

RESTRICTED – POLICY AND COMMERCIAL

To 1. Edward Davey; 2. Secretary of State
From Will Gibson
Date 9 January 2012

“Chairman’s Letter” to Alice Perkins, Chairman of Post Office Ltd

Purpose

1. A “Chairman’s letter” from the Secretary of State to Alice Perkins setting out her objectives and how we, as shareholder, expect her to approach the main issues facing Post Office Ltd as identified in the letter.

Recommendation

2. That the Secretary of State agree to send a Chairman’s letter to Alice Perkins. A draft is attached at Annex A.

Timing

3. Routine, although it would be useful to send at the earliest opportunity as Alice Perkins has been in post since September 2011.

Background

4. As shareholder, it is good practice for the Government to write to the Chairman of a Government-owned business to set out the areas of that business’s activities that the Government sees as important, and to make clear how the Government expects the Chairman to approach them.
5. You wrote to the Chairman of Royal Mail in similar terms in September 2010.
6. Following the successful passage of the Postal Services Act 2011, which has made possible the separation of Post Office Ltd from Royal Mail, Alice Perkins was appointed Chairman of Post Office Ltd. She assumed her duties on 23 September 2011. Ms Perkins has quickly grasped the issues and challenges facing the company, and now is an appropriate time for Government, as shareholder, to outline its expectations.
7. The letter is comprehensive. It covers, inter alia: composition of the Board (you wrote separately to Alice Perkins in October regarding ShEx representation on the Board of a separated Post Office Ltd – copy attached at Annex B); Governance issues; Separation from Royal Mail; the Commercial Strategy, including network transformation, income from government services (the ‘Front Office for Government’ concept), and financial services; Mutualisation; and Communication. Alice Perkins will be expecting this letter (she has seen a draft), and the views expressed have been raised with her by either Ministers or officials already. However, it is important that these be on record going forwards.

Cc: PS/SoS; PS/Davey; PS/Willetts; PS/Perm Sec; PS/SPAD; Stephen Lovegrove; Susannah Storey; Roger Lowe; Rachel James; Mike Whitehead; Jane Hoy; Peter Batten; Katie Wake; Josh Coe

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Annex A

Draft Chairman's Letter to Alice Perkins

Alice Perkins
Chair
Post Office Ltd
148 Old Street
London
EC1V 9HQ

January 2012

I am delighted you have taken on the role of the Chair of Post Office Ltd and I enjoyed meeting you on 3 October last year to hear your initial impressions. I believe, as I know you do, that the reforms of the Post Office and Royal Mail that we are taking through offer an opportunity for us to develop a sustainable Post Office network that, as a nation, we want and need.

As I mentioned in my letter to you of 25 October last year, I thought I should write to explain how the Government will approach its role as ultimate shareholder of Post Office Ltd over the next few years.

Backed by significant Government commitments, this is a period of unprecedented opportunities for Post Office Ltd. Principal among these are:

- a refreshed Post Office Ltd Board operating under your leadership;
- separation from Royal Mail, allowing both companies to focus on their core businesses;
- £1.34bn of Government funding to March 2015 to maintain the Post Office network at around its current size and coverage, to finance network transformation that will reduce its future reliance on subsidy from Government and to support Post Office Ltd's ambitious strategy to grow new revenues;
- the potential, in time, for ownership of Post Office Ltd to be converted to a mutual structure, giving stakeholders a greater say in the business.

Board and Governance

The proposed separation of Post Office Ltd from Royal Mail Group is an important part of the process outlined during the passage of the Postal Services Act and it brings with it necessary governance changes. It is important that Post Office Ltd can flourish under a strengthened Board, providing increased levels of oversight and challenge to the company. Under your leadership as Chair, it is important that the Board's oversight of Post Office Ltd is strengthened through these changes.

One of your immediate priorities will be the appointment of further non-executive directors to bolster the Post Office Ltd Board. I very much welcome Neil McCausland's appointment as senior independent director. A further non-executive appointment will need to be made swiftly. I understand that you are making progress

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in identifying candidates. As we have discussed, and as referred to in my letter of 25 October last year, I expect a Shareholder Executive official to take a position on the Post Office Ltd Board from the point of operational separation from Royal Mail this spring. You and Stephen Lovegrove are in touch to finalise how this change will be implemented.

