



Australia Post's draft notification – response to ACCC Issues Paper

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Introduction

On 1 August 2019 Australia Post provided the Australian Competition and Consumer Commission (ACCC) with a draft notification proposing to increase prices for its reserved ordinary letter services.

As part of the proposed pricing package, Australia Post is not proposing to increase the price of:

- concession stamps.
- seasonal greeting card stamps.

Additionally, the price of the priority label will remain at 50c.

This document has been prepared by Australia Post in response to the Issues Paper released by the ACCC in August 2019 and is provided for the benefit of the ACCC, in assessing Australia Post's draft notification.

This document reinforces and / or supplements information contained within the draft notification.

Australia Post will review submissions the ACCC receives in response to the Issues Paper and may provide additional documentation to the ACCC to address specific issues that are raised.

Australia Post's proposed price increases

1. Considering the factors outlined by Australia Post in its submission, do you consider the proposed price increase is justified? Please explain the reasons for your view

The proposed price increases, along with the efficiency savings outlined in the draft notification, reflect a balanced approach to ensuring a sustainable letter service.

The proposed price increases are the first change to ordinary letter prices (including the basic postage rate) since January 2016. Since then letter volumes have declined by 820m and delivery points have increased by over 700,000.

As part of the proposed pricing package, Australia Post will maintain the existing price of:

- concession stamps – will continue to be available to over 5.7million eligible Australians at the same rate since 2010 (60 cents per stamp).
- seasonal greeting card stamps – will continue to be available during November and December at the same rate since 2014 (65 cents per stamp).
- the priority label – will continue to be available at the 2016 rate of 50 cents.

Australia Post estimates the average household sends around 10 and 20 letters per year. Within this average:

- for households that have taken up the concession stamp offer and use either the Regular or Priority delivery timetable, the price changes have no impact.
- for households that have not taken up the concession stamp offer, or who are not eligible, the impact will be between zero and \$2 per year depending on the proportion of letters they send that are seasonal greeting cards.

At these average usage levels, Australia Post believes the proposed prices are modest and reasonable.

Furthermore, when compared to other OECD countries, at \$1.10 Australia Post's proposed basic postage rate would be the second lowest of countries that offer choice of delivery speed and fourth lowest overall.

In this context, compared to other OECD countries, Australia Post believes the proposed prices are reasonable.

The proposed prices are part of balanced approach that also includes strategies to slow the rate of volume decline and manage network costs (costs of reserved letters decrease by \$161m over the two years to 2020/21). As detailed in the draft notification, even with these strategies and the proposed price increases, the reserved letter service will not make a profit in 2019/20 or 2020/21.

Letter volumes

2. Do you consider that Australia Post's forecasts of declining letter volumes are reasonable?

Australia Post has committed to a structured and comprehensive approach to forecasting letter volumes in conjunction with Diversified Specifics for a 19-year period. Over that time, the methodology applied to the forecasting effort has resulted in a set of forecasts that are premised upon leading edge econometrics combined with sensible overlays of additional off-model intelligence. Importantly, Australia Post's long-standing investment in these techniques has resulted in a proven level of success when attempting to forecast and understand letter volume against the challenging backdrop of a letter market subjected to considerable pressures from a range of digital alternatives.

Australia Post's peak mail volume years was 2007/08. However, the global financial crisis of 2007/08 marked a fundamental change in letter volume demand for Australia Post. When confronted with a profit squeeze there was a greater propensity for firms to concentrate on economising their transaction costs; the costs of doing business. As a result, businesses became more likely to pursue push and pull strategies¹ that cultivated the emergence of digital platforms on the bill presentment (invoices and statements) side of a transaction.

This phenomenon provided further impetus to the already problematic letter volume declines and reflects a common trend across all postal industries worldwide where peak letter volumes were realised years ago (US in 2001, France in 2004, Canada in 2006 and the UK in 2005)².

Since, 2007/08, the volume of addressed letters sent in Australia has fallen by over 48%. Within this, reserved ordinary / other letters, which include the reserved ordinary letter service (of which the basic postage rate represents 23% in 2017/18), has fallen by over 60%.

