
Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control

Consultation

CONSULTATION:

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About this document

Access competition is where rival operators collect and sort mail, before handing it over to Royal Mail to complete delivery. We do not directly regulate the access prices charged by Royal Mail but have in place an ex-ante margin squeeze control which is designed to ensure that the difference between Royal Mail's access price and the equivalent retail price is consistent with principles that allow effective competition between Royal Mail and access operators.

On 31 March 2017, we published a consultation document setting out our proposals for changes to our reporting requirements for Royal Mail, including changes to the Universal Service Provider Access condition (USPA), in particular USPA 6, the condition that deals with the margin squeeze test. The proposed changes affect the calculation and reporting of Royal Mail with regards to compliance with the margin squeeze condition.

We have revised our proposals for the margin squeeze condition in the light of the concerns that respondents raised in response to the March 2017 Consultation and other stakeholder comments as well as our own analysis of additional information received.

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1. Executive summary

Background

- 1.1 Access operators collect, sort and transport bulk mail from business customers and then hand it over to Royal Mail for delivery to the final recipient. Access competition continues to be the main form of competition in the letters market in the UK and has brought various benefits for business customers, such as lower prices.
- 1.2 In March 2012, we put in place a Universal Service Provider Access condition (USPA) which requires Royal Mail to grant access to its network at inward mail centres for the provision of retail D+2 and later than D+2 letter and large letter services. We do not directly regulate the access prices, and Royal Mail has the freedom to set its prices in a way that covers the costs of the network. However, we have in place an ex-ante margin squeeze that is designed to ensure that the difference between Royal Mail's access price and the equivalent retail price is consistent with principles that allow effective competition between Royal Mail and access operators.
- 1.3 In March 2017, we published a consultation on regulatory financial reporting for Royal Mail (the March 2017 Consultation)¹ where we set out, among other proposals, changes to USPA 6 which contains the requirements relating to the margin squeeze condition; i.e. that Royal Mail must take all reasonable steps in pricing its products to ensure there will be sufficient upstream revenues to cover relevant upstream² costs of those products. We proposed in the March 2017 Consultation to clarify some of the requirements for reporting to enable us to obtain information that is more relevant in determining Royal Mail's compliance with USPA 6. We also proposed to clarify certain terms and definitions used in USPA 6.
- 1.4 We published a statement in December 2017 relating to regulatory financial reporting for Royal Mail but decided to re-consult on some proposals related to margin squeeze requirements as a result of the stakeholder responses we received in response to the March 2017 Consultation.

Our approach to this consultation

- 1.5 This consultation sets out revised proposals for amendments to USPA 6 in light of responses to the March 2017 Consultation. In this consultation, we consider three main topics:
 - a) Current USPA 6 requirements; and
 - b) Our proposals for amendments to USPA 6.

¹ Review of Regulatory Financial Reporting for Royal Mail Consultation, March 2017: https://www.ofcom.org.uk/data/assets/pdf_file/0038/99785/Consultation-Review-of-Regulatory-Financial-Reporting.pdf

² The upstream parts of the market include collection, initial sortation and transportation activities.

- 1.6 For the avoidance of doubt, certain proposals made in the March 2017 Consultation remain unchanged. Stakeholder responses and our decisions related to these proposals will be included as part of the final statement on amendments to USPA 6, which will be published following responses to this consultation. This consultation deals only with our revised proposals in certain areas following the March 2017 Consultation.

Current requirements

- 1.7 To demonstrate that Royal Mail complies with the margin squeeze control, USPA 6 requires it to submit the following information every quarter:
- a) details of forecast and actual revenues and costs showing how the tests are performed;
 - b) the prices, volumes, length and signing date of each new or materially amended contract; and
 - c) any other information that Ofcom considers necessary to ensure compliance.

Proposed amendments to USPA 6

- 1.8 Having considered the responses to our March 2017 Consultation, we have decided to propose revised changes in the three areas below.
- 1.9 **Costs used in the calculation of relevant upstream costs:** We propose to include an explicit requirement that the calculation of upstream costs for the purposes of USPA 6 must exclude general overheads and include a rate of return.
- 1.10 **Methodology used to calculate relevant upstream costs:** The methodology currently set out in USPA 6 requires the upstream costs of the retail products subject to the USPA 6 control to be calculated by deducting the downstream costs of the equivalent access products from the end to end costs of those retail products (referred to as the 'Indirect Method'). We now propose to allow Royal Mail to use a direct calculation of the upstream costs of those products (referred to as the 'Direct Method'). We believe that the Direct Method is a more practical way of calculating the relevant upstream cost stack for a Royal Mail retail product for the purposes of USPA 6.
- 1.11 **Treatment of surcharges in the margin squeeze condition:** We are proposing that Royal Mail must include surcharges in the calculation of relevant revenues for the purposes of USPA 6.

