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NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

Department of Trade and Industry

The Acquisition of German Parcel

HC 858 Session 1999-2000
24 August 2000

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John Bourn
Comptroller and Auditor General

National Audit Office
24 July 2000

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Executive summary

1 The Post Office is a state owned business accountable to the Secretary of State for Trade and Industry. It has a statutory monopoly in the delivery of letters and parcels costing less than £1 in the United Kingdom (unless they weigh over 350 grammes) but operates in competition with other businesses for all other mail. The Government announced significant changes in the operating framework for the Post Office in the White Paper "Post Office Reform: A World Class Service for the 21st Century" published in July 1999. This set out plans for:

i) greater competition in the postal market;

ii) giving the Post Office greater freedom to operate commercially so that it can be managed more efficiently and compete more effectively in an increasingly liberalised and competitive international market; and

iii) the creation of a new, transparent and accountable regulatory framework.

2 The Post Office's aim, approved by the Government, is to transform itself into a leading international business supplying customers with a full range of global distribution services. A key element in the strategy to achieve this is a programme of acquisitions:

i) to help the competitiveness of the core business by allowing the Post Office to offer a seamless letters and parcels service, based on high quality networks over which it has direct control, to its large business customers (who represent about a quarter of its turnover); and

ii) to secure a position in key international markets, on which it can then build, while opportunities are still available.

3 In January 1999, in line with policy announced in December 1998 and set out in detail in the White Paper, the Post Office acquired German Parcel, the third largest private parcel business in Germany, for £289 million (see Figure 1). The Post Office also spent £10 million on advisers' fees in connection with the acquisition. This was its first major diversification into overseas markets and was undertaken in agreement with the Department of Trade and Industry (the Department) and Treasury.

4 This report is about the oversight by the Department of this acquisition. The National Audit Office is specifically barred by the National Audit Act 1983 from carrying out the audit of the Post Office. We are, however, the auditors of the Department whose agreement was needed for the acquisition to go ahead. The report takes as given, as a matter of policy, the overall business strategy leading to the acquisition, approved by Ministers. In view of the importance of the acquisition, and the complexity of the situation in that the Department had the responsibility to agree the acquisition but not to carry it out, we decided to examine:

i) the Department's responsibilities and role relating to the acquisition;

ii) how the Department sought to protect the interests of the taxpayer; and

iii) what lessons of good practice can be established for sponsor departments that have oversight of future acquisitions by state owned businesses.

Findings

The Department has a responsibility to scrutinise large acquisitions carefully

5 The proposed reforms of the relationship between the Post Office and the Department allow the Post Office the freedom to acquire other businesses and build its position as a major global distribution company. This freedom is subject to the Department's requirement that it should have oversight of any acquisitions that exceed £75 million (raised from £20 million as part of the reforms). The rationale for such a threshold is that large transactions, even in the ordinary course of business, can be so significant that they merit scrutiny by the owner. We consider that large acquisitions in overseas markets or new product areas are a diversification of the business and merit additional attention from a sponsoring department because they represent an increased risk to the taxpayer's interests **(paragraph 1.13)**.

6 A full assessment of the value for money of the acquisition, taking strategic benefits into account, will not be possible in isolation from the Post Office's overall strategy and programme of acquisitions, which will not come to fruition for a number of years **(paragraph 2.17)**.

The Department appointed an adviser to examine the Post Office's appraisal carefully

7 The Department agreed that the Post Office could go ahead with the acquisition on the basis that:

- it fitted with the strategy for the Post Office approved by Ministers; and
- the Department's analysis of the Post Office's appraisal showed that German Parcel as a stand-alone business, that is without taking into account any potential synergies with the Post Office's other businesses, and after taking into account purchase costs, would not lose money **(paragraph 2.6)**.

8 In our opinion, the Department's approach of assessing the acquisition on a stand-alone basis was reasonable given the difficulties in valuing strategic benefits and uncertainty over the extent to which they might be achieved. The Department was keen not to duplicate work and relied on the Post Office and its advisers to carry out a valuation of German Parcel, to establish the potential risks and liabilities that the acquisition would entail and to negotiate with the vendors. The Department's confidence in the Post Office's judgement derives partly from its historical "arm's length" relationship with the Post Office, which meant that it was usual for the Department to assure itself that the Post Office was taking appropriate advice and approaching a transaction in a sensible way, rather than becoming closely involved in the appraisal. In addition, the Department considered that the Post Office had developed experience in appraising acquisitions, including taking appropriate advice **(paragraphs 2.8, 2.9, 2.11, 2.13 and 2.17)**.

9 The Department's team responsible for advising on the acquisition recognised that it did not have sufficient expertise to assess the proposed acquisition and therefore employed an individual adviser who had senior level commercial banking experience of appraising the risks of major investment proposals by client companies and had been a member of the Department's Industrial Development Advisory Board. When making the appointment in November 1998, the Department sought to satisfy itself that the Post Office had gone through an appropriate process in pursuit of this acquisition. The adviser was not required to carry out a full critique of the valuation exercise undertaken by the Post Office but rather to look at the way in which it was managing its processes and to test some of the key assumptions. In doing so the adviser was required to work to a tight, commercially driven timetable as is usual in an acquisition **(paragraph 2.9)**.

10 German Parcel was a difficult business to assess. It had few assets although it owned the computer software that allowed it to track a package at any stage in a journey which gave the business its main competitive strength. It belonged to 24 franchisees and its managing director, and provided its franchisees with central distribution facilities and administrative and logistical support. The majority of the franchisees also owned road haulage and other distribution businesses, which in some cases were partially dependent on, and integrated with, the parcels franchise business. Central accounts for the whole business, including the franchisees' depot operations, did not exist. Moreover audited accounts for individual depot operations did not, in many cases, exist. The Post Office had to buy out the relevant part of the franchisees' other businesses and enter into two year contracts with them to carry on giving German Parcel the parcels business that they had been routing through it. German Parcel also had a valuable investment in a Europe-wide franchise network (General Parcel), set up on the German Parcel model, which had the potential to offer strategic benefits to a purchaser above the value of German Parcel's 24 per cent shareholding in it **(paragraphs 1.20 to 1.24)**.

11 The Post Office and its advisers, PricewaterhouseCoopers, primarily relied on a model of the business's projected cashflows to develop a valuation. The operating profit assumptions in the model drove the valuation. The lack of central accounts for the whole business, together with the tight timescale that the Post Office was operating to, meant these assumptions were based on 1997 unaudited operating results, as estimated by German Parcel management. Individual profit margins were not taken into account in the price paid to individual franchisees because the Post Office had decided against negotiating special deals with individual vendors. This was the vendors' preference and the Post Office perceived the risk of losing the deal by attempting individual negotiations to be very high. The Post Office, therefore, only had relative certainty on the operating profit made by the central business itself. This accounted for 18.5 per cent of the total operating profit assumed in 1997, the base year for the projections of the value of the business. The Post Office provided for the purchase price to be adjusted after the acquisition to reflect the actual turnover in 1998. The risk of inaccuracies was partly mitigated by a warranty from the franchisees, providing a possible clawback of about 28 per cent of any excess price paid as a result of the assumed operating profit being too high. The effectiveness of this and other contract remedies was underpinned by agreement to pay the purchase price in stages **(paragraphs 2.11, 2.12, 2.14 and 2.16)**.

12 The Department recognised that there was uncertainty attached to its conclusion that, on a stand-alone basis, the acquisition would not be worth less than the purchase price. This is demonstrated by the wide range of the Post Office's financial projections of the value of the business, based on discounting operating profits in perpetuity. The Department and its adviser concentrated their evaluation on the base case and, taking the purchase price into account, the loss making worst case. We have agreed, on grounds of commercial confidentiality, not to publish details of the cases examined. The range from best to worst of about £109 million in 1999 values indicates, however, the degree of uncertainty. The Department was satisfied that the Post Office had identified the key risks to the acquisition and was taking appropriate steps to manage those risks to make a success of the venture and avoid losses. The Department also expected, however, that there would be synergies with the Post Office's other businesses which would lead to financial benefits. The Post Office had quantified some of these benefits - estimating, for example, that the acquisition could protect income that would otherwise be lost in its Parcelforce business in excess of Parcelforce's 1998-99 losses (£25 million). In the limited time available for reviewing the robustness of the business case, the Department's adviser had met the Post Office, questioned the growth rate assumptions and the risks to profitability, such as the possibility that costs in the different franchises might harmonise at a higher level, and formed the overall view that the price proposed was reasonable **(paragraphs 2.12, 2.15 and 2.18)**.

13 If time and access to individual franchise businesses had allowed, it is arguable that a more extensive appraisal of the Post Office's business case and valuation might have reduced the uncertainty attaching to the Post Office's conclusion. But such an appraisal might not have been practical in the circumstances and the Department in any case covered the ground (see Figure 10). The Department also considered that the implementation of the Post Office international strategy, of which this was the first significant step, was essential to the repositioning of the Post Office in the global distribution market. Building on the experience it gained from this transaction, we note that the Department has retained Deloitte & Touche to lead and co-ordinate a multidisciplinary team to comment, as and when required, on the Post Office's proposed strategy and on the range of issues that might arise following any further major acquisition proposal from the Post Office **(paragraphs 2.18 and 3.7)**.

The funding of the transaction is at commercial rates of interest

14 The Department and Treasury agreed that some £80 million of the cost of the transaction could be funded by borrowing in Germany by the Post Office on commercial markets. Unusually for the public sector, the Department proposed that the remainder (up to £238 million to cover the costs of working capital, some property assets, and advisers, as well as the remainder of the base price, Figure 11) should be met from public sector borrowing at commercial rates of interest. This was in part to assure competitors that the Post Office was not acting in an anti-competitive way and also because the Department wanted the Post Office to be subject to commercial disciplines as well as having greater commercial freedom. We note that adopting this method of funding can only act as a commercial discipline on the Post Office if, when the accounting treatment is settled, the Department can see the impact of the higher rate on the financial performance of German Parcel. This could be done in a number of ways depending on the overall reporting structure for the Post Office's European network, currently under discussion with Deloitte & Touche (**paragraphs 2.21, 2.33 to 2.34 and 2.42)**.

15 The Department had not set a rate of interest on the borrowing by mid July 2000 although at the time of the acquisition the Post Office was aware of the maximum rate that was likely to be agreed. The delay in reaching agreement was partly caused by the necessity to undertake wide consultation on the proposed policy of charging a commercial interest rate to bodies in the public sector. The rate will be set following advice from Deloitte & Touche on what the Post Office's credit rating might be if it was a company in the private sector. A credit rating is an assessment of a company's ability to meet its debt service obligations. The exercise was carried out to determine the interest rate that the Post Office would be charged to borrow in the market, on the basis that it did not have an implicit or explicit Government guarantee, nor access to the large cash reserves built up over the years from its monopoly business. As this will be the first time that a public body will be borrowing from the National Loans Fund at a commercial rate of interest, new guidance and procedures are being introduced by the Department to effect this change. The Department told us that the resulting commercial cost of credit will be charged retrospectively and in full once arrangements are in place **(paragraphs 2.36, 2.37, 2.39 and 2.40)**.

Concerns about possible unfair competition have been assuaged

16 The Department confirmed that (as required by legislation) the Post Office obtained clearance from the relevant competition authority - the German Federal Cartel Office, after the European Commission confirmed that it did not have jurisdiction. A number of competitors of the Post Office nevertheless expressed concern to us that the Post Office might have used reserves built from profits earned on its monopoly activities to fund the acquisition or that it had access to borrowing at low rates, giving it an unfair advantage over other businesses in the industry. Their concerns were enhanced because the Post Office did not announce the price it had paid at the time it announced the acquisition. The competitors that we spoke to have confirmed to us that some of their concerns about unfair competition have been assuaged by the agreement that acquisitions should be funded entirely by borrowing at a commercial rate. One competitor, TNT Post Group, called for acquisitions to be evaluated and monitored on the basis of a discount rate that reflects the overall cost of capital. This is how TNT Post Group evaluates and monitors the acquisitions that it makes. The Department expects the Post Office to do this **(paragraphs 2.23, 2.43 and 2.44)**.

The Post Office's performance targets were not adjusted to take account of the acquisition

17 In common with most public sector businesses, the Post Office is set financial targets by the Government. The principal financial targets for the Post Office in 1998-99 were an External Financing Limit of £310 million and a Return on Capital Employed of 20.0 per cent for Royal Mail and 5.5 per cent for Parcelforce. The External Financing Limit was the sum of cash that the Post Office agreed to pay over to the Government from its profits. The Department did not adjust the Post Office's financial targets following the acquisition because arrangements relating to the External Financing Limit were under review as part of the Post Office reforms and because the Return on Capital Employed for the acquisition was forecast to be within one per cent in four out of the next five years. It should be noted, however, that the Department, with advice from Treasury, required that the performance of German Parcel be monitored against the target Earnings Before Interest and Tax in the business plan. The Department also made it a condition of approving the funding, that a percentage of the bonus of the Chief Executive of the Post Office (half of a possible 10 per cent personal bonus) should be linked to how well the acquisition performed against this target measured in Deutschmarks. The Post Office provided its first annual report on the performance of the acquisition to the Department in April 2000 to provide a basis for monitoring this condition. Future monitoring arrangements are currently under review with Deloitte & Touche **(paragraph 2.21)**.

