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<p>In the published version of this decision, some information has been omitted, pursuant to articles 24 and 25 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, concerning non-disclosure of information covered by professional secrecy. The omissions are shown thus [...].</p>	<p>PUBLIC VERSION</p> <p>This document is made available for information purposes only.</p>
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**Subject: State aid No SA.31479 (2011/C - ex 2011/N) – United Kingdom**  
**State aid measures to Royal Mail**

Sir,

The Commission wishes to inform the United Kingdom that, having examined the information supplied by your authorities on the notified measure referred to above, it has decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union (TFEU).

## **1 PROCEDURE AND BACKGROUND**

- (1) On 10 June 2011, the United Kingdom of Great Britain and Northern Ireland (the 'UK') submitted a notification to the Commission, which includes a package of state measures in favour of the Royal Mail Group Limited ("Royal Mail Group" or "RMG"). The notification is accompanied by a restructuring plan and a market survey prepared by Deloitte (the 'Market Survey').
- (2) At the heart of the current notification is the UK's proposal to address the pension deficit under the Royal Mail Pension Plan ("RMPP") by assuming from RMG certain net liabilities that have accrued under the RMPP which RMG is currently responsible for funding ("pension relief"). In addition to the pension relief, the UK has notified certain measures to strengthen RMG's balance sheet ("balance sheet repair measures").

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- (3) Previous measures taken by the UK in favour of RMG, including the creation of an escrow account which allowed RMG to extend the period over which to address its pension deficit, were the subject of Commission Decision C(2009)2486 of 8 April 2009 (hereafter: 2009 Decision).<sup>1</sup>

## 2 THE REFORM OF UK POSTAL SERVICES

- (4) The notified measures form part of a far reaching reform of UK postal services that reflects the main recommendations of an independent review of the UK postal services sector led by Richard Hooper and published in 2008 ("the Hooper Report"<sup>2</sup>). The recommendations were that the UK Government should take over responsibility for reducing substantially the RMPP's pension deficit, that RMG should find a strategic partner in the form of a postal operator who would take a minority stake in the business, and that responsibility for regulating the UK postal market should pass from the dedicated postal regulator Postcomm to the wider communications regulator Ofcom.
- (5) In July 2009, the previous UK Government announced that it had been unable, because of the prevailing market conditions, to find an appropriate private sector partner for RMG and that the Government would return to the issue when conditions changed. In June 2010, the newly elected Government commissioned Richard Hooper to refresh and update his report. The 2010 Update Report<sup>3</sup> concluded that the original Hooper proposals were still valid, if not more so, as the financial situation of RMG had worsened in the intervening period. The Government followed the Hooper recommendations and, in October 2010, put a new Postal Services Bill before Parliament. In June 2011, the Parliament adopted the Postal Services Act ("the Act").
- (6) The Act's intended effect is to create a more sustainable universal postal service, with a view to obviating the need for further Government funding. The Act's objectives will be achieved through the accelerated modernisation of RMG, leading to a more efficient company, better able to continue to deliver the universal service.
- (7) To that end, the Act allows first of all for the introduction of private sector capital by removing existing statutory restrictions on ownership for RMG. The UK is confident that the involvement of the private sector, an injection of private sector capital (by a variety of potential routes) and associated private sector disciplines will enable RMG to deliver efficiencies much more rapidly, to focus better on customer needs, and to respond quickly to opportunities arising from the changing dynamics of the communications sector.

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<sup>1</sup> See also paragraph (45) below.

<sup>2</sup> "Modernise or Decline - Policies to maintain the universal postal service in the United Kingdom; an independent review of the UK postal services sector", 16 December 2008, available at <http://www.berr.gov.uk/files/file49389.pdf>.

<sup>3</sup> Hooper's update of his December 2008 report, "Saving the Royal Mail's universal postal service in the digital age", available at: <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/s/10-1143-saving-royal-mail-universal-postal-service.pdf>.

- (8) The UK envisages that it will be possible to launch the privatisation process in [...]\*. The UK authorities are aiming to achieve completion of the privatisation as early as possible. This is likely to be between [...]. However, according to the UK, there is a risk that they will not manage to find an appropriate investor and privatise RMG.
- (9) In line with the recommendations of the Hooper Report and the Update Report, the post office retail network, Post Office Limited ("POL"), which is currently wholly owned by RMG (and hence ultimately by the UK authorities), will remain in public sector ownership, reflecting the public service nature of its operations. Consequently, POL will need to be separated out from RMG prior to or at the injection of private capital and will be either held directly by the Government or via a Government owned holding company.
- (10) The Act's objectives will also be achieved through a new regulatory regime for the sector, which better reflects the changes the postal market has undergone in recent years, the changing needs of consumers and the fact that postal services form part of the wider communications market. The UK considers that the regulatory framework needs to be more responsive to falling letter volumes and changing user needs; regulation must be limited where possible. Regulation should be focused on the areas where RMG has a monopoly, with deregulation in other areas, giving RMG more freedom to operate in markets which are increasingly competitive.
- (11) The Act therefore makes provision for a new regulatory regime for the postal services sector, including inter alia:
- transferring regulatory responsibility from Postcomm to Ofcom;
  - making 'securing the universal service' the primary duty for the regulator in relation to postal services, including the need for the provision of the universal service to be financially sustainable and efficient;
  - ensuring that competitor access to RMG's services, and the terms on which such access is offered, are required only where access would encourage competition, promote efficiency and be of significant benefit to users; and
  - replacing the current licensing regime for the provision of postal services with a general authorisation scheme.
- (12) Ofcom will ensure a smooth transition of ongoing Postcomm work in order to deliver a new regulatory framework, which is to take effect from Spring 2012.
- (13) Yet, according to the UK, it will not be possible for RMG to achieve viability and thereby be in a position to attract private sector capital without prior action to relieve RMG from the burden of the RMPP's historic pension liabilities and strengthen RMG's balance sheet. The UK has therefore decided to implement a package of State measures in favour of RMG involving the relief of RMG's pension deficit (see section 4.1 below) and balance sheet repair measures (see section 4.2 below). Furthermore, RMG will undertake a restructuring plan to modernise its operations and reduce costs (see section 4.3 below).

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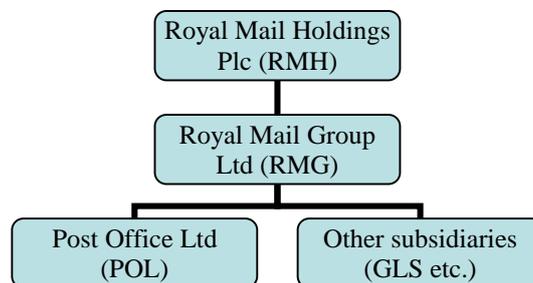
\* Business secret

### 3 THE AID BENEFICIARIES

#### 3.1 Structure of the Royal Mail Group

- (14) RMG (through a holding company, Royal Mail Holdings plc or "RMH") is a 100% state-owned company. RMG is the UK's main postal operator and had a legal monopoly over certain basic letter services until the end of 2005 when the postal markets in the UK were fully liberalised. RMG is responsible for the collection, sorting, transportation and delivery of mail (letters, packets and parcels), using the 'Royal Mail' and 'Parcelforce Worldwide' brands.
- (15) The post office network is operated by POL, which is currently a subsidiary of RMG. RMG has other subsidiaries, notably General Logistics System BV ("GLS") which is RMG's European parcels business, providing parcel services, logistics and express services throughout Europe. The GLS network comprises subsidiary companies and network partners covering 36 European countries.
- (16) POL is currently wholly owned by RMG (and hence by the UK Government). RMG and POL are separate organisations though they are part of the same group. Consistent with the recommendations of the Hooper Report, it is proposed that POL will remain in full public ownership after the reform and will become a sister company of RMG under RMH.

Chart 1: current organisational structure of RMG



#### 3.2 Royal Mail Group (RMG)

- (17) RMG holds a license to provide letter services in the UK under the Postal Services Act 2000 since 23 March 2001. Under the terms of its license, it is required to discharge the universal service obligation ("USO"). These arrangements implement the requirements of Directive 97/67/EC<sup>4</sup> as amended by Directive 2002/39/EC<sup>5</sup> and Directive 2008/06/EC<sup>6</sup>. RMG is required by its license to negotiate commercial

<sup>4</sup> Directive 97/67/EC 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 of 21.1.1998, p. 14.

