



Post Office Limited (“POL”)

Quarterly Review

October 2015

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1 Quarterly Update – Updates Since May Quarterly Review

Current Trading to P5

- **Trading conditions in POL's markets have remained challenging in 2015/16 and year-to-date revenue is behind target by c.£6m and operating profit is behind by c.£2m. Both revenue and operating profit are however stronger compared to 2014/15**
 - Management are committed to 2015/16 targets, although this is starting to look increasingly ambitious. There are no obvious triggers for an improvement in revenue performance, and costs are benefiting from a number of one-off and timing benefits
- **Management are due to complete a full reforecast before the end of the year which could see a move away from budget**
 - While growth on prior year creates a positive external narrative, underperforming budget does raise some concerns (e.g. growth is critical for POL to reduce its future reliance on subsidy, as costs cannot be cut forever and the business cannot keep transforming)
 - From a funding perspective the priority for POL is however to maintain a strong cash position. Given delays / discretion regarding investment activities there is considered to be a low risk of this, even if earnings underperform

Strategy Assurance

- **ShEx has commissioned KPMG to prepare an assurance report on POL's refreshed 3-year strategy, as a follow-up to the work undertaken by the same team in 2013 on POL's original plan. This plan formed the basis for the current 3-year funding deal**
 - KPMG's work is expected to be completed in the coming weeks and while we do not believe it will raise any material concerns it has taken longer than expected. This is partly due to unfocused engagement from POL and partly due to information not being available
 - The final report is likely to highlight a number of areas of risk in the plan, including in relation to revenue growth, key relationships, structural change that is underway in selected areas of the business and in relation to planned transformation initiatives
- **We expect to sit down with POL once this report has been finalised. This will allow us to highlight areas in which POL can improve its planning processes and, potentially, make future assurance undertaken by ShEx (e.g. in 2016) more streamlined**

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1 Quarterly Update – Updates Since May Quarterly Review (cont'd)

Future Funding and the Spending Review

- **Paula Vennells recently wrote to Mark Russell to flag risks to POL post-2018 when funding for the post office network has not yet been secured (i.e. POL's existing funding agreement expires in March 2018)**
 - BIS's Spending Review bid is aligned to the indicative funding set out by POL in 2013 (i.e. £60m in 2018/19 and £50m in each year thereafter). While this should be sufficient, there are significant risks linked to uncertainties in POL's future trading performance
 - It will be critical that any settlement letter between BIS and HM Treasury includes reference to the fact that POL funding after March 2018 is uncertain and that this might need to be revisited in 2016. Critically this approach has the support of Ministers and the SoS

Project Sparrow

- [•]
 - [•]

Industrial Relations

- **Over the coming months POL will be engaging with the CWU and CMA on 5 areas of proposed change to employment terms, staffing and pay. Discussions have commenced in respect of 2 of these matters**
 - Based on prior experience, one or more of these could trigger a hostile response from the unions. Combined with the current backdrop of the Trade Union Bill there is therefore a very high chance that the unions will mobilise support against POL's proposals
 - After a period of relative quiet in its relationships with the unions, and despite improvements in the way the two sides interact, this is likely to lead to a heightened risk of industrial action between now and early-2016
 - POL has a good track record of managing industrial action, and has demonstrated over the past couple of years that it can keep branches open and stocked with cash. Longer and / or coordinated action is however likely to be harder to manage

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1 Quarterly Update – Updates Since May Quarterly Review (cont'd)

Network Transformation

- **POL is tracking 10 per cent. behind targets YTD and so far 621 new branches have been opened against a planned total of 690 for the first 5 months of 2015/16. This is not presently a concern, as POL is taking action and as full year performance is often H2 weighted**
 - In 2015/16 POL is taking a slightly altered approach to unengaged branches, to encourage them to volunteer to convert under Network Transformation. The success of this will be a key factor behind whether full year targets can be met
 - This work is ongoing and we are engaging closely with POL. However it is too early to tell whether POL's plans will have the expected impact on contract signatures or branch conversions

Network Consultation

- **The ShEx team is currently working on the early stages of a network consultation, aimed at soliciting people's views on the post office network as a whole and the services made available across it. We are planning to launch this before Christmas Recess**
 - The consultation updates a previous version completed in 2007. It is expected this will form an important evidence base for policy development in early 2016, as well as being critical for any future State aid notification
 - POL is engaged, which is reassuring. An early conclusion – noting the ambitious timeline – will be useful for POL to support strategy work in early 2016 (i.e. to support their funding bid due later in the year)

