Regulatory financial reporting for Royal Mail

STATEMENT

Publication Date: 18 December 2017

About this document

On 31 March 2017, we published a consultation document (the March 2017 Consultation) where we set out our proposals for changes to the contents, frequency, disclosure, and deadlines of the regulatory financial reporting required from Royal Mail.

The consultation closed on 1 June 2017. In this statement, we consider and assess the responses received from stakeholders, and in light of that work, we set out our decisions with respect to our proposals (with the exception of margin squeeze control, on which we are planning a further consultation next year). We are making some modifications to our proposed requirements in the light of the concerns that the respondents raised; however, for the most part our decisions remain in line with what we proposed.

We expect that the first two sections of this statement (Executive summary and Introduction and overview) and the final section (Conclusions) will be of interest to a wide range of stakeholders that have an interest in the postal sector. The remaining sections of the statement are likely to be of interest to those with an interest in the technical details of Royal Mail's regulatory financial reporting.

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Section

1. Executive Summary

The case for our review

1.1 In March 2012, we put in place a new regulatory framework for the postal sector (the March 2012 Statement[1]). The new framework gives Royal Mail more commercial and operational flexibility (particularly in relation to setting its prices) while ensuring that appropriate regulatory safeguards are in place to protect consumers and, where appropriate, promote effective competition.

1.2 One of the key safeguards of the framework is a comprehensive monitoring regime which includes a range of regulatory financial reporting requirements on Royal Mail to assist us in fulfilling our duties. These regulatory financial reporting requirements have remained broadly unchanged since the March 2012 Statement.[2]

1.3 In light of the changes in the market which have occurred since the March 2012 Statement, we conducted a review of the Regulation of Royal Mail, which concluded in March 2017 with a Statement (the March 2017 Statement[3]). The March 2017 Statement concluded that our overall approach to regulating the postal market remains appropriate and reiterated that on-going monitoring of the postal market remains a key component of the regulatory framework.

1.4 We also indicated in the March 2017 Statement that we would review whether the regulatory financial reporting requirements remain fit-for-purpose. The review would address the requirements set out in our legal instruments for the UK's universal service provider (USP) for post, which is Royal Mail.

1.5 The specific legal instruments are the USP Accounting Condition (USPAC) and Regulatory Accounting Guidelines (RAG), which set out our regulatory financial reporting requirements, the USP Access condition (USPA), which sets out our requirement with regard to the provision of access by the USP including the margin squeeze control, and the Designated USP conditions (DUSP), which set out further requirements for the designated USP including safeguard caps for second class stamps.[4]

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[1] Ofcom, 2012. Securing the Universal Postal Service, Decision on the new regulatory framework, 27 March 2012, http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/

[2] An update to the regulatory reporting framework was published in January 2014 with relatively modest modifications to the reporting requirements – See Ofcom, 2014. Updating the Regulatory Reporting Framework – Statement USP Accounting Condition, 27 January 2014, https://www.ofcom.org.uk/__data/assets/pdf_file/0020/71534/statement.pdf

[3] Ofcom, 2017. Review of the Regulation of Royal Mail, 1 March 2017, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

[4] Consolidated Version of USP Accounting Condition as at January 2014, https://www.ofcom.org.uk/__data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf ,
Regulatory Accounting Guidelines as at January 2014, https://www.ofcom.org.uk/__data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf ,
Consolidated Version of USP Access Condition as at February 2014, https://www.ofcom.org.uk/__data/assets/pdf_file/0013/12811/usp_access.pdf ,

1.6 On 30 March 2017, we published a consultation (the March 2017 Consultation[5]) for Phase I of our current review of regulatory financial reporting for Royal Mail. The March 2017 Consultation set out our proposed changes to the contents, frequency, disclosure, and deadlines of the regulatory financial reporting required from Royal Mail. Phase II will focus on the regulatory accounting rules (including cost allocation) applied by Royal Mail in preparing its financial reports. Section 8 explains our next steps, including expected timings for implementation of the new requirements and Phase II of our review.

Our proposals

1.7 Informed by the changes in the postal market in recent years and the decisions set out in the March 2017 Statement on the overall regulatory framework, we considered the objectives of the regulatory financial reporting requirements to be as follows:

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.

1.8 We then considered where and how the existing reporting requirements needed to be changed to continue to enable us to meet these objectives effectively and proportionately. Table 2.1 in Section 2 of this statement sets out a summary of the changes we proposed in the March 2017 Consultation. The key changes were:

a) removing the requirements for most of the accounting separation reports, to be replaced by a requirement for granular revenue data extracts from Royal Mail's systems;

b) reducing the frequency of monthly revenue and volume reports and cost and efficiency reports to quarterly;

c) adding further detail to the requirements for the contents of the Business Plan, the Annual Budget, as well as certain cost and efficiency reports; and

d) bringing forward the deadlines for the annual reports from 120 days to 90 days and the quarterly reports from 60 days to 45 days.

Consolidated version of Designated USP Conditions 2 and 3 as at July 2013, https://www.ofcom.org.uk/__data/assets/pdf_file/0023/8339/dusp2.pdf , https://www.ofcom.org.uk/__data/assets/pdf_file/0019/8335/dusp3.pdf

[5] Ofcom 2017. Review of Regulatory Financial Reporting for Royal Mail Consultation, https://www.ofcom.org.uk/consultations-and-statements/category-3/review-of-regulatory-financial-reporting-for-royal-mail-consultation

Stakeholder responses

1.9 Stakeholder responses to the March 2017 Consultation were broadly supportive of our proposals. However, Royal Mail raised the following key concerns about them:

a) the proposed change to the deadlines for quarterly reports from 60 days to 45 days would result in Royal Mail having to provide information that is unapproved or in draft form, because the approval process for the information used in its announcement of half-year and full year results is 53 days;

b) the proposed requirement for granular revenue data extracts from Royal Mail's systems, as well as the existing requirement for cost and volume data extracts, were not targeted, could be misunderstood by Ofcom, and were too granular to be proportionate for Ofcom's purposes; and

c) the proposed further detail to be added to the requirements for the contents of the Business Plan, the Annual Budget and cost and efficiency reports over-prescribed the contents and made the structure of these reports too rigid to reflect the future changes in Royal Mail's business and operations, and in some cases resulted in more than one way of calculating certain metrics such as workload (one measure calculated by Royal Mail and the other required by us).

1.10 We also consulted on proposals in respect of reporting and compliance with the margin squeeze control contained in the USPA (USPA 6 requirements). Having carefully considered the responses to those proposals, we have decided that it is appropriate to revise the proposals set out in the March 2017 Consultation. We intend to consult on new proposals next year, and therefore we do not address issues relating to the margin squeeze control in this document.

Our assessments and decisions

1.11 With the exception of changes relating to the margin squeeze control (USPA 6), and some modifications which we briefly explain below, we have decided to put in place the changes we proposed to the regulatory financial reporting requirements in the March 2017 Consultation. Table 8.2 in Section 8 sets out a summary of the modifications we have made to our initial proposals in the March 2017 Consultation.

1.12 A key modification we have made is the change of the deadline for quarterly reports from our initial proposal of 45 days to 54 days. We agree with Royal Mail that the submission of finalised and approved information more than compensates for the extension in the deadline.

1.13 We have decided that our proposal to require granular revenue data extracts from Royal Mail's systems (in addition to cost and volume data extracts we already require) is necessary to give us the ability and the flexibility to produce the accounting separation reporting we need for our monitoring regime, in particular our objectives of monitoring competition issues and protecting consumer interest.

1.14 We also consider this requirement to be proportionate because the required granularity and the scope of the data extract is necessary for the accounting separation reports that we will need to produce ourselves (as it has been necessary for the reports Royal Mail has been producing); and this requirement has enabled us to considerably reduce the number of accounting separation reports that Royal Mail has been required to produce, and help reduce the regulatory reporting burden on Royal Mail.

1.15 We have decided that our proposed level of detail to be included in the Business Plan, the Annual Budget and cost and efficiency reports is both necessary and proportionate to ensure consistency and comparability of the key results and metrics over time, without which, our monitoring of financial sustainability and efficiency of the provision of the universal service would be lacking.

1.16 In addition, we have considered Royal Mail's concerns that the further details we are requiring regarding efficiency and workload calculations, including our requirements for a restatement based on the definitions and assumptions as per the Business Plan 2015, are too rigid and result in more than one way of calculating workload.

1.17 We have decided that our proposed requirements are not overly rigid but are necessary for consistency and comparability over time. They are also necessary for providing transparency over Royal Mail's calculations, showing how the results evolve over time as a result of changes in calculation and measurement methodologies, as well as changes in volume and mix of products and operational changes.

1.18 However, we recognize that our requirement for a restatement based on the definitions and assumptions as per the Business Plan 2015 could be complex and require time and effort for Royal Mail to produce. We have therefore modified our proposal to require only the total results for the Financial Year and the Annual Budget, removing the requirement for quarterly results and the Business Plan.

1.19 Table 1.1 below summarises the new regulatory financial reporting requirements we have decided to impose on Royal Mail after making some modifications to our proposals as set out in the March 2017 Consultation. We discuss our decisions and modifications in the following Sections of this statement (which are also summarised in Tables 8.1 and 8.2 in Section 8 of this statement).

1.20 The existing regulatory financial reporting requirements will be revoked with effect from 25 March 2018, which we understand it to be Royal Mail's year-end date of the 2017/18 Financial Year. As a result, we have decided to impose on the new regulatory financial reporting requirements to take effect on 26 March 2018.

Table 1.1: Summary of the regulatory financial reporting requirements after applying our changes

Reports / Data submissions	Frequency	Disclosure	Deadline	Sections in this statement
Income statement, statement of capital employed, and cash flow statement of Reported Business (including Cost Matrix, PVEO Analysis, annual reconciliation of quarterly income statements, and end-to-end split between universal service and non-universal service products)	Annual	Published, except for Cost Matrix and PVEO Analysis	90 days after Financial Year end	3, 4, 7
Product Profitability Statements for access and PAF	Annual	Published	90 days after Financial Year end	3, 7
Reconciliation of Relevant Group accounts to Reported Business accounts	Annual	Published	90 days after Financial Year end	3, 7
Business Plan including Annual Budget	Annual	Confidential	Before start of Financial Year, and once approved	5
Cost and volume input and output data at SPHCC level	Annual	Confidential	90 days after Financial Year end	3, 6, 7
Second Class safeguard cap submission	Annual	Confidential	One month after the implementation of any new prices	7
Cash headroom projections for the Relevant Group	Quarterly	Confidential	Before start of Financial Quarter	N/A
Income statement of Reported Business (including Cost Matrix and end-to-end split between universal service and non-universal service products)	Quarterly	Confidential	54 days after Financial Quarter end	3, 4, 7
Product Profitability Statements for access	Quarterly	Confidential	54 days after Financial Quarter end	3, 7
Volume and revenue report	Quarterly	Confidential	54 days after Financial Quarter end	3, 7

Reports / Data submissions	Frequency	Disclosure	Deadline	Sections in this statement
Cost metrics report (including volume to workload bridge)	Quarterly	Confidential	54 days after Financial Quarter end	4, 7
Granular data extract file (Revenue, cost and volume data at Short SPHCC level)	Quarterly	Confidential	54 days after Financial Quarter end	3, 5, 7
Costing Methodology Manual	Quarterly	Published, except for Technical Appendices	54 days after Financial Quarter end	6, 7
Accounting Methodology Manual	Quarterly	Confidential	54 days after Financial Quarter end	6, 7
Change control submissions	Quarterly	Confidential	7 days before changes are made (and combined impact statements to be provided 54 days after the last Financial Quarter end and 90 days after Financial Year end)	6
Royal Mail's management accounts for the Board to meet our requirement for monthly sales and volume information (provided for all Financial Months except for the 1st Financial Month of the Financial Year)	Monthly	Confidential	54 days after Financial Month end for the 6th and 12th Financial Month, and 30 days after Financial Month end for all other Financial Months (except for the 1st Financial Month)	3, 7

2. Introduction and overview

2.1 In this Section, we explain briefly the background and the circumstances that led us to the review of the regulatory financial reporting for Royal Mail, and the work we undertook to develop our proposals set out in the March 2017 Consultation. We then summarise the key responses from stakeholders to our proposals. We also assess those responses which do not relate to our proposals but merit consideration due to their regulatory importance to us.

2.2 Finally, we set out an overview of the legal framework, including our powers, in respect of the regulatory financial reporting requirements for Royal Mail; give the details of our general and equality impact assessments; and conclude with an outline of the structure of the following section of this statement.

Background

March 2012 Statement - Securing the Universal Postal Service

2.3 On 27 March 2012, we published our Statement 'Securing the Universal Postal Service: Decision on the new regulatory framework' (the "March 2012 Statement").[6] 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). Regulatory safeguards were implemented to protect consumers and, where appropriate, promote effective competition.

2.4 One such safeguard was an effective and comprehensive monitoring regime,[7] including requirements for Royal Mail to provide Ofcom with relevant financial information.[8] These requirements were set out in the USP Accounting condition (USPAC).[9]

2.5 The monitoring regime allows us to assess how well the regulatory framework is working to meet our regulatory objectives. In particular, it aims to secure the provision of the universal service, incentivise efficiency improvements, maintain quality of service standards and ensure universal services remain affordable. Royal Mail and other operators are required to provide certain specified information to help 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.

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[6] Ofcom, 2012. Securing the Universal Postal Service: Decision on the new regulatory framework, 27 March 2012, http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/Statement.pdf

[7] 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.

[8] A summary of the regulatory financial information that Royal Mail would be required to provide to support our monitoring regime was outlined in Section 11 and Annex 3 of the March 2012 Statement. These have been subject to some minor changes since March 2012.

[9] See Annex 10 Statutory Notification: USP accounting condition of the March 2012 Statement. https://www.ofcom.org.uk/__data/assets/pdf_file/0027/71676/annex10.pdf

2.6 We imposed the USPAC under section 39 of the Postal Services Act 2011 (the PSA 2011), and introduced a supporting direction under the USPAC to specify the Regulatory Accounting Guidelines (RAG)[10] in accordance with section 53 of the PSA 2011, and paragraph 4 of Schedule 6 to the PSA 2011.

2.7 In January 2014, following consultation[11], we updated the regulatory financial reporting requirements set out in the USPAC and the RAG to ensure that the regulatory financial information provided by Royal Mail remained fit for purpose.[12]

2.8 As part of the March 2012 Statement, we also imposed the USP Access Condition (USPA) under section 38 of the PSA 2011[13] in accordance with section 53 of the PSA 2011, and paragraph 3 of Schedule 6 to the PSA 2011. That Condition imposed a margin squeeze control on Royal Mail in relation to the provision of certain access services to Access Operators.

2.9 In February 2014, following consultation[14] we updated the margin squeeze control requirements set out in the USPA to ensure that they remained fit for purpose.[15]

2.10 As part of the March 2012 Statement, we further imposed the Designated USP (DUSP) conditions under sections 36 and 37 of, and paragraph 3 of Schedule 6 to the PSA 2011 in accordance with section 53 of, and paragraph 3 of Schedule 6 to the PSA 2011. DUSP conditions 2 and 3 imposed safeguard price cap controls.

2.11 In March 2013, following consultation, we amended DUSP condition 3 to correct an error in the calculation of the maximum price to be charged for Second Class Large Letters and parcels weighing less than 2kg.[16]

March 2017 Review of the Regulation of Royal Mail

2.12 We published a consultation entitled the Review of the Regulation of Royal Mail on 25 May 2016[17], and subsequently published a statement concluding the review on 1 March 2017.[18]

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[10] And Annex 11 Direction: Regulatory Accounting Guideline (RAG) of the March 2012 Statement. https://www.ofcom.org.uk/__data/assets/pdf_file/0030/71859/annex11.pdf

[11] Ofcom, 2013. Updating the Regulatory Reporting Framework – Notice of proposed modifications to the USP accounting condition. 23 October 2013. http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/summary/framework.pdf

[12] Ofcom, 2014. Updating the Regulatory Reporting Framework – Statement USP Accounting Condition. 27 January 2014. https://www.ofcom.org.uk/__data/assets/pdf_file/0020/71534/statement.pdf

[13] See Annex 9 Statutory Notification: USP access condition of the March 2012 Statement. https://www.ofcom.org.uk/__data/assets/pdf_file/0024/71781/annex9.pdf

[14] https://www.ofcom.org.uk/consultations-and-statements/category-2/royal-mail-margin-squeeze

[15] Ofcom, 2014. Consolidated Version of USP Access Condition. February 2014. https://www.ofcom.org.uk/__data/assets/pdf_file/0013/12811/usp_access.pdf

[16] Ofcom, 2013. Safeguard cap for Second Class Large Letters and packets. 28 March 2013. http:/stakeholders.ofcom.org.uk/binaries/consultations/safeguard-cap/statement/statement.pdf

[17] Ofcom, 2016. Review of the Regulation of Royal Mail, 25 May 2016. https://www.ofcom.org.uk/__data/assets/pdf_file/0028/78184/review-of-royal-mail-regulation.pdf

[18] Ofcom, 2017. Review of the Regulation of Royal Mail statement, 1 March 2017. https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

2.13 The purpose of the review was to ensure that regulation remains appropriate and sufficient to secure the efficient and financially sustainable provision of the universal postal service.

2.14 We concluded that no significant changes in our current regulatory approach were needed. In particular, we considered that market conditions and shareholder discipline were more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation. Our key findings were that:

- Royal Mail is likely to remain financially sustainable in the immediate future, although it faces a number of challenges;
- Royal Mail has made some efficiency improvements in recent years, but there is potential for it to do more;
- Since 2012 Royal Mail has increased prices moderately; and
- Consumers and businesses are satisfied with the postal market.

2.15 We therefore decided to retain our current regulatory approach which gives Royal Mail commercial and operational freedom subject to safeguards. Having carried out this review, we proposed that the regulatory framework should remain settled for a further five years (i.e. until 2022).

2.16 As part of the review, we committed to consulting at a later stage on proposals for possibly updating the USPAC and RAG to ensure they remain fit for purpose and to making technical changes to the detailed working of the margin squeeze control in USPA 6.

