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26<sup>th</sup> January 2009 SPADs

## ROYAL MAIL GOVERNANCE

**Issue:** The post-transaction governance arrangements for Royal Mail.

**Recommendation:** That you:

- (i) note that there is a difference of opinion between the company and ourselves as to the appropriate structure for Royal Mail after any transaction has been completed. In essence the company believes that it is right that key executives from the Company sit on the Board of the top company – the corporate shell that gives effect to your decisions as shareholder, and that officials believe this is neither appropriate or practical; and
- (ii) agree to the proposed governance arrangements set out below in paragraphs 8 to 11, for final communication to the company this week.

You should note that this is a subject that has caused considerable agitation at the Company, and it is clear that the structure proposed seems to be being interpreted by some of its directors, most notable the CEO, as a blow to their prestige. This is illogical in our view, and the types of structure that they are proposing are inconsistent with Government's very public role as shareholder. Nevertheless, it is possible that there will some fall-out from the imposition of the structure recommended in this paper should you agree it is the right one with which to move forward.

**Timing:** Urgent. This is a critical issue which needs to be resolved as soon as possible to enable final communication with the Company during this week.

### Summary

1. The commercial process to find a partner to acquire a minority stake in the Letters business is underway: following an initial round of expressions of interest from potential partners, on 9<sup>th</sup> February a full package of information will be sent to a short list of potential partners. This will enable them to make a formal bid for a minority stake in the Company at the end of the month and for HMG to be in a position to sign a heads of terms with a preferred partner at the end of March.

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2. An important part of the package will be the proposed governance of the Company once the transaction has closed, for which we urgently need approval so that it can be communicated to the Company. There is resistance from the RM Board to accept the proposed strategy. Advice will be provided on the other commercial aspects of the transaction shortly to enable the package for the 9<sup>th</sup> February to be agreed by ministers.

## Background

### ***Re-cap: Existing corporate structure, Board and governance arrangements***

3. Today, Royal Mail **Letters** ("RMG") is a subsidiary of the Holding Company ("RMH"). The formal group board is constituted at **Royal Mail Holdings plc** ("RMH") level with Allan Leighton as Chair and Adam Crozier as CEO. At the Letters level there is an executive team that runs the day to day operations of the group of companies it controls (other than GLS). This is led by Adam Crozier as group CEO and also numbers the managers of the group's four main divisions (including POL, its subsidiary). Post Office Limited is a subsidiary of the Letters business. At this level, Alan Cook leads an executive team comprising finance, network, marketing, and operations directors.

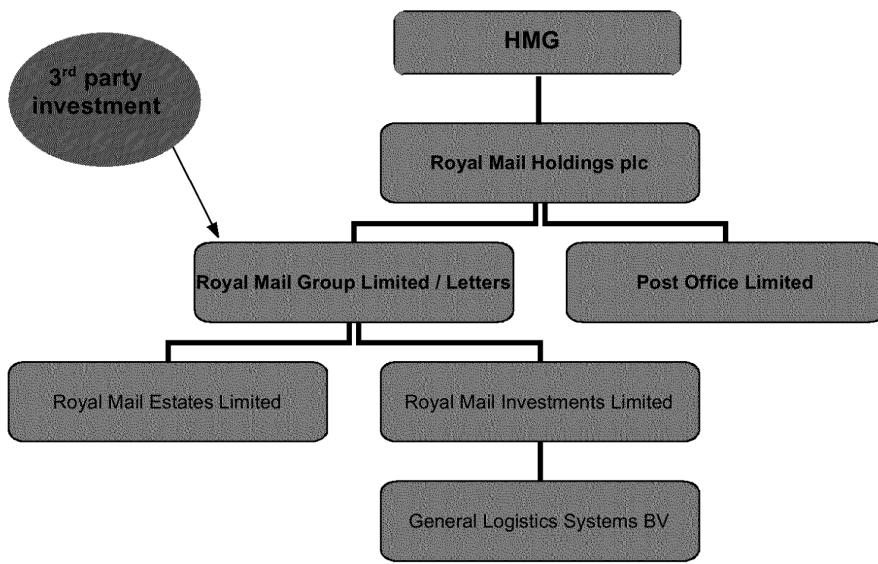
4. The RMH Board is responsible for the day to day operations of the Company, including the subsidiaries. Certain matters require shareholder consent and on certain matters the Secretary of State, as Shareholder, has veto rights. These matters (the Reserved Matters) are set out in the articles of association and include Executive Remuneration, which in practice is approved by both the Secretary of State and the Chief Secretary to the Treasury, material acquisitions or disposals, raising of finance and approving the business' strategic plan. A summary of the existing corporate, board and governance structure is set out in Annex A.

