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Regulatory Accounting Guidelines for Royal Mail.

A Report for Postcomm

28 September 2011

Private and Confidential

This report has been prepared on the basis of the limitations set out in our proposal dated 15th July 2011 and subsequent correspondence, which form part of the Contract, and the matters noted in the Important Notice From Deloitte on page 1.

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1 Introduction

1.1 Background

Ofcom is in the process of developing final proposals for the 2012 regulatory framework for postal services in liaison with Postcomm. It is expected that Ofcom will be publishing these proposals for consultation in autumn 2011. The development of the final proposals builds on the initial proposals which Postcomm published for consultation in April 2011 and on previous consultation documents.

One of the key requirements proposed by Postcomm is the development of Regulatory Accounting Guidelines (RAG). It is envisaged that the RAG should include the guidelines for the preparation of the income statements, balance sheets and cash flow statements for the whole of the activities and entities covered by the RAG. We understand that it is intended that the RAG set out the basis for the preparation of these regulatory financial statements (RFS) and other regulatory financial reports to the extent that they are not included in any future version of the Costing Manual already provided to Postcomm by Royal Mail. The Costing Manual is publicly available and already subject to regulatory oversight via a process set out in Royal Mail's licence.

We understand that, to date, discussion with Royal Mail on the implementation issues associated with accounting separation of the form set out by Postcomm in its initial April 2011 consultation has been limited.

1.2 Scope of Deloitte's engagement

This report has been prepared by Deloitte LLP (Deloitte) in accordance with our engagement with Postcomm in the context of its ongoing consultations on cost transparency and accounting separation.

In 2010 Deloitte was commissioned to carry out a study on the proposed implementation of accounting separation in the UK postal sector. That study was developed as part of Postcomm's consultation on proposals for the regulatory framework for 2012-13 and beyond and focused on three specific areas:

- The development of accounting separation proposals with a particular focus on the practical and conceptual issues arising from Postcomm's intention to request separated financial statements from Royal Mail for regulatory reporting purposes;
- The specification of Royal Mail's Regulatory Accounting Guidelines, which will describe the basis of preparation of the separated accounts; and
- The development of a reporting and disclosure framework to be adopted by Royal Mail in context of the regulatory financial statements.

Deloitte's recommendation were based on a review of relevant precedents in other jurisdictions and industries where accounting separation requirements had been introduced and on Deloitte's experience in working for regulators and regulated companies to implement or review separated financial statements.

In summer 2011 Postcomm asked Deloitte to provide support on:

- The development of the regulatory accounting guidelines; and
- To comment on the content of the proposed guidelines, in the context of the specific circumstances of the postal sector in the UK and of international best practice.

This report summarises our comments to Postcomm regarding the proposed requirements to be included in the RAGs.

1.3 Outline of the report

This report is structured as follows:

- Section 2 summarises the regulatory and competition context of the UK postal sector, within which the guidelines have been developed, and the regulatory objectives which accounting separation is intended to support;
- Section 3 provides a summary of Deloitte’s comments on the proposed guidelines; and
- Section 4 comments on the specific question of the audit standard to be applied in the context of the proposed regulatory reporting framework.

2 Industry background

This section provides a brief background on the interaction between Postcomm and Royal Mail on the development of regulatory accounting guidelines. An understanding of this context is helpful to understand the objectives of Postcomm's recent regulatory policy and its proposals for the introduction of accounting separation.

2.1 Recent development in the UK postal sector

The postal market has been characterised by rapid development in terms of technological advancements and the liberalisation of the market.

Traditional mail volumes are in decline, as the consequence of the increasing use of digital communications. At the same time, the delivery of goods to homes has increased significantly with the growth of eCommerce.

Competition in the market has also developed rapidly, based on two models:

- End-to-end competition, which entails providing the whole service from collection through to sorting and delivery; and
- Access competition, which has developed where a third-party operator collects and sorts mail and uses Royal Mail's final sorting and delivery facilities in order to deliver products to customers.

There are now 59 licensed postal operators. Of these, the majority of Royal Mail's competitors focus on end-to-end services in the niche, express and heavy parcel sectors as well as collection of high volumes of pre-sorted bulk mail which utilise Royal Mail's delivery network through the use of access products. Access competition has grown very rapidly, and at the end of 2010 Royal Mail had less than 20% of second class pre-sorted bulk mail volumes.

