



▶▶ Laying the foundations for a sustainable postal service

Licence modification decision

March 2011

Decision

This document sets out Postcomm's decision to modify Conditions 1, 2, 4, 7, 15 and 21 of Royal Mail's licence to give effect to Postcomm's final decisions on the regulatory framework for 2011-12. This includes changes to the price and access headroom control, cost transparency and accounting separation. This decision has been taken having considered all the representations made in accordance with the formal notice of proposed licence modifications under Section 14 of the Postal Services Act 2000 and not withdrawn. Royal Mail has consented to such modifications.

This document also contains, as appendices:

- The final form of the modifications to Royal Mail's licence.
- The Direction made under Condition 7 in relation to licensed and non-licensed services offered, or intended to be offered, in markets where Postcomm has found Royal Mail Group Limited does not have market power.
- The Methodological Principles.
- The Direction in relation to disclosure of Royal Mail's Costing Manual anticipated by the new Condition 15.
- The undertakings given by Royal Mail in relation to those areas of the Costing Methodology which are not compliant with the Costing Methodology Guiding Principles and the Methodological Principles and in respect of which more time is required for such matters to be addressed.

Implementation

All the above will come into effect on the date of publication of this document.

Summary

- S.1 In February we published our final decisions on changes to the regulatory framework in 2011-12¹. Alongside this we also published a notice, pursuant to section 14 of the Postal Services Act 2000, of the proposed modifications to Royal Mail's licence necessary to implement the changes².
- S.2 These changes relate to:
- The regulatory safeguards that should apply in 2011-12 (including cost transparency, accounting separation and price and headroom controls).
 - The level of price control, including our decision on Royal Mail's application for additional revenue in 2011-12.
- S.3 Having considered the representations received and not withdrawn, we have confirmed the proposed licence modifications subject to certain minor amendments. The final licence modifications are attached as Appendix A. Royal Mail has consented to the final licence modifications.
- S.4 We also provide an update on the Costing Manual and associated undertakings. In this respect, Royal Mail has now addressed the small number of areas which we identified in February as requiring further work in order for them to be compliant where feasible before 1 April 2011. Other areas of non-compliance which we acknowledged could not be addressed in this time frame are addressed by way of undertakings. Additionally we are publishing a Direction under Condition 15 in relation to the publication of the Costing Manual.
- S.5 We are also publishing the Direction under Condition 7 in relation to licensed and non-licensed services offered, or intended to be offered, in markets where Postcomm has found Royal Mail³ does not have market power. This is attached as Appendix B.

¹ "Laying the foundations for a sustainable postal service", Postcomm's Final Decision 2011-12 Regulatory Framework, February 2011.

² See Appendix C to the Explanatory Memorandum and notice of proposed licence modifications under Section 14 of the Postal Services Act 2000 in which it was published in draft form.

³ Royal Mail Group Limited.

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Chapter 1: Introduction

- 1.1 This document summarises the responses we have received to the statutory notice of proposed licence modifications published on 22 February 2011⁴ (the “Notice”) and sets out our response to the issues raised by respondents and our decision.
- 1.2 The licence modifications we proposed are required to give effect to our final decisions on the 2011-12 regulatory framework as set out in our decision document⁵. This includes changes to the price and access headroom control, and requirements for cost transparency and further accounting separation.
- 1.3 We received four responses to the Notice, from the Communication Workers Union (“CWU”), Royal Mail and from two access operators. These responses have been summarised in the relevant sections of this document⁶.
- 1.4 In response to the representations made by Royal Mail and the access operators, we have made some minor amendments to the proposed licence modifications. Our decisions on the relevant modifications are also set out below.
- 1.5 Royal Mail has agreed to the final form of the revised Conditions 1 (Interpretation and construction), 2 (Provision of universal postal service), 4 (Services, standards of service and compensation), 7 (Provision of information to users), 15 (Accounting separation) and 21 (Prices for postal services) attached as Appendix A.
- 1.6 This decision document should be read with the following documents that can be found on our website (www.psc.gov.uk):
- Laying the foundations for a sustainable postal service, 22 February 2011 (the “February decision document”)
 - Explanatory Memorandum and notice of proposed licence modifications under Section 14 of the Postal Services Act 2000, 22 February 2011 (the “explanatory memorandum”)
 - Costing Manual disclosure consultation, 21 December 2010 (the “disclosure consultation”)
 - Laying the foundations for a sustainable postal service, 8 November 2010 (the “November document”).

