UK Government Investments

Department for Business, Energy & Industrial Strategy

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Date: 26 September 2019
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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 Post Office Limited (POL) and follows the previous update submitted on 13 June.

Timing

2. Regular quarterly update. This also provides background for your upcoming meetings with Nick Read (30 September and 17 October) and Tim Parker (date tbc).

Overview

1. The new CEO has arrived at an important moment for POL. He is working to a 100-day timetable with a view to outlining his strategy before Christmas. While headline financial performance is good and with a positive outlook, financial controls need to improve, and we are currently withholding funding pending information on investment spending. The litigation case has exposed both historic weaknesses and an ongoing need for culture change in the business.

Legal

2. Sparrow' litigation. POL has been developing its strategy for mediation, including detailed work by its legal advisors to understand and verify the magnitude of potential claims. Separately, UKGI and BEIS are engaging with HMT to discuss preparations and clearance processes for a possible settlement. The legal advisers have produced a first draft for the Board for approaching settlement including a first range of estimates. The Board has asked for more work to be done to improve its understanding of how the claimants' perspective on the range of outcomes. The final strategy will be contingent on two processes: the judgment of the 'Horizon' trial (no date confirmed, but expected in the next month) and the Court of Appeal's decision on whether POL can appeal the first 'Common Issues' verdict (an oral hearing is due on 12 November). Mediation is unlikely to start before December, but we may need to move quickly to obtain the necessary approvals. UKGI and BEIS comms have met POL to discuss comms around the Horizon judgment. Further advice will follow the judgment and appeal hearing.

3. 'Starling' litigation. A separate litigation ('Starling') relates to 123 Postmasters who have commenced proceedings in the Employment Tribunal claiming "worker" status. Legal Privilege

BEIS0001127

UK Government Investments

Department for Business, Energy & Industrial Strategy

OFFICIAL-SENSITIVE: COMMERCIAL

Legal Privilege

Legal Privilege The case is expected to be heard by the Employment Tribunal in 2020, with a preliminary case management hearing set for 11 October 2019, after which we will provide a further update.

Governance

4. New CEO. Nick Read joined as CEO on 16 September, and you are meeting him on 30 September, and again with Kelly Tolhurst on 17 October. He was previously Chief Executive at Extra Energy (2018-19) and at Nisa (2014-2017). UKGI and BEIS met with Nick on 17 September and he attended his first Board on 23 September. He has publicly stated his intention to establish a clear vision for POL within 100 days (by Christmas), and to agree this both across the business and with its wide set of stakeholders. As part of this, we understand that Nick plans a series of 'roadshows' with staff and postmasters.

5. Bonuses. Remco has discussed and in principle agreed measures to provide significantly greater discretion in future. The company's ability to exercise discretion in a very wide range of circumstances has been clarified. Importantly, in relation to LTIP, discretion would apply to payouts as well as grants. Based on legal advice received, Legal Privilege

Legal Privilege

6. Future of STIP and LTIP. We have also been working with Remco on revised measures for STIP and LTIP for FY 20/21 onwards. While EBITDAS has been effective in focusing management on the turnaround and restructuring, we think we should think about moving away it because it doesn't capture change spend very well or balance sheet efficiency. We have also proposed a change in the operational performance measures to include achieving improvements in areas that the Common Issues judgement highlighted. We are currently waiting a new proposal from Remco. The company is also likely to change the remuneration scheme for employees below the senior leadership group (a larger group than the group executive) to align incentive pay more closely to the performance of the relevant business unit.

7. Executive team and succession planning. POL's senior leadership team is in a period of significant transition. 2019 has seen the departure of the Chief Executive, General Counsel, Chief Information Officer and HR Director. Nick Read is also likely to restructure the leadership team and may make a significant number of senior hires, most likely externally.

