ACCC view on Australia Post's draft price notification

November 2019

Contents

Glossary

BPR	Basic Postage Rate, which refers to the price of carriage within Australia of a standard postal article by ordinary post. This is the price of posting an 'ordinary' small letter according to Australia Post's 'regular' timetable.
CCA	*Competition and Consumer Act 2010*.
Declaration	The current declaration applying to Australia Post's ordinary letters is *Price Notification Declaration (Australia Post Letter Services) 2015*, which declares certain services offered by Australia Post as notified services, and declares Australia Post to be a declared person in relation to these services.
Declared person	Under section 95X of the CCA, the Minister may declare a person to be, in relation to certain goods or services, a declared person for the purposes of Part VIIA of the CCA. Australia Post is a declared person in relation to 'ordinary' letter services carried at the regular timetable.
Draft price notification	Under section 95ZB of the CCA, the applicable period for the ACCC's assessment of a price notification is 21 days. However, a declared person is able to submit to the ACCC a 'draft price notification', which allows the ACCC to conduct a preliminary assessment prior to the lodgement of a formal price notification.
Notified services	Under section 95X of the CCA, the Minister may declare goods or services to be notified goods or services for the purposes of Part VIIA of the CCA. The introduction of a new notified service, or a price increase for an existing notified service, is subject to the ACCC's assessment. For example, Australia Post's reserved 'ordinary' letters carried at the regular timetable are notified services.
Ordinary letters	Ordinary letters refers to postal articles carried by Australia Post by ordinary post. An article is carried by ordinary post if it is carried by means of the letter service in such a way as will not involve the supply of a special service for which a special charge or additional fee is payable in relation to the carrying of the article. The main component of ordinary letters is stamped letters. Small and large ordinary letters (weighing up to 250 grams), including the BPR, are notified services.
Performance standards	Australia Post's current performance standards, including minimum delivery standards for both 'regular' and 'priority' letters, are set out in *Australian Postal Corporation (Performance Standards) Regulations 2019*.
PreSort letters (including Charity mail and Acquisition mail)	Australia Post's PreSort Letters service offers discounted postage rates for customers lodging more than 300 machine-addressed articles that are barcoded and sorted. Charity mail provides for delivery of small PreSort letters at lower prices for approved charitable organisations. Acquisition mail provides for delivery of non-personalised addressed

	mail pieces to households in specific postcodes, suburbs or Census Collection Districts. PreSort services are not notified services.
Price notification (locality notice)	A price notification refers to a 'locality notice' under section 95Z of the CCA. Where a declared person proposes to increase the price of a notified service, it is required under section 95Z of the CCA to give the ACCC written notice ('a locality notice').
Priority letters	Letters carried at the 'priority' timetable. The 'priority' letter service is delivered at the same speed as the ordinary letter timetable prior to January 2016. Priority letters are notified services if the price of a 'stamped' priority reserved letter is proposed to be greater than 150% of the equivalent reserved ordinary letter price.
Regular timetable	Since 4 January 2016 Australia Post has delivered ordinary letters at a 'regular' timetable under which letters may be delivered up to two business days slower than the 'priority' timetable.
Reserved services	Under section 29 of the *Australian Postal Corporation Act 1989*, Australia Post has exclusive rights over the provision of 'reserved services'. These services include the domestic carriage of letters weighing no more than 250 grams and the issue of postage stamps.
Return on capital	The amount of revenue that an investor would require as compensation for the opportunity cost of funding its capital base, calculated by multiplying the WACC by the depreciated regulatory capital base.
WACC	Weighted average cost of capital, which is the rate of return on assets allowed, given the relative level of risk associated with the capital base, averaged across debt and equity funding.

Executive summary

The ACCC does not object to Australia Post's proposed price increases in its draft price notification provided to the ACCC on 1 August 2019.

Australia Post is proposing to increase the basic postage rate (BPR) for reserved ordinary small letters delivered to the regular timetable by 10 per cent, from $1.00 to $1.10. Its proposal also includes an increase of 10 per cent for prices for the delivery of reserved ordinary large letters delivered to the regular timetable. These are part of the services for which Australia Post has a statutory monopoly.

Australia Post is required to notify the ACCC of proposed price increases to 'notified' reserved letter services under section 95Z of Part VIIA of the *Competition and Consumer Act* (CCA). The ACCC must then assess the proposal and decide whether or not it objects.

The ACCC has considered Australia Post's forecasts for letter volumes, its allocation of costs to its reserved letter services, and its past and forecast cost savings, to assess whether the proposed price increases will lead to an over-recovery of Australia Post's costs for its letter services.

Having considered these factors and submissions received from our public consultation, the ACCC has come to the view that Australia Post will not likely recover revenue in excess of its costs for reserved and notified postal services over the period to 2020-21 if the proposed 10 per cent increase in the BPR is accepted. This is due in large part to a continued forecast decline in letter volumes.

Australia Post has exceeded its overall efficiency targets set in 2015 through efficiencies in its processing operations and through facility optimisation, but to date has not made commensurate efficiency gains in its delivery operations. While Australia Post's letter business has still not attained the efficiency levels of its overseas peers, the ACCC acknowledges that Australia Post has begun to bridge the gap through its Reform our Letter Service and One Network programs, with significant improvements in the efficiency of its letter delivery operations remaining a challenge for Australia Post.

The ACCC is satisfied that the costs allocated to reserved and notified services are appropriate for this notification.

Australia Post's proposed price increases do not affect the price of priority labels (50 cents), which are required for delivering ordinary letters under the priority timetable. Prices for concession stamps (60 cents) and stamps for seasonal greeting cards (65 cents) will also remain unchanged.

After releasing this view the ACCC expects to receive a formal price notification from Australia Post and, if the formal notification is in the same form as the draft notification, the ACCC intends to issue a final decision consistent with this view not to object to the proposed price increases in the BPR.

In addition to the ACCC's assessment, Australia Post must give written notice to the Minister for Communications of its intent to vary its rates of postage. Australia Post may increase the BPR only if the Minister does not disapprove the proposed increases within 30 days of receiving notification from Australia Post.

Australia Post intends to implement the proposed price increases in January 2020 subject to the Minister not disapproving the price increases.

1. Introduction

1.1. Australia Post's draft price notification

On 1 August 2019, Australia Post provided the ACCC with a draft price notification regarding proposed price changes for its reserved ordinary letter services. Under Australia Post's proposal, the basic postage rate (BPR) charged for ordinary small letters delivered according to its regular timetable would rise from $1.00 to $1.10. The price of delivering ordinary large letters at the regular timetable would rise by 10 per cent.

Australia Post is not proposing to increase the price of priority labels (50 cents), which provide delivery of ordinary letters according to the priority timetable. Prices for concession stamps (60 cents) and stamps for seasonal greeting cards (65 cents) will also remain unchanged.

The proposed prices are set out in Table 1 and would apply from January 2020.

Table 1. Prices of ordinary letter services ($ nominal)

Letter service	Current price	Proposed price	Increase
Small letters (BPR)	1.00	1.10	10.0%
Large letters up to 125 grams	2.00	2.20	10.0%
Large letters >125 grams <250 gams	3.00	3.30	10.0%

Source: Australia Post, *Draft price notification*, August 2019, p.12.

In its 2019 draft price notification, Australia Post submits that price increases (as well as a continuing focus on cost efficiency) are necessary for providing a financially sustainable letter service due to the combination of ongoing volume decline in letters delivered and an increasing delivery footprint.[1]

Australia Post under-recovered its costs for reserved services (including return on capital and tax) by $76 million in 2018-19. The under-recovery for reserved services is forecast to continue and reach $106 million in 2020-21, even with the additional revenue from the proposed price increases for notified and non-notified reserved services.[2]

The under-recovery arises primarily from a forecast decline in reserved letter volumes averaging 9 per cent per year up to 2021-22, despite:

- the proposed price increase for reserved ordinary letters and planned price increases for bulk letters beyond 2019
- an average decline in forecast costs of 4 per cent per year.[3]

As set out in Figure 1, Australia Post's reserved services for carriage of ordinary letters at the regular timetable are notified services[4] and are a subset of Australia Post's broader reserved services monopoly. Notified services are subject to ACCC review when a price increase is proposed; however, the ACCC assesses the appropriateness of the proposed price increase for notified services considering forecast costs and revenues of all reserved

[1] Australia Post, *Draft price notification*, August 2019 (Australia Post 2019), p. 7.
[2] This is calculated based on the information in Australia Post's financial model.
[3] Australia Post 2019, table 35, p. 60; ACCC calculations.
[4] *Competition and Consumer Act 2010*, s. 95X.

letter services.[5] This is necessary as the notified letter services share most of the same processing and delivery facilities as other reserved letter services, and Australia Post's cost recovery for notified services is affected by the amount of shared and direct costs allocated across reserved services.

In its draft price notification, Australia Post indicates it has achieved significant efficiency savings through implementing its business reform programs. These include Reform our Letter Service (RoLS) and One Network (where Australia Post seeks to use postal delivery workers to deliver parcels and letters on their mail rounds). Australia Post submits that to date the two programs have delivered a combined efficiency saving of $338 million.[6]

Figure 1 provides a categorisation of Australia Post's products, showing the major business segments and their revenues in 2017-18.

[5] Reserved services include all of Australia Post's statutory monopoly letter services, including business mail services that are not notified services but are provided at a discount to notified 'ordinary' letter services prices.

[6] Australia Post 2019, table 25, p. 47.

Figure 1. Categorisation of Australia Post product groups and revenues (revenue in $ millions, 2017–18)

Australia Post – Whole Corporation ($6,783)

Postal ($3,448)

Letters ($2,433)

Reserved ($2,016)

Notified letter services ($174)

Ordinary (stamped) Letters:

Sent at the regular delivery timetable and involves no special service. Comprises:

- Small Letters (up to 250g) – the BPR
- Large Letters;
  - up to 125g
  - over 125g up to 250g

Priority (stamped) Letters: only subject to price notification if it exceeds 150 per cent of the price for an equivalent Ordinary Letter

Other reserved letters ($1,842)
Small and Large Letters up to 250g that incorporate a special service (i.e. not Ordinary letters). Includes:

- Concession stamps,
- Seasonal greeting cards,
- Prepaid Envelopes / cards
- **Business Letter services:**
  - Metered/Imprint
  - PreSort (incl Charity Mail, Promo Post, Acquisition Mail, Impact Mail)
  - Clean Mail
  - Local Country
  - Reply Paid
  - Print Post

• Stamped letters sent to the priority delivery timetable if price is not greater than 1.5 times the Ordinary price

Non-reserved letters ($417)

- Letters (large ordinary and Print Post) over 250g
- Letters charged at more than 4 times BPR

e.g. Express Post, Registered Post

Unaddressed Mail

International outward letters

International inward letters * and packets <2kg

Other Postal ($1,015)

- Mail related e.g. PO boxes, digital communications
- Retail
  - Sale of stationery and merchandise
  - Financial and Agency services – banking, Insurance, travel cards, bill payment, money transfer

Parcels ($3,335)

Delivery of parcels (Parcel and Express)

Freight forwarding

International parcels

Courier

Notes: * International inward letters and international inward parcels weighing less than 250 grams are formally non-reserved services but are subject to Universal Postal Union (UPU) regulation.