We have identified a number of lessons of good practice

18 While the Department took its responsibilities seriously, this was one of the first major acquisitions by a public sector body and there was little experience to draw on. In addition to benefiting from the Department's own experience we, therefore, broadened our analysis to include good practice in the handling of acquisitions by private sector companies, including the requirements that the London Stock Exchange imposes on companies listed on it. We consider Stock Exchange procedure should be taken into consideration when determining the level of disclosure of information by public sector corporations. It will be less relevant to departments' approval of a transaction because departments will generally have set individual materiality thresholds based on considerations particular to the individual company. In the case of the Post Office, the Department has set a threshold of £75 million per year. Sponsoring departments faced with transactions above the relevant threshold for review may wish to consider carefully the benefits of adopting the following practice:

i) **Obtaining assurance from the whole Board of Directors on their detailed knowledge, approval and accountability for the acquisition, together with opinions from relevant external advisers giving assurance on the terms agreed.** This suggestion is compatible with practice in the private sector in that companies quoted on the London Stock Exchange, subject to a materiality test, are required to send shareholders a declaration covering, for example, the completeness of the information sent to them, and a voting recommendation that the acquisition "is, in the opinion of the directors, in the best interests of the shareholders as a whole". It is also usual practice for the directors of quoted companies to ask for opinions from their professional advisers about the implications of a transaction, which they rely on when advising shareholders **(paragraph 3.4)**.

   In the case of the acquisition of German Parcel the Chief Executive of the Post Office wrote to the Department reporting unanimous Board approval to the acquisition. The Department saw the documents the Board received and told us that they were not very detailed. We consider that the level of detail provided to the Board is highly relevant as the Board itself is likely to be the best judge of the implications of the transaction for the business **(paragraph 3.3).**

ii) **Putting together a team with corporate finance experience and industrial sector knowledge, supported by external advisers, to appraise a proposal.** This is standard practice in privatisations although a smaller team is likely to be needed in the case of an acquisition. The Department's current arrangements with Deloitte & Touche allow it to access a wide range of skills. We note that in some countries the practice is for oversight of nationalised industries to be carried out by a single department. This has a number of advantages and disadvantages and in the case of the oversight of transactions such as acquisitions may allow a greater depth and breadth of commercial expertise to be brought to bear; as broadly speaking the establishment of Partnerships UK has allowed a wide range of skills and depth of experience to be brought together to advise on the development of privately financed projects, including the most appropriate advisory team to be used on a transaction **(paragraphs 3.7 and 3.8)**.

iii) **Asking for the disclosure of analogous information to that which would have been required had the state owned business been quoted on the London Stock Exchange. This would, where relevant and material, include information on the price paid, the profits attributable to the net assets being bought, and the effect of the transaction on the profit and loss account and balance sheet of the purchaser (see Figure 13)**. These requirements were developed for investor protection and to allow the market to appraise the prospects of a company adequately. A number of private sector competitors of the Post Office have to meet these requirements and the Government and the Post Office are keen for it to be treated more like a private sector company. The Post Office initially only disclosed a broad indication of the value of the transaction. The Department has told us that it accepts our argument that there is a case for the Post Office and other similar public bodies to accept analogous rules. This should also help assuage competitors' fears that a business is acting uncompetitively **(paragraph 3.12)**.

iv) **Agreeing a clear statement of performance targets, such as a stated contribution to profits, before agreeing to an acquisition**. This can act as a useful discipline on purchasers who, in pursuit of corporate growth, may be less demanding of the performance of an acquisition than the shareholders, whose concentration in the private sector is on earnings per share. This was partly carried out in the German Parcel case by setting short term stand-alone targets based on German Parcel's Earnings Before Interest and Tax for the next two to four years, and the Department did link the Chief Executive of the Post Office's bonus to the financial performance of the acquisition. We see advantages in similar practice of overall performance targets being followed in the public sector to bring greater emphasis on value for money **(paragraphs 3.16 and 3.17).**

Part 1: The Department of Trade and Industry is responsible for the oversight of the Post Office strategy and major acquisitions

1.1 This section of the report sets out the responsibilities and role of the Department of Trade and Industry (the Department) in relation to the Post Office's acquisition of German Parcel. We find that at the time of the acquisition changes to the Department's responsibilities, as a result of Government proposals in December 1998 for the reform of the Department's relationship with the Post Office, had no bearing on its responsibility to oversee the acquisition of German Parcel because of its size. We also find that the Department supports the Post Office's strategy of becoming a global distribution company through a programme of acquisitions in which the acquisition of German Parcel was a key element.

This report focuses on the Department's oversight of the Post Office's acquisition of German Parcel

1.2 The Post Office acquired German Parcel on 8 January 1999, following an agreement on terms and conditions signed in December 1998, for an estimated £289 million and also spent £10 million on advisers' fees in connection with the acquisition, see Figure 1, its first major diversification into overseas markets. The Post Office initiated and managed the acquisition with the oversight of the Department. This report is about the Department's oversight of the acquisition. The National Audit Office is specifically barred by the National Audit Office Act 1983 from carrying out an audit of the Post Office. We are, however, auditors of the Department whose agreement was needed for the acquisition to go ahead. The report takes as given, as a matter of policy, the overall business strategy leading to the acquisition approved by Ministers. In view of the importance of the acquisition, and the complexity of the situation in that the Department had the responsibility to agree the acquisition but not to carry it out, we decided to examine:

- the Department's responsibilities and role relating to the acquisition;
- how the Department sought to protect the interests of the taxpayer; and

- what lessons of good practice can be established for sponsor departments that have oversight of future acquisitions by state owned businesses.

Appendix 1 contains details of the National Audit Office audit methodology for this examination.

Estimated price of German Parcel

Figure 1

This table shows the constituent elements of the estimated price to be paid by the Post Office for German Parcel

	£ million
Base Price payable in 3 tranches (related to turnover)	255
Property assets purchased	11
Debt assumed	23
Total	**289**
Costs of Post Office's advisers	10

Notes: 1. Figures are subject to final audit and Sterling/DM exchange rates for the payment of the 3 tranches

2. Goodwill of £235 million is being amortised over 20 years on a straight line basis

Source: Post Office estimates

The Department's approval was needed because of the size of the acquisition and because there was overseas funding

1.3 The Post Office is a state owned business accountable to the Secretary of State for Trade and Industry under the Post Office Act 1969 (the 1969 Act). It has a monopoly in letters and parcels costing less than £1 in the United Kingdom (unless weighing over 350 grammes), to ensure the delivery of specific Public Service Obligations: universal service at a uniform, affordable tariff - but operates in competition for all other mail.

1.4 The responsibilities of the Department in relation to Post Office activities are of a general nature and are defined in the 1969 Act, as amended by the British Telecommunications Act 1981. It has a duty to:

- monitor and supervise the Post Office, and can require the Post Office to provide it with specific information to support it in this role;

- ensure that the Post Office prepares a statement of account and an annual report of its own performance and that of its subsidiaries; and

- ensure that the Post Office demonstrates value for money from its activities.

1.5 The 1969 Act gives the authority for the Post Office to acquire private companies. The Post Office did not, however, exercise this authority until the reform process was under way. The 1969 Act requires the Post Office to notify the Department of acquisitions and obtain approval for funding. Having regard to these provisions the Department, with the agreement of Treasury, leave the Post Office free to proceed with acquisitions up to a total of £75 million in any one year.

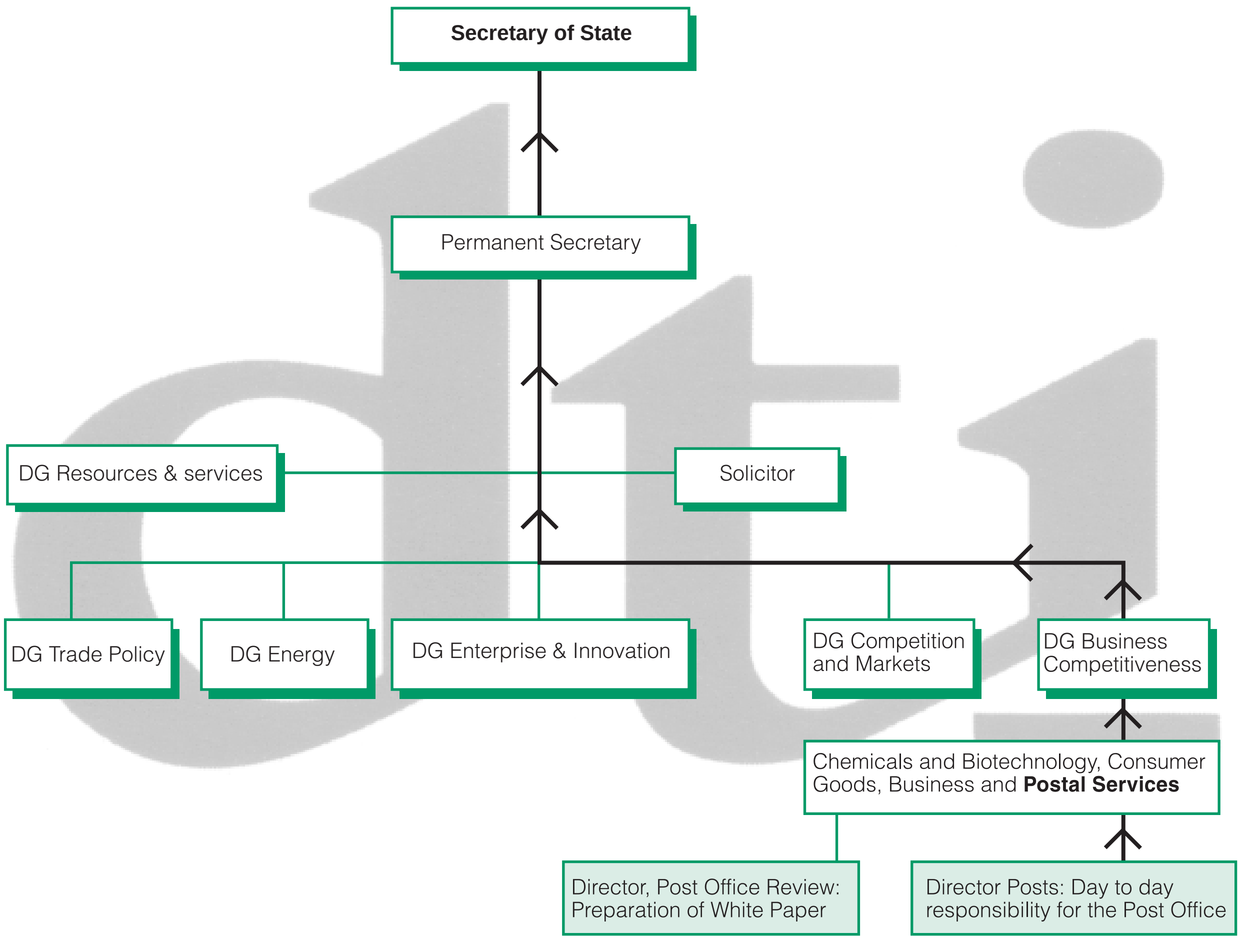
1.6 The consent of the Department and the approval of the Treasury for the acquisition of German Parcel was needed under Section 73 of the British Telecommunications Act 1981 as the acquisition was to be funded in part with overseas debt. The statute requires the Post Office to obtain this consent if it is borrowing in sterling or a currency other than sterling from non-government sources in order to fund its activities.

1.7 The Post Office, as at early July 2000, had acquired nine other small companies since German Parcel: Der Kurier for some £10 million (a German express parcel system with business links with German Parcel); Delacher for some £10 million (a group of franchises in Austria); the Williames Group for some £10 million (a parcel company based in Ireland); the Citipost Group for some £25 million (a company based in the United States); the Crie Group for some £6 million (a French company specialising in domestic and international express mail delivery, mailroom and facilities management and courier services in the Paris area); General Parcel Austria (including General Parcel Slovenia); Pakke-Trans A/S (Denmark) for some £18 million; Nederlandse Pakket Dienst (NPD) (Netherlands) for some £72 million; and Extand (France) for some £71 million.

1.8 The Postal Services Directorate within the Department, see Figure 2, had responsibility for advising the Secretary of State on the acquisition. This part of the Directorate has day to day responsibility for the sponsorship of the Post Office and for international post and courier issues.

Figure 2 **Responsibility for overseeing the acquisition within the Department**

This chart shows the position within the Department of the directorate responsible for dealing with the Post Office



Source: Department of Trade and Industry

The Department supports the Post Office's acquisitions strategy

1.9 In December 1998, following a review of the Post Office and an assessment of developments in the European postal market, the Secretary of State announced a package of reforms for the Post Office.

