



Commission for Communications Regulation

Revised Accounting Direction and Related Issues

8 September 2006

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Glossary

The following abbreviations are used in this report:

ABC	Activity based costing
Accounting Manual	An Post's Accounting Manual. Our work is based on the Accounting Manual for the year commencing 1 January 2004
AMU	Air Mail Unit at Dublin Airport
AS	Accounting separation
BAA	British Airports Authority
CAA	Civil Aviation Authority
CAM-I	Consortium for Advanced Manufacturing International
Ceadúnas	A payment channel for prepaid or invoiced mail sent by bulk mailers. Ceadúnas payment can cover many different types of mail service offered by An Post, eliminating the need for stamps or franking/meter machine indicia
CEN	The European Committee for Standardisation
ComReg	Commission for Communications Regulation: the NRA for postal services in Ireland
CVR	Cost volume relationship
DAM	BT's Detailed Attribution Methods document
Direction	Accounting Direction, 2001 (see ComReg Decision Paper 01/74: "Regulation of Universal Postal Services – Accounting Separation and Costing Methodology – Proposed Direction to An Post". September 2001)
EPMU	Equiproportional mark-ups. An approach to allocating joint and common costs
European Directive	The European Postal Services Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997
GAAP	Generally Accepted Accounting Principles, unless otherwise stated, this refers to Generally Accepted Accounting Principles applied in Ireland
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales

ICAI	Institute of Chartered Accountants in Ireland
IFRS	International Financial Reporting Standards
Indicia	Postal marks imprinted on processed envelopes to designate the payment channel or postal product paid
IPC	International Postal Corporation
IPK	Items per kilogram
ISA	International Standards on Auditing, Auditing Practices Board
NRA	National Regulatory Authority: Designated as ComReg, for Ireland
NSAI	National Standards Authority of Ireland
ODTR	Office of the Director of Telecommunications Regulation
Ofcom	Office of Communications, UK regulator for communications and telecommunications
Ofgem	Office of Gas and Electricity Markets, UK regulator for gas and electricity markets
Oftel	Office of Telecommunications, former UK regulator for telecommunications
Ofwat	Office of Water Services, UK regulator for water services
OPTA	Independent Post and Telecommunication Authority, Postal NRA in the Netherlands
Postcomm	Postal Services Commission, postal NRA in the United Kingdom
PRA	The Postal Reorganisation Act in the United States, passed in 1970
PRC	The US Postal Rate Commission
RAGs	Ofwat's Regulatory Accounting Guidelines
Regulations	European Communities (Postal Services) Regulations, 2000; S.I. No. 310 of 2000, superseded in 2002 by European Communities (Postal Services) Regulations, 2002; S.I. No. 616 of 2002
SAS	Statement on Auditing Standards, Auditing Practices Board
The operator	An Post

The regulator	ComReg
UPU	United Postal Union
USO	Universal Service Obligation
USP	Universal Service Provider: In Ireland, An Post has been designated as the USP
USPS	The United States Postal Service

1 Executive summary

Introduction

- 1.1 The Commission for Communications Regulation (“ComReg”) has retained LECG to review its 2001 Accounting Direction (the “Direction”). The Direction provides An Post with ComReg’s requirements for accounting separation, cost accounting and regulatory information, in accordance with Irish postal law.
- 1.2 We have been asked to review ComReg’s requirements relating to An Post’s: (i) mail volume and revenue measurement; (ii) cost allocation; and (iii) regulatory accounting information and related auditing requirements. We have also been asked to make recommendations where we believe that the requirements should be updated. This report sets out the results of our review.
- 1.3 This report has been written solely for the use of ComReg. We are aware that ComReg will rely, in part, on our findings and recommendations, as set out in this report. We are also aware that this report will be published as part of ComReg’s consultation processes for potential revisions to the Direction.
- 1.4 Some information in this report may be confidential. It should be reviewed by ComReg before publication, to ensure that commercially sensitive data is identified and redacted as appropriate.
- 1.5 In performing our work, we attempted to engage with An Post early in the process. Unfortunately, An Post only engaged with us towards the end of the engagement. This affected the nature and timing of our work, and we have had to adapt our approach accordingly. As a consequence, further consultation may be required before the revised Direction is finalised.

Project scope

- 1.6 In June 2006, ComReg commissioned LECG to review the existing Direction and to set out proposed revisions to that Direction, where we believed revisions were necessary and appropriate, together with supporting explanatory material. Specifically, LECG has been asked to:

- review and assess the existing Direction, the processes and procedures applied by An Post, as set out in its current Accounting Manual, and the regulatory accounts submitted to ComReg;
- assess alternative processes and procedures, taking into account international best practice; and
- prepare a draft revised Direction to reflect any amendments that we believe are necessary, appropriate and in a form consistent with ComReg's legal powers.

1.7 Our terms of reference are set out in full in Appendix 1.

Summary

1.8 We conducted this review in three stages, for each of the three subject areas: mail volume and revenue identification; cost allocation; and regulatory accounts and regulatory information auditing. A summary of our recommendations are provided below. Our full recommendations are contained within a draft revised Direction, which is set out in Appendix 8.

Mail volume and revenue identification

1.9 The identification of mail volume and revenues by service is not straightforward. An Post derives its figures from revenue information by payment channel, to which a number of adjustments are made to eliminate non-core services. It then allocates the residual amounts across formats and between the Reserved and Non-Reserved Sectors. Volume figures are then derived from the resulting revenue estimates by dividing by the weighted average tariff.

1.10 The process requires a number of sampling exercises to determine approximate allocations. These sampling exercises are based on protocols originally developed with the assistance of PwC in 2000. We believe that they would benefit from periodic review and updating by a suitably qualified expert, and that such a requirement should be built into the revised Direction. We believe that there are some reasons for concern as to whether the existing protocols are being properly applied. We believe therefore that the remit of the auditing expert could extend to a periodic review of An Post's application of the sampling procedures as well as the procedures themselves.

- 1.11 A review of European operators suggested that many use operational measures as the primary mechanism for estimating mail volumes. Additionally, experience in the UK has suggested that while revenue and operationally-based measures of volume are difficult to reconcile, the reconciliation process is valuable in revealing areas in which both measures could be improved. We believe that there is merit in such an approach, and that An Post's progressive mechanisation will allow operational measures to play an increasing part in refining volume estimates.
- 1.12 Finally, in our review of An Post's Accounting Manual and Regulatory Accounts we found a number of areas where the level of detail provided was insufficient to allow a full assessment of their compliance with the Accounting Direction.
- 1.13 We have compiled a number of options for revisions to the Direction to address the points noted above. Those options deal primarily with the way in which revenue and operational measures of volume might be used in the reporting of revenues and volumes for regulatory purposes. Our recommendation, for operational measures to be introduced and then reconciled with revenue based measures, has been reflected in the draft revisions to the Direction that are set out in Appendix 8.
- 1.14 Our recommendations are set out in full in Section 8.

Cost allocation

- 1.15 The Direction sets out the principles for cost allocation, which are based on Article 14 of the European Postal Directive. Most Member States have implemented the requirements of Article 14. An Post adopts an ABC methodology. The adoption of this methodology is consistent with common practice.
- 1.16 At a "principles level" An Post's approach appears to comply with the cost allocation requirements of the Direction. However, we have not been provided with enough information to assess An Post's cost allocation system in detail. Consequently, we are unable to determine whether An Post is in full compliance with the Regulations and Direction, or whether its application of ABC is consistent with best practice.
- 1.17 Where we have had access to postal accounting manuals, we have found that the level of disclosure is typically at the level of the principles that are applied.

An Post's Accounting Manual is also stated at a principles level. Based on the accounting manuals we have reviewed it is clear that An Post's Accounting Manual could be improved by increasing the level of disclosure. Our recommendations for further disclosure are set out in paragraphs 11.10 and 11.13.

- 1.18 An Post provides details on how costs are allocated to product groupings and how product grouping costs are allocated to individual products and services. It is questionable, however, whether An Post should provide further information in support of its cost allocation system. Such information might include a full description of each activity¹, the economic justification for each driver and details on how each driver is derived and verified. Such transparency may be beneficial, but ComReg would need to decide whether this extra disclosure would be fair and proportionate. We think this issue should be consulted on more widely.
- 1.19 However, some improvements are still required, particularly in relation to the derivation of equivalent volume drivers. It is not clear from the Accounting Manual how these are derived, how they reflect different mail characteristics, how often they are reviewed and updated or how they are verified.
- 1.20 An Post should have proper safeguards over its cost allocation system to ensure the proper functioning and the fairness of the allocation system. We are not questioning whether such safeguards exist. Rather, the Accounting Manual should document these safeguards, including how the cost allocation system is verified internally and how the system is updated for known factors, such as changes in processes and volume mix.
- 1.21 We believe that the process by which ComReg gains comfort on An Post's cost allocation methodology should be comprised of two components. We believe that there is a need for an initial one-off audit to review of the logic of the methodology and the accuracy of the system. Thereafter, on an annual basis, there is a need to verify changes to the methodology and to audit the accuracy of inputs and outputs. An Post's Accounting Manual should document the scope of the auditor's work.

¹ For further details refer to Table 7 on page 69.

1.22 Around half of the European regulators have reviewed and approved the regulated companies' system for allocating costs to particular services or will soon do so. Best practice would indicate that ComReg should also review and approve An Post's cost allocation system.

1.23 Our recommendations are set out in full in Section 11.

Regulatory accounting and audit issues

1.24 Our work in this area has identified four principal issues which stem from differences in interpretation of the requirements of the Direction. The issues relate to the content and format of the regulatory accounts, the level of transparency of the regulatory accounts, the basis of preparation adopted and the level of audit assurance provided on the regulatory accounting system.

1.25 The Direction needs to provide more clarity about the format and content of the regulatory accounts to ensure that ComReg receives the information and level of detail it requires to perform its legal obligations. We recommend that the Direction specifies a set of schedules to be used for the first year. Any subsequent changes to the schedules should be agreed between An Post and ComReg, as necessary, in advance of each reporting year.

1.26 The level of disclosure in An Post's regulatory accounts is lower than what is provided by other regulated entities. The Direction should be revised to require An Post to increase the level of disclosure in the regulatory accounts. Our recommendations for further disclosure are set out in paragraphs 14.5 and 14.15. In line with other regulated entities in the UK and Ireland, An Post should be encouraged to make its full Regulatory Accounts and Accounting Manual publicly available.

1.27 The basis of preparation of regulatory accounts is generally based on the Generally Accepted Accounting Principles ("GAAP")², which is amended as necessary by the regulator, to ensure that the accounts provide the information they require. ComReg has explicitly stated its desire to have the regulatory accounts prepared to reflect only the costs incurred and revenues earned in providing postal services for the relevant regulatory period. In all other areas,

² Unless otherwise stated, when we refer to "GAAP", we are referring to Irish GAAP.

unless agreed otherwise with ComReg, we recommend that An Post applies GAAP in preparing the regulatory accounts.

- 1.28 Whilst An Post complies with the requirements of the Direction to provide an auditor's statement of compliance with the Direction in its Annual Report, it is unclear whether the scope of this audit includes a verification of An Post's cost allocation system, as required by the Regulations. ComReg has indicated that it does not receive adequate assurance over the completeness, accuracy and validity of the cost allocation systems and the regulatory accounts from the auditor's opinion. We believe that commissioning an external audit of the regulatory accounts and cost allocation systems would provide significant benefits to both ComReg and An Post.
- 1.29 We found that it was common practice for regulated entities to appoint the same auditor for both the financial statement and regulatory audits. We believe that ComReg should be consulted before the appointment and reappointment of the auditor. ComReg should also agree to the auditor's terms of reference and the scope of the audit.
- 1.30 In the absence of specific guidance from the Institute of Chartered Accountants in Ireland ("ICAI"), we have reviewed guidance from the ICAEW which suggests the most appropriate audit form of opinion for the regulatory audit would be '*fairly presents and properly prepared in accordance with...*'. We believe that ComReg should consult further with An Post to develop the exact wording of the opinion.
- 1.31 Our recommendations are set out in full in Section 14.

Report structure

- 1.32 We have structured this report in four parts. The first part provides background to the issues, including our methodology, ComReg's statutory obligations and powers, and an outline of the original Direction. The second part considers mail volume and revenue identification issues, the third part considers cost allocation issues, and the fourth part considers regulatory accounting and auditing issues. In each of these parts, we first consider whether An Post has met the requirements of the existing Direction. We then outline our assessment of international best practice. We then provide our options for revising the Direction,

together with making a recommendation to ComReg. Suggest revisions to the Direction, in accordance with our recommendations, are set out in Appendix 8.

2 Introduction and scope of work

Introduction

- 2.1 In this section, we provide a background to ComReg's regulatory framework, our terms of reference, as well as highlighting our experience used to complete the project. We also set out some limitations to the scope of our work.

Regulatory background

- 2.2 ComReg is the national regulatory authority ("NRA") for the Irish postal industry. It has designated An Post as the universal service provider ("USP") under the powers given by the European Communities (Postal Services) Regulations 2002 ("the Regulations"); S.I. No. 616 of 2002. Under these Regulations, ComReg has a responsibility to issue directions to the USP relating to the preparation of separated accounts for each of its Reserved and Non-Reserved postal services.
- 2.3 In light of this obligation, and following a consultation process, an Accounting Direction ("Direction") was issued to An Post in September 2001. This sets out the procedures to be followed for accounting separation and cost accounting. A key objective of this direction was to increase transparency by making available for regulatory and internal management purposes adequate information on the profitability and costs of the various parts of An Post's business, so that each could be monitored as if it had been operated as a separate business.
- 2.4 Since that time, An Post has provided ComReg with Regulatory Accounts, which detail financial data according to a chosen segregation of services. An Post has also drafted an Accounting Manual, which provides ComReg with the operator's definition of services, as well as its procedure for identifying revenues and measuring mail volumes, and for allocating costs.
- 2.5 This mechanism should enable An Post to demonstrate its compliance with the key elements of the Regulations, including the Tariff Principles, Terminal Dues Principles, avoidance of cross subsidisation and Universal Service Obligations³, while assisting ComReg to fulfil its statutory obligations to monitor such compliance.

³ Statutory Instruments No. 616 of 2002 (EC (Postal Services) Regulations).

- 2.6 ComReg has become concerned with the adequacy and completeness of An Post's Accounting Manual. The regulator has questioned, *inter alia*, the mail volume calculation, the cost allocation procedures, the revenue identification process, the content of the Accounting Manual and the accuracy and reliability of the regulatory accounts, the timing of the Accounting Manual's submission, as well as the results of the revenue and volume identification process.
- 2.7 ComReg therefore commissioned an external review of the Direction. In addition to those noted above, ComReg had two further concerns. The first was that the provisions of the Direction might no longer be consistent with current needs, due to the fluxion of time (e.g. because of changes in the size of the Reserved Sector, increased use of EPOS postage labels, etc). The second was that the processes and procedures currently applied by An Post to identify its revenues, measure its mail volumes and to allocate and apportion its costs at a service level, together with the manner in which information is provided to ComReg, might not be sufficiently robust either to imply or to demonstrate compliance with the Tariff Principles.

Terms of reference

- 2.8 In June 2006, ComReg asked LECG to review the existing Direction and to develop a revised Accounting Direction together with supporting explanatory material. Our full terms of reference are attached in Appendix 1. LECG has been asked to provide:
- a review and assessment of the existing Direction, the information contained within An Post's Accounting Manual and the Regulatory Accounts that are submitted to ComReg;
 - an assessment of alternative processes and procedures taking into account international best practice; and
 - a draft revised Direction to reflect any amendments that we believe are necessary and appropriate and in a form consistent with ComReg's legal powers.

LECG Team

- 2.9 LECG is a global economics and consulting firm, which provides independent and objective advice and analysis on matters of economics, finance, and strategy, to

law firms, businesses, regulators, and governments. Founded in 1988, LECG has over 900 professional staff, including over 275 experts, operating in 30 offices throughout the Americas, Europe, and Asia-Pacific.

- 2.10 The skills required for this work are embodied in the members of the team who have worked actively on the project. Members of the team have extensive first hand experience of regulation and accounting. The team consists of a combination of economists, statisticians, accountants and postal experts. Our experts have advised a wide range of regulators and regulated companies in the UK, in Europe and in the US.

Limitations to our work

- 2.11 We have checked the internal consistency of data supplied to us by An Post, ComReg and other operators and commentators listed in this report. However, nothing in this report should be taken to imply that we have conducted any procedures or investigations in an attempt to verify or confirm, by means of reviewing source documentation or processes, the accuracy of the data underlying An Post's processes, beyond that specifically described in the report. Our work does not constitute an audit.
- 2.12 This report has been written solely for the use of ComReg. We are aware that ComReg will rely, in part, on our findings and recommendations, as set out in this report. We are also aware that this report will be published as part of ComReg's consultation processes for potential revisions to the Direction. Some information in this report may be confidential. It should be reviewed by ComReg before publication, to ensure that commercially sensitive data is identified and redacted as appropriate.
- 2.13 In performing our work, we attempted to engage with An Post early in the process. Unfortunately, An Post only engaged with us towards the end of our engagement. This affected the nature and timing of our work, and we have had to adapt our approach accordingly. As a consequence, further consultation may be required before ComReg's revised Direction is finalised.

Part A: Background

3 Our methodology

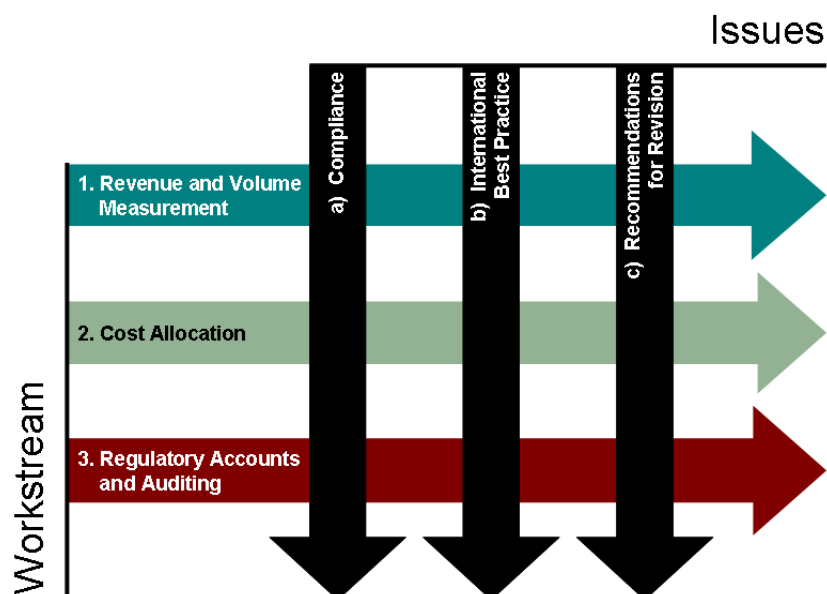
Introduction

- 3.1 This section describes the approach that we have adopted. We also provide a summary of our contact and interaction with An Post and relevant third parties.

Overview

- 3.2 The scope of our work covered three main issues, and involved three principal workstreams. Figure 1 shows a schematic of our approach:

Figure 1 LECG Approach



- 3.3 We attempted to engage with An Post early in the process. We were introduced to the relevant An Post staff members, in a letter dated 30 June 2006, which detailed our terms of reference and our likely approach. Our first opportunity to meet with key An Post representatives was on 21 July 2006, at which time we discussed our workplan and made clear that we were working to a fixed deliverable deadline of 8 September 2006. Our first substantive meeting with An Post, however, was not until 29 August 2006, at which point we were able to gather some information on relevant processes and to discuss issues arising out of our work.

- 3.4 It was unfortunate that our first substantive meeting with An Post was delayed for some 5 weeks after our initial meeting, despite regular contact between ComReg and An Post, and our requests to meet early in the process. The lack of interaction has affected the nature and timing of our work, and we have had to adapt our approach accordingly.
- 3.5 The timing of An Post's engagement affected the review process. Whilst we were able to provide An Post with a summary of our conclusions prior to publication, we have not been able to provide them with an advance copy of our report for comment. This is unfortunate as it would have been beneficial to have received comments on factual accuracy and the validity of our recommendations. We understand that An Post will have an opportunity to comment on our report during the consultation process. We welcome the opportunity to update our report for any comments provided during this process.
- 3.6 We have conducted this review from an independent standpoint. Where possible our conclusions are evidence-based. Where it has not been possible (because of timing constraints and/or a lack of interaction) to gather sufficient evidence we have worded our conclusions accordingly. Our recommendation to ComReg is that our conclusions need to be confirmed through a process of consultation.

Compliance with 2001 Accounting Direction

- 3.7 Our first step was to review whether An Post complies with the requirements of the current Direction. We have considered whether there are any gaps between the information provided by An Post and the requirements of the current Direction. Our consideration of "compliance" with the Direction is based on a review of relevant documents made available to us and discussions/interviews with ComReg and An Post staff. We have not performed an audit of An Post's processes and procedures to assess their compliance with the Direction. In performing our work we reviewed the following documents:
- An Post's Accounting Manuals: 2001, 2002, 2003 and 2004⁴;
 - An Post's Regulatory Accounts: 2001, 2002, 2003 and 2004; and

⁴ ComReg indicated to us that the Accounting Manuals and Regulatory Accounts for 2005 were not available at the beginning of our work. ComReg has reviewed their content and has assured us that there have been no substantive changes. Known changes are summarised in Appendix 7.

- written correspondence between ComReg and An Post between 2003 and 2005, concerning the content of the Accounting Manuals, Regulatory Accounts and the recent application to increase the price of domestic letter services.
- 3.8 The most important documents reviewed were An Post's Accounting Manuals. The Accounting Manual is required by the Direction to set out An Post's procedures for identifying disaggregated revenues, for allocating and apportioning costs, and for detailing its approach to the audit of the regulatory accounts.
- 3.9 We identified a number of compliance gaps in each of our three workstreams. These gaps then informed our review of international best practice and, together with the results of that review, formed the basis of our options and recommendations for a revised Direction.

International best practice

- 3.10 We adopted a number of different processes to identify best practice in Ireland and overseas - for mail volume measurement, revenue and cost allocation, and regulatory reporting and audit.

Mail volume identification and revenue allocation

- 3.11 Unlike many other issues in postal regulation, studies in this area are more limited. For this reason, we conducted a best practice survey. Our strategy focused on five lines of investigation: (i) a questionnaire to European regulators; (ii) a questionnaire to European universal service providers; (iii) contacting international postal bodies; (iv) contacting mail processing manufacturers; and (v) contacting other relevant postal commentators
- 3.12 Where possible, we sent the questionnaire to the regulatory managers from the universal service provider and the manager charged with collating volume and revenue data at the national regulator. Where possible, we conducted follow up phone interviews. We have included a copy of the questionnaire in Appendix 3. The table below shows the NRAs and USPs that responded to our questionnaire.

Table 1 Volume and revenue questionnaire responses

Country	Name	USP or NRA?
Belgium	De Post/La Poste	USP
Denmark	Post Danmark	USP
Estonia	Sideamet	NRA
France	ARCEP and La Poste	NRA & USP
Germany	Bundesnetzagentur and Deutsche Post AG	NRA & USP
Hungary	NHH	NRA
Luxembourg	Entreprise des Postes et Télécommunications (EPT)	USP
Malta	MCA	NRA
Netherlands	OPTA and TNT Post Group	NRA & USP
Slovakia	Postovy Urad	NRA
Slovenia	APEK	NRA
UK	Postcomm and Royal Mail ⁵	NRA & USP

- 3.13 While we were pleased with the level of detail contained in the responses that we did receive, we were disappointed by the number of organisations that did not respond. The timing of our work, which fell substantially during the European holiday period, will have played a part in this. We were also told by a number of respondents that other questionnaires had also been sent to European postal NRAs and USPs recently. Consequently, they decided not to respond to our questionnaire. The feedback we received was that they had decided to limit their responses to wider ranging studies, from which they might themselves derive some benefit.
- 3.14 Despite the low response rate, we did obtain some high quality responses. We received detailed responses from both the regulators and operators in the key markets of Germany, France, the Netherlands and the UK. Complementing these responses were comments from smaller Member States and accession countries, which gave information on the possible volume and revenue procedures in less mechanised postal industries.
- 3.15 We supplemented this evidence base with a range of other information. We investigated whether best practice for calculating volumes and revenues had been studied previously. On this, we contacted the United Postal Union (“UPU”), the International Postal Corporation (“IPC”) and PostEurop. We investigated the measuring abilities of postal machinery by contacting two of the companies that have made An Post’s major equipment: Siemens and NEC. Finally, we were in

⁵ We met with representatives of Royal Mail’s regulatory and finance teams on 30 August 2006.

regular contact with our postal experts and former Royal Mail operational staff, including Derek Osborn, an international postal consultant.

