

Annual Report 207-18

Contingent Liabilities Disclosure – Part II

CONFIDENTIAL AND SUBJECT TO LEGAL PRIVILEGE

Summary

1. Ernst & Young are considering the extent of the proposed disclosure in Note 19 of Post Office's 2017-18 Accounts relating to the Postmaster Litigation. This has been considered by the Post Office Limited ('POL') Board Audit & Risk Committee ('ARC') and the proposed draft disclosure approved by that Committee is set out in **[Appendix 2]**.
2. A paper explaining the rationale behind that wording was presented to Ernst & Young on Wednesday 11 July 2018. By email dated 12 July from Peter McIver, POL was requested to provide further information to its internal Review Panel. This paper addresses the issues underlying those questions and where available, answers to the specific questions have been included in **[Appendix 1]**.

Horizon

3. The Horizon system is the point of sale system operated by POL across all branches. It was developed by Fujitsu in 1995 and has been subject to a series of upgrades since that time.
4. Key statistics:
 - 500,000 users since it was introduced in 1995, serving millions of customers;
 - 78,000 users successfully process six million transactions every working day in communities throughout the UK, across 11,500 branches and by 8,000 agents.
 - POL handles £70 billion cash and £636 million coin every year.
5. As part of POL standard operations Horizon is constantly monitored and managed, with numerous checks and independent audits including:
 - Ernst & Young produce an annual ISAE3402 service auditor report over the Horizon processing environment;
 - Each year Horizon is subject to ISO27001 certification –the industry standard security accreditation; and
 - Horizon is accredited to Payment Card Industry Data Security Standards on an annual basis.

Background to the Litigation

6. Complaints regarding the reliability of Horizon were made by postmasters as early as 2012 through the sponsorship of James Arbuthnot MP. In response to these

claims, POL initiated a number of investigations, including by forensic accountants Second Sight whose interim report in July 2013 stated 'We have so far found no evidence of system wide (systemic) problems with the Horizon software'. Alan Bates – one of the lead claimants in the litigation, stated to the BIS Select Committee in February 2015:

"The whole point of the scheme-it is not purely the software that we are talking about. Everyone seems to homing in on the computer system. It is about the support package that works with it. It is the training and the lack of investigation".

7. In 2013 POL announced the establishment of a Complaint Review & Mediation Scheme and invited postmasters to register with the Scheme. Under the Scheme, applicants whose cases had not been subject to a court ruling, had their cases investigated at POL's cost and were then invited to mediate with POL, and the mediation was independently facilitated by CEDR.
8. The following table summarises the outcome of the Scheme:

Applications to the Scheme		150
Applications rejected (ineligible)		4
Cases resolved prior to entry into the Scheme		10
Cases accepted into the Scheme		136
No. of cases not suitable for mediation: 48	Cases POL found unsuitable for mediation	42
	Cases the WG found unsuitable for mediation	2
	Cases closed owing to a missing / ill applicant	4
Residual		88
No. of cases suitable for mediation: 88	Cases resolved during investigation	5
	Cases resolved prior to mediation meeting	4
	Cases resolved at mediation	22
	Cases not resolved at mediation	22
	Cases referred to CEDR for mediation by POL which could not be resolved due to actions of the Applicants such as unilateral withdrawal or refusal to attend mediation meetings.	35
Residual		0

9. 43 of the Postmasters who had registered for the Scheme had criminal convictions which therefore could not be addressed through mediation as only the criminal courts have authority to overturn a conviction.
10. Claimants in the schemes were requested to quantify their claims, although this was not required to be done to the same standard as would be required for a Court process. The resulting aggregate financial claims sought by the scheme claimants exceeded £65 million. The largest single claim was for £13 million, and over 20% of the applicants each made claims in excess of £1 million. The aggregate losses from branches operated by the 136 applicants in the Scheme totalled £1.28 million. Of the 26 cases resolved through mediation, 14 resulted in ex gratia payments totalling £131,000 with payments ranging from £461 to £50,000.

11. Since 2016 the Criminal Cases Review Commission ('CCRC') has been reviewing the convictions of some [33] former postmasters. Prior to 2014 there were, on average, 40 prosecutions brought each year. The majority of these relate to the period during Royal Mail's ownership; there have been very few prosecutions since 2014. POL has actively cooperated with the CCRC enquiry supplying over [100,000] documents. The CCRC has recently advised POL that it does not expect to complete its review until at least April 2019.
12. Postmaster complaints about Horizon have been the subject of significant press coverage and investigation since 2013 including The One Show, Today Programme, BBC Local Radio and Panorama, as well as print and specialist press including Computer Weekly.
13. There has been significant parliamentary coverage of the issues as well as a Westminster Hall debate in December 2014, and a BIS Select Committee in February 2015. There has also been significant enquiry from UKGI and BEIS.

