



## **Future Efficient Costs of Royal Mail's Regulated Mail Activities**

### **Base Year and Baseline Final Conclusions**

**23 January 2006**

## Contents

<b>Glossary</b>	<b>2</b>
<b>1 Executive summary</b>	<b>4</b>
Introduction	4
Summary of Royal Mail's response	4
LECG final conclusions	5
<b>2 Base Year</b>	<b>10</b>
Introduction	10
LECG initial conclusions	10
Royal Mail response	12
LECG response	12
Conclusions	17
<b>3 Baseline forecast</b>	<b>18</b>
Introduction	18
Royal Mail's response	18
LECG Approach	19
Baseline conclusions	30

## Glossary

We use the following abbreviations in this report:

August Report	LECG's report entitled, "Future Efficient Costs of Royal Mail's Regulated Mail Activities" dated 2 August 2005
BPM	Royal Mail's Business Planning Model, which is used to forecast operating costs over the price control period
BPQ	2006 Royal Mail Price and Service Quality Control Review, Initial Business Plan Questionnaire
CAGR	Compound annual growth rate
Capex	Capital expenditure
HWDC	Heathrow Worldwide Distribution Centre
LRMC	Long run marginal costs
Initial Strategic Plan	The Royal Mail Letters Strategic Plan, Discussion Draft, 7 December 2004
Opex	Operating Expenditure
Postcomm	Postal Services Commission
Postcomm's final proposals	Royal Mail Price and Service Quality Review, Final Proposals for Consultation, Postcomm, December 2005
Postcomm's initial proposals	2006 Royal Mail Price and Service Quality Review, Initial Proposals, Postcomm, June 2005
Regulated activities	USO and the price-controlled services
RM	Royal Mail Holdings Group plc. Used to denote Royal Mail in tables and footnotes
RMG	Royal Mail Group
RML	Royal Mail's letters business.
Royal Mail's Response	Document "Response to LECG's report on Future Efficient Costs of Royal Mail's Regulated Mail Activities", dated

September 2005

RUOC	Real Unit Operating Cost ratio, including either depreciation or capital expenditure
RUOE	Real Unit Operating Expenditure. The ratio reflects total operating accounting costs divided by the most relevant unit of output. The ratio is expressed in real terms and is expressed before depreciation
SDD	Single Daily Delivery
USO	Universal service obligation
VA	Volume adjusted (as in volume adjusted growth rate)
WS Atkins Report	An Efficiency Study of Consignia's Inland Letters Business. A report to Postcomm, WS Atkins, November 2002

# 1 Executive summary

## Introduction

- 1.1 Postcomm is in the process of determining the regulatory arrangements that should apply to Royal Mail's regulated mail activities after the expiry of the current price and service quality control at the end of March 2006. A key input into this review is an assessment of the future efficient costs for Royal Mail's regulated mail activities. Postcomm has engaged LECG to provide this assessment.
- 1.2 Our initial conclusions on the level of future efficient costs for Royal Mail's regulated mail activities is set out in our report "Future Efficient Costs of Royal Mail's Regulated Mail Activities" dated 2 August 2005<sup>1</sup>. We refer to this report hereinafter as our "August Report".
- 1.3 Royal Mail has provided a response to this report, which is set out in their report "Response to LECG's report on Future Efficient Costs of Royal Mail's Regulated Mail Activities", dated September 2005. We refer to this report hereinafter as "Royal Mail's Response".
- 1.4 Since our August Report, "actual" data has become available for Royal Mail's costs in the 2004/05 year. We have considered how best to incorporate this data into our final conclusions. This report summarises our final conclusions with respect to Base Year and Baseline costs, and responds to any points raised by Royal Mail in its review of our initial proposals.

## Summary of Royal Mail's response

- 1.5 Royal Mail raised two points with respect to our Base Year and Baseline calculations:
- we did not consider the requirement for increased annual pension contributions due to the change in investment mix and the introduction of the PPF levy; and
  - our assumption of immediate cost reductions in line with the longer run variability of costs is not feasible, and practical considerations suggest that

<sup>1</sup> An excised version of this report is available at [http://www.postcomm.gov.uk/policy-and-consultations/consultations/price-control/LECG\\_efficiency\\_review\\_report\\_excised.pdf](http://www.postcomm.gov.uk/policy-and-consultations/consultations/price-control/LECG_efficiency_review_report_excised.pdf)

variable cost reductions should be phased such that there are no reductions 'in year'. Variable cost reductions should then be phased to achieve 50% in year 1 and 50% in the following year<sup>2</sup>.

- 1.6 We summarise Royal Mail's response in further detail in Sections 2 and 3 of this report.

### **LECG final conclusions**

- 1.7 The remainder of this section describes our Base Year and Baseline conclusions. Unless otherwise stated, all costs in this section are in 2004/05 prices.
- 1.8 Postcomm has provided final conclusions on which products should be price controlled from April 2006 in its final proposals. In this report, we have assessed Base Year costs and Baseline for Royal Mail's UK inland mails, outgoing international and downstream access products over the period 2005/06 to 2009/10. These products fall within the business described as "Total Mails" in Royal Mail's 2003/04 Regulatory Accounts. Henceforth this scope of products is referred to as Royal Mail's Letters business ("RML"). We have also assessed Baseline costs for the products and services Postcomm plans to regulate from 1 April 2006.

### **Base Year**

- 1.9 The first step in identifying total allowable efficient costs is to establish a robust assessment of actual operating costs for the latest year for which we have available information. For our initial conclusions this was 2003/04, which we referred to as the 'Base Year'. We then used this assessment as a starting point for building forward-looking cost projections based on management initiatives that are currently in place.
- 1.10 Royal Mail has accepted our approach to setting costs in the Base Year and our methodology for forecasting costs, both of which remain unchanged for our final conclusions. However, Royal Mail now has actual data for 2004/05. We have based our assessment of these Base Year costs on figures included in the Regulatory Accounts for 2004/05, which is now the most recent actual data available. Although we have incorporated Royal Mail's cost data for 2004/05 into

---

<sup>2</sup> Royal Mail's Response, pages 4 to 8

our projections, we have made several adjustments to this level of costs, which we describe in the following paragraphs.

