AUSTRALIA POST

Draft Notification

Changes to the domestic reserved letter service

25 January 2011

Glossary

ACCC	Australian Competition and Consumer Commission
APC Act	Australian Postal Corporation Act, 1989
Australia Post	Australian Postal Corporation
AUC	Assets under construction
CC Act	Competition and Consumer Act, 2010 (prior to 1 January 2011, the TP Act)
CPI	Consumer price index
DC	Delivery centre
FDD	Future Delivery Design Program
FTE	Full time equivalent (standardised labour unit)
GDP	Gross domestic product
MRP	Market Risk Premium
OCR	Optical character recognition
Off Peak	Off Peak PreSort letter service
PCS	Product Costing System
PPM	Product Profitability Model
Regular	Regular PreSort letter service
RKR	The Record Keeping Rules, made by the ACCC under section 50H of the APC Act
SBD	Separate bundle delivery
SSM	Sequencing sort machines
Statement of Approach	ACCC's *Statement of regulatory approach to assessing price notifications* June 2009
TP Act	Trade Practices Act, 1974 (renamed the CC Act on 1 January 2011)
WACC	Weighted Average Cost of Capital

Executive Summary

This draft notification proposes changes to certain products within Australia Post's domestic reserved letter service from 4 July 2011. The changes predominantly involve the PreSort letter service, they do not impact the Basic Postage Rate or other Ordinary Letter prices. The full detail of the proposed price changes, with a comparison to the current prices, is at Appendix 1.

For the PreSort letter service the changes involve both price and product design. For price, the changes represent only the third general increase to PreSort since 1992, with the current key PreSort price only increasing by 1.5% (0.6c) since 1992. Over the same period, the Consumer Price Index (CPI) has increased by over 60%. For product design changes the full detail is at Appendix 2.

The key objective of Australia Post's proposal is to encourage the use of the Off Peak PreSort letter service (Off Peak) by:

- re-positioning Off Peak as a more attractive option; and
- increasing the price difference between Off Peak and the Regular PreSort letter service (Regular).

The proposed changes are aligned to Australia Post's longer term direction of providing a sustainable letter service (of which the domestic reserved letter service is a substantial part).

As noted in Australia Post's notification of April 2010 (April notification) the domestic reserved letter service operates in an environment of ongoing declining letter volumes; continued growth in delivery points and likely increase in input costs. A similar environment exists for postal operators worldwide. This presents a long term challenge for Australia Post in providing a sustainable letters service and continuing to meet its Community Service Obligations (CSOs).

To meet this challenge, in 2010 Australia Post undertook a fundamental review of its business model, the outcome of that review was the Future Ready program which went live on 1 July 2010 with the introduction of a new organisational structure (further detail provided at Appendix 3). The new organisational structure builds upon other key achievements including the finalisation of a Fair Work Agreement and reduction of staff numbers in head offices as well as reducing costs associated with overheads.

Future Ready also incorporated a review of Australia Post's strategic objectives and identified the following three key strategies:

1. Restore self-sustaining letters business;
2. Grow full value chain in parcels and win in e-tail; and
3. Build trusted services offer in communications, financial services and identity.

While the proposed changes result in an average increase to domestic reserved letter prices, the resultant revenue increase will not remove the loss (which is forecast to be $108m in 2011/12).

This draft notification is modelled over the 2009/10 – 2011/12 financial years. The forecasts in the notification align with Australia Post's 2010 Corporate Plan, which was approved by the Australia Post Board in June 2010 and subsequently accepted by the shareholder ministries.

The notification is supported by:

- detailed (by price point) information on the proposed price changes;
- disaggregated financial details (volume, revenue and cost) at product and category level;
- information on the revenue and costs forecasts of other Australia Post areas at an aggregate or summary level; and
- supporting documents prepared by independent subject matter experts.

1. Proposed changes

This section provides an overview of:

- *the proposed changes; and*
- *the customer consultation process undertaken by Australia Post prior to finalising the proposed changes.*

Australia Post is proposing changes to the following domestic reserved letter services effective 4 July 2011:

- PreSort, including Acquisition Mail and Charity Mail (product design and price);
- Clean Mail (price); and
- Reply Paid annual fee (price).

The major elements of the pricing proposal are:

- PreSort letters (including Acquisition Mail and Charity Mail), an average increase (incorporating migration) of 1.6c (GST exclusive) (3.8%):
    - 2.8 cents (GST exclusive) (6.6%) for Regular; and
    - 1.3 cents (GST exclusive) (3.0%) for Off Peak.
- Other letter services:
    - an average increase to Clean Mail prices of 2.3 cents (GST exclusive) (4.9%); and
    - an increase to the Reply Paid annual fee (from $65 to $80).

The proposed price changes to the PreSort letter service represent only the third general increase since 1992. A comparison of the key PreSort price in 2010[1] against the key PreSort price in 1992[2] shows an increase of just 1.5% or 0.6 cents. By comparison, the consumer price index (CPI) for the same period has increased by over 60%.

1.1. PreSort

The PreSort letter service, which accounts for over half of domestic reserved letter volumes, provides discounted prices for business customers who barcode and sort their letters prior to lodgement. Under the current PreSort conditions, customers have the choice of the following delivery standards:

- Regular – where the delivery standard is the same as that provided to Ordinary letters; and
- Off Peak – where the delivery standard can be up to 3 (working) days longer than the Regular standard.

A key objective of the proposed changes is to encourage the use of Off Peak (over Regular) by:

- providing a new delivery timeframe for Off Peak based on a 6pm lodgement. The delivery timetable is based on surface / road transport (so the further the distance to travel the longer the delivery time) and provides a delivery window of two days (compared to the current arrangements of delivery over a possible four day window); and
- increasing the price differential between Off Peak and Regular.

As noted earlier, the full detail of the proposed product design changes to PreSort is at Appendix 2.

The current Off Peak delivery window (of up to four days) is often viewed as an inhibitor to the use of Off Peak as it is difficult for customers to plan and co-ordinate other supporting or complimentary activities (eg call centre resourcing, alignment with other media channels, etc.).

---

[1] Small letter, regular delivery, barcode direct tray, same state – 38.82c (GST ex)
[2] Small letter, regular, direct bag – 38.25c

Australia Post believes the 'two day delivery window', a specific delivery timetable and an increased price difference between Regular and Off Peak will encourage customers to migrate from Regular to Off Peak.

Furthermore, customers that do elect to migrate may (depending upon the mix of Barcode Direct Trays to Residue) achieve overall savings as the proposed Off Peak Barcode Direct Tray prices are set below the current Barcode Direct Tray price for Regular.

This migration is being encouraged as Off Peak provides Australia Post with greater flexibility in how and when letters are processed and delivered. This will assist in supporting Australia Post's longer term strategy of a self sustaining letter service.

While in itself migration from Regular to Off Peak does not provide Australia Post with a significant cost saving opportunity, Australia Post believes there is a longer term benefit (greater network flexibility) from encouraging this migration. In the short term Australia Post will realise savings as a result of the change in mode of transport used for interstate carriage (eg from air transport to road / surface transport).

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

As the proportion of Off Peak increases, Australia Post will analyse the impact upon the current network design to identify where opportunities for changes may arise.

The changes to the PreSort product design and price structure will also affect Acquisition Mail and Charity Mail. In addition to special eligibility conditions, access to these services requires the same presentation requirements as 'general' PreSort letters:

- Acquisition Mail is an addressed (non-personalised) saturation mail delivery service, designed for businesses who want to acquire new customers. Acquisition Mail is available for small and small plus sized letters. The delivery standard for Acquisition Mail is the same as Off Peak (ie the changes to the Off Peak delivery standards will apply to Acquisition Mail)
- Charity Mail provides a lower PreSort price for small sized letters sent by recognised charities. Charity Mail provides both Regular and Off Peak delivery standards (ie the changes to the Off Peak delivery standards will apply to Off Peak Charity Mail).

1.2. Other price changes

Clean Mail

As the Clean Mail price is aligned to the Regular unbarcoded residue price, an increase to that price results in a change in the Clean Mail price. Maintaining the same price between (Regular) unbarcoded residue and Clean Mail ensures the price incentive for PreSort is not diminished.

Reply Paid annual fee

The Reply Paid service stimulates response to mailings or other forms of advertising by allowing recipients to respond by mail free of charge. There are two components to Reply Paid charges;

- an annual fee; which contributes towards the cost of setting up a Reply Paid number and the monthly maintenance and administration of the Reply Paid account; and
- a charge for each item returned to the Reply Paid address.

It is the annual fee which Australia Post is proposing to change.

A recent review Australia Post undertook of the Reply Paid service included an analysis of the administration costs of the service. The review highlighted that there are over 26,000 Reply Paid accounts, however, 5% of those accounts generate over 75% of the Reply Paid revenue.

The proposed change in the annual fee provides a more appropriate contribution towards covering the administration and maintenance costs of the Reply Paid service. Australia Post does not believe the increase in the Reply Paid annual fee is unreasonable; it equates to only $1.25 per month and the fee was last increased (from $60 to $65) in September 2008.

1.3. Customer consultation

Prior to finalising this draft notification, Australia Post undertook confidential consultation with a broad cross-section of customers. The intention of the consultation was to:

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

Consultation commenced in early December 2010, with customers briefed on the proposed changes and asked to provide initial feedback on the proposal by 15 December 2010.

While the overall objective of the consultation was to understand whether there were any perceptions that the impact from the proposed changes would result in a significant disadvantage to a particular market segment, a key point that Australia Post also sought feedback on was whether customers would be likely to migrate letters from Regular to Off Peak as a result of the proposed changes. In this regard the feedback sought included:

- the reasons why the use of Off Peak may increase (eg improved delivery standards, change in price or both);
- the type of letters that would be moved to Off Peak (eg statements, bills, promotional mail, etc);
- where a customer indicated that they would be unlikely to migrate letters to Off Peak, the reason why not (eg lodgement time, 2 day delivery window, overall delivery standards, etc); and
- what further changes would be required to Off Peak to make it more attractive.

Customers were also advised that in addition to their initial feedback, additional feedback and questions would be welcome throughout January and February 2011. Furthermore, customers were also advised of the ACCC's likely assessment process and at what point in the process interested parties would have the opportunity to make a submission directly to the ACCC.

1.4. Customer feedback

Australia Post has received feedback from the majority of customers who participated in the consultation process. While some customers have indicated that they would consider shifting non-time sensitive mailings to the Off Peak service, there have been three key areas of concern:

1. Lodgement time – a 12 noon lodgement time was viewed as disruptive and prohibitive in enticing migration to Off Peak;
2. Off Peak imprint – the wording of the Off Peak imprint is seen as a negative product attribute; and
3. Reliability of delivery performance – as delivery performance is not currently measured / monitored some customers want assurance that delivery over the two days will be reliable.

Point 1 is the major area of concern particularly for mail houses as currently mail house production is generally geared to the current 6pm lodgement time. Mail houses have advised that having two different lodgement times (ie one for Regular and one for Off Peak) adds complexity and may create a premium mail house production window (to meet 12 noon) which could offset the lower postage price. Additionally, as the majority of lodgements may be after 12 noon this would create confusion as to the actual delivery window.

