Annex 3

Regulatory financial reporting

Summary

A3.1 We set out in this annex the details of the decisions we have made on our proposals relating to regulatory financial reporting which were published for consultation in October and December 2011. The annex covers the following areas:

- the Relevant Group
- the Reported Business
- National product costing
- Zonal product costing
- Long Run Incremental Costs
- Accounting separation
- Product profitability statements
- Other regulatory financial reports
- Audit
- Materiality
- Publication and disclosure

A3.2 For each area, we set out the following:

- An outline of our proposal;
- A summary of the key responses to our consultations;
- Any further analysis and/or work we have done since the consultations and /or based on the responses; and
- Our decisions together with reasons.

A3.3 The following table summarises our decisions relating to the regulatory financial reporting requirements for Royal Mail. Each item in the table is referenced to the relevant sections in the RAG set out in Annex 11, where the related pro formas are provided:

Table 1 – Summary of regulatory financial reporting requirements

Entity	Requirement	RAG pro forma – see Annex 11 Appendix 1	Frequency	Audit	Publish
Relevant Group	Consolidated income statement	Figure 1	Annual	Yes	Yes
	Consolidated balance sheet statement	Figure 2	Annual	Yes	Yes
	Consolidated cash flow statement	Figure 3	Annual	Yes	Yes
	Consolidated cash flow projection statement	N/A	Quarterly	No	No
	Strategic Business Plan	N/A	Annual	No	No
	Reconciliation of consolidated income, balance sheet and cash flow statements with the consolidated accounts of RMH plc		Annual	Yes	Yes
	Annual Budget	N/A	Annual	No	No
Reported Business – As a whole	Annual income statement	Figure 4	Annual	Yes	Yes
	Quarterly income statement	Figure 5	Quarterly	No	No
	Annual reconciliation of the quarterly income statements with the annual income statement	N/A	Annual	No	No
	Reconciliation of annual income statement with the equivalent information for the Relevant Group	Figure 9	Annual	Yes	Yes
	Annual capital employed statement	Figure 10	Annual	Yes	Yes
	Reconciliation of annual capital employed statement with the equivalent information for the Relevant Group	Figure 11	Annual	Yes	Yes
	Annual cash flow sheet statement	Figure 12	Annual	Yes	Yes
	Reconciliation of annual cash flow sheet statement with the equivalent information for the Relevant Group	Figure 13	Annual	Yes	Yes
Reported Business – Further detail	Annual product profitability statements	Figure 14	Annual	Yes	No except access, PAF & Relay
	Quarterly product profitability statements	Figure 14	Quarterly	No	No
	Monthly revenue, cost and volume information statement	Figure 15	Monthly	No	No
Reported Business– Separated	Annual income statement	Figure 4	Annual	Yes	No
	Quarterly income statement	Figure 5	Quarterly	No	No
	Annual reconciliation of the quarterly income statements with the annual income statement	N/A	Quarterly	No	No
	Annual end to end income statement (published)	Figure 6	Annual	Yes	Yes
	Annual end to end income statement (confidential)	Figure 7	Annual	Yes	No
	Quarterly end to end income statement	Figure 8	Quarterly	No	No
	Annual capital employed statement	Figure 10	Annual	Yes	No
	Annual cash flow sheet statement	Figure 12	Annual	Yes	No
Reported Business - Manuals	Updates of Costing Manual	N/A	Quarterly	No	Yes (excluding technical appendices)
	Accounting Methodology Manual, and updates	N/A	Quarterly	No	No

The Relevant Group

Scope of the Relevant Group

Our consultation proposals

A3.4 In our October consultation we explained that we required regulatory financial reporting information to properly understand and monitor the financial sustainability of universal service provision by Royal Mail, taking into account amongst other things its ability to raise external finance.

A3.5 Because Royal Mail raises such finance as a corporate entity, we proposed to monitor this ability to raise external finance at the level of the Relevant Group, which we defined as Royal Mail Group Limited, excluding POL and its associates and subsidiaries.

A3.6 We excluded POL because it is subject to separate funding and financing arrangements, including the provision of public grant funding for the provision of services of general and economic interest. Royal Mail has recently announced that it has concluded a 10-year agreement with POL under which transactions between the two companies will be undertaken on a commercial arm's length basis. While the Government has announced plans to separate the ultimate ownership of Royal Mail and POL, these plans did not directly affect our regulatory financial reporting proposals.

Consultation responses

A3.7 Most respondents including Royal Mail agreed with our proposal to define the Relevant Group on this basis for regulatory financial reporting purposes, although City Link suggested that Ofcom should scrutinise carefully the financial apportionments between POL and the rest of Royal Mail, which it suggested would need careful reconciliation in the regulatory financial reporting.

A3.8 UK Mail sought further details of the underlying rationale for including GLS, a company without a UK focus of operation, and PFW, a unit not required for the provision of the universal service, in the scope of the Relevant Group.

Further analysis

A3.9 While the new long term inter-business agreement between Royal Mail and POL will separate the costs and revenues of the respective companies, and this will be reflected in Royal Mail's statutory accounting, we agree with City Link that the basis of cost and revenue apportionment should also remain subject to regulatory oversight in that the companies are currently under common ownership and control, and continue to supply significant services to each other, some of which are important for the efficient provision of the universal service.

A3.10 For this purpose we proposed in the October consultation that, as part of the regulatory financial reporting information, a reconciliation between Royal Mail's statutory accounts and the audited financial statements of the Relevant Group should be provided. We also proposed that details of the transfer pricing used to support arms' length commercial transactions between the two companies should be provided to Ofcom. We continue to consider these requirements to be appropriate.

A3.11 In respect of UK Mail's point that not all of the activities undertaken by the Relevant Group are concerned with the provision of the universal service in the UK, we accept that the scope of the Relevant Group is not defined by reference to the scope of the universal service.

A3.12 However, in common with many other universal service providers and other large postal and logistics companies (including UK Mail), Royal Mail engages in a diverse range of markets and our financial advisors have noted that such diversification is consistent with efficient external financing. Given that we need to monitor the ability of Royal Mail to raise external finance in connection with its financial sustainability as the universal service provider, we continue to consider the Relevant Group as defined in our October consultation to be the appropriate scope for a number of our regulatory financial reporting proposals.

Our decision

A3.13 Based on our consultation proposals and the responses to them, we have decided to define the scope of the Relevant Group as Royal Mail Group Limited excluding POL and its subsidiaries and associates. The regulatory financial reports that we have decided to require Royal Mail to provide at the level of the Relevant Group are set out below.

Reporting

Our consultation proposals

A3.14 In our October consultation we proposed that Royal Mail should provide three types of regulatory financial reports at the level of the Relevant Group, each to meet complementary purposes as part of our monitoring framework:

- Audited consolidated financial statements, comprising income statement, balance sheet and cash flow, with associated notes and reconciliation to Royal Mail's statutory accounts.

- Annual updates of the forward-looking Strategic Business Plan, with a comparable scope to the 2011 Plan to which we had regard in developing our October consultation proposals, capable of reconciliation to the audited financial statements.

- Quarterly updates of a two-year cash flow projection, again capable of reconciliation to the audited financial statements and the Strategic Business Plan.

A3.15 We explained that the annual financial statements would provide information on the historic financial performance of the Relevant Group, including the impact of this performance on the financial sustainability of the universal service provider.

A3.16 To complement this, as suggested by Royal Mail, we proposed to require it also to provide us with confidential annual updates to its Strategic Business Plan on a consistent basis. This proposed requirement is of particular relevance given the current market and business environment, where changes can rapidly affect the future prospects for the sustainable and efficient provision of the universal service.

A3.17 This would enable us to understand better the future prospects of the Relevant Group, and within this the contribution to its financial sustainability from internal cash generation from universal service network activities. We explained that such contributions were in part dependent on our own regulatory decisions (which must have regard to the need for Royal Mail to earn a reasonable commercial return on its universal service activities).

A3.18 Finally, given the particular financial challenges being faced by the universal service provider, as identified in Royal Mail's statutory accounts, we also proposed that Royal Mail provide us with quarterly updates of its projected cash flows in the shorter term, to provide us with early warning of emerging financeability issues that might require more urgent regulatory consideration.

Consultation responses

A3.19 With the exception of Royal Mail, most respondents who commented considered our proposals to be generally appropriate, although several respondents considered the details of confidential reporting should be for Ofcom to determine, while the CWU cautioned against imposing unnecessary additional reporting burdens on the business. The SMP noted that the need for rapid reporting of changing financial circumstances was increased given the risk of "market turmoil" arising from Ofcom's wider regulatory proposals.

A3.20 Royal Mail agreed with the broad thrust of our proposals but suggested modifications in the areas of the proposed Strategic Business Plan updates and the quarterly cash flow projections.

A3.21 In respect of the Strategic Business Plan, Royal Mail noted that, other than its annual budget, revisions to the medium-term Plan did not occur in an annual cycle, and that our requiring regular annual updates was therefore inappropriate. Further, the format of the Plan would be aimed at meeting the requirements of the business from time to time. It therefore proposed instead to provide us with copies of its annual budget and any updates to its Strategic Business Plan following their approval by its Board.

A3.22 Similarly, Royal Mail noted that it provided its Board with periodic updates to its cash headroom position for at least the following 18 months, which it proposed to provide to us following their provision to its Audit and Risk Committee, and to complement this with regular quarterly briefing sessions with Ofcom while its financial position remained challenged.

A3.23 Royal Mail also sought clarification as to whether we had powers to impose a requirement for it to prepare new plans.

Further analysis

A3.24 Based on the responses to our consultation we continue to consider that all three types of regulatory financial reporting at the level of the Relevant Group – historic financial statements, Strategic Business Plan updates, and quarterly updates of the future shorter term cash position – are required as part of our monitoring framework, and that we should specify our requirements in the Accounting Condition and supporting Regulatory Accounting Guidelines.

A3.25 However we agree with the general thrust of the points made by Royal Mail, the CWU and others that our own regulatory requirements should avoid, as far as possible, duplication of information that Royal Mail will be generating for its own business management purposes.

A3.26 In striking this balance, we have given further consideration to Royal Mail's proposals to use its own internal reporting processes for the Strategic Business Plan and cash updates for regulatory financial reporting purposes. While a number of the associated proposals will allow our requirements to be met efficiently, our own duties are different to Royal Mail's objectives and in this context we need to retain the ability to specify our own requirements.

A3.27 In particular, we accept that updates to the Strategic Business Plan may not be undertaken on a regular annual basis, and that Royal Mail's suggestion to notify us when they have been made is sensible. We do not intend to require Royal Mail to prepare new plans in addition to those it has in place from time to time.

A3.28 However, as it indicated in its response to our December consultation, Royal Mail does need to set an annual budget on a regular basis and this component of reporting requirement should be reflected in the Accounting Condition.

A3.29 Further, in order to monitor the evolution of, and prospects for, the financial sustainability and efficiency of the business activities required to secure the universal service relative to plans, on a systematic basis, we also need some regular confirmation of the extant Plan against which such monitoring should be undertaken. We therefore consider that an annual reporting cycle can be used to complement the notification of any ad hoc updates to the Strategic Business Plan which Royal Mail proposed.

A3.30 In relation to the format of the Strategic Business Plan, we accept that this will need to remain flexible to meet business needs, and we therefore did not consult over a specific pro forma for providing regulatory financial reporting information.

A3.31 Nevertheless, in order to monitor and understand trends over time, we expect that the basic format will need to be consistent with the Strategic Business Plan which we reviewed in developing our consultation proposals. For example, this will need to continue separately to identify and account for the projected performance of the activities associated with the provision of the universal service (which we have termed the Reported Business) from other activities undertaken by the Relevant Group.

A3.32 Similar considerations apply to the provision of information in relation to Royal Mail's projected shorter term cash position. We agree with Royal Mail that its internal reporting format, which includes projections and scenarios in relation to cash headroom as well as cash flows, should be suitable for regulatory financial reporting purposes. We also accept that significant updates to these projections to maintain a full two-year forward time horizon, as we proposed, could be avoided as long as the minimum information required to assess solvency is provided, and supporting regular discussion of the reports is undertaken.

A3.33 However, we continue to consider it important for our duties to specify the quarterly reporting frequency, basic minimum requirements for the information, and a minimum time horizon for such projections.

A3.34 Finally, we proposed that the historic reports and projections in the annual budget, quarterly cash projections, and the Strategic Business Plan should be internally consistent and reconcilable, so that the basis for projections and actual trends against these projections can be understood. This requirement remains important to support our wider monitoring framework.

A3.35 We explained in our October consultation, and set out in our December consultation, that we intended to implement all these regulatory financial reporting requirements through an USP Accounting Condition under Section 39 of the Postal Services Act 2011.

Our decision

A3.36 Based on the consultation responses and our further analysis, we have decided to include in the USP Accounting Condition requirements on Royal Mail to provide the historic annual audited financial statements (with supporting notes and reconciliations, and a transfer pricing statement) for the Relevant Group as we proposed in our October consultation and set out in detail in the December consultation.

A3.37 We have also decided to impose requirements for it to provide Ofcom with:

- Annual budgets for the Relevant Group before the start of the financial year to which they refer;
- An annual confirmation of the extant Strategic Business Plan for the Relevant Group, together with updates of the Strategic Business Plan before the start of each financial year, in a format which enables changes to the 2011 Strategic Business Plan to be understood; and
- Quarterly updates of the projected cash headroom position of the Relevant Group for at least the next 18 months, before the start of each financial quarter, in a format which enables changes to the previously projected position to be understood.

A3.38 We have also decided to include requirements for the historic and projected financial information provided for the Relevant Group in these reports to be internally consistent and reconcilable.

The Reported Business

Scope

Our consultation proposals

A3.39 In our October consultation we defined the scope of the Reported Business, which would be the focus of our separated regulatory financial reporting requirements, as being coincident with the scope of Royal Mail's integrated activity based costing (ABC) system. This system is used by Royal Mail to generate estimates of Fully Allocated Costs (FAC) of the products using activities analysed in the system.

A3.40 The existing and previous regulatory financial reporting framework requires Royal Mail to document the costing methodology applied in this costing system in a Costing Manual, part of which it publishes, and to use the results in producing its audited regulatory financial statements.

A3.41 We noted that, while a number of activities included in the costing system are used to provide products and services outside of the universal service, they share a consistent methodological approach to cost allocation for regulatory financial reporting purposes, which is subject to regulatory oversight under the cost transparency framework put in place by Postcomm for 2011-12 and continued in our Initial Conditions.

A3.42 Given the importance of shared costs to the efficient provision of the universal service through an integrated network, we proposed to define the scope of the Reported Business with reference to the scope of the FAC estimates over which we would continue to retain regulatory oversight, specifying the relevant costing rules in our Regulatory Accounting Guidelines.

A3.43 We considered that this scope for the Reported Business would then enable us to meet our duty of having regard to the need for Royal Mail to earn a reasonable commercial return on the expenditure incurred for the purpose of, or in connection with, the provision of the universal service. It would enable us to monitor the overall profitability and efficiency of the Reported Business, its contribution to the cash flows of the Relevant Group, and to understand the relative contributions of different products and services using the activities of the Reported Business.

Consultation responses

A3.44 Most respondents agreed with this proposed scope for the Reported Business, which broadly corresponds to Royal Mail's Letters division[1] under its organisation structure up to the end of 2010. UK Mail and Postaf noted that the scope should exclude the other activities of Royal Mail's wider UKLPI business unit, such as those undertaken under the Parcelforce Worldwide ('PFW') brand, which are not subject to reporting and other regulatory requirements.

A3.45 The MUA suggested that the scope should support effective efficiency benchmarking, while eBay cautioned against inflexibility, in that the activities relevant to the provision of the universal service may change over time. As with Relevant Group reporting, the CWU argued that the requirements should not place excessive regulatory reporting burdens on Royal Mail; the Methodist Church of Scotland was also concerned that the reporting requirements could be too costly.