1.10 Overall the reforms are aimed at allowing the business to be operated more efficiently and the Post Office to react more quickly to changes in the market. The White Paper "Post Office reform: A world class service for the 21st Century", published in July 1999, set out the Government's plan for:

- Greater competition in the postal market.

- Giving the Post Office greater freedom to operate commercially so that it can be managed more efficiently and compete more effectively in an increasingly liberalised and competitive international market.

- The creation of a new, transparent and accountable regulatory framework involving setting up a Postal Services Commission, which will introduce a new system of licensing and regulation for postal service providers in the area of the market currently reserved largely as a monopoly for the Post Office. The Post Office will be issued with a licence to operate in its reserved area and other licences may be issued to organisations to allow them to operate within this area to facilitate the introduction of competition.

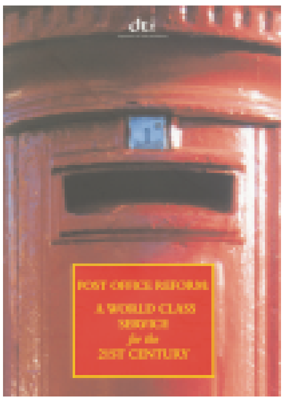
A summary of the White Paper Reforms is contained in Figure 3 below.

Summary of White Paper reforms

Figure 3

This figure summarises the key elements of the White Paper for reform of the Post Office

- relationship with Government which treats the Post Office on the basis of it existing as a PLC;
- a five year strategic plan produced by the Post Office within which it will be able to invest, price commercially and borrow;
- a new independent Regulator to protect customer interests, regulate prices, and enforce fair competition;
- phased liberalisation of the postal monopoly introducing greater competition;
- increase in the retained resources for the Post Office, allowing it to invest any surplus above an agreed dividend rather than surrender surpluses to government;
- a protection of the universal service obligations;
- a commitment to consider further structural reforms if circumstances require.



Source: The Post Office

1.11 The proposals envisage the Post Office being transformed into a public limited company to improve transparency of operations and accountability for decisions and establish the clear separation of the functions of ownership from management, whilst remaining under public ownership. As a public limited company, the Post Office, and its relationship with the Government (as owner), will be disciplined by the full range of company law contained in the Companies Acts. In particular the Department has told us that new legislation will make it clear that the Directors owe their duties to the company (not directly to the Government as owner) and will require the Government as owner to exercise its interests effectively. Strategic direction is to be agreed with the Government while the Board will be responsible for proposing and executing that strategy. The Post Office will be allowed to retain a greater proportion of its profits by providing for it to pay a dividend to Government at commercial levels – 40 per cent of post tax profits from 1 April 2000.

1.12 Key elements of the package include the Government (as shareholder) further extending its "arms-length" relationship with the Post Office Board, allowing it to price commercially and borrow. The current monopoly level of £1 and 350 grammes is in line with European Commission Directive 97/67, December 1997, which is aimed at reducing the monopoly, or reserved area, of all European national post offices. Further phased reduction of the reserved area will be referred to the Postal Services Commission for consideration.

1.13 The proposed reforms of the relationship between the Post Office and the Department allow the Post Office the freedom to acquire other businesses and build its position as a major global distribution company. This freedom is constrained by the Department's requirement that it should have oversight of any acquisitions that exceed £75 million in a year (about 15 per cent of the Post Office's annual operating profits). The rationale for such a threshold is that large transactions, even in the ordinary course of business, can be so significant that they merit scrutiny by the owner. We consider that large acquisitions in overseas markets or new product areas, are a diversification of the business and merit additional attention from a sponsoring department because they represent an increased risk to the taxpayer's interests.

The Post Office is facing increased competition

1.14 A degree of liberalisation already exists in the postal markets of Europe including Sweden, the Netherlands and Germany. More liberalisation is scheduled for the Netherlands and a review is built into recent German legislation. As a result of these and other developments (Figure 4 below) the Post Office faces increased competition for its core business. Competition is increasing in the United Kingdom market for mail destined for overseas. For example Deutsche Post (the national post office in Germany), TNT Post Group (Dutch owned), Nordic Post (Sweden and Denmark) and Swiss Post have all established bases in the United Kingdom to win market share, and to be ready to compete with the Post Office letter service following liberalisation. The Post Office is currently negotiating an international joint venture with TNT Post Group and Singapore Post in the area of cross border mail.

Changes in the external market environment

Figure 4

This figure summarises the principal changes that are affecting the market in which the Post Office operates

Market Change	Details
Deregulation of the Market	Full or partial deregulation in Finland (1991), Sweden (1993), Germany (2003), Portugal (under discussion), Argentina (1993) and New Zealand (1993). European Commission Directive 97/67/EC limited the reserved area for items of correspondence to 350 grammes or where the price is less than five times the basic standard tariff for first class mail. On 30 May 2000, the Commission proposed a new draft directive, that would introduce limits of 50 grammes or 2.5 times the basic standard tariff for first class mail and take effect from 1 January 2003. The new draft directive provides for a decision to be made in 2005 on whether to further liberate the market from 2007.
Privatisation of National Post Offices	Privatisation of post offices in the Netherlands, Singapore and Argentina, and the future privatisation of the post office in Germany (first tranche planned in 2000).
Globalisation	Postal customers themselves are going global with activities and requirements in a number of different countries. The ability to offer a seamless service is of growing importance to package operators.
Technological Advances	Technological developments have changed the market. For example, mail, express and logistics are growing closer together and the advent of email services is a direct threat to postal mail. The development of e-commerce is a boost to the packages market as goods ordered electronically generally have to be delivered via a packages network.

Source: Post Office

1.15 In the run up to liberalisation several of the Post Office's competitors have been acquiring distribution companies across Europe and entering into strategic alliances overseas, thereby widening their business bases. Figure 5 below lists recent acquisitions by several national post offices in the three years to the end of 1998. Little information is available about the prices paid for these acquisitions, as many of these companies are not required to make any public disclosure.

Recent Acquisitions in the European Postal Market

Figure 5

This figure lists a sample of acquisitions that have recently been made by the principal operators in the European postal market to illustrate the consolidation taking place in the industry

Company	Date	Acquisition
Deutsche Post	1996	24.8% of German parcels carrier Trans-o-flex
Scheduled for privatisation	1997	Belgian Parcel (formerly part of General Parcel consortium)
(first tranche in 2000)	1998	IPP Austria
		GP Paket Logistik
		51% stake in Servisco, Poland (Part of General Parcel)
		25% stake in DHL
		Global Mail (US)
		50% of Securicor Distribution in the UK
		68% of Ducros (France)
		Danzas Holdings
	1999	MIT (Express parcels company in Italy)
		Parcel and logistics division of Nedlloyd
		ASG group
		Yellowstone International (US)
		49% stake in Guipuzcoana (Spain and Portugal)
	2000	Herald International Mailing's Ltd (UK)
		QuickMAIL (US)
KPN-Dutch Post (now TPG)	1996	TNT Express worldwide
Privatised with 43% of shares	1998	Net Nacht Express
still held by the Dutch		22.5% stake in Mail 2000
Government		
		Rinaldi, Italian private mail company
		Jet Services (France)
		Foyua (France)
		Spedimacc and Nuova Tenco (Italy)
		Tranjato (Portugal)
La Poste (France)	1998	20% of Denkhaus (DPD)
100% owned by the French	1999	Holding in DPD increased to 33.3%
Government		49% of Birkart
		75% of Interspe
		100% of Incosi
UK Post Office	1998	10.3% of CityMail (Sweden)
100% owned by the UK		Joint Venture with Selektvracht (Netherlands)[1]
Government		German Parcel and share in General Parcel
	1999	German express carrier Der Kurier
		Delacher (Austria)
		Williames Group (Ireland)
	2000	Citipost Group (United States)
		Crie Group (France)
		Pakke Trans A/S (Denmark)
		General Parcel Austria (Including General Parcel Slovenia)
		Nederlandse Pakket Dienst (Netherlands)
		Extand (France)
		Further 57.4% of CityMail (Sweden)

Source: Post Office

Note: 1. This has since been divested.

1.16 The Post Office's parcel distribution company, Parcelforce, provides a parcels service within the United Kingdom and to over 200 companies overseas. It handles some 140 million parcels a year, with a turnover of £474 million in 1998-99 and a loss on ordinary activities before tax of £25 million, Figure 6. This part of the Universal Service Obligation falls outside the Post Office's regulated market and it is therefore open to increasing competition from private sector suppliers particularly companies such as Securicor, TNT Post Group, Parceline and United Carriers in the United Kingdom.

The Post Office's main business activities

Figure 6

This figure describes the operations of the Post Office's main business divisions, together with financial information from 1999 to give an idea of their respective sizes

	Royal Mail	Parcelforce	Post Office Counters
Business	Delivery of letters and small packages throughout the UK and export of letters and small packages abroad	Delivery of parcels in the UK and abroad	Receives cash from Government agencies for disbursement to customers
Regulation	Letters and packages costing less than £1 (unless weighing over 350 grammes)	Subject to a Universal Service Obligation up to 20 Kilograms	Unregulated
1999 Turnover (£ million)	5,570	474	1,148
1999 Profit/(Loss) before tax (£ million)	485	(25)	32
Capital Employed (£ million)	1,927	235	267

Source: The Post Office

The Post Office agreed a long-term business strategy with the Department that was aimed at enabling it to compete successfully in a consolidating market

1.17 The trend for national post offices to acquire private companies, leading to diversification of the range of operations and of products has increased competitive pressure on Parcelforce. The Post Office considers that the recent pattern of acquisitions points to an underlying trend towards consolidation of the parcels and postal markets resulting in market domination by a few global operators. It believes also that unless it develops its business base and strengthens its position while opportunities are still available, it will be pushed into a minority role in the European post and parcels markets and lose market share. It considers that this will affect its ability to sustain its profitability and the public service obligation and to fund necessary investment.

1.18 During 1998 the Post Office analysed the effects of the introduction of the European Directive on liberalisation of the postal services, recent changes in customer needs and developments in new technology. From this analysis it identified its future aim: to transform itself into one of the small number of leading international businesses to supply a full range of global distribution services that it expects will exist following consolidation and change in the market. To achieve this aim the Post Office developed a business strategy which includes a programme of acquisitions to help the competitiveness of the core business: by allowing it to offer a seamless letters and parcels distribution service, and extending its operations overseas to provide a network with global reach. Ministers endorsed this business strategy in December 1998, and the Post Office issued a new strategic plan for 1999 – 2004 in November 1999.

This acquisition was undertaken as part of the realisation of the Post Office's business plan

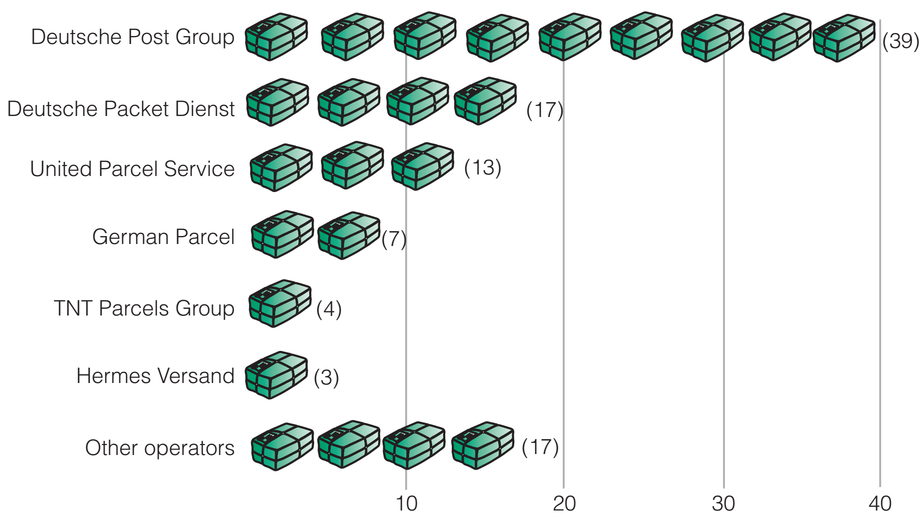
1.19 As part of its new business strategy the Post Office decided to acquire a quality parcel distribution network in Germany. Germany is the key centre for parcel distribution within Europe: the Post Office estimates the size of the German domestic parcel market in 1998 was £3.3 billion, representing some 1.3 billion items, compared to 1 billion items in the United Kingdom. The Department considered that a significant presence in Germany would be important to the Post Office achieving its international ambitions. Investigation of opportunities to invest in companies yielded only two suitable targets, one of which was considered too expensive and not easy to integrate into the Post Office's main operations. The Post Office targeted German Parcel, a company not quoted on the stock market, as an acquisition that would fit its agreed business strategy.

