Chapter 4

The performance of Australia Post

Introduction

4.1 The changing postal environment, particularly the decline in letter volumes, is being felt across all sections of Australia Post's business and the postal network, including Licensed Post Offices (LPOs). This chapter examines the impact on Australia Post itself, including its financial position, as a result of the decline in letter volumes. In order to provide a comprehensive assessment, the committee also examines other factors influencing Australia Post's financial position.

Australia Post's financial performance

4.2 Australia Post has a commercial obligation to, 'as far as practicable, perform its functions in a manner consistent with sound commercial practice'.[1] In addition, Australia Post is required to have regard to the need to earn a reasonable return on assets, the need to maintain financial viability and the cost of carrying out community service obligations (CSOs).

Revenues and profit

4.3 Australia Post submitted that it has been consistently profitable every year since it was corporatised in 1989.[2] Table 4.1 below shows Australia Post's revenue and profit after tax from 2008–09 to 2012–13.

Table 4.1: Australia Post's Revenue and Profit 2009–13

Financial year	Revenue	Profit After Tax
2008–09	$4,975m	$261m
2009–10	$4,856m	$90m
2010–11	$4,987m	$241m
2011–12	$5,126m	$281m
2012–13	$5,893m	$312m

Source: Australia Post, Submission 8, p. 8.

4.4 Australia Post's profit after tax has shown a steady increase since 2010–11. The substantial decline in profit in 2009–10 was the result of $150.2 million in restructuring costs. The restructured business model was implemented on 1 July 2010 and focused on 'strategic business units with profit-and-loss accountability and supported by lean, high-performing functional business units'. The 2010–11 Annual

1 *Australian Postal Corporation Act 1989*, s. 26.

2 Australia Post, *Submission 8*, p. 7.

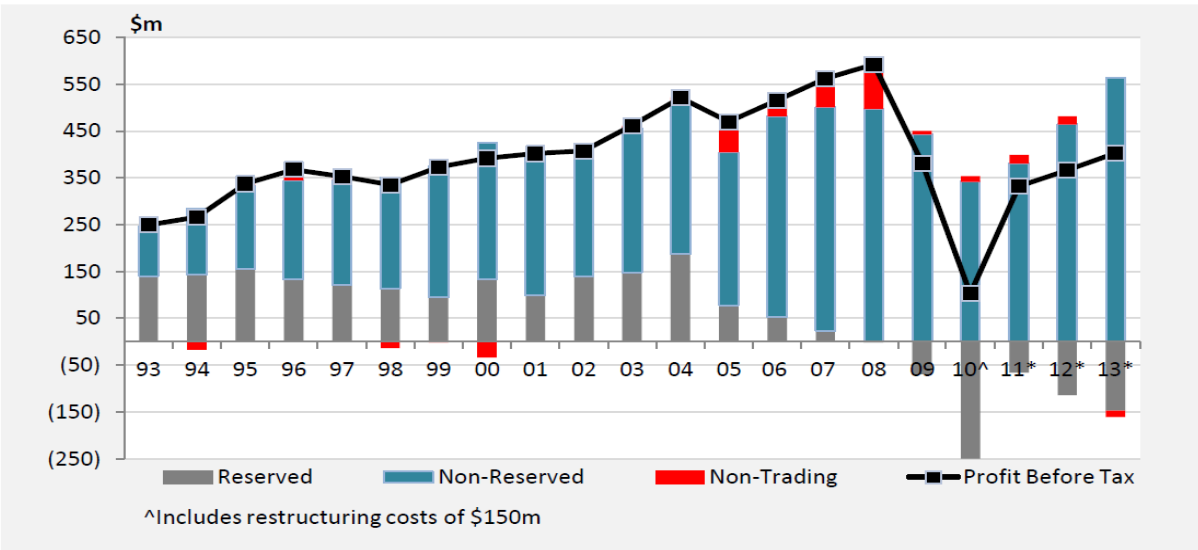
Report noted that the business had been 'stabilised' and that revenue (up 2.8 per cent from 2009–10) grew faster than costs (up 1.2 per cent).[3]

4.5 At the October 2012 Supplementary Estimates, Mr Ahmed Fahour commented that Australia Post had achieved a strong commercial rate of return in 2011–12: revenue had increased by 2.8 per cent to a record $5.1 billion, after-tax profits had increased by 17.1 per cent to $281 million and cash flow had risen 35 per cent.[4]

4.6 The profit that Australia Post reports reflects both its Reserved Service and Non-reserved Services. Australia Post provided the following breakdown of profit.

Figure 4.1: Profit before tax: Contribution of Reserved and Non-reserved Services

Figure 1: Profit Before Tax; Contribution of Reserved & Non-Reserved Services[8]



Source: Australia Post, Submission 8, p. 10.

4.7 Australia Post noted that, up to 2008–09, it had historically earned a profit from both the Reserved and Non-reserved Services. The Reserved Service incurred a loss for the first time in 2008–09 and since then has continued to incur a loss. Australia Post commented that its 'overall profitability (as an enterprise), over the past five years, is solely because of the products and services it sells in competitive markets (i.e. the "Non-Reserved" Services, such as Parcels and Retail)'.[5]

Dividend payments

4.8 Australia Post is required to pay a dividend to the Commonwealth Government of 75 per cent of its profit after tax. The declared dividends for the financial years from 2008–09 to 2012–13 are as follows:

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3 *Australia Post Annual Report 2010–11*, p. 3.

4 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates*, 16 October 2012, p. 73.

5 Australia Post, *Submission 8*, p. 10.

Table 4.2: Australia Post's declared dividends 2008–09 to 2012–13

Financial year	Dividends declared[6]
2008–09	$222m
2009–10	$79m
2010–11	$173m
2011–12	$214m
2012–13	$193m

Source: Australia Post, Submission 8, p. 8.

