Treasury Submission to the National Competition Council Review of the Australian Postal Corporation Act

The National Competition Council (NCC) is currently reviewing the remaining mail services reserved to Australia Post. The review forms part of the Commonwealth's legislation review commitments under the Competition Principles Agreement. An interim report was publicly released by the NCC in early October 1997, with the final report scheduled to be presented to the Government in February 1998.

The main objective of Treasury's submission to the NCC's review is to promote the case for increased competition in the postal services market, given its national significance and importance as an input to other businesses.

EXECUTIVE SUMMARY

The *Australian Postal Corporation Act 1989* (the APC Act) was amended in November 1994 to allow competition in a number of postal services which had previously been reserved to Australia Post. The corporation has subsequently recorded a very strong performance, measured in terms of productivity, revenue growth, profitability and dividend payments to Government.

This strong performance has been achieved against a backdrop of significant technological change whereby postal services are facing increasing competition from other communication modes and losing market share as a result. However, new technology can provide opportunities for Australia Post to improve its standards and speed of service in traditional areas of business, as well as open up new areas of business.

Section 27 of the APC Act embodies a set of social obligations concerning the provision of a comprehensive letter service to all people in Australia. An important feature of Section 27 is that Australia Post has the discretion to determine what is 'reasonable access' to and a 'reasonable standard' of postal service. Australia Post has exercised its discretion by varying the standard of its delivery services to different categories of consumers based on the cost of delivering a postal service.

A key issue for the current review is to examine the way Australia Post's universal service obligation (USO) is currently defined and costed and then assess whether it can be preserved in the face of competition, either through Australia Post competing effectively (including through improving efficiencies) or by some funding arrangement (eg a universal service fund) which 'insulates' the USO from competition.

Treasury recognises that Australia Post would be faced with the need to make a number of adjustments, possibly significant, to its operations in order to continue delivering a universal service at a uniform price in a completely deregulated postal market (or a market where the current level of reserved services is significantly reduced). However, the difficulties Australia Post is likely to face in such a market can be exaggerated and the threat of competition, potential or real, from other suppliers would place pressure on Australia Post to contain its costs and improve the quality of its service.

If the postal services market were to be deregulated, Australia Post would have a number of advantages over potential new entrants who are likely to face significant difficulties establishing competing mail networks. In addition, Australia Post appears to have built up strong customer loyalty and has an established 'brand name'. This would likely be an important competitive advantage in a deregulated postal services market.

Whilst Australia Post's customers appear to have benefited from the nominal price freeze on standard postage articles since January 1992, they may not have shared fully in Australia Post's achieved productivity gains to the extent that might have been possible if a more restrictive price capping arrangement had been in place over the period. To avoid a continuation of this situation, a reduction in prices for Australia Post's reserved services could be investigated. The imposition of a more restrictive price cap for the next three to five years could also be considered.

Finally, there are doubts as to whether Australia Post's existing interconnection arrangements for bulk pre-sorted mail have met the pro-competitive intent of the 1994 legislative amendments and there appears scope for the development of a more desegregated schedule of interconnection discounts for this type of mail.

INTRODUCTION

Australia's National Competition Policy Framework

Competition is a key driver of economic efficiency and innovation in the economy which ultimately delivers benefits to consumers through reductions in prices, increased levels of service quality and choice. Over recent years, Australia has developed a legislative framework which facilitates the competitive process while providing remedies for unacceptable market conduct, and which also allows desirable social policy objectives to be met.

The NCC's review of the APC Act forms part of the Commonwealth's commitment to review by the year 2000 its legislation that restricts competition or imposes costs on business. The guiding principle of the legislation review process is that legislation should not restrict competition or impose costs on business unless it can be demonstrated that the benefits of the restriction to the community as a whole outweigh the costs and that the objectives of the legislation can only be achieved by restricting competition. The legislation review process, in turn, is a key element of the Commonwealth's broad commitments under the Competition Principles Agreement signed by all Australian Governments in April 1995.

Industry Commission's Mail, Courier and Parcel Services Report

The last major review of the Australian postal services market was undertaken by the Industry Commission (IC). In its October 1992 report, *Mail, Courier and Parcel Services*, the IC recommended, amongst other things, several options to increase competition in the delivery of postal services.

In November 1994, legislation was passed amending the APC Act to allow competition in a number of postal services which had previously been reserved to Australia Post (AP). The key changes were that:

- the price threshold for competition was reduced from ten times to four times the standard letter rate ($4.50 to $1.80), and the weight threshold for competition was reduced from 500 grams to 250 grams;
- the movement of letters within document exchange networks was exempted from AP's reserved services;
- the carriage of mail into and out of Australia was deregulated (but the delivery of international mail within Australia continued to be reserved to AP); and
- a framework for bulk mail interconnection to AP's network at designated mail centres was established.

NCC's Review

The review of the APC Act by the NCC reflects the national significance of postal services. In broad terms, the NCC is to examine the need for a statutory protection to AP of the exclusive right to carry letters, and the implications of a reduction or removal of that reservation in the context of the Government's commitment to the provision of a standard letter service to all Australians at a uniform price. In undertaking its review, the NCC is to have regard to the findings of the IC's 1992 report, as well as the reform outcomes arising from the 1994 legislative amendments.

