Australian and International Postal Services Overview

Background Report

June 2014

THE BOSTON CONSULTING GROUP

Preface

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Glossary

The Act	The *Australian Postal Corporation Act 1989* which governs the activities of Australia Post
CAGR	Compound annual growth rate
CMB	Community mail box
CMS	Australia Post's Communication Management Services business unit, which includes its letters business
CPA	Community Postal Agency
BCG	The Boston Consulting Group
D+X	Day plus x days, used to describe the speed of delivery for a letter, the letter will be delivered within x working days of the posting date
Corporate Plan	Unless otherwise specified, refers to Australia Post's Corporate Plan 2013/14 to 2016/17
FTE	Full time equivalent, usually in reference to employees
FY	Financial year
GDP	Gross domestic product
IPC	International Post Corporation
LPO	Licensed Post Office
Minister	Unless otherwise stated this refers to the Minister for Communications
Momentum case	The "base case" against which reform options are compared. Assumes no reform to the letters business. BCG's momentum case is adjusted based on the underlying market volume decline scenario.
Ordinary	All other letters that are not PreSort or some other form of special service for which a special charge or additional fee is payable
Performance Standards	The *Australian Postal Corporation (Performance Standards) Regulations 1998.* These define the service requirements for Australia Post's reserved letters service
PES	Australia Post's Parcels and Express Services business unit
PBT	Profit before tax
P&L	Profit and loss financial statement
PreSort	Bulk letters that are sorted by the customer prior to Australia Post acceptance and delivered by Australia Post at a discount
Reserved service	Australia Post has a statutory monopoly over services reserved to it by the *Australian Postal Corporation Act 1989*. These include the provision of a letters service in Australia.

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1. Executive summary

Changes in technology and consumer behaviour are driving a sharp decline in demand for letter services within Australia, which is putting pressure on Australia Post's profitability and its ability to deliver on its two policy objectives: providing a universal letter service to all Australians, while providing a commercial return to shareholders. Recognising the need for reform, Australia Post conducted an internal review of its letters business, with a particular focus on the challenges arising from the decline in its letter volumes and possible options for reform.

The Boston Consulting Group (BCG) was engaged by the Commonwealth of Australia (as represented by the Department of Communications and the Department of Finance) to provide an expert assessment of this internal review. This document provides a summary of relevant background material developed by BCG as part of its assessment. It includes an overview of the challenges Australia Post is facing, some examples of how overseas postal operators have responded to similar challenges, and a summary of the reform options available.

Overall, BCG agrees that the strategic assumptions underpinning Australia Post's case for postal reform are valid, and reform to the letters business is urgently needed. The four underlying assumptions that underpin Australia Post's case for reform and BCG's assessment of them are as follows:

- Australia Post expects letter volumes will decline by 11.4% per annum to FY19/20. BCG estimates letter volumes will decline by 8 to 11% per annum to FY19/20. Although Australia Post's forecasts are slightly outside this range, BCG considers them to be reasonable for planning purposes;

- The letters cost base is largely fixed, driven by service requirements described in the Performance Standards. BCG estimates the letters business has ~80% fixed costs. The implication of the high fixed cost base is that there are limited opportunities to achieve further cost savings as volumes decline, without making associated changes to the Performance Standards. These standards are defined in the *Australian Postal Corporation (Performance Standards) Regulations 1998.* Changes to these regulations are required to enable postal reform;

- Without reform, letters losses will soon overwhelm parcel profits. BCG's assessment is that escalating letters losses will quickly overwhelm parcel profits with overall losses for Australia Post as early as FY14/15. By our estimates, this will result in a total cumulative deficit of $12.1 billion for the letters business and $6.6 billion for Australia Post overall over ten years from FY13/14 to FY22/23. From a commercial perspective, BCG does not believe it is either feasible or desirable to rely on the profits from a growing, competitive parcels business to fund the losses of the declining letters monopoly; and

- Service levels under the current model of letter delivery exceed the demands of most customers. BCG's analysis of available survey data supports this view. Surveys suggest only one-third of receivers use their mail directly on the day they receive it, half would accept three day delivery and very few would be willing to pay to maintain five day delivery, with little variation across customer segments.

The challenges Australia Post faces in terms of falling letter volumes are common to postal operators around the world. In many cases, these operators are already years ahead of the experience in Australia and lessons can be learned from their experiences. Responses by international postal operators have drawn on a mix of three types of levers – price, service and operating model – used to differing extents and in different combinations depending on local circumstances.

2. Purpose of this report

The Boston Consulting Group (BCG) was engaged in March 2014 by Australia Post's two shareholder Departments (the Department of Communications and the Department of Finance) to undertake an expert assessment (the Assessment) of an internal review of the letters business conducted by Australia Post.

This document provides a summary of relevant background material prepared by BCG as part of its assessment. It provides an overview of the challenges Australia Post is facing, some examples of how overseas postal operators have responded to similar challenges, and a summary of the options available.

3. Context

Changes in technology and consumer behaviour are driving a sharp decline in demand for letter services within Australia, which is putting pressure on Australia Post's profitability and its ability to deliver on its two policy objectives: providing a universal letter service to all Australians, while providing a commercial return to shareholders.

Australia Post operates under the *Australian Postal Corporation Act 1989* (the Act) with dual policy objectives: to provide a universal letter service that is reasonably accessible by all Australians; while operating in a manner consistent with sound commercial practice to provide a financial return to its shareholders.

The organisation employs over 32,000 people and provides employment for some 10,000 licensees, franchisees and contractors.[1] Australia Post has paid a dividend to the Government every year since corporatisation in 1989.

At the time of BCG's analysis, Australia Post was organised into three Strategic Business Units:

- Communication Management Services (CMS), including a letters business with both reserved[2] and commercial services and a digital business including the MyPost Digital Mailbox;
- Parcels and Express Services (PES)[3], including international letters as well as parcels and express products; and
- Retail Services, operating 4,429 retail outlets across Australia (with 2,561 in regional and remote areas), including 761 corporate post offices, 2,895 Licensed Post Offices (LPOs)[4], 29 franchised outlets and 744 community postal agencies (CPAs)[5].

BCG's Assessment focused on the letters business, contained within the CMS unit. The parcels and retail businesses were out of scope for this work.

The CMS unit employs approximately 21,000 FTEs. More than half (55%) are involved in delivery activities; a further 33% are involved in letter acceptance, processing and transport, with the remaining 12% involved in other activities, including corporate support services.[6] The CMS unit has costs of around $2,360 million (2012/13), of which $235 million are payments made to the Retail Services unit for services conducted by retail outlets.[7]

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[1] *Australia Post Annual Report 2013.*

[2] 'Reserved' services are those which Australia Post has exclusive rights over via the *Act*, and include the domestic carriage of letters weighing less than 250 grams.

[3] Australia Post's letter and parcel delivery networks operate separately: metro delivery is typically via motorcycle for letters, and van for parcels.

[4] Of the 66% of Australia Post retail outlets that are LPOs, the majority are in rural and remote areas and are run in conjunction with another business such as a newsagent or general store.

