UKGI00002502

Shareholder Executive

HM Government

Post Office Limited ("POL")

Quarterly Review

October 2014

OFFICIAL – POLICY & COMMERCIAL

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Quarterly Update – Activities Since June Quarterly

Year to Date Trading 2014/15

- **YTD performance has fallen short of budget, although this is not a surprise given the level of ambition underlying the year's plan**
  - To achieve a flat operating profit, taking into account a £40m reduction in subsidy, POL has to deliver strong performance in both revenue and cost. Results have been weak in both areas, although revenue – as is often the case – is seen to be a greater concern
- **Management are taking actions to deliver a stronger performance for the remainder of the year, but the ShEx team is doubtful that POL will be able to stage a marked recovery**
  - Notwithstanding these short-term concerns, and assuming management can deliver action in a narrow range of key areas (e.g. Network Development, work on the Target Operating Model) we remain confident of a firmer medium-term outlook

Network Transformation

- **Progress is on track and at end-September POL had delivered 1,075 openings and 922 signatures in-year taking cumulative totals to 3,133 and 4,168 respectively (against a full year budget of 3,800 and 5,000)**
  - We are confident that 2014/15 targets will be met but do accept that there are risks in relation to the NFSP's engagement and in particular their reaction to Network Development activities and discussions around the "cliff"
- **In addition POL has also started a "Guided Leavers" pilot across 120 branches. This is an important milestone, and will allow the business to understand where the risks are in this partially-mandated element of NT which will ultimately impact up to 800 branches**
- **Dialogue has also recently started with POL on the "cliff" (i.e. the point in 2015 after which POL can make changes to remuneration / compensation). This is an important aspect of NT although thinking is still only at an initial stage – we will remain close to the issue**

Network Development

- **While 140 new access points have now opened we remain concerned that POL will not be able to reach its c.400 branch commitment by March 2015, although since the last ShEx Quarterly Meeting the nature of our concern has shifted**
  - POL has made good progress on the ground (e.g. opening access points, in discussions with new partners and in respect of the technology) but its relationship with the NFSP has deteriorated, and the organisation has also become unreliable
- **We now view the NFSP as the major risk to Network Development and we are working closely with POL to make sure progress is made wherever possible. We are also cognisant of contagion risk that could link initiatives in this area to, for instance, NT**

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Quarterly Update – Activities Since June Quarterly (cont'd)

Crown Transformation

- **Performance is behind budget and it is looking increasingly unlikely that POL will be able to achieve a run-rate breakeven by year end. Revenue growth and franchising activity have both falling short of expectations, and are the main sources of underperformance**
  - While this is disappointing it should not totally overshadow the progress that POL has made since 2010/11, with losses coming down from c.£60m to an expected sub-£5m by the end of 2014/15
  - Additionally, POL has also modernised 250 of the 300 branches it is retaining, with the remainder to be completed by November. This is in line with forecasts and in many instances represents a total renovation of the branch
- **Government and POL has publicly stated its ambition to take the Crowns to breakeven (albeit this has never been a formal goal) and therefore failure to meet targets could have a reputational impact. This might also trigger a response from the CWU and NFSP**
  - ShEx is aware of these possible exposures and is staying close to POL. This includes looking at different ways the Crown narrative could be positioned

State Aid

- **A draft notification has been submitted to Cion and we are in responding to DG Comp's and DG Markt's questions. There are some "sticky" issues (e.g. POL's restrictions policy) but we remain confident of receiving approval prior to March 2015**
  - The ShEx team is concerned about the level of engagement at POL and we have sought to escalate this recently, including asking to have someone at ExCo accountable for POL's involvement in the process. It is disappointing that we have had to take this action

Mutualisation

- **The "bumpy" announcement we achieved earlier in the year was welcomed by Jo Swinson but little activity has taken place since, despite indications from POL that this would mark the beginning of a range of "new and exciting" activities**
  - POL's lack of support, at both Executive and Board levels, is frustrating and we are having to work closely with the business in order to manage Ministerial expectations carefully
  - We have recently escalated this issue within POL and expect to see actions – albeit likely in very limited form – being taken soon, which should help in the mutualisation narrative in the lead up to the election in 2015