Australia Post's Network

The largest part of AP's postal service involves the transportation of physical mail (letters and parcels). The chief functions of its network are the collection, sorting, transportation and delivery of mail. The nodes of this service can be classified into: collection points (post boxes, post offices), sorting points (mail exchanges) and delivery points (private letter boxes). In that regard, **traditional mail is very much a transportation service rather than a communications service, although over time there has been increased bypass of transportation networks through the use of telecommunications networks** (see discussion of technological change below). The variable costs involved in physically transporting mail can be classified into six broad areas:

- costs of establishing and maintaining collection points;
- cost of transportation from collection points to mail exchanges;
- sorting costs;
- cost of transportation between mail exchanges;
- re-sorting costs; and
- cost of transportation to delivery points.

In addition, there are the fixed infrastructure costs of land and buildings for mail exchanges and post offices. A larger proportion of AP's costs appear, however, to be variable rather than fixed. For example, AP's largest cost is labour, reflecting the labour intensive nature of postal operations, accounting for around 60 per cent of its costs. This mix of variable and fixed costs raises the issue of whether there are economies of scale and scope in AP's operations (economies of scale exist where average costs for each unit of output produced falls as output is increased, whilst economies of scope exist when one firm can provide a range of services more cheaply than a number of firms providing each service separately). This issue is closely related to that of whether the postal service is a natural monopoly (ie, a single firm can produce the entire industry output at a lower total production cost than two or more firms).

In its 1992 report, the IC found that economies of scale in collection, transportation between mail exchanges, sorting and delivery were already likely to be exhausted in Australian cities. This was reflected in the fact that other operators (eg couriers, mailing houses) were already performing some of these functions. In contrast, in rural areas, where mail volumes are smaller, the IC considered that it was likely to be more efficient for one firm to provide a letter service. According to the IC, economies of scope were likely to be greater where mail volumes were low.

Treasury concurs with the IC's views and notes that to the extent that economies of scale have been exhausted, there would be net benefits from introducing more competition into the Australian postal market. Nonetheless, a related key issue is the extent to which the standard letter service at a uniform price would be sustainable in the face of greater competition. This will depend on the extent to which AP's economies of scale and scope interact with the varying costs of different mail paths. This issue is discussed in the section 'Australia Post's Ability to Provide its USO in the Face of Increased Competition' below.

Over time, a number of technological changes have occurred which have influenced the nature of the postal service, as well as the breaking of traditional boundaries between different parts of the communications sector.

- **Sorting of mail has become more mechanised and centralised within larger mail exchanges, rather than manually within individual post offices. In that regard, the mail transportation service has become increasingly separable from the post office 'shop front'.**
- **Bulk mailers have also incorporated technology to pre-sort mail, allowing them the option of avoiding the first three of the six broad costs identified above.**
- **Telecommunications has enabled mail prepared in one central facility to be electronically transmitted to a point near the final destination, where letters are printed, enveloped and sorted before delivery to a mail exchange near the end point. While not avoiding the cost of transportation to the delivery point, this avoids most of the other costs.**

Moreover, electronic mail and fax can be used to bypass the whole postal network, provided the receiver has access to the required telecommunications facilities. As this type of bypass becomes more common, the role of the standard letter service will become less significant. Future movements in the relative price of letters to telephone calls could be an important determinant of the speed of this trend.

It is apparent then, that the rapid pace of technological change in the communications sector provides a double edged sword for AP. On the one hand, postal services are facing increasing competition from other communication modes such as fax and electronic mail, and losing market share as a result (although it should be noted that mail volumes are growing at around 4 per cent a year, which AP expects to be maintained into the next decade). On the other hand, new technology can provide opportunities for AP in terms of improving its standard and speed of service in traditional areas of business, as well as expanding into non-traditional areas of business. For example, AP already provides an electronic-to-physical mail service (EDIPost) which has exhibited recent strong growth in volumes.

Australia Post's Recent Performance

The reform of Commonwealth government business enterprises (GBEs) in the late 1980s produced significant gains, in terms of lower costs and better service, to business and the wider community. AP's performance showed marked improvement following its corporatisation in 1989. There are, however, limitations to the degree of efficiency improvement which can arise from GBE reform alone.

Experience in the telecommunications sector has demonstrated that competition is the ultimate engine for efficiency improvement. Fostering more competitive markets and seeking efficiency gains in infrastructure industries such as telecommunications and postal services is particularly important given that they represent a basic cost to business that influences the ability of business to compete in international and domestic markets.

Since its exposure to greater competition as a result of the 1994 legislative amendments, AP has recorded a very strong performance, measured in terms of productivity growth, revenue growth, profitability and dividend payments to Government, notwithstanding a freeze on the standard letter price (of 45 cents) since January 1992. (The freeze has been extended until June 1998.) The standard letter is the most significant product in AP's reserved services, the reserved services accounting for around 56 per cent of total revenues. Moreover, AP has recorded strong growth in its non-reserved services over this period — that is, those services which, in principle, are open to competition. The turnaround in AP's performance since the late 1980s is such that it is now regarded amongst the best performing postal operators internationally.

Notwithstanding AP's high international standing and its recent good performance, it is arguable that there remains scope for AP to improve the efficiency of its postal operations. The experience of the 1994 legislative amendments indicates that a further reduction in the level of reserved protection is likely to be the best means of facilitating this efficiency improvement.

Funding the Delivery of the Postal Universal Service Obligation

This strong financial performance over recent years raises the issue of the funding of AP's universal / community service obligations (USO / CSOs). AP has traditionally emphasised the link between its USO / CSO obligations — broadly, the provision of a reasonably accessible universal letter service at a uniform price — and its reserved services. In other words, AP has suggested that should the reserved services protection be reduced or removed completely, then 'cream skimming' would arise on its most profitable routes. As a consequence, its revenues, profits and employment would all fall and ultimately AP would be unable to meet its USO / CSO obligations. A recent report by the House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform, *Keeping Rural Australia Posted*, which focussed on AP's CSOs, recommended, amongst other things, that the CSOs of AP should continue to be funded through cross-subsidies. Nonetheless, the Committee considered that AP's reserved services could be reduced without disadvantaging rural and remote communities.

