



HM Government

Post Office Limited (“POL”)

Quarterly Review

June 2014

OFFICIAL – POLICY & COMMERCIAL

OFFICIAL – POLICY & COMMERCIAL

Quarterly Update – Summary Since April Quarterly

2013/14 Full Year Financial Performance

- POL outperformed its operating profit target for 2013/14 and finished the year c.£6m ahead of budget, however revenue performance was weak – particularly in Mails and Retail – and was c.£35m below expectations
- ShEx has questions around the sustainability of this operating profit result as the results for 2013/14 appear to have benefited from certain reallocations / one-offs. Management are cautious looking forward but they have reassured us that underlying trading in 2013/14 was robust

P1 Trading 2014/15

- 2014/15 has started softly with both revenue and operating profit under budget. Although it is still early this is cause for some concern – worrying trends in Mails and Retail established in 2013/14 appear to be continuing and cost challenges (phased early in the year) are not being delivered
- ShEx will be monitoring performance particularly closely this year since in order to meet its targets POL has to deliver significant growth and cost efficiencies (e.g. it not be less able than previous years to rely on cost efficiency to make up revenue shortfalls). This is likely to be challenging

2013/14 Annual Report

- POL will be publishing its Annual Report in early July. The ShEx team has had the opportunity to feed into this and – after some initial resistance – most of our substantive comments have been taken on Board. This feedback process was better than in 2012/13, but it could still be improved

State Aid and Funding

- A non-paper was submitted to the Commission in late April and a second meeting to discuss their initial questions took place in mid-June. We understand where the Commission's concerns are, and we remain confident that it will be possible to secure approval prior to March 2015

Operational Planning

- POL is currently “operationalising” the strategy that was approved in November 2013. This detailed planning stage is taking longer than expected but it appears as though the business is engaged, which is reassuring given previous experiences with POL’s strategy planning processes
- It is looking increasingly likely that POL will want to amend its plan. While this raises concerns, our priority is for POL to have a deliverable plan, that management sign up to and which meets HMG’s objectives. We will work closely with / challenge POL during this process

Management Capability / Capacity and Remuneration

- The management capability / capacity issues raised at the ShEx annual review are echoed by the Board and action, in certain areas, is being taken
- Remuneration for 2014/15 needs to be confirmed although progress is being made (e.g. RemCo taking on board some of our requests / concerns)

OFFICIAL – POLICY & COMMERCIAL

Quarterly Update – Summary Since April Quarterly (cont'd)

Government Services – Outcome of PEX(ER) and Possible Cabinet Discussion

- Jenny Willott presented at a recent PEX(ER) and we understand that Ministers were fully engaged in the discussion that followed. This included raising a number of concerns with POL / branches, and as a follow-up it has been proposed that POL is subject of a pre-recess Cabinet discussion
- The Minister also met with POL's CEO and Commercial Director recently to discuss the output of PEX(ER) and possible next steps. While engagement at this level is useful it is not clear what PEX(A) or a possible Cabinet discussion will deliver

Post Office Card Account

- Ministers are fully engaged in the extension process although tangible progress has been slow to emerge. We believe that an agreement is not far off – a Ministerial / POL / officials meeting was held in mid-June – although its final form and terms are still subject to a degree of uncertainty
- ShEx is maintaining a close and active dialogue with POL, DWP and HMT, and this has demonstrated to us some of the frustrations expressed by OGDs in respect of POL's approach to its customers. This feedback has been given to POL

Network Expansion

- POL is moving ahead with its "Project Ivy" network expansion activities which were the subject of a commitment letter agreed between POL and BIS in November 2013. We expect to see the first pilots launched shortly – at Tesco and TfL sites – and for a broader rollout to begin in Q2/Q3
- This is a complete reversal of POL's early stance – management now appear to view this as a strategic priority (e.g. to respond to challenges in the mails market). While targets are still ambitious, POL's commitment to meeting them appears to be strengthening

Project Sparrow

- Moving forward slower than expected and even though an independently Chaired working group has been established, no cases have been brought into the resolution process / been resolved. Despite this POL appears to be expending considerable resource / funds on the project
- Given the possible risk around this project a sub-committee has been set up by the Board, led by POL's Chair, to ensure that progress is monitored carefully (e.g. that the resolution process is managed appropriately). Advice is going to Ministers shortly

Financial Services Transformation

- POL's Financial Services director is starting to take forward the multi-stage transformation of POL's insurance business – one of the first steps being "Project Titan", which restructures POL's travel insurance business to strengthen POL's position in the value chain
- For POL to take on certain activities it (or rather, an entity within the group structure) will have to be regulated by the FCA for the first time. This brings with it governance complexities which will need to be developed and executed carefully – POL's Board is fully engaged in this process

OFFICIAL – POLICY & COMMERCIAL

2013/14 Full Year Performance – Summary

Despite delivering a weak result in revenue terms POL managed to exceed operating profit budget by c.6% in 2013/14...