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Quarterly Update – Activities Since June Quarterly (cont'd)

Target Operating Model

- **POL has ramped up its work to define a 2020 "target operating model" in the last few months and initial findings of this were recently shared with the Board / ShEx. The initial phase of this work appears to be credible and appropriately wide in scope**
  - Some suggestions are welcome (e.g. network reprofiling, IT efficiency, outsourcing of non-core central functions) but others are likely to be difficult to manage from a Ministerial / stakeholder perspective (e.g. restructuring Crowns, "rebalancing" subpostmaster pay)
- **We are increasing engagement with POL on this topic so when more detailed proposals are put to the Board in November our views on content, risks, timing and sequencing can be considered**

Management Capability / Capacity

- **The quality of work emerging from POL has improved recently, in particular in respect of the work on Network Development and Target Operating Model. This gives us comfort on capability but until results start to emerge we will remain cautious**
- **Activities to replace certain senior management personnel are, after a hiatus over the summer, now starting to move forward again as SoS support appears to be strengthening. This is good progress, but is no guarantee that a favourable outcome is likely any time soon**

Post Office Card Account (POCA)

- Verbal Update at Quarterly ShEx Meeting

PEX(ER) and Other Government Services Activities

- **Following Jenny Willott's presentation to PEX(ER) in May we have seen renewed enthusiasm across certain parts of Whitehall to support POL's Government Services growth ambitions. Jo Swinson has also been very supportive since her return**
  - However enthusiasm has not translated into tangible progress or new work. Whilst barriers are being exposed (e.g. GDS), it is proving difficult to reach agreement on solutions.
- **As a follow-up to PEX(ER) the Home Affairs Committee will be taking a paper on POL in October that seeks agreement on a number of "principles" that would go some way to removing the conflict (real or perceived) between POL services and HMG's digital ambitions**
  - While this may lead to some new work (e.g. with DVLA) the financial benefit to POL is likely to be, at best, modest

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Quarterly Update – Activities Since June Quarterly (cont'd)

External Facing ATMs and the VOA

- Verbal Update at Quarterly ShEx Meeting

Project Sparrow

- **There remains no evidence of systemic issues with POL's accounting software (Horizon) and the independent working group established to consider complaints is working through cases. However, progress is slow, costs are high, and stakeholders are restless**
  - Progress is plagued by the involvement of Second Sight, forensic accountants that Jo Swinson gave an unscripted Parliamentary assurance would be involved in the process. They are expensive and incompetent and a cause of considerable frustration
  - Aside from some expected stakeholder (JFSA) noise that was picked up in niche online publications, the issue is moving to resolution (noting above caveats) in November 2015, mitigating some election noise
    - However, programme costs have been higher than POL planned and by the end of the process are likely to come in at a total of c.£12m (i.e. compared to forecasted spend of less than half this amount)

Election Planning

- **Over the past few months the ShEx team has started to think ahead to May 2015, in particular in 3 areas:**
  - Coalition Commitments: We are working with POL to make sure that the Coalition's commitments to POL can be evidenced in the run up to the election, and where there are weaknesses in any of these narratives that we are able to craft appropriate defences. The team will also be engaging with Jo Swinson soon to understand her possible focus areas
  - Pre-Election Approvals: There are a number of difficult actions that POL is likely to be taking in the coming months and some of these are likely to require Ministers to be sighted. We are working closely with POL to manage these various workstreams, to mitigate the possible impact of the election / post-election period on the pace of the business's progress
  - Future POL Policy: To inform advice to an incoming Government the team has been reflecting on existing commitments to POL, and the progress that has been made in these and other areas during this Parliament. We think it is important to try to protect POL's commercial independence in the future while also avoiding commitments that we / Government / POL can not influence directly

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2014/15 Year-to-Date Performance – Revenue

2014/15 was expected to be challenging in terms of revenue, with FY growth of c.7% or £58m expected…

…trading in the first 5 months of the year has been disappointing, and not just compared to an ambitious budget. Performance in core areas has been weak, new growth has fallen short of expectations, new launches have seen delays and concerns have started to emerge in some other areas…

…action is being taken and management think full year revenue will be closer to £900m, c.£25m short of budget. We think this is still very ambitious.