Key: Notified letters (part of Reserved) – subject to price notification to ACCC

Reserved letters – overall cost recovery considered by ACCC in deciding whether to object to price increases for notified services

Source: Australia Post; ACCC.

1.2. Legislative framework

1.2.1. Services subject to ACCC assessment

The ACCC's role in the prices oversight of Australia Post's notified letter services falls within the scope of Part VIIA of the *Competition and Consumer Act 2010* (CCA).

The Minister for Communications has declared the provision of letter services by Australia Post to be a "notified service". Further, the Minister has declared Australia Post is a "declared person" in relation to the notified service pursuant to section 95X of the CCA. The price of ordinary letters carried at the priority timetable is subject to price notification provisions if it exceeds 150 per cent of the equivalent ordinary letter rate.[7] The prices of Australia Post's other services, such as parcels, express post, bulk business letters, concession stamps and seasonal greeting cards are not subject to the ACCC's assessment.

Where Australia Post proposes to increase the price of a notified letter service or introduce a new notified letter service, it must notify the ACCC of the proposal. The ACCC must then consider the proposal and make a decision to either:

- not object to the price increase
- not object to a price that is less than that proposed, or
- object to the price increase.[8]

Australia Post is not permitted to increase its prices until 21 days have elapsed since the notification or the ACCC has decided not to object.[9]

The ACCC's decision is not determinative as to whether prices will increase. Should the ACCC object to the proposed price increase, Australia Post may still propose to increase the BPR.[10] When Australia Post proposes to vary the BPR, it must give written notice to the Minister for Communications of its intent to vary its rates of postage. Australia Post may increase the BPR only if the Minister for Communications does not disapprove the proposed increase within 30 days of receiving notification from Australia Post.[11] In exercising its power, the Minister may have regard to the ACCC's decision in relation to the price notification.[12]

1.2.1. ACCC approach to assessment

The ACCC has adopted a cost-based approach to assessing Australia Post's draft price notification under Part VIIA of the CCA.[13] Under this approach, prices should reflect:

- a cost base that is efficient
- incentives for efficient investment.

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[7] Price Notification Declaration (Australia Post Letter Services) (No. 2) 2015, https://www.legislation.gov.au/Details/F2015L01429. Ordinary large letters weighing more than 250 grams are not reserved or notified.

[8] *Competition and Consumer Act 2010*, s. 95Z.

[9] *Competition and Consumer Act 2010*, s. 95ZB.

[10] *Australian Postal Corporation Act 1989*, ss. 32 and 33.

[11] *Australian Postal Corporation Act 1989*, s. 33(5).

[12] *Australian Postal Corporation Act 1989*, s. 33(4)(b).

[13] A more detailed explanation is contained in the ACCC's *Statement of Regulatory Approach to Assessing Price Notifications*, June 2009, which is available on the ACCC's website at: http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications.

The ACCC has considered a Post-Tax Revenue Model (PTRM) provided by Australia Post to calculate the total revenue required to meet efficient costs. The model aggregates the following cost components:

- operating costs
- return of capital, representing depreciation costs
- return on capital, representing the required rate of return on the capital base.

In assessing Australia Post's draft price notification, the ACCC has considered whether the revenue from the price increases proposed will meet the revenue required for Australia Post to recover the efficient costs of providing letter services, including a rate of return commensurate with the risks faced by Australia Post.

The ACCC has assessed the components of Australia Post's PTRM, including the forecasts of costs, revenue and demand, and other factors included in the model. Australia Post's submitted PTRM is for the period to 2021-22.

As discussed in more detail in this document, the ACCC's assessment has also involved consideration of:

- the effect of the proposed price increases and demand forecasts on Australia Post's forecast revenue
- the efficiency of Australia Post's costs (including any savings achieved and able to be achieved in the future through business reforms)
- Australia Post's cost allocation model (CAM)
- Australia Post's proposed rate of return on capital.

As part of its assessment, the ACCC engaged WIK Consult (WIK) to review Australia Post's CAM and benchmark Australia Post's business reform program against overseas postal operators that have experienced declining mail volumes. WIK specialises in regulatory economics and has extensive international experience in postal regulation. A public version of the executive summary of WIK's report will be made available on the ACCC website.

1.2.2. Confidentiality

During the course of the ACCC's assessment of Australia Post's draft price notification, Australia Post has provided the ACCC with supporting information that it considers to be commercial-in-confidence. The ACCC has had regard to this information in conducting its assessment and there are aspects of the ACCC's decision which refer to this information to support its views regarding elements of Australia Post's proposal. Information that the ACCC considers to be commercial-in-confidence has been redacted in this document.

1.3. Consultation and review process

In considering Australia Post's draft price notification, the ACCC has carried out a public consultation process. The ACCC published an Issues Paper on 23 August 2019 and sought the views of stakeholders with respect to the notification. The ACCC received submissions from ten stakeholders in response to the Issues Paper. The public versions of the submissions are available on the ACCC's website. ACCC staff also held a series of meetings with Australia Post and attended site visits at Australia Post facilities visited by WIK.

Among the issues raised in submissions were concerns about the efficiency of Australia Post's operations and the level of consultation provided by Australia Post regarding its pricing proposals.[14] Some industry groups were also concerned that the price increases proposed will have an adverse impact on future mail volumes and will cause volumes to decline at an accelerated rate.[15] It is noted that the ACCC does not have a role in assessing bulk business mail charges through a price notification process. However, the ACCC has a role in dispute resolution regarding bulk mail charges under paragraph 32B(1)(a) of the *Australian Postal Corporation Act 1989*.

It is anticipated that Australia Post will submit a formal price notification (locality notice) to the ACCC soon after the release of this document. The ACCC will then have 21 days to make a final decision, which it expects to release in December 2019.

Table 2. Process for the review of 2019 Australia Post price notification

Date	Event
7 August 2019	Australia Post draft price notification published
23 August 2019	Issues paper published
13 September 2019	Closing date for submissions
14 November 2019	ACCC publishes its view on draft price notification
November 2019	Australia Post anticipated to submit formal price notification
December 2019	ACCC final decision published

[14] The Real Media Collective, September 2019 submission, p. 9, pp. 21-24.
Print & Visual Communication Association, September 2019 submission, pp. 2-3.
Post Office Agents Association Limited, September 2019 submission, pp. 5-8.

[15] The Real Media Collective, September 2019 submission, p. 9.
Post Office Agents Association Limited, September 2019 submission, p. 11.

2. Letter volumes

2.1. Draft price notification

Forecasts of letter demand are used to assess whether proposed price increases are expected to achieve sufficient revenue to recover costs, without providing excessive returns. These forecasts are also relevant to assessing Australia Post's cost forecasts where volumes impact on operational costs.

Australia Post submitted four-year demand forecasts in the supplementary information for its draft price notification, consistent with its 2018 Corporate Plan. Australia Post's demand forecast is an average volume decline of 9.4 per cent annually from 2017-18 to 2021-22 (see Table 3).

Australia Post argues in its draft price notification that electronic substitution (e.g. email, SMS, web-based portals) remains the dominant factor for the decline in letter volumes.[16]

Table 3. Australia Post's forecast volume rate of change (%) 2018-19 to 2021-22[17]

	Actual volumes in 2017-18 (millions)	2018-19 (%)	2019-20 (%)	2020-21 (%)	2021-22 (%)	CAGR[18] (%)	Forecast volumes in 2021/22 (millions)
Ordinary Small	651	-9.8	-9.7	-9.2	-9.1	-9.5	437
Ordinary Large	86	-16.3	-8.3	-12.1	-8.6	-11.4	53
PreSort Small	1,302	-7.6	-10.6	-9.4	-8.8	-9.1	888
PreSort Large	51	-9.8	-10.9	-9.8	-8.1	-9.6	34
Print Post	185	-12.4	-7.4	-8.0	-8.7	-9.2	126
Total Volumes	2,274	-8.9	-10.0	-9.4	-8.8	-9.4	1,537

Source: Australia Post, *Draft price notification,* August 2019, *tables 36-39; ACCC calculations*.

2.2. Australia Post's forecasting method and considerations

Australia Post describes its methodology for forecasting mail volumes as a two-part process:

- Australia Post engaged Diversified Specifics to construct baseline volume forecasts for each of its key letter volume segments.
- Diversified Specifics' forecasts were then subject to augmentation by Australia Post, taking into account its market intelligence and institutional insights.[19] Australia Post submits this is necessary as projections generated from econometric models can become obsolete due to rapid technological changes.[20]

[16] Australia Post 2019, pp. 19-21.

[17] Volumes include a small number of non-reserved ordinary large letters and non-reserved PreSort large letters in order to remain consistent with Diversified Specifics' forecasts.

[18] Compound Annual Growth Rate (CAGR) from 2017-18 to 2021-22.

[19] Australia Post provides information on the factors underlying its augmentation in Appendix 4 of its draft price notification.

[20] Australia Post 2019, p. 19.

2.2.1. Diversified Specifics' baseline forecasts

Australia Post provided the ACCC with a report which details the econometric modelling undertaken by Diversified Specifics on its behalf. Diversified Specifics employed a number of econometric techniques including tests for structural breaks, non-stationarity, co-integration and optimal lag structures. Diversified Specifics utilised Vector Error Correction Modelling as well as dynamic ordinary least squares methodologies to forecast demand for the five letter segments. The approach sought to isolate, explain and quantify the impact of a number of letter volume drivers with a primary focus on the forces of electronic substitution.[21]

Overall, Diversified Specifics forecast an average annual rate of decline in letter volumes of 9.2 per cent over the four years to 2021-22.

2.2.2. Australia Post's augmentation of the baseline forecasts

Australia Post's demand forecasts are made by augmenting the baseline forecasts derived by Diversified Specifics using management and market intelligence. Generally, this intelligence is acquired through its own sales group by way of discussions with customers and participants in the mail value chain, and from publicly available reports. Australia Post provided a broad overview of the factors it considered in deriving the management augmentations in its draft price notification.

This includes trends identified within Australia Post's internal customer account data, which included off-model augmentations such as State and Federal election-related volume, change in the use of communication media (i.e. electronic substitution), and consolidation and rationalisation.[22]

Australia Post's forecasts compared to the baseline forecasts developed by Diversified Specifics are shown in Table 4 below. Australia Post's forecasts of letter volume decline are generally higher than those of Diversified Specifics.

[21] For more information on the drivers of letter volumes and associated elasticities please see the relevant letter segment sections of Diversified Specifics' 2019 Report published on the ACCC website, https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2019.

[22] Australia Post 2019, p. 19.

