

Royal Mail

Royal Mail's response to Ofcom's Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation

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Executive Summary

Royal Mail is the proud provider of the Universal Postal Service. A modern and contemporary Universal Postal Service is vital to the UK economy. It is the delivery backbone of e-commerce in the UK. Ofcom has a regulatory duty to secure the provision of the Universal Post Service. It has put in place a monitoring regime that requires detailed regulatory financial information from Royal Mail to discharge its duty. Ofcom's consultation sets out certain changes to the regulatory financial reporting regime.

Ofcom's consultation has four broad themes. We make the following points in relation to those themes. In addition, we set out our suggested implementation timeline:

- **Chapter 1 - The role of Fully Allocated Cost (FAC).** FAC can be useful as a first order view of cost. We agree that FAC is not the appropriate cost standard in all circumstances. We make two recommendations. Firstly, Ofcom should amend the Regulatory Accounting Guidelines (RAG) so that overheads can be allocated by methods other than Equi-Proportional Mark-Up (EPMU). It will futureproof the RAG for potential changes that may need to be made as the mix of traffic in our network changes. Secondly, we recommend that Ofcom reviews the attribution approach for the common costs of the Universal Service network. These should be attributed in the first instance to Universal Service products to reflect operational reality and cost causality. The current allocation basis understates the true cost of the Universal Service.
- **Chapter 2 - Detailed review of delivery cost allocation changes.** Ofcom has put in place a detailed and comprehensive regulatory financial monitoring framework. We take compliance with our regulatory obligations very seriously. Therefore, **we are pleased that Ofcom “consider that the new allocation methods better reflect the operational reality of the new delivery methods than the previous allocation methods.”**¹ We consider this assessment as a ‘clean bill of health’ on our regulatory compliance.
- **Chapter 3 - Proposed changes on the detailed rules on cost allocation.** We note that Ofcom intends to clarify certain rules in its Regulatory Accounting Guidelines (RAG). We have provided detailed comments on these rules in **Annex 1**. We have the following observations:
 - » Ofcom has set expectations that Royal Mail undertakes several detailed reviews. Should these reviews be assessed to take significant effort, we will engage with Ofcom on proportionate solutions to meet its objectives. We also welcome any indication from Ofcom on any specific areas of focus.
 - » We suggest that Ofcom clarifies the situation when actual data is no longer appropriate. We propose that actual data needs to be ‘fit-for-purpose’ i.e. relevant and reliable to be used as an input into our costing system.
 - » We note that senior management scrutiny on the regulatory financial results is

¹ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 1.11.

at an aggregated product level. We provide Ofcom with very detailed product information below the level of this review. We therefore recommend caution and early engagement on any conclusions being drawn at this granular level.

- » Ofcom proposes to enhance the definition of data integrity to explicitly include consistency. We note that there will be circumstances when inputs or outputs have to change where there are new data sources or new products. An overemphasis on consistency could lead to the results no longer reflecting operational reality.
- **Chapter 4 – Proposed changes on transfer pricing.** Ofcom's proposal for additional flexibility in transfer pricing is a step in the right direction. We believe Ofcom can go further and futureproof the transfer pricing guidance by allowing three options: **(a)** equivalent (market) price, **(b)** FAC plus an appropriate rate of return, or **(c)** as agreed with Ofcom. This avoids the need to re-open the regulations and re-consult if there is a change to the appropriate transfer prices.
- **Chapter 5 – Implementation.** We understand that Ofcom expects to issue its Statement in the first half of 2019-20. As we have set out above, it may take significant time to complete all the reviews that Ofcom expects Royal Mail to undertake. **We therefore suggest that the changes to the RAG are to take effect for the Q1 2020-21 Regulatory Financial submissions.** This will have the benefit of consistent reporting for the whole year.

As set out in Royal Mail's response to Ofcom's draft Annual Plan for 2019-20, we agree that this review should conclude promptly in the next financial year.

Chapter 1 – Role of Fully Allocated Cost

Section three of Ofcom's consultation sets out Ofcom's requirements for costing data. It also sets out the principles and rules, and explains how Ofcom uses the costing data to achieve its regulatory objectives.

We have no comments on Ofcom's summary of the principles and rules. In relation to how Ofcom uses FAC, we make the following observations:

- **FAC can be appropriate as a first-order view of cost.** We also agree that **FAC is not the appropriate cost standard in all circumstances.** For example, it may be more appropriate to consider long run incremental cost (LRIC) or average avoidable cost for assessing cross-subsidisation.
- Ofcom has set the regulatory accounting framework. We suggest two areas where the calculation of FAC can be improved. Firstly, Ofcom's RAG sets out that overhead costs are required to be allocated by Equi-Proportional Mark-Up (EPMU). **EPMU is too inflexible as the only method to allocate overheads and the "Other Drivers" method should be permitted.** It will futureproof the RAG for potential changes that may need to be made as the mix of traffic in our network changes. Secondly, our view is that **the common costs of the Universal Service should be attributed to Universal Service products in the first instance.** This would be a more appropriate view of FAC.

Ofcom discusses incentives that Royal Mail may have (paragraphs 3.24 – 3.27). We address this in the next section.