In response to this feedback, Australia Post has amended its original proposal whereby the current Off Peak lodgement time of 6pm can be maintained. To achieve this requires a change to some of the delivery times

(proposed delivery times shown at Appendix 2); however, the benefit of delivery over a ‘two day window’ is unchanged.

Australia Post will continue to work with customers regarding point 2 and point 3 to understand and discuss options that may alleviate concerns.

Appendix 4 provides a list of customers who have taken part in the consultation process.

2. Australia Post

This section:

- *provides an overview of functions and obligations of Australia Post; and*
- *explains why, Australia Post is required to notify the ACCC of its proposal to increase prices within the domestic reserved letter service.*

2.1. Functions and obligations

Australia Post is one of Australia's oldest (commercial) organisations and continues to be one of Australia's most trusted brands. Australia Post is a self funding business managed by a Board of Directors and is subject to all applicable Commonwealth, state and local government laws. Under the provisions of the Australian Postal Corporation Act, 1989, (APC Act) Australia Post's principal function is the supply of postal services within Australia and between Australia and places outside Australia.

In performing its legislated functions, Australia Post has a number of obligations summarised as follows:

- Commercial obligation – to perform its functions, as far as practicable, in a manner consistent with sound commercial practice;
- Community service obligations – to supply a letter service that is 'reasonably accessible' to all Australians and meets 'the social, industrial and commercial needs' of the community; and
- General governmental obligations – to perform its functions consistent with general governmental policies of which the directors are notified; directions given by the Minister under section 49; and Australia's obligations under any convention.

Regulations made under the APC Act set out the prescribed performance standards that relate to the frequency, speed and accuracy of mail delivery and the accessibility of services. With the declining volumes and an increasing number of delivery points the cost of meeting these prescribed performance standards is steadily becoming more onerous.

Performance against these standards is subject to independent audit by the Australian National Audit Office. As shown in Table 1, Australia Post continued to meet its regulated performance standards in 2009/10.

Table 1 – Performance standards 2009/10[3]

Standard	Required performance	Actual performance
Number of street posting boxes	10,000	16,039
Delivery timetables	Maintained	Maintained
On time delivery of non bulk letters	94%	96.1%
Points to receive deliveries five days per week	98%	98.8%
Points to receive deliveries no less than twice a week	99.7%	99.9%
Retail outlets	4,000 (2,500 in rural and remote areas)	4,415 (2,531 in rural and remote areas)

In addition to these standards Australia Post monitors Bulk Mail delivery performance. In 2009/10 Australia Post delivered 97.9% on time or early (against a target of 94%).

[3] Australia Post Annual Report, as at 30 June 2010

2.2. Services subject to ACCC prices surveillance

Declaration 75 declares that letter services reserved to Australia Post under Division 2 of Part 3 of the APC Act are notified services, and that Australia Post in relation to those services is a declared person.

The effect of Declaration 75 is that to comply with section 95Z of the Competition and Consumer Act, 2010, (CC Act)[4] 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.

Section 29 of the APC Act details the services reserved to Australia Post and Section 30 of the APC Act details the exceptions to the reserved services, 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; and
- letters that weigh more than 250 grams.

Australia Post notifies the ACCC by lodging a locality notice (price notification).

2.3. Price notifications

The ACCC has a preferred approach to assessing a price notification. This preferred approach is detailed in the ACCC's *Statement of regulatory approach to assessing price notifications*, June 2009 (Statement of Approach). In particular, the Statement of Approach indicates how the ACCC intends to make the requirements of section 95G(7) of the CC Act operational.

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

a) the need to maintain investment and employment, including the influence of profitability on investment and employment;

b) the need to discourage a person who is in a position to substantially influence a market for goods and services from taking advantage of that power in setting prices; and

c) the need to discourage cost increases arising from increases in wages and changes in the conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC considers that the criteria of section 95G(7) can generally be met by assessing price notifications using a cost-based approach with particular attention to:

- the efficiency of the cost base; and
- the reasonableness of the rate of return that is being sought.

In considering these two items the ACCC generally uses a PTRM to calculate the revenue required (also referred to as the Maximum Allowable Revenue).

While this approach may apply in general, the ACCC has acknowledged that a flexible approach is required to reflect the individual characteristics of each price notification.

[4] On 1 January 2011 the Trade Practices Act, 1974 (TP Act) was renamed the Competition and Consumer Act, 2010. References to the TP Act should be read as the CC Act

A factor that requires the flexible approach is section 95ZH of the CC Act which provides for the Minister to direct the ACCC to give special consideration to a specified matter or matters in performing its functions under Part VIIA. As Australia Post noted in its July 2009 draft notification, in the Explanatory Memorandum to the Trade Practices Legislation Amendment Bill 2003 the importance of these special considerations was reinforced in two parts:

- when referencing the ACCCs' functions under Part VIIA (a reference to section 95G of the CC Act) it is noted that any direction under section 95ZH "… would become the paramount factors to be considered …"; and
- when referencing section 95ZH (Division 6 – Other Provisions) of the CC Act which empowers the Minister to direct the ACCC to give special consideration to particular matters in performing its functions under Part VIIA of the CC Act it is noted that "… special considerations are to be paramount; for example, they are to be more important considerations than the particular factors specified in 95G"

The special considerations (Directions) can be general or relate to a specific firm. Australia Post is aware of two Directions:

- Direction 8[5] – a general direction which requires the ACCC to give special consideration to 'The Government's policy that increases in executive remuneration in excess of those conferred under wage fixing principles should generally not be accepted as a basis for price'; and
- Direction 11[6] – a specific direction relating to Australia Post. Direction 11 is discussed below.

2.4. Direction 11

Direction 11 requires the ACCC in performing its coverage of price notifications for standard postal articles carried by the ordinary post and registered publications to give special considerations to the following matters:

- "Australia Post's obligation to pursue a financial policy in accordance with its corporate plans as set out in sections 35-41 of the Australian Postal Corporation Act 1989 and in particular the pricing targets and Government endorsed financial targets contained in Australia Post's corporate plan;
- The functions and obligations of Australia Post as set out in sections 14-16 and 25-28 of the Australian Postal Corporation Act 1989 and to such directions or notifications given to Australia Post by the Minister for Transport and Communications under that Act as may from time to time be in force;"

In 2008/09 and 2009/10 the domestic reserved letter service has returned a loss ($218m in 2009/10). Continued losses within the domestic reserved letter service will limit Australia Post's ability in performing its functions and in meeting its obligations. To control these losses Australia Post, as it has outlined in its current Corporate Plan, must exercise all three levers of profit by:

- defending existing volume and growing volume in markets where opportunities exist (eg direct mail);
- continued pursuit of cost savings and building a greater level of variability into the direct costs for providing the domestic reserved letter service; and
- pursuing reasonable price increases.

Under Australia Post's new business renewal program (Future Ready) a key objective is to restore a self sustaining letters business. The continued operation of the domestic reserved letters business at a loss will either result in a reduction of shareholder equity or will require a cross subsidy from competitive services – which will distort Australia Post's competitive market position and limit the funds available for investment in new technology.

---

[5] Made by the Minister under section 20 of the Prices Surveillance Act, 1983 on 22 April 1988 and given effect in terms of the TP ACT pursuant to carry over provisions of the TP Act (which was renamed the CC Act)

[6] Made by the Minister under section 20 of the Prices Surveillance Act, 1983 on19 September 1990 and given effect in terms of the TP Act pursuant to carry over provisions of the TP Act (which was renamed the CC Act)

3. Letter volumes

This section:

- *details the methodology applied in developing the baseline econometric models and the methodological enhancements that have taken place following Australia Post's notification of April 2010 (April notification);*
- *illustrates how Australia Post generates its baseline volume forecasts via a set of econometric models; and*
- *provides a comparison of the domestic letter volume forecasts in Australia Post's April notification to the latest forecasts.*

The ACCC in its Decision of May 2010 (May Decision) considered that the volume forecasts provided by Australia Post were appropriate for its assessment of the April notification, noting that 'Australia Post has greatly improved the sophistication of its demand forecasting methods by using an approach that is in line with world's best practice…'[7]

The ACCC however, noted that some transparency issues remain in relation to adjustment of the baseline econometric forecasts with management opinion and further market intelligence. As a result, the ACCC considered both adjusted and unadjusted forecasts in its assessment of whether the proposed prices would provide sufficient revenue to recover efficient costs.

3.1. Forecasting method, considerations and assumptions

Australia Post's forecasting methodology can be broadly described as a two part process:

- the development of four systems of dynamic econometric equations that generate the baseline volume forecasts; and
- an augmentation of these baseline forecasts based upon additional intelligence regarding one-off events and emerging trends that may not necessarily be apparent throughout the timeframe over which the econometric models have been constructed..

The dynamic econometric models that provide the baseline forecasts have been developed by Diversified Specifics. The models build upon the previous work undertaken (by Diversified Specifics) on developing explanatory models to combine both short-run and long-run behaviour utilising Vector Error Correction Modelling (VECM) techniques. The process generates four dynamic models that are then used to forecast the following letter segments individually:

- Small letter PreSort;
- Large letter PreSort;
- Small letter Ordinary / Other; and
- Large letter Ordinary / Other.

The ACCC (and their independent expert, Frontier Economics Pty Ltd (Frontier)) were supportive of the development of the VECM methodological framework in the previous notification. While the models themselves reflect world's best practice they do have limitations in that they can only infer associations in cases where tractable data on a hypothesised letter volume driver can be established.

This implies the econometric baseline does not incorporate recently emerging trends known to impact letter volume demand (including consolidation, rationalisation and substitution) and therefore by definition these important factors will not be reflected in the econometric forecast.

[7] ACCC Decision of May 2010, page 103

An overview of the statistically significant volume drivers (which are incorporated into the segmented letter volume models) are as follows:

Small and Large letter PreSort:

- domestic non-farm GDP – positive association suggesting an increase in the level of domestic economic activity will lead to an increase in Small and Large letter PreSort demand; and
- health of the advertising industry index – positive association suggesting an increase in discretionary spend and promotional activity will lead to an increase in Small and Large Letter PreSort demand.

Small letter Ordinary / Other:

- cheque volumes – a positive association , but captures the behavioural change in bill payment practices away from mail towards electronic (phone and internet) alternatives (ie substitution); and
- price – negative association incorporating the impact on demand from changes in real price.

Large letter Ordinary / Other:

- domestic non-farm GDP – positive association suggesting an increase in the level of domestic economic activity will lead to an increase in Large Letter Ordinary / Other demand.

Significantly, with the exception of Small letter Ordinary / Other, the set of econometric models lack a sufficient number of downside drivers despite a widespread acceptance throughout the postal industry that letter volumes are in decline as a consequence of the combined effects of consolidation, rationalisation and substitution. The most commented upon threat is digital substitution, and while often expressed in different ways, as noted by Postcomm's Chairman 'Traditional mail volumes are in decline, email, text and other digital communications are growing…' [8].

It is therefore important that for any letter volume forecasts to be considered robust they must reflect the fact that there are a number of emerging threats to the traditional mail item that are currently impacting upon volumes. However, in a time series framework the Small letter Ordinary / Other model is the only model that can incorporate substitutive impacts given the availability of tractable data over a sustained period of time (observed through the declining use of cheques – which demonstrates a behavioural change in payment practices).

