



Notice of modification to the control preventing Royal Mail margin squeeze

Proposal to remove unrecoverable VAT from the
calculation of downstream costs in USPA6.4

Consultation

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Section 1

Introduction and Notice

- 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 This 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 Together with the March 2012 Statement, we imposed a set of controls and accounting conditions. Included in these was a regulatory condition made pursuant to powers under section 38 and Schedule 3 of the Postal Services Act 2011 (the “Act”) (and in made in accordance with section 53 and paragraph 3 of Schedule 6 of the Act) to impose on Royal Mail, the universal service provider, an access condition. The access condition was made and notified on 27 March 2012 and is available at Annex 9 of the March 2012 Statement the (“USP Access Condition”).
- 1.3 The USP Access Condition gives access to Royal Mail's postal network to other postal operators and users. The USP Access Condition includes a price control condition on Royal Mail. This was imposed because it appeared to Ofcom (when setting the condition) that in the absence of the condition the Royal Mail might impose a price squeeze with adverse consequences for users of postal services.
- 1.4 The Access Condition as a whole relates to “D+2” services, which are retail services offered by Royal Mail that aim to deliver two working days after collection from the sender. Access to these services must be offered on reasonable request. Key obligations on D+2 services access are set out in paragraphs 2 and 3 of the USP Access Condition.
- 1.5 The margin squeeze condition is set out in paragraph 6 of the USP Access Condition. The condition aims to ensure that Royal Mail's pricing for retail services for bulk mail D+2 letters does not involve a price squeeze, with adverse effects for users of Royal Mail access services. An adverse effect might arise because such users of Royal Mail access services are themselves competing with Royal Mail for collection and outward processing i.e. upstream operations.
- 1.6 A central component of these conditions is the calculation of Royal Mail's upstream costs incurred by Royal Mail. These are the costs which Royal Mail incurs in relation to the collection and processing of post for presentation to the inward mail centre² as part of its D+2 retail bulk services.
- 1.7 The condition requires this cost to be calculated by subtracting identified Access services downstream costs³ from the total Royal Mail (end-to-end) cost of the D+2

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

² The “inward mail centres” are where the processes of the final sorting of mail prior to delivery are conducted.

³ “Downstream Costs” means the costs, as calculated in accordance with Royal Mail's Costing Manual, of downstream activities which are the activities relating to the conveyance of mail items from the inward mail centre to the final destination.

retail bulk services. However, as part of our regular compliance reviews of Royal Mail's retail activities, we have highlighted an ambiguity with respect to cost items to be included in the calculation of downstream access cost (required in paragraph 6.4 of the USP Access Condition).

- 1.8 Specifically, the condition may, as it is currently drafted, be unclear and incorrect in one respect as to the treatment of unrecoverable VAT as a cost in this calculation. Unrecoverable VAT is a significant cost element in Access services downstream costs but not in Royal Mail's cost of the D+2 retail bulk service.
- 1.9 In light of the fact that VAT is recoverable in the Royal Mail's bulk retail activities it is therefore not relevant when considering the calculation of costs of providing those services (and the pricing floor) under price control condition and it should not be included in any part of the calculation of Royal Mail's upstream costs. However, as unrecoverable VAT is a cost element for Access services downstream costs (as Access services are exempt from VAT), the condition as it is currently drafted might appear to allow unrecoverable VAT to be part of the calculation.
- 1.10 Ofcom considers that if VAT costs were included there would therefore be potential to distort the outcome sought by the operation of the pricing condition.
- 1.11 We are proposing, therefore to modify paragraph 6.4 in the USP Access Condition to explicitly remove unrecoverable VAT from the downstream cost calculation. A marked-up version of the USP Access Condition which shows these modifications to paragraph 6.4 is set out in Annex 4.
- 1.12 Section 2 explains the nature of unrecoverable VAT that concern Ofcom, how it arises and how it affects the calculation.
- 1.13 Ofcom is satisfied that this proposal satisfies the general test in paragraph 1 of Schedule 6 to the Act.
- 1.14 Copies of this Notice and the accompanying Consultation document have been sent to the Secretary of State in accordance with paragraph 5(1)(a) of Schedule 6 to the Act.