Recent Changes to Commonwealth GBE Accountability Framework

The Government has recently decided on a number of refinements to its GBE governance arrangements aimed at strengthening the existing accountability framework. These include differentiating between CSOs and USOs and the funding of these respective obligations. A full discussion of the implications of the Government's decision for AP is in the section 'What are Australia Post's USO / CSOs?' below.

Future Reform of Postal Services

In light of AP's performance since the 1994 legislative amendments, and the range of developments outlined above which will be impacting on the Australian postal services market in the future, the current review of AP is timely. **Treasury considers that the threshold issue for future reform of the postal services market is the extent to which those services currently reserved to AP should be further opened up to competition and the extent to which any potential loss of revenue will impact on AP's ability to continue delivering a universal letter service.**

AP'S STATUTORY UNIVERSAL SERVICE OBLIGATION

Postal policy in Australia and internationally has traditionally been based on the premise that an unregulated postal market would not provide a universal letter service. Consequently, a universal service obligation is imposed on the (typically) public postal operator which is given monopoly protection to enable it to generate sufficient revenues to cover the costs of supplying the universal service. The most significant policy issue in this case becomes the determination of the scope of the monopoly (ie, the range of postal services 'reserved' to the monopolist) rather than whether there are alternatives to the monopoly provider model. Nonetheless, some countries (eg Sweden, Finland) have recently rejected this postal policy paradigm and completely deregulated their postal markets while maintaining USOs on their public postal operators.

Treasury sees strong merit in this alternative approach and considers that a key issue for the NCC review to examine is the way AP's USO is currently defined and costed and then assess whether it can be preserved in the face of competition, either through AP competing effectively (including through improving efficiencies) or by some funding arrangement (eg a universal service fund) which 'insulates' the USO from competition.

What are Australia Post's USO/CSOs?

Section 26 of the APC Act obliges AP to, as far as practicable, perform its functions in 'a manner consistent with sound commercial practice'. Within this broad framework, AP appears to perform a number of USO / CSOs, both of a statutory and non-statutory nature.

AP's key USO is specified in Section 27 of the APC Act and obliges AP to provide:

- reasonable access to a letter service regardless of location;
- a standard letter service at a uniform charge;
  - for letters that are 'standard postal articles' as defined in the APC Act;
- a reasonable standard of letter service; and
- a letter service between Australia and the world.

Section 27 essentially embodies a set of social obligations concerning the provision of a comprehensive letter service to all people in Australia; however, it is important to recognise that the actual USO is only that part of the letter service that AP would not provide if it were acting commercially. There is a potential principal / agent problem here in that the Government does not have access to full information concerning the nature of the alternative, strictly commercial, decisions that would otherwise be made by AP. Hence, a risk arises that the Government may be induced to fund some loss making activities that AP would have undertaken anyway, as it may not necessarily be in AP's commercial interest to discontinue all loss making services.

In a recent decision concerning its GBE governance arrangements, the Government drew a distinction between a USO and a CSO. The Government determined that a CSO arises when a Commonwealth GBE is required to carry out specified activities which:

- the GBE would not elect to do on a commercial basis (or which it would only do commercially at higher prices); and
- the Government does not, or would not, require other organisations in the public or private sectors to undertake or fund.

In addition, the Government decided that, in-principle, all CSOs would be budget funded.

In contrast, a USO exists where the first condition above holds, but not the second; that is, the Government does, or would, require other organisations in the public or private sectors to undertake or fund the specified activities. The funding of USOs will depend on a range of factors including the nature of the service, the existing and future delivery alternatives and budget considerations. For example, with respect to telecommunications, the Government has decided to impose a USO obligation on the industry as a whole by means of a universal levy. A similar issue could arise if AP's existing reserved services were to be significantly opened up to competition.

More generally, there is a need to clarify exactly the activities that AP is currently engaged in that are considered to be CSOs (ie, not part of the delivery of the universal letter service) and decide whether the provision of these CSOs should continue by means of budget funding.

Finally, **it is also apparent that with the exception of the requirement that it provide a standard letter service at a 'uniform charge', the obligations on AP with respect to the letter service are not tightly defined and so there is a degree of discretion, tempered by public expectations, available to AP on the delivery of the USO. In practice, the use of this discretion has been reflected in consumers facing different quality of service standards depending on the cost of providing that service.**

Australia Post's Discretion in USO Delivery

With respect to AP's statutory USO, an important feature of Section 27 is that AP has the discretion to determine what is 'reasonable access' to a service and a 'reasonable standard' of service. AP has exercised its discretion by varying the standard of its delivery services to different categories of consumers based on the cost of delivering a postal service (using its 'urban base rate' formula).

Hence, AP provides five street mail deliveries a week to residences and business addresses where all of the costs of the delivery can be met from the revenues generated by the delivery, and provided the mail receptacle is reasonably accessible from the footpath of a public road. Where delivery costs are much higher than the average costs of delivery, AP reduces the frequency of delivery progressively, with small decreases in frequency being made in response to large increases in cost, and with some locations not receiving any mail deliveries. Delivery services in rural areas are also contracted out to local transport operators.

