



Australian  
Competition &  
Consumer  
Commission

# Assessing cross-subsidy in Australia Post 2007–08

An ACCC report

JULY 2009



Australian Competition and Consumer Commission  
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# Glossary

ACCC	Australian Competition and Consumer Commission
AIFRS	Australian Equivalents to International Financial Reporting Standards
attributable cost (AC)	costs that are part of a pool of common costs identifiable to a particular service by a separable cause and effect relationship
ATO	Australian Taxation Office
CAM	cost allocation methodology
cross-subsidy	the supply of one group of services at a loss made up by the profits on the supply of another group(s) of services
direct cost (DC)	costs that are solely associated with a particular service and so are incremental to providing that service
fully distributed cost (FDC)	the sum of direct, attributable and unattributable costs allocated to the particular service or group of services
incremental cost (IC)	the additional cost incurred by producing a good or service (in addition to the other goods the firm produces)
non-reserved services	services that Australia Post provides in competition with other entities
RAF	regulatory accounting framework
RAPM	regulatory accounting procedures manual
record-keeping rule (RKR)	the ACCC may require Australia Post to keep records (a record-keeping rule) that relate to any of the ACCC's regulatory roles
regulatory accounts	the statement of financial performance, statement of capital employed, statement of movements in non-current asset values, statement of WACC and the statement of service group usage, required by the record-keeping rules
reserved services	postal services reserved to Australia Post under legislation (i.e. no other entity can provide these services)
service group	the service groups defined in schedule 1 of the record-keeping rule information provided by Australia Post
stand-alone cost	the cost of producing each output in isolation
unattributable cost	costs that are part of a pool of common costs but are not readily identifiable (in whole or part) to any particular service by a separable cause and effect relationship
WACC	weighted average cost of capital

# Summary

The Australian Competition and Consumer Commission issues reports assessing cross-subsidy in Australia Post on an annual basis. These reports should be read in conjunction with the ACCC's principles for the disclosure of information it receives under the record-keeping rules (RKR's).<sup>1</sup>

This report presents the results of the ACCC's analysis of Australia Post's regulatory accounts for the 2007–08 financial year to determine whether it cross-subsidised its non-reserved services with revenue from its reserved services. Reserved services are those services in which Australia Post has a statutory monopoly; non-reserved services are services it provides in competition with others.

The ACCC was given this role in response to complaints Australia Post was cross-subsidising its competitive services with revenue from its reserved services. In June 2004, the *Australian Postal Corporation Act 1989* was amended to allow the ACCC to issue RKR's relevant to its regulatory functions. These amendments also placed an obligation on the ACCC to issue an RKR that would 'enable the ACCC to scrutinise whether or not Australia Post is cross-subsidising from the reserved services to the services it provides in competition with others'.<sup>2</sup>

The term 'cross-subsidy' is often used to refer to any case where the profit from providing one service is used to cover a loss incurred in providing another service. However, a more formal definition of cross-subsidy has developed in economic literature and comprises two tests:

- A service is a potential source of subsidy if the revenue generated by that service is greater than the stand-alone cost of the service. Whether such a service is an actual source of subsidy depends on whether the second test is satisfied. That is, revenue greater than the stand-alone cost is not, of itself, evidence of a cross-subsidy.
- A service is the recipient of a subsidy if the revenue generated by that service is not sufficient to cover the incremental cost of providing it.<sup>3</sup>

The ACCC has therefore sought to identify whether the revenue from any non-reserved service group is less than the incremental cost of providing that service group and whether the revenue generated by the reserved services is greater than the stand-alone cost of providing them. In conducting this analysis the ACCC has used Australia Post's accounting data to derive estimates for the economic cost concepts of incremental and stand-alone costs.

Information that Australia Post considers confidential is not generally disclosed in this report. Such exclusions are indicated by '[information removed]' in the text, or '§<' in charts.

The ACCC's views on the confidentiality of Australia Post information are outlined in its paper *Principles for the public disclosure of record-keeping rule information provided by Australia Post*.<sup>4</sup> In that report, the ACCC considered that the level of disclosure in its cross-subsidy reports should be sufficient for the purpose of the report and that it has a duty of care to protect any confidential information it receives. Generally, this means the ACCC will not disclose information Australia Post claims is confidential if it is not relevant to the purpose of the report.

However, this approach does not necessarily mean that the ACCC will not disclose this information for another purpose, such as for a price notification, or if it is in the public interest to do so.

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<sup>1</sup> ACCC, *Principles for the public disclosure of record-keeping rule information provided by Australia Post*, November 2006, available from [www.accc.gov.au](http://www.accc.gov.au).

<sup>2</sup> Explanatory memorandum to the Postal Services Legislation Amendment Bill 2003, p. 40.

<sup>3</sup> Compare G R Faulhaber, 'Cross-Subsidization: Pricing in Public Enterprises', *American Economic Review*, 65(5), December 1975, pp. 966–77.

<sup>4</sup> ACCC, *Principles for the public disclosure of record-keeping rule information provided by Australia Post*, November 2006, available from [www.accc.gov.au](http://www.accc.gov.au).

## Key findings

The key findings of the ACCC's analysis are:

- The revenue earned by all the reserved services was less than the two stand-alone cost proxies applied in this report. Thus the regulatory accounts do not provide evidence of cross-subsidy from Australia Post's statutory monopoly reserved services to the competitive non-reserved services:
- The revenue from the reserved services was less than the non-capital adjusted fully distributed cost of providing them (by \$1.7 million). The under-recovery of revenue means that reserved services pass the most stringent (lower bound) stand-alone cost test. The ACCC is therefore satisfied that the reserved services were not a source of subsidy.
- Revenue from Australia Post's non-reserved services was greater than the lower and upper bound of the stand-alone cost of providing the non-reserved services. This means that the non-reserved services (as a whole) did not receive a subsidy; rather they appear to be a possible source of subsidy.
- One non-reserved service group received a subsidy in 2007–08:
  - Revenue from logistics services was \$[information removed] less than the direct cost of providing that service. Australia Post stated that the increase in the subsidy to logistics from \$3.3 million in 2006–07 to \$[information removed] in 2007–08 was a result of changes in operational and economic circumstances. While revenue growth has been achieved, it has been insufficient to absorb the significant investment in logistics. In particular, operational changes and deteriorating economic conditions at the end of the 2007–08 year have resulted in an under-recovery of revenue for this service.<sup>5</sup>
  - Australia Post's regulatory accounts show that revenue from non-reserved services (excluding logistics) was greater than the upper bound of the stand-alone cost for non-reserved services.
  - Therefore the source of the subsidy to logistics appears to be the other non-reserved services, not the reserved services.
- Two other non-reserved services—international inward letters and a category described by Australia Post as 'other services'—may also have received a subsidy in 2007–08.
- Revenue from international inward letters (non-reserved) was \$5.5 million less than the direct and attributable cost of providing that service on a non-capital adjusted basis. Australia Post explained that it does not set prices for incoming international letters. Prices are determined by the Universal Postal Union (UPU), which sets 'terminal dues' rates. These rates are capped at a percentage of the basic postage rate and are also set according to a basket of currencies. The capped percentage and an appreciation of the Australian dollar in 2007–08 have resulted in an under-recovery of revenue for this service on a non-capital adjusted basis.<sup>6</sup>
- Revenue from 'other services' was \$[information removed] less than the direct and attributable costs on a capital adjusted basis. Australia Post noted that capital adjusted 'other services' are not expected to recover direct and attributable costs because many assets (including non-income generating properties) are allocated to this service group.<sup>7</sup>
- Revenue from two reserved service groups was not sufficient to fully recover their respective fully distributed costs of providing those services. As these are reserved services, this does not appear to be a concern in the context of monitoring for the existence of cross-subsidy from the reserved services to the non-reserved services.
  - Revenue from small letters ordinary (reserved) was less than the direct and attributable costs of providing the service on a capital adjusted basis.
  - Revenue from international letters inward (reserved) was less than the non-capital adjusted direct and attributable costs of providing the service. The explanation of the under-recovery of non-reserved international inward letters equally applies to the reserved international inward letters.

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<sup>5</sup> Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 1.

<sup>6</sup> Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 4.

<sup>7</sup> Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 3.

# 1 Introduction

As well as administering the *Trade Practices Act 1974*, the Australian Competition and Consumer Commission (ACCC) has specific responsibilities in the regulation of postal services.

These responsibilities include monitoring for the presence of cross-subsidies between Australia Post's reserved and non-reserved services, assessing proposed price increases of Australia Post's reserved services and inquiring into certain disputes regarding the terms and conditions under which Australia Post supplies bulk mail services.