<sup>5</sup> Directive 2002/39/EC of 10 June 2002 amending Directive 97/67/EC with regard to the further opening to competition of Community postal services, OJ L 176 of 5.7.2002, p. 21.

<sup>6</sup> Directive 2008/6/EC 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 of 27/02/2008, p. 3.

agreements with any interested operator for access to its national network. New operators have tended to enter the market through such access agreements with RMG.

- (18) RMG is the only licensee with universal service obligations. The main aspects of the current USO are i) the delivery of postal packets (letters, packets and parcels) up to 20kg every working day to the home or premises of every individual or other person in the UK (Mon-Sat delivery obligations for letters), (ii) at least one collection every working day from each access point, and a service of conveying, receiving, collecting, sorting and delivering postal packets at affordable prices determined in accordance with a uniform tariff, and (iii) the provision of a registered post service at prices determined in accordance with a uniform tariff.
- (19) RMG's license imposes price controls in relation to the provision of regulated services. The current price control was set in April 2006 for a four year period, but has been extended to March 2012.

### **3.3 Post Office Limited (POL)**

- (20) POL, the so called retail arm of RMG, is responsible for the network of around 11,500 Post Office branches. Just fewer than 400 of these are directly owned and managed by POL. All others are privately owned and operated by subpostmasters or franchise partners. POL is entrusted to maintain a network meeting certain access criteria for the UK population (99% of the population to be within 3 miles (4.8km) of an outlet, etc).
- (21) POL does not currently have any employees as all personnel currently working for POL (except those who are self-employed) are seconded from RMG. Approximately 9,000 RMG employees are seconded and work wholly for POL.
- (22) POL provides retail counter services to RMG, whilst RMG provides shared back-office support services to POL. Furthermore, there are a number of shared services in place between RMG and POL (e.g. vehicle services, building security etc.) which are currently provided at cost by RMG. The provision of these services is currently subject to a service agreement between RMG and POL that will be replaced by a series of new service agreements when POL becomes a sister company of RMG.
- (23) In addition to being an SGEI-provider, POL carries out some 'commercial' activities (such as selling telephony and insurance products) through its network and also through a direct internet sales channel.
- (24) On 23 March 2011, the European Commission authorised GBP 180 million of public assistance to Post Office Limited for the funding of its network of post offices during one year starting 1 April 2011.<sup>7</sup> The Commission also authorised the continuation, over the same period, of existing loan facilities funding the provision of cash services at post office counters. The Commission concluded that the aid is compatible with EU rules because it does not overcompensate the net costs of the public service tasks entrusted to POL.

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<sup>7</sup> Commission Decision C(2011)1770. The current authorisation of these measures expires on 31.3.2012. On 23 May 2011 the United Kingdom pre-notified State aid measures for a period between 1 April 2012 and 31 March 2015, registered under SA.33054.

### 3.4 Financial difficulties

- (25) According to the UK, RMG is currently facing severe financial difficulties, which it cannot overcome with its own resources or with funds obtained from market sources. They present the following financial data for the 'new' RMG without POL, based on the assumption that POL will become a sister company of RMG.
- (26) RMG<sup>8</sup> seems to be a "firm in difficulty", in view of:
- its diminishing revenues;
  - the state of its balance sheet, in particular the substantial size of the pension deficit;
  - its projected cash flow shortages;
  - its future inability to repay its debts when they fall due in the absence of the notified measures.
- (27) RMG's revenues are declining: between the 2008/09 and 2010/11 financial years, external revenue fell by 3.1%. In the same period inland addressed delivered volumes decreased by 11.7%.
- (28) RMG's balance sheet shows that the company had serious financial difficulties at the end of the 2010/11 financial year; both its working capital and net operating assets were negative.
- (29) According to the provided projections, RMG will have negative cash headroom by [...], i.e. it will not have sufficient funds to pay for its day-to-day operations, if the notified measures are not implemented. Consequently, RMG will also be unable to repay its existing loan facilities when they fall due in [...]. Indeed, the UK has indicated that the repayments due in [...] will already cause problems for the company.
- (30) The UK claims that the disproportionate size of the pension deficit is at the heart of the current financial problems of RMG (as explained in more detail in section 4.1.2). According to the UK, other factors contributing to RMG's financial difficulties include:
- Impact of early market liberalisation  
Full liberalisation came into effect on 1 January 2006, five years ahead of the deadline imposed by Directive 2008/6/EC. According to UK, the market was opened before RMG had restructured and modernised its business. As a result, the company's operating costs were significantly higher than they would otherwise been.
  - Structural decline in the postal market due to growth of e-communication

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<sup>8</sup> RMG has to be understood in this section as the 'new' RMG without POL.

Although the structural decline in the postal market has been exacerbated by cyclical decline as a result of the global financial crisis, the primary cause of the decline has been the increasing use of electronic media communications (“e-substitution”). From 2005 to 2011, the total number of postal items (including letters and parcels) dropped by around 25% from 84 million to 62 million items. RMG predicts a further decline in its own addressed inland letter volumes of over 20% between 2010/11 and 2015/16.

- Incomplete modernisation of RMG linked to a lack of capital and a challenging industrial relations environment

RMG’s finances have been negatively affected by restrictions on the company’s ability to access private capital and debt financing. Being wholly under public ownership, the UK Government has been RMG’s only source of capital and financing.

- Negative impact of the pro-competitive regulatory regime

According to the UK, the allegedly too low access prices that competitors have had to pay for the use of RMG’s network have led to a substantial decrease of RMG’s market share in the upstream services market.

## **4 THE AID MEASURES**

### **4.1 Relief of pension deficit**

- (31) The Postal Services Act envisages that the UK will assume responsibility for certain of the accrued liabilities under the RMPP. The proposed measure will relieve RMG of the obligation to make good the deficit that has arisen under that scheme, thus relieving RMG of a significant financial burden.
- (32) According to the UK, the size and volatility of the scheme is out of all proportion to RMG’s current business and has proved to be a severe handicap to RMG’s ability to compete on its own merits in the liberalised UK postal market. They believe that by taking certain liabilities over from the RMPP and thereby contributing to the restoration of RMG’s viability, RMG will, as the sole universal service provider in the UK, have the ability to adapt to the liberalised industry environment through modernisation. And, as a consequence, it will remove one of the principal obstacles to attracting private sector capital to RMG.

#### *4.1.1 The RMPP*

- (33) The RMPP is an occupational pension scheme for RMG’s employees, including those employees seconded to and who work wholly for POL.<sup>9</sup> It is a private sector scheme in the sense that it operates under normal UK pensions law as applied to private sector companies. As at 31 March 2011, the RMPP had c.436,000 members, of which c.130,000 were current employees accruing benefits in the scheme (active members),

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<sup>9</sup> The RMPP and the other UK schemes sponsored by RMG do not cover employees of GLS.

c.118,000 were former employees who had left service before retirement age and not yet drawn pension benefits (deferred members) and c. 188,000 were pensioners.