Australia Post forecasts that out to 2021/22, addressed letter volumes will decline by an average of 9.5% and reserved letter volumes by 9.4%.

Australia Post's approach to determining its letter volume forecasting is consistent with that accepted by the ACCC previously and that used in price notifications since 2010.

That is, the econometric modelling work applied to Australia Post's historical volumes acts as the baseline upon which further management intelligence and insights may be overlaid to counter a lack of tractable empirical data on emerging threats to letter volumes.

¹ These strategies include initiatives that impose a cost on the recipient for receiving a bill or statement via the mail or only providing the option of an electronic statement with new product or service offerings.

² Canada Post Corporation, Summary of the 2019 to 2023 Corporate Plan, p.18, See <https://www.canadapost.ca>

2(b) Do you consider that the rates of decline in letter volumes as outlined in table 5 would vary across different letter segments/services?

All postal authorities worldwide are confronting similar issues underlined by the forces of electronic substitution impacting different letter volume segments at different speeds and at different times. Indeed, these patterns of technological diffusion also vary by country limiting Australia Post's ability to leverage completely off the intelligence of other postal authorities for an exact quantification of these effects.

Any methodology that seeks to isolate the impact of price effects on letter volume erosion must therefore be a function of a robust and tested framework that captures and quantifies these substitutive trends accurately. The approach that Australia Post has adopted, acknowledges this variety of substitutive pressures which are emphasised by the following insights across each of the key letter volume product streams.

The rates of decline within the Ordinary / Other segment (individual mailings to other individuals or businesses and non bulk business to business and business to household mailings) have been evident for many years.

Within this segment substitutive pressure arose with the proliferation of the internet and email platforms which enabled individual senders to communicate using a broader array of options beyond the physical letter alone. In the Ordinary / Other small letter sub-segment this tended to reflect an increased willingness to settle bill payments via online based platforms or over the phone rather than simply posting a cheque.

In the Ordinary / Other large letter sub-segment the physical exchange of documentation such as contacts and legal paperwork have tended to be replaced by electronic transmission with email growth facilitating this trend.

PreSort letters are typically high-volume lodgements from businesses that are transactional or promotional – both of these can be impacted by different factors.

In the post global financial crisis era businesses have decreased their usage of PreSort small letter bill presentment and statement related mailings in their attempts to rationalise or consolidate their mailings. Moreover, the major mailers have introduced a range of carrot and stick approaches to change recipient behaviour and gain a wider acceptance of bill presentments via their online platforms. The broader discussion as to the bill recipient's right to choose how their bill is presented without incurring a penalty is topical.

PreSort large letter volumes have also experienced declines as legislative changes surrounding the requirements to post annual reports have undergone change whilst other glossy publications can also now be provided in an online medium.

Print Post articles are publications such as magazines and catalogues. This segment is impacted by electronic alternatives to print based options; whether the magazines are purchased from a retail outlet or via subscription. Declines in this category are reflective of general trends within the magazine and publication industries where subscription and circulation rates have declined worldwide.

3. Do you consider that there are new and/or undeveloped areas of the letter business that have the potential for growth given more targeted pricing and promotion?

Australia Post is committed to exploring opportunities and ideas that either sustain mail or realise new opportunities for mail across the domestic letter portfolio (reserved and non-reserved).

Australia Post aims to achieve this through two approaches:

- working with supply chain partners, industry representatives and industry associations to identify and execute opportunities to sustain mail volumes and maintain the relevance of mail.
- account management teams and dedicated product specialists working with customers to identify opportunities where mail can either be used as part of the customer's advertising mix or as part of any broader customer communications activity.