Cost allocation

3.16 Our review is based on publicly available information. Specifically, we have reviewed:

- a report by CTcon, who performed a study on behalf of the European Commission, on the implementation of Article 14 in the national postal legislation of Member States⁶;
- a survey by CERP⁷, on cost accounting and price controls;
- a survey by WIK⁸, on the main developments in the postal sector;
- regulatory precedent in the postal sector; and
- regulatory precedent in other regulatory sectors.

3.17 We would have liked to perform a more comprehensive survey of cost allocation best practice across postal Europe. ComReg advised us that CERP had recently completed a comprehensive survey in this area and they directed to where the results of the survey were published. In light of concerns relating to the number of surveys performed recently and the resulting pressures on Regulators, we agreed with ComReg not to include questions on cost allocation in our survey. A number of the regulators we contacted expressed a concern that they were being surveyed too frequently. Consequently, we adapted our approach, and surveyed only two countries on cost allocation issues (Holland and the UK).

Regulatory reporting and audit

3.18 Our review is based on publicly available information. In addition to the surveys mentioned above, we have reviewed guidance issued by the Institute of Chartered Accountants in England and Wales⁹ (“ICAEW”) on reporting to regulators of

⁶ CTcon. “Study of the cost accounting systems of providers of the universal postal service”. July 2003.

⁷ CERP. “Cost Accounting and Price Control”. Economics Working Group, PT Cost Allocation and Price Control Systems, CERP PL 2006/1 Doc.10E.

⁸ WIK. “Main Developments in the Postal Sector (2004-2006)”. Study for the European Commission, DG Internal Market. May 2006.

⁹ Institute of Chartered Accountants in England and Wales. “Reporting to Regulators of Regulated Entities” Audit 05/03. October 2003.

regulated industries¹⁰. We also benchmarked the regulatory accounts published by a number of Irish and UK regulated companies.

- 3.19 We agreed with ComReg that the benchmarking of regulatory reporting would focus primarily on the information published by 38 regulated entities from UK and Ireland in the Electricity, Water, Post, Gas and Telecommunications industries.
- 3.20 We believe that historically, there has been general consistency in the application of GAAP in UK and Ireland. Since An Post stated that it applies Irish GAAP, extending the exercise to other European companies would need to reflect differences in either local GAAP or under International Financial Reporting Standards (“IFRS”). We note, however, that European accounting practices are captured in the surveys and reports listed above.

¹⁰ We understand that the ICAI has not issued similar guidance. However, we also understand that the ICAEW and the ICAI often work closely together when developing guidance for their members.

4 Irish postal law and regulations

Introduction

- 4.1 ComReg and An Post operate in a legal and regulatory environment governed by both European and Irish laws and regulations. In this section, we outline the relevant European and Irish legal background most relevant to this study, as well as describing ComReg's legal obligations and responsibilities to regulate the Irish postal industry.

European law

- 4.2 The EC Postal Directive 97/67/EC¹¹ required each Member State to establish a national regulatory authority, independent of the postal company, to enforce a minimum service standard or universal service obligation ("USO"), placed on a universal service provider ("USP"). Article 7 of the Directive permitted Member States to define a monopoly right to handle postal items weighing less than 350 grams and priced at less than five times in the first weight step of the fastest category of the public tariff ("the Reserved Sector"), if needed to protect the provision of the USO.
- 4.3 As a result of the Postal Directive, the Irish State designated An Post¹² as the USP and ComReg as the NRA¹³. ComReg has subsequently defined the USO¹⁴ and has allowed the USP to operate with a monopoly in items falling with the Reserved Sector. This monopoly right has been reduced, in line with changes required by the Postal Directive. Currently, the Reserved Sector includes only postal items weighing less than 50 grams and priced at less than 2.5 times the public tariff in the first weight step of the fastest category.

¹¹ Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2002 with regard to the further opening to competition of Community postal services.

¹² An Post was designated as the USP by Regulation 6(3) of the European Communities (Postal Services) Regulations, S.I. No. 310 of 2000; (which has since been revoked and replaced with Regulation 4(2) of S.I. No. 616 of 2002).

¹³ ComReg was established as the regulator for the postal service industry by the Communications Regulations Act 2002. The functions set out in the European Communities (Postal Services) Regulations, S.I. No. 310 of 2000 (as replaced by S.I. No. 616 of 2002) were transferred to ComReg by the Communications Regulation Act 2002.

¹⁴ See ComReg document 05/85 Response to Consultation "The Universal Postal Service – A working definition".

Irish law

- 4.4 Each EU Member State has been required to ratify the Directive into national law. Both the original 1997 Directive and the amended 2002 Directive (2002/39/EC) were ratified into Irish law, in the form of Statutory Instruments No. 310 of 2000 and No. 616 of 2002 (EC (Postal Services) Regulations; “the Regulations”¹⁵), respectively. While these Regulations followed the format of the Postal Directives, they were also modified so as to take into account the specifics of the Irish postal industry while following the core principles set out in the Directive.

ComReg’s responsibilities

- 4.5 The Regulations charge ComReg with monitoring An Post’s compliance with a core set of principles. Of key relevance is ComReg’s duty to monitor An Post’s USO postal pricing and accounting separation policies. Regulations 9 and 11 detail principles by which An Post is required to set its USO tariffs and report its accounting results, respectively. Further details on each regulation are provided below.

Tariff principles (Regulation 9)

- 4.6 Regulation 9 (also called the *Tariff Principles*) lays down the basic standards by which the USP should set its postal prices, within the USO. Of particular note:
- “...prices must be affordable and must be such that all users have access to the services provided;
 - “prices must be geared to cost;
 - “[a USP shall] comply with any uniform tariff decided by the Regulator under [Regulation 9] paragraph (2);
 - “the application of a uniform tariff shall not exclude the right of An Post to conclude individual agreements on prices with customers; and
 - “tariffs must be transparent and non-discriminatory”.
- 4.7 In addition, Regulation 9 refers to three further postal tariff requirements:
- **Uniform tariffs:** ComReg is able to require An Post to make service tariffs uniform throughout the State, with the consent of the Minister;

- **Special tariffs:** Where An Post applies variations in tariffs, the tariffs and conditions should be transparent and non-discriminatory, and should take account of the avoided cost, as compared to the standard tariff; and
- **Cross subsidies:** USO mail services can be cross subsidised from revenue generated from the Reserved Sector mail only if it is necessary to fulfil the USO obligations in the competitive area.

Accounting systems (Regulation 11)

- 4.8 Regulation 11 relates to the USP's accounting procedures. This Regulation requires An Post to keep separate accounts within its accounting systems for "*each of the services within the Reserved Sector on one hand and the Non-Reserved Sector on the other*". Accounting information for mail items falling within the Non-Reserved Sector is required to be distinguished between USO and non-USO services. The Regulation also requires the internal An Post accounting systems to "*operate on the basis of consistently applied and objectively justifiable cost accounting principles*".
- 4.9 Regulation 11(3) details how the USP's accounting system should allocate costs to Reserved and Non-Reserved Sector services. The costs that can be directly assigned to a service should be assigned in that way. The remaining common costs should be allocated on the "*basis of direct analysis of the origin of the costs*". Where this is not possible, the Regulation states that common costs should be allocated on the "*basis of an indirect linkage to another cost category or group of cost categories*"; or failing this, that the allocation should be on the "*basis of a general allocator computed by using the ratio of all expenses...assigned or allocated*".
- 4.10 Regulation 11(4) allows for the application of an alternative cost accounting system, if it is compatible with the principles of accounting separation and has been approved by the NRA.
- 4.11 Regulation 11(5) requires that the USP's cost accounting systems should be verified by "*auditors engaged by the [universal service] provider*". It also states that the USP should publish a statement of compliance in its annual report.

¹⁵ All references to the Regulations in this document refer to S.I. No. 616, unless stated otherwise.

- 4.12 The final two paragraphs of Regulation 11 are concerned with the information from the accounting systems that should be made available to the regulator. ComReg is charged with keeping information on the cost accounting systems, for submission to the European Commission, on request. Regulation 11(7) requires the USP to provide detailed accounting information from these systems, in confidence, to the regulator or the European Commission, on request.

ComReg's powers

- 4.13 The Regulations enable ComReg to issue a series of *Directions* to the USP. The intention behind the Directions is to aid the USP in its interpretation of the Regulations, and to define how the operator should comply with the requirements. Directions issued by ComReg are legally binding on the USP, subject to the USP's right to legal appeal. Under Regulation 18(2), if ComReg is not satisfied that the USP has complied with a Direction, it can apply to the High Court to order compliance. The USP's compliance with the Regulations and/or European Law is mandatory.

Accounting Direction 2001

- 4.14 In order to allow ComReg to monitor An Post's compliance with the core principles of the Regulations, including the tariff principles and the USP requirement to separate its accounts, the regulator issued an *Accounting Direction*¹⁶ to An Post in 2001. This direction was intended to interpret the Regulations in greater detail. We describe the requirement of the Accounting Direction in the next section.

¹⁶ ComReg/ODTR. "Decision Notice & Report on Consultation 'Regulation of Universal Postal Services – Accounting Separation & Costing Methodology – proposed direction to An Post. 01/74'".

5 Accounting Direction 2001

Introduction

- 5.1 ComReg used the Accounting Direction to require the USP to act in accordance with the Regulations and to ensure that it provided the financial and operational information needed for the regulator to fulfil its legal obligations. The Direction placed five fundamental requirements on An Post, as well as setting out principles as to how the operator should fulfil those requirements. We have included the original Direction in Appendix 2.

Fundamental requirements

- 5.2 There are five requirements listed in the Accounting Direction:

“the financial records and accounting systems to be kept by any designated universal service provider should be sufficiently detailed to ensure that:

- *“...all decisions are supported by sufficient data to enable management to ensure that they comply with the Tariff Principles, Terminal Dues Principles and Universal Service Obligation;*
- *“...the Director [ComReg]¹⁷ can monitor compliance with these principles;*
- *“...separate accounts can be maintained for each of the services within the Reserved Sector on the one hand and each of the service with the Non-Reserved Sector on the other;*
- *“...any request for information by the Director [ComReg] in accordance with Regulation 12(7) or 18(2)¹⁸ can be met; and*
- *“...any request for information by the European Commission in accordance with Regulation 12(7)¹⁸ can be responded to promptly”.*

Detailed requirements

- 5.3 The more detailed requirements are split into two central categories: (i) reporting and transparency and (ii) management Accounting Manual. We list below the specific requirements within each of these categories.

¹⁷ The functions of the ODTR in relation to the Direction are now fulfilled by ComReg.

¹⁸ Regulations 12(7) and 18(2) quoted in the Direction correspond to Statutory Instruments No. 310 of 2000; and to 11(7) and 17(3) in S.I No. 616 of 2002, respectively.

Reporting and transparency

5.4 In order to identify costs, revenues and mail volumes, in accordance with Regulation 11(7) and 17(2)¹⁸, ComReg requires An Post to separate its financial and operational information, disaggregated to the level of *services*¹⁹, with further divisions between the mail that falls into and outside the Reserved Sector. ComReg issued four specific requirements for the fulfilment of this separation and transparency obligation:

- **Regulatory accounts:** An Post should submit profit and loss, and balance sheets, for each business segment, as defined by IAS14. These accounts are required to distinguish between services inside and outside of the Reserved Sector. The accounts are also required to show figures for a full financial year, together with the previous financial year, and for the figures to reconcile with the published financial accounts. The operator must provide profit and loss accounts for each letter and parcel service, independently, reconciled with the profit and loss account for each business segment, as listed above;
- **Pricing change report:** ComReg requires An Post to provide a detailed additional report connected to postal price increases (or applications to increase the price). This analysis must compare existing and potential prices with the estimated costs of providing the related services;
- **Cost of the USO:** An Post must estimate the cost of complying with the USO; and
- **Ad hoc reports:** An Post must prepare ad hoc reports at the request of ComReg.

5.5 The information, with the exception of ad hoc reports, was required to be submitted to ComReg within 19 weeks of the end of the financial year.

Accounting Manual

5.6 The Direction requires the USP to provide a detailed Accounting Manual, listing the key procedures undertaken to calculate costing and operational information.

¹⁹ A service is defined by the Direction as “any service provided by An Post which involves the use of the public postal network as defined in the Regulations and a) is identified as a separate service in the Schemes or price lists published by An Post, or is provided under a contract or standard agreement with individual customers and b) operationally handles all items in the service in the same way.” Taken from the 2001 Direction, under the headline “interpretation”.

The Accounting Manual should identify the basis on which costs and revenues have been allocated/apportioned between services. The Direction lists further principles for fulfilling this guideline.

5.7 *Business segments and intercompany/intersegment transactions:* The key guidelines are:

- revenue and costs are to be assigned to business segments, in accordance with IAS 14;
- fixed assets are to be assigned to the 'Prime User', with other business segment use charged on an arm's length basis; and
- business segments are to be regarded as subsidiaries for the purpose of intercompany/intersegment transactions, with payments being charged on an arm's length basis, being non-discriminatory as between internal charges and the payment that would be expected from an external transaction.

5.8 *Revenue determination, cost allocation and apportionment principles:* The key guidelines are:

- within the business segment, revenue and costs are to be allocated to Reserved and Non-Reserved services;
- direct assignment of revenues and costs to services are required, where this is possible;
- stamp and franking sales that can not be directly assigned should be apportioned to services according to a statistical sample, if the sampling is conducted with an accuracy of +/-1% at the 95% confidence level;
- common costs that can not be directly assigned to a service are required to be allocated: (i) on the basis of an *indirect linkage* to another cost category or group of costs, for which direct assignment is possible, the linkage being based on a comparable cost structure; or (ii) where direct or indirect allocation is not possible, costs are required to be allocated using a ratio of all expenses already assigned to services; and
- a list of services is required.

5.9 *Cost allocation and apportionment rules:* The key guidelines are:

- the Accounting Manual is required to detail the operating cost identification and allocation procedure, per service;
- costs should be apportioned between services that use specific postal pipeline activities according to the mail volume, weighted by the individual cost characteristic of the mail item;
- such weighting factors are required to be described in the Accounting Manual, as well as the range of services to which they apply;
- the Direction provides the minimum requirement for a *hierarchy* of costs for different postal pipeline activities that the USP is expected to analyse in its accounts: revenue collection; collection; outbound sorting; transport; inbound sorting and preparation and delivery; and
- the USP is required to distinguish between *cost categories*.

5.10 *Audit of accounts and confirmation of compliance:* The key guidelines are that An Post is required to engage auditors to verify compliance with the Direction and for the audit statement of compliance to be published in the Annual Report.

Part B: Mail volume and revenue identification

6 Mail volume and revenue identification issues

Introduction

- 6.1 In this section, we consider An Post's submission of mail volume and revenue information to ComReg. The relevant legal and regulatory requirements are covered in the Regulations and the Direction. We have looked at the gap between those requirements and the level of detail provided in An Post's recent submissions to ComReg. This, together with our assessment of best practice, has informed our recommendations for revisions to the Direction.

Background to the requirements of the Direction

- 6.2 ComReg has two central legal obligations for which the provision of volume and revenue information is necessary. First, the Tariff Principles require ComReg to ensure that the universal service provider's prices are geared to cost, among other tests. Second, Regulation 9(5) commits ComReg to ensure that An Post does not unduly cross subsidise liberalised services from the Reserved Sector²⁰. In order for ComReg to monitor An Post's compliance with these principles, it needs to have reliable mail volume information, which is used to calculate unit cost per service, and to match the cost against revenues per service.
- 6.3 The 2001 Accounting Direction addressed these issues. Because revenues cannot typically be attributed directly to individual services, split by format and weight (particularly for stamped and meter mail services), the Direction permits An Post to sample mail to determine the distribution of individual mail characteristics.

Gap analysis

- 6.4 We have reviewed the Accounting Manual and Regulatory Accounts from 2001 through to 2004²¹, together with data submitted for the recent price increase application. The focus of the exercise was to identify whether An Post's mail volume and revenue recording, sampling, and allocation processes have

²⁰ Regulation 9(5) allows the USP to cross subsidise non-reserved USO services, if it *shows* that this subsidy is needed to fulfil the universal service obligation for competitive products.

²¹ ComReg indicated to us that the Accounting Manuals and Regulatory Accounts for 2005 were not available at the beginning of our work. ComReg has reviewed their content and has assured us that there have been no substantive changes. Known changes are summarised in Appendix 7.

complied with the 2001 Direction. We have identified a series of gaps – relating in particular to four specific requirements: (i) the Accounting Manual; (ii) direct assignment; (iii) statistical standards; and (iv) data sufficiency. Each is detailed further below.

Accounting Manual

- 6.5 The Direction states, “*The Accounting Manual should contain a schedule showing how each individual revenue and cost category is treated. The Accounting Manual should therefore specify in technical detail the range and scope of the data to be collected and the basis on which it is to be allocated/apportioned between services*”²².
- 6.6 An Post operates a version of a revenue equated method of calculating mail volumes and revenues. In essence, this method identifies volumes indirectly, by dividing revenue figures by an average price for the service. This method differs from a purely operational measurement, which counts volume directly, via machine and/or hand counts, or weighing consignments of mail batches. The 2004 Manual describes a five-step process by which An Post calculates its revenue and volume figures for its core domestic mail services, separated by format and weight breaks.
- 6.7 First, total revenues for the three payment channels (stamped mail, metered mail and ceadúnas²³) are captured from “internal information systems”. Any commission paid for stamp sales, together with the value of any bulk discounts offered for metered mail, are added back to the relevant payment channel sales figures. An Post also adjusts the total sales figures for stamped and metered mail to reflect the value of unused paid postage.
- 6.8 Second, in order to identify the revenue attributable to the core domestic mail service, An Post strips out the sales figures for non-core services from the payment channel revenue figures²⁴. Table 2 from An Post’s 2004 Manual shows

²² Taken from the Direction: “Management Accounting Manual”, p35.

²³ We would argue that there is at least one other payment channel: counter automation, which is a computer system found in the majority of post offices, that prints labels onto mail items, replacing stamps or franking meter indicia. We believe that the system database records the number of items, as well as key mail item characteristics, such as format, weight and service.

²⁴ We believe that counter automation sales figures are aggregated with stamped mail revenue at this stage.

how revenue figures from non-core services are extracted from the total payment channel revenue figures:

Table 2 “Table 2” Non-core service extraction from payment channel sales figures

Sales	Stamped	Metered	Ceadúnas
Total Sales	X	X	X
less: Parcel Mails Sales	(x)	(x)	(x)
less: Philatelic Sales	(x)		
less: International Outbound Sales	(x)	(x)	
less: Publishers Service Sales		(x)	(x)
less: Registered Sales	(x)	(x)	²⁵
less: Publicity Post Sales			(x)
less: Swiftpost Sales	(x)	(x)	(x)
less: Business Reply Sales			(x)
less: Postaim			(x)
Total Domestic Postal Items Sales	X	X	X

Source: An Post. “Accounting Manual”. 2004. Format changed into LECG formats.

- 6.9 A variety of different methods are used to calculate the non-core service revenue and volume figures, ranging from direct count measurement, through to estimation techniques such as statistical sampling and weighing batches. We provide a breakdown of these techniques below, first in relation to non-core service revenues.

²⁵ The original Manual Table 2 did not include an entry for Registered mail sales through ceadúnas, however, from a review of other material in the Manual, we believe that Registered mail is in fact sold through ceadúnas.

Table 3 Calculation methods for core and non-core service revenue

Sales (Revenue)	Stamped		Metered		Ceadúnas		Counter Automation ²⁶	
	Measured	Estimated	Measured	Estimated	Measured	Estimated	Measured	Estimated
Total Sales	✓		✓		✓		✓	
less: Parcel Mails Sales		✓		✓	✓		✓	
less: Philatelic Sales ²⁷		✓						
less: Int'l Outbound Sales		✓		✓	✓			✓
less: Publishers Service Sales				✓	✓			
less: Registered Sales		✓		✓	✓			✓
less: Publicity Post Sales					✓			
less: Swiftpost Sales		✓		✓	✓			✓
less: Business Reply Sales					✓			
less: Postaim					✓			
Total Domestic Postal Items Sales		✓		✓	✓			✓

Source: An Post. "Accounting Manual". 2004.

6.10 We note that total domestic mail sales figures are derived from headline payment channel figures, less calculated sales figures for non-core services. Some of these non-core service revenue figures are measured by the ceadúnas and counter automation systems, at the point of sale; while the revenue for services paid for by stamps and meters are estimated.

6.11 Volume figures tend to be derived either from the ceadúnas or counter automation accounting systems, or from the revenue figures for estimated for stamped and metered sales. This means that total domestic volumes are not calculated top down, using total volume figures for each payment channel, in the same way as revenue.

²⁶ We would argue that there is at least one other payment channel: counter automation, which is a computer system found in the majority of post offices, that prints labels onto mail items, replacing stamps or franking meter indicia. We believe that the system database records the number of items, as well as key mail item characteristics, such as format, weight and service. We also understand that this approach is undertaken in a number of other European USPs, including Royal Mail.

²⁷ Philatelic sales to agents are measured, however, sales via company and sub offices are estimated. An Post has indicated to us that the estimated volumes account for 20% of total philatelic sales.

- 6.12 Table 4 shows the magnitude of measurement and estimation used to calculate volume figures for core and non-core services. Unlike revenues, calculated volumes for non-core services are not subtracted from total payment channel volumes to create the total domestic service figure. We have maintained the table format, for ease of comparison with Table 3.

Table 4 Calculation methods for core and non-core service mail volumes

Mail Volumes	Stamped		Metered		Ceadúnas		Counter Automation ²⁸	
	Measured	Estimated	Measured	Estimated	Measured	Estimated	Measured	Estimated
Total Volumes ²⁹					✓		✓	
Parcel Mails Sales		✓		✓	✓		✓	
Philatelic Volumes ³⁰								
Int'l Outbound Volumes		✓		✓	✓		✓	
Publishers Service Volumes				✓	✓			
Registered Volumes ³¹		✓		✓	✓		✓	
Publicity Post Volumes					✓			
Swiftpost Volumes ³²		✓		✓	✓		✓	
Business Reply Volumes ³³					✓			
Postaim					✓			
Total Domestic Postal Items Volumes ³⁴		✓		✓	✓		✓	

Source: An Post. "Accounting Manual". 2004.

6.13 Third, the core and some non-core service sales figures are split into different formats (i.e. letters, flats and packets). The Accounting Manual suggests that

²⁸ We would argue that there is at least one other payment channel: counter automation, which is a computer system found in the majority of post offices, that prints labels onto mail items, replacing stamps or franking meter indicia. We believe that the system database records the number of items, as well as key mail item characteristics, such as format, weight and service. We also understand that this approach is undertaken in a number of other European USPs, including Royal Mail.

²⁹ Total volumes per payment channel are not recorded at the point of sale for stamped and metered mail.

³⁰ Stamps sold for philately are not relevant to An Post's mail processing operations and are therefore not recorded as mail volume.

³¹ Total Registered volumes are captured from the track and trace system.

³² Total Swiftpost volumes are captured from the track and trace system.

³³ We believe that Business Reply volumes may be calculated from sales figures, and may therefore not be directly measured in the IFS system.

³⁴ Total domestic postal items volumes for stamped and metered mail are derived from total sales figures, less the revenue allocated to non-core services. We therefore believe that for stamped and metered mail, total domestic volumes are a result of a series of estimations.

volume data by format is available on a daily basis from An Post's automated processing facilities³⁵.

- 6.14 Fourth, the figures are split between the Reserved and Non-Reserved Sectors³⁶. An Post was not able to record sales figures by weight break within its accounting systems, and therefore used a sampling process. That process is described in the Accounting Manual as using a sampling programme established by PricewaterhouseCoopers ("PwC"). While the Accounting Manual does not go into procedural detail, it does mention that the sampling exercise considered 46 mail streams; the sampling process was undertaken between January and early December³⁷; and that the sampling was undertaken at the four An Post mail sorting hubs, as well as the Air Mail Unit ("AMU") at Dublin Airport.
- 6.15 Fifth, once the total revenue figures have been calculated for the individual services, split by format and weight step, An Post calculates *mail volume* numbers for the different groupings of mail items. Total revenue figures are converted into volumes, using the tariff for each service at the given format and weight step.
- 6.16 The Direction requires the Accounting Manual to describe the technical detail behind the calculation of figures submitted to the regulator. We believe that there are several areas where the level of detail provided might reasonably be increased, and/or where the process described might reasonably be improved. In particular:
- *International Outbound* mail can be paid for using any of the core payment channels. The revenues for outbound mail can be identified directly for ceadúnas mail, however the proportions of outbound mail that is paid for using stamps and meters are not available. The Accounting Manual states that these proportions are split according to pre-determined percentages. We believe that the process to determine these proportions is not transparent and requires further explanation in the Accounting Manual;

³⁵ An Post. "Accounting Manual 2004".

³⁶ Between 2003 and 2006 the reserved sector included mail items weighing less than 100g and priced less than 3 times the basic stamp price. The reserved sector was reduced in January 2006 to items weighing less than 50g, and priced less than 2.5 times the basic stamp price.

