

Restricted - appointments

To:

Secretary of State
Mr Fitzpatrick

From:

Stephen Lovegrove
Royal Mail Team & Postal Services Team
Shareholder Executive
V660
215 6191
6 December 2006

ci Brian Bender
Richard Gillingwater
Martin Bryant
Susannah Storey
Liz Baker
Aileen Boughen
Martin Sheehan
Robert Faull
Donald McNeill
Oliver Bayne
SPAD

ROYAL MAIL BOARD COMPOSITION: NON-EXECUTIVE DIRECTORS

Issue

A refresh of the non-executive directors on the Royal Mail Board.

Recommendation

2. That you:

- note that, apart from Margaret Prosser and Helen Weir, the 4 remaining non-executive directors appointments come to an end on 31 December 2006. All 4 have been with the company since January 2003 (see attached list at Annex A);
- note that we understand that John Neill probably wishes to leave the Board, and we would welcome this in the interests of better balance. However, he recognises the delicate state of the company at the moment and Richard Handover has suggested a short extension to his contract (up to three months) to avoid a short term destabilisation of the Board;
- Richard Handover and David Fish have indicated that their wishes will be influenced by the employee shares decision. They will want to renew for a full term should they believe that a decision on shares is reached that offers a “credible” way forward for the group, and, subject to the chairman’s views, we would be content with this as they are two of the more effective members of the board and would represent helpful continuity. In the meantime a short 3 month extension has also been suggested for them;
- Sir Mike Hodgkinson is ready to retire. He would like to leave the Board at the end of the January Board meeting and, hopefully, when there has been an announcement on POL allowing him to bow out with grace. This will mean a very short extension to his appointment;
- as a consequence, agree that we reappoint Neill, Handover and Fish for up to three months and Mike Hodgkinson for up to one month. This will give time

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for the new Deputy Chair to carry out a review of the Board and lead the recruitment process for new non-executive directors.

Timing

3. Routine. But we should advise the non-executive directors of the position before Christmas and need to carry out the formal consent procedures before the end of the month.

Background

4. My submission of 21 June set out ShEx's strategy for refreshing the Royal Mail Board. It also gave our assessment of the performance of the non-executive directors whose terms come to an end on 31 December 2006. The Deputy Chair recruitment process set out in the submission has now been substantially completed and you are considering the suitable candidates.

5. Once the Deputy Chair has been appointed, we expect them to carry out a review of the Board to confirm that it is Higgs compliant and that it follows corporate governance best practice and to lead any non-executive director recruitment. Our primary concern will be to ensure that any new non-executive directors are truly independent. While the Royal Mail non-executive directors' post are not Secretary of State appointments, a near OCPA process is followed and your consent to the appointment is required under the Articles of Association of the company. As is normal practice, ShEx will be represented on the selection panel for these posts.

6. Following discussions with the four non-executive directors and Allan Leighton, all have indicated that, if your decision is decisively against employee shares, they are committed to a sensible and orderly transition on the Board. John Neill is, however, likely to wish to leave even if employee shares go ahead. The Deputy Chair will replace Mike Hodgkinson as Senior Independent Director and Mike will leave after the Royal Mail Board meeting in January and the POL announcement.

7. Mike Hodgkinson is also the Chair of POL. Whether or not there should be such a post, given that Alan Cook now reports direct to Adam Crozier on the post office network, is something that we expect the Deputy Chair to consider during his Board Review.

8. Allan Leighton's own appointment runs out in end March 2008. It is certainly possible that he will leave before that and we have heard persistent rumours that, whichever way the decision on shares goes, he is considering an exit in the summer of 2007. Leighton himself, however, has assured us explicitly that his first priority is the stability of the company and he will not do anything to disturb that, and will certainly not leave in an over-hasty way.

9. With regard to the executive directors, David Burden, the Chief Information Officer, has indicated that he will retire next summer.

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10. As far as, the retention of an HR Director (currently Tony McCarthy) and a Chief Information Officer on the main Royal Mail Board, we again expect that this is something that will be considered in the Deputy Chair's Review.

