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RESTRICTED - POLICY AND COMMERCIAL
ShEx Board 8 December 2010 (10)22

Update on Royal Mail and Post Office Limited for ShEx Board

Introduction

This note provides an update to the Board on the Royal Mail process including Post Office Limited. It covers three areas: (i) progress since the last Board meeting (ii) follow-up on questions asked by the Board (iii) next steps.

Progress since the last Board meeting

Since the Board last met, there has been considerable progress on the Royal Mail process, in particular in relation to the Postal Services Bill, the Post Office funding and in the general preparation for the restructuring envisaged in the Bill and subsequent transaction.

1. The Bill

The Bill was introduced to the Commons on 13th October, and is now in Committee stage. This is proceeding relatively well and we hope to be out of the Commons by December/January. On this basis, we are on-track for our planned Royal Assent before the Summer recess 2011.

The relationship with Royal Mail has been mixed during this period. There have been a number of set-backs, primarily because of communication surprises and because we are still building our relationships with the new team, but overall, the process is on-track. Royal Mail are broadly supportive of the bill, including the need to bring in external capital, the need for regulatory change and for Royal Mail to be relieved of its historic pension deficit. However, Royal Mail have aired their views quite publicly about the approach the Government is taking to regulation.

2. Business underlying performance

On 2 November, Royal Mail announced their interim results. Group profits fell from £184m in H1 2009/10 to £52m in H1 2010/11, a decline of 72%. Royal Mail Letters swung from a profit of £48m to a loss of £66m. The deteriorating performance was a result of revenue pressures in the letters business driven by declining volumes and mix (downtrading and switch to access), and also by a slow start to the modernisation programme given that the union agreement was only signed in March. RM have revised down their full year budget for the Group to c.£240m, vs £404m actual for the full year 2009/10 and a previous budget for 2010/11 of £405m. From the perspective of a sale process, this makes the March 2012 outturn all the more critical.

3. Business plan / funding

Royal Mail delivered a first draft of their business plan to HMG in November, after first promising it in September. The plan is in draft form and still early stage with some critical inputs still required.

UKGI00001342

It will be critical for HMG to get comfortable about the plan, as we must take ownership of it for the Brussels State Aid process. The base case will now be diligenced by PWC, adviser to RM but we will rely on this work and get it supplemented by work from UBS / Deloitte as advisers to HMG.

As well as the outstanding work around diligencing the plan, there are a number of overlays required to convert it from a "business as usual plan" into one that reflects the pensions restructuring contemplated by the Bill and any other funding required, all of which will be scrutinised by Brussels as part of the State Aid process. This Restructuring Plan needs to prove to the Commission that the Aid granted to Royal Mail will ensure its viability, even in downside scenarios, but also, that it is the minimum necessary to do so.

HMG and RM are working on the basis that there will be a business plan which all parties are sufficiently comfortable with such that a state aid notification can be made in late January 2011. However, this currently feels very ambitious given that RM are only just starting to make proposals to HMG on funding requirements and we have not yet had any time to scrutinise this work. There is also a risk that this will be exacerbated by the new Finance Director, who joined w/c 22nd November and will need to establish himself and understand the business.

Moya Greene has indicated to Parliament in her evidence at Committee that the additional funding ask could be of the order of £2-3bn. We now understand that her preference is to capitalise the business sufficiently so that it is investment grade at the point of a deal. While we have sympathy with this position from a transaction perspective, there are real issues in relation to both Brussels and Whitehall in assuming this will be feasible and we need to work through this urgently in the short term. In addition, RM are due to breach the covenants on their existing HMG loan facilities during 2011 and work is getting underway to address this situation, ideally on market terms. All of this funding work will involve ShEx working closely with HMT.

4. Brussels timetable

State aid approval will be required both for the pensions solution and also for any additional funding from HMG that Royal Mail may need. On the current timetable, HMG hope to make a Brussels pre-notification in late January, with a formal notification towards the end of March, and state aid approval in November 2011. However, approval for this amount of aid is not going to be straightforward: the pensions aid is a significant amount with no legal precedent which the Commission can rely on, and the business is under-capitalised, but arguing for more capital for revenue growth (to offset core business decline) will be hard. For this reason, we need to explore all possible avenues for getting a sensible outcome on compensatory measures from Brussels.

5. Regulation

While Royal Mail are supportive of the need for regulatory change, they do not believe that the bill goes far enough in protecting Royal Mail's position as the universal service provider and on this basis have aired their concerns publicly. The CWU is aligned with Royal Mail in criticising the Government's approach to regulation.

