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OFFICIAL SENSITIVE

**Risk & Assurance Committee: Post Office Limited (POL), 19th April 2017**

## 1. Overview

Post Office has been in receipt of Government funding for a number of years, to sustain and modernise the nationwide network of branches. Government sets the minimum number of branches, and the current network has more outlets (c11,600) than all of the supermarkets combined. Given the number of branches, it is uncommercial and in need of subsidy. Since 2011, Government has invested in Post Office to increase its commercial sustainability and reduce subsidy in the long term.

The current funding package expires in March 2018. UKGI has been undertaking due diligence (supported by KPMG) on POL's plans since October, and has drawn its conclusions on the level of funding required, based on our understanding of the Secretary of State's objectives for POL (which are to keep network numbers stable and continue on the path to commercial sustainability).

However, there are a number of pre-existing and emerging risks that we would like the RAC's view on, as set out below, which are caused by the size and complexity of POL's ask, the inherent and perceived risk in the plan, the relatively belated engagement by the SoS, and the increasing urgency of the situation. These risks effect BEIS, POL and UKGI itself.

The accompanying slides will provide you with a background on POL today, the challenges the business faces, its proposed response, and the remaining issues that are still under discussion.

## 2. The Funding Request

Since 2011 POL has received just under £2bn of funding – roughly half of which was to subsidise the loss-making network, with the other half to support modernisation. The last tranche of that funding was paid this month. In the SR2015, POL was allocated £60m in subsidy for FY2018/19, and £50m for FY2019/20, which reflected the falling trajectory of subsidy over time. We flagged clearly at that time that further investment funding would in all likelihood be required beyond 2018, but that it was too early during the SR2015 process to form a view on what that level would be given the changing state of POL's core markets, and the stage that they were at in their modernisation programme.

POL has now applied for funding to cover the three years from 2018/19 – 2020/21. Their initial request made in October consisted of:

- £50m network subsidy for the year 2020/21
- £280m investment grant funding (largely to invest in further cost saving measures)
- £320m commercial facility (largely to invest in revenue growth plans)
- Total = £650m

Following due diligence and pressure from UKGI, POL submitted a revised request:

- £50m network subsidy for the year 2020/21
- £200m investment grant funding (with the difference largely explained by a reduction in their plans to franchise c170 directly managed branches, many of which had payback periods well in excess of 5 years)
- £170m commercial facility (which was reduced to reflect the fact that the remaining £150m did not have any particular use attached to it, but was there to allow Post Office to take advantage of future opportunities as they arose, given HMG is their only source of funding)

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- Total = £420m

In UKGI's view, and based on KPMG's conclusions, there remains scope to reduce this further, without impacting outcomes in POL's plans, but critically, POL's proposals do appear to have the potential to enable POL to reach a level of commercial self-sustainability beyond 2020/21 (or a position of reduced subsidy on a stable outlook going forward). That said, many of POL's proposed initiatives are only partially formed at this stage, or are reliant on key contract renegotiations. This is not altogether surprising however, as whereas most businesses would apply for funding once there has been greater degree of planning and certainty, POL do not have that luxury given that they must apply to Government in cycles and funding requires state aid clearance (making a "drip feed" approach to funding is difficult).

UKGI therefore proposes to present POL with a "cost challenge", shaving another c10% / £40m off the funding request to ensure they remain motivated to control costs and optimise contract discussions. In response to UKGI's experience over the last 3-5 years, and to take account the limited detail in some areas of the strategy, we also plan to increase the level of governance that we and the Board apply to investment decisions to ensure there is proper scrutiny. Finally, the use of a loan for the higher risk and less detailed elements of the strategy allows for greater flexibility in funding (i.e. rather than granting funding, POL can choose whether to draw the funding or not, and must have the confidence that any borrowing can be repaid – HMG similarly could consider only allowing for the release of funding under a loan arrangement with the requisite level of supporting information and Board sign-off).

## 3. Work Done

A significant amount of work has been done on POL's plan since we received the first proposal and funding request in October. The Annex to this paper provides more detail on the themes below:

- Intensive period of initial review and collation of supporting information;
- Detailed review and development of POL's supporting financial model;
- Detailed consideration and further testing of POL's proposals based on the modelling outputs and our initial assessments;
- Reviewing and summarising KPMG's final report and financial model review; and
- High level consideration of funding and governance options going forward.

The above work has arguably meant that POL's strategy and supporting documents and financial model are in much better shape that when UKGI first received them and commenced its review. Specific improvements include:

- Detailed breakdowns of capital spends between categories of expenditure;
- Assessment of the individual returns and paybacks associated with individual investment proposals;
- Supporting documentation, including clearer breakdowns of investment spend and supporting evidence/rationale to support the cost estimates provided. Much of this detail was provided relatively late in the process and only after UKGI requested such information;
- A clearer view on timing and why POL needs a funding decision to be made soon;
- A reconciliation of the sources of investment funding and the application of the funds across multiple funding scenarios;
- A full due diligence report produced by KPMG;
- A supporting annex summarising KPMG's review of POL's financial model (after multiple iterations); and

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- Possible options for amending HMG's requirements over the post office network to assist POL given its baseline financial projections.