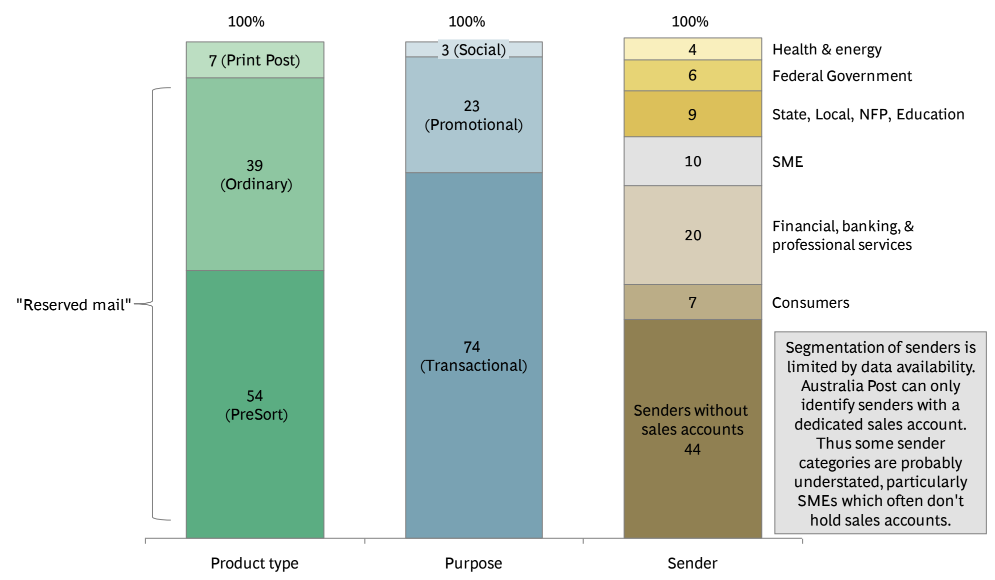
[5] *Australia Post Annual Report 2013.*

[6] Data supplied by Australia Post.

[7] Data supplied by Australia Post.

The addressed domestic letters business within CMS can be split into PreSort (that is, bulk letter mailings), Ordinary (other letters), and Print Post (newspapers, catalogues, and magazines). Exhibit 1 describes the relative size of these products, as well as the split by purpose (i.e. transactional, promotional or social) and sender type.

Exhibit 1: Australia Post's addressed letter 'mailbag' is predominantly business or government transactional mail



Note: Data refers to 2012/13.
Source: All data sourced from Australia Post, with the exception of the share of mail sent by consumers, which is a BCG estimate.

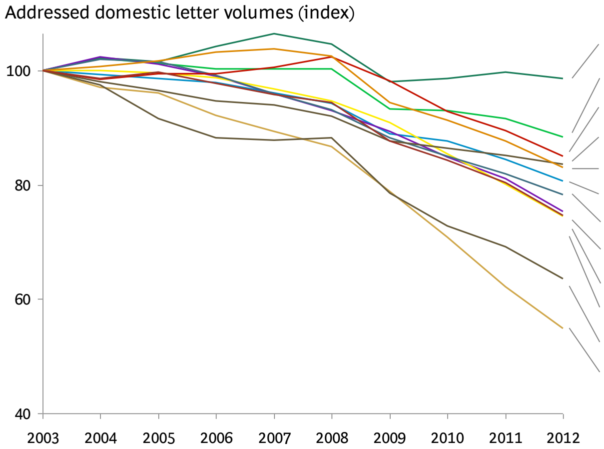
Over 90% of letter volumes are sent by businesses or government. In 2009/10 (the most recent year in which data was available for household expenditure) a typical household spent around $8 to $19 per year on sending letters, substantially less than they spent on phones ($1,750), TVs ($670), computers ($384) or the internet ($404). [8]

Between 2008 and 2012, Australian addressed letter volumes declined at an average rate of 4.7% per annum, with even faster rates of decline in 2013[9]. This is consistent with what BCG has observed in overseas markets, although the Australian peak in addressed letter volumes occurred later than in many European countries (see Exhibit 2).

[8] *ABS Household Expenditure Survey 2009-10*. Television expenditure includes both physical equipment and Pay TV subscriptions. Internet charges include online downloads. Annual spending on letters was estimated at 3-7% of Ordinary and PreSort letters, assuming these were all posted at that year's basic postage rate of $0.55 and divided across the approximate 8 million households in Australia. The Household Expenditure Survey suggests that a higher value of around $68 is spent annually on "postal charges", which would include purchases beyond addressed letters such as parcels.

[9] The annual rate of decline was 6.3% in 2012-2013.

Exhibit 2: Decline rates among international peers are accelerating



	CAGR (%)		
	2003–06	2006–09	2009–12
Germany	+1.4	-2.1	+0.2
Finland	+0.1	-2.4	-1.8
Australia	**-0.2**	**-0.4**	**-4.7**
Switzerland	-1.8	-2.6	-1.6
Canada	+1.0	-2.9	-4.2
Sweden	-0.7	-3.2	-3.2
France	-0.3	-3.8	-3.9
UK	-0.3	-3.4	-5.5
New Zealand	-0.7	-3.6	-5.2
Netherlands	-0.4	-2.7	-6.4
Norway	-4.1	-3.8	-6.8
Denmark	-2.7	-5.1	-11.4

= Decline from low to high

Source: National mail companies annual and quarterly reports; International Post Corporation (IPC).

Overseas, declining volumes have been hastened by consumers embracing digital communications technology. Since the global financial crisis in 2008, volume declines have continued to accelerate, with no sign of stabilising, due to:[10]

- Increased internet usage and adaptation to online platforms, and the rise of smart phones and tablet computers;
- Softer economic growth as a result of the crisis; and
- Cost-cutting measures among major senders, accelerated by the crisis, including increased emphasis on digital substitution (switching to digital channels such as email), rationalisation (for instance, sending account statements at quarterly or half-yearly intervals rather than monthly) and consolidation (sending multiple documents in one envelope).

Most of the decline rates we observe across different countries can be explained by a combination of GDP growth and levels of digital adoption. However, some divergence is still apparent. For example, the rapid decline in Denmark has been encouraged by the successful introduction of "e-Boks" (a secure digital mailbox service), and efforts to promote e-government. In contrast, Germany has maintained relatively strong letter volumes partly due to a high share of low-cost promotional letters, which have not declined as quickly. See section 5 for a discussion of the experiences in other countries.

[10] Interview with Diversified Specifics.

4. Why reform? The case for postal services reform in Australia

The sharp decline in demand for letter services is putting pressure on Australia Post's ability to meet its dual policy objectives. Recognising the need for reform, Australia Post conducted an internal review of its letters business, particularly examining the challenges arising from declining letter volumes.

In its review, Australia Post has argued that there is an urgent need for reform of the letters business. In its assessment of that review, BCG identified four underlying strategic assumptions. The four assumptions, and BCG's assessment of them, are summarised in Exhibit 3.

Overall, BCG's assessment is that Australia Posts' strategic assumptions are valid and reform of the letters business is urgently needed.

