

Royal Mail – Strictly Confidential

RMH(07)2nd
RMH07/17 - 35

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

Minutes of the meeting of the Board of Directors
held at 148 Old Street, London, on 6 February 2007

Present:

Sir Mike Hodgkinson
Allan Leighton
David Burden
Alan Cook
Adam Crozier
Ian Duncan
David Fish
Ian Griffiths
Richard Handover
Tony McCarthy
John Neill
Baroness Prosser
Helen Weir

Non-Executive Director (Chairman of meeting)
Chairman (by telephone – for RMH07/17-28)
Group Technology Director
Managing Director, Post Office Ltd
Group Chief Executive
Group Finance Director
Non-Executive Director
Managing Director, Royal Mail Letters
Non-Executive Director
Group Director, People and Organisational Development
Non-Executive Director
Non-Executive Director
Non-Executive Director

In attendance:

Jonathan Evans

Company Secretary

Also present:

Frank Schinella
Dawid Konotey-Ahulu
Alex Smith
Doug Evans
Paul Tolhurst

Finance Director, Royal Mail Letters, for RMH07/25
Redington and Partners, for RMH07/25
Group Strategy Director, for RMH07/26-28
General Counsel, for RMH07/26-27
Network Director, Royal Mail Letters, for RMH07/29

RMH07/17

CHAIRMAN OF MEETING

- (a) Sir Mike Hodgkinson chaired the meeting as Allan Leighton was unable to be in Old Street, although he was in communication by telephone.

RMH07/18

MINUTES OF PREVIOUS MEETING RMH(07)1ST

- (a) The minutes of the previous meeting were agreed by the Board and signed by Sir Mike Hodgkinson.

RMH07/19

MATTERS ARISING – RMH(07)12

- (a) The Board noted the status report;

RMH07/20

OTHER MINUTES

- (a) The Board noted the minutes of the meetings of:
- the Group Executive Team of 19 December 2006
 - the Pensions Sub-Committee of 12 December 2006
 - the Post Office Ltd Board of 20 December 2006.

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RMH07/21

CHAIRMAN'S BUSINESS

- (a) The Chairman had no business other than that elsewhere on the agenda.

RMH07/22

REPORTS FROM CHAIRS OF BOARD COMMITTEES

- (a) Remuneration Committee: David Fish reported that the Government had been supplied with all the information they had requested in respect of the LTIP, and a decision from them was awaited;
- (b) Nomination Committee: Richard Handover reported that there had been no further progress in the appointment of a Deputy Chairman since the previous meeting.

RMH07/23

EXECUTIVE DIRECTORS' REPORTS

- (a) Royal Mail Letters: Ian Griffiths reported that quality of service levels were holding up well, although during the Christmas period they had shown their usual dip in performance;
- (b) the industrial relations scene was still difficult, with both sides to an extent skirting around some current issues in anticipation of bigger arguments to come later in the year. The CWU had withdrawn its industrial action ballot about drivers' working hours, after having been made aware by the Company that the wording of the ballot paper was flawed. However the proposal for changes to drivers' payments was being progressed, and Ian Griffiths expected it to be eventually accepted;
- (c) the Board discussed the contingency arrangement options for the Company in the event of a drivers' dispute. Ian Griffiths and Tony McCarthy reported that contingency arrangements were in place, but these would not provide for a replacement capability in the event of an all-out drivers' strike. They advised that it would be unlawful for the Company to hire workers to replace employees on official strike, and that there was no other third party company that could replicate at short notice the scale of operation required by Royal Mail;
- (d) Ian Griffiths stated that revenue levels in the Letters business were still following the trend reported at previous meetings of falling short of budget. In order to try to protect the profit position, the business was now heavily engaged in extensive curbing of expenditure;
- (e) Ian Griffiths reported that it was proving very difficult to find a new Operations Director to replace Tom Melvin later in the year. While some good potential candidates had been identified, they were generally cautious about joining the Company at the current time. Other options were being pursued for filling the post, and the Nomination Committee was fully engaged with the matter;

