

RESTRICTED - POLICY AND COMMERCIAL**HWGSG/9/02****DRAFT LETTER FOR THE SIGNATURE OF MR JOHNSON TO**

Charles Clarke MP
Minister of State
Home Office

**PERFORMANCE AND INNOVATION UNIT STUDY ON THE FUTURE OF
THE POST OFFICE NETWORK**

As you know, the Horizon Working Group which I chair was established by Stephen Byers shortly after the linked decisions to proceed with the Horizon project but without the benefit payment card, and to allow the Benefits Agency to migrate benefit recipients to payment of their benefits via the automated credit system over a two year period from 2003-2005. The Group's remit is both to oversee the successful rollout of the project to all offices throughout the network by the Spring of 2001, and to contribute so far as possible to its commercial success.

Our work therefore necessarily has a somewhat narrower focus than the study by the Performance and Innovation Unit into the future of the counters network, but will take place over a much longer period. We nevertheless thought that your team might benefit from the work we have carried out to date, and the limited conclusions we have so far been able to draw from it. We are currently exploring further in particular the scope for a substantial expansion of the agency arrangements that Post Office Counters Ltd has with a number of high street banks to offer front end banking facilities to customers at post offices, and the scope for the counters network to become a major delivery channel for the forthcoming range of electronic government services. We hope to complete our initial work on both subjects within the first few weeks of the New Year, and we will then let you have a further note summarising our findings and conclusions.

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**JOINT SUBMISSION BY THE HORIZON WORKING GROUP TO THE
PERFORMANCE AND INNOVATION UNIT STUDY ON THE POST
OFFICE NETWORK**

INTRODUCTION

1. The Horizon Working Group was established by the Secretary of State for Trade and Industry following the Government's decision in May this year to restructure the Horizon project, notably by discontinuing the Benefit Payment Card element of the project, removing DSS/BA as a party to the contract, and revising the contractual basis to that of a conventional procurement rather than the previous private finance initiative (PFI) basis. The Government also agreed to contribute substantially towards the capital costs of the project by allowing the Post Office to liquidate £480 million of assets already held on their balance sheet. In a parallel decision the Government decided that the existing paper-based methods of paying social security benefits at post offices would be phased out over a two year period starting in 2003, and would be replaced by modern electronic means using the existing automated credit transfer system (ACT).

2. Against an expectation that the Horizon platform would by 2003 have enabled Post Office Counters (POCL) to substantially expand its commercial arrangements with the banks, allowing bank customers to access their accounts at post offices the Government offered assurances that all those benefit recipients who wished to do so would continue to be able to access their benefits in cash at post offices both before and after the changeover. However, the ability to deliver this commitment depends on the success of POCL in establishing the necessary commercial arrangements with the banks, over which the Government has no direct control. The Government stressed that there would be no change to the existing methods of payment before 2003. POCL currently earn some £400 million a year (about one-third of their total income) from carrying out this work on behalf of the Benefits Agency.

MEMBERSHIP AND REMIT

3. The Group is chaired by Alan Johnson, Minister for Competitiveness at the DTI, with membership drawn from the main stakeholders in the Post Office Counters business, namely Post Office Counters Ltd (POCL) itself, the National Federation of Sub-Postmasters who represent the interests of the nearly 18 000 sub-postmasters who run the vast majority of the network outlets (which in turn account for somewhere between 40 000 and 70 000 jobs, many of them part-time, and many

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in areas where alternative employment opportunities are limited); the Communication Workers Union (CWU) representing around 11 000 frontline staff working in the 600 Crown Offices and in headquarters (and around 165 000 non-management grades in the whole of the Post Office; and the Communication Managers Association representing around 1500 managers within the Counters business.

4. The Group was given a remit to contribute to ensuring that the agreement in principle between POCL and ICL (the system supplier) signed on 24 May was carried through to a full agreement; to oversee the roll out of Horizon to all offices in the network within the agreed timescale; to contribute to the smooth migration from paper based methods of paying benefits to payment via ACT; and to contribute to maximising the commercial potential of the Horizon platform and hence the future viability of the counters network. The Group is therefore dealing with all the main stakeholders in the project, and will particularly be looking to establish ongoing dialogue with officials and Ministers in DSS as plans to migrate benefit payments are developed in the run-up to 2003.