Ofcom states that national average FAC provides a good first-order view of cost for monitoring purposes.

1.1 Ofcom states that "*FAC provides a good first-order view of Royal Mail's product costs and how they change over time.*"²

1.2 **As a first-order view of cost, FAC can be appropriate.** There are several reasons why FAC is a helpful measure for regulators. Firstly, FAC is a widely recognised costing concept that businesses are used to producing. It is typically produced using the Activity Based Costing (ABC) approach. There are a range of readily available software tools to produce such information. Secondly, a FAC approach ensures that when all the product cost information is consolidated, it agrees back to the total cost of the business. When revenue is greater than the consolidated fully allocated cost, it is clear the costs of the business are being covered. This cost standard is helpful for assessing the consolidated profitability of the business.

² Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 3.21.

Ofcom has set the regulatory framework. We recommend two areas for improvement. Firstly, there should be more flexibility in the methods used to allocate overheads. Secondly, common costs should be attributed to Universal Service products in the first instance.

- 1.3 Ofcom has set the regulatory accounting rules in the Universal Service Provider Accounting Condition (USPAC) and in the Regulatory Accounting Guidelines (RAG). We have two issues in relation to the calculation of FAC – there should be more flexibility in the methods used to allocate overheads and common costs should be attributed to Universal Service products in the first instance.
- 1.4 **The first issue is that the rules set out that overheads must be attributed using EPMU** – see National Costing Rule 9 and 12 in the RAG. We consider this to be overly prescriptive. Parcels tend to have higher cost than letters due to their handling characteristics (size, weight etc.). The EPMU method will tend to allocate more overhead cost to parcels instead of letters as parcels increase as a share of total traffic in our network. However, the network has been designed to allow delivery of mail everyday as per our Universal Service requirements.
- 1.5 **We suggest that Ofcom considers amending the rules in the RAG to permit the use of “Other Drivers” for overheads.** There are alternative methods for the allocation of overhead costs – we note that BT’s regulatory financial statements has several such methods.³ By making this change to the RAG, Ofcom futureproofs the regulatory framework to allow for such changes. Ofcom will still have oversight on costing changes through the regulatory change control process. The RAG requires Royal Mail to notify Ofcom in advance of making changes to the regulatory accounting methodology. Ofcom can consider our rationale to determine whether the change is appropriate. As Ofcom states in its consultation “*we can consult to reverse any changes which we may consider are not aligned with our needs and applications of FAC data.*”⁴
- 1.6 **The second issue is in relation to the treatment of the common costs of the Universal service.** Royal Mail’s statutory obligation as the sole Designated Universal Service Provider (DUSP) drives the design and costs of the Universal Service mail network. We are proud to deliver a ‘one price goes anywhere’ service on a range of letters and parcels to around 30 million addresses throughout the UK, six days a week. Royal Mail has developed a network to enable it to collect, process and deliver mail throughout the country, including a next day service.
- 1.7 The Universal Service network is used to deliver both Universal Service and non-Universal Service products. Royal Mail relies on revenues from non-Universal Service commercial activities, particularly commercial parcels, to help sustain the Universal Service network. **The annual c.£7 billion cost of running this network is a result of Royal Mail’s USP status.** The mail estate required to meet this obligation would not be materially different,

³ For example, the allocation of BT Group pay costs (where the specific Business unit only support UK operations, for example HR costs) is based on certain factorised current salary and capital salary costs. See BT, Accounting Methodology Document 2018, AG115.

⁴ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, Paragraph 3.22.

and therefore a significant proportion of the cost base would remain, whether the Group used the Universal Service mail network for non-Universal Services or not.

- 1.8 Costs are currently allocated to each product by allocating common costs across all services as determined by Ofcom through the costing rules set out in the RAG and Royal Mail's ABC Manual. However, Royal Mail believes that the cost of the combined network should most appropriately be allocated to Universal Service products in the first instance. **We suggest that Ofcom reviews the treatment of the common costs associated with the provision of the Universal Service. This allocation would better reflect operational reality and cost causality.** We believe the current allocation methods will understate the true cost of the Universal Service.

FAC is not the appropriate cost standard in all circumstances.

- 1.9 Ofcom's consultation also states that there are limitations on the use of FAC data. Ofcom provides two examples:

- In connection to the assessment of cross-subsidisation and predatory pricing, it may be more appropriate to use long run incremental costs (LRIC) or average avoidable cost.⁵ Ofcom also refers to a report that we commissioned from FTI⁶ that sets out the economic principles in relation to the assessment of cross-subsidy.⁷
- In relation to the calculation of the net cost of the Universal Service, a hypothetical network and different cost allocation methods may be required.⁸

- 1.10 Our position on the assessment of cross-subsidy and predatory pricing has not changed. **We believe the appropriate cost standards to assess cross-subsidy are incremental cost and standalone cost.** We also note that average avoidable cost (one of the cost standards that Ofcom mentions) may also be an appropriate cost measure for use.

- 1.11 We note that Ofcom has stated that FAC may not be appropriate to calculate the net cost of the Universal Service network.⁹ As set out above in paragraphs 1.3 – 1.8, the fully allocated costs of the Universal Service products will understate the true cost of the Universal Service. Common costs associated with the Universal Service network are attributed over all products – Universal Service and non-Universal Service products. **Should a net cost calculation of the Universal Service be required, we will engage further with Ofcom on the appropriate economic approach and costing framework.**

⁵ See Paragraph 3.30 of Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018.

