Royal Mail plc

Royal Mail's Response to Ofcom's March 2017 Consultation, Review of Regulatory Financial Reporting for Royal Mail

Royal Mail Submission

June 2017

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 is the proud provider of the Universal Postal Service. We recognise that this role comes with important reporting obligations that support Ofcom in fulfilling its statutory duties. We welcome Ofcom removing some regulatory burdens, such as monthly reporting and reducing accounting separation requirements. But, more can and should be done. The proposed reporting framework is still too burdensome and prescriptive. It also does not introduce a positive, pro-active sustainability framework to help secure the Universal Service

Royal Mail is the proud provider of the Universal Service. We recognise that this role comes with important reporting obligations. Ofcom needs information to fulfil its statutory duty to secure the provision of the Universal Service. But, the proposed framework needs further reform.

i. **Royal Mail is the proud provider of the Universal Postal Service.** We recognise that this role comes with important reporting obligations. Royal Mail is subject to highly demanding reporting requirements. We currently prepare, provide and publish a large volume of regulatory financial information - over 170 financial and non-financial reports to our regulator every year. Many of these reports are produced solely for Ofcom.

ii. Ofcom has made some important steps forward in reducing the regulatory burden. This includes the move away from monthly reporting and the current accounting separation regime. But, more can and should be done. **The proposed framework is too burdensome and prescriptive.** It also does not go far enough to support the financial sustainability of the Universal Service.

iii. **Royal Mail continues to transform. An effective reporting framework should reflect this.** We are committed to working with Ofcom to develop a reporting framework that is effective, proportionate and targeted. This should provide Ofcom with the information it needs to secure the provision of the Universal Service whilst minimising the regulatory burden.

The benefits of any proposed changes should be assessed against the burden they are creating. As a minimum, the new framework should meet the following attributes: proportionality, transparency, relevance and reliability.

iv. While we support the regulatory aims that underpin the reporting framework[1] - "the what" - Ofcom should carefully consider the regulatory burden of its proposals – "the how". At the time of reviewing BT's reporting obligations in 2012, Ofcom identified four key attributes of an effective regulatory financial reporting framework:[2]

- **Relevance** - The information needs to answer the right questions, in the right way, at the right time.
- **Reliability** - The underlying data must be reliable, suitable rules for treatment of those data must be chosen and those rules need to be followed.
- **Transparency** - The basis of preparation should be understood by users of the reports.
- **Proportionality** - The reporting requirements should be proportionate to the benefits.

v. We believe that these attributes are as appropriate today as they were in 2012. This will enable Ofcom to minimise the regulatory burden on Royal Mail while still receiving the information necessary to fulfil its statutory duties. **We have therefore assessed the proposed changes in this Consultation[3] against each of them.**

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1 Ofcom sets out its regulatory objectives on page 14 of the Consultation: (a) monitoring the financial sustainability of the universal service provision; (b) monitoring the efficiency of universal service provision; (c) monitoring competition in the postal market; and (d) protecting the interests of consumers.

2 Ofcom, Regulatory financial reporting: a review, Sep 2012, page 8. - https://www.ofcom.org.uk/__data/assets/pdf_file/0023/53546/condoc.pdf Ofcom noted in paragraph 3.41 that it considered these attributes were consistent with the relevant EC recommendation.

3 Ofcom, Review of Regulatory Financial Reporting for Royal Mail, March 2017. This is referred hereafter as "the Consultation".

Where they fail to meet these attributes, we make alternative proposals which will support Ofcom in achieving its aims.

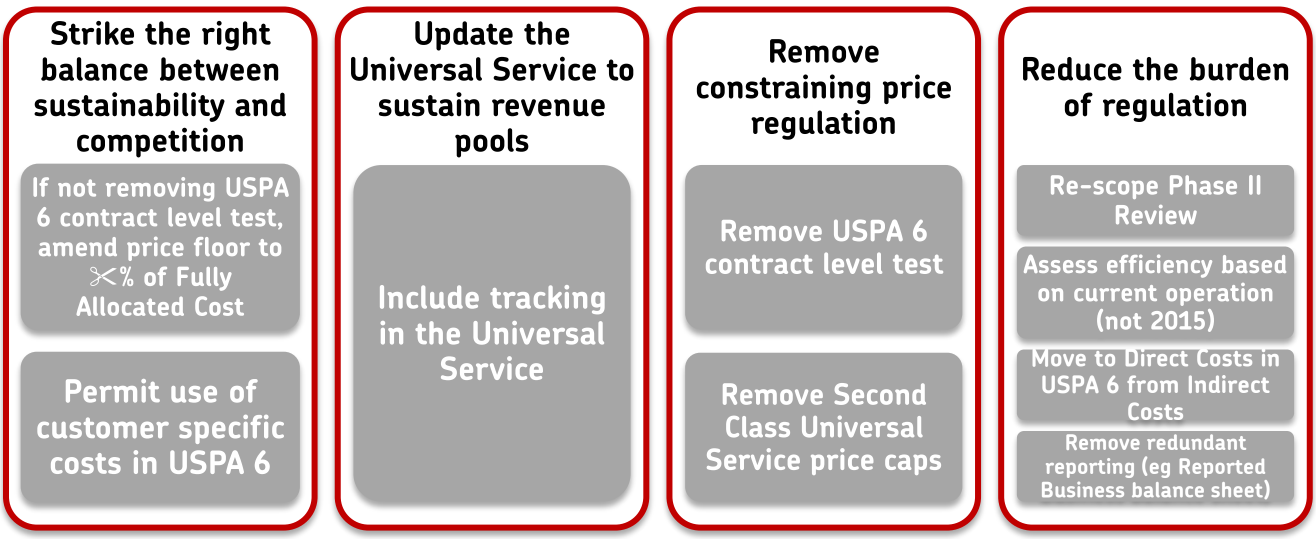
We continue to believe there is a pressing need for a positive, pro-active sustainability framework to help secure the Universal Service.

vi. Ofcom's primary duty is to carry out its functions in a way that it considers will secure the provision of the Universal Postal Service. **As we set out in our 2016-17 annual results, the outlook for the business is very challenging.**[4] **We face downside risks.** E-substitution continues to drive a structural decline in UK addressed letter volumes. We have maintained our outlook for volume declines of between four to six per cent per annum (excluding the impact of political parties' election mailings). We expect it to be at higher end of range of decline in 2017-18 if business uncertainty persists.[5]

vii. **We are also seeing the impact of overall business uncertainty before and after the EU referendum on marketing and business letters.** The UK general election result will only increase business uncertainty. There is significant competition from companies with established delivery capabilities and from new entrants. Growth available in the UK parcels market continues to be impacted by high levels of competition, including from Amazon. For three years in a row, the growth in parcel revenue has not offset the decline faced in letters. Royal Mail also remains at risk of industrial action as we continue to pursue the necessary efficiency programmes to remain competitive in the letters and parcels markets, and negotiate new pay and pension arrangements.

viii. **While we support the wider set of financial health metrics that Ofcom is now planning on regularly reviewing, Ofcom does not at present have the tools to take rapid action if the need arises.** As we have explained elsewhere, compensation funds do not work.[6] The proposed new reporting regime does not address this concern. There is now a pressing need for a pro-active sustainability framework to help secure the Universal Service and sustain the revenue pools that underpin it **(see Chapter 1 responding to Question 8).** While we are still developing our internal thinking on the framework, we consider there to be four key pillars. Where possible, we have outlined some of our reporting proposals relevant to each pillar:

Figure E.1 - Pillars of the proposed sustainability framework including areas for Ofcom to consider as part of its reporting review



4 Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 12.
5 Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 4.
6 Royal Mail, Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail, August 2016, para 9.18.

The assumptions underpinning the USPA 6 margin squeeze test no longer reflect reality. In the interests of consumers, it needs urgent reform to allow Royal Mail to compete fairly.

ix. **We are disappointed that Ofcom has not taken the opportunity to fundamentally review the mechanics of the USPA 6 margin squeeze test.**[7] While regulating the pricing of individual contracts may have made sense when the Access market was in its nascent stages, it is now disproportionate and does not reflect market dynamics. Upstream competition is mature. Royal Mail has a relatively low (and falling) market share in the retail market for bulk mail. Our share of mail sent by large businesses has declined over time. There are now a number of well-established competitors with large market shares. Our share now stands at only ✂%.

x. **Moreover, the decline in Second Class ("2c") pre-sort (USPA 6) volume is substantially higher than other bulk categories such as network access volumes.** We believe this is driven by the pricing constraint imposed on us by USPA 6 rather than changing market preferences. To protect consumers while minimising the regulatory burden in line with its regulatory principles,[8] Ofcom should remove the contract level test.[9] The market level test[10] is sufficient to facilitate competition.

xi. If Ofcom maintains the contract level test, the appropriate cost standard is the Long Run Average Incremental Cost (LRAIC). We again request Ofcom to engage with us on our LRAIC model. We recognise this will take time. As an interim step, our latest data and information on the variability of our cost base suggests that the current standard - **50% of FAC – is inconsistent with operational reality and therefore unreliable. ✂% of FAC is more appropriate.** We ask Ofcom to adopt this urgently so we can compete fairly **(see Chapter 2 and related Annex 1 which respond to Question 7)**.

The case for change to the reporting framework is clear. But, Ofcom can go further to reduce the regulatory burden whilst fulfilling its statutory duties.

xii. **Business planning, cost and efficiency reporting** - Ofcom and Royal Mail have a common goal on efficiency. We consider however that the proposals go beyond what is proportionate. Some of the additional detail appears to fall more into the category of data that is "useful and interesting" rather than data that is necessary for Ofcom to fulfil its statutory duties **(see Chapter 3 responding to Questions 2 and 3)**:

- We have changed the way we do business planning for the outer years of our forecast, moving away from the granular, bottom-up detail proposed by Ofcom to a top-down, value driver approach. This is best practice across FTSE100 companies. **It would be a retrograde step to re-introduce granular forecasting.** Extrapolating out value drivers into Ofcom's formats would be, at best, meaningless, but at worst, highly unreliable.
- We report productivity annually to our investors using the most up-to-date assumptions. Ofcom proposes to require us to provide our efficiency based on our 2015 assumptions to support consistency. **We are concerned that Ofcom's proposals may lead to confusion as there will be multiple workload measures.** Ofcom's efficiency analysis will rely on different assumptions to our productivity metrics. Moreover, we will have the cost of maintaining two sets of workload measures, which we consider to be disproportionate.
- Ofcom has stated that it intends to review Royal Mail's efficiency against the targets that underpin the 2015 Business Plan. **The market conditions and challenges we face are now different to 2015.** The reliability and relevance of this comparison will fade over time.

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[7] Section 6 of the Universal Service Provider Access (USPA) Condition sets out the requirements to maintain a minimum margin between retail prices and access charges for certain retail services.

[8] Relevant principles are: ensure interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome; and always seek the least intrusive regulatory mechanisms to achieve policy objectives. See here for more details: https://www.ofcom.org.uk/about-ofcom/what-is-ofcom

[9] Regulatory test on individual contracts on products within the scope of the USPA 6 margin squeeze test.

[10] Regulatory test on all products within the scope of the USPA 6 margin squeeze test.

xiii. **Accounting separation** – We agree with Ofcom's proposals to remove redundant and unnecessary reporting. However, Ofcom has not addressed our concern that the Universal Service network cost should be attributed to the Universal Service products in the first instance. Ofcom's proposals should go further, such as removing the obligation to provide the Reported Business balance sheet and cash flow. It is a notional analysis that is not helpful for Ofcom's monitoring **(see Chapter 4 responding to Questions 1 and 6)**.

xiv. **Cost Data and Change Control** - Ofcom is proposing to require a greater level of granular detail on a quarterly basis. Greater detail does not necessarily generate greater accuracy. It may actually work against providing a truly relevant and reliable picture that can inform decision making **(see Chapter 5 responding to Question 4)**.

xv. **Reporting Deadlines** - Ofcom is proposing to accelerate reporting deadlines ahead of statutory reporting timelines. We do not think these timescales are realistic or achievable. Until our statutory results are approved, our regulatory financial information remains draft and unapproved. We do not consider the provision of draft unapproved information to be reliable or proportionate. We have therefore proposed alternative dates which would provide Ofcom with approved information in timely manner **(see Chapter 6 responding to Question 5)**.

Chapter 1 – Regulatory financial reporting framework

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

Royal Mail is the proud provider of the Universal Service. We recognise that this role comes with important reporting obligations. Ofcom needs information to fulfil its statutory duty to secure the provision of the Universal Service. We currently prepare, provide and publish a large volume of regulatory financial information and therefore support the case for change to reduce the regulatory burden. We are a dynamic business continuing to transform. An effective reporting framework must support flexibility. But, the proposed framework is still overly burdensome and prescriptive. Importantly, it also fails to introduce a positive, pro-active sustainability framework.

- **As we set out in our 2016-17 annual results, the outlook for the business is very challenging.[11] The profitability of the Reported Business is subject to downside risk.** E-substitution continues to drive a structural decline in UK addressed letter volumes. Business uncertainty before and after the EU referendum has resulted in a slowdown in marketing activity. We face significant competition from companies with established delivery capabilities and from new entrants. Growth available in the UK parcels market continues to be impacted by Amazon's activities. The growth in parcel revenue has not offset the decline faced in letters over the last three years. Royal Mail also remains at risk of industrial action as we continue to pursue the necessary efficiency programmes to remain competitive in the letters and parcels markets, and negotiate new pay and pension arrangements.
- **The current regime – parcel competition, e-substitution and shareholder discipline – creates all the necessary incentives to drive efficiency.** Encouraging even greater competition simply drives volumes down with the risk of a tipping point. This volume loss would significantly impact Royal Mail due to our high, fixed cost structure. A loss of demand would have a greater impact on revenues than on costs. It takes time to remove costs - it requires major structural change. Royal Mail would have very few options available to maintain revenue pools that support the Universal Service.
- While we support the wider set of financial health metrics that Ofcom is now planning on regularly reviewing, Ofcom does not at present have the tools to take rapid action if the need arises. The proposed framework does not address this concern. **There is a pressing need for a pro-active sustainability framework to help secure the Universal Service.** The four key pillars are:
  - » **Strike the right balance between sustainability and competition**
  - » **Update the Universal Service to sustain revenue pools**
  - » **Remove constraining price regulation**
  - » **Reduce the burden of regulation**

Royal Mail is the proud provider of the Universal Postal Service. We recognise that this role comes with important reporting obligations. We support the case for change to reduce the regulatory burden with an April 2018 implementation timescale.

1.1 **Royal Mail is the proud provider of the Universal Postal Service.** We recognise that this role comes with important reporting obligations. We currently prepare, provide and publish a large volume of regulatory financial information - over 170 financial and non-financial reports to Ofcom every year. Ofcom has made some important steps forward in reducing the regulatory burden. This includes moving away from monthly reporting and reforming the accounting separation requirements.

11 Royal Mail, Annual Report and Financial Statements, May 2017, page 12.

1.2 **But, more can and should be done. The proposed framework is too burdensome, prescriptive and does not go far enough to support the financial sustainability of the Universal Service.** The regulatory burden can – and should – be reduced further whilst at the same time providing Ofcom with the information it requires to fulfil its statutory duties. Royal Mail continues to transform. An effective reporting framework should reflect this. We are committed to working with Ofcom to develop a reporting framework that is effective, proportionate and targeted.

1.3 **Ofcom proposes to implement the new regulatory financial reporting framework for 2018-19. We support this timescale.** We would welcome early engagement with Ofcom given the changes required to our systems and processes. These amendments will need to be designed, implemented, tested and signed off. We would like to do so during Q3 2017-18 in order to allow us to develop and parallel run the reports in Q4 2017-18 to ensure we can meet our regulatory reporting requirements.

1.4 **In terms of Phase II of the review, we are disappointed that Ofcom is planning to undertake a review of cost allocation between parcels and letters.** We closely follow the extensive framework and detailed methodology that the regulator put in place some years ago. The review will create unnecessary uncertainty for a prolonged period of time. Ofcom set out potential concerns about cross-subsidisation.[12] A review of our Fully Allocated Costing (FAC) system will not address this issue. Rather, Ofcom should actively engage with us on our Long Run Average Incremental Cost (LRAIC) model.

We welcome Ofcom's recognition of our *"progress on efficiency in recent years"*[13] and *"notable modernisation improvements"*[14]. We have strong market-based incentives to keep this up. But, we also now need a pro-active sustainability framework to continue to meet the public policy goal of a market-funded Universal Service.

1.5 Under PSA 2011, Ofcom's primary duty is to carry out its functions in a way that it considers will **secure the provision of the Universal Postal Service**. In performing that duty, Ofcom must have regard to the need for the provision of the universal postal service to be financially sustainable and efficient. This includes the need for the Universal Service Provider to make a reasonable commercial rate of return. Ofcom estimated this as between 5 – 10% financeability EBIT margin for the Reported Business.[15]

1.6 **Efficiency is a given at Royal Mail following privatisation**. Competition is highly developed, intense, and growing. We have transformed every aspect of our operations, delivering significant efficiency improvements. We outperformed the UK economy's total factor productivity improvements in each year between 2011-12 and 2015-16. Shareholder scrutiny, intense pressure from parcel delivery competitors and rapid e-substitution in letters are major spurs to efficiency. **There is therefore no need for the regulatory framework to create incentives for further efficiency – the market is doing its job.** It is with regard to sustainability where action is needed. Alongside high levels of competition, a pro-active sustainability framework provides the best public policy approach to securing the provision of the Universal Service without recourse to public subsidy.

1.7 A vital part of any pro-active sustainability framework is the ability to identify risks as early as possible. Ofcom has been explicit that the assessment of the financial sustainability of the Universal Service is a central objective of its regulatory reporting regime. With this in mind, we are pleased that Ofcom is committed to **enhancing its monitoring framework through the use of a range of financial health**

12 Ofcom, Press Release – 25 May 2016 http://media.ofcom.org.uk/news/2016/royal-mail-review/
13 Ofcom, Review of the Regulation of Royal Mail, 25 May 2016, para 4.71.
14 Ofcom, Universal postal service returns to financial health, 25 May 2016.
15 Ofcom, Review of the Regulation of Royal Mail, March 2017, page 24, para 3.60.

metrics and indicators assessed at the Relevant Group level. This is in line with how rating agencies assess Royal Mail. But, it should be understood that these - and the 5-10% target EBIT margin - are metrics to identify issues, not the means to solve them.

We operate in a very challenging environment. The profitability of the Reported Business is subject to downside risk.