Table 4. Forecast rates of change in letter volumes: comparison between Diversified Specifics and Australia Post

		2018-19	2019-20	2020-21	2021-22	CAGR[23]
PreSort	Diversified Specifics	-9.9%	-8.6%	-8.9%	-7.7%	-10.0%
	Australia Post	-7.7%	-10.6%	-9.4%	-8.8%	-9.1%
Ordinary/Other	Diversified Specifics	-8.4%	-9.8%	-11.5%	-10.3%	-8.8%
	Australia Post	-10.3%	-9.7%	-9.6%	-9.1%	-9.7%
Print Post	Diversified Specifics	-7.1%	-8.7%	-8.8%	-6.6%	-10.3%
	Australia Post	-12.4%	-7.4%	-8.0%	-8.7%	-9.2%
Total addressed letters	Diversified Specifics	-9.1%	-8.8%	-9.5%	-8.3%	-9.2%
	Australia Post	-8.9%	-10.0%	-9.4%	-8.8%	-9.4%

Source: Australia Post, *Draft price notification,* August 2019, *tables 36-39; ACCC calculations*.

2.3. Submissions received

A number of stakeholders, including the Fundraising Institute of Australia (FIA),[24] Print & Visual Communication Association (PVCA),[25] and the Real Media Collective (RMC),[26] noted the negative impact that the proposed price increases (i.e. for notified and non-notified services) would have on demand for mail services and, as submitted by the RMC, would further accelerate substitution away from mail.

The RMC and PVCA both stated that business letter rates are directly linked to the BPR.[27] The RMC considered that continued price instability and increases pose a significant risk to future business mail volumes as industry change business mail-out decisions.[28] These stakeholders linked previous price increases to letter volume declines.[29]

The RMC raised concerns about the introduction of price increases for business mail midway through the financial year and the level of consultation by Australia Post regarding its proposals. It considered that this leaves businesses and charities mid-term on established budgets, unable to mitigate these price increases, and that this will lead to an immediate volume decline.[30]

The Post Office Agents Association Limited (POAAL) acknowledged that while further price increases may accelerate the pace of electronic substitution, the downward trend in letter volumes is clear, pre-dates Australia Post's current price notification, and will continue regardless of any increase to letter prices.[31]

[23] Compound Annual Growth Rate (CAGR) from 2017-18 to 2021-22.

[24] The FIA specifically raised the negative impact of the proposed price increases on charity mail volumes. See: Fundraising Institute Australia, September 2019 submission, pp. 1-2.

[25] Print & Visual Communication Association, September 2019 submission, pp. 2-4.

[26] The Real Media Collective, September 2019 submission, p. 9.

[27] The Real Media Collective, September 2019 submission, p. 7.
Print & Visual Communication Association, September 2019 submission, p. 3.

[28] The Real Media Collective, September 2019 submission, pp. 7-10.

[29] The Real Media Collective, September 2019 submission, pp. 14-16 & 19-20.

[30] The Real Media Collective, September 2019 submission, p. 10.

[31] Post Office Agents Association Limited, September 2019 submission, p. 11.

Australia Post commented that since reaching a peak in 2007-08, addressed letter volumes have declined by over 48 per cent and are forecast to decline by an average of 9.5 per cent to 2021-22.[32] Australia Post stated that the major driver of declines in letter volumes has been electronic substitution, along with other external factors (such as post-GFC cost rationalisation), rather than increasing prices.[33]

2.4. ACCC view

2.4.1. Assessment of Diversified Specifics' baseline forecasts

Diversified Specifics has previously conducted econometric modelling of letter volumes for Australia Post. The general approach in Diversified Specifics' 2019 report is the same as its 2010, 2013 and 2015 forecasts for Australia Post. While the broad approach taken by Diversified Specifics is appropriate, the ACCC considers that some aspects of Diversified Specifics modelling have the potential for undue downward bias in letter volume forecasts.

The first relates to the construction of electronic substitution variables used to model the effects of electronic substitution. The Diversified Specifics report considered different types of electronic substitution were anticipated to have differing effects on and within each letter volume segment.[34] It therefore constructed the following electronic substitution variables:

- cheque volumes as a proxy for bill payment substitution in the ordinary small letter segment[35]
- mobile broadband index as a proxy for bill presentation substitution in the other four letter segments.[36]

The ACCC agrees with Diversified Specifics that different types of electronic substitution may take place in each mail segment and considers the proxies used for the ordinary small letter segment to be appropriate. However, the ACCC does not consider Diversified Specifics' construction of the mobile broadband electronic substitution variable appropriate for the following reasons:

- mobile wireless technology is only one of the many electronic technologies that Australian consumers can use to access bills and statements online
- in recent years, average data usage from mobile wireless has been increasing exponentially, likely as the result of the increased usage of content streaming services, social media and other content-rich applications[37]
- the mobile data traffic series used is measured for the Asia-Pacific region. This may not be applicable to Australia.[38]

The ACCC also notes that for the PreSort small letters, the mobile broadband variable over the forecast period (2018-19 to 2021-22) is augmented by the growth rate of machine-to-machine (M2M) technology, to capture the aggressive electronic substitution effects in the PreSort small letter segment.[39] Diversified Specifics does not provide justification for further

[32] Australia Post, September 2019 submission, p. 5.

[33] Australia Post, September 2019 submission, pp. 6-8.

[34] Diversified Specifics, *Australia Post domestic letter volume demand update*, August 2019, p. 84.

[35] Diversified Specifics, *Australia Post domestic letter volume demand update*, August 2019, p. 23.

[36] Diversified Specifics, *Australia Post domestic letter volume demand update*, August 2019, pp. 39-59.

[37] ACCC, *Internet Activity Report*, December 2018, p. 3.

[38] It appears that a key driver to this series is rapid growth in data traffic in China, with growth rates increasing from less than five per cent growth in 2011 to over 180 per cent growth in 2017.

[39] Diversified Specifics, *Australia Post domestic letter volume demand update*, August 2019, p. 23.

augmenting mobile data traffic for the Asia-Pacific region by the growth of global mobile data with M2M technology.

Similarly, the ACCC has reservations with some aspects of Diversified Specifics' approach to variable selection and structural break testing. It is not clear from Diversified Specifics' 2019 Report that it has taken a structured approach to truncating the sample periods. In particular, the application of structural-break testing used to identify the choice of estimation periods does not appear to be consistent across the segmented letter volume models.[40]

It is also unclear how Diversified Specifics narrowed down the large number of potential variables for letter demand modelling into the small set of long-run demand drivers used. In the literature,[41] a number of demand drivers have been identified as potential factors driving letter demand. These include: demographic and macroeconomic variables, price of letters, prices of competing services, quality of letter services, and electronic substitution. Diversified Specifics does not consider prices of competing services as a potential driver for letter volume. This may overstate the electronic substitution effect and understate the effect of relative price changes between letter and telecommunication services.

ACCC staff conducted alternative scenario analysis (outlined in Chapter 6) to assess the materiality of the ACCC's concerns in respect of Diversified Specifics' approach. The ACCC tested the effect of a more conservative estimate of electronic substitution on the forecast decline in letter demand, and the removal of post-modelling augmentations.[42] On this basis, the ACCC considers that a reasonable alternative range is an annual decline of 6 to 8 per cent in letter volumes over the forecast period. However, the alternative scenario analysis performed by the ACCC showed that assuming the bottom of the forecast range (6 per cent) did not reverse Australia Post's under-recovery position over the forecast period.

The ACCC acknowledges from submissions to the Issues paper and from its analysis that volumes are likely to continue to decline significantly over the forecast period. Consequently, Diversified Specifics' baseline volume forecast is a reasonable estimate of volume declines. However, the ACCC considers that the issues identified above should be addressed by Australia Post in future price notifications.

2.4.2. Assessment of Australia Post's augmentations

Australia Post has made augmentations to Diversified Specifics' baseline forecasts to account for State and Federal election-related volume, change in the use of communication media (i.e. electronic substitution), and consolidation and rationalisation. Australia Post's total augmentations result in a net decline in volumes compared to the forecast by Diversified Specifics.

Consistent with the 2015 notification,[43] the ACCC remains concerned with potential 'double counting' in the two-step approach, as Diversified Specifics has already accounted for accelerating electronic substitution effects in its baseline modelling. The ACCC is of the view that Australia Post's approach of making further augmentations (for factors already captured in the model developed by Diversified Specifics) is likely to result in an over-estimation of the decline and consequently a lower forecast of future letter volumes than would otherwise be the case.

[40] In particular, the ACCC notes that while the ordinary (small and large letters) sample period begins in June 2002, PreSort has a shorter sample period starting in September 2009, and Print Post in September 2014.

[41] See for example, Nikali, H (2013), *Letter Demand and Explaining Factors in Finland and a Nordic Comparison*, presentation at the 14th Königswinter Seminar on Postal Economics Postal Regulation and Volumes under Pressure, 25-27 November 2013, ss. 12 and 31.

[42] Diversified Specifics includes a Clements-Hendry adjustment which they submit is designed to capture potential increased substitution effects above what is captured in the model.

[43] ACCC, *ACCC's view on Australia Post's price notification*, November 2015, p. 27.

Further, the ACCC does not consider the augmentation approach used by Australia Post to be transparent or replicable. A particular issue with Australia Post's approach is the lack of supporting information to justify and quantify its augmentations. The ACCC notes that Australia Post's augmentations over the forecast period have resulted in:

- net negative adjustments in ordinary large, PreSort small and print post volumes by -16 million, -11 million and -21 million respectively, creating more pessimistic demand forecasts than by the baseline forecasts
- net positive adjustments in ordinary small and PreSort large volumes by 14 million and 2 million respectively, creating more optimistic demand forecasts than the baseline forecasts.

The ACCC observes that Australia Post made similar adjustments in its 2015 notification. However, these previous demand forecasts when compared to actual demand recorded were too optimistic for ordinary small letters[44] and too pessimistic for PreSort small letters.[45] The ACCC further notes that baseline projections from Diversified Specifics (2015) generally over-forecast ordinary small letter volumes and under-forecast PreSort small letter volumes, but to a smaller degree than the final demand forecasts from Australia Post. This is attributable to the post-modelling adjustments made by Australia Post in support of the 2015 price notification; that is, positive adjustments to 'other small' and negative adjustments to 'PreSort small' were made. Therefore, Australia Post's previous demand forecasts when compared to actual demand recorded suggests that its augmentations did not improve the accuracy of previous forecasts and brings into question the need for augmentations for forecasts supporting the 2019 draft price notification.

Based on the analysis discussed above, the ACCC has not accepted Australia Post's augmentations but Diversified Specifics' baseline forecasts for letter volume decline is a reasonable estimate for the purpose of assessing whether Australia Post's proposed prices will achieve sufficient revenue to recover efficient costs. Modelling of letter demand, revenues and costs is discussed in chapter 6 of this document. As noted above, the ACCC considers that the issues identified regarding Diversified Specifics' forecasts should be addressed by Australia Post in future price notifications.

[44] Australia Post forecast an average decline in ordinary small letters of -10.9 per cent over 2014-15 to 2017-18, more optimistic than the realised average decline of -13.3 per cent over the same period.

