NATIONAL AUDIT OFFICE

DEPARTMENT OF TRADE AND INDUSTRY

Financial Support for Post Offices

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 287 Session 2004-2005 | 24 February 2005

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DEPARTMENT OF TRADE AND INDUSTRY

Financial Support for Post Offices

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21 February 2005

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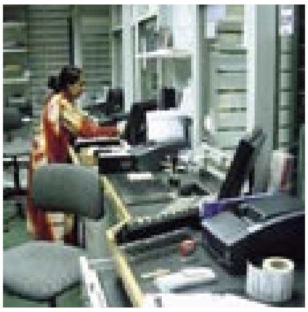


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EXECUTIVE SUMMARY

1 For more than a century post offices have been an important and much valued part of communities across the United Kingdom. But in the last two decades the number of post offices has fallen – from 22,000 in the early 1980s to under 16,000 today. In addition, customers have increasingly found other ways of doing business, for example direct through call centres and over the internet.

2 Apart from the 555 directly managed offices, which are owned and managed by Post Office Limited, all post offices are owned by sub-postmasters or franchisees and run as independent businesses, often alongside a retail outlet. As the volume of post office business has reduced, sub-postmasters have found it harder to make a living from their businesses. Post Office Limited, which manages the network and provides support services for sub-postmasters, reported significant financial losses in recent years. Both Post Office Limited and sub-postmasters faced losing a major share of their business from 2003 as the Department for Work and Pensions started to switch from paying benefits and pensions through the benefit book system at post offices to making payments direct into claimants' bank accounts.

3 For the network to survive, Post Office Limited must make a profit from running the network or receive government support to cover its losses for those parts of the network which are not viable. In addition, sub-postmasters must make an adequate return from running their post offices and have confidence that they will continue to do so in future.

4 Although the Department of Trade and Industry (the Department) does not have a Public Service Agreement target for post offices, its policy is that the post office network should provide convenient and efficient access to postal and government services, and access to cash. The network is also important to the Government in fulfilling its social inclusion objectives, particularly in rural and urban deprived areas. The Department has several potentially conflicting roles in relation to the post office network:

- the Secretary of State for Trade and Industry is the major shareholder of Royal Mail Holdings[1], Post Office Limited's ultimate parent company, and as such wants Post Office Limited to be commercially viable and profitable;
- it has overall responsibility on behalf of Government for the policy of maintaining access to the services currently delivered through the post office network;
- it is responsible for the framework for regulating postal services in the UK, and post offices are an important part of postal service delivery; and
- as champion within government of the small business sector, it has a particular interest in the needs of some 15,000 sub-postmasters in the UK.

1 One ordinary share is held by the HM Treasury solicitor (as a nominee of HM Treasury) and 49,999 ordinary shares and one special share are held by the Secretary of State for Trade & Industry.

5 The Department has sought to reconcile its differing interests as shareholder and policy maker and to minimise the tensions between its roles. It has designed a support package with three key aims:

- to improve the financial position of Post Office Limited;
- to make the urban network viable through a programme of rationalisation and modernisation; and
- to maintain a rural network of post offices.

6 Against this background, we examined the Department's support for post offices and the extent to which it is meeting its main aims. We looked at the way in which the Department has monitored progress and how it is planning for the future.

Improving the financial position of Post Office Limited

7 In April 2002 the Department approved the appointment of a new Chief Executive who had extensive business experience and in December 2002 it approved the company's strategy for returning the company to profitability. The Department wrote off the company's historic debts totalling £715 million.

8 The Department, as shareholder, has put in place sound arrangements for monitoring the performance of Post Office Limited through its analysis of Royal Mail Group financial and management information and its quarterly meetings with the company. But the information the Department receives on Post Office Limited's financial performance is not broken down between the different segments of the network. And the Department does not have a financial model, with varying assumptions for the levels of business, to underpin its monitoring of the company's performance.

9 The new management team at Post Office Limited has achieved some early success in turning round the company's finances. In 2003-04 the company reversed its trend of increasingly severe year-on-year losses, cutting its deficit, before Government subsidy, to £97 million – a reduction of 50 per cent compared with 2002-03. The company has cut over 1,100 jobs in its head office operations and renegotiated supplier contracts. It has also made good progress with its new product lines – it is now the country's leading provider of foreign currency and by November 2004 had advanced £54 million worth of personal loans after launching the product in March 2004.

10 Although the Department's advisers concluded that the company's strategies appeared appropriate, given the constraints placed on it to maintain the network, they considered that the development of new income streams would be inherently risky. The Department recognises that there are on-going uncertainties that may affect Post Office Limited's success in implementing its strategy:

- income streams from post offices' existing range of services may continue to decrease as consumers find other ways of obtaining post office services and government departments continue to develop cheaper and more efficient ways of providing services;
- new income streams may not reach the levels projected – although the number of customers opening a Post Office Card Account was above the company's internal business forecast for December 2004, the level of income from new banking services was 33 per cent below forecast; and
- the company's efficiency programmes may not realise the expected level of savings.

Improving the viability of the urban post office network

11 Post Office Limited estimated that there was around 35 per cent over-supply of post offices in urban areas, with many operating on low margins, contributing to an environment of under-investment, and incurring losses for the company. The Department approved Post Office Limited's plans to close up to 3,000 post offices by the end of 2005 and provided financial assistance of up to £210 million - £180 million to compensate sub-postmasters of post offices that closed and £30 million for an investment grant scheme to encourage sub-postmasters to invest in their businesses. The aim of the programme is to create a commercially viable network of urban post offices that provides sufficient access to services.

12 Post Office Limited is on target to deliver its programme of urban post office closures. By November 2004 over 2,000 branches had closed and £122 million had been paid to over 1,800 sub-postmasters eligible for compensation – at an average of £65,000. Post Office Limited has accelerated the programme, and reduced its size, and is now looking to close around 2,500 post offices by March 2005. This new approach has been welcomed by stakeholders, such as the National Federation of Sub-postmasters, as it reduces the period of uncertainty for sub-postmasters and should allow Post Office Limited to make savings earlier.

13 In autumn 2003 Post Office Limited made changes to the arrangements for closing post offices under its urban reinvention programme, including:

- extending the time allowed for public consultation; and
- moving from a 'single office' to an 'area' approach, enabling stakeholders to understand what post office provision will remain in an area once all programmed closures have taken place.

In February 2004, in response to concerns raised by MPs, Postwatch and others, the Department used its influence, as shareholder and funder of the programme, to persuade Post Office Limited to further amend the public consultation process to ensure greater transparency and sensitivity.

14 The take-up of investment grants by sub-postmasters has been slower than expected and stakeholders have attributed this to the requirement for 'match funding' and uncertainty about the future of the network. As at November 2004 Post Office Limited had paid out some £4 million of the £30 million available. It had, however, approved 2,429 applications and committed to pay out a total of £14.7 million.

15 The programme has had an impact on the volume of business handled by Post Office Limited and on its customers in urban areas. Although 94 per cent of customers continue to use a post office, they do so less frequently or make fewer transactions because, in overall terms, 20 per cent of business volume is lost in the transition process following post office closures. While most customers appear to adapt and are satisfied with the service provided by their new post office, customers have been inconvenienced and have had to change their behaviour.

16 There is still some uncertainty as to whether the rationalisation programme will produce a network that represents a viable business for either Post Office Limited or sub-postmasters:

- although Post Office Limited is confident about the viability of the urban network, in the longer term there is a risk that volumes of business will decline further. This might lead to the company closing more post offices or seeking further financial support from the Department to keep open loss-making parts of the network;
- although the urban network as a whole may be viable for Post Office Limited, individual sub-postmasters may struggle to make a sufficient return on their investment, resulting in a continued exit from the business and further shrinkage in the size of the network;
- sub-postmasters may not have sufficient confidence in the future to put up the 'match funding' needed to obtain an investment grant, defeating the aim of creating 'bigger, better, brighter' post offices and therefore failing to attract new customers; and
- the redistribution of business from closing to remaining post offices may not be sustained as customers are deterred from making visits because of the inconvenience involved.

Maintaining the rural post office network

17 A significant number of rural post offices are not viable businesses and the rural network is heavily loss-making for Post Office Limited. Recognising the need to balance the Department's role of shareholder with the wider policy objective of ensuring public access to post office services, the Government decided to maintain a rural network, at least until 2006. The Department agreed to provide financial assistance (the Social Network Payment) of up to £150 million a year, for the three year period April 2003 to March 2006, to meet Post Office Limited's costs in keeping open the unprofitable part of the rural network and to promote innovative ways of providing post office services in rural areas. In September 2004 the Secretary of State announced an extension to the current financial support package. The Department will provide up to £300 million from 2006 to 2008 to help rural post offices.

18 The Department's advisors, Deloitte & Touche, confirmed in October 2002 that Post Office Limited's planned allocation of costs for servicing unprofitable rural post offices was appropriate. But as costs may have changed, the Department is seeking independent assurance that the sums reported by Post Office Limited for 2003-04 have been incurred, spent for the purposes intended, and allocated correctly. As at 31 January 2005 Deloitte & Touche's report to the Department had not been finalised but the preliminary results of their work have not indicated any significant issues with respect to the costs incurred.

19 The Social Network Payment includes an element each year to promote and finance innovative ways of delivering post office services in rural areas and to help sub-postmasters improve their individual businesses. Post Office Limited spent £1.2 million of the £5 million available in 2003-04. Of this, £777,000 was incurred on trialling pilot activities – the rest was spent on developmental activities (such as IT infrastructure). The Department was aware of the cautious approach adopted by the company in the initial phases of activity, but expressed concern at the slow rate of progress. In July 2004 the Department set up a tri-partite group with Post Office Limited and the Department for Environment, Food and Rural Affairs to better co-ordinate Government policy and the piloting of new ways of delivering services in rural areas. Subsequently, the company has strengthened its management and staffing in this area and reported the results of its evaluation of the first year's pilot activity to the Department in November 2004. This report confirmed that the company has made progress in developing the logistics and processes involved in pilot activity but that it has yet to test sufficiently the economics and viability of the pilot activities.

20 In September 2004 the Department announced a two year extension of its financial support from April 2006 to March 2008. This was intended to allow sufficient time for the lessons from pilot activities to feed into longer term decisions aimed at ensuring that access to post office services for those in rural communities can be maintained on a sustainable basis. Both Postcomm and Postwatch have expressed concerns that the Government's policy of preventing avoidable closures in the rural network is not underpinned by an assessment of the services it wants to be provided. The Department's own analysis of some of the traditional roles of post offices, such as the provision of postal and government services, has suggested that a smaller network would suffice. The Department did, however, identify other roles, such as sustaining the rural economy, where further closures could be harmful.

21 In June 2004 the Department took over responsibility for the Shareholder Executive.[2] The strengthening of the Department's shareholder role, which potentially conflicts with its objective of maintaining access to post offices, means that it will need to balance these roles as it develops future government policy for the rural network and the level of funding required. In achieving this balance, the Department has to manage a number of on-going risks:

- the amount of financial support may prove insufficient to cover Post Office Limited's costs in running the rural network;
- the Department needs to be satisfied that the amount of the Social Network Payment paid each year to Post Office Limited does not exceed the actual costs incurred by the company in keeping open the unprofitable parts of the rural network. To manage this risk the Department has commissioned an independent review of the costs claimed by the company in 2003-04;
- the Department may not communicate effectively its commitment to having a post office network that is viable and capable of being self-sustaining in the longer term;
- problems with financial viability and uncertainty over the future of the rural network may act as a disincentive to sub-postmasters to continue providing post office services, resulting in an increase in the number of closures; and
- the £25 million ear-marked for developing and piloting new ways of providing post office services in rural areas may not result in sustainable alternative mechanisms.

2 The Shareholder Executive leads the Government's day-to-day relationships with certain Government-owned companies and advises Ministers on the shareholder issues including objectives, governance, appointments, remuneration, strategy and performance monitoring of these companies. The Shareholder Executive continues to report to the Cabinet Secretary for the overall success of its mission.

RECOMMENDATIONS

Improving the financial position of Post Office Limited

A The Department, as shareholder of Royal Mail Holdings, has put in place sound arrangements for monitoring the company's performance. The Department, through its Shareholder Executive, should ensure that it has in place similar arrangements for other companies in which the Government has a majority shareholding.

B The Department should obtain a breakdown, by segment of the network, of the monthly information it receives from Post Office Limited.

C The Department should develop a financial model, with varying assumptions for the levels of business, to underpin its monitoring of Post Office Limited's performance.

Improving the viability of the urban post office network

D To help overcome the reluctance of sub-postmasters in applying for investment grants, the Department should work with Post Office Limited to demonstrate how grant-funded improvements have resulted in increased business for individual post offices.

E Given the Department's responsibility within government for small businesses, it should ensure that sub-postmasters have access to its full range of advice and assistance.

Maintaining the rural post office network

F In finalising the amount of the Social Network Payment each year, the Department should seek to recover, or reflect in future years' payments, any amounts that are found not to reflect the legitimate costs incurred by the company in running the loss-making parts of the rural network.

