

**RESTRICTED – POLICY AND COMMERCIAL**

To: Secretary of State  
Ci: McFadden MPST  
Bender MPST  
Geoffrey Norris  
Stephen Lovegrove (ShEx)  
Marc Middleton (ShEx)  
Jo Shanmugalingam (ShEx)  
Susannah Storey (ShEx)  
Jon Booth (BR2)  
POL Team (ShEx)  
Jennie Fuller (LEGAL)  
Mark Fletcher (LEGAL)  
Ian Webster (MPST)  
Martin Simmons (FRM)  
Alex Thompson (COMMS)

From: Will Gibson  
Shareholder Executive

Tel: GRO

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**POST OFFICE NETWORK: FUTURE POLICY OPTIONS**

1. Following your 30 October letter to the Prime Minister, and the award of the POCA contract, what are the future policy options for the Post Office network?
2. We will need to settle the policy options in this paper early in 2009. Government's current funding commitment to Post Office Limited (POL) expires in March 2011. State aid approval processes, and POL's ongoing solvency, require us to agree a further funding deal for POL by the end of 2009. Without a new funding deal we can also expect increasing external speculation about the Government's commitment to the network.
3. While some of the ideas mentioned here have been discussed with POL management in the past few months, the contents of this submission have not been cleared with them.

**Recommendation**

4. That you:
  - (i) agree the policy objectives for the Post Office network (para 9);
  - (ii) consider the broad strategic options to deliver those objectives (para 11), and provide any initial views;
  - (iii) consider the timetable for negotiating and announcing the Government's next funding commitment to POL (paras 18 and 19); and
  - (iv) agree the next steps (para 20), including handling James Purnell's commitment to an MP task force on the future of the Post Office.

**Timing**

5. Routine – though the role of the “MP Task Force” will need to be settled before BERR Oral PQs on 27 November (see **Annex B**).

**Current Post Office policy**

6. The Post Office network has been in decline since the 1960s. The number of Post Offices closing accelerated through the 1990s, with significant reductions since 2000. This recent decline has been driven by consumers choosing to access Government services

## RESTRICTED – POLICY AND COMMERCIAL

(e.g. buying car tax discs) online and the move to paying benefits directly into bank accounts. As a result, Post Office Limited (POL) became loss-making in 2000. To maintain the network in the face of these losses, the Government provided £2bn between 1999 and 2005, and in May 2007 announced a further £1.7bn package to March 2011. This includes an annual £150m subsidy to support the non-commercial parts of the network. **Annex A** provides further background on POL's recent history.

7. The May 2007 funding package was designed to improve the sustainability of the network, in part by closing 2,500 branches. The funding package was predicated on a commercial plan to return POL to profitability (after the £150m annual subsidy) by 2011. Overall POL should just about meet this objective. However, revenue growth in financial services and telephony is falling short of expectations and additional cost savings will need to be identified.

8. In the longer-term the Government's publicly stated aspiration (shared by POL management) to date has been to eradicate the need for subsidy. The realism of this aspiration is highly questionable and we may have reached the point where we need to acknowledge that POL will always be a hybrid public service/commercial organisation.

### Policy objectives

9. Looking forward to the 2011 funding package our proposed objectives are:

- A. To maintain the future of a network of around the current size - 11,500 Post Office branches – and geographical distribution.
- B. To minimise the size of POL's requirement for public subsidy, by maximising POL's commercial and Government services revenues and running the organisation efficiently.
- C. To maximise POL's contribution to meeting Government's broader public policy objectives (e.g. social and financial inclusion) in a way that does not jeopardise the first two of these objectives.

10. There will be some tension between these objectives: the greater the size of the network, the greater the potential need for public funding. And unless relevant departments provide the required funding, supporting broader Government policy objectives could increase the overall need for subsidy. Government will only be intervening if there is a market failure preventing the private sector (so also POL) from providing a commercial service. We are working on the basis that your primary goal will be to maintain the size of network, provided we can demonstrate that the funding required represented value for money. This was a challenging test to meet in 2007, and will be so again.

### How can these objectives be achieved?

11. To maintain the size of the network, POL will need to develop a sustainable business for itself, and develop products which provide sufficient income and footfall to create viable businesses for individual subpostmasters. It will need to both increase revenues (profitably), and provide its services more cost effectively.