These forecasts therefore must then be augmented with management insight and further market intelligence to embody these important emerging trends which are not apparent over the entirety of the timeframe governing the models construction. Australia Post's augmentation of the baseline forecasts with this additional intelligence is a crucial final stage in the development of a set of realistic letter volume forecasts.

Australia Post's notes the comments from the ACCC and Frontier regarding the augmentation of the baseline forecasts and is working towards improving the transparency of the augmentation process in future forecasts. As the next forecasts will be finalised in May / June 2011, the letter volumes in this notification align to Australia Post's 2010 Corporate Plan.

The gap between current economic baseline forecasts and actual results illustrates the need for augmentation of the baseline forecasts. Australia Post requested that Diversified Specifics prepare a report on the need for augmentation especially given a number of one-off events (such as the federal election) have recently occurred to directly impact the divergence between actual volumes and the econometric forecasts. The key points of the report are shown at Appendix 5 and a copy of the report has been provided to the ACCC.

In responding to Frontier's critique of the baseline forecasts, Australia Post and Diversified Specifics provided a broad structure of the econometric framework to be employed in future efforts to model letter volumes to address these concerns. A workshop to progress this matter is planned for February 2011. Additionally, the inputs into the baseline model for GDP and CPI now reflect estimates published by independent bodies.

[8] Page 8, Postcomm Annual Report 2009/10

3.2. Forecast letter volumes

The volume forecasts in this draft notification assume an average annual volume decline of 4.1% per annum out to 2011/12. Table 2 provides a high level comparison of the change in volume forecasts between those in the previous notification and the latest forecasts. Letter volume forecasts for the four letter categories are shown at Appendix 6.

Table 2 – Domestic reserved letters growth rates – 2008/09 to 2011/12

	2008/09	2009/10	2010/11	2011/12	3 year average
April notification[9]	(3.9%)	(5.8%)	(3.5%)	(3.5%)	(4.3%)
Latest forecast [10]	(3.9%)	(5.6%)	(3.3%)	(3.5%)	(4.1%)

A breakdown of volume forecasts by the three letter segments is shown in Table 3 along with the final result for 2008/09 and 2009/10.

Appendix 7 provides a detailed explanation of volume forecasts, illustrating the augmentation of the econometric baseline estimates.

Table 3 – Total domestic letter volumes by segment 2008/09 to 2011/12[11]

Segment	April notification				Current notification		
					Final result	Latest forecast	
	2008/09	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Transactional	3,165	2,959	2,800	2,693	2,975	2,803	2,685
Promotional	777	748	779	761	754	803	798
Social	188	180	173	166	171	165	157
Total	**4,130**	**3,888**	**3,752**	**3,620**	**3,900**	**3,771**	**3,640**

[9] Actual for 2008/09 and forecast from 2009/10

[10] Actual for 2008/09 and 2009/10 – forecast for 2010/11 and 2011/12

[11] Includes Addressed Small and Large letters up to 500g, ie includes some non-reserved letters

4. Costs

This section:

- *provides latest forecasts out to 2011/12 that are aligned with Australia Post's 2010 Corporate Plan ;*
- *demonstrates how Australia Post limited cost growth; and*
- *tracks Australia Post's performance against its assertion that for the period 2009/10 to 2011/12 it will reduce domestic reserved letter service costs*

The cost forecasts in this notification align to Australia Post's 2010 Corporate Plan (approved by the Australia Post Board in June 2010).

The ACCC's May Decision noted a number of deficiencies with Australia Post's cost forecasts, most of which had arisen due to a lack of transparency either through a lack of supporting information or confidentiality concerns meaning that the data or information provided by Australia Post in support of its draft notification could not be subjected to review by third parties or lead to fully informed decision making.

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

4.1. Cost allocation

Until recently, Australia Post used its Product Costing System (PCS) to allocate costs across its range of products and services. These cost allocations have been scrutinised by the ACCC as part of its monitoring for cross subsidy in Australia Post[12]. The ACCC has produced annual 'Assessing cross subsidy in Australia Post' reports since 2004/05 and has not found any evidence of a cross subsidy from reserved to non-reserved services.

During 2010, Australia Post replaced PCS with a commercial off-the-shelf software package (SAS ABM). Existing principles of cost allocation (previously endorsed by the ACCC through the Record Keeping Rules (RKR) process) have been replicated in the new profitability and performance measurement model (PPM), resulting in materially consistent data being generated in both systems.

The new model (PPM) was formally transitioned into production at 30 June 2010 and the 2009/10 Annual Report and RKR Regulatory Accounts were produced using data from PPM. The ACCC has been notified of these changes and Ernst & Young has audited the 2009/10 RKR Regulatory Accounts, without incident.

The costs for the domestic reserved letter service in this notification have been determined by PPM. As shown at Appendix 8, the outcome between the use of PCS and PPM is not material.

4.2. Latest forecasts

The forecasts included in this notification align with Australia Post's 2010 Corporate Plan (therefore do not include the impact of the proposed changes) and are shown in Table 4.

A comparison to the forecasts in the April notification to those in this notification, shows that while the overall revenue growth is more moderate (particularly in 2011/12), lower costs are forecast – reflecting a continued pursuit of cost reduction.

For 2009/10, overall revenue finished in line with the forecast shown in the April notification, with trading expenses (costs) finishing marginally better (0.3% under forecast). The key difference however, is the finalisation of the redundancy provisions relating to the Value Optimisation Program (VOP).

[12] The ACCC's role of monitoring for cross subsidy in Australia Post is commonly referred to as the Record Keeping Rules process.

Table 4 – Financial overview [13]

$million	Current notification		
	Final result	Latest forecast	
	2009/10	2010/11	2011/12
Trading Revenue			
Letters & Associated Services	2,658	2,759	2,723
Parcels & Logistics	1,362	1,441	1,541
Agency Services & Retail Products	712	714	742
Other / Unallocated Trading Revenue	86	75	83
Total trading Revenue	**4,817**	**4,989**	**5,089**
Trading Expenses (Cost)			
Labour and contract services	3,354	3,431	3,473
Depreciation & Amortisation	213	219	247
Accommodation	266	268	282
International Mail Payments	83	82	85
Cost of goods sold, stores & supplies	294	298	308
Vehicle Expenses	76	78	81
Other	281	280	291
Total trading expenses	**4,567**	**4,656**	**4,768**
Trading profit	**250**	**333**	**321**

4.3. Value Optimisation Program

The Managing Director and the executive team remain committed to creating a sustainable cost base for Australia Post. A key program to achieve this result is the VOP.

VOP is a transformational program that commenced in October 2009 in response to declining letter volumes and the impact on the cost base from this decline. The high level elements of VOP are:

- new organisational design – this includes improved customer segmentation and multi channel access, creation of market facing business units and reduced complexity and duplication between state and national structures;
- new operating model – incorporating consistent end-to-end business processes, increased systemisation of manual processes, and re-engineering / rationalisation of non-business critical activities; and
- performance based culture – redefining core values, active and incentivised performance and more focussed performance management where relevant.

The VOP is currently on plan.

4.4. FTE usage

FTEs are now forecast to be lower ✂than what was estimated in the April notification. This reflects an overall reduction. The FTE reductions include the savings from programs such as VOP and Future Delivery Design and are being achieved through a combination of natural attrition, redeployment and redundancy.

[13] A negative (positive) figure in the Variation column is a negative (positive) contribution to profit

4.5. Domestic reserved letter service

Table 5 provides a PCS versus PPM comparison of 2009/10 final result data for the domestic reserved letter service and the latest forecasts using PPM. While the forecast for volume, revenue and costs is for a marginal improvement on the April 2010 forecasts, a sizeable loss ($108m) is still forecast for 2011/12. For 2009/10:

- volume and revenue finished marginally above the estimate included in the April notification; and
- the unfavourable variation in expense was driven by the finalisation of the redundancy provision; as mentioned earlier, the final calculation of the provision for this expense was higher than the preliminary estimate included in the April notification.

Table 5 – Latest cost forecast for domestic reserved letter service 2010/11 to 2011/12

	2009/10 Final Result			Latest forecast	
	PPM	PCS	Var %	2010/11	2011/12
Volume (m)	3,877	3,877	-	3,749	3,619
Revenue ($m)	1,783	1,783	-	1,853	1,817
Cost ($m)	2,001	1,993	0.4%	1,951	1,924
Profit ($m)	(218)	(211)	3.3%	(98)	(108)

A break down of Table 5 by the four product categories is shown at Appendix 8.

A breakdown of costs, by function, for the domestic reserved letter service is shown in Table 6. The allocation of total costs to domestic reserved letters is based on Australia Post's PPM cost allocation.

Table 6 – Breakdown of costs for domestic reserved letter service 2009/10 to 2011/12

Function	Final result	Latest forecast		Av change
	2009/10	2010/11	2011/12	2009/10 – 2011/12
	$m	$m	$m	%
Sales & Acceptance	✂	✂	✂	✂
Processing	✂	✂	✂	✂
Transport	✂	✂	✂	✂
Delivery	✂	✂	✂	✂
Other	✂	✂	✂	✂
Total	**2,001**	**1,951**	**1,924**	**(3.9)**

4.6. Domestic reserved letter service FTE usage

Over the three years to 2011/12 there will be reductions in the allocation of labour (FTEs) to the domestic reserved letter service. The reductions in 2009/10 were not as great as indicated in the April notification, however by 2011/12 we expect the overall FTEs for domestic reserved letters to be consistent with the April notification. The reductions are driven by a number of factors including, VOP and FDD as well as attributable to overall volume decline.

4.7. Relationship between costs and volumes

The ACCC, in its May Decision, noted Frontier's view '…that Australia Post's actions appear to constitute a suitable response to an environment of declining volumes, particularly when costs are considered in real terms'[14] and also noted that Australia Post had explicitly identified and used cost-volume elasticities in its cost forecasting.

While, Frontier believed the cost elasticities suggested and the associated explanations provided a plausible explanation of existing short run cost-volume relationship they were critical of two points:

- that there was no reviewable information supplied to support the relationships; and
- that the elasticities appeared low in comparison to those derived from a number of international studies (ie Frontier estimated Australia Post's overall elasticity of total costs was 0.14 and compared that to the outcome of the international studies which put the cost elasticity between 0.60 and 0.70[15])

On the first point, Australia Post is in the process of undertaking an econometric assessment of the potential cost / volume elasticity; specifically for the processing and delivery functions. This work is not yet finalised but it will be completed and able to be provided in support of any future price notifications. Therefore at this point Australia Post has retained the cost elasticity assumptions it advised in its April notification.

In regards to the second point and the relevance of the cost elasticities estimated from the international studies to the current environment in which Australia Post operates, Australia Post has sought a review of the five studies that were quoted by Frontier. The five studies (by first named author) are as follows;

- Fenster (2008);
- Bozzo (2009);
- Cohen (2004);
- NERA (2004); and
- Moriarty (2006).

The purpose of the review was to understand whether the studies provide an appropriate or relevant guide to the elasticity on Australia Post's total costs. The review was also considered important to ensure that any key outcomes from these studies could be considered in the econometric assessment Australia Post is currently undertaking on cost / volume relationships.