To assist it in undertaking these roles, the ACCC can issue record-keeping rules (RKR) to Australia Post that require Australia Post to keep specified records and provide them to the ACCC.

The RKR provisions placed an obligation on the ACCC to issue Australia Post with an RKR about its reserved services. The purpose of this requirement was 'to enable the ACCC to scrutinise whether Australia Post is cross-subsidising from the reserved services to the services it provides in competition with others'.<sup>8</sup> This requirement was introduced to address allegations raised by some of Australia Post's competitors that it was competing unfairly by using revenue from its reserved services to cross-subsidise services it provides in competition with other businesses.<sup>9</sup>

In March 2005 the ACCC issued an RKR that established a regulatory accounting framework for Australia Post. The primary purpose of the RAF is to allow the ACCC to monitor for the presence of cross-subsidy.

This report does not generally disclose information that Australia Post considers confidential. The ACCC's views on the public disclosure of RKR information provided by Australia Post are outlined in the publication *Principles for the public disclosure of record-keeping rule information provided by Australia Post*.<sup>10</sup>

The remainder of this report is structured as follows:

- Chapter 2 provides an overview of the ACCC's roles in the regulation of postal services.
- Chapter 3 outlines the ACCC's framework for monitoring for cross-subsidy.
- Chapter 4 outlines the findings and outcomes of the review of Australia Post's cost allocation methodology.
- Chapter 5 sets out the results of the ACCC's cross-subsidy analysis for 2007–08.
- Chapter 6 presents the ACCC's conclusions.

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<sup>8</sup> Explanatory memorandum to the Postal Services Legislation Amendment Bill 2003, p. 40.

<sup>9</sup> Explanatory memorandum to the Postal Services Legislation Amendment Bill 2003, p. 39.

<sup>10</sup> ACCC, *Principles for the public disclosure of record-keeping rule information provided by Australia Post*, November 2006, available from [www.accc.gov.au](http://www.accc.gov.au).

## 2 Background

This chapter provides an overview of the Australian Competition and Consumer Commission (ACCC) role in the regulation of postal services and outlines the record-keeping rule (RKR) provisions of the *Australian Postal Corporation Act 1989*.

### 2.1 Australia Post

Australia Post is the government-owned provider of postal services in Australia. In 2007–08 it delivered 5.6 billion articles of mail to 10.5 million delivery points, had 35 256 employees and 4453 post offices, and served around 1 million customers in its retail outlets each business day. It reported a post-tax net profit of \$432.2 million (an operating profit before tax of \$592.2 million), representing a return of 19.4 per cent on average operating assets and a return of 11.9 per cent on revenue.<sup>11</sup>

In 1989 Australia Post was one of the first government businesses to be corporatised. The most significant aspect of this reform was the provision of an independent board and a commercial charter, albeit with ongoing obligations to meet community service obligations.

#### 2.1.1 Obligations on Australia Post

The Australian Postal Corporation Act imposes three general obligations on Australia Post:

- Australia Post must, as far as is practicable, perform its functions in a manner consistent with sound commercial practice.<sup>12</sup>
- Australia Post is required to meet certain community service obligations (outlined below).<sup>13</sup>
- Australia Post must perform its functions in a way consistent with general government policy and any directions given by the minister.<sup>14</sup>

#### 2.1.2 Community service obligations

Australia Post has an obligation to supply a letter service. The purpose of the letter service is to carry, by physical means, letters within Australia and between Australia and places outside Australia.

For letters that are standard postal articles, Australia Post must make the letter service available at a single uniform rate of postage for carriage within Australia.

In recognition of the social importance of the letter service, Australia Post must ensure that:

- the letter service is reasonably accessible to all people on an equitable basis, wherever they reside or carry on business
- the performance standards of the letter service reasonably meet the social, industrial and commercial needs of the Australian community.

#### 2.1.3 Services ‘reserved’ to Australia Post

In recognition of its community service obligations, Australia Post has been granted a general monopoly—although this is limited by a number of exceptions—in the carriage and delivery of letters within Australia, whether the letters originated within or outside Australia.<sup>15</sup> In this context, the term ‘letters’ has a meaning that is wider than its general usage; the Australian Postal Corporation Act defines the term ‘letter’ as meaning any form of written communication that is directed to a particular person or a particular address.<sup>16</sup>

The services captured by this monopoly are generally referred to as ‘reserved services’ and extend to:

- the collection, within Australia, of letters for delivery within Australia
- the delivery of letters within Australia.

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11 Australia Post, *Annual Report, 2007–08*, pp. 2, 10, 38, 51, 120.

12 Section 26 of the Australian Postal Corporation Act.

13 Section 27 of the Australian Postal Corporation Act.

14 Section 28 of the Australian Postal Corporation Act.

15 Explanatory memorandum to the Australian Postal Corporation Bill 1989, p. 3.

16 Section 3 of the Australian Postal Corporation Act.



Australia Post also has the exclusive right to issue postage stamps within Australia.

As noted above, the reserved services are subject to a number of exceptions, which are detailed in s. 30 of the Australian Postal Corporation Act, and include:

- the carriage of a letter weighing more than 250 grams
- the carriage of a letter relating to goods that is sent and delivered with the goods
- the carriage of a newspaper, magazine, book, catalogue or leaflet, whether or not directed to a particular person or address and whether or not enclosed in any sort of cover
- the carriage of a letter otherwise than for reward
- the carriage of a letter within Australia for a charge or fee that is at least four times the then rate of postage for the carriage within Australia of a standard postal article by ordinary post.

## 2.2 ACCC role in the regulation of postal services

The ACCC has three key responsibilities in the regulation of postal services. These responsibilities are contained in the *Trade Practices Act 1974* and the Australian Postal Corporation Act, and can be summarised as:

- monitoring cross-subsidy between Australia Post's reserved and non-reserved services
- assessing proposed price increases of Australia Post's reserved services
- inquiring into certain disputes regarding the terms and conditions on which Australia Post supplies its bulk mail services.

To assist it in undertaking these roles, the ACCC can issue RKR to Australia Post that requires Australia Post to keep specified records and provide them to the ACCC.

This report deals only with the first of these roles—monitoring for cross-subsidy between the reserved and the non-reserved services.

## 2.3 Record-keeping rule powers

The Australian Postal Corporation Act was amended by the *Postal Services Legislation Amendment Act 2004* to provide the ACCC with RKR powers. While these powers were mainly introduced to address concerns about cross-subsidisation, they also allow the ACCC to require Australia Post to keep records relating to any of its regulatory roles.<sup>17</sup>

The ACCC may prepare and publish reports—or may be directed by the minister to prepare and publish reports—analysing information provided to it under the RKRs.<sup>18</sup> Such reports may include information that Australia Post claims is commercial-in-confidence if:

- the ACCC is not satisfied that the claim is justified or
- the ACCC considers it in the public interest to publish the information.<sup>19</sup>

The principles applied by the ACCC when considering whether to publicly disclose information that Australia Post claims is confidential are outlined in a report released in November 2006.<sup>20</sup>

To date, only one RKR has been issued to Australia Post—in March 2005. In accordance with this RKR, Australia Post has submitted regulatory accounts to the ACCC for each financial year starting with 2004–05.

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17 Section 50H of the Australian Postal Corporation Act.

18 Sections 50I and 50J of the Australian Postal Corporation Act.

19 Section 50K of the Australian Postal Corporation Act.

20 ACCC, *Principles for the public disclosure of record-keeping rule information provided by Australia Post*, November 2006, available from [www.accc.gov.au](http://www.accc.gov.au).

## 3 Framework for monitoring for cross-subsidy

This chapter outlines the Australian Competition and Consumer Commission framework for monitoring for cross-subsidy. The economic theory of cross-subsidy is first outlined, followed by a description of the information collected under the regulatory accounting framework (RAF) and how the ACCC has used this accounting information to proxy the economic cost concepts of stand-alone and incremental costs.

### 3.1 Economic theory of cross-subsidy

The economic theory of cross-subsidy seems reasonably settled and is based on the work of Gerald Faulhaber.<sup>21</sup> He explicitly defined subsidy-free pricing and presented two tests for the existence of cross subsidisation:

- A service is the recipient of a cross-subsidy if the revenue generated by producing the service is less than the incremental cost of providing the service.
- A service is a potential source of subsidy if the revenue generated by providing the service is greater than the stand-alone cost of providing it. (Whether it is an actual source of subsidy depends on whether another service is the recipient of a subsidy.)

The incremental cost of a service is defined as the additional cost incurred by producing that service (in addition to the other services the firm produces). Another way of considering incremental cost is to consider what costs would be avoided, in the long run, if the service was no longer offered. If the revenue of each service is at least as great as the incremental cost of that service, no cross-subsidy exists.

