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ROYAL MAIL HOLDINGS plc
AUDIT & RISK COMMITTEE

POST OFFICE LIMITED – POL RISK AND COMPLIANCE ISSUES

Purpose

1. At its last meeting, the Committee reviewed a summary of the report to POL's Risk & Compliance Committee and agreed to request that POL senior management attend the November meeting of the Committee to report on the key issues for POL. The purpose of this paper is to provide the Committee with a briefing on those issues in preparation for the meeting.

2. At the meeting we will seek guidance from the Committee on what regular reports it would like from POL in this respect.

Executive Summary

3. In August POL commissioned Deloitte and Touche to undertake a review of POL's financial services compliance arrangements, including its approach to the FSA's Treating Customers Fairly (TCF) theme. They have now presented their findings to the POL ET and an implementation plan for their recommendations will be taken back to the POL ET for approval on 10 November. Key findings to be addressed are:
   - Conformance standards in the Network fall well short of those FSA looks for and are not consistent with POL's low risk appetite;
   - POL may be over reliant on the Bank of Ireland to ensure that POL's interests are protected
   - Work to embed POL's brand values of 'fairer, easier, better' will have gone a long way to deliver FSA's TCF outcomes, but POL should undertake a detailed gap analysis to be able to demonstrate that and identify any gaps.

   The implementation plan will address all the issues raised and target the earliest possible implementation dates. At a minimum POL will implement measures to meet its TCF requirements and reduce its reliance on the Bank of Ireland. There are some judgemental areas where POL will seek to exceed the minimum requirements for an authorised representative without necessarily aspiring in the immediate term to the level required for a fully authorised company.

4. FSA has challenged whether POL fulfilled TCF principles in launching the Post Office Christmas Club as a product that is not covered by UK or Irish deposit protection schemes, but which is targeted at 'vulnerable' consumers for whom, they argue, such protection is essential. POL and the Bank of Ireland as provider do not believe that we have breached any requirement or principle and, fortuitously the Christmas Club funds are now secured by the Irish Government guarantee of Irish bank liabilities. FSA had sought to involve both HMT and DBERR in seeking to influence POL and we have agreed that we will review the structure of the product to see whether we can bring it within the scope of the Irish protection scheme beyond the expiry of the guarantee.

5. BT Wholesale (BTW) have failed to live up to our expectations in delivering a fully managed telecoms service for us. As well as damaging our brand and our subpostmasters' confidence in promoting our telecoms products, failure by BTW has meant that we are in breach of Ofcom requirements in relation to publication of Quality of Service measures and accuracy of call metering and billing. An Internal Audit review completed in August had an 'improvement required' rating. We have

reorganised our teams to ensure that we manage BTW more effectively and are agreeing with BTW action plans to address remaining problems. We will be pursuing redress from BTW for failure to meet SLAs and for any lost income from billing failures.

6. POL's forecast for losses from controls and compliance failures for 08/09 is £17.25m. That is broadly in line with previous years and with our plan for this year, but within that losses through physical crime (robberies etc) are down whilst discovery of subpostmaster fraud is up. The latter is in part down to more focussed audit and investigation but we think this trend will also be driven by the deteriorating economic conditions. We have also identified new levels of losses in some products. Errors by branch staff in calculating travel insurance premiums have led to POL needing to refund up to £615k to customers. Fraud levels on Post Office Savings Stamps had reached £200k per month – corrective action has reduced this to £60k and further steps are being taken to provide a permanent solution (e.g. card based product). Unacceptably high levels of 'stock adjustment' transactions by subpostmasters have been identified as a means of creating an artificial accounting cash surplus – whether intentionally or not. Manual corrections are being processed pending a long term system solution.

7. The POL Network Efficiency Programme has been established in response to the recognised need to achieve a step change across all aspects of branch conformance and compliance. Key elements of 08/09 activity - undertaken with a view to a significant improvement in performance in 09/10 - are the introduction of
   - a clear standard index of conformance and compliance throughout the business; and
   - A revised tough but fair consequences policy.

8. Following POL ET's review of POL's Top Risks the following risks have been added:
   - POL runs out of cash - e.g. where cheques are not despatched quickly on receipt by branches POL will not receive proceeds to enable it in turn to settle with product owners on a timely basis. These difficulties were experienced during the recent October launch of a Post Office Growth Bond;
   - POL does not secure funding for post 2011 – this is now on the critical path as there is a minimum two year lead time based on our experience of agreeing and obtaining funding including EU clearance.

