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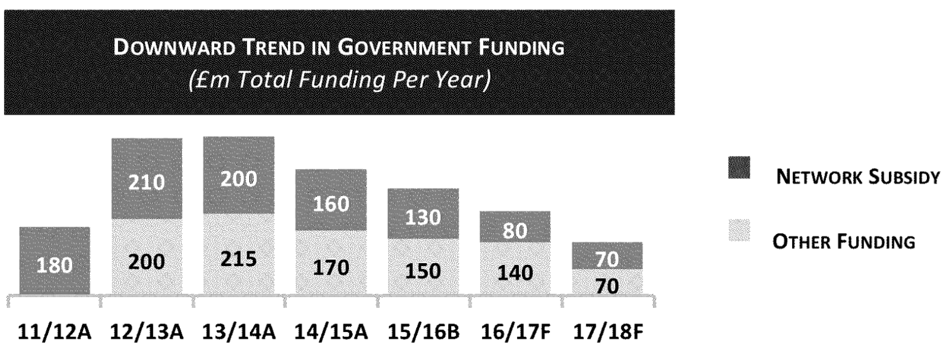
Post Office: Introductory brief

KEY FACTS

Post Office Ltd (POL) is one of the largest retailers in the UK, operating a network of around 11,600 branches. More than 18 million customers – including c.30% of UK small businesses – visit a branch each week. It separated from Royal Mail in April 2012 and now operates as an independently managed and governed business. It is wholly Government owned.

In 2015-16 POL generated a pre-subsidy revenue of £870m, made up of Mails and Retail (c.43%), Financial Services (c.34%), Government Services (c.11%) and Telephony and Other (c.11%). Over the same period it generated an operating loss of c.£25m or, including Government subsidy of £130m, an operating profit of c.£105m.

POL is subsidised by Government to maintain a network above an optimally commercial size. Government also provides investment funding to transform that network to make it more efficient and thereby less reliant on taxpayer support. As the graph below shows, subsidy has declined from a peak of £210m in 2012, to £80m this year.



All Government funding is State aid – the funding to 2018 has been approved by the European Commission. We are in the early stages of discussions with POL to agree their funding post-2018, which under the existing arrangements (and Brexit notwithstanding) will then need to be approved by the Commission – see below.

Out of a network of around 11,600 branches, the majority (over 97%) are operated on an agency or franchise basis (operated by independent business people (postmasters), or large retailers / multiples (e.g. WHSmith or Costcutter)). Only around 300 offices are owned and operated by POL; these are known as Crown branches.

POL directly employs c.6,600 people and is indirectly responsible for the employment of c.53,500 more (i.e. postmasters / retailer partners and their employees). Around 1,300 direct employees currently work in POL's cash "supply chain" which is responsible for moving c.£24bn each year of cash and coin to support POL's branches and third party clients (changes are proposed, see below). It is the UK's third largest cash logistics operation.

BEIS ROLE

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The BEIS Secretary of State is the sole shareholder of POL, and UKGI manage that shareholding for BEIS, representing Government as POL's shareholder and with a position on the Board. UKGI also acts as a voice/guide for POL within Government (e.g. on political and commercial issues, where appropriate) and it maintains relationships with key Departments such as HMT, Cabinet Office and DWP.

As well as funding, BEIS provides a £950m working capital facility for POL on commercial terms.

POL's operations and Government policy and funding apply to the whole of the UK.

POLICY AREAS

Government's policy on the Post Office is to set the parameters within which we expect it to operate (reach of network, types of services it should seek to offer) and then allow the business to operate commercially, at arms-length from Government. POL is a public corporation with a fiduciary Board, chaired by Tim Parker (an experienced commercial Chair, appointed in October 2015). Operational decisions are made by the CEO, Paula Vennells, and her executive team, supported by the Board. CFO Al Cameron, who you are meeting, is the other Executive on the Board.

Ownership

Under legislation (Postal Services Act 2011) POL may only be 100% publicly owned, or it can be transformed into a mutual organisation. UKGI have looked at alternative ownership options but it is important that this is considered alongside POL's work on strategy and its ambitions to build a commercially sustainable organisation. We do not believe Ministers have any appetite at present to consider a change of ownership of POL.

Services and Long Term Strategy

POL's long term strategy is focused on reducing its reliance on taxpayer support through reducing costs and growing revenues, whilst maintaining its network at its current size.

Mails is a key source of revenue with POL offering Royal Mail products exclusively in its branches under a 10 year commercial contract agreed in 2012. In financial services POL is seen as one of the leading challengers to the High Street banks and in recent years it has delivered significant growth in new personal financial services, albeit alongside declines in more commoditised transactional services. POL has also recently been working with the British Bankers Association (BBA) and the high street banks to develop a standardised offer that will enable banks' consumer and business customers to make withdrawals, deposits and check balances at all of POL's branches. Confidentially, POL expects to launch this standardised offer in January 2017.

Government Services revenue is declining, mainly due to contracts being won on less favourable terms and customers' increasing switch to digital transactions. Government cannot legally award contracts directly to POL (they have to be awarded in open and fair competition), although POL have won a framework contract with Government already in use by several departments.

Network

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POL receives Government funding to maintain network size and reach, in line with policy, and to deliver Network Transformation (NT), a 6-year strategy to modernise the vast majority of the 8,300 “addressable” agency branches. Thousands of post offices have received investment to extend opening hours and improve branch environments, while moving agents onto more commercial contract terms and removing fixed payments. These changes are making branches more viable and, importantly, allowing POL’s costs to be varied and reduced. Since implementation began in 2012 over 6,400 branches have been transformed and over 800 more have signed contracts to do the same.

