



Updating the Regulatory Reporting Framework- Statement USP Accounting Condition

Postal Regulation

Statement

Publication date: 27 January 2014

Section 1

Responses to consultation and Ofcom's decision

Introduction

- 1.1 On 27 March 2012 we published our Statement '*Securing the Universal Postal Service: Decision on the new regulatory framework*' ('the March 2012 Statement').¹ It set out our decision on the new regulatory framework for the postal sector, which gave Royal Mail Limited ('Royal Mail') more commercial and operational flexibility (particularly in relation to setting the majority of its prices). Regulatory safeguards were implemented to protect consumers and, where appropriate, promote effective competition.
- 1.2 One of the safeguards was the comprehensive monitoring regime which we would put in place. A summary of the regulatory financial information that Royal Mail would be required to provide to support our monitoring regime were outlined in Section 11 and Annex 3 of the March 2012 Statement.
- 1.3 Almost two years on, to ensure the regulatory financial information provided by Royal Mail remains fit for purpose, we have decided to update the regulatory financial reporting requirements. To that end, we published our proposed changes for consultation on 23 October 2013 '*Updating the Regulatory Reporting Framework – Notice of proposed modifications to the USP accounting condition*' (the 'October 2013 Consultation')² and invited responses on changes to the condition, and to the Regulatory Accounting Guidelines ('RAG') referred to in the condition, by 25 November 2013.
- 1.4 We received responses from Royal Mail and UK Mail, which we have considered; and in this document, we set out our decisions to update Royal Mail's regulatory reporting framework. We also discuss, where relevant, the responses from the above-mentioned respondents, and explain how we have taken those responses into consideration.
- 1.5 The updated USP Accounting Condition ('USPAC') and RAG – highlighting all the changes we have made – are included in Annexes 1³ and 2⁴ respectively of the

¹ <http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/Statement.pdf>

² <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/summary/framework.pdf>

³ <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex1.pdf>

⁴ <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex2.pdf>

accompanying Statutory Notification.⁵ The documents as originally published by Ofcom are available at Annex 10 '*Statutory Notification: USP accounting condition*'⁶, and Annex 11 '*Direction: Regulatory Accounting Guideline (RAG)*'⁷ of the March 2012 Statement⁸. Ofcom's March 2012 statement is at Annex 3 '*Regulatory Financial Reporting*'.⁹

Frequency

Submission of the Strategic Business Plan and Annual Budget

Our proposals

- 1.6 Royal Mail is currently required to submit its Strategic Business Plan and Annual Budget prior to the commencement of the Financial Year to which the budget relates.¹⁰
- 1.7 However, this timetable does not necessarily coincide with Royal Mail's business planning and budgeting timetable, and it does not allow for changes during the year which may be necessary due to market developments.
- 1.8 We therefore proposed that if a revision to the Strategic Business Plan or the Annual Budget is made part way through the year, Royal Mail will be required to submit a copy to Ofcom, when Royal Mail has approved it. This would enable us to understand Royal Mail's up to date expectation for its future performance reflecting its current operational and financial performance and the current market conditions more accurately.

Responses

- 1.9 Royal Mail agreed with our proposal¹¹, but responded that our proposed updated requirement as per USPAC 1.3.9 (ii) (see Annex 1) was too general and should be amended to clarify that the requirement was to provide the Strategic Plan to Ofcom once it had been approved by the Royal Mail Board.

Our decisions

⁵ <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statutory-notification/statutory-notification.pdf>

⁶ <http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/annex10.pdf>

⁷ <http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/annex11.pdf>

⁸ <http://stakeholders.ofcom.org.uk/Consultations/review-of-regulatory-conditions/Statement/>

⁹ <http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/annex3.pdf>

¹⁰ USPAC 1.3.1(e), 1.3.1(g), 1.3.9(b) & 1.3.9(c)

¹¹ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 1.2 and 1.3

- 1.10 With respect to Royal Mail's proposed requirement for approval by the Board, we emphasise that we need to receive the Strategic Plan which has been approved by Royal Mail, regardless of what the specific approval process or the approving body is.
- 1.11 We have therefore decided to update the requirement as originally proposed under USPAC 1.3.9 (see Annex 1).

