



Post Office Limited (“POL”)

Quarterly Review

January 2015

OFFICIAL – POLICY & COMMERCIAL

Quarterly Update – Activities Since October Quarterly

Recent Team Successes

- **In recent months considerable progress has been made by POL / the ShEx POL team in four critical (and previously high-risk) areas**
 - **POCA:** In December a 7-year extension to POL's POCA contract was announced by Steve Webb the Minister for Pensions. While the terms of this agreement might not reflect the outcome POL was targeting it is a significant and welcomed achievement
 - **VOA:** The VOA recently confirmed that it would not be rating POL ATMs separate from subpostmasters' premises, ending an 18m process that could have exposed POL to significant increases in costs. This is a very good outcome
 - **Management:** In early January Alasdair Cameron arrived at POL from Centrica to replace Chris Day as CFO. We accept it will take time for him to settle into this new role however we do expect him to start having a positive influence in the very near term
 - **CWU:** Supply Chain and Admin. strikes scheduled over the Christmas period were called off at the last minute, reflecting the progress that POL has made with the CWU in recent weeks. A resolution is still likely to take time but this is real and important progress

Year to Date Trading 2014/15

- **YTD performance continues to fall short of budget and is starting to make POL's (recent) reforecast look ambitious. Notwithstanding this weakness trading in the first 8 months of the year does compare acceptably to the same period last year**
 - Revenue underperformance to budget has continued to widen since the last quarterly review, and although the shortfall in operating profit has also grown it has increased by a smaller amount
- **Management have been taking actions although it is too early to judge whether these will deliver a tangible impact in-year. Not only does this make current year targets look risky, but the trends now established are increasingly a cause for concern for the future**
 - We expect to see significant progress being made by POL in the coming months to strengthen the medium term outlook (e.g. in relation to its mails work with Royal Mail, its target operating model work). These are – quite rightly – priority areas for POL

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

Network Transformation

- **Progress is on track and at end-December POL had delivered [•] openings and [•] signatures in-year taking cumulative totals to [•] and [•] respectively (against a full year budget of [•] and [•])**
 - ShEx and POL are both confident that 2014/15 targets should be met although we do accept that there are risks. In particular it will be key for POL to maintain positive engagement with the NFSP in relation to Network Development and the “Cliff”
- **POL has expanded the “Guided Leavers” process and early indications suggest it is going well; however while this is reassuring (i.e. it was expected to be a high-risk area of Network Transformation) it is still immature. We are maintaining a close watching brief**
- **Dialogue has also recently started between POL and the NFSP on the “Cliff” (i.e. the point in 2015 after which POL can make changes to remuneration / compensation). We are encouraging progress to be made here in the early months of 2015**

Network Development

- **POL recently confirmed that despite opening 140 new access points in October, it will not reach the 400 target agreed with BIS for March 2014. This is a significant disappointment and unsurprisingly it has not been well received by the Minister**
 - While it is right that POL only does what is commercially right for the network, and that it avoids doing anything too quickly, we firmly believe more could have been done sooner and that management could have managed HMG / Ministerial expectations better
- **We will be working with POL and the Minister closely in the early part of 2015 to make the most of what can be delivered by March 2015. While a network of >12,000 is very unlikely, a positive announcement could be possible before year end**

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

State Aid

- [•]

Project Sparrow

- Jo Swinson attended a Westminster Hall debate in December, called by James Arbuthnot MP in response to issues he saw with the mediation process. As expected this was featured on the BBC's "The One Show" and it was also picked up by a number of papers
 - 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
- [•]

Crown Transformation

- Performance is behind budget and although POL recently confirmed it does not expect to reach breakeven by March 2015 it does expect to reach this position during calendar 2015. While this is a disappointment it is still a significant achievement
 - Other than Government Services revenue (i.e. which is a little stronger than in the rest of the network) and Financial Services revenue (i.e. which is a little weaker) trading in the Crowns echoes performance across the broader network
- Government and POL have publicly stated an ambition to take the Crowns to breakeven, although this has never been a formal goal. Failure to meet targets could therefore have a reputational impact, including possibly triggering responses from the CWU and NFSP

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

Mutualisation

- POL has continued to put limited effort into making progress towards its mutualisation, which is disappointing. Following POL's recent meeting with Jo Swinson it is increasingly important to manage Ministerial expectations in the early part of 2015
 - While we agree management's priority should be ensuring POL's commercial sustainability, and we accept the stakeholder environment has been challenging, more could have been done by POL beyond already established and business-as-usual activities