I understand that the company's executive team has also undergone significant change in recent months, with new appointments made recently to the positions of Finance, Commercial, Human Resources and Financial Services director. It will be important to ensure a continued mix of skills and experience on the Board and executive which equips the business to meet the challenges it faces. As Post Office Ltd separates from Royal Mail, it will inevitably need to increase its corporate capacity, posing a greater leadership challenge to the executive team. Once you have completed the establishment of the Post Office Ltd Board, you should meet with the Shareholder Executive team to discuss your impressions of the current Board and executive and what, if any, further action needs to be taken.

Board reviews should be conducted annually, with the review to be conducted by an external consultant every other year. Shortly after completion, the results of each year's Board review (whether internal or external) should be shared and discussed with the Shareholder Executive team.

Following operational separation from Royal Mail, it is also important that Post Office Ltd's corporate governance conforms to best practice, for example by establishing appropriate remuneration and audit committees.

Separation

I am committed to the separation of Post Office Ltd from Royal Mail. This is not just because it is the Government's policy to introduce private capital to Royal Mail. I also believe that separation will allow each company to focus on its core business. However, the two businesses are obviously natural commercial partners, and they need to have a positive long-term relationship. It will be necessary to ensure the correct protocols and behaviours are in place to buttress the commercial terms of that partnership following separation. In working together during the run up to operational separation at March 2012, it will be important to find a suitable modus operandi for the two companies.

The commitments of Donald Brydon and Moya Greene that the longest legally permissible distribution agreement would be put in place between the two businesses were particularly important in securing Parliamentary support for the Postal Services Act. The businesses must now deliver on those commitments.

The separation of the two businesses is inevitably involving detailed negotiations. These are commercial negotiations and it is right that they have been conducted by those who know each business best – their managements. The final commercial agreements will therefore need to have been expressly approved by the Post Office Ltd and Royal Mail Holdings plc Boards before they are finalised. As the only shareholder in each business we are obviously keen to remain informed on the progress of separation and you should continue to provide regular updates to the Shareholder Executive team.

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The separation process should ensure operational autonomy for each business as soon as possible and certainly by the implementation of the pension solution, following state aid approval. I recognise that Post Office Ltd will need to build certain capabilities so that it can function effectively as a standalone business. However, in doing that it should also ensure that separation costs are minimised, and that one-off costs are incurred only as and when necessary. This is particularly important given that no provision was made for separation costs in Post Office Ltd's October 2010 strategic plan, and any such costs will need to be absorbed by the business within the funding envelope based on that plan. This may mean that moving to a "sister company" structure, in which Government's ownership of Royal Mail and Post Office Ltd is held through Royal Mail Holdings plc as a shared holding company, is likely to be the most sensible initial step. There would then be a later full separation at the point of any Royal Mail transaction or Post Office mutualisation.

Commercial Strategy

Over the course of the spending review period, Post Office Ltd is obliged to maintain a network of at least 11,500 outlets, while continuing to meet the Government's access criteria. Maintaining the Post Office network at around its current size requires significant subsidy from Government. In 2010, Post Office Ltd presented to Government an ambitious strategy to maintain the network while reducing reliance on subsidy over the longer term. As part of the October 2010 spending review, the Government committed £1.34bn to fund the delivery of that strategy to March 2015. There are two major elements to the strategy: transforming the network and growing new revenues.

Transforming the network

Post Office Limited is committed to delivering a roll-out of around 4,000 Main Post Offices and around 2,000 Post Office Locals over the spending review period. Piloting of these models is currently underway, with 139 Locals and 14 Mains already up and running. The piloting process will yield important information on which models best serve which community, and improvements that can be made to each. A further critical element of the transformation is Post Office Ltd's commitment to eradicating the losses sustained by the network of 373 Crown post offices, which currently run at c.£60m a year.

A transformation programme of this scale is a significant undertaking. Post Office Ltd has an impressive record at running such programmes efficiently to time and budget. It is imperative that you and the Board ensure that this programme continues that record and that this is demonstrated to Government. Prior to the large-scale rollout of the plan, I expect the Post Office Board and management team to work with Shareholder Executive officials to develop the most appropriate set of key performance indicators by which the company's progress in implementing the transformation can be measured. This work should include the arrangements to be put in place for engaging with customers and communities over any significant change in their service provision.

Network transformation is critical to the success of the commercial strategy and it is notable that on current forecasts there will still be a significant proportion of the network operating on an outdated model by March 2015. I am pleased to note that Post Office Ltd's current financial performance is £38m favourable to budget and that you intend to apply the proceeds of this outperformance towards the more rapid implementation of the network strategy. I welcome this, and I am keen that any

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future out-performance continues to be applied prudently, after consultation with Shareholder Executive officials, towards reducing the level of risk associated with Post Office Ltd's commercial strategy.

