



Review of Regulatory Financial Reporting for Royal Mail

Consultation

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Publication date:	31 March 2017
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About this document

On 1 March 2017, we published a statement setting out our decisions following our review of the regulation of Royal Mail. In that document, we said we would consult on proposals to amend the Universal Service Provider Accounting Condition (USPAC) and the Regulatory Accounting Guidelines (RAG) to ensure they remain fit for purpose, given our decisions on the overall regulatory framework for the next five years. We also said we would make some technical changes to the detailed workings of the margin squeeze control.

In this document, we set out our proposals for changes to the USPAC and RAG, as well as minor changes to the Universal Service Provider Access condition (USPA) and Designated Universal Service Provider conditions (DUSP). These proposals relate to accounting separation; cost and efficiency reporting; business planning information; cost data submissions and change control, reporting deadlines; and margin squeeze control.

We expect that this consultation, particularly the initial three Sections which provide a broader overview, will be of interest to a wide range of stakeholders that have an interest in the postal sector. The more technical parts within the consultation (Sections 4 to 9) are likely to be of interest primarily to Royal Mail, as well as to others with an interest in the technical details of its regulatory financial reporting. The proposed changes will affect the content, method and timing of Royal Mail's regulatory financial reporting to Ofcom and some information that it makes publicly available.

This consultation will close on 1 June 2017.

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Section 1

Executive summary

The case for our review

- 1.1 In 2012, Ofcom published a new regulatory framework for the postal sector¹ (the 2012 Statement). That framework gave Royal Mail Limited (Royal Mail) more commercial and operational flexibility (particularly in relation to setting its prices) while ensuring that appropriate regulatory safeguards were 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 financial reporting requirements on Royal Mail to assist us in fulfilling our duties. The regulatory financial reporting requirements were designed to provide us with sufficient information to understand and monitor the financial sustainability and efficiency of the provision of the universal service. They inform our understanding of how costs and revenues are allocated across different parts of the business and the relative profitability of different products. The financial reporting requirements specified in the 2012 Statement have remained broadly unchanged,² for more than four years.
- 1.3 In light of the changes which have occurred since the 2012 Statement, we conducted a review of the Regulation of Royal Mail, which concluded in March 2017 (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. We indicated that we would continue to monitor a range of factors including Royal Mail’s performance on efficiency, quality of service, the financial performance of the universal service network, and competition in parcels and letters.
- 1.4 However, we indicated in the March 2017 Statement that we considered it appropriate to review whether the reporting requirements remain fit-for-purpose and provide us with the information we need:
 - to monitor whether the regulatory framework continues to work in the interests of consumers; and
 - to assess the financial sustainability of the universal postal service and Royal Mail’s efficiency performance consistent with our duties.

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

- 1.5 This consultation sets out the first stage of our proposals for a revised reporting framework in light of market changes and the conclusions of the March 2017 Statement.

Our approach to the review

- 1.6 We are approaching our review in two phases which we explain in more detail in Sections 2 and 10. The first phase (Phase I) focuses on the regulatory financial reporting which we require from Royal Mail in the Universal Service Provider Accounting Condition (USPAC)⁴, Regulatory Accounting Guidelines (RAG)⁵, Universal Service Provider Access condition (USPA)⁶, and Designated Universal Service Provider conditions (DUSP)⁷.
- 1.7 The second phase (Phase II) will focus on the costing and accounting rules which are applied by Royal Mail in preparing its regulatory financial reports. This consultation deals with Phase I.
- 1.8 In this consultation, we consider:
- the objectives of the reporting requirements; and
 - the current reporting requirements and how the regulatory financial reporting framework might be made more effective.

The objectives of the reporting requirements

- 1.9 In Section 3, we set out the objectives that we consider an effective regulatory financial reporting framework should achieve. Informed by the changes that have taken place in the postal market in recent years and our recent decision on the overall regulatory framework, we have reassessed the current objectives of our financial reporting framework and identified the broad questions that need to be answered by the reporting framework to allow us to meet these objectives.

The current requirements and how the framework might be made more effective

- 1.10 In Sections 4 to 9, we consider how well the current reporting requirements meet the objectives set out in Section 3, and we identify any gaps in the information we require. We propose some new requirements but also propose that some of the current requirements are no longer necessary. In Section 10, we set out an outline of the proposed financial regulatory framework and its implementation timeline.

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.

⁵ Regulatory Accounting Guidelines as at January 2014.

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

⁶ Consolidated Version of USP Access Condition as at February 2014.

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

⁷ 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.

Our proposals for improved regulatory financial reporting

- 1.11 In Sections 4 to 9, we set out in detail our proposals to improve the regulatory financial reporting framework. In Table 3.1 of Section 3, we provide an outline of the proposed changes. We summarise the key proposals below.
- 1.12 We propose to reduce considerably the accounting separation requirements. We also propose to introduce a requirement for granular revenue data which - together with the granular cost and volume data we already receive - will enable us to produce the accounting separation information required for our regulatory objectives. Other main additions to the requirements are for information Royal Mail already provides us in response to our requests for information (eg Cost Matrix and PVEO Analysis).
- 1.13 Other important proposed changes to the requirements relate to more prescription relating to the contents of the reports (eg business planning information), reducing the reporting frequency from monthly to quarterly for certain reports, and changes in the submission deadlines to speed up our monitoring work and to combine Royal Mail's quarterly submissions into one integrated package.
- 1.14 We consider that our proposals will reduce the regulatory reporting burden on Royal Mail, while increasing the effectiveness of the reporting framework.
- 1.15 An outline of our proposed regulatory financial reporting requirements is set out in the Table 1.1 below (see Table 10.1 in Section 10 for further details):

Table 1.1: Outline of our proposed regulatory financial reporting requirements

Reports/Data submissions	Frequency	Disclosure	Deadline	Section in this consultation
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	4, 5
Product Profitability Statements for access and PAF	Annual	Published	90 days after Financial Year end	4
Reconciliation of Relevant Group accounts to Reported Business accounts	Annual	Published	90 days after Financial Year end	4
Business Plan including Annual Budget	Annual	Confidential	Before start of Financial Year, and once approved	6
Cost and volume input and output data at short SPHCC level	Annual	Confidential	90 days after Financial Year end	7

Reports/Data submissions	Frequency	Disclosure	Deadline	Section in this consultation
Second Class safeguard cap submission	Annual	Confidential	One month after the implementation of any new prices	8
Cash headroom projections for the Relevant Group	Quarterly	Confidential	Before start of Financial Quarter	6
Income statement of Reported Business (including Cost Matrix and end-to-end split between universal service and non-universal service products)	Quarterly	Confidential	45 days after Financial Quarter end	4, 5
Product Profitability Statements for access and PAF	Quarterly	Confidential	45 days after Financial Quarter end	4
Volume and revenue report	Quarterly	Confidential	45 days after Financial Quarter end	4
Cost metrics report (including volume to workload bridge)	Quarterly	Confidential	45 days after Financial Quarter end	6
Revenue, cost and volume data at Short SPHCC level	Quarterly	Confidential	45 days after Financial Quarter end	4
Costing Methodology Manual	Quarterly	Published, except for Technical Appendices	45 days after Financial Quarter end	7
Accounting Methodology Manual	Quarterly	Confidential	45 days after Financial Quarter end	7
Change control submissions	Quarterly	Confidential	7 days before changes are made	7
Margin squeeze submissions	Quarterly	Confidential	Before start of Financial Quarter	9
Management accounts for the Board ⁸	Monthly	Confidential	30 days after Financial Month end	4

Next steps

1.16 We invite responses to this consultation on the first phase of our review by **5pm 1 June 2017**. The period for this consultation is nine weeks, consistent with Ofcom's

⁸ Provided by Royal Mail on voluntary basis

Consultation Guidelines.⁹ We anticipate issuing a final statement in the second half of the 2017/18 financial year.

- 1.17 We expect the consultation on the second phase of our review to be published in the second half of the 2017/18 financial year.

⁹ See <https://www.ofcom.org.uk/consultations-and-statements/how-will-ofcom-consult>.

Section 2

Introduction and background

- 2.1 In Section 2, we set out the background to our review and the key aspects of the regulatory financial monitoring regime that are relevant to the proposals set out in this consultation.

Background to the review

March 2012 Statement

- 2.2 On 27 March 2012, we published our Statement *Securing the Universal Postal Service: Decision on the new regulatory framework* (the “**March 2012 Statement**”).¹⁰ 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.
- 2.3 One such safeguard was an effective and comprehensive monitoring regime,¹¹ including requirements for Royal Mail to provide Ofcom with relevant financial information.¹² These requirements were set out in the USP Accounting condition (USPAC).¹³
- 2.4 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.
- 2.5 In this consultation, we consider the USPAC which was imposed in March 2012 (including the subsequent amendments which were carried out in January 2014). In March 2012, we also imposed the Designated USP condition (DUSP) and the USP Access condition (USPA) on Royal Mail. In this consultation, we propose minor changes to these conditions.
- 2.6 In this consultation, we also consider USPA 6 which sets out our margin squeeze control, and any subsequent amendments.

¹⁰ 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>.

¹¹ 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.

¹² 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.

¹³ 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.

USPAC

- 2.7 As part of the March 2012 Statement, Ofcom imposed a USPAC under section 39 of the PSA 2011¹⁴ and introduced a supporting direction under the USPAC to specify Regulatory Accounting Guidelines (RAG) in accordance with section 53 of the PSA 2011, and paragraph 4 of Schedule 6 to the PSA 2011.¹⁵
- 2.8 In January 2014, following consultation¹⁶, we updated the regulatory financial reporting requirements set out in the USPAC and the RAG to ensure that our regulatory financial information provided by Royal Mail remained fit for purpose.¹⁷

USPA

- 2.9 As part of the March 2012 Statement, Ofcom imposed a USPA under section 39 of the PSA 2011¹⁸ in accordance with section 53 of, 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.
- 2.10 In February 2014, following consultation¹⁹ we updated the margin squeeze control requirements set out in the USPA to ensure that they remained fit for purpose.²⁰

DUSP

- 2.11 As part of the March 2012 Statement, Ofcom imposed 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.
- 2.12 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.²¹

Review of the Regulation of Royal Mail

- 2.13 We published a consultation entitled the Review of the Regulation of Royal Mail on 25 May 2016²², and subsequently published a statement concluding the review on 1

¹⁴ 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.

¹⁵ See 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.

¹⁶ 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>.

¹⁷ 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.

¹⁸ 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.

¹⁹ <https://www.ofcom.org.uk/consultations-and-statements/category-2/royal-mail-margin-squeeze>

²⁰ Ofcom, 2014. *Consolidated Version of USP Access Condition*. February 2014.

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

²¹ 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>.

March 2017.²³ 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 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 6.²⁴ This consultation sets out our proposals for changes to these conditions and the RAG.

2.17 We have also identified an issue with the timing of data provided to secure compliance with the safeguard cap in the DUSP. We set out in this consultation a proposal for change in this respect.

Ofcom's duties are to further the interests of citizens and consumers and to secure the provision of a universal postal service

Our statutory duties

2.18 The legal framework relating to the regulation of postal services is set out in the Postal Services Act 2011 (the "**PSA 2011**").

²² 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.

²³ 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.

²⁴ Ofcom, 2016. *Review of the Regulation of Royal Mail – Consultation*. 25 May 2016.

<http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-review/summary/Review-of-Royal-Mail-Regulation.pdf>. Paragraph 1.32.

- 2.19 Ofcom’s principal duty under the Communications Act 2003 (the “**CA 2003**”) is to further the interests of citizens and of consumers, where appropriate, by promoting competition. For postal services, we also have a duty under the PSA 2011 to secure the provision of 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.
- 2.20 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.
- 2.21 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.
- 2.22 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.
- 2.23 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.
- 2.24 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.
- 2.25 For the reasons set out in this consultation, Ofcom does not consider that there is any conflict between its duty to secure the provision of the universal postal service and its general duties.
- 2.26 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.
- 2.27 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.
- 2.28 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.²⁵
- 2.29 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.

Power to impose USP accounting conditions

- 2.30 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,²⁶ including an obligation to meet the costs of the audit.

²⁵ See <https://www.ofcom.org.uk/about-ofcom/what-is-ofcom>.

²⁶ 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

- 2.31 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.²⁷ 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.
- 2.32 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. A similar test also applies in giving, modifying or revoking directions imposing the requirements and rules in the RAG.²⁸

General impact assessment

- 2.33 The analysis presented in the whole of this consultation represents an impact assessment, as defined in section 7 of the CA 2003.
- 2.34 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the CA 2003, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see our guidelines, '*Better policy-making: Ofcom's approach to impact assessment*'.²⁹
- 2.35 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the CA 2003) is secured or furthered by or in relation to what we propose.

Equality impact assessment

- 2.36 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:
- eliminate unlawful discrimination, harassment and victimisation;
 - advance equality of opportunity between different groups; and
 - foster good relations between different groups.

appointment as a statutory auditor, would not be prohibited from acting by section 1214 of that Act (independence requirement).

²⁷ Paragraph 2 of Schedule 6 to the Act.

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

²⁹ See Ofcom's website, <http://www.ofcom.org.uk/about/policies-and-guidelines/better-policy-making-ofcoms-approach-to-impact-assessment/>.

- 2.37 This assessment is in relation to the following protected characteristics: age; disability; gender re-assignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation. Such equality impact assessments (EIAs) also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 discussed above.
- 2.38 We have therefore considered what (if any) impact the proposals in this consultation may have on equality. Having carried out this assessment, we are satisfied that our proposals are not detrimental to any group defined by the protected characteristics set out in paragraph 2.37.

Structure of this consultation

- 2.39 This consultation constitutes Phase I of our review of the regulatory financial reporting framework for Royal Mail. It focuses on the regulatory financial reports and the submissions that we require Royal Mail to prepare under the USPAC, RAG, USPA and DUSP. In developing our proposals set out in this consultation, we have considered, where necessary, the content, format, frequency and timing of submission, disclosure (confidentiality versus publication), and audit requirements for those regulatory financial reports.
- 2.40 We expect Phase II of our review to focus on the costing and accounting rules which are applied by Royal Mail in preparing the regulatory financial reports. For example, Phase II will include consideration of the zonal costing model, whether the methodology for allocating costs between parcels and letters within Royal Mail's activity based costing FAC system remains appropriate and the transfer pricing applied to derive the upstream/downstream revenue split. In Section 10, we set out our proposed timings for Phase I implementation and Phase II consultation and implementation.
- 2.41 The following Sections are structured as follows:
- Section 3 sets out the objectives of the financial reporting regime in light of our duties and explains how those objectives are met;
 - Section 4 sets out our assessment and proposals on accounting separation and monthly reporting;
 - Section 5 sets out our assessment and proposals on cost and efficiency reporting;
 - Section 6 sets out our assessment and proposals on business plan submissions;
 - Section 7 sets out our assessment and proposals on the cost data and change control and future rule changes;
 - Section 8 sets out our assessment and proposals on changes to the reporting deadlines and the definition of the Relevant Group;
 - Section 9 sets out our assessment and proposals on margin squeeze; and
 - Section 10 sets out an outline of our proposed regulatory financial reporting framework, how it meets the statutory tests for imposing regulatory conditions, and our proposed implementation timeline.

Section 3

The objectives of our regulatory financial reporting framework

Introduction

- 3.1 A key safeguard of the regulatory framework for post is an effective and comprehensive monitoring regime, including requirements on Royal Mail to provide certain financial information in an appropriate format. We have now been receiving the financial reporting information as specified in our 2012 Statement, broadly unchanged, for more than four years. Our recent Review of the Regulation of Royal Mail (the “**March 2017 Statement**”) concluded that, in the main, the regulatory framework remained appropriate. In light of this review, we consider it is appropriate to review whether the existing reporting requirements remain appropriate.
- 3.2 The aim of this review is to consider whether the current financial reporting we receive from Royal Mail allows us to effectively fulfil our duties and objectives, and propose any changes we consider are needed. We have also looked for opportunities to reduce reporting requirements where appropriate.
- 3.3 In Section 3, we set out what we consider to be the objectives of an effective regulatory financial reporting framework appropriate to the current dynamics of the postal sector. We then summarise our proposals for the future financial reporting framework, ahead of a more detailed discussion of our proposals in Sections 4 to 9 of this consultation.

