
Review of regulatory financial reporting for Royal Mail

Cost allocation and transfer pricing

STATEMENT:

Publication Date: 23 July 2019

Contents

Section

1. Overview	2
2. Background	4
3. Our requirements for costing data and Phase II review	11
4. Changes to our costing rules	20

Annex

A1. Direction: new Regulatory Accounting Guidelines (RAG)	Separate document
---	-------------------

1. Overview

As the universal service provider for postal services in the UK, Royal Mail is required to prepare financial information under our financial regulatory reporting requirements. This information plays an important role in our monitoring of the financial sustainability and efficiency of the provision of the universal services as well as the interests of the consumers and the competition in the postal market. We therefore need to ensure that this information remains fit for purpose.

This statement sets out the conclusions of Phase II of our regulatory reporting review, examining specific aspects of the costing and accounting methodologies applied by Royal Mail in preparing its regulatory financial reports. Phase I focused on the form and content of the reports.¹

What we have decided – in brief

As explained in more detail in this statement:

- We have revised some of our costing rules to ensure that cost data Royal Mail provides remains robust and fit for our monitoring purposes in the future.
- Royal Mail may need to make adjustments to some of its cost allocation methods as a result of our findings and in order to comply with our revised costing rules. We will engage with Royal Mail as they carry out any necessary adjustments.
- Royal Mail must provide more supporting data in its regulatory financial reporting to ensure adequate transparency over some of the new allocation methods.
- Transfer prices must be set on a fully allocated cost basis plus an appropriate return.
- Royal Mail is required to comply with the revised requirements for the financial information and reports due for the quarter and the year ending 29 March 2020 and thereafter.

Royal Mail is in the process of implementing a new strategy that involves changes to its UK network (including the universal service network). These changes may lead Royal Mail to change its cost allocation methods further. We will continue to monitor these cost allocation changes and also, if necessary, our costing rules to ensure the cost allocations in Royal Mail's FAC data remain fit for our monitoring purposes.

Introduction

- 1.1 On 18 December 2017, we published a statement setting out our decisions following Phase I of our review of the regulatory financial reporting requirements for Royal Mail. In that document, we set out modifications to the Universal Service Provider Accounting Condition (USPAC) and the Regulatory Accounting Guidelines (RAG). These modifications related mainly to the content, frequency and deadlines for the required regulatory financial reports and the related audit requirements.
- 1.2 Phase II of our review focused on the application of our costing rules in the RAG in light of changes to the cost allocation methods made by Royal Mail in 2013/14 and 2016/17. We

¹ Ofcom, 2017. [*Regulatory financial reporting for Royal Mail – Statement*](#).

published a consultation on 19 December 2018 (December 2018 Consultation) setting out our proposals to amend some of our costing rules to ensure that they remain fit for purpose.²

- 1.3 This statement sets out our amendments to those costing rules (as well as some minor amendments to transfer pricing rules). The first three sections provide an overview of our duties and regulatory objectives, regulatory financial reporting requirements for Royal Mail, and how we use the information they provide. We expect these sections to be of interest to a wide range of stakeholders that have an interest in the postal sector.
- 1.4 In Section 4 we explain our proposals set out in the December 2018 Consultation, stakeholders' responses and the amendments we have decided to make to the relevant costing rules. The modifications we have made to the RAG to reflect those amendments are set out in the statutory notification, which is published at Annex 1. This annex is likely to be of interest primarily to Royal Mail and other stakeholders with an interest in the technical details of our regulatory financial reporting requirements.

² Ofcom, 2018. [Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation](#).

2. Background

- 2.1 In this section, we set out:
- the background to our monitoring regime;
 - the effect of Royal Mail's changes to the cost allocation methods in 2013/14 and 2016/17;
 - our relevant powers and duties and the relevant sectoral rules;
 - our broader policy objectives for this Phase II review; and
 - explain our approach to our impact assessment and our equality impact assessment for our decisions.

Our monitoring regime

- 2.2 In March 2012, we put in place a new regulatory framework for post which gave Royal Mail more commercial freedom and operational flexibility. We also put in place regulatory safeguards to protect consumers and, where appropriate, promote effective competition. One such safeguard was a comprehensive monitoring regime.
- 2.3 The monitoring regime enables us to assess how well the regulatory framework is working to meet our regulatory objectives of securing the provision of the universal service, incentivising efficiency improvements, maintaining quality of service standards and ensuring universal services remain affordable. The monitoring regime also helps us consider the impact of any changes on the regulatory framework and assess whether there is a need to intervene to protect the universal service, customers and competition.
- 2.4 The monitoring regime relies on our regulatory financial reporting requirements for Royal Mail to provide us with relevant financial information. These requirements are set out in the USP Accounting Condition (USPAC) and are supplemented by the Regulatory Accounting Guidelines (RAG).
- 2.5 The detailed requirements in the RAG include, among other things, costing rules that explain how Royal Mail must calculate and allocate national average fully allocated costs (FAC) data.
- 2.6 The national average FAC data provides a good first-order view of Royal Mail's product costs and how they change over time. These product costs are a key input in our monitoring of competition and consumer issues and how the market is working for competition and consumers. FAC is also a key input in monitoring the financial sustainability and efficiency of the provision of the universal service where there is a need to have full view of all costs incurred. FAC is also currently used in our *ex ante* margin squeeze control which is intended to ensure an appropriate margin between Royal Mail's wholesale access and retail bulk prices.

Changes to the cost allocation methods in 2013/14 and 2016/17

- 2.7 In 2013/14 and 2016/17, Royal Mail made a series of changes to its cost allocation methods which affected the way the national average FAC was allocated to products. According to Royal Mail, the key reason for these changes was to ensure the costing reflected the new operational reality on the ground including the introduction of new delivery methods. These new delivery methods included, among other elements, the removal of bicycles, the introduction of High Capacity Trolleys (HCTs) and the use of Shared Vans.
- 2.8 The effect of these changes seemed to be broadly: (i) to allocate more costs to letter products by moving costs away from parcel products; and (ii) to allocate more costs to USO parcel products by moving costs from non-USO parcel products. We consider these changes in detail in Sections 3 and 4.

Our powers and specific duties

Our powers to impose or modify the sectoral rules

- 2.9 The legal framework relating to the regulation of postal services is set out in the Postal Services Act (PSA) 2011, which transposes the EU Postal Services Directive³ into UK legislation.
- 2.10 Our decisions in this statement concern specific changes to our Regulatory Accounting Guidelines (the “RAG”). The obligation on Royal Mail to comply with the RAG is derived from our powers under section 39 of the PSA 2011 to impose a USP accounting condition (“USPAC”) on Royal Mail as the universal service provider. Specifically, under the USPAC, we may require Royal Mail to do one or more of the following things:
- To maintain a separation for accounting purposes between such different matters as we may direct for such purposes as we may direct, including separation in relation to different services, facilities or products or in relation to services, facilities or products provided in different areas as well as the accounting methods to be used in maintaining the separation.
 - To comply with rules made by us in relation to those matters about the identification of costs and cost orientation, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such accounts and other information relating to anything required to be done by us in this regard.
 - To comply with rules made by Ofcom about the use of cost accounting systems in relation to those matters, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such

³ [Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service](#), as amended in particular by *Directive 2002/39/EC* and *Directive 2008/6/EC*.

accounts and other information relating to anything required to be done by Ofcom in this regard.

- To secure that the universal service provider's compliance with those systems is audited annually by a qualified independent auditor, including an obligation to meet the costs of the audit.

2.11 Our powers to impose a regulatory condition, like the USPAC, include powers to impose obligations also requiring the universal service provider to comply with directions with respect to the matters to which the condition relates, and also powers to impose obligations with respect to those matters framed by reference to, or conditional on, our consent, approval or recommendation.⁴ The process for giving, modifying or withdrawing such directions is similar to the statutory process for imposing, modifying or revoking regulatory conditions, including to consult for a minimum of one month prior to making our decision.

2.12 We may, however, impose or modify a regulatory condition only if we are satisfied that the general test set out in paragraph 1 of Schedule 6 to the PSA 2011 is met. According to this test, Ofcom must be satisfied that the condition is objectively justifiable, does not discriminate unduly against particular persons or a particular description of persons, is proportionate to what it is intended to achieve and is transparent in relation to what it is intended to achieve. A similar test also applies in giving, modifying or revoking directions imposing more detailed requirements and rules under the USPAC, such as the RAG.⁵

Our statutory duties

2.13 In carrying out our functions, such as exercising our above-mentioned powers (including to modify the RAG), Ofcom's principal duty under the Communications Act 2003 (the "CA 2003") is to further the interests of citizens and of consumers, where appropriate, by promoting competition. For postal services, we also have a duty under the PSA 2011 to secure the provision of a universal postal service, to which we must give priority if we consider that there is any conflict with our principal duty. We explain in more detail below how these duties fit together.

2.14 Section 29(1) of the PSA 2011 provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service. Section 29(2) of the PSA 2011 provides that Ofcom's power to impose access or other regulatory conditions, like the USPAC, is subject to the duty imposed by section 29(1) of the PSA 2011.

2.15 Section 29(3) of the PSA 2011 provides that, in performing our duty under section 29(1), we must have regard to the need for the provision of a universal postal service to be:

- financially sustainable; and

⁴ Paragraph 2 of Schedule 6 to the PSA 2011.

⁵ Paragraph 4(2) of Schedule 6 to PSA 2011.

- efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 2.16 Section 29(4) of the PSA 2011 states that ‘financially sustainable’ includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.
- 2.17 Section 29 of the PSA 2011 does not require that Ofcom gives more weight to one of those considerations referred to in section 29(3) over the other. We must take them both into account in arriving at a judgment as to how we ought to carry out our functions, including when considering imposing or modifying regulatory conditions.
- 2.18 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom’s general duties in the CA 2003 in the case of conflict between the two where Ofcom is carrying out its functions in relation to postal services. However, if we consider that no conflict arises, Ofcom must carry out our functions in accordance with these general duties and so must further the interests of citizens and of consumers, where appropriate by promoting competition.
- 2.19 Ofcom does not consider that there is any conflict between its duty to secure the provision of the universal postal service and its general duties in respect of our proposals in this consultation.
- 2.20 In performing its general duties, Ofcom is also required under section 3(4) of the CA 2003 to have regard to a range of other considerations, which appear to Ofcom to be relevant in the circumstances. In relation to our proposals in this consultation, we consider that the following considerations appear particularly relevant:
- the desirability of promoting competition in relevant markets; and
 - the desirability of encouraging investment and innovation in relevant markets.
- 2.21 Section 3(5) of the CA 2003 provides that, in performing its duty to further the interests of consumers, Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.
- 2.22 Additionally, pursuant to section 3(3) of the CA 2003, in performing its general duties, Ofcom must have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice. In this regard, we also note Ofcom’s general regulatory principles.⁶
- 2.23 Finally, we have an on-going duty under section 6 of the CA 2003 to keep the carrying out of our functions under review with a view to ensuring that regulation by Ofcom does not involve the imposition of burdens which are unnecessary or the maintenance of burdens which have become unnecessary.

⁶ See [What is Ofcom?](#)

Our current sectoral rules relevant in this context

- 2.24 On 27 March 2012, we published a statement on securing the Universal Postal Service (the March 2012 Statement).⁷ This set out our decision on the new regulatory framework for the postal sector, which gave Royal Mail more commercial freedom and operational flexibility (particularly in relation to setting its prices). Regulatory safeguards were however implemented to protect consumers and, where appropriate, promote effective competition.
- 2.25 One such safeguard was an effective and comprehensive monitoring regime. In our March 2012 Statement, we noted that establishing a comprehensive monitoring regime was essential to ensure that Royal Mail's commercial and operational flexibility was used in a way that accords with our regulatory objectives in respect of the universal service.
- 2.26 The monitoring regime relies on our regulatory financial reporting requirements for Royal Mail to provide us with relevant financial information. These requirements are imposed on Royal Mail in the USPAC, as supplemented by our more detailed requirements in the RAG. One specific set of detailed requirements contained in the RAG are our rules that govern the so-called National Costing Methodology that Royal Mail applies to calculate national average Fully Allocated Costs (FAC) data. These specific rules are known as the National Costing Rules (NCRs), which are the main subject of our decisions in this statement. We therefore discuss the detail of the relevant NCRs affected by our proposals in Section 5.
- 2.27 The main purposes of the USPAC (as well as the related RAG) is to provide assurance that we can rely on the financial information reported by Royal Mail for regulatory purposes. In that regard, the USPAC also sets the high-level regulatory accounting principles (the 'Guiding Principles'), as well as the types of information Royal Mail must provide and/or publish, including the deadlines and frequency. The RAG contains, in particular, the detailed regulatory accounting rules (including costing rules such as the NCRs) which may change over time to adapt to Royal Mail's operational changes and our regulatory needs and priorities.
- 2.28 In Section 3, we explain how Royal Mail's FAC data is prepared and how we use that data for our regulatory purposes. We also explain in further detail the role that the Guiding Principles and the NCRs play in the preparation of FAC.

Our broader policy objectives in this context

- 2.29 As part of Phase I of our review, we adopted revised objectives for the regulatory financial reporting requirements to assess whether the existing regulatory financial reporting continued to provide us with the information appropriate to enable us to meet our above-mentioned duties, for the purposes of the overall regulatory framework, in light of the changes in the postal market. Those objectives were:

⁷ Ofcom, 2012. [*Securing the Universal Postal Services – Decision on the new regulatory framework*](#).

- a) monitoring the financial sustainability of the universal service provision;
- b) monitoring the efficiency of universal service provision;
- c) monitoring competition in the postal market; and
- d) protecting the interests of consumers.

2.30 We consider that those four objectives remain relevant to this Phase II of our review, including our decisions in this statement. In Section 3, we explain how the FAC data helps us in achieving these objectives and how our Phase II review is guided by these objectives.

2.31 The financial regulatory reporting requirements, together with the information we obtain from other operators, provide us with the information necessary for our monitoring regime. As explained above, the monitoring regime allows us to assess how well the regulatory framework, as a whole, is working to meet our regulatory objectives which includes securing the provision of the universal service, incentivising efficiency improvements, maintaining quality of service standards, and ensuring universal services remain affordable. The monitoring regime helps us consider the impact of any changes on the regulatory framework and assess whether there is a need to intervene to protect the universal service, customers and competition.

General impact assessment

2.32 The analysis presented in this statement represents in its entirety an impact assessment, as defined in section 7 of the CA 2003.

2.33 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy making. This is reflected in section 7 of the CA 2003, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see our guidelines, *Better Policy Making: Ofcom's approach to Impact Assessment*.⁸

2.34 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the CA 2003) is secured or furthered by or in relation to what we propose.

Equality impact assessment

2.35 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation;

⁸ Ofcom, 2005. [*Better Policy Making: Ofcom's Approach to Impact Assessment*](#).

- advance equality of opportunity between different groups; and
- foster good relations between different groups

in relation to the following protected characteristics: age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation.

2.36 Such equality impact assessments also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 mentioned above.

2.37 We have therefore considered what (if any) impact the decisions in this statement may have on equality. Having carried out this assessment, we are satisfied that our decisions are not detrimental to any group defined by the protected characteristics set out above.

