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Recipient	To Note / Comment	To Approve / Decide
Permanent Secretary	X	
Kelly Tolhurst	X	

Post Office Limited (POL): Quarterly update**Summary**

1. This is a regular quarterly update on POL, and follows the previous update submitted on 26 September.

Timing

2. Routine. You are meeting with officials on 11 February.

Overview

3. The litigation settlement in December capped a significant year for POL and, while major challenges remain, there has been tangible progress compared to 12 months ago. A new CEO was appointed and has made a positive start in setting a new path for the company, linking to the policy team's work on a Long Term Vision. POL has signed a new deal with Bank of Ireland and looks close to finalising a critical agreement with Royal Mail. The agreement of a new Banking Framework has unlocked a major source of revenue to support the network and is an area where an active Shareholder has added particular value. While important issues remain with the convicted claimants, the settlement was a major milestone. In addition, POL continues to make progress commercially, with trading profits currently ahead of budget.
4. Overall the company is heading into 2020 in better shape than it began 2019. There is a significant agenda of work in the months ahead. Most critical will be the completion of Nick Read's *Purpose, Strategy and Growth* (PSG) strategy review and the company's 5 Year Plan as well as the associated restructuring of the business and management structure. For BEIS and UKGI, our biggest areas of focus will be ensuring POL's plans are aligned with the department's vision, assuring the 5YP, getting funding in place beyond March 2021 and obtaining state aid approval.

5 Year Plan, Spending Review and long-term policy work

5. Long-term policy work: The objectives of this work are to (a) define a clear, relevant and impactful social purpose and (b) ensure that Government's network and access criteria help strike the right balance between supporting POL's commercial growth and meeting the accessibility requirements of citizens, particularly the most vulnerable. We therefore have a programme of work underway to deliver on the post 2021 subsidy; future network sustainability; and role and value of the social purpose which includes the future government services offer. Separate advice is being provided to Minister Tolhurst. Following a commission to POL to provide details of their post 2021 funding request, we are expecting a return in February which will flesh out our understanding of the cost of the uncommercial parts of the network.

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6. 5 Year Plan (5YP). Nick Read has brought in McKinsey to work on the PSG and 5YP. The work aims to set a new vision for the company, make strategic investment choices ('big bets') and clarify the IT and organisational structures required to deliver the strategy. It will also indicate the government support POL believe they need to fulfil the commercial strategy and meet their network commitments.
7. McKinsey's initial work analyses in much greater detail than before the profitability of different parts of the branch network and the company overall. It shows that 50% of POL's network revenues are driven by just 14% of branches. Around 5,600 of POL's 11,600 branches are loss-making, including all DMBs, outreaches and most of the traditional (pre-Network Transformation) branches. As a result, we expect that POL will seek to accelerate the completion of the franchising programme.

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9. Timetable. Delivery of the 5YP has slipped, with the Board now seeing an outline plan on 28 January, followed by a full discussion in February and sign-off in March. The plan will then require shareholder approval, which we will seek to obtain by June. We are procuring consultancy support to assist us in scrutinising and assuring the 5YP, as we did for POL's previous Strategic Plan. This work will be funded by POL but procured by UKGI/BEIS and we are going through the relevant process. We will be testing the assumptions underpinning the plan, and ensuring that the targets for profit, cost efficiencies and cash generation are realistic and sufficiently challenging. POL also need to convince us that the plan is deliverable and can be bought into by staff and postmasters.
10. Obtaining the relevant State Aid approval and getting the final Funding Agreement and updated Working Capital Facility (WCF) in place requires careful sequencing, given the potential for the spending review to be pushed back to the Autumn. The current WCF expires at the end of March 2021. A new WCF needs to be signed by the end of 2020 so that POL's accounts for 2019/20 can be signed off without a going concern qualification. Officials have worked closely on agreeing a timetable, which is attached separately at **Annex D**.
11. Investment. Nick Read's letter to you on 4 December stated that POL will not be bidding for any investment funding. However, the 5YP work is suggesting a need for substantial investment and we expect that POL will once again request that they are allowed to borrow for investment, either from Government or private markets. When POL has submitted its 5YP we will need to consider whether there is a justification for allowing to company to borrow from Government for investment purposes. If so it's likely that a new borrowing facility will be needed in addition to the existing WCF.
12. Dividend or subsidy waiver. We are considering options that would allow the Government to receive a share of future surpluses that POL generates. This could be through an explicit dividend policy or POL effectively waiving the subsidy it is entitled to. POL have agreed to an aspiration for the payment of a dividend in future as part of the new Framework Document but believe that they are some years away from being able to pay a dividend due to the need to finance significant ongoing investment. POL would need to have sufficient cash flow to be able to pay a dividend, requiring a shift in focus from EBITDAS to cash generated in the company targets and remuneration packages. It would also require agreement from Ministers.