2. Introduction

- 2.1 Access operators collect, sort and transport bulk mail from business customers and then hand it over to Royal Mail for delivery to the final recipient. Access competition continues to be the main form of competition in the letters market in the UK and has brought various benefits for business customers, including lower prices.
- 2.2 In March 2012, we put in place a Universal Service Provider Access condition (USPA) which requires Royal Mail to grant access to its network at inward mail centres for the provision of retail D+2 and later than D+2 letter and large letter services³⁴. We do not directly regulate the access prices, and Royal Mail has the freedom to set its prices in a way that covers the costs of the network. However, we have in place an ex-ante margin squeeze control (USPA 6)⁵ that is designed to ensure that the difference between Royal Mail's access price and the equivalent retail price is consistent with principles that allow effective competition between Royal Mail and access operators.
- 2.3 We believe that this margin squeeze control has been an effective remedy in protecting access competition. Access mail accounted for 61% of total addressed letters in 2016-17,⁶ up from 44% in 2011-12 when responsibility for postal regulation was transferred from Postcomm to Ofcom.⁷ However, the implementation of access regulation has not been without challenges. The application of the control at the granular level of costs, the changes in Royal Mail's costing system and data preparation timings, and the complexities of the contract negotiating process have highlighted areas in which the condition may be improved to clarify how the margin squeeze control set out in USPA 6 should work.
- 2.4 On 31 March 2017, we published the Review of Regulatory Financial Reporting for Royal Mail Consultation (the March 2017 Consultation)⁸ where we set out our proposals for changes to the Universal Service Provider Accounting Condition (USPAC), the Regulatory Accounting Guidelines (RAG), the Designated Universal Service Provider conditions (DUSP), and the Universal Service Provider Access condition (USPA). This included proposals to change Royal Mail's reporting timeline and clarify some of the requirements for reporting which would have enabled us to obtain information that is more relevant in determining

³ Securing the Universal Postal Service, March 2012, Section 10:

https://www.ofcom.org.uk/_data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf

⁴ Markets for D+2 and later than D+2 services are those where the suppliers of retail services aim to ensure that the mail is delivered in a minimum of two working days after collection.

⁵ https://www.ofcom.org.uk/_data/assets/pdf_file/0022/105259/usp-access-condition.pdf

⁶ Annual Monitoring Update on the Postal Market 2016-17, November 2017, Section 5:

https://www.ofcom.org.uk/_data/assets/pdf_file/0019/108082/postal-annual-monitoring-report-2016-2017.pdf

⁷ Annual Monitoring Update on the Postal Market 2011-12, November 2012, paragraph 5.8:

https://www.ofcom.org.uk/_data/assets/pdf_file/0020/49502/monitoring-update2011-12.pdf

⁸ Review of Regulatory Financial Reporting for Royal Mail Consultation, March 2017:

https://www.ofcom.org.uk/_data/assets/pdf_file/0038/99785/Consultation-Review-of-Regulatory-Financial-Reporting.pdf

Royal Mail's compliance with USPA 6. We also proposed to clarify certain terms and definitions used in USPA 6.

- 2.5 Several stakeholders commented on our proposals in the March 2017 Consultation. In addition, Royal Mail provided additional evidence with regards to the calculation of upstream costs to be used in the USPA 6 margin squeeze calculation⁹. In light of those responses and the additional evidence, we have decided to revise certain of our proposals for changes to USPA 6.
- 2.6 For the avoidance of doubt, certain proposals made in the March 2017 Consultation remain unchanged¹⁰. Stakeholder responses and our decisions related to these proposals will be included as part of the final statement on amendments to USPA 6, which will be published following responses to this consultation. This consultation deals only with our revised proposals in certain areas following the March 2017 Consultation.
- 2.7 The revised condition in Annex 5 includes, where appropriate, changes to the condition which were included in the March 2017 Consultation but on which we are no longer consulting (e.g. on the reasonable expectation).
- 2.8 The remainder of this document sets out:
- a) Current requirements; and
 - b) Our revised proposals based on the March 2017 Consultation.

⁹ In its response to the March 2017 Consultation, Royal Mail explained why there were differences between the Direct and Indirect method.

¹⁰ Note the updated USPA in Annex 5, reflects proposals made in the March 2017 Consultation and this consultation.

3. Current requirements

Introduction

- 3.1 In this section we provide some background information on the purpose of the margin squeeze test, how it is applied and how costs are calculated.

The objectives for USPA 6

- 3.2 USPA 6 is designed to protect competition in the upstream parts of the market, which includes collection, initial sortation and transportation activities. Margin squeeze is a type of exclusionary abuse where a vertically-integrated firm holds a dominant position in one part of the supply chain of a product and uses this position to prevent non-vertically integrated competitors from achieving an economically viable price-cost margin on another part of the supply chain of that product.
- 3.3 USPA 6 covers all Second Class Mailsort and Walksort services (which were access mail services where the items were presented in a pre-sorted form to Royal Mail), and any current, new or successor retail services that were substantially similar services, offered by Royal Mail. Royal Mail has changed its access services since 2012, and USPA 6 currently applies to the successor products of all Second-Class letter and large letter products offered as Business Mail, Advertising Mail, Sustainable Advertising Mail, and Royal Mail 48.
- 3.4 Our main regulatory objective with regards to implementing a margin squeeze test was, and it continues to be, to ensure the difference between the access price and the retail price is kept at a level that allows efficient access competitors to compete effectively.¹¹

The cost standard

- 3.5 Using LRIC for margin squeeze control would provide the correct signals for entry in the market and we would expect Royal Mail to set its prices to maintain a minimum LRIC margin between its access prices and the equivalent retail prices.¹²
- 3.6 However, robust LRIC information is not currently available. Therefore, we use 50% of fully allocated costs (FAC)¹³ as a proxy for LRIC for the purposes of the margin squeeze control.¹⁴

The margin squeeze tests

- 3.7 The margin squeeze control includes two tests. These tests are required to be performed at the start of each financial year and thereafter quarterly. The tests must use forecast

¹¹ Securing the Universal Postal Service, paragraph 2.12.

¹² Securing the Universal Postal Service, Paragraph 10.117

¹³ 'Fully Allocated Cost' is a costing methodology in which all costs (including Overheads) are allocated to the outputs of the business. FAC should be calculated in accordance with Royal Mail's costing manual and the regulatory accounting guidelines.