Detailed Report

9. In the Annex attached to this summary is a more detailed explanation of all of the points covered above.

Peter Corbett
Finance Director
Post Office Limited
November 2008

Post Office Limited – Strictly Confidential

Annex A

POST OFFICE LIMITED – POL Risk and Compliance issues: Detailed report

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1. Financial services compliance arrangements

1. POL's role as distributor rather than provider of financial services has purposefully put POL in the position that it should be able to rely on product providers as principals to take responsibility for regulatory compliance in respect of their products and services in most instances. Following this model, the Bank of Ireland (the bank) takes regulatory responsibility for POL's compliance with FSA requirements for activities regulated by FSA i.e. intermediation in relation to General Insurance and investment products. Arranging bank savings products is regulated by the Banking Code Standards Board and POL must follow the bank's instructions about the way in which these products are introduced to customers to ensure that the bank remains compliant with the Code requirements. A Regulatory Guidance Manual issued by the bank to POL is intended to provide clarity for POL about what it can and cannot do when dealing with customers.

2. NS&I are not regulated by FSA but are also a voluntary signatory to the Banking Code and NS&I look to POL, through their contract with us, to enable them to meet their obligations under the Code.

3. For bureau de change and money transmission services, POL itself is directly accountable to HM Revenue and Customs (HMRC) for compliance with anti-money laundering statutory and regulatory obligations. And POL has recently become a signatory to the Banking Code and a voluntary participant in the Financial Ombudsman Scheme in respect of its bureau de change and Postal Order services.

4. Whether fulfilling indirect or direct obligations, POL's strategic objective to build a viable financial services business, and its reputation and brand values are put at risk by non compliance. To ensure that POL is correctly positioned to manage these compliance risks, we commissioned Deloitte & Touche to undertake a review of the adequacy of our financial services compliance arrangements both against regulatory requirements in relation to POL's role as distributor, and against standards reflecting industry best practice in compliance.

5. Key findings from the Deloitte review, as presented to POL ET in September, in respect of regulatory responsibilities were that:-

- whilst policies and standards are appropriate, the levels of conformance with compliance requirements in the POL branch network are generally significantly short of those that FSA would look for; and
- allocation of some aspects of regulatory responsibilities between POL and product providers is not documented in agreements with those providers.

In respect of industry good practices, they noted that:-

- there appeared to be an acceptance of levels of non conformance that were inconsistent with POL's stated low risk appetite
- the frequency of audit in branches is low with a large proportion of branches not likely to receive a compliance audit where they are perceived to be low risk;
- MI for line managers about compliance is not put in context with other business indicators; and
- the Compliance Department does not have a role in areas where a compliance functions in an authorised firm would have a strong involvement, including the allocation and fulfilment of senior management responsibilities or prudential 'systems and controls'. These are areas that are largely driven by FSA's Principles for Business as distinct from rules directly applicable to POL's activities.

6. Deloitte also suggested that POL should consider whether reliance on the Bank of Ireland for compliance guidance is the best strategic positioning for POL. They said that TCF provides an example where the bank's and POL's interests may not be wholly aligned. They also said that POL should consider segmentation of the branch network to differentiate between those outlets that do a level of business that would justify greater investment in training and other controls to ensure adequate compliance and those that do not. We should consider reducing risks by restricting the product and service offering in the latter type of branch.

7. POL ET accepted that it should address all these issues. An implementation plan to address Deloitte's recommendations is being developed at the time of writing and will be put to POL ET for approval on 10 November. This plan will give priority to addressing issues relating to directly applicable responsibilities and will ensure alignment of POL's strategic programmes (see comments below on Network Efficiency) and other initiatives with the actions necessary to address Compliance gaps.

2. Treating Customers Fairly

8. FSA has given a high profile over recent years to its retail theme of Treating Customers Fairly. This theme was a response by FSA to mis-selling 'scandals' in which firms put their own interests ahead of those of their customers. The FSA has set a deadline of the end of December this year for authorised firms to be able to demonstrate that they are meeting its required 'outcomes' and that they are treating customers fairly. The Bank of Ireland is accountable for ensuring compliance, where the requirements are relevant to POL's role as distributor of FSA regulated products. The bank has worked through the Post Office Financial Services (POFS) joint venture to meet FSA's requirements in respect of the POFS products. Through the Regulatory Guidance Manual it controls how we deal with customers, the bank approves all customer facing material and internal training material and its approval is required for all product development. We understand that in its reviews of the bank's TCF work, FSA has not challenged any aspect of the bank's approach in relation to POL's activities.