Exhibit 3: BCG's assessment is that the underlying strategic assumptions are valid

Strategic assumptions	BCG assessment
1 Letter volumes will decline by 11.4% per annum to FY19/20	**BCG expects letter volumes to decline by 8 to 11% per annum to FY19/20.** Although the Australia Post forecasts as used in planning are slightly outside this range (11.4%), BCG believes it is reasonable for business planning to be based on this slightly larger decline
2 Cost base is fixed, driven by service obligations	**The letters business has ~80% fixed costs, predominantly driven by service requirements.** Opportunities for cost savings as volumes decline are limited without changes to Performance Standards. Our understanding is that normal efficiency savings are mostly depleted. Although further centralisation and automation will provide savings, this requires significant labour transformation.
3 Letters losses will soon overwhelm parcel profits	**In a momentum case, escalating Letters business losses will quickly overwhelm parcel profits.** This will result in overall losses as early FY14/15, and total cumulative losses through to FY22/23 of $12.1 billion for the letters business and $6.6 billion for Australia Post overall. Even if possible, BCG would question the merit of relying on a fast growing, fully competitive parcels business or the profits of other businesses to fund a declining letters monopoly
4 Service levels exceed demands of most customers	**Current service standards for letter delivery exceed the needs of most customers.** Only one third of receivers use their mail directly on the day they receive it, half would accept three day delivery and very few would be willing to pay to maintain five day delivery, with little variation across segments

4.1. BCG expects letter volumes to decline by 8 to 11% per annum to FY19/20

BCG expects domestic addressed letter volumes[11] will decline by 8 to 11% per annum to FY19/20. Although the Australia Post forecasts used in planning are slightly outside this range (11.4%), BCG believes it is prudent for business planning to be based on larger declines given the inherent uncertainty in digital adoption across the economy.

[11] For consistency with Australia Post forecasts, BCG has excluded unaddressed and international letters from its analysis as these make a relatively small contribution to total revenue.

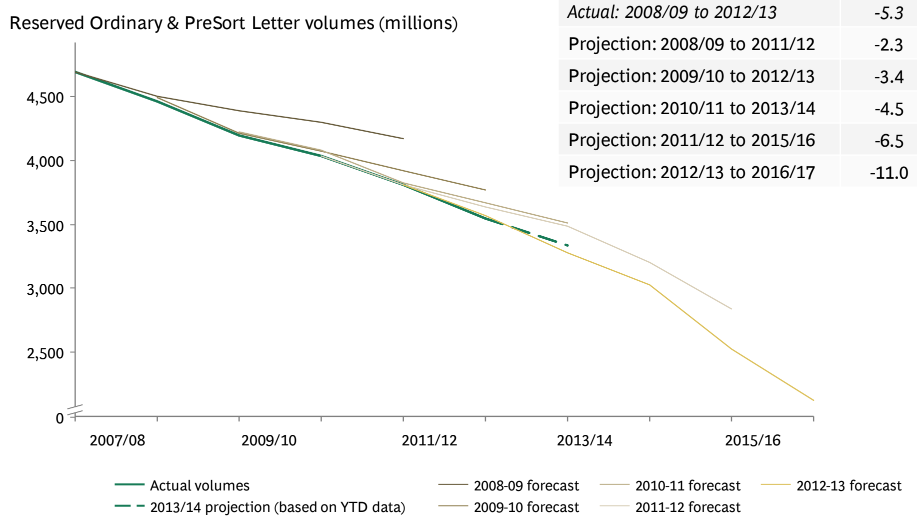
The remainder of this section describes BCG's understanding of the Australia Post letter volume forecasts, and describes the outcomes of BCG's analysis.

4.1.1. BCG's understanding of Australia Post's forecasts

Australia Post has forecast significant declines in letter volumes in the last five successive Corporate Plans. Although these forecasts have typically been quite accurate in the first year, they have consistently underestimated the speed of decline in later years; even as they have become increasingly pessimistic (see Exhibit 4). The discrepancies highlight the inherent uncertainty in predicting rates of digital adoption and its impacts in the medium term.

Exhibit 4: Changes in letter volumes are difficult to forecast; Australia Post has consistently under-estimated letter volume declines in the medium term

Time period	CAGR
Actual: 2008/09 to 2012/13	*-5.3*
Projection: 2008/09 to 2011/12	-2.3
Projection: 2009/10 to 2012/13	-3.4
Projection: 2010/11 to 2013/14	-4.5
Projection: 2011/12 to 2015/16	-6.5
Projection: 2012/13 to 2016/17	-11.0



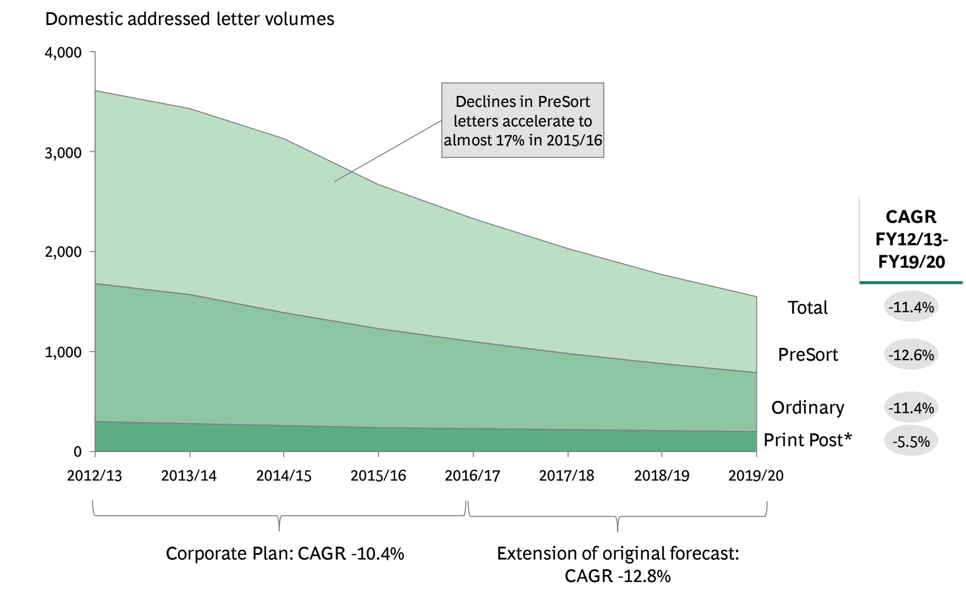
Note: Higher decline rates due to the exclusion of Print Post in corporate plan forecasts. Actual volumes are trading-day adjusted. 2013/14 projection assumes non-reserved and reserved rates of decrease are identical.
Source: Australia Post corporate plans.

Outcomes to date in FY13/14 represent a rare exception, in that actual rates of letter volume decline have been lower than forecast. This was even after factoring in softer declines compared to the previous year due to the impact of the Federal election.

Australia Post forecasts an average decline in domestic addressed letters of 11.4% per annum through to FY19/20. This comprises an average decline of 10.4% per annum through to the end of the current Corporate Plan in FY16/17, after which major letter categories are rolled forward at 2016/17 rates resulting in an aggregate decline of 12.8% per annum to 2019/20.

The Australia Post volume forecast to FY19/20 by product line is presented below in Exhibit 5.

Exhibit 5: Australia Post forecasts an 11.4% annual letter volume decline to FY19/20



* Print Post also includes a small proportion of other non-reserved addressed letters.
Source: Australia Post.

