



Royal Mail's view on the costing methodology

Annex 3 - Response to the Postal Services
Commission's May 2010 consultation document

August 2010

Cost transparency

May Consultation

Summary

- *Postcomm makes specific proposals on improving the transparency of the costing methodology through a three level framework, outlining the need for a change control process around the Level 2 costing methodology and Postcomm's role in agreeing such changes.*
- *Royal Mail has been working actively with Postcomm since Jan 2010 to build the regulator's understanding of the company's costing.*
- *Royal Mail broadly agrees with Postcomm's proposals on the cost transparency methodology, although believes that the level 2 principles should be focused on generic ABC methodology rather than Royal Mail specific approaches, which will be addressed in fine level of detail in the level 3 costing manual to which Royal Mail is committed to produce.*
- *However, Royal Mail disagrees with much of the detail of the change control process which would require ex-ante application and assessment by Postcomm. Royal Mail's view is that ex-post notification is sufficient, given acceptance of the overall Level 1 and 2 principles.*
- *In addition, Postcomm's consideration of materiality is unnecessarily detailed and will lead to a burdensome administrative process. If Postcomm's Option 2 for change control stands, then a process for dealing with unresolved differences between Postcomm and Royal Mail will be required.*
- *Postcomm also asserts that its proposals for greater transparency through accounting separation are a prerequisite for the majority of deregulation. Royal Mail disagrees with this as the Licence stipulates that deregulation should occur in markets demonstrated to be competitive but will work with the regulator on developing a set of proforma accounts for the business linked to a clear timetable for rapid deregulation and access regime reform.*

Cost transparency

Royal Mail recognises the importance of cost transparency to the Regulator and has worked closely with Postcomm to ensure it has a greater understanding of the costing methodology and results.

Postcomm has for some years received significant cost information on a regular basis, including current methodologies, documentation and explanation of costing changes and the Cost Allocation Model which provides Activity Based Costing results at the lowest level of disaggregation available. Over the last year Royal Mail

has spent further time with Postcomm and its consultants to ensure a solid understanding of Royal Mail's approach to costing.

Royal Mail will continue to work with Postcomm to provide it with the necessary understanding of Royal Mail's approach to cost allocation and product costing to undertake its duties. As such, Royal Mail has already signalled to Postcomm its willingness to:

- Ensure its costing methodologies are consistent with costing principles set out by Postcomm, and document the application of these;
- Make its change control process visible to Postcomm in a timely manner and to share the details of changes made to its costing methodology.

Royal Mail is engaging with Postcomm on ensuring its timetable is met. Starting in January 2010 as part of the engagement in the PCR4 work plan, Royal Mail ran a series of workshops to take Postcomm and its consultants in detail through the end-to-end operation of Royal Mail's costing system, providing the underlying costing principles and the assumptions of the ABC costing application. In parallel with the costing workshops, over a two-month period from mid January 2010, Royal Mail worked closely with Postcomm's consultants, responding to all information requests and queries raised in relation to the operation and application of the Royal Mail costing system to enable them to complete their costing system review which was published alongside the May 2010 consultation document.

Royal Mail is now driving forward the production of a level 3 costing manual, even though the draft licence does not require it until April 2011. Royal Mail confirms that it:

- Will produce a costing manual irrespective of Postcomm's decision on the consultation outcome in November 2010;
- Agrees with the proposed manual section headings;
- Has commenced work on some of the more complex annexes;
- Will share a milestone delivery plan with Postcomm in mid September 2010.

Royal Mail is aiming to have a full draft Costing Manual to share with Postcomm in October 2010.

However, as detailed in our response to Annex 3 there are a number of issues that need to be addressed to ensure Postcomm's proposals work in practice: These include:

- Methodological principles - Royal Mail believes that the Level 2 methodological principles should centre around the ABC methodological principles and could therefore be reduced in number.
- Change Control - Postcomm proposes a process of *ex-ante* application and consideration of changes, whereas Royal Mail believes that *ex-post* notification, together with a commitment to satisfy the Level 1 and 2 Principles, should meet the reasonable needs of all parties. Royal Mail's

conclusion on the proposals, which lack clarity on how the proposals would work, is that they may be disproportionate and onerous. The result will likely be delays in implementing changes, at a time where the business is going through a period of frequent change, leading to delays in keeping the costing model closely aligned to operational reality and adding the burden of responding to formal consultations for changes that are 'business as usual' events.

