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POL Strategy

What is POL and how does it work?

POL provides mails services, government services, telephony and financial services to consumers across a network of 12,000 (by end 2008) Post Offices nationwide. It is a subsidiary of Royal Mail Group Limited, which is the letters and parcels operating subsidiary of Royal Mail Holdings plc, which is 100% owned by HMG.

POL's network comprises of three main types of Post Office:

- 375 Crown offices directly owned by POL, and generally based in town and city centres, offering the full range of POL's products.

- 11,000 Sub Post Offices, varying in size and service offering, depending upon their location and market. Sub Post Offices are run on an agency basis, in partnership with individual Sub-Postmasters who will generally also provide a local retail outlet. Sub-Postmasters receive fixed pay from POL and additional variable pay based upon the number of transactions processed by the Sub-Postmaster concerned.

- 500 Outreach outlets, which are a flexible service delivery channel. There are different types of Outreach outlet – for example, some are mobile offices where a Post Office will be within a van that travels around generally rural areas; others are hosted services which typically set up for a certain period a week within a host site such as a church hall or community centre.

Given that such a large proportion of its outlets are dependent upon having willing agents to run them, to a certain degree the exact size of POL's network is out of its hands. There is always likely to be a level of natural attrition in the network. POL's investment case to March 2011 assumes a further 600 closures by natural attrition by then. POL's services are also available over the internet and via its call centre.

Strategic challenges

Changing customer patterns driven by technology: the network loses half a million pounds a day – these losses have more or less doubled in the past few years. In large part the losses are driven by changes in consumer behaviour. Four million fewer people use the Post Office each week than did two years ago - eight out of ten pensioners now have their pensions paid directly into the bank and among new retirees the figure is nine out of ten. Car tax online is a new service now used by a million people a month – last year it was only half a million. Most of the population pays one or more bills through Direct Debit.

A Government requirement to maintain a network that is not economically viable: POL's network of 12,000 is far larger than the purely commercial network – which POL estimates to be of the order of 4,000 to 4,500 outlets (by the end of the current funding period). To maintain the larger network, POL receives subsidy payments of around £150m per annum under the Network Subsidy Scheme.

Lack of direct control over the majority of its network: POL and its network will not always have exactly aligned interests – particularly given the point in relation to the network's size above. For example, certain of POL's current revenue streams produce a contribution to POL and hence cross-subsidise the larger than commercial network. However, sales of many of these products and services (e.g. broadband or savings products) do not produce the steady stream of footfall upon which many Sub-Postmasters rely to keep their retail businesses afloat. Where an associated retail outlet is unviable, POL's hands are to a certain extent tied since the Government requires it to maintain a larger than commercial network. POL often therefore faces the expense of seeking an alternative, viable outlet nearby, or over-compensating the existing Sub-Postmaster in order to keep his branch open.

Leading to financial losses:

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Financial Year	2007/08 actual (£m)	2008/09 forecast (£m)	2009/10 forecast (£m)	2010/11 forecast (£m)
Operating profit/ (loss) ex NSP	(186)	(133.5)	(64.9)	(106.7)
Operating profit/ (loss) net of £150m NSP	(36)	16.5	85.1	43.3

POL's operating loss for 2007/8 was £36m, which was smaller than the £72m loss predicted in its investment case. This reflects a slight over-performance in its Mails and Government Services revenue streams and also progress ahead of schedule on some cost-cutting programmes. The loss figures are after the revenue receipt of the £150m network subsidy payment – indicating that POL has further to go to break even net of its subsidy (the goal of the current investment case). Currently Government funding (separate from the NSP) covers these additional losses. In the past 3 financial years, POL has received nearly £700m to cover past and future losses (covering the period 2003/4 to 2010/11).

A lack of investment in the branch network: POL is pursuing a transformation plan which entails refurbishment of its Crown offices and certain cost saving measures (including franchising agreements with WH Smiths and some associated property and staff savings). However, this has no impact on the majority of Post Offices that are agency branches, the improvement of which will depend a great deal more on the entrepreneurial capabilities of individual Sub-Postmasters.