This highlights a very large forecast decline in PreSort letter volumes, linked to the expected uptake of the MyPost Digital Mailbox and other similar products. Based on international experience, BCG believes this overstates the likely scale and speed of the impact of digital mailboxes. The experience in Denmark with e-Boks remains an isolated exception that was driven by specific circumstances (in particular very early adoption on a homogenous platform co-owned with the banks before senders developed their own portals) and this is unlikely to be replicable now in Australia.

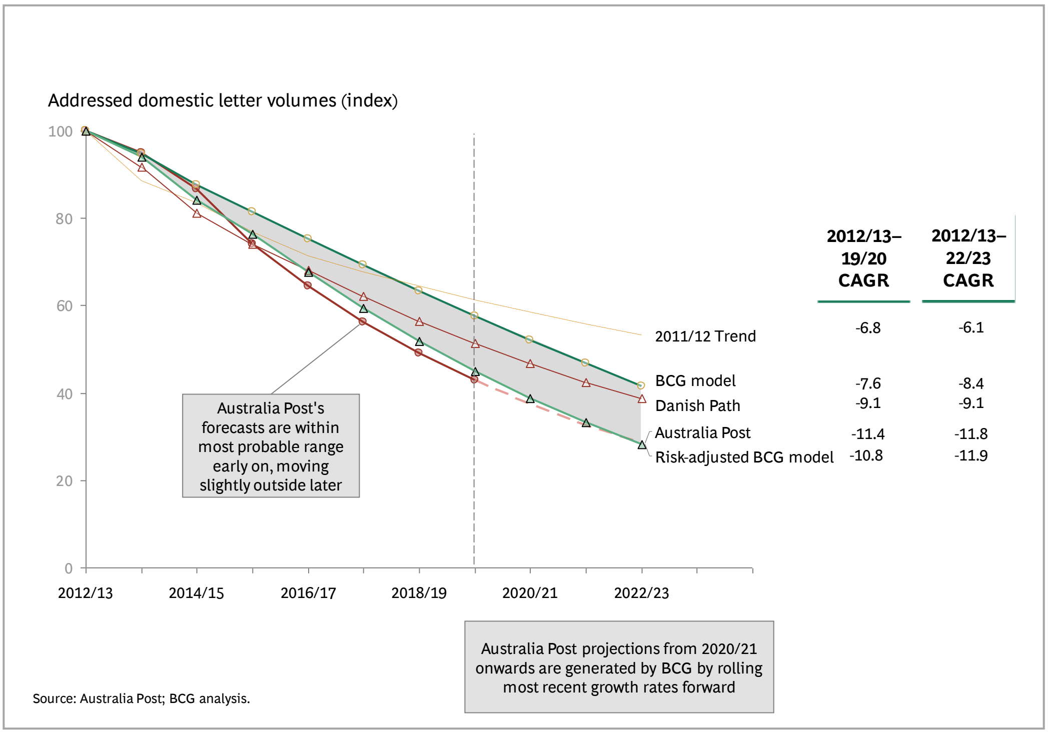
4.1.2. BCG's estimates of Australia's letter volume declines

BCG expects domestic addressed letter volumes to decline by 8 to 11% per annum through to FY19/20, and 8 to 12% by FY22/23. This range is derived by applying variations of BCG's regression-based letter volume model, described in this section. Rates of decline are expected to accelerate: BCG's estimates suggest per annum declines of 7 to 9% to FY16/17, moving to between 9 to 13.5% over FY16/17 to FY22/23.

BCG extended the forecast time horizon to FY22/23 (ten years) to produce longer-term estimates for reform planning and to support the subsequent financial modelling of alternate reform plans. To make the Australia Post forecasts comparable, BCG extended these forecasts out a further three years to FY22/23 using the FY19/20 decline rate, giving an average annual decline of 11.8% through to FY22/23.

Exhibit 6 compares the BCG and Australia Post volume forecasts.

Exhibit 6: BCG expects volume declines to be in the range of 8 to 12% per annum over the next ten years



Source: Australia Post; BCG analysis.

The lower end of the range (8% per annum to FY22/23) is based on applying an existing BCG regression model linking letter volumes to digital adoption that has been tested in other markets. The analysis was conducted in three steps:

- First, historical growth rates in letter market volumes across 13 different countries were adjusted for the portion driven by changes in GDP;
- Second, the adjusted change in letter volumes was regressed against an index of online retail sales and online media spending over 2010 to 2012; and
- Finally, independently-sourced projections of Australian online retail sales, online media spending data and GDP were used to forecast letter volumes.

The upper end of the range (12% per annum to FY22/23) is based on risk adjustments that were applied to the BCG regression model described above, to account for the 'downside' risks that a historical model is unlikely to capture. Three risk factors were included:

- An additional 4% per annum decline in PreSort letters from 2016/17, translating into a 2% decline in the overall mailbag, due to a rapid introduction of Digital Mailboxes by Australia Post and other players with a concerted effort to drive volumes;
- GDP growth being 1% below forecasts[12] from 2014/15 onwards; and
- An additional 1.5% per annum decline from 2013/14 to account for additional uncertainty about technology adoption and to accommodate the impact of new technologies. This was based on observations of typical forecast errors in other markets.

[12] GDP forecasts for Australia were sourced from Euromonitor.

Note also that Australia Post's Corporate Plan forecasts over the past five years have underestimated average letter volume declines by between 0.7 – 2.1% per annum.

BCG's view is that the Australia Post forecast decline of 11.4% per annum through to FY19/20 is at the upper end of the range of probable outcomes. Note that BCG's model did not explicitly account for the impact of price changes; rather, price rises consistent with those that have occurred in other markets are captured implicitly.

BCG also tested a range of other methodologies. Two are included for reference in this report, but the results were not used as the basis for the estimated range:

- Danish Path (9.1% per annum to FY22/23): assumes that Australian letter volumes per $GDP follow the same rate of decline shown by Denmark over the past five years – this approach falls within the forecast range (see section 5.2 for further discussion of the experience in Denmark); and
- 2011/12 Trend (6.1% per annum to FY22/23): based on assuming the growth rates at the level of major mailbag components (PreSort Small and Large, Ordinary Small and Large, Print Post) over FY11/12 to FY12/13 are sustained going forward – this approach cannot capture accelerating declines.

Predicting the future path of letter volumes involves an inevitable degree of uncertainty. BCG believes that the regression-based estimates reflect the probable range of outcomes, and that this range provides sufficient guidance for government decision making.

4.2. The letters business has ~80% fixed costs, predominantly driven by service requirements described in the Performance Standards

BCG estimates the letters business has ~80% fixed costs, factoring in the network economics associated with prescribed Performance Standards. There are limited opportunities to reduce costs within the framework of the current Performance Standards.

BCG believes that normal efficiency savings are likely to be mostly depleted given recent profit improvement efforts. While centralisation and automation would provide additional savings they would also involve significant labour transformation and are best considered as part of reform planning.

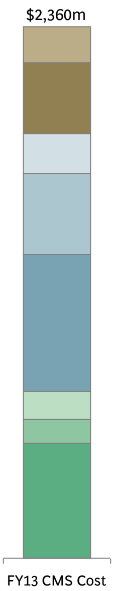
Our estimate of fixed costs in the letters business is based on an outside-in consideration of network economics across each step of the value chain (see Exhibit 7). For each 'cost bucket', BCG assessed the extent to which activity was linked to letters volume versus some other driver (e.g. requirement to visit homes daily). BCG then determined the resulting level of fixed cost for each cost bucket (high is 90% fixed, medium is typically 70% fixed, with processing around 60% fixed, there are no categories with a low fixed cost) based on our experience with other postal operators. The weighted average of this assessment is ~80% fixed costs overall.

