

RESTRICTED – POLICY AND COMMERCIAL

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21 November 2008

Post Office strategy

Issue

1. Following your 30 October 2008 letter to the Prime Minister, and the 13 November decision to award Post Office Limited (POL) the Post Office card account contract (POCA) contract, we have been considering the best strategy to build on the will within Government to strengthen the position of the Post Office and the associated media handling.
2. In addition, Government's current funding commitment to POL only extends to March 2011. State aid approval processes, and the requirement for POL's directors to assess the business's going concern status up to 18 months into the future, dictate the need to agree a further funding deal for POL by late summer of next year.
3. This submission seeks your agreement to the proposed objectives for and scope of all of this work.

Recommendations

2. You are asked to agree our plans for the following:
 - **Engagement with the BERR Select Committee "task force" (Annex A);**
 - **Liaison with POL over the development and communication of its financial services offering (Annex B);**
 - **Raising POL's profile across Government as a potential provider of Government services via, among other things, chairing a meeting of the MISC 33 cabinet committee on the Post Office network (as proposed in Annex C);**
 - **Recommending any desirable change to POL's corporate status on a timetable that ensures any consequent necessary legislative**

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amendments can be packaged with any legislation connected with Hooper recommendations (Annex D);

- Putting in place a process (involving engagement with the relevant interested parties) to ensure that a suitable funding package for POL for 2011-16 is in place by summer 2009 (Annex E); and
- The parameters for the development of POL's commercial strategy for 2011-16 so that it can be announced in summer 2009 (Annex F, to the extent not covered by Annexes B and C); and
- Adopting the proposed handling strategy for POL issues (Annex G).

Will Gibson
Shareholder Executive
21 November 2008

RESTRICTED – POLICY AND COMMERCIAL**ANNEX A – MP TASK FORCE**

1. The Secretary of State for Work and Pensions agreed, in the context of the Lib Dem Opposition Day debate on 10 November on POca, to a proposal from Lindsay Hoyle MP. This was for a task force of MPs to be established to identify new services (beyond the new POCA contract) that could help secure the long term viability of the post office network.

2. Having discussed with Pat McFadden, we consider that the Select Committee for Business and Enterprise (BEC) could provide a 'ready made' task force of MPs to undertake this role.

- It has the advantage of being a cross party group of MPs, constituted under clear Parliamentary procedures.
- It has extensive knowledge of post office network issues, having regularly reported on network related issues over the last 10 years, including 5 reports in the last 12 months.
- The BEC route allows the Task Force to make an early start on its work. If a new free standing body were to be required there would inevitably be delays in considering its composition and identifying funding and support staff.
- We understand that BEC will lose its role on energy matters with the establishment of a new DECC select committee in January and so should have the capacity and staff resource to take on the Task Force remit.
- Pat McFadden has established that Lindsay Hoyle considers the BEC to be well suited to take on the Task Force role. Soundings have yet to be taken of the Chairman, Peter Luff, but we would expect him to welcome the proposal as continuing to give topical political prominence to the Committee's role.

3. **Are you content that we ask BEC to take on the Task Force role? If so we will provide a letter for you to send to Peter Luff.**

4. The Select Committee route will almost certainly result in the Task Force's findings and conclusions issuing as a Select Committee report but this will still allow considerable flexibility (if required) for a Government response in the form either of a Memorandum or of a Command Paper.

5. It is for consideration how far an invitation/commissioning letter to BEC to take on the Task Force role should seek to focus the direction of their interest. The Committee, based on its existing knowledge, can be expected to focus particularly on the scope for increasing Government (central and local) services through the network - making 'joined up' Government a particular (if long standing) issue and theme.

6. A second area of particular interest will be in extending the range of financial services available at post offices, drawing on your recent letter to the

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Prime Minister, and the wider (also long standing) view that all High Street banks should allow access to current account transactions (drawing cash, paying in cash and cheques) at post offices. Now only RBS and HSBC do not. It could be helpful to seek to encourage the Committee to consider the scope for new business opportunities for POL beyond central Government and Government Agencies.

7. It is also for consideration whether there is scope for some management of the Task Force's expectations at the outset. This could perhaps be achieved by an informal meeting of Ministers and Alan Cook, POL Managing Director, with members of the Committee.

8. Such a meeting would enable POL (on a confidential basis where necessary) to inform the Committee of products and services under development/negotiation and where potential sensitivities might lie. It would also enable some parameters relating to competition and procurement to be discussed frankly. For example, the BBC TV licensing contract, currently with Pay Point, is a perennial bone of contention among MPs in this context.

