

Royal Mail – Strictly Confidential

RMH(06)5TH
RMH06/78 - 93

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

Minutes of the meeting of the Board of Directors
held at 148 Old Street London, on 27 April 2006

Present:

Allan Leighton
David Burden
Alan Cook
Adam Crozier
David Fish
Ian Griffiths
Richard Handover
Sir Mike Hodgkinson
Tony McCarthy
John Neill
Baroness Prosser
Helen Weir
Bob Wigley

Chairman
Group Technology Director
Managing Director, Post Office Ltd
Group Chief Executive
Non-Executive Director
Managing Director, Royal Mail Letters
Non-Executive Director
Non-Executive Director
Group Director, People and Organisational Development
Non-Executive Director
Non-Executive Director
Non-Executive Director
Non-Executive Director

In attendance:

Jonathan Evans

Company Secretary

Also present:

Rico Back
Frank Schinella
Phil O'Gorman
Jane Newell
Alex Smith
Martin Gafsen
Jeff Triggs
Richard Gillingwater
Mark Higson

Chief Executive, GLS
Acting Group Finance Director
Vehicle Services Director, for RMH06/79(d)
Chair, Royal Mail Pensions Trustees Ltd, for RMH06/85(a)-(d)
Group Strategy Director, for RMH06/85
Group Investment Director, for RMH06/85
Slaughter and May, for RMH06/85
Chief Executive, Shareholder Executive, for RMH06/85(f)-(n)
Deputy Chief Executive, Shareholder Executive, for RMH06/85(f)-(n)
HM Treasury, for RMH06/85(f)-(n)
Operations Director, Post Office Ltd, for RMH06/87
Finance Director, Post Office Ltd, for RMH06/87

Olly Robbins
Ric Francis
Peter Corbett

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MINUTES OF PREVIOUS MEETING RMH(06)4TH

- (a) The minutes of the meeting held on 4 April 2006 were approved, subject to the following amendments:
- RMH06/66(c) – delete "and the Audit Committee";
 - RMH06/68(b) – replace "defined contribution" with "defined benefit".

RMH06/79

MATTERS ARISING – RMH(06)48

- (a) The Board noted the status report;
- (b) Pension Fund volatility (RMH06/52(e)): Frank Schinella said that a summary of the Company's plans for mitigating the volatility of the pension fund would be presented to the Board in June.

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ACTION
Ian Griffiths

- (c) Royal Mail Way (RMH06/60(b)): John Neill enquired whether management's views about Unipart and *Royal Mail Way*, as reported in the minutes of the March meeting, had changed in the light of subsequent discussions. Ian Griffiths replied that his team had held a number of meetings with those working on *Royal Mail Way* as a result of which there had been some noticeable improvements. Ian Griffiths undertook to give a full progress report to the Board about *Royal Mail Way* within the following few months;
- (d) Vehicle Replacement Programme (RMH06/71(d)): the Board noted the paper (RMH(06)60) from Phil O'Gorman which addressed the issues raised in the discussion at the previous meeting. Phil O'Gorman supplemented this with an overview of the achievements of Vehicle Services over the previous few years, in which time considerable reductions had been made in the size of the fleet, and the costs of operating and maintaining it. In response to questions from the Board, Phil O'Gorman expressed the view that further savings of some 3% should be possible during the current year, but this depended less on the activities of Vehicle Services than on operational management. Frank Schinella confirmed that the balance between purchasing vehicles and leasing them was being appropriately assessed on the basis of the marginal cost of capital. In conclusion, the Board was satisfied with the responses to its questions raised at the previous meeting, and therefore approved the proposal sought in paper RMH(06)42: the Board
- approved the annual vehicle plan at a cost of £82.9m, of which £20m had been drawn under advance authority; and
 - devolved authority to the Investment Committee for £33.3m for tranche 2 and £29.5m for tranche 3 of 2006/07 and £25m for tranche 1 of 2007/08;
- (e) Budget 2006/07 (RMH06/66(e)): Adam Crozier and Ian Griffiths informed the Board that a substantial revenue risk had come to light in respect of *Pricing in Proportion*. An interrogation of the pricing model used to assess the revenue implications of the pricing change had revealed that the previous estimate of the impact of the change had been mis-stated. While it was not possible to determine the impact with complete accuracy, as revenues would in part be dependent on customer behaviours following the change, it now appeared that there could be a risk of up to some £58m in 2006/07, while for later years the shortfall could be corrected. Work was currently urgently taking place to understand why this modelling error had occurred, and to determine the appropriate course of action. The Board was concerned to be informed of this new risk: Adam Crozier undertook for the Board to be given an explanation of why the error had occurred, and any subsequent actions including how management proposed to cover the risk in budgetary terms. David Fish suggested that the assumptions within the pricing model in respect of changes to product mix be thoroughly tested.