As a result of this approach there have been a number of initiatives covering promotional activity and changes to the letters product portfolio that include:

- Campaign Targeter – a free online mapping tool which organisations can use to more easily identify and develop mail campaigns for their target markets. Campaign Targeter has a range of demographic and geographic data to assist in better targeting campaigns;
- Print Post personalisation – an enhancement that enables senders to incorporate content specific advertising information to improve the value and effectiveness of the publication being sent;
- partnering with and supporting industry bodies to execute marketing programs that protect and proactively promote mail as a valued and effective communication channel;
- trialling large letter sizes (small plus and large) for Promo Post to assess customer take up and effectiveness;
- introducing trials and incentives to encourage organisations to test promotional mail;
- introducing enhanced tracking and reporting capability for Registered Post articles which significantly improves the customer experience for Registered Post users;
- trialling the Domestic Letter with Tracking product which provides customers with the option of tracking (no signature) their domestic letters;
- introducing a new contract category for Print Post and printed matter articles up to 2kg;
- introducing new volume categories for Acquisition Mail, effectively making it available for any volume; and
- enhancing the Unaddressed Mail booking system to improve the customer experience by allowing more categories of Unaddressed Mail to be booked online by the customer.

4. Diversified Specifics' modelling suggests that prices are not a major driver for declines in letter volumes and declines are driven by electronic substitution. Do you agree? If not, why not.

The key long run statistically significant letter volume drivers identified through the Diversified Specifics research are electronic substitution and price.

Of the statistically significant drivers contained within the Diversified Specifics models, electronic substitution is substantially more potent than price as an explainer of the underlying downward letter volume trends. Further, this modelling has consistently found price to be inelastic.

This should not detract from the economic significance of letter volume drivers that are crowded out by the dominant effects of electronic substitution such as population growth, letter delivery service performance and the level of economic activity. Nor should shocks to the system be ignored.

That is external factors arising from events, such as the global financial crisis in 2008/09 or one-off mailing occurrences. Such events may have an impact on the future state of letter volumes that fall outside of the drivers detected within the econometric models. In these cases, measurements on such variables may not have exhibited the requisite variation for formal inclusion within the modeling framework or, in the case of events, may not have been previously encountered over the period the statistical models have been developed. It does not however, diminish their economic significance.

If senders were solely seeking to migrate away from the physical letter item based purely on a cost that favors the digital alternative, then they would have already ceased any form of letter usage long ago.

This is because the net cost differential to the sender will always favor the digital alternative whatever the magnitude of an increase in the basic postage rate. That is, the marginal cost of mailing a physical letter will always be positive whereas for the mature digital channels, at the margin the cost of communicating a message generally approaches zero. The reality is senders instead base their decisions about their preferred communication channel upon not only price but also a range of non-price factors including security, habit, convenience, reliability, promotional effectiveness and trust.

The letter has an intrinsic value in multiple non-price dimensions that the digital platforms are continually attempting to resolve and as they do it results in a further deterioration of letter volumes independent of price. This does not imply that letter prices can be increased *ad-infinitum* without any deterioration in demand however it does assist in explaining the inelastic set of letter prices as estimated by Diversified Specifics and the dominant threat of the digital alternatives to the traditional letter item.

5. Is Australia Post's approach to augmenting Diversified Specific's econometric forecasts appropriate, and does it provide more accurate forecasts for letter volumes?

As detailed in Australia Post's draft notification, Australia Post's approach to letter volume forecasting is consistent with that accepted by the ACCC previously and that used in price notifications since 2010.

That is, the econometric modelling work applied to Australia Post’s revenue based volumes acts as the baseline upon which further intelligence may be overlaid to counter a lack of tractable empirical data on emerging threats to letter volumes.

This additional information includes the trends identified within Australia Post’s internal systems; including customer charge account data (i.e. trend by specific customers and industries). This information can show industries are in different stages of developing alternative communication strategies as well as customers that are likely to respond positively to expected ‘one off’ events (e.g. the ABS census). These management insights are also used in the setting of internally agreed targets and form part of Australia Post’s overall planning process (for both revenue and costs) and the development of its Corporate Plan.