1.8 The financial performance of the Reported Business (the entity Ofcom has defined as providing the Universal Service), has improved significantly since 2012 due to management action. **But, profitability of the Reported Business is subject to downside risk.** E-substitution continues to drive a structural decline in UK addressed letter volumes. We have maintained our outlook for volume declines of between four to six per cent per annum (excluding the impact of political parties' election mailings). We expect it to be at higher end of range of decline in 2017-18 if business uncertainty persists.[16]

1.9 **We are also seeing the impact of overall business uncertainty before and after the EU referendum on marketing and business letters.** In 2016-17, our marketing mail revenue decreased by eight per cent,[17] the same trend as at the half year. Other forms of advertising, particularly print media, have seen steeper declines. In 2016, there was an overall decline of 10 per cent in direct mail.[18] Economic growth in the Eurozone also remains fragile. Low growth or recession in Europe could impact our international parcel volumes.

1.10 **The rapid pace of change in the UK parcels sector is expected to continue. This is due to low barriers to entry, greater disintermediation and disruptive business models.** The structure and behaviour of the parcels sector, for example, continues to be influenced by the rapid expansion of Amazon. At the same time, parcel carriers continue to invest in new capacity, which exerts downward pressure on prices. Traditional retailers are also improving their in-house collection and delivery services. For example, Sainsbury's recently completed its £1.4 billion acquisition of Argos. We expect that competition will continue to intensify, driven by retailers' investment in delivery options, logistics and technology to support the growth of their online sales.

1.11 Royal Mail also remains at risk of industrial action as we continue to pursue the necessary efficiency programmes - to remain competitive in the letters and parcels markets - and negotiate new pay and pension arrangements. **Widespread localised or national industrial action would cause material disruption to our business in the UK. It would be likely to result in an immediate and potentially ongoing significant loss of revenue for the Group.** It may also cause Royal Mail to fail to meet the Quality of Service targets prescribed by Ofcom, leading to enforcement action and fines. Moreover, the industrial relations environment may impact our efficiency measures. For example, there is a risk we cannot make the required short term business as usual and/or programme-level cost reductions in a timely way.

1.12 In its March 2017 Review of the Regulation of Royal Mail (FRR) decision document, Ofcom acknowledged the risks: *"Our assessment indicates that the universal service is likely to remain financially sustainable in the immediate future. However, we recognise that downside risks remain in the forecasts that inform our assessment. These downside risks include economic and market downturn (which could cause higher decline or lower growth in volumes than expected), cost challenges such as those relating to Royal Mail's defined*

[16] Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 4.
[17] Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 9.
[18] Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 9.

benefit pension scheme and the new pay deal under negotiation, and the competitive pressures on Royal Mail's parcel volumes and revenues."[19]

The financeability EBIT margin is declining. If the financial sustainability of the Universal Service were to come under threat, there is little which Ofcom could do to return the business to profitability.

1.13 Our confidential quarterly regulatory financial statements for 2016-17 (provided on 25 May 2017) and our budget for 2017-18[20] (provided on 24 Mar 2017) highlighted important trends. Due to increasing competition in parcels, continued e-substitution, and very significant investment in reducing costs, the financeability EBIT margin for the Reported Business is declining. It has fallen from 5.6% in 2014-15 to 5.0% in 2015-16, ✂.[21]

1.14 **The EBIT margin trend underlines the risk to Universal Service finances.** There is heightened uncertainty about the economy, including the impact of Britain's exit from the European Union and the recent UK general election result. This economic uncertainty is having a direct impact on revenue pools which sustain the Universal Service, in particular, advertising and business letters.

1.15 Royal Mail must be able to earn a commercial rate of return on our activities. We can then maintain an investment grade rating, have the ability to raise funds at reasonable rates, invest to boost profitability, improve customer service and drive shareholder value. Ultimately, this provides the foundation to provide the Universal Service to all at affordable prices. **A supportive regulatory environment with the central pillar of a pro-active sustainability framework is now vital.** It provides the strongest foundation to ensure the provision of the Universal Service for as long as possible without recourse to public subsidy. This is firmly in the interests of UK consumers and the wider economy,

Risks to financial sustainability occur earlier than risks to viability. Supporting the sustainability of the Universal Service will help to ensure that viability does not become an issue.

1.16 **It is possible to be viable but face significant sustainability concerns.** Risks to financial sustainability occur much earlier and therefore have a longer time horizon before they are realised. A vital early indicator is a reduction in profitability. In the case of Royal Mail, this relates to our ability to secure a commercial rate of return.[22] Ofcom re-confirmed in the March 2017 Statement[23] that the Financeability EBIT margin of the Reported Business continued to be the appropriate metric to use to assess financial sustainability over the medium to long term. It noted that 5-10% continued to be a reasonable range for the commercial rate of return. A supportive regulatory framework will enable us to avoid much more pressing viability issues from occurring.

1.17 **In setting out its approach to assessing financial sustainability, Ofcom recognises the importance of looking at short, medium and long run indicators**. For example, Ofcom notes that: *"We would consider the medium to long term financial performance of the Reported Business. We will consider the recent actual EBIT margins achieved, as well as the forecast EBIT margins over an appropriate period... We would apply*

[19] Ofcom, Review of the Regulation of Royal Mail, March 2017, page 25 - https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

[20] Royal Mail, Budget 2017 presentation pack, 24 March 2017.

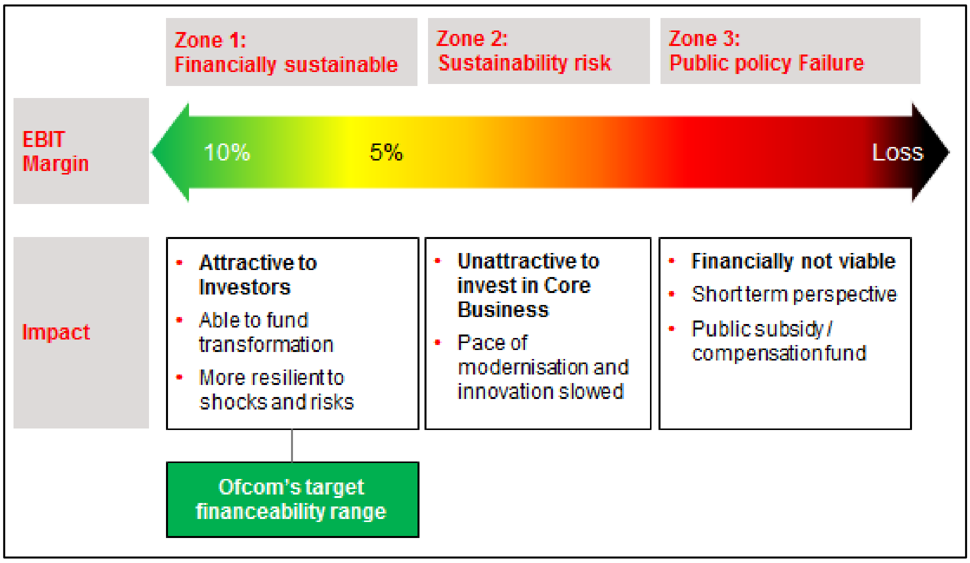
[21] ✂.

[22] For more discussion of the hypothetical circumstances in which there may be an immediate threat to the financial sustainability of Royal Mail, please see Ofcom's Nov 2015 report prepared by CEPA entitled Relevance of margin-based approach: https://www.ofcom.org.uk/__data/assets/pdf_file/0027/79830/relevance-of-margin-based-approach.pdf

[23] Ofcom, Review of the Regulation of Royal Mail, March 2017, paras 3.44 to 3.63 - https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

the financial health metrics, such as FFO / Net Debt, to the recent actual results and forecast results of the Relevant Group over an appropriate period in order to assess the Relevant Group's short to medium-term financial sustainability."[24] Importantly, Ofcom set out some generalised conclusions it might draw (noting that it will depend on the particular circumstances and facts prevailing at that time): ***"…if the forecast EBIT margin stays consistently below 5% or has a decreasing trend taking it below 5% – then there may be indications that the universal postal service faces financial sustainability issues in the long term."***[25]

Figure 1.1 – EBIT margin and sustainability



1.18 **In our view, although still profitable, without a commercial rate of return, the core business will find it much harder to attract investment, transform and therefore compete.** Management will allocate investment funds to boost profitability, improve customer service and drive shareholder value. If returns were insufficient in the core business, we may reallocate capital expenditure to more profitable UK and international opportunities. As a result, the pace of modernisation and innovation in the core business would in turn be constrained by the available investment capital.

1.19 **The type and scale of the regulatory action needs to reflect the seriousness of the sustainability issue.** ✂. As we have explained elsewhere, compensation funds do not work.[26] To avoid the latter, it is in the interests of the regulator (and consistent with its duties) to develop and deploy a pro-active sustainability framework as early as possible.

Market forces are doing their job. We need a positive, pro-active sustainability framework to help sustain the Universal Service.

1.20 Against the backdrop of intense competition and significant risks to Universal Service finances, it is important that Ofcom does not take actions that undermine the sustainability of the Universal Service. As we have raised on a number of occasions, including in our August 2016 response to the FRR, **Ofcom's dual role in competition enforcement and postal regulation creates the risk that any conflict will not be resolved in favour of sustainability.**[27] The 2008-10 Hooper Reports noted the contradiction between the

[24] Ofcom, Review of the Regulation of Royal Mail, May 2016, Annex 6, page 59 – https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf

[25] Ofcom, Review of the Regulation of Royal Mail, May 2016, Annex 6, page 60 – https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf

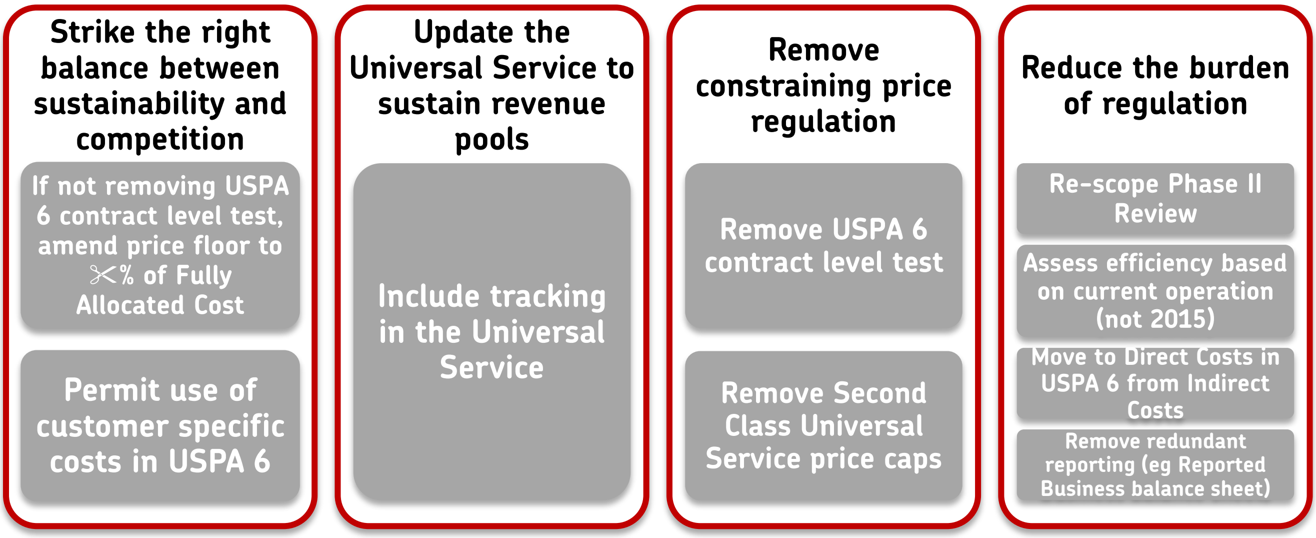
[26] Royal Mail, Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail, August 2016, para 9.18.

[27] Royal Mail, Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail, August 2016, para 9.11.

sustainability of the Universal Service and competition. Hooper stated; "*there are some risks*" associated with competition, and "*some forms of competition may be inefficient if they simply exploit the constraint placed on Royal Mail to provide the universal service*".[28]

1.21 There is no need for the regulatory framework to incentivise further efficiency or competition. The market is doing its job. It is with regard to sustainability where action is needed. Central to this is the urgent need to develop a positive, pro-active sustainability framework to help secure the Universal Service. We would welcome Ofcom's engagement on this. While we are continuing to develop our internal thinking, we consider the framework involves the following four key pillars:

Figure 1.2 - Pillars of the proposed sustainability framework and areas for Ofcom to consider as part of its reporting review



1. **Strike the right balance between sustainability and competition** – The current regime creates all the necessary incentives to drive efficiency. Encouraging even greater competition simply drives volumes down with the risk of a tipping point. This volume loss would significantly impact Royal Mail due to its high, fixed cost structure. A loss of demand would have a greater impact on revenues than on costs. It takes time to remove costs - it requires major structural change. Royal Mail would have very few options available to maintain Universal Service revenue pools. As set out in Chapter 2, in markets with falling volume, total unit costs will increase, and the proportion of fixed to variable unit cost will increase. Using a static proportion of FAC (i.e. 50% FAC) as a proxy for LRAIC is therefore flawed. We therefore request that Ofcom urgently moves to ✂% of FAC as a more appropriate standard if it is not minded to remove the contract level test altogether.

2. **Update the Universal Service to sustain revenue pools** – The regulator should adopt a proactive, supportive stance toward Royal Mail as the Universal Service Provider. There are at least two sides to this. First, any interventions should be premised on the need to ensure that Royal Mail is not obstructed from accessing revenue pools available in the market to support the Universal Service. Second, Ofcom should proactively work with Royal Mail to ensure that the Universal Service is updated on a regular basis. If the regulator does not update it, over time, Royal Mail will be unable to access new or existing revenue pools essential to fund it. The UK economy and UK consumers need a contemporary Universal Service that is forward looking and relevant. However, Ofcom has, to date, adopted a backstop mindset. For example, the decision not to include tracked parcels in Universal Service exemplifies this. Rather than taking a decision to support sustainability, it prioritised the promotion of competition on the basis that we would get an

[28] Hooper Report, Modernise or Decline, 16 December 2008.

advantage because Universal Service products are VAT exempt. This rationale is a major concern. Universal Service products are VAT-exempt because they are in the public interest. All European posts have the same exemption for Universal Service products. Any 'advantage' that is gained from the VAT position on Universal Service products is outweighed by the large network and high fixed costs of being the Universal Service Provider.

3. **Remove constraining price regulation** - We have a track record of fair, reasonable and prudent pricing in letters and parcels. Market forces are doing their job. In May 2016, Ofcom found that the postal services sector saw an increase in customers' perception of value for money from 2005 to 2015. This was at a time when ratings declined in many other sectors.[29] While we welcome Ofcom's decision not to re-introduce further price controls during the FRR, we are disappointed that the existing safeguard Second Class (2C) price caps were not removed. We are also disappointed that Ofcom has not taken the opportunity to fundamentally review the design of the USPA 6 margin squeeze test. While regulating the pricing of individual contracts may have made sense when the Access market was in its nascent stages, it is now disproportionate and overly prescriptive. Ofcom should remove the contract level test. The level test is sufficient to facilitate competition. If the contract level test is retained, the appropriate cost standard, as recognised by Ofcom, is LRAIC. As an interim step, our latest data and information on the variability of our cost base suggests that the current standard - 50% of FAC – is inconsistent with operational reality and therefore unreliable. ✂% of FAC is more appropriate. We discuss this and other USPA 6 issues further in responding to Question 7 in Chapter 2.

4. **Reduce the burden of regulation** - We are committed to working with Ofcom to develop a proportionate reporting framework that is targeted and fit-for-purpose. The framework should provide Ofcom with the information it needs to fulfil its duty to secure the provision of the Universal Service and minimise the regulatory burden. We support the reforms which aim to simplify certain requirements. This includes removing monthly reporting. But, Ofcom's proposals increase the burden of regulatory reporting in other areas. For example, we report our productivity bi-annually to our investors using the most up-to-date assumptions. Ofcom proposes to require us to provide our efficiency based on our 2015 assumptions. Far from creating a transparent, relevant and reliable reporting framework, Ofcom's proposals may lead to confusion. Ofcom's efficiency analysis will rely on different assumptions to our productivity metrics. Moreover, we will have the cost of maintaining two sets of workload measures, which we consider to be disproportionate. We also propose that Ofcom changes the scope of its stated second phase (Phase II) of its review of our regulatory reporting. It should focus on reviewing our LRAIC model so that we can price more competitively, rather than a detailed cost allocation review between letters and parcels and a review of transfer pricing.

[29] Ofcom, Consultation on Review of the Regulation of Royal Mail, 25 May 2016, para 4.12.

Proposed amendments.

1.22 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
Pro-active sustainability framework	N/A	While we support the wider set of financial health metrics that Ofcom is now planning on regularly reviewing, it does not at present have the tools to take rapid action if the need arises. Ofcom's proposed framework does not address this concern. There is a pressing need for a pro-active sustainability framework to help secure the Universal Service.
Proposed timeline	New requirements should be formally implemented at the beginning of the 2018-19 Financial Year to give Royal Mail sufficient time to prepare to meet them.	We support this timescale.
Phase II of the Regulatory Reporting Review	Scope of Review will cover zonal cost modelling, cost allocation between parcels and letters and the transfer pricing applied to derive the upstream/downstream revenue split.	We do not support the scope of this review and instead encourage Ofcom to actively engage with us on our LRAIC model.

Chapter 2 – Margin squeeze

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

Royal Mail has a relatively low (and falling) market share in the retail market for bulk letters. Its share of letters sent by large businesses has declined over time, and now stands at only ✂%.[30] **The dynamics of the access market is now well defined. But, regulation hasn't kept pace with the maturity of the market. The USPA 6 pricing constraint is, in part, driving the decline in volumes. There is now an urgent need to review the mechanics of the margin squeeze control (USPA 6), particularly the contract level test. It is disproportionate - it does not allow Royal Mail to compete fairly in its current form. It is therefore undermining the revenue pools Royal Mail needs to sustain the Universal Service. We believe it should be removed or at the very least set at a level that reflects economic fundamentals.**

- Our competitors have the freedom to price individual contracts according to the demand characteristics of their customers. In a highly competitive market, they have the flexibility to price at incremental cost or even below. **We are subject to a disproportionate contract level test. It has not kept pace with the maturity of the market or economic fundamentals.** This prevents us from competing fairly. This is neither in the interests of consumers nor efficient competition. Our lack of price competitiveness is leading to ever greater volume decline. Our share of this market is now so low that, for any large deal, the basket, not the contract test, is binding. **The contract level test should now be removed. The basket level test is sufficient for Ofcom's purposes.**
- If Ofcom decides to retain the level test, the appropriate cost standard is the long run average incremental cost (LRAIC). In 2012, Ofcom acknowledged LRAIC gives the correct signals for market entry. Its intention was to move to using LRAIC in the margin squeeze test in the future. We therefore again request Ofcom to engage with us on our LRAIC model. We recognise this will take time. **As a pragmatic interim step, ✂% of FAC is appropriate.** The current standard - 50% of FAC – is inconsistent with operational reality and therefore unreliable. Using a static percentage of FAC is not reflective of incremental cost in an industry which is experiencing significant volume decline. **We therefore request that Ofcom urgently moves to ✂% of FAC as a more appropriate standard.**

We also make a number of detailed technical and clarification points on the methodology and proposed amendments in Annex 1. They include:

- Ofcom has decided it has not seen sufficient evidence to move from the USPA 6 methodology to using costs taken directly from our costing system. **The costing system numbers best reflect operational reality and should be used. They also have significant advantages in terms of transparency and reliability.** They are calculated in line with Ofcom's Regulatory Accounting Guidelines and are independently audited.