¹⁴ Securing the Universal Postal Service, paragraph 10.135

revenues and costs because USPA 6 requires that Royal Mail has a reasonable expectation that it passes the tests in that financial year. The two tests are:

- a) **The basket test:** total upstream revenues of all USPA 6 products must be equal to or greater than the total upstream costs of those products. This is used to demonstrate that an efficient competitor would be able to make sufficient margin to compete with Royal Mail in provision of these services; and
- b) **The contract test:** for any new contract which includes products subject to USPA 6, the total relevant upstream revenues of the USPA 6 products in the contract must be equal to or greater than 50% of the total relevant upstream costs of those products. This is used to demonstrate that Royal Mail is not pricing individual contracts at such a low level that it makes a loss, which would be an indication of predatory pricing.

The calculations

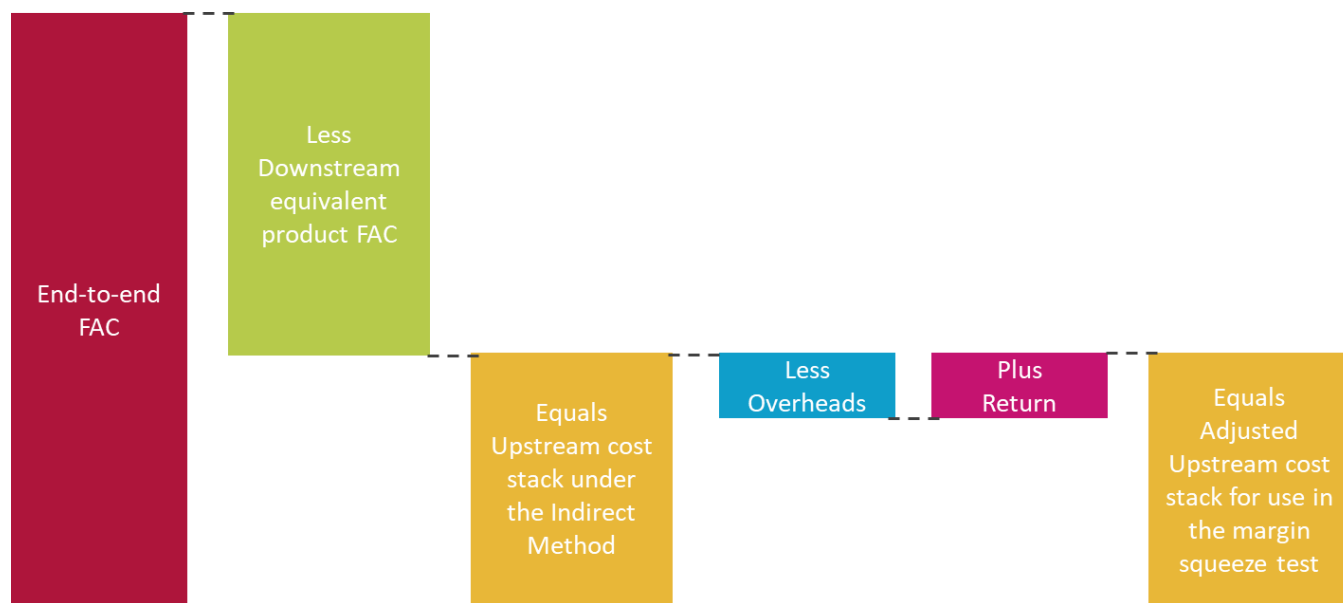
- 3.8 In order to assess compliance with the margin squeeze obligations, Royal Mail is required to calculate the relevant upstream revenues from the products within the scope of USPA 6 as the difference between end-to-end retail revenues and the relevant downstream revenues of the products.¹⁵
- 3.9 The relevant downstream revenues are calculated by assuming the unit downstream revenues for USPA 6 products are equal to the prices of their equivalent access products (as if Royal Mail provided itself with access products as well).
- 3.10 Relevant upstream costs for the tests are calculated as the end-to-end costs of USPA 6 products less the costs of equivalent access products. The cost standard used is based on FAC excluding general overheads but including returns¹⁶. However, In March 2012, we took the pragmatic approach not to require Royal Mail to remove general overheads and include a return from its base FAC data, as the two were expected to be broadly similar in magnitude and therefore making the adjustments would not materially impact the base FAC data used in the test.¹⁷
- 3.11 Figure 1.1 illustrates how the upstream costs are currently calculated. We refer to this method of deriving upstream costs, by deducting downstream costs from total costs, as the indirect method.

¹⁵ See Annex 5, USPA 6.3

¹⁶ FAC for retail and access products should be calculated in accordance with USPA and the regulatory accounting guidelines

¹⁷ Securing the Universal Postal Service, March 2012, Paragraph 10.125

Figure 1.1: Illustrative calculation of upstream costs under the indirect method



- 3.12 To comply with the basket test, the total upstream revenues must be at least equal to the adjusted upstream costs.
- 3.13 To demonstrate that Royal Mail complies with the margin squeeze control, USPA 6 requires it to submit the following information to Ofcom every quarter:
- a) details of forecast and actual revenues and costs showing how the tests are performed;
 - b) the prices, volumes, length and signing date of each new or materially amended contract; and
 - c) any other information that Ofcom considers necessary to ensure compliance.
- 3.14 We outlined our proposals related to margin squeeze in the March 2017 Consultation, but in light of stakeholder responses we are now amending those proposals. Our revised proposals are outlined in the following section.