4.9 Over the five financial years 2008–09 to 2012–13, Australia Post paid a total of $881 million in dividends to the Commonwealth. This was a decrease from the previous five financial years where a cumulative dividend of $1,516 million had been paid to the Commonwealth. Australia Post noted that this dividend was the result of record letter volumes during this period which had contributed to sustained high levels of profitability.[7]

Financial outlook

4.10 Evidence received from both Australia Post and the Department of Finance indicated that Australia Post, in its present operating structure and with its current obligations, was facing a significant decline in its profits from the 2013–14 financial year. At recent estimates hearings, Australia Post has reported concerns about its financial outlook: at the November 2013 Supplementary Estimates, Mr Fahour stated that:

> We are pleased with last year's results but we are also conscious it is a rear view vision of what has already happened to our business. When we look into the future, as I have said on a number of Senate estimates, we are very concerned about what lies in front of us.[8]

4.11 Mr Fahour went on to point to the decline in letter volumes and the expense of the Australia Post legacy defined benefit superannuation scheme as major factors

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6 Dividends are paid twice a year. The dividends declared relates to the dividends relating to the Operating Profit for that particular year. Dividends paid reflects the physical cash payments made during the year. This includes the final dividend for the prior year (payment made in October) and the interim dividend for the current year (payment made in April).

7 Australia Post, *Submission 8*, p. 7.

8 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates Hansard*, 19 November 2013, p. 19.

contributing to a change in Australia Post's financial position.[9] Of particular concern were the increasing losses from the letters business.[10]

4.12 At the February 2014 Additional Estimates, Mr Fahour provided an indication of the outcome for the 2013–14 financial year and stated that Australia Post would report a worsening financial result:

> At the current rate, we anticipate Australia Post as a whole is likely to lose money in the second half of this financial year for the first time since corporatisation.[11]

4.13 Mr Fahour went on to explain that, while the parcel service had returned a profit in previous years, 'losses in the postal service also for the first time will exceed our profit in parcels'. He concluded that the gross profit in the full financial year 2013–14 would be less than the full year 2012–13 reported profits.[12] At the May 2014 Budget Estimates, Mr Fahour stated that the loss from regulated mail 'will grow to around $350 million' and that it would 'soon grow to around a billion dollars a year'.[13]

4.14 Mr Fahour also stated that it was 'unlikely' that Australia Post would be able to pay future dividends to the Commonwealth Government.[14] The dividend payment for 2014–15 was projected to be $21 million. At the May 2014 Budget Estimates, Mr Fahour stated that he believed that it is 'highly unlikely' that the dividend of that magnitude would be paid based on 'the revelation of our new trading position, given the acceleration of the letters losses that is occurring'.[15]

4.15 In September 2014, Australia Post announced a group profit of $116.2 million after tax for 2013–14, down 34.5 per cent on the previous financial year. Australia Post also indicated $78.8 dividend declared to the Commonwealth, down 59.1 per cent on the previous financial year.[16]

4.16 In its submission, the Department of Finance commented that Australia Post expected to make losses from 2015–16 with dividend payments to the Commonwealth reduced to zero. This assessment was based on financial forecasts provided by

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9 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates Hansard*, 19 November 2013, p. 19.

10 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates Hansard*, 19 November 2013, p. 33.

11 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 108.

12 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 108.

13 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 80.

14 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 108.

15 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 84; see also p. 87.

16 Australia Post, 'Australia Post reports FY14 Financial Results', *Media Release*, 4 September 2014.

Australia Post 'which have experienced some volatility in the past, reflecting the changing business environment'.[17]

4.17 The Department of Finance also noted that total Commonwealth Government equity in Australia Post at 30 June 2013 was approximately $1.7 billion, down from $2.8 billion at 30 June 2008. It was anticipated that there would be further significant declines for the out years.[18]

4.18 The Australia Institute put forward an alternative view of Australia Post's financial position and commented that it is 'a large, profitable and growing enterprise'. It pointed to Australia Post's 'substantial' capital investment campaign and stated that 'such a strategy clearly suggests that the management of Australia Post have significant confidence in both the current and future financial position of the organisation'.[19]

4.19 The Australia Institute also commented on the complex way in which Australia Post reports on its financial position. For example, it noted that in the 2012-13 financial statements, regulated international inbound letters and packets (<2kg) have been reclassified from Mail to Parcel and Express. The Australia Institute stated:

> The separation of 'regulated mail services' (international letters and small parcels) from 'reserved mail' (domestic letters) in the 2012–13 Annual Report, effectively isolates the letter delivery segment as a loss-making entity, while the international letters component is then cross-subsidised by the lucrative parcel segment.[20]

4.20 The Australia Institute also drew attention to the accounting for the $400 million investment in AUX (the parent company of StarTrack) purchased from Qantas, capital transfers to Parcel and Express, the $800 million increase in 'Other Commitments' (contractors), assets held for sale valued at cost, significant write-downs of assets and revenue and 'significant irregular movements' in Australia Post's holdings of bonds and other debt instruments.[21]

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17 Department of Finance, *Submission 5*, p. 6.

18 Department of Finance, *Submission 5*, p. 6.

19 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 2.

20 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 12.

21 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, pp 12–16.

Factors influencing Australia Post's financial performance

4.21 There are a range of factors influencing the financial performance of Australia Post. These include:

- the costs of meeting the community CSOs;
- the cost of the Reserved Service;
- increase in the number of mail delivery points;
- the under recovery of international inwards mail costs;
- the adequacy of basic postage rate; and
- the costs of the legacy superannuation scheme.