Post Office Policy Development

- **The new Government's stated policy for Post Office is currently limited to their manifesto commitment to "secure the future of 3,000 rural post offices". This is not restrictive, as today there are c.6,000 rural branches in the network**
 - While detailed areas of policy still need to be developed and agreed, the present direction of travel is based on discussions with Ministers and existing parameters inherited from the previous Government (e.g. modernisation, reducing reliance on subsidy, etc.)
 - We expect to use the YouGov / London Economics study and the Network Consultation to inform work in early 2016 around a refreshed policy. This has been raised with Ministers and they broadly agree with ShEx's proposed approach

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1 Quarterly Update – Actions Highlighted in May

TITLE	OVERVIEW	ACTIONS TAKEN
Funding Options	<i>Team to look at menu of options for POL funding in the event pressures emerge, and the impact of these (i.e. both costs and benefits of change).</i>	<ul style="list-style-type: none"> ▪ ShEx is working with POL to develop of a variety of funding scenarios, in preparation for any push back from within BIS or HM Treasury linked to the Spending Review ▪ Near-term funding should be secure, as there is a legally binding contract between BIS and POL. However ShEx is taking a cautious approach to this ▪ Scenarios look at both near-term and medium-term funding. It will be important to understand what any cuts might mean for the network, recent spending and any other POL / HMG commitments
IT Assurance	<i>The team to consider Women on Board NEDs re. a digital assurance role with POL, regarding its IT transformation.</i>	<ul style="list-style-type: none"> ▪ Given changes to POL's Board (e.g. a new Chair and ongoing recruitment for 2 NEDs) we have not actively sought to bring in a dedicated IT assurance capability ▪ Once the new Chair has settled and new NEDs have been appointed we will revisit, with POL, to make sure POL / the Board is properly resourced and supported ▪ POL's IT transformation has already seen delays / risks crystallise. Appropriate oversight and effective delivery is therefore critical to POL's strategy and to avoid the risk of future Sparrow-like challenges
Government Relations	<i>The team to explore routes to strengthen POL's relationship management with Government (i.e. Government both as shareholder and client).</i>	<ul style="list-style-type: none"> ▪ While limited progress has been made in this area in recent months, POL has now appointed a new Head of Government Services who joins the business shortly ▪ We will engage once he has settled to understand his strategy and also in relation to how he sees ShEx supporting POL. POL's new Chair also has ambitions in this area which we will look to explore ▪ If required we will then take action to support POL in developing a stronger dialogue with Government. It is however hoped that this will not be required

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2 Update on ShEx Team's Priorities for 2015/16

Priority	Commentary
Transformation	Network Transformation
	<ul style="list-style-type: none"> POL is currently behind target for the year, which is being monitored closely. The main risk to full-year outturn will be the impact of POL's work on the unengaged branches and whether the Network Transformation team's proposed strategy delivers expected results
	Crown Transformation
	<ul style="list-style-type: none"> POL is making progress with business-as-usual transformation which is planned to deliver a range of benefits across the owned estate (e.g. franchising, hosting, retail efficiency, automation, etc.), helping POL to reach breakeven in the near-term
Commercial Strategy	Business Transformation
	<ul style="list-style-type: none"> While POL is delivering results in the form of reduced costs, performance is currently mixed. Good progress is being made in some areas (e.g. redundancies) but it has been slow or delayed in others (e.g. Supply Chain transformation)
	<ul style="list-style-type: none"> The ShEx team's primary focus at the moment is in relation to POL's IT transformation. This is moving into implementation shortly and a good pace of progress will be critical to establish the foundation other areas of the business need to deliver their long term strategies
	Strategic Planning
Mutualisation	<ul style="list-style-type: none"> KPMG's assurance work on POL's 3-year strategy "refresh" is nearing completion; we do not expect this to raise any significant concerns with the substance of POL's forecasts but we do expect the team to highlight areas of improvement / lessons to be learned
	Network Strategy
	<ul style="list-style-type: none"> We are engaging well with POL in relation to a refreshed network strategy; we expect to have greater visibility over this in early 2016 once both the YouGov / London Economics work and the upcoming Network Consultation have both been completed
	Pre-Election Update on Progress
Policy and Stakeholder Issues	<ul style="list-style-type: none"> There is uncertainty regarding Ministers appetite to press forward with mutualisation options for POL. This is likely to be raised with the Minister among similar issues after Party Conferences. It might also form part of the upcoming network consultation
	Project Sparrow: [•]
	Stakeholder Relations: POL's relationship with the unions and Citizen's Advice continue to present challenges, although progress has been made recently in other areas (e.g. with the NFSP and the Plunkett Foundation)
	Other Ad-Hoc Activities: No material issues at present

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3 2015/16 First 5 Months' Performance – Revenue

After the first 5 months of 2015/16 POL is trading in line with prior year but is behind budget...