9. In commissioning Deloitte we asked that they review, in the context of meeting industry best practice standards, whether POL would meet FSA's broader TCF

requirements for authorised firms. They concluded that the POL initiative to embed 'Fairer, Easier, Better' as brand values in all that POL does, was likely to also meet many of FSA's expectations in relation to TCF. They recommended that;

- the alignment between FEB and TCF should be documented and any gaps identified and addressed to ensure that POL could demonstrate culturally embedded consideration of fairness for customers in senior management decision making;
- TCF values should be reinforced through inclusion of specific TCF/FEB objectives within the performance management process;
- new MI should be developed to better evidence TCF/FEB delivery; and
- controls over customer experience in Post Office branches should be strengthened to improve product knowledge and reduce risks that advice is given.

10. Actions to address these recommendations will be included in the implementation plan for the Deloitte review.

3. Post Office Christmas Club

11. POL launched its Post Office Christmas Club in January this year and received strong support from Government Ministers and from consumer groups concerned with easy access to safe Christmas savings schemes. This followed the failure of the Farepack hamper company scheme. The product is provided by Bank of Ireland cross border from Ireland and is structured as an E-money card rather than as a bank savings account. As such it falls outside the coverage of either the UK or the Irish deposit protection schemes. The security of having funds held by a major bank was seen as a strong feature of the scheme and we believed that the E-money card was the only economically viable product we could offer that provided good payment features for customers. The current average balance on cards (i.e. at the point just before they can be spent) is less than £100 and the maximum saving is £1000. The absence of protection in the unlikely event of the Bank of Ireland defaulting was explained in terms and conditions and repeated immediately adjacent to the customer's signature box on the application form.

12. FSA do not regulate any aspect of the provision or sale of this product in the UK. However, earlier this year their retail policy team raised a number of questions about the product and how it was structured, focussing solely on the issue of protection coverage. Their concern was said to be that under TCF Principles it was not appropriate for POL to have designed a product that was aimed at 'vulnerable' customers that did not benefit from protection of funds at every stage. We responded to their questions and in September agreed to their requests that we should consider whether the product could be restructured on a viable basis, to bring it within the Irish Deposit Protection Scheme and if not to give a greater prominence in leaflets to the lack of compensation cover. Whilst we do not believe that POL or the bank are in fact in breach of any legislative or regulatory requirement or that FSA has any jurisdiction in relation to this product, we none the less felt that it would not be appropriate to risk confrontation with FSA.

13. FSA – with support apparently from HMT - then told DBERR that it was still not satisfied and that it was formally considering whether or not it should itself publicise the weakness (in its view) of the scheme under the broad umbrella of fulfilling its statutory objectives in relation to consumer protection. They asked DBERR to pass this message to POL. DBERR did so but with a strong message of its own to FSA that DBERR did not regard this as an appropriate matter for them to be getting involved in. We arranged to meet FSA directly to address their remaining issues.

14. Before that meeting took place the Irish Government announced its scheme to guarantee the obligations of a number of Irish banks including Bank of Ireland. Advice from the bank was that the guarantee would cover E-money funds. In our subsequent discussion with FSA they agreed that so long as the guarantee remains in place, they would regard the funds as secure and that they did not propose further action unless and until that changed. We restated that we were in any case seeking guidance from the Irish Deposit Protection Scheme to enable us to identify what changes could be made to the structure of the Christmas Club to bring it within the scope of the protection scheme.

15. We are now progressing those discussions with the Bank with a view to introducing any changes from the relaunch of the scheme for 2009.

4. Telephony

16. POL's HomePhone and Broadband products are provided by BT Wholesale (BTW) as a 'managed service'. BTW undertake end to end activities including customer facing call centres and application processing, servicing and complaints handling and billing. There are comprehensive service level agreements and non-compliance penalties in POL's contracts with BTW. However, BTW has struggled to deliver appropriate standards in many areas since the transfer of this business to them in November last year, resulting in poor service to our customers, breaches of regulatory requirements and damage to confidence in the products in our branch network . POL believes that BTW have been on a steep learning curve and we have tried to work with them to prioritise actions and focus on delivering service standards for our customers. But we recognise that POL has also not tackled BTW in the most effective way. An Internal Audit review of the management of BTW's delivery of this service for POL reported in August with an 'improvement required' rating. The most significant issues from that report are included below.

