

Royal Mail plc

Royal Mail's Response to Ofcom's May 2018 Margin Squeeze Control Consultation

Royal Mail Submission

July 2018

Redactions:

Royal Mail is of the opinion that selected information supplied in this submission is commercially confidential and that its disclosure in any form would have an extremely prejudicial effect on its commercial interests. Royal Mail is also of the opinion that there could be no public interest or other argument which could possibly justify the disclosure of the information supplied; in whole or in part, without obtaining Royal Mail's express written consent in advance.

Public Version



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Executive Summary

- **Royal Mail generally welcomes Ofcom's proposals regarding the calculation of upstream costs used in USPA 6. However, we are disappointed that Ofcom have not taken the opportunity to undertake a more fundamental review of the margin squeeze test.** In particular, that Ofcom has not taken this opportunity to engage on Royal Mail's LRAIC model.
- **We particularly welcome Ofcom's proposal to move to the Direct Method of calculating upstream costs.** As we have previously argued, this method of calculating costs best reflects operational reality and is the business's best estimate of product level upstream costs. It also has significant advantages in terms of transparency and reliability compared to the Indirect Method. Ofcom also propose that it would be appropriate to make three further adjustments to costs for wholesale specific, revenue protection and commercial costs. We agree there are grounds to make these adjustments. However, whilst they would be expected to reduce upstream costs, Royal Mail would not envisage making these adjustments in the short term. Our key objectives are to increase transparency and reduce complexity. Making these adjustments goes against these objectives.
- **We are also supportive of Ofcom's proposal to explicitly include a rate of return and exclude overheads from the calculation of upstream FAC.** Unlike when the test was introduced in 2012, they now no longer net off so it is sensible to explicitly include each of them in the calculation. We would, however, welcome greater clarity on the respective definitions in either guidance or within the condition itself.
- One further area that we believe Ofcom should consider relates to the inclusion of VAT in upstream costs. The requirement to use costs excluding VAT is a legacy of the Indirect method due to the different VAT status of Retail and Access products. This will no longer be a concern under the Direct approach. **We therefore believe that, under the Direct method, the cost standard used should be inclusive of VAT.**
- **We fundamentally disagree with inclusion of surcharges in the margin squeeze test. We are disappointed that Ofcom is proposing this.** Surcharges exist to incentivise customers to meet the service specification they have bought. They are completely avoidable for customers. Surcharge rates are the same for both Access and Retail customers. It is only the level of compliance which differs. This is primarily driven by Access and Retail serving customers with different characteristics. **Failure to take the difference in compliance rates into account could unfairly penalise Retail customers if surcharges are included in USPA 6.**
- Surcharge revenue only represents a small proportion of our total revenue and is declining. **Given the scale of their impact, relative to the added complexity they will introduce, their inclusion is disproportionate.**

Chapter 1 – Calculation of Upstream Costs

- **Royal Mail is disappointed that Ofcom has not taken the opportunity to undertake a more fundamental review of the technical workings of the margin squeeze test.** In particular:
 - » Ofcom has chosen not to engage on our LRAIC model despite Royal Mail being very willing to do so;
 - » Ofcom has not explicitly addressed the use of customer specific costs even though this would benefit customers.
- **We welcome Ofcom's proposal to explicitly include a rate of return and exclude overheads from the calculation of upstream FAC.** However, we believe it would reduce any regulatory uncertainty if greater clarity was provided on the respective definitions in terms of specific guidance or within the condition itself. We are happy to work with Ofcom to get to a common understanding.
- **We also welcome Ofcom's proposal to move to the Direct Method of calculating upstream costs and support its analysis on appropriate Direct Method adjustments.** The Direct Method of calculating costs best reflects operational reality and is the business's best estimate of product level upstream costs. It has significant advantages in terms of transparency and reliability compared to the Indirect Method. Royal Mail would look to adopt this methodology as soon as permissible.
- **However, at least in the short-term, Royal Mail would not envisage reducing Direct costs for the three adjustments identified by Ofcom.** Although there is a small commercial advantage to Royal Mail by applying these adjustments, they also bring additional complexity, hence increasing the risk of error. We are seeking to reduce complexity, not increase it, something we can achieve by adopting the Direct methodology.
- **Royal Mail suggest that under the Direct method, the cost standard used should be inclusive of VAT.** The requirement to use costs excluding VAT is a legacy of the Indirect method. This will no longer be a concern under the Direct approach. It would also allow Royal Mail to avoid bespoke modelling for USPA 6, improving transparency and reducing complexity.

Royal Mail is disappointed that Ofcom has not taken the opportunity to undertake a more fundamental review of the technical workings of the margin squeeze test.

- 1.1 Royal Mail has a relatively low (and falling) market share in the retail market for bulk letters. Our share of mail sent by large businesses has declined over time. It now stands at only \pounds .¹ There are now a number of well-established competitors with larger market shares. While our competitors have complete pricing freedom, we are highly restricted by USPA 6. They have the freedom to choose how to price individual contracts according to the demand characteristics of their customers. Some of those prices could theoretically be priced at incremental cost, others above FAC. Royal Mail does not have this commercial flexibility. USPA 6 artificially increases our costs. This is neither in the interests of consumers nor efficient competition.

¹ Paragraph 2.2, Royal Mail's response to Ofcom's March 2017 Consultation, "Review of Regulatory Financial Reporting for Royal Mail" (June 2017)

Ofcom has chosen not to engage on our LRAIC model.

