

RESTRICTED - COMMERCIAL & POLICY

Secretary of State

From: Sarah Graham PFD Sp Proj

Date: 17 August 1998

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BA/POCL AUTOMATION PROJECT : TOWARDS AN INTER-MINISTERIAL DECISION

Issues:

- (i) update on developments over the past two weeks;
- (ii) review of the options: your preferred route forward and handling strategy;
- (ii) suggested next steps.

Timing: You may wish to discuss with officials in w/c 17 August.

Recommendations: That you discuss the position and handling strategy with Stephen Byers, before Wednesday, 19 August: he is on holiday after that, his office do not know for how long.

Summary

1. There have been a number of developments over the past two weeks, including the emerging findings of the Post Office Review, all of which appears to support your preferred outcome to cancel the project, or at least the Benefit Payment Card (BPC) elements of it, on grounds of ICL Pathway's failure to deliver.

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Sent by email : 17/08/98 : 15:09.

2. For the moment, the main focus of work to support the necessary inter-Ministerial decision has shifted to:

- (a) DTI/POCL, who have been asked by Stephen Byers to clarify the future requirements of the Post Office; (you have been copied his letter of 30 July to Ian McCartney);

and

- (b) No. 10 Policy Unit, who are exploring variants on a cancellation option .

3. Here within DSS we have been elaborating our plans for implementing the agreed Ministerial decision; and are also preparing more detailed material for early this week on the contractual background and proposed negotiating strategy to take forward the decision. You may wish to discuss this with officials.

The Treasury Working Group Options

4. The three options on the table from the HMT led-working group are broadly as follows:

- Option 1: continuing with the project, but extending the overall period of the project from the original end date of May 2005 to at least September 2007; thus securing DSS indirect subsidy of the Post Office Network for a longer period, and offering ICL a better prospect of payback for its investment, despite its failure to deliver. It is not certain that this option will be sufficiently attractive to ICL who, in order to achieve the desired rate of return, have asked for a five year extension (or a 30% price increase). You will also be aware the Independent Panel believe this option carries ongoing risks; and only a 50/50 chance of meeting their recommended (and further extended) timetable.
- Option 2: proceeding with the project in name, but withdrawing from the benefit payment card elements of it; POCL to offer ICL the task of bolting on a banking facility to the "Horizon" automation platform. DSS to plan its migration to ACT to take account of Post Offices developing capability to handle encashments from bank accounts; ICL to be able to develop a more marketable product and share in the success of Government's long term policies. POCL automation with banking facilities should be easier to implement than the currently planned systems. Implementation of POCL banking facilities can be achieved in a timetable that would not delay DSS implementation of ACT.
- Option 3: cancellation of the whole project on grounds of ICL's failure to deliver; otherwise essentially as option 2 but leaving POCL free to run a proper competition and to utilise other companies rather than ICL; this would probably mean around 12 - 18 months to procure a new partner for POCL to establish a banking facility in Post Offices, but the end product might well be cheaper and better focused,

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particularly if the Post Office was able to enter into a strategic partnership with a retail or banking organisation; again, DSS would plan its migration to ACT to take account of Post Offices' developing capability to handle encashments from bank accounts. This should not affect the overall timetable for DSS to move to ACT.

5. There is also an option in the background (option 4) favoured by the HMT Public Expenditure Team - in essence, option 3 but without any DSS commitment to attempt to work with the Post Office in planning a co-ordinated migration to ACT development of banking facilities in Post Office outlets. Given the action required to move to ACT, as the standard method of payment, this is unlikely to mean that we could reach 100% ACT-based payments significantly more quickly; equally, costs and savings would not be materially affected. This approach could, however, add to the fears of sub-postmasters and many of the benefit recipients who use Post Offices to collect their cash, particularly pensioners; and could make it more difficult for Government to provide reassurance.