The strategic implication of a high fixed cost base in the face of large declines in letter volumes is escalating losses as the basic postage rate can no longer cover the actual cost of processing and delivering letters. Reducing delivery speed and frequency are the key levers to significantly reduce the fixed component of ~60% of costs (that is all cost buckets except indoor delivery, other operating and indirect costs), but such moves are constrained by the prescribed Performance Standards. Moreover, the annual growth in new households is steadily increasing the physical network required to meet Performance Standards, which is driving cost increases, despite declining volumes.

Even with a highly fixed cost base, there may still be opportunities to improve efficiencies, though these appear limited. Given that Australia Post has already undertaken efficiency improvements to offset previous volume declines it is unlikely to achieve savings of more than 5-10%, based on BCG's experience with other operators. This would only offset an additional 1-2 years worth of volume declines.

Further centralisation and automation would deliver additional savings (for example in indoor delivery) without requiring changes to the Performance Standards. However, as these would significantly change the operations of the business, including the labour model, they are beyond the scope of what would ordinarily be considered efficiency savings and are best considered as part of reform planning.

Exhibit 7: There are limited opportunities to reduce costs within current Performance Standards



Cost bucket	Level of fixed cost²	Rationale	Ways to address
Acceptance	Medium	• Driven by number of customers and letters as well as how often collected	• Longer delivery speed to allow less frequent collection
Processing	Medium	• Volumes as well as delivery speed due to need to process overnight • Level of equipment needed	• Reduce delivery speed to remove need for penalties • Improve sorting logic
Transport	Medium	• Need to cover all routes • Reduces with lower volume	• Longer delivery speed for more efficient transport
Indoor Delivery	Medium	• Need to setup frames (required to sort the letters) regardless of volume	• Automation to allow removal of frames
Outdoor Delivery	High	• Still need to visit every household regardless of volume, number of households continues to increase while volume decreases	• Less frequent delivery • Reduce number of delivery points (i.e. through Community mail boxes)
Retail Delivery	High	• Still need to slot letters • LPO costs vary more with volume	• Less frequent delivery
Other Ops¹	High	• Not linked directly to volumes	• N/A
Indirect	High	• Not linked to volumes	• Optimisation activities to bring down indirect costs as other cost buckets fall

1. Includes Cost of Goods Sold (COGs) which is variable 2. High is 90% fixed, Medium is 70% fixed, Processing is 60% fixed; LPO commission for acceptance and processing is variable .
Source: Australia Post: Fixed Cost Reconciliation; BCG analysis.

4.3. In a momentum case, escalating letters losses will soon overwhelm parcel profits

A momentum case is a "base case" against which reform options are compared. It assumes no reform to the letters business.

The letters business has made a trading loss every year since FY08/09. These losses have been in the range of $30-160 million. At an enterprise level the impact of declining letter volumes has, until now, been largely mitigated through business improvement initiatives centred on efficiency as well as growth in profits in parcels and retail, enabling the corporation to continue to return a dividend to Government.

In a momentum case, BCG expects that escalating letters losses will soon overwhelm parcel profits. This will result in losses at an enterprise level as early as FY14/15. Although additional efficiency savings might defer losses for 1-2 years, time is required to implement reforms. Even if reforms commenced now they will take years to yield the full financial benefit. BCG does not believe it is either feasible or desirable to rely on the profits of the growing, competitive parcels business, or the profits of other businesses (e.g. government service delivery through Australia Post's retail outlets), to fund the losses of the declining letters monopoly.

BCG modelled two 'momentum' scenarios to estimate the scale of potential losses for Australia Post if letters reform is not undertaken. Exhibit 8 summarises the outcomes of this modelling.

In the 'conservative' momentum scenario, BCG assumes that letter volumes will decline in line with the Australia Post forecast (11.8% per annum to FY22/23)[13] and assumes the parcels, retail and MyPost Digital Mailbox businesses meet the profit forecasts outlined in the *Corporate Plan 2013/14-2016/17*.[14] In this scenario, BCG expects an overall Profit before tax (PBT) loss for Australia Post as early as FY14/15, delivering a cumulative deficit of $12.1 billion for the letters business and $6.6 billion for Australia Post overall over ten years from FY13/14 to FY22/23. This would deliver a cash flow[15] deficit from FY15/16 with a total cumulative cash flow deficit from FY13/14 to FY22/23 of $4.5 billion. See Table 1 for further details. Failure to implement reform may mean that these impacts are borne by the Australian Government and ultimately Australian taxpayers.

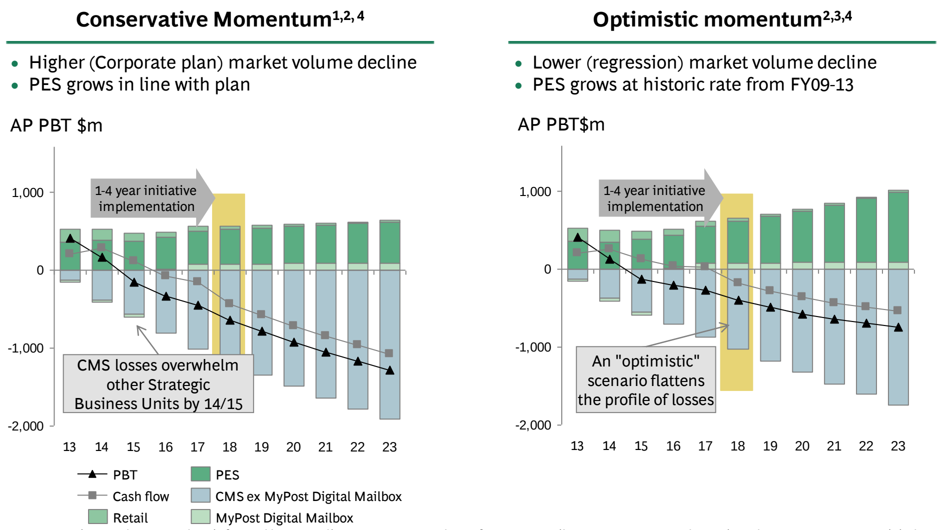
Each year of delay in implementing reforms implies an incremental risk to the Budget bottom line of $100-200 million in that year or around $600 million over the four year forward estimates as the underlying cash flow position declines under a conservative scenario (see Table 1). As described in section 4.2, additional efficiency savings of 5-10% may offset 1-2 years' worth of volume declines and thus delay the first year of deficit by 1-2 years at most. However, even if reforms are commenced now they will take years to yield the full financial benefit.

[13] The 11.8% decline comprises 11.4% average annual decline to FY19/20 and 12.8% annual decline from FY19/20 to FY22/23. Cost savings in the letters business are based on a weighted average fixed cost percentage of 80%, no additional efficiency savings are assumed.

[14] After the end of the plan period in FY17, it is assumed retail costs grow at 3% and margin reduces to 2%; MyPost Digital Mailbox grows at 3% with constant margins; PES grows at FY14-17 trend.