Cost of meeting community service obligations

4.22 Australia Post noted that there is a financial cost associated with meeting its CSOs when the charge to a consumer for a mandated service does not recover the cost of Australia Post delivering that service. Australia Post provided costs of the CSOs for the last five financial years, noting that the CSOs have been achieved at an increasing cost.[22]

Table 4.3: Community service obligation costs incurred by Australia Post

Financial year	CSO cost
2008–09	$113.8m
2009–10	$147.7m
2010–11	$144.7m
2011–12	$165.2m
2012–13	$177.5m

Source: Australia Post, Submission 8, p. 9.

4.23 For the 2012–13 financial year, the cost of meeting the CSOs was $177.5 million, an increase of seven per cent over the previous financial year.[23] Mr Fahour noted that the loss for the total domestic letter business was $218 million in that financial year, with $177.5 million being the 'calculation of how much the CSO within the letters business under one particular methodology is costing to provide'.[24] Mr Fahour also stated that he believed that the calculated cost of the CSO 'underestimates the investment in the CSO'.[25]

22 Australia Post, *Submission 8*, p. 9.

23 Australia Post, *Annual Report 2013*, October 2013, p. 115; see also Australia Post, *Submission 8*, p. 9.

24 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 93.

25 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 90.

4.24 Australia Post also stated that it was given a statutory monopoly over the Reserved Service so that it could fund the cost of meeting its CSOs; 'however, Australia Post must deliver its CSOs regardless of whether revenue from its Reserved Services is sufficient to cover the costs of the CSOs'.[26] In its submission to the ACCC's 2014 stamp price determination, Australia Post submitted that 'its CSO-related standards effectively impose fixed costs on the letters sorting and delivery network'.[27]

4.25 The Department of Finance submitted that:

> To date, Australia Post's profit from its commercial activities has been sufficient to meet the financial losses from its letters services. However, the cost of servicing its CSOs…is becoming increasingly unaffordable.[28]

The cost of the Reserved Service

4.26 As noted in Chapter 3, letter volumes have declined substantially since 2008, and are continuing to decline.[29]. With this decline, Australia Post has reported a loss on the Reserved Service. The following table provides the five-year trend.

Table 4.4: Five year trend in the Reserved Service

	2009 $m	**2010 $m**	**2011 $m**	**2012 $m**	**2013 $m**
Losses from reserved service[1]	(69.2)	(250.1)	–	–	–
Losses from reserved mail service	N/A	N/A	(66.5)	(114.4)	(147.4)
Losses from regulated services arising from Universal Postal Union arrangements	N/A	N/A	(55.9)	(72.5)	(71.0)
Total *loss* from regulated mail services[2]	N/A	N/A	(122.4)	(186.9)	(218.4)

1. Amounts prior to 2011 included inbound letters and packets (weighing less than 2kg) in accordance with the arrangement of the Universal Postal Union (UPU).
2. Regulated mail is composed of the collection, processing and distribution of domestic letters defined as reserved by the APC Act and the processing and distribution of international inbound letters and packets (less than 2kg) in accordance with arrangements of the UPU (where Australia Post has been nominated by the Australian Government to fulfil its obligations in Australia).

Source: Australia Post, Annual Report 2013, October 2013, p. 11.

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26 Australia Post, *Submission 8*, p. 9; see also Mr Stephen Giles, *Submission 1*, p. 11.

27 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 16.

28 Department of Finance, *Submission 5*, p. 4.

29 Australia Post, *Submission 8*, p. 11; Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 80.

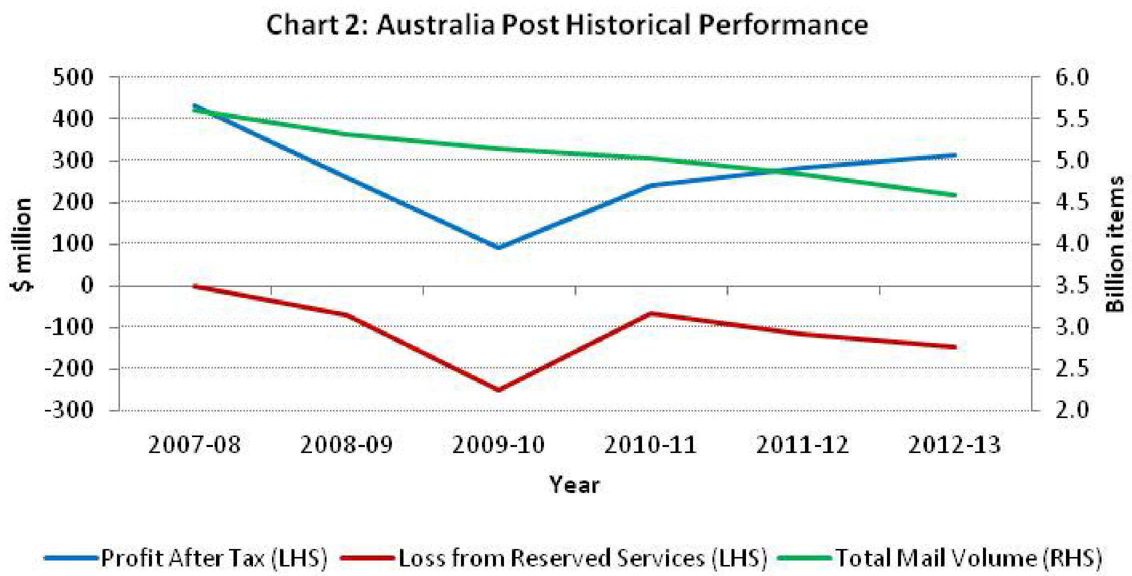
4.27 The table indicates a steady increase in losses. Losses prior to 2011 included those attributable to both Australian mail services and Universal Postal Union (UPU) arrangements. Since that time, the regulated mail service losses increased by $47.9 million between 2010–11 and 2011–12 (41.8 percent increase) and $33 million between 2011–12 and 2012–13 (22.3 per cent). During this three year period, the loss attributable to the UPU arrangement increased by $16.6 million (15.4 per cent increase) and then fell by $1.5 million between 2011–12 and 2012–13.