G In negotiating the final amount of financial support for 2006-2008, the Department should ensure that Post Office Limited has a strong incentive to reduce costs in the way that economic regulators have used efficiency incentives to encourage regulated companies to improve their efficiency.

H The Department should ensure that Post Office Limited adopts a more robust approach to identifying and piloting innovative ways of providing post office services in rural areas, so that by the end of 2005 the Government has a sound assessment of the outcomes from the various pilot activities.

I In determining its long term policy for rural post offices, the Government needs to determine what services it wants the rural network to provide, the size of network necessary to perform that role, the costs and benefits involved in maintaining it, and how much it is willing to spend supporting it. The Department has a pivotal role as the central policy co-ordinator across all government departments with an interest in the rural network.

PART ONE
Introduction

1.1 Sub-postmasters must have confidence in the future or else they will leave the business. In the last two decades, the number of post offices run by sub-postmasters has declined and many sub-postmasters have retired or discontinued their business and not been replaced. In addition the Post Office (now Post Office Limited) faced mounting debts and an uncertain future. Against this background the Government commissioned a report in 2000 from the Performance and Innovation Unit. The report recommended a way forward that was aimed at modernising the post office network.

The network of post offices in the UK

1.2 Post offices provide some 170 postal, government and commercial services (the main ones are set out at Appendix 1). Each week some 29 million transactions are carried out by people at post office branches. The key services provided by post offices, and those on which the public rely the most, are: selling postage stamps, cashing pensions and benefits, issuing television licences, accepting payment of household bills, and handling special delivery/recorded and large items.[3] Only the last of these services has to be carried out at a post office.

1.3 As at 31 March 2004 there were 15,304 post offices in the UK, as shown in **Figure 1**. The network is larger than those of the major banks and building societies put together, and is by far the largest retail network in the UK. There is no other public or private service provider with a comparable physical infrastructure. It is second to France as the largest network of its kind in Europe.

1.4 In some rural and deprived urban areas, post offices can play a role in sustaining local communities. In rural areas, the post office may be the only village shop. Post offices can also act as a focal point for the community and closures may impact adversely on some people's lives. Vulnerable people (for example, the elderly and those lacking mobility) tend to rely more heavily on post offices and are least able to adapt if their local office closes.

1 Number and type of post offices in the United Kingdom, September 2004

Directly-managed offices (run by Post Office Limited or its agents)	555
Sub-post offices (run by private individuals, sub-postmasters, often alongside another retail business):	
Urban (in settlements of 10,000 or more)	6,671
Rural (in less densely populated areas)	8,078
Total	**15,304**

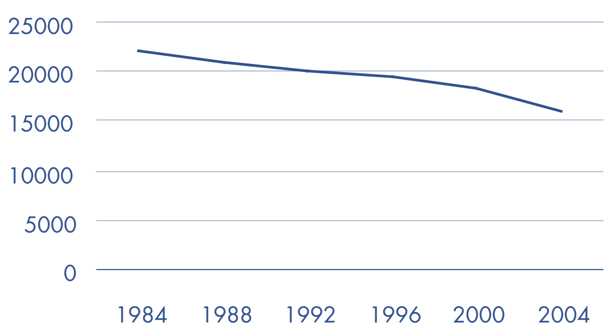
Source: Post Office Limited

3 'Assessment of the Urban Network Reinvention Programme for Postwatch', MORI, February 2004.

1.5 The network contracted from 22,058 post offices in March 1984 to 15,961 in March 2004 **(Figure 2)**, a reduction of 28 per cent. Most of the 6,097 post offices that closed in this period were in rural areas.

1.6 This fall is not unique to the UK. **Figure 3**, which compares the percentage reductions from 1994 to 2002 for six countries, shows that Sweden (76 per cent) and Germany (35 per cent) suffered the largest proportionate reductions. Only in France and Italy has the size of the network remained broadly the same.

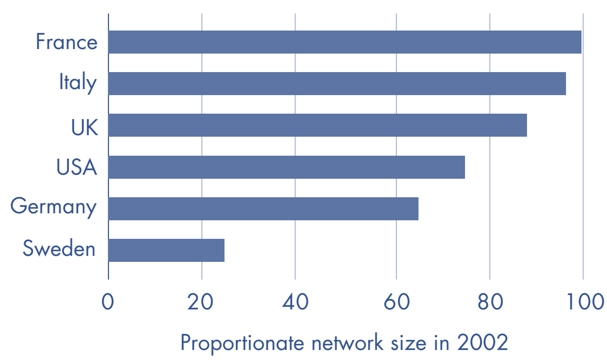
2 The total number of post offices in the UK, 1984 to 2004



Source: Postcomm (figures as at 31 March each year)

3 The size of post office networks in selected countries in 2002 compared with 1994

Key: 1994 = 100



Source: Triangle

1.7 Another indication of the extent or density of the network in these countries is provided by comparing the number of post offices with the population. **Figure 4** shows that the number of people per post office in the UK is the second lowest after Sweden, so the UK network is still relatively extensive.

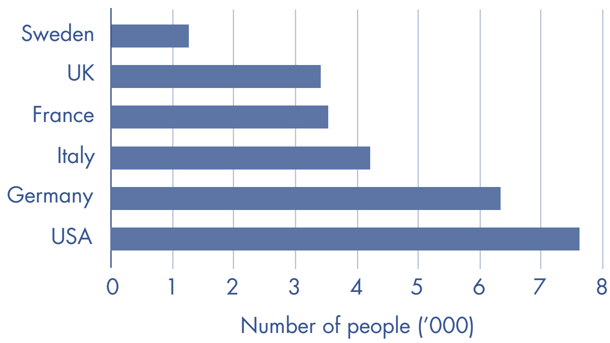
The viability of post offices

1.8 Running a post office on its own does not usually provide sufficient income for sub-postmasters and many run a retail business on the same premises, typically a convenience store. Sub-postmasters are responsible for meeting the staff and other costs of running their businesses, while Post Office Limited provides infrastructure support such as cash, IT systems, helpdesks, and network management. Sub-postmasters' income from providing post office services depends on their transaction volumes, and as a result many of those running rural offices have the lowest incomes.

1.9 Sub-postmasters are facing increasing strains on their post office businesses that raise questions over their future viability:[4]

- a major source of income (payment of pensions and benefits) is ending, and it is too early to know whether new services will bridge the gap;
- customers are getting the services they require without going to a post office; and
- many post offices, particularly those in rural areas, make a loss for Post Office Limited (i.e. they cost the company more than the income they provide for it).[5]

4 Comparison of population per post office in the UK with selected countries, 2004



Source: Department of Trade and Industry

4 The results of a MORI survey, for the National Federation of Sub-postmasters, on sub-postmasters' incomes and views of the future are at Appendix 4.
5 'Cost-benefit analysis of rural post office branches', prepared for Postcomm by NERA and RAND Europe, June 2003.

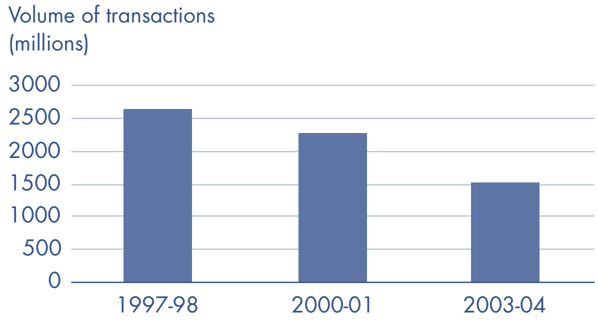
1.10 Over the years post offices have relied on the payment of pensions and social security benefits as a major part of their business. In many areas over 40 per cent of sub-postmasters' income has come from these transactions.[6] The Government announced in May 1999 that from April 2003 it would, wherever possible, make payments direct into a claimant's bank account to provide them with a more modern, secure, efficient and reliable service and to improve value for money at the Department for Work and Pensions. As at 31 March 2003, 43 per cent of claimants were already receiving their payments this way and it is the preferred payment method for nearly 70 per cent of new claimants. The transfer of the rest to direct payment started in April 2003 and should be completed in 2005. By November 2004, the proportion of people paid some or all of their benefits by direct payment stood at 85 per cent.

1.11 Post Office Limited is retaining some of this business through customers opening a Post Office Card Account. Although the number of customers opening card accounts is slightly higher than forecast, the number of customers using other bank accounts at post offices is lower than Post Office Limited and sub-postmasters had hoped for (paragraph 2.20). The result is a significant loss of business for the post office network.

1.12 Technological developments coupled with changing preferences and lifestyles mean that consumers' needs are changing. People are finding new ways of obtaining services traditionally provided by post offices; for example, by paying bills electronically. Government departments that use post offices as a channel for providing services (such as the issue of vehicle tax discs) are increasingly looking for cheaper methods of doing business. There has been a steady decline in the volume of transactions across the network - 42 per cent in the seven year period to 2003-04 **(Figure 5)**.

1.13 The market for products and services provided by post offices is forecast to grow more slowly (12 per cent) than the wider economy (25 per cent) in the period to 2011. In addition, social, economic and technological trends will mean that demand for current post office products and services will continue to fall and that by 2011 the cumulative reduction will be some 12.5 per cent.[7]

5 Volume of transactions across the post office network, 1997-98 to 2003-04



Source: Post Office Limited

1.14 Rural post offices, in particular, are not viable for Post Office Limited; almost all cost it more to run (support costs plus sub-postmaster salary) than the revenue they bring in.[8] The smallest branches cost £17 for every £1 generated. The ten per cent of rural branches that are profitable are relatively large and average a net profit for Post Office Limited of one pence per customer visit, which equates to an average annual profit per branch of around £1,000.

The financial position of Post Office Limited

1.15 Historically the distinction between the viable and loss-making parts of the post office network has been unclear. The Post Office was expected by the Government to maintain the network on the grounds that it was needed to provide services to the public (access to cash, postal services and Government information and services). In practice the loss-making parts of the network (mainly rural offices and directly-managed offices) were cross-subsidised by the profitable parts (mainly larger urban agency offices).

1.16 In addition, with the creation of Post Office Limited as a separate accounting entity in October 2001[9], the extent of the losses incurred by the post office network as a whole became clear. This was compounded by heavy investment in automation during 2000. By the end of 2002-03, Post Office Limited owed Royal Mail Group plc £715 million in intra-company debt.

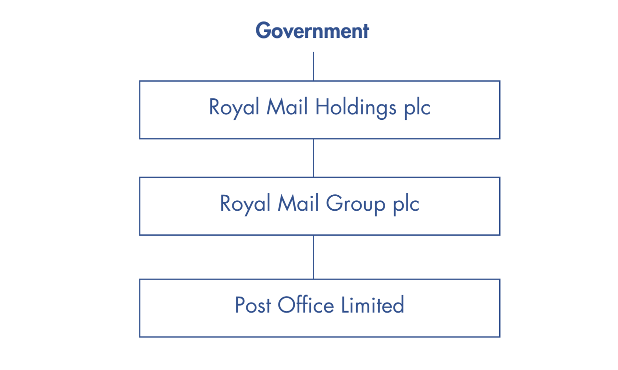
6 'Banking on the Future', Postcomm's third annual report on the network of post offices, 2002-03.
7 Postcomm's Advice on the Future of the Rural Post Office Network, July 2003, page 18.
8 Ibid.
9 Post Office Limited has been in existence as a legal entity since 1987 (initially called Post Office Counters Limited).

The status of Post Office Limited

1.17 Until the Postal Services Act 2000, the business of Royal Mail was vested in the Post Office, a statutory corporation established under the Post Office Act 1969.[10] The Post Office was organised into three separate businesses – Royal Mail Letters, Royal Mail Parcels and Post Office Counters Limited. In 2001 the Government decided to put relations between the post offices and mails businesses onto a commercial footing and separate the post offices business from the rest of the company. This was intended to improve the transparency of the cost structure of the mails business and to end any cross-subsidy between the mails business and the post office network.

1.18 In March 2001 the Post Office transferred the assets and liabilities on its balance sheet to Consignia plc (since re-named Royal Mail Group plc), and transferred the share capital to Consignia Holdings plc (now Royal Mail Holdings plc).[11] In October 2001 Consignia plc, with the agreement of the Government, established Post Office Limited, owned by Consignia plc, as a separate business for accounting and management purposes. Post Office Limited has its own board of directors who are accountable for its performance. The Government is the 100 per cent owner of Royal Mail Holdings plc which is the parent company of Royal Mail Group plc. The organisation structure is outlined in **Figure 6**.