- (34) The RMPP is governed by the Third Principal Trust Deed and Rules dated 21 December 2009, as subsequently amended (the "Trust Deed"). The principal employer in relation to the scheme is RMG and the trustee is a company, Royal Mail Pensions Trustees Limited ("the Trustee"). In addition to the Trust Deed, the obligations of the Trustee and RMG under the RMPP are governed by legislation introduced by the Department for Work and Pensions applying to occupational schemes, set out, principally, in the Pension Schemes Act 1993, the Pensions Act 1995 and the Pensions Act 2004. The RMPP falls within the jurisdiction of the UK Pensions Regulator.
- (35) The board of the Trustee includes representatives of the members of the plan. The Trustee is in a fiduciary position as regards the plan members, meaning that under UK law it can only give its consent to changes in the scheme if it is satisfied that an amendment would be in the members' best interests. RMG currently sponsors four pension plans: the RMPP and the Royal Mail Senior Executives Pension Plan ("RMSEPP"), the Royal Mail Retirement Savings Plan ("RMRSP") and the Royal Mail Defined Contribution Pension Plan ("RMDCPP"). The notified measure concerns only the RMPP and will not affect members of the RMSEPP, the RMRSP or the RMDCPP.
- (36) The RMPP is a defined benefit scheme, that is, benefits are determined by reference to a pension of a target amount at normal retirement age, related to the amount of the member's annual pay and length of service with the employer. This is in contrast to defined contribution schemes under which only the level of the contributions required from the employer/employee is specified. The contributions are invested and when a member retires, the value of the accumulated fund is used to provide the member with an income for life.
- (37) There are two main types of defined benefit scheme, known as final salary and career average. A final salary scheme provides a pension based on a stated fraction or percentage of the employee's final pensionable salary for each year of pensionable service. In contrast, a career average scheme provides for each year of pensionable service a pension based on a stated percentage of the employee's average pay over the whole period of pensionable service (usually adjusted in some way to take account of inflation).
- (38) Until April 2008, benefits accrued by members of the RMPP were calculated on the basis of a final salary method. However, in April 2008 RMG implemented pension reforms by amendment of the RMPP rules which included changes to benefits accrued in respect of service from 1 April 2008, such that they are now calculated on the basis of a career average salary method rather than a final salary method (although benefits accrued in respect of service prior to that date will continue to be linked to a member's salary at the date of leaving service). Other reforms implemented on 1 April 2008 included raising the retirement age to 65 for service accrued from 1 April 2010 (benefits built up before that date can still be taken at age 60 without an early retirement reduction being applied) and closure of the RMPP to new members and joiners with effect from 1 April 2008. The RMPP was replaced with a defined contribution scheme for new members and joiners after 1 April 2008, the RMDCPP.

#### 4.1.2 *The pension deficit of the RMPP*

- (39) The cost of defined benefit in pensions in the UK has risen sharply in recent years due to:
- Rising life expectancy – in 1970 the average pensioner lived for 12 years in retirement, whereas by 2010 the average period in retirement was 19 years.
  - Falling interest rates have increased the current cost of providing benefits far in the future. UK inflation-linked Government bond yields were approximately 4% in the mid-1990s and are now less than 1%. As a result the cost of pension liabilities increased by approximately 80%.
  - Poor investment returns – over the last 10 years the UK stock market has produced returns broadly in line with price inflation.
  - Increased regulation leading to more prudent funding requirements.
- (40) As a result of the factors mentioned above, the vast majority of defined benefit pension schemes in the UK are currently in deficit. The impact of the pension deficit on corporate profitability and cash-flow varies from one company to the next and is critically dependent on the size of the pension scheme relative to the business. The companies in older, more labour intensive industries, such as RMG, are most affected by these factors. The recent 2010 valuation of the RMPP, based on the assumptions agreed with the Trustee, showed a deficit of GBP 8.4 billion.
- (41) RMG's pension deficit seems to be larger than average relative to its balance sheet and relative to the value and operational scale of its business. RMG's pension liabilities (on an accounting basis<sup>10</sup>) were as at 31 May 2011 over 60 times its EBITDA, whereas most FTSE 100<sup>11</sup> companies have a ratio of pension liabilities to EBITDA that is less than 2.
- (42) The UK claims that RMPP's liabilities are significantly higher than those of private sector companies due to the public sector heritage of RMG. Two main reasons are put forward:
- Inflation-linked indexation of pensions
- The RMPP offers for members who joined before 1987 a full linking of the pension payments to inflation. The UK cites studies that only a limited number of private pension funds offer such a full linking to inflation. However, the majority of private pension schemes do offer some limited price indexation for pension payments.

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<sup>10</sup> See section 6.2.1 below on valuation methodologies.

<sup>11</sup> FTSE 100 is a share index of the 100 most highly capitalised UK companies listed on the London Stock Exchange.

- Below-average retirement age

Before the last reform that took effect in 2010 moved the retirement age to 65, the retirement age for male and female members was 60 under the RMPP. The UK acknowledges that a survey of private pension schemes reveals a range of retirement ages in operation. However, it is emphasised that the RMPP's historical retirement age of 60 seems to have been situated at the more generous end of the range.

#### 4.1.3 Former measures to fund the pension deficit of the RMPP

- (43) The UK points out that RMG's ability to amend the RMPP over time has been materially constrained. These constraints derive from general UK pensions law and from specific features of the RMPP scheme.
- (44) Under UK law RMG has no power of veto over its contribution rate to the RMPP. These are normally agreed between the sponsoring employer and the trustee of a pension scheme, but against a background where a failure to reach agreement within 15 months of the effective date of a valuation will lead to contributions being determined by the UK Pensions Regulator ("TPR"), which was established on 6 April 2005 by the Pensions Act 2004 and which enforces compliance with pensions legislation. TPR has made clear, among other things, that it expects schemes to have a certain level of solvency, and that it expects trustees to seek recovery of any deficit as against that technical provisions funding target from the sponsoring employer "as quickly as the employer can reasonably afford".
- (45) In this context, RMG agreed a memorandum of understanding with the Trustee in June 2006 to fund the RMPP deficit over 17 years, in addition to the annual payments RMG makes to the RMPP to fund the cost of the accrued benefits. Conditions included the establishment of the escrow accounts totalling GBP 1 billion secured in favour of the RMPP that were the subject of the 2009 Decision.<sup>12</sup>
- (46) On 30 June 2010, following the March 2009 valuation, RMG agreed on a further recovery plan with the Trustee aiming to fund the RMPP deficit by March 2047, by paying the following annual contributions (hereafter "pension deficit contributions"):
  - From 1 April 2009 to 31 March 2047: annual deficit payments of GBP 282 million per annum increasing in line with retail prices inflation.
  - From 1 April 2013 to 31 March 2023: additional contributions of 4.0% of members' contributions.
- (47) POL contributes a 7% share of the deficit payments. The share is calculated on the basis of the number of employees seconded to POL in relation to RMG's total number

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<sup>12</sup> RMG holds certain investments in Government securities or National Loan Fund deposits, classed as current assets and often referred to as the 'gilts'. They are subject to a specific legal regime of directions by the UK authorities under section 72 of the Post Office Act 2000. Following directions dated 30 January 2003, RMG placed these assets in a special reserve ("the Mails Reserve") which were then used to fund measures in favour of POL until 2007. The remaining reserves were then placed in the escrow account in favour of the RMPP.

of employees. POL's annual contribution to the pension deficit in the 2010-11 financial year was GBP 21 million.

#### *4.1.4 Relief of pension deficit*

- (48) The UK proposes to set up a new statutory pension scheme ("New Scheme") which will be a liability of the UK Government and will have no legal connection to RMG or the RMPP. Certain part of the accrued liabilities of the RMPP and assets held by the RMPP Trustee will be transferred to the New Scheme.
- (49) In terms of liabilities, it is intended that benefits accrued in respect of historic pensionable service up to 31 March 2012 will be transferred to the New Scheme. The persons to whom this proposal applies include current pensioners, deferred members and active members of the RMPP. However, RMG will remain liable for any current obligations under the RMPP to maintain a continuing final salary link together with certain enhancements (e.g. on early retirement) in respect of the historic pension benefits. This means that after the pension relief, RMG will continue to bear the risk that the historic liabilities for deferred members may increase by reason of any salary increases, which exceed price inflation, as the pension benefits have to be linked to the current final salary level.
- (50) The assets to be transferred will be such that the assets retained by the RMPP will be equal in value to the liabilities remaining with the RMPP immediately following the date of transfer. They will be valued based on the assumptions used for the last formal actuarial valuation, the valuation as at 31 March 2009, updated to reflect more recent market conditions.
- (51) It is anticipated that approximately GBP 1.5 billion of assets and GBP 1.5 billion of liabilities will be left with the RMPP after the pension relief. For the purposes of illustration, based on 31 March 2010 actuarial valuation figures, the new pension scheme will be taking over GBP 32.9 billion of liabilities. It will also take over GBP 24.5 billion of associated assets. However, the exact amount to be left with the RMPP will depend on the valuation as at 31 March 2012.
- (52) After the pension relief RMG will continue paying to RMPP normal pension contributions. The pension relief will concern only the pension deficit.
- (53) As already mentioned above, all employees working for POL are seconded from RMG. POL bears the cost of employment and makes a contribution towards the pension deficit relating to seconded employees.
- (54) On the day after the pension relief, the employees seconded from RMG to POL will be transferred to POL's legal employment. To cater for this arrangement, the RMPP will, for funding purposes, be divided into segregated sections: RMG will continue to participate in one section and POL will, going forward, participate in the other section.
- (55) Finally, it is planned that at 31 March 2012 the existing escrow arrangements established by RMH and RMG in March 2007 (as explained in paragraph (3)) will be terminated and the funds held in escrow will be released to RMH and RMG respectively.

