

# COST RULES AND OTHER REQUIREMENTS TO MEET USP PROVIDER ACCOUNTING OBLIGATIONS

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This note sets out Frontier Economics updated recommendations on cost rules and other requirements to inform ComReg's Direction to the Universal Postal Service Provider (USP). Following the publication of Frontier Economics report in November 2015, ComReg issued their Accounting Direction Consultation in December 2015. Following stakeholder consultation on that report, and taking into account the findings of an expert report by PLCWW into a number of operational volume count issues, we have updated a number of our previous recommendations<sup>1</sup>. This notes outlines the details and reasoning of the updated recommendations.

## Amendments to recommendations

As a result of detailed consideration of the consultation responses received, and further analysis, Frontier Economics have amended a number of the recommendations in our original report. We detail these below, however we note that the majority of our original report – “Cost rules and other requirements to meet USP provider accounting obligations” – and the recommendations contained within, remain unchanged following the consultation. For completeness Annexe 1 provides a complete set of recommendations following the revisions described below<sup>2</sup>.

We have amended recommendations, in relation to:

1. reconciliation of revenue derived and operating volumes;
2. audit of reconciliation with operational volumes;
3. reporting process for measuring operational volumes and their accuracy;
4. reconciliation of operational volume counts;
5. inter-segment / inter-company transactions;
6. capital expenditure;
7. payroll;
8. scope of regulatory auditor;
9. appointment of regulatory auditor; and
10. format of the summary Regulatory Accounts.

We discuss the details of each of these recommendations below.

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<sup>1</sup> Annexe 2 to this paper sets out the timeline and engagement undertaken as part of the report development.

<sup>2</sup> Note that the recommendation numbers throughout the note refer to the recommendation numbers in the Frontier report issued in November 2015, whereas the recommendation numbers in Annexe 1 refer to the updated recommendation numbers.

## 1. Reconciliation of revenue and operationally based volumes

This relates to recommendations 2 and 3 in the report by Frontier Economics.

- Recommendation 2 of Frontier Economics' report states that the Direction should require the reconciliation between revenue-derived and operationally-based volumes be provided by format (letters, flats, packets and parcels) as a supplementary schedule in the Regulatory Accounts (confidential) and published in the Summary Regulatory Accounts (non-confidential).
- Recommendation 3 of Frontier Economics' report states that the Direction should require that An Post provide detailed commentary explaining the reasons for the differences between operational and revenue figures for each individual format.

Following the consultation, Frontier Economics has amended these recommendations as follows.

- Recommendation 2 still requires An Post to complete the reconciliation between revenue-derived and operationally-based volumes be provided by format (letters, flats, packets and parcels). The recommendation is now amended to require An Post to use DSU operational counts for flats, packets and parcels and machine counts for letters. Publishing the reconciliation as a supplementary schedule in the Summary Regulatory Accounts is no longer required.
- Recommendation 3 is amended to require An Post to provide detailed commentary explaining the differences between operational and revenue figures, when the difference exceeds 5% for each individual format.

### UPDATE OF ORIGINAL RECOMMENDATIONS 2 AND 3

Recommendation 2: We recommend the Direction requires the reconciliation between revenue-derived and operationally-based volumes be provided by format (letters, flats, packets and parcels). We recommend that the Direction requires An Post to use DSU operational counts for flats, packets and parcels and machine counts for letters.

Recommendation 3: We recommend the Direction requires that An Post provide detailed commentary explaining the reasons for the differences between the operational and revenue figures for each individual format, when the difference exceeds 5%.

## 2. Audit of reconciliation with operational volumes

This relates to recommendation 4 in the report by Frontier Economics, in which we recommended that An Post's revenue-derived and operationally-based volumes reconciliation be audited.

Following the consultation responses received from An Post, PWC, KPMG and the Chartered Accountants of Ireland, Frontier Economics has amended this recommendation. We now consider that An Post should not be required to audit the reconciliation of operational and revenue based volumes. Instead, we recommend that ComReg should have the ability to require a review when

ComReg considers it appropriate. For example, when the reconciliation shows a difference in the operational and revenue derived volumes of greater than 5% by format. In our view, this should be sufficient to give ComReg the necessary confidence in this aspect of An Post's volume measurements, without necessarily requiring an annual audit.

