



EUROPEAN COMMISSION

Brussels, 28.03.2012
C(2012) 1905 final

Subject: State aid SA.33054 (2012/N) – United Kingdom
Post Office Limited (POL): Compensation for net costs incurred to keep a non-commercially viable network for the period 2012-15 and the continuation of a working capital facility

Sir,

1. PROCEDURE

1. On 24 January 2012, the United Kingdom notified under Article 108§3 of the Treaty on the Functioning of the European Union ("TFEU") two State measures in favour of Post Office Limited (hereafter "POL") for the period 1 April 2012 to 31 March 2015. This followed pre-notification contacts that began in May 2011.
2. First, the notification concerns a measure to finance POL's obligation, for the period 1 April 2012 to 31 March 2015, to ensure the delivery of a bundle of public services over a network that is larger than the network POL would maintain on a purely commercial basis. The United Kingdom considers this mission to be a service of general economic interest ("SGEI") called "Network SGEI".
3. Second, the notification concerns an extension, for the period 1 April 2012 to 31 March 2015, of a working capital facility to cover POL's cash and near-cash needs, connected with the processing of social benefits for individuals and the payment of taxes. The terms of the working capital facility have been amended to ensure market conformity as of 1 April 2012. The United Kingdom notified the working capital facility for legal certainty only as the United Kingdom considers that the measure does not constitute State aid.
4. On 3 February 2012, the Commission requested additional information, which was provided by the UK authorities on 6 February 2012.

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2. CONTEXT AND DETAILED DESCRIPTION OF THE MEASURES

2.1. POL, Royal Mail Group Holdings plc and Royal Mail Group

5. The United Kingdom has a nationwide network of around 11,500 post office counter outlets. This post office network is operated by POL, a limited liability company incorporated under private commercial law in 2001. POL is a subsidiary company of Royal Mail Group plc (henceforth "RMG"). RMG is the UK's designated universal service provider, which essentially provides mail and parcel services. RMG is wholly owned by Royal Mail Holdings plc, of which the UK Government is the 100% owner.
6. A large majority of post offices (more than 11,000) are run as franchises by private businesses, known as sub-postmasters, usually with the post office counter at the back of a private shop.
7. A small proportion of the outlets (373 according to the notification) are directly managed, owned and run by POL. These are usually the town centre outlets and are not run in conjunction with any associated business.
8. The UK Government takes the view that the post office network performs an important social and economic role which extends beyond the specific postal and Government services offered over the post office counter. According to the UK Government, post offices (especially in rural areas) act as focal points for the communities they serve and are used by many citizens as sources of information and advice on Government services.
9. The UK Government underscores the social need for a network of post offices providing certain public services throughout the country that cannot be provided through internet or telephone-based access. In particular, the dispersed nature of the UK population means that a commercially optimal network, which would largely be located in densely populated urban areas, would be insufficient to meet the needs of many communities.

2.2. POL's services of general economic interest

10. POL is entrusted with the delivery of several SGEIs (Product SGEI and Network SGEI as defined below) by an entrustment letter from the Minister for Employment Relations, Consumer and Postal affairs and a funding agreement (Post Office Limited Funding Agreement dated 25 October 2010, hereafter the "Funding Agreement") signed between POL and the Department for Business, Innovation & Skills. While the agreement letter imposes to POL the overall obligations to deliver the Product and Network SGEIs, the Funding Agreement describes precisely the contractual obligations of the UK state and POL.

11. According to that entrustment letter, POL is under a public service obligation "to maintain, from the Effective Date¹ until the end of its financial year ending on or around 31st March 2015, a network of post offices beyond its optimal commercial size (the "Network SGEI"). That network must number a minimum of 11,500 post offices and also meet the following minimum access requirements:

- Nationally, 99% of the UK population to be within 3 miles and 90% of the population to be within 1 mile of their nearest post office outlet;
- 99% of the total population in deprived urban areas across the United Kingdom to be within 1 mile of their nearest post office outlet;
- 95% of the total urban population across the United Kingdom to be within 1 mile of their nearest post office outlet;
- 95% of the total rural population across the United Kingdom to be within 3 miles of their nearest post outlet.

In addition the following criterion will apply at the level of each and every individual postcode district, establishing a minimum level of coverage at a very local level.

- 95% of the population of the postcode district to be within 6 miles of their nearest post office outlet."

12. POL is required to maintain this network of post office branches to make available the services of general economic interest that can be regrouped into the categories detailed in Table 1 below ("Product SGEI") on the basis set out in the Funding Agreement.

Table 1: Product SGEI

<i>Product SGEI</i>
<i>1. Processing social benefit and tax credit payments</i>
<i>2. Processing of national identity and licensing scheme applications</i>
<i>3. Payment facilities for public utility services</i>
<i>4. Access to postal services</i>
<i>5. Access to basic cash and banking facilities and Government savings</i>

13. Furthermore the entrustment letter specifies that "The Network SGEI obligation therefore extends the provision of the Product SGEI over a network which may go beyond that required under individual Product SGEI contracts entered into on a commercial basis between POL and the relevant Government department or body (whether public or private) purchasing the Product SGEI. The delivery of the Product SGEI by Post Office Limited across its network will be governed in accordance with the contractual terms which apply to each service."