Our March 2017 Consultation proposals

2.17 On 30 March 2017 we published a consultation (the March 2017 Consultation[19]) as Phase I of our review of our requirements for Royal Mail's regulatory financial reporting. The March 2017 Consultation set out our proposed changes to the contents, frequency, disclosure, and deadlines of the regulatory financial reporting required from Royal Mail. Phase II will focus on the regulatory accounting rules (including cost allocation rules) applied by Royal Mail in preparing its financial reports (see Section 8 for next steps for Phase II).

Our approach

2.18 In the March 2017 Consultation, we set out to assess whether the existing regulatory financial reporting continued to provide us with the information appropriate to enable us to meet our duties and objectives, in light of the changes in the postal market and our consequent review of the overall regulatory framework.

2.19 We adopted the following approach:

- we reassessed the objectives of our financial reporting framework; and

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[19] Ofcom 2017. Review of Regulatory Financial Reporting for Royal Mail Consultation, https://www.ofcom.org.uk/consultations-and-statements/category-3/review-of-regulatory-financial-reporting-for-royal-mail-consultation

- having established the objectives, we identified the broad questions that need to be answered by the reporting framework to fulfil the objectives.

2.20 As we explain in more detail later in this section, we have a duty under the PSA 2011 to carry out our functions (including the imposition of regulatory conditions) in a way that we consider will secure the provision of the universal postal service. In performing this duty, we must have regard to the need for the provision of a universal postal service to be both financially sustainable and efficient.

2.21 In addition, and as we explain in more detail later in this section, our 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.

2.22 We therefore considered that the information requirements collected through financial reporting should help us to fulfil the following regulatory objectives:

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.

2.23 We also consider that, in accordance with the requirements in section 3(3)(a) of CA 2003 (see paragraph 2.42 below) our regulatory financial reporting requirements should enable us (i) to ensure transparency with regard to the methodologies that Royal Mail employs in order to prepare our required data and reports and (ii) to gain assurance from external auditors, where necessary, that the data and reports have been prepared in accordance with our requirements.

2.24 We have also assessed our proposals against four key attributes (relevance, reliability, transparency and proportionality) identified in our 2012 review of BT's regulatory financial reporting. In its response to the March 2017 Consultation, Royal Mail specifically suggested that we should assess our proposals against these four attributes; we consider that we have done so.[20] In our assessment of the statutory tests for implementing regulatory conditions in the consultation and this Statement (see Section 8), we set out how we consider our proposals are proportionate, transparent, and objectively justifiable (or relevant).

Our proposals

2.25 Table 2.1 below summarises the changes to the regulatory financial reporting requirements which we proposed in the March 2017 Consultation. Removals and reductions in the requirements are marked in red; additions are marked in green:

[20] Royal Mail, Consultation response, page 23.

Table 2.1 – Summary of our main proposals in the March 2017 Consultation

Frequency of submission	Reports / Data submissions	Proposed changes
Annual	Income statement, balance sheet and cash flow statement of Relevant Group	Removed – Covered by statutory accounts of Royal Mail plc required by Companies Act (see Section 4 of the March 2017 Consultation document)
Annual	Income statement[21], statement of capital employed, and cash flow statement of Reported Business	Added – Cost matrix and PVEO Analysis[22] (see Section 6 of the March 2017 Consultation document)
Annual	Reconciliation of Relevant Group accounts to Reported Business accounts	None
Annual	Business Plan including Annual Budget	Added – Further detail requirements and templates for content (see Section 6 of the March 2017 Consultation document)
Annual	Income statement, statement of capital employed, and cash flow statement separated between four FREs[23]	Removed – New granular data extract submission to be required to enable us to prepare the separations of income statement needed going forward (see Section 4 of the March 2017 Consultation document)
Annual	Product Profitability Statements (PPSs)	Reduced – From 25 to 2, namely access and PAF, with new granular data extract submission required to enable us to prepare any PPSs needed going forward (see Section 4 of the March 2017 Consultation document)
Annual	Cost and volume input and output data at SPHCC[24] level	None
Annual	Second Class safeguard cap submission	Reporting deadline to change from three months after the end of the year to which the cap is applied, to reporting one month after the implementation of any new prices
Quarterly	Cash headroom projections for the Relevant Group	None

[21] Including the end-to-end split between universal service and non-universal service products.
[22] Analysis segmented by key drivers: Price, Volume, Efficiency and Other drivers.
[23] Financial Reporting Entities as defined in the Consolidated Version of USP Accounting Condition as at January 2014, https://www.ofcom.org.uk/__data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf
[24] Sales Product Handling Characteristic Combination as defined in the new RAG (see Annex 2 to this statement).

Frequency of submission	Reports / Data submissions	Proposed changes
Quarterly	Income statement of Reported Business[25]	Added – Cost Matrix added (see Section 5 of the March 2017 Consultation document)
Quarterly	Income statement separated between four FREs	Removed New granular revenue data extract submission to be required to enable us to prepare the separations of income statement needed going forward (see Section 4 of the March 2017 Consultation document)
Quarterly	Product Profitability Statements	Reduced – From 25 to 2, namely access and PAF, with new granular data extract submission to be required to enable us to prepare any PPSs needed going forward (see Section 4 of the March 2017 Consultation document)
Quarterly	Cost and volume output data at SPHCC level	Granular revenue, cost and volume data extract submission to be required at short SPHCC level (plus transfer prices) to enable us to prepare the accounting separation and PPS reports that we propose removing, with granularity to be reduced to Short SPHCC level and removal of activities breakdown for cost and volume (see Section 4 of the March 2017 Consultation document)
Quarterly	Costing Methodology Manual	None
Quarterly	Accounting Methodology Manual	None
Quarterly	Change control submissions	Added – Restated income statement and upstream/downstream impact to be required (see Section 7 of the March 2017 Consultation document)
Quarterly	Margin squeeze submissions	Minor clarifications in Access Condition (see Section 9 of the March 2017 Consultation document)
Monthly	Volume and revenue report	To be made less granular and required quarterly, with our monthly information needs to be met by Royal Mail's monthly management accounts (see Section 4 of the March 2017 Consultation document)

[25] Includes the end-to-end split between universal service and non-universal service products.

Frequency of submission	Reports / Data submissions	Proposed changes
Monthly	Cost metrics report (including volume to workload bridge)	To be required quarterly (see Section 5 of the March 2017 Consultation document)
Monthly	Management Accounts to the Board	None – Continue to be provided on a voluntary basis

Stakeholder responses

2.26 We received responses to the March 2017 Consultation from Royal Mail, the Mail Competition Forum (MCF), the BBC Licensing Fee Unit (the BBC), the Postal Address File (PAF) Advisory Board, and also Ian Paterson personally (one of the members of the PAF Advisory Board).[26]

2.27 The stakeholder responses to the March 2017 Consultation were broadly supportive of our proposals. However, Royal Mail raised the following key concerns about them:

a) the proposed requirement for granular revenue, cost and volume data extract is not targeted, could be misunderstood by Ofcom, and is too granular to be proportionate for Ofcom's purposes;

b) the proposed further detail to be added to the requirements for the contents of the Business Plan, the Annual Budget and cost and efficiency reports over-prescribe the contents and make the structure of these reports too rigid to reflect the future changes in Royal Mail's business and operations; in some cases this can result in more than one way of calculating certain metrics such as workload (one measure calculated by Royal Mail while another is required by us); and

c) the proposed change to the deadlines for quarterly reports from 60 days to 45 days would result in Royal Mail having to provide information that is unapproved or in draft form, because the approval process for the information used in its announcement of half-year and full year results is 53 days.

2.28 We assess in detail, in Sections 3 to 7 of this statement, the above responses and concerns and all other key relevant issues raised by stakeholders.

2.29 In the March 2017 Consultation, we also consulted on proposals in respect of reporting and compliance with the margin squeeze control contained in USPA 6. Having carefully considered stakeholders' responses to those proposals, we have decided that it is appropriate to revise the proposals. We will be consulting on new proposals, and therefore do not consider the margin squeeze control in this statement.

[26] We have published non-confidential versions of responses to the March 2017 Consultation on our website (https://www.ofcom.org.uk/consultations-and-statements/category-3/review-of-regulatory-financial-reporting-for-royal-mail-consultation).

2.30 In addition to the matters set out in the March 2017 Consultation, Royal Mail raised a number of additional issues:

- it urged us to "introduce a positive, pro-active sustainability framework to help secure the Universal Service.";
- it suggested that it continues "to believe that the Second Class safeguard cap should be removed" and asked Ofcom to consult on this in early 2018; and
- it set out its views in relation to the appropriate allocation of the costs of its network as between universal service activities and non-universal service activities.

2.31 These issues go beyond the scope of the issues covered by the March 2017 Consultation and we do not therefore consider it appropriate to address them further in this document. We will however consider the cost allocation rules in Phase II of our review which will include a consideration of whether the methodology for allocating costs between parcels and letters within Royal Mail's activity based costing FAC system remains appropriate. We expect to publish the Phase II consultation next calendar year.

Our duties and powers

Our statutory duties

2.32 The legal framework relating to the regulation of postal services is set out in the PSA 2011.

2.33 Ofcom's principal duty under 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 the 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.

2.34 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 is subject to the duty imposed by section 29(1) of the PSA 2011.

2.35 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
- efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.

2.36 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.

2.37 Section 29 does not require that Ofcom gives more weight to one of those considerations 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.

2.38 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.

2.39 As set out in this statement, we do not consider that in our work to update the regulatory financial reporting requirements there is any conflict between our duty to secure the provision of the universal postal service and our general duties.

2.40 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 this context, a number of such considerations appear relevant, including:

- the desirability of promoting competition in relevant markets;
- the desirability of encouraging investment and innovation in relevant markets;
- the needs of persons with disabilities, of the elderly and of those on low incomes;
- the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas; and
- the extent to which, in the circumstances of the case, the furthering or securing of the matters mentioned in section 3(1) is reasonably practicable.

2.41 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.

2.42 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.[27]

2.43 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.

[27] See 'Statutory duties and regulatory principles', https://www.ofcom.org.uk/about-ofcom/what-is-ofcom

Our powers to impose USP accounting conditions

2.44 We have the power under section 39 of the PSA 2011 to impose a USP accounting condition on Royal Mail as the universal service provider requiring it:

- 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 accounts and other information relating to anything required to be done by Ofcom in this regard; and
- to secure that the universal service provider's compliance with those systems is audited annually by a qualified independent auditor,[28] including an obligation to meet the costs of the audit.

2.45 Our power to impose a regulatory condition, like the USP accounting condition, includes 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.[29] 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.

2.46 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 Act 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.

[28] Under section 39, a qualified independent auditor means a person who is eligible for appointment as a statutory auditor under Part 42 of the Companies Act 2006 and, if the appointment were an appointment as a statutory auditor, would not be prohibited from acting by section 1214 of that Act (independence requirement).
[29] Paragraph 2 of Schedule 6 to the Act.

A similar test also applies in giving, modifying or revoking directions imposing the requirements and rules.[30]

General impact assessment

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

Equality impact assessment

2.48 We have 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 identified in the Equality Act 2010.

Outline of the rest of this document

2.49 The remaining Sections of this document set out stakeholder responses to our proposed changes to the regulatory financial reporting requirements imposed on Royal Mail, our assessment of those responses, and our decisions after considering the responses. The structure of the remainder of this document is similar to the March 2017 Consultation document covering:

- accounting separation and separate reports for the Reported Business in Section 3;
- cost and efficiency reporting in Section 4;
- Business Plans in Section 5;
- cost data and change control in Section 6; and
- reporting deadlines and Relevant Group definition in Section 7.

2.50 Section 8 sets out our conclusions and provides a summary of our decisions. Annexes 1 to 3, published alongside this document, set out the legal notifications confirming modifications to the regulatory conditions, namely USPAC, RAG and DUSPs.

[30] 28 Paragraph 4(2) of Schedule 6 to the Act.

3. Accounting separation and separate reports for the Reported Business

3.1 The accounting separation requirements provide us with important information to achieve the objectives of the financial regulatory reporting regime. In particular, accounting separation reports help us assess the financial sustainability of the universal service, monitor competition issues, and protect consumer interests by helping us monitor how Royal Mail is using its commercial freedom and how the revenues and costs of its various product groups compare.

What we proposed

3.2 In the March 2017 Consultation, we proposed the following changes to the accounting separation and separated reports for the Reported Business which, if adopted, would reduce some of Royal Mail's regulatory burden:

a) removing the requirement on Royal Mail to produce accounting separation of the Reported Business (income statement, capital employed statement, and cash flow statement) into the four separate Financial Reporting Entities (four FREs) separated by Lines A, B and C (see Figure 3.1 below);

b) removing the requirement on Royal Mail to produce Product Profitability Statements (PPSs - see Figure 3.2 below) for pre-determined product groups, apart from in relation to access and Postcode Address File services (PAF), which we propose to continue to require Royal Mail to publish in its annual regulatory accounts;

c) maintaining the requirement on Royal Mail to prepare an end-to-end split of the income statement of the Reported Business into universal service and non-universal service products;

d) removing the requirement for monthly reporting of costs but maintaining the requirement for monthly reporting of volumes and revenues which we consider Royal Mail's monthly management accounts currently meet;

e) introducing a requirement for Royal Mail to prepare a high-level summary volumes and revenues report, including a comparison against budget on a quarterly basis; and

f) introducing a requirement for quarterly granular revenue data extract and transfer pricing data to enable us to produce our own revenue and volume splits, accounting separation by Lines A, B and C, PPSs, and other income statement splits, flexible enough to meet our evolving needs.

3.3 To enable the production of the flexible reporting mentioned above, we also proposed to maintain the requirement on Royal Mail to provide granular cost and volume data extract (see Section 6 of this statement). These requirements, alongside the new requirement for granular revenue data extract mentioned above, would allow us to produce accounting separation reports by Lines A, B and C to the extent which we will find necessary for the fulfilment of our reporting objectives going forward.

3.4 We proposed that Royal Mail provide us with a quarterly granular revenue, cost, and volume data extract file, which we refer to in the rest of this Section as the 'granular data extract file'. The lowest level at which Royal Mail splits revenue, FAC and volumes on a consistent basis is a sub-product level which Royal Mail refers to as Short Sales Product Handling Characteristic Combination (Short SPHCC). It is at this level of granularity that we proposed Royal Mail provide us with the granular data.

3.5 We also proposed to maintain the requirement for some of the existing transfer pricing data, because this would enable us to prepare income statements and product profitability statements separated between upstream and downstream (Line B type of accounting separation – see Figure 3.1 below). We referred to this as the 'targeted separation' approach. For those products we proposed that the data file should also provide the upstream/downstream split of revenue and total operating costs.

Figure 3.1: The four FREs defined by Lines A, B and C

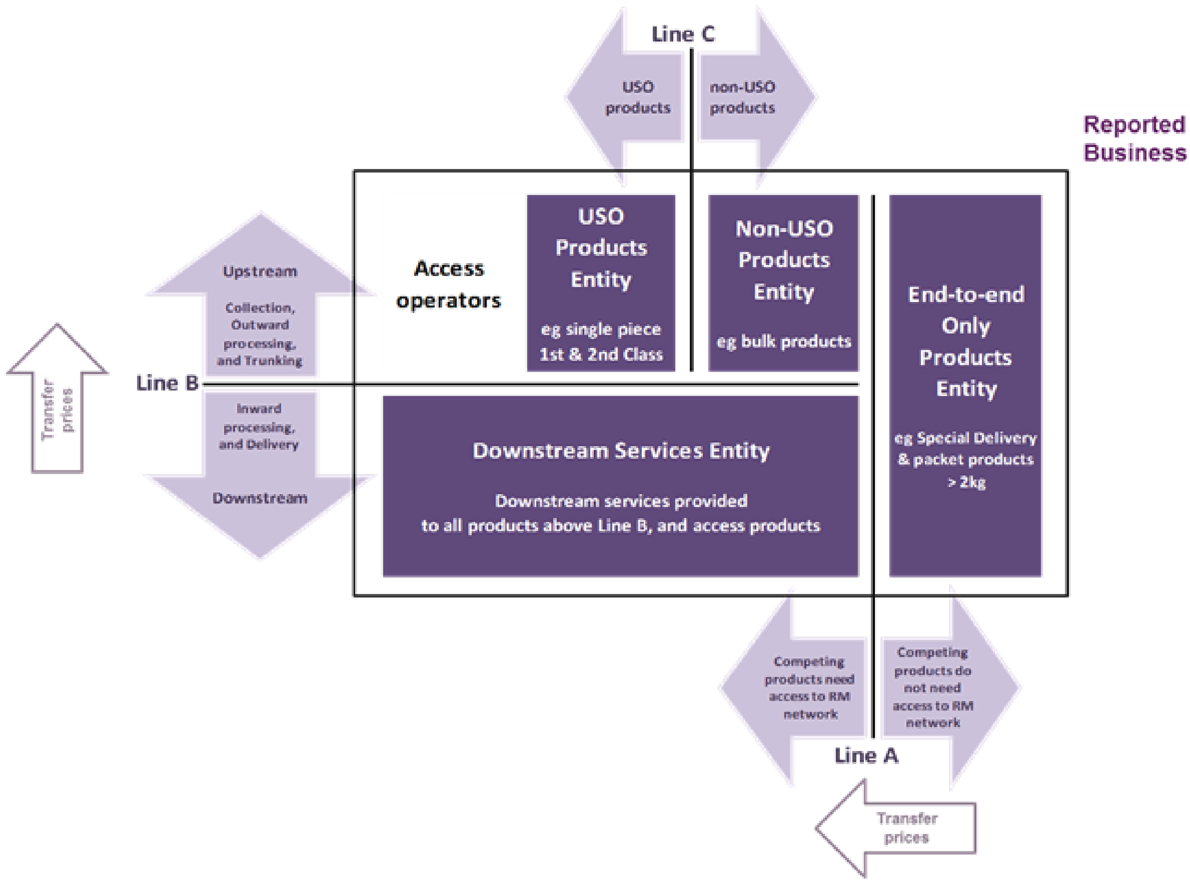

Figure 3.2: PPSs

#	Accounting separation entities	PPS
1	Downstream services	Access products D+2 and later, letters and large letters
2		Other Access products
3	Non-USO products + Downstream services	Business, Advertising, and Sustainable Advertising Mail D+2 and later, letters and large letters
4		Other Bulk Mail products
5		Non-USO B2X Deferred Light (1kg - 2kg)
6		Non-USO B2X Deferred Light (< 1kg)
7		Non-USO International
8		Other non-USO services
9	USO products + Downstream services	USO single piece first class letters sold via stamps payment channel
10		USO single piece first class large letters and parcels < 2kg sold via stamps payment channel
11		USO single piece first class large letters and parcels > 2kg sold via stamps payment channel
12		USO single piece second class letters sold via stamps payment channel
13		USO single piece second class large letters and parcels < 2kg sold via stamps payment channel
14		USO single piece second class large letters and parcels > 2kg sold via stamps payment channel
15		USO single piece first class products sold via non-stamps payment channel
16		USO single piece second class products sold via non-stamps payment channel
17		USO Special Delivery products
18		USO International
19		Other USO services
20	End to end only products	Non-USO Special Delivery products
21		Non-USO B2X Deferred Heavy (>2kg)
22		Relay
23		PAF
24		International Contract Bulk
25		Other end to end only products

Stakeholder responses and our assessment

3.6 Stakeholders' responses were generally related to one of the following categories below:

- the general approach;
- monthly management accounts;
- reconciliation of quarterly regulatory accounts to annual regulatory accounts;
- capital employed and cashflow statements of the Reported Business;
- quarterly PPSs for PAF and access;
- quarterly and annual end to end income statement split between USO, non-USO and non-Mails;
- PAF framework; and
- granular data extract file.