If any service is the recipient of a subsidy, identifying the source of subsidy requires identifying which service (if any) has revenues greater than the stand-alone cost of providing the service. The stand-alone cost of a service is the cost of producing that service in isolation.

Further, because costs are sometimes common to some, but not all, of the services provided by a multi-product firm, Faulhaber's tests require testing not only each individual service but also each and every group of services.

The incremental cost test is a floor test with two parts:

- Revenue from each service must at least equal its incremental cost in order not to be the recipient of a subsidy.
- The combined revenue from all possible combinations of a firm's services must at least equal the incremental cost of providing that combination of services.

The stand-alone cost test is a ceiling test with two parts:

- Revenue from each service must not exceed its stand-alone cost in order not to be a potential source of a subsidy.
- The combined revenue from all possible combinations of a firm's services must not exceed the stand-alone cost of providing that combination of services.

Where the firm is subject to a break-even constraint, the tests are equivalent. That is, to establish the existence of cross-subsidy, one need only identify a violation of either the stand-alone cost test or the incremental cost test. However, without a break-even constraint, failing the stand-alone cost test does not, of itself, indicate the presence of a cross-subsidy—the firm may simply be making economic (or excess) profit.

Australia Post is not subject to a break-even constraint because only the reserved services are subject to price regulation. Therefore, to establish that Australia Post is cross-subsidising its non-reserved services with revenues from its reserved services, it is necessary to establish that:

- revenue from a non-reserved service (and each group of non-reserved services) is less than the incremental cost of providing that non-reserved service (or group of non-reserved services) and
- revenue from Australia Post's reserved services is greater than the stand-alone cost of providing the reserved services.

It is possible that there may be more than one source of subsidy. For example, if reserved revenue is greater than the stand-alone cost of the reserved services and non-reserved revenue is greater than the stand-alone cost of the non-reserved services, both the reserved and non-reserved services are possible sources of subsidy. Where there are multiple sources of subsidy, it is impossible to determine which particular group of services provides the subsidy. If all or many service groups are sources of subsidy, it is also impossible to determine their relative contributions.

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21 G R Faulhaber, 'Cross-Subsidization: Pricing in Public Enterprises', *American Economic Review*, 65(5), December 1975, pp. 966–77.

Alternatively, if revenue from the reserved services is less than the stand-alone cost of providing these services, there can be no cross-subsidy from the reserved to the non-reserved services. In this case, even if non-reserved services are recipients of a subsidy, there must be an alternative source of subsidy or Australia Post would be operating at an economic loss.

## 3.2 Regulatory accounting framework

As noted earlier, in March 2005 the ACCC issued an RKR that established an RAF for Australia Post. In the RAF, Australia Post's product categories were consolidated into 19 service groups (five reserved, 14 non-reserved).

Australia Post is required by the RAF to provide regulatory accounts disaggregated by the 19 defined service groups. Where applicable, these accounts are reconciled to Australia Post's published annual report, including:

- statement of financial performance
- statement of capital employed
- statement of movement of non-current asset values
- statement of weighted average cost of capital (WACC)
- service group usage statement.

The regulatory accounts are independently audited to ensure Australia Post complies with the rules and a regulatory accounting procedures manual. Australia Post must provide a RAPM with detailed information on how its regulatory accounts were prepared. Importantly, the RAPM must include detailed account mapping of how items are:

- allocated to service groups
- reported as direct, attributable or unattributable account items.

### 3.2.1 Direct account items

Direct account items are account items that are solely associated with a particular service and will be incremental to providing that service.

Australia Post has few direct revenues for its mail services because it is difficult for revenue to be identified by product at the point of sale. For example, eight 55-cent postage stamps may be used to mail eight separate small letters or one small parcel. In contrast, non-mail revenues can be directly attributed to the source at the point of sale.

Australia Post has few direct costs due to the nature of its operations. Its operational infrastructure supports a variety of products which, although differentiated by size, weight and handling characteristics, share common transport, processing and delivery costs. As a consequence, no costs within the reserved services are direct to a particular service group.

### 3.2.2 Attributable account items

Attributable account items are part of a pool of common account items that are identifiable to a particular service by a separable cause-and-effect relationship. Due to Australia Post having very few direct account items relating to its mail services, most of these revenues and costs are attributed to the various letter services according to an activity-based allocation methodology.

### 3.2.3 Unattributable account items

Unattributable account items are part of a pool of common account items but are not readily identifiable (in whole or part) to any particular service by a separable cause and effect relationship. For example, costs associated with senior management and central support functions such as finance and corporate affairs are classified as unattributable items. Unattributable account items are allocated to particular service groups using a relevant, reliable and verifiable factor such as relative use.

### 3.3 Using accounting information to proxy economic cost concepts

The ACCC considered that Australia Post would incur significant compliance costs if it were required to keep financial records on the economic cost concepts of stand-alone and incremental costs. Such a requirement would entail devising new estimates of costs, revenues and assets on a different basis from that which Australia Post currently uses to keep its accounting records.<sup>22</sup>

Accordingly, the incremental and stand-alone costs applied in this report are based on accounting data and provide a proxy for what the true economic incremental or stand-alone costs may be.

#### 3.3.1 Approximating incremental cost

As discussed above, the data provided by Australia Post under the RAF identifies costs (and revenues) as direct, attributable or unattributable. The purpose of this distinction is to derive an approximation of incremental cost.

Costs that are direct to a particular service group will be incremental to that service group as they are 'solely associated with a particular service group' and would therefore be avoided if that service group was no longer offered.

Costs that are attributable to a particular service group are incremental to the group of services over which they are attributed (if that group of services were no longer offered, the cost would be avoided) and may be incremental to a particular service group. The extent to which they are incremental to a particular service group depends on the extent to which Australia Post can avoid these costs by not providing that service group.

#### 3.3.2 Approximating stand-alone cost

In this case (as in most other cases where cross-subsidy is alleged), stand-alone costs are not observable. Karen Palmer has proposed substituting the actual stand-alone cost with an 'upper bound' on the stand-alone cost based on the lowest observed output of the second good.<sup>23</sup>

Although Palmer applies a cost function to observable data (rather than relying on accounting data reported as direct, attributable and unattributable), her approach does not seem dissimilar to the approach suggested by the ACCC's *Record keeping rules for the telecommunications industry*:

An upper boundary for the stand-alone cost of providing a service could be obtained by subtracting the direct and attributable costs associated with all other services from the total wholesale cost base. In practice, this boundary will usually be higher than actual stand-alone cost ...<sup>24</sup>

As noted in the above extract (and acknowledged by Palmer), it seems reasonable that the true stand-alone cost of a service (or group of services) lies between the sum of direct, attributable and unattributable (i.e. the fully distributed) costs allocated to the particular service (or group of services) and the sum of direct and attributable costs for that service (or group of services) plus all of the company's unattributable costs.

This approach establishes fully distributed costs as a lower bound of the stand-alone cost, and fully distributed costs plus all unattributable costs allocated to other services as an upper bound of the stand-alone cost for any given service, or group of services. However, this approach will only be valid if the direct costs and attributable costs are an accurate reflection of the incremental costs of the group of services concerned. Whether this is the case will depend on the particular circumstances and so some care is necessary in interpreting these 'lower' and 'upper' bounds.

In Australia Post's case, it appears likely that the fully distributed cost may not be an accurate reflection of the lower bound of the stand-alone cost in some cases. This is especially so for the reserved services because of the large proportion of attributable and unattributable costs common to more than one 'letters' service group.

Australia Post has argued that many of the costs attributable between the reserved and non-reserved letter services would not significantly alter even if the non-reserved letter services were no longer offered. Australia Post argues that this is due to the costs being driven by its community service obligations and delivery standards, which are specified by legislation, rather than by mail volumes. For example, the labour costs associated with the delivery of letters is driven by the number of delivery points and the frequency of delivery rather than by the number of letters delivered. If the non-reserved letter services were no longer offered by Australia Post, this is unlikely to significantly reduce Australia Post's labour costs associated with delivery. Similarly, Australia Post has argued that transport costs for mail are largely driven by the need to meet service standards (rather than mail volumes), which are prescribed by the Australian Postal Corporation (Performance Standards) Regulations 1998.

22 ACCC, *Regulation impact statement, record keeping rules for establishing a regulatory accounting framework for Australia Post*, March 2005, p. 6.

23 Karen Palmer, 'Using an upper bound on stand-alone cost in tests of cross-subsidy', *Economic Letters*, 35, 1991, pp. 457–60; and 'A test for cross-subsidies in local telephone rates: do business customers subsidize residential customers?', *RAND Journal of Economics*, 23(3), 1992, pp. 415–31.

