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with compliments

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 POST  
OFFICE

**IN COMMERCIAL CONFIDENCE**  
**Without Prejudice and Subject to Contract**

Post Office Counters Ltd

Development Director

George McCorkell  
Project Director  
Benefits Agency  
Holborn House  
Caxton Road, Eastway  
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16 October 1998

1016a

Dear George

**HORIZON DISCUSSIONS: 'AGREEMENTS' AND 'OUTSTANDING  
BA/POCL ISSUES'**

1. As I promised, I have recorded where we are now on agreements, and the few issues that are 'outstanding' between us as at today. I am pleased that the former far outweighs the latter!
2. I was pleased we reached agreement last Wednesday around the terms of the extension to March 2008 as part of our latest package offer to ICL Pathway under the Graham Corbett 'Option 1' discussions. The key elements of these are (£m in constant prices):

|                              | 2005/6             | 2006/7             | 2007/8            |
|------------------------------|--------------------|--------------------|-------------------|
| a) ACT migration assumptions | 40% volume         | 40% volume         | 20% volume        |
| b) Contract 'A' structure    | per now, except c) | per now, except c) | see below         |
| c) Contract 'A' floors       | £320m              | £310m              | Nil               |
| d) Fixed charge              | see b)             | see b)             | £100m             |
| e) Variable charges          | see b)             | see b)             | estimated at £15m |
| Total BA charge (estimated)  | £320m              | £310m              | £115m             |

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- 2 -

16 October 1998

George McCorkell

For completeness, up to March 2005, current Contract A and B structures will prevail.

3. We also agreed, in principle, that DSS/BA would not object to the BES application being used on other multi-functional cards we might promote (eg a 'Post Office' branded smartcard), or that other applications could be used on the benefit payment card, which we might promote or develop, if it were made multi-functional.

This would be on the conditions that this did not adversely affect your security requirements, materially delay any programme arrangements, that PO would take responsibility for assuring data protection aspects, and that benefit customers could not be forced to accept other applications alongside BES.

4. Of course, all the above 'agreements' are dependent on Option 1 being progressed, and are, of course, subject to contract.
5. You raised on Wednesday the issue of POCL demonstrating to BA that it was properly incentivised to complete national roll out of post offices, and so, enable BA to realise the full extent of its planned administration savings. As I have said before, our view has always been that essentially this is an ICL Pathway implementation service risk - and we have put in considerable extra funding, outside what we are contractually obliged to do, to support that. Indeed, I have made very clear that our own market development and process engineering benefits will not accrue to us either until roll out is complete. We have a vested interest in ensuring this happens quickly too. You will also have seen Jonathan Evan's note to Sarah Graham which sets out, for example, how seriously we are taking this in planning to deal with the very most difficult offices.
6. Nonetheless, in the spirit of moving forward and settling all issues that are important to us, we have considered carefully how we can convince BA just how serious we are. In coming to a view, I have consulted with Dave Miller and also tried to balance the right levels of your net savings foregone, our ability to pay given our level of annual operating profit, the

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- 3 -

16 October 1998

George McCorkell

latest agreed programme timetable, and the relevant dependencies upon the rate of post office roll out. I have also tried to set a fair balance of incentives as well as penalties (as originally augured in Contract A), and am mindful of ICL Pathway's proposals to us too about the incentive "funds pot" they have put to us.

Our proposal is set out at Annex 1, and I trust you will agree that it is both fair and demonstrates our real commitment to completing roll out as fast as is sensible. If we fall into the 'penalty zone' we could be faced with the loss of over half our operating profit until that is remedied, or until ACT migration really "bites".

7. Finally, there are a few other outstanding issues which we should aim to settle as part of the overall deal in the spirit of what we said we would do at the outset of these discussions. These are set out at Annex 2; I hope that they will not be contentious; but they do require clarity. I trust we can work together, bringing in 'experts' as necessary, to clear these soon too.
8. I would be pleased to discuss these over the next few days.

Yours sincerely

**GRO**

*PAUL RICH*

Copy: Sarah Graham  
Ross Newby, for information  
Stuart Sweetman  
Roger Tabor  
Mena Rego  
Jeff Triggs  
Jonathan Evans  
Dave Miller

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Annex 1<sup>5</sup>

POST OFFICE ROLL OUT RISK: POCL OFFER TO BA - INCENTIVES/PENALTIES

A) Offer

1. POCL will pay £1million penalty payment per month to BA for each month beyond 36 months from the commencement of National roll out should 100% of Post Offices trading throughout the previous 12 months (ie months 25-36 after commencement of National roll out) not be card enabled, until such completion is made. This compensation will be payable for a maximum of 30 months, and is subject to the number of benefit payment transactions per month being greater than 45 million (which we have calculated at 80% of current forecasts for the end of the compensation period).
2. BA will make an incentive payment of £1million for each month in advance of 20 months from the commencement of National roll out that POCL have achieved full roll out (ie 100% of Post Offices trading throughout the previous 12 months are card enabled). This incentive will be payable for up to a maximum of 10 months.