- 1.11 First, we have made adjustments for a number of non-cash costs, to avoid distortions arising from the application of accounting principles. We have eliminated *depreciation* and we have made adjustments to regular *pension* contribution charges to ensure that only cash costs are included within the projection of costs. We have excluded any consideration of charges relating to *pension deficits*. Postcomm has commissioned Hymans Robertson to provide an independent assessment of Royal Mail's future cash pension deficit requirements over the coming price control. We have also adjusted for provisions. Accounting for *provisions* involves recording an expense before there is certainty over the amounts required, and therefore inevitably involves a degree of judgement.
- 1.12 Second, we have also removed *exceptional items* and any *one-off costs or benefits* incurred in 2004/05, since these are costs that are not expected to be incurred in a normal year of operation and therefore should form no part of our Baseline projections. Although there may be other one-off costs that need to be taken into account in future years, we assess those separately as part of our assessment of future efficiencies.
- 1.13 Third, in determining a suitable level of Base Year costs, we believe that, as a general principle, it is inappropriate to include costs associated with *penalties and compensation* related to Royal Mail for failing to meet its quality of service targets. We anticipate that, in setting a price control, Postcomm will assume that the targets will be met.
- 1.14 Finally, we have considered the difference between forecast and reported actual costs for 2004/05. Despite the fact that projections were given to us by Royal Mail in February 2005 (close to their March 2005 year end) it appears that actual costs have been £162m higher than expected.
- 1.15 Where Royal Mail has been able to provide adequate support for cost increases we have allowed this cost. In this respect, we have incorporated an £84m increase into our projections. Royal Mail has not however, provided sufficient evidence to support the remaining £78m difference between forecast and reported actual costs for 2004/05. The evidence Royal Mail has provided is of poor quality and internally inconsistent, and such information as has been

provided supports the notion that costs are non-recurring. On this basis, we have not incorporated the remaining increase into our projections.

- 1.16 We summarise our Base Year adjustments in the table below, and provide further detail on each adjustment in Section 2.

**Table 1: RML Base Year operating costs in 2004/05**

<b>Adjustments</b>	<b>Total £m</b>
Operating costs per Regulatory Accounts	6,141
Depreciation	(134)
Cash pensions	57
One-off costs	(47)
Bulk compensation and fines	(40)
Unsupported/ non recurring	(78)
<b>Base Year cash operating costs</b>	<b>5,899</b>

Source: LECG analysis. In 2004/05 prices

#### **Baseline cost projection**

- 1.17 From the assessment of costs in the 2004/05 Base Year we are able to build forward-looking projections of Royal Mail's operating expenditure, before one-off costs and capital expenditure, based on forecasts of volumes across Royal Mail's different products, and taking current management initiatives into account. We refer to this projection of costs from the Base Year as the Baseline estimate of operating expenditure. In determining our final view on an efficient cost path for Royal Mail's allowable regulated activities, we adjust this Baseline estimate for future efficiencies we believe are achievable by Royal Mail.
- 1.18 We show our assessment of RML's Baseline operating expenditure from 2004/05 to 2009/10 in the table below. The Baseline includes a number of "step changes" to 2005/06 costs, to ensure that total costs align with current forecasts for the remaining years of the current price control. The step change includes an additional allowance for increased annual pension contributions due to the change in investment mix and the introduction of the PPF levy. The step change also includes an additional £25m in costs for 2005/06. This step change is significantly lower than the step change proposed by Royal Mail of around £345m. Again, the evidence Royal Mail has provided to support this change is of

poor quality and is internally inconsistent. The information that has been provided supports the notion that these costs are either non-recurring, non cash, accounted for elsewhere in the control, or disallowable. On this basis, we have not incorporated the remaining increase into our projections. Our conclusions are explained in detail from paragraph 3.8 below.

**Table 2: LECG Baseline operating expenditure for RML, 2003/04**

	04/05	05/06	06/07	07/08	08/09	09/10	CAGR
LECG opex, £m	5,899	5,908	5,877	5,929	5,875	5,811	(0.4%)
LECG unit opex, £	0.240	0.237	0.237	0.229	0.224	0.220	(1.9%)

Source: Royal Mail and LECG analysis. CAGR measured over period 05/06 to 09/10 (i.e. rate of change over the forthcoming pricing control period)

1.19 We anticipate that over this period total Baseline costs will decline at a rate of 0.4% per annum, and that unit costs will fall by 1.9% per annum. We derived these figures using Royal Mail's BPM2 v2.8.

1.20 In addition to step changes, and our adjustments to the Base Year, discussed above, there are two key inputs to these figures where we have used assumptions different to those used by Royal Mail. First, we have used different assumptions relating to volumes and product mix. Our Baseline projection is based on work performed for Postcomm by Frontier Economics. We show the relevant assumptions at a high level in Table 3 below.

**Table 3: Projected volumes in millions**

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Royal Mail volumes	24,543	25,114	25,167	26,183	26,437	26,337
Postcomm volumes	24,543	24,926	24,797	25,934	26,281	26,443

Source: RM BPM2 v2.8. Frontier Economics volume submission of 16 November 2005.

1.21 The second key difference relates to the time period over which costs respond to volume changes. Royal Mail assumes that costs take three years to respond fully to a change in volume, using a 0%, 50%, and 50% phasing. In our August Report, we noted that Royal Mail had provided virtually no support for this assumption. On balance, we concluded that costs would respond more quickly to changes in volume than Royal Mail anticipated. Based on the evidence that

we reviewed, we believed that it would be reasonable to assume that variable/incremental costs change immediately with changes in volume.

1.22 In response, Royal Mail has provided only very limited additional information in support of its phasing assumptions. Absent better information, we continue to believe that costs will respond more quickly to changes in volume than Royal Mail suggests. Based on the evidence that we have reviewed, we still believe that it would be reasonable to assume that costs change immediately with changes in volume. Our review of the information provided by Royal Mail is set out from paragraph 3.31.

1.23 The table summarises the difference between these two sets of assumptions.

**Table 4: Difference in Baseline costs relating to cost phasing assumptions**

2003/04 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Impact of phasing assumptions	0	(23)	(63)	33	(22)	(92)

Source: LECG analysis

1.24 Over a four-year price control (as proposed by Postcomm), our phasing assumption lowers RML's total operating cost allowance by around £144m.