24 ACCC, *Record keeping rules for the telecommunications industry*, December 1999, p. 47.

Finally, it is noted that the reasonableness of the upper bound appears to increase as the number of service groups included in the test increases. That is, adding all unattributable costs to one individual service group is likely to significantly overestimate the stand-alone cost of providing that service; however, when adding all unattributable costs to a larger group of services, the magnitude of the overestimation is likely to fall.

### 3.4 Tests applied in this report

The tests applied in this report use the accounting-based proxies for the economic cost concepts of incremental cost and stand-alone costs discussed above.

In conducting the tests described below, the ACCC derived a 'capital adjusted' statement of financial performance.<sup>25</sup> The ACCC has previously stated that it believes a return on capital is a legitimate cost to business.<sup>26</sup> Accordingly, in seeking to identify the existence of cross-subsidy, it is appropriate to identify and quantify this cost.

The ACCC has applied the tests for cross-subsidy on both a capital-adjusted and non-capital adjusted basis and found that the results are generally robust whether this capital adjustment is made or not. That is, adding a return on capital as a cost does not generally change whether services pass or fail; it only changes the amount by which they pass or fail (for 2007–08, the exceptions are small letters ordinary and non-reserved 'other services').

The cost figures presented in this report have not been adjusted to reflect a return on capital. This approach allows readers to reconcile the figures presented with Australia Post's annual report and recognises Australia Post's claim of confidentiality over the capital employed figures.

The RKR requires Australia Post to keep records and provide them to the ACCC on an annual basis; however, this 'static' reporting ignores the fact that costs incurred in one period might be recovered from revenue earned in another period. That is, while the ACCC's analysis is based on annual accounting records and can show that a particular service received a subsidy in any given period, such a service may not receive a subsidy over time, and a long-run consideration is required.

#### 3.4.1 Incremental cost test

Where revenue is less than direct costs, the service group is the recipient of a subsidy. Where revenue is sufficient to cover the direct costs but less than the sum of direct and attributable costs, the service group may be the recipient of a subsidy—further information about the attributable costs will be required. Whether the service is the recipient of a subsidy in such a case depends on the extent that the costs attributable to the service are incremental to that service—that is, to the extent that these costs are avoided if the service was no longer provided.

#### 3.4.2 Stand-alone cost test

If the sum of direct and attributable costs is an accurate reflection of the incremental cost of each service group, the sum of direct and attributable costs for the particular service (or group of services) plus all unattributable costs then represents an upper bound for the stand-alone cost.

If revenue is above this upper bound, that particular service (or group of services) is a potential source of subsidy. Whether it is an actual source of a subsidy depends on whether the revenue from another service (or group of services) is below the incremental cost of providing that service (or group of services). That is, finding that revenue is greater than the stand-alone cost is not sufficient to identify a cross-subsidy; it may be that the firm is simply earning positive economic profit.

However, if the sum of direct and attributable costs is not an accurate reflection of the incremental cost of the service, an adjustment (such as that discussed under section 3.3.2) may be necessary to arrive at a reasonable estimate of the stand-alone cost.

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<sup>25</sup> The WACC is applied to the value of capital employed for each service group, and this cost of capital is added to the statement of financial performance to derive a 'capital adjusted' statement of financial performance for each of the 19 service groups.

<sup>26</sup> ACCC, *Issues raised during consultation: record-keeping rules establishing a regulatory accounting framework for Australia Post*, p. 3, published on [www.accc.gov.au](http://www.accc.gov.au).

### **3.4.3 Fully distributed cost test**

While the ACCC's analysis is primarily concerned with the economic cost concepts of incremental and stand-alone costs (as proxied by accounting data), fully distributed cost is also reported. Although not strictly relevant to determining the existence of cross-subsidy, fully distributed costs are compared with revenue to show whether each of the service groups is, in addition to meeting its estimated incremental cost, also meeting Australia Post's allocation of common costs. This is also important because incremental costs need to be considered over the long run and, as discussed in section 3.3, the use of accounting data to estimate incremental costs is problematic and may in some cases underestimate long-run incremental costs.

The fully distributed cost test is more stringent than the incremental cost test described above because it requires revenue to be sufficient to recover the incremental cost (proxied by the sum of direct and attributable costs) of providing the service and Australia Post's allocation of common (unattributable) costs.

Fully distributed cost can also be considered a lower bound for the stand-alone cost.

## 4 Review of Australia Post's cost allocation methodology

In its assessment of Australia Post's 2008 price notification, the Australian Competition and Consumer Commission engaged WIK Consult to assess Australia Post's cost allocation methodology. In its report, WIK Consult expressed some concerns about Australia Post's CAM. In light of these concerns, the ACCC decided that Australia Post's CAM required a comprehensive review before Australia Post provided the ACCC with any further price notifications.

The ACCC commenced its review of Australia Post's CAM in late 2008 after its assessment of the 2008 price notification, and completed the review in June 2009. This was the first time the ACCC has reviewed the allocation procedures used by Australia Post to generate its regulatory accounts.

The objective of the cost allocation review was to improve the transparency of Australia Post's CAM. The ACCC considered three assessment principles when reviewing Australia Post's CAM:

- at each stage of Australia Post's cost allocation, ensuring there is sufficient information and explanation of its CAM—this way the ACCC can 'replicate' the results of Australia Post's CAM
- assessing whether the allocation procedures are consistent over time
- assessing whether the CAM is internally consistent—that is, there is consistency between Australia Post's descriptions of the allocation process and its allocation methodology, and there is consistency and traceability of cost allocation to different products.

The ACCC selected a subset of Australia Post's CAM for review. The ACCC selected activities and asset pools on the basis of materiality and the degree to which the activities and asset pools were shared between reserved and non-reserved services. The ACCC did not assess current assets in its review because these are not used by the ACCC to determine Australia Post's return on capital.

The outcomes of the CAM review were as follows:

- The level of detail and transparency in Australia Post's regulatory accounting procedures manuals have been improved. The RAPMs will now include more data and description of allocation procedures, which will better enable the ACCC to monitor changes in Australia Post's CAM over time.
- It was discovered that an asset driver had the wrong activity assigned. The correction resulted in an asset reallocation from reserved to non-reserved of less than \$4 million.
- Platinum Post was removed from two outdoor delivery activities. This resulted in a small reallocation of attributable costs between Australia Post's reserved and non-reserved services.

Australia Post had addressed all of the ACCC's concerns and issues raised during the CAM review and, as a result of the review and its outcomes, the ACCC is satisfied with Australia Post's CAM.

The current cross-subsidy report is based on the Australia Post 2007–08 regulatory accounts using the revised and updated CAM.

As an aside, it is noted that while the ACCC did recommend some changes to Australia Post's allocation procedures for assets and attributable costs, these changes were not significant enough to alter the ACCC's conclusions regarding Australia Post's 2008 price notification. Moreover, while there was a small reallocation of costs from reserved services to non-reserved services as a result of the CAM review, the 2007–08 regulatory accounts remained largely unchanged.

## 5 Analysis of Australia Post's 2007–08 accounts

This chapter sets out the results of the Australian Competition and Consumer Commission (ACCC) analysis of Australia Post's regulatory accounts for 2007–08. Australia Post has used an activity-based costing system to allocate its account items (i.e. its revenues, costs and assets).

As noted in section 3.4, the test results outlined below were performed using capital-adjusted costs; that is, Australia Post's accounting costs were adjusted to include a rate of return<sup>27</sup> on the capital employed for each service group. However, the results are generally robust whether or not this capital adjustment occurs (i.e. the capital adjustment only affects the amount of the pass/fail result with the exception of small letters ordinary and 'other services' (non-reserved)).<sup>28</sup>

Despite use of the capital adjusted costs in testing, the ACCC is not reporting the capital adjusted costs due to Australia Post's claim of confidentiality over the information contained in the statement of capital employed. Accordingly, all costs in this report are reported on a non-capital adjusted basis and are reconcilable to Australia Post's annual report.

Australia Post's 2007–08 schedules have been prepared on financial data using Australian Equivalents to International Financial Reporting Standards. Companies and entities that prepare financial reports under the Corporations Act 2001 are required to comply with AIFRS for financial years commencing on or after 1 January 2005.

The statement of financial performance and test results for all 19 service groups is presented in chart 5.1.

### 5.1 Changes to accounting policy

As required under the RKR, Australia Post must provide the ACCC with details of material changes to the accounting policies it implemented between the submission of the 2007–08 regulatory accounts and the 2008–09 regulatory accounts.

