

Royal Mail – Strictly Confidential

RMH(06)8TH
RMH06/133 - 151

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

**Minutes of the meeting of the Board of Directors
held at 148 Old Street, London, on 2 August 2006**

Present:

Allan Leighton	Chairman
David Burden	Group Technology Director
Alan Cook	Managing Director, Post Office Ltd
Adam Crozier	Group Chief Executive
David Fish	Non-Executive Director
Ian Griffiths	Managing Director, Royal Mail Letters
Richard Handover	Non-Executive Director
Sir Mike Hodgkinson	Non-Executive Director
Tony McCarthy	Group Director, People and Organisational Development
John Neill	Non-Executive Director
Baroness Prosser	Non-Executive Director
Bob Wigley	Non-Executive Director (by telephone)

Apologies:

Helen Weir	Non-Executive Director
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In attendance:

Jonathan Evans	Company Secretary
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Also present:

Rico Back	Chief Executive, GLS
Frank Schinella	Acting Group Finance Director
Alex Smith	Group Strategy Director, for RMH06/143 – 144
Doug Evans	General Counsel, for RMH06/143 – 144
Mark Higson	Deputy Chief Executive, Shareholder Executive, for RMH06/143 (part)

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MINUTES OF PREVIOUS MEETING RMH(06)7TH

- (a) The minutes of the meeting held on 4 July 2006 were approved and signed.

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MATTERS ARISING – RMH(06)81

- (a) The Board noted the status report;
- (b) Royal Mail Way (RMH06/79(c)): the Board noted that a progress report had been due to be presented to this meeting. Ian Griffiths explained that the reason for deferring the item was the non-availability of key people involved in the project. There would be a full report-back on progress in September;
- (c) Special stamp programme (RMH06/124(b)): Ian Griffiths reported that the stamp programme had been reviewed in the light of the Board's comments at the previous meeting. Plans

Royal Mail – Strictly Confidential**ACTION
Ian Griffiths**

were being drawn up to increase the number of issues in 2006/07, and further work was in hand to enhance the diversity of subjects in the 2008 programme. Margaret Prosser observed that 2008 would mark a significant anniversary of women's suffrage, and wondered whether this was being commemorated in the programme. Ian Griffiths undertook to find out and report back;

- (d) Oil leakage (RMH06/116(f)): the Board noted Ian Griffiths' report in response to the points made at the previous meeting. Ian Griffiths confirmed that the complete removal of fuel cards would be impractical due to the wide geographical spread of vehicles, but their usage would continue to be tightly controlled;
- (e) Special delivery (RMH06/120(c)): the Board noted Ian Griffiths' report which showed the current profile of special delivery business, and the main reasons for volume variances.

RMH06/135**OTHER MINUTES**

- (a) The Board noted the minutes of the meetings of
 - the Group Executive Team of 20 June 2006
 - the Audit and Risk Committee of 6 June 2006
 - the Pensions sub-Committee of 16 June 2006
 - the Post Office Ltd Board of 28 June 2006.

RMH06/136**CHAIRMAN'S BUSINESS**

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

RMH06/137**REPORTS FROM CHAIRS OF BOARD COMMITTEES**

- (a) Nomination Committee: Richard Handover reported that he had agreed on behalf of the Committee that Ian Duncan, when he joined the Company on 1 September 2006, would become a member of the GLS Supervisory Board, in addition to Allan Leighton and Jonathan Evans. The Board endorsed this appointment. Richard Handover further explained that work was continuing to find suitable candidates for the director-level vacancies in Post Office Ltd;
- (b) Remuneration Committee: David Fish reported that while Government agreement had not yet been secured to the proposed base pay and annual bonus arrangements, he did not anticipate there would be any major difficulty. However in respect of the LTIP, there were still some important issues of principle remaining to be resolved which he was continuing to pursue with Government officials.

