

Royal Mail

Royal Mail's response to Ofcom's consultation on the Proposed regulation of new D+5 Letters Access services

23 December 2020



Executive Summary

We welcome the opportunity to respond to Ofcom's consultation document on extending the USPA condition to our new D+5 Access Letters services. We are pleased that Ofcom has conducted a targeted consultation which focuses on achieving the best outcome for both ourselves and our customers. We note that Ofcom's upcoming regulatory review will be the appropriate forum for any wider discussion of the Access regime.

Royal Mail and Ofcom have had constructive engagement on the appropriate regulatory treatment of the new Access D+5 service in recent months. As a result, we are generally supportive of Ofcom's proposals.

The one area where we have a different view to Ofcom's proposal is the date when the new condition will take effect. Ofcom has proposed that the new condition should take effect from the date that its decision is published. However, this poses a number of practical challenges which we describe in more detail in our response to Ofcom's Question 3 below. We suggest that a more appropriate start date for the new condition should be the start of our Financial Year i.e. 29th March 2021.

Question 1: Do you agree with our proposal to extend the USPA condition to the new D+5 Letters Access services?

- 1.1 Yes, we agree with Ofcom's proposal to require Royal Mail to provide access to our network for the purpose of providing the new D+5 Access Letters services.
- 1.2 Ofcom's proposal is in line with our request that the new D+5 Access Letters services be brought within the scope of the USPA condition. The new services are due to launch on 4 January 2021 with five variants for Mailmark Letter format: Advertising Mail; Advertising Responsible Entry; Advertising Responsible Intermediate; Partially Addressed and Mailmark Letter¹.
- 1.3 As we explained in our letter of 21st August 2020, for Royal Mail to achieve the efficiency gains anticipated from the Delivery to Specification programme (which makes the introduction of the new D+5 Access service possible), sufficient volumes will need to migrate to the new Access services. This will only occur if the new services are attractive to customers, which means that the D+2 volumes transferring will need to retain their VAT exempt status. We do not expect the volumes sent using the new D+5 services will be new to the market. Instead they will be existing D+2 volumes which will transfer to the new D+5 services.
- 1.4 It is important to note that the new Access services form an important part of Royal Mail's Delivery to Specification programme and our wider efforts to improve efficiency, and in turn ensure financial sustainability. We have already provided Ofcom with extensive information on this. We can provide further information if Ofcom would find that helpful.

¹ Includes all Mailmark Letters not included within the other four categories, but primarily Business Mail.

Question 2: Do you agree with our proposal to include Royal Mail's new Retail Economy Mailmark Letter services and their access equivalent services in the margin squeeze control?

- 1.5 Yes – the services listed in Ofcom's proposed new USPA condition (new USPA6.8) are the appropriate Royal Mail Retail services. They are the Retail equivalent to the existing Access D+2 and later than D+2 Letters and Large Letters services, and to the new Access D+5 and later than D+5 Letters services.

Question 3: Do you agree that, if adopted, the proposed changes to the USPA condition should become effective from the date of Ofcom's statement? For example, do you foresee any practical issues, or otherwise, with making the changes effective on the date of Ofcom's statement?

- 1.6 No, given the likely timing of Ofcom's statement we do not agree that the best approach is for the USPA condition to become effective from the date of Ofcom's statement. The timing of the consultation and subsequent statement means that Ofcom will be unable to make a decision on the regulatory status of the D+5 service before the start of January when the new access service will go live. This has implications for implementing the change in VAT status within our systems.
- 1.7 Whilst we are keen for the new regulatory condition to take effect as quickly as possible, for the status to change mid-way through a quarter would raise a number of practical challenges which we set out below. It is for these reasons that we propose the condition becomes effective from the start of our next financial year i.e. **29th March 2021**.
- 1.8 The significant practical challenges can be grouped into three key areas:
- i. The time needed to make the relevant systems changes – we estimate 4 to 6 weeks is required, once we know the effective date with certainty;
 - ii. Implications for the calculation of VAT and the issuing of credit notes to customers; and
 - iii. Requirement for an additional USPA6 submission and significantly increased complexity of the remaining 2020-21 USPA6 submissions

Time needed to make relevant systems changes

- 1.9 The first issue relates to the need for certainty around the effective date of the condition and the time needed to make the required systems changes. This affects both Royal Mail and our Access customers. The new Access D+5 product will be launched on 4th January 2021 as VATable at the standard rate. Our systems have been set up to reflect that the product is VATable at the standard rate. If Ofcom, following consultation, decides that the appropriate regulatory treatment is that the product should be subject to regulation (USPA) and to the price control (USPA6) then the VAT status for the product will change from VATable at the standard rate to VAT exempt. Once we have Ofcom's decision i.e. we know if and when the VAT status will change, and its effective date with certainty, we need to make changes in our IT systems.
- 1.10 Changing the VAT status to VAT exempt in our systems will take 4 to 6 weeks in total. This will include
- Updating the relevant system codes;
 - Testing to ensure the VAT status change is being implemented correctly in all scenarios; and

- Testing that it is not adversely impacting any other product.

