Modification to the control preventing Royal Mail margin squeeze

Statement

Removal of unrecoverable VAT from the calculation of downstream costs in USPA6.4

Statement

Publication date: 26 February 2013

Section 1

Responses to consultation and Ofcom considerations and decision

1.1 On 27 March 2012 we published our Statement '*Securing the Universal Postal Service*: *Decision on the new regulatory framework'* ('the March 2012 Statement').[1] This set out our decision on the new regulatory framework for the postal sector, which gave Royal Mail Limited ('Royal Mail') more commercial and operational flexibility (particularly in relation to setting the majority of its prices). Regulatory safeguards were implemented to protect consumers and, where appropriate, promote effective competition.

1.2 Together with the March 2012 Statement, we imposed a set of controls and accounting conditions. Included in these was a regulatory condition made pursuant to powers under section 38 and Schedule 3 of the Postal Services Act 2011 (the "Act") (and in made in accordance with section 53 and paragraph 3 of Schedule 6 of the Act) to impose on Royal Mail, the universal service provider, an access condition. The access condition was made and notified on 27 March 2012 and is available at Annex 9 of the March 2012 Statement the ("USP Access Condition").

1.3 The USP Access Condition gives access to Royal Mail's postal network to other postal operators and users. The USP Access Condition includes a price control condition on Royal Mail.

1.4 On 28 November 2013, we consulted a proposed modification to paragraph 6.4 in the USP Access Condition to explicitly remove unrecoverable VAT from the downstream cost calculation[2].

1.5 This Statement sets out the stakeholder replies to this consultation, our responses to those comments and our final decision

Intent of existing regulations

1.6 In the consultation 'Notification of the modification of the control preventing Royal Mail margin squeeze' on 28 November 2013 ("November Consultation") we set our view of the intent of the existing regulations and the need for a modification to that regulation with respect to unrecoverable VAT.

1.7 We noted the success of the original Postcomm intervention in 2006 which encouraged competitive entry in upstream services by directly controlling the headroom between Royal Mail retail prices and its Access service charge offered to new entrants. But that in 2012, we moved away from explicit headroom controls to regulation that allowed more flexibility so as to ensure that Royal Mail would have similar pricing freedom as its upstream competitors.

[1] http://stakeholders.ofcom.org.uk/binaries/Consultations/review-of-regulatory-conditions/Statement/Statement.pdf
[2] Notification of the Modification of the Control to Prevent Royal Mail margin squeeze' http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-margin-squeeze/summary/Notice_for_change_to_USPA_6.pdf, 28 November 2013

1.8 To allow this we needed to ensure that the costs against which Royal Mail was pricing were equivalent to that of an equally efficient operator; in other words it was not able to undercut access operators purely by virtue of its vertical integration with the downstream system.

1.9 In constructing the USP Access Condition, we were conscious that the preferred test for margin squeeze was a comparison of prices against the Long Run Incremental Costs ("LRIC") of Royal Mail's upstream services.

1.10 However, in the absence, at that time, of a robust LRIC model we based the condition on Fully Allocated Costs[3] but with the aim that this test should "should provide an appropriate step in a glide-path between the existing headroom control and our preferred long-term vision of how the risk of margin squeeze should be addressed in the future ... (when the) control should be replaced in the long-term by an approach more consistent with competition law, which is likely to use LRIC as the relevant cost measure"[4].

1.11 Such a glide-path clearly identifies the need for the derived upstream costs to as accurately as possible (subject to the limits of FAC) include all those costs that Royal Mail Retail must recover within its pricing. It is, therefore, essential that the derived upstream cost is not inappropriately reduced through the calculation set out in the condition.

1.12 As set out in Annex 7 of the October 2011 Consultation, paragraphs 7.46, and confirmed in the March 2012 Statement, Royal Mail is required to recover Upstream FAC across a basket of products with a further headroom control relating to individual new contracts at a proportion of FAC. This is set out in USPA 6.2.