1.25 The table below summarises our assessment of baseline costs for the regulated business. We have adopted the same methodology to derive these costs as stated in our August Report.

**Table 5: LECG Baseline operating costs for the regulated business – final proposals scope**

2003/04 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
LECG Baseline	5,393	5,409	5,354	5,399	5,334	5,265

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005, Postcomm and LECG analysis. The regulated business is as defined in Postcomm's final proposals.

## 2 Base Year

### Introduction

2.1 Section 7 of our August Report sets out our methodology for assessing Base Year costs. In this section, we first summarise our initial Base Year conclusions. We then consider Royal Mail's response to our estimate of Base Year costs. We then consider whether the Base Year should be restated, before providing our final conclusions.

2.2 We note that in this report, all views, unless otherwise attributed, are those of LECG.

### LECG initial conclusions

2.3 Our approach to assessing Base Year operating costs and our findings are set out in full in our August Report. A robust assessment of actual operating costs in the Base Year is required so that forward-looking projections can be developed. We referred to the projection of costs from the Base Year, subject to any accounting adjustments, as the Baseline estimate of future operating costs. Adjustments to the Baseline were then required to take account of possible efficiency gains arising from *future* management initiatives – as determined through our top-down and bottom-up reviews. Baseline costs formed only one aspect of the profile of total efficient costs. Other elements of this cost profile included:

- investment and operating expenditure cost savings arising from future efficiency initiatives;
- restructuring and one-off costs relating to the implementation of future management initiatives;
- capital expenditure relating to both normal operating conditions and the implementation of future management initiatives; and
- costs relating to pension deficits.

2.4 Each of the cost elements identified above was considered separately. For the purposes of projecting Baseline costs, however, these elements were excluded from the Base Year – to ensure operating and capital costs were not double counted, and to reflect the assumption that costs identified as “one-off” were

treated as non-recurring. In addition, further adjustments were required to ensure that costs are properly stated on a cash basis. In summary, we adjusted the 2003/04 Base Year for the following items:

- non-cash costs, such as provisions and depreciation, to avoid distortions arising as a result of the application of accounting principles;
- the appropriate allocation of group overheads;
- one-off costs and benefits, such as restructuring costs and items unrelated to the regulated businesses; and
- costs that are disallowed for price control purposes (i.e. should not be included in the calculation of allowable revenues).

2.5 The table below identifies the adjustments we made to derive our total Base Year operating cost figure in 2003/04.

**Table 6: Derivation of estimate of Base Year operating costs**

Adjustments	Adjustment type	Total £m
Operating costs per BPC		6,095
Depreciation	Cash costs	(91)
Property depreciation	Cash costs	(36)
Logistics depreciation	Cash costs	(26)
Provisions	Cash costs	0
Pension accruals	Cash costs	(216)
Cash pension costs	Cash costs	271
Allocation of costs	Cost allocation	(0)
Project costs	One-off costs	(77)
Bulk compensation scheme	Disallowed	(68)
<b>Base Year cash operating costs</b>		<b>5,852</b>

Source: LECG analysis. Numbers stated in 2003/04 prices

### **Royal Mail response**

- 2.6 Royal Mail's response to LECG's Base Year cost analysis is set out in Section 3 of its report<sup>3</sup>. Royal Mail "*considers that the LECG report adopts a reasonable approach to establishing base year costs*".<sup>4</sup>
- 2.7 Royal Mail raised two issues, relating to provisions and to pensions. However, in relation to both points, Royal Mail acknowledged that LECG's conclusions were correct and proposed no adjustments to the analysis.

### **LECG response**

- 2.8 Royal Mail accepted our approach to calculating Base Year costs. Royal Mail made no representations within its report to restate the Base Year to reflect 2004/05 actuals. As such, our starting position is to continue to forecast costs from the 2003/04 Base Year. In part this decision is driven by the amount of work that was conducted to restate 2003/04 costs. This work took over six months to complete.
- 2.9 Whilst Royal Mail does not specifically ask for the Base Year to be restated, its Business Planning Model (BPM 2.8) takes 2004/05 actuals as the Base Year and projects future costs from this revised starting point, using volume changes, inflation and initiatives as the main drivers of change. We make three observations with respect to Royal Mail's approach.
- 2.10 First, we are surprised that after accepting our approach to forecast costs from the 2003/04, Royal Mail then changes the basis of its own calculations. It makes no reference to this change in its response to our August Report.
- 2.11 Second, after accepting the Base Year adjustments identified in our report, it fails to adjust the 2004/05 cost base for similar items. We challenged Royal Mail on this issue, and it subsequently agreed that the 2004/05 cost base should be adjusted for the following items:

---

<sup>3</sup> Response to LECG's report on "Future Efficient Costs of Royal Mail's Regulated Mail Activities", Royal Mail, September 2005.

<sup>4</sup> Royal Mail Response, paragraph 3.2

**Table 7: Royal Mail proposed adjustments for 2004/05**

<b>Adjustments</b>	<b>Adjustment type</b>	<b>Total £m</b>
Operating costs per BPM2 v2.8 and Regulatory Accounts		6,141
Depreciation	Cash costs	(85)
Property depreciation	Cash costs	(33)
Logistics depreciation	Cash costs	(16)
Pension accruals	Cash costs	(220)
Cash pension costs	Cash costs	277
Project costs*	One-off costs	(47)
Bulk compensation scheme	Disallowed	(40)
<b>Base Year cash operating costs</b>		<b>5,977</b>

Source: Royal Mail, "Base Year Operating Cost Adjustments 2004/5", 7 October 2005. Note: \* We have added an additional £11m in project costs relating to restructuring costs charged to the mails business as identified in note 15 to the RMH plc 2004/05 Statutory Accounts. Numbers stated in 2004/05 prices

- 2.12 Third, we compared Royal Mail's original forecast for 2004/05 to the 2004/05 actuals included within the re-submitted BPM 2.8. The forecast for 2004/05 was based on Royal Mail's BPM 2.7, which was provided to us in February 2005<sup>5</sup>. Royal Mail identified a number of "step changes" to 2004/05 costs, to ensure that total costs aligned with their latest expectations of costs in 2004/05.
- 2.13 Given that Royal Mail submitted its model in February 2005, and given that Royal Mail's financial year-end was 31 March 2005, we would expect that forecast and actual costs would be closely aligned<sup>6</sup>. However, as shown in the comparison table below – of actual and forecast costs for 2004/05 – they are not.