What are POL's main business areas?

POL's business is focussed on 4 main revenue streams – the "4 Pillars":

- Mails

  POL provides access to Royal Mail's services, under its "inter business contract". Last financial year these services accounted for £335m in net income (33%). Royal Mail is obliged under its licence to provide a universal postal service, and it is subject to a requirement to keep open a certain geographic distribution of "access points capable of handling the largest postal packets". This it does via its relationship with POL. However, Royal Mail estimates that it could achieve its licence commitment using approximately 2,000 POL outlets, and even Postcomm estimates the figure at 3,500-4,000 post offices.

  POL's revised investment case predicts that Mails net income will remain relatively stable at around the £320m mark until 2010/11. However, this is in the general context of declining Mails volumes, and so POL is looking to substitute income lost from declining traditional mails volumes with greater income from revenue streams such as parcels resulting from e-commerce.

- Government Services

  POL provides access to benefit and pension payments for millions of people across the country via the Post Office Card Account (POca). POca is responsible for approximately 15% of POL's revenues. Additionally, POL provides access to other Government Services, such as the Passport check and send service, and DVLA services. It is also attempting to build its local authority business (e.g. for the payment of council tax and as a focal point for local consultations). In total, last financial year Government services accounted for £255m in net income (25%).

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POL's current investment case predicts a downturn in revenues to approximately £70m in 2010/11, reflecting the assumption that there will be no POca revenue in that financial year. DWP is currently tendering the successor Government Card Account. In the event that POL should win, its revenues would be healthier, though its bid was priced keenly and it would be unlikely to be able to maintain the additional approximately £140m in revenues it currently derives from POca.

POL has faced stiff competition in recent years for Government services work from companies such as PayPoint and Payzone. For example, POL lost the BBC licence fee contract to PayPoint. However, POL is focused in particular on generating new products for local authorities and in relation to identity card services, and Government business seems to be stabilising (ex. POca).

- Financial Services

Post Office, generally via its two joint ventures with Bank of Ireland (POFS and FRES), provides a range of financial services products, including: business banking (this is in association with Alliance and Leicester); foreign exchange; MoneyGram wire transfers; insurance; savings products (both offering those provided by NS&I and providing its own accounts in conjunction with Bank of Ireland); and credit. Last financial year these services accounted for £325m in net income (32%).

POL's current investment case predicts increased financial services revenues to 2010/11 though the picture is rather complicated. For example, banking revenues are predicted to rise from £100m to £122m, but bill payment revenues are expected to fall from £79m to £66m. A key driver in revenue growth is expected to be travel and leisure services (FOREX and travel insurance), which is projected to increase from £64m to £100m.

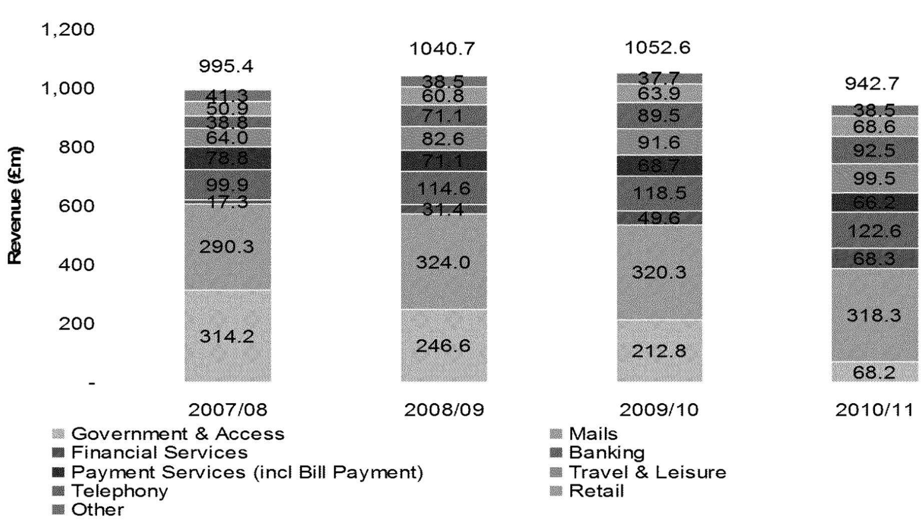
Competition in financial services is keen, and current forecasts from POL suggest that it will fall short of the challenging targets it set itself for this sector in its current investment case (potential net income shortfall of £13m). However, POL is now the UK's largest provider of FOREX and a major provider of car insurance and can point to some significant success in this sector.