A3.46 The most substantive proposal in relation to the scope of the Reported Business was from Royal Mail, which proposed that a number of products currently classified as "non-Mails", and their associated activities, should be removed from the scope.

A3.47 It estimated that this would reduce the revenue captured by the definition of the Reported Business by around £100million p.a. (around 2%) based on the 2010-11 regulatory accounts but reduce the associated costs subject to the rules in the RAG by more. Royal Mail argued that the activities relevant to these "non-Mails" products were not required for the provision of the universal service, and should not be defined as part of an integrated universal service network for regulatory financial reporting purposes. It proposed to remove the relevant costs from regulatory financial reporting in 2012-13.

A3.48 In our December consultation we indicated our expectation that the most up to date version of the Costing Manual, reflecting the most recent scope of activities in the costing system, would be published in December 2011. Therefore in the proposed draft of the Accounting Condition we defined the Reported Business as all the activities and products and/or services, the costing of which was covered by the Costing Manual published by Royal Mail as at December 2011.

1 Including Royal Mail Wholesale business unit

A3.49 However, in its response Royal Mail proposed to discuss some further changes to the costing system with us in January. Following these discussions Royal Mail published an updated Costing Manual on 23 March 2012.

Further analysis

A3.50 Based on the consultation responses we continue to view the appropriate scope of the Reported Business as being narrower than the scope of the UKLPI unit under Royal Mail's current organisation structure. Accordingly, the scope is not already defined by Royal Mail for statutory reporting purposes, and we need to define it to meet our own regulatory financial reporting requirements.

A3.51 Further, our basic proposal to align cost and other regulatory financial reporting to the scope of activities covered by Royal Mail's ABC costing system was accepted by respondents. This continues the basis of regulatory financial reporting that is already in place, and minimises the issues associated with aligning product revenues and product FAC within a consistent regulatory accounting framework. It should also meet the objective of minimising any additional burdens on Royal Mail, as the relevant administrative processes already exist.

A3.52 The key issue is therefore the future scope of the outputs of the integrated ABC system itself that are used in regulatory financial reporting. While the non-Mails products costed in this system are typically associated with some distinct "non-network" activities not required for the provision of the universal service, as highlighted by Royal Mail, the derivation of FAC estimates involves the allocation of costs of other shared activities, such as commercial overheads, as between non-Mails and Mails products.

A3.53 We therefore evaluated the extent of cost sharing between non-Mails and Mails products currently reflected in the costing system, using data from the 2010-11 regulatory financial reports and the first half of 2011-12.

A3.54 We found that non-Mails products accounted for over £150million of FAC in 2010-11 and are expected to account for more cost in 2011-11, so that they constitute a significant component of the Reported Business we had proposed. Around half of these costs are shared network costs which Royal Mail does not propose to remove from the scope of the regulatory costing rules. The remainder are mainly associated with non-network activities used for marketed non-Mails products (such as Stamps and Collectibles, data services and mailroom management). However some marketed non-Mails products, such as Relay and Sameday, do share some costs with the Mails products.

A3.55 Royal Mail suggested that one reason why it was now appropriate to remove non-Mails products from the costing system for regulatory reporting purposes was that the evolution of the business no longer made this costing approach as relevant.

A3.56 We therefore compared the recent 2011-12 costings with those from 2010-11, and found that the treatment of shared customer management costs (such as call centre costs) has changed in 2011-12, so that, based on emerging half-year outcomes, we expect there to be greater transparency of the treatment of these costs in the costing system in 2011-12.

A3.57 Clearly, further changes to the scope of regulatory financial reporting of the form proposed by Royal Mail would require rapid implementation in order that they could be implemented from the first quarterly reporting period of 2012-13. Bearing in mind the need to minimise additional administrative costs from regulatory financial reporting, we therefore sought further details for the implementation requirements from Royal Mail. It confirmed that it would be able to implement the changes without needing to change the operation of the costing system itself.

A3.58 Taking these analyses together, we consider that the case for the removal of at least some non-Mails products, where there is limited sharing of activities and costs, is stronger than for others where the sharing issues are more significant. In particular we accept that costs associated with non-network products such as Stamps and Collectibles have very limited association with the costs directly associated with universal service provision.

A3.59 However, as a matter of principle, we consider that the scope of regulatory reporting of the costing system used to generate FAC estimates should continue to cover all the costs concerned. This would mean that any activity costs that are not reported as part of the costing system should be removed from it, so they do not directly affect the basis of the FAC estimates prepared for regulatory financial reporting purposes. Implementation of such methodology changes, if material, would need to be pre-notified to us.

A3.60 A consequence of removing such activity costs from the scope of the costing system would be that the basis of allocating any associated shared costs between the Reported Business and the rest of Royal Mail would not be documented in the Costing Manual. Instead it would be documented in the Accounting Methodology Manual, which we have decided Royal Mail should provide to us by May 2013 in finalised form; in the meantime, the detailed basis of allocation would not be fully documented for regulatory financial reporting purposes.

A3.61 Further, while some costs currently included in the non-Mails category are potentially straightforward, the treatment of other activity costs associated with the shared use of Reported Business resources by other business products, such as those marketed by PFW and POL, and used for the PAF, is potentially more complex.

A3.62 For these costs, we consider that the appropriate approach to changing the costing system (and hence the scope of the Reported Business) as Royal Mail propose will be for us to review any impacts on Reported Business costings with Royal Mail and, if appropriate, then to consult on further scope changes in due course. This may best be undertaken later in 2012-13 in the context of our review of the universal service needs, if that review had any consequences for the scope of activities undertaken for the purpose of, or in connection with, universal service provision and hence the appropriate scope of the Reported Business.

A3.63 Finally, some of the activities identified to non-Mails products give rise to more revenues than costs, and while these activities are currently undertaken in connection with Royal Mail's activities as a universal service provider, the associated revenues are relevant in assessing its ability to earn a reasonable commercial return on the activities concerned. Accordingly, the materiality of activity costs and the extent of cost sharing are not the only relevant criteria in assessing the scope of the Reported Business.

Our decision

A3.64 We have decided to retain the existing scope of the Reported Business for 2012-13, to include non-Mails as set out in our October consultation, while accepting Royal

Mail's proposal that all relevant costs associated with the relevant products and services (e.g. for PAF) should be included in this scope.

A3.65 However, following further review of Royal Mail's proposals for removing the relevant activity costs from the costing system, the impacts on the FAC estimated by the costing system, and the consequential documentation of the treatment of shared costs outside of the costing system in the Accounting Separation Manual, we intend to consult later in 2012-13 on the implications of removing some non-Mails products from the scope of the Reported Business in 2013-14.

A3.66 We set out in our December consultation our proposal that this scope should be defined by reference to the Costing Manual which documents the activities, products and services included in the costing system. We have decided that this definition of the scope of the Reported Business remains appropriate.

A3.67 We have clarified in the Accounting Condition that the scope of the Reported Business should be defined by the most up to date costing methodology, as documented in the most recent version of the Costing Manual. This approach ensures that the scope remains consistent with Royal Mail's costing methodology which continues to evolve to take account of operational changes, and to incorporate zonal costing.

Reporting

Our consultation proposals

A3.68 We explained in our October consultation that, because Royal Mail raises external finance at the level of the Relevant Group, we proposed that regulatory financial reports at the level of the Reported Business should exclude accounting for long term financing.

A3.69 For the Reported Business, we proposed to require Royal Mail to provide us with annual audited income statement information to the level of Earnings before Interest and Tax, and associated statements of capital employed and operational cash flow, and reconciliation, including a transfer pricing statement, to the statements for the Relevant Group.

A3.70 This approach would avoid potentially arbitrary allocations of long term finance costs between the Reported Business and the rest of the Relevant Group, while sustaining consistency for the reporting of the resources, including the capital employed in assets, required for activities relevant to the provision of the universal service.

A3.71 This approach would enable the depreciation and other operating cost estimates used in the derivation of the FAC of the Reported Business in the costing system to be reconciled to the relevant financial statements for the Reported Business.

A3.72 However, Royal Mail also includes exceptional operating costs – not included in the ABC costing system – in deriving its reported operating profit for statutory reporting purposes. Consistent with this, we proposed that the EBIT of the Reported Business should also include an allowance for such exceptional operating costs – involving an allocation of these costs between the Reported Business and the rest of the Relevant Group on a basis set out in the Regulatory Accounting Guidelines.

A3.73 Royal Mail prepares quarterly updates to its FAC estimates, based on the outputs of its costing system. Where required, these are used in statutory reporting (e.g. for half-year accounts). These quarterly updates both reflect within-year changes in the underlying drivers of costs – such as seasonal volumes – and changes in the business and its costing methodology.

A3.74 Given that such changes have been significant, the current regulatory framework requires Royal Mail to provide Ofcom with quarterly updates of the outputs of its ABC costing system. In our October consultation we proposed that, as well as continuing this requirement, Royal Mail should also provide unaudited quarterly income statements (again to EBIT level) for the Reported Business.

A3.75 In addition, we also proposed that Royal Mail should provide us with complementary and consistent information on the profitability of separated elements of the Reported Business, as well as additional monthly information on revenue, volume and costs and supporting documentation on the methodologies used for costing and accounting in the Reported Business. These additional proposals are discussed in subsequent sections.

Consultation responses

A3.76 Respondents who commented generally agreed with the thrust of our proposals, although there was little comment on the specific reporting that we proposed at the level of the Reported Business overall.

A3.77 The main concern was expressed by Royal Mail which, while it agreed with our proposals in relation to annual reporting, disagreed with our proposal for quarterly income statements. It highlighted that seasonal variations would render the profitability information provided by such statements of limited regulatory value, and if published would risk misleading the market, and that its quarterly costing outputs were subject to revision and review within the year, which significantly reduced the reliance which could be placed on such quarterly information.

A3.78 Royal Mail did however accept that quarterly product profitability information would be relevant and proposed to provide this – on a confidential and unaudited basis - as part of its regulatory financial reporting outputs.

Further analysis

A3.79 Given the general agreement with our proposals for annual reporting of the Reported Business as a whole, we have focused our further consideration on Royal Mail's concerns with quarterly reporting.

A3.80 In this context, it is important to note that the substantive difference between our October consultation proposals and those of Royal Mail relates to the treatment of exceptional operation costs. These costs, which Royal Mail's published accounts indicate account for less than 5% of the total costs relevant to its reported operating profit, mainly comprise staff-related costs such as Colleague Share payments and modernisation costs.

A3.81 While these are important in determining the overall profitability of the activities required to provide the universal service, a number of them do not arise as a consequence of quarterly activity, and Royal Mail does not at present generate quarterly accounting allocations of these costs. Accordingly we accept that our October consultation proposal would have imposed some limited additional reporting costs on Royal Mail, while the information concerned would provide relatively limited insight into the quarterly variations in profitability arising from its business operations.

A3.82 In contrast, quarterly information on product profitability of the form proposed by Royal Mail would signal how within-year changes in markets and Royal Mail's costings affected the margins in the Reported Business. We continue to consider such information to be important as part of our monitoring framework. Royal Mail will generate it by comparing quarterly product revenues with quarterly product FAC estimates already available from its costing system.

A3.83 Given that Royal Mail propose to provide disaggregated product profitability information on a quarterly basis, we consider that it would not be burdensome for it also to provide this information in aggregated form for the Reported Business as a whole.

Our decision

A3.84 Based on the consultation responses and our further analysis, we have decided to require Royal Mail to provide us with the audited annual regulatory financial reports for the Reported Business as a whole as proposed in our October consultation and set out in detail in our December consultation.

A3.85 However in relation to quarterly reporting, we have decided to remove the proposed requirement to split exceptional operating costs between the Reported Business and the Relevant Group, and hence to require only aggregate product profitability reports on a quarterly basis.

Transfer pricing

Our consultation proposals

A3.86 As proposed in our October consultation, transfer pricing may be required in relation to the transactions:

- between the Relevant Group and the RMH group entities which are outside the Relevant Group;
- between the Reported Business and the rest of the Relevant Group; and
- between the Four Financial Reporting Entities ('Four FREs') and components of them.

A3.87 We consider each of the above requirements for transfer pricing in this section.

A3.88 In our October consultation, we proposed that transfer pricing in general should comply with the following principles:

- Equivalence pricing - Use of available open market or regulated prices of externally provided products and services as the basis of transfer prices, where appropriate comparable products and services exist (applying necessary equivalence adjustments for FAC differences);
- Cost-plus pricing - where no comparable open market or regulated products exist but where a transfer price is still needed for regulatory financial reporting

purposes, use of product FAC estimates plus an appropriate mark-up, which we proposed to be 10%.

Consultation responses

A3.89 No respondent raised any specific issues with our proposals, and Royal Mail supported our principles. However, Royal Mail also expressed concerns with regard to implementation of these principles to the transfer prices between the Reported Business and the rest of the Relevant Group.

A3.90 Royal Mail argued that since the Reported Business does not correspond to an existing business unit within Royal Mail Group, our proposal would require *"the creation of a number of memorandum financial records. These do not currently exist and will require a structured and detailed review of the existing financial records and non financial data sources to create the required transfer charges."*

A3.91 From our discussions during the consultation period, Royal Mail inferred that we required that the transfer prices for any services supplied by UKLPI to other parts of UKLPI should be based on FAC, while those for all transactions between UKLPI and business units outside of UKLPI should be based on market rates. We explain below Royal Mail's response in further detail.

A3.92 To clarify our transfer pricing principles, we set out below, in further detail, our decision on the application of these principles to the transfer prices between the Reported Business and the rest of the Relevant Group.

Further analysis and our decision

Transfers between the Relevant Group and the RMH group entities outside the Relevant Group

A3.93 These transfer prices should be set based on equivalent market prices or, if no such price exists for the service concerned, an appropriate mark-up to FAC.

A3.94 Considering our definition of the Relevant Group (see previous section), the affected transfers would currently involve only those between POL and its subsidiary and associated undertakings (which are outside the Relevant Group), and the Relevant Group.

Transfers between the Reported Business and the rest of the Relevant Group

A3.95 If the transfer of services or products is between another separate company (i.e. a separate legal entity) within the Relevant Group and the Reported Business, then the transfer prices should also be based on equivalent market prices or, if no such price exists for the service concerned, an appropriate mark-up to FAC.

A3.96 RMEL is a current example of the above principle, where the use of properties owned by RMEL is charged to the Reported Business at a transfer price based on market rental prices. These transfer charges are included in the existing costing methodology for regulatory financial reporting purposes. The approach is however general, and would be similarly applicable to any transactions between GLS and the Reported Business.

A3.97 With regard to transactions between business units or divisions of the Relevant Group which are not separate legal entities (including other UKLPI business units outside the scope of the Reported Business), and the Reported Business, we need to first establish whether there is transfer of services or a sharing of services.

A3.98 If services are centralised and shared between the different operating entities, then there will be no need for transfer pricing, and the FAC of the services can be allocated according to the appropriate rules, documented as part of the Accounting Methodology Manual. Conversely, if there is a transfer of services from one entity to another or others, then transfer pricing will be necessary, which should be applied based on our proposed general principles explained above.

A3.99 To establish whether a service is provided from one entity to another entity or shared with that other entity, we need to ascertain which entity owns the risks and rewards of having the resources or the assets which are employed to provide the service. If the ownership lies with one entity, then that entity is the provider and the other entity is the recipient. If the risks and rewards are shared, then the services should also be treated as shared between the two entities.

A3.100 In its response, Royal Mail considered a number of services:

- Central Finance and HR (including payroll and pensions)services used by a range of UKLPI business units, but managed centrally;

- Purchasing and Customer Management services, also used by a range of UKLPI business units, but managed centrally; and

- Vehicles, used by the Reported Business, but also used by various other UKLPI business units (eg PFW, iRED) which are outside the Reported Business.