ACTION
Ian Griffiths

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OTHER MINUTES

- (a) The Board noted the minutes of the meetings of
 - the Audit and Risk Committee of 14 March 2006
 - the GLS Supervisory Board of 15 March 2006
 - the Corporate Risk Management Committee of 2 February 2006;
- (b) in respect of CRMC06/02(e), which referred to an action seeking confirmation of the Company's ability to insure against fines and compensation payments, Bob Wigley asked that the Board be informed of the outcome.

ACTION
David Burden

RMH06/81

CHAIRMAN'S BUSINESS

- (a) The Chairman had no business other than that on the agenda.

RMH06/82

REPORTS FROM CHAIRS OF BOARD COMMITTEES

- (a) Nomination Committee: Richard Handover updated the Board on progress with finding a new Group Finance Director. There were two clear front-runners, and the aim was to conclude interviews by the end of the month;
- (b) good progress continued to be made in the search for a General Counsel. The front-runner candidate had been endorsed by the Committee and Bob Wigley;
- (c) Remuneration Committee: David Fish reported that the position on the LTIP was looking more positive following further discussions with shareholder representatives. There was however some important detail yet to be resolved, including agreement to the annual ROTA targets;
- (d) Audit and Risk Committee: Bob Wigley reported that the Committee had met informally on 19 April to be updated on the issues surrounding the Company's position as a going concern, in readiness for the next full meeting of the Committee on 8 May.

RMH06/83

EXECUTIVE DIRECTORS' REPORTS

- (a) The Board noted the reports from the executive directors, including the good Quality of Service outturn results in Royal Mail Letters, and the commendable profit performance of Parcelforce. The Board noted further:
- (b) Post Office Ltd: Alan Cook reported that he and his team were continuing to develop the five-year strategy for Post Office Ltd, in readiness for a discussion at the Board's July awayday. Meanwhile it had been encouraging that new product sales had ended the year on a high, with the target to secure 845,000 new customers being hit. The launch of the instant savings account had gone well, with it attracting deposits well ahead of plan;

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ACTION
Tony McCarthy

- (c) the loss-making directly managed branches were a big challenge to POL, with their adverse mix of staff and property costs, combined with mediocre sales performance. In the Chairman's opinion a root cause of the poor performance of these branches was the lack of engagement of the branch managers: he had encouraged Alan Cook to hold workshop meetings with all the branch managers, which were now being arranged. The Chairman saw parallels with how the performance of RM delivery offices had been improved by the greater involvement of the managers. The Chairman added that he did not want POL to incur any further industrial action over franchising as it was clear that POL was not currently best equipped to respond to opposition to the DMB conversion programme, and wanted more attention to be given to the management of the branches;
- (d) People and organisational development: Tony McCarthy updated the Board on a number of people issues. Work had been progressing on refining proposals for an employee share scheme, and changes to the levels of pensions provision: proposals would be brought to the June Board meeting;
- (e) the scheme to encourage staff not to take sick leave by incentivising good attendance was proving successful: 56,000 people had had no absence within the previous 12 months, and 86,000 within the previous six months. It was estimated that the resultant reduction in absence was worth some £40m a year;
- (f) on pay matters there was a mixed picture. The Parcelforce pay offer had been accepted, including a large vote in favour of moving to monthly pay; while in Royal Mail Letters, the CWU had rejected a 2.9% offer as it "did not meet expectations". Similarly 2.4% offers in POL and Cash in Transit had been rejected by CWU. Discussions continued on changes to London Weighting payments, but the CWU had unachievably high expectations. CWU were embarking on a membership consultation exercise in advance of their annual conference in late May to test the level of backing the union leadership had for its eight-point "vision", which included higher pay, shorter working hours, greater job security, and opposition to a share scheme. The Chairman was planning to write to all staff within the near future to explain the current position of the Company, to foreshadow the annual results and heighten expectations of a *Share in Success* payment, as well raising the profile of the rationale for an employee share scheme. On the latter point Margaret Prosser stressed the need to conduct a major PR campaign targeted at persuading MPs of the benefits of employee shares – she was very conscious of the extent of opposition to the plan, but felt that the opposition was not well informed;
- (g) the number of employment tribunal cases settled before they reached court raised some concern amongst directors, as it was a potential encouragement for people to pursue their alleged grievances through to a tribunal in expectation of receiving a payoff. Tony McCarthy was reviewing the practice to ensure that as far as was sensible all tribunal cases were defended;