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ACTION
Jonathan Evans

- (f) Parcelforce Worldwide: the Board noted that David Smith had taken over as MD of Parcelforce. The Board asked Jonathan Evans to draft a letter to Vanessa Leeson thanking her for her work over the previous seven years, and for her achievements in restoring the business to profitable trading;
- (g) GLS: Rico Back reported that period 9 revenues were 0.6% higher than prior year, while EbitA was €3.4m lower than prior year, and €2.0m lower than budget. Margins in GLS Germany had been impacted by a difficult trading environment, and reductions in oil prices had had an adverse flow-through effect on revenues. The salesforce was very active in trying to gain and retain business, and a major cost-cutting drive was in place;
- (h) the performance of GLS France had been impacted by an increase in line haul costs, caused by the implementation of a revised transport plan which was not yet working well. Revenues were holding up well, and Rico Back estimated that the operational problems would be resolved by February;
- (i) plans were being worked upon for start-up operations in the Baltic states and Romania. In Italy the Bologna acquisition had been completed, and discussions were continuing on the Milano case. A new possible target company was being investigated in Spain;
- (j) overall Rico Back confirmed that he still expected GLS as a whole to meet its forecast profit target, with the possibility of there being a £2m upside. The budget process for 2007/08 was currently underway: he warned that it could prove difficult to sustain profit levels. He anticipated that there would not be a cash problem, but that the profit margin was likely to be some 1% lower than the current year;
- (k) Post Office Ltd: Alan Cook reported that negotiations were continuing with both WHSmith and the Bank of Ireland about crown offices. He estimated that there was potentially a £25m per annum profit benefit from franchising opportunities with WHSmith, and £15m per annum from Bank of Ireland. The Board agreed with his strategy to keep both partners in play for a while longer, before returning to the March Board meeting with a definitive proposal for how to proceed. Alan Cook said that he would also require a mandate from the Board to enter pay negotiations with the CWU in respect of changes to the crown office network. The Board agreed that he could circulate these for the Board's approval in correspondence in advance of the March meeting;
- (l) Alan Cook updated the Board on progress with finalising the new Horizon contract. The Board had given him authority on 2 August 2006 to sign the contract, subject to the satisfactory conclusion of negotiations with Fujitsu. The contract provided for Post Office Ltd to back out of the new contract if suitable funding from Government had not been forthcoming. Alan Cook informed the Board that although the funding arrangement with

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Government had not been finalised, it was nevertheless sufficiently advanced to proceed with completing the Fujitsu contract. The Board concurred with the course of action;

ACTION
David Burden

- (m) Technology: David Burden referred to the actions in hand to improve the relationship with CSC. The Board asked for a report on the state of the relationship and the future strategy in respect of CSC for the May meeting of the Board;
- (n) People and Organisational Development: Tony McCarthy reported that the pension scheme non-joiners exercise was reaching the final cut-off dates. The latest position was that 568 people had opted to join the scheme from a retrospective date, and this would incur a past liability of some £4.5million, substantially below the earlier estimates reported to the Board. The final figure would be known within the following few weeks when all replies had been received;
- (o) Tony McCarthy reported that following a recent EU decision on the VATability of medical services, the ATOS contract would be incurring an additional £2million per annum VAT charge.

RMH07/24

FINANCE DIRECTOR'S REPORT – RMH(07)13

- (a) The Board noted the period 9 report, and Ian Duncan's accompanying presentation giving the flash results for period 10;
- (b) Group profit before exceptional items in period 10 was £7million below forecast and £1million below the prior year. This performance to an extent masked the fact that there had been a revenue shortfall of £29million against budget, mainly in the Letters business, as expenditure had fallen substantially during the month as a result of some one-off issues. Were revenue to continue its trend, as was likely, then it could not be assumed that expenditure would continue to fall commensurately in the remaining weeks of the year;
- (c) the cumulative profit position at period 10 showed a Group operating profit before exceptional items of £110million, £1million adverse to forecast and £170million adverse to prior year;
- (d) Ian Duncan estimated that there was a further £40-60million revenue risk in the Letters business. Action was being taken to pursue additional sources of revenue aggressively, while management was making all efforts to cut any unnecessary expenditure, including significant reductions in operational overtime and new hires. The Board supported these actions, providing they did not jeopardise Letters quality of service performance. Ian Griffiths assured the Board that the actions would fall short of doing that, as the loss in terms of reputation and risk of regulatory fines would make such action counter-productive;
- (e) the Board went on to discuss the importance of making costs in the Letters business more responsive to changes in volume: as