STEPHEN LOVEGROVE

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Annex A

ROYAL MAIL NON-EXECUTIVE DIRECTORS

	Appointment date	Expiry date
Sir Mike Hodgkinson	1 January 2003	31 December 2006
David Fish	1 January 2003	31 December 2006
Richard Handover	1 January 2003	31 December 2006
John Neill	1 January 2003	31 December 2006
Margaret Prosser	1 November 2004	31 October 2007
Helen Weir	1 January 2006	31 December 2008

note: Bob Wigley resigned as a non-executive director on 31 October 2006.

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Annex B

To:

Secretary of State

From:

Stephen Lovegrove
Royal Mail & Postal Services Team
Shareholder Executive
21 June 2006

ci Jim Fitzpatrick
Brian Bender
Richard Gillingwater
Mark Higson
Stephen Lovegrove
Liz Baker
Susannah Storey
Robert Faull
Oliver Bayne
Erica Mallon
Jessica Thai
SPAD

Issue

The extension of the appointments of five Royal Mail non-executive Directors until 31 December 2006 and the future composition of the Royal Mail Holdings Board.

Recommendation

2. That you:

- agree that four of the five non-executives whose terms run until 30 June 2006 should be extended to 31 December 2006 on the basis that, in the intervening six months, SHE will hold top level discussions with Allan Leighton about the future composition of the Board. The fifth non-executive who falls into this category only wishes to have his appointment extended to September, after which he proposes to step down from the Board and we recommend that you agree to this;
- note our preliminary views about the composition of the Board and agree that, in our discussions with Allan Leighton, we should seek:
 - to reduce the size of the main Royal Mail Holdings Board;
 - to ensure that the non-executive team is truly independent; and
 - to appoint a Deputy Chair who would also act as the Senior Independent Director (and be a potential future Chair)
 - to establish immediately with the company the board review that we have requested, and the ways in which we can co-ordinate this with the other governance changes we need, particularly on skills balance and shareholder relations.

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3. We will need to discuss with you the best way to handle what are delicate decisions without precipitating unhelpful conflict with the Board and Chairman at a time when a number of critical decisions, such as the share scheme, are still outstanding. For instance, should you decide to approve any form of share scheme, it may make sense to link the communication of this to less palatable messages on the composition of the Board.

4. You highlighted the need to refresh the Board in your letter of 17 May to Allan Leighton prior to the announcement of the company's results and the proposed finance framework.

Timing

5. Routine. But we should begin the process of reappointing the NEDs before 27th June.

Background

Current size of the Board and Best Practice

6. At present the Royal Mail Holdings Board has fourteen members - six executive directors; seven non-executives plus the Chairman. A full list of the Board is shown at annex A. While there is no prescription for the size and composition of a Board, the Financial Services' Agency's Combined Code sets out recommended best practice and guiding principles. It states that the Board should include a balance of executive and non-executive directors (in particular, independent NEDs) so that no individual or group of individuals can dominate the Board's decision making. It also states that the Board should not be so large as to be unwieldy but be of sufficient size that the balance of skills and experience is appropriate to business requirements and can be managed without undue disruption.

7. In the case of Royal Mail's current Board, we believe that we meet the letter of the principle for the right balance (although we have some concerns about the true independence of some NEDs) but consider that the Board has become too large.

How we got where we are

8. When the Post Office was transformed into a public limited company in 2001, the existing Board of the Post Office corporation was transferred across to become the Board of Royal Mail (then Consignia). It soon became clear that the Board did not have sufficient commercial skills to address the problems of the business. When Allan Leighton was appointed Chairman in March 2002, the business was already in financial difficulty and it was recognised that the Board needed strengthening. Several of the new recruits, in particular the NEDs and Adam Crozier, had previous connections with Allan Leighton. The shareholder was content for them to be appointed as the business was in trouble and the people being put forward had a wealth of commercial experience and would indeed enhance the Board's skills and experience base. Most of the appointments were made prior to Derek Higgs' report in 2003 which informed the principles set out in the current Combined Code.