4.28 Australia Post submitted that, since 2008, it has incurred losses $600 million in Reserved Service with losses of over $400 million being incurred over the last three years.[30] Australia Post explained that this has been due to:

> …the current combination of rapid volume decline and fixed operating costs imposed by the existing regulatory framework (particularly the CSO-related Performance Standards). This combination is leading, inevitably, to deteriorating and unsustainable financial results.[31]

4.29 The Department of Finance provided the following graph of the trends in financial performance and letter volumes.

Figure 4.2: Trends in financial performance and letter volumes



Source: Department of Finance, Submission 5, p. 6.

4.30 The committee notes that in its decision on Australia Post's 2014 stamp price notification, the Australian Competition and Consumer Commission (ACCC) provided some comments concerning the forecasts and financial outlook for the

30 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates Hansard*, 19 November 2013, p. 33; Australia Post, *Submission 8*, p. 3.

31 Australia Post, *Submission 8*, p. 9.

Reserved Service.[32] The ACCC noted that Australia Post had forecast losses in its domestic Reserved Service of $289 million in 2013–14 and $313 million in 2014–15 due to continuing declines in letter volumes and increasing costs from 2012–13 levels.[33]

4.31 Australia Post announced that in 2013–14, the mail business losses were $328.4 million before interest and tax (EBIT) due to falling letter volumes and high fixed costs.[34]

Allocation of costs

4.32 In coming to final profit or loss on Reserved Services, Australia Post allocates direct and non-operational (indirect) costs to Reserved Service. Australia Post uses a cost allocation methodology (CAM) to apportion costs.

4.33 The ACCC commented that, in an environment of declining demand for letter services, questions are raised as to what the appropriate contribution towards shared costs by Reserved Service need to be.[35] In response, Australia Post commented that 'the CAM has safeguards to avoid over-costing declining products with reserved service letter products bearing less of the fixed cost burden of the network over time'.[36]

4.34 As part of its decisions on Australia Post's 2014 price notification, the ACCC commented on Australia Post's CAM and stated that:

> …on the basis of the information provided by Australia Post about its non-operational costs, is that while Australia Post's CAM is continuing to improve there is still some capacity for further improvements in the use of cost drivers within the CAM. For example:
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> - Australia Post appears to effectively use the same approach to cost allocation for some direct and indirect activities. If the nature of cost incurrence is similar for both direct and indirect activities, such a practice may be appropriate. However, cost incurrence between direct and indirect activities is more likely to be different and therefore such a practice may not be cost reflective.
> - For some of Australia Post's indirect activities, Australia Post currently allocates costs to reserved and non-reserved services based on the relative number of 'transactions' undertaken. However, if the

32 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision,* 20 February 2014.

33 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision,* 20 February 2014, p. 28.

34 Australia Post, 'Australia Post reports FY14 Financial Results', *Media Release*, 4 September 2014.

35 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 12.

36 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 11.

> time taken to perform each transaction is very different, an allocation based on the relative frequency of transactions may not be reflective of the actual costs that are attributable to reserved and non-reserved services.
>
> Notwithstanding the above, the ACCC did not consider there was evidence of any systematic bias in Australia Post's CAM that would likely lead to an inappropriate allocation of non-operational costs to reserved services.[37]

4.35 The ACCC went on to comment that it had tested the sensitivity of the results to several key factors as 'uncertainty surrounds the forecast data for a number of components of the financial model'.[38] As a consequence of the sensitivity analysis, the ACCC was of the view that:

> Given the potential for Australia Post's forecasts to overstate its losses, in the limited time available to the ACCC, the ACCC has made two cumulative adjustments to Australia Post's base data in order to test the sensitivity of the net result to certain assumptions. These adjustments comprise an alternative [weighted average cost capital] WACC[39] and a different assumption regarding shared cost allocations.
>
> The ACCC's analysis shows that Australia Post's under recovery for reserved services could be closer to $220 million in 2013–14 and $245 million in 2014–15 under these alternative assumptions.[40]

4.36 While the ACCC made adjustments to Australia Post's financial model base data, it concluded that 'the most likely outcome is an under recovery of reserved services costs, albeit by less than that estimated by Australia Post'.[41]

4.37 At the May 2012 Budget Estimates, Mr Fahour also commented on the costs of the monopoly letter business. He stated that:

> The reality is that 80 per cent of our costs in the monopoly business are driven by the CSO requirements. So we have an 80 per cent fixed-cost structure and a 20 per cent variable-cost structure. So what that effectively means is that, for every dollar lost due to volume declines in revenue, we variably can lose 20c and 80c will go to a loss to the bottom line.[42]

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37 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 12.

38 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 29.

39 Weighted average cost capital, which is the reasonable rate of return allowed, given the relative level of risk associated with the capital base, averaged across debt and equity funding.

40 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 28.

41 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 28.

42 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 24 May 2012, p. 38.