[45] Australia Post forecast an average decline in PreSort small letters of -8.9 per cent over 2014-15 to 2017-18, compared to the realised average decline of -7.2 per cent over the same period.

3. Costs, reforms and operational efficiencies

The ACCC has adopted a cost-based approach to assessing Australia Post's draft price notification and whether the proposed price increase for notified services is justified. Under this approach, prices should reflect an efficient cost base. An efficient cost base in the current context includes those costs which would be incurred by a hypothetical efficient operator supplying letter services and operating to maximum efficiency in line with world's best practice.

In response to declines in letter volumes, Australia Post has been implementing a range of reforms to find cost savings within its mail business. This includes its:

- Reform our Letter Service (RoLS) program, which is a modernisation program to improve its cost structure, and includes implementation of 'two-speed' letter delivery services.
- One Network program, whereby Australia Post is using its letter delivery network to deliver small parcels, utilising excess capacity in this network.

The ACCC engaged WIK to assess the efficiency of Australia Post's letter operations and compare this with postal operators overseas that have faced declining letter volumes over the past decade.[46] In 2015, WIK found that the efficiency of Australia Post's letter service was behind that of comparable international peers. In 2017, the Australian National Audit Office also observed that Australia Post has not improved efficiencies in its letters business as quickly as its international counterparts, despite developing strategies to improve efficiency.[47] In deciding not to object to the proposed price increase in the 2015 price notification, the ACCC took WIK's findings into account, noting that we would look closely at Australia Post's progress in achieving operational efficiencies and cost reductions at the time of considering the next price notification.

3.1. Australia Post's forecasts

3.1.1. Cost of providing letter services

Australia Post forecasts that its costs (operating costs and depreciation) for the reserved letter service will decline from $1.9 billion in 2017-18 to $1.6 billion in 2021-22 (16 per cent) (Table 5 below). In contrast, trading costs for its overall business are forecast to increase by 17 per cent to $7.4 billion in the same period.

Table 5. Costs (nominal $m) of reserved letters and overall business[48]

	2017-18 (Actual)	2018-19 (Actual)	2019-20	2020-21	2021-22
Total reserved services	1,884	1,861	1,708	1,653	1,588
Overall business	6,632	6,863	6,968	7,160	7,399

Source: Australia Post, *Draft price notification*, August 2019, tables 8 and 35, pp. 30, 60; Australia Post, *Draft price notification* (confidential), August 2019, table 47, p. 70; Australia Post, updated actual data for 2017-18 and 2018-19 provided to ACCC, October 2019.

[46] A public version of the executive summary of WIK's review of Australia Post's efficiency program will be made available on the ACCC website.

[47] Australian National Audit Office, *Australia Post's Efficiency in Delivering Reserved Letter Services*, 28 September 2017, p. 8.

[48] Trading costs include operating and maintenance expenses plus depreciation at historic cost. They exclude interest, return on capital and income tax.

Operating costs represent the majority of Australia Post's costs for the provision of reserved letter services (92 per cent), with the balance being depreciation (around 5 per cent), return on assets (around 2 per cent) and tax expense (around 1 per cent).[49]

The bulk of Australia Post's operating costs in the reserved letters business is labour (around two-thirds),[50] which is driven by the number of full time equivalent employees (FTEs) and their wages. The number of FTEs supporting Australia Post's reserved letter services has fallen by approximately 15 per cent over the period 2015-16 to 2018-19.[51] Australia Post forecasts that this number will continue to decline by 18 per cent over the period 2018-19 to 2021-22, from 13,345 to 10,971.[52]

FTEs supporting non-reserved services are forecast to increase by 17 per cent from 17,519 in 2018-19 to 20,559 in 2021-22,[53] in part due to a higher demand for staff in non-reserved services such as parcels processing and delivery.

3.1.2. Reform programs

In its draft price notification, Australia Post submitted that it has achieved significant efficiency gains through implementing its reform programs – RoLS and One Network.[54]

The RoLS strategy implemented two-speed delivery for letters – regular and priority – which was implemented by Australia Post to achieve efficiency gains and lower costs in the context of declining letter volumes. The RoLS program comprised of three key areas in which efficiencies were sought: processing (automation and shift alignment), delivery and facility optimisation. The One Network strategy, which evolved from the planned National Delivery Model (NDM) and RoLS program, aims to further improve efficiencies largely through streaming together letter and parcel processing and delivery. Table 6 shows Australia Post's claimed savings from the RoLS and One Network programs for each key area and its forecast of RoLS' savings in the 2015 price notification.

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[49] Australia Post financial model; ACCC calculation.

[50] Australia Post, *draft price Notification* (confidential) 2019, table 11; ACCC calculation.

[51] ACCC calculation. For consistency, Print Post FTEs were not included in the 2018-19. Print Post has only been considered a reserved letter service since 2017.

[52] Australia Post 2019, table 12, p. 32; Australia Post, updated actual data for 2018-19 provided to ACCC, October 2019; ACCC calculation.

[53] Australia Post 2019, tables 10 and 12, p. 32; Australia Post, updated actual data for 2018-19 provided to ACCC, October 2019; ACCC calculation.

[54] Australia Post 2019, pp. 46-51.

Table 6. RoLS and One Network savings (nominal $m)

Activity	2014-15	2015-16	2016-17	2017-18	2018-19
Processing (Automation and Shift alignment)	24.5	74.7	137.3	199.9	225.0
Delivery & Streaming	2.7	15.4	21.5	86.7	106.2
Facility Optimisation	0	2.2	6.8	6.8	6.8
Total Savings	**27.2**	**92.3**	**165.6**	**293.4**	**338.0**
Savings forecast in the 2015 price notification	27.2	83.3	158.2	319.0	323.8

Source: Australia Post, *Draft price notification*, August 2019, table 25, p. 56; Australia Post, *Draft Price Notification* (confidential), August 2019, table 25, p. 47; Australia Post, updated actual data for 2018-19 provided to ACCC, October 2019.

According to Australia Post, the savings achieved from RoLS and One Network over 2015-16 to 2018-19 exceeded the amount forecast for RoLS in its 2015 price notification. Australia Post submitted that the higher-than-forecast savings are largely driven by changes to the original delivery strategy, and the increased streaming of parcels and packets to postal delivery officers under the One Network program.[55] Forecast savings in the cost of delivery from RoLS were not met; however, cost savings in processing (automation and shift alignment) and facility optimisation exceeded the forecasts made in 2015.

Australia Post submits that it is targeting a further $200 million per annum cost saving from 2018-19 to 2021-22 through its Enterprise Efficiency Program (EEP).[56] This target is inclusive of savings being pursued through the One Network program.

3.2. WIK's findings

The ACCC engaged WIK to assess the progress of Australia Post's reform programs and benchmark these against comparable overseas postal operators that have experienced declining mail volumes over the past decade.

WIK found that Australia Post has made efficiency improvements in the processing component of its letter operations but has not yet made substantial progress in improving the efficiency of its delivery operations. Under the RoLS program, Australia Post increased automation and introduced the two-speed letter product but did not implement the National Delivery Model (NDM) as proposed in 2015.[57]

WIK considered that Australia Post has not yet achieved the reorganisation of its delivery operations required to achieve further cost savings. WIK observed that the number of delivery rounds remained fairly stable between 2014 and 2018 and that Australia Post still retains its 'one postie-one round' approach whereby a single postal officer is responsible for both sorting and delivery of mail for each postal round.[58] WIK concluded that more flexible delivery and a re-design of delivery rounds could improve delivery efficiency; however, rigidities in Australia Post's current delivery operations are a barrier to Australia Post implementing such reforms effectively.[59]

[55] Australia Post 2019, p. 47.

[56] Australia Post 2019, p. 46.

[57] WIK, *Assessment of Australia Post's cost allocation methodology and operations' efficiency*, October 2019 (WIK 2019), pp. 90-91.

[58] WIK 2019, pp. 93-94.

[59] WIK 2019, p. 94.

WIK noted that Australia Post's implementation of the One Network program and the streaming of small parcels and letters together for delivery by postal officers makes use of excess delivery capacity arising from declining letter volumes.[60] WIK also noted that One Network is an ambitious program which will change Australia Post's letter and parcel operations substantially, although future cost savings from the program are not well quantified by Australia Post.[61]

WIK concluded that, together, the RoLS and One Network programs have to date provided efficiency gains in excess of those projected in Australia Post's 2015 notification.[62]

WIK's review also compared Australia Post to five major European postal operators: Deutsche Post (Germany), La Poste (France), PostNL (the Netherlands), PostNord Denmark and PostNord Sweden. These operators commenced business reform programs over a decade ago to reduce their cost structures in response to declining letter volumes.

Figure 2 illustrates Australia Post's progress since WIK's 2015 assessment and how Australia Post now compares to international operators.

Figure 2. Automation and efficiency levels in letter operations

	Australia Post (2015)	Australia Post (2019)	Deutsche Post	La Poste	PostNL	PostNord Denmark	PostNord Sweden
Sorting of large letters to rounds by machine	○	◕	●	◕	●	●	●
Sorting of small letters into walk order by machine	◑	◕	●	◕	●	●	●
Minimising mail preparation in delivery centres	○	◔	◕	◑	●	●	●
Separate manual sequence sorting from outdoor delivery (different persons)	○	○	◕	◔	●	●	●
Centralise manual sequence sorting	○	○	◕	◔	●	●	◕

Source: WIK assessment

Note: ○◔◑◕●- not implemented/applied, implementation/application started, ongoing implementation, mostly implemented/applied, largely implemented/applied

WIK considered that Australia Post has been able to better automate operations in line with international operators through the implementation of the RoLS program. For example, like its international counterparts, Australia Post has installed more efficient letter sorting machines, reduced the number of letter sorting centres and decreased the share of letters delivered to the priority timetable.[63] In other areas, WIK considered that Australia Post still lags the international comparators, specifically regarding:

- sequence sorting of small letters by machine
- reorganisation of the delivery process
- manual handling in delivery centres.[64]

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[60] WIK 2019, pp. 96-97.

[61] WIK 2019, p. 101.

[62] WIK 2019, p. 102.

[63] WIK 2019, pp. 111-112.

[64] WIK 2019, p. 117.