³⁷ We have assumed that this excludes the approach to Christmas, which is traditionally the busiest time for USPs. Usually, the profile of mail changes in this period.

- *Publishers Service* can be sold either through the ceadúnas or through meter mail payment channels. While ceadúnas revenue for this service can apparently be identified, metered mail payments for this service cannot. An Post apparently conducts a survey of Publishers Service customers to identify the proportion that use metered mail. The Accounting Manual does not contain, however, any procedural detail about this survey. Further, while ceadúnas sales for Publishers Service customers are recorded according to the format and weight of the items, metered sales are not. The Accounting Manual suggests that the mail characteristics profile from the ceadúnas sales is superimposed on the metered sales, without any further measurement or even sampling evidence. We believe that some evidence of similarity in profiles is required before this approach can be considered appropriate³⁸;
- *Swiftpost Weight Breaks*: The Accounting Manual states that weight breaks are derived using counter automation information and sampling, but does not identify how this is done, or how the information from the two different sources is combined;
- *Philatelic Sales*: Most sales outlet categories for philately record their revenue figures in the main accounting system. Sales in company and sub offices, however, have to be estimated. The Accounting Manual does not describe how this estimation is done; and
- *St. Patrick's Day Cards*: The Accounting Manual notes that there is a separate adjustment made for revenue generated for St. Patrick's Day Cards, but does not state how the figures are identified.

6.17 We acknowledge that the Accounting Manual provides a good overview of An Post's revenue allocation process, but we believe that it would be difficult for the process to be replicated without additional information on the procedures that An Post follows. Without that additional information, we do not believe that ComReg can either confirm the company's compliance with the Tariff Principles, or assess the requirement for a USO price increase, without some risk of error.

³⁸ We understand that it may be possible for Publisher Service mail to be double counted as part of the core domestic mail figures, although we do not have firm evidence to support this claim.

Data sufficiency

- 6.18 The Direction requires that “...*financial records and accounting systems...should be sufficiently detailed to ensure that...all decisions are supported by sufficient data to enable management to ensure that they comply with the Tariff Principles, Terminal Dues Principles and Universal Service Obligation*”³⁹.
- 6.19 This requirement of the Direction concerns the obligation for An Post’s management to have access to sufficient data to fulfil their duties. The natural extension from this requirement is that ComReg also needs this data to fulfil its legal obligations and that *data sufficiency* should not be measured solely in terms of the quantity of figures submitted, but also in terms of the quality of the data.
- 6.20 Although we have reviewed the procedures documented by An Post for creating its volume and revenue figures, we are not in a position to investigate whether these procedure are in fact being followed. We note, however, that the volume figures derived do in some cases show movements that are counter-intuitive.
- 6.21 ComReg highlighted unanticipated movements in letter and parcel volumes, in its letter to An Post, dated 20 May 2005⁴⁰. ComReg questioned, among other things, why the letter format should attract a declining share of the domestic mails volume, declining from $\text{X}^{41}\%$ to $\text{X}\%$ between 2003 and 2004, while the letter format share of the Outbound International volume was increasing, from $\text{X}\%$ to $\text{X}\%$ between 2003 and 2004.
- 6.22 While it is possible that the underlying cause of the movements is simply customer reaction to price increases, as suggested by An Post⁴², it seems possible that additional measurement error may have contributed to the results – since the price elasticities implied are outside the range of normal results (and the movement in Outbound International volumes is in any case in the wrong direction). We remain concerned that there are issues, in particular relating to the way in which the processes described in the Accounting Manual are *actually* carried out, that need to be addressed.

³⁹ Taken from the Direction: “Fundamental Requirements”, p34.

⁴⁰ ComReg. “Letter to Diarmuid O Conghaile: Regulatory Accounts for the Year Ending 31 December 2004”. 20 May 2005.

⁴¹ The text has been redacted due to confidentiality.

⁴² An Post letter of 8 June 2005.

Direct assignment

- 6.23 The Direction requires that “...*revenue and costs which can be directly assigned to a particular service shall be so assigned*”⁴³.
- 6.24 The Accounting Manual describes a process by which the majority of mail items are assigned to services using some form of measurement, statistical sample or weighing. Few, however, are measured directly. Many of the revenue figures for non-core services which are subtracted to create the core domestic mail revenue figures, are estimated. As shown in Table 3 above, few service revenue figures are quoted in the Accounting Manual as being calculated without the aid of any estimation techniques.
- 6.25 We question whether An Post could not make greater use of its outward sorting machine counts and of the sales figures available through its *counter automation* system⁴⁴. It appears to us that processes for revenue and volume measurement may not have evolved to take advantage of the modernisation of An Post’s sorting and retail systems.
- 6.26 While the requirement in the original Direction referred to the direct attribution of *revenue* figures, we would also highlight the low proportion of mail items directly attributed to services in An Post’s *volume* figures. Across the different service lines, An Post conducts a version of a revenue-equated methodology for calculating volumes. As mentioned above, this means that the majority of volume figures are derived from the revenue calculated for a service, split by format and by weight breaks, and divided by some form of average price. We have already highlighted above our concerns with some of the methods undertaken to create disaggregated revenue figures, but the point needs to be made that calculating volumes from revenues is in itself an indirect methodology.

Statistical standards

- 6.27 The Direction requires that “...*postage stamps sold and franking machine credits, which cannot be directly assigned to their use for specific services or retention by*

⁴³ Taken from the Direction: “Management Accounting Manual: Revenue Determination and Cost Allocation and Apportionment Principles, paragraph (a)”, p36.

⁴⁴ We understand that ComReg has raised the latter issue with the operator.

*users for later use shall be apportioned to services on the basis of statistical sampling accurate to +/-1% at the 95% confidence level*⁴⁵.

- 6.28 The statistical standards for sampling, where this occurs, appear in principle to be broadly consistent with the requirement to work to an +/-1% accuracy (or *margin of error*), with a 95% confidence level. We do have several observations to make, as set out below. It is possible that these reflect gaps in the information contained in the Accounting Manual, rather than underlying weaknesses in the sampling procedures.
- 6.29 First, the overall procedures for sampling were originally established with the aid of PwC, in 2000. We asked An Post for a copy of the procedures, as well as the changes to the processes since that time, however, on 4 September 2006, 4 days before this final report was submitted, An Post provided the procedures in the form of a 60 page document. Given the size of document and the available time, we could not conduct a detailed review of these procedures. This was communicated and agreed with ComReg.
- 6.30 Without being able to comment further on the detail of the procedures, our only point would be that it is possible that the procedures may benefit from, and could be overdue for, independent review, if this has not already been undertaken. Format based changes to tariff structures introduced in 2002 may need to be taken into account, and sample sizes may need to be revisited.
- 6.31 Second, the location and timing of sampling exercises appear to us to be likely to introduce bias. Registered and Swiftpost mail are not, as we understand it, sampled at the Cork sorting hub⁴⁶; and the sampling exercises undertaken exclude late December – a period in which the profile of mail is influenced by cards sent in the run up to Christmas. Absent some adjustment, the figures are unlikely to be properly representative, within the limits of accuracy specified in the Direction, of mail profiles over a full year.
- 6.32 Third, ComReg is concerned that it could be possible for some mail items to be processed without going through any of the four main hubs at which samples are

⁴⁵ Taken from the Direction: "Management Accounting Manual: Revenue Determination and Cost Allocation and Apportionment Principles, paragraph (b)", p36.

⁴⁶ An Post has told us that the work was not undertaken at Cork because of a lack of properly trained staff.

tested. We do not know whether any volumes processed in this way are sufficient to introduce bias into the sampling results, but absent further information, we are concerned that they might be. An Post denies that mail is processed outside of its four main hubs.

- 6.33 Fourth, we are concerned that sample sizes for different services and formats are determined using "*estimated revenues*". At a minimum, this introduces an element of circularity into the overall process of estimating revenues and volumes.
- 6.34 Fifth, and finally, we note that the Accounting Manual correctly identifies that for mail streams with a low overall volume, the accuracy of sampling is likely to fall. In such circumstances, we believe that it is important to establish some form of compensating mechanism, either by enlarging the overall sample size, or by conducting separate tests focused on the lower volume services.

7 Mail volume and revenue identification best practice

Introduction

7.1 We have reviewed current practice in the area of mail volume and revenue identification across different postal administrations, in part through a survey of European USPs and NRAs⁴⁷, and in part by reviewing best practice studies and through discussions with international postal organisations.

7.2 We have considered best practice in the following areas:

- the level of volume and revenue data submitted to regulators (relating in part to questions of the Accounting Manual and data sufficiency, as described in the previous section);
- operational and revenue based measurement systems (relating to the direct assignment of data);
- direct assignment: international mail identification (relating to the direct assignment of data); and
- statistical sampling.

The level of volume and revenue data submitted to regulators

7.3 While Article 14 of the European Directive requires NRAs to retain detailed information about the USPs' cost accounting systems, there is no specific requirement for this information to include volume and revenue data. However, at least for those countries who responded, our survey results showed that at a minimum some basic information was submitted to each of the regulators. Table 5 shows the key responses from European NRAs and USPs in this area.

⁴⁷ The questionnaire used is attached in Appendix 3.

Table 5 European NRA and USP survey – volume and revenue data submissions

Issue	Number of Member States		
	Yes	Revenues, not volumes	No response
The regulator is given detailed volume and revenue data, disaggregated to a detailed level.	9	1	2
The regulator asks for explanations of the trends in the volume and revenue figures.	6	2	4
The regulator has the power to reject volume and revenue data.	5	3	4
The regulator has used this power to reject volume and revenue data.	0	6	No response/No power 6

Source: LECG mail volume and revenue data survey 2006.

- 7.4 In a few instances, some of the responding NRAs and USPs had requested or received a request for analysis of the trends of volume and revenues figures. However, these requests had not formed part of the regular submissions of data, but had formed part of a subsequent stand-alone assessment, such as an ex ante review of a price increase application.
- 7.5 The majority of NRAs and USPs reported that the regulators had not rejected the information provided. A respondent from one accession Member State noted that it was aware of the limitations in the calculation procedure, however, until the process had been fully assessed, there was little that the parties could do, other than to accept the submitted figures. Some regulators noted that they did not have the power to challenge volume figures, while others stated that they would not have the ability to challenge the magnitude of the figures, but they could consider the process undertaken to compile the figures.
- 7.6 Our findings are consistent with the latest European Commission sponsored report into developments in the postal sector. WIK concluded that “some NRAs appear to lack basic authority to collect information or enforce their orders. The new directive could, therefore, take steps to define more clearly the enforcement tools that should be given to NRAs to implement Community postal policy.”⁴⁸
- 7.7 We believe that in assessing these results it is important to take into account the form of regulation that takes place in each of the Member States. Different forms of regulation require different operational data. We note that in the UK, the price

⁴⁸ WIK. “Main Developments in the Postal Sector (2004-2006)”. May 2006.

control process has taken into account detailed historic and forecasted volume and revenue information. More limited price cap systems, which do not take into account volume and revenue factors, would not require data to such a level of detail. In Member States that have more limited regulatory requirements for price caps, the NRA may not seek to retain more detailed information, and would not necessarily seek to challenge data trends or compilation techniques.

- 7.8 In the case of Ireland, ComReg's regulatory framework requires unit cost (incorporating volume and cost data) and revenue information for core regulated services, both to assess compliance with the Tariff Principles and to respond to a request to increase postal prices. The approach taken by ComReg encompasses a detailed assessment of services at a disaggregated level. This necessarily requires a detailed level of information, as well as an assurance that the data is correct.

Operational and revenue based measurement systems

- 7.9 We are aware that there has been some debate within the postal industry as to the relative merits of revenue based systems and direct operational counts of mail. Operational measurements typically feature a count of mail items as they proceed through the postal pipeline, while revenue based systems use data recorded at the time of purchase, for different payments channels (i.e. the number of stamps, the meter machine record and the invoices sent to bulk mail customers etc.).
- 7.10 *Operational measures* tend to include some form of count made by the sorting machines in the outward sorting⁴⁹ phase of the pipeline; as well as a sampling process for counting the number and characteristics of items that are sorted manually. For the calculation of volumes, our survey showed that the majority of European systems, according to the NRAs or USPs that responded, use some form of operational count for the volume information submitted to the regulator, as shown in Table 6 below.

⁴⁹ Outward sorting can be defined as the stage in the postal pipeline where unsorted raw mail from collection points is sorted between different local processing offices.

Table 6 European NRA and USP survey – volume and revenue data submissions

Issue	Number of Member States		
	Operational	Revenue based	No response
Operational or revenue based figures are primarily used to calculate the mail volumes submitted to the regulator ⁵⁰ .	10	2	2
A mechanised count is used in the calculation of the mail volumes submitted to the regulator.	Yes 8	No 0	No response 4
Revenue figures are calculated from a revenue based accounting system.	Yes 10	No 1	No response 1

Source: LECG mail volume and revenue data survey 2006.

- 7.11 We note that the most mechanised operators are able to sort the majority of flats and even packets, with the use of flat sorting machines and different forms of barcode systems for packets. According to the machine manufacturers⁵¹, the equipment is able to recognise additional characteristics of the mail, including the format, destination and indicia used. The actual accuracy of operational measurements is of course heavily influenced by the proportion of manually sorted items flowing through the postal pipeline.
- 7.12 We note however, that the machinery is not able to measure the weight of individual items, and weight steps would therefore need to be separately sampled. Additionally, both Royal Mail and An Post told us that the OCR has difficulty in recognising the difference between the indicia used for meter and bulk mail (referred to as “PPI” in the UK and ceadúnas in Ireland).
- 7.13 Notwithstanding these issues, we were assured by representatives from the more highly mechanised postal operators that automated counts were in their experience more accurate than the sampled counts of manually sorted items.
- 7.14 *Revenue based systems* are formed from data collected at the point of sale. We note that Royal Mail in the UK uses operational measurements for cost allocation information submitted to the regulator, but use revenue based approaches to calculate the price control, together with high level volume figures for internal planning purposes⁵².

⁵⁰ Both the UK and a smaller EU accession country reported using both operational and revenue equated volume calculation methods; we have counted these member states twice in the table.

⁵¹ We spoke to Siemens and NEC.

⁵² Royal Mail. “Response to Postcomm’s Initial Proposals for the 2006 Price and Service Quality Review”. October 2005.

- 7.15 We note that in other European postal markets, the coverage of detailed revenue data is increasing. One respondent claimed that it had a strategy to increase the use of post office printed label sales for non-standard domestic letters, flats and packets. This would mean that although stamps and meters could still be used to pay for all postage costs, it was increasingly unlikely that ordinary domestic stamps would be used for non-domestic mail. The use of computerised labelling systems in post offices meant that volume, revenue and format data was being recorded for mail that is typically non-mechanised in the postal pipeline.
- 7.16 The same postal company also claimed that the proliferation of so called *intelligent meters* has increased the ability of accounting systems to record detailed information. We have reviewed the available equipment from one of the major meter machine manufacturers. We note that such equipment is increasingly able to record the mail characteristics at the level of disaggregation required by ComReg.
- 7.17 Many of the respondents commented that operational volumes tended to be overstated, while revenue based systems tended to be understated. We understand from Postcomm that reconciliations have been attempted in the case of Royal Mail, and that these have not yet been able to explain the gap between the two approaches in full. However, the attempt to explain and narrow the gap has revealed operational and incentive problems with the way that the systems record volumes⁵³.
- 7.18 For volume measurement, we believe that it will be important to derive both revenue based and operational measures, and to attempt, progressively, to reconcile the results from the two approaches. Experience across Europe suggests that operational measures can be usefully derived, and that their accuracy increases with increasing automation. Experience within the UK has suggested that there is additional value in reconciling the two approaches.

International mail identification

- 7.19 Currently, An Post identifies international mail numbers by reference to the terminal dues method of counting. Items sent and received are sampled to

⁵³ We also note that Royal Mail conducts a verification of its revenue systems, referred to as *revenue protection*, in order to match paid postage against the mail volumes processed through the postal pipeline.

calculate the average items per kilogram (“IPK”). The total weight of mail items then determines the recorded volume for outbound and inbound services. Special priority classes of international mail, such as Swiftpost and Registered, are separately recorded. Further characteristics, such as weight breaks are identified using sampling.

- 7.20 Similar to other forms of mail, we recognise that there are a number of different approaches to counting and identifying the mail characteristics of both outbound and inbound international mail. In addition to the terminal dues system currently used, outbound mail is processed in the outward phase of the postal pipeline in the same way as mail that is sorted for delivery within the State. Inbound international is sorted once it reaches the acceptance point, in readiness for trunking and delivery to addresses in Ireland. Similar to other forms of operational count, it is possible to identify volumes for both forms of international mail using sorting machine⁵⁴ and manual sorting counts.
- 7.21 The UPU, REIMS II and other bilateral agreements determine the terminal dues that are set for the IPK of outbound and inbound international mail. Revenue information is therefore available through the clearing processes agreed through the UPU based, REIMS II, or other negotiated system⁵⁵. We have reviewed the relevant UPU recommendations surrounding the measurement of volumes and particular mail characteristics⁵⁶. Comparing these minimum standards for the calculation of terminal dues volumes and revenues with the information about An Post’s processes contained in the Accounting Manual, it appears that the operator is currently compliant with the UPU’s minimum standards for terminal dues.

Statistical sampling

- 7.22 An Post samples 46 mail streams in order to profile weight breaks for different services and formats. The procedure was established in 2000 by PwC, and we believe that it has been updated in-house since that time. We identified above a number of concerns in respect of the procedures. We have not been able to

⁵⁴ We have spoken to Siemens and NEC, and we have been assured that postal sorting machinery is capable of recognising the different destinations, between domestic and international outbound mail.

⁵⁵ We recognise that An Post has a difficulty in accounting for mail sent and received from the postal companies that have left or did not enter the REIMS II agreement, however, in talking to An Post, we understand that the operator is in ongoing discussion with these companies.

⁵⁶ UPU. “*Statistics and Accounting Guide*”. January 2006.

conduct a detailed review either of the current or the original PwC detailed procedures, so we do not know to what extent our concerns may be addressed in practice⁵⁷.

- 7.23 The European Committee for Standardisation (“CEN”) has written a series of standards for the sampling of mail items for the calculation of delivery time quality of service. Standard CEN 13850⁵⁸ details the procedure needed to fulfil a quality of service assessment for single piece priority and first class mail. Although the *purpose* of the sampling exercise described in the standard is different, we believe that the guidance on sampling procedures is relevant and provides a benchmark for An Post’s procedure.
- 7.24 Quality of service sampling consists of test mail items being sent from one location to another, with the duration being timed to monitor the delivery time of particular types of mail. The standard outlines the type of mail that should be sent and specifies that the distribution of test items should be representative of the characteristics of the mail, such as service type, format and the location of the sender and receiver. The sampling organisation needs know these distributions of mail items, as well as the locations of senders and receivers, in order to correctly identify a representative sample. Therefore, before any quality of service assessment can take place, CEN 13850 states that the sampling organisation should conduct a *real mail study* to identify the correct profile of mail across the country. We note that An Post conducted a real mail study in 1998, and is currently undertaking a new study.
- 7.25 Drawing on the precedent set by CEN 13850, we believe that An Post’s procedure should at the very least contain the following features:

⁵⁷ An Post provided the original PwC procedure document in the final week of the project. We did not have the opportunity to conduct a detailed review of the material.

⁵⁸ CEN 13850 was designed in 2002 and is available from the NSAI website. CEN 14709 is a technical report, which provides background guidance for the implementation of CEN 13850. The CEN has also produced similar standards for the sampling of bulk mail and non-priority single piece mail items for quality of service purposes (CEN 14534 and CEN 14508, respectively).

- the sample sizes should be representative of the profile of mail services⁵⁹, both by geographic entry and exit points into the system and by the profile of mail experienced over the year;
- studies should be repeated at least every three years⁶⁰; and
- a statistical audit of procedure, with a recognised statistical expert.

7.26 As part of its current real mail study assessment, An Post has retained a statistical expert to audit the statistical procedure used.

⁵⁹ This can be achieved in two ways. First, there can be strict proportionality between the sample and the population sizes; or second, there can be an over or under-representation of population size, which can be corrected by weighting.

⁶⁰ The repeat of a real mail studies every three years fulfils the requirement for quality of service assessment data, however, we suspect that a mail characteristics sampling procedure, used for the purpose of compiling annual volume figures, would need to be repeated on an ongoing basis.

8 Mail volume and revenue identification recommendations

Introduction

- 8.1 We have reviewed the gaps in compliance with the current Direction and considered current practice across a range of European postal operators. In this section, we make a series of recommendations based on that assessment. Overall, we believe that these recommendations should be seen as confirming the objectives of the 2001 Direction, but with an intention to tighten the specification of required procedures.
- 8.2 Where relevant, we also outline options where we believe that there is no clear best practice, but where the issue might sensibly be the subject of consultation. We have made recommendations in the following areas: (i) the provision of information in the Accounting Manual; (ii) operational and revenue based measurement systems; and (iii) statistical standards.
- 8.3 In making our recommendations, we have taken into account ComReg's powers, under the European Directive and the Regulations. We have also taken into account ComReg's desires for relatively light touch regulation and to reduce compliance costs. We have prepared a draft amendment to the 2001 Direction to take account of these recommendations, which is included at Appendix 8.

Accounting Manual

- 8.4 ComReg needs reliable data in order for it to fulfil its statutory obligations. By extension, ComReg also needs sufficient information to be able to confirm that the data with which it has been provided is reliable. The choice of an appropriate level of data is one on which different regulators have taken different views – as shown by our survey of other European postal operators, and by our survey of other industries later in this report. As a practical matter, however, we believe that there are three areas in which An Post's reporting could be improved.
- 8.5 First, we identified a number of areas in which the descriptions that we had been provided with by An Post did not make clear in sufficient detail the procedures that had been undertaken to establish the weighting factors used to identify revenues and volumes by service. We believe that these should be addressed.

- 8.6 Second, the evolution of postal practices means that a given set of weighting factors and indeed a given process by which volume and revenue measurements are derived may not be suitable for very long. We believe that the volume and revenue measurement process, together with the Manual that explains the procedure, should be subject to periodic review by an independent reviewer.
- 8.7 Third, and finally, we believe that the Direction should include a requirement that *trends* in revenues and volumes be included and explained within the Regulatory Accounts. This is similar to recommendations made in section 14 below that are designed to ensure that the information set out in the Regulatory Accounts is sufficiently put into context so that its importance can be readily understood.

Operational and revenue based revenue systems

- 8.8 The collection of *volume* figures at a service level is a non-trivial problem to which operators have brought a range of operational and revenue-based measurement techniques. Neither is in principle superior, and both require estimation issues to be addressed. However, we note that European operators with a greater proportion of sorting machinery appear to prefer operational measures – in particular outward machine counts.
- 8.9 Given An Post's *current* operations, there is no obvious basis for preferring one approach over another. An Post has told us that it cannot comprehensively measure the characteristics of stamped and metered mail from revenue based systems, but also has lower levels of mechanisation than some operators in Europe who rely more heavily on operational measures. We understand that the typical profile of mail in Ireland contains a higher proportion of non-mechanisable mail items, than is the case in some continental Member States.
- 8.10 We have therefore considered options for volume measurement (and any associated revisions to the Direction) as follows:
- Option 1: Revenue based approach;
 - Option 2: Operational approach;
 - Option 3: Progressive reconciliation between the two approaches.
- 8.11 *Option 1* would broadly reflect a continuation of the current status quo, subject to comments elsewhere on tightening reporting standards. Under *Option 2*, An Post

would need to improve the use and capability of its outward sorting machines in order to generate reliable data. Our understanding from the machine manufacturers is that the outward sorting machines currently operated by An Post are able to record the number of mail items, as well as the destination (domestic or international), service indicia and format. We expect that close liaison with the manufacturers would enable improvements in An Post's ability to capture accurate information on mail volumes and characteristics. We recognise, however, that this would take time to achieve.

- 8.12 An operational approach would still require sampling - in particular to establish the weight profiles of items. In addition, An Post would of course need to sample manually sorted items, for both volume figures and for mail characteristics. However, we anticipate that An Post will over time increase the proportion of mechanised sorting. We recommend standards for sampling below.
- 8.13 *Option 3* would require An Post to progressively reconcile between the volume figures derived from revenue based systems and from operational counts. We accept that both systems are stronger at identifying different characteristics of mail, given An Post's current operational configuration. The revenue systems cannot give a detailed break down of all stamped and metered mail⁶¹; while the operational systems cannot guarantee accuracy for manually sorted items. Since the weaknesses in both approaches arise in different areas, we believe that there will be value for An Post in reconciling between the approaches, both at an aggregated and disaggregated level.
- 8.14 Under this option, we would recommend that An Post should initially simply report the results from the two systems⁶². The suggested requirement above, to report on trends, would apply in particular where the two sets of numbers showed different trends; and again we anticipate that it will prove valuable for both An Post and ComReg to understand the reasons for any divergence between the two measures. After some period agreed with ComReg, we believe that sufficient

⁶¹ As stated in 7.15, some other European USPs have increased the use of printed label postage for non-standard domestic items. This means that it would be increasingly unlikely that ordinary domestic stamps would be used for non-standard domestic mail. An Post might wish to adapt this approach as it could allow it to increase the amount of stamped mail volume and revenue that is directly attributable to a particular service.