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- (h) GLS: Rico Back informed the Board of current developments in GLS. The profit outturn for the year was showing a £1.6m improvement on the previous forecast. He cautioned the Board that the coming year was expected to be much tougher, in view of the significant attack on prices from competitor companies that GLS was experiencing, particularly in Germany.

RMH06/84

FINANCE DIRECTOR'S REPORT

- (a) The Board noted the results for period 12, and the full year results which showed a Group operating profit before exceptional items of £355m, which was £53m favourable to the prior year;
- (b) Going concern (RMH(06)50): the Board noted Frank Schinella's paper, the analysis within which had been prepared to enable the Board to determine whether it would be appropriate to sign the annual accounts on a going concern basis;
- (c) the Board noted that detailed analysis prepared by Group Finance, with appropriate external review by Ernst and Young's audit and insolvency teams, together with Slaughter and May, had demonstrated that the Group as a whole and its subsidiaries were going concerns. This analysis had been considered at a special briefing meeting of the Audit and Risk Committee on 19 April;
- (d) this analysis had also concluded that POL's statutory accounts should include an "emphasis of matter" statement and appropriate note disclosure with respect to the long-term funding for POL and the fact that directors had placed reliance on the Government's "route map" for determining the future strategy and funding of POL;
- (e) the analysis further showed that in the unlikely circumstances of POL being forced into a radical closure programme similar, there were sufficient management actions available to cover the financial impact on RMG;
- (f) the analysis also showed that the existing financial covenants of the Company were unlikely to be breached;
- (g) taking all these factors into account, the Board was satisfied that in the scenario of the Government supporting the Company's commercial case with proposed levels of funding, the Group accounts could be prepared on a going concern basis. In the scenario of Government funding not being forthcoming, while it appeared that there would be sufficient management actions to ensure that the Group could remain a going concern, some directors asked for a more detailed analysis of these actions and their impacts to show this beyond doubt. Frank Schinella undertook to produce this further analysis, which would be made available to the Audit and Risk Committee, and the Board's accounts sub-committee. The Board delegated to these committees the final confirmation in respect of going concern, in

ACTION
Frank Schinella

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the light of the further analysis;

- (h) IAS 19 Pension disclosure (RMH(06)51): the Board noted Frank Schinella's paper which asked the Board to approve the key assumptions supporting the calculations of the IAS19 pension disclosure for the Group's pension schemes in the statutory accounts. The Board noted that the choice of assumptions had been based on advice from the Company's independent actuary, Watson Wyatt, and the approach to the derivation of the assumptions had broadly followed the practice of previous years, with the exceptions of a strengthening in mortality and inflation. After some discussion, the Board endorsed the use of the assumptions proposed in the paper;
- (i) Draft 2005/06 accounts (RMH(06)49): the Board noted Frank Schinella's paper which provided the Board with the draft accounts for 2005/06. An earlier version of the accounts had been provided to the Board at its previous meeting, and a later version had also been considered by the Audit and Risk Committee. Directors were asked to submit any further comments or suggested drafting changes as soon as possible. The Board was informed that the intended timetable for publication – still to be confirmed in the light of the continuing discussions with Government about the funding package – was 18 May, with the Audit and Risk Committee meeting on 8 May to clear the accounts;
- (j) the Board authorised the accounts sub-committee to give the final approval to the Group accounts on the Board's behalf, including the Chairman's and CEO's statements, and any related press release. The Board agreed that the sub-committee would comprise Allan Leighton, Adam Crozier and Bob Wigley.