...while Mails & Retail and Government Services performance are both holding up – which is reassuring after recent years' performance – revenue in Financial Services (in particular) and Telephony is a concern...

...Financial Services is ahead of prior year but as it is a key growth driver in POL's strategy expectations were for more significant expansion. This will be a focus of the ShEx team in the second half of the year.

5 Months to August 2015 - £m	Actual	Budget	% vs.	Prior Year	% vs.
Mails & Retail	151.4	149.6	1.2%	153.6	(1.4%)
Financial Services	126.2	130.7	(3.4%)	121.1	4.1%
Government Services	44.6	43.0	3.7%	45.7	(2.3%)
Telephony	20.6	23.5	(12.4%)	20.8	(1.3%)
Other	13.8	15.6	(11.9%)	15.2	(9.3%)
POL Net Income	356.5	362.4	(1.6%)	356.4	0.0%

Mails & Retail

- Currently trading ahead of budget but modestly behind prior year
 - Performance versus budget favourable across most product areas, with particular strength in Special Delivery, RM Signed For and Home Shopping Returns. Other Mails income is under budget due to unspecified new products not emerging
 - Versus prior year, after adjusting for the contractual reduction in the RM Fixed Payment (£2.7m lower YTD), revenue is up on 2014/15. Mostly driven by performance in Special Delivery, Labels, Home Shopping Returns and Mails Other

Financial Services

- YTD trading in most areas has been broadly in line with budget although Insurance and Foreign Exchange have both traded behind materially behind expectations. Year-on-year comparables look generally strong
 - Insurance has been impacted by weak travel volumes and delays to Project Hawk (i.e. acquisition of Bol's share in POL's General Insurance business), while lower Foreign Exchange is mostly due to customers buying forward and competition

Government Services

- Favourable performance due to stronger than expected performance in ID Assurance, Rod Licenses and other ID Services. All other areas are broadly trading in line with budget
 - Recent developments with HMRC in ID Assurance likely to impact H2 performance significantly, potentially reversing much of the strong performance seen YTD
- Compared to prior year Motoring Services and POca are both behind, as expected. However Passports, AEI, ID Assurance and Other Government Services are all performing well

Telephony and Other

- Weak performance in Telephony, mainly driven by lower subscriber numbers and ARPUs, and Supply Chain where expected external growth has not materialised

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3 2015/16 First 5 Months' Performance – Income Statement

While revenue performance YTD has fallen short of expectations, favourable overall cost performance has meant operating profit is only £2m behind YTD...

...however up to £[●]m of cost outperformance is due to one-off benefits and timing effects which are expected to unwind as the year progresses...

...notwithstanding this, on a year-on-year basis POL is still making good progress. Operating profit is >£18m ahead before accounting for reduced subsidy...

...there are still concerns across the P&L though. These will be monitored closely as the year progresses.

5 Months to August 2015 - £m	Actual	Budget	% vs.	Prior Year	% vs.
POL Net Income	356.5	362.4	(1.6%)	356.4	0.0%
Staff Costs	(98.7)	(96.8)	2.0%	(106.2)	(7.0%)
Agents Costs	(175.7)	(180.2)	(2.5%)	(189.3)	(7.2%)
Non-Staff Costs	(119.7)	(121.6)	(1.5%)	(111.8)	7.1%
Project Operating Costs	(6.8)	(6.9)	(2.4%)	(11.9)	(42.9%)
POL EBITDAS	(44.5)	(43.1)	3.1%	(62.8)	(29.2%)
Financial Services JVs	20.1	20.9	(3.6%)	19.8	1.7%
Total EBITDAS	(24.3)	(22.2)	9.4%	(43.0)	(43.4%)
Depreciation	(0.2)	(0.3)	(28.8%)	(0.2)	(3.5%)
Network Subsidy Payment	55.0	55.0	0.0%	67.7	(18.7%)
Group Operating Profit	30.5	32.5	(6.2%)	24.5	24.3%
<i>Memo: Net Income (incl. NSP)</i>	411.5	417.4	(1.4%)	424.1	(3.0%)