WIK considered that Australia Post's One Network program is broadly consistent with programs implemented by international operators in response to declines in letter volumes and increases in parcel volumes.[65] While Australia Post still lags its international peers in terms of automation and efficiency levels, it has begun to bridge the gap through its RoLS and One Network programs. WIK advised that Australia Post's strategy to better use excess delivery capacity is both useful and an important element of the One Network program, but that Australia Post should also consider the flexibility and design of delivery operations and rounds to improve efficiency.[66]

3.3. Submissions received

Submissions did not generally consider Australia Post's costs or the reforms Australia Post has implemented to improve efficiency. Some submissions indicated that Australia Post may be able to generate further efficiencies in its delivery network. Measures suggested by POALL included varying mail delivery schedules where every-day delivery is not warranted, further out-sourcing mail carriage operations, further combining letter and parcel delivery, and converting corporate post offices to LPO operations.[67] The Real Media Collective stated that Australia Post could reduce its fixed costs where over-servicing occurs, modernise its labour force and work in partnership with industry to realise efficiencies in mail processing.[68]

In its response to the Issues Paper, Australia Post considered that there are a number of difficulties in comparing efficiencies of international operators. These include differences in legislation and community service obligations, geographic dispersion and customer density, commercial profiles of business beyond the core letter business, and local economic environments which impact on costs.[69]

3.4. ACCC view

The ACCC's assessment has involved consideration of the impact of the RoLS and One Network programs and other business reforms including EEP on Australia Post's efficiency, and the advice by WIK on the efficiency of Australia Post's letter operations since 2016 and as compared with other postal operators that have faced declining letter volumes.

The ACCC considers that Australia Post has exceeded its overall efficiency targets set in 2015 despite not implementing the NDM or achieving targeted efficiencies in delivery related operations. That is, Australia Post has attained efficiencies in its processing operations and through facility optimisation, but has not made significant efficiency gains in its delivery operations, as identified by WIK.

Australia Post's efficiency reforms have allowed it to make progress in operational efficiency although it has not yet achieved the automation and efficiency levels attained by the five international operators identified by WIK that have also faced declining letter volumes.

While the ACCC considers that the One Network and other business reforms including EEP should enable Australia Post to achieve further cost savings over the next three years, the level of savings is unlikely to eliminate under-recovery of Australia Post's costs to provide reserved services within this period. This view has regard to the additional revenue forecast by Australia Post from the proposed price increases for notified and non-notified reserved services. This view is supported by the modelling of Australia Post's forecast costs, demand and revenues under different scenarios as discussed in chapter 6 of this document.

[65] WIK 2019, p. 124.

[66] WIK 2019, p. 125.

[67] Post Office Agents Association Limited, September 2019 submission, pp. 5-8.

[68] The Real Media Collective, September 2019 submission, pp. 21-24.

[69] Australia Post, September 2019 submission, p. 11.

4. Cost allocation

4.1. Introduction

Australia Post's draft price notification covers its notified services (i.e. reserved ordinary letters delivered to the regular timetable), which are the only letter services that are declared under section 95X of the CCA and therefore subject to ACCC review of price increases.

In considering the justification for the proposed price increase, the ACCC has regard to the revenue required to support Australia Post's notified letter services. However, the notified letter services are a subset of the wider segment of reserved letter monopoly services, which also includes business letter services. Also of relevance is that Australia Post is required under its community service obligations to make its letter service reasonably accessible to all Australians, which applies to its whole reserved letter service.[70]

The notified letter services use most of the same processing and delivery facilities as other reserved letter services, with cost recovery on any one segment being sensitive to the amount of the shared costs allocated to it.

The reserved letter services to a lesser extent also share the use of some resources (for example, in post offices and on delivery rounds) with non-reserved services, for example the growing segment of parcels. Growth in the parcel delivery segment and e-commerce have been key contributors to revenue for Australia Post in recent years. Since the previous price increase in 2016, Australia Post has been implementing the One Network program, which has increased the number of parcels delivered on letter delivery rounds to 41.5 per cent of all parcels.[71] The way in which shared costs are allocated between the various product groups is essential for analysis of how Australia Post is recovering the costs of supplying monopoly notified and reserved letter services.

As part of the assessment of Australia Post's proposed prices, WIK has reviewed Australia Post's cost allocation model. WIK was also tasked with assessing the progress Australia Post had made in improving aspects of the model which WIK and the ACCC had found deficient in the assessment of Australia Post's price notification in 2015.

4.2. Australia Post's cost allocation model

Australia Post uses an Enterprise Profit Model (EPM) to allocate costs, assess profitability and support commercial pricing decisions. This incorporates a Cost Allocation Model (CAM) which allocates costs across the business between the various products and services and between reserved and non-reserved services.

Australia Post states that its CAM is a fully absorbed costing model and allocates costs to products and services under the following guiding principles:[72]

- all products and services are to be charged appropriately with the costs of the enterprise
- Activity Based Costing is used as the cost allocation methodology
- the Activity Based Costing model identifies resource costs from the General Ledger and assigns these costs to activities; these activities are then assigned to products and services primarily according to consumption (i.e. usage of assets and labour)

[70] *Australian Postal Corporation Act 1989*, sections 27, 29.

[71] Australia Post, *Annual Report 2019*, p. 8.

[72] Australia Post 2019, p. 38.

- direct attribution of costs to products is conducted, wherever possible
- miscellaneous revenues, unrelated to a product or service, are treated as miscellaneous, with any associated costs allocated to them.

Australia Post submits that it has improved and refined the CAM since 2015, partly in response to WIK's and the ACCC's recommendations. Its progress in these areas is outlined below.

4.3. WIK review of the cost allocation model

WIK considers that the Activity Based Costing system used in the CAM is a state-of-the-art tool if appropriately applied.[73] WIK's investigation in 2015 found that there was no systematic bias in Australia Post's CAM, but there were a number of shortcomings. These centred on the level of documentation, the degree of disaggregation of processes and activities, and regularity of updating. In particular, some major factor values had not been updated to reflect changes in processes and some values for parcels were low compared to some large letter mail products.

WIK's tasks in the current review included:

- reviewing the extent to which Australia Post has implemented the recommended improvements to its CAM as outlined in 2015[74]
- whether the CAM accurately reflects cost differences between reserved letter services that would support the projected financial losses for certain reserved letter services over the forecasting period.

In its current review, WIK found that Australia Post's current CAM retains its previous strengths, such as:

- consistency with record-keeping rules kept for the ACCC[75]
- consistency with its financial accounts, General Ledger and externally audited accounts
- fully allocated costing, ensuring costs are fully accounted for use as an internal management tool as well as regulatory reporting.

WIK found major progress had been made in the following areas:

- The level of documentation has been increased, particularly related to the Delivery Cost Review, allowing better transparency and understanding of the CAM. The raw data was accompanied with detailed explanations and descriptions of the variables.[76]
- The current model exhibits a deeper level of disaggregation in several areas, with about 800 activities now specified. This brings the modelled production process closer to the actual production structure and, as a result, allocation of costs should be more robust and reliable.[77]
- The more granular and differentiated separation of sub-activities in the Delivery function generates a significantly more precise and accurate allocation methodology.

[73] WIK 2019, p. 24.

[74] ACCC, Decision 2015, p. 7; WIK-Consult, *Final Report, Study for the Australian Competition and Consumer Commission: Review of Australia Post Cost Allocation Methodology*, 9 November 2015, pp. 94, 107.

[75] Record Keeping Rules are in place to enable the ACCC to assess the potential for cross-subsidy of competitive services supplied by Australia Post from its statutory monopoly letter services.

[76] WIK 2019, p. 31.

[77] WIK 2019, p. 86.

- Factors are updated more frequently, at least every three years; many of them yearly, monthly, or automatically.

WIK commended Australia Post on a number of other improvements to the CAM. For example, product volume is the dominant cost driver in the core postal functions (acceptance, processing, transport and delivery). This approach implies that the relative allocation of fixed costs becomes smaller for services for which volumes are declining and it becomes larger for services with growing volumes. Time has also been introduced as a major factor and cost driver of delivery activities. The application of time-based and consumption drivers instead of generic effort factors represents a more detailed and highly disaggregated approach.[78] The current CAM also allows the capture of changes in operations and product specifications more accurately and faster.

WIK concluded that Australia Post has substantially improved the CAM, in particular for its delivery activities by disaggregating major activities into sub-activities.[79] The improvements resulted particularly from Australia Post's Delivery Cost Review and Processing Cost Update in 2016, in response to WIK's 2015 recommendations.

For the current review, WIK has noted the CAM's strengths as being mainly in terms of allocating costs ex post, and has recommended a number of developments to enhance the CAM's future capability as a tool for cost forecasting, for both management and regulatory purposes, specifically:[80]

- the CAM should include an integrated forecast module to allow for parameter change and scenario simulation
- the CAM should generate the short-run and long-run incremental cost of services, to support proper business decisions and assess the appropriateness of the profitability of certain services
- Australia Post should provide a decomposition of cost changes related to input price changes, volume changes, economies of scale, changes in the production process (efficiency) and economies of scope. This would allow for better assessment of forecasts and should be provided in a coherent and consistent way for major product groups such that the forecast data are consistent with the EPM/CAM data.

WIK also recommended that:

- unattributable costs should be allocated to products according to an Equi-Proportionate Mark Up (EPMU) rule
- restructuring costs should be treated as unattributable and allocated by an EPMU rule.

4.4. Submissions received

The only submission to comment on cost allocation was from The Real Media Collective (RMC). The RMC supports the recommendations for improvements in the CAM made by WIK in its 2015 report.[81] It also states that the losses reported on the letters business are inflated and not cognisant of latent capacity in postal distribution networks. Further, it considers future projects to deliver more parcels via this network are not reflected in the forecasts. The RMC also considers that letters and parcels must be reported under one

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[78] WIK 2019, p. 24, 71.

[79] WIK 2019, p. 31.

[80] WIK 2019, p. 87-8.

[81] The Real Media Collective, September 2019 submission, p. 25.

business, as they sit within a common distribution network afforded by the existing letters infrastructure.[82]

4.5. ACCC view

The following considers the scope of services assessed for cost recovery and the method of cost allocation between products within this scope.

Scope of services

The extent to which Australia Post recovers its full costs depends on the scope of services considered when assessing whether additional revenue generated by price increases is sufficient to allow full cost recovery. The results depend heavily on how shared costs are allocated between different services using the same facilities. Options considered for the scope of services include:

- notified services
- reserved services
- letters and parcels.

Since 2011, Australia Post has been required to notify price increases only for ordinary reserved letters. This segment accounted for 8 per cent of total letter revenue and 2.5 per cent of Australia Post's whole of corporation revenue in 2017-18. Australia Post reports losses on the notified services, with under-recovery projected by Australia Post to equal 35 per cent of required revenue in 2020-21, even after the proposed price increase for these services.[83] The notified services share the great majority of the resources and activities used by other reserved letters, such as bulk business letters. This includes sorting machines, transport and delivery resources. However, the appropriate allocation of shared costs between the various letter services is less clear than between the letter services and other Australia Post services.

The reserved letter services are those for which Australia Post has a statutory monopoly. In this context the ACCC notes subsection 95G(7) of the CCA which requires the ACCC to have regard to 'the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices.' Accordingly, as for previous notifications, the ACCC considers it is appropriate to consider Australia Post's cost recovery across all reserved services.

The Real Media Collective raised the option of considering the letter and parcel segment together, arguing that they have become increasingly integrated. The ACCC accepts that parcels share a considerable and increasing part of Australia Post's letter network, particularly in the delivery and acceptance activities, as parcel volumes grow and an increasing proportion are delivered on postal delivery rounds. Parcels have provided a growing source of revenue, based partly on the established national network and brand of Australia Post which it has been able to develop with the aid of its statutory monopoly.