- 1.11 The fact that the product will be launched, and used, as VATable at the standard rate makes the change even more complex. If a product has previously been sold it is not possible to simply change the tax code from VATable at the standard rate to VAT exempt. Our systems need to preserve the fact that the product had been previously sold as VATable at the standard rate. We need to configure a new tax classification and create corresponding tax conditions in our systems so the correct code can be determined, should retrospective adjustments need to be applied.
- 1.12 Making these changes is also a costly process. Every time we make a change there is a cost associated with it. We need clarity on the date at which the tax treatment will change. This will enable us to make one change to the system rather than potentially multiple changes. If we have to change the date of implementation of the new regulations at a later stage, we will incur additional cost. Therefore, the most efficient approach in terms of time and money is to start the process of updating our systems when we know the effective start date of the condition with certainty. There is not a simple on/off switch that we can use to change the VAT status. If Ofcom's decision is not published until for example, mid-February, and work then starts on making the system changes, these cannot be implemented until around the start of the financial year. We understand that our Access customers are likely to face similar timescales in order to make the appropriate system changes.
- 1.13 The VAT rules, unfortunately, do not provide for any flexibility – once the regulatory condition becomes effective, the relevant VAT status changes and we, and our customers, need our systems to reflect that. Hence our proposal for Ofcom to announce its decision as soon as possible and for the implementation to take effect from 29th March 2021.

Implications for the calculation of VAT and the issuing of credit notes to customers

- 1.14 The date that Ofcom implements its decision has implications for whether we charge VAT to our customers and what we need to pay to HMRC. Our systems cannot instantaneously change the VAT status of products. Hence, we will need to do significant work to issue credit notes if our systems have not been amended to reflect the implementation date of the new Access regulatory condition.
- 1.15 If the VAT status of the D+5 Access products changes mid-way through the quarter, but our systems are not in place to immediately switch from VATable at the standard rate to VAT exempt, some customers will have been charged and paid VAT on the products when they should not have been. Whilst we can issue credit notes to customers this will be resource intensive.
- 1.16 Further, those credit notes ideally need to be issued within the quarter in which the VAT is charged. If those VAT credit notes are not issued until the following quarter/financial year, we would in effect have overpaid VAT to HMRC. This would need to be reclaimed from HMRC outside of the normal VAT return process. This would involve submitting an Error Correction Notification which is administratively time consuming for us (and for HMRC to review and process) and has potential implications for our general tax governance position. We cannot start the process of reviewing affected accounts, preparing and issuing the credit notes until the correct VAT status has been updated on our systems. It is crucial that we have clarity on the effective date as soon as possible to avoid this situation arising.

Requirement for an additional USPA6 submission and significantly increased complexity of the remaining 2020-21 USPA6 submissions

- 1.17 It would require an additional USPA6 submission and this submission would be significantly

more complicated, with products coming into the test mid-way through a quarter. Our quarterly ex post submissions use cumulative data extracts from the costing system based on standardised reports. If we had to include the relevant Retail Economy products mid-way through a quarter, we would need to identify the relevant Retail Economy volumes on a weekly basis (not currently in the reports) to be able to add the volumes and revenues for the weeks those Economy products were covered by USPA6.

- 1.18 Our systems and models are not set up to extract and analyse the data on this basis. It would require a one-off process to be put in place. This process would first involve our data team extracting the data in the required format (i.e. on a weekly basis) which they currently do not do. This data extract would then need to be run through our costing system to provide the output used in our USPA6 model – again this is an additional one-off run. Re-running our reports on this bespoke basis for one quarter only is very resource intensive. It would be even more challenging as it would have to be run at year end.
- 1.19 Updating our USPA6 report for the short period of time for which these Retail Economy products would be covered by USPA6 (e.g. c.6 weeks if Ofcom were to publish its decision in mid-February) would have no impact on the test itself or the prices in the market. In anticipation of the specified Retail Economy products being brought into USPA6, as part of our January 2021 Tariff, we set the prices to ensure that they met the USPA6 test on both a contract basis (i.e. covering 50% of upstream FAC) and at the market level. We therefore believe it would be simpler and more transparent if the new Retail Economy products were included from the start of new 2021-22 financial year i.e. the condition becomes effective from 29th March 2021.
- 1.20 If Ofcom were to go ahead with its proposal to make the changes effective from the date of its decision, we would ask for clarification on its position with regard to the 2020-21 ex ante forecast. To remain compliant with USPA6, and unless Ofcom made a direction otherwise, we would be required to re-submit our 2020-21 ex ante forecast to include the D+5 Access products and associated Retail Economy services for the remainder of the 2020-21 financial year i.e. covering the period from the date of Ofcom's statement until 28th March 2021. This is a significant piece of work.
- 1.21 We do not believe the outputs of the test would be materially different as Access customers are unlikely to be extensively using the new D+5 service at this point (for the systems reasons we state above) during the period to the end of March and therefore volumes are likely to be relatively low over that period.
- 1.22 Hence, on administrative grounds we suggest Ofcom implement the new regulatory USPA condition from 29 March 2021. If Ofcom implements the new regulatory USPA condition from the date of its decision, we request that Ofcom either:
 - i. Issue a direction at the same time specifying that the USPA6 2020-21 tests (both FY forecast already submitted and future quarterly outturns) should exclude the introduction of the D+5 product; or
 - ii. Confirm that no enforcement action would be taken against Royal Mail if we were to submit our USPA6 2020-21 tests without reflecting the introduction of the D+5 product.
- 1.23 The uncertainty over the effective date is also affecting our customers in different ways. Our Wholesale customer base sit in three broad categories:
 - i. Carriers, who will have customers across all sectors, but with the potential for some slight sector bias within their respective customer groups (i.e. some carriers' customer base may have a greater prevalence of posting customers in particular sectors e.g. financial services);
 - ii. Intermediaries, who have a cross sector customer base, but as above there is the

