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Department for Business, Energy & Industrial Strategy

Date: 15 March 2019
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Recipient	To Note / Comment	To Approve / Decide
Secretary of State / Kelly Tolhurst MP		X
Permanent Secretary	X	
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OFFICIAL SENSITIVE
PROPOSED REMUNERATION FOR NEW CEO OF POST OFFICE LTD

Summary

1. Post Office Ltd (POL) are recruiting a new CEO and have proposed a significant increase in remuneration compared to the previous CEO. This would see base salary and performance pay rise by 27%, taking the maximum available pay to just under £1m. POL propose rebalancing performance pay towards the short term (annual) incentive relative to the long term (three year), in order to attract candidates who are likely to be taking a pay cut to join the organisation. To comply with HMT rules, neither cash-in-lieu of pension and cash allowances would be offered. This submission sets out the proposals in detail and the supporting evidence. UKGI believe the evidence for increasing base pay is compelling; the case for a corresponding increase in performance pay is reasonable given the nature of the role and the benchmarking data Even at the increased pay level proposed by POL, base pay and total potential compensation are lower quartile. External support for this has been provided by PwC and Russell Reynolds. POL also has a significant pay compression issue at senior level in the company which would be addressed by the increase in CEO base pay. If, however, you decide that the total potential compensation is too high, we would recommend increasing base pay and freezing potential performance pay at the current level.

Timing

2. By 25 March. You have asked for reassurance that a permanent appointment be made by 1 September and the Permanent Secretary has also asked officials to accelerate the process following his meeting with POL's Chair. An early response would enable us to see approval from the CST before the Easter recess. Your support for a competitive package would also help to attract a high-quality candidate and reduce the risk of failure to attract an external candidate. There are two internal candidates for the role.

Recommendations

3. We recommend that you **approve the proposed remuneration package** comprising base salary of £415k, a maximum STIP bonus of £344,450 (83% of

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base) and a maximum LTIP bonus of £232,400 (56% of base). If you are uncomfortable with the extent of the rise in maximum pay out, we recommend you approve the rise in base pay, but ask POL to freeze maximum performance pay at current levels, while granting them flexibility to rebalance between shot and long term incentives. Following your decision, we will seek approval from the CST as soon as possible. Annex A is a proforma that sets out further details and would be included alongside advice to the CST.

Background

4. POL's current CEO Paula Vennells formally leaves POL in April but she has already stepped back from day-to-day activities GRO You have indicated that you are content for POL to appoint Al Cameron, the current Chief Financial and Operating Officer, as interim CEO, pending recruitment of a permanent replacement. You have approved his remuneration package, conditional on him effecting a successful handover, and have indicated that you plan to write to POL to approve the appointment. We are currently seeking CST clearance for his remuneration package.

5. With Al stepping up to CEO, POL should appoint an interim CFO to avoid excessive concentration of responsibility in one person. We understand that you are content to follow the Permanent Secretary's advice that this appointment is delegated to POL's Board, and that this includes the delegation of pay and terms and conditions, provided that they are within the existing pay envelope approved for the current CFO. POL have identified and interviewed a candidate GRO UKGI's representative director Tom Cooper has met with her and believes she would be a high-quality appointment, who would add value to POL in this post, and potentially beyond. A biography is provided at Annex B. GRO has two alternative job offers and we are seeking approval from the CST such that this appointment can be made as soon as possible.

6. The BEIS SCS Recruitment Panel are expecting to see this case and have emphasised that they do not want the interim CFO to be given the same package as the incumbent as this includes cash allowances for private medical insurance and in lieu of a company car. While recognising that these allowances run counter to government policy, they are currently available for all the senior people within POL and we believe this is better dealt with at the level of the whole organisation, rather than in the context of a short term temporary appointment We have already indicated to POL that they will need to remove such allowances for the permanent CEO. Your letter to POL is a good opportunity to communicate that government will no longer allow the payment of such allowances for new hires By way of context, the maximum pay being offered to the interim CFO is £471k compared to £648k for Al Cameron, in his current permanent role as Chief Financial and Operating Officer.

