Public Document Pack

Overview and Scrutiny Committee Agenda

Tuesday, 31 October 2017
7.00 pm, Council Chamber
Civic Suite
Lewisham Town Hall
London SE6 4RU

For more information contact: Charlotte Dale (Tel: 020 8314 8286)

This meeting is an open meeting and all items on the agenda may be audio recorded and/or filmed.

Part 1

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Overview and Scrutiny Committee Members

Members of the committee, listed below, are summoned to attend the meeting to be held on Tuesday, 31 October 2017.

Barry Quirk, Chief Executive
Thursday, 19 October 2017

Councillor Alan Hall (Chair) Councillor Gareth Siddorn (Vice-Chair) Councillor Obajimi Adefiranye Councillor Abdeslam Amrani Councillor Chris Barnham Councillor Peter Bernards Councillor Andre Bourne Councillor David Britton Councillor Bill Brown Councillor Suzannah Clarke Councillor John Coughlin Councillor Liam Curran Councillor Brenda Dacres Councillor Amanda De Ryk Councillor Colin Elliott Councillor Carl Handley Councillor Maja Hilton Councillor Simon Hooks Councillor Sue Hordijenko Councillor Mark Ingleby Councillor Joyce Jacca Councillor Stella Jeffrey	

Councillor Liz Johnston-Franklin Councillor Roy Kennedy Councillor Helen Klier Councillor Jim Mallory Councillor Sophie McGeevor Councillor David Michael Councillor Jamie Milne Councillor Hilary Moore Councillor Pauline Morrison Councillor John Muldoon Councillor Olurotimi Ogunbadewa Councillor Jacq Paschoud Councillor John Paschoud Councillor Pat Raven Councillor Joan Reid Councillor Jonathan Slater Councillor Luke Sorba Councillor Eva Stamirowski Councillor Alan Till Councillor Paul Upex Councillor James-J Walsh Councillor Susan Wise Councillor Paul Bell	

MINUTES OF THE OVERVIEW AND SCRUTINY COMMITTEE

Tuesday, 11 July 2017 at 7.30 pm

PRESENT: Councillors Alan Hall (Chair), Gareth Siddorn (Vice-Chair), Abdeslam Amrani, Paul Bell, Peter Bernards, Andre Bourne, Bill Brown, John Coughlin, Brenda Dacres, Amanda De Ryk, Carl Handley, Maja Hilton, Sue Hordijenko, Councillor Joyce Jacca, Stella Jeffrey, Liz Johnston-Franklin, Helen Klier, Jim Mallory, Sophie McGeevor, David Michael, Jamie Milne, Pauline Morrison, John Muldoon, Olurotimi Ogunbadewa, Jacq Paschoud, John Paschoud, Joan Reid, Jonathan Slater, Luke Sorba, Alan Till and James-J Walsh

APOLOGIES: Councillors Chris Barnham, Suzannah Clarke, Colin Elliott, Simon Hooks, Mark Ingleby, Roy Kennedy, Hilary Moore, Eva Stamirowski and Susan Wise

ALSO PRESENT: Paul Aladenika (Service Group Manager, Policy Development and Analytical Insight), Andrew Potter (Chief Executive) (Lewisham Homes), David Austin (Head of Corporate Resources), Councillor Kevin Bonavia (Cabinet Member Resources), Sir Steve Bullock (Mayor), Charlotte Dale (Interim Overview and Scrutiny Manager), Jeff Endean (Housing Programmes and Strategy Team Manager), Barrie Neal (Head of Corporate Policy and Governance), Janet Senior (Executive Director for Resources & Regeneration), Kevin Sheehan (Executive Director for Customer Services), Martin Corbett (Borough Commander) (London Fire Brigade), Gary Price (Senior Fire Safety Officer) (London Fire Brigade), Guy Ware (London Councils) and Emma Talbot (Head of Planning)

1. Minutes of the meetings held on 23 January and 27 March 2017

1.1 **RESOLVED:** That the minutes of the meetings held on 23 January and 27 March 2017 be agreed as an accurate record.

2. Declarations of Interest

2.1 No declarations of interest were made.

The order of the agenda was changed, item 6 was taken next, followed by item 5, item 4, item 3, then item 7.

3. Business Rates Update

3.1 Guy Ware from London Councils was welcomed to the meeting. The presentation attached at Appendix A of the report was given and a discussion held on the content.

3.2 The following key points were made:

- The Local Government Finance Bill had not featured in the Queen’s Speech and clarity was being sought from Government in relation to the future of the business rates devolution proposals.

- A key principle of the proposed London pilot scheme would be that there should be no detriment to any participant (as was the case in existing pilots). i.e. an individual borough would not be any worse off under the pilot scheme than it would have been under existing arrangements.
- In terms of the proposed governance arrangements, initial agreement to participate would need to be unanimous but subsequent decisions would be taken on a majority basis (with the rules governing what constitutes a majority, to be agreed).

3.3 In response to questions from Members, the following points were noted:

- The three way split of proceeds (incentives pot, needs pot, investment pot) had been proposed in order to gain Government approval and to ensure unanimous agreement on the part of the boroughs. The scheme needed to fulfil the Government's policy purpose (promoting economic growth, with incentives to encourage high performing boroughs to continue to perform highly) and ensure that the boroughs' desire for better cross-London infrastructure was met (the investment pot) whilst addressing varying levels of need across the capital (needs pot). However, the percentages allocated to each pot were up for negotiation.
- It would be essential that boroughs did not become reliant on any additional funding generated as was currently the case with a number of sources of local government funding that did not form part of base budgets.
- Existing pools had memorandums of understanding covering the way in which members could leave, and the notice required, and a similar memorandum would be drawn up for the London pilot.
- The proposals did not represent autonomy over London's finances (only representing approximately £200m) but were an important concession in terms of financial devolution.
- The Government might still be minded to pursue the pilot in order to drive growth and meet the requirement in law, for funding generated by business rates to be spent on local government services (taking into account the current surplus).

3.4 The Chair thanked Guy Ware for providing a very informative presentation.

3.5 **RESOLVED:** That the report and presentation be noted.

4. Lewisham's Response to the Grenfell Fire

4.1 The Chair introduced the item, thanked all those involved in responding to the fire, and welcomed the Mayor to the meeting. The Mayor echoed these thanks, outlined the Council's responsibilities to all Lewisham residents in terms of fire safety and talked about short and long-term responses, anticipating fundamental changes to fire regulations and public housing over time.

4.2 The Chair welcomed Martin Corbett, and his colleague Gary Price, from the London Fire Brigade (LFB) to the meeting. Martin made the following key points:

- The LFB was reassuring residents in Lewisham tower blocks that where they live is safe.
- Whilst the responsibility for fire risk assessments lies with housing providers, the LFB had set up a task force to help councils conduct audits of 'high risk' buildings (mainly those with ACM cladding). Three buildings in Lewisham had ACM cladding.
- As a result of the Grenfell fire, the LFB's tactical plans had changed and they now sent five, rather than four, appliances to fires in tower blocks (a decision taken two days after the fire).
- The LFB was also conducting home fire safety visits (available on request) to reassure and assist worried residents.

4.3 In response to questions from the Committee it was noted that:

- There had been no requests, to date, in Lewisham, for audits of any non-residential buildings, but the LFB worked with commercial buildings on a daily basis. Gary Price confirmed that 30 inspecting officers had been seconded to a task force to inspect premises identified with ACM, regardless of the residential/commercial status of the building. The audits included an assessment of access, hydrants, voids, compartmentalisation, fire stops, fire doors and escape routes. They also involved scrutiny of the fire risk assessment. In addition, there was a specialist hospital team that would be inspecting Lewisham Hospital in due course. Schools would also be inspected in due course.
- The same tests were being conducted on each ACM sample and additional tests could also be undertaken. All landlords of tall buildings in Lewisham had been asked to test their cladding to DCLG standards and were doing this. All had responded although the results of some tests were still outstanding.
- Whilst the LFB would always advocate the use of sprinklers, there was a spectrum of opinion on whether they were always the best option. Kevin Sheehan confirmed that their use in Lewisham's social housing buildings would be considered should a fire safety risk assessment suggest they might be of benefit and installed wherever they would be the safest option.

4.4 Martin Corbett and Gary Price were thanked for attending the meeting and it was noted that the programme of work arising from this tragedy would continue and would continue to be scrutinised.

4.5 **RESOLVED:** That the relevant Select Committees keep this issue under review.

5. The Conservative Party Manifesto, Queen's Speech and Brexit Update

5.1 **RESOLVED:** That the report be considered by each Select Committee to inform the 2017/18 work programmes.

6. Thames Water Scrutiny

6.1 **RESOLVED:** That the joint recommendations outlined at paragraph 5.11 of the report, be endorsed.

7. Items to be referred to Mayor & Cabinet

The meeting ended at 8.35 pm

Chair: --

Date: --

Overview and Scrutiny Committee			
Title	Declarations of Interest	**Item No.**	2
Contributor	Chief Executive		
Class	Part 1 (open)		31 October 2017

Declaration of interests

Members are asked to declare any personal interest they have in any item on the agenda.

1 Personal interests

There are three types of personal interest referred to in the Council's Member Code of Conduct:-

(1) Disclosable pecuniary interests
(2) Other registerable interests
(3) Non-registerable interests

2 Disclosable pecuniary interests are defined by regulation as:-

(a) Employment, trade, profession or vocation of a relevant person* for profit or gain

(b) Sponsorship –payment or provision of any other financial benefit (other than by the Council) within the 12 months prior to giving notice for inclusion in the register in respect of expenses incurred by you in carrying out duties as a member or towards your election expenses (including payment or financial benefit from a Trade Union).

(c) Undischarged contracts between a relevant person* (or a firm in which they are a partner or a body corporate in which they are a director, or in the securities of which they have a beneficial interest) and the Council for goods, services or works.

(d) Beneficial interests in land in the borough.

(e) Licence to occupy land in the borough for one month or more.

(f) Corporate tenancies – any tenancy, where to the member's knowledge, the Council is landlord and the tenant is a firm in which the relevant person* is a partner, a body corporate in which they are a director, or in the securities of which they have a beneficial interest.

(g) Beneficial interest in securities of a body where:-

(a) that body to the member's knowledge has a place of business or land in the borough; and

(b) either
(i) the total nominal value of the securities exceeds £25,000 or 1/100 of the total issued share capital of that body; or

(ii) if the share capital of that body is of more than one class, the total nominal value of the shares of any one class in which the relevant person* has a beneficial interest exceeds 1/100 of the total issued share capital of that class.

*A relevant person is the member, their spouse or civil partner, or a person with whom they live as spouse or civil partner.

(3) Other registerable interests

The Lewisham Member Code of Conduct requires members also to register the following interests:-

(a) Membership or position of control or management in a body to which you were appointed or nominated by the Council

(b) Any body exercising functions of a public nature or directed to charitable purposes, or whose principal purposes include the influence of public opinion or policy, including any political party

(c) Any person from whom you have received a gift or hospitality with an estimated value of at least £25

(4) Non registerable interests

Occasions may arise when a matter under consideration would or would be likely to affect the wellbeing of a member, their family, friend or close associate more than it would affect the wellbeing of those in the local area generally, but which is not required to be registered in the Register of Members' Interests (for example a matter concerning the closure of a school at which a Member's child attends).

(5) Declaration and impact of interest on members' participation

(a) Where a member has any registerable interest in a matter and they are present at a meeting at which that matter is to be discussed, they must declare the nature of the interest at the earliest opportunity and in any event before the matter is considered. The declaration will be recorded in the minutes of the meeting. If the matter is a disclosable pecuniary interest the member must take not part in consideration of the matter and withdraw from the room before it is considered. They must not seek improperly to influence the decision in any way. **<u>Failure to declare such an interest which has not already been entered in the Register of Members' Interests, or participation where such an interest exists, is liable to prosecution and on conviction carries a fine of up to £5000</u>**

(b) Where a member has a registerable interest which falls short of a disclosable pecuniary interest they must still declare the nature of the interest to the meeting at the earliest opportunity and in any event before the matter is considered, but they may stay in the room, participate in consideration of the matter and vote on it unless paragraph (c) below applies.

(c) Where a member has a registerable interest which falls short of a disclosable pecuniary interest, the member must consider whether a reasonable member of the public in possession of the facts would think that their interest is so significant that it would be likely to impair the member's judgement of the public interest. If so, the member must withdraw and take no part in consideration of the matter nor seek to influence the outcome improperly.

(d) If a non-registerable interest arises which affects the wellbeing of a member, their, family, friend or close associate more than it would affect those in the local area generally, then the provisions relating to the declarations of interest and withdrawal apply as if it were a registerable interest.

(e) Decisions relating to declarations of interests are for the member's personal judgement, though in cases of doubt they may wish to seek the advice of the Monitoring Officer.

(6) Sensitive information

There are special provisions relating to sensitive interests. These are interests the disclosure of which would be likely to expose the member to risk of violence or intimidation where the Monitoring Officer has agreed that such interest need not be registered. Members with such an interest are referred to the Code and advised to seek advice from the Monitoring Officer in advance.

(7) Exempt categories

There are exemptions to these provisions allowing members to participate in decisions notwithstanding interests that would otherwise prevent them doing so. These include:-

(a) Housing – holding a tenancy or lease with the Council unless the matter relates to your particular tenancy or lease; (subject to arrears exception)
(b) School meals, school transport and travelling expenses; if you are a parent or guardian of a child in full time education, or a school governor unless the matter relates particularly to the school your child attends or of which you are a governor;
(c) Statutory sick pay; if you are in receipt
(d) Allowances, payment or indemnity for members
(e) Ceremonial honours for members
(f) Setting Council Tax or precept (subject to arrears exception)

Agenda Item 4

Overview and Scrutiny Committee		
Title	Post Office changes	
Contributor	Executive Director for Customer Services	Item 4
Class	Part 1 (open)	31 October 2017

1. Summary

1.1 This report updates the Overview and Scrutiny committee on the changes to New Cross and Sydenham Post Offices and the actions that have been taken.

2. Recommendation

2.1 Note the actions taken to date.

3. Background

3.1 The Post Office plans to introduce changes to the operation of New Cross and Sydenham Crown Post Offices. The plan is to change these Crown Post Offices to franchises which the Post Office says will allow them to keep these services on the high street.

3.2 On 22 February 2017 a motion was adopted at Council calling for New Cross Post Office to remain open and for it to be operated and managed directly by the Post Office.

3.3 On 8 March 2017 the Sustainable Development Select Committee considered a report about the Post Offices changes. On the 22 March 2017 the Sustainable Development Select Committee referred their discussions on the Post Office changes to Mayor and Cabinet and asked that:

- The Mayor write to the government minister responsible and the Chief Executive of the Post Office about the potential loss of Sydenham Crown Post Office
- Officers be tasked with investigating how lease arrangements might be negotiated to retain the Crown Post Office in Sydenham
- The Mayor writes to Jim Dowd MP about the potential closure
- The Council requests further information from the Post Office about its strategy to preserve the full range of Post Office services for Lewisham residents.

3.4 On the 19 July 2017 a report went back to Mayor and Cabinet outlining the actions that had been taken in response to the request made and confirmed all actions had been completed. This report went to the Sustainable Development Select Committee on the 13 September 2017 where the updates were noted.

3.5 The Executive Director for Customer Services was asked to provide a further update. This report provides that update.

4. Update

4.1 The Mayor has written to Ellie Reeves MP, the Chief Executive of the Post Office and the minister responsible opposing the changes to the Sydenham Post Office. The Post Office Chief Executive has also been asked for further information about their strategy to preserve the full range of Post Office services for Lewisham residents.

Update - Sydenham

4.2 The Post Office occupy the ground floor of 44 Sydenham Road. Terms for the proposed lease renewal have now been agreed and solicitors instructed to draw up the new lease.

4.3 The Post Office timetable was to complete the consultation on 26 May 2017 and to make the changes in August 2017. The Post Office say that they are still at the decision making stage. Once a decision is made they will communicate this to staff at the branch, then to locally elected stakeholders, then to customers. The communication would include details of the feedback they received and how this was considered in the process.

Update – New Cross

4.4 The Post Office timetable was to complete the consultation on the 18 October 2017 and implement the changes in February 2018. The Post Office say that the consultation will help them take all relevant factors into account when making their final decision on whether to make the proposed changes. A period of review will commence after the 18 October 2017 and a decision will be made as soon as possible. The process for communicating the decision will be the same as for the Sydenham branch.

Other Post Office changes

4.5 In their update the Post Office wanted to make the Council aware of the new agreement they have with UK banks which came into effect in January 2017. The agreement brings together the Post Office's existing arrangements with individual banks into a single set of services available to customers of virtually all UK banks which allows personal and business customers to withdraw cash, deposit cash and cheques and make balance enquiries at all Post Office branches.

4.6 The Post Office say that currently there are not any changes proposed to the remaining branches in Lewisham and that any future changes would be communicated to the elected MP and the Council in line with their code of practice.

5. Financial Implications

5.1 There are no financial implication arising out of this report per se; but there may be financial implications arising from carrying out the actions.

6. Legal Implications

6.1 The constitution provides for select committees to refer reports to Mayor and Cabinet who are obliged to consider the report and the proposed responses from the relevant Executive Director and report back to the committee within 2 months (not including recess).

6.2 The Equality Act 2010 (the Act) introduced a public sector equality duty (the equality duty or the duty). It covers the following protected characteristics: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation.

6.3 In summary, the Council must, in the exercise of its functions, have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation and other conduct prohibited by the Act.
- advance equality of opportunity between people who share a protected characteristic and those who do not.
- foster good relations between people who share a protected characteristic and those who do not.

6.4 It is not an absolute requirement to eliminate unlawful discrimination, harassment, victimisation or other prohibited conduct, or to promote equality of opportunity or foster good relations between persons who share a protected characteristic and those who do not. It is a duty to have due regard to the need to achieve the goals listed above.

6.5 The weight to be attached to the duty will be dependent on the nature of the decision and the circumstances in which it is made. This is a matter for the Mayor, bearing in mind the issues of relevance and proportionality. The Mayor must understand the impact or likely impact of the decision on those with protected characteristics who are potentially affected by the decision. The extent of the duty will necessarily vary from case to case and due regard is such regard as is appropriate in all the circumstances.

6.6 The Equality and Human Rights Commission has issued Technical Guidance on the Public Sector Equality Duty and statutory guidance entitled “Equality Act 2010 Services, Public Functions & Associations Statutory Code of Practice”. The Council must have regard to the statutory code in so far as it relates to the duty and attention is drawn to Chapter 11 which deals particularly with the equality duty. The Technical Guidance also covers what public authorities should do to meet the duty. This includes steps that are legally required, as well as recommended actions. The guidance does not have statutory force but nonetheless regard should be had to it, as failure to do so without compelling reason would be of evidential value. The statutory code and the technical guidance can be found at: https://www.equalityhumanrights.com/en/advice-and-guidance/equality-act-codes-practice

https://www.equalityhumanrights.com/en/advice-and-guidance/equality-act-technical-guidance

6.7 The Equality and Human Rights Commission (EHRC) has previously issued five guides for public authorities in England giving advice on the equality duty:

The essential guide to the public sector equality duty

Meeting the equality duty in policy and decision-making

Engagement and the equality duty: A guide for public authorities

Objectives and the equality duty. A guide for public authorities

Equality Information and the Equality Duty: A Guide for Public Authorities

6.8 The essential guide provides an overview of the equality duty requirements including the general equality duty, the specific duties and who they apply to. It covers what public authorities should do to meet the duty including steps that are legally required, as well as recommended actions. The other four documents provide more detailed guidance on key areas and advice on good practice. Further information and resources are available at: https://www.equalityhumanrights.com/en/advice-and-guidance/public-sector-equality-duty-guidance#h1

7. Equalities Implications

7.1 There are no direct implications arising from this report. However, access to Post Office services for the community has equalities implications that the Post Office should be considering.

Background papers

Meeting of Council 22 February 2017:

http://councilmeetings.lewisham.gov.uk/ieListDocuments.aspx?CId=138&MId=4255

Sustainable Development Select Committee agenda 8 March 2017:

http://councilmeetings.lewisham.gov.uk/ieListDocuments.aspx?CId=136&MId=4176

Sustainable Development Select Committee agenda 13 September 2017:

http://councilmeetings.lewisham.gov.uk/ieListDocuments.aspx?CId=136&MId=4639

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Making the Case for a Post Bank

Report Prepared for the Communications Workers Union

September 2017

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CONTENTS

EXECUTIVE SUMMARY

This report sets out the case for a Post Bank in the UK.

The establishment of a Post Bank provides a solution which would enable the Post Office to ensure its long-term sustainability, by diversifying its portfolio of activities and increasing revenues. In addition, a state-owned Post Bank would also enable other important economic and social goals:

- better access to finance for Small and Medium Enterprises (SMEs)
- improved financial inclusion
- a rebalancing of the UK economy away from London and other major urban centres

The establishment of a Post Bank would also align the Post Office with the successful strategy of other postal operators around the world.

Post Office banking services are currently provided by the Bank of Ireland UK (Plc).

Background

Since 2010, the economic and financial landscape in the UK has changed substantially. Our analysis suggests that the Post Office's current partnership with the Bank of Ireland has not delivered the expected and potential results. The revenues the partnership has brought in for the Post Office remain significantly lower than post banks around the world and it has not delivered a full range of banking products for the Post Office's customers.

During a period where many new challenger banks have obtained a banking licence and some, such as Metro Bank, have managed to grow significantly, the Bank of Ireland has decreased its investments in the UK. The Irish lender was severely weakened by the financial crisis and needed state bailouts. To approve state aid, the European Commission imposed conditions which forced the Bank of Ireland to sell non-core activities, including its business banking and corporate banking activities in Great Britain, resulting in a significant gap in the partnership's provision of financial services which includes no business banking services. Another significant weakness is the failure to roll out current accounts on a national basis.