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

> "Upstream FAC is calculated as the end-to-end FAC less the equivalent access FAC (including wholesale costs)
>
> - o Under this approach, the direct costs of Royal Mail Wholesale are included in access costs and by virtue reduce the minimum level of costs that Royal Mail must recover to meet the requirements of the margin squeeze control. "

Treatment of unrecoverable VAT

1.14 We noted in the November Consultation that in setting out the approach described above, the issue of the treatment of unrecoverable VAT was not discussed.

1.15 Unrecoverable VAT arises when a trader is selling goods or service which is not subject to VAT. In such cases, the VAT that the trader has paid on its input goods and services, which are needed to deliver VAT-exempt output goods and services, cannot be reclaimed. This input VAT is unrecoverable, hence simply a cost component of the output goods or service.

[3] Fully allocated costs are the summation of direct and allocated costs for a product, or product group, developed in a cost study in which none of the firm's joint and common costs are left unallocated. In this case the FAC are derived from Royal Mail's costing manual are agreed with Ofcom.
[4] Annex 7 of the October 2011 Consultation paragraph 7.44

1.16 In the context of the ex-ante margin squeeze condition, the issue arises due to the different VAT treatment of Access Services and Royal Mail Bulk mail services. The former, as it is considered to be subject to mandated provision, is exempt from VAT by HMRC, the latter is not.

1.17 By way of explanation, Royal Mail pays VAT on services it receives from third parties which are necessary to run downstream operations. The downstream operations are necessary for Royal Mail's delivery of both retail and Access Services. For example, Royal Mail pays VAT on electricity and fuel used in downstream operations. When Royal Mail then retails its services through its upstream component, it charges VAT to its customers and, in turn, is entitled to reclaim from HMRC the input VAT it has paid on the electricity and fuel which have been used to deliver those retail services. However, when Royal Mail provides Access Services it does not charge VAT which means that it is not able to reclaim the input VAT it has paid on the electricity and fuel used to deliver those Access services. Thus unrecoverable VAT is a feature of the Access service downstream costs but not Royal Mail's end-to-end costs.

1.18 However, the price control condition seeks in paragraph 6.4 to deduct the downstream costs attributable to the provision of access services, rather than the downstream costs attributable to retail services. This is because for the purposes of this control the downstream cost of access services are a proxy for the downstream costs of end-to-end retail services.

1.19 As downstream costs of access services are being used as a proxy, they should as far as possible be composed of the same cost elements (or equivalent cost elements) as you would expect to be in the Royal Mail's end-to-end cost for retail services[5]. Accordingly VAT payments made by Royal Mail in connections with these downstream costs for access services should not be taken into account in the calculation.

1.20 If unrecoverable VAT from downstream costs were to be deducted from the End-to-End cost of retail bulk services (under calculation required by the price control), this would mean that the upstream costs Royal Mail has to recover in its pricing would be, in our view, artificially reduced.

1.21 Such a reduction would impede the objective sought by the pricing condition and distort the pricing condition in its application. The distortion would be that the VAT cost would be an additional deductible cost form the total of end-to-end retail costs. This would lower the cost floor further than intended by the condition such that the cost floor would actually be a sum which was below the upstream costs within the end-to-end bulk retail services (which the condition is aiming to calculate and identify).

1.22 This would increase the risk that an equally efficient upstream operator would not be able to sustainably compete with Royal Mail because its cost floor would be expected to be higher than the cost identified in this calculation.

1.23 Accordingly, we set out in the November Consultation that in our opinion, the inclusion of unrecoverable VAT in the calculations would not be consistent with this

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

policy intent and so we wish to remove ambiguity as to how it should be treated for the purposes of the calculation. Hence we proposed the modification of USP6.4 which explicitly removes unrecoverable VAT from the Downstream cost calculation.