4.38 The Boston Consulting Group (BCG) assessment of Australia Post's internal review commented on letters' costs. BCG also estimated the letters business has approximately 80 per cent fixed costs, factoring in the network economics associated with prescribed performance standards. While BCG commented that there may still be opportunities for Australia Post to improve efficiencies, these appeared to be limited and would only offset an additional 1–2 years' work of volume declines.[43]

4.39 However, The Australia Institute put forward a different view and noted that the network not only provides for the delivery of letters but also small parcels:

> While the costs of maintaining a delivery network for letters is large it is important to note that the costs of this network underpins not just the delivery of letters but of small parcels as well. While Australia Post and the Boston Consulting Group have recently argued that the delivery of letters is placing an 'unsustainable' financial burden on Australia Post, in fact the delivery network used for letters is actually the foundation on which the rapidly growing, and highly profitable, small parcel delivery business is based.[44]

4.40 The Australia Institute also argued that the way in which Australia Post presents its financial accounts:

> …conceals the relationship between the 'losses' made delivering letters and the 'profits' made delivering small parcels. In turn, any proposal to reform the letter delivery business of Australia Post needs to be based on a detailed analysis of the inter-relationship between different Australia Post business units rather than a simple analysis of the costs and revenues of a particular administrative 'silo'.[45]

4.41 In relation to BCG's analysis of the fixed cost base, The Australia Institute commented that:

> **The high 'fixed cost' base** of the mail delivery system assumed in BCG's estimation of 80% is opaque and at odds with standard economic analysis. As the BCG report is not transparent about its estimates, it is likely that it exaggerates the level of fixed costs to the segment.[46]

4.42 The Australia Institute also stated that 'the BCG report describes their estimate of fixed costs in the letters business as "based on an outside-in consideration of

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43 The Boston Consulting Group, *Australian and International Postal Services Overview Background Report*, June 2014, p. 15.

44 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 1.

45 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 1.

46 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 5.

network economics across each step of the value chain". This is a dubious and opaque justification.'[47]

4.43 The committee notes that postal employees now not only deliver letters but also small parcels. Mr Fahour stated at the May 2013 Budget Estimates that approximately a quarter of all parcels delivered by Australia Post are now delivered by postal employees. Mr Fahour went on to comment that this was a 'massive shift'.[48]

4.44 BCG stated that 'Australia Post's letters and parcel delivery networks operate separately: metro delivery is typically via motorcycle for letters, and van for parcels'.[49] The committee also notes that postal employees are now delivering small parcels.

Increase in number of delivery points

4.45 In addition to the decline in mail volumes, Australia Post has been faced with an increasing number of delivery points. In 2012–13, delivery points increased by 200,000 to a total of 11.2 million delivery points across Australia, up from 8.8 million delivery points in 2000.[50]

4.46 The impost of rising numbers of delivery points was noted by the Department of Finance which stated that the 'CSOs represent a rising fixed cost as the number of delivery points increase in line with population and commercial growth'.[51] The Department of Communications described that as an 'inexorable pressure'.[52]

4.47 Australia Post stated in its 2011–12 Annual Report that it was 'commercially challenging' to meet the prescribed performance standards set out under its CSOs when letter volumes were declining and the network of delivery points was growing.[53] BCG agreed with this position and commented that the annual growth in new households was steadily increasing the physical network required to meet performance standards and was driving cost increases, despite declining volumes.[54]

4.48 A consultancy report commissioned by Australia Post from Economic Insights identified that 'an increasing number of delivery points and increases in the

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47 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 9.

48 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 30 May 2013, p. 54.

49 The Boston Consulting Group, *Australian and International Postal Services Overview Background Report*, June 2014, p. 7.

50 Australia Post, *Annual Report 2013*, pp 5, 131; *Annual Report 2012*, p. 30.

51 Department of Finance, *Submission 5*, p. 4.

52 Mr Keith Besgrove, Department of Communications, *Committee Hansard*, 6 December 2013, p. 53.

53 Australia Post, *Annual Report 2012*, p. 22.

54 The Boston Consulting Group, *Australian and International Postal Services Overview Background Report*, June 2014, p. 15.

distance covered on postal delivery rounds are having a significant impact on Australia Post's operating costs'.[55]

International inward letter and parcel costs

4.49 As shown in Table 4.4, Australia Post returns a loss on international inward letters. Australia Post delivers most international mail in accordance with UPU arrangements (international regulated mail). Payment for delivery is made under a system known as 'terminal dues'. The ACCC 2014 report, *Assessing Cross-subsidy in Australia Post 2012–13*, stated that:

> The terminal dues payable to the destination postal operator are not based on the actual costs incurred in delivering this [international] mail. Rather terminal dues remuneration is linked to a formula that uses a percentage of the basic postage rate.[56]

4.50 The ACCC noted that revenue received by Australia Post from both international regulated and non-regulated mail was below the costs of providing these services in 2012–13. At the same time, international outward letters over recovered fully distributed costs. However, the over recovery on outwards letters has been less than under recovery in all years since the ACCC has monitored cross-subsidy (except 2004–05).[57]

4.51 The UPU arrangements include delivery of small packets less than 2 kg. The remuneration to Australia Post for these services is also determined by the terminal dues system. The ACCC commented that the revenue for this group of items was also below the direct and attributable costs for providing the service in 2012–13. The ACCC noted that the decline in cost recovery was due to a shift in volume-mix towards the parcels less than 2 kg category, which forms part of the terminal dues stream, where Australia Post's remuneration is currently linked by a formula to the basic postage rate. With the high Australian dollar, and increase in online purchasing/shopping, there has been rapid growth in volumes in this category.[58]

4.52 In February 2012, Australia Post sought an increase in the terminal dues rate with the UPU. This was not successful with the UPU not supporting the proposal. As a consequence, a majority of the Postal Operations Council voted against an increase in terminal dues.

4.53 Mr Fahour explained the losses suffered by Australia Post and other developed nations attributable to international mail:

> We lose a huge sum of money handling the imports of any of these parcels or letters.…There is only really one solution to this problem, and that is

55 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision*, 20 February 2014, p. 21.