BEIS0001127

UK Government Investments

Department for Business, Energy & Industrial Strategy

OFFICIAL-SENSITIVE: COMMERCIAL

8. We have seen numerous examples over the last year or so of the company lacking commercial expertise and being poor at execution. The company is also missing a strategy/corporate development function that can: address the many strategic questions the company faces; and coordinate and oversee the execution of specific projects/negotiations. We have raised this a number of times in the past and we are hopeful that Nick Read will take active steps to bring much more commercial DNA into the company.

9. <u>NEDs</u>. Following a selection process, POL has identified three lead candidates for the two open roles (all women, one BAME) and we expect them to request shareholder approval shortly. We are hopeful that they will be in place for POL's next Board on 29 October, but to guard against the prospect of a double gap on the Board, we have agreed to extend the term of one of the outgoing NEDs (Tim Franklin) until both new NEDs have joined the Board.

10. <u>New leadership at PO Insurance</u>. POI have appointed Ed Dutton as CEO to execute its growth strategy. Ed had previously been CEO of British Gas Insurance for 8 years. Rob Clarkson, the previous head is leaving the company. In addition, Tim Franklin has been appointed as POI Chairman.

11. <u>Culture change</u>. The litigation case has exposed historic failings in POL's dealings with postmasters and a degree of complacency in preparing for, and reacting to, an adverse judgment. At the UKGI Board, you indicated that you see the POL Board's attitude to 2019/20 bonuses as reflecting the same problem, and that culture change must become a primary focus for the senior leadership of POL and especially its Chair, Tim Parker. Encouragingly, POL's Board had a discussion on corporate culture at September's Board and UKGI's NED suggested they commission an 'organisational health check' to provide a clearer picture of the current situation.

12. <u>Engagement with the Chair</u>. You are due to meet with Tim Parker in October, to provide clear direction on BEIS's priorities. We would also expect to send a new Chair's letter in early 2020 to supersede that of January 2019. We would also recommend that you aim to meet with the Chair on a quarterly basis, in line with best practice across the UKGI portfolio.

13. <u>Framework Document</u>. POL is finalising a corporate restructuring for increased efficiency and to ensure a robust governance framework is in place. They have decided against forming a new HoldCo, instead moving their financial services operations into a new expanded Post Office Insurance subsidiary. They have provided external legal assurance that this will comply with the relevant FCA regulation. As part of the project, we are revising POL's Articles of Association and establishing a Framework Document for the first time. This will provide greater clarity on our relationship, governance requirements and information-sharing arrangements. Agreement has taken longer than expected, with POL's engagement generally slow and unduly legalistic. A few outstanding issues remain, focusing on Shareholder reserved matters and applicability of HMG pay

BEIS0001127

guidance, but following progress at the September Board, we hope to agree these shortly.

14. Compliance with pay guidelines POL have now agreed to stop offering private medical insurance (PMI) to new joiners and to state within the Framework Document that they will comply with guidance on public sector pay and terms. This is a positive development as it had been a sticking point for several months. POL is not currently required to comply with the £95k cap on exit payments but have indicated that they would face significant problems if they were. These relate to long-serving employees are covered by pre-existing agreements with unions, as well as the remuneration of their most senior executives.

15. Shareholder meeting. UKGI and BEIS will hold a formal Shareholder meeting with POLin November (date tbc) covering issues of both operational effectiveness and policy. While standard practice across the UKGI portfolio, this was a missing piece of POL's governance and holding them every six months been stipulated as a requirementwithin the new Framework Document.

16. Board review and Chair appraisal. POL completed a Board evaluation in January 2019. We have agreed with the SID to delay the next reviewuntil March 2020 to allow time for the new Board members to form a view on its effectiveness. It makes sense to carry out the Chair appraisal at the same time. This will be led by the SID and you will be invited to share your thoughts on the Chair's performance.