6 Government and Royal Mail/Post Office Limited structure



1.19 **Figure 7** shows the roles of the different parties involved in the post office network. Taking the public bodies:

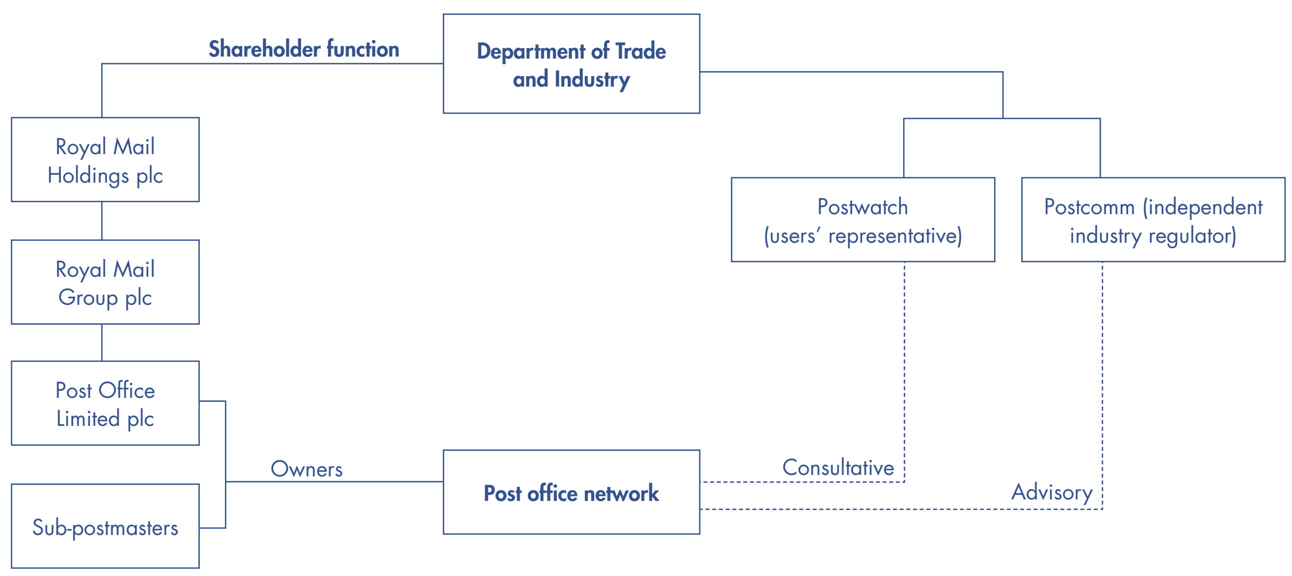
- *The Department of Trade and Industry* has several distinct roles: the Secretary of State for Trade and Industry, on behalf of the Government, is the major shareholder of Royal Mail Holdings plc; the Department has overall responsibility for the policy of maintaining access to the services currently provided by the post office network; and it is responsible for the framework for regulating postal services in the UK. There are potential tensions between these differing roles, particularly given the Department's recent re-organisation which makes the Shareholder Executive responsible for all three.[12] The Department also has Government responsibility for the small business sector;
- *The Postal Services Commission (Postcomm)* is an independent regulator created by the Postal Services Act 2000 to ensure the provision of a universal postal service and to further the interests of users of postal services, wherever appropriate by promoting effective competition. Postcomm does not regulate Post Office Limited but has a remit to report to the Government on developments in the post office network; and
- *Postwatch* represents customers of postal services in the UK and monitors standards of service. It operates through a network of nine regional committees around England, Scotland, Wales and Northern Ireland. The chairman of each committee sits on the Postwatch national council.

Providing services through the post office network

1.20 The Government requires certain levels of access to key services for the population as a whole. Royal Mail's licence specifies criteria for access to postal services:[13] the premises of not less than 95 per cent of users (or potential users) of postal services must *at a national level* be within 5 km of an access point and within 10 km *at a local postcode level*. Royal Mail fulfils these requirements through the post office network and across most of the United Kingdom the requirement is met comfortably.

10 The Post Office became a nationalised industry in 1969, prior to which it had been a Government department.
11 Both Consignia plc and Consignia Holdings plc were newly incorporated companies.
12 The Department is currently considering moving responsibility for the framework for regulating postal services to a different Division.
13 Royal Mail's licence specifies the density of access points that must be capable of receiving the largest relevant postal packets and registered mail.

7 Administrative context of the post office network



1.21 The Department for Environment, Food and Rural Affairs, as part of its remit to tackle social exclusion in rural areas, has a Public Service Agreement target to improve the accessibility of services for rural people. This includes access to cash, in particular for people who are socially excluded and those who currently have no bank account. This can be through post offices, banks, building societies, and automated telling machines.

1.22 Post Office Limited had been slow to modernise the network in the face of a rapidly changing business environment. In October 1999, therefore, the Prime Minister asked the Government's Performance and Innovation Unit to identify the contribution made by post offices to the vitality of local communities; consider how the post office network could best contribute to the Government's objectives in the future; and formulate objectives for the network. The report set out two objectives for the network which the Government accepted. One objective was that the network should provide convenient access for all to post offices and the other was to maximise the potential of the post office network. A list of the report's recommendations that relate specifically to the post office network and the action taken to implement them is at Appendix 2.

1.23 Our consultants, Triangle, concluded that the UK is not alone in facing difficulties with its post office network. Each of the seven countries examined had a recognised conflict between a strictly commercial approach to the number, and siting, of post offices, and providing a reasonable service to consumers.

The scope and methodology of this report

1.24 Given its position as shareholder and its overall responsibility for Government policy on post offices, the Department's strategy is to:

- return Post Office Limited to profitability, through restructuring and re-financing the company, together with the introduction of new management;
- rationalise and modernise the urban network; and
- maintain the rural network and pilot alternative methods of providing services.

This report examines the extent to which each of these is being achieved. The scope and methodology of the study are set out at Appendix 3. To provide a context for the situation in the United Kingdom, we commissioned consultants, Triangle, to examine aspects of post office provision in seven other countries and their report, which was produced in April 2004, is on our website (www.nao.org.uk).

PART TWO

Improving the financial position of Post Office Limited

2.1 Post Office Limited was facing mounting losses which the Government, as owner of the company, ultimately had to bear. The company's weak financial position was also a threat to the Department's policy of retaining a network of post offices that provides reasonable access to users. To address its dual interests as shareholder and sponsor of the post office network, the Department set out to improve the company's financial position.

The appointment of a new management team

2.2 The Secretary of State for Trade and Industry (as Shareholder) appoints the Chairman of Royal Mail Holdings plc, gives consent to the appointment of other Directors of Royal Mail Holdings, including the Chief Executive of Post Office Limited, and agrees their terms and conditions, including incentives. The Department monitors the performance of Royal Mail Group and Post Office Limited, but does not intervene in day-to-day operational and commercial matters. Royal Mail Holdings plc appointed a senior non-executive independent director to its Board in March 2003 and there is an annual meeting between Royal Mail Holdings' non-executive directors and shareholder representatives.

2.3 With the establishment of Post Office Limited as a separate company within the group, Royal Mail Holdings sought a new chief executive for the company – someone who had a track record in business, could deliver a strategic plan that would turnaround the company's finances and deliver a profit within five years, and who could lead the company successfully through a period of rapid change. The Department approved the appointment of David Mills as Chief Executive in April 2002. He was previously General Manager for Personal Banking at HSBC plc and had 40 years experience in the banking sector.

2.4 Post Office Limited submitted a five year strategic plan to the Department in October 2002. The plan aimed to make the company profitable by increasing revenues, reducing costs and securing Government funding for the 'social element' of the network. It focused on key strands of activity, including:

- providing banking services and introducing new financial products;
- reducing costs by cutting staff numbers and contracting-out some operations; and
- rationalising and modernising the urban post office network.

2.5 The Department commissioned advisers (Deloitte & Touche) to undertake a high-level review of Post Office Limited's strategic plan to help it assess whether the plan was a realistic strategy for returning the company to profitability (after allowing for an appropriate payment to support the rural network). The advisers concluded that overall the plan was appropriate. In December 2002 the Department endorsed Post Office Limited's plan for its first three years (2003-04 to 2005-06) and is holding the company's new management accountable for implementing it.

The write-off of Post Office Limited's debts

2.6 Post Office Limited was unable to repay its debts to Royal Mail Group. To ensure that Post Office Limited could continue trading, and to maintain the network of post offices, the Department decided on a refinancing package for the company which included the repayment of debt to Royal Mail Group and cover for forecast trading losses up to 2006-07.

2.7 In May 2003 the European Commission approved the Department's proposal to provide this funding as, in its view, it did not constitute state aid. In September 2003 the Department instructed Royal Mail Group to write off Post Office Limited's intra-company debt of £715 million. Royal Mail Group had built up £1.8 billion of reserves, ring-fenced on its balance sheet, and on the Department's request Royal Mail Group released £671 million of these funds, together with £44 million from Royal Mail Group reserves, to pay for the write-off.

Funding Post Office Limited's working capital requirements

2.8 In addition, the Department received European Commission approval to provide a loan facility to the company, at a commercial rate of interest, to fund its working capital requirements. Under its contract with Post Office Limited for the payment of pensions and benefits, the Department for Work and Pensions has made a daily payment to Post Office Limited to cover the amounts the company would pay out. The move to direct payment from April 2003 is reducing the amount advanced to Post Office Limited. However, many people still prefer to draw cash at their local post office. To cover its cash requirements to make these payments, the company attempted to obtain a funding facility in the market place. But lending institutions were not prepared to provide one[14] and the Department decided to make a loan facility, up to £1.15 billion, available to the company at normal commercial rates – placing a strong incentive on the company to minimise its cash needs.

The Department's monitoring of Post Office Limited's performance

2.9 We commissioned consultants, Wilmington Capital Limited, to examine whether the Department's financial monitoring of Post Office Limited is appropriate. Using the private sector as a benchmark, they analysed the shareholding relationship between the Department and Post Office Limited and considered whether the monitoring and corporate governance relationships meet the parties' objectives.

2.10 The Department exercises some control and influence over the affairs of Royal Mail Group, and the consultants considered that there were similarities with two types of shareholder relationship in the private sector:

- investors with a significant minority holding in a company who achieve influence, but not control, through a director they have nominated; and
- those with a majority holding, who would be in a stronger position to intervene if a business is going off track and would often do so forcibly.

2.11 In the consultants' view the relationship between the Department and Royal Mail Group is somewhere between the two. The Department nominates the board of Royal Mail Group but is not represented directly; and is closely involved in agreeing the strategy of the Group but in no sense controls it. As the Department has no shareholding in Post Office Limited, its influence and monitoring of the company has to be exercised as shareholder of Royal Mail Holdings plc. The consultants added that the accountability of Ministers to Parliament for a public service adds an additional dimension to the relationship between the Department and Royal Mail Group that has no direct parallel in the private sector, although they noted that in some respects it is similar to the duty that a private equity company has to the investors that have subscribed to its fund.

14 The main difficulty was the nature of the security that a commercial lender would require – realising this security would involve closing the post office network and lenders did not view this as realistic.

2.12 The consultants concluded that:

Monthly financial information, including performance against targets, provided by Royal Mail Holdings is comprehensive and well presented and the Department's own summary of the report is clear and concise. This procedure should, if used properly, be adequate for monitoring the situation of all the business units within Royal Mail Group, including Post Office Limited; and

Quarterly shareholder meetings between the Department and Royal Mail Holdings' Board are the correct forum for the Department to exercise its shareholder influence over Post Office Limited. Informal meetings between Post Office Limited and the Department (or the Minister) provide an additional source of information, but should not be seen as an alternative means to influence Post Office Limited. If the Department gives the impression it is influencing Post Office Limited management directly, it could undermine the Royal Mail Holdings Board which has its own responsibility to tackle issues at Post Office Limited.

2.13 The monthly information provided to the Department by Royal Mail Holdings plc provides an indication of the Post Office Limited's performance at overall business unit level. It does not, however, enable the Department to compare the performance of the various different segments of the post office network.

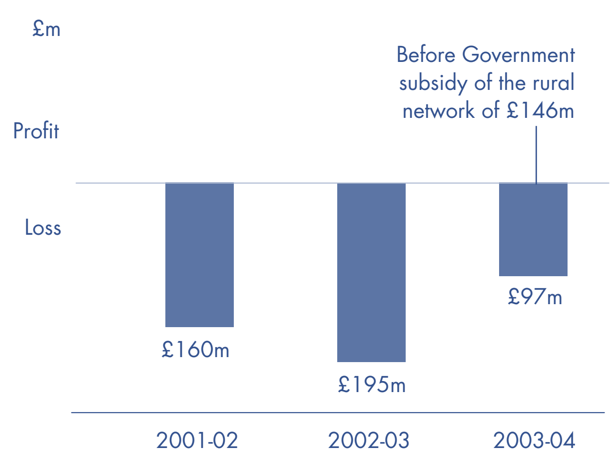
Post Office Limited's financial performance

2.14 The Department accepted Deloitte & Touche's advice that Post Office Limited's strategic plan could be viewed as aspirational, and that any strategy involving the development of new income streams would be inherently risky. But Deloitte & Touche considered that in view of the obligation to maintain the size of the network, the strategies proposed to return the company to profitability appeared to be appropriate. The company's profitability will ultimately depend on its success in cutting costs and introducing new products.