There were no material changes to accounting principles or policies for the 2007–08 financial year.

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<sup>27</sup> The ACCC determined that the weighted average cost of capital is 10.8 per cent for Australia Post's 2007–08 regulatory accounts. This is consistent with the WACC approved by the ACCC in its final decision on Australia Post's 2008 price notification.

<sup>28</sup> There are four exceptions to this general finding. Two services pass the direct and attributable cost test without a capital adjustment, but fail once a capital adjustment is made. The group of services in charts 5.2 and 5.4 are a possible source of subsidy without a capital adjustment, but not once a capital adjustment has been made.



**Chart 5.1 Australia Post's revenues and costs by service group (\$'000)**

Service group	Revenue (R)	Direct cost (DC)	Attributable cost (AC)	Unattributable cost	Fully distributed cost (FDC)	R>DC?	R>(DC+AC)?	R>FDC?
<b>Reserved services</b>								
Small letters ordinary	766.4	0.0%	91%	9%	100%	Yes	Yes	No
Small letters PreSort	762.6	0.0%	91%	9%	100%	Yes	Yes	Yes
Large letters ordinary	204.5	0.0%	90%	10%	100%	Yes	Yes	Yes
Large letters PreSort	106.3	0.0%	91%	9%	100%	Yes	Yes	Yes
International inward letters	45.0	0.0%	91%	9%	100%	Yes	No	No
<b>Reserved services total</b>	<b>1884.8</b>	<b>0.0</b>	<b>1717.4</b>	<b>169.2</b>	<b>1886.6</b>	<b>1884.8</b>	<b>167.5</b>	<b>(1.7)</b>
<b>Non-reserved services</b>								
Large letters ordinary	∞	∞	∞	∞	∞	Yes	Yes	Yes
Large letters PreSort	∞	∞	∞	∞	∞	Yes	Yes	Yes
Other letter mail services	∞	∞	∞	∞	∞	Yes	Yes	Yes
International outward letters	∞	∞	∞	∞	∞	Yes	Yes	Yes
International inward letters	∞	∞	∞	∞	∞	Yes	No	No
Other letters associated	∞	∞	∞	∞	∞	Yes	Yes	Yes
<b>Non-reserved letters total</b>	<b>846.3</b>	<b>80.8</b>	<b>559.6</b>	<b>56.5</b>	<b>696.1</b>	<b>766.3</b>	<b>206.7</b>	<b>150.2</b>
Parcels	∞	∞	∞	∞	∞	Yes	Yes	Yes
International outward parcels	∞	∞	∞	∞	∞	Yes	Yes	Yes
Courier services	∞	∞	∞	∞	∞	Yes	Yes	Yes
International inward parcels	∞	∞	∞	∞	∞	Yes	Yes	Yes
Logistics	∞	∞	∞	∞	∞	No	No	No
<b>Parcels and logistics total</b>	<b>1315.1</b>	<b>235.4</b>	<b>769.9</b>	<b>85.8</b>	<b>1091.0</b>	<b>1120.5</b>	<b>350.6</b>	<b>224.1</b>
Retail	∞	∞	∞	∞	∞	Yes	Yes	Yes
Financial services	∞	∞	∞	∞	∞	Yes	Yes	Yes
<b>Retail and financial total</b>	<b>713.4</b>	<b>304.1</b>	<b>263.4</b>	<b>59.4</b>	<b>626.9</b>	<b>426.5</b>	<b>163.1</b>	<b>86.4</b>
<b>Other services total</b>	<b>68.8</b>	<b>4.4</b>	<b>23.8</b>	<b>4.2</b>	<b>32.5</b>	<b>65.7</b>	<b>41.9</b>	<b>36.3</b>
<b>Non-reserved services total</b>	<b>2943.6</b>	<b>623.9</b>	<b>1616.7</b>	<b>205.9</b>	<b>2446.5</b>	<b>2388.1</b>	<b>771.5</b>	<b>497.1</b>
<b>TOTAL</b>	<b>4828.4</b>	<b>623.0</b>	<b>3334.0</b>	<b>375.1</b>	<b>4333.1</b>	<b>4273.0</b>	<b>938.9</b>	<b>495.3</b>

## 5.2 Did any service group receive a subsidy?

Revenue from the following service groups did not cover the fully distributed costs of providing them:

- logistics services
- non-reserved international inward letters
- non-reserved other services (capital adjusted)
- small letters ordinary
- reserved international inward letters
- international inward parcels (capital adjusted).

Small letters ordinary and reserved international inward letters are reserved services and so are of limited concern in the context of monitoring cross-subsidy from reserved services to non-reserved services. Logistics services, which is a non-reserved service, was the recipient of a subsidy in 2007–08.

### 5.2.1 Logistics

Revenue from logistics was not sufficient to cover even the direct costs of providing that service on a non-capital adjusted basis and so received a subsidy of \$[information removed] in 2007–08. Logistics services also received a subsidy in 2004–05, 2005–06 and 2006–07. The subsidy to logistics increased by over \$2 million to \$3.3 million in 2006–07 and then increased to \$[information removed] in 2007–08. Logistics continued to be subsidised by other services due to changes in operational and economic circumstances. While Australia Post logistics has achieved good revenue growth, operational changes and deteriorating economic conditions at the end of the 2007–08 year have resulted in an under-recovery of its direct costs.<sup>29</sup>

As discussed in section 5.3, revenue from reserved services was less than the lower bound of the stand-alone cost for reserved services. Therefore, the statutory monopoly reserved services do not appear to be a source of cross-subsidy.

Australia Post's regulatory accounts show that revenue from non-reserved services (excluding logistics) was greater than the upper bound of the stand-alone cost for non-reserved services. Therefore the source of the subsidy to logistics appears to be the other non-reserved services, not the reserved services.

### 5.2.2 International inward letters (non-reserved)

Revenue from international inward letters in the non-reserved services was sufficient to cover the direct costs, but was \$5.5 million less than the direct plus attributable costs on a non-capital adjusted basis and so could be the recipient of a subsidy. In these circumstances, whether the service is the recipient of a subsidy depends on whether its attributable costs are incremental to that service—that is, would these costs have been avoided if the service was no longer provided.

Again, if there is a subsidy, as discussed in section 5.3, it appears to be from other non-reserved services, not from reserved services.

Payment for the delivery of international mail is generally overseen by the Universal Postal Union (UPU) under a system known as 'terminal dues'. The terminal dues payable to the destination postal operator are not based on the actual costs incurred in delivering this mail. Rather, the terminal dues rates are capped at a percentage of the basic postage rate and set according to a basket of currencies.

In 2007–08, the capping of the terminal dues rates—which is divorced from the recovery of delivery costs of these products—and the appreciation of the Australian dollar had resulted in an under-recovery of direct and attributable costs of non-reserved inward letters.<sup>30</sup>

Overall, international inward letters (non-reserved) does not recover its fully distributed costs on a non-capital adjusted basis.

Generally, the destination postal operator receives less revenue than its actual cost of delivery. However, while there was an under-recovery in 'international inward' for both the reserved and non-reserved services, the corollary of the under-recovery is the over-recovery of revenue for international outward letters. International outward is non-reserved.

International letters as a group—international inward and outward letters, reserved and non-reserved—did not recover its fully distributed costs on a capital-adjusted basis.

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29 Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 1.

30 Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 4.

### 5.2.3 Other services (non-reserved)

'Other services' is a category used by Australia Post that relates to non-product specific operations of Australia Post's business, so there is no direct relationship between revenues, costs, profit and assets allocated to this category.

Revenue from other non-reserved services includes other miscellaneous revenue that cannot be attributed to other products such as property rents, licensed Post Office sales and other revenue such as unclaimed money orders. Costs under other services consist of an allocation of corporate overheads and includes property management for external leases. Assets purchased for future use are included under other services.

While revenue from other services was greater than the direct and attributable costs on a non-capital adjusted basis, it was less than the direct and attributable costs on a capital-adjusted basis, meaning that other services may have received a subsidy in 2007–08.

Because the 'other services' segment of Australia Post carries many assets (including many non-income generating properties), capital adjusting the direct and attributable costs resulted in an under-recovery of revenue for this service group. Further, in 2007–08 many of these assets incurred substantial revaluations and new assets were added.<sup>31</sup> These factors have served to further raise the capital-adjusted direct and attributable costs and have led to a substantially greater under-recovery of revenue compared with 2006–07.

### 5.2.4 Small letters ordinary and international inward letters (reserved)

Revenue from international letters inward was less than the direct plus attributable costs of providing the service on a non-capital adjusted basis and could be the recipient of a subsidy. Revenue from small letters ordinary was less than the fully distributed costs of providing that service on a non-capital adjusted basis, and less than the direct and attributable costs of providing the service on a capital-adjusted basis, so this segment could also be receiving a subsidy.

