Department
for Business
Innovation & Skills

Royal Mail: Sale of Shares

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1. The need for reform

1.1 The Government's primary objective in relation to Royal Mail and postal market reforms is to safeguard the universal postal service in the UK. The one-price-goes-anywhere, six-days-a-week universal postal service provided by Royal Mail is part of the social and economic fabric of the United Kingdom. Royal Mail is the only company currently capable of providing this service which is vital to consumers, businesses and the UK economy.

1.2 The universal postal service is facing significant challenges due to the digital revolution and the growth in electronic communication. The Independent Review of the Postal Sector led by Richard Hooper published a report on the maintenance of the universal postal service in 2008 which was updated in 2010. On both occasions the Reports concluded that the postal market faced an uncertain future; that there was a substantial threat to Royal Mail's financial stability; and that the universal service was under threat.

1.3 Hooper's 2008 report recommended that HMG implement the following package of measures:

- reform of the regulatory framework, with responsibility for postal regulation transferring to Ofcom;
- removal of Royal Mail's historic pension deficit; and
- a strategic private sector partner for Royal Mail.

1.4 The Coalition Agreement[1] included a commitment to give Royal Mail access to private capital, including opportunities for employee ownership. It also committed to retaining Post Office Ltd in public ownership.

1.5 Hooper's updated report, published in September 2010, confirmed that his original recommendations regarding regulatory reform, relief of the pension deficit and private sector involvement remained valid. The updated report noted that whilst the need for private capital and disciplines remained as strong as ever, the specific need for a private partner had reduced. He concluded that private sector capital was needed to:

- ensure that cash is readily available when needed to fund the accelerated modernisation programme on a commercial basis that matches, indeed tries to get ahead of, the rapid changes in
- the market;
- inject private sector disciplines into the business; and
  reduce the risk of political intervention in commercial decisions.

[1] The Coalition: our programme for Government, page 10
http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_187876.pdf

1.6 Hooper's recommendations of regulatory reform, pension relief and private sector capital were a package: "each element of the package is needed if the universal service is to be sustained".[2]

1.7 The Government accepted these recommendations in full and introduced the Postal Services Bill in December 2010 to enable implementation of the package of recommendations. The Postal Services Act received Royal Assent in June 2011.

2. Progress to date

2.1 The Postal Services Act 2011 gave the Government the powers to implement Hooper's recommendations in full.

2.2 In 2011, Government reformed the regulatory regime by abolishing Postcomm and transferring regulatory responsibility for postal affairs to Ofcom. The Act gives Ofcom a clear primary duty to secure the provision of the universal postal service and in March 2012, Ofcom set the regulatory regime for the next seven years. This regime gave Royal Mail more commercial freedom and removed price controls from 1st class stamps, while placing a price cap of 55p subject to inflation on 2nd class stamps. Ofcom also imposed a price cap on 2nd class large letters and parcels up to 2kg.

2.3 On 1 April 2012 the Government relieved Royal Mail of its historic pension deficit of approximately £12 billion by transferring pension benefits accrued up to that date to a new Government pension scheme. The Government transferred approximately £28 billion of assets and approximately £40 billion of liabilities. The management of the ongoing Royal Mail Pension Plan is a matter for Royal Mail and its Pension Trustees.

2.4 On 1 April 2012, the Government separated Royal Mail and the Post Office Ltd (POL) into sister companies to allow shares to be sold in Royal Mail whilst retaining POL in public ownership.

2.5 The action that Government has taken on regulation and pensions, coupled with Royal Mail's ongoing modernisation programme, has already produced positive results. The company has returned to profitability thanks to employees' and management's hard work on modernisation and Government's actions. Royal Mail's results for the financial year ending 31 March 2013 were strong. Revenue of £9,146 million was £382 million (+5%) ahead of the last year (financial

[2] 'Saving the Royal Mail's universal postal service in the digital age' by Richard Hooper CBE https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31808/10-1143-saving-royal-mail-universal-postal-service.pdf

year ending 31 March 2012). Operating profit after transformation costs grew from £152 million to £403 million with profit margin increasing from 1.7% to 4.4% on a like-for-like basis.[3]

3. Safeguarding the Universal Postal Service

3.1 There is still more to do to return Royal Mail to a level of profitability consistent with international postal operators and to safeguard the universal postal service. The postal market is changing; the number of letters being sent is in decline, while the parcels market is growing rapidly. The changing market presents an opportunity which Royal Mail must exploit if it is to grow the business and have a sustainable future.

3.2 A Royal Mail freed from Government control will be able to innovate and compete for new business. It must be nimble and able to raise capital on the open market. Royal Mail will need continued investment as it focuses on high growth in the parcels market, develops its mail automation in line with peers and improves its efficiency. The company now needs the commercial disciplines associated with external shareholders and the long-term ability to access flexible private capital. These will enable it to maintain this performance, adapt to take advantage of new opportunities, such as the rapid growth in the parcels market, and to continue to deliver the one-price-goes-anywhere, six-days-a-week universal postal service.