RMH06/85

GOVERNMENT FUNDING – RMH(06)54

- (a) The Chairman welcomed Jane Newell to the meeting, and invited her to give her perceptions of the discussions taking place on agreeing a memorandum of understanding in respect of the future funding of the Royal Mail Pension Plan;
- (b) Jane Newell reported that while the discussions with the Company to agree the MOU had been constructive, the Trustee had become frustrated by the continuing delay in bringing the MOU to a conclusion. It was clear that this was due to interventions by the shareholder, and she found their inability to meet deadlines, and to change their position, intensely disappointing. She explained that she had kept closely in touch with The Pensions Regulator throughout the period of discussion about the MOU, and TPR had proved to be a very strong source of guidance. While it would not be necessary for TPR to be involved formally in agreeing the MOU, assuming that the Trustee and the Company would finally be able to reach agreement, TPR's influence was substantial, and she had made shareholder representatives fully aware of this;

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- (c) Jane Newell felt that in view of the continuing sequence of “drop dead dates” to agree the MOU which had come and gone, she had a duty to write to the Government to inform them at first hand that the continuing delay was causing considerable anxiety amongst the hundreds of thousands of members of the scheme;
- (d) on behalf of the Board, the Chairman endorsed the action Jane Newell was taking, and thanked her for her professionalism and patience in dealing with this difficult matter.

Jane Newell then left the meeting.

- (e) Adam Crozier updated the Board on the current state of discussions with the Government about the funding package. The DTI had made a formal recommendation to the Chancellor of the Exchequer that the Company's strategic plan was value-enhancing, and that it should be supported. The DTI had yet to make a recommendation about an employee share scheme: this was partly because the Company had only recently tabled a formal proposal, but more because the Secretary of State had yet to make up his mind on his stance to the issue. Adam Crozier considered that in the discussion with Government representatives which was to follow, it would be important to gauge the extent of Ministerial commitment to the commercial case, including the proposed employee share scheme, and the likelihood of the funding discussions reaching a conclusion in time for the publication of the Company's accounts on 18 May.

Richard Gillingwater, Mark Higson and Olly Robbins joined the meeting.

- (f) The Chairman invited the Government representatives to update the Board on their current understanding of progress towards finalising agreement to the Company's commercial case;
- (g) Mark Higson said that Government had been working vigorously towards providing a satisfactory outcome to the funding discussions in time for the Company's announcement of its annual results on 18 May;
- (h) the letter of comfort for the POL directors had been discussed at length between the Company and the Government, and Mark Higson handed over at the meeting a signed copy of it. He stressed that one of the letter's conditions was that the existence of the letter should remain confidential to the parties. The Chairman said that the letter would be checked with the Company's legal advisers, and the Royal Mail Group and Holdings directors would need to be reassured that the proposed level of confidentiality would not fetter their fiduciary duties;
- (i) on progress with the employee share scheme, Mark Higson said that the Secretary of State was sympathetic towards the Company's wish to introduce such a scheme, but there were a number of important details still to be resolved. At present it was not settled Government policy to support an employee share

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scheme. Work was continuing on the terms of a statement which could be made about this on 18 May;

- (j) Olly Robbins, on behalf of HM Treasury, reaffirmed that the Company's commercial plan had been put forward to the Chancellor as value-enhancing. The matter was currently with the Chancellor who was fully engaged with the issues involved. In response to a question from the Chairman, Olly Robbins explained that the Chancellor was fully aware that an employee share scheme formed an integral part of the Company's plan, but no formal proposal had yet been made to him about this. Margaret Prosser stressed to the Government representatives the importance of ensuring that the decision-makers in Government heard a balance of stakeholders' views about introducing a share scheme, rather than just listening to those against the scheme who "shouted loudest";
- (k) the Chairman mentioned the subpostmasters, who could be a powerful lobby group in favour of a share scheme. Mark Higson recognised this, but pointed out that it was not yet agreed Government policy that, should a share scheme go ahead, subpostmasters would be included in it;
- (l) the discussion turned to the planned consultation arrangements in respect of the future of POL. Mark Higson said he wanted the process for this to be clear by September 2006, but considered it to be important that by then there was a clear and consistent view across Government about the desired future state of POL. He would be working towards this aim;
- (m) Helen Weir referred to the frustration caused by the succession of missed deadlines to secure a conclusion to the discussions on the Company's commercial case. Mark Higson repeated that all efforts were now being made to work towards the 18 May, also recognising the importance of the Audit and Risk Committee meeting on 8 May;
- (n) in conclusion the Chairman thanked the Government representatives for attending the meeting, and for the efforts they were making to bring matters to a conclusion. He re-emphasised the importance of being able to make an announcement on 18 May.