4. Proposed changes to requirements

Introduction

- 4.1 In this section, we set out our proposed changes to USPA 6, as follows:
- a) **Costs used in the calculation of relevant upstream costs:** We propose to include an explicit requirement that the calculation of upstream costs for the purposes of USPA 6 must exclude general overheads and include a rate of return.
 - b) **Methodology used to calculate relevant upstream costs:** The methodology currently set out in USPA 6 requires the upstream costs of the retail products subject to the USPA 6 control to be calculated by deducting the downstream costs of the equivalent access products from the end to end costs of those retail products (referred to as the 'Indirect Method'). We propose to allow Royal Mail to use a direct calculation of the upstream costs of those products (referred to as the 'Direct Method'). We consider the Direct Method is a more practical way of calculating the relevant upstream cost stack for a Royal Mail retail product for the purposes of USPA 6.
 - c) **Treatment of surcharges in the margin squeeze condition:** We are proposing that Royal Mail must include surcharges in the calculation of relevant revenues for the purposes of USPA 6.

Costs to be reflected in the calculation of upstream costs

Current requirements

- 4.2 As discussed above, the cost standard used to assess relevant upstream costs is based on FAC excluding general overheads but including a return. FAC was used rather than LRIC due to the lack of a robust estimate of LRIC being available (as explained above).
- 4.3 In March 2012, we took the pragmatic approach not to require Royal Mail to remove general overheads and include a return from its base FAC data, as the two were expected to be broadly similar in magnitude and therefore making the adjustments would not materially impact the base FAC data used in the test.¹⁸
- 4.4 We did not propose any changes from the March 2012 approach¹⁹ in the March 2017 Consultation.

¹⁸ Securing the Universal Postal Service, Paragraph 10.92

¹⁹ Prior to 2012 there was no margin squeeze test.

Stakeholder comments

- 4.5 In its response to the March 2017 Consultation, Royal Mail stated that the return for the Reported Business which is measured by Financeability EBIT²⁰ was 4.6% of revenue in 2016-17 (which means the return was 4.9% of total costs), [3<] whereas general overheads, as a percentage of cost base were broadly the same as they were in 2012 [3<]. It therefore proposed that we should make an explicit requirement for an adjustment to exclude general overheads and include a return as defined by the Financeability EBIT.
- 4.6 Royal Mail proposed including a return on sales of 5% (which means 5.26% of costs),²¹ as this represents the bottom end of the 5-10% Financeability EBIT range that we use as our measure of commercial rate of return.²²

Our proposals

- 4.7 Based on additional information regarding overheads and our review of Royal Mail's financial performance²³, returns and overheads are no longer expected to net off in the manner envisaged in 2012. We are therefore proposing to require Royal Mail to make the appropriate adjustment to exclude overheads and include a return from in the margin squeeze calculation in line with the relevant cost standard stated in March 2012.
- 4.8 We would expect this return to be that which an investor would demand to receive from an access operator. We noted in the Review of Regulation of Royal Mail that in an asset light business, investors may use return on sales as a more appropriate measure of the returns they demand.²⁴

Question 1: *Do you agree with our proposals to add in an explicit reference to exclude overheads and include a rate of return in the upstream cost calculation as detailed USPA6?*

Calculation of relevant upstream costs – use of the direct method

Current requirements

- 4.9 As explained in section 2, to calculate the relevant upstream costs in compliance with USPA 6.4²⁵, Royal Mail currently takes the end-to-end unit costs of the products that are subject

²⁰ 'Earnings Before Interest and Tax', namely revenue less all the costs of products and services provided before the deduction of interest and tax including transformation costs with pension costs restated on a cash basis rather than the rate derived in accordance with the accounting standards. The approach to use Financeability EBIT as the main profitability metric was reaffirmed in the Review of Royal Mail Regulation, May 2016 (see paragraphs 3.54 to 3.63)

²¹ In a simple example, if sales = £100, costs = £95 and profit = £5 there would be a 5% margin (profit divided by sales). As a percentage of costs, though, this would be 5.26% (£5 / £95).

²² Royal Mail Response, Paragraphs A.12 to A.13

²³ Financeability EBIT has been closer to 5% than to 10% over the past few financial periods.

²⁴ See Review of Royal Mail Regulation, Annex 6 for further discussion.

²⁵ Consolidated version of USP Access Condition as at February 2014.

https://www.ofcom.org.uk/data/assets/pdf_file/0013/12811/usp_access.pdf.

to the margin squeeze tests and subtracts the unit cost of the equivalent access product²⁶ (the Indirect Method).

- 4.10 Once the relevant upstream unit costs are calculated, they are used to calculate the relevant upstream costs of the whole basket or individual contracts by applying the volumes of the relevant products to their calculated upstream unit costs.
- 4.11 Royal Mail has identified an alternative method to calculate the relevant upstream costs ('the Direct Method'). This involves adding up the costs of the upstream activities (mainly collections, outward sortation at Regional Distribution Centres ("RDCs")²⁷ and transportation to the inward mail centres) of the products subject to the margin squeeze tests and then subtracting any wholesale specific costs.²⁸ This contrasts with the current method which could be called the 'Indirect Method' in that it calculates relevant upstream costs by subtracting access costs from end-to-end retail costs.
- 4.12 Prior to the March 2017 Consultation, Royal Mail made submissions to us to argue that the Direct Method would:
- a) require less work, as the calculation is less complex due to the fact it avoids the need for granular matching of the margin squeeze test products to equivalent access products (at sub-product level); and
 - b) result in a value for relevant upstream costs which is not materially different from the Indirect Method.
- 4.13 In the March 2017 Consultation, we did not accept the Direct Method as an alternative to the Indirect Method because:
- a) there were significant differences between the downstream costs allocated to some retail bulk products and the costs of their equivalent access products which were reflected in the calculated relevant upstream costs; and
 - b) Royal Mail had not provided sufficient evidence of, adequately explained, or fully resolved these significant differences.