2.15 In 2002 Post Office Limited envisaged that by the end of the plan period (2007-08) the company would be close to breaking even (after including financial support for the rural network provided by the Department). Post Office Limited's audited results for 2003-04 showed a loss of £97 million[15] before taking account of the government subsidy of £146 million for the rural network, which resulted in a net profit of £49 million. **Figure 8** shows that in 2003-04 the company reversed its trend of increasingly severe year-on-year losses, cutting its operational loss from £195 million in 2002-03 to £97 million in 2003-04 – an improvement of 50 per cent.

2.16 In the year to 31 March 2004 Post Office Limited cut over 1,100 jobs in its head office operations and renegotiated supplier contracts which contributed significantly to the improved operating performance.[16] During the same period post office closures, under the urban reinvention programme, have realised net benefits of £1 million for the company and this is forecast to rise to £37 million a year by 2006-07. However, the company dropped its plan to contract out its cash handling and delivery operation, estimated to save £40 million a year.[17] Faced with the prospect of industrial action, it considered that the costs that would result from service disruption would outweigh the benefits of contracting-out. Instead, the company embarked on an internal rationalisation of the operation.

8 Post Office Limited's financial position 2001-02 to 2003-04



Source: National Audit Office analysis of Post Office Limited audited accounts

15 This figure is the loss on ordinary activities before taxation.
16 Post Office Limited audited accounts 2003-04, Directors' Report.
17 Post Office Limited Strategic Business' Plan 2002-07.

2.17 The network of directly managed post offices lost more than £70 million in 2003-04, with losses projected to continue in future years. In November 2004 the company announced that it was working on plans, in consultation with the unions, to bring these offices to break-even. The company anticipates that fewer than five directly managed offices will close in 2005-06 and they have pledged a £20 million investment programme to improve these post offices for customers.

2.18 The main strategy of other countries to increase income is to develop banking and financial services.[18] Post Office Limited has adopted the same approach with some success. It is now the leading UK foreign currency provider, with 25 per cent of the market, and the largest single network in the UK for transferring money abroad. In addition, the company is the third largest provider of travel insurance in the UK. Since 2003 the company has launched a number of new financial products, including savings stamps, guaranteed equity bonds, home insurance and personal loans. Personal loans were launched in March 2004 and by 30 November customers had borrowed £54 million. The company launched its Homephone service in January 2005 and plans to launch further new services throughout the year.

2.19 In 2001 Post Office Limited signed an agreement with 11 major banks to allow customers to access their basic bank accounts at any post office. As at June 2004, 5.4 million basic bank accounts were open, of which 1.7 million could be operated through a post office branch. In 2003 the company negotiated electronic access to current accounts with four major high street banks.[19] Postcomm has noted, however, that some of the big banks have been slow to join up and provide access to their current accounts.

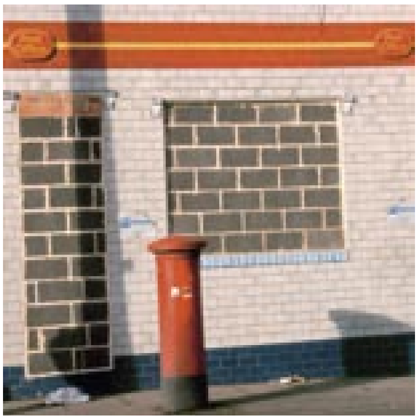
2.20 By 31 December 2004 the number of customers who had opted to have their pensions or benefits paid into a Post Office Card Account stood at 3.3 million, six per cent above Post Office Limited's internal business forecast. However, development of some other new income streams has been less successful. At the end of 2004 new banking income was 33 per cent below the company's forecast.[20]

2.21 After a promising start, with an earlier than expected return to profitability in 2003-04, the challenge for Post Office Limited will be to sustain this improvement. This will depend on the company looking for further cost reductions and building up sustainable new income streams. In their fourth annual report on the post office network, Postcomm considers that a considerable amount has been achieved, but that there is still some way to go in the transition to establishing a viable network. The Department's challenge will be to monitor closely the company's performance in pursuing these ends, recognising the possibility that, despite early progress, a successful outcome is not a certainty.

18 Research by Triangle.
19 Alliance & Leicester, Barclays, Lloyds TSB, and Clydesdale.
20 Post Office Limited Business Unit Key Performance Indicators.

PART THREE

Improving the viability of the urban post office network



3.1 For the urban post office network to survive in the long-term, it needs to provide a profitable business for both Post Office Limited and sub-postmasters. Following the Performance and Innovation Unit Report, the Government accepted the need to rationalise and modernise the urban network. Post Office Limited's urban reinvention programme aims to make the urban network commercially viable by closing some post offices and migrating their business to nearby branches.

Funding the modernisation programme

3.2 Post Office Limited's own analysis found that in many areas there were several sub-post offices within streets of each other resulting in low margins and under-investment. The company estimated that of the 8,000 urban post offices, 3,000 were surplus to requirements and would need to be closed to bring capacity into line with projected income and create a sustainable business environment for the company and sub-postmasters. The Performance and Innovation Unit Report recognised that sub-postmasters of branches that closed should be adequately compensated and that Government would need to fund this.

3.3 The Department approved Post Office Limited's programme and provided for up to £210 million of vote funding:

- compensation of up to £180 million for sub-postmasters who leave their businesses under the programme;[21] and
- investment grants of up to £30 million to encourage remaining sub-postmasters to invest in their businesses and make them more attractive to customers.

3.4 In return for the Department's financial assistance, Post Office Limited was required to ensure that, on completion of the programme, there would be a post office branch within a mile of 95 per cent (or more) of the population in urban areas. The Department received state aid clearance for its support from the European Union in September 2002 and Parliament approved the £210 million urban reinvention programme a month later.[22] Post Office Limited started to implement the programme in November 2002.

21 The £180 million available for compensation was based on up to 3,000 sub-postmasters receiving an average of £60,000.
22 The administrative costs of the scheme, which have been estimated at some £30 million, are being met by Post Office Limited.

The procedures for closing post offices

3.5 Once Post Office Limited has completed its internal processes to determine which of the post offices in an area it wishes to close, it consults with stakeholders. Postwatch, the consumer representative body, examines the case for each closure and investigates all the local factors, including the accessibility of nearby post offices and transport links. Postwatch must complete its investigations and raise any points of concern before the end of the six week public consultation period.

3.6 Postwatch opposes a proposed closure if it considers that customers would face excessive difficulty obtaining postal services. Post Office Limited takes its views into account, but Postwatch cannot overturn a closure decision. By mid-October 2004 Postwatch had examined over 2,600 closure proposals and had convinced the company to withdraw 59.[23] In another 138 cases the company has modified its proposals at Postwatch's request. Post Office Limited has also withdrawn proposals (in 76 cases) or modified them (in 139 cases) after reviewing, with Postwatch, concerns expressed during the public consultation stage.

3.7 When the programme had been running for nearly 12 months, Post Office Limited, in response to concerns raised by Postwatch and others, proposed a number of changes to which the Department assented:

- *extending the time allowed for public consultation.* A common complaint was the lack of time allowed for consultation with parties affected by a closure. The original consultation period of four weeks was based on an existing Code of Practice covering single branch closures. Stakeholders considered that this was too short for an extensive programme of closures with far reaching implications for the public. Post Office Limited extended the period to six weeks in September 2003;
- *moving from a 'single office' approach to an 'area approach'.* Postwatch, Members of Parliament and stakeholders were concerned that dealing with closures on a 'single office' basis did not provide an overall context of post office provision in an area. It also gave no guarantee that the company would not propose further closures in the same area at a later date. In September 2003 the company moved from case-by-case closures to an area-based approach (linked to Parliamentary constituencies). This shows stakeholders which post offices will remain in their area after the closures programme; and
- *introducing a 'dispute resolution' procedure to consider closures opposed by Postwatch.* This involves a three stage formal review, culminating where necessary in the consideration of the contested closures by the Chief Executive of Post Office Limited and the Chairman of Postwatch.

3.8 In February 2004, in response to pressure from the Department and Postwatch, Post Office Limited agreed to strengthen further the consultation process by:

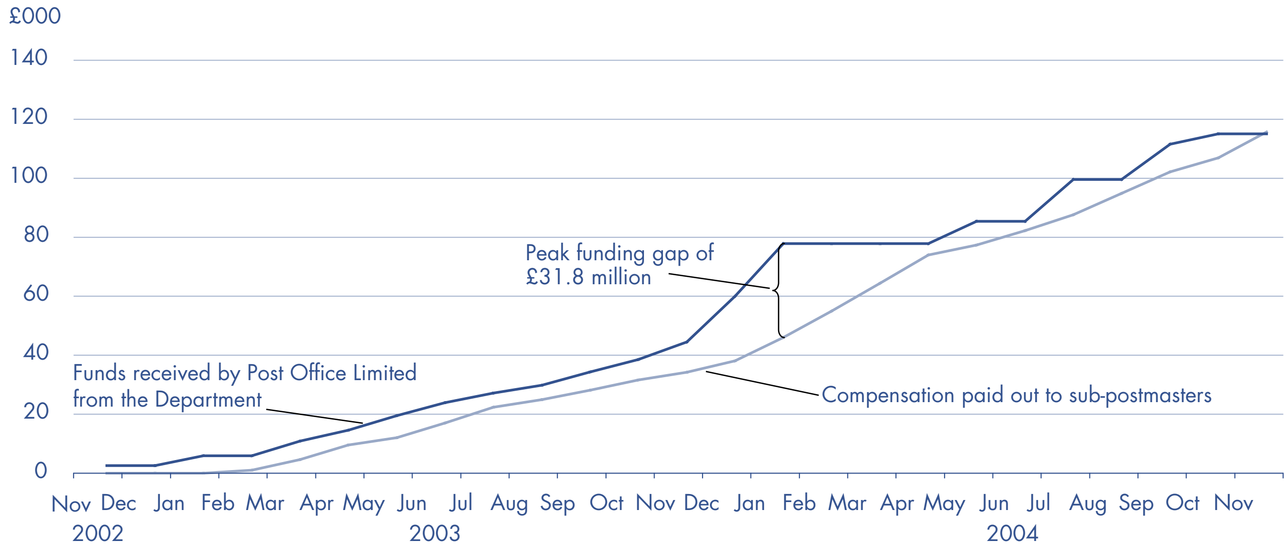
- advising Members of Parliament and devolved administrations of proposals, including the overall rationale for the closures in each area, one week before they are put out to public consultation;
- taking account of, and responding to, views expressed about the proposed service provision in the area in reaching decisions on closures; and
- informing Postwatch, Members of Parliament and local authorities of the main points raised during the consultation and giving reasons for its decision.

3.9 When the programme was first set up the Department made a monthly payment to Post Office Limited in respect of post offices for which consultation had started. The company paid over the money to the sub-postmaster about six weeks later, after consulation had been completed. The company earned interest on these surplus funds which peaked at £31.8m in January 2004 **(Figure 9)**. We estimated that by the end of November 2004, the benefit that had accrued to the company was around £672,000.[24]

3.10 Since February 2004 the Department has paid the company at the end of the consultation period. This greatly reduces the timing gap and minimises the amount of interest foregone by the Department.

23 Figures on closure proposals from Postwatch website (www.postwatch.co.uk).
24 We calculated low, mid and high range estimates depending on the timing of payments to Post Office Limited and sub-postmasters. The figure of £672,000 represents the mid-range value.

9 Payment of compensation for closures under the Urban Reinvention Programme



Source: National Audit Office analysis of Post Office Limited data

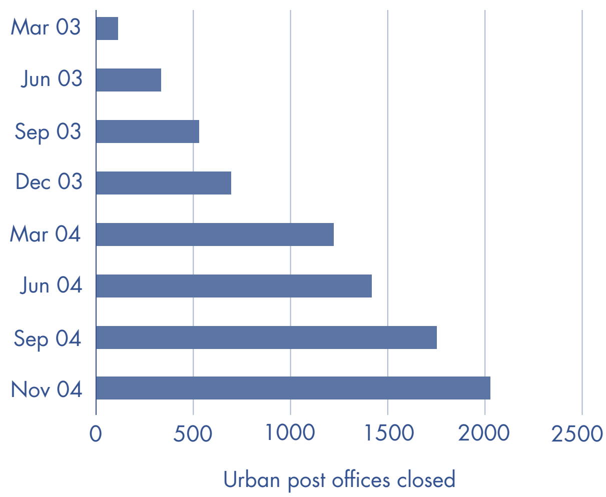
Progress in closing post offices

3.11 In September 2003 Post Office Limited announced it was accelerating closures to complete the programme by March 2005 (the original date was late 2005). This change:

- reduces the time urban sub-postmasters have to wait before knowing whether their branch is to be closed, which reduces their uncertainty about the future; and
- should allow the company to make savings earlier.