As the methodology deployed at this price notification replicates that of the 2015 price notification, a direct comparison between the actual movements in total letter volumes can be made with the econometric forecasts against those that contain the Australia Post overlays using the forecasts generated within the 2015 price notification.³

The table below uses the starting point of 2013/14 (the year that Diversified Specifics used in the development of its projections and which was an actual volume) and compares it to total volumes in 2017/18 for actual, projected and forecast.

	2013/14	2017/18	4 year CAGR	Variation to Actual
	m	m		m
2013/14 Forecast volumes	3191			
2017/18 Actual volumes		2,090	(10.4%)	
DS projected volumes by 2017/18		2,248	(8.4%)	158
Forecast volumes in 2015 draft notification		2,104	(9.9%)	14

This process of overlaying the additional intelligence upon the econometric models was deemed an essential final step in the forecasting process as advised by Diversified Specifics in their 2015 final report. The outcome of the adjustments led to Australia Post slightly under-estimating the actual letter volume decline.

The Australia Post methodology that combines off-model intelligence with the econometric baseline is an intuitively sound approach that is proven to deliver the most accurate set of forecasts. Baseline projections derived from empirical data are likely to become obsolete over time. There will always be a need to overlay further information upon the baseline projections particularly when confronted with rapid technological change.

³ Comparisons at an individual letter product level are complicated by a number of factors including the closure of some letter product services and the introduction of others.

The econometric model may not fully recognise trends in their embryonic stage that are likely to impact letter volumes in future periods. Moreover, the econometric forecasts alone also do not consider future mailing events Australia Post may have a prior awareness of, so the process of overlaying additional intelligence reflects a responsible adjustment to such knowledge gaps.

Reforms and operational efficiency

6. It appears that Australia Post has achieved certain cost efficiencies in its letter business by reforming mail processing and delivery. Have Australia Post's reform efforts to date been sufficient and in line with earlier commitments? Is Australia Post's progress so far comparable to international benchmarks?

Australia Post has a broad spectrum of initiatives and programs that support network cost containment and productivity targets.

These range from efficiencies at the local level to achieve plan and budget targets through to national programs to re-engineer network processes.

Specific to Australia Post's reform efforts, as detailed in the draft notification, Australia Post will achieve a higher than forecast benefit from the extension of the major reform program (Reform out Letter Service – RoLS) to the One Network program of work.

Compared to the original forecast RoLS benefit (detailed in Australia Post's draft notification of 2015) the forecast benefit is now circa \$13m higher.

Australia Post believes this was an extremely good outcome given the inherent challenges in delivering a program like RoLS: a complex five year change program across Australia Post's processing and delivery function (encompassing the majority of operational costs for reserved letters). The multiyear change meant the environment was not static with continued growth in delivery points (increasing by more than 700,000) and continued change in product mix (within letters and between letters and parcels). Furthermore, over this period of change, Australia Post continued to meet its statutory delivery performance requirements of delivery at least 94% of letters within the published timetable

Producing comparisons against international postal peers is extremely difficult.

Meaningful benchmarking requires detailed disaggregated data to provide a consistent data set to enable like-for-like analysis. This information is generally not publicly available, and is considered confidential. Using only publicly available data, severely limits the accuracy of any comparison.

The difficulty in making accurate comparisons between countries is further complicated due to the differences in:

- local economic environments that drive different changes in costs - particularly labour and revenue (for example, Australia's wage environment post-GFC was much stronger than Europe or America);
- governing legislation and community service obligation requirements;
- efficiency baselines, when measuring efficiency of defined time periods;
- mail densities (mail volume per delivery point) and
- customer densities (delivery points per km of route length); and
- commercial profiles of the postal businesses beyond their core letters business and how this is segmented / reported (for example, the provision of financial services, parcels business, acquisitions and divestments).

When Australia Post has sought to undertake this type of analysis previously (2009 and 2012 – see below) we have had to engage an independent consultant to manage it and they have been required to give confidentiality undertakings to each participating postal operator before they would participate.

International Benchmarking Studies

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

In response to this, in late 2008, Australia Post, commissioned Economic Insights Pty Ltd to undertake an international benchmarking study, the outcome of which would be provided as part of a future price notification.