[15] Cash flow is an 'equity free operating cash flow' so assumes debt levels are constant and is before any dividend payments. Adjustments are made to PBT for income tax, non-cash expenses in the P&L, and balance sheet items.

Exhibit 8: In a momentum case, losses in letters will soon overwhelm parcel profits



(1): Assumptions and FY13-17 data informed by Australia Post Corporate Plan. After FY17 retail costs grow at 3% and margin reduces to 2%; MyPost Digital Mailbox also grows at 3% with constant margins. (2): CMS momentum case modelled based on labour cost growth of 3% and a weighted average fixed cost percentage of 80%; Conservative scenario applies Corporate Plan forecast letter declines (-11.8% FY13-23) while Optimistic scenario applies lower declines (-8.4% FY13-23) as per the Regression based volume scenario. (3): In Optimistic scenario, PES revenue and cost modelled from FY14 onwards at historic rate from FY09-13 (4): Cash flow is an equity free operating cash flow so assumes debt levels are constant and is before any dividend payments. Adjustments are made to PBT for income tax, non-cash expenses in the P&L, and balance sheet items

Source: Australia Post P&L statements by Strategic Business Unit; Australia Post 2013/14-2016/17 Corporate Plan; BCG analysis.

Table 1: Australia Post PBT and cash flow under the 'conservative' momentum case

FY	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	21/22	22/23	Σ 10 years
PBT ($m)	160	-150	-330	-450	-640	-790	-920	-1,050	-1,170	-1,280	**-6,620**
Cash flow ($m)	280	110	-80	-160	-430	-580	-710	-840	-960	-1,080	**-4,450**

In contrast, the 'optimistic' momentum scenario assumes that letter volumes decline at the shallower end of BCG's estimated range (8.4% per annum to FY22/23) and that parcels profit grows at faster levels in line with the experience over FY08/09 to FY12/13. In this scenario, BCG also expects an overall PBT loss for Australia Post as early as FY14/15, but expects lower cumulative deficits over ten years from FY13/14 to FY22/23 of $10.9 billion for the letters business and $4.0 billion for Australia Post overall. Similarly, a cash flow deficit is delayed to FY17/18, with a total cumulative cash flow deficit from FY13/14 to FY22/23 of $1.9 billion.

The difference between cumulative losses and the cumulative cash flow deficit of $2.2 billion is in large part driven by an accounting change in relation to Australia Post pension liabilities which has not impacted expected cash contributions to the fund. Although not a focus of the Assessment, BCG notes that with other postal operators, changes in investment markets have had significant impacts on funding needs and future increases in required cash contributions could reduce cash flow and bring it back in line with expected losses.

When considering the 'optimistic' momentum scenario it is worth noting that the parcels and retail businesses are also facing challenges. Although a detailed assessment of parcels and retail is out of scope for this work, BCG understands that both businesses operate in competitive markets and are exposed to volume and margin pressures, so continued growth as shown above is very optimistic.

The retail business is under pressure from declining letter volumes and falling foot traffic due to the introduction of digital alternatives for making payments. BCG has not assessed the retail business as it is out of scope for this work. However our overseas experience suggests that financial contributions from Australia Post's proposals to invest in or extend activities in, for example, government service delivery through Australia Post's retail outlets, are unlikely to fund losses in the letters business.

BCG also advises caution when trying to subsidise letters with profit from the parcels business. In other markets where BCG has observed this practice (e.g., trying to maximise profit in parcels via price increases to offset letters losses) it has typically led to an erosion of competitiveness.

Given lead times with the implementation of interventions, it will likely take years for the full financial impact of any reforms to be felt. Therefore, it is important for Australia Post to plan for the expected financial impact in FY17/18. Depending on continuing profit growth in other business units is risky, and it is prudent for the letters business to prepare for the more conservative market volume scenario. BCG believes the 'conservative' momentum scenario appropriately sets the context for policy decision making.

4.4. Current service standards for letter delivery exceed the demands of most customers

Postal services are mostly sold to business customers. However the service requirements of these customers are determined by the needs of receivers, in terms of how they use, and how much they value, postal services. Understanding the needs of receivers is a good way of determining the extent to which service standards are aligned to customer demand.

BCG believes that service levels under the current model of letter delivery exceed the demands of most customers. This is supported by analysis of both BCG and Australia Post survey data.

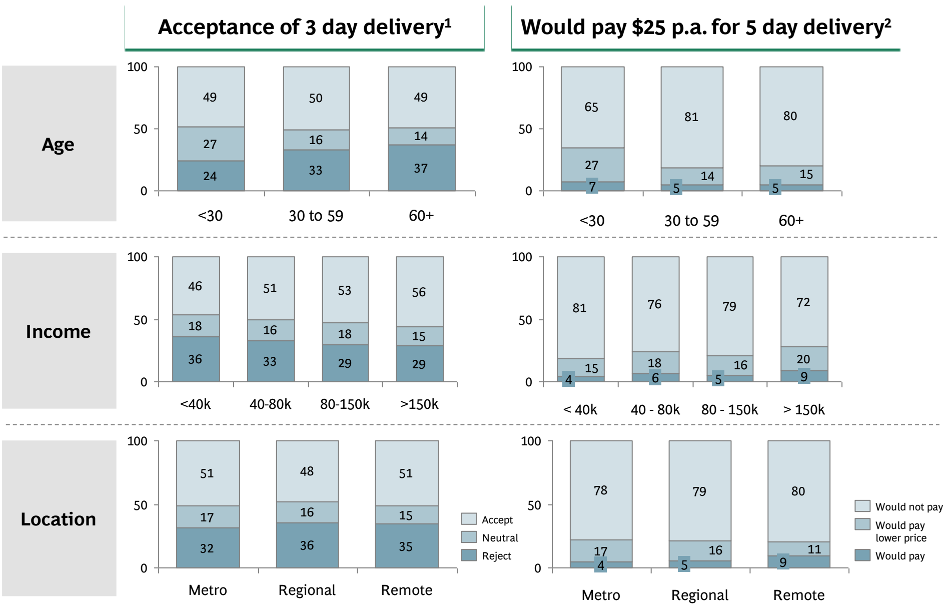
BCG data on mail usage[16] shows only one third of customers use their mail directly on the day they receive it. Approximately two-thirds of customers use their mail a few times a week or less and therefore do not need five day delivery.

[16] "Consumer requirements of mail service levels"; survey of 400 customers in Australia and 400 each in 13 peer countries cited in *The Postman Always Brings Twice: Receiver-driven Transformation of the Mail Business Model*, Bas van Heel, Marco Airoldi, Sjoerd Bos, March 2011.

BCG analysis of the results of a 2014 survey of 8,000 customers, conducted by Australia Post, showed approximately half of survey respondents in all segments were willing to accept a move to three day delivery, with only about a third rejecting this change and the remainder neutral (see Exhibit 9). Further, among those customers who would reject a move to three day delivery, only an average of 5% would be willing to pay $25 per annum to retain current standards. Over three quarters of these customers would not be willing to pay to retain five day delivery, even at a lower price, with little variation across segments. We believe that willingness to pay is a reasonable proxy for the true level of customer need.