<sup>5</sup> The model we have used is contained within RM 2023a and is labelled BPM2\_v2.7RR Updated 05-02-02.xls

<sup>6</sup> Since Postcomm's Final Proposals were published, Royal Mail has claimed that whilst the forecast was submitted in February 2005, it was based on data available as at the end of November 2004. This is newly disclosed, and we have not had a chance to verify this fact. We would still expect costs to be closely aligned, however, especially given that by February Royal Mail should have known whether the November forecast was likely to be accurate. If Royal Mail knew the forecast to be inaccurate, then it would be unusual for it not to be disclosed

**Table 8: Comparison of 2004/05 actual and forecast costs**

2004/05 prices	2004/05 Forecast £m	2004/05 Actual £m	Difference £m
RML	6,048	6,141	93
Adjustments	-234*	-164**	69
Adjusted RML	5,814	5,977	162

Source: LECG analysis of BPM2 2.7, BPM2 v2.8 and RM submission "BPM Base Year cost adjustments: Further response", 14 October 2005. Note: \* Base Year adjustments in 2003/04, as stated in Table 6 above, adjusted to 2004/05 prices. Adjustments agreed with Royal Mail and expected to flow through to 2004/05. \*\* Base year adjustments from Table 7 above.

- 2.14 Royal Mail's actual costs for 2004/05, adjusted for non-cash items, one-off costs and disallowed items, has turned out to be £162m higher than expected. The implication of including these additional costs would be to increase allowable costs in each year of the forthcoming price control by £162m. In total this amounts to an additional £650m.
- 2.15 This increase is surprising, given that the latest forecast was made only two months prior to year-end. We also find it unusual that Royal Mail did not formally identify in its response to our August Report that the costs in 2004/05 were understated. Instead, it simply updated its models, without explaining that the cost base had increased (or how or why). Royal Mail's approach to this issue has lacked transparency.
- 2.16 To validate the change in costs from 2003/04 to 2004/05, we requested additional information from Royal Mail. In principle, this difference might reflect any or all of the following: technical issues (including modelling issues, changes in cost allocation methodologies, etc), volume related differences, or one-off costs.
- 2.17 On the technical modelling front, Royal Mail has identified £84m, which appears - based on the descriptions that we have been given - to be an intra-company interest adjustment arising from a combination of intra-company accounts. This income should in principle (and on the basis of the descriptions given) be excluded from our figures, with the result that underlying costs are correspondingly higher. We propose to accept this adjustment.

2.18 On the volume front, actual volumes were slightly lower than the forecast. Volumes changes do not, therefore, explain the remaining £78m difference. Such explanations as we have been given in respect of this amount have not been compelling. Importantly:

- Royal Mail did not provide a detailed reconciliation between forecast 2004/05 costs and actual 2004/05 costs;
- Royal Mail did not provide a complete set of management accounts for 2004/05. The management accounts that Royal Mail did provide were excised and provided very little information. We find this unusual because the 2003/04 management accounts contained significantly more detailed information;
- Royal Mail provided a very high-level cost bridge between 2003/04 and 2004/05. Royal Mail explained that this bridge was prepared from its management accounts. However, the management accounts we were allowed to review were not sufficiently detailed for us re-create the cost bridge. In our experience, we would expect Royal Mail to have documents that explain in detail cost changes between 2003/04 and 2004/05 and between forecast and actual for 2004/05. If these documents exist they have not been provided;
- the cost bridge between 2003/04 and 2004/05 excludes material changes that we know have occurred – such as a reduction in lease payments and changes in the level of absenteeism; and
- the explanations provided were not consistent with information provided in the Royal Mail 2005/06 budget (see below).

2.19 From the evidence that Royal Mail has provided, we believe that the remaining difference should be treated as relating to non-recurring items. Royal Mail has argued that it should not, but we do not find its arguments convincing. For example<sup>7</sup>, *inter alia*:

- Royal Mail explains that Single Daily Delivery (“SDD”) costs increased by £109m in 2004/05 and HWDC costs increased by around £25m. Royal Mail stated that it does not expect these costs to fall in later years. This is

<sup>7</sup> Royal Mail, document entitled “Review of developments within the RM costing system 2004/05”, dated 5 October 2005

inconsistent with the 2005/06 budget<sup>8</sup>, which shows SDD and HWDC costs falling by £40m<sup>9</sup>;

- Royal Mail explained that the costs of temporary resource increased by £52m to £111m in 2004/05. The primary reason for this increase was the use of temporary workers to infill vacancies generated in the early stages of deployment of SDD. Royal Mail had to manage out large numbers of people through a voluntary redundancy scheme, and says that in a scheme of the scale of SDD it is not possible to time the loss of people with the deployment timeline of the operational change. We understand that leavers through the VR scheme often left their roles in delivery before deployment of the SDD changes. In the interim period, temporary workers were used to fill vacancies. This allowed Royal Mail to derive optimum savings as soon as the deployment of the SDD happened in each office. Since the deployment of SDD, Royal Mail has sought to reduce its dependence on temporary workers. We understand that some additional full time staff has been brought in as part of the move to restore quality of service. From the explanation provided, it appears that an element of this increase could be one-off in nature; and
- Royal Mail indicated that vehicle costs have increased by £10m due to an increase in spot hire charges. We understand this relates to short term, vehicle hire agreements taken out by local delivery managers. We understand that this is driven by local demands, and would expect the level of spot hire charges to fluctuate around an average level. Any increases above the average are likely to be followed by decreases the following year – depending on local conditions. As such, this cost might be expected to be one-off in nature.

2.20 In general terms, we must consider the fact that the price control process and the existence of asymmetric information can provide the regulated entity an incentive to try game the process (i.e. delaying, hiding or transferring cost savings between years in order to inflate opening year costs, which have a disproportionate impact on forward cost projections). This is a standard concern of regulators. We also

<sup>8</sup> Royal Mail Group Plc, Budget Proposal 2005-06, July 2005

<sup>9</sup> This is broadly consistent with the BPM 2.7, which included additional savings of £31m in 2005/06 relating to the end state savings of the renewals project. BPM 2.8 now excludes this savings. LECG believes that Royal Mail has not provided a satisfactory explanation for this change

note that in respect of the current price control period, Base Year costs for Royal Mail's regulated activities in 2002/03 were assessed at £6,397m (in 2003/04 prices). Actual costs then turned out to be only £5,769m - some £628m lower. This difference is significant. In light of the two points above, Postcomm and LECG have been particularly concerned to ensure that the Base Year and Baseline only include recurring allowable cash costs.