- 1.2 Ofcom acknowledge in its consultation document that “Using LRIC for margin squeeze control would provide the correct signals for entry in the market and we would expect Royal Mail to set its prices to maintain a minimum LRIC margin between its access prices and the equivalent retail prices”.²
- 1.3 We agree with this statement and have spent considerable resource developing our LRAIC model. We are therefore disappointed that Ofcom simply states that “robust LRIC information is not currently available”; it has not taken the opportunity to engage further on this point.³ In particular, with regard to a more appropriate proxy than the 50% of FAC currently used in the contract level test.
- 1.4 We provided extensive evidence in our response to the Ofcom March 2017 consultation document (referred to in the remainder of the document as the ‘June 2017 response’) that the test in its current form is acting as a competitive distortion on the market.⁴ It is becoming increasingly divorced from economic reality. As volumes in the relevant market decline, it forces Royal Mail to use a higher cost standard than our competitors.
- 1.5 In our response, we urged Ofcom to engage with us on our LRAIC model. We recognised that this would take time so we suggested an interim step. This was to move from 50% upstream FAC to \approx upstream FAC – a proposal which reflected the proportion of our pipeline costs which are variable. This proposal was reflective of operation reality, unlike the 50% of FAC which is currently used in USPA 6. Maintaining the status quo will mean Royal Mail will continue to be unable to compete fairly for many large contracts. Our share of mail sent by large businesses will continue to decline. However, in this latest consultation, Ofcom have not responded to any of the arguments we put forward.
- 1.6 Royal Mail has spent considerable time and money on developing our LRAIC model and we believe it produces robust LRAIC information. We recognise that Ofcom has expressed some concerns with our LRAIC model for the use in the margin squeeze test. We have reflected on Ofcom’s comments, and although we do not agree with all of them, we have made changes to our model to align more closely with Ofcom’s position. We strongly urge that Ofcom actively engages with us to address any remaining concerns. We are disappointed that instead Ofcom appear to be building a cost allocation model, to generate – amongst other things – an additional view of incremental costs.

Ofcom has not addressed the use of customer specific costs. We do not believe USPA 6 allows customer specific costs to be used. This has limited our ability to offer innovative upstream customer solutions.

- 1.7 Ofcom’s consultation focuses on three specific topics where it proposes changes from its previous consultation i.e.:
 - Costs used in the calculation of relevant upstream costs;
 - Methodology used to calculate relevant upstream costs;
 - Treatment of surcharges in the margin squeeze condition.

² Paragraph 3.5, Ofcom’s consultation on “Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control” (24th May 2018)

³ Ibid, Paragraph 3.6

⁴ Royal Mail’s response to Ofcom’s March 2017 Consultation, “Review of Regulatory Financial Reporting for Royal Mail” (June 2017)

- 1.8 It makes the statement that certain proposals made in the March 2017 Consultation remain unchanged.⁵ One area from our June 2017 response that we believe is important to revisit relates to the use of customer specific costs.⁶
- 1.9 As we explained in that response, given past experience in the face of regulatory ambiguity, we have been conservative in our interpretation of 'customer specific' costs. Royal Mail has interpreted the requirement to assess costs in accordance with Royal Mail's costing manual as not supporting the use of 'customer specific' costs – as the costing system produces costs on a national average basis.
- 1.10 We believe this limits our flexibility to offer customers prices on the basis of their specific costs, which might vary from the national average. Previous experience has highlighted the challenges of being able to offer innovative upstream customer solutions reflecting individual customer requirements.

Case Study: Challenges with using customer specific costs

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- 1.11 The proposed amendments to the condition, set out in Annex 5 of Ofcom's consultation, do not address customer specific costs. As we stated in our June 2017 response, the condition needs to explicitly recognise the need for customer specific costs.
- 1.12 Given Ofcom is now consulting on a move to using Direct costs, we believe this offers the ideal opportunity to reconsider making the use of customer specific costs more explicit in the condition. Where cost savings occur upstream it will be easier to provide greater transparency around the calculation of these costs since it will use the standard cost allocation methodology used to calculate costs under the Direct method.

⁵ Paragraph 1.6, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

⁶ We defined 'customer specific' costs as a contract specific variation on the cost reported by the costing system for a given retail service.

We welcome Ofcom's proposal to explicitly include a rate of return and exclude overheads from the calculation of upstream FAC. However, greater clarity on the respective definitions is needed in terms of specific guidance or within the condition itself to reduce regulatory ambiguity.

- 1.13 As Ofcom recognise, returns and overheads are now no longer expected to net off in the manner envisaged when the regulatory framework was put in place in 2012. We agree with the proposal to require an appropriate adjustment to exclude overheads and include a return within the margin squeeze calculation. The divergence we are now seeing between the two metrics, together with the increasingly competitive market dynamics, now makes this an appropriate adjustment. Any adjustment that allows Royal Mail to compete on a more level playing field is welcomed. Explicitly making an adjustment to exclude overheads and include a return in our upstream costs allows Royal Mail to price to a level which is more reflective of the costs we face.
- 1.14 We would, however, welcome confirmation from Ofcom regarding the definitions of both overheads and rate of return either in the form of guidance or explicit changes to the condition itself.
- 1.15 We note that Ofcom have drafted the notification so that 'General Overheads' are defined by the December 2017 Regulatory Accounting Guidelines. On this basis, our assumption on overheads is that this will include Business Sustaining and Support pipeline cost categories. However, within Business Sustaining and Support, there are two activities which do not fit into this definition of General Overhead ('York Preparation' and 'Warehousing and Stores').⁷ The total cost of these activities was £ in 17/18 (incl.VAT), £ of total Business Sustaining and Support costs. Royal Mail could continue to reattribute these specific activity costs when producing USPA 6 costs. However, this would mitigate, to a large extent, the resource benefit of removing overheads from the test. Given the impact is small, Royal Mail proposes a more practical implementation i.e. exclusion of Business Sustaining and Support pipeline categories in full.⁸
- 1.16 We would also welcome clarity from Ofcom on the definition of rate of return. In principle, we agree with Ofcom's suggestion of using the return which an investor would demand to receive from an Access Operator. However, we do not think this is a practical approach. It creates too much uncertainty regarding the calculation. There is very little information on the return Access Operators make in the public domain (e.g. from published accounts) that would enable us to calculate this on a consistent ongoing basis. We therefore maintain our view that the starting point for the appropriate rate of return should be based upon the Financeability EBIT range set by Ofcom as a measure of Royal Mail's commercial rate of return.
- 1.17 In its statement on the Review of the Regulation of Royal Mail, Ofcom re-iterated that "*We... consider that the 5-10% EBIT (Earnings Before Interest and Tax) margin range we identified in 2012 remains an appropriate benchmark. Royal Mail is currently making returns at the lower end of this range.*"⁹ Given it is our understanding that Access Operators returns are low¹⁰, we believe it would be appropriate to set the rate of return at the bottom end of the Financeability EBIT range set by Ofcom i.e. 5%. This would equate to 5.26% of costs. This approach would be consistent with Ofcom's statement that Royal Mail is currently making returns at the lower end of the 5-10% range. It is also consistent with our understanding that Access Operators' returns are below £.
- 1.18 We are very happy to work with Ofcom on agreeing a common understanding.

