



DEPARTMENT OF TRADE AND INDUSTRY
Financial Support for Post Offices

LONDON: The Stationery Office
£9.25

Ordered by the
House of Commons
to be printed on 21 February 2005

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 Holdings¹, 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.