5. Specifically, the terms of reference of the Group are

“In relation to carrying forward the work on the POCL/ICL Horizon project:

- to oversee the negotiations between POCL and ICL which will develop the letter of agreement signed between the parties on 24 May into a Codified Agreement governing the contractual relationship under which the project will be taken forward, together with the consequential arrangements between POCL and the Benefits Agency; and to facilitate solutions to any problems which may arise;
- to oversee, to contribute actively to, and to facilitate solutions where problems arise, the completion of the development phases of the Horizon project, and in particular the smooth and timely roll-out of the system to all offices within the post office network, and the subsequent satisfactory migration of benefit payments from the present paper-based methods to more modern, ACT-based, methods of payment accessible through post offices; and
- to contribute through ideas, contacts and other practical measures, to maximising the commercial potential of the Horizon infrastructure and the future viability of the post office network as a whole.”

THE HORIZON PROJECT

6. The Horizon project was initiated under the previous Administration. Its objectives were to automate the network of post offices in order to make existing business more efficient and help to win new business; to provide a more secure and efficient way of paying social security benefits by replacing the existing paper-based methods by a magnetic strip benefit payment card; and to provide the Department of Social Security/Benefits Agency (DSS/BA) with the means to account fully for their vast programme expenditure.

7. The project was by any standard huge, worth some £1 billion, involving automation in 19 000 post offices and 40 000 counter positions; and providing links into DSS/BA and PO systems. The agreement to take forward the project on a PFI basis was signed in May 1996 between POCL, DSS/BA and ICL Pathway as the private sector partner. However it emerged over the next few months that the project was necessarily of a complexity which had not previously been fully understood and by February 1997 substantial revisions to the timetable for the project were agreed by all the parties. Despite this there were further significant slippages and by March 1998 the project was almost two years behind even the revised timetable agreed in February 1997. At the same time, ICL sought a change in contractual terms either in the form of an extension to the contract (to allow them further time to recover their costs) or increases in charges. At that point Ministers established an interdepartmental working group comprising officials from the DTI, DSS, Treasury and CITU to advise on the way forward for the project. Intensive efforts over the following 14 months involving substantial external assistance on technical evaluation and commercial facilitation resulted in the decision by Ministers described at paragraph 1 above.

THE NETWORK CHARACTERISTICS

8. Post Office Counters Limited is a wholly owned subsidiary of the Post Office. It oversees the nationwide network of post offices, negotiating and co-ordinating the contracts with Government bodies and other clients which provide business for the network. The post office network comprises more than 18 500 outlets. Six hundred of these comprise the directly run and staffed Crown Offices which account for some £240 million of assets. The remainder are run on an agency basis, the vast majority by private individuals. The network thus represents a partnership between the public and private sectors, with subpostmasters investing over £1 billion of their own money to provide the outlets which comprise over 95 % of the post office network. In addition it is estimated that subpostmasters have invested at least a similar amount again in the private retail businesses that operate in synergy with the post office, often being dependent on the customer footfall attracted into the site by

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the post office activity there. Around 85% of post offices share premises with another retail business, enabling cost-effective operation of the post office through shared overheads, whilst generating additional trade for the retail business through the “footfall” effect of benefit recipients collecting their benefit cash at the post office counter, and staying to make purchases from the retail side of the business.

9. Although the post office counters network has been shrinking by some 200 offices a year for some years now, as subpostmasters leave and replacements cannot be found, it remains the largest retail network in Europe. Statistics show that around 94% of the UK population live within a mile of a post office (99.9% within 5 miles), compared to 75% for all banks and building societies combined and 32% for major supermarkets. It is also estimated that 28 million people per week make around 45 million visits to a post office each week.