Reported Business in the Strategic Business Plan and Annual Budget

Our proposals

- 1.12 Royal Mail currently provides a Strategic Business Plan and Annual Budget for the Relevant Group.¹² As defined in USPAC 1.1.2, the Relevant Group comprises Royal Mail Group Limited and all of its subsidiary undertakings. It excludes Royal Mail Holdings plc and Post Office Limited.
- 1.13 However, we use the concept of the "Reported Business" to assess the financial sustainability of the universal service. The Reported Business is defined as the part of the Relevant Group that undertakes the activities for the purpose of, or in connection with, the provision of the universal service (USPAC 1.1.2)¹³. We need separate projected figures for the Reported Business in order to more accurately monitor the financial performance of the universal service.
- 1.14 In light of the above, we proposed to require Royal Mail to separate the projections for the Reported Business from the Relevant Group projections in its Strategic Business Plan and Annual Budget.

Responses

- 1.15 Royal Mail agreed with our proposal.¹⁴

Our decisions

- 1.16 We have therefore decided to add the requirement as originally proposed.
- 1.17 Accordingly, Annex 2 sets out the updates to RAG Table 2 relating to USPAC 1.3.1(e).

Monthly budget information for the Reported Business in the Annual Budget, revenues and volumes, and cost and efficiency information

Our proposals

¹² USPAC 1.3.1(e) and 1.3.1(g)

¹³ It does not include certain other entities, mainly ParcelForce Worldwide or General Logistics Systems B.V., see Para 1.31 – 1.32, Annex 6 of the October 2011 Consultation
<http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/Annex6.pdf>

¹⁴ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 2.2

- 1.18 The Annual Budget provided to Ofcom does not currently include a monthly breakdown. We proposed that Royal Mail provides a monthly breakdown of the Annual Budget for the Reported Business.
- 1.19 For all the products and services of the Reported Business, Royal Mail is required to provide revenue, volume and cost information for each financial month.¹⁵ Currently, only the current year and the comparative prior year's results are required.¹⁶
- 1.20 We proposed that the budgeted revenue and volume information should also be reported for all the products and services of the Reported Business.
- 1.21 We proposed to no longer require the provision of monthly cost data for all the products and services of the Reported Business. Instead, we proposed to require certain other more useful metrics, both actual and budgeted, on monthly basis. These metrics include productivity metrics (gross hours, workload, and productivity data which have been developed by Royal Mail since April 2012), staff headcount, Full Time Equivalent data, and transformation spend and data.
- 1.22 The rationale for requiring monthly budgeted information was that it would help us assess how the Reported Business is performing against its budget within a financial year. This is of particular importance given the seasonal nature of Royal Mail's operations and financial results. The monthly breakdown would also enable us to monitor the performance of the Reported Business against both the original and any modified budgets (ie reforecast) which may happen part way through the financial year).

Responses

- 1.23 Royal Mail responded¹⁷ that the provision of monthly data – both actual and budget - for the Reported Business is unduly intrusive and disproportionate, because while Ofcom has regulatory oversight, it is *“not responsible for running the business”*.
- 1.24 Royal Mail stated that the monthly information is volatile due to the nature of the postal market and a quarterly approach to monitor performance would be more proportionate. A quarterly reporting regime would enable Ofcom to understand the underlying trends in the business.
- 1.25 Royal Mail proposed to stop all monthly reporting - either actual or budgeted - and instead provide us with quarterly information on the Reported Business - both actual and budget - 30 days after the quarter-end. Royal Mail argued that other postal operators are also required to report quarterly.
- 1.26 Royal Mail also stated that providing monthly breakdown on the Annual Budget is not practicable, because the calendarisation of the Annual Budget is done after the year-end and monthly budget figures are report from Period 2 (i.e. May) onwards.
- 1.27 Finally, with respect to our proposed monthly cost information, Royal Mail has provided¹⁸ a slightly revised definition of Full time Equivalent staff headcount which

¹⁵ USPAC 1.4.1(k)

¹⁶ Annex 11 'Direction: Regulatory Accounting Guidelines (RAG)', figure 15, page 62

¹⁷ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 3.2 to 3.6

we had included in our proposed updates to the RAG¹⁹. Royal Mail's revised definition is more accurate and we accept it. We have amended the RAG accordingly (see Annex 2, Page 9).

Our decisions

1.28 In our view, requiring monthly information on the Reported Business, either actual or budget, is not inappropriate or disproportionate, because:

- we need timely information for our monitoring of Royal Mail's financeability and efficiency, in order to fulfil our primary duty under the Act. Quarterly data, even if Royal Mail provides it 30 days after the quarter end, would be months in arrears; and
- budget data is particularly important in our monitoring of financeability and efficiency. It helps to understand how Royal Mail is performing in contrast with its own intentions and expectations. In the absence of that, actual numbers can only be compared with prior year figures providing only limited information on historical trend without adequate information as to whether the trend is something to be concerned about or not.