5. Despite the fact the Company has been set up to operate on an arm's length basis, in practice there are difficulties with the existing relationship, as identified in Hooper's report. These include the time it takes for Government and Company to reach decisions on key matters and the difficult area of the Government having to approve strategic plans that may include job losses which are needed to modernise the Company. To take one example, as you are aware, for the last few years, despite best efforts the annual bonus arrangements for executive directors – which are supposed to incentivise them for the full year's performance – are only agreed right at the end of the financial year.

### ***Proposed corporate structure***

6. To try and improve on today's situation and to bring real benefit from a commercial partner for the Letters business, it is imperative that any partner has Board seats on a fully constituted Letters Board. It is also a clear policy objective and commercial necessity that the Post Office be excluded from any partnership. For these reasons, the proposed partnership structure (illustrated below) involves POL being moved to become a sister company of the Letters business. Both POL and Letters would remain subsidiaries of the ultimate holding company. The partner would acquire shares in the Letters business from RMH as shown below. This sister company route enables POL to have much of the benefit of separation (i.e. full demerger) but with the attraction of remaining within the Group.

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### ***Proposed governance arrangements***

7. After the transaction, it is proposed that the board structure of the group of companies would change to match the legal structure, such that RMG and POL would each have their own, fully-constituted boards, including non-executive directors. As part of any partnership, this would enable a third party to have an appropriate amount of seats on the RMG board (proportionate to their shareholding) and therefore be involved in key decisions alongside the other RMG directors, but without having any input into POL. In summary then, the three main Boards would be as follows:

- **RMH Board:** It is envisaged that RMH would have a small board of HMG representatives but would not be responsible for operational decisions of either company. The objectives of this Board would be to ratify specified decisions by RMG (operational and other matters) and to oversee the assets of RMH including, for example, any financing of POL from RMH's existing assets. It is essentially a shell company, constituted to give effect to ministers' decisions regarding the company.
- **RMG / Letters Board** would be made up of: those existing members of today's RMH Board (executives and non-executives, including the new Royal Mail Chairman when he starts) and representatives from the partner proportionate to their percentage shareholding. As today, HMG would have no "direct" (i.e. ShEx / HMT type) representatives on the Letters Board and would have to rely on the Chairman.
- The **POL Board** would become a "full" board (including a non-executive Chair) and Alan Cook, CEO would move from RMH Board to the POL Board only.

8. In terms of governance, for both the Letters and POL boards, there would be agreement on those matters which required shareholder consent (effectively HMG consent in the case of POL and HMG or HMG / partner consent in the case of Letters) and those matters which could be agreed by the Letters or POL Boards without reference to the shareholder (in other words "Shareholder Reserved Matters" or "Board Reserved Matters"). There would then be certain matters solely for

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decision by the SoS/RMH (“Existing Shareholder Reserved Matters”), over and above those into which the Partner has input. These would underline from a proportionality perspective the fact that the partner is a minority shareholder. These matters reserved to HMG alone might include matters such as the appointment of the Chair, future borrowing and one or two other key issues.

***Rationale for and key issues in relation to this proposal***

9. The advantages of this structure include the fact that it is based on the existing modus operandi of the Group, and the partner becomes a part of the core governance of the Letters business, albeit with only a minority of representatives on the Board. POL would have both more independence and oversight than today, albeit with the advantages of remaining in the same corporate group as the Letters business.

10. To the extent it was appropriate, the Holding Company Board could exercise shareholder rights similar to those the Secretary of State, as shareholder, has today (for example in relation to approving executive remuneration and signing off on the business plan). There may be advantages to the Secretary of State delegating some of the powers he today exercises directly to this Board – to make the Company more arm’s length and to “close the back door”.

11. However, there will be matters that need to be retained for the Secretary of State to decide (such as the Company’s borrowing as it will score to the public sector). In practice, it is likely that the Secretary of State will continue to exercise these rights directly, with RMH Board operating more as a shell with officials raising matters to the Secretary of State for approval or veto where appropriate.

12. We are not in favour of a UKFI style Board (UKFI is the company which has been established to hold HMG’s interests in the banks and has a full complement of high profile independent non-executive directors and a number of full time employees). This would mean that there would be effectively another operational and strategic Board above the Letters and POL boards which would serve to demotivate both those bodies and provide a real focus for union lobbying on matters regarding mail.

