Draft Price Notification
Changes to Australia Post's Ordinary Letter Service

August 2015

Glossary of Terms

ACCC	Australian Competition and Consumer Commission
APC Act	Australian Postal Corporation Act, 1989
APSS	Australia Post Superannuation Scheme
BCG	The Boston Consulting Group
BCS	Barcode Sorter Machine
CFCP	Culler, Facer, Canceller and Preparation Machine
CPI	Consumer Price Index
CSO	Community Service Obligations
D/D+E	Debt over Debt plus Equity
FTE	Full Time Equivalent
FSM	Flat Sorting Machine
GST	Goods and Services Tax
LPO	Licensed Post Office
MLOCR	Multi Line Optical Character Reader
MRP	Market Risk Premium
NDM	National Delivery Model
NCAU	Network Cost Allocation Update
OECD	Organisation for Economic Co-operation and Development
PDF	Portable Document Format
PPS	Prescribed Performance Standards
PSR	Postal Services Review
Q1, 2, 3, 4	Quarter 1, 2, 3, 4.
RKR	Record Keeping Rules
RoLS	Reform our Letter Service
VECM	Vector Error Correction Model
WACC	Weighted Average Cost of Capital
WPI	Wage Price Index

Context

On 3 March 2015 a joint release by Hon Malcolm Turnbull, Minister for Communications and Hon Mathias Cormann, Minister for Finance announced that to support a more sustainable letter service, with the aim of breaking even, the Australian Government had approved Australia Post's request to introduce a two-speed letters service (Regular and Priority) and that the price of Regular letters would be overseen by the Australian Competition and Consumer Commission (**ACCC**) (Appendix 1).

The release also noted:

- The introduction of this service would be 'no earlier than September 2015';
- To support the sustainability of the letter service, Australia Post would apply to the ACCC to increase the Regular stamp price from $0.70 to $1.00;
- Australia Post would continue to deliver mail five days a week to 98% of addresses;
- The concession stamp (available to 5.7 million Australians) would be frozen at 60 cents; and
- The seasonal greeting card rate would be frozen at 65 cents.

Consistent with the announcement by the Australian Government, effective 4 January 2016, Australia Post proposes to introduce product and price changes that give all Australian consumers a choice between a 'Priority' letter service (delivered according to the existing delivery timetable) and a 'Regular' letter service that will be delivered to a slower delivery timetable.

1. Executive summary

Australia Post is lodging this Draft Price Notification (notification) following the introduction of the most significant regulatory reform of Australia's letter service in more than 20 years. Central to the reform, is the introduction of a two-speed letter service that gives Australian consumers a choice between a 'Priority' letter service (delivered according to the existing delivery timetable) and a 'Regular' letter service that will be delivered to a slower delivery timetable.

Australia Post is proposing to introduce this two-speed letter service along with changes to letter prices on 4 January 2016. These changes follow the successful introduction of an extended two-speed letter service for Australian business letter services in June 2014.

Australia Post's letters business operates in a substantially different market environment than that of 10 years ago. The advance of digital communications technology and mobile devices have led to the rapid substitution of letters as a form of communication. Australian letter volumes peaked in 2008 and have fallen steeply since. In the six years since 2008, the volume of addressed letters sent in Australia has fallen by 25.3 per cent.

Simultaneously, Australia Post's nationwide delivery network has expanded to provide coverage to Australia's growing population and to meet its community service obligations (**CSOs**). From 1993/94 to 2013/14, Australia Post's delivery network expanded by around 50%, to 11.2m delivery points. This increased delivery workload has caused increases in Australia Post's cost base.

In the context of these persistent market pressures, Australia Post has embarked on a major business transformation program, called 'Reform our Letter Service' (**RoLS**). The RoLS Program was developed following a review of Australia Post's business in 2013, and involves a portfolio of changes to reduce network costs and maintain service levels, while providing Australians with more choice.

Therefore, the broader context for this notification is that Australia Post is continuously striving for efficiency gains while meeting its CSOs, but is attempting to achieve this at a time when the community's reliance on letters continues to decline.

In addition to meeting its CSOs, the letters business also needs to operate as a self-sustaining business. Over recent years, Australia Post has sought to achieve financial sustainability in the letters business without extensive price increases and, instead, relying primarily on cost reductions. However, given the current market context, it is now becoming impossible for Australia Post to maintain its position as a sustainable, world-class letters business.

While the proposed prices do not cover the efficient cost of providing the notified services e.g. reserved ordinary letter services they reduce the loss that Australia Post incurs and as such assist Australia Post's objective of providing a sustainable world class letters business.

Australia Post is required to notify the ACCC of proposed changes to its notified services. Australia Post's notified service is the reserved ordinary letter service which comprises three price points:

- The uniform rate for an ordinary small letter (the basic postage rate); and
- Two large letter prices.

While under the Declaration, only 16% of domestic reserved letter volume comprises the 'notified' component, Australia Post is providing detail on some of the other domestic letter price changes, as this will assist the ACCC in understanding the need for the ordinary letter prices to be increased.

This notification acknowledges and addresses the specific issues raised by the ACCC in previous decisions on Australia Post's letter prices. In particular, Australia Post now employs a more sophisticated cost allocation model.

Financial data in the document is based on Australia Post's 2014 Corporate Plan. However, given the proposed date of effect of the price changes is six months later than originally projected and the size of the increase is different, volume and revenue information have been updated along with a further review of the costs to reflect these changes.

To assist the ACCC in its assessment, Appendix 8 provides a reconciliation between the financial targets in the 2014 Corporate Plan and the new financial targets as a result of the proposed pricing and timing changes.

2. Introduction

The Australian Postal Corporation Act, 1989 (**APC Act**) prescribes that Australia Post is required to supply a letter service that is reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business.

Under the APC Act, Australia Post has the exclusive right to collect, carry and deliver letters within Australia that (subject to exceptions) weigh not more than 250 grams. These statutory monopoly services, along with the right to issue postage stamps, are termed Australia Post's 'reserved services'.

Australia Post's CSO under the APC Act is to provide a letter service. A CSO is a government requirement for a service provider to engage in non-commercial activities to meet affordability and access objectives.

The commonly agreed definition of a CSO[1] adopted by Australian governments is:

> '*A community service obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other business in the public or private sectors to generally undertake, or which it would only do commercially at higher prices*.'

Australia Post's CSO has traditionally been funded by an internal cross-subsidy from within Australia Post's reserved letter service. However, revenue from the reserved service has not been sufficient to meet the cost of meeting the CSO since 2007/08. This is an unsustainable position for Australia Post as losses from the reserved letter service will eventually overtake profit from the non-reserved areas of the business.

Since 2004, the ACCC has assessed annually whether or not Australia Post is cross-subsidising from reserved services to the services it provides in competition with others.

In April 2015 the ACCC released its tenth report. The report noted that since 2009/10, Australia Post's reserved services have been a potential recipient of a subsidy, from non-reserved services within Australia Post, and that in general, the cost recovery of reserved services has been declining together with letter volumes.

As noted in the 3 March 2015 joint release, the Australian Government's position is that the letter service be '…a more sustainable letters service with the aim of breaking even over time.'

The challenge is balancing the need for Australia Post to be financially sustainable (not a drain on the public purse) and to continue to meet the requirement of its CSO.

2.1. The case for change

Changes in technology and consumer behaviour are driving a decline in letter volumes in Australia. Over the period 2007/08 to 2013/14 total domestic reserved letter volumes have fallen by over 25%.

The challenge of how to continue to provide a universal letter service in an environment of ongoing decline from a largely fixed cost network base is not unique to Australia Post. Operators worldwide are following a balanced approach of restructuring their operations to lower cost with appropriate levels of price increases.

[1] Steering Committee on the National Performance Monitoring of Government Trading Enterprises 1994, page xi

Royal Mail, has focused on increasing operational efficiency with initiatives such as improved mail sequencing and sorting automation and optimising delivery routes across the UK. In October 2011 a price cap on the majority of products and services including 1st Class mail was removed. Currently, there is no official limit on how much the former state monopoly can raise stamp prices by or a cap on how many times prices can be increased each year.

A 'safe-guard' direct price cap will remain for 2nd Class standard letters, 2nd Class large letters, and standard packets up to 2kg. Only circa 5% of revenue is now subject to direct price control. Before 2012, more than 80% of Royal Mail revenues were directly price controlled. Since March 2012, 1st Class mail prices have increased by 35% and 2nd Class mail prices by 47%.

Canada Post is consolidating the sorting of mail and parcels into plants with the highest concentration of cost-effective high-speed automated sorting equipment to reduce costs.

In March 2014, Canada Post introduced a new tiered pricing structure for domestic stamped mail, to better reflect the cost of serving various customer segments. Under these changes, the majority of Canadians, because they buy stamps in booklets or coils, will pay $0.85 (CAD) per stamp, representing a 35% increase over the 2013 stamp price. The minority of consumers who purchase stamps one at a time will pay $1.00 (CAD) per stamp.

Postal operators in Sweden, Norway, Denmark and Portugal continue to focus on streamlining and rationalising operations, optimising delivery routes, increasing round sequenced automation and sorting efficiency and integrating mail, express and parcel networks.

Sweden, Norway and Denmark, where letter volume declines have been steep, are pursuing changes to their regulatory framework to have greater freedom to adapt to rapid changes in customer requirements and demand. Stamp prices in Sweden, Denmark and Portugal have increased between 10% and 17% over the past year.

The New Zealand government has agreed to allow New Zealand Post the flexibility to reduce mail delivery services to as little as three days per week in urban areas since July 2015. New Zealand Post is not currently subject to any price caps.

In 2013 Australia Post was asked to undertake a review on the options available for change to ensure Australia Post's financial sustainability and in October 2013, Australia Post submitted the Postal Services Review (**PSR**) Shareholder Statement.

The PSR identified that Australia Post was at a critical turning point and although widespread business change and cost reduction initiatives had been implemented successfully over the past four years, without substantial change, the losses associated with the letter volume decline will threaten the future financial health of Australia Post.

To address this situation and protect the unique role Australia Post plays in connecting communities and the PSR recommended a program of changes (the 'what') to address changing customer behaviour that included:

- Aligning product and prices with changing customer needs and cost to service through the introduction of a two-tier service model for the delivery of letters
- Encouraging migration from the Priority delivery timetable to the Regular delivery timetable; and
- Reducing the costs of operating the network.

While it is incumbent on Australia Post (from a community service perspective) to continue delivering the nation's physical letters service, it is also necessary (from a commercial perspective) to secure the sustainable delivery of this declining service.

Independently, in March 2014 the Departments of Communications and Finance engaged The Boston Consulting Group (**BCG**) to validate Australia Post's planning assumptions. Their findings were generally supportive. The outcome of that review is in Section 2.3.

2.2. Reform our Letter Service

Since the submission of the PSR, Australia Post has continued to develop plans for implementing reform in the letters business (the 'how').

Over the past 18 – 24 months, a range of opportunities for reform have been identified and presented to the Australia Post Board noting that each opportunity has:

- Differing stakeholder implications and approaches required to manage the need for reform;
- Significantly different risk profiles for the organisation; and
- A range of economic outcomes and staff implications.

When the Australia Post Board agreed on the most appropriate options to support the sustainability of the letters business, a high level design document and a detailed design document of the future operating model of the letters business were commissioned.

These documents identify a series of inter-related and connected projects to be managed under the RoLS Program; however realising the benefits is dependent upon securing Government support to the proposed changes in the PSR.

The key objective of the RoLS Program is to implement the changes required to reduce Australia Post's network costs while providing customers with choice and maintaining service levels in an environment of structural letter volume decline.

These inter-related projects include:

- Extend the two-speed product offer (the Broad Based 2 Speed Letter Service);
- Maximize the volume of letters processed during the day;
- Increase the level of automation;
- Implement a National Delivery Model (implementing a service aligned delivery model); and
- Optimise the network of delivery facilities.

Detail on each of these projects is in Section 6

Successful execution of the RoLS Program relies on managing the sequence of the projects and co-ordination with customer behaviour as changes are implemented. There are clear dependencies that exist to realise the full benefits of the RoLS Program:

- The starting point is a shift in customer behaviour to sending letters according to the Regular delivery timetable. This provides more time and greater flexibility as to when letters need to be processed;
- Increasing the use of current mail processing equipment, in particular to increase the volume of sequenced mail in the short term; and
- Implementation of new mail processing equipment to further increase the level of automation and to ensure the efficient mail flow of the Priority and Regular product.

These inextricably linked projects are the foundation for the key elements of the RoLS Program.

Figure 1 shows the dependency between the projects and the need to execute them in a structured, sequenced manner. These projects are forecast to deliver circa $262m of benefits by 2017/18.

Figure 1 – High level RoLS blueprint

2.3. Independent review

The Departments of Communications and Finance, as joint shareholders of Australia Post, engaged BCG to assess Australia Post's PSR and the need to reform the letter service.

BCG's key findings[2] were as follows:

> *'Overall, BCG agrees that the strategic assumptions underpinning Australia Post's case for postal reform are valid, and reform to the letters business is urgently needed.'*
>
> *'Without reform, letters losses will soon overwhelm parcel profits. By our estimates, this will result in a total cumulative deficit of $12.1 billion for the letters business over the ten years from FY13/14 to FY22/23.'*

2.4. Australia Post Corporate Plan 2014/15 – 2017/18

Consistent with the PSR the 2014 Corporate Plan models two scenarios; with and without changes (reform) to highlight the financial necessity of the changes proposed.

The 2014 Corporate Plan reform scenario includes:

- Introduction of a broad based two speed offer from July 2015;
- Pricing that minimises the loss on letters and continues to encourage migration to the slower (Regular) delivery timetable service; and
- Realisation of the benefits identified as part of the RoLS Program.

This reform scenario has continued to be refined and is the foundation upon which this notification is based.

[2] Australian and International Postal Services Overview Background Report, June 2014, page 4

2.5. Government announcement

As noted previously, on 3 March 2015 the Federal Government issued a joint release announcing it had "…ensured that Australia Post can maintain a sustainable mail service for all Australians" by approving Australia Post's request to introduce a two speed letters service – Priority and Regular. The release detailed:

- The losses in the letters business and that without reform letter losses over the next 10 years could reach over $12bn;
- The price of the Regular letters e.g. ordinary would be overseen by the ACCC; and
- The Priority product would be a commercial product.

The release also noted:

- To support the sustainability of the letter service, Australia Post would apply to the ACCC to increase the Regular stamp price from $0.70 to $1.00;
- Australia Post would continue to deliver mail five days a week to 98% of addresses;
- The concession stamp (available to 5.7 million Australians) will be frozen at 60 cents; and
- The seasonal greeting card rate will be frozen at 65 cents.

The Government's decision provides the regulatory reform necessary for Australia Post to align letter services to the changing communication needs of Australian customers and communities and to stem growing losses caused by changing consumer and business behaviour.

Introduction of the reform requires the Australian Postal Corporation (Performance Standards) Regulations 1998 and the Price Notification Declaration (Australia Post Letter Services) (No.2) 2011 to be amended. Section 4 provides further detail on these amendments.

3. Stakeholder engagement

In this section:

- *Detail on the intensive stakeholder engagement program Australia Post is undertaking; and*
- *Outcomes from consumer research.*

Australia Post has engaged with stakeholders and undertaken research to:

- Facilitate an exchange of information;
- Facilitate mutual understanding of the perspectives of Australia Post and stakeholders; and
- Understand whether the proposed changes would result in a significant disadvantage to a particular market segment.

3.1. Overview

Over the past year, Australia Post has run a coordinated stakeholder engagement program to raise community awareness of the need for changes to its letter service. This engagement program has been intensified since the Federal Government's announcement on 3 March 2015 that it will support regulatory reform of the letters service.

Australia Post has a detailed plan in place for engaging all key stakeholder groups on the implementation of these reforms. Under this plan, a range of stakeholder-specific communications and forums are scheduled over the coming months and outcomes from these activities may lead to fine tuning until there is a final decision by the ACCC on our proposal for changes.

The program is being implemented across the following four key stakeholder segments:

- Community – community and not-for-profit groups representing the general public, senior citizens, underprivileged and regional and rural communities;
- Customers – major corporations, businesses (small and medium enterprise owners), as well as business and industry representative bodies;
- Workforce – employees, unions and Licensed Post Office operators; and
- Government – Shareholder Ministers, Parliamentarians and their advisors, as well as relevant departmental officials.

In July 2015, Australia Post produced a report that provides an update on community feedback since the announcement of the proposed introduction of a Regular and Priority letters service. Australia Post has provided this document separately to the ACCC.

3.2. Engagement activities already conducted

An overview of the approach to each of these stakeholder follows.

3.2.1. Community

There has been extensive community consultation on the proposed letter service reforms, throughout metropolitan, regional and rural areas of Australia. This engagement has taken various forms – from local community meetings to a national online portal.

Australia Post's 'National Conversation' portal (www.conversation.auspost.com.au) is a website dedicated to promoting community awareness about the future of the letter service – and Australia Post's commitment to serving all Australians. It has been available online as a community resource since June 2014. Visitors to the website can view information, videos and fact sheets about Australia Post's future, as well as participate in a discussion forum, ask a question or complete a survey.

Approximately 135,000 Australians visited the National Conversation portal in the year following its launch, with one-third of all visitors actively downloading some of the site's content.

Australia Post has also been running a comprehensive program of face-to-face community meetings – or 'Listening Posts' – outside of Post Offices, throughout Australia. The first of these Listening Posts were conducted in the western Victorian towns of Avoca and Beaufort in May 2014.

In the 14 months since then, Australia Post representatives have conducted 197 community events in 166 towns. These community events have been held in every State and Territory, with a particular focus on regional and rural communities.

The events have included a combination of Listening Posts (open to everybody) and 'Community Leader Lunches', where Australia Post representatives sit down over an informal lunch to engage directly with local community leaders. All of these community visits have been promoted through local media, and they have attracted widespread media coverage – via local print, TV and radio outlets.

Australia Post has also mailed a letter to around 10 million Australian addresses that explains, in simple terms, the proposed changes to the letters service. Given the size of this mail-out, the letter was lodged in batches from 18 March through to 4 May 2015.

3.2.2. Customers

Key customers are being briefed on the proposed letters reforms, individually, through a series of face-to-face meetings and telephone conversations. These business briefings are on-going.

Australia Post is also seeking to engage directly with the leaders of many peak business, industry and community representative organisations – via a series of Stakeholder Forums.

Through these consultation processes, we are identifying the key issues and concerns of business and community groups in relation to the proposed changes to the letters service. Feedback from these key customer groups are being considered in the final design of our future letter service.