1.29 We understand the volatility of some monthly data, e.g. unit product costs. However, there are items of monthly data that are not highly volatile (eg volumes and revenues of certain major products). Additionally, as we explained in the March 2012 Statement²⁰, the primary purpose of our requirement for monthly information is to understand the raw trading results of the Reported Business as opposed to the detailed product profitability outcomes which we expect to understand through quarterly reports.

1.30 As for our requirements on other postal operators, we note that we do not have a duty towards financeability and efficiency of other operators.

1.31 In light of the above and the issues Royal Mail identified in relation to the calendarisation of the Annual Budget, we have decided to require Royal Mail to provide:

- Quarterly budget for the Reported Business as a whole, setting out its total budgeted revenues and costs, to be submitted alongside the quarterly regulatory accounts for the Reported Business (see paragraphs 1.40 to 1.52).
- Monthly budgeted revenue, volume and cost metrics, as soon as the information has been calendarised and prepared by Royal Mail, i.e. from Period 2 (i.e. May) onwards.

¹⁸ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 12.7

¹⁹ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/annexes/Annex_5.pdf, Page 9

²⁰ <http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex3.pdf>, Para A3.274

- 1.32 Accordingly, Annex 2 sets out the updates to RAG Table 2 relating to USPAC 1.3.1(e); RAG Table 4 relating to USPAC 1.4.1(k); and RAG Appendix 1, Figures 15(a) and 15(b).

Quarterly costing data

Our proposals

- 1.33 Royal Mail is required to prepare, maintain and keep up-to-date the Costing Manual for the Reported Business on a quarterly basis.²¹ As part of the confidential information provided to Ofcom, Royal Mail is also required to provide additional Technical Appendices to the Costing Manual.²² These contain both the relevant input and output costing data that allow us to build our Cost Allocation Model ('CAM'). We use the CAM to gain a detailed understanding of the costs of individual activities and products within the Reported Business and how they are calculated by Royal Mail.
- 1.34 It was important for us, in the first year of the regulatory framework, to have both input costing data and output costing data on a quarterly basis, because the reporting requirements were being tested and embedded. Going forward it is less important to have the input data on a quarterly basis, because it will be adequate for us to build the CAM on an annual rather than quarterly basis. However, it will be important to continue to have the output costing data quarterly to inform our monitoring programme.
- 1.35 If we are concerned about some of the outputs and/or need more up-to-date detailed costing information for other purposes, we will always be able to require Royal Mail to provide the necessary data on an ad hoc basis (through Section 55 of the PSA).

Responses

- 1.36 Royal Mail²³ welcomed and agreed with our proposals because a considerable amount of work is needed to prepare quarterly input costing data in the format we require for the CAM.
- 1.37 Royal Mail proposed that the change comes into effect starting from the Technical Appendices for the quarter ending December 2013 (due at the end of March 2014). The input costing data will then be included only in the Technical Appendices for the full year to be submitted with all the other annual information on 28 July 2014.
- 1.38 Royal Mail also proposed that we no longer require the Technical Appendices to the Costing Manual on a quarterly basis, and instead require them annually.

Our decisions

- 1.39 We have decided to update the requirement as originally proposed, i.e. to require input costing data annually and output costing data quarterly. Since we are not planning to build the CAM on a quarterly basis for the remainder of 2013-14

²¹ USPAC 1.6.1 and 1.6.2(a)

²² March 2012 Statement, para 11.57 and Regulatory Accounting Guideline (RAG), Appendix 4 'Information to be included in the pro-forma's for the technical appendices of the Costing Manual

²³ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 4.2 to 4.4

financial year, we have decided that the new requirement comes into effect starting from the costing data for quarter ending December 2013 (due at the end of March 2014).

- 1.40 With respect to the requirement for the Technical Appendices, we emphasise that the Technical Appendices are there to capture any costing information which is confidential and cannot be included in the public version of the Costing Manual. The quarterly updated Technical Appendices, together with the version of the Costing Manual that is updated and published quarterly, provide the full set of information which we require to achieve cost transparency on a quarterly basis.
- 1.41 We have therefore decided to retain the requirement for quarterly Technical Appendices. If in one quarter there happens to be no new information that is confidential (and to be included in the Technical Appendices), then Royal Mail will simply be required to inform us that the previous quarter's Technical Appendices continue to be up to date.
- 1.42 Accordingly, Annex 2 shows the updates to RAG Appendix 4.