- Telephony

POL offers its "Home Phone" telephony service, together with accompanying broadband packages. Last financial year these services accounted for £34m in revenues (3%). POL's current investment case predicts revenue growth from £39m to £92m in telephony by 2010/11. However, POL is struggling to break into this market, particularly in respect of broadband services, and recent revised forecasts predict a £25m net income shortfall by 2010/11 as against the investment case projection.

Additionally, POL's retail offering (greetings cards, stationary etc) accounted for £48m of revenue last financial year (5%).

Revised Investment Case, Revenues FY08 – FY11 (£m) [query re numbers]



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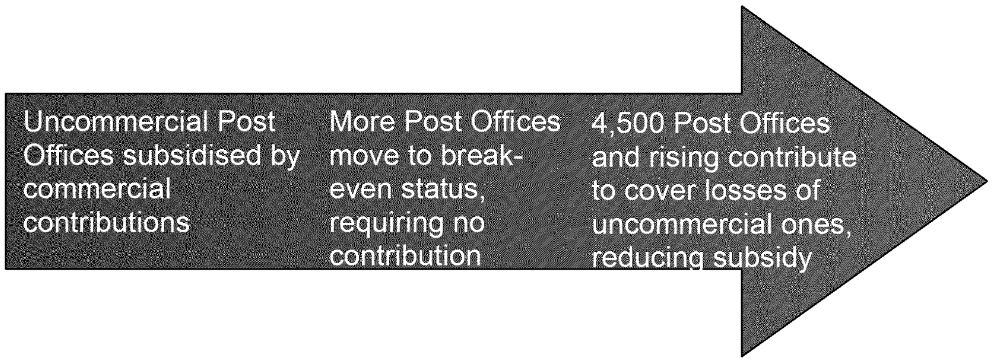
2011-16 – target scenario



Ideally, POL would be able to grow its commercial revenue streams to the extent that the positive contributions they made to POL's finances covered the losses inherent in running an uncommercial network of (currently) 7,500 additional outlets. This would lead to there being an increased proportion of commercially-viable outlets, making greater profits, and those that were not would require a smaller contribution to be redistributed from the commercial side to cover their losses. The aim would be that over the course of the next funding period (2011-16), POL's commercial successes could reduce POL's reliance on Government subsidy eventually down to the level of zero.

In order to attain this aim, numerous obstacles require to be overcome, and strategic questions must be answered. For example, the appropriate network size will have to be identified for the period 2011-16. It is assumed that the maintenance of a network at around the current size is desired, though other issues may affect this – for example a loss of the GCA tender might lead to a reduction in network size outwith POL's control (as footfall decreases lead to agency SPOs become unviable as retail businesses) and might prompt debate about POL's structural relationship with Government.

It will be important for POL to make its cost base as variable as possible, to enable it to have flexibility in reacting to market changes and to enable as many branches as possible to become cost-neutral to POL. This will also enable it to react more swiftly to revenue raising opportunities as they arise. Management must be structured and incentivised appropriately in order to get the best from POL's resources. Finally, any government funding required over the period will require state aid approval.

Strategic Options

In the light of the above, there are various strategic options to be considered for the period from 2011.

- ***Structural/management*** - Include POL in any wider transaction involving RMG.

  If there is to be the introduction of private capital into the letters business, as some respondents to the independent review (notably Postcomm) have suggested, then the inclusion of POL in such a transaction would extend the desired benefit of private sector expertise into the POL network.