RMH06/86

OPERATIONAL STAFF VOLUNTARY REDUNDANCY PROGRAMME 2006 – RMH(06)52

- (a) The Board noted Ian Griffiths' paper, which sought approval for the 2006 operational staff headcount voluntary redundancy programme to support structural change and deliver efficiency savings in Royal Mail Letters. The Board noted in discussion:
- (b) the full impact of the programme on pension costs had been included in the costing of the programme;
- (c) management intended to pursue changes to the level of

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voluntary redundancy terms applicable to operational colleagues at a later date. This programme would be the first large-scale exercise to offer voluntary redundancy to operational staff, and at this stage a lessening of the terms would be inappropriate.

- (d) In conclusion the Board:
- (e) agreed voluntary redundancy costs of up to £120m to allow the exit of some 3500 operational staff;
- (f) noted that 40% of the £88m estimated annual savings from salaries, bonus, national insurance and pension contributions and benefits expected from the investment would be paid back to employees as a consolidated annual increase to pensionable pay, in line with the pay deal previously agreed with CWU;
- (g) noted that voluntary redundancies provided an enabler for efficiency savings anticipated as part of the 2006 national productivity pay agreement between Royal Mail and the CWU.

RMH06/87

HORIZON: NEXT GENERATION – RMH(06)53

- (a) The Board noted Alan Cook's paper, and Ric Francis' further explanation of the business case for the replacement of Post Office Ltd's Horizon electronic point-of-sale system. The Board noted further in discussion:
- (b) the proposed deal with Fujitsu offered a replacement system at a significantly lower cost than any of the other available options. For a total investment of £127m, the proposed deal would deliver an incremental post-tax NPV of some £90m compared with continuing with the current system and contract until 2015. Richard Handover pointed out that while this scale of cost reduction was commendable, in his experience of dealing with Fujitsu, cost reduction could also be accompanied by service degradation. Ric Francis noted this;
- (c) David Fish expressed some surprise at the 10-year length of the proposed contract, which in his view was high for an IT contract. Ric Francis responded by pointing out that the proposal was based on a multi-contract approach, making it simpler to exit from various elements should that be necessary.
- (d) After further discussion the Board:
 - expressed its support for the business case set out in the paper
 - authorised release of up to £25m of capital, in addition to £10m already approved, to enable the continued development of the Horizon replacement system
 - approved POL's concluding detailed contract negotiations with Fujitsu Services as proposed, in line with the parameters of the business case. This was subject to POL resolving its funding issues currently being discussed with Government,

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and to the Investment Committee authorising the signing of the contract.

RMH06/88

COMPETITOR INTELLIGENCE QUARTERLY REPORT – RMH(06)55

- (a) The Board noted the report.

RMH06/89

QUARTERLY DIVERSITY REPORT – RMH(06)56

- (a) The Board noted Tony McCarthy's paper which identified key areas of achievement and concern in connection with Diversity and Inclusion, based on the analysis of data available from five key sources during 1 December 2005 to 28 February 2006;
- (b) the Board noted further the achievements and concerns highlighted in the report. Of particular concern was from a total of 65 recommendations for Conduct Code action made during the quarter in respect of bullying and harassment cases, only 14 had been applied. This followed a similar trend in previous quarters. The Board endorsed the action being taken to communicate a clear message to managers that appropriate use should be made of the conduct code, in line with the Business' stated values of zero tolerance of bullying and harassment.

RMH06/90

YEAR-END INVESTMENT REPORT – RMH(06)57

- (a) The Board noted the report. The Board noted further that the Transport Review post-implementation review showed a large difference between the authorised business case and outturn, and requested an explanation of the disparity.

ACTION
Frank Schinella

RMH06/91

REGULATION REPORT – RMH(06)58

- (a) The Board noted the report. Adam Crozier reported that Mike Prince was taking over from Stephen Agar as Group Regulation Director. With Luke March, Mike Prince was putting in place procedures to ensure that information flows between Royal Mail and Postcomm/Postwatch were properly controlled, with appropriate sign-offs being given.

RMH06/92

COMPANY SECRETARY'S REPORT – RMH(06)59

- (a) The Board noted the report.

RMH06/93

CLOSE

- (a) In the absence of any further business, the Chairman closed the meeting. The next meeting was scheduled for 6 June 2006 at 148 Old Street, London.

GRO