Stakeholder responses

1.24 TNT Post and Royal Mail responded to the November Consultation.

TNT Post

1.25 TNT Post supported the proposed change to remove unrecoverable input VAT from the calculation of downstream costs. It noted that to "*continue to allow unrecoverable input VAT to be treated as a downstream cost would unfairly reduce the cost level attributable to Royal Mail's upstream activities (by the amount of that unrecoverable VAT on its downstream activity). It would be unfair to leave the condition in its current form because Royal Mail's upstream competitors need to cover all of their own upstream costs in order to compete but Royal Mail's upstream costs would be artificially reduced.*"

1.26 TNT Post also noted that "*OFCOM could usefully clarify that, for the purposes of USPA 6.3, Relevant End to End Revenue is net of VAT. This would avoid any potential ambiguity which would lead to an artificial inflation of End to End Revenues.*"

1.27 Finally TNT Post suggested that in USPA 6.4 "*it would be appropriate to clarify the position in relation to recoverable VAT' in both paragraphs (a) and (b). While recoverable VAT is not itself a direct cost to Royal Mail, to the extent that it is an indirect cost (because of the time lag between paying the VAT to suppliers and recovering it from HMRC), then those indirect costs should be not be treated as part of the downstream costs*."

Royal Mail

1.28 Royal Mail agreed 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*."

1.29 However, they do not believe that the proposal to limit the modification of the USPA6 test to the removal of unrecoverable VAT is the best response. They argue that 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.

1.30 They argue that 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.

1.31 Further Royal Mail "*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*. They 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*."

1.32 Royal Mail believes the intended approach to calculating upstream cost as set out in USPA6.4 has a number issues that should have been considered as part of any consultation on changes to USPA6. In particular Royal Mail suggests that the proposal regarding the calculation of Relevant Upstream Cost gives rise to a number of practical and methodological issues including inconsistency with other regulatory reporting requirements; the need for bespoke costing activity and the need for subjective pairing of Royal Mail Retail and Access products.

1.33 Accordingly, Royal Mail, noting the requirement under Ofcom's duties that regulatory activities should be proportionate, 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. They consider this approach would be less of an imposition on them; remove the complexity of pairing and less subject to movement between quarterly and annual outputs.

Ofcom considerations

Further clarification of the position of VAT

1.34 TNT has suggested that it would be useful to modify the condition further to remove any potential ambiguity as whether the Relevant End to End Revenue is net of VAT and that delays in the recovery of VAT should not contribute costs.

1.35 While we agree that Relevant End to End Revenue is net of VAT and that delays in the recovery of VAT should not contribute to costs we do not consider that further modification to the legal instruments are required.

1.36 On the first point the Regulated Accounting Guidelines ("RAG") make it clear that revenue should always be expressed net of VAT. The RAG (paragraph 8.6) requires "To recognise revenue, Royal Mail must follow the revenue recognition accounting policies adopted by Royal Mail as part of their compliance with the accounting standards used in producing its audited annual statutory accounts."

1.37 Royal Mail's 2012-13 statutory accounts (page 118) state that "Revenue reported in the income statement is net of value added taxation ..." which complies with IFRS (International Financial reporting Standards)."

1.38 We would not expect Royal Mail to present Revenue that is not consistent with its regulated accounting guidelines.

1.39 As to second, we would note that this is a very detailed accounting point which we would not consider suitable for inclusion in the condition but for the avoidance of doubt we would confirm that in any compliance review we would expect delayed recovery of VAT not to be included in costs for the purpose of this condition.

Request for a more comprehensive review

1.40 Royal Mail argues that a more comprehensive review of the margin squeeze control is urgently needed.

1.41 We note that Royal Mail has not set out any evidence as to why the issue is urgent now but we accepted in the March 2012 Statement that as the current control is based on fully allocated costs (FAC) rather than long run incremental costs it was a second best option and we made a commitment to review the control in near future.

1.42 As we noted in the March 2012 Statement[6], paragraph 10.149 – 10.151:

"10.149 Concerns were also raised about using LRIC costs as part of Ofcom's preferred long-term approach to preventing margin squeeze. These concerns related to the level of Royal Mail's LRIC costs (and thereby the level of costs that other operators would need to compete against), the reliability of LRIC estimates and the transparency of those costs.