The general approach

3.7 The BBC Licence Fee Unit supported our proposals. The MCF said that "the proposals seem to be requiring Royal Mail to provide less reporting detail yet more granular data. If the intention is to enable Ofcom to be better able to construct, on the basis of this data, the analysis it needs, then this appears to be a positive proposal" but was concerned "that Ofcom is removing reporting it has found useful so far."[31]

3.8 While Royal Mail said it agreed "with the thrust of Ofcom's proposals for change"[32], it argued that we should have gone further and removed other reports and requirements which Royal Mail considered redundant and unnecessary for Ofcom to fulfil its regulatory obligations. It explained that "Royal Mail does not use accounting separation information in its management reporting" and these "reporting obligations represent additional activity – a regulatory burden – that Royal Mail would not undertake absent regulation."[33] Royal Mail made a number of specific suggestions for further changes in addition to our proposals. We consider Royal Mail's key suggestions in the sub-sections below.

3.9 We note Royal Mail's comments that requiring reporting that is additional to the reporting Royal Mail considers necessary to manage its business could increase the regulatory burden. However, we do not agree that our reporting framework should necessarily be set up to align with Royal Mail's internal reporting. While such an alignment, where possible, would be ideal, we have specific regulatory duties, which the reporting we have set out is designed to support us to meet. The internal reporting on which Royal Mail has decided best meets its commercial needs and it is possible that it may not be fully aligned with our needs.

3.10 In the March 2017 Consultation, we invited the stakeholders to provide their views and evidence as to which specific products should be separated between upstream and downstream (the 'targeted separation' approach) to allow us to monitor the risk of margin

[31] MCF, Consultation response, page 2.
[32] Royal Mail, Consultation response, page 31.
[33] Royal Mail, Consultation response, paragraph 4.1, page 32.

squeeze (by comparing upstream revenues and costs). We have had significantly different views from Royal Mail and the MCF which we consider below.

3.11 Stakeholders’ comments were generally related to one of the broad categories outlined below.

Monthly management accounts

3.12 We proposed to maintain the requirement for monthly reporting of volumes and revenues within 30 days of the Financial Month end (also see Section 7 of this statement). We considered that Royal Mail’s monthly management accounts (provided on a voluntary basis) would meet this requirement.

3.13 Only Royal Mail made a specific response on our proposal and said that it agreed with our proposal that the monthly reporting presently in place be removed, but that we should remove the requirement for its management accounts to be submitted and instead continue with the current arrangement whereby they are sent on a voluntary basis.[34]

3.14 Royal Mail pointed out that its management accounts for the Financial Months 6 and 12 are approved by the Board at the same time as our statutory financial results, i.e. 54 days after the Financial Month end (see Section 7 of this statement). Royal Mail also explained that it does not produce a full set of management accounts for Financial Month 1 due to its finance teams being busy preparing the detailed budget information.[35]

3.15 Royal Mail proposed that our proposed modified USPAC should be amended to remove the requirement for monthly reports altogether to avoid a technical breach of the USPACs. Royal Mail emphasised that it still intends to provide us with its management accounts, on a voluntary basis, 30 days after the Financial Month end (except for the Financial Month 1 for which no management accounts are produced and for the Financial Months 6 and 12) after 54 days once the statutory reporting results have been approved (see Section 7 of this statement).[36]

3.16 We do not agree with Royal Mail that the practicability issues relating to the Financial Months 1, 6 and 12 justifies removing the monthly requirement for monthly reporting of volumes and revenues. However, we recognise the issues Royal Mail has raised and will make provisions in the USPAC and the RAG to accommodate these issues (see Section 7 and Table 8.2 in Section 8 of this statement).

[34] Royal Mail, Consultation response, pages 33-34.
[35] Ibid
[36] Ibid

Reconciliation of quarterly regulatory accounts to annual regulatory accounts

3.17 Royal Mail proposed that our requirement for a reconciliation of the quarterly regulatory accounts to the annual regulatory accounts could be removed (see USPAC 1.4.1(c), set out in Annex 5 to the March 2017 Consultation).[37]

3.18 Royal Mail stated that it has refined its cost allocation system over time and the current system now processes financial data on a cumulative basis. As a consequence, Royal Mail argued, the regulatory accounts for the Financial Quarter 4 would be the same as the annual regulatory accounts so there is no need for a reconciliation.[38]

3.19 We disagree with Royal Mail in removing the requirement, because we have designed our requirements to allow for changes in its systems. If Royal Mail's accounting system or the data preparation timeline changes in the future in a way that results in adjustments being introduced between the regulatory accounts for the Financial Quarter 4 and the annual regulatory accounts, then our requirement will capture those adjustments and provide us with sufficient transparency. Additionally, we do not consider that the reconciliation is resource intensive as Royal Mail rightly pointed out. The required reconciliation can currently be met by a simple statement which requires minimal effort.

Capital employed and cash flow statements of the Reported Business

3.20 Royal Mail also proposed that our requirement for the Reported Business "balance sheet" and cash flow should be removed "because they are not useful or necessary."[39] Royal Mail argued that there is no value in the provision of the balance sheet or cash flow of the Reported Business to Ofcom or to external stakeholders in assessing the financial sustainability of the universal service.[40]

3.21 We disagree with Royal Mail's view that the balance sheet and cash flow information is not necessary.

3.22 Firstly, the proposal we set out in our consultation was not to require a full balance sheet for the Reported Business, but only a statement of capital employed (i.e. assets and current liabilities, and not long-term debt).

3.23 We also do not agree with Royal Mail that statements of capital employed and cash flow of the Reported Business are of no value. As an example, and as we explained in the Review of Royal Mail Regulation consultation document,[41] we expect that, in order to assess potentially excessive returns, we may need to consider metrics such as return on assets (ROA). An ROA approach would require the sort of information which a statement of capital employed provides. Additionally, the cash flow statement of the Reported Business aids us

[37] Royal Mail, Consultation response, paragraph 4.15, page 34.
[38] Ibid.
[39] Royal Mail, Consultation response, page 34.
[40] Royal Mail, Consultation response, paragraph 4.19, page 35.
[41] https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf , paragraph A6.63

by providing information about the contribution the Reported Business makes to the cash generated by the Relevant Group and therefore our wider assessment of the financial sustainability of the universal service.

3.24 Royal Mail also argued that the same reasons that we cited diminished the objectivity and robustness of the separated statements of capital employed and cash flow for the four FREs (and was a factor in our proposal for their removal), also applied to the Reported Business as a whole, making the objectivity and robustness of the Reported Business cash flow and balance sheet unreliable.[42] We do not agree with Royal Mail's argument because, while the four FREs are almost completely regulatory constructs, the Reported Business is to a large extent an independent business unit with its clearly demarcated workforce, fixed assets and to a large extent working capital. The capital employed and cash flow statements of the Reported Business are not, despite Royal Mail's argument to the contrary, the results of merely notional and mechanistic analysis. We consider that they are based on the tangible and relatively distinct set of operations and assets of the largest business unit with Royal Mail.

3.25 Royal Mail also proposed that we should remove the requirement for the notes to the statement of the capital employed stating "they are not relevant to stakeholders."[43] We disagree with Royal Mail, as we consider that the notes provide useful information about the different types of assets and liabilities included in the statement, which assists a user to decide which items to include or exclude in its assessment of the asset base of the Reported Business.

3.26 Contrary to Royal Mail's assertion in its response, we have also ensured the pro forma in the new RAG for the notes including the categorisations do align to Royal Mail's statutory accounts (see Appendix 1 to the new RAG set out in Annex 2 to this statement and the proposed modified RAG set out in Annex 6 to the March 2017 Consultation).

3.27 We therefore consider that our proposal, as we set it out in the March 2017 Consultation, will provide the information that will assist us in assessing the financial sustainability of the universal service and protecting consumer interests.

Quarterly PPSs for PAF and access

3.28 Royal Mail said that our proposal to maintain the requirement for the PAF and Access PPSs should be removed. Royal Mail said it did not see the need to provide the PAF and Access PPSs on a quarterly basis arguing that "the relevant financial information will be contained within the granular data extract file that Ofcom has requested" [44] and would therefore mean, Royal Mail argued, the provision of the same information twice.

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[42] Royal Mail, Consultation response, paragraph 4.20, page 35.
[43] Royal Mail, Consultation response, page 35.
[44] Royal Mail, Consultation response, paragraph 4.22, page 35.

3.29 We have considered Royal Mail's suggestion against both our need for ready clarity on the performance of each PPS and the work involved in Royal Mail's production of each on a quarterly basis.

3.30 We agree with Royal Mail that we will be able to source the relevant information from the granular data extract file (which we proposed to require in the March 2017 Consultation). However, the quarterly PPSs prepared by Royal Mail will ensure they are prepared based on exactly the same assumptions and as accurately as those that are published in the annual regulatory accounts. This will also provide us with early transparency about the products that Royal Mail would include as its access products in its annual PPS at the end of the Financial Year. Considering the importance of this area to the fulfilment of our duties, our proposal for quarterly reporting of this PPS remains appropriate. We agree, though, with Royal Mail's suggestion to remove the quarterly PAF PPS, as we consider the PAF information will be both readily distinguishable from the granular data extract file, and that the need for the quarterly information is less immediate than that of the Access services.

Quarterly and annual end to end income statement split between USO, non USO and non-Mails

3.31 Royal Mail proposed that we should remove the requirement to provide a quarterly and annual report of USO, non-USO and non-mails, because we can generate this information from the granular data extract file we proposed to require from Royal Mail going forward.[45]

3.32 The end to end USO and non-USO split which is published in the annual regulatory accounts shows the overall contribution of these products to the rate of return of the Reported Business, and how the contributions compare. The split helps us and stakeholders gain an understanding of how Royal Mail is using its commercial freedom to price its range of products. This is a key question under our objective of protecting consumers.

3.33 The split is also helpful in our work on monitoring the impact of Royal Mail's pricing decisions on competition as the majority of Royal Mail's products in parts of the sector where there is greater competition are non-universal services and the majority of universal services are provided in parts of the sector where Royal Mail has a significant share.

3.34 We agree with Royal Mail that the quarterly and annual further splits (with non-Mails separated out) can in future be extracted from the granular data extract file which Royal Mail will be providing us. However, we consider that the continuing requirement for the further splits to be provided in the quarterly and confidential annual regulatory accounts will ensure they are prepared based on exactly the same assumptions and as accurately as those that are published in the annual regulatory accounts. It will also provide us with early transparency about the products that Royal Mail would include in the splits.

[45] Royal Mail, Consultation response, pages 35-36.

PAF framework

3.35 In the March 2017 Consultation, we made an erroneous statement that "[t]he performance of PAF against an agreed target operating margin continues to be important to us and stakeholders." [46] This was an oversight because we removed the target in 2013.[47] This error was pointed out by the PAF Advisory Board, Ian Patterson (a member of the PAF Advisory Board) and Royal Mail.[48]

3.36 This error does not affect our arguments for the profitability of PAF to be published as part of Royal Mail's annual regulatory accounts.

Granular data extract file

3.37 Royal Mail disagreed with our proposal to require the granular data extract file (containing revenue, cost and volume data at Short SPHCC level). Royal Mail argued that the level of granularity we required would not be reliable for our purposes, and that it could lead us to erroneous conclusions. Royal Mail also argued that the scope we proposed was not needed for the fulfilment of our regulatory duties.[49]

3.38 The other respondents broadly supported our proposal for the granular data extract file, with the MCF stating that "if Ofcom are confident that this change will enable them to perform better analysis" without losing any current regulatory oversight, then they support the proposal.[50]

3.39 Royal Mail set out a number of specific objections to the proposed granular data extract file which we assess below.

Unnecessarily broad scope

3.40 Royal Mail argued that our proposal that the scope of the granular data extract file, which we proposed to include all the short SPHCCs related to all the products provided by the Reported Business, was unnecessarily broad for us to fulfil our regulatory duties. In addition, Royal Mail said the proposed coverage was contrary to "Ofcom's guiding principles that regulation should be proportionate and targeted"[51] and "will not provide Ofcom with what it needs – relevant, reliable information."[52]

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[46] Paragraph 4.50.
[47] Postcode Address File Review Statement, 22 July 2013, para 1.7, https://www.ofcom.org.uk/__data/assets/pdf_file/0024/62628/statementpaf.pdf
[48] PAF, Consultation response, page 1 https://www.ofcom.org.uk/__data/assets/pdf_file/0018/105633/PAF-Advisory-Board.pdf ; I Paterson response https://www.ofcom.org.uk/__data/assets/pdf_file/0019/105634/Paterson,-Mr-I.pdf and Royal Mail, Consultation response, paragraph 4.30, https://www.ofcom.org.uk/__data/assets/pdf_file/0020/105635/Royal-Mail.pdf
[49] Royal Mail, Consultation response, Chapter 5.
[50] The MCF, Consultation response, page 3.
[51] Royal Mail, Consultation response, page 41.
[52] Royal Mail, Consultation response, page 40.

3.41 We do not agree with Royal Mail that the scope of the granular data extract file is unnecessarily broad. As we explained in the March 2017 Consultation, our objectives for the reporting requirements include monitoring competition and protecting consumer interests See Section 3 of the March 2017 Consultation and Section 2 of this Statement). The Reported Business provides many of its products in markets with varying degrees of competition (e.g. bulk mail and parcels) where monitoring competition is necessary for us to ensure our regulatory framework remains appropriate. The Reported Business also provides products in markets in which Royal Mail has market power (e.g. single piece mail) where protecting consumer interest is important to us. Only by including the products provided in all these markets we can obtain sufficient information to meet our objectives. This means including all the products of the Reported Business.

Not needed to assess financial sustainability of the universal service

3.42 Royal Mail stated that we do not need a granular data extract file to fulfil our duty to have regard to the need for the provision of a universal postal service to be financially sustainable as "the financial sustainability of the universal service is measured at the Reported Business level"[53] and that "instead, for insight into the commercial performance of Royal Mail, Ofcom should use our management accounts"[54] and its own high-level internal quarterly product group profitability reports.[55]

3.43 We do not agree with Royal Mail because the volume, revenue and cost data at the more granular level will enable us to better understand the key performance drivers that underpin the profitability of the Reported Business and consequently the financial sustainability of the universal service. The management accounts data does not provide profitability at product group level and the suggested internal product group reporting does not provide the same segmentation that we consider will best allow us to understand the performance drivers of the Reported Business to fulfil our duty.

Not needed to support competition in the postal market and not targeted

3.44 Royal Mail argued that the provision of data on the Short SPHCC level is too granular and that it is not required for Ofcom to support competition in the postal market and the requirement was therefore unnecessary and disproportionate. Royal Mail proposed that "should Ofcom have questions on the nature of competition for particular product groups" we could review its monthly management accounts, its "Scorecard" level reporting as well as the targeted separation products it agrees it should provide (see sub-section below).[56]

3.45 The Short SPHCC level of granularity is the level of granularity where we can demarcate products groups which fall into markets with varying degrees of competition, e.g. parcels below 1 kg, between 1 and 2 kg and heavier than 2 kg (see PPSs in Table 3.2). Royal Mail's

[53] Royal Mail, Consultation response, paragraph 5.1, page 41.
[54] Royal Mail, Consultation response, paragraph 5.2, page 41
[55] At Royal Mail's 'product scorecard' internal reporting level.
[56] Royal Mail, Consultation response, paragraph 5.3, page 41.

proposed "Scorecard" level is not targeted for our purposes as it does not provide such a breakdown. We therefore consider the level of granularity we proposed to be the level therefore necessary to enable us to assess how Royal Mail's pricing of its products in markets with varying degree of competition and the resulting revenues compare with the costs of providing those products. Such comparisons provide important information for our monitoring of competition and our work on protecting consumer interests.

Unreliability of cost data at Short SPHCC level

3.46 Royal Mail stated that the detailed information in the granular data extract file may not be reliable. It explained that it makes informed assumptions in how it attributes costs to activities and activities to products and that this "is not an exact science."[57] It further explained that its costing system relies upon sampling and other statistical techniques to generate activity and product costs. Royal Mail then concluded that reviewing at a short SPHCC level is taking the analysis down to a level that is not appropriate or relevant, and provides an artificial level of transparency.

3.47 Royal Mail stated that the proposed granular data would include some information significantly below the level of Ofcom's present level of materiality. Royal Mail then suggested that at this detailed level, any analysis would be of limited value. We agree with Royal Mail that some of the information might fall below the materiality level that USPAC 1.7.2(h) may imply. However, that fact on its own does not render the information without value or unreliable.