RMH06/138**EXECUTIVE DIRECTORS' REPORTS**

- (a) The Board noted the executive directors' reports;

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ACTION
Ian Griffiths

- (b) Royal Mail Letters: the Board expressed disquiet about the rate of accidents involving vehicles, and coupled with this was a concern that the current system for allocating vehicles to drivers led to higher levels of vehicle damage because drivers felt little sense of ownership of the vehicles they drove. Ian Griffiths agreed to bring to a future meeting an outline plan for improving this performance;

ACTION
Ian Griffiths

- (c) the Board recalled that over a year had passed since the completion of the Transport Review. Ian Griffiths was asked to provide for the Board at a future meeting a critique of the effectiveness of the transport changes;
- (d) GLS: Rico Back reported that performance levels were remaining good, although revenue had been under pressure due mainly to a downturn in economic activity in continental Europe arising from recent high temperatures. The excessive heat had also been a contributory factor to the capital programme falling behind schedule, although it was expected that lost time would be caught up in the rest of the year. He was also continuing to pursue the acquisition opportunities he had outlined at previous meetings;
- (e) Post Office Ltd: Alan Cook reported that sales in POL were slightly behind target, and that a sales campaign would soon be starting to address this shortfall. Agreement with the CWU had been reached for a pay settlement in the Cash in Transit unit, while the options for reaching a settlement in the rest of POL now needed to be considered in the light of the Royal Mail Letters settlement. The announcement of proposals to franchise six directly-managed branches in stores of WHSmith was continuing to cause some union dissent and minor demonstrations: however Alan Cook was in frequent dialogue with the Chief Executive of WHSmith, who was continuing to be positive about the venture;
- (f) work had been continuing on the challenges to the POL strategy made at the Board's July strategy meeting, and these would return to be discussed further in September;
- (g) the Chairman raised the issue of ISA Retail, the company appointed to supply retail products to the POL network, about which there had recently been some negative press coverage. While disappointed by the appearance of the news story, Alan Cook stated that he had some reservations about the appropriateness of some of the product range and was reviewing it. He surmised that the news story had probably emerged from a leak from a disaffected ex-employee of POL;
- (h) Technology: David Burden informed the Board of the considerable progress that was being made with the development of a semi-automatic system for sorting packets at Gatwick mail centre;
- (i) People and Organisational Development: Tony McCarthy

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reported that following the last board meeting, his team had been making plans for a major launch of the employee share scheme. While the timing of such a launch was still uncertain, action was going ahead with installing televisual IT equipment in all work locations to provide a rapid and effective internal communications channel;

- (j) Parcelforce Worldwide: Adam Crozier reported that Vanessa Leeson had returned that week following a period of three months' recuperation after a hospital operation. In her absence David Smith, the PFWW Finance Director, had very commendably led the executive team in ensuring that Parcelforce performance remained well on track;
- (k) Adam Crozier informed the Board that he had recently been in Korea to discuss whether there may be an opportunity for a commercial link-up with Japan Post for handling parcels business between the Far East and Europe. Talks between Japan Post and Fedex had recently been concluded without agreement, which may give scope for a venture via GLS. He would keep the Board informed of progress.

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FINANCE DIRECTOR'S REPORT

- (a) The Board noted Frank Schinella's report and presentation. The results for the first quarter of 2006/07 showed that Group operating profit before exceptional items was £18m, some £15m favourable to budget and £59m adverse to the prior year. The results showed a continuing and disturbing downward trend in revenue, mainly in the Letters business, where there was now a net £70m revenue risk against budget;
- (b) of further concern was the position on productivity levels: while work hours had been adjusted to correspond with reduced traffic levels, the cost per work hour had increased, leading to unit costs rising by 4.6% in the year to date;
- (c) overall the analysis showed net profit risks of £31-36m for the Group as a whole. The Group Executive Team was addressing these risks, and were initiating actions to reduce the cost base accordingly;
- (d) Frank Schinella updated the Board on the work being done with the pension fund Trustee to explore options for de-risking the fund. He was still searching for an independent source of expert advice on de-risking strategies.