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

The study covered the period 2002 to 2009. The study concluded that:

‘Australia Post has shown the most consistent improvement in total factor productivity (TFP) of the seven⁴ postal services reviewed. Importantly, Australia Post improved its ranking when formal, statistically based adjustments were made for differences in mail and customer density with its TFP level being ranked first or second after the adjustments were made.’

In late 2011, Australia Post commissioned Economic Insights to update and extend the 2009 study. Additional postal services were invited to participate (including Germany, France and the United Kingdom), however, as not all were able to accept the invitation, five⁵ postal services were reviewed. The output and input categories were the same as in the 2009 study.

As productivity performance is influenced by the operating environment conditions to allow like-with-like comparisons of performance, it is necessary to adjust for the most important operating environment conditions to put the services on a relatively even footing.

For postal services two of the most important operating environment differences are mail density (mail items per delivery point) and customer density (delivery points per kilometre of route length).

On an unadjusted basis, Australia Post ranked second in terms of TFP. However, when the adjustment was made to take account of both mail and customer density differences, Australia Post improved its relative position from second to first.

⁴ Australia, Canada, Denmark, Italy, Japan, New Zealand and the United States

⁵ Australia, Canada, Chile, Denmark and New Zealand

7. What is the likely remaining scope of efficiency gains of the reform measures? Over what time period do you believe they will be realised?

The RoLS Program was developed in 2014. At that time, the focus was on establishing a sustainable operating model in the letters business.

As the RoLS program of work progressed towards achieving its targets, Australia Post determined that pursuing a more integrated letter and parcel network would ensure benefits would continue to be pursued (and achieved) beyond the RoLS program of work.

Following the development of the One Network Program, the combined benefit from the RoLS Program to date plus changes to the original delivery strategy as part of the One Network strategy program of work will now realise a higher benefit by 2018/19 than through just the RoLS Program.

Australia Post's 2018/19 Corporate Plan details business efficiency benefits of \$200m per annum through to 2021/22 to be achieved from enterprise efficiency initiatives including the One Network strategy program of work.

8. Are there any other specific areas where Australia Post can seek to improve its operational efficiency?

Australia Post has a long history of pursuing and achieving operational efficiencies and asserts its cost base is efficient. This is evidenced by a recent independent review of Australia Post's total factor productivity (TFP) by Economic Insights Pty Ltd.

TFP measures output growth compared with the change in all inputs overcoming issues of interpretation that arise with single (partial) factor productivity results.

The report shows that Australia Post has been able to maintain TFP growth for both Australia Post in total and the reserved letter services over the longer term;

- for Australia Post as a whole, TFP grew by an average of 1.7% per annum over the last 28 years (from 1992 to 2019). In the last five years TFP grew by an average of 0.9% per annum
- for reserved letters, TFP grew by an average of 2.5% per annum over the last 23 years (from 1997 to 2019). Over the period 2013 to 2019, TFP grew by an average of 1.5%

The report concluded

“Given that Australia Post's reserved services mail output has fallen substantially since 2008 and to such an extent that the negative impact has outweighed the impact of increasing delivery point numbers on total functional output, being able to outperform the productivity performance of the economy as a whole has been an impressive achievement.” (page 35)

Costs of reserved letter services

9. Australia Post has forecast that it will be able to reduce its trading costs for reserved letter services by around 16 per cent over the period 2017-18 to 2021-22, resulting in a cost reduction of \$296 million over the four years. Is Australia Post's forecast cost reduction and efficiency improvement comparable with that which would be expected under best international practice?

As detailed in Australia Post's draft notification, efficiency benefits from the RoLS Program and One Network strategy program of work will be over \$336m by 2018/19.

Beyond this period there is a further \$200m per annum target efficiency benefit allocated across the business. The programs to deliver these efficiency benefits are one of the key reasons why reserved letter costs are forecast to reduce in actual terms – despite increases to input costs.