56 ACCC, *Assessing Cross-subsidy in Australia Post 2012–13*, June 2014, p. 14.

57 ACCC, *Assessing Cross-subsidy in Australia Post 2012–13*, June 2014, p. 14.

58 ACCC, *Assessing Cross-subsidy in Australia Post 2012–13*, June 2014, p. 14.

> they tie the international price to the domestic price. So the only way we can minimise our losses is if the domestic price goes up.[59]

4.54 While Australia Post was unsuccessful in its bid to increase terminal dues, at the same meeting, a new model for determining terminal dues rates was considered. The new model is scheduled to take effect from 1 January 2014. Australia Post commented in 2012 that 'if it proceeds in its current form, [it] will significantly improve the terminal dues paid to Australia Post'.[60]

4.55 The Australia Institute also commented on international mail costs and stated that, 'based on the publicly available information provided in the Australia Post annual report, the largest financial losses relate to the delivery of international mail'.[61]

Basic Postage Rate

4.56 As explained in Chapter 2, Australia Post has the monopoly right to issue postage stamps in order to fund its CSOs. The price of postage for items less than 250 grams is known as the Basic Postage Rate (BPR). Currently, letters less than 250 grams account for 99 per cent of total letter volumes.[62]

4.57 In its November 2013 submission, Australia Post noted that postage in Australia is the second cheapest in the OECD.[63] In addition, Australia Post stated 'while CPI [Consumer Price Index] has risen by more than 70% over the past 21 years, the Basic Postage Rage (BPR) has only increased by 33% (from 45c to 60c)'.[64]

4.58 Australia Post provided an indication of changes in the BPR and CPI from 1992 to 2012.

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59 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 24 May 2012, p. 35.

60 Additional Estimates 2011–12, Australia Post, *Answer to question on notice*, No. 11.

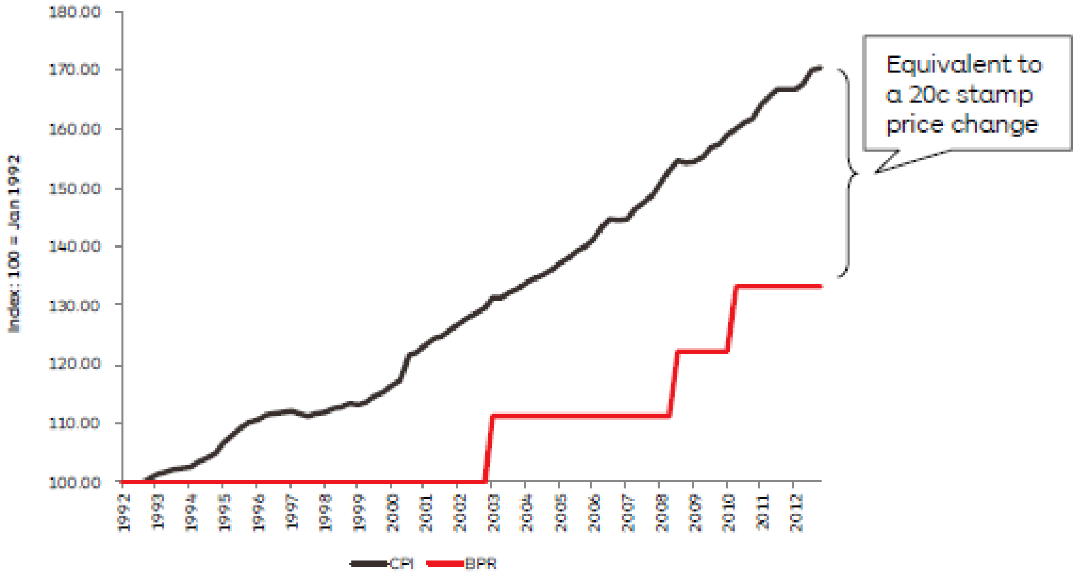
61 CWU Australia, *Supplementary Submission 2*, The Australia Institute, 'Review of the Boston Consulting Group's report to the Minister for Communications, Briefing for the CWU on Australia Post's operations', *Technical Brief No. 32*, July 2014, p. 1.

62 Department of Finance, *Submission 5*, p. 3.

63 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 24 May 2012, p. 35.

64 Australia Post, *Submission 8*, p. 17.

Figure 4.3: CPI and Basic Postage Rate



Source: Australia Post, Submission 8, p. 17, Figure 7.

4.59 Mr Fahour commented that up to 2008, while the BPR did not keep up with inflation, letter volume was rising. He went on to argue that from 2008 the stamp price kept up with inflation on average and with it, compensation; however, 'the issue was not the spread between the BPR and inflation; the issue was declining volume and declining foot traffic' into post offices.[65]

4.60 Mr Fahour also noted that government and business were the largest beneficiaries of a lower BPR:

> That basic postage rate—95 per cent of stamps, essentially—is really for business and government. So the biggest beneficiary of holding the stamp price below inflation is business and government.[66]

4.61 Australia Post successfully sought an increase in the BPR, with effect from 31 March 2014, arguing that, along with falling letter volumes, another important contributing factor for the financial loss in the letter services is that Australian stamp prices have been held at levels well below inflation. The ACCC did not have an objection to the 10c BPR increase proposed by Australia Post. However, while the increase in the BPR is expected to generate around an additional $95 million in 2014–15 in revenue, it will not lead to full recovery of costs, with Mr Fahour stating that 'the loss is going to be little bit less but still substantial'.[67]

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65 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 124.

66 Mr Ahmed Fahour, Australia Post, *Supplementary Estimates Hansard*, 19 November 2013, p. 29.

67 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 122.