The NT programme is due to complete by March 2018 and good momentum continues to be maintained as the programme now starts to move towards targeting the remaining uncommitted branches and close out. There are likely to be approx. 500 branches which cannot (or which choose not to) transform under NT. To reflect the reducing activity being undertaken as NT nears its conclusion, POL are now beginning to scale down the staff required to deliver the programme (from just over 600 to 50 by the end of March 17).

POL have also used their Government funding to transform their Crown (directly owned) branch network, and have cut losses in that network from c. £45m p.a. in 2012 to nearing break even. However more work needs to be done to ensure the network is placed on a long-term sustainable footing. In recent months POL announced a number of plans to franchise in total around 60 of its Crown branches to partners such as WHSmith and to move to a host model for another 33 (i.e. where the branch would sit within another shop but would still be run by POL). POL conducts local consultations on any proposed changes. Potential changes to the network have generated concern from the public and MPs; POL has a great deal of experience handling these and after changes take place they are usually well received.

Finally, over 3,000 branches are classified as “Community Branches” (typically the last shop in a community – usually rural or urban-deprived areas), many of which would be unsustainable if they transformed given their reliance on fixed rather than variable payments. They are therefore exempted from the Network Transformation programme and means they will continue to receive a fixed payment to keep them running. They can also benefit from a £20m branch improvement fund, which will ensure they are secure for the future – helping to meet the manifesto commitment to “secure 3,000 rural post offices”.

<u>Pensions</u>

Post Office still operates a defined benefit pension scheme for c3,000 employees. Whilst this is currently in surplus, that surplus is eroding quickly and management have asked the Pension Trustees to consider the scheme’s closure. This has angered unions, and a decision from the Trustees is expected in the next few weeks.

<u>Cash supply chain</u>

POL’s cash supply chain currently services both the Post Office branch network and a number of external clients (e.g. Mothercare, Aldi). POL has now formally served notice that it will cease to provide these services to third party businesses. As these were

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unprofitable, this allows POL to make a number of efficiencies in the supply chain including closing several depots, with approx. 600 staff redundancies (i.e. c.46% of the division's staff). These changes will not affect post offices or their customers.

Industrial relations

POL's agents (postmasters) are represented by the National Federation of Subpostmasters (NFSP). The NFSP receives funding from POL and is recognised to negotiate on postmasters' behalf.

POL's directly employed personnel – predominantly staff in Crown branches and the cash supply chain – are represented by the Communication Workers Union (CWU) for non-management grades and Unite Communication Managers Association (CMA) for management grades. Union representation is high across the business. Industrial relations, which have historically been variable, are currently fractious given POL's proposed reforms to the Crown branch network and cash supply chain, as well as proposed changes to POL's pension scheme, and both unions have recently taken strike action.

Other issues

Following complaints from a small number of sub-postmasters regarding the POL's Horizon IT (point of sale) system, an investigation was undertaken by an independent firm, Second Sight, over two years. Whilst this received relatively high profile press attention, no systemic issue with Horizon has been found. However, affected sub-postmasters continue to put pressure on POL, the Criminal Cases Review Commission (CCRC) are considering some cases where individuals have received criminal convictions, and group civil litigation is being launched against POL in the High Court.

Funding Negotiations

Between April 2011 and March 2018 POL will have received almost £2bn funding from government, to maintain the post office network and to invest in a modernisation programme designed at reducing long term subsidy. This subsidy has been declining on a steady trajectory since 2012.

In October UKGI officials will be entering into funding discussions with POL regarding the support the network will require for the period after March 2018, when the current agreement comes to an end. A new deal needs to be concluded in early-2017 at the latest to allow 12 months for a state aid notification process with the European Commission. As part of refreshing the evidence base to support any future state aid requirements, UKGI will be running a public consultation on the Post Office's network to endorse (ideally) the current shape, size and key services provided.

POL is still developing the strategy that will support its funding request, but early indications suggest that the business will continue to require subsidy to maintain its network, and a decision will need to be made by Government as to whether to support further transformation activities and specific commercial investments to consolidate the progress made so far towards commercial sustainability.

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POL is likely to submit a request for a 3-year period (i.e. 18/19, 19/20 and 20/21), and for the first two years its "ask" will be greater than the amount understood to have been allocated in the SR (i.e. £60m in 18/19 and £50m in 19/20). It is worth noting that during the SR process, it was clearly flagged to HMT that funding discussions would open in 2017, given that 2015 was too far away from the post-2018 funding period to offer any forecasting certainty at that time. POL's current funding package was agreed outside the SR process.

UKGI officials have already engaged with BEIS Finance and HMT regarding POL funding and will continue to do so as the process develops in the coming months. Like previous processes we will work to make this as open and collaborative as possible.

<u>CFO AL CAMERON</u>

Al joined POL from British Gas in January 2015, and since then has strengthened the finance function in difficult circumstances (inheriting sub-optimal financial controls, ambitious cost challenges and transformation programmes, and flat revenues).

Given the level of funding and the working capital facility that BEIS provides, Al requested to meet with your predecessor twice a year to build and maintain a relationship with BEIS Finance directly, as well as UKGI. This has proven helpful, particularly with some of the difficult issues that have arisen over the past year (e.g. strikes, pension closure plans, accounting errors etc). We expect Al would welcome a similar approach with you, particularly with new funding discussions to be held over the autumn.