#### **UPDATE OF ORIGINAL RECOMMENDATION 4**

We recommend the Direction gives ComReg the ability to undertake a review of the revenue derived and operationally based volumes reconciliation when ComReg considers it appropriate (e.g. ComReg could consider it appropriate to do so in circumstances where the reconciliation shows a difference in the operational and revenue derived volumes of greater than 5% by format).

### **3. Reporting process for measuring operational volumes and their accuracy**

This relates to recommendations 6, 7 and 8 in the report by Frontier Economics.

- Recommendation 6: We recommended that An Post should include details of the process for reviewing average container fills in its Accounting Manual.
- Recommendation 7: We recommended that An Post reviews its average container fills every quarter.
- Recommendation 8: We recommended that An Post should report the results of the average container fill reviews in the Accounting Manual.

Following the consultation responses, Frontier Economics has amended the above recommendations. While manual counts remain an important part of An Post's volume controls, given that letters are counted predominantly by machine, rather than average tray fills, and flats and packets are counted individually, we no longer consider it necessary to include the above recommendations on average container fills. Instead, we recommend that An Post details the process it undertakes for counting and verifying flats and packets volumes at DSUs. This process is important because PLCWW's report has recommended that the DSU counts for flats and packets should be the primary operational volume measure for flats and packets to compare against the revenue-derived figures for these particular formats.

#### **UPDATED RECOMMENDATION 6/7/8**

We recommend the Direction requires An Post details the process it undertakes for counting and verifying flats and packets volumes at DSUs.

### **4. Reconciliation of operational volume counts**

This relates to recommendation 9 in the report by Frontier Economics, whereby we recommended that An Post reports on quarterly reconciliations between MC and DSU volumes at the format level (i.e. letters, flats, packets and parcels) and to include a schedule of volume reconciliation in An Post's Regulatory Accounts.

Following the consultation, Frontier Economics has removed this recommendation. This recommendation is no longer required as the operational volume used as part of the reconciliation of operational and revenue-derived volumes will now use a combination of MC and DSU volumes.

## 5. Inter-segment / inter-company transactions

This relates to recommendation 16 in the report by Frontier Economics, which recommended that the Direction requires the Regulatory Auditor to include the source of inter-segment revenue in order to show how charges flow between various An Post business segments. The recommended Regulatory Account templates prepared by Frontier Economics required a matrix of inter-segment revenue to be published in both the Confidential and Non-Confidential versions of the Regulatory Accounts. This was recommended to allow greater transparency to the Direction, and to show changes in trends of inter-segment revenue.

Following the consultation, Frontier Economics has amended this recommendation so that the proposed matrix of inter-segment revenue is to be published only in the Confidential Regulatory Accounts. This is in response to An Post's concerns about the commercially sensitive nature of some of the data, including detailed information from its non-USO business.

### UPDATE OF ORIGINAL RECOMMENDATION 16

We recommend the Direction requires the confidential version of the Regulatory Accounts include the source of inter-segment revenue in order to show how charges flow between various An Post business segments. This will allow greater transparency to the direction, and changes in trends, of inter-segment revenue.

## 6. Capital Expenditure

This relates to recommendation 22, which recommended that An Post include commentary on its capex figures in the Confidential and Non-Confidential Regulatory Accounts.

Following the consultation, Frontier Economics has amended this recommendation to require that An Post's commentary on its capex figures should only be published in the confidential version of the Regulatory Accounts. Capex information and the related USO / non-USO split of investment should be readily available to An Post as part of the business case approval process and therefore this requirement should not add significant cost. However, given confidentiality concerns with regard to the non-USO segment, we amend this requirement such that commentary is only included in the confidential version of the Regulatory Accounts.

## UPDATE OF ORIGINAL RECOMMENDATION 22

We recommend the Direction requires An Post to include commentary on its capex figures in the confidential version of the Regulatory Accounts. Commentary shall include but is not limited to explanation of investment additions and disposals to the universal service in the applicable period.

### 7. Payroll

This relates to recommendations 23 and 24 in the report by Frontier Economics.