Similarly, AP aims to locate street post boxes and other lodgement facilities in places where customer demand is sufficient to warrant the cost of establishing, clearing and maintaining such facilities. Street post boxes are sometimes installed in locations which would not be justified on commercial criteria, for example, to meet the needs of the aged or disabled near hospitals or nursing homes. However, while AP maintains street post boxes for uneconomic reasons, it generally only does this while they achieve a minimum lodgement of 25 articles per day.

Because they relate to the delivery of mail along mail paths, these measures also have a direct effect on the cost of meeting the non-discretionary commitment to 'a standard letter service at a uniform charge'. It is important to bear this in mind when considering the possible deregulation of the postal services market and the delivery of a universal letter service.

It can be seen that, by using its discretion as far as access and reasonable standards of service are concerned, AP is directly affecting the cost of delivering a universal letter service. In other words, AP is already differentiating access conditions (and quality of service) to minimise the cost differences of mail flows within and between metropolitan and non-metropolitan areas. Moreover, as part of this cost minimisation approach, AP has contracted out parts of the delivery of the universal letter service (see below).

If the reserved protection were to be reduced or removed, AP would need explicit guidance from the Government as to the comprehensiveness of the postal service it would be expected to provide. Under Section 28C of the APC Act, regulations may prescribe performance standards in relation to the frequency, speed or accuracy of delivery or in relation to availability and access of services supplied by AP. This would be an important mechanism by which the Government could provide comfort to consumers that postal service standards would be maintained at an appropriate level. Indeed, the Government has already made a commitment to develop a Charter of Responsibilities for AP. It is intended that the Charter will be based on minimum performance standards established under Section 28C.

AP also differentiates between the type of retail outlets in metropolitan and non-metropolitan areas as far as the range of services supplied is concerned. Hence, in metropolitan areas, there are 'post shops' and traditional post offices, both of which offer a full range of postal and financial services (in addition, there are specialised ‘business centres’ for business users). In contrast, in rural areas there are post offices run in conjunction with other business, such as chemists, convenience stores and dry cleaners, and community postal agencies, both offering a smaller range of postal services.

Indeed, the extensive licensing of retail outlets means that AP is essentially providing ‘reasonable access’ to and a ‘reasonable standard’ of letter service in partnership with others. For example, as noted above there are already a number of post offices being run (by licensees) in conjunction with other businesses, while delivery services in rural areas are generally contracted out. This is an important issue when considering deregulation of the postal services market and the delivery of a universal letter service.

Standard Letter Service at a Uniform Charge

It is generally accepted that uniform charging implies the use of a cross-subsidy whereby revenues from parts of the network which exceed costs are used to fund the costs of servicing other users where revenues are insufficient. Under the current arrangements, there are no mechanisms in place to ensure that cross-subsidisation is limited to services reserved to AP and is not used to support services open to competition.

It is not clear that in a deregulated environment, a requirement on AP to continue providing a letter service at a uniform charge would necessarily be onerous. The introduction of differential tariffs (for instance reflecting geographical cost differences) would impose transaction costs which may not be liked by consumers or postal operators. These may arise from the difficulties of determining marginal costs for individual mail routes and operating a schedule of prices for different routes, for example, charging different prices for intra or interstate mail. As noted above, AP has already taken steps to reduce geographical cost differentiation and this assists uniform pricing. There may be scope to take this process further. In the US, private couriers appear to have adopted uniform quoted rates for delivery anywhere within the 48 adjoining states, including to rural areas some distance away from the airports used by courier firms. Competition occurs on service and price (eg negotiated volume discounts), however, rates are set such that a profit is not made on every delivery. Finally, it should be noted that larger AP customers already receive a selective discount for bulk mail. This issue is discussed in more detail in the section ‘Interconnection Arrangements’ below.

Australia Post’s Reserved Services

Section 29 of the APC Act provides AP with an exclusive right to: carry letters within Australia, collect and deliver letters; and issue postage stamps. The APC Act defines a ‘letter’ as any form of written communication directed to a particular person or address.

Section 30 of the APC Act provides a reasonably large number of exceptions to those reserved services, the most well known being the carriage of letters greater than 250 grams (subject to certain conditions) and the carriage of a letter within Australia at a rate at least four times the uniform charge ($1.80) for standard postal articles.

Notwithstanding these legislative exceptions, in practice it will always be difficult to perfectly delineate a reserved service from a non-reserved service. Consequently, 'grey' areas will likely develop at the boundary of a particular legislative exception where potential competitors see an opportunity to provide a service in competition with AP, despite AP considering that the service is reserved. There is no doubt that when faced with artificial constraints on competition, a company may seek to 'push the boundaries' if it can see a profitable business opportunity.

One area that has generated a number of these boundary problems, and which was identified by the IC in its 1992 report, is addressed advertising mail. The IC identified companies which had run into problems with AP when attempting to deliver addressed advertising mail. Hence, under the APC Act, an advertising catalogue with a one page insert addressed 'Dear valued customer' or 'Dear cardholder' could be interpreted by AP as being a letter and hence a reserved service. While the 1994 legislative amendments partially addressed this problem by removing some forms of addressed advertising material from the reserved services, Treasury understands that boundary problems remain as far as 'personalised' advertising mail is concerned. Moreover, the delivery of such mail has little relevance to the provision of a universal letter service.