Timing of submission of the quarterly information²⁴

Submission of the quarterly regulatory accounts (and the accompanying Costing Manual and Accounting Methodology Manuals)

Our proposals

- 1.43 Royal Mail is required to provide the regulatory accounts for the Reported Business as a whole and for each of the four financial reporting entities (the 'Four FREs') within the Reported Business, as well as Product Profitability Statements for various product groups within the Reported Business.²⁵ This information is currently required to be provided to Ofcom within 90 days after the end of the financial quarter for which the Statement and information have been prepared.²⁶
- 1.44 This means the information provided for the monitoring regime is more than three months old by the time it has been analysed and presented within Ofcom. This can be after Royal Mail's public announcement of its results for the following quarter. Given the nature of the postal market, this could delay the identification of issues that may threaten the universal service and therefore Ofcom's response to it.
- 1.45 We therefore proposed to shorten the deadline for submission from 90 days to 60 days after the end of the financial quarter. We also proposed that both the Costing Manual and Accounting Methodology Manuals are submitted 60 days after the end of the financial quarter, not 90 days. This will ensure the quarterly regulatory accounts are accompanied by the supporting manuals which set out the methodologies applied in the accounts.

²⁴ For the avoidance of doubt, we do not propose to change the current deadline of 120 days from the year end which applies to the annual regulatory financial statements.

²⁵ USPAC 1.4.1(b), 1.4.1(j), 1.5.2(b) and 1.5.2(e)

²⁶ USPAC 1.4.9(a) and 1.5.10(b)

- 1.46 We recognised that this proposal presented Royal Mail with the challenge of speeding up its reporting and internal approval processes. However, we expected that our proposed removal and reduction of certain other requirements should free up time to be dedicated to the preparation of the quarterly regulatory accounts. In particular, we expected that the removal of the requirement for quarterly preparation and submission of full costing data would release significant amount of time (see paragraphs 1.30 to 1.39).

Responses

- 1.47 Royal Mail responded²⁷ that the deadline should remain 90 days. Royal Mail stated that the 60 days deadline is:

- Not proportionate, because Ofcom does not need the accounting separation information (included in the quarterly regulatory accounts) to carry out its financeability assessment. Royal Mail stated that accounting separation is an “*artificial construct*”, which Royal Mail does not use in running its business. Instead, Royal Mail proposed to provide Ofcom with the profit and loss for the Reported Business (including actual and budget figures), 30 days after the quarter end.
- Not practicable, because accounting separation is an artificial construct, which requires a great deal of data processing (up to 50 days), report building (up to 20 days) and executive review and sign-off (up to 20 days). Royal Mail has provided a table of these activities including how long each takes.

Our decisions

- 1.48 It is important that the quarterly regulatory accounts are provided to us 60 days after each quarter end. We reiterate that the undesirable consequence of the current 90 days deadline is that the information provided for the monitoring regime is more than three months old by the time it has been analysed and presented within Ofcom. Currently, by the time we complete our internal quarterly monitoring report, Royal Mail will have published a statement of its results for the following quarter²⁸.
- 1.49 The current 90 days deadline means our quarterly monitoring reports are not as fresh and timely as they could be. While we believe our monitoring regime is sufficiently in-depth and detailed, we recognise the need to make it more timely to allow us to react to regulatory issues not only appropriately but also promptly.
- 1.50 Accounting separation is an important part of our quarterly monitoring reports which we regularly consider and review. It shows how the profitability of the Reported Business is distributed between competitive (non-USO and end-to-end) and non-competitive (USO and access) markets. The fact that the accounting separation is a

²⁷ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 5.1 to 5.9

²⁸ The quarterly reporting requirement for the listed companies has been removed at the European Union level as part of the amendments to the Transparency Directive and must be transposed into UK law by November 2015. Until then, Royal Mail will be required to publish quarterly reports to the market. Beyond that date, Royal Mail will still be required to publish half-yearly accounts.

regulatory construct is a reflection of the fact that the objectives and the information needs of the regulator are not the same as those of the markets.

