



Australian Government

**Competitive Neutrality
Complaints Office**

EDI Post

AGCNCO
Investigation
No. 12

May 2005

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ISBN 1 74037 174 7

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An appropriate citation for this report is:

Australian Government Competitive Neutrality Complaints Office 2005, *EDI Post*, Investigation No. 12, Canberra, May.

The Australian Government Competitive Neutrality Complaints Office

The Australian Government Competitive Neutrality Complaints Office is an autonomous unit within the Productivity Commission. It was established under the *Productivity Commission Act 1998* to receive complaints, undertake complaint investigations and advise the Treasurer on the application of competitive neutrality to Australian Government business activities.

Information on the Office and its publications can be found at www.pc.gov.au or by contacting Media and Publications on (03) 9653 2244.



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24 May 2005

The Hon. Chris Pearce MP
Parliamentary Secretary to the Treasurer
Parliament House
Canberra ACT 2600

Dear Parliamentary Secretary

In accordance with section 21 of the *Productivity Commission Act 1998* and the Commonwealth Competitive Neutrality Policy Statement, I have pleasure in submitting the results of the Australian Government Competitive Neutrality Complaints Office's investigation of EDI Post (a business unit of Australia Post).

Yours sincerely

A handwritten signature in cursive script that reads "Mike Woods".

Mike Woods
Commissioner

Competitive neutrality policy

Competitive neutrality is a policy which aims to promote efficient competition between public and private businesses. It seeks to ensure that significant government businesses do not have net competitive advantages over their competitors simply by virtue of their government ownership. The Australian, State and Territory Governments have implemented this policy as part of their commitment to the National Competition Policy Reform Package.

The Australian Government's approach is outlined in its 1996 *Competitive Neutrality Policy Statement*. The publication, *Australian Government Competitive Neutrality - Guidelines for Managers* (available from the Department of Finance and Administration) provides further implementation details.

Competitive neutrality requirements automatically apply to Australian Government Business Enterprises, designated business units of budget sector agencies and all in-house units that tender for competitive contracts. It may apply to other businesses if the benefits outweigh the costs.

The Australian Government's competitive neutrality arrangements require that its designated government business activities:

- charge prices that fully reflect costs;
- pay, or include an allowance for, government taxes and charges such as payroll tax, the goods and services tax and local government rates;
- pay commercial rates of interest on borrowings (or include an allowance equal to the benefit of any government guarantee);
- generate commercially acceptable profits; and
- comply with the same regulations that apply to private businesses (such as the Trade Practices Act and planning and environmental laws).

The Australian Government Competitive Neutrality Complaints Office is located within the Productivity Commission and is responsible for administering the Australian Government's competitive neutrality complaint mechanism. The Office can receive complaints from individuals, private businesses and other interested parties that:

- an exposed government business is not applying competitive neutrality requirements;
- those arrangements are ineffective in removing competitive advantages arising from government ownership; or
- a particular government activity which has not been exposed to competitive neutrality should be.

Contents

Competitive neutrality policy	IV
1 The complaint	1
1.1 Nature of the complaint	1
1.2 Competitive neutrality status of Australia Post	2
2 Assessment of issues	3
2.1 Mailhouse pricing	3
2.2 Access to information	6
2.3 Findings	7

1 The complaint

1.1 Nature of the complaint

EDI Post (EDI) was created as a division within Australia Post in 1991. EDI specialises in the electronic acceptance, preparation and printing of invoices, statements, accounts, cheques and direct mail from high-volume business mailers. It has three main areas of activity:

- transactional mail, covering traditional mailhouse activities — undertaking all the activities associated with high-volume bulk mailouts by businesses;
- Post eLetter — the transmission of large-quantity letter lodgements from the customer's computer to Post for printing, barcoding, sorting, enveloping and posting; and
- promotional mail — a digital colour-printing service introduced in 2002-03 that provides personalised stamps and a range of personalised, full-colour direct mail.

Particularly in the transactional mail component of its business, EDI competes with a range of private mailhouses. Overall, EDI has a market share of around 3-5 per cent of the mailhouse market.