⁴ See Appendix C to the Explanatory Memorandum and notice of proposed licence modifications under Section 14 of the Postal Services Act 2000.

⁵ “*Laying the foundations for a sustainable postal service*”, Postcomm’s Final Decision 2011-12 Regulatory Framework, February 2011.

⁶ The response of the CWU is published on our website.

Chapter 2: Background

2.1 In the November document, Postcomm published its conclusions regarding the proposals for changes to the regulatory framework for 2011-12 that were set out in May 2010⁷. Specifically, the November document covered the following:

- Final conclusions on the analysis of packet and parcel products and wholesale Letter and Large Letter markets, and candidate retail Letter and Large Letter markets (based on a supply side analysis).
- Final decisions on the need for improved cost transparency and further accounting separation.
- A final decision to roll forward the price control in other respects, and to allow Royal Mail to increase the price of the controlled P.O. Box product in 2011-12.
- Final proposals for changes to the notification and publication requirements of Condition 7 and changes to the regulatory safeguards for the packet and parcel product markets.
- Minded to decisions on the remainder of the changes proposed to the price control and access headroom regime particularly in relation to the regulation of pre-sorted bulk mail products.
- Our minded to decision to accept Royal Mail's application for additional allowed revenue to support the funding of its modernisation programme and safeguard the provision of the universal service (the "Application").

2.2 In the disclosure consultation we set out our proposals in relation to the requirements for disclosure of Royal Mail's product Costing Manual. This is part of our ongoing work to secure greater transparency of Royal Mail's costs as a key input to support more targeted regulation.

2.3 In the February decision document, we published our final conclusions on the regulatory safeguards to apply in 2011-12 in relation to:

- The form of disclosure of Royal Mail's Costing Manual.
- A revised accounting separation pilot with respect to Royal Mail's Letters business.
- The regulatory safeguards that should apply to packet and parcel, and pre-sorted bulk mail products.
- The level of the price control, including our decision on the Application.

2.4 Alongside the February decision document we published the explanatory memorandum and notice of proposed licence modifications as required under

⁷ "Laying the foundations for a sustainable postal service", May 2010 consultation.

section 14 of the Postal Services Act 2000, as well as a draft Direction under Condition 7⁸ and a Direction under Condition 21⁹. These documents reflected the final conclusions set out in the February decision document.

Representations on the notice of proposed licence modifications were sought by the end of 22 March 2011.

- 2.5 This decision document considers the issues raised by the respondents to the notice of proposed licence modifications, sets out our response to these issues, and explains any implications for our final decision on the licence modifications to the various conditions of Royal Mail's licence. These are described in detail below.

⁸ Draft Direction in relation to licensed and non-licensed services offered, or intended to be offered, in markets where Postcomm has found Royal Mail does not have market power.

⁹ Direction in relation to Private Boxes Transfer to PO Boxes 12 Months.

Chapter 3: Package of regulatory safeguard measures

- 3.1 In this chapter we address responses received relating to our decisions on the package of regulatory safeguard measures. We also provide an update on the preparation of Royal Mail's Costing Manual and associated undertakings.
- 3.2 The responses referred to the following:
- The scope and form of Condition 7.
 - Targeting regulation – packet and parcel products.
 - Targeting regulation – retail and access pre-sorted bulk mail products.
 - The relationship between the reduced scope and form of the accounting separation pilot and the above decisions in relation to the regulation of packet and parcel products and retail and access pre-sorted bulk mail products.
 - Our approval of the Application.
- 3.3 We also set out whether, in addressing these responses or otherwise, any changes to the proposed licence modifications we published alongside our February decision document are required.

Section 1: Summary of responses

- 3.4 As set out above in Chapter 1, we received four responses to our consultation on proposed licence modifications: from Royal Mail, the CWU and two access operators. None of these responses proposed significant changes to the proposed licence modifications. Both Royal Mail and the CWU did raise concerns relating to the more limited extent of our decisions to reduce regulation in comparison with what we had set out in the November document. In that regard, Royal Mail provided further commentary from its independent consultants on the package of regulatory safeguard measures we set out in our February decision document, in particular the link we had drawn between the reduced scope of the accounting separation pilot to which Royal Mail was prepared to commit and the scope of our proposed deregulation.
- 3.5 The access operators raised two concerns in relation to possible future developments in relation to access charges that they considered may have an impact on the level of headroom and equivalence of treatment between Royal Mail's retail operations and access operators. We have set out our response to these issues below. Overall, and aside from the points raised by the access

operators, no new substantive issues were raised that had not been raised previously.