- Recommendation 23: We recommended that An Post reports payroll costs by business segment, and within segment as recorded internally by An Post.
- Recommendation 24: We recommended that An Post report average staff numbers (FTE equivalent) by business segment, and within segment as recorded internally by An Post.

Following the consultation, we have amended these recommendations. We now recommend that An Post should include details of all payroll costs by business segment and FTEs to ComReg in its confidential Regulatory Accounts. This is in response to An Post's concerns about the commercially sensitive nature of payroll data while recognising that such information is important to ComReg as payroll accounts for most of the cost of the USO.

## UPDATED RECOMMENDATIONS 23 AND 24

Recommendation 23: We recommend that the Direction requires An Post to report in the confidential version of the Regulatory Accounts, all payroll costs by business segment, and within segment as recorded internally by An Post.

Recommendation 24: We recommend that the Direction requires An Post's to report in the confidential version of the Regulatory Accounts, average staff numbers (FTE equivalent) by business segment, and within segment as recorded internally by An Post.

### 8. Scope of Regulatory Auditor

This relates to recommendation 28 in the report by Frontier Economics, where we recommended that the Direction requires the "letter of engagement" with the auditor cover an audit scope which includes:

- the scope of costs included in the regulatory accounts and the scope of costs allocated to individual regulated products (where appropriate);
- the reconciliation between regulatory accounts and statutory accounts;
- correctness of figures, including operational data like volumes;
- methodologies used regarding amortization, cost capitalization, allocation and for the evaluation of the assets;
- transfer charges in separated accounts (entities and/or products);
- appropriateness of usage of the drivers;

- the frequency of index updates used for cost allocation purpose; and
- appropriateness of possible important changes in the methodology.

Following the consultation responses received from An Post, PWC, KPMG and the Chartered Accountants of Ireland, Frontier Economics has amended this recommendation. We are now of the view that the scope of the Regulatory Auditor should remain as set out in the existing audit scope, which is documented in the existing letter of engagement. The detail of the existing audit scope should therefore be included in the updated Direction. In our view the existing audit scope is sufficient to meet ComReg's needs.

#### **UPDATED RECOMMENDATION 28**

We recommend the Direction includes the detail of the existing audit scope which is documented in the existing letter of engagement.

### **9. Appointment of Regulatory Auditor**

This relates to recommendation 29 in the report by Frontier Economics, which recommended that the Direction requires the auditor of the Regulatory Accounts to be appointed by ComReg.

Following the consultation responses received from An Post, PWC, KPMG and the Chartered Accountants of Ireland, we are now of the view that the auditor of the Regulatory Accounts should be appointed by An Post, with a "Duty of Care" to ComReg. We consider that this arrangement should be sufficient to meet ComReg's needs. We note that, as per the existing letter of engagement, ComReg should have the ability to appoint the auditor for separate expert engagement, where required. Also, we consider that ComReg should also maintain the ability to appoint another competent body, other than the Regulatory Auditor, to provide a separate expert opinion, where required.

#### **UPDATED RECOMMENDATION 29**

We recommend the Direction requires the auditor of the Regulatory Accounts to be appointed by An Post, with a "Duty of Care" to ComReg. As per the existing letter of engagement, ComReg should continue to have the ability to appoint the auditor for separate expert engagement, where required. ComReg should also maintain the ability to appoint another competent body, other than the Regulatory Auditor, to provide a separate expert opinion, where required.

### **10. Summary Regulatory Accounts**

This relates to recommendation 25 in the report by Frontier Economics, where we recommended that the Direction requires An Post's Regulated Accounts to comply with the required format, as stipulated by ComReg. The required format of the Regulatory Accounts is based on the existing format with the inclusion of some additional items, as required.

Due to confidentiality concerns raised by An Post, Frontier Economics consider that a number of items should not be required to be published in non-confidential Regulatory Accounts, namely:

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- the reconciliation of revenue-derived and operationally-based volumes by format;
- the inter-company and inter-segment revenue;
- the detailed commentary on capex; and
- total payroll and FTE numbers.

We are of the view that the above should be published in the confidential Regulatory Accounts only.

## ANNEXE 1: REVISED RECOMMENDATIONS

Below we provide a complete set of revised recommendations in relation to cost rules and other requirements to inform ComReg's Direction to the USP<sup>3</sup>.