## Conclusions

- 2.21 Royal Mail has accepted our approach to setting costs in the Base Year and with our methodology for forecasting costs. Our final conclusions are based on this approach.
- 2.22 We recognised that Royal Mail now has actual data for 2004/05. Where Royal Mail has been able to support cost increases we have allowed this cost. In this respect, we have incorporated an £84m increase into our projections. Royal Mail has not provided sufficient evidence to support the remaining £78m difference between forecast and reported actual costs for 2004/05. The evidence Royal Mail has provided is of poor quality and internally inconsistent. Where information has been provided, it supports the notion that costs are non-recurring. On this basis, we have not incorporated the remaining increase into our projections.
- 2.23 The table below summarises our estimation of Base Year costs for 2004/05.

**Table 9: Royal Mail's 2004/05 Base Year costs**

2004/05 prices	2004/05
Operating costs per BPM2 v2.8 and Regulatory Accounts*	6,141
Base Year adjustments identified by Royal Mail from Table 7	-164
Disallowed/ unsupported / non recurring costs from paragraph 2.22	-78
Base Year costs for 2004/05	5,899

Source: LECG analysis. Note: \* Stated before Royal Mail Base Year adjustments

### 3 Baseline forecast

#### Introduction

- 3.1 In our August Report, Section 8 set out our methodology for projecting a Baseline level of operating costs. In this section, we consider Royal Mail's response to our estimate of Baseline costs. We first summarise Royal Mail's response to our initial conclusions. We then consider each of these points in turn, and provide an updated estimate of Baseline costs.

#### Royal Mail's response

- 3.2 Royal Mail's response to LECG's Baseline forecast is set out in Section 4 of its report<sup>10</sup>. Royal Mail appeared to accept the overall approach that LECG has adopted, but disagrees with some of the adjustments we made. Royal Mail stated that it is "*clearly beneficial to have a common understanding of the modelling methodology and assumptions*".<sup>11</sup> In terms of our initial adjustments, Royal Mail:

- accepted the removal of non-RML products and costs. Royal Mail's latest version of the BPM2 v2.8 (i.e. 10 October 2005) now excludes these costs, so this adjustment is no longer required;
- indicated that step changes should not have been removed from the Baseline cost projections. Step changes allow non-volume related cost projections to be modelled. Royal Mail indicated that there was no obvious reason these costs would not be assumed to continue over the planned period. We believe that Royal Mail has misunderstood our approach. Step changes were included, not removed, from our initial Baseline projection;
- argued that removing wage inflation in excess of RPI from the Baseline (as we had done) did improve transparency, but lost the automatic link between volume changes and related cost changes. Notwithstanding this, Royal Mail's latest version of the BPM2 v2.8 now treats wage inflation in

<sup>10</sup> Response to LECG's report on "Future Efficient Costs of Royal Mail's Regulated Mail Activities", Royal Mail, September 2005.

<sup>11</sup> Royal Mail response, paragraph 4.2

excess of RPI as a separate cost initiative. As such, an adjustment for this element is no longer required;

- did not accept the volume forecasts used in our projections, which were based on work performed by Frontier Economics. We understand that Frontier Economics will comment on Royal Mail's concerns separately;
- did not accept LECG's assumption of immediate cost phasing and indicated that further information was provided in its report to support its position; and
- argued that additional allowance should be given with respect to pension costs. This issue is addressed further below, but in principle we agree that an allowance should be made for pension levy costs and an increase in the ongoing cash contribution rate.

### **LECG Approach**

3.3 Other than the points discussed above, Royal Mail accepted the approach we adopted to estimating Baseline costs. In revising our Baseline forecast we have adopted the same approach. However, we have updated our analysis using Royal Mail's latest dataset, as contained in the latest version of Royal Mail's BPM2 v2.8 dated 10 October 2005. Our approach is explained in detail in paragraphs 8.3 to 8.15 in our August Report, and is not repeated here.

3.4 Given that the BPM2 v2.8 represents Royal Mail's current view of costs, we have used the data contained in the BPM as the basis of our cost projections. Royal Mail's own modelling is based on this dataset. Deriving the Baseline requires a number of adjustments to be made. Each adjustment is summarised below.

### **Base Year adjustments**

3.5 For modelling purposes operating costs must be stated in cash terms. The table below adjusts Royal Mail's forecasts for Base Year adjustments (as set out in our section on Base Year costs above).

**Table 10: Baseline after Base Year adjustments**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Royal Mail BPM2 2.8*	6,141	6,147	6,161	6,160	6,181	6,193
Baseline after LECG Base Year adjustments	5,899	5,905	5,919	5,917	5,939	5,952

Source: RM 2023a, BPM2 v2.8 (stated before initiatives) and LECG analysis. Notes: \* stated before any Base Year adjustments. Royal Mail subsequently updated its BPM to include Base Year adjustments.

### Non letters business and wage inflation

3.6 In our August Report, we removed Royal Mail's assumption of wage inflation in excess of RPI from the Baseline projections and added it back as a separate HR cost initiative, to increase transparency and to improve the link between operational savings and the costs of achieving them. Royal Mail has accepted this approach and within BPM2 2.8, wage inflation costs have been removed from their own Baseline estimate. Consequently, no adjustment is now required for this factor.

3.7 For our initial conclusions we also needed to make an adjustment for non-letters products, which were included in BPM 2.7. In the latest version of the BPM, these costs have been excluded. As such, no adjustment is now required.

### Step changes

3.8 Royal Mail has identified a number of "step changes" to 2005/06 costs, to ensure that total costs align with current forecasts for the remaining years of the current price control. The table below summarises the impact of these costs.