¹ 1 April 2012

14. The entrustment letter specifically states that *"the Product SGEI is provided under commercial contracts entered into by POL and the Government department or body (whether public or private) purchasing the service. In the case of access to postal services, the services to be made available at post office branches are the ones which the universal service provider (Royal Mail Group Limited) is required to provide under regulatory conditions and directions issued by OFCOM in accordance with section 66 and paragraphs 4 to 6 of Schedule 9 of the Postal Services Act 2011. The delivery of the Network SGEI set out in the entrustment letter to Post Office Limited therefore does not replace or change in any way contracts and other agreements under which the terms of the provision of the individual Product SGEI are specified. POL is expected to use reasonable endeavours to enter into contracts with the Government department or body (whether public or private) purchasing the service to provide the Product SGEI."*
15. In addition, the UK authorities have informed the Commission that *"the UK Government commits to comply with all applicable Union rules in the area of public procurement as regards the public contracts currently held by POL to provide the SGEIs at the point of future award or material renegotiation. If it decides to extend the POCA contract when it expires in March 2015 at the latest, it will do so in full compliance with the applicable Union rules on public procurement. Furthermore, the UK authorities will review by the end of 2017 the processes under which all public contracts to provide the SGEIs have been awarded and ensure their compliance with obligations under Union public procurement rules. The UK authorities' assessment under this review will be made available to the Commission."*
16. The entrustment letter contains the following additional arrangements: *"It is possible that POL may during the period of this entrustment cease to provide a Product SGEI(s), the provision of which over the Post Office network beyond its optimal commercial size is compensated by the UK Government. In those circumstances, the UK Government shall, provided that the provision of the Network SGEI will still be maintained, withhold such proportion of that compensation (if any) which corresponds to the net direct costs of providing that product SGEI."*
17. The Commission considers that these arrangements give sufficient guarantees that the competitive awarding procedure of future public service contracts will not be biased by the notified Network SGEI subsidy. Indeed should an existing contract be lost, POL would not be allowed to keep the share of the Network SGEI subsidy that was granted for the extension of that contract which could provide it an advantage for future bids.

2.3. The notified measures

18. The UK Government has notified measures to compensate POL for its net costs to provide the Network SGEI for the financial years 2012/13, 2013/14 and 2014/15 as follows:
 - a) a yearly subsidy to compensate POL for the net operating cost of the network SGEI ('Network Subsidy Payment' or NSP):
 - £210m in the financial year beginning 1.4.2012;
 - £200m in the financial year beginning 1.4.2013;
 - £160m in the financial year beginning 1.4.2014.
 - b) a yearly subsidy to compensate POL for the net investment cost of improving the efficiency of the network SGEI:
 - £200m in the financial year beginning 1.4.2012;
 - £215m in the financial year beginning 1.4.2013;
 - £170m in the financial year beginning 1.4.2014.

19. The UK Government has also notified the continuation from 1.4.2012 to 31.3.2015 of a working capital facility ("WCF") of up to £1150 million, at financing conditions different from the ones which were approved by previous Commission State aid decisions². Indeed, the United Kingdom and POL have decided to increase the interest rate to LIBOR plus [...]*, which according to the United Kingdom is in line with market terms, taking into account the situation of POL after the adoption of the Royal Mail decision of 21 March 2012 (see paragraph 30). This facility will be available to fund cash items (such as the over-the-counter cash withdrawal service) and near-cash items (such as cheques in payment of local and national taxes) to the extent they are concerned with the provision of the POCA contract and the universal access to basic cash and banking facilities. The UK authorities have modified the conditions of the facility to align it with the conditions on which similar facilities are available on the market. The measure is therefore notified as a non-aid measure for legal certainty.

20. The measures that POL will take to improve the efficiency of the *entire* network are set out in POL's Government Funding and Strategic Plan (henceforth "Strategic Plan"), dated 25 October 2010. As the United Kingdom specified in the entrustment, compensation is only meant to cover the additional net costs due to the Network SGEI.

21. The Strategic Plan is to be considered as POL's business plan for the period 1 April 2012 – 31 March 2015, reflecting the challenges the business will face over this period. The Strategic Plan includes a forecast of POL's costs and revenues over the entrustment period and specifies the assumptions underlying this forecast. It spells out how POL will improve the provision of services over its network, according to yearly efficiency milestones. The consequence for POL of failing to meet a Strategic Plan

² Most recently for the period 1 April 2008 – 31 March 2011 in Commission Decision N388/2007 and in Commission decision N508/2010 for the period 1 April 2011-31 March 2012.

* Business secret

milestone is that the United Kingdom will no longer be obliged, under the Funding Agreement to make the network subsidy available to POL.