1.20 German Parcel is the fourth largest parcel delivery network in Germany (Figure 7) based in Neuenstein (4,800 employees serving 38,000 customers) with sales of £265 million in calendar year 1998. It operates one of the most modern parcel distribution centres handling some 2 million parcels for next day delivery every week. Its main competitive strength is a sophisticated information technology system that allows bar-coding and tracking of parcels throughout the entire network. Products include an express delivery service, a return shipments service and sophisticated parcel tracking throughout its hi-technology network.

The German parcels market

Figure 7

This chart shows the estimated share of the German Parcels market that each operator held in 1997



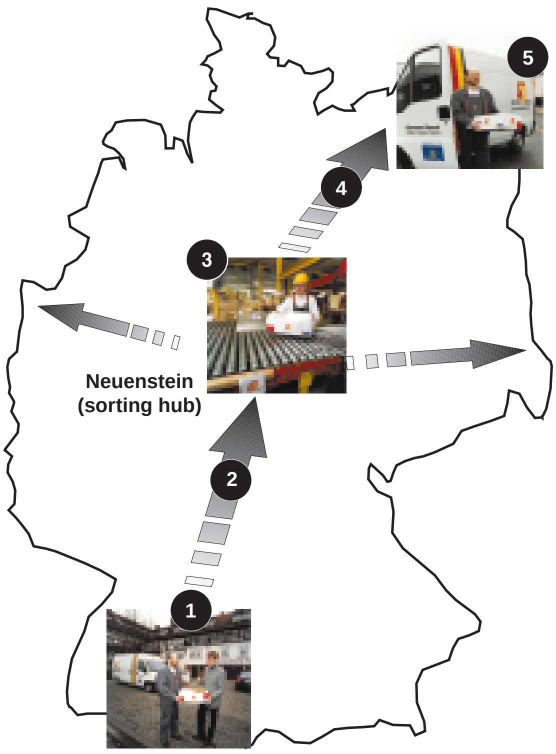
Estimated share of market in 1997 per cent (based on revenue)

Source: German Parcel estimates

1.21 German Parcel had a complex ownership structure that resulted in part from the way the business evolved from an agreement between several freight forwarding businesses to sell, collect and deliver parcels in non-overlapping territories across Germany (Figure 8). In 1988 this service, the hub of the business, was formally established as German Parcel, with the freight forwarders becoming shareholders and franchisees in the business. The majority of the franchisees also owned road haulage and other distribution businesses, which in some cases were partially dependent on, and integrated with, the parcels franchise business. Audited accounts for the parcels franchise business did not, in many cases, exist. In 1989 the franchisees hired a Managing Director who created a nation-wide operating and systems network as well as a central company. The central company had subsidiaries that provided information technology and container rental to the franchisees and operated a franchise in the former East Germany. The Managing Director and the 24 franchisees owned the central company. The structure was aimed at incentivising the franchisees, while retaining control of the system in the central company. It was designed to ensure that no one franchisee could take overall control of the business and the franchisee shareholdings were all of an equal size. This complexity made German Parcel a difficult business to assess.

Figure 8 **The business of German Parcel**

This figure illustrates the structure of German Parcel's business system



German Parcel's operation

Key Dates

1988 - German Parcel is formally established
1989 - A Managing Director is hired by the 25 franchisees. Hub opened in Neuenstein
1990 - Number of parcels carried exceeds 12 million during the year
1992 - German Parcel sets up General Parcel
1998 - Number of parcels carried reaches 95 million during the year
1999 - German Parcel acquired by the Post Office

Business information (1997)

50 Depots countrywide
4,800 full time workers (equivalent)
38,000 customers
Main hub capacity is 60,000 parcels per hour

Note:
1. Originating driver (A) charges customer agreed price which covers all costs of delivering the parcel as well as a profit which is retained by driver A.
2. Driver A takes package to the sorting hub (Neuenstein).
3. Driver A feeds package into the sorting hub and pays a small fee for services to the hub as well as a sum covering the costs of delivery to driver B.
4. Delivery driver (B) collects the package from the sorting hub and receives a sum that covers the cost of delivery only.
5. Driver B delivers the package.

Source: The Post Office

1.22 The profit in the system mainly stayed with the franchisee that originated a transaction by picking up a parcel and feeding it into the hub. The delivering franchisee that then picked the parcel up from the hub and delivered it to its final destination merely recovered the cost of this process. In addition there was a payment for services to the hub, which was covered in the price charged to the consumer. Central accounts for the whole business, including the franchisees' operations, did not exist. The Post Office had to buy not only the shares in the German Parcel hub, but also the parcels business depots run by the franchisees and a small number of sub franchisees. The Post Office also had to enter into two year contracts with the franchisees to carry on giving German Parcel the parcels business that they had been routing through it.

1.23 As German Parcel grew in size it needed to offer a pan-European service to its customers to maintain its competitive position. It therefore set up a Europe-wide franchise network based on the German Parcel model and found partners to link up with in other countries. The company was called General Parcel and is based at Neuenstein in the same location as German Parcel. The partners in each country have rights to sales in their national territory, and an obligation to deliver parcels from the other partners according to agreed quality and cost standards. German Parcel provides the computer systems and operating methods used by General Parcel, sorting and customs clearance services, and also provides 40 per cent of its traffic. In addition to a 24 per cent shareholding, it also owns and controls the intellectual property and information technology systems and grants free licences for use of these to the other partners in the network.

1.24 The Post Office saw considerable strategic benefit in acquiring German Parcel's shareholding in General Parcel thereby providing it with the ability to improve its handling of cross border mail.

1.25 The Post Office believes that the acquisition of German Parcel offers a number of advantages, which are summarised in Figure 9.

Advantages to the Post Office of owning German Parcel

Figure 9

This figure lists key advantages to the Post Office of buying German Parcel

German Parcel

- Has an established high quality parcel distribution service that complements the position of Parcelforce in the United Kingdom, and builds on the experience of the Post Office with City Mail and Selectvracht overseas.
- Offers the Post Office a gateway to Germany allowing it to gain knowledge of the German market pre-deregulation and, through its holding in General Parcel, to other parts of Europe.
- Offers the opportunity through its shareholding in General Parcel, to participate in the fastest growing segment of the package market, the cross border market. In doing so it extends the Parcelforce range of services across Europe.
- Has sophisticated Information Technology, a unique bar coding system, which allows effective parcel tracking facilities at all stages in its delivery.
- Combined with the Post Office and Parcelforce, offers large business customers a total letter and package distribution service across Europe. A Post Office survey of its major customers, representing some 50 per cent of the Post Office business by market volume, indicated that they would prefer one supplier to provide letter and package services to their customers, increasing numbers of whom are located overseas. At that time the Post Office and Parcelforce could not meet such demand; German Parcel was perceived to be an opportunity to fill the gap.

Source: The Post Office

1.26 We examine how, at this time of changing strategy and impending reforms, the Department discharged its role and responsibilities in relation to the acquisition of German Parcel in Chapter 2 of this report.

Part 2: The Department aimed to protect the taxpayer's interest without duplicating unnecessarily the work of the Post Office

2.1 This section of the report describes the Department's oversight of the acquisition. We find that the Department assured itself that the acquisition accorded with the strategy agreed by ministers and was satisfied by the work of the Post Office and its advisers in assessing the financial implications of the acquisition. We also find that the Department aimed to achieve funding arrangements for the deal that would reinforce commercial disciplines on the Post Office.

This was a novel transaction that took place before tried and tested monitoring and supervisory arrangements existed

2.2 As this was one of the first major acquisitions by a nationalised industry the Department did not have in place tried and tested guidelines for the procedures to be followed. The Department, however, had put together with the Post Office an outline of the process that would be followed, the likely timescale required, and the documentation and information that would be needed to assess the case. This outline, which was broadly followed in this acquisition, was finalised on 10 November 1998 **(Appendix 2)**, and did not detail assessment criteria or the Department's objectives, which were developed later in consultation with its adviser (see **paragraph 2.9** below).

The Department had a tight commercial timetable to evaluate the transaction

2.3 Early in 1998 the Post Office approached German Parcel to discuss the possibility of its acquisition. In August 1998 the Post Office informed the Department that it wished to proceed with a major acquisition and, in early October 1998, named the target company formally. Having informed the Department of its wish to proceed, the Post Office stressed the need to progress the deal quickly because of the possibility that competitors would also approach the company. The Post Office indicated that it was concerned that it might lose the deal through inaction, and that it considered it unlikely that such an opportunity would arise again in the near future.

2.4 At the end of October impetus was added to the negotiations as a result of proposed changes to German tax legislation that had important financial implications for the franchisees that owned German Parcel. These changes would have meant that certain capital gains tax allowances then available to the majority of the franchisees (50 per cent reduction in the applicable tax rate on sale of shares) would be removed by 31 December 1998 leading to increased tax liabilities for the vendors if the deal was concluded later. Certain franchisees made it known that they would only sell to the Post Office provided the transaction was documented and signed in 1998.

2.5 The Post Office gave a presentation of its case to acquire German Parcel to the Department on 16 November 1998 during which it indicated a deadline for approval of 15 December 1998 (Figure 10), and that it had exclusive negotiating rights with the vendors until that time. The Department considered this to be an ambitious timetable, particularly as the Post Office did not anticipate that a full business case would be completed before 8 December, but it accepted that it was not commercially prudent for the Post Office to alter this timetable and was concerned to do everything it could to meet the deadline. This included a number of meetings at short notice and question and answer sessions based on the draft business case in addition to the key dates shown in Figure 10.

The Department took steps to assess the commercial robustness of the deal

2.6 Although the Department did not agree in advance with the Post Office its role and responsibilities for a major acquisition, it told the Directors that the Board was accountable for ensuring that the investment in German Parcel was commercially robust and fitted the agreed business strategy. The Department did not define what it meant by "commercially" robust despite being asked by the Post Office for more specific guidance. The Department told us that in its assessment of whether the acquisition was commercially robust it was questioning whether the proposed acquisition:

- fitted with the agreed business strategy;
- was based on reasonable assumptions;
- demonstrated at least a financially neutral impact on the Post Office's projected finances on a stand-alone basis (that is without taking into account any possible synergies with the Post Office's other businesses); and

- had been subject to rigorous review of market risks; legal and regulatory requirements affecting the business; liabilities and any other risks; and the range of possible earnings arising under different assumptions.

Chronology of events relating to the purchase of German Parcel

Figure 10

This chronology shows key events surrounding the acquisition of German Parcel

Date	Event
August 1998	Post Office informed the Department of its aim to purchase a parcel distribution company
2 October	Post Office informed the Department and the Treasury that German Parcel was the target acquisition
16 November	Presentation to Department and requested deadline for approval by 15 December
24 November	Selection and initial briefing of adviser to the Department
1 December	Adviser starts work reviewing the strategy material
4 December	Adviser receives the financial forecasts which had been prepared by PricewaterhouseCoopers
4-6 December	Adviser scrutinises the financial forecasts and requests amendments to be made
6 December 1998	Revised financial forecasts received by adviser. Adviser submits report to the Department who also receive the draft business case
19 December 1998	Ministerial agreement to the purchase and offer to shareholders
22 December	Clearance from the competition authority in Germany, the Bundeskartellamt, for the deal
31 December 1998	Signing of the deal (subject to certain conditions being met)
8 January 1999	Commercial conditions of the deal satisfied
11 January 1999	Secretary of State for Industry publicly announces the acquisition
13 January	The Minister of State, Department of Trade and Industry, states in Parliament that a good indicator of the price paid for German Parcel is £265 million plus any special assets
17 January	The Parliamentary Under Secretary of State for Trade and Industry describes the acquisition of German Parcel as “an investment of nearly £300 million”

Source: The Post Office

2.7 Acquiring German Parcel was a novel transaction for the Post Office, although it had earlier entered into two small joint ventures. As a potentially risky transaction the Department recognised that it needed to ensure that the Post Office had undertaken a sufficient evaluation of the project and conducted the acquisition process prudently.

The Department and the Post Office commissioned advisers to assess the acquisition

2.8 The Department discussed with the Post Office the use of advisers for the acquisition, the work it would undertake for the prime analysis, and the approximate timescale for completion. The Post Office employed PricewaterhouseCoopers as corporate finance advisers, Ernst & Young, its auditors, to provide advice on accounting issues, and Clifford Chance to provide legal advice. The Department decided that it would rely on the work of the Post Office and its advisers in preparing the business case and managing the day to day transaction processes as it considered the Post Office was best placed to undertake the research required. It did not see a need to get involved in detailed analysis, and it did not wish to try to second guess the Post Office or duplicate work, in its area of commercial expertise, particularly as the Government was moving towards granting the Post Office more freedom to run its ordinary commercial business. In addition, the Department considered that the Post Office had developed experience in appraising acquisitions and had appointed a suitable team of advisers.