In particular, UKGI's review (supported by KPMG), changed POL's attitude and approach from one in which it appeared to consider the process as merely being one of valediction, rather than a detailed diligence into its plans and corresponding funding requirements. This more detailed and investigative process has inevitably led to a large amount of senior POL staff time and Board "buy-in" (although this was not initially provided resulting in a longer process than it could have been).

Ultimately, as part of the UKGI review and analysis of POL's strategy, POL submitted a reduced funding request from £650m to £420m, with further scenarios providing optionality for BEIS and HMT in order that it can make a reasoned and evidenced funding decision.

## 4. HMT and BEIS Positions

The Government's manifesto stated that it would secure 3000 rural offices. This was somewhat inaccurately drafted as there are actually 6000 rural offices and the manifesto was really making reference to protecting the c3000 "last shops" in rural and urban deprived areas. In addition, we have clarified with Ministers (including the Secretary of State) that their objective for Post Office is maintaining a stable number of branches, and increasing the commercial sustainability of POL to reduce subsidy requirements in the longer term.

The Secretary of State has stated that he considers this issue to be a cross-Government one. As part of discussions with the CST, he agreed that UKGI should provide "joint advice" to BEIS and HMT ministers. However, HMT officials are not prepared to advocate what is in effect a request to access the Reserve, and are concerned as much about short term affordability constraints for the exchequer as they are about longer term value for money. We have therefore agreed that UKGI will submit to ministers a set of funding scenarios (which will be vouched for by HMT officials), to demonstrate the trade-offs between affordability, value for money, and policy requirements, for a decision to be made by ministers as to the broad shape of the funding. This is likely to involve trade-offs against other BEIS spending pressures (and could be tied up with the cross Government Efficiency Review which doesn't conclude until the September Budget), and it is unclear in the context of the scenario analysis provided how we provide further advice to advocate our position (or further discuss policy/funding trade-offs).

The Secretary of State recently met with the Chair of POL (Tim Parker) and CEO (Paula Vennells), and was left primarily questioning the following two issues (noting more background for the RAC on these matters are in the accompanying slides):

- Whether it was better to wait for the contract renegotiations with Royal Mail to conclude before making a funding decision (POL would like the funding up front)
- Whether POL has the capability to further grow financial services, particularly in the online space.

However, we think the source of these questions are in part due to his lack of knowledge of POL's current operations e.g. their financial services business is already generates >£300m p.a. of revenue, they have a regulated subsidiary dedicated to insurance, with significant experience at the NED and management level to take such initiatives forward. Whilst the growth strategy is not without risk, POL are not starting from a zero base.

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Separately, the Secretary of State and Permanent Secretary asked BEIS commercial to review UKGI's due diligence work. This reflects some of the SoS's concerns about the closeness he perceives between UKGI and POL, and the difficulties created by UKGI having a seat on the Board whilst also representing his interests in the scrutiny of the plan. BEIS Commercial have now concluded their review. Whilst we have only had feedback verbally to date, they have not found any material deficiencies in our analysis and will not be undertaking any further work. Their main observations were that the funding ask was clearly large and complex, and that there could be greater clarity around the investment priorities and a clearer articulation of the strategy and policy objectives.

## 5. The risks

There are number of risks to be considered, from differing perspectives, as set out in the table below:

| **Risks to BEIS** | **Risks to POL** | **Risks to UKGI** |
|---|---|---|
| That any further investment in POL is not as successful as planned (due to execution and market risk)<br><br>That any investment decision (to fund in full, in part, or not at all) means current policy objectives are not met (leading to public criticism and a higher level of longer term funding being required)<br><br>That affordability constraints take precedence over value for money (or policy objectives), leading to a reversal of POL's improved performance over recent years<br><br>That investment in POL means sacrificing investment or expenditure in other areas of the Department | That it doesn't receive sufficient funding to undertake a strategy that meets current policy objectives<br><br>That Ministers take time to decide to consider policy objectives (for affordability or other reasons), leaving the business with a period of significant uncertainty as to how to proceed.<br><br>That BEIS does not make a decision quickly enough, exposing POL to business and market risk unnecessarily, forcing POL to make short term decisions that have longer term value implications<br><br>That members of the Board or management consider their position if HMG is perceived to have not backed their judgement<br><br>That State aid permission is not granted in time for the first payment of any new funding, which would be due in April 2018<br><br>That continued forecast profit growth in the short term (to | That BEIS Commercial, or the Secretary of State, does not agree with our commercial judgement on the appropriate level of funding (which could be reputationally damaging and bad for our "BEIS business")<br><br>That a material error is found in POL or our work<br><br>That POL's plan does not play out as intended, leaving people to question UKGI's judgement<br><br>That, rightly or wrongly, we are perceived to be too close to Post Office<br><br>That the difficulties we have had with the process and the way POL has prepared its plan generates less confidence in the funding case (rather than focussing on the end result and the "right" level of funding)<br><br>That UKGI are not given sufficient opportunity to present our views on funding to Ministers (given the |