3.2.3. Workforce

Australia Post employees have been engaged in the issues surrounding the reform of the letter service, with consistent communication and feedback opportunities, via a range of different channels.

The Managing Director and Group CEO has held face-to-face briefings with the Top 250 leaders of the business, as well as telephone briefings for the top 1,000 managers and supervisors. Information from these sessions has been 'cascaded' to all employees, via facility and team-based face-to-face briefing sessions as well as roadshows across Australia facilitated by senior executives within the Postal Services Strategic Business Unit.

Written communications about the proposed changes to the letter service have been distributed via Post Journal (Australia Post's national staff magazine); POGO (the company intranet site); via Staff Updates (newsletters that are distributed to all facilities); as well as letters to employees' homes.

An employee hotline and email enquiry address have also been established for staff with specific questions or who want more personalised information.

Australia Post is engaging directly with the national and state-based leadership of the Unions that represent its workforce in the Postal Services business (the CPSU and the CEPU/CWU).

In addition to existing consultative forums and establishment of local working groups where appropriate, Australia Post has engaged with the national and state Union leadership through a newly created Enterprise Reform Forum.

The first Enterprise Reform Forum occurred on 25 March 2015 with follow up meetings of subgroups on 11 May 2015, 29 May 2015, 1 July 2015 and 13 August 2015. Consultation with the Unions on issues related to reform of the letter service is continuing.

There are multiple organisations that represent the interests of Australia Post's licensees – including APLAC, POAAL and the Licensed Post Office (**LPO**) Group. In late 2014, Australia Post brought these representative groups together for the first meeting of the 'Licensee Forum', which is chaired by former Federal Senator Helen Kroger. This forum has been used to discuss / consult implementation of a two speed letter service.

3.2.4. Government

Australia Post has been consulting extensively with all levels of Government in the lead-up to, and since, the announcement on the reform of the letter service. The engagement has been directly with Ministers, backbenchers, opposition MPs, political advisers and senior public servants.

The engagement has intensified over the past nine months as Australia Post has sought to involve Parliamentarians in the Listening Posts and Local Community Leader events that we have staged in their electorates.

3.3. Consumer research

Australia Post continually monitors consumer satisfaction with sending and receiving letters. In the April to June 2015 quarter, consumers rated their satisfaction with sending letters and receiving letters at 8/10. Satisfaction has remained at this high level for over two years.

Timeliness of delivery is of paramount importance to consumers when thinking of sending or receiving letters. In the context of all services from Australia Post, timeliness of letter and parcel delivery, from both a sender and receiver perspective, is the most important area of focus for consumers.

3.3.1. Delivery certainty

Consumers are well aware of the speed of delivery in many instances but equally there is an elasticity in their expectations. On average, consumers think that a letter will take two days within the same metropolitan area but some think that it will take up to four days.

If a letter needs to be somewhere the next business day then the option to use Express Post is universally understood, while the current stamped letter offer is for letters than can be received in a longer time frame.

Consumers value certainty of delivery (i.e. the expectation that a letter will get to its destination according to the delivery timetable they chose) over the actual speed.

3.3.2. Delivery speed

In June 2014, Australia Post began offering an extended two-speed letter service for business customers. Prior to the June change, the PreSort letter service (which includes Charity Mail) was the only addressed letter service that offered senders a choice of delivery speed.

The June changes meant that circa 85% of addressed letter volume (compared to 55% pre June) now had the choice of being delivered to a Priority or a Regular delivery timetable.

Customer migration to the Regular delivery timetable has exceeded Australia Post's initial expectation. With this choice of delivery speed over 70% of business letter volume is now delivered to the Regular delivery timetable.

In November 2014, Australia Post conducted a market research survey to gauge consumer and small business reaction and preferences in relation to these new, differentiated letter speed options.

Consumers were asked, in relation to the letters they had sent in the previous six months, which delivery service would they have used. Over three quarters (78%) responded that they would have opted for sending all those letters by the slower, but cheaper, service.

On asking small businesses the same question, a majority (54%) responded that they would have used the slower, but cheaper, service.

4. Ordinary letter service – product and price changes

In this section:

- *The regulatory environment in which the ordinary letter service operates;*
- *The proposed product and price changes; and*
- *How the proposed prices are affordable and compare to other OECD countries.*

4.1. Regulatory environment

As noted in Section 2, introducing the regulatory reform detailed in 3 March 2015 Federal Government announcement requires the Australian Postal Corporation (Performance Standards) Regulations 1998 (**PPS**) and the Price Notification Declaration (Australia Post Letter Services) (No.2) 2011 to be amended.

The Australian Postal Corporation (Performance Standards) Amendment (Speed of Mail Delivery) Regulation 2015, Explanatory Statement, states that the purpose of the Amending Regulation is to enable Australia Post to introduce a two-speed letter service for all consumers; comprising letters delivered to either a regular or priority timing standard, as selected by the sender.

The Price Notification Declaration (Australia Post Letter Services) 2015, Explanatory Statement, notes that the purpose of the Declaration is to declare certain letter services supplied by Australia Post as ‘notified services’ and Australia Post in relation to those services a ‘declared person’.

The combined effect of the Amending Regulation and the Declaration is that the ordinary letter service will be delivered to the Regular delivery timetable and continues to be subject to ACCC pricing oversight.

To avoid breaching section 95Z of the Competition and Consumer Act, 2010, Australia Post must notify the ACCC if it proposes to:

- Increase the price of an ordinary letter service; or
- Introduce a new service that would fall within the definition of an ordinary letter service; or
- Provide the ordinary letter service under terms and conditions that are not the same or substantially similar to the existing terms and conditions of that service.

4.2. Ordinary letter service

Ordinary letters are letter services offered by Australia Post that do not include the provision of a special service for which a special charge or additional fee is payable. A special service will generally include special requirements or conditions that need to be met to qualify for the particular price charged.

Ordinary letters account for around 16% of Australia Post’s domestic reserved letter service volume. The basic postage rate (standard postal articles carried by ordinary post), represents the majority of ordinary letter volume, but there are two price points provided for large letters; up to 125 grams and over 125 grams up to 250 grams.

Postage for ordinary letters is predominantly paid for using postage stamps (to the correct value) or postage labels. In certain circumstances postage can be paid for by cash and Australia Post applies a ‘Paid’ postmark.

Ordinary letters are the foundation upon which Australia Post’s letters service is based and are included within the delivery performance monitoring of the PPS. Details on Australia Post’s delivery performance against its PPS is shown at Appendix 2.

4.3. Proposed product and price changes

Following the successful introduction of an extended two-speed letter service for Australian business letter services in June 2014, from 4 January 2016, Australia Post is proposing to introduce product and price changes to provide all Australians with access to a Priority and Regular (Priority plus two days), delivery timetable.

The changes support the sustainability of the letter service and build upon the June 2014 changes by:

- Providing the foundation for a step change in network costs, as letter volumes migrate to the Regular delivery timetable; and
- Reducing the current level of cross-subsidy from non-reserved services to reserved services.

The proposed price changes (Table 1), include increasing the basic postage rate to $1.00 and retaining the relativity of ordinary large letter prices to the basic postage rate (they continue to be expressed in multiples of the basic postage rate).

The proposed price changes are accompanied by changes to other domestic letter prices. Appendix 3 details some of those prices and Appendix 4 details the financial impact of the proposed prices across the domestic letters business.

In setting the proposed prices, Australia Post applies a number of principles (including Australia Post's Letter Pricing Principles (Appendix 5)). Key principles are:

- The Regular letter service is a 'safety net' service priced to recover the efficient cost of providing the service;
- The Priority letter service is a commercial product but is priced to incentivise migration to the Regular service;
- The concession stamp will continue to be offered to eligible Australians at 60 cents for a small letter; and
- The seasonal greeting card rate[3] will continue to be offered at 65 cents for a small letter.

Table 1 – Proposed prices ordinary letters (reserved)

	Current Price	Proposed Price	Increase %
Ordinary small letter	$0.70	$1.00	42.86%
Ordinary large letter			
Up to 125g	$1.40	$2.00	42.86%
Over 125g up to 250g	$2.10	$3.00	42.86%

[3] Available November and December only

4.4. Impact of the price changes

Australia Post estimates that the average household sends around 20 – 40 letters per year. Within this average estimate, for households that have taken up the concession stamp offer and use the Regular delivery timetable, the price changes have no impact as the concession stamp rate is not increasing.

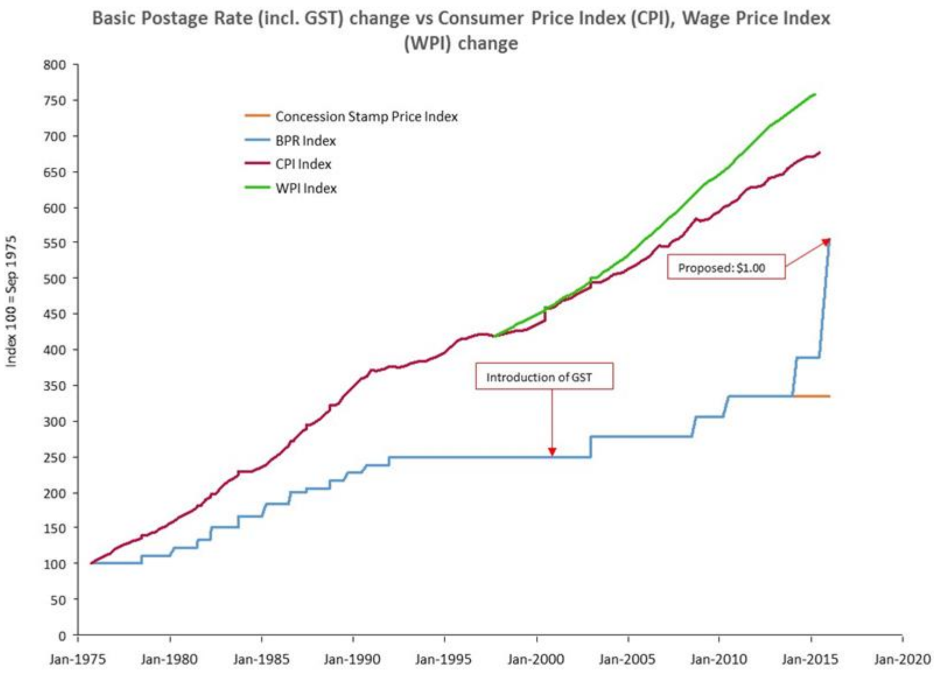
For households that have not taken up the concession stamp offer, or are not eligible for the concession stamp and on the assumption that letters are sent by the Regular delivery timetable, the impact is between $6.00 and $12.00 per annum. However, if 30 per cent of the 20 – 40 letters sent per year are seasonal greeting cards, the impact reduces to between $4.20 and $8.40 per annum.

The proposed prices include only the fifth increase to the basic postage rate since January 1992 and at $1.00, Australia Post asserts the basic postage rate remains affordable.

Chart 1 compares the change in stamp prices (basic postage rate including GST) to the change in the Consumer Price Index[4] (**CPI**) since 1975[5] and the change in the Wage Price Index[6] (**WPI**) since 1997[7]. The analysis shows that the degree of change in the basic postage rate since 1975 has been well below the degree of change in the CPI since 1975.

Chart 1 also shows that the concession stamp rate index is significantly below the basic postage rate Index, CPI and the WPI.

Chart 1 – Affordability of the basic postage rate



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[4] Consumer Price Index; All groups; Quarterly; Publication Date: 23 April 2015; Australian Bureau of Statistics / Reserve Bank of Australia; ABS Cat No. 6401.0.

[5] The Postmaster General's Department was separated into the Australian Telecommunications Commission (trading as Telecom Australia) and the Australian Postal Commission (trading as Australia Post) in mid-1975 and hence was taken as a starting point for comparison

[6] Wage Price Index; Quarterly, Total hourly rates of pay excluding bonuses, All Australia, Private and Public, All industries; Australian Bureau of Statistics; ABS Cat No. 6345.0.

[7] As Wage Price Index data is only available from September 1997 it has been indexed from the level of CPI in September 1997.

4.5. Comparison to other OECD countries

As shown in Chart 2, when compared to other OECD countries[8], at $1.00, Australia's basic postage rate is the second lowest. While the Priority rate will be determined once the ACCC's decision is known, against those same countries, Australia's priority rate is expected to be one of the most affordable (Chart 3).

Chart 2 – Domestic postage rates, Regular

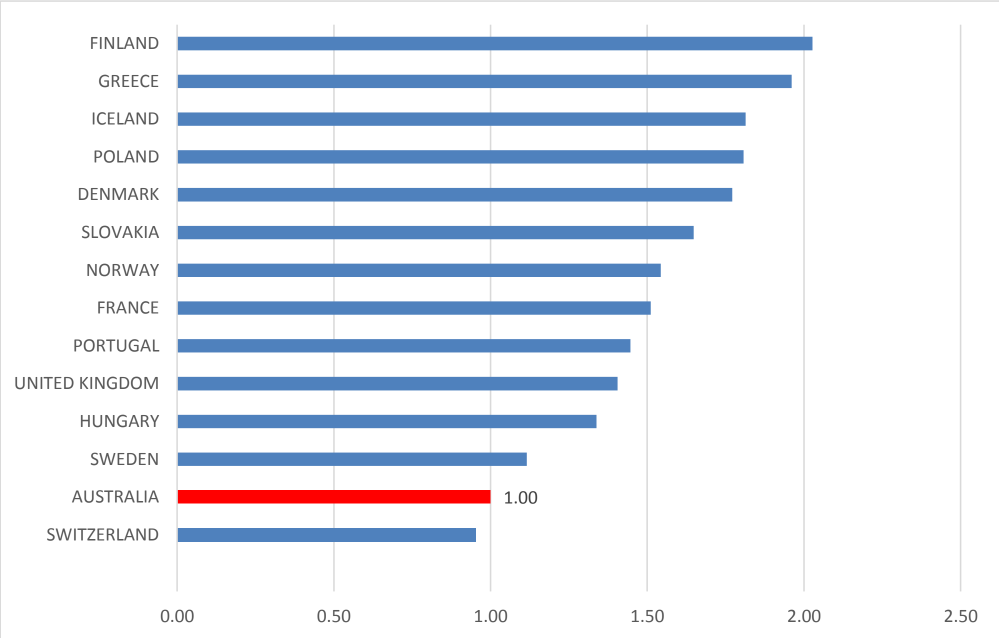
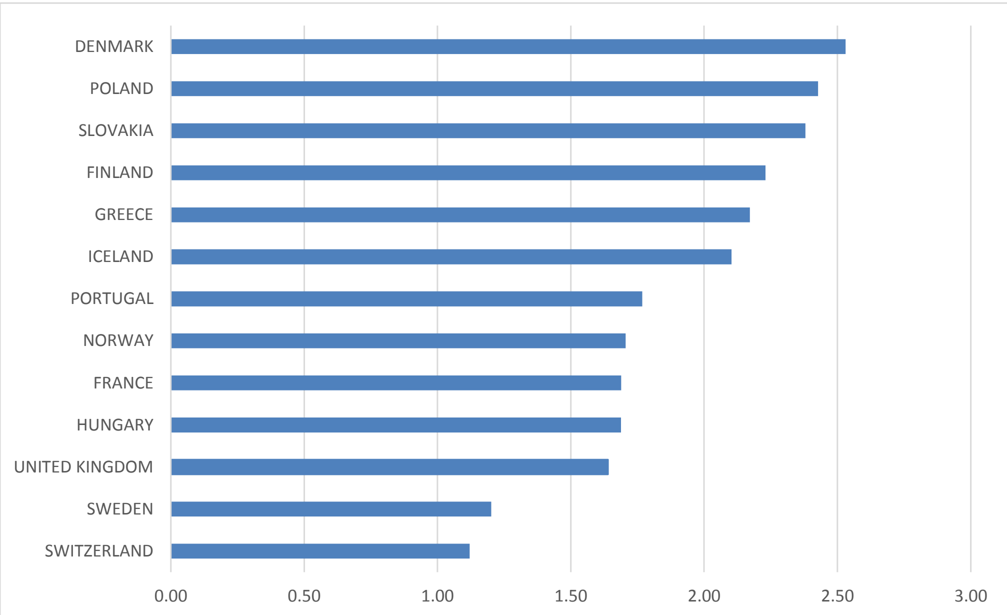


Chart 3 – Domestic postage rates, Priority



[8] Purchasing Power Parity (PPP) of basic letter price in A$ - source OECD and Australia Post, prices in other countries as at 20 July, 2015. Does not include the impact of VAT exemptions in some countries

5. Letter volumes

In this section:

- *The approach to forecasting – the methodology is consistent with that accepted by the ACCC previously – baseline forecasts derived from an econometric model then augmented with market intelligence and management insight;*
- *Continuing pressure – the rate of decline is increasing; and*
- *Price elasticity – the impact on forecast demand.*

5.1. Establishing a set of robust econometric letter volume forecasts.

A forecasting methodology applied by Diversified Specifics to Australia Post's revenue based volumes acts as the baseline for the letter volume projections presented in this notification.[9]

The techniques used are premised upon best practice econometric methods in line with internationally accepted approaches to letter volume forecasting.

These projected baselines represent logical advances on previous forecasting efforts that have also acted as the foundation for prior letter price notifications submitted to and accepted by the ACCC.

Given the constantly changing technological and behavioural landscape confronting all modes of communications including letters, the econometric baseline projections represent an initial step in the forecasting process at Australia Post.

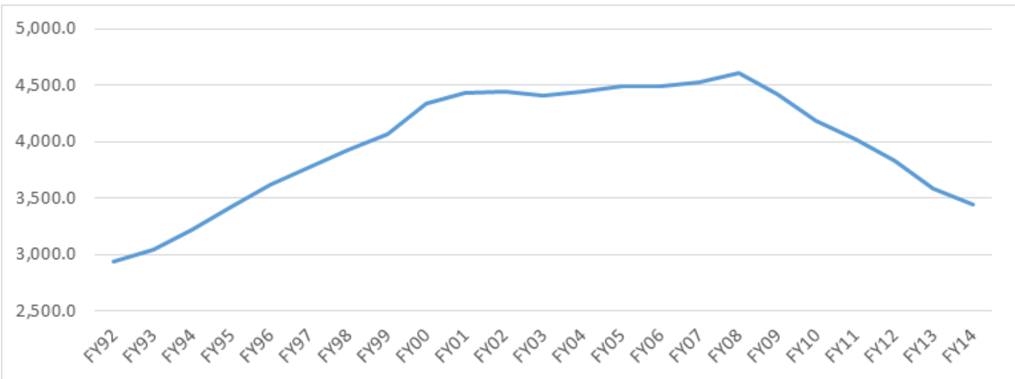
As has been the case in the past, the baseline letter volume forecasts must be augmented by further internal and market-based intelligence to ensure optimal levels of relevance.