The review looked at 15 items within each of the studies including:

- unit level ie processing centre, delivery centre, both;
- activities modelled (acceptance, transport, processing, delivery etc);
- type of data cross sectional or panel;
- number of units of observation;
- whether volumes were increasing or decreasing;
- functional form; and
- population density.

Of the 15 items only two were consistent across all five studies;

- that the studies were undertaken in an environment of increasing volumes;
- that the population density was higher than that in Australia.

[14] Page 66

[15] Frontier Economics, Review of Australia Post's volume and input cost forecasts, a report prepared for the ACCC, May 2010, page 30

Both of these two points are key points of difference in a comparison to Australia; where volumes are declining and where population density is lower.

It is Australia Post's belief that there would be an asymmetry in the cost / volume relationship between situations of volume growth and declining volumes in at least the short to medium term. Further, it is accepted that higher population density provides an advantage for those operators relative to those services with lower population density. This is because a higher population density implies that delivery costs are a smaller proportion of total costs and, since delivery costs are less variable when volume falls, the total cost elasticity in high density countries is likely to be higher.

These are two examples of major points of difference that would question the relevance of these studies being used to estimate the elasticity on total costs for Australia Post. However, as shown at Appendix 9, which provides a more detailed summary, there were other deficiencies that would question the robustness of these studies and therein the credibility of using these studies to derive a benchmark cost elasticity for postal operators and Australia Post in particular.

4.8. Superannuation

The ACCC, in its May Decision, expressed concern that a major driver of cost increases over the period of the price notification is the forecast increases in superannuation expense and that Australia Post, by offering a defined benefit scheme, faces a higher financial risk than if it provided superannuation benefits through an accumulation scheme, because costs under a defined benefit scheme are influenced by a number of factors including fluctuations in global financial markets.

As noted in the April notification, at present – and over the forecast period of this draft notification – Australia Post would incur a higher annual cost if it provided superannuation benefits solely under an accumulation scheme as opposed to a defined benefits scheme. Under an accumulation scheme (where the minimum payment is 9%) Australia Post would incur a superannuation cost of around $165m per annum which is greater than the superannuation costs over the 2009/10 to 2011/12 period ($129m, $154m and $162m respectively).

4.9. Depreciation

Australia Post's capital plan was updated as part of Australia Post's 2010 Corporate Plan. A comparison of the depreciation expense in the April notification (based on the June 2009 capital plan as per the PTRM) to the current capital plan is shown in Table 7.

Table 7 – Depreciation expense

$million	2009/10	2010/11	2011/12
April notification – as per PTRM	210	222	245
Latest forecast	213	222	250
Variation	(3)	0	(5)

5. Productivity

This section provides:

- *an overview of the accelerated pace at which the Future Delivery Design Program is being implemented; and*
- *an update on progress towards a future international benchmarking study.*

Australia Post's April notification contained information on a range of initiatives and programs supporting Australia Post's cost containment and productivity targets for the network. They cover a spectrum from:

- process efficiencies that are pursued on a localised basis throughout the network in order to achieve budget and plan targets: to
- major programs to re-engineer core network processes in order to extract cost, build flexibility, and create new network capabilities for future revenue growth.

These initiatives and programs are continuing, however, the major productivity program Australia Post is implementing remains Future Delivery Design (FDD), on which the following section provides an update.

5.1. Future Delivery Design

In an environment of ongoing volume decline and continuing growth in delivery points, Australia Post activated FDD to contain delivery costs and create greater flexibility in letter delivery operations. FDD consists of three key elements:

1. increasing the volume of letters sorted to the highest delivery point identifier level – **enhanced OCR address recognition**;
2. enabling a more efficient processing and delivery process to be rolled out to target delivery centres and rounds – **automated small letter sequencing**; and
3. realising the benefits from automation – **reconfiguring indoor and outdoor delivery operations.**

Australia Post's previous notification detailed the accelerated pace and scope of change in which automated small letter sequencing was being deployed. As evidenced in this notification, there has been major progress towards implementation of the core elements of FDD, as well as significant developments in identifying additional savings opportunities from process innovation such as the introduction of separate bundle delivery (SBD) on all modes of delivery.

As shown in Table 8, at the time of the April notification, forecast savings out to 2013/14 were $69.8m. The latest forecast savings, based on final approved business cases, are now $65.4m. Business case forecasts reflect an increase over previously expected savings from the implementation of delivery round optimisation and phase 2 of the recognition improvement project. A decrease in forecast savings from SBD on motorcycles is now expected.

Table 8 – FDD net savings previous forecast

Net savings $million Components	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Enhanced OCR address recognition	✂	✂	✂	✂	✂	✂	✂
Sequencing 2008 – 2010 (1,950)	✂	✂	✂	✂	✂	✂	✂
SBD on 1,950 rounds	✂	✂	✂	✂	✂	✂	✂
Sequencing 2011 – 2014 (4,550)	✂	✂	✂	✂	✂	✂	✂
SBD on 4,550 rounds	✂	✂	✂	✂	✂	✂	✂
Delivery round optimisation	✂	✂	✂	✂	✂	✂	✂
Total	**(2.9)**	**10.1**	**2.6**	**24.1**	**19.2**	**16.6**	**69.8**

Table 9 – FDD net savings latest forecast

Net savings $million Components	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Enhanced OCR address recognition	✂	✂	✂	✂	✂	✂	✂
Sequencing 2008 – 2010 (2,134)	✂	✂	✂	✂	✂	✂	✂
SBD on 2,134 rounds	✂	✂	✂	✂	✂	✂	✂
Sequencing 2011 – 2014 (4,366)	✂	✂	✂	✂	✂	✂	✂
SBD on 4,366 rounds	✂	✂	✂	✂	✂	✂	✂
Delivery round optimisation	✂	✂	✂	✂	✂	✂	✂
Total	**(2.9)**	**10.7**	**2.6**	**16.2**	**23.5**	**15.4**	**65.4**

Table 10 – Comparison of FDD Savings

$million	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Previous forecast	(2.9)	10.1	2.6	24.1	19.2	16.6	69.8
Latest forecast	(2.9)	10.7	2.6	16.2	23.5	15.4	65.4
Variation	-	0.6	0.0	(8.0)	4.4	(1.2)	(4.2)

5.2. Enhanced OCR address recognition

The recognition improvement project is both a generator of cost savings in its own right and an important enabler of other FDD projects – most importantly automated small letter sequencing. A comparison of Table 8 to Table 9, shows that latest forecast net savings for this element have increased due to a greater than originally planned recognition rate.

Recognition Engine Improvements Stage 1a and Address Learning System Stage 1b have been completed and have collectively provided savings greater than expected. The Recognition Engine Stage 2 contract was signed late December 2010 and work has commenced.

5.3. Automated small letter sequencing

Australia Post's previous notification noted the increased speed in which automated small letter sequencing was being deployed. Specifically a total of:

- 4,000 machine-sequenced rounds by the end of 2011;
- 5,000 machine-sequenced rounds by the end of 2012;
- 6,150 machine-sequenced rounds by the end of 2013; and
- 6,500 machine-sequenced rounds by the end of June 2014.

As shown in Table 11, the latest forecast confirms that we are on track to achieve the overall target. Furthermore, by extending the processing window on existing barcode sorting machines in processing and delivery locations, at the end of calendar year 2010 the total number of sequenced rounds was 2,134 (184 above the 1,950 original planning baseline).

Table 11 – Sequencing rollout, comparison against previous forecast

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Previous forecast	774	876	1,325	1,525	1,075	925	6,500
Latest forecast	774	640	1,561	1,525	1,075	925	6,500
Variation	-	(236)	236	-	-	-	-

On a calendar year basis:

- 2011 – targets up to 1,866, rounds, with new sequence sort machines (SSMs) and associated process change. Achieves a total of 4,000 machine-sequenced rounds (over 50% of the total number of delivery rounds);
- 2012 – targets up to 1,000 rounds with new SSMs. Achieves a total of 5,000 machine-sequenced rounds adds (over 65% of the total number of delivery rounds);
- 2013 – targets up to 1,150 rounds with new SSMs. Achieves a total of 6,150 machine-sequenced rounds (over 80% of the total number of delivery rounds); and
- 2014 – targets residual rounds justifying machine sequencing (around 350 rounds). Achieves a total of 6,500 machine-sequenced rounds by the end of June 2014 (over 85% of total number of delivery rounds).

5.4. Separate bundle delivery

While the early assumption was that the rollout of automated small letter sequencing would be based on a manual merge of machine sequenced and manual sequenced mail at delivery facilities prior to final delivery, Australia Post has been evaluating an alternative concept in association with the trials of alternative modes of delivery – SBD to maximise the productivity gains possible through mechanised sequencing of mail.

While the implementation of SBD to sequenced non-motorcycle delivery rounds will conclude by the end of March 2011, negotiation, with the relevant staffing associations, on the implementation of SBD to motorcycle delivery rounds is still underway. As such financial projections assume the implementation of SBD to motorcycle delivery rounds to be finalised by the end of calendar year 2011.

The savings from the implementation of SBD out to 2013/14 are now forecast ✂. The reason for this variation is as a result of the SBD motorcycle trials showing that additional outdoor delivery time is required to enable the rider to complete their delivery duties.

5.5. Reconfiguring indoor and outdoor delivery operations

The rollout of small letter automated sequencing requires significant delivery round recasting to enable the optimal use of outdoor delivery resources.

Delivery round optimisation

Delivery round optimisation (DRO) uses information related to the outdoor delivery activities and proprietary geographical information systems software to calculate optimum delivery rounds and labour resource requirements. This enables maximisation of the benefits from FDD by ensuring outdoor delivery resources are better aligned to round type, delivery mode, letter volume fluctuations and labour mix.

DRO involves a two stage approach:

- Stage 1 – implementation at delivery centres (DCs) with > 20 delivery rounds – targets 158 DCs involving a total of 6,358 delivery rounds (about three quarters of all existing delivery rounds) with an approved business case for implementation of Stage 1; and
- Stage 2 – automated interface of DRO process with other Australia Post systems – subject to separate business case approval.

Stage 1 update – following approval of the DRO Business Case, by the Australia Post Board:

- all required hardware, the RouteSmart licensing agreement and 20 licenses have been procured; and
- an implementation team established and trained.

Rollout commenced in July 2010, slightly later than the planned rollout of June 2010 to meet the requirement of a two week break in between training classes for the implementation team.

Stage 2 update – as noted above Stage 2 was subject to development of a separate business case to assess the merits of progressing. After completion of the business case the recommendation was that Stage 2 be suspended due to high implementation costs (ie manual updating was a more cost efficient option out to 2013/14 than the IT cost).

Other FDD elements

Remote commencement and / or cessation provides DC managers with greater flexibility to realise productivity savings in local delivery networks from the other FDD elements outlined above, through savings in accommodation and managerial costs and a reduction in dead running time (ie the time spent travelling to and from the DC to the start and finish of the delivery round). This alternative network design will enable further DC centralisation notwithstanding ongoing growth in delivery points. To date 1,062 rounds involve either remote commencement and / or remote cessation; with 513 involving both.