17. POL's management of the relationship with BTW has been split across Marketing and Operations functions within POL resulting in a risk of duplicated activities and of poor communication between the two areas. This has now been addressed and all relationship management activities and accountabilities are now focussed on the Operations team. At the same time work is underway to rationalise the MI received by POL to ensure that it is able to identify and address key issues more effectively

18. Regulatory breaches have occurred because BTW has failed to meet Ofcom requirements for publishing audited quality of service measures showing standards of handling of new customer set ups, fault reports, complaints and other customer service activities. External audits of the accuracy of data collected by BTW for these measures have been failed each quarter since last November, putting POL in breach. These failures originate in weaknesses in BTW's systems, training and controls that it has been seeking to resolve, but we are now looking to the improved focus of our relationship management activity to give this area higher priority for BTW.

19. Similarly Ofcom sets externally audited standards that larger providers must meet in relation to the accuracy of call metering and billing and POL should have met those requirements from the end of the last financial year. BTW have experienced difficulty managing the HomePhone billing systems and POL has had to work with them to manage down the number of customers who have not been billed for services. This work has been following an agreed plan that will mean that the number of bills that have been held up for any reason is less than 2000 at any one time from early 2009. POL has been working with the British Standards Institution to gain approval for BTW's metering and billing systems and they and Ofcom are aware of our progress on these issues.

20. As POL is accountable to Ofcom for the regulatory breaches, we have kept Ofcom informed of the issues we have experienced since BTW took on the provision of our telecoms services and we do not believe that, in respect of either the quality of service or billing requirements, they are contemplating any form of investigation or other action. However they have commented about the high level of calls they receive from our customers about billing problems and if we fail to deliver on reductions in the number of unbilled customers, they may feel that there is a case to investigate.

21. Under our contracts with BTW, they are responsible for financial losses that arise from billing failures and there will be instances where we have not been able to bill older call charges and line rental because Ofcom limit the period we can bill for. We intend to pursue settlement from BTW for this lost income and where possible for penalties on service level failures.

5. Losses

22. POL incurs losses from controls and compliance failures in its activities through:
    - Robberies and burglaries in branches and attacks on cash in transit
    - Fraud and theft against POL by customers, staff and subpostmasters
    - Transaction processing errors in branches including cheque collection
    - Stock mis-management and write offs of unsaleable stock
    - Bad debts on telecoms products

    In 08/09 we currently expect these items to amount to £17.25m. That is broadly in line with recent years and the overall level of losses has proved difficult to reduce. Some loss types are influenced by external factors – for example we anticipate that recession in the UK economy and contraction of bank lending will increase the likelihood of subpostmaster fraud – others are the result of weaknesses in product design or accounting processes that facilitate fraud or make processing errors more likely.

23. Crown Office losses were £2.2m last year and an initiative has been underway since the start of this year to achieve a 25% reduction this year. This has included implementing in September a revised Losses and Gains policy requiring branch managers to take performance management action where staff errors cause losses and an audit of cash holdings in Crown Offices using surplus Network management resources. These actions will not yet have had an impact and losses are still running at a similar level to previous years. Further action to address the worst performing branches is planned.

24. Subpostmasters can commit fraud by inflating cash, stock or cheques values to hide theft. POL's first line of defence is its branch audit team. To the end of period 6 this year, branch audit had identified £4.2 million of accounting discrepancies in 633 audits. These audits were focused on branches identified through risk modelling of all Network branches and through issue specific analysis of data such as outstanding cheque values, cash holdings and transaction corrections. 20% of these risk based audits resulted in suspension of the subpostmaster and the effectiveness of the risk based approach is demonstrated by random sample audits that have, over time resulted in suspension in only 3% of cases.