2.4. Net cost calculation and recovery of overpayment

22. The UK authorities consider that the net cost calculation and recovery of overpayment schemes, present in the entrustment, guarantee that the compensation granted in the form of subsidies only finances the net costs associated to the Network SGEI.
23. Net costs calculation: According to the entrustment, *"the SGEI Compensation Statement must be accompanied by a supporting statement from an independent financial adviser, to confirm that the aggregate actual amount of the SGEI compensation payments made by the Government to Post Office Limited in respect of Financial Years 2012/13, 2013/14 and 2014/15 under the 2010 Funding Agreement did not exceed the difference between the actual net costs incurred by Post Office Limited and the net profits that would have been incurred in connection with the provision of a network of post offices of the optimal commercial size during those Financial Years"*.
24. The entrustment further specifies that the calculation of the actual net costs of the network shall take into account all revenues, variable and fixed costs of the Product SGEIs, Network SGEI, and non SGEI services.
25. The actual net cost above has then to be compared with the net profit of an optimal network which is calculated by taking into account all revenues, variable and fixed costs of the Product SGEIs and non SGEI services that would be delivered over that optimal network.
26. The recovery of overpayment is set out in the following way in the entrustment letter: *"In the event that the aggregate actual amount of the SGEI compensation payments made by the Government to Post Office Limited in respect of Financial Years 2012/13, 2013/14 and 2014/15 exceeds the costs incurred by Post Office Limited in providing the network of post offices of beyond its optimal commercial size providing access to the SGEI during those Financial Years, as calculated in accordance with the above formula, Post Office Limited will be required to repay to the Government, within 10 Business Days of the receipt by Government of the SGEI Compensation Statement, an amount equal to such excess."*

3. ASSESSMENT

3.1. Product SGEIs

27. The Commission considers that the current entrustment letter delineates a separate Network SGEI mission, clearly distinct from the Product SGEIs, and ensures that the subsidies paid are sufficiently ring-fenced to finance exclusively the Network SGEI.

28. Therefore the only notified measure financing Product SGEIs that could potentially qualify as State aid is the WCF. Indeed, in past decisions³ because the accounts of POL showed that the company was technically insolvent, the Commission considered that it was highly doubtful that the interest rate that POL paid on its WCF (which was calculated on the basis of cost of funds (LIBOR) plus a margin of [...] % per annum) could be considered to correspond to the terms that would be available to POL in the market.
29. However, the current notification differs from previous ones in two important respects:
30. Firstly, following the Commission's Royal Mail decision (in case SA 31479) adopted on the 21 March 2012, RMG has been relieved of its pension deficit and as a consequence, POL will no longer carry on its balance sheet a 7% of the RMG pension deficit as it did before. Thus, POL which was technically insolvent due to that pension deficit burden is not in that position any longer following the adoption of the Royal Mail decision, and will, on 1 April 2012, be able to finance itself on the market.
31. Secondly, the United Kingdom and POL decided to increase the interest rate to LIBOR plus [...] %, which according to the United Kingdom is in line with market terms. In order to prove the market conformity of the above interest rate, the UK authorities provided the Commission with information on an unsecured facility that POL currently has with [...], which will carry a rate of interest of LIBOR + [...] % starting 1 April 2012, which is below the interest of the WCF on 1 April 2012. The amount of the [...] loan is £[...].
32. Although the [...] loan amount of £[...] is considerably lower than the loan amount of the WCF, the [...] loan has some special comparative features that make it riskier. Therefore it can be considered as an appropriate benchmark to determine the market conformity of the WCF:
- The [...] loan can be drawn on immediately, while a minimum notice period of five business days applies for drawdowns of the WCF, which means that the [...] loan is likely to be a more expensive financial product than the WCF.
 - The minimum notice period of the WCF makes it difficult for POL to be completely accurate about its funding requirement and often results in POL borrowing more than its actual requirement. Therefore, POL would have a lower average drawdown level, and lower interest costs if the terms of the comparator facility applied.
 - The [...] loan did not require any guarantees while the guarantee of the network facility is the cash available in the network.
33. On the basis of the elements above, the Commission considers that the claim of the UK authorities that the higher interest rate of the WCF

³ Most recently for the period 1 April 2008 – 31 March 2011 in Commission Decision N388/2007 and in Commission decision N508/2010 for the period 1 April 2011-31 March 2012.

demonstrates that the WCF is awarded to POL on commercial terms is acceptable.

34. The WCF therefore does not provide an economic advantage which POL would not obtain under normal market conditions and consequently does not entail State aid.

3.2. Network SGEI

3.2.1. Existence of aid under Article 107§1 TFEU

35. According to Article 107§1 TFEU, “*save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market*”.
36. In determining whether a measure constitutes State aid within the meaning of Article 107(1) of the Treaty, the Commission has to apply the following criteria: the measure must be imputed to the State and use State resources, it must confer an advantage on certain undertakings or certain sectors which distorts competition and it must affect trade between Member States.

Selectivity and economic activity

37. The subsidies for the Network SGEI apply to POL only. All activities of POL to which the notified State measures relate are economic activities.

Economic advantage financed by State Resources

38. The subsidies for the Network SGEI are state resources since they are paid out directly by the State budget on the basis of the funding agreement. They would provide an economic advantage financed by State resources unless the four criteria of the ECJ jurisprudence of the Altmark⁴ judgment are fulfilled.

Application of Altmark criteria

39. It is apparent from the case-law of the Court of Justice of the European Union that public service compensation does not constitute State aid within the meaning of Article 107§1 TFEU if it fulfils certain conditions. However, if public service compensation does not meet these conditions and if the general criteria for the applicability of Article 107§1 are satisfied, such compensation constitutes State aid and articles 107 TFEU and 108 TFEU apply.
40. In its judgment in Altmark, the Court laid down four cumulative conditions under which public service compensation does not constitute State aid:

⁴ Judgements in Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747 (paragraphs 88-94) and Joined Cases C-34/01 to C-38/01 Enirisorse SpA v Ministero delle Finanze [2003] ECR I-14243.