⁶² In order to maintain comparability in the short term, we believe that An Post should continue to report other figures that are calculated from volumes, based on the current revenue based system, until such time as both measures can be properly reconciled.

experience should have been gathered for both sets of figures to be properly reconciled.

- 8.15 As stated above, European best practice in this area appears to be dependent on the local profile of mail and the type and number of machines used. We therefore believe that these options might reasonably be the subject of consultation by ComReg. However, at this stage, our preference is for Option 3.

Statistical standards

- 8.16 Our review above of CEN 13850 highlighted some best practices for mail sampling - albeit for quality of service and real mail studies. We believe that the same principles should reasonably apply to sample studies designed to reveal characteristics of the mail population, such as those required for revenue and volume measurement. In particular, we believe that An Post's sampling processes, and ComReg's oversight of the results of those processes, would benefit from:

- **Statistical audit:** An Post's procedure should be audited, either by a statistical expert, ComReg or part of the financial auditing process. An Post should share the results of the audit with ComReg as part of the regulatory accounts; and
- **Procedural review:** The sampling procedure should be reviewed annually, to take account of service population size or other significant market changes. Any alterations to the procedure should be stated in the Accounting Manual.

Part C: Cost allocation

9 Potential cost allocation issues

Introduction

- 9.1 In Sections 4 and 5, we outlined the legal and regulatory requirements contained within the Regulation and the 2001 Accounting Direction. In this section, we consider in further detail the cost allocation obligations placed on An Post.
- 9.2 Our terms of reference required us to perform a review and assessment of the processes employed by An Post to apportion its public postal network (common) costs between the Reserved, USO Non-Reserved and Non-USO business segments. Our terms of reference also required us to identify costs that could be allocated directly to specific services and products. Due to our limited access to An Post and its data (as explain in Section 3), we have not been able to perform our analysis at this level of detail.
- 9.3 Consequently, we have reviewed the data that has been made available to us. This includes An Post's Accounting Manual and correspondence between ComReg and An Post. Based on this limited dataset we have tried to review An Post's compliance with it its cost allocation obligations⁶³. Non-compliance falls into two broad areas. First, where the submissions provided by An Post falls short of the actual requirements specified by the Direction. Second, where An Post has failed to comply with the "spirit" of the Direction (and consequently fails to meet ComReg's expectations). We also seek to identify were the Direction provides insufficient guidance.
- 9.4 In undertaking our analysis, we have identified areas where the Direction or An Post's compliance falls short of "best practice". Our conclusions and recommendations for an amended direction are set out in Section 11.

Potential issues

- 9.5 ComReg sets out the concept of an Accounting Manual in its Direction. It has provided some guidance on its contents, purpose and the timing of the required submissions. In this section, we identify a range of potential issues.

⁶³ We have not been asked to perform an audit of An Post's cost allocation system. This would not be possible based on the information that has been provided.

Approval process

- 9.6 The Direction requires An Post to submit an Accounting Manual for approval by 1 December of the year preceding the year to which the Accounting Manual is applied. For example, for the 2007 regulatory accounts, An Post should submit the relevant Accounting Manual to ComReg for approval by 1 December 2006.
- 9.7 We understand that for 2004 and 2005 An Post did not submit an Accounting Manual to ComReg for approval. We understand that for 2001, 2002 and 2003, a manual was submitted, but ComReg was unable to approve the manual.
- 9.8 We believe there are benefits to agreeing the content and format of the Accounting Manual and the basis of accounts preparation in advance. Open and transparent communication at the start of the process might avoid subsequent challenge and will help to ensure expectations are met. Subsequent changes could be documented in supplemental submissions during the course of the year.

Content

- 9.9 We understand from An Post that the Accounting Manual is finalised after the regulatory accounts are developed. The Accounting Manual provides an ex post and high-level account of the costing process that has been applied.
- 9.10 The Direction indicates that the Accounting Manual should contain a schedule showing how individual revenue and cost categories are treated. The Accounting Manual should specify in technical detail the range and scope of the data to be collected and the basis of allocation between services.
- 9.11 The Direction does not provide, however, further guidance on what is meant by “in technical detail”. It does not explicitly specify the content of the Accounting Manual and it does not provide guidance on the level of detail required.
- 9.12 From our review and from our discussions with An Post, it appears that the Accounting Manual contains most of the relevant cost allocation information. For example, the Accounting Manual sets out how the operating costs are apportioned between services. Costs are apportioned between the various services, based on volumes that are “weighted” by factors to reflect the different impact of each item on the cost of the activity. The weighting factors appear to be specific to each operational process. The prescribed hierarchy of costs to be

applied to each service is identified, distinguishing between categories of costs (such as pay and non-pay expenditure).

- 9.13 We understand that An Post's cost allocation system is not able to separately capture costs for Products in the Non-Reserved Sector by weight step. If this is the case, then An Post would not be complying with a fundamental requirement of the Direction to keep financial records and accounting systems which are sufficiently detailed to ensure that *"separate accounts can be maintained for each of the services within the reserved sector on the one hand and each of the services within the non-reserved sector on the other"*. This requirement is especially important when different tariffs are charged for products at different weight steps, but the costs associated with these products cannot be separately identified and so are assumed to be the same.
- 9.14 We understand that An Post and ComReg interpret Regulation 11(2) differently. We recommend that ComReg consults on this issue further. Until such time as the difference is agreed, we cannot determine whether An Post complies with the Regulations.
- 9.15 At a high level it appears that An Post provides the required information by the Direction in its Accounting Manual, though the level of disclosure could be improved. For example, greater clarity could be provided on the hierarchy of costs, how equivalent volumes are measured, etc. We provide further examples of improved disclosure in the next two sections.
- 9.16 A number of key questions still need to be considered. First, does the level of information provided allow ComReg to perform its legal obligations? Second, what is the definition of "in technical detail"? Should it be interpreted to mean sufficiently detailed enough to allow an individual who has accounting knowledge and skills to be able to follow the Accounting Manual and create the draft regulatory accounts? Third, is the level of disclosure consistent with best practice in other regulatory sectors or in other countries?

Updating the Accounting Manual and cost allocation system

- 9.17 The weighting factors and basis of allocation by activity should be reviewed and updated on an annual basis. We understand from ComReg that An Post has continued to use the same equivalent volume and weightings for allocating costs

to products since 2001. However, we understand that An Post has changed its business processes and organisational structure over this period. We would expect best practice to require the cost allocation system to be updated annually to reflect known changes and for material changes to be communicated and documented. We do not know to what extent An Post does update its cost allocation system, however it is clear that these changes are not documented and communicated to ComReg.

- 9.18 An annual review and update process is not evident in An Post's documentation. Although the Manual is updated year on year for certain aspects, there appear to be several instances where it refers to outdated processes or references. For example, the Accounting Manual includes activities relating to Telecom Eireann, a company that is no longer connected to An Post (and has subsequently changed its legal name).

Audit process

- 9.19 The Regulations state how costs should be allocated, in Regulation 11. Regulation 11(5) states that the cost allocation method/systems should be "*...verified by auditors engaged by the provider and shall publish a statement to that effect in its annual report.*" The Direction, however, does not explicitly state that An Post is required to subject its cost allocation system to independent audit. All it states is that it must "*engage auditors to verify compliance with the Direction*" and "*publish an auditor's statement of compliance in its annual report.*" The Direction, therefore, does not require it to audit the cost allocation system.
- 9.20 An Post's legal requirements are defined by the Regulations. The intention behind the Direction is to aid the USP in its interpretation of the Regulations, and to define how the operator should comply with the requirements. It is our understanding that in the event of an inconsistency between the Regulations and the Direction, the Regulations have primacy. As such it is our understanding, and one which is supported by ComReg, that the cost allocation system should be audited. The regulatory accounts and the Accounting Manual do not specify whether the cost allocation system has been audited.
- 9.21 Not auditing the cost allocation system reduces the reliability of the data provided. We understand that a number of specific inconsistencies and errors have been

found in the Accounting Manual⁶⁴. One example, relates to the allocation of costs to Election and Publicity Post. The Accounting Manual states that preparation and delivery costs are allocated to all services on a fully distributed basis. However, An Post confirmed that in 2004, delivery costs were allocated to Publicity Post and Elections Mail on an incremental cost basis. An audit of the process would help to identify errors and inconsistencies.

Other potential issues

- 9.22 It is important to consider whether An Post's general approach is consistent with the EC Postal Directive, the Regulations and with common practice. We review this in the next section.

⁶⁴ Various correspondence between ComReg and An Post.

10 Cost allocation best practice

Introduction

- 10.1 This section summarises our review of cost allocation best practice. The focus of our review has not been to assess best practice in terms of cost allocation principles or the application of those principles at the most granular level⁶⁵. This would require access to detailed cost allocation information from both An Post and other regulators. We have not had access to this level of information.
- 10.2 We have reviewed whether An Post's cost allocation approach (in broad high level terms) is fundamentally different from other postal operators in Europe, and whether the level of information provided to ComReg is consistent with best practice. In particular, our assessment has focused on the: (i) approval process; (ii) level of disclosure; (iii) process of updating the Accounting Manual; (iv) verification and audit processes; and (v) compliance in general with the European Postal Directive and the Regulations.
- 10.3 Our review is based on publicly available information. Our methodology is summarised in Section 3. The information we have relied on is summarised in paragraphs 3.16 to 3.17.
- 10.4 We first provide an overview of the key regulatory requirements in Europe (to ensure that we have a level playing field for benchmarking purposes). Next we review surveys by CTcon, CERP and WIK. We then review regulatory precedent in the postal sector. Finally, we consider regulatory in other regulatory sectors. In the next section, we summarise our key conclusions and their implications for the revised Direction.

European regulatory environment

- 10.5 Postal services are regulated by the Postal Directive, which establishes a harmonised regulatory framework for postal services throughout the European Union and for securing improvements in the quality of service provided. The

⁶⁵ For example, we do not consider whether costing should be performed using Activity Based Costing techniques, whether marginal costing is preferable to fully distributed costing, whether Ramsey Pricing principles should be used to allocate joint and common costs, etc. In addition, we do not provide a detailed assessment of whether An Post allocates *each* cost activity on an appropriate basis.

Postal Directive seeks to establish rules concerning the transparency of accounts for universal service provision (Article 1).

10.6 Article 14 of the Postal Directive also provides for certain accounting rules, in particular the separation of accounts for Reserved universal services, Non-Reserved universal services and non-universal services and the allocation method of costs. Article 12 of the amended Postal Directive indicates that all special tariffs shall take account of the avoided costs as compared with the standard service. The amended Postal Directive does not amend Article 14 of the Postal Directive.

10.7 Article 14(3), states that costs should be allocated to each of the Reserved and to the Non-Reserved services respectively in the following manner⁶⁶:

- (a) *“costs which can be directly assigned to a particular service shall be so assigned;*
- (b) *“common costs, that are costs which cannot be directly assigned to a particular service, shall be allocated as follows:*
 - (i) *“whenever possible, common costs shall be allocated on the basis of direct analysis of the origin of the cost themselves;*
 - (ii) *“when direct analysis is not possible, common cost categories shall be allocated on the basis of an indirect linkage to another cost category or group of cost categories for which a direct assignment or allocation is possible; the indirect linkage shall be based on comparable cost structures; and*
 - (iii) *“when neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of all expenses directly or indirectly assigned or allocated, on the one hand, to each of the Reserved services and, on the other hand, to the other services.”*

⁶⁶ Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service.

10.8 The Direction is consistent with these requirements. As such, it would appear that there is a level playing field for benchmarking purposes

10.9 The Postal Directive provides no further guidance on cost allocation, and provides virtually no guidance on the level of disclosure to provide to the regulator. However, the Postal Directive does state:

“the national regulatory authorities shall keep available,...information on the cost accounting systems applied by a universal service provider, and shall submit such information to the Commission on request”⁶⁷.

10.10 Again, the Direction is consistent with the Postal Directive.

CTcon study

10.11 In July 2001, CTcon performed a study, on behalf of the European Commission, on the implementation of Article 14 in the national postal legislation of Member States. CTcon surveyed 15 countries. With respect to the implementation of Article 14(3), CTcon found that nine Member States (Austria, Belgium, Denmark, France, Ireland, Italy, Luxembourg, Portugal and the United Kingdom) had adopted Article 14(3) in their national postal laws.

10.12 CTcon does not provide a great level of detail, so comprehensive comparisons to best or common practice cannot be made. In addition, CTcon does not disclose the practices of individual USPs. However, they found that (out of 15 USPs), *inter alia*:

- 13 USPs said they were actually fulfilling Article 14(3);
- 12 USPs were using ABC and two were applying activity-oriented costing;
- 13 USPs used a full costing method;
- 12 USPs were distributing their costs via cost centres and processes;
- 4 USPs allocated their production costs according to volume, weight, labour time needed and quantity simultaneously. Three other USPs used labour time needed and quantity. Two others used allocating production costs according to weight and quantity; and

⁶⁷ EC Postal Directive, Article 14 (6).

- overhead costs which could not be allocated directly are allocated according to the percentage of allocated production costs by five of the 14 USPs. The other USPs were using for example previously allocated costs, number of staff, revenues or multiple criteria as allocation basis.
- 10.13 With respect to Article 14(6), CTcon found that 13 of the 15 national regulatory authorities received information about the cost allocation systems by way of descriptions, reports, demonstrations and lectures. No further information was provided on the level or frequency of disclosure.
- 10.14 CTcon concluded that most USPs were applying a cost accounting system that was in line with the main aspects of Article 14. It concluded, however, that there was a need to define some of the terms used in the Postal Directive; for example, the term “service”.
- 10.15 It also concluded that no further harmonisation of cost accounting was required even though there would be differences between how cost allocation systems were implemented. Cost accounting principles will differ between USPs due to different production processes and cost accounting systems (i.e. data availability). This makes benchmarking systems at a granular level extremely difficult.
- 10.16 CTcon does not provide enough detailed information to allow us to draw definitive conclusions with respect to An Post’s cost allocation system⁶⁸. At a high level there is clearly a degree of compliance with the Postal Directive (at the principles level). In addition, An Post’s approach does not appear to be inconsistent with the approaches adopted by other USPs. However, CTcon’s scope of work was limited and did not seek to identify “best practice” or compliance at a more detailed level. As such, from this data, we can not conclude that An Post’s approach is consistent with best practice.
- 10.17 CTcon did not seek to assess the level and adequacy of data provided to the national regulators.

CERP study

- 10.18 In November 2005, members of CERP were asked to fill in a questionnaire on a range of issues covering the obligations on operators and powers available to

⁶⁸ The survey is over 4 years old. As such, it does not capture current practices.

NRAAs. The survey did focus on the level of compliance or cost accounting best practice. CERP received answers from 29 countries. Relevant findings include, *inter alia*⁶⁹:

- all but one country has implemented cost accounting rules into their national legislation (28);
- most cost accounting regulations do not go beyond the requirements of the Postal Directives (24);
- the majority of countries do not have any more detailed regulations for the separation of costs (18);
- public availability of regulatory accounts on cost accounting varies from “not existing” (2), “only principles” (5), “not publicly available” (8); “NRA yearly report/site” (2); “USP yearly report/website” (8); “State agency” (1); “USP specific report” (4); and “with the exception of confidentiality” (5);
- most countries require common costs to be apportioned between US/non-US and use a full distribution of costs method (25);
- when US and non-US services are jointly provided the costs are mostly separated based on real use/ABC (19); and
- cost information to justify tariffs has to be provided by all but 2 USPs, mostly by regular reports (14) and/or in case of tariff modifications (15).

10.19 The Irish response is consistent with European norms.

10.20 Assessing best practice at a detailed level, however, is complicated by a lack of publicly available information. Of the 28 countries surveyed (i.e. excluding Ireland), 15 countries do not publish data; do not develop accounts; or only report at the principle level. It should be noted that the question relates to cost accounting data in general and not specifically about cost allocation. Of the remaining 13 countries that *apparently* publish data, we found only two countries (the UK and Holland) that provide specific information on cost allocation (again only at the principles level).

10.21 It is also instructive that most cost accounting regulations do not go beyond the requirements of the Postal Directives and that the majority of countries do not

⁶⁹ Numbers in brackets refer to the number of countries supporting the statement.

have any more detailed regulations for the separation of costs. This complicates the task of making the Direction more prescriptive based on best practice.

WIK study

10.22 WIK performed a study for the European Commission, on the main developments in the postal sector between 2004 and 2006. Relevant findings include, *inter alia*:

- with respect to the regulation of the prices of universal services they found that it is questionable whether NRAs have sufficient data to apply the Directive's standards to *each* universal service with objective data and criteria;
- with a few notable exceptions, NRAs do not appear to have sufficient data and expertise to ensure that special tariffs comply with the pricing principles of the Directive;
- only half of NRAs have conducted more than very infrequent investigations into the prices of universal services;
- with respect to the regulation of the accounts, NRAs generally lack the accounting data required to evaluate whether tariffs comply with the pricing principles of the Directive;
- although about half of the NRAs declare that they have positively reviewed and approved the USP's system for allocating costs to particular services or will soon do so, it is interesting that only seven NRAs can determine the percentage of postal costs that cannot assigned to particular services. WIK concludes that this a critical and seemingly automatic result of a well developed costing system – and hence questions the level of investigations that have been performed. We understand that ComReg does not get this information from An Post; and
- a final issue presented by cost allocation is the quality of the data to be allocated. Data quality depends on complex statistical issues such as the size and reliability of sampling techniques. Only nine NRAs have so far investigated the quality of data used in the costing systems of the USP. Only six NRAs have reviewed and approved both the costing system of the USP and the data quality.

- 10.23 ComReg has not yet fully reviewed or approved An Post's cost allocation methodology or system. The WIK study provides no information on best practice, either in terms of cost allocation methodologies or in terms of the required level of disclosure. The findings suggest, however, that data sufficiency/robustness is a common problem in other European postal sectors.

UK postal precedent

- 10.24 In the previous subsections, our focus was mostly on approach. We now review other regulatory precedent. Here we focus on the level of disclosure and verification.
- 10.25 The requirements Postcomm places on Royal Mail in respect of regulatory accounts are set out in Condition 15 of its new licence (available on Postcomm's website) and Condition 14 of its old licence. The drafting of the cost allocation requirements contained within Condition 15 replicate, for the most part, the requirements of Article 14 of the EU Postal Services Directive. Based on discussions with Postcomm⁷⁰, we understand that whilst the Directive sets out the causation principles required for cost allocation, a particular issue is that it does not define much of the detail. In particular, the terms 'indirect linkage' and 'comparable cost structure' are not set out in the Directive. The term 'comparable cost structure' causes particular problems since a very strict interpretation might rule out Royal Mail's nested-EPMU cost allocation system.
- 10.26 Royal Mail's licence does not take a position on the interpretation of the Directive and some ambiguity remains (even though these areas have been consulted on). Postcomm does not require detailed cost allocation information to be provided on an annual basis as part of its regulatory submissions. Royal Mail is required to produce an Accounting Manual, which is publicly available. The following table compares the contents of Royal Mail's Accounting Manual to An Post's Accounting Manual.

⁷⁰ These views are LECG's views based on prior meetings with Postcomm, they do not necessarily represent Postcomm's current concerns or views.

Table 7 Comparison of Accounting Manuals

Content	Royal Mail	An Post
Total number of pages	36	32 plus appendices*
Regulatory & legal background/position	✓	✓
Summary of what the regulatory accounts comprise	✓	X
Year on year changes to regulatory accounts	✓	X
Overview of the regulatory accounting process	✓	✓
Why the regulatory accounts differ from the Statutory accounts	✓	X
Information on the audit of regulatory accounts	✓	No audit required
Information on sources of financial data	✓	X
Cost allocation information and principles	~ 5 pages	6 pages plus appendices on how activities are allocated*
Volume and revenue measurement	X	✓

Source: Royal Mail and An Post * We note that the appendices are 87 pages. Appendix 1 contains a description of operational pay activities allocated to product groupings. Appendix 2 contains a description of non-pay expenditure allocated to product groupings. Appendix 3 contains a description of product grouping costs allocated to individual products/services. Despite the level of detailed information provided in the appendices, we believe that this does not sufficiently describe the economic justification of cost allocation rules, details on how cost driver information is produced etc.

- 10.27 In terms of content, the Accounting Manuals appear to be broadly comparable. Both Accounting Manuals provide information at a “principles level only”. In terms of best practice, it appears that a number of small changes could be made to enhance An Post’s document (e.g. include information on changes made to the regulatory accounting process, explain and reconcile differences between the regulatory and statutory accounts and provide more information on the sources of financial data).
- 10.28 Neither Accounting Manual provides detailed information on the cost allocation system (e.g. descriptions of each activity⁷¹, the economic justification of cost allocation rules, details on how driver data is produced etc.). Royal Mail believes that it would not be appropriate to provide Postcomm with full ABC documentation and internally it does not maintain a consolidated document. Royal Mail’s ABC

⁷¹ As summarised in the table above, the An Post Accounting Manual provides a description of activities in the appendices.

system is summarised in many different operational and training documents (each describing different aspects of the system) and the data is contained within many different systems and financial models (i.e. there is not one ABC costing model).

- 10.29 Royal Mail believes that it is essential for the system to be audited, and it is. Royal Mail's auditors adopt a risk based approach, and accordingly focus on changes that have been made to the system since the last review. In the past, fuller audits have been performed. We have not been provided with information defining the scope of this audit.
- 10.30 Royal Mail also believes that it is important for Postcomm to review the cost allocation system and we understand that Postcomm has just finished such a review. This was a lengthy process and required both parties to work closely together. The process included specific data requests from Postcomm, a detailed review (but not an audit) of the information received and a large number of detailed meetings between Postcomm and Royal Mail staff, which were essential because not all information was documented. We understand that the review focused on material items and took a sampling based approach.
- 10.31 Oxera has summarised Royal Mail's cost allocation methodology⁷². Oxera notes that accounting bodies have not set ABC standards but a de facto standard has been developed by the Consortium for Advanced Manufacturing International (CAM-I). CAM-I has produced an ABC glossary and suggests a best practice ABC methodology. Royal Mail's ABC system follows the CAM-I method closely, to the point of incorporating the CAM-I method into its training materials.

Other postal precedent

- 10.32 We provide a brief overview of cost allocation documentation in Holland and in the United States below.

⁷² Oxera. "How could Royal Mail undertake 'class costing'? Report prepared for Royal Mail". 1 September 2005.

TNT

- 10.33 TNT provided us with a copy of its cost allocation manual⁷³. The table below summarises the key contents of this document:

Table 8 Comparison of Accounting Manuals

Content	TNT	An Post
Total number of pages	32	32 plus appendices*
Regulatory & legal background/position	✓	✓
Management structure	✓	X
Accounting systems	✓	X
Overview of operational processes	✓	X
Overview of cost structure	✓	X
Safeguards in the allocation system	✓	No audit required
Cost allocation information and principles	~ 10 pages but mostly high level	6 pages plus appendices on how activities are allocated*

Source: TNT and An Post. * We note that the appendices are 87 pages. Appendix 1 contains a description of operational pay activities allocated to product groupings. Appendix 2 contains a description of non-pay expenditure allocated to product groupings. Appendix 3 contains a description of product grouping costs allocated to individual products/services.

- 10.34 A key difference between the manuals is a 5-page section on safeguarding the allocation system. TNT explains the internal safeguards that are in place to ensure the proper functioning and the fairness of the allocation system. It also summarises how the system is audited by an external auditor. It explains the scope of the auditor's work and the form of the opinion to be provided. Independent Post and Telecommunication Authority ("OPTA") may also designate a second auditor to review the audit activities.

United States

- 10.35 In 1970, the Postal Reorganisation Act (PRA) set up two independent establishments within the executive branch of the Government of the United States: The Postal Service (USPS) and the Postal Rate Commission (PRC). The PRA gives USPS the authority to provide postal, "non-postal", and philatelic

⁷³ TNT Post Group. "Allocation system for costs and revenues relating to mandatory services". English version, November 2000. We were informed by TNT that the document has not changed materially since this publication.

services to the public. USPS bears primary responsibility for postal policy and management of the Postal Service. The PRC is responsible for evaluating proposals for changes in rates of postage and mail classification, and making recommendations to the Postal Service's Governors regarding rates and classification.

- 10.36 The USPS employs an advanced system of ABC to allocate costs, for the purposes of estimating marginal and incremental costs⁷⁴. We understand that USPS' product costing system is fully vetted. That is, the cost allocation methodology is reviewed by competitors, customers and the PRC. As such, USPS' cost allocation methodology is *fully* documented.
- 10.37 To require An Post to fully document its cost allocation system at the same level of detail, based on this one benchmark, might not be appropriate for a number of reasons. For example, the USPS is significantly larger than An Post, it has more sophisticated costing and financial systems, it has been regulated for a longer period and the nature of regulation is different.