Our view on the purpose of the financial reporting framework

- 3.4 The current framework for Royal Mail’s regulatory financial reporting was established in 2012, with some (relatively minor) modifications in January 2014. To assess whether the current regulatory financial reporting still provides 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, we have:
- reassessed the objectives of our financial reporting framework; and
 - having established the objectives, we have identified the broad questions that need to be answered by the reporting framework in order to fulfil the objectives.

Objectives

- 3.5 As we set out in Section 2 our principal duty under the CA 2003 is to further the interests of citizens and of consumers, where appropriate, by promoting competition. We also have a duty under the PSA 2011 to secure the provision of the universal postal service, and in performing this duty 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. We therefore consider that the information requirements collected through financial reporting should help us to fulfil the following regulatory objectives:

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

What questions need to be answered?

3.6 Having set out the objectives of the regulatory financial reporting framework, we discuss below specific questions that we consider need to be answered by the reporting framework to meet these objectives. While the questions we have identified below are not a comprehensive list, we consider them to be key questions.

Monitoring financial sustainability

3.7 As discussed in Section 2, our primary duty under the PSA 2011 is to carry out our functions in relation to postal services in a way that we consider will secure the provision of a universal postal service. We therefore need to monitor whether the activities used to provide the universal service are financially sustainable, and whether the Relevant Group (being the entity with access to external financing) can continue to finance the universal service.

3.8 We need to be able to assess the financial sustainability of the provision of the universal service:

- on an ongoing basis;
- if we need to assess the impact of any changes we may propose to the regulatory framework, on the financial sustainability of the universal postal service; and
- if we need to assess the impact of any changes in the competitive environment on the financial sustainability of the universal postal service.

3.9 To address this financial sustainability objective, we consider we need information to answer the following key questions:

- *Is the Reported Business³⁰ earning and expected to earn a reasonable commercial rate of return within the medium to long-term?*

We decided in the March 2017 Statement³¹ that the Financeability EBIT margin³² of the Reported Business continued to be the appropriate metric to use to assess the

³⁰ The Reported Business is the regulatory entity which contains the universal service network and all the products provided through or in relation to that network.

³¹ Ofcom, 2017. March 2017 Statement.

https://www.ofcom.org.uk/_data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf, Paragraphs 3.44 to 3.63.

³² We refer to our particular measure of EBIT margin, which we use for our financial sustainability assessments, as the 'Financeability EBIT margin metric'. To calculate the EBIT margin metric, we deduct transformation costs³² and adjust EBIT to restate pension costs on a cash basis, rather than the rate derived in accordance with the accounting standards. We consider the cash based rate to give a better view of current and future pension costs.

commercial rate of return of the universal service provider for the purposes of assessing financial sustainability over the medium to long-term, and that 5-10% continued to be a reasonable range for the commercial rate of return.

- *Do the cash flow projections of the Relevant Group show that it can meet its cash requirements in the short to medium-term?*
- *Do the financial health metrics when applied to the actual results/forecast projections indicate that the Relevant Group's investment grade status is/would be threatened in the short to medium-term?*

In the March 2017 Statement³³, we decided that in our assessment of the Relevant Group's short to medium-term financial sustainability we would consider the entity's cash flows and appropriate financial health metrics (such as FFO/Net Debt³⁴).

- *How does the rate of return of the Reported Business compare with the rates of return of the Relevant Group and its other business units?*

Identifying the contribution the Reported Business and other business units make to the universal service provider's ability to fund the service will assist us in understanding the cause of any potential financial sustainability concerns.

- *What are the key financial performance drivers contributing to the rate of return of the Reported Business (e.g. product volumes and revenues, cost categories) and how are these drivers performing?*

Having sight of the performance of the key drivers will allow us to identify if there is a deterioration which could adversely impact on the financial sustainability of the Reported Business.

Monitoring efficiency

- 3.10 In requiring Ofcom to carry its functions in a way that will secure the provision of a universal service, the PSA 2011 requires us to "have regard to the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times".
- 3.11 In assessing efficiency, we consider both the actual operating and capital costs achieved and Royal Mail's planned efficiency improvements. We consider the key question that we need to address is:
- *Is Royal Mail's planned and achieved level of efficiency improvement reasonable?*
- 3.12 Understanding the level of efficiency Royal Mail expected to achieve and comparing that to both its actual achieved efficiency and what we consider a reasonable rate of

³³ Ofcom, 2017. March 2017 Statement.

https://www.ofcom.org.uk/data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf, Paragraphs 3.54 to 3.63.

³⁴ Net Debt is a measure of a company's liabilities at a certain point in time which nets off the company's cash and other liquid assets against its debts. FFO (Funds From Operations) is a measure of the net cash flows generated by a company's operations in a financial period, typically one year.

improvement to be will allow us to determine its performance. Therefore, to answer the key question we would be looking to answer the following questions in particular:

- *How does Royal Mail's actual efficiency performance compare to its budgeted efficiency levels and the efficiency targets it set out in its 2015 Business Plan?*
- *How do Royal Mail's latest efficiency targets compare to its historic performance and to the targets it set out in its previous Business Plans (with particular regard to its 2015 Business Plan)?*
- *What are the key reasons and drivers behind Royal Mail's actual and forecast efficiency performance?*

3.13 Understanding the level of efficiency Royal Mail could potentially achieve and what it expects to achieve relative to this potential will enable us to assess its efficiency performance.

Monitoring competition

3.14 As discussed in Section 2, Ofcom's principal duty under the 2003 Act is to further the interests of citizens and consumers, where appropriate by promoting competition. Therefore, we consider that a key aim for the regulatory financial reporting obligations should be to provide information to assist in identifying whether our regulatory framework continues to support competition in the postal market. Following from this we have identified two key questions:

- *Margin Squeeze: is there a large enough gap between the access price and Royal Mail's retail price so that an efficient competitor can make a reasonable upstream margin?*

We have in place an *ex-ante* margin squeeze control set out in USPA 6, and we should have regard to the upstream/downstream revenues and costs of those bulk products for which there is a risk of margin squeeze by Royal Mail.

- *Does our regulatory framework continue to support competition in the postal market?*

We need to recognise whether our regulatory framework remains the most appropriate structure to ensure that Royal Mail does not use its position to limit the development of competition in the postal market.

3.15 We recognise that in most cases the answer to these questions will not be satisfied by the regulatory financial reporting alone. Often, we will require more detailed and/or additional information that we cannot require as part of the regulatory financial reporting framework. Our information-gathering powers supplement our regulatory reporting requirements to ensure that we are able to obtain additional information where needed to investigate specific issues.

Protecting consumer interests

3.16 As we have set out in Section 2, the 2003 Act requires us to further the interests of citizens and consumers. We consider that the financial reporting provided should help to inform us whether our regulatory framework continues to effectively meet this objective. The two key questions we consider relevant are:

- *Are the Safeguard caps being complied with?*

In the March 2017 Statement, we decided to retain the caps on the price of Second Class stamps for letters and parcels up to 2kg to ensure vulnerable consumers can access a basic universal service.

- *Does the regulatory framework continue to enable us to further the interests of citizens and consumers with respect to choice, price, quality of service and value for money?*

Our proposals for the future financial reporting framework

Information requirements

3.17 We have used the questions set out above to help us identify the information we require to meet our regulatory objectives for the financial reporting framework. We set out below the broad information we consider will enable us to answer those questions and identify the Sections of this consultation in which we propose related information requirements.

Monitoring financial sustainability

Is the Reported Business earning and expected to earn a reasonable commercial rate of return within the medium to long-term?

- Reported Business forecast income statement (see Section 6)
- Reported Business historical actual income statement (see Section 4)

Do the cash flow projections of the Relevant Group show that it can meet its cash requirements in the short to medium-term?

- Cash headroom projections for the Relevant Group (see Section 6)

Do the financial health metrics when applied to the actual results/forecast projections indicate that the Relevant Group's investment grade status is/would be threatened in the short to medium-term?

- Financial health metrics, including FFO/Net Debt for the Relevant Group (see Section 6)

How does the rate of return of the Reported Business compare with the rates of return of the Relevant Group and its other business units?

- Reported Business forecast income statement (see Section 6)
- Relevant Group forecast income statement (see Section 6)
- Reconciliation of Relevant Group forecast income statement to Reported Business forecast income statement (see Section 6)
- Reported Business actual income statement (see Section 4)
- Relevant Group actual income statement (see Section 8)

- Reconciliation of Relevant Group accounts to Reported Business accounts (see Section 4)
- Royal Mail monthly management accounts for the Board (see Section 4)

What are the key financial performance drivers contributing to the rate of return of the Reported Business (e.g. product volumes and revenues, cost categories), and how are these drivers performing?

- Reported Business actual income statement and product profitability information (see Section 4)
- Forecast volumes, costs and revenues of the Reported Business (see Sections 5 and 6)
- Historical volumes, costs and revenues of the Reported Business (see Sections 4 and 5)
- Historical Cost Matrix (see Section 5)
- Forecast Cost Matrix (see Section 6)

Monitoring efficiency

How does Royal Mail's actual efficiency performance compare to its budgeted efficiency levels and the efficiency targets it set out in its 2015 Business Plan?

- Historical costs of the Reported Business (see Sections 4 and 5)
- Historical Cost Matrix and PVEO Analysis (see Section 5)
- Historical cost metrics, including Gross Hours, Workload and Productivity, and headcount (see Section 5)
- Historical volume to workload bridge (see Section 5)
- Management report to the Board (see Section 4)
- Business Plan and quarterly budget for the Reported Business costs (see Section 6)
- Business Plan Cost Matrix and PVEO Analysis (see Section 6)
- Business Plan cost metrics, including Gross Hours, Workload and Productivity, and headcount (see Section 6)
- Business Plan volume to workload bridge (see Section 6)

How do Royal Mail's latest efficiency targets compare to its historic performance and to the targets it set out in its previous Business Plans (particularly with respect to its 2015 Business Plan)?

In addition to the above:

- Forecast Cost Matrix and PVEO Analysis (see Section 6)

- Forecast cost metrics, including Gross Hours, Workload and Productivity, and headcount (see Section 6)
- Forecast volume to workload bridge (see Section 6)
- Management report to the Board (see Section 4)

What are the key reasons and drivers behind Royal Mail's actual and forecast efficiency performance?

- Reconciliation between and understanding of changes between the latest Business Plan and Annual Budget and prior Business Plan and Annual Budget (see Section 6)
- Management report to the Board (see Section 4)

Is Royal Mail's planned and actual level of efficiency improvement reasonable?

- All the information answering the above questions under monitoring efficiency

Monitoring competition

Margin Squeeze: is there a large enough gap between the access price and Royal Mail's retail price so that an efficient competitor can make a reasonable upstream margin?

- Margin squeeze control submissions as required by USPA 6 (see Section 9)
- Revenues, costs, and volumes of access and retail bulk by product (see Section 4)

Does our regulatory framework continue to support competition in the postal market?

- Revenues, costs, and volumes of products (see Section 4)

Protecting consumer interests

Are the Safeguard caps being complied with?

- Price increase for Second Class stamps Letters, Large Letters and Parcels since 2012-13

Does the regulatory framework continue to enable us to further the interests of citizens and consumers with respect to choice, price, quality of service and value for money?

- Revenues, costs, and volumes of products (see Section 4)
- Management report to the Board (see Section 4)

Summary of our proposals

3.18 The main reports which we are proposing to require from Royal Mail are summarised in Table 3.1 below, which also explains the key changes from our existing regulatory

financial reporting requirements (removals and reductions in the requirements are marked in red and additions are marked in green)³⁵:

³⁵ The regulatory financial reporting we are proposing to require from Royal Mail is summarised in Table 10.1 in Section 10.

Table 3.1: Summary of the main proposed changes to regulatory financial reporting requirements

Frequency of submission	Reports/Data submissions	Proposed changes	Monitoring financial sustainability	Monitoring efficiency	Monitoring competition	Protecting consumer interests	Transparency and assurance
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)	✓				
	Income statement ³⁶ , statement of capital employed, and cash flow statement of Reported Business	Added – Cost Matrix and PVEO Analysis (see Section 6)	✓	✓			
	Reconciliation of Relevant Group accounts to Reported Business accounts	None	✓				
	Business Plan including Annual Budget	Added – Further detail requirements and templates for content (see Section 6)	✓	✓			
	Income statement, statement of capital employed, and cash flow statement separated between four FREs	Removed – New granular data submission to be required to enable us to prepare the separations of income statement needed going forward (see Section 4)			✓	✓	
	Product Profitability Statements	Reduced – From 25 to 2 namely access and PAF, with new granular data submission required to enable us to prepare any PPSs needed going forward (see Section 4)			✓	✓	
	Cost and volume input and output data at SPHCC level	None	✓	✓	✓	✓	

³⁶ Including the end-to-end split between universal service and non-universal service products.

Frequency of submission	Reports/Data submissions	Proposed changes	Monitoring financial sustainability	Monitoring efficiency	Monitoring competition	Protecting consumer interests	Transparency and assurance
	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	✓				
	Income statement of Reported Business ³⁷	Added – Cost Matrix added (see Section 5)	✓	✓			
	Income statement separated between four FREs	Removed (see Section 4) – New granular data submission to be required to enable us to prepare the separations of income statement needed going forward (see Section 4)			✓	✓	
	Product Profitability Statements	Reduced – From 25 to 2 namely access and PAF, with new granular data submission to be required to enable us to prepare any PPSs needed going forward (see Section 4)			✓	✓	
	Cost and volume output data at SPHCC level	Granular revenue, cost and volume data 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	✓	✓	✓	✓	

³⁷ Includes the end-to-end split between universal service and non-universal service products.

Frequency of submission	Reports/Data submissions	Proposed changes	Monitoring financial sustainability	Monitoring efficiency	Monitoring competition	Protecting consumer interests	Transparency and assurance
		volume (see Section 4)					
	Costing Methodology Manual	None					✓
	Accounting Methodology Manual	None					✓
	Change control submissions	Added – Restated income statement and upstream/downstream impact to be required (see Section 7)					✓
	Margin squeeze submissions	Minor clarifications in Access Condition (see Section 9)			✓		
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)	✓		✓	✓	
	Cost metrics report (including volume to workload bridge)	To be required quarterly (see Section 5)		✓			
	Management Report to the Board	None – Continue to be provided on a voluntary basis	✓	✓		✓	

Section 4

Accounting separation and separated reports for the Reported Business

Introduction

- 4.1 The current accounting separation requirements provide us with important information to achieve the objectives of financial regulatory reporting regime. In particular, it helps us in assessing the financial sustainability of the universal service, monitoring competition, and in protecting consumer interests by helping us monitor how Royal Mail is using its commercial freedom.
- 4.2 Section 4 outlines the information we currently require from Royal Mail and sets out the assessment of the changes that we are proposing in to four aspects of reporting of the Reported Business: i) separation into Financial Reporting Entities (FREs), ii) separation into Product Profitability Statements (PPSs), iii) separation between universal and non-universal products, and iv) monthly volume and revenue reporting.
- 4.3 Overall, we are proposing changes to the current accounting separation requirements to support a more flexible approach to understanding accounting separation and monitoring changes in the postal market, while reducing the reporting burden on Royal Mail. We consider that the increased flexibility would enable us to achieve our objectives more effectively.
- 4.4 To provide this additional flexibility, however, we are proposing to put in place a requirement on Royal Mail to provide us with granular revenue data which would enable us to produce various revenue and profitability splits ourselves. As a result, we will have more flexibility to change our own internal monitoring reports as the postal market evolves.