A3.101 Royal Mail proposed that the FAC of all of the above resources should be allocated between the Reported Business and the rest of UKLPI for regulatory financial reporting purposes.

A3.102 We confirm that Central Finance, HR (including payroll and pensions), Purchasing, and Customer Management services should be treated as services that are shared between UKLPI business units, and their FAC should therefore be allocated using appropriate allocation rules for regulatory financial reporting purposes (to be set out in the Accounting Methodology Manual).

A3.103 We expect these allocation rules to comply with the Guiding Principles set out in the USP accounting condition.

A3.104 This process of cost allocation is undertaken outside of the rules of the FAC product costing system which are subject to the rules in the Regulatory Accounting Guidelines (RAG). The process is therefore not documented in the Costing Manual, and we propose that the Accounting Methodology Manual should document the allocation rules concerned.

A3.105 The case for vehicles is different. Vehicles are treated as Reported Business assets and all of the associated depreciation charges are accordingly included in the FAC product costing system for regulatory financial reporting purposes. However, some vehicles may be used by business activities undertaken outside the Reported Business (e.g. by PFW). The Reported Business should therefore be treated as the entity providing the use of vehicles, and in principle, should be charging a transfer price for their use by a business unit outside it.

A3.106 We have investigated the magnitude of the effect of transfer pricing vehicles in this way, and in our view, the effect is significant enough to justify applying a simple approach for transfer pricing in line with the above general principles.

A3.107 Royal Mail informed us that transfer pricing for vehicles along these lines could be done by an additional manual process without changing the way the related costs are currently calculated in the FAC product costing system.

A3.108 We have therefore decided that Royal Mail should apply transfer prices to use of vehicles by entities outside the Reported Business, by applying a cost-plus approach (FAC plus 10% mark-up). The exercise can be a manual quarterly adjustment based on the relevant FAC product costs for the purposes of regulatory financial reporting only.

Capital employed statement and operational cash flow statement

A3.109 In our October consultation, we proposed that Royal Mail should prepare separated an operating balance sheet (capital employed statement) and a cash flow statement for the whole of the Reported Business.

A3.110 These statements would help us meet the regulatory objectives of understanding the Reported Business's return on capital employed and financeability.

A3.111 Respondents generally supported our proposals. Royal Mail, however, disagreed with our proposals, and in particular with our proposed separation of the balance sheet and cash flow statement below the Reported Business level. We address these issues in a later section.

A3.112 We have therefore decided to confirm the requirements for a capital employed statement and operational cash flow statement to be included in the audited annual regulatory accounts for the whole of the Reported Business.

National product costing

Traffic measurement

Our consultation proposals

A3.113 The existing 'Traffic Measurement' costing rule allows Royal Mail to use either of two methods of traffic measurement in its costing methodology for regulatory financial reporting purposes: the operational measurement method or the revenue-derived measurement method. Our October consultation proposal was to amend the relevant rule such that Royal Mail should adopt a single method of traffic volume measurement for 2012-13 and beyond and that method should be the revenue-derived traffic measurement method.

Consultation responses

A3.114 Ofcom received no specific responses to this proposal. This may have been a consequence of the explanation provided by Royal Mail that we reproduced in the October consultation that Royal Mail had, in both its 2010-11 audited statutory and regulatory accounts, moved all its traffic measurement reporting to the revenue-derived method. Royal Mail had made the change having "*passed the audit walkthrough tests and the calculations performed to derive traffic and revenue were deemed reasonable by the Ernst & Young Actuarial"* and having decided at senior management level to have “*full alignment on all external reporting to ensure consistency moving forward*”.

Our decision

A3.115 Our decision is to implement our October proposal and amend the ‘Traffic Measurement’ National Costing Rule so that Royal Mail will be required to adopt a single method of traffic measurement and that will be the revenue-derived traffic measurement method. The revised ‘Traffic Measurement’ National Costing Rule is set out in the RAG.

Allocation of overheads

Our consultation proposals

A3.116 At present, Royal Mail’s FAC product costing methodology uses a ‘non-nested’ Equi-Proportional Mark Up (‘EPMU’) approach to overhead allocation. This approach allocates both the pipeline overheads and the general overheads to products *pro rata* to the direct costs already attributed to those products. This approach is compliant with the relevant costing principles in the Initial Conditions.

A3.117 Both Postcomm’s earlier April 2011 consultation and our subsequent October 2011 consultation proposed that, for the 2012 regulatory framework, the relevant regulatory costing rule should be amended so as to require Royal Mail to apply a two-step “Nested” EPMU approach for its 2012-13 regulatory financial reporting and beyond. This would involve:

i) first allocating pipeline overheads *pro rata* to the relevant direct costs (as now); but then,

ii) allocating general overheads *pro rata* to the sum of the attributed direct costs *and* the pipeline overheads allocated in the first step.

A3.118 In our October consultation we proposed that the somewhat more accurate representation of costs that the Nested EPMU approach could provide, and our belief that adoption of a nested approach would be more consistent with the Postal Services Directive, meant that it should be adopted for regulatory financial reporting purposes unless there were more clearly defined grounds for a temporary derogation than those which had been provided by Royal Mail to that date.

Consultation responses

A3.119 Apart from Royal Mail those stakeholders that did respond to this proposal agreed with our proposed move to a Nested EPMU approach to overhead allocation in 2012-13.

A3.120 The MCF stated that the more accurate costing using a Nested EPMU approach would improve the accuracy of Royal Mail’s cost allocation and that *“it could make a difference to individual product costs (and therefore prices)*” which would support Ofcom’s ability to “*better monitor Royal Mail performance and prevent anti-competitive behaviour as well as promote cost-oriented pricing.”*[2]

2 Mail Competition Forum, 5 January 2012, Securing the Universal Postal Service – MCF response to Ofcom consultation Technical Annexes, A report by SLG Economics Ltd

A3.121 Onepost responded by stating that *"it would not be possible for Ofcom to be an effective regulator without a clear understanding of the costs relating to ...how overheads are allocated."*[3]

A3.122 In its consultation response Royal Mail asserted that there was no necessity for the proposed move to a nested EPMU approach as it "*had invested a great deal of effort to examine and understand the various overhead cost pools across the business processes resulting in a very detailed (30 individual rules) methodology and alignment to products and services benefitting from the overhead areas*" and therefore within its current EPMU methodology it employed a sophisticated attribution of its overheads. It considered that the evidence for a causal link between pipeline and general overhead costs, implied by our proposal, was unclear.

A3.123 Royal Mail also stated that the proposal would be a very burdensome requirement and would result in an incremental increase in the "*processing burden by 5 days per quarter and the audit activity by 7 days per year*". Subsequently Ofcom asked for confirmation from Royal Mail that its best estimate of the impact of the proposal would be an additional 27 days a year and this was confirmed.

A3.124 Ofcom also sought to understand from Royal Mail whether, and if so by when, the increased days' effort would be reduced by future possible system investments, but Royal Mail was not able to provide a more detailed response on this issue.

Our decision

A3.125 We still consider that the Nested EPMU approach should be adopted, as it would provide both a somewhat more accurate representation of costs, and our estimate of the impact of the change is that it may be material or close to material for the estimated FAC product costs for a number of products.

A3.126 We agree with Royal Mail that the causal links between general and other different types of overheads are typically weak and difficult to evidence, with many of the general overheads being fixed and common in nature. Nevertheless there is likely to be some relationship between the relative scale of activities undertaken at different stages of the pipeline, including pipeline overheads, and the general overheads required to support these pipeline activities. We should emphasise that general overheads in the FAC product costing system should in principle be excluded from margin squeeze controls and tests in any event, and we have reflected this in our decision for the *ex ante* margin squeeze control we have decided to put in place, which we expect to remain in place until 2014-15.

A3.127 The stakeholder support (with the exception of Royal Mail) for our proposal also indicates that, while it would not necessarily imply a strong causal link between overhead types, it would on balance improve the representation of costs relative to the status quo (where no link at all is assumed), and persuades us that the change should be made. However, the response provided by Royal Mail estimated that, with its current systems, our proposal would require an extra 20 days' effort a year to implement, plus additional audit costs, somewhat more than we had previously understood.

A3.128 Further, Royal Mail could not advise us of any short term plans to implement changes to its costing system that could avoid the manual effort currently implied by

3 Onepost, 4 January 2012, Response to October Consultation

our proposal. Accordingly, while the additional implementation costs that Royal Mail had estimated were being incurred, it may be disproportionate to require it to make an immediate change to the methodology in 2012-13.

A3.129 However, we would expect an efficient company to adapt its internal systems and processes to meet its regulatory reporting requirements at least cost over time. Further, we expect the identification and treatment of pipeline and other overhead costs also to be a key feature of Royal Mail's methodology for deriving LRIC estimates using where appropriate the outputs of its FAC product costing methodology, such that any move towards *ex ante* LRIC estimates for regulatory financial reporting would need to be internally consistent with the treatment of these overhead costs in FAC product costing.

A3.130 Given the expected timescales for moving towards LRIC estimates as a basis for margin squeeze testing, we therefore consider it to be appropriate to require the move to nested EPMU to have occurred by 2014-15, and we have included this deadline in the RAG. We consider it would be reasonable to expect an efficient company to have amended its systems and business processes to be able to implement this relatively simple change at least cost, with notice of up to two years.

The Costing Manual

Our consultation proposals

A3.131 In our October consultation we stated that we would review the detailed formats of the data currently provided to us in the Costing Manual and would include in a finalised version of the RAG any amended requirements to support our wider regulatory proposals for the 2012 framework. In November we provided to Royal Mail the proposed detail of our proposed additions to the Costing Manual that we required, in order to facilitate our monitoring of product costs on a quarterly basis. These consisted of proposed additional data templates.

Consultation responses

A3.132 In its responses to the October and December consultations Royal Mail stated that it would be inappropriate and disproportionate to Royal Mail to have to supply the proposed templates as well as the existing format of the Technical Appendices, and that this would *"increase the burden of preparation as the ABC Model system tables need to be manipulated to the required format*". It went on further to state that the templates "*largely*" request existing data already supplied to be provided in a certain format but that the templates also required*" 2 sets of results so that they (Ofcom) can check their Cost Allocation Model has indeed replicated the ABC Model*".

A3.133 Royal Mail stated that it believed that such a proposal was inappropriate and disproportionate as:

- "The ABC Model has been passed as compliant and the change control process is effectively managing any changes";
- "The external assurance across the system including the assurance of disclosure of material changes removes the need for the regulator to check the ABC model";
- "The proposed portfolio of regulatory financial reports will provide a wealth of results";

- “It is unclear how replicating the ABC Model helps the regulator meet its primary duties.”

- “The intention of the technical annex information was to allow the regulator to replicate the costing system results. Royal Mail does not believe it is appropriate to produce both raw data sets and results from the costing system.”

- “we do not have transparency on how this information is used by the regulator and therefore do not understand whether it is useful information for the regulator.”

A3.134 Royal Mail stated that it believed that 3 reports from its ABC system could replace the need “for any base data and would demonstrate the ongoing integrity of the ABC Model, providing detailed costing outcomes to support any detailed reviews Ofcom might undertake:

- *Activity cost by cost type*

- *SPHCC cost by activity and unit cost*

- *SPHCC volumes*”

Our decision

A3.135 We have decided to retain our proposed requirement for the additional data templates as a supplement to the existing Costing Manual information that will be provided on a quarterly basis.

A3.136 We require the information in the form requested so that we can build a quarterly Cost Allocation Model efficiently that will allow us to analyse the activities used by Royal Mail to generate FAC product cost estimates for regulatory financial reporting purposes.

A3.137 We believe that our retaining this type of analytical capability will be important in the context of the significant increase in freedom we are allowing Royal Mail in relation to the pricing of most of its products and services in the 2012-13 regulatory framework. We do not consider the three proposed reports suggested by Royal Mail, to replace the existing scope of the Technical Appendices, to be sufficient in this context.

A3.138 Nevertheless we have taken into consideration Royal Mail’s detailed feedback on the format of the proposed templates, and as a consequence we have made some modifications to our earlier proposals, and have also accepted that some of the data tables and other information that are presently contained in the Technical Appendices would, with the alternative availability of the new templates, no longer be necessary. The templates are set out in the Appendix 4 to the RAG.

A3.139 We outline below a table setting out, for each of the new templates, which items in the 2011-12 Technical Appendices will be superseded by these new templates in 2012-13, and hence will no longer need to be provided in the Technical Appendices for 2012-13.

Table 2 – Summary of items in the Technical Appendices superseded by inclusion of Cost Allocation Model Templates

Template	Item within the Technical Appendices no longer required
Template A 'SPHCC Volumes and FAC' & 'Template F 'FAC Allocations'	• Appendix 6.1 'Sales Product' ('QX Appendix 6.1 Sales Product.xls') • Appendix 6.1 'Sales Product SPHCC' ('QX Appendix 6.1 SPHCC.xls') • Appendix 6.1 'Sales Product Volumes' (QX Appendix 6.1 Sales Product Volume.xls') • Appendix 6.1 'Sales Product Groups' (QX Appendix 6.1 Sales Product Groups.xls')
Template B 'Activity Costs'	Appendix 4.1 'ABC Activity Dictionary ('ABC Activity Dictionary.xls')
Template C 'RFs and WFs'	• Appendix 5.1.1 'Routing Matrix' ('QX Appendix 5.1.1 Routing Matrix.xls' & 'QX Appendix 5.1.1 SPHCC to Route.xls') • Appendix 6.1 'Sales Product SPHCC' ('QX Appendix 6.1 SPHCC.xls') • Appendix 5.1.1.1 'Weighting Factors' ('QX Appendix 5.1.1.1 WF.xls')
Template D 'Class Activity Rules'	Appendix 7.2.2 'Class Activity to Product' ('QX Appendix 7.2.2.xls')
Template E 'EPMU Rules'	'QX Appendix 5.3 EPMU Drivers.xls'
Template F 'FAC Allocations'	Not applicable

Zonal product costing

The Zonal Costing Rules

Our consultation proposals

A3.140 In our October consultation we proposed the introduction, as part of the RAG, of additional costing rules specific to the zonal costing methodology. More specifically, while we defined a total of nineteen proposed zonal costing rules with which Royal Mail's zonal product costing methodology would have to comply, many of them were identical to the National Costing rules. However we considered it necessary for there also to be specific rules to cover the characteristics of the zonal methodology that differ to that of the national costing methodology. The proposed rules were set out in the draft Regulatory Accounting Guidelines in our December consultation.

Consultation responses

A3.141 Apart from Royal Mail there were no specific responses to our zonal costing proposals.

A3.142 In its response Royal Mail stated its view that additional rules for the zonal costing methodology to those for National Costing were not needed. Specifically, for the nine zonal costing rules that differed from the national costing rules (4, 7, 13,14,15,16,17,18 and 19), Royal Mail considered the additions to be unnecessary. Further, it stated these additions *"would appear to drive the business to commit to additional expenditure without the business case for that expenditure being made or assessed*."

Our decision

A3.143 At this stage in the development of end to end competition, and the associated lack of estimates of national and geographically-specific LRIC estimates, we think that providing Royal Mail with freedom to develop and change its own zonal FAC product cost estimates, without even high-level regulatory rules, could undermine market confidence in the relevant components of our monitoring regime.

A3.144 We have therefore included zonal costing rules in the RAG in line with our consultation proposals. However, we have, taking into account the consultation responses, and further discussions with Royal Mail, amended the detail of the zonal rules concerned, to allow Royal Mail with some continued flexibility over how it evolves its zonal costing methodology for regulatory financial reporting purposes in future. Below we set out our decisions in relation to each of the nine rules in this general policy context.

Rule 4

A3.145 We have decided not to amend Zonal Costing Rule 4 'Zonal General Ledger costs and Cost Types' despite Royal Mail's comment that "*geographical differences in Cost Type can be considered where there is the data to do it with a reasonable degree of data reliability to meet the RAG principles of objectively and accuracy".* We consider it essential that the specificity of this rule be retained, as differentials between the total reported FAC estimates for the zones should reflect all the relevant geographical cost differentials of the zones as far as practicable.