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13. Management team. Nick Read has embarked on changes to his senior leadership team, to address in capability and to provide a structure better suited to his vision for Post Office. Debbie Smith, the Head of Retail, has left the business, and the post will disappear as part of the organisational restructuring. Owen Woodley, the current Head of Financial Services, will move to a new role with responsibility for all POL's different products. A new HR Director has been promoted from within POL while the new Head of Comms is an external hire. Nick asked the Interim Chief Information Officer to leave at the end of her probation period and a recruitment process is underway. Nick also plans to recruit externally to give POL much-needed commercial and strategy expertise. None of these changes require shareholder approval as they are not Board positions. Nick will present further details to the Board on 28 January. While Nick reports that Al Cameron has worked well with him after stepping down as Interim CEO, it remains unclear whether Al will continue as CFOO in the long term. Al will become eligible for his six-month retention payment in March.

Legal

14. 'Sparrow' litigation. On 11 December POL agreed a settlement of [REDACTED] to settle the GLO proceedings. The settlement also includes other elements aimed at strengthening POL's relationship with its postmasters. This followed the Court of Appeal's decision to reject on all grounds POL's permission to appeal the 'Common Issues' Judgment (22 Nov) and was followed shortly afterwards by the 'Horizon Issues' Judgment (16 Dec). The settlement announcement received balanced coverage, but there has been some noise from claimants unhappy with the payment they received once the funders had been paid and legal fees deducted. On 4 January Alan Bates (lead claimant in the GLO) wrote to Kelly Tolhurst expressing discontent at the final fee received. This was accompanied by an invoice of £47m. The story was also picked up by Computer Weekly who have asked the Department for comment. Advice was submitted on 14 January noting these developments and proposing a firm but sympathetic "no" to the claimants' request for payment following UKGI and BEIS legal advice.
15. As you know, POL is still potentially exposed to further claims from i) the cohort of convicted claimants, and ii) other postmasters who were not part of the GLO. Now that the litigation has been settled, the "Further Issues" trial that was scheduled for March will no longer go ahead.

Legal Privilege

Financial and Operational performance

17. Trading update. POL achieved a trading profit of £32.8 million in the eight months to November 2019. This was ahead of budget by £2.4 million. Turnover was £18.2 million below budget due to



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challenging conditions in the travel business and across the Financial Service, Telecoms and Insurance divisions. Retail and Identity revenues continue to perform well despite a poor trading month in November 2019. POL's cost savings have offset the negative impact of poor revenues. **Annex A** has more detail.