A proposal for the creation of a Post Bank was put forward in 2009 and rejected by the government in 2010, which concluded that the Post Office should continue to build on its existing relationship with the Bank of Ireland (UK) Plc. The arguments behind this rejection were:

1. It would be costly
2. It would require a new set of skills
3. It would introduce increased risk in the Post Office's balance sheet
4. It would be difficult to gain market share in a very competitive market.

Our proposal for a Post Bank addresses each of these concerns.

Recommendations

Our recommendation is that the partnership with the Bank of Ireland should be ended, for two key reasons:

1. Due to the persistent negative legacy from the financial crisis and further current challenges, the Bank of Ireland is unlikely to invest substantially in the partnership in the near future.
2. In more general terms, a partnership model with a large private bank for the provision of postal financial services leaves the Post Office's ambitions for growth dependent on the fortunes of the partner.

We advise that the Post Office acquires the Bank of Ireland UK portfolio (or part thereof), thereby retaining all the customers that have acquired products and services white-labelled via Post Office Money. This strategy would alleviate previous concerns that it would be difficult to gain market share in a very competitive market. This would also allow the Post Office to capitalise on existing skills and expertise.

We recommend that the Post Bank be set up as a subsidiary, with a separate management team. This would facilitate the newly established entity application for a banking licence to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). It would also help ease the government concern that a Post Bank would introduce risk to the Post Office's balance sheet, as the new entity would be endowed with its own capital.

We estimate that the initial equity should be in the region of £2 billion. This amount of equity would be sufficient, for example, to allow the Post Bank to acquire the Bank of Ireland UK portfolio. While we discuss different alternatives to raise this initial capital, the amount equates to the investment the government has put into the Post Office in the past seven years. We estimate that the profits the Post Bank would generate would eliminate the need for an ongoing annual subsidy for the Post Office and put it on a sustainable footing for the future. Furthermore, the current macroeconomic conditions are ideal to raise the initial capital, due to the low interest rates environment.

Opportunities: building on existing strengths

A Post Bank is an opportunity to build on the Post Office's significant existing strengths.

The report identifies market opportunities for a Post Bank, particularly in SME lending. Several policy institutions in the UK have expressed concerns about a lack of competition in this market segment, which results in restricted access to finance for small and medium size firms.

This sector is characterised by barriers to entry such as a need for an extensive branch network and the offering of a broad range of financial products. Notably, while these represent barriers for traditional credit institutions, and even more so for newcomers, they would not be barriers for a Post Bank, as it could leverage on its large branch network very efficiently and on the current offer of a broad range of financial products through its partnerships and joint ventures.

Additionally, the Post Bank could join forces with those challenger banks that specialise in SME lending, in order to take full advantage of this opportunity, acquire new technology and make sure that lending and related risks are managed prudently and in a sustainable way. **We**

posit that there is room for a Post Bank as a new player aiming to gain market share in this sector—thus benefiting the whole economy.

In this strategy, the Post Bank will also capitalise on other existing strengths of the Post Office which include the **very positive public perception of the Post Office brand** compared to financial institutions. A strong brand and a solid reputation are key factors for a successful new player in any financial system, but these usually take years to build – the Post Office already has this significant advantage.

Finally, the capillary structure of the Post Office branch network puts the new Post Bank in a strong position to support financial inclusion by addressing the large pockets of people and small firms which are currently unbanked or face the consequences of the branch closure programmes operated by banks.

Introduction

This report sets out the case for a Post Bank in the UK. We will argue that a Post Bank is a viable business opportunity that will enable the government to achieve several objectives.

Firstly, it will contribute to the revenues of the Post Office, thereby ensuring its long-term sustainability and ending its reliance on government subsidies. Secondly, a Post Bank will also increase competition in the banking sector and offer a wider choice to consumers and a much-needed alternative source of funding to small businesses, thus contributing to the country's economic growth. Building upon the strong Post Office brand, a unique, capillary branch network, and free from the legacy of the financial crisis that still affects traditional banks, a Post Bank can be a modern, sophisticated and innovative player offering a range of banking services at a large scale.

The idea of a Post Bank is neither new nor exclusive to the UK. Declining revenues from postal services and mail business are a common experience for Post Offices around the world and the need to diversify revenue has become a necessity for them in most countries. A Post Bank is an established and successful player with a long history of collecting deposits and offering postal savings services to the public in many countries. They are often set up following major restructuring of the traditional Postal Service.

In Germany, the independent Deutsche Postbank was established in 1990, following the split of the Deutsche Bundespost into the three companies: Post, Telekom, and Postbank. Japan Post Bank (Yū-cho) was established in 2006, again following a restructuring of the sector. Along similar lines, the establishment of the BancoPosta in Italy in 1999 was part of the restructuring of Poste Italiane. Several examples from other countries show that a Post Bank can be a sophisticated, innovative and profitable player in the financial services industry, capitalising on core strengths (such as brand and branch network) and contributing to economic growth while delivering returns to shareholders.

The idea of a British Post Bank is also not new: In 2009, the Post Bank Coalition—a group comprised of the Federation of Small Businesses, Countryside Alliance, the New Economics Foundation, Unite, CWU and others—presented a case for a Post Bank in the UK. The group campaigned for a state-owned bank to be established in the Post Office. However, they were unsuccessful. In 2010, the Department of Business Innovation & Skills (BIS) recognised that a Post Bank was, in principle, a good idea, but they raised the following concerns:

1. Capitalising a new bank would be time consuming and expensive
2. It would require the development of a new set of skills
3. It would create a much more volatile and risky balance sheet
4. It would necessitate building a significant market share very quickly in a competitive market.

BIS (2010)[1] concluded that:

[1] https://www.gov.uk/government/publications/securing-the-post-office-network-in-the-digital-age.

"*Post Office Ltd should build on its relationship with the Bank of Ireland. The Bank of Ireland is committed to making a success of its tie-up with the Post Office and has major plans to expand in Britain*."

As we set out below, this expansion has not happened. Furthermore, since then, market circumstances have changed significantly, and have resulted in a more favourable environment for the establishment of a Post Bank. In this report, we will argue that the establishment of a Post Bank is not only a viable business opportunity, but also a means by which to increase competition in parts of the banking sector that have high barriers to entry. We will point out and discuss the reasons why the partnership with the Bank of Ireland is not delivering the expected and potential results and we will propose and evaluate alternatives strategies. In doing so, we will provide counter-arguments to the concerns raised above.

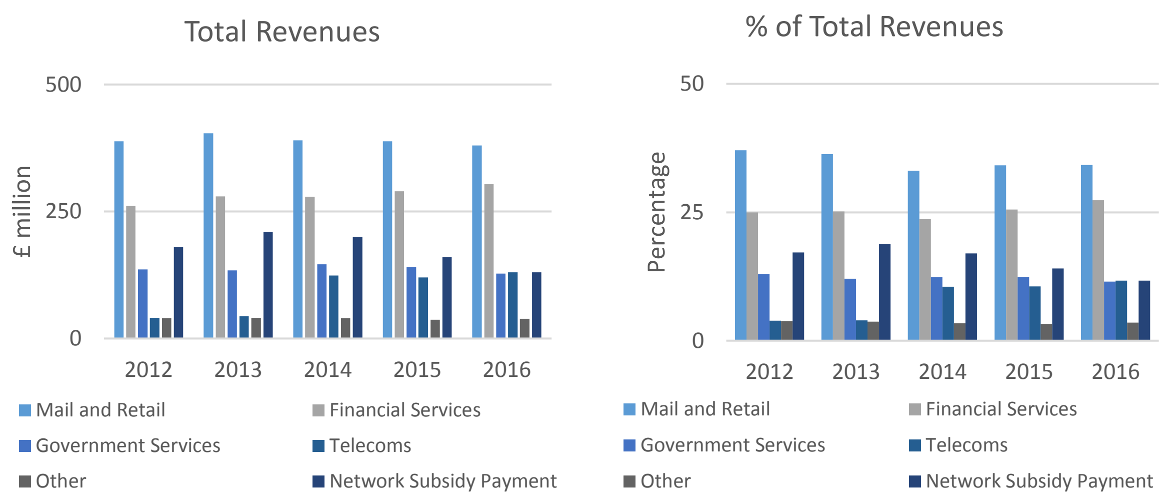
To present the case for the establishment of a Post Bank, **Part I** of this report evaluates the current performance of Post Office Ltd and of **Post Office Money** (the financial services brand operated by Post Office Ltd). **Part II** discusses the relevant changes in the financial services sector since the previous Post Bank proposal. The objective is to emphasise that most of the assumptions, which led to the government decision to prioritise the partnership model with the Bank of Ireland are no longer relevant. **Part III** of this report will provide a detailed proposal for the establishment a profitable Post Bank, by highlighting market opportunities and more importantly, by emphasising how the Post Office can leverage its current strengths.

Part I. Current situation of the Post Office

1. Current performance of Post Office Ltd

The current performance of the Post Office Ltd highlights the need for revenue diversification. In 2016, the Post Office revenues decreased by £43 million (-3.6%) to £1,136 million (Figure 1). This includes the decrease of £40 million in the Network Subsidy Payment from the government, which is expected to continue decreasing in the following years. Moreover, the operating loss in 2016 was £24 million, despite a series of cost-saving measures implemented since 2012, when the operating loss was £119 million.

Figure 1. Post Office Revenues from Financial Services



Source: Post Office Ltd Annual Reports, various years.

One part of the business where revenues increased is across Financial Services, in aggregate, operated via Post Office Money. This trend is in line with income diversification generated by Postal Operators (or Posts) around the world, as financial services revenues are increasingly used to diversify the sources of income and offset the decline in the traditional postal business. In industrialised countries, revenue from financial services (as share of total revenues) has increased from 10.8% in 2005 to 16.6% in 2015 (Box 1).

BOX 1: Current Trends in Postal Financial Services around the world

Despite their key role in a country's economy, postal operators around the world are currently facing financial difficulties. The main reasons why several postal operators have been operating at a loss—or have seen their profits decline dramatically—include **the strong decline in traditional mail revenues** (for both domestic and international services), which has not been fully compensated by the increase in parcel revenues. Another reason is that the **postal sector has been liberalised in many countries**, and hence those postal services that used to have a monopoly position now face domestic and international competition.

With increased competition and declining revenues, diversification into other services has become a necessity for the viability of Post Offices in many countries.

These trends have led Post Offices to diversify their business into financial services to generate profits or at least to compensate losses from traditional business. Across industrialised countries, the share of income from postal financial services increased from

10.8% in 2005 to 16.6% in 2015. This share of income is even higher for European countries, reaching 22.8% in 2015.

Industrialised countries

- Share of income from postal financial services in 2005: 10.8%
- Share of income from postal financial services in 2015: 16.6%

Europe

- Share of income from postal financial services in 2005: 19.2%
- Share of income from postal financial services in 2015: 22.8%

Italy

In 2015, **Poste Italiane** operating profit was €880m, of which:

- Operating loss of €568m in the core postal business
- Operating profit of €930m in the financial services unit
- Operating profit of €487m in the insurance unit

New Zealand

In 2015, **New Zealand Post Office** operating profit was NZD143mn – of which:

- Operating loss of NZD3m for mail and logistics services
- Operating profits of NZD132m from financial services

Switzerland

PostFinance represents 56% of the Group's operating profits

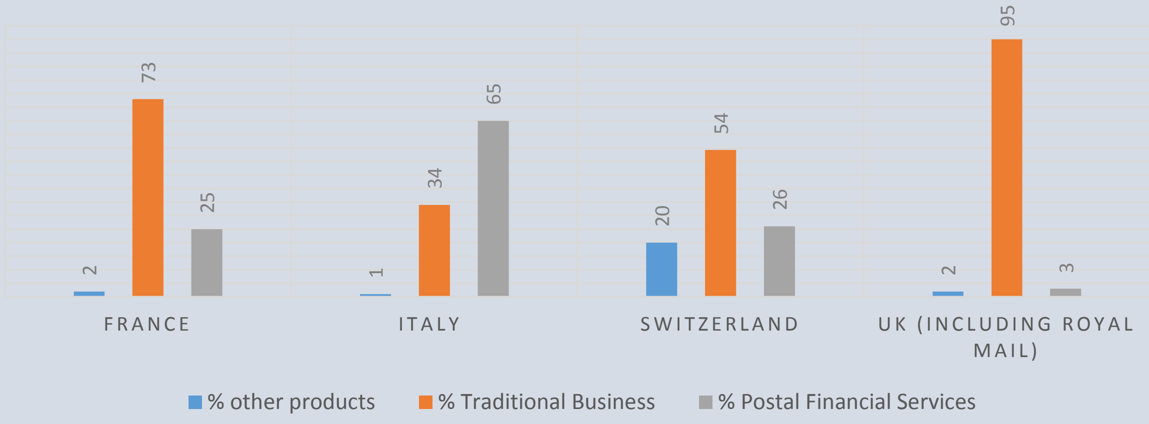
France

La Banque Postale represents about 25% of Poste Group's overall operating profit, roughly the same the parcels business.

Figure 1.1 presents a comparison in terms of income composition for France, Italy and Switzerland, where the national Post has expanded strongly in the financial services provisions via the establishment of a Post Bank. UK data are sourced from the Post Office and Royal Mail annual reports; this allows us to compare the financial revenues with the revenues from the whole postal business as it is the case for the other countries.

Adding the 2015 revenues for Royal Mail UKPIL — Royal Mail's core UK business (£7,757m) — to the Post Office revenues would see the percentage of income from postal services in the UK to account for just above 3%.

Figure 1.1. Percentage of income from postal financial services (selected countries) in 2015



Source: Data from Universal Postal Union (UPU) Database, Post Office Annual Report 2015, and Royal Mail Annual Report 2014-15.

Post Office Money is a financial services brand operated by Post Office Ltd, which provides credit cards, insurance products, mortgages and personal loans to customers in the United Kingdom through **Post Office** branches, the internet and telephone.

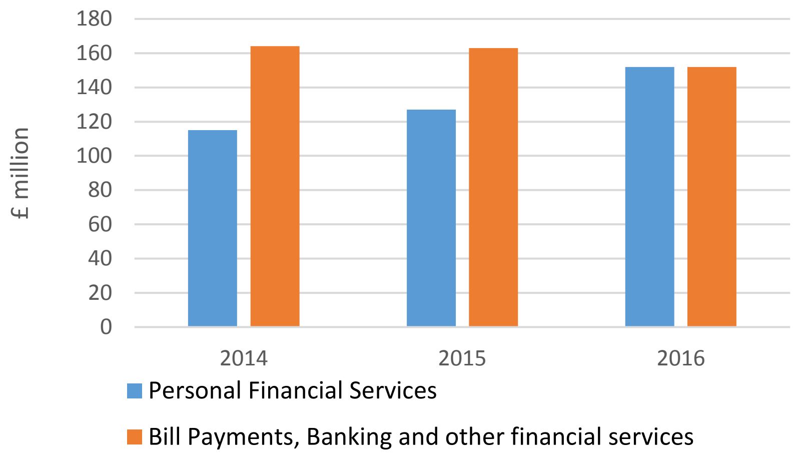
For the Post Office Ltd, Financial Services revenues are allocated between *Personal Financial Services* and *Traditional Financial Services* products:

1. *Personal Financial Services* include savings commissions (ISAs and online savings), insurance and new mortgage products.

2. *Traditional Financial Services* include bill payment services, business banking services and Postal Orders.

Revenues from *Personal Financial Services* have increased recently, driven by a strong growth in savings commissions (particularly ISAs and online savings), insurance and new mortgage products. However, revenues from *Traditional Financial Services* products have declined. Much of this decline is commonly attributed to the increased use of online banking services and decrease in bill payment services and Postal Order. However, it is also driven by the fact that business-banking services are no longer offered by the Bank of Ireland UK (the current partner of the Post Office for the provision of banking services). In fact, taking into account the lack of revenues from business banking, traditional financial services have remained remarkably profitable.

Figure 2. Post Office Revenues from Financial Services



Source: Post Office Ltd Annual Reports, various years

Table 1 shows the Post Office's current business model for the provision of financial services, under the umbrella of Post Office Money, for each of the three types of financial services offered: i) banking services; ii) insurance services; iii) currency services.

i) For the provision of banking services, the Post Office launched a joint venture with the Bank of Ireland (Midasgrange Ltd) in 2004. In 2012, the Bank of Ireland bought out the Post Office's share of this joint venture for £3m and moved to a contractual relationship between the two organisations that runs until 2023. Under the new agreement, which is referred to as an *exclusive partnership*, the Bank of Ireland is responsible for product development and delivery while the Post Office has the primary responsibility for product sales and marketing and ensuring all customer interactions meet the Post Office's brand values. In addition, the Post Office also offers a Post Office card account, designed especially for receiving pensions, benefits and tax credit and aimed at people without a bank account. The Post Office card account is offered by J.P. Morgan Europe Ltd.

ii) In the insurance business, the Post Office has recently completed its first acquisition, buying the joint insurance business from the Bank of Ireland (UK) plc and incorporating it into its subsidiary Post Office Management Services Limited, which operates the business alongside its existing travel insurance activities. From the date of acquisition (September 2015) the insurance business has contributed £15m of financial services revenue and £6m of profit before tax.

iii) For currency services, the Post Office has a joint venture with the Bank of Ireland, called First Rate Exchange Services Holdings Limited, whose principal activity is the supply of foreign exchange in the UK. The Post Office owns 50% of First Rate Exchange Services Holdings Limited, which generated £35m in dividends in 2015-2016.

For banking services, the reliance on the partnership with the Bank of Ireland is very strong (it is the only partner for almost all banking services), whereas for other financial services Post Office Money acts as a platform for different providers. In the provision of insurance services, the Post Office both offers own products (travel insurance) and sells policies of specialist providers. Overall, the profits from the foreign currency Joint Venture increased significantly in absolute terms since 2012, but decreased by £1m in 2015/16.

Table 1. Post Office Money – the current business model

Banking services	Provider	Insurance services	Provider	Currency services	Provider
Current Accounts	Bank of Ireland	Travel Insurance	Post Office Limited and Post Office Management Services Limited (bought out Bank of Ireland in 2015)	Travel Money	First rate Exchange Services Ltd (Post Office and Bank of Ireland joint venture 50-50)
Credit cards Personal Loans	Bank of Ireland	Home Insurance Motor Insurance	BISL Limited Devitt Insurance Services Limited		
Mortgages Money ISAs	Bank of Ireland One Family	Life Insurance Business Insurance	Royal London Arthur J. Gallagher Insurance Brokers Limited		
Savings	Bank of Ireland	Pet Insurance	Pinnacle Insurance Plc		
Post Office Card Account	J.P. Morgan Europe Ltd.				

In general terms, Post Office Money's business model follows the *Partnership Model* (*BM3 – Partnership with a financial services provider*); see Box 2 for a description of business models. This model has both advantages and disadvantages, as shown in Table 2. One of the main drawbacks of the partnership model in terms of revenue generation is the strong dependence on the partner's willingness or ability to expand the business. This dependence is even more critical when the partner is a traditional bank facing financial distress, following the legacy of the financial crisis, as is the case with the Post Office's partnership with the Bank of Ireland. Instead, a Post Bank (*BM4* and *BM5*) has no such dependence.

Table 2. Partnership model: Advantages and disadvantages

Advantages	Disadvantages
Easier implementation in terms of changes to the organisation	Products offered may not come with the Post's brand. No say on the quality of products and on the sales strategy.
No significant initial investment required	Limited revenue if only certain functions are performed.
Possibility of partnership with multiple providers	Reliance on the partner for the provision of services (i.e. if the partner is a bank, exposure to the banking industry) and reputational risks.
Easier in terms of regulatory burden	Possible coordination issues with the partner(s)
Lower exposure to financial risks	Limited impact on financial inclusion
Brand capitalisation	Limited training/learning process for staff who fail to acquire the necessary skills

BOX 2: Different arrangements for the provision of financial services

By choosing the types of postal financial services to offer and the business strategies to adopt, Postal operators define their business model. These models are constantly evolving because of economic and political changes, making it difficult to identify winning models and strategies. In general terms, Post Offices have adopted one or a combination of five business models (BMs) described below, presented in order of increasing commitment and potential impact on revenues and financial inclusion.

Figure 4: Business models for Post operators offering Postal Financial Services.

Source: Authors' elaboration based on Universal Postal Union (UPU), 2016.

BM 0: Real estate provider (no provision of financial services)

Under this strategic model, the Post Office enters into an arrangement with an external financial services provider whereby the partner uses the space rented in a postal branch to install an office or a window, and provides its own services with its own staff. In this case, the Post Office plays no role in the provision of the services.

BM 1: Cash merchant

The Post Office acts as a cash-in/cash-out agent for one or various partners (Money Transfer Operators (MTO); Mobile Money Operators (MMO); government entities; utility companies; financial institutions, etc.). The services facilitated by the Post Office are transactional financial services, such as remittances, bill payments, mobile payments, account withdrawals/deposits. This is the easiest model to deploy for Post Offices that are starting to offer financial services as it does not require much know-how and is relatively inexpensive to organise.

BM 2: Proprietary domestic and cross-border payments

The Post Office operates its own domestic payments and international remittance services (for the latter, also in partnership with other Post Offices).

BM 3: Partnership with a financial services provider

The Post Office partners with a financial services provider, such as a bank, an insurance company, an MTO (Money Transfer Operator), or a microfinance institution (MFI) to offer the financial services of that partner. The main difference from the previous model is that the Post Office is not merely providing cash-in/cash-out services, but is much more involved in the provision of the services. Products can be developed jointly with the partner and adapted to the postal clientele. In many of such partnerships, the postal brand is used to sell financial products. In the BM 3 model, the Post Office is involved fully in all front-office aspects and postal staff has an important role to play in promoting financial services.

