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OFFICIAL SENSITIVE - COMMERCIAL

Date: 11 February 2022
From: David Barnett – GRO / Ed Emerson GRO
SCS clearing: Tom Cooper – GRO

Recipient	To Note / Comment	To Approve / Decide
Minister Paul Scully	X	
Permanent Secretary		X
Special Advisers (SpAds)	X	

POST OFFICE LIMITED ("POL") BUDGET FOR 2021/22 AND RELEASE OF NETWORK SUBSIDY AND NETWORK INVESTMENT FUNDING

Summary

1. As part of the Funding Agreement entered into to fund POL for 2021/22, Network Investment and Network Subsidy payments are due to be paid periodically in-year from BEIS to POL.

2. IRRELEVANT of funding due to POL has been withheld in 2021/22, following the recommendation of officials in May 2021, because of the absolute scale, inadequate control and forecasting of legal costs. The IRRELEVANT includes: Network Investment IRRELEVANT, due 1/10/21) and Network Subsidy (3 payments of IRRELEVANT due 1/7/21, 1/10/21 and 1/1/22, 2022). For prior submissions on this matter, please see Annexes A-D.

3. BEIS and UKGI officials have been working intensively together with the company to challenge and improve POL's legal cost controls and forecasting such that POL can present a 2021/22 budget that could be approved by BEIS. After considerable effort and engagement some reductions in legal costs have been obtained, albeit offset by other unforeseen costs, and there has been some improvement in PO's oversight.

4. The position remains unsatisfactory however and this note puts forward options for dealing with the funding that has been withheld in the current financial year and the legal costs issue. It is recommended that POL's budget for 2021/22 is approved so that funding can be released before the end of the financial year.

Recommendation

5. **To release the IRRELEVANT of withheld funds to POL** alongside clear commitments from Management about the further work and collaboration needed in managing legal cost. Options 2 and 3 at paragraphs [30] and [31] set out different approaches to this.

Timing

6. A decision by close 23 February is requested allow orderly payment in line with the BEIS cash forecasting assumption (payment on 8 March 2022) and avoid potential cash forecasting penalties POL must receive funds by mid-March 2022 in order to remain a Going Concern.

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Background

Table 1: Extract from POL HMBU Paper22.1.2022 – Long Term Forecasts

£m	Pre 21/22	9+3 Forecast			Total
Project		**21/22**	**22/23**	**FY 24-25**	
Forecast Costs	IRRELEVANT				
GLO					
HSS					
OHC					
Postmaster Detrimer					
CCRC					
Inquiry					
Other					
Total					

7. Projected POL legal spendis set out in Table 1. Spend over the next 2 yearsis now projected at c IRRELEVANT - a material increase over the c. IRRELEVANT assumed inPOL's August SR submission, with subsequent increases driven by the Inquiry(which has since announced an extended timeframe)and Historical Shortfall Scheme (HSS). POL spend on historical matters is already subject to significant public scrutiny (including BEIS Select Committee and PAC enquiries) soofficials and POL note these costs are sensitive, especially in the context of compensation paid to Postmasters.

8. **Initial 21/22 legal cost budget of** IRRELEVANT was presented to March 21 POL Board. UKGI advised BEIS that the legal cost budget and overall POL budget should not be approved given quantum and visibility concerns, leading to the initial withholding (**Annex A**).

9. A **revised budget of** IRRELEVANT **was prepared** for November 21 POL Board, with most of the net increase reflectingthe Inquiry (IRRELEVANT increase). This revised budget also contained a IRRELEVANT legal cost challenge, meaning gross costs were estimated at £60.7m

10. After significant challengefrom officials and effort from POL, **current 21/22 forecasts total** IRRELEVANT a IRRELEVANT reduction from the November position, but a IRRELEVANT increase over the March budget Increased Inquiry costs account for most of the change(up £9.5m) and results fromthe move to Statutory footing and expanded scope

11. The evolution ofthese 21/22 forecasts by major activity is set out at Table 2 and shows the underlying movements within thesecategories:

Table 2: Extract from POL HMBU Paper 22.1.2022– 2021/22 Forecasts

	9+3 Forecast					Nov Board Report	Mar 21 Bud Submission
FY Cost Profile by Major Project	Q1	Q2	Q3	Q4	FY22 Total	FY22 Total	FY22 Total
Historical Shortfall Scheme	IRRELEVANT						
HSS Post Offer							
CCRC / Prosecutions							
POHIT Inquiry							
Overturned Historical Prosecutions							
Legal / General Advice							
Other							
Total							
Further Legal Cost Challenge							
Revised Total							

Actions Undertaken Since Cost Saving Challenge& Savings Achieved

12. Following challenge from UKGI and BEIS, POL have undertaken extensiveand challenging discussions with their primary legal advisorsHerbert Smith Freehills (HSF) and Peters and Peters (P&P). Savings achieved with P&P reflect process and approach efficiencies IRRELEVANT against a budget of IRRELEVANT– a c.21% rate discount.