Current requirements

- 4.5 In addition to the income statement of the Reported Business as a whole, Royal Mail prepares a number of different splits of that income statement as follows:
- a) separation into four Financial Reporting Entities (FREs) by Lines A, B and C defined in the USPAC³⁸ (see Figure 4.1 below);
 - b) separation into Product Profitability Statements (PPSs) for 25 product groups defined in the RAG³⁹ (see Figure 4.2 and Table 4.3 below); and
 - c) end-to-end split between universal service and non-universal service products.⁴⁰

³⁸ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.5.1. https://www.ofcom.org.uk/_data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf

³⁹ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.4.1(i) and (j). https://www.ofcom.org.uk/_data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf; and Regulatory Accounting Guidelines as at January 2014, Table 5, https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf

- 4.6 Royal Mail is also required to provide us with a breakdown of monthly volumes and revenues of the Reported Business.⁴¹ In addition to the capital employed and cash flow statements of the Reported Business as a whole, Royal Mail prepares separated statements for the four FREs. We explain these requirements in further detail below.

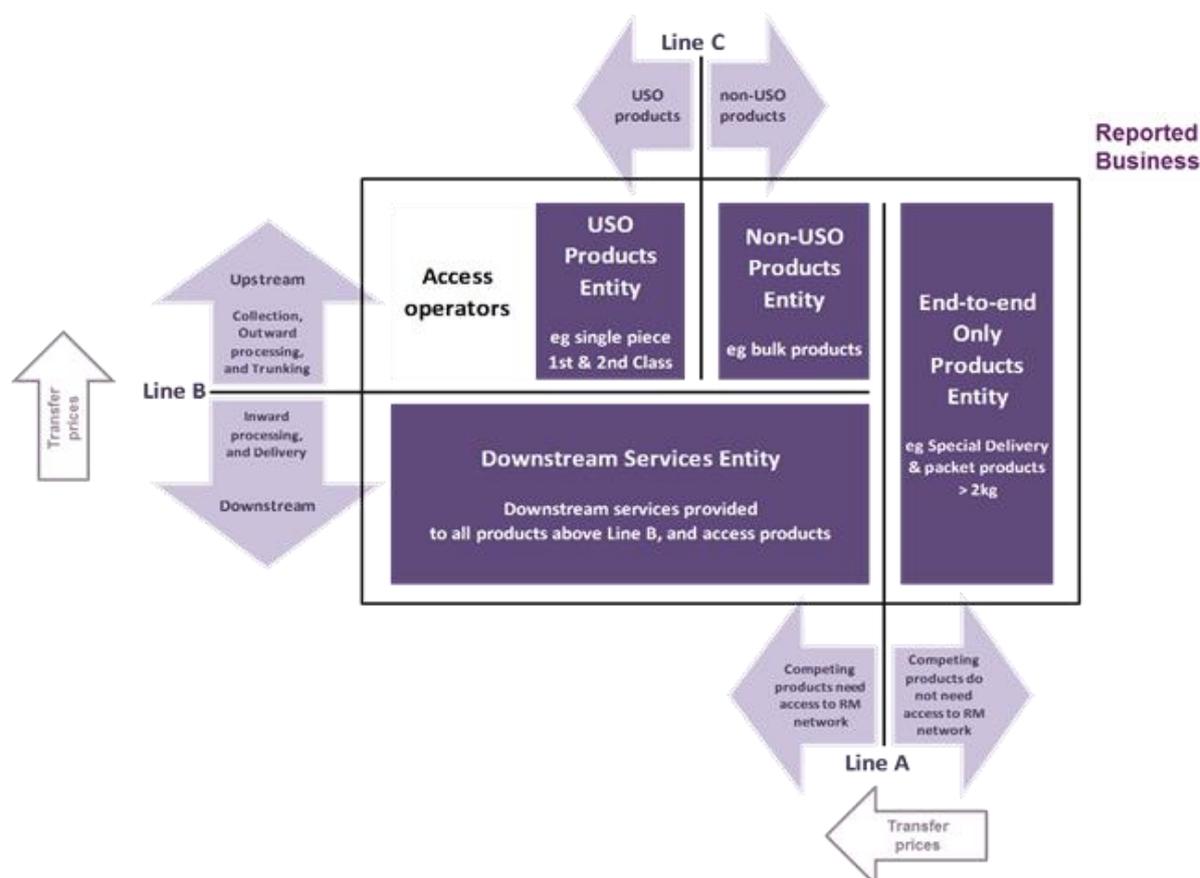
The four FREs separated by Lines A, B and C

- 4.7 We introduced the requirement to split the income statement into the four FREs in March 2012 (see Figure 4.1 below). Lines A, B and C serve to create four notionally separate entities within the Reported Business (which is itself a separation from the Relevant Group as a whole):
- **Line A** separates products into those where competitors of Royal Mail need access to Royal Mail's network in order to provide their own products, and those where they do not. Key examples of the markets where there is no such need are special delivery products and parcel products above 2kg. This separation was considered an important step in separating products that are subject to more competition and the non-competitive parts of the Reported Business.
 - **Line B** separates products, where access is required for competing products, into upstream and downstream services; the financial results of downstream services are important for (i) monitoring financial sustainability, and (ii) assessing the impact of Royal Mail's prices on access competition.
 - **Line C** separates the upstream entity created by Line B into universal service and non-universal service products entities, because (i) the split was considered important for identifying products and areas of the pipeline where there is some competition and those which are required to be provided under the universal service, and (ii) the latter entity was considered comparable to the operations of an access operator and comparing its financial performance with that of the competing access operators would shed light on potential competition issues, in particular margin squeeze.

⁴⁰ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.5.2(d) and (e). https://www.ofcom.org.uk/_data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf.

⁴¹ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.4.1(k). https://www.ofcom.org.uk/_data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf; and *Regulatory Accounting Guidelines as at January 2014*, page 58, Figure 15(a). https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

Figure 4.1: The four FREs defined by Lines A, B and C

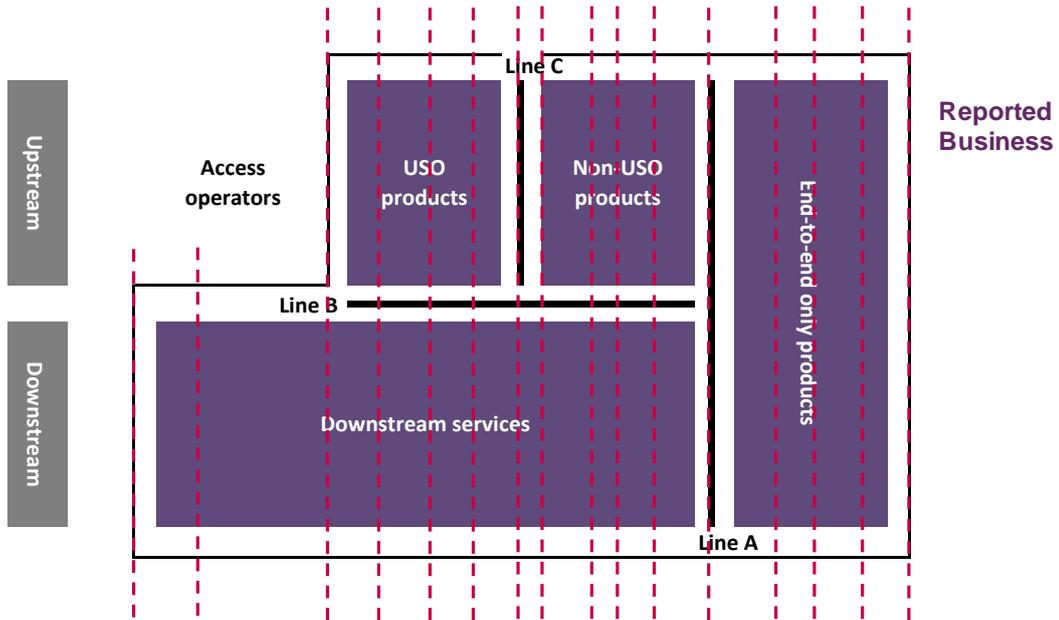


4.8 Royal Mail is also required to prepare separated capital employed and cash flow statements for the four FREs. These statements were intended to help complete our understanding of the relative contributions being made by each of the four FREs to the financial sustainability of the universal service.

Separation into Product Profitability Statements (PPSs)

4.9 PPSs are slices in the income statements of the Reported Business and the four FREs:

Figure 4.2: PPSs



4.10 PPSs were introduced to provide us with information about the relationship between the total revenues of various product groups and their underlying costs (measured using a fully allocated cost (FAC) standard). This information helps us to understand how Royal Mail is using its commercial freedom in pricing its range of products and the potential impact of this on competition. We consider these applications in further detail later in this Section. Table 4.3 sets out the product groups currently covered by PPSs.

Table 4-3: Current product groups covered by 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

End-to-end split between universal service and non-universal service products

- 4.11 We currently require Royal Mail to provide, in its published annual regulatory accounts, an end-to-end split of the income statement of the Reported Business into:
- universal service products; and
 - non-universal service products (Mails and non-Mails⁴²).
- 4.12 In the confidential quarterly and annual regulatory financial statements, Royal Mail is also required to provide an end-to-end split of the income statement of the Reported Business into:
- universal service products;
 - non-universal service products (Mails); and
 - non-Mails.
- 4.13 The split between end-to-end universal service and the non-universal service) shows the overall contribution of both of these sets of products to the Reported Business' rate of return, and allows us to compare the different rates of contribution. The split therefore helps us and stakeholders gain an understanding of how Royal Mail is using its commercial freedom to price its range of products.

Monthly volume and revenue reporting

- 4.14 We currently require Royal Mail to submit to us confidential monthly volume and revenue reports. These reports break down the total year-to-date actual and budgeted volume and revenue of the Reported Business into a set of product groups defined by us. The format of these reports is prescribed in the RAG.⁴³
- 4.15 These monthly reports provide us with regular updates on how the Reported Business is performing. The performance of the Reported Business is essential for monitoring the financial sustainability of the universal service.
- 4.16 Royal Mail also provides us, on a voluntary basis, its monthly management accounts prepared for its Board. The monthly managements reports provide information explaining the trends and movement in volumes, revenues, and costs which is necessary for our monitoring work. These reports save both Royal Mail and us a considerable amount of time, as they reduce the need for further questions and clarifications that tend to arise after the submission of the monthly regulatory reports and quarterly regulatory accounts.

Assessment of current requirements

- 4.17 In the following sub-sections, we assess the current requirements and introduce our proposals and explain the reasons for those proposals. In particular, we explain why

⁴² "Non Mails" means all of the products and/or services provided by the Reported Business that do not fall within the meaning of postal services, which products and/or services Ofcom may direct from time to time to be treated as "Non Mails" for the purpose of matters relating to the USPAC condition.

⁴³ *Regulatory Accounting Guidelines as at January 2014*, page 58, Figure 15(a).

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf

we consider we no longer need the full extent of the accounting separation by Lines A, B and C. We also explain which parts of this type of accounting separation we consider are still necessary and how we plan to produce that information from our proposed new requirements ourselves, including a requirement for quarterly granular revenue data in addition to cost and volume data we already receive.

The four FREs separated by Lines A, B and C

- 4.18 The requirements for accounting separation by Lines A, B and C are relevant to our assessment of financial sustainability and the monitoring of competition, and we therefore consider the effectiveness of these requirements against these objectives.
- 4.19 Line A was defined to help us monitor Royal Mail's profitability in more competitive areas of the market (as defined at that point in time), primarily by separating revenues and costs for parcels that we considered were in parts of the sector where there was more competition from the rest of the sector. However, competition has developed in the parcels sector, and Line A no longer takes full account of the resulting market changes. We consider that more granular revenue data - together with granular cost data that we currently receive - would allow us to generate better targeted accounting separation and PPSs for parcels which could be modified as competition in the parcels sector develops.
- 4.20 Line C was defined to help us monitor Royal Mail's profitability in relation to universal service products and non-universal service products where there were varying degrees of competition, particularly in upstream parts of the postal pipeline. As set out above, we also require Royal Mail to publish the separation of universal service and non-universal service products in its regulatory accounts. We consider this report gives us a better understanding of the profitability of universal service products, because there is little upstream competition for universal service products.
- 4.21 With regard to the non-universal service products, by separating the 'Non USO products' entity, which includes bulk letter products, Line C was intended to provide a better understanding of Royal Mail's profitability in this area to complement the *ex-ante* margin squeeze test that is in place (discussed in Section 9).
- 4.22 However, we consider that we can better target Royal Mail's products that compete with access operators by requiring separate upstream and downstream revenues and costs for the specific products that access operators compete with. The reason is that the 'Non-USO products' entity also includes products that do not compete against access operators' products. We continue to consider that it is important to monitor Royal Mail's upstream and downstream profitability in relation to the products that compete with access operators' products, particularly where the products are not included in the margin squeeze control (such as unsorted bulk products).
- 4.23 Line B separates the upstream and downstream parts of the pipeline at the inward mail centre. This is consistent with the point in the network that access operators hand their mail over to Royal Mail. Line B was therefore intended to help us both monitor Royal Mail's profitability in more competitive areas and understand how this part of the pipeline contributes to the financial sustainability of the universal service.
- 4.24 While it is interesting to know the contribution of downstream operations to the rate of return of the reported business, we have found that it is not necessary for monitoring financial sustainability. It is more useful to monitor the relative profitability of product groups. We could do this using granular revenue data which we propose to require Royal Mail to provide (together with granular cost data we currently receive).

- 4.25 Further, the 'Downstream services' entity, as currently defined, does not include the full extent of the downstream activities (as some of the products delivered over the universal service network are in the end-to-end only products entity). Therefore, the profitability of the 'Downstream services' entity does not provide a full picture of the profitability of all downstream activities.
- 4.26 In monitoring Royal Mail's profitability in parts of the pipeline where there is greater upstream competition, however, Line B separation has been useful. In particular it helps produce upstream PPSs for Royal Mail bulk retail products (including those that are not subject to the margin squeeze control). These upstream PPSs can be used as an indicator of whether we should consider that there is a risk of a margin squeeze on access operators' competing services, in particular from those Royal Mail products which are outside the scope of our *ex-ante* margin squeeze control.
- 4.27 In assessing how the current scope of Line B type of separation needs to be better targeted to answer our regulatory questions considered above, we have considered three options for upstream/downstream separation:
- a) no separation (i.e. removing Line B and not replacing it with any upstream / downstream separation);
 - b) targeted separation – applied to products where there is a risk of margin squeeze; or
 - c) full separation – splitting all products of the Reported Business (i.e. greater than the current Line B which excludes the end-to-end products entity).
- 4.28 Requiring full separation would give us an indication of the possibility of margin squeeze issues in products outside the scope of the *ex-ante* margin squeeze control and show the profitability of downstream operations, but this option would mean more reporting than under the current regime, as more products will need transfer pricing information.
- 4.29 Ending the requirement for separation would result in a significant reduction in reporting work for Royal Mail (as there would be no need for current transfer pricing for hundreds of products), but this option would leave us with no information on margin squeeze issues in products outside the scope of the margin squeeze control, or on the overall profitability of downstream operations.
- 4.30 We consider adoption of the targeted separation option to be the most effective way of fulfilling our regulatory objectives because it allows us to monitor the products at risk of margin squeeze. We do not consider that the profitability of downstream operations, which is provided under a full separation, is sufficiently useful for financial sustainability assessments to justify the considerably larger scope of transfer pricing that Royal Mail would have to generate.
- 4.31 The separation of the capital employed and cash flow statements between the four FREs was meant to aid us in assessing the financial sustainability. However, we have found that the capital employed and cash flow statements of the Reported Business as a whole and those of the Relevant Group are considerably more useful in our assessments. Also, the separation of the capital employed and cash flows involves various assumptions that diminish the objectivity and robustness of the resulting separated statements.