General

- 3.6 Royal Mail welcomed recognition from Postcomm of the financial pressures on Royal Mail. It stated, however, that there was an urgent need for fundamental regulatory reform and a very different approach to regulation¹⁰. It considered that the approach we have followed to date remains one of incremental change to an existing framework and that this is no longer fit for purpose.
- 3.7 The CWU supported “*moves to grant Royal Mail more freedom and to create a more level playing field on which it can compete*”. However, it noted that, in its view, even with the deregulatory measures being introduced, the 2011-12 price control for Royal Mail “*will still apply to a wider range of products – and be more restrictive – than the controls imposed on other European incumbents, such as TNT and Deutsche Post, in their home markets*”.

Condition 7

- 3.8 Regarding our decision on the scope and form of Condition 7, the CWU was disappointed that we did not reduce the notification and publication requirements where competition is developing but Royal Mail retains market power. It noted that competitors to Royal Mail do not face such general publication or notification requirements and reiterated its view, expressed in its response to the November document, that the current regulatory regime in this respect unduly restricts Royal Mail and denies it a level playing field on which it can compete.
- 3.9 Royal Mail also expressed its “*great disappointment*” that we had not implemented our November final proposals for reducing the advance notification and publication requirements of Condition 7.

Targeting regulation – packet and parcel products

- 3.10 Regarding our decisions for packet and parcel products, Royal Mail again regretted that we were not fully implementing what we set out in the November

¹⁰ Royal Mail cited in this respect the Hooper review, published in December 2008 and updated in September 2010. Royal Mail also said their view was reiterated by the Government when introducing the Postal Services Bill.

document, in particular the proposal to remove price and headroom controls down to 500g¹¹.

- 3.11 The CWU also expressed its disappointment that the deregulation of packet and parcel products was to be narrower than the final proposal we consulted upon in the November document. It reiterated its view, expressed in its response to the November document, that our decision did not reflect the competitive conditions in this market¹².

Targeting regulation – retail and access pre-sorted bulk mail products

- 3.12 Regarding our decisions for the retail and access pre-sorted bulk mail products, Royal Mail raised a specific issue in relation to its First Class Mailsort packet product. In our February decision document we explained that, as a result of Royal Mail's indicative access prices and our decision on the level of headroom for packet products, the minimum prices for Second Class Mailsort packet products would be above the maximum permitted First Class Mailsort packet prices up to 323g in 2011-12. To resolve this pricing anomaly Royal Mail had requested that the sub-cap in respect of First Class Mailsort low weight packet products be increased to the level of the Second Class price increase.

- 3.13 In the February decision document, we explained that Royal Mail's First Class Mailsort 1400 packet revenue accounts for a small percentage of its total revenue in the B2X deferred light (less than 2kg) market. Accordingly the market impact of any temporary distortion that would arise between First Class and Second Class Mailsort packet prices, if the relevant sub-cap was not adjusted, would be small, while removal of the sub-cap would result in price increases of up to 25% for some affected products.

- 3.14 On the basis of the information provided to us by Royal Mail at the time, we decided not to agree to its request. In its response to the February decision document, however, Royal Mail repeated its earlier request for the sub-cap concerned to be relaxed, to permit its retail prices to be adjusted to avoid the anomaly and associated distortion that would otherwise arise due to the increase in headroom for low weight packets, and the consequent increase in Second Class Mailsort packet prices. It provided further information to support its request.

- 3.15 The CWU reiterated the view it expressed in its response to the November document that our approach to the level of headroom was a clear indication that

¹¹ Under our November proposals, the advance notification and publication obligation in relation to price and non-price changes would also have been limited in relation to packet and parcel services to this weight threshold.

¹² The B2X deferred light (less than 2kg) market.

we were “*continuing to prioritise competitors – and the business models they have developed based upon the flawed access regime – over Royal Mail and the universal service*”.

- 3.16 Two access operators expressed concern about the proposed introduction of additional access charges by Royal Mail as a surcharge over the standard access price. One of these initiatives would raise a potential issue of non-equivalence and the other as to the maintenance of the appropriate level of headroom.
- 3.17 The access operators also sought clarification on how the formula which permits Royal Mail to offer a small cost-reflective discount of up to 2% for zonal prices by comparison with the national access price would apply in various circumstances.