3. Our requirements for costing data and Phase II review

3.1 In this section we summarise our requirements for costing data produced by Royal Mail as part of our regulatory financial reporting framework. We also set out an outline of the principles and rules which we impose on Royal Mail as part of that framework to ensure the costing data is fit for purpose. We then explain how we use the costing data in achieving our regulatory objectives and the aims and scope of our Phase II review.

Our regulatory financial reporting framework

3.2 On 27 March 2012, we published the Securing the Universal Postal Service Statement (the “March 2012 Statement”).⁹ This set out our decision on the new regulatory framework for the postal sector, which gave Royal Mail more commercial and operational flexibility (particularly in relation to setting its prices). However, we also introduced regulatory safeguards to protect consumers and, where appropriate, promote effective competition.

3.3 One such safeguard was an effective and comprehensive monitoring regime¹⁰, which relies on our regulatory financial reporting requirements for Royal Mail to provide relevant financial information. As explained in Section 2, these requirements are imposed on Royal Mail in the USPAC, as supplemented by our more detailed requirements in the RAG. We explain later in this section the objectives of the monitoring regime and how the costing data helps us in achieving those objectives.

3.4 Our regulatory financial reporting framework requires Royal Mail to produce national average Fully Allocated Costs (FAC) data¹¹ which underpins much of its financial regulatory reports. There is also a set of detailed requirements contained in the RAG that govern the ‘National Costing Methodology’ which Royal Mail applies to calculate national average FAC data. These specific rules are known as the National Costing Rules (NCRs). We explain the role of the NCRs in this section and in Section 4 we set out the changes we are making to ensure the FAC data remains robust for regulatory monitoring purposes in the future.

The USPAC and the RAG

3.5 One of the main purposes of the USPAC and the RAG is to provide assurance that we can rely on the financial information reported by Royal Mail for regulatory purposes. It sets the high-level regulatory accounting principles (the ‘Guiding Principles’) and sets out the types

⁹ Ofcom, 2012. [Securing the Universal Postal Service: Decision on the new regulatory framework](#).

¹⁰ In our March 2012 Statement, we noted that establishing a comprehensive monitoring was essential to ensure that Royal Mail’s commercial and operational flexibility was used in a way that accords with our regulatory objectives in respect of the universal service.

¹¹ Royal Mail also produces zonal costing data which is not the subject of this consultation.

of information Royal Mail must provide and/or publish, including the publication and audit requirements, deadlines and frequency.

- 3.6 The RAG contains detailed regulatory accounting rules, including costing rules such as the NCRs, which may change over time to adapt to Royal Mail's operational changes and our regulatory needs and priorities.
- 3.7 The USPAC and RAG provide a framework within which Royal Mail can choose methods to allocate its costs.

Guiding Principles

- 3.8 USPAC 1.7 outlines the obligation to comply with the Guiding Principles and provides details of those principles.
- 3.9 There are eight principles which provide Royal Mail with the broad framework for the allocation of costs. They are:
 - a) Completeness;
 - b) Equivalence;
 - c) Causality;
 - d) Objectivity;
 - e) Accuracy;
 - f) Compliance with the statutory accounting standards;
 - g) Consistency; and
 - h) Materiality.
- 3.10 When there is a conflict between the Guiding Principles, the conflict must be resolved using the hierarchy as listed in USPAC 1.7.1 (as listed above). Put broadly, if there are relevant specific rules in the RAG for a case in hand, then those more detailed specific rules must be applied obviating the need to appeal to the Guiding Principles.

National Costing Rules

- 3.11 Section 8 of the RAG contains the National Costing Rules ("NCR"). These rules provide Royal Mail with additional guidance and more detail of how to allocate costs in order to calculate national average FAC.¹² They aim to provide Royal Mail with clear limits, while still allowing it a significant degree of freedom when choosing the cost allocation methods.
- 3.12 There is no specified order in which to apply the NCRs and all rules will not necessarily apply to all costs and products. However, we expect Royal Mail to demonstrate compliance with all the relevant rules for each item of cost.

¹² Royal Mail also produces zonal costing data which is not the subject of this consultation.

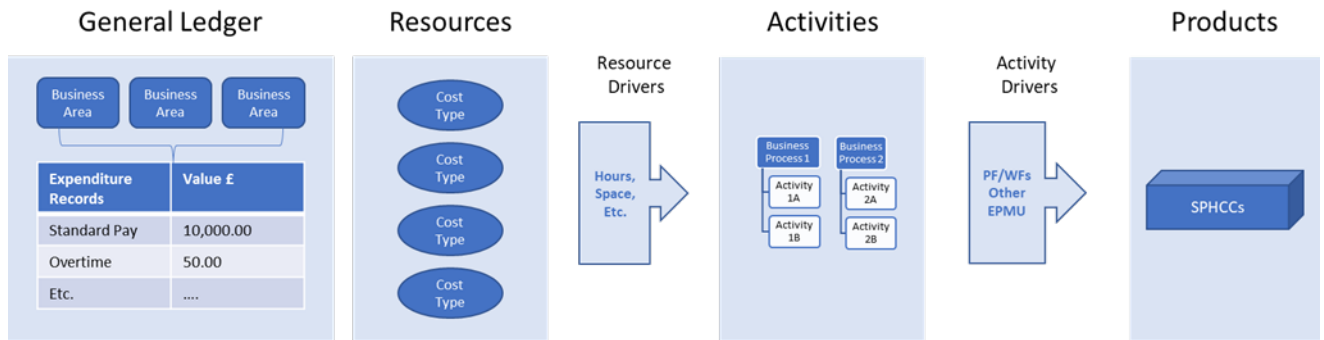
- 3.13 Where conflict between the rules arises, we expect Royal Mail to identify the nature of the conflict and document the manner in which it chooses to resolve it. In doing so, Royal Mail should explain its choice of rules, which rules have been disregarded and why that is deemed appropriate.

Activity Based Costing

- 3.14 The NCRs in the RAG require Royal Mail to calculate the national average FAC using Activity Based Costing (ABC). Royal Mail's ABC costing system produces national average FAC by allocating all direct costs as well as a share of common costs to each product.
- 3.15 The ABC approach identifies and allocates costs to Activities, based on the resources consumed by those Activities. Then it allocates the resulting Activity Costs to products based on the contributions of the relevant Activities to those products.
- 3.16 As illustrated in figure 3.1, the main components and allocation steps in Royal Mail's ABC approach are as follows:
- a) All costs of the Reported Business¹³ which have been recorded in the General Ledgers of Royal Mail's accounting systems are grouped into Cost Types.
 - b) Business Processes, which are largely the same as the elements of Royal Mail's network (e.g. processing and indoor and outdoor delivery) are divided into Activities, which are various tasks or work (whether operational or non-operational) required to complete a Business Process.
 - c) Activities are costed by allocating Cost Types to them using Resource Drivers which determine what proportion of each Cost Type must be allocated to each relevant Activity.
 - d) Activity Costs are then allocated, using Activity Drivers to Sales Product Handling Characteristic Combinations (SPHCCs) which are commercial products and services broken down further to allow more accurate and causal cost allocation. Activity Drivers represent the relative contribution of each Activity to the relevant SPHCCs.

¹³ Ofcom, USP Accounting Condition, Schedule dated 18 December 2017, USPAC 1.1.2 Definitions, (s) "Reported Business" means the part of Royal Mail's business that undertakes activities for the purpose of, or in connection with, the provision of USO and non-USO (including, but not limited to, non-Mails), the fully allocated costs of which are derived by the National Costing Methodology and Zonal Costing Methodology as described in the Costing Manual. For the avoidance of doubt, those activities shall be treated to include all the activities, products and/or services which fall within the scope of the Costing Manual from time to time. The reference to fully allocated costs is a reference to a costing methodology in which all costs are allocated to the outputs of the business.

Figure 3.1: Illustrative example of Royal Mail’s costing system



Granular FAC data

3.17 Section 6 of the RAG requires Royal Mail to produce a Costing Manual which provides a comprehensive level of detail of the National Costing Methodology to demonstrate compliance with the NCRs (as well as the Zonal Costing Rules). The Costing Manual contains, among other things, granular FAC data (in the Technical Appendices), which we use to build our own static costing model, Cost Allocation Model (CAM). The CAM is a static model which simulates parts of Royal Mail’s costing system. We use the CAM to understand how costs are calculated and allocated at the most granular level. Royal Mail updates the Costing Manual quarterly.

Change control

3.18 The USPAC and the RAG set out the details Royal Mail needs to submit to us when it makes any changes to its costing methodologies. Specifically, USPAC 1.6.3 requires Royal Mail to notify us in writing of any material changes within 7 days of making those changes. This requirement is referred to as the ‘Change control’. This allows us to ensure that Royal Mail’s methods continue to produce cost data which adheres to the Guiding Principles and costing rules in the RAG.

3.19 Section 2 of the RAG (2.1 (f)) defines a material change. Appendix 3 of the RAG also provides the pro-formas and the information Royal Mail must disclose when informing us of any material change.

3.20 While Royal Mail is permitted to make changes to its costing methodologies subject to the above requirements, we may give directions pursuant to USPAC 1.2.2 (b) and (c) to Royal Mail in relation to its compliance with the rules on the identification of costs, charges and the use of accounting systems. Therefore, following a consultation, we could direct Royal Mail to reverse changes if we consider that they do not align with our objectives.

How we use FAC

Our monitoring regime

- 3.21 As we explained in Section 2, we have a comprehensive monitoring regime which is essential to ensure that Royal Mail's commercial and operational flexibility is used in a way that accords with our regulatory objectives in respect of the universal service. The monitoring regime enables us to assess how well the regulatory framework is working to meet our regulatory objectives. The monitoring regime also helps us to consider the impact of any changes to the regulatory framework and assess whether there is a need to intervene to protect the universal service, customers and competition.
- 3.22 We also explained in Section 2 that our regulatory financial reporting requirements are set up in order to inform our monitoring regime. In Phase I of our review, we updated our objectives for the regulatory financial reporting requirements to ensure the requirements continue to inform our monitoring regime effectively. These objectives are:
- a) monitoring the financial sustainability of the universal service provision;
 - b) monitoring the efficiency of universal service provision;
 - c) monitoring competition in the postal market; and
 - d) protecting the interests of consumers.
- 3.23 These objectives remain relevant to this Phase II of our review, including our decisions to change some NCRs.

FAC data

- 3.24 FAC is a well understood and widely used costing method which spreads the entire cost of the organisation across the products and services it offers. Additionally, the use of established accounting methods for FAC can make it a more reliable cost measure in practice than other cost standards, which rely comparatively more on modelling assumptions. FAC provides a good first-order view of product costs and how they change over time, and this is how it is used for Royal Mail's products. These product costs are a key input to the broad indicators we use to monitor competition and consumer issues. In addition, FAC is a key input in monitoring the financial sustainability and efficiency of the provision of the universal service, where there is a need to have full view of all costs incurred. FAC is also currently used in our *ex ante* margin squeeze control.¹⁴
- 3.25 We consider that, for the purposes of monitoring and specifically, assessing financial sustainability, FAC remains an appropriate cost standard as it can be used to reliably

¹⁴ The margin squeeze control is intended to ensure that the difference between Royal Mail's access prices and the equivalent retail prices are consistent with principles that allow efficient competition and thus prevent margin squeeze from happening. As explained in [our recent statement relating to technical changes to the margin squeeze control](#) (November 2018 Statement), assessing margin squeeze by reference to LRIC is likely to be the most appropriate approach in the longer-term, subject to appropriate LRIC data being available. However, robust LRIC information is not currently available. Instead, we currently use 50% of FAC in the absence of robust LRIC data. See Paragraphs 3.6-3.11.

calculate a measure of the profitability of a business or a product group and track it over time consistently.

- 3.26 Royal Mail agreed that, as a first order view of costs, FAC can be appropriate as it is a “widely recognised costing concept” and “ensures that when all product cost information is consolidated it agrees back to the total cost of the business”.¹⁵ It acknowledged that FAC is a useful cost standard for assessing the profitability of a business.
- 3.27 However, Royal Mail considered that there were two areas for improvement: more flexibility in the allocation of overheads (we address this in Section 4); and the attribution of common costs where it considered those costs should be attributed to the Universal Service products in the first instance. We address this latter comment below.

Royal Mail’s changes to cost allocations and their implications

- 3.28 Royal Mail made a series of significant changes to its national average FAC allocation methods related to the outdoor delivery part of its network in 2013/14 and 2016/17. Royal Mail’s main justification for these changes was the introduction of new delivery methods and the significant changes in the operational reality on the ground (set out in Section 4).
- 3.29 We recognise that Royal Mail may have incentives to allocate its costs in certain ways, including:
- a) allocating less costs to competitive products to help justify lower prices; and
 - b) allocating more costs to the USO products, making the USO appear more costly to provide (or to help justify raising prices for USO products).
- 3.30 Royal Mail’s cost allocation changes made in 2013/14 and in 2016/17 (as referred to in Section 2 and described in further detail in Section 4) appear to broadly align with these incentives. The new allocation methods had the broad impact of making parcels less costly and letters more costly. The changes also allocated more costs to USO parcel products by moving them out of non-USO parcel products.

Stakeholders’ responses

- 3.31 Some stakeholders raised concerns regarding these cost allocation changes. One respondent to our 2015 discussion document¹⁶ requested that we review the allocation of Royal Mail’s costs, pricing and margins. It was concerned that Royal Mail might be able to engage in predatory pricing through inappropriate cost allocations where it faces competition, which would disadvantage its competitors, increasing Royal Mail’s market share and potentially driving competitors out of the market.¹⁷

¹⁵ Royal Mail’s response to the Consultation, paragraphs 1.6-1.8.

¹⁶ Ofcom, 2015. [*Review of the regulation of Royal Mail – Discussion paper.*](#)

¹⁷ [3<]

- 3.32 In the May 2016 Consultation¹⁸ we noted these concerns and indicated our intention to review Royal Mail’s changes and our costing rules. We stated that, as part of the review, “we intend to consider whether there are ways to better ensure that Royal Mail is appropriately allocating costs between parcels and letters”.¹⁹
- 3.33 In its response to the December 2018 Consultation, the MCF expressed concern that “customers of captive and regulated services have little or no choice of service provision”, and “there is a clear incentive for Royal Mail to disproportionately allocate costs to these services in order to justify higher prices”.²⁰
- 3.34 We recognise that there is a risk relating to Royal Mail’s incentives in setting its prices as we have allowed Royal Mail significant commercial and operational flexibility to react to the rapidly changing market conditions. To address this risk, as explained earlier, we have put in place our comprehensive monitoring regime as well as other safeguards such the margin squeeze control and the Second-class stamps safeguard cap. Our monitoring work covers competition and how well the markets perform. It enables us to assess how well the regulatory framework is working to meet our regulatory objectives and whether there is a need for considering further regulation or deregulation.
- 3.35 In addition to our ongoing monitoring, we may need to carry out in-depth analysis of specific regulatory issues which may arise. In such circumstances, we may need to adjust Royal Mail’s FAC and its cost allocations, apply different cost allocation methods, or use cost standards other than national average FAC. We discuss examples of these potential circumstances below.
- 3.36 In connection with cross-subsidisation and associated predatory pricing issues, it may instead be more appropriate to use LRIC or average avoidable costs. Further, in considering the allocation of cost between letters and parcels, one method may be to take the total costs of the business and subtract the standalone cost of letters to estimate the incremental cost of parcels. Alternatively, the avoidable cost of parcels could be calculated, which puts the onus on calculating the incremental cost of parcels directly, rather than approaching it indirectly.
- 3.37 In its response, the MCF also stated that “Ofcom’s monitoring regime should be sufficiently robust and informed to spot, challenge and reverse any potential malfeasance in this area”.²¹
- 3.38 Our monitoring regime draws on a wide range of detailed financial data. We have ensured through timely updates (in January 2014, December 2017, and November 2018) that the data provided by Royal Mail helps us meet our objectives in an effective and proportionate manner. As explained earlier in this Section, we also have Change control requirements

¹⁸ Ofcom, 2016. [Review of the Regulation of Royal Mail – Consultation](#).