3.3 EU Member States are required by European law to provide an affordable universal postal service five days a week. The Government has strengthened this by enshrining in UK law the minimum requirement for a six day letters service to every address in the UK at both affordable and uniform prices. The Postal Services Act 2011 also enshrines in law a requirement for the universal service to include free services for the blind, an affordable registered items service, an affordable insured items service and a free service for conveying legislative petitions and addresses.

3.4 The minimum requirements of the universal service can only be changed by the Government with the agreement of Parliament[4]. In addition, the requirement that the universal service be geographically uniform throughout the UK can only be changed through new primary legislation.

3.5 The Government has also ensured that protection of the universal service is at the heart of the regulatory regime by giving Ofcom a

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[3] The 2012-13 financial year was a 53 week year and to provide meaningful comparisons, revenue and operating costs are also presented on an adjusted 52 week basis. The year-on-year comparisons provided above are on an adjusted 52 week basis
[4] Via the affirmative resolution procedure

primary duty to secure the provision of the universal service. Ofcom also has a principal duty under the Communications Act 2003 to further the interests of citizens and consumers, where appropriate, by promoting competition. Should the two duties be in conflict, Ofcom's duty to the universal service takes precedence.

3.6 In March 2013, Ofcom published guidance on its approach to regulating end-to-end competition in the letters market. In the guidance Ofcom stated that where it considers that end-to-end competition gives rise to a threat to the provision of the universal service, it has the powers to take proportionate regulatory action and will do so if it considers it necessary and appropriate. Ofcom further stated that it will conduct a review of end-to-end competition in 2015, if it has not already done so by that time.

3.7 In this financial year the Government intends to conduct a sale of shares in Royal Mail to give the company access to the capital and commercial disciplines that it will need to have a sustainable future in a rapidly changing postal market.

4. Objectives for the sale of shares

4.1 The Government published the objectives for a sale on the gov.uk website on 25 April 2013:

"The Government will secure the universal postal service for the benefit of all users by securing Royal Mail's future through the introduction of private sector capital and associated disciplines.

This will be achieved through:

- delivering a sale of shares in Royal Mail within this Parliament;
- creating an employee share scheme that, as Parliament has decided, will lead to at least 10% of the company in employee ownership, to drive stronger staff engagement; and
- delivering a financial outcome for the taxpayer, which when considered in the context of the overarching policy objective, represents overall value for money."

5. Structure of the sale of shares

5.1 The Government has made clear the attractions of an Initial Public Offering (IPO) and can now confirm that Ministers have taken the decision to move forward with an IPO, subject to meeting the published sale objectives. An IPO is the most transparent and open form of sale and will allow us to offer shares to the public as well as provide shares for Royal Mail employees from the day of the sale.

5.2 The Government announced on 29 May 2013 the appointment of a syndicate of lead banks to undertake an IPO. This syndicate consists of Goldman Sachs and UBS as Joint Global Coordinators and Joint Bookrunners, Barclays as Sponsor and Joint Bookrunner, and Bank of America Merrill Lynch as Joint Bookrunner. Since that date the Government has also appointed Investec, Nomura and Royal Bank of Canada as Co-lead Managers. These appointments followed a highly competitive tender process that was contested by a large number of leading banks. This syndicate of banks will be responsible for preparing and ultimately executing the IPO.

5.3 The Government's firm intention is to conduct the IPO during the current financial year which ends on 31 March 2014. The Government will retain flexibility around the size of stake to be sold, as this will be influenced by market conditions at the time of the transaction, investor demand and the objective to ensure that overall value for money for the taxpayer is achieved. It is the intention to dispose of a majority stake, taking into account shares sold and those transferred to employees as part of the employee share scheme.

5.4 The IPO will include a retail offer which will enable members of the public to buy shares in this iconic company on the same terms as institutional investors. The retail offer will comprise two application routes: (i) via intermediaries, which will allow members of the public to apply for Royal Mail shares through existing or new stockbroking accounts and (ii) a direct route, where members of the public can apply directly to Government. All applications, whether through intermediaries or direct to Government, will be treated in the same way, and applicants will pay the same share price. Within the retail offer there will also be a priority offer for employees. Further details will be provided ahead of the IPO.

6. Employee Share Scheme

6.1 Parliament decided in 2011 that Royal Mail employees should have a stake in the company. If the IPO goes ahead, Government will implement this commitment in full and will introduce the largest employee share scheme of any major privatisation for almost 30 years.

6.2 This scheme will offer eligible employees a meaningful stake in the company and will strengthen employee engagement by better aligning employee incentives with those of other stakeholders and the company itself.