1. We recommend the Direction continues to require the Regulatory Accounts to contain volume information that shows mail volume, by service, recorded from revenue data recorded at the point of sale.
2. We recommend the Direction requires the reconciliation between revenue-derived and operationally-based volumes be provided by format (letters, flats, packets and parcels). We recommend that the Direction requires An Post to use DSU operational counts for flats, packets and parcels and machine counts for letters.
3. We recommend the Direction requires that An Post provide detailed commentary explaining the reasons for the differences between the operational and revenue figures for each individual format, when the difference exceeds 5%.
4. We recommend the Direction gives ComReg the ability to undertake a review of the revenue based and operationally derived volumes reconciliation when ComReg considers it appropriate (e.g. ComReg could consider it appropriate to do so in circumstances where the reconciliation shows a difference in the operational and revenue derived volumes of greater than 5% by format).
5. We recommend the Direction requires the Accounting Manual to include details of how operational volumes are calculated, including the process for validating machine counts and the degree of accuracy to which machines are tested.
6. We recommend the Direction requires An Post details the process it undertakes for counting and verifying flats and packets volumes at DSUs in the Accounting Manual.
7. We recommend the Direction requires the Accounting Manual to provide detailed information on the process for the identification of avoidable, variable, and fixed costs, including worked examples, to enable ComReg to exercise its functions under the Act.
8. We recommend the Direction requires An Post to provide ComReg with the details of the annual review of the cost drivers.
9. We recommend the Direction requires An Post to provide ComReg with details of any year-on-year methodological changes in cost drivers, and that the nature and reason of that change is fully detailed by An Post.
10. We recommend the Direction continues to require An Post to provide detailed cost estimates for providing the required service at each price point.
11. We recommend the Direction requires An Post's Accounting Manual provide a detailed explanation of how costs are allocated to products with different tariffs.

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<sup>3</sup> Note that due to changes in number of recommendations, the numbering of these recommendations do not match the preliminary recommendations in Frontier's original report.



12. We recommend the Direction requires An Post's Accounting Manual provide a detailed explanation where the weight factors used in the allocation process do not align with the various tariff price points.
13. We recommend the Direction requires the confidential version of the Regulatory Accounts include the source of inter-segment revenue in order to show how charges flow between various An Post business segments. This will allow greater transparency to the direction, and changes in trends, of inter-segment revenue.
14. We recommend the Direction requires An Post to prepare separate confidential and non-confidential versions of the Regulatory Accounts.
15. We recommend the Direction requires profit and loss accounts for all USO services to be included in the non-confidential version of the Regulatory Accounts.
16. We recommend that the Direction requires An Post's Regulatory Accounts includes detailed commentary in the "regulatory accounting principles and basis of preparation" section on:
  - large adjustments made to produce the Regulatory Accounts;
  - the impact of changes in accounting policies, methodologies and estimation techniques; and
  - transfer charges, including an expanded explanation summarising the basis of transfer charges similar to that found in sections 9.2, 9.3 and 9.4 of An Post 2014 Accounting Manual.
17. We recommend the Direction requires An Post to report its balance sheet to ComReg on a quarterly basis, when An Post's cash balance is below a €100 million (excluding amounts held in trust).
18. We recommend the Direction requires An Post includes a commentary on its capex figures in the confidential version of the Regulatory Accounts. Commentary shall include but is not limited to explanation of investment additions and disposals to the universal service in the applicable period.
19. We recommend that the Direction requires An Post to report in the confidential version of the Regulatory Accounts, all payroll costs by business segment, and within segment as recorded internally by An Post.
20. We recommend that the Direction requires An Post to report in the confidential version of the Regulatory Accounts, average staff numbers (FTE equivalent) by business segment, and within segment as recorded internally by An Post.
21. We recommend the Direction requires An Post's Regulated Accounts to comply with the required format, as stipulated by ComReg.
22. We recommend the Direction continues require ad hoc reports that shall be prepared and provided by An Post, as may be required by ComReg from time to time.
23. We recommend the Direction requires the audit to be conducted on a 'fairly presents' basis rather than on an 'agreed-upon procedures' basis.
24. We recommend the Direction includes the detail of the existing audit scope which is documented in the existing letter of engagement.