5.2. Electronic substitution away from the physical letters is accelerating

The threats to mail of substitution, consolidation and rationalisation continue to place pressure on each of Australia Post's key letter volume segments irrespective of price increases.

As clearly illustrated in Chart 4 the decline in the Australian community's use of the letters service means that, the total volume of domestic letters Australia Post delivered has already shrunk back to around the same level as in 1993/94 with the rate of letter volume decline accelerating at an increasingly rapid rate each year since 2007/08.

Chart 4 – Domestic addressed letter volume



[9] The findings of this section are largely based upon the Diversified Specifics report: 'Australia Post Domestic Letter Volume Demand Update', August 2015. The reader is advised to consult the source documentation for greater detail where required.

Emerging digital communication platforms are presently in various stages of development and are likely to exacerbate an already deteriorating situation for Australia Post's core letter volume segments in the immediate future.

This is especially obvious at an industry level, as certain electronic portals are emerging to threaten presentment type mail (e.g. a bill, invoice or statement) beyond that which might be predicted by any empirical examination.

5.3. Letter volume forecasts and methodologies – a consistent approach

In establishing a set of baseline forecasts for each of the key letter volume segments, Diversified Specifics employed a number of advanced econometric techniques including tests for structural breaks, co-integration and optimal lag structures.

Vector error correction modelling (**VECM**) in conjunction with dynamic ordinary least squares methodologies were then employed to ensure a robust set of forecasting models.

In the ACCC Decision of May 2010, with reference to the econometric baselines derived by Diversified Specifics the ACCC concluded.[10]

> *Australia Post has significantly improved the sophistication of its demand forecasting methods. The ACCC considers that the volume forecasts are appropriate for its assessment of the 2010 price notification.*

Moreover, Frontier Economics resolved*:* [11]

> *Diversified Specifics' econometric analysis was in line with internationally accepted leading practices in mail volume forecasting.*

And, that:[12]

> *Australia Post has adopted a more sophisticated approach to forecasting mail demand [and] Diversified Specifics has derived baseline econometric forecasts based on best practice time series technique for mail volume forecasting.*

The econometric forecasts are intended to represent a baseline upon which further intelligence may be overlaid to counter a lack of tractable empirical data on the emerging threats to letter volumes.

Information obtained via further off-model investigations conducted by Diversified Specifics, in addition to trends identified within Australia Post's internal charge account data, have revealed a diversity in the rate of electronic substitution across differing industry classifications.

Some industries are in the advanced stages of developing alternative communication portals that will result in letter volume declines in excess of those predicted by any econometric process.

Diversified Specifics have developed an indicative example[13] that outlines the possible consequences of these likely declines by examining the letter volume losses accruing to initiatives that seek to digitise the majority of government based communications by 2017.

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[10] ACCC, Australian Postal Corporation 2010 Price Notification Decision Public version, May 2010, p.45

[11] Frontier Economics, Review of Australia Post's volume and input cost forecasts, report prepared for the ACCC, November 2009, p. 19

[12] Frontier Economics, Review of Australia Post's volume and input cost forecasts – a report prepared for the ACCC, May 2010, p. iii.

[13] Diversified Specifics report, Australia Post Domestic Letter Volume Demand Update, August 2015, p.p. 50,51

Although this example is restricted to the public sector, any widespread establishment of effective online bill or statement presentment portals into the private sector could prove catastrophic for PreSort small letter volumes and severely diminish the relevancy of any econometric forecasts.

As a result of this, Australia Post's volume forecasts are derived by generating a baseline forecast using Diversified Specifics model and then augmentation by Australia Post is undertaken to account for 'off-model' impacts.

This approach is consistent with that adopted by Australia Post in prior notifications and accepted by the ACCC:

> *'These forecasts, which are also reflected in Australia Post's 2013 Corporate Plan, are broadly consistent with recent trends in letter volumes.[14]'*

In summary, the dynamic statistical methodologies and augmentation approach that support the letter volume forecasts outlined within this notification are consistent with those previously accepted by ACCC.

The following sections delineate Australia Post's key letter volume categories of Ordinary / Other and PreSort into its small and large letter components.

This facilitates a discussion of the diversity in how these trends have evolved and how they are subsequently modelled to generate letter volume forecasts.

5.4. Ordinary / Other letters

The Ordinary / Other letter classifications consist of:

- Non-bulk business-to-business and business-to-household mailings; and
- Individual mailings from household-to-business and household-to-household.

Some specific attributes of Ordinary / Other letters are that they:

- Generally consist of letters that are produced or mailed on an ad hoc or a daily basis;
- Can consist of mailings in response to a one-on-one interaction; and
- Reflect lodgement sizes that are well below those in PreSort (for which there is a minimum of 300).

As a result, these segments have traditionally been more susceptible to substitutive pressures over a longer period of time.

This has resulted in stagnant or gradually declining Ordinary / Other letter volumes over the longer term. In the recent past however, volumes within each of these letter segments have experienced an accelerated rate of decline as a greater array of alternatives to the Ordinary / Other letter item have gained a wider level of acceptance amongst senders and receivers.

5.4.1. Ordinary / Other small letter volume trends

The Ordinary / Other small letter segment category consists of full rate business mail, cheque payments and other consumer correspondence that satisfy the relevant small letter category size and weight requirements as set by Australia Post. Ordinary / Other small letter volumes declined by 10.3% in 2012/13 and 5.8% in 2013/14.

[14] Australia Post Price Notification Final Decision, February 2014, page 26

Two decades ago the majority of volumes sent within this category tended to be bill payment type mail consisting of cheques, money orders or cash.

Since then, there has been a number of alternative bill payment channels emerge to successfully redefine the behaviour of consumers interested in settling an invoice.

These alternatives consist of phone, internet and direct debit payment facilities and their collective popularity has substantially reduced the use of Ordinary / Other small letter based modes of bill payments such as cheques and money orders (Chart 5).

Chart 5 – Changing bill payment behaviour in Australia

These trends are likely to continue into the forecast horizon due to public sector digitization initiatives such as the Australian Tax Offices 'Data and Payment Standards' legislation for electronic contributions which involves a phased mandatory requirement for employers to pay super contributions electronically.[15]

This segment also contains a portion of small and medium enterprise bill presentments which continue to be impacted by substitution, consolidation and rationalisation.

Through these practices firms (senders) in the post 2007/08 period have shown an increasing tendency to minimise their transaction costs and thereby reduce their usage of this letter category.

5.4.2. Ordinary / Other small letter volume drivers

Using a VECM framework the statistically significant volume drivers over the 2002Q2 to 2014Q3 timeframe are electronic substitution, followed by real price.

Bill payments substitution away from the traditional mail item is captured by fluctuations in cheque volumes, utilised as a proxy for declines in all traditional modes of bill payments.

A deterministic cheque volume decline of 14.13% per annum was selected for each year in the forecast horizon as reflective of the September 2013 to September 2014 percentage change in that variable.

[15] www.ato.gov.au/datastandards

The quantification of a reliable price variable requires a combination of real (inflationary) declines and nominal increases. CPI projections resulting in real price changes of -2.5% per annum over 2014/15 to 2017/18 as given by the Commonwealth Budget were utilised as proxies to capture the inflationary component. Then the price changes of October 2015 and January 2016 were incorporated within the variable.

5.4.3. Ordinary / Other large letter volume trends

This segment consists of full rate letters up to a maximum size, weight and thickness of 360x260mm, 500g, and 20mm respectively.

Historically, these letters were typically used by senders wanting a hardcopy transfer of larger documentation.

Consequently, this letter segment was directly impacted by the number of households and businesses with online connections in Australia given this technological shift encouraged a greater penetration of email and internet usage.

Electronic substitution in this segment manifested itself in the form of:

- Electronic document transmission – files such as Word or .pdf documentation could be transmitted in a costless and instantaneous manner via softcopy; and
- The provision of websites enabling online document completion and retrieval – this limited the need for a physical letter item as the exchanging and processing of contractual arrangements could now be achieved via an alternative medium to the hardcopy format.

More recently, further waves of technological change have accelerated volume declines and in the period 2007/08 to 2013/14 the average annual volume decline was circa 6.4%.

The increasing popularity of cloud storage facilities and flash drives has again provided senders with a greater scope and flexibility of alternatives when dealing with the exchange of larger documents and acted to overcome some of the limitations in file (document) sharing experienced by email.

5.4.4. Ordinary / Other large letter volume drivers

Using a VECM framework the statistically significant volume drivers over the 2008Q1 to 2014Q3 timeframe are electronic substitution and real price.

Substitution away from this category is proxied within the modelling process by Australian fixed-line broadband growth, representative of the historical development of EDI technology, email transmission of larger documents and the proliferation of online form facilities.

Projections of 1.89%p.a. on this variable were utilised throughout the forecast period and obtained from the Australian fixed-line broadband growth rate attributable to the twelve months preceding September 2014.

The econometric process also highlighted a positive linkage between Ordinary / Other volumes and movements in the general health of the Australian economy. Annual Gross Domestic Product growth rate projections used for forecasting purposes were 2.5% in 2014/15, 3.00% in 2015/16 and 3.50% for both 2016/17 and 2017/18 financial years as given by the Commonwealth Budget.

The derivation of a real price variable initially consists of CPI projections of 2.5% per annum over the 2014/15 to 2017/18 period that were utilised to capture inflationary effects. As with the small letter equivalent, the price changes of October 2015 and January 2016 were incorporated within the variable.

5.5. PreSort

Each of the PreSort letter volume segments consist of bulk (300+) lodgements that tend to consist of business and public sector transactional, promotional or trans-promotional material that satisfies the relevant letter category size and weight requirements.

PreSort transactional mail is generally generated by large business and government who service large customer bases. They are typically quite structured in their planning and mailings and are an outcome of a business process linked to servicing customers. This traditionally translated into a strong correlation with movements in the level of Australian economic activity.

As will be discussed in the following sub-sections a combination of events commencing in 2007/08 emerged. The associated effects continue to the present day and have effectively curtailed PreSort letter volume growth.

Market intelligence indicates that declines for this letter volume category are likely to be impacted further than historical trends, as evidenced by a series of important public sector initiatives.

5.5.1. PreSort small letter volume trends

This segment consists of the following items that satisfy the relevant small letter category size and weight requirements.[16]

- Business transactional presentment letter volumes such as bills, statements, share notices and letters advising customers of price increases, policy changes, etc.; and
- Direct mail including promotional letters, brochures and other addressed promotional material.

As bill presentments comprise a vast majority of this segment, PreSort small letter volumes experienced healthy volume growth throughout the 1990's.

In that period Australian consumers were connected to a greater number of mobile phones, tended to own at least a primary, and in some cases secondary, credit card and became increasingly likely to commit to Pay T.V. subscriptions and so on.

Each of these lifestyle changes were very often accompanied by an additional invoice and/or statement that directly flowed through to strong PreSort small letter volume growth.

With the onset of the global financial crisis businesses profit margins were squeezed and many businesses began to pursue a cost containment strategy that involved investigation of a number alternatives to reduce their exposure to mail, thereby economising on transaction costs.

Two of these strategies that could be enacted immediately to achieve these objectives included:

- Rationalisation – reducing the frequency that invoices and statements were provided to the recipient via traditional postal mechanisms; and
- Consolidation – integrating a transactional and promotional message within a single letter item as against the option of sending two separate mail pieces.

Although these practices had the ability to reduce the demand for PreSort small letters, two other factors also emerged that had the potential to eliminate that demand altogether:

- *Sender sponsored electronic substitution* – businesses themselves began investigating, developing and promoting a widespread acceptance of alternative electronic bill presentment channels to the traditional mail item; and

[16] The dominant product category within the PreSort small letter segment is business transactional PreSort Letters.

- *Government sponsored electronic substitution* – the Federal government recently embarked on a number of initiatives to stream recipients away from the traditional letter item through its strong promotion of the '*myGov'* platform (see Appendix 6).

Multi-country cross sectional surveys have indicated recipients' preferences for the physical letter item remains strong despite a wider range of alternatives. As a result, private senders of bill presentments appear to fall into two categories:

- Those fundamentally motivated by reductions in transaction costs;
    - These senders have tended to engage in a range of push and pull tactics aimed at changing recipient behaviours to facilitate a wider acceptance of new substitutive platforms;[17] and
- Those who might forego the cost advantages of pursuing an electronic alternative to instead retain a relationship with the recipient by remaining loyal to the letter due to its effective reach and promotional qualities.
    - These senders do not formulate their decisions about mail based upon cost or incremental changes in price. Rather, they form their communication decisions based upon technological availabilities, the effectiveness of each platform, the behaviour of the recipient, etc.

This discussion is relevant when the sender and recipient retain the power to choose their own communication channel.

In countries such as Denmark, legislative change has eliminated that choice. In such cases, government led digitization occurs and this has resulted in the mass migration of presentment communications towards electronic mediums and away from the traditional letter item.[18]

In Australia while policies on a transition into a digital economy and e-Government are presently restricted to government services and public interactions, the threats to PreSort small letter volumes in the medium to long term are very real if these initiatives translate to senders within the private sector.

5.5.2. PreSort small letter volume drivers

Utilising a dynamic ordinary least squares framework the statistically significant PreSort small letter volume drivers over the timeframe of 2008Q1 to 2014Q3 are electronic substitution and real price.

Within the modelling framework PreSort small letter volume substitution in recent times has been facilitated by the growth in wireless broadband technology**.**

This has extended the ability of senders to reach those recipients who not only have access to a computer but also to those using tablets and smartphones.

For the purposes of letter volume projection, the mobile broadband connections growth rate is set to the anticipated quarterly growth rate utilising forecasts on global mobile traffic in the Asia Pacific region of 78.94% in 2014/15, 71.64% in 2015/16, 75.51% in 2016/17 and 93.58% in 2017/18.[19]

[17] See Paterson C.J. Nikali H. & Elkela K. (2014), *"Digitalization of Consumer Invoices - A Comparative Study"* The Role of Postal Service in a Digital Age, M.A. Crew and T.J. Brennan (eds), Edward Elgar Publishing Ltd, p.283.

[18] See: The digital path to future welfare (2011), eGOVERNMENT strategy 2011-2015, The Danish government/Danish Regions/Local Government Denmark

[19] Cisco (2012), 'Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update', 2011–2016, Asia Pacific Mobile Data Traffic, p.24

When projecting price changes both the inflationary and nominal components are required. CPI projections resulting in real price changes of -2.5% per annum over 2014/15 to 2017/18 as given by the Commonwealth Budget represent the inflationary component.

Overlaying these trends, a linear combination of PreSort small letter Regular and Priority volume proportions was used to incorporate the price effects given by the October 2014 and January 2016 price changes.

The scenarios constructed do not provide any explicit treatment of possible cross segment volume migration resulting from the asymmetrical pricing policies across service speeds.

5.5.3. PreSort large letter volume trends

The 'PreSort' large letter volume segment consists of bulk (300+) lodgements of large letter mail that emanates primarily from the business and the government sectors. It includes non-standard sized material such as prospectuses, annual reports, promotions, etc.

The nature of these bulk mail items suggested a strong dependence upon business activity and a consistently strong Australian economy resulted in an average annual growth in PreSort large letter volumes of 2.25% over the 2000/01 to 2007/08 period.

Since the global financial crisis of 2007/08 highly erratic year on year movements in PreSort large letter volumes have been observed.

Annual report volumes have traditionally comprised a healthy proportion of items within this segment and therefore letter volume declines were associated with the Corporations Legislation Amendment Act of 2007 (Chart 6).

This legislative change enables the transmission of company annual reports in an electronic format resulting in a significant negative impact on the volume of hardcopy reports mailed directly to eligible members. Most of these reports were previously sent through the PreSort large letter service.

Chart 6 – PreSort large letter volumes in annual report months

Diversified Specifics investigations also concluded that post 2007/08 movements in a number of theoretical drivers of PreSort large letter volumes moved in a direction that tended to impede further volume growth in this category. These factors include:

- The natural growth of general electronic substitution effects;
- A level of economic activity that remains below pre 2007/08 levels;
- An increase in the price of paper as a direct input for promotional activities using mail; and
- An increase in the real price of a PreSort large letter item.

5.5.4. PreSort large letter volume drivers

The PreSort large letter volume drivers included within the VECM over the 2008Q1 to 2014Q3 timeframe included the health of the advertising industry, electronic substitution and the impact of large initial public offerings.[20]

Bulk non-standard sized direct mail such as that offered by the PreSort Large Letter represents a part of marketing mix across the spectrum of promotional alternatives.

Projections on the consumer discretionary index growth rate are set to zero for the projection years of 2014/15 to 2017/18 due to the volatile nature of variations in this variable and in the presence of no recognised institutional forecasts on the state of the advertising industry in future years.

Mobile wireless broadband connections are employed as a proxy for the increasing popularity of alternative electronic channels that allow for the receipt and evaluation of non-standard sized documents.

This variable also intends on capturing the impacts that have arisen since the relaxation on listed companies in sending annual reports via a traditional large letter service. The construction of the substitution variables for PreSort large letter volumes follows an identical set of assumptions as that discussed within the PreSort small letter section of this notification.

Prospectuses and related documentation can account for an amount of PreSort Large Letter volumes. The market capitalisation associated with large scale initial public offerings are utilised to proxy these effects. Due to the uncertain nature of future public offerings and their impending market capitalisations over the forecast horizon, this variable is set at zero within the projection process.

5.5.5. Summary of econometric forecasts

The econometric forecasts as derived by Diversified Specifics suggest declining letter volumes in every year for every letter segment irrespective of price changes.

These results emphasize the significant role wide ranging threats to Australia Post's core letters business are likely to have over the short run time horizon.

Although the forecasts suggest a more dire outcome for the Ordinary / Other letter segments, the off-model impacts are likely to be greater for the PreSort categories.

In particular the recent emergence of electronic bill presentment portals such as myGov bodes for significant PreSort small letter volume declines over and above the econometric forecasts outlined.

5.6. Estimating a reliable set of price elasticities

In the years following 2007/08 and in contrast to any period previous, each letter volume segment has been characterised by an increasing number of price changes as Australia Post responds to the very real threats to its core letters business.

[20] In this model PreSort large letter volume real price is not statistically significant at conventional levels.

In acknowledgment of the differing substitutive landscape Australia Post now operates in, it is important to estimate any letter volume effects associated with this overt change in pricing policy.