- Materiality - the proposed definition and calculation seems likely to cover all changes in cost within any product or activity grouping. In the course of ordinary business activity, there may well be changes in the cost of activities and products that are not linked to the costing methodology but are due to operational changes. The current modernisation programme may further extend the number of changes in process and activity costs. Royal Mail would therefore propose that impacts from certain specified causes (see response to Annex 3) are explicitly excluded from the scope of any materiality or change control processes.
- Change control resolution process - if Postcomm's option 2 for change control stands, then there will be a need for an expedient resolution process. Whilst Royal Mail would hope not to need this, it is nevertheless a necessary 'backstop' so the Licence should make reference to the process for expedient resolution, given the significance of the use of the costing outputs for both internal and external uses.

1. Do you think the introduction of Guiding Principles for the Royal Mail product costing process, into Royal Mail's licence is an appropriate means of supporting greater transparency of Royal Mail's costs?

Royal Mail recognises the importance of cost transparency to the Regulator and has worked closely with Postcomm to ensure it has a greater understanding of Royal Mail's costing methodology and results. Royal Mail agrees with this proposal in principle as an appropriate way to ensure ongoing transparency.

2. Do you suggest any changes to the content or the order (which reflects their hierarchy) of the Guiding Principles below?

Royal Mail agrees with the Guiding Principles (GP) as representing the attributes that would support any effective management information system. Indeed GP 2-9 are consistent with the preparation of Statutory Financial Statements and Royal Mail's costing system uses the cost information that is used in the Statutory Financial Statements. The costing results are already subject to independent External Audit.

3. Do you think the introduction of Methodological Principles for the Royal Mail product costing process is an appropriate means of supporting greater transparency of Royal Mail's cost?

The Methodological Principles (MP) provide a high level specification of the current methodology. They are an effective way to provide clarity and aid communication and understanding on what the methodology is aiming to achieve. Royal Mail believes that the MP concept is an appropriate means to communicate the current ABC costing methodology.

4. Do you suggest any changes to the content of the Methodological Principles below?

Whilst Royal Mail is generally supportive of the thinking behind the MP there are nevertheless a number of technical details that Royal Mail disagrees with, as set out below:

- Whilst MP2 sets out the ABC principles adequately it would appear that MPs 6 – 10, which expand on specifics relating to Royal Mail, are unnecessary, and potentially restrict our ability to keep track of the operational reality and/or to modify our costing model to meet other business needs. Those specifics are proper to level 3.
- MP11 refers to the detailed way in which Royal Mail attributes activity costs. Royal Mail believes that this principle could be better expressed as stating that there is a requirement to reflect the level of consumption of each activity by the items that go through that activity, and that the details of the attribution rules should be described in the Costing Manual.
- MP12 is part of the Third Postal Directive so is unnecessary.
- MP13 is very specific to Royal Mail; this could be more appropriately covered if incorporated into MP2 using more generic ABC terminology.

- MP14 is a duplication of MP2's reference to activity drivers. Postcomm does not state a preference on which measure of traffic it requires. Royal Mail believes that it is both inappropriate and unnecessary to publicly discuss the alternative traffic measurements currently available. In addition Postcomm's suggestions for reconciliation statements are not realistic. If volume measures are different then it will not be the case that "the two measurement methods result in the same unit costs calculated by the Costing Methodology" (Annex 3, p52).
- MP17 refers to Materiality; the appropriateness of Postcomm's materiality proposals is discussed in response to question 13 of the June consultation below.

14. Do you think our proposed change control process, including option 2 for changing the Methodological Principles for product costing, is an appropriate and proportionate means of supporting greater transparency of Royal Mail's costs and improved accounting separation? Do you think either option 1 or option 3 for changing the Methodological Principles for product costing is more appropriate than option 2? If so, why?

Royal Mail accepts that there is a need for changes to costing methodology to be described and documented in a transparent way with Postcomm and, for changes that depart from the ABC methodology, to be agreed with Postcomm.

Postcomm discusses 3 options to implement the change control process on levels 1 and 2:

- Option 1 – include in licence;
- Option 2 – include commitment in licence for Royal Mail to comply with Level 1 and 2 Guiding and Methodological principles; and can only be changed with Postcomm's consent; and
- Option 3 – as per option 2 except that changes to Level 2 Methodological principles could be changed without Postcomm's consent.