■ Although revenue is £5.9m behind target operating profit is only £2.0m short YTD. Mostly due to strong cost performance in Agents Costs and Non-Staff Costs, partially offset by higher than expected Staff Costs

- Agents Costs are £4.5m favourable due to the impact of lower income and 2014/15 progress under Network Transformation. Phasing of some payments is also not in line with budget, and is expected to unwind during the second half of the year
- Non-Staff Costs are £1.8m favourable due to a one-off £3.7m compensation payment received from Fujitsu, lower vehicles costs and a phasing benefit of marketing spend (which will unwind).
 - Partially offset by unhedged Foreign Exchange losses, higher card transaction costs, higher than expected property costs and unbudgeted RM Segregation Penalty
- Staff Costs are £2m ahead of expectations mostly due to a pension rate adjustment (although notably it is also £7.5m ahead of prior year due to the savings activities undertaken in 2014/15 and so far this year)

■ Although operating profit is behind expectations it is £6m ahead of prior year and, adjusting for the reduction in subsidy between 2014/15 and 2015/16, it is >£18m ahead. This is reassuring progress

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4 Board and Management Update

Quality of management team is **RED** in POL's traffic light assessment

1. Questions remain regarding the CEO's ability to manage the business and deliver POL's strategy. Early views of POL's new Chair will be of interest
2. Recruitment processes are ongoing for two key Board roles. It is critical that these are concluded soon
3. The senior team will continue to be tested as key strategies move into more challenging areas of implementation later in the year. This should expose any shortfalls in capability

POL Board

- In October 2015 Tim Parker joined POL as its new Chair
 - Although Tim has only been with the business a few days he has made an immediate impact. He met staff at POL's Finsbury Street offices in an all-staff event and has spoken at length with each member of POL's Executive Committee
 - Compared to his predecessor, and given his background, we expect Tim to take a far more commercial approach to POL. This is what the business needs, and we (tentatively) expect him to have the support of Ministers in this
 - In the coming weeks ShEx will engage with Tim, both to understand his early thoughts about the business, its resources, strategy and how it functions but also to agree a new Chairman's Letter
 - At the Minister's request Tim will also take a fresh look at Project Sparrow. Certain stakeholders in this process will be interested in his views, and this might trigger renewed external / internal interest in the process later in the year
- After reaching the end of his term and deciding that he did not want to renew, POL's Senior Independent Director Neil McCausland has now left the business
 - A process to identify a replacement got underway earlier in the Summer and Tim Parker has been involved throughout. We expect a replacement to be appointed in November
- Earlier in 2015 Alasdair Marnoch also informed POL that he would be stepping down from his role as NED and ARC Chair, to allow him to focus on his role as CFO of CPA Global
 - A recruitment process for a new NED and ARC Chair is also underway. As with the process to recruit a Senior Independent Director, Tim Parker is involved in this and we also expect an appointment to be made in November
- ShEx has faced challenges in respect of both of these NED recruitment processes. While the principle that replacements are required has not been questioned, broader internal interest and changes to the design of the process has caused difficulties

POL Senior Management

- POL has recently appointed a new Head of Government Services, who arrives late-Summer. ShEx will look to meet him once he has settled into the business to understand his background and strategy for growing POL's Government Services franchise
 - After a period of softening focus this new appointment marks a renewed interest for POL to work with Government. It is currently unclear what it might mean on the ground, nor where there might be opportunities to unlock revenues
- ShEx's concerns regarding the imminent departure of POL's Head of Corporate Finance remain, and in the coming months we will continue to challenge the business to make sure corporate memory in key areas is protected

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5 Objectives for the Next Period

Objective	Commentary
Progress on Network Transformation	<ul style="list-style-type: none"> Support POL, including with Ministers and other stakeholders, in making progress towards completing Network Transformation, in particular in respect of the Transitional Locals process and the branches that have so far not engaged with the strategy
Network Consultation and Policy Development	<ul style="list-style-type: none"> Complete the YouGov / London Economics work on the social value of the post office network, and take forward the Network Consultation to help establish a solid evidence base for a refreshed network policy. Start developing this with Ministers
Commercial	<ul style="list-style-type: none"> Work alongside POL to encourage progress in respect of its ongoing Supply Chain review and work to strengthen / realign the Bol and RM relationships. Engage with POL's new Head of Government Services when he arrives
Project Sparrow	<ul style="list-style-type: none"> Work with POL and Ministers to make sure the process continues to be handled appropriately (e.g. MP and stakeholder interest, Criminal Cases Review Commission interest, etc.). Also continue to make sure communications risks are handled appropriately
Board	<ul style="list-style-type: none"> Finalise recruitment of a new SID and NED / ARC Chair, making sure that the POL Board remains fully and appropriately resourced Agree a new Chairman's letter with Tim Parker, and also engage with him once he has settled into his role regarding his early views on POL, its Board and governance, etc.