Growing new revenues

The Post Office Ltd strategy for the next few years sees a significant growth in new Government services income. The strategy focuses the business on the opportunity to become the Front Office for Government, by providing the face-to-face services that will still be required to support a digital by default approach to service delivery on behalf of Government. Opportunities identified to expand revenues focus on application services (including "assisted digital" applications), identity verification, and payment services. Post Office Ltd is looking to expand its offering in these areas through working with both local and national Government.

The success of this element of Post Office Ltd's strategy will depend greatly on its ability to identify early the developing service requirements of relevant organisations, working with them as necessary to tailor its offering and proactively sell into local and national Government. It will be important to ensure that the team tasked with delivering this work has the requisite skills and is sufficiently resourced. Ministers and officials in BIS stand ready to assist you in this effort.

Given the tight fiscal environment, the savings that Post Office Ltd can deliver for Government departments and local authorities by offering these services will be of critical importance. Similarly, the requirements on public bodies to deliver value for money to the taxpayer and to conduct competitive tenders mean that it is all the more important for Post Office Ltd to manage its costs carefully, successfully implement the network transformation plan and to submit the most competitive bids it can. To do otherwise would hinder its ability to win this business.

Finally, any focus on opportunities to win new Government business should not prevent Post Office Ltd from seeking to maximise profitable revenues in other areas – for example through the provision of financial services. I am committed to supporting the expansion of accessible financial services products at the Post Office, and I am keen that Post Office Ltd builds on the good progress that has already been made, for example through the recent introduction of Junior ISA accounts.

With the recent introduction of RBS (including Natwest), around 80% of people can now access their current accounts at the Post Office and it is important that Post Office Ltd progresses its discussions with HSBC and Santander with the aim that this becomes 100% in the near future. I am aware that Post Office Ltd is currently investigating how it might introduce its own branded transactional accounts in the future. This could expand the business's customer base and also ensure the company is well positioned to offer access to benefit payments, as DWP further develops its delivery plans for Universal Credit and Post Office Card Account arrangements are replaced over time. I am also aware that Post Office Ltd is currently negotiating amendments to the terms of its POFS joint venture with Bank of Ireland and I support the company's push to maximise its revenues from that partnership. However, the duration of the joint venture should not be extended to achieve this without significant changes to increase Post Office Ltd's ongoing flexibility in this area.

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Provided that the commercial strategy is successful, I believe that the Post Office could be well suited to a mutual model in due course. This would help to align the interests of stakeholders like sub-postmasters, customers and staff better with those of the business. Carefully implemented, mutual ownership could also enhance the business's commercial flexibility. As you are aware, on 19 September last year Edward Davey launched a public consultation to develop further the mutualisation options identified by Co-operatives UK in their report on the topic from May last year. This consultation closed on 12 December last year and I expect us to publish our response in the spring.

A suitable mutualisation proposal must achieve the balance of sufficiently engaging the population of members, while allowing management the space to get on with running the business without undue burden or cost. Any change of ownership structure will also bring with it a range of operational issues that will need to be carefully considered. Your assistance in advising this Department on the practical implications of potential mutual models will be extremely important.

Given the need for commercial sustainability and significantly reduced subsidy, a formal transfer of ownership to a mutual model may be some years away. A successful transition to a mutual will also require the continued building of strong, two-way, stakeholder relationships between the business and, among others, its staff, subpostmasters and customers. This is a process which can and indeed must be advanced prior to any formal transfer of ownership if a mutual Post Office is to flourish. I would appreciate it if you could reflect on this and discuss the options with the Edward Davey and Shareholder Executive early this year in advance of the publication of the Government's response to the consultation.

Communication

The day to day relationship between the shareholder and Post Office Ltd will be conducted through the Shareholder Executive. Susannah Storey, as you know, is responsible for the Royal Mail and Post Office team and Will Gibson is the company's main point of contact. Stephen Lovegrove, of course, has overall responsibility for the Shareholder Executive. As now, I would like all proposals from the company to be discussed with the Shareholder Executive prior to them being presented to Ministers.

You and Edward Davey should meet on a regular basis, to discuss progress on the issues set out in this letter and other issues that will arise during your term. I understand that you and he had a very constructive initial meeting on 19 October last year and that his office will contact yours to put further dates in your diaries. This does not, of course, rule out your speaking with us between these meetings as appropriate.