Alternative delivery mode technologies also enable reduced reliance on motorcycle delivery to address recruitment and safety issues and are a proven method of delivery that can accommodate SBD. Our progress with alternative delivery modes is summarised as follows:

- Aussie Mail Bike – contract in place for the supply of AMB frames;
- E-bicycle kit-converted AMB – contract in place for supply;
- E-Tricycle (Industrial E-Trike) – increased level of implementation;
- All Terrain Buggy including SBD carrier – currently in prototype stage; and
- Walk Buggy (PT200) – 238 PT200s have arrived, with the remaining 62 arriving in Sydney mid January 2011.

5.6. International benchmarking study

The ACCC, in its Preliminary View of June 2008[16], noted 'There is only a limited amount of research on international benchmarking of postal service performance in the academic literature.' Then stated that 'An international benchmarking study comparing the productivity performance of Australia Post with other overseas postal service operators could provide insight into the relative efficiency of Australia Post compared with postal operators overseas.'[17]

Consequently, to provide an international perspective, Australia Post, in late 2008, commissioned Economic Insights to undertake an international benchmarking study, the outcome of which would be provided as part of a future price notification. The study covered the period 2002 to 2009. Its main features were:

- three broad output categories were modelled – letters, parcels and 'other' outputs;
- four broad categories of inputs were included – labour, other operating expenditures, land and buildings, and all other plant and equipment, software and other capital; and
- to put all of the participating postal authorities on to a comparable operating base, raw data results were adjusted for differences in mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length).

[16] Page 138
[17] Page 139

The study concluded that:

> 'Australia Post has shown the most consistent improvement in total factor productivity (TFP) of the seven postal services reviewed. Importantly, Australia Post improved its ranking when formal, statistically based adjustments were made for differences in mail and customer density with its TFP level being ranked first or second after the adjustments were made.'[18]

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

In reviewing the study the ACCC wanted to independently verify the results of the TFP analysis – something that was unable to be facilitated due to the confidentiality arrangements in place between Economic Insights and the participating postal authorities. Consequently, the ACCC's view was that the findings of the report could not be used to support Australia Post's assertion that it operates at a very high level of performance in the postal world.

In August 2010, Australia Post, the ACCC and Economic Insights met to discuss how a future international benchmarking study could be conducted to ameliorate the ACCC's concerns regarding; the independence of the study; the countries sampled; the integrity of the data collected; and the methodology applied in deriving the study results.

Australia Post has provided the ACCC a draft 'Terms of Reference' outlining how a future study could be conducted that would satisfy the ACCC's concerns (and therefore be able to be used to support a future price notification) while most importantly maintaining the confidentiality arrangements in place between the conductor of the study (Economic Insights) and the participating postal authorities.

[18] Page iv, International Benchmarking of Postal Service Productivity, Economic Insights, 5 June 2009

6. Asset base

This section:

- *provides an update to the asset base in the April notification.*

This section focuses on Australia Post's fixed asset base and includes both the inherited fixed asset base and the incremental changes to it arising from the Australia Post's capital investment plans out to 2011/12.

6.1. Australia Post's balance sheet

As at 30 June 2010[19] Australia Post's balance sheet comprised $3,915m in total assets, $2,356m in liabilities, and $1,559m in equity, or net assets. Table 12 shows the current and non-current (fixed) assets as per the balance sheet.

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

Table 12 – Australia Post total assets

Assets	Value ($million)
Current assets	
Cash and cash equivalents	501
Trade and other receivables (including accrued revenues)	507
Inventories	44
Other current assets	78
Total current assets	**1,130**
Non-current assets	
Trade and other receivables	227
Investments in jointly controlled entities	296
Superannuation asset	173
Land and buildings[20]	795
Plant and equipment (including motor vehicles)	510
Intangible assets (including software)	235
Investment property	225
Deferred income tax assets	315
Other non-current assets	11
Total non-current assets	**2,786**
Total Assets	**3,915**

[19] Australia Post Annual Report 2009-10, Financial and Statutory Reports, page 43
[20] Historic cost (book value)

6.2. Asset accounting policies and practices

As show in Table 12, at 30 June 2010 Australia Post had $2,786m of fixed assets recognised in the balance sheet.

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. These practices are required for the annual statutory financial audit purposes to ensure that asset balances are not being maintained above their appropriate values. Appendix 10 provides further detail on Australia Post's fixed assets.

6.3. Capital investment plan

Australia Post prepares a capital investment plan each year as part of the annual planning process. The current capital investment plan was updated as part of Australia Post's 2010 Corporate Plan.

Table 13 – Capital investment plan

$million	2007/08	2008/09	2009/10	2010/11	2011/12
2008 – capital investment plan	286	412	404	372	
2009 – capital investment plan		332	316	308	307
2010 – capital investment plan[21]			226	269	316

As detailed in the April notification, while Australia Post's 2009 capital investment plan continued to implement the regeneration of much of Australia Post's fixed asset base, the annual level at which it did so was at a lower level than the levels within the previous two plans. However, the difference to the capital investment plan is due to the effect of underspend in 2009/10 and the flow on effect of that underspend in 2010/11 and 2011/12.

Table 14 provides a comparison of the current capital expenditure items anticipated (with the final result for 2009/10) to those within the April notification. Data within the Table (as noted above) is consistent with Australia Post's 2010 Corporate Plan.

Table 14 – Capital investment outlays by category

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Sales & Acceptance	24	33	31	18	28	38
Processing	20	22	49	11	16	34
Delivery	19	30	45	10	22	29
Information technology	176	162	118	136	139	139
Motor vehicles	28	46	49	23	35	48
Other capital investment	50	16	14	28	29	28
Total capital investment	**316**	**308**	**307**	**226**	**269**	**316**

[21] Consistent with Australia Post's current corporate plan (but actual for 2009/10)

6.4. Forecast asset base

Table 15 shows the Australia Post total fixed asset forecasts in the April notification, the final result for 2009/10 and the latest forecast. Data within this table is consistent with the RKR schedules (the allocation of costs, asset values are allocated to products according to procedures specified in the Regulatory Accounts Procedures Manual (RAPM), which has been provided to the ACCC in accordance with section 23 (6) of the RKR).

Fixed assets are at fair value and are the sum of Land and Buildings, Plant and Equipment, Intangible assets, and Investment property. Fixed asset opening and closing balances exclude assets under construction (AUC) and agree to the RKR schedules.

Table 15 – Australia Post total fixed assets

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	2,570	2,683	2,756	2,295	2,255	2,358
Additions[22]	323	296	306	173	325	317
Depreciation[23]	(210)	(222)	(245)	(213)	(222)	(250)
Closing balance	2,683	2,756	2,818	2,255	2,358	2,424

Table 16 provides reconciliation between Table 12 and Table 15 for the 2009/10 financial year.

Table 16 – reconciliation 2009/10

Land and buildings	795
Plant and equipment (including motor vehicles)	510
Intangible assets (including software)	235
Investment property	225
Total fixed assets at cost	**1,765**
Add fair value adjustment	634
Total fixed assets at fair value (RKR)	**2,399**
Less AUC	(144)
Table 15 – closing fixed assets	**2,255**

Table 17 shows the domestic reserved letter service total fixed asset forecasts in the April notification, the final result for 2009/10 and the latest forecast.

[22] Additions include Additions, Transfers, Retirements and Revaluations
[23] As per PTRM

Table 17 – Domestic reserved letter service fixed assets

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	1,003	1,033	1,029	903	875	922
Additions[24]	137	107	205	67	157	130
Depreciation	(107)	(111)	(118)	(95)	(110)	(111)
Closing balance	1,033	1,029	1,116	875	922	941

Data within this table is consistent with the RKR schedules (the allocation of costs, asset values are allocated to products according to procedures specified in the RAPM and reconciles to the PTRM. Table 17 does not include any AUC. Appendix 11 provides a breakdown of Table 17 by the four letter categories.

[24] Additions include Additions, Transfers, Retirements and Revaluations

7. Rate of return

This section details that:

- *as in previous price notifications, the rate of return proposed is a weighted average cost of capital (WACC) based on the capital asset pricing model (CAPM); and*

- *Australia Post has sought and adopted independent advice regarding the WACC for the domestic reserved letter service.*

Australia Post's 2010 Corporate Plan sets out the most recent expectations for the business. In that plan, profit targets and pricing expectations for the domestic reserved letter service were formed on the assumption that the ACCC's pricing model continued to apply to reserved services. That is:

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

Australia Post has modelled the proposed prices against the WACC that the ACCC included in its May Decision. However, as Australia Post has also sought independent advice regarding the WACC for the domestic reserved letter service, Australia Post has also undertaken modelling using that WACC. As the Post Tax Revenue Model (PTRM) in Section 8 indicates, the WACC parameters do not make any practical difference to this notification given that the revenue from the proposed prices – using either of the WACCs – is below that calculated by the PTRM as the maximum allowable.

7.1. WACC for Australia Post's domestic reserved letters business

As noted in the April notification, while Australia Post had reservations about some of the ACCC's WACC parameters, Australia Post accepted them for the purpose of that notification.

To address these reservations Australia Post approached Value Adviser Associates (VAA) to undertake an independent assessment of certain inputs in estimating the WACC for domestic reserved letters. In undertaking the assessment VAA were requested to examine four areas:

- determine a new asset beta and equity beta for Australia Post's domestic reserved letters business;
- update the more generic CAPM parameters such as the market risk premium and imputation adjustments;
- provide a brief survey of recent Australian material (eg regulators decisions) on the second point; and
- provide a brief survey of overseas and Australian research on the impact of price regulation on the cost of capital of regulated firms.

At the time of completing their report VAA had not found any research that dealt directly with the last point. A copy of VAA's report has been provided to the ACCC.

A comparison of the WACC parameters from the ACCC May Decision and those provided by VAA is shown in Table 18. Appendix 12 provides further detail on the assumptions behind the derivation (update) and estimation.

Table 18 – Australia Post domestic reserved letter service WACC

WACC Parameter	ACCC May Decision	Based on latest advice
rf nominal risk-free rate-of-return	5.8%	5.5%
$rm\text{-}rf$ market risk premium	6.0%	8.0%
Tc corporate tax rate	30.0%	30.0%
γ imputation factor	0.65	0.30[25]
Cost of debt	8.51%	6.9%
D/V Australia Post's gearing ratio	30.0%	30.0%
βa asset beta	0.355	0.6
βd debt beta	0.10	0.175
βe equity beta	0.463	0.8
Nominal vanilla WACC	**8.52%**	**10.3%**

[25] Indicating VAA estimate for an average Australian company – specific to Australia Post it is 0.0

8. Post Tax Revenue Model

Australia Post is proposing that the price changes take effect from 4 July 2011. For 2011/12, revenue is included for entire financial year as the exclusion of revenue for one working day (ie Friday July 1) would not materially change the result.

A comparison of the proposed and allowable revenues over the 2009/10 – 20011/12 financial years is shown in Table 19.