Target Operating Model

- POL has been continuing to work on its "Target Operating Model" project which was expected to identify, plan and execute a number of restructuring and cost saving initiatives. Some activity (e.g. compulsory redundancies) has recently moved into implementation
 - Although progress is being made the direction this is taking differs from POL's initial steer and our early expectations (e.g. less emphasis on organisational redesign and stronger links to income efficiency and restructuring of subpostmaster remuneration)
 - We also have some concerns that POL is planning to take actions in areas where investment has already been made (e.g. franchising Crowns that have been modernised). While we would not reject this out of principal we would need to ensure a credible VFM case
- We will stay close to POL on this work given its importance to future financial performance and the possible need for HMG / Ministerial approval (see Election Planning below)

PEX(ER) and Other Government Services Activities

- Jo Swinson has enthusiastically been pushing POL across Whitehall since her return from [GRC] earlier in 2014. Progress is certainly being made (e.g. in respect of Assisted Digital, DVLA, Home Office) although this has not yet translated into new revenues
 - Announcements in early 2015 could be possible, which is a good development, however benefits from these are likely to be both relatively limited and far from immediate

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

Election Planning

- **The ShEx POL team continues to put thought 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. There are challenges emerging in a number of areas (e.g. Crown Transformation, Mutualisation, Government Services) and this will be the focus of much of our attention in the New Year
 - **Pre-Election Approvals:** For the past few months we have been encouraging POL to seek early support from HMG / Ministers for a number of actions it needs to take (e.g. the "Cliff", Target Operating Model) and where an election could delay / impact progress. We have seen limited activity from POL to date and as such we are encouraging the business to move faster in these areas
 - **Future POL Policy:** The ShEx POL team has been reflecting on existing HMG commitments to POL / POL's network and their deliverability, and how this might impact our work over the coming months (i.e. future policy development). We recently appointed YouGov / London Economics to undertake an update of the 2009 NERA study on the value of the post office network to inform this

ShEx POL Team Resourcing

- **In December the ShEx POL team lost 2 of its 3 Assistant Directors – Leonie Lambert and Peter Batten**
 - A replacement has been appointed for Leonie ([*] from DECC who is scheduled to join on [*]) while the process to recruit a new G7 to fill the Network Monitoring, Correspondence and Stakeholder Management role is ongoing
- **The ShEx POL team is therefore currently facing resource constraints, although this is not materially impacting the work we do. The constraints should start to be released in February as new resource settles in**

2014/15 Year-to-Date Performance – Revenue

Trading over the last three months has maintained trends established earlier in the year...

...while responses are being developed by POL in some areas these are not comprehensive, plus is it not clear what impact they will have by year end...

...furthermore the mix of sales within some divisions (e.g. Financial Services) is starting to raise concerns...

...management are sticking to their reforecast however unless December delivered a material reversal of certain unfavourable trends, even this is now starting to look like it could be at risk.



YE Mar - £m	Nov. 14/15	Budget	% vs.	Prior Year	% vs.
Mails & Retail	249.2	273.7	(9.0%)	250.5	(0.5%)
Financial Services	195.0	195.7	(0.3%)	188.9	3.3%
Government Services	68.6	76.3	(10.0%)	75.7	(9.4%)
Telephony	29.1	40.2	(27.4%)	32.7	(10.8%)
Other	24.5	20.5	19.2%	26.8	(8.6%)
POL Net Income	566.4	606.3	(6.6%)	574.5	(1.4%)

Mails & Retail

- Weak trading identified earlier in 2014/15 has continued despite POL working closely with Royal Mail to address underperformance. Activity undertaken in December should have an impact, but it is too early to tell
 - Volumes are weak across the board, due to both less market growth than expected and loss of market share. Performance vs. budget has been poor although compared to prior year weakness is less stark
 - Weakness is of particular concern in Home Shopping Returns and Labels, and furthermore given budget phasing shortfall to budget is widening (albeit not accelerating) month-on-month

Financial Services

- Performance is broadly flat to budget and is ahead of prior year although strength is mainly down to NS&I, personal banking, Moneygram and Postal Orders (i.e. due to an accounting change, not strong trading).
 - Personal Financial Services – a key growth “engine” – is doing well compared to prior year although trading is below budget. This is a cause for some concern given the strategic importance of this area for future growth

Government Services

- Still trading behind budget and prior year with particular weakness in POCA (e.g. due to a late delivery of the new contract which was expected to bring in-year benefits) and passports (e.g. lower than planned volumes)
- Offset by DVLA volumes, although trading (along with other parts of Government Services) is behind prior year

Telephony and Other

- Telephony is facing challenges including low subs, higher than planned cost of sales, new contract terms with Fujitsu and the further delayed launch of mobile. Responses are only being developed to some of these
- POL’s decision not to launch an Energy offer is continuing to bite on performance against budget

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

POL is currently trading £14m behind its operating profit budget which, although disappointing, is reassuring given the wide and widening shortfall in revenue ...