However, the parcel market is competitive, particularly in metropolitan areas, so that despite Australia Post's advantages, market forces constrain it from setting monopoly prices for parcel services. Further, significant parts of parcel processing are still separate from letters, particularly for larger parcels, so there is a clearer division in cost allocation between letters and parcels. As discussed below, the ACCC is also satisfied that Australia Post's method of allocating shared costs between letters and parcels is more robust than was previously the

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[82] The Real Media Collective, September 2019 submission, p. 10-11.

[83] Derived from data on Ordinary reserved letters in Australia Post 2019, table 31, p. 56.

case. Therefore, the ACCC does not consider it necessary for the costs and revenues of Australia Post's parcel businesses to be included in our assessment of the current proposal for price increases for reserved ordinary letters.

The ACCC therefore considers that at this stage it is preferable to focus on Australia Post's cost recovery for notified and reserved letters rather than extending the scope to include parcels. If a broader review of Australia Post's functions and efficient costs as a fully integrated parcel/letter business were required or desirable in the future, the current price notification framework would not be the appropriate mechanism.

Allocation of costs

The ACCC agrees with WIK's finding that Australia Post's cost allocation methodology has improved substantially since 2015, particularly in delivery activities.[84] Activities, factors and factor values better reflect the actual processes in the core postal functions.[85] Processes are modelled in detail at a highly disaggregated level and factor values are more clearly based on recorded volumes and work studies. Aspects of the model are discussed briefly below.

Volume drivers

The CAM uses volumes, updated monthly, as a key driver of cost allocation. This results in an automatic increase in the allocated cost burden for products such as parcels experiencing volume growth and a concomitant reduction in cost for products such as letters with declining volume.

This effect is indicated in forecasts provided by Australia Post – the number of reserved letters delivered by postal delivery officers (PDOs) is projected to decrease by 32 per cent between 2017-18 and 2021-22 (from 1.6 billion in 2017-18 to 1.1 billion in 2021-22), while the number of parcels is projected to increase by [C-i-C] per cent.[86] Over the same period, the share of PDO delivery costs allocated to reserved letters decreases from 66 to 52 per cent, while the share allocated to parcels increases from 18 to 34 per cent. Parcels incur 18 per cent of the cost while accounting for only [C-i-C] per cent of the volumes as a result of the higher time and factor values associated with parcels.

Although Australia Post's cost-recovery on parcels is outside the scope of the ACCC's consideration, the amount of shared costs allocated to reserved letters depends significantly on the volume forecasts for parcels as well as letters.

Factor values

The amount of cost allocated in the CAM depends not just on volumes but also on factor values which include relative effort or time, and frequency of activity. The ACCC agrees with WIK that the activities, factors and factor values now better reflect actual processes following the operational reforms. The factor values are based to a greater extent on time standards and frequency of use for different activities and so better reflect the consumption of resources.

The volume component in Australia Post's terminology refers to the number of articles carried, giving the same weighting to one letter or one parcel. There is likely to be an additional factor related to the weight or cubic volume of parcels which are substantially

[84] WIK 2019, p. 31.

[85] WIK 2019, p. 72.

[86] Australia Post, confidential data provided in response to information request (Delivery Centre Pool Cost), email received 27 May 2019.

larger than letters.[87] Either weight or cubic volume may impose constraints on how much can be carried on a motorbike or other delivery vehicle on a single round. After capacity is reached, increasing volume may ultimately change network cost, for example, for restocking along the delivery route, more separate rounds, or larger and slower vehicles. The ACCC considers that Australia Post should consider changes in cost allocation in the future that take appropriate account of such causal factors in the context of operational changes.

It was not possible for the ACCC or WIK to confirm the accuracy of all factor values used in the CAM. However, the ACCC considers that the greater granularity in modelling of activities has allowed a more accurate allocation of costs between different products, and accordingly between the reserved and non-reserved segments.

Conclusion

The ACCC accepts that Australia Post has made clear progress in implementing the recommendations made by WIK in 2015 regarding the CAM. WIK has noted the CAM's strengths as being mainly in terms of allocating costs ex post, and has recommended a number of improvements to enhance the CAM's future capability as a tool for cost forecasting, for both management and regulatory purposes. For the purposes of this notification, the ACCC accepts that the CAM provides an adequate measure of Australia Post's historic costs for reserved letters, including the notified letter services.

[87] Postal delivery officers carry small to medium parcels which fit through a fixed parcel gauge which has length 40 cm, width 35 cm and thickness 10 cm.

5. Cost of capital

In assessing Australia Post's draft price notification, the ACCC has had regard to whether the estimated revenue generated is required to recover the efficient costs of providing its reserved services,[88] including a return on capital. Generally, a return on capital should reflect the opportunity cost to investors of choosing to finance a firm's operations. The return on capital is calculated as a weighted average of the opportunity cost of debt and equity, known as the weighted average cost of capital (WACC).

Australia Post has submitted that a nominal 'vanilla' WACC[89] of 6.9 per cent should be applied for its return on capital, based on a report by Value Adviser Associates (VAA).[90] The ACCC's view is that Australia Post's WACC is not appropriate and has derived an alternative WACC of 5.24 per cent. The WACC parameters proposed by Australia Post, and the parameters calculated by the ACCC, are set out below.

Table 7. Australia Post's proposed WACC parameters, ACCC view

WACC Parameter	**Australia Post proposal**	**ACCC view**
Risk free rate	1.34%	1.03%
Market risk premium	7.00%	6.10%
Corporate tax rate	30.00%	30.00%
Imputation factor γ	0.00	0.585
Asset beta (β_a)	0.70	0.66
Debt beta (β_d)	n/a	n/a
Equity beta (β_e)	0.90	0.81
Gearing ratio (debt percentage) D/V	22.9%	19%
Cost of equity	7.6%	5.95%
Cost of Debt	4.6%	2.14%
Nominal vanilla WACC	**6.90%**	**5.24%**

Notes: Australia Post, *Draft price notification*, August 2019, table 30; ACCC analysis.

The impact on required revenue is around $7.1 million per annum for reserved services (the impact is less than $1 million per annum for notified services) for the combined change in the parameters. The effect is relatively small and would not substantially affect Australia Post's under-recovery for reserved services, as the return on capital accounts for only 2 per cent of Australia Post's total required revenue for reserved services.

The most significant differences between the WACC parameters proposed by Australia Post and the ACCC's view relate to the market risk premium (MRP), the value of gamma, the cost

[88] As set out in Chapter 1, the ACCC considers Australia Post's cost recovery for all reserved services, as the notified letter services share most of the same processing and delivery facilities as other reserved letter services.

[89] The nominal, vanilla WACC is the weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity. In other words, it excludes all tax-related matters from the WACC calculation. A provision for the cost of taxation is made separately from the WACC, in the form of an estimate of the company tax that would be payable each year by the regulated entity.

[90] Value Adviser Associates, *WACC Assessment - Reserved Letters Business as at 15 February 2019* (available at https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2019/draft-price-notification).

of debt, the gearing ratio, and the value of the asset and equity betas. The ACCC notes that it sets the cost of capital in reference to an efficient comparable firm operating in Australia rather than the regulated business' actual financial statements. The ACCC considers that this approach balances the need for a firm to earn a competitive rate of return to encourage investment but not lead to monopolistic pricing while providing an incentive to improve overall performance.

The ACCC's approach to these parameters is discussed in Appendix A.

6. Australia Post's cost recovery

6.1. ACCC's approach

As outlined in chapter 1, the ACCC's key consideration in assessing the proposed price increases is whether revenue generated by the proposed price increases is sufficient to allow Australia Post to recover its efficient costs, without generating excessive or monopoly profits. Its full costs include a return on capital, based on a rate of return commensurate with the risks faced by the firm.

The ACCC typically considers a building block model provided by Australia Post to aggregate its full costs. The cost components of the building block model are:

- operating costs
- return of capital, representing depreciation of fixed assets
- return on capital, representing the required rate of return on the asset base
- tax allowances.

The sum of these building block costs represents the **required revenue** to recover the costs of providing letter services (also referred to as maximum allowable revenue). The type of building block model provided by Australia Post is a Post-Tax Revenue Model (PTRM), meaning that the corporate tax allowance is a separate cost block in the model so the rate of return is the return required after tax has been paid.

6.2. Draft price notification

Australia Post has provided the ACCC with a PTRM which includes its forecasts of costs and revenue and other inputs used to estimate its cost recovery for the period of 2018-19 to 2020-21.[91] The required revenues at several levels of Australia Post's letters business – ordinary reserved letters, domestic reserved letters and domestic letters – are shown in Table 8. All costs and revenues are presented in nominal dollars.[92] The revenue figures include the additional revenues from proposed price increases from notified and non-notified reserved services, as forecast by Australia Post.

[91] The high-level results from the PTRM are shown in table 31 (p. 56), of Australia Post's DPN 2019. Australia Post also supplied its full model to the ACCC, with modelling to 2021-22, on a confidential basis.

[92] Australia Post has presented monetary amounts in nominal dollars of each year. The ACCC has maintained this approach in this chapter, rather than converting to real values for a base year, allowing easier comparison with Post's estimates and nominal postal prices. The difference between nominal and real is small given the relatively short time span involved.

Table 8. PTRM forecast cost recovery by letter segment (nominal $ million)

	2018-19	2019-20	2020-21
Ordinary reserved letters only			
Required revenue	223	188	176
Revenue proposed	150	125	114
Over(under) recovery	(72)	(63)	(62)
Over(under) recovery as % of required revenue	(32%)	(33%)	(35%)
All domestic reserved letters			
Required revenue	1912	1759	1706
Revenue proposed	1835	1690	1599
Over(under) recovery	(76)	(69)	(106)
Over(under) recovery as %	(4%)	(4%)	(6%)
All domestic letters			
Required revenue	2204	2037	1984
Revenue proposed	2025	1873	1776
Over(under) recovery	(179)	(164)	(208)
Over(under) recovery as %	(8%)	(8%)	(10%)

Source: Australia Post's financial model.