Funding implications of the options for DSS

6. No additional funding provision for continuing with the restructured project (or for taking any other route) has been agreed with HMT, beyond that agreed following the February 1997 re-plan. Discussions on the funding position have been on hold pending the inter-Ministerial decision on the future of the project; and as acknowledged at the meeting with Stephen Byers on 30 July, DSS funding will now need to be taken forward in separate discussions with HMT.

7. All routes forward will require additional administration funding for DSS (ie beyond DEL provision in the CSR), as well as cover for programme savings foregone due to the delays. The funding implications for this year, and the next three CSR years, are:

- *cancellation and moving to ACT instead (whether of the whole project of the benefit payment card element):*

additional administration funding: total of £41m (15\(-32)\37\21m)

programme savings foregone: total of £410m (104\137\105\64m)

(This assumes outright cancellation - as in option 3 - with the minimum payment guarantee (floor) to POCL not being applied. Should the floor continue to apply the administration cost figures would increase to a total of £72m [15\ (-32) \42\47m]).

- *continuing with the project, for two and a half years beyond the current contract period (option 1):*

additional admin requirement: total of £169m (23\26\94\26m)

programme savings foregone: total of £378m (103\134\84\57m)

Current Position

8. At the point when you started your holiday, the Chief Secretary to the Treasury had commissioned some work from DTI in particular to clarify:

- the future business strategy of the Post Office Counters Limited;
- the automation needed to underpin this;
- how far POCL could reduce the costs of the network; and at the margin what is the extra social benefit Government are buying for the extra cost of any subsidy we may put in;
- what scope there is for involving a private sector partner.

This information was requested by 14 August. I have not seen the output of this work but I understand that Peter Mandelson has said that nothing in this area should be agreed by DTI without his specific endorsement. Both he and Ian McCartney are now away until the end of the month. We will wish to check that this work takes account of the emerging findings of the Post Office Review which concludes the network should be rationalised as soon as possible with inevitable reduction in size and likely need for direct subsidy (see summary at Annex 1).

9. Number 10 Policy Unit are continuing to take an interest in assessing the options for a route forward. So far as we can gather, their emerging views are that:

- an option to continue with the project is not attractive; the main advantage appears to be around supporting the Post Office network which can be done as well if not better in other ways;
- the logical decision is to cancel the project on grounds of ICL's failure to deliver; but there are inevitably some presentational difficulties.

I believe they are actively exploring variants around the 'cancellation' option, which might minimise these difficulties; in particular, they are interested in exploring the potential links with wider government objectives to promote universal banking/social inclusion and its IT/Electronic Government objectives. I am in contact with the No. 10 Policy Unit and others involved, to play in DSS ideas and information where helpful, and safeguard your interests. The danger here is it could take many months to work through this type of option and we cannot afford to further delay the decision.

10. Other recent developments are:

- we have written to ICL, as agreed, to note that the 13 week "cure" period expired on 12 August and that the Department had no present intention of terminating its contract as it was now entitled to do, but that it reserved all its rights and remedies (including termination in the future); ICL were expecting this, and a routine response denying fault is anticipated (as they are bound to do to protect *their* negotiating position) - but nothing beyond that;
- in anticipation of the discussions that will need to take place with ICL,

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whatever the Ministerial decision, the joint programme lawyer and the Departmental legal team have agreed a strategy which will protect our legal position; the first - and key - step in this strategy involves a "standstill" agreement where both parties agree not to initiate legal action during negotiations; in parallel, the programme lawyer in consultation with Departmental lawyers, has been commissioned to prepare for litigation as a last resort in case a negotiated settlement cannot be agreed with ICL on acceptable terms; we are seeking POCL agreement to this strategy;

- I have suggested you write personally to Keith Todd at ICL, to inform him of the longer timescale for the Ministerial decision on the future of the project (see separate submission in last Friday's box).