9. **Are you content that the scope for a meeting of this kind be explored?**

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ANNEX B – FINANCIAL SERVICES

1. You requested advice on areas for development of POL's financial services offering.

2. POL already offers a wide range of financial services products – including insurance (such as POL's travel insurance product), loans (POL offers personal loans, credit cards and mortgages) and savings products (such as ISAs, the Growth Bond or NS&I products). Given the weakness of POL's balance sheet, it cannot hold a banking licence in its own right. While its financial services products are therefore all branded as 'Post Office', they are all actually provided by major players in the financial services sector. For example many of POL's savings and lending products are offered through its joint venture with Bank of Ireland (POFS).

3. However, POL is currently still a "niche" player in the financial services market. It is looking to grow existing products but also to develop its offering to a full suite of financial services products. Areas of focus include:

- A transactional, interest-paying current account;
- A children's savings account (child trust funds are already available);
- Small business deposit accounts;
- A general purpose savings account with no annual limit on the number of withdrawals; and
- Small business insurance;

POL will only be able to launch these products if they are commercially beneficial both to POL and its relevant financial services partner. However, POL's new products are also likely to support the Government's financial inclusion and SME objectives.

4. To support its financial services objectives, POL will be looking to designate around 600 of its larger town-centre branches as financial services centres with an appropriate bank-style layout.

5. **We will work with POL to ensure that press opportunities for new products are maximised over the coming months, and recognise that this strategy ties with your own vision for POL's future.**

6. As well as POL's own commercial products, HMT is considering sponsoring a variety of products to support its financial inclusion agenda. For example:

- HMT is currently working on introducing a "savings gateway" scheme to encourage savings among those on lower incomes. The Government will match a proportion of savings made by qualifying individuals over a two-year period. **We expect the Savings Gateway to be announced in the PBR [and for the Chancellor to note that POL will be one of the first providers]**

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- We are exploring whether POL might be able to act as a gateway to credit unions.
- HMT believes introducing savings accounts specifically designed for children could help inculcate the savings habit early.

7. There will be a clear fit between HMT's target audience for these products and POL's customer base. However, in all cases POL will either need to be able to make a commercial return on the product, or Government will need to provide direct funding. We will work with HMT to maximise the opportunities for POL, and again seek appropriate media opportunities.

8. **Are you happy for us to proceed on this basis?**

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ANNEX C – GOVERNMENT SERVICES

Central Government

1. POL's principal revenue source in this sector is of course from DWP in relation to POCA. However, it also provides passport and driving licence application services. POL is working to secure new business in this identity verification role, for example a 10-year renewal of its contract with the DVLA for driving licences, and long-term opportunities with the Home Office in relation to immigration and any potential identity card scheme.

2. A separate area of potential growth would be in harnessing any opportunity for POL to become the physical channel for Government customers who do not use internet or phone channels. Many current Government physical networks could potentially be rationalised to some degree within a POL offering, supporting the Government's overarching efficiency agenda. For example:

- DVLA has 39 local offices; and
- HMRC has 278 enquiry offices.

3. Central Government departments have historically been resistant to contracting exclusively with POL, both because of concerns about the requirements of procurement law and the need to demonstrate value for money. Therefore alongside POL's own organic development of its Government services business, we need to push their cause from within Government. We believe that using the Cabinet Committee structure will be the most effective way of getting traction with other Departments. We therefore **propose that you chair a series of meetings of the Post Office Cabinet Committee (MISC 33) to push ministerial colleagues on what further Government business could be made available through the network. We will push Cabinet Office to arrange the first for before Christmas. Are you content?**

Local Authorities

4. There is also significant potential for Local Authorities to work more closely with POL:

- to disseminate local information and conduct local consultations
- provide services such as the provision of parking permits, or even registering births, marriages and deaths
- potentially co-locate with their own physical infrastructure

5. We will need to consider how best to engage with local authorities. While they could provide significant business to POL, they will have their own political agenda to pursue. As Leader of Essex County Council, Lord Hanningfield has already proposed that local authorities be given responsibility (and the associated funding pot) for Post Offices. While the