Are you content to delegate the appointment, and pay, terms and conditions for the interim CFO to POL's board?

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7. You have previously approved the job description and the overall recruitment process, including the indicative timetable. You are receiving a separate submission which restates this and updates the indicative timetable. It also highlights where the process can get held up and what can be done to minimise these risks.

8. POL is not a regular public sector organisation. It is a large and complex business that operates in competitive markets including mails, retail and financial services It has an ambitious three-year strategy aimed at continuing to increase profitability, and, absent unforeseen events, we believe that it should be in a position to start paying material dividends to HMG in the next few years. Delivering this agenda, and developing a comprehensive strategy requires an experienced and high calibre leader. POL believes that the pay package of the existing CEO is unlikely to be sufficient to attract a diverse and high calibre field of candidates This is supported by market intelligence from headhunters, independent benchmarking analysis and the severe pay compression within POL's executive team.

Current CEO Remuneration

9. The current CEO's remuneration is split into base pay and performance pay. Base pay consists of salary, a pension contribution of 25%, and allowances for a car and private medical insurance. Since Paula has maxed out on her pension pot, she chooses to take cash-in-lieu of pension. Performance pay consists of a short-term incentive plan ("STIP") based on performance in that financial year, and a long-term incentive plan ("LTIP"), based on performance in three years time. Profit is the primary measure of performance, as measured by EBITDAS. For 2019/20, the maximum pay available to the CEO would be £782,500, made up as follows

Table 1 - Current CEO pay opportunity, 2019/20

Base pay	
Base salary	£255,000
Benefits – car allowance plus medical	£9,900
Cash in lieu of pension	£63,750
Total base pay	*£328,650*
Performance pay	
STIP (2018-19)	£204,000
LTIP (2016-19)	£249,900
Total maximum performance pay	*£453,900*
Total pay (maximum opportunity)	**£782,500**

Base pay

10. Benchmarking analysis suggests POL's current CEO is substantially underpaid relative to comparator organisations, with base pay lying well below the lower quartile. POL's Remco commissioned PWC to carry out specific benchmarking analysis against similar-sized organisations in three areas: social purpose, mail

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and retail, and challenger banks. PWC constructed a weighted average of the lower quartiles of each group, based on a 40/40/20 split. Lower quartile base salary was £429,000, which is more than two-thirds greater that received by POL's current CEO. Pension contributions would be additional to this. While benchmarking exercises have their limitations, we believe that the evidence that base pay is too low is compelling.[1]

11. UKGI also asked POL to work with their headhunters Russell Reynolds to assess the potential candidates at the POL's current CEO package (base salary of £255k) and at a higher level (£325k) proposed by POL. Russell Reynolds advise that while the role would be attractive to some people at the lower level, there is a material difference compared to the candidates who might consider joining POL at £325k (Annex C). Details of the candidates, including their existing remuneration, is set out in confidence in Annex D.

12. In their letter Russell Reynolds write that their "strong advice is that the current compensation is insufficient to attract the right leader of the Post Office, and that it could attract a far more experienced set of candidates if base salary is raised to a minimum of £325k." This assumes that pension and bonus schemes (as a % of salary) and all benefits remain unchanged.

13. A higher base salary for the new CEO would also help to address the severe pay compression at executive level in POL. The CEO's base pay is currently just 4% above the CFOO's. This compares to a pay gap of 57% in comparable organisations and 54% in the FTSE 250. Pay compression can limit the ability to attract candidates at lower levels in the organisation, and, frankly, is often a source of frustration for CEOs. POL's proposal would create a gap of 32% in the base pay of CEO and CFO, which we believe is more appropriate.

14. POL's initially proposed retaining the structure of the current CEO package that includes £9,900 of allowances plus a 25% pension contribution that can be taken as cash if the candidate has maxed out their pension pot (and many will have done). Both the BEIS SCS Review Panel and HMT have indicated that they will not approve either cash in lieu of pension or other cash allowances. POL will eliminate these, but in order to offer candidates an equivalent amount, the base salary will need to rise.