- **Maximising commercial and public service revenues**

There are four key opportunities:

## RESTRICTED – POLICY AND COMMERCIAL

Financial services: While POL has a wide range of financial services products (principally through its Bank of Ireland JVs), it is still a “niche” player in the market. It is looking to grow existing products but also to develop its offering to a full suite of financial services products. Key options and opportunities include:

- Introducing a transactional, interest-bearing current account.
- Considering whether the advantages of POL continuing to develop its business through its Bank of Ireland JVs continue to outweigh those of becoming a standalone provider. POL’s balance sheet would need to be completely overhauled, with very significant implications for HMG. Additionally, we would need to be confident that POL could develop in-house banking expertise. Additionally,
- Deepening POL’s ties with National Savings & Investments.
- Any DWP or HMT interest in providing direct funding to meet perceived market failures in the provision of financial inclusion products (e.g. Savings Gateway).
- Rebranding POL’s JV with Bank of Ireland as a “Postbank”.

Government services: POCA is POL’s principal Government contract, though this will decline over time as more people choose to have their benefits paid directly into a bank account. POL therefore needs to expand into a broader range of Government services. Key options and opportunities include:

- Providing ID verification services for passports, driving licences and visas.
- Making POL the physical channel for Government customers who do not use internet or phone channels (e.g. replacing local DVLA or HMRC offices).
- Securing further business from Local Authorities: disseminating local information, providing services (e.g. parking permits; registering births, marriages and deaths), or co-location with their own physical infrastructure.

While POL needs itself to be proactive in seeking new Government services business, BERR needs to be active in identifying opportunities for them within Government (see the suggested “Next Steps” at para 20 below) and reminding all parts of Government of the collective value of the Post Office network.

Mails services: As internet shopping has grown, there has been greater demand for services that allow customers to collect purchases from Post Offices. POL currently only provides this service for goods sent through Royal Mail. POL has also been looking at providing more flexible services for small businesses. Key options and opportunities include:

- Broadening POL’s collection service to encompass packages delivered by other mails providers.
- Developing models of service provision that make posting packages more convenient (e.g. automated “Post and Go” machines).

Customer experience: POL could also drive revenue growth by reversing the decline in its customer base through improved service. For example it could:

## RESTRICTED – POLICY AND COMMERCIAL

- Support its financial services strategy, through refurbishing larger town-centre branches with an appropriate bank-style layout.
- More widely, many of its branches would benefit from refurbishment, which might make potential customers more likely to visit Post Offices.

There will need to be a clear commercial business case for any Government funding to improve the branch infrastructure.

- **Improving cost effectiveness**

Subpostmasters currently receive fixed pay (similar to an annual salary) alongside variable income dependent on the volume of transactions they process. This contrasts with POL's competitors (such as PayPoint) which pay retailers solely on a transaction volume basis. POL's standard operating model is therefore uncompetitive.

POL has sought to address this issue by developing new delivery models. To date, these have principally been outreach services (e.g. vans) designed for rural communities. However, POL has recently developed a model that involves no fixed payments with subpostmasters paid on a per-transaction basis. This is the Post Office Essentials (POE) model Alan Cook talked to you about when he came in to see you last month.

POEs are based in local (independently viable) retail outlets, offering POL products during the shop's full opening hours. This is usually significantly longer than normal post office hours. Key options and opportunities therefore include:

- A large-scale (approx. 6,000) conversion of outlets from the traditional model to POE could put the network on a subsidy-free footing by 2016. This would either be through the compensated conversion of existing outlets, or closing an outlet and opening a new POE nearby. The efficiency gains would need to exceed compensation costs.
- Considering how best to minimise the perception that this represented any change to Post Office provision. Voluntary rather than compulsory conversions?
- Further rollout of low-cost outreach services in rural areas.

12. A large-scale conversion programme could prove controversial and the National Federation of SubPostmasters (NFSP) is unlikely to be supportive. If the objective is to take the future of the Post Office out of the political arena there may be a limit to our ability to pursue this option. However, in the longer term this may be an opportunity to significantly reduce POL's need for public subsidy and therefore the threat of further closures.

### Status and structure

13. Our current Post Office policy is predicated on the basis that POL is best able to maximise its revenues and minimise its costs by being a commercial, limited company. However, given that POL has received £3.6bn of public funding since 1999, and that Government will always be nervous about POL taking the steps it needs to reduce its cost base fundamentally, we should reassess whether that assumption still holds true. If the aspiration of a subsidy-free business is unrealistic, would it be better to bring it back under direct Government control as some form of agency?



**RESTRICTED – POLICY AND COMMERCIAL**

14. We need to do some urgent work to understand the detailed consequences of a change of status. On a preliminary view, the potential advantages are:

- It would potentially be easier for Government to route its services through POL without always having to go through a competitive tender process. We need to explore this matter further but our initial legal advice is that the more we make POL a part of central Government the smaller the procurement problems would become. However, this would limit the revenues POL was able to source from commercial services.
- Giving Ministers a greater degree of control over how POL spends its money.
- Other mail providers would find it easier to use the Post Office network.