Signed by

A handwritten signature in black ink, appearing to read 'Chris Newb', with a long horizontal line extending from the end of the signature.

Competition Policy Director

A person duly authorised by Ofcom under paragraph 18 of the Schedule to the Office of Communications Act 2002

28 November 2013

Section 2

Background and proposal

- 2.1 The detailed discussion on these ex-ante controls were first set out in Annex 7 of our consultation “Securing the Universal Postal Service: Proposals for the future framework for economic regulation”⁴ of 20 October 2011 (“October 2011 Consultation”). In this discussion we noted the success of the original Postcomm intervention in 2006 which encouraged competitive entry in upstream services by directly controlling the headroom between Royal Mail retail prices and its Access service charge offered to new entrants.
- 2.2 However, in 2012, we moved away from explicit headroom controls to regulation that allowed more flexibility so as to ensure that Royal Mail would have similar pricing freedom as its upstream competitors.
- 2.3 To allow this we needed to ensure that the costs against which Royal Mail was pricing were equivalent to that of an equally efficient operator; in other words it was not able to undercut access operators purely by virtue of its vertical integration with the downstream system.

Intent of existing regulations

- 2.4 In constructing the USP Access Condition, we were conscious that the preferred test for margin squeeze was a comparison of prices against the Long Run Incremental Costs (“LRIC”) of Royal Mail’s upstream services.
- 2.5 However, in the absence, at that time, of a robust LRIC model we based the condition on Fully Allocated Costs⁵ but with the aim that this test should “should provide an appropriate step in a glide-path between the existing headroom control and our preferred long-term vision of how the risk of margin squeeze should be addressed in the future ... (when the) control should be replaced in the long-term by an approach more consistent with competition law, which is likely to use LRIC as the relevant cost measure”⁶.
- 2.6 Such a glide-path clearly identifies the need for the derived upstream costs to as accurately as possible (subject to the limits of FAC) include all those costs that Royal Mail Retail must recover within its pricing. It is, therefore, essential that the derived upstream cost is not inappropriately reduced through the calculation set out in the condition.
- 2.7 As set out in Annex 7 of the October 2011 Consultation, paragraphs 7.46, and confirmed in the March 2012 Statement, Royal Mail is required to recover Upstream FAC across a basket of products with a further headroom control relating to individual new contracts at a proportion of FAC. This is set out in USPA 6.2.

⁴ <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/annex7.pdf>

⁵ Fully allocated costs are the summation of direct and allocated costs for a product, or product group, developed in a cost study in which none of the firm’s joint and common costs are left unallocated. In this case the FAC are derived from Royal Mail’s costing manual are agreed with Ofcom.

⁶ Annex 7 of the October 2011 Consultation paragraph 7.44

- 2.8 The approach set out in detail in Annex 7 detailed the calculations for determining the Upstream FAC. Specifically:

“Upstream FAC is calculated as the end-to-end FAC less the equivalent access FAC (including wholesale costs)

- Under this approach, the direct costs of Royal Mail Wholesale are included in access costs and by virtue reduce the minimum level of costs that Royal Mail must recover to meet the requirements of the margin squeeze control. “

