Cost of community service obligations	$88m	$97m
Small businesses directly supported	7,191	7,127
Licensed and franchise post offices	2,975	2,969
▪ Metropolitan	1,277	1,283
▪ Rural and remote areas	1,698	1,686
Mail contractors	3,586	3,524
▪ Metropolitan	719	723
▪ Rural and remote areas	2,867	2,801
Community postal agencies	630	634
▪ Metropolitan	35	35
▪ Rural and remote areas	595	599
New services and products introduced in last two years	$179m	$186m
Access to bill payments and financial services		
▪ Number of billing principals	681	722
▪ Number of banks/financial institutions	76	77
Outlets with on-line banking facilities	3,188	3,291
▪ Metropolitan	1,797	1,824
▪ Rural and remote areas	1,391	1,467
Basic postage rate (ranking in OECD)	3rd lowest	3rd lowest
Revenue foregone through Letter price restraint (compared with CPI):		
▪ last 10 years	$2,585m	$2,672m
▪ last 5 years	$507m	$822m
Delivery points (at 30 June)	10.0m	10.3m
Shareholder value		
▪ profit after tax	$368m	$401m
▪ dividends declared	$267m	$297m

Note: all financial data are shown to the nearest $ million

The following provides an overview of the services and products within each of Australia Post's three main business portfolios:

<u>Letters & Associated Services</u>

Letter Delivery Services:

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

Associated Services:

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

<u>Retail & Agency Services</u>

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

<u>Parcels & Logistics</u>

Domestic Services include:

- Parcel Post, Express Post Parcels, Messenger Post Couriers, Post eParcel, Post Logistics

International Services Include:

- Express Courier International, Express Post International, Air Mail and Sea Mail

Australia Post's domestic letter services are considered to provide for the carriage of reserved letters unless excluded by the conditions (or the circumstances) of the particular service, eg Print Post. Additionally, where a service has a weight step for letters weighing over 250 grams or the price charged is equal to or greater than four times the BPR (currently $2.00) those particular items will not be reserved because they fall within exceptions under section 30 of the APC Act.

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

- Ordinary Small letters (including Seasonal Greeting Cards)
- Ordinary Large Letters – where the weight step applies to letters weighing 250 grams or less
- PreSort Small Letters (including Charity Mail)
- PreSort Large Letters – where the weight step applies to letters weighing 250 grams or less
- Clean Mail
- Reply Paid – where the weight step applies to letters weighing 250 grams or less
- Impact Mail
- Acquisition Mail
- Local Delivery Letters – where the weight step applies to letters weighing 250 grams or less

A domestic letter would also be non-reserved if the price charged was equal to or greater than four times the BPR (currently $2.00), none of the above services contain a price point for a letter weighing 250 grams or less that is above this amount.

Australia Post also categorises Incoming International letters as reserved if:

- the item weighs 250 grams or less; or
- the price charged is less than four times the BPR.

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

Transactional (78% of the domestic letters market) – typically mass produced bills, statements and other transactional correspondence from business. Transactional volumes are flat to declining and this is attributable to two factors:

- the move by all senders to use electronic/digital communication channels, (i.e. substitution), eg
  - from private consumers a reduction in cheque payments by mail, and
  - from business senders an uptake of email, fax streaming, etc.; and
- the move by business senders to look at strategies that rationalise their mailings (eg Bill consolidation).

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

Promotional (18% of the domestic letters market) – typically advertising mailings between businesses, and between businesses and consumers, i.e. Direct Mail packs, brochures etc. While growth has been relatively robust over the past three years (average growth estimated at around 6-7%), driven by a number of factors including the Mail Marketing initiatives that Australia Post has developed, in the future Australia Post expects promotional growth to average around 3 ½ %

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

All segments of the domestic letters market are under threat. However, the impact is heightened for the transactional segment, which represents 78% of domestic letter volumes. As promotional mail accounts for around 18% of total volumes, a 5% growth is needed to offset a 1% decline in social and transactional mail.