18. Investment spending. In November, POL received the final £42m tranche of the £210m allocated from BEIS under the Funding Agreement. We held back from releasing the payment pending further information from POL on their change programme. POL's reporting of change spend to the Board and UKGI continued to be poor in 2019. This is despite considerable effort in 2018 on our part to obtain improvements (including withholding funds in 2018) as well as an internal audit report into the company's management of change spend. Towards the end of 2019 the company has also made some changes to the management team running its change programme and this does appear to have resulted in improved discipline in the way projects are managed and reported. We will continue to receive a quarterly report on the investment spend and we have begun discussions with POL on how to develop a final report card on the Funding Agreement at the end of the period. More information is in **Annex B**.
19. Network performance and sustainability. POL continues to meet its network commitments. At the end of November 2019, there were 11,613 post office branches, above the minimum of 11,500 and POL met the geographical access criteria (**Annex C**). In addition to the programme of franchising its directly managed branches, POL plans to open 220 new post offices in 2019/20 (165 have opened YTD). However, in recent years POL has only been able to meet its network commitment through a sustained increase in the use of outreach branches, which open for as little as a few hours a week. There are important policy questions about the minimum branch standards and the degree of reliance on outreaches that will be considered as part of the long-term policy work and SR bid.
20. Some of POL's network partners operate multiple branches, with McColl's hosting over 600. The potential for one of these partners to hit financial difficulty is a risk to POL's ability to sustain the network and UKGI have encouraged POL to analyse the financial stability of its partners and build mitigation plans. While we are satisfied with their plans, if a partner of this size were to get into financial difficulties it could lead to disruption.

Other business issues

21. Agent Pay. POL's Agent Pay review delivered its final report to the Board in October. It proposed increases worth £33m per year, on top of the £17m announced in August, but we were disappointed with the evidence underpinning the recommendations. This highlighted both POL's recurring weakness in the use of data and the need to get a better grip on postmaster economics – a point we have made repeatedly to management and the Board. Our concern is that the increase would not have been directed to the parts of the network that needs it most. The Board agreed to a lower uplift of £20m, payable from FY 20/21, with the components of the increase to be agreed. Nevertheless, the news was well-received by the NFSP. Further work to improve the relationship with postmasters and retail partners will form part of the 5YP.
22. Royal Mail. POL is close to finalising a new non-exclusive deal with Royal Mail to replace the existing exclusive agreement. The high-level understanding between the parties is that overall the economics for POL should not change materially from the existing contract. POL expect to reach agreement on Heads of Terms by the end of January, with a final deal coming to Board at the end



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of March. Mails – and particularly parcels – is fundamental to POL's commercial future and POL is now exploring the opportunities and threats in a non-exclusive environment and the organisational changes necessary. A paper is expected for the March Board.

23. Royal Mail was able to prevent a potential strike action by CWU members during the peak Christmas period as it won its legal challenge to prevent the strike after the High Court backed its application for an injunction in November 2019. There is currently no indication of imminent action.

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25. IT – Belfast Exit and PCI. POL is seeking to migrate two key elements of its IT – the Horizon application and the Oracle database - to the cloud from a physical datacentre in Belfast on which the lease runs out in December 2021. This is a complex process but once completed it will reduce costs and improve service. Having paused the project in the Autumn, POL is now pressing ahead after it transpired that Oracle needs to be upgraded before technical support is withdrawn in December 2020. Once Oracle is upgraded and migrated to the cloud, there will be a significant period of testing before Horizon can be migrated and POL can exit the datacentre. A further complication is the pressing need to achieve compliance with PCI regulations, since PCI is currently a component within the Horizon system. The timetable for completing the migration is tight, but POL believes it is achievable. The greater risk is probably achieving PCI compliance before the end of 2021 deadline. Both projects will be top of the in-tray for POL's new CIO.
26. BF2 and Barclays. The new Banking Framework began on 1 January and includes Barclays, who reversed their decision to opt out of the cash withdrawal service following significant pressure from the media, Ministers and other MPs. It has become increasingly apparent that the provision of cash banking is central to both POL's social purpose and its commercial viability. As such, it is vital that government sets a clear vision for access to cash and the obligations on banks to support this. This will be a focus for our engagement with HMT over the coming months.
27. Cash logistics. Post Office's supply chain business manages the cash that it provides to branches, handling an average of £1.5bn every day. Having reviewed the business in Summer 2019, POL see opportunities for efficiencies in the short to medium term, while they wait for HMG's ambitions for a 'cash utility' to come to fruition. POL has been discussing outsourcing options with several partners and would like to move towards the development of business cases. Such a move would be unpopular with unions and pose execution challenges, but POL believe the risks are manageable and the commercial upside significant. However there is considerable political interest in the cash agenda and HMT are nervous that any movement by POL could undermine a



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co-ordinated consolidation of the industry. We have asked POL to engage with the Bank of England to check that their plans fit with the wider direction of travel.