There is little doubt that there are a number of companies that could immediately expand their presence in this market segment. Consequently, the grounds for some forms of addressed advertising mail continuing to be reserved to AP are not compelling. Treasury acknowledges that AP will likely lose some mail volumes as a result. However, there would seem little real likelihood that even a significant loss of business in this area would pose any risk to AP's ability to continue delivering a universal letter service. Moreover, the extent of the loss of volume will be dependent on AP's willingness to compete and be innovative in the face of new entrants to the market.

AP has a larger network than its competitors which provides a competitive advantage. On the other hand, smaller private sector operators may be able to provide a lower cost, more innovative service than AP.

More broadly, **Treasury supports the NCC closely examining the current definition of a 'letter' and other exceptions to the reserved services to see whether similar boundary problems to those in advertising mail are occurring.**

Australia Post's Ability to Provide its USO in the Face of Increased Competition

AP claims that should its reserved services be reduced or completely removed, it would lose significant market share and the resulting economies of scale and scope that a significant market share delivers. In combination with 'cream skimming' on its most profitable routes, AP believes that it would be unable to continue delivering a universal letter service at a uniform price.

Treasury recognises that AP would be faced with the need to make a number of adjustments, possibly significant, to its operations in order to continue delivering a universal service at a uniform price in a completely deregulated postal market (or a market where the current level of reserved services is significantly reduced). However, the difficulties AP is likely to face in such a market can be exaggerated.

As has been noted in the above section on 'Australia Post's Discretion in USO Delivery', AP has already taken a number of steps to reduce the geographical cost differences between mail paths, including contracting out and reducing the frequency of delivery in rural and remote areas, as well as licensing retail postal outlets that are run in conjunction with other businesses in these areas.

In considering AP's ability to compete with potential new entrants, it is important to make a broad distinction between mail lodged in AP's network that is charged at the uniform price and mail that attracts bulk discounts. AP currently provides discounts for bulk pre-sorted mail reflecting costs saved in processing and handling. In effect, the uniform letter price becomes a 'list' price off which AP offers discounts for its largest customers. Bulk pre-sorted mail accounts for around 30 per cent of the total letter mail posted.

In a deregulated environment, AP would continue to be able to offer differentiated bulk mail rates to compete with new operators in this market segment. These discounts may have a geographic dimension. Clearly, AP would still remain susceptible to a new operator entering the market and undercutting its discounted prices, however, AP would have some degree of flexibility in pricing in a key segment of its postal business. In contrast, for 'single piece' items (letters posted in small quantities), the legislative requirement to provide a 'standard letter service at a uniform price' would bind AP so it would not be able to compete with lower cost operators on price. AP would, nonetheless, still have some non-price competitive advantages which are discussed below.

In analysing the potential extent of 'cream skimming', the key feature of the economics of postal operations is the interaction between the economies of scale and scope of the postal network (to the extent they exist) and the varying costs of different mail paths. There is no direct connection between the size of the losses incurred on those (low density) mail runs where costs exceed the uniform price (the cost of the USO) and the size of the revenues on those (high density) mail runs where marginal costs are below the uniform price (the profitable routes used to cross-subsidise the USO). AP's high density runs are those most susceptible to competition, while its lowest density mail runs are those which it would be required to continue providing as part of its USO. Competitors, on the other hand, would choose not to operate on these latter routes.

AP may be vulnerable to competition on the lowest cost runs, despite the presence of economies of scale and scope, depending on the number of individual mail runs which are viable on a stand alone basis. If the cost to AP of any loss of market share is greater than the benefit to all consumers, then competition will lead to a static welfare loss. However, this potential loss needs to be set against the likely dynamic gains, through increased consumer choice, innovation and pressure to reduce costs. This is conceptually no different to the introduction of competition to Telstra. Moreover, there are credible alternative means of funding the USO apart from cross-subsidies (see below)**.**

In assessing how AP would cope in a deregulated environment, it should be recognised that it has a number of advantages over potential new entrants who are likely to face significant difficulties establishing competing mail networks. AP's current network allows it to connect all households and businesses across the country. Customers know that the one postal service is capable of delivering a piece of mail from its origin to final destination. In contrast, a mail network which does not provide a universal service faces a major problem of having to assess whether it can actually deliver the mail prior to acceptance. For example, such a network may need to rely on interconnection with AP's network or other smaller networks in order to deliver interstate items — a piece of mail could conceivably have to flow though two or more postal networks to reach its final destination.

Interconnection between different providers is difficult in the supply of postal services given the physical transfer of large volumes of mail that it entails. Difficulties include the fact that there are multiple points in the network where interconnection can take place and there is a significant task in coordinating the transport and delivery functions of different networks. These problems can be compared with the relative ease of interconnection in telecommunications. There may also be particular problems negotiating competitive interconnection fees with other network operators (see the section 'Interconnection Arrangements' below).

In addition to operating the only universal network, AP has built up what appears to be strong customer loyalty as a result of the provision of a reliable service over many years, and has an established 'brand name'. In contrast, it might take time for new operators to establish a similar reputation, particularly with household users.

AP generally downplays the commercial value generated by its provision of a universal postal service and the presence in the market that provision of such a service gives it. For example, it is possible that AP's very strong performance in recent years in the non-reserved services sector of the postal market has been assisted by its provision of a universal service. In addition, AP's extensive coverage of retail outlets has enabled it to provide a wide range of non-postal services, including financial facilities such as bill paying and banking, which are showing strong volume and revenue growth.

Overall, it seems quite plausible that if the postal market were significantly deregulated, the extent to which competing networks would set up in competition with AP is likely to be limited. One possibility would be local services in high density areas, such as central business districts, with links to similar areas in other States/Territories, as currently occurs with document exchanges. Nonetheless, a deregulated market would provide scope for other suppliers to develop new services or provide the same services as AP at lower cost. This threat, potential or real, would in turn place pressure on AP to contain its costs and improve the quality of its service.