For each letter volume segment the econometric modelling process estimates a price elasticity that is relevant to the current postal environment and provides a guide as to how volumes might respond to any future changes in postage rates.

5.6.1. Price impact and elasticity

Diversified Specifics most recent econometric analysis highlighted the impact of real price changes as statistically significant at conventional levels for three of the four key letter volume segments.

Table 2 – Price elasticities of demand (Diversified Specifics model)

Price elasticity by segment	
Small Letter Volumes	
Ordinary / Other	0.41
PreSort	0.35
Large Letter Volumes	
Ordinary / Other	0.78
PreSort	N/A[21]

The results of the Diversified Specifics study suggest the resultant volume response has remained largely inelastic. Previous studies have also indicated that price is either inelastic or not statistically significant. In developing volume forecasts Australia Post has elected to use a conservative estimate of price elasticity of 0.25 for all categories.

The findings of the Diversified Specifics study emphasise the importance of adopting a non-price explanation of falling letter volumes.

Rather, Australia Post’s letter volume declines are driven primarily by the forces of electronic substitution which itself depends upon the extent to which senders and receivers are motivated to alter their behaviours and accept an electronic alternative to the traditional letter item.

Given the anticipated increase of ‘off-model’ electronic substitution effects over the next few years, each of the econometrically estimated price elasticities are likely to overstate the estimated volume impact of any price changes.

5.7. Promotion of the mail channel

Australia Post supports the promotion of the mail channel at an industry and customer level through education on mail channel effectiveness and providing necessary tools to maximise use of the channel. This includes:

- Supporting events such as the Association for Data driven Marketing and Advertising (ADMA) Global Forum and ACE awards, Mumbrella360, the Australian Catalogue Association Awards and Fundraising Institute of Australia gala dinner to ensure direct mail is part of the multi-channel marketing conversation;
- Commissioning regular research into mail effectiveness and multi-channel interaction, and promoting findings to customers, subscribers and the business community through our website and emails;

[21] The PreSort large letter real price elasticity is not statistically significant at conventional levels and therefore is assumed to be perfectly price inelastic with a price elasticity approximating zero.

- On 1 June 2015, Australia Post launched Promo Post; a service for addressed direct mail delivered to the Regular delivery timetable, which provides lower prices than PreSort. At the time of introduction the discount was set at 3%. As part of the regular pricing review cycle, Australia Post is planning to increase the discount in October 2015.
- Consulting with industry associations such as ADMA and the Fundraising Institute of Australia to seek advice and discuss relevant opportunities or developments that may impact the mail channel.

Customer Engagement – Australia Post's:

- Coverage sales teams work with customers across all industry verticals to ensure that the benefits of physical mail are understood and that the mail channel remains a relevant channel for promotional and transactional communications;
- Mail specialists work as a conduit between Australia Post's coverage sales teams and product areas to ensure products and product extension initiatives continue to meet the changing needs of customers and the market; and
- Mailhouse Account teams are the interface between mail houses and Australia Post, assisting in the coordination of information and in the education on how to present mail to the network. Mailhouse Account teams also conduct training sessions with mail house sales teams across the full range of Australia Post services.

6. Productivity

In this section:

- *An overview of the productivity challenge facing all postal operators;*
- *Australia Post's cost containment initiatives; and*
- *Detail on the Reform our Letter Service Program.*

6.1. Operating environment

Australian domestic addressed letter volumes reached a peak in 2007/08 (4.6 billion letters). Australia Post's latest forecast is that in 2014/15 the domestic addressed letter volume will be 3.2 billion letters.

Although volumes are declining, the nationwide delivery network that Australia Post services continues to grow. Population growth currently adds around 135,000 delivery points each year.

With addressed letter volumes in 2014/15 forecast to be at the same level as 1993/94 and a delivery footprint that has increased by circa 52% over the same period, as illustrated in Table 3, the number of addressed letters per delivery point will have decreased by 35% (from 430 letters per delivery point per annum to 278 letters per delivery point per annum).

Table 3 – Addressed letter volume

	1993/94	2014/15	Change
Number of delivery points	7.5m	11.4m	52%
Addressed letter volume	3.2b	3.2b	(2%)
Average per delivery point per annum	430	278	(35%)

Table 4 shows the rate of volume decline since 2007/08 for the domestic reserved letter service and domestic reserved Ordinary / Other letter service.

Table 4 – Domestic reserved letter volume

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	CAGR	Total (%)
Total	(3.9%)	(5.6%)	(3.6%)	(5.2%)	(6.8%)	(4.0%)	(4.8%)	(25.7%)
Ordinary/Other	(4.8%)	(6.5%)	(5.8%)	(5.7%)	(9.9%)	(5.8%)	(6.4%)	(32.9%)

6.2. Forecast letter volume

As shown in Table 5, domestic reserved letter volume decline is ongoing and increasing. The volume forecasts in this notification assume an average annual volume decline of 10.7% per annum over three years to 2016/17.

Table 5 – Forecast domestic reserved letter volume

	2014/15	2015/16	2016/17	CAGR
Total	(8.6%)	(11.1%)	(12.5%)	(10.7%)

As shown in Table 6 domestic reserved Ordinary / Other letter volumes are also forecast to decline. By 2016/17 Australia Post expects a decline of over 50% since the volume peak in 2007/08.

Table 6 – Domestic reserved Ordinary / Other letter volume

Financial Year	Volume (b)	Year-on-year decline
2007/08	1.9 billion	(1.7%)
2008/09	1.8 billion	(4.8%)
2009/10	1.7 billion	(6.5%)
2010/11	1.6 billion	(5.8%)
2011/12	1.5 billion	(5.7%)
2012/13	1.4 billion	(9.9%)
2013/14	1.3 billion	(5.8%)
2014/15	1.2 billion	(10.9%)
2015/16	1.0 billion	(12.5%)
2016/17	0.9 billion	(13.9%)

Ordinary / Other letter volume forecasts are included in the financial data at Appendix 4. An explanation of volume forecasts, illustrating the augmentation of the econometric baseline estimates is provided at Appendix 7.

6.3. International benchmarking study

In an environment of ongoing and increasing volume decline postal operators face the same 'productivity challenge'. To provide perspective on how well Australia Post has responded to this challenge compared to other postal operators, in late 2008, Australia Post commissioned Economic Insights to undertake an international benchmarking study.

The study covered the 2002 to 2009 period. Its main features were:

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

As productivity performance is influenced by the operating environment conditions to allow for 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).

The study concluded that:

> 'Australia Post has shown the most consistent improvement in total factor productivity (**TFP**) of the seven postal services reviewed. Importantly, Australia Post improved its ranking when formal, statistically based adjustments were made for differences in mail and customer density with its TFP level being ranked first or second after the adjustments were made.'[22]

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

In late 2011 Australia Post commissioned Economic Insights to update and extend the 2009 study. Additional postal services were invited to participate however, not all were able to accept the invitation. The output and input categories of this study were the same as in the 2009 study.

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

The 2011 study concluded that:

- Australia Post showed improvement over the sample period for its unadjusted TFP measure compared with three of the five postal businesses; and
- While another postal business, which was the highest ranked postal service for the unadjusted TFP measure, showed a slightly better performance over the sample period, Australia Post improved its ranking to first for its TFP level when formal, statistically based adjustments were made for differences in mail density and customer density.

The ACCC acknowledged that international benchmarking potentially enabled verification of Australia Post's performance in relation to other postal operators. However, as the ACCC were unable to independently verify the results of the TFP analysis, due to confidentiality arrangements between participating postal operators and Economic Insights, they were limited in their ability to analyse the studies as part of an assessment. Noting this, the study has not been updated.

6.4. Productivity initiatives

The major network program (that impacts the letters business) is the Reform our Letter Service (RoLS) Program (Section 6.5). However, there are also a range of local and national initiatives and programs that support Australia Post's cost containment and productivity targets for the network.

They cover a spectrum from:

- Process efficiencies that are pursued on a localised basis throughout the network in order to achieve budget and plan targets: to
- National programs to re-engineer core network processes in order to extract cost and build flexibility.

Each year the network identifies a range of local and national network initiatives / projects. In 2014/15 the benefit from these initiatives is forecast at just over $4m. To implement the initiatives:

- Initiative champions are assigned nationally and within regions for the implementation and management of cost out / productivity improvement programs;
- Improved reporting and transparency is implemented to increase the communication and focus of cost out targets; and
- Continued collaboration is undertaken with other functional business units to continue to share opportunities and learning.

Productivity initiatives aimed at cost containment need to be viewed in a strategic context:

- The aim is to drive out costs wherever possible; without risking a failure to meet the service standards, which Australia Post is required to meet and that the community has come to expect; and
- Larger / national initiatives invariably have cross functional impacts and these are assessed against a strategic view of the future network requirements and a 'whole of network' architecture – to avoid cost shifting from one function to another – a risk in any network environment.

Australia Post operates an organisation-wide business efficiency and optimisation program which is focused on increasing the efficiency of the cost base through cost containment and cost out initiatives. This program has focus across both the mail and parcel networks as well as support functions and overheads.

In June 2014, Australia Post announced it was implementing a Headcount Reduction Program as part of a broader business restructure to support a customer centric organisation. The objective of the program is to reduce labour cost overheads in support functions through a net reduction of roles across management, administration and back-office support staff.

The program is planned to deliver a total headcount reduction of around 1,000 employees resulting in a labour saving across the business in 2014/15 of $40m, including $21m in labour savings for domestic reserved letter products, with the full annualised benefit realised by 2015/16.

6.5. Reform our Letter Service

The RoLS Program defines the Postal Services strategy and the changes required to reduce Australia Post's network costs while providing customers with choice and maintaining service levels in an environment of structural letter volume decline.

In 2014, RoLS identified five interdependent product and operational reforms required to support the strategy:

- Extend the two-speed product offer (the Broad Based 2 Speed Letter Service);
- Maximize the volume of letters processed during the day;
- Increase the level of automation;
- Implement a National Delivery Model (**NDM**) (implementing an aligned service delivery model); and
- Optimise the network of delivery facilities.

As shown in Figure 2, these reforms are the foundation for the key elements of the RoLS Program.

Figure 2 – High level RoLS blueprint

6.5.1. Extend the two-speed product offer

The foundation to provide the flexibility to achieve the financial benefits is detailed below. There are two key dependencies to realising the value from the RoLS Program:

- The overall volume of letters; and
- The proportion of addressed letter volume sent to the Regular delivery timetable achieves a minimum level of 80%.

6.5.2. Maximise the volume of letters processed during the day

Objective:

- Reduce the work effort for overnight processing of letters from 95% to 20% by 2016/17 by processing all regular letters during the day in an extended processing window; and
- Within the extended processing window increase the volume of letters sequenced at mail centres which in turn will reduce the time required at the delivery centre to prepare letters for delivery.

The use of an extended processing window will enable an increase in the volume of sequenced letters leading to full time equivalent (**FTE**) reductions in delivery.

Prior to reform, only around 5% of mail centre staff work on shifts that do not attract a penalty payment. The majority (95%) work on shifts that attract a 15% or 30% penalty payment.

As multi-speed product options are introduced and the proportion of letters sent via the Regular delivery timetable increases, Australia Post expects that by 2017/18, the percentage of mail centre staff required to work on shifts that attract a penalty payment will reduce from 95% to approximately 60%.

Australia Post has responded to the greater than forecast migration of letters sent to the Regular delivery timetable following the June 2014 changes. As of 30 June 2015, 327 staff have voluntarily changed to a daytime shift. To date no staff have been forced to change shifts and the current shift changes are aligned to work requirements in line with progressive letter migration from the Priority delivery timetable to the Regular delivery timetable.

6.5.3. Increase the level of automation

Objective:

- Lay a foundation for the long term by purchasing mail processing equipment that delivers benefits even at very low levels of letter volume; and
- Reduce manual work by increasing the level of automation at major mail centres.

The use of the longer processing window will allow the rationalisation and replacement of aged processing equipment with faster and more capable processing equipment in the major mail centres for small and larger flat letters. This will reduce the labour required to process letters through to delivery preparation.

Once implemented, automation (with the use of a longer processing window) will be responsible for 69% of the cost benefit in 2017/18 (53% directly and 16% indirectly) by reducing the manual work effort and mail processing equipment maintenance costs.

There are two types of mail processing equipment that will be introduced:

- Culler, facer, canceller and preparation (**CFCP**) machines (small letters only); and
- New large letter flat sorting machines (**FSM**).

Small Letter Automation – in December 2014, the small letter business case was presented to the RoLS Program Control Board. The business case presented two options; purchase mail processing equipment (twelve CFCPs) and maintain existing mail processing equipment.

Purchasing the mail processing equipment – CFCPs was the preferred option as small letter automation delivers ongoing processing efficiencies, a reduction in delivery work effort and lays the foundation for investment in large letter automation.

The total investment for the preferred option is circa $65m with a discounted payback period of 3.02 years. The CFCPs:

- Replace equipment near its end of life (63 machines with up to 25 years in operation);
- Perform initial sort functions; and
- Are fully interoperable with retained equipment.

Large Letter Automation – in February 2015 the large letter business case was presented to the RoLS Program Control Board. The business case presented three options. Two for the purchase of mail processing equipment and the third to maintain the existing mail processing equipment.

The preferred option was the purchase of six FSMs to be located at major mail centres. The total investment for this option is circa $91m with a discounted payback period of 3.03 years.

Purchasing the FSMs means that automation will become the default option for all large letters. The FSMs will eliminate significant manual work effort by introducing:

- Greater capacity and capability to sort large letters to round level; and
- Greater capability to sort most small letters that are unable to be processed by small letter processing equipment.

It is important to note that although the Government's decision on reform was not known until early March, the RoLS Program Control Board approved both business cases prior to the announcement in recognition of the importance that automation plays in supporting the overall RoLS Program and the lead time required to purchase and deploy new mail processing equipment.

Both types of mail processing equipment will be rolled out progressively in 2016 and fully operational in 2017/18.

6.5.4. Implement a National Delivery Model

Objective – by 2017/ 18 realise cost savings by implementing the National Delivery Model.

The program allows a significant improvement in delivery labour efficiency. To succeed it requires:

- Implementation of automation to significantly reduce the level of manual work in delivery centres;
- Volume forecasts in line with 2014 Corporate Plan; and
- Over 80% of addressed letter volume to be sent to the Regular delivery timetable.

Notwithstanding that the delivery network grows on average by around 135,000 delivery points per year, the introduction of NDM (as part of the RoLS Program) will enable a reduction in FTEs.

Processing – implementing NDM requires a change in the processing environment. All letters need to be streamed as Priority or Regular with the sorting / sequencing of the Regular product aligned to the change in the delivery model.

6.5.5. Optimise the network of delivery facilities

Objective – migrate work to maintain efficient operations resulting in a reduction of the number of delivery centres reducing operating costs and future investment.

Overall, the delivery centre footprint will be reduced, subject to the availability of suitable sites, with a net financial benefit of $✂m by 2017/18, excluding property divestments.

Other projects that will be pursued are the review of the most efficient and optimal mode of transport to deliver product safely as well as a review of staff arrangements, via our Enterprise Agreements, such as start times that attract penalties.

All elements of the RoLS program will be executed over the 2014/15 – 2017/18 period and carefully orchestrated to ensure safety, service performance and cost targets are achieved.

Table 7 – RoLS Benefits

	2014/15 $m	2015/16 $m	2016/17 $m	2017/18 $m
Total RoLS Benefits (cumulative)	**1.5**	**67**	**158**	**262**

7. Costs

In this section:

- *An overview of Australia Post's costs by major category; and*
- *Detail on how management of Australia Post's defined benefit superannuation scheme has historically materially reduced Australia Post's superannuation expense.*

The total costs are as per the 2014 Corporate Plan. However, as the 2014 Corporate Plan assumed that reform would be introduced in July 2015, the 2014 Corporate Plan data has been adjusted to recognise:

- 5 October 2015 – price changes to most business letter services; and
- 4 January 2016 – implementation of a two speed letter service and price changes across the domestic letter service.

Consequently the 2014 Corporate Plan costs needed to be adjusted to recognise the impact on LPO commissions from the change to the timing of the price changes.

While excluding the impact on LPO commissions, the total costs are unchanged, the different price and volume forecast have also lead to a change in costs allocated to product.

Detail on Australia Post's approach to cost allocation including examples of how Australia Post continually refines its methodology to provide more accurate allocation of costs is provided in Section 9.

Table 8 – Financial overview

	Final	**Forecast**	**Forecast**	**Forecast**
$million	**2013/14**	**2014/15**	**2015/16**	**2016/17**
Trading Revenue				
Postal Services	3,132	3,096	3,356	3,489
Parcel Services	3,083	3,190	3,351	3,524
Other	(5)	(10)	49	55
Total Trading Revenue	**6,210**	**6,277**	**6,757**	**7,068**
Trading Expenses (Cost)				
Labour and Oncosts / Contract Services	3,180	3,206	3,196	3,172
Goods / Services for Sale	209	226	243	250
Accommodation	323	338	369	387
Depreciation	274	316	400	390
Other Non-Labour	2,067	2,164	2,310	2,426
Total Trading Expenses	**6,053**	**6,251**	**6,517**	**6,626**
Trading Profit	**157**	**26**	**240**	**442**

7.1. FTE usage

As shown in Table 9, the number of FTEs is forecast to decline.

Table 9 – Total FTEs by function

Activity / Area	Actual	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Sales / Acceptance	✂	✂	✂	✂	✂
Processing	✂	✂	✂	✂	✂
Transport	✂	✂	✂	✂	✂
Delivery	✂	✂	✂	✂	✂
Other areas	✂	✂	✂	✂	✂
Total	**31,416**	**31,485**	**31,485**	**30,998**	**29,724**

7.2. Domestic reserved Ordinary / Other letter service

Table 10 details actual and forecast data for the domestic reserved Ordinary / Other letter service. Financial data for the domestic letter service is at Appendix 4.

Table 10 – Ordinary / Other

	Actual	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Volume (m)	1,296	1,155	1,155	1,011	871
Revenue ($m)	816	792	792	839	863
Cost ($m)	984	976	934	911	864
Profit ($m)	(169)	(184)	(142)	(72)	(2)

7.3. Domestic reserved letter service FTE usage

As detailed in Table 11, there is a reduction in FTEs within the domestic reserved letter service.