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Our relationship with the Board

9. The shareholder/Board relationship has been far from ideal. It is expected that there will always be some element of tension between the two parties but at various times over the last three years the company has indulged in gaming and has tried to apply pressure on the shareholder without taking due consideration of the fact the shareholder is the Government and has to work within certain constraints (albeit that we strive to act as a commercial shareholder). This has manifested itself in the company refusing or being slow in providing information; threats of resignations and insolvency; and the playing out of issues in the media. There has been no shared vision of the ideal profile of members of the board, with difficulties arising over the appointment of Baroness Prosser and the need for at least one board member to have regulatory experience. There has also been poor consultation over key executive appointments in letters, POL and the finance function. In a word, "trust" is missing from the relationship.

10. There is an agreed shareholder/company relationship document (attached at Annex B) but it is not always followed by the company.

How can we address the problems

11. We believe that the fact that the Board has been pulled together by Allan Leighton, albeit in circumstances where this was necessary to address the company's problems and to turn it round, is detrimental to the balance of the Board, in terms of independence, and its relationship with the shareholder. In particular, it is normal for the shareholder to have confidence and a close relationship with the Senior NED (in this case Mike Hodgkinson) but this has not been possible to develop. On several occasions Sir Mike has shrunk from raising matters with the Chair which he had been specifically asked to, for instance our concerns about the quality of the FD and recent threats of insolvency. More broadly, at one stage, Allan Leighton opposed our proposal for a series of regular meetings between the shareholder and the NEDs. Even now there are only a few ad hoc meetings and a formal annual lunch. We do, however, meet the Remuneration and Nominations Chairs quite frequently.

12. We believe that getting the Board composition right and refreshing the NEDs is the best way forward to improving the shareholder relationship and also to enhance the decision making processes of the Board going forward. Our intention would be to become more involved in the recruitment process at all stages so that we are confident that the people selected for the Board are acceptable to us and, in the case of the NEDs, are appropriately independent. The Treasury supports the idea of refreshing the Board. These matters were explicitly addressed in the term sheet agreeing the Royal Mail's financial framework signed by the company and us on the 17th May, and referenced in some detail in the letter from you accompanying that term sheet.

Renewal of 5 NED posts

13. The refresh process should start with the five NED appointments that come to an end on 30 June 2006. That so many of the non-executives have come up for renewal at one time is symptomatic of our broader relationship with the Board. We originally recommended to Allan Leighton that these appointments should be extended by twelve

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months to the end of 2006 so that we could consider Board composition. However, there has been an element of gaming as we have been constantly told that the NEDs were considering their positions in the light of the decision on the investment case, and would only review for six months.

14. We believe that we should propose to Allan Leighton that these appointments, bar that of Bob Wigley, should be extended to 31 December 2006 to allow us to discuss with him the composition of the Board.

15. At Annex C, we attach a list of the five NEDs involved together with an indication of how we consider they have performed and whether they wish to remain with the company.

Future Composition

16. As set out above, we believe that a Board of fourteen members has the potential to be unwieldy. It would be our strong preference to reduce the members of the main Board to a more conventional level of eleven or twelve members.

a) Executive Directors

Currently there are six members of the Executive Board. There are broadly two possible approaches to the executives:

1. Remove the two least important members of the Board (the HR Director and the Chief Information Officer). This is likely to be resisted by both these Board members and the Chairman;
2. Allow the executive members of the Board to reduce to five of its own accord, as one member, the Chief Information Officer, is due to retire in the course of the year and it would be possible to persuade the Board not to replace him.

b) Non-Executives

17. Given the reduction in the executive Board, the number of NEDs should be reduced to five or six plus the Chairman, depending on how many Executive Directors go. Helen Weir and Margaret Prosser would be expected to serve their terms. We propose that, at a minimum, Wigley's post should disappear after his term comes to an end in September.

18. We also recommend that Mike Hodgkinson should be replaced, as, we believe, does the company. His replacement would be the Deputy Chair of Royal Mail and Senior Independent Director with a specific remit to establish and maintain an appropriately open and effective relationship with the shareholder. We would not expect the Deputy Chairman also to be, as is currently the case, Chairman of POL, as POL is no longer separately managed from the Royal Mail Group. When making this appointment we should also consider succession and appoint a candidate that could eventually take over as Chair (when Allan Leighton's term comes to an end in 2008 or

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should he wish to leave earlier). This may mean we have to go through a full Nolan process.