3.48 We disagree with Royal Mail's arguments. Royal Mail has been providing us cost and volume data at a more granular level than Short SPHCC level, i.e. SPHSCC level, for a number of years (even prior to the introduction of the new regulatory financial requirements in March 2012). Royal Mail's position would suggest that the reliability of much of the data it has produced (revenue, FAC costs and profitability) and submitted to us has not been robust for regulatory purposes for a number of years.

3.49 Any ABC approach to allocating general ledger costs to activities and then to products will necessarily involve making informed and reasonable assumptions and using statistical and sampling techniques and data. This does not invalidate the results of the ABC costing as artificially transparent or unreliable unless the assumptions, or the underlying data or the techniques are flawed or deficient.

3.50 Royal Mail is required to comply with the rules and requirements we have set out in the USPACs and the RAG, including rules for ABC costing. If Royal Mail fully complies with these rules and requirements, the results of its ABC costing, whether at Short SPHCC level or SPHCC level, should be sufficiently reliable for our regulatory purposes. Having reviewed Royal Mail's response and had subsequent discussions with Royal Mail we consider the revenue, FAC costing, and volume data should adhere to our costing principles and change control system (although it is important to note, as we set out in the March 2017

[57] Royal Mail, Consultation response, paragraph 5.9, page 42.

Consultation, that there are elements of Royal Mail's costing that we are in the process of scrutinising in more detail).

Ofcom may draw erroneous conclusions

3.51 Royal Mail argued that as "a professional and experienced regulator with significant knowledge of the postal industry and experience of managing large volumes of data",[58] Ofcom should rely on Royal Mail's management accounts to understand the real message of its underlying commercial performance. Royal Mail stated that there is a risk that Royal Mail's business insight will be missed - obscured by detailed analysis of this data "clutter", and that Ofcom could draw erroneous conclusions from the data.[59]

3.52 Ofcom will consider a number of different sources of information in performing its regulatory duties including the management accounts Royal Mail has suggested. As we have set out, we regard the granular data extract file as a key set of the necessary data we will consider, and we do not agree that this key information would clutter Ofcom's view of the key insight we are seeking to gain in order to achieve our objectives.

Quarterly data is more volatile than annual data and may lead to misinterpretation

3.53 Royal Mail argued that its business has a noticeable seasonal profile, selling more of its products and generating significantly more revenue in the Financial Quarter 3 (which includes the run-up to Christmas). Royal Mail also stated that the timing and scale of its discretionary expenditure can vary significantly over the year. Therefore, Royal Mail expressed concerns that we may use the quarterly information to discern trends, while the seasonality of the data may make the analysis meaningless.[60]

3.54 We have had experience of analysing data such that we can gain meaningful trends and insight from data that has distinctive seasonal characteristics and we do not agree with Royal Mail that we could be misled by seasonal fluctuations.

Targeted separation of PPSs between upstream and downstream

3.55 In the March 2017 Consultation, we proposed a targeted separation approach, i.e. to require Royal Mail to provide us with transfer pricing data to enable us to split all letters and large letters bulk products (sorted and unsorted) with which access operators directly compete and where there could potentially be a risk of margin squeeze (currently included in PPSs 3, 4 and 8). We proposed to require Royal Mail to provide us with the transfer pricing data alongside the proposed quarterly granular revenue data submissions.[61]

3.56 Royal Mail supported our proposed targeted separation approach, but stated that we had proposed too broad a set of products for targeted separation. Royal Mail argued that the

[58] Royal Mail, Consultation response, paragraph 5.11, page 43.
[59] Ibid.
[60] Royal Mail, Consultation response, page 43.
[61] The March 2017 Consultation, Section 4.

product set should only include those subject to upstream competition, which in Royal Mail's view include the D+2 and later bulk letters and large letters services (Royal Mail provided a proposed list in its response)[62]. In Royal Mail's view, we included bulk products that would not fall into this category.

3.57 Royal Mail's proposal included advertising mail, business mail, publishing mail and RM48 large letters, but excluded all 1st class bulk letter products; all sales agent products; all returns services; and all miscellaneous services such as compensation, pouch services or safebox.

3.58 The MCF responded that we should give some thought to the possibility of further services coming into mandated access and whether our proposals could accommodate margin squeeze protection for these new services.[63] In further discussion with the MCF, they clarified that we should include bulk parcels and single piece mail including USO mail.

3.59 As we explain above, the aim of our targeted separation approach is to provide further information to enable us to monitor those Royal Mail bulk products with which access operators directly compete, and where there is a potential risk of margin squeeze. We have therefore decided to include within the scope of the targeted separation all relevant letter and large letter sorted and unsorted bulk products which are currently included within PPS 3, PPS 4 and PPS 8 (see Figure 3.2 and Appendix 2 to the new RAG set out in Annex 2 to this statement). We do not consider Royal Mail provided us with sufficient evidence as to the appropriateness of excluding certain products included in these PPSs.

3.60 We do not propose to extend the scope of the targeted separation to bulk parcels (included in PPS 5, 6 and 21 – see Figure 3.2). This is because we have not mandated access to Royal Mail's network for parcels and given the level of competition in the parcels sector, access operators have options for operators to deliver their parcels.

3.61 We understand that the access operators may have been interested in targeting Royal Mail's customers who use single piece (universal service) meter and PPI products (included in PPS 15 and 16 - see Figure 3.2). However, it is not necessary to extend the scope of the targeted separation requirement to these single piece products. The prices of these products are considerably higher than bulk products, and if Royal Mail were to win back any lost volumes of these products, it is likely that it would do that by offering its unsorted bulk products which have lower prices, and these bulk products are within the scope of targeted separation.

3.62 We therefore do not agree with the MCF that it is appropriate to include these further product groups in our targeted separation approach.

[62] Royal Mail, Consultation response, Annex 6.
[63] The MCF response, page 2.

Decisions

3.63 We have decided to implement the following changes to the accounting separation and separated reports for the Reported Business:

a) removing the requirement on Royal Mail to produce accounting separation of the Reported Business (income statement, capital employed statement, and cash flow statement) into the four FREs by Lines A, B and C (see Figure 3.1 and USPAC 1.5.1 and 1.5.2 in the new USPAC set out in Annex 1 to this statement);

b) removing the requirement on Royal Mail to produce PPSs (see Figure 3.2) for pre-determined product groups, except in relation to access and PAF PPSs, which we propose to continue to require Royal Mail to publish in its annual regulatory accounts (see Table 5 of the new RAG set out in Annex 2 to this statement);

c) removing the requirement on Royal Mail to produce a quarterly PPS for PAF, while maintaining the requirement on Royal Mail to produce quarterly PPS for access (see Table 5 of the new RAG set out in Annex 2 to this statement);

d) maintaining the requirement on Royal Mail to prepare an end-to-end split of the income statement of the Reported Business into universal service and Non-universal service products (see USPAC 1.5.2 in the new USPAC set out in Annex 1 to this statement);

e) removing the requirement for monthly reporting of costs but maintaining of the requirement for monthly reporting of volumes and revenues which we consider Royal Mail's monthly management accounts for the Board currently meet (see USPAC 1.4.1(k) in the new USPAC set out in Annex 1 to this statement);

f) removing the requirement for Royal Mail’s monthly management accounts for the Board for the 1st Financial Month of the Financial Year, and extending the deadline for the submission of those management accounts for the 6th and 12th Financial Month of the Financial Year from 30 days to 54 days (see USPAC 1.4.1(k) and USPAC 1.4.9(d) and (e) in the new USPAC set out in Annex 1 to this statement);

g) introducing a requirement for Royal Mail to prepare a high-level summary volumes and revenues report, including a comparison against budget on a quarterly basis (see USPAC 1.4.1(l) and USPAC 1.4.9(f) in the new USPAC set out in Annex 1 to this statement, and Figure 9 in Appendix 1 to the new RAG set out in Annex 2 to this statement); and

h) introducing a requirement for quarterly granular revenue and transfer pricing data at Short SPHCC level (for products set out in Appendix 2 to the new RAG set out in Annex 2 to this statement), combined with granular cost and volume information at Short SPHCC level and one integrated (see Figure 11 in Appendix 1 to the new RAG set out in Annex 2 to this statement).

4. Cost and efficiency reporting

4.1 One of the objectives of our regulatory financial reporting framework is to provide us with information that enables us to assess the efficiency of the provision of the universal service.

4.2 It is essential to our regulatory functions that we obtain sufficient information to enable us to make a judgement as to whether Royal Mail's planned and achieved level of efficiency improvement is reasonable. We do this on an ongoing basis as part of our monitoring regime, but we may also conduct a more detailed review on an ad hoc basis, in response to a specific concern, such as any specific threat to the financial sustainability of the universal service.

4.3 We recently conducted a detailed review of efficiency as part of our Review of Royal Mail Regulation. We considered Royal Mail's performance across a variety of efficiency metrics, comparing historic and forecast trends. Our assessment also included benchmarking data, both internal and external to Royal Mail, and a qualitative assessment of factors influencing efficiency. We concluded that Royal Mail had sufficient incentives for efficiency and that the efficiency targets in its Business Plan were reasonable but that it could do more. We also determined it was important to continue monitoring Royal Mail's actual achieved efficiency against the targets set in the 2015 Business Plan.[64]

What we proposed

4.4 In the March 2017 Consultation, we proposed the following changes to inform our view of Royal Mail's actual and planned efficiency improvements.

Cost Matrix

4.5 We proposed to introduce a requirement for a Cost Matrix, which shows a detailed breakdown of the costs of the Reported Business included in the calculation of the Financeability EBIT, in accordance with a set of rules we set out in the proposed RAG (see paragraphs 8.81 and 8.82 in the proposed modified RAG set out in Annex 6 of the March 2017 Consultation), and as per the template provided in the proposed RAG (see Figure 7 in Appendix 1 to the proposed modified RAG in Annex 6 of the March 2017 Consultation).

4.6 We proposed the Cost Matrix:

- to be included in the confidential quarterly and annual income statements of the Reported Business; and
- to be prepared for each forecast year of the Reported Business within the Business Plan.

[64] Ofcom, 2017. Review of the Regulation of Royal Mail, 1 March 2017, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

PVEO Analysis

4.7 We proposed to introduce a requirement for a PVEO Analysis, which is an analysis of the changes in a Financial Year, from the prior Financial Year, of the all costs of the Reported Business included in the calculation of the Financeability EBIT, between the effects of price, volume, efficiency and other factors, in accordance with the rules set out in the RAG (see paragraph 8.83 in the proposed modified RAG set out in Annex 6 of the March 2017 Consultation), and as per the template provided in the RAG (see Figure 8 of Appendix 1 to the proposed modified RAG in Annex 6 of the March 2017 Consultation). We proposed the PVEO Analysis:

- to be included in confidential annual income statements of the Reported Business; and
- to be prepared for each forecast year of the Reported Business within the Business Plan.

Cost metrics reporting

4.8 We also proposed the following changes to our requirements with respect to cost metrics:

- to provide the current monthly cost metrics report on a quarterly basis, using an updated template (Figures 10 in Appendix 1 to the proposed modified RAG set out in Annex 6 of the March 2017 Consultation), including gross hours reduction and productivity, together with detailed workload calculations and a restatement of those calculations based on the definitions and the assumptions as per the Business Plan submitted to Ofcom on 14 May 2015 (Business Plan 2015) (see Tables 2 and 4 in the proposed modified RAG set out in Annex 6 of the March 2017 Consultation); and
- to introduce requirements for certain new Business Plan information and further detailed prescription of the Business Plan information required (see Section 6 of the March 2017 Consultation).

Stakeholder responses and our assessment

4.9 We received responses from three stakeholders on our cost and efficiency proposals. Stakeholders' comments were generally related to one of the following broad categories below:

- the general approach and the level of prescription in the requirements;
- the Cost Matrix;
- using Royal Mail's Business Plan 2015 assumptions in our efficiency metrics;
- understanding the changes in Royal Mail's view of efficiency; and
- the Business Plan information, which we address in Section 5 of this statement.

The general approach and the level of prescription in the requirements

4.10 The BBC License Fee Unit said that it “supports the proposals” but stated that it had a “concern that in reducing the regulatory burden on Royal Mail, in particular by reducing frequency that it supplies data from monthly to quarterly that Ofcom may not be able to fully evaluate Royal Mail's efficiency gains."[65] The MCF also welcomed the proposals.

4.11 We note the BBC Licence Fee Unit's concern about the reduction in the frequency of some of the data we are requiring. However, we are confident that our requirements will still be met and that the updated framework as a whole, with increased prescription in some areas, enables us to better assess the efficiency of the provision of the universal service. Table 5.1 on page 44 of the March 2017 Consultation sets out how the information enables us to answer the questions relevant for our monitoring of efficiency.

4.12 Royal Mail suggested that we should assess our proposals against four key attributes - relevance, reliability, transparency and proportionality, as these were the attributes used "by Ofcom in 2012 in its review of BT's regulatory financial reporting."[66]

4.13 In response to Royal Mail's suggestion that we should assess our requirements against the four attributes it sets out, we consider that we have done so. In our assessment of the statutory tests for implementing regulatory conditions in the March 2017 Consultation and this statement (see Section 8), we set out how we consider our proposals are proportionate, transparent, and objectively justifiable (or relevant).

4.14 Royal Mail argued that the market conditions and challenges faced are now different to those in 2015, meaning that using the Business Plan 2015 as a reference point has become less reliable and relevant as a comparator. Royal Mail explained that "our Business Plan for 2015 was appropriate for 2015, but not for 2017", and argued that "the postal industry in 2015 is very different to the postal industry in 2017" and that the validity of using the Business Plan 2015 will continue to fade over going forward.[67]

4.15 We accept that market conditions and challenges will have changed since 2015 and will continue to change. However, our framework is such that it incorporates qualitative judgement, and the efficiency metric quantification takes some of these elements into account.

4.16 Royal Mail argued that it was concerned that a number of our proposals "may embed rigidity into the regulatory financial reporting framework and increase the regulatory burden."[68] Royal Mail said that "from time to time we re-organise our business units or re-classify our functions to better manage our business and drive efficiency"[69] and that embedding rigidity of regulatory reporting "could constrain how we run our business" and could prevent the company from "moving quickly and making changes which are beneficial to how we run our business."[70] Royal Mail said that "reporting on a legacy hierarchy- which will have no benefit to the ongoing running of Royal Mail- would represent a significant increase in the

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[65] BBC Licence Fee Unit, Consultation response, page 2.
[66] Royal Mail, Consultation response, page 21.
[67] Royal Mail, Consultation response, paragraph 3.12 and the text above it, page 23.
[68] Royal Mail, Consultation response, page 21.
[69] Royal Mail. Consultation response, paragraph 3.21, page 25.
[70] Royal Mail, Consultation response, paragraph 3.22, pages 25-26.

regulatory burden and be disproportionate relative to the benefits" and that the reporting framework should allow regulatory reporting to align to its internal reporting.[71]

4.17 While we note Royal Mail's concern that the proposals could embed rigidity and increase the regulatory burden, we consider that the current framework which has minimal amount of prescription does not ensure the consistency in the data over time (from one Financial Quarter to the next and from one Financial Year to the next). We need such consistency to reliably, effectively and efficiently review Royal Mail's efficiency, and that is why we have added this level of prescription. To enable trends to be identified and planned activities to be compared to achievements to date, we need consistency across both actuals and forecast data. With consistent data, we can be sure that movements in costs reflect a change in cost rather than a change in categorisation or assumptions.

4.18 We do not agree that the regulatory reporting framework should necessarily be set up to align with Royal Mail's own internal reporting. While such an alignment, where possible, would be ideal, we emphasise that we have specific regulatory duties. An important duty we have is to secure the provision of an efficient universal postal service, which we consider the framework of reporting we have set out will contribute to us fulfilling. The internal reporting Royal Mail has decided best meets its commercial needs is thus unlikely to be fully aligned with our needs. We do not agree that the reporting we are requiring Royal Mail to provide will be a significant impediment, if any, to the speed at which it can produce "beneficial changes" in the company.

The Cost Matrix

4.19 Royal Mail was the only stakeholder that responded on our Cost Matrix proposals, raising a number of concerns, which we address below.

4.20 Royal Mail stated that it, from time to time, re-organised both its business units and organisational structure and also re-defined its cost categorisation, and argued that the prescription of cost categories in our proposals would embed rigidity and Ofcom could instead require Royal Mail provide the "same level of detail, just with less rigidity."[72] Royal Mail suggested that Ofcom instead specify a broader level of cost categorisation and that, instead of the more detailed level of cost that we currently have specified based on the Business Plan 2015 cost categorisation, we use the existing categorisation that Royal Mail adopts at a point in time. Royal Mail said that this "would ensure there is sufficient flexibility to ensure the regulatory framework aligns to our internal reporting" and "it would minimise the regulatory burden while providing Ofcom valuable insight into our business."[73]

4.21 Royal Mail stated that the broad level of cost categorisation used should be at the level of 'People', 'Non-People' and 'Transformation' of cost categorisation because the information at broader cost categories remains broadly unchanged and consistent.

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[71] Royal Mail, Consultation response, paragraph 3.23, page 26.
[72] Royal Mail, Consultation response, paragraph 3.23, page 26.
[73] Royal Mail, Consultation response, paragraph 3.23, page 26.

4.22 Royal Mail went on to say that "in the event that there are material changes or re-classifications in our reporting at a broader cost category level for the Reported Business, we would restate the prior year comparatives."[74] Royal Mail explained that as part of its proposals it would provide one-year comparatives of "revenue and cost lines within a forecast"[75] and "if necessary, explanations of material changes between revenue and cost categorisation across years."[76]

4.23 We do not agree with Royal Mail's suggestion that, instead of the requirements we proposed, we should be provided with a people, non-people and transformation costs breakdown as well as its extant Cost Matrix in whichever form it happens to be at the time. We outlined in the March 2017 Consultation that we intended to review Royal Mail's efficiency against the targets that underpinned Royal Mail's 2015 Business Plan. Further, we proposed to adopt the cost categorisation Royal Mail used in the Business Plan 2015 Cost Matrix. The number of cost categories we are prescribing, as was in the Business Plan 2015 Cost Matrix, is around thirty, and the proposed breakdown will provide transparency of cost movements in different parts of Royal Mail's business. This will facilitate both a high level and more detailed review, consistent with the analytical framework used in our Review of Royal Mail Regulation. Receiving the three highly aggregated cost elements that Royal Mail has suggested would not allow us the insight we consider we need to effectively monitor efficiency.

