

The Rt Hon Vince Cable MP

Donald Brydon
Chairman
Royal Mail Holdings plc
100 Victoria Embankment
LONDON
EC4Y 0HQ

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I thought that I should write to explain how the Coalition Government will approach our shareholder role in Royal Mail over the next few years.

I understand that my predecessor wrote to you in similar terms last November. This letter supersedes that letter. That said, I note that Royal Mail still faces many of the same challenges so I am sure this letter addresses much of the ground covered by my predecessor. There are, of course, differences in the approach to how these challenges should be tackled.

It remains important that the Board as a whole is focused on meeting the shareholder's objectives for the business while fulfilling its legal responsibilities and I look to you as Chair to ensure that the composition of the Board and the way it operates achieve this on my behalf.

We have a common goal in securing the future of Royal Mail and through it the universal postal service. I want us to work together to achieve this. While there may be areas where our views differ, I can assure you that we will listen to your views with an open mind and without prejudice. You will no doubt appreciate that we must move quickly with the Postal Services Bill so that we can move forward with implementing the Hooper package of reforms.

The immediate future

The Bill and a future transaction for Royal Mail together with a sustainable position for the Post Office are very much in our minds but, before turning to them, I should first set out what we wish to see from the Board on a "business as usual" basis.

It will be important that neither of us takes our eye off the ball by looking to the future rather than concentrating on what is happening now in the business. The financial performance for the current year clearly demonstrates the difficulties the company is facing.

1 Victoria Street, London SW1H 0ET
www.bis.gov.uk

Enquiries

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We expect the Board to continue to drive shareholder value through the implementation of the transformation plan, introduction of new products and focus on meeting customer needs.

I should make it clear, however, that we do not expect Royal Mail to make any cash calls on Government. Our policy is to enable Royal Mail through legislation to have access to private sector capital. In the meantime, Royal Mail would be competing with other priorities and it would be difficult to justify further funding for the company in this climate. Moreover, the funding package agreed in 2007 was for the implementation of the company's transformation plan and we expect the company to deliver that transformation within that existing funding envelope.

Objectives for the Postal Services Bill and transaction process

As you will be aware, the Government's core objectives for Royal Mail and the postal services sector are to:

- secure the future of the universal postal service;
- introduce private sector disciplines to Royal Mail, and the ability to raise private finance, to enable its rapid modernisation free from the perception of Government interference; and
- support a sustainable future for the national post office network.

These are supported by delivery objectives as set out at the end of this letter. In addition, officials have already sent you some specific Board objectives for the Royal Mail which Edward Davey and I agreed to help the Board in its work on this process. For completeness these are also set out at the end of this letter.

The Bill

We are committed to taking forward the Postal Services Bill so that we can address the issues raised in the 2008 Hooper report (which Richard Hooper has now updated for me). We will publish a detailed policy document in the early autumn but I would like to give you my views on specific areas so that you will know our thinking and it will help your business planning and other activities (both with regard to the Bill and business as usual). This legislation is not without its challenges, and I look to you, the Board of the company in general to play a full part in bringing it to the statute book.

Form and timing of transaction

As you know, we are not at this stage making a decision on the form or timing of any transaction which best fits our objectives for the Letters business. We deliberately want to keep all options open to maintain flexibility to achieve the best outcome for the taxpayer and I expect your stance to echo that. Our intention is to develop these options in discussion with you. As we refine our views officials will of course communicate those to you.

Post Office Limited

I am clear that I want the post office network to be maintained at around its current size. Doing so is presently uneconomic and requires significant subsidy from Government. Given the current position of the public finances, it is vital that Post Office Limited develops a viable commercial strategy delivered through a network of that size at significantly lower ongoing cost to Government. Both funding new revenue streams and implementing cost-cutting measures will obviously play a big role in that process.

As you will be aware, we see Royal Mail and Post Office Limited as distinct businesses and believe that they are best separated. Officials have communicated to you our objectives for the Board in this regard. It is therefore important that no action is taken prior to a Royal Mail transaction which could make the implementation of that separation more complex or difficult. There should be no move to further integrate the Post Office and Royal Mail.

The process of separating two such interlinked businesses will doubtless be complex in any event. There will be areas where the commercial interests of the Post Office come into tension with those of Royal Mail. It is your role as Chairman to ensure that when this happens the Board gives full, and equal, consideration to the interests of each business. I will expect you to discuss and agree any significant decisions on the apportionment of value between the two businesses with officials in the Shareholder Executive.

You will be aware that the Bill contains provisions which would permit a move in due course to a mutual ownership model. I believe that, following separation, such a move might in future be attractive as it could better align the interests of subpostmasters with the commercial interests of the business. But I am clear too that mutual ownership will not be possible unless the Post Office is commercially self-sustaining.

Regulation

Our intention is that Ofcom will be the postal sector regulator as soon as practicable after the Bill receives Royal Assent. We welcome the improved relationship between the company and Postcomm but agree with Richard Hooper that postal services should be regulated as part of the wider communications market. The existing regulator has taken forward much of the work proposed in the Hooper report in his original report and we intend to ensure that this work will not be lost in any transition period so that Ofcom can put in place the new price control from April 2012. We are developing transitional arrangements in discussion with Postcomm and Ofcom and will keep you informed of progress.