Finally, it should be recognised that any discussion of the likely effects of reducing AP's reserved protection on the provision of the USO is hindered by a lack of meaningful data. Notwithstanding the complexity of deriving a value for the USO, AP's annual point estimate of the total cost of providing the USO does not contribute significantly to the debate on the best means of funding and delivering its USO, and particularly the sustainability of the USO if the postal services market were further deregulated. For example, there does not appear to have been any attempt to estimate the net cost of the USO by major traffic volumes (eg city-city, city-country, country-country, international) since the IC's estimates in 1992.

The Australian community potentially pays a high price for this lack of transparency, as a result of the maintenance of a level of reserved service protection for AP that may not be necessary for delivering the postal USO. However, without adequate information which can be subjected to independent scrutiny, this remains only a suspicion rather than a fact. This information asymmetry clearly places AP in a powerful position in arguing for maintenance of the status quo, although its strong financial performance in recent years suggests that its ability to continue delivering the USO in the face of deregulation should not be underestimated.

This information asymmetry is exacerbated by the standard reliance internationally on the monopoly provider model as the best means of delivering a universal letter service and a general unwillingness to look at alterative ways of delivering that service. This can be contrasted with the telecommunications sector both in Australia and internationally, where greater reliance on competition, in combination with a more extensive use of universal service funds, has proven to be a credible alternative to the monopoly provider model. As already noted, the Government recently decided that Telstra's requirement to provide access to pay phones and the adoption of a standard local call tariff was a USO and should be funded by all industry participants in proportion to their respective market shares.

Similarly, **AP's requirement to provide a universal letter service, as specified in Section 27 of the APC Act, could be funded by a levy on new entrants if the postal services market were to be deregulated. A more tightly defined postal USO could also be developed as part of this process. AP would continue to be required to provide the USO, however, it could choose to subcontract some parts of the supply of the universal service.** As noted in the above section on 'Australia Post's Discretion in USO Delivery', AP has already taken steps down this path, including contracting out roadside delivery in rural and remote areas.

An alternative means of injecting greater competition into the postal services market while allowing AP to continue funding the cost of the USO would be to set a price floor to limit the extent of 'cream skimming' on AP's most profitable (lowest cost) routes. For example, in a completely deregulated postal market, competitors could charge below the current 45 cents uniform price for a standard letter but not below 40 cents. In principle, the price floor would be set at a level sufficient to protect enough of AP's lowest cost routes to enable it to generate sufficient revenues to continue cross-subsidising the cost of the USO.

In practice, there would be features of such a price floor which would make it an unattractive option compared to a universal service levy. It would likely be a difficult regulatory task to set the floor at a level which promoted greater competition while not excessively protecting AP's lowest cost routes. The regulator would need to acquire detailed information on the nature of AP's average and marginal costs in order to meet this objective. While opening up some mail runs to greater competition, a price floor could protect AP from competitive pressure on its lowest cost runs which could dull its incentive to improve efficiencies. Alternatively, a floor price could lead to inefficient non-price competition in terms of the quality of delivery service offered. The result could still be 'cream skimming' on some routes unless the regulator was able to regulate quality of service as well as the floor price.

Competition at Different Price Thresholds

International experience suggests that it is not until the level of protection of standard postal articles is reduced to around two times or less the standard letter rate (in AP's case 90 cents per letter or less) that true competition is likely to take place. For example, the level of protection provided for NZ Post was phased down in three steps from $NZ1.25 to $NZ0.80 between October 1989 and October 1991 (the standard letter price in NZ is $NZ0.40). Full deregulation is foreshadowed in 1998.

There appears to be some support for this in an Australian context, where industry observers have estimated that a reduction in AP's protection to

90 cents would only expose to competition around $300 million of its business. AP has claimed that the previous reduction in protection to $1.80 only exposed to competition around $250 million in revenue. In the absence of full data, there will always be a degree of uncertainty about the extent of competitive pressure at different price thresholds. Nonetheless, as the reserved service generates revenues of around $1.5 billion, it is quite possible that reducing the level of protection to 90 cents would only expose around 20 per cent of the reserved service to competition. Consequently, reducing the level of protection to significantly below 90 cents would appear to be required to allow effective competition over the bulk of the reserved service.

Australia Post's Non-Statutory CSOs

In addition to its Section 27 obligations, there appear to be a number of services that, over time, AP has chosen to undertake, or has been required to undertake by successive governments, which could be classified as CSOs. Community expectations also may have built up around the provision of certain services by AP. AP has argued that in costing its USO / CSOs, special allowance should be made to include recognition of the additional costs of government ownership. For example, AP argues that the annual costs of around $30 million to operate and maintain post offices which are also heritage properties should be included in the cost of the CSO. Other activities that could potentially be categorised as CSOs include the provision of medical and educational materials in rural areas.

With respect to heritage properties, it is possible that AP's responsibilities are greater than those faced by the private sector. This might be occurring as a result of the higher proportion of heritage buildings it owns, and community expectations that AP should continue to operate out of such buildings, notwithstanding that these buildings are likely to be more expensive to maintain and / or may be inappropriate for modern postal operations. However, the issue of AP operating out of heritage buildings needs to be separated from the provision of a universal letter service at a uniform price. The provision of a universal letter service at a uniform price does not depend on AP operating out of heritage buildings. It is inappropriate then for any additional costs this imposes to be reflected in a higher uniform price or an excessively high level of reserved services.