19. There are two possible approaches to the other non-executives (David Fish, Richard Handover and Jon Neill), depending on the level of resistance from the Chairman and the number of executive directors remaining:

- (i) Replacing or removing two of these three Directors;
- (ii) Replacing or removing only one of them, probably John Neill.

We will need to discuss with you how far it is appropriate to push on these decisions, having regard to the need for both a significant refresh and, for continuity.

c) SHE involvement in recruitment process

20. We wish to have greater involvement in the recruitment process for both executive and non-executive Directors. The executive team is settled with three new appointments having been recently made. In the short term, this will effectively mean involvement in the recruitment of new NEDs including the Deputy Chair. We intend to insist that the shareholder be involved in the selection panel and the recruitment of head-hunters. This may well be resisted by Allan Leighton (he previously showed great resistance to Patricia Hewitt's insistence that there should be a NED with trade union experience on the board - Margaret Prosser was eventually appointed) and there needs to be several difficult conversations with him to get this right. It will also take time and this is why we have recommended that the NEDs currently on the Board should be rolled over to 31 December 2006.

21. It was also a requirement of the letter of 17th May that Royal Mail institute a proper independent Board audit process, strongly resented by Allan Leighton. In the short term we would propose that the headhunters appointed conduct a very short preliminary review of the ideal skills balance on the Board in order to inform the subsequent recruitment process, with a fuller Board audit to be conducted when the new Board is in place.

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Annex A

Current Composition of Royal Mail Holdings Board

Allan Leighton, non-executive Chairman (term ends 31 March 2008)
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Executive Directors
Adam Crozier, Group CEO
Ian Griffiths, MD Mails
Alan Cook, CEO POL
Ian Duncan, Finance Director
Tony McCarthy, Human Resources
David Burden, Chief Information Officer

Non-Executive Directors	Term of appointment ends
Sir Mike Hodgkinson	30 June 2006
Richard Handover	30 June 2006
Margaret Prosser	30 October 2007
David Fish	30 June 2006
Bob Wigley	30 June 2006
John Neill	30 June 2006
Helen Weir	31 December 2008

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Annex B

ROYAL MAIL SHAREHOLDER RELATIONSHIP

introduction

1 The Memorandum and Articles of Association of Royal Mail Holdings, and Company law, define the formal statutory relationship between the Company and its shareholder. This document, agreed between Royal Mail and DTI, builds on the letters exchanged between the Chairman and Secretary of State on 20 and 22 March, 31 May and 13 June 2002, and sets how the day-to-day shareholder relationship will work in practice.

overall aim

2 Royal Mail and its shareholder share the common objective of having a working relationship in which

- the roles of each party are clearly defined;
- each party recognises and respects those roles, and the demands placed upon each party to fulfil them;
- dialogue and interactions are professional, efficient, and based on trust.

Government as shareholder

3 Unlike a listed company, Royal Mail does not have a quoted share price nor is it subject to rigorous external financial analysis – the means by which a shareholder would normally assess a company's performance. In the absence of these mechanisms, the basic relationship between Royal Mail and its shareholder works on these principles:

- the Shareholder appoints the Board, and agrees the terms on which the Directors are appointed and incentivised (annually and for the longer term);
- the Shareholder agrees the Company's strategic plan with the Board;
- the Board is accountable to the Shareholder for delivering the agreed Plan;
- the Shareholder gives the Board the freedom to take the action necessary to deliver the Plan;
- the Shareholder monitors the Company's performance to satisfy itself that the Plan is on track.

The following paragraphs show how these principles are put into practice.

principles in practice

Board appointments

4 The composition of the Board is a critical factor for the Shareholder. The aim is to secure an environment in which the Shareholder and the Chairman share a common view about Board composition (including size, and balance of experience and background), and succession. To achieve this, the following will take place:

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- the Secretary of State and the Chairman will discuss and confirm Board composition and succession each year in the light of performance and the requirements of the Strategic Plan;
- during the year, the Chairman will discuss with the Secretary of State any impending changes to Board membership;
- Government officials will meet the Chair of the Nomination Committee as necessary to discuss any proposed Board changes before they become subject to the formal consent procedure;
- the Board will ensure that suitably rigorous appraisals are made of the effectiveness of the Chairman and Board, in line with the requirements of good corporate governance.