Key Findings

Domestic Small Letter Segment Volume Demand

1995/96 – 2006/07

Overview

Diversified Specifics conducted a detailed econometric analysis of Australian domestic small letter volumes at a segmented level over the July 1995 to June 2007 period.

The main objectives of the study were to isolate trends, establish demand drivers, estimate statistically significant market-based demand elasticities and develop forecasting models for the two major product streams within Australia Post's domestic reserved letter service:

- PreSort Barcoded small letters; &
- Other small letters.

The major findings of this research undertaking are as follows:

1. ***Substitutive pressures have impacted volumes since the mid 1990's***

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

   This decline has emanated in the Other small letter volume segment by virtue of credit card penetration throughout the Australian economy.

   In particular, credit card growth has enabled Australian consumers and businesses to engage in telephone and internet bill payment mediums to a greater extent than previously possible.

   Such a trend has resulted in a movement away from the traditional mail item (via reductions in cheque & money order volumes) towards settling the bill payment component of a commercial transaction using an electronic medium.

2. ***Volumes have become more income inelastic as rationalisation and consolidation trends intensify***

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

International and domestic evidence suggest the emergence of trends in these areas that may negatively impact PreSort Barcoded small letter volume growth in future years.

In addition, the income elasticity of demand with respect to PreSort Barcoded small letter volumes differs considerably when comparing the late nineties with the subsequent period to June 2007 (See Table 5.1).

Table 5.1.

PreSort Barcoded Small Letter Volumes Income Elasticities	
Timeframe	**Income Elasticity**
1995/96 - 2000/01	1.887
2001/02 - 2006/07	0.549

This implies PreSort Barcoded small letter volumes are not as responsive to fluctuations in economic activity as previously were the case as recent trends towards consolidation and rationalisation of letter volumes begin to challenge this traditional association.

Section 5 presents this evidence and then highlights research conducted in the United States and Canada, in addition to a case study involving Telstra within Australia, to demonstrate the realities of mail consolidation and rationalisation.

Such findings suggest a fundamental change to the Australian postal landscape in recent times.

Given these changing dynamics, Australia Post is advised to monitor trends in substitution, rationalisation and consolidation when engaging in letter volume demand analysis, strategic planning and policy formulation within the Australian postal industry.

Small Letter Hypotheses Tested

Theoretical explainers were grouped into thematic groups and mapped against the PreSort Barcoded and Other small letter volume segments to ascertain a set of variables that exhibited statistically significant associations.

List of Examined Explanatory Variables & Thematic Groupings		
Category	**Other Small Letter Volume Segment**	**PreSort Barcoded Small Letter Volume Segment**
Financial & Substitutive	Credit Card Volumes Cheque Volumes Money Order Volumes Electronic Bill Payment Volumes	Credit Card Volumes Electronic Bill Presentment Volumes
Macroeconomic	Australian Non-farm GDP	Australian Non-farm GDP Advertising Industry Health Measure Australian Retail Trade
Product	Small Letter Delivery Performance Real Price of Other Small Letters	Small Letter Delivery Performance Real Price of PreSort Barcoded Small Letters
Demographic	Estimated Australian Population	Estimated Australian Population
Postal	Introduction of Barcoding Technology Closure of the Unbarcoded PreSort Service	Introduction of Barcoding Technology Closure of the Unbarcoded PreSort Service
Extraneous	Socio-economic Disruptions	Political Events Major Events

Statistically Significant Small Letter Volume Drivers & Elasticities

The econometric process gave rise to a suite of preferred small letter forecast models, developed over differing timeframes, and the statistically significant elasticities[29] were estimated to be:

- A 5% increase in **credit card volumes** was associated with a 4.0% decrease in Other small letter volumes.
- A 5% increase in the **real price** of sending Other small letters was associated with a 3.3% decrease in Other small letter volumes.
- A 5% increase in **Real GDP (Non-farm)** was associated with a 4.4% increase in PreSort Barcoded small letter volumes; and
- A 5% increase in **the health of the advertising industry** was associated with a 0.8% increase in PreSort Barcoded small letter mail volumes.

[29] All elasticities are estimated at their mean and are applicable only to the timeframe over which the econometric models have been developed. In interpreting the elasticities within this study, it is assumed all other factors are held constant.