B) Definitions

1. "Card enabled offices" = POCL's ability to make card benefits payments securely and for at least the same price to BA.
2. The percentage definition of post offices is meant to cover instances of post offices, where - at any one point in time - a post office may not be equipped or open because of business-as-usual trading reasons - eg a new post office recently taken over but waiting for equipment; or 'seasonal post offices' not open at that particular point. An alternative definition might be "99% of post offices".

C) Conditions

1. Benefit roll out completion: no compensation will be paid by POCL until 95% of benefit transactions are capable of being made by Benefit Payment Card. Current plans showing the last benefit rolling out 25 months after the commencement of National roll out. There is a programme link to completion of this and pace of roll out around change management issues.
2. POCL should not accept liability for force majeure, eg strikes/bankruptcy of ICL Pathway or its subcontractors.
3. POCL should not be liable should BA contribute materially, for its own reasons, to deceleration of roll out. (eg by delaying major software releases as this has potential knock on effect to eg POCL training.)

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**HORIZON - BA/POCL: OTHER OUTSTANDING ISSUES**

There are three other outstanding issues between BA and POCL in regard of the BA/POCL project

1. VAT and Contract B

Both parties have worked hard together to persuade Customs and Excise that their view that VAT charged by ICL Pathway under Contract 3 is not chargeable as VAT on Contract B means that either:

- the input VAT is treated as an unrecovered charge and passed straight to BA who cannot reclaim it within their budget, or
- the input VAT is absorbed by POCL and does form part of the charges under Contract B.

We are scheduled to go to tribunal next week to try and change the Customs and Excise ruling. If the tribunal is successful then there is no issue. If, however, it is unsuccessful there appears a number of options to us;

- a) proceed as above with either BA or POCL shouldering the VAT burden in solus (circa £7m pa in steady state) neither party would wish this;
- b) split the difference between us;
- c) change the way the charging schedule works to place service points from BES into PAS. POCL would suffer higher less discounts on its residual transactions but BA would gain higher discounts in PAS. Guarantees would need to be adjusted to ensure the same amounts were due by each party as originally intended.

It would be useful to agree now what the position should be in the event of an unsuccessful tribunal to avoid another 'running sore' appearing after these negotiations. We need to bear in mind the different VAT-recovery positions of both organisations in deciding.

POCL would like to propose that should the tribunal be unsuccessful the Authorities will work together to achieve option c) above. Tim Brown (or Kevin Corrigan) have been working with Ken Davenport on this issue to date, and Tim stands ready to discuss.

2. The Common Basis of Settlement

An apparent difference of opinion has developed between the Authorities over the interpretation of the Common Basis of Settlement between them. POCL takes the view that it is what the system has told the clerk to pay out, BA take the view that it

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Annex 2

excludes payments made by BES in error. Settlement to date has reflected the POCL interpretation.

This has led to much debate (up to, and including, our respective Finance Directors) over where the boundary lies between PAS and BES because many PAS requirements are met within BES. POCL is willing to accept the BA interpretation of the boundary if BA is willing to stand by the original interpretation of the CBOS. This, of course, excludes where POCL staff have paid out something different to that shown on the screen. Again, our relevant experts would need to take a view - but I would hope that this could be put to bed now too.

3. OBCS

It also seems that, from discussions on the programme prior to the present negotiations, BA have changed their requirement of OBCS from the original plan now to be only at high fraud risk post offices. I think for completeness and to avoid another post negotiation area, we need to nail this down across all three parties. The assumption we have been working to assume OBCS at all BG post offices (ie excluding Northern Ireland). Any difference in this will affect both ICL Pathway and POCL's projections. It would be useful if you could clarify the position to all for the sake of completeness.

SSA - for information

In addition to the three BA related issues, there is the issue of 'Contract A' extension with SSA. We touched upon this briefly at the outset of these talks.

As you know, I wrote yesterday (15 October 1998) to SSA setting out the working assumptions around our agreement around the latest 'offer' to ICL; ie an extension to March 2008 between us. I am pleased to say that Chris Thompson, Chief Executive of SSA, has called me to say, that, subject to negotiation between POCL and SSA, he is content in principle to follow the key principles of our agreement to date. Hopefully, this will not prove an obstacle but SSA will need briefing by BA next week, I believe.