Current Position

14. In early 2016 Freeths solicitors issued proceedings against POL on behalf of a number of postmasters. These proceedings are now being heard pursuant to a Group Litigation Order (the UK version of a 'class action') through which the claims of 561 claimants will be assessed. To date we have only had high level details of the majority of the claimants, with more detailed claims being received in relation to a pool of [12] claimants from which the 6 lead claimants were selected. The group of claimants includes:
 - both current and former postmasters;
 - postmasters with criminal convictions;
 - postmasters who have been declared bankrupt;
 - POL employees, and
 - employees (assistants) of postmasters.

The common theme among the claimants (although not universal) is that they were required to repay shortfalls occurring in their branches; in many cases this resulted in postmasters being terminated and in some cases, prosecuted.

15. In order to manage the litigation, the Court has mandated the following:
 - a 4 week trial in November 2018 to determine as matter of legal interpretation the proper construction of the contract between POL and postmasters, and the meaning of key terms (the 'Common Issues trial'). Put simply, this requires the Court to make a legal decision as to whether any additional terms should be implied into the current contracts in order for those contracts to operate effectively as between POL and each postmaster. Although there are 6 'lead cases' which will be used to demonstrate the contractual terms, no findings of fact will be made as part of this trial as to whether POL breached any of the terms of the contract, nor will any of the 6 claimants be required to provide details of the losses allegedly incurred as a result of POL's actions;

POST OFFICE

PAGE 4 OF 8

- a 4 week trial in March 2019 to consider whether the Horizon System operates as it should. This case will rely on expert evidence and the outcome will be findings of fact; and
 - Between the two trials, the parties will be expected to attempt mediation to determine whether agreement or settlement could be reached on any of the issues raised by the claimants.
16. Following the decision in the Horizon trial (and possibly before) the Court will set out how it expects the issues raised by the various claimants will be addressed through the Courts. This is likely to involve one or more trials in which claimants will have the opportunity to put the legal basis on which they argue POL has breached the contract (in light of the decision in the November trial), the damages suffered as a result of that breach and to quantify the loss suffered as a result.
17. Given that the range of complaints raised by the postmasters to date is very wide and encompasses a number of potential causes of action, we do not believe that we will receive any indication of the potential damages sought by the claimants (either individually or collectively) until after receipt of the decision in the Common Issues trial, and potentially not until after receipt of the decision in the Horizon trial
18. POL is actively defending the action. It believes that in many cases there are operational reasons to explain in branch losses, however due to the nature of branch operations, only the postmaster (or his employees) will be able to explain how the loss occurred. Where a postmaster seeks to hide or cover up losses (eg through false cash declarations), then POL has no way to determine the cause of the loss.
19. POL's response to operational losses varies according to the circumstances however there are guidelines as to how losses should be addressed. Responses include allowing the postmaster to repay shortfalls (or have them repaid via deductions from remuneration); suspension while the cause of the loss is investigated, and depending on the cause and materiality of the loss, termination. POL seeks to recover losses from terminated postmasters through debt collection.
20. In 2017-18 £xm was identified as missing, £xm paid back, £xm being paid back and everything else was 100% provided for.

Jane MacLeod

General Counsel & Company Secretary
[] July 2018

APPENDIX 1
Specific responses

	EY Question	POL Response
1.	What analysis has POL undertaken to date to determine the population of Postmasters affected, both in number of Postmasters and quantum/value of the claim?	<p>There are 561 claimants in the Group Litigation. These include c120 current postmasters. There are currently c 8000 postmasters some of whom are companies, others have multiple post offices, and others operate single post offices. Since 2000 there have been c[] separate postmasters. Accordingly the number of claimants represent a very small percentage of the total number of current postmasters (120/8000) and an even smaller percentage of all postmasters since the introduction of Horizon.</p> <p>As set out in paragraphs [16 and 17] there has been no quantification of claims to date, and we do not expect to be able to estimate the total claims with any reliability until receipt of further particulars of claim specifying the damages sought, and this is unlikely before at least early 2019</p>
2.	Do POL have a record of the number of postmasters terminated over time that may be possibly part of this claim (and possible future claims) or a list of all Postmasters who were terminated for breaching their contracts?	No
3.	Do POL have an idea of the value or quantum of money that was owed by these Postmasters when a termination was sought?	No