The under-recovery of revenue in international inward letters (reserved) had arisen for the same reasons that Australia Post had under-recovered revenue in international inward letters (non-reserved). That is, the rates Australia Post receives for international inward letters are determined by the UPU, and these rates are not set to recover the costs of delivering letters from other countries.

As these are both reserved services, this does not appear to be a concern in the context of monitoring cross-subsidy from the reserved services to the non-reserved services.<sup>32</sup>

### 5.2.5 International inward parcels

Revenue from international inward parcels was less than fully distributed costs on a capital-adjusted basis. Australia Post explained that there were multifaceted reasons behind the under-recovery of revenue for inward parcels:

- Parcels less than 2 kg are subject to the same price setting regime as inward international letters. For this reason, this product line has always been marginal or loss making.
- While prices for parcels greater than 2 kg can be negotiated between international administrations, they are still subject to a price cap (a ceiling price) that is linked to the receiving country's consumer price index.
- The revenue-to-cost ratio for inward international parcels was also adversely influenced by the appreciation of the Australian dollar in 2007–08.<sup>33</sup>

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31 Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, pp. 1–2.

32 It may, however, be an issue in the context of considering a price notification.

33 Australia Post, Letter: Australia Post 2007–08 Regulatory Accounts, 2 June 2009, p. 4.

## 5.3 Is the source of the subsidy the reserved services?

Chart 5.2 provides revenue and cost data for Australia Post's reserved services only.

**Chart 5.2 Australia Post's revenue and cost for reserved services (\$m)**

Service group	Total revenue	FDC	Surplus
Small letters ordinary	766.4	✂	✂
Small letters PreSort	762.6	✂	✂
Large letters ordinary	204.5	✂	✂
Large letters PreSort	106.3	✂	✂
International inward letters	45.0	✂	✂
<b>Total reserved</b>	<b>1884.8</b>	<b>1886.6</b>	<b>(1.7)</b>

Revenue from the reserved services was less than the fully distributed costs on both a capital and non-capital adjusted basis. On a non-capital adjusted basis, the revenue was less than fully distributed costs by \$1.7 million (chart 5.2). Therefore, if the fully distributed cost is a fair approximation of the stand-alone cost of providing the reserved services, the reserved services cannot be the source of a subsidy for any other of Australia Post's services.

The fully distributed cost of the reserved services may underestimate the actual stand-alone cost of providing these services. It is necessary to add back some of the unattributable costs that were allocated to the non-reserved services (i.e. the unattributable costs that would be incurred by Australia Post whether the non-reserved services were provided or not). However, identifying the appropriate amount to be added back is problematic.

As discussed in chapter 3, one approach is to establish an upper bound on the stand-alone cost. This could be done by adding back the common (unattributable) costs that were allocated to the non-reserved services to the fully distributed cost of the reserved services.

Chart 5.3 adds all the unattributable costs from non-reserved services back to the reserved services.

**Chart 5.3 Australia Post's reserved services with all unattributable costs (\$m)**

Service group	Total revenue	FDC	Surplus
Total reserved	1884.8	1886.6	(1.7)
Non-reserved unattributable cost adjustment		205.9	
<b>Adjusted total</b>	<b>1884.8</b>	<b>2092.5</b>	<b>(207.6)</b>

Revenue from the reserved services is not sufficient to cover this upper bound of the stand-alone cost once non-reserved unattributable costs are included. Accordingly, the reserved services cannot be considered the source of a cross-subsidy if this upper bound is a reasonable approximation of the true stand-alone cost of providing the reserved services. Further, if the upper bound estimate is capital adjusted, revenue is substantially less than the stand-alone cost estimate.

The ACCC is satisfied that the reserved services were not a source of subsidy.

### 5.3.1 Widening the scope of the tests

As the reserved services do not appear to be the source of subsidy, the ACCC has also applied the upper bound of stand-alone cost test to other groups of services in order to identify possible sources of subsidy.

Chart 5.4 widens the scope of services to be tested against the upper bound of the stand-alone cost to all letter services—that is, adding unattributable costs to the fully distributed costs of all letter services, reserved and non-reserved. It seems reasonable that Australia Post may have some degree of market power in the non-reserved segment of its letter services due to its ubiquitous collection and distribution networks, despite the fact that it does not have a legislated monopoly in the provision of non-reserved letter services.

**Chart 5.4 Australia Post's letter services with all unattributable costs (\$m)**

Service group	Total revenue	FDC	Surplus
<b>Reserved services</b>			
Small letters ordinary	766.4	∞	∞
Small letters PreSort	762.6	∞	∞
Large letters ordinary	204.5	∞	∞
Large letters PreSort	106.3	∞	∞
International inward letters	45.0	∞	∞
<b>Total reserved</b>	<b>1884.8</b>	<b>1886.6</b>	<b>(1.7)</b>
<b>Non-reserved services</b>			
Large letters ordinary	∞	∞	∞
Large letters Presort	∞	∞	∞
Other letters mail services	∞	∞	∞
International outward letters	∞	∞	∞
International inward letters	∞	∞	∞
Other letters associated	∞	∞	∞
<b>Total non-reserved services</b>	<b>846.3</b>	<b>696.1</b>	<b>150.2</b>
<b>TOTAL</b>	<b>2731.2</b>	<b>2582.7</b>	<b>148.5</b>
'Non-letters' unattributable cost adjustment		149.4	
<b>Adjusted total</b>	<b>2731.2</b>	<b>2732.1</b>	<b>(0.9)</b>

Revenue from this group of services was slightly less than the upper bound of the stand-alone cost without a capital adjustment. Since revenue was slightly less than the stand-alone cost of both reserved and non-reserved services, this group of services could not be the source of a cross-subsidy. The revenue was also not sufficient to cover the upper bound of the stand-alone cost on a capital-adjusted basis. As a result, Australia Post's letter services as a group was not considered the source of a cross-subsidy.

Chart 5.5 changes the scope of services to be tested against the upper bound of the stand-alone cost to all non-reserved services.

**Chart 5.5 Australia Post's non-reserved services with all unattributable costs (\$m)**

Service group	Total revenue	FDC	Surplus
<b>Non-reserved services</b>			
Large letters ordinary	∞	∞	∞
Large letters PreSort	∞	∞	∞
Other letters mail services	∞	∞	∞
International outward letters	∞	∞	∞
International inward letters	∞	∞	∞
Other letters associated	∞	∞	∞
<b>Non-reserved letters</b>	<b>846.3</b>	<b>696.1</b>	<b>150.2</b>
Parcels	∞	∞	∞
International outward parcels	∞	∞	∞
Courier services	∞	∞	∞
International inward parcels	∞	∞	∞
Logistics	∞	∞	∞
<b>Parcels and logistics</b>	<b>1315.1</b>	<b>1091.0</b>	<b>224.1</b>
Retail	∞	∞	∞
Financial services	∞	∞	∞
<b>Retail and agency services</b>	<b>713.4</b>	<b>626.9</b>	<b>86.4</b>
Other services	68.8	32.5	36.3
<b>TOTAL NON-RESERVED</b>	<b>2943.6</b>	<b>2446.5</b>	<b>497.1</b>
All reserved unattributable cost adjustment		169.2	
<b>Adjusted total</b>	<b>2943.6</b>	<b>2615.7</b>	<b>327.9</b>

Revenue from non-reserved services was greater than the upper bound of the stand-alone cost both with and without a capital adjustment. Accordingly, these services were a potential source of cross-subsidy. Further, removing logistics services (which was the recipient of a subsidy) and international inward letters (also the possible recipient of a subsidy) from the non-reserved services increased the amount of the potential subsidy.

Chart 5.6 shows a smaller group of non-reserved services (excluding letter services) tested against the upper bound of the stand-alone cost.

**Chart 5.6 Australia Post's non-reserved non-letter services with all unattributable costs (\$m)**

Service group	Total revenue	FDC	Surplus
<b>Non-reserved services</b>			
Parcels	∞	∞	∞
International outward parcels	∞	∞	∞
Courier services	∞	∞	∞
International inward parcels	∞	∞	∞
Logistics	∞	∞	∞
<b>Parcels and logistics</b>	<b>1315.1</b>	<b>1091.0</b>	<b>224.1</b>
Retail	∞	∞	∞
Financial services	∞	∞	∞
<b>Retail and agency</b>	<b>713.4</b>	<b>626.9</b>	<b>86.4</b>
<b>Other services</b>	<b>68.8</b>	<b>32.5</b>	<b>36.3</b>
<b>TOTAL</b>	<b>2097.2</b>	<b>1750.4</b>	<b>346.8</b>
All letters (reserved and non-reserved) unattributable cost adjustment		225.7	
<b>Adjusted total</b>	<b>2097.2</b>	<b>1976.1</b>	<b>121.2</b>

Revenue from the non-letter service group of the non-reserved services was greater than the upper bound of the stand-alone cost without a capital adjustment. On a capital adjusted basis, there was a modest under-recovery of revenue of non-letter non-reserved services for the upper bound of the stand-alone cost test. Therefore, as a potential source of a cross-subsidy, there were mixed results for this group of services.