⁷ These activities fall outside of Ofcom's formal definition because they relate to Operational Business Processes, but they cannot be allocated to a specific part of the pipeline. For regulatory purposes they are reattributed upstream and downstream.

⁸ £

⁹ Paragraph 1.11, Ofcom's statement on "Review of Regulation of Royal Mail" (1st March 2017)

¹⁰ £

The Direct Method of calculating costs best reflects operational reality. It is the business's best estimate of product level upstream costs. It has significant advantages in terms of transparency and reliability compared to the Indirect Method.

- 1.19 We welcome Ofcom's proposal to move to the Direct Method of calculating upstream costs and support their conclusion on appropriate Direct Method adjustments.¹¹
- 1.20 Ofcom suggest that Royal Mail has stated a "*preference for the Direct Method, as this is easier for it to estimate and calculate*".¹² Our June 2017 response to the March 2017 consultation stated that, due to refinements we had made to the USPA 6 model, the gap between the Direct and Indirect costs had narrowed over time. Our preference for the Direct Method was driven by a desire to:
- Align USPA 6 with Royal Mail's audited, reported and best assessment of upstream costs;
 - Reduce complexity and risk of error;
 - Reduce the regulatory burden associated with USPA 6.
- 1.21 As we set out in our June 2017 response, although some differences in costs across the methodologies remain, our preference is not commercially driven.
- 1.22 Royal Mail agrees with Ofcom's identification of the reconciling items that explain the remaining differences in Direct and Indirect Methods and their categorisation into 'efficiency advantages' and 'other cost differences'. We discuss further below.
- 1.23 Royal Mail also agrees, in principle, with all Ofcom's proposed Direct Method adjustments.¹³ However, in practice, implementing such adjustments would be contrary to the aims of adopting the Direct Method. In the short-term they would add complexity and reduce transparency.¹⁴
- 1.24 Although, as Ofcom identified, these adjustments would work in Royal Mail's favour, their impact is small. In their consultation, Ofcom stated "*we would accept Royal Mail choosing not to make any of these adjustments when it calculates the relevant upstream costs...[providing] Royal Mail the freedom to reduce the complexity of the test where it is willing to face a higher margin threshold test in order to do so.*"¹⁵ As such, when permitted, Royal Mail intends to use the Direct Method, and in the short-term at least, would not make any of the commercially advantageous adjustments identified by Ofcom.¹⁶
- 1.25 Under the Direct Method; Royal Mail suggest a refinement to the condition. The existing USPA 6 condition defines costs "*not including recoverable or unrecoverable Value Added Tax*".¹⁷ The requirement to use costs excluding VAT is a legacy of the Indirect Method. It reflected the different VAT status of Retail and Access products and the associated impact on upstream costs under the Indirect approach. Under the Direct Method, this is not a concern. As such, Royal Mail believes the correct cost standard to use under

¹¹ Ofcom define the Direct Method as adding up the costs of the upstream activities (mainly collections, outward sortation at Regional Distribution Centres ("RDCs") and transportation to the inward mail centres) of the products subject to the margin squeeze tests and subtracting any wholesale specific costs.

¹² Paragraph 4.37, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

¹³ Wholesale, Revenue Protection & Commercial

¹⁴ All proposed adjustments to Direct Costs are likely to require a similar methodological approach. This is likely to involve the adaptation of USPA 6 models (or raw data) to reflect pipeline activity costs. It will also require a continuation of retail and access product cost matching. While feasible, this will re-introduce complexity into the calculation of upstream costs. However, if adjustments were pursued at a later date, it is likely that the necessary changes would allow all adjustments (Wholesale, Revenue Protection & Commercial) to be implemented at the same time.

¹⁵ Paragraph 4.39, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

¹⁶ To be explicit we would make no adjustment for Wholesale, Revenue Protection or Commercial costs.

¹⁷ USP Access Condition (USPA) 6.4 (b)

the Direct Method would be one including VAT. There is an administrative benefit to Royal Mail from using costs including VAT. Costs excluding VAT are not a standard business output. They are produced only for USPA 6 submissions. In contrast, costs including VAT are a standard costing output. As such, allowing their use in the USPA 6 condition would reduce the regulatory cost of compliance, reduce complexity and improve transparency. We suggest an amendment to USPA 6.4 which simply removes “(not including recoverable or unrecoverable Value Added Tax)”.

We support Ofcom's conclusion on appropriate Direct Method adjustments.

Efficiency Advantages

- 1.26 We agree with the adjustments Ofcom propose under the Direct Method to reflect Royal Mail's downstream efficiency advantages. As Ofcom state, Access competition is well-established and consumers should benefit from allowing Royal Mail to price according to our comparative efficiency advantages. Under the Indirect Method, these adjustments are already accounted for. Under the Direct Method, this is not the case, and manual adjustments are needed to avoid overstating relevant upstream costs.
- 1.27 Despite this, after adopting the Direct Method, Royal Mail do not intend to implement these adjustments at this point in time. For a small reduction in cost, adjustments would re-introduce complexity, which is contrary to our principle objective from adopting the Direct Method.
- 1.28 **Revenue Protection:** Royal Mail agrees with Ofcom's conclusion that Revenue Protection costs should be adjusted under the Direct Method. Ofcom is correct that Royal Mail undertakes Revenue Protection on both Retail and Access products. In our June 2017 response, we had stated that it was our understanding that Access operators do not undertake Revenue Protection on their own customers, relying instead on Royal Mail's downstream Revenue Protection checks to identify any issues. We note that Ofcom understand that Access operators do undertake their own checks, resulting in Access products undergoing two rounds of Revenue Protection. However, Ofcom also state that Royal Mail have suggested that due to where Revenue Protection takes place (for Retail: RDCs and for Access: Inward Mail Centres) the Revenue Protection activities are lower cost for Retail than for Access products.¹⁸ ✗. This does not affect Ofcom's conclusion on the need to adjust Direct costs. To adjust Direct costs to the same extent as Indirect costs, the adjustment would not remove the entire 'RDC mails verification' activity from the Direct upstream cost stack. Instead, it would adjust a Retail product's direct upstream costs for its Access equivalent's downstream Revenue Protection costs.
- 1.29 **Wholesale:** In Royal Mail's June 2017 response, we stated that we did not believe an adjustment should be made to Direct costs for Wholesale costs. Ofcom have reached a different conclusion, suggesting that Direct costs should be adjusted down for Wholesale costs. Given Ofcom's explanation that upstream costs should reflect the differences in Royal Mail's downstream Retail and Access costs, where these are due to genuine efficiency advantages, we agree with Ofcom's conclusion that Direct costs should be adjusted for Wholesale costs.¹⁹

