Principal risks

The Corporate Governance section describes in detail how the Group manages its risk from the Group Board level, its respective sub-committees and throughout the organisation. Further details can be found on pages 42-84.

The table below details each principal business risk, those aspects that would be impacted were the risk to materialise, our assessment of the current status of the risk and how the Group mitigates it.

Key

Relative severity	Change during the year	Speed at which the risk could impact	
High	Increasing risk	Fast: 6 months	V Included in Longer Term Viability assessment
Medium	Decreasing risk	Medium: 6-12 months	
Low	Stable	Slow: >12 months	

Principal risk	Status	How we are mitigating the risk

Changes in market conditions and customer behaviour

The industry sectors in which we operate remain highly competitive, with customers demanding more and our competitors responding quickly to these changing demands.

Customer behaviour and Royal Mail's responsiveness to market changes

V

Principal risk

Changes in customer behaviour, and changes to the markets in which the Group sells its products and services, could impact our forecast rates of decline and growth of letter and parcel volumes, respectively.

There is a risk that our product offerings and customer experience may not adequately meet evolving customer needs, or that we are unable to innovate or adapt our commercial and operational activities quickly enough to respond to changes in these markets.

Status

The parcels sector is undergoing rapid and profound change. Competition in the UK domestic and international markets continues to intensify, with competitors offering innovative solutions that include convenient, reliable delivery and return options, and improved tracking facilities. Capacity expansion in the sector continues to exert downward pressure on prices.

In the parcels business, disintermediation in the on-line marketplaces may divert our business to other carriers or collection providers.

We expect the letters sector to remain in structural decline, in the medium-term, driven by the growth in mobile and online advertising, and e-substitution.

There is a continuing requirement to invest in growth and innovation to meet these challenges in the marketplace.

How we are mitigating the risk

- We use continuous in-depth market monitoring and research to track how well we match our customers' needs, including relative to our competitors, and to predict volume trends.
- We are investing in introducing, at pace, new and improved products and services that: enhance customers' online and delivery experience; expand our core offering to small and medium-sized businesses and marketplace sellers; and extend our product coverage. We target investments that will extend our value chain offer and increase our presence in faster growing areas of the parcels sector.
- We promote the value of letters to customers through our MAILMEN initiative for marketing mail, Keep Me Posted and other campaigns, and innovations such as Mailmark®.

Economic environment

V

Principal risk

Historically there has been a correlation between economic conditions and mail volumes. Slowing economic growth could impact our ability to maintain and grow revenue, either through reduced volumes or by encouraging customers to adopt alternative service options for sending letters and parcels.

Status

The outlook for economic conditions in the UK is broadly in line with our planning assumptions, but uncertainty around the outlook has increased.

Economic growth in the Eurozone is more moderate and recovery remains fragile. Low growth or recession in Europe could impact our international parcel volumes, including those handled by GLS.

How we are mitigating the risk

- We have a robust modelling and forecasting framework that uses a range of quantitative and qualitative approaches to provide early warnings of changes to overall volumes and the profile of letter and parcel business, and to assess the effect of our pricing structures. We have a programme of regular reviews of outcome data compared to forecast, and recalibration and upgrade of these models.
- We have a challenging cost avoidance programme in place in response to revenue headwinds.
- We are pursuing initiatives to find new areas of growth, such as fleet maintenance services and leveraging data assets.