Rule 7

A3.146 Although Royal Mail stated that Zonal Costing Rule 7 ' Zonal Products and sub-products' was unnecessary as it would be "subordinate" to the existing Guiding Principle of 'Completeness', we consider that reliance on the 'Completeness' Guiding Principle would not adequately focus where we required the zonal costing principles to be applied. We have however, made modifications to the rule to clarify both the scope of the zonal costing methodology is to be in line with the proposed scope set out in our October consultation, and the required differentiation of FAC product cost estimates by type of handling characteristic relates only to instances where the relevant costs for regulatory financial reporting purposes vary geographically, with the four characteristics listed being non-exclusive in this respect.

Rule 13

A3.147 Royal Mail considered that Zonal Costing Rule 13 'Zonal Traffic Measurement' was "subordinate" to the existing principles of 'Completeness' and 'Accuracy' and was unnecessary. However we have retained this Rule as we consider that it is essential to specify that the specific sampling used for estimating the volumes required to derive geographically differentiated estimates of zonal downstream service costs(not required for national FAC product costing) should reflect the delivered volumes of those downstream services. We have, however, clarified when this rule will be required to be in effect (from Q2 in 2012-13), based on Royal Mail advice on the timing of suitable data being available for the purpose.

Rule 14

A3.148 Royal Mail's considered that in relation to this rule, covering 'Zonal Operational data and sampling', the general principles relevant to FAC product costing for regulatory financial reporting of 'Accuracy', ' Materiality' and 'Consistency' would sufficiently cover its intention. We have decided to retain Zonal Costing Rule 14 as we consider that the specific characteristics of the data and sampling for zonal costing purposes that are set out in this rule need to be specified. However, we have modified the rule to clarify that the timing of the annual review should align with the specified timing of the Financial Year used in the remainder of the USP Accounting Condition and associated Direction. As a result of Royal Mail's suggestions, we have also removed references to requirements to use cost functions as a result of econometric regression and/or applied to postcode sectors, to enable greater flexibility to amend the specific costing methodology where suitable data permit. Furthermore, the reference to cost differentials in part (d) of the rule has been clarified to relate to the geographic differentials in the underlying costs, and the reference to sampling soundness has been generalised to relate to its application to all zonal costing estimates.

Rule 15

A3.149 Although Royal Mail considered that this rule, previously entitled ' Zonal data integrity', was "subordinate" to the general principles of "accuracy, materiality, and transparency" to be applied to regulatory financial reporting, we have decided to retain it as its purpose is to ensure that specific reconciliations of zonal to national cost estimates are undertaken. However, we have renamed the rule 'Zonal Data consistency' and modified it in favour of more general drafting and to avoid implying that postcode sector level costs must necessarily continue to be estimated.

Rule 16

A3.150 Although Royal Mail considered that this rule, entitled 'Geographic cost reflectivity', was unnecessary given the general principles of "objectivity, accuracy, materiality, and transparency" to be applied to regulatory financial reporting, we have decided to retain it as its purpose is focused on the specific requirement for zonal cost estimates to reflect geographic cost relativities. We have, though, modified the rule to make clear that the requirement is a general one.

Rule 17

A3.151 Royal Mail's response stated that this rule, entitled 'Postcode sector cost estimation', *"does not take into account of whether the business records or will record data at this level and the costs involved. The proposed principle is not appropriate.* However, as postcode sector cost estimation is a currently a key constituent of Royal Mail's current zonal costing methodology, implemented following prior consultation, we see it as essential to retain this rule. However, we have changed the wording to avoid implying that postcode sector level costs must necessarily continue to be estimated indefinitely, and we have clarified the reference to actual postcode sector data to apply to its use in the validation of zonal cost estimates as well as in primary estimation.

Rule 18

A3.152 We have decided to amend Zonal Costing Rule 18 'Definition of zones' having regard to Royal Mail's consultation response, which stated that our proposed wording "*does not take into account of the stability and customer impact of such a principle. The proposed principle is not appropriate."* The requirement to establish material cost differences to support the redefinition of zones for regulatory financial reporting purposes has been narrowed to additional zones, to avoid any implied obligation on Royal Mail immediately to review the existing zone boundaries being used for this purpose, pending review of additional data in 2012-13 (see Rule 13 above). We have retained the restriction on the number of zones used for regulatory financial reporting purposes in 2012-13 to a maximum of four.

A3.153 We expect Royal Mail not to change the basis of zone definition without prior Royal Mail consultation, which should be undertaken with regard to a longer term aim of grouping geographic areas with similar estimated unit costs into the same zone. This aligns the proposed rule with the views of respondents to Royal Mail's 2010 consultation that such changes (where they have relevance to Royal Mail's zonal pricing) should not be implemented precipitately.

Rule 19

A3.154 Although Royal Mail considered that this rule, entitled 'Reconciliation of zonal and national cost estimates', was unnecessary given the general principles of "accuracy and consistency" to be applied to regulatory financial reporting, we have decided to retain it, as we consider reconciliation between zonal and national cost estimates for regulatory financial reporting purposes to be key to assurance of the costs concerned. We have, though, modified the rule to ensure the timing of the annual review within the rule aligns with that proposed in Rule 14.

The Zonal Costing Manual

Our consultation proposals

A3.155 Royal Mail presently produces a two-part Costing Manual to document its national FAC costing methodology. The first part is publicly disclosed and provides an explanation of its costing methodology, while the second part, the Technical Appendices, contains the detailed tables, matrices, account hierarchies, costing structures and other data that are supplied to the regulator on a confidential basis.

A3.156 In our October consultation we proposed that Royal Mail should extend the existing scope of the Costing Manual from 2012-13 to include the documentation of its zonal costing methodology, compliant with the Zonal Costing Rules in the RAG discussed above.

A3.157 As with the present two-part Costing Manual, we proposed that the additional sections on zonal costing would be produced at a level of detail sufficient to allow a reader to replicate the derivation of the relevant zonal costs if given the detailed input data. We proposed that the relevant section headings of the additional zonal components of Part 1 and Part 2 of the Costing Manual would be almost identical with the level of detail provided in each part subject to consistent commercial confidentiality constraints (so that the Technical Appendices would include an additional section identifying the unit and total costs of the zones).

Consultation responses

A3.158 Apart from Royal Mail there was no specific response to our proposals for the future documentation of Royal Mail's zonal costing methodology.

A3.159 In its own response, Royal Mail stated that it understood the proposals to add regulatory transparency and consistency measures around zonal costing, including an expanded scope for the present Costing Manual to include its zonal costing methodology. Royal Mail stated it was "*developing such an extension which will look to reflect Ofcom's proposed content for the document as expressed on pages 40-42 of Annex 6"*.

A3.160 Royal Mail has subsequently provided to Ofcom an initial draft of such an extension, which it intends to incorporate within the Costing Manual in accordance with the RAG. We have provided feedback on this initial draft to Royal Mail.

Our decision

A3.161 We have decided that Royal Mail should extend the exiting scope of the Costing Manual to encompass documentation of its zonal costing methodology, with the form and content outlined in our October consultation. As with the national costing methodology, those aspects of the Costing Manual covering the zonal costing methodology will be required to be fully compliant with the relevant regulatory costing rules set out in the RAG.

A3.162 On this basis Royal Mail will be required to provide a final draft of the proposed zonal content of the Costing Manual for Ofcom to review by 30 June 2012. This draft will set the finalised information and data that Royal Mail propose to provide in both the published part of the Manual, and the confidential Technical Appendices covering the methodology it proposes to use to comply with the RAG for regulatory financial reporting purposes in the first quarter of 2012-13.

A3.163 The complete first part of the Costing Manual for 2012-13 will then be published, and the complete Technical Appendices provided to Ofcom, no later than 90 days after the end of the first quarter in 2012-13 (September 2012).

A3.164 This Costing Manual will document the national and zonal costing methodologies that comply with the respective national and zonal costing rules in the RAG. However, as discussed above, compliance with Zonal Rule 13 'Zonal Traffic measurement' will not require a change in the MCS sampling data used for estimating downstream service costs to reflect the total delivered volumes until the second quarter in 2012-13. The compliant Costing Manual documenting the zonal costing methodology adopted for this quarter will reflect these new data.

A3.165 The following table summarises our decisions relating to the regulatory financial reporting requirements for Royal Mail in relation to its zonal costing methodology:

Table 3: Zonal costing requirements

Milestone	Requirement
Q1 2012-13	New zonal costing rules are effective
30 June 2012	Final draft zonal content of Costing Manual is provided to Ofcom for review, setting out how the Q1 Costing Manual will document the zonal costing methodology as being compliant with the new zonal costing rules.
90 days after end Q1 2012-13	Compliant Q1 Costing Manual is published, with confidential Technical Appendices supplied to Ofcom, including documentation of zonal costing methodology that complies with zonal costing rules
90 days after end of Q2 2012-13	Compliant Q2 Costing Manual published, with confidential Technical Appendices supplied to Ofcom, including documentation of zonal costing methodology that complies with the zonal costing rules including use of End-to-end MCS volumes for zonal cost estimation (Rule 13).
Before start of 2013-14	• Completion of cost and boundary reviews required under rules 14/19 and 18 respectively (and completion of prior Royal Mail consultation over any proposed changes to boundaries under Rule 18) • Evidence on postcode sector sampling undertaken to meet Rule 17 • Pre-notification to Ofcom of any associated material compliant change to the Costing Methodology applicable from Q1 2013-14

Long Run Incremental Costs

Background

A3.166 In our October consultation we highlighted the potential future use of LRIC data to monitor access margin squeeze.[4] We also stated that LRIC data could have an important role to play in the wider regulatory framework, for example as a tool for cost orientation monitoring.[5] Included in this section is a brief overview of the potential uses of LRIC data.

A3.167 The potential use of LRIC data for access margin squeeze was highlighted in Postcomm's April 2011 consultation.[6] As set out in that consultation, if the differential between retail and access prices is based on Royal Mail's LRIC then only operators who are more efficient than Royal Mail at providing upstream services should be able to sustain market share. In this way, an ex ante margin squeeze test based on LRIC is likely to be preferable to a FAC based regime in that it should promote greater efficiency of entry and competition.[7]

4 Ofcom Consultation "Securing the Universal Postal Service" October 2011, paragraph 7.86

5 Ofcom Consultation "*Securing the Universal Postal Service*" October 2011, paragraph 8.90

6 Postcomm April 2011 Consultation "*The building blocks for a sustainable postal service*, *Annex B: Cost transparency and accounting separation*" Chapter 6.

7 Margin squeeze tests which are based on an incumbent's costs, effectively the EEO (Equally Efficient Operator) test are typically used in ex-post investigations. In using LRIC data ex-ante an alternative cost base often used is that of the REO (Reasonably Efficient Operator) which can be more effective in promoting competition. (For more information refer to Postcomm Consultation referenced above).

A3.168 LRIC data can also be used by competition authorities to aid detection of anti-competitive pricing behaviour such as margin squeeze or predation.

A3.169 Margin squeeze occurs where a vertically integrated undertaking holding a dominant position in the supply of an important input prevents efficient non-vertically integrated competitors from achieving an economically viable price cost margin. In assessing whether there is a viable price cost margin in a regulatory context LRIC data is often needed.

A3.170 Predation in contrast involves an undertaking deliberately incurring losses by pricing below average avoidable cost in order to either eliminate a competitor or to create a barrier to entry into the market for potential new competitors so as to be able to charge excessive prices in the future. In assessing any allegation of predation, LRAIC[8] is thus often used as a regulatory benchmark for setting a floor below which a firm should not price its products.

A3.171 Further, LRIC data can be used in the identification of cross-subsidies. Cross subsidisation occurs where a product's revenues do not cover its incremental costs while the revenues from other products exceed their standalone costs (SAC). The SAC of a product is the cost that a firm producing nothing else would incur in producing the product. If a product's revenue over the long run is lower than LRIC, it is unlikely to be sustainable without such cross-subsidy. Under some circumstances, this may be a concern if it leads to foreclosure.[9]

A3.172 In summary LRIC data are potentially useful for a variety of different purposes including ex ante and ex post margin squeeze assessment, the assessment of whether retail prices are cost orientated the detection of anti-competitive behaviour and identifying the presence of undue cross-subsidies.

A3.173 For these different purposes, different types of LRIC estimates may be needed which may vary on a case by case basis. In particular, depending on the focus of the regulatory need, it may be appropriate to include some form of mark-up for common costs in addition to the LRIC estimate. Further in the event that cross-subsidies or predation were being considered, it is also plausible that a form of SAC data would also be required.

A3.174 Hence we believe that LRIC and SAC estimates are useful tools for regulatory purposes whose precise definition may vary on the regulatory or competition law requirement.

Derivation of LRIC Data

A3.175 LRIC data does not currently form part of the regulatory regime and moving to a regime which utilises LRIC estimates is dependent on the provision of reliable LRIC data.

[8] LRAIC (Long Run Average Incremental Costs) is a form of LRIC in which the incremental costs are averaged across the volume within the increment. LRIC is often used as a generic term which encompasses LRAIC data.

[9] See OFT 417, Competition Act 1998 the application in the telecommunications sector says in paragraph 7.11 *"….the existence of economies of scope means that if the prices of each of an undertaking's services are equal to each service's LRIC, the undertaking will not recover its common costs. To ensure that such a situation could not have an anticompetitive effect, the undertaking would need to be able to demonstrate two things: first that its individual prices are set at or above LRIC and secondly, that the combined prices of services in groups that share common costs cover both LRIC and the common costs of supplying those services."*

A3.176 In the context of ex ante margin squeeze tests, the provision of robust LRIC data by Royal Mail was set out as a key dependency within our October consultation.[10] The October Consultation proposed reviewing the ex ante margin squeeze regulation in the short term, with the expectation of moving to a LRIC based regime by 2014-15.

A3.177 In the October consultation we stated our intention to work with Royal Mail to understand how their top down LRAIC data is being generated.[11] We have since received a version of Royal Mail's model and are in the process of discussing its structure and assumptions with Royal Mail. This should enable us to assess whether this model will be able to provide robust data in a timely manner appropriate for use in ex ante regulatory monitoring and/or ex post investigations.

A3.178 The top down LRAIC model that Royal Mail is in the process of developing is based on historic costs, referred to as a Type One model. They also plan to use the same framework to develop a LRAIC model based on forecast data, referred to as Type Two model.[12]

A3.179 To provide appropriate estimates we would expect Royal Mail's model to exhibit the following characteristics, some of which are specific to a Type One approach:-

- **Transparent**: The model should produce intuitively sensible results, the derivation of which can readily be traced back to audited FAC costs. All output should be transparent including common cost groupings as well as increment LRICs / and product LRAICs.
- **Relevant**: The structure should be defined with relevance to the regulatory / competition question being asked.
- **Accurate**: The Cost Volume Relationships (CVRs) and common costs identified should accurately reflect Royal Mail's operations. Volumes and costs should be reconcilable with the FAC system.
- **Comprehensive**: the model should identify the LRIC components of all parts of Royal Mail's relevant cost base and facilitate an audit trail between FAC and LRIC.
- **Timely**: results should be available on a LRIC basis shortly after the production of FAC.

A3.180 We would also expect appropriate controls around the model including formal audit and control procedures.

A3.181 The draft model Royal Mail has provided us is not yet populated with data such that the output can be effectively interpreted and hence we are unable to indicate at this stage whether we feel it will be able to provide, in due course, an appropriate tool for use in ex ante margin squeeze testing or for regulatory purposes more widely.

Summary

A3.182 The availability of suitable LRIC data has been identified as an important tool within the UK postal regulatory framework. Robust LRIC data are however not yet available. Progress to date by Royal Mail in producing and sharing LRIC data has been slower than that anticipated both originally, by both Postcomm and Ofcom.