Treatment of unrecoverable VAT

- 2.9 In setting out the approach described above, the issue of the treatment of unrecoverable VAT was not discussed.
- 2.10 Unrecoverable VAT arises when a trader is selling goods or service which is not subject to VAT. In such cases, the VAT that the trader has paid on its input goods and services, which are needed to deliver VAT-exempt output goods and services, cannot be reclaimed. This input VAT is unrecoverable, hence simply a cost component of the output goods or service.
- 2.11 In the context of the ex-ante margin squeeze condition, the issue arises due to the different VAT treatment of Access Services and Royal Mail Bulk mail services. The former, as it is considered to be subject to mandated provision, is exempt from VAT by HMRC, the latter is not.
- 2.12 By way of explanation, Royal Mail pays VAT on services it receives from third parties which are necessary to run downstream operations. The downstream operations are necessary for Royal Mail's delivery of both retail and Access Services. For example, Royal Mail pays VAT on electricity and fuel used in downstream operations. When Royal Mail then retails its services through its upstream component, it charges VAT to its customers and, in turn, is entitled to reclaim from HMRC the input VAT it has paid on the electricity and fuel which have been used to deliver those retail services. However, when Royal Mail provides Access Services it does not charge VAT which means that it is not able to reclaim the input VAT it has paid on the electricity and fuel used to deliver those Access services. Thus unrecoverable VAT is a feature of the Access service downstream costs but not Royal Mail's end-to-end costs.
- 2.13 However, the price control condition seeks in paragraph 6.4 to deduct the downstream costs attributable to the provision of access services, rather than the downstream costs attributable to retail services. This is because for the purposes of this control the downstream cost of access services are a proxy for the downstream costs of end-to-end retail services.
- 2.14 As downstream costs of access services are being used as a proxy, they should as far as possible be composed of the same cost elements (or equivalent cost elements) as you would expect to be in the Royal Mail's end-to-end cost for retail services⁷. Accordingly VAT payments made by Royal Mail in connections with these

⁷ For the purposes of margin squeeze control, we allow Royal Mail to include its wholesale specific costs in the downstream costs attributable to the provision of access services, as we assume these costs are broadly efficiently incurred. See Annex 7 of the October 2011 Consultation, page 42, footnote 18: <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/annex7.pdf>

downstream costs for access services should not be taken into account in the calculation.

- 2.15 If unrecoverable VAT from downstream costs were to be deducted from the End-to-End cost of retail bulk services (under calculation required by the price control), this would mean that the upstream costs Royal Mail has to recover in its pricing would be, in our view, artificially reduced.
- 2.16 Such a reduction would impede the objective sought by the pricing condition and distort the pricing condition in its application. The distortion would be that the VAT cost would be an additional deductible cost from the total of end-to-end retail costs. This would lower the cost floor further than intended by the condition such that the cost floor would actually be a sum which was below the upstream costs within the end-to-end bulk retail services (which the condition is aiming to calculate and identify).
- 2.17 This would increase the risk that an equally efficient upstream operator would not be able to sustainably compete with Royal Mail because its cost floor would be expected to be higher than the cost identified in this calculation.
- 2.18 As we noted in the March 2012 Statement paragraph 1.50, we refrained from directly regulating the price of access. Instead, we intended to ensure, “by means of an ex ante margin squeeze test, that the difference between its access price and the equivalent retail price is consistent with principles that will provide for effective competition between Royal Mail and access operators”. We further noted in paragraph 2.12 that the “margin squeeze test that ensures the difference between the access price and retail price is kept at a level that allows efficient access competitors to compete effectively”.
- 2.19 In our opinion, the inclusion of unrecoverable VAT in the calculations would not be consistent with this policy intent and so we wish to remove ambiguity as to how it should be treated for the purposes of the calculation.
- 2.20 Accordingly, we are proposing a modification of USP6.4 which explicitly removes unrecoverable VAT from the Downstream cost calculation. The revised condition is set out in Annex 4.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 10 January 2014**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <http://stakeholders.ofcom.org.uk/consultations/royal-mail-margin-squeeze/howtorespond/form>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email markham.sivak@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Markham Sivak
Floor 4
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4109
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Markham Sivak on 020 7783 4659.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether

all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in early 2014.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom's consultation champion:

Graham Howell
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email Graham.Howell@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. 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

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 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 to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

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)

Annex 4

Modification to USPA6.4

Please see Annex 9 of the March 2012 Statement, referenced in the footnote to paragraph 1 of this Notice for the full text of the USP Access Condition.

The text in bold italics below indicates the wording we propose to make after the word “costs” in sub-paragraphs (a) and (b) of paragraph 6.4.