Australia Post's reserved service is not operated as a separate network but as part of the overall Australia Post network. The network is principally made up of four functions; sales & acceptance, transport, processing and delivery. All of these functions will support the delivery of both reserved and non-reserved items – no function or process just supports reserved letters.

Cost allocation

10. What are your views on Australia Post's proposed method of cost allocation? Are there any other cost allocation issues that the ACCC should be considering?

As detailed in Australia Post's draft notification of August 2019, Australia Post uses an enterprise profit model (EPM) to calculate the operational cost for 'reserved' and 'non-reserved' services provided by Australia Post.

The model is a fully absorbed costing model and allocates costs to products and services via the following guiding principles:

- all products and services are to be charged appropriately with the costs of the enterprise;
- Activity Based Costing is used as the appropriate cost allocation methodology;
- the Activity Based Costing model identifies resources costs from the general ledger and assigns these costs to activities, these activities are then assigned to products and services primarily according to consumption.
- direct attribution of costs to products is conducted, wherever possible; and
- miscellaneous revenues, unrelated to a product or service, are treated as miscellaneous, with any associated costs allocated to them.

Australia Post continually reviews its EPM in line with business changes to ensure it reflects the fundamentals of the business. This includes the allocation of non-operational (e.g. support) costs to the appropriate operational functional areas, allocation of operational costs reflective of operational procedures change (e.g. as manual labour is replaced by an automated process).

11. Have Australia Post sufficiently responded to the concerns identified by the ACCC and WIK in 2015 concerning the CAM, including the level of granularity applied to activities and factors to reflect changes in processing activities?

Australia Post is confident it has responded to concerns identified by the ACCC and Wik in 2015.

Following the Wik Review there have been a number of updates to the (fully distributed) cost allocation model impacting the way costs are allocated between reserved and non-reserved services. For example, Australia Post undertook the Delivery Cost Review which encompassed over \$2b of Australia Post's almost \$7b cost base.

Outcomes of the Delivery Cost Review included:

- the disaggregation of the previous 30 delivery processes and activities to 270 activities which not only detail the operational environment, but also make important time and effort distinctions associated with products travelling through the Delivery Channel (e.g. Parcel Delivery Officer, Parcel Delivery Contractor, Street contractors, Roadside contractors), and the Delivery round type (e.g. walk, push bike, electric bike, motor bike).

- different categories of cost – particularly volume and non-volume-driven cost with relativities that better relate to the causal nature of each. For example, the time taken to scan or sort different products vs the equal relativity of fixed travel cost based on required service standard.
- a shift in costs from indoor to outdoor reflecting the savings made indoor, for example on mechanised sequencing, and the continuing increase in outdoor costs resulting from increased network scope (mainly due to more delivery points).
- Delivery Processes, Activities and Factors:
 - Are detailed by delivery channel and delivery type.
 - Are more detailed – eliminating the need for Gen Weight One (GENWGT1).
 - Have been documented including process maps and volume flow diagrams.

Weighted average cost of capital

12. Are the WACC parameters proposed by Australia Post for its reserved services (including a MRP of 7.0 per cent) consistent with an efficient benchmark cost of capital commensurate with the risks faced by Australia Post?

Australia Post adopted the Value Adviser Associates estimated Weighted Average Cost of Capital (WACC) parameters per their 'Reserved Letters Business WACC Assessment' Report (February 2019).

The Australia Post WACC represents the after-tax opportunity cost to investors to finance Australia Post's operations, taking into account the relative weighting of Australia Post's debt and equity in its overall funding mix.

The WACC takes into account the return investors require or expect to compensate for:

1. the time value of money (the risk free rate); and
2. risk premiums associated with Australia Post's operations by reference to the returns of companies with comparable size and market risks (equity risk premium) and credit ratings (debt risk premium).

Advice from Value Adviser Associates is that an MRP of 7.0% is appropriate at this time and is in line with a large body of evidence supporting an MRP estimate in the range of 7.0-7.1% under 'normal' capital market conditions.