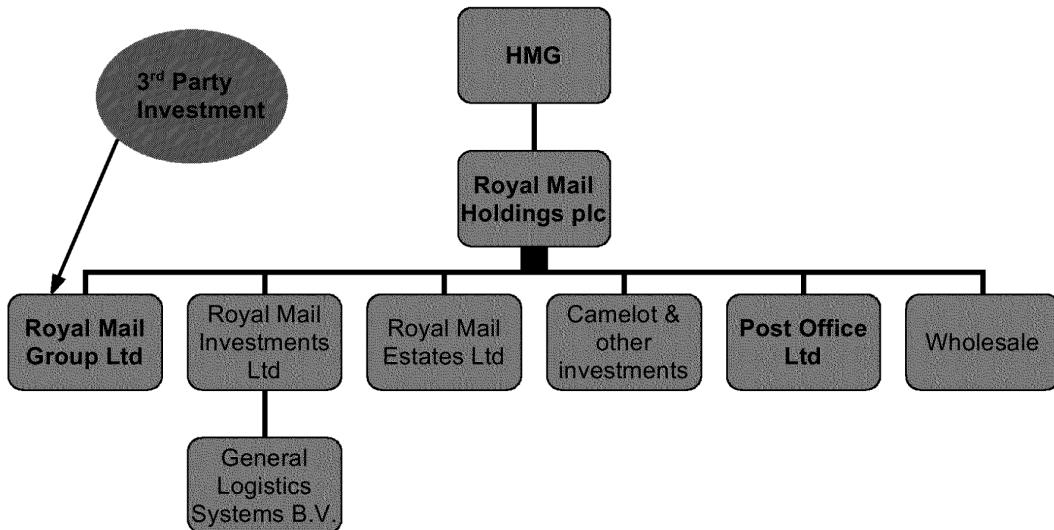
13. As today, the Secretary of State’s only ways of exerting influence would be: (i) exercising a veto if the matter is a “Shareholder Reserved Matter”; (ii) removing Non-Executive Directors he appoints (a “nuclear” option that would be difficult in practice and would still not ensure a board majority); and (iii) any rights he has as lender. The key difference in the new structure would be that the Shareholder Reserved Matters will be decided by the Partner and HMG (via RMH) and both would have a veto (negative control rights as normal). The partner would effectively sit alongside HMG on more of a 50:50 basis in decision making, when such Shareholder Reserved Matters are agreed. If there was a deadlock between the shareholders or Board over the Reserved Matters, a timetable for resolution would be set involving escalating levels of involvement, Board Committee, Chairman of Partner vs. Chairman of Shareholder Executive, arbitration and potentially a final Secretary of State over-ride to ensure an outcome.

14. While we need to decide the balance of rights between the Letters Board and RMH/the Secretary of State immediately, the division of decisions between the RMH Board and the Secretary of State does not need to be finalised at this stage. We will provide further advice in due course.

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### The Company's position

15. There is an unresolved and on-going debate with the Company about the proposed structure of any partnership. They accept that the Letters business and POL should have separate, fully constituted Boards. However, their preference is that the chairman and CEO of Letters, as well as the chairman of POL, should be on the RMH Board alongside HMG officials and newly appointed non-executives, as they believe that: (i) the Secretary of State should delegate all his powers to this Board in order to close the union backdoor; and (ii) as such this Board needs to have people on it with the operational exposure to deal with matters which may come up to it for decision from the operating boards.



16. We do not believe this is a workable solution for a number of reasons including:

- Even if this were possible, if the partner sat on the Letters Board and some Letters Board members sat on the Holdings Board, it devalues the partnership and does not meet our objective of making the Letters Board the main board that makes all the operational decisions for that entity – it would be more akin to the Executive Board at Letters today. Though we have not raised this structure with any of the potential partners, we would be very surprised if such a structure was acceptable to them.
- There is an inherent conflict in their proposal: RMH is the corporate body which exists solely to give effect to the decisions of the Secretary of State. If there is a dispute about the commercial arrangements around POL (e.g. the mails contract), where the Secretary of State has to decide on a course of action after receiving officials' advice, there is potential for conflict in using a vehicle where the chairman also chairs the board of one of the potentially disputing parties, and from where one side of the dispute has emanated.