YE Mar - £m	Sept. 14/15	Budget	% vs.	Prior Year	% vs.
Mails & Retail	153.6	165.6	*(7.2%)*	153.9	*(0.2%)*
Financial Services	121.1	119.1	*1.7%*	115.8	*4.6%*
Government Services	45.7	48.8	*(6.5%)*	50.1	*(8.9%)*
Telephony	20.8	25.0	*(16.5%)*	22.6	*(7.7%)*
Other	15.2	13.1	*15.6%*	16.1	*(5.5%)*
POL Net Income	**356.4**	**371.6**	*(4.1%)*	**358.5**	*(0.6%)*

Mails & Retail

- **Weak trading which emerged in 2013/14 (and which we thought had been addressed with Royal Mail's "Project Bentley" pricing / sizing changes) has persisted, with volumes continuing to fall short of expectations**
  - Volumes are weaker than expected across the board, due to both less market growth than expected and loss of market share. Actions being taken but likely to be too-little-too-late for recovery in 2014/15
  - Slow progress in home shopping returns (e.g. delay to eBay rollout and fewer C&C customers) is also now starting to bite as the year's budget ramps up from P5

Financial Services

- **Outperforming budget and prior year with favourable trading mainly down to NS&I (e.g. new contract and increased Premium Bond limits), personal banking (e.g. volumes) and Moneygram (e.g. terms of new contract)**
  - Personal Financial Services, a key strategic growth area, is performing well ahead of prior year and is broadly in line with budget (albeit with some weakness starting to emerge in Insurance), which is reassuring overall

Government Services

- **Currently trading behind budget and prior year, with particular weakness in passports (e.g. lower than planned volumes) and POCA (e.g. due to delays to agreeing an extension, which was expected to bring in-year benefits)**
- **Offset by strong DVLA volumes, although withdrawal of tax discs will start to impact from now versus prior year**

Telephony and Other

- **Telephony continues to suffer on lower subs numbers, higher than planned cost of sales and delayed launch of mobile. Also POL's decision not to launch an Energy offer is now starting to show up due to budget phasing**

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2014/15 Year-to-Date Performance – Income Statement

POL is currently trading £4m behind budget at P5 which is reassuring given the weak revenue performance YTD…

…however this masks a number of concerns particularly around the pace being made against cost saving activities and the expected £25m VAT benefit effectively "saving the day" for the FY…

…management see P6-P12 being in-line with budget and FY ending £4m below plan at operating profit level. Not only is this is extremely ambitious but it relies on a number of non-trading or one-off benefits

YE Mar - £m	Sept. 14/15	Budget	% vs.	Prior Year	% vs.
POL Net Income	**356.4**	**371.6**	*(4.1%)*	**358.5**	*(0.6%)*
Staff Costs	(106.2)	(103.4)	*2.7%*	(110.6)	*(4.0%)*
Agents Costs	(189.3)	(201.0)	*(5.9%)*	(189.8)	*(0.3%)*
Non-Staff Costs	(111.8)	(117.8)	*(5.1%)*	(108.9)	*2.6%*
Depreciation	(0.2)	(0.3)	*(26.2%)*	(0.2)	*14.2%*
POL Operating Profit	**(51.1)**	**(50.9)**	***0.3%***	**(51.0)**	***0.1%***
Financial Services JVs	19.8	19.7	*0.6%*	18.8	*5.0%*
Group Operating Profit (pre-POOC)	**(31.3)**	**(31.2)**	***0.1%***	**(32.2)**	***(2.8%)***
Project One-Off Costs	(11.9)	(7.8)	*51.7%*	(14.5)	*(18.1%)*
Group Operating Profit (post-POOC)	**(43.1)**	**(39.1)**	***10.4%***	**(46.7)**	***(7.5%)***
Network Subsidy Payment	67.7	67.7	*0.0%*	84.6	*(20.0%)*
Group Operating Profit (post-NSP)	**24.5**	**28.6**	***(14.3%)***	**37.9**	***(35.3%)***
Memo: Net Income (incl. NSP)	424.1	439.3	*(3.5%)*	443.1	*(4.3%)*