...this is a good result but the revenue performance signals a number of very concerning trends – particularly when revenue growth is going to be so crucial in POL meeting its 2014/15 targets...

...there also seemed to be a number of one-offs / reallocations during the year which call into question how sustainable the £108m operating profit actually is, and the level of discretion management have on POL's financials

YE Mar - £m	13/14 FY	Budget	% vs.	Prior Year	% vs.
POL Net Income	866.1	900.0	(3.8%)	902.4	(4.0%)
Staff Costs	(252.3)	(256.1)	(1.5%)	(257.4)	(2.0%)
Agents Costs	(447.6)	(480.0)	(6.8%)	(478.1)	(6.4%)
Non-Staff Costs	(264.8)	(257.6)	2.8%	(260.7)	1.6%
Depreciation	(0.4)	(0.9)	(54.4%)	(0.4)	0.8%
POL Operating Profit	(98.9)	(94.5)	4.7%	(94.2)	5.0%
Financial Services JVs	33.1	31.5	4.8%	31.9	3.8%
Group Operating Profit (pre-POOC)	(65.9)	(63.0)	4.6%	(62.4)	5.6%
Project One-Off Costs	(26.0)	(35.0)	(25.6%)	(52.3)	(50.2%)
Group Operating Profit (post-POOC)	(91.9)	(98.0)	(6.2%)	(114.7)	(19.9%)
Network Subsidy Payment	200.0	200.0	0.0%	210.0	(4.8%)
Group Operating Profit (post-NSP)	108.1	102.0	5.9%	95.3	13.4%
<i>Memo: Net Income (incl. NSP)</i>	1,066.1	1,100.0	(3.1%)	1,112.4	(4.2%)

- Revenue performance was weak with POL reporting turnover c.£35m down on both budget and prior year
 - Primary driver was the impact of Royal Mail's product changes at the start of 2013/14 which drove significant volume out of the market / to competitors. Actions were taken but these were insufficient on a full-year basis
 - Also delivered a weak performance in Retail in particular in respect of Lottery, where Camelot's pricing changes, a slow rollout of new terminals and fewer rollovers than expected impacted performance
- However full year operating profit was c.£6m ahead of budget. This was driven by favourable subpostmaster costs (mainly due to pass-through from lower Mails revenue) and deferred / postponed / reallocated project costs

OFFICIAL – POLICY & COMMERCIAL

2014/15 Year-to-Date Performance – Revenue

Delivering budgeted growth in 2014/15 was always expected to be difficult however after one month this is looking like it could be a real challenge...

...worrying trends in underlying trading have continued from 2013/14 with no clear end-point or solution on the horizon...

...active steps are therefore going to be needed but with current mitigating actions seemingly having only a modest effect questions remain

YE Mar - £m	Apr 2014/15	Budget	% vs.	Prior Year	% vs.
Mails & Retail	34.9	36.9	(5.4%)	35.9	(2.9%)
Financial Services	25.9	25.0	3.5%	24.4	5.8%
Government Services	10.2	10.4	(1.8%)	11.1	(7.3%)
Telephony	4.6	5.5	(15.7%)	5.3	(12.8%)
Other	2.9	2.8	2.7%	3.3	(12.5%)
POL Net Income	78.5	80.6	(2.6%)	80.0	(1.9%)

Mails & Retail

- Poor start to the year with revenue below both budget and weak prior year comparables. All categories (with the exception of stamps) saw challenges but labels remains – following 2013/14 – an area of particular concern
 - POL was severely impacted by Royal Mail product changes in 2013/14, against which actions were taken and performance had been improving. Currently trading c.10% behind budget, driven by weaker volumes
- Retail is also trading behind budget and prior year, with Lottery volumes continuing to be impacted by the Camelot pricing changes and a smaller number of rollovers

Financial Services

- Currently ahead of budget although divisional numbers mask complex mix effects. Underlying prospects – in particular in key growth areas – do however remain favourable.
 - Majority of outperformance due to new NS&I terms, which were not reflected in budget

Government Services

- Favourable trading in DVLA and Passports is more than offset by weakness in POCA and ID Services. Stronger DVLA performance is reassuring after 2013/14 but near term avenues for growth remain limited

Telephony and Other

- Telephony remains an area of concern after 2013/14's migration to Fujitsu and the related billing issues that emerged late in the year. Current trading impacted by lower customer numbers and higher cost of sales

OFFICIAL – POLICY & COMMERCIAL

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

POL is currently c.£2m behind operating profit budget after one month's trading in 2014/15...

...this is a cause for concern, particularly since in order to meet budget the business will need to deliver on a wide variety of initiatives (e.g. new product launches, cost saving initiatives). Many of these are still not in implementation...