Chandler Enterprises is a private Melbourne-based company which provides a range of database management, printing and mailhouse services. On 27 April 2004, Chandler lodged a competitive neutrality complaint against Australia Post with the Australian Government Competitive Neutrality Complaints Office (AGCNCO). Chandler alleged that the pricing of Australia Post's transactional mail services, provided through EDI, does not comply with competitive neutrality principles. It also alleged that EDI derives an advantage over its competitors through access to information about competitors' clients.

In deciding to investigate this complaint, the AGCNCO is satisfied that the complaint falls within the purview of the Australian Government's competitive neutrality complaints process (see below) and is neither trivial nor vexatious.

1.2 Competitive neutrality status of Australia Post

As a Government Business Enterprise, Australia Post has been subject to competitive neutrality since the implementation of the policy in 1996. This complaint, therefore, concerns whether those requirements have been applied effectively, not whether they should be applied.

2 Assessment of issues

Chandler has alleged that, contrary to competitive neutrality principles, mailhouse services undertaken by EDI:

- are priced below commercial rates; and
- derive an advantage in the market through access to details about the mail volumes of competitors' clients.

2.1 Mailhouse pricing

Competitive neutrality complaints are often prompted by a specific pricing or tendering decision by a government-owned business. It is often argued that a government business cannot set such prices and be operating commercially.

However, all businesses, both public and private, tend to vary individual prices to suit market conditions. The key issue for compliance with competitive neutrality is whether the prices set by a government business, for all its products, generate sufficient revenue to cover all relevant costs and yield (over a reasonable period of time) a commercially acceptable level of profits. Indeed, as set out in the Competition Principles Agreement, 'cost reflective pricing' is one of the requirements of competitive neutrality. Mailhouse services are the major product line within EDI and the AGCNCO has assessed the performance of EDI as a business unit, rather than just the performance of the mailhouse services.

In cases where a government business is a demonstrably separate entity, it is not usually necessary to examine internal costing or pricing policies to determine whether it is complying with competitive neutrality. Such an assessment can generally be based on its aggregate financial performance; such as the rate of return earned on its assets (including any adjustments for taxation exemptions, debt guarantees etc).

However, EDI is not a stand-alone government business. It operates within Australia Post, alongside its regulated letter services and other competitive businesses. EDI relies on centrally provided personnel, IT and other corporate services. For such a business, the level of indirect costs and overheads allocated to it can have a pervasive impact on its profitability. In these circumstances, to ensure

that the unit is not being cross-subsidised, a competitive neutrality assessment needs to examine both the reported level of profits generated, and the construction of the cost base.

Thus, in addition to information about revenue, costs and the assets of EDI, the AGCNCO sought details from Australia Post on:

- how prices are set; and
- the proportion of EDI's costs which are direct costs and those which are indirect and common costs (such as overheads).

Australia Post provided information on EDI's financial performance and a template of its costing model on a commercial-in-confidence basis.

Cost allocation method

Australia Post advised that it employs a traditional 'full absorption costing' approach throughout its operations. This means that all products and services — including those involving EDI — share in the overheads of the enterprise. Discrete profit/cost centres exist in the general ledger allowing Australia Post to identify revenue, expenses and capital for each business unit (and for major products within each unit). Centrally provided services such as IT, property and the shared services division are charged out on the basis of each activity's proportion of use, consumption and/or occupancy.

Australia Post provided a sample of its pricing model which is completed for each tender. The costing schedule contains inputs for unallocated costs and overheads. Of EDI's total costs, around 30 per cent are overheads and indirect costs.

The AGCNCO considers that the cost allocation approach adopted by Australia Post results in a sufficient level of common and indirect costs being allocated to EDI. Indeed, as discussed below, it results in a higher proportion of overheads being allocated to EDI than necessary to satisfy the requirements of competitive neutrality.

Financial performance

Under the cost allocation method employed by Australia Post, over the past five years EDI has either broken even or made a slight loss. Over the past two years EDI has broken even, and Australia Post projects it to be more profitable over coming years.