⁶ https://www.ofcom.org.uk/_data/assets/pdf_file/0024/90780/FTI-Report-on-Testing-for-Cross-Subsidisation.pdf

⁷ See Paragraph 3.33 of Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018.

⁸ See Paragraph 3.29 of Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018.

⁹ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, Paragraph 3.29.

Chapter 2 – Detailed review of delivery cost allocation changes

Section four of Ofcom's consultation explains how the ABC approach is used to produce FAC data. It also explains certain improvements made to Royal Mail's delivery cost allocation.

In relation to Royal Mail's changes to its cost allocation, we make the following observations:

- Ofcom has put in place a detailed and comprehensive regulatory financial reporting framework. **We take compliance with our regulatory obligations very seriously**
- We are pleased that Ofcom "*found that Royal Mail's changes are consistent with the NCRs [National Costing Rules] in the RAG. In particular, we found the new allocation methods better reflect the operation reality of the new delivery methods.*"¹⁰ We consider this assessment as a 'clean bill of health' on our regulatory compliance.

Ofcom has put in place a detailed and comprehensive regulatory financial reporting framework. We take compliance with our regulatory obligations very seriously.

2.1 Section three of Ofcom's consultation sets out its regulatory financial reporting framework. This framework is based around the USPAC and the RAG. In addition to specific requirements in the USPAC, there are Guiding Principles with which Royal Mail must comply. These principles are as follows:

- a. Completeness
- b. Equivalence
- c. Causality
- d. Objectivity
- e. Accuracy
- f. Compliance with the statutory accounting standards
- g. Consistency and
- h. Materiality.

2.2 Where there is a conflict between the Guiding Principles, they must be resolved using the hierarchy set out in USPAC 1.7.1 (as listed above).

2.3 Ofcom notes that "*The USPAC and RAG provide a framework within which Royal Mail can choose methods to allocate its costs.*"¹¹ It also stated that "*Royal Mail may have incentives to allocate its costs in certain ways which helps it to achieve its own objectives.*"¹² **We would like to reinforce that take compliance with our regulatory obligations very seriously.**

¹⁰ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, Paragraph 5.6.

¹¹ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 3.7.

¹² Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 3.24.

Ofcom concluded its review that our changes were in line with the rules, and that they better reflected operational reality.

- 2.4 Ofcom also sets out details on the cost allocation changes made by Royal Mail in relation to its delivery costs. Ofcom reviewed changes made in 2013/14 and 2016/17. Over the last 18 months, we have engaged with Ofcom on its review of our changes. We have committed significant resources – including senior management time – in supporting this forensic review.
- 2.5 Ofcom has set very clear guidance in the form of the Guiding Principles, and the order in which they should be applied. There are clear requirements to be objective in what we do – the Objectivity Guiding Principle sets out that there should not be “*undue bias*”¹³ in the assumptions underpinning our cost allocations.
- 2.6 We recognise that we do have some choice as to the methodologies we adopt within this framework. **The Guiding Principles that sit above the detail of this framework mean that our changes are required to be objective and cost causal.** Therefore, we welcome Ofcom’s findings on this review that “*As a result of our work, we found that Royal Mail’s changes are consistent with the NCRs in the RAG. In particular, we found the new allocation methods better reflect the operation reality of the new delivery methods.*”¹⁴
- 2.7 **We consider this assessment as a ‘clean bill of health’ on our regulatory compliance.** It reflects the integrity of Royal Mail in complying with Ofcom’s regulatory financial reporting regime.

¹³ Ofcom, USP Accounting Condition 1.7.2 (d)

¹⁴ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.6.

Chapter 3 – Proposed changes on the detailed rules on cost allocation

Section five of Ofcom's consultation sets out detailed changes to Ofcom's RAG. Ofcom explains that these changes are a consequence of Ofcom's detailed review of Royal Mail's cost allocation changes. We note that Ofcom does not expect there to be a significant change to cost allocation in Royal Mail's regulatory accounts

In relation to the individual proposals, we set out our detailed comments on each proposal in Annex 1. There are four specific points that we draw out here:

- (1) Ofcom has set expectations that Royal Mail undertakes several detailed reviews. **Should these reviews be assessed to take significant effort, we will engage with Ofcom on proportionate solutions to meet its objectives.** We also welcome any indication from Ofcom on any specific areas of focus.
- (2) For several rules, Ofcom proposes that only when actual data is unavailable or lacks sufficient granularity, can Royal Mail use modelled or theoretical data. **We suggest that Ofcom makes it clear that actual data also needs to be fit for the purpose intended, i.e. relevant and reliable.**
- (3) Ofcom proposes that Royal Mail undertakes detailed reviews of the costing methodology. We note that care should be taken in the use of detailed regulatory financial information:
 - » Royal Mail senior management review aggregated product results. It does not review each product result for all c3,000 products – the level at which information is provided to Ofcom.
 - » The calculation of this costing data uses samples and management judgement.
 - » Royal Mail is on a journey to transform and improve its data. We still have very manual processes and not all mail items are monitored at each stage through our pipeline.
- (4) In National Costing Rule 15, Ofcom has changed the definition of data integrity to make it clearer that the definition includes consistency over time. We note that **as our business changes, our data will change in line with our product portfolio and our IT data capture capabilities.** An overemphasis on consistency could lead to the results no longer reflecting operational reality.