15. The equivalent of £325k with pension and allowances is £416k without. **POL have therefore proposed offering a base salary of £415k.** UKGI believe this is justified by the evidence above. In addition, we would give POL the flexibility to offer this in a combination of cash and pension contribution, should a candidate so wish.

Performance pay

[1] The aggregate lower quartile (LQ) figure was calculated as (40% x the Social Purpose LQ) + (40% x the Mails & Retail LQ) + (20% x the Challenger bank LQ). The figure excludes cash in lieu of pension and allowance in lieu of a company car.

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16. The performance pay available at POL, while generous, is also well below comparator organisations. The current CEO is eligible for an STIP bonus of 48% for hitting target (80% for hitting stretch) and an LTIP of 70% (98% stretch) At the weighted lower quartile, the STIP bonus for hitting target performance is 131% while the LTIP bonus is 81%. For FTSE 250 CEOs, the maximum opportunity at the Lower Quartile is 125% of base for STIP and 150% for LTIP.[2] Detailed benchmarking analysis is provided at Annex E. We are satisfied that the FTSE 250 is an appropriate reference point for a business of POL's size and complexity.

17. POL propose that total performance pay should rise proportionally with the increase in base salary, <u>excluding</u> the increase that occurs simply because pension and allowances are move into base salary. This creates a total performance pay envelope of £578,500 (table 2).

Table 2 - Calculation of <u>maximum</u> performance pay envelope

Salary	STIP stretch at 80% of salary	LTIP stretch at 98% of salary	Maximum performance pay
325,000	260,000	318,500	578,500

18. This would create a maximum pay-out of £991,850 (table 3).

Table 3 - Maximum pay out under new package

Base salary	£415,000
STIP (2019-20)	£344,450
LTIP (2019-22)	£232,400
Total (maximum opportunity)	**£991,850**

19. This represents an increase in maximum pay of £209,300 (27%). This is large and could be challenged by some stakeholders who have criticised current levels of executive pay in the context of the franchising programme and the decline in aggregate postmaster pay. On balance, we believe it is justified in order give POL the best possible chance of attracting a high quality and diverse field of candidates. If you are uncomfortable with the level of the maximum pay out, we recommend that you agree to the increase in base pay but ask POL to freeze performance pay at the current envelope of £453,900. Maximum pay would fall to £868,900.

20. A third option is to require POL to freeze maximum pay at its current level (£782,500), but allow them to increase base pay and reduce performance pay. We would not advise this as it would materially weaken executive incentives once in post. It would also present its own communication challenges.

The balance between short and long term incentives

21. Within the overall envelope of performance pay, POL would like to place greater emphasis on STIP. They propose maximum STIP bonus rises slightly to 83% of

[2] Deloitte, *Directors' remuneration in FSE 250 companies*, October 2018

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base while the maximum LTIP bonus reduces to 56% (table 4). This represents a significant shift in the ratio of STIP to LTIP from 45:55 to 60:40.

Table 4 - Overall performance pay envelope, new CEO (if performance pay rises in proportion with base pay)

Base	STIP stretch at 83%	LTIP stretch at 56%	Total performance pay available
415,000	344,450	232,400	576,850

22. POL's rationale is that the candidates they want to attract are likely to be taking a hit on annual compensation (base and short term bonus), and this avoids exacerbating the issue further. PWC's benchmarking also found a greater emphasis on STIP than LTIP in relevant comparator organisations (para 16). There is a real trade-off here between attracting the highest calibre candidates and providing appropriate long-term incentives once they are in post. Government policy towards executive pay emphasises long term incentives and while the LTIP bonus of 40% (56% stretch) remains substantial, it will be outweighed by the larger, more immediate STIP. You could object to POL's proposal and insist on a relative strengthening of the LTIP. However, this will make it more difficult to attract a diverse pool of credible candidates. On balance, our advice is to approve POL's proposals as they will help to attract a wider range of high quality candidates.