Financial and Operational performance

17. Trading update. POL achieved a trading profit of £24.5million in the first five months of 2019/20. This was ahead of budget by £1.9 million, falling to £0.3 million on a like-for-like basis that takes into consideration accounting and timing differences. Turnover has been slightly below budget due to challenging conditions in the travel business and across the Financial Service, Telecoms and Insurance divisions. Retail and Identity revenues continue to perform well. The improvement in profit reflects POL's continued progress on cost management. Annex A has more detail.

18. Investment spending. BEIS allocated POL £210m of investment funding ('change spend') for the period 2018-2021, of which they drew down £168m in 2018/19. While some projects have changed in scope and cost, the overall portfolio is on track to meet its budget. We are currently withholding the remaining £42m until POL provide a rolling 3-year lookahead on investment spend. Once this has been provided (now expected in October), we would expect payment to be approved. Annex B has more detail on POL's investment spending. You have received separate advice from Alex Cole recommending release of the Q3 subsidy payment. This advice also provides a detailed review of POL's performance against the obligations and criteria set out in POL's Funding Agreement

BEIS0001127

19. The company continues to have problems with the way change spend is authorised and controlled. We asked for greater disclosure and analysis in 2018 and asked for an internal audit to identify the issues with the change spend process and recommend changes. Despite this, problems have continued. This has highlighted that POL has been insufficiently focused on managing change spend and in future it will need to reduce its overall need for change spend and improve its efficiency if the company is to be genuinely financially self-sufficient.

20. Overall, the DMB restructuring programme seems to be managed reasonably well currently, but the record in IT is very mixed. The company seems to have done reasonably well when the organisation is focused on a small number of large and mission-critical projects. In the last year or two attention has turned to projects that are enhancements or provide essential new functionality and these have sometimes been more problematic. As a result, the company has been very slow in digitising its business in line with a coherent customer proposition across the group and developing good management information systems that can assist postmasters in running their businesses and POL in its decision-making. The company has recently recruited a new Chief Transformation Officer who is in the process of a major reorganisation of the approval and monitoring processes, which we hope should lead to an improvement.

21. Our experience on change spend has also informed our view on incentive pay. The company has been too focused on EBITDAS at the expense of managing the much larger value in change spend. The use of cash flow metrics would mitigate this problem significantly. We raised this at Remco in early 2018 but Remco wanted to stick with the existing focus on EBITDAS. We have moved this debate on significantly now as noted above.

22. <u>Network performance</u>. At the end of August 2019, there were 11,628 post office branches, comfortably above the network commitment of 11,500. In addition to the franchising programme (see para 32), POL also plans to open 220 new post offices in 2019/20 (92 have opened YTD).The use of outreaches has risen significantly rising 9.5% p.a since 2014/15, to reach 14% of the network (1,647 branches). Officials are exploring the role of outreaches as part of the long-term policy review. UKGI have encouraged POL to analyse the financial stability of its partners, which has raised concerns about some of the multiples which host post offices. McColls is the largest in this category, hosting over 650 branches. POL will now be developing mitigation plans.

23. <u>Network Accessibility and SGEIs</u> POL continues to meet the geographical access criteria (annex C). POL provides a range of Services of General Economic Interest ("SGEI") and UKGI has asked POL for assurance that these meet the contractual requirements with Government departments. This work is being carried out by POL's internal audit. The annual Network Report has been approved by Board and will shortly be layed in Parliament.

BEIS0001127

24. 5 Year Plan (5YP). POL has started work on a 5YP which was discussed at the Board's July away day, and also with UKGI. The plan sees growth in revenues through BF2 and improvements in FX and Insurance, and falling costs via a reduction in headcount, including completion of the DMB programme. While profits are forecast to grow, the business would not generate any cash despite the additional revenues from the banking framework, known cost reduction programmes and expectation that change spend should now fall significantly. In our view the plan we have seen should not be acceptable to the Shareholder and we have expressed that view to the company Nick Read will be reviewing the 5YP as part of his first 100 days and will also incorporate conclusions from the review of Agent Pay. We expect the 5YP to finalised before the end of the calendar year.