We also seek guidance on our flexibility to price contracts on the basis of 'customer specific' costs. With the current regulatory ambiguity in the condition, Royal Mail has taken a conservative approach. This highlights the **chilling effect that regulation has had on the business.** We propose to submit details of any customer specific cost to Ofcom but not create separate cost codes each time.

Ofcom should undertake a fundamental review of the technical workings of the margin squeeze (USPA 6) condition.

2.1 Ofcom introduced the current margin squeeze test as part of its decision on the revised regulatory framework introduced in March 2012. It acknowledged that the previous headroom control had prevented Royal Mail from competing for large bulk contracts. Moving to an ex post competition law approach was its ultimate aim. However, it believed that in the absence of regulatory safeguards, there was still a risk of price

[30] Royal Mail internal analysis.

squeeze in the relevant markets. Alongside the basket level test, Ofcom decided it was necessary to establish a price point control for individual contracts. It believed this was important "……*since relying on the margin squeeze basket alone would enable Royal Mail to price at levels for individual contracts below LRIC whilst maintaining the minimum average price (and thereby meeting its margin squeeze basket obligation). Although Ofcom could investigate this behaviour under ex post competition law powers, for the reasons set out earlier we are concerned that this leaves a risk of targeted pricing which could result in the permanent exit of competitors from the market.*"[31]

Royal Mail is subject to a disproportionate contract level USPA 6 test. This has not kept pace with the maturity of the market or economic fundamentals. It should now be removed. The basket level test is sufficient for Ofcom's purposes.

2.2 A key reason for imposing the individual price point control at the contract level was to mitigate the risk of Royal Mail using targeted price cuts to deter/prevent entry and expansion by upstream competitors. It is important that all competitors are able to fairly compete within a relevant market for effective competition to continue.[32] In reality, 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 ✂%.[33] **The dynamics of the access market are now well defined. There are now a number of well-established competitors with larger market shares.** This highlights that competitors have not been prevented from entering or expanding.

2.3 **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. This is neither in the interests of consumers nor efficient competition.

2.4 Our lack of price flexibility is leading to ever greater volume decline. **Our share of this market is now so low that, for any large deal, the basket, not the contract test, is binding.** As long as this trend continues, and the basket or "market" level test is passed, the case for the individual price point control is weak. For any large volume deal, the market level assessment has effectively become a contract level test. ✂. **The contract level test should now be removed. Instead, the basket level test is sufficient for Ofcom's purposes.**

The contract test is becoming increasingly divorced from economic reality as volumes decline and Royal Mail transforms.

2.5 The current proxy for LRAIC, as defined by Ofcom, is 50% of FAC. In justifying this, Ofcom noted that *"..[it had] considered a range of evidence regarding what might be an appropriate proxy for contract LRIC. Furthermore, our analysis indicates that 50% of FAC falls within the middle of the range of these estimates.*"[34] **This test is, however, acting as a competitive distortion and 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.

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[31] The building blocks for a sustainable postal service Initial proposals for regulatory safeguards, April 2011. Annex 7 – Access. page 42 para 7.48.

[32] The relevant "market" in the case of USPA 6 being the services included in the test.

[33] Royal Mail internal analysis.

[34] Securing the Universal Postal Service: Decision on the new regulatory framework. March 2012. para 10.135.

2.6 FAC includes both fixed and variable costs. If volume decreases, given our high fixed cost network, fixed unit cost, by definition, must increase. If total variable costs move in proportion with volume, variable unit cost will remain the same. Therefore in markets with falling volume, total unit costs will increase, and the proportion of fixed to variable unit cost will increase. Using a static proportion of FAC (i.e. 50% FAC) as a proxy for LRAIC is therefore flawed. LRAIC considers a long run future where costs can be removed in response to volume decline. **Even if the FAC proxy and actual LRAICs were broadly aligned in 2012 (which we would dispute), they are likely to have diverged over time as volumes have fallen.**

2.7 We demonstrate this divergence in Figures 2.1 and Figure 2.2 below using the example of a hypothetical 30% volume decline:[35]

- Figure 2.1 shows that in 2017-18, Royal Mail's FACs were split approximately ✂% fixed and ✂% variable.[36] We assume the fixed costs do not change with volume and the variable costs reduce in proportion to volume. As such, if we assume the 30% volume decline, the proportion of fixed and variable costs changes to ✂% and ✂% respectively.
- Figures 2.2 and Figure 2.3 consider costs on a per unit basis. For the base year (2017-18), total unit cost (fixed + variable) is ✂ and 50% FAC would give a unit cost of ✂. Assuming the 30% volume decline considered in Figure 2.1 above, this would increase the unit cost to ✂. This is because variable unit costs have remained constant at ✂ given variable total costs have declined in line with the volume decline. Fixed unit costs have, however, increased to ✂. The total fixed cost in Figure 2.1 - which remained unchanged - is being spread across a lower volume.
- Volume decline would lead to a 50% FAC of ✂- an increase of ✂ or ✂%. Over the same period, the variable cost – a proxy for LRAIC - has remained constant at ✂. In other words, even though variable cost hasn't changed over time, the 50% FAC value has increased by ✂. This divergence is shown in Figure 2.3. Using a static percentage of FAC is not reflective of incremental cost in an industry which is experiencing significant volume decline.

35 ✂.
36 ✂.

Figure 2.1 – Total FAC split by Fixed and Variable costs

✂

Figure 2.2 – Impact of volume decline on contract level test based on 50% FAC

✂

Figure 2.3 – Growing mis-alignment of 50% FAC to Incremental Cost over time with volume decline

✂

The mis-alignment created by Ofcom's "proxy LRAIC" stops us competing fairly with Access operators. It is not in the interest of consumers. We believe this is driving our declining volume and share of 2c pre-sort letters. This in turn raises our unit FACs creating a vicious circle.

2.8 ✂.[37]

Figure 2.4 – Annual volume growth by product group 2012-13 to 2016-17

✂

Figure 2.5 – Compound annual growth rates by product group – 2012-13 to 2016-17

✂

2.9 ✂. However we believe it is the effect of the pricing constraint imposed on us by USPA 6. Tenders by companies for these products are extremely competitive with contracts being won and lost on margins of ✂ per item. ✂. For the USPA 6 products, Royal Mail is required to use a higher cost standard – 50% FAC.

[37] ✂.

2.10 **The market distortion created by the mis-alignment of Ofcom's proxy LRAIC stops us competing fairly, increasing volume decline, the pace of which has accelerated in recent years.** Volume decline further increases unit FACs, driving up the contract level price floor, and widening the market distortion. Our ability to price competitively is further restricted. The widening of the market distortion becomes self-perpetuating. This results in market share transferring to Access operators via regulatory restrictions, not cost based competition. With no USPA 6 reform, Royal Mail will be unable to compete with Access operators for the large customer specific contracts. This is not in the interests of consumers or the wider market.

2.11 ✂.

LRAIC is the correct cost standard. Ofcom should engage with us on our revised model.

2.12 In 2012, Ofcom acknowledged that LRAIC provides the correct signals for market entry and noted its intention to move to it in the margin squeeze test in the future. However, it concluded that robust LRAIC information was not currently available.[38] 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. But, we urgently need a pragmatic solution in the interim period.**

As we move towards using LRAIC, the contract test should reflect operational reality. Our analysis ✂ supports a move to ✂% of FAC.

2.13 **The contract level test gives Ofcom the discretion to define an FAC percentage, currently 50%.** The ability of the contract level test to promote efficient competition in the 2c pre-sort market is entirely reliant on Ofcom defining a suitable FAC percentage. This places significant responsibility on Ofcom. We believe the current figure does not reflect economic fundamentals. It is distorting the 2c pre-sort market creating unfair competition by forcing Royal Mail to use a higher cost standard than competitors.

2.14 Royal Mail has considered a pipeline split of our upstream FACs and identified which of those pipeline costs are variable and which are fixed. **Considering all USPA 6 products on an aggregate basis, variable costs are ✂% of FAC across the entire upstream pipeline.**[39] Figure 2.6 below sets out the proportion of variable costs in each segment of the pipeline.

Figure 2.6 – Explanation of cost variability by pipeline segment

Pipeline	Variability	Principal cost driver
Collection	✂%	The principal cost driver is number of collection visits. Some customers may have dedicated collections. In many cases, a collection run will pick up mail from more than one customer. Customers will also send multiple formats. ✂.
RDC	✂%	✂. The remaining cost is ✂. Hence the ✂ cost in this section of the pipeline.
Network Distribution	✂%	This cost is ✂. The key cost drivers are mileage and driver time. Since journeys need to be made between the Mail Centres and RDCs regardless of volume, cost is ✂. There will be some vehicle runs

38 Securing the Universal Postal Service: Decision on the new regulatory framework. March 2012. para 10.118.
39 Weighted average across the pipeline.

		which can be removed as volume declines.
Commercial	✂%	These costs are ✂. Commission and compensation costs are assumed to be ✂. However, the commercial teams deal with multiple products not just those covered by USPA 6. The remaining costs (e.g. bids and tenders, brand marketing and customer experience) are therefore assumed ✂.
Upstream Business Sustaining and Support	✂%	The key cost drivers are Technology and Central Support costs. The IT infrastructure is ✂. For example, the number of servers, connectivity and website ✂ with USPA 6 volume. It needs to be a certain size. Similarly Central Support costs will ✂.

✂

2.15 ✂.

Case Study - ✂

2.16 Another area for consideration is the appropriateness of using FAC at the market level. In a multi-product company such as Royal Mail there will be shared costs which competitors will not incur. Therefore using the LRAIC of the group of products covered by the basket is more appropriate. This would be lower than FAC.

Proposed amendments.

2.17 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
Design of the contract level test	N/A	The contract level test should be removed. Instead the basket level test is sufficient to address Ofcom's concerns. See paragraph 2.2 to 2.11 If a contract level test is retained, the percentage should be reduced to ✂% FAC – which is a better proxy for incremental costs. See paragraph 2.13 to 2.14
Technical amendments	Ofcom have proposed a number of amendments to the condition.	Please see Annex 1 for more details of our position on these amendments.

Chapter 3 – Cost, efficiency and Business Plan

Ofcom question 2: *"Do you agree with our proposals regarding cost and efficiency reporting, as presented in Section 5?"*

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

We believe that the changes proposed in this Consultation should be assessed against the four key attributes – set out by Ofcom in 2012 in its review of BT's regulatory financial reporting – for an effective regulatory financial reporting framework. They are relevance, reliability, transparency and proportionality.[40] We are concerned that a number of Ofcom's proposals may embed rigidity into the regulatory financial reporting framework and increase the regulatory burden.

- **We want to work collaboratively with the regulator to ensure the regulatory financial reporting framework provides Ofcom with the information it needs to fulfill its statutory duties while minimising the regulatory burden.** We recognise that the regulatory reporting framework needs to provide Ofcom with sufficient information to monitor our progress on cost transformation. Since the IPO,[41] we have had a proven track record of efficiency and cost reduction, while maximising the absorbable rate of change. Ofcom has recognised that *"Royal Mail has sufficient incentives for efficiency."* [42]

We have four main concerns with Ofcom's approach to business planning and efficiency:

- We have streamlined the information we produce internally. We focus on the information we need to effectively run and manage our business. As a consequence, we have been able to significantly reduce our headcount in finance. We still produce detailed forecasts for our annual budget. But, **we have changed the way we do business planning for the outer years of our forecast.** We have moved away from the granular, bottom up detail in our previous model suites. We now adopt a top down, value driver approach. This approach aligns to business planning best practice used elsewhere by other large companies. We believe extrapolating out value drivers into Ofcom's formats would not be a helpful exercise. It is not relevant, reliable or proportionate. Rather, Ofcom can discharge its duties on assessing the efficiency of our forecasts by focusing on PVEO at the broader categories of cost.
- Ofcom has stated that it intends to review Royal Mail's efficiency against the targets that underpin the 2015 Business Plan. **The market conditions and challenges we face are now different to 2015.** The reliability and relevance of this comparison will fade over time.
- **We have concerns with Ofcom's proposal to require Royal Mail to report our workload measure on the assumptions we used in 2015.** This is technically possible, as a desktop exercise. However, these were moment in time assumptions. They will not capture important developments. For instance, there has been ✂, which will have a flow through impact on workload. This would not be captured by simply running today's traffic through the old assumptions. It would not be relevant or reliable. Further, it will increase the regulatory burden. We therefore recommend that Ofcom remove this requirement.
- We appreciate Ofcom's desire for information to be presented on a consistent basis. However, from time to time we refine our reporting hierarchies to ensure reporting responsibilities align with business hierarchies. **There needs to be sufficient flexibility in the framework** to ensure any changes are reflected in regulatory reporting. We set targets for business units at broad categories of cost. We do not set detailed line-by-line targets. Ofcom can track its own measure of efficiency – PVEO – at a total Reported Business level. We are concerned prescribing detailed reporting hierarchies will imbed rigidity. We therefore recommend Ofcom does not specify the individual cost categories, instead allowing Royal Mail to provide the cost category structure in use at the time.

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[40] Ofcom, Regulatory financial reporting: a review, Sep 2012, page 8.

[41] Initial Public Offering. Royal Mail's IPO occurred in October 2013.

[42] Ofcom, Review of Regulatory Financial Reporting for Royal Mail, 31 March 2017, para 5.3.

In carrying out its primary duty, Ofcom must have regard to the need for the provision of the Universal Service to be efficient. We want to work collaboratively with the regulator to ensure the regulatory reporting framework provides Ofcom with the information it needs to fulfil its statutory duties while minimising the regulatory burden.

3.1 We recognise that the regulatory reporting framework must provide Ofcom with the right information to discharge its statutory duties. Since Ofcom took over responsibility for postal regulation, it has invested significant time to understand efficiency performance across our operations and our business plan forecasts. It will have gained many useful insights. We are pleased Ofcom concluded our targets are reasonable. [43] **Ofcom has stated that we have sufficient incentives for efficiency.** *"Market conditions and the shareholder discipline which Royal Mail is subject to as a privatised company are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation."*[44]

3.2 **Since the IPO, we have had a proven track record on cost reduction and efficiency, while maximizing the absorbable rate of change.** We are continuing to see the positive impact of our cost reduction activities across the UK business. This has involved continuous focus on our efficiency performance in all areas, while providing a high quality service to our customers through our engaged workforce. Last year, we achieved a productivity improvement of 2.7%, towards the upper end of our 2-3% range. We are confident we will deliver our £600m cumulative annualised operating cost avoidance target in UKPIL by 2017-18. This target has increased from the £500m target set in 2015-16. Cost avoidance is embedded in both our strategy and our culture.

3.3 We have been transparent with Ofcom on our actual and forecast cost since it took over as our regulator. As a matter of course, **we have shared with Ofcom the same Business Plan and monthly management information we share with our senior management team and Board**. The management information pack has been provided - voluntarily - since 2012, soon after Ofcom took over as our regulator. Royal Mail has no plans to cease providing this information. Providing Ofcom with this information not only meets the four key attributes but also helps to minimise regulatory burden.

Our management are targeted on total UKPIL cost, not at detailed line-by-line targets.

3.4 ✂.[45] The cost KPI used for bonus setting is total UKPIL cost. This replaced the separate people and non-people KPIs we previously used. A single total cost metric is a more appropriate measure to drive overall efficiency to focus cost reduction activity on those areas that reduce total cost.

3.5 ✂.

3.6 We continually evolve our operational processes to **drive productivity and cost savings across our entire pipeline.** Our pipeline is becoming more integrated. Some activities, such as collections, straddle different pipelines. In some instances, higher cost in one part of the pipeline enable us to reduce cost by more elsewhere. The recent changes described below – and other similar operational changes - can make analysis of discrete pipeline elements difficult and therefore unreliable.

- **Collections on delivery** will drive productivity and reduce overall cost. However, some cost will shift from the collections pipeline into the delivery pipeline.

[43] Ofcom, Consultation on Review of the Regulation of Royal Mail, 25 May 2016, para 1.10.
[44] Ofcom, Consultation on Review of the Regulation of Royal Mail, 1 March 2017, para 1.2 – Key Decisions box.
[45] For example, Letters and Network, Parcels, Central Functions, etc.

- Improvements to our **large letter sorting machines.** The investment in these machines has created the capacity for additional activity / workload in processing. It enabled work to be taken out of indoor delivery.
- ✂.[46]
- **Reductions in our air network** have meant savings in non-people cost through fewer flights. ✂.
- Investment in **double decker trailers** has brought more network transportation in-house. This has led to a reduction in road haulage cost ✂.

We have changed the way we do business planning. Forecasts for years 2 and 3 are based on value drivers, rather than detailed bottom up models.

3.7 **The granular, bottom-up approach we previously employed to business planning was a consequence of the previous price control framework.** Under price controls, there was a deep dive on our Business Plan once every price control period. A detailed model suite was required to test and set the parameters of the price control. Ofcom moved away from a price control approach to a monitoring framework in 2012. ✂.

3.8 ✂.[47]

3.9 ✂.

3.10 ✂.

3.11 It is possible to provide Business Plan information at the granular level of detail proposed by Ofcom in Figure 7 and 8 of the RAG. However, it will be based on extrapolating the top-down value driver assumptions to our detailed budget. While forecasts would reconcile at broad cost categories, **it would not represent a formal, business forecast at a detailed level.** In our view, this information would not be reliable. We believe that Ofcom should instead focus on broader categories of cost when assessing our Business Plan.

Our Business Plan for 2015 was appropriate for 2015, but not for 2017, nor for 2022. The validity of this comparison will fade over time.

3.12 Our Business Plan for 2015 needs to be reviewed in the context of the market conditions at the time. Post is a dynamic industry – we have to respond to changes in our customer expectations and market dynamics. Our financial forecasts will vary each year as a consequence. **Our 2015 Business Plan has a fixed shelf life and has gone well beyond its use by date.** The postal industry in 2015 is very different to the postal industry in 2017:

- Brexit has had a chilling effect upon forecast GDP growth and business confidence. ✂.
- Total letter volume decline has fallen to the high end of our medium term guidance of 4-6% decline. Our marketing mail revenue decreased by eight per cent in 2016-17.
- We face significant competition from companies with established delivery capabilities and from new entrants.
- We have had to reform our Defined Benefit pension scheme. The resolution of this was beyond the time period of the 2015 Business Plan.