- (56) The Postal Services Act grants a wide power to make regulations in connection with tax aspects of the pension relief. The overall aim is to prevent unintended tax charges that might otherwise arise (notably to RMG) as a result of the formation of the New Scheme.
- (57) As a result of the transfer of liabilities from the RMPP to the New Scheme, a significant accounting provision will be released in RMG's accounts, resulting in a large credit to its reserves. As a strict technical legal matter there is some uncertainty whether that credit would trigger a tax charge. According to the UK, the new regulations will specify that any credit recognised by RMG as a result of the transfer of its pension liabilities will not be taxable.
- (58) The UK notes that, as RMG has not been able, according to UK tax law, to claim tax relief in respect of the related provisioning for the pension deficit which is currently reflected in its accounts, equally, it should not suffer tax on the release of this provision.<sup>13</sup>

## **4.2 Balance sheet repair measures**

- (59) The UK believes that implementation of the pension relief alone will not be sufficient to restore RMG to viability and that some element of balance sheet restructuring is required to put the company on a sustainable footing going forward.
- (60) The Balance Sheet Repair Measures which the UK intends to provide to RMG will consist of:
- Writing off a certain amount of debt owed by RMG to the UK Government, expected to be up to GBP 1.7 billion (plus accrued interest), and
  - RMH making available certain amounts in the Mails Reserve to RMG by way of a revolving credit facility (Escrow RCF) with a maximum drawdown of GBP 200 million.

### *4.2.1 Debt write-off*

- (61) The timing and amount of RMG debt to be written off by the UK in the scenarios described in more detail below will be driven by the requirement to ensure that only the minimum amount of aid necessary to ensure RMG's viability is provided.
- (62) In the event that a privatisation takes place, the proceeds of the privatisation will be used to relieve an amount up to the total amount of the debt and the interest. The UK will write off some or all of the difference (if any) between the amount paid and the total amount of the debt plus interest.
- (63) The exact amount of the debt write-off will be such an amount as will ensure RMG's viability based on an assessment at the relevant time. The debt write-off will be sized

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<sup>13</sup> The UK refers, in this respect, to the Commission's approach in the British Energy Decision; Case C 52/2003 Aid in favour of British Energy plc, OJ L 142 of 6.6.2005, p. 26.

so as to ensure that after privatisation, RMG will have financial metrics equivalent to an investment grade rating (using a proxy for such a rating of [...] Free Funds from Operations (FFO) to adjusted net debt) and will therefore be in a position to raise external finance on commercial terms.

- (64) If no privatisation process has commenced by [...], the UK will write off an amount up to [...] plus interest.
- (65) Furthermore, the UK authorities may take two further debt measures if needed:
- Given RMG's current financial difficulties, the covenants given by RMG to the UK under the terms of facilities put in place in 2007 on a commercial basis may be breached at the next covenant testing in [...]. If RMG looks likely to breach the covenants, the UK will make appropriate adjustments to avoid any such breach (a Debt Covenant reset).
  - Some debt facilities are due to mature on [...]. If a privatisation has not been completed by [...], the UK will extend the maturity date of the senior credit facilities to the earlier of the date of a privatisation or [...] (a Debt Roll-over).

#### 4.2.2 Escrow Revolving Credit Facility (RCF)

- (66) Assuming that the pension relief will be implemented in March 2012, the UK authorities plan to transfer the pension escrow account security back from the Pension Trustee to RMH and to put it into the Mails Reserve on RMH's balance.
- (67) The UK authorities are proposing to make available GBP 200 million of the funds in the Mails Reserve to RMG under the terms of a revolving credit facility (the Escrow RCF). The Escrow RCF is intended to provide RMG with working capital to ensure that it has sufficient cash headroom during the period of the Restructuring Plan.
- (68) The main terms of the Escrow RCF will be as follows:
- the maximum amount which can be drawn under the Escrow RCF will be GBP 200 million;
  - the interest rate will be LIBOR plus [...] % per annum; and
  - it will be subordinated and unsecured.
- (69) If a privatisation is completed the Escrow RCF will be cancelled immediately prior to the privatisation and the funds will be released, remaining in the Mails Reserve on the balance sheet of RMH but subject to the Government's direction.
- (70) Any amounts drawn under the Escrow RCF as at the date of privatisation will be refinanced:
- with a commercial lender if the UK Government's indirect shareholding in RMG is less than 50%; or

- by the UK on MEIP terms if the Government's indirect shareholding in RMG is equal to or more than 50%.
- (71) If no privatisation process has commenced by [...], the UK authorities intend the Escrow RCF to remain available to RMG on the same terms until the end of the Restructuring Plan period.
- (72) At the end of the Restructuring Plan period:
- the Escrow RCF will be cancelled and any undrawn amounts will be released, remaining in the Mails Reserve on the balance sheet of RMH but subject to the Government's direction; and
  - any amounts drawn under the Escrow RCF will be refinanced by the UK on MEIP terms.

### **4.3 Business restructuring plan**

- (73) RMG's<sup>14</sup> plans, which are focused primarily on costs reduction and revenue diversification, build on the significant restructuring measures that RMG has taken since 2002 (including implementing significant changes to the RMPP) to modernise its business and drive costs down. RMG's plan for restoring the company to viability may be split into five key areas:

#### Operational modernisation

- (74) RMG's proposed operational modernisation covers changes in all areas of the RMG pipeline and results in significant cost savings for the business. The modernisation will deliver savings via the introduction of new technology and more effective working practices as RMG rolls out "World Class Mail" operations throughout the letters network, which aims to raise productivity through the deployment of best practices. World Class Mail is now being implemented throughout RMG's operations in all 11 regions and all mail centres will be on the World Class Mail programme [...]. Operational modernisation is projected to result in annual cost savings of GBP [...]bn (net of pay increases) by 2015/2016, driven by a headcount reduction of [...].

#### Corporate and back-office restructuring measures

- (75) In line with the conclusions of a root-and-branch review of the organisation's support function structure in summer 2010, a re-centralisation of the business' support functions was implemented by RMG in the remainder of the 2010/11 financial year in order to deliver a better quality of service to customers and to extract overhead savings. Support functions have been removed from within business units and re-located to sit within the central group structure. Defunct roles and unnecessary layers of management have been removed from the organisational structure to support more efficient decision making throughout the organisation. In total, almost [...] central managers will be removed from the business by [...] (of whom over [...] had left by March 2011). The re-centralisation of the organisation is projected to lead to savings

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<sup>14</sup> RMG has to be understood for this section as RMG without POL and GLS.

of around GBP [...] million per annum from 2012/13. The new management team has also implemented a new strategy focused on financial control and reducing discretionary expenditure (e.g. zero-based budgeting and procurement savings). This is expected to result in cumulative costs savings totalling almost GBP [...] million over the next five years.

#### Commercial transformation

- (76) RMG's commercial transformation plan involves a renewed focus on the changing needs of customers in order to mitigate further revenue declines in the structurally declining market of letter services.

#### Investment in a new IT Platform

- (77) [...]. The investment programme covers a number of essential projects. An upgraded IT platform will be an essential component in the successful delivery of the Restructuring Plan through improving customer experience, enhancing data capture, enabling operational data capture (e.g. tracking) and analysis and improving information flow and business control.

#### Cash generation initiatives

- (78) Given its worsening cash flow profile, RMG has engaged in an asset disposal programme to help fund the restructuring programme. The disposal programme has already provided GBP [200 to 250] million of cash from 2008/09 to 2010/11, and aims to generate a further GBP [...] million by 2015/16:
- GBP [...] million of cash is forecast to be generated from real estate disposals between 2011/12 and 2015/16, including the sale of London real estate; and
  - the divestment of Romec Services Limited in April 2011 generated GBP [...] million of cash in the 2011/12 financial year.