Stakeholder comments

- 4.14 In its response to the March 2017 Consultation, Royal Mail provided additional evidence:
- a) explanations of the differences between the downstream costs allocated to retail bulk products and the costs of their equivalent access products;²⁹

²⁶ All unit costs exclude recoverable and irrecoverable VAT as per USPA 6.4.

²⁷ RDCs are dedicated to outward processing of bulk mail.

²⁸ Wholesale Specific Costs are costs that relate solely to access products such as managing access. It should be noted that the only reason Royal Mail is allowed to deduct these costs is that they are assumed to be efficiently incurred. For more discussion around this, refer to Securing the Universal Postal Service Consultation, October 2011, Annex 7, Page 42, footnote 18

https://www.ofcom.org.uk/_data/assets/pdf_file/0030/62499/annex7.pdf

²⁹ Royal Mail Response, Paragraph A.8, Page 59

- b) for each of these differences, its view on whether the Direct or Indirect Method yielded the most appropriate outcome with regards to the regulatory purposes of USPA 6;³⁰ and
- c) the impact of applying the Direct Method on the aggregate basket test.³¹

Our analysis

- 4.15 In light of Royal Mail's response, we have considered whether we now have sufficient evidence and explanation for the differences between the calculation of upstream costs under the Direct and Indirect Methods and how the results under the Direct method would need to be adjusted to provide the appropriate measure of upstream costs.
- 4.16 We have reviewed the two methods using the additional information provided by Royal Mail and have identified the reconciling items that explain the differences in the results. Broadly, they can be categorised as 1) differences due to Royal Mail's downstream efficiency based on its vertical integration and 2) differences due to cost allocations and operational handling. As explained below, we have considered the nature of the differences and concluded that in some cases the Direct Method before adjustments provides the more appropriate measure of costs (so would not need any adjustment) and in others the Indirect Method before adjustments provides the more appropriate measure of costs.
- 4.17 Specifically, as explained below, we consider that before adjustments the Indirect Method better reflects the appropriate treatment of Royal Mail's efficiency advantages than the Direct Method before adjustments which would tend to overstate upstream costs (thereby making it more difficult to demonstrate that upstream revenues are at least equal to those costs).
- 4.18 We consider the differences between the Direct and Indirect methods in turn below.

Efficiency advantages

- 4.19 Under Section 29 of the Postal Services Act 2011 we have a duty to secure the universal postal service, having regard to the need for its provision to be efficient.³² In some cases Royal Mail has downstream advantages over access operators due to its position as a vertically-integrated provider.
- 4.20 We have identified two downstream efficiency advantages that Royal Mail has over access operators:
- a) **Wholesale-specific costs:** these are costs faced by Royal Mail when providing access products that relate specifically to selling access products to access operators which

³⁰ Ibid, Figure A.1, Page 59

³¹ Ibid, Paragraph A.10 -A.11, Page 59

³² Postal Services Act 2011, section 29(3) (b)

Royal Mail does not face when providing its own retail products, such as wholesale billing costs and the costs of receiving and initial processing of access mail to ensure it is in the correct format for Royal Mail's downstream processes.

- b) **Revenue protection:** Royal Mail undertakes revenue protection activities to ensure that for each customer the profile of bulk mail received matches the contracted profile. Royal Mail currently undertakes revenue protection on both retail and access products. Therefore, access products undergo two rounds of revenue protection (once by access operators and again by Royal Mail), while retail products undergo a single round of revenue protection. Furthermore, according to Royal Mail, due to where these processes take place (for retail: RDCs and for access: inward mail centres) the revenue protection activities are lower cost for retail than for access products.

- 4.21 In these cases, there is a tension between shorter-term and longer-term benefits to consumers. In the shorter-term, allowing Royal Mail to account for its downstream efficiency advantages in setting its prices would allow it to lower its prices, to the benefit of consumers who receive the same service for a lower price. However, this would have an impact on competition upstream; there would be a smaller margin between the retail and access prices, meaning that competitors would be less able to compete with Royal Mail. Greater competition through an increased margin in the shorter-term could lead to greater efficiency savings being made by Royal Mail and its competitors over the longer-term, which would in turn lead to downward pressure on retail prices.
- 4.22 If we were to place greater weight on the shorter-term benefits to consumers this would make it more difficult for access operators to compete. It would require access operators to be more efficient than Royal Mail in providing the upstream products in order to counteract Royal Mail's downstream cost advantages. However, Royal Mail's services could be set at a level that reflects the end-to-end cost, resulting in lower prices in the short term.
- 4.23 Conversely, if we place greater weight on longer-term benefits to consumers this would make it easier for access operators to compete. Access operators that are at least as efficient as Royal Mail in providing the upstream products would be able to effectively compete with Royal Mail in the upstream market. However, Royal Mail's services would be set above end-to-end cost, meaning higher prices to consumers in the short term. We would need to believe that the increased competition would result in greater incentives for operators including Royal Mail to reduce their costs, which could lead to lower prices in the longer term.
- 4.24 Given Royal Mail's current position in the upstream market, in particular its market share of around [3<] in 2016/17, competition appears to be already well-established. While these conditions prevail, we are minded to favour the shorter-term benefits to consumers of allowing Royal Mail to take advantage of its comparative efficiency advantages.
- 4.25 For the purposes of the margin squeeze test, this means that upstream costs should reflect the differences in Royal Mail's downstream costs of providing access vs retail products where these are due to genuine efficiency advantages (rather than, for example,

differences in cost allocation methodology between access and retail). Generally, these are already accounted for under the Indirect Method as part of the calculation.³³ The Direct Method, however, would require adjustments to account for these differences in order to avoid overstating the relevant upstream costs.³⁴

Other cost differences

- 4.26 We have identified three reasons other than downstream efficiencies which lead to differences in the outputs from the Direct and Indirect Methods. These arise from how each Method accounts for certain differences between access and retail products.