11. You will also be aware that press coverage is becoming more pointed: the recent article in the Observer sent to you under John Cummins' submission of 12 August 1998) suggests that the media are well-briefed, and it may be difficult to keep Ministers' thinking under wraps for much longer - with all the risks of POCL and ICL media campaigns that would entail.

Assessment of Options

12. Following the discussion between Ministers on 30 July 1998, the view which appears to be emerging is that:

- the main choice is between Option 1 (continuation of the project broadly "as is") and some version of Options 2-4 (which are options about cancellation, on a continuum from retaining some elements of the project, but without the BPC, through to a completely fresh start for achieving DSS and POCL objectives);
- there is mounting consensus between the Chief Secretary, you and the No.10 Policy Unit (but not yet Ian McCartney, POCL Management and possibly the Paymaster General) *against* Option 1:
 - the issue of the future of the Post Office, its funding and required Government subsidy should be addressed directly and separately from the decision about the future of the current BA/POCL automation project;
 - Option 1 - or any option involving continuation with the BPC - will require a Ministerial direction to the Chief Executive of the Benefits Agency (the issues are summarised at Annex 2); also, additional funding arrangements will need to be agreed;
 - if this is accepted, Option 1 to continue with the project is not a sensible way forward, given ICL's failure to deliver to time, and the knock-on effects of this delay on the Government's policy objectives as well as the financial implications; the main reason

now for continuing with the project is to continue the indirect DSS subsidy for POCL for longer, to allow it more time to get its house in order preparatory to establishing itself in the market place in the longer term; the emerging findings of the Post Office Review indicate that POCL should move faster than the timetable suggested; otherwise the opportunity to enter the banking market may well disappear;

- the logical route forward is cancellation of the whole project as suggested under Options 3 and 4;
- if it can be agreed that Option 1 falls, our view is that DSS could live with any of the further choice (at least as currently on the table); our - and Government's - main concerns would be for:
 - pensioners and others who wish to continue to use the Post Office;
 - the future of the Post Office and its network;
 - the future of ICL (and the potential impact therefore on UK PLC);
- the way forward therefore may be to look at variants on the option to cancel, which might minimise the potential disadvantages outlined above; and which might maximise the opportunities to further the Government's wider agenda in a positive way;
- politically, our view is that Option 2 would generate least "noise" - and indeed could be presented very positively, both to the three parties involved *and* to the wider public:
 - offers ICL a practicable and more marketable alternative to the project as currently designed (ie by re-shaping the project to round a generic banking facility, capable therefore of transfer to other Post Office networks, in a way that the currently planned, bespoke BPC system is not, despite ICL's claims);
 - provides the Post Office with some measure of reassurance and assistance from DSS in ensuring a smooth transition from its current customer base of benefit recipients to its future likely levels of such customers, and in introducing early provision of the banking facilities it will need to implement its chosen future business strategy, likely to be endorsed by the Post Office Review (due to report in early/mid-October);
 - provides DSS with the freedom to move to an ACT-based system as soon as practicable, in support of the Government's wider objectives for welfare reform and to achieve most efficient use of tax payers' money;

- will provide benefit recipients with increased choice of location for collecting their cash - banks, ATMs, retail outlets, in addition to the Post Office; and helps support Government's wider ambitions to promote social (and financial) inclusion through encouraging the approximately 3 million benefit recipients currently without bank accounts to have one;
- will support Government's approach to Electronic Government, by exploiting generic, commercially-developed systems (and minimising risks associated with Government-led bespoke systems) and in practical terms enable DSS benefit payment to "piggy-back" effortlessly on the technological developments we know will take place shortly eg use of the Smartcard by banks.