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13. The relationship with HSF is more complex. The firm was appointed in 2019 at short notice following Justice Fraser's judgment. HSF's mandate was to settle the Group Litigation Order (GLO) which was achieved in December 2019. POL has since expanded HSF's role to advise on HSS, historical governance matters related to Horizon, the civil litigation related to postmaster prosecutions, potential claims against Fujitsu, Project Starling and the Inquiry. HSF has become embedded in working for POL and much of the work has been awarded without competition. The Shareholder team has challenged the use of HSF throughout, recognising that without competition their commercial leverage would be hard to challenge, but given timelines, complexity and risk POL concluded the best course was to continue with HSF.

14. HSF have been resistant to engagement on fees – both with POL and Shareholder Team officials – and have been slow to provide cost forecasting in required formats.

15. HSF accounts for more than half of the legal costs savings secured – POL believes these total IRRELEVANT across HSS IRRELEVANT, OHC IRRELEVANT and Inquiry IRRELEVANT. However, the majority of these savings have been more than offset by increases in scale and / or scope of work (visible in the 'Benchmark Rates' lines), including, for example, the implementation of options to accelerate the HSS to meet March '22 targets. The IRRELEVANT represents c.41% discount on rates. HSF spend is summarised in Table 3 below.

Table 3: Extract from POL HMBU Paper 22.1.2022 – 2021/22 HSF Costs (savings in red)

HSF Costs & Discounts (£m)	March Budget Submission	Nov Board Report	9+3 Forecast
Historical Shortfall Scheme			
Benchmark Rates			
Rate Discounts			
Other Negotiated Savings			
Acceleration Savings			
Total HSS Costs			
Overturned Historical Convictions			
Benchmark Rates		IRRELEVANT	
Rate Discounts			
Total OHC Costs			
Statutory Inquiry			
Benchmark Rates			
Rate Discounts			
Total Inquiry Costs			
Total HSS, OHC, Inquiry			

16. Although POL has achieved significant reductions in HSF's charge-out rates, it has been extremely difficult to establish: 1) whether the amount of time HSF has been devoting to the various tasks assigned to it represents good value, and 2) whether the work could have been done more cost-effectively by POL using its own or additional contracted-in resource, or indeed by a combination of legal firms.

17. POL, UKGI and BEIS officials continue to push HSF for further savings given the belief that, by spend, POL is among HSF's top 5 clients. However, HSF have so far pushed back hard on further discounts and engagement. In addition to working level challenge escalated conversations have been held between HSF, Ben Tidswell (the POL Legal NED) and Tom Cooper. Given the limited progress that has been made and recognising that a large proportion of the legal costs have already been incurred, UKGI continued to encourage POL to negotiate a retrospective rebate of HSF's fees, but POL has not taken this idea up with much enthusiasm – perhaps coloured by their commercial dynamic with the company and success to date

18. The November POL Board saw the matter of BEIS approval for legal cost control delegated to Nick Read and Al Cameron. Separately, POL have acknowledged the

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poor leadership and organisation to date in the Historical Matters business unit (HMBU) which has been responsible for a significant proportion of legal costs incurred. A new HMBU Director, Simon Ricaldin, joined POL in January 2022. Simon has substantial, relevant experience and has already signalled a focus on delivery and cost control which should drive improvements compared to previous leadership structures.

19. Overall, following UKGI and BEIS challenge, POL have secured some savings. Excluding the Inquiry, – a c. **IRRELEVANT** in the budget has been achieved.

Controls

20. Following significant concerns expressed by UKGI and BEIS officials about the absence of a modelling tool that would enable POL to forecast and control its substantial legal costs, POL commissioned KPMG to build a detailed cost model to improve the monitoring and scrutiny of HSF costs. The model is not yet fully operational (expected ahead of the March POL Board). POL have worked in an open, collaborative and constructive fashion with UKGI and BEIS officials during model development which has been encouraging, but it is not clear yet whether the model will serve its purpose and enable POL to fully understand legal costs on an activity basis that would better enable negotiation of reductions fee reductions with HSF and P&P.

21. POL have recently added further discipline HSF cost control by introducing single points of contact for sign-off of HSF work, and pausing invoice payments subject to assurance on the cost/ content of work being aligned to wider cost efficiency efforts.

22. POL are planning further active negotiation with HSF on costs in the coming weeks – supported by the improved modelling and controls. They would like senior POL, BEIS and UKGI representatives to present a united front which officials support and will take forward. POL ensured HSF are aware that legal costs are likely to come under significant public scrutiny which may bring reputational risk to the company, further strengthening the case for significant savings to be offered given overall fee levels. These efforts are part of drive by POL to optimally act as an intelligent client, ensuring work is scoped as efficiently and effectively as possible for output and cost - Simon Ricaldin is well placed to take forward and enhance this intelligent client approach.

23. POL has also augmented controls across 14 areas including: monthly Board reporting and scrutiny; monthly invoice reviews; formal forecasts change control, and monthly challenge meetings on forecast v actuals among numerous other measures.

24. We have requested that POL's Internal Audit function review the quantum of legal spend and the control framework as soon as they practicably can in 2022.