However Royal Mail still delivers over 99%[1] of addressed mail to the door. Despite this, Royal Mail's retail non-bulk mail volumes have also declined at a steady rate and are forecast to decline even further in future.

2.2 Royal Mail's position

These recent changes have had significant effects on Royal Mail's financial situation and market position. The substantial decrease in market volumes, combined with the transition of corporate and residential customers from premium products to cheaper delivery options, are the main contributors to the substantial decrease in Royal Mail's core letter business revenues. This primary effect has been reinforced by the rapid progress of competition in the bulk and pre-sorted market, which has captured up to 80% of the pre-sorted bulk mail market. This decline in revenues,

[1] Laying the foundation for a sustainable postal service, Overview, May 2010

together with the limited flexibility in the ability to adjust the labour cost in the short term has created substantial stress to Royal Mail's financial position[2].

During 2010 Royal Mail has developed a restructuring plan to address these financial issues and to improve Royal Mail's financial position, particularly in view of Government policy to, at least partially, privatise Royal Mail. The restructuring plan involves short term investments for modernising operations, the implementation of corporate and back office restructuring and commercial transformation.

It is therefore essential that, in developing a regulatory framework for Royal Mail, Postcomm assesses very carefully the impact of such framework on Royal Mail's financial performance in the short, medium and long term.

2.3 Regulatory policy objectives

Postcomm is currently liaising with Ofcom to develop Ofcom's policy on regulatory financial reporting. Postcomm, in the April 2010 Consultation[3], set out the following objectives for cost transparency and accounting separation:

- Supporting the financial sustainability of the universal service through:
    - Improved efficiency as a key driver of long term financeability.
    - Short term cost recovery.
- Effective protection for customers and users from unreasonable high prices from Royal Mail;
- Enabling efficient entry and competition; and
- Minimising the risk of regulatory failure.

To ensure the feasibility of, and to support, the provision of the universal service Postcomm is required to monitor Royal Mail's financeability. In order to achieve this, it needs to ensure that, while measures should be put in place to limit Royal Mail's power in those markets in which it is dominant and create incentives for increasing efficiency, it can generate sufficient revenues to finance its operations and recover the costs involved in the provision of the universal services.

[2] The financial position of the Royal Mail is further worsened by the large pension deficit which is mostly related to liabilities from historic operations.

[3] Section 1 of "The building blocks for a sustainable postal service, Annex B, April 2011

2.4 Regulatory financial reporting proposal

At the time of writing, we understand that the following key elements are being considered for inclusion within the financial reporting requirements:

- Financeability statements: Provide Consolidated Income Statement, Balance Sheet Statement and Cash Flow Statements for the entity defined for the financeability test on an annual basis, defined as Royal Mail Group Limited, excluded Post Office Limited (POL) and quarterly cash flow statements.

- RFS: these are to be provided for Royal Mail's Letter business (the reported business) and separated entities within the reported business.

- The definition of three main lines of separation: line A, separating the end-to-competitive products from the rest of Royal Mail's letter business; line B, separating the upstream from the downstream business, at the point of entry to the inward mailing centre; and line C, separating the upstream Universal Service Obligation (USO) and non-USO products.

- The requirement to provide, for each separated entity within the reported business, and for the reported business as a whole, Income Statements on a quarterly and annual basis, and Balance Sheet Statements and Cash Flow Statements on an annual basis. In addition, product profitability statements need to be provided for a limited number of product groups specified by the regulator on a quarterly and annual basis.

- The requirement to provide reconciliation between the reported business and Royal Mail Group excluding Post Office Limited (RMG – ex POL) and between RMG – ex POL and Royal Mail Holding's statutory accounts for each main item in the three statements.

- The requirement to provide Costing and Accounting Methodology manuals, explaining the assumptions that have been used to allocate each line of revenue, cost, asset or liability to each business.

3 High level review of guidelines

In this section we review the proposed RAGs by comparing their key proposed elements with the corresponding guidelines developed by other regulators requiring accounting separation; we then comment on the scope and the level of detail provided in the RAGs.