3.12 At the start of the programme the urban network consisted of some 8,000 post offices. Post Office Limited plans now to close around 2,500 branches instead of the 3,000 originally proposed.[25] **Figure 10** shows progress since the start of the programme - by the end of November 2004, 2,019 branches had closed. Taking into account branches in the process of closing and Post Office Limited's announcement of the final 400 proposed closures in January 2005, the company should meet its revised forecast of 'around 2,500 closures' by March 2005.[26] As at 30 November 2004 Post Office Limited had paid out £121.8 million in compensation for 1,876 branch closures where sub-postmasters were eligible for compensation – an average of £65,000.[27]

10 Post Office closures (cumulative) under the Urban Reinvention Programme

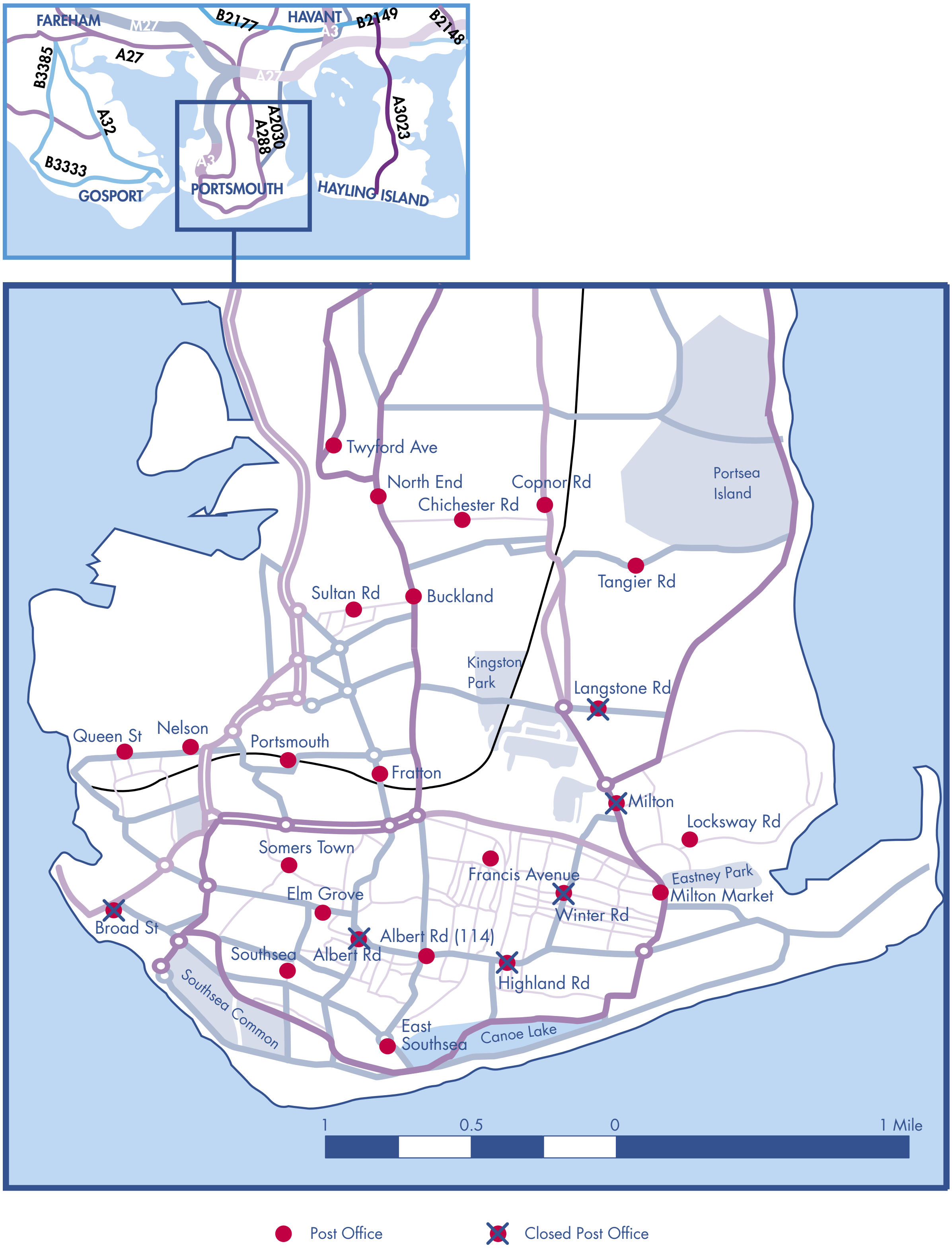


Source: Post Office Limited

NOTE
Figure for November 2004 is provisional.

25 The figure of 3,000 was a top-down estimate of the likely scale of the programme. Once the detailed work on the programme had been completed, it was clear that the scale of the programme would be broadly in line with this estimate. The programme has actually involved around 2,700 proposals for closure, and after taking account of those proposals withdrawn following consultation, the end result is expected to be around 2,500 closures.
26 Not all of the post offices designated to close will have actually closed by 31 March 2005.
27 Not all sub-postmasters were eligible for compensation (some were not permanent appointments and some branches had already closed temporarily).

11 The effect of the programme in Portsmouth



Source: National Audit Office based on Post Office Limited data

3.13 **Figure 11** shows the effect that the programme has had in an urban area (Portsmouth) where the number of post offices has fallen from 25 to 19.

The take-up of investment grants

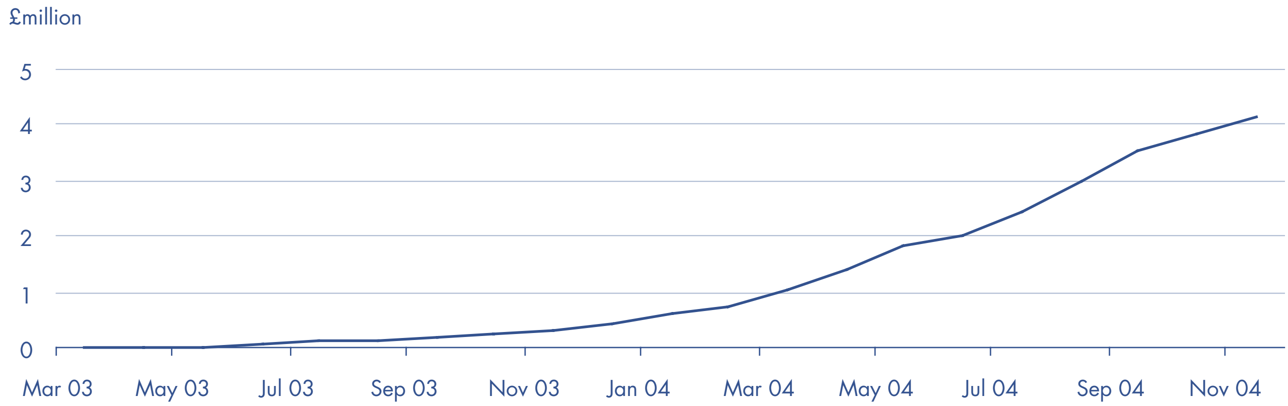
3.14 The Government recognised the need to provide funding to encourage sub-postmasters to invest in their businesses to make them more appealing and accessible to the public. The £30 million investment grant programme allows sub-postmasters to apply for grants of up to £10,000 (exceptionally £20,000) provided they put forward a similar amount of 'match funding'. Grants are available for branches that are likely to receive additional post office business as a result of the closure of a nearby post office under the programme.[28]

3.15 Sub-postmasters appeared initially to be showing some caution about applying for investment grants and the House of Commons Trade and Industry Committee and Postwatch expressed concern at the slow take-up.[29] The National Federation of Sub-postmasters suggested that sub-postmasters were having difficulty finding the required match funding and that they were reluctant to apply because of the uncertainty facing the network. Post Office Limited informed the House of Commons Trade and Industry Committee that investment in improvements to 'receiving' offices would inevitably lag behind the closure programme because sub-postmasters needed to feel confident that the programme would have the desired results. To assist sub-postmasters who may be unable to take advantage of investment grants for financial reasons, the company and the Federation have made available an additional support fund of £3 million a year.

3.16 After a relatively slow start the number of applications approved by Post Office Limited has increased rapidly from 400 in the 12 months to the end of 2003 to 2,429 by November 2004. Similarly, the amount of money paid out under the programme has increased significantly – rising from £420,000 in December 2003 to some £4 million by November 2004 **(Figure 12)**. In total, Post Office Limited has committed to pay out a total of £14.7 million to date.

3.17 The Department receives a monthly monitoring report from Post Office Limited detailing investment grant expenditure, but it does not cross-check the report to other sources of information (for example, sub-postmasters' applications) and so lacks assurance as to the validity of the payments made. Postwatch has started to visit branches where investment was promised in order to check, from a customer viewpoint, that promised improvements to services and facilities have been implemented. Postwatch intends to provide regular reports of its visits to the Department.

12 Cumulative investment grants paid from March 2003 to November 2004



Source: National Audit Office analysis of Departmental data

28 The types of improvements that are eligible under this grant programme include the installation of extra customer service points, improvements in disabled access and amenities, and signage.

29 House of Commons Trade and Industry Committee, Seventh Report of Session 2003-04, HC 611-1.

The effect on customers

3.18 Following closure of their local post office, most customers seem to adapt and start using an alternative post office. In 2003 Postwatch commissioned MORI to undertake research to clarify how customers expected the closure of post offices to affect them and how they adapt over time.[30] MORI reported early in 2004 that 94 per cent of customers use an alternative post office once their former branch has closed. But people are finding other ways of obtaining post office services – Post Office Limited has calculated that 20 per cent of business from branches that close is lost in the transition process. Although this represents less than two per cent of Post Office Limited's total business, it is significant at branch level in the urban network.

3.19 The programme has, however, caused inconvenience for customers. The MORI research found that many customers are satisfied with the service provided by their new post office but that customers have suffered inconvenience and many have had to change their behaviour:

- some journeys have become longer in time and distance, and more customers are driving or using the bus, making it more expensive to get to the post office;
- parking and disabled facilities at the new post office are not always adequate; and
- half the customers visit the post office less often and may use other providers for some services.

Postcomm plans to undertake research in 2005 to assess the impact of the urban reinvention programme on customers' needs and in securing the viability of the network for sub-postmasters.

3.20 Customers appear to be spending more time queuing at post offices. Postwatch research at directly managed post offices in Greater London showed that customers had to wait for 10 minutes or more to be served for 45 per cent of their visits.[31] Postwatch is currently broadening the scope of this research to include large franchise post offices and directly managed branches across the UK. The London Assembly conducted its own study on the effect of post office closures in London[32] and recommended that Postcomm should use the time spent queuing at post offices, and other measures of the quality of service, as performance indicators for the company.

The viability of the remaining network

3.21 The issue facing the Department and Post Office Limited is whether the programme will produce an urban network that is viable in the longer term, contributes to the company's attempts to return to profitability, and improves sub-postmasters' confidence about their businesses. If it fails, the Government will potentially face a choice between further closures to reduce the company's costs and funding the loss-making part of the urban network to ensure reasonable access to post offices.

3.22 The Department does not have access to information within Post Office Limited on the overall financial position of the urban network and does not, therefore, know whether the programme is making the urban network profitable. The House of Commons Trade and Industry Committee has questioned whether the programme will draw a line under the recent unmanaged decline of the urban post office network.[33]

30 Assessment of the Urban Network Reinvention Programme July- November 2003, MORI research for Postwatch, February 2004.
31 Postwatch's research was based on 120 visits conducted at different times of the day. Post Office Limited point out that the research only surveyed particular offices at a time when closures had recently taken place.
32 'Post Office Closures in London', A Report by the London Assembly's Public Services Committee, April 2004. A copy is available from the Greater London Authority website at www.london.gov.uk
33 House of Commons Trade and Industry Committee, Seventh Report of Session 2003-04, HC 611-1.

3.23 Post Office Limited is now promoting a wide range of financial and other services to increase the level of sales to customers and thereby increase post offices' chances of survival. Sub-postmasters, however, remain concerned about the prospects for their businesses in the future as new income streams, such as card account transactions and automated banking, will not necessarily replace income lost from pension and benefit encashment. A recent survey of sub-postmasters found that over 40 per cent were worried that their businesses would not have a future.[34] The survey also found that whilst 60 per cent of sub-postmasters had seen their 'total product payment' increase between February 2003 and February 2004, the other 40 per cent had either seen no increase or a fall.[35]

3.24 Sub-postmasters' contracts with Post Office Limited give them little flexibility as to the services they can provide. In particular, to protect the company's position in the market, they are not allowed to offer services that would compete with those offered by the company. This helps the company protect its product base and income levels. Postcomm has noted that for the network to succeed, changes are needed to address the restrictions to the sub-postmaster contract and pay system to ensure sub-postmasters have the right incentives and the freedom to sell products and services from their private business that will ensure that they can make a living. Post Office Limited and the National Federation of Sub-postmasters have agreed upon a new, sales oriented, pay system but have been unable to agree on changes to the terms of the contract. In November 2004 the Association of Convenience Stores submitted a complaint to the Office of Fair Trading on the restrictions in the contract.

3.25 Some sub-postmasters have seen themselves as providing a public service rather than running a business and may not feel comfortable adopting a more commercial, sales-oriented approach. Postcomm considers this to be a challenge for many sub-postmasters who see themselves as service providers and not sales people. Post Office Limited has held sessions for sub-postmasters to explain the new services and has supplemented this with training.