Ofcom proposes detailed changes to Royal Mail's costing rules.

3.1 Ofcom has identified certain revisions to the National Costing Rules (NCR) to ensure that our FAC data remains robust and fit for Ofcom's purposes. Ofcom has set out a series of detailed proposals. We comment on the specifics of each proposal in Annex 1. We note that Ofcom stated that:

- It expects Royal Mail to make certain adjustments to its allocation methods.

- It does “*not expect these changes to have a significant impact on Royal Mail's costing data.*”¹⁵

3.2 We have four specific points that are set out below.

(1) Ofcom has set expectations that Royal Mail undertakes several detailed reviews. Should these reviews be assessed to take significant effort, we will engage with Ofcom on proportionate solutions to meet its objectives. We also welcome any indication from Ofcom on any specific areas of focus.

3.3 Ofcom is proposing to add to the cost of regulatory compliance. Ofcom's consultation proposes that Royal Mail provides a new annual schedule (CAM template G) that sets out all cost types whose cost is allocated to activities by the application of planning values or theoretical or modelled operational data. On the back of this, we will need to put in a new process to produce, review and approve this schedule on an annual basis. It is our understanding that this schedule is required for outdoor delivery activities.

3.4 In addition, Ofcom expects Royal Mail to undertake detailed reviews of its costing methodology in light of changes to the following NCRs:

- Review of Resource Drivers to ensure they are calculated in relation to the amended NCR 6.¹⁶
- Review of Activity Costs of the Non-operational Business Processes to ensure they are treated and allocated in accordance with the amended NCR 8.¹⁷
- Review the use of the terminology related to the Weighting Factors and Proportional Factors in its published Costing Manual and its submissions to Ofcom to ensure that they are consistent with the amended NCR 10.¹⁸
- Set out its rationale for all its assumptions in determining the Weighting Factors including where it assumes parcels and letters to have equal Weighting Factors in relation to the amended NCR 10.¹⁸
- Review of Activities that are allocated using Other Drivers (as opposed to Weighted Volume Drivers or EPMU), and the basis for those allocations, as expected in relation to the amended NCR 11.¹⁹

3.5 We estimate that to perform the detailed review of the rules and setting our Royal Mail's rationale for determining weighting factors will take a minimum of two man-months during 2019-20.²⁰ **It could be materially longer – we will not know how many activities or drivers will require change until we undertake this detailed review.** Should significant changes be required, it will take significant time. For example, there could be:

¹⁵ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.10.

¹⁶ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.52-5.66.

¹⁷ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.26-5.31.

¹⁸ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.32-5.51

¹⁹ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.67 – 5.74.

²⁰ There will also be a small ongoing overhead to produce CAM Template G.

- New methodologies developed.
- New data sources to be identified.
- Impact assessment of the changes.
- Review through Royal Mail's internal governance.
- Formal change control notification to Ofcom.

3.6 We will not know the true scale of the reviews until we start. We will start once Ofcom has published its statement to make sure that we understand the full scope of the necessary activities. **Should these reviews be assessed to take significant effort, we will engage with Ofcom on proportionate solutions to meet its objectives.** One possible solution would be to limit the reviews to the significant / material activities and resource drivers only. We would also welcome whether there are any specific concerns – apart from those highlighted in the consultation – that would help Royal Mail to assess the focus of the review, and therefore the scale and time required.

(2) Actual data needs to be fit-for-purpose to be used.

3.7 Ofcom proposes to amend several NCRs to clarify when theoretical or modelled data can be used. Ofcom's guidance is that "*only where such actual data is unavailable or lacks sufficient granularity, Royal Mail may use modelled or theoretical data*".²¹ The actual data is described as "*appropriate operational data*".

3.8 In some circumstances, Royal Mail uses theoretical or modelled data where actual data does exist. Royal Mail does so because it has reservations as to whether the actual data is 'fit-for-purpose' (i.e. is appropriate to be used to attribute costs within Royal Mail's costing system). Our business is different to other regulated industries. In telecommunications, the extensive use of IT over a long period of time has enabled rich data sources of volumes. In airports, passenger numbers must be accurate due to security concerns requiring tracking and IT systems. In post, our data recording is very different. For example,

- We have significant volumes of items – billions of letters and parcels in our network.
- We cannot count all of these mail items at all points in our pipeline:
 - » We have significant volumes of parcels that are manually sorted as opposed to automated. Not all our parcels have a barcode.
 - » We are heavily reliant on manual tracking of parcels which will be subject to human error. We do not scan letters on delivery.
- We also rely on survey data for the attribution of revenues and other purposes.