...while it is still an early point in the year the ShEx POL team is keeping a very close watching brief on financial performance and underlying trading / trends

YE Mar - £m	Apr 2014/15	Budget	% vs.	Prior Year	% vs.
POL Net Income	78.5	80.6	(2.6%)	80.0	(1.9%)
Staff Costs	(23.4)	(22.7)	3.2%	(23.5)	(0.2%)
Agents Costs	(43.7)	(45.0)	(2.8%)	(43.1)	1.3%
Non-Staff Costs	(28.0)	(28.3)	(0.8%)	(21.6)	30.0%
Depreciation	(0.0)	(0.1)	(35.7%)	(0.0)	(0.5%)
POL Operating Profit	(16.7)	(15.4)	8.4%	(8.2)	103.7%
Financial Services JVs	2.5	2.5	(2.2%)	2.5	0.4%
Group Operating Profit (pre-POOC)	(14.2)	(12.9)	10.4%	(5.7)	147.9%
Project One-Off Costs	(2.0)	(1.3)	52.3%	(7.4)	(73.4%)
Group Operating Profit (post-POOC)	(16.2)	(14.2)	14.2%	(13.1)	23.4%
Network Subsidy Payment	15.4	15.4	0.0%	19.2	(20.0%)
Group Operating Profit (post-NSP)	(0.8)	1.2	(166.3%)	6.1	(113.2%)
<i>Memo: Net Income (incl. NSP)</i>	93.9	96.0	(2.2%)	99.3	(5.4%)

- Cost performance was mixed in April, with staff costs coming in higher than budget – due to targeted savings not being achieved – and agents costs and non-staff costs coming in lower. Non-staff costs have been impacted by some timing effects which are expected to unwind in the next couple of periods
 - Spend on one-off costs are also higher than expected, mainly driven by £700k unbudgeted spending on Project Sparrow activities
- Operating profit is currently running c.£2m behind budget and c.£7m behind prior year

OFFICIAL – POLICY & COMMERCIAL

2014/15 Year-to-Date Performance – Key Activities

2014/15 is expected to be very difficult for POL, both in respect of financial targets and the progress that needs to be delivered across a wide range of strategic initiatives...

...management remain confident of meeting these targets but the ShEx team is taking a more cautious view...

...in particular with the 2015 election nearing it will be increasingly important to build credible and defendable narratives around key Government commitments to POL

Network Transformation

- In the first two months of the financial year POL has signed up 206 subpostmasters and opened 318 branches under Network Transformation, taking cumulative totals to 3,477 and 2,376 respectively
 - Mixed performance YTD (behind c.46 contracts and ahead c.21 openings). Expectations for the full year are for 4,800 signatures to have been achieved and 3,600 modernised branches to have been opened
 - Profile of conversions in 2014/15 is expected to be very different to 2013/14 with a greater share of Local and / or Offsite conversions. These are more complex, more costly and take longer to deliver

Crown Transformation

- Crown budget missed by c.£4m in 2013/14 (i.e. delivered a £27m operating deficit vs. a £23m operating deficit budget). c.£10m savings for 2014/15 are already “banked” although performance is currently behind budget
 - Redundancy targets have been met and a pay-deal has been secured with the CWU / its members
 - Franchising is progressing well but there is a risk that not all slated 70 Branches will be exited
 - Branch investment activity is ahead of plan. Early signals of performance from these branches is strong
 - Revenue is a concern. Growth is needed to meet targets, and softness in 2013/14 has continued in 2014/15

Government Services

- Following the PEX(A) meeting ShEx and POL are preparing for a possible Cabinet discussion pre-recess
 - This will be an important opportunity to encourage support for the network and to dispel misplaced views among Ministers that POL is costly and uncommercial and its branches are outdated, unwelcoming, etc.
 - Jenny Willott faced resistance from subpostmasters at the recent NFSP conference who are continuing to push for Government to deliver on its “commitments” around Government Services revenue
- In the meantime trading remains challenging with no significant “big wins” on the horizon. However risks to current revenue are significant (e.g. POCA negotiations, DVLA steps on tax-discs and direct debit payments)

Mutualisation and Public Purpose

- After some resistance POL published its mutualisation milestones / public purpose in May – unfortunately this was not picked up widely externally. This had been trailed by Jo Swinson in November 2013
 - The ShEx POL team is working with POL to ensure further progress can be made this year, in order to build a robust case demonstrating “clear progress” being made towards mutualisation before the end of 2014/15