2.9 The Department decided to concentrate its examination of the acquisition on the strategic case made by the Post Office and its advisers because it considered that the Post Office was better placed to manage the day to day details of the acquisition. The Department's team recognised that it did not have sufficient expertise to assess the proposed acquisition. It took steps therefore to identify the resources and skills that it considered necessary to assess the Post Office's business case for the deal. This was one of the first acquisitions by a public sector body and there was little experience to draw on. The Department considered that there was insufficient time available to conduct a tendering exercise for the advice required, but identified Mr Matthew Bullock, an individual, with relevant skills to undertake the assessment. Mr Bullock had been a member of the Department's Industrial Development Advisory Board, having previously worked as a divisional risk management director in a major commercial bank. Although he did not have specialist experience of acquisitions or any prior knowledge of the post or parcels markets, Mr Bullock had senior level commercial banking experience on credit committees, that is experience of appraising the risks involved in major investment proposals by client companies. He was selected as the Department's adviser on 24 November 1998. In making this appointment the Department sought to satisfy itself that the Post Office had gone through an appropriate process in pursuit of this acquisition. The adviser was not required to carry out a full critique of the valuation exercise undertaken by the Post Office but rather to look at the way in which it was managing its processes and to test some of the key assumptions. In so doing the adviser was required to work to a tight commercially driven timetable as is usual in an acquisition. Details of the Department's contract specification given to Mr Bullock are included in **Appendix 3**.

2.10 During 1998 the Department received and examined analyses made by the Post Office of its strengths and weaknesses, changes in the postal market and competitive developments as the basis of the international business strategy that was agreed with Ministers. The Post Office employed financial advisers PricewaterhouseCoopers, together with Pegasus Consulting, a small consultancy with knowledge of the parcels market, to help it enhance the robustness of the business case for the acquisition. This case primarily relied on a model of the business's projected cashflows to develop a valuation, and included a risk assessment and the arguments supporting the link between the acquisition and the business strategy. The Department recognised also that the successful outcome of the deal was dependent on the Post Office's analysis of potential synergies between German Parcel and its own business, for example the link to General Parcel (see **paragraph 1.23**). The Department was unable to obtain information about the financial impact expected from these synergies because the Post Office's advisers found them difficult to evaluate at such an early stage in the development of a European network.

2.11 Once the Post Office and German Parcel agreed that the acquisition process should proceed, PricewaterhouseCoopers, Clifford Chance, and the Post Office carried out an examination of certain information provided by German Parcel to verify the assets and liabilities of German Parcel in what is called a "due diligence" exercise. The Department relied on this work and the assurance that the Post Office gave it about risks to the taxpayer in this transaction (see **paragraph 2.25**). Based on this reliance the Department did not consider it appropriate to see a report on the due diligence findings.

2.12 As German Parcel had a complicated ownership and organisational structure, it was essential for the Post Office Board to develop a detailed understanding of the nature of the acquisition that could be clearly stated and communicated to the Department. PricewaterhouseCoopers reported that access to the component parts of the business was unusually restricted, and that central accounts for the whole business, including the franchisees' operations, did not exist. The lack of central accounts for the whole business together with the tight timescale that the Post Office was operating to, meant the operating assumptions driving the valuation of the business were based on unaudited 1997 operating results, as estimated by German Parcel management. This meant that the advisers had full access to German Parcel itself, the hub business accounting for 18.5 per cent of 1997 profits, and unaudited figures for the franchise businesses (the depots), estimated to account for 81.5 per cent of 1997 profits. In this connection, a number of risk factors emerged during the due diligence process with consequent implications for the robustness of core assumptions built into the business case. Without a report of the findings from the due diligence examination, and in particular on variations in profitability between franchises, we conclude that it was difficult for the Department's adviser to be confident that the Post Office had taken adequate and appropriate account of identified risks. He was, however, able to form the view that these risks had been identified and that steps had been proposed to manage them.

2.13 Members of management from the Post Office and its advisers from PricewaterhouseCoopers and Clifford Chance, undertook negotiations with the Managing Director of German Parcel and the franchisees to reach a single master agreement for the acquisition of all the shares in German Parcel, as well as the franchisees' operating businesses. In keeping with its "arms length" approach the Department did not follow negotiations closely, for example by obtaining minutes of meetings to keep it informed of the background to the Post Office's key decisions and the nature of the discussion of potential risks. We note that the explanation of why variations, not in turnover but in profit margins, were disregarded in the price paid to individual franchisees, was that the Post Office had decided against any special deals with individual vendors. This approach was the vendors' preference and the Post Office considered that the risk of losing control of the acquisition, by attempting to agree deals with individual franchisees, was very high. Pegasus Consulting argued that taking over cost control post acquisition would level up performance through efficiency gains, whereas PricewaterhouseCoopers warned that there would be no protection against higher arms length prices for related services than in 1997 or a levelling up of costs, for example when harmonising management remuneration.

The Department concluded that the acquisition was financially justifiable on a stand-alone basis but saw the main benefits as being strategic

2.14 The Post Office's business case for the acquisition was based on an evaluation of German Parcel on a stand-alone basis as requested by the Department. The Post Office and its advisers had limited information on the individual franchise businesses and relied on broad assumptions about increasing turnover and achieving healthy profit margins. Although the Post Office identified a number of strategic benefits associated with the deal, for example that German Parcel's shareholding in General Parcel offered strategic opportunities, it did not quantify the value of all of these benefits. The Department could not therefore assess the merits of the shareholding in General Parcel until the strategy was provided in September 1999. Looking at German Parcel on a stand-alone basis, on the assumption of a Weighted Average Cost of Capital of between eight and eight and a quarter per cent, the evaluation of the financial impact of the acquisition on the Post Office was broadly neutral. An alternative analysis on the basis of a nine per cent weighted average cost of capital showed a negative present value which the Post Office considered represented a strategic premium of perhaps 10 per cent to 20 per cent.

2.15 The Department judged that the acquisition fitted with the strategy for the Post Office approved by Ministers and, after taking account of investment costs, that German Parcel as a stand-alone business would not have an adverse impact on the Post Office's financial position. The Department expected that there would be synergies with the Post Office's businesses in the United Kingdom and overseas which would lead to financial benefits. The Post Office had quantified some of these benefits – estimating, for example, that the acquisition could protect income that would otherwise be lost in its Parcelforce business, in excess of Parcelforce's 1998-99 losses (£25 million).

2.16 The Post Office reached an agreement with the franchisees of German Parcel that they would use consolidated turnover as the basis for calculating the price paid for German Parcel. The basic price was divided between the various vendors according to a formula based on specific assets and liabilities, as well as parcels volume per depot. For each vendor there was a further adjustment calculation based on a working capital and debt related formula. The price paid for German Parcel was subject to the Post Office's audit of the company post completion of the transaction and to exchange rates. This final figure for the price paid was not available at mid July 2000, some 18 months after the deal was completed, as the Post Office was in dispute with four of the franchisees. Payment for the company was structured in tranches to allow the Post Office to reflect the results of the post completion audit of 1998 consolidated results, and, by delaying the last tranche to June 2000, to give the Post Office some cover should any claims arise against the vendors. The risk of inaccuracies was partly mitigated by a warranty from the franchisees, providing a possible clawback of about 28 per cent of any excess price paid as a result of the assumed operating profit being too high.

2.17 The Department considers that a full assessment of the value for money of the acquisition, taking strategic benefits into account, will not be possible in isolation from the Post Office's overall strategy and programme of acquisitions, which will not come to fruition for a number of years, and we agree with this. We agree that the Department's approach of assessing the acquisition on a stand-alone basis is reasonable given the difficulties in valuing strategic benefits and uncertainty over the extent to which they might be achieved.

2.18 The Department recognises that there was uncertainty attached to its conclusion that, on a stand-alone basis, the acquisition would not be worth less than the purchase price. This is demonstrated by the wide range of the Post Office's financial projections of the value of the business, based on discounting operating profits in perpetuity. The Department and its adviser concentrated their evaluation on the base case and, taking the purchase price into account, the loss making worst case. We have agreed, on grounds of commercial confidentiality, not to publish details of the cases examined. The range from best to worst of about £109 million in 1999 values indicates, however, the degree of uncertainty. In coming to its judgement that, on the base case examined, the acquisition would not lead to losses after investment costs were taken into account, the Department relied on the Post Office's appraisal, after its adviser had met the Post Office, questioned the growth rate assumptions and the risks to profitability, such as the possibility that costs in the different franchises might harmonise at a higher level, and formed the view that the price proposed was reasonable. If time and access to individual franchise businesses had allowed, it is arguable that a more extensive appraisal of the Post Office's business case and valuation might have reduced the uncertainty attaching to the Post Office's conclusion. But such an appraisal might not have been practical in the circumstances and the Department covered the ground (see Figure 10). The Department also considered that the implementation of the Post Office's international strategy, of which this was the first significant step, was essential to the repositioning of the Post Office in the global distribution market.

2.19 The Post Office had identified the need to take steps to ensure, as far as possible, that the Managing Director of German Parcel and key members of staff were tied in to the company post acquisition. The Post Office informed the Department that it had addressed this issue in the terms of the acquisition documentation signed in December 1998.

2.20 In its role of approving funding for the deal, the Treasury reviewed the business case for the acquisition. Following this examination it asked the Post Office to ensure that performance of the business was reviewed regularly against targets in the business plan.

2.21 In common with most public sector businesses the Post Office is given financial targets by the Government. The principal financial targets for the Post Office in 1998-99 included an External Financing Limit of £310 million, and a Return on Capital Employed of 20.0 per cent for Royal Mail and 5.5 per cent for Parcelforce. The External Financing Limit was the sum of cash that the Post Office agreed to pay over to the Government from its profits. The Department did not adjust the Post Office's financial targets following the acquisition because the External Financing Limit arrangements were under review as part of the Post Office reforms. The Return on Capital Employed target for the acquisition, was forecast in the business case to be within one per cent in four out of the next five years.

2.22 It should be noted, however, that the Department, with advice from Treasury, required that the performance of German Parcel be monitored against a target of Earnings Before Interest and Tax in the business plan, and as a condition of funding approval, that a percentage of the bonus of the Chief Executive of the Post Office (half of a possible 10 per cent bonus) should be linked to how well it did. The Post Office provided its first annual report on the performance of the acquisition to the Department in April 2000 (which had been due in February 2000) to provide a basis for monitoring this condition measured in Deutschmarks. Future monitoring arrangements are currently under review with Deloitte & Touche and should also cover the exchange rate basis for such arrangements.

2.23 TNT Post Group, a competitor of the Post Office in European parcels markets, indicated in discussions with us that its evaluation and performance monitoring arrangements for an acquisition use a notional interest charge based on the company's Weighted Average Cost of Capital, which it estimates at higher than 9 per cent. By using this measure it can determine whether or not an acquisition is value enhancing, in other words, whether future revenues from the business acquired will exceed the costs involved. Although it does not disclose publicly the results of the analysis it has told us that it does disclose whether an acquisition is value enhancing after taking account of the amortisation of goodwill and a notional interest charge based on its weighted average cost of capital. The Department expects the Post Office Board to evaluate and monitor the performance of acquisitions in this way.

The Department obtained assurance on the terms agreed from the Post Office

2.24 The business case was prepared in parallel with the due diligence process undertaken by the Post Office and its advisers. The complicated business structure meant that this process delayed completion of the business case, which was still in draft form as at 6 December 1998, with uncertainties remaining as to the nature and value of assets owned by German Parcel, the accuracy of the management accounts prepared for the business, and the status of contracts between franchisees and customers.

2.25 The Post Office informed the Department that it had been difficult to obtain complete information about German Parcel. It was agreed that this would be addressed through the provision of warranties and indemnities in the documentation for the acquisition and a mechanism for the deferred payment (see **paragraph 2.28**). The Department did not see copies of key documents underpinning the acquisition. For example, it did not obtain a copy of the sale and purchase contract, containing details of the structure of the transaction and the terms negotiated, nor did it ask for a summary of the terms of the contract. Without such details the Department was relying on the Post Office and its advisers to take appropriate action in the legal documentation to identify and address risks. It therefore made this a condition of its approval and required formal confirmation from the Post Office management that this had been achieved.

2.26 On 20 January 1999 the Department obtained a written assurance from the Post Office that its solicitors, Clifford Chance, had reviewed and advised on the legal risks involved in the transaction and that indemnities and warranties which were appropriate in the circumstances had been negotiated and were adequately incorporated into the contractual documentation. This assurance was qualified by a summary setting out a number of limitations, for example that the maximum amount that can be recovered from vendors for breach of warranty is less than half the agreed price. Clifford Chance said this was not unusual in the German market and acceptable in the context of the transaction.