Separation into Product Profitability Statements (PPSs)

- 4.32 The requirement for PPSs supports our work to monitor the impact of Royal Mail's pricing flexibility on competition (see Section 3). We consider it is important to have separate revenue, cost and profitability for relevant product groups to monitor how Royal Mail is using its pricing flexibility and the impact this has on competition.
- 4.33 As the postal market has developed, the product splits we have needed have not always coincided precisely with the current definitions of the PPSs. We therefore consider that greater flexibility than could be provided by a set of pre-defined product groups is necessary to be able to answer our questions. We consider that this flexibility is best addressed by requirements for granular revenues, cost and volume data (which we discuss in the following sub-section).
- 4.34 As we explain in the proposals sub-section below, granular revenue data – together with granular cost and volume data – will enable us to produce the accounting separation information we need, including the current PPSs and other profitability splits (less or more granular than the current PPSs). These requirements will also allow us to produce accounting separation by Lines A, B and C, albeit not fully, but to the extent which we now find useful (for which we will be keeping some of the current transfer pricing data requirements).

End-to-end split into universal service and non-universal service products

- 4.35 The end-to-end universal service versus non-universal service split shows the overall contribution of these products to the rate of return of the Reported Business, and how the contributions compare. The split therefore 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.
- 4.36 The split is also helpful in our work on monitoring the impact of Royal Mail's pricing decisions on competition. This is because:
- most of Royal Mail's products in parts of the sector where there is greater competition, are non-universal service products; and
 - most of universal service products are provided in parts of the sector where Royal Mail has a significant market share.

Monthly volume and revenue reporting

- 4.37 It is important for us to have frequent trading and financial information that will quickly give us visibility of any potential issues in the financial sustainability of the universal service. We therefore consider that monthly reporting of volume and revenue is necessary for us to achieve our objective of monitoring the financial sustainability of the universal service.

Our proposals

The four FREs separated by Lines A, B and C

- 4.38 We consider that Lines A and C are no longer the most effective way to answer our regulatory questions. We therefore propose to remove them from the regulatory reporting requirements⁴⁴.
- 4.39 We propose to adopt the ‘targeted separation’ option that we set out above and require Royal Mail to split upstream and downstream revenues (by providing transfer prices) for all letter and large letter bulk mail products (sorted and unsorted) which directly compete against access operators retail products. Royal Mail offers a wholesale equivalent to most of the letter and large letter sorted bulk mail products, and a number of access operators offer unsorted bulk mail services which compete with Royal Mail’s similar products.
- 4.40 We currently require the income statements of sorted bulk products within the scope of the margin squeeze control to be provided in PPS 3, while the sorted letter and large letter bulk products outside the scope are in PPS 4 (see Table 4.3). Unsorted letter and large letter bulk products are included in PPS 4 and PPS 8 (see Table 4.3).
- 4.41 We have set out in Appendix 2 to our proposed modified RAG (see Annex 6 of this consultation) a full list of products currently sold by Royal Mail, which are reported within PPS 3, PPS 4 and PPS 8. However, we expect that not all those listed products will be necessary for our proposed new targeted separation requirements. We are seeking to capture within the scope of the targeted separation all relevant letter and large letter sorted and unsorted bulk products within PPS 3, PPS 4 and PPS 8. Therefore, we invite stakeholders’ views on which of the products we have set out in the full list in Appendix 2 to our proposed modified RAG would be relevant for those purposes. We will take account of responses to this question in finalising that list in making our decision on this matter.
- 4.42 We do not propose to extend the scope of the targeted separation to bulk parcels (currently included in PPS 5, 6 and 21 – see Table 4.3). This is because we have not mandated access to Royal Mail’s network for parcels (at this point in time) and, given the level of competition in the parcels sector, access operators have options for operators to deliver their parcels. We also do not propose to include First Class bulk letter and large letter services in the scope of the targeted separation because there is no significant access equivalent or risk of margin squeeze for these products.
- 4.43 The access operators have been interested in targeting Royal Mail’s customers who use single piece (universal service) meter and PPI products (currently included in PPS 15 and 16 – see Table 4.3). However, we do not propose to extend the scope of the targeted separation to these products as access operators offer these customers the sort of services (sorted or unsorted bulk, not single piece) which are covered in our proposed scope of the targeted separation.

⁴⁴ Additionally, we consider that the information that would be provided from our proposed requirement for submission of granular revenue, cost and volume data (which we set out in a sub-section below), would enable us to reproduce a version of Line A separation of the income statement, if we considered this was necessary. We would also be able to produce similar information to that provided by the Line C separation of the income statement which we consider useful, i.e. where there is a risk of margin squeeze (as long as we adopt either the ‘targeted separation’ or the ‘full separation’ options discussed above).

- 4.44 To be able to produce the targeted separation for our proposed scope of products, we will require Royal Mail to provide us with transfer pricing data alongside the proposed quarterly granular revenue data submissions, which we explain further in the following sub-sections.
- 4.45 Transfer prices and the total transfer charges calculated based on them are needed to split the end-to-end income statement of a product group into an upstream and a downstream income statement. Transfer charges represent the notional income that the downstream services receive from the upstream services for providing inward processing and delivery services. These transfer charges will also be a notional cost to the upstream services in providing retail services to customers.
- 4.46 Royal Mail has suggested that we should also review the rules relating to transfer pricing set out in the RAG⁴⁵. We agree with Royal Mail and are planning to review these rules in Phase II of our review of the Regulatory Financial Reporting.

Separation into Product Profitability Statements (PPSs)

- 4.47 We propose that we no longer require Royal Mail to produce the majority of the PPSs (see Table 4.3), but that we continue to require Royal Mail to provide PPSs for access (PPS 1 and 2 aggregated) and PAF (PPS 23) in quarterly regulatory financial statements and require Royal Mail to publish those PPSs in the annual regulatory accounts.
- 4.48 Instead, our proposed requirement for quarterly granular revenue data (which we explain in detail in the following sub-section), together with the existing requirements for granular cost and volume data, would enable us to produce ourselves the current PPSs and many other profitability splits to more flexibly meet our evolving needs.
- 4.49 We consider the profitability and the rate of return for access products is important for:
- monitoring competition in access and bulk mail; and
 - providing transparency to stakeholders, particularly access operators and bulk mail customers, over the relationship of access prices to underlying costs.
- 4.50 The performance of PAF against an agreed target operating margin continues to be important to us and stakeholders.
- 4.51 We propose to continue to require Royal Mail to prepare and include these PPSs in the confidential quarterly accounts as well. This will ensure these PPSs are prepared based on the same assumptions as those that are published in the annual regulatory accounts.
- 4.52 We propose to remove the requirement for Royal Mail to publish a PPS for Relay (PPS 22) because this service is provided over a separate network and in an unregulated market. In addition, the confidential information we are proposing to require from Royal Mail would enable us to produce a quarterly PPS for Relay ourselves.

⁴⁵ *Regulatory Accounting Guidelines as at January 2014*. Paragraphs 8.72-8.80 and 9.8-9.15 https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

- 4.53 Our proposal to remove the requirement on Royal Mail to produce PPSs means Royal Mail will not provide the upstream/downstream splits currently applied to PPSs 3 to 19 through the Line B accounting separation requirement (see Figure 4.2 and Table 4.3). As we explained in the previous sub-section, we propose to adopt the targeted separation option. We will 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 is a possibility of margin squeeze (currently included in PPSs 3, 4 and 8). We propose to require Royal Mail to provide us with the transfer pricing data alongside the proposed quarterly granular revenue data submissions.

Requirement for granular revenue, cost and volume data

- 4.54 We propose that Royal Mail should provide us with quarterly granular revenue data in addition to the granular cost and volume data it provides us under the current requirements.
- 4.55 The lowest level at which Royal Mail splits revenue, FAC and volumes on a consistent basis is a sub-product level it refers to as 'Short' Sales Product Handling Characteristic Combination (Short SPHCC). We are proposing that Royal Mail provides us with quarterly submissions of this data.
- 4.56 Royal Mail's activity based costing (ABC) system attributes costs to sub-products of sales products named Sales Product Handling Characteristic Combinations (SPHCCs) level. The Royal Mail costing system considers that the key characteristics that determine the operational activities and processes required to deliver the different products, are sales product description, class, payment method, size and format, and handling (e.g. manual or machined handling).
- 4.57 The Short SPHCCs contain the following characteristic identifiers: sales product description, class, payment method, and size and format. The Short SPHCCs do not include the further split into manual and machined handling in the SPHCCs. Short SPHCCs are the lowest level at which Royal Mail split its revenues. While Royal Mail splits volumes and costs to a lower level (by handling method), it does not report revenues to this level. Therefore, the most granular level at which revenues, FAC and volumes are reported on a consistent basis is the Short SPHCC level.
- 4.58 We are proposing the submission of an integrated data file with current year-to-date and prior year-to-date actuals with the following information specified by Short SPHCC (see Figure 11, Appendix 1 of the proposed modified RAG set in Annex 6 to this consultation):
- Characteristics: format; weight step; class; payment method; Separated/non-Separated⁴⁶ scorecard category; product group; sales product; and V4 Format category (which is a method of grouping products used by Royal Mail in its reporting).

⁴⁶ 'Separated' refers to those Short SPHCCs for which we will require Royal Mail to provide us with a split of total revenue into upstream revenue and downstream revenue, and total FAC operating costs into upstream FAC operating costs and downstream FAC operating costs; with 'Non-separated' referring to those Short SPHCCs for which we do not require an upstream/downstream split.

- Data: volumes; revenue; people costs; depreciation costs, amortisation and impairments costs; operating costs; other operating costs; Transformation Costs; and total operating costs.
- 4.59 For those products for which we have identified a need for upstream/downstream separation (the relevant Short SPHCCs will be required to be labelled as 'Separated' in the data file), we will require additional upstream/downstream data:
- Upstream/downstream data: upstream revenue; downstream revenue; upstream total operating costs; and downstream total operating costs.
- 4.60 The proposed requirements mentioned above would allow us to remove the current requirement for quarterly granular cost and volume data at SPHCC level (see Section 7).
- 4.61 We propose that the integrated data file is to be provided quarterly, within 45 days of the end of each quarter (see Section 8 of this consultation). The outputs of the file are required to be reconciled to the revenue, FAC and volume information provided in other regulatory reports for the same periods.
- 4.62 Our proposal for the integrated granular data file is intended both to reduce the regulatory burden on Royal Mail – as the information provided will facilitate the removal and reduced frequency of many of the current regulatory reports submitted – and to enable us to answer more effectively and efficiently some of the regulatory questions we consider pertinent (see Tables 4.4, 4.5 and 4.6 below).

End-to-end split into universal service and non-universal service products

- 4.63 We propose to continue to require Royal Mail to provide in its published annual regulatory accounts an end-to-end split of the income statement of the Reported Business into:
- universal service products; and
 - non-universal service products (Mails and non-Mails).
- 4.64 We propose to continue to require Royal Mail to prepare and include the following end-to-end split in the confidential quarterly and annual regulatory accounts as well:
- universal service products;
 - non-universal service products (Mails); and
 - non-Mails.
- 4.65 This will ensure the split is prepared based on the same assumptions as those that are published in the annual regulatory accounts.

Monthly volume and revenue reporting

- 4.66 As set out above, we consider that visibility of monthly volumes and revenues is necessary to enable us to fulfil our financial sustainability objective. We therefore propose to retain the requirement on Royal Mail to provide monthly volume and revenue information.

- 4.67 However, we consider Royal Mail's monthly management accounts (provided on a voluntary basis) in their current form and content meet this requirement. Therefore, instead of the current monthly volume and revenue report provided by Royal Mail,⁴⁷ we propose to have a high-level summary volume and revenue report on a quarterly basis. Figure 9 in the proposed modified RAG in Annex 6 to this consultation sets out the template for this new report.
- 4.68 We consider that our proposed requirement for quarterly granular revenue data, together with the existing requirement for quarterly granular volume data, will provide us with the information to look further into any change in volumes and/or revenues of any products or product groups and will allow us to produce the revenue and volumes splits we require every quarter.
- 4.69 The current monthly volume and revenue report includes the budget for the volumes and revenues.⁴⁸ The budgeted figures help us to monitor the performance of the Reported Business against Royal Mail's forecasts and strategic plans and are important to allow us to assess the future financial sustainability of the universal service. We propose the new quarterly volume and revenue report will also include budgeted volumes and revenues to allow us to continue this assessment. We consider the higher-level break down in the new quarterly reports alongside Royal Mail's monthly management accounts is sufficient for our budget comparison purposes.

Summary of our proposals

- 4.70 In summary, we propose the following changes to the accounting separation and separated reports for the Reported Business:
- a) remove 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;
 - b) remove the requirement on Royal Mail to produce PPSs, 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) maintain 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) remove the requirement for monthly reporting of costs but maintain the requirement for monthly reporting of volumes and revenues which we consider Royal Mail's monthly management accounts currently meet;
 - e) require Royal Mail to prepare a high-level summary volumes and revenues report, including a comparison against budget on a quarterly basis; and
 - f) introduce a requirement for quarterly granular revenue and transfer pricing data to enable us to produce our own revenue and volume splits, accounting

⁴⁷ *Regulatory Accounting Guidelines as at January 2014*, page 58, Figure 15(a).

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

⁴⁸ *Regulatory Accounting Guidelines as at January 2014*, page 58, Figure 15(a).

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

separation, PPSs, and other income statement splits, flexible enough to meet our evolving needs.

- 4.71 To enable the production of this flexible reporting, we propose to retain the requirement on Royal Mail to provide granular cost and volume data (see Section 7). These requirements will also allow us to produce accounting separation by Lines A, B and C, albeit not fully, but to the extent which we will find useful going forward (for which we will be keeping the requirement for some of the current transfer pricing data).
- 4.72 As we explained at the start of this Section, accounting separation requirements provide us with important information to achieve the objectives of financial regulatory reporting. Accounting separation information, in particular, helps us in monitoring competition, but it is also helpful in the assessment of financial sustainability of the universal service, and also in protecting consumers by helping us monitor how Royal Mail is using its commercial freedom.
- 4.73 The following tables show which questions under the above objectives our proposed requirements would help us answer:

Table 4.4: Monitoring financial sustainability

Questions for our regulation	Proposed information
<i>What are the key financial performance drivers contributing to the rate of return of the Reported Business (e.g. product volumes and revenues, cost categories) and how are these drivers performing?</i>	<ul style="list-style-type: none"> • Quarterly volume and revenue reports • Quarterly granular revenue, cost and volume data submissions (to enable us to produce revenue, volume and profitability splits for product groups) • Royal Mail’s monthly management accounts

Table 4.5: Monitoring competition

Questions for our regulation	Proposed information
<i>Margin Squeeze: is there a large enough gap between the access price and Royal Mail’s retail price so that an efficient competitor can make a reasonable upstream margin?</i>	<ul style="list-style-type: none"> • Quarterly granular revenue, cost and volume data submissions (to enable us to produce profitability statements for upstream activities of products subject to risk of margin squeeze to complement the information from our <i>ex-ante</i> margin squeeze control) • Quarterly and annual PPS for access
<i>Does our regulatory framework continue to support competition in the postal market?</i>	<ul style="list-style-type: none"> • Quarterly granular revenue, cost and volume data submissions (to enable us to produce revenue and costs splits for products groups where there is upstream competition and other potential competition issues) • Quarterly and annual end-to-end split between universal service and non-universal service products

Table 4.6: Protecting consumer interests

Questions for our regulation	Proposed information
<p><i>Does the regulatory framework continue to enable us to further the interests of citizens and consumers with respect to choice, price, quality of service and value for money?</i></p>	<ul style="list-style-type: none"> • Quarterly granular revenue, cost and volume data submissions (to enable us to produce profitability splits for products groups) • Quarterly and annual end-to-end split between universal service and non-universal service products • Quarterly and annual PPS for PAF

Question 1: *Do you agree with our proposals in relation to accounting separation requirements, as presented in Section 4?*

Section 5

Cost and efficiency reporting

Introduction

- 5.1 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. Section 5 outlines the current information we require from Royal Mail with this objective in mind. It also sets out the changes we propose to those requirements to ensure that they achieve our objectives appropriately and more effectively.
- 5.2 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.
- 5.3 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.
- 5.4 Our proposals in Section 5 aim to capture the future information needs of our monitoring regime relating to our efficiency assessment.