28. Bill payments / British Gas. British Gas swapped its over-the-counter bill payment service from PayPoint to Payzone, with the exclusive contract beginning on 1 January 2020. While the vast majority of transactions have been handled successfully, there are a small number of customers that have not been able to transact at their Payzone or Post Office retailer. POL is working hard to solve the technical and connectivity issues preventing customers from topping up in Payzone outlets and are expecting problems to be solve within the next 5 weeks. In addition, the Post Office public affairs team is working closely with the Centrica and British Gas public affairs team to deal with all incoming inquiries from stakeholders, including the 94 MPs that wrote to British Gas encouraging them to overturn their decision. Nevertheless, the failure to deliver a smooth transition is disappointing and highlights POL's challenges in execution.

Governance

29. Culture and stakeholder views. As part of Nick Read's 'Purpose, Strategy and Growth' work, McKinsey conducted their Organisational Health survey, which has now been discussed extensively with POL's employees. The results were very poor. POL had third or fourth quartile scores in nearly every area and staff currently lack a clear sense of engagement and accountability. McKinsey have also conducted surveys and focus groups with postmasters and customers. All stakeholders believe that trust is a key asset of the Post Office. Postmasters also ranked serving the local community very highly, but this was not reflected in customer feedback. Customers valued Post Office's reputation and convenient location, but scores were lower for the customer experience. Customer awareness of non-mail products was weak and all scores were considerably lower for younger age groups.
30. Future of STIP and LTIP. POL's Remco has approved financial targets for the 19/20 STIP (£59.2m/ On Target: £74m / Stretch: £88.8m) and the 19/22 LTIP (£93.5m/110m/126.5m). The bonus payments themselves are unchanged from those agreed with the CST at the time of the CEO's appointment. We are seeking approval in time to meet end of year bonuses. Remco have also proposed a new set of metrics for future years and changes to strengthen their discretion to clawback bonuses. There is potential for Unite to raise issues as the changes will apply to *all* employees covered by the STIP, not just the CEO and CFO. POL do not envisage an issue but are monitoring.
31. NEDs. Following a successful recruitment campaign, two candidates, Zarin Patel and Lisa Harrington, were identified as good fits for the vacant NED posts. Zarin was approved and appointed on 5 November (before the pre-election period) and Lisa's appointment has been confirmed following the election, with her 3-year term commencing from 24 March 2020. Tim Franklin, whose term was extended to cover the recruitment campaign, stepped down on 21 December but continues as Chair of Post Office Insurance. Lisa and Zarin's appointments will improve the diversity of the POL Board which now consists of 5 men, 3 women and 1 BAME.
32. Legal Entity Optimisation (LEO) and Framework Document. In April we advised Ministers on POL's plans for a corporate restructure (project LEO). This is also an opportunity to i) refresh the Articles of Association to include enhanced and clarified consent rights for BEIS SoS, and ii) put in place a new Framework Document that includes compliance with HMT public sector pay guidelines. POL initially proposed to put in place a new HoldCo but after significant work (subject to independent



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assured) they concluded this is no longer needed. The Articles and Framework Document have been agreed with POL and approved by the Permanent Secretary, subject to one change. Advice has been submitted to Ministers with the aim of gaining 'final' approval by POL's Board on 28 January. POL is agreeing an implementation plan to enable both documents to be fully in force for POL and its subsidiaries from 1 April 2020.