Government Strategy and Spending Review

25. Long term policy work: The BEIS Post Office policy team are working with UKGI, POL and other stakeholders to develop options to advise the Minister on the 16th October on the following areas:
    - Funding, ownership and commercial sustainability: we are exploring the feasibility of and case for continuing a Government subsidy post 2021, taking account of POL's aspirations to become commercially sustainable whilst recognizing the need to maintain a footprint that reflects POL's social purpose balanced against fair agent pay.
    - Sustainability of the network and workforce relations: we are exploring a range of options from reviewing network size, access criteria and definition of a branch to potential L&D and professional development support offers for postmasters (to complement POL's agent pay initiatives).
    - Role of social purpose: we are undertaking a review of cross-government agendas that could link with POL's 'social purpose' including the cross-government loneliness agenda (DCMS) and community assets agenda (MHCLG). We are also considering the role of community branches and exploring ways in which the social purpose could be better defined and measured.
    - Alignment of POL's activities with wider Government agendas: we will be undertaking further work to better understand opportunities linked to digitisation of Government services vs tailored support for vulnerable customers.

26. Future subsidy. POL's draft 5YP included a proposal for £30m of annual subsidy from April 2021. The 2018/19 cost of the uncommercial network was £67m so £30m of subsidy would meet State Aid requirements. The subsidy requirement will need to be considered in light of the long-term policy work, such as changes to the minimum network size or access criteria.

27. Subsidy waiver/dividend. POL feel that they are some years away from being able to pay a dividend. This is primarily because they may need to fund a

BEIS0001127

UK Government Investments

Department for Business, Energy & Industrial Strategy

settlement on GLO, but also because they want to finance significant ongoing investment (of which we are more sceptical– see above). Work is ongoing at official level to develop a suitable dividend policy, including the potential for POL to be able to instead waive the subsidy it receives.The aspiration for the payment of a dividend in futureis to be inserted in the Framework Document.

28. Investment facility. UKGI are working with BEIS Finance to develop a business case for an investment facility that POL could use to finance material acquisitions outside of BAU investment that it will be expected to finance itself from 2021. We aim to conclude agreement on the investment facility, subsidy and dividend policy as part of the next Spending Review.

POL Business Strategy

29. Agent Pay. POL is carrying out a Review of postmaster pay in light of an increase in resignations, difficulty in recruiting people to run a post office and significant parliamentary and media attention. POL is implementing some 'quick wins', increasing fixed remuneration by 10% for all community and hard to-place branches and bringing forward increases for banking transactions Plans for addressing more fundamental questions about the structure and level of postmaster pay will be brought to the Board in October, and officials are engaging with POL on this work These issues will be a crucial part of the 5YP and the wider issue of how to improve POL's relationship with postmasters

30. Royal Mail. Mails still represents a critical part of POL's business model. The existing agreement with Royal Mail Group (RMG) ends in January 2022, with exclusivity arrangements due to expire at the end of 2019. After a long pause, RMG have now started to engage positively and both sides are targeting an agreement on a new, non-exclusive 10 year deal early in the New Year. The high-level understanding between the parties is that overall the economics for POL should not change materially from the existing contract. Again, this would be a significant achievement for the company if delivered. POL appears well prepared for the negotiation, with a clear understanding of its red lines and aims for the new contract.

31. Royal Mail has received formal notice from CWU that it intends to ballot its members for industrial action. Experience suggests CWU are likely to win the ballot. We understand the earliest potential date of any action would be 29 October. POL is currently assessing the scope, areas and priority for contingency plans with Royal Mail. POLare able to draw on preparations made in of potential strikes in 2016/17.

32. Telecoms – Market Sensitive Information POL's July Board agreed that it would proceed with the process which would either extendPOL's contract with Fujitsu or replace Fujitsu with anothersupplier , depending on the successful bidder. This process is underway and is expected to achieve a significant cost saving. The alternative of a sale is alsoplanned and the timetable and expected valuation being developed. The Board will be updated in October.