4.24 For the same reasons that we gave in the previous section when discussing the responses on the general approach and the level of prescription in the framework, we do not consider that the requirements we have for monitoring efficiency will necessarily need to align perfectly with Royal Mail's own internal reporting.

4.25 Royal Mail suggested that the breakdown of operational people cost by function we proposed only be provided annually and not be provided in the quarterly Cost Matrix we had proposed for the actual costs. Royal Mail stated that to provide this people cost functional breakdown quarterly would require it to perform additional, manual analysis and that the data would also be subject to seasonal variation.

4.26 While we accept that some additional analysis might be involved, Royal Mail has not, in either its response or subsequent discussions and correspondence[77] we have had, provided us with evidence that the amount of resource required would be disproportionate to the understanding we would gain from the information. We monitor Royal Mail's progress on efficiency on a quarterly basis as part of our internal quarterly monitoring regime, and we have set out this requirement to enable us to assist us in our review and monitoring. We recognise that the quarterly information will reflect seasonal variations, but we have now years of experience of being able to identify underlying trends through these variations,

[74] Royal Mail, Consultation response, paragraph 3.23, page 26.
[75] Royal Mail, Consultation response, paragraph 3.25, page 26.
[76] Royal Mail, Consultation response, paragraph 3.24, page 26.
[77] Including Royal Mail's letter to Ofcom (Pamela Allsop to David Brown) of 20 October 2017, published as a further consultation response at https://www.ofcom.org.uk/__data/assets/pdf_file/0025/108772/Royal-Mail-2.pdf

which will be assisted by our requirement for the provision of prior year comparatives. We therefore continue to believe that provision of the operational people costs by function on a quarterly basis is necessary for us to meet our reporting objectives.

4.27 Royal Mail said that our requirement for the people costs in the Cost Matrix to be provided on both a cash and accounting pension basis, should be adjusted so that "there is sufficient flexibility to only require reporting on both cash paid and IAS19 if differences are non-trivial."[78] Royal Mail said that it was "reforming" its defined benefit pension scheme so the difference between the two might be immaterial going forward so our requirement should reflect this and our requirement for reporting on both bases should only be imposed if the differences between the two are non-trivial.[79]

4.28 We agree with Royal Mail that, if there were an immaterial difference between the two bases for calculating the pension costs, our requirement would be redundant. However, presently Royal Mail's pension cost is a significant component of the total costs used to calculate the Financeability EBIT margin of the Reported Business, and the cash pension cost is considerably lower than that calculated using the accounting standards basis. Royal Mail is in the process of coming to an agreement on its future pension costs which might result in the continuance of a significant gap between the two measures of pension cost. Therefore, we consider that it remains appropriate to require people costs on both bases.

4.29 Royal Mail said that we should also remove our requirement that it reallocate the centrally held pay cost to the pay cost categories within the Cost Matrix. Royal Mail said that it did not re-allocate all centrally held cost for target setting and it believed that re-allocation of the centrally held cost would not be a meaningful exercise, and that Ofcom should focus its monitoring on broader cost categories.

4.30 We do not agree with Royal Mail's argument that a reasonable basis for allocating the forecast centrally held pay cost cannot be adopted in the Cost Matrix submissions provided. While we accept these will only be estimates of where the costs will be realised, we consider that this will provide greater insight into how Royal Mail is realising its intended cost savings, compared with the current approach which provides no comparability in the forecast and the actual cost incurred for the costs currently allocated to the 'Centrally Held' cost line.

4.31 Royal Mail stated that our proposal that it report its transformation costs to include its voluntary redundancy cost split into frontline, management and other staff categories should be removed. We emphasise that such a breakdown is an important piece of information in building our knowledge of how Royal Mail is going about increasing its efficiency. Royal Mail explained that it does not capture this information within its accounting systems. It explained that it would have to undertake more work to do so.

4.32 While we note Royal Mail's argument that its accounting systems do not presently facilitate the provision of the information we proposed, Royal Mail has nonetheless been able to provide us with this information in previous submissions. We continue to be of the opinion,

[78] Royal Mail, Consultation response, paragraph 3.32, page 27.
[79] Royal Mail, Consultation response, paragraph 3.32, page 27.

therefore, that breaking down its transformation costs to include a split of its voluntary redundancy cost into frontline, management and other staff categories is a practical and proportionate requirement. If Royal Mail's management reassign the transformation spend during the year, we would expect that to be reflected in each submission it provides to us.

4.33 Royal Mail argued that our proposal that the Cost Matrix and PVEO Analysis reported be audited on a PPIA basis each year as part of the regulatory accounts audit should be removed. Royal Mail explained that as the Cost Matrix layout was based on its management accounts the cost categorisation breakdown and split between business units would require a level of detailed additional review above that that its auditors are presently required to perform, for example its auditor "audits people costs as a whole. It does not audit the split between different business units."[80] Royal Mail explained that it did not think that the audit would be practical as it would require judgement by its auditors "for example, confirming whether an item is a one-off cost or not. This does not fit with a PPIA audit opinion, as there is no set definition of what constitutes a one-off item set out in the RAG."[81]

4.34 In the light of Royal Mail's comments on the practicalities involved, we have reconsidered our proposal for the Cost Matrix and PVEO Analysis to be audited. We accept that the RAG, as presently set out, would require auditors to form conclusions that they may be unable to under a purely PPIA opinion, and that the level of judgement required on the auditor's part could be significant. Having considered this we conclude that imposing such a requirement on Royal Mail would be disproportionate at present.

Using Royal Mail's Business Plan 2015 assumptions in our efficiency metrics

4.35 Royal Mail has argued against our proposal to require a restatement of productivity assessment and PVEO Analysis based on Business Plan 2015 definitions and assumptions. It said our proposal would not capture important developments such as changes in operations and in the volumetrics of parcels, and therefore we should remove this proposal. Royal Mail said that it had "serious reservations with creating a view of workload today by tying it to moment in time assumptions[82]" and that there were various changes since 2015 that would have had a flow through impact on its calculation of workload.

4.36 Royal Mail argued that using the 2015 Planning Values, which underpin the workload calculations within the metrics, would result in efficiency metrics that do not reflect changes including:

- productivity improvements, which included extending workload coverage to include RDCs and outdoor collections and increasing the sophistication of its measurement;
- parcel volumetrics increasing as a result of customer wins in larger parcel sizes with improvements in how it measures operational volumes to better reflect these changes in size and the seasonality of the medium parcels market;

[80] Royal Mail, Consultation response, paragraph 3.27, page 27.
[81] Royal Mail, Consultation response, paragraph 3.27, page 27.
[82] Royal Mail, Consultation response, paragraph 3.15, page 24.

- the updating of its Planning Values to better reflect operational reality which happens on a regular basis; and
- the extension of its measure of productivity to other parts of the pipeline.

4.37 Royal Mail said that these, and other “important developments”[83] would not be captured by our proposal so that while our proposal was “technically possible”[84] it would not be “a helpful exercise for Ofcom to understand our efficiency”[85] and would not reflect the operational reality of today.

4.38 Further, Royal Mail also stated that for Ofcom to use a different workload measure from its own could lead to confusion and result in difficulties with stakeholders.

4.39 We accept that using our proposed restatement will not take in to account the changes in operations and processes that Royal Mail has set out. However, the restatement based on Business Plan 2015 assumptions is a useful tool to help us build a consistent way of measuring efficiency over a number of years, which is the type of trend analysis we find necessary in our monitoring of Royal Mail’s efficiency.

4.40 The restatement will also help us better understand the relative impact, on the workload and efficiency calculations, of the changes due to efficiency initiatives, operational reality and methodology (including the type of changes Royal Mail has pointed out).

4.41 Finally, with regard to our overall approach to efficiency assessment, we are mindful of the limitations of adopting any one approach or any one metric and the lack of adequate transparency associated with those limitations. Both Royal Mail’s own calculations and the restatements of those calculations that we require, as well as applying our judgement, are necessary for our monitoring of efficiency.

4.42 We assess Royal Mail’s response in further detail below.

Productivity

4.43 We consider the use of Business Plan 2015 as a reference base year for assessing productivity is appropriate. The productivity metric compares weighted volumes or workload, to the actual hours taken. This produces a non-financial ratio of output to input. The input is represented by the gross hours, which are the hours paid for by Royal Mail. The output is the volume of mail worked, weighted by Business Plan 2015 Planning Values, reflecting the time required in the base year to work each different volume type. In this way both the gross hours and the volumes used within the calculation correspond to the latest “operational reality”.

4.44 The use of consistent weights across time periods allows the metric to capture all productivity changes; process and labour related since the base year. Updating the volume

[83] Royal Mail, Consultation response, paragraph 3.15, page 24.
[84] Ibid.
[85] Ibid.

weights for the latest processes, as suggested by Royal Mail, would result in the metric not capturing all efficiencies (or inefficiencies) due to changes in operation.

4.45 Royal Mail has suggested we adopt the productivity metric it includes in its annual report.[86] Royal Mail has highlighted that the workload in this metric differs from that of 2015 with regard to changes in operational processes, calculation methodology, and measurement methods. The metric has also been expanded to include different parts of the pipeline.

4.46 We believe, for the reasons set out above, it is appropriate to consider productivity using Business Plan 2015 as a reference base year. We also believe it is useful to consider Royal Mail's own productivity metric to understand its view of productivity. Further, the reconciliation between the two approaches allows further insight into how Royal Mail's operations have changed against the 2015 base on which we completed our detailed assessment as part of our 2017 Review of Royal Mail Regulation. Following discussions with Royal Mail we have now revised our proposals to include requirements for a reconciliation of the workload calculations used within its Corporate Scorecard Productivity Metric[87] and that obtained by applying 2015 weights.

4.47 Royal Mail also stated that Ofcom's use of a different workload measure from its own could lead to confusion and result in difficulties with certain stakeholders. We do not agree with Royal Mail that a reporting requirement, which is confidential to us and is designed to increase transparency for our monitoring purposes, should confuse any stakeholders. It is appropriate for us to adopt different metrics according to the requirements at hand, and the stakeholders expect that our requirements as a regulatory body may differ from those of Royal Mail.

PVEO Analysis

4.48 We also calculate efficiency through PVEO Analysis. This approach identifies cost movements because of price (i.e. inflation), volume and one-offs, the remaining cost to bridge the gap is identified to be efficiency. PVEO Analysis is applied to each of the cost lines within the Cost Matrix.

4.49 We outlined in detail our approach to this calculation in the consultation document of our Review of Royal Mail Regulation. In brief, we used CPI to account for inflation across all cost lines. With regards to volume, or demand, drivers we considered cost movements across frontline delivery and processing and also those relating to the cost of sales.

4.50 We acknowledged that this was a simplification. We considered the materiality of other cost movements due to volume to be low. Further, we were not seeking one definitive measure of efficiency but rather a metric to form part of a suite of metrics to inform our view. Our proposal was that our view of Royal Mail's efficiency should be informed by comparing

[86] Up to 2015/16 our approach and Royal Mail's was aligned as Royal Mail applied constant weights (2012 Planning Values) to weight volumes in its workload calculation.

[87] This is the metric included within the Chairman's Statement of Royal Mail's Annual Report.

efficiency calculated in this way a consistently calculated estimate of efficiency form Business Plan 2015. In this way our proposed efficiency calculation met our requirements.

4.51 We continue to believe it appropriate to compare Royal Mail's performance and ambitions with regard to efficiency against those set out in its Business Plan 2015. Further, in order to do it, it is necessary to assess efficiency in the same way, i.e. applying the same scope and measures for cost movements as previously adopted.

Understanding the changes in Royal Mail's view of efficiency

4.52 In monitoring efficiency, we take into account Royal Mail's latest views of workload, productivity and efficiency (derived using PVEO Analysis methods).

4.53 To facilitate our inclusion of Royal Mail's latest views on workload, productivity and efficiency, it is imperative that we understand why and how these differ from the calculations based on the Business Plan 2015 approach (on which we conducted a detailed review). This will allow us to understand the key developments since 2015.

4.54 We understand from our further discussions with Royal Mail that the key differences in its latest approach to workload calculation versus the approach adopted in Business Plan 2015 can be divided into four categories:

- Calculation Methodology - differences in either the structure of the calculation or the sampling approach adopted.
- Processes - changes in Planning Values resulting from changes in processes adopted across the existing scope of the calculation.
- Measurement - changes in Planning Values resulting from changes in measures used within the calculation such as 'fills' or distances or time where processes adopted, and measurement methods have not been changed but the measurement applied has been updated.
- Scope - changes to the activities included within the calculation not due to process change but due to the workload calculation covering different parts of Royal Mail's operations.

4.55 Understanding the changes to workload calculations set out in a reconciliation along the above lines is important, because it will help us understand better the changes that have occurred since 2015, and how these changes impact Royal Mail's assessment of its efficiency. It will help us separate the impact of changes due to efficiency initiatives, operational reality, calculation methodology and changes in measurement. Further, it will help us understand the development of Royal Mail's workload measure as it evolves in scope.

4.56 We have therefore added further details to our restatement requirements in the RAG to include a reconciliation (set out in Annex 2 to this statement, Tables 2 and 4). We believe that this reconciliation will provide valuable insight into Royal Mail's efficiency. However, we recognise that our requirement for a restatement based on the definitions and assumptions as per the Business Plan 2015 and the added reconciliation requirement could be complex and require time and effort for Royal Mail to produce. We have therefore modified our original proposed requirement for the restatement (and the added reconciliation requirement) to cover only the total results for the Financial Year, rather than our original proposal to cover quarterly results.

4.57 Finally, to understand Royal Mails' view of efficiency, we need to understand the development of Royal Mail's view of the variability of its network; both with regard to extending the scope of the workload calculation and through the identification of other, non-workload related demand drivers. We did not propose to introduce new reporting requirements on this; however, we expect that transparency of the calculations and assumptions used to derive these estimates, including the volumes drivers and the level of variability assumed, will better enable us to understand these changes.

4.58 Further, we have decided to remove our proposed requirement that an external audit of the PVEO Analysis be undertaken. This is in part due to concerns raised by Royal Mail[88], and also because we believe the reconciliation will provide us with the assurance we seek.

The Business Plan information

4.59 We discuss this requirement in Section 5 on the Business Plan.

Our decisions

4.60 We have decided to:

a) include a Cost Matrix in the confidential quarterly and annual income statements of the Reported Business. The Cost Matrix will show a detailed breakdown of the costs of the Reported Business included in the calculation of the Financeability EBIT, in accordance with the rules set out in the RAG (see paragraphs 8.81 and 8.82 in the new RAG set out in Annex 2 to this statement), and as per the template provided in the RAG (see Figure 7 in Appendix 1 to the new RAG in Annex 2 to this statement);

b) include a Cost Matrix for each forecast year of the Reported Business (see Section 5 for further discussion), within the Business Plan, in accordance with the rules set out in the RAG (see 8.81 and 8.82 in the new RAG set out in Annex 2 to this statement), and as per the template provided in the RAG (see Figure 7 in Appendix 1 to the new RAG 8.81 and 8.82 in Annex 2 to this statement;

c) include in confidential annual income statements of the Reported Business a PVEO Analysis, which is an analysis of the changes in a Financial Year, from the prior Financial Year, of the all costs of the Reported Business included in the calculation of the Financeability EBIT, between the effects of price, volume, efficiency and other factors, in accordance with the rules set out in the RAG (see paragraph 8.83 in the proposed new RAG set out in Annex 2 to this statement), and as per the template provided in the

[88] Royal Mail, Consultation response, paragraph 3.26-3.30, page 27.

new RAG (see Figure 8 of Appendix 1 to the proposed new RAG in Annex 2 to this statement); and remove the originally proposed audit requirement;

d) include in the Business Plan a PVEO Analysis for each forecast year of the Reported Business (see Section 5 for further discussion), in accordance with the rules set out in the RAG (see paragraph 8.83 in the new RAG set out in Annex 2 to this statement), and as per the template provided in the RAG (see Figure 8 in Appendix 1 to the new RAG in Annex 2 to this statement);

e) provide the current monthly cost metrics report on a quarterly basis using an updated template (Figures 10 in Appendix 1 to the new RAG set out in Annex 2 to this statement), including gross hours reduction and productivity, together with detailed workload calculations (see Tables 2 and 4 in the new RAG set out in Annex 2 to this statement);

f) provide a restatement, only for the whole of the Financial Year, of gross hours reduction, productivity and the detailed workload calculations required in (e) above, using the definitions and the assumptions of the Business Plan 2015, together with a reconciliation of the differences between the restated detailed workload calculations and the detailed workload calculations required in (e) above; and

g) Include a further detailed prescription of Business Plan information needed for monitoring efficiency which is discussed in detail in Section 5.

5. Business plan

5.1 Royal Mail's Business Plans include information that supports our assessment of the future financial sustainability and efficiency of the provision of the universal service. Therefore, we currently require Royal Mail to provide us with its most current Business Plan once it has been approved.

5.2 While the form and content of Royal Mail's Business Plans is a matter for Royal Mail to decide, we proposed to prescribe the structure of some of the content to be submitted to us to accompany the Business Plan submission. The aim of our proposals was to ensure that we will receive a comprehensive and consistent set of data and information that will allow us to better answer some key questions (set out in Section 6 of the March 2017 Consultation) for assessing the financial sustainability and efficiency.