3.9 Our costing system will use the best and most appropriate data, but Royal Mail is on a journey to improve and transform its data capture and management. With the increased tracking of parcels and the investment in IT infrastructure, it will be possible to enhance and improve the current methods we have for counting and estimating product volumes. We will continue to improve and refine our data sources. In turn, this will improve the quality of our decision making and understanding of our business. Nevertheless, the actual data we have

²¹ See Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraphs 5.50, 5.62, and 5.72 where this text is referenced.

and use currently – as the best information available – is subject to all the issues listed above.

3.10 Ofcom notes that Royal Mail stopped using RCS hours as an input into outdoor delivery cost allocation and instead used modelled data.²² We believe that it is Ofcom's intention that the actual data used is 'fit-for-purpose'. Ofcom sets out that "*we consider that our Guiding Principle of Objectivity and NCR 2 on Operational reality require Royal Mail to use actual data where there is reliable and relevant data recorded.*"²³

3.11 Therefore, we suggest that:

- Ofcom clarifies that it considers "*appropriate operational data*" to be data that is fit-for-purpose, i.e. reliable and relevant; or
- Ofcom adds the following text in red (or similar text) into the proposed changes to the RAG. "*Only where such actual data is unavailable or lacks sufficient granularity **or is not fit for the purpose intended**, Royal Mail may use modelled or theoretical data*".²⁴

(3) Care should be taken in the use of detailed Regulatory Financial information.

3.12 We take very seriously our obligation to comply with Ofcom's regulatory financial reporting requirements. Great care is taken to ensure that the inputs into our ABC system are appropriately sourced, checked and approved. The ABC model calculation functionality has been subject to internal and external review. There is strict change control over methodology changes. The results from the ABC system have been produced in line with the requirements set out in the USPAC and the RAG. There is management review of the aggregated results – such as at the Reported Business level. The totals are reconciled back to the management accounts.

3.13 Royal Mail senior management does not – however – review the detailed product profitability at the c3,000 product level provided to Ofcom. They review the results at a more aggregated "scorecard level". We consider that the regulatory financial information becomes more robust at the more aggregated level. **We therefore recommend caution and early engagement on any conclusions being drawn at the granular level.**

²² Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 4.19c.

²³ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.60.

²⁴ See Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraphs 5.50, 5.62, and 5.72 where this text is referenced.

(4) Royal Mail is consistent in its preparation of regulatory financial information. As the business changes, so will the costing model to ensure it reflects operational reality.

- 3.14 Ofcom proposes amending NCR 15 to state that: “*Data integrity is the maintenance of, and the assurance of the accuracy and consistency of any data over time, and the data includes (but is not limited to) inputs, models and outputs*”.²⁵
- 3.15 We agree that – as far as possible – data should be prepared on a consistent basis over time. It may not be always possible. There will be times when data will change. As explained above, we are on a journey to improve our data and have been investing in new IT infrastructure. New and improved data sources will become available – such as our Automated Hours Data Capture (AHDC).
- 3.16 In addition, as our business changes, so will our procedures, ways of counting and measuring what we do. For example, most of our parcels are monitored in some way through our network. Our product portfolio will evolve as we develop new products to meet ever-changing consumer needs.
- 3.17 So, whilst we consider consistency important, there will be times when Royal Mail must make changes in how it sources or processes costing data. An overemphasis on consistency could lead to the results no longer reflecting operational reality.
- 3.18 Therefore, to address our points above, we suggest that NCR 15 includes words similar to the following “***It is expected that, as Royal Mail's Business changes, the data used may need to change or new and updated data sources become available. These amended or new sources will need to be used to ensure the regulatory accounting methodology reflects operational reality.***”

²⁵ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.82 – 5.97.

Chapter 4 – Proposed changes on transfer pricing

In section five of Ofcom's consultation, it proposes changes to transfer charging. Ofcom's proposal for additional flexibility in the transfer pricing is a step in the right direction. We believe Ofcom can and should go further. We propose that the transfer pricing guidance should allow three options **(a)** equivalence price, **(b)** FAC plus an appropriate rate of return, or **(c)** as agreed with Ofcom. This avoids the need to re-open the regulations and re-consult if there is a change to the appropriate transfer prices.

Ofcom proposes increased flexibility in transfer charging. But, this can go further to futureproof the transfer charging arrangements.

- 4.1 We agree that the transfer pricing rules within the regulatory financial statements should be more flexible. However, we believe that Ofcom should go further.
- 4.2 In section five of its consultation, Ofcom sets out the transfer pricing rules in the RAG. These can be broadly summarised as the 'equivalence (or market) price' failing which FAC+10%. Ofcom proposes to amend the rules to be 'equivalence (or market) price' failing which FAC plus an appropriate return. Ofcom states that "*we consider it reasonable to base the appropriate rate of return on the Financeability EBIT range of 5-10% which we have set as a measure of Royal Mail's commercial rate of return for the provision of the universal service.*"²⁶ Ofcom notes that it expects the equivalent pricing approach to be applicable in the majority of cases.
- 4.3 The requirement to set transfer prices for services (for which there is no wholesale equivalent) using FAC costs plus a mark-up of between, say, 5 – 10% considerably restricts the potential range of transfer prices. An alternative transfer pricing approach could be to set transfer prices based on incremental cost. We consider this approach to transfer pricing to be consistent with the economic literature²⁷ on assessing product profitability. There are a range of other costing options that could be considered. For example, it may be appropriate to include a fixed and variable charge for transfer pricing.
- 4.4 **Our view is that FAC may not be the appropriate transfer price in all circumstances.** So, where there is no equivalent price, limiting the transfer price to be FAC with an appropriate rate of return between 5 and 10% is too restrictive. For example, individual product returns should not be required to be in the 5-10% range. Given competitive pressures, some will be well below this level.
- 4.5 Given the range of different costing approaches, **we suggest that Ofcom makes the transfer pricing regime more flexible.** We suggest that Ofcom includes provision for an alternative transfer charging approach without having to amend the RAG. This avoids the need to re-open the regulations and re-consult if there is a change to the appropriate transfer prices. Our suggested text is below with our amends in red:

²⁶ Ofcom, Review of regulatory financial reporting for Royal Mail – Cost allocation and transfer pricing consultation, 19 December 2018, paragraph 5.106.

²⁷ For example, see: An Economic Perspective on Transfer Pricing, Gox and Schiller, 2006, that sets out a summary of the economic literature on transfer pricing.

- 4.6 Paragraph 8.76 c *“if the product and/or service does fall within 8.76(a) or (b), the Transfer Price shall be equal to the FAC of that product and or service, **plus an appropriate return or as agreed between Royal Mail and Ofcom.**”*

Chapter 5 – Implementation Timetable

We understand that Ofcom expects to issue its Statement in the first half of 2019-20. As we have set out above, it may take significant time to complete all the reviews that Ofcom has proposed in its consultation. **We suggest that the changes to the RAG take effect from the Q1 2020-21 Regulatory Financial submissions.**

This is based on our estimate that it could take two man-months (or more) to undertake these reviews. These detailed reviews would need to be undertaken by the costing team who already have commitments to produce the quarterly regulatory financial statements. **The benefit of making the change for the 2020-21 Q1 results is that these results would be presented on a consistent basis for the whole year.**

We propose that changes to the RAG take effect from the 2020-21 financial year. During 2019-20, we will perform the reviews that Ofcom has requested.

5.1 As set out in paragraph 3.4, Ofcom expects Royal Mail to undertake certain reviews. We have also explained that these reviews will take some time – we estimate two-man months (or longer). The estimated timeline below indicates that the earliest that we could complete the review would be after the annual Regulatory Accounts in June 2020.

- Ofcom issues its statement in September 2019.
- Costing team produce Q2 Regulatory Accounts (30 September to 22 November 2019).
- Costing team start review – 1 man-month of effort.
- Costing team produce Q3 Regulatory Accounts (30 December to 21 February 2020).
- Costing team start review – 1 man-month of effort.
- Costing team produce Q4 Regulatory Accounts (30 March to 22 May 2020).
- Costing team produce annual Regulatory Accounts (30 March to 26 June 2020).

5.2 We believe that there would be clear benefits from starting the 2020-21 year on a consistent basis. Ofcom would be able to see the results from Q1-Q4 2019-20 on a consistent basis. The Q1-Q4 2020-21 would similarly be consistently presented. It will also give us enough time to work through how to do it, consider all the implications and to discuss the changes with Ofcom. We do not want to make changes to discover that this was not what Ofcom had intended.

5.3 Changes from these reviews will need to pass through Royal Mail's governance processes as well as being notified to Ofcom as part of the regulatory change control process. **We would like to discuss with Ofcom a proportionate way to do so.** We believe that, in this instance due to the expected volumes, it would be appropriate and materially less burdensome to assess the impact during 2019-20, share the results with Ofcom and implement in Q1 2020-21, without the need to then restate the results as part of the annual change control notification at the end of 2020-21.

Annex 1 – Detailed comments on Ofcom's proposed changes

A1.4 This section sets out detailed comments on Ofcom's proposed changes. This schedule is based on Ofcom's consultation Annex 5 which sets out the changes (columns two and three). We have added in the first column the relevant NCR from the consultation. The fourth column sets out comments on this change made by Ofcom in the consultation. The fifth column sets out our view on the proposed change.

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
NCR 5 – Activities Sections 5.12 to 5.25	1	8.19 Where appropriate (and to the extent possible), Business Processes shall be divided into Activities. When identifying an Activity, consideration must be given to the Cost Types used by that Activity to ensure those Cost Types are caused, in accordance with the Guiding Principle of Causality, by the SPHCCs to which the Activity Cost is allocated.	Ofcom expects Royal Mail to create at least two Stem Time Activities (Unmotorised v Motorised) as a consequence.	We will review Ofcom's proposal to confirm whether this is material and therefore warrants change.