Customer support costs

- 4.27 It appears that Royal Mail allocates a greater amount of customer support costs to access products than it does to downstream retail products. This appears to be a function of Royal Mail's allocation method rather than a difference between the actual cost or level of service applied to retail vs access products.
- 4.28 We do not think that it is appropriate for this difference in downstream costs to cause a distortion in the relevant upstream costs taken into account as would be the case under the Indirect Method. Such distortion results from Royal Mail's cost allocation policies rather than any genuine difference between the costs of retail and access products and could allow Royal Mail to weaken the margin squeeze test by changing its cost allocation policies.
- 4.29 The Direct Method does not result in such a distortion since the calculation of relevant upstream costs is no longer dependent upon the allocation used for the purposes of the calculation of relevant downstream costs.

Sub-product mix

- 4.30 Within Royal Mail's bulk products there are sub-products (such as the distinction of products being handed to Royal Mail in bags vs in trays) which have different costs of handling but are treated as a single product from the perspective of the margin squeeze test. Differences in the sub-product mix of a product lead to differences in the unit cost of that product. These differences are driven mainly by access operators generally (but not always) having greater proportions of cheaper-to-handle products than Royal Mail.
- 4.31 We do not think it is appropriate for Royal Mail's relevant upstream costs to be distorted by these differences in the downstream costs, as they are caused by a lack of true comparability between products.
- 4.32 The Indirect Method allows these differences to distort the calculation of the relevant upstream costs, as it nets off access product costs from retail product costs. However, the

³³ The Indirect Method effectively calculates [Retail upstream costs] + [Retail downstream costs] – [Access downstream costs], so the differences in downstream costs between access and retail are accounted for.

³⁴ The Direct Method calculates [Retail upstream costs] directly, and so any consideration of downstream differences between access and retail are not included without adjustment.

Direct Method is not affected by these differences as it only considers the costs of retail products and therefore does not cause the distortion identified.

Commercial costs

- 4.33 Royal Mail applies a ‘commercial costs’ mark-up to its retail and access products to cover the costs of supporting the bulk mail markets as a whole. Royal Mail claims that this covers, for example, the costs of encouraging direct mail advertising. Royal Mail applies these mark-ups equally to access products and retail products, but for retail products the mark-up is split between upstream and downstream. Thus, the downstream portion bears a lower cost than the equivalent access product, which is made up for in the upstream part of the cost stack.
- 4.34 Given that these costs are faced as downstream costs by access operators, we believe they should be treated as such in the margin squeeze condition and be excluded from the relevant upstream costs.
- 4.35 The upstream portion of these costs is included in retail upstream costs by the Direct Method, as it includes all costs allocated to upstream by Royal Mail. The Indirect Method nets them off as part of the calculation (so long as the overall retail unit mark-up is equal to the access unit mark-up) and so is unaffected by how Royal Mail chooses to split them between upstream and downstream.

Summary

- 4.36 In order to reflect what we consider to be the relevant upstream costs; each method would need to be adjusted in some ways. These are shown in Table 4.1.

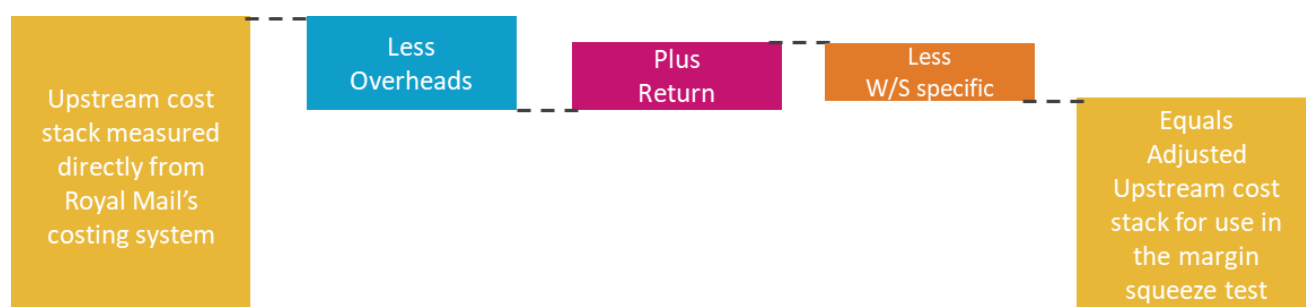
Table 4.1: Summary of adjustments to each calculation method to reflect relevant upstream costs

Cost difference	Proposal for U/S cost stack	Indirect method	Direct method
Wholesale-specific costs	Account for RM’s downstream efficiency	Specified in calculation, no adjustment required	Needs adjustment ↓
Revenue protection	Account for RM’s downstream efficiency	N/A	Needs adjustment ↓
Customer support costs	Account only for RM’s actual U/S costs	Needs adjustment ↓	N/A
Sub-product mix	Account for RM’s actual sub-product mix	Needs adjustment ↓	N/A
Commercial costs	Treat as downstream cost equivalent to cost faced by access operators	N/A	Needs adjustment ↓