Recent Movements in the Statistically Significant Small Letter Volume Drivers[30]

Other small letter volumes were found to be driven by fluctuations in credit card volumes and movements in real price.

- Credit card volumes have been growing at an annual average rate of 5.95% since the start of 2000 and by 4.40% in the 12 months prior to June 30, 2007; &
- Real price has decreased at an annual average rate of 1.20% since the start of 2000 although in the 12 months prior to June 30, 2007 it has declined by 3.27%.

PreSort Barcoded small letter volumes were found to be driven by fluctuations in Non-farm real GDP and movements in the consumer discretionary index (i.e. the measure of health of the advertising industry).

- Non-farm real GDP has been growing at an annual average rate of 3.46% over the past six years and by 5.27% in the 12 months prior to June 30, 2007; &
- The Consumer Discretionary Index has increased at an annual average rate of 2.08% over the past six years and increased by 25.26% in the 12 months prior to June 30, 2007.

Small Letter Volume Seasonality

Seasonal factors[31] provide, in percentage terms, a historical indication of the tendency for volumes to fluctuate during the course of any particular year over the sampled timeframe. When contrasting the late nineties with the early 2000's it is evident that the seasonal mix has slightly altered within each of the two small letter product segments.

Domestic Small Letters				
Monthly Seasonal Factors				
	Other Small Letters		PreSort Barcoded	
Month	Jul 95 - Jun 01	Jul 01 - Jun 07	Jul 95 - Jun 01	Jul 01 - Jun 07
Jan	82.15%	85.23%	93.76%	90.40%
Feb	92.36%	89.34%	93.79%	92.62%
Mar	98.20%	96.08%	103.70%	105.31%
Apr	90.15%	88.89%	89.39%	95.80%
May	98.24%	97.87%	102.87%	107.34%
Jun	97.94%	93.91%	96.07%	99.42%
Jul	101.84%	104.00%	109.44%	108.11%
Aug	99.96%	101.39%	104.00%	99.62%
Sep	97.92%	98.54%	100.33%	97.94%
Oct	99.63%	100.77%	104.70%	109.12%
Nov	107.91%	112.24%	110.16%	107.13%
Dec	133.71%	131.75%	91.78%	87.19%

[30] The non-market based volume drivers have been excluded from this summary however, a discussion may be found in Table 3.6.1 of the source document.
[31] Inferences on seasonality are given by historical data throughout the examinable timeframe and therefore only provide an indicative guide to future seasonal fluctuations. Estimates should be compared to a value of 100% to assess whether letter volumes for that month were above or below the monthly average.

Appendix 8 – Wage and Salary Rises and Bonus Payments under EBA5, EBA6 and EBA7

	Date	Amount
EBA5	September 2002	$300 cash performance bonus
	24 April 2003	3.0%
	18 December 2003	2.5%
EBA6	9 August 2004	4.0%
	30 June 2005	2.0%
	9 March 2006	2.0%
	22 March 2006	$400 cash performance bonus
	2 November 2006	2.0%

As part of the negotiation of EBA7, Australia Post has committed to the following salary increases:

	Date	Amount
	23 August 2007	4.0%
	August 2008	4.0%
	August 2009	4.0%
	September 2009	$500 performance bonus
	August 2010	2.0%
	December 2010	2.0%

		Small Letters			Large Letters			Total
		Ordinary	Bulk	Subtotal	Ordinary	Bulk	Subtotal	Letters
2007/08								
Volume	m	1,725.3	2,121.3	3,846.6	211.0	178.7	389.7	4,236.3
Revenue	$m	$ 767.9	$ 745.7	$ 1,513.6	$ 206.9	$ 113.3	$ 320.1	$ 1,833.8
Total Cost	$m	✂	✂	✂	✂	✂	✂	$ 1,835.8
Contribution	$m	✂	✂	✂	✂	✂	✂	-$ 2.0
ROR	%	✂	✂	✂	✂	✂	✂	-0.1%
2008/09								
Volume		1,686.6	2,164.6	3,851.2	209.6	175.7	385.2	4,236.4
Revenue		$ 803.8	$ 802.1	$ 1,605.9	$ 222.8	$ 115.5	$ 338.3	$ 1,944.2
Total Cost		✂	✂	✂	✂	✂	✂	$ 1,910.8
Contribution		✂	✂	✂	✂	✂	✂	$ 33.4
ROR		✂	✂	✂	✂	✂	✂	1.7%