6.3 Under the Postal Services Act 2011, the Secretary of State must ensure that arrangements are made by the time of the first sale of shares in Royal Mail for the establishment of an employee share scheme. The Act states that if at any time the proportion of the company owned by the Crown is reduced to nil, the proportion of the company owned by or on behalf of the employee share scheme is at that time (or has been before that time) at least 10%.

6.4 On or around the point of IPO, Government will transfer 10% of its shares in Royal Mail to an employee share scheme.

6.5 These shares will be offered to eligible employees for free and will be the same class as those available for wider sale, meaning employees will therefore obtain voting rights and be eligible to receive dividends like other shareholders.

6.6 Government intends to allow eligible employees to benefit from the tax advantages of HMRC's Share Incentive Plan arrangements.

6.7 The following rules will therefore apply to the scheme to promote its longevity, enable employees to benefit from those tax advantages, and to strengthen employee engagement:

- shares must be held for at least three years. Full tax benefits are only available if the shares are held for at least five years or for 'good leavers'[5];
- shares will be forfeited if an employee leaves Royal Mail within three years of their award. This will not apply to 'good leavers' whose shares will vest and benefit from tax advantages upon departure;
- shares will be allocated to employees equally, regardless of grade or pay levels. The allocation will be pro-rated based on an employee's typical hours to differentiate between full and part time workers; and

[5] Good leavers include those retiring (as defined by Royal Mail and the scheme rules), redundancy, disability or illness, and death.

- to be eligible for shares, employees will be subject to a qualifying period of employment.

6.8 General Logistics Systems (GLS) employees, and those of joint venture companies, will not be eligible for the scheme, which is focused on the company that directly delivers the universal service in the UK.

6.9 Employees can opt not to receive shares. Further details will be provided in the run up to the IPO.

6.10 The Government hopes that eligible Royal Mail employees will participate in the employee share scheme and make the most of this opportunity to hold a stake in their company.

6.11 In addition to the free shares that they will be offered in the employee share scheme, eligible Royal Mail employees will also receive priority in allocation when purchasing shares at the same price as the general public in the retail offer as part of the IPO.

7. Commercial relationship between Royal Mail and Post Office Limited

7.1 Royal Mail and Post Office Limited (POL) were formally separated in April 2012. For the past year the two companies have operated independently of each other, strengthening their relationship and allowing each organisation to focus on its own priorities.

7.2 Before the businesses separated, two key agreements governing Royal Mail's ongoing relationship with POL were signed in January 2012. These are commercial agreements that were keenly negotiated by the businesses, at arm's length, reflecting their independence from one another. The first such agreement is the Mails Distribution Agreement, which governs the retail mail and parcels services offered by POL on behalf of Royal Mail. This agreement was designed with the sale of shares in Royal Mail in mind and therefore sets out in detail the commercial terms of the long-term relationship between the businesses.

7.3 Under the Mails Distribution Agreement, POL provides retail mail and parcels services to consumers on behalf of Royal Mail (under both the "Royal Mail" and "Parcelforce Worldwide" brands). The Post Office branches also act as a drop off point for Royal Mail prepaid items and can be designated as a customer collection point for items sent using Royal Mail services. Royal Mail is the only postal operator which uses POL either as a retailer of services or as an acceptance or collection point for postal items. The Mails Distribution Agreement will continue in force for a period of at least ten years from its commencement date – 26 March 2012.

7.4 Since this is a long-term agreement in a dynamically changing market, it is important that, if necessary, the businesses are able to agree changes to ensure it remains commercially fit-for-purpose and the relationship between POL and Royal Mail continues to work effectively for its duration. There is therefore a provision allowing for a review of the agreement's terms, five years into its duration. Any changes proposed as a result of that review must either be agreed between the parties or, if they are unable to reach agreement, be taken to an expert for resolution. The other limited circumstances in which a party may seek a review of the agreement's terms are in cases where there has been a material adverse effect on POL or Royal Mail. Finally, there are very limited circumstances under which the Mails Distribution Agreement could be terminated by one of the businesses – insolvency or material/persistent breach on the part of the other.

7.5 The second key agreement is the Master Services Agreement. This is a transitional agreement which deals with the separation of POL and Royal Mail and ensures that POL retains access to certain key functions while it develops its own standalone capabilities appropriate to an independent business. Under the Master Services Agreement, Royal Mail provides services such as finance, IT and facilities management services to POL on a temporary basis. The separation process is ongoing as the parties work together to facilitate the migration of POL away from transitional services provided by Royal Mail. The majority of services under the Master Services Agreement are due to terminate on 31 March 2014. However, the IT and finance services are to terminate on 28 September 2014. These will be the last services to be provided under the Master Services Agreement, after which it will then expire.

8. Next Steps

8.1 The next public step if the Government proceeds with the IPO will be the publication of the Intention to Float. At this point Ministers will write to inform the House.

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