What we proposed

5.3 In the March 2017 Consultation, we proposed to retain the current requirement for Royal Mail to provide Ofcom with its most current Business Plan and Annual Budget (before the start of a new Financial Year and when a new Business Plan and Annual Budget have been approved by the Board), but proposed to require it also to include the following information as part of each Business Plan submission (see Table 2 of the proposed modified RAG set out in Annex 6 of the March 2017 Consultation):

a) forecast income statement, balance sheet and cash flow statement for the Relevant Group;

b) forecast financial health metrics, including the metrics required by the covenants of loans and borrowing facilities, and the metrics considered in assessing and monitoring credit rating;

c) reconciliation of forecast income statements of the Relevant Group to forecast income statements of UKPIL and the Reported Business (the reconciliation must include a reconciliation of the pension costs of the Relevant Group, UKPIL, and the Reported Business calculated on both the cash paid basis and the IAS 19 basis);

d) forecast income statement of the Reported Business supporting the Financeability EBIT;

e) breakdown of forecast revenues and volumes in V4 Format and showing separately any contingencies provided against the revenues of any products or product groups;

f) forecast Cost Matrix;

g) forecast PVEO Analysis;

h) forecast gross hours reduction and productivity, broken down by the relevant pipeline elements (e.g. delivery and processing) and format;

i) forecast workload detailed calculations;

j) forecast gross hours reduction, productivity and workload detailed calculations restated based on the definitions in the the Business Plan submitted to Ofcom on 14 May 2015 (Business Plan 2015);

k) forecast headcount and FTEs broken down between frontline, management and other staff;

l) explanation of the main assumptions underpinning the Business Plan and its key drivers;

m) a statement of changes to the forecast revenues and costs between the current Business Plan being submitted and the previous Business Plan;

n) the relevant comparative historical information in the above for previous two Financial Years immediately preceding the first forecast Financial Year; and

o) sensitivity analyses on the key inputs including a restatement of the relevant calculations and outputs assuming those risks materialise.

Stakeholder responses and our assessment

5.4 We received responses from three stakeholders on our Business Plan proposals. Stakeholders' comments were generally related to one of the following broad categories below:

- the general approach and the level of prescription;
- Royal Mail's business planning approach has become less detailed;
- restating based on the Business Plan 2015 definitions and assumptions;
- volumes and revenues; and
- headcount and FTEs.

5.5 Responses on the Cost Matrix and PVEO Analysis information, and using Royal Mail's Business Plan 2015 definitions and assumptions to report workload have already been addressed in Section 4 on Cost and Efficiency.

General approach and the level of prescription

5.6 The MCF said it "fully supports" our proposed approach if it strengthens the information provided for Ofcom to fulfil its duties.[89] The MCF argued that the difficulties we outlined in obtaining consistent Business Plan information under the current requirements "suggests that the current system is not fit for purpose, and has not been so for some time."[90] The BBC Licence Fee Unit stated that our "reporting requirements are very comprehensive and should ensure Ofcom can evaluate future financial sustainability and efficiency

[89] The MCF, Consultation response, page 3.
[90] The MCF, Consultation response, page 3.

performance" but that we "must be wary of shifting increasing regulatory burden back to Royal Mail."[91]

5.7 We note the MCF's comments and believe that the level of prescription we proposed in the March 2017 Consultation will give us sufficient information and insight to assist us to effectively assess the financial sustainability and efficiency of the universal postal service network.

5.8 In response to the BBC Licence Fee Unit's concern on the regulatory burden we have carefully considered our regulatory needs, which we explained in the March 2017 Consultation and go into more detail in the other parts of this Section, and consider our final decisions to be necessary and proportionate.

5.9 Royal Mail's concern that our overall approach was too prescriptive was addressed both to our Business Plan proposals and to our cost and efficiency proposals. Royal Mail argued that there should be "sufficient flexibility" in the framework to ensure any changes in its "business hierarchies" are "reflected in the regulatory reporting."[92]

5.10 As we explained in the March 2017 Consultation, in our Review of Royal Mail Regulation Consultation, we conducted a detailed assessment of Royal Mail's planned efficiency levels using the 2015 Business Plan, which we set out as our reference point for future monitoring of efficiency. As we explained in Section 4 of this statement, while we note Royal Mail's concern, we consider that a lack of prescription in the requirements will mean that we will be unable to effectively and efficiently identify trends from the base we have set out, and it is only with this consistent data can we be sure that movements in costs reflect a change in cost rather than a change in categorisation.

Royal Mail's business planning approach has become less detailed

5.11 Royal Mail stated that it had streamlined its business planning process with the result that some of the level of detail proposed for the later years of its forecast would require the sort of extrapolation that was neither "relevant, reliable or proportionate".[93]

5.12 It explained that the granular, bottom up approach it had previously employed was a necessary consequence of the previous price control framework, and that since the regulation had moved away from a price control approach to a monitoring approach, it had looked to move away from the detailed forecasting approach resulting in a significant change after the 2015 Business Plan. Royal Mail explained that the bottom up approach was too time consuming and was no longer appropriate for forecasting beyond the budget year.

5.13 Royal Mail explained that, while it continued to use a detailed, granular bottom up approach for the first year of its forecast, i.e. the budget year (the year to which our Annual Budget

[91] BBC License Fee Unit, Consultation response, section 3.1, question 3, page 4.
[92] Royal Mail, Consultation response, page 21.
[93] Royal Mail, Consultation response, page 21.

requirements relate), for the later years it had moved to a "value driver" approach[94] basing the forecasts on the relevant economic assumptions and strategic initiatives. Royal Mail explained that it would be possible to provide the granular level of detail we had proposed for later years two and three. However, that would "be based on extrapolating the top-down value driver assumptions to our detailed budget" level. Royal Mail said it would not be reliable to do so and "while forecasts would reconcile at broad cost categories, it would not represent a formal, business forecast at a detailed level." Royal Mail proposed that we should instead "focus on broader categories of cost when assessing our Business Plan." [95]

5.14 We do not agree with Royal Mail's suggestion that we should focus at the broader level of cost when understanding its plans for the future, as we consider it will give us insufficient insight for our monitoring of efficiency and the financial sustainability of the USO. While we note Royal Mail's drive to streamline its business planning process and the resource involved, our decision to move from a price control to a monitoring framework should not be interpreted as one that would necessarily require that less information be provided to us as the regulator. In fact, the reverse is true, as the monitoring regime requires a higher level of information more frequently, since there are no ex ante price controls in place to ensure our regulatory objectives are met. We consider that the majority of the information we proposed in the March 2017 Consultation is necessary to enable us to adopt the approach we decided as the most appropriate for monitoring efficiency in the Review of Royal Mail Regulation March 2017 Statement, and we believe, after consideration of the responses and through further discussions and correspondence[96] with Royal Mail, that Royal Mail can produce reliable detailed information.

Restating based on the Business Plan 2015 definitions and assumptions

5.15 We proposed a requirement for forecast gross hours reductions, productivity and the detailed workload calculations for all forecast years in the Business Plan to be restated using the Business Plan 2015 definitions and assumptions. As we explain in Section 4 of this statement, the restatement is important in providing us with an understanding of how Royal Mail's view of its efficiency and its approach to measuring its efficiency have evolved over time, in particular since 2015 when we did a review of Royal Mail's efficiency.

5.16 In further discussions with Royal Mail, and as we explain in Section 4 of this statement, we have come to the view that a reconciliation of the differences in the forecast gross hours reduction, productivity and detailed workload calculations in Royal Mail's Business Plan to our required restatement based on Business Plan 2015 would be important in providing us with an understating of those changes. It will help us separate the impact of changes due to efficiency initiatives, operational reality, calculation methodology and changes in

[94] Royal Mail, Consultation response, page 23, heading above paragraph 3.7.
[95] Royal Mail, Consultation response, paragraph 3.11, page 23.
[96] Including Royal Mail's letter to Ofcom (Pamela Allsop to David Brown) of 20 October 2017, published as a further consultation response at https://www.ofcom.org.uk/__data/assets/pdf_file/0025/108772/Royal-Mail-2.pdf

measurement. Further, it will help us understand the development of Royal Mail's workload measure as it evolves in scope.

5.17 We have therefore added further details to our restatement requirements in the RAG to include a reconciliation (set out in Annex 2 to this statement, Tables 2 and 4). We believe that this reconciliation will provide valuable insight into Royal Mail's efficiency. However, we recognise that our requirement for a restatement based on the definitions and assumptions as per the Business Plan 2015 and the added reconciliation requirement could be complex and require time and effort for Royal Mail to produce. We have therefore modified our original proposed requirement for the restatement (and the added reconciliation requirement) to cover only the Annual Budget, rather than our original proposal to cover all the forecast year.

Volumes and revenues

5.18 Royal Mail argued that - for the same reasons that it gave that we should look at only its broad level of costs - we should also only require revenues and costs forecast at "broader categories of revenues and volumes."[97]

5.19 The content of our proposals for revenue and volume forecasting was to provide a breakdown of volume and revenue at Royal Mail's V4 Format level[98] for each year of the Business Plan. The information at the level of detail we set out is designed to allow us to assess effectively Royal Mail's financial sustainability, monitor competition issues and protect consumer interest (by comparing the revenues and costs of product groups). It also allows us specifically to understand the key financial performance drivers contributing to the rate of return of the Reported Business and how these drivers are performing and are expected to perform. We also note that Royal Mail currently holds forecasts of its revenues and volumes at the V4 level, and it has not presented the same issue of extrapolation of a broad level to a more detailed level that it has done when discussing the forecasting of costs.

Headcount and FTEs

5.20 Royal Mail stated our proposals to require headcount and FTEs broken down between frontline, management and other staff should be removed for all but the first year of the Business Plan (i.e. the Annual Budget).[99] It said that while it forecasts this information for the budget year, it does not forecast headcount or FTEs for years 2 and 3 of its Business Plan.

5.21 Royal Mail argued that the mix between full-time, part-time and agency staff is not needed to forecast the financial outcome for years 2 and 3 of the Business Plan, and therefore it did not produce a headcount or FTE forecast. Royal Mail argued that while it could present a

[97] Royal Mail, Consultation response, Table 3.33, page 29.
[98] See the new RAG, paragraph 2.2 for the definition of V4 Format (Annex 2 to this statement).
[99] Royal Mail, Consultation response, Table 3.33, page 29.

mechanistic calculation of the headcount and FTEs, it would not represent a formal business forecast and would therefore not be relevant, proportionate or reliable.

5.22 We do not agree with Royal Mail's argument that a reliable basis for providing a headcount and FTE forecast cannot be adopted. While we accept these may not form part of the forecasts done as part of Royal Mail's Business Planning process, we believe the data is necessary and proportionate to our understanding of Royal Mail's future efficiency plans.

5.23 The ability to see separately the forecast management and frontline staff headcount and FTE provides a key indicator of how efficiency initiatives are expected to yield results, because the drivers for determining the headcounts of these two groups of staff, their costs (pay, pension, etc.) and their unionisation attributes are considerably different.

Our decisions

5.24 We have decided to retain the current requirement for Royal Mail to provide Ofcom with its most current Business Plan and Annual Budget (before the start of a new Financial Year and when a new Business Plan and Annual Budget have been approved by the Board), but require it to also include the following information as part of each Business Plan submission (see Table 2 of the new RAG in set out in Annex 2 to this statement):

a) forecast income statement, balance sheet and cash flow statement for the Relevant Group;

b) forecast financial health metrics, including the metrics required by the covenants of loans and borrowing facilities, and the metrics considered in assessing and monitoring credit rating;

c) reconciliation of forecast income statements of the Relevant Group to forecast income statements of UKPIL and the Reported Business (the reconciliation must include a reconciliation of the pension costs of the Relevant Group, UKPIL, and the Reported Business calculated on both the cash paid basis and the IAS 19 basis);

d) forecast income statement of the Reported Business supporting the Financeability EBIT;

e) breakdown of forecast revenues and volumes in V4 Format and showing separately any contingencies provided against the revenues of any products or product groups;

f) forecast Cost Matrix (also see Section 4 of this statement);

g) forecast PVEO Analysis (also see Section 4 of this statement);

h) forecast gross hours reduction and productivity, broken down by the relevant pipeline elements (e.g. delivery and processing) and format (also see Section 4 of this statement);

i) forecast workload detailed calculations (also see Section 4 of this statement);

j) a restatement, in the Annual Budget only, of the forecast gross hours reduction, productivity and workload detailed calculations, using the definitions and the assumptions of the Business Plan 2015, together with a reconciliation of the differences between the restated detailed workload calculations and the detailed workload calculations in (i) above (also see Section 4 of this statement);

k) forecast headcount and FTEs broken down between frontline, management and other staff;

l) explanation of the main assumptions underpinning the Business Plan and its key drivers;

m) a statement of changes to the forecast revenues and costs between the current Business Plan being submitted and the previous Business Plan;

n) the relevant comparative historical information in the above for previous two Financial Years immediately preceding the first forecast Financial Year; and

o) sensitivity analyses on the key inputs including a restatement of the relevant calculations and outputs assuming those risks materialise.

6. Cost data and change control

6.1 Royal Mail's regulatory financial reporting framework includes a change control process relating to the regulatory accounting and costing methodology, as well as a requirement to provide us with granular cost data in a form which enables us to replicate parts of Royal Mail's cost allocation calculations. We also require Royal Mail to prepare costing and accounting methodology manuals. Royal Mail is required to publish the non-confidential parts of the costing methodology manual.

6.2 In the March 2017 Consultation, we proposed to update and simplify our requirements for granular cost data and change control submissions. The proposed changes were aimed at providing us with more transparency in areas where it is needed, and were intended to ease the reporting burden on Royal Mail where there is no longer an essential need for information.

What we proposed

Cost data

6.3 We proposed to require quarterly cost data (including volume data):

a) at Short SPHCC level, instead of the SPHCC cost data which we currently receive, and

b) without the breakdown into activities which we currently receive.

6.4 We also proposed the above cost and volume data to be integrated into the new quarterly revenue data extract which we proposed (see Section 3 of this statement).

Change control

6.5 We proposed to require Royal Mail to include in its change control submissions:

a) a restatement of the quarterly income statement for the Reported Business and the separated income statement for the universal service and non-universal service products as if the changes made in the accounting or costing methodology in the previous Financial Quarters of the Financial Year had not been introduced;

b) a statement of the combined impact of all the changes made in the accounting and costing methodology in the previous Financial Quarters of the Financial Year on the costs of all affected Short SPHCCs; and

c) a statement of the impact of the individual changes on total upstream and downstream costs of the Reported Business.

6.6 We set out the proposed new templates, which reflect the above proposals, in Appendix 3 to the proposed modified RAG in Annex 6 of the March 2017 Consultation.[100]

Stakeholder responses and our assessment

Cost data

6.7 In its response[101], Royal Mail addressed our proposal to require quarterly submissions of granular data at Short SPHCC level in general, which we consider in Section 3 of this statement. Royal Mail did not comment specifically on proposals we have set out in this section.

6.8 Whilst the MCF stated that it was not able to comment on the technicalities of this area, it "supported the sentiment expressed" and our proposals on cost data.

6.9 As explained in the March 2017 March Consultation, the transparency requirements discussed in this Section are essential for making sure we receive reliable and clear information for our work on assessing and monitoring financial sustainability and efficiency and monitoring how Royal Mail is using its commercial freedom and the impact of this on both consumers and competitors. We consider our proposals in this Section will help us answer effectively all our questions under those objectives."

Change control

6.10 Whilst the MCF is not able to comment on the technicalities of this area, it "supported the sentiment expressed" and our proposals on change control as well.

6.11 In its response[102], Royal Mail considered our proposals for a restatement of the income statement for the Reported Business and the separated income statement for the universal service and non-universal service products, and a statement of the combined impact of all the changes on the costs of all affected Short SPHCCs (see paragraph 6.5 (a) and (b) above) not to be practical or proportionate. Royal Mail stated that it would have to increase the resourcing and undertake new processes.

6.12 Royal Mail explained that, in order to meet this requirement, it would need to run a separate model which would be ring-fenced from its 'live' model. A further complication would be that the changes made in a period may involve overlapping impact which would need to be worked through. Royal Mail stated that the time needed to produce a statement of combined impact could be at least as much as the time needed to run all the individual changes one after another.

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[100] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/99734/Annex-6-Proposed-modified-RAG.pdf
[101] Royal Mail, Consultation response, pages 40-48.
[102] Royal Mail, Consultation response, pages 40-48.

6.13 Royal Mail proposed that instead of our proposed combined impact statement, it could provide a statement that simply adds together the impact of individual changes in a given quarter.

6.14 As we explained in the March 2017 Consultation,[103] a restatement of the income statement for the Reported Business and the separated income statement for the universal service and non-universal service products would help us gain a better understanding of how the changes impact on Royal Mail's overall profitability and the profitability of the universal service and non-universal service products.

6.15 As we explain in Section 3 of this statement, we have decided to require from Royal Mail granular volume, revenue and cost data to enable us to prepare our own separated income statements and PPSs. And, as we explained in the March 2017 Consultation,[104] we will need to have the combined effect of all the changes on the costs and revenues of all affected Short SPHCCs to understand how our separated income statement or PPSs is affected by the changes to the accounting and costing methodologies.

6.16 Royal Mail's proposal of simply adding up the impact of individual changes would not be suitable for the above purposes, mainly due to the potential for overlapping of impact of some changes, which Royal Mail has also recognised.

6.17 It is apparent from Royal Mail's explanations that our requirement is not impracticable, but meeting it is likely to require considerably more resources by Royal Mail. We therefore consider that an appropriate modification to our proposal would be to require an annual, rather than quarterly, combined impact assessment, which would still provide us with sufficient transparency but would require considerably less resourcing from Royal Mail.

6.18 Royal Mail proposed various changes to other aspects of change control requirements, which were not subject to any proposed changes by us in the March 2017 Consultation. We consider Royal Mail's proposals below.

6.19 Royal Mail proposed that the materiality threshold of methodology changes for change control notification should be increased to a more proportionate level of £1 million and 5% impact on products and activities. Royal Mail stated that the current required levels of £0.5 million and 1% impact are very low and onerous. Royal Mail also stated that the impact should be measured at the line item affected (such as revenue or cost) and not on calculated figures (e.g. profit).

6.20 Royal Mail did not provide any evidence as to why it considered the current materiality thresholds too low or onerous, but it referred to Ofcom's requirements for BT's regulatory financial statement which include a materiality threshold of the higher of 5% or £1 million.

6.21 Our regulatory approach to BT has significant differences compared with our approach to regulating Royal Mail. A high level of commercial freedom Royal Mail has been granted and the need for our monitoring regime to ensure our deregulatory approach remains

[103] Paragraph 7.18.
[104] Paragraph 7.19.

appropriate are some of the key differences. Our reporting requirements for Royal Mail reflect the information needs of this different regulatory approach.