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

Australia Post's WACC was a source of discussion between Australia Post and the ACCC during the 2002 Notification. Since the 2002 Notification, Australia Post commissioned a review of its WACC by independent financial experts Capital Partners, under the direction of Professor Officer. Their report was provided to Australia Post in August 2005.

The new WACC has been applied in the regulatory accounting assessment process begun by the ACCC in 2005. A copy of the Capital Partners report has been provided to Ernst and Young, the external auditors appointed by Australia Post to provide independent review of the regulatory accounts on behalf of both Australia Post and the ACCC.

The WACC is calculated according to standard finance practice. It includes a cost of equity derived from the Capital Asset Pricing Model and a cost of debt containing a corporate risk premium over the risk-free rate.

Australia Post's WACC in this Notification is calculated according to the formula set out by the ACCC in section 18 of the RKR.

Table 15 details current WACC parameter values applied by Australia Post in its WACC calculation. The changes to the equity and debt betas since the 2002 Notification have the impact of reducing the WACC and the allowable revenue as calculated in the Post Tax Revenue Model.

Table 15 – WACC Parameter Values

WACC Parameter	Value
Risk-free rate	6.2%
Market Risk Premium	6%
Asset β	0.52
Imputation Credits Value	50%
Equity β	0.66
Tax Rate	30%
Debt β	0.10
Cost of debt	8.0%
Gearing (D/D+E)	25%

The application of the methodology and the parameters above yields a pre-tax nominal WACC of 11.0%. Commentary on the WACC parameters set out above is as follows.

Risk Free Rate

The Capital Partners WACC report recommended that Australia Post use the Commonwealth 10 year bond rate as an appropriate risk-free rate.

For capital investment and acquisition purposes Australia Post uses that Commonwealth 10-year bond rate as the risk-free rate. This reflects the longevity of the Corporation's capital base.

The average rate for the period 14 April 2008 to 16 May 2008 has been used in this Notification.

Market Risk Premium

The ACCC uses a standard 6% market risk premium (MRP). Australia Post also uses a 6% market premium, on the advice of Capital Partners and Professor Officer.

Australia Post understands that the market risk premium preferred by the ACCC (i.e. 6%) is based on a 10 year Commonwealth bond rate. This was also the basis on which Capital Partners recommended a 6% premium.

If the term structure of interest rates is normal, ie upward sloping, then choice of a shorter term bond will require a compensating and consistent rise in the market premium to reflect the same level of market returns.

Asset β

Australia Post's asset beta was assessed by Capital Partners and Professor Officer.

Imputation Credits

Australia Post's imputation credit value was part of the Capital Partners report. Its selected value (50%) is identical to the value preferred by the ACCC in the 2002 price case.

Capital Partners point out that in Australia Post's case, imputation credits are not actually able to be utilized because of Australia Post's ownership. Consequently, the actual value of imputation credits in Australia Post's case is zero. Adoption of a zero value for imputation credits will raise Australia Post's cost of capital, and therefore also the "allowable" revenue that the ACCC's pricing model will determine.

Despite the relevance to Australia Post of a zero value for imputation credits, Australia Post proposes to retain the 50% factor preferred by the ACCC, reflecting Australia Post's belief in the desirability of a competitive neutrality outcome rather than one based on government ownership.

Equity β

The equity beta is calculated according to the formula in the RKR.

Tax Rate

Australia Post pays all Commonwealth, State and Local taxes on the same terms as any other corporation.

The effective company tax rate has been marginally below the statutory rate in recent years, but the gap is not material, and adoption of the average effective tax rate for the past four years would result in a WACC change of less than a decimal point.

