

Royal Mail Group

100 Victoria Embankment
London
EC4Y 0HQ

David Brown
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

By email (David.Brown@ofcom.org.uk)

20 October 2017

Dear David,

I am very keen that we develop and share a common understanding on efficiency. As regulated company and regulator, we both recognise the importance of efficiency in delivering an affordable sustainable universal service. For Royal Mail, efficiency is key to ensure we remain competitive. We wish to work with Ofcom to address the concerns that Ofcom has expressed. We recognise the need for a fit for purpose – both now and to the end of the regulatory period – regulatory financial reporting framework.

Ofcom has identified the following needs or concerns in relation to efficiency:

- To monitor against the 2015 Business Plan.
- The extension of the workload calculation to other parts of the pipeline.
- The ability to report productivity on a consistent basis over time for trend analysis.

Ofcom's solution for the reporting of consistent productivity trends and for calculating the workload in the PVEO is to use 2015 Planning Values (PVs) within the regulatory financial reporting framework. We have a number of key concerns with Ofcom's proposal. We have discussed these issues with your team on a number of occasions, most recently at the 6 September 2017 meeting on productivity and workload. We have also received email feedback on 22 September 2017 in relation to the PVEO calculation. **Ofcom's approach appears to be to use 2015 PVs within a mechanistic spreadsheet approach to determine productivity and efficiency.** This approach, in our opinion, fails to appreciate the complexity of a business going through fundamental change. Our business has to transform to deliver efficiency and to meet changing customer needs. We believe it would be helpful to both Ofcom and Royal Mail to discuss this further prior to Ofcom concluding its regulatory financial reporting consultation.



The use of the most up to date PVs ensures that efficiency and productivity measures are accurate and relevant. We are concerned that metrics based on 2015 PVs may be misleading to Ofcom and other stakeholders

The use of the most up to date PVs in the regulatory financial reporting framework aligns to Ofcom's guiding principles in the USPAC – specifically the accuracy and causality principles. **The regulatory financial results will be more accurate.** The results will reflect the most up to date operational practice and the impact of the change in products and services on our network. We also consider that the **results will more robustly reflect the causality principle** as the impact of workload within the PVEO calculation will be calculated in line with the drivers that have caused the cost to be incurred.

We invest considerable time and resource to make sure the PVs reflect operational reality and are as robust as possible. We go through a rigorous governance process to agree changes to the PVs prior to their use in our budgeting and reporting process. Our internal audit team review our process and approach to PVs on an annual basis. Royal Mail's productivity outturn drives 10% of the management bonuses. We need to be confident that the metric correctly captures the reality of what is happening in our business to make sure that we remunerate management on an appropriate basis. We report our productivity results within our statutory financial reporting to our shareholders.

As a consequence of using the 2015 PVs within the regulatory financial reporting framework, we are concerned that the efficiency metrics (from the PVEO) and productivity trends will not reflect the operational reality that Royal Mail faces. The 2015 PVs are only fit for purpose for the 2015-16 financial year. We rebase our productivity metric annually to make sure the productivity reported in each year correctly reflects the operational practices embedded within our PVs. We are concerned that regulatory financial metrics based on 2015 PVs will be misleading, inaccurate and not helpful to Ofcom and to other stakeholders.

Four main changes affecting the workload calculation since 2015

Our presentation on 6 September 2017 set out the evidence supporting our concerns. It provided data and evidence to demonstrate that 2015 PVs do not reflect operational reality today. These PVs do not take account of product change (such as increasing number of larger parcels) and process changes which have happened since 2014. The presentation summarised four main changes that affected the use of 2015 PVs and the calculation of workload since 2015-16:

1. We now use [Σ] for volume size change to take account of the ongoing change in volume size and to better reflect the seasonality of the medium parcels market. We have provided Ofcom with schedules that demonstrate that parcels are getting bigger.
2. We update **PVs on a regular basis.** To give Ofcom the insight into the process we follow to update PVs, we explained in detail the changes to one PV. In this example, we had



improved the methodology and updated the average container fill (ACF) rate. The ACF is also affected by the volumetric changes.

3. We have **extended our measure of productivity** to include [X]. We believe this extension of workload was consistent with Ofcom's intent for the evolution of productivity measurement within Royal Mail. We consider that Ofcom has actively encouraged us to extend our productivity measure to cover other parts of the pipeline. [X] We also provide Ofcom with information that provides more granularity on the productivity measure by pipeline.
4. We have [X] to make the calculation more accurate over time by aligning with other business data.

We provided an estimate of the impact that shows how these four changes affected the workload calculation. We have provided detailed evidence and gave Ofcom the opportunity to question our planning value experts. Should Ofcom require further information, we are happy to arrange a follow up meeting.