6.22 We agree with Royal Mail that changes must be calculated on input items in the regulatory reports, including revenues, costs, assets, liabilities, and cash flows (as explained in the RAG[105]). Changes need not be calculated on calculated figures including profit figures.

6.23 Royal Mail pointed out that it did not consider year on year changes in its data (e.g. to use latest Mail Characteristic Survey data) as methodology changes. In Royal Mail's view, such data changes are out of scope of our change control requirements.

6.24 We agree with Royal Mail that changes in the data caused by updating or refreshing the measurements do not constitute methodology changes. However, we consider changes in the measurement methodology as a change in methodology which must be reported to meet our change control requirements.

6.25 Royal Mail noted that we proposed amendments in Table A, which is one of our prescribed templates for change control submissions[106], to make it clear that an impact assessment on activity costs is required as part of the change control submissions. Royal Mail did not consider that this was useful for our purposes of assessing the impact of methodology changes at a product level and it required a different analysis of the same cost data. Royal Mail proposed that we removed "this new requirement".

6.26 The impact of changes on activity costs are necessary for our understanding of the impact of costing methodology changes on costs. The change control submissions are there to help us understand the impact of methodology changes on cost allocation in general which includes activity costs as well as product costs. Furthermore, as Royal Mail correctly states, we have made amendments "to make it clear" that an impact assessment on activity costs must be included in the submissions. However, this is not a new requirement. We have simply clarified an existing requirement. The template as per the RAG put in place in March 2012 (and revised in January 2014) included a row for 'activity costs'[107] all along.

6.27 Royal Mail stated that another change control template (Table B in Appendix 3 to the proposed modified RAG[108]), which sets out the impact of accounting methodology changes on the Income, Capital Employed and Cash Flow statements, is not practical. Royal Mail also argued that the information required in Table B is not relevant to the assessment of the impact of methodology changes at a product level, which Royal Mail considered to be Ofcom's purpose for change control process. Royal Mail proposed that we should remove the requirement for Table B.

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[105] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/99734/Annex-6-Proposed-modified-RAG.pdf , paragraph 2.1(f)
[106] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/99734/Annex-6-Proposed-modified-RAG.pdf , Appendix 3,Table A, page 87
[107] https://www.ofcom.org.uk/__data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf , Appendix 3, Table 12, page 61
[108] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/99734/Annex-6-Proposed-modified-RAG.pdf , Appendix 3, Table B, page 88

6.28 The change control process was set up in March 2012 to help us understand the impact changes in both the costing methodology and the accounting methodology on Royal Mail's regulatory reports and statements (see USPAC 1.6.3[109] and see RAG paragraph 2.1(f)[110]). Table B is essential in helping us understand the impact of change in the accounting methodology on Royal Mail's regulatory financial statements. Royal Mail did not provide any evidence why Table B is not practical.

Our decisions

Cost data

6.29 We have decided to require quarterly cost data (including volume data):

a) at Short SPHCC level, instead of the SPHCC cost data which we currently receive, and

b) without the breakdown into activities which we currently receive.

6.30 We have also decided that the above cost and volume data must be integrated into the new quarterly revenue data extract which we have decided to require (see Section 3 of this statement).

Change control

6.31 We have decided to require Royal Mail to include in its change control submissions:

a) an annual restatement, as part of the change control submissions for the Financial Year (90 days after the Financial Year end), of the annual income statement for the Reported Business and separated income statement for the universal service and non-universal service products as if the changes made in the accounting or costing methodology in the previous Financial Quarters of the Financial Year had not been introduced;

b) an annual statement, as part of the change control submissions for the fourth Financial Quarter (54 days after the Financial Quarter end), of the combined impact of all the changes made in the accounting and costing methodology in the previous Financial Quarters of the Financial Year on the costs of all affected Short SPHCCs; and

c) a statement, as part of quarterly change control submissions (7 days prior to the changes in question being made as per USPAC 1.6.3), of the impact of the individual changes on total upstream and downstream costs of the Reported Business.

6.32 We have set out the templates for the above requirements, in Appendix 3 to the new RAG set out in Annex 2 to the statement.

[109] https://www.ofcom.org.uk/__data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf , and https://www.ofcom.org.uk/__data/assets/pdf_file/0031/99733/Annex-5-Proposed-Modified-USPAC.pdf
[110] https://www.ofcom.org.uk/__data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf , and https://www.ofcom.org.uk/__data/assets/pdf_file/0032/99734/Annex-6-Proposed-modified-RAG.pdf

7. Reporting deadlines and the Relevant Group definition

7.1 In this Section, we address two further areas that we proposed changes to:

- the deadlines for submission of regulatory reports and data (in light of our proposed changes that reduce the reporting burden and the reporting frequency for Royal Mail); and
- the definition of the Relevant Group, as the structure of the Royal Mail group of companies has undergone significant changes since the 2012 Statement.

What we proposed

Reporting deadlines

7.2 We proposed:

a) to reduce the deadline for submission of the annual regulatory accounts from 120 days to 90 days after the end of each Financial Year;

b) to reduce the deadline for submission of the quarterly regulatory accounts from 60 days to 45 days after the end of each Financial Quarter;

c) to require granular revenue, cost and volume data submissions 45 days after each Financial Quarter end (superseding the requirement for cost and volume data submissions 60 days after each Financial Quarter end);

d) to reduce the frequency of the volume and revenue reports and the cost metrics reports from monthly to quarterly;

e) to increase the deadline for the reports in (d) above from 30 days after the Financial Month end to 45 days after the Financial Quarter end; and

f) to require the data necessary to monitor compliance with the Second Class stamp safeguard caps one month after the implementation of any new prices (superseding the requirement for this data to be submitted within three months of the end of the year in which the cap applied).

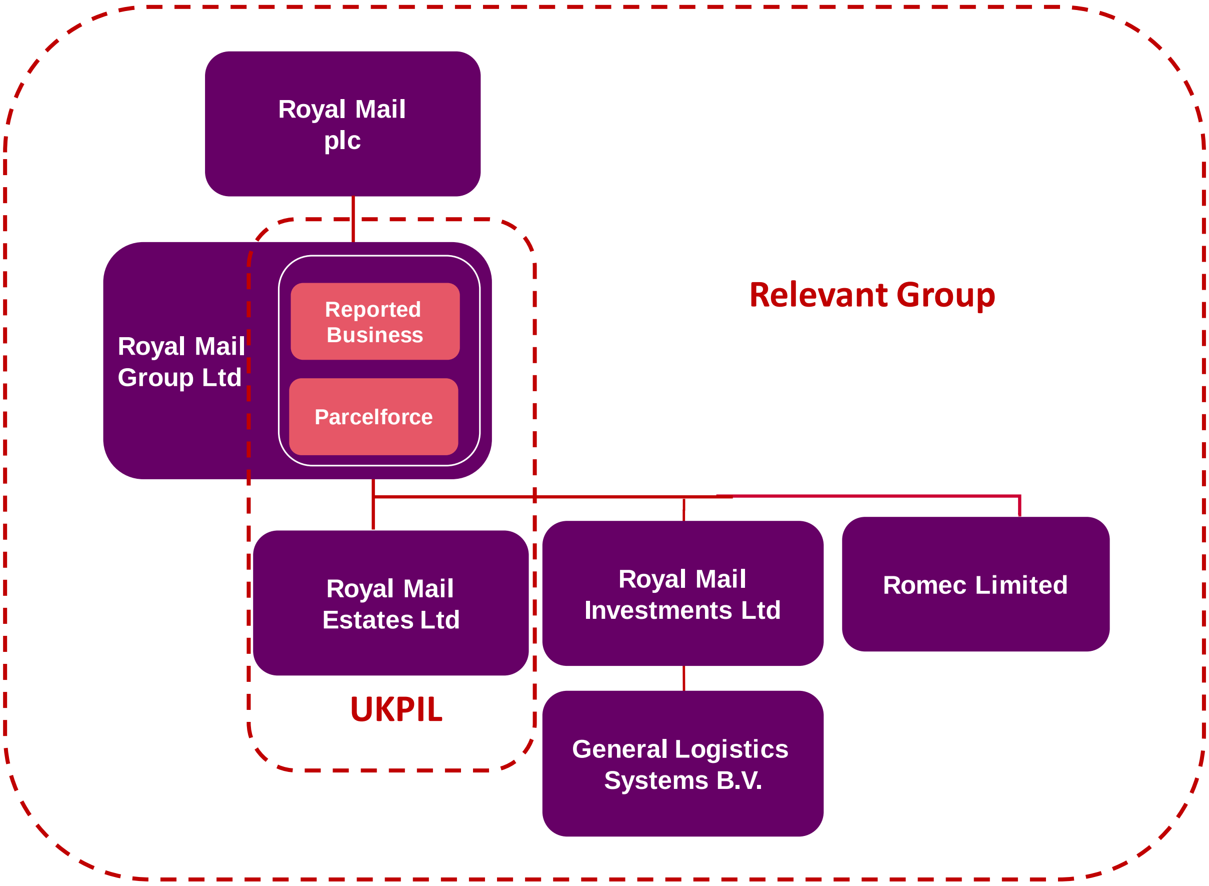
7.3 We explained in the March 2017 Consultation that the proposals set out in (a) and (b) above would enable us to complete our internal quarterly monitoring reports and publish our annual monitoring report earlier, and closer to the dates Royal Mail publishes its reports. The proposal set out in (c) would allow us to carry out our monitoring on a more-timely basis and prepare our quarterly internal monitoring reports earlier. The proposal set out in (e) would enable Royal Mail to make all its quarterly submissions in one combined quarterly package which is internally fully consistent and reconciled. The proposal set out in (f) would allow us to assess whether Royal Mail's prices are compliant with the safeguard cap on a more-timely basis.

7.4 We also explained that, while some of the above proposals shorten deadlines, others lengthen the deadlines and reduce the frequency and the granularity of some of the reports. All in all, we considered the net effect of the above proposals, and our proposals to reduce accounting separation requirements considerably (see Section 3), would be to reduce the reporting burden for Royal Mail.

Definition of the Relevant Group

7.5 We proposed to update the definition of the Relevant Group to encompass Royal Mail plc, all of its subsidiaries, and all of its subsidiary undertakings (including any subsidiaries or subsidiary undertakings of those subsidiaries or subsidiary undertakings, and so forth). The proposed definition is illustrated in Figure 7.1:

Figure 7.1: Definition of the Relevant Group



7.6 The new definition supersedes the definition of the Relevant Group, which was put in place in March 2012 to encompass the whole of Royal Mail group of companies at the time excluding Royal Mail Holdings plc (RMH plc) and Post Office Limited (POL). We explained in the March 2017 Consultation that these proposed changes were necessary to reflect the changes in the structure of Royal Mail group of companies since March 2012 (mainly removal of POL from Royal Mail group and the setting up of Royal Mail plc as the ultimate parent company listed on the London Stock Exchange).

7.7 We also proposed to remove the requirement for Royal Mail to prepare a consolidated income statement, balance sheet and cash flow statement for the Relevant Group on an annual basis. We explained that our proposed definition of the Relevant Group meant the annual report of Royal Mail plc - which includes the statutory accounts of Royal Mail plc required by Companies Act 2006, including the consolidated accounts for Royal Mail plc and the whole group held by it - would satisfy this requirement. Accordingly, we also proposed to remove the requirement for Royal Mail to reconcile those statements to the corresponding statements for RMH plc.

Stakeholder responses and our assessment

Reporting deadlines

7.8 The MCF welcomed our proposed requirements for Royal Mail to submit materials more quickly as a "positive development".[111]

7.9 The BBC Licencing Fee Unit asserted, "The reduced deadlines will benefit Ofcom in terms of evaluation, particularly where evaluation is required of Royal Mail impact on competition through leverage of its commercial freedom and the wider stakeholder community."[112]

7.10 In its formal consultation response,[113] Royal Mail broadly agreed with our proposed changes to the regulatory reporting timetable, but Royal Mail also expressed two main concerns:

- Our proposed quarterly reporting deadline of 45 days after the quarter end was not workable or proportionate; and
- The deadline for the submission of the Annual Budget and the Business Plan needed to take account of when the information has been prepared, reviewed and approved.

7.11 Royal Mail explained that the information included in its announcement of the half-year and the full year results are not approved until around 53 days after the period end. Until the information contained in these announcements have been approved, the information to be included in the quarterly regulatory accounts (the second and fourth Financial Quarters) would be in draft, hence not reliable or relevant. Royal Mail explained in further discussions that the 53 days deadline represented the best timing it could achieve for its announcements of half-year and full year results, given the necessary assurance and approval processes that are undertaken.

7.12 Royal Mail also raised the concern that the submission of quarterly regulatory accounts and granular data in advance of the results announcements would expose them to a risk of a leak of strictly confidential and highly sensitive information.

[111] The MCF, Consultation response, page 4
[112] The BBC, Consultation response, page 2
[113] Royal Mail, Consultation response, pages 49-53

7.13 Royal Mail explained further that our proposals to simplify regulatory reporting does not remove 15 days from the timetable, and that at best it saves around three days.

7.14 Royal Mail proposed that a more proportionate deadline would be the same as the timing for the announcements of its results for the half-year and full year, namely 54 days after quarter end.

7.15 In the March 2017 Consultation document, we acknowledged the fact that the timing of the half-yearly and year-end results announcements by Royal Mail are a few days later than 45 days after the period ends. However, we also explained our expectation that Royal Mail would provide us with information about the material changes that have been made and their impact on the quarterly regulatory reports.

7.16 We do not agree with Royal Mail that the submission of regulatory information to us in advance its results announcements increases the risk of a leak of sensitive and confidential information. We do receive and will continue to receive sensitive and confidential information from Royal Mail on a monthly, quarterly, annual and at times ad hoc basis, and we have all the necessary measures in place to safeguard the confidentiality of the information, in particular the provisions of section 56 PSA 2011.

7.17 We have considered Royal Mail's arguments about how much time our proposals to reduce regulatory reporting remove from its reporting process. We also understand that a deadline of 54 days - instead of our proposed 45 days – may defer the regulatory quarterly reports by 9 days (7 working days), but it will have the benefit of providing us with final information. It will also remove the need - and the time and effort needed - for Royal Mail to explain and assess the impact of any changes between the two deadlines.

7.18 In light of the above, we now consider that a deadline of 54 days for quarterly regulatory reports for the second and fourth Financial Quarters meets our regulatory needs in the most proportionate manner. To simplify the requirements, we consider a similar deadline of 54 days for the first and third Financial Quarters would be appropriate. The deadline of 54 days will represent a six days acceleration from the current deadline of 60 days.

7.19 With regard to the Annual Budget and Business Plan submission deadline, we did not propose any changes in the March 2017 Consultation. The current requirement is that:

a) the information in relation to each Financial Year must be submitted before the start of that Financial Year, and

b) any subsequent updates during the Financial Year to be submitted when the update has been approved by Royal Mail.[114]

7.20 Royal Mail however proposed a two-phase drop of information with regard to the Annual Budget and Business Plan:

[114] See our proposed modified USPAC 1.3.4, https://www.ofcom.org.uk/__data/assets/pdf_file/0031/99733/Annex-5-Proposed-Modified-USPAC.pdf

i) Before the start of the financial year but subject to the approval of the Royal Mail Board - submission of the Relevant Group and Reported Business Annual Budget and Business Plan (including the Financeability EBIT margin, main assumptions and key drivers, Cost Matrix, a plan on plan impact and reconciliation to UKPIL and Relevant Group.)

ii) 92 days after the start of the year – submission of the remaining information (including the financial health metrics, PVEO Analysis built on the actual Cost Matrix, the productivity and workload schedules, headcount metrics, detailed volume and revenue in V4 format).

7.21 Royal Mail's proposal does not represent better or more proportionate submission timings. We expect Royal Mail to have its Annual Budget for each Financial Year to be completed and approved before the start of that Financial Year. We therefore require the Annual Budget to be provided to us before the start of the Financial Year as per the requirement (a) set out in paragraph 7.19. Any further Business Plan information that has been approved at that point (for example relating to subsequent Financial Years) must also be provided as they will be subject to the requirement (b) in paragraph 7.19.

7.22 Any further updates and additions, which could be the information Royal Mail describes under phase (ii), is required to be provided to us when the information has been approved as per the requirement (b) in paragraph 7.19. The addition of the deadline of 92 days to these updates or additions actually reduces the flexibility which we have in our requirements.

7.23 Royal Mail also proposed that we consider setting the reporting deadlines generally in relation to working days after period end, rather than total days after the period end, in order to avoid having a deadline falling on a non-working day.

7.24 We expect Royal Mail to comply with a submission deadline that happens to fall on a non-working day, by submitting at the latest on the last working day prior to the deadline. This avoids the need to submit on a non-working day and does not shorten the deadline. The length of time available to Royal Mail to meet the deadline depends on the number of working days between the period end and the submission deadline. When a submission deadline falls on a non-working day, whether the submission is made on the last working day prior to that non-working day or on that non-working day itself, it does not change the total working time available to Royal Mail.

7.25 Royal Mail's response also proposed as another alternative that for some deadlines when a submission deadline falls on a non-working day, we should require the submission on the first working day after the deadline. This would mean that Royal Mail would effectively have one more working day to submit. We do not consider there is a need to introduce potentially a one-day extension to our required reporting deadlines.

Definition of the Relevant Group

7.26 Royal Mail agreed with our proposal to change the definition of the Relevant Group and remove the requirements for Royal Mail to prepare consolidated income statement, balance sheet and cash flow statement for the Relevant Group on an annual basis. Royal Mail agreed that the proposals provided better clarity and remove redundant requirements.[115]

7.27 Royal Mail also pointed out that, following the acquisition of the minority shareholding in Romec Limited on 31 March 2016, it now accounts for Romec Limited as part of UKPIL. Royal Mail suggested that we should amend the group structure as depicted in Figure 7.1 above accordingly. We agree with this proposed amendment (see Figure 7.2).