15. The potential disadvantages are:

- Could make Ministers more directly accountable for the operational performance of the business and, for example, whether individual post offices remain open.
- It could jeopardise POL's contractual relationship with the Royal Mail letters business which represents c.30% of POL's revenues.
- It removes the possibility of using money held within the Royal Mail group which might in due course be available for ongoing funding for POL.

16. If there are significant procurement advantages to making POL a Government agency, we will consider whether there are any ways to minimise the potential downsides.

17. Any change to POL's constitutional status would require primary legislation. If we were to seek to add it to any 4<sup>th</sup> session postal services bill, it is likely to make an already exceptionally demanding timetable for that legislation undeliverable. Assuming it was not possible we would need to find a different legislative vehicle. This is unlikely to be a legislative priority and could well fall into the next Parliament.

**Funding deal**

18. These broad policy options will shape POL's 2011-16 strategic plan, which we will be asked to fund. It is only in announcing the next funding package for the network that Government will be able to demonstrate its long-term commitment to the network. Simply maintaining current subsidy levels would take us to c.£750m over five years, and with investment in the network (or any further deterioration in POL's financial position) this could reach £1.5bn. However, Treasury has already indicated that BERR should plan to receive a flat cash (or flat real at best) settlement in SR09, so any increase in the subsidy above the existing £150m per annum could well require compensating cuts elsewhere in the BERR budget.

19. State aid approval processes, and POL's ongoing solvency, dictate the need to agree a further funding deal for POL by the end of 2009 and we have had preliminary discussions with Treasury officials on this basis. It could be possible to proceed faster, though it would be stretching. **Are you happy with an end-2009 funding deal, or do you want us to aim for a faster timetable?** Treasury's commitment to negotiate with us and POL to an accelerated timetable would be key. We are unlikely to secure this commitment at official level: you would probably need to speak to the Chancellor to secure his personal commitment to an accelerated timetable.

## RESTRICTED – POLICY AND COMMERCIAL

### Next steps

20. We would suggest the following next steps:

- **Select Committee**

In a POCA debate on 10 November, James Purnell agreed to establish a task force of MPs to identify new services (beyond the POCA contract) that could help secure the long term viability of the post office network. Having discussed with Pat McFadden, we consider this would best be conducted through the Business and Enterprise Select Committee (BEC). Annex B provides further details. **We will need to settle handling before BERR Oral PQs on 27 November.**

- **Government business**

We believe that using the Cabinet Committee structure will be the most effective way of getting traction with other Departments to push POL's Government services offering. A number of your predecessors sought to increase Government business channelled through the network, with very limited success. Your commitment, and that of the Treasury, will be vital if we are to get a more constructive response. **As a start, we therefore propose that you chair a meeting of the Post Office Cabinet Committee** (MISC 33) to push ministerial colleagues. We will ask Cabinet Office to arrange this for before Christmas. **Are you content?**

- **POL commercial plan**

We will continue to engage with POL and HMT on the development and funding of its 2011-16 commercial plan. We will feed in any steers you are able to provide now on the policy options in this paper.

- **Media handling**

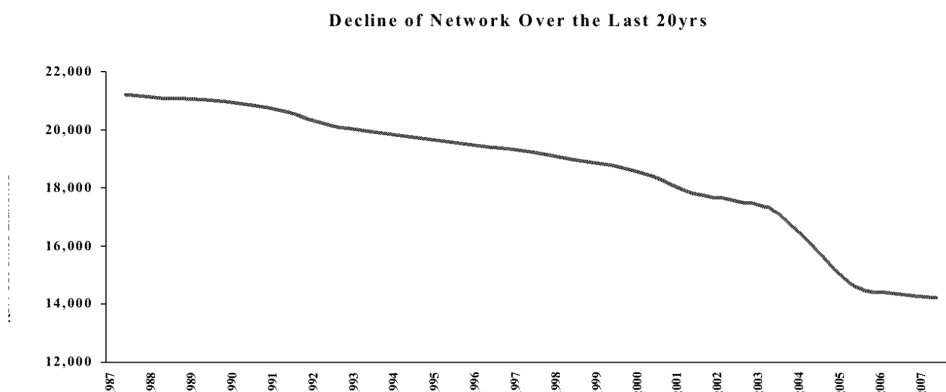
COMMS will provide you with separate advice on Post Office media handling.