**Table 11: RM step changes**

Initiative (£m)	04/05	05/06	06/07	07/08	08/09	09/10
Step change	0	346	346	346	346	346
Compensation	0	(15)	(20)	(25)	(29)	(32)
Vehicle procurement	0	0	(20)	(33)	(42)	(46)
Pension costs	0	0	0	0	0	0
Total	0	331	306	288	275	267

Source: RM submission "initiatives\_BY 2004\_2005\_v 050905\_MAIN\_PSC.xls". All figures stated in 2005/06 prices. Positive costs reflect cost increases

- 3.9 The largest item in the table above is a suggested step change (permanent increase) in recurring costs<sup>12</sup> in 2005/06 of £346m – i.e. over and above what would otherwise be projected for 2005/06 on the basis of actual costs in 2004/05. The impact of this suggested increase would be to add some £1.3 billion to Royal Mail's required revenues over the four years of the next price control period.
- 3.10 We would expect Royal Mail to identify formally in its response to our August Report that it now believed that cost projections for 2005/06 were understated. However, it simply updated its models, without explaining that the cost base had been increased by an adjustment for £346m. Royal Mail's approach to this issue has lacked transparency.
- 3.11 We therefore asked Royal Mail to provide *comprehensive* support for this adjustment, given its scale. Royal Mail provided a very limited response<sup>13</sup> as set out below:
- FRS17 pension requirements amounting to £210m;
  - a revised London allowance pay deal accounting for around £10m;
  - a refinement to group allocations, which increases costs by £10m;
  - an allowance for volume growth of around £50m;
  - the full year impact of the HWDC project, which adds around £20m;
  - the full year impact of Single Daily Delivery;
  - the impact of changing the vehicle procurement policy, which increases depreciation and reduces lease charges;
  - the impact of allowing for higher fuel and other vehicle related costs; and
  - increases in property related costs.
- 3.12 No further information was provided, other than the one-line explanations given above. Again we would expect further detail on these items, given the scale of the proposed adjustment.

<sup>12</sup> Whilst Royal Mail did not formally submit that these costs were "cash" costs, there is some evidence to suggest that they have been modelled as such. For example, Royal Mail's model, PCRModel-Extension-jw5\_v150905@1213\_RPI+0,P0+8\_CENTRALCASE\_External.xls appears to include the step change in full in the setting of P0 and X, without an adjustment for non cash cost elements

<sup>13</sup> Royal Mail, BPM Base Year cost adjustments, 19 October 2005

- 3.13 Slightly more information on Royal Mail's projected costs for 2005/06 is contained within Royal Mail's Budget<sup>14</sup>. The budgeted increase in costs, however, is inconsistent with the step change increase described above. The budget includes only a £221m increase in expenditure between 2004/05 and 2005/06. The discrepancy is odd, and Royal Mail did not provide a reconciliation between the two amounts.
- 3.14 We have analysed the budget in detail, and it would appear that much of the increase relates to non-recurring costs (e.g. project costs and restructuring expenditure), non-cash costs (e.g. depreciation and IAS pension charges) and/or cost increases where specific allowances are provided elsewhere in the control (e.g. costs relating to volume changes, which are modelled explicitly and immediately within LECG's version of the BPM).
- 3.15 The table below summarises our conclusions with respect to Royal Mail's suggested step change increase in costs of £346m.

---

<sup>14</sup> Royal Mail Group Plc, Budget Proposal 2005-06, July 2005. Received final approval from Royal Mail Board on 5 July 2005

**Table 12: Step change between 2004/05 and 2005/06**

Area	RM	LECG conclusions
Pension restatement	£210m	Non-cash cost. FRS17 adjustment. Inconsistent with Hyman pension conclusions
Revised London Allowance pay deal	£10m	Potentially allowable though no details have been provided.
Refinement of group allocations	£10m	Ignore. LECG performed a comprehensive review of RM group allocation methodology and concluded that the resulting allocations were fair. This change has not been fully supported or justified and was not detailed in RM's budget
Volume growth	£50m	Ignore. Volume-related cost increases are already allowed for in Baseline modelling.
HWDC project	£20m	Ignore. Inconsistent with RM budget, which assumes savings of £5m relating to roll out of WAND.
Single Daily Delivery	Not stated	Ignore. Inconsistent with RM budget, which assumes that the full year implementation of SDD, Flats and MCR will lead to savings of £35m.
Vehicle procurement	~£30m	Change in lease policy will lead to a fall in lease charges. Royal Mail separately accounts for this as a cost initiative. The BPM identifies additional depreciation charges of £30m, which is a non-cash cost. No indication of the size of the reduction in lease payments was provided, but we assume that this amount was low given the reductions that happen in future years and the reductions that apparently took place in 2004/05. We are surprised that RM included vehicle lease reductions within this adjustment given that it accounts for this impact separately elsewhere in its submissions
Fuel charges	Not stated	Potentially allowable though no details have been provided. Budget includes similar point.
Property costs	Not stated	Potentially allowable though no details have been provided. Budget includes similar point.
Total <sup>1</sup>	~£346m	

Source: LECG analysis. Areas shaded in green highlight possible areas where step change increases may be justified.

- 3.16 Of the £346m increase, it appears that only the London Allowance, the higher fuel charges and property costs might constitute valid cost increases that would need to be accounted for using a step change adjustment. The other elements reflect non-recurring costs, non cash costs and/ or cost increases where specific allowances are provided elsewhere in the control. Analysis of the budget leads to broadly similar conclusions.

- 3.17 Royal Mail has not provided an indication of the scale of the step change increase in relation to fuel and property costs, although other specified items account for £330m, including the additional depreciation contained in BPM2 2.8, of the step change, leaving a residual difference of around £15m. The maximum amount that could be attributed to the fuel and property increases is, therefore, £15m - assuming that the suggested increase in single daily delivery costs is offset by the reduction in vehicle lease payments. Adding in the additional London allowance of £10m gives an overall potential step change of £25m.
- 3.18 We have therefore adopted a step change of £25m in costs for 2005/06 in our revised projections using BPM2 2.8.