Principal risk	Status	How we are mitigating the risk
Pension risk The Group continues to operate a defined benefit pension scheme, the Royal Mail Pension Plan, open to accrual for existing members.		
Affordability of the defined benefit pension scheme Our ongoing ability to maintain the Royal Mail Pension (Plan) in its current form is subject to financial market conditions.	As part of the Pension Reform in 2013, we committed, subject to certain conditions, to keep the Plan open until at least March 2018. Current financial market conditions suggest that keeping the Plan open to accrual in its current form beyond 2018 will not be affordable.	• The Plan is hedged against future interest rate and inflation rate exposures, and we are confident that this will enable us to meet our commitment to keep the Plan open to accrual up to March 2018. • We are in discussions with the unions, and are developing proposals for sustainable post-March 2018 pension arrangements.
Business transformation Royal Mail must continuously become more efficient and flexible in order to compete effectively in the letters and parcels sectors.		
Efficiency The success of our strategy relies on the effective control of costs and the delivery of efficiency benefits.	We continue to make efficiency improvements. Our productivityimprovement is within our target range, and through our strategic focus on costs we have reduced our underlying UKPIL operating costs, before transformation costs, by one per cent.	• We have a strategic programme of cost avoidance, involving approximately 70 projects targeted to avoid around £500 million of annualised costs by 2017-18. • Our Agenda for Growth agreement with the CWU, supported by the Together for Growth training programme, and a joint mediation process, which facilitates a collaborative approach to improving efficiency at a local and national level. • We have redefined and rolled out across the network core Operations Standards that are based on best observed practice. A programme to enable better alignment of resourcing and workload is also being implemented across the Delivery Office network. • We are simplifying our operational management structure and have programmes of activity in hand to support operational managers in improving efficiency. • We continue to reduce levels of Lost Time Accidents and other sick absence through a positive focus on compliance with attendance management procedures, safety and wellbeing support.
Attracting and retaining senior management and key personnel Our performance, operating results and future growth depend on our ability to attract and retain talent with the appropriate level of expertise.	Turnover in senior and key personnel has been at normal levels for the business during the year, but this remains an inherent business risk.	• The Group's remuneration policy sets out that the overall remuneration package should be sufficiently competitive to attract, retain and motivate executives with the commercial experience to run a large, complex business in a highly challenging context. • We operate a succession planning process and have in place talent identification and development programmes.
IT transformation The scale and complexity of our IT transformation programme and the ongoing requirement for effective management of the transition are sources of risk to its successful delivery. Failure to improve our IT systems or successfully implement the IT transformation programme could increase the risk of: security breaches and attacks; a material adverse effect on the Group's operations; and inability of IT systems to support the business plan.	We have made significant progress in delivering the IT transformation programme. Infrastructure changes and transition to new providers are close to completion. This will provide us with an effective technical infrastructure that, going forward, better supports both routine functional activity and business growth.	• In view of the size and complexity of the transformation programme, we have, throughout its lifecycle, strengthened standard programme management and governance disciplines to provide intensive focus on key aspects; completing residual elements of the transition is now the primary focus.

Principal risk	Status	How we are mitigating the risk

Regulatory and legislative environment

The business operates in a regulated environment. Changes in legal and regulatory requirements could impact our ability to meet our targets and goals.

Fundamental review of postal services regulation

In June 2015 Ofcom announced a fundamental review of the regulation of Royal Mail. The review, currently in progress, incorporates previously announced reviews into efficiency, parcels and access pricing. It also examines: what changes to the overall postal regulatory framework might be appropriate to secure the Universal Postal Service; Royal Mail's wholesale and retail pricing; and whether the current level of commercial flexibility allowed to Royal Mail remains appropriate, and, if not, whether additional wholesale or retail price controls should be introduced.

A regulatory system or approach that applies restraints to Royal Mail's ability to compete for traffic to support the costs of the Universal Service network, or imposes operational requirements not applied generally to the industry, may impact our revenues, our ability to compete in the highly competitive industry sectors in which we operate, and ultimately our ability to deliver the Universal Service on a sustainable basis.

Status: New

This is a new risk that has emerged during the year. It was disclosed in our financial results for the half year ended 27 September 2015.

Ofcom has stated that it expects to complete the process and have a regulatory framework in place in early 2017.

There is an ongoing Competition Act investigation by Ofcom relating to certain of our access pricing proposals in January 2014, which we suspended without implementing and subsequently withdrew. We dispute the allegations and are robustly defending the investigation.

How we are mitigating the risk:

- We have made comprehensive submissions to Ofcom as part of its initial call for evidence and we have ongoing engagement with Ofcom to build on the response to issues raised.
- Our response to the proposal will be shaped by the detail of the proposal and any threat it may present to our ability to compete effectively, and to the sustainability of the Universal Service. We will seek to work with Ofcom to protect the Universal Service.
- We have a strategic focus on cost avoidance and delivering efficiency improvements, as noted against the Efficiency risk in the Business transformation section above.
- We have made a detailed submission to Ofcom in relation to its Competition Act investigation.

VAT status

The Value Added Tax (VAT) treatment of Royal Mail's services, including exemption applying to certain products, is under threat in two areas:

- The EU has published a proposal for a Vouchers Directive, which could adversely impact Royal Mail's VAT position, if as a result, postage stamps were treated in the same way as other vouchers; and
- The European Commission is reviewing a number of VAT exemptions, including the exemption applying to postal services. Although Royal Mail could benefit from greater recoverability of VAT on costs if the VAT exemption for postal services was removed, the cost to customers who cannot reclaim VAT would be likely to increase.

The VAT exemption applying to mandated access services has also been under threat, with HMRC's implementation of VAT legislation on these services subject to a judicial review.

Status:

The proposed Vouchers Directive is under discussion in Europe. The outcome remains uncertain.

The European Commission has published details of responses to its consultation about the future of VAT exemptions, but there has been no indication of the likely outcome or timescale of the review.

The appeal against the decision that HMRC had correctly implemented VAT legislation in respect of exemption applying to mandated access services has been withdrawn and the matter is now concluded.

The improved risk trend reflects our re-assessment of the potential impact of these issues.