Table 11 – Domestic reserved letter service FTEs

	Actual	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Sales / Acceptance	✂	✂	✂	✂	✂
Processing	✂	✂	✂	✂	✂
Transport	✂	✂	✂	✂	✂
Delivery	✂	✂	✂	✂	✂
Other	✂	✂	✂	✂	✂
Total	**16,809**	**16,298**	**15,559**	**14,174**	**12,711**

7.4. Superannuation

This section details how historically providing defined benefits through the Australia Post Superannuation Scheme (**APSS**) has materially reduced Australia Post's superannuation expense and cash superannuation contributions over this period.

7.4.1. Defined benefit scheme

Since 1991, Australia Post has provided employee members of the APSS with retirement benefits equal to 14.3% of their final average salary for each year of service. At 30 June 2015 the APSS defined benefit component held $3,983m in assets, representing a $307m surplus over the $3,676m of vested employee liabilities.

Although the nominal benefit rate of 14.3% provided to employees is greater than legislated Superannuation Guarantee obligations, these benefits are largely funded from the returns on existing APSS investments as well as company contributions to the scheme.

Based on independent actuarial assumptions, funding the defined benefit obligations of all existing APSS members currently requires annual employer contributions equal to 9.5% of employee superannuation salaries. This contribution rate is lower than the Australia Post superannuation contribution rate for Award level staff which is 10.5% in 2014/15, 11.25% in 2015/16 and 12% in 2016/17.

Providing defined benefits through the APSS has materially reduced the corporation's superannuation expense and cash superannuation contributions.

7.4.2. Change in Accounting Standards

In financial reporting periods up to 2012/13, calculation of Australia Post's defined superannuation benefit expense assumed that investments within the APSS would generate market returns of 7.25% to 8.30%, as determined by the fund's independent actuary. These returns acted to reduce Australia Post's superannuation expense.

From 1 July 2013, new international and Australian accounting standards require calculation of the defined benefit expense to assume all investments will generate returns equal to the long term government bond rate. At 30 June 2014, this rate was 3.54%. The use of this rate significantly reduces subsidisation of superannuation expense previously provide by investment returns and is projected to increase the enterprise superannuation expense from 2013/14 onwards.

7.4.3. APSS Cost Management

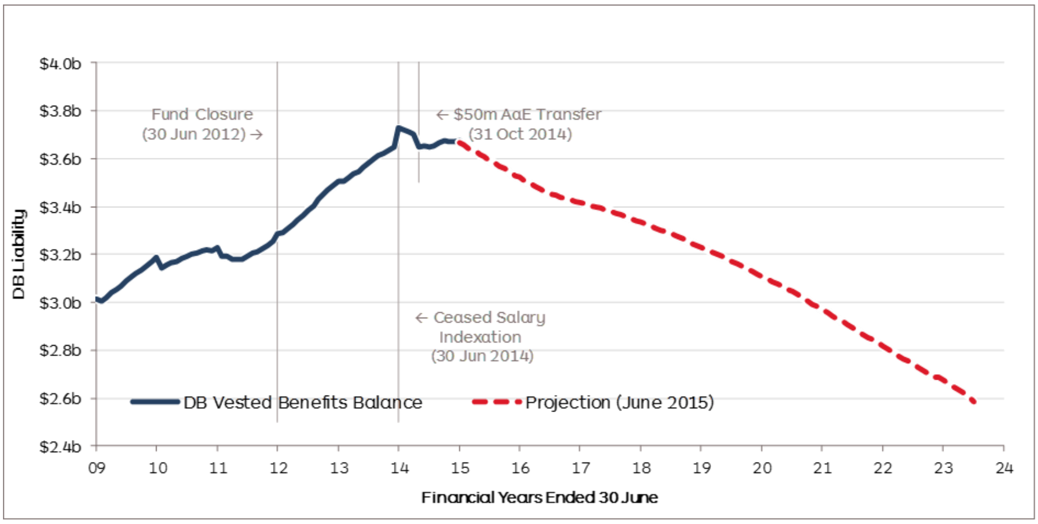
The financial benefits (e.g. a lower superannuation expense) derived by Australia Post from sponsoring the APSS have reduced since the global financial crisis and are no longer considered adequate to compensate for the risk of exposure to movements in the $3.5bn of funds invested.

To actively manage the growth in superannuation liabilities and superannuation expense, the scheme was closed to new members in July 2012. In addition, operational efficiency gains of nearly $2m have been achieved over the past few years.

Indexation of superannuation salaries that do not grow, or grow by less than the Enterprise Bargaining Agreement rate for that year, between birthdays, with AWOTE was ceased on 1 July 2014. At the same time, superannuation accruals during periods of leave without pay was modified from 12 months, to 28 consecutive days.

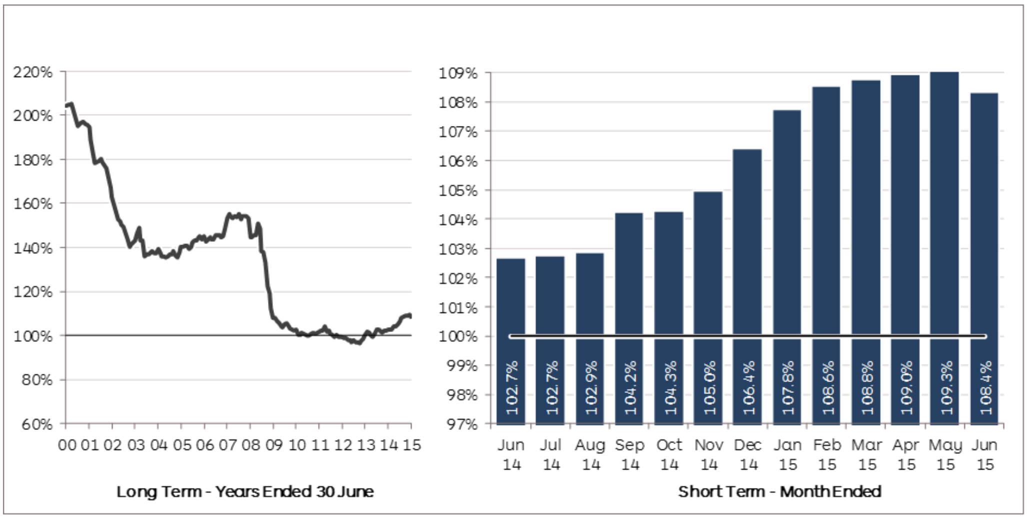
With the combination of all these changes, current projections show the total vested defined benefit liability peaked at 30 June 2014 and overall decline is expected Chart 7.

Chart 7 – APSS vested defined benefit liabilities



As a result of these changes and strong investment returns, the Vested Benefits Index has also grown as illustrated in Chart 8.

Chart 8 – APSS vested defined benefit index



7.5. Depreciation

As shown in Table 12, the continued capital investment across the Enterprise over the past four years has resulted in a higher depreciation expense for the domestic reserved letter service.

Table 12 – Depreciation expense, domestic reserved letter service

$million	Actual	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Buildings and Fitout	20	18	19	21	21
Plant and equipment	31	25	25	35	28
Computer software	37	44	44	43	47
Motor vehicles	13	13	13	16	15
Total	**101**	**100**	**100**	**115**	**110**

8. Asset base

In this section:

- *Australia Post's balance sheet as at 30 June 2014; and*
- *Australia Post's capital expenditure plan out to 2016/17.*

This section focuses on Australia Post's fixed asset base and includes both the inherited fixed asset base and the incremental changes to it arising from the Australia Post's capital investment plans out to 2016/17.

8.1. Australia Post's balance sheet

As at 30 June 2014[23] Australia Post's balance sheet comprised $4,651m in total assets, $2,889m in liabilities, and $1,763m in equity, or net assets. Table 13 shows the current and non-current (fixed) assets as per the balance sheet (Appendix 9).

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

Table 13 – Australia Post total assets

Assets	Value ($million)
Current assets	
Cash and cash equivalents	419
Trade and other receivables (including accrued revenues)	513
Inventories	49
Other current assets	257
Total current assets	**1,237**
Non-current assets	
Trade and other receivables	97
Investments in jointly controlled entities	2
Superannuation asset	48
Land and buildings	879
Plant and equipment (including motor vehicles)	728
Intangible assets (including software)	1,113
Investment property	192
Deferred income tax assets	333
Other non-current assets	22
Total non-current assets	**3,414**
Total assets	**4,651**

[23] Australia Post Annual Report 2013/14, Financial and Statutory Reports, page 58

8.2. Asset accounting policies and practices

As show in Table 13, at 30 June 2014 Australia Post had $3,414m of non-current assets recognised in the balance sheet.

Fixed assets are grouped into approximately 500 asset classes. Depreciation rates are set asset by asset within each asset class level, and are reviewed annually. Asset stocktakes are also conducted annually where assets and their location are confirmed, transferred to a new work centre, or removed from the asset register if they cannot be located or are no longer used. These practices support the annual report preparation process to ensure that asset balances are not being reported above their appropriate values.

Appendix 10 provides further detail on Australia Post's fixed assets.

8.3. Capital investment plan

Australia Post prepares a capital investment plan each year as part of the annual planning process. Table 14 details forecast capital investment out to 2016/17 and is consistent with the 2014 Corporate Plan.

Table 14 – Capital investment outlays by category

$million	Final Result	Forecast		
	2013/14	2014/15	2015/16	2016/17
Strategic Initiatives	**405**	**243**	**290**	**290**
Asset Replacement	118	106	110	110
Corporate Initiatives	-	101	-	-
Total	**523**	**450**	**400**	**400**

8.4. Forecast asset base

Table 15 details Australia Post's total fixed assets out to 2016/17. Data is consistent with the Record Keeping Rules schedules (the allocation of costs), asset values are allocated to products according to procedures specified in the Regulatory Accounts Procedures Manual, which has been provided to the ACCC in accordance with section 23 (6) of the Record Keeping Rules (**RKR**).

Investment Property and Land and Buildings are measured at Fair Value, whereas Plant and Equipment and Intangible Assets are measured at cost, net of any accumulated depreciation/amortisation and/or impairment losses. Fixed asset opening and closing balances include assets under construction and agree to the RKR schedules.

Table 15 – Australia Post total fixed assets and intangibles

$million	Final Result	Forecast		
	2013/14	2014/15	2015/16	2016/17
Opening balance	3,351	3,676	3,770	3,621
Net Additions[24]	616	433	270	390
Depreciation	(291)	(338)	(419)	(409)
Closing balance	3,676	3,770	3,621	3,602

[24] Net Additions is presented as capital investment additions less forecast disposals.

Table 16 details the domestic reserved letter service total fixed assets which consistent with RKR practice, excludes assets under construction until the assets are in service and transferred out.

Appendix 11 provides a breakdown of Table 16 by each letter category

Table 16 – Domestic reserved letter service fixed assets

$million	Final Result	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Opening balance (pre NCAU)	792	809	809		
Transition to NCAU			(36)		
Opening balance (post NCAU)			773	748	643
Net Additions	112	89	75	10	71
Depreciation	(95)	(100)	(100)	(115)	(110)
Closing balance	809	798	748	643	604

Additions in 13/14 comprise primarily the annual motor vehicle asset replacement program, mail handling equipment delivery centre building and system upgrades and replacement. Out-year forecasts are also primarily for asset replacement.

9. Cost allocation

In this section:

- *An overview of Australia Post's cost allocation model and methodology;*
- *Detail on the Network Cost Allocation Update project and how it results in more accurate cost allocation; and*
- *Cost elasticity – the relationship between costs and volume.*

9.1. Australia Post's cost allocation model

Australia Post uses an Enterprise Profit Model (**EPM**) which calculates the operational cost for 'reserved' and 'non-reserved' services provided by Australia Post. This is a fully absorbed costing model and allocates costs to products via the following main 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 activities within the organisation and assigns the cost of each activity resource to all products and services according to consumption. The methodology assigns the resource costs through activities to the products and services provided to customers;
- 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.

The cost allocation model is used as a key internal reporting tool, providing financial metrics for each business unit to ensure a sharp focus is maintained on costs.

The cost allocation model also supports a number of external reporting requirements including:

- RKR requirements;
- Price notifications;
- Audited annual report (segment note); and
- Quarterly shareholder reports.

RKRs are a fundamental component of our external validation processes. The audit of the RKRs takes place over an intensive five week period each year.

The annual compilation of the Regulatory Accounting Procedure Manual enables an annual checkpoint of policies. The Regulatory Accounting Procedure Manual is reviewed both by external audit and the ACCC prior to its finalisation.

9.2. Methodology

Australia Post's cost allocation methodology is robust and relevant.

- Product volume is the dominant cost driver in the model;
- Product volume is measured in each activity (providing activity specific volume) and in each geographic state (state originating and terminating volumes); and
- Products do not receive activity cost if there is no volume of product in the activity.

The use of volume as a key driver means that the methodology employed by Australia Post inherently increases the cost burden for products experiencing volume growth and lessens the burden for products in structural decline.

As this methodology reflects a 'dual till' approach, as demand for reserved service letter products declines, an increasing proportion of Australia Post's total cost base is borne by non-reserved products.

While the principles underpinning the cost allocation model are unchanged, Australia Post continues to refine and update the model to reflect changes in the business.

9.3. Safeguards

The cost allocation model has safeguards to avoid over-costing declining products – reserved service letter products bear less of the fixed cost burden of the network over time.

The model achieves this as all activity cost is volume variable, regardless of whether the underlying resource used in the activity is fixed or variable.

In multi-product activities, product volume and the product consumption rate of activity resources, determine the cost allocation to each product. If consumption rates remain relatively stable over time, then cost allocation is predominantly volume dependent.

Within Australia Post's cost allocation model, products experiencing volume growth are deemed to be placing greater demand on shared activity resources than those declining. A consequence of the long term structural decline of reserved service letter products is rising activity cost per unit through diseconomies of scale, coupled with increases in input costs (factor prices).

In the absence of productivity improvement, activity cost per unit of throughput (measured as standard article equivalent) will proportionately increase or decrease by the % change in throughput and % change in factor prices.

All products in the shared activity therefore bear the same proportional change in activity cost per unit, however, products experiencing volume growth will absorb a greater share of the total activity cost pool, while products in decline absorb a lower share.

9.4. Influence of cost driver changes

Product volumes are updated in the model monthly and activity throughput is assessed annually. Changes are reflected in the model if there are material changes identified in mail flows across the network.

Consumption rates (time, weight, mass, repetitions) are reviewed when activity costs deviate from expected tolerances (i.e. activity unit costs increase / decrease sharply)

The increasing rate of losses in the reserved letter service is a function of regulated prices and declining volume combining to generate insufficient revenue to cover rising unit costs through diseconomies of scale and rising factor prices.

9.5. Network Cost Allocation Update

Australia Post continually reviews its cost allocation model in line with business changes.

Since the introduction of the Enterprise Profit Model methodology, updates have been applied in regard to non-operational cost allocations and network cost allocations.

The model is also updated to reflect the most up-to-date organisation structure to ensure it reflects the fundamentals of the business. The most recent review of methodology has focused on network cost allocations – the Network Cost Allocation Update (**NCAU**)

NCAU commenced by verifying letter and parcel network activities and then updated, included or excluded activities to reflect current business operations e.g. parcel pickups by van operations at business hubs (traditionally, vans have been used in the clearance of letters from street posting boxes, vans are now used to also pick up customer parcels).

A 'Resource to Activity Driver Update' was then undertaken by:

- Confirming source level data to ensure that the cost(s) purpose is accurate at the cost centre level;
- Sourcing and implementing operational data for cost drivers wherever possible. For example Australia Post now uses operational data for product centric activities e.g. 'Letters Processing' 'Parcel Processing Small Parcels';
- Reviewing each network function (Sales and Acceptance, Processing, Transport and Delivery) and updating activities and channels against products; and
- Refreshing the network functions including recalculated probability factors.

NCAU will result in a more accurate allocation of costs between reserved and non-reserved services for the following reasons:

- Completed review of all network cost centres ($4.5bn of cost excluding StarTrack); and
- Sourced operational data wherever possible, to provide business related activity cost drivers.

Appendix 12 shows the pre and post impact of NCAU on domestic reserved Ordinary / Other letters for the 2014/15 transition year against the 2014 Corporate Plan.

9.5.1. Allocation of costs Priority v Regular

Australia Post has adopted a top down approach to estimate the operational unit cost difference. Detail of this is at Appendix 13.

The purpose of providing these cost estimates is to provide the ACCC with Australia Post's current view on the likely operational unit cost difference between a Regular and a Priority small stamped letter. However, it is important to note that the operational unit cost differentials are preliminary, high level estimates.

When the RoLS Program is fully implemented, Australia Post estimates the operational unit cost difference between a small stamped Regular letter and small stamped Priority letter lodged via a street posting box to be ✂cents.

As projects within the RoLS Program rollout, Australia Post will review activities and their cost factors / drivers to ensure activities are allocated to the right product.

9.6. Relationship between costs and volumes – cost elasticity

In 2013 Australia Post engaged Economic Insights Pty Ltd to undertake an econometric analysis of the likely effects of declining mail volumes and declining mail density on Australia Post's future costs.

This is done by econometrically estimating cost elasticities which show the percentage change in costs in response to a one per cent change in output. A cost elasticity of one would indicate that costs change by exactly the same percentage as output while a cost elasticity of zero would indicate that costs are totally independent of output changes.

That study provided information on postal cost elasticities specifically for Australia using recent data from the period of declining mail volumes. It also used flexible functional forms for the estimated cost function and covers all inputs whereas earlier studies have tended to use simple functional forms and only cover labour data.

Based on their econometric analysis of Australia Post's processing (mail centres) and delivery (delivery centres) functions (which they noted combined account for over 80% of Australia Post's operational costs), Economic Insights Pty Ltd concluded that the output changes observed in 2012/13 in isolation would have increased Australia Post's reserved service real operational costs by 0.2%.

In its Decision of February 2014, the ACCC welcomed the econometric analysis undertaken by Economic Insights but noted that it had only a limited time to review. Subject to this qualification however, the ACCC noted that the 'report appears to be a relatively robust and transparent study of Australia Post's cost structures'[25] and contains a 'convincing argument regarding how the ACCC should not calculate cost forecasts'.

In support of this notification Australia Post requested that Economic Insights update its econometric analysis. The current study '*Updated Estimates of Australia Post's Mail Centre and Delivery Centre Cost Elasticities, 14 May 2015*' provides updated cost elasticity estimates for the conditions Australia Post currently faces.

It contains an extra 13 months of data increasing the number of monthly mail centre observations by 15% (from 440 to 505) and delivery centre observations by 80% (from 2,000 to 3,625).

While for mail centres, the cost elasticity estimates from the updated study were expected to be generally very similar to those obtained in the initial January 2014 study. For delivery centres, the increased robustness of delivery centre data (only 16 month of consistent national data were available at the time of the January 2014 study), was expected to result in a different outcome.