Pensions

The Bill will include provisions that will enable the Government to take on the bulk of Royal Mail's historic pension deficit. But, like the previous Government, we will not

tackle pensions in isolation. The pension solution has to be part of a wider transaction in order to represent value for money for the taxpayer. The funding settlement that you have reached with the Trustees for the next three years seems to be a practical and sensible way forward given our commitment to take forward the Bill and a transaction. The positioning of the Pension Regulator is difficult and we will have to ensure that the company and officials liaise closely on this, as they are already doing.

Employee Shares

The Government is committed to employee ownership in Royal Mail and there will be a commitment to introduce an employee share scheme in the Bill. We are still exploring and developing how this can be achieved: the Bill will not specify the detail of the scheme although we now expect it will specify a headline figure available for employees. In this work, I wish to ensure that employees can share in the success of the business and that employee shares act as an incentive to the workforce, driving value in the business for all shareholders, including the Government. Real employee engagement will be needed to make shares a genuine incentive. You are obviously well placed to offer advice on the design of the scheme and my officials will work with you on the options.

Royal Mail Transformation

Throughout this process, you will need to continue to press forward with modernisation and accelerate the process wherever possible particularly in the light of increasing competition from the wider communications market. As shareholder, we encourage you to take forward the modernisation as quickly as you can, within your existing funding envelope.

This remains critical to the business and the Board must ensure that, while we look to the future in terms of the Bill and a transaction, the current transformation of the mails business is the central focus of the company. Taking forward "business as usual" is critical and we must keep focussed on this.

The modernisation agreement reached with the CWU in March has the potential to be a fundamental change in the way you and the union engage. Such agreements have been reached in the past but still have failed to deliver real change in the business. The successful implementation of the agreement is vital and I understand that so far this is going well. We will continue to look to you and your colleagues to demonstrate clearly that modernisation is proceeding to plan and that the targets and metrics for the progress on modernisation are transparent and measurable. Continued engagement with the CWU will be vital during this period and, where we can, it will be important for both of us to put distance between the modernisation agreement and the Bill so that the issues are not blurred.

Whilst recognising the constraints imposed by regulation in terms of lead times and competitive information sharing, we share the Board's desire to see Royal Mail introduce new and innovative products faster than we have seen in recent times

provided that they are possible to finance. There has to be a greater focus on customers. In a falling market, you will have to give them products that meet their needs and compliment those being offered through other media.

I reiterate that the company must maintain quality of service throughout this transformation process to ensure that the customer base remains satisfied with your levels of service.

Parcels/GLS

Parcels and packets remain a vital part of Royal Mail's future. This is a highly competitive market especially in e-fulfilment. The company has been developing Royal Mail's "packets and parcels strategy" for some time and no doubt the company will be looking at the strategic importance of GLS and Parcelforce to the postal business as a whole. It is important that the Shareholder Executive is fully sighted on your work in this area. I am pleased that you have already taken steps to help recipients of parcels (who were not at home when the attempt to delivery the parcel was made) to pick them up in the evenings by extending the opening hours of deliveries. This type of initiative is important and directly addresses the concerns consumers and their representatives have expressed.

Health and Safety

Health and safety is an important issue and I am looking to you and the Board to ensure that Royal Mail improves its safety record and manages the business to the highest environmental and safety standards.

The Board

Since you joined Royal Mail the main Board has been completely reshaped. I am pleased that the new Board has the right mix of skills. We will need to make sure we have regular reviews with you to ensure that this remains the case. It will of course be important to secure a new Finance Director as quickly as possible.

I reiterate that the Board must have a clear understanding of the responsibility that it holds to the shareholder. The relationship needs to be one of mutual respect and trust. But the underlying principle is that the Board should be focused on delivering the shareholder's objectives as set out above. I would like to ensure that there are regular sessions for all of the Board to meet my officials so that both teams can deepen their understanding of the challenges we mutually face.

Board Remuneration

This remains a difficult issue. I welcome the fact that the salaries agreed for the new CEO and MD of POL are lower than their predecessors and that the NED's average salaries will be lower. While recognising that the Board should be properly incentivised and that there is a need to retain and recruit the right people, I expect the downward trend in remuneration to continue, where possible, and for you to

come forward with proposals that reflect that there is a need for restraint in the public sector.

The large bonuses achieved under the last LTIP would be difficult to reconcile in the current environment. Any future bonus arrangements, either annual or long term, would have to be linked to performance, demonstrate achievement of objectives set by the Remuneration Committee and continue to be transparent. In addition to reflecting the performance of the company they should reflect a link to the modernisation of the company which remains the priority for the business.

The day to day relationship between the shareholder and Royal Mail should be conducted through the Shareholder Executive. Susannah Storey, who has worked on Royal Mail issues for a number of years, is the company's main point of contact. Stephen Lovegrove, as you know, has overall responsibility for the Shareholder Executive, including the Royal Mail. I would like all proposals from the company to be discussed with the Shareholder Executive prior to them being presented to Ministers.

I would like to continue the arrangements to meet on a regular basis, to discuss progress on the issues set out in this letter and other issues that will arise during your term. I will ask my office to contact yours to put dates in our diaries. This does not, of course, rule out us speaking between these meetings if appropriate as we have discussed.

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VINCE CABLE