BM 4: Postal savings bank

Under this model, the Post Office offers its own insurance and/or account-based services (savings or current accounts), under a regulatory framework that is specific to the Post. This is the traditional postal savings model. Usually in BM 4, the Post is not allowed to offer lending services or any other sophisticated financial products, which is often one of the main reasons why Post Offices are willing to transition to BM 5.

BM 5: Fully-fledged postal bank

Under this model, the Post Office offers its own insurance and/or account-based services as well as loans, but under the supervision of the central bank or financial services regulatory authority. In some cases, postal banks still have some limitations either on the type of product they can offer (not all types of loans for example) or the clientele they can target. The products have the postal brand and are defined in accordance with the role of the Post Office.

Key Points

- *The Post Office is currently suffering from weak financial performance, and lacks a clear plan to ensure its long-term sustainability.*
- *Revenues from financial services via Post Office Money are increasing but still limited, both in terms of the range of products generating revenues and in terms of plans to grow the banking business.*
- *The revenues currently generated via Post Office Money are substantially below those achieved by Posts offering financial services via a Post Bank in other countries.*

2. The Partnership with the Bank of Ireland UK

As mentioned above, the provision of banking services of the Post Office relies almost entirely on the partnership with the Bank of Ireland (UK) plc, which is a separately incorporated subsidiary of Bank of Ireland Group, employing 505 staff (full-time equivalent) in the UK at the end of 2016. The partnership was first established in 2003 as a joint venture and in 2007 it was renewed to 2020. In 2012, the Bank of Ireland bought out the Post Office's share of the joint venture and moved to a contractual relationship, defined as an *exclusive partnership,* which runs until 2023. The Bank of Ireland (UK) plc has no branches and relies on Post Office branches to distribute financial products and raise deposits. Table 3 outlines the bank's recent history. The Bank of Ireland was severely affected by the financial crisis and needed two state bailouts. The European Commission (EC) approved two restructuring plans in 2010 and 2011, which entailed deleveraging and selling non-core activities, including the exit from its business banking and corporate banking activities in Great Britain.

Table 3. Key events for the Bank of Ireland (BOI) after the financial crisis

2009	**The Irish government provides €3.5bn for recapitalisation of the BOI and other state aid assistance.**
2010	Bank of Ireland UK plc is incorporated and established as a separate legal entity. The partnership with the Post Office (created in 2003) in terms of **a Joint Venture** is **extended to 2020.** A first restructuring plan was approved by the European Commission (EC), on 15 July 2010. The plan anticipates that the BOI will pay a considerable proportion of its own restructuring costs, to limit competitive distortions deriving from state aid. The BOI is forced to reduce its presence in certain market segments through the transfer or winding down of assets and through divestitures. **The plan requests that the BOI significantly reduces its presence in the UK corporate lending market.**
2011	The EC confirms the second restructuring plan for the BOI in December 2011. The plan is meant to restore the bank's viability by exiting risky portfolios and by implementing more prudent risk management practices. The BOI will have to substantially deleverage its balance sheet to reduce its dependency on wholesale funding, and will need to refocus its business model on balanced-risk lending in Ireland and the United Kingdom. The plan also ensures a fair burden sharing of past losses and that the bank and its capital providers contribute significantly to the financing of the restructuring costs by selling several businesses and portfolios.
2012	The BOI records a loss of €1.8bn (£1.6bn) for 2012. The value of customer deposits rises from €16bn to €19bn during the year, exceeding expectations. **The BOI buys out the Post Office from their 50% share in the joint venture (Midasgrange Ltd). The new partnership agreement is extended to 2023.**
2013	The EC authorises changes to BOI's second restructuring plan, approved in December 2011. The BOI is no longer required to divest New Ireland Assurance Company (NIAC), but **confirms the exit from the Great Britain Business Banking and Great Britain Corporate Banking businesses.** Additionally, the Irish authorities commit to ensure that the BOI will extend limitations on the distribution of

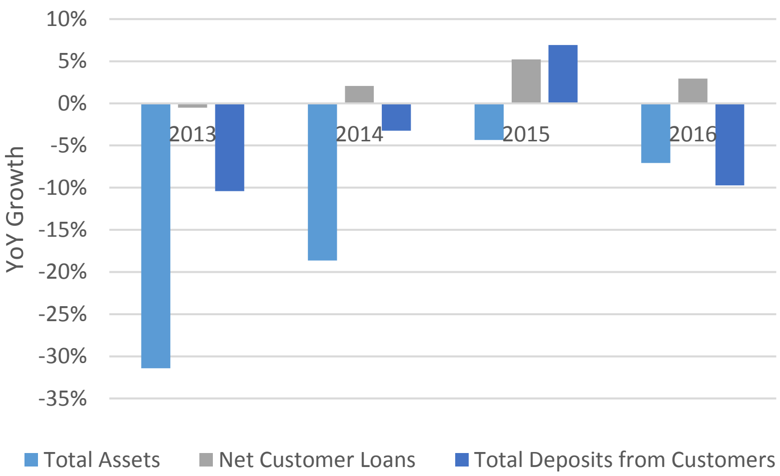
	dividends beyond December 2015 or until it has reimbursed the Irish State for the preference shares.
2014	Regulation of the bank transferred to the European Central Bank (ECB).
2015	The Bank of Ireland sells the joint insurance business to the Post Office Ltd, which incorporates it into its subsidiary Post Office Management Services Limited.
2017	The Group intends to implement a corporate reorganisation, which would result in the Bank of Ireland Group plc (BOIG plc) being introduced as the listed holding company of the Group. The reorganisation will be implemented by a scheme of arrangement under the Companies Act 2014 (the "Scheme"). The corporate reorganisation was required by the EU's Single Resolution Board and the Bank of England to provide a framework for the bail-in of bondholders in the event of another financial crisis.

Source: EU Commission, Bank of Ireland and Post Office press release.

After several years of severe losses following the financial crisis, the Irish lender returned to profitability in 2014. Despite posting a pre-tax profit of about €1bn in 2016, the overall performance of the Bank of Ireland is still uncertain as the latest profit figure is 16% lower than in 2015.

Since its establishment, the overall performance of the UK subsidiary of the Bank of Ireland has been similarly lacklustre, as illustrated in Figure 3, with a noticeable decrease in 2016 in terms of total assets and total deposits from customers.

Figure 3: Bank of Ireland expansion into the UK banking system



Source: Data from Bank of Ireland (UK) annual reports.

Commenting upon the performance of the Bank of Ireland UK, analysts suggest that the lender still faces several challenges, both legacy issues and several new ones.[2] Among the new potential threats to the Bank of Ireland's operations are the risks deriving from currency fluctuations following the Brexit referendum, the potential litigation costs and reputational

[2] The legacy problems derive mainly from the Irish bank financial operations and do not relate to the UK portfolio.

losses related to the tracker mortgage review case and the need for restructuring its IT system.[3] We review these challenges below.

Brexit. Currency fluctuations strongly impacted the 2016 results. The Bank of Ireland has a substantial exposure to the UK market, the highest among Irish institutions. Due to the weakness of the pound, **profits in its UK retail business declined by 24 per cent to £106m** for the parent bank. The Bank of Ireland UK has 3 million UK customers, which is more than the adult population of Ireland. But the bank is a small player in a highly competitive market and therefore Brexit poses unique challenges for the Irish lender. With increasing risks and decreasing revenues from the UK market, the viability of the partnership with the Post Office is at risk.

Reputation. In terms of reputational risk, the Bank of Ireland is facing a review over potential mis-selling of a tracker mortgage. Against potential litigation costs, the bank has already set aside €25m. A large fine could also call into question the viability of the partnership with the Post Office.

Rising modernisation costs. For Bank of Ireland to remain competitive in the future, a major modernisation of its technology and infrastructure is overdue, thus raising IT costs substantially. The bank has earmarked capital expense of €225m annually over the next four years for this purpose. This represent a major investment for the lender, which will result in an increase in an already higher than average cost-to-income ratio.

Key Points:

- *The partnership with the Bank of Ireland has not delivered the expected and potential results.*
    - *Since the renewal of the partnership in 2010, the Irish partner had no plans for further expansion in the UK market.*
    - *In 2012, it exited from the Great Britain Business Banking and Great Britain Corporate Banking businesses.*
- *Because of the persistent negative legacy from the financial crisis, the partner is not expected to deliver significant growth in the near future.*
- *A partnership model with a large private bank for the provision of postal financial services leaves the Post Office’s ambitions for growth dependent on the fortunes and willingness of the partner.*

[3] https://www.irishtimes.com/business/financial-services/bank-of-ireland-s-results-something-of-a-curate-s-egg-1.2987751

PART II. The new UK competitive landscape

One of the reasons for the rejection of the proposal for a Post Bank in 2010 was the consideration that it would be difficult for it to become profitable in a highly competitive sector such as the banking sector. This statement was in line with the political view at that time: the UK public authorities opted for consolidation in the banking sector in the immediate aftermath of the financial crisis. Accordingly, in 2010 the UK banking sector was deemed as highly competitive. Nevertheless, this view has changed radically since then: the authorities have repeatedly expressed concerns about the lack of competition in the banking sector in more recent years.

In 2010, the Office of Fair Trading (OFT) published a report focused on competition in retail banking.[4] They concluded that "*new entrants face significant challenges in attracting personal and SME customers through a combination of low levels of switching, high levels of brand loyalty and consumers' preference for providers with a branch network*."

In 2011, the Independent Commission on Banking presented its final report[5] and highlighted that: "*There are long-standing competition issues in UK retail banking. On the supply side, core markets are concentrated—the largest four banks account for 77% of personal current accounts and 85% of SME current accounts. On the demand side, competition between banks on current accounts is muted by difficulties of switching between providers and by lack of transparency about banking services on offer*."

Partly as a response to these concerns, during the creation of the new institutional banking regulatory landscape, both the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) were given explicit objectives to promote competition. In particular, it is one of the three FCA objectives to promote effective competition, and a secondary objective for the PRA to act in a way that facilitates effective competition.

As part of this push towards increasing competition in the banking sector, the Financial Services Authority first, and the Bank of England later, simplified the process for obtaining a banking license. Additionally, to facilitate the process the New Bank Start-up Unit was set up at the Bank of England.

Based on these considerations, this section reviews the key changes that have impacted the UK financial sector in recent years, to foster an understanding of the industry a newly formed Post Bank would be operating in. Our analysis highlights the challenges as well as the opportunities in a fast-changing sector.

Market competition

The UK banking market is dominated by the presence of five large banking groups: Lloyds, HSBC, RBS, Barclays and Santander UK. Together, these large banking groups control over 50% of the mortgage market, 77% of the personal current account market and 85% of small business banking. These banks operate throughout the UK and provide the full range of retail banking services. In addition, there are a number of smaller banks and over 40 building societies. The largest six banks and building societies (the five above plus Nationwide) now

[4] http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
[5] http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf

account for 80% of the outstanding household and corporate lending, up from 65% at the start of 2008.[6] Other providers also offer elements of retail banking services such as credit unions, alternative finance providers (for example, crowd-funding and peer-to-peer lending), as well as new payment providers offering digital wallets and other services (for example PayPal, Amazon, Google and Apple).

As mentioned before, there have been numerous investigations into the competitive nature of UK banking, most recently highlighted by the findings of the Competition and Markets Authority report on retail banking.[7] This highlights the authorities' desire to increase competition in the system, especially in the light of the high degree of market concentration[8] in certain sectors of the banking business—personal and SME areas. Concentration levels have increased since the financial crisis following Santander's acquisitions of Bradford & Bingley and Alliance & Leicester building societies and Lloyds Banking Group's acquisition of HBOS. Despite the divestment of TSB and the entry of challenger banks, the large banks have lost only 5% of their market share since 2005, thereby justifying the renewed focus on increasing competition.

i) Challenger banks

Partly because of the authorities' efforts highlighted above, we have seen new entrants to the banking sector in recent years: in 2010 Metro Bank was the first new high-street bank to obtain a full banking licence in over a century (see Box 3 for a brief overview of Metro Bank) and since then several new banks have been authorised by regulators. The changes in the regulatory requirements and authorisation process, designed to reduce entry barriers in the sector and increase competition, have contributed to this new trend.

These new entrants are referred to as challenger banks because they compete in a market dominated by long-established operators. Technological and regulatory change have enabled the emergence of these new competitors. They have some advantages compared to traditional players: their size enables them to be nimbler, easier to manage and they are not hampered by old technology. Moreover, they have no legacy from the financial crisis. While many of these entities are unlikely to survive as stand-alone companies, triggering a likely wave of M&As with more established players—although not necessarily from the financial sector—will enable them to increase their competitive and disruptive potential.

Box 3. Case Study: Metro Bank

When it launched in 2010, Metro Bank was the UK's first new high-street bank in over 100 years. It offers a range of retail banking services to personal and business customers (including SMEs) in and around London. Its aims are to differentiate itself from other banks. Metro's strategy is based on building a strong and recognisable brand and offering a good customer experience, with a customer-focused culture borrowed from retailer-type operations. It is also defined a **branch-based challenger**, as it focuses on an innovative use of "stores" to attract customers. Today, Metro Bank has about 41 stores (opened in the last six years),

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[6] http://www.bis.org/review/r140515b.htm.
[7] Competition and Markets Authority. 2016. Retail banking market investigation. https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf.
[8] See Haldane, A. 2011. Control rights (and wrongs). http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2011/speech525.pdf.

with a further 59 expected by 2020. This strategy also differentiates Metro Bank for traditional banks, which are cutting costs precisely via branch closures.

The Set-up of a Challenger Bank

2009 - Banking Authorisation process begins.
2010 - £75m of private capital raised (February).
2010 - Banking license granted (March).
2010 - Launch; first branch opened (July).

Financial Highlights

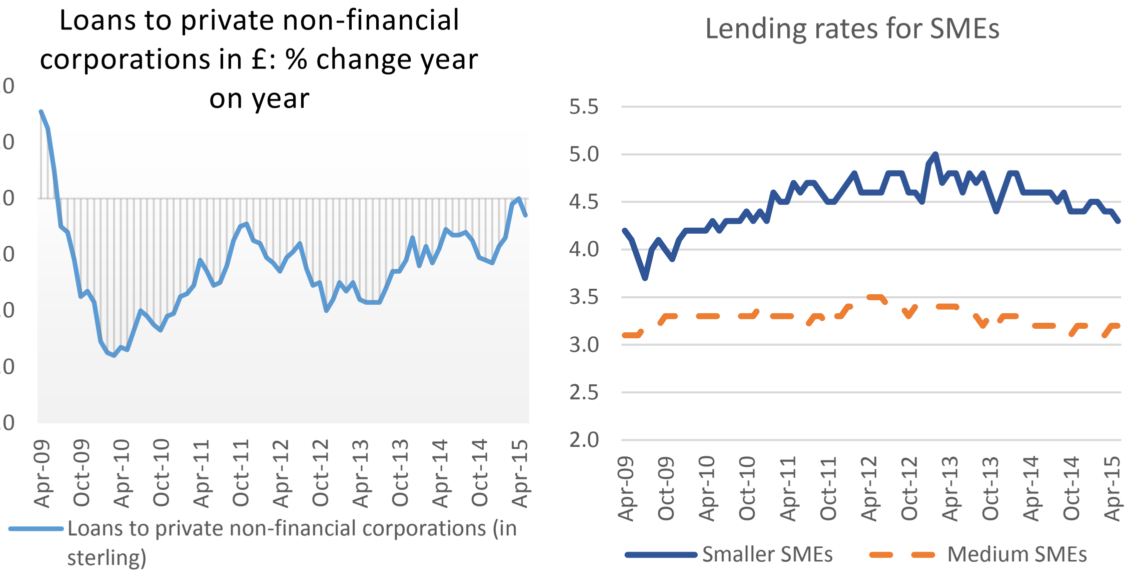
Six years later, Metro Bank is a fast-growing player in the UK retail service market. The results for 2016 confirm this trend:

- Asset growth up 64% year-on-year to £10,057m
- Revenue up 62% year-on-year to £195m
- Strong Common Equity Tier 1 capital ratio at 18.1%
- Record 260,000 increase in customer accounts to a total of 915,000

ii) SME Lending

Despite its paramount importance for the recovery of the economy, one type of business has found it difficult to recover: **Business and SME lending**. Business lending was severely affected by the crisis and decreased steadily between 2008 and 2015. As it can be seen in Figure 4, the annual growth rate of the outstanding lending to non-financial corporations in the UK remained negative until 2015. SME lending became expensive (especially for smaller SMEs) and mostly unresponsive to the unconventional monetary interventions during the post-crisis period.

Figure 4. Business lending since the crisis



Source: Bank of England – Credit Conditions Survey 2015Q2

A recent report by the Competition and Markets Authority and the Financial Conduct Authority[9] found that the provision of business current accounts (BCAs) and business loans is highly concentrated among the four top banks: they make up for 85% of BCAs and 90% of all business loans. These levels of concentration imply a Herfindahl-Hirschman Index (HHI) score of slightly below 2,500, the level that the U.S Department of Justice considers to be “highly concentrated”.[10] This feature has barely changed since 1999.

These two facts—**business lending has been decreasing for several years after the crisis, and it remains highly concentrated**—remain true even though there has been a significant political appetite to increase both SME lending and banking competition. An example is the Funding for Lending Scheme (FLS), an initiative launched in July 2012 by the Bank of England and HMT. [11] The policy provides cheaper funding for banks and building societies that invest in the real economy. It was further amended to incentivise lending to SMEs. The policy has provided more than £60bn funding.[12]

At the same time, more and more challenger banks have taken an interest in this type of lending; for instance, Virgin Money and TSB. However, they face the costs related to the high entry barrier—the need for a physical presence to encourage and support SMEs via branches. We will expand the discussion on this issue in Part III of this report.

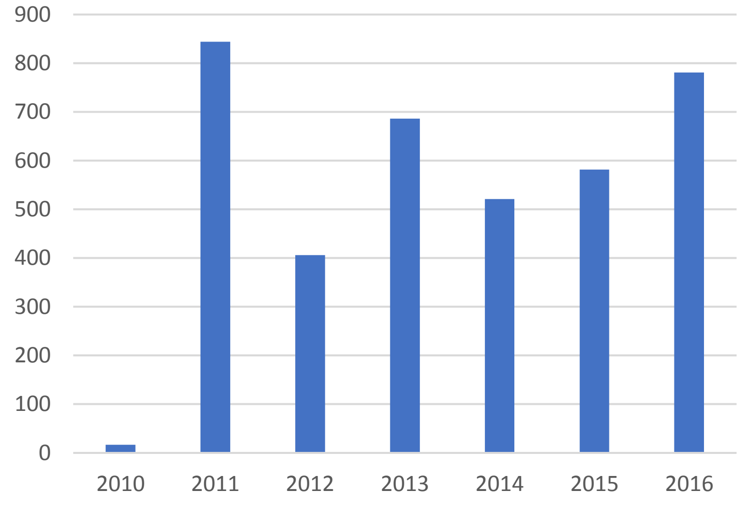
iii) ***Branch closures***

Another reason why SME lending business has been suffering is the vast rate of bank branch closure—especially in more remote and rural areas. About 3,000 branches have closed over

[9] CMA & FCA. 2014. Banking services to small and medium-sized enterprises. https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf.
[10] https://www.justice.gov/atr/herfindahl-hirschman-index.
[11] http://www.bankofengland.co.uk/markets/pages/fls/default.aspx.
[12] https://www.ft.com/content/a8b1d864-976c-11e5-95c7-d47aa298f769.

the last decade, according to the Campaign for Community Banking Services, leaving around 8,000 in 2016. Data from SNL Financial indicate, as shown in Figure 5, that almost 4,000 branches have closed since 2010. In many areas, basic banking services are only available through the Post Office branches.

Figure 5: Bank branch closures over the period 2010-2016



Source: SNL Financial

Data from the big five banks derived from BBC research[13] and reported by the House of Commons[14] show that about 650 branches closed in 2015 and 2016 and Which? reported estimated closures in 2016 to be 1,046,[15] equal to 11% of the network of the seven largest banks. Some challenger banks, such as Metro Bank, are following an opposite strategy, expanding their network through branches in order to take advantage of the retreat of big banks. However, most of these branches are in major urban centres, while rural areas and communities are the most affected by bank branch closures and many of them are left with only certain basic services of the Post Office.

Key Points:

- *Regulators and policy makers have put in place initiatives to increase competition in the UK financial system, in particular in the provision of retail banking services.*
- *To this end, they have licensed new entrants, which are now fast-growing participants in the UK banking system, while traditional banks are still recovering from the financial crisis and dealing with post-crisis regulation.*
- *Among retail banking businesses, SME lending is suffering the most from high concentration and branch closures.*
- *While non-traditional competitors (challenger banks) find this business potentially attractive, they lack the required physical infrastructure to offer local business banking and SMEs services in a profitable manner.*

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[13] http://www.bbc.co.uk/news/business-36268324

[14] Edmonds, T. (2016) Bank Branch Closure, Briefing Paper, House of Commons Library, Number 385, 15 December.

[15] http://www.which.co.uk/news/2016/12/revealed-1000-bank-branches-shut-in-two-years-458451/.

PART III. A Post Bank model for UK

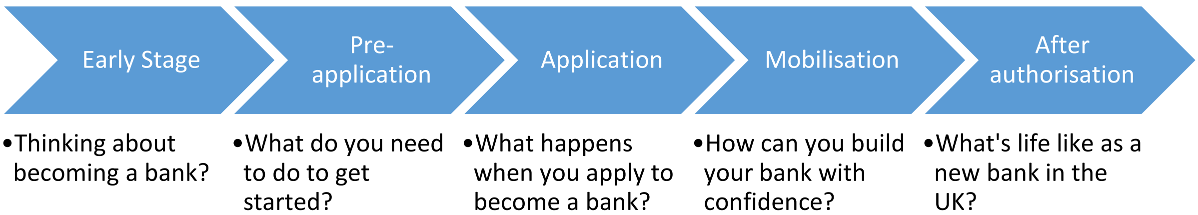
In this section, we outline the case for a Post Bank and present an analysis that illustrates the opportunities for the Post Office if it were to choose this strategy. We look at the change in regulatory requirements for the process of obtaining a banking licence and argue that to take full advantage of the new process the Post Bank should be set up as a separate subsidiary. We then look at the possible ownership structure and how to raise the initial capital. We discuss the growth opportunities for a Post Bank within the current market developments. Finally, we will show how a Post Bank can also help achieve broader objectives, both in terms of increased credit available to the economy and increased financial inclusion.