The tax rate input to Australia Post's WACC calculation is the statutory company tax rate, while Australia Post's PTRM determines an effective tax rate for the purposes of WACC values expressed in pre-tax and post-tax terms.

Debt β

Australia Post's debt β of 0.1 was advised by Capital Partners. This was considered be equivalent to the expected yield on an investment grade security with strong ability to meet debt service. Australia Post has received a AAA rating from Standard & Poor's at each annual review since the initial rating in 1994, and that rating matches the security definition selected by Capital Partners.

Australia Post notes that adoption of a debt β of 0.05, as previously preferred by the ACCC, would marginally lift the WACC.

Cost of Debt

The cost of debt, and the associated interest rate margin over the bond rate, is derived from the weighted average floating interest rates that match Australia Post's debt structure. The rates used to set the effective interest rate for this application is the average for the period 14 April 2008 to 16 May 2008.

Gearing

In the 2002 Notification the ACCC noted that gearing had a limited impact on the WACC and it endorsed Australia Post's proposal to use Debt:Equity in 30:70 proportions.

30:70 was a long-term ceiling set many years ago by the Australia Post Board. The actual gearing ratio has been below this for many years and is still declining.

The ACCC will note that Australia Post's statutory accounts have two factors that mask the underlying position from a regulatory point of view. These factors are as follows:

- Australia Post's balance sheet now shows a significant superannuation asset. At June 2007 this added $1244 million to equity. The superannuation net asset entered the balance sheet under the AIFRS accounting standards applicable since 2004/05, but in fact it is not an asset which either is controlled by Australia Post or which is used in Australia Post's operations. Its impact on equity needs to be removed to determine underlying gearing. Note that most other corporations do not face such a significant issue, as it concerns only defined benefit schemes. The scheme to which Australia Post belongs has a large asset surplus which creates the asset in Australia Post's balance sheet; and
- property assets are now measured at cost in Australia Post's balance sheet. For ACCC purposes these assets need to be restated to market value, as has been done in the regulatory accounts process. The impact at 30 June 2007 would be an increase in property assets of $707 million. Market values are provided by independent expert valuers.

The two adjustments combine to reduce Australia Post's equity, thereby reducing the WACC. However, as noted by the ACCC in the 2002 Notification, gearing changes have a limited impact on the WACC.

For the purpose of this Notification, Australia Post's gearing reflects the adjusted gearing as at 30 June 2007. This is consistent with the data provided for the 2006/07 RKR assessment by the ACCC.

Appendix 11 – Domestic Reserved Letter Service Asset Values

Fixed Assets ($ million)	June 2007		June 2008		June 2009	
Land						
Opening Balance	267		303		303	
Additions						
Depreciation						
Sales/Transfers		(7)				
Revaluations		42				
Closing Balance		303		303		303
Buildings and Fitout						
Opening Balance	293		295		305	
Additions		6		28		38
Depreciation		(20)		(18)		(20)
Sales/Transfers		(5)				
Revaluations		21				
Closing Balance		295		305		323
Plant & Equipment, Software						
Opening Balance	311		339		357	
Additions		69		86		85
Depreciation		(61)		(63)		(70)
Sales/Transfers		20		(6)		(6)
Revaluations						
Closing Balance		339		357		366
Total						
Opening Balance	870		937		964	
Additions		76		114		122
Depreciation		(80)		(81)		(90)
Sales/Transfers		7		(6)		(6)
Revaluations		64				
Closing Balance		937		964		991

Current Assets ($ million)	June 2007	June 2008	June 2009
Cash	✂	✂	✂
Other current assets	✂	✂	✂
Total Current Assets	234	236	253

Pricing Asset Base ($ million)

Fixed Assets	937	964	991
Plus			
Operating Cash Float	✂	✂	✂
Permanent Investment	✂	✂	✂
Plus			
Other Current Assets	✂	✂	✂
Deferred Tax Asset	✂	✂	✂
Adjusted Total Assets	1322	1356	1405
Less			
Creditors	(23)	(24)	(25)
Asset Base for Pricing	1299	1332	1380

Data are shown to the nearest $ million

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

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

At 30 June 2002 Australia Post had 577 owned properties, down from 1311 a decade earlier. By 30 June 2007 that number had fallen further to 519.