The fundamental policy difference between the company and HMG's policy team (which is separate from Shareholder Executive) is that the company believes that HMG should be making regulatory policy explicit, including through the legislation, whereas HMG has chosen to largely devolve the specifics to an independent regulator. Royal Mail believe that without greater regulatory certainly, the value of the business and the ability to attract private capital will be compromised. While in a narrow shareholder perspective ShEx of course has some sympathy with this, we recognise that HMG cannot set the regulatory framework in order to maximise sale returns. However, Edward Davey is well seized of the fact that Royal Mail is the only company capable of delivering the USO, and that private capital is critical to securing its future. Ensuring that the regulatory regime enables a transaction is therefore an essential part of securing the future of the USO.

From a shareholder perspective, we do not want Royal Mail's concerns about regulation to derail the bill process, and this message has been communicated very clearly directly by Edward Davey to Moya Greene. We also believe that the regulatory framework, if correctly interpreted by Ofcom, should be capable of producing a sustainable USO (and an investment proposition for Royal Mail).

6. Pensions

Our investment banking advisers have been clear that in order to attract private capital, HMG will need to take responsibility for RM's historic pension deficit. The Bill will allow HMG to take on the deficit but it is HMG's policy that the pension solution is linked to the introduction of private capital and we cannot have one without the other. While HMG will take on all of the historic net deficit at RM, RM will be left with c.£1.5bn of assets and c.£1.5bn of liabilities (i.e. fully funded initially). This is calculated to leave the RMPP with that portion of liabilities attributable to the projected uplift in salaries above inflation (the "salary link"). This is a different position from the 2009 Bill, where the cut off point would have left the Company with c.£3bn of liabilities (and assets). However, UBS' view is that given the wider risks in this situation, it is not feasible to layer on significant pension risk as well.

The CWU's view is that the pension is Government's policy anyway and that we should get on and remove it regardless of privatisation. Clearly once the Bill is on the statute book, this pressure to take on the pension deficit immediately will only increase, particularly if a transaction takes longer than expected and therefore the Pension Regulator (which is currently investigating the funding agreed between the company and trustees) cannot avoid taking action.

7. Post Office Limited (POL)

As part of the spending review, £1.34bn of funding was agreed for POL which is an enormous achievement. The key element of this is a movement to a variable pay model for agents, thereby reducing the ongoing costs of sustaining the network and mitigating downside revenue risk. POL's commercial strategy also sets out ambitious revenue growth in government services (£175m over the plan), which we are working with POL, Cabinet Office and other government departments to help deliver. A policy statement setting out the Government's plans for the network was published on 9

UKGI00001342

November. This included details of the new network models mentioned above and opportunities for government services with the Post Office acting as a 'Front Office for Government'.

The Postal Services Bill creates a framework for the future mutualisation of POL, which Ministers hope will better align the interests of POL staff, sub postmasters, and potentially customers. The proposals have been well received and we have commissioned Co-operatives UK to seek the views of major stakeholders and to report on options in spring 2011.

There has, however been significant parliamentary and stakeholder pressure for the legislation to include a statutory link between Royal Mail and POL, to ensure that RM continues to use POL as its retail channel after a transaction and to prevent further post office closures, despite the clear commitment that there will be no further closure programme. Two options are frequently suggested – legislating to require a ten year commercial agreement between the companies (which to be meaningful would likely breach competition law) or requiring Royal Mail to provide access points for parcels with the same density as the Post Office network. Though we have resisted this so far, some concession, ideally only a reporting requirement may well be needed.

Before bringing private capital into RM, POL will need to be separated as it will not be included in the sale. The details and timing for the separation are being worked through with Royal Mail. The separation may take place as early as September 2011. ShEx are working through options for Governance of POL going forward because we recognise that even before a separation, it is important that both RM and POL's interests are represented.

Follow up questions asked by the Board

At the last Board, there were questions on two areas:

- What needs to be done to deliver a sale
- What happens if a sale cannot be undertaken

UBS have prepared a number of papers for the Shareholder Executive over the last few months and we attach at Annex A their high level summary on these two issues.

Next steps

The key next step for the Letters business is for the business plan and funding situation to be resolved, so that HMG is in a position to begin the state aid notification process. Any delays to the state aid application process will likely have knock-on implications for the plans to bring in private capital as early as H1 2012. For the Post Office, there is work on-going on the mutualisation proposals and governance in advance of separation as outlined above. In parallel, the legislative process will continue but the experience so far is that this is going well and, we hope, will continue to do so.

We will also need to focus on some business as usual issues. In particular, we are keen to build a strong working relationship with the new Finance Director. We will also

UKGI00001342

need to consider how best to support RM through their short-term funding situation, including by way of covenant waivers as required.