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| | 2020) persuades Ministers that further investment at this stage is not required<br><br>That clients and counterparties interpret a lack of clarity around POL funding negatively, impacting POL's commercial performance and outlook | complexity and multi-faceted nature of the strategy) |

To mitigate against these risks, we will continue to:

- Attempt to make our case in the strongest possible terms to SoS, BEIS Commercial and HMT
- Cooperate with BEIS Commercial in an "open book" way if required
- Engage proactively with HMT to enhance their understanding of the policy and commercial issues
- Keep the POL Board informed so that they understand Government's position, constraints and timetable

**6. UKGI POL Team's next steps**

At the time of writing, we intend to put the submission referred to above to BEIS and HMT ministers on Friday 21st or Monday 24th April. This will be accompanied by a number of background slides, should Ministers want to see them (which would not be dissimilar to the slides that accompany this paper).

There is then a more open question about how we bring this matter to a close, particularly by the end of May.

**7. Questions for the RAC**

- Are there any risks that we have not considered?
- Are there any areas that we should further probe?
- Are there any further mitigations we can put in place to protect UKGI, BEIS and/or POL?

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**Annex – Work done**

UKGI has undertaken the following actions over the course of the last six months to understand the funding position:

i) ***Intensive period of initial review and collation of supporting information, which included:***
- Detailed review of POL's initial strategy and funding request, a final version of which was provided in November 2016, including a period of daily meetings and calls with POL's Head of Strategy;
- Follow up meetings and daily calls with individual business segment team leaders and review of individual business segment strategy papers and supporting information; and
- Assisting KPMG such that it was provided access to key individuals and individual business cases and supporting financial models underpinning each element of the strategy, covering each of POL's business segments;

ii) ***Detailed review and development of POL's supporting financial model, which included:***
- Requiring POL to develop sensitivity testing capability within the Model, including a sources and uses of funds reconciliation to enable it easier to trace investment spending through to POL's proposed actions and initiatives;
- Ensuring that POL reflected its baseline forecasts (i.e. a no new HMG investment scenario) into the Model to provide an accurate "counterfactual" against which to judge POL's request;
- Generating a summary paper detailing all investment spend items, their source of funding and an accompanying audit trail to the financial model. This should have been produced at the outset of the review process by POL but was produced several months into the process after UKGI intervention;
- Requiring updates to the model as various issues and potential errors were flagged as part of our and KPMG's review. Twelve versions of the model have ultimately been produced over a five month period;
- Requiring specific funding and network scenarios to be run in the model in order to demonstrate the impact on POL's future profitability and cashflow of different amounts of HMG funding. 25 scenarios have been developed to date reflecting the extent of the review and analysis undertaken; and
- Requesting KPMG to do a review of the final version of the model to verify that its cashflow and profitability forecasts for each scenario were considered to reasonably reflect the model inputs.

iii) ***Detailed consideration and further testing of POL's proposals based on the modelling outputs and our initial assessments. This included:***
- Consideration of POL's minimum cash headroom over the period under review as it became clear that this was a key factor being targeted by the financial model and which was used to determine funding phasing and the overall quantum of funding requested;
- A focus on POL's priority spend and how POL views each area in terms of criticality;

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- How POL's future EBITDAS forecasts under each funding scenario tested feed through to cashflow and future HMG subsidy requirements, as a means of testing POL's medium to long term commercial self-sustainability under each scenario;
- Further detailed consideration of the Royal Mail, Fujitsu and Bank of Ireland contract negotiation strategies and the urgency of the need to prepare for these, particularly with Royal Mail given the mid-term review period for this particular contract opens in May 2017;
- Options for POL to mitigate future financial performance by reducing the size of the post office network (either within the remit of HMG's current access criteria or ignoring these criteria completely);

***iv) Reviewing and summarising KPMG's final report and financial model review***

- KPMG provided a draft of its final due diligence report in February, which UKGI has summarised for ministers. On UKGI's instruction, KPMG has provided a detailed risk assessment of each of POL's strategic priorities and investment proposals, as well as the revenue risks from each area. This supports KPMG's overall broad review of the appropriateness of the strategy. KPMG has also, on UKGI's request, set out some recommendations and suggested next steps.

***v) High level consideration of funding and governance options going forward***

- Discussions on structure and terms for a possible HMG loan facility. Whilst these discussions are at a high level UKGI has developed a draft set of outline terms that could be used in any future funding documentation;
- Future governance arrangements post funding award have been considered at a high level. A draft set of options has been set out but this will need to be subject to further detailed work.