- 1.51 With respect to the practicability of the 60 days deadline, Royal Mail provided us with a breakdown of how it uses the current 90 day period to prepare and review the regulatory accounts, but we have not been persuaded by its arguments that it could not deliver those accounts in less time (ie, within 60 days) if it was required to do so. For example, with reference to the timeline provided by Royal Mail:
- it is not clear to us why Royal Mail needs 70 days to process data and build reports and Royal Mail has not provided any evidence that it could not do so more quickly by, for example, prioritising the analysis or by allocating more resources to the task; and
 - the 20 days Royal Mail says is taken up by executive review and sign-off appears to be excessive and we consider that Royal Mail could do this more quickly if necessary to meet a regulatory deadline.
- 1.52 However, we recognise that the move from 90 days to 60 days cannot be achieved immediately, and that Royal Mail will require time to reorganise and rationalise its relevant activities.
- 1.53 We have decided that the requirement for the 60 days deadline comes into effect for the second financial quarter in 2014-15, i.e. for the accounts for the quarter ending September 2014. These accounts will need to be submitted by the end of November 2014, rather than December 2014.
- 1.54 We have decided not to put into effect the requirement for the 60 days deadline from the first financial quarter of 2014-15, i.e. for the accounts for the quarter ending June 2014. We understand that this would coincide with the work Royal Mail will be doing on preparing the annual regulatory accounts for the year ending March 2014 (due to be published by end of July 2014); and it would be difficult for Royal Mail to introduce the faster processes for the first time during that period.
- 1.55 Accordingly, Annex 1 sets out the updates to USPAC 1.4.9, USPAC 1.5.10, USPAC 1.6.6 and USPAC 1.6.8. Annex 2 Tables 4 and 7 set out the updates in relation to the above USPACs.

Assurance

Auditor approval

Our proposals

- 1.56 The USPAC currently requires²⁹ Royal Mail to appoint a Qualified Independent Auditor on an annual basis, and for Ofcom to approve the appointment including the terms of engagement. The requirement for approval by Ofcom means we need to conduct a public consultation each year setting out our proposal to approve (or not) the choice of auditors and/or their terms of engagement.
- 1.57 To comply with the above requirements, in February 2013, we consulted on Royal Mail's choice of Ernst & Young as the auditors for the financial year ended 31 March

²⁹ USPAC 1.3.5, 1.4.5 and 1.6.5

2013. In our Statement *'Royal Mail's regulatory reporting audit for the year ending 31 March 2013'* (the March 2013 Statement)³⁰, we approved the appointment of Ernst & Young as Royal Mail's auditor for the financial year ending 31 March 2013, including their terms of engagement.

- 1.58 In its response to this consultation, Royal Mail requested auditor approval to be given for more than one year, unless the auditor is changed or there is a significant change in the terms of their engagement.
- 1.59 We agree that an annual approval process through public consultation is not necessary. However, we remain of the view that it is important for us to have an option to intervene (eg carry out a public consultation) with respect to the choice of the auditors and their terms of engagement, if we consider either unsatisfactory.
- 1.60 We therefore proposed that the requirement for Ofcom to approve the choice of auditors every year is removed, and Royal Mail is required to notify us of its choice of auditors and their terms of engagement 60 days prior to the appointment of the auditors.

Responses

- 1.61 Royal Mail responded that the proposed change is not practicable due to the tender process which is conducted if Royal Mail decides to consider changing its auditors. The tender process may also be required for statutory auditors under the new Competition Commission measures³¹. Since Royal Mail has historically selected the same auditor to do both the statutory and regulatory audits, the selection of the regulatory auditors will also be decided through the tender process for statutory auditors.
- 1.62 Royal Mail stated that if there is a tender process, it cannot wait 60 days after that process has been completed in order to engage the auditors. Royal Mail instead proposed to inform us of those who have tendered.

Our decisions

- 1.63 Issues arise when there is a tender process. Royal Mail's proposal to inform us about the participants in the tender would not work. The reason is that we cannot consult - for practicability and confidentiality reasons - on eliminating from the tender those firms which we do not find suitable. However, in practice this may be an informal way of pre-empting disagreement.
- 1.64 Moreover, Royal Mail's proposal does not resolve the issues that arise if we do not find the proposed terms of audit engagement for tender satisfactory.
- 1.65 It is important for us to have control over the choice of the auditors and the terms of engagement (to the extent that they define the scope of the audit and the

³⁰ <http://stakeholders.ofcom.org.uk/binaries/Consultations/rm-reporting/Statement/Statement.pdf>

³¹ FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years. The Financial Reporting Council's Audit Quality Review team should review every audit engagement in the FTSE 350 on average every five years. See 15 Oct 2013 Competition Commission report: <http://www.competition-commission.org.uk/media-centre/latest-news/2013/Oct/cc-finalises-measures-to-open-up-audit-market>

responsibilities of the auditors). This control would significantly enhance the confidence in the audit opinion and the assurance provided by the audit, both for us and the stakeholders.

1.66 This level of control over the regulatory audit is also in line with the requirements we have in place for BT. We require BT to do the following³²:

- If BT decides to change the auditors, they must notify us of the proposed change 28 days prior to change taking effect; and
- If we find the auditors unsatisfactory, BT must engage alternative auditors.