Current Requirements

- 5.5 We currently require Royal Mail to provide cost and volume information, both forecast and actual, to inform our efficiency assessment⁴⁹.
- 5.6 In brief, the efficiency information that is currently required is:
- Monthly cost metrics report which includes:
 - Gross Hours, Workload and Productivity;
 - Full Time Equivalent (FTE) and headcount figures for the Reported Business;
 - mail centre and modernised delivery office numbers;

⁴⁹ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.4.1(k). https://www.ofcom.org.uk/_data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf; and Regulatory Accounting Guidelines as at January 2014, Table 4. https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

- Voluntary Redundancy (VR) costs; and
 - Transformation Costs (operating and capital costs) excluding VR; and
 - Monthly calculations including the Revenue Derived volumes to Workload bridge model and other calculations underpinning Workload figures.
- 5.7 In addition to the above, we require the following information which informs our work on efficiency as well as other areas of work:
- Quarterly and annual income statements for the Reported Business, which we discuss in Section 4;
 - The Strategic Business Plan and Annual Budget which includes the forecast income statement for the Reported Business. We discuss this in Section 6;
 - Granular cost and volume data at SPHCC level which allows us to build the Cost Allocation Model (CAM), which we discuss in Section 7;
 - Royal Mail's Monthly management accounts, which we discuss in Section 4; and
 - Monthly volume and revenue report, which we discuss in Section 4.

Our assessment of the current requirements

- 5.8 We have reviewed how well the current requirements meet our needs in terms of reviewing Royal Mail's actual and planned efficiency levels in its provision of the universal service. Our assessment has included a review of the structure of the data required to enable us to review efficiency against the figures underpinning the 2015 Business Plan.
- 5.9 We have found that our current framework does not ensure consistency in the data provided by Royal Mail, either in terms of structure or scope.
- The form and content of Royal Mail's Business Plan and its categorisation of costs is constantly evolving, which results in data not always being presented on a consistent basis. Further, elements of data relied on in one year are not always available in subsequent years.
 - Royal Mail's measure of volume, Workload, which is used within its efficiency calculations, is continually being refined. Both the scope of the calculation and the methodology adopted is continually evolving.
 - Similarly, Royal Mail's Productivity calculation is continually evolving.
- 5.10 These changes present a challenge to our efficiency assessment, which involves consideration of how the business is changing, expecting to change and why. To enable trends to be identified and planned activity to be compared to achievements to date, we need consistency across both actual 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.
- 5.11 To date, inconsistencies in data have been addressed by working with Royal Mail to understand the differences. This informal process is often time-consuming, and we

consider that this process could be avoided by better defining the structure of our requirements which we propose in the next Section.

- 5.12 Our review of efficiency depends on understanding the elements which underpin costs (e.g. hours, volumes). Insight is provided from discussions with Royal Mail, including its submissions of costs broken down into cost categories (Cost Matrix) and segmented by key drivers: price, volume, efficiency and other (PVEO Analysis). Cost Matrix and PVEO Analysis do not form part of our current regulatory reporting framework, but we often request Royal Mail to provide these to us.
- 5.13 We consider it would be more efficient to include a requirement for Royal Mail to provide a Cost Matrix and PVEO Analysis of its actual and forecast costs as part of our regulatory framework. Further, the rules we propose to include in the RAG regarding the calculation of the Cost Matrix and the PVEO Analysis would provide consistency and comparability in the information provided.
- 5.14 We outlined in the March 2017 statement that we intended to review Royal Mail's efficiency against the targets that underpin the 2015 Plan.⁵⁰ To do this, we need to be able to view the data at a consistent level of granularity and format, using consistent assumptions (e.g. 2015 Workload weights) to those adopted in our review of the 2015 Plan. This requirement is not currently captured by our regulatory framework.
- 5.15 In addition, we consider that, while the current requirement for Royal Mail to provide actual data each month meets our needs, the requirements would also be met by quarterly data, which would present a lower regulatory burden on Royal Mail.

Our proposals

- 5.16 We propose the following changes to the regulatory reporting framework to inform our view of Royal Mail's actual and planned efficiency improvements:
- a) including a Cost Matrix in the confidential quarterly and annual income statements of the Reported Business. The Cost Matrix should 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 proposed modified RAG set out in Annex 6 to this consultation), and as per the template provided in the RAG (see Figure 7 in Appendix 1 to the proposed modified RAG in Annex 6 to this consultation);
 - b) including a Cost Matrix for each forecast year of the Reported Business (see Section 6 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 proposed modified RAG set out in Annex 6 to this consultation), and as per the template provided in the RAG (see Figure 7 in Appendix 1 to the proposed modified RAG 8.81 and 8.82 in Annex 6 to this consultation);
 - c) including 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,

⁵⁰ Ofcom, 2017. *Review of the Regulation of Royal Mail*, 1 March 2017, paragraph 3.101. https://www.ofcom.org.uk/_data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf.

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 to this consultation), and as per the template provided in the RAG (see Figure 8 of Appendix 1 to the proposed modified RAG in Annex 6 to this consultation);

- d) including in the Business Plan a PVEO Analysis for each forecast year of the Reported Business (see Section 6 for further discussion), in accordance with the rules set out in the RAG (see paragraph 8.83 in the proposed modified RAG set out in Annex 6 to this consultation), and as per the template provided in the RAG (see Figure 8 in Appendix 1 to the proposed modified RAG in Annex 6 to this consultation);
- e) providing the current monthly cost metrics report quarterly using an updated template (Figures 10 in Appendix 1 to the proposed modified RAG set out in Annex 6 to this consultation), together detailed prescriptions for Revenue Derived volumes to the Workload Bridge Model and other calculations underpinning Workload figures to ensure consistency (see Tables 2 and 4 in the proposed modified RAG set out in Annex 6 to this consultation); and
- f) including further detailed prescription of Business Plan information needed for monitoring efficiency which is discussed in detail in Section 6.

5.17 We consider the changes we propose to the regulatory reporting framework should better facilitate the provision of reliable, timely, accurate and consistent data to enable us to assess the efficiency of the provision of the universal service by Royal Mail. In addition, we also expect to ease the regulatory burden on Royal Mail by reducing our dependence on separate informal or formal information requests and, where appropriate, by reducing the frequency of the data submissions. We therefore consider that this approach strikes the right balance of easing some of the regulatory burden on Royal Mail while allowing us to assess Royal Mail's actual and planned efficiency improvements as set out in the March 2017 statement.

5.18 As set out earlier in the consultation, our overall aim is to make a judgement as to whether Royal Mail's planned and achieved levels of efficiency improvement are reasonable. We set out in Section 3, under our objective of monitoring efficiency, the questions that we would typically seek to answer in making this judgement. In Table 5.1 below, we have shown which questions our proposed requirements would help answer:

Table 5.1: Monitoring efficiency

Questions for our regulation	Proposed information
<p><i>How does Royal Mail's actual efficiency performance compare to its budgeted efficiency levels and the efficiency targets it set out in its 2015 Business Plan?</i></p>	<ul style="list-style-type: none"> • Quarterly and Annual actual and budget Cost Matrices • Annual actual and budget PVEO analysis • Annual actual and budget cost metrics including calculations underpinning Workload numbers • Reconciliation data to enable restatement of actual performance and budget on 2015 basis • Quarterly cost metrics report including calculations underpinning Workload numbers
<p><i>How do Royal Mail's latest efficiency targets compare to its historic performance and to the targets it set out in its previous Business Plans (particularly with respect to its 2015 Business Plan)?</i></p>	<ul style="list-style-type: none"> • Annual forecast Cost Matrix • Annual forecast PVEO Analysis • Annual forecast calculations underpinning Workload numbers • Reconciliation data to enable restatement of forecast performance on 2015 basis • Reconciliation data to previous business plans
<p><i>What are the key reasons and drivers behind Royal Mail's actual and forecast efficiency performance?</i></p>	<ul style="list-style-type: none"> • Annual actual and forecast PVEO Analysis • Management information on business plan and actual performance

Question 2: *Do you agree with our proposals regarding cost and efficiency reporting, as described in Section 5?*

Section 6

Business Plan

Introduction

- 6.1 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.
- 6.2 While the form and content of Royal Mail's business plans is a matter for Royal Mail to decide, in this Section 6, we propose 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 is 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 discussed below for assessing the financial sustainability and efficiency.

Current requirements

- 6.3 We currently have the following requirements in the RAG specific to Royal Mail's business plans:⁵¹
- a) the business plan must set out the revenues and costs of the Reported Business separately from that of the Relevant Group;
 - b) Royal Mail must provide quarterly forecast revenues and costs of the Reported Business alongside the quarterly regulatory accounts of the Reported Business; and
 - c) if there are material presentational or methodological changes from the previous business plan, Royal Mail must restate the information relating to the previous business plan together with explanatory notes.
- 6.4 In the USPAC and the RAG, we distinguish between the Strategic Business Plan and the Annual Budget, with the latter being part of the former and covering the first forecast year. In the current USPAC 1.3.9,⁵² we require Royal Mail to submit to us the Strategic Business Plan and the Annual Budget:
- a) in relation to each financial year (starting in late March / early April and ending in late March) before the commencement of the financial year to which it relates; and
 - b) in relation to any subsequent updates during the financial year, when the update has been approved by Royal Mail.

⁵¹ *Regulatory Accounting Guidelines as at January 2014*, Table 2, page 11.

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

⁵² *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.

Our assessment of the current requirements

6.5 Royal Mail's 2016 business plan submission to Ofcom included presentations and a suite of models (i.e. a number of Excel models) covering the following broad areas:

- a) [REDACTED];
- b) [REDACTED];
- c) [REDACTED]; and
- d) [REDACTED].

6.6 However, while the broad level of content made available through the business plans has been consistent, Royal Mail has over the years changed both the content of and its approach to its business plans. We have experienced issues with the current arrangements which have required both us and Royal Mail to spend considerable time and effort to obtain the information we require on a consistent basis. The issues can be categorised as:

- obtaining information for the Reported Business - Most of our reporting requirements focus on the Reported Business. Royal Mail, however, does not recognise the Reported Business as a separate business unit and carries out its relevant business planning at UKPIL⁵³ level;
- difficulties in comparing the business plans on a like-for-like basis;
- lack of clarity on where certain central adjustments have been allocated;
- lack of sufficiently granular data in certain areas of the plan; for example, the type of costs included in certain aggregated costs lines;
- obtaining costs consistent with our regulatory decisions; for example, people costs with pension costs restated on a cash basis rather than the rate calculated using the accounting standards; and
- [REDACTED].

6.7 The purpose of Royal Mail's business planning is to assist it in its management of the company. The company is best placed to decide on the most effective business planning process including the content of its plans, and it is not for the regulator to tell the company how to do this. However, we have a duty to secure the provision of the universal postal service and, given the difficulties we have experienced in obtaining consistent information to sufficiently understand Royal Mail's forecasts in relation to financial sustainability and efficiency, we are proposing to update the reporting requirements to ensure we get the information we need to fulfil these duties. Therefore, to the extent that the information we need is not set out in the business plan, we will require Royal Mail to provide it with the business plan submission.

⁵³ 'UK Parcels, International and Letters', which is the operating unit of Royal Mail that includes the Reported Business, ParcelForce Worldwide and Royal Mail Estates Limited – See Figures 8.2 and 8.3.

Our proposals

6.8 We propose to retain the current requirement for Royal Mail to provide Ofcom with its most current Strategic Business Plan and Annual Budget (before the start of a new Financial Year and when a new Strategic 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 proposed modified RAG in set out in Annex 6 to this consultation):

- forecast income statement, balance sheet and cash flow statement for the Relevant Group;
- 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;
- 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 basis⁵⁴);
- forecast income statement of the Reported Business supporting the Financeability EBIT;
- breakdown
 - of forecast revenues and volumes in V4 Format⁵⁵ and showing separately any contingencies provided against the revenues of any products or product groups;
 - forecast Cost Matrix (also see Section 5 of this consultation);
 - forecast PVEO Analysis (also see Section 5 of this consultation);
 - detailed workload calculations including a reconciliation of revenue-derived and operational volumes;
 - forecast
 - Gross Hours Reduction and Productivity calculations, broken down by the relevant pipeline elements (e.g. delivery and processing) and format, also restated based on the definitions in the Strategic Business Plan submitted to Ofcom on 14 May 2015;
 - forecast headcount and FTEs broken down between frontline, management and other staff;
 - explanation

⁵⁴ International Accounting Standard 19 - Employee Benefits (2011), which outlines the accounting requirements for employee benefits, including short-term benefits (e.g. wages and salaries, annual leave), post-employment benefits such as retirement benefits, other long-term benefits (e.g. long service leave) and termination benefits.

⁵⁵ V4 product categorisation is a single billing code or grouping of similar billing codes.

- of the main assumptions underpinning the Business Plan and its key drivers;
- a statement of changes to the forecast revenues and costs between the current Business Plan being submitted and the previous Business Plan;
- the relevant comparative historical information in the above for previous two Financial Years immediately preceding the first forecast Financial Year; and
- sensitivity analyses on the key inputs including a restatement of the relevant calculations and outputs assuming those risks materialise.

6.9 From our four overarching objectives, we have identified monitoring financial sustainability and monitoring efficiency as the objectives which are relevant to the information we can obtain from the Business Plans.

6.10 In the following tables, we have set out which questions, under each of the above objectives, we consider our proposed requirements would help answer:

Table 6.1: Monitoring financial sustainability

Questions for our regulation	Proposed information
<i>Is the Reported Business earning and expected to earn a reasonable commercial rate of return within the medium-to-long term?</i>	<ul style="list-style-type: none"> Forecast income statement of the Reported Business supporting the Financeability EBIT
<i>Do the cash flow projections of the Relevant Group show that it can meet its cash requirements in the short-to-medium term?</i>	<ul style="list-style-type: none"> Forecast income statement, balance sheet and cash flow statement for the Relevant Group 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 IFRS basis)
<i>Do the financial health metrics (e.g. FFO/Net Debt), when applied to the actual results/forecast projections, indicate that the Relevant Group's investment grade status is/would be threatened in the short to medium-term?</i>	<ul style="list-style-type: none"> 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
<i>What are the key financial performance drivers contributing to the rate of return of the Reported Business (e.g. product volumes and revenues, cost categories) and how are these drivers performing?</i>	<ul style="list-style-type: none"> Forecast income statement of the Reported Business supporting the Financeability EBIT Breakdown of forecast revenues and volumes in V4 Format and showing separately any contingencies provided against the revenues of any products or product groups Forecast Cost Matrix (also see Section 5 of this consultation) Forecast PVEO analysis (also see Section 5 of this consultation) Detailed Workload calculations including revenue-derived volumes to operational volumes bridge Forecast Gross Hours Reduction, and Productivity calculations, broken down by the relevant pipeline elements and format, also restated based on the definitions in the Strategic Business Plan submitted to us on 14 May 2015 Forecast Headcount and FTEs broken down between frontline, management and other staff Explanation of the main assumptions underpinning and the key drivers A statement of changes in the forecast revenues and costs between the current Business Plan being submitted and the previous Business Plan The relevant comparative historical information in the above for previous two Financial Years immediately preceding the first forecast Financial Year Sensitivity analyses on the key inputs including a restatement of the relevant calculations and outputs assuming those risks materialise

Table 6.2: Monitoring efficiency

Questions for our regulation	Proposed information
<p><i>How does Royal Mail's actual efficiency performance compare to its budgeted efficiency levels and the efficiency targets it set out in its 2015 Business Plan?</i></p> <p><i>How do Royal Mail's latest efficiency targets compare to its historic performance and to the targets it set out in its previous Business Plans (particularly with respect to its 2015 Business Plan)?</i></p> <p><i>Is Royal Mail's planned and actual level of efficiency improvement reasonable?</i></p>	<ul style="list-style-type: none"> • Forecast Cost Matrix (also see Section 5 of this consultation) • Forecast PVEO analysis (also see Section 5 of this consultation) • Detailed workload calculations including revenue-derived volumes to operational volumes bridge • Forecast Gross Hours Reduction, and Productivity calculations, broken down by the relevant pipeline elements and format, also restated based on the definitions in the Strategic Business Plan submitted to us on 14 May 2015 • Forecast Headcount and FTEs broken down between frontline, management and other staff • Explanation of the main assumptions and the key drivers • The relevant comparative historical information in the above for the previous two Financial Years immediately preceding the first forecast Financial Year • Sensitivity analyses on the key inputs including a restatement of the relevant calculations and outputs assuming those risks materialise • Explanation of the main assumptions and the key drivers of the business plan • A statement of changes in the forecast revenues and costs between the current Business Plan being submitted and the previous Business Plan

Question 3: *Do you agree with our proposals regarding the business planning information, as presented in Section 6?*

Section 7

Cost data and change control

Introduction

- 7.1 Royal Mail's regulatory financial reporting framework includes a number of transparency requirements. These include a change control process relating to the regulatory accounting and costing methodology, as well as a requirement to provide Ofcom 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. These requirements provide us and the stakeholders with important information to achieve the objectives of financial regulatory reporting regime (see Section 3).
- 7.2 These transparency requirements help us understand how Royal Mail allocates its costs to activities and products, how and why these allocations change over time, and what the impact of those changes was. This understanding is essential for informing our work on assessing and monitoring financial sustainability and efficiency and monitoring how Royal Mail is using its commercial freedom (i.e. how its revenue streams compare with the costs allocated to those streams) and the impact of this on both consumers and competitors.
- 7.3 We are proposing to update and simplify our requirements for costing data submission and change control. The proposed changes will provide us more transparency in areas where it is needed, and ease the reporting burden on Royal Mail where there is no longer an essential need.