However, on a capital adjusted and non-capital adjusted basis, removing logistics (which was the recipient of a subsidy) from the non-reserved non-letter services results in this group of services becoming a potential source of a cross-subsidy.

## 6 Conclusion

Australia Post's regulatory accounts for 2007–08 do not provide evidence of cross-subsidy from Australia Post's reserved services to its non-reserved services. On a non-capital adjusted basis, the revenue from the reserved services was less than the fully distributed cost of providing them (by \$1.7 million). The non-capital adjusted fully distributed cost is the most stringent test for not being a source of cross-subsidy—it is the 'lower bound' of the stand-alone cost. However, the lower bound of the stand-alone cost test is a less reasonable estimate of the stand-alone cost. To obtain a reasonable estimate of the stand-alone cost it is necessary to add back costs that were allocated to the non-reserved services but which would still be incurred if the non-reserved services were not offered.

Revenue from the reserved services was not sufficient to cover the lower and upper bound of the stand-alone cost on either a non-capital adjusted or capital adjusted basis. The Australian Competition and Consumer Commission (ACCC) is therefore satisfied that the reserved services were not a source of subsidy.

However, revenue from Australia Post's non-reserved services appears to be greater than both the fully distributed cost and the upper bound of the stand-alone cost of providing the non-reserved services, with and without a capital adjustment. This means that the non-reserved services (as a whole) do not receive a subsidy; rather they appear to be a possible source of subsidy.

Revenue from logistics services was \$[information removed] less than the direct cost of providing that service in 2007–08. This non-reserved service group also received a subsidy in 2004–05, 2005–06 and 2006–07. However, as noted above, the source of subsidy appears to be the other non-reserved services, not the reserved services.

While logistics services received a subsidy in 2007–08, the role of the ACCC is to monitor whether Australia Post's reserved services were subsidising the non-reserved services. The analysis in this report indicates that the non-reserved services were the possible source of a subsidy, not the reserved services.

Another non-reserved service may also have received a subsidy in 2007–08. Revenue from non-reserved international inward letters was \$5.5 million less than the direct and attributable cost of providing that service. However, international mail is generally settled on a 'terminal dues' basis, which is overseen by the Universal Postal Union and is not cost based. Generally, the postal service in the receiving country receives less revenue than the actual cost of delivery. On a capital adjusted basis, Australia Post made a loss on the international letters group as a whole (inward and outward letters, reserved and non-reserved).

Finally, the review of Australia Post's cost allocation methodology has been conducted and the 2007–08 cross-subsidy test done on the basis of regulatory accounts using the revised and updated CAM. However, it is noted that while there was a small reallocation of costs from reserved to non-reserved services, the 2007–08 regulatory accounts remained largely unchanged.



# Appendix A Regulatory accounting framework information not claimed as confidential

## Schedule 1 Service group definitions

### Schedule 1(a) Reserved service group descriptions

Service Group	Product/service	Description
Small letters ordinary	SL—ordinary—stamped	Small letters include enveloped mail, letter-sheets, pre-stamped envelopes and unenclosed postcards no larger than 130 mm x 240 mm, no thicker than 5 mm and no heavier than 250 gms.
	SL—clean	Reduced charges for customers who present quantities of correctly machine-addressed small letters.
	SL—ordinary—other	Ordinary small letters, where postage has not been paid via a postage stamp (includes payment via charge account and postage meters).
	SL—reply paid	Small letters within the above definition where the addressee has supplied a ‘reply paid’ envelope—i.e. the addressee is ‘paying’ the postage. Revenue includes the additional ‘fee’ for the service.
	SL—impact mail	Irregular shaped mail—small.
Small letters PreSort	SL—local rate	Reduced charges for customers who reside or carry on business in any postcode area serviced by the delivery office and who lodge small letters. Only found in country areas.
	SL—regular PreSort	Reduced charges for small letters displaying a delivery point indicator within a four-state barcode when presented by the customer in accordance with relevant mailing conditions. Normal delivery standards apply.
	SL—regular charity mail	Presort small letters from organisations that are endorsed as income tax exempt charitable institutions and trust funds for charitable purposes, by the Australian Taxation Office (ATO). Normal delivery standards apply.

Service Group	Product/service	Description
Large letters ordinary	S L—off peak PreSort	Reduced charges for small letters displaying a delivery point indicator within a four-state barcode when presented by the customer in accordance with relevant mailing conditions. Delivery standard up to three days longer than 'regular'.
	SL—off peak charity mail	PreSort small letters from organisations that are endorsed as income tax exempt charitable institutions and trust funds for charitable purposes, by the ATO. Delivery standards up to three days longer than 'regular'.
	LL—ordinary—stamped (0–250 g)	Large letters include enveloped mail, pre-stamped envelopes and unenclosed postcards that are rectangular in shape, no larger than 260 mm x 360 mm, no thicker than 20 mm, no heavier than 250 gms, not a small letter and postage does not exceed \$2.
	LL—ordinary—other (0–250 g)	Ordinary large letters, where postage has not been paid via a postage stamp (includes payment via charge account and postage meters).
	LL—clean	Reduced charges for customers who present quantities of correctly machine-addressed large letters.
	LL—reply paid	Large letters within the above definition where the addressee has supplied a 'reply paid' envelope—i.e. the addressee is 'paying' the postage. Revenue includes the additional 'fee' for the service.
	LL—impact mail	Irregular shaped mail—small plus.
Large letters PreSort	LL—local rate	Reduced charges for customers who reside or carry on business in any postcode area serviced by the delivery office and who lodge large letters. Only found in country areas.
	LL—regular PreSort (0–250 g)	Reduced charges for large letter size items under 250 grams displaying a delivery point indicator within a four-state barcode when presented by the customer in accordance with relevant mailing conditions. Normal delivery standards apply.
	LL—off peak PreSort (0–250 g)	Reduced charges for large letter size items under 250 grams displaying a delivery point indicator within a four-state barcode when presented by the customer in accordance with relevant mailing conditions. Delivery standard up to three days longer than 'regular'.
International inward	international letters (inward)	The carriage and delivery within Australia of incoming international letter mail which meet the scope of the reserved service.

## Schedule 1(b) Non-reserved service group descriptions

Service group	Product/service description	Description
Non-reserved large letters ordinary	LL—ordinary (250–500 g)	Large letters include enveloped mail, pre-stamped envelopes and unenclosed postcards that are rectangular in shape, no larger than 260 mm x 360 mm, no thicker than 20 mm, no heavier than 500 gms, not a small letter and postage is at least \$2.
Non-reserved large letters PreSort	LL—regular PreSort (250–500 g)	Reduced charges to customers who sort their large letters in excess of 250 gms before lodgement and comply with relevant mailing conditions. Normal delivery standards apply.
	LL—off peak PreSort (250–500 g)	Reduced charges for customers who sort their large letters in excess of 250 gms before lodgement and comply with relevant mailing conditions. Delayed delivery standards apply.
Non-reserved international inward letters	non-reserved inward international letter services	The carriage and delivery within Australia of incoming international letters and related services that are outside the scope of the reserved service.
International mail (outward)—letters	outward international letter services	All letter and related services lodged in Australia for delivery to overseas addressees.
Other non-reserved letter mail services	unaddressed mail	The unaddressed delivery service is the distribution of such items as catalogues, merchandising samples and leaflets to all letterboxes in a certain area.
	periodical publications	Reduced charges for customers who lodge authorised publications and catalogues that are no larger than 260 x 360 x 20 mm and up to 1 kg for delivery within Australia.
	registered post fees	Additional fees for service include optional prepaid envelopes or registered post labels or imprints. Also entails insurance cover up to \$100.
	express letters	Express post articles with a weight less than 500 grams and a thickness less than 20 mm.
Other letters associated	forces mail	Mail and parcel services to deployed military units.
	mail rooms	The running of customers' internal mail rooms.

