

RESTRICTED – POLICY AND COMMERCIAL

BACKGROUND NOTE FOR SIMON FRASER ON THE POST OFFICE AND THE NETWORK CHANGE PROGRAMME

1. What is the Post Office?

Introduction: 'The Post Office' is used interchangeably to describe the company, Post Office Limited, and the network of 12,000 individual Post Offices.

Post Office Ltd (POL), a wholly-owned subsidiary of Royal Mail Group, itself owned by Royal Mail Holdings of which the Secretary of State for BERR is the shareholder. The SoS has the power to appoint the Chairman of POL (currently Donald Brydon on an interim basis) and approves the appointment of its Managing Director (Alan Cook). POL employs around 9,000 people.

Post Office Limited v the Post Office network: Around 97% of Post Offices are not actually owned by POL. They are private businesses which operate under licence from POL, selling Post Office products from their own premises. Often, these Post Offices – known as SubPostOffices and run by SubPostmasters – are run alongside another retail business (usually a convenience store or in some cases a chain store such as a Co-Op). SubPostmasters are not employees of POL, but they are paid a contribution (both a fixed contribution and a variable element dependent on sale volumes) as POL's agents.

Size and Reach: The Post Office is by some way the largest retail network in the country, with more branches than all the banks and building societies combined, and over five times as many branches as Tesco. 99.7% of the population live within 3 miles of their nearest Post Office branch. The spread of Post Offices is underpinned by Government-set Access Criteria, which at a national level require POL to ensure that there are Post Offices within certain maximum distances for the population as a whole – for example, these require that 90% of the population should live within 1 mile of their nearest branch or that 95% of the rural population should live within 3 miles of their nearest branch.

Other Types of Outlet: POL itself directly runs and staffs 373 offices. These are known as Crown Offices and are usually the "flagship" branches, located in city centres and with higher customer numbers. POL has also been developing more flexible service models – known as Outreach and Post Office Essentials. Both of these involve more innovative ways of providing a Post Office outlet – in the case of Outreach by e.g. providing the service through a mobile van coming to a village, say, two mornings a week; in the case of the Post Office Essentials by giving a retailer a lottery-style terminal providing a slightly lower number of services but at a much reduced cost to POL.

RESTRICTED – POLICY AND COMMERCIALBreakdown of Post Offices by type

Crowns	373
Outreach	799
SubPostOffice	10,754
Sub-total	<u>11,926</u>
Locally-funded (offices paid for by Local Auths)	4
Post Office essentials pilot	22

Make-Up of the Network: The size of the Post Office network had declined steadily from a peak of around 25,000 in the 1960s, to around 14,000 by the end of 2006. Except for two Government-backed programmes (Urban Reinvention in 2003-04 and Network Change 2007-08), all these closures were unplanned with individual SubPostmasters deciding not to continue their business and being unable to sell on as a going concern. Of the current network of around 12,000 offices, it is estimated that only 3,000 – 4,000 are “commercial”. That is, these are the ones that provide a net income to POL (Post Offices can be profitable for individual SubPostmasters to run, but can still make a loss for POL). The income from these branches is used to help offset the cost of maintaining the other branches.

2. What does it do?

Introduction: The Post Office provides services in four main areas: Mails, Financial Services, Government Services, and Telephony. In total, POL provides over 170 services across these four “pillars”.

Mail Services: This is the service people most often associate with Post Offices – buying stamps, special delivery, collection services. POL is paid for operating this service via an Inter-Business Agreement with Royal Mail Group Ltd (i.e. the letters business). This contract currently accounts for a little under 30% of POL revenue.

