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John Roberts
Chief Executive
The Post Office
148 Old Street
LONDON
EC1V 9HQ

28 September 1998

Dear John,

ICL

RE: BA/POCL PROGRAMME

The appointment of Graham Corbett as Independent Advisor to the HM Treasury has initiated commercial discussions between the parties on the way forward for the BA/POCL Programme.

There is no doubt that a high degree of creativity will be needed to construct an acceptable and workable way forward.

As a part of this ICL would like to engage with the Post Office to explore the opportunity for the Post Office to acquire a stake in ICL Pathway. This we believe offers a number of benefits.

We discussed the broad ideas with Paul Rich on Friday 25 September and agreed to produce an outline paper which is attached.

I hope that this can be discussed further this week, prior to the meeting between yourself and Keith Todd scheduled for Monday 5 October. I shall therefore be discussing with Paul Rich whether an early meeting, possibly with Gerry Cope, can be arranged.

Yours sincerely
GRO

JOHN BENNETT

cc: Paul Rich
Stewart Sweetman
Jerry Cope

J. H. Bennett
Managing Director

ICL Pathway Ltd
Forest Road
Feltham
Middlesex TW13 7EJ
Tel: GRO
Fax: GRO

ICL Pathway Ltd.
Registered in England no 3011561
Registered Office
20 Pinbury Square
London EC2A 1DG

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COMMERCIAL IN CONFIDENCE - WITHOUT PREJUDICE**BA / POCL PROGRAMME****EQUITY STAKE BY THE POST OFFICE IN ICL PATHWAY****1 INTRODUCTION**

The Horizon Programme is vital for the long term business interests of POCL and the Post Office.

The Programme is at a critical stage and must be restructured if it is to go forward. ICL financial investment including future commitments stands at some £250m with a future funding requirement of a further £250m before the peak cash flows are passed. An external cash injection of £250m is considered essential for any successful restructuring. The options to achieve this include an early direct payment from HMG, a guaranteed payment profile over the contract life, and an equity share in ICL Pathway by the Post Office. ICL considers that a major component (but not the only one) of a solution should be the equity approach.

ICL believes that a joint approach along these lines brings together the strategic intent of both organisations and aligns the incentives to rapidly implement the Programme and aggressively search out and win new business streams.

2 EQUITY PROPOSITION

It is recommended that POCL takes a 49% stake in ICL Pathway with the share price to be based on the par value of the current assets of the company. On this basis the equity stake would be £125m. ICL Pathway already has a set of articles of association and trades as a separate entity and these would be modified by agreement with the Post Office to assign appropriate rights to the Post Office including Board representation. The ICL cash requirement is such that this arrangement must be in place by 31.12.98

3 OPTIONS AT 2005

Recognising the current contract term for the Programme, a number of safeguards are available for the Post Office at the end of the contract term. Firstly the Post Office could, on conditions to be agreed, acquire the full equity ownership of the company and ICL's involvement would from that point in time cease. The Post Office would under these arrangements be free to manage the Programme as they felt best including bringing in a new set of IT companies if this was considered necessary.

Alternatively, the Post Office could extend the existing arrangements. A new service management contract with ICL Pathway could be put in place. The contract length would depend on the investment decisions then to be made for the further development of the services and any technology refresh needed for the basic infrastructure. Depending on these factors the contract extensions could vary from a further long term arrangement to a rolling 1 year contract and the service pricing adjusted accordingly.

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It is envisaged that ICL Pathway would deal exclusively with POCL, and that DSS would assign the PAS/CMS contracts to POCL. Service arrangements would need to be put in place to provide the operating framework up to the end of the current contract. No other changes to the service contracts would be required subject to any changes agreed as part of a restructuring of the contracts to provide the complete solution to the situation for the future. As an equity partner the Post Office would share in the financial returns of the company and, through its Board representation, the management decisions for the successful running of the enterprise, and the future direction of the technologies to be applied.

Furthermore once ICL Pathway's infrastructure is implemented across the Post Office network, it will be the only practical platform (due to counterspace and timing considerations) for all future services and their development. ~~Because of this, the Post Office needs to have the ability to influence and direct the business plans and forward strategy of ICL Pathway.~~ Thus an equity stake in ICL Pathway is the best way for the Post Office to achieve this.

5 PARTNERSHIP BENEFITS

The arrangements described above support a number of desirable outputs. It establishes a real basis for partnership, with shared risks and rewards. It provides a large proportion of the necessary funding framework for the Programme to proceed. Any successful restructuring needs to position the Programme under one sponsor, which can only be the Post Office. The DSS needs to be supported as a major and highly valued client.

There are three unique benefits in the Post Office becoming the equity partner in ICL Pathway:-

- i) The successful implementation of Horizon opens the way for future new revenue streams (eg Financial Services, Better Government) which should regenerate the business prospects for POCL with additional income streams and contributions.
- ii) The revenues earned by ICL Pathway on these new revenue streams should be on a better margin structure than the core business, due to the incremental nature of the relevant infrastructure costs which will apply. These contributions will be shared equally between the parties.
- iii) The success of Horizon will maintain the Post Office as a major channel for DSS business, with its positive effect on the additional new revenue streams.

It is ICL's view that no other third party could benefit in this way, and for this reason ICL considers the Post Office to be the natural, and sole, prospective equity partner.

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Termination of the contract would not only leave the Post Office with no prospect of an alternative automated infrastructure for many years with the consequential loss of revenues from the new business streams. It would release DSS from any obligation to implement a card based payment service. Rapid progress to ACT would inevitably follow.

6 NEXT STEPS

It is essential that agreement to consider this equity proposition is placed before the main Post Office Board urgently. Although there are many important details to determine it will be necessary to reach an agreement in principle within the timescales of the HM Treasury review which has to report back to the Chief Secretary by 16th October.

Richard Christou
28.9.98

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