There is a greater level of customer sensitivity towards changes to delivery location. On average, only one-quarter of customers in Australia Post's survey would support a move to PO Box rather than home delivery. However, only 6% of Australians would be willing to pay $30 per annum to retain home delivery, again with only slightly higher willingness among high income and remote customers. Around three-quarters of Australians across all segments would not accept paying $30 per annum or a lower amount to retain home delivery.

Exhibit 9: A majority of Australian postal customers appear willing to accept reductions in delivery frequency



1. Survey question: "Please chose your level of acceptance of the following: Letters would be delivered a minimum of 3 times per week"
2. Survey question: "If letters delivery 3 times per week is unacceptable for you would you be willing to be charged $25 p.a. for 5 day delivery?"
Note: Customers relate to both senders and receivers. Respondent categories aggregated for ease of presentation; for instance, strong and moderate levels of acceptance both classified as "accept".
Source: Australia Post "Rural Post Strategy", survey of 8,000 customers, February 2014 .

5. International experiences and responses

The challenges Australia Post faces in terms of falling letter volumes are common to postal operators around the world. In many cases, these operators are already years ahead of the situation in Australia and lessons can be learned from their experiences.

Exhibit 10 provides an overview of five international case studies that illustrate different responses to the challenge of falling letter volumes. The remainder of this section provides further details on each case study.

Exhibit 10: Other postal services have adopted alternative approaches to reforms

	postnl	POST	Royal Mail	CANADA POST / POSTES CANADA	New Zealand Post
Price	• Limited increase due to last mile competition, • Large differential based on service level	• Regular price increases • Large differential based on service level	• Increased pricing freedom, large price increases & differential	• Large increases	• Limited increase due to last mile competition • Large differential based on service level
Service	• 2 speed delivery model • ↓ delivery frequency (3/week) • ↓ post boxes • Cheaper format retail stores	• Multiple speed delivery model • Alternating delivery model (X/Y) for slower speed products	• 2 speed delivery model • 6/week delivery (both speeds)	• Single speed delivery model • 5/week • Transition to full use of Community Mailboxes	• ↓ urban delivery speed (discontinuance of D+1) • Price and 5/week delivery maintained • ↓ Street Post Boxes (planned)
Operating Model	• New technology piloted, first batch purchased • Part time delivery workforce • Gradual centralisation	• Centralisation of processing and plant consolidation • Investment in automation • Shifted more parcels to letter delivery network	• Parcels & mail in single route • Park & loop delivery model • Continuing decentalised processing, some plant consolidation	• Merged letters/ parcels last mile • Continuing decentalised processing, some plant consolidation • Investment in automation • Realigned wages to the market	• Plant consolidation • Increased use of contract labour

Source: PostNL; Post Danmark; Royal Mail; Canada Post; New Zealand Post; Australia Post; WIK-Consult "Review of Postal Operator Efficiency" 2013.

5.1. PostNL – primarily operating model changes

PostNL is fully privatised and has been operating in a liberalised mail market since 2009. It has experienced significant volume decline since 2002, with volumes reduced by 60% over the subsequent ten years. This reflects a decline in both Dutch letter volumes and PostNL's market share.

PostNL reformed its letters operations through a series of efficiency programs, or "Master Plans", beginning in 2001 and revised in 2006, 2008 and 2011.

Price increases implemented by PostNL have been limited due to strong last mile competition in the domestic letters market. However, from 2012, PostNL introduced a non-priority service with a 'D+2' or 'D+3' delivery for bulk letters. The goal of this change was to consolidate delivery on three peak days per week. There is a differential in price between the D+1 and D+2 or D+3 bulk letter services of €0.46 versus €0.42 and €0.39, respectively.[17]

Most of PostNL's reforms focused on operating model levers and involved significant automation. PostNL had installed 286 sequence sorting machines by the end of 2005 and plans to fully integrate letter and flat sorting by 2015. This automation has facilitated significant centralisation; PostNL has significantly reduced its number of delivery offices and pick up points and plans to fully centralise letter processing. PostNL created part time delivery workforce in 2003 and has progressively transitioned to a completely part time delivery workforce since. This was achieved with a few hundred involuntary redundancies through natural attrition, strongly supported internal and external voluntary mobility, and (after 3 years of negotiations) with union support.

5.2. Post Danmark – primarily price and operating model

Post Danmark was partially privatised in 2005 and operates in a fully liberalised domestic mail market. A dramatic decrease in Danish letter volumes over the preceding decade saw a deficit in the Post Danmark letters business for the first time in 2012. Despite annual savings of 3-5% of operating expenses, it is unclear whether Post Danmark's efficiency programs will result in long term positive profitability.

Post Danmark has regularly increased prices; over 2004 to 2013, the inflation adjusted standard domestic letter price rose 67%[18]. 'A' and 'B' service levels are offered; B letters, under a recent legislative amendment, can be delivered up to D+4, while A letters target D+1.[19] A-mail is currently priced at €1.20, with B-mail at €0.87; these prices follow rises of 12.5% and 8.3%, respectively, at the beginning of 2014.[20] Price rises have been facilitated by the departure of Norway Post as the only last mile competitor.

The "X/Y" distribution model and "Small Monday" have resulted in significant savings to Post Danmark. Under the "X/Y" model the service delivers non time sensitive letters every second day while "Small Monday" allows the concentration of deliveries in five days (Tuesday through Saturday) with only priority deliveries on Monday. These reforms are accompanied by daily route optimisation based on letter volumes. In addition, Post Danmark has piloted new vehicles for delivery staff to enable them to take more parcels en route.

Post Danmark is ahead of the curve in automation, and was the first European postal operator to automate sequence sorting, beginning in 1996. It has also automated the sorting of flats and mechanical handling of unaddressed letters. Reinvestment in automation continues. As a result of this automation, Post Danmark has been able to rapidly consolidate letters processing centres,

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[17] Reference is to the cost of small letter mail as detailed in 'Postal Rates as from January 2014', PostNL, for bulk mailings of between 250 to 2,500 items. Exact prices are €0.464 (for D+1), €0.421 (D+2), and €0.397 (D+3).

[18] Letter Prices in Europe, Deutsche Post DHL, March 2014.

[19] 'General terms and conditions for domestic letters applicable from 1 March 2014', Post Danmark, 2014.

[20] 'Post Danmark to push stamp prices up 12.5%', http://postandparcel.info/58239/news/companies/post-danmark-to-push-stamp-prices-up-12-5/.

from eight to three between 2003 and 2010. Post Danmark also more than halved the number of delivery offices between 2000 and 2012.

5.3. Royal Mail – primarily price and operating model

Royal Mail was partially privatised in late 2013, with the UK Government retaining a 30% ownership share and full ownership of the retail network. Although Royal Mail's service monopoly ended in 2006, it did not face significant competition on last mile delivery until the entry of TNT in April 2012. Addressed letter volumes processed by Royal Mail declined at a rate of 7.4% per annum from 2007 to 2012.

The UK has had a two-tier basic letter delivery service in operation since 1968. First-class letters target D+1 delivery, while second class letters target D+2 or D+3. Both services are delivered six days per week. Frequency and speed of delivery standards are set by the UK government regulator; while Royal Mail is obligated to meet these service standards, competitors are not.