RMH06/140

POST OFFICE LTD: RURAL NETWORK PAYMENTS – RMH(06)83

- (a) The Board noted Frank Schinella's paper which set out an analysis of the merits of treating rural network payments as revenue or capital. The main benefit of revenue treatment was an increase in POL's accounting profit and that it gave a better reflection of the nature of services provided to Government: on

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the other hand revenue treatment would incur an additional tax liability of some £53m discounted over ten years. After some discussion the Board:

- (b) agreed to treat the payments as capital;
- (c) agreed to keep the matter under review to ensure that this decision would not adversely impact on other areas of balance sheet restructuring work. It was also recognised that in different future circumstances the arguments for revenue treatment may have more weight.

RMH06/141

INVESTMENT RETURNS – RMH(06)82

- (a) The Board noted Frank Schinella's discussion paper on possible changes to hurdle rates for investment projects. The paper was in response to concerns expressed by the Board earlier in the year about what it saw as the comparatively unchallenging nature of the current hurdle rate regime;
- (b) in discussion, the Board considered that the proposed increase in the overall average hurdle rate from 11% to 12% did not go anywhere near far enough to provide the necessary challenge to the Company in its investment project performance. Many directors considered that an overall rate of nearer 30% would be more appropriate. As the Board had seen earlier in the meeting, productivity trends were worryingly adverse: therefore much tougher target returns for projects generating manpower efficiency gains were needed;
- (c) the Board acknowledged that it was appropriate for different types of project to be measured against different hurdle rates. Investment needed for statutory or health and safety reasons could be justified with low or zero rates of return, while manpower efficiency projects should seek payback within a year. The key point for the Board was that as the Company was about to embark on a major infrastructure investment programme, it was vital that investment projects were implemented in a manner which resulted in step-change improvements in labour productivity;
- (d) while supporting the call for tougher hurdle rates, Bob Wigley cautioned that if higher rates were to be approved, then care needed to be taken to understand the implications for the regulatory environment. He recommended trying to establish the returns achieved by peer group companies, and further asked for the Board to see more results of post-investment reviews of investment projects;
- (e) in conclusion, the Board invited management to consider the points raised in the discussion, and to return to a future meeting with a revised proposition. The Board agreed that no changes should be made to the current methodology for assessing and authorising investment projects in GLS.

ACTION
Frank Schinella

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RMH06/142

INDUSTRIAL RELATIONS UPDATE

- (a) Tony McCarthy gave a presentation to the Board on the state of industrial relations following the agreement reached with the CWU on 25 July on pay and working practice changes in Royal Mail Letters;
- (b) the agreement itself, which included a 2.9% consolidated pay increase, and an extension of the productivity scheme until the end of March 2007, provided a way forward for testing new ways of working at sites trialling new equipment, which had previously been embargoed; it paved the way for a new agreement, to be reached within 12 weeks, for removing the current limits on the handling of unaddressed mail; and it would lead to a trial of a new attendance procedure, also within 12 weeks. The Company had reaffirmed some previous commitments, dependent on satisfactory resolution of Government's future funding of the Company, to continue to manage job losses by voluntary means, and for no-one to be compelled to move from full- to part-time working. In addition there was an agreement to joint management and union training, and to agree a new industrial relations framework by the end of 2006. The overall agreement was now subject to a CWU membership ballot;
- (c) the tortuous progress of the union negotiations had revealed a good deal about the current state of the union and its leadership. While the basic agreement had been struck at a high-level meeting with the CWU General Secretary in June, it had taken a further month for the union executive to accept the position. There was still a degree of dissent amongst some executive council members, which in turn was expected to lead to potential difficulties on the ground in coming months in implementing the various elements of the agreement. Overall the union leadership had shown itself as divided, with no one person able to exert influence to make decisions;
- (d) in Tony McCarthy's view, there were also lessons for the Company. He had been dismayed to learn of a number of separate negotiations with the union taking place at the same time – an issue he was addressing. He also felt that the negotiations had been conducted at too high a level in the Company;
- (e) looking ahead, even if as expected the union secured approval to the pay deal in its membership ballot, there were a number of potentially serious industrial relations flashpoints anticipated in the coming months. Some of these related to the change elements of the recent agreement, while there were a number of others in areas where the Company needed to make change – for example the closure of Liverpool airport mails facility, the closure of some mail centres, and the introduction of a vehicle tracking system.
- (f) In subsequent discussion the Board fully supported the need to progress the changes in working practices that were needed.