Option 1 would prevent any changes being made without following a process for changing the Licence, which is clearly disproportionate and would inhibit Royal Mail using its costing system effectively; Option 2 would still require a detailed (and possibly onerous) administrative process covering all proposed changes that would potentially delay changing the cost model to reflect changing business circumstances; Option 3 would be the most workable and with an additional requirement to notify Postcomm of changes would still provide Postcomm with the costing transparency it requires.

Royal Mail's concerns with the Postcomm proposal as described include:

- Additional delays in implementing changes at a time when the business is going through a period of significant change;
- Delays in keeping the costing model closely aligned to operational reality;
- The potential for disruptive disagreements – if option 2 is chosen then the absence of a process for resolving differences could cause difficulties, as the

only other option available (Judicial Review) is not likely to be a suitable process in these circumstances;

- An additional burden of responding to formal consultations for changes that we believe are business as usual events.

Royal Mail believes the proposals will not be effective from the perspective of supporting a business going through major transformational change which will have significant impact of its cost base as it responds to operating in a market with structural decline.

Royal Mail therefore favours Option 3 with the understanding that Royal Mail would provide detailed impact analysis to Postcomm. We would of course be required to comply with the Level 1 Guiding Principles as proposed.

15. Do you suggest any changes to the proposed change control process?

Royal Mail disagrees with the blanket requirement to seek Postcomm's consent to changes, even with some measure of materiality applied, and seeks specific clarification and recognition of items that should be excluded.

Postcomm's proposals do not preclude any particular cause for the change in an activity or product cost. A change to an input cost of the costing system (e.g. pay award, increased price of fuel) is not in any way a change to methodology or a change to the model structure. Therefore, Royal Mail believes that the proposed change control regime has more far-reaching consequences than just managing the deployment of material changes to the costing methodology, unless exceptions are specifically made. In Royal Mail's view the change control process should be concerned with changes to the 'rules' of costing rather than changes to input data.

Royal Mail takes the view that the costing system and its documentation (i.e. the Costing Manual) is its responsibility and it is committed to making changes that comply with the Guiding Principles and the Methodological Principles and to informing Postcomm of the changes that have been made. Therefore in Royal Mail's view there is no requirement for Postcomm to review changes prior to their implementation.

However, in the event that this requirement stands, the proposed review timescale of 56 days for more detailed changes to the Costing Manual could lead to extensive delays in maintaining the system to closely reflect operational reality, and at key reporting times e.g. year end, put at risk our ability to meet the reporting timescales (including other requirements of Licence Condition 15)

Therefore, Royal Mail would propose the following changes to the proposed change control process;

- That Postcomm is not required to concur with any proposed change for compliance to Level 2 methodological principles - we accept the responsibility to operate the costing model that supports regulatory

reporting in an appropriate manner, compliant with the Level 1 Guiding Principles and with independent external verification via the annual audit;

- However, if Option 2 is chosen Postcomm and Royal Mail should work together to establish a process for resolving any disputes concerning changes to the Methodological Principles;
- That Royal Mail may modify the Costing Manual without prior permission provided that it provides timely and detailed impact analysis of material changes to Postcomm;
- That change control (relating to either the Methodological Principles or the Costing Manual) specifically excludes the effects of:
 - Changes to input costs (e.g. pay rates, fuel costs, inflation, taxation)
 - Migration to new and/or additional data sources
 - The developments of a new traffic and hours recording system as part of the transformation programme should deliver a step change in the quality of this data
 - Changes to product volumes
 - Creation of new activities better reflecting operational reality
 - Creation of new products and services
 - Changes to standard planning values
 - Updates to product related characteristics (e.g. maintenance of average sizes)
 - Updates to routing matrix percentages (e.g. maintenance of traffic flows following operational reality)
 - Updates to fall to earth of mail (e.g. maintenance of customer behaviour)
- For the costing of new products or sub products, that a minimum value of £1m be set under which detailed impact analysis is not required;
- Limit the review period to 28 days

In addition Royal Mail believes that it is more appropriate to have *ex-post* notification of changes rather than a requirement to obtain *ex-ante* permission to make such changes.

16. Do you agree with our plan and timetable for implementing changes to cost transparency and regulatory accounting separation set out above?