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ACTION
Ian Duncan

the profile of mail volumes in the future was likely to be downward, it was vital that the business model was changed. The Board wanted to understand how the future business plan, now supported by the funding arrangements agreed with Government, would be used to bring about such a change in the business model. Ian Duncan would bring the budget proposals for 2007/08 to the April Board, when this would be considered further;

ACTION
Ian Duncan

- (f) the Board observed that a feature of the past year's financial reports had been the inaccuracy of sales forecasts in the Letters business. Ian Duncan agreed to examine ways of improving the forecasts, possibly by taking more input from the front-line sales force, and to bring to the Board periodic reviews of forecasting accuracy.

RMH07/25

RMPP INVESTMENT STRATEGY – RMH(07)14

- (a) The Board noted Ian Duncan's paper and Frank Schinella's presentation, which set out the rationale for the proposed phased reduction in equities to 50% of the Plan's assets, an assessment of why the Company should endorse a liability matching strategy considering the relatively low yields available in current markets, and an explanation of how the impact on the Board's return on assets could be minimised. The Board was reminded that ultimately the RMPP investment strategy was a matter for the Trustee, although in view of the major impact of the strategy on the Company's finances the Company was seeking to influence the Trustee to arrive at a strategy that reduced investment risk while minimising the impact on expected returns;
- (b) Company representatives had been having in depth discussions with the Trustee and its advisors, and had broadly reached a consensus around the preferred investment strategy identified in the paper. The Board also concurred that this strategy was the appropriate one to follow to achieve the objective of reducing risk while protecting returns;
- (c) there were however some concerns that the Trustee may be more driven to move quickly from equities to bonds than to implement some of the alternative investment approaches, such as the use of swaps and other investment vehicles. Also the Board wished to ensure that in effecting the new strategy, the Trustee would do so in such a way as to minimise transaction costs;
- (d) overall, after full discussion, the Board supported the Trustee's proposed investment strategy. In order to reinforce the Board's support and raise its concerns with the Trustee, Ian Duncan was asked to write to the Trustee setting out the Board's views.

ACTION
Ian Duncan

RMH07/26

GOVERNMENT FUNDING

- (a) Adam Crozier shared with the Board the final version of the term sheet agreed with Government for the future funding of the

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Company, together with draft internal and external announcements. He explained to the Board the course of events over the previous few days of intense and difficult negotiations with the Government. The result that had been achieved was within the Board's remit given at the previous meeting;

- (b) the Board congratulated Adam Crozier and his team on achieving this outcome in what had been very testing circumstances. Although it had not been possible, for political reasons, to secure the Government's agreement to a real employee share scheme, the terms of the rest of the deal – a phantom share scheme based on 20% of the economic value of the Company, further funding to allow for the business plan to be implemented over a longer period in view of the lack of the extra incentive from a real employee share scheme, Government support for the change programme that management would need to introduce including amendments to arrangements for pension provision – provided a good basis for the Company to proceed with its transformation plan;
- (c) directors made suggestions for amendments to the communication material which Adam Crozier undertook to review before finalising the documents over the following few days;
- (d) the Board recognised that now the funding negotiations were over – subject to formally agreeing them before the end of March – it should increasingly turn its attention to discussing the key strategic issues that implementing the plan presents. The Board agreed that the July awayday should be devoted to the consideration of these;
- (e) in order to finalise the funding arrangements, the Board delegated to Adam Crozier and Ian Duncan the authority to finalise the documentation and sign it on behalf of the Company.

RMH07/27

BUSINESS PRIORITIES

ACTION
Tony McCarthy

- (a) Tony McCarthy updated the Board on the current state of progress with developing the plans for introducing the phantom share scheme and changes to pension arrangements. In future meetings specific items would be presented for the Board's approval, beginning at the March Board meeting with the terms for the phantom share scheme.