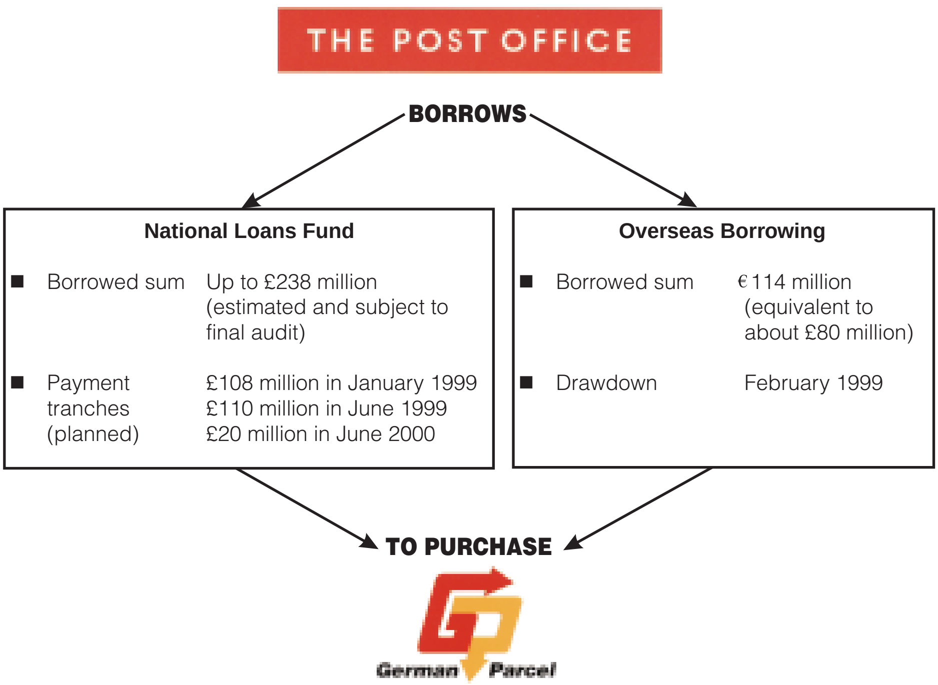
The Department's monitoring arrangements for the period following the completion of the deal were frustrated by delays

2.27 For information purposes, the Department required the Post Office to submit the results of the first six months of German Parcel operations following the acquisition. The Post Office agreed to provide an interim report by the end of June 1999. The Department accepted that the Post Office had had difficulties in finalising the post completion audit of the acquisition (largely because of difficulties in obtaining financial data from some vendors) and it did not press the Post Office to keep to the original timetable because formal monitoring of the Post Office's activities was normally conducted on an annual basis. The Post Office instead requested an extension of time until September and provided the report on 9 November 1999.

Payment Tranches and funding structure

Figure 11

This figure describes the intended funding structure for the purchase of German Parcel



Note: 1. Figures are subject to final audit and Sterling/Dm exchange rates for the payment of the tranches.

2. These figures cannot be added together to get the estimated price since the amount Of overseas borrowing will reduce the amount required from the National Loans Fund.

Source: The Post Office

2.28 Payment for German Parcel was arranged in three tranches, as detailed in Figure 11. It was agreed that the second tranche should fall in June 1999, to provide for the eventuality that adjustments might be required following the audit of completion of the deal and transfer of assets arising from the above difficulties. The June 1999 payment was made in January 2000, because there were still four vendor groups with whom the Post Office had material disagreements.

2.29 The Post Office decided not to integrate German Parcel with its own business immediately, or impose overly burdensome levels of supervision and control that might constrain the entrepreneurial nature of German Parcel. The Post Office appointed the then Managing Director of German Parcel as Managing Director European Parcels, with a separate Managing Director responsible for international letters, both reporting to the Post Office Board Member responsible for strategy. The two Managing Director appointments are not Board level appointments.

Funding arrangements were proposed that reinforced commercial disciplines

2.30 This was the first major acquisition which required approval for funding from Treasury, and at the time Treasury did not have a policy in place that provided clear guidance on the level of rates that should be applied to funds borrowed by public bodies to fund investments in commercial activities.

2.31 The Treasury was concerned in particular that the acquired business would be able to stand as an economically viable entity in its own right irrespective of potential synergies with other parts of the Post Office business and without state subsidies. As the Post Office is being given more commercial freedom to operate in a competitive market, the Treasury believes that it should be seen to be in fair competition with its competitors. It proposed therefore that the source of funds and the structure of the funding package should be such that it puts the Post Office, as far as possible, on the same terms as its competitors in the market.

The Department and Treasury succeeded in putting in place some commercial disciplines as part of the funding arrangements

2.32 Approval to purchase German Parcel was given on the basis that the maximum investment and funding would not exceed £322 million in aggregate to be deployed over three financial years: £176 million in 1998-99, £110 million in

1999-2000 and £36 million in 2000-01. The Treasury, Post Office and Department first met to discuss possible options for funding the acquisition in early October 1998.

2.33 Public bodies usually borrow funds through the National Loans Fund. This is a fund set up with money that is borrowed by the government at a favourable rate from the money market and loaned to public bodies at cost plus administration charges. The Post Office therefore has access to loans at a relatively low rate of interest when compared to private companies borrowing from commercial banks. By borrowing, under section 37 of the Post Office Act 1969, from this source of funds at low rates of interest, the Post Office might be viewed by competitors and the European Commission as likely to be benefiting from anti-competitive practice.

2.34 The Treasury and the Department agreed that the usual rate of interest available through the National Loans Fund would not be appropriate for a commercial investment. The Treasury therefore determined to adopt a policy that would allow it to apply an appropriate commercial rate of interest to funds loaned to the Post Office from the National Loans Fund. This was in part to assure competitors that the Post Office was not acting in an anti-competitive way, and also because the Department wanted the Post Office to be subject to commercial disciplines as well as having greater commercial freedom.

2.35 While the Post Office cannot issue shares to raise funds, unlike its private sector competitors, (for example United Parcel Service sold shares in an Initial Public Offering for US$5,470 million in 1999), in principle it does have the powers to borrow funds from commercial markets. It decided partly to fund the acquisition with overseas borrowing, which offered an opportunity to offset some of the exchange rate risk involved with the acquisition. As German Parcel generates its profits in Euro, the Department and the Treasury agreed with the Post Office that up to £80 million of the cost of the transaction could be funded from Euro denominated borrowing on commercial markets in Germany at a commercial rate. The remainder (up to £238 million to cover the costs of working capital, some property assets, and advisers, as well as the remainder of the base price, Figure 11) should be met from public sector borrowing at commercial rates of interest.

2.36 The Secretary of State for Trade and Industry, with the approval of Treasury, sets the rate of interest charged to the Post Office on loans obtained through the National Loans Fund. To determine the rate of interest that should apply to such a loan, a rate that would be broadly comparable to the rate the Post Office would be charged in the commercial market, the Department initiated an independent commercial credit rating of the Post Office in January 1999. A credit rating is an assessment of the ability of a borrower to meet debt service obligations. This provides an indication of the interest rate or interest margin that the Post Office would be charged to borrow in a commercial market, on the basis that it was a public limited company which did not have an implicit or explicit Government guarantee, nor access to large cash reserves built up over the years from its monopoly business.

2.37 The Department sought independent external advice from Deloitte & Touche as to what an appropriate rate of interest would be, based on the credit rating of comparable private sector companies, assuming that the Post Office did not hold significant past reserves in its balance sheet and the implicit Government guarantee for borrowing did not exist. On the basis of the credit rating report the Post Office has been assessed as an AA rated company for borrowing purposes, and the Department has told us that the resulting commercial cost of credit will be charged retrospectively and in full once arrangements are in place.

2.38 The Treasury judged that the funds should be borrowed through the National Loans Fund rather than the commercial financial markets as it offered the best value for money. By charging the Post Office a commercial rate of interest on National Loans Funds, the difference between this rate and the normal preferential rates for other public sector bodies can be retained in the public purse.

The precise rate of interest was not agreed at the time the deal was evaluated but the Post Office knew the maximum likely rate

2.39 There were unanticipated delays in reaching agreement on the precise interest rate to be charged. These delays were partly caused by the Treasury's need to prepare a new interest charging policy for loans to fund investments in commercial activities. In addition, the Post Office credit rating commissioned by the Department was not completed until April 2000.

2.40 Although the Post Office had submitted its consideration of options for the funding, including an estimation of the interest rates that might apply, before the deal was authorised, the agreement of the final funding structure and the precise level of interest rate to be charged will be settled retrospectively. Companies in the private sector may obtain funds for an acquisition from a number of different sources including the commercial lending market. Commercial financiers would require a company seeking to borrow such funds to agree key terms such as the amount of funds required, its source, the rate of interest charge to be applied, and the repayment period. The company would not proceed with such a transaction unless it had a clear picture of the full financial costs associated with it, allowing a full evaluation of the overall merits of the business case prior to completion of the contract.

2.41 The Department and Treasury considered that the Post Office evaluation using a Weighted Average Cost of Capital of eight per cent was a sufficiently strong evaluation test to justify leaving the funding arrangements and costs to be settled later.

2.42 By not finalising the funding arrangements at the time of completion of the contract, the Post Office did not know the full costs of the acquisition or the period over which the debt would need to be repaid and to this extent was not under all the same pressures as a private company. We also note that adopting the method of funding described above can only act as a commercial discipline on the Post Office if, when the accounting treatment is settled, the Department can see the impact of the higher rate on the financial performance of German Parcel. This could be done in a number of ways depending on the overall reporting structure for the Post Office's European network, currently under discussion with Deloitte & Touche.

Limited early disclosure of the price paid and terms of the deal led to concerns of possible unfair competition

2.43 Before giving its consent for the deal to proceed, the Department required the Post Office to comply with the statutory requirement to obtain clearance for the transaction from the relevant competition authorities **(Appendix 4)**. The European Commission told the Post Office on 13 November 1998 that the transaction did not have a community dimension and that it was not the responsible authority for notification purposes. The Post Office's legal advisers then notified details of the transaction to the Bundeskartellamt (German Federal Cartel Office), as the relevant country authority. The Bundeskartellamt concluded that the transaction did not represent a creation or strengthening of a market dominant position, and gave clearance for the acquisition to proceed on 22 December 1998.

2.44 A number of competitors of the Post Office nevertheless expressed concern to us that the Post Office might have used reserves built from profits earned on its monopoly activities to fund the acquisition or had access to borrowing at low rates, giving it an unfair advantage over other businesses in the industry. Their concerns were enhanced because the Post Office did not announce the price it had paid at the time it announced the acquisition. The Department was also concerned that the Post Office should account for the acquisition in a transparent way so that its performance/impact on the wider parcels business could be assessed. The competitors that we spoke to have confirmed to us that some of their concerns about unfair competition have been assuaged by the agreement that acquisitions should be funded entirely by borrowing at a commercial rate. One competitor, TNT Post Group, also called for acquisitions to be evaluated and monitored along the lines set out in **paragraph 2.23**.

2.45 In its announcement of the acquisition, the Post Office described the nature of the business and its annual sales, but did not provide details of the price it paid for the company. The Post Office was reluctant to disclose the price paid for the acquisition as it believed this information would be of benefit to its competitors. At that time the Government agreed with the Post Office that disclosure of this information was not in its best commercial interests, particularly as major competitors such as Deutsche Post did not disclose similar information for acquisitions that they had carried out.

2.46 In a statement to the House of Commons on 13 January 1999 about the acquisition, the Government recognised however that the Post Office needed to be as transparent as possible in its dealings, and that Parliament should be aware of Post Office investments and financial commitments. The Government indicated the size of the investment by stating that a normal core price for such an acquisition might be the annual turnover of the company plus any special assets. For German Parcel the estimated turnover given for calendar year 1998 was £265 million.

2.47 Private sector companies wrote to the National Audit Office expressing concern that the Post Office may have paid too much for the acquisition. The companies complained about the lack of information about the deal, and stated their belief that the Post Office was acting in an anti-competitive manner in withholding information about the price paid and how the deal was being funded. Failure to disclose was viewed by private sector competitors as possibly hiding anti-competitive practice. The Post Office has now adopted a policy of announcing the acquisition price at the same time as announcing the acquisition.

2.48 In Chapter 3 we examine the lessons of good practice to be drawn from the Department's pathfinder transaction and which, taken together with private sector practice, may assuage these concerns.

Part 3: What lessons of good practice can be learned from this transaction?

3.1 This chapter broadens our analysis to include some reference, where it may be helpful, to the handling of acquisitions by private sector companies, and generally to examine the lessons of good practice from the Department's pathfinder transaction to draw to the attention of sponsoring departments in overseeing other transactions.

3.2 We found from our analysis that the following points of good practice could benefit departments and help protect the interests of the taxpayer when handling major acquisitions:

- **i)** formal assurances from the Board of the acquiring company to the sponsoring department covering the acquisition proposals;
- **ii)** a procedure to monitor the acquisition process based on that adopted by the Department (**Appendix 2**) with consideration given to expanding the information provided using elements of private sector practice (Figure 12);
- **iii)** formation of a departmental team with corporate finance experience and sectoral knowledge, supplemented by external advisers, to oversee the acquisition being kept fully informed on all aspects including negotiations and due diligence;
- **iv)** the provision of transparent information on the transaction as if the acquisition were subject to London Stock Exchange disclosure requirements;
- **v)** the arrangement of acquisition finance on commercial terms to reduce competition concerns; and
- **vi)** the setting of financial targets to reflect the improvements in overall financial performance expected as a result of an acquisition.