1. *'(...) First, the recipient undertaking must actually have public service obligations to discharge and those obligations must be clearly defined (...).*
 2. *(...) Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner (...).*
 3. *(...) Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public services obligation, taking into account the relevant receipts and a reasonable profit (...).*
 4. *(...) Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs, which a typical undertaking, well run and adequately provided within the same sector would incur, taking into account the receipts and a reasonable profit from discharging the obligations.'*
41. Concerning POL, the Commission considers that the fourth criterion is not met. The Network SGEI was not awarded as a result of an open public procurement procedure but following a negotiated procedure without prior publication. According to paragraph 66 of the Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest⁵, *"the negotiated procedure without publication of a contract notice cannot ensure that the procedure leads to the selection of the tenderer capable of providing those services at the least cost to the community."*
42. In addition, the UK authorities did not provide any evidence showing that the costs incurred by POL when providing the Network SGEI correspond to the cost of a well-run undertaking. The Network SGEI subsidy thus provides an economic advantage.
43. This advantage is granted through State resources since the subsidies are paid out directly by the State budget on the basis of the funding agreement.

⁵ OJ C 8, 11.01.2012, p. 4-14

Distortion of competition and affectation of trade between Member States

44. The subsidy for the Network SGEI may distort competition and affect trade between Member States. POL is the largest retailer by outlets in the United Kingdom and it provides access to postal services and facilities for banking transactions and payment services. In the postal and financial sectors, competition and intra-Union trade take place either in a direct form originating from other operators providing the same service, including some based in different Member States, or indirectly from other operators providing substitutable services. The measure in question has the potential to distort competition and to impact intra-Union trade in that it is potentially making the entry and the development of other retailers or retail financial services institutions in the United Kingdom more difficult.

Conclusion

45. In view of the above paragraphs the subsidy for the Network SGEI constitutes State aid within the meaning of Article 107§1 TFEU while the Working Capital Facility does not constitute State aid within the meaning of Article 107§1 TFEU. Table 2 quantifies the subsidies given to POL to fund the net costs of the Network SGEI over the relevant period covered by the notification.

Table 2

Compensation (in million £)	2012/13	2013/14	2014/15	Total
Operating costs of the Network SGEI	210	200	160	570
Investment costs of the Network SGEI	200	215	170	585
Total	410	415	330	1155

3.2.2. Legal basis for the compatibility assessment

46. Following the adoption of the French La Poste decision (SA 34027), the Commission has clarified that a territorial presence mission consisting in extending the delivery of postal and other services beyond the access requirements of the Postal Directive as defined and implemented in the Member State is to be assessed under the 2012 Framework and not under the Postal Directive 97/67/EC of the European Parliament and the Council of 15 December 1997 on the common rules for the development of the internal market of Community postal services and the improvement of quality of service⁶ (hereafter “Postal Directive”).

⁶ Directive 97/67/EC of the European Parliament and the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, OJ L 15, 21.01.1998, p. 14 as amended by Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2002 amending Directive 97/67/EC with regard to the further opening to competition of Community postal services, OJ L 176, 5.7.2002, p. 21 and as amended by Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008 amending Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services, OJ L 52, 27.2.2008, p. 3.

47. Under the Postal Directive, as implemented into UK law, only RMG is the provider of universal postal service in the United Kingdom. In fact, RMG subcontracts to POL the part of the universal postal service which consists in ensuring a certain distribution of access points capable of receiving the largest relevant postal packets and registered mail. In order to fulfil its contract with RMG, POL must in practice have a network of [...] branches (henceforth "universal service network").
48. As regards postal services, the Network SGEI consists in extending the access requirements to postal services beyond the requirements of the universal postal service, as defined in the entrustment of RMG as universal postal service provider, which is clearly identified in the entrustment letter. As regards the other four product SGEIs, the Network SGEI also consists in an extension of the geographical coverage of the services beyond the access requirements of the Product SGEIs as laid down in the respective contracts. However, it should be observed that the optimal network, which allows calculating the net cost of the Network SGEI is only determined by the universal service requirement since the UK authorities consider that without the Network SGEI, POL's priority would be to keep the RMG/POL contract (see paragraph 77).
49. According to the entrustment letter, the Network SGEI subsidy is awarded exclusively to finance the Network SGEI. Since the Network SGEI is not part of the universal service in the postal sector the Postal Directive is not applicable to the compensation for the Network SGEI.
50. Furthermore, the danger of cross-subsidization of RMG by the Network SGEI compensation (i.e. the risk that the costs of the RMG/POL contract would be partially financed by the Network SGEI compensation) is averted by the contract between POL and RMG concluded on 19 January 2012. The terms of this new contract with regard to pricing between POL and RMG were agreed upon already anticipating the full separation of the two entities (as foreseen in the UK Postal Service Act of 13 June 2011) and were negotiated on an arm's length basis for a period of ten years with a mid-term review after five years. This contract ensures that the price paid by RMG covers fully the cost borne by POL to ensure the access to universal services⁷.
51. Since the notified compensations do not fall in any category listed in the article 2 of the Commission Decision on the application of Article 106(2) of the Treaty on the Functioning of the European Union to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (hereafter the "2012 SGEI Decision"), the 2012 SGEI Decision is not applicable in this case.

⁷ More generally, it can be noted that since all the contracts underlying the Product SGEIs were concluded on a commercial basis, the remuneration received by POL for the delivery of these product SGEIs covers the costs of the service ensuring the absence of any cross-subsidization of Product SGEIs by the Network SGEI.