Government Services: This was formerly a much more significant source of income for POL. Until recently, it was possible to purchase a TV licence at the Post Office and, for those who didn't want pensions/benefits paid into bank accounts, the Post Office was the only place to collect payments via an order book. Two factors have led to a significant reduction in POL's Government Services business:

- i) The Internet - with Government preferring cheaper forms of e-payment and customers preferring the convenience of accessing services online. DWP removed the order book system for pensions and benefits between 2003 - 2005. For those who did not have bank accounts or did not want pensions/benefits paid into them, a very simple account – the Post Office Card Account (or POCA) – was created. This now forms the main Government Service available at

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Post Offices. But 9 out of 10 new pensioners choose to have their pension paid directly to their bank account

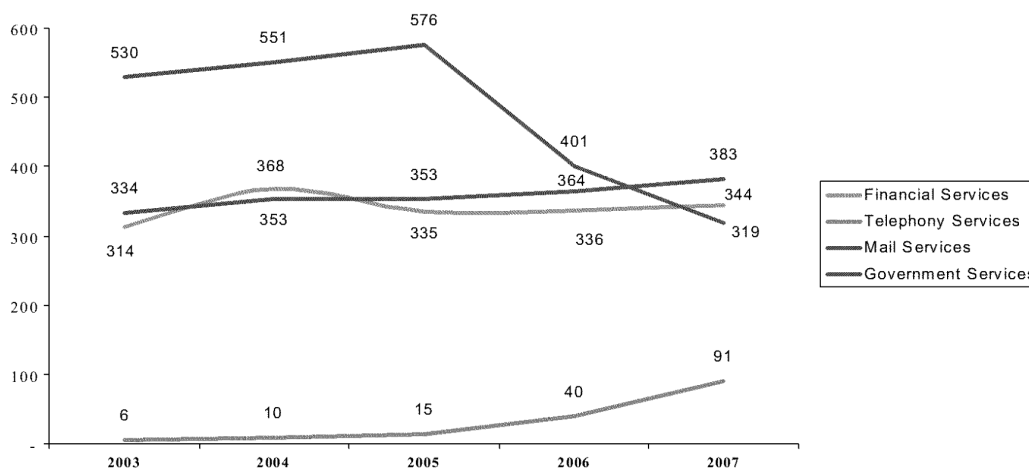
- ii) Competition - with the growth of a small number of competitors to POL. POL lost the contract for TV licences provision to Paypoint.

POL however still provides a broad range of Government services which still account for just under 30% of POL revenue: Car Tax payment, Passport “Check and Send” services, and a range of other services. Peter Mandelson is also leading work across Whitehall to increase the number of Government services provided through the network.

Financial Services: As POL is balance sheet insolvent, it could not obtain a banking licence in its own right. Accordingly, in 2004 it set up a joint venture with the Bank of Ireland, known as Post Office Financial Services (POFS). Through this joint venture, it offers a wide range of financial services – including savings products, insurance, and credit cards. It plans to launch a current account next year and it is also the UK’s largest provider of foreign exchange. POL also sells National Savings and Investment products through its network. Again this revenue stream accounts for around 30% of POL revenue.

Telephony Services: POL has created a telephony arm, providing broadband and telephone services. As this is a very competitive market, this revenue stream has not grown significantly for POL and is currently around 10% of revenue.

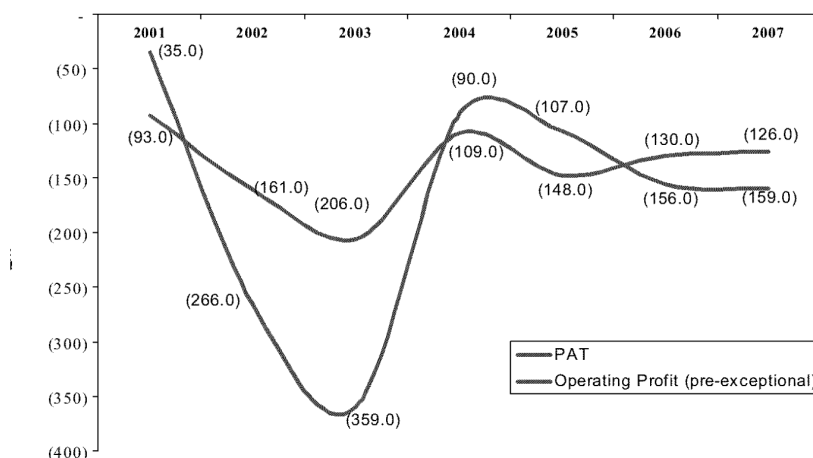
Recent Trends: Many of the services above are available across a range of channels (from physical branches to internet and phone). The volume of business handled by the Post Office has therefore been declining, as lifestyle habits mean that more people choose to, for example, pay their car tax online rather than go to a branch. The spread of income across the four pillars has also shifted recently, as Government services have declined significantly:



3. How is it funded?

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Introduction: The decline in business and the need to sustain a network of mainly unprofitable branches means that POL has been operating at a loss since 2000. In 2007/2008, it made an operating loss of £220m (over £4m a week).

POL losses since 2001:

Government Role pre-2007: Government first provided significant subsidy funding to POL in 2001 to cover losses that had been incurred and to assist in cost saving programmes. In all, around £2bn was provided between 2001 and 2006. For example, Government funding supported a previous (voluntary) closure programme aimed at addressing substantial overprovision in urban areas, known as the Urban Reinvention Programme, between 2003 and 2005. Government also provided a £150m a year subsidy to allow POL to write-off losses relating to the provision of branches in rural areas. All these payments were intended to be temporary measures to enable the network to turn itself around.

Government role from May 2007: In May 2007, Government entered a Funding Agreement with POL covering the period up to 2011. This provided up to £1.7bn of funding, including £150m a year to offset the cost of providing services across the Post Office network (effectively subsidising the uneconomic parts of the network). This funding package was intended to be sufficient to sustain a network of around 11,500 – 12,000 branches. As part of this funding package, Government supported plans for a closure programme involving the compulsory closure of up to a maximum of 2,500 Post Offices partially offset by the creation of at least 500 new Outreach services – the Network Change Programme.

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Breakdown of 1.7bn funding:

- £176 million cost of the Network Change Programme, mainly in compensation for SubPostmasters.
- £750 million network subsidy payment, comprising £150 million per year over five years.
- £620 million to cover past losses.
- £150 million of other costs (including central efficiencies/IT costs not linked to Network Change Programme)

4. The Network Change Programme (NCP)

Background to the NCP: Despite the measures taken since 2000, by 2005 it was clear that the Post Office network was still not sustainable and Post Office Limited could not continue to trade as a going concern without further Government funding. This was partly the result of decline in business (there are, for example, five million fewer users of the network a week now than in 2003). A large number of the remaining branches were unprofitable to POL and there was substantial overprovision in some areas. For example, some 800 of the least-used rural branches received fewer than 16 customers per week. Each transaction at those branches cost POL £17. Consequently, POL estimated that if the network was run as a purely commercial operation, there would be only around 3,500 Post Offices in the network.

Decision to Close 2,500 Offices (December 2006): Even accepting that Government would continue to subsidise the network, and that POL would have to increase revenues and cut central costs, it was clear that a network of around 14,000 offices (as the total stood in 2006) was unsustainable. As part of the £1.7bn funding package agreed, Ministers agreed to the compensated closures of a maximum 2,500 branches, offset by the creation of 500 new Outreach services. The funding package was therefore intended to support a network of around 11,500 – 12,000 branches going forward. As 97% of the network is made up of private businesses, neither BERR nor POL can guarantee a specific network size. This programme, the Network Change Programme, was intended to cost around £176m (mostly through compensation to SubPostmasters) and was intended to produce benefits of £45m a year from the end of the Programme.

Access Criteria: As part of the funding agreement, Government put in place a framework of minimum access criteria, which at a national level require POL to ensure that there are Post Offices within certain maximum distances for the population as a whole. These criteria have specific protections in them for vulnerable consumers in urban, rural and remote areas. The Post Office are legally obliged to ensure the criteria are met (and are monitored in this by Postwatch).