Other regulatory benchmarks

- 10.38 We now provide an overview of cost allocation in telecommunications, gas, water and airports. These sectors share some of the fundamental characteristics of the postal services sector (e.g. regulated network industries with significant common costs) – and hence might provide an important reference to best practice.

Telecommunications

- 10.39 To promote community-wide telecommunications services and liberalise the internal market in telecommunications within the European Union, the European Parliament and the Council have adopted various Directives and Recommendations. These Directives specify in some detail how costs must be categorised (direct versus common costs), as well as how to allocate common costs.
- 10.40 BT is required under Condition 78 of its Licence, as set out in Schedule 1 to Oftel's Continuation Notice dated 23 July 2003, to prepare Financial Statements

⁷⁴ For details on the cost allocation mechanism of USPS see "Summary Description of USPS Development of Costs and Segments, FY 2000", (Docket Nr: LR-J-1/R2001-1)

under the Current Cost Convention for each of its Businesses and Activities⁷⁵. These Financial Statements are prepared in accordance with Accounting Documents agreed between Ofcom and BT and must achieve accounting separation on the basis of cost causality, objectivity, consistency of treatment, UK GAAP and transparency.

- 10.41 Cost causality requires that costs are allocated to products or components in a way that reflects the way that products drive the costs to be incurred. In some situations, there is a direct causal relationship between a cost type and a product, and in other cases, the causal relationship must be built up over a series of intermediate stages in a manner similar to ABC. The method that BT uses for this purpose is to calculate a cost volume relationship (CVR) between the cost and the volume of the relevant cost driver.
- 10.42 Objectivity requires that attributions are free from bias, which supports the use of an objective principle of attribution, such as cost causality. Transparency requires that the attribution methods be readily understood, in particular, that the descriptions of the methods should provide sufficient information for a suitably informed reader to understand the structure of BT's financial information systems, understand the cost allocation methodology and to make a judgement as to the reasonableness of the methodologies and driver data.
- 10.43 BT's Detailed Attribution Methods ("DAM") report⁷⁶ details *in full* the methods used to derive the fully allocated costs of the business and disaggregated activities. The purpose of the DAM is to, *inter alia*:
- describe the costing principles used by BT to prepare the Regulatory Financial Statements on a fully allocated cost basis;
 - describe the methods used in the Accounting Separation process to attribute revenue, costs and capital employed to the Markets, Technical Areas and Disaggregated Activities in the Regulatory Financial Statements;
 - outline the systems and processes used by BT to support Accounting Separation; and

⁷⁵ BT. "BT Accounting Documents and Financial Statements". 2003.

⁷⁶ BT. "Detailed Attribution Methods, Used in the production of the Financial Statements for the Businesses and Activities, Volumes 1 to 3". Issue 11: 14 December 2001.

- outline the methods for preparing the Statement of Costs on a Current Cost Basis and the Statements of Costs and Charges for Internal and External Wholesale Services
- 10.44 The DAM provides detailed and granular descriptions of the procedures used to apply the principles set out in the Accounting Documents. The DAM is over 1500 pages in length.
- 10.45 The initial sections of the DAM provide an overview of the cost allocation systems (in around 40 pages). In summary, they provide an overview of the BT business, explaining the main activities and functions performed by BT to deliver services to customers. It describes how the underlying financial transactions supporting the business activities and functions are recorded in the financial ledgers, and how the transactions are grouped to provide the starting costs, revenues, assets and liabilities used by the Accounting Separation (AS) system. It then provides an overview of the AS solution, in terms of the underlying costing principles and the conceptual flow of costs and revenues from source financial systems to the separated businesses. Finally, it describes the system and processes, which underpin the flow of costs and revenues in the AS solution.

Gas

- 10.46 Transco has developed a Transaction Model to allocate operating costs within business areas to price controlled activities. The cost allocation methodology is complex. Ofgem does not require Transco to provide detailed cost allocation information details as part of its regulatory submissions. Ofgem appointed Andersen to review Transco's cost allocation system⁷⁷. Andersen's analysis was restricted to an assessment of allocations at a Transaction Product level only. Andersen did not assess how costs were allocated through the ABC exercise to these Transaction Products. Ofgem required Transco's auditors to audit the ABC system below the Transaction Product level.

Water

- 10.47 Ofwat's approach to cost allocation has been summarised by NERA⁷⁸. Guidance on allocating costs to activities such as water and sewerage services are set out

⁷⁷ This section is based on information contained in the following publicly available document: Report on Transco's operating costs for the 2002/03 to 2006/07 Price Control Period, Final Report, Andersen, 7 September 2001.

⁷⁸ NERA. "Regulatory approaches to cost allocation". A report for ORR, Appendix B. April 2001.

in Ofwat's Regulatory Accounting Guidelines (RAGs). NERA concluded that in some cases Ofwat leaves the mechanism for allocating common costs to individual companies to determine, though companies are required to explain the basis for their allocations and to explain the reasons for any changes to their cost allocation mechanisms.

Airports

- 10.48 Under the Airports Act 1986, the Civil Aviation Authority (CAA) has to set price caps on airport charges, generally every five years, at airports designated by the Secretary of State. The CAA has issued consultation and discussion papers on cost allocation and cost standards. The CAA does not require BAA to provide full details of its cost allocations system as part of its regulatory submissions. In setting prices, the CAA does perform a review of BAA's cost allocation approach. We understand that BAA does not maintain a document describing its cost allocation systems in full.

11 Cost allocation findings and recommendations

Introduction

- 11.1 This section provides a summary of our findings and recommendations, based on the analysis set out in the prior two sections and our accounting and postal experience.

Compliance with EU Directive

- 11.2 Article 14(3) provides guidance on how to allocate costs. Most Member States have implemented the requirements of Article 14(3). Most postal companies, including An Post, indicate that they comply with the EU Directive.
- 11.3 Most universal providers are using ABC-based costing techniques to fully allocate costs to businesses and/or products. Postal operators in New Zealand, Australia and the US also use advanced ABC costing techniques. The information we have collected so far does not allow us to study these allocation systems in more detail. While the broad allocation principles, based on causality, appear to be similar across countries, it is expected that there will be differences in the treatment of indirectly attributable, and joint or common costs.
- 11.4 An Post adopts an ABC methodology, which is consistent with common practice. An Post's approach also appears to comply with the broad requirements⁷⁹ of the EU Postal Directive. For example, Article 14(3)(b) (iii) implies that when costs cannot be directly or indirectly allocated, they should be allocated using the ratio of all expenses previously directly or indirectly assigned. As such, it would appear that the Postal Directive requires the use of equiproportional mark-ups (EPMU). Our review of the Accounting Manual suggests that An Post uses EPMU to allocate costs that cannot be directly or indirectly attributed.
- 11.5 However, we have not been provided with enough information to review An Post's cost allocation approach and system in detail. Such information has never been provided to ComReg. Therefore, we are unable to determine whether An Post is in full compliance with the EU Postal Direction, or whether An Post's ABC system is consistent with best practice.

⁷⁹ In terms of principles.

- 11.6 As noted in the gaps section there is a possible issue relating to the allocation of costs to Products in the Non-Reserved Area by weight step. Further investigation and consultation is required to determine whether An Post's cost allocation system does or does not comply with the fundamental requirements of the Direction. If non-compliance is determined, then ComReg would need to assess if An Post can provide the data. If it cannot at the moment, a timetable on how the cost allocation system will be adapted and improved to ensure compliance will need to be agreed between the two parties.
- 11.7 We note that Royal Mail claims that its costing system is consistent with certain industry standards (i.e. CAM-I). As part of its disclosure requirements, An Post should comment on whether its ABC system is consistent with any known industry standards or known best practice.
- 11.8 We recommend that An Post disclose to ComReg:
- details of expenditure by pipeline process distinguishing between costs which have been directly allocated to specific services, common costs which have been allocated on the basis of analysis of the origin of the costs themselves, and common costs which have been allocated on the basis of a general allocator; and
 - details of revenues distinguishing between revenues which have been directly allocated to specific services and other revenues which have been allocated or apportioned on the basis of a general allocator.

Accounting manual content

- 11.9 We have not had full access to the level of information that is typically disclosed between USPs and NRAs across Europe. Where we have had access to postal accounting manuals, we have found that the level of disclosure is typically at the level of broad principles. An Post's accounting manual is also stated at a principles level.
- 11.10 Based on the Accounting Manuals we have reviewed (including eircom's) we believe that An Post's Accounting Manual could be improved by providing an overview of:

- An Post's business, explaining the main activities and functions performed by An Post to deliver services to customers, clearly indicating which businesses and services are regulated;
 - An Post's management structure;
 - how the underlying financial transactions supporting the business activities and functions are recorded in the financial ledgers, and how the transactions are grouped to provide the starting costs, revenues, assets and liabilities used within the internal costing systems to allocate costs;
 - the accounting systems, in terms of the underlying costing principles and the conceptual flow of costs and revenues from source financial systems to the separated businesses;
 - what the regulatory accounts comprise and the regulatory accounting process (including the basis of preparation of the regulatory accounts);
 - year on year changes to regulatory accounts and changes to cost allocations, together with an assessment of the impact of these changes;
 - how the regulatory accounts differ from the statutory accounts;
 - the internal safeguards that are incorporated to ensure that the cost allocation system is free from material error; and
 - the audit of regulatory accounts (in terms of scope of the audit and the process to appoint auditors).
- 11.11 An Post would still be required to provide information at a detailed level on how costs and revenues are allocated/apportioned between services. An Post already provides details on how costs are allocated to product groupings and how products grouping costs are allocated to individual products and services.
- 11.12 A question remains as to whether An Post should provide greater detail (e.g. comparable to the level of information provided by either the USPS or BT). Such information might include a full description of each activity⁸⁰, the economic justification for each driver and details on how each driver is derived and verified. Such transparency may reflect best practice, but ComReg would need to decide

⁸⁰ We note that the An Post Accounting Manual provides a description of activities in the appendices.

whether this extra disclosure would be fair and proportionate. We think this issue should be consulted on more widely.

- 11.13 Some improvements are still required, particularly in the derivation of equivalent volume drivers. It is not clear from the Accounting Manual how these are derived, how they reflect different mail characteristics, how often they are reviewed and updated and how they are verified. In addition, the Accounting Manual does not provide sufficient details on how costs are found to be directly or indirectly attributable, or joint or common. It also does not distinguish between variable and fixed costs or explain how variable costs are defined (i.e. how costs vary for different volume decrements or increments). The Accounting Manual should summarise these aspects of the cost allocation system.

Auditing and verification

- 11.14 An Post should have proper safeguards over its cost allocation system to ensure the proper functioning and the fairness of the allocation system. These safeguards should cover how the system is verified internally and how An Post updates the system for known changes in processes, volumes, etc. These controls should be properly documented in the Accounting Manual.
- 11.15 We believe that the cost allocation system should be audited by an external auditor. This review should not just be a review of the process, but should also seek to comment on the principles used, the appropriateness of selected cost drivers, etc. An Post should document the scope of the auditor's work and the form of opinion to be provided, in the Accounting Manual.
- 11.16 Around half of the NRAs have positively reviewed and approved the USP's system for allocating costs to particular services or will soon do so. Best practice would indicate that ComReg should also fully review and approve An Post's cost allocation system as required by the Directive.
- 11.17 This does not imply that ComReg should request full documentation to be provided on an annual basis. There are two alternative options. The first would be to designate a second auditor to review the audit activities (e.g. the option open to OPTA). The second would for ComReg to perform a one-off review. The process would require specific data request from ComReg, a detailed review (but not an audit) of the information received and a large number of detailed meetings

between ComReg and An Post staff. The review would need to be conducted using a sampling approach.

- 11.18 In general, detailed technical information (potentially at the most disaggregated level) needs to be made available to ComReg. The Postal Directive requires NRAs to keep available information on the cost accounting systems and to provide information to the Commission on request. This does not imply a fully documented ABC system. Nevertheless, it does mean that An Post needs to keep sufficient information to allow ComReg to approve the system. We believe that it is essential for An Post and ComReg to discuss the most efficient way of achieving this objective.

Part D: Regulatory accounts and audit

12 Regulatory accounting and reporting and audit issues

Introduction

- 12.1 In Sections 4 and 5, we outlined the legal and regulatory requirements contained within the Regulations and the Direction. In this section, we consider in greater detail the regulatory accounting and reporting obligations placed on An Post. We first consider issues related to the basis on which the regulatory accounts are prepared, and then address the role of external auditors in verifying compliance with the terms of the Direction.
- 12.2 We have reviewed the data that has been made available to us. This includes the Accounting Manual, the regulatory accounts and correspondence between ComReg and An Post. We have tried to identify areas where An Post may not be complying with either the detail or the perceived intention underlying with the Direction. Non-compliance falls into two broad areas. First, where the submissions provided by An Post may be considered to fall short of the actual requirements specified by the Direction. Second, where An Post's interpretation of the required compliance does not meet with the intention or "spirit" of the Direction (and consequently fails to meet ComReg's expectations). We also seek to identify where the Direction provides insufficient guidance.
- 12.3 Our conclusions and recommendations for an amended Direction are set out in Section 14.

Regulatory accounting issues

- 12.4 ComReg's position is that the information provided by An Post is not sufficiently transparent, both in terms of the process and in terms of the level of disclosure. ComReg has identified a number of items that it considers to be reporting errors. When combined with the lack of transparency this reduces the robustness and credibility of the data provided. An Post, on the other hand, has consistently claimed that the reporting is clear, transparent and accurate, and is in full compliance with the Direction. An Post also claims that it has sought to work with ComReg to improve the level and quality of the reporting over the period since 2001.

Format and content of regulatory accounts

- 12.5 ComReg and An Post have different views on the appropriate information requirements. These differences relate to both the scope and level of analytical detail and commentary that should be contained within the regulatory accounts and fall into two main areas: (i) the transparency of reporting; and (ii) the level of detailed information provided.
- 12.6 With respect to *transparency*, An Post does not provide any commentary or narrative explanation to support the contents of the regulatory accounts. There is no explanation of trends or key adjustments year on year to assist the reader in their understanding. By way of example, in 2004, there was a significant consolidation adjustment of €26 million contained within the regulatory accounts, but no information was provided to explain the adjustment. Commentary is necessary to explain the basis of preparation. Regulations cannot be so prescriptive as to provide certainty as to the basis of preparation.
- 12.7 The Direction does not explicitly require An Post to provide any commentary or narrative explanations, and therefore the approach adopted by An Post complies with the requirements of the current Direction even if it does not meet with ComReg's expectations that reporting should be transparent. The application of GAAP would generally encourage additional disclosure as necessary to assist the reader of the accounts. In addition, certain accounting and financial reporting standards, such as FRS 18, specifically require the disclosure of significant items and their impact on the accounts.
- 12.8 The lack of explanatory information in the regulatory accounts has resulted in a significant volume of correspondence between ComReg and An Post after the submission of each set of regulatory accounts. The provision of a sufficient level of commentary and explanation in An Post's regulatory accounts would be consistent with best practice, and would increase the level of actual and perceived transparency.
- 12.9 The Direction does not require An Post to publish the regulatory accounts. An Post has voluntarily published a brief summary of the regulatory accounts for each year 2001 to 2004 on its website. Similar information for 2005 has not yet been made available. ComReg believes that there is significant value in publishing regulatory financial information.

- 12.10 With respect to the *level of information* to be provided, the Direction is not clear and instead refers to compliance with IAS 14. IAS 14 is an accounting standard that sets out the requirements for segmental reporting by companies. Whilst IAS 14 contains detailed guidance on how to derive reportable segments, it leaves some areas open to the application of judgement and interpretation.
- 12.11 The information provided routinely to ComReg by An Post includes schedules showing:
- a note on the basis of the preparation of the regulatory accounts;
 - summary results for the current year and the prior year covering volume, turnover, payroll costs and non-payroll costs, broken down by Reserved and Non-Reserved USO service area;
 - consolidation of letter and parcels segmental accounts by Reserved and Non-Reserved USO service area;
 - letter mails segment information for Reserved USO services accounts;
 - letter mails segment information for Non-Reserved USO services accounts;
 - parcels mails segment information for Non-Reserved USO services accounts⁸¹;
 - statement of net assets; and
 - reconciliations of regulatory turnover, regulatory profit and regulatory statement of net assets to the turnover, profit and net assets shown in the statutory financial statements.
- 12.12 ComReg believes that it has not received the level of detail it requires. Consequently, ComReg has requested An Post to provide additional schedules on an ad hoc basis. By way of example, ComReg has requested, in the past, financial information relating to letters, disaggregated by payment type. ComReg believes that this information is necessary for it to fulfil its statutory obligations.

⁸¹ We understand that due to a business re-organisation the parcels business is no longer treated as a separate segment in the 2005 regulatory accounts.

- 12.13 We have not had access to sufficient information to perform a full analysis of An Post's compliance with IAS 14. However, based on the analysis we have been able to perform, it appears that An Post may not have complied fully with all of the requirements of IAS 14 in the production of its regulatory accounts. For example, An Post has not provided balance sheet information for each reportable segment. ComReg has not granted An Post an exemption from this requirement.
- 12.14 The Direction also requires An Post to maintain accounting systems that will allow it to produce information at a more detailed level. This would enable An Post to respond promptly to requests from ComReg for additional detailed information. An Post has not always provided such information on a timely basis. For example, in relation to An Post's proposals to increase International Outbound prices in January 2004, ComReg requested further information in December 2003. This information was not provided until December 2004. It is not known whether this delay was due to deficiencies in the accounting systems.

Basis of preparation

- 12.15 The Direction is mostly silent on the basis of regulatory accounts preparation. It does not specify whether the accounts should be prepared in accordance with recognised accounting standards and where departures from such standards are required or permitted.
- 12.16 Despite this lack of clarity, there appears to be broad agreement between ComReg and An Post on a number of preparation issues. For example, there is agreement that the reporting of regulatory information should be undertaken on a consistent and comparable basis from year to year.
- 12.17 There is a difference of opinion relating to when a restatement of prior year accounts is required. In its letter to An Post dated 28 June 2005, ComReg requested An Post to restate its 2003 regulatory accounts "*given the changes in accounting methodologies adopted in 2004*". An Post claimed that in compliance with GAAP, restatements are only made for changes in accounting policy and to correct for material errors. An Post asserted that it had followed this policy consistently. It stated that there was no change in accounting policy in 2004 but that a non-material error was identified. Therefore, no restatement was required.

- 12.18 We have not had access to sufficient details about the specific circumstances that gave rise to the disagreement between ComReg and An Post. We are unable, therefore, to offer a considered opinion on whether a restatement or a disclosure, by way of a note to the accounts, would be required in order to comply with the applicable accounting standards.
- 12.19 As the Direction does not explicitly state the basis upon which the regulatory accounts are to be prepared, it does not provide guidance on which alternative treatments should be adopted with regard to restatements. In particular, whether:
- restatements should always take place to ensure consistency between accounting periods, even when such a restatement might not be required to conform with the relevant accounting standards;
 - normal accounting standards should apply, and hence restatements only take place when they are required by the applicable standards; or
 - no restatements should be made so that the regulatory accounts for each year record the situation as it was understood at the time.
- 12.20 The eircom regulatory accounts include an accounting policy in relation comparative figures that states that eircom will restate comparative figures, as directed by ComReg, for changes in the methods of attribution, so that comparative figures are restated and presented on the same basis as those for the current year. This would appear to support the first option above where restatements are made for *all* types of changes. On further review with ComReg, however, we understand that in recent years, restatements have only been made for correction of errors and misstatements or for changes to the basis of preparation, such as a change to the definition of reportable segments. This would be consistent with the requirements of GAAP.
- 12.21 The third option outlined above has been adopted by Royal Mail. In agreement with Postcomm, Royal Mail effectively freezes each set of regulatory accounts once they have been published. This means that prior years are not restated unless events are so significant that the comparative figures would be rendered meaningless without a restatement. We note, that in 2006, the 2005 comparatives were restated to reflect the introduction of IFRS.

Audit issues

- 12.22 The Direction requires that An Post engage an auditor to verify its compliance with the Direction, and that An Post publishes the auditor's statement of compliance in its annual report. An Post is required to consult with ComReg before appointing the auditor.
- 12.23 ComReg believes that An Post has not complied with these requirements. An Post has not consulted ComReg before the appointment or reappointment of KPMG, who is the auditor responsible for verifying An Post's compliance with the Direction. In addition, the statement of compliance contained in An Post's annual report does not comply with ComReg's interpretation of the requirements of the Direction and the Regulations. On this issue, the Direction may not provide sufficient or clear guidance.
- 12.24 As explained in paragraphs 9.19 and 9.20 above, there is a difference in the audit requirements specified by the Regulations and those required by the Directions. Both requirements need to be met. We understand that in the event of an inconsistency between the Regulations and the Direction, the Regulations have primacy. ComReg believes that An Post is required to engage an auditor to "verify" that An Post's cost allocation system complies with the Regulations.
- 12.25 ComReg has in the past identified potential or perceived errors in the regulatory reporting. This has led ComReg to question the credibility of the regulatory accounting information. We have not sought to verify or validate the specific errors. If errors have been found this reduces the reliance that can be placed on them.
- 12.26 As ComReg has not been consulted on the appointment or reappointment of the auditors, it has not been involved in setting the terms of reference for the audit engagement. ComReg cannot influence the extent to which the processes supporting the data collection and recording have been tested and verified as part of the audit.
- 12.27 An Post has published a directors' statement of compliance with the Regulations and the Direction in its annual reports for 2002, 2003, 2004 and 2005. In each of these years, the publication of the annual report has occurred before the deadline for submission of the regulatory accounts.

- 12.28 We understand that at each of these dates the regulatory accounts had not been completed. As a result the statement of compliance provided in the annual report has not been able to confirm that An Post has complied with all of the requirements of the Direction, including the requirement that An Post has prepared the regulatory accounts for submission to ComReg. For example, on page 38 of the annual report for the year ended 31 December 2005, the directors of An Post state that “*segmental profit and loss accounts and statements of net assets are being prepared for submission to ComReg for the year ended 31 December 2005, within the specified deadline of 19 weeks from the end of the financial year*”.
- 12.29 Due to the sequence in which the annual report and regulatory accounts are produced, the auditors are not in a position to confirm that all of the reporting requirements of the Regulations and Direction have been met when their opinion is issued. Their opinion relates to a review of the directors’ statement of An Post’s compliance with both the Regulations and with the Direction. In the case of the 2005 annual report, the directors’ statement on which KPMG issued an opinion is the statement on page 38 of An Post’s annual report.
- 12.30 The auditor states that they have performed their duties in accordance with guidance issued by the Auditing Practices Board, and that based on “*enquiry of certain directors and offices of the Company and examination of certain documents*”, and that it is their opinion that the directors’ statement reflects An Post’s compliance with the Regulations and the Direction. It is unclear from the auditor’s opinion on An Post’s compliance with the Direction to what extent, if any, they have audited the cost allocation system.
- 12.31 The auditors do not issue an opinion on the regulatory accounts when these are subsequently produced by An Post.
- 12.32 It is ComReg’s position that the opinion provided by the auditors does not provide it with adequate comfort. ComReg believes that such comfort requires an independent audit of the regulatory accounts.

13 Regulatory accounts and audit best practice

Introduction

- 13.1 This section summarises our review of best practice in relation to regulatory accounts and the audit of regulatory accounts. The focus of our review has been on assessing whether An Post's approach is fundamentally different from other postal and regulated companies, and whether the information provided to ComReg is consistent with best practice. Our approach is summarised from paragraph 3.18. We have focused our review to the issues presented in the previous section.

Basis of preparation of the regulatory accounts

- 13.2 Our benchmarking of UK companies regulatory accounts showed that in every instance the basis of preparation was UK GAAP as amended by relevant regulatory requirements. It is normal for the basis of preparation to be driven by the requirements of the regulator. Departures from GAAP were, in each instance, pre-defined/agreed and either stated in the relevant regulatory direction or licence, or agreed on an exception basis between the company and the regulator. An example of the latter approach is the agreement between Royal Mail and Postcomm to dispense with the requirement for Royal Mail to present balance sheet and cash flow information in the 2005/06 regulatory accounts.
- 13.3 Our review indicated that where there was a departure from GAAP, this was accompanied by a requirement to reconcile the information contained in the regulatory accounts with the information contained in the audited financial statements. Consistent with good practice, the Direction requires a reconciliation between the audited financial statements and the regulatory accounts. An Post provides such a reconciliation.
- 13.4 In the case of An Post's regulatory accounts, our analysis indicated that there was a clear requirement from ComReg to ensure that the regulatory accounts reflected only the costs and revenues relating to the provision of the services in the current period. In this instance, ComReg appear to be placing their need for consistency and comparability above certain GAAP principles.