*Compensation*

- 3.19 In determining a suitable level of Base Year costs, we believe that, as a general principle, it is inappropriate to include costs associated with penalties and compensation related to Royal Mail not meeting its quality of service targets. Royal Mail accepted this point.
- 3.20 Royal Mail assumed that improved quality and customer focus would significantly reduce the level of retail compensation in later years. We believe that the compensation step change noted in the table above includes reductions both in bulk compensation and in retail compensation payments. Given that we have already made an adjustment in respect of 2004/05 for bulk compensation, the further adjustment proposed by Royal Mail could include an element of double counting.
- 3.21 Royal Mail's BPM2 v2.8 includes a separate category of costs labelled "Product Compensation" totalling around £60m (in 2004/05 prices). We have scaled Royal Mail's compensation adjustment downwards to ensure the total compensation adjustment does not exceed the opening compensation cost – i.e. to ensure that compensation payments are not reduced below zero. This is consistent with the approach taken by Royal Mail in BPM 2.7.

*Vehicle procurement*

- 3.22 Royal Mail has changed its vehicle procurement policy to one of buying rather than leasing. We do not discuss the merits of the change in policy here.

Elsewhere<sup>15</sup> we have incorporated the effects of this change in policy into our projections, albeit with reduced levels of capital expenditure to ensure revenue neutrality. We have modelled the resulting reductions in lease costs as part of the revised baseline, rather than as an individual efficiency initiative.

*Pension related costs*

- 3.23 We understand that a change in investment mix is expected to increase the ongoing cash contribution rate from 12.6% to 13.8%. Royal Mail believes that this increase should be included in the forecast Baseline. We agree with this treatment. Hymans Robertson, Postcomm's pension advisors, has estimated that this would increase the annual cash contribution by about £40m in 2006/07.
- 3.24 Similarly, the impact of PPF levy payments is not included in the Base Year. Royal Mail believes that the Baseline should also be adjusted for this. Again, we agree with this treatment. Hymans Robertson has estimated that this would increase costs by about £16m in 2006/07.

*Overall adjustments*

- 3.25 The matters discussed above require a number of "step change" adjustments to 2004/05 costs, to ensure that projected costs are properly aligned with current forecasts for the remaining years of the current price control. The table below summarises our conclusions as to the required adjustments.

**Table 13: LECG step changes**

<b>Initiative</b>	<b>04/05</b>	<b>05/06</b>	<b>06/07</b>	<b>07/08</b>	<b>08/09</b>	<b>09/10</b>
Step change	0	25	25	25	25	25
Compensation	0	(15)	(20)	(20)	(20)	(20)
Vehicle procurement	0	0	(20)	(33)	(42)	(46)
Pension costs	0	16	56	56	56	56
<b>Total</b>	<b>0</b>	<b>26</b>	<b>42</b>	<b>29</b>	<b>19</b>	<b>15</b>

Source: LECG analysis. All figures stated in £'ms, 2005/06 prices. Positive costs reflect cost increases

- 3.26 The table below adjusts Royal Mail's projections for Base Year adjustments and step changes.

<sup>15</sup> Refer to our report "Future Efficient Costs of Royal Mail's Regulated Mail Activities, Bottom-up Review of Royal Mail's Strategic Plan: Final Conclusions"

**Table 14: Baseline after Base Year adjustments and step changes**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Baseline after Base Year adjustments from Table 10	5,899	5,905	5,919	5,917	5,939	5,952
Baseline after Base Year adjustments and step changes	5,899	5,931	5,961	5,946	5,958	5,967

Source: RM BPM2 v2.8 and LECG analysis.

### Volumes

- 3.27 Postcomm engaged Frontier Economics to undertake a volume projection of Royal Mail's inland product volumes at the SPHCC level over the price control period. Frontier Economics has provided LECG with a replica template of Royal Mail inland volumes for inclusion in the BPM. We have forecast operating costs based on two different volume scenarios: Royal Mail's projection of volumes, and Frontier Economics' projections of volumes.
- 3.28 The table below summarises the two volume scenarios at the letters business level. Whilst total volumes are similar, Frontier Economics' volumes are slightly lower in each year of the price control. However, there are also significant differences in product mix: Royal Mail assumes, for example, that Access volumes will reach some 5 billion items by 2010/11, while Frontier Economics' equivalent figure is 4.5 billion items.

**Table 15: Projected volumes in millions**

	2005/06	2006/07	2007/08	2008/09	2009/10
Royal Mail BPM2 v2.8 volumes	25,114	25,167	26,183	26,437	26,337
Postcomm/Frontier Economics volumes	24,926	24,797	25,934	26,281	26,443

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005

- 3.29 The table below summarises Baseline costs adjusted for Base Year adjustments and step changes under the two volume scenarios.

**Table 16: Adjusted Baseline costs using RM's central case volume forecast and Postcomm's forecasts**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Adjusted Baseline assuming RM volumes (from Table 14)	5,899	5,931	5,961	5,946	5,958	5,967
Adjusted Baseline assuming Postcomm/Frontier Economics volumes	5,899	5,931	5,940	5,896	5,897	5,903

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005

### Cost elasticity

- 3.30 Royal Mail indicates that it has a cost elasticity equal to 60%<sup>16</sup>. A cost elasticity of 60% implies, for example, that for a 10% increase in volumes, operating costs would change only by 6%. Royal Mail states that its cost elasticity "*factors have been developed over time and during a period of growth*" but believes "*that the validity of these factors remain... but within reasonable limits of volume movement, either increase or decrease*"<sup>17</sup>. In our August Report, we accepted this elasticity estimate, and continue to do so.

### Phasing

- 3.31 Royal Mail assumes that costs take three years to fully respond to a change in volume, with no change in costs in the year the volume change takes place, 50% of the full cost impact making itself felt in the following year, and the full cost impact felt only in the second year. For example, for a volume decrease of 10%, Royal Mail assumes that there will be no cost reduction within the year of the volume change. In the following year, Royal Mail assumes that costs fall by 3%, (i.e. 10% volume change x 60% cost elasticity x 50% phasing), and in year three, costs fall by a further 3% to give the full 6% cost decrease.

