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Post Office

RESTRICTED - POLICY

FROM : PETER SCHOFIELD
DATE : 5 May 1999
EXTN : GRO
ROOM: 25/G

CHIEF SECRETARY

cc : Chancellor
Economic Secretary
Sir Andrew Turnbull
Steve Robson
Harry Bush
John Gieve
Adam Sharples
Mike Williams
Alan Mawdsley
Sarah Mullen
Robert Ricks
Ed Balls
Shriti Vadera
Spencer Livermore

BA/POCL

Issue: Your meeting with Alistair Darling, Stephen Byers and Lord Falconer this evening.

Objective: To get colleagues to agree to drop Option B1 on value for money grounds. POCL and DTI have not come up with anything that would bridge the affordability gap since your last Ministerial meeting.

Developments since the last meeting

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2. The key paper for the meeting is attached. This has been prepared by Sarah Mullen and cleared with DTI and DSS. The other Ministers also have this.

3. The paper sets out the developments since your meeting of 21 April. Briefly, these are that:

- on Option A, ICL have now withdrawn their offer of 18 December. This confirms that Option A is no longer a viable option for Ministers;

- on Option B1, POCL and DTI have not come up with anything that would bridge the value for money gap (£870 million compared with Option A or some £400-500 million compared with termination). All they have come up with are ways of financing the gap, which I understand Stephen Byers' raised with you recently, neither of which look attractive (see Annex A);

- we have worked up an Option B3, along the lines set out in our last report and proposed by Alistair Darling at the last meeting, in which POCL would buy the automation platform from ICL, but then move straight to a network banking strategy without either the benefit payment card or the POCL bank. This option is estimated to have a similar NPV to the non-ICL termination option (Option C) - £350 million worse than Option A, but £500 million better than Option B1. It therefore looks attractive if it could be negotiated. However, both POCL and ICL have indicated they would not be interested in it (at least while Option B1 remains on the table).

<u>Views of other Ministers</u>

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4. We expect both Stephen Byers and Lord Falconer to press for Option B1. We expect them to make the following points:

The figure of £870 million for the affordability gap is disingenuous, since it compares Option B1 with Option A which is no longer viable.
and
Option B1 still has a positive NPV (i.e. the savings exceed the costs compared with the "do nothing" option of continuing with paper-based systems).
But the public spending baselines were based on the savings which would have emerged under Option A. So the Treasury would have to find an additional £870 million, compared to an estimated additional £350 million on Option B3;

The cost over the next 3 years of Option B1 is similar to that for B3 or C. We can sort out the additional costs of Option B1 for 2002-03 onwards in the next CSR.
For all 3 options, the delay to moving away from paper-based systems of paying benefits compared to Option A means there is a cashflow hit during the CSR years. We will have to find some way of meeting the costs (see Annex A).

But the decision between the options should be based on the costs over the whole life of the project. Option B1 is much more expensive than any of the alternatives over that time frame.

Option B1 is the only option that delivers Modern Government services. It has the potential to deliver huge savings to Government and large revenues to POCL.

- But there are any number of potential providers of Modern Government services. And the Cabinet Office policy is to leave it to

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individual Government departments to decide who to contract with to provide these services - there is no cross-Government strategy to focus on a single provider;

- In order for the Post Office to compete as a provider, they need an automation platform. That is implied under all the options;

- Accept that Option B1 is likely to give POCL and ICL a major boost compared to other potential providers of these services - they would have the first smartcard in wide circulation. But this would be at great cost to the Exchequer. And so far, neither POCL nor ICL have been prepared to commit to what this might mean in terms of additional revenue. We have asked them to reconsider this view this afternoon.

We are unclear what Alistair Darling's views are likely to be. There are signs that he may push for either of the termination options (option C or B3 - the one he originally suggested). But now that Option A is firmly off the table, he should be satisfied with any of the alternatives.

<u>What line should you push for?</u>

5. The value for money analysis provides a clear steer in favour of options B3 or Option C which have similar NPVs:

- Option B3 has the advantage that we retrieve from the project the automation platform for the Post Office. There would be a presentational advantage if a deal could be done with ICL on this before termination of the benefits payment card became public, although ICL would be likely to exert a heavy price in return. We might get better value if we reached this option via termination;

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- Option C would be a non-ICL solution. It might allow the PO to buy an IT system which better fit their long term network banking strategy, but much greater uncertainty, and hence difficult presentational issues (e.g. with subpostmasters), in the meantime.

6. We advise you to argue strongly against Option B1 as it stands. But we have been considering what could be done to Option B1 to make it more acceptable. The key is whether there are additional revenues from modern Government which could be realised under option B1 compared to option A or any of the other options, and whether we can reduce the risk being borne by the public sector. This might involve:

(i) a cross-Government strategy for Modern Government services which focussed on POCL as the main provider, given in particular their unique geographical and social reach. We have this afternoon asked POCL and ICL for a view as to what such a strategy could mean in terms of additional value. But note that this approach flies in the face of the existing modern Government strategy, and is likely to be resisted by some of the main potential customers in Government;

(ii) trying to bring greater dynamism into POCL's management culture. It is hard to imagine anything achieving this short of (iii) below;

(iii) introduction of a strategic partner on a risk sharing basis (preferably with an equity interest). But it is hard to imagine anyone wanting to make such an investment, even if a minority share sale of POCL was a realistic option politically. ICL have said they might be interested in coming in once the initial investment has been made by the Government.

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ANNEX A

How would we finance the affordability gap?

Given the affordability gap for options B1, B3 or C compared to the public expenditure baselines, you asked for advice on how this might be financed. I understand you spoke to Stephen Byers about this recently.

The net costs of any of these options would fall to the Post Office (and probably also DSS), who would pay for it from the following sources:

- first, from the savings which would be received by the DSS (compared to Option A) which we would recycle to the Post Office. But this would leave the affordability gap worth some £870 million NPV for option B1 or around £350-500 million for options B3 and C. This would be funded by the other two sources;

- second, by reduced cash flow for the Post Office (or potentially greater borrowing from the Government in the form of the National Loans Fund). We would relax the Post Office's dividend regime/EFL to compensate, thus avoiding this damaging the rest of the business. Because the PO is a self-financing public corporation, this relaxation would hit AME rather than DEL;

- third, some of the cost of termination (under option C at least) might fall to the DSS. This could cost up to £150 million and would be a hit to the DEL Reserve.

However, you also asked us to consider two alternative sources for meeting the affordability gap proposed by Stephen Byers:

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- additional, commercial borrowing by the PO. But borrowing by the PO from whatever source scores within AME. The only difference is that commercial borrowing costs the Exchequer more, since the interest rate is higher than the Government can obtain by issuing gilts;

- whether we might delay by 3 years the reduction of the PO monopoly from £1 to 50p. DTI are currently anticipating that this reduction should take place next April (although we have been suggesting you press for this reduction to be at the time the White Paper is published). We are not yet clear what DTI believe this delay would save the Post Office in revenue.

We would strongly advise you to oppose any delay to the reduction in the monopoly. This is a key element of the PO reforms. Indeed, with the decision last December not to pursue any form of share sale for the PO, it is the only way we have left to inject additional disciplines on the PO to mirror the commercial freedoms they have been given. We are concerned that it would leave Government policy on the PO in disarray.

Our strong view is that you should decide on the options according to the value for money (i.e. the NPV) case. Decisions on funding should flow from this decision, rather than determine it.