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However in the view of many directors the Company was not well-prepared to mount an effective campaign to introduce change in the face of union opposition, notwithstanding the extreme and unrepresentative positions being taken by some of the CWU leadership. In particular the calibre of front-line managers was not generally adequate for seeing through the degree of change necessary. In the Chairman's view, which the Board fully supported, this implied that change needed to be introduced by stealth rather than by direct confrontation, and every effort should be made to avoid making unintentional gifts to the union of "causes" around which it could unite its membership. On the other hand there needed to be some visible signs of the need for change – for instance the closure of some depots – to reinforce the message that competition was hitting the Business and that change was necessary;

- (g) a potentially limiting factor was the likely response of Government to the prospect of a prolonged period of industrial unrest. Recent events had cast some doubt on Ministers' ability to support the Company in the face of political pressure: the Board should therefore be wary of assuming a level of support that might turn out to be transitory. In David Fish's view this raised a potentially serious problem for the Company: change introduced incrementally could lead to the Company being seriously unprofitable in a short time, which in turn could result in the Company needing to face even more drastic recovery action. There needed to be a serious debate with Government to ensure that they fully appreciated the scale and speed of change needed to transform the Company, and the level of support they would be called upon to give;
- (h) the Board recognised that industrial relations was a key issue to which it would need to return in depth in coming months, and that it was closely allied to the stance the Government would take on the Company's plans for an employee share scheme. In the meantime, Tony McCarthy was asked to map out a plan of the potential industrial action flashpoints, scenarios, and possible management responses, in readiness for a further discussion at the Board meeting in September.

ACTION
Tony McCarthy

RMH06/143

GOVERNMENT FUNDING AND EMPLOYEE SHARE SCHEME

- (a) Alex Smith presented to the Board a summary of the latest position with the discussions with Government about the funding package and the proposed introduction of an employee share scheme. The background to this latest discussion was the news that for political reasons it would not be until November 2006 that the Secretary of State would be able to provide an answer on whether the Government would support a real employee share scheme;
- (b) in his presentation Alex Smith reminded the Board that the investment case put to Government in February 2006 had the capacity to create over £4billion of shareholder value. Underlying the investment case was a radical transformation of

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Royal Mail which, without some effective means of overcoming union and workforce attitudes of opposition to change, would fail to be delivered;

- (c) delay in finalising the funding package, and particularly in getting a clear Government response to the share scheme proposal, was already resulting in the Group's slipping behind schedule in implementing the transformation. On the other hand proceeding with the transformation on the assumption that Government would in the end support a real employee share scheme would carry considerable risk for the Company and the Board;
- (d) management had developed a transformation plan for the Letters Business that it believed was deliverable without a real employee share scheme. This showed a £3billion reduction in the market value of the Company compared with the investment case, with the potential financial stake for each employee reduced from £5000 to £1000, rendering even a phantom share scheme unviable. Furthermore such a reduction in the pace and scale of transformation, and the lower returns from it, could lead to the Pension Fund Trustee having to consider abandoning its agreement to a 17-year deficit repair period for a shorter period nearer to the Pension Regulator's benchmark of ten years. This in turn, because of the resultant higher annual payments, could lead to the Group becoming cash-flow insolvent. In that event the Board would need to consider developing a "manage for cash" case, requiring a confrontational approach with workforce and unions to force change through;
- (e) this analysis therefore suggested that, if the Board considered that there was a reasonable prospect of getting Government agreement to a real employee share scheme in November, the best course for the Board to take was:
 - to confirm to Government that the Board intended to pursue the delayed transformation plan, but solely at Government's risk
 - to release none of the Mails Reserve, other than that contractually committed, to fund POL and require new funding for Letters until November
 - to demonstrate to Government the consequences of their failing to meet the November deadline in terms of possible Group insolvency, depending on the stance of the Trustee, and the disruption and political complexity of following a "manage for cash" route
 - to work with the DTI to prepare a compelling case for an employee share scheme.
- (f) In subsequent discussion, the Board expressed its great disappointment that the Secretary of State had been unable to support the Company's proposal for a share scheme at the current time, and that it would be necessary to wait a further three or more months before getting a decision. Nevertheless the Board, having considered the analysis in the presentation,