The 30 June 2007 asset values which form a foundation for this Notification include land and building assets at market value. Its total at 30 June 2007 was $1,476 million, compared with the book value of $768 million shown on the face of the balance sheet. Valuations for the 30 June 2007 accounts were carried out by Chesterton International (Qld) Pty Ltd for all property in Queensland, and by Savills Pty Ltd for properties in all other states and territories. All properties are revalued annually.

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

At 30 June 2007 the value of properties covered by this asset class was $127 million. This amount is not allocated to products and services, and is not part of the asset base on which this Notification is based.

The impact of the introduction of this class is to reduce by the $127 million the value of Australia Post's operational properties compared with the outcome if the 2002 accounting treatment had been maintained.

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

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

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

Buildings – GPOs	70 years
Buildings – other facilities	40-50 years
Leasehold Improvements	Lower of lease term and 10 years
Motor Vehicles	3-7 years
Specialised plant/equipment	12-20 years
Other plant/equipment	3-10 years

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)

Background

- The BPR is the uniform rate that applies to domestic ordinary small letters.
- The increase to the BPR is the first increase to this rate since January 2003.
- When the GST was introduced on 1 July 2000, it was absorbed into the BPR, which reduced Australia Post's revenue to 40.9 cents per article. The increase in 2003 increased the revenue that Australia Post earned from the BPR to just over that which applied in 1992 (ie 45.45c compared to 45c). By July 2008, CPI is estimated to have increased by almost 50% since January 1992, and over 15% since January 2003: the proposed 55c BPR therefore represents a price reduction in real terms.
- Ordinary (Full Rate) Large Letter, Local Delivery, Seasonal Greetings and Prepaid Envelope rates are all set relative to the BPR.

The Market / Volumes

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

- a migration of full rate letters to Australia Post's Bulk services (eg PreSort and Clean Mail) as part of Australia 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 (down to 300 in 1999);
  - simplification of sorting breaks;
  - introduction of Clean Mail in 2003; and
  - introduction of commercial aggregation, enabling smaller mailers to access bulk mail discounts.
- the increased take-up of substitutes including alternate bill presentment and payment channels

The volume decline has generally been from the most profitable segments of full rate mail eg business full rate migrating to PreSort, movement to electronic channels for those 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.

Customer Impact

- The introduction of a Metered / Imprint Mail category will enable the majority of business senders to reduce the size of the increase.
- 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	50 letters pa	$ 2.72
Small Business	731 full rate letters pa	$48.60

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

2. Introduction of new rate for items that are paid for by Postage Meters or contain a postage paid imprint (and paid for by an Australia Post charge account or a Postage Meter)

Background

- The creation of this price category recognises the different acceptance and processing costs associated with letters that are paid for by this method.
- In April 2005 a similar price differentiation was introduced by Royal Mail.
- The new letter lodgement conditions are set out in Appendix 14

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.).

Customer Impact

Introduction of a metered / imprint rate will address business concerns regarding the lack of any recognition for work that is undertaken to simplify the lodgement process (eg Correctly assessing postage charges, correct addressing, use of return address, lodging mail across a post office counter in mail trays ready for processing, etc.).

3. Increase to PreSort prices (all categories)

Background

- PreSort prices were not increased in 2003 and there has not been a general increase to PreSort prices since 1992. In 1992 the key bulk letter price (Small Letter, Regular Delivery, Same State Barcode Direct Tray) was 38.25 cents, had this price moved with CPI it would now be over 57c; which on today's price represents a real price saving of over 67%.
- PreSort letter prices were overall reduced in 1995 and 1999 and for Barcoded Small Letters in July 2000.
- The only area of notable increase has been the removal of the AdPost discount (offered for promotional mail that met specific content conditions) which was withdrawn in a two step process (July 2002 and January 2003).
- A new category – Charity Mail – was introduced for small letter items when the advertising discount was removed (July 02); this effectively quarantined charitable institutions (as recognised under the Income Tax Assessment Act) from the withdrawal of the advertising discount and applied to all PreSort small letters items they lodged (ie. eligibility was based on the sender not the content of the mail piece).

