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PRIVILEGED AND CONFIDENTIAL**Royal Mail Holdings plc Audit & Risk Committee****Fines, Compensation and Material Litigation Report half year update****Purpose of Paper**

1. The purpose of this paper is to provide an update on accruals and provisions covering potential fines, quality of service compensation and current material litigation and environmental issues.
2. The movements in the balances reported held at the 2010-11 year end are summarised in the table below:

	Specific regulatory accrual	Claims provisions						Total
		REIMS	TUPE	Industrial diseases	Amazon	Risk * accrual		
	£m	£m	£m	£m	£m	£m	£m	£m
Opening balance at 28 March 2011	5	12	2	30	-	5	54	
Released in P1-6	(5)	-	(2)	-	-	-	(7)	
Utilisation in P1-6	-	-	-	(1)	-	-	(1)	
Raised in P1-6	-	5	-	-	7	17	29	
Unwinding of discount	-	-	-	1	-	-	1	
Amendments in P7	-	-	-	-	(3)	3	-	
Closing balance at Sept 2011	-	17	-	30	4	25	76	
<i>Business unit</i>	<i>UKLPI</i>	<i>UKLPI</i>	<i>POL</i>	<i>Group</i>	<i>UKLPI</i>	<i>UKLPI</i>		

* - Central regulatory, litigation, IT and environmental accrual

Specific regulatory accruals

3. There was a regulatory accrual of £4.7m held at the end of 2010-11. The subsequent movement is explained below.

Quality of Service Compensation – 2010-11

4. Quality of service in April 2010 was impacted by volcanic ash which resulted in flight cancellations, impacting first class and premium products such as special delivery.
5. Quality of service for first class/special delivery fell below the target in September, October and November 2010 for a number of reasons including the mail centre rationalisations in the North West.

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6. Quality of service across all major products was impacted in December 2010 due to the adverse weather conditions across the country and particularly the North and Scotland, rendering it impossible to collect, trunk and deliver mail during the run up to Christmas.
7. There was a knock on effect into January 2011 to recover from the Christmas backlog such resulting in quality of service below targets for most products.
8. Although trends improved in February 2011, almost every major product other than DSA was below target.
9. Compensation is paid to account customers if the actual results are >1% lower than the target. Pre force majeure, first class account mail's quality of service was 89.2% versus a target of 91.0% and, at this level, £5m would be payable.
10. A robust force majeure case (relating to both ash and the impact of the severe weather) was presented to Postcomm/Ofcom to seek dispensation for this service failure.
11. Postcomm issued a decision letter on 26 July 2011 accepting in full three of Royal Mail's force majeure submissions and accepting in part a fourth submission, thereby granting dispensation for service failure sufficient to remove the requirement to pay compensation to account customers.
12. Accordingly, the accrual of £4.7m has been released at 25 September 2011.

Claims provisions

REIMS exit provisions

13. REIMS provides a system for intercompany pricing (terminal dues) for postal operators in Europe which are parties to it (Royal Mail is no longer a party to REIMS). REIMS rates are higher than those of the UPU (Universal Postal Union).
14. REIMS exit provisions represent Royal Mail's estimate of how much we expect to agree terminal dues rates with other European postal operators over and above UPU rates.
15. No new claims in respect of REIMS settlements have been received although amounts provided at the 2010-11 year end have been reassessed and adjusted as appropriate.
16. The balance of the REIMS exit provision at 25 September 2011 is £16.9m and includes amounts relating to Germany (£5m), France (7m) and Greece (£3m).

CWU TUPE Regulations challenge

17. This matter relates to claims by the CWU in respect of WH Smith conversions that TUPE information and consultation obligations have not been complied with by RMG (as employer of record with the relevant employees seconded to POL).
18. The CWU succeeded in its claims before the employment tribunal. RMG appealed to the Employment Appeal Tribunal (EAT). The EAT found in RMG's favour in December 2008. The CWU sought leave to appeal to the Court of Appeal and permission was granted. The Court of Appeal heard the CWU's appeal which was on the narrow point of whether there is a breach of TUPE where an employer informs employee representatives of its mistaken but genuinely held belief that employees will not transfer under TUPE.