46 ✂.
47 ✂.

3.13 The financial forecast for the 2015 Business Plan finished in 2017-18. This is before the new Regulatory Reporting Framework comes into effect in 2018-19. We consider that the specific outputs – such as efficiency and profit progression - from the 2015 Business Plan will have time expired. **We believe that Ofcom should review the assumptions in each year of the Business Plan.** The regulatory financial reporting framework is intended to last for five years through to 2022 and needs to remain relevant.

3.14 Accordingly, the best way for us to plan our business is to reset the assumptions for the future each year to reflect reality. We adopt what we consider to be the most appropriate assumptions. In the Business Plan presentation to our Board, we provide a bridge from last year's plan to the current plan to show the impact. We typically do not go back further than one year – this is sufficient for our Board.

We have concerns with Ofcom's proposal to require Royal Mail to report our workload measure using our 2015 assumptions. We propose that Ofcom presents our efficiency movements as an index.

3.15 We understand Ofcom's desire to assess our progress on efficiency against the findings from its in depth review of our 2015 Business Plan. Ofcom's proposal to require Royal Mail to report our workload measure on the assumptions we used in 2015 is technically possible. But, we consider it is not a helpful exercise for Ofcom to understand our efficiency. We have serious reservations with creating a view of workload today by tying it to moment in time assumptions. **It will not capture important developments, such as the** ✂[48] [49]. This and other similar effects will have a flow through impact on our planning values and workload. This would not be captured by simply running our current traffic through the old assumptions.

3.16 We improve our methodology every year to make it more robust. This includes:

- **Productivity improvements** - We have extended workload coverage to include ✂. We have also increased the sophistication of measurement. ✂.
- **Operational volume improvements** - ✂. We have improved how we measure operational volume. ✂. It is possible to restate current volumes and revert to using 2015 assumptions. However, calculating workload on the assumptions used in 2015 would not capture this significant change.

3.17 **Requiring workload on moment in time assumptions will lead to confusion.** It is not reliable or proportionate. We do not back fit current information to out-of-date assumptions and models. It would be produced for Ofcom only. It would be a duplication of analysis, with no benefit for day-to-day management of the business. It could lead to results that are unhelpful for Ofcom as the calculation will be based on moment in time assumptions that are no longer relevant. Simply put, the factors driving the results will not be accurately understood. Understanding them will require scarce management resource, drawing time and focus away from tasks with a business benefit.

3.18 We use our workload measure for day-to-day management of our business. It is not simply a desktop exercise. Resourcing to workload is used to drive operational efficiency in Mail Centres and Delivery Offices. ✂.

3.19 As an alternative, **Ofcom could present our productivity movements as an index.** In our recent presentation to investors in May 2017, we set out our productivity metric indexed from 2010-11. The scope of what is covered by the workload metric has expanded over this time period. We have re-estimated planning values and refreshed assumptions. However, as explained above, each time we report productivity, we restate prior year workload to reflect any changes in coverage and present it on a like for like basis as the previous year. This means the change in our reported productivity each year, purely takes into account the

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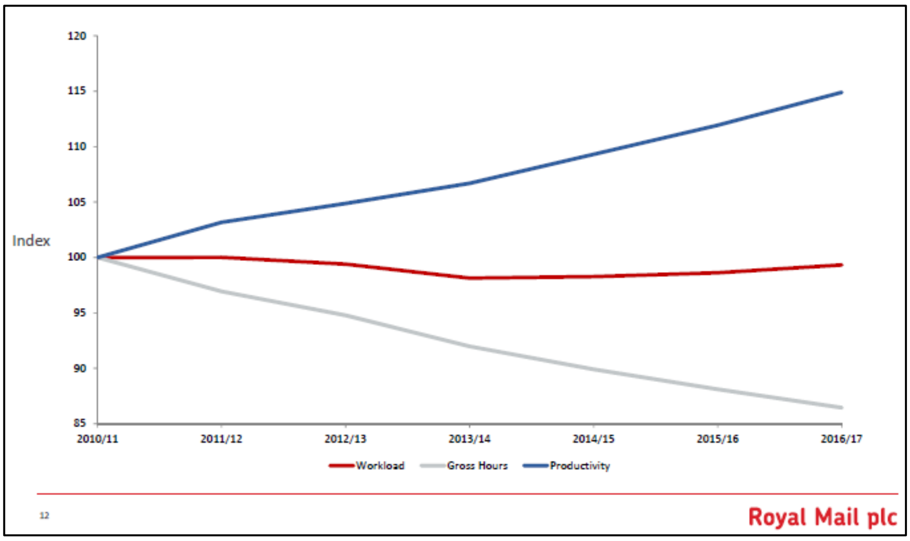
48 ✂.

49 ✂.

year on year movements once any changes in the metric's coverage have been made. No change in productivity is a result of us simply expanding the metric. We considered this to be an appropriate, accurate presentation of our results, recognising the scope has increased over time. We do not believe it is proportionate for Ofcom to put in place a parallel reporting of workload.

Figure 3.1 Royal Mail productivity trends since 2010-11



We make changes to our internal reporting hierarchies to drive efficiency. There needs to be sufficient flexibility to ensure regulatory reporting continues to reflect operational reality.

3.20 We recognise Ofcom's desire for information to be presented on a consistent basis to aid its assessment of efficiency and financial sustainability of the Universal Service. At the same time, we must continually adapt our business and operations to respond to ever changing market dynamics. Things do not stand still. **From time to time we have to refine our reporting hierarchies** to ensure responsibilities align with business activities. This is good business practice. It will help us to deliver a better customer service and deliver further operational efficiencies.

3.21 **From time to time we re-organise our business units or re-classify our functions to better manage our business and drive efficiency.** The regulatory reporting framework will be in place until 2022. It is possible we may make changes to our organisational structure within that time period. The framework needs to be future proof. We made major organisational changes to our logistics function in early 2016-17. As we presented to Ofcom in March 2016, we are aiming to deliver an overall underlying saving of ✂ across logistics by 2017-18.[50] Our One Logistics programme is one of many initiatives implemented to achieve this target. It put all our logistics functions into one place, under a single team. Previously, national logistics and local distribution were spread across a number of functions and regions. We have updated our reporting structures to reflect these changes. The changes have helped realise efficiencies across our 7.5t and larger vehicle fleet.

3.22 **Ofcom's proposals prescribe reporting hierarchies in the Cost Matrix and PVEO. We are concerned this will imbed rigidity** and could constrain how we run our business. The industry we operate in is incredibly competitive. We need to be dynamic and able to respond rapidly. Having prescribed, detailed reporting hierarchies could create artificial barriers and would add an extra layer of complexity. This could prevent us from moving quickly and making changes which are beneficial to how we run our business. Reporting on a legacy hierarchy – which will have no benefit to the ongoing running of Royal Mail – would

[50] Starting from 2013-14, before cost effects of volume and volumetric

represent a significant increase in the regulatory burden and be disproportionate relative to the benefits. There needs to be sufficient flexibility in the framework to allow regulatory reporting to align to our internal reporting.

- For example, ✂. It would be very difficult to untangle this unit transfer in our management accounts. Restating hierarchies is only possible where discrete cost centres have moved that are captured within our hierarchical reporting framework.

3.23 We believe we can maintain flexibility within the framework by **having a less prescriptive cost hierarchy in the Cost Matrix and PVEO.** Royal Mail would provide the same level of detail, just with less rigidity. Ofcom could specify Royal Mail must report broader categories of cost[51] but - while requiring a more detailed breakdown - do not specify the more detailed cost category rows. Instead, Ofcom should require a detailed cost category breakdown based on its internal reporting hierarchies at that time. This would ensure there is sufficient flexibility to ensure the regulatory reporting framework aligns to our internal reporting. It would minimise the regulatory burden while providing Ofcom valuable insight into our business. Our proposals are set out in Annex 2.

Ofcom can achieve its objectives – consistent reporting of actual and forecast financial information - in a more proportionate way that recognises the significant changes in our planning process.

3.24 **We recognise the need to provide Ofcom with sufficient, consistent information to track our cost progression over time.** We focus on broader categories of cost to deliver overall targets. Ofcom's efficiency metric - PVEO - is calculated at a total cost level, with further focus at people, non-people and transformation cost. **We believe this is the appropriate level to ensure cost is reported on a consistent basis.** Analysis below this level may change from year to year. But, information at broader cost categories remains broadly consistent, ✂. In the event that there are material changes or re-classifications in our reporting at a broader cost category level for the Reported Business, we would restate the prior year comparatives. These may require estimates being applied, depending on the nature of the change required.

3.25 In summary, we propose:

- Ofcom's need for consistent reporting of actual and forecast financial information can be met by:
  - » Consistent reporting of broad cost categories[52] within the Cost Matrix across historic and forecast years to feed into Ofcom's PVEO framework.
  - » Consistent reporting of revenue and cost lines within a forecast, including one year comparatives.
  - » If necessary, explanations of material changes between revenue and cost categorisation across years.
- Ofcom's need for robust efficiency reporting across time can be met by an index of productivity movements over time, in line with our reporting to investors in May 2017.
  - » We propose that Ofcom removes the requirement to also report productivity and workload calculations on the assumptions used in the 2015 Business Plan.

[51] People cost, non-people cost and transformation cost.
[52] People cost, non-people cost and transformation cost.

Ofcom made a number of detailed proposals which we comment on below.

We are not clear of the benefit of having PVEO actuals audited.

3.26 Ofcom has proposed that PVEO actuals are audited each year on a PPIA basis. This would form part of the wider audit of our regulatory accounts. We are unclear why Ofcom needs specific assurance on this schedule, in comparison to other unaudited information we provide. **PVEO, by its very nature, is subjective and based on judgment.**

3.27 Our auditors would need to perform additional work. The Cost Matrix lay-out is based on our management accounts. It is a different format and more detailed than our statutory reporting. Additional checks would need to be performed. For example, our auditor audits people costs as a whole. It does not audit the split between different business units**. An audit may require judgement by our auditors.** For example, confirming whether an item is a one-off cost or not. This does not fit with a PPIA audit opinion, as there is no set definition of what constitutes a one off item set out in the RAG.

3.28 If Ofcom did not agree with any assumptions made by Royal Mail, **it is likely Ofcom would overlay its assumption, even if the PVEO analysis had been audited.** We therefore believe the audit would be of little use. Currently, our regulatory accounts include both audited and unaudited sections. We could provide the PVEO on an unaudited basis, in line with the current framework. We therefore think the requirement to audit our PVEO analysis should be removed.

3.29 We have streamlined the information we produce in our business planning process to focus on the information we need to run and manage our business. ✂.

3.30 Ofcom has proposed to require headcount and FTEs broken down between frontline, management and other staff. ✂.[53] We therefore propose Ofcom remove this proposal and instead focus on total hours reduction and cost.

We propose that we provide a functional view of pay on an annual basis not quarterly.

3.31 Ofcom proposes that Royal Mail provides the Cost Matrix on a quarterly basis. The proposed report includes a **breakdown of operational people cost by function.** [54] ✂. This data will also be subject to seasonal variations. We therefore recommend we provide a functional analysis of operational pay on an annual basis for actual costs.

Cost Matrix detail.

3.32 ✂. Ofcom's proposal to require a Cost Matrix for the Reported Business therefore broadly follows the information used by our management team. We therefore agree, in principle, with its inclusion in the reporting framework. However, we have some specific concerns, detailed below.

- **Reporting structure** – to avoid embedding rigidity into the framework, Ofcom should adopt a more flexible approach. See paragraphs 3.20 - 3.25. Our proposals are set out in Annex 2.
- **Pension costs** - we are reforming our defined benefit pension scheme. Ofcom should ensure there is sufficient flexibility to only require reporting on both **cash paid and IAS19** if differences are non-trivial.
- **Re-allocation of centrally held pay** - Ofcom's guidance note 2 in Figure 7 proposes Royal Mail re-allocate centrally held pay cost including pension cost to business units. ✂. **We therefore believe the**

[53] ✂.

[54] For example, in Figure 7 of the RAG, Ofcom has specified Processing and Regional Logistics, Delivery etc.

requirement to re-allocate centrally held pay cost would not be a meaningful exercise. This would represent a further manual manipulation of the information, undertaken only for Ofcom and would not be aligned to how we manage our business. We recommend this guidance note is removed and Ofcom focuses its monitoring on broader cost categories.

- **Breakdown of transformation payments** – Ofcom has proposed a further breakdown of transformation payments in Figure 7 and Figure 8. ✂. We therefore propose to provide a breakdown of transformation costs by voluntary redundancy, business transformation payments and other transformation costs. ✂. Providing this information would be more relevant, proportionate and reliable.

Proposed amendments

3.33 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
Overarching n.a.	Focus analysis on cost at detailed, line-by-line level.	Focus analysis at broader categories of cost. Namely people cost, non-people cost and transformation cost. See paragraph 3.4-3.11
USPAC 1.3.1 (b), (d) Strategic plan – volume and revenue	Provide detailed breakdown of volume and revenue at V4 level for strategic plan.	Focus on broader categories of volume and revenue. See paragraph 3.4-3.11
USPAC 1.3.1 (b), (e) **USPAC 1.3.1 (b), (f)** Strategic plan – cost	Provide detailed breakdown of cost for strategic plan in the Cost Matrix and PVEO	Focus on cost movements for the Reported Business at broader categories cost. Further detail provided by value drivers. See paragraph 3.4-3.11 and 3.20-3.23
USPAC 1.3.1 (b), (g) (6) **USPAC 1.3.1 (b), (i)** **USPAC 1.3.1 (c), (g) (6)** **USPAC 1.3.1 (c), (i)** Workload on 2015 assumptions	Provide workload based on assumptions used in 2015 Business Plan	Remove this requirement. See paragraph 3.12-3.19
USPAC 1.3.1 (c), (j) Strategic Business plan - Headcount and FTEs	Provide forecasts of headcount and FTEs for years 2 and 3 of the Business Plan,	Remove this requirement for Business Plan (years 2 and 3). NB: we can provide this for budget. See paragraph 3.30
USPAC 1.3.1 (c) 2 preceding years actuals	Provide 2 preceding years actuals for volume, revenue and cost.	Reduce the requirement to 1 year. See paragraph 3.23-3.23
RAG Figure 7 **RAG Figure 8** Reporting hierarchies in Cost Matrix and PVEO	Prescribing detailed cost categories in the Cost Matrix and PVEO templates	Ofcom should require Royal Mail to provide people cost, non-people cost and transformation cost data, with a further breakdown but not specify the breakdown. See paragraph 3.4-3.11 and 3.20-3.23 and Annex 2

Condition/Area	Ofcom consultation proposal	Royal Mail position
RAG Figure 7 **RAG Figure 8** Breakdown of voluntary redundancy	Require a breakdown of voluntary redundancy to frontline, management and other	Change requirement to voluntary redundancy, business transformation payments and other transformation costs. See paragraph 3.23
RAG Figure 7 (note) **RAG Figure 8 (note)** Reallocate centrally held pay cost	Require Royal Mail to reallocate all centrally held pay cost to pay cost categories	Remove this requirement. See paragraph 3.23
RAG Figure 7 **RAG Figure 8** Functional breakdown of operational pay	Require Royal Mail to provide a breakdown of operational pay on a functional basis quarterly	Include a guidance note to only require Royal Mail to provide a functional breakdown annually. See paragraph 3.31
USPAC 1.4.1 (a) Audit of Cost Matrix and PVEO actuals	Cost Matrix and PVEO full year actuals would be audited as part of audit of regulatory accounts	Remove the requirement. See paragraph 3.26-3.30

Chapter 4 – Accounting Separation

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

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

We agree with the thrust of Ofcom's proposals for change. Ofcom should remove redundant and unnecessary reporting that is no longer relevant for Ofcom meeting its regulatory objectives. However, the Consultation does not address our fundamental concerns on the appropriate allocation of the Universal Service network cost. The cost of the Universal Service network should be attributed to Universal Service products in the first instance. We also believe Ofcom can go further to reduce the burden of regulation whilst continuing to meet its duties.

In relation to the Consultation's proposals, we agree that:

- **Current accounting separation reporting should be replaced with "targeted separation".** We propose that the "targeted" product set applies to those areas where there is upstream competition. We consider the relevant product set to be the D+2 and later bulk letters and large letters services.
- **Current FRE[55] and PPS[56] reporting requirements should be removed.** We note that Ofcom's proposal for the removal of the FRE and PPS reporting is partly justified by its request for a granular data file. This is addressed in our response to Question 4 with an alternative proposal.
- **Current monthly reporting requirements should be removed.** Ofcom's need for monthly information is met through our voluntary provision of the management accounts.

However, Ofcom's proposals should go further. There are additional areas where Ofcom could reduce the reporting burden to a more proportionate level while not impacting its ability to meet its statutory duties:

- **Quarterly to Annual reconciliations** – we now process our results cumulatively so these obligations are redundant.
- **Reported Business balance sheet, cash flow and associated notes** – the Reported Business balance sheet and cash flow are produced using a set of rules. It is a notional analysis and not used within Royal Mail – we do not consider this information to be relevant[57] for Ofcom's monitoring framework. We recognise the importance of the cash flow metric, but only at Relevant Group level.
- **Provision of quarterly PPS information for PAF and Access** – Ofcom can create this from the new data file[58] it has requested.
- **Provision of quarterly and annual reports of USO, non-USO and non-mails[59]** – if required, Ofcom can create this from the new data file it has requested. We consider this a "legacy" requirement that is no longer needed.
- **Audit of the confidential submission of our annual report of USO, non-USO and non-mails and Reported Business budget.** We do not consider it appropriate for our budget to be audited. In addition, we will publish the audited historic Reported Business returns by USO and Other. It is not necessary for another audited schedule just to split "Other" into non-USO and non-mails.

We agree with Ofcom's proposals to update the relevant group definitions (Question 6).

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[55] Financial Reporting Entity. The Reported Business consists of 4 FREs.

[56] Product Profitability Schedule. The Reported Business consists of 25 PPS. Ofcom proposes all PPS reporting is removed except PAF and Access.

[57] We consider one of the key attributes for regulatory financial reporting is relevance – the information must answer the right questions. As this is a notional mechanistic calculation, we do not consider this to be providing Ofcom with the right information for its monitoring.

[58] In the event that Ofcom adopts our proposal to replace the data file with product scorecard reporting, we would continue to provide PAF and Access. See our response to Question 4 which sets out our alternative proposal.

[59] As per footnote 4, we would continue to provide this schedule should Ofcom adopt our product scorecard proposal.

We agree that redundant, unnecessary reporting and other related regulatory obligations should be removed.