- **Despite revenue being £15m behind budget at P5 operating profit is only £4m off plan, driven mainly by:**
  - Subpostmaster costs which are £11m favourable due to flow through from lower mails revenue and VAT
  - Non-staff costs which are £6m favourable due to a £14m VAT recovery rate benefit. Without this underlying costs are £8m unfavourable due to savings targets not being met and accruals for Mails Segregation penalties
- **Staff costs are unfavourable by c.£3m due to savings tasks not being met (e.g. in Supply Chain) and Project One-Off Costs are also running above budget (e.g. business transformation, strategy and Project Sparrow)**

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Update on ShEx Team's Top Priorities for 2014/15

Priority	Commentary
Transformation	***Network Transformation*** ▪ 2014/15 performance is ahead of budget, which is not a surprise given the momentum NT had coming into the year, and this also highlights why the ShEx team challenged POL during its planning and budgeting process. Assuming risks linked to stakeholders do not crystallise (e.g. NFSP withdrawal of support for NT) we fully expect this years targets to be beaten at both branch openings and contract signatures ▪ The monitoring regime has continued to improve, particularly with the broadening of NT activities into Guided Exits and dialogue starting in respect of the "cliff" – this has meant that the breadth of information and our ability to shape it has also increased ***Crown Transformation*** ▪ Performance is behind budget and it is looking increasingly unlikely that POL will be able to achieve a run-rate breakeven by year end. While this is disappointing it should not overshadow the progress that POL has made – losses have fallen from £60m to (it is expected) below £5m by March 2015 ▪ As ShEx had expected, revenue growth is the main source of underperformance (even with targets 50% lower than earlier iterations of the strategy), although franchising activity is also falling short of plan with up to 15-20 of the 70 slated branches likely to remain on POL's books ▪ The stakeholder environment has fortunately remained quiet since agreement was reached in respect of Crown pay in June although there is a risk that failure to reach "breakeven" might trigger a wide response from both the CWU and the NFSP. This narrative needs to be managed carefully ***State Aid*** ▪ A draft notification has been submitted to Cion and we are in responding to DG Comp's and DG Markt's questions. While there are some "sticky" issues (e.g. POL's restrictions policy) we remain confident of receiving approval prior to March 2015 when the current funding agreement expires
Mutualisation	▪ ShEx has expressed its concerns to POL that there is little activity happening around mutualisation or POL's purpose, despite prior indications that May's milestones announcement would kick-off a range of "new and exciting" activities. We will be staying close to POL on this in the coming months, and we will be seeking the views of the Minister, to make sure that "clear progress towards mutualisation" can be evidenced
Policy and Stakeholder Issues	▪ Progress around Government Services – both in existing and new areas – remains an uphill struggle and risks remain in respect of both 2014/15 trading and expected performance in future years. The PEX(ER) process triggered some engagement but results are yet to emerge from this process ▪ Even though we do not believe POL has performed strongly in these areas we are increasingly in agreement that the revenue opportunity is likely to remain modest and that management's attention is potentially better targeted at clearer / easier "wins" (e.g. Mails and Financial Services) ▪ Reassuringly POL is engaging with us in respect of Network Development and we are also seeing clear results on the ground. However considerable work remains to be done here, in respect of technology, POL's ability to secure clients and, most importantly, managing stakeholder risks