Market / Volume

- PreSort accounts for around 54% of Australia Post's domestic reserved letter volumes
- There are around 5,000 customers who lodge PreSort Letters with Australia Post each year. These will vary from large corporations to some larger SMEs. The minimum lodgement volume for PreSort was reduced to 300 letters (of the same size and weight step) in 1999, while this has enabled larger number of customers to use the service, the majority of volume is generated by large corporations.
- PreSort is used for the delivery of both transactional and promotional messages.

Customer Impact

Overall the average increase to PreSort prices is 7%, this compares to the change of 15% in the CPI since 2003 and over 67% since 1992.

4. Introduction of a new category – Acquisition Mail

Background

After extensive customer consultation and product development, Acquisition Mail was developed. Acquisition Mail is an addressed (non-personalised) bulk mail delivery service which allows customers to geographically target, addressed mail campaigns to postcodes, suburbs (localities) or Census Collection Districts. Letter lodgement conditions for Acquisition Mail are detailed at Appendix 14.

Market / Volume

Acquisition Mail is designed for specific circumstances and is not expected to become a significant category in its own right.

The major users of Acquisition Mail will be businesses who want to acquire new customers and:

- have a communication message linked to a geographic target;
- would like to exclude existing customers from the mailing; and
- want to protect their brand integrity by using addressed rather than unaddressed communication.

Customer Impact

By providing addressed geographic targeting with the ability to exclude existing customers the service provides the opportunity for businesses to increase their mail communication effectiveness and customer reach ie by only mailing prospects in a target area, print volumes are reduced and ROI increased. Additionally:

- Trial results indicate that as Acquisition Mail is addressed it is more likely to be opened than unaddressed mail, which means it has a better chance of being read;
- Clients have the option to exclude address points in the 'Do Not Mail' file, available from the Australian Direct Marketing Association; and
- Compensation will be available to clients for returns in excess of 10%.

Metered / Imprint (New Category)

Definition	A price category providing a moderate discount for full rate letters that are paid for by a postage meter or via the use of a Postage Paid imprint (and paid for by an Australia Post charge account).
Scope	To apply to all Full Rate size categories (does not extend to Clean Mail, PreSort, Charity Mail etc.).
Eligibility	No minimum volume to apply.
Presentation Requirements	Addressing and envelope conditions that currently apply to the use of Postage Meters or Postage Paid Imprint apply (eg Return address, items must be faced, etc.).
Lodgement Requirements	At lodgement, items to be separated from other letter categories.
Documentation	Items paid for by a Postage Paid Imprint must be recorded on Full Rate Letters – Lodgement Document (8835114). Items paid for by a postage meter need to be recorded on the meter (as per other categories).

Acquisition Mail (New Category)

Definition	Addressed (non-personalised) saturation mail delivery service
Scope	To apply to Small and Small Letter Plus categories. Provides a delivery standard consistent with the Off Peak PreSort service.
Eligibility	Minimum of 30,000 letters. Clients must mail a minimum of 60% of the address points in their defined geographic areas over a six week period for any given lodgement. Content of the mailing must be acquisition in nature and contain no personal content. Variable copy and images are acceptable to cater for the needs of multi-network and franchised operations. To facilitate delivery, the service is only available to addresses (in nominated regions) supplied by Australia Post. A copy of the mailing statement must be received to be eligible for the return mail compensation.
Presentation Requirements	PreSort Letter service. Regular 37 length barcode with the Acquisition Mail Job ID to be printed in the address block Australia Post provided centralised return address to enable compensation to clients for returns in excess of 10% is mandatory
Lodgement Requirements	Lodgement must be prepared according to the Acquisition Mail presentation requirements, be accompanied by the Australia Post provided lodgement document and meet all eligibility requirements
Documentation	Lodgement document will be generated for the client upon registration for the service and assignment of a job identification number. The lodgement documentation details all the clients eligibility requirements based on their registration details.