Current requirements

Cost data

- 7.4 We currently require the following costing data submissions from Royal Mail (in accordance with the current USPAC 1.6.1 and 1.6.2⁵⁶ and paragraph 6.6 of the current RAG⁵⁷):
- a) Full year input and output costing data from Royal Mail's Activity Based Costing (ABC) system annually to allow us to build our Cost Allocation Model (CAM); and
 - b) Output of Royal Mail's ABC system quarterly (costs allocated to all activities and products at SPHCC level).
- 7.5 Royal Mail publishes its 'ABC Costing Manual'⁵⁸ which is updated quarterly if necessary. This manual is required under USPACs as the Costing Methodology

⁵⁶ 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.

⁵⁷ Regulatory Accounting Guidelines as at January 2014

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf

⁵⁸ <http://www.royalmailgroup.com/sites/default/files/ABC%20Costing%20Manual%20%202016.pdf>

Manual.⁵⁹ It is required to set out, subject to commercial confidentiality, all the information that a competent user of Royal Mail's regulatory reports may need in order to understand how costs are allocated. The confidential parts of the Costing Methodology Manual and the costing data submissions are submitted to us as part of the confidential Technical Appendices.

Change control

- 7.6 The change control process helps us understand how:
- costs change from one period to another purely as a result of the changes Royal Mail makes to the regulatory costing methodology; and
 - other items of financial reporting, i.e. revenues, assets, liabilities, and cash flows change from one period to another, purely as a result of a change in the regulatory accounting methodology.
- 7.7 The change control requirements relating to costing provide us with further transparency on how and why Royal Mail's treatment and allocation of its costs to activities and products changes over time, and what the impact of those changes is. This information helps us develop a better understating of the costs of Royal Mail's activities and products. This understanding is essential for informing our work on monitoring Royal Mail's efficiency and monitoring the impact of Royal Mail's commercial freedom in pricing on competition and consumers.
- 7.8 The change control rules require Royal Mail to notify us of any material changes to the accounting and costing methodology manuals seven days before those changes are implemented (current USPAC 1.6.3⁶⁰). We understand that, in practice, Royal Mail implements changes on a quarterly basis and reports to us the changes it considers material every quarter.
- 7.9 We provide guidance on what types of changes we consider to be material in the RAG.⁶¹ A material change is defined in the RAG as one which results in:
- a change of over 1% and £0.5m in any product or activity cost in Royal Mail's ABC system; or
 - a change of 5% in any other item (including revenues, costs, assets, liabilities, and cash flows) in any of Royal Mail's regulatory accounts.
- 7.10 The quarterly change control submissions are required to include a description of the changes and the impact that they had on the affected items in the regulatory reports, including the costs of all the affected activities and products (at SPHHC level) and the total costs of universal service, non-universal service and access products.
- 7.11 The auditors of the regulatory accounts are required every financial year to provide an opinion on whether Royal Mail has complied with the change control requirements in that financial year.⁶²

⁵⁹ Royal Mail's Regulatory Accounting Methodology covers all areas of accounting apart from costing and is described in a separate manual provided to us on a confidential basis.

⁶⁰ *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.

⁶¹ *Regulatory Accounting Guidelines as at January 2014*, paragraph 2.1(f).

https://www.ofcom.org.uk/_data/assets/pdf_file/0027/35766/regulatory_accounting_guide.pdf.

Assessment of current requirements and our proposals

- 7.12 As we explain above, the current transparency requirements have been an essential element of the regulatory reporting framework since March 2012. We consider the changes we propose below will make costing data submissions more targeted and the change control submission more transparent:
- a) quarterly output of Royal Mail's ABC system to be simplified to include only product costs at Short SPHCC level not SPHCC level, and without the breakdown into activities, and to be integrated into the proposed quarterly volume, revenue and cost data extract (see Section 4, the proposed modified USPAC 1.4.1(l) set out in Annex 5 to this consultation, and Table 4 of the proposed modified RAG set out in Annex 6 to this consultation); and
 - b) add the following information to the impact analysis required as part of the change control submissions (see Appendix 3 to the proposed modified RAG set out in Annex 6 to this consultation):
 - i) quarterly income statement for the Reported Business and separated income statement for the universal service and non-universal service products to be restated as if the changes in the accounting or costing methodology in the previous quarters of the financial year had not been made;
 - ii) the combined impact of all the changes made in the accounting and costing methodology in the previous quarters of the financial year on the costs and revenues of all affected Short SPHCCs; and
 - iii) the impact of the individual changes made in the costing methodology in the previous quarters of the financial year on total downstream and upstream costs of the Reported Business.

Cost data

- 7.13 As we explain in Section 4, we are proposing to require quarterly granular volume and revenue data to enable us to produce the existing quarterly accounting separation reports (four FREs and PPSs) and other separated income statements we need. To do that, we will also need product cost data.
- 7.14 The quarterly output of Royal Mail's ABC system which we currently require provides product costs at SPHCC level. For the purposes of own-generated accounting separation reports, we consider cost data at Short SPHCC will be sufficient. We do not consider that the quarterly cost data at SPHCC level is likely to be essential to our work in future.
- 7.15 The quarterly output of Royal Mail's ABC system also includes a breakdown of product costs into activities. We consider the full year input and output costing data submission from Royal Mail's ABC model – which allows us to build the CAM on an annual basis – would provide us with sufficient transparency as to how Royal Mail allocates its costs to activities and products and how these allocations change over time.

⁶² *Royal Mail Regulatory Financial Statements 2015-16, July 2016, page 22.*
<http://www.royalmailgroup.com/sites/default/files/2015-16%20Regulatory%20Financial%20Statements.pdf>.

- 7.16 We therefore propose to require quarterly cost data at Short SPHCC level (instead of the current SPHCC cost data we receive) and without the breakdown into activities. We also propose this cost data should be integrated into the proposed quarterly volume and revenue data extract (see Section 4). This will simplify the submissions package for Royal Mail and facilitate our use of the data.

Change control

- 7.17 Our proposals aim to enhance the transparency on the impact of the changes made by Royal Mail to the accounting and costing methodologies. We propose to require Royal Mail to include in its change control submissions a restatement of the quarterly income statement for the Reported Business and separated income statement for the universal service and non-universal service products.
- 7.18 The restated reports set out in paragraph 7.12 (b)(i) shall be prepared as if the changes made in the accounting or costing methodology in the previous quarters of the financial year had not been introduced. By comparing these restated reports with the main quarterly income statements – which reflect the effect of all the changes made in the financial year – we could gain a better understanding of how the changes impact on Royal Mail's overall profitability and the profitability of specific product groups and/or parts of the pipeline.
- 7.19 We also propose to require Royal Mail to provide the combined impact of all the changes made in the accounting and costing methodology in the previous quarters of the financial year on the costs of all affected Short SPHCCs. As we explain in Section 4, we propose to receive from Royal Mail granular volume, revenue and cost data to enable us to prepare separated income statements (including PPSs). 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 any new separated income statement, which we will generate ourselves, is affected by the changes to the accounting and costing methodologies.
- 7.20 Finally, we propose to require Royal Mail to show the impact of the individual changes on total upstream and downstream costs of the Reported Business. This information will provide us with further transparency on how the split of costs between upstream and downstream costs is evolving which is important in helping us monitoring competition and potential margin squeeze issues.
- 7.21 We have set out the proposed new templates, which reflect the above proposals, in Appendix 3 to the proposed modified RAG in Annex 6 to this consultation.
- 7.22 In conclusion, 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.

Question 4: *Do you agree with our proposals regarding cost data and change control, as presented in Section 7?*

Section 8

Reporting deadlines and Relevant Group definition

Introduction

- 8.1 In this Section 8, we address two further areas that we propose changes to:
- a) 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
 - b) the definition of the Relevant Group, as the structure of the Royal Mail group of companies has undergone significant changes since the 2012 Statement.

Reporting deadlines

Annual and quarterly regulatory accounts

- 8.2 We propose to remove most of the current accounting separation requirements, including the separation of the income statement, statement of capital employed and cash flow statement of the Reported Business into four FREs, as well as the vast majority of the PPSs (see Section 4).
- 8.3 These proposals will make both the annual and the quarterly regulatory accounts considerably smaller, and we expect this will considerably reduce the time and effort Royal Mail needs for the preparation of the regulatory accounts. We also expect the reduction in requirements for the annual regulatory accounts would reduce the time needed for the audit of those regulatory accounts.
- 8.4 In light of the above, we propose to reduce the deadline for submission of the annual regulatory accounts from 120 days to 90 days after the end of each Financial Year⁶³ (see our proposed modified 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 5 to this consultation), and the deadline for submission of the quarterly regulatory accounts from 60 days to 45 days after the end of each Financial Quarter⁶⁴ (see our proposed modified USPAC 1.4.9 (a) and 1.5.10(b) set out in Annex 5 to this consultation).
- 8.5 Reducing the deadlines for the regulatory accounts will enable us to complete our internal quarterly monitoring reports and publish our annual monitoring report earlier. Royal Mail publishes its first and third quarter trading updates just over 20 days after the quarter ends. It publishes its half yearly and full year financial reports just over 50 days after the period ends. Royal Mail publishes its annual report in June. To be able to complete our internal quarterly monitoring reports and publish our annual

⁶³ Financial Year means any period of twelve consecutive months for which the annual statutory financial statements of Royal Mail plc are prepared, the most recent twelve months period of which ended on 27 March 2016.

⁶⁴ Financial Quarter means each period of three consecutive months comprised in the Financial Year, the first quarterly period of which begins with the first month of the Financial Year.

monitoring report closer to these dates would provide us and stakeholders with more timely information about how our regulation of Royal Mail is progressing.

Other submissions

- 8.6 We currently receive granular cost and volume data from Royal Mail on a quarterly basis, 60 days after each Financial Quarter end (current USPAC 1.6.6⁶⁵). We propose to add a new requirement on Royal Mail to provide granular revenue data for each Financial Quarter (see Section 4).
- 8.7 We propose to have this granular revenue data submission alongside granular cost and volume data, all of which we propose to receive 45 days after each Financial Quarter end. This will allow us to prepare our quarterly internal monitoring reports earlier which, as we explain in the sub-section above, is important in enabling us to carry out our monitoring on a more timely basis.
- 8.8 As we explain in Section 4, we propose to reduce the frequency of the volume and revenue reports and the cost metrics reports from monthly to quarterly, while also reducing the granularity of the volume and revenue reports. We also propose to increase the deadline for these reports from 30 days after the Financial Month end to 45 days after the Financial Quarter end. This will enable Royal Mail to make all its quarterly submissions in one combined quarterly package which is internally fully consistent and reconciled. This would help prevent discrepancies which could arise from timing differences in data preparation and submission.
- 8.9 We recognise that some of the above proposals shorten deadlines, but other proposals above lengthen the deadlines and reduce the frequency and granularity of the reports. All in all, we consider the net effect of the above proposals would be to reduce the reporting burden for Royal Mail.
- 8.10 Other reductions in the above requirements which will help reduce the reporting burden further are our proposals to reduce the granularity of the quarterly cost and volume data submission from SPHCC level to Short SPHCC level and to remove the requirement to provide a breakdown by activities (see Section 4 for details).
- 8.11 Our proposals above regarding changes in the reporting deadlines are reflected in our proposed modified USPAC 1.4.9 (e), 1.6.6 and 1.6.8 set out in Annex 5 to this consultation.
- 8.12 Under DUSP 2.2.4 and 3.2.4⁶⁶, we require Royal Mail to provide us with the data necessary for us to monitor compliance with the Second Class safeguard caps. Currently, Royal Mail is required to provide this to us within three months of the end of the year in which the cap applied. However, the safeguard cap for large letters and parcels is based on historical volume information. Royal Mail will therefore have had the historical data needed for the safeguard cap to undertake the calculations and analysis required for submission to us before it sets its prices for each financial year.
- 8.13 Earlier submission of this information would allow us to assess whether Royal Mail's prices are compliant with the safeguard cap at an earlier stage and, as the

⁶⁵ 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.

⁶⁶ 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.

information should be available in any event, we do not consider this will cause any onerous reporting burden on Royal Mail.

- 8.14 We therefore propose to require Royal Mail to provide the data necessary to monitor compliance with the safeguard caps one month after the implementation of any new prices (see proposed modified DUSP set out in Annex 8 to this consultation). For the avoidance of doubt, if Royal Mail were to increase its Second Class stamp prices more than once a year, we would expect it to provide this data one month after the implementation of the actual price rises.
- 8.15 The following table shows the current and proposed new deadlines for those Royal Mail submissions we propose to change (we do not propose to change any deadlines which are not included below):

Table 8.1: Proposed changes to the regulatory reporting submission deadlines

Submissions	Current deadline	Proposed 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	45 days after Financial Quarter end
Quarterly revenue and volume report Currently required monthly	30 days after Financial Month ⁶⁷ end	45 days after Financial Quarter end
Quarterly cost metrics report Including RDT to workload bridge, currently required monthly	30 days after Financial Month end	45 days after Financial Quarter end
Quarterly revenue, volume and cost granular data submission Currently only granular volume and cost data required quarterly	60 days after Financial Quarter end	45 days after Financial Quarter end
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

8.16 Royal Mail often publishes its half-yearly and year-end results announcements a few days later than 45 days after the period ends. It is therefore possible that Royal Mail could make further changes to its financial data after it has submitted the quarterly reports to us within our proposed 45 days' deadline. In such circumstances, we expect Royal Mail to provide us with information about the material changes that have been made and their impact on the key metrics included in the quarterly reports, such as Financeability EBIT and productivity figures.