4.62 The committee notes the ACCC's comment on the forecast under recovery:

> While the ACCC accepts Australia Post's claim that the proposed price increases are still likely to result in Australia Post under recovering its costs, Australia Post's estimates may overstate the extent of under recovery of efficient costs. In the limited time available, the ACCC has not been able to form a view on the efficiency of Australia Post's cost base as part of its assessment.[68]

4.63 Most submissions and witnesses supported an increase in the BPR, which some described as 'long overdue'.[69] The Post Office Agents Association Limited (POAAL) also supported an increase in the BPR, noting that delivery cost pressures include rising fuel costs, staff wage rises, maintenance costs and vehicle purchase or leasing costs. POAAL also pointed to Australia Post's financial loss for its Reserved Service in the 2012–13 financial year as justification for a BPR increase.[70]

4.64 However, the Department of Finance cautioned that 'pricing reform alone would be insufficient to put Australia Post on a sustainable footing given the inevitability of letter volume declines'.[71]

4.65 In view of the continuing under recovery of costs for letters, even with a 10c increase in the BPR, the committee sought Australia Post's view on whether a 20c increase in the BPR would be more appropriate. Mr Fahour commented 'in order to match inflation the basic postage rate would need to rise 20c to equal the same number and that this postage rate, by going up by 10c, gets you halfway'.[72] In relation to why a 20c increase had not been sought, Mr Fahour stated 'there is a balance that you need to have between society's ability and affordability'.[73]

Bulk mail

4.66 Bulk (PreSort) mail accounts for 54 per cent of reserved mail. This mail is bulk letter mailings consisting of business correspondence such as superannuation statements and retailers' promotional material.

4.67 Since 2011, the ACCC is no longer required to review and make a determination in relation to price increases for bulk mail. However, it has a role in certain disputes regarding the terms and conditions under which Australia Post supplies bulk mail services.

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68 ACCC, *Australia Post price notification for its 'ordinary' letter service February 2014, ACCC Decision,* 20 February 2014, p. 33.

69 Conrad and Jane Silvester, *Submission 28*, p. 4; see also Ms Angela Cramp, Licensed Post Office Group Chairperson and Foundation Member, *Committee Hansard*, 6 December 2013, p. 3; Ms Lisa Cooper, *Submission 71*, p. 3; Mr John Fisher, *Submission 73*¸ p. 3; Ms Cynthia Turner, *Submission 86*, p. 2.

70 POAAL, *Submission 9*, p. 19.

71 Department of Finance, *Submission 5*, pp 7–8.

72 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 122.

73 Mr Ahmed Fahour, Australia Post, *Additional Estimates Hansard*, 25 February 2014, p. 123.

4.68 Evidence was provided to the committee on the impact of recent price increases on the use of bulk mail. Mr Alan Read, CEO, Dynamic Direct, commented that his business was moving from a mail house distribution through Australia Post to a digital platform for clients, including superannuation funds and credit unions providing statements to their customers. He stated that the recent increases in the cost of bulk mail had forced clients to seek other avenues for providing information to customers at an accelerated rate. In relation to advertorial and marketing material (print post), Mr Read stated that his business was experiencing a slight increase in volumes.[74]

4.69 While acknowledging that there were general moves towards digital communications, Mr Read commented the bulk mail price increases were accelerating this trend. Mr Read suggested a price moratorium for two years to allow for analysis of trends.[75]

4.70 As part of its review of Australia Post's 2014 price notification, the ACCC received a submission from The Mailing House which commented that:

- the sharing of costs between 'ordinary' mail and bulk mail should be more realistic;
- if the same level of increases made to the bulk mail rate had been applied to the BPR, the BPR would have been in the 65c to 70c range;
- Australia Post could reduce costs by ceasing to compete with its customers in the mail house market; and
- physical mail is a very effective method of promoting goods and services but continual bulk price increases are speeding up its demise.[76]

4.71 The Printing Industries Association of Australia (PIAA) submitted to the ACCC that there is insufficient discount in bulk mail rates. It noted that following the removal of ACCC surveillance, Australia Post had increased prices for bulk mail services without taking into account the efficiencies that have been generated by capital investment and improved systems introduced by bulk mail operators.

4.72 PIAA went on to comment that Australia Post had advised the industry that in April 2014 fees would be increased for a range of bulk mail services. Some of these increases are as high as 7 per cent. PIAA concluded that this would negate one of the key principles underpinning the decision to remove price monitoring for these areas in 2011 and that the obligation of Australia Post to seek approval for price increases in other categories of reserved mail should be restored.[77]

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74 Mr Alan Read, CEO, Dynamic Direct, *Committee Hansard*, 5 August 2014, p. 4.

75 Mr Alan Read, CEO, Dynamic Direct, *Committee Hansard*, 5 August 2014, p. 2.

76 https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2014/call-for-submissions, The Mailing House.

77 https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2014/call-for-submissions, PIAA, p. 4.