4.1 Ofcom has specifically identified its duties in relation to financial sustainability, monitoring competition (including margin squeeze) and protecting consumer interests. We have explained previously[60] that we consider the current regulatory financial reporting framework is burdensome and disproportionate. Royal Mail does not use accounting separation information in its management reporting. These reporting obligations represent additional activity – a regulatory burden - that Royal Mail would not undertake absent regulation. **Therefore, we agree that Ofcom should take the opportunity of removing redundant and unnecessary reporting and other related regulatory obligations whilst ensuring Ofcom has sufficient information to fulfil its statutory duties.**

The Consultation does not address our fundamental concerns about the appropriate allocation of the Universal Service network cost. The cost of our Universal Service Network should be attributed to Universal Service products in the first instance.

4.2 The Consultation does not address how the cost of the Universal Service Network should be attributed. As we have explained previously, the costs of the Universal Service Network should be attributed to Univeral Service products in the first instance. **Accordingly, we do not consider the current product costing rules appropriate.**

4.3 Royal Mail's statutory obligation as the designated Universal Service Provider (USP) drives the architecture and costs of the Universal Service mail network. Royal Mail has developed a network to enable it to collect, process and deliver mail throughout the country, to ensure it can offer a one price goes anywhere, next day service six days a week to more than 29 million addresses throughout the UK.

4.4 The Universal Service upstream and downstream network is used by both Universal Service products and non-Universal Service products. Royal Mail relies on revenues from non-USO commercial activities, particularly commercial parcels, to help sustain the Universal Service. The annual c£7 billion cost of running this network is a result of Royal Mail's status as the UK's sole provider of the Universal Service. The core estate required to meet this obligation would be broadly the same, and therefore a significant proportion of the cost base would remain, whether the Group used the Universal Service core network for non-Universal Service products or not.

4.5 Costs are allocated to each product channel by allocating daily collection and delivery common costs across all services as determined by Ofcom through the costing rules. However, **Royal Mail believes that the cost of the combined network should most appropriately be allocated to Universal Service products in the first instance.** If this were the case, under the current revenue structure, Universal Service products would be significantly loss- making, and non-Universal Service products would be profitable. Hence, the current cost allocation provides a misleading picture of our product profitability.

Ofcom's proposals to replace accounting separation with "targeted separation" should focus on the relevant products where there is upstream competition.

4.6 The Consultation proposes adopting "targeted separation". It requires Royal Mail to provide a more granular analysis[61] of the cost and a transfer price for each product. As part of this consultation, Ofcom seeks stakeholders views on which of the products currently included in PPS3, PPS4 and PPS8 should be included within scope.

[60] See, for example, Royal Mail, Response to Ofcom's May 2016 Fundamental Review of the Regulation of Royal Mail, August 2016.
[61] See Ofcom Consultation, Annex 6, Figure 11.

4.7 Whilst we support the removal of unnecessary regulation, we are concerned that Ofcom has proposed too broad a set of products for inclusion.[62] We understand that one of Ofcom's key objectives from "targeted separation" is to monitor competition in the market where Access operators are competing. Ofcom should focus on the services where Royal Mail faces upstream competition. It is therefore important for the **product set to cover only those products which are subject to upstream competition.[63] We consider the relevant product set to be the D+2 and later bulk letters and large letters services.** Ofcom's proposed product list includes other bulk products that would not fall into this category. Our proposed list (see Annex 6 provided separately) outlines a proportionate set of products.

4.8 Our proposal includes advertising mail, business mail, publishing mail and RM48 large letters. It excludes:

- All 1st class bulk letter products;
- All sales agent products – these volumes are generated outside of the UK;
- All returns services; and
- All miscellaneous services such as compensation, pouch services or safebox.

Current FRE and PPS reporting requirements should be removed.

4.9 **We agree with Ofcom's proposals to remove the AS view of the Reported Business results by FRE.**[64] This is an unnecessary reporting burden. FRE level reporting was created for Ofcom – it is not a view of our financial results that we use within Royal Mail. We have not received any recent questions from Ofcom upon these schedules nor have we seen any reference to these schedules in Ofcom's monitoring. [65] We are unaware of whether and how these schedules are used by Ofcom. We agree that this redundant reporting should be removed.

4.10 Ofcom's proposal to remove the requirement to produce PPSs apart from PAF and Access also removes unnecessary reporting.[66] Ofcom can create product group level reporting from the granular data file or - should Ofcom adopt our proposal[67] for a more proportionate scorecard level reporting – review our results using our scorecard product group analysis.

We agree that additional monthly reporting should be stopped.

4.11 Ofcom states that its monthly reporting requirements can be met by Royal Mail's voluntary submission of its management accounts.[68] We agree. **The most proportionate way that Ofcom can discharge its duties is to use information that our business already has.** The management accounts have been reviewed and approved at an appropriate level. We consider this information to be relevant, reliable and transparent.

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62 See Appendix 2 of the RAG, page 84.

63 We expect that each short SPHCC product can be mapped to an equivalent network access service i.e. none will require a transfer price to be created on the basis FAC plus 10%. This pricing rule is set out in the RAG where an equivalent network access service does not exist.

64 The Consultation, para 4.70 a.

65 We note that in Ofcom's annual monitoring report it does refer to USO and non-USO split of Reported Business results. We will continue to provide this split in the published Regulatory Financial Statements (see Figure 1).

66 The Consultation, para 4.70 b.

67 See our response to Question 4.

68 The Consultation, para 4.70 d.

4.12 We provide our management accounts[69] to Ofcom monthly on a voluntary basis. We provide this information within 30 days or as soon as the information is approved. ✂. In addition, we do not produce a full set of management accounts for Period 1. ✂.

4.13 We propose that the USPAC should be amended to remove the requirement for monthly reports to avoid a "technical" breach of regulation when – in Period 1, 6 and 12 – we do not provide our management accounts 30 days after period end. For the avoidance of doubt, we will continue to share with Ofcom our management accounts, on a voluntary basis, 30 days after period end except:

- Period 1 which is not produced, and
- Period 6 and Period 12 which will be submitted once the statutory results have been approved.

4.14 We note that Ofcom proposes introducing a new high level summary volume and revenue report on a quarterly basis.[70] This replaces a monthly revenue report that provides similar information. We agree that it is more proportionate to move to a quarterly provision of such information given that Ofcom also receives our management accounts.

There are additional areas where Ofcom could reduce the reporting burden to a more proportionate level while not impacting its ability to fulfil its statutory duties.

4.15 We agree with the broad thrust of Ofcom's proposals to simplify the accounting separation framework. However, we consider that there are further opportunities to remove unnecessary or redundant regulation that does not affect Ofcom's ability to discharge its duties as set out below.

Quarterly to Annual reconciliations can be removed.

4.16 We consider that Ofcom should also remove USPAC 1.4.1 (c) in its entirety. [71] It requires a reconciliation of the income statement with the quarterly information provided. Since the regulatory accounting framework was put in place, Royal Mail has refined its cost allocation system. Our system now processes revenue, volume and cost information on a cumulative basis. As a consequence, the submission to Ofcom in Quarter Four is the same as the annual submission. No reconciliation is required. Accordingly, this requirement is redundant and should be removed.

Reported Business balance sheet and cash flow should be removed. They are not useful or necessary.

4.17 Ofcom states in paragraph 4.31 of the Consultation that "*the capital employed and cash flow statements of the Reported Business as a whole and those are of the Relevant Group are considerably more useful [than the FRE equivalent schedules]*" Ofcom intends to maintain the obligation to provide this information.

4.18 We agree that the FRE level reporting is not useful or relevant. The financial sustainability of the Universal Service is measured through:

- **Reported Business Financeability EBIT[72] margin.** This is an income statement measure. Ofcom requires this to be produced and monitored on a regular basis.

[69] The full title of our management accounts is "*Group Monthly Management Accounts and KPI Performance Pack*" as this contains financial and non-financial information. ✂.

[70] The Consultation, para 4.70 e.

[71] Ofcom can also remove from Table 4 of Section 4 of the RAG additional requirements on Royal Mail related to USPAC 1.4.1 (c).

[72] Ofcom has set a measure called "Financeability EBIT" measured as the Reported Business EBIT margin as % calculated with pensions costs on a cash basis not an accounting basis.

- **Relevant Group financial health metrics.** These include such metrics as Funds From Operations (FFO) / net debt to measure our underlying financial sustainability. We finance our operations at the Relevant Group level. We do not produce these metrics at a Reported Business level.

4.19 **We do not see the value of the balance sheet or cash flow of the Reported Business to Ofcom or to external stakeholders in addressing financial sustainability.** It is not required to produce the Financeability EBIT margin, nor used in our financial health metrics. The Financeability EBIT margin is an income statement measure. Debt and equity is raised at a Relevant Group level – not at a Reported Business level. We are unaware as to how this schedule is used within Ofcom or the value other stakeholders place on such information. Nor have we received any recent questions from Ofcom on these schedules.

4.20 The same assumptions that "*diminish the objectivity and robustness of the resulting separated statements [for the four FREs]*" [73] also reduce the objectivity and robustness of the Reported Business cash flow and balance sheet. The Reported Business balance sheet and cash flow are produced using a set of academic rules. **It is a notional, mechanistic analysis and not used within Royal Mail.** One of the key attributes for an effective regulatory financial reporting framework is relevance – where the information answers the right questions in the right way at the right time. In our view, this mechanistic calculation provides data but not useful insight. It should not be data that Ofcom relies upon. Within the Consultation, Ofcom has set out the use of cash flow at the Relevant Group level. However, Ofcom has not fully explained how the Reported Business balance sheet and cash flow information is useful for its monitoring purposes. We do not consider the ongoing production of this notional analysis useful for Ofcom's purposes.

Remove the notes to the balance sheet in the annual regulatory financial accounts as required by the RAG. They are not relevant to stakeholders.

4.21 Ofcom should also remove the obligation to provide further notes to the balance sheet as set out in the RAG. The notes and categorisation required by Ofcom does not align to our statutory accounts. We produce these schedules with additional manual effort which is not necessary. We have not had any recent questions from Ofcom on these schedules. We are unaware as to how Ofcom or other stakeholders may use this information. We consider the ongoing provision of these notes as disproportionate. For example, we are currently obliged to provide further detail on inventories. We do not see the value that stakeholders will gain from analysing the £15m[74] of inventories into £12m of supplies and materials (such as uniforms) and £3m of merchandising. We do not make such a disclosure in our statutory accounts.

Provision of quarterly PPS information for PAF and Access can be removed. Remove the requirement to provide a quarterly and annual report of USO, non-USO and non-mails.

4.22 We do not see the need to provide separate PAF and Access financials on a quarterly basis to Ofcom. The relevant financial information will be contained within the granular data file[75] that Ofcom has requested. In effect, we are providing the same information twice. Moreover, we still have the obligation to annually publish audited PAF and Access results.

4.23 Ofcom requires Royal Mail to continue to provide a report of the USO, non-USO and non-mails returns. Ofcom can generate this information from the granular data file[76]. Therefore, there is no need for Royal Mail to provide these reports separately. We consider this a "legacy" requirement. This structure of

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73 The Consultation, para 4.31.
74 From 2015-16 Regulatory Financial Statements Note 3.
75 Should Ofcom adopt our proposal for scorecard level reporting, we will continue to provide PAF and Access on a quarterly basis.
76 The Reported Business budget is not in the granular data file. This would need to be provided separately.

reporting was prescribed while Royal Mail was regulated by PostComm. It appears that this requirement has been rolled over – we do not consider this analysis remains useful for Ofcom.

Remove the requirement to audit the confidential annual end to end income statement for USO, non-USO and non-mails. Firstly, it has budget information – this is not auditable. Secondly, this statement is similar to an already audited published statement.

4.24 Table 11 of the RAG sets out Ofcom's proposal that the annual end to end income statement in respect of USO, non-USO and non-Mails to be audited to a PPIA standard. There are two versions of this statement:

- Figure 1 - a published and audited version that analyses the Reported Business results into USO Mail and "Other".
- Figure 2- a confidential version that analyses the Reported Business results into USO, non-USO and non-mails. It also requires the Reported Business budget.

4.25 As noted above, the annual (and quarterly) requirement for USO, non-USO and non-mails can be met though the granular data file. We do not consider it necessary that there is a separate audited submission:

- Firstly, Figure 2 contains our Reported Business budget. **We do not consider it to be** appropriate **for our external auditors to audit our budget.** The budget is a forecast taking outputs from our planning systems. Our forecasts will be based upon assumptions and judgements. The RAG does not cover our budgeting process.
- Secondly, we are required to audit and publish an analysis of USO Mail and "Other" (Figure 1). The only difference – apart from budget – between Figure 1 and Figure 2 is that "Other" is analysed into non-USO and non-mails in Figure 2. **It is not necessary for another audited schedule just to split "Other" into non-USO and non-mails.** It is disproportionate.

4.26 Instead, we propose that Ofcom amends Figure 2 to only disclose the Reported Business total returns compared to budget, and that Figure 2 is not audited. This is in line with the existing regulatory obligations. We consider this is a more relevant and useful schedule for Ofcom. It will enable the regulator to compare our budgeted ambition for the Financeability EBIT with the actual out-turn.

Update the RAG to make it clear that the Cost Matrix and the PVEO should not be published.

4.27 Table 10.1 of the Consultation presents an outline of Ofcom's proposed regulatory financial reporting framework. On page 69, it is made clear that the Cost Matrix and PVEO should not be published as part of the annual publication of the results of the Reported Business. We agree. This provides confidential commercial information about our business that is not in the public domain. This has not been reflected in the RAG. We propose that Ofcom amends Table 4 of the RAG to make this clear.

We agree that reconciliations should be performed at total cost and total revenue level. There may be minor reconciliation differences.

4.28 We note that Ofcom has asked for reconciliations to be performed – for example see RAG Table 4, the obligation in relation to USPAC 1.4.1 (l), in column 2 part (f), Ofcom requires reconciliations at total cost and total revenue level for quarterly submissions. We agree that the reconciliation should be performed at a total cost and total revenue level. There could be small reconciliation differences due to sourcing information from different systems to meet Ofcom's requirements. We will source information from:

- our costing system to produce the detailed costing down to short SPHCC.[77]
- our management accounts to provide detailed cost analysis, such as the Cost Matrix, at a Reported Business level.

4.29 There will be some difference between the two due to issues such as allocation of overheads. These differences will be relatively small.

PAF framework – there is not an agreed target operating margin.

4.30 Ofcom states in paragraph 4.50 of the Consultation "*The performance of PAF against an agreed target operating margin continues to be important to us and stakeholders*". This ignores the Ofcom's 2013 PAF Statement. Ofcom stated that "*we consider that the current voluntary profit cap on PAF revenues should be removed. We have also provided some high-level guidance at Annex 1 on the factors we will consider when assessing whether the terms on which PAF is made available are reasonable.*"[78] We price PAF products appropriately on a fair and reasonable basis – not to an agreed operating margin.

We agree with Ofcom's proposals regarding relevant group definition (Question 6).

4.31 We agree with Ofcom's proposals. They provide better clarity and remove redundant requirements. We note that:

- Ofcom's proposals recognise that the Royal Mail plc statutory accounts satisfy the requirements for the Relevant Group reporting.
- Following the acquisition of the minority shareholding in Romec Limited on 31 March 2016, we now account for Romec as part of UKPIL for statutory accounting purposes. Figure 8.3 needs to be updated.

[77] Sales Product Handling Cost Characteristic.
[78] Ofcom, Postcode Address File Review Statement, 22 July 2013, para 1.7.

Proposed amendments

4.32 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
USPAC 1.4.1 (c) (requirement for reconciliation of quarterly information with annual information)	No change	Remove this obligation for the reconciliation as our Quarter 4 submission will provide the annual submission. See paragraph 4.16.
USPAC 1.4.1 (k) and USPAC 1.4.9 (d) (requirement for monthly reporting)	No change.	Remove these obligations. Royal Mail will continue to provide – on a voluntary basis – the management accounts to the timescales outlined above in paragraph 4.13.
USPAC 1.4.1 (e), (f), (g) and (h) (requirement for balance sheet and cash flow information for the reported business)	No change	Remove these obligations to produce a balance sheet and a cash flow statement for the Reported Business. It is a notional, mechanistic analysis. See paragraph 4.17 - 4.20.
RAG – Table 4 Obligations in relation to USPAC 1.4.1 (e), (f), (g) and (h)	Minor updates to text.	Remove these obligations to produce a balance sheet and a cash flow statement for the Reported Business. It is a notional, mechanistic analysis. See paragraph 4.17 - 4.20.
USPAC 1.5.2 (a) and (b) (requirement for USO, non-USO and non-mails split of Reported Business)	Ofcom proposes to remove FRE level reporting from USPAC 1.5.	Remove USPAC 1.5.2 (a) and (b) - as well as the remainder of USPAC 1.5 which becomes redundant. Ofcom can produce the analysis of USO, non-USO and non-mails from the granular data file. See paragraphs 4.24 - 4.26.
RAG Table 6 Obligation in relation to USAPC 1.5.2 (b) (requirement for quarterly reporting of USO, non-USO and non-Mails)	Ofcom proposes minor update	Remove this section from the RAG in its entirety. Ofcom can generate this information from the granular data file. See paragraph 4.24 - 4.26.

Condition/Area	Ofcom consultation proposal	Royal Mail position
RAG – Section 8 Various paragraphs that set out requirements to provide notes to the annual regulatory accounts – 8.89, 8.97, 8.102, 8.103, 8.109, 8.110, 8.114, 8.117, 8.120 **RAG Table 4** Obligation in relation to USPAC 1.4.1 (e) – breakdown of fixed asset NBV	No change.	Remove the relevant paragraphs in Section 8. Remove the text below in Table 4 in relation to USPAC 1.4.1 (e) *Royal Mail shall provide a breakdown of the total fixed asset NBV allocated to the Reported Business as a whole, by main asset classes.* The notes do not provide relevant information for Ofcom or other stakeholders. See paragraph 4.21.
RAG Table 4 Obligation in relation to USPAC 1.4.1 (a) and (b) – PVEO and Cost Matrix	Ofcom requires the Cost Matrix to be produced quarterly and annually and PVEO to be produced on an annual basis.	Update the RAG to make it clear that the annual Cost Matrix and PVEO are not to be published. See paragraph 4.27.
RAG Table 5 Obligations in relation to quarterly reporting requirements of PPS level information to comply with USPAC 1.4.1 (j)	Ofcom proposes to remove the requirement for all PPS information, apart from PPS1, PPS2 and PPS23.	Remove PPS1, PPS2 and PPS23 are from this table – i.e. no PPSs are specified. We note that the requirement to publish PAF and Access remains in USPAC 1.4.7. See paragraph 4.22.
RAG Table 6 Obligation in relation to USPAC 1.5.2 (a). (requirement for annual reporting of USO, non-USO and non-Mails)	Ofcom proposes to amend the requirement for an annual end to end income statement to make it clear that this provides an income statement in respect of USO, non-USO and non-Mails.	Remove the following text *Figure 2, Appendix 1 (for statements to be delivered to OFCOM by USPAC1.5.10).* It removes a requirement for an annual statement that Ofcom can generate from the granular data file. See paragraph 4.23.
RAG Appendix 2 ("targeted separation" product list)	Ofcom proposes a full list of products sold by Royal Mail reported within PPS3, PPS4 and PPS8. Ofcom has invited feedback.	We consider the relevant product set to be the D+2 and later bulk mail letters and large letters services. Our list of the relevant products is set out in Annex 6. See paragraph 4.6 - 4.8.