Consistency of presentation and prior year restatements

- 13.5 Best practice in this area is set out by the relevant accounting standards and principles surrounding the preparation of the accounts. This would require that prior year comparatives were restated if there was a change in basis of preparation (such as a change in the accounting policy or a change in the size of the Reserved Sector, etc.). A restatement would also be required to correct a fundamental error. For changes to estimation techniques, where the change is material, the change and the rationale for the change should be explained and the impact of the change should be disclosed.
- 13.6 We note that eircom has been directed by ComReg to restate its comparative information whenever methods of attribution are amended. In principle, this would go beyond the requirements of GAAP. We understand from ComReg, however, that recent restatements of comparative figures have only been required for changes that would have required restatement under GAAP.
- 13.7 Although the option of “freezing” prior year regulatory accounts (as described in 12.19) has the merit of being “light touch”, it introduces a degree of ambiguity (in terms of when a restatement is required because it is “so significant”). This approach would hinder ComReg’s ability to review and understand underlying trend information. Trend analysis has been identified as a key analytical tool used by ComReg in fulfilling its legal obligations.

Format of the regulatory accounts

- 13.8 Our analysis indicates that the form and content of regulatory accounts is driven primarily by criteria within the applicable national legislation and the relevant accounting standards. This format and content is then amended and refined by the specific requirements of each regulator, which we found to vary between industries.
- 13.9 The guidance note from the ICAEW⁸² states, “*there is no precise definition of Regulatory Accounts, either in law or in practice, although they are commonly referred to by Regulatory Bodies, Regulated Entities and accountants within*

⁸² We are not aware of any similar guidance that has been issued by the Institute of Chartered Accountants in Ireland (ICAI). We understand that the ICAEW and the ICAI often work closely together in developing technical guidance.

RAGs and the Regulated Entities' Licence arrangements." It goes on further to state that a typical set of regulatory accounts contains:

- *"A profit and loss account;*
- *"A balance sheet or statement of mean capital employed;*
- *"Detailed/segmental analyses of operations, costs and income, as defined in the regulatory licence; and*
- *"A reconciliation between the results and net assets reported within the Regulatory Accounts and those reported within the statutory financial statements prepared in accordance with the Companies Act 1985."*

13.10 The CERP survey showed that five European postal operators supplied the regulator with additional supplementary information as a matter of course beyond that contained in their regulatory reporting.

13.11 We have performed a comparison of An Post's regulatory accounts to a selection of regulatory accounts prepared by other regulated entities. Summary tables comparing An Post's regulatory accounts to those of Royal Mail and eircom are included below. The first table compares the full regulatory accounts of An Post as submitted to ComReg to the published Royal Mail regulatory financial statements. It is worth noting that Royal Mail only publishes a summary set of regulatory accounts. Additional detailed information is provided to Postcomm each year. We have not had access to this additional confidential information.

Table 9 Comparison of Royal Mail and An Post regulatory accounts

Content	Royal Mail	An Post
Total number of pages	32	12
Summary of results table	✓	✓
Business review commentary on financial performance; USO performance; USO revenue, operational volumes and operational costs trends	✓ 5 pages	X
Review of licence/regulatory requirements	✓	X
Income statements	✓	✓
Statement of Net Assets	X Not provided by agreement with Postcomm	✓
Cash flow information	X Not provided by agreement with Postcomm	X
Basis of preparation and regulatory accounting policies/principles	6 pages	1 page – very high level
Reconciliation of regulatory accounts to Financial Statements	Full income statement reconciliation	Turnover, Profit Net Assets reconciled
Additional information on costs by pipeline etc	Unaudited information showing (i) fully allocated and (ii) long run marginal costs by pipeline process and Property, plant, vehicle and equipment information by pipeline process	Fully allocated costs by pipeline process split by Pay and non Pay costs

Source: An Post and Royal Mail Regulatory Accounts.

- 13.12 Eircom publishes both its historical cost separated accounts as well as its accounting methodology (equivalent of An Post's manual of accounting) on its website. The table below compares the regulatory accounts of An Post and eircom.

Table 10 Comparison of eircom and An Post regulatory accounts

Content	eircom	An Post
Total number of pages	82	12
Summary of results table	✓	✓
Commentary	✓	X
Review of licence/regulatory requirements	✓	X
Income statements	✓	✓
Statement of net assets/ capital employed	✓	✓
Basis of preparation and regulatory accounting policies/principles	✓ High level in regulatory accounts, separate accounting document published	✓ 1 page – very high level

Source: An Post and eircom Regulatory Accounts.

- 13.13 If a regulated entity were to apply the ICAEW guidance or rely on formats prescribed by the accounting rules or companies legislation, to derive the format and content for its regulatory accounts, it would have a large degree of choice. The format chosen may not present the information in the manner desired by the regulator. Therefore, good practice is for the format and content of regulatory accounts to be clearly specified by the regulator. In the UK, this is often done within the Regulatory Licence Conditions.
- 13.14 We believe that the format and content of the accounts should be agreed through negotiation (in advance) between the regulator and the regulated entity before the end of the reporting period. This approach has been adopted by Royal Mail and Postcomm in the UK. It provides flexibility to alter the format when it is appropriate to do so, particularly when changes to the company's systems or processes allow for the production of new or better information, or there is a change to the information requirements of the regulator. The approach also encourages early communication about potential issues between the regulator and the regulated entity. As the format is agreed in advance of producing the accounts, the approach adopted by Royal Mail and Postcomm provides the company with a degree of certainty about its regulatory obligations and allows the company to plan its financial reporting activities appropriately.

- 13.15 An important concept in the preparation of accounts is that of materiality. Materiality is defined in ISA 320⁸³ (Audit Materiality, International Standards on Auditing, UK & Ireland) as “*Information is material if its omission or mis-statement could influence the decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold of cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.*”
- 13.16 Auditors would be expected to consider materiality in the context of the primary financial statements or of individual items included in them. The concept of materiality will drive many decisions in the preparation and presentation of the regulatory accounts. For example, the commentary should only focus on material changes in the accounts. Disclosure of changes in estimation techniques should be based on the concept of materiality. Materiality also links to the issue of proportionality and level of detailed information ComReg requires versus the costs of compliance, from An Post’s perspective.
- 13.17 It would be considered best practice for both ComReg and An Post to agree a common understanding and definition of materiality in relation to the regulatory accounts. We understand that this approach is consistent with Postcomm’s approach. It is also consistent with guidance to the audit profession contained within SAS 610⁸⁴, which requires the auditor of financial statements to communicate certain items such as the level of materiality and its impact on scoping and reporting to those responsible for governance. In the case of An Post, we believe that this would be the Audit and Security Committee.
- 13.18 Finally, our review of best practice indicates the regulatory accounts should be supported by commentary and explanations of significant issues and events in the year. Nearly all the companies whose full regulatory accounts we reviewed provided some commentary, which typically included an overview of financial and operational performance in the year. Although the exact content and format varied between companies, the following areas were generally covered: details of significant events in the period, explanation of major movements year on year and

⁸³ International Standards on Auditing (“ISA”); Audit Practices Board.

⁸⁴ Statement on Auditing Standards (“SAS”); Audit Practices Board.

commentary on key trends. A number of companies also discussed future issues and strategic plans, commenting on how these might affect the business.

Publication of regulatory accounts

- 13.19 The European Postal Directive does not require the regulatory accounts of the USP to be published. The WIK report states, “*nonetheless, such information could enable users and citizens to evaluate better the efficiency of the different services (both relative to one another and to the services of other USPs) and the potential for unfair discrimination. By comparing such information year to year, users and citizens will be able to assess improvements and changes in the universal service over time. This information may also help users and citizens evaluate the performance of the NRA, both absolutely and relative to other NRAs*”.
- 13.20 Even though not required to do so, six NRAs confirmed that they published a summary of the regulatory accounts. The CERP survey showed that 14 European operators made their regulatory accounts available to the public. Another operator published its regulatory accounting principles.
- 13.21 We reviewed the regulatory practices of 40 companies in the UK and for eircom in Ireland. Tables of our results are shown in Appendix 4. We found that most (38 companies) publish regulatory accounting information. We understand that some companies, including An Post, have concerns about the commercial sensitivity of publishing regulatory information. Some organisations, such as Royal Mail and National Grid in the UK, address this by publishing only summary level information, the content of which is agreed in advance with the regulator. On a confidential basis, they then provide more information to the regulator. The CERP survey showed that in Europe, five USPs provide additional confidential information to the regulator.

Audit of the regulatory accounts

- 13.22 Article 14(5) of the Postal Directive states “*National regulatory authorities shall ensure that compliance with one of the cost accounting systems described in paragraphs 3 or 4 is verified by a competent body which is independent of the universal service provider. Member States shall ensure that a statement concerning compliance is published periodically.*”

- 13.23 Our review of regulatory accounts and regulatory reporting requirements suggests that the most usual interpretation of terms such as “a *competent body which is independent of the universal service provider*” would be an independent auditor, and that the most usual interpretation of “verified” would be some form of audit.
- 13.24 Our analysis indicates that where an audit of the regulatory accounts is commissioned, best practice would be to include the auditors report within the actual regulatory accounts themselves. This was the case for most of the companies in our benchmarking exercise.
- 13.25 General practice is for the regulatory accounts to be audited annually. In addition, many regulated entities have commissioned periodic independent reviews and/or audits of their cost allocation systems.

Scope of the audit

- 13.26 CTcon concluded that to prevent conflicts during the regulatory process and to ensure an efficient approval of the cost accounting system there should be minimum requirements concerning the review of the regulatory process as well. Based on its interviews and workshop results, CTcon recommended that to comply with Article 14(5) of the EC Postal Directive, the independent body should approve: (i) the separation of cost activities between postal services and the regulatory areas; (ii) the cost accounting principles set out in Article 14(3) of the EC Postal Directive; (iii) the reconciliation of cost accounts to the financial accounts⁸⁵; and (iv) the use of appropriate and consistently applied cost drivers.

Auditor appointment and skills

- 13.27 Despite the fact that the NRAs are independent by their constitution, CTcon recommends the accounting principles should be checked by an expert (e.g. an auditor or a consultant) and approved by the regulator. CTcon observed that several universal service providers would have much more confidence in allowing access to their systems and accounts by an independent expert rather than by the regulator.

⁸⁵ Costs are derived from the expenditures of the company, which are defined by external accounting laws, rules or standards. According to Article 15, the financial accounts should be checked. International standard accounting principles, such as IAS (International Accounting Standards) are not applicable for cost accounting because they do not specify how costs should be allocated to services, which is the most important aspect of cost accounting in the context of postal services.

- 13.28 The CERP survey shows that 19 universal service providers have appointed an independent auditor to verify compliance and in three cases, the audit is performed by the regulator directly. Our independent benchmarking exercise of UK regulatory companies shows that regulatory audits are performed by independent auditors.
- 13.29 The WIK report provides an analysis of who is responsible for the appointment of an independent auditor. Of the 22 countries in which an independent body reviews the universal service providers' accounts, in seven the universal service provider appointed the auditor, in six the regulator appointed the auditor and in six the audit was performed by the regulator itself. In the remaining two countries, the universal service provider performed its own review in one and an unspecified arrangement was used in the other. In the instances where the universal service provider appointed the auditor, it is not clear whether the regulator was involved or consulted.
- 13.30 In the time available to complete our work, we have been unable to verify the auditor appointment process for all of the companies in our benchmark review. We note, however, that in the large majority of the companies in our sample, the same auditors undertake the audit of the financial statements and the regulatory accounts. In these cases, a reasonable conclusion might be that the auditor was appointed by the regulated entity.
- 13.31 In several cases, the regulator has been involved in agreeing the audit scope. The regulator may also have been party to the terms of engagement. We infer this from the auditor's report, which is addressed to the regulator as well as to the regulated entity. It would be normal for auditors to address the report to those it has been engaged by to perform work.
- 13.32 ICAEW guidance provides some detail on how to agree auditor terms of reference. The guidance discusses the question of whether the auditor has a duty of care towards the regulator when they provide their report on the regulatory accounts. Technical Release Audit 1/01 states "*When accountants know that their report has been requested by a third party and that third party will rely on the report, there is a risk, in the absence of an effective disclaimer, that the accountants owe the third party a duty to take reasonable care in the preparing and providing the report. If the accountants do owe the third party such a duty,*

they could be liable to that third party if they were negligent and the third party suffered loss in reliance on the report.” The auditor may seek to address this liability by making the regulator a party to the terms of engagement, and defining the extent of its liability in the contractual documentation.

- 13.33 Discussions with auditors engaged in the audit of regulated entities indicate that the emerging best practice is for auditors to enter into formal engagement contracts with both the regulator and the regulated entity. This increases clarity in terms of the scope of the auditors work; their terms of reference; the form of report; and the extent of their liability. ICAEW guidance provides different options for effecting such multi-party arrangements.
- 13.34 Our review revealed an interesting case in the Netherlands where OPTA appoints an independent auditor to verify TNT’s compliance⁸⁶ with the Postal Directive and the Postal Decree in Netherlands. As stated in TNT’s document entitled “Allocation system for costs and revenues relating to mandatory services”, this audit approach gives assurance, on an annual basis, that
- *“the system approved by OPTA for allocating costs and revenues relating to the provision of the mandatory services has been properly applied by TPG over the previous year”;*
 - *“TPG has accurately and completely included the costs and revenues relating to the mandatory services in the financial accounts for the year under review”;* and
 - *“TPG has properly included the separate financial accounts for the year under review drawn up in this manner, in TPG’s financial statements, with information on the return earned and financial results achieved from the conveyance of mail, to be distinguished into the separate categories of activities, as this is included in the annual statement of the turnover and expenses, on the basis of which the net result of those activities can be determined.”*
- 13.35 During this examination, the auditor carries out activities, beyond the measures TNT has taken, such that he may obtain reasonable assurance that the financial

⁸⁶ TNT was formerly known as TPG.

information supplied by TNT gives a true and fair view of the financial position of the company.

13.36 In addition, OPTA can appoint a second auditor to perform a quality assurance or peer review of the audit activities of the first auditor. The commissioning of such a review by a second auditor can be seen as good practice, especially if the primary auditor has a close relationship with the universal service provider.

13.37 One of the postal companies that we met during our work raised the issue of the appropriate skill set required by the auditor to perform an effective audit of the scope as envisaged by CTcon. Their view was that a combination of skills was required including an understanding of regulatory economics and cost accounting systems, audit skills and postal industry experience.

Form of audit opinion

13.38 Best practice in this area can be derived from the ICAEW Guidance, Auditing Standards and our benchmarking of regulatory accounts. Statement of Auditing Standard 600 (Auditors Reports on Financial Statements) states, “*much of the guidance provided can be adapted to auditors’ reports on financial information other than financial statements*”.⁸⁷

13.39 Regulatory accounts are not prepared in accordance with the Companies Act and not necessarily in accordance with GAAP. Nevertheless, the guidance contained in SAS 600 can be applied equally to opinions expressed by independent accountants on regulatory accounts.

13.40 The ICAEW guidance paper states that “*Regulatory Accounts are analogous to financial statements prepared under the Companies Act, but are usually prepared under some variation of, or other basis to, UK GAAP⁸⁸ and therefore a ‘fairly presents in accordance with’ opinion is more appropriate in the circumstances of Regulatory Accounts. Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.*”

⁸⁷ SAS 600, paragraph 1.

⁸⁸ Except as specified by the Regulatory Accounting Guidelines.

- 13.41 The results of our review of regulatory accounts show that the form of the opinion in every full set of regulatory accounts was a 'fairly presents and properly prepared in accordance with ...' opinion. The opinion would then refer to the basis of preparation set out in the relevant regulatory accounting guidelines, Accounting Manual or other relevant documentation.

14 Regulatory accounts and audit recommendations

Introduction

- 14.1 This section sets out our recommendations and suggested revisions to the Direction in relation to the reporting of regulatory information (including the regulatory accounts in particular) and to the audit requirements. Our recommendations are drawn from our analysis of best practice, our own experience and our observations of regulatory and other precedent.

Basis of preparation

- 14.2 Regulatory precedent shows that the basis of preparation of the regulatory accounts is driven by the information requirements of the regulator. Although GAAP is a useful starting basis, the regulatory accounts of An Post should be prepared so that they reflect the actual costs and revenues relating only to the provision of services in the relevant regulatory period, as required by ComReg. This basis of preparation is appropriate as it will provide ComReg with the information it has identified as being necessary to fulfil its legal obligations.
- 14.3 The regulatory accounts should be reconciled to the statutory financial statements. Each reconciling item should be properly explained.
- 14.4 Since the basis of preparation may not be consistent with GAAP, the accounting convention and key accounting policies used as the basis of preparation should be clearly described in the regulatory accounts and agreed in advance with ComReg.
- 14.5 We believe that the information disclosed on the basis of preparation should include, *inter alia*, details such as the income recognition policy, depreciation policy, capitalisation policy, and the approach to dealing with issues such as prior year adjustments and changes in accounting policy. This list is not exhaustive and would need to be developed by An Post in agreement with ComReg and the auditors of the regulatory accounts.
- 14.6 The basis of preparation should also be included in the Accounting Manual at a more detailed level than is contained within the regulatory accounts (i.e. a summary of all accounting policies, not just the key accounting policies). The increased disclosure will improve the transparency of the accounts. This is

particularly important if the regulatory accounts are published but the Accounting Manual is not.

- 14.7 Best practice relating to the restatement of prior year's accounts follows GAAP and this approach should be followed in the preparation of An Post's regulatory accounts.

Content and format of regulatory accounts

- 14.8 The Direction should be enhanced to provide more clarity about the format and content of the regulatory accounts. A number of options are available. The Direction could be amended to: (i) include a description of the format and contents for the accounts; (ii) provide specific formats, by way of schedules; and/or (iii) require the format for each year's regulatory accounts be agreed between ComReg and An Post, in advance, by a certain date.
- 14.9 To avoid any misinterpretation regarding the format and content required, and to ensure that ComReg receives the information required to fulfil its legal obligations, we recommend that the Direction is amended to require An Post to use specific formats, as set out in schedules prescribed by ComReg. These schedules should take into account best practice, as seen in other regulated entities, and should be proportionate.
- 14.10 We believe that ComReg can specify a set of schedules by one of two approaches. ComReg could seek to agree a set of schedules through the Public Consultation process. This would require ComReg to disclose the information and format it requires. An Post, and other interested third parties, would then be invited to comment on the proposed schedules. Alternatively, ComReg could derive the schedules in consultation with An Post (involving other experts as appropriate). This option might allow a more detailed exchange of views. However, it might be more difficult to gain agreement and the process could take longer. Once the process is complete, ComReg can issue a revised Direction to An Post requiring the use of the agreed schedules.
- 14.11 For subsequent years, the regulatory accounts should be produced in the same format as those for the first year under the revised Direction, except where changes have been agreed in advance between An Post and ComReg. We understand that Royal Mail, for example, agrees changes to the format of the

regulatory accounts with Postcomm by the end of September 2006 for the year ending 31 March 2007. Royal Mail indicated that a notable by-product from the collaborative approach is that it encourages an earlier and more pro-active discussion of potential issues with Postcomm.

- 14.12 The approach we have recommended for subsequent periods allows for increased flexibility for both the company and the regulator. It will allow future regulatory accounts to be more responsive to changes, for example: changes to An Post's systems and processes; changes in the postal industry and changes in the information needs (increased or decreased) of the regulator. The proposed approach will also afford An Post the ability to secure dispensation from requirements to report certain items (e.g. Balance sheet and cash flow information in the case of Royal Mail) by having regard to materiality and relevance of the information.
- 14.13 The principles of IAS 14 referred to in the Direction are still relevant to the production of An Post's regulatory accounts, but perhaps the full extent of its disclosure requirements may not be. For example, the provision of balance sheets by each service might be disproportionate and may not actually be required by ComReg or other potential users of the regulatory accounts. The proposed approach to agreeing the format of the regulatory accounts would ensure the appropriate level of compliance with IAS 14 (i.e. either full disclosure or agreed part disclosure). This approach would also address the issue of what disaggregated data should be provided (i.e. any agreed pro-forma(s) could show for which parts of An Post's business information is required).
- 14.14 ComReg appears to issue a large number of ad hoc information requests to An Post each year for information that it needs to perform its regulatory obligations. By agreeing the level of detail to be provided, it is hoped that this regulatory burden would be reduced.

Transparency of the regulatory reporting

- 14.15 The Direction should be revised to require An Post to provide commentary and narrative explanations within the regulatory accounts. This is in line with best practice and in many cases mandated by the relevant accounting standards. As part of the process of agreeing the format, the parties should agree a common

understanding of materiality, which would help to guide the appropriate level of disclosure.

14.16 In terms of general disclosure, we would expect the minimum level of commentary to cover:

- trends relating to revenues, products and volumes, future events and how these might impact the regulatory accounts;
- significant movements in the accounts year on year;
- one-off or exceptional events in the year;
- large adjustments to produce the accounts (e.g. consolidation adjustments); and
- changes in accounting policies, methodologies and estimation techniques.

14.17 Best practice indicates that An Post should make its regulatory accounts and Accounting Manual publicly available unless the information is commercially sensitive. This exception is when there is an overriding, public interest, reason for not publishing the information. The onus would be on the company to demonstrate to the regulator why the information is “commercially sensitive”.

14.18 Consistent with best practice, our recommendation would be to require An Post to publish its full regulatory accounts and the Accounting Manual. We understand that ComReg may not have the power to enforce such an obligation on An Post. If this is the case, we recommend that the revised Direction should strongly encourage An Post to follow best practice and to publish the regulatory accounts.

Audit recommendations

14.19 We believe that commissioning an independent audit of the regulatory accounts would provide significant benefits to An Post, ComReg and the general public.

14.20 ComReg uses information generated by An Post’s regulatory accounting system and processes but gains little comfort from the current review arrangements. One of the benefits of audited regulatory accounts is to provide additional comfort with respect to the robustness of the regulatory information and the systems and processes used to derive the regulatory accounts.

- 14.21 The auditor's opinion on the regulatory audit and the statement to confirm An Post's compliance with the Direction should be included with the published regulatory accounts rather than in An Post's Annual Report.
- 14.22 If only summarised regulatory accounts are published (rather than the full regulatory accounts), then this summary information should have an auditor certification confirming that the information has been properly extracted from the full regulatory accounts and should also confirm the nature of the opinion issued upon those regulatory accounts. Such an approach is adopted by National Grid in the UK (i.e. in relation to the regulatory accounts for the electricity transmission business). In that case the summary is publicly available but the full accounts are private to Ofgem. The form of the audit opinion provided in this instance has been included in Appendix 5.

Appointment of auditor and scope of audit

- 14.23 A number of options are available with respect to how the auditor is appointed. Such options include revising the Direction to allow the regulator to appoint an independent auditor. We found that in the majority of cases, the universal service provider has primary responsibility for the appointment of the auditor.
- 14.24 In most cases, the universal service provider typically appoints the same auditor as the one performing the audit of the statutory financial statements. This tends to be the most cost effective approach (i.e. there are economies of scope given the overlap between financial statements and regulatory statements).
- 14.25 Although the statutory auditor needs to have a good understanding of the Company and of the postal industry, performance of the regulatory audit may require different and additional skills, such as a detailed understanding of the Regulations and Direction, economic, regulatory and cost allocation expertise. These skills should be assessed as part of the appointment process.
- 14.26 It remains important for ComReg to be consulted in the appointment/re-appointment of the auditor of the regulatory accounts. The consultation with ComReg, before the appointment/reappointment of the regulatory auditor, should allow ComReg the ability to review and understand the auditor's skills and capability to perform the audit as well as to gain assurance over the auditor's independence. In addition, ComReg should agree to the terms of reference for

the auditor, including the scope of their work. The auditor should address its opinion to both the Company and to the Regulator.

14.27 This may require the auditor to enter into a tri-partite engagement contract with both An Post and ComReg, or into separate bi-partite engagement contracts with An Post and ComReg.

14.28 Where the auditor is appointed by An Post, ComReg may wish to appoint a second auditor to perform a quality review of the work performed by the first auditor. This process could be performed periodically rather than annually. ComReg may wish to explore this option further during the consultation process.

Form of audit opinion

14.29 Best practice and guidance from the ICAEW suggests that the most appropriate form of opinion for the regulatory audit is one that states 'presents fairly and properly prepared in accordance with the Accounting Direction and the basis of preparation as set out'.

14.30 The exact nature of the wording should be guided by consultation with An Post's auditor, the Accountancy profession and international best practice. In Appendix 6, we have reproduced a specimen example of an unqualified audit report, which is included in the ICAEW guidance paper as an example that can be used to inform the consultation process.

14.31 As discussed in Section 14.22 a different form of opinion should be used where a summarised version of the regulatory accounts is produced.