How we are mitigating the risk:

- We continue to liaise with HM Treasury and HMRC to seek to minimise any adverse impact of the proposed Vouchers Directive.
- We are monitoring and continue to feed into discussions with the European Commission on potential developments in VAT legislation.

Employment legislation and regulation

Changes to laws and regulations relating to employment (including the interpretation and enforcement of those laws and regulations) could, directly or indirectly, increase the Group's labour costs, which, given the size of the Group's workforce, could have an adverse effect on the Group.

Status:

Recent case law has suggested that regular overtime and commission payments should form part of holiday pay calculations. The legal position remains unclear as case law is still evolving in this area.

Other risks to our cost base associated with employment legislation have emerged and were disclosed in our financial results for the half year ended 27 September 2015. These are:

- Proposal for an Apprenticeship Levy. Draft legislation sets the levy at 0.5 per cent of payroll costs, applicable from April 2017.
- Proposed changes to National Insurance (NI) on termination of employment have been announced, which will increase employers' NI costs from April 2018.
- The Government has consulted on how pensions tax relief is provided, but has not proposed changes at this time. If changes are proposed in the future, they could have a significant impact on the cost of providing pensions.

How we are mitigating the risk:

- We continue to monitor developments in case law relating to the application of the Working Time Directive in respect of holiday pay calculations. Based on our estimates of the potential financial impact, we believe that we have made sufficient provision for any historic liabilities that may arise.
- We liaise with the CBI, HMRC and HM Treasury to influence employment tax developments and minimise the impacts for Royal Mail as far as possible.

Principal risk	Status	How we are mitigating the risk

Cyber security

New

We are subject to a range of regulations and contractual compliance obligations around the governance and protection of various classes of data, and are susceptible to cyber attacks that could threaten the confidentiality, integrity and availability of data in our systems.

A cyber security incident could also trigger material service interruption.

Either of these outcomes could result in financial and reputation damage, including loss of customer confidence.

While no material losses related to cyber security breaches have been suffered, given the increasing sophistication and evolving nature of this threat and our reliance on technology and data for operational and strategic purposes, we now consider it is appropriate to include this as a principal risk.

- As external threats become more sophisticated, and the potential impact of service disruption increases, we continue to address our ongoing investment in cyber security. We take a comprehensive view of cyber security and continually review our resilience in light of the changes and threats we face.

Industrial relations

There is extensive trade union recognition in respect of our workforce in the UK, with a strong and active trade union which, historically, has used industrial action to lever benefits for their members.

Industrial action

V

There is a risk that one or more material disagreements or disputes between the Group and its trade unions could result in widespread localised or national industrial action.

Widespread localised or national industrial action would cause material disruption to our business in the UK and would be likely to result in an immediate and potentially ongoing significant loss of revenue for the Group. It may also cause Royal Mail to fail to meet the Quality of Service targets prescribed by Ofcom, leading to enforcement action and fines.

The Agenda for Growth agreement developed jointly with the CWU represents a fundamental change in our relationship with the CWU, and promotes stability in industrial relations.

However, industrial relations is an inherent risk within our business: we are negotiating a new pay deal for 2016-17, the Pension Plan affordability is under discussion, and the increasingly competitive environment and other sources of pressure on costs and efficiency may put the stability of our industrial relations under strain.

- Our Agenda for Growth agreement with the CWU provides a joint commitment to improved industrial relations, and to resolving disputes at pace and in a way that is beneficial to both employees and Royal Mail.
- As part of our collaborative approach with the CWU, the Agenda for Growth is supported by our Together for Growth programme, an industrial relations and business skills package for managers and CWU representatives designed jointly to improve the way that managers and unions work together. A resolution process for local disputes uses trained mediators nominated by and representing both the CWU and the business.
- The Agenda for Growth agreement has legally binding protections for the workforce in respect of future job security and our employment model, but which can be rescinded in the event of national industrial action.

Viability Statement

The Directors have assessed the viability of the Group as part of their ongoing risk management and monitoring processes.

While the Directors have no reason to believe that the Group will not be viable over the longer term, they consider the three financial years to March 2019 to be an appropriate planning time horizon to assess Royal Mail's viability and to determine the probability and impact of our risks. This is the same time frame of our existing medium-term planning cycle.

The Directors considered all principal risks set out in the Principal risks section on pages 32-35 but focused on those that could have a plausible and severe financial impact over the plan horizon. In particular they considered the potential impact of industrial action and deteriorating economic and market conditions.

The risks were quantified to create a downside scenario that took into account the levels of committed investment and expenditure, as well as other short-term cost and cash actions which could mitigate the impact of the risks. Consideration was also given to the large fixed cost base required to deliver the Universal Service Obligation in its current form. The downside scenario was tested to determine whether the Group would remain solvent.

The Directors have made the assumption that the RMPP funding rate remains unchanged from 2015-16.

Based on the results of their analysis, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2019.