¹⁹ Ofcom, 2016. [Review of the Regulation of Royal Mail – Consultation](#), paragraph 5.36.

²⁰ The MCF’s response to the December 2018 Consultation, page 1.

²¹ The MCF’s response to the December 2018 Consultation, page 1.

which provide further transparency over material changes to the regulatory accounting and costing methodology used by Royal Mail.

- 3.39 In its response to the December 2018 Consultation, Royal Mail said the current cost allocation methods understate the true cost of the Universal Service and suggested that we review the allocation of common costs.²² Royal Mail said that it uses the “Universal Network to deliver both Universal Service and non-Universal Service products”, but its costs are “the result of its USP status” and a significant proportion of the cost base would remain regardless of whether it uses the Network to deliver non-Universal Service products. Therefore, Royal Mail argued that the “costs of the network should be allocated to Universal Service products in the first instance”.
- 3.40 For our monitoring of the financial sustainability of the provision of the USO, we monitor the profitability of the Reported Business which encompasses the USO network as well as various other financial metrics including those related to the Relevant Group. We consider our costing rules in the USPACs and the RAG, including those related to common cost allocation, to be appropriate for this work. We have not seen any evidence in support of changing our current approach.
- 3.41 We may need to consider other regulatory questions relating to the USO in the future. For example, as part of an assessment of the continued sustainability of the USO, we may consider the net cost of the USO. This could involve alternative common cost allocations including those suggested by Royal Mail.

Conclusion

- 3.42 As explained above, we recognise that FAC data produced by Royal Mail will not necessarily provide an appropriate measure of costs for all the regulatory questions we may need to answer in future. However, we remain of the view that robust FAC data provides a key input in the broad indicators we use in our monitoring regime and is also a useful starting point for any future analysis we may need to undertake in future to answer specific regulatory questions.
- 3.43 Royal Mail must continue to prepare and provide FAC data using a coherent and transparent set of allocation methods and in accordance with the USPAC and the RAG.

Scope of Phase II review

- 3.44 Phase II of our review of the regulatory financial requirements has focused on reviewing Royal Mail’s cost allocation changes and our costing rules as indicated in the May 2016 Consultation. It is also intended to address some of the concerns we and stakeholders have about Royal Mail’s changes to its outdoor delivery cost allocation methods.
- 3.45 As we explain in detail in Section 4, we have decided to revise certain NCRs in the RAG to ensure the national average FAC that Royal Mail produces remains fit for the purposes of

²² Royal Mail’s response to the Consultation, paragraphs 1.6-1.8.

our monitoring regime. These revisions were brought to light following the changes Royal Mail made to its cost allocation methods discussed above.

- 3.46 We do not expect our decisions to result in fundamental changes to the National Costing Methodology which Royal Mail uses to produce national average FAC. We also do not expect these changes to have a significant impact on Royal Mail's cost allocations. As we explain above, national average FAC continues to be a key input in the broad indicators we use in our monitoring regime, particularly in monitoring competition and consumer issues.
- 3.47 However, as we explain above, the findings of our Phase II review and our decisions should not be interpreted as an endorsement of Royal Mail's cost allocation methods to be used for all our regulatory purposes. In considering specific regulatory questions, such as for example, cross-subsidisation etc, we may not consider Royal Mail's current choice of allocation methods to be appropriate.
- 3.48 Royal Mail is in the process of implementing a new strategy that involves considerable changes to its UK network (including the universal service network).²³ These changes may lead Royal Mail to change its cost allocation methods further. We will continue to monitor these cost allocation changes and also, if necessary, our costing rules to ensure the cost allocations in Royal Mail's FAC data remain fit for our monitoring purposes.
- 3.49 The MCF agreed we were right to recognise that the proposed changes should be flexible enough to account for changes to operational practices. However, they also stated that there was a weakness in our current cost allocation monitoring in that we are only looking to see if costs had been appropriately allocated across the existing operation. The MCF considered that Royal Mail are free to adopt inefficient operational methods so as to allocate costs in ways that favour Royal Mail's competitive position.
- 3.50 The MCF considers we should compare Royal Mail's operational methods with those of other major national postal operators, which may be more efficient.
- 3.51 As outlined in the 2019/20 Annual Plan, we will be conducting a separate review of Royal Mail's efficiency this year. This work will give us more insights into the likely future sustainability of the universal postal service. We intend to provide our latest view on the sustainability of the universal postal service later this year.
- 3.52 Additionally, in order to help develop our own view of the costs of Royal Mail's delivery operations and other key areas of its network, and how these might change over time under different scenarios, we are continuing to develop our own costing models.²⁴ We expect these costing models to further inform and support our views on the issues we discuss above, including the financial sustainability and efficiency of Royal Mail's provision of the universal service, as well as our consideration of how costs might vary under different scenarios.

²³ Royal Mail Plc, <https://www.royalmailgroup.com/media/10705/fy-2018-19-results-and-strategy-presentation.pdf>.

²⁴ This model differs fundamentally in its scope, design and functionalities from the CAM which is a static representation of parts of Royal Mail's ABC costing system.

4. Changes to our costing rules

- 4.1 In this section, we set out our conclusions of the Phase II review and our decisions to change some of our regulatory accounting rules in the RAG.
- 4.2 Our decisions mainly concern changes to some of the NCRs.²⁵ We also set out our decision to make some minor changes to transfer pricing rules in the RAG²⁶ and provide clarifications in relation to NCR 2 – Operational Reality and how it must be applied in conjunction with other NCRs.

Royal Mail's changes to its cost allocation methods

- 4.3 Since March 2012, Royal Mail has made various changes to its costing methodology. Some of these changes, which were made mainly to the allocation of outdoor delivery costs, were significant in their scope and impact.
- 4.4 These changes have been the subject of our Phase II review. In addition to their scope and impact, the changes are relevant to concerns relating to the allocation of costs to letters and parcels (as explained in Section 3). This is because the net effect of the changes was broadly to move costs from parcels to letters and from Non-USO parcels to USO parcels. It was therefore important for us to review these changes and assess whether the resulting costing data still met our needs. Additionally, it was necessary to assess whether the NCRs continue to be fit for purpose in light of those changes.

Royal Mail's reasons for the cost allocations changes

- 4.5 In 2010, Royal Mail began to introduce new delivery methods and implement a programme designed to put in place delivery best practice, such as the removal of bicycles as a method of delivery, the introduction of High Capacity Trolleys (HCTs) and the use of Shared Vans.
- 4.6 Royal Mail informed us that the new delivery methods were introduced to:
- a) take account of the change in mix of parcels and letters, including the growth in the absolute range and size of parcels;
 - b) take weight off the shoulder and stop delivery by bicycle, due to health and safety concerns; and
 - c) allow route lengths to be increased so post men and women spend more time outdoors, to take account of short hours indoors following the automation of sortation.
- 4.7 As a result of the above and other operational changes, Royal Mail also introduced a series of changes to its cost allocation methods in its ABC system. Royal Mail said that these changes were predominantly intended to reflect the new operational reality.

²⁵ Ofcom, 2017. [Regulatory financial reporting review for Royal Mail – Statement, Annex 2](#), paragraphs 8.12-8.43.

²⁶ Ofcom, 2017. [Regulatory financial reporting review for Royal Mail – Statement, Annex 2](#), paragraphs 8.72-8.76 and 9.8-9.13.

4.8 Royal Mail informed us of these changes and their impact as part of our change control requirements (see Section 3). We requested further information regarding the details, reasons and impact of these changes and, as part of our Phase II review, we have reviewed the changes in detail. We engaged with Royal Mail – through a series of meetings and further detailed information requests – to ensure we have a proper understanding of its reasons for making these changes.

Result of the review

4.9 In summary, we found that Royal Mail’s changes were consistent with the NCRs in the RAG. In particular, we found that the new cost allocation methods better reflected the operational reality of the new delivery methods.

4.10 In response to the December 2018 Consultation, Royal Mail suggested that our findings gave Royal Mail “a ‘clean bill of health’ on [its] regulatory compliance”.²⁷ We do not accept Royal Mail’s characterisation of our findings in the Consultation, including the work and analysis that we carried out in making our findings.

4.11 As set out in Section 3, our decisions and findings should not be interpreted as an endorsement of Royal Mail’s cost allocation methods to be used for all regulatory purposes. In the December 2018 Consultation, we limited our consideration to whether the changes made by Royal Mail in 2013/14 and 2016/17 were consistent with the NCRs. These NCRs are in place to ensure the consistent method of calculation of FAC for the purposes of monitoring. In considering specific regulatory questions, such as cross-subsidisation, we may consider alternative choices of cost allocation methods more appropriate for those purposes.

Summary of our decisions

4.12 We have revised some of the NCRs to ensure the FAC data provided remains robust and fit for our monitoring purposes in the future.

4.13 Royal Mail may need to make adjustments to some of its cost allocation methods as a result of our findings and to comply with the NCRs going forward (see NCR 5). We will engage with Royal Mail as they carry out any necessary adjustments.

4.14 We also require Royal Mail to provide more supporting data in its financial reporting to ensure adequate transparency over some of the new allocation methods (see on NCR 6).

4.15 We set transfer prices, which are calculated using a cost-plus approach, on a FAC basis plus an appropriate return.

4.16 Royal Mail is required to comply with the revised requirements for the financial information and reports due for the quarter and the year ending 29 March 2020 and thereafter.

²⁷ Royal Mail’s response to the December 2018 Consultation, paragraph 2.7.

Changes to the NCRs

Our Proposals

- 4.17 We proposed to make changes to seven NCRs. Our proposed revisions reflected two themes which we identified in relation to Royal Mail's changes:
- a) defining new Activities to better reflect the new operational reality and how we can make sure the Causality Guiding Principle is considered in those definitions in a more appropriate manner (NCR 5 – Activities, NCR 8 – Activity Costs and NCR 10 – Weighted Activity Drivers); and
 - b) use of theoretical or modelled data, instead of actual data, to calculate certain cost drivers and how we can make sure that is done appropriately (NCR 6 – Resource Drivers, NCR 11 – Other Drivers, NCR 14 - Operational data and sampling and NCR 15 - Data Integrity).
- 4.18 Below we set out our original proposals with respect to each NCR and how they fit within the above two themes.

Changes to NCR 5: Activities

- 4.19 NCR 5 is in place to ensure that Business Processes are divided into Activities.
- 4.20 In the Consultation we explained that, due to the introduction of a new activity (Stem Time), we recognised that under the current rule it may be possible to allocate Activity Costs to products which did not cause the costs to be incurred.
- 4.21 Therefore, we proposed that NCR 5 should be changed to include an explicit requirement to consider the Guiding Principle of Causality. This is to ensure that the Business Processes are divided into Activities in a manner which allows the best fit with causality considerations.
- 4.22 We proposed the new rule to be amended as follows (proposed amendments are in bold):

8.19 Where appropriate (and to the extent possible), Business Processes shall be divided into Activities. **When identifying an Activity, consideration must be given to the Cost Types used by that Activity to ensure those Cost Types are caused, in accordance with the Guiding Principle of Causality, by the SPHCCs to which the Activity Cost is allocated.**

Changes to NCR 6: Resource Drivers

- 4.23 The purpose of NCR 6 was to provide guidance on the calculation of Resource Drivers, the means of allocating costs from Cost Types (as recorded in the general ledger) to Activities.
- 4.24 As part of our review of the cost allocation changes, we noted that NCR 6 does not refer explicitly to the use of theoretical or modelled data. However, we recognised that the use of theoretical or modelled data may be the most proportionate way to get suitably detailed information for cost allocations in some circumstances. Therefore, we considered

it necessary to provide greater clarification on the use of theoretical and modelled data in determining these drivers.

- 4.25 As such, we proposed to amend NCR 6 to include guidance about the appropriate use of theoretical and modelled data (proposed amendments are in bold).

8.20 All costs aggregated into Cost Types shall be attributed to the Activities which cause those costs to be incurred. Where a Cost Type is incurred as a result of more than one Activity, Resource Drivers shall be used to attribute an appropriate share of the Cost Type to each Activity.

8.21 The Resource Driver for each Cost Type shall be—

a) based on the resource consumption giving rise to the Cost Type (e.g. staff hours, machine hours, accommodation footprint, vehicle hours);

b) quantified based on appropriate operational and financial data **using actual data containing the necessary granularity.**

Only where such actual data is unavailable or lacks sufficient granularity, Royal Mail may use modelled or theoretical data, provided that this data is—

(c) based on sampling or industrial engineering studies; and

(d) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.21, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

- 4.26 Additionally, we proposed to require that Royal Mail provide us with the Resource Drivers for outdoor delivery Activities which are based on Planning Values, rather than actual hours recorded, where these Resource Drivers are displayed as a proportion of the total resource required for that Cost Type and Pipeline segment.

- 4.27 We intended to use this data to monitor how the theoretically based Resource Drivers change from one year to another and to identify any changes which may be necessary for us to understand better and investigate further.

Changes to NCR 8: Activity Costs

- 4.28 NCR 8 defines the different types of Activity Costs.

- 4.29 We explained that the definition of a General Overhead categorises any Activity Cost related to Non-operational Business Processes as General Overheads and, according to

NCR 9, it follows that all Activity Costs related to Non-operational Business Processes must be allocated using EPMU)²⁸.

- 4.30 However, it is possible that there are some Non-operational Business Processes which have direct causal links to specific SPHCCs and, as such, it would not be appropriate to categorise the cost relating to those processes as General Overheads and use EPMU to allocate those Activity Costs.
- 4.31 We therefore proposed to amend NCR 8 so that the Overhead definitions only covers Operational and Non-operational Business Processes which do not have a causal link to specific SPHCCs (proposed amendments are in bold). As such, those with a causal link to specific SPHCCs would have to be categorised as Attributable Costs and allocated appropriately.