Appendices

Appendix 1: ComReg terms of reference

This appendix provides the original terms of reference from ComReg's invitation to tender. We have not altered the text from the invitation. We note that our actual scope of work had to be adjusted, in agreement with ComReg, due to timescales, the period in which we were performing the review and limited access to information. We have not been asked to audit An Post's methodologies. Our actual scope of work, and our approach, is set out in Sections 2 and 3.

Specific requirements

As part of the development of a revised Accounting Direction, ComReg requires the successful tenderer follow a three-staged approach. This will involve a thorough review and documentation of the methodologies applied by An Post, together with an assessment and recommendation of alternative options.

ComReg expects that all work undertaken in the review of An Post's processes and procedures to be adequately documented in order to ensure continuity and consistency for future reviews.

Review and assessment of the existing Accounting Direction and the processes and procedures applied by An Post

The successful tenderer will be tasked with the responsibility to review the processes and procedures applied by An Post with regard to revenue identification, cost allocation/apportionment and volume measurement, and to assess compliance with the existing Accounting Direction.

Identification/allocation of service revenues

A review of the processes and procedures applied by An Post in the identification of revenues for each postal service/product should be conducted, in particular:

- an examination of the procedures used to allocate/apportion revenues to specific services arising from the sale of postage stamps, EPOS postage labels and credits to franking machines.
- an assessment of the statistical sampling techniques applied in circumstances where revenues cannot be directly allocated to each postal service/product.

- a review and assessment of An Post's compliance with the requirements of the existing Accounting Direction; identifying issues that need further attention and revision following developments in the postal industry, legislative change etc.

Cost allocation/apportionment

A review of the processes and procedures applied by An Post to allocate and apportion its costs including:

- an analysis, review and assessment of the processes employed by An Post to apportion its public postal network (common) costs between the Reserved, USO Non-Reserved and Non-USO business segments; and
- identification of costs that can be allocated directly to specific services and products.

Measurement of mail volumes

A review of the processes and procedures applied by An Post to measure mail volumes for individual products/services and handling processes, with particular reference to:

- preparation of regulatory accounts;
- operational control;
- revenue protection; and
- "Real Mail Studies" as required by European and Irish Standards.

In addition, a reconciliation between volume and revenue should be undertaken.

Review of most recent Regulatory Accounts

Regulatory accounts (i.e. detailed and published summary) provide financial information about the regulated businesses of An Post for use by ComReg, consumers, postal operators and other stakeholders. Regulated accounts provide information that is more focused and detailed than that contained in the published financial accounts and therefore assist ComReg in fulfilling its statutory obligations specifically with regard to tariff principles, terminal dues principles and USO obligations.

The existing Accounting Direction sets out principles regarding the format, content and level of detail of An Post's regulated accounts and frequency of preparation.

The successful tenderer will be required to assess whether this is sufficient to enable ComReg fulfil its legal obligations efficiently and effectively, and assess the extent of compliance by An Post.

Assessment of alternative processes and procedures taking into account international best practice

Identification/allocation of service revenues

With the objective of maximising the proportion of revenues and costs that can be directly identified at the service level, the successful bidder should, if appropriate devise alternative allocation and apportionment rules, having regard to:

- the need to determine accurate service profitability, identify potential cross-subsidies and increase overall transparency;
- the need for consistency of approach for both revenues and costs and so prevent any under/over statement of profits between different postal products / services and classes of services;
- reducing the size of the pool of revenues that has to be apportioned and so increase the accuracy of the separated accounts of An Post as universal service provider (USP);
- the need to reconcile revenues with the value of stamps printed and destroyed, and with volumes handled in the public postal network;
- the legal obligations of An Post together with ComReg's responsibilities to monitor such compliance;
- processes and procedures employed by other postal operators and Universal Service Providers (USP's) to identify service revenues;
- recent technological developments employed by other postal operators to increase the proportion of revenues that can be directly allocated to the service employed e.g. use of EPOS postage labels, production of postage stamps for specific services, meter machines with data capture capability etc; and

- the implications of the further liberalisation of the market in January 2006, in particular for the allocation of standard format letter revenues between Reserved and Non-Reserved Sectors.

Cost allocation/apportionment

In considering alternative cost allocation and apportionment rules, the successful tenderer must have regard to the principles of Cost Causation, Consistency, Materiality and Transparency. The successful tenderer must also establish clear, concise and prescriptive rules for cost allocation and apportionment which:

- identify and analyse costs by category i.e. attributable, sunk and common costs;
- maximise the proportion of costs that can be directly allocated to specific services and products and so reduce the need for apportionment;
- prevent arbitrary cost apportionment by ensuring costs are apportioned on an appropriate and relevant basis (i.e. should be a driver of the associated cost); and
- require the USP to continue to provide an Accounting Manual to ComReg (for its review and approval) on an annual basis detailing its cost allocation/apportionment methodology. In devising such rules, it is also expected that the consultant will observe industry best practice.

Measurement of mail volumes

The accurate measurement of mail volumes, and reconciliation of these figures with revenue, is an essential prerequisite for the production of separated and cost accounts which identify unit costs and business trends for each specific product / service. It is also an important input into the accurate apportionment of the costs of the various components of the public postal network that cannot be allocated to a specific product / service.

The successful tenderer will be required to recommend a suitable approach that should be applied by An Post in establishing volume data and reconciling same with revenue so as to maximise the accuracy of An Post's product costing.

Regulatory accounts format

The successful tender will be required to make recommendations with regard to the format, frequency of production, audit and publication of the regulatory

accounts. In making the recommendations the following points should be considered:

- the need to devise schedules so as to eliminate any ambiguity with regard to content, format and level of detail of the regulated accounts;
- the need for further analysis of service results by payment type for each format type (Reserved and Non-Reserved);
- the format that should be adopted when An Post publishes a summary of regulated accounts; method, content, timing and circumstances necessitating publication;
- the need for restatement of prior year regulated accounts when necessary to ensure comparability; and
- the need for transparency and non discrimination in relation to special tariffs and associated conditions.

Auditors statement of compliance

As regulator, ComReg requires a high level of assurance as to the reliability and accuracy of An Post's regulatory accounts. In response to a recent public consultation initiated by ComReg specific issues were raised regarding the scope of the auditor's statement of compliance published in An Post's annual report.

The successful tenderer will therefore be required to make recommendations on the scope of the auditor's letter of engagement, the issues to be addressed in the auditor's statement of compliance, and any other measures necessary to ensure transparency.

Development of draft Accounting Direction

The successful tenderer will be responsible for the development of a set of instructions, which are consistent with ComReg's legal powers. In devising such instructions, the successful contractor should review the requirements of the current Accounting Direction and identify areas where further clarification is required. The instructions should outline the recommended approach that should be applied by An Post for revenue and cost allocation and volume measurement.

Appendix 2: 2001 Accounting Direction

Direction on the accounting systems of An Post

The Director of Telecommunications Regulation (hereafter “the Director”) in pursuance of Regulation 12(2) of the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000), and having taken into account the views of interested parties following a public consultation, hereby gives the following direction:

Interpretation

In this Direction, except where the context otherwise requires:

“IAS14” means International Accounting Standard No 14 “Segment Reporting” published by the International Accounting Standards Committee.

“ODTR” means the Office of the Director of Telecommunications Regulation

“Service” means any service provided by An Post which involves the use of the public postal network as defined in the Regulations and

- (a) is identified as a separate service in the Schemes or price lists published by An Post, or is provided under a contract or standard agreement with individual customers and
- (b) operationally handles all items in the service in the same way;

If the service falls partly into the Reserved Sector and partly into the Non-Reserved Sector it shall be accounted for as if it were two separate services.

“Tariff Principles” means the principles set out in Regulation 10 of the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000).

“Terminal Dues Principles” means the principles set out in Regulation 11 of the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000).

“The 1983 Act” means the Postal and Telecommunications Services Act, 1983 (No, 24 of 1983).

“The 1996 Act” means the Telecommunications (Miscellaneous Provisions) Act, 1996 (no. 34 of 1996).

“The Regulations” means the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000).

“Universal Service Obligation” means the obligations and principles set out in Regulation 6 of the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000).

“Universal service provider” means An Post or any other legal person designated by the Minister for Public Enterprise under Regulation 6(3)(b) of the European Communities (Postal Services) Regulations 2000 (S.I. No. 310 of 2000).

Fundamental requirements

The financial records and accounting systems to be kept by any designated universal service provider should be sufficiently detailed to ensure that:

- (a) all decisions are supported by sufficient data to enable management to ensure that they comply with the Tariff Principles, Terminal Dues Principles and Universal Service Obligation;
- (b) the Director can monitor compliance with these principles;
- (c) separate accounts can be maintained for each of the services within the reserved sector on the one hand and each of the services within the nonreserved sector on the other;
- (d) any request for information by the Director in accordance with Regulation 12(7) or 18(2) can be met; and
- (e) any request for information by the European Commission in accordance with Regulation 12(7) can be responded to promptly.

The financial records and accounting information should also be maintained in sufficient detail to facilitate a detailed analysis, on a geographic or category of customer basis, for the purpose of calculating the cost of complying with the Universal Service Obligation and ensuring that tariffs are transparent and non-discriminatory.

Reason:

To enable An Post comply with its obligations under the 1983 Act and the Regulations and to enable the Director to exercise her functions under the 1983 Act, the 1996 Act, the Regulations or any other relevant legislation.

Reporting and transparency

In accordance with Regulation 12(7) and 18(2) the following separated accounts, disaggregated to the level of services, should be provided to the ODTR in confidence, within 19 weeks of the end of each financial year:

- (a) Profit and loss accounts and balance sheets for each business segment of An Post as defined in IAS14. The relevant accounts should distinguish between services wholly or partly in the Reserved Area and those outside. These accounts to show data for the last complete Financial Year and the previous Financial Year and to be fully reconciled to the published financial accounts of the Company.
- (b) A profit and loss account for each letter and parcel service. These to be fully reconciled to the profit and loss accounts at 1 above.
- (c) An annual report based on the above estimating the cost of complying with the Universal Service Obligations.

A detailed report must also be prepared annually in connection with item (b) above, or whenever prices are changed (or whenever An Post applies for permission to increase prices within the reserved area), comparing the existing and/or proposed price with a detailed estimate of the costs of providing the service.

In addition, such Ad hoc reports shall be prepared as may be required by the ODTR from time to time.

Reason:

To enable the Director to exercise her functions under the 1983 Act, the 1996 Act, the Regulations or any other relevant legislation.

Management Accounting manual

Each universal service provider must:

- (a) document the procedures and policies being used in the preparation of its management accounts,
- (b) review the Accounting Manual annually, and
- (c) obtain the Director's approval for each annual edition of the Accounting Manual.

The Accounting Manual should contain a schedule showing how each individual revenue and cost category is treated. The Accounting Manual should therefore specify in technical detail the range and scope of the data to be collected and the basis on which it is to be allocated/apportioned between services.

This should be guided by the following principles:

i.) Business Segments & Inter-Company / Inter-Segment transactions

Revenue and Costs should initially be directly assigned to business segments in accordance with the principles set out in IAS14. Fixed Assets (Buildings, Vehicles, Sorting Equipment, etc) should be shown in the Balance Sheet of the “Prime User”, with use by other business segments charged for on an arm’s length basis.

Inter-Company and similar Transactions between a designated Universal service provider and its subsidiaries or associated companies must take full cognisance of the Tariff, Terminal Dues and Universal Service Obligation principles. Business segments, as defined by IAS14, should be regarded as “subsidiaries” for this purpose. In this regard payments / charges should be calculated on an arm’s length basis, and in a transparent and non-discriminatory manner, with the proviso that this transfer “charge” should be the same as the price the universal service provider would charge to any competitor who wished to use their network or pay to any external supplier.

ii.) Revenue Determination and Cost Allocation and Apportionment Principles

Within the business segments, as defined by IAS14, revenue and costs should be allocated to each of the reserved and to the non-reserved services respectively in the following manner:

- (a) revenue and costs which can be directly assigned to a particular service shall be so assigned;
- (b) Postage stamps sold and franking machine credits, which cannot be directly assigned to their use for specific services or retention by users for later use shall be apportioned to services on the basis of statistical sampling accurate to +/- 1% at the 95% Confidence Level.
- (c) common costs, that is costs that cannot be directly assigned to a particular service, shall be allocated as follows:

- (i) whenever possible, common costs shall be allocated on the basis of direct analysis of the origin of the costs themselves;
- (ii) when direct analysis is not possible, common cost categories shall be allocated on the basis of an indirect linkage to another cost category or group of cost categories for which a direct assignment or allocation is possible; the indirect linkage shall be based on comparable cost structures;
- (iii) when neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of all expenses directly or indirectly assigned or allocated, on the one hand, to each of the reserved services and, on the other hand, to the other services.

A list of the services (as defined in this Direction) provided by An Post shall be included in the Accounting Manual and may be published by the Director.

iii.) Cost Allocation and Apportionment Rules

The Accounting Manual should set out how the operating cost of the various aspects of the public postal network, as defined in the regulations, should be identified.

It should also set out the basis on which the costs of particular activities are to be apportioned between services. Costs should be apportioned between the various services that use each aspect of the network on the basis of volumes, “weighted” by factors which reflect the different impact of each item on the cost of the activity. The weighting factors should be specific to each operational process, as will be the range of services that use that process.

As a minimum, the hierarchy of costs to be applied to each service should enable the cost of the following activities to be calculated:

- (a) Revenue Collection
- (b) Collection
- (c) Outbound sorting
- (d) Transport
- (e) Inbound sorting

(f) Preparation and Delivery

The hierarchy of accounts should also distinguish between categories of costs (e.g. pay and non-pay expenditure). Accounting items not involving the movement of funds [e.g. depreciation] should also be separately identified.

Reason:

To enable the Director to exercise her functions under the 1983 Act, the 1996 Act, the Regulations or any other relevant legislation, and to enable the Director to comply with Regulation 12(6).

Audit of Accounts and Confirmation of Compliance

Each universal service provider should:

- (a) engage auditors to verify compliance with the Direction, and
- (b) publish an auditor's statement of compliance in its annual report.

Each universal service provider should consult with the Director before appointing auditors for this purpose.

Reason:

To enable the Director to exercise her functions under the 1983 Act, the 1996 Act, the Regulations or any other relevant legislation, and to enable each universal service provider to comply with Regulation 12(5).

Timetable

The above Direction will apply to accounting periods beginning on or after 1 January 2002. It is necessary for the Accounting Manual to be available as near to the start of the accounting year as possible. An Post are therefore required to submit for approval by the Director, no later than 1 December 2001, their timed programme for compliance with this Direction, including preparation of the Accounting Manual. In the same document An Post should indicate the extent to which they can comply with the Direction for accounting periods commencing on or after 1 January 2000 and ending on or before 31 December 2001, and the reasons why they cannot comply with any specific item.

Appendix 3: Mail volume and revenue benchmarking questionnaire

The following questions were sent to international postal operators and regulators.

1. How does the USP calculate the mail volumes data submitted to the regulator: via an operational method (i.e. a machine or hand count, or weighing), a revenue equated method, a sampling approach or a mixture of all three? Do you have a view on the best methodology? What is your view of best practice in this area?
2. What information does the regulator request from the USP with respect to volume and revenue?
 - Are these figures separated by:
 - Reserved/non-reserved services?
 - Universal Service/Non-Universal Service?
 - Individual service?
 - Format/ weight breaks?
 - Are the revenue figures separated/allocated to these different service groups directly, using an electronic accounting system, by using volumes, or by using some other driver?
 - Is the USP compelled to submit such figures by a postal law, regulation, licence condition or by agreement with the regulator?
 - Are these figures independently verified, or investigated by the regulator?
 - Do these volume figures reconcile with the total annual volume figures published by the USP?
 - Does the regulator ask for explanations of the trends in the volume and revenue figures between years?
 - If 'sampling' is used, does the USP independently verify its sampling process? Does the USP conduct the sample survey according to European Standards (such as CEN 13850 - quality of service sampling standards)?

- Does the USP conduct Revenue Protection on Universal Service Mail and Bulk Mail? If so, what does this entail?
- Does the regulator have the power to reject volume and/or revenue figures collected from the USP? Have these powers ever been used?

Appendix 4: Summary of regulatory accounts review

The first table below provides the results of our regulatory accounts review and provides information on the company, the industry, the regulator, whether full or summary regulated accounts are provided to the regulator, the latest accounts that are available and whether they are subject to independent audit.

Company	Industry	Regulator	Latest year available	Subject to independent audit	Published regulatory accounts
Central Networks East plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
Central Networks West plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
EDF Energy Networks Plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
Northern Electric Distribution Limited	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
Scottish Hydro-Electric Power Distribution Limited	Electricity distribution	Ofgem	31/03/2006	Y	Full accounts
Southern Electric Power Distribution plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
SP Distribution Limited	Electricity distribution	Ofgem	31/03/2006	Y	Full accounts
SP Manweb plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
United Utilities Electricity PLC	Electricity distribution	Ofgem	31/03/2006	Y	Full accounts
Western Power Distribution (South West) plc	Electricity distribution	Ofgem	31/03/2006	Y	Full accounts
Yorkshire Electricity Distribution Plc	Electricity distribution	Ofgem	31/03/2005	Y	Full accounts
National Grid Company plc	Electricity transmission	Ofgem	31/03/2005	Y	Summary accounts (additional confidential info to regulator)
Transco plc	Gas transportation	Ofgem	31/03/2005	Y	Full accounts
Royal Mail Group plc	Post	Postcomm	27/03/2005	Y	Summary accounts (additional confidential info to regulator))
BT	Telecom	Oftcom	31/03/2005	Y	Full accounts

eircom	Telecom	ComReg	31/03/2006	Y	Full accounts
Albion Water Ltd	Water	OFWAT			Not available
Anglian Water Services Ltd	Water	OFWAT	31/03/2006	Y	Full accounts
Bournemouth and West Hampshire Water	Water	OFWAT	31/03/2006	Y	Full accounts
Bristol Water plc	Water	OFWAT	31/03/2006	Y	Full accounts
Cambridge Water plc	Water	OFWAT	31/03/2006	Y	Full accounts
Cholderton and District Water	Water	OFWAT			Not available
Dee Valley Water plc	Water	OFWAT	31/03/2006	Y	Full accounts
Dwr Cymru Cyfyngedig	Water	OFWAT	31/03/2006	Y	Full accounts
Folkestone & Dover Water Services Limited	Water	OFWAT	31/03/2006	Y	Full accounts
Mid Kent Water Company	Water	OFWAT	31/03/2006	Y	Full accounts
Northumbrian Water Limited	Water	OFWAT	31/03/2006	Y	Full accounts
Portsmouth Water Ltd	Water	OFWAT	31/03/2005	Y	Full accounts
Scottish Water	Water	WICS	31/03/2006	N/A	Overview of financial and operational performance
Severn Trent Water Ltd	Water	OFWAT	31/03/2006	Y	Full accounts
South East Water plc	Water	OFWAT	31/03/2006	Y	Full accounts
South Staffordshire Water plc	Water	OFWAT	31/03/2005	Y	Full accounts
South West Water Ltd	Water	OFWAT	31/03/2006	Y	Full accounts
Southern Water Services Limited	Water	OFWAT	31/03/2006	Y	Full accounts
Sutton and East Surrey Water	Water	OFWAT	31/03/2006	Y	Full accounts
Tendering Hundred Water Services Limited	Water	OFWAT	31/03/2006	Y	Full accounts
Thames Water Utilities Limited	Water	OFWAT	31/03/2006	Y	Full accounts
Three Valleys Water	Water	OFWAT	31/03/2006	Y	Full accounts

plc					
United Utilities Water Plc	Water	OFWAT	31/03/2006	Y	Full accounts
Wessex Water Services Ltd	Water	OFWAT	31/03/2006	Y	Full accounts
Yorkshire Water Services Limited	Water	OFWAT	31/03/2006	Y	Full accounts

The next table summarises the basis of preparation for the accounts and the form of opinion.

Company	Basis of preparation	Form of audit opinion
Central Networks East plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
Central Networks West plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
EDF Energy Networks Plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
Northern Electric Distribution Limited	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
Scottish Hydro-Electric Power Distribution Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Present fairly, properly prepared
Southern Electric Power Distribution plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
SP Distribution Limited	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
SP Manweb plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
United Utilities Electricity PLC	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
Western Power Distribution (South West) plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
Yorkshire Electricity Distribution Plc	Under historical cost convention unless specifically addressed by Regulatory Licence	Present fairly, properly prepared
National Grid Company plc	UK GAAP under historical cost convention and as prescribed in the	The summary Regulatory Accounts... have been properly extracted from the full

	Transmission Licence	Regulatory Accounts
Transco plc	UK GAAP under historical cost convention except on disclosure of operation discontinued post year end	Fairly present, properly prepared
Royal Mail Group plc	UK GAAP. Principles as documented in "An overview of the principles and methodologies used in preparing regulatory financial statements for 2005", developed following consultation with Postcomm	The records are sufficient to comply with the requirements of paragraph 2 of Condition 14 of the Licence. Fairly present
BT	As far as possible, revenues, costs, assets and liabilities are allocated to the items are directly attributed to that item. Current cost accounting	Properly prepared
eircom	Historical costs separated accounts prepared for businesses as defined by Decision Notices	Fairly presents
Albion Water Ltd		
Anglian Water Services Ltd	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Bournemouth and West Hampshire Water	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Bristol Water plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Cambridge Water plc	Under historical and current cost convention unless specifically addressed by Regulatory Licence	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Cholderton and District Water		
Dee Valley Water plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Dwr Cymru Cyfyngedig	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Folkestone & Dover Water Services Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Mid Kent Water Company	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Northumbrian Water	UK GAAP unless issues specifically	Fairly present; properly prepared; proper

Limited	addressed in the Regulatory Accounting Guidelines	accounting records have been kept; information is in agreement with accounting records
Portsmouth Water Ltd	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Scottish Water	No detailed financial information available. Submission prepared in the form of report rather than financial statement	No information available
Severn Trent Water Ltd	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
South East Water plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
South Staffordshire Water plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
South West Water Ltd	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Southern Water Services Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Sutton and East Surrey Water	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Tendering Hundred Water Services Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Thames Water Utilities Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Three Valleys Water plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
United Utilities Water Plc	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
Wessex Water Services Ltd	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records

Yorkshire Water Services Limited	UK GAAP unless issues specifically addressed in the Regulatory Accounting Guidelines	Fairly present; properly prepared; proper accounting records have been kept; information is in agreement with accounting records
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Appendix 5: Example of regulatory accounts audit opinion

Independent Accountants' statement to National Grid Company

We have examined the summary Regulatory Accounts of National Grid Company plc ("the Company") on pages 4 to 11 which comprise the profit and loss account, the statement of total recognised gains and losses, the balance sheet, the cash flow statement and the related notes to the summary Regulatory Accounts.

Our audit report on the full Regulatory Accounts was made, on terms that have been agreed, solely to the Company and the Regulator in order to meet the requirements of the Transmission Licence. Our audit work on the full Regulatory Accounts was undertaken so that we might state to the Company and the Regulator those matters that we agreed to state to them in our report. In order (a) to assist the Company to meet its obligation under the Transmission Licence to procure such a report and (b) to facilitate the carrying out by the Regulator of its regulatory functions, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Regulator, for our audit work, for our audit report on the full Regulatory Accounts, or for the opinions we have formed.

This statement on the summary Regulatory Accounts, including the opinion, has been prepared for, and only for, the Company. To the fullest extent permitted by law, we do not accept or assume responsibility in making this statement to anyone other than the Company for our examination, for our report on the summary Regulatory Accounts, or for the opinions we have formed.

Basis of Preparation

The summary Regulatory Accounts have been extracted from the full Regulatory Accounts for the year ended 31 March 2005. The full Regulatory Accounts were prepared under the historical cost convention and in accordance with Condition B1 of the Company's Transmission Licence and the accounting policies set out in the statement of accounting policies on pages 4 and 5.

The Regulatory Accounts present details only in respect of the Separate Businesses (as defined on page 2) of the Licensee and do not show information in respect of the other business operations of the Licensee.

The Regulatory Accounts are separate from the statutory financial statements of the Company and have not been prepared under the basis of Generally Accepted Accounting Principles in the United Kingdom ("UK GAAP"). Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.

Respective responsibilities of the Regulator, the Directors and Auditors

The nature, form and content of Regulatory Accounts are determined by the Regulator. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the Regulator's purposes. Accordingly we make no such assessment.

The Directors' are responsible for preparing the summary Regulatory Accounts.

The Directors' responsibilities for preparing the Regulatory Accounts in accordance with Condition B1 of the Transmission Licence are set out in the statement of Directors' responsibilities on page 2.

Our responsibility is to report to you our opinion on the consistency of the summary Regulatory Accounts with the full Regulatory Accounts.

Basis of audit opinion

We conducted our audit of the full Regulatory Accounts with regard to Audit 05/03 'Reporting to Regulators of Regulated Entities' issued by the institute of Chartered Accountants in England and Wales and in accordance with Auditing Standards issued by the Auditing Practices Board except that, as the nature, form and content of Regulatory Accounts are determined by the Regulator, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under Auditing Standards.