Prices of both first- and second-class letters have risen significantly over the last decade, especially following market liberalisation. In 2012, the UK postal regulatory environment was restructured in line with the Hooper report and price controls on first-class letters were removed, though a regulatory cap remains on second-class letters. Following the relaxing of price controls, first-class stamps increased in price from 46p to 60p, and second-class from 36p to 50p; a further small rise occurred in March 2014. Over the past three decades, the pricing premium for first-class letters has varied between around 20% to 40%.

Royal Mail has implemented an active transformation program to manage declining letter volumes. A particular focus has been increased efficiency in delivery systems, with increased use of automation in sequencing and sorting, merger of postal routes and shifts to a park and loop delivery model, but largely maintaining decentralised processing (with some plant consolidation). In March 2014, it announced plans to cut 1,600 jobs, accompanied by 300 hires, from a workforce of around 150,000.

5.4. Canada Post – primarily price and service

Canada Post remains a government-owned enterprise with a monopoly on letters under 500g. Letter volumes in Canada have fallen 20% since their peak in 2007, with Canada Post recording underlying financial losses in recent years.

Canada Post is obligated to target five day per week delivery, and has traditionally outperformed its performance standards: for example, delivering at D+1 rather than D+2 for metro to metro areas. Reducing such over-servicing has been one avenue for reform. In addition, in March 2014, the price of the basic letter service was increased from C$0.63 to C$0.85 for stamps bought in booklets, and to C$1.00 when bought individually. Simultaneously, Canada Post is planning to increase reliance on community mailboxes, in order to significantly phase out door-to-door delivery in a number of urban centres over five years. This is expected to result in the loss of 6,000 to 8,000 jobs (from a workforce of around 70,000), through attrition. Canada Post is also reorganising and rationalising delivery routes over its large territory.

5.5. New Zealand Post – primarily price and service

While the New Zealand Government remains the 100% shareholder in New Zealand Post, the New Zealand postal market has been liberalised since 1998. Although more than 20 postal operators are now registered with the government, and DX Mail competes directly in end-to-end letter delivery, New Zealand Post continues to control the bulk of the national letter market.

Letter volume decline started earlier in New Zealand than Australia, but recent rates of decline have been similar: addressed letter volumes fell at an average rate of -5.8% from 2008 to 2012. Similar to Australia Post, New Zealand Post anticipates strong declines in PreSort letters.

To respond to these challenges, the price of a standard letter rose to 50 cents in 2007, 60 cents in 2010, and 70 cents in 2012, with a further rise to 80 cents planned in July of this year. Although New Zealand Post does need to advise its shareholders of price rises, there is much less regulatory overhead compared to Australia. The threat of competition may have some limiting effect on price rises.

New Zealand Post has historically been obliged to deliver letters six days per week. Following public discussions through 2013, from June 2015 that obligation will drop to a 'minimum' of three days per week. Five days per week deliveries will be maintained for Rural Delivery Points, except for those Rural Delivery Points which had lower frequency as at 30 June 2013.

Since 1988, New Zealand Post has offered a 'FastPost' option, which targets next-day delivery between major metro areas, with a medium envelope priced at double the Standard rate. Until October 2013, Standard mail delivered in the originating metro area was targeted D+1; all Standard mail now targets D+3.[21] With reduced pressure on processing times, New Zealand Post has also been rationalising and centralising its processing facilities.

[21] Changes to 'across town' delivery target for standard post, http://www.nzpost.co.nz/about-us/media-centre/media-release/changes-to-across-town-delivery-target-for-standard-post.

6. Options for addressing the challenge

Responses by international postal operators have drawn on a mix of three types of levers – used to differing extents and in different combinations depending on the circumstances:

- Price, including the price differential between products;
- Service, including speed, frequency and delivery location; and
- Operating model, including processing model, acceptance model, labour model and indirect costs. [22]

The full set of levers across each of these categories is laid out in Exhibit 11.

Exhibit 11: Potential levers for postal reform

Categories	Levers
Price	Price level for basic service
	Difference in price between service levels (e.g. Speed 1 and Speed 2 services)
Service	Delivery speed· including for alternative speeds services
	Link between letters delivery (especially for fast speed) and Parcels delivery
	Delivery frequency for slower speed service
	Role of retail in letter acceptance and delivery
	Delivery points (urban)
	Delivery points (rural)
Operating model	Processing model - Centralisation
	Processing model - Automation
	Mode of delivery (e.g. vans vs motorbikes)
	Labour – compensation and overtime
	Labour model (mix of full-time, part-time and outsourced)
	Indirect cost

Price levers can be used to align product revenue with the cost of service, and provide incentives for customers to shift to products that are lower cost to deliver. Pricing levers include:

- The price of a basic stamp; and
- The price difference between premium products and the base stamp price, for example percentage price premium paid for faster delivery.

Service levers aim to reduce costs through changes to the model of service provided to customers and closer alignment between product price and cost. Service levers include:

[22] BCG also considered three other levers, but discounted these based on size or feasibility: delivery pricing (impractical outside of parcel network); combining last-mile job with other tasks (low value and incompatible with current last-mile job); and Street Posting Box reduction (low value and independent of other lever options).

- Delivery speed, which is the time between posting a letter and its delivery to a letterbox or other delivery point. Delivery speeds for ordinary letters are defined in the *Australian Postal Corporation (Performance Standards) Regulations 1998* and vary according to location (e.g. metropolitan or regional and within or between states). Changes to the delivery speed could include offering multiple delivery speeds at different price points as is the case in the Netherlands, Denmark and the UK;
- Link between letters and parcels delivery, including whether they are delivered through the same or different delivery networks;
- Delivery frequency, which is the number of days per week letters are delivered to delivery points (including letterboxes and post boxes). Daily delivery (5 days per week in Australia) is required for the delivery of faster speed services, however slower speed letters may only need to be delivered on some days. This is the case in Denmark with its "X/Y" model and "Small Monday";
- Role of retail in the letter business, including the role of retail in accepting letters, providing sorting services and managing some delivery services such as delivery to post office boxes or local delivery routes; and
- Delivery points including the mix of street letterboxes, community mailboxes (grouped mailboxes for whole streets or developments, common in Canada), road mail boxes and post office boxes.

Operating model levers aim to reduce costs through changes to the back-end operating model. In some cases, there are links between service levers and operating levers – for example some changes to delivery speed and frequency may be linked to changes in the processing model and the labour model. However, in many cases, operating model changes do not impact service levels seen by customers, but do require changes for the postal workforce. Operating model levers include:

- Centralisation of operations across fewer processing sites and delivery centres;
- Increased automation of letter processing through the investment in a greater number of and/or more sophisticated (for example able to automatically sequence a greater mix of different sizes and types of letters) automated sequencing machines;
- Changes to the model of delivery, such as the mix of motorbikes, vans or alternative vehicles, or innovations in the delivery approach such as the park and loop delivery model used in the UK;
- Labour compensation and labour model including compensation rates, level of overtime and mix of full-time, part-time and outsourced labour; and
- Indirect cost, including the proportion of costs spent on corporate support services such as finance, IT and human resources.

Postal operators embarking on reform have typically used a combination of different levers, with the specific mix of levers employed depending on local circumstances.

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