52. Therefore, the Commission has assessed the subsidies for the Network SGEIs solely in the light of the European Union Framework for State aid in the form of public service compensation⁸ (hereafter the '2012 Framework'). Under the 2012 Framework, the Commission considers that public service compensation which is State aid within the meaning of Article 107§1 TFEU may be declared compatible with the Treaty under Article 106§2 TFEU if it is "*necessary to the operation of the service of general economic interest and does not affect the development of trade to such an extent as would be contrary to the interests of the Union.*"
53. Under the 2012 Framework the basic criteria of compatibility are that (i) the service in question is a genuine service of general economic interest (i.e. that the Member States has not committed a manifest error in qualifying it as a SGEI), that (ii) the service is entrusted to the undertaking by an official act that contains the elements specified in section 2.3 and 2.4 of the 2012 Framework, that (iii) the undertaking complies with EU Directive on the transparency of financial relations between Member States and public undertakings (Directive 2006/111/EC), that (iv) the responsible authority has complied or commits to comply with the applicable Union public procurement rules, that (v) there is no discrimination when the same service is entrusted to different undertakings, that (vi) the entrusted undertaking is not overcompensated for the provision of the service of general economic interest (taking into account a reasonable profit), that (vii) the Member State publishes the information as specified in section 2.10 of the 2012 Framework. Where all those criteria are satisfied, the Commission may also assess whether additional requirements are necessary to ensure that the development of trade is not affected to an extent contrary to the interests of the Union.

3.2.3. Compatibility assessment under the 2012 SGEI Framework

Genuine service of general economic interest as referred to in Article 106 of the Treaty⁹

54. The aid must be granted for a genuine and correctly defined service of general economic interest as referred to in Article 106(2) TFEU.
55. The UK authorities consider that the Network SGEI is a genuine public service mission for the following reasons:
- POL's network performs an important social and economic role which even extends beyond the universal postal service provided by RMG or specific postal and Government services offered over the post office counter¹⁰. According to the UK Government, post offices (especially in rural areas) act as focal points for the

⁸ OJ C 8, 11.01.2012, p. 15.

⁹ Paragraphs 12-14 of the 2012 Framework

¹⁰ A 2009 study by NERA commissioned by POSTCOMM on the social value of the Post Office Network concludes that "there is a large difference between the values for the network as a whole and the *values associated with the specific services provided by post offices (...). We interpret this as representing the value that customers attach to the wider social role of post offices.*"

communities they serve and are used by many citizens as sources of information and advice on Government services.

- The UK Government underscores the social need for a network of post offices providing public services throughout the country that cannot be provided through internet or telephone-based access. In particular, the dispersed nature of the UK population means that a commercially optimal network, which would largely be located in densely populated urban areas, would be insufficient to meet the needs of many communities.
- The specific access requirements of the Network SGEI have been publicly consulted.

56. The Commission endorses the above reasons and considers that there is no manifest error in the qualification of the Network SGEI as a service of general economic interest by the UK authorities.

Need for an entrustment act specifying the public service obligations and the methods of calculating compensation.¹¹

57. Responsibility for the operation of the service of general economic interest must be entrusted to the undertaking concerned by way of one or more acts, the form of which can be determined by each Member State.

58. In this case, the ministerial instruction (see paragraph 10) indicates the precise nature of the public service obligation, the undertaking and the territory concerned, the parameters for calculating the compensation, the mechanism to monitor and review compensation and the arrangements for avoiding and repaying any overcompensation.

59. The Funding Agreement sets out the precise terms and conditions under which, subject to State aid clearance by the Commission, the funds are made available to POL and shall be repaid in case of overcompensation. In assessing overcompensation, all income and costs allocated to SGEIs are taken in to account.

60. The Commission considers that the entrustment condition of the 2012 SGEI Framework is met in the present case.

Duration of Entrustment¹²

61. The duration of the entrustment is 3 years and does not exceed the period required for the depreciation of the most significant assets needed to provide the SGEIs. The entrustment period is aligned on the time frame of the Strategic Plan of POL (2012-2015) which aims at addressing the challenges the business faces, and putting the Post Office network and the on-going provision of SGEI services on a more sustainable footing.

¹¹ Paragraphs 15-16 of the 2012 Framework

¹² Paragraph 17 of the 2012 Framework

62. The Commission therefore considers that the duration is in line with the obligation from the paragraph 17 of the 2012 Framework which states that *"The duration of the period of entrustment should be justified by reference to objective criteria such as the need to amortise non-transferable fixed assets. In principle, the duration of the period of entrustment should not exceed the period required for the depreciation of the most significant assets required to provide the SGEI."*

Compliance with the Directive 2006/111/EC¹³

63. According to paragraph 18 of the 2012 Framework: *"Aid will be considered compatible with the internal market on the basis of Article 106(2) of the Treaty only where the undertaking complies, where applicable, with Directive 2006/111/EC on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings."*
64. The Commission considers that, within POL, the accounting separation between SGEI activities as well as between SGEI and non-SGEI activities is made on the basis of well-accepted accounting principles since:
- a) The revenue of each SGEI can be traced to each individual transaction at each branch through an accounting system called Horizon;
 - b) Direct costs are attributed directly to each SGEI;
 - c) Common costs are attributed to each SGEI by using an income based allocation key.
65. The Commission therefore opines that POL complies, where applicable, with Directive 2006/111/EC.