[10] Ofcom October 2011 Consultation "*Securing the Universal Service Obligation*" paragraph 7.86
[11] Ofcom October 2011 Consultation "*Securing the Universal Service Obligation*" paragraph 8.91
[12] Refer to Royal Mail December 2010 Discussion Document "*The Development of Long Run Incremental Cost Estimates in the Postal Sector*" for further details.

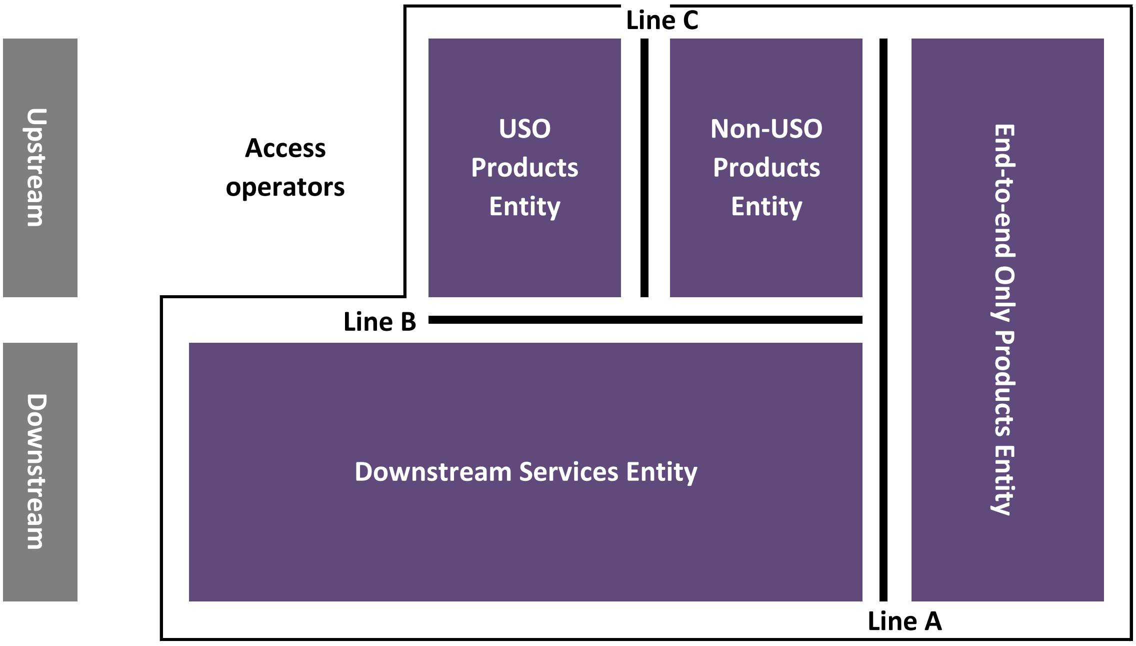
A3.183 We expect to focus our resource on the immediate requirement of LRIC data for ex ante margin squeeze testing, on which we will need to make significant progress in the short term before we can consult on how it may be incorporated within a new regime.

Accounting separation

Our consultation proposals

A3.184 In our October consultation, we proposed that for regulatory financial reporting purposes, the Reported Business should be separated into four Financial Reporting Entities ('Four FREs'), as shown below:

Figure 1: The Four FREs



A3.185 We proposed that these accounting separations should be implemented by dividing the financial statements of the Reported Business (income statement, capital employed statement and operating cash flow statement) into four consistent components along the following accounting separation lines:

- Line A, which separates products that do not require the benefit of access to Royal Mail's integrated core universal service network for their provision from those that do;

- Line B, which separates Royal Mail's end-to-end products that do require the benefit of access to its core universal service network, into downstream and upstream entities, at the point of entry to the Inward Mail Centre; and

- Line C, which separates USO retail products from other retail products using Royal Mail's core universal service network.

Separation by Line A

Our consultation proposals

A3.186 Our proposed Line A would separate the costs and revenues of retail Mails products which do not need access to Royal Mail's downstream network (because they may be in effective competition with products which are provided end to end by other operators), from the universal service and other Mails products which need access to Royal Mail's downstream network (where different forms of market power exist and different regulatory remedies apply).

A3.187 As we explained in the October consultation, separation by Line A would provide us with important information about the relative contributions to the overall financing of the universal service, by the products requiring access to Royal Mail's downstream network, in contrast with those products which did not require that access. The separation would also provide us with important information about the relationship of average price levels to costs.

Consultation responses

A3.188 The respondents supported these proposals, with the exception of Royal Mail.

A3.189 Royal Mail stated that any separation within the Reported Business (including Line A) would not be proportionate to prepare, because

- it would not provide additional useful or necessary information for Ofcom's primary postal services duty or competition duties; and
- it would be costly to prepare (Royal Mail stated that it had already spent 300 days on reporting which would increase by 100% by Ofcom's overall proposals for regulatory financial reporting).

A3.190 Royal Mail proposed to provide Ofcom with its internal monthly management reports ('Group Monthly Accounts and KPI Performance Pack') which, in Royal Mail's view, would adequately address our information needs.

A3.191 Royal Mail's advisers, Oxera, however acknowledged that our proposed Line A had merit and was consistent with Ofcom's regulatory objectives[13].

Our decision

A3.192 We do not agree with Royal Mail's assertion that separation by Line A would not provide useful or necessary information for Ofcom's primary duty or competition duties. We have reviewed Royal Mail's internal monthly management reports. While we agree with Royal Mail that they provide useful information for Ofcom's regulatory objectives, we do not believe they provide the information we would obtain from Line A separation.

A3.193 Additionally, we do not consider the Line A separation to be a costly exercise. As we explain later in this annex, Royal Mail supported the preparation of product profitability statements. Preparing a separated income statement for 'End to end only products' entity would require relatively insignificant additional work to allocate

[13] Oxera, Assessments of Ofcom's proposals on financial reporting, Prepared for Royal Mail, 5 January 2012, page 8, section 3.3.1, first paragraph

exceptional costs once the relevant product profitability statements have been prepared.

A3.194 Given the importance of monitoring the effectiveness of end to end and access competition, we remain satisfied that our proposed income statement split by Line A will provide us with valuable additional information without significant additional costs to Royal Mail. We therefore believe Line A separation is proportionate.

A3.195 We explain our reasons for separation of the capital employed and cash flow statements in paragraphs A3.240 to A3.248.

Transfer pricing across Line A

Our consultation proposals

A3.196 In the October consultation, we proposed that transfer prices may be necessary across Line A. We proposed that these transfer prices should be determined by applying our proposed cost-plus pricing principle (FAC costs plus the mark-up of 10% proposed for transfer pricing).

A3.197 In particular, we referred to the case of two universal service products: standard parcels heavier than 2kg and Special Delivery by 1pm. The operations and costs related to these products are associated with activities which generally support the provision of products located in the ‘End to end only products’ entity, but their revenues are allocated to the ‘USO products’ entity.

A3.198 We therefore proposed that there should be transfer prices for the provision of activities required to support these products by the ‘End to end only products’ entity to the ‘USO products’ entity.

Consultation responses

A3.199 Both Royal Mail and Oxera stated that our proposed transfer pricing between the ‘End-to-end only products’ entity and the ‘USO products’ entity was unnecessary and overcomplicated.

A3.200 Royal Mail stated that both above-mentioned products use the USO network heavily, and their costs should therefore be allocated to the ‘USO products’ and ‘Downstream services’ entities. This would eliminate the need for transfer pricing across Line A (while resulting in a requirement for transfer pricing these products across Line B).

Further analysis

A3.201 We have considered Royal Mail’s arguments, and reviewed the supporting costing data that Royal Mail subsequently provided.

A3.202 The data indicate that the universal service Special Delivery Next Day product incurs certain costs that, Royal Mail argues, are specific to its universal service status (in particular the POL counter handling and POL product fees). However, these costs are also incurred by the non-USO Special Delivery single piece product (9am), and other network costs are shared with other Special Delivery products. This means few costs are specific to the universal service status of particular products.

A3.203 The data also show that the provision of Special Delivery products more generally share various dedicated end to end network activities to the extent that the associated costs outweigh the POL counter handling and POL product fees highlighted by Royal Mail.

A3.204 The FAC data provided for universal service standard parcels were not split between > 2kg and < 2kg. These data indicate that the provision of the product relies on various end to end network activities shared with non-US products. The sharing is significant, to the extent that the associated costs outweigh the POL counter handling and POL product fees, which might be more specific to single piece universal service parcels.

A3.205 The data therefore do not support Royal Mail's argument that these universal service products alone use dedicated network activities to the extent that their costs should be allocated to the 'USO products' and 'Downstream services' entities.

Our decision

A3.206 We have decided to confirm our proposals with respect to transfer pricing across Line A. Specifically, we have decided that the costs of the two universal service products, standard parcels above 2kg, and Special Delivery Next day, should be included in the 'End-to-end only products' entity, and that there should be transfer prices for the provision of activities required to support these products by the 'End to end only products' entity to the 'USO products' entity.

Separation by Lines B and C

Our consultation proposals

A3.207 In our October consultation, we proposed that Royal Mail should prepare separated accounts for:

- the horizontally integrated downstream network activities ('Downstream services' entity) access to which is necessary for the efficient provision of universal service and certain other retail products (Line B separation), and
- the two sets of upstream activities required for these retail products, covering the provision of universal service and other products respectively, both of which use the integrated downstream network (Line C separation).

A3.208 In the October consultation, we explained that Line B separation would assist us in monitoring the financial performance of the downstream network activities to secure a financially sustainable and efficient universal service. It would also help us monitor the impact of competition by providing transparency in the relative profitability of upstream and downstream activities.

A3.209 We also explained that Line C separation would help us monitor the profitability and operating financial performance of USO and non-USO products and their respective contribution to the financeability of the USO. It would also assist us in assessing the extent to which the prices charged for universal service products are cost orientated, particularly in the absence of reliable LRIC data for regulatory purposes at this stage.

A3.210 The 'non-USO products' entity broadly corresponds to the operations of access operators handling bulk mail, and hence the financial performance of this entity would be broadly comparable to those access operators, allowing us to assess costs and revenues on a comparative basis.

Consultation responses

A3.211 The respondents supported these proposals, with the exception of Royal Mail.

A3.212 Royal Mail responded that any separated accounts within the Reported Business (including Lines B and C) would not be proportionate to prepare, because they:

- would not be useful or necessary for Ofcom's primary duty or competition duties, involving large number of arbitrary assumptions, not reflecting true costs of the integrated USO network, and involving transfer prices not reflecting market rates; and

- would be costly to prepare (as mentioned before, Royal Mail stated that it had already spent 300 days on regulatory financial reporting in total which would increase by 100% by Ofcom's proposals), and to audit, likely to lead to qualifications, if a higher "fairly presents" audit standard was applied in due course as we proposed.

A3.213 Royal Mail stated that the internal monthly management reports ('Group Monthly Accounts and KPI Performance Pack') that it proposed to provide to us would address our information needs.

A3.214 Royal Mail's advisers, Oxera, also argued that Line B and Line C separations did not seem necessary for Ofcom to meet its regulatory objectives. They stated that these separations are not needed for securing the financeability of the USO, and are of limited benefit for ex post competition investigations. Oxera also argued that there is no clear rationale for a transfer price for USO products (i.e. the split by Line B for those products).

Further analysis

A3.215 Having considered Royal Mail and its advisor's arguments, we still consider that Lines B and C provide information which is important for our regulatory objectives.

A3.216 We have reviewed Royal Mail's internal monthly management reports, and we do not believe that they provide us with all the information we would obtain from Line B and C separations.

A3.217 We do not agree that separation by Line B and C involve any fundamentally different assumptions from those already applied by Royal Mail in allocating costs and assigning revenues for audited regulatory financial reporting purposes.

A3.218 In particular, we do not believe transfer pricing between upstream and downstream (across Line B) requires arbitrary assumptions. We believe - and have satisfied ourselves by our own modelling and analyses - that transfer pricing can be implemented using external market prices for access services.

A3.219 Based on our own modelling and analyses, we do not believe that implementing Line B and C separations requires extensive additional effort – and could require less than the effort estimated by Royal Mail. Indeed, even Royal Mail's estimate of extra 300 man days needed for all the new reporting requirements is not a disproportionate cost (equivalent to one extra member of staff) for reporting on over £6billion of costs and revenues, to assist us in discharging our statutory duties.

A3.220 We acknowledge that the case for applying transfer pricing for USO products, based on equivalence, is not as strong as the case for non-USO products. There is significantly less competition for single piece USO products.

A3.221 Further, the downstream network activities are horizontally integrated and are efficiently operated by providing joint services to both USO and non-USO products (e.g. using the same postman). Assessment of the overall efficiency of these integrated downstream activities, and the cost orientation of the prices for the associated services, therefore requires their integrated assessment. This requires Line B to be extended to all downstream services, and hence to USO products as well as non-USO products.

A3.222 However, we accept that transfer pricing USO products is primarily to allow us to build a full picture of the overall profitability of the downstream network (the 'Downstream services' entity). Therefore, the transfer pricing of the USO products need not be as sophisticated or detailed as that for the non-USO products, as long as it complies with the principles of equivalence, cost-plus pricing and grouping set out in the RAG.

Our decision

A3.223 The information from our proposed Line B and C separations is necessary for our regulatory objectives, and cannot be fully derived from RM's internal monthly management reports. We have therefore decided to require Line B and C separations.

A3.224 We explain our reasons for separation of the capital employed and cash flow statements in paragraphs A3.240 to A3.248.

Transfer pricing across Line B

Our consultation proposals

A3.225 In transfer pricing across Line B, i.e. between the 'Downstream services' entity on the one hand and the 'USO products' and 'non-USO products' entities on the other, we proposed that standard access (D+2 and later) products, rather than premium access (D+1) products should be used as the basis for transfer pricing the downstream services used by Royal Mail's D+1 retail products.

A3.226 In our October consultation, we stated that in principle, any premium for D+1 transfer prices should have regard to relative willingness of different users to pay for the downstream services concerned.

A3.227 We noted however that the existing premium access products were little used at existing price levels (less than 1% of the total access volume in 2009-10), and this would not provide a robust basis for applying transfer pricing in line with our general principles.

A3.228 In contrast, the standard access products were well-established in the market with significant volumes (over 7billion items in 2010-11). In the absence of more robust market evidence, making FAC-based adjustments to these standard access prices seemed more objective and transparent "at least in the near future".

Consultation responses

A3.229 Royal Mail, Mail Competition Forum (including TNT), Secured Mail, and DX Group all responded that premium access is a more appropriate basis for transfer pricing D+1 retail products.

A3.230 Royal Mail argued that transfer prices should reflect differences in demand as well as cost, and premium access prices were in practice a closer representation of the market demand for its relevant D+1 downstream services.

A3.231 Other operators argued for premium access because in their view such a basis would:

- increase downstream revenues, thereby (i) reducing the need for standard access prices to be raised to yield a given overall return on downstream services, and (ii) increasing the pressure on RM to reduce standard access prices to maintain allowable return;

- avoid further regulatory judgement over an appropriate premium; and

- signal cost differences between D+1 and D+2 and later downstream services better than Royal Mail's FAC product costing system.

Further analysis

A3.232 As explained in our October consultation, we agree with Royal Mail's argument that, in principle, there should be a premium for D+1 transfer prices which has regard to relative willingness of different users to pay for the downstream services concerned.

A3.233 However, we do not agree that the way in which its premium access products has been priced would necessarily offer in practice a closer representation of the demand, because low premium access sales in 2009-10 or 2010-11 (albeit higher than 2009-10) did not seem to provide a robust basis for inferring users' actual willingness to pay for the services concerned.

A3.234 Our modelling of accounting separation for 2010-11 has shown that the total profitability of the 'USO products' and 'Downstream services' entities taken together would be significantly higher if premium access were to be used as the basis for transfer pricing.

