

Kamak Arzhang  
Ofcom  
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30th November 2018

Dear Kamak,

## **Amendments to the USP Access Condition in relation to the margin squeeze control**

Shortly after you published your statement on changes to the USP Access condition on 8<sup>th</sup> November, I spoke to you regarding the date of implementation of the proposed changes. Your document stated that the new condition would take effect immediately i.e. as from 8<sup>th</sup> November 2018.<sup>1</sup> As you will appreciate the changes required by the new condition are detailed and technical, particularly around surcharges. Hence, it is not feasible for Royal Mail to implement the revised condition in our December submissions due to the limited period of notice.

We believe it would be better for the new condition to take effect from the date of the March 2019 submission i.e. 29<sup>th</sup> March 2019 and that this should apply to 2019-20 data only. There are two benefits to this approach:

1. It would allow Royal Mail sufficient time to put in place the processes to meet the new requirements which I discuss further below; and
2. Continuing to provide quarterly ex post data for 2018-19 using the approach set out in the pre-8<sup>th</sup> November 2018 USPA condition and Ofcom statement would allow Ofcom to make a direct comparison between outturn data and the forecasts already submitted earlier in the year.

## **Amendments to the condition that require changes to Royal Mail's data collection, model and processes**

The new condition requires Royal Mail to implement a number of changes to its data collection and associated processes and to also undertake further development of its USPA6 model. The key areas requiring further consideration following Ofcom's statement are:

1. ***Inclusion of surcharges.*** The statement did not specify a methodology, instead stating '*that it is for Royal Mail to adopt a suitable methodology which ensures all relevant surcharge adjustments are captured*' (4.67). Although Royal Mail put forward a proposed methodology in

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<sup>1</sup> 2.5 The revised condition, which will come into effect on the date of this statement, is set out in Annex 1

our consultation response, the proposal was linked to use of Mailmark data. Ofcom have advised that Mailmark and non-Mailmark surcharges should both be included within the methodology. As a result, we need time to reconsider and agree internally a methodology which will meet Ofcom's requirements. We also need time to collate additional information and put in place the relevant processes for both collation and sign-off of the data.

2. **Overheads and rate of return.** The revised condition requires Royal Mail to exclude general overheads and include an appropriate rate of return when calculating upstream costs. Given Ofcom's statement requested that we should specifically exclude some Business Sustaining and Support costs from General Overheads, this will require a new costing report to be generated. This will take time to design and implement.
3. **USPA6 Model Development.** We realise some of the other proposals such as the move to the use of Direct Costs or making further adjustments (such as for wholesale specific costs) are not explicit within the condition and will be left to Royal Mail's discretion. However, we believe it would be appropriate to develop the model for all the changes we want to include going forward rather than working with a hybrid version that only has some of the changes in the shorter term. We therefore will need to finalise the surcharge discussion before the model can be finalised. Again this will take time.

#### **Proposed Timetable for implementation**

With this in mind we would suggest that it would be most appropriate for the changes set out in your statement to take effect from the March 2019 submission and that this should apply to the ex ante (forecast) and ex post (quarterly outturn) submissions relating to financial year 2019-20 only

We therefore propose that all of our submissions relating to financial year 2018-19 will reflect the pre-8<sup>th</sup> November 2018 USPA condition and Ofcom statement. This would include all upcoming quarterly 2018-19 ex post submissions up to June 2019 and the updated 2018-19 ex ante forecast which we are planning to send to you shortly.

This would also mean that any bespoke contracts signed before March would be priced on the basis of the old condition i.e. based on indirect costs, not adjusted for overheads and rate of return changes and will not explicitly include a quantified surcharge adjustment.

The March 2019 ex ante 2019-20 model we submit on 29<sup>th</sup> March 2019 will then fully reflect the updated condition and guidance in Ofcom's statement. Bespoke contracts signed after this date will also be priced on this basis.

In summary we would propose submitting the following to Ofcom:

<b>Date of Submission</b>	<b>Content of Submission</b>
21 <sup>st</sup> December 2018	Q2 ex post 2018-19 model based on pre-8 <sup>th</sup> November 2018 condition  Updated 2018-19 ex ante full year forecast reflecting updated Q2 2018-19 Budget based on pre-8 <sup>th</sup> November 2018 condition. (Note: Timing of this may be subject to change)
29 <sup>th</sup> March 2019	An ex ante 2019-20 forecast model reflecting the new condition  A Q3 ex post 2018-19 model based on the pre-8 <sup>th</sup> November 2018 condition
28 <sup>th</sup> June 2019	Full year 2018-19 ex post submission based on the pre-8 <sup>th</sup> November 2018 condition

If you have any issues with this approach could you please let us know as soon as possible. We are of course very happy to discuss the matter further with you.

Yours sincerely,

Dawn Longman  
Head of Competition Policy