Confidence on Future Spending (Visibility and Cost)

25. Although there has been progress on both costs (though offset with additional substantive work e.g., the Inquiry) and visibility (primarily through development of the KPMG model), officials are disappointed by the progress that has been made so far

26. POL has decided to refocus on its negotiation with HSF for FY22/23 once the cost forecasting model has been fully developed. This means that BEIS must take a decision in relation to this year's budget approval and the release of funds before the negotiations with HSF have concluded. A number of options on how BEIS can signal its continuing disappointment with lack of progress are set out below.

27. In all cases, BEIS would approve POL's 2021/22 budget in order to release the withheld funding. BEIS could also obtain formal and renewed Senior commitment from POL to meet and maintain improved monitoring and cost controls of legal costs. This

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could be through an exchange of letters with Tim Parker and Nick Read, emphasising Shareholder expectations that are directly related to the release of withheld funds.

Options

28. **OPTION 1: Do not pay part of the withheld funds to POL (e.g. £10m). This is not recommended**. Firstly, some elements of overall cost have been upward pressures outside of POL control – notably the Inquiry. Secondly, unless agreed by BEIS Finance and HMT (with such agreement considered unlikely), failure to remit funds by 31 March 2022 would mean they are permanently lost and cannot carry over into the next financial year. This would exacerbate the already difficult SR funding position

29. **OPTION 2: Pay the withheld funds in exchange for clear, renewed commitments from POL on legal cost visibility and control**. This would mitigate the risks of option 1 by ensuring funds are transferred and made available to POL as originally agreed and assumed in SR projections. The requirement for POL to make renewed commitments and acknowledge the need for further progress would ensure clear senior understanding and focus The SR settlement could be an opportunity to amplify these asks. For example, part of the SR settlement could be tied to achieving reductions in the level of legal costs and achieving satisfactory controls

30. **OPTION 3: Augment Option 2 by also writing to the POL RemCo Chair, to set expectations on legal cost management being factored into remuneration and reward decisions for the years 2021/22 and 2022/23**. This option would add a further tangible lever to incentivise strong control and management. By making clear to RemCo the Shareholder expectation that legal cost management should impact Senior team reward we would expect direct recognition to feed through into performance assessments. However, in the context of a management team that is already under a lot of pressure and, rightly or wrongly, somewhat resentful about the level of incentive pay over the last two years, this option is likely to be very badly received and could lead to further instability in the management team. Tom Cooper as Shareholder NED engaged UKGI Senior colleagues who did suggest the RemCo lever should be used. Tom informally flagged the issue to Tim Parker and Lisa Harrington – Tim confirmed this approach would likely cause challenges with the management team. The aim of releasing withheld funds is to settle the current year position while ensuring the continued Shareholder dissatisfaction with legal costs is clearly articulated to POL. As such Option 3 may have a small incremental risk of being less of a 'clean break' than Option 2. You could choose to formalise this option by writing to the RemCo Chair.

31. **Do you agree with the recommended option to release withheld funding due to POL, totalling £101.5m? Please confirm whether you prefer Options 2 or 3. If you prefer Option 3 do you wish to write to the Remco Chair?**

Annexes

Annex A: Minister Scully's letter to POL on 8 June 2021
Annex B: 2 June 2021 submission re. POL's original budget
Annex C: 27 September 2021 submission re. 1 October funding due to POL
Annex D: 14 December 2021 submission re. 1 January funding due to POL
Annex E: January 2022 HMBU Budget Paper from POL

Clearance checklist

Team	Outcome of conversation
Finance	Cleared by Daniel Heath (BEIS)
Communications	Not applicable. Funding specifics between POL and shareholder are not public
Legal	Cleared by Eleri Wones (BEIS)
Delivery	Not applicable.

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Annex A: Letter from Minister Scully toPOL on 8 June 2021

Dear Nick,

POST OFFICE: BUDGET 2021/22

I am writing to you regarding Post Office's proposed budget for 2021/22 that requires shareholder approval from BEIS.

In our discussions, I have been pleased to hear about improved trading conditions and I look forward to seeing the Post Office operating at full capacity of its branch network during 2021/22.

In reviewing Post Office's 2021/22 budget, I am encouraged to see debate and challenge on Post Office's budget targets and urge continued ambition to grow Post Office's profitability to ensure its future relies on a more self-sustained footing.

However, based on advice from UKGI officials, I understand that there is not adequate control regarding the Post Office's litigation costs. Clearly, the Post Office's litigation proceedings are a very important matter given its history, scale and doing the right thing for postmasters.

The operation of strong controls in this area is critical to the Post Office's financial future and until I am content that there is a robust forecast in place, I am not able to approve the budget. Consequently, under the 2021/22 Funding Agreement, I am not able to release payment of the Network Subsidy until there is a shareholder approved budget.

I trust you understand my concerns and I look forward to considering Post Office's budget which has an improved grounding for forecasted litigation costs. I thank you for your continued cooperation and collaborative efforts with officials.

Yours sincerely,

PAUL SCULLY MP
Minister for Small Business, Consumers & Labour Market, Minister for London

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Annex B: 2 June 2021 submission re. POL's original budget

Attached under separate cover for reference and to avoid any confusion between submissions.

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