A comparison of the latest estimates to the January 2014 estimates is shown in Table 17.

Table 17 – Cost elasticity estimates

	Percentage change in costs from a 1 per cent increase in outputs	
	Mail Centres	**Delivery Centres**
2014 study		
Total cost	0.44	0.76
Variable cost	0.56	0.58
2015 study		
Total cost	0.48	0.51
Variable cost	0.58	0.36

Consistent with the previous report, Economic Insights found that the estimated elasticities imply that mail centre real costs (driven by the declining number of articles) have decreased and delivery centre real costs (driven by the increasing number of delivery points) have increased.

Using this information and assuming that the cost elasticities of other inputs such as acceptance and transport are zero, Economic Insights concluded that the output changes observed between 2012/13 to 2013/14 in isolation would likely have decreased Australia Post's reserved service real costs by 0.95 per cent.

[25] ACCC Decision of February 2014, page 21

10. Rate of return

In this section:

- *As in previous price notifications, the rate of return proposed is a weighted average cost of capital (WACC) based on the capital asset pricing model; and*
- *Australia Post has sought independent advice regarding the WACC.*

The 2014 Corporate Plan sets out the most recent expectations for the business. In that Plan, profit targets and pricing expectations for the domestic reserved letter service were formed on the assumption that the ACCC's pricing model continued to apply to reserved services. That is:

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

10.1. Australia Post Corporation WACC

Australia Post engaged Value Adviser Associates to undertake an independent assessment and provide estimates of certain parameters used to derive Australia Post's (reserved letters business) WACC. Table 18 details those parameters with further detail provided at Appendix 14.

Table 18 – Australia Post (reserved letters business) WACC

WACC Parameter	Based on latest advice
rf nominal risk-free rate-of-return	2.96%
rm-rf market risk premium	7.0%
Tc corporate tax rate	30%
γ imputation factor	0.0
Cost of debt	4.35%
D/V Australia Post's gearing ratio	30%
βa asset beta	0.60
βd debt beta	0.15
βe equity beta	0.80
Nominal post tax vanilla WACC	7.29%

11.Post Tax Revenue Model Summary

Australia Post is proposing that the price changes take effect from 4 January 2016. A comparison of the proposed and allowable revenues over the 2014/15 to 2016/17 financial years is at Table 19.

Table 19 – Post Tax Revenue Model summary 2014/15 to 2016/17

		2014/15 $m	2015/16 $m	2016/17 $m
Nominal Vanilla WACC	7.29%			
Required Revenue		$ 1,990	$ 1,950	$ 1,841
Present Value of Required Revenue		$ 1,942	$ 1,856	$ 1,710
Sum of PV over 3 years		$ 5,507		
Letters Revenue at proposed prices		$ 1,721	$ 1,880	$ 1,925
Present Value of Proposed Letters Revenue		$ 1,679	$ 1,790	$ 1,787
Sum of PV over 3 years		$ 5,256		
Deficiency of Letters Revenue to Required Revenue		$ 262	$ 66	-$ 77
Sum of PV over 3 years		$ 251		

Note: PV calculations are future values discounted by inflation

Appendix 1 – Reforming Australia Post, Joint Release

Minister for Communications

Joint Release with the Hon Mathias Cormann Minister for Finance: Reforming Australia Post

3 March 2015

The Australian Government has today ensured that Australia Post can maintain a sustainable mail service for all Australians.

Australia Post is facing significant structural decline as people choose to communicate over the Internet. Australians are now sending one billion fewer letters a year than they were in 2008, with letters losses rising to more than $300 million a year.

While Australia Post has been able to offset these losses by growing its parcels business, losses in letters are now so large that they are overwhelming all profitable areas of the business. Without reform total projected company losses could reach $6.6 billion over the next 10 years, with letters losses of $12.1 billion.

Australia Post does not receive funding from taxpayers and Australians must not be forced to subsidise business and government mail, which accounts for 95 per cent of total letters volume.

The Government has approved Australia Post's request to introduce a two-speed letters service – a Priority and Regular service that will be introduced for consumers no earlier than September 2015. The Regular service will be delivered two days slower than the current timetable.

The price of Regular letters will be overseen by the Australian Competition and Consumer Commission (ACCC), consistent with the current practice. Australia Post has advised the Government it will apply to the ACCC to raise the regular stamp price from $0.70 to $1.00. This is necessary to support a more sustainable letters service with an aim of breaking even over time. The Priority service will be a commercial product.

Australia Post will continue to deliver mail five days a week to 98 per cent of addresses, and the delivery speed will vary depending on the service. The Priority service will be delivered to a faster timetable than the Regular service.

Concession card holders will continue to be offered a concession rate stamp, which will be frozen at $0.60, and all Australians will continue to have access to a $0.65 Christmas rate stamp.

These measures will also help Australia Post maintain its extensive post office network, particularly Licensed Post Offices (LPOs) in regional and remote communities.

Date: 3 March 2015

Media contact:

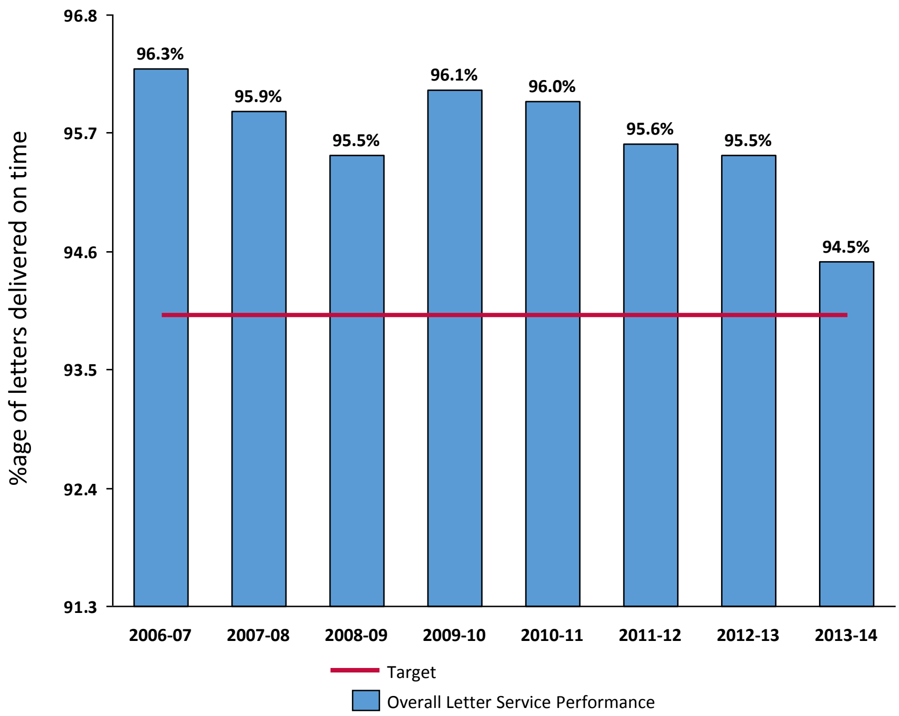
For Minister Turnbull – David Bold: 0427 784 451

For Minister Cormann – Karen Wu: 0428 350 139

Appendix 2 – Australia Post's delivery performance

The Prescribed Performance Standards include a requirement that Australia Post delivers letters five-days-a-week to at least 98 per cent of all Australian delivery points. The work associated with meeting this 'delivery frequency' standard continues to grow, as population growth adds, on average, 135,000 delivery points to Australia Post's network each year.

Australia Post's performance against the delivery timetable within the PPS is subject to independent audit by the Australian National Audit Office. As shown in the following Chart, Australia Post continues to exceed the minimum delivery performance level required.



Appendix 3 – Price changes

While only ordinary letter services are notified services, Australia Post is providing, for information only, detail on some other proposed domestic reserved letter service price changes. All prices are effective 4 January 2016.

Ordinary & Other Prices by the Regular Timetable

Proposed Ordinary - GST Inclusive

Regular Timetable Size / Weight	Current $	Proposed Price $	Increase %
Small			
Ordinary / Stamped	$0.70	$1.00	42.9%
Seasonal Greeting *	$0.65	$0.65	0%
Concession ^	1 stamp	1 stamp	0%
Large			
Ordinary / Stamped			
Up to 125	$1.40	$2.00	42.9%
Over 125 up to 250g	$2.10	$3.00	42.9%
Over 250 up to 500g	$3.50	$5.00	42.9%
Seasonal Greeting *			
Up to 125	$1.30	$1.30	0%
Concession stamp ^			
Up to 125	2 stamps	2 stamps	0%
Over 125 up to 250g	3 stamps	3 stamps	0%
Over 250 up to 500g	5 stamps	5 stamps	0%

Notes:
* Seasonal greeting card rate available during November and December
^ Concession stamps available in packs of five for $3.00. For small letters use one stamp, for large use number stated.

Proposed Other Prices - GST Inclusive

Regular Timetable Metered/Imprint	Proposed Price $
Small	
Metered/Imprint	$0.95
Large	
Metered/Imprint	
Up to 125	$1.90
Over 125 up to 250g	$2.85
Over 250 up to 500g	$4.75

Proposed Prepaid Envelopes Prices - GST Inclusive

Regular Timetable	Per item	Pack of 10	
Size / Weight	$	Single $	5+ packs $
Envelope			
DL Plain	$1.20	$11.40	$10.80
C6 Plain **	$1.20	$11.40	$10.80
C5	$2.45	$23.30	$22.05
C4	$4.35	$41.35	$39.15
B4	$5.25	$49.90	$47.25
	Per item $	Pack of 50 $	Box of 500 $
Window face			
DL	-	$57.00	$540.00
C6 **	-	$57.00	$540.00
Postcard	$2.20	-	-

** Limited Stock, under review to be phased out.

For Priority Timetable

The price for Priority delivery is based on the price for Regular delivery plus a premium for Priority

The additional premium for Priority will be confirmed once the ACCC's decision on the proposed Ordinary Letter prices is known

Notes:

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

Non reserved prices

No Change

Proposed Other Prices - GST Inclusive

	Proposed Prices Regular $	Proposed Prices Priority $
Local (Country)		
Small	$0.92	$0.95
Large		
Up to 125	$1.65	$1.90
Over 125 up to 250g	$2.20	$2.50
Over 250 up to 500g	$2.45	$2.90
Clean Mail		
Small	$0.90	$1.125
Small Plus up to 125g	$1.42	$1.734

Proposed Other Prices - GST Inclusive

Reply Paid	Proposed Prices Regular $	Proposed Prices Priority # $
Small		
Barcoded	$0.65	$0.80
Unbarcoded	$1.20	
Large - Barcoded		
Up to 125	$2.00	$2.20
Over 125 up to 250g	$3.00	$3.20
Over 250 up to 500g	$5.00	$5.20
Large - Unbarcoded		
Up to 125	$2.20	
Over 125 up to 250g	$3.20	
Over 250 up to 500g	$5.20	
Annual Fee	$100.00	

Certain restrictions apply

Proposed PreSort Prices - GST Inclusive

	Regular Timetable				Priority Timetable			
	Barcode Direct Tray		Barcode	U/Bcode	Barcode Direct Tray		Barcode	U/Bcode
Size / Weight	Same State $	Other State $	Residue $	Residue $	Same State $	Other State $	Residue $	Residue $
Small Letters								
Up to 125g	$0.795	$0.820	$0.855	$0.900	$0.960	$0.995	$1.080	$1.125
Charity Mail	$0.495	$0.515	$0.546	$0.900	$0.600	$0.635	$0.700	$1.125
PromoPost	$0.684	$0.705	$0.735	$0.900				
Small Plus								
Up to 125g	$1.000	$1.048	$1.300	$1.420	$1.275	$1.330	$1.473	$1.734
Large								
Up to 125g	$1.390	$1.470	$1.730	$1.880	$1.740	$1.845	$2.125	$2.244
Up to 125g - Charity Mail	$1.030	$1.088	$1.292	$1.880				
Over 125 up to 250g	$1.850	$2.010	$2.280	$2.420	$2.350	$2.505	$2.700	$2.850
Over 250 up to 500g	$2.380	$2.580	$2.900	$3.200	$2.880	$3.080	$3.390	$3.700

Acquisition Mail	Barcode Direct Tray		Barcode	U/Bcode
Regular Timetable	Same State $	Other State $	Residue $	Residue $
Small - up to 125g	$0.585	$0.610	$0.855	$0.900
Small Plus - up to 125g	$0.815	$0.858	$1.300	$1.420

Impact Mail Regular Timetable	Postcode Direct Tray $	Area Tray $	Residue $
Small - up to 125g			
Same State	$1.050	$1.110	$1.190
Other State	$1.080	$1.140	$1.220
Small Plus - up to 125g			
Same State	$1.522	$1.603	$1.690
Other State	$1.560	$1.650	$1.740

Notes:

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

Non reserved prices

No Change

Appendix 4 – Financial data

Table 20 shows the impact of the 4 January 2016 changes across the domestic letters business.

Table 20 – Domestic letters business

	Domestic Reserved					
	Ordinary[26] (Stamped)	**Other**	**Sub Total**	**Presort**	**Non Reserved**	**Total Domestic Letters**
2013/14						
Volume	475	821	1,296	1,878	941	4,115
Revenue ($m)	280	536	816	955	339	2,110
Total costs ($m)	421	564	984	✂	✂	2,452
Contribution[27] ($m)	(141)	(28)	(169)	✂	✂	(342)
ROR %	(50.3%)	(5.2%)	(20.7%)	✂	✂	(16.2%)
2014/15 (pre NCAU)						
Volume	411	745	1,155	1,745	958	3,859
Revenue ($m)	282	510	792	929	337	2,059
Total costs ($m)	409	567	976	✂	✂	2,427
Contribution[27] ($m)	(127)	(57)	(184)	✂	✂	(368)
ROR %	(45.1%)	(11.1%)	(23.2%)	✂	✂	(17.9%)
2014/15 (post NCAU)						
Volume	411	745	1,155	1,745	958	3,859
Revenue ($m)	282	510	792	929	337	2,059
Total costs ($m)	359	575	934	✂	✂	2,359
Contribution[27] ($m)	(77)	(64)	(142)	✂	✂	(300)
ROR %	(27.5%)	(12.6%)	(17.9%)	✂	✂	(14.6%)
2015/16						
Volume	335	676	1,011	1,568	925	3,505
Revenue ($m)	272	567	839	1,041	360	2,240
Total costs ($m)	333	578	911	✂	✂	2,338
Contribution[27] ($m)	(62)	(11)	(72)	✂	✂	(98)
ROR %	(22.6%)	(1.9%)	(8.6%)	✂	✂	(4.4%)
2016/17						
Volume	287	584	871	1,387	922	3,181
Revenue ($m)	280	583	863	1,062	366	2,291
Total costs ($m)	321	544	864	✂	✂	2,255
Contribution[27] ($m)	(41)	39	(2)	✂	✂	37
ROR %	(14.6%)	6.8%	(0.2%)	✂	✂	1.6%

[26] Ordinary stamped column includes only notified services. From 2015/16 stamped letters sent to the Priority delivery timetable are in the 'Other' column.

[27] Gross contribution before cost of capital

Appendix 5 – Australia Post’s Letter Pricing Principles

- The letters pricing structure will be as simple as possible;
- The letters pricing structure will reflect Australia Post’s commercial, social and governmental obligations;
- The primary social obligation is to supply a letter service that is accessible, available equitably and meets community needs;
- Letter prices will be set to enable Australia Post to meet its statutory requirement to provide an adequate commercial return and to fund its Community Service Obligations (CSO);
- The Regular letter service is a ‘safety net’ service priced to recover the efficient cost of providing the service;
- The Priority service is a commercial product but is priced to incentivise migration to the Regular service;
- The basic postage rate – the rate for the ordinary small letter – is the keystone of the letter pricing structure;
- Carriage of the Ordinary Small Letter at a uniform rate is central to the CSOs. Pricing of the basic postage rate reflects the need to maintain an affordable rate. Consequently, the basic postage rate may not always fully recover the costs of providing these services and as such, prices for other domestic reserved letter services may contain a cross subsidy to the basic postage rate;
- Subject to this need to cross subsidise letter products, letter prices have been set to achieve an appropriate aggregate rate of return for the letters business as a whole;
- Price changes will wherever possible be implemented on a regular basis with adequate notice and after appropriate consultation with stakeholders and customers;
- Subject to meeting minimum agreed quantities and conditions, bulk interconnection prices will be applied uniformly regardless of volume;
- Bulk interconnection prices will, in addition to, the requirements of section 32A(2) (c) of the APC Act, broadly reflect the level of work saved by Australia Post through work carried out by customers; and
- Bulk interconnection prices will be applied uniformly for carriage within Australia subject to the point of lodgement (same/other state prices apply).

Appendix 6 – Overview of myGov

The myGov digital mail service enables Australians to receive messages and transact with the Commonwealth Government in one place, in a seamless, secure, and authenticated digital environment.

Members can access services from a growing range of government organisations including Medicare, Australian Taxation Office (ATO), Centrelink, Australian JobSearch, Personally Controlled eHealth Record, My Aged Care, Child Support, Department of Veterans' Affairs, and the National Disability Insurance Scheme.

The myGov digital mail service was first launched by the then Labor Government in May 2013. At that time 1.3 million australia.gov.au users were transferred over.

The current myGov digital mail service commenced in March 2014 and currently has over 6.5 million active accounts, with the number of new accounts growing by approximately 15,000 each day. To date, this service has delivered more than 45 million letters on behalf of Centrelink, Medicare and Child Support. The ATO commenced using the service in March 2015.

The Coalition's Policy

The Coalitions' Policy for E-Government and the Digital Economy, August 2013, states that governments can, and should lead by example in their use of Information and Communications Technology (ICT) to provide services or engage with citizens. Furthermore, a Coalition government will:

- Designate the Internet as the default way to interact with users, other than for defined exceptions;
- Give people the option to elect to receive material from the government in digital form or in hard-copy, depending on their circumstances; and
- Seek to ensure every government interaction that occurs more than 50,000 times per year can be achieved online by 2017.

Government's Strategic Intent for myGov

In January 2015, the Commonwealth Government established the Digital Transformation Office (DTO) within the Department of Communications so that government services can be delivered digitally from start to finish. One of the DTO's first tasks is to ensure that Australians no longer have to complete separate 'log on' processes for each government service by having a 'digital identity', which they can use to log in to each of the government services.