Issues for DSS in pursuing a preferred route forward

12. From the DSS perspective, the preferred route forward involves withdrawal from the Benefit Payment Card elements of the project. There remains an issue around the advantages and disadvantages of working with the Post Office:

- * for DSS, customers' current preferences mean that there would be advantages for us in working with the Post Office to support the continued ability for benefit recipients to collect cash from post offices if they wish, even though DSS will be paying benefits into bank accounts;
- * in the immediate to medium term, the DSS needs to work with the Post Office anyway, to sustain a reliable delivery system for benefits in the interim before complete migration to an ACT based system is achieved;
- * it should be noted that currently POCL handle 25% of accounted cash transactions;
- * in contractual terms, there could be problems if we seek to withdraw from the contracts with ICL Pathway, and POCL withhold their agreement to such action. A note on this will be included in the separate submission being prepared on legal issues, which will be available tomorrow.

Follow-up to the inter-Ministerial decision

13. Beyond these issues around working with the Post Office, for DSS the options that involve cancellation of the project (or at least the BPC elements), are broadly the same in terms of moving to an ACT based system. Key issues that need early consideration include:

13.1 The contractual situation

You have already had some preliminary discussion of this issue with officials and the joint programme lawyer. To re-cap:

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- the automation project involves three separate contracts:
 - DSS and ICL Pathway.
 - POCL and ICL Pathway.
 - DSS POCL and ICL Pathway - covering matters of common interest;
- DSS also have two "back-to-back" contracts with POCL:
 - Contract A, covering benefit transactions made by POCL, whether paper-based or card-based;
 - Contract B - which provides for the services provided by ICL pathway to support the benefit payment card encashment transactions;
- clearly if both POCL and DSS Benefits Agency terminate the project on grounds of ICL failure to deliver, all contracts with Pathway would be cancelled;
- if the DSS only withdraws from the Benefit Payment Card elements of the project, then the DSS/ICL Pathway contract would be cancelled on grounds of failure to deliver and DSS would withdraw from the joint DSS/POCL contract with Pathway; latest legal advice indicates this would require POCL agreement although there may be ways we could effectively secure it if, for example, POCL sought to withhold their agreement, despite a Ministerial decision; under this option the POCL/Pathway contracts will require re-negotiation;
- any option which cancels the Payment Card will require re-negotiation of our direct contracts (A and B) with POCL: prior to the current contract arrangements which run to 2005, the BA renegotiated with POCL the terms and conditions for benefit encashment on an annual basis.

13.2 Government Negotiating strategy

Under any option, it will be important to decide in advance the way a settlement will be approached with ICL Pathway. Advice from the Joint Programme lawyer, endorsed by the DSS in-house legal team, suggests that:

- under any option, the first preference will be to reach a negotiated settlement, and avoid litigation;
- before any discussion is opened with ICL, a "standstill" agreement is established for a set period;
- there will be a two-step process, first to communicate Ministers' decision in principle, second, to agree the detailed terms of the settlement;
- Ministers will need to set a clear negotiating brief at the outset, which sets

firm financial parameters for an agreement; a strict time in which it is to be completed with a condition that failure to agree implies termination with litigation if necessary.

- A substantive announcement will need to await the completion of this 2-step process.

A separate submission is in preparation, setting out a proposed negotiating strategy to implement Ministers' decision, including consideration of the risks of, and preparation for, litigation.

13.3 Communication of the decision

ACT for BA combined with banking for POCL can be presented very positively, as suggested above. Nonetheless, a decision which involves cancelling all or part of the project will require very careful presentation, with the following main audiences:

- Post Office owners/users: previous attempted changes which were perceived to threaten the Post Office network were fiercely opposed by the Federation of Sub-Postmasters, who orchestrated a well-crafted media campaign; there are also sensitivities around the rural lobby;
- benefit recipients: a carefully managed information programme will be needed to pre-empt the potential scope for worry and confusion among the 70% benefit recipients who currently collect their cash from post offices: many benefit recipients will not be aware that a payment card was in prospect;
- DSS and Post Office staff;
- the general public.