**Will Gibson**  
**Shareholder Executive**  
**21 November 2008**

## RESTRICTED – POLICY AND COMMERCIAL

### ANNEX A – POST OFFICE OVERVIEW

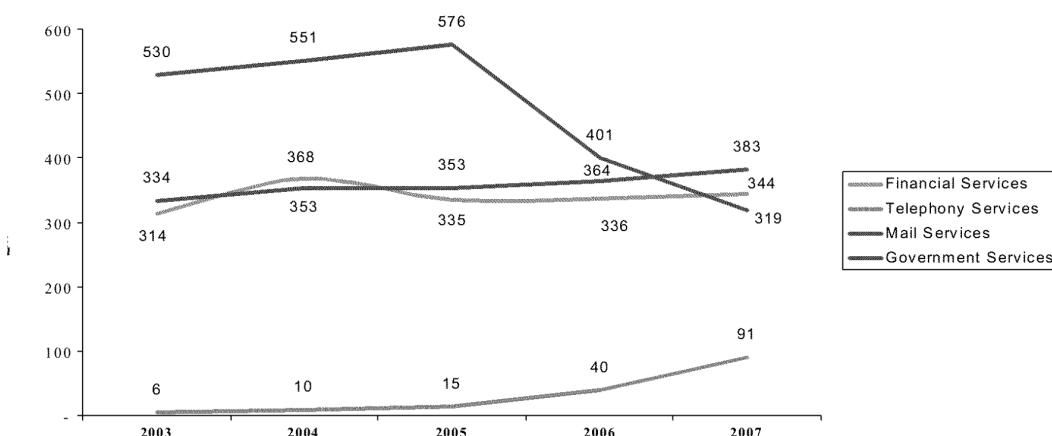
Over 20 years from 1986/87 to 2006/07, the post office network shrank by 7,000 offices from 21,200 to 14,200 (as set out in the graph below).



This included a Government funded programme of 2,500 urban office closures between 2003 and 2005. A second compensated closure programme (now virtually completed) has seen the closure of a further 2,450 offices, of which 500 will be offset by a new outreach (e.g. mobile van) service. At the end of this programme the network will comprise around 12,000 offices, of which some 7,500 are not commercial and supported by a Government social network subsidy of £150m a year until 2011. The non-commercial offices are predominantly in rural and deprived urban areas.

#### **POL revenue streams**

POL's revenues in 2007/08 were £1,268m of which mails services generated £335m (26%); financial services £326m (26%); Government services (incl POCA) £294m (23%); telephony £100m (8%), retail and lottery £58m (5%) and Government subsidy £150m (12%).



The chart above shows the trends in revenue mix over the past five years. The decrease in revenues from Government services corresponds to the move by DWP to pay more benefits via direct payment into bank accounts, leading to lower POCA revenues for POL as time has passed.

**RESTRICTED – POLICY AND COMMERCIAL****ANNEX B – MP TASK FORCE**

1. In a POCA debate on 10 November, the Secretary of State for Work and Pensions agreed, to a proposal from Lindsay Hoyle MP to establish a task force of MPs to identify new services (beyond the POCA contract) that could help secure the long term viability of the post office network.

2. Having discussed with Pat McFadden, we consider that this would best be conducted through the Business and Enterprise Select Committee (BEC). This has the advantage of:

- being a cross party group of MPs, constituted under Parliamentary procedures
- the BEC already having extensive knowledge of post office network issues
- allowing the Task Force to make an early start on its work. There would be inevitable delays in convening a new free standing body and identifying funding.
- Pat McFadden has established that Lindsay Hoyle considers the BEC to be well suited to take on the Task Force role. Soundings have yet to be taken of the Chairman, Peter Luff, but we would expect him to welcome the proposal as continuing to give topical political prominence to the Committee's role.

3. **Are you content that we ask BEC to take on the Task Force role? If so we will provide a letter for you to send to Peter Luff.**

4. It would be helpful to focus the direction of the Committee's interest. Based on its existing work, it can be expected to focus particularly on the scope for increasing Government (central and local) services through the network - making 'joined up' Government a particular (if long standing) theme.

6. A second area of particular interest will be in extending the range of financial services available at post offices, drawing on your recent letter to the Prime Minister, and the wider (also long standing) view that all High Street banks should allow access to their current accounts at post offices. Now only RBS and HSBC do not. It could be helpful to seek to encourage the Committee to consider the scope for new business opportunities for POL beyond central Government and Government Agencies.

7. There is also scope for some management of the Task Force's expectations at the outset. This could perhaps be achieved by an informal meeting of Ministers and Alan Cook, POL Managing Director, with members of the Committee.

8. Such a meeting would enable POL (on a confidential basis where necessary) to inform the Committee of products and services under development/negotiation and where potential sensitivities might lie. It would also enable a frank discussion about the requirements of competition and procurement law. This could help prevent the Committee saying for example, that the BBC TV licence contract, currently with Pay Point, must be returned to the Post Office, irrespective of relevant law.

9. **Are you content that the scope for a meeting of this kind be explored?**