### **5 THE UK AUTHORITIES' VIEWS**

- (79) The Commission notes in the first place that in the present case the UK has not contested that the pension relief itself and the balance sheet repair measures constitute State aid.
- (80) The notification sets out a number of legal and factual bases for the Commission to declare the proposed measures compatible with the internal market. According to the UK, these legal and factual bases can be analysed and applied either cumulatively or as alternatives.
- (81) For the avoidance of doubt, the UK emphasises that their notification does not present a case that the proposed measures can be approved as remuneration for RMG's provision of a service of general economic interest (SGEI) under Article 106(2) TFEU. However, they do believe that RMG's public service mission provides important

context for their notification, in particular for the compatibility assessment under the Guidelines on rescue and restructuring aid to companies in financial difficulties.<sup>15</sup>

### 5.1.1 *Rescue and Restructuring aid Guidelines ("RR Guidelines")*

- (82) The UK submits that the aid should be regarded as compatible with the TFEU as restructuring aid under the terms of the RR Guidelines. In this connection the UK has submitted a restructuring plan and indicated how it believes the plan is consistent with the requirements under the RR Guidelines.
- (83) Whilst describing RMG as a firm in difficulty (see section 3.4 above), the UK indicates in their notification that delivery of the Restructuring Plan restores RMG to viability by [...]. The ability to take out high levels of fixed cost, optimise prices (facilitated by a less constraining and more flexible regulatory framework), and diversify revenues to replace lost revenues from declining mails volumes, will create a viable RMG, which, in turn, is capable of attracting private sector investment to ensure its long term future. The figures presented by the UK project that:
- operating profit margins post-modernisation costs of [...] % by the end of the Restructuring Plan (2015/16) will be more in line with postal operator peers;
  - positive free cash flows before interest of GBP [...] million are forecast for 2015/16; and
  - RMG's credit profile (post-debt restructuring) will be more in line with postal operator peers.
- (84) As concerns compensatory measures they submit that no such measures are necessary given (i) the exceptional nature of RMG's case, including the many links between RMG's current financial difficulties and its public sector monopoly legacy and its role as the only USO provider in the UK; (ii) the fact that, any distortions of competition arising from the proposed measures will be minimal and will be more than offset by the benefits flowing to consumers and competitors from RMG's survival; (iii) the advantage that competitors in the UK have already received through the operation of the regulatory regime; and (iv) the network nature of RMG's business and the need to diversify revenues, as well as reduce the cost base, in order to respond to the structural changes in the market.
- (85) The UK authorities further argue that the aid it proposes to grant to RMG is limited to the minimum necessary to restore RMG's long-term viability. According to the UK, RMG will still continue to have very substantial pensions obligations even following the implementation of the pension relief. Furthermore, they argue that the balance sheet repair measures, which are inextricably linked to the historic pensions burden, are the minimum required to ensure RMG can pay for its restructuring and restore RMG to viability, thereby placing the company in a position to attract private sector capital investment.

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<sup>15</sup> OJ C 244 of 1.10.2004.

- (86) As concerns the requirement in the RR Guidelines for there to be an own contribution to the costs of restructuring, the UK draws attention to the investment of private capital by one or more third party investors. They observe that the Guidelines specifically note that investment by a third party on market terms is a good example of an appropriate contribution, particularly since it signals that the private sector believes that RMG's future viability is a good prospect.
- (87) The UK also considers that an asset disposal programme to help fund the restructuring programme should be counted as part of RMG's contribution towards the restructuring. Furthermore, the UK claims that the historical funds used for the modernisation to date, that have been raised by RMG from its own resources or from financial facilities granted by the UK Government on market terms (as confirmed by the Commission in its 2009 Decision), represent a cost of restructuring that has been borne by the company. Although this historic investment pre-dates their notification, given that RMG has been under a continuous process of restructuring since 2008, the UK submits that such investment should nonetheless be eligible to be counted as part of RMG's "own contribution" under the RR Guidelines.
- (88) The UK argue in addition, however, that the Commission should use its 'exceptional circumstances' discretion under paragraph 44 of the RR Guidelines, and require only a limited contribution from RMG, noting that it is unlikely that RMG will be in a position to meet 50% threshold referred to in the RR Guidelines. The State aid represented by the proposed pension relief will be of a scale that will not easily be matched by a contribution from RMG's own business even including any contribution from an investor. That said, they do draw attention to the proposed modernisation investment of GBP [...] billion over the next five years. They make reference to the requirement on RMG to continue to provide the USO, to the importance for RMG as a network business to maintain widespread coverage, and to their expectation that a more substantial contribution from RMG's own resources could result in a diminution of the contribution to be made by the investor or failure to negotiate any deal with an investor.
- (89) In the alternative, the notification considers three other routes for a compatibility decision on the pension relief for RMG under Article 107(3)(c) TFEU based on analogies with cases such as La Poste<sup>16</sup>, EDF<sup>17</sup> and OTE<sup>18</sup>.

#### *5.1.2 Notified measures to be considered in the interest of Union as a whole*

- (90) Firstly the UK argues that the aid, in particular the pension relief, could be considered as justifiable under 107(3)(c) 'as a matter of principle'. They claim that the relief of the

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<sup>16</sup> Commission Decision of 10 October 2007 on the State aid implemented by France in connection with the reform of the arrangements for financing the retirement pensions of civil servants working for La Poste, 2008/204/EC, OJ L 63 of 7.03.2008, p. 16.

<sup>17</sup> Commission Decision of 16 December 2003 on the State aid granted by France to EDF and the electricity and gas industries, 2005/145/EC, OJ L 49 of 22.02.2005, p. 9.

<sup>18</sup> Commission Decision of 10 May 2007 on State aid C 2/06 (ex N 405/05) which Greece is planning to implement for the early voluntary retirement scheme of OTE, 2008/722/EC, OJ L 243 of 11.9.2008, p. 7.

pensions obligations is in line with the common interest because it enables RMG to operate efficiently in the context of the UK's liberalised postal services market, to the benefit of its customers (both end-to-end users and those who use the access regime described in paragraph (17) above); that the aid is the appropriate instrument to secure that benefit to the common interest, and is no more than is strictly necessary to achieve that benefit because it does no more than achieve some degree of equalisation of the pensions burden of RMG and its competitors, with RMG's continuing pensions burden remaining significantly more onerous than that of its competitors; and that being so limited, the aid does not significantly distort competition.

- (91) In support of this analysis, they argue that RMG is currently the only entity with the capability to deliver the UK's obligations under the Postal Services Directives, and is also important to competitors in the UK postal services sector because although there is no restriction on the development of competitive end-to-end services, a large number of market entrants in the UK have done so through downstream access arrangements under which they contract with RMG for the "last mile" delivery. They argue that the scale of RMG's pension liabilities is directly linked to its public service obligation and the previous monopoly situation where the market was not yet liberalised. They claim that no significant distortions of competition will be caused by the aid to RMG in the relevant economic markets. On the contrary, relief of RMG's legacy pension burden will put an end to a distortion of competition which has until now operated to RMG's detriment.

### 5.1.3 Application of Commission's reasoning in *La Poste*

- (92) Secondly, the UK submits that the Commission's reasoning in the *La Poste* case<sup>19</sup>, in which the Commission approved the grant of approximately EUR 76 billion of aid to La Poste, can properly be read across to RMG's case to justify approval of the pension relief under Article 107(3)(c). They argue that in the language of UK pension schemes, the Commission in *La Poste* in effect permitted the French State to convert La Poste's pension funding obligations from a defined benefit basis to a defined contribution basis. While the individual entitlements of La Poste's civil servant employees and civil servant pensioners did not change, the measure changed the share of the financial burden of meeting those entitlements between La Poste and the French State. The UK also argues that the change in La Poste's funding obligations in effect wiped its slate clean of pension liabilities in respect of its historic/accrued pensions liabilities.
- (93) Furthermore the UK argues that the pension relief proposed for RMG will be considerably less generous in net terms for RMG than that approved for La Poste: whereas the French State simply took over La Poste's accrued liabilities, the UK will take over not just RMG's liabilities but also most of the assets in RMG's pension scheme that have been built up over forty years to discharge those liabilities as they fall due. The UK also points out that unlike La Poste, RMG will continue to be fully responsible for the future liabilities (defined benefit or defined contribution) of its current and future employees.