Over an appropriate time-frame a commercial level of profit is required for a government business to comply with competitive neutrality.

However, EDI's business is not capital intensive and the book value of its assets is modest. The AGCNCO estimates that a revenue increase of around 3.0 per cent would 'on paper' be required to generate a commercial margin on the costs attributed to EDI by Australia Post.

More fundamentally, EDI's measured profitability depends significantly on how its cost base is established. For any large business a significant proportion of overheads are not directly attributable to any product line. Most businesses — Australia Post included — tend to allocate these costs according to various measures of the unit's relative size within the total business. This approach provides a useful rule of thumb for assessing the unit's performance, and imposes a discipline on unit managers. If each unit generates revenue to cover its costs as calculated in this way, the business as a whole will be profitable.

For the purpose of competitive neutrality, however, it is necessary to identify the minimum level of revenue that is consistent with the continued commercial supply of the service. This involves identifying the amount by which the business unit increases the total costs of the company, often termed its incremental costs.¹ If a business unit earns revenue in excess of its incremental costs it will be 'paying its own way' and contributing towards joint costs and the profitability of the company. Conversely, if in these circumstances the business unit were to cease operation, overall the company would be worse off. These issues are discussed in detail in CCNCO 1998 (available on the website).

In response to information requested by the AGCNCO, Australia Post advised that around 90 per cent of allocated and indirect costs attributed to EDI would remain, even if it were to cease operation. This means that the incremental overheads are only some 10 per cent of the level attributed under the full absorption approach. Thus, the level of costs attributed to EDI exceeds that necessary for the purposes of competitive neutrality.

Recasting EDI's financial statement on an incremental basis indicates that EDI is generating revenue which covers:

- the Unit's direct costs;

¹ A similar concept is the unit's avoidable cost — the amount the company would save if the unit ceased production. In the accounting literature this method is also often termed a 'contributions approach'.

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- Australia Post's overheads which can be causally attributed to EDI (the amount by which it increases the total Australia Post overheads); and
 - a contribution to common overheads (which cannot be causally allocated to any particular function), and ultimately profits.

Although EDI is falling short of Australia Post's desired level of profitability, its revenue is sufficient to make a contribution to common overhead costs. Therefore, the AGCNCO concludes that the EDI's revenue exceeds the minimum necessary for competitive neutrality.

2.2 Access to information

Mailhouses use Australia Post's network to distribute material on behalf of their clients. Chandler alleges that EDI has used knowledge of bulk mail volumes lodged with Australia Post to cherry pick its larger and more profitable clients.

In response to this claim, Australia Post stated that, at present, it did not collect the information that would allow it to know the origin of an individual company's volumes put through a mailhouse. It said that any knowledge of such volumes is either an estimate, or is obtained through its relationship with the specific company. Australia Post stated:

EDI's knowledge of the volumes generated by individual customers (which may include volumes lodged via a particular mailhouse) is either obtained through its relationship with the specific company or estimated through publicly available information (e.g. analysis of publications such as AC Nielsen's "Who's Mailing What" which identify direct mail campaigns by customer).

This said, Post believes it is very important for the future growth of the Letters business to be able to provide as much detail to the industry on mailing trends, including trends by market segments. In that context, Post is currently working with the Major Mail Users Association (MMUA) to agree a future system of capturing individual customer/company information when mail is lodged by a mailhouse. (email 24 December 2004)

Since the original complaint, Chandler has not made further representations to the AGCNCO about alleged cherry picking. While Chandler's claims are difficult to test, the AGCNCO has found no evidence that EDI has derived a competitive advantage by gaining access to information on bulk mail volumes of mailhouse clients.

2.3 Findings

The AGCNCO finds that:

- Australia Post's business unit, EDI Post, is setting prices that are in accordance with competitive neutrality principles; and
- there is no evidence that EDI Post has obtained information, from other areas of Australia Post on the major clients of competing mailhouses, which could provide it with a competitive advantage.

Consequently, the AGCNCO finds that no further action is required in relation to this complaint.