We consider that the London Stock Exchange disclosure requirements (the class test procedures described in **paragraph 3.10**) should be taken into consideration when departments determine the appropriate level of disclosure of information to give some assurance on the impact of the transactions. We do not regard it as relevant to a department's approval of a transaction, as departments will generally have set materiality thresholds for the approval of transactions which are appropriate to the particular circumstances of individual companies. In the case of the Post Office, this is currently £75 million.

Obtaining assurance of the whole Board on their detailed knowledge, approval and accountability for the acquisition

3.3 We note that in the case of the acquisition of German Parcel the Chief Executive of the Post Office wrote to the Department reporting the unanimous approval of the transaction by the whole Board. The Department also saw the documents the Board received and was surprised that they were not very detailed. We consider that the level of detail provided to the Board and non-executive Directors is highly relevant because, given the "arms-length" level of the Department's scrutiny, the Board is likely to be the best judge of the implications of the transaction for the business. For example the Board is best qualified to assess the overall balance of commercial risk, taking into account the worst case scenario, and the expected benefits from the acquisition strategy.

3.4 As a further step, on material transactions, such as those above £75 million in the case of the Post Office, a sponsoring department may wish to consider asking the whole Board to accept responsibility for the accuracy and completeness of the information provided, and to confirm that the value of the acquisition justifies the price paid, thereby explicitly accepting responsibility for the financial projections presented for the combined business. This would be similar to the private sector practice of giving shareholders, subject to a materiality test, a declaration of responsibility for the information provided and a voting recommendation that the acquisition "is, in the opinion of the directors, in the best interests of the shareholders as a whole". It is also usual practice for the directors of quoted companies to ask for opinions from their professional advisers about the implications of a transaction, which they rely on when advising shareholders.

A procedure to monitor acquisitions that preserves accountability but avoids second guessing

3.5 The monitoring procedure agreed by the Department in the case of German Parcel (**Appendix 2**) forms a basis for a department to check that an acquirer has taken an appropriate approach to the acquisition. The information required by this approach is already close to private sector practice. As shown in Figure 12 there could, however, be greater emphasis on key financial aspects which departments might find useful. Advisers to the Department and the Post Office have expressed the concern that tight commercial timetables may not easily accommodate these procedures. Nevertheless the procedure set out in Figure 12, which illustrates good practice, could be a useful starting point for a department even if, in the circumstances of a particular acquisition, it decided to relax some of the provisions.

Illustrative information to be provided for public sector acquisitions

Figure 12

In summary, departments should consider asking a state owned business to provide, depending on the nature of the acquisition, the following information.

(italicised elements were not applied to German Parcel)

- Description of the business to be acquired, *including a three-year financial record*
- Strategic and financial justification for the transaction and the financial impact on the acquirer, *with financial projections demonstrating that the pre-agreed required return on its investment is achieveable*
- Details of key features of the transaction, for example:
  - Financial – including projections and valuation
  - Legal – including *a summary of any material contracts* and any outstanding litigation
  - Operational
  - Management arrangements – including details of remuneration and any service contracts
  - Any conflicts of interest
- Risks associated with the transaction
- Intended plan for integration of the acquisition with the acquirer
- Consideration, including any earn-out arrangements, advisers' costs and assumed liabilities
- Method of financing the transaction including working capital
- Advisers' views of the transaction, *directly addressing a department's concerns*
- Formal confirmation that the Board considers that *the value of the acquisition justifies the price paid for it*

Source: National Audit Office

3.6 Departments may be able to gain some comfort from the business judgement and previous experience of the acquirer and its retained advisers. Details of the range of skills typically employed by an acquirer in the private sector, and the steps in the transaction, are detailed in **Appendix 5.** A department should check, as was the case in this acquisition, that skills mobilised by the acquirer include corporate finance skills to analyse the business case, legal skills to assess management of risks identified, and banking skills to consider an appropriate funding structure for the deal.

Departments should ensure that they also have ready access to appropriate skills

3.7 As in the case of a privatisation, departments should consider forming a departmental transaction team with corporate finance and relevant sectoral skills. The Department recognised that, even after calling on internal specialists such as lawyers, and colleagues with experience of evaluating businesses in the Industrial Development Unit, its internal team did not have all the relevant experience needed. It told us that its own post event review of the acquisition highlighted the need to identify the range of expertise it would require for assessing future transactions. The Department has since appointed Deloitte & Touche to lead and co-ordinate a multidisciplinary service in combination with strategy consultants (OC&C Consulting) and a law firm (Lovell White Durrant). Their terms of reference include reviewing elements of the strategy, analysing the business case, testing its commercial robustness, commenting on the proposed management structure, and advising on its implications for the Post Office. We note that in some countries the practice is for oversight of nationalised industries to be carried out by a single department. This has a number of advantages and disadvantages and in the case of the oversight of transactions such as acquisitions, may allow a greater depth and breadth of commercial expertise to be brought to bear; as broadly speaking the establishment of Partnerships UK has allowed a wide range of skills and depth of experience to be brought together to advise on the development of privately financed projects, including the most appropriate advisory team to be used on a transaction.

3.8 Given the historical “arms-length” relationship and the mutual confidence it has engendered, the Department relied on the Post Office to keep it adequately informed about the progress of this acquisition which it considered to be part of the Post Office’s core business. In other cases a step by step briefing with copies of minutes, or even an adviser’s presence as an observer, may help a department to understand what it is being asked to evaluate and approve.

Departments should consider the Stock Exchange disclosure requirements on listed companies

3.9 A major company, quoted on the Stock Exchange, is required to abide by the Stock Exchange rules on disclosure of information about material acquisitions both to its shareholders and to the market. In being obliged to disclose details, for example, on price paid at the time transactions are completed, private sector companies are subject to disciplines not imposed on the Post Office. The financial markets may react adversely to the price paid for an acquisition causing a fall in the company share price. Such disciplines encourage company management to seek to avoid overpaying or pursuing a controversial strategy, and are not easy to replicate through the approval procedures adopted by departments.

3.10 The Stock Exchange Listing Rules, which reflect requirements of European Commission directives and the Financial Services Act 1986, apply to all listed companies and have specific requirements relating to transactions of a certain classification and size. The extent of disclosure by a listed company acquiring another is based on tests (called “class tests”) on a percentage basis. These class tests take into account the relative size of the target’s assets, profits and turnover compared to those of the acquirer; also the price paid compared to market capitalisation and compared to gross capital adjusted for non-current liabilities. Broadly speaking, if any of the tests result in percentage ratios of 25 per cent and above, the classification is called “Class 1", a result of more than 5 but less than 25 per cent is called ”Class 2", and classification below 5 per cent (“Class 3”) is considered less material.

3.11 The amount of information disclosed to Parliament about German Parcel two days after the acquisition was an indication that the price to be paid approximated turnover (about £265 million) adjusted for the value of any special assets, then on 17 January 1999 “an investment of nearly £300 million”. Because it covered the overall cost and financing of the acquisition, for example including working capital, this information was not in a form that can easily be reconciled with the notes in the Post Office 1998-99 accounts which state that the “fair value of consideration” was £247 million. On any of these figures, however, the assets, profits and the turnover of German Parcel were below the 5 per cent threshold, taking the Post Office’s regulated and unregulated businesses as a whole. The amount to be paid was, however, clearly above the 5 per cent threshold indicating a transaction equivalent to a Class 2 transaction. Companies carrying out Class 2 transactions are required to disclose the further transaction details such as asset values and profits which are included in Figure 13 below.

3.12 The White Paper on the future of the Post Office requires the Post Office to be transparent in its operations and in accounting for its activities and to demonstrate that it is competing fairly with its competitors. The Department has told us that it accepts our argument that there is a case for the Post Office and other similar public sector bodies to accept analogous rules to those of the Stock Exchange. This would, where relevant and material, include information on the price paid, the profits attributable to the net assets being bought, and the effect of the transaction on the profit and loss account and balance sheet of the purchaser. This should also help assuage competitors’ fears that a business is acting uncompetitively.

Details of Class 2 transactions are required to be announced

Figure 13

This figure summarises the details that a company undertaking a Class 2 transaction (as described in paragraph 3.10) would have to announce publicly

- particulars of the transaction, including the name of any company or business, where this is relevant;
- a description of the business carried out by, or using, the net assets the subject of the transaction;
- the consideration, and how it is being satisfied (including the terms of any arrangements for deferred consideration);
- the value of the net assets the subject of the transaction;
- the profits attributable to the net assets the subject of the transaction;
- the effect of the transaction on the listed company including any benefits which are expected to accrue to the company as a result of the transaction;
- details of any service contracts of proposed directors of the listed company;
- in the case of a disposal, the application of the sale proceeds; and
- in the case of a disposal, if shares or other securities are to form part of the consideration received, a statement whether such securities are to be sold or retained.

Source: National Audit Office

Departments should consider funding for an acquisition on the strength of the business itself

3.13 We have noted in Chapter 2 that the Post Office will be charged commercial rates of interest on funds borrowed for the purpose of acquiring German Parcel following a credit review process that assesses the Post Office as a stand alone business entity. This will introduce an additional element of commercial discipline if the appropriate cost of funds is applied accurately and transparently to the line of business in question.

3.14 The funding model for an acquisition of a strategic nature by the Post Office, as used in this case, may not always be applicable and should not automatically be followed. For example, in the private sector, parent companies would be likely to give a parent company guarantee under similar circumstances. In different cases with a less strategic profile parent companies may well prefer not to give such a guarantee in favour of a subsidiary or separate business that can obtain a stand–alone credit rating. Departments may wish to consider and seek Treasury guidance on the alternatives open to them. We note that in this case the chosen method of guaranteed funding does not alter the investment risk. Indeed PricewaterhouseCoopers commented in their business evaluation report that a Post Office guarantee of borrowing by German Parcel "could be akin to contingent equity".

3.15 By way of comparison, a separate credit rating for parcels, for example by restructuring the parcels business in the UK and internationally, would further alleviate any suggestions of a cross-subsidy from the rest of the business. As an alternative to such a restructuring, consideration could be given to attributing a cost to the parent company guarantee, as given by the Post Office in support of the overseas borrowing for German Parcel.

Targets set for any public sector entity should be adjusted to reflect the financial performance expected as a result of an acquisition

3.16 This acquisition was undertaken by the Post Office without the Department setting a specific financial target either in respect of a positive impact on the External Financing Limit or any other overall profit target for the UK and overseas parcels business. The Department, however, on advice from Treasury, did require the performance of the acquisition to be monitored against the short term Earnings Before Interest and Tax targets set out in its own base case business plan and intends this to be linked to the performance-related pay of the Post Office Chief Executive. We understand that a system will be put in place to link the achievement of this plan to half of his 10 per cent bonus element (being the personal objectives retention bonus additional to a maximum bonus of 40 per cent under the Board bonus scheme based on various measures of Post Office profits and service levels). Consideration might usefully be given to linking incentive remuneration to achieving the overall agreed strategy rather than to an individual acquisition.

3.17 In the interests of shareholders, the Board of a private sector company will usually agree a clear statement of performance targets for monitoring an acquisition before deal clearance is given. For example the Board may stipulate that the acquisition must make a stated contribution to profits over the first three years of ownership or set other performance targets in the case of a transaction such as German Parcel which had been undertaken for strategic, and partly defensive, reasons. In this way the Board seeks, on behalf of shareholders, to satisfy itself that the acquisition will provide value for money in terms of earnings per share and that the company executives are not free to pursue corporate growth for its own sake. Although 1999-2000 short term financial targets were set for

German Parcel itself, we would see advantages in a more comprehensive set of targets covering both the acquired company and its financial impact on the acquirer in order to bring about greater emphasis on value for money.

3.18 We note that the White Paper provides for Treasury and the Department to set targets for the Post Office which link the performance of acquisitions to requirements for future dividends to be paid. The move to public limited company status and balance-sheet re-organisation will facilitate this and make it easier to compare the Post Office's performance to competitors, as will the preparation of periodic independent analysts' reports which has been proposed by the Department to the Post Office.

Appendix 1: Methodology used by the National Audit Office

1 Our work was aimed at enabling us to understand: how the Department discharged its responsibilities for overseeing the Post Office's acquisition of German Parcel; private sector practice in relation to acquisitions; and what elements of good practice sponsoring departments could learn from this transaction. The National Audit Office is specifically barred by the National Audit Act 1983 from carrying out the audit of the Post Office. We are, however, the auditors of the Department whose agreement was needed for the acquisition to go ahead, which is why we examined the role of the Department in the acquisition rather than the Post Office's handling of the acquisition. The report takes as given, as a matter of policy, the overall business strategy approved by Ministers.

2 The Report is divided into three parts:

i) the responsibilities of the Department;

ii) what the Department did to protect the interests of the taxpayer; and

iii) the lessons that there are for handling any future acquisitions.