17. In addition, we disagree with their objections to the Government proposal: Royal Mail are concerned that the Government structure proposed may not work because of their perception of a lack of operational knowledge on the proposed Board of RMH and that it may not "close the back door" of the unions to the Government. We do not agree with this. Though the Holdings Board needs

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commercial expertise, which it will access principally from Shareholder Executive, given the scope of the decisions it needs to make it does not need operational exposure to the businesses. Further, legitimate union contact with HMG can never be eradicated while Royal Mail is a public sector company. Moreover, by ensuring that all key decisions are made at the Letters Operating Board level, HMG will be sending as clear a signal as it can that the running of the company is down to management and the partner.

18. We suspect their views may be driven partly by the perception that today they run the whole group and after the partnership, they will be 'subordinated' to the Letters board and so will not, in effect, be looking a potential investor in the eye and on the same level, in that they will not make *shareholder* decisions for the Letters business. We believe Royal Mail are confused between ownership and operations: it is not possible for the Secretary of State as shareholder to abdicate his ownership responsibility this way. We know the partner will want to invest alongside HMG as shareholder (represented through RMH) and not be exposed to POL in any way.

19. In our view, the only basis on which we might have to revisit our structure is in the unlikely event that other subsidiaries of RMG other than POL (e.g. GLS, property or the wholesale business), did not end up as part of the deal. If this were the case (and there is no apparent need for this today), there is obviously a case for operational experience to sit above the two companies to oversee its other subsidiaries. This would mean that we would reshape RMH so that it has a number of direct subsidiaries or interpose a new board between RMH and the operating companies. But we should not legislate for a scenario that we do not expect to occur, and we would retain the scope to respond effectively if it did.

### **Conclusion**

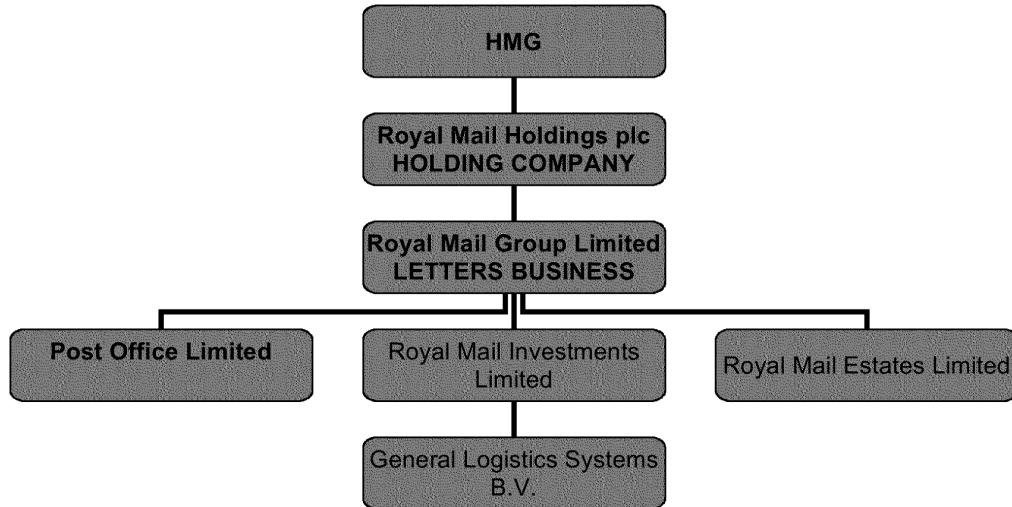
20. This Governance and structure debate is the key issue to progress the commercial process and must be agreed before 9<sup>th</sup> February when information goes to potential purchasers. Accordingly, we welcome your confirmation that you agree with the proposal as set out in this submission. Further advice on the detailed arrangements will be provided in due course as we engage with potential partners.

**Marc Middleton / Susannah Storey**

## Annex A: Existing Arrangements

### ***Existing Board and structure***

Currently, the formal group board is constituted at **Royal Mail Holdings plc** ("RMH") level. This is chaired by Allan Leighton and the non-execs sit on this board. The CEO of this board is Adam Crozier. The CEOs of both POL (Alan Cook) and RMG's letters business (Mark Higson) also sit as executives on the RMH board. Ian Duncan is the Finance Director. Jonathan Evans is the Company Secretary.