33. Shareholder meeting. The first six-monthly Shareholder Meeting was held on 13 November, attended by POL's Chair, CEO and CFO. We are currently looking for a date for the next meeting in May 2020.
34. Board review and Chair appraisal. POL's next Board review will take place in March 2020 and we have agreed that they will procure an externally-led review in 2021. We have also agreed the process for the Chair's annual appraisal, as part of which you will be invited to share your thoughts on the Chair's performance.
35. Chair Letter. You will shortly receive advice on a Chair Letter which will set out the department's priorities. As part of this we are planning to include a list of topics that we believe need to be discussed at POL's Board over the coming year.

Government policy

36. Verify / Digital ID. As you are aware, Cabinet Office have asked POL to pay a higher fee to Digidentity to stop them making losses and potentially leaving the market. Currently GDS pays POL £2 per user sign up (due to drop to £1 soon), of which £1.70 is passed onto Digidentity. However, it costs Digidentity £4.50 to issue a digital identity to a POL customer. Requiring POL to pay £4.50 per user would turn a 30p profit into a £2.50 loss - a loss of £4.2m per year based on POL's projections of securing 1.5m users a year. Post Office do not want to bear this loss and are unconvinced by Cabinet Office's promises about the potential of a future digital identity 'ecosystem'. A further meeting is being set up between POL and John Manzoni in February. In the meantime, Digidentity is threatening to stop accepting new registrations on POL's behalf in the next few weeks, which, according to POL, is a breach of contract. We believe the key to resolving this issue is for HMG to be clear with POL about its future ambitions and how participants in Verify could benefit as this would enable POL to make a commercial decision to continue to invest in the business. Our views have been communicated to Cabinet Office.
37. Post Office Card Account (POCa). POL believe that DWP's plans for POCa will have significant negative impacts on both customers and postmasters and they have informed us that they are not minded to bid for the replacement service. They also expect increase in public commentary about the implications of DWP moving to a voucher scheme in the next few months. It is highly likely that postmasters and stakeholders will react negatively to services being withdrawn from the Post Office network, with specific areas of the country (Northern Ireland in particular) being severely affected. However, POL's plan for doing so will not be finalised until the POCa steering group meets next Thursday. BEIS officials have been in discussion with DWP counterparts to make sure they are aware of these risks, ahead of their planned procurement for POCa's replacement, which is now due to go live in March 2021.

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Financial performance 2019/20 Year to Date (YTD)

	Actual (£m)	Budget (£m)	Variance (£m)	Year on Year
Retail (inc Payzone)	382.5	380.6	1.9	3%
Financial Services and Telco (inc Insurance)	206.6	231.5	(24.9)	-3%
Identity	27.3	25.6	1.7	-29%
Supply Chain/Other	9.2	9.0	0.2	1%
Total Revenue	625.5	646.6	(21.1)	-1%
Cost of Sales	(80.5)	(90.5)	10.1	-4%
Net Income	545.0	556.1	(11.1)	-1%
Agents Pay	(255.9)	(256.2)	0.3	8%
Staff Cost	(117.4)	(114.4)	(3.0)	-6%
Non Staff Cost	(171.7)	(188.9)	17.1	-9%
FRES	23.6	25.1	(1.5)	-12%
Other Income	9.3	8.7	0.6	-1%
Trading Profit	32.8	30.4	2.4	-7%

Revenue

Revenue is down on budget. Higher revenue in Retail and Identity, predominantly driven by mails and banking, has been offset by weakness in Financial Services, Telecoms and Insurance. This is mainly due to lower than expected Bank of Ireland commissions, weak demand for foreign exchange and overseas travel. Performance in Post Office Insurance has also been disappointing.

Costs

Overall costs were favourable to budget, particularly non-staff costs. Half of this was due to IFRS15 accounting adjustments that require costs to be recognised over the lifetime of the contract and the bulk of the remainder is due to the reallocation of GLO costs to other cost lines. Cost of Sales and Agent Pay are below budget as a function of weaker revenues.