¹⁸ Paragraph 4.20 (b), Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

¹⁹ Paragraph 4.25, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018).

A point of clarification. Ofcom state that Wholesale costs include "the costs of receiving and initial processing of access mail to ensure it is in the correct format for Royal Mail's downstream processes" 4.20 (a). ✗. Further in Footnote.33 Ofcom define the Indirect Method as Retail costs net of Access Downstream Costs. In some cases Access costs also include a small amount of upstream cost e.g. Commercial costs.

Other cost differences

- 1.30 We agree with Ofcom's identification of the drivers behind the remaining differences in Direct and Indirect methodologies, and the benefit of the Direct method in the majority of these cases. As above, although Ofcom propose an adjustment (for Commercial costs) that would reduce USPA 6 upstream costs, Royal Mail do not intend to implement this adjustment at this time.
- 1.31 **Downstream Customer Support costs:** Ofcom state in their consultation "*it appears that Royal Mail allocates a greater amount of customer support costs to access products than it does to downstream retail products.*"²⁰ ✗. However, this does not affect Ofcom's conclusion. Royal Mail agree with Ofcom. We would expect downstream customer support costs to be broadly similar for equivalent Retail and Access products. Therefore, differences in downstream customer support costs are a function of cost allocation methodologies, not a difference in actual cost or service levels. We also agree with Ofcom that we do not want differences in downstream costs, as a result of cost allocation, to cause distortions in upstream costs through the Indirect Method.²¹ Ofcom are correct in stating that the Direct Method does not result in such distortions because upstream costs are no longer dependent upon the allocation used for the purposes of the calculation of relevant downstream costs.²² The Direct Method would align costs used in USPA 6 with audited regulatory accounts and financial statements prepared in accordance with USP Accounting condition (USPAC) and the Regulatory Accounting Guidelines (RAG).
- 1.32 **Sub-product mix:** We agree with Ofcom's conclusion that upstream costs should not be distorted by differences in downstream costs caused by a lack of true comparability between products.²³ As we highlighted in our June 2017 response,²⁴ there are legitimate differences in the average profile of Retail and Access mail which can explain much of the difference between the downstream costs allocated to some Retail bulk products and the costs of their equivalent Access products. Even at a disaggregated SPHCC level, a product's cost reflects the average characteristics of all the mail posted against that product code. A Retail product and its Access equivalent might have different characteristics on average and, therefore, different average costs. The move to adopting Direct methodology will help to remedy this.²⁵
- 1.33 **Commercial costs:** We agree with Ofcom's conclusion that an adjustment should be made to the Direct method for Access Commercial costs. However, we wish to clarify Ofcom's explanation. ✗. Under the Indirect Method, Access Commercial costs are excluded from upstream cost estimates (as Access Commercial costs cancel out an equivalent amount of Retail Commercial costs). Without adjustment, these shared costs would remain under the Direct Method. We agree with Ofcom that, as these are downstream costs to Access operators, they should be treated as such in the margin squeeze condition and excluded from the estimate of Direct upstream costs. However, given the small impact this adjustment would make

²⁰ Paragraph 4.27, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

²¹ Paragraph 4.28, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

²² Paragraph 4.29, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

²³ Paragraph 4.31, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

²⁴ Royal Mail's response to Ofcom's March 2017 Consultation, "Review of Regulatory Financial Reporting for Royal Mail" (June 2017)

²⁵ Ofcom state that there are sub-products (such as the distinction between bag and tray products) that have different costs of handling but are treated as a single product from the perspective of the margin squeeze test. To clarify. ✗.

to upstream costs, and the complexity it would re-introduce into the process, at this time we do not intend to implement this adjustment.²⁶

1.34 To summarise, Royal Mail welcomes Ofcom's proposal to allow us to adopt the Direct Method for the purposes of calculating the upstream cost stack. This approach better reflects our upstream costs and aligns the costs used in USPA 6 with the business's audited, reported and best assessment of upstream costs. It also reduces complexity and risk of error and significantly reduces the administrative burden associated with USPA 6.

Figure 1: Summary of Ofcom's proposed adjustments and Royal Mail's response

Cost difference	Ofcom's proposal for Upstream (U/S) cost stack	Ofcom's proposal for Direct method adjustments	Royal Mail proposal under Direct method
Wholesale-specific costs	Account for Royal Mail's downstream efficiency	Needs adjustment ↓	Agree with Ofcom's proposal. However, in short-term, do not intend to implement adjustment.
Revenue Protection	Account for Royal Mail's downstream efficiency	Needs adjustment ↓	Agree with Ofcom's proposal. However, in short-term, do not intend to implement adjustment.
Downstream Customer Support costs	Account only for Royal Mail's actual U/S costs	N/A	Agree with Ofcom's proposal. No adjustment necessary.
Sub-product mix	Account for Royal Mail's actual sub-product mix	N/A	Agree with Ofcom's proposal. No adjustment necessary.
Commercial costs	Treat as downstream cost equivalent to cost faced by access operators	Needs adjustment ↓	Agree with Ofcom's proposal. However, in short-term, do not intend to implement adjustment.