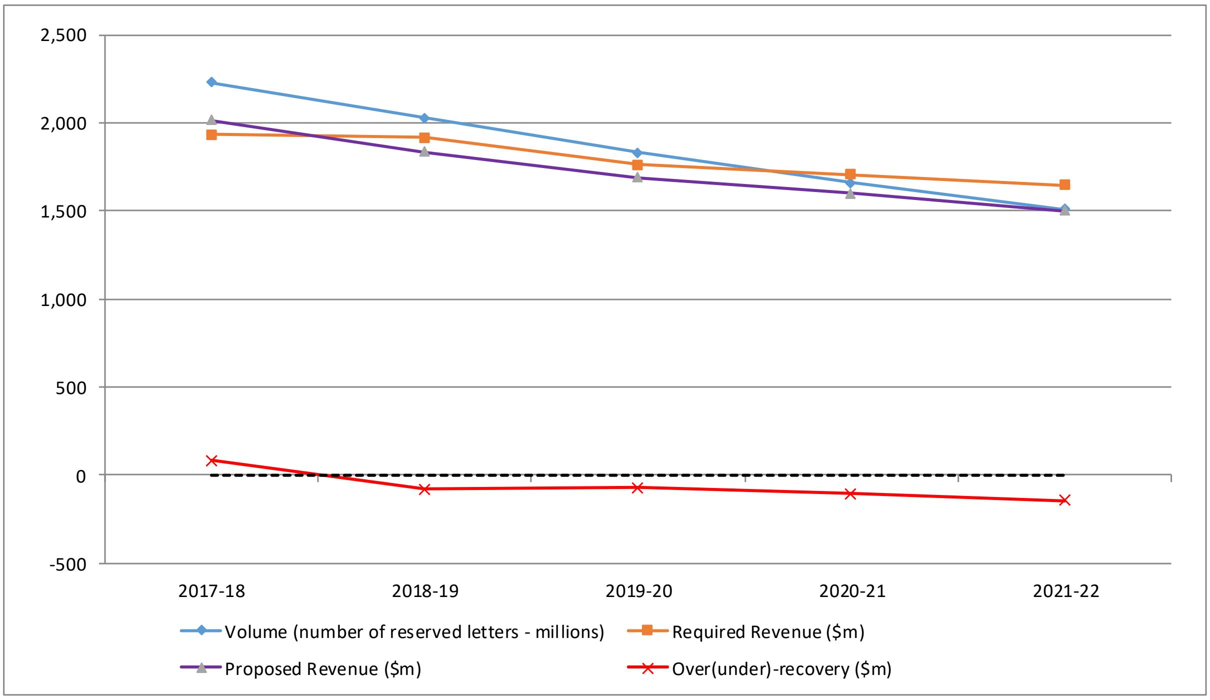
Required revenue in the PTRM represents the full economic costs of providing the services, as distinct from Australia Post's operating costs discussed in chapter 3 of this document, which are a subset of full economic costs. Required revenue includes operating costs and, in addition, return on capital, corporate tax, and current rather than historical cost depreciation. The under-recovery for reserved services of $76 million in 2018-19 in Table 8 above is therefore greater than the accounting loss of $26 million before interest and tax reported by Australia Post.[93]

For its ordinary reserved letter service (notified services), Australia Post's PTRM shows an under-recovery of $72 million in 2018-19 and, even with the proposed price increases, further under-recoveries in 2019-20 ($63 million) and 2020-21 ($62 million). The improvement in 2019-20 reflects the benefit of half of the proposed price increase (in January 2020) and a reduction in costs due to efficiencies and volume decline, offset by an expected letter volume decline of 13 per cent. For 2020-21, the recovery reflects the full-year effect of the price increase and further cost reductions, offset by a further letter volume decline of 14 per cent.

For all reserved letter services there was an under-recovery of $76 million in 2018-19, with forecast under-recoveries of $69 million in 2019-20 and $106 million in 2020-21, as shown in Figure 3. The relatively smaller under-recovery of this much broader segment is due to it including the PreSort letter service. However, the under-recovery increases as forecast letter volumes continue to decline by around 9 per cent per year.

[93] The under-recovery is the amount by which Required Revenue exceeds Letters Revenue at proposed prices. Australia Post, updated actual data for 2018-19 provided to ACCC, October 2019. This loss/profit is labelled Contribution in Australia Post's DPN (table 35).

Figure 3. Australia Post's forecasts of key financial data for reserved services, 2019-20 to 2021-22, with actual 2017-18 and 2018-19



Source: Australia Post DPN 2019; Post Tax Revenue Model, August 2019 and updated data provided to ACCC.

Table 9 below provides a high-level summary of the building block components for Australia Post's reserved services.

Table 9. PTRM cost components for reserved letter services ($ million)

	2018-19	2019-20	2020-21
Required revenue (Maximum Allowed Revenue)	1912	1759	1706
Operating costs	1778	1626	1567
Return on asset	33	32	31
Depreciation	87	87	93
Tax expenses	13	13	13
Forecast revenue	1835	1690	1599
Over(under) recovery	(76)	(69)	(106)

Source: Australia Post's financial model.

Table 9 highlights the predominance of operating costs for Australia Post, unlike many other infrastructure providers such as energy, telecommunications, transport and water, which are capital-intensive.

6.3. ACCC view and adjustments

The under-recoveries forecast by Australia Post in its PTRM reflect the forecasts and assumptions on factors such as volumes, costs and rate of return made by Australia Post. The ACCC discussed these factors in earlier chapters of this document. The following considers how alternative assumptions would affect the extent of cost recovery for reserved services. That is, considering whether under-recovery is still likely to occur, assuming the proposed price increases are accepted, on the basis of reasonable alternative assumptions.

Time horizon

One factor that affects the view of cost recovery is the future time horizon. Australia Post has provided public estimates of its PTRM up to 2020-21 – effectively a time horizon of less than two years – although it has also provided high-level forecasts of revenue and costs up to 2021-22.[94]

Setting prices for a longer time period would provide greater certainty to Australia Post and its stakeholders. However, on current trends the under-recovery will grow each year with declining volumes, and the longer the time horizon, the larger would be the immediate price increase needed for cost recovery over the period. The ACCC considers the limited horizon is reasonable in the current circumstances of rapidly changing but uncertain future demand.

Prices

Australia Post's revenue forecasts reflect:

- the proposed price increases in 2019-20, both for notified letters subject to this notification and (smaller) increases for other reserved letters as set out in the draft price notification (DPN)[95], and
- further increases for business letter prices in 2020-21 based on high-level assumptions by Australia Post.

Australia Post submits that no other changes in the basic postage rate have been assumed up to 2020-21.

The ACCC tested the hypothetical increase in the price for notified services that would be necessary to remove Australia Post's under-recovery on notified services. It would require a further increase of approximately 120 per cent in January 2020 to break even on notified services on average across the two years 2019-20 and 2020-21. This reflects, besides the large initial under-recovery and the assumed price increase:

- a reduction in volume due to the price elasticity of letters[96] and therefore an increase in revenue less than proportionate to the price increase
- a reduction in costs due to, but proportionately smaller than, the reduction in volume.[97]

For business letters, Australia Post has committed to single increases each financial year[98] but the specific magnitude of those increases is not yet decided. These prices are not subject to ACCC review or notification, and the actual increase in future years may not be the same as forecast for this notification.

A further significant increase in business letter prices would increase revenue and could invalidate the cost recovery assumptions made by Australia Post and the ACCC for this notification. The ACCC notes that significant variations from the forecasts have occurred in

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[94] For example, Australia Post 2019, table 35, p. 60.

[95] Australia Post 2019, Appendix 1, tables 34-36.

[96] The price elasticity of demand is the percentage change in volume associated with a 1 per cent change in price. A favourable value of minus 0.25 for ordinary letters has been assumed here for scenario testing.

[97] The elasticity of costs with respect to volume is the percentage change in costs associated with a 1 per cent change in volume. A value of 0.3 has been assumed for scenario testing, having regard to short-run estimates by Economic Insights based on data up to 2016, and later cost reductions due to improvements in operational efficiency in letter centres.

[98] Australia Post 2019, p. 13.

the past. For example, actual revenue for reserved services in 2017-18 was 8 per cent above Australia Post's forecast for the 2015 notification, after Australia Post increased PreSort prices twice in 2017 – in January and July.[99] The ACCC has estimated that it would require an average price increase of 9 per cent across all reserved letters (above the proposed increases) to remove Australia Post's under-recovery – that is, to break even across the two years 2019-20 and 2020-21.

Volumes

The ACCC adopted the letter volume forecasts based on Diversified Specifics' demand forecasts, that is, excluding the augmentations made by Australia Post. The reasons for adopting Diversified Specifics' forecasts are set out in chapter 2 of this document. Overall, the impact of adopting Diversified Specifics' volume estimates is to reduce the under-recovery for reserved services by around $14.6 million per annum. This is driven by a slower decline in ordinary letter volumes.

Given some uncertainty over Diversified Specifics' demand forecasts, the ACCC has further tested the effect of a slower decline in volumes forecast. This affects the PTRM through a direct increase in revenues, tempered by an associated downward adjustment to costs based on an assumed cost elasticity of 0.3. Assuming the lower end of the ACCC's alternative range for the rate of volume decline (i.e. 6%), the average under-recovery per year across 2019-20 and 2020-21 is reduced from $88m to $37m.

The ACCC has estimated that the rate of decline in letter volumes would have to slow to around 4.5 per cent per year across all reserved letters to break even across the two years 2019-20 and 2020-21. The ACCC considers this would be unrealistic based on current information.

Costs

In chapter 3, the ACCC considered the efficiency of operational costs forecast by Australia Post. Although Australia Post has made cost savings since the 2015 notification, WIK and the ACCC concluded that further savings were possible.

Sensitivity testing on the PTRM indicates that Australia Post would require an average reduction in nominal costs of 3.4 per cent per year, in addition to the average reduction of 5 per cent currently forecast by Australia Post, across all reserved letters to break even across the two years 2019-20 and 2020-21. The ACCC considers that this level of cost savings is unlikely to be achievable by Australia Post in this time period.

WACC

The ACCC adjusted a number of the WACC input parameters proposed by Australia Post for the reasons set out in chapter 5 and Appendix A of this document. The combined effect of adjusting the parameters was to reduce the nominal WACC from Australia Post's proposed 6.9 per cent to 5.2 per cent. This results in a decrease in required revenue through the return on capital component.

The impact on required revenue is around $7.1 million per annum for reserved services for the combined change in WACC parameters. The effect is relatively small, as the return on capital accounts for only 2 per cent of Australia Post's total required revenue, and would not substantially affect the under-recovery.

[99] Prices for the major regular PreSort categories increased by around 12 per cent across these two increases in 2017.

Combined changes

The changes under the alternative assumptions discussed above were tested separately, holding other factors unchanged in Australia Post's PTRM, and various combinations of input changes were tested.

For example, if the rate of letter volume decline slowed by 2 per cent[100] per year and WACC was reduced to 5.2 per cent, then cost savings would need to be 1.8 per cent greater per year (i.e. nominal 6.6 per cent per year including Australia Post's assumed savings of 5 per cent in the PTRM) for Australia Post to break even on reserved services. While the more conservative forecast of letter volume decline is plausible, the ACCC considers that annual cost savings of 6.6 per cent per annum by Australia Post exceeds a reasonable expectation at this time.

Conclusion

Having regard to the analysis discussed above, the ACCC considers that the expected under-recovery of around 34 per cent of required revenue for notified services (over the forecast period of 2019-20 to 2020-21) is so large that this mail segment is likely to remain in an under-recovery position over the period even with reasonable alternative assumptions on forecasts of costs and letter volumes.