Accounting Separation

- 3.18 Royal Mail did not consider that our linkage of deregulation to accounting separation was well founded. It commented that its independent consultants were of the view that the information Royal Mail has agreed to provide should still allow Postcomm to give Royal Mail the flexibility in 2011 as proposed in the November document.
- 3.19 The CWU also noted that the changes in the February decision document reflected the reduced accounting separation measures agreed by Royal Mail for 2011-12 as a pilot year. It also considered that this did not warrant the scaling back of our proposals for deregulation set out in our decision.
- 3.20 The CWU considered that product profitability statements would be sufficient for us to achieve our regulatory aim of preventing cross-subsidisation by Royal Mail from areas where it has a dominant market position, to those where it faces increasing competition. It considered that there was not a material difference between product profitability statements and the information available from fully separated accounts (which would also take account of exceptional items). It also considered that in our November document we had stated that product profitability statements would be sufficient to prevent cross-subsidisation within the regulated area and to monitor margins in Royal Mail’s access basket. It did not believe it was clear why Postcomm changed its position on this point.

Royal Mail’s Application

- 3.21 Regarding our decision to allow the Application, Royal Mail welcomed the additional revenue allowance as a necessary part of an overall package of measures being undertaken to safeguard the progress of on-going modernisation and the future of Royal Mail and the universal service. The CWU also welcomed our decision to grant the Application.
- 3.22 The CWU also reiterated the view it expressed in its response to the November document, that the current price control has been unduly restrictive and the additional price increases were necessary to address this. It considered that Royal Mail “*will still be forced to price below its costs for a number of services*” in 2011-12. The CWU also commented that, as a consequence of Royal Mail being forced “*to improve its performance on an uneven playing field*”, its members have been put under great strain¹³. The CWU urged us to understand the human impact of regulation and reflect this in our work.

Changes to the proposed licence modifications and the draft Direction under Condition 7

- 3.23 Regarding Condition 7, Royal Mail suggested adding, for clarity, the following words to the end of sub-paragraph (e) of paragraph 5 of Condition 7: “*This need not extend the original notification/publication period [unless Postcomm so directs]*”.
- 3.24 Regarding the draft Direction in relation to market power under Condition 7¹⁴, Royal Mail noted the definition of individually negotiated contracts should be amended to *include* terms relating to price because individually negotiated contracts by their nature include price variations for individual customers.
- 3.25 Regarding Condition 21, Royal Mail proposed a number of minor amendments to the numbering of Controlled Services in paragraphs 28 and 38, and to the definition of Miscellaneous Services. Royal Mail also proposed an amendment to the formula in paragraph 16 to implement its request that the sub-cap in respect of First Class Mailsort low weight packet products be increased to the level of the Second Class Mailsort price increase.
- 3.26 The access operators also pointed out an incorrect cross-reference in the Notice.

¹³ The CWU referred to increased workloads and unacceptable pressure being placed upon them by the business.

¹⁴ Draft Direction in relation to licensed and non-licensed services offered, or intended to be offered, in markets where Postcomm has found Royal Mail does not have market power (see Appendix C to the explanatory memorandum).

Section 2: Postcomm's analysis and decision

General

3.27 Regarding Royal Mail's and the CWU's general criticism of our approach, we repeat that the February decision was the culmination of our work to implement a package of changes to the regulatory framework for 2011-12 in order to lay the foundations for a new regulatory framework to take effect from 2012. Our work included careful consideration of:

- Our statutory duties under the Postal Services Act 2000.
- The deterioration in Royal Mail's financial performance highlighted to us by the Application.
- The importance of reaching a timely resolution in relation to a transitional regulatory framework for 2011-12 in the interests of users and other market participants, as well as Royal Mail.
- The consistent concerns raised by users, trade associations and other operators in relation to regulatory risk arising from deregulating too far and too fast, by reference to our duty to further users' interests.
- Royal Mail's position in relation to the scope of accounting separation pilot that it was prepared to commit to.
- Royal Mail's continued market power in a number of postal markets.

3.28 As set out in the February decision document, we always considered that, while it was necessary to make some changes for 2011-12, the proper context within which to address the broader and fundamental issues arising from the present market context, including factors relating to Royal Mail's performance and position in a market in structural decline, was in developing proposals for 2012 and beyond.