7.28 The MCF fully supported our proposals in this area.[116]

Our decisions

Reporting deadlines

7.29 We have decided:

a) to reduce the deadline for submission of the annual regulatory accounts from 120 days to 90 days after the end of each Financial Year (see new USPAC 1.4.7, 1.4.9 (b) and (c), 1.5.8, 1.5.10(a) and 1.6.4 set out in Annex 1 to this statement);

b) to reduce the deadline for submission of the quarterly regulatory accounts from 60 days to 54 days after the end of each Financial Quarter (see new USPAC 1.4.9 (a) and 1.5.10(b) set out in Annex 1 to this statement);

c) to require granular revenue, cost and volume data submissions 54 days after each Financial Quarter end (see new USPAC 1.4.9(l) set out in Annex 1 to this statement) - We currently require cost and volume data submissions 60 days after each Financial Quarter end;

d) to reduce the frequency of the volume and revenue reports and the cost metrics reports from monthly to quarterly (see new USPAC 1.4.1(l) set out in Annex 1 to this statement);

e) extend the deadline for the reports in (d) above from 30 days after the Financial Month end to 54 days after the Financial Quarter end (see new USPAC 1.4.9(f) set out in Annex 1 to this statement); and

f) to require the data necessary to monitor compliance with the Second Class stamp safeguard caps one month after the implementation of any new prices (see modifications to DUSP 2.2.4 and 3.2.4 as set out in Annex 3 to this statement).

7.30 For the avoidance of doubt, we have decided not to change the submission deadline requirements for the Annual Budget and the Business Plan.

7.31 As we explain in Section 3, we consider that Royal Mail's management accounts for the Board meet our requirement for monthly sales and volume information. We also explain

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[115] Royal Mail, Consultation response, page 37.
[116] The MCF, Consultation response, page 4.

(see paragraphs 3.16 and 3.63) that we have decided to extend the deadline from 30 days to 54 days for the submission of Royal Mail's management accounts for the 6th and 12th Financial Month of the Financial Year (see new USPAC 1.4.9(d) and (e) set out in Annex 1 to this statement).

7.32 Table 7.1 below shows the old and the new deadlines for those Royal Mail submissions which have been subject to change in this statement:

Table 7.1: Changes to the regulatory reporting submission deadlines

Submissions	Old deadline	New deadline
Annual regulatory accounts Including income statement, statement of capital employed, and cash flow statement of Reported Business; reconciliation of Relevant Group accounts to Reported Business accounts; PPSs (proposed to be access and PAF only); and accompanying notes proposed to include Cost Matrix and PVEO Analysis	120 days after Financial Year end	90 days after Financial Year end
Annual cost and volume input and output data at SPHCC level	120 days after Financial Year end	90 days after Financial Year end
Quarterly regulatory accounts Including income statement of Reported Business; PPSs (proposed to be access and PAF only); and accompanying notes proposed to include Cost Matrix	60 days after Financial Quarter end	54 days after Financial Quarter end
Quarterly revenue and volume report Previously required monthly	30 days after Financial Month end[117]	54 days after Financial Quarter end
Quarterly cost metrics report Including RDT to workload bridge, previously required monthly	30 days after Financial Month end[118]	54 days after Financial Quarter end
Quarterly revenue, volume and cost granular data submission Previously only granular volume and cost data required quarterly	60 days after Financial Quarter end	54 days after Financial Quarter end
Management Accounts for the Board for the 6th and 12th Financial Month of the Financial Year	30 days after Financial Month end	54 days after Financial Month end

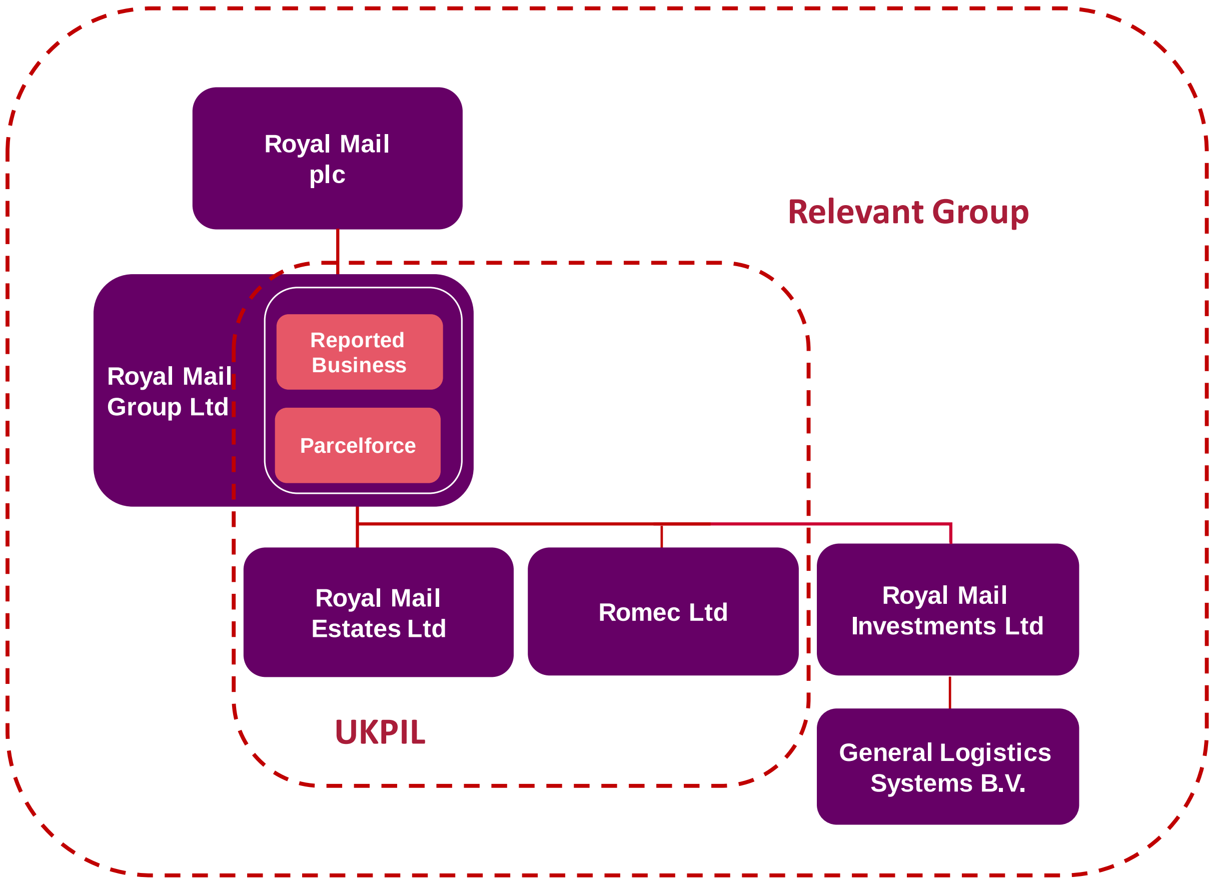
[117] Financial Month means each month comprised in the Financial Year.
[118] Financial Month means each month comprised in the Financial Year.

Submissions	Old deadline	New deadline
Second Class safeguard caps submission	Three months after the end of the year to which the cap is applied	One month after the implementation of any new prices

Definition of the Relevant Group

7.33 We have decided to adopt the definition of the Relevant Group as illustrated in Figure 7.2 below and included in the new USPAC 1.1.2(r) set out in Annex 1 to this statement:

Figure 7.2: Definition of the Relevant Group



8. Conclusions

8.1 In this Section, we summarise our conclusions on the regulatory financial reporting framework which we have decided to put in place. These conclusions follow our consideration of the consultation responses discussed in previous Sections of this statement. We also explain in this Section how we consider that this amended framework meets our duties and statutory tests for revoking and imposing the new USPAC and the new RAG.

8.2 As explained in Section 2, this statement concludes Phase I of our review of the regulatory financial reporting requirements (apart from our proposals relating to the margin squeeze control). Phase I has focused on changes to the contents, frequency, disclosure, and deadlines of the regulatory financial reporting required from Royal Mail. Phase II will focus on the regulatory accounting rules (including cost allocation rules) applied by Royal Mail in preparing its financial reports.

8.3 We conclude this Section by explaining our proposed timeline for our new proposals relating to the margin squeeze control, and the next steps for Phase II of our review.

Our decisions

8.4 Table 8.1 summarises, at a high level, the regulatory financial reporting requirements we have decided to impose on Royal Mail under the new USPAC and the new RAG. The more detailed requirements are set out in the new USPAC and the new RAG at Annexes 1 and 2 to this statement. In Table 8.2 below, we summarise aspects of our decisions on those requirements with such modifications to our proposals set out in the March 2017 Consultation that appear to us to be appropriate after having regard to consultation responses (see previous Sections):

Table 8.1: Summary of the regulatory financial reporting framework

Reports / Data submissions	Frequency	Disclosure	Audit	Deadline	New USPAC requirement (Annex 1)	Pro formas in new RAG (Annex 2)	Sections in this statement
Income statement, statement of capital employed, and cash flow statement of Reported Business (including Cost Matrix, PVEO Analysis, annual reconciliation of quarterly income statements, and end-to-end split between universal service and non-universal service products)	Annual	Published, except for Cost Matrix and PVEO Analysis	Audited, except for Cost Matrix and PVEO Analysis	90 days after Financial Year end	USPAC 1.4.1 (a), (c), (e) and (g); and USPAC 1.5.2 (a)	Appendix 1, Figures 1, 4, 5, 7 and 8	3, 4, 7
Product Profitability Statements for access and PAF	Annual	Published	Audited	90 days after Financial Year end	USPAC 1.4.1 (i)	Appendix 1, Figure 6	3, 7
Reconciliation of Relevant Group accounts to Reported Business accounts	Annual	Published	Audited	90 days after Financial Year end	USPAC 1.4.1 (d), (f) and (h)	Appendix 1, Figures 3, 4 and 5	3, 7
Business Plan including Annual Budget	Annual	Confidential	Not audited	Before start of Financial Year, and once approved	USPAC 1.3.1 (b) and (c)	Appendix 1, Figures 7 and 8	5
Cost and volume input and output data at SPHCC level	Annual	Confidential	Not audited	90 days after Financial Year end	USPAC 1.6.1	Appendix 4	3, 6, 7

Reports / Data submissions	Frequency	Disclosure	Audit	Deadline	New USPAC requirement (Annex 1)	Pro formas in new RAG (Annex 2)	Sections in this statement
Second Class safeguard cap submission	Annual	Confidential	Not audited	One month after the implementation of any new prices	DUSP 2.2.4 and 3.2.4	N/A	7
Cash headroom projections for the Relevant Group	Quarterly	Confidential	Not audited	Before start of Financial Quarter	USPAC 1.3.1 (a)	N/A	N/A
Income statement of Reported Business (including Cost Matrix and end-to-end split between universal service and non-universal service products)	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.4.1 (b); and USPAC 1.5.2 (b)	Appendix 1, Figures 2 and 7	3, 4, 7
Product Profitability Statements for access	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.4.1 (j)	Appendix 1, Figure 6	3, 7
Volume and revenue report	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figure 9	3, 7
Cost metrics report (including volume to workload bridge)	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figure 10	4, 7
Granular data extract file (Revenue, cost and volume data at Short SPHCC level)	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figure 11	3, 7

Reports / Data submissions	Frequency	Disclosure	Audit	Deadline	New USPAC requirement (Annex 1)	Pro formas in new RAG (Annex 2)	Sections in this statement
Costing Methodology Manual	Quarterly	Published, except for Technical Appendices	Not audited	54 days after Financial Quarter end	USPAC 1.6.1	N/A	6, 7
Accounting Methodology Manual	Quarterly	Confidential	Not audited	54 days after Financial Quarter end	USPAC 1.6.1	N/A	6, 7
Change control submissions	Quarterly	Confidential	Not audited	7 days before changes are made (and combined impact statements to be provided 54 days after the last Financial Quarter end and 90 days after Financial Year end)	USPAC 1.6.3	Appendix 3	6
Royal Mail's management accounts for the Board to meet our requirement for monthly sales and volumes information (provided for all Financial Months except for the 1st Financial Month of the Financial Year)	Monthly	Confidential	Not audited	54 days after Financial Month end for the 6th and 12th Financial Month, and 30 days after Financial Month end for all other Financial Months (except for the 1st Financial Month)	USPAC 1.4.1 (k)	N/A	3, 7

8.5 As shown in the legal instruments at Annexes 1 and 2 to this statement, the existing USPAC Condition and the existing RAG will be revoked with effect from 25 March 2018, which we understand it to be Royal Mail's year-end date of the 2017/18 Financial Year. As a result, we have decided to impose on Royal Mail the new USPAC and the new RAG to take effect on 26 March 2018. Therefore, to take an example, we expect that Royal Mail will submit the Annual Budget for its 2018/19 Financial Year by following the requirements in the new USPAC and the new RAG.

8.6 As explained above, Table 8.2 below summarises key modifications we have decided to make to our proposals in the March 2017 Consultation.

Table 8.2: Modifications to the proposals in the March 2017 Consultation

Requirement	March 2017 proposal	Modification	Section in this statement	New USPAC (Annex 1) / New RAG (Annex 2)
Product profitability statement for PAF	To be published annually and submitted to Ofcom quarterly on a confidential basis	To be published annually only	3	RAG, Table 5
Annual Cost Matrix and PVEO Analysis	To be audited	Not to be audited	4	RAG, Table 10
Restatement of workload calculations, and gross hours and productivity results, based on the assumptions and definitions in the Business Plan submitted to Ofcom on 14 May 2015	To be required for the Annual Budget, the Business Plan, and the quarterly cost metrics reports	To be required only for the Annual Budget, and the Financial Year as a whole together with a reconciliation of the differences (submitted with the quarterly cost metrics report for the last Financial Quarter)	4 and 5	RAG, Table 2 (additional requirements relating to USPAC 1.3.1(b), 1.3.1(c), and Table 4 (additional requirements relating to USPAC 1.4.1(l)
Restatement of quarterly income statements for the Reported Business showing the combined impact of all the changes made in the accounting and costing methodology	To be required for quarterly income statements 45 days after Financial Quarter end	To be required only for the annual income statement 90 days after Financial Year end	6	RAG, Appendix 3

Requirement	March 2017 proposal	Modification	Section in this statement	New USPAC (Annex 1) / New RAG (Annex 2)
Combined impact of all the changes made in the accounting and costing methodology on the costs and revenues of all affected Short SPHCCs	To be required for quarterly revenue, cost and data extract submission 45 days after Financial Quarter end	To be required only for the whole Financial Year (submitted with the revenue, cost and data extract submission for the last Financial Quarter 54 days after Financial Quarter end)	6	RAG, Appendix 3
Submission deadline for: Quarterly regulatory accounts Quarterly revenue and volume report Quarterly cost metrics report (including RDT to workload bridge) Quarterly revenue, volume and cost granular data submission	45 days after Financial Quarter end	54 days after Financial Quarter end	7	USPAC 1.4.9(a), 1.4.9(f), 1.5.10(b), 1.6.6, 1.6.8(a), 1.6.8(b),
Submission deadline for Management Accounts for the Board for the 6th and 12th Financial Month of the Financial Year	30 days after Financial Month end	54 days after Financial Month end	3 and 7	USPAC 1.4.9(d)
Management Accounts for the Board for the 1st Financial Month of the Financial Year	Required	Not required	3	USPAC 1.4.1(k)

Assessment of statutory tests for implementing regulatory conditions

8.7 In Section 2, we explain that our decisions (summarised in Table 8.1 above) must secure our relevant duties and satisfy relevant tests set out in Schedule 6 of the PSA 2011. We explain below why we consider that our decisions satisfy those tests (which also fulfil our regulatory objectives and, in turn, therefore seek to secure our relevant duties). The key reasons are that our decisions:

a) are objectively justifiable;

b) do not unduly discriminate against a particular person or a particular description of persons;

c) are proportionate; and

d) are transparent in relation to what they are intended to achieve.

8.8 Our decisions are objectively justifiable because, as we have explained in previous Sections of this Statement, the reporting obligations we have decided to put in place are necessary for us to effectively achieve our objectives for regulatory financial reporting in the light of the overall decisions we made in the March 2017 Statement.

8.9 More specifically, we consider that these reporting obligations are objectively justifiable, as they will enable us to:

a) monitor both whether the activities used to provide the universal postal service are financially sustainable and can earn a reasonable commercial rate of return, and the ability of the entity with access to external financing, the Relevant Group, to continue to be able to finance the universal service, therefore assisting us in securing the provision of the universal postal service;

b) monitor the relative profitability and relative contributions to cash of the Reported Business's product groups (including universal service products) that use Royal Mail's network and are provided to meet the needs of users in different markets, in order to (i) monitor the risk of cross-subsidisation and (ii) assess the relative cost reflectivity of the pricing of the products in these different groups;

c) understand the basis by which Royal Mail's shared costs of its integrated universal service network are attributed and allocated for the purpose of relevant regulatory decisions; and

d) 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.

8.10 The regulatory reporting framework we have decided to put in place is not unduly discriminatory because it aims to address Royal Mail's unique position as the universal service provider. Some detailed aspects of the obligations (see in particular our specification for targeted upstream and downstream separation set out in Section 3) also seek to reflect Royal Mail's market power in the respective markets.

8.11 The regulatory reporting framework we have decided to put in place is proportionate because the reporting obligations are necessary and appropriate 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 effectively achieve our objectives for regulatory financial reporting, nor do they produce adverse effects which are disproportionate to those objectives.

8.12 The regulatory reporting framework we have decided to put in place is transparent because we consider it is clear from the wording of the USPAC, RAG, USPA and DUSPs 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.

Next steps and proposed timeline

8.13 In the March 2017 Consultation, we also set out proposals in respect of reporting and compliance with the margin squeeze control contained in USPA 6. Having carefully considered the stakeholders' responses to those proposals, we have decided that it is appropriate to revise the proposals set out in the March 2017 Consultation. We intend to consult on new proposals next year. We therefore do not address the margin squeeze control in this statement.

8.14 We expect that Phase II of our review will mainly focus on the costing and accounting rules which are being applied by Royal Mail in preparing the regulatory financial reports. For example, Phase II will include consideration of whether the methodology for allocating costs between parcels and letters within Royal Mail's activity based costing FAC system remains appropriate. We expect to publish the Phase II consultation in the next calendar year.