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Traffic Light Analysis

	09/13	01/14	04/14	06/14	Cur.	Comments
Shareholder Relationship						• There is a good and constructive relationship with POL's Chair, and a strong relationship with the CEO who appears committed to meeting HMG's objectives. POL's NEDs are challenging management, and this is expected to be maintained going forward - in particular in relation to key strategic initiatives, financial performance and POL's new plan / its operationalisation more generally.
Implementation of Shareholder Model						• Generally strong and improving application of a shareholder model, with appropriate monitoring structures in place – this includes frequent dialogue with management. Management remuneration was finalised faster this year, although separately ShEx does have questions as to whether it is incentivising the wrong commercial behaviours (e.g. in relation to recent POCA discussions).
Quality of Management Team & Board						• ShEx has questions in respect of POL's management team and whether they are right / capable of delivering the new strategic plan. The Board are dealing with this, although they have prioritised some recruitment activities over others and are facing challenges from Government processes. They are also keeping a watching brief on other areas. Recent arrivals seem to be settling in well, although they have yet to be tested fully (e.g. we are reserving judgement until they start delivering).
Strategy						• ShEx is monitoring the business closely across a broad range of areas (broader than in early 2013/14), and we are also working to ensure POL has the best chance of delivering its strategy successfully. While early questions in respect of POL's commitment have now subsided we remain cautious over the extent, complexity and ambition of the plan.
Financial Performance						• POL's financial performance is monitored closely by ShEx on a monthly basis, and this has increased in recent months as performance has started to fall short of budget. We are close to POL and its plans to address underperformance although we still feel that in-year activities / revised targets are very ambitious. We also continue to have questions in respect of how performance is reported and, linked to this, the transparency of underlying trading.
Balance Sheet & Risk						• POL has a business plan in place, and it is funded to deliver this strategy (and POL is clearly aware that additional funding is not possible). However POL is only a going concern due to HMG subsidy, and it makes losses which means it is unable to pay dividends (both today, and likely in the medium term).

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Annex – Top Priorities for 2014/15

Priority	Commentary
Transformation	***Network Transformation*** ▪ To continue to closely monitor Network Transformation and help POL to manage local and stakeholder concerns – this includes ensuring that implementation of the strategy is done properly and that it addresses HMG's concerns identified with the old plan. In monitoring it will be key to make sure targets continue to be met, and if not that appropriate mitigating actions are taken ***Crown Transformation*** ▪ Same as Network Transformation but with a closer focus on key stakeholder concerns (e.g. voluntary redundancy and franchising activities) and in parallel, progress being made with CWU and Unite. It is also important that the team is able to assess the impact of the actions being taken (e.g. both to ensure progress towards breakeven can be maintained and that they support other strategic activities) ***State Aid*** ▪ In support of POL's recently announced funding agreement the ShEx POL team will be working with POL throughout 2014/15 on a State Aid notification to the European Commission – the process will begin formally in late January / early February. This will ensure that approval is received before the end of POL's existing funding in March 2015
Mutualisation	***Spring Announcement on Progress*** ▪ To work closely with POL in January / February in ensuring that an update on mutualisation, which was trailed in Jo Swinson's November speech to the HoC, is made alongside the publication of the "public benefit purpose" of the post office in the Spring. It will be key to ensure that any such update is aligned to Ministerial expectations (and indications provided to Ministers by POL in December) ***Other Workstreams*** ▪ In parallel the ShEx POL team will also continue to support POL in its work on developing more mutual ways-of-working across the business and with its key stakeholders. This will include working with POL directly and, in certain areas, participating in new working groups that are being brought together
Policy and Stakeholder Issues	▪ On a business-as-usual basis it will be important for the ShEx POL team to continue to work closely with HMG stakeholders and POL to ensure that HMG's policy objectives for POL and its network can continue to be met (e.g. network size, access criteria) and that commercial or stakeholder issues that arise can be managed and dealt with quickly and effectively (e.g. NS&I, DWP / POCA, VOA, etc.) ▪ Working alongside POL's new commercial team this will also include looking at new ways in which POL and ShEx can work together – e.g. both to strengthen POL's financial performance and also to ensure that HMG's objectives can be achieved