Strategic Plan

5 The Board is responsible for developing and recommending a strategy to deliver the Shareholder's objectives. The strategy will be updated annually, and be subject to review by and approval of the Shareholder. This will be achieved by:

- effective informal dialogue between Government officials and Company representatives to enable any proposed changes in strategy to be understood and agreed
- a formal meeting between the Board and the Secretary of State to agree the Plan and the specific annual targets on which the performance of the Board will be judged.

Delivering the Plan – reward

6 The Shareholder approves the reward arrangements for the Directors. The Shareholder's interest is primarily in ensuring that remuneration levels are sufficient to attract and motivate high calibre individuals to drive shareholder value through the delivery of the Plan rather than the control of pay costs in the public sector.

7 The Shareholder requires the rewards for Directors to be tied closely to performance as measured by the achievement of Plan targets. The Shareholder is committed to paying market rates for success. Conversely the Shareholder does not condone rewards for failure, and would expect the Chairman to remove any director responsible for a failure to deliver the plan, or for other serious failure.

8 The role of the Remuneration Committee is central in developing reward proposals, covering total remuneration packages, based on comprehensive, market-based benchmark analysis. The Remuneration Committee recommends proposals for the Shareholder's consent based on performance made against the Strategic Plan, and market benchmarks.

9 The chair of the Remuneration Committee will discuss proposals at an early stage with the shareholder and the shareholder expects to be able to input their views to the process at an early stage.

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Delivering the Plan – the Board’s freedom to act

10 The Shareholder is committed to giving the Board the freedom to act to deliver the agreed Plan. In that context, the Shareholder will not interfere in day-to-day operational and commercial matters.

11 The Board recognises that Government Ministers also have a public accountability role. The Shareholder will give early warning of issues which may conflict with actions the Board wishes to take to deliver the Plan: equally the Board will ensure that the Company is alert to issues of potential sensitivity to Ministers, and will proactively seek clarification of the Government’s position on such issues. Subject to the Articles of Association, final decisions on running the Company will rest with the Board given the directors’ fiduciary responsibilities.

Monitoring Company performance

12 The Shareholder having agreed the Strategic Plan for the Company and the annual targets within the Plan, needs some means of monitoring the Company’s performance throughout the year. This is achieved as follows:

- the Quarterly Shareholder Meeting is the centrepiece of the formal regular reporting relationship between Company and Shareholder. The purpose of the meeting, between the senior executive directors of the Company and senior representatives of the shareholder, is to be the forum to review performance to date against Plan targets, but is intended to be mainly weighted towards being a forward-looking and risk-based analysis of Plan progress;
- monthly financial performance monitoring assists this process. In principle, the Shareholder expects to be provided with financial information at the same level as the Board, recognising that the type of information provided will vary from month to month depending on performance priorities. This information will be adequate to ensure that all key financial data pertinent and relevant to tracking the achievement of the Plan and the Company’s performance against the agreed targets can be reviewed and monitored on a timely, regular and appropriate basis. If additional information is required, the Shareholder will give the Company reasonable warning of the request and the rationale for making it: the latter in order for the Company to be able to satisfy the requirement most effectively.

13 These interactions between Company and Shareholder need to be underpinned by resolve on both sides to conduct affairs on the basis of a professional, efficient, trust-based dialogue:

- professional: competent people engaged in intelligent dialogue relevant to creating value for the Company and the Shareholder, with commitments delivered on time and to specification;
- efficient: both parties ensuring a joined-up approach amongst their constituent elements, with clear statements of requirements, avoiding duplication and unnecessary additional analysis;
- trust-based: open dialogue, based on a shared commitment to providing Royal Mail with the ability to compete in the future.