3.29 Therefore, in balancing the relevant considerations to reach the decisions adopted in February, we considered it relevant to take account of the fact that the overall package of changes to the regulatory framework would only be for a transitional year. Regardless of whether or not the Postal Services Bill is passed in its current form, we agree that a more fundamental review of the regulatory framework from 2012 is needed. Our February decision was, in our view, appropriate to enable a suitable transition to this medium term position and fully consistent with our statutory duties, including taking due account of Royal Mail's financial position.

3.30 In this context, however, it is important to re-iterate that our decisions do not amount to confirmation of compliance by Royal Mail with its licence obligations

with regard to the actual level of prices it chooses to adopt in using the additional flexibility provided as a result of our approval of the Application. As stated in our February decision document, we expect Royal Mail to ensure compliance with its licence obligations under the 2011-12 regulatory framework in relation to both price and non-price terms.

Condition 7

- 3.31 Our decision to make no change to the existing notification and publication requirements for Condition 7 in markets where Royal Mail has market power (including those markets where competition is developing but Royal Mail retains market power) was taken following consideration of responses to the November document and Royal Mail's position on accounting separation. We set out the analysis that supported this decision in the February decision document and we have not received any new evidence that would call this analysis into question.
- 3.32 Regarding the CWU's observation that Royal Mail's competitors do not face such general publication or notification requirements and that these requirements deny Royal Mail a level playing field on which to compete, in our view such a level playing field would exist where Royal Mail does not have market power. This is reflected in our decision not to apply Condition 7 in markets where Royal Mail does not have market power, with only more limited notification and publication requirements for Condition 7 for the transitional year of 2011-12 in such markets. It is the absence of such a level playing field in other markets that has led us to consider whether additional safeguards are required.

Targeting regulation – packet and parcel products

- 3.33 Our decision to only remove price and headroom controls down to 1kg was a result of considering responses to the November document and Royal Mail's position on accounting separation. We set out the analysis that supported this decision and our decisions in relation to the package of deregulatory measures for packet and parcels products in the February decision document. While we note the observations made, we have not received any new evidence that would call this analysis into question.

Targeting regulation – retail and access pre-sorted bulk mail products

- 3.34 In considering the specific issue raised in relation to Royal Mail's First Class Mailsort packet product, we note Royal Mail's view that leaving the anomaly in

place would “*perplex customers*” and add cost to its network, as addressing it in retail prices would involve further changes to both First Class and Second Class Mailsort packet prices. In support of its further request, Royal Mail provided us with additional evidence to the effect that relaxing the sub-cap would have a very small revenue impact¹⁵. We have also taken account of the fact that, in applying a greater increase to such products, Royal Mail would still be subject to the obligation to be within the overall revenue constraint for Basket B.

- 3.35 We acknowledge Royal Mail’s point that leaving the sub-cap unchanged could have wider market impacts than adjusting the sub-cap to avoid the anomaly, given the small revenue impact of such an adjustment. We also note that, based on the additional information provided by Royal Mail, relaxing the sub-cap could assist in improving the cost-orientation of the retail prices concerned, as the product is currently loss-making.
- 3.36 In light of the additional information provided by Royal Mail and on this exceptional basis, we have therefore decided to allow a relaxation in the sub-cap for First Class Mailsort packet prices so that in the 2011-12 transitional year they can be increased by the higher of the Basket B sub-cap and the equivalent price increase for Second Class Mailsort packet products to ensure the existing retail prices for relevant First Class Mailsort products remain above those for Second Class Mailsort products. As a consequence of using such a relaxed sub-cap, other Basket B price increases will need to be correspondingly lower in order to comply with the overall Basket B limits set out in our February decision document.
- 3.37 In response to the CWU’s view that our decision on headroom meant that we were prioritising competitors over Royal Mail and the universal service, we do not accept this view. We set out our analysis that supported our decision on the level of headroom in the February decision document. This analysis took into account the views and evidence received in response to our November document and, on the basis of this, we remained of the view that our approach to changing headroom was appropriate for the 2011-12 transitional year and consistent with our statutory duties. We have not received any new evidence that would call this analysis into question. The initial proposals that we intend to publish on the safeguards that should apply for a new regulatory framework from 2012 will review the need to retain ex ante controls on headroom and, if required, the form, structure and level of any control.
- 3.38 The access operators have highlighted two issues of equivalence between Royal Mail’s access products and its corresponding retail products. If Royal Mail did apply a surcharge for not complying within certain tolerance levels of

¹⁵ £0.2m, and the product concerned would still be loss-making following the change.

the national geographic posting profile without applying a similar surcharge to its own retail operations, this is likely to raise issues of non-equivalence. The access review¹⁶ (on which initial proposals were published in March 2011) is considering equivalence of non-price terms. Should this issue arise before relevant changes are implemented to the regulatory framework, this could if necessary be considered and addressed further under the existing terms of Royal Mail's licence.