potential for an individual intermediary's customer base to have more bias to certain sectors; and

- iii. Direct Customers, who are brands such as major banks.

- 1.24 Some are keen to press ahead and migrate customers from sectors not impacted by the VAT outcome (i.e. VAT registered companies that are fully taxable) to the D+5 product when it launches in January. However, others do not intend to develop the product until the new year or even until the VAT status is confirmed. Whichever approach they take, customers need time, like us, to be able to plan and implement changes to systems to move or create the product to VAT exempt status. Hence our proposal for a 29th March effective date., We will already be working with customers who are not impacted by the regulatory treatment to ensure they can move to the new product as soon as possible. We therefore propose that the new regulatory condition should take effect from our new financial year on 29th March 2021.
- 1.25 However, given the implementation issues flagged above we would stress the importance of having certainty as to the effective date of the condition as soon possible. This should make it more likely that we, and our Access customers, are able to make the required systems changes to meet a 29th March implementation date.
- 1.26 We note, if Ofcom's statement was not published until mid-March, we would face the same systems implementation issues (i.e. 4 to 6 weeks would be needed from that point to update our systems) discussed above. Hence, we ask that Ofcom publish its decision as soon as possible to provide certainty to the market, but implementation should be from 29th March 2021.

Question 4: Do you have any other comments on our proposals as set out above or our proposed amendments to our legal instrument (USPA condition)? Please provide your reasons.

- 1.27 We are pleased that Ofcom has conducted a targeted consultation. We note that Ofcom's upcoming regulatory review will be the appropriate forum for any wider discussion of the Access regime.
- 1.28 We have two further points regarding this consultation: (i) Quality of Service, (ii) Alignment of Definitions.
- 1.29 **Quality of Service** - In its consultation document, Ofcom states that its *"...proposals would promote effective upstream competition and the interests of consumers would also be furthered in respect of choice, price, quality of service and money, given that access operators would be able to offer retail services based on either D+2 or D+5 regulated access."*² One of the amendments to USPA 8.1 is to add a reference to D+5 Access. This includes a requirement to publish quality of service information for this service. We have no objections to this addition. We recognise the importance of providing transparency on the quality of service that customers are receiving on the products that we provide.
- 1.30 **Alignment of definitions** - The new USPA1.3(fa) contains a definition of "D+5 Access" which is more detailed than the definition of "D+2 Access". Our understanding is that Ofcom's reference to "later than D+5 Letters services" would cover a situation where Access customers could delay items themselves upstream, for example to offer a D+6 service to their customers, but once those items reach our network they must still be delivered no later than the fourth working day after handover at the IMC. We therefore consider that one or other of these definitions should be updated to ensure they align. Either:

² Para 5.90

- i. The definition of "D+2 Access" in USPA1.3(f) should be updated to say *"D+2 Access" means access to the universal service provider's postal network at the IMC for the purposes of providing D+2 and later than D+2 Letters and Large Letters services for delivery by the universal service provider on the next working day;* (we do not consider that this would amount to imposing an additional obligation on Royal Mail); or
 - ii. The new definition of "D+5 Access" in USPA1.3(fa) should be brought in line with the definition of "D+2 Access" i.e. *"D+5 Access" means access to the universal service provider's postal network at the IMC for the purposes of providing D+5 and later than D+5 Letters services for delivery by the universal service provider on a working day that is later than the next working day after the Letters were handed over by the D+5 Access Operator at the IMC, but which day is no later than the fourth working day after such a handover"*
-