8.24 The National Costing Methodology shall assign an appropriate share of each Activity Cost to each of the relevant SPHCCs as set out below. To determine how an Activity Cost shall be assigned to the relevant SPHCCs, it shall first be determined into which one of the following categories the Activity Cost falls:

[...]

d) Overheads, which shall be classed either—

- i) if the Activity Costs relate to one or more Operational Business Processes which do not have a direct causal link to any of the SPHCCs being processed, as Pipeline Overheads; or
- ii) if the Activity Costs relate to Non-operational Business Processes **which do not have a direct causal link to any of the SPHCCs being processed**, as General Overheads.

Changes to NCR 10: Weighted Volume Drivers

- 4.32 The purpose of NCR 10 is to provide necessary detail on the calculation of Weighted Volume Drivers, including guidance on the variables Royal Mail may use in determining the Weighting Factors.
- 4.33 To ensure the definition of Weighting Factors and the method of calculation is sufficiently clear, we proposed two amendments to NCR 10 (proposed amendments are in bold and strikethrough):
- a) to improve the definition of a Weighting Factor (Guiding Principle of Causality); and
- b) to provide further guidance on the use of theoretical or modelled data in determining Weighting Factors (See NCR 6 – Resource Drivers).

²⁸ EPMU stands for Equi-Proportional Mark-Up, which means that costs are allocated to products based on the proportions of costs already allocated to those products. Cost allocated using EPMU tend to be overheads which do not have a direct causal link to the products. EPMU is defined in the Regulatory Accounting Guidelines.

8.28 Weighted Volume Drivers shall incorporate two types of factors for each relevant attributable Activity Cost, namely—

- a) Proportional Factors, which represent the proportion of the total number of revenue derived volumes of each SPHCC which uses the related Activity; and
- b) Weighting Factors, which represent the relative proportions of amount of work that units of each SPHCC require from the related Activity, **when compared to a different SPHCC using the same Activity.**

8.29 Proportional Factors referred to in §8.28(a) shall be based on operational data collected using representative measurements of total volumes (including statistical sampling techniques where necessary, **see National Costing Rule 14**).

8.30 Depending on the nature of the Activity, one or more of the following variables may be used as a determinant of the amount of work to calculate the Weighting Factors—

- (a) time (needed to carry out the Activity): ~~where appropriate, industrial engineering studies must be carried out in accordance with relevant ISO standards;~~
- (b) weight (**of an item**): ~~appropriate operational data must be used;~~ and
- (c) size (**or physical dimensions of an item**): ~~appropriate operational data must be used,~~

provided that each variable used by Royal Mail to calculate each Weighting Factor is quantified based on appropriate operational data using actual data containing the necessary granularity.

Only where such actual data is unavailable or lacks sufficient granularity, Royal Mail may use modelled or theoretical data, provided that this data is—

- (d) **based on sampling or industrial engineering studies; and**
- (e) **prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).**

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.30, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

4.34 We proposed that Royal Mail should review its use of the terminology related to the Weighting Factors and Proportional Factors, in its published Costing Manual and in its submissions to us. to ensure that they are consistent with the proposed amendments of NCR 10.

4.35 Additionally, we proposed that Royal Mail revised its published Costing Manual and its relevant Technical Appendices to explain its reasons clearly for all its assumptions in determining the Weighting Factors, including where it assumes parcels and letters to have equal Weighting Factors.

Changes to NCR 11: Other Drivers

- 4.36 The purpose of NCR 11 was to provide guidance on the calculation of Other Drivers, the means of allocating costs from Activities to SPHCCs.
- 4.37 As for NCR 6 and NCR 10, we considered it necessary to provide greater clarification on the use of theoretical and modelled data in determining these drivers.
- 4.38 As such we proposed to amend NCR 11 to include guidance about the appropriate use of theoretical and modelled data (proposed amendments are in bold letters and strike-through letters).

8.34 Other Drivers shall be used for costs (certain Attributable Operational Costs and all Attributable Non-operational Costs and Aggregate Costs) which are directly linked to a factor other than mail traffic in the Pipeline.

8.35 Other Drivers shall be ~~defined in a way which appropriately reflects the causal link with that factor~~ **quantified based on appropriate operational data using actual data containing the necessary granularity which reflects the causal link to that factor.**

Only where such actual data is unavailable or lacks sufficient granularity, Royal Mail may use modelled or theoretical data, provided that this data is—

- (a) based on sampling or industrial engineering studies; and**
- (b) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).**

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.35, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

- 4.39 Additionally, we proposed that Royal Mail should ensure it is clear which Activities are allocated using Other Drivers (as opposed to Weighted Volume Drivers or EPMU) and the basis for those allocations in the Activity Bible.²⁹ This would allow us to identify anomalies which we might want to investigate further.

Changes to NCR 14: Operational data and sampling

- 4.40 In the Consultation, we explained that the purpose of NCR 14 was to ensure that the operational data used by Royal Mail is accurate and consistent (over time and in similar applications), including the use of appropriate sampling techniques to obtain the necessary data where actual data is not available for each and every data point.
- 4.41 Although the rule explained that operational data needs to be regularly reviewed by Royal Mail for accuracy and consistency, we considered it necessary to include theoretical and

²⁹ As part of the submission of the Costing Manual, Royal Mail provides a file which details Activities and associated attributes/characteristics (the Activity Bible). This includes, amongst other things, details of how activity costs are assigned to products and/or services.

modelled data in the definition of operational data. We also considered it necessary to link NCR 14 to NCR 15 in order to maintain the integrity of the operational data.

4.42 We therefore proposed NCR 14 to be amended as follows (amendments are in bold):

8.40 All operational data —**whether actual, modelled or theoretical data**— used by the National Costing Methodology shall be regularly reviewed by Royal Mail and, where necessary, updated to ensure the accuracy of costing and its consistency with the operational reality (see National Costing Rule 2). **In so doing, for the avoidance of doubt, Royal Mail must ensure the integrity of all the data in accordance with National Costing Rule 15.**

8.41 Royal Mail must ensure that all sampling used by the National Costing Methodology is applied by a qualified professional statistician as such sampling must be based on statistical techniques regarded as appropriate for such purposes. The reference to a “qualified professional statistician” is a reference to a person with the relevant statistical knowledge and expertise, who shall have a qualification in statistics from a recognised professional body, such as the Royal Statistical Society in the United Kingdom.

Changes to NCR 15: Data integrity

4.43 In the Consultation, we explained that the purpose of NCR 15 was to ensure the integrity of financial and operational data through adequate checks and controls.

4.44 However, we found that the absence of appropriate checks and controls could lead to the consistency of this data over time not necessarily being assured, which may lead to unintended or artificial year-on-year variances. This could mean we are unable to accurately compare data over time which is important for our monitoring work.

4.45 We considered it necessary to include a definition of data integrity within NCR 15 which includes the maintenance and assurance of consistency of any data over time.

4.46 We therefore proposed NCR 15 to be amended as follows (amendments are in bold and strikethrough):

8.42 Data integrity is the maintenance of, and the assurance of the accuracy and consistency of any data over time, and the data includes (but is not limited to) inputs, models and outputs. The data integrity of financial and operational data —**whether actual, modelled or theoretical data**— used for the National Costing Methodology shall be preserved by adequate checks and controls ~~which~~ **on the data for the same period as well as adequate checks and controls on the development of data from one period to another. The checks and controls** shall include, **(but are not limited to)** reconciliation of total cost data at appropriate points in the National Costing Methodology.

8.43 The total amount of input costs relating to any element of the National Costing Methodology shall be equal to the total amount of output costs relating to that element. In particular, the following total figures shall be reconciled to each other—

- a) the total costs in the General Ledger;
- b) the total Activity Costs; and
- c) the total costs of all SPHCCs.

Clarification to NCR 2: Operational reality

- 4.47 In the Consultation, we explained that the purpose of NCR 2 was to ensure the that the National Costing methodology reflected the trading operations of Royal Mail, with one exception relating to Class costing.
- 4.48 We provided clarification to that rule but did not propose any changes because we considered it to be adequate for our purposes.

Stakeholders' responses

- 4.49 We received responses from two stakeholders on our NCR proposals. Stakeholder comments on our proposed changes to the NCRs generally related to one of the following broad categories:
- use of theoretical and modelled data;
 - consistency of data used over time; or
 - detailed reviews.
- 4.50 Royal Mail explained that it takes compliance with its regulatory obligations seriously and set out its response under four broad themes, which included some suggested modifications to the proposed RAG amendments.
- 4.51 The MCF supported the changes we proposed to the RAG and urged us to proceed with the changes.

Use of theoretical and modelled data

- 4.52 In response to further guidance around the use of theoretical or modelled data, Royal Mail explained that “in some circumstances, [it] uses theoretical or modelled data where actual data does exist. Royal Mail does so because it has reservations as to whether the actual

data is 'fit-for-purpose' (i.e. is appropriate to be used to attribute costs within Royal Mail's costing system)."³⁰

- 4.53 Royal Mail said that its "costing system will use the best and most appropriate data, but [it] is on a journey to improve and transform its data capture and management. With the increased tracking of parcels and the investment in IT infrastructure, it will be possible to enhance and improve the current methods [it has] for counting and estimating product volumes."³¹
- 4.54 In the Consultation, we said that the Guiding Principle of Objectivity and NCR 2 on Operational reality requires Royal Mail to use actual data where there is reliable and relevant data recorded. Royal Mail "believe that it is Ofcom's intention that the actual data used is 'fit-for-purpose'" and suggested that we should add the following text in [bold] (or similar text) into the proposed changes to the RAG. "Only where such actual data is unavailable or lacks sufficient granularity **or is not fit for the purpose intended**, Royal Mail may use modelled or theoretical data".
- 4.55 In its response, the MCF stated it is concerned about any move from actual data to sampled data or planning values. It thinks "it is beneficial to have both actual and planning values; the gap being the benefits of doing things in the most efficient way".
- 4.56 The MCF also stated that Royal Mail must justify any use of planning values with substantive evidence why actual data could not be provided.
- 4.57 The MCF go on to request that Ofcom receive detailed justification for any change in weighting or volume drivers since these clearly can have dramatic impacts on cost allocations.

Consistency of data used over time

- 4.58 In response to our proposal to amend NCR 15 to include a definition of data integrity which captures the assurance of the accuracy and consistency of any data over time, Royal Mail agreed that as far as possible data should be prepared on a consistent basis over time.³²
- 4.59 However, Royal Mail highlighted it may not be always possible and that there will be times when data will change. Royal Mail noted it is "on a journey to improve [its] data and have been investing in new IT infrastructure. New and improved data sources will become available – such as [its] Automated Hours Data Capture (AHDC)."³³
- 4.60 Furthermore, Royal Mail stated that as its business changes, so will its procedures, ways of counting and measuring what it does. For example, it noted most of its parcels are

³⁰ Royal Mail's response to the December 2018 Consultation, paragraph 3.8.

³¹ Royal Mail's response to the December 2018 Consultation, paragraph 3.9.

³² Royal Mail's response to the December 2018 Consultation, paragraph 3.15.

³³ Royal Mail's response to the December 2018 Consultation, paragraph 3.15.

monitored in some way through its network and that its product portfolio will evolve as it develops new products to meet ever-changing consumer needs.³⁴

4.61 Therefore, while Royal Mail considered consistency to be important, it also recognised that there may be times when it must make changes in how it sources or processes costing data. Royal Mail went on to state that an overemphasis on consistency could lead to the results no longer reflecting operational reality³⁵ and suggested that NCR 15 includes the following text:

“It is expected that, as Royal Mail’s Business changes, the data used may need to change or new and updated data sources become available. These amended or new sources will need to be used to ensure the regulatory accounting methodology reflects operational reality.”³⁶

Detailed reviews

4.62 As part of the changes to the NCRs, we stated that we expect Royal Mail to review its current allocations and regulatory reporting to ensure that costs are treated and allocated in accordance with the new NCRs. We also proposed that Royal Mail be required to provide further costing information in relation to the use of theoretical or modelled data.

4.63 In response to our proposal for the provision of additional information Royal Mail considered that Ofcom is proposing to add to the cost of regulatory compliance. It went on to say that as a result, it will need to put in a new process to produce, review and approve this schedule on an annual basis. It is Royal Mail’s understanding that this schedule is required for outdoor delivery activities.

4.64 Royal Mail also asked that Ofcom clarifies that Data Template G is only for outdoor delivery as in the Consultation we refer to outdoor delivery activities, but the draft Legal Instrument refers only to Activities.

4.65 Royal Mail considers it will take time to implement our proposals. Royal Mail explained that some examples of changes might require new methodologies to be developed or new data sources to be identified.

4.66 Specifically, in relation to NCR 8, Royal Mail said it would undertake a review during 2019/20 of all activities within non-operational business processes and then advise Ofcom of those activities that need to be changed (as part of the change control process).

4.67 Additionally, in relation to NCR 10, Royal Mail said it will need to undertake a review during 2019-20 in relation to the use of weighting factors and proportional factors. As part of this review, it will set out, in the relevant document, the basis or source of assumptions, including the use of equal weighting factors where this applies.

³⁴ Royal Mail’s response to the December 2018 Consultation, paragraph 3.16.

³⁵ Royal Mail’s response to the December 2018 Consultation, paragraph 3.17.

³⁶ Royal Mail’s response to the December 2018 Consultation, paragraph 3.18.

Other themes

- 4.68 Royal Mail made no specific comment on the change to the NCR 5. However, it said it would review Ofcom’s proposal to create at least two Stem Time Activities to confirm whether this is a material change.
- 4.69 In response to our proposal to improve the definition of a weighting factor, Royal Mail requested that Ofcom rephrases “relative proportions” in 8.28 (b) “to make a clearer distinction between proportional factor and weighting factor”. It goes on to explain that it would be helpful and clearer for the description of a weighting factor not to use “proportions of”.
- 4.70 Additionally, in relation to NCRs 9 and 12, Royal Mail consider EPMU to be overly prescriptive and Ofcom should allow the use of Other drivers for the allocation of General overheads. Royal Mail used BT as an example where a specific Business Unit only supports UK operations, BT use factorised salary costs.

Our reasoning and decisions

- 4.71 Having considered the responses to the December 2018 Consultation we have decided to amend the NCRs consistent with our proposals. We explain our reasoning for each NCR below.

Changes to NCR 5: Activities

- 4.72 In line with our proposal, we have decided to amend NCR 5 to help ensure that cost allocations are accurate and causal.
- 4.73 As explained in the Consultation, each task is an Activity in the Royal Mail costing system and must be allocated costs based on the resources that Activity requires.
- 4.74 The RAG defines Activities as tasks or work (whether Operational or Non-operational), which are required to be carried out in order to complete a Business Process.
- 4.75 In 2016/17, Royal Mail changed the Activities in the Business Process known as outdoor delivery to take account of the introduction of its new delivery methods. This included introducing a new Activity called Stem Time.³⁷ Stem Time is the time taken to get from the Delivery Office (DO) to the first Delivery Point (DP) on a route and then from the last DP back to the DO again.
- 4.76 In the case of Stem Time, which includes costs for all types of delivery methods (HCT, Shared Van, Rural Van etc.), the Cost Types allocated to the Activity are vehicle, fuel and people costs. The Stem Time Activity Costs are then allocated to SPHCCs.