Chapter 5 – Cost data and change control

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

Ofcom is proposing to amend the cost and data reporting obligations on Royal Mail. Ofcom's proposal for a new granular data file provided on a quarterly basis is too detailed and subject to seasonality. Instead we propose Ofcom relies on annual data with the granular detail only for the "targeted separation" product set. This information, alongside the other reports, provides Ofcom with proportionate, relevant, reliable and transparent regulatory financial information. We also propose an alternative approach for change control modelling that provides Ofcom with a new combined file that provides the combined impact of changes on a consistent basis.

Ofcom proposes that Royal Mail provides a detailed granular data file of revenue, cost and volume information on a quarterly basis. In our view, the new granular data file will not provide Ofcom what it needs – relevant, reliable information:

- **Quarterly data is volatile and our results are seasonal.** Annual data avoids seasonality and will be more robust. It would be more appropriate to interrogate annual data than quarterly.
- **The data provided will be excessively detailed – ✂ products**. It is significantly below the level of materiality for internal management review. Our costing system relies upon sampling and other statistical techniques that are less robust the more disaggregated the analysis.
- **The management accounts provide information at the right level for review and commentary**. There is a risk that detailed analysis of this granular data "clutter" will miss genuine business insight.

Ofcom should only target its activity where action is needed. For example, Ofcom does not need the granular data file for margin squeeze purposes and to support competition in the postal market[79] for all products – it only needs this information for the "targeted separation" product set. Instead of requiring us to provide this granular file on a quarterly file, Ofcom could and should instead rely on the following information:

- voluntary provision of the monthly management accounts. This is discussed in our response to Chapter 4;
- quarterly provision of the reported business results. This will provide a regular update of our financial sustainability;
- annual provision of short SPHCC level "targeted separation" data, with product profitability reporting at a product scorecard[80] level. This information enables Ofcom to review profitability at a product category level;
- annual provision of cost and volume information for Ofcom's Cost Allocation Model.

Ofcom's proposal for new change control reports could be a significant new regulatory burden. Based on our current understanding of Ofcom's proposals, we would have to run a separate model. This would be ring-fenced from our 'live' model to enable us to model the combined effect of all individual method changes. Instead, we propose that Ofcom should **amend the existing change control process to provide analysis on changes using a previous quarters[81] results.**

The materiality level of methodology changes for change control notification should be increased to a more proportionate level. We propose £1m and 5% impact on products and activities – rather than £0.5m and 1% impact. The impact should be measured at the line item affected (such as revenue, cost) and not on calculated figures (e.g. profit).

[79] The Consultation, Table 4.5 Monitoring competition.
[80] Product scorecard level is a grouping of products into ✂ major product groups.
[81] In some circumstances, it may be more appropriate to provide the analysis on a prior full year view.

Ofcom's proposal for a new granular data file will not meet Ofcom's purposes. Quarterly results are more volatile than annual. The data file is too granular. Ofcom is asking for a file that will provide an artificial sense of accuracy.

Ofcom does not need a granular data file to fulfil its statutory obligations.

5.1 In Table 4.4, Ofcom explains that one of the reasons it wants more granular information is to understand the key performance drivers that underlie the results of the Reported Business. In performing its duties, Ofcom must have regard to the need for the provision of a universal postal service to be financially sustainable. The financial sustainability of the Universal Service is measured at the Reported Business level.

5.2 **However Ofcom does not need the granular data file – it will receive our monthly management accounts.** As explained below, the granular data file will contain ✂ short SPHCC products. It will not have commentary. It will not report information in a way that is recognised by senior managers within Royal Mail. We do not believe that this will give Ofcom the insight it needs. Instead, for insight into the commercial performance of Royal Mail, Ofcom should use our management accounts. ✂.[82] To augment our monthly accounts information, we propose that Ofcom requests quarterly product information at a product scorecard level ✂. Should Ofcom require further detail, it can request it. This set of product reporting will provide Ofcom with the insight it needs to understand the key performance drivers.

5.3 In Table 4.5, Ofcom explains that the additional granular information is required for margin squeeze assessment and "*to support competition in the postal market*".

- **Margin Squeeze** - we recognise Ofcom may find it helpful to have granular detail on the "targeted separation" product set. However, Ofcom does not need this granular detail on all products – only the "targeted separation" product set. It is this set of products that are subject to upstream competition – see Chapter 4.
- **Support competition in the postal market** – we do not agree that provision of a granular data file - of c. ✂ products - is necessary or proportionate for general oversight of competition in the postal sector. Should Ofcom have questions on the nature of competition for particular product groups, Ofcom can review the following data:
  - » monthly management accounts - the management accounts provide ✂; and
  - » annual "targeted separation" product set reporting at short SPHCC level and annual scorecard level reporting across all products. The scorecard level can be sensibly reviewed as opposed to a quarterly review of ✂ short SPHCCs.

The proposed data file is not proportionate. It is not a targeted request. In our view, this request for all short SPHCC level information is contrary to Ofcom's guiding principles that regulation should be proportionate and targeted.

5.4 The introduction of Section 7 of the Ofcom Consultation explains that our reporting framework includes a number of transparency requirements. Transparency is a principle from the Communication Act 2003 under which Ofcom is required to perform its regulatory activities. The other principles include accountability, proportionality, consistency and regulatory action being targeted at cases only where action is needed. It follows that Ofcom's requests for regulatory financial reporting should be targeted and justified.

5.5 Ofcom justifies the request for the new granular data file on the basis that it is to enable Ofcom to monitor competition. Ofcom can produce product group analysis for "*upstream competition and other competition*

[82] ✂.

concerns".[83] We are unaware of any upstream competition concerns. We comply with competition law and Ofcom's margin squeeze test (USPA 6). We propose to provide relevant detail – as set out by Ofcom in Figure 11 - for the "targeted separation" product set. It does not follow that Ofcom needs all the short SPHCC level product reporting. Ofcom can ask for specific data on a "case by case" basis if it needs it.

Ofcom's proposed data file is too granular. The file provides information significantly below the level of its own materiality.

5.6 Ofcom's proposal for a new quarterly detailed data file will generate information which is at far too granular a level. The format of this file is set out in Figure 11 of the RAG. It requires detailed revenue, cost and volume information by short SPHCC for the current year and prior year.

5.7 **We estimate that the new granular data file will contain ✂ products – we do not report nor review at this level**. Short SPHCC is not the level at which we review our product profitability. ✂. This level of detail enables us to understand how the market is evolving. Ofcom should start its quarterly analysis at this level. It is the level at which we can provide management insight on the back of our existing review of our performance. Should Ofcom require further information below scorecard level – due to a question or observation – Ofcom can request this. This will provide greater transparency, as we will also be able to provide sector insight.

5.8 **We do not review our results at short SPHCC level - it is not proportionate**. Hence the detailed information in the granular data file may not be reliable. We have a targeted approach that reviews key products, such as USPA 6 products. However, at this level of disaggregation, more than ✂ of the products have a volume of less than ✂ items (✂[84] of Reported Business volumes) and generate less than ✂ of revenue per annum (✂[85] of our Reported Business revenue). At this detailed level, any analysis would be of limited value and the identification of material movements would be unnecessarily complicated due to the volume of data. It would therefore need to be aggregated up into product groups or aligned with other existing internal reports in order for us to provide any meaningful insight.

5.9 We make informed assumptions in how we attribute costs to activities and activities to product. It is not an exact science. **Our costing system relies upon sampling and other statistical techniques to generate activity and product costs**. Reviewing at a short SPHCC level is taking the analysis down to a level which we do not consider is appropriate or relevant.

5.10 **We consider Ofcom's proposal as one that provides an artificial level of transparency**. We will calculate the results at the very granular level and aggregate to product level for review. We review and assure ourselves of the robustness of data at a product group level. Ofcom may take an artificial level of assurance that it is meeting its transparency principle by relying on short SPHCC data, but this data has not been reviewed at this detailed granular level. Ofcom will get a better level of assurance by relying on data that has been subject to management review – such as our management accounts or scorecard level product reporting. It is not clear to us what level of assurance Ofcom expects from this data. **One of the key attributes of effective regulatory financial information is reliability. This decreases the more disaggregated the data becomes.**

[83] Ofcom Consultation, Table 4.5.
[84] ✂.
[85] ✂.

Analysis of this detail by Ofcom risks drawing extraneous conclusions from volatile and detailed quarterly data. This detail has not – and will not have – been reviewed at that level by Royal Mail management.

5.11 Ofcom is a professional and experienced regulator with significant knowledge of the postal industry and experience of managing large volumes of data. The real message of our underlying commercial performance can be found in our management accounts. There is a risk that our business insight will be missed - obscured by detailed analysis of this data "clutter".

5.12 **There is a risk that Ofcom could draw erroneous conclusions from the data.** While we are confident the results are appropriate when consolidated, we do not evaluate all ✂ short SPHCC. We review our product profitability at a consolidated level. Within our regulatory financial accounts, we review product profitability at Product Profitability Schedule level (25 product groups). We review our internal product profitability at scorecard level (✂). This level of aggregation represents an appropriate level at which our financial information should be reviewed.

5.13 Furthermore, Ofcom may require Royal Mail to provide insight upon any analysis Ofcom has performed. We will not be able to do so without expending considerable time and resource. As we do not review our regulatory results at short SPHCC level, we do not have existing management reports to rely upon. This would not be proportionate. Instead, it is appropriate that Ofcom asks for insight upon product groups – such as our scorecard level reporting.

Quarterly data is inherently more volatile than annual. It may not show meaningful trends.

5.14 Our business has a noticeable seasonal profile. **We sell more of our products and generate significantly more revenue in quarter three than in the other quarters**. In part, this is why we have a Christmas period exemption in relation to our quality of service to reflect the marked increase in volumes. The timing and scale of discretionary expenditure can vary significantly over the year. We are concerned that Ofcom may use our quarterly information to discern trends. The seasonality of the data may make the analysis meaningless.

5.15 Annual data avoids seasonality issues. We already provide Ofcom with a detailed annual submission of cost information for Ofcom's Cost Allocation Model. We propose that we amend this annual submission to include any further information required. We propose that any detailed assessment is only performed on an annual basis to avoid seasonality issues.

There are some practical considerations in the lay-out of Ofcom's data file (Figure 11 of the RAG).

5.16 Notwithstanding our concerns that Ofcom's proposed data file is too granular, if Ofcom nevertheless insists that we provide this information, we would request that the following changes are made:

- Figure 11 is amended to set out product information in rows as opposed to columns. It will greatly help with filtering and other standard spreadsheet analysis.
- Royal Mail has flexibility in how this information is provided. We may want to amend the format slightly to take account of how our systems can produce the information. For example, Figure 11 combines revenue, cost and volume reporting with reporting of the information required for "targeted separation" (see Question 1). It may be significantly easier to provide the information required for "targeted separation" as a separate report.

Ofcom's proposal for new change control information is unnecessary. We believe we can provide Ofcom with the information it needs using the existing change control reports.

5.17 Ofcom proposes that we provide additional information for monitoring of changes made to our attributions.[86]

- We are required to show the impact on quarterly income statement for Reported Business, Universal Service and non-Universal Service products. It is to be "*restated as if the changes in the accounting or cost methodology in the previous quarters of the financial year had not been made*".
- We are required to show the impact at individual SPHCC level "*combined impact of all the changes made in the accounting and costing methodology in the previous quarters of the financial year on the costs and revenues of all affected Short SPHCCs*".

5.18 Our understanding is that Ofcom's proposal is for the **combined effect** of all material changes to be provided at short SPHCC level on a **previous quarter's results.**

We do not consider a combined impact assessment to be practical or proportionate. It will consume considerable resources.

5.19 In order to provide the analysis that Ofcom requires, we will have to increase the resourcing and undertake new processes. We would have to create a new "run" of our ABC model that would combine all changes made in that quarter. Our initial assessment is that this could take considerably more time to implement than individual changes.

5.20 An individual change may require a series of changes to static reference tables and other information. The impact analysis will be relatively simple to work through – the impact of the change can only be due to the one change.

5.21 Running all the changes together will almost certainly require overlapping changes on the same information which will need to be worked through. It may require the same table to be updated multiple times for each change. In addition, the analytical review of the outputs will be more complex. Should there be a large impact on a given product set, it will be significantly harder to work out which of the several changes led to that effect.

5.22 **In total, the time spent to produce the combined schedule could take as much time as running all the individual changes – or longer.**

We propose that we provide a new table that adds together the impact of changes in a given quarter. Ofcom can use this information to provide insight on the combined impact of the changes.

5.23 We have identified an alternative option for change control modelling that we believe will meet Ofcom's aims. We propose that we submit with our quarterly change control a new table that adds together all of the impacts of changes in that quarter. It would not show the impact of changes on changes – where a change has a 'knock-on' impact on another change. Nevertheless, it will give Ofcom a very good insight as to what the impact of that change would be. In order that this new table would be helpful to Ofcom, it would need to be modelled on a consistent previous quarter. Currently, our change control submissions are typically modelled on different months or quarters. Our proposal is that we would submit:

- For each material change, the Table A impact of the change against **a consistent quarter**.

[86] The Consultation, para 7.12 b i and 7.12 b ii. See RAG, Appendix 3, Table C and Figure 2 for the formats.

   » Depending on the change, it may not be the most recent quarter. For example, it may be more appropriate to show the impact of changes made in quarter two against the prior year results than against the quarter one results.

- A new table that adds together the impact of all the changes at short SPHCC level. As all the individual impacts were calculated on the same quarter, the results are consistent. It means that there is no need for Royal Mail to provide the combined effect on the Reported Business quarterly income statements as Ofcom can generate it themselves.

Further comments

5.24 Table A has been amended to make it clear that an analysis of activity costs is required as part of the change control process. We do not consider that this is useful for Ofcom's purposes of assessing the impact of methodology changes at a product level - short SPHCC level (or scorecard level should Ofcom adopt our proposal). An analysis of activity impacts is a different analysis of the same cost data. It does not add to a product-based comparison. We propose that Ofcom removes this new requirement.

5.25 Ofcom has retained Table B in the RAG. This relates to changes in the Income, Capital Employed and Cash Flow statement that are caused by changes in the Accounting Methodology Manual. This template is not practical – ✂. We understand Ofcom's purpose is to assess the impact of methodology changes at a product level. Table B does not do so- Table A does. Ofcom should remove Table B and require that all changes to our methods (whether in the costing manual or accounting methodology manual) should be reported to Ofcom using Table A.

5.26 We note that:

- Ofcom's format for short SPHCC reporting (Table C of Appendix 3) has a comments column. For the avoidance of doubt, we do not consider that it will be possible or practical to provide comments on ✂ different products.
- Ofcom's change control is intended to capture changes in methodology. We also make transactional changes to our data, e.g. to use latest Mail Characteristic Survey data. We do not consider such transactional changes to be methodology changes. There is no change to methodology – the data has changed year on year. As such, transactional changes are out of scope of change control reporting for methodology changes.

There are a number of other points that Ofcom has not addressed. These need to be considered as part of this review – such as materiality.

5.27 Ofcom's materiality thresholds are set in the RAG.[87] We repeat Ofcom's summary from (Ofcom Consultation, Para 7.9) –

- a [cost] change of over 1% and £0.5m in any product or activity in our ABC system; or
- a change of 5% in any other item (including revenues, costs, assets, liabilities and cash flows) in any of Royal Mail's regulatory accounts.

5.28 The change control materiality is a very low threshold and onerous to comply with. We share all our costing methodology changes with Ofcom. We note that the equivalent guidance for BT's change control change is:

- "***Change control materiality*** *- A change in any element of the Regulatory Financial Reporting is material if the resultant percentage change (be it positive or negative) in any figure in the Regulatory*

[87] Ofcom, Regulatory Accounting Guidelines, January 2014, para 2.1f.

Financial Statements exceeds the higher of 5% or £1 million. The resultant percentage change in a figure shall be calculated by taking the value of the affected figure before the change in the Regulatory Financial Reporting is applied, and subtracting from it, the value of the same figure after the change in the Regulatory Financial Reporting is applied, and then dividing this result by the former value."[88]

5.29 We propose that Ofcom amends the guidance in the RAG to reflect a more appropriate level of materiality. The suggested drafting is set out in the proposed amendments table below.

5.30 We note that the Consultation outlines a material change as a change of 5% in any item (including revenues, costs, assets, liabilities and cash flows) in any of Royal Mail's regulatory accounts. Ofcom does not list profit. We agree. Due to our low margins, the impact on profit will be magnified in percentage terms but be the same in absolute terms. We consider materiality should be assessed at the line item affected. ✂. We propose that the wording should be changed to remove cash flow and balance sheet as we do not produce this on a quarterly basis.

[88] Ofcom, Directions for Regulatory Reporting, 30 March 2015, para 7.20.

Proposed amendments

5.31 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
RAG – Figure 11 (requirement for detailed product information)	Ofcom proposes this new schedule that requires revenue, cost (people, non-people and depreciation) and volume by short SPHCC. It also proposes for the "targeted separation" product set that further information is provided – transfer price, upstream / downstream costs.	Provide this information at short SPHCC level for the "targeted separation" alone. Provide the revenue, cost (people, non-people and depreciation) and volume by product scorecard level. Allow for flexibility in how this information is provided. See paragraphs 5.1 - 5.16.
RAG – Appendix 3 Table A	Ofcom confirms that activity detail is required.	Remove activity detail as it is not required for product level analysis. See paragraph 5.24.
RAG Appendix 3 Table B	No change.	Remove Table B. Instead, all changes to the costing manual and accounting methodology manual use Table A in line with current practice. See paragraph 5.25.
RAG – Appendix 3 Table C	Ofcom proposes amendments to Appendix 3 of the RAG that require two new change control reports. Ofcom has set out a template in Table C.	Remove the following proposed wording. "(c) in relation to the combined effect of all the material changes to the Costing Manual and the Accounting Methodology Manual on Short SPHCCs, use the pro forma set out in Table C of this Appendix 3; and (d) in relation to the combined effect of all the material changes to the Costing Manual and the Accounting Methodology Manual on the Reported Business quarterly income statements, use the pro forma set out in Figure 2 of Appendix 1 of these Guidelines." Create a new version of Table A that sums all the changes in a quarter. See paragraph 5.17 - 5.23.