Officials are writing up a communication strategy, which will consider what might be done in the period leading up to the final announcement of a decision (including preparation of positive media briefing to counter any ICL/POCL briefing); as well a positive strategy for handling the announcement of the agreed way forward.

13.4. Implementation of the decision within the Benefits Agency:

We have drawn up plans for the immediate as well as medium-term action that will be required following Ministers' decision. A decision to continue with the project will require continuing with existing operational plans and the main focus of activity in the immediate term will be the negotiation with ICL and the negotiation of funding with HMT to cover existing shortfall and ongoing risk (preferably diverted from direct DSS responsibility). But options that involve withdrawing from the Benefit Payment Card or all of the project, will require:

- immediate action to cancel and replace current cards in use in the 200 pilot offices;

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- formally setting in place a project to implement plans for moving to an ACT based system as the normal method of benefit payment: our initial planning has established an outline timetable and identified the main issues to be resolved. See Annex 3. We believe all issues have solutions but some of the more detailed planning will need to await Ministerial resolution of the way forward; and, in some areas (eg around banking issues) will need to await the public announcement.
- negotiating revised terms with POCL for the period until ACT is fully implemented and co-ordinate where possible the DSS ACT plans with the POCL banking plans.

Timetable for a decision

14. this decision is needed urgently:

- This issue has been on DSS Ministers' agenda for twelve months and has been a cross-government issue since the beginning of this year;
- ICL have said in their letter to the Minister of State, dated 27 July, that it will not be possible to raise the additional funding beyond September, unless they receive unequivocal commitment soon; they can be expected to lobby vigorously from that time;
- Ian McCartney will be visiting Japan (and Fujitsu) in w/c 7 September;
- the timing of the decision needs to avoid "noise" around the party conference;
- your Direction to Peter Mathison not to proceed with cancellation of the contract, expires on Monday, 14 September.

15. We have been working on the assumption that an agreed cross-Government decision *in principle* can be achieved in w/c 7 September. On this timetable, a substantive announcement following completion of negotiations with ICL could be made mid-October.

Next Steps

16. At this stage, it is unclear how the Chief Secretary is planning to progress matters in order to present a recommended way forward to the Prime Minister on his return from holiday at the end of the month. Both Peter Mandelson and Ian McCartney are away until after that date. The Chief Secretary himself is away on holiday from Wednesday, 19 August; and his office are uncertain when he is planning to return. There do not seem, therefore, to be any prospects of further tri-partite inter-Ministerial discussions before the Prime Minister's return.

17. In any event, an agreed recommendation between the 3 main Departments looks unlikely, *unless* DTI can be persuaded to shift their position in the light of:

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- (a) the emerging Post Office Review findings, which will recommend a strategic shift for POCL to banking and financial services; and
- (b) Treasury reassurance that POCL requirements for automation and possible Government subsidy will be met, if DSS indirect funding falls out of the picture.

18. It will be to DSS advantage to support a greater transparency of subsidy to POCL, not only for its own sake, but also because this undermines the cash for pursuing Option 1.

19. You may wish to resist Treasury pressure to move to ACT independently of any links with Post Office (Option 4): this could leave you vulnerable to the brunt of any adverse publicity that will arise amongst our benefit population and does not sit easily with the objectives of modern active service and its purpose to provide a more efficient but a more customer-focused form of service delivery. Full co-operation from a re-focused POCL would help enable ACT implementation.

20. In the absence of any clear guidance at this stage from CST's office, you may wish to consider an approach on the telephone, to:

- explore CST's current thinking and re-emphasise the urgent need for a decision;
- offer further help in defining an option which would suit DSS and wider Government interests, while leaving the Post Office subsidy/network issues on one side for the Post Office Review.

Action Requested

21. You are asked to:

- note the current position;
- consider your preference for the optimum route forward;
- decide whether you wish to discuss handling strategy with Stephen Byers at this stage (see 19 above); and
- whether you would like to have a discussion with officials and lawyers w/c 17 August.

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