Service group	Product/service description	Description
	fax post	The acceptance and/or delivery of fax messages to customers without a private fax facility.
	electronic mail services	The production of hard-copy documents for mailing to addressees from computer generated data. Covers production costs only—i.e. excludes postage which is included in relevant areas above.
	private boxes and bags	The provision by post of numbered boxes and private mail bags that act as delivery points for customers 'renting' the boxes/bags.
	address post	The provision of 'change of address' data to customers wishing to update their mailing lists.
	redirection fees	The provision of mail redirection service (both short-term 'hold' and permanent on-forwarding) for both private individuals and businesses.
Parcels	Parcels	All other domestic mail items that do not meet the criteria for letters, including items mailed under the 'express' banner excluding express letters.
Courier services	courier services	All courier services including Messenger Post and Express Courier International.
Logistics	logistics and fulfilment services	Provision of storage facilities, receipt of orders, picking, packing and despatching of products for both domestic and international customers.
	online delivery	The provision of specialised delivery operations requiring dedicated, specialised vehicles.
	other fulfilment services	Miscellaneous logistics services.
Non-reserved international inwards Parcels	non-reserved inward international parcel services	The carriage and delivery within Australia of incoming international parcels and related services outside the scope of the reserved service.
International mail (outward)—Parcels	outward international parcel services	All parcel and related services lodged in Australia for delivery to overseas addresses.
Retail	Philatelic	The sale of stamps, related products and coins to the collector market.
	Postpak	The sale of postal packaging and related items.

Service group	Product/service description	Description
Financial services	complementary products	The sale of stationery, cards, communications and other products through retail outlets.
	transaction services	The provision of financial transactions facilities, including money orders, banking services (both personal and business) and the undertaking of passport interviews.
	other agency	The provision of bill payment and related services.
Other services	other miscellaneous	Other minor items from which revenue is earned.

### Schedule 3 List of account items for revenues

Account code	Account item	Description
3-1	mail revenue	All revenue earned from the carriage of mail items (including letters and parcels), including through sale of postage stamps, postage labels, bulk postage and franking machines. (Note: individual categories of reserved and non-reserved mail will be separated through the split of service items.)
3-2	licence fees	All revenue earned from licence fees not included in other revenue categories.
3-3	transaction fees	All revenue earned from transaction fees not included in other revenue categories.
3-4	retail sales	All revenue earned from retail sales not included in other revenue categories.
3-5	property rents	All revenue earned from property leasing not included in other revenue categories.
3-6	other	All other revenue earned not included above.

## Schedule 4 List of account items for cost

Account code	Account item	Description
4-1	labour (including contract services)	All costs associated with the employment of staff, including wages and salaries, payroll tax, leave and other entitlements, separation and redundancy and workers' compensation. Includes contract staff utilised in post administered operational areas.
4-2	motor vehicle operating	Costs (excluding depreciation) for the operation of motor vehicles including their maintenance and upgrade.
4-3	accommodation	Costs (excluding depreciation) for accommodation and property, including their maintenance, upgrade and the supply of basic services (i.e. power, water).
4-4	depreciation and amortisation	A periodic allocation of the historical cost of plant and equipment over the useful life of the asset. Includes a periodic allocation of the value of intangible assets.
4-5	licensees	All payments made to licensed post offices, including post points located in non-post retail outlets.
4-6	carriage of mail	Payments made to non-post employees for the carriage and/or delivery of mail.
4-7	cost of goods sold	Cost of purchases for retail merchandise, philatelic products and Sprintpak.
4-8	international mail settlements	Payments made to overseas postal administrations for the transport, processing and delivery of international mail originating in Australia.
4-9	general administration	General corporate type costs not already included, including corporate centre, legal, regulatory, accounting and finance, human resources and personnel, and non-product specific research and development. Will include costs from Account Items 4-1, 4-2, 4-3 and 4-4.
4-10	other	All other costs not already included.

## Schedule 6 List of account items for fixed assets

Account code	Account item	Description
6-2-1	land and buildings	
6-2-1-1	land	All land (including freehold and perpetually renewable leasehold land) owned by Australia Post. Includes land improvements but excludes buildings or other limited-life structures.
6-2-1-2	buildings	All buildings including those under construction, owned by the company and the associated building alterations.
6-2-1-3	fit-out	All extensions, structural attachments, improvements; and building plant and equipment such as electric light and power equipment, lifts and air-conditioning which are considered an integral part of the building. Included are improvements on leased buildings.
6-2-2	plant and equipment	
6-2-2-1	motor vehicles	All motor vehicle and related equipment.
6-2-2-2	mail handling plant	All equipment related to the sorting of mail and/or parcels.
6-2-2-3	other plant and equipment	All plant and equipment not already included.
6-2-2-4	office equipment	All office and related equipment.
6-2-2-5	counter equipment/EPOS	All equipment related to the servicing of customers in retail outlets, including the provision of electronic point-of-sale facilities.
6-2-3	other	
6-2-3-1	software	Computer software.
6-2-3-2	intangibles	Identifiable assets having no physical existence, their value being limited by the rights and anticipative benefits that possession confers upon the owner, such as goodwill, trademarks, copyright, patents, licences and other assets of a similar nature.
6-2-4	assets under construction	
6-2-4-1	assets under construction	Value of assets under construction.

## Schedule 7 Movements in valuation of non-current assets

RESERVED	Opening Tyr	Addition	Retire	Transfer	Revalue	Depreciation	Closing
Land	315.3	6.6	-0.2	-6.8	45.5	-	360.4
Buildings	289.3	8.7	-1.8	-0.1	7.9	-14.5	289.4
Fit-out	12.7	6.4	-0.0	0.8	-0.0	-4.9	15.0
Motor vehicles	64.2	20.7	-4.4	-0.5	0.0	-14.4	65.6
Mail handling plant	191.2	3.7	-0.1	2.2	-	-22.8	174.3
Other plant and equipment	41.7	31.1	-2.7	-5.6	-	-12.8	51.7
Office equipment	9.6	1.1	0.1	-0.1	-	-1.7	9.0
Counter equipment/EPOS	1.1	0.0	0.1	-0.6	-	-0.2	0.4
Software	30.7	24.8	-0.0	18.3	-	-15.5	58.3
Intangibles	0.1	0.1	-	-0.0	-	-	0.2
Assets under construction	31.6	26.8	-	-25.4	-	-	33.0
<b>TOTAL RESERVED</b>	<b>987.5</b>	<b>130.0</b>	<b>-9.0</b>	<b>-17.8</b>	<b>53.4</b>	<b>-86.8</b>	<b>1057.3</b>

  

NON-RESERVED	Opening Tyr	Addition	Retire	Transfer	Revalue	Depreciation	Closing
Land	555.8	3.9	-4.9	6.8	70.1	-	631.7
Buildings	386.0	40.2	-2.9	9.3	42.7	-18.2	457.0
Fit-out	23.5	12.1	-1.0	4.0	-0.0	-9.7	28.8
Motor vehicles	49.3	18.0	-3.7	2.3	0.0	-10.1	55.8
Mail handling plant	99.4	3.2	-0.1	3.8	-	-11.6	94.8
Other plant and equipment	67.8	32.4	-2.2	-4.0	-	-19.7	74.3
Office equipment	13.4	1.4	-0.0	0.9	-	-1.8	13.9
Counter equipment/EPOS	1.7	0.0	-0.0	-0.0	-	-0.4	1.2
Software	40.1	27.2	-1.3	22.3	-	-20.2	68.0
Intangibles	76.6	1.6	0.0	0.1	-14.0	-7.6	56.7
Assets under construction	33.4	25.2	-	-27.5	-	-	31.0
<b>TOTAL NON-RESERVED</b>	<b>1346.8</b>	<b>165.2</b>	<b>-16.1</b>	<b>17.8</b>	<b>98.7</b>	<b>-99.4</b>	<b>1513.1</b>
<b>TOTAL FIXED ASSETS</b>	<b>2334.4</b>	<b>295.2</b>	<b>-25.1</b>	<b>0.0</b>	<b>152.1</b>	<b>-186.1</b>	<b>2570.5</b>

Note 1: Movements in non-AM adj are entered as balancing items as only opening and closing balances are provided.  
Entries are not material.

Note 2: The transfer column includes both transfers of physical assets and movements due to changes in allocations.

Note 3: Movements for assets under construction are split between reserved and non-reserved are calculated on a pro rata basis.



## Schedule 9      Statement of service group usage

Service Group	Volume (m)	Description
Total—ordinary small letters	1721.136	Total posted ordinary small letters
Total—PreSort small letters	2170.287	Total posted PreSort small letters
Total—ordinary large letters	169.877	Total posted reserved and non-reserved ordinary large letters
Total—PreSort large letters	130.762	Total posted reserved and non-reserved PreSort large letters