Table 19 – Post Tax Revenue Model summary 2009/10 – 2011/12

		2009/10 $m	2010/11 $m	2011/12 $m
Nominal Vanilla WACC	10.3%			
Required Revenue		$ 2,076	$ 2,027	$ 2,008
Present Value of Required Revenue		$ 2,076	$ 1,968	$ 1,893
Sum of PV over 3 years		$ 5,937		
Letters Revenue at proposed prices		$ 1,783	$ 1,853	$ 1,817
Present Value of Proposed Letters Revenue		$ 1,783	$ 1,799	$ 1,712
Sum of PV over 3 years		$ 5,295		
Deficiency of Letters Revenue to Required Revenue		$ 293	$ 168	$ 180
Sum of PV over 3 years		$ 642		

Appendix 1 – Pricing proposal – change in unit prices

PreSort Letters

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	$ 0.427	$ 0.457	7.0%	$ 0.438	$ 0.473	8.0%	$ 0.477	$ 0.506	6.1%	$ 0.510	$ 0.535	4.9%
Charity Mail	$ 0.372	$ 0.402	8.1%	$ 0.383	$ 0.418	9.1%	$ 0.422	$ 0.451	6.9%	$ 0.510	$ 0.535	4.9%
Small Plus												
Up to 125g	$ 0.550	$ 0.578	5.1%	$ 0.572	$ 0.605	5.8%	$ 0.660	$ 0.688	4.2%	$ 0.800	$ 0.840	5.0%
Medium												
Up to 125g	$ 0.693	$ 0.732	5.6%	$ 0.737	$ 0.776	5.3%	$ 0.831	$ 0.869	4.6%	$ 0.968	$ 1.018	5.2%
Over 125 up to 250g	$ 0.913	$ 0.952	4.3%	$ 1.001	$ 1.040	3.9%	$ 1.106	$ 1.144	3.4%	$ 1.249	$ 1.287	3.0%
Large												
Up to 125g	$ 0.825	$ 0.853	3.4%	$ 0.869	$ 0.897	3.2%	$ 0.990	$ 1.018	2.8%	$ 1.034	$ 1.062	2.7%
Over 125 up to 250g	$ 1.155	$ 1.183	2.4%	$ 1.243	$ 1.271	2.3%	$ 1.375	$ 1.403	2.0%	$ 1.485	$ 1.513	1.9%
Over 250 up to 500g	$ 1.595	$ 1.623	1.8%	$ 1.727	$ 1.755	1.6%	$ 1.815	$ 1.843	1.5%	$ 2.035	$ 2.063	1.4%

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	$ 0.416	$ 0.424	1.9%	$ 0.427	$ 0.435	1.9%	$ 0.465	$ 0.506	8.8%	$ 0.505	$ 0.535	5.9%
Charity Mail	$ 0.356	$ 0.364	2.2%	$ 0.367	$ 0.375	2.2%	$ 0.405	$ 0.429	5.9%	$ 0.505	$ 0.535	5.9%
Small Plus												
Up to 125g	$ 0.539	$ 0.545	1.1%	$ 0.561	$ 0.567	1.1%	$ 0.649	$ 0.688	6.0%	$ 0.795	$ 0.840	5.7%
Medium												
Up to 125g	$ 0.671	$ 0.688	2.5%	$ 0.704	$ 0.721	2.4%	$ 0.820	$ 0.869	6.0%	$ 0.963	$ 1.018	5.7%
Over 125 up to 250g	$ 0.875	$ 0.891	1.8%	$ 0.919	$ 0.935	1.7%	$ 1.084	$ 1.144	5.5%	$ 1.238	$ 1.287	4.0%
Large												
Up to 125g	$ 0.803	$ 0.809	0.7%	$ 0.836	$ 0.842	0.7%	$ 0.979	$ 1.018	4.0%	$ 1.029	$ 1.062	3.2%
Over 125 up to 250g	$ 1.089	$ 1.095	0.6%	$ 1.155	$ 1.161	0.5%	$ 1.331	$ 1.403	5.4%	$ 1.474	$ 1.513	2.6%
Over 250 up to 500g	$ 1.375	$ 1.381	0.4%	$ 1.463	$ 1.469	0.4%	$ 1.650	$ 1.843	11.7%	$ 1.925	$ 2.063	7.2%

Acquisition Mail	Same State BDT			Other State BDT			Residue			Unbarcoded Residue		
		Proposed Price			Proposed Price			Proposed Price			Proposed Price	
	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var	Current	Amount	% Var
Off Peak Delivery												
Small - up to 125g	$ 0.300	$ 0.310	3.3%	$ 0.320	$ 0.330	3.1%	$ 0.465	$ 0.506	8.8%	$ 0.505	$ 0.535	5.9%
Small Plus - up to 125g	$ 0.415	$ 0.430	3.6%	$ 0.435	$ 0.450	3.4%	$ 0.649	$ 0.688	6.0%	$ 0.795	$ 0.840	5.7%

Other Letter Prices		Proposed Price	
	Current	Amount	% Var
Clean Mail			
Small	$ 0.510	$ 0.535	4.9%
Small Plus	$ 0.800	$ 0.840	5.0%
Reply Paid			
Annual Fee	$ 65.00	$ 80.00	23.1%

Notes/Comments

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

Non-reserved products (over 250g or more than four times the BPR) are shaded

The changes to the PreSort product design support Australia Post's longer term vision of developing a sustainable letter service. While the proposed prices are likely to result in an overall increase in price, the product design changes will encourage behavioural change which will lessen the overall impact of the proposed price increases.

Further, the effective reduction in the discount provided is not expected to reduce the incentive for customers to access the PreSort letter service. An overview of the product design changes is as follows:

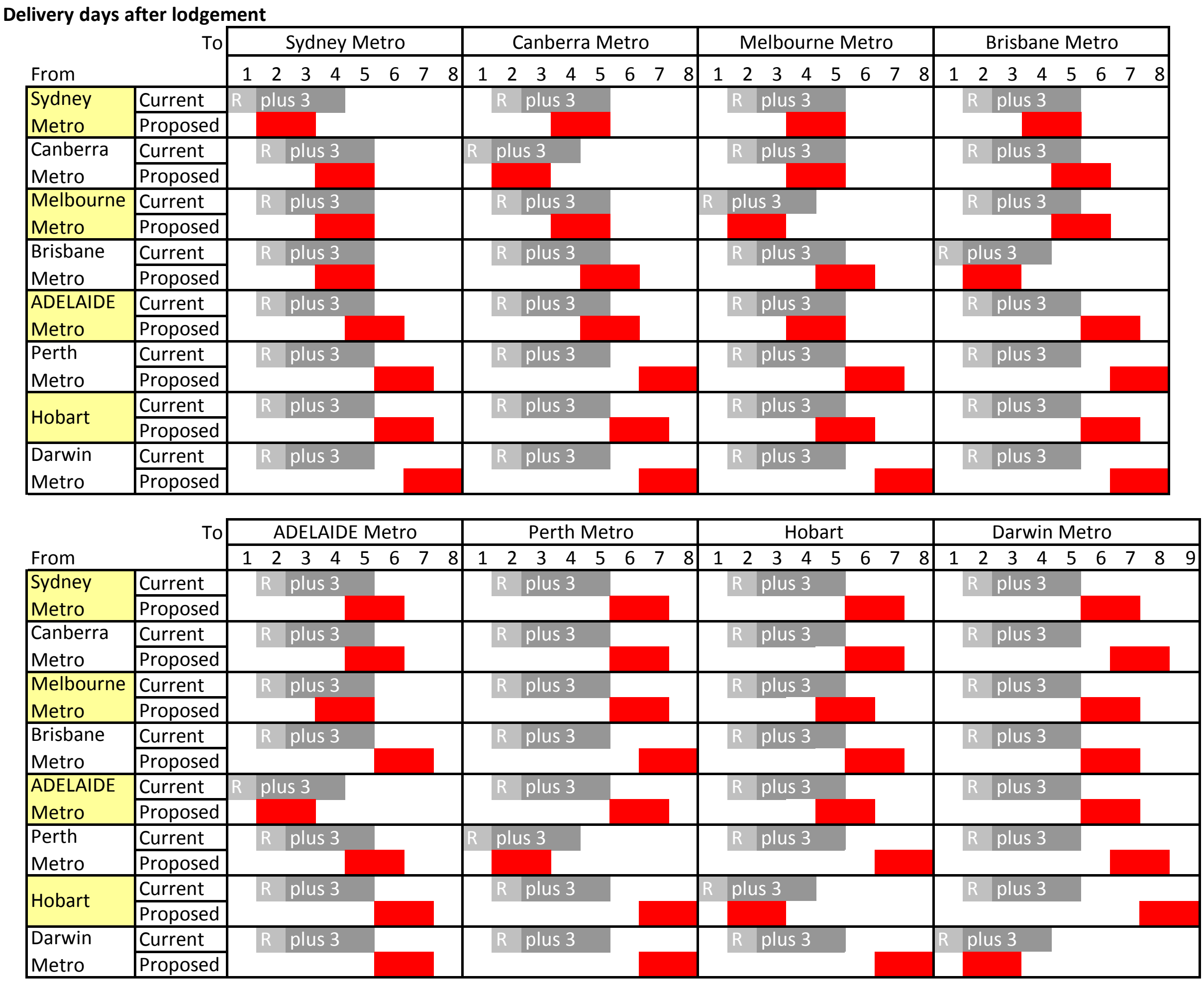
Provide a more certain delivery window:

- the current Off Peak delivery standard is up to 3 days on top of the Regular delivery standard (ie a four day window). The proposal is to provide a specific delivery window over a two day period (based on road / surface transport) providing operational flexibility in processing and delivery;

- in the initial customer consultation process a lodgement time of 12 noon was proposed. However, based on customer feedback this has been changed to 6pm with an additional day added to the proposed delivery times, except for those applying to same state metropolitan; and

- a comparison of the delivery times for metropolitan areas is shown in the table below. Country areas would generally be an additional day to the metropolitan, except for within larger states and distant / remote areas where a longer time would apply.

Table 20 – Comparison of Off Peak delivery times – current and proposed



Increase in the price differential between Regular and Off Peak:

- For small letters the current difference of 1.1 cents will be increased to 3.3 cents. This will encourage customers to move from Regular to Off Peak with an increase in the proportion of Off Peak leading towards increased flexibility within the network on how the product is managed. This is a change consistent with Australia Post's longer term aim developing a sustainable letter delivery model. Australia Post has modelled expected behavioural change and this sensitivity analysis is shown in Table 21; and

- where volumes migrate from Regular to Off Peak there will be immediate savings realised, from a reduction in interstate air transport usage (over those sectors where it is used). The financial modelling includes assumptions on this.

Align Off Peak barcode residue and unbarcoded residue prices to the equivalent Regular price:

- Off Peak Residue (barcoded and unbarcoded) items comprise around 23% of total Off Peak volumes and around 4% of total PreSort Letter volumes. As only Off Peak Barcode Direct Trays can be readily managed in the network to the Off Peak delivery time frame, Off Peak barcode residue and unbarcoded residue prices have been increased to the equivalent Regular price; and

- an exception to this change is made for Off Peak Barcode Residue Charity Mail where to avoid a larger increase in the Off Peak Residue prices only the Charity Mail unbarcoded residue price has been aligned.

Increase in the price differential between Regular same and other state prices:

- increasing the difference between same and other state for Regular ensures Australia Post is providing a price difference that at least reflects the estimate of average transport cost avoided; and

- while for small letters the current difference of 1.1 cents is proposed to increase to 1.6 cents the majority of PreSort letters are lodged for delivery in the state of lodgement (over 60% for Regular). As such, the increase is not expected to have a significant impact upon customer behaviour. Therefore no behavioural change is assumed.