Legacy superannuation fund

4.73 Australia Post is facing significant liability for its legacy defined benefit superannuation scheme. In 2011–12, Australia Post ceased to offer its defined benefit superannuation fund to new employees commencing with Australia Post. Australia Post indicated that this was 'to prevent the corporation being exposed to unacceptable investment risk over time'. Employees joining Australia Post are offered membership of an accumulation fund.[78]

4.74 The costs of the legacy defined benefit superannuation scheme have significantly increased: in 2004 to 2008 the cost was some $50 million per annum; it is now projected to be $300 million. In its 2012–13 Annual Report, Australia Post commented that:

> Adding to these market pressures, next financial year our profit will be significantly impacted by a change to accounting standards. This will impose a new recurring expense of more than $175 million in 2013–14 relating to the Australia Post Superannuation Scheme. This equates to around 44 per cent of our 2013 profit before tax.[79]

4.75 At the May 2014 Budget Estimates, Mr Fahour noted that 'the superannuation scheme is a massive liability that we have inherited over the past several decades'. Mr Fahour confirmed that the annual cost was over $300 million in 2013–14. He went on to note that 'now the assets equal the liabilities, so we are running at about 100 per cent. But the bad news is that that has come down from 180 per cent' – this posed a significant problem for Australia Post.[80]

4.76 In addition, Mr Fahour stated that the closure of the defined benefits scheme to new employees had very successfully limited the liability growth in the scheme. While the closure of the defined benefit scheme to new entrants was important, Mr Fahour also pointed issues with scheme's portfolio:

> That was very important, but we are not completely out of the woods because, unfortunately, the portfolio we inherited was weighted mostly to fixed assets. That is why the VBI [value-based investing] deteriorated the way it did.
>
> We have managed to significantly increase the liquidity of the portfolio without losing any of the VBI performance—around 100 per cent…The trustees, who are both union trustees as well as employer trustees, have done a good job in the difficult circumstances of the last three years. I commend the trustees on the good work.[81]

4.77 In response to questions about the risk to Australia Post of the remaining liability, Mr Fahour stated:

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78 Australia Post, *Annual Report 2012*, p. 10.

79 Australia Post, *Annual Report 2013*, p. 11.

80 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 96.

81 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 96.

> We have a very big scheme that has approximately $6 billion in total assets. The net assets of Australia Post are only $2 billion. The net equity is $2 billion and the pension fund assets are $6 billion. So this is a very high-risk area and it is one the board and the management team are managing incredibly well in the circumstances.[82]

4.78 In response to a question from the committee regarding the impact of the superannuation liability on Australia Post's ability to make payments to licensees, Australia Post stated:

> The impact of the change in superannuation will have a significant impact on Australia Post's profit before tax and will need to be taken into consideration when making any additional payments to licensees.[83]

Committee comment

4.79 The committee acknowledges that Australia Post is facing increasing pressures on its financial position. In the 2013–14 financial year, for first time in its corporate history, Australia Post has made a half year loss. The group profit after tax for 2013–14 is 34.5 per cent less than for the previous financial year. Without change, the outlook is not expected to improve, with losses forecast from 2015–16.

4.80 Australia Post provided evidence on the factors contributing to the worsening of its financial position, in particular the costs of the CSOs, the decline in letter volumes, international letter cost under recovery, the adequacy of the BPR and superannuation liability. Some progress has been made in relation to the superannuation liability, the BPR and international inward letter costs.

4.81 The committee notes the significant efforts by Australia Post and the relevant unions to come to agreement on the closure of the defined benefits superannuation fund and the establishment of the accumulation fund for new employees. In addition, changes to the portfolio associated with the legacy scheme have been implemented to improve its performance. The committee considers that these are important steps which will limit the growth in the, albeit significant, financial liability of the scheme.

4.82 The 10c increase in the BPR came into effect in March this year. While this was welcomed, Australia Post indicated that the letters business would continue to experience losses. Australia Post did not believe that the increase in the BPR would accelerate the decline in letter volumes. Rather, e-substitution and the emergence of the digital economy were the key factors. The committee agrees with this assessment.

4.83 In relation to bulk mail, the committee understands that the price for bulk mail has increased every year since 2011, with an overall increase of 29 per cent over that time. The evidence points to a fall in demand as the bulk mail price has increased. As a consequence, clients of mail houses are moving more quickly into digital communications and seeking more cost effective media for marketing campaigns.

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82 Mr Ahmed Fahour, Australia Post, *Budget Estimates Hansard*, 28 May 2014, p. 96.

83 Australia Post, *Answer to question on notice,* No. 12.

4.84 While not having access to Australia Post's cost models, it appears to the committee that successive increases in bulk mail prices may run counter to curtailing losses in the letters business. Australia Post has indicated that PreSort (bulk mail) accounts for 54 per cent of its addressed mailbag and that it is the most cost-effective way to send fully addressed mail. Mail houses have introduced systems to facilitate efficient bulk processing by Australia Post which requires all items to be machine-addressed, barcoded and sorted.

4.85 The committee notes that the ACCC has a role in dispute resolution in relation to bulk mail. However, the committee considers that, given the importance of bulk mail's contribution to the sustainability of the letters business, and the magnitude of increases in prices in recent years, Australia Post should again be required to notify the ACCC of proposed changes in the price of business mail.

Recommendation 1

4.86 The committee recommends that Australia Post be required to submit notifications of changes to the price of business mail services to the Australian Competition and Consumer Commission.

4.87 International inbound mail is another area where there has been some progress in addressing under recovery of costs. The committee notes that proposed changes to the terminal dues arrangements were expected to be implemented from 1 January 2014.

4.88 A matter of great significance is the cost of providing the CSOs and its impact on the losses being incurred in the letters business. These matters are crucial to the overall performance of Australia Post and the long-term sustainability of the postal network.

4.89 The committee has also noted the views in relation to the assessments of the cost of the letters business and cost allocation within Australia Post's business as a whole. While not disputing that Australia Post is suffering losses in its letters business, the committee considers that a more thorough examination of cost allocation within Australia Post would be beneficial. This is particularly the case given that part of the parcels businesses is now no longer delivered through a 'parcel only' network, rather, postal employees are also now delivering parcels. Further, the expansion of the parcels business has occurred through the existing distribution and delivery network.

Recommendation 2

4.90 The committee recommends that the Minister for Communications undertake a thorough examination of cost allocation within Australia Post and report back to the committee.