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policy contact with Royal Mail

14 The Government maintains a regular dialogue with a range of companies, particularly those critical to national infrastructure, regardless of their ownership status, and for a variety of reasons. In some cases such as policing or Customs and Excise, that contact is clearly delineated; however the Government recognises that where DTI policies are involved or where Government is a customer (especially to POL) those distinctions may be different. The Government commits to make clear the purpose and nature of different interactions with Royal Mail. By the same token the Government will conduct its shareholder relationship with the Company through a clearly identified shareholder team.

ensuring success

15 The success of the relationship depends in the end on the nature and quality of the contacts between people. The overall responsibility for ensuring that the intentions of this document are carried out in practice lies ultimately with the Secretary of State and the Chairman, who will keep in regular contact. Below them the Director of Postal Services in DTI, and the Chief Executive of Royal Mail, have the responsibility to ensure that all contacts between the Company and the Shareholder are conducted at the right level, with the right people, and in the right spirit.

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ROYAL MAIL SHAREHOLDER RELATIONSHIP

FINANCIAL MONITORING AND INFORMATION FLOW

General Shareholder Objectives

To receive all appropriate financial information to enable the Shareholder to:

- Carry out forward-looking and risk-based analysis
- Track performance against Plan, budget and forecast
- Look at lead indicators as well as historic performance
- Assess the economic structure of the business
 - Expenditure run-rate
 - Sustainable cash flow and profit margins
- Assess quality as well as quantity of earnings
- Monitor the level of shareholder value creation in the Group
 - Cash flow and earnings potential
 - Risk-adjusted return on capital invested

Minimum Financial Information Contents

Without prescribing the overall contents and format of the monthly information flow, which will reflect the Directors' judgement on what is relevant to giving an informed view of the financial position and performance of the Group, the monthly information will include:

- Group profit and loss *
- Group cash flow *
- Group balance sheet *
- Analysis of group expenditure (between staff and non-staff costs and by type) *
- Group capital expenditure (gross) *
- Group headcount *
- Group volumes *
- Opportunities and Risks
- Overview of Strategic Programmes
- Overview of Service Targets
- Segmental information for Letters, POL, GLS, ParcelForce *
- Revenue *
- EBIT and EBITDA *
- Operating cash flow *
- Working capital (where segmentally meaningful – for Royal Mail and POL at least) *
- Capital expenditure (gross) *
- Net assets *
- Headcount *

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○ Volumes *

- Details of any significant change in accounting policy or treatment and the financial implications
- Details of any material reconciling item between the management accounts and published interim and statutory accounts

* For month, year to date and projected full year, with variances to budget and forecast

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Annex C

ASSESSMENT OF NON-EXECUTIVE DIRECTORS PERFORMANCE

David Fish

As Chair of the Remuneration Committee, he is the NED that we have had most contact with. This relationship has been occasionally problematic. He has shown reluctance to take on board the shareholder's views and has been very slow in coming forward with proposals. When proposals do come forward these are often on a fait accompli basis having already been debated by the Remuneration Committee without our input and shown to the executive. He is, however, intellectually able and apparently offers a meaningful challenge function to the Chairman of the Board.

Richard Handover

As Chair of the Nominations Committee, he has been successful in recruiting Ian Griffiths to the Board but failed to come up with a top level Finance Director (he recognises that this was a failure). He has not involved the shareholder in the selection and recruitment process for Directors and we are normally asked to approve the appointment of a new Director at short notice once the appointee has been offered the post. This was particularly the case in the appointment of the new CEO of POL, with whom Treasury had some serious reservations (subsequently allayed), and Handover had ultimately to make a semi-formal apology for the process. There was a sense, as is often the case with the board, that Handover was over-enthusiastically enacting the wishes of the Chairman without exerting independent judgment.

Bob Wigley

As Chair of the Audit Committee, which he took on reluctantly, he has done a good job. However, he has indicated that he no longer wishes to remain with Royal Mail and wishes to concentrate on his job at Merrill Lynch and his new appointment to the Bank of England.

Sir Mike Hodgkinson

As Chair of POL, he has seen the company's position worsen during his time in office, and many of the shocks and setbacks that the network has sustained seemed to have come as a complete surprise to him and his team at POL. Until late last year a plausible and convincing corporate plan had not been worked at POL under his stewardship, and only then under pressure from the shareholder. As the Senior Independent Director, he has not sought to form a relationship with the shareholder as we would have expected and only tends to intervene to pressurise the shareholder.

John Neill

He is a member of the audit and risk committee but has remained virtually anonymous to the shareholder.

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