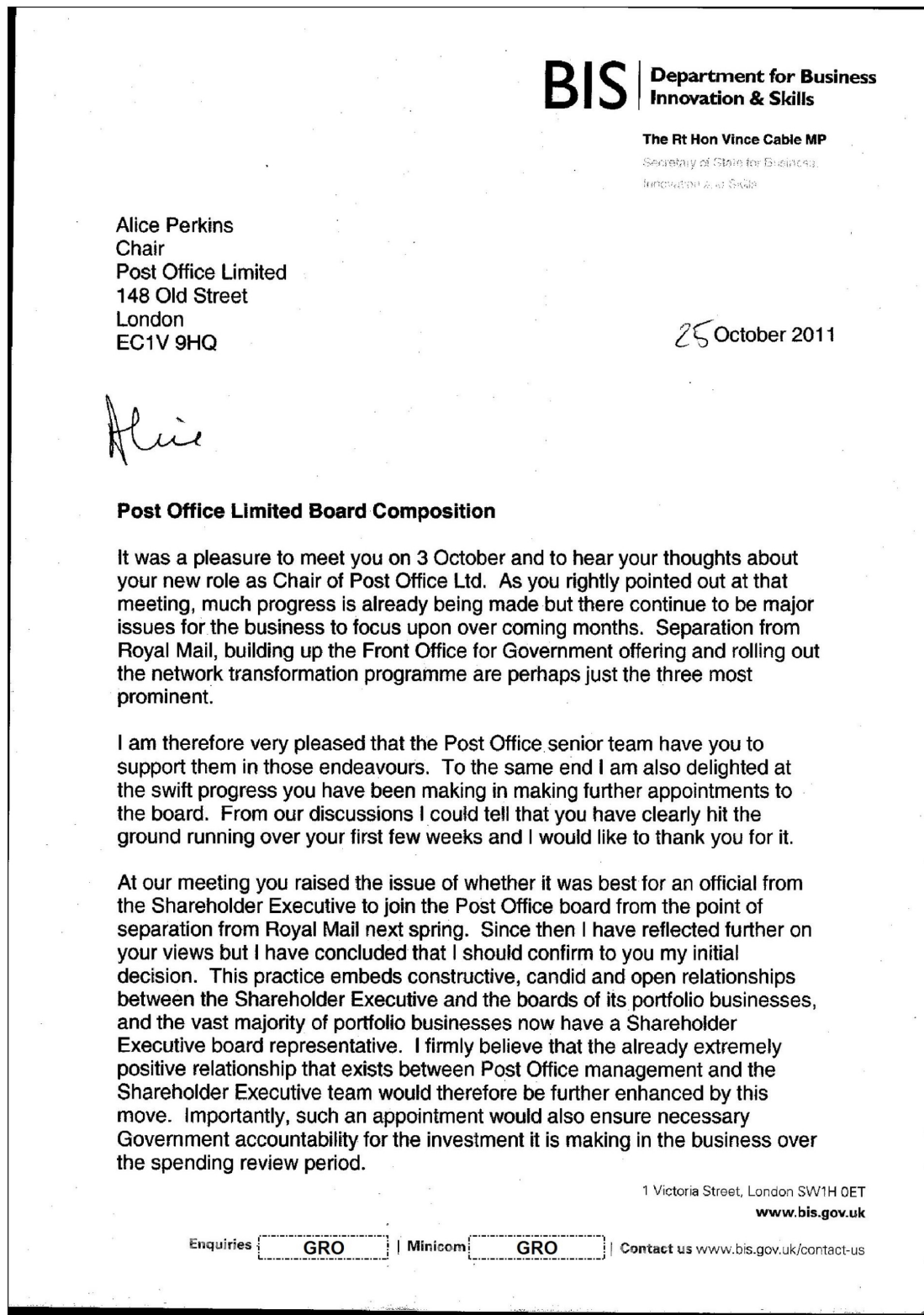
Finally, on a personal note, I would like to wish you well on your stewardship of one of our most important and well loved national assets during this critical period in its development.

Etc., etc..

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Annex B

Copy of letter sent to Alice Perkins regarding ShEx representation on POL Board



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I would also like to reassure you that any Shareholder Executive appointee would be subject to the full range of legal duties applicable to other directors. So there would be no risk that such an appointment would lead to any diminution of the arm's length relationship between Government and the business.

I will write to you in more detail in a few weeks' time to set out in more detail my objectives for the Post Office over the next few years. However, given its relevance to your ongoing work to form the Post Office board, I thought you would appreciate clarity on this one issue at an early stage. Stephen Lovegrove will be discussing with you the identity of the individual the department nominates in the coming days.

GRO

VINCE CABLE