<sup>16</sup> Comparative analysis and trend analysis efficiency paper, RM, page 14, reference 3106

<sup>17</sup> RM 9003. RM refers to cost elasticity in terms of LRMC factors. We note that further support/explanation is provided in document RM 2049

- 3.32 When volume changes are forecast to be significant, this assumption has a material impact on costs compared to an assumption that costs change immediately in response to volume changes<sup>18</sup>.
- 3.33 In document RM 2049 Royal Mail confirms that no detailed studies have been carried out to underpin this assumption. The assumption is based on the specific experience of operational managers – and reflects a pragmatic approach based on “*it is believed, realistic and prudent assumptions*”. Royal Mail put forward a number of factors in support of its assumptions, which are set out in paragraph 8.27 of our August Report.
- 3.34 To determine whether there are any precedents for Royal Mail’s assumptions we performed a benchmarking exercise across other regulatory determinations. Our findings are set out in paragraph 8.28 of our August Report.
- 3.35 Overall, we found that Royal Mail’s arguments were not compelling and concluded that their combined assumptions on cost elasticity and phasing result in costs that have too high a level of fixity. Our reasons are set out in paragraph 8.29 of our August Report.
- 3.36 We noted that it is also important to consider the size of the volume increment or decrement, and whether the change could be foreseen or not. We accepted that for significant and unforeseen changes in volume, it might take Royal Mail a longer period to adjust costs. For smaller changes that can be foreseen, however, we would expect costs to be more immediately variable in nature (because the changes can be planned for in advance). We explained why we thought Royal Mail fell into the latter category in paragraph 8.30 of our August Report.
- 3.37 In response, Royal Mail provided limited additional information to support its phasing assumptions. It argued that we have not considered the practical issue of accurately forecasting volume changes, and argued that its labour force is not flexible, even though it has high levels of staff turnover, overtime and casual labour. With respect to this specific response, Royal Mail has not introduced any new or robust evidence, and we remain unconvinced of its case. On this matter

---

<sup>18</sup> At the “margin” (i.e. for an increment/ decrement of one mail item) costs are unlikely to respond in this manner. We focus on incremental changes rather than marginal changes

Postcomm has indicated that Royal Mail needed to provide quantitative support for its assumption.

- 3.38 In a separate response<sup>19</sup>, Royal Mail re-stated that it has not performed such analysis and that its phasing assumptions are drawn from its operational experience. Royal Mail argued that there is some evidence that other regulated businesses and regulators recognise that the phasing of volume and cost changes could be an issue. Royal Mail indicated that the ORR and Network Rail are currently undertaking more work on this issue, but that the issue is still being investigated by both parties. Royal Mail also indicated that Oftel in the past considered whether the relationship between volume and cost within a price control period might differ from the longer run relationship. Whilst Oftel consulted on the issue<sup>20</sup>, our understanding is that Oftel did use the long run estimates for setting prices. This understanding is consistent with the information that we have received from Ofcom, stating that costs are linked to volumes by means of cost and asset-volume elasticity that generally take effect within the year of the volume change.
- 3.39 We agree that phasing needs to be properly considered, and we have repeatedly asked Royal Mail to provide robust evidence in support of its assumptions. Royal Mail has however provided only limited qualitative support – to the effect that its phasing assumptions are based simply on its operational experience. If Royal Mail had put forward more robust support, we would have considered it.
- 3.40 Absent such support, we continue to believe that costs will respond more quickly to changes in volume than Royal Mail's approach implies. Based on the evidence that we have reviewed, we believe that it would be reasonable to assume that costs change immediately with changes in volume.
- 3.41 We have considered the sensitivity of Baseline costs to different assumptions on cost variability. In our first scenario, we assume that cost changes would be phased 50:50. That is, cost savings would occur one year earlier than Royal Mail assumes. Under the second scenario, we assume cost changes occur

---

<sup>19</sup> Phasing of volume and cost changes, 2 November 2005

<sup>20</sup> Oftel (1996), 'Network Charges from 1997—Consultative Document', Chapter 5: Financial Modelling: Calculation of the Initial Charges and X'.

immediately. Under both scenarios, we take the cost elasticity in Royal Mail's BPM as given.

- 3.42 The table below shows the impact of our assumptions on our Baseline projection, assuming Postcomm's central case volumes. The Baseline includes the cumulative adjustments made above and shows both phasing scenarios.

**Table 17: Adjusted Baseline costs for phasing using Postcomm's central case volume forecast**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Adjusted Baseline assuming Postcomm volumes and RM phasing (from Table 16)	5,899	5,931	5,940	5,896	5,897	5,903
Adjusted Baseline assuming 50:50 phasing	5,899	5,919	5,903	5,900	5,901	5,844
Adjusted Baseline assuming immediate phasing	5,899	5,908	5,877	5,929	5,875	5,811

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005, and LECG analysis, adopting different cost elasticity phasing and volume assumptions

- 3.43 The impact of the phasing assumption depends on the direction of volume change, as well on mix effects. Although volumes increase across the period under both Royal Mail's and Frontier Economics' volume forecasts, the effect of mix variances means that the effect of phasing assumptions varies from year to year. Overall, forecast costs are lower if phasing assumptions are more immediate.

### **Baseline conclusions**

- 3.44 The Baseline adopted in this report is summarised below. The forecast is based on Frontier Economics' central volume case. We have adjusted costs in the Base Year. We have assumed that costs change immediately with respect to changes in volume.

**Table 18: LECG Baseline operating costs for RML**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
LECG Baseline operating costs	5,899	5,908	5,877	5,929	5,875	5,811

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005, and LECG analysis

3.45 The overall trend in costs can be assessed in unit cost terms as follows.

**Table 19: LECG Baseline unit operating costs for RML**

2004/05 prices	2005/06	2006/07	2007/08	2008/09	2009/10	CAGR
LECG Baseline	0.237	0.237	0.229	0.224	0.220	(1.9%)

Source: LECG analysis

3.46 The profile suggests that unit costs will fall by 1.9% per year in real terms over the period of the price control. This change does not relate to a change in productivity. Changes in volume ("the volume effect") and changes in product mix ("the mix effect") explain most of the reduction in unit costs<sup>21</sup>.

3.47 Baseline costs for the regulated business are stated below. We have adopted the same methodology to derive these costs as stated in our August Report.

**Table 20: LECG Baseline operating costs for the regulated business – final proposals scope**

2004/05 prices and £m	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
LECG Baseline	5,393	5,409	5,354	5,399	5,334	5,265

Source: RM BPM2 v2.8 and Frontier Economics' volume submission of 16 November 2005, Postcomm and LECG analysis. The regulated business is as defined in Postcomm's final proposals.

<sup>21</sup> In other words, on a volume and mix-adjusted basis the Baseline would show no change in unit costs over the price control period