As a first step of this analysis, we note that there is an appetite for increased competition in the banking sector. This is evident in the number of new licences granted in recent years and by the fact that the supervisory authorities have reviewed and simplified the authorisation process.

In March 2013, the Financial Services Authority (FSA) simplified the process of obtaining permission to offer banking products. Now the permission is granted by the PRA (Prudential Regulation Authority, Bank of England), with the Financial Conduct Authority (FCA)'s consent.

The process is managed on a case-by-case basis. The managers of the firm seeking authorisation typically have a preliminary meeting ("pre-application stage") with the PRA at the Bank of England to present their proposal. This meeting's goal is to help the firm to prepare the application as well as possible. After this meeting, the regulators would explain the documentation that the firm needs to prepare, as well as the initial requirements. The whole process might take up to 6-12 months. Figure 6 illustrates the process.[16] The application is to obtain permission to undertake regulated financial activities. Deposit-taking, mortgages, and SME lending, for instance, all fall in this category.

Figure 6: Banking licence application process



Source: Authors' elaboration based on Bank of England's guidelines

[16] http://www.bankofengland.co.uk/pra/nbsu/Pages/default.aspx

We now turn to how a Post Bank could work in practice (see Box 4 for brief case studies of the Post Banks in Italy and France). Our proposal for a Post Bank considers the following aspects:

- **i) A separate subsidiary entity for financial services**
- **ii) Raising equity capital and ownership structure**
- **iii) Size and portfolio composition**
- **iv) Market analysis**
- **v) Capitalising on existing strengths**

BOX 4: Successful Post Banks

POSTE ITALIANE AND BANCOPOSTA

An example of a Post Office that has successfully expanded into different business areas is **Poste Italiane**, which started to focus on financial services when the European Union began liberalising postal markets in 1997. Italy's national postal service, Poste Italiane, became a public limited company in 1999 and relinquished their monopolies on many postal services. Today, Poste Italiane is partially state-owned (around 60% percent) after it completed an IPO in 2015. Poste Italiane has a network of 13,000 branches.

Early set-up of the Italian PostBank

1998 Poste Italiane becomes a public limited company
1999 BancoPosta is created as a business unit of Poste Italiane and Poste Vita, the Group's life insurance company, is established
2002 First profit for the Poste Italiane reported after fifty years in the red
2003 Postepay, the most widely used prepaid card in Europe, is created
2006 Poste Italiane pays its first ever dividend to shareholders.
2015 IPO on Italian Stock Exchange (40%)

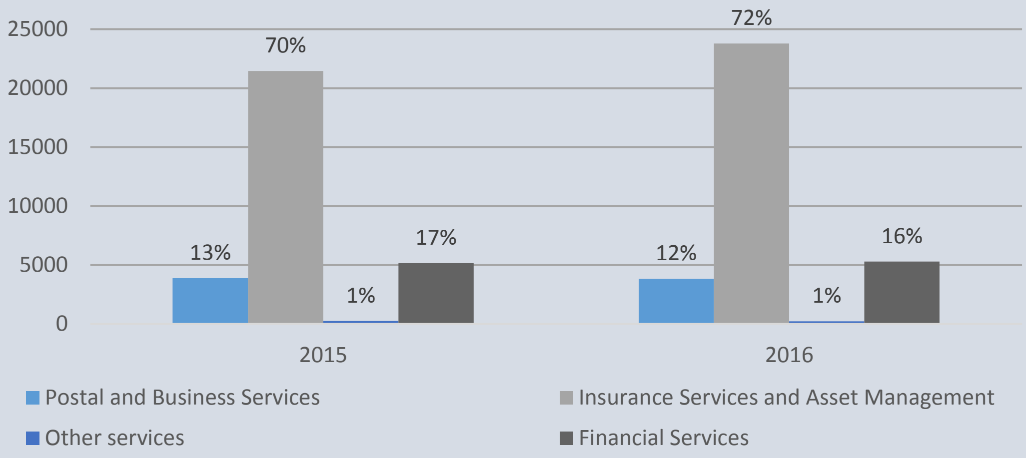
Business diversification strategy and revenues

Poste Italiane has earned a reputation for diversification and innovation. Along with postal services, the company offers integrated products in communications, logistics, finance, insurance, and mobile telephone services. Currently, Poste Italiane has plans to adopt mobile technology to improve and modernise all services and products.

Poste Italiane's revenues are generated by financial services, insurance services and asset management for more than 80% and only 13% from core postal services. In 2016, revenues increased by 7.7%. The improvement primarily reflects the positive performance of insurance services and asset management, where total revenue amounts to €23.8bn.

Poste Italiane saw a large increase in deposits in 2016 and 2017, as savings were transferred from traditional banks to the Italian Post Office due to the emerging evidence of Italian banks' bad loans.

Figure 4.1: Poste Italiane's revenue by business units (in €m and as percentage)



Institutional setting and capital regulation (ring-fencing)

Banking services are offered via BancoPosta. Poste Italiane SpA manages BancoPosta's operations through an entity with ring-fenced capital, called BancoPosta RFC, established in 2011. At December 2016, the ring-fenced capital was equal to €3,386m.

LA POSTE AND LA BANQUE POSTALE

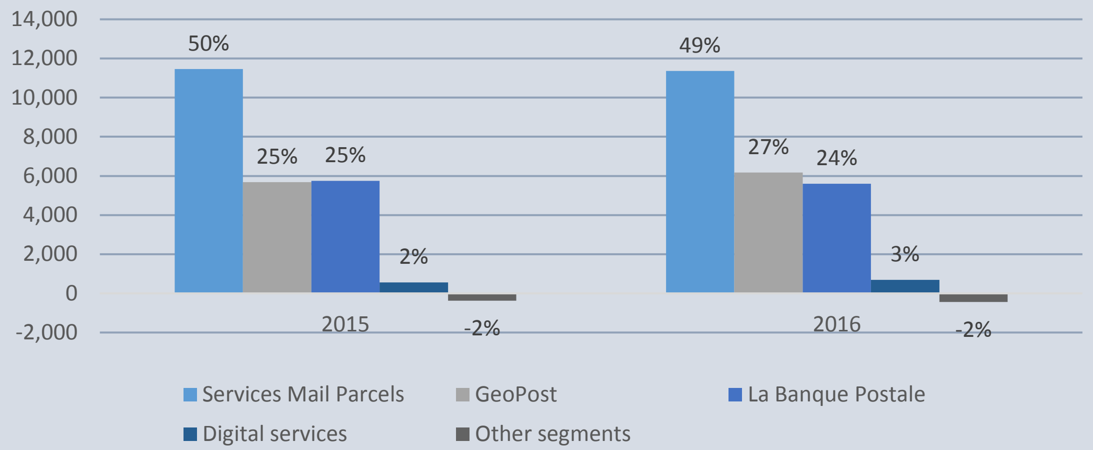
La Poste became an independent, public sector company in 1991, following the split of the French PTT, a government department responsible for mail, telegraph and telephone services. By the mid-1990s, the Group expanded into financial services, which soon generated about one-fourth of its revenues. In 1997, the French Government forced La Poste to separate its financial services products from its mail services, to reduce its competitive advantage. Meanwhile, La Poste was facing increasing competition in its mail and parcel delivery services. As a response, La Poste began diversifying its operations, including financial services offerings. To comply with French law and EU directives, banking activities had to be provided through a separate subsidiary. La Banque Postale was established in 2006 and it is currently one of the major public banks providing retail financial services in France, based on a network of about 17,000 outlets.

Multi-business model and revenues

La Poste has a multi-business model which, next to more traditional postal services, includes logistics and corporate mail and parcels services, and digital services for corporations. In addition, La Banque Postale—a separate subsidiary—offers retail banking, insurance and asset management products and services.

The Group consolidated operating profit totalled €975m in 2016, up 11.5% from 2015. There are four main business units as shown in Figure 4.2 below. About 25% of the revenues come from the financial services offered by the Banque Postale.

Figure 4.2: La Poste's revenue by business units (in €m and as percentage)



La Banque Postale

La Banque Postale Net Banking Income (NBI) was €5.60bn in 2016. Of these, NBI from the Retail banking division amounted to €5.24bn. At the end of 2016, La Banque Postale capital position was very strong, with a CET1 ratio of 13.7 %. The bank successfully expanded both deposits and loans: retail demand deposit reached €52bn (+6.4 % / 2015) while corporate credit outstanding saw the highest growth to €15.3bn (+25.9 % / 2015).[17]

i) A separate subsidiary entity for financial services

One of the goals of the Post Bank is to provide a steady stream of income for the Post Office to ensure its long-term viability and reduce its reliance on government subsidies. It is therefore crucial that the Post Office receives the profits of the Post Bank. Setting up the Post Bank as a subsidiary, fully or majority-owned by the Post Office, would achieve this objective.

There are different ways to set up a Post Bank in the Post Office. However, a fully-fledged subsidiary seems to be the right structure for several reasons: (1) regulatory purposes; (2) isolating risks related to financial services provision, and (3) management.

In this context, a separate subsidiary would simplify the process of obtaining a banking licence. In addition, as the new entity would be subject to the supervision of the PRA and FCA, a separate subsidiary would increase transparency and would allow for the separation of risk between the bank and the Post Office. This structure would also appease some of the concerns previously voiced by the government, that is, a Post Bank would create a much more volatile and risky balance sheet for the Post Office.

A separate subsidiary would also allow the Post Bank to have a separate management team, with financial markets experience and the ability to make independent decisions within the Group. This would also ensure that the management's decisions are not politically driven.

[17] https://www.ipc.be/en/reports-library/publications/member-publications/le_groupe_la_poste_2016_ar

There are numerous examples of government-owned financial institutions (for example, the Cajas in Spain) that have undertaken financial investments for political reasons rather than economic ones, with disastrous consequences for the sector in many countries.

To account for the fact that the Post Bank will be part of a government-owned group (The Post Office Ltd) and therefore subject to the Group's overall management, a possible model is that of *functional independence*. Under this model, while the overall goals are set by the Group management (and, in this case, the government), the way how these goals are pursued is a matter for the bank's management. An example of this is the Bank of England model. The Bank of England is not independent: its objectives are set by Parliament. However, the Bank of England is independent in the way it chooses to achieve these objectives—under their regulatory powers. The Post Office could do something similar: it would set the objectives—in terms of financial inclusion and portfolio composition—but the actual day-to-day operations would be performed by the management of the Post Bank.

ii) Raising equity capital and the ownership structure

Another concern raised in the previous discussion on setting up a Post Bank back in 2010 was that capitalising a new bank would be time consuming and expensive. As mentioned before, the licence process can take less than a year. In this section, we discuss in detail the financial implications of raising equity to finance the Post Bank.

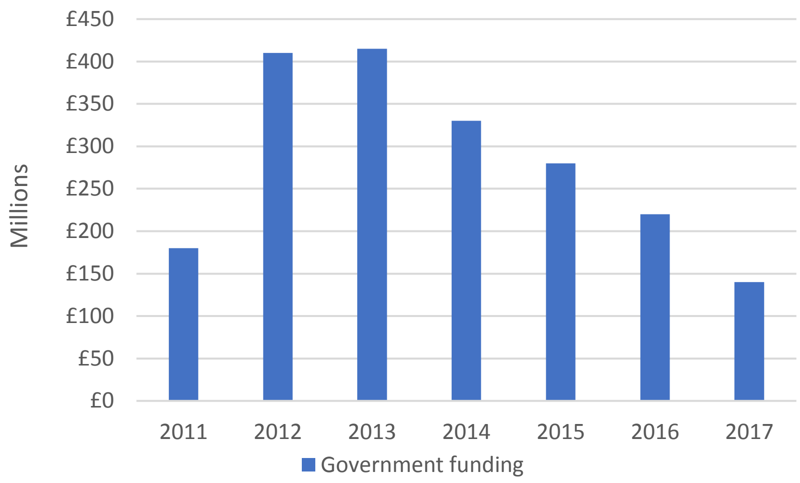
We note that raising the initial equity would be relatively cheap as current market conditions are favourable for this. There are various possible options available, each with different implications in terms of ownership structure, whereby the resulting firm would be either entirely or partially government owned.

- ***Initial capital injection from the government***

The initial capitalisation could come directly from HMT. Under current arrangements, the Government is subsidising the Post Office annually; in the last seven years, it has provided funding in the region of £2bn, as it can be seen in Figure 7.[18]

[18] We consider the last seven years to reflect the new funding structure set out by the coalition government in 2010, as highlighted in the document "Securing the Post Office Network in the Digital Age". https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31809/10-1260-securing-the-post-office-network.pdf.

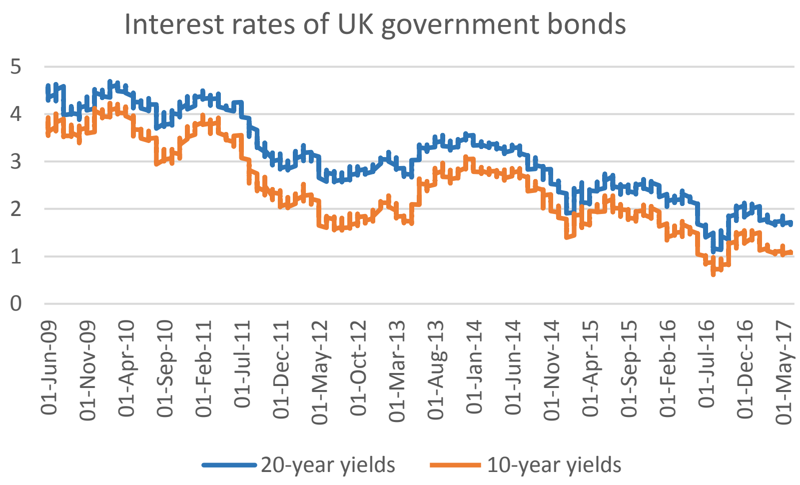
Figure 7: Government funding to the Post Office over the period 2011-2017.



Source: Post Office Annual Reports.

Given the current low interest rate environment, it would be cheaper to capitalise the Post Bank than continue subsidising the Post Office. The Government could issue long-term debt (20 – 30 years) to finance this equity. The UK Government is currently able to issue debt at a very low interest rate. As Figure 8 shows, the interest rates paid by the UK government on long-term debt are a fraction of what they were in the last stages of the financial crisis. The current yield for 10-year-bond securities from the British Government is very close to 1%. This means that issuing debt to finance the set-up of a Post Bank would not be expensive.

Figure 8. Cost of issuing debt for UK government



Source: Bank of England IUDLNPY and IUDMNPY series.

The low rates faced by the UK Government reflect their strong credit rating, which is set at AA despite some turmoil generated by the Brexit referendum. The Credit Rating Agencies have not changed their assessment since the referendum, and hence we expect that these ratings will continue in the medium term. Furthermore, the public debt levels are now under control, and they are on the lower end when compared to other OECD countries—at around £1.7tr or 89% of GDP.

Therefore, an initial capitalisation of circa £2bn—we explain below how we arrive at this number—would have a minor impact on public finances. Indeed, the government has already spent a similar amount over the last seven years, just to ensure the on-going business of the Post Office. A key difference is that this investment would ensure its long-term sustainability.

- ***Post Office to issue long-term debt to finance initial equity***

There are alternatives to the Government raising the full initial equity of the Post Bank. For instance, the Post Office, rather than the Government, could issue long-term debt (20 – 30 years) to finance it. Ideally, this debt would be backed by HMT, making it very cheap—similar in terms of costs to the case where the Government would issue it directly. To the extent that the Post Bank is profitable—and we will see it should be—then this would not assume any burden for the Post Office operations.

- ***Government/Post Office issuing external equity***

There is also the possibility of issuing external equity. The Post Office does not need to retain 100% of its Post Bank participation in order to retain control of the entity: a 51% stake would suffice. Poste Italiane is an example of a Post Bank only partially government-owned. This option implies that the share of profits would be lower, but it also means that risks are shared and that the Post Bank's operations can potentially grow faster. Given the nature of the business of the Post Bank, with a strong component of financial inclusion, as we explain below, several firms could be interested in taking part of it, to boost their Corporate Social Responsibility (CSR) profile.

- ***Mutual ownership model***

The options we just described refer to the case where the Post Office sets up a Post Bank. There are, however, different ownership structures that characterise other types of financial institutions, such as mutual banks. Mutuals are owned by their customers, cannot readily raise external capital and rely almost exclusively on accumulated reserves of retained profits. These features can constrain their growth opportunities.

In the financial services industry, a mutual ownership model is followed by Building Societies, with some success. Building societies are mutual organisations, owned by their customers or members. Although technically they are not "banks" and do not offer the full range of banking services, as mutuals they are a subset of stakeholder-based financial institutions. In recent years, building societies have enjoyed political support as the importance of mutuals within a more diverse financial sector has been highlighted by policymakers and regulators. This support is also recognised by customers, as indicated by the high levels of satisfaction and trust.[19]

The government has promoted mutual ownership in various sectors, citing evidence that this ownership structure can help to ensure that decisions are focused on the long-term sustainability of the business.[20] The Government believes that Post Office Ltd could be ideally

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[19] Casu, B. and Gall, A. (2016). *Building Societies in the Financial Services Industry.* Palgrave Macmillan UK.

[20] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31678/11-1401-guide-mutual-ownership-models.pdf

suited to a mutual model; they do however recognise that a move to a mutual would not be possible until the business is on a more financially sustainable footing.[21]

iii) Size and portfolio composition

Having discussed possible ways to raise the initial equity capital, the key question is *how much* initial capital would a Post Bank need. The answer to this question depends both on the size and the riskiness of the initial portfolio.

Equity capital is only a small part of a bank funding; the large majority of funds relates to retail deposits. More specifically, equity capital would only form around 5 – 10% of the total funding of the Post Bank. Most of the funding would come from different types of deposits, from personal current accounts (PCAs), business current accounts (BCAs), and savings products with different terms. As a retail-oriented bank, deposits could make around 70% of the total funding.

The rest of the funding would come from long-term debt to be placed to institutional investors. This long-term debt would have the implicit guarantee of the government, which again would make it cheap. Part of this long-term debt could also be offered to retail investors looking for a secure long-term investment.

- ***The size of the bank portfolio***

A crucial part of the process to set up the Post Bank, and something that needs to be decided before applying for a banking license, concerns its initial portfolio. We highlight several options, which are not mutually exclusive. This is, however, a simplified exercise, and a much deeper market analysis would be needed to inform appropriate decisions.

OPTION 1: Acquiring the Bank of Ireland UK portfolio[22]

A first option to explore is acquiring the portfolio of the current partner of the Post Office, the Bank of Ireland UK plc. Table 4 shows the balance sheet of this institution in 2016. Most of the asset portfolio is made up of loans to customers and mortgages. The liquidity is managed with cash and central bank balances, as well as some Available-for-Sale (AFS) financial assets.

Table 4. Bank of Ireland UK plc – balance sheet in 2016

Assets: £25,960m	**Liabilities: £25,960m**
Cash and CB balances: £1,172m	Deposits from banks: £2,691m
Loans to banks: £3,369m	Customer accounts: £19,475m
Loans to customers: £19,821m	Subordinated liabilities: £335m
AFS financial assets: £1,140m	Other liabilities: £1,409m
Other assets: £458m	**Equity: £2,050m**

Source: BoI UK Annual Report 2016

[21] http://webarchive.nationalarchives.gov.uk/20121030091159/http://www.bis.gov.uk/assets/biscore/business-sectors/docs/b/12-939-building-a-mutual-post-office-government-response
[22] https://www.bankofirelanduk.com/fs/doc/wysiwyg/boi-uk-annual-report-2016-web.pdf.

In terms of funding, most of it comes from customer accounts (75%). Among these accounts, £15,500m are already Post Office-branded deposits. Equity capital is around £2bn.

We believe that acquiring this portfolio—or a similar one—would constitute a solid *first stage* for the Post Bank. This is because most of its products have been offered through the Post Office branch network, and hence there is already expertise in the institution. As mentioned before, many of the Bank of Ireland UK products are already branded as Post Office. Moreover, the Bank of Ireland UK's current profits are well above the 2017-18 planned government subsidy to the Post Office; in other words, with such portfolio, the need for this subsidy would be eliminated. Finally, the Post Office undertook a similar operation when it acquired the Bank of Ireland share of their joint insurance business, which has become a profitable stream of revenues.

For comparison, if the Post Bank were to acquire the Bank of Ireland UK portfolio, it would be one order of magnitude bigger than many of the new challengers, and approximately *twice* as big as Metro Bank.

A key question relates to the price for such acquisition. If we estimate the UK subsidiary of the Bank of Ireland' market value to be equal to its book equity, the price would be around £2bn. This amount, as discussed above, could be raised in different forms.[23] Nevertheless, banks, especially the biggest ones, currently have price-to-book ratios below 1.[24] In other words, the market value of these institutions is below their book value. The Bank of Ireland UK could be a similar case, therefore reducing the price of the initial investment to below the £2bn price tag. An important remark on these lines is that, given the difficulties discussed in Part I, the Bank of Ireland might be forced to divest from the UK market, making the acquisition terms advantageous for the Post Office.