19. The Court of Appeal handed down its decision on 14 October 2009 dismissing the CWU's appeal and found that the information and consultation obligations under TUPE only oblige an employer to describe what it genuinely believes to be the legal, social and economic implications of a proposed transfer.
20. Having clarified the law, the Court of Appeal remitted the matter to a fresh tribunal to hear the facts and apply the law as clarified to those facts. The Employment Tribunal found in favour of Royal Mail in that it had not breached the requirements to inform and consult in accordance with the requirements of TUPE in relation to Post Offices which had been franchised to WH Smiths.
21. A provision of £2.4m was held at the 2010-11 year end but reassessment at half year has resulted in this no longer being deemed necessary and the provision has therefore been released.

Industrial diseases provision

22. The background to the industrial diseases provision can be found in Appendix A.
23. The report from Towers Watson in March 2011 gave their best estimate of the potential for industrial diseases claims against Royal Mail as circa £75m gross (ie unadjusted for the time value of money). Using a discount rate of 5% as a proxy for the risk free rate (based on government bond rates for the term of the provision), a total provision of £30m was raised at the year end.
24. The provision will be reassessed formally at the 2011-12 year end and the movement during the first half year relates to utilisation and the unwinding of the discount.

Amazon claim accrual

25. Amazon claimed mid way through September 2011 that Royal Mail overcharged it between 1 April 2010 and 31 July 2011, in respect of Packet Post Services. On 1 April 2010, due to regulatory concerns, Royal Mail stopped applying a reconciliation process to Amazon Packet Post (which would give a debit or credit at the end of a month depending on the actual weights of posted items). Amazon claims it was overcharged as a result of the reconciliation process ending. Royal Mail refutes that Amazon was overcharged. Amazon has not yet issued a legal claim, but has escalated its claim to the top levels of Royal Mail. While further investigation was being undertaken into this claim at the half year, an accrual of £6.8m was raised.
26. Subsequent to the half year, a confidential agreement settling the dispute was signed on 12 October 2011.

Horizon claims

27. Post Office Limited has received four letters before action from a firm acting for former subpostmasters who were dismissed when discrepancies between their branch accounts and cash positions were discovered. Two of the claimants previously pleaded guilty to false accounting in criminal prosecutions brought by POL.
28. Each claimant alleges wrongful termination of contract (based on alleged failings in POL's processes and computer system) and seeks circa £150k in damages. We may receive a large number of similar claims - possibly between 55 and 150 according to press reports.
29. The key legal issues arising are common to all the claims but the factual allegations are different. Our strategy is to defend each claim robustly to deter future claims and we will be responding to each in full. At present we consider the legal claims to be

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weak and the damages claims to be inflated. We do not know what the ultimate value of these claims will be. We do not know what the ultimate value of these claims will be.

30. In summary, the considered legal view is that the claimants are unlikely to succeed. Nevertheless, given the potentially high volume of claims that may be issued in the county courts, we were advised by our QC, Richard Morgan of Maitland Chambers, that “the quality of the judges would be unpredictable making it more likely that one or two cases might be lost”. In light of this litigation risk, and the fact that a large volume of claims may be received (that collectively may pose a material financial risk), it is prudent to flag these cases at this stage. However, these claims are at an early stage and we do not know how many claims we will receive or what their ultimate value will be. We understand that it has therefore been proposed that no provision will be made and there is no disclosure requirement at the half year.

Jeff Triggs
November 2011

Central Regulatory, Litigation, IT and Environmental accrual

31. A central accrual of £25m exists at the half year to address various regulatory, litigation and environmental risks including three that have only emerged in the last two months:

- a. Overall Quality of Service failure: currently 7 of the 11 licence quality of service targets are not being met and 6 of our commercial targets are not being met. Details of P6 QoS results are shown at Appendix B. Although the majority of these in themselves would not trigger compensation payments at this point in time – because they are within the tolerable error of 1% absolute lower than target – we would normally expect to be in a far better place given Q1 and Q2 are the periods where the weather is most favourable and the volumes are lighter. Indeed in prior periods we have generally been in favourable positions and “banked” this over performance recognising that Q3 and Q4 can be difficult months even without adverse weather. Subsequent to the half year, P7 QoS results were worse than prior year by 0.3% but early indications for P8 are encouraging.

We are not currently meeting the USO collection and delivery targets and in fact we have not met both these targets since 2006-07 without adjustment for force majeure (for industrial action and/or bad weather) and this appears to be due to both industrial action and Letters modernisation. This and the underperformance in first class retail could be used by the media which could put pressure on the new regulator to take a tough stance.