Compliance with European Union public procurement rules¹⁴

66. According to paragraph 19 of the 2012 Framework: *"Aid will be considered compatible with the internal market on the basis of Article 106(2) of the Treaty only where the responsible authority, when entrusting the provision of the service to the undertaking in question, has complied or commits to comply with the applicable Union rules in the area of public procurement. This includes any requirements of transparency, equal treatment and non-discrimination resulting directly from the Treaty and, where applicable, secondary EU legislation. Aid that does not comply with such rules and requirements is considered to affect the development of trade to an extent that would be contrary to the interests of the Union within the meaning of Article 106(2) of the Treaty."*

¹³ Paragraph 18 of the 2012 Framework

¹⁴ Paragraph 19 of the 2012 Framework

67. The Network SGEI, based on the entrustment letter and the Funding Agreement, qualifies as a public service contract which in principle falls within the scope of the EU Public Procurement Directives. However, at present, POL is the only operator whose network and contractual relationships actually satisfy the requirements for the provision of the network SGEI, as described in the entrustment. In these circumstances, the Commission considers that the negotiated procedure without prior publication, which is followed to entrust POL with the network SGEI, is justified under Article 31 (1) b) of Directive 2004/18 and therefore can be considered compliant with EU public procurement rules.
68. Furthermore, the Commission takes note that the UK government commits to ensure, in the future, the compliance of all POL's public contracts with European Union public procurement rules (see paragraph 15). This commitment is particularly important in the light of the link between Product SGEI and Network SGEI. The Commission will also check that this commitment has been respected in case of extension of the subsidies for the Network SGEI beyond 2015 or adoption of new State aid measures for the financing of that SGEI.
69. In conclusion, the Commission considers that the entrustment of the Network SGEI to POL respects the applicable EU public procurement rules in line with paragraph 19 of the 2012 Framework.

Absence of discrimination¹⁵

70. Since POL is the only operator whose network and contractual relationships actually satisfy the requirements for the provision of the Network SGEI and therefore only undertaking being able to be entrusted with the Network SGEI, this requirement does not apply in the present case.

Amount of compensation and verification of the absence of overcompensation¹⁶

71. According to paragraph 21 of the 2012 Framework, *"the amount of compensation must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit."*
72. In the current case, the compensation is based on the costs that POL is expected to incur to provide the SGEI. These expected costs are specified in the government Funding and Strategic Plan, which is annexed to the Funding agreement. The Strategic Plan includes a forecast of POL's costs and revenues over the entrustment period and specifies the assumptions that underlie this forecast. The assumptions are based on plausible and observable parameters concerning the economic environment in which the SGEI is being provided. Starting 2014/15, the operating cost base of the network SGEI is expected to decrease significantly, reflecting the results of the efficiency investments made over the lifetime of the entrustment.

¹⁵ Paragraph 20 of the 2012 Framework

¹⁶ Paragraphs 21-50 of the 2012 Framework

Net cost necessary to discharge the public service obligations

73. According to paragraph 24 of the 2012 Framework, *"the net cost expected to be necessary to discharge the public service obligations should be calculated using the net avoided cost methodology where this is required by Union or national legislation and in other cases where this is possible."*

Net avoided cost methodology

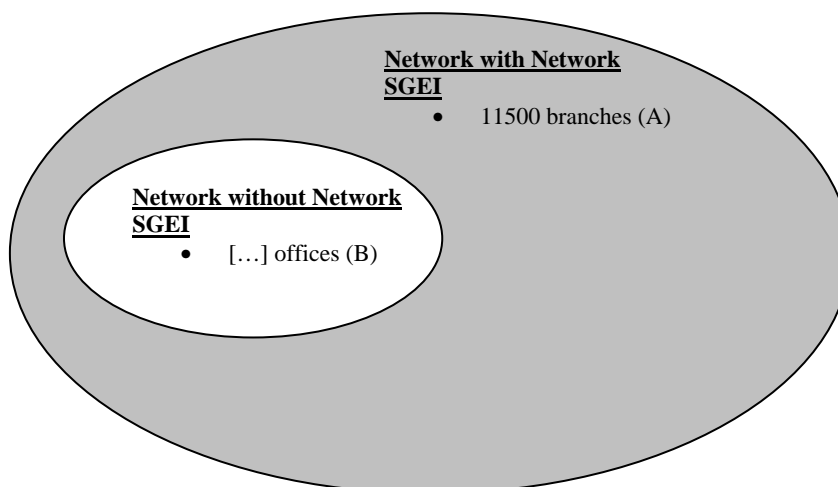
74. According to paragraph 25 of the 2012 Framework, *"under the net avoided cost methodology, the net cost expected necessary to discharge the public service obligations is calculated as the difference between the net cost for the provider of operating with the public service obligation and the net cost or profit for the same provider of operating without that obligation. Due attention is to be given to correctly assessing the costs that the service provider is expected to avoid and the revenues it is expected not to receive, in the absence of the public service obligation. The net cost calculation should assess the benefits, including intangible benefits as far as possible, to the SGEI provider¹⁷."*
75. The net avoided cost methodology is clearly specified in POL's entrustment letter (see paragraphs 23 above)
76. In order to perform the net avoided cost calculation the following steps were taken by the UK authorities:
- A. Calculate the net income of a scenario *with* the network SGEI based on POL's financial projections (current network of 11,500 offices).
 - B. Calculate the net income of a counterfactual scenario *without* the network SGEI.
 - C. Take the difference between (B) and (A).
77. The UK authorities consider that the optimal commercial size of the network is the minimal one which would still allow POL to keep the RMG/POL contract. Such network corresponds to the one which allows RMG to fulfil its universal postal service obligations. In its universal service license, RMG is required:
- a) to have, in each postcode area where the delivery point density is not less than 200 delivery points per square kilometre, not less than 99% of users or potential users of postal services are within 500 metres of a post office letter box, and
 - b) to ensure that the distribution of access points capable of receiving the largest relevant postal packets and registered mail is such that