A3.235 However, around a third of this difference arises because the matching between premium access products and Royal Mail's D+1 retail products is imperfect, due to the absence of any sales and costs for some of the premium access products concerned.

A3.236 If more of the existing range of premium access products were sold, the available base for transfer prices would increase, and as a result it would be possible to achieve better matching. Our initial analysis of the first two quarters of 2011-12, which include a wider variety of premium access products now being sold as Royal Mail indicated in its consultation response, confirms this.

A3.237 Therefore, the growth in the volume and variety of premium access sales may not only make these products a more economically robust basis for transfer pricing, but it may also make closer matching and more accurate transfer pricing possible.

Our decision

A3.238 In light of the above, and given the recent increase in sales volume of premium access products, we have decided to allow Royal Mail to use those premium access prices (as a basis for transfer pricing D+1 retail products), for which it can demonstrate:

- sufficient sales volumes to form a statistically valid basis for the calculation of the FAC, and
- material sales volumes, when compared to the volume of mail which is to be transfer priced (to be judged on case by case basis with regard to our definitions of materiality as set out in the RAG).

A3.239 In all other cases, Royal Mail should use the most comparable standard access product as the basis, as set out in our October consultation.

Capital employed statement and cash flow statement

A3.240 In our October consultation, we proposed that Royal Mail should prepare an operating balance sheet (capital employed statement) and cash flow statement for the Reported Business as a whole, as well as separated operating balance sheets (capital employed statements) and cash flow statements for the Four FREs (separated accounting entities created by Line A, B and C separations).

A3.241 This information would help us meet the regulatory objectives of understanding there turns on capital employed and financeability of the Reported Business, as well as the relative contribution of different parts of the Reported Business to its returns on capital employed and financeability.

A3.242 The respondents supported the proposal with the exception of Royal Mail.

A3.243 Royal Mail responded that the balance sheet and cash flow and their splits would not be useful for Ofcom's primary duty or competition duties, because:

- The splits would be arbitrary, as they are based on ABC costing, and given the integrated nature of the USO network activities; and
- Royal Mail does not itself use separated balance sheet and cash flow for monitoring performance.

A3.244 Royal Mail therefore argued that the additional effort required for preparing and separating balance sheets and cash flows would be disproportionate.

A3.245 Despite the above response, in responding to our proposed ex ante margin squeeze controls, Royal Mail proposed[14] to reflect asset splits based on FAC and stressed the importance of recognising different upstream and downstream asset intensity. This shows that Royal Mail considers an upstream-downstream split of the network assets – which is consistent with the depreciation splits already reflected in its FAC product costing - not only to be significant, but also achievable.

[14] Royal Mail's response to our October 2012 proposals, Annex A: Empirical evidence regarding the appropriate "return" in Ofcom's proposed margin squeeze test

A3.246 Having considered Royal Mail's responses, we are still of the view that different parts of the Reported Business should be expected to earn widely divergent profits given the different processes, market/regulatory conditions, and asset intensities involved. Our proposed splits therefore provide valuable additional and better targeted regulatory information to assess profitability, efficiency and financeability of the activities used for, or in connection with, the provision of the universal service.

A3.247 We have reviewed Royal Mail's proposed internal monthly reports which provide some information about the assets and cash flows of the Reported Business. In our view, they do not provide most of the information which we expect the separated capital employed and cash flow statements to provide.

A3.248 We have therefore decided to confirm the requirements for separated statements of capital employed and operational cash flows. We propose to work with Royal Mail and its auditors, under the tri-partite arrangement, to confirm any remaining issues in relation to the detailed workings of the separations in the context of reviewing the draft Accounting Methodology Manual during 2012-13.

A3.249 We have also simplified the rules set out in the RAG for the preparation of cash flow statements for the Reported Business and the Four FREs, and allowed Royal Mail to allocate cash flows as appropriate, based on splits in either the income statement or the capital employed statement.

Reporting

A3.250 In our October consultation, we proposed that Royal Mail should prepare the following statements for the Reported Business as a whole, and the Four FREs:

- Annual audited income statements (to EBIT only), capital employed statement and operational cash flow statement; and

- Quarterly unaudited income statements (to Operating profit after FAC and before exceptional costs only).

A3.251 In light of our decisions above, and considering our decision as to the need for quarterly reporting set out in the previous section, we confirm the above requirements.

A3.252 We consider audit and publication in separate sections below.

Product profitability statements

Our consultation proposals, responses, and further analysis

A3.253 In the October consultation, we proposed that Royal Mail should prepare a set of product profitability statements. These statements were to include the product FAC estimates covered in the National Costing Methodology, and show the results down to the profit after FAC but before exceptional items.

A3.254 Most respondents supported our proposal as part of their general endorsement of our regulatory financial reporting proposals. A number of responses emphasised the importance of the monitoring regime in the context of the proposed new regulatory framework, as well as the importance of ensuring adequate and accurate information is available for the monitoring regime to be effective.

A3.255 Royal Mail also agreed with our proposal on product profitability statements. There were not many detailed responses on the types of products we had included in our proposed statements, and no respondent raised any issues about the general proposal.

A3.256 We acknowledge that we cannot foresee the future detailed reporting requirements for the monitoring regime, because this will depend on evolving issues such as:

- the future scope of Royal Mail's universal service obligation;
- our other universal service safeguards following our needs review;
- Royal Mail's product portfolio; and
- the evolution of access and end to end competition, and the associated safeguards.

A3.257 The uncertainty over the exact requirements of the monitoring regime in future particularly applies to product profitability statements, which provide relatively more granular financial information.

A3.258 Notwithstanding the above limitations, we have continued to consider the needs of the monitoring regime at this stage in light of the responses and our discussions with Royal Mail. As a result we have decided to amend the list of product profitability statements to align it with our final decisions for other regulatory safeguards for 2012-13. These amendments are explained in the following section.

A3.259 We will consult as required, if further changes to the detailed scope of reporting set out in the RAG become necessary in the future.

Our decision

A3.260 The following table sets out the product profitability statements which we have decided to require, also showing within which one of the Four FREs each statement falls:

Table 4: Product Profitability Statements

No.	No. as per draft RAG	Statement	FREs
1	1	Access products < 2kg	Downstream services
2	2	Pre-sorted D+1 Letters and Large Letters	Non-USO products Downstream services
3	3	Pre-sorted D+2 and later Letters and Large Letters	
4	4	High volume D+1 unsorted Letters	
5	5	High volume D+1 unsorted Large Letters	
6	6	High volume unsorted D+2 and later Letters	
7	7	High volume unsorted D+2 and later Large Letters	
8	8	Low volume unsorted non-USO Letters	
9	9	Low volume unsorted non-USO Large Letters	
10	12	Non-USO B2X Deferred Light (1kg - 2kg) PPS	
11	13	Non-USO B2X Deferred Light (500g – 1kg) PPS	
12	14	Non-USO B2X Deferred Light (0-500g) PPS	
14		Non-USO International	
15		Non-USO Return to sender	
16		Other non-USO services	
17	15	USO single piece first class products sold via stamps payment channel	USO products Downstream services
18	16	USO single piece second class products sold via stamps payment channel	
19	17	USO single piece first class products sold via non-stamps payment channel	
20	18	USO single piece second class products sold via non-stamps payment channel	
21		USO Special Delivery products	
22		USO International	
23		USO Return to sender	
24	19	Other universal services	
25	10	Non-USO B2X Express PPS	End to end only products
26	11	Non-USO B2X Deferred Heavy (>2kg) PPS	
27		Other non-USO Special Delivery products	
28	20	Relay	
29	21	PAF	
30		International Contract Bulk	
31		Access products > 2kg	
32		Other end to end only products	

A3.261 Our amendments, together with the reasons for them, are as follows:

- Clarifying that Access products heavier 2kg should be included in the 'End to end only products' entity, in line with all non-USO retail products heavier than 2kg;

- Changing the scope of the two statements for USO first and second class products sold via the Meter payment channel to include all other payment channels (including PPI), to ensure all non-stamp payment methods are captured in these two statements;

- Two separate statements for USO Special Delivery and Other non-USO Special Delivery products(all products other than those Special Delivery products being within Non-USO B2X Express PPS), due to the different network activities;

involved in the provision of these products (compared with others) and also the size of the related revenue;

- Two separate statements for USO International and non-USO International products (excluding International Contract Bulk), due to the different network activities involved in the provision of these products (compared with others) and also the size of the related revenue;

- Two separate statements for Return to sender USO and Return to sender non-USO products, due to our proposals to monitor the respective financial results of these products, where Royal Mail may introduce charges for the universal service products concerned; and

- Two additional statements for two further residual categories for other non-USO and end to end only products to ensure completeness, so that by adding up all the relevant product profitability statements, a complete picture of the profitability to FAC (before exceptional items) of each of the Four FREs can be obtained[15].

A3.262 Accordingly, following our decisions over the scope of and safeguards for, the universal service in 2012-13, we now propose a total of 32 product profitability statements, compared to the 22 specified in our October consultation (including Relay, International Contract Bulk, and PAF).

A3.263 The distinction between 'high' volume and 'low' volume markets was defined at a threshold of 250 collections per day in Postcomm's market study[16]. We consider that a sufficiently close and practical proxy for this distinction to be made for a particular service is whether Royal Mail offers a discount to a customer for providing that service (which would, among other things, exclude it from the universal service as we have now defined it).

A3.264 However, for the purposes of product profitability statements, a further acceptable simplification is to assume that the distinction between 'high' volume and 'low' volume is aligned to Royal Mail's specification of its products in the reporting period in question. Broadly speaking, this means the following assumptions can be made for the current specification of products by Royal Mail:

- 'Low volume unsorted' approximates to USO single piece products; and

- 'High volume unsorted' approximates to Non-USO unsorted products.

A3.265 We have however retained in our table the two additional categories of 'Low volume unsorted non-USO Letters' and 'Low volume unsorted non-USO Large Letters', to allow for the possibility that these two categories become significant as a result of future potential changes to the definition and the scope of the universal service and Royal Mail's products.

Reporting

A3.266 We proposed that product profitability statements should prepared on a quarterly basis. No respondent raised any issues with this proposal.

15 We expect products 1 to 24 in the Table to include all the products needed to form a complete picture of the revenues and costs of the 'Downstream services' entity. Item 1, 'Access products' should cover all the revenues which Royal Mail (hence the 'Downstream services' entity) earns from access operators.

16 Laying the foundations for a sustainable postal service, Annex 2: Analysis of markets, May 2010

A3.267 As explained before, Royal Mail accepted that quarterly product profitability statements would be relevant, and agreed to provide them, on a confidential and unaudited basis, as we proposed.

A3.268 We have therefore decided to confirm the requirement for quarterly reporting of the product profitability statements set out in the table above.

Other regulatory financial reports

Monthly management information

A3.269 In our October consultation, we proposed that Royal Mail should continue to provide Ofcom with monthly revenue, traffic and cost data.

A3.270 None of the respondent raised any issues with these proposals with the exception of Royal Mail.

A3.271 In its response to our December consultation, Royal Mail noted that the revenue and traffic information was broadly in line with the existing format of monthly regulatory financial information that Royal Mail currently provides to Ofcom. However, Royal Mail stated that its monthly cost information was only available at UKLPI level, and not at the Reported Business level reflected in our December consultation proposals for the RAG.

A3.272 In its response, Royal Mail offered to provide to us, on a confidential basis, their internal monthly management reports ('Group Monthly Accounts and KPI Performance Pack'). It argued that these reports provide information which would address our information needs better than our proposed separated accounts for the Four FREs, and also provide monthly cost information at UKLPI level.

A3.273 As explained before, we have reviewed Royal Mail's current monthly management reports; and we do not agree that they would meet the same information needs which our proposed accounting separations are expected to do. However, we do acknowledge that they provide useful information, including a detailed financial and operational context which would help us interpret better the monthly revenue, volume and cost information for regulatory financial reporting purposes.

A3.274 We understand that monthly cost information at UKLPI level would not exactly match the revenue and volume information which is related to the Reported Business. The former will include the monthly costs of other UKLPI business units as well as the Reported Business. However, the primary purpose of our requirement for monthly management information is to understand the raw trading results of the Reported Business as opposed to the detailed product profitability outcomes, which we expect to understand through quarterly product profitability statements based on the FAC outputs of the costing system.

A3.275 In our view, monthly cost information at UKLPI is a sufficiently helpful and proportionate proxy, considering the amount of additional work that Royal Mail would otherwise need to carry out to produce monthly cost data for the Reported Business, given that the FAC product costing system only operates on a quarterly cycle,

A3.276 We have therefore decided to reflect Royal Mail's suggestions in our finalised requirements, in so far as they relate to monthly management information. We have amended the related pro forma in the RAG accordingly.

Accounting Methodology Manual

A3.277 In our October consultation, we proposed that Royal Mail should prepare an Accounting Methodology Manual (in conjunction with the existing Costing Manual) to document the methodology it uses to produce its regulatory financial reports in compliance with our USP Accounting condition and RAG, and set out fully the basis on which these reports have been prepared and audited.

A3.278 None of the respondents raised any issues with these proposals with the exception of Royal Mail, which had concerns over our proposed implementation timetable for the Accounting Methodology Manual.

A3.279 We proposed that a copy of the competed Accounting Methodology Manual to be provided to us by 23 June 2012. Royal Mail responded that this timing was not practicable, because Ofcom's decision would not be made available until March 2012. The preparation of the Accounting Methodology Manual would therefore coincide with the normal year end process which occupies all existing accounting resources in the period following year end, leaving minimal resource available.

A3.280 Royal Mail therefore proposed to provide Ofcom with a first draft of the Accounting Methodology Manual covering the quarterly reports by 31 August 2012,as the first quarterly reports are not due until 30 September 2012. Royal Mail also proposed to provide Ofcom with further drafts during 2012-13 encompassing the full reporting requirement as they become due.

A3.281 We acknowledge the practical difficulties of preparing the Accounting Methodology Manual in the period immediately following the year-end. However, a period of a month for Ofcom to review a draft, provide comments, and for Royal Mail to address these as required, also does not appear to be practical.

A3.282 We have therefore decided that Royal Mail is to provide us with a first draft of the Accounting Methodology Manual covering quarterly reports earlier, by 31 July 2012. This is to be followed by the final version of the quarterly reports Manual which complies fully with the RAG, by 30 September 2012 (when the first quarterly reports covered by the methodology documented in the Manual fall due).

A3.283 This timing would provide sufficient time to Royal Mail to prepare first draft and to Ofcom to review the Manual and have sufficient confidence that the final version to be produced by 30 September is compliant with the RAG.

A3.284 We have also decided that Royal Mail should provide to Ofcom the first full draft of the Accounting Methodology Manual, including the preparation of the annual audited information and statements such as capital employed and cash flow statements, by 31 December 2012. This is to be followed by the final full version of the Accounting Methodology Manual by 31 May 2013.

A3.285 The above timetable would allow the opportunity for the content to be fully discussed and agreed with Royal Mail's auditors under the tri-partite assurance process before processing of year-end data gets underway.

Audit

Scope

Our consultation proposals

A3.286 In our October consultation we proposed that, in order to gain adequate assurance about the accuracy and appropriateness of the regulatory financial information provided to us by Royal Mail, external audit opinion should be obtained for the annual regulatory financial statements for the Relevant Group, Reported Business and the Four FREs, along with the separated income statements for universal service products, other Mails products and non-Mails products as set out below:

Table 5: Audit requirements

Entity	Requirement
Relevant Group	Consolidated income statement
	Consolidated balance sheet statement
	Consolidated cash flow statement
	Reconciliation of all of the above statements to consolidated accounts of RMH plc
Reported Business	Annual Income statement
	Annual reconciliation of income statement with the equivalent information for the Relevant Group
	Annual capital employed statement
	Annual reconciliation of capital employed statement with the equivalent information for the Relevant Group
	Annual cash flow sheet statement
	Annual reconciliation of cash flow sheet statement with the equivalent information for the Relevant Group
Reported Business – Separated	Annual Income statements
	Annual Income statement for USO, non-USO and non-Mails
	Annual capital employed statements
	Annual cash flow sheet statements
	Annual product profitability statements

A3.287 In the October consultation, we also proposed that Royal Mail should notify Ofcom, in advance, of any material changes made to its Costing Manual and Accounting Methodology Manual.