We conducted our review of the summary Regulatory Accounts with regard to Bulletin 1999/6 'The Auditors' Statement on The Summary Financial Statement' issued by the Auditing Practices Board.

Our review of the summary Regulatory Accounts comprised only of an assessment of whether the summary Regulatory Accounts are consistent with the full Regulatory Accounts and have been properly extracted from the full Regulatory Accounts.

Our opinions of the full Regulatory Accounts and the summary Regulatory Accounts are separate from our opinion on the statutory accounts of the Company on which we reported on 19 May 2005 which are prepared for a different purpose. Our audit report in relation to the statutory accounts of the Company (our "Statutory" audit) was made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our Statutory audit work was undertaken so that we might state to the Company's members those matters we are required to state to them in a Statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the Company and the Company's members as a body, for our Statutory audit work, for our Statutory audit report, or for the opinions we have formed in respect of the Statutory audit.

Opinion

In our opinion the summary Regulatory Accounts set out on pages 4 to 11 are consistent with and have been properly extracted from, the full Regulatory Accounts for the year ended 31 March 2005 on which we issued an unqualified report on 7 December 2005.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Birmingham
7 December 2005

The maintenance and integrity of the National Grid Company plc website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no

responsibility for any changes that may have occurred to the Regulatory Accounts since they were initially presented on the website.

Legislation in the United Kingdom governing the preparation and dissemination of financial statements and Regulatory Accounts may differ from legislation in other jurisdictions.

Appendix 6: ICAEW Appendix B - Unqualified audit report example

The text below would need to be tailored as appropriate for the particular circumstances of each engagement.

Independent Accountants' report to the Director General, [Regulator] ("the Regulator") and ABC Limited⁸⁹

We have audited the Regulatory Accounts of ABC Limited ("the Company") on pages x to x which comprise the profit and loss account, the statement of total recognised gains and losses, the balance sheet, [the cashflow statement] and the related notes to the Regulatory Accounts.

This report is made, on terms that have been agreed⁹⁰, solely to the Company and the Regulator in order to meet [the requirements of the Regulatory Licence⁹¹]. Our audit work has been undertaken so that we might state to the Company and the Regulator those matters that we have agreed to state to them in our report, in order (a) to assist the Company to [meet its obligation under the Regulatory Licence to procure such a report] and (b) to facilitate the carrying out by the Regulator of its regulatory functions, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Regulator, for our audit work, for this report or for the opinions we have formed.

Basis of preparation

The Regulatory Accounts have been prepared under the historical cost convention (as modified by the revaluation of certain fixed assets) and in accordance with conditions [], [] and [] of the Company's Regulatory Licence,

⁸⁹ Any modification to this form of report should be made in accordance with SAS 600 – see Section 3. The report is addressed to the Regulator as well as to the Company without any disclaimer of responsibility to the Regulator only where the Regulator has signed a tri-partite engagement contract or there is a bi-partite engagement contract supplemented by written notice signed by the Regulator. In other cases the report may be addressed to the Company and the Regulator (to meet the requirements of the Regulatory Licence) but includes a disclaimer under which responsibility is accepted to the Company only and co-addressing to the Regulator is expressed to be only to meet the requirements of the Regulatory Licence. Refer to paragraph 13 for further guidance.

⁹⁰ This requires an engagement letter in a satisfactory form to be in place.

⁹¹ Or other reference. If the appropriate reference is to a Regulatory Licence that licence will require to be defined appropriately in the reference or in some other suitable place.

Regulatory Accounting Guidelines [], [] and [] (“the RAGs”) issued by the Regulator and the accounting policies set out in the statement of accounting policies.

The Regulatory Accounts are separate from the statutory financial statements of the Company and have not been prepared under the basis of Generally Accepted Accounting Principles in the United Kingdom (“UK GAAP”). Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.

Respective responsibilities of the Regulator, the Directors and Auditors

The nature, form and content of Regulatory Accounts are determined by the Regulator. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the Regulator’s purposes. Accordingly we make no such assessment.

The directors’ responsibilities for preparing the Regulatory Accounts in accordance with conditions [], [] and [] of the Regulatory Licence are set out in the statement of directors’ responsibilities on page x.

Our responsibility is to audit the Regulatory Accounts in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board, except as stated in the ‘Basis of audit opinion’, below and having regard to the guidance contained in Audit 05/03 ‘Reporting to Regulators of Regulated Entities’.

We report our opinion as to whether the Regulatory Accounts present fairly, in accordance with conditions [], [] and [] of the Company’s Regulatory Licence, the RAGs [], [] and [], and the accounting policies set out on page x, the results and financial position of the company. We also report to you if, in our opinion, the Company has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

[We read the other information contained within the Regulatory Accounts, including any supplementary schedules on which we do not express an audit opinion, and consider the implications for our report if we become aware of any

apparent mis-statements or material inconsistencies with the Regulatory Accounts.]

Basis of audit opinion

We conducted our audit in accordance with Statement of Auditing Standards issued by the Auditing Practices Board except as noted below. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Regulatory Accounts. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Regulatory Accounts, and of whether the accounting policies are consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Regulatory Accounts are free from material mis-statement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of Regulatory Accounts are determined by the Regulator, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under Auditing Standards.

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory accounts of the Company on which we reported on [date], which are prepared for a different purpose. Our audit report in relation to the statutory accounts of the Company (our “Statutory” audit) was made solely to the Company’s members, as a body, in accordance with section 235 of the Companies Act 1985. Our Statutory audit work was undertaken so that we might state to the Company’s members those matters we are required to state to them in a Statutory auditor’s report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the Company and the Company’s members as a body, for our Statutory audit work, for our Statutory audit report, or for the opinions we have formed in respect of that Statutory audit.

Opinion

In our opinion the Regulatory Accounts fairly present in accordance with conditions [], [] and [] of the Company’s Regulatory Licence, Regulatory

Accounting Guidelines [], [] and [], and the accounting policies set out on page x, the state of the Company's affairs at [date] and of its profit (or loss) [and cashflow] for the year then ended, and have been properly prepared in accordance with those conditions, guidelines and accounting policies.

[Name of auditor]

[Chartered Accountants and Registered Auditors]

[Address]

[Date]

1. The maintenance and integrity of the [name of entity] web site is the responsibility of the Directors and the maintenance and integrity of the [name of Regulator] web site is the responsibility of the Regulator; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the Regulatory Accounts since they were initially presented on the web sites.

2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements and Regulatory Accounts may differ from legislation in other jurisdictions.

Appendix 7: Comparison of 2004 and 2005 Accounting Manuals

Relevant base year for review

We have reviewed the 2004 Accounting Manual and regulatory accounts as part of our assessment. We understand that An Post submitted the 2005 Accounting Manual and regulatory accounts part way through our assessment.

ComReg reviewed the Accounting Manual for 2005 and compared it with the Accounting Manual for 2004 (except appendices and net assets sections), and have highlighted the differences between the Manuals, as given below. Similarly, ComReg is currently reviewing the 2005 regulatory accounts. At the time of writing, ComReg had not finished its review of the accounts.

ComReg indicated to us that any differences between the Accounting Manuals, and between the regulatory accounts were not relevant to the areas of our review. On this basis, we agreed with ComReg that we should continue to base our review on the 2004 Accounting Manual and regulatory accounts.

ComReg's comparison of the 2004 and 2005 Accounting Manuals

ComReg indicated the following, as key differences between the 2004 and 2005 Accounting Manuals:

- page 8 removed the reference to page 24 equivalent volume explanation;
- page 9 under the heading of Ceadúnas/Invoiced removed 'international mail';
- inserted new sentence above table 2 on page 10 which reads 'The IFS system captures the format and weight break analysis for ceadúnas';
- inserted new sentence above table 3 on page 11 which reads 'This information is part of our International Mail System (IMS) which is used to exchange data and settle accounts with other postal administrations';
- removed paragraph 2 under Registered (page 12) which reads 'This service is available to stamped.....';
- removed paragraph 2,3 and 4 under general overview on page 16;

- section 3.3.2 b has been amended to read 'All Inbound zone 1 mail is sampled at the DMC, whilst inward core international air mail for zones 2,3 and 4 is sampled at the AMU. All inward surface mail is sampled in Cork and Athlone';
- section c on page 20 has been amended to now read 'Data from the Counter Automation system and the Parcel Mails accounting systems is used to generate the required income/volume allocations for the production of the regulatory accounts';
- paragraph 1 of page 24 has been removed and replaced with 'A detailed review of the work conducted by staff paid in corporate and shared service cost centres is performed annually to ensure that these costs are accurately allocated to product groupings';
- in addition to the three drivers mentioned in 2004, the 2005 manual also includes 'direct allocation'. A separate section follows which states that 'Operational pay costs are allocated to products directly wherever possible';
- last paragraph on page 25, in addition to equivalent volumes, the 2005 manual also refers to direct and other cost driver methods;
- paragraph entitled 'Other drivers' has been amended to read 'In addition the above other drivers are used to allocate costs to products. Examples of these include turnover, pure volumes and scale payment remuneration. All of the cost drivers utilized in the production of the 2005 regulatory accounts are outlined in appendix 3';
- table 5 has been removed; and
- parts b & c of section 6 have been removed from the new accounting manual.

Appendix 8: Revised Accounting Direction

This draft (starting on the next page) of the revised Accounting Direction is based on our initial review of the current Direction, together with our assessment of best practice. This document represents our recommendation to ComReg, but it has no legal standing, and is subject to consultation and final legal review.

The Secretary
An Post
GPO
O'Connell Street
DUBLIN 1

Direction on the accounting systems of Universal Service Providers

The Commission for Communications Regulation (hereafter "ComReg") in pursuance of Regulation 11(2) of the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002), and having taken into account the views of interested parties following a public consultation, hereby gives the following Direction:

Interpretation

In this Direction, except where the context otherwise requires:

"ComReg" means the Commission for Communications Regulation;

"GAAP" means Generally Accepted Accounting Principles and unless specified otherwise refers to Generally Accepted Accounting Principles applied in Ireland;

"IAS14" means International Accounting Standard No 14 "Segment Reporting" published by the International Accounting Standards Committee;

"Reserved Sector" means the services reserved for An Post as a universal service provider, as set out in Regulation 8 of the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002);

"Scheme" means a scheme made under section 70 of the Postal and Telecommunications Act 1983, No 24 of 1983, as amended;

"Service" means any service provided by a An Post that involves the use of the public postal network as defined in the Regulations; and

- (a) is identified as a separate service in the Schemes or price lists published by An Post, or is provided under a contract or standard agreement with individual customers; and
- (b) operationally handles all items in the service in the same way;

If the service falls partly into the Reserved Sector and partly into the Non-Reserved Sector it shall be accounted for as if it were two separate services;

“Tariff Principles” means the principles set out in Regulation 9 of the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002);

“Terminal Dues Principles” means the principles set out in Regulation 10 of the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002);

“The 1983 Act” means the Postal and Telecommunications Services Act, 1983 (No. 24 of 1983) as amended;

“The 2002 Act” means the Communications Regulation Act, 2002 (no. 20 of 2002);

“The Regulations” means the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002);

“Universal Service Obligation” means the obligations and principles set out in the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002); and

“Universal Service Provider” means An Post or any other legal person designated by the Minister for Public Enterprise under Regulation 4(2)(b) of the European Communities (Postal Services) Regulations 2002 (S.I. No. 616 of 2002).

Fundamental requirements

The financial records and accounting systems to be kept by An Post shall be sufficiently detailed to ensure that:

- (a) all decisions are supported by sufficient data to enable management to ensure that they comply with the Tariff Principles, Terminal Dues Principles and obligations in relation to Universal Service and cross subsidisation;
- (b) ComReg can monitor compliance with these principles;
- (c) separate accounts can be maintained for each of the services within the Reserved Sector on the one hand and each of the services within the Non-Reserved Sector on the other;
- (d) any request for information by ComReg in accordance with Regulation 11(7) or 17(3) can be met promptly; and
- (e) any request for information by the European Commission in accordance with Regulation 11(7) can be responded to promptly.

The financial records and accounting information shall be maintained in sufficient detail to facilitate a detailed analysis, on a geographic and/or category of customer and/or payment method basis, for the purpose of calculating the cost of complying with obligations in respect of Universal Service and cross-subsidisation and ensuring that tariffs are geared to accost, affordable, transparent, non-discriminatory and, where appropriate, take account of the avoided costs, as compared to services utilising all features of the public postal network.

Reason:

To enable An Post to comply with its obligations under the 1983 Act and the Regulations and to enable ComReg to exercise its functions under the 1983 Act, the 2002 Act, the Regulations or any other relevant legislation.

Reporting and transparency

Regulatory accounts

In accordance with Regulation 11(7) and 18(2), An Post shall provide to ComReg regulatory accounts, disaggregated to the level of services, within 19 weeks of the end of each financial year. The regulatory accounts shall contain:

- (a) a commentary on the regulatory performance. The commentary shall explain at a minimum:
- trends relating to products, expected significant future events and how these might impact the business;
 - trends relating to revenue, by service;
 - trends relating to the mail volumes, by service, recorded separately from (i) revenue data recorded at the point of sale; and (ii) operational data recorded in the outward phase of the postal pipeline;
 - the reasons for any divergence between mail volumes, by service, recorded separately from (i) revenue data recorded at the point of sale; and (ii) operational data recorded in the outward phase of the postal pipeline;
 - significant year on year movements in the reported performance and balances;

- one-off or exceptional events in the year;
 - large adjustments made to produce the accounts; and
 - the impact of changes in accounting policies, methodologies and estimation techniques;
- (b) a comprehensive explanation of the basis of preparation of the regulatory accounts, including an explanation of the key regulatory accounting policies adopted by An Post. This shall include, *inter alia*, details of An Post's income recognition policy, depreciation policy, capitalisation policy, and its approach to dealing with issues such as cost allocation, prior year adjustments and changes in accounting policy. This list is not exhaustive and shall be agreed between An Post, ComReg and the auditors of the regulatory accounts;
- (c) profit and loss accounts and balance sheets for each business segment as defined in IAS14 or as agreed by ComReg, and prepared in accordance with IAS14. These accounts are required to show data for the last complete Financial Year as well as the previous Financial Year;
- (d) profit and loss accounts for the business segments providing services within the scope of universal service as defined in the Regulations and clarified by ComReg in any document issued following a public consultation, distinguishing between services wholly or partly within the Reserved Sector and those wholly within the Non-Reserved Sector. These accounts shall also include profit and loss accounts for each service. They are also required to be fully reconciled to the published financial accounts of An Post, identifying all items not relevant to the accounting period that have been excluded from the regulatory accounts;
- (e) The information relating to the first regulatory reporting period to which the Direction applies shall be presented in the formats and the level of detail shown in the template schedules to be prescribed by ComReg, in this Direction or a subsequent Direction. For future reporting periods the same schedules shall continue to be used unless specific changes to either the format and/or the content of the regulatory accounts are agreed between ComReg and An Post, before the end of the relevant regulatory reporting period;

- (f) the regulatory accounts shall include volume information that shows mail volume, by service, recorded separately from (i) revenue data recorded at the point of sale; and (ii) operational data recorded in the outward phase of the postal pipeline;
- (g) the regulatory accounts shall include details of expenditure by pipeline process distinguishing between costs which have been directly allocated to specific services, common costs which have been allocated on the basis of analysis of the origin of the costs themselves, and common costs which have been allocated on the basis of a general allocator;
- (h) the regulatory accounts shall include details of revenues distinguishing between revenues which have been directly allocated to specific services and other revenues which have been allocated or apportioned on the basis of a general allocator;
- (i) a signed statement from the Directors of An Post acknowledging their responsibilities for the preparation of the regulatory accounts and confirming their compliance with the requirements of the Direction;
- (j) an auditor's reports and opinions on the regulatory accounts and An Post's compliance with the requirements of the Direction; and
- (k) the results of the annual audit of any statistical sampling process undertaken to identify revenue or mail volumes.

Cost of service information

A detailed report must be prepared annually in connection with the regulatory accounts, or whenever revised prices are announced (or whenever An Post seeks concurrence with proposals to increase prices within the Reserved Sector), comparing the existing and/or proposed price with a detailed estimate of the costs of providing the service.

Ad hoc reporting

Such ad hoc reports shall be prepared and provided, as may be required by ComReg from time to time.

Publication

An Post is strongly encouraged to publish and make readily available the regulatory accounts. These accounts could be included on An Post's website.

Reason:

To enable ComReg to exercise its functions under the 1983 Act, the 2002 Act, the Regulations or any other relevant legislation; and to provide increased transparency of the regulatory performance.

Accounting Manual

An Post must:

- (a) document in an Accounting Manual the procedures and policies being used in the preparation of its regulatory accounts;
- (b) document in the Accounting Manual the procedures undertaken to establish the processes used to identify revenues and mail volumes; by service;
- (c) review the Accounting Manual annually;
- (d) make the Accounting Manual subject to periodic review by an independent reviewer; and
- (e) obtain ComReg's approval for each annual edition of the Accounting Manual in advance of the start of the relevant regulatory period.

The Accounting Manual shall contain a schedule showing how each individual cost category is treated. The Accounting Manual shall, at a minimum, provide an overview of:

- An Post's business, explaining the main activities and functions performed by An Post to deliver postal services to customers, clearly indicating which businesses and services are regulated;
- An Post's management structure;
- how the underlying financial transactions supporting the business activities and functions are recorded in the financial ledgers, and how the transactions are grouped to provide the starting costs, revenues, assets and liabilities used within the internal costing systems to allocate costs;
- the accounting systems, in terms of the underlying costing principles and the conceptual flow of costs and revenues from source financial systems to the separated businesses;

- what the regulatory accounts comprise and the regulatory accounting process (including the basis of preparation for the regulatory accounts);
- year on year changes to regulatory accounts and changes to cost allocations, together with an assessment of the impact of these changes;
- how the regulatory accounts differ from the statutory accounts;
- the internal safeguards that are incorporated to ensure that the cost allocation system is free from material error; and
- the audit of the regulatory accounts in terms of scope of the audit and the process to appoint auditors.

The collection of data and the basis on which it is to be allocated/apportioned between services shall be guided by the following principles:

i.) Business segments & inter-company/inter-segment transactions

Revenue and costs shall initially be directly assigned to business segments in accordance with the principles set out in IAS14. Fixed assets (buildings, vehicles, sorting equipment, etc.) shall be shown in the balance sheet of the “prime user”, with use by other business segments charged for on an arm’s length basis.

Inter-company and similar transactions between An Post and its subsidiaries or associated companies must take full cognisance of the Tariff, Terminal Dues and Universal Service Obligation principles. Business segments, as defined by IAS14, shall be regarded as “subsidiaries” for this purpose. In this regard, payments/charges shall be calculated on an arm’s length basis, and in a transparent and non-discriminatory manner, with the proviso that this transfer “charge” shall equal the price An Post would charge to any competitor who wished to use its network or pay to any external supplier.

ii.) Mail Volume and Revenue Identification

Within the business segments, as defined by IAS14, mail volumes and revenue shall be allocated to each of the Reserved and to the Non-Reserved services respectively in the following manner:

- (a) mail volumes and revenue which can be directly assigned to a particular service shall be so assigned;

- (b) mail volumes, by service, shall be recorded separately, from (i) revenue data recorded at the point of sale; and (ii) operational data recorded in the outward phase of the postal pipeline;
- (c) mail volumes, by service, separately recorded, from (i) revenue data recorded at the point of sale; and (ii) operational data recorded in the outward phase of the postal pipeline, shall be compared. An Post shall understand and shall be able to report the reasons for any divergence between the two measures;
- (d) revenue, by service, shall be recorded at the point of sale;
- (e) mail volumes and revenue recorded at the point of sale that cannot be directly assigned to their use for specific services or retention by users for later use (e.g. postage stamps sold and franking machine credits) shall be apportioned to services on the basis of statistical sampling accurate to +/-1% at the 95% Confidence Level;
- (f) for mail volumes recorded in the outward phase of the postal pipeline, which cannot be directly assigned to their specific services (e.g. manually sorted mail items), mail volumes shall be apportioned on the basis of statistical sampling, by service, with a margin of error agreed with ComReg; and

A list of the services (as defined in this Direction) provided by the An Post shall be included in the Accounting Manual, and may be published by ComReg.

iii.) Cost Allocation and Apportionment Principles

Within the business segments, as defined by IAS14, costs shall be allocated to each of the Reserved and to the Non-Reserved services respectively, in the following manner:

- (a) costs which can be directly assigned to a particular service shall be so assigned;
- (b) common costs, which are costs that cannot be directly assigned to a particular service, shall be allocated as follows:
 - (i) whenever possible, common costs shall be allocated on the basis of direct analysis of the origin of the costs themselves;

- (ii) when direct analysis is not possible, common cost categories shall be allocated on the basis of an indirect linkage to another cost category or group of cost categories for which a direct assignment or allocation is possible; the indirect linkage shall be based on comparable cost structures;
- (iii) when neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of all expenses directly or indirectly assigned or allocated, on the one hand, to each of the Reserved services and, on the other hand, to the other services.

iv.) Cost Allocation and Apportionment Rules

The Accounting Manual shall set out how the operating cost of the various aspects of the public postal network, as defined in the Regulations, shall be identified.

It shall set out the basis on which the costs of particular activities are to be apportioned between services. Costs shall be apportioned between the various services that use each aspect of the network on the basis of volumes, "weighted" by factors which reflect the different impact of each item on the cost of the activity. The weighting factors shall be specific to each operational process, as well as the range of services that use that process, and shall be updated annually

As a minimum, the hierarchy of costs to be applied to each service shall enable the cost of the following activities to be calculated:

- (a) Revenue Collection;
- (b) Collection;
- (c) Outbound sorting;
- (d) Transport;
- (e) Inbound sorting; and
- (f) Preparation and Delivery.

The hierarchy of accounts shall also distinguish between directly allocated costs, common costs which have been allocated on the basis of analysis of the origin of the costs themselves, and common costs which have been allocated on the basis

of a general allocator. Accounting items not involving the movement of funds (e.g. depreciation) shall also be identified separately.

The Accounting Manual shall specify in technical detail the range and scope of the data to be collected and the basis on which it is to be allocated/apportioned between services. The Accounting Manual shall also provide, at a minimum details of:

- the process by which An Post identifies how costs are found to be directly or indirectly attributable, joint or common;
- the process by which An Post identifies how avoidable, variable and fixed costs are defined;
- how equivalent volume drivers are derived;
- how costs are allocated to products with different weight, format and payment characteristics; and
- how cost allocation drivers are reviewed, updated and verified.

Reason:

To enable ComReg to exercise its functions under the 1983 Act, the 2002 Act, the Regulations or any other relevant legislation, and to enable ComReg to comply with Regulation 11(6).

Audit and Confirmation of Compliance

An Post shall:

- (a) engage an independent auditor(s) to verify compliance with the Direction and to perform an audit of the regulatory accounts in accordance with the principles and guidance of the Auditing Practices Board;
- (b) publish the auditor's report and opinions on An Post's compliance with the requirements of the Direction in its annual report submitted to the Minister under section 33 of the 1983 Act; and
- (c) publish the auditor's report and opinions on the regulatory accounts and on An Post's compliance with the requirements of the Direction within the regulatory accounts. The auditor's report and opinions shall be addressed to both An Post and to ComReg. The precise form of the

audit opinion shall be developed by ComReg after consultation with An Post's auditors and the Irish accountancy profession, amongst others and with regard to international best practice. ComReg will issue a separate Direction containing the form of the opinions.

An Post shall consult with ComReg before appointing or reappointing auditors for this purpose. ComReg shall be party to the auditor's terms of engagement and agree to the scope of the audit of the regulatory accounts.

In addition, An Post shall make:

- (a) the Accounting Manual subject to periodic review by an independent reviewer;
- (b) the processes used to identify revenue and mail volumes subject to periodic review by an independent reviewer; and
- (c) any statistical sampling conducted to identify mail volumes subject to (i) annual statistical audit; and (ii) annual procedural review, taking into account changes to the population size of each service or other significant market changes. The audit and procedural review shall be conducted either by a statistical expert, ComReg or as part of the regulatory auditing process. Any alterations to the procedure resulting from the review shall be stated in the Accounting Manual.

Reason:

To enable ComReg to exercise its functions under the 1983 Act, the 2002 Act, the Regulations or any other relevant legislation, and to enable An Post to comply with Regulation 11(5).

To enable ComReg to gain assurance over the robustness of the regulatory accounting system and processes, and the proper preparation and presentation of the regulatory information.

Timetable

The above Direction will apply to accounting periods beginning on or after 1 January 2007. An Post is required to submit for approval by ComReg, no later than 1 February 2007, its timed programme for compliance with this Direction, including preparation of the Accounting Manual. In the same document, An Post shall indicate the extent to which it can comply with the Direction for accounting

periods ending on or before 31 December 2006, and the reasons why they cannot comply with any specific item.