³⁷ Prior to 2016/17, there was no individual Stem Time Activity. Instead, Royal Mail included this Activity under a wider Activity, for example Delivery Rural Motorised, which accounted for the total time for each delivery method. The total time for the Delivery Rural Motorised Activity was then used to calculate the weighting factors which were used to attribute costs of each delivery method to the SPHCCs.

- 4.77 However, the SPHCCs, which the Stem Time Activity Costs are attributed to, are not always delivered by all these delivery methods. Specifically, parcel formats 3 and 4 are not delivered on an HCT.
- 4.78 The way the Stem Time Activity is defined may result in some costs being allocated to SPHCCs which do not cause those costs to be incurred. For example, it is possible that fuel costs are allocated to SPHCCs delivered by HCT routes.
- 4.79 Furthermore, there may be further changes and additions to Activities as a consequence of Royal Mail changing its network in order to modernise and optimise it. Therefore, there may be subsequent cost allocations where it is possible to allocate Cost Types to SPHCCs which don't cause those costs to be incurred. As such, this amendment to NCR 5 is required to help ensure that the cost allocations are accurate and causal and therefore FAC data remains fit for our monitoring purposes.
- 4.80 We therefore adopt our proposal and amend NCR 5 to read as follows (amendments are in bold):

8.19 Where appropriate (and to the extent possible), Business Processes shall be divided into Activities. **When identifying an Activity, consideration must be given to the Cost Types used by that Activity to ensure those Cost Types are caused, in accordance with the Guiding Principle of Causality, by the SPHCCs to which the Activity Cost is allocated.**

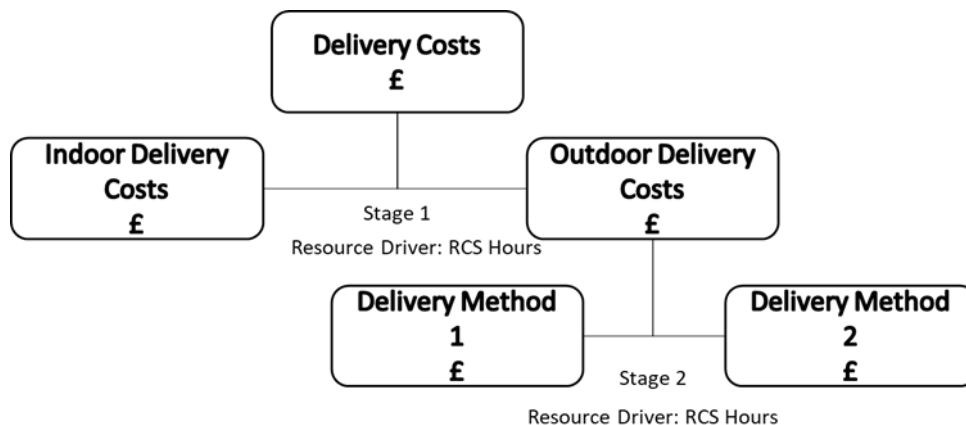
- 4.81 As explained in the Consultation, we would expect Royal Mail to consider whether it must create at least two Stem Time Activities, one for the Stem Time of unmotorised delivery routes and another for Stem Time for motorised delivery routes.
- 4.82 Royal Mail stated it will consider if the change to Stem Time activities is material and therefore warrants a change to the costing system. We recognise that the change may take time for Royal Mail to implement and the relative impact on the products are expected to be small (approximately 1% of Stem Time costs in 2016/17). However, the issue may be broader than just this one example and the impact on subsequent years may be larger. As a result, we expect Royal Mail to be able to justify its decision should it choose not to action this change.
- 4.83 In addition, we expect Royal Mail to be able to demonstrate compliance with the RAG in all years. This may involve it reassessing the materiality of this single activity on an annual basis, which may result in additional work than making the change to the allocation system once.
- 4.84 In conclusion, Royal Mail must this change (in line with the implementation timeline discussed later in this section), if and when the impact of the change is material.

Changes to NCR 6: Resource Drivers

- 4.85 In line with our proposal, we amend NCR 6 to provide further guidance on the use of theoretical or modelled data.

- 4.86 As explained in the Consultation, NCR 6 sets out the rule for calculating and applying Resource Drivers, for example, that staff costs could be allocated to Activities based on the number of hours booked to a timesheet system or taken from shift pattern information.
- 4.87 Actual outdoor delivery hours are recorded by staff in Royal Mail’s Resource Control System (RCS) against a series of defined tasks. Prior to 2016/17, these recorded hours were used as the basis of the Resource Drivers to allocate both staff and non-staff Cost Types to the relevant outdoor delivery Activities (See Figure 4.1).

Figure 4.1: Illustrative example of the use of RCS Hours as a Resource Driver



- 4.88 In 2016/17, Royal Mail stopped using RCS hours as the basis of calculating Resource Drivers and splitting costs between different Delivery Methods (stage 2, Figure 4.1), but it continued to use these actual hours to split total costs between indoor and outdoor delivery methods (stage 1, Figure 4.1). Royal Mail instead began using Planning Values³⁸, namely theoretical or modelled hours, as the basis of the Resource Drivers to split costs between different delivery methods. The Planning Values are assessed by industrial engineering methods and represent standard hours or hours that each task should take, and not the actual hours.
- 4.89 Royal Mail has stated that it does not currently have sufficiently reliable and granular data to calculate the Resource Drivers for the Activities which relate to the new delivery methods. As explained, the new Activities were introduced into the costing system to reflect the new delivery methods.
- 4.90 Royal Mail has also said that Postal Digital Assistant (PDA) Outdoor actuals, alongside the ongoing trials of Automated Hours Data Capture (AHDC) and Resource scheduler, are being used to align hours worked with workload and fairness in processing, logistics and delivery. This is a potential new source of outdoor actual hours. However, Royal Mail said that currently, the Planning Values (i.e. theoretical data) are a more reliable basis for the calculation of Resource Drivers than actual hours recorded in the RCS.

³⁸ Planning Values (PVs) express the expected time to undertake a wide variety of tasks within operational processes. PVs are obtained from standard Industrial Engineering work measurement exercises undertaken over a number of years. A task is observed, the specific actions involved in the task are recorded, and the relevant time standards are applied to arrive at the time it should take to undertake the activity at a given rate of working

- 4.91 In the current RAG, NCR 6 only refers to the use of operational and financial data and does not refer explicitly to the use of theoretical or modelled data. We recognise that the use of theoretical or modelled data may be the most proportionate way to get suitably detailed information for cost allocations in certain circumstances. Many of the Activity Drivers used by Royal Mail to allocate Activity Costs to the SPHCCs are based on Planning Values as actual data could not be reasonably and cost-effectively recorded at the required level of granularity.³⁹
- 4.92 However, we consider that our Guiding Principle of Objectivity and NCR 2 on Operational Reality require Royal Mail to use actual data where there is reliable and relevant data recorded. Theoretical or modelled data should be used only where this is not the case because we consider there is more risk of bias when data is not grounded in actual operations and actual work done.
- 4.93 In its response, Royal Mail explained that in some cases it does have actual data but has reservations as to whether that data is ‘fit -for-purpose’. It therefore suggested that we supplement the new rule with “or is not fit for the purpose intended”.
- 4.94 Royal Mail went on to explain that the costing system will use the best and most appropriate data and, because it is improving data capture, it will continue to improve and refine its data sources.
- 4.95 Having considered Royal Mail’s response we consider the use of the term “fit for purpose” to be too broad and also unclear as it does not explain what that purpose is. We consider that the amendment which we proposed in the Consultation gives Royal Mail sufficient freedom to use either actual or modelled data. Therefore, we do not think that Royal Mail’s proposed amendment is a necessary addition to the rule.
- 4.96 However, we recognised that the use of the term ‘sufficient granularity’ might be overly prescriptive and limit the scenarios where Royal Mail would need to make use of modelled data. Sufficient granularity is one necessary attribute of the data which is used for cost allocation. Therefore, we have changed this to ‘the necessary components for cost allocation’, so that it allows Royal Mail to reasonably use modelled or sampled data for cost allocation when the actual data lacks some necessary components. For example, in the case of the RCS data to re-record the actual data under the activities for all delivery offices (c. 1400) would be considered disproportionate and the use of planning values is an acceptable alternative as they are based on industrial engineering studies.
- 4.97 Like the MCF, we were also concerned about the move away from actual data and that was why we proposed the changes to the NCRs to ensure it only happens under the right circumstances and for the right reasons. However, requiring both actual and planning value data from Royal Mail, as the MCF suggests, would create a disproportionate

³⁹ For example, updating the recorded data to reflect the new Activities would require each postmen and postwomen to record how much time they spent on each part of their delivery route; paths to front doors, on the street between paths, waiting at a front door etc. This might not provide a reliable source of data, as postmen and postwomen might not all record the information in the same way, and they each have to remember to record possibly hundreds of data points for each route.

regulatory reporting burden for Royal Mail. As long as Royal Mail is able to demonstrate that a particular source of data is the most appropriate for its costing and regulatory accounting, it does not seem necessary for it to use alternative data sources simultaneously. Having said that, we consider transparency over changes in the data sources to be important and we consider our change control requirements to provide the necessary transparency.

- 4.98 We would consider a movement from one data source to another to be a regulatory accounting methodology change if that data source is a key source for the regulatory reports. Consequently, we would expect a submission as part of the change control each time this occurs, subject to the usual materiality thresholds. As part of our change control requirements, Royal Mail will be required to report the evidence to us as to why theoretical or modelled data may be used instead of actual data in each instance. The change control reports are required to include an assessment of the impact of the change which could include the impact of the use of theoretical or modelled data compared with actual data. The change control system also captures the justifications of changes, including the requirement for Royal Mail to refer to the relevant obligations in the RAG and an explanation of how it considers that the change complies with those obligations.
- 4.99 Therefore, we adopt our proposal, but with the minor modification of replacing ‘sufficient granularity’ with ‘the necessary components for cost allocation’ so that the amended NCR 6 reads as follows (amendments are in bold):

8.20 All costs aggregated into Cost Types shall be attributed to the Activities which cause those costs to be incurred. Where a Cost Type is incurred as a result of more than one Activity, Resource Drivers shall be used to attribute an appropriate share of the Cost Type to each Activity.

8.21 The Resource Driver for each Cost Type shall be—

a) based on the resource consumption giving rise to the Cost Type (e.g. staff hours, machine hours, accommodation footprint, vehicle hours);

b) quantified based on appropriate operational and financial data **using actual data containing the necessary granularity.**

Only where such actual data is unavailable or lacks the necessary components for cost allocation, Royal Mail may use modelled or theoretical data, provided that this data is—

(c) based on sampling or industrial engineering studies; and

(d) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.21, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

- 4.100 In addition, we adopt our proposal for Royal Mail to provide us with the Resource Drivers for the outdoor delivery Activities which are based on Planning Values, rather than actual

hours recorded, and displayed as a proportion of the total resource required for that Cost Type and Pipeline segment. Royal Mail must include this data in the cost data it provides to us for the building of the CAM (we referred to this as Template G). This data will allow us to monitor how the theoretically based Resource Drivers change from one year to another and identify any changes.

- 4.101 In its response, Royal Mail highlighted that the Legal Instrument did not limit the contents of Template G to outdoor delivery only and asked that we clarify this. The scope of Data Template G is limited to all Cost Types which have cost allocated to outdoor delivery Activities by the application of Planning Values, or theoretical or modelled operational data. This is reflected in Appendix 4 of the new RAG in Annex 1.
- 4.102 As a result of our proposals, we said that we expected Royal Mail to review the Resource Drivers to ensure that they are calculated in accordance with the amended NCR 6. In its response, Royal Mail said it would undertake a review during 2019/20 in relation to resource drivers to ensure they are calculated in relation to the amended NCR 6.
- 4.103 Royal Mail considered that this, and other reviews, will take a minimum of two man-months and that it could be materially longer. However, we have not seen any indications in this review that the change to NCR 6 will require Royal Mail to recalculate its Resource Drivers.
- 4.104 Finally, we consider that any use of theoretical or modelled data must be done in accordance with the NCR 14 and 15 which address the use of operational data and data integrity respectively. We also proposed changes to NCR 14 and 15, as explained later in this section, to ensure all types of data are robust regardless of source.

Changes to NCR 8: Activity Costs

- 4.105 Stakeholders had no specific comments on the change to NCR 8. Therefore, in line with our proposal, we have amended NCR 8 to refine the definition of a General Overhead cost.
- 4.106 As explained in the Consultation, Activity Costs are allocated to SPHCCs using Activity Drivers. NCR 8 defines categories of Activity Costs and NCR 9 sets out how Activity Drivers must be determined and applied to each category of Activity Cost.
- 4.107 The definition of General Overheads in NCR 8, paragraph 8.24(d)(ii), categorises any Activity Cost related to Non-operational Business Processes as General Overheads. NCR 9 prescribes equi-proportional mark up (EPMU) as the appropriate Activity Driver for General Overheads. Using EPMU, General Overheads are allocated based on the relative proportions of costs already allocated to SPHCCs (having used other Activity Drivers). It follows that all Activity Costs related to Non-operational Business Processes must be allocated using EPMU.
- 4.108 Most Non-operational Business Processes – which include commercial, support, wholesale and business sustaining, management, marketing and financing activities – do not have a direct causal link to any of the SPHCCs.

- 4.109 However, if there is an Activity Cost within a Non-operational Business Process which has a direct causal link to specific SPHCCs, then it would not be appropriate to categorise it as General Overheads and use EPMU to allocate that Activity Cost. The Activity Cost in question must be categorised as an Attributable Non-operational Cost (as defined in NCR 8, paragraph 8.24(b)) and a causal Activity Driver (as defined in NCR 9) must be used to allocate it to the relevant SPHCCs (a Weighted Volume Drivers or an Other Driver). This will ensure consistency with the Causality Guiding Principle.⁴⁰
- 4.110 Additionally, in relation to General Overheads and EPMU, Royal Mail explain in its response that it considers the use of EPMU, as required by NCR 12, to be overly prescriptive. Specifically, Royal Mail considers this method may over allocate costs to parcels. Royal Mail wants to be able to use 'Other Drivers' for overheads to future proof the regulatory framework. It uses an example from our regulation of BT where Group Pay costs are allocated on a version of previously allocated salary costs.
- 4.111 First, we highlight that we do allow Royal Mail to use Other Drivers where the cause of the cost is linked to a specific factor. These costs would therefore be classed as attributable. If Royal Mail has been unable to identify a specific driver, then the cost must be an overhead. In raising this point, Royal Mail had not provided a specific example or any evidence why its suggested change is necessary for future proofing the regulatory framework.
- 4.112 In relation to the BT example, the costs being allocated are Human Resource (HR) costs relating to UK operations. It is reasonable to assume that HR costs would be linked to the time and effort taken to manage people and so some measure of headcount or pay could be considered suitable causal drivers. Under the RAG definitions these HR costs might be categorised as Attributable Non-operational Costs.
- 4.113 Consequently, we do not consider that making this change to the RAG provides any further future proofing of the regulatory framework.
- 4.114 We therefore adopt our proposal by amending NCR 8 as follows (amendments are in bold):

⁴⁰ Ofcom, [USP Accounting condition](#), USPAC 1.7. (c), dated 18 December 2017.