OPTION 2: A new partnership or merger with a challenger bank

Another option to consider is to partner or merge with one or more challenger banks. There are two main reasons why this option would be beneficial: expertise acquisition in some banking products and technology.

The Post Office has already expertise in offering some banking products, such as mortgages and savings accounts. Other types of products, such as business accounts and SME lending, have not been provided in Post Office branches and hence the institution lacks expertise. Therefore, especially if one of the objectives is to expand in a type of product without prior experience, using the expertise of challenger banks—via partnership or acquisition—would ensure that the products meet the customer demand.

The other reason is the technology. Challenger banks are new, and hence most of their technological infrastructure has been built very recently. Older institutions tend to have lower flexibility to improve their IT, which is associated with higher operating expenses. For this reason, acquiring a challenger's technology would put the Post Bank in a good position to contain costs and be profitable enough to sustain other parts of the Post Office.

Table 5 below provides a summary of some challenger banks that focus on the SME sector, which is a target market segment but also one where the Post Office lacks strong expertise.

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[23] This would amount to approximately 0.12% of the Government debt in the UK.

[24] https://www.bloomberg.com/news/articles/2016-06-16/europe-s-biggest-banks-are-worth-more-on-paper-these-days-chart.

This sector would offer strong growth opportunities for a Post Bank. Most challenger banks have relatively small portfolios, but as already mentioned, this would not be the main reason to join forces with them. Importantly, none of these challenger banks have a branch network: they could be very interested in having access to the Post Office's extensive one.[25] The last column of Table 5 shows the equity of these banks when available, which serves as an approximation of the cost of acquiring these institutions.

There are several players which are of potential interest. First, the ***British Business Bank***, a government-owned business development bank dedicated to making finance markets work better for smaller businesses. We understand from the Communication Workers Union that this is an option the government is aware of and may consider for the Post Office. A closer relation or partnership with the British Business Bank would help the Post Bank gain market share in the SME lending market, as well as capitalising on the state-owned development bank's expertise. In numbers, the British Business Bank currently supports over 48,000 small business, for over £3.1bn, through its partnership with other lenders.

Another note-worthy example is the ***Cambridge & Counties Bank***, a unique partnership between two established and respected institutions—Trinity Hall, Cambridge & Cambridgeshire Local Government Pension Fund. This bank is of interest in this context, as it is a partnership with a Local Authority.

Finally, the ***Community Savings Bank Association (CSBA)***, a new association which markets itself as "customer owned local banking for Britain" and aims to create a UK-wide network of customer-owned, regional banks to serve the every-day financial needs of ordinary people, local community groups and small and medium sized companies.

[25] Some of these banks are more digitally-focused, but this is partly by necessity, since the initial investment required to set up a branch network is too high for them.

Table 5. Challenger banks specialising in SME lending

Bank	Banking License	Business Model	Equity
Aldermore Bank	Established in 2009, Aldermore is essentially the reincarnation of private bank Ruffler after it was sold off to private equity group Anacap Financial Partners.	Serving customers and intermediary partners online, by phone and face to face through our network of twelve regional offices	£626m
British Business Bank	A government-backed bank	A development bank (start up; scale up and stay ahead)	£791m
Cambridge & Counties Bank	Granted a licence in 2012; it is fully in operation	It is owned by Trinity Hall Cambridge and Cambridgeshire Local Government Pension Fund	£29m
Community Savings Bank Association (CSBA)	Originally working with Airdrie Bank, which failed in 2017. The banks' model and legal form has been agreed with the FCA and registered. Individual banks will apply for banking licences	Mutual business model. CSBA intends to set up a network of independent, customer-owned, regional banks to support local communities and businesses. Once set up, these banks will own and run the CSBA	NA
Hampshire Trust Bank	Granted. Formed in 1977, relaunched in 2014.	Specialist lender.	NA
OakNorth	Granted in 2015	A start-up bank, focusing on business lending	£81m
Redwood Bank	Granted in 2017 (subject to restrictions). In post-authorisation mobilisation phase	SME Business Bank. It will provide secured lending products and deposit accounts to SME businesses	NA
Shawbrook Bank	Formed in 2011, owned by RBS Equity Finance	Specialist lender	£370m
Tide	Tide is a current account, not a bank.	Tide is a business current account aimed at sole traders and SMEs.	NA

Sources: annual reports and websites of the different institutions.

iv) Market analysis

Another concern raised by the government to the previous Post Bank proposal was that it would be extremely difficult to build a significant market share quickly in a competitive market. We argue that there is room for growth in the UK banking sector, as demonstrated by Metro Bank. We build the case by considering the current revenues of the Bank of Ireland UK and comparing it with the growth rate of Metro Bank.

Revenues of Bank of Ireland UK

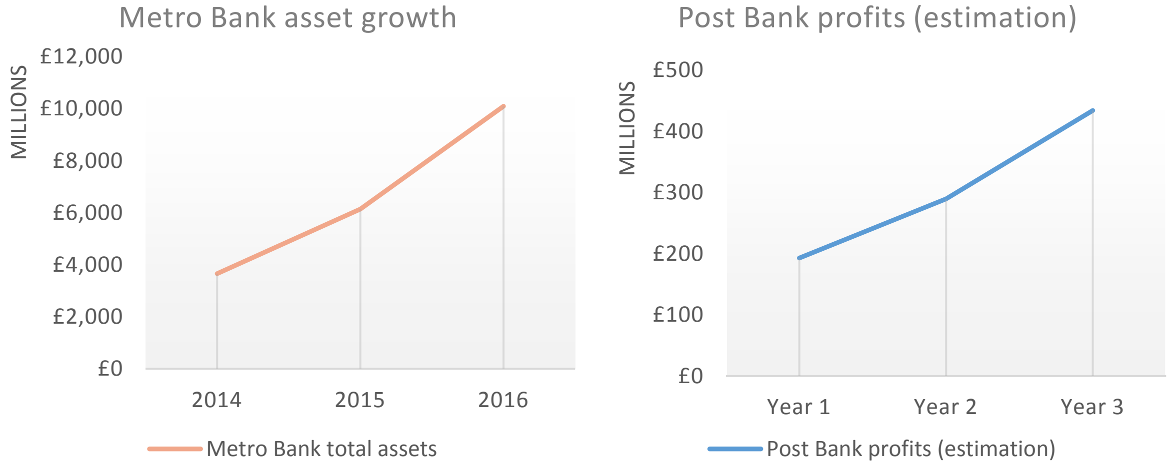
The Bank of Ireland UK had £193m in profits in 2016. We take this number as a close estimate of the initial profits that the Post Bank would be able to obtain if it acquired the Bank of Ireland UK portfolio. While it is true that the transition from the Bank of Ireland UK to the Post Bank could carry some costs, the Bank of Ireland UK has been underinvesting in recent years and hence the potential profits of its current portfolio are probably higher.

The current profits are higher than the average Network Subsidy Payments from the UK Government in recent years, which means that such operation would allow these payments to stop. This is one of the main objectives of the Post Bank: to make the Post Office financially viable without depending on regular government subsidies.

Moreover, the initial portfolio has a strong potential to grow substantially. Metro Bank, for instance, was growing its assets at a 64% growth rate in 2016.[26] Metro Bank's initial portfolio was smaller, but even in absolute terms, this growth amounts to £4bn, and this is without the availability of an extensive branch network to distribute the products. Figure 9 shows that Metro Bank has been able to maintain a growth rate above 60% the last two years.

[26] https://www.metrobankonline.co.uk/about-us/press-releases/news/metro-bank-reports-record-annual-growth-in-deposits-and-strengthening-profitability/.

Figure 9: Metro Bank asset growth vs Post Bank estimated profits



Source: Metro Bank and Bank of Ireland UK annual reports and authors' estimations

A working assumption would be, then, that the Post Bank would be able to grow at similar rates initially. For instance, assuming a growth rate of 50% (slightly below Metro Bank's growth rate in 2016) during the first two years, this would imply that the profits by Year 3 would be above £400m. Profits and assets would grow at a similar rate in a Post Bank given that a large initial investment in a branch network is not needed.

These profits would be added to the current ones that the Post Office already receives for financial products; these products, such as currency services, should continue to be offered by the Post Bank. Furthermore, as we highlight below, we think that there is also an opportunity for the Post Bank in SME financing that would increase profits even further.

Branches

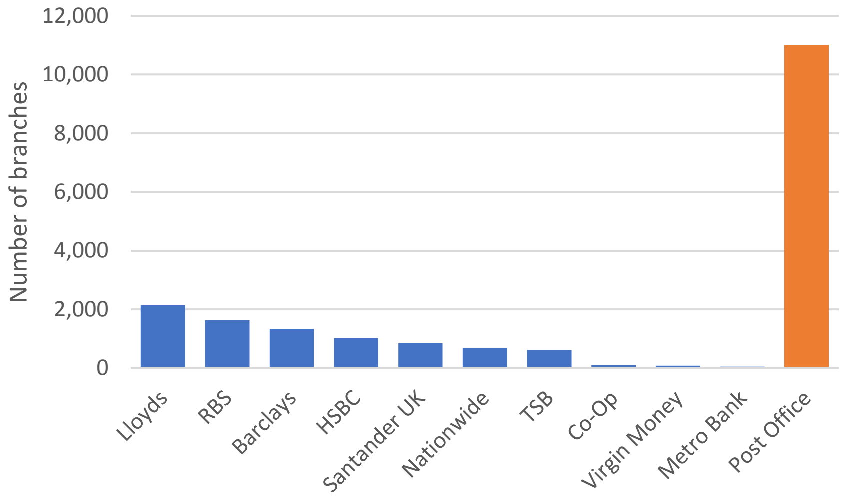
The assumption that the Post Bank would be able to grow significantly during the first years capitalises on the strongest asset that the Post Bank would have: its branch network. As we have mentioned before, the UK banking sector has experienced many branch closures in recent years, an on-going trend which accelerated after the financial crisis. There are pockets of customers that have had their banking options severely reduced, and here is where the Post Bank would have room to grow.

The branches of the Post Office are present in many areas where banks have no longer a presence. In fact, some banks have argued that the presence of the Post Office allows them to withdraw from some areas. When asked about why they dropped the pledge to stay open when RBS was the last bank in town by the Treasury Committee, Moray McDonald, Managing Director of Products, Personal and Business Banking Division, mentioned that "*We have an alliance with the Post Office, which has 11,000 locations—more than we ever could have*".[27]

As Figure 10 shows, the Post Office has more branches than the rest of the banks in the UK combined. Not only that, but its distribution is not as centered around urban areas as it is the case for commercial banks.

[27] Briefing paper 385, "Bank branch closures".

Figure 10: A comparison of branch network of the Post Office vs major UK banks



Source: SNL Financial and Post Office

At the moment, the Post Office has agreements with several banks so that the customers can access their bank accounts and perform some basic operations. Nevertheless, the branch network could be much more profitable if it was used directly by the Post Bank.

The reduction of bank branches has been a trend for at least 30 years. In fact, nowadays there are less than half the number of bank branches as compared to 1988.[28] One of the reasons for this trend is related to technological advances and the diminished need of continued interaction between the bank and its customers. The recent digitalisation push is also contributing to the lower use of branches. According to a report by the British Bankers Association ("Digital Disruption"),[29] "*the number of people going into branches to do their banking is falling dramatically (by around 30% in the last three years)*". However, this decline is not homogenous across gender, age and income (as we show in the next section on financial inclusion).

While some banks are pursuing this strategy, a few others, such as Metro Bank, have developed a different business model where branches—stores, as they call them—are at the centre of it. In the words of Craig Donaldson, its CEO, "*I see the store as central to what we do*". Part of the reason why customers are using branches less and less is because, in an effort to cut costs, the services offered in branches have been progressively cut down and customers encouraged to use online services. While some challengers are countering this trend and expanding their branch network, this is far from enough to compensate the branch closures of the main banks. Not only that, challenger banks will typically open their branches in places where they can be more profitable, and this means that they will expand around urban areas whereas more rural areas are barely serviced by either traditional or challenger banks.

For a Post Bank, the marginal cost of keeping a large branch network is very small as it would be capitalising on the existing real estate of the Post Office Ltd rather than having to acquire or lease new buildings. This would allow the Post Bank to achieve an immediate national

[28] Ibid.
[29] https://www.bba.org.uk/news/reports/digital-disruption-uk-banking-report/.

presence and therefore become a competitive player much faster than challenger banks could achieve.

As we shall see in the next sections, some customers, especially SMEs, do still use bank branches frequently and hence would benefit from a Post Bank operating through Post Office branches.

Opportunity in SME finance

As explained in Part II, the banking sector is particularly concentrated for SME products, both lending and business current accounts (BCAs). There are several reasons for this situation, but two of them stand out: small businesses value the presence of a branch network much more than other banking consumers, and they need their main lender to provide different products. This makes it very difficult for new competitors to enter this market: some of them lack the branch network infrastructure, and some of them specialise in specific products.

The Post Bank would be in an ideal position to reverse the low competition trend in this sector. Small businesses typically obtain finance via their main personal bank, as highlighted by a recent CMA and FCA report.[30] Moreover, small businesses use the Post Office branches on a regular basis, be it to send their products or to make payments. Therefore, the Post Bank would be able to use its extensive branch network, its existing retail products, and its current stock of business customers to build up a portfolio of SME lending and BCAs rapidly.

The revenues and volume of these businesses are substantial. According to the CMA and FCA report, BCAs generate in excess of £2bn in revenue a year. In terms of SME business loans, the total outstanding amount is around £90bn.

There are other reasons why the Post Bank would be better equipped than the large banks to undertake this type of business. Commercial banks have been reducing the supply of credit to SMEs because of a combination of debt overhang problems from the financial crisis and the new regulatory framework of Basel III: their objective has been to reduce risk-weighted assets, a measure of bank asset riskiness that is used to calculate the capital requirements, as well as costs associated with branches.

The Post Bank, on the other hand, would not need to deleverage as commercial banks have done. Moreover, the branch network already exists as it is needed for postal services, so the marginal cost associated to branches is much smaller than for commercial banks. Furthermore, the main line of business would be domestic retail and SME, which would isolate the Post Bank from global shocks and make their activities less pro-cyclical; this is in line with the empirical evidence that government-owned banks' lending is substantially less pro-cyclical that private banks' lending.[31] As seen during the financial crisis, this is very important since it means that the Post Bank would counteract, rather than exacerbate, future recessions.

Targeting SMEs lending and BCA, therefore, would increase competition in the sector and allow the Post Bank to obtain substantial revenues from these activities. But there are other social benefits. The increased availability of products for SMEs would be more important in

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[30] CMA / FCA (2014) "Banking services to small and medium-sized enterprises" (https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf).

[31] Bank ownership and credit over the business cycle: Is lending by state banks less procyclical? By Ata Can Bertay, Asli Demirgüç-Kunt, and Harry Huizinga. Journal of Banking & Finance 50, 2015. http://www.sciencedirect.com/science/article/pii/S0378426614000958.

areas where commercial banks have recently been retreating from, typically more rural and poorer areas. Therefore, these areas would benefit more from the existence of the Post Bank: banking products availability would improve their SMEs' performance, which would have positive economic consequences for these areas.

Given the privileged position that the Post Bank would have, it could acquire a substantial market share in the SME segment in a relatively short period of time, especially if it partners with an institution with some expertise. Several surveys suggest that there is strong demand from SMEs for better banking services.[32] We suggest, as an initial target, a goal of 5% of the market share. Acquiring a 5% market share in small business loans would give rise to a portfolio of circa £5bn, and it would amount to £100m in terms of profits from BCAs.

This SME lending portfolio would need additional equity capital to maintain healthy solvency ratios. For the mentioned portfolio of £5bn, this would imply additional equity of around £500m. However, this would be a gradual process, and the Post Bank's own profits could be used to build up this additional equity to enter into the SME market segment, without the need of an additional equity injection by the government.

v) Capitalising on existing strengths

Brand

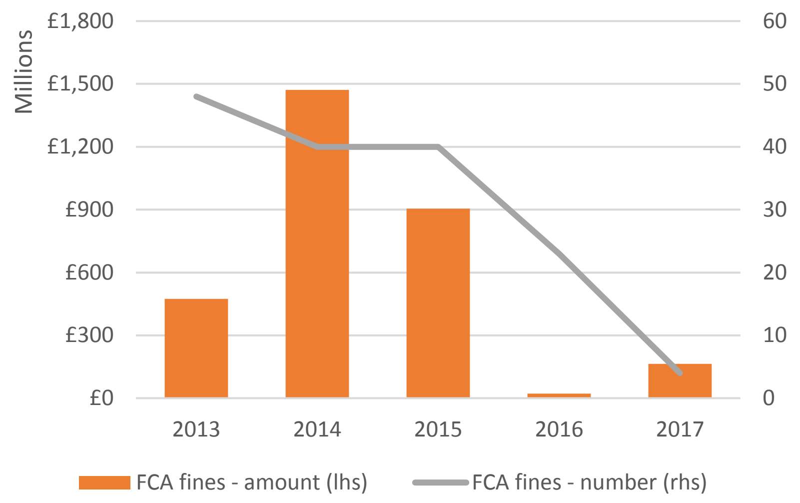
The perception of banks by the public in the UK is generally negative. The financial crisis, together with the excesses of the sector and its conduct scandals, has increased the mistrust towards banks. A report by YouGov[33] published in 2013 highlights that 73% of the people surveyed described the reputation of banking as bad, the highest number among the industries they tested.

The industry itself recognises this issue. Antonio Simoes, the CEO of HSBC, believes that "*the public trust in us might take a generation to re-establish itself*".[34] Mark Carney, the Governor of the Bank of England, has expressed similar thoughts: "*A series of scandals ranging from mis-selling to manipulation have undermined trust in banking, the financial system and, to some degree, markets themselves.*"[35]

The Libor and the PPI scandals are probably the two best known recent misconduct behaviours, but they are not the only ones. As Figure 11 shows, the FCA has imposed 155 fines since 2013, with the total amounting to over £3bn. Even in the first months of 2017, fines of a total of £163m have been imposed.

[32] https://yougov.co.uk/news/2017/05/22/smes-want-banks-do-more-support-business/.
[33] http://cdn.yougov.com/cumulus_uploads/document/ylf7gpof19/Public_Trust_in_Banking_Final.pdf.
[34] http://www.telegraph.co.uk/business/2016/03/08/hsbc-boss-customers-wont-trust-banks-for-a-generation/.
[35] http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech970.pdf.

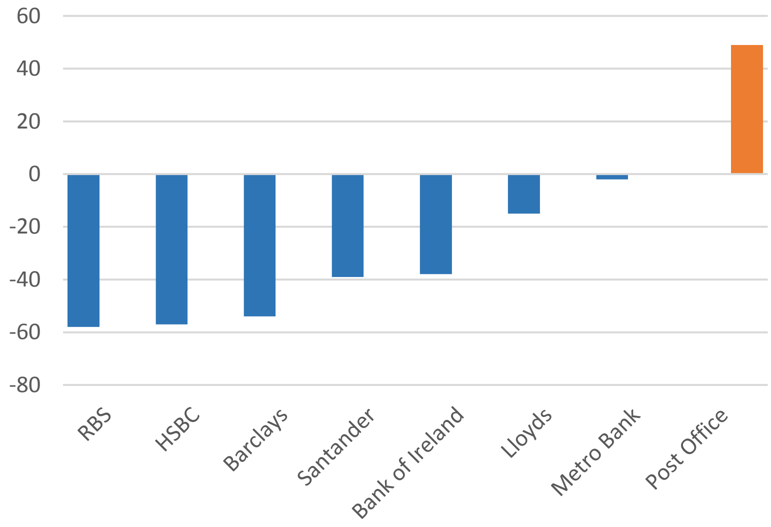
Figure 11: Fines on banks for misconduct cases in the period 2013-2017



Source: FCA website.

In contrast, the public opinion of the Post Office is very positive. A recent survey showed that the Post Office is the second most trusted brand by the British people.[36] The website YouGov, where users can rate different brands, shows the difference in perception between banks and the Post Office. Figure 12 shows that the ratings for the top banks are significantly negative; the current partner of the Post Office, the Bank of Ireland, is no exception. Even Metro Bank, which is a new lender with a strong focus on customer service, has a slightly negative rating. The Post Office, on the other hand, shows a highly positive rating.

Figure 12. Brand perception for the Post Office vs other banks.



Source: YouGov (June 2017)

[36] http://www.thedrum.com/news/2014/04/11/britons-trust-aa-post-office-boots-and-google-more-any-other-brand.

This positive perception would allow the Post Bank to attract customers more easily and faster than new challengers could achieve, since it would capitalise on an already known and valued brand.

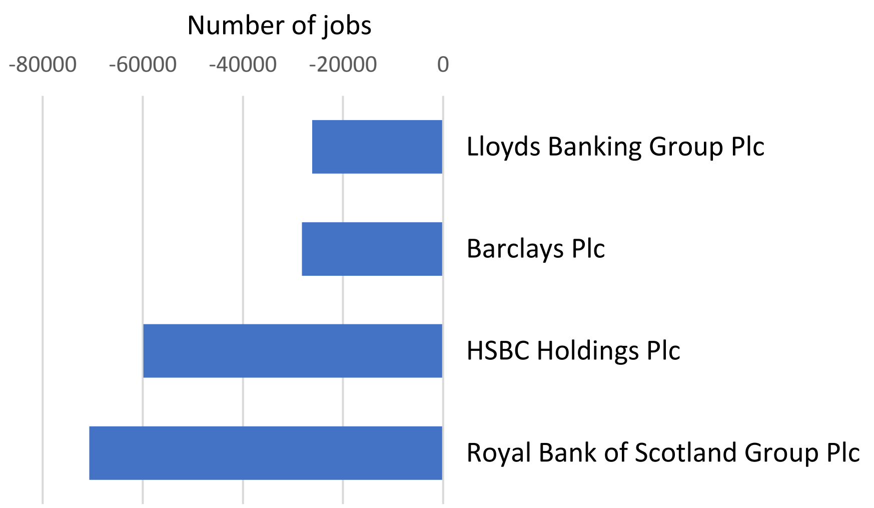
Skill availability

The Post Office has already a number of staff with the relevant skills. For example, there are mortgage advisors in approximately 100 larger branches. While the Post Office will be able to retain and retrain some of the current workforce, it is also true that a Post Bank will require a recruitment drive for personnel with the right skill set. This can be also seen as an opportunity to create highly skilled jobs, particularly in areas where there is a paucity of opportunities.