- 3.39 In respect of the formula which permits Royal Mail to offer a small cost-reflective discount of up to 2% for zonal prices by comparison with the national access price, the access operators asked for clarity as to how this would apply. This is particularly relevant in the event that Royal Mail, within 2011-12, introduces a price differential between the national access price for wholesale customers who provide additional information about the zonal profile of the mail that they send through Royal Mail Wholesale and those who do not.
- 3.40 The zonal pricing formula for 2011-12¹⁷ relies upon a definition of a national price by reference to which zonal pricing is to be assessed¹⁸. The definition of that term refers to an Access Service that is "priced on a geographically uniform basis"¹⁹. We would not expect Royal Mail to 'double count' by reference to discounts that are set by reference to any zonally based differential, including one based on the provision of zonal data or zonal information. Such discounts could be interpreted as bringing the terms of national access more in line with the terms of zonal access.
- 3.41 For the avoidance of doubt, for the purposes of calculating headroom²⁰ the Reference Service²¹ is that corresponding to the relevant retail Controlled Service which by definition is not offered on a zonal basis at present. Therefore the price of the Reference Service could not reflect any price differential based on any form of zonal differentiation including the provision of information.
- 3.42 In relation to another clarification requested by the access operators, any levy or charge generally applicable on a compulsory basis to all customers of a particular wholesale service would be assumed to be included within the base case price for the purposes of compliance with the formulae within the licence, whether or not that charge is separated by Royal Mail in its presentation of prices to customers.

¹⁶ "The building blocks for a sustainable postal service", Access Review 2012 – Initial Proposals, March 2011.

¹⁷ See sub-paragraph 4 of paragraph 5A of Condition 21.

¹⁸ p(s,t).

¹⁹ Ibid.

²⁰ See paragraph 5 of Condition 21.

²¹ As defined in paragraph 38(a) of Condition 21.

Accounting separation and the extent of deregulation

3.43 The February decision document summarised a number of key areas where the reduced accounting separation measures that Royal Mail was prepared to undertake in 2011-12 fell short of those underpinning our deregulation proposals set out in the November document²². This included the following:

- There will be no split, using 2011-12 data relevant to the deregulation proposed in the November document, of revenues and costs between Royal Mail's regulated upstream and downstream activities. Given that our market study has concluded that Royal Mail has market power in the supply of the downstream services concerned, this is a significant reduction in the scope of the 2011-12 pilot. The relative profitability of upstream and downstream services can no longer be monitored during the 2011-12 year.
- There will be no separation of costs, assets and liabilities other than at the operating cost level in 2011-12 as a result of the reduced measures. Existing regulated price control limits are set by having regard to relevant costs beyond operating costs, including extraordinary costs and cash contributions to Royal Mail's pension deficit. Given the respective sizes of Royal Mail's transformation programme and pension deficit, these are, in our view, material factors to consider in identifying the relative profitability of the regulated and deregulated parts of Royal Mail's Letters business.
- While Royal Mail has committed to use its reasonable endeavours in preparing historic (2010-11) information according to a set of Accounting Separation Guiding Principles, there will be no specific regulatory oversight or documentation of the basis on which the reduced form of accounting separation will be undertaken, of the form assumed in putting forward our November proposals.

3.44 Taken together therefore, we remain of the view that the reduced form of accounting separation which Royal Mail has agreed to undertake in 2011-12 represents a material reduction in the scope and quality of the regulatory reporting information available to support deregulation in the 2011-12 transitional year. It was on this basis that we made the decisions on deregulation set out in the February decision document. We do not consider that Royal Mail or the CWU put forward material new arguments.

Amendments to the proposed licence modifications and the draft Direction under Condition 7

3.45 We have decided largely to incorporate the changes put forward by Royal Mail and the access operators to the proposed licence modifications. We have also made minor amendments where relevant to reflect changes in dates, to clarify

²²See paragraph 3.46.

and ensure consistency of language and address some circular wording, and to address typographical errors.