RMH07/28

PACKETS STRATEGY – RMH(07)16

- (a) The Board noted Adam Crozier's paper and Alex Smith's presentation which outlined the progress made since July 2005, when the Board first considered the packets strategy, in delivering a suite of changes to ensure the Company was fit to compete successfully for the growth in this market. The presentation also highlighted the latest developments in the market and showed that competitors were beginning to compete aggressively with both Royal Mail and Parcelforce Worldwide. A business model being deployed by the competition was using

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self-employed couriers equipped with hand held devices, bringing the advantages of low labour costs and new generation IT;

- (b) Royal Mail's response had been two-fold. First, the launch was planned for July 2007 of the new Techpack product to fill the gap in the Royal Mail portfolio. The Investment Committee had given in principle approval to the product, in particular the initial development costs. The business case (RMH907)16b), a copy of which had been circulated in advance and which was noted by the Board, was being submitted for full approval of the Investment Committee later in February. The Group Executive Team considered this to be a vital development for 2007, but in the medium term a "necessary but not sufficient" response to changes in the marketplace;
- (c) secondly evaluation was being undertaken of whether RMG should build or acquire a courier capability in order to be fully competitive at all weight steps up to 15kg in the "budget business to consumer" marketplace. If it were considered the right thing to do then the relevant business case would need to be approved in time to secure a share of the autumn 2007 growth that would be available. Work was in hand to assess a number of potential solutions to this, and further reports would be made to the Board;
- (d) after some discussion the Board supported the direction the work was taking, and requested that the evaluation of the options for a courier capability be conducted with pace.

RMH07/29

LAST LETTER DELIVERIES – RMH(07)15

- (a) The Board noted Ian Griffiths' paper and Paul Tolhurst's verbal summary of the proposals. Further to the Board's earlier consideration of the impact of driving speed restrictions in November 2006, analysis had been carried out on options for minimising the impact of the restrictions on latest delivery times. The preferred option now was not to make a wholesale change to delivery times across the UK, but to retain the existing specification except in those isolated areas where service could not be maintained without unjustifiable additional cost. The additional capital expenditure requested in the earlier submission would still be required to upgrade air and road network capabilities, and in addition some £5-10million of operating expenditure would be required to maintain service levels;
- (b) Paul Tolhurst indicated that it would probably become necessary to review latest delivery times again in the future on the introduction of walk sequencing;
- (c) Adam Crozier said that to retain the existing specification generally would be challenging, a factor which should influence the approach made to Postcomm about the possible impact of the speed restrictions, but he felt it was the right course to be followed. Tony McCarthy added that there was a substantial

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management challenge in making the changes of start and finish times to many thousands of front-line people's work patterns;

- (d) after further discussion the Board:
- (e) approved the investment of £10.1m Capital Expenditure, £1.7m Operating Expenditure, £2.2m Capitalised Lease, £3.3m recurring costs in the Network and £5m recurring costs in Area operations for a total cost to the Business of £47.0m over four years;
- (f) noted that of these sums, the Board had authorised at the November 2006 Board meeting £11.7m in respect of the net increase in air flights;
- (g) directed that consideration of the requested incremental area operating costs of £5-10m be considered as part of the forthcoming budget discussions for 2007/08.

RMH07/30

REGULATION REPORT – RMH(07)17

- (a) The Board noted the report.

RMH07/31

TECHNOLOGY AT ROYAL MAIL – RMH(07)18

- (a) The Board noted David Burden's paper. David Burden emphasised that there was a big unexploited opportunity in the usage made of the Royal Mail website, which had over 7million registered users, but negligible revenue; while the biggest risk in the technology area arose from the lack of an adequate HR system;
- (b) the Board considered that the issues raised in the paper merited a longer strategic discussion, which it aimed to do at the July awayday. In the meantime David Burden was asked to clarify the "general principles and strategies" referred to in his paper.

ACTION
David Burden

RMH07/32

QUARTERLY INVESTMENT REPORT – RMH(07)19

- (a) The Board noted the report.

RMH07/33

CORPORATE RISK SCORECARD – RMH(07)20

- (a) The Board noted the report.

RMH07/34

COMPANY SECRETARY'S REPORT – RMH(07)21

- (a) The Board noted the report.

RMH07/35

CLOSE

- (a) In the absence of any further business, the Chairman closed the meeting. The next meeting of the Board was scheduled for 13 March 2007 at 148 Old Street, London.

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