3.26 Postcomm recognises that the company is making some headway in providing sub-postmasters with a living, through the introduction of new products and training to sell financial services. However, sub-postmasters are still concerned about whether the loss of income from benefit and pension transactions can be made up through new business from banking and other services.

34 The results of the survey are at Appendix 4.
35 Total product payment refers to the payment made to sub-postmasters for all services and products transacted over the post office counter.

PART FOUR
Maintaining the rural post office network

4.1 Many rural post offices are unprofitable for Post Office Limited and, in a commercial environment, would be closed. To meet the Government's objective of providing access to post offices, the Department is compensating Post Office Limited for the costs of keeping open unprofitable rural branches. It is also encouraging the development of alternative ways of delivering post office services in rural areas.

The Department's grants for the rural network

4.2 The Performance and Innovation Unit Report recommended that the Government should require Post Office Limited to maintain the rural network of post offices and prevent avoidable closures until March 2006 in the first instance. The Report recognised that, although there would be opportunities for Post Office Limited to develop new lines of business, there may be a period during which the company might not be able to sustain the rural network. It stated that, should this situation arise, the Government should be prepared to provide support.[36] The company made clear to the Department that, without financial support, it would have no choice but to take a commercial view and close all but 2,000 rural post offices, keeping only those which were commercially viable or were necessary to meet Royal Mail's postal licence obligations.

4.3 The Government accepted that, in order to ensure continued access to the range of essential public services provided through rural post offices, it would have to fund the non-commercial element of the company's business. The Framework Agreement[37] of December 2002 formed the legal basis for this support and the purposes of this Social Network Payment were set out in a Memorandum of Understanding in July 2003 **(Figure 13)**. In return, Post Office Limited agreed to maintain the rural network by doing all it reasonably could to prevent all avoidable closures[38], and provide reasonable access for all citizens to 'over the counter' services.[39] The funding was provided from the gilts, owned by the Government, on Royal Mail Group's balance sheet. The European Commission approved the Department's proposal to provide this funding in May 2003. The amount and breakdown of the Social Network Payment is set out in **Figure 14**.

4.4 The Department's advisers, Deloitte & Touche, analysed Post Office Limited's planned allocation of costs to ensure that they were fairly stated. They confirmed that the company's allocation of costs appeared to be appropriate, subject to two assumptions:

- an IT contract would be renegotiated; and
- the cash handling and distribution operation would be contracted out.

The IT contract was renegotiated successfully. The company, however, did not proceed with plans to contract out the cash handling and distribution operation – faced with the prospect of industrial action, it considered that the costs would outweigh the potential financial benefits.

13 Purposes of the Social Network Payment set out in the Memorandum of Understanding

Payments to sub-postmasters (the fixed element of their pay)[40]

Post Office Limited's direct support costs for loss-making post offices

The Flexible Fund (for promoting and financing innovative ways of providing post office services in rural areas and funds for sub-postmasters to improve individual businesses)

NOTE

Unspent support costs can be used to increase payments to sub-postmasters, at the company's discretion, or can be added to the Flexible Fund, subject to the agreement of the Secretary of State.

14 Breakdown of the Social Network Payment

	2003-04 £m	2004-05 £m	2005-06 £m
Payments to sub-postmasters	66	66	66
Direct support costs	79	74	74
Flexible Fund	5	10	10
Totals	**150**	**150**	**150**

36 'Counter Revolution', The Performance and Innovation Unit, June 2000.
37 The Agreement was between the Secretary of State for Trade and Industry, Royal Mail Holdings PLC, Royal Mail Group PLC, and Post Office Limited.
38 There is no provision for a specific number of post offices in the rural network, as it is recognised that some closures will be unavoidable, but the support is to maintain the rural network as a whole.
39 These include encashment of state pensions and benefits; access to cash through banking services; despatch points for letters and parcels; sale of postage stamps; renewal of licences; and payment of utility bills.
40 These payments are known as 'assigned office payments'.

4.5 The Department wanted to avoid the Social Network Payment creating a dependency culture within Post Office Limited. It therefore gave the company an incentive to deliver services efficiently by reducing the annual payment to reflect improvements in efficiency. Thus the allowance for direct support costs of £79 million in 2003-04 reduces to £74 million in the second and third years of the agreement – a real terms reduction of 12 per cent by March 2006.[41] Sub-postmasters also have an incentive to operate efficiently. The level of the assigned office payment to sub-postmasters (which the Social Network Payment supports) remains constant over the three years of the agreement resulting in a decline in real terms.

4.6 The net annual closure of rural post offices rose in the late 1990s and jumped significantly in 1999-2000 and 2000-2001 **(Figure 15)** – at a time of uncertainty about the long term future viability of rural post offices. But since then the closure rate has fallen sharply.

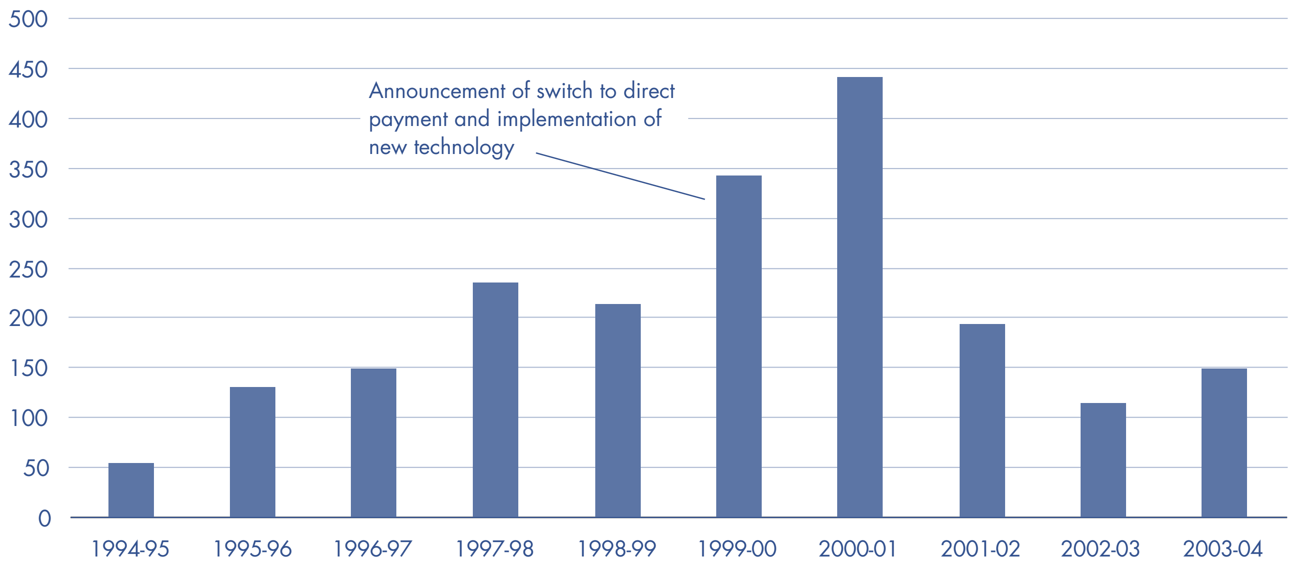
4.7 In autumn 2001, as part of Post Office Limited's commitment to maintain the rural network, the company appointed Rural Transfer Advisors to support post offices in difficulty. They work with the parties involved to try to prevent a closure and to identify ways of providing alternative services where a post office does close. They have managed to prevent some post offices from closing by assisting with changes to branch opening hours and methods of operation. Postcomm has noted that the work of the Rural Transfer Advisors has been highly commendable in slowing down the rate of closure, but it considers that this arrangement is not sustainable.

4.8 The Department monitors the company's expenditure on maintaining the unprofitable portion of the rural network by analysing Post Office Limited's classification of expenditure in its cost outturn reports. According to the company's report for 2003-04, it spent the full amount of £79 million for direct support costs. On the other two elements there were under-spends:

- payments to sub-postmasters amounted to £64.8 million (against a budget of £66 million); and
- Flexible Fund expenditure amounted to £1.2 million (against a budget of £5 million).

4.9 Deloitte & Touche's review of the company's allocation of costs (paragraph 4.4) provided assurance for the Department. But as costs may have changed during the year, the Department is seeking independent assurance that the sums reported by the company for 2003-04 have been incurred, spent for the purposes intended, and allocated correctly. As at 31 January 2005 Deloitte & Touche's report to the Department had not been finalised but the preliminary results of their work have not indicated any significant issues with respect to the costs incurred.

15 Net closures of rural post offices since 1994-95



Source: Postcomm

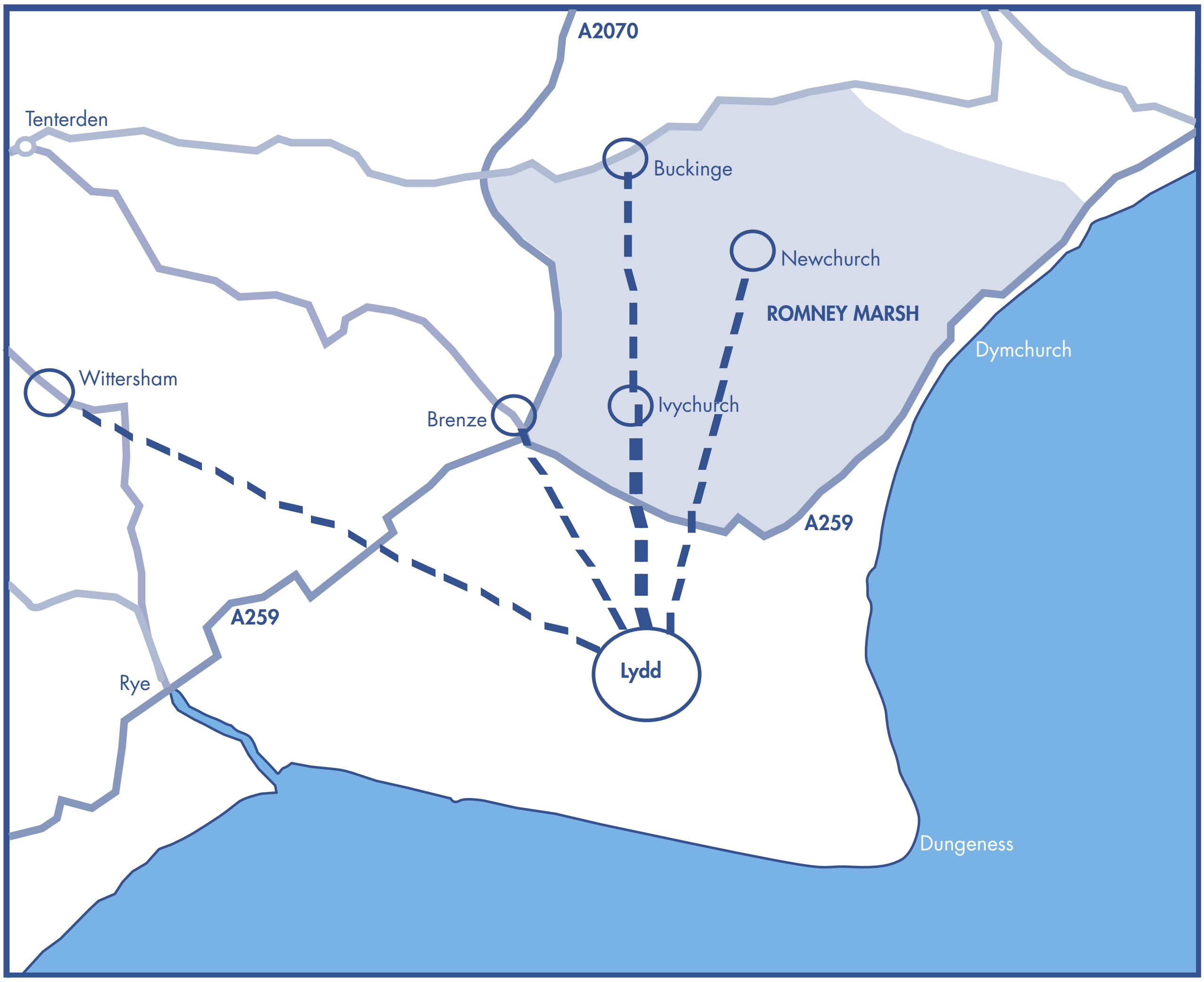
41 Assuming inflation of three per cent per annum.

Alternative provision of post office services

4.10 The Flexible Fund has £25 million available over three years for the company to promote and finance innovative ways of providing post office services and to fund improvements in individual post office businesses. Post Office Limited has made limited progress in developing and piloting alternative methods of provision. In the first year the company spent only £1.2 million of the £5 million available, with the rest carried over to 2004-05, and incurred only £770,000 on the live trialling of pilot activities. The rest was used to fund enabling activities, such as portable IT; establish partnerships; and manage the programme.