A key impact of the financial crisis on the banking industry has been a severe cut in jobs in order to reduce costs. As for the bank branch closure, this is an on-going process. The cumulative sum of the job losses over the period 2011- 2017 is presented in Figure 13 for the Big-4 UK banks. In absolute term, full time equivalent workers (excluding temporary workers) that have been dismissed by the Royal Bank of Scotland numbers to above 60,000. On similar level are the jobs cuts by HSBC. Slightly behind, we find Lloyds and Barclays. Even assuming that some of these workers have been absorbed by the fast-growing challenger banks, many have been left behind.

A Post Bank will need their expertise to adequately offer banking products and more in general the management skills to run the banking business—for instance in terms of marketing strategy, risk management and accounting. Part of this expertise could come from bank staff that were laid off but have the relevant skills and experience in the different banking business areas in which the Post Bank will plan to expand. The upside will also be to alleviate the negative implication of banks' decisions on the economy in terms of employment.

Figure 13. Job losses in Full-Time Equivalent terms since the financial crisis



Source: SNL Financial

Financial inclusion

UK banking was traditionally centred on physical branches and personal interaction with bank staff; for this reason, branch closures are worsening the ability to access financial services particularly in remote and less densely populated areas. As noted by the FCA,[37] "*bank branch closures are commercial decisions by banks that may disproportionately affect certain consumer segments such as older people, those in low-income communities… and small business.*"

The government has acted upon these concerns by negotiating with banks to maintain an adequate coverage of the most remote areas, and in most of the cases suggesting the use of Post Office branches. However, only basic banking services are offered in this case. Given that physical branches are still crucial for accessing to banking services, particularly for those customers who are less likely to have internet access, the set-up of a Post Bank would allow the offering of retail services via an extensive network and thus alleviate the additional financial exclusion created by bank branch closure and their reliance on online banking services.

This issue is very relevant for a considerable part of the population: around 1.5 million UK adults remain unbanked;[38] 3.8 million UK households do not have internet at home, and 12 million people live in rural or remote areas of the UK where poor internet access can make it difficult for them to manage their money online.[39] Moreover, 1 in 5 consumers in UK lacks digital skills.[40]

Access to financial services is globally recognised as important to financial stability and the integrity of markets. Consumers excluded from mainstream financial services are more likely to use the cash economy and alternative providers. In the process, they are more vulnerable to being exploited or scammed by criminals. More in general, research has indicated that financial inclusion facilitates greater participation in the economy and cost savings. Indeed, formal financial services, such as savings or insurance, can help planning and provide protection against potential income losses deriving from illnesses, accidents and natural disasters. Access to credit for micro, small and medium-sized enterprises is an indispensable tool for economic growth. For people on low income, ready access to formal financial services can make the difference between poverty and the ability to stay above the poverty line.

Table 6 discusses the role that a Post Bank plays in terms of: i) easier and "wider" access to financial products for customers; ii) financial products offered to a larger set of customers, including traditionally "unbanked" customers; and iii) financial products offered at a lower cost, thereby contributing to socio-economic development [41].

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[37] https://www.fca.org.uk/publication/occasional-papers/occasional-paper-17.pdf.
[38] Rowlingson, K., and McKay, S. 2015. Financial inclusion annual monitoring report 2015. http://www.friendsprovidentfoundation.org/wp-content/uploads/2015/10/University-of-Birmingham-Financial-inclusion-report-2015-final.pdf.
[39] Office for National Statistics, 2015. Statistical bulletin: Internet Access - Households and Individuals: 2015 https://www.ons.gov.uk/peoplepopulationandcommunity/householdcharacteristics/homeinternetandsocialmediausage/bulletins/internetaccesshouseholdsandindividuals/2015-08-06
[40] House of Lords, 2015. Make or break. The UK digital future. https://publications.parliament.uk/pa/ld201415/ldselect/lddigital/111/111.pdf
[41] Cull, R., Ehrbeck, T., and Holle, N. 2014. "Financial Inclusion and Development: Recent Impact Evidence", Focus Note No. 92, CGAP.

Table 6. Post Bank and Financial Inclusion

	Main challenges	*Post Bank's role*
Access	• **Physical barriers** This relates both to the ability to access financial services in the local community as well as the accessibility of these services.	The Post Bank would own one of the largest and most 'capillary' retail networks in the world which aims to connect all parts of a country - unlike banks which tend to concentrate in profit centres such as larger and wealthier cities.
Eligibility	• **Income** Banks tend to focus on higher-income customers.	Based on its unique public-oriented mission and universal service obligation, a Post Bank would be more willing to accept all types of customers (in terms of income, employee status, race, gender).
Affordability	• **Cost** The cost of accessing financial services, including both direct and indirect costs, is a main barrier to financial inclusion.	Post Banks can provide financial services at a large scale, which should enable them to exploit economies of scale, thereby minimising production costs and increasing their likelihood to be profitable

Source: UPU (2016)

Final remarks

In the above we have set out a case for the establishment of a Post Bank as a separate subsidiary of the Post Office. We envisage the Post Bank to be a modern, sophisticated and innovative player offering a range of banking services at a large scale. We argue that a Post Bank is a viable business opportunity that will contribute to the revenues of the Post Office, thereby ensuring its long-term sustainability and ending its reliance on government subsidies.

We make the following recommendations.

1. We recommend that the partnership with the Bank of Ireland should be ended, as it has failed to deliver the expected outcomes.
2. We recommend the establishment of a Post Bank that is (at least partially) owned by the Government and operates through the Post Office branch network.
3. We advise that the Post Office acquires the Bank of Ireland UK portfolio as the initial portfolio of the Post Bank, retaining all the customers that have acquired products and services white-labelled via Post Office Money.
4. We recommend the Post Bank to be set up as a separate subsidiary, with a separate management team and separate accounting, and endowed with its own capital.
5. We advise the Post Bank to make use of the capillary branch network to expand in SME lending and BCA segments.
6. We identify possible mergers or partnership with challenger banks that specialise in SME lending in order to acquire modern technology and skills.
7. We encourage the Post Office capitalise on its existing strengths, its strong brand and reputation, to fully benefit from the establishment of a Post Bank

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Agenda Item 5

Overview and Scrutiny Committee		
Title	Thames Water Strategic Review and Response to Scrutiny Recommendations	
Contributor	Executive Director for Resources and Regeneration (Overview and Scrutiny Manager)	Item 4
Class	Part 1 (open)	31 October 2017

1. Purpose

1.1 To provide the Overview and Scrutiny Committee with information on the Trunk Mains Strategic Review (Appendix A) carried out By Thames Water.

1.2 To ask the Committee to note the response from Thames Water to the joint recommendations arising from pan-London scrutiny on burst water mains (Appendix B).

2. Recommendations

2.1 The Overview and Scrutiny Committee is recommended to:

1. Note the content of this report.
2. Note the findings of the Strategic Review.
3. Consider the response to the joint recommendations arising from pan-London scrutiny of burst water mains and question Mark Mathews, Local and Regional Liaison Manager, Thames Water; and Tim McMahon, Head of Water Networks, Thames Water.

3. Thames Water incidents

3.1 Eight major bursts occurred in London between October and December 2016. The bursts were significant both in terms of the number of people affected by the flooding caused, and the number of road closures necessary to repair the pipes.

3.2 In Lewisham there was a major burst on 26th November 2016 in Lee High Road. 52 properties were flooded and customers in the surrounding area were without water or experienced low pressure for a short period. In addition, a coach got stuck in the collapsed carriageway. The burst was from a 24” diameter pipe laid in 1900.

3.3 A further event on 10 December 2016 in Lee Road, Blackheath, flooded 10 businesses and 8 homes in Meadowcourt Road. This was a distribution main, not a trunk main, and the burst was caused by accidental contractor damage.

4. Reports

4.1 Following these major bursts, Steve Robertson, Thames Water Chief Executive, commissioned an independent forensic analysis review. This was completed at the end of March 2017 and was made public on 25 April 2017. The report can be found here:

https://www.thameswater.co.uk/sitecore/content/Corporate/Corporate/About-us/Investing-in-our-network/Trunk-mains-review

4.2 A strategic review of trunk mains was then carried out by Thames Water and published on 2 October 2017. This can be found at Appendix A. The report builds on the recommendations of the preceding independent forensic analysis review, led by Paul Cuttill. The strategic review makes 15 commitments, across five key areas: operating model; monitoring; asset information; risk management and event response. Thames Water has said it will deliver these commitments over the next 18 months.

5. Scrutiny of the incidents

5.1 Four of the London boroughs affected by these bursts (Islington, Hackney, Lewisham and Lambeth) conducted scrutiny investigations into the incidents. The boroughs also agreed, following a meeting held at Lewisham on 3 February 2017, to pursue a coordinated approach to providing their findings to Thames Water, in consultation with the London Assembly Environment Committee, which also investigated these matters.

5.2 At the Overview and Scrutiny Committee meeting on 11 July 2017, The Committee endorsed a series of joint recommendations. A response to these recommendations can be found at Appendix B. Mark Mathews, Local and Regional Liaison Manager and Tim McMahon, Head of Water Networks, from Thames Water are attending the meeting to present the response.

5 Financial implications

6.1 There are no financial implications arising from this report per se.

6.2 The engineering response to Thames Water incidents is generally directly managed so the cost to the Council should be limited to staff time managing the incident through to recovery and providing community assistance and accommodation etc. if required.

6.3 Highway costs for Temporary Traffic Regulation Orders etc. are recoverable. The number of Thames Water incidents, although the majority are small, still result in a significant workload in terms of Street Works co-ordination and noticing etc. and the cost of these works are also recoverable.

6.4 Individuals and the wider community may be adversely affected and incur costs as a result of more serious incidents also affecting insurers etc. Larger Thames Water incidents also impact on traffic movements leading to delays and congestion with associated lost output to individuals, the community and wider London with associated financial and economic implications.

6.5 Flooding incidents on the public highway can have a significant impact on the durability and lifecycle of both footways and carriageways. This can result in the need for earlier programmed maintenance and potentially also reactive works which have an ongoing cost to the Council in terms of both capital and revenue budgets.

6 Legal implications

7.1 There are no legal implications arising from this report.

For further information, contact Charlotte Dale on 0208 314 8286

Thames Water
Trunk Mains Strategic Review

Final Report

Date of issue: 2 October 2017

Table of contents

1 Executive Summary

We commissioned the Trunk Mains Forensic Review in mid-December 2016 as an independent review of the major burst / leak events that occurred in 2016. It covered the potential causes of the failures and our response, set in the context of our management framework to monitor, maintain and replace trunk mains.

We recognise how upsetting and disruptive these incidents were for our customers, and the very significant impact they had both at the time and since, particularly for people whose homes and businesses were flooded. We provided both immediate and longer term support and have been working with people to help them get their lives and businesses back to normal as quickly as possible.

This Trunk Mains Strategic Review report sets out the commitments we are making to reduce the risk of such events, and the distress and disruption they cause. The commitments have been drawn up in response to recommendations set out in the preceding Trunk Mains Forensic Review. Those recommendations have already been the subject of continuing discussions and meetings with the communities affected by the trunk main bursts of 2016, and a range of stakeholders, including their elected representatives in Parliament and London Boroughs. We have mapped the 80 recommendations in the Trunk Mains Forensic Review to 15 commitments set out in this report which we will deliver through an implementation phase over the next 18 months. Specifically;

- we have started work on 16 of the 80 Trunk Mains Forensic Review recommendations, each of which has been allocated to an accountable lead individual, and an implementation owner;
- 20 of the 80 Trunk Main Forensic Review recommendations are being addressed by business as usual activity or other programmes within Thames Water;
- 41 of the 80 Trunk Main Forensic Review recommendations are directly addressed by Trunk Main Strategic Review commitments and will be implemented through the trunk mains implementation phase though they may require some planning or, in some instances, further design work before implementation; and
- we have decided not to implement three of the Trunk Main Forensic Review recommendations at this time, and explain our reasons in this document.

We look forward to communicating and discussing the outcome of this review with affected communities, our customers more generally, their political representatives, Ofwat and other stakeholders. We recognise the importance of continuing the dialogue with them about the delivery of the commitments we have made. We are also committed to continuous learning from past and future trunk main burst events.

The Trunk Mains Forensic Review recognised that much of the trunk mains network was constructed in the early 19th century. A key recommendation was that there should be an ‘intensive care’ period for our Trunk Mains assets. We have interpreted this as the need for a period of focus across the end-to-end asset management lifecycle for our Water network assets. Through these two reviews, our work with communities and stakeholders, and the work to re-line and replace trunk mains that burst, we have had an intense focus on these assets since December 2016. We will continue this focus through the trunk mains implementation phase.

The trunk mains implementation phase will begin in earnest by October 2017. At its conclusion the changes and improvements that we have made will be continued as business as usual. The trunk mains implementation phase will:

- provide the focus and resource needed to implement the Trunk Mains Strategic Review commitments;

- satisfy the recommendation from the Trunk Mains Forensic Review; and
- provide the necessary end to end focus on trunk mains so that improvements are sustained.

We have set out a high level implementation plan for the trunk mains implementation phase, and it includes a number of pilot projects that will allow us to test our proposed improvements. Following these pilots we will revisit the commitments we have made in this report to confirm that we are implementing the right improvements for our customers and the business. We expect to conduct this review six months after the start of the trunk mains implementation phase. Significant improvement steps have already been taken and we have set aside additional money to support the trunk mains implementation phase. This is in addition to the dedicated budget for the re-lining of sections of burst trunk mains such as in Leigham Vale and Upper Street.

In the long term our strategy is to replace the trunk mains network, starting with those parts where the risk of a failure is greatest. Better information about our network and better risk models will help improve the detailed planning required. Our business plan for the period from 2020 onwards will be released for consultation in 2018 and will include options for a comprehensive long term programme of replacement.

The Trunk Mains Strategic Review is structured into five themes. We have made a total of 15 commitments across the five themes.

Theme 1 - Operating model: The operating model theme contains commitments that will improve the way in which the business is structured, the roles, accountabilities and responsibilities, and the governance to support this. The commitments in this theme build on work already done to develop and implement a 'Single System Owner' model for end to end asset management that is in line with international standards for asset management.

Theme 2 - Monitoring: The monitoring theme commitments will renew the trunk mains monitoring strategy, improve our use of monitoring data to proactively and reactively identify bursts, and achieve completion of the existing monitoring equipment installation programme.

Theme 3 - Asset information: The asset information theme commitments will improve the way that we collect, assure, view and analyse data on the trunk mains asset.

Theme 4 - Risk management: The risk management commitments will improve the way that we predict, model and understand the probability of a trunk mains burst and the consequence of such a burst.

Theme 5 - Event response: The event response commitments will develop and strengthen our incident and emergency management capability, including the operational response to containing the burst and repairing the trunk mains, customer communications and care, stakeholder engagement, and operational rotas and working patterns.

We are grateful for the support that Ofwat have given us in the direction and governance of the Trunk Mains Strategic Review report, including seconding their Principal Engineer to provide challenge and technical expertise through the Trunk Mains Strategic Review Steering Group.

We acknowledge that this is not the end of our learning process from the trunk main bursts in 2016, and we are committed to systematic changes that make it easier to identify and embed learning from past and future trunk main burst events. We are confident that the commitments in this report are deliverable, that they will improve our management of trunk mains, improve our response to trunk main bursts and reduce the impact of future bursts on our customers. We also recognise that due to the nature, age and use of these assets, it is inevitable that for the foreseeable future some trunk mains may continue to fail from time to time.

A high level programme and timescales to deliver the 15 commitments are presented in Table 1.

2 Introduction

2.1 Background to trunk mains

A trunk main is a classification given to larger diameter mains in a water transmission and distribution system. Historically our trunk mains were considered as those 12” diameter and greater in London and 10” and greater in Thames Valley. We are improving the classification of Trunk Mains to incorporate their function, focusing on the key mains that convey large volumes of water at high pressure from treatment works across our network to a number of service reservoirs.

Figure 1 - Modern trunk main

Figure 2 - Burst trunk main from the Upper Street event

We have over 3,200km of trunk mains. Approximately 2,000 km of these and their control mechanisms are in London, buried under busy streets, red routes and key third party assets. Much of the trunk mains network was constructed before 1900 using simple techniques, and fabricated in challenging environments with little or variable quality control. We currently experience an average of 310 trunk main bursts and leaks per year[1], of which we expect approximately 60 to be the result of failures on larger-diameter mains that are 18”/450mm and above (based on averages from the last 13 years[2]). Overall, the number of bursts in the entire network is running at about the same level as in 2015/16.

The planned investment in the AMP6 objectives[3] in the Thames Water Investment Strategy for Trunk Mains totalled £147m at 2012/13 prices. This included spending money on:

- expanding the monitoring of high consequence trunk mains from 5% to 8% of the trunk mains network by the end of AMP6;
- re-laying 45km of the highest consequence trunk mains. This replaces 1.2% of the overall network; and
- gathering information and building data models on trunk main condition and deterioration, in order to support the case for further investment in the next periodic review.

In March 2017 we committed to invest an additional £97m, over and above the budget in our Investment Strategy for Trunk Mains. This includes additional expenditure on the following:

- increased expenditure on re-lining trunk mains to include the trunk mains involved in recent bursts;
- additional condition surveys and monitoring equipment installation;
- trunk main focussed studies; and
- implementation of the Trunk Mains Strategic Review commitments.

[1] average visible leaks from the last 13 years, June (Regulatory) Return Period (”JR”) JR04 – JR16
[2] JR04-JR16
[3] Asset Management Planning period 6, from April 2015 to March 2020 inclusive

2.2 Summary of our overall response to the trunk mains bursts

In response to the eight high profile bursts that occurred between October and December 2016 we have implemented a staged programme to improve the service to customers both in the short-term (by identifying things we can do immediately) and in the longer term, by identifying appropriate levels of future investment. Specifically, this programme covers:

- **Our customer response**: We recognise how upsetting and disruptive these incidents were for our customers, and the very significant impact they had both at the time and since, particularly for people whose homes and businesses were flooded. We provided both immediate and longer term support and have been working with people to help them to get their lives and businesses back to normal as quickly as possible.
- Event teams were dispatched to isolate the bursts as quickly as possible, provide immediate customer support such as alternative water supplies and accommodation, work closely with the emergency services, and to provide information on the ground and at resident's meetings. We also provided welfare units, flood remediation services, sent loss adjustors to site as part of the immediate response, made ex gratia payments of £1,000 to household customers with internal flooding, and £2,000 to household customers who have been flooded more than once.
- **Re-lining critical trunk mains**: The additional budget commitment of £97m, over the period up to 2020, to deliver the full programme of relining, monitoring, and reviews has been approved. We have committed to re-line or replace the pipes at Upper Street (around) and Leigham Vale. At the time of publication, 1.31km of the 21" main at Leigham Vale had been re-lined, 0.43km of the 36" main at Upper Street had been re-lined with a total of 0.62km planned to complete by the end of September. Additional re-lining work is underway at Baker Street and New Malden.
- **The Trunk Mains Forensic Review**: A forensic review of 31 significant trunk main bursts in 2016, starting with the eight high profile trunk main bursts that occurred between October and December 2016. The Trunk Mains Forensic Review commenced in December 2016 and the report was published on the Thames Water website in April 2017. The review was commissioned by Thames Water and independently led by Paul Cuttill, OBE. The complete list of 80 Trunk Mains Forensic Review recommendations can be found in the Trunk Mains Forensic Review report available on our website at https://corporate.thameswater.co.uk/About-us/Investing-in-our-network/Trunk-mains-review
- **The Trunk Mains Strategic Review**: A review of our strategy for managing the trunk main assets. The review sets out the actions we are taking and commitments we are making in response to the Trunk Mains Forensic Review findings and recommendations, given the wider context of ongoing business change. Ofwat have participated in the Trunk Mains Strategic Review, in particular through the involvement of their Principle Engineer as part of the Trunk Mains Strategic Review Steering Group. The output of that review is summarised in this document.
- **Long-term investment strategy**: our long term strategy is to replace the trunk mains network, starting with those parts where the risk of a failure is greatest. The improved information about our network, and better risk model outputs from the above activities will feed into the work that we are already doing to develop the detail behind this long-term approach. This will form part of our proposed business plan for the period from 2020 onwards, on which we will consult widely with all our customers and stakeholders and will include the comprehensive programme to replace all our Trunk Mains assets over the longer term.
- **Social media and communications improvement plan**: A complete review of our customer engagement methods, with the intention of helping Thames Water customer engagement teams manage their interaction with customers more effectively, and position Thames Water as a role model for incident management. This includes analysis and improvement of contact centre practices, media engagement, social media response and event broadcasting/narrowcasting.
- **Stakeholder engagement**: Our approach to engaging with stakeholders is focused on building relationships before, throughout, and in the aftermath of an event in order to keep them sufficiently

well informed to ensure that they can carry out their own functions effectively. We maintain relationships with relevant third party organisations, including emergency services and Transport for London ("TfL"). We use stakeholders' communication networks to push out key messages to a more targeted audience to reduce customer contacts and improve customer experience.

- **Ofwat engagement**: The recent event in South London is an example of where we have raised issues with Ofwat pro-actively at the earliest opportunity. We accept that we did not follow this approach with the spate of bursts in 2016 on our trunk network in London. We have taken steps to improve our communications with Ofwat and will build upon this for future engagement.