Condition/Area	Ofcom consultation proposal	Royal Mail position
RAG – Section 2.1f (This sets out the materiality level for change control)	No change.	Amend this section of the RAG with the changes below. "for the purposes of the National Costing Methodology and the Zonal Costing Methodology only, a change in any reported item of product cost, SPHCC cost, or Activity Cost shall be deemed to be material if the resultant percentage difference (be it positive or negative) exceeds the higher of 5% or £1 million ~~1%, unless the change itself is smaller than £0.5 million~~. The resultant percentage difference shall be calculated by reference to the Compliance Base Value;" See paragraph 5.27 - 5.30.

Chapter 6 – Reporting deadlines

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

Ofcom has set out a new reporting timetable. We broadly agree. However, we would propose two main amendments. Ofcom's quarterly reporting deadline needs to be set after our statutory results are published. We propose 54 days. The reporting timetable for Business Plan information needs to take account of when information has been approved by our Board. We propose that the information is delivered in two phases.

We have two main issues with Ofcom's proposals. Firstly, **Ofcom's quarterly reporting deadline of 45 days after period end is not workable or proportionate**.

- **Our statutory UKPIL results for Period 6 and Period 12 are not approved until c53 days after period end**. Until UKPIL is approved, the Reported Business numbers would be in draft. In draft form, this information would not be reliable[89] or relevant for Ofcom's monitoring purposes. The reporting deadline should be after our statutory results have been published.
- By accelerating the Quarterly Regulatory Accounts and granular data file in advance of our statutory accounts, **we will be exposed to the leak of strictly confidential and highly sensitive information**.
- Ofcom has asked that it is briefed on changes after it has received our 'draft' results. **It is not proportionate when Ofcom can wait 9 days (7 working days) – it is extra work for limited benefit**. This additional work could be avoided if Ofcom receives the information after our statutory result publication.
- **Ofcom's proposals to simplify reporting (e.g. replacing accounting separation with "targeted separation") does not remove 15 days from the timetable** – at best it saves around three days. Accelerating the timescales reduces the time available for management scrutiny.

Instead, we propose a more proportionate timeline that balances Ofcom's requirement to receive the information sooner with our statutory reporting deadlines. We propose that quarterly information should be provided 54 days after period end. This accelerates the current timetable by six days. We consider this to be stretching but proportionate, taking account of Ofcom's proposed simplifications.

Secondly, **the Business Plan reporting deadlines need to take account of when the information has been prepared, reviewed and approved**. We propose a two phase drop of information:

- **Phase i: Before the start of the financial year (subject to the approval of the Royal Mail Board)** – submission of the Relevant Group and Reported Business Budget and Business Plan. It will include the Financeability EBIT margin, main assumptions and key drivers, Cost Matrix, a plan on plan impact and reconciliation to UKPIL and Relevant Group. Ofcom has asked for actual results for some of this information. As we are required to provide this in advance of finalising the actual results for the year before the budget year, we will provide a forecast or outlook for that year.
- **Phase ii: 92 days after the start of the year** – the financial health metrics, actual Financeability EBIT margin, actual Cost Matrix, PVEO (built on the actual Cost Matrix), the productivity and workload schedules, headcount metrics[90], detailed volume and revenue in V4 format (once detailed budgets have been input).

We note that Ofcom proposes to accelerate the timescale of the annual regulatory accounts to 90 days after the period end. This is a Saturday. We propose the submission date should be moved to the next working day. Accordingly, the timeline needs to be 92 days after period end. Alternatively, we propose that Ofcom considers setting the deadlines in relation to working days after period end to address this issue.

[89] We have defined these terms in our executive summary.
[90] The headcount metrics (headcount and FTE) are only produced for the Budget year. This is explained in our response to Question 2.

We do not consider the reporting deadlines for the Quarterly Regulatory Accounts and Quarterly granular data submission are practical or proportionate.

6.1 Ofcom proposes to accelerate the reporting deadlines for the Quarterly Regulatory Accounts from 60 days to 45 days. Ofcom proposes the same deadline for the quarterly granular data submissions. Ofcom's justification is that it has reduced its requirements so the timetable can be reduced, and Ofcom's desire for more timely information. We recognise the importance of timely information – we need to also make sure that the information is accurate, reliable and complete. The acceleration proposed by Ofcom is neither practical nor appropriate.

6.2 Had Ofcom's proposal applied for 2016-17 year-end, we would have needed to provide the Quarterly Regulatory Accounts 45 days later on 10 May 2017. There were six week-ends, two bank holidays for Easter and the early May bank holiday. **There were only 30 working days to produce this information**. It can take twenty working days (or more) to produce the first iteration of our Quarterly Regulatory Accounts. Ofcom's proposal means that we would have typically have ten working days (or less) to produce, review, update and approve the regulatory accounts. The final run of the costing system needs to wait for the main ledgers to close. For 2016-17, the main ledgers closed on ✂. Ofcom's proposal does not give Royal Mail enough time to produce the required information.

6.3 **We propose that the Quarterly Regulatory Accounts and granular data submission are delivered 54 days after period end.** It takes account of Ofcom's simplification and allows sufficient time for our statutory results to be completed (a key input) and for our regulatory accounting system to be run, results produced, reviewed and approved.

6.4 Ofcom asserts that stakeholders would value more timely information. We consider that our proposal strikes the right balance between timeliness, accuracy and proportionality.

UKPIL statutory results are approved typically around 53 days after period end. Once they are approved, our Quarterly Regulatory Accounts are approved. Any information provided before this would be in draft.

6.5 **Ofcom's proposal is for Royal Mail to provide a set of regulatory financial accounts in advance of Board approval of our statutory annual report and accounts.** This will require us to provide draft information. Ofcom needs to take account of our statutory reporting timelines. We are subject to legislation and regulation that determines our statutory reporting timelines and we publish our audited statutory accounts in line with these obligations as follows:

- **Companies Act 2006 (the Act)**: as a public company, we have to file our accounts with Companies House within six months after the end of our financial year, being the last Sunday in March. Our annual report and accounts are presented to our shareholders at our Annual General Meeting (AGM) for approval and, cannot be filed before shareholder approval has been obtained (see sections 411, 437, 441 and 442 of the Act). The final report and accounts is made available to shareholders at the same time as the Notice of AGM which must be communicated with shareholders at least 21 days in advance of the meeting.

- **Disclosure Guidance and Transparency Rules (DTR) issued by the FCA**[91]: as a UK listed company we must make public our annual report and accounts within four months from the end of our financial year. (See DTR section 4.1.3).

6.6 The quarterly regulatory financial submissions are based on our management accounting data for UKPIL. The statutory UKPIL results can vary right up until the results are approved for publication. We approve and

[91] Financial Conduct Authority.

publish our results typically 53 days after period end. Once the UKPIL results have been approved, then the inputs into the Reported Business results are approved. Until this occurs, our Quarterly Regulatory Accounts are in draft. In addition to the approval of the inputs, the Quarterly Regulatory Accounts go through a rigorous review and approval process. **We can only approve the Quarterly Regulatory Accounts once the UKPIL results have been approved by the Board.**

6.7 We have set out in the executive summary the four attributes for an effective regulatory financial reporting framework. We consider information must be reliable and relevant (i.e. answer the right question). Draft information is clearly not reliable. It may not be correct and therefore not relevant for Ofcom's monitoring purposes.

By accelerating the Quarterly Regulatory Accounts and granular data file in advance of our statutory accounts, the risk of the leak of strictly confidential and highly sensitive information is increased.

6.8 The Quarterly Regulatory Accounts report the revenue, costs and profit of the Reported Business. This regulatory entity contains the vast majority of the activities of UKPIL. It is therefore possible to infer the UKPIL performance from our Quarterly Regulatory Accounts. The UKPIL performance is clearly of high interest to our shareholders; we disclose it to the market as a whole via stock market announcements as part of our statutory reporting obligations. In this way, we comply with one of the underlying principles of the Listing Rules (to which we are subject as a listed company) to treat our shareholders equally. The accidental release or leak of the quarterly regulatory financial results in advance of our statutory reporting could – amongst other implications – breach our obligation to treat shareholders equally and, more broadly, undermine investor confidence in Royal Mail and in the credibility of Royal Mail management.

6.9 In addition, it is possible that elements of our Quarterly Regulatory Accounts constitute inside information. In those cases, the relevant inside information will be subject to very tight controls and, prior to it being announced, we would be obliged under the Disclosure Guidance and Transparency Rules to keep that information strictly confidential.

6.10 We do not consider the additional risk of widening the circulation of our commercial information as appropriate or proportionate as it increases the risks for both organisations. **Submitting our information on day 54 not day 45 would avoid a great deal of unnecessary risk – it means Ofcom would wait for 9 days (or 7 working days)**. Ofcom receives our monthly management accounts so has access to timely information about our business performance.

6.11 Ofcom is a professional regulator covering several industry sectors and regularly receives or generates highly commercially sensitive information. We recognise that Ofcom – like Royal Mail – will take the necessary steps to minimise the risk associated with holding such information. However, there is significant risk associated with the disclosure of this information in advance of our statutory publication, including potential breaches of our obligations as a listed company. The more people who have access to our regulatory results in advance of statutory results publication, the more risk. We consider our proposal to provide information on day 54 is an appropriate risk reduction strategy in these circumstances.

Ofcom asks for any changes after it has received the Regulatory Accounts and before publication is briefed to them. This is not a proportionate ask.

6.12 Ofcom asks that we inform it of any changes between issuing the Regulatory Accounts to Ofcom and the publication of the full year or half year data - "*we expect Royal Mail to provide us with information about the* *material changes that have been made and their impact on the key metrics included in the quarterly reports, such as Financeability EBIT [margin] and productivity figures.*"[92]

6.13 **This update is additional work that could be avoided if Ofcom received the information after our statutory result publication.** Our auditors can require (and we can identify) changes to be made to the accounts up to the date that they are published. This year, our financial results for the period ended 26 March 2017 were published on 18 May 2017 – 53 days after period end. There are eight days between Ofcom's proposed deadline and the results announcement.

6.14 In practice, we would expect our results to have been finalised in advance of publication. However, it remains possible there could be a late change[93]. This late change could be too late to incorporate in a submission due 45 days after period end, but could be included 54 days after period end, which is our proposed timetable. The extra seven working days would avoid this unnecessary work.

Ofcom's simplification proposals do not significantly reduce process time. Ofcom has increased the complexity of some of the submissions. We propose 54 days from period end for the submission.

6.15 Ofcom explains that its proposals to reduce and simplify the process "*considerably reduce the time and effort Royal Mail needs for the preparation of the regulatory accounts*". It does not.

6.16 The removal of some of the accounting separation requirements and the production of FRE and most PPS level information will save some time. This will primarily be in the review of the results, but not in their production. As part of our finance transformation, we have invested time and resource in the production of standard reports to meet the regulatory requirements. Most of these schedules are now produced by standard reports from our systems. **We estimate that the time saved by Ofcom's proposals in the review of the quarterly reports is – at most – three days in our process.** The accelerated timetable proposes removing 15 days from the process. Ofcom's proposal simply reduces time for senior management review of this information. It increases the risk that the information that Ofcom receives will not have received the appropriate level of senior review and scrutiny due to the artificial and onerous time constraints.

6.17 Our results need to be internally reviewed, late changes made, master data files updated, reviewed and approved. The outputs need to be reconciled to other data, such as the UKPIL results. We are not confident that Ofcom's proposals will give us sufficient time to undertake all these activities to the standard required.

6.18 We consider that the information that was previously provided at 30 days[94] ✂. We propose that the quarterly information is all submitted at the same time to make sure that it is aligned and reconciled.

6.19 **Due to the need to reconcile across all the schedules, we propose that the timetable is aligned for the quarterly submissions at 54 days after period end.**

The acceleration of the annual regulatory accounts timetable is challenging. Nevertheless, we consider that it is possible.

6.20 Ofcom proposes to accelerate the delivery of this information from 120 days to 90 days after period end. The savings in time to which Ofcom refers above does not remove 30 days of effort from the process. We consider this acceleration to be challenging. Based on our understanding of the requirements, we believe that we can accelerate the timetable to meet this deadline. We note that this will significantly reduce the senior management review time for these schedules.

[92] Ofcom Consultation, para 8.16.
[93] As noted above, the main ledgers closed on ✂. This gave us enough time for a final run of the costing system. It would not have, had Ofcom's proposed deadlines applied for 2016-17.
[94] The revenue and volume information, cost metric information and RDT to workload bridge.

6.21 We note that Ofcom proposes to accelerate the timescale of the annual regulatory accounts to 90 days after the period end. Given our year end is always be on a Sunday, 90 days after will always be on a Saturday. **To move the submission date to the next working day, the timeline should be 92 days after period end.**

6.22 As an alternative, we propose that Ofcom considers setting the timetable in terms of working days. It will avoid the final delivery date for submissions being on a bank holiday or week-end.

2C Safeguard cap submission.

6.23 **Given our pricing track record and the ongoing competitiveness of the postal sector, we continue to believe that the 2C safeguard caps should be removed**. The competitive postal landscape – not regulation – already maintains strong downward pressure on prices. The safeguard caps are not in keeping with Ofcom's stated principle of only intervening where necessary. These caps could increase the risk to the financial sustainability of the Universal Service.

6.24 If Ofcom continues to require these caps to be maintained, then we understand that Ofcom's proposed changes on the 2c Safeguard cap submission will take effect for our financial year 2018-19. The 2017-18 submission is due under the previous conditions – three months after the 2017-18 year end. The 2017-18 submission would be due in June 2018. If we changed prices at the start of 2018-19, the 2018-19 submission would be due before June 2018. In the event that this occurs, we would accelerate the 2017-18 submission to provide both at the same time.

6.25 **We ask Ofcom to consult on the level of the 2c Safeguard cap early in 2018**. We need regulatory certainty for our commercial price setting. It is possible that our 2c stamp letter pricing will be constrained in 2019-20 by Ofcom's safeguard caps. There are other technical changes that we believe would make the safeguard cap more transparent (e.g. addressing parcel weight steps) and stable (e.g. using an average inflation rate instead of a single month inflation rate) that needs to be considered as part of this consultation.

Timelines for the voluntary submission of our monthly management accounts.

6.26 Our comment on the timeline for the submission of our management accounts is provided in Chapter four.

The Business Plan timelines do not work – there needs to be a phased delivery.

6.27 USPAC 1.3.4 requires the Business Plan information to be provided before the start of the financial year. Our current practice is to provide Ofcom with the information that has been approved by the Board and then – at a later date - to provide further information when it has been prepared and approved. Ofcom has not set out in the RAG a timetable for submission – it could be construed as requiring all the information Ofcom has required in advance of the budget year. This is not practical or proportionate - not all the information will have been prepared, reviewed or approved. We propose a two stage drop of information as set out below:

Phase i - we propose to provide Ofcom with the same information that we provide to our Board in advance of the budget year, once the Board has approved the Business Plan. This is in line with current practice.

6.28 It is possible to provide Ofcom with the materials that we have used with our Board to approve the (high-level) Budget and Business Plan. Our Board typically meets in the second half of March. This timing means that we can provide our Budget and Business Plan once approved. We propose that we provide – in advance of the financial year:

- The Relevant Group Budget and Business Plan at a summary level. It will include the main assumptions and key drivers and a plan on plan impact. The Business Plan will contain the income statement, the key balance sheet cost categories[95] and cash flow[96].
- The Reported Business Budget and Business Plan at a summary level, with a reconciliation to UKPIL and to the Relevant Group. The Reported Business Budget and Business Plan would also include:
  - » the Financeability EBIT margin on a historic basis and forecast basis. Note that the year before the budget year will not have been finalised by the time the Business Plan is provided. We will provide our latest forecast for that year. The actual historical results would be provided in the second drop once the results have been audited and published;
  - » the Cost Matrix on a historical basis and forecast basis. Like the Financeability EBIT margin, the year before the budget year will not have been finalised by the time the schedule is required to be provided. We will provide our latest forecast – note that we will not have a functional split of the people costs available at this time. The actual historic figure will be provided in the second drop once the results have been audited. We will provide the functional split in the second phase.

6.29 The above would address the requirements (a), (c), (e) – forecast only, (k) and (l) in the RAG to meet USPAC 1.3.1 (b) and USPAC 1.3.1 (c) reporting.

Phase ii - the remaining information relies upon data to be entered into our financial systems or audit or from further review by our finance team. It will take significant time after year end to provide aligned and reconciled data.

6.30 We propose that the remaining information (RAG requirements (a), (b), (d), (e) (actual Cost Matrix), and (f)) is provided once it has been prepared, reviewed and checked for internal consistency. We propose 92 days after Financial Year has started. This is to take account of the following:

- **Reported Business Income statement (RAG reconciliation requirement for (a)) –** the income statement for the Reported Business will only be finalised once audited.
- **Financial health metrics (RAG requirement (b)) –** these are calculated based on the audited actual financial results for the Relevant Group. These will not be completed until the annual results are published.
- **Revenue and volume information at V4 level (RAG requirement (d))** - we would provide the final Budget at v4 product level once the Budget has been finalised for Period 2 reporting. This will occur shortly before Period 2 reporting occurs, which is around 90 days after period end.
- **Cost Matrix (actuals) (RAG requirement (e))**. The historical cost years will need to align to the audited reported business results. The audited Cost Matrix is due 90[97] days after the period end.
- **The PVEO analysis (RAG requirement (f)) is built upon the (audited) historical Cost matrix.** The forecast PVEO uses the historical results as the opening cost base for the forecast PVEO calculation. Accordingly, we cannot provide the final approved PVEO until we have an approved (and audited) Cost Matrix. The audited Cost Matrix is due to be provided 90[97] days after the period end.

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[95] We do not need to forecast the complete balance sheet for business planning purposes – only those elements sufficient to enable a cash flow forecast.

[96] Ofcom requires the income statement, balance sheet and cash flow information for the Relevant Group to be provided with two years history. It will be provided by the publication of our annual results. Our submission will include the latest forecast for the year before the budget year.

[97] We propose that this is changed to 92 days after period end.

- **Productivity and workload - (RAG requirements (g), (h) and (i))** Ofcom has set out procedures to be followed in preparing the productivity and workload calculations to meet the USPAC 1.3.1 (b) and USPAC 1.3.1 (c) obligations. We do not need to do these for the Budget and Business Plan to be produced. The key finance activities at the start of the financial year are to finalise year-end reporting and to make sure that the finance systems and processes are set up and ready to report performance for the new year, starting from the end of Period 2.
- **Headcount metrics (RAG requirement (j)) –** Ofcom proposes that we provide headcount and FTE broken down between frontline, management and other staff. This will be available for the budget year alone. It is not ready by the time that our budget is approved.

Proposed amendments

6.31 The table below summarises our proposed changes to the timetable and deliverables. It is based upon Table 8.1 from the Consultation.