  However, this approach has down sides. Public feelings on POL, and the Post Office network in particular, run high. It would be difficult politically to introduce part private ownership of the Post Office. Additionally, there would be state aid concerns over Government funding potentially "leaking" across to the benefit of any private sector third party.

- ***Structural/management*** - Introduce private sector management at the POL level.

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Absent any wider stake in the letters business, it is very difficult to see what incentive Government could provide to convince a private business to manage POL, save for the paying of significant management fees.

POL's Managing Director, Alan Cook, was appointed in March 2006. Most of his management team are subsequent appointees. While previous POL management may not have been particularly successful in driving revenue and contribution growth (for example via a flawed retail strategy), we consider Alan Cook and his team to be a marked improvement.

- ***Structural/management*** - Bring POL back closer to HMG.

  In the event that the POca contract is lost, it may be that state aid difficulties necessitate POL being brought closer back to Government. This poses many difficulties. The main difficulty is that a directly state controlled POL will be more constrained in the products and services it is able to offer to mitigate the costs inherent in the social role it plays. The current model asks POL to seek to cross-subsidise its social role by offering commercial products that make a contribution. That contribution may therefore be hit if POL it hamstrung in its abilities to compete with private businesses by being brought closer to Government. And perversely, should POL lose POca, it would be the social side of the business that is being reduced, not the commercial.

  We would assume on the basis of the currently defined "services in the general economic interest" that a Government-managed POL was able to continue to operate in the Mails, Government services, bill payment and banking sectors (for basic banking products). However, POL would still potentially lose out on a significant contribution from purely commercial services it offers if it were taken back into Government and state aid issues prevented it from being able to operate in those sectors. POL's investment case projected a contribution from financial services, retail and telephony in 2010/11 of approximately £313m. This contribution is required to maintain a network at 12,000 offices – so without it there would be a greater need for Government funding.

- ***Structural/financial*** - Introduce new revenue streams into POL non-organically.

  A merger with NS&I has been mooted by POL management. The immediate attraction of this to them is that NS&I's strong revenue streams are thought to provide a ready source for the contribution required for the uncommercial network. However, NS&I currently offers tax-free products, and is allowed to do so under state aid rules on the basis that it is not an economic undertaking but a means of Government revenue raising. Were those revenues directly channelled into a POL that still competed widely with private sector companies (and indeed without POca might arguably have little social function remaining) then the Commission would be likely to raise objections. An alternative is that NS&I was to lose its tax benefits but this could be disastrous for NS&I's commercial position.

  There would also be little impact on footfall in the network as a result of such a move. In order to address the declining consumer base for Post Office services, POL needs to develop a transactional bank account where individuals visit branches frequently to, e.g. pay in cheques. NS&I's suite of savings products will not provide that increased footfall. And as NS&I's products are already available across the Post Office network, it would not change POL's product offering.

  An NS&I merger would also provide a "shelter" behind which POL's management would be able to hide. At present management have to present Government with a 5-year plan and, on the back of it, agree a subsidy for the non-commercial network. If POL merger with NS&I, losses incurred by the POL business would be hidden by the success of NS&I, and there would be little incentive for management to reduce POL's losses. We would consider it far preferable for POL to grow its own revenue streams which would therefore be inextricably linked to management commitment, with HMT retaining its existing NS&I revenues.

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- ***Financial*** - "Post bank"

  The point above leads to the consideration of a "Post Bank", which can be easily confused with the NS&I option above.

  The model operated in many other European countries is that of a "Post bank", where the post office also serves as a bank to a large proportion of customers. If POL can harness its network to provide a greater range of banking services (perhaps in conjunction with its current partner, Bank of Ireland) then it may be able to maintain or even increase footfall (potentially also mitigating any loss of the POca contract). Key to this would be the provision of a suitably attractive current account.

  POL management is developing its banking offering with BoI and has indicated that it may have created a viable current account model. However, it is worth bearing in mind that no other high street bank is required to generate sufficient revenue to cover a branch network of 11,500 – indeed that size of network is greater than that of all of the UK high street banks put together.