Main aspects of the National Audit Office methodology

3 The main aspects of our methodology were:

a) we undertook an extensive examination of files held by the Department to collect information relating to: the acquisition; the Department's monitoring and oversight of the acquisition process; and, to the role of the Treasury in the approval for the Post Office to borrow funds to finance the acquisition; we only obtained Post Office documents available to the Department as this was the Post Office's preferred way of dealing with the study;

b) we interviewed staff from the Department and Treasury about how they handled key aspects of the acquisition process, and discussed with the Department's adviser (Matthew Bullock) the work he had undertaken in support of the Department's assessment of the acquisition;

c) we examined the Post Office's report, prepared with PricewaterhouseCoopers, on the financial status and future prospects of German Parcel prior to the acquisition, and the analysis of reports following the outcome of the acquisition;

d) we interviewed parties who had an interest in the acquisition process for their views, including competitors to the Post Office in the parcel distribution business (United Parcel Service and TNT Post Group), officials from the Bundeskartellamt and the European Commission. The Post Office declined to talk to us directly although it responded to the Department's requests for clarification of factual issues on drafts of the study;

e) we evaluated the evidence obtained from interviews and from documentary sources.

The National Audit Office employed Wilmington Capital Limited to advise on private sector practice in the handling of acquisitions.

Appendix 2: The Department's proposed process for overseeing a major international acquisition

The Department's proposal for the process for overseeing a major acquisition at the time it was evaluating the acquisition of German Parcel is detailed below as at 10 November 1998. This process was discussed with Treasury and the Post Office.

The process

- Advance notification to Department/Treasury that deal under consideration and that business case being prepared with external adviser. Post Office to submit an indicative paper setting out what is proposed, how deal fits into overall strategy, why it's being considered & what objectives are, nature and structure/scale/cost of deal. Estimated timescale for coming forward with proposal;

- Department will alert ministers;

- Post Office to keep Department informed of progress and thinking plus any relevant papers;

- ***[DAY ONE]*** Post Office to confirm intention to proceed and submit (externally validated) case to Department and Treasury together with the other relevant papers put to the Post Office Board. Case to include:

  strategy fit (including where proposed deal fits into Post Office core business and the opportunities it will provide)

  market analysis (including market impact/effect on competition/any competition policy implications)

  legal analysis (including any regulatory requirements to be fulfilled)

  company analysis and health check (including liabilities)

  objectives

options available

proposal (including proposed ownership structure/how acquired investment will be handled/risk management/how liabilities will be ring-fenced)

amount of investment (including how much/how deal will be financed/what is being bought/liabilities)

assumptions

sensitivity analysis around assumptions

business projections (best and worst case)

expected returns (best and worse case)

identification of key risks and risk management strategy

next steps (including how deal will be achieved/negotiating parameters)

- ***[DAY TWO]*** Department to set up meeting with Post Office and Treasury

- ***[DAY TWO]*** submission to Department's ministers

- Department internal consultation with:

Economists

Lawyers

Competition policy

Industrial Development Unit

[independent financial advisers?]

auditors

Treasury

- *[DAY SEVEN]* Department /Treasury meeting with Post Office: providing opportunity for questions, notification of any immediate conditions/sensitivities, to seek clarification and further information;
- *[DAY NINE]* Post Office to provide any additional information required;
- inter-departmental consultation between officials;
- further dialogue/clarification as needed;
- *[DAY THIRTEEN]* advice to ministers;
- answer questions raised by ministers;
- *[DAY SIXTEEN]* – inter-ministerial correspondence (if necessary);
- *[DAY TWENTY ONE]* – target date for ministerial decisions;
- *[DAY TWENTY ONE]* – Department to advise of ministerial decisions and any conditions/qualifications (eg subject to European Union or other competition clearance) and negotiating parameters (including investment limits and timescales);
- If negotiations proceed. Post Office to keep the Department informed of progress, consult on any proposed changes to the parameters and before final completion/closure of deal;
- Department to seek final ministerial agreement;
- Post Office to notify outcome to Department before any announcements;
- Department to advice ministers and Treasury officials (writing if necessary);

- Post Office to consult Department re terms/timing of announcements?

Key principles

- these guidelines are designed to apply to any international deal that goes beyond the parameters set in the existing “Guidelines for international joint ventures”;
- any proposals should be within the context of the Post Office Corporate Strategy;
- Department/Treasury must be consulted on any deal proposed and from the earliest opportunity ie well before DAY ONE;
- within the strong framework of commercial confidentiality there must be the greatest openness and frankness between Department/Treasury and the Post Office;
- Department/Treasury will have access to all the papers to be seen by the Post Office Board;
- the business case will be prepared with the support of appropriate external advisers;
- any agreement to enter into negotiations will be subject to specific parameters and conditions (including financial parameters and agreed timescales);
- Department/Treasury must be consulted on progress through-out negotiations and before any deal is finalised.

NB: days refer to working days

Source: Department of Trade and Industry

Appendix 3: The contract specification given by the Department to its external adviser to examine the Post Office acquisition of German Parcel

1 The Department employed an independent consultant, Matthew Bullock, to provide advice on the strengths and weaknesses of the Post Office proposal to acquire German Parcel and to evaluate the Post Office's business case. In particular he was asked to advise the Department whether:

- The Post Office's approach to the acquisition was sound, and/or whether the Post Office needed to consider other issues.
- The Department had asked for sufficient information to be presented, and whether the information presented was of sufficient detail and quality to allow for an informed judgement.
- The Post Office's analysis contained in the business case was sufficiently rigorous.
- The business projections prepared by the Post Office's own advisers were based on reasonable assumptions.
- The proposed ownership and management structure of German Parcel following acquisition was workable and alternatives that should be considered.
- The risk assessment in the business case was realistic and the risk management strategy proposed by the Post Office was appropriate to the circumstances.
- The financial case for the acquisition was sound, for example that the valuation of the investment was realistic and that identified liabilities had been sufficiently addressed.

2 And overall to advise on how good a deal (or not) the acquisition represented in both the short and long term.

Appendix 4: Clearance with the Competition Authorities

1 Before giving its consent for the deal to proceed, the Department required the Post Office to obtain the necessary clearances for the transaction from the relevant competition authorities. Clifford Chance, the Post Office's solicitors, wrote to the Merger Task Force in the European Commission on 11 November 1998 asking for confirmation of their view that there was no requirement to make a "notification of merger" to the Merger Task Force in respect of the proposed acquisition. The European Commission confirmed to the Post Office on 13 November 1998 that the European Commission did not have jurisdiction over this transaction, it was a matter for the relevant country authority - in this case the Bundeskartellamt (German Federal Cartel Office). This was because it considered the acquisition represented 25 separate mergers of individual franchisees, together with the hub company, and each merger was below the threshold, in terms of the value of individual business turnover, at which it would need to be assessed by the European Commission.

2 Clifford Chance subsequently filed a pre-merger notification of the Post Office's intention to proceed with the acquisition to the Bundeskartellamt on 3 December 1998. An acquisition will be prohibited by the Bundeskartellamt where it is expected to create or strengthen a dominant position in a particular market unless the undertakings concerned prove that the acquisition will also lead to improvements in the conditions of competition, and that these improvements outweigh the disadvantages of market dominance. Also the Bundeskartellamt decided that the Post Office did not have any business connections with Deutsche Post, the German national post office, which would have had to be taken into consideration.

3 The Bundeskartellamt concluded that the transaction did not create or strengthen a market dominant position, and gave clearance for the acquisition to proceed on 22 December 1998. This information was not provided to the public at the time the deal was announced.

Appendix 5: Steps taken by an acquirer in proceeding with an acquisition transaction

The following tables set out some of the usual steps (transactions will, however, vary) taken by an acquirer in the acquisition of a private company, which is financed by debt.

	Professional skills involved						
Transaction steps	Company transaction team	Corporate Finance	Legal	Accounting	Property Valuation	Industry knowledge	Banking
Identification of target	✔	✔	-	-	-	-	-
Preliminary analysis of the target from publicly available information	✔	✔	-	-	-	-	-
Determination of business fit, strategic attraction and potential for merger benefits	✔	-	-	-	-	-	-
Appointment of advisers	✔	-	-	-	-	-	-
Analysis of Target to determine:							
■ key areas for investigation	✔	✔	✔	✔	-	✔	-
■ preliminary valuation	✔	✔	-	-	-	-	-
■ basis of offer and indicative terms	✔	✔	-	-	-	-	-
■ funding structure	✔	✔	-	-	-	-	✔
■ financial impact on acquirer	✔	✔	-	✔	-	-	-
Approach to Target	✔	✔	-	-	-	-	-
Negotiations with target and agreement to obtain preliminary information	✔	✔	-	-	-	-	-
Preliminary information analysed:							
■ assets and liabilities	✔	-	✔	✔	✔	-	-
■ projections for Target prepared	✔	-	-	✔	-	✔	-
■ financial impact on acquirer	✔	✔	-	✔	-	-	-
■ further consideration of value	✔	✔	-	-	-	-	-
■ integration issues	✔	-		✔	-	✔	-
Proposal to acquirer Board for preliminary approval of terms of offer	✔	-	-	-	-	-	-
Further negotiations with Target on terms of offer	✔	✔	-	-	-	-	-

continued ...

Transaction steps	Professional skills involved						
	Company transaction team	Corporate Finance	Legal	Accounting	Property Valuation	Industry knowledge	Banking
Agreement reached with target on offer terms subject to: due diligence and contract	✔	✔	-	-	-	-	-
Due diligence commenced:							
legal	-	-	✔	-	-	-	-
financial		-	-	✔	✔	-	-
Contract negotiations, including:							
■ warranties and indemnities	✔	✔	✔	-	-	-	-
■ price adjustment mechanism	✔	✔	✔	-	-	-	-
■ earn-out provisions (if any)	✔	✔	✔	-	-	-	-
■ protection in areas where due diligence not possible	✔	✔	✔	-	-	-	-
Terms of funding agreed and commitments obtained from banks	✔	✔	-	-	-	-	✔
Final proposal and terms of acquisition put to Board (and shareholders where necessary)	✔	✔	✔	✔	✔	✔	✔
Final agreement, contract signed and public announcement made	✔	✔	-	-	-	-	-

Note: The green ticks may not apply in all cases

Source: Wilmington Capital Limited

Glossary

Cost of Capital	This is the cost to an organisation of raising capital. It is expressed as a percentage of the sum to be raised.
Credit rating	A credit rating on a company is a judgement about a company's financial and business prospects. It reflects the probability of a company defaulting on its obligations to its creditors. There is no fixed formula by which ratings are calculated, but important determinants may be the company's debt-to-equity ratio, the ratio of earnings to interest, and the return on assets. The ratings are expressed in the form of A+, AAA etc.
The Companies Act 1985 (as amended 1989)	The statutes that govern the setting up and running of a company. These two Acts are the main source of company law.
Due Diligence	A process by which the purchaser can verify the facts and assumptions that it has used as the basis upon which to make an offer for the company.
External Financing Limit	The limit on external borrowing set annually for public sector bodies by the Government taking account of the forecast financial position of the business, including its expected profitability and investment needs. Where this is negative, the generation of a cash surplus is required for investment in Government Securities. Where positive, funds may be realised for investment in the business.
Industrial Development Advisory Board (IDAB)	IDAB is a statutory body set up to provide independent expert advice to the Secretary of State on the exercise of his powers to grant selective financial assistance. This assistance may be to develop, modernise, promote efficiency, or maintain productive capacity where this provides or safeguards employment in assisted areas, or where the assistance is likely to benefit the economy.
Industrial Development Unit	This is a unit within the Department of Trade and Industry which appraises large applications for Regional Selective Assistance grants, negotiates terms and conditions of assistance and advises on major commercial and financial issues.
National Loans Fund	Government's borrowing and lending account at the Bank of England
Parcel	A parcel is an item weighing up to 50 (although generally only 30) kilos, moved as a single item or as a collection of items (known as a consignment).

Public Limited Company A public limited company is distinct from a private limited company since it can offer shares to the public in order to raise capital. Its name must end with the words ‘public limited company’ or the abbreviation ‘plc’.

Return on Capital Employed This is a measure of a company’s financial performance expressed as a ratio of its profits to the capital it employs in its business.

Universal Service Obligation Section 59(1) and (2) of the British Telecommunications Act 1981, as amended by the Postal Services Regulations 1999, requires that the Post Office provide a universal postal service: at least one delivery of postal packets is made every working day to each postal address in the United Kingdom; at least one collection of postal packets is made every working day from each collection point designated by the Post Office; postal services for the collection, sorting, transport and delivery of postal packets, whose weight does not exceed 20 kilograms and whose dimensions fall within permitted limits, are provided at affordable prices; and a registered post service is provided at such prices.

The European Union Postal Services Directive requires Member States to ensure that users enjoy the right to a universal service involving permanent provision of a postal service at all points in their territory. The Directive further requires that tariffs should be affordable, transparent and non-discriminatory.

Weighted Average Cost of Capital This is the cost for a company of raising capital through a combination of shares and debt. It is expressed as a percentage of the sum to be raised.