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<sup>19</sup> Decision of 10 October 2007 on the State aid implemented by France in connection with the reform of the arrangements for financing the retirement pensions of civil servants working for La Poste, OJ L 63 of 7.03.2008, p. 16.

#### 5.1.4 Abnormal costs

- (94) As an alternative line of analysis, the UK advances what they term an 'abnormal costs' argument. They argue that the RMPP has certain unusual features that, collectively, entail additional entitlements for the members of the scheme and, therefore, additional costs to RMG. These features include: (i) the scale of RMG's employment costs, resulting from the company's position as the USO provider with a necessarily extensive network and large labour force; (ii) the indexation of a substantial portion of the pensions being and to be paid under the RMPP; (iii) the early retirement age for pensionable service before 1 April 2010; and (iv) the enhanced redundancy terms for employees in line with collective agreements with the unions.
- (95) The UK argues that these features are a direct result of RMG's central government department/public monopoly legacy, resulting in RMG having to bear labour-related costs significantly in excess of those of its private sector comparators. These abnormal costs, which have severely hampered RMG's ability to compete effectively in the liberalising industry environment, can (by analogy with the EDF<sup>20</sup> and OTE<sup>21</sup> cases and the Commission's Communication on stranded costs in the energy sector) be regarded as "stranded costs".

## 6 ASSESSMENT OF PRESENCE OF AID UNDER ARTICLE 107 (1) TFEU

### 6.1 Existence of aid

- (96) State aid within the meaning of Article 107(1) TFEU is granted by a Member State or through State resources in any form whatsoever which distorts, or threatens to distort, competition by favouring certain undertakings, in so far as it affects trade between Member States.
- (97) As regards the **pension relief**, the UK's assumption of the pension deficit is financed by State resources and is imputable to the State.
- (98) The measure provides an advantage first of all to RMG, given the effects on RMG of the deficit in the RMPP, as noted above in section 4.1.2, and the obligations RMG has to the RMPP under UK pensions law. These obligations include the payment of contributions, in particular to address the deficit, and are reflected in the fact that the deficit is recorded on RMG's balance sheet as required by IAS 19. The measure also confers an advantage on POL as it relieves POL of the obligation under the secondment arrangements with RMG to contribute to the pension deficit (as described in paragraph (47)). At this stage it is not yet clear whether other subsidiaries of RMG might also profit from the pension relief. Accordingly the Commission concludes that the measure provides an advantage to (at least) RMG and POL.
- (99) As regards the tax treatment of the pension relief, it needs to be further investigated whether, as the UK points out, the non-taxation of the release of the provisions made

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<sup>20</sup> OJ L 49 of 22.02.2005, p. 9.

<sup>21</sup> OJ L 243 of 11.09.2008, p. 7.

in the accounts as a result of the pension deficit is justified on the grounds that the building-up of the provision could not be deducted from tax.

- (100) Concerning the **balance sheet repair measures**, these are financed from State resources and are imputable to the State: the UK will write off up to GBP 1.7 billion from the outstanding sums that RMG currently owes to it and will make available GBP 200 million of the funds in the Mails Reserve to RMG under the terms of a revolving credit facility.
- (101) The write-off would relieve RMG of its debts obligations and, given that RMG is to be considered a company in difficulty (as described in section 3.4), it is very unlikely that a private market investor would have acted in the same way. In any event, the UK has not claimed that it is acting in line with the Market Economy Investor Principle ("MEIP") in relation to the balance sheet repair measures. Therefore, these measures confer an advantage on RMG. As the UK has only submitted financial projections for the 'new' RMG (i.e. without POL), more information is required in order to assess whether POL would also benefit from the balance sheet repair measures.
- (102) As the pension relief and balance sheet repair measures are limited to RMG (including at least POL), they constitute a selective advantage.
- (103) The aid measures will allow RMG to reinforce its strong position on the UK postal market. Given that that market was opened to competition in 2006, while already being competitive even before that date in certain market segments (e.g. delivery of parcels and delivery of bulk mail in case of postings above 4,000 items), it follows that, by favouring RMG, the aid in question distorts or threatens to distort competition on that market. Furthermore, given that the business of letters and parcels is an international one with many important players active in a number of Member States, as evidenced in particular by RMG's ownership of GLS, the Commission believes that the aid in question affects trade between Member States.
- (104) In light of the above, the Commission concludes that both the assumption of the pension deficit by the UK and the balance sheet repair measures involve State aid within the meaning of Article 107(1) TFEU.

## **6.2 Quantification of the aid element involved in the pension relief**

- (105) The UK considers two approaches to the quantification of the aid element involved in the pension relief: based on the net present value of either (i) the pension deficit or (ii) the pension deficit contributions as agreed with the Pension Trustee.<sup>22</sup>

### *6.2.1 Net present value of the pension deficit*

- (106) The pension deficit is defined as the difference between pension assets and liabilities. The valuation of assets is usually straightforward while the valuation of liabilities is more complex and depends on assumptions made (e.g. regarding discount rate, mortality, salary growth and inflation). In principle, the valuation of the liabilities can

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<sup>22</sup> See paragraph (46) for the details of the contribution plan to finance the pension deficit.

be based on two different methods that differ in the discount rate that is used for the calculation of the liabilities' net present value:

#### Accounting valuation

- (107) An accounting valuation of the pension deficit is based on the rules prescribed in IAS 19, the same as the rules followed for financial reporting.
- (108) Full formal actuarial valuations are carried every 3 years, with appropriate updates and accounting adjustments at each balance sheet date. On an IAS 19 basis, as at 29 March 2009 the assets were valued at GBP 19.9 billion and accrued liabilities at GBP 26.6 billion which results in a deficit of GBP 6.7 billion.

#### Cash funding valuation

- (109) A cash funding valuation is based on the assumptions agreed between the Trustee and RMG. Cash funding requirements are negotiated every three years between RMG and the Trustee. Legislation requires that the assumptions for the valuation are prudent, rather than best estimates. Therefore the cash funding valuation applies lower interest rates compared to the accounting valuation and results in a higher net present value for the pension deficit.
- (110) Full formal actuarial valuations are carried out every 3 years, with appropriate updates at each balance sheet date. The last actuarial valuation of the RMPP was carried out as at 31 March 2009 and showed assets of approximately GBP 20.2 billion and past service liabilities of approximately GBP 30.5 billion, giving rise to a deficit of GBP 10.3 billion.
- (111) The UK points out that the value of the pension deficit is highly volatile over time because it depends on the actual asset values in the financial markets. (e.g. based on the cash funding method, the pension deficit decreased from GBP 10.3 billion as at March 2009 to GBP 8.4 billion by March 2010 because the financial markets came out of the crisis and the asset values increased). Consequently, a valuation of the pension deficit based on either method would only provide a snapshot of the pension fund's financial position at a given moment in time and depends to a significant extent on the short-term fluctuations of the financial markets.

#### *6.2.2 Net present value of pension deficit contributions*

- (112) As an alternative method, the UK proposes to consider the cash costs that RMG would save based on the currently applicable agreement between RMG and the Pension Trustee for the coverage of the pension deficit.
- (113) As explained in section 4.1.3, RMG agreed with the Pension Trustee to pay annual pension deficit contributions to the RMPP until 2047. The UK estimates the net present value of these pension deficit contributions at approximately GBP 3 billion and would consequently consider this amount as the financial advantage for RMG.
- (114) According to the UK, this method based on RMG's current payment obligations to make good the pension deficit would not entirely eliminate any uncertainties as it is possible that the pension deficit contributions would be renegotiated with the Trustee

at some point, which could increase or reduce the cost to RMG. However, it would represent a less volatile approximation than the accounting and cash funding methods.

### 6.2.3 Conclusion

- (115) As the valuation methods under discussion lead to markedly different values for the financial advantage (e.g. in a range of GBP 3 billion to GBP 10.3 billion), the Commission has at this stage doubts on the appropriate method to use.