A3.288 Additionally, in the proposed USP Accounting condition in our December consultation, we reflected the existing regulatory requirement that Royal Mail should secure a statement by the external auditor setting out whether or not Royal Mail has complied with the pre-notification requirements of the USP accounting condition.

A3.289 This compliance audit would allow Ofcom to continue to assess, in a timely fashion whether Royal Mail's regulatory accounting methodology continues to be in compliance with the USP Accounting condition and the RAG.

Consultation responses

A3.290 A key theme of the consultation responses was that the market should have confidence in the quality of regulatory financial reporting information used by Ofcom, and most respondents, including Royal Mail, agreed to the proposed statements and reports being subject to external audit.

A3.291 In response to the December consultation, Royal Mail raised concerns regarding the compliance audit for material changes, both in relation to its timing and its potential impact on the work relating to the quarterly financial statements and reports. Royal Mail stated that the work required for the compliance audit would jeopardise its ability to deliver the quarterly financial statements and reports within the 90 days proposed by Ofcom.

Further analysis

A3.292 To address Royal Mail's concerns in relation to the compliance audit, we clarify that this audit is to be done on an annual basis, as part of the annual audit of the regulatory financial reports. The compliance audit and its scope are only intended to apply to changes in the Accounting Methodology (to be documented in the Costing and Accounting Methodology Manuals) which would result in material changes in the regulatory financial statements and information.

A3.293 The objective of the compliance audit is to provide assurance that Royal Mail has complied with its obligation to notify Ofcom of any material changes in the methodologies set out in these manuals.

A3.294 The compliance audit is therefore not expected to be related to, or interfere with the preparation work related to the quarterly financial statements and reports. In practice, except for the implementation of previously agreed compliance undertakings, there has only been a handful of costing methodology changes that have been pre-notified to the regulator to date in 2011-12.

Our decision

A3.295 As confirmed by the general theme of the consultation responses, we believe that an external audit opinion greatly assists us in meeting our regulatory reporting objectives, and that it enhances market confidence in the underlying information. The level of assurance and quality of information should be constantly under review in order to improve the quality of the information, and our understanding of it.

A3.296 Based on the consultation responses and our further analysis, we have decided to confirm the requirement for an external audit of the regulatory financial statements and information as set out in the October consultation and summarised in Table 5 above.

A3.297 We have also decided to retain the annual compliance audit requirement to notify Ofcom of material changes to the Costing Manual and the Accounting Methodology Manual.

Audit Opinion

Our consultation proposals

A3.298 In our October consultation, we proposed that, with respect to the 2012-13 financial year, the audit opinion should address whether the accounts have been 'properly prepared' in accordance with the RAG.

A3.299 To enhance the level of assurance, we also proposed that the underlying external audit should then move to a 'fairly presents' audit opinion on a phased basis, starting with the key reports, in 2013-14.This represents a similar opinion to that provided by the auditors of BT's regulatory accounts, as this requires the auditors to review and opine on the methodology underlying the regulatory financial statements and information prepared by Royal Mail, as well as whether the rules in the RAG have been followed.

Consultation responses

A3.300 As noted in the previous section, a general theme of the consultation responses was that it is *"essential"* that the regulator and the market have confidence in the financial information that Royal Mail provides. No respondents raised any issue with our proposals relating to audit opinion, except for Royal Mail.

A3.301 Royal Mail responded that their auditors had significant concerns over a move to a 'fairly presents' audit opinion. The auditors had concerns about the current status of data quality, especially at the disaggregated level of the Four FREs, and that such a form of opinion would significantly increase the external audit workload.

A3.302 In addition, the requirement of this form of opinion, that the auditors should review the appropriateness or 'fairness' of the RAG, would in practice be likely to lead to audit opinion qualifications which would defeat the purpose of the external assurance.

A3.303 Royal Mail also stated that Ofcom's proposals for the RAG already represented a far more detailed level of guidance for a documented methodology compared to the existing documentation prepared by Royal Mail. Royal Mail argued that it was unclear why it was necessary to move to a 'fairly presents' audit when the more detailed methodology documented in accordance with Ofcom's RAG could support any 'properly prepared' opinion.

A3.304 Royal Mail also believed that, to address the data integrity issues necessary to obtain a 'fairly presents' audit opinion in relation to the Four FREs, additional resource information based on the Four FREs' definitions. This would lead to "*increased bureaucracy in the operations and slowing down the processing of mail*". Royal Mail also stated that it would require the automated data capture raising HR issues and requiring the need to introduce new IT systems.

Further analysis

A3.305 The accounting rules set out in the RAG are intended to provide a clear framework of regulatory rules within which Royal Mail can develop its methodology to implement our regulatory financial reporting requirements, and improve the underlying data quality to meet these obligations where necessary. However, we acknowledge that any such data quality improvements would be expected to incur additional resources.

A3.306 However, we do not believe that the inadequate data quality alone is a sufficient reason to keep the audit as a ‘properly prepared’ opinion indefinitely. Royal Mail should seek to improve the quality of the underlying information, where and when it is proportionate.

A3.307 This is why, in our October consultation, we proposed that the initial audit opinion for 2012-13 should be a ‘properly prepared’ opinion, and that any move towards the higher threshold of a “fairly presents” opinion could be gradual – starting for example with the aggregate reports for the Relevant Group and Reported Business, where Royal Mail saw fewer issues with data quality.

Our decision

A3.308 We have decided to confirm our October consultation proposal for a ‘properly prepared’ opinion for 2012-13. We appreciate that an early move to the higher audit standard of ‘fairly presents’ would be challenging for Royal Mail, and we therefore propose to keep the preparedness of Royal Mail for such a move under review. We will review the form and scope of the audit opinion regularly as part of the tri-partite meetings (see following section) between Ofcom, Royal Mail and the external auditor.

Audit agreement

Our consultation proposals

A3.309 Currently Royal Mail appoints the external auditors of its regulatory financial statements, who then report to Royal Mail in accordance with the regulatory obligations set out in Ofcom’s initial conditions.

A3.310 In our October consultation, we proposed and invited responses on two options regarding the addressees of the audit report – Royal Mail alone or Royal Mail and Ofcom jointly. The latter option is similar to the tri-partite arrangement that exists between Ofcom, BT and the auditors.

A3.311 Under the first option, auditor’s duty of care relating to their audit report would be to Royal Mail only. Under the second option, i.e. a tri-partite audit arrangement, the duty of care would like be to Royal Mail and Ofcom jointly.

A3.312 We also proposed that Royal Mail should select, and appoint the auditors of the regulatory financial reports, and meet the costs of the audit. However, Royal Mail should agree the terms of the engagement with us, and we should have the right to approve the selected auditors based on an assessment of their ability to undertake the work concerned.

Consultation responses and further analysis

A3.313 No respondents responded specifically to our proposals relating to audit agreement.

A3.314 Given the lack of any concerns over these proposals in the responses, Ofcom believes that the tri-partite option would give Ofcom and the market more confidence in the regulatory financial statements, by giving it more control over the scope, the nature of the opinion (as explained in the previous section), and the methodology of the audit, and also potentially enhance legal recourse in the event of any issues with the audit.

A3.315 Under a tri-partite audit arrangement, Ofcom can address its regulatory reporting issues and concerns directly with the auditors as well as receiving an independent view of the challenges that Royal Mail may face in meeting its reporting requirements.

A3.316 We believe that this will lead to a more productive audit relationship that would help address issues, such as data quality and the appropriate audit opinion standard, in a more efficient and expedient way.

Our decision

A3.317 In light of the above, we have decided to confirm our consultation proposals for a tri-partite audit requirement. We have also decided that Royal Mail should select and appoint the auditors with our approval, and meet the costs of the audit.

Materiality

Criteria

Our consultation proposals

A3.318 In our October consultation, we proposed a further definition of materiality to complement the definition which has been in place for:

- assessing the compliance of the national FAC product costing methodology with the regulatory principles in the existing USP accounting condition, and
- pre-notifying Ofcom of material changes to this FAC product costing methodology.

A3.319 The additional definition of materiality would apply for both compliance and change control purposes to the remainder of Royal Mail's regulatory financial reporting methodology, as set out in the Accounting Methodology Manual in compliance with the RAG.

A3.320 Among other things, the Accounting Methodology Manual is to set out the detailed accounting rules for revenues, assets and liabilities, and cash flows. The FAC product costing methodology itself, documented in the Costing Manual, will continue to be subject to the existing materiality definition.

Consultation responses

A3.321 Respondents to the October consultation broadly agreed that the continuity of the current cost transparency regime was important in underpinning confidence in the new regulatory regime.

A3.322 Royal Mail raised a concern regarding how the new proposed materiality criteria would work in practice. It also stated that the proposal seemed at odds with the current audit practice "*where a materiality threshold would more likely be set at the EBIT line*."

A3.323 Royal Mail questioned the need for applying a compliance threshold for any number in the published information, and claimed that it would require a detailed modelling exercise for every costing change to understand whether the materiality threshold has been reached.

A3.324 Royal Mail also stated that items can be material by virtue of their scope or nature, as well as their size. It proposed that materiality often involves judgement and is best determined by annual discussions on what is material for each part of the statements produced.

Further analysis

A3.325 We emphasise that the new materiality definition is intended to complement, and not replace, the existing materiality concept for FAC product costing. The latter has worked well to date, striking a balance between the level of compliance and the pre-notification achieved, and the work required from Royal Mail. We therefore proposed to preserve it within the new definition.

A3.326 We do not believe that leaving the assessment of materiality for all items other than costs to an annual discussion is appropriate. Royal Mail's proposed approach would not provide Ofcom with sufficient ongoing transparency as to whether Royal Mail has met its regulatory reporting obligations, particularly in the environment of a quarterly reporting cycle. It will also fail to provide Royal Mail itself with clear guidance and certainty on whether it has met its regulatory reporting obligations. As a result, the approach will not provide the market with sufficient confidence that the regulatory reporting requirements have been met.

A3.327 While there will always be some items that are important in scope and nature but fall below the materiality threshold set, these items are expected to be identified and discussed as part of the direct engagement with auditors under the tri-partite audit arrangement.

A3.328 In addressing Royal Mails concerns about how the new materiality definition would work, we clarify that the new materiality definition and the related threshold should operate in the same way as the existing definition for the product costing, but simply to be applied to other elements of the Accounting Methodology used for regulatory financial reporting (which will be covered in the Accounting Methodology Manual).

A3.329 Finally, we emphasise that these definitions of materiality would apply to both compliance with the rules set out in the RAG, and the pre-notification to Ofcom of material changes to the Costing and Accounting Methodology Manuals respectively.

Our decision

A3.330 In light of the above, we have decided to confirm our proposals set out in the October consultation for a new additional materiality definition encompassing all regulatory reporting items addressed in the RAG, in addition to the existing threshold for FAC product costing.

A3.331 We have also decided that Royal Mail must pre-notify material changes to its FAC product costing methodology and regulatory accounting methodology seven days before making those changes. This will enable us to review the changes, and if necessary commence a statutory consultation to deal with the regulatory implications of the changes. We consider a longer notice period to be disproportionate, given the amount of time Royal Mail typically requires to develop, pre-notify and implement changes to its systems.

Thresholds

Our consultation proposals

A3.332 In our October consultation, we proposed that the existing materiality threshold of 1% for FAC product costing should be retained. We also proposed a higher materiality threshold of 3% for the remaining regulatory financial information covered by the Accounting Methodology Manual (including revenues, assets and liabilities, and cash flows). This was to be applied in the same way as the 1% threshold for the purposes of both compliance with the RAG and pre-notification of material changes.

A3.333 The higher threshold of 3% was proposed because:

- the need for full consistency with the regulatory principles for product costing is more fundamental than that required for other wider reporting obligations contained in the RAG; and
- a lower threshold could disproportionately increase the burden of the audit beyond that typically expected for statutory auditing purposes.

A3.334 In our October consultation, we also explained that the 3% threshold was a compromise between the threshold that is currently adopted for BT's regulatory financial reporting (5%), and the 1% used for FAC product costing. We welcomed respondents' views on whether we had struck the appropriate balance.

Consultation responses

A3.335 As mentioned above, the respondents broadly agreed that continuity of the current cost transparency regime (which uses a 1% threshold) was important in underpinning confidence in the new regulatory regime. However, no specific responses were made about the appropriateness of 3%, apart from the response from Royal Mail.

A3.336 Royal Mail responded that the proposed 3% materiality threshold was too low, and that typically a starting point for this type of materiality would be 5% of pre-tax profit (and where profit is not the most appropriate basis, a materiality threshold based on revenue in the range between 0.5% and 1% could be used).

Further analysis

A3.337 As mentioned in our October consultation, our proposed 3% threshold was a compromise on which we sought views from respondents.

A3.338 Given we have had no specific responses apart from Royal Mail's concerns over the 3% threshold being too low and potentially disproportionate, we considered the alternative of a 5% threshold.

A3.339 It is not possible to assess with confidence what the difference in workload associated with a 3% versus 5% threshold for Royal Mail would be. It is also impossible to assess with certainty how much more accuracy and assurance a 3% threshold over 5% threshold would provide. These assessments can only be made with sufficient confidence once we have put the new reporting framework in place and have observed it in action. However, there is still a need for an appropriate starting point.

A3.340 The 5% threshold is consistent with the current practice established by BT's regulatory reporting framework. Given Royal Mail's concerns over disproportionality, and as long as we keep the threshold under close review (particularly as part of the ongoing tri-partite audit meetings),the 5% threshold appears to represent a more appropriate starting point which mitigates the risks identified by Royal Mail.

Our decision

A3.341 In light of above, we have decided to set at 5% the materiality threshold for all items in the regulatory financial statements and information (including revenues, assets and liabilities, and cash flows) excluding product costing. We will keep this threshold under close review to assess any need to change.

Publication and disclosure

Criteria for publication

A3.342 In our October consultation we noted that there was a distinction between the information which we need to ensure our duties are discharged, and the information that the market is entitled to in relation to Royal Mail's performance and financial position, and the effect of regulation on it.

A3.343 Publication of some information could adversely affect Royal Mail's commercial interests and risk affecting the level playing field needed for effective competition, and in consequence could adversely affect its ability to provide the universal service in a financially sustainable and efficient manner.

A3.344 Hence, in general terms, there is a balance to be struck between the benefits and potential risks and costs of publishing information, which will typically result in only a sub-set of the information we require being published.

A3.345 In striking this balance, the specific nature of the information needs to be assessed. In previous sections we have set out the full set of regulatory financial reporting information we have decided that Royal Mail should make available to us.

A3.346 In the remainder of this section we assess each of the major components against a series of criteria for publication. These criteria reflect the broader regulatory objectives for regulatory financial reporting we set out in our October consultation.

A3.347 In relation to potential benefits from publication we need to assess whether it helps to:

- Demonstrate that we have met our relevant duties, in particular in relation to:
  - The financial sustainability of universal service provision
  - The efficiency and returns associated with universal service provision
  - Furthering consumer and citizen interests, by promoting competition where appropriate
- Enable other stakeholders to provide informed inputs to support effective regulation;
- Improve Royal Mail's accountability for the information provided.

A3.348 However these potential benefits need to be weighed against the risks of harm from publication including:

- The risks of harm to Royal Mail – for example from unfair competition arising from disclosure of commercially confidential data – and associated with that the financially sustainable and efficient provision of the universal service;

- The risks of harm to consumers and citizens more widely – for example through misleading information creating incorrect signals for investment and other market activity.