4.11 The 'hub and spoke' model is one of the 'outreach' models being piloted by the company. This model expands the reach of an existing post office to outlying small communities which do not have their own post office. The sub-postmaster of the 'hub' post office provides a mobile service at locations such as village halls and public houses in the outlying areas for several hours a week. **Figure 16** illustrates a 'hub and spoke' pilot in Romney Marsh, Kent. The post office in Lydd provides a two hour service each week at five satellite offices covering 3,000 people who previously had no local service. The company has piloted this model in rural areas where the post office closed some time ago or where there has never been a post office. The company initially adopted this cautious approach, rather than close down post offices that were still in business, to gain assurance that the model works in practice.

16 Illustration of a 'hub and spoke' operation in Romney Marsh, Kent



Source: *Post Office Limited*

4.12 In line with the Memorandum of Understanding, the company established a consultative group (the Rural Strategy Advisory Group) to advise on the use of the Flexible Fund.[42] The company has kept the Department informed of its progress by means of periodic reports and visits to pilot schemes. Although the Department was aware of the cautious approach adopted by the company in the initial phases of activity, it expressed concern that the company was making slower progress than it had hoped for. Some members of the Rural Strategy Advisory Group have also raised concerns at the direction and progress of the pilot activities.

4.13 In July 2004 the Department set up a tri-partite group with Post Office Limited and the Department for Environment, Food and Rural Affairs to better co-ordinate Government policy and the piloting of new ways of delivering services in rural areas. Subsequently, the company has strengthened its management and staffing in this area and reported the results of its evaluation of the first year's pilot activity to the Department in November 2004. This report confirmed that the company has made progress in developing the logistics and processes involved in pilot activity but that it has yet to test sufficiently the economics and viability of the pilot activities.

Further financial support for the rural network

4.14 In September 2004 the Secretary of State for Trade and Industry announced an extension of Government support for a further two years from April 2006 to March 2008. This is intended to allow sufficient time for the lessons from the pilot activities to feed into longer term decisions aimed at ensuring that access to post office services for those living in rural communities can be maintained on a sustainable basis. The Government's requirement that Post Office Limited should maintain the rural network and prevent avoidable closures of rural offices will remain in place at least until 2006; however, the requirement will be reviewed again once the outcome of pilot activity is clear.

4.15 The Secretary of State saw a number of other advantages to extending the existing financial support in the short term:

- decisions on the long term future of the rural network would be better informed after benefit payment transition is completed in 2005;
- it was too early to assess the full commercial potential of the company's new products; and
- some of the future options for the rural network could involve planned programmes of closures similar to the current urban reinvention programme from which lessons were still being learned.

4.16 The Treasury and a Cabinet Committee approved the decision to extend Government financial support, by up to £300 million, but it is subject to 'state aid clearance' from the European Commission.

The future of the rural network

4.17 The need to identify the role of the network was set out in the Performance and Innovation Unit's Report which recommended that Postcomm "should work with key stakeholders … to develop a shared understanding of the role that post offices should play in the longer term and advise the Government on the main options for the policy framework after 2006".

4.18 People are finding other ways of obtaining services that post offices traditionally provided, and it is too early to know whether a sustained demand will exist for the new post office products. Postcomm forecast a continuing decline in demand for post office services, though recognised that disadvantaged groups will continue to need access to cash.[43] Postcomm considered that the problem of the public wanting a local post office, but not using it enough, would get worse.

42 Members of the Group include Postwatch, Postcomm, Department for Environment, Food and Rural Affairs, the National Federation of Sub-postmasters, the Countryside Agency, and Virsa – Rural Shops Alliance.
43 Postcomm's Advice on the Future of the Rural Post Office Network, July 2003.

4.19 Many rural post offices have relatively few customers and a very high proportion of them lose money for Post Office Limited. Postcomm commissioned NERA to carry out a cost-benefit analysis of them. This translated the value placed on a branch by local people into a monetary figure and then compared it to the costs incurred by the company. Postcomm concluded that for twenty per cent of the existing network, there was no commercial or economic rationale for keeping it open, even taking into account the social value that rural customers place on their local post office. The analysis showed that:

- *Costs v Revenue*. Almost all rural post offices cost the company more to run (support costs plus sub-postmaster remuneration) than the revenue they bring in. The smallest branches make the largest losses in proportion to income generated, have the fewest customers, and the highest closure rate. The profitable branches, around 10 per cent and all in larger rural areas, produce an average net profit of 1p per customer visit for the company.
- *Benefits v Costs*. If, for the smallest 20 per cent of branches, the household benefits (the value placed by local people on the local branch's availability) are added to Post Office Limited's revenue generated by those branches, this 'benefits' total is still less than the cost of those branches to the company.

4.20 Postcomm concluded that the Government needed to determine the services it wanted from the rural network and then make the necessary funding available. It could not expect Post Office Limited to fund losses on a network far larger than it needs. In Postcomm's view, the Government's current policy of 'preventing avoidable closures' is inadequate. Postwatch echoed these views, considering it was crucial to the future of the rural network that the Government made an explicit declaration of the social role(s) of rural post offices[44]. Both Postcomm and Postwatch consider that where customer numbers are insufficient to support a post office, local solutions must be found to provide post office services to disadvantaged groups, who are less able to adapt.

4.21 In January 2004, when identifying future options, the Department considered a number of roles for rural post offices that suggested that a smaller network might be adequate:

- *Provision of Postal services*. Royal Mail's licence requirements stipulate that it must provide the public with a minimum standard of access to postal services. To meet this standard, however, Royal Mail believes that a much smaller rural network of 2,000 access points would suffice and that this number could be sustained without financial support from the Government;[45]
- *Provision of Government services*. This is a traditional role of post offices, but the trend is for government departments to develop direct access alternatives, such as post, phone or internet. None of the government departments using the rural post office network to deliver their services considers that they need a network of more than 2,000 rural outlets;
- *Safety net for the vulnerable*. Access to services for vulnerable people is of particular concern to the Government. Postcomm's research suggests that whilst the loss of a post office may be inconvenient and unwelcome, most people, including the vulnerable, do adapt. Furthermore, two thirds of rural settlements manage without a post office and always have done. The Government believes that more targeted support, aimed at people's specific needs (for example, social services outreach work) would be more effective than relying on post offices as a safety net for all vulnerable consumers.

44 'The Future of the Rural Post Office Network: Policy Paper', Postwatch, July 2003.
45 Royal Mail currently fulfils this access requirement in rural areas through the rural post office network.

4.22 The Department's analysis, however, identified other roles that implied that further closures could be potentially harmful:

- *Social value.* Even with declining use, the public perceive rural post offices to have a special value in the country's rural infrastructure. They are viewed as a focal point for communities, performing a social function and a trusted source of guidance and advice. It is very difficult to quantify and price this social value.
- *Sustaining the rural economy.* Post offices can make a contribution to the local economy by supporting village shops and other small businesses. In small villages the post office, combined with a shop, is often the last remaining retail outlet. If the post office side of the business is removed, the private retail business may lose custom, threatening its viability. The Department for Environment, Food and Rural Affairs and the devolved administrations for Scotland and Wales believe that the closure of rural post offices would undermine the stability of many fragile local economies, and that many thousands of private businesses (such as village shops and pubs) that serve communities could be put at risk. The Department of Trade and Industry considered this the strongest of the arguments put forward for Government funding of a larger rural post office network than could be sustained commercially by Post Office Limited. The Department for Environment, Food and Rural Affairs considers that the results of the pilots will be important in determining how any such funding is targeted (for example, by supporting commercially unviable post offices, direct to village shops, or via Parish Councils).

4.23 The current three year package of £450 million was intended as a transitional measure, designed to help rural post offices through the changes in the network's business between 2003 and 2006, and to allow time for the company to pilot new methods of service delivery. The lessons that emerge from these pilots by the end of 2005-06 will be crucial in informing the Government's longer-term decisions about the future shape of the rural post office network. This should provide sufficient time for the Government to make decisions to ensure that access to post office services for those living in rural communities can be maintained on a sustainable basis, and for Post Office Limited to take appropriate action before the current funding ends in 2008.

APPENDIX 1

The main types of services available at post offices

Type of service	Availability	Description
Postal services		
Standard services	All branches	Parcels and letters accepted for standard 1st class, 2nd class and overseas delivery, standard parcel service and additional services such as recorded delivery.
Express services	All branches	Variety of express delivery services, including Royal Mail Special Delivery and Parcelforce 24.
Philatelic	All branches	Royal Mail special issue stamps and associated products, such as presentation packs and first day covers.
Banking and bill payments		
Banking	All branches, however some banking partners not available in some parts of the UK	Personal cheque encashment and cash and cheque deposits in respect of bank accounts with one of Post Office Limited's banking partners.
National Savings and Investments	All branches	Variety of savings products, including Premium Bonds.
Bill payments	All branches	Payment of utility and council bills, including pre-payment and instalment schemes.
Savings stamps	All branches	Saving towards regular bills like utility and rent bills.
Benefits and pensions		
Benefits	All branches	Benefit and pension encashment.
Post Office Card Account	All branches	This card, if chosen as the preferred method of direct payment, gives people on benefits access to their cash, at no charge.
Driving		
Photo driving licence application checking service	700 branches (5 per cent)	Applications are checked and sent to the DVLA.
Vehicle excise duty	4,700 branches (31 per cent)	Applications are processed and tax discs issued.
Car insurance	All branches	Insurance cover for cars.
Financial products		
Personal loans	All branches	Decision available almost immediately with funds available the next day; loans up to £25,000 and repayment terms of 1 to 7 years are available.
Home		
Home insurance	All branches	Insurance cover for home contents with a variety of payment methods.
Television licences	All branches	Issue of television licence.

Type of service	Availability	Description
Leisure		
Fishing licences	All branches	Range of rod licences available for angling in England and Wales.
Retail	200 branches (1 per cent)	Range of Post Office Limited supplied stationery and books and publications.
Lottery	10,000 branches (65 per cent)	National Lottery scratchcards for sale.
	5,000 branches (33 per cent)	Main Lottery draw terminals selling tickets for Lotto, Lotto Extra and Thunderball games.
Tickets and travel products	All branches	For local bus and train services (as agreed with Local Authorities).
Post Office flowers	All branches	Flowers can be ordered and paid for at the counter and the flowers are delivered through the postal network.
Money transmission		
Postal Orders	All branches	Purchase and encashment of Postal Orders.
MoneyGram	3,000 branches (20 per cent)	International money transfer of up to £5,000 to over 150 countries, taking just 10 minutes.
Telephony		
Homephone Service	All branches	Key features include cheaper calls, no minimum charges, free calls to favourite numbers. There are no connection charges and customers can keep their existing number.
Phonecards	All branches	Post Office phonecards for cheaper rate calls when calling from the UK to abroad.
Holiday phonecard	Available to all branches but stocked on demand	Post Office phonecard that allows cheap rate calls from over 50 destinations abroad.
Mobile phone vouchers	8,000 branches (52 per cent)	Pre-pay vouchers for all main providers.
Mobile phone E-Top ups	All branches	Electronic pre-payment for mobile telephones.
Travel		
Passport checking	2,000 branches (13 per cent)	Checking and forwarding of application to the Passport Office for priority processing.
Bureau de Change	All branches	Exchange of sterling for foreign currencies and travellers cheques.
Travel insurance	All branches	Purchase of a range of family and individual policies.
E111 Form	All branches	Supply of an E111 form that entitles holder to free or discounted emergency medical treatment.

APPENDIX 2

The Government's action on the main recommendations of the Performance and Innovation Unit Report: Counter Revolution - Modernising the Post Office Network, June 2000

Recommendation	Government action has included:
Today's network of rural post offices enhances the quality of life in their communities. For that contribution to continue in the future, there is a need for rural post offices to modernise and for the services they provide to be broadened and improved. The Government should back this modernisation with financial support.	£450 million support for the rural network from April 2003 to March 2006.
The Government should place a formal requirement on the Post Office to maintain the rural network, and to prevent any avoidable closures. The requirement in relation to the rural network should apply in the first instance until 2006.	Formal requirement placed on the Post Office in November 2000 plus a request for strategies to prevent closures.
Postcomm, informed by Postwatch, should report annually to the Secretary of State for Trade and Industry on the urban and rural networks.	Postcomm has published annual reports since 2001.
In order to plan for the possibility that financial assistance might be necessary, the Government should make provision to support the rural network.	£450 million support from April 2003 to March 2006 (as set out above).
Postcomm, informed by Postwatch and other key stakeholders, including the National Federation of Sub-postmasters, should advise the Government on the best way to channel financial assistance to post offices, reporting by Autumn 2001.	Postcomm submitted advice by Autumn 2001. It proposed transitional assistance for rural post offices during the period of the switch to direct payment of pensions and benefits.
The Post Office should embark on a programme of modernisation of the urban network in partnership with sub-postmasters and other stakeholders, including the National Federation of Sub-postmasters.	Parliament approved £210 million support for urban network reinvention in October 2002.
If the Post Office does decide that it needs fewer outlets than at present in some urban areas, then it will need to ensure that sub-postmasters who are affected are adequately compensated for the loss of the value of their asset. The Government may also need to consider providing financial assistance to the Post Office for this purpose if necessary.	£180 million of the £210 million urban reinvention package is for compensating sub-postmasters.
Postcomm, informed by Postwatch, should work with key post office network stakeholders, including the National Federation of Sub-postmasters, over the next five years to develop a shared understanding of the role that post offices should play in the longer term and advise the Government on the main options for the policy framework after 2006.	Postcomm submitted advice to the Department in July 2003.