Over the next 2 to 3 years, an increasing number of government agencies are expected to use myGov to deliver messages, letters and statements to Australians. In addition to that, the messages will contain links to help people navigate to services and seamlessly complete digital transactions, from start to finish.

The Department of Human Services (DHS) plans to phase out Medicare and Pharmaceutical Benefits Scheme payments via cheque or credit EFTPOS from July 2016 in favour of the Electronic Funds Transfer payment method. It will also phase out the use of cheques and Electronic Benefits Transfer Cards for all Centrelink payments from 1 January 2016 and 1 January 2017 respectively, with payments made directly into the bank accounts of eligible citizens. Medicare is also moving towards online claims and making statements available online.

Other permissions have been progressively put in in place to allow digital transactions e.g. the ATO directs refunds to bank accounts.

In the 2015/16 budget, the Commonwealth Government allocated $254.7 million over the next four years to implement the initial stage of a ‘Digital Transformation Agenda’. Projects that are part of the Digital Transformation Agenda include:

- $106.8 million to streamline the administration of government grants through a common ICT platform and single portal to search and apply for grants;
- $33.3 million for the development of a trusted digital identity framework; and
- $7.1 million for developing a “whole-of-government digital mailbox solution to enable individuals and businesses to receive and transact with digital messages and documents from government in a seamless, secure environment.”

The DTO will leverage myGov and the Australian Business Register to transform the way services are delivered to both individuals and business. While the DTO will champion digital by default, users will still be able to access a number of government services over the counter or phone. The DTO will work with State and Territory Governments to identify areas of synergy, including opportunities for states to leverage myGov, the digital mailbox and a digital identity platform.

In mid-2016, the DTO plans to launch a new Digital Business Account which will make it easier for the more than 2 million Australian businesses to access government services using a safe and secure online channel. As with the myGov service, this will enable businesses to receive messages from government agencies in the one secure account and enable businesses to update their contact information once which will then be sent to relevant government agencies. The Digital Transformation Agenda will also include the implementation of a streamlined Business Registration service.

<u>Impacts to Australia Post’s Letter Demand</u>

The myGov agenda detailed above will have a negative impact on Australia Post’s letter volume particularly PreSort Small letter volume. While only twenty percent of those eligible have registered for myGov, the following examples demonstrate the use of the myGov portal as an emerging electronic alternative:

- Between March 29, 2014 and June 30, 2014 the myGov inbox sent over 10 million letters online;
- Medicare letters online commenced with the implementation of myGov inbox on March 29, 2014; and
- In 2013/14 the number of customers registered to receive letters online with DHS was up 31% on the previous year and 110% on 2011/12.

Appendix 7 – Detail on Augmentation

As noted in Section 5, the econometric forecasts are intended to represent a baseline upon which further intelligence may be overlaid to counter a lack of tractable empirical data on emerging threats to letter volumes.

As such, to derive the final volume forecasts, Australia Post augments the baseline forecasts with management and market insight. Management and market insights are derived from:

- Input from the salesforce and account managers regarding customer behaviour;
- Market intelligence from participants in the mail value chain;
- Information in the public domain; and
- Interpretation of qualitative and quantitative reports commissioned by Australia Post and external sources.

Table 21, Table 22 and Table 23 detail the augmentation from baseline volume forecast to final volume forecast for the 2014/15 to 2016/17 years.

Each table provides an overview of Ordinary / Other letters (small and large) and PreSort letters (small and large) split between their transactional and promotional components.

Table 21 – 2014/15 volume forecast

		Baseline Volume Est		Transactional		Promotional			
	2013/14 Volumes (m)	Raw Growth	Raw Volume	Underlying Market Changes	Changes in use of Comm Medium	Underlying Market Changes	Changes in use of Comm Medium	Total Market Adjust (m)	2014/15 Volumes (m)
Ordinary / Other									
Small	1,153	-11.7%	1,018	2	5	0	0	7	1,025
Large	156	-4.8%	148	(2)	(4)	0	0	(6)	142
Total Ordinary / Other	1,309	-10.9%	1,166	(0)	1	0	0	0	1,166
PreSort									
Small	1,753	-5.5%	1,657	(5)	(10)	(6)	(2)	(23)	1,634
Large	129	-2.3%	126	(2)	(4)	(0)	(3)	(10)	116
Total PreSort	1,882	-5.3%	1,782	(7)	(13)	(7)	(6)	(33)	1,750
Total Addressed Mail (Excluding Print Post)	3,191	-7.6%	2,949	(8)	(13)	(7)	(6)	(33)	2,916

Table 22 – 2015/16 volume forecast

		Baseline Volume		Transactional		Promotional			
	2014/15 Last Est Volumes (m)	Raw Growth	Raw Volume	Underlying Market Changes	Changes in use of Comm Medium	Underlying Market Changes	Changes in use of Comm Medium	Total Market Adjust (m)	2015/16 Volumes (m)
Ordinary / Other									
Small	1,025	-8.9%	933	(22)	(3)	0	0	(25)	908
Large	142	-4.4%	136	(4)	(18)	0	0	(22)	114
Total Ordinary / Other	1,166	-8.3%	1,069	(26)	(21)	0	0	(47)	1,022
PreSort									
Small	1,634	-9.3%	1,483	0	(6)	(12)	0	(18)	1,464
Large	116	-3.9%	111	(1)	(1)	0	0	(2)	110
Total PreSort	1,750	-8.9%	1,594	(1)	(7)	(12)	0	(20)	1,574
Total Addressed Mail (Excluding Print Post)	2,916	-8.7%	2,663	(27)	(29)	(12)	0	(67)	2,596

Table 23 – 2016/17 volume forecast

	2015/16 Last Est Volumes (m)	Baseline Volume Est		Transactional		Promotional		Total Market Adjust (m)	2016/17 Volumes (m)
		Raw Growth	Raw Volume	Underlying Market Changes	Changes in use of Comm Medium	Underlying Market Changes	Changes in use of Comm Medium		
Ordinary / Other									
Small	908	-17.2%	752	33	0	0	0	33	785
Large	114	-21.2%	90	6	0	0	0	6	96
Total Ordinary / Other	1,022	-15.1%	841	39	0	0	0	39	880
PreSort									
Small	1,464	-8.3%	1,342	(17)	(29)	11	(9)	(44)	1,298
Large	110	-9.3%	99	(2)	(2)	(1)	(0)	(5)	94
Total PreSort	1,574	-5.9%	1,442	(19)	(31)	10	(9)	(49)	1,392
Total Addressed Mail (Excluding Print Post)	2,596	-9.5%	2,283	20	(31)	10	(9)	(10)	2,273

Table 24 and Table 25 detail the key factors impacting volume growth in the Transactional and Promotional letter segments which account for over 95% of domestic reserved letter volume.

Table 24 – Transactional letter segment

Type	Driver	Observation / Comment
Underlying market changes – impact from expected customer behaviour	Prepaid / prearranged (i.e. direct debit)	Prepaid / direct payment arrangements; most notable in the telecommunications industry where growth in mobile phones is typically in prepaid.
	Mailing consolidation	Trend across most industries. Senders are consolidating communications for the same customer / householder
	Price	Impact of price on customer behaviour
	Rationalisation of statement cycles	Most notable within the banking / finance industry with a trend for statements to be provided over less frequent periods (e.g. movement of monthly statements to quarterly).
Change of communication mode - incorporates the impact of substitution to (generally) electronic or digital channels	Online presentment (by the biller)	Use of third party providers to receive bills digitally. Used across a variety of industries and often provided as an alternative (not instead of) to a digital communication from the business
	Online servicing	Trend of businesses encouraging their customers to interact in an on-line environment. Occurring across different businesses, strong push in the government sector. Trend in business to offer 'online only' products. Also includes activities such as downloading brochures, forms, conditions, price lists etc. as well as the completion and submission of some forms electronically (e.g. through use of new software applications widely available).
	Online payments	Payment of bills / accounts (however received) electronically
	Mobile	Presentment and payment of bills / accounts electronically

Table 25 – Promotional letter segment

Type	Driver	Observation / Comment
Underlying market change – impact of expected customer behaviour	Improved market campaigns	Better targeting, improved metrics around predictive response rates, etc.
	Specific events	Incorporating impact from specific events (e.g. elections).
Change of communication mode - incorporates the net impact of movement in and out of the direct mail channel	Movement away from direct mail	The negative impact of expectations that 'traditional' marketing budgets will continue to be put under pressure from online offerings.
	Movement to direct mail	The positive impact of movement into direct mail from more traditional advertising media.

Appendix 8 – Comparison of updated prices and timings v 2014 Corporate Plan

$million	Final result	2014 Corporate Plan	Forecast (updated pricing and timings)			2014 Corporate Plan Forecast	
	2013/14	**2014/15**	**2015/16**	**2016/17**		**2015/16**	**2016/17**
Trading Revenue							
Postal Services	3,132	3,096	3,356	3,489		3,405	3,273
Parcel Services	3,083	3,190	3,351	3,524		3,351	3,524
Other	(5)	(10)	49	55		49	55
Total trading Revenue	**6,210**	**6,277**	**6,757**	**7,068**		**6,805**	**6,852**
Trading Expenses (Cost)							
Labour & Oncosts / Contract Services	3,180	3,206	3,196	3,172		3,196	3,172
Goods /Services for Sale	209	226	243	250		243	250
Accommodation	323	338	369	387		369	387
Depreciation	274	316	400	390		400	390
Other Non-Labour	2,067	2,164	2,310	2,426		2,326	2,426
Total trading expenses	**6,053**	**6,251**	**6,517**	**6,626**		**6,533**	**6,625**
Trading profit	**157**	**26**	**240**	**442**		**273**	**226**

Appendix 9 – Australia Post consolidated group balance sheet at 30 June 2014

	2013	2014
ASSETS	**$million**	**$million**
Current assets		
Cash and cash equivalents	292.9	418.6
Trade and other receivables	594.4	513.1
Inventories	48.6	48.5
Accrued revenues	149.1	141.4
Assets classified as held for sale	48.8	0.0
Other current assets	106.1	115.8
Total current assets	**1,239.9**	**1,237.4**
Non-current assets		
Trade and other receivables	99.4	97.3
Investments in joint venture entities	2.7	1.8
Net superannuation asset	0	47.8
Land and buildings	796.5	879.3
Plant and equipment	647.0	727.9
Intangible assets	1,123.1	1,112.7
Investment property	172.5	192.1
Deferred tax assets	303.7	333.2
Other non-current assets	16.7	21.7
Total non-current assets	**3,161.6**	**3,413.8**
Total Assets	**4,401.5**	**4,651.2**
LIABILITIES		
Current liabilities		
Trade and other payables	880.6	883.0
Interest bearing liabilities	342.4	0.0
Provisions	684.8	767.1
Income tax payable	27.6	19.9
Total current liabilities	**1,935.4**	**1,670.0**
Non-current liabilities		
Interest bearing liabilities	290.5	713.9
Provisions	232.9	231
Net superannuation liability	1.6	0
Deferred tax liabilities	228	225.3
Other non-current liabilities	31.1	48.3
Total non-current liabilities	**784.1**	**1218.5**
Total Liabilities	**2,719.5**	**2,888.5**
Net assets	**1,682.0**	**1,762.7**
EQUITY		
Contributed equity	400	400
Reserves	10.3	7.7
Retained profits	1271.7	1355.0
Parent interest	**1682**	**1762.7**
Total Equity	**1,682.0**	**1,762.7**

Appendix 10 – Fixed assets

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

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

Land, Buildings and Fitout – at 30 June 2014 asset values provided in this notification include land and building assets measured at market value. The market value of land and buildings at 30 June 2014 was $1642.9m compared with a historical cost book value of $879.3m

Market value has been determined through valuations performed by Savills Pty Ltd with each property valued once over a 3 year period, on a rolling basis. Savills is an industry specialist in valuing these types of properties in accordance with Australian Valuation Standards. The market value of each property has been determined by reference to the highest and best use of the property taking into account the specific characteristics and location of the asset.

Investment Property – at 30 June 2014 the value of this asset class was $192.1m. Investment property is not allocated to products and services, and is not part of the asset base on which this notification is based.

Investment property is initially recorded at cost and subsequently remeasured to fair value on an annual basis with the valuations undertaken by Savills Pty Ltd.

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

Asset Lives – a high level summary of asset lives is shown below and is consistent with the summary provided in note 1 of the annual financial statements.

Asset Category	**Useful Life Range**
Buildings – general post offices	70 years
Buildings other facilities	40 – 50 years
Leasehold Improvements	Lower of lease term and 10 years
Motor Vehicles	3 – 10 years
Specialised plant / equipment	10 – 20 years
Other plant / equipment	3 – 10 years

Appendix 11 – Domestic reserved letter service fixed assets

The following Tables provide a breakdown of the domestic reserved letter service fixed assets (shown at Table 16) by product category.

Table 26 – Small Ordinary / Other letters

$million	Final result	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Opening balance (pre NCAU)	359	351	351		
Transition to NCAU			(62)		
Opening balance (post NCAU)			289	277	232
Net Additions	36	36	30	4	28
Depreciation	(43)	(43)	(42)	(49)	(47)
Closing balance	351	344	277	232	213

Table 27 – Small PreSort letters

$million	Final result	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Opening balance (pre NCAU)	325	337	337		
Transition to NCAU			2		
Opening balance (post NCAU)			339	332	288
Net Additions	50	40	34	4	32
Depreciation	(37)	(42)	(41)	(48)	(45)
Closing balance	337	335	332	288	275

Table 28 – Large Ordinary / Other letters

$million	Final result	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Opening balance (pre NCAU)	70	79	79		
Transition to NCAU			12		
Opening balance (post NCAU)			91	88	78
Net Additions	19	8	7	1	7
Depreciation	(9)	(10)	(10)	(11)	(11)
Closing balance	79	78	88	78	74

Table 29 – Large PreSort letters

$million	Final result	Forecast			
	2013/14	2014/15 (pre NCAU)	2014/15 (post NCAU)	2015/16	2016/17
Opening balance (pre NCAU)	39	42	42		
Transition to NCAU			13		
Opening balance (post NCAU)			54	52	46
Net Additions	8	5	5	1	4
Depreciation	(5)	(5)	(6)	(8)	(8)
Closing balance	42	42	52	46	43

Appendix 12 – Impact of NCAU

The following table shows the pre and post impact of NCAU on domestic reserved Ordinary / Other letters for the 2014/15 transition year against the 2014 Corporate Plan.

	2014 Corporate Plan Forecast		**Forecast (updated pricing and timings)**	
	2014/15		**2015/16**	**2016/17**
$million	**Pre NCAU**	**Post NCAU**	**Post NCAU**	**Post NCAU**
Trading Revenue	792	792	839	863
Trading Expenses (Cost)				
Labour & Oncosts / Contract Services	630	597	553	500
Goods/Services for Sale Expenses	9	9	5	5
Accommodation	45	45	46	47
Depreciation	53	52	60	58
Other Non-Labour	239	230	247	253
Total trading expenses	**976**	**934**	**911**	**864**
Trading profit	**(184)**	**(142)**	**(72)**	**(2)**

Appendix 13 – Priority v Regular cost difference

Australia Post's current network is largely built around the requirement to deliver letter services (including the basic postage rate) to a delivery timetable that requires overnight processing and delivery to at least 98% of delivery points five days a week.

Delivering letters to this timetable requires Australia Post to maintain a capability (the network) that is largely fixed. For Australia Post to fully realise the benefits over the longer term will require a change to the Prescribed Performance Standards. This will enable all products to offer the choice of delivery speed and Australia Post to encourage a significant majority of volume to migrate to the slower (Regular) speed.

In the lead up to this change, since 2011, Australia Post has implemented a number of product and price changes designed to encourage letter senders to migrate to the slower delivery timetable from the faster delivery timetable.

Importantly, each of these changes must be viewed as one part of the broader strategy to maintain delivery of a sustainable letters service, of which the domestic reserved letter service is the predominant part.

- **4 July 2011**, Australia Post narrowed the delivery window for the slower delivery service from four days to two days and only used surface. Consultation with customers indicated that a four day delivery window was an inhibitor to using the slower delivery timetable as it made it difficult for them to plan and co-ordinate other supporting or complimentary activities (e.g. call centre resourcing, alignment with other media channels, etc.).
- As part of the July 2011 changes, pricing was set so that customers electing to migrate had the opportunity (depending upon the mix of Barcode Direct Trays to Residue) to achieve overall savings as the new slower speed Barcode Direct Tray prices were set below the then current faster speed Barcode Direct Tray prices.
- **31 March 2014**, with the increase to the basic postage rate, Australia Post, in response to feedback, built on the July 2011 changes by introducing an improved, nationally consistent 'slower' delivery timetable (two days longer than the faster speed) and increasing the price differential between the faster and slower delivery option for each product.
- Australia Post also protected disadvantaged members of the Australian community from the increase to ordinary letter prices by introducing the concession stamp.
- **2 June 2014**, Australia Post extended the range of business letter products that offered customers a choice of delivery standard.
- The effect of the June changes was that circa 85% of addressed letter volume (compared to 55% pre June) now had the choice of being delivered to a faster (Priority) or slower (Regular) delivery timetable.
- Pricing of the Priority and Regular products was set so that:
    - Customers who elected to send letters to the Priority delivery timetable provided more revenue towards recovering the cost of providing the service plus a reasonable rate of return; and
    - Customers who elected to send letters to the Regular delivery timetable provided Australia Post with the opportunity to explore longer term benefits through network change.

The change to the PPS, to align ordinary letter services to a slower delivery timetable (the Regular delivery timetable) provides Australia Post with greater opportunity to explore alternatives to how the network is structured and continue the broader strategy to maintain a sustainable letters service. For example:

- Processing – a longer processing window can lead to redesign in the processing shifts that can increase the level of automation; and
- Delivery – within particular areas, a longer delivery window may provide the opportunity to restructure activities of postal delivery officers.

The proposed **4 January 2016** product and price changes provide:

- All Australians with a choice of delivery speed; and
- Australia Post with the ability to reform / remodel its letters processing and delivery functions to be more efficient and cost effective.

Products sent to the Priority delivery timetable will be priced to:

- Incentivise migration to the Regular delivery timetable;
- Recognise the higher cost in relation to products sent to the Regular delivery timetable;
- Cover their efficient cost and provide a commercial rate of return

Products delivered to the Regular delivery timetable will be, as a primary objective, priced to cover the cost of providing the service on an efficient basis.

As noted in section 6 one of the key dependencies to achieving the full financial benefit from the RoLS Program is that the volume of addressed letters sent the Regular delivery timetable is at least 80%. The 4 January 2016 product and price changes are critical to achieving this mix.