The product design changes are expected to result in a movement of some letters from Regular to Off Peak. Table 21 illustrates the revenue sensitivity from mix changes – comparing the current to Australia Post's estimate and two further scenarios.

Table 21 – Revenue sensitivity to mix change

PreSort Letters	Current mix	Estimated mix change	Scenario 1 mix	Scenario 2 mix
% Regular	83	51	25	0
% Off Peak	17	49	75	100
Average price increase (%)	**6.3**	**3.8**	**1.8**	**0.0**

Appendix 3 – Future Ready

Future Ready, Australia Post's business renewal program, will enable Australia Post to meet the future needs of customers and ensure the long term sustainability of the business. Future Ready comprises four key pillars:

1. implementing a new business model;
2. capitalising on customer growth opportunities;
3. finding smarter ways to work; and
4. revitalising the corporate culture.

As part of Future Ready, the corporation's strategic objectives were also reviewed and three key strategies were determined:

1. restore self-sustaining letters business;
2. grow full value chain in parcels and win in e-tail; and
3. build trusted offer in communications, financial services and identity.

Future Ready went 'live' from 1 July 2010 with the introduction of the four strategic business units, supported by four support functions.

Strategic Business Unit	Postal Services	Retail Services	Express Distribution Services	e-Services
Customer focus	All customer segments	Consumer	Business	All customer segments
	Manger letter decline with growth in parcels	Opportunity to service customers with their trusted needs	Time sensitive – importers and exporters (Asia) B2B	Whatever we do physically, we can do digitally
	Letters Parcels Network Business centres International, Government, Corporate and State (SME) sales	Stores Financial services Merchandise / Philatelic PO boxes Trust based services	Post Logistics Messenger Post STE (J/V) AaE (J/V) Sai Cheng (J/V)	Internet / eFinance/ eCommerce Call Centres IVC Digital comms services Decipha, PrintSoft, FDS, eLetter & iPrint
Support function	Finance	People & Community	Strategy & Marketing	Corporate Services

Appendix 4 – Consultation participants

Customers and stakeholders who elected to participate in the consultation process prior to finalisation of this draft notification were as follows:

Customers

- Commonwealth Bank
- ANZ
- NAB
- Westpac
- Centrelink
- Australian Taxation Office
- Medicare
- Australian Electoral Office
- Optus
- American Express
- Telstra
- Readers Digest

Industry associations and representative bodies:

- Australian Direct Marketing Association
- Printing Industries Association of Australia
- Major Mail Users of Australia Limited

Industry suppliers:

- Mail Houses - (including Salmat)

Key Findings – Econometric Validations and Augmentations, January 2011

To accurately forecast segmented small and large letter volumes at Australia Post it is important to recognise there are two stages in the process:

1. Establishing an econometric baseline based upon historical associations; &
2. Augmenting that baseline with additional intelligence regarding one off events and emerging trends.

This validation report attempts to illustrate how the econometric and augmentation process must crucially combine to generate realistic volume forecasts for use in future price notifications whilst also enhancing managerial decision making beyond the econometric drivers of each letter volume segment at Australia Post.

Table 22 highlights that, in the absence of further augmentation regarding one-off events and the emerging threats to mail, the econometric forecasts tended to over-estimate letter volumes (in aggregate) by 3.25%.

Table 22 – Primary validation

	Letter volumes (m)			
Category	**Actual**	**Econometric forecast[26]**	**Actual**	**Econometric overestimation**
	2008/09	**2009/10**	**2009/10**	**2009/10**
PreSort Small	2,113	2,053	2,016	37
PreSort Large	162	154	149	5
Ordinary Small	1,631	1,602	1,536	66
Ordinary Large	222	221	198	23
Total	4,128	4,030	3,899	131

By way of illustration the two stage process this research undertaking utilises actual and projected letter volumes across the September Quarter of 2010 to highlight:

- the known associations as delivered through the econometric modelling process; &
- the areas of unexplained variation that require identification, collection and quantification through the augmentation process.

This research undertaking is intended to represent a commencement point for the econometric validation and augmentation process in line with recent advances in the international econometric and postal literature aimed at assisting Australia Post in their forecasting effort.

Australia Post will need to continue to cultivate additional mail data channels capable of generating further business intelligence to quantify and incorporate future events and emerging trends into the set of ex-ante forecasts.

Throughout the source documentation Diversified Specifics highlights areas where the existing data channels may be limited or new data channels may need to be considered to provide additional insights and facilitate the augmentation process. Diversified Specifics notes that change to existing or developing of new data channels would also require an assessment of the associated practicalities, robustness of the outcomes and cost implications.

[26] Diversified Specifics (March 2010), 'Domestic Letter Segment Forecasts 2009/10-2011/12', Prepared on behalf of Australia Post. Econometric forecasts via Vector Error Correction modelling techniques as reported in this Table are sourced from the following sections: PreSort Small (p.62); PreSort Large (p.67); Ordinary Small (p.58); Ordinary Large (p.65).

Augmenting the Econometric Baseline

When contrasting the econometric forecasts to actual small letter volumes in the September Quarter of 2010 the federal election is an example of a significant one-off event that may have inflated volumes beyond the models projections.

Therefore, the danger in interpreting the econometric forecasts at face value is that once positive and negative factors outside the model are discounted for it then allows a deeper investigation into the emerging threats to mail that may be beginning to suppress volumes beyond that anticipated econometrically.

Table 23 – Small letter growth comparisons

September quarter 2010	% growth on previous quarter (SA)		
	Actual	Econometric forecast	Augmentation Part 1
Other small letters	(0.77)	(2.41)	(1.73)
PreSort barcoded small letters	5.34	1.77	7.77

Table 23 illustrates the following key points for the two small letter segments:

- Although the econometric forecast underestimates actual volume growth for the September quarter, once election related mailings are added to the econometric baseline the augmented forecast (in the final column) reduces the gap for Other small letters and overshoots the actual volumes considerably for PreSort Barcoded small letters;
- Of particular concern for Australia Post is the Part 1 augmented econometric forecast for PreSort Barcoded small letter volumes is based on historical associations and it "misses" very recent trends towards consolidation, rationalisation and bill presentment substitution; and
- This is the X-factor that requires a second round of augmentation to better quantify and provide robust support for these emerging trends.

Table 24 – Large letter growth comparisons

September quarter 2010	% growth on previous quarter (SA)		
	Actual volumes	Econometric forecast	Augmentation forecast
Other large letters	(2.37)	(2.02)	See section 4
PreSort barcoded large letters	18.54	10.14	See section 5

With regard to the large letter segments the reasons for the variations (to PreSort Barcoded Large Letters) require further investigation. However, a possible influence is the recent QR National share market listing which represented the second largest float (behind Telstra in 1997) in Australian history and it is hypothesised that an associated substantial number of prospectus mailings would have occurred.

If this were the case then it could be expected to contribute in a major way to the PreSort Barcoded large letter quarterly volume growth that is in excess of the econometric forecast (8.40%) in Table 24.

To adequately test this hypothesis though, further data channels may need to be cultivated to capture and quantify the mailings associated with one-off events such as the QR National float.

Only then may the clear impact upon actual volume growth for the quarter be incorporated into the adjusted ex-ante forecasts despite their exclusion from the econometric framework.

Appendix 6 – Letter forecasts

The following Table details letter volume, revenue and cost forecasts out to the 2011/12 financial year.

The financial forecasts in this version are based on the corporate plan but are adjusted to account for the impact of the proposed changes.

		PreSort Letters			Other (inc Ordinary) Letters			Total
		Small	Large	Subtotal	Small	Large	Subtotal	Letters
2009/10								
Volume	m	2,016.1	142.4	2,158.4	1,536.2	182.0	1,718.1	3,876.6
Revenue	$m	$ 751.4	$ 93.2	$ 844.6	$ 743.1	$ 195.3	$ 938.4	$ 1,783.0
Total Cost	$m	✂	✂	$ 935.6	✂	✂	$ 1,065.8	$ 2,001.5
Contribution	$m	✂	✂	($ 91.0)	✂	✂	($ 127.4)	($ 218.4)
ROR	%	✂	✂	(10.8%)	✂	✂	(13.6%)	(12.3%)
2010/11								
Volume	m	1,961.0	138.2	2,099.1	1,477.5	172.0	1,649.5	3,748.6
Revenue	$m	$ 781.4	$ 97.4	$ 878.8	$ 773.9	$ 200.6	$ 974.5	$ 1,853.3
Total Cost	$m	✂	✂	$ 921.7	✂	✂	$ 1,029.4	$ 1,951.1
Contribution	$m	✂	✂	($ 42.8)	✂	✂	($ 54.9)	($ 97.8)
ROR	%	✂	✂	(4.9%)	✂	✂	(5.6%)	(5.3%)
2011/12								
Volume	m	1,937.9	136.8	2,074.7	1,383.3	160.6	1,543.9	3,618.6
Revenue	$m	$ 803.3	$ 98.1	$ 901.4	$ 727.7	$ 187.5	$ 915.2	$ 1,816.6
Total Cost	$m	✂	✂	$ 930.4	✂	✂	$ 993.9	$ 1,924.3
Contribution	$m	✂	✂	($ 29.0)	✂	✂	($ 78.7)	($ 107.7)
ROR	%	✂	✂	(3.2%)	✂	✂	(8.6%)	(5.9%)

Appendix 7 – Transactional and Promotional letter segments

Table 25 and Table 26 detail the key factors impacting volume growth in the Transactional and Promotional letter segments which account for over 95% of domestic reserved letter volume.

Table 25 – Transactional

Type	Driver	Observation / Comment
Underlying transaction growth	Economic	Factors such as GDP which are incorporated in the econometric model that stimulate overall activity.
	Prepaid / prearranged (ie direct debit)	Incorporating the negative impact of increased uptake of prepaid products and opt in to pre-arranged payment arrangements (in lieu of account based transactional activity). Mainly visible in telcos (post paid mobiles).
	Statement cycles	Incorporating the generally negative impact of change in statement frequency. Most visible in banks, but may follow in telcos and utilities.
	Account consolidation	Incorporating the negative impact of bundling of multiple services under a single account. Most visible in telcos, utilities and investments.
Communication Mode / Type	Online presentment (by the biller)	Incorporating the negative impact of a switch to email or online channels (both sent by the biller or via a third party).
	Online servicing	Incorporating the negative impact of the move from business and governments to encourage customers to adopt an online service model (ie entering information, submitting claims etc).
	Online payments	Incorporating the negative impact of the move of consumers (private and business) to use online payment methods (in lieu of cheques). This is partly recognised in the econometric model for Ordinary / Other Small Letters.
	Mobile	Incorporating the relatively new trend of transactions undertaken using mobile devices. Expected to grow as functionality, handset base and speed of mobile devices increase

Table 26 – Promotional

Type	Driver	Observation / Comment
Underlying advertising growth	Economic	Factors such as GDP which are incorporated in the econometric model that stimulate overall activity.
	Improved targeting	Enhanced Customer Relationship Management practices and marketing strategies to improve return on investment from campaigns.
	Specific events	Incorporating impact from specific events (eg elections).
Communication Mode / Type	Movement to online	Incorporating the negative impact of expectations that 'traditional' marketing budgets (eg direct mail) will continue to be put under pressure from online offerings.
	Declining power of mass media	Incorporating a positive impact of the general trend to consider use of direct media (including direct mail) – in lieu of current spend on mainstream mass media (TV, press, etc).