Bulk compensation accruals have been raised at the year end in the last two years when relative underlying performance at the half year was better (2010-11 £5m; 2009-10 £10m), but have been released in prior periods after dispensation was approved.

The risk is assessed to be in the £0m to £5m range.

- b. Changes to customers entitlements to seek compensation: Postcomm announced in September 2011 it was consulting on the removal of entitlement to claim compensation from Royal Mail for loss or damage of untracked contract mail services and a reduction in the claim period for loss of or damage to mailed items where the right to claim compensation remains (such as contract tracked services) to 80 calendar days from 12 months.

We expect this consultation to complete in January 2012 and that Ofcom will agree with our proposals. We believe that the publicity around this will increase the level of claims for compensation for loss / damage in the short term and in the rest of this financial year. We have never implemented such a change in recent times – and

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therefore there is no precedent - but have already received a claim from Amazon (of £1.8m over and above the one explained above). We expect further claims from Amazon and the rest of the bulk mail and packets market.

The risk is assessed to be in the £0m to £15m range.

c. iRed: A decision to close iRed down has been taken and a provision of £1m has been booked to business disposals / closure within exceptional items. A forensic audit has been performed by PwC and the interim CEO, Declan Salter. There is a risk that iRed claimed too many savings than contractually entitled to and that these may have to be de-recognised.

The risk is assessed to be in the £0m to £5m range.

d. IT risks: a £5m accrual was booked in 2010-11 to cover a risk that IT licences fees have been under paid compared to the amount of use. Although no formal request has been made by IT suppliers to review the usage in 2011-12, we did settle with Oracle for £8m last year.

The new CIO has identified a number of risks in the IT estate that have potential cost and reputation impact on RM, should they occur. These encompass

- an inadequate IT security framework
- a gap in our current email archive process
- an aged server estate, a proportion of which is now out of support from the vendors.

Although work has started in all 3 areas to address these and some of the exposure will be reduced fairly quickly, for the 3rd area in particular, the exposure will remain for 12-18 months.

The risk is assessed to be in the £0m – 25m range.

32. The range for all of the above is £0m - £50m and driven by several abnormal events and the size, scale and complexity of the Group. Accruing £25m (50% of the maximum risk, or 0.5% of sales or costs) is considered to be reasonable at the half year and until further information and facts are known. This would not be specifically disclosed given the sensitive and commercial nature of the above risks.

33. Ernst & Young have been made aware of these risk areas and ranges and agree with the approach taken.

Mike Prince
November 2011

Recommendation

34. The Audit & Risk Committee is asked to:

- a. Note the amounts recorded for fines, compensation and material litigation at 25 September 2011 and agree they are reasonable in light of the risks and factors that have emerged since March 2011; and
- b. Agree that the Horizon claims are a contingent liability which is considered remote at this stage which means no accrual is booked and no disclosure is made.

Mike Prince
November 2011

Background to the Industrial Diseases Provision

35. The need to identify a specific industrial diseases provision has arisen through BT seeking clarification from the Court as to the liabilities transferred to BT following the split of the old Post Office Corporation in 1981. A test case was issued on 22 December 2008, with a stated value of over £100,000. The test case brought was based on one individual's claim for compensation as a result of his exposure to asbestos dust during his employment at the Post Office Corporation between 1961 and 1970. The individual was employed on the telecommunications side of the business.
36. Historically, BT had taken the approach of assuming liability for any pre-1981 claim that was addressed to it. Since 2008, BT have stated that claims from employees who left the old Post Office Corporation prior to 1981 should be met by Royal Mail regardless of whether or not that person worked mainly in the telecommunications or the postal areas of the business. In 2008, Royal Mail and BT agreed to split the liability of these claims 50/50, pending the outcome of the test case.
37. In November 2009, the test case was heard by the High Court which gave judgment in favour of Royal Mail's interpretation of the British Telecommunications Act (the Act) (namely that liability for ex-employees who had worked mainly in the telecommunications side of the business but had left the business prior to separation in 1981, remained with BT and not Royal Mail). The judgment was subsequently overturned on appeal.
38. In December 2010, Royal Mail was refused permission to appeal to the Supreme Court. As there are insufficient grounds to refer the case to the European Court, there is no option but to accept that the liabilities remain with Royal Mail.
39. There can be a long period (potentially up to 50 years) between exposure to asbestos and development of asbestos-related diseases. The heaviest period of exposure was between 1955 and 1975. Actuarial advice has therefore been sought from a specialist industrial diseases team from Towers Watson to quantify the potential value and profile of such claims going forward.