¹⁷ Annex IV to Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services, and Annex I to Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, contain more detailed guidance on how to apply the net avoided cost methodology

- i. in the authorised area as a whole the premises of not less than 95% of users or potential users of postal services are within 5 kilometres of such an access point, and
 - ii. in all postcode areas the premises of not less than 95% of users or potential users of postal services are within 10 kilometres of such an access point, and such access points are available to the public in accordance with conveniently published schedules.
78. According to the RMG/POL contract, POL must ensure, in particular, that RMG can satisfy point b) of these two requirements. This condition is less strict than the conditions imposed on POL through the entrustment letter.
79. The determination of the size of the counterfactual (i.e. universal postal service network) of POL is based on two models, a gravity model and a financial model which are used together to determine the optimal network size based on geographical criteria, including demand, and the associated income and costs of the network.
80. The Gravity Model calculates the expected impact on transaction volumes and income of changes to POL's branch network. It is based on mapping data for each post office and predicts demand at an outlet level taking into account the purchasing behaviour of potential customers as well as the location of the competition including other post office outlets.
81. The model predicts demand at a product group level and is able to give an accurate prediction of changes in customer behaviour as a result of changes to the network of post offices.
82. The financial model is a large Excel model with the base network data provided by an Access database. The database has all the financial data for each individual office. This financial model forecasts the income and costs by network segment and can be used to model different network sizes using consistent assumptions about migration, which are provided by the Gravity model.
83. The Financial and Gravity Models are used in tandem to determine the optimal network size based on geographical criteria, including demand, and the associated income and costs of the network.
84. Based on these two models, it is estimated that POL would need [...] Post offices to satisfy the access obligations of RMG. The difference between the 11500 offices of POL and the optimal commercial network of [...] offices consists of [...] offices (henceforth "non-commercial branches").

85. Given this counterfactual scenario, the net avoided cost methodology is illustrated graphically in Figure 1:

Figure 1: Net avoided cost methodology



*A. Net cost for the provider of operating **with** the network SGEI (current network)*

86. The United Kingdom provided estimates of the financial situation of POL for the period 2012-2015. These estimates are in accordance with the Strategic Plan.

*B. Net cost for the provider of operating **without** the network SGEI (universal service network)*

87. The United Kingdom provided the Commission with a counterfactual scenario specifying how the financial results of POL would look over the same period if it were not entrusted with the Network SGEI. It is assumed that POL would not have the liberty to discontinue some of the public service contracts it currently has. Instead, it is assumed that POL would keep providing all the services it currently provides, but on a smaller scale.

88. In order to construct the counterfactual scenario, a list of the constraints imposed by the Network SGEI has been identified:

- a) Cash logistics costs for POL branches in the non-commercial branches;
- b) Banking facilities equipment costs for POL's non-commercial branches;
- c) Third party relationship management costs for the (i) social benefit and tax credit payments and (ii) banking facilities SGEIs in POL's non-commercial branches;
- d) Personnel training costs for the (i) social benefit and tax credit payments and the (ii) banking facilities SGEIs POL's non-commercial branches;
- e) Network maintenance costs for POL's non-commercial branches;
- f) Agents' pay for POL's non-commercial branches; and

- g) Personnel training costs and central office management costs, relating to POL's non-commercial branches.
89. The Commission agrees that these costs would no longer be incurred by POL if it were not entrusted with the Network SGEI.
90. The forecasted income figures reflect the assumptions that underpin the Strategic Plan for POL and are in line with the forecast financial statements on page 19 of that Strategic Plan. An adjustment was made to take into account the revenue currently achieved at non-commercial branches that would transfer to the retained branches of the universal service network in the counterfactual scenario, as it is natural to assume that some of the demand of the beyond universal service branches would substitute to the remaining universal service branches. However, not all of the demand would switch to universal service branches. The Commission is therefore satisfied that the income of the universal service network has been adjusted appropriately and that the UK has provided sufficient evidence to substantiate its underlying assumptions.
91. These forecasted income figures already take into account monetary effects of intangible and market benefits of a larger network due to the obligation to provide the Network SGEI (in economic terms), such as the brand or enlarged footfall in offices and consequent increased opportunities to cross sell.
92. Table 3 shows the result of the net avoided cost methodology, presenting the estimated costs and revenue of POL in a scenario with and without the Network SGEI:

Table 3: Net Avoided Cost of the Network SGEI

			2012/13	2013/14	2014/15	Total
Network			Million £	Million £	Million £	Million £
(a)	Network SGEI [11500 offices]	Income:	[...]	[...]	[...]	[...]
		Costs	([...])	([...])	([...])	([...])
		Net Income/(loss)	([...])	([...])	([...])	([...])
(b)	No Network SGEI [[...] offices]	Income	[...]	[...]	[...]	[...]
		Costs	([...])	([...])	([...])	([...])
		Net Income/(loss)	[...]	[...]	[...]	[...]
(c=b-a)	Net Avoided Cost		([...])	([...])	([...])	([...])
(d)	Compensation		410	415	330	1155
(e=c-d)	Undercompensation		[...]	[...]	[...]	[...]