“6. Control to prevent price squeeze

USPA 6.1	<p>Unless <u>OFCOM</u> direct otherwise, the <u>universal service provider</u> shall in setting prices be subject to the requirement to take all reasonable steps to ensure that it:</p> <ul style="list-style-type: none"> (a) maintains a minimum margin between the retail prices of the <u>Relevant Retail Services</u> and the access charges for the <u>Relevant Access Services</u> during the <u>Relevant Period</u> in accordance with USPA 6.2 to USPA 6.5 below; and (b) maintains a minimum margin in relation to every individual contract between the retail price of the <u>Relevant Retail Service</u> and the access charge for the <u>Relevant Access Service</u> during the <u>Relevant Period</u> in accordance with USPA 6.2 to USPA 6.5 below.
USPA 6.2	<p>In order to satisfy the requirements in USPA 6.1(a) and (b) to maintain a minimum margin, the <u>universal service provider</u> must have a reasonable expectation that:</p> <ul style="list-style-type: none"> (a) <u>Relevant Upstream Revenue</u> will be no less than <u>Relevant Upstream Costs</u> for the <u>Relevant Period</u>; and (b) the <u>Relevant Upstream Revenue</u> for each individual contract for any <u>Relevant Retail Service(s)</u> will be equal to or more than 50% of the <u>Relevant Upstream Cost</u> for that individual contract for the <u>Relevant Period</u>.
USPA 6.3	<p><u>Relevant Upstream Revenue</u> should be calculated by deducting <u>Relevant Downstream Revenue</u> from <u>Relevant End to End Revenue</u> where:</p> <ul style="list-style-type: none"> (a) <u>Relevant End to End Revenue</u> is the revenue that the <u>universal service provider</u> earns from the supply of <u>Relevant Retail Services</u> during the <u>Relevant Period</u>; and (b) <u>Relevant Downstream Revenue</u> is calculated by multiplying the average price per unit charged by the <u>universal service provider</u> for <u>Relevant Access Services</u> by volume during the <u>Relevant Period</u>.

USPA 6.4	<p><u>Relevant Upstream Costs</u> should be calculated by deducting <u>Relevant Downstream Costs</u> from <u>Relevant End to End Costs</u> where:</p> <p>(a) <u>Relevant Downstream Costs</u> are the costs (not including recoverable or unrecoverable Value Added Tax) attributed to the provision of <u>Relevant Access Services</u> as calculated in accordance with <u>Royal Mail's Costing Manual</u>, subject to <u>Directed Adjustments</u> that <u>OFCOM</u> may direct from time to time; and</p> <p>(b) <u>Relevant End to End Costs</u> are the total costs (not including recoverable or unrecoverable Value Added Tax) of providing the <u>Relevant Retail Services</u> on an end to end basis as calculated in accordance with <u>Royal Mail's Costing Manual</u>.</p> <p>Unless <u>OFCOM</u> otherwise direct, the value of <u>Directed Adjustments</u> shall be zero.</p> <p>In calculating 6.4(a) and 6.4(b) the <u>universal service provider</u> should exclude <u>Downstream Costs</u> to the extent that those <u>Downstream Costs</u> relate to activities which are common to both <u>Relevant Access Services</u> and <u>Relevant Retail Services</u>, or are incurred in a directly comparable manner between <u>Relevant Access Services</u> and <u>Relevant Retail Services</u>.</p>
USPA 6.5	<p>The <u>Relevant Period</u> during which the minimum margin referred to in USPA 6.1(a) and 6.1(b) above shall be maintained is twelve months.</p>
USPA 6.6	<p>The <u>universal service provider</u> shall set prices for the <u>Relevant Retail Services</u> and the <u>Relevant Access Services</u> at the start of each <u>Relevant Period</u> or at any point within the <u>Relevant Period</u> on the basis of a forecast of the costs and volumes for that period.</p>
USPA 6.7	<p>The <u>universal service provider</u> shall be required to provide the following information at the start of the first <u>Relevant Period</u> and thereafter on a quarterly basis:</p> <p>(a) With respect to each <u>Relevant Contract</u> for <u>Relevant Retail Services</u> that the <u>universal service provider</u> has entered into during the previous quarter or that has been materially amended during that quarter, the following information:</p> <ul style="list-style-type: none"> i. prices; ii. volumes; iii. date that the <u>Relevant Contract</u> was signed or most recently materially amended; iv. length of the <u>Relevant Contract</u> if applicable; and <p>(b) such other information as <u>OFCOM</u> considers necessary in order to enable it to ensure compliance with the requirements of USPA 6."</p>