BEIS0001127

33. Franchising. POL is continuing to franchise its Directly Managed Branches (DMBs). There are currently 151 DMBs and POL has exited 37 of the 69 DMBs they plan to franchise in this financial year This ongoing programme has led to a reduction in losses from this part of the network but continues to create noise in affected communities, mainly due to misconceptions in the consultation process. POL is currently reviewing its communications around the consultation process to mitigate these misconceptions and are due to report on the outcomes of this review on 30 September.

34. The Minister and officials are broadly satisfied that common concerns about decreased accessibility, service level and quality in franchised locations are addressed by POL on a case-by-case basis. We continue to work closely with POL to equip Minister Tolhurst to address concerns about specific cases. Customer satisfaction levels are typically high after franchising has taken place. Further, we also plan to engage with Citizens Advice who are currently carrying out research to better understand customer satisfaction and difference in quality of service between traditional DMBs and franchised DMBs. Whilst they are due to publish a report on their findings in January 2020, we plan to engage with their recommendations early and build this into ourlong term vision work, as appropriate.

35. BF2 and Barclays. All 28 major High Street banks have signed up to the renegotiated Banking Framework agreement, which will take effect from January 2020, but Barclays have made the decision to uniquely opt out of cash withdrawal services due to the increased rates. Minister Tolhurst wrote to Barclays UK CEO Matt Hammerstein on 5 August to express her disappointment with Barclays' decision. Matt Hammerstein responded on 19 August to outline Barclays' decision in detail and offered to talk officials through their analysis, which we have accepted. Minister Tolhurst has also written to John Glen MP (Economic Secretary to the Treasury) to suggest a call to discuss the matter further, which he accepted and is currently being set up. Following a conversation between Tim Parker and the Barclays UK Chair, Sir Ian Cheshire on 17 September, Sir Ian undertook a review of their decision, with the outcome of no change in their position. Barclays are due to start informing their customers on 9 October;we are working with POL to prepare communications for this.

36. As part of the renegotiated Banking Framework agreement, POL announced in April that postmasters would receive increased rates for cash deposits from October 2019. On 1 August following the July POL Board meeting, POL announced that they would be bringing forward the increased rates for cash deposits from October to August.

37. POca. Ahead of a meeting that was scheduled between Al Cameron and the then DWP SoS Amber Rudd for 22 May (but subsequently cancelled), you asked officials to send a note to DWP officials to provide background information and analysis on (1) the impact of removing POca from POL and (2) POL's suitability for involvement in the replacement scheme.Having worked

BEIS0001127

with legal and procurement colleagues, to ensure we do not encourage breach of procurement regulations, a factual note was sent by Carl Creswell to Nick Joicey (DWP Financial Director) and Tara Smith (DWP Finance and Banking Director) on 17 September 2019. We will keep you updated.

38. Bank of Ireland. POL and BOI have now signed a new agreement that will run until 2026, releasing POL from some exclusivity in areas such as SME and Investments offerings and improving the performance review and termination mechanisms. This is a significant achievement for the company. Separately, POL is seeking to reduce the costs of operating FRES, the travel money business run as a joint venture with BOI.

39. Cash logistics. POL undertook a strategic review into its cash logistics operations and presented findings at the July Board. It has decided against either a material acquisition or divestment in this area and will instead focus on optimising the current operation. It will look to develop its technology and explore commercial partnerships to reduce the cost of excess capacity in the market. POL is onboarding staff with relevant experience and creating a business case.