With regard to costing transparency Royal Mail is engaging with Postcomm on ensuring its timetable is met. Starting in January 2010 as part of the engagement in the PCR4 work plan Royal Mail ran a series of workshops to take Postcomm and its consultants in detail through the end-to-end operation of Royal Mail's costing system exposing the underlying costing principles and the assumptions of the ABC costing application. In parallel with the costing workshops, over a two-month period from mid January 2010, Royal Mail worked closely with Postcomm's consultants, responding to all information requests / queries raised in relation to the operation / application of the Royal Mail costing system to enable them to complete their costing system review which was published alongside the May 2010 consultation document.

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June Consultation

3. Do you think the proposed outline of the Costing Manual is a suitable and proportionate means of achieving cost transparency on the basis proposed in our May consultation?

Royal Mail agrees with Postcomm's proposal for developing a costing manual and that the five steps of a conventional ABC product costing model form an appropriate framework within which to document Royal Mail's ABC costing system. Such a costing manual will show in detail how Royal Mail's costing system conforms to the agreed Guiding and Methodological principles.

4. Do you have any suggested changes to the outline (please provide your reasons)?

Royal Mail would not anticipate the inclusion of any actual results, but the document will reference actual cost attribution criteria that are within the structure of the model.

5. Do you think the Costing Manual should be published?

- a) in its entirety
- b) In its entirety but with redactions where Royal Mail's commercial confidentiality may otherwise be compromised or
- c) As a descriptive narrative of the model and its underlying assumptions but omitting the detailed tables and other specific data that define the structure of the model?

Please provide your reasons.

Royal Mail disagrees with the need for the costing manual to be made available outside of Postcomm for the following reasons:

- It is Postcomm's role to provide assurance to the market on the appropriateness of Royal Mail's costing model; this is achievable without publication of the Level 3 document;
- The Level 2 methodological principles provide an appropriate overview of the costing methodology in place;
- Appropriate notes should form part of the regulatory outputs to provide sufficient understanding to the reader; and
- Publication of detailed Royal Mail information would result in an asymmetry of information in the market with potentially damaging commercial consequences for Royal Mail in an increasingly, and in some areas fully, competitive market

11. Do you agree with our more detailed proposals with respect to change control over the Methodological Principles (Level 2)? Are they effective and proportionate?

Royal Mail is concerned that many 'changes' could come within the scope of change control that should not. As a consequence of changes to its daily business activity and the current major programme of modernisation there will be a number of changes, which do not represent a change in costing methodology, but reflect a

change in the business dynamics which will undoubtedly change the cost of activities and the products that pass through them. We do not believe it is correct for these to be subject to change control (see response to question 15 in the May consultation).

For example, in 2009/10, there were 11 changes over and above business as usual maintenance of mapping tables e.g. cost centres, general ledger codes. Of these;

- none were a change to methodology – ABC is the methodology;
- 2 were directly related to the modernisation programme, hence alignment to operational reality;
- 8 were improvements in the accuracy of the costing outputs through closer alignment to operational reality; and
- 1 was the inclusion of an existing product to be costed under ABC, hence improvement in coverage and accuracy.

In addition, Royal Mail is concerned that Postcomm's proposed process allows it to determine changes without any apparent need for assessment or consultation on its part, if it regards changes as 'minor' or if Royal Mail disagrees with the change. It would be consistent with good regulatory practice that Postcomm should be required to carry out and provide to Royal Mail an impact assessment for all changes that it proposes, whether or not they are regarded as minor.

13. Do you agree with our proposed compliance materiality threshold of 1%?

Royal Mail agrees that it is reasonable and appropriate to set some limit above which more scrutiny of changes is required. However, even after discussions with Postcomm on points of clarification, our understanding of the practical application, of the 1% compliance assessment against MP 1-16 remains unclear so we are not able to agree with the specific proposal.

By way of exemplification of the concerns around the calculation of materiality we believe that the compliance test is intended to be undertaken against groups of products and/or groups of activities. To illustrate our concerns on the practical application of the proposal, we outline two potential scenarios below which, depending on the interpretation of the results, appear to lead in some instances to a materiality threshold well below 1%.

1. Activity grouping Access

There are 13 individual activities, with a total cost of £[X]m. The individual activity costs vary from between £[X]m to £[X]m. We believe that the intention is to divide the Activity Group cost by the number of activities ($\text{£}[X]\text{m}/13$) to derive the average activity cost i.e. £[X]m. This average activity cost is then the basis of the 1% compliance test i.e. £[X]m. This value presents 242% of the lowest activity cost and 0.25% of the largest activity cost. It remains unclear how this numeric value will then be used to test for compliance with any of the MP 1-16, or indeed whether it has any real meaning.