Looking more broadly at all reserved letters, the under-recovery is more marginal, averaging 5 per cent of required revenue over the forecast period. However, the ACCC considers that, given the expected rate of letter volume decline, alternative reasonable assumptions to the forecasts of letter volumes, costs and WACC are unlikely to result in a break-even of costs and revenue for reserved services and less so an over-recovery of revenue. Therefore, the proposed increase in the basic postage rate for notified services, along with Australia Post's accompanying current assumptions about business letter price increases, are unlikely to generate revenue in excess of Australia Post's efficient costs of supplying the notified services.

[100] A slowing in the rate of decline of 2 per cent is equivalent to a decline of 7 per cent per annum – about the mid-point of the alternative range proposed by the ACCC.

Appendix A: ACCC's approach to cost of capital parameters

Market risk premium

The market risk premium (MRP) is the expected return over the risk free rate that investors require to invest in a well-diversified portfolio of assets. It represents the risk premium that investors can expect to earn for bearing only non-diversifiable (systematic) risk. The MRP is common to all businesses in the economy and not specific to an individual business or industry.

Australia Post has proposed, on the advice of VAA, an MRP of 7 per cent. VAA considered that an estimate of 7 per cent is appropriate under 'normal' capital market conditions.[101]

The ACCC considers that the MRP should be estimated based on evidence regarding historical returns above the risk free rate. The ACCC also considers that the majority of evidence in Australia, including evidence other than historical returns, is consistent with an MRP of 6.1 per cent.

This view is consistent with recent ACCC/AER decisions. For example, in the AER's December 2018 Rate of Return Guideline review, it cited a range of evidence in support of a 6.1 per cent MRP including historical excess returns, surveys of investor expectations, and evidence from stakeholder submissions of a declining risk premium both domestically and internationally.[102] This rate was reflected in its recent decision for NSW government-owned electricity distributor Ausgrid.[103]

Therefore, the ACCC's view is that an MRP estimate of 6.1 per cent should be applied in determining the nominal vanilla WACC.

Gamma

In general, the ability of a listed company to pay imputation credits with dividends is taken into account in determining the WACC in order to avoid over-compensation of a regulated business. Since Australia Post's PTRM applies a vanilla WACC, gamma is used to capture all tax effects in the estimation of cash flows and tax liabilities. The revenue allowance to cover Australia Post's expected tax liability is reduced in a manner consistent with the value of gamma.

Australia Post has proposed, on the advice of VAA, that the value of gamma should be zero. VAA argued that since Australia Post, as a government-owned company, does not distribute franking credits and its shareholder does not claim them, a gamma of zero is appropriate.[104]

The ACCC notes that Australia Post and VAA have held this position in previous price notifications and the ACCC has not accepted this position. The ACCC sets gamma with reference to a benchmark for an efficient firm operating in Australia rather than the regulated business' actual financial statements. This is on the premise that the cost of capital should be independent of the regulated firm's ownership structure, it should instead reflect a competitive capital market that is supporting investment in real assets. The ACCC considers that this approach allows the firm to earn a competitive rate of return to encourage investment but not lead to monopolistic pricing while providing an incentive to improve overall performance.

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[101] Value Adviser Associates, *WACC assessment - Reserved Letters Business as at 15 February 2019*, August 2019, p. 13.

[102] AER, *Rate of return instrument, Explanatory Statement*, December 2018, pp. 221–222.

[103] AER, *Final decision, Ausgrid distribution determination 2019-24 – Overview*, April 2019, p. 27.

[104] Value Adviser Associates, *WACC assessment - Reserved Letters Business as at 15 February 2019*, August 2019, pp. 10-11.

The ACCC has adopted a value for gamma consistent with the approach taken in recent ACCC/AER decisions. For example, the AER's 2019 determination for electricity distributor Ausgrid adopted a gamma of 0.585.[105] The AER's decision took an economy-wide approach to calculating the value of gamma, determined as a function of:

- the proportion of imputation credits generated by a regulated firm operating efficiently in Australia that is expected to be distributed to investors[106], and
- the extent to which an Australian investor is able to use imputation credits to reduce their personal tax (or receive a refund).

The ACCC's view is that a gamma of 0.585 be applied in estimating Australia Post's tax liabilities.

Cost of debt

Australia Post has proposed, on the advice of VAA, a cost of debt of 4.6 per cent. VAA has employed this value based on Australia Post's actual cost of debt as computed from the 2017-18 annual audited financial statements.[107]

The ACCC holds the view that the cost of debt should be estimated based on a forward-looking expected cost of debt to the firm, with the cost of debt set with reference to a benchmark business facing similar risks to Australia Post's reserved services. The ACCC considers VAA's method of using an actual cost of debt to be inconsistent with this approach.

Australia Post is currently rated AA- by Standard & Poor's. Standard and Poor's does not separately rate individual component businesses, therefore Australia Post's overall credit rating extends to Australia Post's reserved services. As such, we have estimated the cost of debt using yields on AA rated Australia corporate bonds.[108]

The ACCC has adopted a 10-year AA rated bond yield over a 20 trading day averaging period. The ACCC considers that 10 years represents a trade-off between the long asset lives of regulated assets and better quality of available data for shorter maturities.

On this basis the ACCC considers a cost of debt of 2.14 per cent is appropriate for Australia Post's reserved services.

Gearing

Gearing is the proportion of capital funding sourced through debt as opposed to equity. The gearing level weights the return on equity and cost of debt in the WACC formula.

Where the firm is highly geared (that is, the firm has a high level of debt) and holding all else equal, this implies greater financial risk for the firm and therefore a greater required rate of return for equity holders.

Australia Post has proposed, on the advice of VAA, a gearing ratio of 22.9 per cent. VAA has adopted this ratio based on the book value of debt and equity of Australia Post as at 30 June 2018.[109]

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[105] AER, *Final decision, Ausgrid distribution determination 2019-24 – Overview*, April 2019, pp. 27-28.

[106] The AER in its decision used the dividend imputation rate of the top 50 ASX listed firms as a reasonable estimate for a regulated firm operating efficiently. For further information see: AER, *Rate of return instrument, Explanatory Statement*, December 2018, pp. 308-310.

[107] Value Adviser Associates, *WACC assessment - Reserved Letters Business as at 15 February 2019*, August 2019, p. 5.

[108] The ACCC has obtained its corporate bond yield data from Bloomberg's Corporate AA Bloomberg Fair Value Curve. This curve includes bonds rated AA+, AA or AA- by Standard & Poor's, Moody's, Fitch and/or DBRS. There is no equivalent curve for bonds rated AA- only.

[109] Value Adviser Associates, *WACC assessment - Reserved Letters Business as at 15 February 2019*, August 2019, p. 9.

The ACCC does not accept this approach, noting that gearing is not reflective of the observed proportion of the regulated firm that is financed through debt. Rather, it is the long-term gearing that an efficient firm in the industry would target.[110] The ACCC has adopted a gearing ratio of 19 per cent by observing comparable companies' gearings. We consider that the gearing ratios of the comparable listed companies will most closely reflect the range of operations of Australia Post.

Equity beta

The equity beta measures the 'riskiness' of a firm's returns compared with that of the market as a whole. Equity beta measures how sensitive a firm might be to the systematic risk that affects the overall market. A firm's exposure to these risks depends on its activities and level of financial leverage.

VAA has proposed an equity beta of 0.9. VAA states that it has estimated the equity beta with reference to betas for comparable listed companies that collectively reflect the range of operations of Australia Post. VAA notes that postal services companies have the most comparable operations, but as all listed postal companies are overseas, it has also included Australian logistics companies.

Comparable Companies

VAA includes six international postal companies: Deutsche Post, Royal Mail, PostNL, Bpost, Osterreichische Post and Singapore Post. The ACCC accepts these six companies as comparable; however, we would also add two other publicly listed international postal companies: CTT Portugal and Pos Malaysia. The business activities of these two companies are similar to other international postal companies, as they are broadly exposed to similar operation and financial risks as the reserved services.

VAA includes five Australian logistics companies: CTI, K&S, Lindsay, Qube and Chalmers. The ACCC accepts these companies as comparable; however, we note that transport and logistics are estimated to consist of only 19 per cent of the reserved services' operating cost.[111] In calculating the average beta of comparable companies, the ACCC adjusts the weight on the logistics group accordingly.

VAA also includes Woolworths, stating that its logistics is similar to Australia Post's business. The ACCC does not accept this inclusion, as the comparator set already includes Australian logistics companies and other business segments of Woolworths are not comparable to the reserved services.

The ACCC considers several aspects of VAA's approach to estimating Australia Post's equity beta to be inappropriate. This includes the approach to estimating the equity and asset betas (and associated gearing assumptions) to arrive at a final estimate.

The ACCC does not accept VAA's argument for using adjusted equity betas over raw equity betas.[112] VAA has not provided evidence that Australia Post's systematic risk will revert towards the mean systematic risk of the market over time.

The ACCC gives weight to empirical estimates from comparable listed companies to construct a benchmark beta for Australia Post's reserved services. The ACCC sources an

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[110] Using a firm specific gearing exposes the possibility of firms manipulating their leverage levels to improve their allowed revenues or prices (for example, raising its leverage in order to increase its allowed revenues or prices). The ACCC considers that a benchmarking approach incentivises a firm to efficiently finance its operations.

[111] Economic Insights, *Updated estimates of Australia Post's mail centre and delivery centre cost elasticities*, May 2015, p. 36. Available at: https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2015/draft-price-notification.

[112] The raw equity beta measures the 'riskiness' of a firm's returns compared with that of the market as a whole, and compares the historical returns of the firm against that of the overall market. The adjusted beta is derived from historical data, but modified by the assumption that a security's beta moves toward the market average of one over time.

average of weekly equity betas over a 5-year time period.[113] The ACCC considers that this approach represents a trade-off between a shorter period with most recent data that is reflective of current systematic risk and a longer period with more data that improves accuracy of estimates.

The ACCC has also identified concerns with VAA's approach of using a 'mean of means'[114] for selection of a total reserved services beta, noting that this approach attributes equal weights to each of the comparable sectors. As noted above, the transport and logistics sector reflects a relatively low share of the reserved service's total operating cost. The ACCC therefore applies a weighted average across the two groups to more accurately reflect the comparable companies' contribution to the reserved services' cost structure. The ACCC assigns a weight ratio of 0.84:0.16[115] to the international postal group and logistics group.[116]

Having regard to the analysis above, the ACCC's view is that an equity beta of 0.81 should be applied to Australia Post's reserved services.

[113] The ACCC adjusts the equity beta to use a monthly return interval for the small cap logistics companies (CTI, K&S and Chalmers). The ACCC notes that these firms suffer from the typical nonsynchronous trading problem for estimates of small-stock betas. As a consequence use of weekly data does not necessarily improve the beta estimates for these firms.

[114] The 'mean of means' approach uses a simple average within each group, and then a further simple average across the two groups.

[115] This weight ratio is derived from the break-up of costs across functions in Australia Post's reserved services supply chain estimated in the Economic Insights report.

[116] Economic Insights, *Updated estimates of Australia Post's mail centre and delivery centre cost elasticities*, May 2015, p. 36.