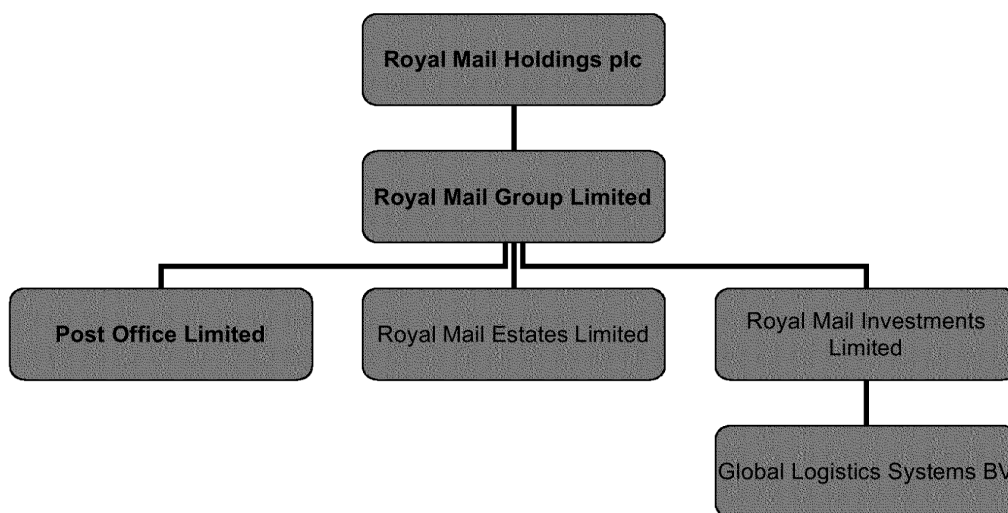
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Government's May 2007 response to the last Post Office consultation committed to look at the scope to devolve Post Office funding to either the devolved administrations or local authorities, we have since taken the view that this would be inconsistent with our objective of ensuring consistent provision of Post Offices across the UK.

6. We will provide further advice on local authority handling.

RESTRICTED – POLICY AND COMMERCIAL**ANNEX D – CORPORATE STATUS**

1. POL's is currently a limited liability company within the Royal Mail group of companies, as set out in the diagram below:



2. We are considering whether a different constitutional status for POL (e.g. some form of Government agency), would make it easier for Government to route its services through POL without always having to go through a competitive tender process. This would necessarily entail removing POL from the Royal Mail corporate group. We need to explore further but our initial legal advice is that even bringing POL back within the central Government may not resolve the procurement problems.

3. There are also advantages from POL's current corporate position:

- it provides Ministers with a degree of insulation from operational matters. For example, if POL were an executive agency Ministers would be more directly accountable in Parliament for the operational performance (or even closure) of individual Post Offices.
- retaining POL within the Royal Mail corporate group ensures that its link with Royal Mail's letters business is safeguarded. This is 30% of POL's revenues.
- any sums released from the £850m pensions escrow held on the Royal Mail Holdings balance sheet might in due course be available for ongoing funding for POL.

4. We need to consider this question urgently: changes to POL's status which involve POL coming out from the corporate group beneath Royal Mail Holdings plc require legislation. We will therefore need to know whether we want to do this (and if so, what subsequent constitutional form POL should take) in time for the relevant provisions to be included in any Bill that may flow from Government's response to the Hooper recommendations. **We will therefore advise you further on this point early in the new year.**

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5. If there is no legislation flowing from the Hooper recommendations, any change to POL's corporate status would require an alternative legislative vehicle.

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ANNEX E – 2011-16 FUNDING PACKAGE

Purpose

1. In May 2007 the Government announced a £1.7bn funding package for POL, including an annual £150 subsidy to support the non-commercial parts of the network. However, this funding commitment only extends to March 2011. State aid approval processes, and the requirement for POL's directors to assess the business's going concern status up to 18 months into the future, dictate the need to agree a further funding deal for POL by the end of 2009.
2. In addition, although Alastair Darling made clear in May 2007 that the Government expected to subsidise the network beyond 2011, we can expect increasing public calls for the Government to provide firm funding commitments as we move into the final two years of the current deal. **We are working on the basis that, if possible, the new funding package should be ready for announcement in summer 2009. Do you agree?** This is however a challenging timetable, given the number of interested parties, and it may be that timings slip into the autumn.
3. We propose that the outcome of this project is a public announcement that:
 - Restates Government's objectives for the network - to put it on a permanently sustainable footing with the associated commercial strategy;
 - Confirms POL's constitutional position in a post-Hooper environment; and
 - Provides the necessary financial (and potentially legislative) commitments to achieve these goals.
4. To secure a new funding deal:
 - POL will need to prepare a strategic plan for the 2011-16 period and then an investment case to Government to support that plan.
 - HMT will need to commit the funding. We could be talking about a further £1.5bn over five years – there will be no capacity to support this sort of deal from BERR's baseline budget.
5. Before a funding deal can be finalised, there will need to be a number of significant cross-Government decisions. For example:
 - The future size of the network, and any guarantees that either Government or POL could provide that it will not reduce below specified levels.
 - Whether POL converts branches to lower cost operating models.

