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RESTRICTED – POLICY AND COMMERCIAL

Royal Mail – ShEx Board Briefing

1. Purpose

An update on the process to inject private capital into Royal Mail and the risks to successful implementation. This is part of a broader package of measures to sustain the universal postal service.

2. History

There have been attempts to sell the Royal Mail stretching back over twenty years. The previous Administration commissioned the independent 2008 Hooper Review to assess how best to secure the future of the universal postal service. It recommended:

- introducing a private sector strategic partner
- changing the regulatory framework
- Government to take on the bulk of Royal Mail's pension deficit (reported to be around £10bn)
- Post Office Ltd to be kept in public ownership

The Hooper Report was accepted by all parties. The Labour Government introduced the 2009 Postal Services Bill to implement the package. At the same time, a process was launched to sell a minority stake (the legislation would have required HMG to retain control of Royal Mail). Both the legislation and the auction were halted in July 2009 due to market conditions.

3. Market update

We expect market conditions in the European mails market to improve over the next 12-24 months. In particular, postal services companies across Europe are going through significant change as they endeavour to cope with the rapidly declining letters market – TNT is in the process of splitting its letters and Express parcels businesses and Deutsche Post (DP) could follow suit. Meanwhile, Belgian Post is planning a public offering of its shares for later this year. Once the dust has settled on this corporate activity, TNT, DP and, possibly, Belgian Post might be potential buyers for Royal Mail, as players look to consolidate the European letters markets in order to drive further efficiencies. Deutsche Post has already given serious thought to creating a "EuroPost", and TNT now believes that the only valid growth strategy for mails businesses is cross border consolidation. However, it is more likely, in our view, that private equity will be the most serious bidders in an auction.

It is possible that RM could be ready for an IPO in 3-5 years. The current business plan shows that management expect RM to turn cash flow positive in 2013/14. However, if HMG relieves RM of its pension obligations, and if the regulator does not require RM to pass on these savings to customers, RM will turn cash flow positive earlier. RM management, particularly the Chairman and new CEO, prefer an IPO. We also understand the CWU would oppose an IPO less than a trade sale. For these reasons, it is important to keep the IPO option open. However, RM's long-term business plans are consistently ambitious and they have frequently been revised downwards. An auction remains a more credible medium term sale strategy, at least as a first phase.

4. Coalition Agreement

The Coalition Agreement states that the Government will '*seek to ensure an injection of private capital into Royal Mail, including opportunities for employee ownership. Post Office Ltd will be retained in public ownership.*'

The Secretary of State has been clear from the outset that resolving the 'nagging problem' of Royal Mail is one of his top priorities. The Queen's Speech committed that the Government

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would take through a Postal Services Bill to implement the Hooper measures in the first session of Parliament (this runs to November 2011).

Ministers' objectives for the process and the overall reform of the postal services market are attached at Annex A.

ShEx is responsible for the ownership, pensions and Post Office elements of this project. We are also leading the legislation. For propriety reasons, responsibility for regulatory policy sits with the BIS Business Group.

5. 2010 Strategy

The 2009 process failed for a number of reasons, but in part because of an extremely high risk strategy of legislating and trying to conclude a commercial deal in parallel, and constraints on exactly what could be sold.

Following ShEx advice, the Secretary of State has therefore agreed two key changes:

- to take a sequential approach, securing legislation and state aid approval before launching a sale process
- to take total flexibility on how much equity can be sold, in what form (auction or IPO) and when

6. Process

The proposed timetable for implementing the package is therefore as follows:

1. Summer 2010: Richard Hooper to update his analysis on problems facing Royal Mail and provide ministers with advice on any changes to his recommendations. This will not alter any of the substantive conclusions.
2. Autumn 2010-Spring/Summer2011: Legislate to implement all three parts of the package: ownership, pensions and regulation.
3. Spring/Summer 2011: After Royal Assent, begin transfer of regulatory responsibility from Postcomm to Ofcom.
4. 2011: Seek EU state aid clearance to take on the pension deficit (could take 12 months).
5. Late 2011/2012:With state aid clearance and the new regulatory regime in place, be in a position to introduce private capital and take on the pension deficit in tandem.