Reasonable profit and no overcompensation

93. In the counterfactual scenario POL makes a 7.3% return on sales (£[...] of net income for £[...] of sales). This rate is in line with rates of return on SGEI of previous Commission decisions on POL¹⁸. Regarding all SGEI activities that POL performs, it appears to be difficult to identify a

¹⁸ 12.5% return on sales was taken into account in Commission decision N 822/2006 and around 7% in Commission decision N 388/2007.

comparable undertaking. It can be observed that PayPoint, which is POL's main competitor for bill payment services, earned a ROS of 18.6%¹⁹ in 2011.

94. On the basis of the net avoided cost methodology, the net cost of discharging the SGEIs beyond the universal service network amounts to £[...] (£[...] + £[...]) in 2012/13, £[...] (£[...] + £[...]) in 2013/14 and £[...] (£[...] + £[...]) in 2014/2015. These amounts are higher than the compensation provided in the aid measures: £410m in 2012/2013, £415 in 2013/2014 and £330 in 2014/2015. Based on this analysis, POL is undercompensated for the delivery of the Network SGEI.

Efficiency incentives

95. The 2012 SGEI Framework imposes that the method of compensation of SGEI devised by the Member State must introduce incentives for the efficient provision of the SGEI of a high standard, unless the Member State can duly justify that it is not feasible or appropriate to do so.
96. In particular, paragraphs 40 and 41 of the 2012 SGEI Framework state that *"Efficiency incentives can be designed in different ways to best suit the specificity of each case or sector. For instance, Member States can define upfront a fixed compensation level which anticipates and incorporates the efficiency gains that the undertaking can be expected to make over the lifetime of the entrustment act. Alternatively, Member States can define productive efficiency targets in the entrustment act whereby the level of compensation is made dependent upon the extent to which the targets have been met [...]"*.
97. The Strategic Plan contains yearly efficiency milestones. These milestones require POL to demonstrate that clear steps have been taken in increasing the efficiency of the network (for example, the development of replacement agency contracts, or reporting on the introduction of new network models over the previous year within the annual plan). The consequence for POL of failing to meet a Strategic Plan milestone is that the United Kingdom is no longer obliged under the Funding Agreement to make the network subsidy available to POL.
98. In addition, even though, as mentioned in paragraph 26, POL is obliged to repay excess compensation to the UK Government beyond the net costs of the service which include a reasonable profit, POL is likely to be incentivised to increase its efficiency. The reason is that POL will receive a fixed upfront compensation that is below the expected net costs of the SGEI. Taking into account the State compensation, POL is expected to make a loss in real terms (£1155m - £[...] = -£[...])²⁰ corresponding to (-4%) returns on sales over the entrustment period. POL is however allowed to keep efficiency gains as long as it is not overcompensated according to the Net Avoided Cost methodology. Since POL is undercompensated by £[...], POL could keep up to that amount of efficiency gains over the

¹⁹ Source: <http://www.paypoint.co.uk/uploads/ppannualreport2011final210611.pdf>

²⁰ Difference between the total amount of State compensation and the expected net costs of POL on the entrustment period as calculated in Table 3

entrustment period which would allow the operator to reach a profit level of (£[...] - £[...]= £[...]) corresponding to [...] % return on sales²¹ (£[...]/£[...]).

99. Based on the above arguments, it can be considered that the entrustment letter contains sufficient efficiency incentives for the provision of the Network SGEI.

Additional requirements which may be necessary to ensure that the development of trade is not affected to an extent contrary to the interests of the Union²²

100. The requirements set out in sections 3.3.2 to 3.3.7 are usually sufficient to ensure that the aid does not distort competition in a way that is contrary to the interests of the Union.
101. It is conceivable however, that, in some exceptional circumstances, serious competition distortions in the internal market could remain unaddressed and the aid could affect trade to such an extent as would be contrary to the interest of the Union.
102. The contracts that POL has with the sub-postmasters are such that other network operators can sign contracts with any sub-post master to deliver services which are not offered by POL. As a consequence, were POL to lose any contract to an alternative provider, this provider can use POL's network of sub-post masters to provide this service.
103. As a consequence, the Commission considers that the exceptional circumstances that would require additional conditions are not present.

Transparency²³

104. The United Kingdom will publish the following information: (a) the results of public consultation of the Network SGEI access requirements, (b) the content and the duration of the public service obligation, (c) the undertaking and territory concerned and (d) the amounts of aid granted to POL on a yearly basis.

²¹ Assuming that the operator would manage to reduce its costs while keeping the same revenues

²² Paragraphs 51-59 of the 2012 Framework

²³ Paragraph 60 of the 2012 Framework

4. CONCLUSION

The Commission has accordingly decided that Network SGEI subsidy constitutes compatible State aid within the meaning of Article 107§1 TFEU, while the Working Capital Facility does not constitute State aid within the meaning of Article 107§1 TFEU.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:

http://ec.europa.eu/eu_law/state_aids/state_aids_texts_en.htm.

Your request should be sent by registered letter or fax to:

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Yours faithfully,
For the Commission

Joaquín ALMUNIA
Vice-president