More generally, **consideration may need to be given to defining more precisely what is expected of AP by way of CSOs, so that these CSOs can be more accurately costed and, preferably budget funded, in line with the Government's recent decision on GBE accountability arrangements** (see above section on 'What are Australia Post's USO / CSOs?').

Resale Price Maintenance (RPM) of Standard Postage Stamps

RPM is *per se* prohibited under the *Trade Practices Act 1974* (ie, it is not subject to the substantial lessening of competition test). However, RPM can be authorised by the Australian Competition and Consumer Commission (ACCC) subject to a public interest test, if it is judged that a particular RPM arrangement results in a benefit to the public that outweighs any anti-competitive effect.

Section 33A of the APC Act prohibits, amongst other things, the sale of postage stamps for less than their usual retail price. This legislated RPM is intended to support the uniform pricing policy for standard letters. Effectively, AP supplies stamps to retailers at a particular 'wholesale' price and the margin or commission received by those retailers is fixed. A retailer has no discretion to lower the final price and take a lower commission. For each stamp sold outside the retail chain, AP only receives the 'wholesale price' and, by losing the difference between the retail and 'wholesale' price, it arguably diminishes its ability to fund the USO. It has been further argued that if retailers were allowed to undercut the retail price this would exacerbate the loss of revenue.

Treasury considers that this argument should be tested by the ACCC and that authorisation under the Trade Practices Act would be preferable to an industry specific exemption.

INFORMAL 'FREEZE' ON THE STANDARD POSTAGE STAMP PRICE

Prices Oversight of Australia Post

Under Section 33 of the APC Act, postage charges for standard articles are subject to Ministerial review. In exercising the powers under Section 33, the Minister is required to have regard to changes in the Consumer Price Index (CPI). In practical terms, this could be expected to impose some form of cap on any increases in the price of standard postal articles. AP's reserved services are also declared under the *Prices Surveillance Act 1983* (the PS Act). Under the provisions of the PS Act, AP is required to notify the ACCC before increasing the price of its reserved services.

AP has held the price for delivery of a standard postal article constant at 45 cents since 1 January 1992 and has indicated its intention to maintain the freeze until June 1998. In other words, AP will have held the nominal price of delivering a standard postal article constant over this period, while real prices have fallen. The Steering Committee on National Performance Monitoring of Government Trading Enterprises has estimated that the real price of a standard letter has declined by 7.5 per cent since 1991-92; however, most of this gain has been concentrated in the last two years (real prices increased by around 2.5 per cent between 1990-91 and 1992-93, reflecting an increase in the standard postage stamp price from 41 cents to 45 cents between September 1990 and January 1992). The nominal price freeze was originally agreed between AP and the former Government, consequently the appropriateness of the freeze vis-a-vis alternatives such as a nominal price fall under a formal price cap, has never been subject to independent scrutiny by the ACCC.

The principal aim of a price cap is to prevent a firm with monopoly power exercising that power through restricting output or charging higher prices than would occur in a competitive market. A CPI-X price capping arrangement places a limit on the growth in the monopolist's prices equivalent to the rate of CPI growth minus the rate of productivity growth it would be likely to achieve relative to economy-wide productivity growth (the 'X'). It can be seen that AP's nominal price freeze has been equivalent to a price cap of CPI=X (in other words, CPI-X = 0 therefore CPI = X). To the extent that AP's productivity growth has outstripped inflation over this period, then the company will have made significant gains in revenue, notwithstanding the nominal freeze in the standard letter price.

Australia Post's Performance under the Nominal Price Freeze

Since AP instituted the price freeze, it has recorded a very strong financial performance. AP's return on assets has increased each year since 1992-93, reaching 17.6 per cent during 1995-96, reflecting strong increases in its earnings. Between 1991-92 and 1995-96, AP's earnings before interest and tax increased by 62 per cent compared with growth in average total assets of 7 per cent. AP's operating sales margin has increased steadily since 1992-93 reaching 12.5 per cent in 1995-96. Over this period, AP's annual average labour productivity growth has been around 5 per cent, compared to annual CPI growth of 2½ per cent (labour accounts for around 60 per cent of AP's total costs).

Reserved services account for around 55 per cent of AP's business, with the standard letter service being the major reserved product. It would also appear that the prices of other reserved services have been held broadly constant since 1992. The balance of AP's business activities are non-reserved services which, in principle, are subject to competitive pressures. Hence, it would be fair to say that the performance of AP's reserved services has been an important contributor to its overall strong financial performance.

Distribution of Productivity Gains

AP's strong productivity growth in recent years in combination with its strong recorded financial performance raises the issue of the distribution of those productivity gains. In a competitive market, increases in productivity would tend to be shared amongst all stakeholders, with consumers gaining through lower prices, as costs fell and rivals fought for market share. In contrast, if competition is lacking, prices may not fall in response to productivity gains.

Furthermore, in the absence of a sufficiently strong competitive environment, there may not be a sufficient inducement for AP to explore all avenues to increase productivity.

While at face value AP's customers appear to have benefited from the nominal price freeze (ie, as a result of the real price fall), they may not have shared fully in AP's achieved productivity gains to the extent that might have been possible if a CPI-X price capping arrangement with X > CPI had been in place over the period. To avoid a continuation of this situation, a reduction in prices for AP's reserved services could be investigated. This could be achieved by reviewing the 1994–97 period to see whether a price reduction could have been feasible and, if so, whether an immediate price reduction is warranted. The imposition of a CPI-X price cap for the next three to five years, which could be administered by the ACCC under the provisions of the PS Act, could also be considered.