25. Analysis of subpostmaster fraud has shown that the risk is greatest in the first five years of an appointment and within the Network Efficiency Programme (see below) a number of initiatives are being developed to improve the effectiveness of vetting and monitoring of the credit worthiness of subpostmasters, the support by way of induction training and assistance offered to new subpostmasters and the nature of management information provided to Network Line Managers to enable them to spot and manage risks at specific branches. POL has also had considerable success in

recovery against subpostmaster losses, utilising powers to confiscate assets under the Proceeds of Crime Act. £1.2 m has been recovered to date this year in this way and an additional accredited Financial Investigator has been taken on to boost resources to prosecute and recover

26. Product specific loss issues:

- Stock adjustments: Branches perform some 3 million stock adjustment transactions a year. In almost all cases this is an inappropriate way of correcting accounting records. They are typically using the "other postage" icon in Horizon for ease to account for other things and then attempting to reverse that out by doing a "stock adjustment". The three prime reasons are:
    - booking in stock from Swindon – but using "stock adjustment" instead of the "stock remittance" icon;
    - reversing sales entries – again using "stock adjustments" instead of the reversals icon; and
    - Stock quantity errors – e.g. booking in rolls of 1,000 stamps as 1,000 rolls.

  A stock adjustment transaction will change the reported cash position on Horizon and branches may be using this transaction to fraudulently manipulate cash balances or may merely have been surprised to find Horizon telling them that they have a cash surplus.

  Transaction corrections are being processed going back over the last 3 months to recover funds from branches and POL has stepped up its controls in respect of these accounting transactions. We are also discussing with RML the impact of these 'adjustments' on our accounting to them for sales of mails products. The cost to POL this year is estimated at £1.2m.

- Savings stamps: POL's Savings Stamps product is paper based, with branches selling £5 savings stamps that customers then attach to a card and retain until they want to use them to purchase products or services in PO branches. They cannot be 'cashed' either for sterling or currency and hence POL avoids being considered to be deposit taking. Branches are required to send redeemed stamps to POL's branch accounting team. That team have recently stepped up their checking of these returns and have reduced discrepancies from inflated claims or failure to return stamps from £215k to £60k per month. POL's Marketing team are now reviewing whether this product would remain viable with improved security from bar coding stamps or whether there are other non-paper based products that could meet customers' needs more effectively.

- Travel insurance refunds: POL discovered earlier this year that there was around a 6% error rate in branch calculations of travel insurance premiums. Data identifying these errors had been in POL's hands for over two years and concerns had focussed on the possibility of recovery of undercharges from Subpostmasters, but some 50,000 customers had been overcharged in the period for data was held. In keeping with POL's brand value of fairness and to meet FSA's likely concerns we agreed with Bank of Ireland that we would refund up to £615k of premiums to customers. The bank briefed FSA who confirmed that in the light of our action they would not investigate or take other action. These refunds have now been offered to customers and we have so far paid out £375k. Calculations will be automated through Horizon from mid November which should remove the risk of this error in branches. Costs of writing off of both under and over charges and remedial action are likely to exceed £2m.

- Post Shop: POL has taken the decision to focus its Post Shop offering on stationery and mails related products and to drop the much wider range of electrical and other products. This will involve write downs in values this year currently estimated at £1.7m. Where possible old stock is being sold back to suppliers but much will be disposed of as having no value.

6. Network Efficiency

27. POL has over 45, 000 people working at counters in over 12,000 branches. Over three quarters of those are employed by someone other than Post Office Limited and in circumstances where we have little control over their competence and skills. To keep branches open we have sometimes had to accept subpostmasters who have little if any experience of running a retail outlet or of managing a small business. POL has traditionally accepted that the level of non-conformance that this gives rise to is a cost of running our business. We have carried the costs of writing off small value transaction corrections, of employing staff to investigate and correct larger transactions (currently over 40 staff generating around170, 000 corrections per year) of having more cash held in branches than is necessary, of settlement delayed because branches have held on to cheques and of course of complaints to our customer care teams about service in branches.

28. To deliver our 2011 objectives we cannot ignore the potential savings from driving up conformance and, equally we need to ensure that failure to meet statutory and regulatory requirements does not threaten our ability to deliver sales and income. FSA, Ofcom and HMRC all have powers to require us to stop sales activities and will do so were they to find that we have systematically failed to meet their standards.

29. To tackle these challenges we have established a cross functional programme as part of POL's 2011 Strategic Programme with the objective of optimising benefits from conformance improvements and achieving a step change in branch conformance. This programme is known as the Network Efficiency Programme and is working across both Crown Office and agency networks. Some of the key issues and deliverables are set out below.