3.46 Regarding Condition 7:

- We have amended the reference in sub-paragraph (d) of paragraph 2 to paragraph 16 of Condition 4 to paragraph 19²³ to reflect the outcome of our Licensing Review which has resulted in a re-numbering of the paragraphs in Condition 4²⁴.
- We have changed the tense in sub-paragraph 1 of sub-paragraph (ii) of sub-paragraph (a) of paragraph 5 for clarificatory purposes²⁵.
- We have amended the date referred to on which the Direction under Condition 7 in relation to licensed and non-licensed services offered, or intended to be offered, in markets where Postcomm has found Royal Mail does not have market power, has been made²⁶.
- We have inserted the following at the end of sub-paragraph (e) of paragraph 5: “, but this need not extend the submission and publication period already given unless Postcomm so directs”²⁷.

3.47 Regarding Condition 21:

- In sub-paragraph (i) of sub-paragraph (a) of sub-paragraph 4 of paragraph 5A we have amended the definition of “ $p_{(s,t)}$ ” for clarificatory purposes²⁸.
- In sub-paragraph (ii) of sub-paragraph (a) of sub-paragraph 4 of paragraph 5A, and sub-paragraph (b) of sub-paragraph 4 of paragraph 5B, we have amended the formula by inserting a bar over “p” to ensure the formula operates appropriately to give effect to our decision to allow Royal Mail to offer a small cost-reflective discount of up to 2% on zonal access prices²⁹.
- In sub-paragraph (b) of paragraph 10 we have inserted a footnote to clarify that although the formula set out to define the representative price in the relevant Formula Year³⁰ has been deleted, it remains relevant for external auditing purposes up to and including Formula Year $t = 6$ ³¹.
- In the new sub-paragraph (i) of sub-paragraph (b) of paragraph 10 we have deleted the following words that are no longer necessary for Formula Year $t = 6$: “and for each Price Range for every other Controlled Service”³².

²³ See paragraph 1 of the modifications to Condition 7 set out in Appendix A.

²⁴ See “*Licensing review: Licence modification decision*”, published 29 March 2011.

²⁵ See paragraph 3 of the modifications to Condition 7 set out in Appendix A.

²⁶ See paragraphs 3 and 6 of the modifications to Condition 7 set out in Appendix A.,

²⁷ See paragraph 3 of the modifications to Condition 7 set out in Appendix A.

²⁸ See paragraph 12 of the modifications to Condition 21 set out in Appendix A.

²⁹ See paragraphs 13 and 14 of the modifications to Condition 21 set out in Appendix A.

³⁰ As defined in paragraph 38(a) of Condition 21 of Royal Mail’s licence.

³¹ See paragraph 27 of the modifications to Condition 21 set out in Appendix A.

³² See paragraph 30 of the modifications to Condition 21 set out in Appendix A.

- In sub-paragraph (d) of paragraph 16 we have amended the wording to reflect our decision to allow a relaxation in the sub-cap for First Class Mailsort packet prices³³.
- In paragraph 28 we have inserted “and where $t + 1 = 6$ ” in place of “and where $t + 1 = t = 6$ ”, and we have inserted “Controlled Services numbered 14 to 38” in place of “Controlled Services numbered 14 to 32 and in respect of Controlled Services 33 to 38”, for clarificatory purposes³⁴.
- In paragraph 38 we have amended the numbering of Controlled Service Mailsort 700 CBC 2nd Class to reflect a typographical error, and we have corrected an additional typographical error³⁵.
- In paragraph 38 we have amended the wording in the definition of Miscellaneous Services and the accompanying footnote for clarificatory purposes and we have corrected a typographical error³⁶.

3.48 Regarding the draft Direction under Condition 7:

- We have amended the definition of individually negotiated contracts to make clear that an individually negotiated contract clearly includes one where there has been negotiation on price. The original wording was a typographical error.
- Paragraph 4 has been deleted since there is no longer any need to make special provision for universal service products where Royal Mail does not have market power, in light of our final market study conclusions³⁷.

Section 3: Update on the Costing Manual and associated undertakings

3.49 Royal Mail provided a draft Costing Manual to Postcomm on 1 March 2011. Together with our advisers, Analysys Mason, we reviewed this draft for compliance with the Costing Methodology Guiding Principles and the Methodological Principles as set out in the February decision document. Royal Mail had made substantial progress on the Costing Manual and following this review we identified only a relatively small number of areas (both in the first part of the Costing Manual and the Technical Appendices) which required further work in order for them to be compliant. Royal Mail has now addressed all such matters other than those which were already known to be non-compliant and that could not be immediately addressed. These are being addressed by way of undertakings (see below). Analysys Mason has also provided its opinion (a

³³ See paragraph 43 of the modifications to Condition 21 set out in Appendix A.