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The latest quarterly update on investment performance came to the October Board.

In Q2, POL underspent by £12.7m compared to budget, due to the new CEO and new Chief Transformation Officer reassessing the portfolio to try to spend more smartly and improve the focus on delivering benefits. This welcome development has caused delays in two major projects (Retail Point of Sale Integration and the Paystation terminal upgrades) and a number of smaller ones. We have been reassured by the company that these delayed projects will recover during the year and still have strong business cases. An exception to this is PCI compliance for which completion is delayed until late 2020 due to difficulties POL is having in solving the problems. This is an essential regulatory project that must proceed until completion. These delays have meant benefits have not been fully delivered either.

Project spend and benefits, Q2 2019/20

Strategic Priority	Project Spend			Project Benefits		
	Q1 FY1920 Actual	Q1 FY1920 Budget	Variance	Q1 FY1920 Actual	Q1 FY1920 Budget	Variance
Simplify the retailer proposition	13.6	12.0	1.6	4.9	5.0	(0.1)
Modernise our products and services	8.5	12.2	(3.7)	5.5	6.3	(0.8)
Build innovative, flexible and secure IT	3.9	7.2	(3.3)	1.9	2.0	(0.0)
Digitise and optimise the business	2.6	4.9	(2.3)	0.9	0.9	(0.0)
Modernise our skills, policies and processes	1.8	2.2	(0.4)	0.1	0.5	(0.4)
Non-UKGI Funded	4.4	4.0	0.4	0.4	1.0	(0.5)
Total Change Spend	34.8	42.5	(7.7)	13.7	15.6	(1.8)

Q3 2019/20 investment spending is forecast to be £54.7m, including £6.7m on the DMB franchising programme, £5.4m on HR programmes, £4.2m on the Horizon Integration Hub and £4.2m on group litigation. Expected benefits are £17.4m within year. BEIS funding supports POL's investment programme, limited to projects approved at the Funding Agreement (Jan 2018). This does not include the legal costs of the litigation.

A follow-up to the UKGI-requested internal audit report into investment spend controls will begin on 20th January.

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Branch numbers (as at end November 2019)

Type	Mains	Local	DMB	Traditional	Outreach	Total
Number	3,419	4,081	132	2,322	1,659	11,613

Programme	Commentary
Franchising	Plan to franchise 69 DMBs in 2019/20 (59 YTD). This can be poorly received by unions and local stakeholders but once open, customers usually welcome better accessibility and opening hours provided by the franchised branch.
New branches	Plan to open 220 new branches in 2019/20 (165 opened YTD) to meet under-served customer demand.
Outreaches	Typically small, part-time branches using a village hall or a mobile van which enable services to be provided to communities which would not otherwise receive them. While Outreaches can represent the most appropriate provision in rural areas for continuity of service, we have some concerns about their rapid increase.
Hard to Place postmasters	Around 360 postmasters have expressed a wish to leave the network but cannot because, under current policy, POL is only allowed to pay compensation to departing postmasters when a replacement branch is available - otherwise communities will lose their post office.

Network Accessibility Performance

Criteria	Total Population within 3 miles	Total Population within 1 mile	Deprived Urban Population within 1 mile	Urban Population within 1 mile	Rural Population within 3 miles	Postcode Districts less than 95% Population within 6 miles
Target	99%	90%	99%	95%	95%	0
Performance	99.7%	92.6%	99.4%	98.3%	98.6	8*

*POL is working on restoring services in these Post Code Areas

Network coverage of SGEIs (Services of General Economic Interest)

	Category of Service	No. of branches required	No. branches where service is available
1	Processing social benefits and tax credit payments to the public	11,000	11,485
2	Processing of national identity and licensing scheme applications	11,500	Client contract dependent
3	Universal payment facilities for public utility services	11,500	11,613
4	Access to postal services	11,500	11,613
5	Universal access to basic cash and banking facilities, especially for rural customers and those on social benefits	11,000	11,485