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
<p>NCR 6 – Resource Drivers</p> <p>Sections 5.52 to 5.66</p>	<p>2</p>	<p>8.21 The Resource Driver for each Cost Type shall be—</p> <p>a) based on the resource consumption giving rise to the Cost Type (e.g. staff hours, machine hours, accommodation footprint, vehicle hours);</p> <p>b) quantified based on appropriate operational and financial data using actual data containing the necessary granularity.</p> <p>Only where such actual data is unavailable or lacks sufficient granularity or is not fit for the purpose intended, Royal Mail may use modelled or theoretical data, provided that this data is—</p> <p>(c) based on sampling or industrial engineering studies; and</p> <p>(d) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).</p> <p>For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.21, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.</p>	<p>Ofcom propose that Royal Mail provides them with the Resource drivers for Activities which are based on Planning Values rather than actual hours recorded. Ofcom has set out a new CAM template to capture this. (Comments on this new template are reported later).</p>	<p>Once the changes have been implemented to the RAG, we will undertake a review during 2019-20 in relation to all the Resource Drivers to ensure they are calculated in relation to the amended NCR 6.</p> <p>As explained above, actual data must also be 'fit-for-purpose' i.e. relevant and reliable (as set out in paragraph 5.60 of Ofcom's consultation). This has been added in red to the text.</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
<p>NCR 8 – Activity Costs</p> <p>Sections 5.26 to 5.31</p>	3	<p>8.24(d) (ii) if the Activity Costs relate to Non-operational Business Processes which do not have a direct causal link to any of the SPHCCs being processed, as General Overheads.</p>	<p>Ofcom expects Royal Mail to review the Activity Costs of the Non-operational Business Processes to ensure they are treated and allocated in accordance with the amended NCR 8.</p>	<p>We have no further comment on this change.</p> <p>Once the changes have been implemented to the RAG, we will undertake a review during 2019-20 of all activities within non-operational business processes. We will advise Ofcom of those activities that need to be changed (as part of change control process).</p>
<p>NCR 10 – Weighted Volume Drivers</p> <p>Sections 5.32 to 5.51</p>	4	<p>8.28 b) Weighting Factors, which represent the relative proportions of amount of work that units of each SPHCC require from the related Activity, when compared to a different SPHCC using the same Activity.</p>	-	<p>We suggest Ofcom rephrases “relative proportions” in 8.28 b) to make a clearer distinction between proportional factor and weighting factor. Ofcom has drawn a distinction between a proportion factor and a weighting factor. It would be helpful and clearer for the description of a weighting factor not to use “proportions of”. This is shown as the red crossed out text.</p>
<p>NCR 10 (continued)</p>	5	<p>8.29 Proportional Factors referred to in §8.28(a) shall be based on operational data collected using representative measurements of total volumes (including statistical sampling techniques where necessary, see National Costing Rule 14).</p>	-	<p>No comment</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
NCR 10 (continued)	6	<p>8.30 Depending on the nature of the Activity, one or more of the following variables may be used as a determinant of the amount of work to calculate the Weighting Factors—</p> <p>(a) time (needed to carry out the Activity): where appropriate, industrial engineering studies must be carried out in accordance with relevant ISO standards;</p> <p>(b) weight (of an item): appropriate operational data must be used; and</p> <p>(c) size (or physical dimensions of an item): appropriate operational data must be used.</p> <p>provided that each variable used by Royal Mail to calculate each Weighting Factor is quantified based on appropriate operational data using actual data containing the necessary granularity.</p> <p>Only where such actual data is unavailable or lacks sufficient granularity <i>or is not fit for the purpose intended</i>, Royal Mail may use modelled or theoretical data, provided that this data is —</p> <p>(d) based on sampling or industrial engineering studies; and</p> <p>(e) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).</p> <p>For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.30, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.</p>	<p>Ofcom expects Royal Mail to review its use of the terminology related to the Weighting Factors and Proportional Factors in its published Costing Manual and its submissions to us to ensure that they are consistent with the amended NCR 10. They also expect Royal Mail to explain its reasons clearly for all its assumption in determining the Weighting Factors including where it assumes parcels and letters to have equal Weighting Factors.</p> <p>Ofcom do not anticipate changes in the costs because of the proposed changes to NCR 10. However, they expect Royal Mail to revise its published Costing Manual and its relevant Technical Appendices to address the issues they have identified in paragraphs 5.39 to 5.44.</p>	<p>As explained above, actual data must also be 'fit-for-purpose' i.e. relevant and reliable (as set out in paragraph 5.60 of Ofcom's consultation). This has been added in red to the text.</p> <p>Once the changes have been implemented to the RAG, we will undertake a review during 2019-20 in relation to our use of weighting factors and proportional factors.</p> <p>As part of this review, we will set out, in the relevant document, the basis or source of assumptions, including the use of equal weighting factors where this applies.</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
<p>NCR 11 – Other Drivers</p> <p>Sections 5.67 to 5.74</p>	7	<p>8.35 Other Drivers shall be defined in a way which appropriately reflects the causal link with that factor quantified based on appropriate operational data using actual data containing the necessary granularity which reflects the causal link to that factor. Only where such actual data is unavailable or lacks sufficient granularity <i>or is not fit for the purpose intended</i>, Royal Mail may use modelled or theoretical data, provided that this data is—</p> <p>(a) based on sampling or industrial engineering studies; and</p> <p>(b) prepared in accordance with relevant statistical sampling techniques and ISO standards (see National Costing Rule 14).</p> <p>For the avoidance of doubt, where Royal Mail uses either actual, modelled or theoretical data under this §8.35, Royal Mail must ensure the integrity of the data in accordance with National Costing Rule 15.</p>	<p>Ofcom propose that Royal Mail should ensure it is clear which Activities are allocated using Other Drivers (as opposed to Weighted Volume Drivers or EPMU), and the basis for those allocations.</p>	<p>Once the changes have been implemented to the RAG, we will undertake a review during 2019-20 in relation to the mapping of Activities to drivers as set out by Ofcom.</p> <p>As explained above, actual data must also be 'fit-for-purpose' i.e. relevant and reliable (as set out in paragraph 5.60 of Ofcom's consultation). This has been added to the text in red.</p>
<p>NCR 12: Equi-Proportional Mark-up (EPMU)</p>	8	<p>8.36 EPMU shall be used for allocating Overheads (See National Costing Rule 8) by treating them in the following manner</p>	<p>Not referred to in consultation</p>	<p>No comment.</p>
<p>Heading change</p>	9	<p>'National Costing Rule 14: Operational data and sampling' substitute the heading 'National Costing Rule 14: Data and sampling'</p>	<p>Not referred to in consultation</p>	<p>No comment.</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
<p>NCR 14 – Operational data and sampling</p> <p>Sections 5.75 to 5.81</p>	10	<p>8.40 All operational data — whether actual, modelled or theoretical data — used by the National Costing Methodology shall be regularly reviewed by Royal Mail and, where necessary, updated to ensure the accuracy of costing and its consistency with the operational reality (see National Costing Rule 2). In so doing, for the avoidance of doubt, Royal Mail must ensure the integrity of all the data in accordance with National Costing Rule 15.</p>	-	<p>Please see our comments in the consultation response in relation to NCR 15.</p>
<p>NCR 15 – Data Integrity</p> <p>Sections 5.82 to 5.97</p>	11	<p>8.42 Data integrity is the maintenance of, and the assurance of the accuracy and consistency of any data over time, and the data includes (but is not limited to) inputs, models and outputs. The data integrity of financial and operational data — whether actual, modelled or theoretical data — used for the National Costing Methodology shall be preserved by adequate checks and controls which on the data for the same period as well as adequate checks and controls on the development of data from one period to another. The checks and controls shall include, (but are not limited to) reconciliation of total cost data at appropriate points in the National Costing Methodology.</p> <p><i>It is expected that, as Royal Mail's Business changes, the data used may need to change or new and updated data sources become available. These amended or new sources will need to be used to ensure the regulatory accounting methodology reflects operational reality.</i></p>	-	<p>Please see our comments in the consultation response in relation to NCR 15.</p> <p>Our suggested text is shown in red in the text.</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
Transfer Charges Sections 5.98 to 5.107	12	<p>8.76 (c) if the product and/or service does not fall within §8.76(a) or (b), the Transfer Price shall be equal to the FAC of that product and/or service plus an appropriate return or as agreed between Royal Mail and Ofcom a mark up of 10% on FAC.</p> <p>Equivalence pricing 9.9 Where there are appropriate comparable Access products and/or services provided by Royal Mail to external customers, Royal Mail must apply the equivalence pricing approach referred to §9.10 in determining Transfer Prices.</p> <p>Cost-plus pricing</p>	<p>Ofcom consider that it is reasonable to base the appropriate rate of return on the Financeability EBIT range of 5-10% which they have set as a measure of Royal Mail's commercial rate of return for the provision of the Universal Service.</p> <p>Ofcom expect Royal Mail to regularly evaluate the appropriateness of the rate of return it uses and monitor the available information to ensure the rate of return remains reasonable for downstream services.</p>	<p>Please see our comments in relation to transfer pricing in the consultation document. Our proposed amendment is shown in red.</p>
As above	13	<p>9.10 (d) The Transfer Price shall be determined as the sum of the price of the appropriate comparable Access product and/or service, the FAC differences referred to in §9.10(c) plus an appropriate return or as agreed between Royal Mail and Ofcom a mark up of 10% on those FAC differences.</p>	See above	<p>Please see our comments in relation to transfer pricing in the consultation document. Our proposed amendment is shown in red.</p>