Appendix 8 – PCS v PPM domestic reserved letter service

Australia Post's cost forecasts for the domestic reserved letter service in the April notification were allocated according to the PCS whereas, the cost forecasts for the domestic reserved letter service in this notification are allocated according to the PPM. The difference between the two allocation systems is not material as demonstrated by the following Tables.

- Table 27 shows 2009/10 data with costs allocated using PCS
- Table 28 shows 2009/10 data with costs allocated using PPM
- Table 29 shows the variance between the two Tables

Table 27 – PCS PreSort and Ordinary letters 2009/10

	PreSort			Ordinary			
	Small	Large	Subtotal	Small	Large	Subtotal	Total
Volume (m)	2,016	142	2,158	1,536	182	1,718	3,877
Revenue ($m)	751	93	845	743	195	938	1783
Cost ($m)	✂	✂	✂	✂	✂	✂	1,994
Profit ($m)	✂	✂	✂	✂	✂	✂	(211)

Table 28 – PPM PreSort and Ordinary letters 2009/10

	PreSort			Ordinary			
	Small	Large	Subtotal	Small	Large	Subtotal	Total
Volume (m)	2,016	142	2,158	1,536	182	1,718	3,877
Revenue ($m)	751	93	845	743	195	938	1,783
Cost ($m)	✂	✂	✂	✂	✂	✂	2,001
Profit ($m)	✂	✂	✂	✂	✂	✂	(218)

Table 29 – Variance PCS v PPM 2009/10

	PreSort			Ordinary			
	Small	Large	Subtotal	Small	Large	Subtotal	Total
Volume (m)	-	-	-	-	-	-	-
Revenue ($m)	-	-	-	-	-	-	-
Cost ($m)	✂	✂	✂	✂	✂	✂	(8)
Profit ($m)	✂	✂	✂	✂	✂	✂	(8)
Cost ($m) %	✂	✂	✂	✂	✂	✂	(0.4)
Profit ($m) %	✂	✂	✂	✂	✂	✂	(3.6)

Summary table comparing aspects of the five studies referenced by Frontier Economics.

Item	Fenster	Bozzo	Cohen	NERA	Moriarty
What is the unit-level?	Processing centres	Processing centres	Country	Country	Processing centres and delivery centres
What activities are modelled?	Various processes & shapes (40 models)	Various processes & shapes (12 models)	Delivery, processing, transport, window service, other, total (6 models)	Collection, delivery, sorting, transport, total (5 models)	All within each centre (2 models)
Cross-sectional or panel data?	Panel	Panel	One data point only	Panel	Cross-sectional
Location of data	USA	USA	USA	EU	UK
Years of data	1999-2005	1999-2006	1999	1998-2003	2003/04
Number of units	268	371	1	23	1,108 and 69
Period of increasing or decreasing volumes?	Increasing	Increasing	NA	Increasing	NA
Any data reliability issues?	Recording errors	Recording errors	Small sample size	Price deflators and capital measures questionable	Recording errors
Function?	Production function	Labour demand function	Cost function	Cost function	Labour cost
Functional form?	Restricted translog	Cobb-Douglas	Linear	Cobb-Douglas	Cobb-Douglas
Any issues with econometric methods?	Endogenity of regressors	Model is derived assuming cost minimization in a regulated monopoly.	No econometrics used	Estimated in a system with a labour share equation and hence assumes cost minimization in a regulated monopoly.	No non-labour cost information
What is the dependent variable?	Volume	Labour hours	Total cost	Total cost	Labour cost
Short run or long run?	LR	SR	LR	LR	LR
Similar population density to Australia?	Higher	Higher	Higher	Higher	Higher
Similar volumes per capita to Australia?	Higher	Higher	Higher	Yes	Yes
Other issues?	Results suggest that extra delivery points result in extra productivity	Only considers run-time labour and not allied labour (or other inputs)	Extrapolations very brave		Assumes no effect of density on processing centres
Returns to density estimates	*Mostly 0.6-0.8*	*Mostly 0.8-0.9*	*0.63 for USA But can predict 0.43 for Australia*	*0.65 for total*	*0.67 for delivery*

Appendix 10 – Fixed assets

Asset Register structure – Australia Post's fixed assets are grouped into approximately 500 asset classes each of which is a broadly descriptive of the nature of the assets contained within that class rather than by each asset's accounting treatment. For example, the buildings asset class (asset class no. ZB00) comprises administrative buildings, post offices, depots, mail centres etc.

Assets within a class do not necessarily have the same accounting treatment. Within class ZB00, for example, there are three different service lives – 40 years, 50 years, and 70 years – depending on the type of building. Other asset classes similarly can have a range of service lives and/or residual values.

Land, Buildings and Fitout – at 30 June 2010 asset values which form a foundation for this notification include land and building assets at market value. Its total at 30 June 2010 was $1,430 compared with the book value of $795m shown on the face of the balance sheet. Valuations for the 30 June 2010 accounts were carried out by Savills Pty Ltd for properties in all states and territories. All properties are revalued annually.

Investment Properties – at 30 June 2010 the value of properties covered by this asset class was $225m. This amount is not allocated to products and services, and is not part of the asset base on which this draft notification is based.

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

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

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

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

Appendix 11 – Domestic reserved letter service fixed assets

The following Tables provide a breakdown of the domestic reserved letter service fixed assets (shown at Table 17) by product category.

Table 30 – Small Ordinary / Other letters

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	452	455	447	411	394	411
Additions	50	41	90	26	67	58
Depreciation	(48)	(49)	(53)	(44)	(49)	(51)
Closing balance	455	447	484	394	411	418

Table 31 – Small PreSort letters

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	374	402	415	332	328	353
Additions	69	56	82	31	66	52
Depreciation	(41)	(43)	(45)	(35)	(42)	(42)
Closing balance	402	415	451	328	353	363

Table 32 – Large Ordinary / Other letters

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	116	116	110	109	102	106
Additions	12	6	22	5	16	13
Depreciation	(12)	(12)	(13)	(12)	(13)	(12)
Closing balance	116	110	119	102	106	107

Table 33 – Large PreSort letters

$million	April notification			Current notification		
				Final result	Latest forecast	
	2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Opening balance	60	60	58	51	50	52
Additions	6	4	11	5	9	7
Depreciation	(6)	(6)	(7)	(6)	(6)	(6)
Closing balance	60	58	62	50	52	54

As noted in section 7, Australia Post approached Value Adviser Associates (VAA) to provide independent assessment of certain inputs to estimating the cost of capital for Australia Post's reserved letters business. This included specific WACC parameters such as the asset beta and equity beta and more generic parameters such as the market risk premium (MRP).

Table 34 shows VAA's recommendations as inputs to cost of equity and the WACC with further detail on the parameters (and methodology) provided below. Australia Post has adopted all of VAA's recommendations for this draft notification.

Table 34 – WACC parameter values

WACC parameter	Value
Risk-free rate	5.5%[27]
Market Risk Premium	8%
Asset β	0.6
Imputation Credits Value γ	0.30[28]
Equity β	0.8
Tax Rate	30.0%
Debt β	0.175
Cost of debt	6.9% (a 140 bbp premium)
Gearing (D/D+E)	30%

Risk Free Rate

The nominal risk-free rate used for this notification is the 10-year Commonwealth bond rate; which appears to be the rate conventionally used in the CAPM, and it was the rate used by the ACCC in its May Decision. Australia Post will nominate a 30 day period as close to the decision date as is practicable.

Market Risk Premium

It is VAA's view that it is important to estimate a cost of equity that reflects the same economic effects that affect the cost of debt. As such VAA has adopted an approach that does this and their profile of the equity MRP largely mirrors that prevalent in the Australian corporate debt market.

VAA's forward estimates of the MRP are derived by applying a constant premium per unit risk to the forward view of risk (volatility). While ideally the horizon for this estimate would be equivalent to the regulatory period, as this is not available, VAA has assumed the implied volatility for a one year period regresses to the mean derived from historical data.

The 'glide path' from the one year view of MRP to the long run estimate of 7% provides an average out to 2015 of 7.9% to 8.9%. VAA has then adopted a conservative view and recommended the lower end of the range (a MRP of 8.0%) be used.

[27] Current (ie 14 January 2011) rate included, Australia Post will nominate a 30 day period closer to the time of the decision

[28] As noted in VAA's report while 0.3 is an estimate for an average Australian company, Australia Post's actual imputation credit value is 0.0

Asset β

VAA has independently recalculated Australia Post's reserved service asset beta using the same range of listed international postal authorities and listed Australian companies that ACCC identified in its May Decision. In addition to this, VAA also considered three additional Australian companies considered to have similar characteristics (in that they operate within the letter value chain) to the reserved letter business.

In calculating the asset betas VAA has used 5 years of monthly data. VAA believe their analysis supports this approach, noting that monthly data reduces the 'thin trading' issue that is prevalent in weekly data.

VAA recommended a reserved letter service asset beta of 0.6.

Equity β

Adoption of an asset beta of 0.6 leads to a calculated equity beta of 0.8.

Imputation Credits

VAA have noted that imputation credits (gamma) are specific to the circumstances of the individual company – for Australia Post its gamma is 0.0 as:

- Australia Post does not distribute franking tax benefits; and
- its shareholder does not claim franking tax benefits.

VAA has considered an average gamma for Australian companies; an approach consistent with what the ACCC considered in its May Decision. The average gamma calculated by VAA was 0.30 and this was based on:

- a distribution ratio of 70% (based on ATO statistics); and
- a payment ratio of 50% (being the average ratio with an upper ratio of 70%).

Tax Rate

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

Debt β

VAA calculate the beta of debt by back-calculating that beta from the ratio of the debt premium to the MRP. With a debt premium of 140 basis points and an MRP of 800 basis points, the implied debt beta is 0.175.

Australia Post notes that, in practice, the impact of modest debt beta changes on other WACC parameters is small. Using the other WACC input settings assumed in this notification, a change in the debt beta from 0.1 (as used by the ACCC in Post's last price case) to 0.175 (used in this case) results in an equity beta rounded to the same 0.8. Stating the equity beta to an unwarranted 2 basis point level is needed to see a difference (when the equity beta moves from .81 to .78. Similarly, the final WACC impact is also small.

Cost of Debt

It is VAA's view that the cost of long term debt is the most appropriate input into the WACC, best estimated from yields arising from current market trades (where available). VAA has advised that the current market pricing of an appropriate benchmark of corporate debt for Australia Post is a premium of 140 basis points.

Gearing

Australia Post's gearing (D/D+E) at 30 June 2010 was 28%, after adjusting the balance sheet for the financial impact of the APSS superannuation fund which is not controlled by Australia Post. Current forecasts for adjusted gearing to 30 June 2012 are in the range 25% to 28%.

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

Table 35 – Debt, Equity and Gearing

	Debt $m	Equity $m	Adjusted Equity $m	Gearing %	Adjusted Gearing %
June 2009	561	1,845	1,518	23	27
June 2010	558	1,559	1,438	26	28
June 2011	553	1,878	1,576	23	26
June 2012	553	1,933	1,631	22	25