30. POL does not currently have a single measure or index of all aspects of branch conformance. We have in the last two years established a 'regulatory' Network Compliance Scorecard that incorporates numbers from branch audit activity, compliance mystery shopping and monitoring of all over £5k bureau de change transactions for identification compliance. A single regulatory compliance basket measure is calculated from the Scorecard, but that measure does not pick up other broader conformance measures such as the number of branches exceeding their expected cash holdings or the number of transaction corrections. The Network Efficiency Programme will address this to create a new composite measure can be used by Network line managers to focus efforts on failing branches and track improvement.

31. POL typically has between £400m and £600m in cash held at branches at any time. This is inflated when additional one off benefits payments are being made and is currently being pushed up by the roll out of ATMs and an extension of bureau on demand branches. A number of specific activities have already been undertaken to drive reductions in overnight cash holdings (ONCH). These have included improving management of cash in ATMs, where we are seeking a reduction of £25m in ONCH and action to reduce cash holdings in Crown Offices and 1500 agency branches thought to be holding too much cash. The Programme has also used this as an opportunity to deploy LEAN methodology to look for further savings opportunities.

32. One key weakness in POL's approach to conformance to date has been that it has not had a consistent approach to enforcing conformance with operating procedures. The Network Efficiency Programme is now looking at communicating and implementing a 'Consequences' policy that sets out for both Crown Offices and agency branches how POL will respond to persistent or serious failings at branches. To be effective this policy will have to ensure that outcomes are seen as fair and proportionate and we will want to seek to ensure that the NFSP is supportive. The key requirement for implementation will be to able to pull together information about branch errors from different sources and have a formal process of trigger points for warnings and action. However the impact of more active policing of standards will be that action to stop branches undertaking specific activities (for example withdrawing bureau de change) or to terminate a subpostmaster appointment, will lead to concern from local communities that offices are not offering a full service or are not being kept open.

7. Top Risks

33. POL tracks its Top Risks through a quarterly review by the Exec Team. The number of Top Risks will vary over time and recent events in financial services and in the economy generally have given rise to a number of new or refocused risks being identified in the latest review.

34. In the early part of October, the flow of savings through POL branches into both NS&I and Bank of Ireland products was such that daily settlements by POL to these clients reached £350m, against normal levels of around £60m. POL is required to settle with the Bank of Ireland on the third day after funds are accepted at branches, which is the day before we receive the proceeds of cheque collections even where branches despatch those cheques correctly on the day of receipt. At one point RMG had to cover a shortfall in POL funding through an external loan, but had that not been found POL may have been unable to meet its obligations. Settlements have reduced to nearer normal levels and POL has tightened its management of forward settlement requirements to avoid unfunded shortfalls.

35. POL has long recognised the risk that industrial action by union members in branches or in management could damage POL's delivery of services to customers and its brand. The pay settlements in 2007 should have reduced this risk, but a number of issues may re-emerge over the next year. In particular, RMG's plan to fulfil the 'Safe Net' service themselves will create 150 redundant posts in POL's Cash in Transit business and could lead to industrial action. And if inflation remains higher than anticipated, the unions could seek to re-open the 3 year pay deal. Mitigating these risks is largely out of POL's control, but we are seeking to strengthen relations with union leaders to encourage a longer term view.

36. POL's five year plan to 2011 called for significant growth in sales across the new product areas of financial services and telecoms products. In some product areas – particularly in savings even before the inflow of funds in October – we had done well against expectations, but in others that has not been the case. In terms of the objectives of the 2011 plan we will have to fill gaps through new income streams from developments in other areas, such as new identification validation products, or through greater cost savings (see below) and we remain confident that we can achieve the planned outcomes.

37. The lower than expected income numbers have meant that to meet the overall plan POL has to make greater costs savings. POL has established an Operational Efficiency Programme within its Strategic Programme to manage identification and realisation of cost savings and to date has identified £265m of a revised £300m

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target. Further savings are expected to be delivered through efficiency savings in Network and Cash in Transit costs and POL has done well in the recent past on delivering cost objectives. However, reliance on cost cutting to hit plan objectives is becoming increasingly difficult and budgets for 09/10 may have to incorporate lower headcount targets across the business. Inflation pressures on costs, in particular staff costs, would exacerbate this issue as will increased pension contributions by POL.

38. POL's current funding agreement with Government lasts until March 2011. Based on our experience of the length of time taken to reach agreement and obtain approval, and the extreme impact of failure to do so, POL ET agreed that this should be added to our Top Risks. Modelling of what may be required will be undertaken in this quarter with a view to developing a strategic approach before the end of this financial year.

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