OFFICIAL – POLICY & COMMERCIAL

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

Priority	Commentary
	<p><i>Network Transformation</i></p> <ul style="list-style-type: none">■ 2013/14 targets were beaten although 2014/15 appears not to have started well. Management remain committed to in-year targets, which we have been assured are challenging given the shift in mix of expected conversions. ShEx believes they could be more stretching■ ShEx has been working with POL to develop a stronger monitoring framework, and to set out long term targets for signatures and openings. POL is providing us with more information although further improvements would be welcome (e.g. in respect of speed, depth and quality of information)
Transformation	<p><i>Crown Transformation</i></p> <ul style="list-style-type: none">■ 2013/14 was behind budget however POL remains committed to achieving run-rate break-even by the end of 2014/15. Many of the actions taken last year will deliver benefits in 2014/15 however this is not enough and POL will need to deliver growth to meet targets. This will be challenging■ The stakeholder environment has improved considerably since a landmark agreement was reached with CWU around Crown pay (for which POL achieved a favourable ballot result in June). This removes one of the key risks to the delivery of 2014/15 targets <p><i>State Aid</i></p> <ul style="list-style-type: none">■ A non-paper was submitted to Cion at the end of April and a second meeting was held in Brussels in mid-June. ShEx remains confident that an approval will be received prior to March 2015 when the current funding agreement expires
Mutualisation	<p><i>Spring Announcement on Progress</i></p> <ul style="list-style-type: none">■ Despite resistance from POL an announcement incorporating “mutualisation milestones” and the “public benefit purpose” was made at the beginning of May. The release was not managed well by POL although its timing was broadly in line with the timing trailed by Jo Swinson <p><i>Other Workstreams</i></p> <ul style="list-style-type: none">■ The Post Office Advisory Council held its first meeting in March, and in addition POL – with firm encouragement from ShEx – will be taking forward a number of other workstreams in the coming months (e.g. working groups, defining milestones, etc.). This should deliver progress and it is important that ShEx stays close to POL to make sure momentum is maintained / progress is improved■ Progress has been made in some areas (e.g. NS&I and DWP) while in other areas considerable risks remain (e.g. VOA’s proposals re. ATM ratings, CO’s digital and identity strategy, DVLA timing of tax-disc withdrawal / launch of direct-debit payment)
Policy and Stakeholder Issues	<ul style="list-style-type: none">■ Jenny Willott has now presented to PEX(ER) and a pre-recess Cabinet discussion has been proposed. This is a positive development and could catalyse progress, although to date Ministerial engagement has not delivered / accelerated results■ Jo Swinson returns at the end of June

OFFICIAL – POLICY & COMMERCIAL

Traffic Light Analysis

	06/13	09/13	01/14	04/14	Cur.	Comments
Shareholder Relationship						<ul style="list-style-type: none"> 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						<ul style="list-style-type: none"> Generally strong and improving application of a shareholder model, with appropriate monitoring structures in place – this includes frequent dialogue with management. However, policy and shareholder roles are combined. Management remuneration for 2013/14 was finalised towards the end of the financial year and similar questions are likely from HMT in 2014/15 (agreement with BIS SoS has been reached).
Quality of Management Team & Board						<ul style="list-style-type: none"> We have fundamental questions in respect of POL's management team and their ability to deliver the new strategic plan. The Board are dealing with this, and have prioritised some recruitment activities - they are also keeping a watching brief around other members of the senior team. Recent arrivals seem to be settling in well, although it is unlikely that a solution can be found to all questions in the short term.
Strategy						<ul style="list-style-type: none"> ShEx is monitoring the business closely across a broad range of areas (broader than in early 2013/14), and is also working to ensure POL has best chance of delivering its strategy successfully. Questions are starting to emerge around POL's commitment to delivering the detail of its recently agreed strategy and this is being monitored VERY closely by ShEx.
Financial Performance						<ul style="list-style-type: none"> POL's financial performance is monitored closely by ShEx on a monthly basis, and sessions are held with divisional management (both revenue and cost) to understand current trading and near term outlook in more detail. ShEx does have questions in respect of how challenging POL's targets really are / the level of discretion exercised by management (e.g. ability to meet targets despite wide-ranging weaknesses), but in-year targets for 2014/15 are challenging.
Balance Sheet & Risk						<ul style="list-style-type: none"> POL has a business plan in place, and it is funded to deliver this strategy. 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).

OFFICIAL – POLICY & COMMERCIAL

Annex – Top Priorities for 2014/15

Priority	Commentary
Transformation	<p><i>Network Transformation</i></p> <ul style="list-style-type: none">▪ 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
	<p><i>Crown Transformation</i></p> <ul style="list-style-type: none">▪ 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)
	<p><i>State Aid</i></p> <ul style="list-style-type: none">▪ 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	<p><i>Spring Announcement on Progress</i></p> <ul style="list-style-type: none">▪ 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)
Policy and Stakeholder Issues	<p><i>Other Workstreams</i></p> <ul style="list-style-type: none">▪ 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▪ 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