1.35 Finally, Ofcom make reference in their consultation to the fact that "*certain proposals made in the March 2017 Consultation remain unchanged*" and "*stakeholder responses...to these proposals will be included as part of [Ofcom's] final statement on amendments to USPA 6.*"²⁷ Ofcom's updated USP Access Condition reflects the combination of proposals made in the March 2017 Consultation and May 2018 consultation. Where they are still relevant, Royal Mail reproduce comments previously made in response to the March 2017 consultation below.

²⁶ Similar to other adjustments, Commercial costs would require Pipeline level cost data. For each Retail product, the equivalent Access product's Commercial costs are netted off the Direct upstream cost estimate. While feasible, this would be data intensive and require modelling development.

²⁷ Paragraph 2.6, Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

Figure 2: Summary of Royal Mail's response to USP Access Condition changes

Condition/Area	Ofcom consultation proposal	Royal Mail position
Use of customer specific costs in USPA 6	N/A	<p>USPA 6 does not allow customer specific costs to be used. This limits our commercial flexibility. The condition needs to explicitly recognise the need for customer specific costs and we would welcome further engagement with Ofcom to agree how best to report this.</p> <p>See paragraphs 1.17 to 1.12 and A.14 to A.21 of June 2017 response.</p>
Amend USPA 6.2 - reasonable expectations	<p>Ofcom is proposing to amend the condition to make it clear that Royal Mail must have a reasonable expectation that the margin squeeze tests in USPA 6 are satisfied at the time of setting new prices</p> <p>Infers we should also update our annual forecast of costs at the time of offering prices for a new contract which was not foreseen at the time of the original forecast</p>	<p>We welcome this clarification.</p> <p>See paragraph A.23 of June 2017 response.</p> <p>To formally update the product cost forecast on each such occasion and submit to Ofcom would result in a disproportionate burden. We seek clarity that Ofcom does not have this intention.</p> <p>See paragraph A.23 to A.25 of June 2017 response.</p>
USPA 6.7 (b) - new contract information	Minor change to condition	<p>We agree with the proposal to change “materially amended” to “amended”.</p> <p>See paragraph A.32 of June 2017 response.</p> <p>We believe further clarity is needed to make it explicit that only changes to the contract relating to price, volume, date of contract signature or length of contract would need to be re-notified.</p> <p>See paragraph A.32 of June 2017 response.</p>

Chapter 2 – Inclusion of Surcharges in USPA 6

- **We are disappointed that Ofcom are proposing to include surcharges in the margin squeeze test.** Surcharges exist only to incentivise customers to meet the service specification they have bought. This enables us to handle the mail we receive efficiently. They are completely avoidable for customers.
- Surcharges rates are the same for both Access and Retail customers – it is only the level of compliance which differs. Failure to take the difference in compliance rates into account could unfairly penalise Retail customers if surcharges are included in USPA 6.
- Surcharges revenue represents a small proportion of our total revenue and is declining. Given the scale of their impact, relative to the added complexity they will introduce, their inclusion is disproportionate.
- **Using average Access surcharges in margin squeeze calculations would bias estimates of Royal Mail Retail upstream margins by introducing non-equivalence:**
 - » Retail and Access have different types of customers with different levels of compliance;
 - » Adjustment charges are reviewed at Tariff. Historic averages may not provide a reasonable expectation of future surcharges;
 - » Surcharges are characterised by a large number of compliant customers and a small number of non-compliant customers. In such cases, a mean based average is a poor predictor of customer level compliance; and
 - » Royal Mail Retail complies with national price plan requirements. Including profile surcharges in average surcharges is an obvious area of non-equivalent treatment of Royal Mail Retail compared to our Access customers. If surcharges are to be included in the test, at a minimum, profile surcharges should be removed from the calculation.
- **We fundamentally disagree with the inclusion of surcharges.** However, if Ofcom pursues its current proposal for them to be included, we believe the only practical approach would be to add surcharges as an uplift to the Retail bulk and downstream Access prices in some form. We believe Ofcom should consider an approach which controls for differences in compliance rates across Retail and Access. We provide details of a calculation in Annex 1 and are happy to work with Ofcom on refining this.
- If Ofcom were to accept our suggested approach to the implementation of surcharges, we believe Ofcom need to provide more explicit guidance on the methodology to implement surcharges within the margin squeeze control. This would reduce any regulatory ambiguity.

We are disappointed that Ofcom are proposing to include surcharges in the margin squeeze test. Given the scale of their impact, relative to the added complexity they will introduce, their inclusion is disproportionate.

- 2.1 We are disappointed that Ofcom has not given more weight to the arguments we made in submissions and subsequent meetings with Ofcom. Surcharges are low and have a marginal impact on USPA 6 outputs. They would be administratively onerous to maintain and inclusion in the tests would be disproportionate. We completely disagree with Ofcom's comment that Royal Mail could use surcharges to disadvantage Access operators in the future.