Reforming the letters service – Processing

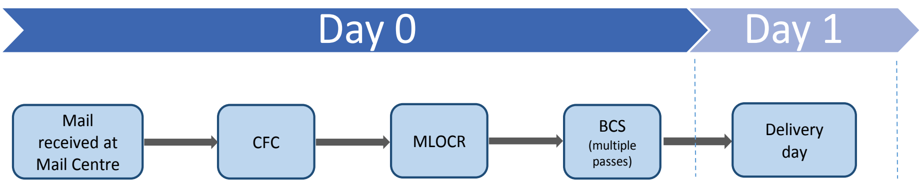
The RoLS Program is a program of separate, yet interdependent projects that combined, will generate $262m in cost savings and drive the operational unit cost difference between the Regular and Priority product as demonstrated in the following sections.

Processing small stamped letters

Figure 3 illustrates how a small stamped letter lodged for next business day delivery is currently processed. Day 0 is the day of posting, Day 1 is next business day and is the day of delivery.

One of the key constraints in the current mail processing window is the limited time available before mail needs to be moved on to delivery. This window limits the opportunity for the amount of mail that can be machine sequenced.

Figure 3 – Small stamped letter – current



With the introduction of the January 2016 product changes, as shown in Figure 4, small stamped letters are separated between Priority and Regular letters when they pass through the Multi Line Optical Character Reader (**MLOCR**) for the first time.

Small stamped Priority letters, for next business day delivery, then pass through the MLOCR again to identify the barcode sortplan. They then move to the Barcode Sorter Machine (**BCS**) where they are sorted to delivery round then sequenced. They are then dispatched that night for delivery the following business day (Day 1) (Figure 5).

Small stamped Regular letters for delivery within two day longer than Priority, are then held for processing the following morning at which time they are processed by the barcode sorter where they are sorted to delivery round then sequenced before being dispatched to the delivery centre for delivery (Figure 6).

Figure 4 – Small stamped letter (Priority and Regular)

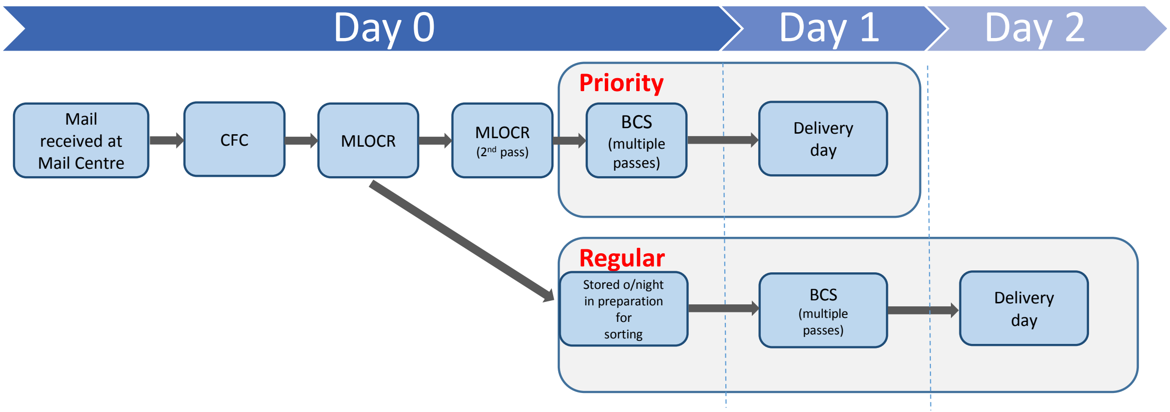


Figure 5 – Small stamped letter (Priority)

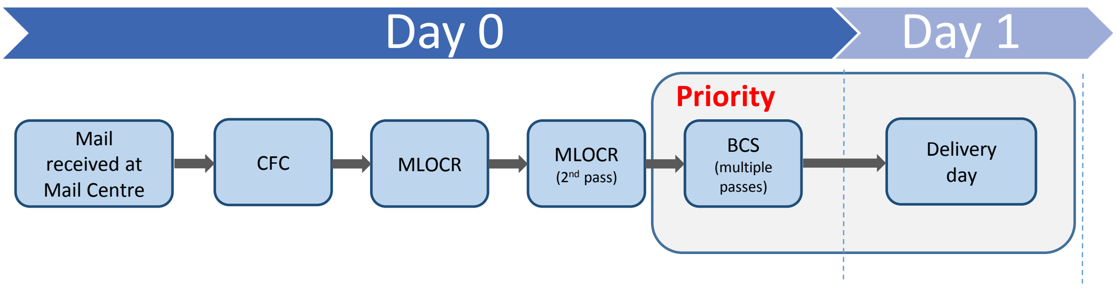
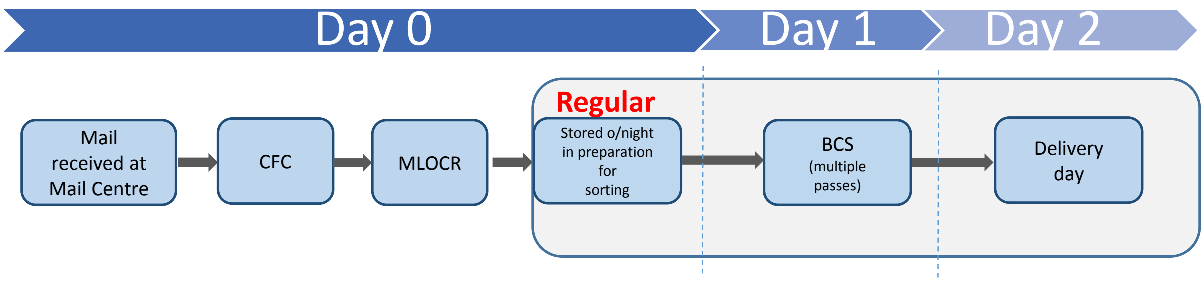


Figure 6 – Small stamped letter (Regular)



Key processing differences

There are two key differences between the processing of small stamped Regular and small stamped Priority letters:

- *Priority letters pass through the MLOCR twice*. As shown in Figure 5, Priority letters pass through the MLOCR twice. The primary purpose of the MLOCR is to sort letters into 54 geographical areas (barcode sort plans). As Australia Post expects the majority of letters to be sent to the Regular delivery timetable and there is a limit on the number of available stackers that can be attached to the MLOCR, the first pass on the MLOCR is to separate Priority letters from Regular letters and sort the Regular letters into the 54 geographical areas.

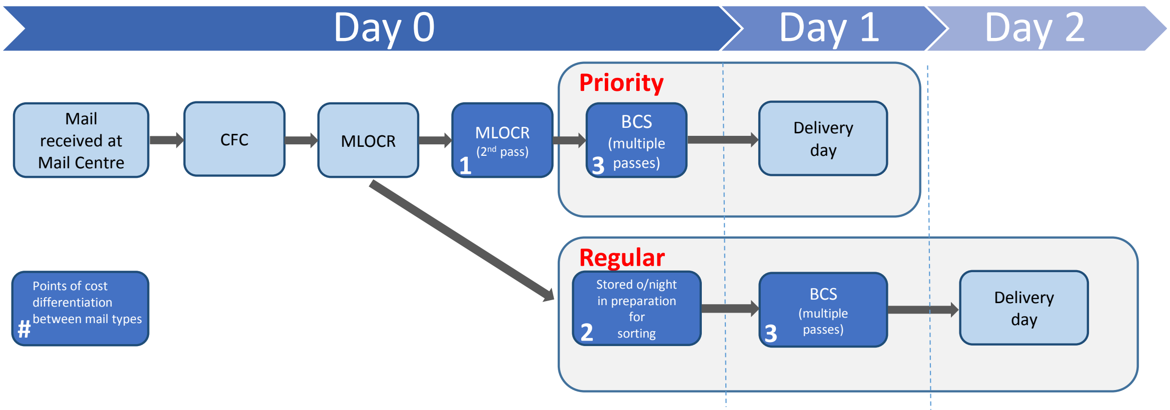
The Priority letters are then passed through the MLOCR for the second time. On the second pass, the Priority letters are split into 54 geographic areas before being transferred to the BCS where they are sorted to delivery round and if time available sequenced (i.e. sorted in the order they will be delivered by the postal delivery officer). Having a fully sorted / sequenced product minimises the indoor work at the delivery centre.

- *Longer daytime processing window.* As shown in Figure 6, once Regular letters have passed through the MLOCR they are stored at the mail centre overnight. The benefit of this is that the remaining processing activities (i.e. sorting / sequencing via the BCS) are undertaken the next day in a longer window overcoming a current constraint that limits the volume of mail that can be machine sequenced. The resulting shifts also attract a lower / or no penalty rate.

As a result of increased automation at the mail centre the level of indoor activity undertaken by the postal delivery officer is reduced. Consequently, Australia Post can restructure the activities of the postal delivery officer. This includes changes to how the outdoor component is undertaken with greater time for outdoor delivery; this should also lead to a later start time minimising the need for penalty shifts.

Figure 7 shows illustrates the processing differences between a small stamped Regular letter and a small stamped Priority letter. Note: this is illustrative only and excludes the treatment for letters not suitable for machine processing.

Figure 7 – Points of cost differentiation



Processing large stamped letters

Figure 8 details the current processing steps for large stamped letters. As shown in Figure 9, large stamped letters, like small stamped letters, are separated between Priority and Regular, with Priority processed that night and Regular processing held over to the next day.

However, the mail processing equipment used for large is different to small and as a result there are differences in the automation process and the tasks that can be automated. The differences are due to both the physical size differences between small and large, but also the fact that large letter volumes are around 10% of small letter volumes.

Figure 8 – Large stamped letter – current

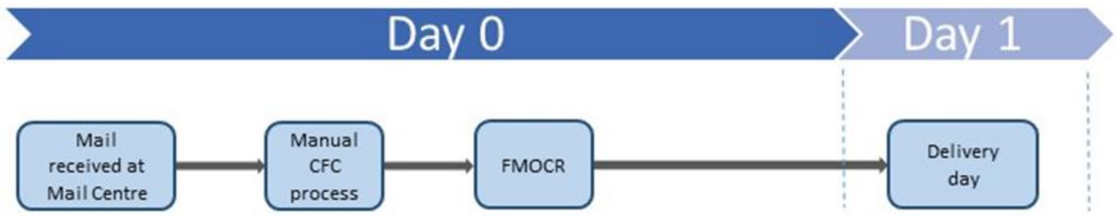
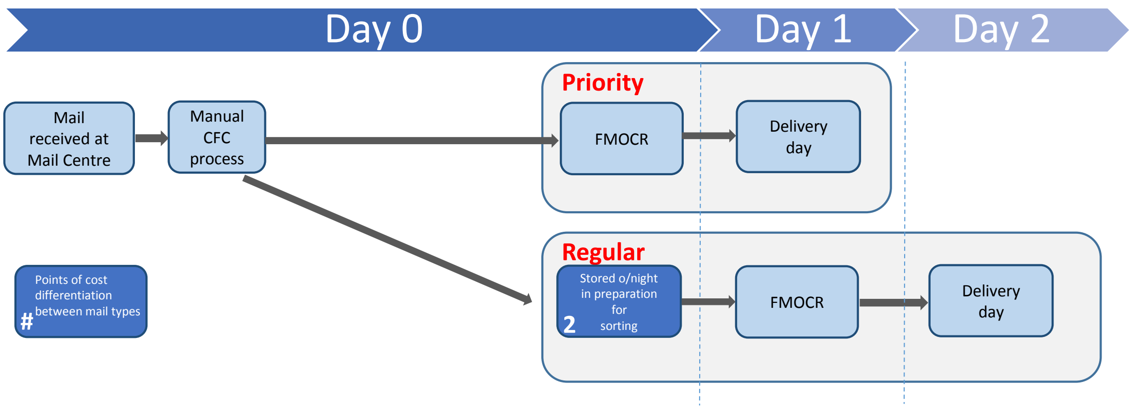


Figure 9 – Points of cost differentiation



Reforming the letters service – Delivery

As detailed in Section 6, the introduction of National Delivery Model (NDM) as part of the broader RoLS Program will enable a reduction in FTEs.

At a high level, a key requirement to enable this change is at least 80% of addressed letter volumes are sent to the Regular delivery timetable however, success depends on other factors such as:

- Consistency in behaviour – the mix between Priority and Regular needs to be considered over a daily, weekly, monthly basis;
- The particular geographic / demographic area – the more affluent areas generally receive more letters;
- The level of volume to be delivered – the plan assumes that adopting a national delivery model doesn't exceed physical capacity limits; and
- Automation (i.e. sequencing) within the Processing function – this minimises the indoor component of a postal delivery officers duties allowing a greater amount of time to be used on outdoor tasks.

Priority stamped v Regular stamped – cost difference

When the RoLS Program is fully implemented, Australia Post estimates the operational cost difference between a small stamped Regular letter and small stamped Priority letter lodged via a street posting box to be ✂ cents.

While the purpose of providing these cost estimates is to provide the ACCC with Australia Post's current view on the likely operational unit cost difference between a Regular and a Priority small stamped letter, importantly these differentials are preliminary, high level estimates.

A more precise estimate will be available, as projects within the RoLS Program rollout and Australia Post, reviews activities and their cost factors / drivers to ensure activities are allocated to the right product.

The following section details the methodology applied by Australia Post in estimating the operational unit cost difference between a small stamped Priority letter and a small stamped Regular letter.

Adoption of a top down approach

Australia Post adopted a top down approach[28] (based on the total cost savings from the RoLS Program) to estimate the operational unit cost difference between Regular letters and Priority letters. The reason for adopting this approach is that as projects within the RoLS Program are implemented the network will change.

However, the size of the changes coupled with the uncertainty of how and when senders will respond means that modelling can be high level only given the nuances of how the changes will manifest at a particular facility are unknown.

As detailed in Section 6, two projects within the RoLS Program; Maximise the volume of letters processed during the day and the introduction of a National Delivery Model will deliver $✂m in cost savings by 2017/18.

Australia Post mapped out the activities associated with each project to determine whether an activity was driven by a stamped letter delivered to the Priority delivery timetable or the Regular delivery timetable. The cost savings were then allocated, using Australia Post's activity based costing model, to each activity.

Adopting this approach, Australia Post estimates the operational unit cost difference between a small stamped Regular letter and a small stamped Priority letter lodged via a street posting box to be ✂ cents.

For the purpose of this analysis savings on automation throughputs (speed and value add service including sequencing) were assumed to be common to both the Regular and Priority letter services.

[28] A 'top-down' approach, in the context of estimating letters operational unit cost differences, refers to using total cost savings for letters, and then disaggregating them to arrive at the unit cost differences for individual Regular and Priority letter products. This is distinct to a 'bottom-up' approach where the individual cost components for each individual Regular and Priority letter product are identified and summed in order to estimate a unit cost difference.

Appendix 14 – Weighted Average Cost of Capital

Australia Post has adopted all Value Adviser Associates (**VAA**) estimated WACC parameters for the purposes of this notification. The parameters have been assessed on a forward looking basis as at 23 July 2015.

Table 30 – WACC parameter values

WACC parameter	Value
Risk-free rate	2.96%
Market Risk Premium	7.0%
Asset β	0.60
Imputation Credits Value γ	0.0
Equity β	0.80
Tax Rate	30%
Debt β	0.15
Cost of debt	4.35%
Gearing (D/D+E)	30%

Risk Free Rate

The nominal risk-free rate used is the 10-year Commonwealth Government bond yield, a widely-used proxy for the risk-free rate of return on investment, and the rate conventionally used in the capital asset pricing model. To avoid the impact of daily volatility, VAA has used a 20-day average 10-year Commonwealth bond yield to 23 July 2015.

Market Risk Premium (MRP)

Advice from VAA is that a market risk premium of 7.0% is appropriate at the current time. This MRP is at a level in line with a large body of evidence supporting an MRP estimate in the range of 6.0 - 8.0% under 'normal' capital market conditions.

With the implied equity market volatility reverting towards its historical average, the resultant short term MRP estimate is also reverting towards its historical average of 7.0%, VAA do not recommend the use of an elevated short term MRP and recommends an MRP of 7.0% as at 23 July 2015.

Asset β

VAA has independently estimated Australia Post's (reserved letters business) asset beta using a range of listed Australian and international postal services. In estimating asset betas, VAA has used its standard practice of using 60 months (five years) of data observations. VAA has recommended an asset beta of 0.60.

Equity β

Adoption of an asset beta of 0.60 leads to a calculated equity beta of 0.79, rounded to 0.80.

Imputation Credits (gamma)

In assessing the appropriate imputation factor, VAA's view remains unchanged from previous WACC assessments. That is, the appropriate gamma value used to determine the tax component of the PTRM's cost build-up should be zero as:

- Australia Post does not distribute any franking tax credits; and
- Australia Post's shareholder, the Australian Government, does not claim franking tax credits.

Tax Rate

As previously accepted by the ACCC, the statutory corporate tax rate of 30% is used.

Debt β

In estimating the appropriate debt beta, VAA uses long term average bond spreads rather than spot bond spreads as:

- Use of long term average spreads result in greater consistency; and
- Use of spot bond spreads would currently result in unusually high debt beta values, especially for lower debt ratings such as BBB.

Using spreads for AA rated corporate bonds VAA has calculated an appropriate debt beta for of 0.14, rounded to 0.15.

Cost of Debt

Australia Post is currently valued at AA- by Standard & Poor's. As the reserved letters business does not have a credit rating, VAA believes it is appropriate to assume the same rating would apply to the reserved letters business as to Australia Post (AA-).

As the longest maturing AA rated corporate bonds trading as at 23 July 2015 had 7 years to maturity, VAA estimated the yield and spread for 10 year AA rated bonds by adding a term premium based on AA+ rated Queensland Government Bonds.

Applying this approach, VAA has calculated a cost of debt or 4.35%.

Gearing

Australia Post's gearing (D/D+E) at 30 June 2014 was 29% a level at which it remains after a minor adjustment of the balance sheet to account for the financial impact of the APSS superannuation fund which is not controlled by Australia Post.

This gearing range is very close to the 30% ratio previously adopted by the ACCC, and Australia Post has assumed that 30% is used again.

Table 31 – Debt, Equity and Gearing

$ million	Debt	Equity	Adjusted Equity	Gearing (D/D+E)	Adjusted Gearing
June 2009	562	1845	1377	23%	29%
June 2010	559	1559	1387	26%	29%
June 2011	556	1804	1517	24%	27%
June 2012	618	1506	1740	29%	26%
June 2013	633	1682	1684	27%	27%
June 2014	714	1763	1715	29%	29%