Our proposals

- 4.37 As explained above, either method could be used to calculate the relevant upstream costs, with the necessary adjustments. Royal Mail has stated a preference for the Direct Method, as this is easier for it to estimate and calculate.
- 4.38 All of the adjustments we have discussed above would be expected to reduce the calculated upstream costs and, therefore, would reduce the margin Royal Mail is required to maintain on these services compared with the current calculation. Despite this, Royal Mail has suggested that, in its opinion, some of the adjustments would not be worth it making as the net effect is relatively small compared to the complexity and opacity they add to the calculation method. For example, it estimated that the adjustments for revenue protection and commercial costs would reduce the upstream cost of a letter by around [X].
- 4.39 Given that making these adjustments would work in Royal Mail's favour (by reducing the margin it is required to maintain) we would accept Royal Mail choosing not to make any of these adjustments when it calculates the relevant upstream costs. This provides Royal Mail the freedom to reduce the complexity of the test where it is willing to face a higher margin threshold test in order to do so. However, we would not accept Royal Mail choosing to ignore any adjustments (were we to have identified any) that would increase the required margin as this would undermine the test.
- 4.40 We have amended the draft condition to remove the requirement to use the Indirect Method. As a result, Royal Mail will be free to use whichever method it considers appropriate subject to the other requirements in USPA 6. We expect Royal Mail to adopt the Direct Method adjusted for wholesale-specific costs but without the further adjustments explained above. See Annex 5 for the draft condition.
- 4.41 Figure 4.2 illustrates how upstream costs would be calculated under the Direct Method assuming Royal Mail chooses to make the adjustment to wholesale specific costs.

Figure 4.2: Illustrative calculation of upstream costs under the direct method



Question 2: Do you agree with our proposal to allow Royal Mail to adopt the Direct Method for the purposes of calculating the upstream cost stack?

Treatment of surcharges in the margin squeeze condition

Current requirements

- 4.42 As part of the terms and conditions of access, Royal Mail may levy surcharges on its access customers when the mail provided does not conform to required standards.³⁵ Surcharges may be applied for a number of reasons including where mail is not presented correctly, where ineligible items are handed over or where a mailing does not meet the correct product specifications. We understand that Royal Mail also chooses to impose surcharges on its retail customers in certain circumstances. Royal Mail stated that “the primary objective of the surcharges levied by Royal Mail is to drive compliant customer behaviour across all customer groups.”³⁶
- 4.43 Currently, the USPA 6 margin squeeze calculation does not require surcharges to be included as part of relevant revenue or relevant upstream costs.

Our analysis

- 4.44 We have obtained information from Royal Mail about the extent to which it surcharges its access and retail customers, and the quantum of surcharges imposed. We understand from Royal Mail that the price of the surcharges levied on access and retail customers for issues of non-compliance with Mailmark postings are equivalent³⁷. To ensure this is the case, Royal Mail has stated that it has one team responsible for levying the Mailmark surcharges to ensure consistency across Retail and Wholesale customers.³⁸
- 4.45 However, according to the data provided by Royal Mail, the percentage incidence of surcharging is significantly higher for access customers than retail bulk customers. Royal Mail has told us that this is due to operational differences between access and retail customers. For example, it claims its own retail customers (which tend to post smaller volumes) are able to respond to required changes in processes quickly so as to avoid future surcharges. In contrast, it claims access operators’ end customers (who are often large senders of bulk mail) tend to be more willing to incur surcharges rather than change their processes due to a trade-off between the cost of changing processes and the cost of surcharges themselves.³⁹
- 4.46 Royal Mail has also stated that the decision on whether to charge customers for Mailmark non-compliance, or not charge them and absorb the costs of dealing with the non-compliance, is a commercial decision.⁴⁰ We understand that Royal Mail retains discretion to waive surcharges for both access and retail customers.

³⁵ As noted in the User Guide V16, Condition 9 Access Services for Inward Mail Centres, Royal Mail, dated October 2016

³⁶ Royal Mail response dated 22 January 2018, to the Section 55 request for information dated 22 January 2018, page 3

³⁷ Royal Mail response dated 22 January 2018, to the Section 55 request for information dated 22 January 2018, page 4.

³⁸ Royal Mail response dated 22 January 2018, to the Section 55 request for information dated 22 January 2018, page 4.

³⁹ Royal Mail submission dated 23 March 2018, Surcharges in Margin Squeeze, page 9.

⁴⁰ Royal Mail response dated 22 January 2018, to the Section 55 request for information dated 22 January 2018, page 8.

- 4.47 However, data provided by Royal Mail shows that it did not surcharge any of its own retail Mailmark customers for missorts (the most common surcharge for Mailmark) between January and March 2017-18. We understand that the large majority of missorted Mailmark volumes from access operators were subject to surcharges during this period. Mailmark volumes comprised around [X] of its 2017/18⁴¹ bulk mail volumes, up from around [X] in 2016/17). Royal Mail was not able to provide us with historic data on missorted retail mail as it did not routinely collect this data.
- 4.48 We are concerned that the routine waiving of surcharges for retail customers as compared to access customers means that Royal Mail's retail business avoids the notional upstream costs associated with surcharging which access customers are subject to. This adds more to the costs that the access operators face as compared with Royal Mail's upstream retail operations. This disparity could potentially give Royal Mail an unfair competitive advantage because it may reduce the margin available to access operators, especially if access operators are unable to pass these surcharges on to their own mail producing customers. This problem could become more acute in future if the level of the surcharges were to increase, and the disparity in surcharge treatment were to continue.