- 2.2 The primary objective of the surcharges levied by Royal Mail is to drive compliant customer behaviour across all customer groups.²⁸ Surcharges are avoidable for customers. They exist to incentivise customers to meet the service specification they have bought. This enables us to handle the mail we receive efficiently. We seek to minimise the surcharges on customers and proactively engage with customers to reduce surcharges. We provide transparency and advice to both Retail and Access customers on how to improve compliance rates. In particular, our investment in Mailmark has significantly increased the visibility of issues. This has enabled us to provide better intelligence to customers and to work more closely with them to resolve issues.
- 2.3 Surcharge revenue represents a small proportion of our total revenue. It is declining and is already less than 1% of the relevant Retail and Access total revenues.²⁹ We expect levels to reduce further as customer compliance continues to improve and the new reduced 2018/19 surcharge rates take effect. Surcharges are not having any material impact on the competitive dynamics in the market.
- 2.4 In fact, by including surcharges in the margin squeeze test, it could be argued that Ofcom is introducing an element which is not entirely within our control. It could have an adverse impact on the market. For example, a customer may have 10 instances of non-compliance in a given period or 100, and we will not be able to control that. However, under Ofcom's proposal, the cost of these 100 non-compliance incidents in Access would need to be factored into Royal Mail's Retail price. Therefore, if Access operators have a significant number of failures, it will be Royal Mail's Retail customers who will be forced to pay a higher price as a result of something over which they, or Royal Mail, has no direct control. Regulation should not be changed if it has the potential to provide incorrect incentives on the behaviour of Access operators.
- 2.5 With Mailmark, Access operators are able to see who the members of the supply chain are. In particular, they can identify the mail producer and pass on the non-compliance charges, as more often than not, non-compliances occur 1%.
- 2.6 Total surcharges would have to increase many times over before they would have any material impact on the margin squeeze test. For the market upstream margin to change by **five percentage points** a surcharge adjustment would need to reduce upstream prices by 1%. Any final adjustment will depend on the difference between average Retail and Access surcharges. If we make the unrealistic assumption that surcharges are only applied to Access products, for a surcharge adjustment to decrease upstream prices by 1% of surcharge revenue would need to be levied on Access mail. This is 1% the revenue recorded in the two years assessed for our recent RFI response (1%). For a **ten percentage point** reduction in the upstream margin, prices would need to fall by 1%, with 1% needing to be levied on Access mail. This would be 1% **historic levels**. Further, given the offsetting impact Retail surcharge revenue will have on the final surcharge adjustment, these are underestimates.³⁰
- 2.7 To try and minimise the biases created by a simple application of surcharges in USPA 6, Royal Mail have suggested an alternative methodology in Annex 1. However, all methodologies will create new and ongoing costs to Royal Mail from recording and applying surcharge data in USPA 6. Given the negligible impact this is likely to have on USPA 6 outcomes, Royal Mail believe an ongoing requirement to adjust USPA 6 for surcharges is disproportionate.

²⁸ It is important to highlight the distinction between surcharges and adjustments. Surcharge fee per mailing can be defined as 'Charge is applied to per mailing when items are not declared in as per Mailmark Specifications'. Adjustment per item can be defined as 'Charge is applied to unique count of items which failed Mailmark Specifications and resulted in additional work for Royal Mail machinery to process this items'.

²⁹ Royal Mail response to Surcharging RFI (22nd January 2018)

³⁰ 1%

Using average Access surcharges in margin squeeze calculations would bias estimates of Royal Mail Retail upstream margins by introducing non-equivalence.

- 2.8 As we discuss in the next section, whilst we fundamentally disagree with the inclusion of surcharges, if they are to be included, we believe that the only practical approach would be to add average surcharges as an uplift to the standard Retail Bulk and Access prices. However, using average surcharges will bias estimates of Royal Mail Retail upstream margins.
- 2.9 USPA 6 is designed to promote upstream competition by allowing equally efficient Access operators to earn sufficient margin to compete with Royal Mail Retail. Royal Mail Retail's upstream costs and revenues define the minimum margin Access operators should be able to earn.
- 2.10 Margins are currently calculated on an equivalent basis by assuming that both Retail and Access customers meet the product's specification. Operators can achieve these margins by complying with product specifications. Surcharge rates are the same for Retail and Access. However, including average surcharge rates in the margin squeeze calculation introduces a potential non-equivalence into the test. Although surcharge rates are identical for Retail and Access customers, compliance varies, resulting in differences in the average surcharges applied to Retail and Access customers.
- 2.11 When deciding whether or not USPA 6 should be adjusted with average surcharge rates, the following areas need to be considered:
- Royal Mail Retail customers have different characteristics to the Access average. ✗. The surcharges Royal Mail Retail customers incur are different to the Access average.
 - Historic averages may not provide a reasonable expectation of future surcharges. Volume is migrating to Mailmark and surcharges are regularly reviewed. In 2018, some surcharge rates fell significantly.
 - A mean based average is a poor predictor of customer level compliance. The majority of customers and mailings are compliant. In a distribution with a positive skew (or a long tail from a small number of customers facing a relatively large surcharge) a mean defined average will be higher than both a median and mode defined average.
 - Average surcharge rates presented in Royal Mail's response to Ofcom's RFI reflect the combined impact of Mailmark, Non-Mailmark and price plan surcharges.³¹ Royal Mail Retail meets a national price plan and would not incur a price plan surcharge. This is an obvious area of non-equivalent treatment of Royal Mail Retail.

Retail and Access customers have different characteristics so applying average surcharges is inappropriate.

- 2.12 Access operators ✗.
- 2.13 We have refreshed the evidence previously presented to Ofcom with updated 17/18 data where this was available. By the end of 17/18, ✗ of Access mail had migrated to Mailmark, while ✗ of Retail volume had migrated.³² Mailmark data shows that across both 16/17 and 17/18 Retail mailings have a ✗.

³¹ Royal Mail response to Surcharging RFI (22nd January 2018)

³² Access accounts for ✗ of total manifested 17/18 volume.

Figure 3: Comparison of Retail and Access items per mailing

No. of items in eManifest	% of Access eManifests (16/17)	% of Retail eManifests (16/17)	% of Access eManifests (17/18)	% of Retail eManifests (17/18)
<=999	✂	✂	✂	✂
>=1,000 to 4,999	✂	✂	✂	✂
>=5,000 to 9,999	✂	✂	✂	✂
>=10,000	✂	✂	✂	✂

2.14 Differences in customer mix can impact compliance in a number of ways:

- Differences in posting profiles can impact the type of surcharges incurred. ✂.
- ✂.

2.15 We also observe differences in the speed at which customers can respond to compliance failures. Often, ongoing compliance failures are associated with high-volume customers, for whom adjustment processes take longer. Smaller Royal Mail Retail customers tend to be more responsive to rectifying compliance failures, potentially because resolution is easier and less costly (e.g. smaller IT or data changes) or because they are billed directly via Royal Mail Retail (rather than being billed through an intermediary). Retail customers may also have more flexibility to use alternatives to Mailmark – while compliance issues are resolved. In contrast, Access customers tend to continue with Mailmark and incur the per unit surcharges (potentially because this is a more cost-effective option).

2.16 We set out in Annex 2 the refreshed evidence in full.

Historic averages will not provide a reasonable expectation of future surcharges.

2.17 Volume is migrating to Mailmark and surcharges are reviewed on an annual basis. In 2018, many surcharge rates fell. For example, Missort letter rates fell by c.30% and Not Machine Processed letter rates almost halved. In addition, there is large variation in the total magnitude of Non-Mailmark and Mailmark surcharges year to year. This is consistent with migration towards Mailmark. Mailmark migration is expected to continue, so it is likely we will continue to see significant year on year variations.