**RMG Board:** At RMG level there is an executive team that runs the day to day operations of the group of companies it controls (other than GLS). This is led by Adam Crozier as group CEO and also numbers the managers of the group's 4 main divisions (including POL, its subsidiary) – the letters business (Mark Higson), Parcelforce, RM Wholesale and POL (Alan Cook). It also numbers finance, strategy, corporate & HMG affairs and technology directors, a head of legal and a company secretary.

**POL Board:** At POL level, Alan Cook leads an executive team comprising finance, network, marketing, and operations directors. There is a perception that POL is considered very much as the poor relation and the RMH board does not give sufficient scrutiny to its activities. Therefore enhancing the POL board to include non-executive directors and raising Alan Cook's status to equivalent of Adam Crozier's would have advantages for POL.

### **Re-cap on existing rights**

- Today the Board has operational responsibility for the Company's day to day matters
- The shareholder (through the articles of association) has (in addition to its residual powers as 100% shareholder) specific consent / veto rights over:
  - Strategic plan and any material updates (note technically the budget is not approved but informally we can provide input to it);
  - Material acquisitions and disposals;
  - Dividend policy;
  - Guarantees over granting security;

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- Borrowing and capex, over a certain level (and note HMG has public sector rules about borrowing only from HMG which are likely to continue to apply);
- Appointment of Chair (in practice the Chair is very much HMG's process today);
- Appointment of CEO;
- Consent to the appointment and/or removal of other directors (including NEDs);
- In practice, executive appointment processes are run by the Company but SoS approves candidates;
- SoS has to approve executive remuneration as recommended by the Remuneration Committee; and
- Certain other residual matters such as rights to information and veto rights over changes to company constitutional documentation.

## Annex B – proposed arrangements

<b>Board</b>	
<b>Existing Board</b>	<b>Possible new Board (RMG)</b>
<b>Non Execs [6]</b>	<b>Non Execs [4+3]</b>
<ul style="list-style-type: none"> <li>• Allan Leighton (Chair)</li> <li>• Richard Handover</li> <li>• Margaret Prosser</li> <li>• Helen Weir</li> <li>• David Currie</li> <li>• Andrew Carr Locke</li> </ul>	<ul style="list-style-type: none"> <li>• HMG Chair (HMG appointed [initially])</li> <li>• NED 2 [SoS approve only]</li> <li>• NED 3 [SoS approve]</li> <li>• Ned 4 [SoS approve]</li> <li>• Partner NED 1</li> <li>• Partner NED 2</li> <li>• Partner NED 3</li> </ul>
<b>Execs [5]</b>	<b>Execs [4 – Alan Cook goes to POL]</b>
<ul style="list-style-type: none"> <li>• Adam Crozier (CEO)</li> <li>• Alan Cook (POL CEO)</li> <li>• Ian Duncan (FD)</li> <li>• Mark Higson (COO Letters)</li> <li>• [HR directors – tba]</li> </ul>	<ul style="list-style-type: none"> <li>• CEO (joint appt)</li> <li>• Finance Director (joint appt)</li> <li>• Head of Letters [(HMG appoint)]</li> <li>• HR director [(HMG appoint)]</li> </ul>

### Reserved matters

As part of any partnership, we would have to distinguish between those matters for which the Secretary of State's consent (and Partner's) would be required (Shareholder Reserved Matters) and those matters which could be decided by the Board (Board Reserved Matters). The Secretary of State's rights may differ from the Special Shareholder rights currently set out in the articles of RMH. The partner should be given fewer reserved matters than the Secretary of State but could not be given more. Below is an initial indication of our thinking in relation to these reserved matters.

#### ***HMG Only Shareholder Reserved matters***

- Appointment and removal of the Chair
- Approval of NEDs (other than the partner appointed NEDs)
- Other key appointments
- Borrowing

#### ***Shareholder Reserved Matters (each shareholder has a veto over a decision)***

- Constitutional documents
- Scope of business (materially changing the nature of scope of Rose)
- Acquisitions and disposals (material acquisitions and disposals)
- Dividend policy (material change)
- Sale of GLS
- Material amendments to the POL IBA
- Guarantees over granting security
- Borrowings (over a certain threshold)
- Adoption of and any material changes to the business plan
- Approval of the CEO, FD

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- Key executive appointments and remuneration

***Board Reserved Matters (majority of decisions for Board as today)***

- Operation of the business (effectively)
- Approval of accounts
- Employee policies: material policies in relation to employee remuneration
- Board employment terms: changes to the terms or conditions of the board of directors and senior management
- Operational appointments
- Material contracts
- Executive appointments (below board level)