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reluctantly came to the conclusion that it should support the proposed approach, recognising that it was the best option available and therefore in the interests of the Company to pursue it;

- (g) in Bob Wigley's view it would be important to relay the Board's decision and opinions directly to Ministers in writing as well as to officials. He considered that officials were supporting the Board's view, and it was Ministers who needed persuading. It was therefore important that Ministers fully understood the Board's view, and the risks the Government would be taking in not supporting management's preferred proposals. Also the Government should be reminded that the current directors had agreed to serve on the basis that the Government wished them to turn the Company into a world-class operation: Government delays in making decisions were jeopardising this;
- (h) in Margaret Prosser's view, based in part on a conversation she and the Chairman had had with the Secretary of State in the previous month, the Secretary of State was personally supportive of the need for the employee share scheme, but the political environment made a public expression of support at the current time difficult. In her view the Company should be doing all it could by way of an influencing plan to ensure that the key people who would be instrumental in Government coming to a decision were fully briefed on the Company's rationale for a share scheme: her experience to date was that the Company was considerably behind the game, and needed to address this urgently. Other directors supported this proposal, adding that care should be taken not to over-dramatise the implications of failure to secure agreement to a share scheme, as this would be counter-productive;
- (i) the Chairman concluded that the clear view of the Board was to proceed with the proposal as set out in Alex Smith's presentation, but to consider further, partly in the light of the forthcoming appearance of Mark Higson at the Board, how best to respond to Government.

Mark Higson joined the meeting.

- (j) The Chairman welcomed Mark Higson, and invited him to give his assessment of the Government's position in respect of the proposed employee share scheme;
- (k) Mark Higson said that in his personal view, the Government would give its agreement to an employee share scheme in November. The reasons for his confidence were that by then the political environment should allow a decision to be made more on its commercial merits; but fundamentally he believed that Government had no real alternative. It could fund the Business on a non-commercial basis, but that would simply prove the unions and workforce that the Government was prepared to bail the Company out; to pursue a plan that relied on confrontational change would not be politically attractive; or Government could

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change the management of the Company to some who would be able to manage without an employee share scheme. Backing a share scheme was preferable to any of these other options. Furthermore the share scheme had the full backing of the Shareholder Executive, and he felt it would be easier to secure Treasury agreement to a share scheme than it was to the funding package. In Mark Higson's view, the key action now would be to spend time working up a full and compelling case for employee shares to make the decision as easy as possible in November;

- (l) Mark Higson added that Government was ready to sanction the Post Office Ltd Subscription Agreement, the terms of which would leave the Mails Reserve intact, but needed a positive indication from the Board that it would work with the November timetable.
- (m) In subsequent discussion the Board acknowledged the sterling efforts that Mark Higson had made to try to bring Government to a position of being able to agree the employee share scheme. The Board's concern was that the delay could be interpreted as a lack of commitment on the part of Government to the Board's plans to turn Royal Mail into a world-class company. The Board questioned whether Ministers were sufficiently aware of the challenges facing the Company, particularly the impact of competition: in effect the mail service in the UK was being privatised, and it was crucial that the Government and the Board had a shared and detailed vision of what this meant for the future of Royal Mail. As Government had agreed to invest in the Company, the best way for the Government to mitigate the risks of that investment was to back the Company's management in taking the tough decisions necessary. Mark Higson agreed with this analysis, and suggested that it would be necessary to engage Ministers face-to-face in a discussion to ensure that the issues were well understood;
- (n) the Chairman expressed his concern that a decision in November, even if it was positive and clear-cut, would still mean that the Company had lost eight months of the year. His faith in Ministers holding to deadlines had also been weakened by recent events, and it was vital that there was a climate of trust between the Board and the Government. Mark Higson agreed, and reiterated his view that "providing we all play our cards right", Ministers will make a positive decision on employee shares in November;
- (o) the Chairman thanked Mark Higson for attending the meeting, and for the great efforts he was making.