## 7 PRELIMINARY VIEWS OF THE COMMISSION ON THE LEGAL BASES FOR A COMPATIBILITY ASSESSMENT

- (116) Concerning a direct application of Article 107(3)(c) TFEU, the Commission notes that it has published numerous guidelines and communications on the application of this sub-paragraph. Where a State aid measure falls within the scope of such guidelines, the Commission believes that in the first instance it should be assessed against them. In this case, the measure accompanies a significant restructuring of RMG in response to its financial and operational difficulties.
- (117) The Commission therefore intends to assess the measure against the RR Guidelines. The Commission is sensitive to the arguments made by the UK in connection with their proposed line of analysis, and notably those concerning RMG's role in delivering the universal service in line with the postal directives. The argument that RMG's status as designated universal service provider can be taken into account in a restructuring aid assessment such as to justify an adaptation of the compatibility conditions does not appear obvious and the Commission is not in a position to conclude thereon without further detailed assessment carried out in the light of comments received from interested parties.
- (118) Concerning the UK's arguments by analogy with the Commission's decision on La Poste, and on the basis of 'stranded' or 'abnormal' costs (jointly referred to as 'legacy' costs), the Commission has considered these precedents and to what extent the situation of RMG can be assimilated to those of the relevant beneficiaries. Although there are differences between the cases cited, they all have in common the comparison between the situation of the beneficiary and a normal case of other undertakings in the economy or at least the sector in question. As already noted in the 2009 Decision, pensions arrangements in the UK differ from those in other Member States and notably France. Most occupational pension schemes are 'contracted out' of the State pension arrangements known as the State Earnings Related Pension Scheme. Most large employers run their own pension schemes whose terms vary from one to the next. The rules requiring RMG to account for its deficit are not different from those applying to other companies, and there is no clear choice of a 'normal' case with which to compare the position of RMG. In its 2009 Decision the Commission decided that certain features of RMG's pensions liabilities (notably terms inherited from the civil service scheme and arising from a period of monopoly) were similar to those existing in certain precedents<sup>23</sup>, and established a benchmark against which the additional costs of these features could be compared in order to apply the principles of the precedents

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<sup>23</sup> See references in footnotes 16, 17 and 18.

mentioned. However, the Commission doubts that this approach can be applied to the entire pension deficit of the RMPP. These matters therefore need to be considered further as part of the current investigation.

- (119) To conclude, the Commission proposes to analyse the planned aid measures against the RR Guidelines and against the principles of 'legacy' costs. Preliminary assessments on these two bases follow in the next paragraphs.

## **8 COMPATIBILITY ASSESSMENT OF THE AID MEASURES UNDER THE RESCUE AND RESTRUCTURING AID GUIDELINES**

### Eligibility of the beneficiary as a firm in difficulty

- (120) In order to be eligible for State aid under the RR Guidelines, an undertaking must be in difficulty in the terms of those Guidelines. According to the RR Guidelines, a firm is considered to be in difficulty, if it is unable to recover through its own resources or by raising the funds it needs from shareholders or on the market, and without the intervention of public authorities. The RR Guidelines also list some usual signs of such companies, such as mounting debt and falling net asset value.
- (121) According to the notification, as described in more detail in section 3.4 above, RMG is an enterprise in difficulty in view of its diminishing revenues; the state of its balance sheet; its projected cash flow shortages; and its future inability to repay its debts when they fall due in the absence of the proposed measures. The UK describes RMG as 'balance sheet insolvent'; the acceleration in market decline combined with the fast pace of competitive entry has led RMG's revenues to decline at a pace faster than that at which RMG has been able to take out costs.
- (122) The Commission notes the Hooper 2008 report's assessment that RMG's financial position is 'already precarious' and 'without significant change ... will deteriorate'<sup>24</sup>. Furthermore, according to the Hooper 2010 update, compared to the 2008 report, 'the financial health of Royal Mail...has worsened' and 'the deficit continues to pose a significant constraint on Royal Mail's business, sapping cash from the company and causing Royal Mail to be balance sheet insolvent'.<sup>25</sup>
- (123) The Commission also notes that from the data mentioned in section 3.4 above, it could be concluded that RMG exhibits certain features of a company in difficulty listed in paragraph (11) of the RR Guidelines, notably a declining turnover in the key RMG Letters division and a negative cash flow.
- (124) In conclusion, the Commission's current view is that RMG is a company in difficulty within the meaning of the RR Guidelines.

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<sup>24</sup> Hooper Report (already cited), paragraph 92.

<sup>25</sup> Update Report 2010 (already cited), p. 26.

### Restoration of long-term viability

- (125) According to point 34 of the RR Guidelines, the grant of aid must be conditional upon the implementation of the restructuring plan which must be endorsed by the Commission in all cases of individual aid to large companies.
- (126) According to point 35 of the RR Guidelines, the restructuring plan, the duration of which must be as short as possible, must restore the long-term viability of the firm within a reasonable timescale and on the basis of realistic assumptions as to future operating conditions. According to point 36 of the RR Guidelines, it must contain best-case, worst-case and intermediate assumptions on the future prospects.
- (127) In terms of restoring viability, the restructuring plan proposes a package of internal and external measures to restore RMG to viability, leading to positive projections in the later part of the plan period (see section 4.3 above). Besides a range of structural and financial measures to secure the future of RMG, it foresees significant cost-cutting and revenue diversification by way of operational modernisation, corporate and back-office restructuring, commercial transformation, investment in new IT platform and the implementation of structural cash generation initiatives (including asset disposals).
- (128) Nonetheless the Commission has noted that the duration of the plan from 2008 to 2016 is particularly long and that the projections in the restructuring plan are sensitive to changes in the assumptions such as total mail volumes. The Commission therefore has serious doubts as to the restoration of long-term viability of the firm by the implementation of the notified plan and would wish to be satisfied, in the context of the investigation, of the fulfilment of all the requirements for a restructuring plan and in particular of the robustness of the viability projections. The participation of a private investor, if this is confirmed, would provide independent evidence of the realism of RMG's projected return to viability.

### Avoiding undue distortions of competition

- (129) Pursuant to points 38-42 of the RR Guidelines, measures must be taken to mitigate as far as possible any adverse effects of the aid on competitors. The aid shall not unduly distort competition. This usually means a limitation of the presence which the company can enjoy on its markets at the end of the restructuring period. The compulsory limitation or reduction of the company's presence on the relevant market represents a compensatory factor in favour of its competitors.
- (130) The UK has submitted that only limited or even no compensatory measures are necessary and appropriate, as noted at paragraph (84) above. This does not appear to be in line with the text of the RR Guidelines and the Commission will particularly welcome the comments of third parties on this issue.
- (131) The Commission recognises that the UK has liberalised its market and that especially upstream competition on the basis of access arrangements has developed significantly. It also recognises that RMG is subject to regulation and is required to provide a universal service, which may therefore limit its ability to divest assets, or to reduce capacity or market presence. However the Commission also notes that RMG is present on unregulated markets including, via its subsidiary GLS, outside the UK. The need

for further compensatory measures may possibly depend on the identity of the third party investors and the nature of their relationship with RMG, given that under the RR Guidelines compensatory measures must be in proportion to the relative importance of the firm on its market or markets. The UK has supplied a market survey which confirms that, while losing a significant market share to competitors in the upstream letters markets through downstream access arrangements, RMG still delivers some 98% of the UK addressed mail market to its final destination (downstream delivery). The survey gives estimates of RMG's share of the European express market around 5% but shows that in some Member States its presence through GLS is significant.

- (132) The Commission therefore has doubts whether these conditions for the compatibility of restructuring aid are met.

#### Aid limited to the minimum and own contribution

- (133) Pursuant to point 43 of the RR Guidelines, the amount and intensity of aid must be limited to the strict minimum of the restructuring costs necessary to enable restructuring to be undertaken, taking into account the existing financial resources of the company. Aid beneficiaries will be expected to make a significant contribution to the restructuring plan from their own resources, i.e. through the sale of assets that are not essential to the firm's survival, or through external financing at market conditions.
- (134) In terms of showing aid to be the minimum necessary, the UK argues that the RMG will still continue to have very substantial pensions obligations and the Balance Sheet Repair Measures are the minimum required to ensure RMG can pay for its restructuring and restore RMG to viability. The Commission would like to analyse these arguments further in the context of a formal investigation.
- (135) Concerning the UK's argument that only limited "own contribution" should be required, the requirement in the RR Guidelines concerns the percentage of restructuring costs which such an own contribution must cover. For these purposes the discharging of the pensions deficit represents the principal restructuring cost. As noted in section 6.2 above, the valuation of the deficit depends on the basis and assumptions used. The Commission also recalls at this point the discussion of the quantification of aid in section 6.2 above.
- (136) From the information available to the Commission it appears that the principal source of an own contribution to the restructuring of the business would be the consideration for the investment of private capital by one or more third party investors. Such private investment would show that the markets believe in RMG's return to viability. However, as the UK has neither provided specific privatisation plans nor wants to commit to the extent of private sector investment, it is not possible to take such considerations into account.
- (137) The Commission observes that RMG has sold and intends to sell, over the term of the Restructuring Plan, various properties and other assets that are not essential to RMG's survival. The restructuring plan foresees an asset disposal programme which would generate GBP [...] million from 2011/12 to 2015/16.