Recommendation	Government action has included:
Post Office should see 'Universal Bank' as a major new business opportunity. It should urgently develop the concept in partnership with high street banks and others. Government should positively support Universal Bank, viewing it as the best means to ensure that benefits recipients can continue to access their entitlements in cash at post offices.	The 'Universal Bank' concept evolved into universal banking services at post offices by August 2000. A Memorandum of Understanding with 11 major financial institutions (99 per cent of the UK current account market) was agreed in May 2001. Under this, banks allow Post Office Limited access to their basic bank accounts and contribute to the costs of the Post Office Card Account (a simple card account accessible only at post offices to receive benefits and tax credits) - £180 million over 5 years.
Government clients of the post office network should be free to develop new channels for delivering their services to citizens. But there should be a presumption that they continue also to offer their existing services at post offices, so long as there remains sufficient customer demand to make it cost effective to do so.	The Secretary of State for Trade and Industry wrote to colleagues in 2000 reminding them of the service and reach of the post office network. It was agreed that Departments should be free to develop new channels but that they should also always consider post office access to their services as an option. The presumption is that they continue to offer their existing services at post offices so long as there remains sufficient customer demand to make it cost effective to do so. The Driver and Vehicle Licensing Agency increased by 600 to 4,600 the number of post offices offering motor vehicle licences by March 2004.
Post Office should urgently take forward work to maximise the commercial potential of the network, efficiency in the operation of the network, and the quality of individual post offices.	Private sector expertise was brought in with the appointment in 2002 of Mike Hodgkinson as Chairman and David Mills as Chief Executive. Post Office Limited was separated from the main company in October 2001 and set up with its own Board, finance structure, assets and targets. £30 million Government support for grants to improve outlets remaining in the urban network. From 2001 a range of new financial products have been introduced, including travel insurance, foreign exchange, access to bank accounts of selected banks, unsecured personal loans, and insurance.
The Secretary of State for Trade and Industry needs to review progress against the Post Office's plans for exploiting new sources of revenue and improving efficiency, taking action as necessary in light of this.	The Department of Trade and Industry monitors Post Office Limited's financial performance through quarterly shareholder meetings.
Overall responsibility for overseeing and monitoring the conclusions of this report should rest with the Secretary of State for Trade and Industry who should report on progress to the Prime Minister.	The Department keeps No10 Policy Unit closely informed on progress.

APPENDIX 3

Study scope and methodology

Scope

1 This report covers the Department of Trade and Industry's financial support for Post Office Limited and the UK-wide network of post offices. Our examination covered the package put together by the Department to help put Post Office Limited on a sounder financial footing, to finance the rationalisation and modernisation of the urban network, and to maintain the size of the rural network. The report does not cover schemes put in place by other Government departments, such as the Deprived Urban Post Office Fund set up by the Office of the Deputy Prime Minister, or schemes operated by the devolved administrations.

2 The report focuses on the actions taken by the Department of Trade and Industry and includes references to other public bodies, such as the Postal Services Commission, the industry regulator, and Postwatch, the consumer representative body. While the activities of Post Office Limited feature significantly in the report, the National Audit Office is not the external auditor of Royal Mail Group or Post Office Limited. Although we have no right of access to documents held by Post Office Limited, we were provided with relevant information, sufficient for the purpose of this study, by the Department. We also held meetings with senior staff of Post Office Limited.

Methodology

3 The key elements of our study methodology were:

File review and interviews

We met officials within the Department's Postal Services Directorate to discuss the development of the package of financial support for Post Office Limited, the Department's monitoring of the company's financial performance and progress on the individual support programmes, and issues surrounding the future of the rural network. We reviewed and analysed relevant documents and reports, including those supplied to the Department by Post Office Limited and those drawn up by the Department's external advisers.

Stakeholder consultation

We had discussions with a wide range of bodies with an interest in the post office network (Table 1) and attended meetings of Postwatch's Counters Advisory Group, a forum used by Postwatch to meet with representatives of consumer bodies at a national level.

TABLE 1

Stakeholders consulted during the study
HM Treasury
The Department for Environment, Food and Rural Affairs
The Department for Work and Pensions
Post Office Limited
Postal Services Commission (Postcomm)
Postwatch
National Federation of Sub-postmasters
Federation of Small Business
Village Retail Services Association
The Countryside Agency
National Association of Local Councils
Age Concern
Help the Aged

Specialist advice

We engaged experts to give us advice in two areas:

- Triangle, experts in the postal sector, to undertake a study of aspects of post office networks in selected countries: France, Germany, Italy, Netherlands, New Zealand, Sweden and the United States. Their report is available on our website (www.nao.org.uk).
- Wilmington Capital Limited, experts in corporate finance, to look at the appropriateness and suitability of the Department's financial monitoring of Post Office Limited, and to identify any lessons that can be learnt from private sector practices, particularly in the private equity industry.

Analysis of published information

We analysed and drew on existing sources of published material and reports from bodies with an interest in the post office network including Postcomm (in particular Postcomm's annual report on the network of post offices), Postwatch, and the National Federation of Sub-postmasters.

Visits to post offices

We visited a range of urban and rural post offices during the course of the study, including one of Post Office Limited's 'hub and spoke' pilot operations in Kent.

APPENDIX 4

Results of the MORI survey, for the National Federation of Sub-postmasters, of sub-postmasters' incomes and views

The National Federation of Sub-postmasters commissioned MORI to undertake a survey of a representative sample of their members to find out what impact the changes to the benefits payment system is having on sub-postmasters' income and their views of the future.[46] The survey was conducted in two phases - in November 2003 and in May 2004 - in order to gain an accurate picture of the initial effects (after the first four months of direct payment) and the longer-term consequences (after 12 months). The survey found that:

On gross pay

For most sub-postmasters their gross pay is made up largely of two elements – a fixed sum paid by Post Office Limited and a variable element ('product payment'), which depends on the products and services sold over the post office counter. From their gross pay, a sub-postmaster must pay tax, National Insurance contributions, and also the running costs of the post office.

- The average gross monthly pay that sub-postmasters reported for February 2004 was £2,504. The majority (68 per cent) reported gross pay amounts between £1,001 and £3,500. One in twelve reported gross pay amounts of £1,000 or less; a similar proportion recorded over £4,000 (it was assumed that most of these sub-postmasters were running more than one post office or very large post offices).
- Many sub-postmasters had seen changes in gross pay between February 2003 and February 2004. MORI discovered that 44 per cent of sub-postmasters had seen a decrease in their gross pay over the period (in total 25 per cent of sub-postmasters saw a 1-4 per cent decrease, 15 per cent saw a 5-9 per cent decrease and 4 per saw a 10-19 per cent decrease), whilst 36 per cent saw an increase. The remaining 20 per cent saw no change in their gross pay.
- Interestingly, sub-postmasters whose business had been affected by other factors, such as the closure of a nearby post office under the urban reinvention programme, are more likely to have seen increases in gross pay during the past 12 months.

On total product payment

Total product payment refers to the payment made to sub-postmasters for all services and products transacted over the post office counter. Sub-postmasters are paid different amounts for different types of transactions. These include the whole range of transactions such as postage stamp sales, issuing of E111 certificates and television licences, travel insurance and foreign currency - as well as the encashment of benefits and pensions, banking transactions and bill payments focused on in this study.

- The mean amount of total product payment received by sub-postmasters for February 2004 was £1,326. Sixty per cent of sub-postmasters had seen their product payment increase between February 2003 and 2004. This increase may be partly explained by customers transferring from post offices which have closed under the network reinvention programme.
- Nineteen per cent had seen their product payments decrease in the last year – again mainly by under 10 per cent.

46 Survey of the impact of changes to the benefits payment system on sub-postmasters' income, available on the National Federation of Sub-postmasters website (www.subpostmaster.org.uk)

On Order Books and Giro-cheques

- In August 2002, order book and giro-cheque income made up, on average, 64 per cent of a sub-postmaster's total product payment. By February 2004, order book and giro-cheque income accounted for only 23 per cent of total product payment. Since August 2002, 82 per cent of sub-postmasters had seen their income from this source nearly halved.
- By 2005, when order book and giro-cheques will no longer be available for benefit claimants and pensioners, sub-postmasters will receive no income at all from this source.

On income from Post Office Card Account

Post Office Card Accounts are simple electronic accounts, available only through post offices, designed to receive state pension and benefit payments only. Card accounts were introduced in April 2003. Sub-postmasters are paid a one-off payment for each card account opened and also transaction payments which relate to the amount of money withdrawn from the accounts by account holders.

- The mean average payment for card account openings in February 2004 was £28.31, an increase of 9 per cent since August 2003.
- 45 per cent of sub-postmasters had seen an increase in income from card account openings since August 2003; 25 per cent of sub-postmasters had experienced an increase of 100 per cent in payments for card account opening.
- Whilst over half the sub-postmasters reported no transaction payments in August 2003, by February 2004 nearly all reported payments. Half received payments in the range of £5-£20.
- The mean average income from card account transactions was £24.19 for February 2004 and this had almost doubled in the previous six months (in August 2003 it was £12.46).

On income from automated banking

Automated banking includes a number of transactions made over the post office counter, including some transactions made using Alliance & Leicester, Barclays and Lloyds TSB current accounts. It also includes all cash withdrawals and most balance enquiry transactions for basic bank account customers using the post office.

- The mean automated banking payment for February 2004 was £16.34. Although this is a small figure, it is a relatively large increase since August 2003, when the mean average reported was £6.00.
- Automated banking income remains particularly low in certain parts of the UK. For instance, around 60 per cent of sub-postmasters in Scotland received under £4 for automated banking transactions in February 2004.
- Sixty two per cent of sub-postmasters believe that previous benefit and pension book customers have 'migrated' to the direct payment system; most other sub-postmasters (34 per cent) think that automated banking customers are a mixture of new and 'migrated' customers.

On automated bill payments income

Automated bill payments include post office customers' payments for bills ranging from electricity and gas bills to cable television, telecommunications services and council tax. Traditionally many post office customers have paid their bills over the post office counter at the same time as cashing their order books or giro-cheques. The National Federation of Sub-postmasters is concerned that the change to direct payment will mean many people no longer pay their bills at the post office.

- Over half of sub-postmasters were paid £51-£400 per month for automated bill payment transactions. The mean average rose to £142 in February 2004 from £129 in August 2002. Nineteen per cent of sub-postmasters had seen a decrease in their income for automated bill payment transactions.
- However, seven in ten had seen their automated bill payment income increase. Those who saw the greatest increases over the last year were also more likely to report external factors affecting their business and to work in excess of 45 hours per week.

On personal drawings

For February 2004, sub-postmasters were asked about their personal drawings.

- Of the 90 per cent who provided information about their personal income, 6 per cent took nothing at all for February 2004, 50 per cent under £1,000 (but at least something), 19 per cent drew £1,001-£1,500 and 14 per cent paid themselves £1,501 or more. (£1,000 per month is equivalent of an employee's salary of around £15,000 a year, £1,500 equivalent of around £25,000).
- For two-thirds of sub-postmasters this income is for both themselves and their spouse/partner (42 per cent of sub-postmasters share the running of their post offices with their spouse/partner).
- For those whose personal income is under £1,000, 68 per cent generate additional income from the business they run alongside the post office. But 26 per cent supplement their post office income from a pension, 14 per cent from savings and investments, 12 per cent from state benefits and 9 per cent from a personal loan.

On changes in use of attached businesses

The survey asked sub-postmasters with an adjoining business to their post office, whether they thought their non-post office business (from post office customers) had changed during the past six months.

- Sixty per cent of sub-postmasters believed that their other business had been affected. Forty four per cent of sub-postmasters said that they had experienced a decrease in the amount spent by post office customers over the last six months. The mean average decrease in spending was estimated at 16 per cent. Yet 57 per cent of sub-postmasters said they relied on this income to boost their own household income.
- Only 14 per cent of sub-postmasters interviewed said that they have experienced an increase in spend in their attached business over the last six months.

On the future

Sub-postmasters remain worried about their future and the evidence from this research continues to suggest that this concern is valid.

- Although most sub-postmasters were not optimistic about the next six months, 42 per cent say they could see a future for their business (higher than 35 per cent in October 2003). The proportion who are most worried – those who "see no future whatsoever" (12 per cent), and those who were "expecting to be bankrupt within a few months" (2 per cent) - were in the minority.
- However, 43 per cent said they were "worried my business won't have a future".

Financial Support for Post Offices

A report by the Comptroller and Auditor General

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