8.24 The National Costing Methodology shall assign an appropriate share of each Activity Cost to each of the relevant SPHCCs as set out below. To determine how an Activity Cost shall be assigned to the relevant SPHCCs, it shall first be determined into which one of the following categories the Activity Cost falls:

[...]

d) Overheads, which shall be classed either—

i) if the Activity Costs relate to one or more Operational Business Processes which do not have a direct causal link to any of the SPHCCs being processed, as Pipeline Overheads; or

ii) if the Activity Costs relate to Non-operational Business Processes **which do not have a direct causal link to any of the SPHCCs being processed**, as General Overheads.

4.115 As stated in its response, Royal Mail will review the Activity Costs of the Non-operational Business Processes to ensure they are treated and allocated in accordance with the amended NCR 8. Royal Mail will inform us about any activities which need to change (as part of the change control process).

Changes to NCR 10: Weighted Volume Drivers

4.116 In line with our proposal, we have decided to amend NCR 10 in order to:

- a) improve the definition of a Weighting Factor; and
- b) provide further guidance on the use of theoretical or modelled data in determining Weighting Factors.

4.117 As we explain above, our revisions to the costing rules reflected two themes which we identified in Royal Mail's changes:

- a) ensuring that the Causality Guiding Principle is considered in definitions in a more appropriate manner; and
- b) using theoretical or modelled data instead of actual data to calculate certain cost drivers and how we can make sure that it is done appropriately.

4.118 For NCR 10, we explain our decisions for each theme below.

Causality

4.119 We explained in the Consultation that, according to NCRs 8 and 9, if an Activity Cost has a direct causal link to the processing of some or all of the SPHCCs, then it must be categorised as an Attributable Operational or Attributable Non-operational Cost, and must be allocated to the SPHCCs in question using either a Weighted Volume Driver or an Other Driver.

4.120 In 2013/14, Royal Mail changed the Weighting Factors related to outdoor delivery. As a result of these changes, in some instances the Weighting Factor for parcels was reduced from 40 to 12 compared with the Weighting Factor of 1 for a letter.

- 4.121 This change in Weighting Factors was one of the key reasons why Royal Mail’s changes to its cost allocations in 2013/14 resulted in less cost being allocated to parcels and more cost allocated to letters.⁴¹
- 4.122 In its response, the MCF stated it would like Royal Mail to provide “detailed justification for any change in weighting or volume drivers”. However, as part of the change control, we already require Royal Mail to provide information to Ofcom for each separate material change⁴² to the Costing Manual.⁴³
- 4.123 In doing so Royal Mail must provide⁴⁴:
- a) a description of the change;
 - b) reasons for the change, including possible alternatives; and
 - c) a reference to the relevant obligations in the RAG and how the change complies with these.
- 4.124 Royal Mail is already required to provide sufficient detail on the changes to Weighting Factors as a result of a methodology change and where they have a material impact on the costs of Activities and products. We can also request more detail from Royal Mail on future changes, as appropriate.⁴⁵
- 4.125 In 2016/17, Royal Mail made further changes to the Activities and Weighting Factors. As a result of these changes, new Street and Path Activities were introduced to reflect the way mail is conveyed along the street or the path to the recipient’s door in a Shared Van, on foot or in an HCT.
- 4.126 Royal Mail considered that, while letters and parcels are en route (e.g. while they are being transported on a Shared Van or an HCT), the relative effort of conveying them is the same. Royal Mail therefore sets the Weighting Factors for letters and parcels for those Activities as equal. Royal Mail informed us that this assumption underpinned the previous cost allocation methods, although it was not explicitly stated in the Costing Manual.
- 4.127 Royal Mail argued that, while letters and parcels are en route, the cost drivers depend only on the distance and the time taken, which is independent of the format, weight or size of the mail items being conveyed.

⁴¹ Royal Mail Group Limited, [Regulatory Financial Statements 2013-14 \(dated December 2005\)](#), ‘Delivery Methods’, pages 5-6.

⁴² Ofcom, USPAC, in relation to the identification of material changes for the purpose of complying with the requirements set out in USPAC 1.6.3, materiality shall be determined as follows— (ii) for the purposes of the National Costing Methodology and the Zonal Costing Methodology only, a change in any reported item of product, SPHCC, or Activity Cost shall be deemed to be material if the resultant percentage difference (be it positive or negative) exceeds 1%, unless the change itself is smaller than £0.5 million. The resultant percentage difference shall be calculated by reference to the Compliance Base Value.

⁴³ Ofcom, RAG, Paragraphs 6.5 and 6.10 stipulate that Royal Mail must provide information to OFCOM on each separate material change to the Costing Manual and to the Accounting Methodology manual respectively, in a format that is clear and transparent using the pro-formas set out in Appendix 3 of the RAG.

⁴⁴ Appendix 3 – RAG 2017.

⁴⁵ Weighting Factors changes as a result of updated measurements, without any changes to the measurement methodologies, do not necessarily require reporting in the change control. However, annually we receive a schedule of the Weighting Factors, as part of the CAM, which allow us to observe the changes and any effects on cost allocations.

- 4.128 Instead, the format affects the new cost allocation methods by determining the proportions of various SPHCCs going through different delivery methods.
- 4.129 For example, parcel SPHCCs are classified into four formats which determine the method by which they are to be delivered. Format 1 and 2 parcels, which are smaller and lighter, and most letters are considered foot deliverable (including Shared Van and HCT delivery methods). Format 3 and 4 parcels, which are larger and heavier parcels, are delivered using motorised delivery methods (including dedicated vans). These formats are therefore allocated the Activity Costs of motorised delivery methods, as a result the total delivery costs allocated to larger and heavier parcels are generally higher.
- 4.130 We considered Royal Mail's assumption relating to the equal effort of conveyance for letters and parcels to be consistent with the NCRs and appropriate for our monitoring purposes. However, Royal Mail has not explained and justified this assumption in its published Costing Manual.⁴⁶
- 4.131 In addition, Royal Mail's calculations, some of which are reflected in its published Costing Manual⁴⁷, are not consistent with the terminology for Weighting Factors as defined in the NCRs. For example, we note that for some outdoor delivery cost allocations, Royal Mail conflates the function of a Weighting Factor and a Proportional Factor so that, for certain delivery methods, the Weighting Factor reflects the proportion of SPHCCs parcel traffic between foot deliverable and non-foot deliverable routes. We consider this to be the function of Proportional Factors as required by NCR 10 (paragraph 8.28 (a)).⁴⁸
- 4.132 Royal Mail informed us that the Weighting Factors have been used in this way as it was the most practical means of updating cost allocation calculations and was deemed to be the simplest and easiest to maintain and control.
- 4.133 In its response, Royal Mail suggested we rephrase 'relative proportions' in 8.28 (b) to make a clearer distinction between a Proportional Factor and a Weighting Factor. We agree this change provides the user of the NCRs with greater clarity, without diminishing the definition of a Weighting Factor.
- 4.134 While we understand Royal Mail's reasons for its calculations, we expect Royal Mail to explain its approach more clearly in its published Costing Manual and other relevant submissions and ensure those explanations use terminology that is consistent with the RAG.
- 4.135 If the use of Weighting Factors and Proportional Factors are combined in a single set of numbers to simplify the calculations, this must be explained clearly. Royal Mail must also

⁴⁶ Royal Mail, ABC Costing Manual Technical Appendices, 2016-17.

⁴⁷ Royal Mail, ABC Costing Manual Technical Appendices, 2016-17, Appendix 5.1.1.7: Derivation of Delivery Outdoor SPHCC Weightings.

⁴⁸ As an illustrative example, if 20% of all parcels are delivered using an HCT route, and 94% of the parcels which weigh between 0 – 100g are Format 1 and 2 which makes them foot deliverable (the remaining 16% being Format 3 and 4, which makes them deliverable using a motorised method); then Royal Mail states in the Costing Manual that the Proportional Factor is 20% and the Weighting Factor is 0.94. Whereas, if the definitions in line with RAG are applied appropriately, the Proportional Factors for Format 1 and 2 parcels would be 18.8% (20% x 0.94) and the Weighting Factors for those parcels would be 1 (equal to letters' Weighting factor of 1).

ensure that it has the ability to break down, if needed, the single set of numbers into separate Weighting Factors and Proportional Factors.

- 4.136 Therefore, we have decided to adopt our proposal, but with the slight modification of removing ‘proportions of’ to ensure the definition of Weighting Factors is sufficiently clear. The amended NCR reads as follows (amendments are in bold and strike-through):

8.28 Weighted Volume Drivers shall incorporate two types of factors for each relevant attributable Activity Cost, namely—

a) Proportional Factors, which represent the proportion of the total volume of each SPHCC which uses the related Activity; and

b) Weighting Factors, which represent the relative ~~proportions of~~ amount of work that units of each SPHCC require from the related Activity, **when compared to a different SPHCC using the same Activity.**

- 4.137 We expect Royal Mail to review its use of terminology related to Weighting Factors and Proportional Factors in its published Costing Manual and its submissions to us to ensure that they are consistent with the amended NCR 10. We do not consider that this should delay the implementation of the new rules as this should not involve a calculation or methodology change.
- 4.138 We also expect Royal Mail to explain its reasons clearly for all its assumption in determining the Weighting Factors, including where it assumes parcels and letters to have equal Weighting Factors. We do not expect this to be a significant piece of work as we assume Royal Mail has documented its reasoning when setting up the initial allocations.

Theoretical and modelled data

- 4.139 We explained in the Consultation that many of the Activity Drivers used by Royal Mail are based on Planning Values and industrial engineering measurements, because actual data could not be reasonably and cost-effectively recorded at the required level of granularity.
- 4.140 We considered that the Guiding Principle of Objectivity and the NCR 2 on Operational Reality require Royal Mail to use actual data where there is reliable and relevant data recorded. Theoretical or modelled data must be used only where this is not the case, because we consider there is more risk of bias when data is not grounded in actual operations and actual work done.
- 4.141 As we outlined in our discussions relating to NCR 6, Royal Mail believes that Ofcom’s reference to the use of actual data where there is reliable and relevant data has the intention of meaning the actual data is ‘fit for purpose’. In some case, Royal Mail has a form of actual data, but has reservations about its suitability for cost allocation purposes.
- 4.142 As previously explained, we do not agree that Royal Mail’s proposed amendments are necessary.

- 4.143 Additionally, we considered that any use of theoretical or modelled data must be done in accordance with NCR 14 and 15 which address the use of operational data and data integrity respectively. Please see our discussion of NCR 6 above.
- 4.144 Therefore, we have decided to adopt our proposal with a slight modification as explained in relation to NCR 6. That modification is to replace ‘sufficient granularity’ with ‘the necessary components for cost allocation’ to provide further guidance on the use of theoretical or modelled data and clarify other related aspects of the rules. The amended NCR 10 reads as follows (amendments are in bold and strike-through letters):

8.29 Proportional Factors referred to in §8.28(a) shall be based on operational data collected using representative measurements of total volumes (including statistical sampling techniques where necessary, **see National Costing Rule 14**).

8.30 Depending on the nature of the Activity, one or more of the following variables may be used as a determinant of the amount of work to calculate the Weighting Factors—

(a) time (needed to carry out the Activity): ~~where appropriate, industrial engineering studies must be carried out in accordance with relevant ISO standards;~~

(b) weight (**of an item**): ~~appropriate operational data must be used;~~ and

(c) size (**or physical dimensions of an item**): ~~appropriate operational data must be used,~~

provided that each variable used by Royal Mail to calculate each Weighting Factor is quantified based on appropriate operational data using actual data containing the necessary granularity.

Only where such actual data is unavailable or lacks the necessary components for cost allocation, Royal Mail may use modelled or theoretical data, provided that this data is

—

(d) **based on sampling or industrial engineering studies; and**

(e) **prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).**

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.30, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

Changes to NCR 11: Other Drivers

- 4.145 Similar to NCR 6 and 10, we have amended NCR 11 to include further guidance on the use of theoretical or modelled data.
- 4.146 We consider that our Guiding Principle of Objectivity, which requires the regulatory accounting methodology takes account of all the available financial and operational data, and the NCR 2 on Operational Reality, which means allocations must reflect the trading

operations, require Royal Mail to use actual data where there is reliable and relevant data recorded.

- 4.147 Therefore, theoretical or modelled data must only be used where this is not the case. We consider there is more risk of bias when data is not grounded in actual operations and actual work done.
- 4.148 As we outline in our discussions relating to NCR 6 and NCR 10, Royal Mail believes that Ofcom’s referral to the use of actual data where there is reliable and relevant data has the intention of meaning the actual data is ‘fit for purpose’. In some case Royal Mail has the form of actual data but has reservations about its suitability for cost allocation purposes.
- 4.149 As previously explained, we do not agree that Royal Mail’s proposed amendments are necessary.
- 4.150 Additionally, we considered that any use of theoretical or modelled data must be done in accordance with NCR 14 and 15 which address the use of operational data and data integrity respectively.
- 4.151 Therefore, we have decided to adopt our proposal, but with a slight modification as explained in relation to NCR 6. That modification is to replace ‘sufficient granularity’ with ‘the necessary components for cost allocation’. The amended NCR 11 reads as follows (amendments are in bold and strike-through):

8.34 Other Drivers shall be used for costs (certain Attributable Operational Costs and all Attributable Non-operational Costs and Aggregate Costs) which are directly linked to a factor other than mail traffic in the Pipeline.

8.35 Other Drivers shall be ~~defined in a way which appropriately reflects the causal link with that factor~~ **quantified based on appropriate operational data using actual data containing the necessary granularity which reflects the causal link to that factor.**

Only where such actual data is unavailable or lacks the necessary components for cost allocation, Royal Mail may use modelled or theoretical data, provided that this data is

—

(a) based on sampling or industrial engineering studies; and

(b) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).

For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.35, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.

- 4.152 In the Consultation, we proposed that Royal Mail should ensure it is clear which Activities are allocated using Other Drivers and the basis for those allocations.
- 4.153 Royal Mail said it will “undertake a review during 2019-20 in relation to the mapping of Activities to drivers as set out by Ofcom”.

- 4.154 To clarify, we expect Royal Mail to improve the categorisation and descriptions within the Activity Bible⁴⁹ to ensure it is clear which Activities are allocated using Other Drivers (as well as Weighted Volume Drivers or EPMU), and the basis for those allocations. This will allow us to gain a better understanding of Activity Drivers and identify differences which we may want to understand in more detail.
- 4.155 Royal Mail considers that this, and other reviews, “will take a minimum of two man-months” and that it “could be materially longer”. However, we do not consider that this should delay the implementation of the new rules as this should not involve a calculation or methodology change.