2.3 The Trunk Mains Forensic Review

Following the eight high profile trunk main bursts that occurred between October and December 2016 our Chief Executive, Steve Robertson commissioned an immediate forensic review of all our trunk main bursts in 2016. The independent Trunk Mains Forensic Review was led by Paul Cuttill OBE. Paul has over 30 years' experience in utilities, including as EDF Power Networks' Chief Operating Officer. The Trunk Mains Forensic Review commenced in December 2016 and the report was published on the Thames Water website in April 2017. The Trunk Mains Forensic Review used a management framework to assess the Thames Water approach to managing the trunk main asset network across the 4 lifecycle stages (asset planning, asset operation and maintenance, asset monitoring, and event response.) The Trunk Mains Forensic Review produced 80 recommendations derived from the findings,

Specifically the Trunk Mains Forensic Review covered:

- the factors contributing to each burst – asset condition, its location and environment, and whether any patterns of failure could be identified;
- the impact – on customers, the wider community, and the cost;
- our immediate response – identifying what we and others did well and what we need to improve; and
- the network – whether we need to make changes to network configuration, pumping and control regimes.

The key findings from the Trunk Mains Forensic Review are:

- there is no single common cause of the bursts. Whilst age and condition of the pipes is an underlying factor in the eight high-profile failures, there were no systematic failings that could be said to have consistently caused or enabled the bursts
- there is a clear investment strategy and plan for our trunk mains that is supported by advanced risk and statistical modelling, we improve our understanding of our network and improve how we manage our existing data and knowledge
- the 'building blocks' necessary to deliver our trunk main plans and commitments are in place, we focus on improving the management of our planned works and make better use of local knowledge
- improving how we monitor our trunk mains and spot potential future bursts, recommending that we accelerate the roll-out of monitoring units (equipment that can monitor where bursts may happen or have already occurred), refresh how we prioritise alarms, increase our capacity to analyse data, and work with our alliances to develop new, innovative ways of assessing the condition of our pipes and
- a number of recommendations for improving communication with both customers and within the company immediately after bursts have happened, our capacity to deal with multiple major incidents, and how we can better learn from incidents after they've taken place.

The findings from the Trunk Mains Forensic Review have been communicated to our stakeholders and customers, particularly those who were affected by the 2016 bursts. This has involved presentations at London Borough Scrutiny committees, community liaison events, London Assembly committee meetings, and in one-to-one briefings. The Review is also available on our website.

2.4 Purpose and approach of the Trunk Mains Strategic Review

The purpose of the Trunk Mains Strategic Review is to:

- define and document our response to the Trunk Mains Forensic Review and the changes that we will commit to in order to meaningfully address its recommendations;
- deliver discrete improvements to trunk mains management based on the Trunk Mains Forensic Review recommendations; and
- define the changes we will make to reduce the impact of a trunk mains burst on our customers

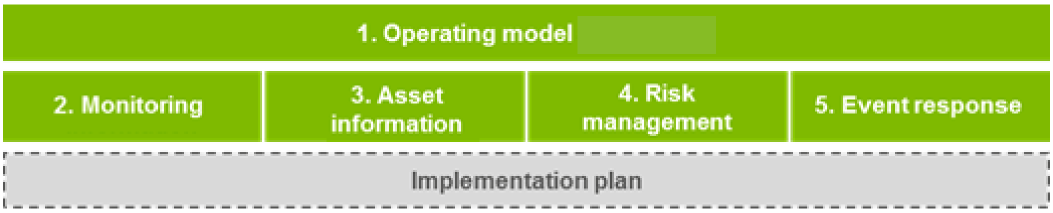
We commenced the Trunk Mains Strategic Review in February 2017 to coincide with and follow on from the Trunk Mains Forensic Review. We recognised that we needed to review our capability, supporting systems and accountabilities in light of the 2016 trunk main bursts and the findings of the Trunk Mains Forensic Review. The publication of this report is an important milestone in our programme of learning and improvements following the trunk mains bursts in 2016.

We look forward to communicating and discussing the outcome of this review with affected communities, our customers more generally, their political representatives, Ofwat and other stakeholders. We recognise the importance of continuing the dialogue with them about the delivery of the commitments we have made. Following the publication of this report we will focus on the implementation of the commitments through the trunk mains intensive care period, building on the changes that we have put in place already.

3 Summary of Commitments

This section provides a summary of each of the 15 Trunk Mains Strategic Review commitments. The Trunk Mains Strategic Review commitments were grouped into 5 themes, underpinned by an implementation plan. There are up to four commitments in each theme. Each commitment is made up of a number of improvements that we are committing to in order address specific Trunk Mains Forensic Review recommendations.

Further detail on each commitment can be found in sections 4 to 8.



Trunk Mains Strategic Review themes

3.1 Theme 1: Operating Model

The operating model theme contains commitments that will improve the way in which the business is structured, the roles, accountabilities and responsibilities, and the governance to support this. The commitments in this theme build on work already done to develop and implement a ‘Single System Owner’ model for end to end asset management that is in line with international standards for asset management. There is one commitment in the operating model theme.

- Commitment 1.1: Develop a ‘Single System Owner’ model and implement through the Trunk Mains Intensive Care Period

3.2 Theme 2: Monitoring

The monitoring theme commitments will renew the trunk mains monitoring strategy, improve our use of monitoring data to proactively and reactively identify bursts, and achieve completion of the existing monitoring equipment installation programme. There are four commitments in the monitoring theme.

- Commitment 2.1: Formalise the trunk mains monitoring policy
- Commitment 2.2: Provide updated and repeatable control room training
- Commitment 2.3: Develop our data utilisation capabilities
- Commitment 2.4: Revitalise the monitoring unit installation process

3.3 Theme 3: Asset information

The asset information theme commitments will improve the way that we collect, assure, view and analyse data on the trunk mains asset. There are four commitments in the asset information theme.

- Commitment 3.1: Improve our visibility of and access to reliable asset information
- Commitment 3.2: Develop new methods of data collection
- Commitment 3.3: Improve processes so that data is reliably collected across the trunk main network
- Commitment 3.4: Improve asset information standards and policies

3.4 Theme 4: Risk management

The risk management commitments will improve the way that we predict, model and understand the probability of a trunk mains burst and the consequence of such a burst. There are three commitments in the risk management theme.

- Commitment 4.1: Increase utilisation of existing risk management resources, models and tools
- Commitment 4.2: Improve risk management capability
- Commitment 4.3: Investigate an operational risk model

3.5 Theme 5: Event Response

The event response commitments will develop and strengthen our incident and emergency management capability, including the operational response to containing the burst and repairing the trunk mains, customer communications and care, stakeholder engagement, and operational rotas and working patterns. There are three commitments in the event response theme.

- Commitment 5.1: Mobilise a dedicated out of hours event response capability
- Commitment 5.2: Trunk mains event response improvement programme
- Commitment 5.3: Improve customer care standards and communications during a trunk mains event response

4 Theme 1: Operating Model

This section sets out the commitments under the operating model theme. The operating model theme contains commitments that will improve the way in which the business is structured, the roles, accountabilities and responsibilities, and the governance to support this. The commitments in this theme build on work already done to develop and implement a 'Single System Owner' model for end to end asset management, in line with international standards for asset management.

There is one commitment under the operating model theme:

- 1.1: Develop a 'Single System Owner' model and implement through the Trunk Mains Intensive Care Period

This components of this commitment have already been implemented. Further implementation of this commitment will be undertaken outside the trunk mains implementation phase. They will be implemented alongside other operating model improvements across the Thames Water business. The high level implementation plan can be found in section 9 of this report.

4.1 Commitment 1.1: Develop a 'Single System Owner' model and implement through the Trunk Mains Intensive Care Period

In order to provide clear ownership of the end-to-end asset management process and line of sight from organisation strategy to activity on the ground, the Strategy, Planning and Assurance (SPA) team took on an enhanced System Owner role for Infrastructure (below ground) in late 2016. Through this commitment we will further define and implement the Single System Owner model, which includes the enhanced System Owner role as well as establishing a new Head of Networks role. We will be commencing an implementation period by October 2017 to improve the focus across the end-to-end trunk main asset management lifecycle, and make it more consistent.

We have appointed a Head of Networks to operate as the Asset Manager alongside the role of SPA, and made some changes to the delivery of trunk mains outcomes by clarifying the role of deliverer, for example for trunk mains leak detection and repair, emergency repairs, trunk mains monitoring installation and trunk mains replacement.

We will complete the detailed design of the Single System Owner model and implement alongside wider operating model changes within our business. This will be done in line with a wider Organisation Design review to align with the delivery of our corporate strategy. This will improve our asset management capabilities in line with the Single System Owner model, and increase control of our assets through the establishment of four new roles.

- **Owner –** the head of the SPA team currently takes on this role of Asset Owner with accountability for the longer-term planning and end-to-end management of our assets;
- **Manager –** The Asset Owner will take on accountability for implementation of the recommendations in this report. We recruited a new Head of Networks in May 2017 who will fulfil the Manager role. This will address a gap we identified in translating the longer-term plan and strategy into a rolling 1 year plan. They will be responsible for ensuring the delivery of the plan to the correct standards.
- **Controller –** the Systems Operations teams currently perform the role of the Controller. They are accountable for maintaining the security of supply for the system by managing the operating risks. This includes facilitating access to the network for repair, installation and

shutdown. They are also responsible for managing the asset system during an event and managing the operating priorities across the asset system; and

- **Deliverer –** our alliances, eight$_2$O and the Infrastructure Alliance (''IA''), are accountable for delivering the programme of work agreed by the Head of Networks, to the agreed budget and timescales. They undertake maintenance and construction including trunk mains replacement and re-lining.

In addition, improvements to risk escalation processes through the risk management framework must encompass all relevant risks and not focus specifically on trunk mains risks. We are progressing these improvements across risk types, via our Enterprise Risk Management project.

5 Theme 2: Monitoring

This section sets out the commitments under the monitoring theme. The monitoring commitments will renew the trunk mains monitoring strategy, improve our use of monitoring data to proactively and reactively identify bursts, and achieve completion of the existing monitoring equipment installation programme.

There are four commitments under the monitoring theme:

- 2.1: Formalise the trunk mains monitoring policy;
- 2.2: Provide updated and repeatable control room training;
- 2.3: Develop our data utilisation capabilities; and
- 2.4: Revitalise the monitoring unit installation process.

The four commitments will be implemented as part of the Monitoring workstream activities in the trunk mains implementation phase. The high level implementation plan can be found in section 9 of this report.

Syrinix and Hydroguard are the two primary types of monitoring units that are used to identify bursts and leaks across the trunk mains network. They operate by detecting changes to pressure and sound in the trunk main. Data collected by Syrinix and Hydroguard is sent back to their respective third party servers and notifications are sent to us when certain thresholds are crossed, either by text message or email. Syrinix units are our preferred monitoring unit because it can alert us to leaks and bursts whereas Hydroguard units can only alert us to bursts.

Photograph of a Syrinix monitor on a main

5.1 Commitment 2.1: Formalise the trunk mains monitoring policy

Through this commitment we will develop and implement a policy that will shape how the business approaches trunk mains monitoring. This will provide us with appropriately-timed, accurate, and usable data to assist in response to trunk main leaks and bursts. This commitment seeks to provide the right data to support informed business planning, risk mapping, condition assessment, performance assessment and network optimisation.

There is internal monitoring guidance on how to invest in, use, and manage trunk mains monitoring solutions, however there is no detailed process documentation that sets out a consistent approach to achieving the end-to-end trunk mains monitoring policy. This commitment will address this.

The trunk mains monitoring policy will be structured into three tiers. The three tiers are aligned to our approach to risk management and the division of our trunk mains into sections ('spans') based on consequence of failure levels. Our risk model assigns a consequence level to each trunk main span. Tier 1 is composed of the trunk main spans with the highest consequence and tier 3 is composed of the lowest. Each tier has a different approach to trunk mains monitoring.

Once concluded, the policy will identify the appropriate monitoring equipment and supporting infrastructure, data collection, analysis and reporting for a range of conventional applications. Our formal change process will be improved to allow better adoption of learning and innovation across the monitoring network.

5.2 Commitment 2.2: Provide updated and repeatable control room training

Through this commitment we will increase the ability of the control room team to correctly and consistently use monitoring unit data. This will improve our ability to identify possible bursts and leaks.

The control room is a component of the System Controller role who acts as one of the primary users of the information received from the monitoring units. As part of this role, the System Controller will provide an auditable trail as to how alarms are responded to across all of the monitoring units. The System Controller will also develop capabilities for the proactive use of monitoring data to better inform risk management and event response.

The focus of this commitment is to provide all control room staff with the latest and most appropriate training on the Syrinix and Hydroguard systems so that raw data received from the monitoring units can be better interpreted and used. This will include training on how to perform analysis on the Syrinix and Hydroguard data so that we can identify trends that can be used to better mitigate the risk of or react to bursts and, in the longer term leaks. The longer term vision is that training will be provided to control room staff across all our relevant monitoring units to interpret leak data in order to develop a proactive response to identify and fix leaks before they result in bursts.

5.3 Commitment 2.3: Develop our data utilisation capabilities

Through this commitment we will make appropriate use of the data that is gathered by our monitoring units and increase our in-house capabilities to further the level of analysis that is carried out on this data to inform decisions.

The control room is staffed 24 hours a day so that burst alarms are appropriately dealt with. We have developed a process which sets out how a Syrinix or Hydroguard burst alarm will be dealt with. The process has been formally documented and is available to all control room staff for burst alarms however no such process or training exists for leak alarms.

There is guidance in place on how to set alarm thresholds across the trunk mains network. In some cases however, thresholds are not calibrated to account for the characteristics of leaks and bursts on particular spans of the trunk mains network. We are planning to conduct a pilot study to improve how we actively manage alarm thresholds. We are also carrying out a deep dive analysis exercise to identify potential leading indicators for a burst. This forms part of a wider review of all our existing trunk mains monitoring data to understand how we can get the best use from it.

To improve the visibility of trunk mains monitoring data the aim is improve the integration of all data. The integration of our Syrinix and Hydroguard monitoring unit data is being managed outside of the Trunk Mains Strategic Review and will form part of the business plan for the five year period from 2020. In the interim we are installing a bespoke desk in the control room which will receive all the raw data that is gathered by Syrinix, Hydroguard, and the district meters. This will allow an individual to view all monitoring data on dedicated screens so they do not have to log into separate systems on screens displaying other control room data.

5.4 Commitment 2.4: Revitalise the monitoring unit installation process

Through this commitment we will increase the speed and reduce the complexity of our processes for installing and commissioning Syrinix and Hydroguard monitoring units.

Through this commitment we will increase the pace of installation and commissioning of all monitoring units. We will develop a target profile of trunk main locations that should have monitoring units installed, aligning with the trunk mains monitoring policy as set out in commitment 2.1. The target profile will include an assessment of buildability risk to reduce the instances of the location not being suitable for installation due to a lack of physical space, encroachment by other utilities or difficulty in securing road closures.

The improvements identified will implemented as part of our ongoing trunk mains monitoring programme to design, scope, commission, install and handover new Syrinix monitoring units.

6 Theme 3: Asset Information

This section sets out the commitments under the asset information theme. The asset information commitments will improve the way that we collect, assure, view and analyse data on the trunk mains asset.

There are four commitments under the asset information theme:

- 3.1: Improve our visibility of and access to reliable asset information;
- 3.2: Collate historical data and develop new methods of data collection;
- 3.3: Improve processes so that data is reliably collected across the trunk main network; and
- 3.4: Improve asset information standards and policies.

The four commitments will be implemented as part of the Asset Information workstream activities in the trunk mains implementation phase. The high level implementation plan can be found in section 9 of this report.

6.1 Commitment 3.1: Improve our visibility of and access to reliable asset information

Through this commitment we will create and trial a tool that improves the visibility of all trunk main asset information to inform decision-making across our wholesale water business.

We are working with external experts to develop our current GIS[4] tool based on feedback and requirements from across the Wholesale Water business. This is referred to as the 'visibility tool' and it will include additional risk and event response features including contingency plans. We will pilot this tool with a limited user group and then will make decisions about further development and rollout.

Preliminary designs indicate that the tool will have a number of layers. Each layer will provide a map of the trunk main network overlaid with information that can be used by different teams working on the trunk main network. All the layers will be available to all our staff regardless of whether their role is office or field based. Pending a successful pilot and rollout across the business, certain features of the tool will then be made available to relevant external stakeholders (e.g. the emergency services) as appropriate.

We will invest in the setup and delivery of a programme of work to update our trunk main contingency plans for our trunk main 'shut-able' sections' (the length of trunk main between two shut-able valves). Once developed, the updated contingency plans will be regularly reviewed and updated. This will be done in conjunction with the development of the visibility tool as it is important the visibility tool allows easy access to the required contingency plans.

6.2 Commitment 3.2: Develop new methods of data collection

Through this commitment we will focus on developing new methods of data collection. In time, we expect that this will help drive a greater emphasis on the value of good quality data. This commitment will also collate our historic trunk mains data and improve its availability for evidence based decision-making.

By developing an accurate single view of data and increasing the interaction between our SPA[5] and operations teams, we will drive a culture that recognises the importance of data as a business asset. The

[4] Geographical Information Services
[5] Strategy, Planning and Assurance

SPA team is committed to engaging directly with our operations teams to formalise the understanding of how data will be accurately, consistently and efficiently updated in GIS.

We are committed to developing new and innovative technologies to better analyse trunk main condition. We will continue to work closely with the University of Surrey to develop these technologies and we are in the process of developing a new testing rig, operational in 2018, that will allow us to work with our supply chain to test new tools for assessing asset condition. This is being managed as a project outside of the Trunk Mains Strategic Review by our innovation team.

We are collating all of our historic trunk main burst data across the various databases to produce a single view of the data. We are undertaking infill analysis for trunk main spans where we have identified gaps or where we have low confidence in the data that is currently being recorded. We will develop and communicate a revised process to our in-house operations teams and our alliances, that clearly sets out how all trunk main bursts will be recorded in one single database in an accurate and timely manner.

6.3 Commitment 3.3: Improve processes so that data is reliably collected across the trunk main network

Through this commitment we will identify the most informative data types that exist for our trunk mains network and then develop appropriately governed processes that, once implemented, enable us to collect this data in a reliable and consistent way.

We will first identify the most informative trunk main data types that exist to enhance risk management and event response decisions. Once these data types have been identified we will assess the quality of the current data and the current process by which information is updated for each data type. We will then prioritise which data types and associated processes will be taken forward for improvement.

To address immediate recommendations on operational data collection from the Trunk Mains Forensic Review we have simplified the process to fully capture all local knowledge. We have also arranged a series of ‘‘toolbox talks’’ (workshops for our operations teams) to deliver the message to our operations teams on the importance of updating asset information and the correct process to follow.

6.4 Commitment 3.4: Improve asset information standards and policies

Through this commitment we will improve existing standards and policies to address how asset information will be collected and validated.

We will formalise key definitions regarding our trunk mains network (e.g. risk probability) in order to develop a consistent policy for trunk mains asset information that can be communicated and used across our wholesale water business. This policy will also formalise how we identify which trunk mains require a contingency plan.

The policy will also include all the trunk main data types identified as part of commitment 3.3 and will set out the owner and the formal processes that have been developed to collect data for each data type. We will underpin the data standards and policies by encouraging a cultural shift that places more trust in the information provided by our operations teams, rather than performing excessive validation activities. Appropriate governance and regular checks of the information provided by our operations team will continue to take place to maintain accuracy.

7 Theme 4: Risk Management

This section sets out the commitments under the risk management theme. The risk management commitments will improve the way that we predict, model and understand the probability of a trunk mains burst and the consequence of such a burst.

There are three commitments under the asset information theme:

- 4.1: Increased utilisation of existing risk management resources, models and tools;
- 4.2: Improve risk management capability; and
- 4.3: Develop an operational risk model.

The three commitments will be implemented as part of the Risk Management workstream activities in the trunk mains implementation phase. The high level implementation plan can be found in section 9 of this report.

7.1 Commitment 4.1: Increased utilisation of existing risk management resources, models and tools

Through this commitment we will focus on increasing the extent to which we utilise our existing risk management capabilities and tools to their full potential, enabling increased understanding of risk, improved maintenance of the trunk main network, and better resolution of trunk main events.

To support a one-off improvement activity we will conduct a capability assessment of the risk model to understand its strengths and weaknesses and compare it to risk models and methods used by companies and industries with similar asset failure risks to Thames Water. The assessment will cover the consequence and probability calculations as well as the quality and types of data used. This assessment will inform a number of improvement initiatives that we will prioritise and undertake as part of this commitment, for example development of our predictive analysis capability. It will also provide evidence on whether or not our approach to risk modelling is fit for purpose.

7.2 Commitment 4.2: Improve risk management capability

Through this commitment we will further develop and improve our risk management capability and, where possible and helpful, identify and manage risk at an operational level. This will require us to re-assess the capabilities of the existing risk model, harness the skills and experience of operations teams, seek more innovation in asset condition assessment and place greater emphasis on continuous improvement.

We are in the process of developing a more detailed model that will enhance our ability to accurately predict the flooding footprint of potential events. This in turn will improve our consequence modelling and enable future decision support tools for the control room team to use for 'what if' scenarios when managing events and assessing risk.

We are working more closely with our supply chain to develop new and innovative ways of assessing asset condition. The most notable examples of this are the trunk main condition assessment tool project and the building of a physical testing environment for testing new asset assessment tools. Going forward, this type of collaborative project will be incorporated into business as usual.

7.3 Commitment 4.3: Develop an operational risk model

Through this commitment we will develop and trial a dynamic operational risk model that can be used by our strategic business planning, system control and operational teams.