10. The post office network provides communities with access to a wide range of services (some 170 products), of which the most important include access to postal services, benefit payments, cash, banking and bill payment services, licensing and other Government services and a range of other customer driven services (e.g. lottery, bureau de change, insurance). Small businesses are also reliant on the network e.g. 90 % of small businesses with less than 9 employees use the post office, mainly for access to banking/deposit facilities, cash provisioning and access to mail services. Around 25% of all notes and coins in circulation in the UK are acquired across a post office counter.

11. Numerically rural post offices account for almost half the network (57% of rural parishes have a post office, less than 10% have a bank or building society), yet they account for less than 20% of the network’s turnover. The post office outlet is particularly valuable in rural areas where neighbourhood village shops are often only able to survive in the face of retail pressures because of the income which operating a post office provides. The village post office and store can provide a focal point in the community providing access to cash and essential everyday items, an information centre in areas where frequently other retail and banking facilities are absent. The accessibility of such post offices is crucial to the least mobile sections of the community - poor, elderly, infirm, mothers with young children, etc.

12. As in rural areas, post offices in urban deprived areas play a particularly important role. Here also the post office is often the last remaining shop and financial services outlet in a neighbourhood. The post office in such communities can also act as a lynch pin in sustaining the local centre, having the potential to generally increase the amount of trade of other shops located in its vicinity (a somewhat wider manifestation of the “footfall” effect referred to above). Post Office statistics show that 92% of deprived wards have a post office and, in more than one

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third of the most deprived wards in England and Wales, covering almost three million people, there is at least one post office but no bank or building society. As banks and building societies continue to prune and rationalise their branch networks and their customer base, the number of deprived wards and customer segments dependent solely on the post office seems certain to continue to rise.

13. A further significant statistic in terms of the potential value of the post office network as a delivery channel for services which contribute towards achieving the Government's objectives in combatting various forms of social exclusion is that post office customers in deprived urban areas carry out 33% more business at their post office than the national average. As almost all adults visit a post office the post office customer profile matches the population profile closely. The visit profile is, however, more weighted towards the Es (31% compared with 29%), older people (24% for 65 plus as compared with 20%) and women (56% compared with 51%).

14. Distribution of pensions and benefits is a significant element of the business transacted at post offices in these areas. The range of products available at post offices makes them particularly well suited to meeting the needs of the socially disadvantaged, for example schemes for easy budgeting for household bills through traditional well-tried methods such as saving stamps (as well as their modern replacement, the plastic card). As well as providing access to cash - vital to those on low incomes and/or who currently lack access to a bank account - post offices offer a range of financial products aimed at this market including National Savings Pass Book accounts allowing small sums of money to be saved, postal orders for easy money transmission and more recently insurance products such as bill payment cover, tailored for this market.

15. Currently around half of Post Office Counters' income is derived from its contracts with Government departments and agencies, including the Benefits Agency, the Driver and Vehicle Licensing Authority and the Department for National Savings. By far the largest of these is the contract with the Benefits Agency which runs until 2005, accounts for more than one-third of POCL's total income, and constitutes the UK's largest single service agreement. In more than 8 000 post offices BA work accounts for 40% or more of the total income. The impending loss of income from the BA, as a result of the Government decision to migrate payments to ACT, will therefore be a significant blow to the finances of POCL and adds sharply to the case for securing stability in the remaining public sector contracts.

16. The loss of benefits will also affect bill and budget payments which account for some 15% of POCL's income. Around 45% of bill and budget payment transactions are generated as a result of benefit encashment and there will also be

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similar dependence on benefit transactions for some of the services highlighted below. Other business includes Royal Mail/Parcelforce business which accounts for around 20 % of POCL's income. New services such as the sale of lottery tickets, bureau de change facilities, insurance products and simple banking transactions for banks other than Girobank generate about 10 per cent of POCL's business. It is this successful provision of diverse products and services that the Post Office must be looking to expand in future. It has already shown, with the National Lottery in particular, that it can deliver and has the ability to be competitive and flexible (in terms of opening hours). The Government will be looking to capitalise on the success of the network in delivering this, and recognises the role of the Post Office in making the Lottery a success.