We believe the extension of our productivity measure helps to address concerns that Ofcom has raised before. As Ofcom noted in its May 2016 consultation (paragraph A5.142) "*Further we note there are some limitations in the derivation of the metric [productivity] within the 2015 Business Plan; e.g. it does not include all frontline pipelines areas. There are also some inconsistencies in the data used, for example collections hours are included but collections workload is excluded.*"

As we have explained at the meeting, the use of 2015 PVs risks understating our efficiency improvements. We change our processes and activities to deliver efficiency and for other reasons such as to improve the customer experience. Making changes to improve the customer experience could increase the time taken. Under Ofcom's proposal, Royal Mail will appear less efficient. For example, we are enhancing the tracking of parcels within our network to meet customer needs. In 2015, we were tracking around 20% of our parcels. Today, around two-thirds of parcels are barcoded and one-third can be tracked in some way. We intend to barcode as many of our parcels as possible. **The potential impact of Ofcom's approach for efficiency modelling is that we will be disincentivised to make changes to enhance the customer experience.**

Our business continues to transform - there are many changes that will affect the relevance of the 2015 PVs

Unfortunately, due to timing constraints, there were a number of areas that we were not able to discuss in depth at our meeting on 6 September. We are concerned that the impact of future changes to our business is not fully understood. These programmes include:

- Our [X] programme. [X]
- Our [X] programme. [X]

At a further meeting with Ofcom on 13 September 2017, Royal Mail already indicated future changes to [X]. It will further improve our understanding of [X] and associated PVs.



In summary, our business will change, our IT infrastructure will change and we will have new sources of more robust information to improve our PV calculation. The 2015 PVs are out of date now, but, Ofcom's proposed regulatory financial reporting framework will continue to require these to be used until 2022. **Ofcom's approach will result in Ofcom's monitoring of Royal Mail's productivity becoming increasingly divorced from operational reality.** We are concerned that we will need to undertake detailed ongoing reconciliation exercises for Ofcom to explain why the outcomes from the use of the 2015 PVs are different to the metrics produced by Royal Mail. It will take time and additional resource to do so.

We are negotiating to use productivity in our pay deal with CWU

Our productivity and workload measures are already embedded within business performance. It is a relatively recent development that we are currently discussing with CWU the use of productivity to impact pay rises for April 2018. Our pay offer (published on 8 September) to our unions is 1.25% + 60% of the national productivity achieved (in excess of 1.25%) up to a maximum of 3.5%. For example, if we delivered 3% productivity, our employees would be paid 1.25% + 60% of (3%-1.25%) = 2.3%. We believe our productivity measure is an important tool for driving efficiency in our operation. [X]

Ofcom has stated that the use of 2015 PVs in the PVEO calculation has been set out in the March 2017 statement

Your team recently (22 September 2017) provided us with a response to our feedback on the PVEO calculation. It is helpful to understand Ofcom's approach. This email stated that "*As a general point we are aligning the calculation of PVEO efficiency with the approach as set out in the March 2017 Ofcom statement 'The Review of Royal Mail Regulation' (2017 Review statement)*" (emphasis added)

In paragraph 3.183 of the March 2017 Statement, Ofcom stated that "*we intend to monitor Royal Mail's future efficiency performance with reference to its 2015 Business Plan.*" It was our expectation that this would be a high level monitoring against the key outcomes from the 2015 Business Plan not a detailed regulatory financial reporting framework using 2015 PVs. We believe that it is the regulatory reporting consultation that will give effect to Ofcom's implementation of the new detailed regulatory financial framework. We have set out a range of concerns to the approach and have provided evidence to demonstrate these concerns in the regulatory reporting consultation, in subsequent meetings and in this letter.



Ofcom's approach to demand drivers for PVEO appears to only include workload driven metrics

In our August 2017 response on the Annual Monitoring Update validation, we provided an impact analysis that showed the key differences between our view of PVEO efficiency of [X] with Ofcom's of [X]. Of the gap:

- [X] was due to an assumption difference on inflation. We believe RPI is appropriate. Ofcom has set out it is CPI.
- [X] was due to the impact of the national insurance change. We now understand Ofcom intends to include this one-off impact in their calculation.
- [X] was due to calculating the workload on 2015 PVs.
- [X] was due to excluding other demand drivers.

It appears that Ofcom's approach to PVEO is to only include demand drivers where the inputs can be modelled within the PVEO spreadsheet itself. **Our business is not sufficiently straightforward that all demand drivers can be distilled down to simple calculations and metrics.** [X] We have estimated this as [X]. This real operational impact is not captured as part of the workload calculation, and so is ignored in Ofcom's approach. We propose that Ofcom changes the PVEO calculation to allow these additional demand drivers to better reflect operational reality.

Potential approach to address Ofcom's concerns

We are keen to work with Ofcom to address the concerns Ofcom has. As previously set out (see Annex), we propose an alternative to the use of 2015 PVs which we believe meets Ofcom's objectives and addresses Ofcom's concerns:

- provide Ofcom with an explanation of how PVs and workload have been rebased on an annual basis, and further data Ofcom requires. It would give Ofcom transparency and confidence in these PVs. These PVs would reflect operational reality.
- use most current PVs in the calculation of workload and efficiency for regulatory financial reporting.
- provide a consistent productivity trend over time by calculating year on year changes using consistent workload assumptions, by rebasing prior year.
- annual review of the PVEO calculation including the non-workload demand drivers.

I would be happy to discuss any of these issues with you further.

Yours sincerely



Pamela Allsop
Director of Competition Policy and Regulation