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Appendix B

LICENCE CONDITION 4 - QUALITY OF SERVICE
PERFORMANCE TO PERIOD 6 2011-12 (21 March to 4 September 2011)

No.	Scheduled Service or Standardised Measure	Licence Full Year Standard	Actual Period 6	Actual YTD To Period 6	Actual YTD To Period 5	Actual Performance Band I,II,III or IV	Rest Of Year Requirement To Meet Licence Target	Financial Consequences £m	Commentary from Head Of Service Compliance	
									Business C Factor Compensation	
1	Retail First Class	93.0	92.8	92.5		II	93.5	0.0	0.0	Performance in the period was impacted by the civil disruption in week one which disrupted collections and deliveries in parts of the country. In the remaining 3 weeks of the period the target was met. Cumulative performance remains below the full year licence standard. We still need to achieve an average rest of year performance of 93.5% for 1C Retail to achieve the full year target of 93.0%
2	Retail Second Class	98.5	98.8	98.6		I	98.4	0.0	0.0	Above the Licence Standard for the period and cumulatively. As with 1C Retail, performance in the period was impacted by the civil disruption in week one which disrupted collections and deliveries in parts of the country.
3	Bulk First Class	91.0	90.7	90.4		II	91.6	0.0	0.0	Above the Licence Standard for the period and 0.2% below cumulatively.
4	Bulk Second Class	97.5	97.6	97.3		II	97.7	0.0	0.0	Above the Licence Standard for the period and cumulatively.
5	Bulk Third Class	97.5	99.6	97.9		I	97.1	0.0	0.0	Above the Licence Standard for the period and cumulatively.
6	Standard Parcels	90.0	98.2	96.3		I	83.7	0.0	0.0	Above the Licence Standard for the period and cumulatively. The Standard Parcels result of 98.2% for P6 is the best ever.
7	European International Delivery	85.0			95.2	I	77.7	0.0	0.0	Well above the licence standard in Period 5. The Period 6 result is awaited from IPC.
8	Special Delivery Next Day Non-Account Customers	99.00	98.67	98.48		II	99.52	Not Applicable		Remains below the licence standard cumulatively. There remains an underlying issue with Special Delivery QoS as the Licence Standard has not been achieved in any period since Period 6 of 2008-09. Also impacted in this period by the civil disruption in week one.
9	Postcode Area: 1st Class Stamped And Meter Delivered From UK	91.5% minimum in all Postcode Areas except 3 (118)		88		IV		9.5	0.0	A modest improvement for the fifth period in a row with 88/118 PCA's now year-to-date at or above the Licence Standard for geographical 1C Retail Delivered performance. Of the 10 poorest performing PCA's 6 are in the South East, where transformational activity is contributing to the performance in the GU, BR, TW, RH, ME and KT PCA's. The rest of year requirement for the poorest performing PCA's remains achievable but extremely challenging.
10	Percentage Of Collection Points Served Each Day (USO)	99.90	99.83	99.89		II	99.91	0.0	0.0	Below the Licence Standard for the period and just falling below the full year standard cumulatively. The result in the period was impacted by the civil disruption in week one.
11	Percentage Of Delivery Routes Completed Each Day (USO)	99.90	99.83	99.84		II	99.96	0.0	0.0	Below the Licence Standard for the period and falling below the full year standard cumulatively. The result in the period was impacted by the civil disruption in week one.
12	Percentage Of Items Delivered Correctly	99.50	99.62	99.70		I	99.30	0.0	0.0	Above the Licence Standard.
Total £(m) =								9.5		

NB. Financial Consequences

* If the results continue at the Period 6 level for the remainder of the reporting year the financial punitive consequence would be C-factor revenue adjustment of £9.5m.

Red = Performance is below the full year Licence Standard

Green = Performance is at or above the full year Licence Standard

Key Points To Note:

- * Period 6 for all measures except International was 08.08.11 to 04.09.11 (4 weeks)
- * Year-to-date for all measures except International was 21.03.11 to 04.09.11 (24 weeks)
- * Period 5 for International was 01.08.11 - 31.08.11
- * Of the 10 results available, 5 are at or above the full year licence standard in the period
- * The civil disruption in week one has had an adverse impact across the board.

ANALYSIS COMPLETED BY : STEVEN HAWKSWORTH - HEAD OF SERVICE COMPLIANCE

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