NATIONAL COSTING RULE	No	REVISED RULE DESCRIPTION	OFCOM COMMENTS	ROYAL MAIL RESPONSE
As above	14	9.12 Where there are no appropriate comparable Access products and/or services, Royal Mail must set the Transfer Price as equal to the FAC of the product and/or service in question plus an appropriate return <i>or as agreed between Royal Mail and Ofcom</i> a mark up of 10% on that FAC.	See above.	Please see our comments in relation to transfer pricing in the consultation document. Our proposed amendment is shown in red.
Appendix 4 of RAG	15	<p>Data Template G Scope: all Cost Types whose cost is allocated to Activities by the application of Planning Values or theoretical or modelled operational data.</p> <p>Significant digits: to minimise the impact of rounding errors please provide all data to the maximum number of significant figures allowed by the RM system.</p>	-	In paragraph 5.63, Ofcom explains that it needs this information in relation to outdoor delivery activities. We ask that Ofcom clarifies that Data Template G is only for outdoor delivery.
NCR 2: Operational reality Sections 5.108 – 5.113	-	No changes to the rules.	No changes required. Ofcom notes that there is no hierarchy to the rules in the RAG. Where Royal Mail considers that there is conflict between rules and gives priority to one of those rules, Royal Mail must be able to demonstrate its reasoning to Ofcom on request.	