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- POL's product range and focus.
- Whether there is to be any investment in the physical infrastructure and therefore customer experience.

As POL develops its Strategic Plan, we will provide you with detailed advice on your policy options. However, we believe that there may already be a significant gaps between POL's expectations and what will be acceptable to the Government. For example POL is considering a mass compulsory conversion of Post Offices to its new variable cost model. **To manage expectations, Annex F sets out the proposed parameters for POL to develop its strategic plan. Your views would be extremely helpful.**

Treasury

6. The Chancellor's response to your letter to the Prime Minister suggested that BERR should look to other Government departments to share costs where they have policy interests in the future shape of the network. You should be aware that we tried this approach for the May 2007 funding deal but were unsuccessful. A working group of interested Government departments was set up to consider proposals for the Post Office network, but no department was willing to provide funding. The Treasury will need to engage heavily with other Departments if their approach is to be successful.

7. Notwithstanding the degree of funding to be contributed by other Government departments, Treasury commitment to negotiate a funding deal for POL by summer 2009 will be vital. Given the sums of money involved, and this will probably take place outside the SR/CSR timetables, it is unlikely we will be able to achieve this commitment by engaging with Treasury officials alone. We would therefore **recommend that you speak to the Chancellor at the earliest available opportunity to secure his commitment to working towards a summer 2009 announcement of the new funding deal. Do you agree with this approach?** Any announcement would be subject to subsequent state aid clearance.

Process

8. Once we have agreed the parameters for this project with you, we propose to engage as quickly as possible with POL, HMT and No.10. Early engagement with POL and HMT is critical to achieving substantive conclusions on the tight timescale proposed.

9. We will also seek input from stakeholders such as the National Federation of SubPostmasters, the CWU, Postcomm and Consumer Focus, but will advise further on handling in due course.

10. The 2006 national consultation on the Post Office network had major timing and resource implications, both for Ministers and officials. We would assume that a national consultation process would not be desirable, though will need to provide advice next year when the scope of the funding deal (and any associated changes to the network) is clearer.

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ANNEX F – Parameters for POL's 2011-16 Commercial Plan

As set out in Annex E above, effective management of the development of POL's commercial plan will be critical to delivering a strategy aimed at putting POL's network on a permanently sustainable basis on time. It will be important to identify as early as possible potential areas of divergence between POL's management's plans and what is politically deliverable. We will then need to resolve any differences swiftly. **We would therefore appreciate your steer on the parameters for POL's strategic development suggested below.**

	Parameters for POL
<p><i>Geographic Coverage</i></p> <p>The Government established a comprehensive set of criteria applying to the Post Office network at national level, for the first time, in 2007. This was to ensure that reasonable access to postal services was available to all across the country. There are particular protections for rural and deprived urban communities. The access criteria replaced the 'No Avoidable Closures' policy which obliged POL to replace branches closing in <u>rural</u> areas wherever possible. Currently POL is only obliged to provide replacement services to the extent necessary to comply with the access criteria.</p> <p>It is estimated that the 7,500 Post Offices are required to meet the access criteria. A purely commercial network would number approximately 4,000 branches.</p> <p>With a network so large, inevitably there will be "natural attrition" – when subpostmasters retire or move on and are unable to sell their Post Office as a going concern. It is estimated that approximately 200-300 subpostmasters leave the network per annum in this way.</p> <p>By the end of the current closure programme, POL estimates that there will be c. 12,300 outlets. We have consistently used the line that the current funding package is designed to secure a network of 'around 11,500' outlets to 2011, so there remains scope to accommodate some further attrition.</p>	<p>No appetite for a further closure programme in the 2011-2016.</p> <p>Desire to see the network stabilise at around 11,500 outlets.</p> <p>Desire to explore whether POL should again be obliged to provide replacement services where a Post Office closes, irrespective of whether it's necessary to meet to the access criteria (though note this will increase POL's funding requirements).</p>

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Delivery Model

Under POL's existing agency model, subpostmasters are remunerated on a basis that includes both fixed and variable elements. The variable pay is based upon the type and quantity of POL products that they sell. Fixed pay is broadly like a salary: a set payment for each counter operated by a subpostmaster. This fixed element is particularly important where the business underlying the Post Office is otherwise unviable (e.g. where it's the last shop in a village), since without it those Post Offices would close. However, there are doubtless subpostmasters operating in viable retail shops who receive the fixed pay element when it is not required for their business's ongoing viability.