Once we have proved the use of the strategic hydraulic models we will adapt this model to include risks and make it usable as a day-to-day dynamic operational risk model. This model will be available for use by SPA, system control and operations team members to assess the impact of bursts, network changes and asset enhancements in a dynamic way that supports day-to-day network management decisions. The model will utilise up-to-date asset and network information, including asset status information, from the risk model, SAP and operational activity. This commitment is to develop a trial operational risk model and to pilot it with a limited user group. We will then make decisions about further development and rollout based on the success and benefits of the pilot.

8 Theme 5: Event Response

This section sets out the commitments under the event response theme. The event response commitments will develop and strengthen our incident and emergency management capability, including the operational response to containing the burst and repairing the trunk mains, customer communications and care, stakeholder engagement, and operational rotas and working patterns.

There are 3 commitments under the asset information theme:

- 5.1: Mobilise a dedicated trunk mains event response capability;
- 5.2: Trunk mains event response improvement programme; and
- 5.3: Ensure we provide appropriate customer care.

The three commitments will be implemented as part of the Event Response workstream activities in the trunk mains implementation phase. The high level implementation plan can be found in section 9 of this report.

8.1 Commitment 5.1: Mobilise a dedicated out of hours event response capability

Through this commitment, we will improve our ability to respond to water mains events by establishing a dedicated out of hours operational event response capability. This is in addition to the changes we have already made to provide a dedicated customer response team for major events such as a Trunk Mains burst..

We are considering various methods to better control and contain the impact of a burst main. Whilst we evaluate and develop a sustainable solution that works in the longer-term (commitment 5.2) we will mobilise a suitably equipped dedicated event response capability to handle mains bursts. These teams will be our first response to a potential burst and will work to provide on-the-ground information, control and contain the impact.

The service will bring together teams and expertise from across Thames Water and our alliances to ensure that when a burst occurs we can contain and isolate it in the most effective manner. We will define the processes, policies and service levels required to manage this team in line with our corporate strategy for improved holistic network management.

8.2 Commitment 5.2: Trunk mains event response improvement programme

Through this commitment, we will instigate a programme of works to improve our response and recovery capabilities by making changes to the way we are organised, our processes and governance as well as our capacity to respond to major events. We will evaluate options on how we manage events, and better prepare our core operations by reviewing skills, tools & equipment and ways of working across Thames Water and our alliances. We will set appropriate Service Level Agreements aligned to customers and stakeholder needs to improve our performance, and refine our event response processes to bring them closer into line with those of the Category 1 responders under the Civil Contingency Act.

Transforming the way our organisation operates will not happen overnight. Under commitment 5.1 we will take steps to reduce the time between an event being triggered and containment but this is not enough to radically improve the way we operate. Achieving longer-term sustainable change requires a coordinated programme of initiatives to understand, design, pilot, review and implement new ways of working.

We will instigate a comprehensive Trunk Mains Improvement Programme that will:

- Better align our operational response to customers & stakeholders needs;
- Provide our people with the right skills, training and support now and for the future;
- Streamline governance and decision making;
- Codify our processes and policies to simplify the way we work;
- Introduce technology and making better use of the of the data we manage; and
- Ensure we have the right equipment and resources in place to do our jobs well.

Whilst in many ways the high-level process and technical capabilities will not change significantly, cultural change is an integral part of the transformation journey for our Event Response. The working environment in which managers and staff operate will change considerably. The introduction of new technology, data transparency, simplifying governance arrangements and alternative working patterns will change the way in which staff are expected to operate daily. It will be these new ways of working and shaping a new culture of response that is focused on impacts and outcomes for customers.

8.3 Commitment 5.3: Improve customer care standards and communication during a trunk mains event response

Through this commitment, we will change the way customers and stakeholders experience a Trunk Mains burst event, mitigating the impact through communication, engagement and our in-field response. We will also develop a more joined up approach in line with commitment 5.2 on what we do for our customers during an event.

We will join up our customer communications across event response and customer teams to ensure accurate and consistent messaging. Our Customer Communications Playbook will also provide the Customer Incident Management team with clear standard messaging to support with customer engagement across all channels within input from Events Communications Lead.

There is a team within the contact centre that has clear accountability for liaising with operations teams to understand the customer impact and to ensure that customer messages are disseminated across all channels within 15 minutes and updated regularly.

We utilise a number of methods to interact and communicate with our customers in order to keep them regularly informed. We are investing more into social media, as this is a channel increasingly used by our customers. We have assigned more of our people to provide coverage 24/7 and we have a new tool that enables us to listen to customer conversations about Thames Water on social media and can respond rapidly.

During the recovery phase of an event we will aim where possible to return life back to normal for customers. Our commitment to customer communication and engagement will continue, our customer facing teams will be provided with clear information on the clean-up and insurance processes. Focus will be given to communicating to customers what our insurance coverage is able to provide to them and how to submit a claim.

A new Customer Advice booklet is being developed to be used by the insurance loss adjusters when engaging with customers. This will make it simpler and easier for customers, and teams engaging with customers, to understand insurance claims.

9 High Level Trunk Mains Strategic Review Implementation Plan

This section sets out the high level implementation plan for delivering the commitments through the trunk mains implementation phase. The implementation of the Trunk Mains Forensic Review recommendations has been in progress for several months as we did not want to wait for the conclusion of the Strategic Review to begin. Changes already implemented are those which did not require further design work to determine a solution and were identified as quick to implement.

The remainder of the recommendations were aligned to one of the five themes identified for the Trunk Mains Strategic Review for further investigation and development. Where these recommendations can be implemented this will occur during the trunk mains implementation phase.

There are three Trunk Mains Strategic Review recommendations that will not be implemented at this time. These are:

Recommendation	Reason for not addressing
R4.2.3 Remote valve cost/benefit analysis Work should be undertaken to better understand the feasibility and risks of increased valve automation on the network in order to build a cost/benefit analysis of the investment.	Increasing the number of automated valves on the network is considered as part of the existing trunk mains strategy for this AMP and will continue to be reviewed within our current business processes.
R6.6.1b Establish maximum response times Analysis of flood impact over time in different scenarios should be undertaken in order to understand the impact of response times on the extent of flooding and establish a 'maximum response time' for Trunk Main bursts, with a clear and detailed policy accordingly.	There is a dependency on the further development of the risk model to understand flood impact before dynamic SLAs can be put in place. This is not a capability that is currently available. The focus of the commitments for operational response will be to establish out of hours dedicated response teams.
R6.5.1b Contact Centre Location moved Move the Contact Centre location to sit alongside the Control Room to improve the dissemination of customer information and insight to the Control Room.	Physical space issues prohibit the movement of the Contact Centre to alongside the Control Room; this will be considered as part of any future reviews of our control functions.

The trunk mains implementation phase is a period of 'intensive care' of at least 18 months to improve and make more consistent our focus across the end-to-end asset management lifecycle. We will be commencing this period in October 2017. Within 18 months the changes and improvements that we have made will be continued as business as usual. The trunk mains implementation phase will:

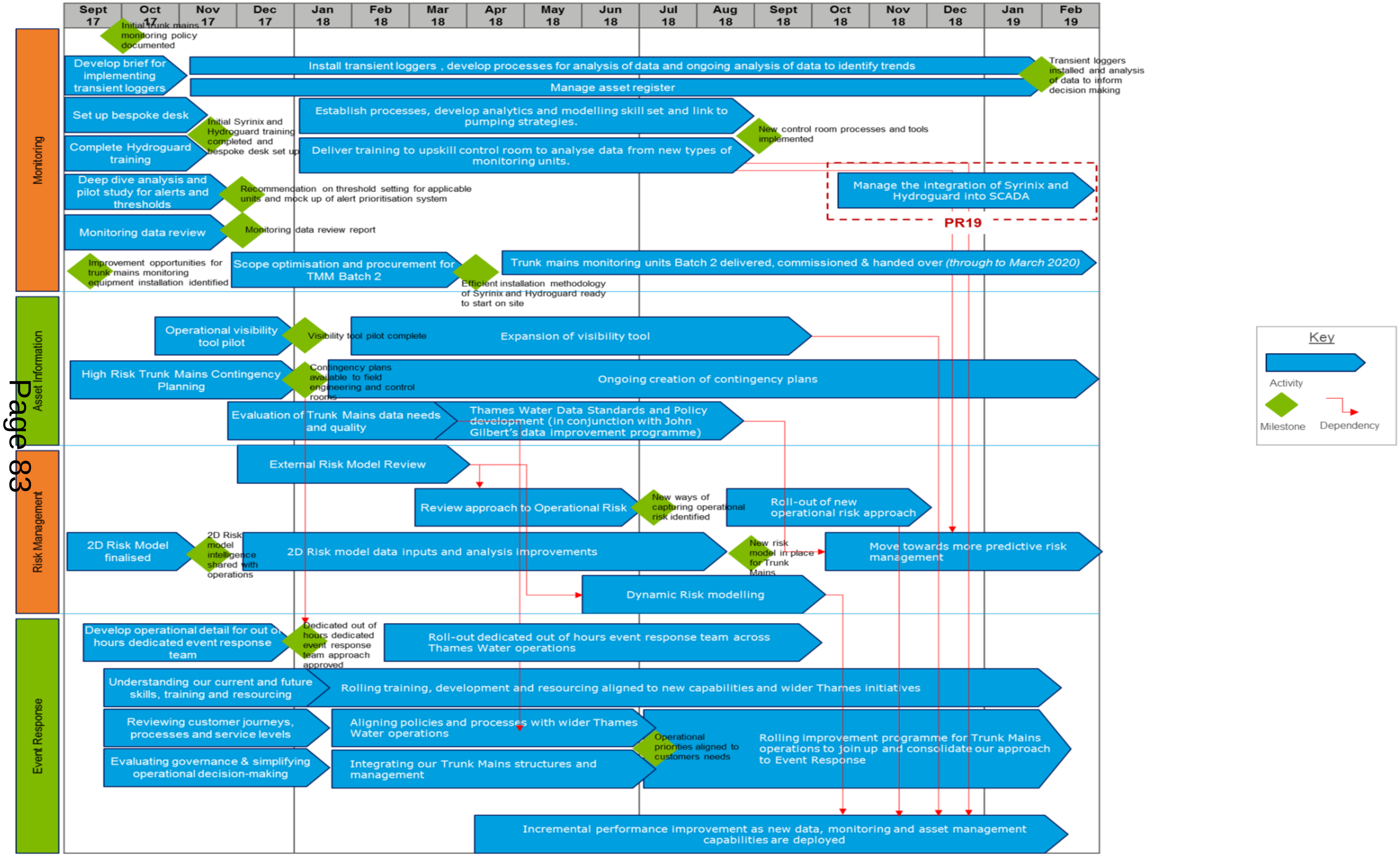
- provide the focus and resource needed to implement the Trunk Mains Strategic Review commitments;
- satisfy the intensive care period recommendation from the Trunk Mains Forensic Review; and
- provide the necessary end-to-end focus on trunk mains so that improvements are sustained.

To guide the activity during the trunk mains implementation phase we have developed an implementation plan aligned to the Trunk Mains Strategic Review commitments detailed in sections 4 to 8.

The high level implementation plan for the trunk mains implementation phase includes a number of pilot projects that will allow us to test our improvements. Following these pilots we will revisit the commitments we have made in this report to confirm that we are implementing the right improvements for our customers and the business. We will commence this review six months after the start of the trunk mains implementation phase. The implementation plan will be managed by a dedicated Programme Management Office (PMO) and overseen by the Head of Networks.

The implementation plan on the following page outlines the key activities and milestones. Each activity is aligned to the relevant theme and associated commitments.

Table 1: High level implementation plan for the Trunk Mains Strategic Review



10 Appendix 1: Glossary of Terms

AIM	Asset Investment Manager
AMP	Asset Management Planning period
AMP5	Asset Management Planning period 5, from April 2010 to March 2015 inclusive
AMP6	Asset Management Planning period 6, from April 2015 to March 2020 inclusive
AMP7	Asset Management Planning period 7, from April 2020 to March 2025 inclusive
APS	Asset Planning System
ARRC	Audit, Risk and Regulatory Committee
Broadcasting	Provision of information to a wide audience i.e. information available on the Thames Water website
Capex	Capital expenditure
CCTV	Closed Circuit Television
DEFRA	Department for Environment, Food and Rural Affairs
DMA	Distribution Management Areas
eight$_2$O	Alliance partnership to deliver capital investment programmes
FTE	Full Time Equivalent
GIS	Geographical Information Services
GPR	Ground penetrating radar
HCV	High consequences valve
Hydroguard	Monitoring units that are installed on trunk main valves that, through monitoring pressure and flow, can identify bursts. When a burst is identified a notification is sent to the Thames Water Control Room
IAD	Investment Area Document
IAM	Institute of Asset Management
IBM	A global cloud platform and cognitive solutions company who are part of the eight$_2$O alliance.
Infrastructure Alliance (“IA”)	Alliance partnership to maintain Thames Water’s supply network
IPT	Integrated programme team within the eight$_2$O alliance
ISO 55001	The requirements specification for an integrated, effective management system for asset management
LA	Local Authority
MP	Member of Parliament
Narrowcasting	Provision of information to a particular audience i.e. those within a specific postcode
NST	Network Service Technician
ODI	Outcome Delivery Incentive
Ofwat	Regulator for water and sewerage providers in England and Wales
Opex	Operational Expenditure
PR	Periodic review conducted by Ofwat for the purpose of determining one or more price controls in accordance with Condition B of the Thames Water Instrument of Appointment
PR14	Price Review 2014 covering the regulatory period from 1 April 2015 to 31 March 2020

PR19	Price Review 2019 covering the regulatory period from 1 April 2020 to 31 March 2025
PTW	Permit to Work
ROCC	Risk, Opportunities and Controls Committee
Sahara	A probe that is placed into the trunk mains network, whilst under pressure, that uses acoustics to identify leaks within the internal walls of the pipes
SFT	Strategic Field Technicians
SI4	Unplanned interruptions to customer > 4 hours
SI12	Unplanned interruptions to customer > 12 hours
SLA	Service Level Agreement
SPA	Strategy, Planning and Assurance
Syrinix	Leak and burst detection system that is installed on trunk mains that 'listens' to the acoustics of the water flow. When bursts are detected notifications are sent to the Thames Water Control Room
Single System Owner Operating Model	An operating model aligned to ISO 55001 and the Institute of Asset Management. It is intended to develop System Owner, System Management, System Controller and System Deliverer capabilities across end-to-end asset management.
TfL	Transport for London
Transient loggers	A monitoring unit that captures momentary pressure variations in our network
Trunk mains	A classification of larger diameter mains (typically 18" or greater) in a water distribution system
TTA	Thames Technology Alliance composed of Accenture, Bilfinger, Deloitte and IBM
WSC	Wholesale Service Centre

Charlotte Dale
LB of Lewisham Scrutiny Manager
LB of Lewisham

Wholesale Water

Our ref	Strategic Trunk Mains Review
Name	Timothy McMahon
Phone	0800 0093965
E-Mail	Customer.Feedback@thameswater.co.uk

12 October 2017

Dear Charlotte,

Lewisham Council Overview and Scrutiny Committee

Thank you for your email of the 19 July setting out the trunk main burst recommendations from the London Borough of Lewisham's Overview and Scrutiny Committee.

The recommendations submitted by the Council have assisted us in finalising our Trunk Mains Strategic Review and we are pleased to provide a detailed response to the Committee's recommendations.

We recognise how disruptive and upsetting the 2016 trunk main bursts were for our customers. They had a significant impact both at the time, and since, particularly for people whose homes and businesses were flooded.

We continue to work hard to provide the support people need to bring their lives and businesses back to normal as quickly as possible.

Our Trunk Mains Strategic Review, which builds on the recommendations of the preceding independent 'Forensic Review' led by Paul Cuttill OBE, was published on the 2 October. Enclosed with this letter is a copy of the Strategic Review. The Strategic Review makes 15 commitments, across five key areas:

- our operating model;
- monitoring;
- asset information;
- risk management and
- event response.

We will deliver the 15 commitments from our Strategic Review through an implementation phase over the next 18 months.

Many of the recommendations are fulfilled by our commitments in the Strategic Review or through our business as usual processes.

Set out below we respond to each of the Committee's recommendations:

Registered address: Thames Water Utilities Limited, Clearwater Court, Vastern Road, Reading RG1 8DB
Company number 02366661 Thames Water Utilities Limited is part of the Thames Water Plc group. VAT registration no GB 537-4569-15

1) **That Thames Water improve their emergency response arrangements including instituting a dedicated emergency response line for the reporting of leaks and investigating the possibility, with the Metropolitan Police Service, of receiving a 'blue light' service from the Police should a major incident be declared.**

Theme 5 of the Trunk Mains Strategic Review provides details of our proposed improvements to event responses. This includes mobilising a dedicated trunk mains event response capability; creating a trunk mains event response improvement programme; and ensuring we provide appropriate customer care.

I can confirm we have a dedicated emergency response line for the reporting of leaks for priority services, including the Police, Fire Brigade and Local Authorities. This number connects direct to our control room and works 24 hours a day.

We work closely with key resilience stakeholder groups, for example through the London Resilience Forum, to discuss and determine best practice measures we can deploy in emergency response events.

The possibility of receiving a 'blue light' service from the Police, should a major incident be declared, is one that is considered on a case by case basis at the time of the event or incident. The ability to provide a 'blue light' service will depend on the circumstances of the incident, including the location of our technical teams and the Police. We continue to work closely with the Police and other emergency services to look at opportunities to improve our speed of response.

2) **That Thames Water improve and join up their monitoring system for detecting the likelihood of bursts on major trunk mains.**

We can confirm this forms part of our Trunk Main Strategic Review. Theme 2 of the Trunk Mains Strategic Review sets out our commitments under monitoring. Our commitments include, formalising our trunk mains ongoing policy; providing updated and repeatable control room training; developing our data utilisation capabilities; and revitalising our monitoring unit installation process.

For example, through our commitment to revitalise our monitoring installation process, we will increase the speed and reduce the complexity of our process for installing and commissioning Syrnix and Hydroguard monitoring units.

We would be happy to keep you updated on our work to improve our monitoring system.

3) **That Thames Water, when submitting their case to OFWAT for their future 5 year investment plans, prioritise the phased improvement of ageing Victorian pipe replacement on major trunk mains. This should be completed within a specified period to be determined and published by Thames Water, but 15 years is proposed, given the problems that major bursts on these roads cause to businesses and residents.**

In the long term our strategy is to replace the trunk mains network, starting with those parts where the risk of a failure is greatest. Better information about our network and better risk models will help improve the detailed planning required. Our Business Plan for the period from 2020 to 2025 will be released for consultation in early 2018 and will include options for a comprehensive long term programme of replacement. We would be happy to share and seek feedback on our draft plans with the Council in early 2018.

4) **That Thames Water develop and publish performance and attendance standards, both in relation to major and minor pipe bursts.**

Commitment 5.2 of our Trunk Mains Strategic Review confirms that we will instigate a programme of works to improve our event response capabilities. We will set appropriate Service Level Agreements aligned to customers and stakeholder needs to improve our performance, and refine our event response processes to bring them closer into line with those of the Category 1 responders under the Civil Contingency Act. As part of this work we will consider the most appropriate methods to share our performance.

It may also be helpful to explain that the Discover Water website (https://discoverwater.co.uk/loss-of-supply) provides an overview of how all the water companies in England and Wales compare in relation to the number of burst pipes.

5) **That a clear and comprehensive compensation policy be developed by Thames Water, covering clean up/insurance/compensation and goodwill payments. This should be clearly communicated to customers and available on the company website. Compensation for inconvenience should be formally recognised and included in the policy.**

We have drafted an information booklet which lays out what a claimants' options are following flooding and explains the claims process. This booklet has been produced in cooperation with the Consumer Council for Water, an independent body that represents water and sewerage consumers in England and Wales. The organisation provides impartial advice and advocacy for consumers.

We have recently shared this draft booklet with customers' affected by flooding events and they have asked for further refinement to our policies, particularly in relation to clarity on insurance and goodwill payments. We have commitment to address these concerns and we will present a final version of the booklet in the near future.

6) **That the Mayor, GLA and London Boroughs support the campaign of the Fire Brigade Union to become the statutory Emergency Response Service for flooding, as recommended by the Pitt Review in 2008, in view of the recent major bursts resulting in severe flooding and given the fact that such occurrences are more likely in the future due to the ageing Victorian trunk mains network across London.**

This recommendation is noted:

7) That the London Plan should include provision, when planning permission for basements is being requested, to ensure that a risk assessment is carried out prior to approval to ensure the risk to life of flooding is minimised.

This is duly noted. It may be helpful to explain that we work closely with the Mayor of London's planning team on the drafting of strategic planning policies for London, including on water, wastewater infrastructure and flooding. We would be happy to work with officers on a flood risk assessment policy, should the Mayor's planning team consider one appropriate.

Next steps

Significant improvement steps have already been taken on our journey to improve our trunk main water network. We have already committed an additional £97m investment into our trunk main network over and above what was in our business plan for 2015 to 2020 and we have set aside additional money to support the trunk mains implementation phase, which we will deliver over the next 18 months.

In Lee High Road in Lewisham we recently trialed a new technology with the aim to help us detect defects on our water pipes and reduce the likelihood future bursts. This innovative trial, a first in the UK, involves lowering a rocket-shaped scanning device through a specially designed hatch built onto the pipe. Following this work we are planning to install new monitors and valves to the trunk main in 2018. This will help to reduce the risk of future bursts in this location.

We will continue to share our progress on the Trunk Mains review with our stakeholders and work with our partners, including the London Boroughs, to deliver on the investment with minimal disruption, engaging with our customers throughout.

I trust you find the above update helpful. Should you have any queries please don't hesitate to contact my colleague Mark Mathews on 07747 647 862 or via email at mark.mathews@thameswater.co.uk.

Yours sincerely

pp

Tim McMahon

Head of Water Networks, Wholesale Water