The Secretary of State is keen to introduce legislation as soon as possible in the autumn. Our immediate focus is therefore the decisions required to prepare the legislation which will set the framework for what and how HMG can do. We are currently working closely with BIS ministers to get Coalition and HMT agreement to the necessary policy decisions.

Alongside introduction of the Bill, the Government will publish a detailed policy statement. For that, further decisions will be required on, for example, how much of the pension deficit HMG will take on. We do not expect that the policy statement will provide much detail on how or when equity will be sold.

7. Risks

Although the current strategy is considerably lower risk than the 2009 process, serious obstacles remain:

- Although we expect market conditions to improve, RM will remain a difficult asset to sell. There is no guarantee that we can sell the business on acceptable terms.

- Although it is infinitely preferable to secure legislative powers before launching a transaction, we need to ensure that the legislation does not restrict commercial decisions we may not want to take for 2 or 3 years.
- Decisions on the regulatory regime will affect the value of RM, and potentially the ability to finance the universal service on a sustainable basis.
- To take on the pension deficit we need European state aid clearance. Although ultimately we expect approval, the Commission will have powers to impose 'compensatory measures' which could include restrictions on RM's operations or strategy, or changes to the pensions solution itself.
- Our relationship with the Royal Mail Board and management will be key, but there is inevitably scope for considerable friction, particularly if we do not follow their preferred transaction route.
- The capacity of the Royal Mail management is a risk, given the new CEO does not arrive until mid July and the FD resigned (with immediate effect) last week. In particular, before we can submit an application for state aid approval RM need to have prepared, with us, a detailed restructuring plan for the business.
- The Coalition Agreement commits to looking at opportunities for employee shares. We need to ensure that any commitments offer value for money and do not undermine our ability to do a deal.
- Getting rapid Coalition Agreement on the key policy decisions in order to keep the timetable on track: in particular employee shares and how much of the pension deficit to take on.
- Although the Post Office will remain in public ownership, we need a strong credible story, underpinned by funding, on the Government's commitment to the network. Public concern about the impact on local post offices has derailed previous efforts to sell RM.
- Given the historic controversy around Royal Mail, there will always be a risk (albeit now relatively small) that the legislation is not passed, or is materially changed in Parliament.

We will update the Board further on the likelihood of these risks crystallising as the process progresses.

8. ShEx resourcing

This project will consume a considerable proportion of the ShEx team over the next 2-3 years. At present we have the following resources:

- Royal Mail: 2 SCS, 4x G6, 1x G7, 1xR8
- Bill Team: 1 SCS, 1 G6, 1 G7 and recruiting for further G7, faststreamer and admin support
- POL: 1 SCS, 1 G6, 1 G7, 1 faststreamer, 1 HEO and recruiting for further G7 and HEO

A few of the RM/POL team work on other businesses, but the majority are full time.

The team is probably adequately resourced for now, though we will need to keep under review. We are also considering whether we have sufficient regulatory expertise in the team given the significant impact of the regulatory framework on value.

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ANNEX – HMG OBJECTIVES FOR ROYAL MAIL PROCESS

- Secure the future of the universal postal service (an obligation stemming from the European Directive)
- Introduce private sector disciplines to Royal Mail, and the ability to raise private finance, to enable its rapid modernisation free from the perception of HMG interference
- Transfer the future risk of ownership from the taxpayer to the private sector
- In order to facilitate a transaction, relieve Royal Mail of the burden of its historic pension deficit
- For Royal Mail's employees to be engaged in the transformation of RM and able to share in its future success
- Modernise the regulation of postal services, setting it in the broader context of the communications market and placing the universal service at its heart
- To ensure the right structure for RM, for profitability, shareholder value and the regulatory system
- Support a sustainable future for the national Post Office network
- For all of the above to be delivered in a way which maximises value for money for the taxpayer