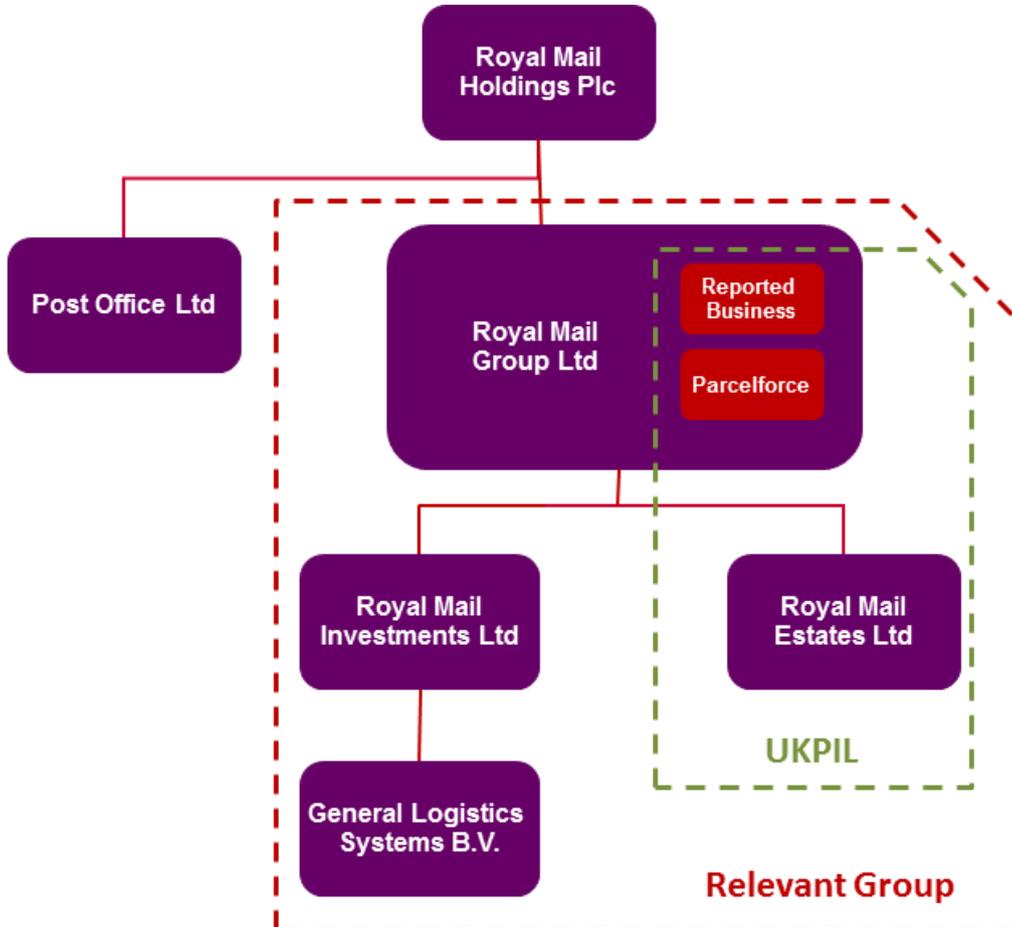
Question 5: Do you agree with our proposals regarding reporting deadlines, as presented in Section 8?

⁶⁷ Financial Month means each month comprised in the Financial Year.

Definition of the Relevant Group

8.17 The Relevant Group is currently defined in the current USPAC 1.1.2(v), and it effectively encompasses the whole of Royal Mail group of companies at the time (March 2012) excluding Royal Mail Holdings plc (RMH plc) and Post Office Limited (POL). Figure 8.2 illustrates the definition:

Figure 8.2: Current definition of the Relevant Group as per USPACs



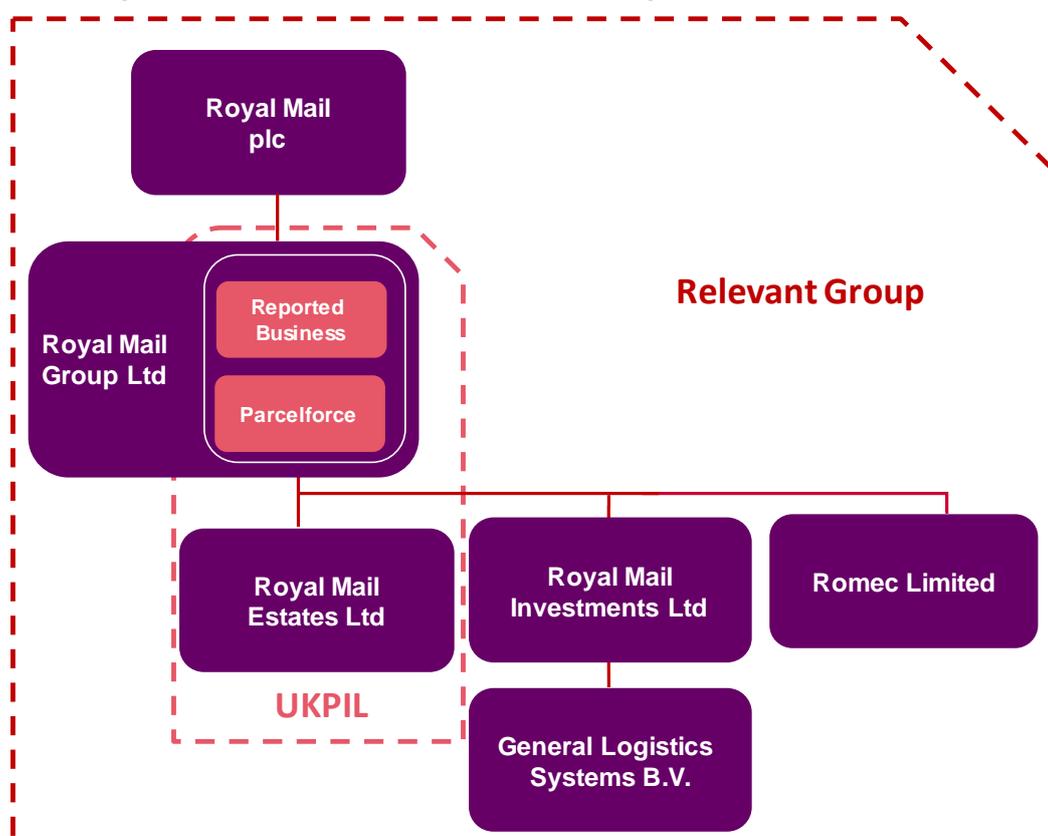
8.18 Since the formulation of this definition in March 2012, the structure of Royal Mail companies group has undergone significant changes. POL was removed from the Royal Mail group of companies on 1 April 2012 by the Government. The new ultimate parent company of the group is currently Royal Mail plc, which is the company listed on the London Stock Exchange.

8.19 As we explain in Section 3, one of our objectives for regulatory reporting is to be able to assess the financial sustainability of the provision of the universal service. In order to do that, as we explain in Section 4, we need to consider the financial results of the Reported Business. However, we also need to have sufficient understanding of the financial results and position of Royal Mail at the level of the group structure where all cash resources and borrowings are managed and key investment decisions are made. Shareholders, investors and analysts also consider Royal Mail's financial prospects and health at this level. We intend the Relevant Group to capture this level of group structure, which is currently at the level of Royal Mail plc.

8.20 We therefore propose 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).⁶⁸ The proposed definition is illustrated in Figure 8.3:

Figure 8.3: Proposed definition of the Relevant Group



- 8.21 We currently require Royal Mail to prepare its income statement, balance sheet and cash flow statement for the Relevant Group on an annual basis.⁶⁹ Our proposed definition of the Relevant Group means 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.
- 8.22 We also currently require⁷⁰ Royal Mail to reconcile those statements to the corresponding statements for RMH plc. Our proposed definition of the Relevant Group makes this requirement redundant.
- 8.23 We therefore propose to remove the above requirements from the USPAC (see Annex 5 to this consultation).

Question 6: Do you agree with our proposals regarding relevant group definition, as presented in Section 8?

⁶⁸ See proposed modified USPAC 1.1.2(r), set out in Annex 5 to this consultation.

⁶⁹ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.3.1(a), (b) and (c).

https://www.ofcom.org.uk/data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf.

⁷⁰ Consolidated Version of USP Accounting Condition as at January 2014, current USPAC 1.3.1(f).

https://www.ofcom.org.uk/data/assets/pdf_file/0015/31731/usp_accounting_condition.pdf.

Section 9

Margin squeeze

Introduction

- 9.1 Access operators collect, sort and transport bulk mail from business customers and then hand it over to Royal Mail for delivery to the final recipient. Access competition continues to be the main form of competition in the letters market in the UK and has brought various benefits for business customers, such as lower prices.
- 9.2 In March 2012, we put in place a Universal Service Provider Access condition (USPA) which requires Royal Mail to grant access to its network at inward mail centres for the provision of retail D+2 and later than D+2 letter and large letter services. We do not directly regulate the access prices, and Royal Mail has the freedom to set its prices in a way that covers the costs of the network. However, we have in place an *ex-ante* margin squeeze control⁷¹ (USPA 6) that is designed to ensure that the difference between Royal Mail's access price and the equivalent retail price is consistent with principles that allow effective competition between Royal Mail and access operators.
- 9.3 We believe that this margin squeeze control has been an effective remedy in protecting access competition. However, its implementation has not been without challenges. The application of the control at the granular level of costs, the changes in Royal Mail's costing system and data preparation timings, and the complexities of the contract negotiating process have highlighted areas in which the condition may be improved to clarify how the margin squeeze control set out in USPA 6 should work.
- 9.4 Our proposals include changing Royal Mail's reporting timeline and clarifying some of the requirements for reporting which should enable us to obtain information that is more relevant in determining Royal Mail's compliance with USPA 6. We also propose to clarify certain terms and definitions used in USPA 6.

Current requirements

- 9.5 USPA 6 is designed to protect competition in the upstream parts of the market, which includes collection, initial sortation and transportation activities. It does so by ensuring there is sufficient upstream margin for effective competition – largely access operators – to continue operating. Royal Mail is therefore required to take all reasonable steps in pricing its products to ensure there will be sufficient upstream revenue to cover all relevant upstream costs on a FAC basis.
- 9.6 USPA 6 covers all Second Class Mailsort and Walksort services, and any current, new or successor retail services that were substantially similar services, offered by Royal Mail.⁷² Royal Mail has changed its access services since then, and USPA 6 currently includes the successor products of all Second Class letter and large letter

⁷¹ Consolidated version of USP Access Condition as at February 2014, USPA 6.

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

⁷² Consolidated version of USP Access Condition as at February 2014, USPA 1.3(x).

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

products offered as Business Mail, Advertising Mail, Sustainable Advertising Mail, and Royal Mail 48.

- 9.7 The margin squeeze control includes two tests. These tests are required to be performed at the start of each financial year and thereafter quarterly. The tests must use forecast revenues and costs because USPA 6 requires that Royal Mail has a reasonable expectation that it passes the tests in that financial year. The two tests are:
- a) the basket test – total relevant upstream revenues of all USPA 6 products must be equal to or greater than the total relevant upstream costs of those products; and
 - b) the contract test – for any new contract which includes products subject to USPA 6, the total relevant upstream revenues of the USPA 6 products in the contract must be equal to or greater than 50% of the total relevant upstream costs of those products.
- 9.8 To perform these tests, Royal Mail is required to calculate the relevant upstream revenues from the products within the scope of USPA 6 as the difference between end-to-end retail revenues and the relevant downstream revenues of the products. The relevant downstream revenues are calculated by assuming the unit downstream revenues for USPA 6 products are equal to the prices of their equivalent access products (as if Royal Mail provided itself with access products as well).
- 9.9 Relevant upstream costs for the tests are calculated as the end-to-end costs of USPA 6 products less the costs of equivalent access products. The cost standard used is based on FAC excluding general overheads but including returns.
- 9.10 In March 2012, we explained that our preferred long-term approach to addressing the risk of margin squeeze was to monitor Royal Mail's costs and revenues to assess the impact of its pricing on competition, as opposed to imposing an *ex-ante* control on Royal Mail's pricing. We also considered that LRIC costs provided the correct signals for entry in the market and that Royal Mail should set its prices to maintain a minimum LRIC margin between its access prices and the equivalent retail prices (subject to guidance from the regulator regarding the derivation of LRIC costs).⁷³
- 9.11 We recognised in March 2012 that robust LRIC information was not available. Therefore, we decided that an *ex-ante* margin squeeze control based on FAC was the best option at that point in time.
- 9.12 We have engaged with Royal Mail as it has developed its LRIC modelling over an extended period of time, and it has made some improvements to its model based on this engagement. We recently concluded that there were a number of limitations to the model's structure, methodology, and transparency of the underlying data, which meant that it was not suitable for our regulatory purposes, specifically, for the purpose of assessing compliance with the margin squeeze test imposed under USPA 6 by reference to LRIC.

⁷³ *Securing the Universal Postal Service, Decision on the new regulatory framework, 27 March 2012*, paragraphs 10.89-10.90. https://www.ofcom.org.uk/_data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.

- 9.13 However, we still consider that assessing margin squeeze by reference to LRIC costs is likely to be the most appropriate approach in the longer term subject to appropriate LRIC data being available.
- 9.14 To demonstrate that Royal Mail complies with the margin squeeze control, USPA 6 requires it to submit the following information every quarter:
- a) details of forecast and actual revenues and costs showing how the tests are performed;
 - b) the prices, volumes, length and signing date of each new or materially amended contract; and
 - c) any other information that Ofcom considers necessary to ensure compliance.
- 9.15 There has been one modification since March 2012 to clarify the treatment of VAT in USPA 6.⁷⁴ The modification was made to ensure recoverable and unrecoverable VAT are both excluded from the relevant costs used in the margin squeeze tests (see paragraph 9.7).

Our assessment of the current requirements and our proposals

- 9.16 We have reviewed the current USPA 6 and considered it in the light of our experience with the submissions we have received from Royal Mail and our experience with the process of checking compliance. We have also considered proposals for change to how the margin squeeze test works in practice suggested by Royal Mail.
- 9.17 We set out below some minor amendments to USPA 6 for the purposes of clarifying how the margin squeeze control works and how Royal Mail can ensure compliance with it.

Reasonable expectation

- 9.18 USPA 6.2 requires that Royal Mail “must have a reasonable expectation” that both basket and contract tests are satisfied. USPA 6.2 does not currently set out at which point in time Royal Mail must have such a reasonable expectation, although USPA 6.1 requires that Royal Mail “shall in setting prices be subject to the requirement to take all reasonable steps...”.
- 9.19 We therefore propose to amend USPA 6.2 to make clear our intention that Royal Mail must have a reasonable expectation that the margin squeeze tests in USPA 6 are satisfied at the time of setting new prices (see proposed modified USPA set out in Annex 7 to this consultation). We expect Royal Mail’s reasonable expectation to be informed by the latest revenue, cost and volume⁷⁵ forecast information available at that time.
- 9.20 With respect to new contracts that Royal Mail is attempting to win, Royal Mail must have a reasonable expectation that the margin squeeze tests are satisfied at the time

⁷⁴ Notice of modification to the control preventing Royal Mail margin squeeze, January 2014. <https://www.ofcom.org.uk/consultations-and-statements/category-2/royal-mail-margin-squeeze>.

⁷⁵ Volume forecasts affect the calculation of relevant upstream costs because they affect the calculation of unit costs.

it offers prices for any new contract. This includes not only ensuring that the contract prices satisfy the contract test, but also that the basket test is satisfied when the new contract is included in the basket.

- 9.21 We also expect Royal Mail to consider the need to update its annual forecast of relevant costs and revenues in light of any newly won or lost contracts which were not foreseen at the time the annual forecast was prepared. We consider this updating should happen at the time of offering prices for a new contract. It should also be reflected in the forecast costs and revenues used in Royal Mail's margin squeeze quarterly submissions that follow the update.

Calculation of relevant upstream costs

- 9.22 Royal Mail is required to calculate the relevant upstream costs and revenues to demonstrate it satisfies both basket and contract tests.
- 9.23 To calculate the relevant upstream costs in compliance with USPA 6.4⁷⁶, Royal Mail currently takes the end-to-end unit costs of the products that are subject to the margin squeeze tests, and subtracts the unit cost of the equivalent access product⁷⁷ to arrive at the relevant upstream unit cost.
- 9.24 Once the relevant upstream unit costs are calculated, they are used to calculate the relevant upstream costs of the whole basket or individual contracts by applying the volumes of the relevant products to their calculated upstream unit costs.
- 9.25 Royal Mail has identified an alternative method to calculate the relevant upstream costs ('the Direct Method'). This involves adding up the costs of the upstream activities (mainly collections, outward sortation at RDCs⁷⁸ and transportation to the inward mail centres) of the products subject to the margin squeeze tests and then subtracting any wholesale specific costs⁷⁹. This contrasts with the current method which could be called the 'Indirect Method' because it calculates relevant upstream costs by subtracting access costs from end-to-end retail costs.
- 9.26 Royal Mail has made submissions to us to argue that the Direct Method would:
- b) require less work, as the calculation is less complex due to the fact it avoids the need for granular matching of the margin squeeze test products to equivalent access products (at sub product level); and
 - c) result in a value for relevant upstream costs which is not materially different from the Indirect Method.
- 9.27 In theory, the Direct Method and Indirect Method should give the same results for the relevant upstream costs. This is because the downstream costs of the products subject to margin squeeze tests should be the same or similar to the downstream costs of their access equivalents. These costs relate to the activities of inward processing and indoor and outdoor delivery, which should be the same for both Royal Mail's retail bulk mail and Royal Mail's access mail.

