Annex A(4)

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~~CONFIDENTIAL~~

MEMO

From	Postmaster General	*To*	Secretary for Financial Services and the Treasury
Ref.	(1) in ADF/ROR/PART IV	*(Attn:*	Mr. Edmond Chu)
Tel. No.	2921 2450	*Your ref.*	TsyB I 00/665-3/1/0(C)
Fax. No.		*dated*	*Fax. No.*
Date	20 December 2011	*Total Pages*	5

Review of Target Rates of Return
For Trading Funds

Thank you for your memo on the captioned and please find our comments in the following paragraphs.

2. We have no objection in principle to the consultant's recommendation on continuing the existing methodology of determining the target rate of return for the competitive services of POTF. However, we are of the view that the target rate of return concept should not be applicable to our Universal Services Obligation (USO).

3. Given our obligation to provide universal postal service to the public at affordable pricing, Hongkong Post (HKP) is unable to levy price increase to cope with the general inflation. In setting prices for USO services, HKP has to take into accounts factors apart from cost recovery, such as general economic conditions, public affordability and public sentiments. By reviewing the postage price in other postal administrations, we note that they have implemented price increases in recent years broadly in line with or exceeding the inflation rates. Details are at Annex A. HKP is the only exception since our principle postage of $1.4 per letter has not been adjusted since 1.4.2002.

4. Concerning the cost aspects, inflexibility in resources management including human resources, procurement of goods and services and choice of business partners have further limited HKP in a great extent its ability to respond to market changes. Facing with the declining traditional mail volume due to weak economic outlook, electronic substitution, consolidation of bills by

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large-volume mailers, shifting of customer demand for products such as digital versions of books and music, other postal administrations, including the Australian Post, Canada Post Group, Royal Mail and the United States Postal Services (USPS) have reacted by carrying out redundancy plans, closing down of mail centres, establishment of more flexible workforces, etc in recent and coming years to reduce staff costs.

5. HKP, being bounded by the Civil Service Regulations and related guidelines, is unable to modify the employment terms and conditions of civil service staff. Meanwhile, the flexibility of employing contract staff is constrained by government's prevailing policy. While we have drawn up some aggressive and cost saving measures (details are to be provided in the Business Plan of 2012-13), the fact that around 70% of our staff are civil servants and staff cost accounts for about 77% of the operating costs of Local Mail, all of the aforesaid restrictions make drastic reduction of staff costs extremely difficult. Besides, terminal dues / imbalance charges and conveyance costs also pose serious threats to the financial viability of HKP. All these three cost elements which account for 85% of HKP's total operating costs, are largely beyond HKP's direct control.

6. Our inability to proceed with fundamental cost structure changes and price revisions makes our USO services similar to the nature of a subsidized service. Imposing a target rate of return to subsidized service may not be realistic and appropriate. A research on the position of other postal administrations reveals that there is no such return requirement for the Royal Mail, Canada Post, USPS and Korea Post.

7. By referencing to the treatments of other postal administrations and considering HKP's unique features as explained in the above paragraphs, we have come to the conclusion that any target rate of return on USO services should be dispensed with as it does not provide any meaningful and reasonable measurement on such services.

8. For the competitive services segment, by applying the latest financial data up to the year 2011, the target rate has been updated as 3.9% (as compared to 5.2% in our last submission). We believe that the refined rate of 3.9% for competitive services will serve as a more reasonable target for our competitive service segment. Detailed calculations are at Annex B. We also consider appropriate that the refined target rate of return proposed by POTF for the

competitive services segment to be made effective from 1.4.2011

9. Grateful for your consideration on the refined approach and the proposed implementation time frame. Should you require further information or calculation schedule, please do not hesitate to contact me.

10. Thank you.

(Stella Au)
for Postmaster General

Annex A

Postal Admin	Postage Price Change (for Domestic Letter)	Average annualized increase	Annualized inflation of the same period
Australia Post (Gov't)	2003 to 2008 Price Freeze, Sep 2008 (from 50c to 55c, 10%), Jun 2010 (from 55c to 60c, 9%)	2.64% (from 2003 to 2010)	2.84% (from 2003 to 2010)
Canada Post Group (Gov't)	Jan 2006 (from 50c to 51c), Jan 2007 (from 51c to 52c), Jan 2009 (from 52c to 54c), Jan 2010 (from 54c to 57c), Jan 2011 (from 57c to 59c) from 2012 to 2014 (+2c per annum)	3.37% (from 2006 to 2011)	1.71% (from 2006 to 2011)
New Zealand Post Group (Gov't)	Year 2007 - Oct 2010: N$0.5 Oct 2010 - Present: N$0.6	3.7% (from 2007 to 2011)	1.3% (from 2007 to 2011)
Royal Mail Holding plc (Gov't)	April 2007: 34p April 2008: 36p +5.9% April 2009: 39p +8.3% April 2010: 41p +5.1% April 2011: 46p +12.2%	6.0% (from 2007 to 2011)	2.0% (from 2007 to 2011)
United States Postal Services (USPS) (Gov't)	May 2007: $0.41 May 2008: $0.42 +2.4% May 2009: $0.44 +4.8% Year 2010: N/A +0.0% April 2011: $0.44 +0.0%	1.4% (from 2007 to 2011)	0.9% (from 2007 to 2011)
Hongkong Post (Trading Fund)	from Apr 2002 to now ($1.4)	0% (from 2002 to 2011)	1.47% (from 2002 to 2011)

Annex B

Target Rate for Competitive Services	**3.9%**
Constituent figures	
Risk Free Rate	2.8%
Asset Beta	0.29
Risk Premium (i) - (ii)	3.9%
(i) Return of Utilities Subindex	6.7%
(ii) Yield of 10-year HK Exchange Fund Notes	2.8%