  The General Secretary of the National Federation of Sub-Postmasters has repeatedly expressed his desire to see POL move towards becoming a "Post bank" although he does also seem to conflate this desire with leanings towards the NS&I proposal outlined above.

- ***Financial*** - Alter the Remuneration model for Sub-Postmasters.

  The current remuneration model operated by POL for its Sub-Postmasters is commercially damaging to POL. POL's competitors, notably PayPoint, are able to pay their agents on an exclusively variable cost basis. POL pays a large proportion of fixed pay that does not reflect the transactions carried out by its Sub-Postmasters. However, were POL to change this, and move to a PayPoint model, many current Sub-Postmasters would be unable to continue to operate as their underlying businesses are not viable without the contribution to them made by POL's fixed pay. POL's competitors do not face similar constraints because they are unfettered in their freedom to pull out of outlets and go into other ones as and when viability fluctuates. POL is constrained by the access criteria and also public opinion in altering its network.

  POL has been piloting trials of "POL Local" which is a variable cost model. It shows the potential to be viable in many outlets where there is currently a more expensive fixed model. However, we would expect politically Sub-Postmasters to be required to be compensated for any forced conversion onto this model. A roll-out of the POL Local model, as aggressively as possible, would have the most significant impact on POL's cost base.

- ***Financial*** - Devolved funding

  In the May 2007 response to the Post Office consultation, we committed to looking at whether decision-making and associated funding for the Post Office network could be devolved to a local level. We have identified a number of possible options, ranging from the status quo to complete and non-ring fenced devolution of Post Office funding to local authorities. All the options carry risks. Devolution of funding in whole or part would be difficult to reconcile with a national Post Office network, with uniform access to outlets, since different local authorities would be likely to have different spending priorities (or might look to contract with a competitor to POL) leading to potential variance in network provision from one area to another. It might be possible to ring-fence devolved funding for spending only on Post Offices, but this raises legal issues and in any cases goes against the Government's policy of letting local authorities decide how devolved spending can best meet the needs of communities.

  Devolving funding would also represent a considerable operational challenge to POL, which would have to devote resource to negotiating levels of service provision with

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individual local authorities. Both POL and local authorities would be likely to require additional funding to cover the administrative costs of agreeing network provision at the local level, which BERR would be expected to pay.

We have proposed to Pat McFadden that we don't further progress this policy until the Network Change Programme completes at the end of the year.

- ***Financial*** – further cost savings

  POL is already taking cost out of its business at a faster rate than forecast in the current Investment Case. The overall cost savings envisaged in the Investment Case are £222m per annum. Of this, an approximate breakdown is as follows:

  - £56m relates to savings arising from Crown Office network change;
  - £44m relates to savings arising from Agency network change (approximately £30m of which is reduced agency costs, the other £14m is overhead saving such as IT and cash logistics associated with a smaller network); and
  - £122m relates to "other cost reduction". This can be broken down in the following approximated manner: £60m IT cost savings; £20m head-office non-staff savings; £20m head office staff savings; and £20m cash logistics savings.

  It would be possible to take out further cost in the business by drastically reducing its cash handling costs. This would depend upon the roll-out of POL's "POL Local" trails, which involve using cash in the Sub-Postmaster's retail operation to provide working capital for the Post Office business.

Next steps

POL's management is putting some proposals to the Royal Mail Holdings plc Board (i.e. the overall Group management team) in July and will come back to us thereafter with further advice. The topics to be discussed by the Holdings Board include commercial strategy, sales channels, cost reduction and the network.

Timetable

June/July 2008	Potential DWP Decision
September/October 2008	DWP announcement, immediate POL going concern evaluation.
October 2008	Postal Review reports
November/December 2008	HMG response to Postal Review
December 2008/January 2009	Network Change Programme completed
May 2009	POL's accounts signed off – formal going concern evaluation
Autumn 2009	POca migration expected to begin. Latest date for agreement of post-2011 funding.
Winter 2009	Submit post-2011 funding package for state aid approval.
May 2010	Latest potential general election date.
March 2011	Latest date for state aid approval. New funding period begins.