The setting of the price cap would require information on AP's cumulative productivity and cost performance during the period of the freeze, as well as AP's expectations of future trends in these variables. It would be possible, in broad terms, to establish a cap which provides an incentive for AP to seek efficiency gains while ensuring that productivity gains are shared with consumers in the form of lower prices.

Clearly, the need for a cap to be applied to the price of standard postal articles supplied by AP is linked directly to the level of competition it faces in their delivery. Hence, if AP was exposed to greater competition in the delivery of standard postal articles, the pricing discipline this could be expected to impose would lessen the need for a cap. However, a reduction in reserved services protection may not result in strong competition developing in the short term. Consequently, a price cap regime may still be required as a transitional mechanism while sufficiently robust competition to ensure price restraint developed. This would be a similar situation to Telstra which is still subject to price caps on a range of services in markets where competition is weak or non-existent.

INTERCONNECTION ARRANGEMENTS

Legislative Framework

Interconnection is a potentially important means of facilitating greater innovation and efficiency in the delivery of postal services. In practical terms, interconnection allows competitors of AP to carry bulk quantities of letters which would otherwise be reserved to AP some part of the distance towards their destination, and to then lodge the letters with AP for final delivery to the addressee. By interconnecting in this way, AP's competitors receive some level of discount reflecting the costs avoided by AP.

The establishment of a legislative framework for bulk mail interconnection to AP's network was an element of the former Government's 1994 postal reforms. Under Section 32A of the APC Act, AP must provide interconnection on the basis of a rate reduction which reflects its estimate of the average transport costs per letter avoided in respect of the letters lodged for delivery. Nonetheless, the provision allows AP to take a broader interpretation of the interconnection terms and conditions than avoided transport costs. It is open to AP to negotiate individual terms and conditions of a service with customers.

Section 32B of the APC Act allows for regulations to be made to enable the ACCC to inquire into a dispute arising from the operation of a bulk interconnection service provided by AP under Section 32. The ACCC is not the final arbiter in disputes but rather makes recommendations to the Minister for Communications, the Information Economy and the Arts.

Australia Post's Interconnection Arrangements

Under the interconnection arrangement, AP has chosen to average all interstate line haul costs for a specific type of mail to arrive at a single discount of around one cent per letter for regular delivery (and a single discount for off-peak delivery). **In other words, as well as being relatively small, the discount is constant for letters regardless of their origin and distance carried to the mail centre of lodgement.** There are separate schedules for different sized letters and the discount for avoided transport costs is additional to pre-sort discount arrangements. AP notified the former Prices Surveillance Authority (PSA) of its proposed charges for bulk mail, including the interconnect discount, in July 1994. The PSA did not object to the notification.

As a consequence of bulk mailers getting the same interconnection discount regardless of the distance they have line hauled their mail, in practice they might be expected to bypass AP mainly on short haul segments rather than longer haul segments. This is because the averaging of all interstate line haul costs to arrive at the single interconnection discount makes it extremely difficult for third parties to successfully compete with Australia Post on line hauling mail when transport costs for longer routes are greater than those for shorter routes.

Moreover, while AP may be able to negotiate relatively favourable rates for its air transport contracts compared to potential competitors because of its very high mail volumes, the current interconnection discount does not recognise that part of the transportation function can be bypassed through electronic distribution. However, a bulk mailer utilising this option would still only receive a one cent per letter discount for AP's avoided costs.

It is questionable then whether the averaging of costs underlying the interconnection discount truly reflects AP's avoided costs. The overall effect of the arrangement has been to introduce a further level of cross-subsidisation in mail services. In addition, Section 32A is open to

interpretation as to the extent to which bulk mailers can actually negotiate with AP on interconnection terms and conditions.

Overall, there are doubts as to whether the existing interconnection arrangements have met the pro-competitive intent of the 1994 legislative amendments and there appears scope for a more desegregated schedule of interconnection discounts for bulk pre-sorted mail to be developed.

Part IIIA Access Provisions of the Trade Practices Act

Since the 1994 amendments to the APC Act, a national access regime under Part IIIA of the Trade Practices Act has been introduced as part of the competition policy reforms agreed with the States and Territories in April 1995. It effectively establishes a right for persons to negotiate with owners for access to a 'declared service' provided by a nationally significant infrastructure facility. Where these negotiations fail, the ACCC can arbitrate the terms and conditions of access. Applications for the declaration for a service are made to the NCC. The NCC is required to make a recommendation to the 'designated Minister' (in the Commonwealth sphere, the Treasurer) and that Minister must then decide for or against a declaration and publish his or her decision. Currently, AP's services are exempt from declaration under Part IIIA.

The primary role of the access regime is to prevent a vertically integrated firm from misusing market power that arises from one of the markets in which it operates. Where structural separation has not occurred, the access regime could be used to inject competition into upstream or downstream markets.

An issue arises whether the Part IIIA access provisions potentially provide a better means of promoting competition in the postal services market than the legislative framework under Section 32A of the APC Act. It is not clear whether AP's postal services network would meet all of the statutory criteria necessary for an access declaration to be successful, although clearly this would have to be tested in practice. Nonetheless, **there is no apparent reason why AP's reserved services should continue to be exempt from Part IIIA. Finally, while the issue of interconnection is an important one, the need for interconnection arrangements for AP is lessened or removed if the level of reserved letter protection is reduced or removed.**