⁷⁶ Consolidated version of USP Access Condition as at February 2014.

https://www.ofcom.org.uk/data/assets/pdf_file/0013/12811/usp_access.pdf.

⁷⁷ All unit costs exclude recoverable and irrecoverable VAT as per USPA 6.4.

⁷⁸ RDCs are Regional Distribution Centres, which are dedicated to outward processing of bulk mail.

⁷⁹ Wholesale Specific Costs are costs that relate solely to access products such as managing access and revenue protection.

- 9.28 Our analysis shows that in practice the Direct Method results in slightly lower total relevant upstream costs for the whole basket than the Indirect Method. However, Royal Mail's submission shows that there are significant differences between the downstream costs allocated to some retail bulk products and the costs of their equivalent access products. We have sought from Royal Mail further explanations regarding these individual product differences. However, we do not consider that the information Royal Mail has so far provided to us adequately explains or fully resolves these significant differences. Therefore, we do not consider there is sufficient evidence to show that it is appropriate to adopt the Direct Method.
- 9.29 The last paragraph in USPA 6.4⁸⁰ also sets out a principle which Royal Mail must apply when calculating relevant upstream costs. The intention of the principle is that in calculating relevant upstream costs of the retail products subject to the margin squeeze tests, the downstream costs of equivalent access products must be 'deducted' from the end-to-end costs of those retail products only to the extent that those downstream costs are incurred in a directly comparable manner between the access products and the retail products.
- 9.30 USPA 6.4, however, currently uses the word 'exclude' which could be clearer if we change it to 'deduct'. We therefore propose to make this change for clarification (see proposed modified USPA set out in Annex 7 to this consultation).

Calculation of relevant upstream revenues

- 9.31 To calculate the relevant upstream revenues in compliance with USPA 6.4, Royal Mail currently adopts the following approach: it takes the end-to-end unit revenues of the products that are subject to USPA 6, and subtracts the downstream revenues of those products calculated based on the prices of their equivalent access products.
- 9.32 According to USPA 6.3(b)⁸¹, the downstream access prices should be calculated as "the average price per unit charged". This rule ensures that the relevant downstream revenues are calculated taking account of all the prices in force.
- 9.33 Royal Mail has in place the following two types of contracts with its access customers:
- b) Condition 9 contracts which are older contracts and most access operators have switched off these contracts; and
 - c) Access letters contracts ('ALC') which are the new contracts and are used for most access customers.
- 9.34 The price for an access product should therefore be calculated as the weighted average of the prices of that product under different types of contracts (using volumes in the contracts as weights). Royal Mail has told us in the past that the weighted average access price calculation adds complexity and requires more effort with little further accuracy because the volumes under the Condition 9 contracts continue to fall and are now considerably less than the volumes under the ALC contracts.

⁸⁰ Consolidated version of USP Access Condition as at February 2014.

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

⁸¹ Consolidated version of USP Access Condition as at February 2014.

https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

- 9.35 In a letter to Royal Mail dated 1 November 2013, we said that we considered it would be reasonable for Royal Mail to use the mode price⁸² as a first order approximation of the average price when reporting for compliance purposes, providing the volume of traffic on this rate was over 50% of all traffic for a particular product.
- 9.36 We continue to consider that the general rule of using average access prices as per USPA 6.3(b) and the above guidance on using mode prices as simplifying approximation are appropriate. We therefore do not propose to revise USPA in this regard.

New contract information

- 9.37 Royal Mail is currently required to submit to us every quarter information about any new contracts that have been won. This requirement is set out in USPA 6.7(b)⁸³:
- “(b) With respect to each Relevant Contract for Relevant Retail Services that the universal service provider has entered into during the previous quarter or that has been materially amended during that quarter, the following information:*
- i. prices;*
- ii. volumes;*
- iii. date that the Relevant Contract was signed or most recently materially amended;*
- iv. length of the Relevant Contract if applicable...”*
- 9.38 The intention of this clause is to require Royal Mail to provide us with information about the contracts that Royal Mail has won in the financial quarter that has just ended. However, the reference to “the previous quarter” in the text above may be taken to suggest a period prior to that sought. For example, if Royal Mail is making a submission at the end of June, our intention is, and has always been, that Royal Mail must provide information about the new contracts that were won in the financial quarter that ended in June, not in the previous quarter ending in March.
- 9.39 We therefore propose to amend the wording to clarify the intention of the requirement (see proposed modified USPA set out in Annex 7 to this consultation).
- 9.40 USPA 6.7(b) also requires Royal Mail to provide information about contracts which have been “materially amended” during the quarter. We propose to remove the word “materially” from the condition in this respect. It is not possible to formulate a general and future-proof definition of materiality that covers prices, volumes, dates and contract lengths. Amendments must therefore be judged in light of the particular circumstances to determine whether or not they are material.
- 9.41 Therefore, we propose to make clear that Royal Mail is required to submit all amendments. We do not expect this to lead to a significant increase in the amount of information Royal Mail is required to provide on individual contracts (see proposed modified USPA set out in Annex 7 to this consultation).

⁸² The mode price is the price which has the highest volume.

⁸³ Consolidated version of USP Access Condition as at February 2014, USPA 6.
https://www.ofcom.org.uk/_data/assets/pdf_file/0013/12811/usp_access.pdf.

Contents of quarterly submissions by Royal Mail

- 9.42 USPA 6.7(a) and (b) describe the information Royal Mail is required to submit every quarter. USPA 6.7(a) refers to the forecast and actual relevant upstream costs and revenues. The purpose of USPA 6.7(a) is to require Royal Mail to demonstrate how both the basket test and the contract test are applied using the forecast and actual costs and revenues (see paragraph 9.7). We recognise, however, that this may not be sufficiently clear on the face of the condition.
- 9.43 We therefore propose to amend USPA 6.7(b) to clarify that forecast and actual relevant upstream costs and revenues must demonstrate compliance with USPA 6.2(a) and 6.2(b), including the detailed calculations (see proposed modified USPA set out in Annex 7 to this consultation).

USPA Definitions

- 9.44 The definition of the Relevant Retail Services in USPA refers to all Second Class Mailsort and Second Class Walksort services, as well as any current, new or successor retail services that are substantially similar services offered by Royal Mail.
- 9.45 Royal Mail has changed its products since then, and currently USPA 6 covers the following successor products: all Second Class letter and large letter products offered as Business Mail, Advertising Mail, Sustainable Advertising Mail, and Royal Mail 48.
- 9.46 We propose to update the definition of the Relevant Retail Services to include the current product offerings (see proposed modified USPA set out in Annex 7 to this consultation).

Question 7: *Do you agree with our proposals regarding margin squeeze control, as presented in Section 9?*

Section 10

Conclusions

Introduction

- 10.1 In Section 10, we set out an outline of our proposed regulatory financial reporting framework and explain how the proposed framework meets the statutory tests for imposing regulatory conditions.
- 10.2 As explained in Section 2, this consultation is Phase I of our review of the regulatory financial reporting requirements. We also set out here our proposed timeline for the implementation of these proposals and Phase II of our review.

Outline of the new regulatory financial reporting requirements

- 10.3 The regulatory financial reporting we are proposing to require from Royal Mail is summarised in Table 10.1 below:

Table 10.1: Outline of our proposed regulatory financial reporting framework

Reports/Data submissions	Frequency	Disclosure	Audit	Deadline	Modified condition requirement (Annex 5 to this consultation)	Pro formas in proposed modified RAG (Annex 6 to this consultation)	Section in this consultation
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	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	4, 5
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	4
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 3, Figures 4 and 5	4
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	6
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	7
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	8
Cash headroom projections for the Relevant Group	Quarterly	Confidential	Not audited	Before start of Financial Quarter	USPAC 1.3.1 (a)	N/A	6
Income statement of Reported Business (including Cost Matrix and end-to-end split between	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.4.1 (b); and USPAC 1.5.2 (b)	Appendix 1, Figures 2 and 7	4, 5

Reports/Data submissions	Frequency	Disclosure	Audit	Deadline	Modified condition requirement (Annex 5 to this consultation)	Pro formas in proposed modified RAG (Annex 6 to this consultation)	Section in this consultation
universal service and non-universal service products)							
Product Profitability Statements for access and PAF	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.4.1 (j)	Appendix 1, Figure 6	4
Volume and revenue report	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figure 9	4
Cost metrics report (including volume to workload bridge)	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figures 10	6
Revenue, cost and volume data at Short SPHCC level	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.4.1 (l)	Appendix 1, Figure 11	4
Costing Methodology Manual	Quarterly	Published, except for Technical Appendices	Not audited	45 days after Financial Quarter end	USPAC 1.6.1	N/A	7
Accounting Methodology Manual	Quarterly	Confidential	Not audited	45 days after Financial Quarter end	USPAC 1.6.1	N/A	7
Change control submissions	Quarterly	Confidential	Not audited	7 days before changes are made	USPAC 1.6.3	Appendix 3	7
Margin squeeze submissions	Quarterly	Confidential	Not audited	Before start of Financial Quarter	USPA 6	N/A	9
Management accounts for the Board	Monthly	Confidential	Not audited	30 days after Financial Month end	USPAC 1.4.1 (k)	N/A	4

Assessment of statutory tests for implementing regulatory conditions

- 10.4 In Section 2 (paragraph 2.32) we explain that our proposals (summarised in Table 10.1) must satisfy relevant tests set out in Schedule 6 of the PSA 2011. We explain below why we consider our proposals satisfy those tests, namely that our proposals:
- are objectively justifiable;
 - do not unduly discriminate against a particular person or a particular description of persons;
 - are proportionate; and
 - are transparent in relation to what it is intended to achieve.
- 10.5 Our proposals are objectively justifiable because, as we have explained in the appropriate Sections of this consultation, the reporting obligations we are proposing are necessary for us to effectively achieve the objectives for regulatory financial reporting in the light of the overall decisions we made in the March 2017 Statement.
- 10.6 More specifically, we consider that these reporting obligations are objectively justifiable, as they will enable us to:
- 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;
 - 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;
 - 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
 - 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.
- 10.7 Our proposed regulatory reporting framework 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 4) also seek to reflect Royal Mail's market power in the respective markets.
- 10.8 Our proposed regulatory reporting framework is proportionate because the reporting obligations are necessary to enable us to discharge our statutory duties and

effectively monitor Royal Mail's position and activities. In our view, these obligations are no more onerous than is required to effectively achieve our objectives for regulatory financial reporting, nor do they produce adverse effects which are disproportionate to those objectives.

- 10.9 Our proposed regulatory reporting framework 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 consultation.

Proposed timeline

- 10.10 If we decide to implement the changes to the regulatory financial reporting requirements set out in this consultation, we propose that the new requirements should be formally implemented at the beginning of the 2018/19 Financial Year to give Royal Mail sufficient time to prepare to meet the new requirements.
- 10.11 Phase II of our review will focus on the costing and accounting rules which are applied by Royal Mail in preparing the regulatory financial reports. For example, Phase II will include consideration of the zonal cost modelling, consideration of whether the methodology for allocating costs between parcels and letters within Royal Mail's activity based costing FAC system remains appropriate and the transfer pricing applied to derive the upstream/downstream revenue split.
- 10.12 We currently envisage that the Phase II consultation will be published in the second half of the 2017/18 Financial Year, and the new rules to be implemented in the 2018/19 Financial Year.

Question 8: *Do you agree with our proposals regarding the proposed new regulatory financial reporting framework and our plan for its implementation, as presented in Section 10?*

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom would like to receive views and comments on the issues raised in this consultation, **by 5pm on 1 June 2017**.
- A1.2 We strongly prefer to receive responses via the online form, which you can find at <https://www.ofcom.org.uk/consultations-and-statements/category-3/review-of-regulatory-financial-reporting-for-royal-mail-consultation>. We also provide a cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>) for responses sent by email or post; please fill this in, as it helps us to maintain your confidentiality, and speeds up our work. You do not need to do this if you respond using the online form.
- A1.3 If your response is a large file, or has supporting charts, tables or other data, please email it to postal.regulation@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>).
- A1.4 Responses may alternatively be posted to the address below, marked with the title of the consultation.
- Adam Goodman or Kamak Arzhangji
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- A1.5 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.
- A1.6 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.
- A1.7 It would be helpful if your response could include direct answers to the questions asked in the consultation. The questions are listed at Annex 3. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.
- A1.8 If you want to discuss the issues and questions raised in this consultation, please contact Adam Goodman on 020 7783 4327, or by email to Adam.Goodman@ofcom.org.uk or alternatively contact Kamak Arzhangji on 020 7783 4339, or by email to Kamak.Arzhangji@ofcom.org.uk.

Confidentiality

- A1.9 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in

the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on our website, www.ofcom.org.uk, as soon as we receive them.

- A1.10 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.
- A1.11 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.12 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further at <http://www.ofcom.org.uk/terms-of-use/>

Next steps

- A1.13 Following this consultation period, Ofcom plans to publish a statement.
- A1.14 If you wish, you can register to receive mail updates alerting you to new Ofcom publications; for more details please see <http://www.ofcom.org.uk/email-updates/>

Ofcom's consultation processes

- A1.15 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 2.
- A1.16 If you have any comments or suggestions on how we manage our consultations, please call our consultation helpdesk on 020 7981 3003 or email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.17 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact Steve Gettings, Ofcom's consultation champion:

Steve Gettings
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601
Email steve.gettings@ofcom.org.uk

Annex 2

Ofcom's consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

- A2.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

- A2.2 We will be clear about whom we are consulting, why, on what questions and for how long.
- A2.3 We will consult for up to ten weeks, depending on the potential impact of our proposals.
- A2.4 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.
- A2.5 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

- A2.6 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	<input type="checkbox"/>	Name/contact details/job title	<input type="checkbox"/>
Whole response	<input type="checkbox"/>	Organisation	<input type="checkbox"/>
Part of the response	<input type="checkbox"/>	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 3

Consultation questions

A3.1 In this consultation, we are seeking input related to our regulatory financial reporting requirements.

A3.2 Below is a list of the questions in this consultation:

Question 1: *Do you agree with our proposals accounting separation requirements, as presented in Section 4?*

Question 2: *Do you agree with our proposals regarding cost and efficiency reporting, as described in Section 5?*

Question 3: *Do you agree with our proposals regarding the business planning information, as presented in Section 6?*

Question 4: *Do you agree with our proposals regarding cost data and change control, as presented in Section 7?*

Question 5: *Do you agree with our proposals regarding reporting deadlines, as presented in Section 8?*

Question 6: *Do you agree with our proposals regarding relevant group definition, as presented in Section 8?*

Question 7: *Do you agree with our proposals regarding margin squeeze control, as presented in Section 9?*

Question 8: *Do you agree with our proposals regarding the new regulatory financial reporting framework and our plan for its implementation, as presented in Section 10?*

Annex 4

Glossary

A4.1 The key terms used in this consultation are defined in

- Annex 5: Statutory Notification: proposed modification of the USP Accounting Condition (USPAC);
- Annex 6: Statutory Notification: proposed modification of the Regulatory Accounting Guidelines (RAG); and
- Annex 7: Statutory Notification: proposed modification of the USP Access condition (USPA).

A4.2 To avoid duplication and due to the technical nature of this consultation, we are not replicating these here.