10.150 We recognise that estimating LRIC costs is complex and a number of issues will need to be considered by Ofcom. However, in principle we consider that in the long-term any margin squeeze test should be set with reference to LRIC costs, such that, a minimum of LRIC margin is maintained between the access price and the equivalent retail price and that compliance is monitored by Ofcom through provision of regular information.

10.151 As set out in October, Ofcom will only move to such a margin squeeze control following completion of a review and after consultation. We will endeavour to review the margin squeeze control in around 18-24 months. However, we stress that a key input that will enable a review of the margin squeeze control (with the aim of moving to a regime aligned with competition law principles) is the availability of robust LRIC data from Royal Mail. In this regard we note that Royal Mail's progress in deriving LRIC data has been slower than originally indicated to Ofcom. "

1.43 We note that Royal Mail has now constructed a LRIC model. We propose that in the next financial year we will undertake a review of this model and consider the suitability of the USPA 6 in the light of this review. However, in the meantime we consider it is important that the existing control operates as intended.

Proportionality of the proposed modification

1.44 Royal Mail has highlighted what they consider to be undue complexity in complying with the current proposed approach and suggested an alternative based on directly costing the upstream retail Royal Mail operations.

1.45 With respect to Royal Mail's concerns we consider that the process objections overstate the complexity of the task. We address each of their points below.

Inconsistency with the accounting condition (USPAC.

1.46 For its submissions, Royal Mail is required to use the cost data prepared in accordance with its Costing Manual (which must in turn comply with the USPAC and RAG). However, USPA's purpose is quite specific and targeted (i.e. prevent margin squeeze). This contrasts with the general reporting and transparency objectives of the USP Accounting Condition ("USPAC") and the RAG. There is therefore good reason for USPA to require further adjustments to ensure its specific purpose is met.

[6] http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf

Bespoke runs of the costing system to exclude VAT requiring significant additional time and effort.

1.47 Royal Mail has been doing this for the past two quarters. Therefore they have clearly been able to undertake this analysis, and have not identified in this response or in any of their submission any evidence of significant difficulty in completing the work.

1.48 We have also examined Royal Mail's quarterly compliance submissions in detail and consider that the identification of VAT is relatively straightforward.

Pairing of access and bulk products.

1.49 We would note that Pairing is needed only to update the annual forecast with quarterly actual figures (not to prepare the annual forecast) and again that Royal Mail has been undertaking this task for the past two quarters.

1.50 Further making assumptions to overcome any pairing difficulties do not fundamentally undermine the validity of the calculations. As Royal Mail states, closest equivalent access product, or potentially equivalent product costs from last quarter or last years (plus inflation) can be used for pairing. RM needs to apply its best judgement in dealing with pairing objectively, as it is required to do so in various other areas in regulatory reporting.

Direct upstream cost alternative.

1.51 We accept that Royal Mail's preferred alternative – to use a direct calculation of its upstream costs – has not so far given rise to a materially different cost estimate.

1.52 However, we consider that there is a more fundamental rationale for preferring an approach based on access costs.

1.53 While the division between Royal Mail's upstream and downstream costs within their end-to-end cost of delivering bulk mail is always subject to some interpretation, the cost of providing access services is by necessity more clearly defined. Accordingly, to ensure certainty that

1.54 the price Royal Mail asks for providing a retail service (ie those services in beyond those provided to access customers) is truly covering the costs of doing any such retail work we need to ensure that only access related costs are excluded from the comparison. We currently consider this requires the calculation to be based on the Access Costs.

Conclusion

1.55 On the basis of our consideration set out above, we have concluded that we should modify USPA 6.4 to explicitly remove unrecoverable VAT from the downstream cost calculation in the manner proposed in the November Consultation. This change is set out in the Statutory Notification accompanying this Statement.