

Royal Mail's response to Ofcom's consultation:

Notice of modification to the control preventing Royal Mail margin squeeze Proposal to remove unrecoverable VAT from the calculation of downstream costs in USPA6.4

Overview

1. Royal Mail welcomes the opportunity to comment on Ofcom's proposals to modify the control preventing Royal Mail margin squeeze by removing unrecoverable VAT from the calculation of downstream costs in USPA6.4.
2. We agree with Ofcom that USPA6 as currently drafted is not clear and we acknowledge that the treatment of unrecoverable VAT is not as Ofcom intended when the condition was initially drafted. We therefore welcome the initiative to clarify the test as set out in this consultation.
3. However, we do not believe that the proposal to limit the modification of the USPA6 test to the removal of unrecoverable VAT is the best response that Ofcom could have put forward at this point in time. It does not fix some other important problems with the condition such as the identification of the appropriate cost metric to enable a competitive upstream market.
4. Even with the proposed amended wording of USPA6.4, the calculation of relevant upstream cost will continue to be:
 - Burdensome to calculate; and
 - Not proportionate given there is a simpler solution available i.e. we could use Royal Mail's costs directly coming out of our costing system.
5. Moreover, we believe a more comprehensive review of the margin squeeze regime is urgently required. Regardless of the approach to calculating upstream cost, as currently framed, on the basis of Royal Mail's fully allocated cost, the margin squeeze regime prevents Royal Mail from competing effectively for retail bulk mail contracts to the detriment of competition and consumer interests.
6. We would therefore welcome further discussions with Ofcom on the appropriate derivation of the upstream costs and more broadly on the condition.

Detailed response on Ofcom's proposal to remove unrecoverable VAT from the calculation of downstream cost

7. On 27th March 2012, Ofcom published its decision on the new regulatory framework for the postal sector and at the same time published the universal service provider access (USPA)

condition which included a price control on Royal Mail. A key element of this price control as set out in the access condition is the calculation of upstream cost which is specifically set out in USPA6.4.

8. It is also worth noting that at the time of Ofcom's March 2012 decision document, a large proportion of bulk retail services in addition to the access services were VAT exempt, albeit the former services were then to become VAT rated. As such the extent of the VAT impact would not have been apparent to either Ofcom or Royal Mail at the time of drafting the condition.
9. In the current consultation, Ofcom proposes to amend USPA6.4 to remedy an issue that it perceives arises in the calculation of upstream cost due to the differential VAT treatment between Royal Mail's Access and bulk retail mail services. In effect Ofcom suggests this results in a distorted upstream cost which is artificially lower than Ofcom intended when the USPA condition was initially drafted.
10. Royal Mail acknowledges that the approach to VAT recovery does differ between retail and access services. As Ofcom recognises, this situation arises because of the VAT treatment of access services which are VAT exempt, whereas Royal Mail's bulk retail mail services are VAT rated. This differential VAT treatment does make the impact of any VAT changes difficult to predict, due to the fact that the actual amount of VAT that Royal Mail is able to recover changes with the mix of both VAT exempt and VAT rated services provided by Royal Mail. This differential treatment of VAT is entirely consistent with standard accounting procedures. However, Ofcom's proposed amendment to USPA6.4 would remove this element of unpredictability and make the calculation of upstream cost more stable, which Royal Mail would acknowledge is a beneficial change.

Alternative proposal for amending USPA6

11. Whilst we support improving the clarity of USPA6, Royal Mail believes the intended approach to calculating upstream cost as set out in USPA6.4 has a number of issues that should have been considered as part of any consultation on changes to USPA6. In particular Ofcom's proposal regarding the calculation of Relevant Upstream Cost gives rise to a number of practical and methodological issues, and in our view Ofcom's proposed solution is not the most proportionate regulatory response.
 - Firstly, this approach to the calculation of Relevant Upstream Costs is inconsistent with the approach used for other regulatory reporting under the USPAC. For example, in the quarterly Regulatory Financial Statements submitted to Ofcom and the annual regulatory accounts.
 - Secondly, Royal Mail will need to undertake bespoke runs of its costing system to exclude VAT. Calculating a separate measure of upstream cost for this standalone purpose, as is required under the proposed amended USPA6.4, would involve a significant amount of additional time and effort.

- Thirdly, the methodology requires each retail product to be "paired" with an equivalent access product for the purposes of calculating the Relevant Upstream Cost. However, not every access product is sold in every quarter, so there may be no downstream cost information available for the paired retail product. In these circumstances, Royal Mail would have to use cost data for the next closest access product, in order to quantify the Relevant Upstream Cost for the quarter. Royal Mail can use data for the most closely related access product, but it will not be strictly equivalent and is open to a degree of subjectivity. This problem could also therefore introduce methodological inconsistencies between different quarterly results, and between the quarterly results and the annual returns (because the average of four quarters may not equal the annual figure).

12. Ofcom's general duties are set out in section 3(3) of the Communications Act 2003:

*"In performing their duties under subsection (1), OFCOM must have regard, in all cases, to—
(a)the principles under which regulatory activities should be transparent, accountable, **proportionate**, consistent and targeted only at cases in which action is needed..." (our emphasis)*

13. From a practical standpoint, Royal Mail would propose that the more proportionate approach in the present case would be to use the upstream component of RM's E2E retail product costs sourced directly from our costing system. This approach has a number of significant advantages:

- The methodology for calculating "Relevant Upstream Cost" would be the same as other regulatory reporting information that Royal Mail provides under the USPAC. Since this measure of upstream cost is already created for these other purposes, there are significant synergy benefits to Royal Mail from using the same measure of upstream cost.
- The upstream costs, as calculated in our costing system, follow the costing rules set by Ofcom and are subject to an annual external audit.
- It avoids the complexity of having to pair the retail product against a related access product as discussed above.
- The outputs will be more reliable, since they will be generated using a consistent methodology and not be subject to the access traffic profile. There will therefore be less potential volatility between quarterly and annual outputs.

14. Overall, while the redrafted USPA6.4 may offer clarity, Royal Mail believes it is inferior to using Royal Mail's upstream costs directly generated from its costing system from both a methodological and practical standpoint.

15. Royal Mail believes that our proposed approach would still achieve Ofcom's policy intention of ensuring that the costs against which Royal Mail prices is equivalent to that of an equally efficient operator i.e. that it is not able to undercut access operators by virtue of its vertical

integration. We would therefore welcome the opportunity to discuss further the relative merits of this alternative approach with Ofcom.

16. Royal Mail would also emphasise that, in our view, a more comprehensive review of the margin squeeze regime is urgently required. As currently framed, on the basis of Royal Mail's fully allocated costs, the margin squeeze regime prevents Royal Mail from competing effectively for retail bulk mail contracts, to the detriment of competition and consumer interests. We would therefore urge Ofcom to initiate a further review, to consider alternative approaches to identifying the appropriate cost metric for use in an ex ante margin squeeze condition. This review should consider a range of cost metrics including, for example, Royal Mail's LRICs and the relevant costs of an efficient entrant.

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