POST OFFICE

PAGE 6 OF 8

	EY Question	POL Response
4.	Do POL have a record of how much money if any has been collected or has not been collected from these postmasters as part of the terminations above?	No, however the aggregate amount owing from former postmasters [and which is subject to debt collection processes][and shown in our accounts] is c£[]
5.	Are there any receivables or payables carried in POL's books for these amounts?	See Q4
6.	Has any amount been paid out by POL in the event of differences from Horizon (or Fujitsu) to postmasters who were terminated as per above? Do POL have a record of such amounts/value involved?	POL does not have these records, however it is unlikely that POL would have made any material payments to postmasters where the postmaster was summarily terminated for breach of contract.
7.	Prior to the case, we understand there was mediation and possibly some settlements made – can we have the full number and value of those please?	£131,000 as set out in paragraph [10].
8.	You have mentioned some cases may be time barred now – do we have an analysis of those or others?	No. Whether any particular case will be time barred will depend whether the Court accepts the basis of their claim against POL.
9.	Similarly some instances where there was legal proceedings against the individuals an analysis of them please?	In light of the information already provided, please explain what kind of information is anticipated by this question.
10.	How many terminations of postmasters were subsequently replaced by alternative postmasters?	POL seeks to keep post offices open wherever possible in order to maintain services to customers within local communities. Where a contract is terminated there are a variety of options that POL can implement including, with the consent of the landlord, appointment of a replacement or temporary operator. Due to the length of time covered by the litigation, it is not possible to provide a definitive answer to the question.
11.	What were the key contractual terms under which these terminations occurred and the general reasons for termination?	The contract provides for termination in a variety of situations and notice of termination may be given by either the postmaster or POL. Postmasters may be terminated by POL on minimal notice

	EY Question	POL Response
		for breach of their contract. The exact wording of these terms has varied over time.
12.	What is the level of analysis undertaken by in house legal/ external lawyers on the terms of the contracts i.e. are they relevant/water tight and the resulting strength of POLs position?	There are a number of variations of the standard contract depending on the status of the postmaster (company, sole trader, multiple branches etc and the type of branch operated (mains, local etc). Core provisions are broadly similar, although there have been changes to the contract language over the period since Horizon was introduced. The original standard contract terms and any subsequent changes were drafted by external lawyers. The process for amending the standard contract involves consultation with the National Federation for Sub-Postmasters.
13.	Have any experts been used by POL to report on the functioning of Horizon and Fujitsu to date? What was the outcome of that?	Yes – beginning with Second Sight in 2013. No systemic problems have been identified.
14.	What is the historic trend in terms of the accuracy of the reporting from Horizon? Any assessment made to date on its robustness?	<p>POL believes that Horizon does accurately record transactions in accordance with its design. As stated in paragraph [4], there have been c500,000 users since Horizon was introduced in 1995. Over 78,000 Horizon users successfully process six million transactions every working day across the UK in 11,500 branches and by 8,000 agents and [] employees in directly managed branches.</p> <p>As stated in paragraphs [6] and 18] above, and as reported by Second Sight as far back as 2013, in the vast majority of cases losses can be attributable to human interactions.</p>

APPENDIX 2

Draft Disclosure regarding Contingent Liability (note 19)

Following the meeting on 28 June, the draft disclosure was revised and reviewed by ARC members. It is now proposed that the following text be included in Note 19 in relation to the Postmaster litigation:

"On 11 April 2016, a High Court claim was issued on behalf of a number of postmasters against Post Office in relation to various legal, technical and operational matters, many of which have been the subject of significant external focus for a number of years. Post Office is defending the claim and welcomes the opportunity to have these matters resolved through the Court managed Group Litigation Order.

The Court has ordered two trials to be heard in 2018-19 to determine a subset of the preliminary issues in dispute between the parties. The Court has not yet ordered a process for determining any issues of liability or quantum. To date, the Claimants have not asserted the aggregate value of their claims in any of the Particulars of Claim filed in the litigation.

While the Directors recognise that an adverse outcome could be material, they are currently unable to determine whether the outcome of these proceedings would have a material adverse impact on the consolidated position of the Group, and are unlikely to be able to do so until the Court has made further determinations and the Claimants have provided the necessary information about the value of their claims. The Directors continue to keep this under close review."