POL's competitors run on almost purely variable cost delivery models. For example, PayPoint terminals are placed in independently viable retail shops, and then PayPoint pays the shopkeeper on a "per transaction completed" basis. This significantly reduces their running costs relative to POL's, therefore making them more competitive when tendering for the opportunity to provide services (as evidenced for example by the POCA process and PayPoint winning the TV licence contract from POL).

To try to overcome this difficulty, POL has in recent years been working on the development of cheaper delivery models, involving a lower proportion of fixed cost. To date, these have principally been 'outreach' services (e.g. mobile vans) designed for rural communities with low levels of demand. POL is now piloting a variable-cost model for urban communities - Post Office Essentials (POE) – similar to the model used by POL's competitors. POE works in partnership with a local (viable) retailer who offers a slightly scaled-down range of post office services and products – it looks similar to a lottery terminal on a newsagent's counter. POL's products are available during the shop's normal opening hours – usually significantly longer than normal post office hours.

Alan Cook's aspiration to remove POL's need for Government subsidy is based on converting a significant proportion (c.6000 branches) of the current network to the POE model. This would involve converting a number of existing post offices (or closing them and opening a new POE in an existing shop nearby). There are clearly significant presentational risks from both disgruntled

Any changes in delivery model for the POL network going forward would need to have no significant risk of adverse public reaction. Any compulsory "conversion" programme to the POE model is therefore unlikely to be acceptable.

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<p>subpostmasters and the potential public perception that the POE model is somehow less ‘secure’ than a traditional branch. However, there will be a clear tension here with the value for money of the new funding deal – it is likely to be much easier to demonstrate the VFM of the POE model than continuing to subsidise fixed payments to subpostmasters.</p>	
<p>Product Range</p> <p>POL’s products are currently divided into “4 Pillars”. These are: financial services, Government services, mail services and broadband and telephony.</p> <p>Your letter to the Prime Minister focused in particular on the potential for development of POL’s offering in relation to financial and Government services. These are also the areas that POL is looking to focus upon as it seeks to move towards a permanently sustainable footing. POL’s strategy for financial and Government services is therefore considered separately in more detail in Annexes B and C.</p> <p><i>Mails</i></p> <p>Mail revenue has remained broadly stagnant for the past few years for POL (at approximately 30% of total revenues), at a time of falling social mail volumes but increasing parcels business from internet-shopping. POL is looking at innovative ways in which customers might be able to access Mails services without taking time at Post Office counters, for example by printing off their own postage labels, or using automated “Post and Go” machines.</p> <p><i>Telephony and Broadband</i></p> <p>POL’s telephony and broadband offering is a recent introduction, which has not proved totally successful. While it is making a small positive contribution to POL’s financial position it is not producing the returns that had been hoped for, and management is appraising its ongoing viability and the degree to which, even if viable at the current level, it is something that merits further</p>	<p>POL’s product range must provide as large a contribution as possible to POL’s costs, with a focus on financial and Government services.</p>

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<p>investment. We have put POL staff in touch with officials working on the Government's "Broadband for All" project, to see if this presents any significant opportunities for POL.</p>	
<p><i>Customer Experience</i></p> <p>A consistent theme of customer feedback to POL is that the experience of going to a Post Office could be improved by cutting time spent on one's feet queuing and by improving the appearance of the more run-down branches.</p> <p>Under the current funding package, POL has invested funds into a limited refurbishment of its Crown (i.e. directly owned/operated) offices. POL has taken the opportunity to pilot different approaches, ranging from radically revamped city centre outlets with soft-seating waiting areas and no fortress counters (in Bristol and Doncaster, for example) to outlets which have simply benefited from redecoration and improved signage. Officials from BERR and HMT will be visiting one of the new city centre outlets in the new year.</p> <p>Additionally, to support its financial services objectives, POL will be looking to designate around 600 of its larger town-centre branches as financial services centres with an appropriate bank-style layout. These will be a mixture of Crown offices and agency branches.</p>	<p>Any Government investment sought by POL for a refurbishment of its branches will need to demonstrate a commensurate return to POL in terms of footfall, customer satisfaction and ultimately revenue.</p>

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ANNEX G – HANDLING

[To be discussed with COMMS this afternoon]

Maximise hmg services and FS we manage +ve news that way.

Not helpful to talk about “a review” given uncertain timetables, tensions with POL, pressure to consult.

Tie in with Hooper handling in new year.

Closer to announcement in Summer 09 manage announcement.

Note existing issues such as JR and NAO.