Furthermore, the 1% compliance test, from the average activity cost, is then the basis of determining the value of a material cost i.e. £[X]m. This material cost value appears to be the reference point in determining if a proposed change is a material change. Therefore, if a proposed change impacted on the £[X]m activity, the materiality threshold test is actually 0.25% (£[X]m/£[X]m).

2. Product grouping Public Tariff

Public Tariff will generally refer to the Stamp, Meter and PPI STL services. At the product level there are 6 products (total cost of £[X]m) with a cost range of £[X]m - £[X]m, and at a lower level in the region of a potential of 26 sub products for each of the products. Therefore this group could cover over 150 sub products.

Royal Mail believes that the intention is to divide the Product Group cost by the number of products (£[X]m/6) to derive the average product cost i.e. £[X]m. This average product cost is then the basis of the 1% compliance test i.e. £[X]m. This value presents 2.24% of the lowest product cost and 0.48% of the largest product cost. It remains unclear how this numeric value will then be used to test for compliance with any of the MP 1-16.

Furthermore, the 1% compliance test, from the average product cost, is then the basis of determining the value of a material cost i.e. £[X]m. This material cost value is then the reference point in determining if a proposed change is a material change. Therefore, if a proposed change impacted on the £[X]m product, the materiality threshold test is actually 0.48%.

In the context of using the same tests to assess the materiality of cost changes Royal Mail believes that the above illustration demonstrates that the scope of application of this proposal would be greater than Postcomm would expect, or would seek.

Another possibility is that Postcomm has misunderstood the scope of the costing system or Royal Mail's use of it. Paragraph 8.4 of Postcomm's Supplementary consultation states "Our proposed Guiding Principle 9 (...) states that Guiding Principles 1 to 8 must be applied to all material costs, or material changes in costs, that arise from changes to the Guiding Principles themselves or from changes to the Methodological Principles". The first clause of this (i.e. 'all material costs') is redundant because Royal Mail's costing system (and the associated Regulatory Accounting Statements) includes all costs associated with the Royal Mail Letters business. Therefore a requirement to maintain the scope of the model at its existing coverage would be adequate to deal with this issue without requiring detailed numerical compliance tests.

Also, as described in the response to question 15 (May consultation), what is not covered adequately are the conditions within which the material change criteria would apply. Royal Mail proposes that the same range of causes as listed above be explicitly excluded from the materiality assessment.

14. Do you agree that the change materiality threshold should lie in the range of 1-5%? Depending on the evidence of potential impacts? Do you have any evidence to support a particular threshold in this range?

Postcomm acknowledges that the materiality threshold needs to be proportionate but believes that as the number of changes historically is low (less than 1 per month) prudence would suggest that a lower threshold is appropriate. Its view is that a compliance threshold of 1% (compliance to Level 1 and 2 guiding and methodological principles), and a 5% threshold for material changes to material costs is therefore appropriate.

As noted above the compliance threshold may not be relevant

The change threshold should be a minimum of 5% because:

- The proposed definition and calculation of material cost (1%) is highly likely to cover all changes in cost within any product or activity grouping as illustrated above;
- There seems to be little recognition for changes in cost that are not in any way linked to the costing methodology (examples are detailed in response to May consultation question 15 above); and
- There seems to be little recognition that the current modernisation programme will deliver stepped changes in process and activity costs; inclusion of these business events will create changes that are not linked to the costing methodology, and which occur merely because the operations have changed. The value-add is in the maintenance of the cost model to reflect the operational reality. In addition, just because there have been only a few examples of change in the past (most of which were material at the 1% level) does not mean that this will be so in the future nor that this justifies a low materiality limit.

15. Do you agree with our proposed refinement of the Methodological Principles on materiality (Principle 17) to incorporate the proposed threshold percentages?

See response to question 14 above.

17. Do you have any initial comments on the proposed licence conditions?

See earlier responses.

If, after consideration of the above, Postcomm retains the current draft text then Royal Mail would wish to see an additional clause in Licence Condition 15 (9) that includes a requirement for Postcomm to only issue directions to the Licensee to make changes to the Methodological Principles after mutual agreement to the changes has been reached.

In addition, Licence Condition 15 (9) should also include an obligation on Postcomm to carry out and publish impact assessments for all changes that it proposes, whether or not Royal Mail agrees with them and it should also include a definition of 'minor change'