3.1 Key elements of the typical RAGs

The role of the RAGs is to provide a framework against which Royal Mail can prepare and submit RFS. As such the content of the RAGs need to take into account the appropriate balance between high level principles and prescription, in particular the level of detail provided should be appropriate to the materiality of various components of the financial performance of the company. For example, in the case of Royal Mail the RAGs are expected to provide a greater focus on cash flows, rather than assets, given that Royal Mail is a cash intensive business with relatively low asset values.

In our experience the following key elements are normally covered by a regulator's regulatory accounting guidelines:

- Links to regulatory policies and licence conditions requiring additional reporting;
- Definition of the businesses and products for which reporting is required;
- Definition of the reports that need to be provided as part of the RFS, including, when necessary, pro forma reports;
- Definition of accounting principles and practices;
- In addition to the basic principles, additional details on the methodology to be used for the preparation of specific items in the accounts, such as choice of drivers, asset revaluation approach, excluded items, etc;
- Definition of the timeline and frequency for the submission of the RFS;
- Details of the accompanying documentation to be provided with the RFS; and
- If assurance on the RFS is required, details on the level of assurance sought by the regulator.

We have reviewed the proposed RAGs, which we understand will be included in Ofcom's future consultation document, with reference to these elements. We note that all of the key elements outlined above are provided as part of the guidelines.

3.2 Scope and level of detail of the RAGs

Based on our experience of working with clients in regulated industries, supporting either regulators or regulated companies, and on our review of publically available and confidential information on the RAGs defined for accounting separation in various jurisdiction and sectors, and telecoms in particular, we have observed a variety of different approaches in the development of regulatory accounting guidelines. The specific nature of the guidelines in various jurisdictions depends on factors including the progress of liberalisation of the industry, the policy objectives of the regulatory authority, the quality of the relationship between regulators and regulated operators, the legal powers granted to the regulator and other sector- and company- specific factors.

The level of detail we expect to see in the guidelines generally depends on the development stage of the regulatory accounts. In the first few years from the initial implementation of accounting separation requirements, it is common to see regulators define requirements at a high level, based on observations of best practice in other jurisdictions. Regulated companies would develop their methodology for the preparation of their accounts by choosing the appropriate drivers and reporting format in line with these high level requirements. The level of details in the guidelines often increases after the review of early years' submissions, as the regulators provide more guidance on the specific issues emerging from their review of RFS reports.

The complexity and level of details in the guidelines also depends on the type of requirements defined for the RFS submission. Detailed requirements are often imposed when Current Costing Accounting is required to define the asset revaluation approaches, or as part of the definition of the Long Run Incremental Cost methodology, as the quality and the relevance of the results is heavily dependent on the methodology used. Guidelines which relate to accounting separation based on historical costs are generally less detailed and prescriptive as they tend to be based on the accounting principles defined in the statutory accounts and on commonly used activity based cost allocations for operating costs and historic assets.

On the basis of the observations above, the proposed RAGs are substantially more detailed than we would ordinarily expect to observe at this stage in the regulatory process. The proposed RAGs are very detailed in terms of the definition of the format of the statements (and in particular for the balance sheet and cash flow statements and their reconciliation statements to the statutory accounts) and of the approach to the apportionment of assets and balance sheet items. However, in the specific context of the UK postal sector, we believe that there are a number of factors which could justify such an approach:

- Royal Mail's financial position: Royal Mail's weak financial position differentiates it from the majority of operators in similar stages in the process, which tend to be incumbents with limited effective competition and the ability to generate healthy profits. The regulator's responsibility to monitor Royal Mail's financeability is a valid justification to be more prescriptive in the definition of the reporting requirements and the calculation approach.

- The proposed requirement for quarterly reporting can also be considered in this context; the regulator may be required to react at short notice in order to provide timely intervention in the event of financeability issues or other rapid changes to the business or the market becoming evident.

- Short timeline for implementation of requirements: when regulators introduce the requirements for the introduction of accounting separation it is generally accepted that it may take a number of years before the regulatory statements become stable, reliable and therefore fit for use in, for example, the determination of wholesale prices. This process is generally considered to be compatible with the development of competition in those markets. However, we understand that the regulator's objective is to ensure that a reliable set of separated accounts could be produced for financial year 2012/03, after having successfully run a pilot for 2011/12. Providing specific instructions is likely to be an effective approach to achieve this target. This objective is likely to be in line with Royal Mail's desire to see some of the areas of the market deregulated, and to gain the ability to respond more effectively to competition. The production of reliable separated statements is likely to be a key factor in determining the regulator's ability to deregulate the market.