BEIS0001127

Annex A: Financial performance

Financial performance 2019/20 Year to Date (YTD)

	Actual (£m)	Budget (£m)	Variance (£m)	Year on Year
Retail (inc Payzone)				
Financial Services and Telco (inc Insurance)				
Identity				
Supply Chain/Other				
Total Revenue	IRRELEVANT			
Cost of Sales				
Net Income				
Agents Pay				
Staff Cost				
Non Staff Cost				
FRES				
Other Income				
Trading Profit	**24.5**	**22.6**	**1.9**	**17%**

Revenue

The Retail and Identity businesses are up compared to budget, predominantly driven by mails and banking. This was offset by weakness in Financial Services, Telecoms and Insurance mainly due to weak demand for foreign exchange and overseas travel The Telecoms business continues to face a highly aggressive market with heavy discounting.

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, while the majority of the remainder is due to the reallocation of GLO costs to other cost lines. Furthermore, Cost of Sales and Agent Pay have been impacted positively by lower revenues.

BEIS0001127

UK Government Investments

Department for Business, Energy & Industrial Strategy

OFFICIAL-SENSITIVE: COMMERCIAL

Annex B: Investment Performance

The latest quarterly update on investment performance came to the July Board. POL has reprioritised its portfolio to keep within its planned budget of IRRELEVANT A number of key projects were either delayed, put on hold or reduced in scope:

- Retail Point of Sale (IT integration to enable Post Office transactions from an independent retailer's till)
- Youth Strategy
- End User Computing (IT project looking at bringing the management of some hardware in-house)
- Self Service Kiosk procurement

In Q1, POL underspent by IRRELEVANT compared to budget, due to delays in four workstreams: PCI compliance, DMB franchising, BOI negotiations and target operating model. 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 are 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.

<u>Project spend and benefits, Q1 2019/20</u>

	Project Spend			Project Benefits		
Strategic Priority	Q1 FY1920 Actual	Q1 FY1920 Budget	Variance	Q1 FY1920 Actual	Q1 FY1920 Budget	Variance
Simplify the retailer proposition	IRRELEVANT					
Modernise our products and services						
Build innovative, flexible and secure IT						
Digitise and optimise the business						
Modernise our skills, polices and processes						
Non-UKGI Funded						
Total Change Spend						

Q2 2019/20 investment spending is forecast to be IRRELEVANT, including IRRELEVANT on the DMB programme, £IRRELEVANT on HR programmes, IRRELEVANT on supply chain and back office improvements and IRRELEVANT on group litigation. Expected benefits are IRRELEVANT within year. BEIS funding supports POL's investment programme, limited to projects approved at the Funding Agreement (Jan 2018). This does <u>not</u> include the legal costs of the litigation.

POL has allocated a further IRRELEVANT of investment spend for 2019/20 for responding to the outcome of the litigation, including updates to the Horizon system, accelerating the implementation of the field manager structure and updates to the Branch Hub. Little of this has been spent to date as the business cases are being developed and scrutinised.

POL have restructured this area of the business and appointed Dan Zinner to a new role of Chief Transformation Officer. Dan has been tasked with implementing a new

BEIS0001127

centralised investment spend portfolio aimed at removing duplication between different siloed business units. A follow-up to the UKGI-requested internal audit report into investment spend controls has been delayed to early.

BEIS0001127

UK Government Investments

Department for Business, Energy & Industrial Strategy

OFFICIAL-SENSITIVE: COMMERCIAL

Annex C: Network update

Branch numbers (as at end August 2019

Type	Mains	Local	DMB	Traditional	Outreach	Total
Number	3,411	4,019	158	2378	1,662	11,628

Programme	Commentary
Franchising	Plan to franchise 69 DMBs in 2019/20 (37 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 (92 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 361 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%	92.7%	99.4%	98.2%	98.6	4*

*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	11,491
2	Processing of national identity and licensing scheme applications	11,500	Client contract dependent
3	Universal payment facilities for public utility services	11,500	11,625
4	Access to postal services	11,500	11,625
5	Universal access to basic cash and banking facilities, especially for rural customers and those on social benefits	11,000	11,491