Changes to NCR 14: Operational data and sampling

- 4.156 In line with our proposal, we have amended NCR 14 to:
- a) include theoretical and modelled data in the definition of operational data; and
 - b) link NCR 14 to NCR 15 in order to maintain the integrity of the operational data.
- 4.157 As explained in our proposals, many of the cost allocations and NCRs use or discuss operational data. NCR 14 ensures the operational data used by Royal Mail is accurate and consistent (over time and in similar applications). It also ensures that, where data is not available for each and every data point, Royal Mail may use appropriate sampling techniques to obtain the necessary data.
- 4.158 The rule refers to operational data, but not explicitly to theoretical and modelled data. However, we would expect all data sources to be reviewed and updated for accuracy and consistency, so we proposed to link NCR 14 to NCR 15.
- 4.159 As explained in NCR 6, Royal Mail made some changes to the use of data used for Resource Drivers. To support the changes Royal Mail has conducted studies using Industrial Engineers (IE). It states that IEs accompany delivery postmen and postwomen on their delivery route and measure the time taken for each element of work observed. Thousands of observations are captured in this way across delivery operations. The information is collated in a database, which is then used alongside calculated workloads to produce standard (or ‘should take’) hours for each Activity.
- 4.160 Sampling can be defined as a statistical method of obtaining representative data or observations from a group or population, as such, the IE studies could be considered sampling.
- 4.161 Stakeholders did not have any specific comments to our proposed changes to NCR 14 other than those made in reference to data integrity as covered by NCR 15 below.
- 4.162 We therefore have adopted our proposal. The amended NCR 14 reads as follows (amendments are in bold):

⁴⁹ As part of the submission of the Costing Manual, Royal Mail provides a file which details Activities and associated attributes/characteristics called the Activity Bible. This includes details of how activity costs are assigned to products and/or services.

8.40 All operational data —**whether actual, modelled or theoretical data**— used by the National Costing Methodology shall be regularly reviewed by Royal Mail and, where necessary, updated to ensure the accuracy of costing and its consistency with the operational reality (see National Costing Rule 2). **In so doing, for the avoidance of doubt, Royal Mail must ensure the integrity of all the data in accordance with National Costing Rule 15.**

8.41 Royal Mail must ensure that all sampling used by the National Costing Methodology is applied by a qualified professional statistician as such sampling must be based on statistical techniques regarded as appropriate for such purposes. The reference to a “qualified professional statistician” is a reference to a person with the relevant statistical knowledge and expertise, who shall have a qualification in statistics from a recognised professional body, such as the Royal Statistical Society in the United Kingdom.

Changes to NCR 15: Data integrity

- 4.163 In line with our proposal, we have decided to amend NCR 15 to separate:
- a) the definition of data integrity, which captures the maintenance and assurance of the consistency of any data over time; and
 - b) the rules in relation to theoretical and modelled financial and operational data.
- 4.164 In addition to the above amendments, we have included further guidance in NCR 15 which explains that all changes to data sources and methodologies from one period to another must be justified by reference to the other requirements of the RAG and the Guiding Principles in the USPACs. We have also included ‘in so far as possible’ in the definition of data integrity as we understand Royal Mail may need to introduce or change the data sources and methodologies to ensure the data it uses continues to be appropriate, and accurate and includes all the necessary components for cost allocation.
- 4.165 As explained in our proposals, NCR 15 explains how to ensure the integrity of financial and operational data.
- 4.166 Financial and operational data – whether actual, modelled or theoretical – could be subject to changes in data collection, processing methodologies and techniques. Royal Mail is required to ensure any such changes are consistent with the relevant Guiding Principles and the relevant rules in the RAG.
- 4.167 However, in the absence of appropriate checks and controls, such changes mean that the consistency of this data over time is not necessarily assured and may lead to unintended or artificial year-on-year variances. This could mean that we are unable to accurately compare financial and operational data over time and appropriately inform our decisions.
- 4.168 Our observations of the 2016/17 costing data provided two examples, set out below, of changes in the methodology or technique used to measure operational data. These examples highlighted the importance of having checks and controls over the development of data from one period to another.

- 4.169 In 2016/17, when Royal Mail introduced the new method for categorising parcel products to formats, it used sampling data obtained through the Mail Characteristics Survey (MCS).⁵⁰ The data for SPHCCs with similar characteristics is segmented into a number of product groups (e.g. stamp parcels or tracked parcels) based on statistically valid samples. Prior to 2016/17, the sample data used included two product groups, Tracked and Untracked Parcels, which are collectively referred to as Domestic Account Parcels.
- 4.170 The method used for the MCS survey, which informed the 2016/17 cost allocations, did not produce statistically significant sample sizes for Tracked Parcels which led Royal Mail to combine these samples with Untracked Parcels to create a single product group. Royal Mail stated that using separate product groups “could not be justified or supported by empirical data from MCS and [it] could not therefore be confident that this would give a more accurate cost attribution”.⁵¹
- 4.171 The way the MCS is conducted at present means that issues such as this are not identified until after the survey period has ended. Royal Mail has confirmed that the issue, which resulted in sample sizes that were not statistically significant in Tracked Parcels, has now been addressed and the distribution by format for Tracked and Untracked Parcels is separated back into two groups.⁵² As a result the data in the 2016/17 financial year is not comparable to that in 2015/16 and 2017/18.
- 4.172 Royal Mail’s reasons for the above changes appeared to be valid. However, prior to commencing those surveys or studies, Royal Mail must design sampling surveys and engineering studies as far as possible in a way that ensures they produce statistically valid outputs in order to remove or reduce unintended year on year variances.
- 4.173 Another example of changes in how data are measured relate to the weight bands of parcels used for sampling. We noted that in 2016/17 Royal Mail made a change to the size bandings of parcels. It removed the more than 5kg weight band and combined these items with the 2-5kg parcels to create a single +2kg weight band.
- 4.174 [§].^{53, 54} Royal Mail’s changes to the weight bands appear appropriate in light of the operational reality of the network for the future, although they may make data for the weight bands in question harder to compare for periods directly before and after the change.
- 4.175 Overall, Royal Mail’s reasons for the changes in the above two examples appeared to be valid. However, these examples highlighted the importance of having checks and controls on the development of data from one period to another. These checks and controls ensure the maintenance and assurance of accuracy and consistency of any data over time.

⁵⁰ Mail Characteristics Survey (MCS) is a nation survey that has been operating in its current form since 1999. The MCS captures details on the attributes, such as dimensions and weights, of a sample of mail passing through Mail Centres and Regional Distribution Centres.

⁵¹ Source: Royal Mail’s response to Question 2(b) of “Phase II of Review of Regulatory Financial Reporting for Royal Mail: Costing System Changes for 2014 and 2017” sent on 14th March 2018, dated 28 March 2018 (“RRFR”).

⁵² Ibid.

⁵³ [§]

⁵⁴ Confirmed in email received from Royal Mail, dated 27 July 2018.

- 4.176 The overall purpose of any data integrity requirement is to ensure that data is recorded exactly as intended and, when utilised later, ensure the data is the same as it was when it was originally recorded. In short, data integrity aims to prevent unintentional changes to information. It is a critical aspect to the design, implementation and usage of any system or model which stores, processes or retrieves business data.
- 4.177 Any unintended changes to data as the result of a storage, retrieval or processing operation, including malicious intent, unexpected hardware failure and human error, could be seen as a failure of data integrity.
- 4.178 In its response Royal Mail considered consistency to be important. However, it also recognised that there may be “times when [it] must make changes in how it sources or processes costing data.” Royal Mail believes that “an overemphasis on consistency could lead to the results no longer reflecting operational reality.”⁵⁵
- 4.179 Therefore, to address any overemphasis on consistency, Royal Mail suggested that NCR 15 includes:
- “It is expected that, as Royal Mail’s Business changes, the data used may need to change or new and updated data sources become available. These amended or new sources will need to be used to ensure the regulatory accounting methodology reflects operational reality.”⁵⁶
- 4.180 In addition to its response, Royal Mail has informed us that it is planning on changing two of its data sources in its 2019/20 financial year. First, Royal Mail is planning on replacing sampling data used for revenue reporting with actual data from a billing system for the allocation of its stamp revenue. Second, Royal Mail plans to change the data source used to calculate outdoor workload. Currently it uses national averages to calculate national workload, however new data sources and processing systems have allowed it to calculate information at a more granular level, e.g. at the Delivery Point. Royal Mail will still be using sampling data, but at a more granular level, and consider this to be more accurate and a better reflection of operational reality.
- 4.181 These changes proposed by Royal Mail highlight the fact that new or updated data sources will become available and that changes will be required to ensure that the data it uses continues to be appropriate and accurate. However, Royal Mail must ensure that these changes are justified by reference to the other requirements of the RAG and the Guiding Principles in the USPACs. It must also ensure checks and controls are in place over these new data sources to ensure the maintenance and assurance of accuracy and consistency of this data over time.
- 4.182 We have considered Royal Mail’s response and the above proposed changes in its 2019/20 financial year. We understand that Royal Mail’s business will change from time to time. Furthermore, we understand that to ensure the data it uses continues to be appropriate

⁵⁵ Royal Mail’s response to the December 2018 Consultation, paragraph 3.17.

⁵⁶ Royal Mail’s response to the December 2018 Consultation, paragraph 3.18.

and accurate, Royal Mail may need to introduce or change the data sources it uses, as well as methodologies for data collection and processing.

- 4.183 We do not think that Royal Mail's proposed amendment is necessary. However, we recognise that our proposed amendment may not have been clear. We have therefore amended NCR 15 to accommodate the above-mentioned possibilities through the inclusion of 'so far as is possible' in the definition of data integrity. Our amendments are consistent with the wording of the Guiding Principle of Consistency (USPAC 1.7.2(g)).
- 4.184 We have also now included guidance in NCR 15 that specifies all changes to data sources and methodologies from one period to another (whether or not they captured by the change control requirements) are justified by reference to relevant requirements in the RAG and the Guiding Principles in the USPACs. In considering such changes, we expect Royal Mail to be guided in particular by NCR 2 and the Zonal Costing Rule 2 on Operational Reality and the Guiding Principles of Causality, Objectivity, Accuracy and Consistency.
- 4.185 Therefore, we adopt our proposal, but with slight modifications. Those modifications are the inclusion of 'so far as possible' in the definition of data integrity and separation of the definition of data integrity from the rules and guidance. The amended NCR 15 now reads as follows (amendments are in bold and strike-through):

8.42 Definition: Data Integrity is the maintenance of and, so far as is possible, the assurance of the accuracy and consistency of any data over time, and the data includes (but is not limited to) inputs, models and outputs.

In light of that definition, Royal Mail shall ensure that:

a) the **Data Integrity** of financial and operational data —**whether actual, modelled or theoretical data**— used for the National Costing Methodology is preserved by adequate checks and controls ~~which shall~~ **on the data for the same period as well as adequate checks and controls on the development of data from one period to another;**

b) **those checks and controls** include (**but are not limited to**) reconciliation of total cost data at appropriate points in the National Costing Methodology; **and**

c) **any and all changes to data sources and methodologies from one period to another are justified by reference to relevant requirements in the RAG and the Guiding Principles in the USPAC Condition.**

8.43 The total amount of input costs relating to any element of the National Costing Methodology shall be equal to the total amount of output costs relating to that element. In particular, the following total figures shall be reconciled to each other—

a) the total costs in the General Ledger;

b) the total Activity Costs; and

c) the total costs of all SPHCCs.

Clarification to NCR 2: Operational reality

- 4.186 Stakeholders had no specific comments on the clarification to NCR 2. Therefore, in line with our proposal, we have not made any changes to NCR 2.
- 4.187 As we explained in the Consultation, in 2013/14 and 2016/17, Royal Mail made various significant changes to its costs allocation methods to reflect the new delivery methods it has adopted. Royal Mail informed us, while we were conducting the Phase II review, that those changes rely heavily on NCR 2 and the need to observe operational reality without significant references to the other rules in the RAG or the Guiding Principles.
- 4.188 In the Consultation, we emphasised that Royal Mail is required to comply with all relevant rules in the RAG in each instance (including all the NCRs). We reiterated that there is no hierarchy or priority among the NCRs in the RAG.
- 4.189 We confirmed that the only hierarchy we recognise is that specific rules in the RAG override the Guiding Principles in the USPAC 1.7.1. In other words, if there is a clear and specific rule for an issue in the RAG, that rule will take precedent over any alternative application of the Guiding Principles to that issue.
- 4.190 However, we also recognised that there may be cases where Royal Mail considers there to be a conflict between two or more rules in the RAG. We confirm that in such cases, Royal Mail must satisfy itself that, in giving priority to one rule over another, it complies with the

Guiding Principles. Royal Mail must also demonstrate its reasoning to us as part of its change control submissions, if necessary or upon request.

- 4.191 Therefore, as there were no stakeholder comments in relation to this clarification, we have not made changes to NCR 2 and continue to believe that it is adequate for our monitoring purposes.
- 4.192 However, we highlight that:
- a) there is no hierarchy or priority to the NCRs and Royal Mail is expected to comply with all relevant rules in each instance;
 - b) there is a hierarchy relating to specific rules in the RAG overriding the Guiding Principles in USPAC 1.7.1;
 - c) if a conflict between two or more NCRs arises, Royal Mail must satisfy itself that, in giving priority to one rule over another, it complies with the Guiding Principles; and
 - d) if a conflict between two or more NCRs arises, Royal Mail must demonstrate its reasoning for such priority, as part of its change control submissions or upon request.

Changes to Transfer Charges

Our proposals

- 4.193 We currently require Royal Mail to set transfer charges for the services which the Reported Business may provide to other companies or business units within the Relevant Group, and for services which it may receive from them. The transfer charges are necessary to ensure that the costs and revenues of the Reported Business represent those of an independent commercial entity. This is important for our considerations of the financial sustainability and efficiency of the provisions of the universal service which we carry out by monitoring the costs and revenues of the Reported Business.
- 4.194 The RAG requires that these transfer charges are calculated on an arm's length basis following the rules below⁵⁷:
- a) Equivalence pricing:
 - i) if the Reported Business provides a service to another entity within the Relevant Group, it must charge that entity a transfer price that is equivalent to the price it charges to third parties in the open market for a similar service; and
 - ii) if an entity within the Relevant Group provides a service to the Reported Business, it must charge the Reported Business a transfer price that is equivalent to the price it charges to third parties in the open market for a similar service.

⁵⁷ Ofcom, 2017. [Regulatory financial reporting review for Royal Mail – Statement, Annex 2](#), paragraphs 8.72 -8.76.