³⁴ See paragraphs 58 and 59 of the modifications to Condition 21 set out in Appendix A.

³⁵ See paragraphs 66 and 67 of the modifications to Condition 21 set out in Appendix A.

³⁶ See paragraphs 68 and 69 of the modifications to Condition 21 set out in Appendix A.

³⁷ See Annex 1: Analysis of markets – Decision document to the November document, and paragraph 4.28 of the February decision document.

copy of which has been published on our website alongside this document) that the Costing Manual complies with the Costing Methodology Guiding Principles and the Methodological Principles subject to the outstanding matters set out in the undertakings.

- 3.50 As envisaged in the revised Condition 15(7), Royal Mail has given Postcomm undertakings in relation to those areas of the Costing Methodology which are not compliant with the Costing Methodology Guiding Principles and the Methodological Principles and in respect of which more time is required for such matters to be addressed. A copy of the undertakings is attached as Appendix C. Broadly, the undertakings relate to the following areas:
- Updates to the Technical Appendices and Costing Manual once unaudited and audited 2010-11 data become available.
 - Third class delivery costing and the RDC infill methodology.
 - The costing methodology in relation to certain services (Timed Delivery, Safebox, Keepsafe, Mail Collect, Rural Newspapers, Poste Restante and Diversions).
 - Attribution of Post Office Limited contract costs.
 - Attribution of commercial activity costs.
- 3.51 Annex C to the undertakings has been redacted as it contains commercially sensitive information which relates to the specific issues in the areas set out above and which we do not consider it is appropriate to publish at this time.
- 3.52 Further, we note that in relation to these issues there is still work to be done to agree with Royal Mail the most effective and efficient method to remedy the non-compliance. Indeed, it is for this reason that they have been included in the undertakings and were not addressed before the start of the 2011-12 financial year. The undertakings reflect this and provide for a process through which compliance will be achieved.
- 3.53 On this basis, Postcomm is satisfied with the undertakings given by Royal Mail for the purposes of paragraph 7 of Condition 15.
- 3.54 We have also attached as Appendix D the Methodological Principles which shall apply and which are also available on our website. A number of minor changes have been made to align certain defined terms in Condition 15 with the defined terms in the Methodological Principles (for example, in relation to the definitions of the “Costing Manual” and “Costing Methodology”) and also to

ensure consistency in language more generally and to address typographical errors³⁸.

- 3.55 We have also made some minor changes to the drafting of Condition 15 to reflect operational changes due to timing and because some of the obligations as envisaged in the Notice no longer apply (for example, Royal Mail has already provided the draft Costing Manual). We have also made a small drafting change in relation to the requirement for Royal Mail to ensure its auditors provide the necessary Assurance Statement in relation to the Costing Manual.
- 3.56 Finally, in relation to disclosure of the Costing Manual we have attached to Appendix E the relevant Direction requiring the first part of the Costing Manual which shall include a list of the headings of the Technical Appendices to be published by 31 March 2011.

³⁸ We now refer to “postal packets” rather than “letters or other mail items”; the reference in the definition of Activity Drivers is now to Principle 10; the definitions of Royal Mail Letters and Sub-products now align with the licence definitions.

Chapter 4: Decision on licence modifications

- 4.1 In light of the representations received and not withdrawn, we have made some minor changes to the draft of the licence modifications contained in the Notice. The final licence modifications are attached as Appendix A.
- 4.2 As indicated above in Chapter 1, Royal Mail has already consented to these revised licence modifications and therefore they will come into effect on the date of publication of this document.
- 4.3 A copy of the licence modifications will be sent to Royal Mail, Consumer Focus and the Secretary of State, in accordance with Section 14(6) of the Postal Services Act 2000.

Appendix A: Notice of licence modifications

A.1 Attached as separate document.

Appendix B: Direction under Condition 7

B.1 Attached as separate document.

Appendix C: Royal Mail undertakings

C.1 Attached as separate document.

Appendix D: Methodological Principles

D.1 Attached as separate document.

Appendix E: Direction under Condition 15

E.1 Attached as separate document.