- (138) The UK also claims that the funds used for the modernisation to date, have been raised by RMG from its own resources or from financing from the UK, should be eligible to be counted as part of RMG's "own contribution" under the RR Guidelines, given that RMG has been under a continuous process of restructuring since 2008.
- (139) Without taking a position at this stage on the issue of when the restructuring began, the Commission notes the UK's view that even including those transactions, it is unlikely that RMG will be in a position to meet the requirement of an own contribution of 50% of restructuring costs.
- (140) The Commission has noted the arguments of the UK why it should, exceptionally, require only a limited contribution from RMG. These include the many links between RMG's current financial difficulties and its public sector monopoly legacy and its role as a sole USO provider which may limit RMG's ability to divest assets. The Commission will analyse these arguments further in the context of the procedure.

#### The "one time, last time" principle

- (141) The Commission notes that RMG has not previously received rescue or restructuring aid within the meaning of the RR Guidelines and the "one time last time" condition is therefore fulfilled. The Commission's decision of 8 April 2009 stated explicitly that it did not represent an application of the RR Guidelines.

#### Conclusion

- (142) In conclusion, the Commission has doubts, on the basis of current information, as to whether all the requirements for compatibility under the RR Guidelines are met.

### **9 COMPATIBILITY ASSESSMENT OF THE PENSION RELIEF AS COMPENSATION FOR 'LEGACY' COSTS**

- (143) The UK has argued that part of the pension relief to RMG can be authorised by analogy with the Commission's *La Poste* decision. However the Commission recalls the essential difference between the cases which concerns the pensions systems of the two Member States. Before the measure approved by the Commission's decision entered into force, La Poste's financing regime for the civil servants' pension was at variance with the general pension system for private undertakings in the French economy. Contrary to the French situation, no general pension system exists in the UK but each large company – such as RMG – runs its own capital-based pension plan and is in principle free to define the features of its pension plan. As the pension benefits are an important means to attract employees, there exist significant differences between the individual pension plans over time as well across companies. While noting the UK's argument that RMG was in practice severely constrained in its ability to revise its pensions arrangements through a combination of legal and industrial relations concerns, the Commission does not accept the UK's description of the differences between the two cases as purely 'formal'.
- (144) These differences are reflected in the evaluation of the situation of La Poste and of RMG following implementation of the state aid measures in question. In the case of

La Poste, the social security contributions which La Poste would pay in order to be placed in the same situation as its competitors could be calculated in a mechanical way compared to the general pension system in France. In the case of RMG, given that large UK employers have a variety of different pension schemes, it does not seem possible to identify any existing pension plan as the single comparator which can be said to place RMG in the same situation as its competitors.

- (145) These same observations also apply to the UK's arguments that the State aid does no more than relieve RMG of abnormal charges in the sense of other decisions taken by the Commission, since the comparison to a general pension system is not possible. Furthermore, the UK's arguments that certain features of the RMPP (notably index-linking and retirement at age 60) could be considered abnormal are not conclusive in the light of the number of other UK pension schemes in which one or other of these features can also be found. Finally, it must be noted that, according to an expert study submitted by the UK, the claimed 'legacy' costs would at most explain [...] percent of RMPP's deficit.
- (146) Considering alternative explanations for RMPP's deficit, it must be noted that the RMPP was still in surplus during the 1990s as most other pension funds. It could be contended that the current deficit mainly resulted from general changes in the UK pensions environment after 2000 (e.g. rising life expectancy, bad financial performance of equity markets that affected in particular the RMPP because of its high holding of equities (e.g. up to 70 percent of the fund's assets at a certain time). Furthermore, it should be taken into account that, according to the information submitted by the UK, RMG's management decided to use up the surplus in the 1990s to grant benefit enhancements to members.
- (147) Regarding the allegedly above-average exposure of RMG to pension liabilities, the UK puts forward that the ratio of pension liabilities to EBITDA is much higher with RMG than other large UK companies. However, doubts exist whether the ratio of pension liabilities to EBITDA is an appropriate risk measure. As RMG is running a labour intensive business and has therefore low depreciation and amortization costs, its EBITDA will always be lower than with companies that are more capital intensive. The ratio of pension liabilities to EBITDA for RMG would therefore always be above the average of large UK companies even if all companies offered the same pension plan.
- (148) Furthermore, the comparison of the pension liabilities to EBITDA (as opposed to e.g. total assets or turnover) may create bias given that RMG's profitability is currently depressed. The Commission also notes that after the pension relief, the RMPP remaining with the company will be in balance, i.e. with assets of a value matching its liabilities. This would appear to be a relatively favourable position for a company running a defined benefit scheme.
- (149) The Commission does however recognise, as it already did in its 2009 Decision, that some liabilities of the RMPP arise from pension terms inherited from the UK civil service and from a period where RMG held a letters monopoly. It also recognises that RMG has taken progressive steps to limit the liabilities which would otherwise have built up in the RMPP, in particular through reforms carried out in 1987 and 2008. In addition it accepts the UK's observation that it is not proposing to relieve RMG of any of the burden for funding the future liabilities of its current employees, which will

remain with RMG on a defined benefit basis. These points may be relevant to the assessment of the proportionality of the State aid.

- (150) In conclusion, while carefully noting the UK's arguments, the Commission believes that to authorise the pension relief on this basis would constitute a significant extension of its previous practice. Such a step should only be considered on the basis of a thorough investigation which allows interested parties to comment.

## **10 COMPATIBILITY ASSESSMENT OF THE AID UNDER THE DEROGATION PROVIDED FOR IN ARTICLE 106(2) TFEU**

- (151) Although RMG is a public undertaking and has been entrusted with the operation of a service of general economic interest to provide postal services throughout the UK, the UK has not claimed up to now that the application of Article 107 TFEU would obstruct the performance of that public service mission. In accordance with the views of the UK, the Commission has therefore, at this stage, not been in a position to conduct an assessment under the derogation provided for in Article 106(2) TFEU.
- (152) However, given the doubts which the Commission raises at this stage as regards the applicability of Article 107(3)(c) TFEU to the restructuring plan of RMG, the Commission invites comments as to the extent to which the compatibility criteria should be qualified to take account of the public service missions entrusted to RMG and POL and/or the extent to which the Commission could apply alternatively Article 106(2) TFEU in this case.

## **11 CONCLUSION**

- (153) On the basis of the information currently available, the Commission has doubts on the compatibility of the notified aid measures under either of the bases for assessment which it has considered. As the measures are designed to fundamentally restructure the business of RMG, the Commission is particularly interested to give third parties the opportunity to comment. Furthermore, at this stage, the Commission also has doubts concerning the quantification of the aid amount that would result from the pension relief.

## **12 DECISION**

- (154) In the light of the foregoing considerations, the Commission, acting under the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union, requests the United Kingdom to submit its comments and to provide all such information as may help to assess the aid, within one month of the date of receipt of this letter. It requests your authorities to forward a copy of this letter to the potential recipient of the aid immediately.
- (155) The Commission wishes to remind the United Kingdom that Article 108(2) of the Treaty on the Functioning of the European Union, has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

(156) The Commission warns the United Kingdom that it will inform interested parties by publishing this letter and a meaningful summary of it in the *Official Journal of the European Union*. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publication of a notice in the EEA Supplement to the *Official Journal of the European Union* and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication.

If this letter contains confidential information which should not be published, 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 publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

European Commission  
Directorate-General for Competition  
Directorate F  
State Aid Greffe  
J-70 3/232  
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Yours faithfully,  
For the Commission

Joaquín ALMUNIA  
Vice-President