25. We recommend the Direction requires the auditor of the Regulatory Accounts to be appointed by An Post, with a “Duty of Care” to ComReg. As per the existing letter of engagement, ComReg should continue to have the ability to appoint the auditor for separate expert engagement, where required. ComReg should also maintain the ability to appoint another competent body, other than the Regulatory Auditor, to provide a separate expert opinion, where required.
26. We recommend the Direction requires An Post to notify ComReg of any significant changes to the Accounting Manual and provide the Accounting Manual to ComReg at the same time as providing the Regulatory Accounts.
27. We recommend the Direction requires the Regulatory Accounts include 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 this Direction.
28. We recommend the Direction is amended to remove reference to the Reserved Sector (and the Non-Reserved Sector) in:
  - Section 1.1
  - Section 2.1
  - Section 3.1 (d)
  - Section 4.3.2
  - Section 4.3.3
29. We recommend the Direction is amended to remove reference to IAS14 and replace with IFRS8 in:
  - Section 1.1
  - Section 3.1 (c)
  - Section 4.3.1
  - Section 4.3.2
  - Section 4.3.3

## ANNEXE 2: PROCESS TO DATE

Frontier Economics was commissioned by ComReg to prepare an independent report for publication setting out recommendations on cost rules and other requirements to inform ComReg's Direction to the USP. This report, alongside ComReg's Accounting Direction Consultation, was published in December 2015.

Below we summarise the consultation process for our assessment of cost rules and other requirements to meet USP provider accounting obligations, including the original report and updated recommendations.

- Frontier Economics had an initial workshop with An Post on 3 March 2015.
- An information request was sent to An Post on 30 April 2015, which required An Post to send the requested information by 15 May 2015.
  - An Post provided responses to this information request on 7, 11, 14 and 22 May 2015.
  - Frontier Economics and ComReg had a meeting with An Post on 26 May 2015 to discuss the information received.
  - Following this meeting, An Post was requested to provide further information. They provided some of this information on 5 June 2015.
- An Post was informed on 16 June 2015 that there were a number of items requested that remained outstanding.
  - An Post provided their response to these outstanding items on 23 June 2015.
- Frontier Economics issued a draft report to An Post for comment on 28 July 2015.
  - An Post's response to the draft report was received on 3 September 2015.
- Following An Post's response to the draft report, Frontier Economics provided An Post with a request for further information on 17 September 2015. This required An Post to provide the requested information no later than 1 October 2015.
  - An Post provided its response on 1 October 2015.
- An Post received Frontier Economics draft proposed schedules for the Regulatory Accounts on 28 October 2015.
- Frontier Economics and ComReg had a meeting with An Post on 6 November 2015.
- Frontier Economics provided ComReg with the final report on 26 November 2015.
- An Post provided ComReg with its draft schedules on 27 November 2015. Frontier Economics considered these schedules in their letter to ComReg on 3 December 2015.

- An Post sent a letter to ComReg on 9 December 2015 outlining their views about Regulatory Account schedules and the legal basis of the recommendations.
- ComReg published the Accounting Direction Consultation on 21 December 2015.
- Responses to the consultation were received from An Post, Chartered Accountants Ireland, KPMG and PwC.
- On 15 March 2016, ComReg requested in a letter to An Post to provide explanation / additional clarification on points raised in their response to consultation.
- ComReg received response and additional information from An Post on 26 April 2016.
- ComReg and Frontier Economics met with Chartered Accountants of Ireland (CAI), as well as representatives from PWC and KPMG on 26 April 2016.
- Frontier Economics and PLCWW met with An Post team in Cavan on 17 August 2016 to discuss its volume recording systems used at DSUs.
- Frontier Economics and PLCWW met with An Post team at the GPO on 18 August 2016 to discuss its volume recording systems used at MCs.
- Meeting on 4 October 2016 between ComReg, An Post, Frontier and PLCWW (operational volumes expert) to discuss process for recording operational volumes.
- An expert report from PLCWW on operational volume reconciliation and other matters was provided in November 2016.
- Frontier Economics and An Post met on 1 December 2016 at the GPO for a practical demonstration of An Post's volume recording systems.