1.67 We have therefore decided that:

- (i) If Royal Mail intends to retain the existing auditors, it must notify us of its decision and the proposed terms of engagement 60 days before engagement. (The longer notice period in comparison with the requirement for BT is necessary because we would need to do a public consultation if we do not approve of the choice of the auditors or their terms of engagement, which is not necessary in BT's case.)
- (ii) If there is a tender process, Royal Mail must notify the name of the selected auditors and the proposed final terms of engagement as soon as the tender process has been completed. If we decide to consult on the choice of the auditors or their terms of engagement, then the formal engagement of the regulatory auditors will have to wait until we have concluded our consultation.

1.68 The possible outcomes under (ii) are as follows:

- (a) We are satisfied with the both the choice and the terms: the auditors are engaged as soon as possible.
- (b) We are not satisfied with the terms only: we will consult and change the terms. Royal Mail will have to wait for our decision.
- (c) We are not satisfied with the choice only and our decision after the consultation is that the choice is actually acceptable. Royal Mail can then proceed and engage the auditors.
- (d) We are not satisfied with the choice only and our decision after the consultation is that the choice is not acceptable. Royal Mail will have to consider engaging other auditors for the regulatory audit.

1.69 Clearly, outcomes (b) to (d) - and in particular (d) – could delay the commencement and thereby the completion of the audit. Royal Mail will therefore need to time the tender process, so far as possible, to avoid a delay in the publication of the audited annual regulatory accounts. The required deadline for the publication of the annual

³² 'The regulatory financial reporting obligations on BT and Kingston Communications Final statement and notification - Accounting separation and cost accounting Final statement and notification' dated 22 July 2004, see page 50, clauses OA12 and OA 13:

http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

regulatory accounts is 120 days after the year-end. These delays do not need to affect the statutory audit process which Royal Mail can press ahead with.

- 1.70 Outcomes (b) to (d), however, appear to be unlikely. In practice, we expect Royal Mail to discuss with us the participants in the tender and the terms of engagement, from the start or considerably earlier than the end of the tender process. We do not expect that Royal Mail would include auditors in a tender process or select them after the tender process, if we have our concerns about their suitability. We expect the same to apply to the terms of engagement.
- 1.71 Accordingly, Annex 1 sets out the updates to USPAC 1.3.5, 1.4.5 & 1.5.6.

Audit opinion

Our proposals

- 1.72 The annual regulatory financial statements should be prepared in accordance with the RAG³³ and the Guiding Principles set out in the USPAC³⁴. Currently, the audit opinion within the financial statements makes reference to compliance with the RAG only.³⁵
- 1.73 We proposed to require the audit opinion to include a reference to the Guiding Principles, in addition to the RAG (see Annex 2, page 10, definition of 'PPIA'). This will ensure that the assurance given by the audit is explicit that the accounts have been prepared in accordance with the Guiding Principles.

Responses

- 1.74 Royal Mail proposed³⁶ that the audit opinion should be amended to include the following statement: "These Financial Statements have been prepared in accordance with the Regulatory Accounting Guidelines, the Regulatory Accounting Methodology as agreed with the Regulator, based on the Guiding Principles as required within USPAC 1.7.2".

Our decisions

- 1.75 Royal Mail's proposed wording does not constitute an opinion on the compliance of the regulatory accounts with the Guiding Principles. It is a statement that RAG has been based on the Guiding Principles.
- 1.76 It is important for us that the audit opinion covers compliance both with the RAG and the Guiding Principles. In preparing the regulatory accounts, Royal Mail is required to refer to the RAG for guidance. If there is not sufficient guidance in the RAG – perhaps because the issue is too detailed or it is related to a new area that was not anticipated in the RAG - then Royal Mail is required to exercise its judgment in

³³ Section 10

³⁴ USPAC section 1.7

³⁵ http://www.royalmailgroup.com/sites/default/files/Regulatory_financial_Statements_2012-13_v2.pdf, see pages 20-22

³⁶ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 8.2 to 8.4

compliance with the Guiding Principles. Our proposal ensures the audit opinion covers the compliance of such exercise of judgement with the Guiding Principles.

- 1.77 Following Royal Mail's response, we discussed further the required audit opinion with Royal Mail and its auditors. We understand that while the auditors can in principle provide an audit opinion on the compliance of the regulatory account with the Guiding Principles, because of the limitations of any audit and the wording of the Guiding Principles, they may need to introduce certain qualifications with respect to some of the Guiding Principles, even where there is no evidence of non-compliance. We are working with Royal Mail and its auditors to agree these qualifications in more detail. Our aim is to achieve as much assurance as possible, without imposing disproportionate audit requirements or costs on Royal Mail.
- 1.78 Accordingly, Annex 2, page 10 shows the updates to the definition of 'PPIA'.