Submissions	Current deadline	Ofcom proposed deadline Royal Mail proposal in red
Annual regulatory accounts Including income statement, statement of capital employed, and cash flow statement of Reported Business; reconciliation of Relevant Group accounts to Reported Business accounts; PPSs (proposed to be access and PAF only); and accompanying notes proposed to include Cost Matrix and PVEO Analysis.	120 days after Financial Yr end	90 [92] days after Financial Year end
Annual cost and volume input and output data at SPHCC level	120 days after Financial Yr end	90 [92] days after Financial Year end
Quarterly regulatory accounts Including income statement of Reported Business; PPSs (proposed to be access and PAF only); and accompanying notes proposed to include Cost Matrix	60 days after Financial Quarter end	45 [54] days after Financial Quarter end
Quarterly revenue and volume report Currently required monthly	30 days after Financial Month end	45 [54] days after Financial Quarter end
Quarterly cost metrics report Including RDT to workload bridge, currently required monthly	30 days after Financial Month end	45 [54] days after Financial Quarter end
Quarterly revenue, volume and cost granular data submission[98] Currently only granular volume and cost data required quarterly	60 days after Financial Quarter end	45 [54] days after Financial Quarter end
Second Class safeguard caps submission	Three months after the end of the year to which the cap is applied	One month after the implementation of any new prices

98 Note that in our response to Question 4, we propose that the quarterly granular data file is replaced by an annual submission at short SPHCC level for the "targeted separation" products and an annual submission at the product scorecard level reporting.

Submissions	Current deadline	Ofcom proposed deadline Royal Mail proposal in red
Budget and Business Plan submissions (phase i) Relevant Group and Reported Budget and Business Plan. It will include the • Financeability EBIT margin (year before budget on forecast basis) • main assumptions and key drivers • Cost Matrix (year before budget on forecast basis without functional split of people cost) • a plan on plan impact • reconciliation to UKPIL and Relevant Group.	-	Before the start of the budget year (in line with USPAC 1.3.4) subject to Board approval.
Budget and Business Plan submissions (phase ii) • financial health metrics (year before budget updated to audited actual results) • Productivity and workload schedules • Cost Matrix (year before budget updated to audited actual results. Functional split of people cost provided for budget year.) • PVEO (built on the actual Cost Matrix), • headcount metrics (only for the budget year) • Financeability EBIT margin (year before budget updated to audited basis) • Detailed volume and revenue in V4 format	-	92 days after start of financial year subject to Board approval.

Annex 1 – Detailed technical and clarification points on USPA 6 methodology

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

Direct versus indirect costs

Royal Mail is disappointed that Ofcom has decided it has not seen sufficient evidence to move from the USPA 6 methodology (Indirect costs) to using costs taken directly from Royal Mail's costing system (Direct Costs).

A.1 Royal Mail has previously proposed an alternative approach to the calculation of relevant upstream costs which Ofcom refer to in its consultation document as "the Direct Method". This involves adding up the costs of the upstream activities (mainly collections, sortation at RDCs and transportation to the inward mail centres) of the products subject to the margin squeeze tests and then subtracting any wholesale specific costs. Given the previous engagement on this subject, **Royal Mail is disappointed that Ofcom has stated it does not consider there to be sufficient evidence to adopt the "Direct Method" rather the 'Indirect Method'[99] currently used**.

A.2 Royal Mail believes USPA 6 costs should reflect operational reality, as reflected by the Direct method. Direct method costs are audited, consistent with Regulatory Accounts, and the business's best estimate of product level upstream costs. The Indirect method creates anomalies which distort upstream costs, with no methodological or economic justification given the objectives of USPA 6.

Royal Mail has undertaken significant work to get the two methodologies closer, but this has come at considerable expense in terms of complexity and resource. This significantly increases the regulatory burden.

A.3 Although indirect costs now align more closely to the direct ones, correcting past anomalies has resulted in significant increased complexity and placed a substantial resource burden on Royal Mail. For example, aligning the proportions of mechanised and manual mail in retail and access has resulted in the number of product codes doubling from ✂.

A.4 **We have previously illustrated to Ofcom that on a product and aggregate basis, the gap between the two methodologies has narrowed over time due to the detailed refinements we have made to the USPA 6 model.** In our latest 2017-18 forecast the two methodologies align closely. At an aggregate level the two methodologies are within ✂.

A.5 While these differences can be removed through further methodological refinements, this would come with significant resource expense and add to the complexity of the USPA 6 model. **With greater complexity, transparency is reduced, the risk of error increases, and the costs of mitigating those risks rises.** This cannot reflect regulatory best practice.

A.6 **A further benefit to using Direct costs is that it improves the transparency and ownership of the costs.** The accounts are audited and financial statements prepared in accordance with USP Accounting Condition (USPAC) and the Regulatory Accounting Guidelines (RAG). Under USPAC (1.7.1) Royal Mail must ensure that financial statements comply with the 'Guiding Principles'. These accounts are also independently

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[99] So called because it calculates relevant upstream costs by subtracting access costs from end-to-end retail costs.

audited. The Indirect approach moves ownership of the cost figures away from their appropriate place within the business, further increasing the risk of error and resource required to review and clear results. Finance are responsible for producing the direct costs and are best placed to understand and explain any significant movements in cost. However, this is not so easy to identify after the indirect methodology has been applied since it is unclear whether cost movements are due to the USPA 6 methodology or underlying cost changes. Use of direct costs makes the accountability clearer.

A.7 **Moving to the direct method will have limited impact on the USPA 6 assessment at a product and aggregate level.** There is not a strong commercial incentive motivating this request. The driving force behind this request is to:

- Reduce the regulatory burden associated with USPA 6 (on an upfront and ongoing basis);
- Reduce complexity and risk of error;
- Align USPA 6 with Royal Mail's audited, reported and best assessment of upstream costs

A.8 We have queried with Ofcom the information it thought was missing in rejecting our proposal to use Direct costs. We are providing additional information in this response to address that. One of the reasons put forward by Ofcom was that there were significant differences between the downstream costs allocated to some retail bulk products and the costs of their equivalent access products. Much of the difference can be explained by legitimate differences in the average profile of retail and access mail. 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.

In some cases the Indirect method better meets the equivalence aims of USPA 6. However, adjustments can be incorporated into direct costs with the added advantages this methodology brings.

A.9 We have undertaken significant detailed forensic investigation to understand why the two methods produce different results. We have identified six areas of pipeline cost which might differ between access and retail products, and therefore result in different costs under the two methodologies. In some cases, we believe the Indirect methodology does better reflect the equivalence aims of the USPA 6 condition. However the same benefits of the Indirect method can be achieved with similar adjustments to the Direct method (with the added advantages this methodology also brings). We set out our thinking on this in the table below:

Figure A.1 – Pipeline cost difference between methodologies

✂

A.10 Two of the identified differences reflect areas where the indirect methodology provides a cost metric more representative of an upstream competitors upstream cost – hence more suited to USPA 6 given the aims of the condition. However these factors could be adjusted for under the direct cost methodology with the added benefits this methodology brings.

A.11 We believe there are economic grounds for making adjustments for ✂. Our estimate is that adjusting for ✂ would equate to approximately ✂[100] reduction in upstream costs for a letter. However, we think the added complexity and reduction in transparency of this outweighs the relatively small reduction in upstream cost that would be observed. **We would not therefore propose to make an equivalence adjustment for these two costs. In the interests of proportionality and transparency, we would not propose these adjustments are made.**

[100] Source: Royal Mail internal analysis.

Regardless of whether Ofcom choose to maintain the Indirect cost method or move to the Direct cost method, there is now a case for adjusting the methodology to exclude general overheads and include returns.

A.12 In paragraph 9.9, Ofcom refers to the cost standard as being based on FAC excluding general overheads but including returns. Ofcom first raised this issue in 2011 as part of its review of Royal Mail's regulatory framework but concluded that as the overheads and returns were likely to cancel each other out it was not necessary to make that adjustment. In 2012 our assumed return was 5-10% and we were seeking to achieve the top end of that range. General overheads[101] were c ✂.

A.13 ✂[102] We believe Ofcom now need to make an explicit adjustment in the condition. Whilst overheads have been broadly stable over the past few years, returns can vary from year to year. For simplicity and transparency, we would propose that we use a return of 5% (i.e. at the bottom end of Ofcom's commercial rate of return range). The costing system already identifies the actual upstream overhead for the suite of USPA 6 products so this is easy to calculate each year. We therefore propose that actual costing system adjustment for overheads is applied each year.

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

A.14 Given past experience in the face of regulatory ambiguity, we have been conservative in our interpretation of 'customer specific' costs. The current wording of USPA 6 does not allow them to be used. This has limited our ability to offer innovative upstream customer solutions.

A.15 USPA 6.4 (a) states that: "*Relevant Downstream Costs are the costs attributed to the provision of Relevant Access Services* ***as calculated in accordance with Royal Mail's Costing Manual,*** *subject to Directed Adjustments that OFCOM may direct from time to time*;"

A.16 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.

A.17 We define 'customer specific' cost as a contract specific variation on the cost reported by the costing system for a given retail service. This limits our flexibility to offer customers prices on the basis of their specific costs, which might vary from the national average. This is particularly true for collection costs. Contract specific collection costs can vary considerably from the national average currently used. We seek clarification over whether that interpretation is correct. The chilling effect of regulation means that we take a very prudent approach to our interpretation of the regulatory conditions. Investigations, and even potential investigations, create significant uncertainty and by their nature are costly and time consuming.

A.18 **Self-regulating our use of customer specific costs means we are limited in our ability to innovate and offer bespoke solutions to the benefit of our customers, a constraint upstream competitors do not face.** Our inability to price on the basis of customer specific costs reduces the incentive to offer customer specific innovations. For example, in the way mail is collected or presented. Increasingly Royal Mail needs to innovate to win business. However, when pricing close to regulatory price floors, we are limited in our ability to pass on customer specific cost savings. Consumers lose out as a result.

[101] Business sustaining and support i.e. all costs which cannot be attributed to a pipeline.

[102] ✂.

A.19 ✂. Further, where an innovation might be customer specific, for example cost savings related to the distance from our network, this would require a separate SPHCC for each customer. This would be completely impractical.

A.20 To allow us to respond quickly to customer needs in a non-burdensome manner, while still ensuring we are compliant with USPA 6, we propose the following:

- Customer specific unit FAC costs are produced by Royal Mail's costing team from a 'standard' retail product, consistent with Royal Mail's Costing Manual.
- Customer specific costs are reported in quarterly deal submissions.
- Customer specific costs are not identified as a separate SPHCC in either ex-post or ex-ante submissions. Relevant deals would still be reflected in margin squeeze assessments. However rather than explicitly reported as separate SPHCC's their lower costs (and typically lower AURs) would be reflected in the costs and revenues of the 'standard' retail product.

A.21 **The condition needs to explicitly recognise the need for customer specific costs.** We would welcome further engagement with Ofcom to agree how best to report these costs to Ofcom within the USPA 6 framework.

Points of clarification on proposed amendments

Reasonable expectation

A.22 In para 9.19, Ofcom propose to amend USPA 6.2 "*to make clear our intention that Royal Mail must have a reasonable expectation that the margin squeeze tests in USPA 6 are satisfied at the time of setting new prices (see proposed modified USPA set out in Annex 7 to this consultation). We expect Royal Mail's reasonable expectation to be informed by the latest revenue, cost and volume forecast information available at that time.*"

A.23 We welcome the clarification in the amended drafting that, for specific contracts, Royal Mail's reasonable expectation of costs and revenues is at the point of offering prices to the customer. However, para 9.21 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. Royal Mail already undertakes an assessment of the impact on the basket level test every time we offer a price. This includes any deal which was not included in our original forecast.

A.24 Royal Mail has previously explained to Ofcom the difficulties with updating the cost forecast at this granular level on a quarterly basis. Royal Mail produces an annual cost forecast as part of its Business Plan process. ✂. Updating any more frequently is challenging. Cost forecasting at the granular level required under USPA 6 is a time-consuming process. Notwithstanding the time necessary to update the annual forecast, it is only appropriate to do this when we have sufficiently robust information to do so. **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.

A.25 Quarterly outturn data is inherently volatile so amending our annual forecast based on one or two quarters of data is not appropriate. ✂. It would not be proportionate to require us to update the cost forecast each time we undertake this additional step.

Calculation of relevant upstream costs

A.26 In paragraph 9.29 and 9.30, Ofcom propose a change to the last paragraph of USPA 6.4. "*USPA 6.4 sets out a principle which Royal Mail must apply when calculating relevant upstream costs. The intention of the principle is that in calculating relevant upstream costs of the retail products subject to the margin squeeze tests, the downstream costs of equivalent access products must be 'deducted' from the end-to-end costs of those retail products only to the extent that those downstream costs are incurred in a directly comparable manner between the access products and the retail products".*

A.27 Earlier in our response, Royal Mail has argued that USPA 6.4 should be redrafted to allow the use of "Direct costs" to calculate relevant upstream costs. However, if Ofcom are not minded to move to this approach, we would agree with the proposal to change the word 'exclude' to 'deduct'.

Calculation of relevant upstream revenues

A.28 In paragraph 9.35 and 9.36, Ofcom states that "*In a letter to Royal Mail dated 1 November 2013, we said that we considered it would be reasonable for Royal Mail to use the mode price as a first order approximation of the average price when reporting for compliance purposes, providing the volume of traffic on this rate was over 50% of all traffic for a particular product. We continue to consider that the general rule of using average access prices as per USPA 6.3(b) and the above guidance on using mode prices as simplifying approximation are appropriate. We therefore do not propose to revise USPA in this regard*"

A.29 However, this is not helpful if Ofcom does not change the actual condition. Royal Mail will still be exposed if, in the event of an investigation, Ofcom revert back to the wording of the condition which requires us to use the "average price". **We do not therefore believe we can use the mode price unless Ofcom change the wording in the condition. We believe it would be proportionate to make this change.** Approximately ✂[103] of national access volumes are on different prices to the mode. We would ask Ofcom to reconsider its position.

New Contract Information

A.30 Royal Mail welcomes Ofcom's proposals to amend the wording of USPA 6.7(b) to make it clear when Royal Mail is required to submit information on relevant contracts. We agree with the proposed change - if we make a submission at the end of June, we must provide information about new contracts that were won in the financial quarter that ended in June. As Ofcom are aware, Royal Mail has been behaving in the spirit of the condition and already does this.

A.31 In para 9.41, Ofcom states that "..*we propose to make clear that Royal Mail is required to submit all amendments. We do not expect this to lead to a significant increase in the amount of information Royal Mail is required to provide on individual contracts (see proposed modified USPA set out in Annex 7 to this consultation*".

A.32 Ofcom has amended the condition to change "materially amended" to "amended". The removal of materially provides clarity and removes any subjectivity around what is or is not material. However, it is still unclear as to whether the amendments cover anything other than the four pieces of information set out in 6.7(b). For example, we assume that Ofcom would not expect us to notify of changes to contractual terms and conditions other than those set out in USPA 6.7(b). It would be disproportionate to notify Ofcom of all changes to the contracts. **We propose that Ofcom should make it explicit that only changes to the**

[103] ✂.

contract relating to price, volume, date of contract signature or length of contract would need to be re-notified.

Contents of quarterly submissions by Royal Mail

A.33 In paragraph 9.43, Ofcom propose to amend USPA 6.7(b) to clarify that forecast and actual relevant upstream costs and revenues must demonstrate compliance with USPA 6.2(a) and 6.2(b), including the detailed calculations. **Royal Mail has been submitting data in line with the amendments being proposed in this consultation. We therefore welcome the clarification.**

USPA Definitions

A.34 **In paragraph 9.45, Ofcom proposed to update the Relevant Retail Services List covered by USPA 6. However, the definition needs to be tightened further to ensure there is no ambiguity around the products covered.** The successor services to Mailsort and Walksort are the pre-sorted variants of both Advertising and Business mail. Referring to these services as simply "Advertising Mail" and "Business Mail" could also capture the unsorted variants of these services which is incorrect. This needs to be clarified. Similarly, RM48 LL has both unsorted and sorted variants but it is only the pre-sorted subset (which is substantially similar to the other pre-sorted services covered by USPA 6) that should be included. This was agreed in discussions between Ofcom and Royal Mail in early 2014. The list is therefore incorrect as currently defined in the consultation and needs to be refined. We would suggest amending the definition to read: ""**Relevant Retail Services**" means, all Second Class pre-sorted Business Mail, Advertising Mail, Sustainable Advertising Mail and Royal Mail 48 sort plus services."

Proposed amendments

A.35 Below is a list of our proposed amendments.

Condition/Area	Ofcom consultation proposal	Royal Mail position
Calculation of upstream costs – USPA 6.4	Ofcom does not propose to amend the calculation of upstream costs i.e. to not move from the "indirect" to Direct" approach.	The costing system numbers (Direct costs) best reflect operational reality and should be used. Ofcom should amend the condition to reflect this. See paragraph A.1 to A.11 Upstream costs should be adjusted to exclude general overheads and add in returns. See paragraph A.12 to A.13
Calculation of upstream costs – USPA 6.4	Minor amends to USPA 6.4	If Ofcom are not minded to move to Royal Mail's preferred move to using "Direct" costs, we agree with the proposal to change the word "exclude" to "deduct". See paragraph A.26 to A.27

Condition/Area	Ofcom consultation proposal	Royal Mail position
Use of customer specific costs in USPA 6	N/A	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. See paragraph A.14 to A.21
Amend USPA 6.2 - reasonable expectations	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 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	We welcome this clarification. See paragraph A.23 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. See paragraph A.23 to A.25
USPA 6.3 (b) - calculation of upstream revenues	No change	We believe it would be proportionate to amend the condition to confirm it is appropriate to use the mode price. See paragraph A.28 to A.29
USPA 6.7 (b) - new contract information	Minor change to condition	We agree with the proposal to change "materially amended" to "amended". See paragraph A.32 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. See paragraph A.32
USPA definitions	Update the relevant retail services list	The proposed list needs to be refined. See paragraph A.34

Annex 2 – Proposed Cost Matrix

Figure 7: Cost Matrix	Prior Financial Quarter £m	Current Financial Quarter £m
[Functional breakdown]		
…		
[Functional breakdown]		
[Business unit breakdown]		
…		
[Business unit breakdown]		
Total people costs		
[Detailed cost category]		
…		
[Detailed cost category]		
Total non-people costs		
Total costs before Transformation Costs		
Voluntary Redundancy		
Business transformation payments		
Transformation Costs		
Total Transformation Costs		
Total costs after Transformation Costs		

- Functional, Business unit and Detailed cost category breakdowns to be reported in line with Royal Mail's management reporting systems.
- NB: International terminal dues will be shown separately from its detailed cost category.

- Functional breakdown provided annually