Our proposal

- 4.49 USPA 6 is in place to ensure that efficient access competitors are able to compete effectively with Royal Mail. We are of the view that surcharges imposed on access operators are relevant to the calculation of margins in the margin squeeze test because they represent a relevant upstream cost which access operators incur, which may have an impact on their ability to compete effectively. As such we propose to explicitly include surcharges in the calculation of margins in USPA 6.
- 4.50 Royal Mail has stated in a meeting with Ofcom that it believes that the effect of accounting for surcharges would have a small effect on the test and so could be immaterial⁴². While we have considered the materiality as a relevant issue for deciding between the Direct and Indirect Methods earlier in this document, we do not believe it to be determinative in the case of surcharges. Royal Mail has control over both the level of surcharges and the extent to which its treatment of surcharges to its notional upstream retail business and to access operators is consistent, whereas it has far less control over the cost differences considered in deciding the calculation method for the test. Even if the effect of including surcharges in the test would be immaterial based on current levels of surcharging (and without making a judgment as to whether that is the case), we consider the risk that Royal Mail could use surcharges in a way that disadvantages access operators (for example, by increasing surcharges on access mail considerably in future) is great enough to warrant its inclusion in the test.
- 4.51 There are two approaches that we have identified that would allow Royal Mail to include surcharges in the USPA 6 control which are set out below. Under each of these options, the

⁴¹ Per Royal Mail's Q2 December 2017 Margin Squeeze submission

⁴² Ofcom and Royal Mail meeting on 7 March 2018.

average unit surcharge by product would need to be included in the downstream access prices of equivalent products used in the calculation. Royal Mail could include surcharges:

- 1) As an additional cost representing an equivalent notional surcharge in the relevant upstream costs which Royal Mail must cover by its relevant upstream revenues; or
- 2) As an uplift to standard retail bulk and downstream access prices to account for an estimate of surcharges, to the extent that the difference between retail and access surcharges do not relate to operational differences or differences in customer behaviours. This would potentially reduce the relevant upstream revenues to cover the relevant upstream cost stack.

4.52 We propose that option two be adopted because it is simpler for Royal Mail to apply to the current calculations it provides to Ofcom.

4.53 From high level analysis performed by Royal Mail including surcharges in the Margin Squeeze calculation would have decreased Royal Mail's upstream unit margin by [X]. The effect on the most recent ex-ante forecast for 2017-18 would have reduced total upstream margin (i.e. upstream revenues of the basket divided by its upstream costs) by [X]. It should be noted that this impact includes both differences due to customer behaviour and operational differences. As stated above, even if the effect of including surcharges within the test is immaterial based on current levels of surcharging, we consider the risk that Royal Mail could use this to advantage its own operations in future is sufficient to warrant their inclusion within the test.

Question 3: *Do you agree surcharges should be included in the margin squeeze control?*

Question 4: *Do you agree with the methodology to implement surcharges in the margin squeeze control?*

A1. Responding to this consultation

How to respond

- A1.1 Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 19 July 2018.
- A1.2 You can download a response form from <https://www.ofcom.org.uk/consultations-and-statements/category-2/post-uspac-margin-squeeze>. You can return this by email or post to the address provided in the response form.
- A1.3 If your response is a large file, or has supporting charts, tables or other data, please email it to postal.regulation@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>).
- A1.4 Responses may alternatively be posted to the address below, marked with the title of the consultation:
- Kamak Arzhangji
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- A1.5 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:
- Send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files. Or
 - Upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.
- A1.6 We will publish a transcript of any audio or video responses we receive (unless your response is confidential)
- A1.7 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.
- A1.8 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.
- A1.9 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 4. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.

- A1.10 If you want to discuss the issues and questions raised in this consultation, please contact Sunjit Kamboj on 020 7783 4098, or by email to Sunjit.kamboj@ofcom.org.uk, or alternatively Kamak Arzhanghi on 020 7783 4339, or by email to Kamak.arzhanghi@ofcom.org.uk.

Confidentiality

- A1.11 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on our website, www.ofcom.org.uk, as soon as we receive them.
- A1.12 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.
- A1.13 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.14 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further at <https://www.ofcom.org.uk/about-ofcom/website/terms-of-use>.

Next steps

- A1.15 Following this consultation period, Ofcom plans to publish a statement later this financial year.
- A1.16 If you wish, you can register to receive mail updates alerting you to new Ofcom publications; for more details please see <https://www.ofcom.org.uk/about-ofcom/latest/email-updates>

Ofcom's consultation processes

- A1.17 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex x.
- A1.18 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.

A1.19 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact Steve Gettings, Ofcom's consultation champion:

Steve Gettings

Ofcom

Riverside House

2a Southwark Bridge Road

London SE1 9HA

Email: corporationsecretary@ofcom.org.uk

A2. Ofcom's consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

- A2.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

- A2.2 We will be clear about whom we are consulting, why, on what questions and for how long.
- A2.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.
- A2.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.
- A2.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.
- A2.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

- A2.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

A3. Consultation coversheet

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

Name/contact details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts? _____

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

A4. Consultation questions

Question about margin squeeze control

A4.1 We seek responses regarding our margin squeeze control proposals presented in Section 4.

Question 1: *Do you agree with our proposals to add in an explicit reference to exclude overheads and include a rate of return in the upstream cost calculation as detailed USPA6?*

Question 2: *Do you agree with our proposal to allow Royal Mail to adopt the Direct Method for the purposes of calculating the upstream cost stack?*

Question 3: *Do you agree surcharges should be included in the margin squeeze control?*

Question 4: *Do you agree with the methodology to implement surcharges in the margin squeeze control?*