Content of reports

Quarterly exceptional items information

Our proposals

- 1.79 In the March 2012 Statement³⁷, we set out our view that the financial sustainability of the universal service should take into account the need for the universal service provider to be able to earn a reasonable commercial rate of return in connection with the provision of the universal service. It was decided an Earnings Before Interest and Tax ('EBIT') margin range of 5% to 10% is indicative of returns consistent with the financial sustainability of the universal service.
- 1.80 In the March 2012 Statement³⁸, we expressed our intention for the referenced EBIT margin to be a pre-exceptional measure of profitability. We also stated that we would not expect restructuring or redundancy costs, which are likely to recur year on year, to be included in exceptional items. We concluded that our decision to determine the exceptional nature of items would be made on a case by case basis.
- 1.81 A significant proportion of the transformation exceptional costs in the past financial years have been recurring redundancy and restructuring costs which we would not consider as exceptional.
- 1.82 Royal Mail is currently required to report EBIT before and after all exceptional costs in the annual regulatory income statement. A note to the accounts sets out a breakdown of the exceptional items. However, only EBIT before all exceptional items is required to be disclosed within the quarterly regulatory income statement.
- 1.83 We therefore proposed that Royal Mail would also be required to provide EBIT both before and after all exceptional costs within the quarterly regulatory income statements. In addition, we proposed that the annual and quarterly income statements contain a breakdown of the items of revenue or cost which Royal Mail categorises as exceptional, together with explanations as to the nature of each item and the reasons why it arose.

³⁷ Section 5

³⁸ Footnote 69, section 5

- 1.84 This would enable us to analyse the exceptional items on a case-by-case basis to determine their nature and recurring frequency, thus facilitating a more effective quarterly analysis and monitoring of Royal Mail's financial sustainability as the universal service provider.

Responses

- 1.85 Royal Mail agreed³⁹ that it is important for us to have a breakdown of the exceptional items. Royal Mail proposed that the breakdown of the exceptional items for the Reported Business in the regulatory accounts should be aligned with the level of disclosure provided in Royal Mail's statutory accounts.

Our decisions

- 1.86 We have decided to update the requirement as originally proposed. We also agree with Royal Mail's proposal about the level of disclosure (see paragraph 1.85).
- 1.87 Accordingly, Annex 2 sets out the updates to RAG Table 4: USPAC 1.4.1(a) & (b) and RAG Table 7: USPAC 1.5.2(a) & 1.5.2(b).

Revenue and volume information split by format

Our proposals

- 1.88 We proposed that Royal Mail provides revenue and volume split by format on a monthly basis. The trends in volumes of letters and large letters are significantly different from the trends in parcels; while the former is generally declining, the latter is growing. Therefore, format data would facilitate further analysis of the factors affecting the overall financial performance of the Reported Business.

Responses

- 1.89 Royal Mail agreed⁴⁰ that it was important for Ofcom to have revenue and volume information split by format, because it would help Ofcom understand the key underlying trends in the business. Royal Mail also pointed out that it reports similar information to the market.
- 1.90 However, Royal Mail stated that the reporting requirement should be monthly because quarterly reporting would provide the necessary level of detail for Ofcom to understand a key driver of business performance impacting the overall financial performance of the Reported Business.
- 1.91 We discuss Royal Mail's response with respect to monthly reporting in general in paragraphs 1.25 to 1.27.

³⁹ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 9.1 to 9.4

⁴⁰ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 11.1 and 11.2

- 1.92 UK Mail⁴¹ expressed concern that ‘parcels’ is a very wide format definition and it would cover postal items carried within both Royal Mail’s network and Parcelforce Worldwide’s network. UK Mail asked for our clarification and confirmation on what would be included within the proposed format categories.
- 1.93 We confirm that – as UK Mail has also pointed out in their response – our proposed requirement relates to the Reported Business only (i.e. it excludes Parcelforce Worldwide products). Therefore, by ‘parcels’, we only mean to include the parcels carried in Royal Mail’s network. We also add that our proposed requirement is based on Royal Mail’s definitions of ‘parcels’ and ‘letters’. Other postal operators may have different definitions.

Our decisions

- 1.94 We have decided to update the requirement as originally proposed. Accordingly, Annex 2 shows the updates to RAG Appendix 1, Figure 15(a).

Streamlining Product Profitability Statements

Our proposals

- 1.95 Royal Mail is currently required to provide quarterly and annual Product Profitability Statements (‘PPS’) for 32 product groups. These Statements are provided to Ofcom on a confidential basis, as part of the quarterly and annual regulatory accounts.
- 1.96 The product groups, on which the PPS are based, were defined as part of Postcomm’s market study in 2010, which is now out of date. We therefore proposed to modify and streamline the product groups to provide more targeted and relevant information. We also proposed to merge certain groups where granularity is not essential for our monitoring regime. The proposals would result in a reduction in the number of PPSs from 32 to 25 product groups.