- b) Cost-plus pricing – if there are no similar services provided to or by third parties in the open market, the transfer price must be equal to the FAC of the service plus a mark-up of 10% on the FAC.
- 4.195 We also require Royal Mail to provide us with transfer prices between its upstream services (collection, outward processing and trunking services) and downstream services (inward processing and delivery services) for certain end-to-end products, mainly retail bulk products. These transfer prices are based on the assumption that the retail products in question receive services from the downstream operations as the access operators receive similar services from Royal Mail wholesale services.
- 4.196 These requirements provide us with the information necessary to calculate separately the profitability of the upstream and downstream parts of the retail products in question. The products captured by this requirement are those which could potentially be at the risk of margin squeeze and include all the products within our margin squeeze control as well as those outside that control.
- 4.197 The RAG requires the transfer prices between the upstream services and the downstream services to be set following the rules below⁵⁸:
- a) Equivalence pricing – where there are appropriate comparable access services, Royal Mail must base the transfer price of the service in question on the price of that service, adjusting for the FAC differences, plus a mark-up of 10% on those FAC differences, of the operational and activity differences between the service in question and the equivalent access service.
- b) Cost-plus pricing – where there are no appropriate comparable Access services, Royal Mail must set the transfer price of the service in question as equal to the FAC of that service plus a mark-up of 10% on that FAC. As explained above, where we require cost-plus pricing or FAC adjustments for differences in equivalent pricing (between equivalent retail and access services in question), we currently require a 10% mark-up to be added to the FAC of the services or differences in question respectively. This is to ensure a measure of return is included in the FAC, because Royal Mail’s ABC costing system generates FAC which do not include any measure of return or profit.
- 4.198 We proposed to replace the requirement to include a 10% mark-up on FAC with a requirement to include ‘an appropriate return’. We now consider there is sufficient data to estimate an appropriate return to be used. We expect this return to be that which an investor would demand to receive from Royal Mail’s downstream services (including its wholesale services) if it were an independent entity. As we concluded in our March 2017 Statement⁵⁹, for an asset-light and labour-intensive business such as Royal Mail, a return on sales metric is a more appropriate metric, and investors are more likely to use it as a measure of the returns they demand, as opposed to a return on assets metric.

⁵⁸ Ofcom, 2017. [Regulatory financial reporting review for Royal Mail – Statement, Annex 2](#), paragraphs 9.8-9.13.

⁵⁹ Ofcom, 2017. [Regulatory financial reporting for Royal Mail – Statement](#), paragraphs 3.44-3.63.

- 4.199 We set out below our proposed amendments to the relevant transfer pricing rules in the RAG (the amendments are in bold and strike-through):

8.76 Subject to §§8.77-78, Royal Mail must calculate a Transfer Charge on an arm's length basis in accordance with §8.72 by securing that—

- (a) if the product and/or service provided is provided to persons other than the Relevant Group, the Transfer Price shall be equivalent to the price charged to those persons;
- (b) if the product and/or service is provided to the Relevant Group by other persons, the Transfer Price shall be equivalent to the price charged by those persons; and
- (c) if the product and/or service does not fall within §8.76(a) or (b), the Transfer Price shall be equal to the FAC of that product and/or service plus **an appropriate return** ~~a mark up of 10% on FAC.~~

...

Equivalence pricing

9.9 Where there are appropriate comparable Access products and/or services provided by Royal Mail to external customers, Royal Mail must apply the equivalence pricing approach referred to §9.10 in determining Transfer Prices.

9.10 The equivalence pricing approach means—

- (a) An appropriate comparable Access product and/or service shall be identified for the internal product and/or service for which the Transfer Price is to be determined.
- (b) The operational and Activity differences between the internal product and/or service for which the Transfer Price is to be determined, and the appropriate comparable product or service shall be identified.
- (c) The FAC differences of the operational and Activity differences referred to in §9.10(b) above shall be identified in a manner consistent with the National Costing Methodology.
- (d) The Transfer Price shall be determined as the sum of the price of the appropriate comparable Access product and/or service, the FAC differences referred to in §9.10(c) plus **an appropriate return** ~~a mark up of 10% on those FAC differences.~~

...

Cost-plus pricing

9.12 Where there are no appropriate comparable Access products and/or services, Royal Mail must set the Transfer Price as equal to the FAC of the product and/or service in question plus **an appropriate return** ~~a mark up of 10% on that FAC.~~

- 4.200 We considered that it is reasonable to base the appropriate rate of return on the Financeability EBIT range of 5-10% which we have set as a measure of Royal Mail's

commercial rate of return for the provision of the universal service.⁶⁰ We also stated that we expected Royal Mail to regularly evaluate the appropriateness of the rate of return it uses and monitor the available information to ensure the rate of return remains reasonable for downstream services.

Stakeholders' responses

- 4.201 Royal Mail responded that, while we proposed increased flexibility in transfer charging, we could go further to future-proof the transfer charging arrangements. Royal Mail suggested that this could be achieved by including provisions for alternative transfer charging approaches which would remove the need to amend the RAG in the future.
- 4.202 Royal Mail stated that an alternative transfer pricing approach could be to set transfer prices based on incremental costs. Royal Mail considered this approach to transfer pricing to be consistent with the economic literature on assessing product profitability. Royal Mail also stated that there were a range of other costing options that could be considered. For example, it may be appropriate to include a fixed and variable charge for transfer pricing.
- 4.203 Royal Mail stated that FAC may not be the appropriate transfer price in all circumstances and limiting the transfer price to be FAC with an appropriate rate of return between 5 and 10% is too restrictive. Royal Mail stated that, for example, individual product returns should not be required to be in the 5%-10% range, given competitive pressures, and that some will be below this level.
- 4.204 To address the above point about varying product profitability, Royal Mail suggested that the RAG provides a choice between an appropriate return or a return agreed between Royal Mail and Ofcom.

Our reasoning and decisions

- 4.205 We acknowledge that there may be various approaches to setting transfer charges which could include using costs standards other than FAC. The most appropriate approach would depend on the purpose of the transfer pricing in question and the availability and reliability of the data available.
- 4.206 As explained in Section 2, our objectives for regulatory financial reporting that supports our monitoring regime include monitoring the financial sustainability and efficiency of the provision of the universal service. It is therefore important for us to ensure the Reported Business is clearly defined and separated from the rest of Relevant Group. We achieve this by ensuring transfer prices are set on an arms' length basis (i.e. equivalent to market prices where possible) for transactions between the Reported Business and the rest of the Relevant Group. In the absence of an appropriate open market benchmark, we consider FAC plus an appropriate return to be the most appropriate approach. As we explain in

⁶⁰ Ofcom, 2017. [Regulatory financial reporting for Royal Mail – Statement](#), paragraphs 3.58-3.60.

Section 3, we consider the FAC to be the appropriate cost standard for assessing financial sustainability and efficiency of the provision of the USO.

- 4.207 As explained in Section 2, our objectives for regulatory financial reporting also include monitoring competition issues, including potential margin squeeze relating to retail bulk products. As we explain above, it is therefore important that we are able to monitor the upstream profitability of retail products. We achieve this by setting transfer prices at arms' length between upstream and downstream services. In the absence of an appropriate open market benchmark, we consider FAC plus an appropriate return to be the most appropriate approach for our monitoring purposes. This is consistent with our approach to the margin squeeze control set out in USPA 6.
- 4.208 We recognise that different product groups may carry different levels of risk and therefore may merit different levels of return which may also differ from the overall return of the Reported Business. Our proposed changes to the transfer pricing rules allow for such variations by requiring 'an appropriate return'. We expect Royal Mail to have sufficient evidence to support the appropriateness of any rates of return it may decide to use.
- 4.209 We also recognise Royal Mail's concern that some of its prices may be set below FAC and based on its estimate of incremental costs. As we explained in Section 3, we consider the requirements in the RAG and the FAC calculated in compliance with those requirements to be appropriate for our monitoring purposes. We also consider FAC plus an appropriate return to be sufficient for our monitoring purposes. To address other specific regulatory concern, we may need to consider other cost standards.
- 4.210 In light of the above, we consider we have allowed sufficient flexibility in our proposed changes to the transfer pricing rules in the RAG and therefore we do not consider the extent of flexibility suggested by Royal Mail to be appropriate.
- 4.211 We therefore adopt our proposal by amending the guidance in Section 8 relating to Transfer Charges as follows (amendments are in bold and strikethrough):

8.76 Subject to §§8.77-78, Royal Mail must calculate a Transfer Charge on an arm's length basis in accordance with §8.72 by securing that—

(a) if the product and/or service provided is provided to persons other than the Relevant Group, the Transfer Price shall be equivalent to the price charged to those persons;

(b) if the product and/or service is provided to the Relevant Group by other persons, the Transfer Price shall be equivalent to the price charged by those persons; and

(c) if the product and/or service does not fall within §8.76(a) or (b), the Transfer Price shall be equal to the FAC of that product and/or service plus **an appropriate return** a ~~mark up of 10% on FAC.~~

- 4.212 We therefore adopt our proposal by amending the guidance in Section 9 relating to Transfer Pricing between Upstream Services and Downstream Services as follows (amendments are in bold and strikethrough):

Equivalence pricing

9.9 Where there are appropriate comparable Access products and/or services provided by Royal Mail to external customers, Royal Mail must apply the equivalence pricing approach referred to §9.10 in determining Transfer Prices.

9.10 The equivalence pricing approach means—

(a) An appropriate comparable Access product and/or service shall be identified for the internal product and/or service for which the Transfer Price is to be determined.

(b) The operational and Activity differences between the internal product and/or service for which the Transfer Price is to be determined, and the appropriate comparable product or service shall be identified.

(c) The FAC differences of the operational and Activity differences referred to in §9.10(b) above shall be identified in a manner consistent with the National Costing Methodology.

(d) The Transfer Price shall be determined as the sum of the price of the appropriate comparable Access product and/or service, the FAC differences referred to in §9.10(c) plus **an appropriate return** ~~a mark up of 10% on those FAC differences.~~

[...]

Cost-plus pricing

9.12 Where there are no appropriate comparable Access products and/or services, Royal Mail must set the Transfer Price as equal to the FAC of the product and/or service in question plus **an appropriate return** ~~a mark up of 10% on that FAC.~~

Effective date

Our proposal

4.213 We proposed that the modifications to the RAG come into effect from the date of this statement. We expected this timing to be proportionate as we did not expect Royal Mail would need to make any significant changes to its costing methodology as a result of the modifications proposed.

Stakeholder responses

4.214 In response, Royal Mail proposed that changes to the RAG take effect from the 2020-21 financial year and it stated that during 2019-20, it will perform the reviews that Ofcom has requested.

4.215 As set out above, Royal Mail explained the reviews it believes it will need to undertake. It estimates that these reviews will take “two-man months (or longer).”⁶¹ Royal Mail presented Ofcom with the below estimated timeline which indicates that the earliest that

⁶¹ Royal Mail’s response to the December 2018 Consultation, paragraph 5.1.

it could complete the review would be after the submission of the annual Regulatory Accounts in June 2020:

- Ofcom issues its statement in September 2019.
- Costing team produce Q2 Regulatory Accounts (30 September to 22 November 2019).
- Costing team start review – 1 man-month of effort.
- Costing team produce Q3 Regulatory Accounts (30 December to 21 February 2020).
- Costing team start review – 1 man-month of effort.
- Costing team produce Q4 Regulatory Accounts (30 March to 22 May 2020).
- Costing team produce annual Regulatory Accounts (30 March to 26 June 2020).

- 4.216 Furthermore, Royal Mail proposed that there would be clear benefits from starting the 2020-21 year on a consistent basis. It noted that Ofcom would be able to see the Q1-Q4 2019-20 results on a consistent basis. The Q1-Q4 2020-21 would similarly be consistently presented. It also claimed it would give Royal Mail enough time to work through its processes, consider all the implications and to discuss the changes with Ofcom. Royal Mail highlighted that it does not want to make changes which were unintended by Ofcom.⁶²
- 4.217 Royal Mail also explained that these changes will need to pass through Royal Mail's governance processes as well as notifying Ofcom of these changes as part of the regulatory change control process and that it would like to discuss with Ofcom a proportionate way to do this. It believes that, in this instance due to the expected volumes, it would be appropriate and materially less burdensome to assess the impact during 2019-20, share the results with Ofcom and implement in Q1 2020-21, without the need to then restate the results as part of the annual change control notification at the end of 2020-21.⁶³

Our decision

- 4.218 We have decided that Royal Mail is required to comply with the revised requirements in the revised RAG for the financial information and reports due the quarter and year ending 29 March 2020 and thereafter. For the avoidance of doubt, the reports required for the third quarter of the 2019-20 financial year ending on 29 December 2019 (due for submission 54 days after the quarter end) could still be prepared under the current RAG.
- 4.219 We have carefully considered Royal Mail's arguments in support of its desired effective date. Our view is that Royal Mail should be able to comply with the revised requirements and implement any necessary changes by the final quarter of the current financial year (Q4 2019-20), noting in particular:
- a) our statement has been published earlier than anticipated by Royal Mail in its timeline set out above; and

⁶² Royal Mail's response to the December 2018 Consultation, paragraph 5.2.

⁶³ Royal Mail's response to the December 2018 Consultation, paragraph 5.3.

- b) we do not expect the revised requirements will result in a large number of considerable changes to be made by Royal Mail to its cost allocation methods, as we have explained in our considerations of the NCRs above.
- 4.220 Furthermore, Royal Mail is concerned about producing results on a consistent basis for Q1 to Q4 2019-20. However, we note that in the past, Royal Mail has implemented significant changes to its costing methodology part way through the year, notably changes to delivery methods which was the subject of this Phase II review. We consider that the change control submissions received in Q4 2019-20 will provide us with sufficient initial transparency over the changes as a result of the new requirements.
- 4.221 Finally, as mentioned under NCR 15, Royal Mail plan to introduce at least two new data sources to be used for revenue reporting and calculating workload. We would like to ensure that the changes to the NCRs are effective for the reporting of Royal Mail's annual results for the full 2019-20 financial year and thus the adherence, by Royal Mail, to the changes to NCRs in implementing these new data sources.

Assessment of statutory tests, duties and policy objectives for our proposals

- 4.222 In Section 2, we explain that our decisions to modify the RAG must satisfy relevant tests set out in Schedule 6 of the PSA 2011. We explain below why we consider our decisions satisfy those tests, namely that they:
- are objectively justifiable;
 - do not unduly discriminate against a particular person or a particular description of persons;
 - are proportionate; and
 - are transparent in relation to what it is intended to achieve.
- 4.223 Our decisions are objectively justifiable because, as we have explained in respect of each decision in this section, the modifications to the RAG that we are making are necessary for us to effectively achieve the objectives for regulatory financial reporting. This is in light of the overall decisions we made in the March 2017 Statement, namely monitoring the financial sustainability and efficiency of the provision of the universal service, as well as monitoring competition and consumer issues.
- 4.224 More specifically, we consider that these reporting obligations are objectively justifiable, as they enable us to:
- gain an overview of the revenues, costs and profitability of the Reported Business's products (including universal service products) that use Royal Mail's network and are provided to meet the needs of users in different markets, to help us (i) monitor the risk of cross-subsidisation and (ii) assess the relative cost reflectivity of the pricing of the products in these different groups;

- understand the basis by which Royal Mail's total costs of its network are allocated to various parts of that network and its products for the purpose of relevant regulatory decisions; and
- discharge our general duties in section 3 of the Communications Act 2003 to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

- 4.225 Our decisions are not unduly discriminatory because they address Royal Mail's unique position as the universal service provider.
- 4.226 Our decisions are proportionate because they are necessary to enable us to discharge our statutory duties and effectively monitor Royal Mail's position and activities. In our view, these obligations are no more onerous than is required to comply with our statutory duties and effectively achieve our objectives for regulatory financial reporting set out in Section 2, nor do they produce adverse effects which are disproportionate to those duties and objectives.
- 4.227 Our decisions are transparent because we consider it is clear from the wording of the respective changes to the rules in the RAG what Royal Mail must do and by when. We further consider that the transparency of these obligations is aided by our explanations in this statement.