2.18 Whilst this degree of flux is ongoing, forecasts based on average surcharges in prior years may be poor proxies for future levels.

A mean based average is a poor predictor of customer level compliance.

2.19 The majority of customers and mailings are compliant. The majority of customers incur small or zero surcharges, with a small number of customers incurring relatively large surcharges (the distribution exhibits a long tail). Surcharges per customer will therefore be positively skewed. In such a distribution a mean based average would be distorted upwards by large outliers (customers who incur significant failure), and will be higher than median or mode defined averages. In such cases, the most reasonable expectation of customer level compliance would not be defined by a mean based average. Including surcharges in the margin squeeze test, which may lead to higher prices for Royal Mail Retail's customers, will therefore unfairly impact the majority of customers who are, in fact, compliant.

Including profile surcharges in average surcharges is an obvious area of non-equivalent treatment of Royal Mail Retail compared to our Access customers. If surcharges are to be included in the test, at a minimum, profile surcharges should be removed from the calculation.

- 2.20 Averaged surcharge rates, presented in Royal Mail's response to Ofcom's RFI, reflect the combined impact of Mailmark, Non-Mailmark and price plan surcharges. Royal Mail Retail meets a national price plan and would not incur a price plan surcharge. This is an obvious area of non-equivalent treatment of Royal Mail Retail. A downstream surcharge, based on average Access surcharges, would penalise Royal Mail Retail for price plan non-compliance, when in fact it is compliant.
- 2.21 Royal Mail Retail services meet a national profile. Hence, if Retail services were to be assessed on the basis of profile, Royal Mail would not face any surcharges. However, under the Ofcom proposal, our Retail price would be impacted by the charges Access operators may incur.
- 2.22 Even if surcharges were to be included in the margin squeeze calculation, at the very least profile surcharges should be excluded from the average surcharge calculation.

Ofcom provides very little guidance on the methodology to implement surcharges within the margin squeeze control. We believe more detailed guidance is required to remove regulatory uncertainty.

- 2.23 Whilst we fundamentally disagree with the inclusion of surcharges, if they are to be included, we believe that adding surcharges to the price is the most practical approach along the lines proposed under Ofcom's Option 2 – i.e. adding surcharges “*..as an uplift to standard retail bulk and downstream access prices to account for an estimate of surcharges ..*”³³
- 2.24 However, the only practical solution to this would be to include revenues and volumes as part of the market level test and not against individual products. ✗. To accurately report against specific products would require investment in time and resources and introduce complexity into the revenue protection process.
- 2.25 We believe the only practical approach would be to add surcharges as an uplift to the standard Retail bulk and downstream Access prices in some form. However, there is an approach which works to reduce the bias that could result from using a simple average. The methodology we suggest offers the ability to control for differences in compliance rates across Retail and Access and is presented in full in Annex 1. We are very happy to work with Ofcom on refining this approach.
- 2.26 The consultation also makes no acknowledgement of the specific application to the contract level test. The only implementable way surcharges could be included at a contract level is for the aggregate contract level upstream price to be adjusted for average Retail and Access surcharges. At a market level this approach is imperfect, but permissible due to its small overall impact. At a contract level this approach would create large distortions.
- 2.27 Average Access surcharges will not be representative of the likely costs of providing services to all individual customers. We have already illustrated how average surcharges vary across Retail and Access, due to the different types of customers they typically serve. An expected Access surcharge should therefore have consideration for customer type.

³³ Paragraph 4.51 (2), Ofcom's consultation on “Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control” (24th May 2018)

- 2.28 Even if the customer was known to be an 'Access' type customer (i.e. large, high volume), a mean based average Access surcharge would be a poor choice for assessing a specific customer's expected compliance. A mean based average implicitly assumes that all customers equally fail a small amount. In reality, the majority of customers' mailings are compliant, and incur no surcharges, while some customers incur repeated surcharges. Using a mean based average would be counter to observed customer behaviour.
- 2.29 Adjusting prices for Access and Retail surcharge averages, with no consideration for the customer's actual expected compliance, will unfairly penalise Retail customers who we expect will send perfectly compliant mail.
- 2.30 Surcharges are there to drive compliant behaviour from customers. At the contract level, it may be reasonable to assume that customers would be compliant and would therefore incur no surcharges. We interpret this as being compliant with the wording of the condition.

Ofcom consultation question	Royal Mail response
<p>Question 1: Do you agree with our proposals to add in an explicit reference to exclude overheads and include a rate of return in the upstream cost calculation as detailed USPA 6?</p>	<p>Royal Mail agrees with Ofcom's proposal. See Chapter 1.</p>
<p>Question 2: Do you agree with our proposal to allow Royal Mail to adopt the Direct Method for the purposes of calculating the upstream cost stack?</p>	<p>Royal Mail agrees with Ofcom's proposal. See Chapter 1.</p>
<p>Question 3: Do you agree surcharges should be included in the margin squeeze control?</p>	<p>Royal Mail does not agree with Ofcom's proposal. See Chapter 2.</p>
<p>Question 4: Do you agree with the methodology to implement surcharges in the margin squeeze control?</p>	<p>Royal Mail has suggested a refined version of Ofcom's proposal to minimise distortionary effects. See Chapter 2.</p>

Annex 1 – Surcharges implementation methodology

A.1 Ofcom has set out a proposal to include surcharges within USPA 6 by adjusting Retail and Access prices:

“As an uplift to standard retail bulk and downstream access prices to account for an estimate of surcharges, to the extent that the difference between retail and access surcharges do not relate to operational differences or differences in customer behaviours. This would potentially reduce the relevant upstream revenues to cover the relevant upstream cost stack.”³⁴

A.2 Below we set out a methodological implementation of this proposal. Currently USPA 6 defines upstream prices as:

$$p_u = p_r - p_a$$

A.3 Where p_u is the upstream price, p_r is the end-to-end Retail price and p_a is the price of the equivalent Access product. Under Ofcom's consultation proposal Royal Mail believe the definition of upstream price would change to:

$$p_u^s = (p_r + s_r) - (p_a + s_a)$$

A.4 Where s_r is the retail surcharge, and s_a is the Access surcharge. Neither of these adjustments can be identified on a product basis. The main practical implementation challenge with Ofcom's proposal is defining the methodology used to estimate s_r and s_a .