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National Consultation (December 2006 – March 2007): The decision was therefore taken to reshape the network proactively to a more sustainable size. In terms of the consultation, the exact number of closures (up to 2,500) was not up for discussion, because this was dictated by commercial/financial considerations. But the way that the closure programme would be operationalised including the rationalisation of the network and the establishment of access criteria was put to a full twelve week public consultation. As a result of this consultation, some changes were made to the operation of the programme – in particular tweaks were made to the Access Criteria provision on proximity of Post Offices in Urban Deprived areas. In addition, the Government's response to the consultation in May 2007 set out certain provisions that had to be taken into account when deciding on branch closures – for example that no part of the UK could be more adversely affected than any other, and that accessibility for the disabled had to be taken into account. Following the consultation, BERR signed the funding agreement with POL, imposing legally-binding obligations on the company.

How the Programme Worked (May 2007 – October 2007): POL put together 42 Local Area Plans covering the UK. These 42 Local Area Plans were shared with Postwatch, then the consumer watchdog for postal consumers, who agreed a Memorandum of Understanding with POL setting out their respective roles in the programme. Through joint-working, around 10% of the proposed closures were changed prior to consultation. The Area Plans were then to be put out to six-week local consultations, with the final decisions taken one month after the end of the consultation. SubPostmasters of branches that were to be closed were offered either 28 months compensation if they closed 1 month after the decision was announced, or 26 months compensation if they closed after three months. Postwatch could challenge individual decisions through a Review process set out in the MoU. This process had four stages, culminating in final a decision by the Chairman of Royal Mail. Over the course of the NCP, only three cases made it to this final, fourth stage. The rest were resolved prior to this.

The programme in Operation (October 2007 – November 2008): The public response to the Network Closure Programme was unprecedented. POL received over 190,000 responses to the local consultations. There were also 31 parliamentary debates, 51 Early Day Motions, well over 200 Oral and written PQs, and five BERR select committee reports (as well as an NAO report). Despite this, all of the consultations and decision documents were published to schedule. The programme was due to be completed by November 2008. However, because specific cases were under review and challenged by Postwatch, and alternative proposals were being put to a further six week consultation, there was a small tail of closures which are still to be completed. This is also partly due to the fact that in places where Outreaches are due to be placed, POL has committed to keep open the branch that is proposed for closure until the Outreach service is in place.

End of the Programme: At the end of the Programme, the NCP will have resulted in 2431 compensated closures and 506 new Outreach services. It will

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have come in £16m under budget, largely through having paid out less in compensation than was originally forecast.

5. National Audit Office Report:

Background: The NAO Report was requested by the Chairman of the Public Accounts Committee in March last year, when the programme was in full swing. The NAO have been working on the report since early Summer 08. The specific question that the NAO were asked to consider was whether BERR had complied with the undertakings that it had given on the outcomes for the Network Change Programme.

Summary: The report is in four sections:

- background to the closure programme;
- how the decision was taken and how the expected outcomes were calculated;
- how the programme was implemented in practice, in particular with respect to the undertakings;
- how the programme fared overall and what the impact of it has been.

The overall conclusion of the report is that “*overall [...] the network change programme has largely met its targets and complied with the undertakings given by BERR.*” Nevertheless, there are a few areas where concerns have been raised – mainly on communications during the programme. Additionally, there may be questions about how BERR assessed the “social” benefits of the network.

6. Other issues:

Hooper: The Post Office network was not included in the Hooper Report because POL and Royal Mail Group are distinct organisations providing different services to the public. The Report was specifically about how to safeguard the universal postal service, and although Post Offices play a role in this, mails are only one element of the services that Post Offices provide. In addition, POL does not exist purely for commercial reasons, so POL will remain entirely in Government ownership. This will require some reorganisation of the Group structure. In addition to guaranteeing POL’s public ownership, the Postal Services Bill currently going through Parliament will increase transparency of POL by requiring publication of annual accounts and an annual network report.

Risks: Although POL is not the primary focus of the Bill, the timing of the PAC hearing is tricky as there is often conflation between Royal Mail and Post Office in media reports. Similarly, a hearing on Post Office closures during the passage of the Bill through Parliament brings the Post Office back into focus.