Our consultation proposals

A3.349 In our proposal we proposed to strike this broad balance by requiring the following information to be published:

- Audited annual financial statements relating to the Relevant Group as a whole;

- Annual audited and quarterly unaudited financial statements related to the Reported Business both as a whole, and for the four FREs;

- Annual audited and quarterly unaudited income statements for universal service and non-Mails products;

- Annual audited and quarterly unaudited product profitability statements for access, Relay, and PAF; and

- Front part of the Costing Manual, including any relevant quarterly updates.

A3.350 In addition we sought views on whether additional product profitability information for universal service products should be published, in the context of our wider proposals for a monitoring framework.

Consultation responses

A3.351 Although some respondents (such as Consumer Focus and the MCF) did not provide particular views, those respondents addressing the issue generally supported some financial reporting information being published, though different views were offered on the extent of publication which would be appropriate.

A3.352 Some respondents suggested there should be at least the level of disclosure we proposed. For example, UK Mail suggested that radical deregulation that we were proposing in other areas increased the case for more disclosure.

A3.353 Individual respondents sought disclosure in particular areas. Intellect argued for more granular disclosure, and considered that publication of the contributions from stamp and business mail was fundamental to our achieving our primary duty. Standard Life proposed that more details of the Costing Methodology should be published, while City Link suggested that complementary non-financial performance metrics also needed to be published. The PAF Advisory Board agreed that both quarterly and annual profitability information on PAF should be published, while the DX Group supported our proposals in relation to PAF and Relay, and also proposed that the profitability of International Bulk Mail should also continue to be published.

A3.354 Some respondents, such as One Post, Laithwaites and the DMA, sought further detail more generally on the level of information that would be in the public domain and the types of reports Ofcom would be publishing.

A3.355 Other respondents accepted that a balance had to be struck between improving wider confidence and safeguarding Royal Mail's commercial interests. For example, while Postaf suggested that a historic lack of trust needed to be addressed via the maximum disclosure possible, there were nevertheless commercial limits to this. The MUA, while supporting the Intellect proposal for a split of profitability between stamped and business mail as a minimum, considered the other details of disclosure should be for Ofcom to determine. In striking the balance, the CWU put forward the general principle that Royal Mail should not be required to publish information at a greater level of detail than its competitors.

A3.356 Royal Mail considered that we had got the balance wrong in our proposals in a number of specific areas. In particular, while Royal Mail agreed with our proposals in relation to the publication of the existing detail on the Costing Manual, the audited annual financial statements of the Relevant Group and Reported Business as a whole, and the separation of the Reported Business EBIT between the universal service and other products, it strongly disagreed with our other proposals to publish:

- Quarterly unaudited financial information;
- Separated audited annual accounts for the four FREs[17]; and
- Separated audited annual product profitability statements for PAF, Relay and access.

A3.357 In relation to the unaudited quarterly information, Royal Mail provided further evidence to illustrate that the nature of its business made such figures volatile and difficult for third parties to interpret. Volumes and revenues were subject to seasonal and market fluctuations, while quarterly costs were liable to within-year restatement. These issues were exacerbated where disaggregated reports were concerned. It noted there was no regulatory precedent for companies being required to publish quarterly financial performance information.

A3.358 Royal Mail strongly objected to publishing information on the separated financial performance its universal service network activities. It considered that, as these activities were integrated for operational and business management purposes, published information would only reflect the results of arbitrary regulatory separation rules in relation to the allocation of shared costs and assets, and therefore would not provide the market with useful, comparable or reliable information.

A3.359 On the contrary, it argued that publication would provide a misleading picture of the relative profitability of elements of the Reported Business. This could lead to significant risks of harm to its business and the sustainable and efficient provision of the universal service. There were risks of inefficient investment and market entry decisions from "cherry picking", as other service providers would recover shared costs in different ways. These risks were, Royal Mail argued, heightened during its modernisation programme, when its historic results would not provide a reliable indication of the sustainable costs of service provision.

[17] As Royal Mail did not propose to retain non-mails the scope of the Reported Business, the issue of publishing separate non-Mails profitability information was not specifically addressed.

A3.360 In addition, Royal Mail argued that being required to publish separated financial information in this way, which was of commercial value, would undermine its position in competitive markets and would not promote a level playing field, as other operators did not face similar publication obligations.

Further analysis

Quarterly reports

A3.361 In our October consultation we acknowledged that our proposal for Royal Mail to prepare and publish unaudited quarterly financial profit information for the different parts of its Reported Business represented a new regulatory requirement and that there was a need to interpret such information with care. In consequence, we suggested that publication of at least some of the information should be deferred.

A3.362 With the exception of Royal Mail, there was little specific comment from respondents on either the market need for the information or the attendant risks. Assessed against our evaluation criteria, there are relatively limited benefits to the market to be derived from historic quarterly profitability information without the supporting details to understand the causes of fluctuations. We proposed in October that such details would need to remain commercially confidential, and respondents generally accepted that there were limits to disclosure in this area.

A3.363 Accordingly financially sustainable and efficient provision of the universal service is more effectively assessed with the aid of annual reporting, by taking one quarter with another. As Royal Mail noted, this is the conventional frequency of published regulatory reporting, and has been the previous basis of its own regulatory financial reporting.

A3.364 Against these limited benefits, Royal Mail provided additional evidence to underline its view that there were significant risks from publishing quarterly profitability information. Recent history suggests that the performance of different parts of its business remains very volatile, with the relative impacts of different factors difficult to interpret without a variety of supporting information.

A3.365 In terms of our evaluation criteria therefore, the risks of publication may well outweigh the benefits in this area, and as we suggested in our October consultation there is a need to proceed with caution in defining how new forms of information are presented and interpreted in the public domain. We therefore consider there is a need to keep the quarterly reports confidential, at least for 2012-13, while we give further consideration to the presentational details of the wider monitoring framework.

A3.366 However we should emphasise that quarterly financial reporting – of both the historic profitability of the Reported Business and the contributions of its component elements, and the projected overall cash position of the Relevant Group - will remain an important element of our own monitoring framework.

A3.367 Further, as the scope of the Reported Business, and hence the published audited regulatory financial statements, will continue to be defined by the costing system, we consider it is important to alert the market to material changes in this costing system if they occur within the year. Accordingly we will continue to require Royal Mail to publish quarterly updates to its Costing Manual in the event of any such changes.

Relevant Group, Reported Business, and Universal Service profitability

A3.368 Royal Mail and other respondents agreed with our October consultation proposals to publish annual audited financial statements (and supporting information) on the financial performance of the Relevant Group and Reported Business as a whole, although a number of respondents sought further details on how this would fit with our own annual report under the monitoring framework. We address this issue in Section 11 of this statement.

A3.369 Assessed against our evaluation criteria, we continue to consider that publication of these statements would provide the market with important complementary information of Royal Mail's progress in relation to the overall financial sustainability and efficiency of universal service provision, with additional assurance being provided by the enhanced audit arrangements we have decided to implement.

A3.370 Because the information will be aggregated across the range of different markets served by the integrated business, comparable to the public reporting of other service providers, we think there are limited risks from this form of disclosure, which is comparable to the information that Royal Mail has previously published for some time.

A3.371 In contrast, we continue to consider it to be inappropriate to require Royal Mail to publish details of its Strategic Business Plan covering projected future business initiatives and financial performance, as such information is typically commercially confidential and disclosure would present significant risks to the competitive position of the business.

A3.372 Royal Mail and other respondents also supported our October consultation proposal to require the continued publication of a split in the respective profitability of universal service (subject to specific regulatory requirements including in relation to the geographical uniformity and cost orientation of prices) and other products of the Reported Business. As noted, some respondents such as Intellect and the MUA suggested that disclosure of such a basic profitability split was essential to assuring the market of the performance of our primary duty.

A3.373 Although such a split can only be undertaken though allocations of shared costs in line with regulatory rules, we have decided to continue to specify these rules for the costing system, and to require Royal Mail to publish how they are being applied via the Costing Manual. Where costs are shared between universal service and other products, the basis of allocation needs to be transparent and reflected in separated accounting, in line with the Postal Services Directive.

A3.374 We therefore consider that the risks to the market of requiring Royal Mail to continue publishing this basic split on comparable lines are limited and outweighed by the benefits to stakeholders.

The Four FREs and non-Mails

A3.375 In contrast to the split of universal service and other products' profitability, mainly using the existing FAC outputs of the costing system, the scope of all the four FREs within the Reported Business is defined by the upstream/downstream split that we have proposed to be implemented across the core universal service network for the first time. In turn this split depends on the bases of transfer pricing used for Royal Mail's horizontally integrated downstream services.

A3.376 As discussed in previous sections, in our decision relating to transfer pricing across Line B, we have decided that these transfer prices should be implemented along the lines proposed by Royal Mail and the MCF, but acknowledge Royal Mail's contention that this will require some judgment and that the accounting splits that result will be a new regulatory requirement, that will not be directly replicated in its own ongoing operational business management activity.

A3.377 While we consider the resulting financial reporting information to be a key component of our monitoring regime requirements, and it will be subject both to regulatory rules and an enhanced external audit framework, it is less clear that the benefits of early publication of these results outweigh the potential risks identified by Royal Mail.

A3.378 In respect of our evaluation criteria, there was little comment from respondents on how the availability of aggregated FRE information would provide market assurance in relation to the overall financial sustainability and efficiency of universal provision. Further, while information on the profitability of products in specific markets may in principle improve confidence in the effectiveness of regulation in those markets, the information aggregated to FRE level covers products in a diverse range of markets, which therefore limits the usefulness of publication for this purpose.

A3.379 In contrast, Royal Mail provided persuasive arguments in respect of the attendant risks of publication. As with quarterly information, the separated profitability information would be new to the market and would at minimum require careful interpretation and explanation, to avoid the risks of inefficient decisions being taken. In general, such interpretation can only be provided at the detailed level with the supporting publication of commercially confidential details (such as the relative levels of prices for different products outside of the universal service) which we have decided Royal Mail should not be required to publish.

A3.380 As a number of respondents such as City Link pointed out, understanding the context for specific financial performance outcomes also requires the publication of supporting information on non-financial performance (such as quality of service, general market trends, and operational efficiency). These are areas where respondents sought further detail on the published information available from our wider monitoring framework, including our own annual report.

A3.381 As set out in Section 11 of this statement, we will be giving further consideration to these issues before our first annual report in 2013. We will be considering the risks of requiring early publication of separated financial performance information for the FREs are great enough to require us to exercise caution in the intervening period. We therefore will not require such publication at this stage.

A3.382 In the meantime however, we propose to focus on reviewing the new separated financial information for 2012-13 with Royal Mail and its auditors, prepared on the basis of the rules set out in the RAG and Royal Mail's accounting methodology manual.

A3.383 The publication of separated profitability information for the non-Mails products within the 'End to end only products' entity (one of the Four FREs) needs to be considered in this light. As with the wider FRE concerned, these products have widely different costs and are provided in very different markets, such that aggregation of their profitability may provide relatively limited value to the market in isolation from the rest of the Reported Business. Rather, the benefits of publication of profitability information may be better achieved via a more targeted approach to individual products and services, as discussed below. We will therefore not be requiring publication of the separate total non-Mails profitability statement at this stage.

Product profitability statements

A3.384 We proposed that Royal Mail should provide most of the product profitability statements (exceptions are discussed below) on a confidential basis. We considered that confidentiality was necessary due to the risk that this information could adversely prejudice Royal Mail's commercial interests and the development of effective competition(given that a range of the relevant markets served by the products concerned are increasingly competitive and such detailed profitability information is typically commercially confidential).

A3.385 However, we proposed that product profitability statements in the following three specific areas, which are required to be published for the 2011-12 results due later this year under Ofcom's initial conditions, should continue to published for the 2012-13 results next year:

- Access
- Relay (formerly Branch Direct and Parts Express)
- Postcode Address File ('PAF')

A3.386 We considered that the access profitability information would help the market to make its assessment of the overall relationship between revenues and costs for access products. It will also help the market understand the relative contribution made by access products to the profitability and financeability of the Reported Business as a whole.

A3.387 We proposed continued publication of Relay profitability, because it continued to provide the market with needed transparency in an area which had been subject to this form of regulatory remedy for a number of years.

A3.388 We also proposed continued publication of PAF profitability, because we considered there was a continuing need to allow the market to see PAF's performance against its agreed target operating margin, given the external governance arrangements relevant to PAF.

A3.389 We proposed not to continue to require the publication of International Contract Bulk product profitability results, because available market study evidence indicated that Royal Mail does not have sufficient power in that market to warrant continued publication.

A3.390 No respondent has raised any issues with these proposals. While Royal Mail did not raise any specific issues with these proposals, it disagreed with publication of any information below the Reported Business level. We have discussed Royal Mail's arguments in previous sections, and we have summarised above our specific reasons for the publication of access, Relay, and PAF.

A3.391 We have therefore decided to confirm our proposals with regard to the confidential provision of the product profitability statements (including International Contract Bulk), except for those relating to access, Relay, and PAF products which we have decided that Royal Mail should continue to publish.

Other reports

Costing and Accounting Methodology Manuals

A3.392 We proposed that Royal Mail should continue to publish the front part of the Costing Manual. The front part describes the basis on which FAC product costing outputs are derived, and these outputs then provide key inputs for a range of specific regulatory remedies (e.g. margin squeeze controls on headroom) and all the regulatory reports and statements used for monitoring purposes. Therefore, the publication of the methodology used to derive these FAC product costs was necessary to provide cost transparency to the market.

A3.393 We also proposed that Royal Mail should continue to provide Ofcom with the Technical Appendices for the Costing Manual so that Ofcom has a complete picture of how Royal Mail does its product costing. However, we proposed that this information should continue to be provided on a confidential basis, for the same reasons that the information is currently confidential, because publication could adversely prejudice Royal Mail's commercial interests and the development of effective competition.

A3.394 We also proposed not to require the publication of the new Accounting Methodology Manual, because the RAG should provide the market with sufficiently detailed information about the relevant principles which are being applied in the production of regulatory financial reports and statements.

A3.395 No respondent raised any issues with our proposals. Royal Mail stated its continued commitment to the existing cost transparency measures, including the publication of the front part of the Costing Manual.

A3.396 We have therefore decided to preserve the existing publication requirement for the front part of the Costing Manual, and confirm our proposals for the confidential provision to us of the Accounting Methodology Manual.

Monthly management information

A3.397 We proposed that Royal Mail should continue to provide confidential monthly management information to Ofcom to enable ongoing and timely monitoring of market trends. We considered that confidentiality was necessary due to the risk that this information could adversely prejudice Royal Mail's commercial interests and the development of effective competition.

A3.398 Royal Mail agreed with our proposal, and no respondent has raised any issues with it. We have therefore decided to confirm our proposals for the confidential provision of the monthly management information.

Our decisions

A3.399 Based on our review of the responses to our October and (where relevant) December consultations, and the further analysis set out above, we have decided to implement our October proposals to require Royal Mail to publish:

- Annual audited financial statements and supporting information for the Relevant Group and (as now) the Reported Business;

- Annual audited income statements (to EBIT level) for universal service and non-universal service products within the Reported Business (as now);

- Annual audited product profitability information for access, PAF, and Relay; and

- The front part of the Costing Manual, updated quarterly for any material changes.

A3.400 Similarly, based on the consultation responses and our further analysis, we have decided, also in line with our October consultation proposals, not to require publication of:

- The updates to the Strategic Business Plan and the cash flow projections for the relevant Group;

- Most of the product profitability statements;

- Royal Mail's monthly management information on revenue, volumes and costs; and

- The remainder of the Costing Manual, and the Accounting Methodology Manual.

A3.401 However, in addition, we have decided not to require Royal Mail to publish the following at this stage:

- Quarterly financial information; and

- Other separated financial information for the Reported Business.