Proposed package and maximum pay out

23. POL's proposed package is summarised in table 5.

Table 5 – Proposed remuneration package compared to current CEO

Current CEO										
Salary	**STIP (% of salary)**			**LTIP (% of salary)**			**Allowances**		**Total**	
	Entry 38.4%	Target 48%	Stretch 80%	Entry 56%	Target 70%	Stretch 98%	Car & med	Pension 25%	Target	Stretch
255,000	97,920	122,400	204,000	142,800	178,500	249,900	9,900	63,750	629,550	782,550
New CEO: POL's proposal										
Salary	**STIP (% of salary)**			**LTIP (% of salary)**			**Allowances**		**Total**	
	Entry 40%	Target 50%	Stretch 83%	Entry 32%	Target 40%	Stretch 56%	Car & med	Pension	Target	Stretch
415,000	166,000	207,500	344,450	132,800	166,000	232,400	-	-	**788,500**	**991,850**
New CEO: rise in base pay and freeze in performance pay										
Salary	**STIP (% of salary)**			**LTIP (% of salary)**			**Allowances**		**Total**	
	Entry 31.5%	Target 39.3%	Stretch 65.3%	Entry 25.2%	Target 31.5%	Stretch 44.1%	Car & med	Pension	Target	Stretch
415,000	130,619	163,273	271,034	104,495	130,619	182,866	-	-	**708,892**	**868,900**

Note: We propose that the new CEO has the option of taking up to 25% of their base salary as a pension contribution. We believe this is unlikely in practice since most candidates will already have maxed out their pension pot. STIP and LTIP bonuses are expressed as a % of base salary. Eligibility for Entry, Target and Stretch are determined by meeting relevant thresholds for EBITDAS

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Automatic increase

24. Annual changes to executive pay currently require Shareholder and CST approval, in accordance with POL's articles of association. POL's previous CEO received only one increase in base pay in six years, and the multiple stages of approval have meant that final decisions have often taken many months and added significantly to the workload of ministers and officials. UKGI recommends that the CEO's base salary increases automatically in line with the rest of POL's workforce, whenever there are annual pay increases. This would reduce workloads and remove uncertainty for candidates (and once in place, for executives). It would protect against executives receiving a rise in excess of that received by the rest of the workforce, and any changes in performance pay would require ministerial approval. However, it would mean effectively devolving your, and the CST's, approval powers to the POL Board. You recently approved a similar measure in relation to Ordnance Survey.

Are you content to approve automatic rises in pay, up to a maximum of the average across the rest of POL's workforce?

Recommendations and Next Steps

25. UKGI recommend that you approve POL's proposed package to allow the recruitment to progress. While it represents a substantial increase to the current arrangements, this is necessary to bring it closer to that offered by the wider market and so to attract a sufficiently high calibre candidate for this important role.

26. The shift in performance pay towards STIP is significant and you should consider whether you want to press POL to redress it.

27. If you are content to approve the remuneration package, we would like you to write to the CST as soon as possible, so that the package can be finalised before recess. We have worked closely with HMT officials to remove contentious elements. However, they have indicated that the CST will require compelling evidence to support an increase in maximum pay of this magnitude.

Contributors

28. The Post Office Policy team has been consulted on this submission. The proposal has not been seen by the SCS Recruitment Panel, as the Permanent Secretary asked for it to be accelerated through the system. However, the Panel have asked to see the evidence underpinning this case including benchmarking, performance measures and metrics. The have also expressed a view that POL should not offer cash-in-lieu of pension or other cash allowances, because this goes against wider government guidance. We have followed this advice.

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29. We have not been able to consult BEIS HR or BEIS Communications in the time available.

30. This advice is not considered to raise legal issues and Legal has not been consulted.

Annexes

A. Proforma to accompany letter for the CST
B. Biography of prospective interim CFO, GRO
C. Letter from Russell Reynolds (POL's head-hunters)
D. Information on prospective candidates from Russell Reynolds (Contains confidential personal information OFFICIAL-SENSITIVE)
E. PWC benchmarking analysis