Note: For more information on the above please see Section 1 and Section 2 of this Quarterly Review

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6 Traffic Light Analysis

	04/14	06/14	01/15	05/15	Cur.	Comments
Shareholder Relationship						<ul style="list-style-type: none"> POL's new Chair has made a good first impression in the business and albeit early he seems to be responsive to shareholder concerns. There is also 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.
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. However there is no Chairman's letter in place (due to the timing of his recent arrival) or clear Government policy (which we plan to work with Ministers to develop in early 2016).
Quality of Management Team & Board						<ul style="list-style-type: none"> ShEx has questions in respect of POL's management team and whether they are right / capable of delivering the strategic plan. The Board are dealing with this, although they have prioritised some recruitment activities over others. 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). There are also two vacant positions on the POL Board, although we expect these to be filled in the coming weeks.
Strategy						<ul style="list-style-type: none"> POL's approach to its strategy is aligned to HMG's known objectives although given recent trading / market developments, and the refreshed strategy is certainly more credible than the one done in 2013.
Financial Performance						<ul style="list-style-type: none"> As expected 2015/16 has been a challenging year so far although POL has still made considerable progress on prior year. POL's financial performance is monitored closely by ShEx on a monthly basis, however we do have questions in relation to how performance is reported and, linked to this, the transparency of underlying trading (although this appears to be improving under the new CFO).
Balance Sheet & Risk						<ul style="list-style-type: none"> 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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A ShEx Team's Priorities for 2015/16

Priority	Commentary
Transformation	<p>Network Transformation</p> <ul style="list-style-type: none"> Continue to monitor and help POL manage local / stakeholder concerns. This includes ensuring that credible targets are set (and met), that implementation is done properly and that POL progresses the “Transitional Leavers” cohort and work on the “Cliff” <p>Crown Transformation</p> <ul style="list-style-type: none"> Continue to monitor the programme, with a close focus on areas of high risk (e.g. voluntary redundancy, franchising, relationships with CWU and Unite), and also on assessing benefits accruing – in the form of reduced losses – from the actions being taken <p>Business Transformation</p> <ul style="list-style-type: none"> Work closely with POL to ensure appropriate plans are developed, that these have necessary support, and that execution can start. Also make sure that robust monitoring / evaluation regimes are developed and in place
Commercial Strategy	<p>Strategic Planning</p> <ul style="list-style-type: none"> Make sure POL finalises a refreshed commercial strategy that includes a credible budget for 2015/16, a long term plan for 2016/17 and 2017/18 and a clear vision on Royal Mail / Bol contracts. It will be important to ensure that this is monitorable <p>Network Strategy</p> <ul style="list-style-type: none"> Make sure POL develops a new Network strategy to support its Business Transformation and Strategic Planning work, in respect of: (i) network growth; (ii) new technology; (iii) the future of the Crowns; and (iv) key clients relationships
Mutualisation	<p>Pre-Election Update on Progress</p> <ul style="list-style-type: none"> Make sure Ministerial expectations are managed in the run-up to the election – including encouraging POL to make further progress (e.g. developing a mutual culture, embedding POL's purpose) and that a clear narrative is crafted to express progress made in this Parliament
Policy and Stakeholder Issues	<ul style="list-style-type: none"> Project Sparrow: Following developments in December continue to work with POL to make progress in relation to Project Sparrow, including managing comms / reputational risk and Ministerial interest and concerns Stakeholder Relations: Support POL in taking forward work with the NFSP and CWU / Unite to set out a foundation for a long term future with all 3 organisations (e.g. future funding and role of the NFSP, ways-of-working and structure of representation with CWU / Unite) Other Ad-Hoc Activities: Work with POL to anticipate, manage and address any other <i>ad-hoc</i> issues as and when they arise (e.g. like with VOA, POCA, NS&I and other Government Services activities in 2013/14)