Responses

- 1.97 Royal Mail agreed⁴² that our proposals, in particular the grouping of the products subject to specific regulatory measures (e.g. the USP Access margin squeeze control and the Safeguard Cap requirements) would provide more useful information for our monitoring of Royal Mail’s performance against regulatory targets.
- 1.98 Royal Mail stated that there may be further scope to refine the PPSs, following a full review of market definitions. While this may be true, currently there are no plans for us to carry out a full market review.
- 1.99 Royal Mail also stated it is not appropriate for the PPS for Relay to be published because this product is in a fully competitive market, and publication of its results places Royal Mail at a competitive disadvantage. As Royal Mail has also pointed out, we did not consult on removing the publication requirement for Relay PPS. The reason is that such a proposal will have to be based on a review of the specific

⁴¹ http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/UK_Mail.pdf, page 1

⁴² http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/responses/Royal_Mail.pdf, Para 13.2 and 13.3

market in which Relay is provided. Such a market review and indeed any market review was beyond the scope of the consultation.

- 1.100 Finally Royal Mail proposed that our proposed changes to the product profitability statements should be applied from the start of the 2014-15 financial year. This would mean that the structure of the regulatory accounts from the beginning to the end of the 2013-14 financial year is consistent, and therefore more readily comparable.
- 1.101 UK Mail stated that our proposed new PPS for 'Business and Advertising Mail D+2 Letters and Large Letters' would not capture all the products subject to our margin squeeze control which it should, because:
- The margin squeeze protection relates to Royal Mail's 'D+2 or later' retail bulk mail products and not only 'D+2' retail bulk mail products.
 - Royal Mail provides not only Business Mail and Advertising Mail, but also Publishing Mail and Sustainable Advertising Mail, which should be protected by our margin squeeze control.
- 1.102 UK Mail asked Ofcom to clarify how the proposed PPS achieves the reporting distinction necessary for correct operation of the margin squeeze control.
- 1.103 We clarify that the margin squeeze control required by the USP Access Condition 6 ('USPA 6') only covers 'D+2' retail bulk products and not 'later' products. USPA 6 applies to the 'Relevant Retail Services' which are defined as *"all Second Class Mailsort and Second Class Walksort services, and any current, new or successor retail services that are substantially similar services, offered by Royal Mail"*.⁴³
- 1.104 The definition of the 'Relevant Retail Services' also means that Publishing Mail is not covered by margin squeeze control, because Publishing Mail succeeded Presstream and not Second Class Mailsort or Walksort.
- 1.105 However, Sustainable Advertising Mail is covered by the margin squeeze control as Advertising Mail is. We therefore propose to clarify that in the naming and the definition of the PPS.

Our decisions

- 1.106 We agree with Royal Mail's proposal that the new requirement for the PPSs should come into effect from the start of 2014-15 financial year. Apart from this, we have decided to update the requirement as originally proposed.
- 1.107 In light of UK Mail's request for clarification, we have decided to rename the PPS 3 "Business, Advertising Mail, and Sustainable Advertising Mail D+2 Letters and Large Letters".
- 1.108 Accordingly, Annex 2 shows the updates to RAG Table 5.

Cash flow scenarios

Our proposals

⁴³ <http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex9.pdf>, USPA 1.3(x), and USPA 6.1

- 1.109 Royal Mail is currently required to provide us with quarterly consolidated cash flow projection Statements as per USPAC 1.3.1(d). In the RAG, we specify in detail what these Statements should include (RAG paragraph 3.2, Table 2). The RAG requires quarterly consolidated cash flow projection Statements to include three scenarios: (1) the 'best case' scenario; (2) the 'most likely' scenario; and (3) the 'worst case' scenario.
- 1.110 We proposed to remove the requirement for the above-mentioned three scenarios to allow Royal Mail to provide us with the sensitivity analyses which are provided to Royal Mail's Board. These do not necessarily include the three scenarios in the current RAG prescribed, but are expected to provide a range of likely outcomes to inform the Board.

Responses

- 1.111 Royal Mail welcomed our proposals because they meant using the same information that is provided to Royal Mail's Board to manage the business.

Our decisions

- 1.112 We have decided to update the requirement as originally proposed. Accordingly, Annex 2, which shows the updates to RAG Table 2, USPAC 1.3.1(d).