- Limited discussion with stakeholders about regulatory accounts' implementation details: we understand that discussion with Royal Mail on the implementation issues associated with accounting separation of the form set out by Postcomm during initial consultation has been limited to date. Given the pressing timetable, it may therefore be considered to be justifiable for the regulator to have developed more detailed RAGs than it would have done had more detailed discussions taken place. Indeed, Royal Mail may actually benefit from having such levels of detail in the guidelines, as these may facilitate the development of the new RFS.

We also note that the general structure and content included in the proposed RAGs reflect, in part, the intention that the RAGs will need to be fit for purpose for the next 7 years, and that there is no intention to refine or update the requirements across that period, other than possible changes to the list of services.

3.3 Conclusions

Our review of the proposed Regulatory Accounting Guidelines for Royal Mail has highlighted that:

- The RAGs contain the main elements that are generally observed in RAGs developed for other jurisdictions and industries; and

- Whilst the level of detail provided in the guidelines exceeds that which would normally be expected at this stage of development of reporting requirements, the specific circumstances of the consultation process and the regulator's obligations and objectives outlined above suggest that the proposed approach is appropriate to the situation.

4 Discussion of specific issues

4.1 Audit opinion

Regulators generally choose between one of following two options when specifying the opinion that an auditor will be required to provide.

- “Properly prepared in accordance with the regulation”. For the avoidance of doubt, the regulation includes both the regulator’s guidelines and the licensee’s methodology documents.

- “Fairly presents” opinion. This imposes a much higher level of assurance from the auditors, which is reflected in a considerably higher cost to the licensee.

The “properly prepared” opinion is, by far, the most common opinion that we have observed, in particular in the early years in which accounting separation is required.

Traditional ex ante incentive regulation of network businesses requires the preparation of regulatory accounts on a top down basis, i.e. starting from the same information contained in the company financial systems which is used for the preparation of the statutory accounts. This ensures that the separated accounts and the statutory accounts can be reconciled. The use of the audited statutory accounts as a starting point provides assurance that the regulatory statements provide a robust representation of the company’s businesses because the inputs to the regulatory accounts are directly and transparently linked and reconciled to the audited statutory accounts. This transparent link is supported by the preparation of methodological documentation describing the rules used to determine the attribution of revenues, costs, assets and liabilities across the separated regulatory reporting entities.

The imposition of a requirement for a separate “fairly presents” audit opinion on the regulatory accounts might ordinarily be considered to be disproportionate, especially in the early stages of regulatory reporting development, due to the additional financial burden that this imposes on the company. More commonly, the audit requirements during the early stages of regulatory reporting development is based on a “properly prepared” opinion. In some cases, there might be specific circumstances which might justify, over an appropriate time period, a transition from a “properly prepared” to a “fairly present” opinion. The regulator may, for example, be able to demonstrate that such a higher level of assurance is required, i.e. in this context the requirement to monitor Royal Mail’s financeability. A stronger case for the more onerous standard could also be made in the case of a regulator relying on the regulatory accounts for monitoring purposes in context of potential future market liberalisation measures.

Where there are significant changes to the regulatory reporting framework, we would find it difficult to recommend stringent audit requirements in the first years of implementation of regulatory accounting, at a time when the licensee is challenged to build new regulatory models and define the rules and the assumptions needed to run them. This would be likely to lead to qualifications of the accounts which could undermine their usefulness for regulation. It is, in fact, not uncommon for regulators to only impose the audit requirement on the regulatory models, only after the second or third year of implementation.

Given the particular challenges that may be presented for Royal Mail's regulatory auditors by the new proposals it would be appropriate for the regulator to impose the requirement for a "properly prepared" audit opinion for Royal Mail (albeit this could be reviewed). A tripartite audit arrangement, in which the auditors have a contract and therefore a duty of care to both the regulated company and the regulator, would provide the regulator with additional visibility on the audit process and to take part to the audit planning process. In this respect it is very important that, as part of this arrangement, Postcomm defines specific additional elements of disclosure required from the auditors.

Following the initial implementation of accounting separation, the regulator would have the option to review and consult on whether a more stringent audit requirement may be needed, if specific issues were highlighted and additional assurance required.