...POL has benefited by £25m from better than expected VAT recovery rates. While these are continuing, note that they are non-trading...

...the £14m shortfall to budget is consistent with the full-year position in POL's reforecast. However given continued weakness in revenues, we believe that these operating profit targets could still be hard to deliver.

YE Mar - £m	Nov. 14/15	Budget	% vs.	Prior Year	% vs.
POL Net Income	566.4	606.3	(6.6%)	574.5	(1.4%)
Staff Costs	(164.0)	(161.9)	1.3%	(173.3)	(5.4%)
Agents Costs	(295.7)	(328.0)	(9.8%)	(299.2)	(1.1%)
Non-Staff Costs	(183.4)	(181.3)	1.2%	(172.5)	6.3%
Depreciation	(0.3)	(0.4)	(17.5%)	(0.3)	27.7%
POL Operating Profit	(77.1)	(65.3)	18.1%	(70.8)	8.9%
Financial Services JVs	28.0	27.5	1.8%	26.8	4.6%
Group Operating Profit (pre-POOC)	(49.1)	(37.8)	30.0%	(44.0)	11.6%
Project One-Off Costs	(15.2)	(12.9)	18.1%	(18.9)	(19.8%)
Group Operating Profit (post-POOC)	(64.3)	(50.6)	27.0%	(62.9)	2.2%
Network Subsidy Payment	107.7	107.7	0.0%	134.6	(20.0%)
Group Operating Profit (post-NSP)	43.4	57.1	(23.9%)	71.7	(39.5%)
Memo: Net Income (incl. NSP)	674.1	714.0	(5.6%)	709.1	(4.9%)

▪ Despite the shortfall to budgeted revenue increasing by £25m to £40m since the last quarterly review the shortfall on operating profit has only increased by £10m (and is now £14m behind budget)

- Subpostmaster costs are now £32m favourable to budget (compared to £11m favourable at the time of the last quarterly review) due to flow through from lower mails revenue, a favourable VAT recover rate and NI benefits
- Non-staff costs have swung from £6m favourable to budget to £2m unfavourable due to a POCA customer compensation charge, savings targets not being achieved and other small variations (e.g. mails segregation)

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

Priority	Commentary
	<p>Network Transformation</p> <ul style="list-style-type: none"> 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 year's 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
Transformation	<p>Crown Transformation</p> <ul style="list-style-type: none"> Performance is behind budget and we now understand that POL will not 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 under-performance (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 <p>State Aid</p> <ul style="list-style-type: none"> [•]
Mutualisation	<ul style="list-style-type: none"> ShEx remains concerned that POL is undertaking very little activity around mutualisation or in "embedding" its purpose. Management will be submitting an update to Jo Swinson in the New Year, however since this will be limited in respect of new content we will be trying to work with POL to manage HMG's expectations as best as we can. Note we have faced resistance from POL in recent months when we have tried to provide guidance
Policy and Stakeholder Issues	<ul style="list-style-type: none"> Progress around Government Services – both in existing and new areas – remains an uphill struggle although in recent weeks some progress has been made. Risks do however remain in respect of both 2014/15 trading and expected performance in future years 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) POL's work on Network Development has recently taken an unfavourable turn, although management do continue to engage with us. The Minister is clearly disappointed with progress, and we will be working with POL to manage this situation and expectations in the coming months

Traffic Light Analysis

	01/14	04/14	06/14	10/14	Cur.	Comments
Shareholder Relationship						<ul style="list-style-type: none"> There is a good and constructive relationship with POL's Chair, although she is expected to step down during 2015. 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 (e.g. in relation to key strategies, financial performance and POL's new plan).
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. 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						<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 new strategic plan. The Board are dealing with this, although they have prioritised some recruitment activities over others. 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						<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 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						<ul style="list-style-type: none"> 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						<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).

Annex – Top Priorities for 2014/15

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