A.5 In our surcharging RFI response, on Ofcom's behalf we estimated an average Access and Retail surcharge rate by dividing total surcharge revenue by an estimate of relevant volume.³⁵ The USPA 6 aggregate market level upstream price could be adjusted for surcharges by netting off the difference between the Access and Retail average surcharge rate.

$$p_u^s = p_u - (s_a - s_r)$$

A.6 However, Royal Mail believe this approach risks biasing the estimate of upstream prices:

- a. **Backward looking:** The value of surcharges often changes alongside other Tariff changes. For example, between 2017 and 2018 Not Machine Processed Letter surcharges decreased from 4.02p to 1.98p. Using an average value based on the previous year's average surcharge may be a poor forecast for average surcharge in the year ahead.
- b. **Differences in customer behaviour:** Some of the observed difference in average Retail and Access surcharges will reflect differences in Retail and Access customers. Average Access surcharges may not be representative of the surcharges the Retail business would incur. For example:
 - i. **National Price Plans:** Average Access surcharges include national price plan surcharges. If Royal Mail Retail is compliant with a national price plan then it would not incur such a surcharge.

³⁴ Paragraph 4.51 (2), Ofcom's consultation on "Amendments to the Universal Service Provider Access Condition in relation to the margin squeeze control" (24th May 2018)

³⁵ Royal Mail response to Surcharging RFI (22nd January 2018)

- ii. Differences in customer types: Royal Mail believes there are differences in the types of customers using Royal Mail Retail and Access operators. This manifests itself as differences in compliance rates, with differences in average surcharges reflecting differences in customer behaviour.

A.7 The methodology described below would correct for these limitations.

A.8 Under a simple average approach, average Retail surcharges are given by:

$$s_r = \frac{\sum_{i=1}^N R_{r,i}}{V_r}$$

A.9 Where V_r is total relevant retail volume and $R_{r,i}$ is total Retail surcharge revenue for surcharge i , therefore $\sum_{i=1}^N R_{r,i}$ is total Retail revenue across all surcharges (N in total). There is an equivalent equation defining the Access average.

A.10 The average Retail surcharge could also be defined as:

$$s_r = \frac{\sum_{i=1}^N s_{r,i} V_{r,i}^{CNC}}{V_r}$$

A.11 Where $s_{r,i}$ is the per unit value of surcharge i and $V_{r,i}^{CNC}$ is the volume of surcharged non-compliant items (for surcharge i). This simply states that the total revenue from a given surcharge is a product of its per unit value and the number of items that are surcharged. A further step can disaggregate the volume of non-compliant items surcharged.

$$s_r = \frac{\sum_{i=1}^N s_{r,i} V_{r,i}^{NC} \alpha_{r,i}}{V_r}$$

A.12 Where $V_{r,i}^{NC}$ is the total number of non-compliant items under surcharge i , and $\alpha_{r,i}$ is the proportion of total non-compliant items which are actually surcharged. Therefore, the average retail surcharge can be thought of as:

$$s_r = \frac{\sum_{i=1}^N s_{r,i} V_{r,i}^{NC} \alpha_{r,i}}{V_r} = \sum_{i=1}^N s_{r,i} \beta_{r,i} \alpha_{r,i}$$

A.13 Where $\beta_{r,i}$ is the number of non-compliant items (for surcharge i) as a proportion of total volume ($\frac{V_{r,i}^{NC}}{V_r}$). In words, the average Retail surcharge can be thought of as the sum (across all surcharges) of each surcharge's per unit value multiplied by the proportion of all volume which are non-compliant and the proportion of those non-compliant items which are actually surcharged.

A.14 The fact that per unit values are direct inputs into the equation allows the methodology to reflect any annual changes in surcharge levels. Although other inputs will be based on historic data, this would provide some improvement over a simple average.

A.15 An equivalent calculation could be undertaken to derive an Access average.

$$s_a = \sum_{i=1}^N s_{a,i} \beta_{a,i} \alpha_{a,i}$$

A.16 However, this would not control for differences in Retail and Access customer behaviour. A further benefit of this methodology is its ability to control for differences in compliance rates across Retail and Access. For example, we can estimate an Access surcharge average holding the compliance rate (β) constant at Retail levels. In other words, what would the average Access surcharge rate be if they complied at the same rate as Retail customers do (practically we replace $\beta_{a,i}$ with $\beta_{r,i}$):

$$s_a^* = \sum_{i=1}^N s_{a,i} \beta_{r,i} \alpha_{a,i}$$

A.17 Under this methodology the net difference between s_r and the adjusted s_a^* would define the adjustment applied to the market upstream price at the end of the USPA 6 model.

A.18 This approach would control for equivalence in customer behaviour and allow use of forward looking surcharge values. It would also disaggregate average surcharges into different components, allowing greater visibility over why differences exist. Under this approach, if there was no difference in the proportion of Retail and Access items surcharged (α), the surcharge adjustment would net to zero.

A.19 Although this approach has a number of advantages over a simple average, if Ofcom were minded to pursue this methodology further, there are a number of practical implementation issues we would need to discuss. These include:

- a. **Data availability:** This approach is more data intensive than a simple average. Practically such an approach would have to be limited to Mailmark surcharges only.
- b. **Surcharge inclusion:** The above methodology is most easily implemented with per unit surcharges (where volume or mail items are the unit adjusted). Surcharges applied on a per transaction basis may not be suited to this approach e.g. because they require an estimate of the number of transactions, rather than volume.

A.20 Royal Mail suggest that this calculation is undertaken once a year to inform the first USPA 6 forecast of the year (typically submitted in March). This value would then be used to adjust market level prices in subsequent forecasts and ex-post models.

A.21 Despite its limitations Royal Mail believe the benefits of this approach make it a superior methodology in comparison to the simple average. If Ofcom are minded to consider this approach we would propose further work is undertaken to assess its feasibility.