Mark Higson left the meeting.

- (p) In subsequent discussion the Board concluded that the discussion with Mark Higson had confirmed its view that the right course of action would be as set out in Alex Smith's presentation. The Board therefore agreed the actions at (e)

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above, and further agreed:

ACTION
Adam Crozier

RMH06/144

- (q) • that the Chairman should write to the Secretary of State, setting out the Board's decisions and views
(A copy of the letter, sent on 4 August 2006, is attached to these minutes)
- and that Adam Crozier should prepare a communications and influencing plan to promote the employee share scheme.

POST OFFICE LTD SHORT-TERM FUNDING – RMH(06)84

- (a) The Board noted Frank Schinella's paper, which updated the Board on the current status of the discussions with Government on the funding of Post Office Ltd, and proposed that the Board gave its approval to a Subscription Agreement, as negotiated with Government for the purposes of funding Post Office Ltd in the short term;
- (b) after some discussion, and taking into account the views expressed earlier in the meeting in the wider context of the other issues being discussed with Government, the Board supported going ahead with the Subscription Agreement. However the Board considered that it would be preferable to inform Government of this decision after the letter to the Secretary of State about the employee share scheme, as discussed in the previous item, had been received by Government. The Board:
- (c) approved the Subscription Agreement;
- (d) authorised Jonathan Evans to arrange the requisite board and other meetings to enact the agreement, including a meeting to issue new shares in the Company;
- (e) delegated to Jonathan Evans the authority to sign the Subscription Agreement on behalf of the Company, Royal Mail Group plc and Post Office Ltd;
- (f) delegated to the Group Finance Director the authority to negotiate the form in which the remaining contributions in 2006/07 and 2007/08 would be made by Government, as set out in the paper.

RMH06/145

POST OFFICE LTD: REPLACEMENT OF HORIZON – RMH(06)85

- (a) The Board noted Alan Cook's paper, which recalled that the Board on 27 April 2006 had approved Post Office Ltd's plan to conclude contract negotiations with Fujitsu with regard to the replacement of the Horizon Electronic Point of Sale system, and had authorised additional interim funding of £25m to take the total authorised sum to £35m. This paper sought final authority to sign the contract with Fujitsu. After due consideration the Board:
- (b) approved Post Office Ltd's plan to conclude negotiations with

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Fujitsu, and

- (c) delegated authority to the Managing Director of Post Office Ltd to sign the contract, subject to the satisfactory conclusion of the final negotiations with Fujitsu within the Board's authorised sum.

RMH06/146

CUSTOMER INSIGHT

This presentation was deferred to a future meeting.

RMH06/147

REGULATION REPORT – RMH(06)88

- (a) The Board noted the report.

RMH06/148

QUARTERLY INVESTMENT REPORT – RMH(06)89

- (a) The Board noted the report.

RMH06/149

DIVERSITY AND INCLUSION QUARTERLY REPORT – RMH(06)90

- (a) The Board noted the paper, and after discussion noted that management was pursuing the action outlined in the paper.

RMH06/150

COMPANY SECRETARY'S REPORT – RMH(06)91

- (a) The Board noted the report.

RMH06/151

CLOSE

- (a) In the absence of any further business, the Chairman closed the meeting. The next meeting was scheduled for 5 September 2006 at 148 Old Street, London.

GRO