17. In summary, the Post Office network has significant strengths in terms of its social and geographical reach. Over 95% of the outlets in the network operate using the agency 'model' with its long-standing, successful track record of combining private and public investment to make the continued existence of the overall network possible. However this 'model' is underpinned in the agents' eyes by the perception of a relatively stable ongoing income/footfall generation capability. Therein lies, however, a vulnerability - because if agents' confidence in that model is undermined and they cannot see a viable future in operating an individual outlet they may be forced to withdraw from operating post offices and the network becomes at risk of collapsing. The remaining 5% of the outlets in the network - the directly run and staffed Crown offices - which are mainly in urban areas account for some 20% of the throughput of the network.

A POST OFFICE SMARTCARD

18. Against the background of the Government's decision on the way forward for the Horizon project set out in paragraphs 1 and 2 above, and the network characteristics described in paragraphs 7 to 16, the Horizon Working Group has begun to examine the wider commercial potential of the Horizon platform. As noted above, the Benefit Payment Card had from the outset been at the heart of the Horizon project (and arguably a major cause of the delay and cost escalation), and the decision to discontinue it changed substantially the nature of the project from a technical viewpoint and also affected significantly the project's commercial potential.

19. The technical simplification which resulted from removal of the card, and the contractual simplification which flowed from it, enabled a clear goal of equipping every counter position at every Post Office throughout the land by Spring 2001 to be set. However the decision to migrate all social security benefits to payment by ACT over a two year period starting in 2003 not only stands to lose POCL some £400m a

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year in revenue from BA once the migration has been completed, but the loss of the Benefit Payment Card risks removing an important commercial opportunity which the Horizon platform could otherwise have provided.

20. It had been considered that the Benefit Payment Card might become a smartcard over time thus creating an important database for commercial application. In particular, the introduction of smartcard technology would have assisted many benefits recipients towards becoming socially and financially included by introducing them to card based financial products and services. No other commercial or Government application is currently known that could justify the Post Office launching its own smartcard at this point in time. However, the Post Office continues to search for suitable commercial opportunities to develop a multi-application smartcard. Widespread use of smartcards will require a secure, integrated, trusted and nationwide network of acceptance points and the Post Office is therefore well placed to fulfil this future.

21. The Horizon Working Group therefore believes that the early identification of alternative applications which would justify the creation of a Post Office smartcard as a basis for unlocking a further series of commercial opportunities could play an important part in helping to replace revenue lost from BA. However this window of opportunity may be strictly time limited, since despite the Post Office's trusted image and ubiquitous availability, there are likely to be overwhelming "first to market" advantages.

WORKING WITH THE GRAIN OF WIDER GOVERNMENT OBJECTIVES

22. The Group has also been looking at two further key areas of activity in which the existence of the Horizon platform can be expected to open up significant commercial opportunities. The first of these is network banking, to which reference has already been made. The second is the electronic interface between the public and Government, government agencies, local authorities etc. The electronic delivery of public sector services has been branded as "electronic government" or "Modernising Government" but is referred to generically by the Post Office as "Government Gateway". In looking at these, and in future at other areas of potential commercial opportunity for the Horizon platform, the Group will be concerned to look beyond simply the straight commercial potential for the Post Office, important though that unquestionably is, and to explore in addition the extent to which such developments could best be carried forward in a way which would work with the grain of wider Government objectives rather than against it.

23. It is clear to the Group that a combination of the unique reach of the counters network, the social groups who regularly use and trust it, and the potential of the

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Horizon network combine to create a powerful weapon in the campaign against social exclusion, particularly in the fields of financial, retail and IT exclusion; and in the Government's wish to communicate with citizens in a modern, convenient and cost effective manner.

BANKING

24. The development of network banking facilities at post offices forms an important part of POCL's plans for the future, but is also key to the Government's plans to migrate to the payment of benefits by ACT from 2003. POCL already has agreements in place with Alliance and Leicester Girobank, the Cooperative Bank and Lloyds TSB. But these arrangements rely on slow and expensive paper-based transactions, which severely constrain the scope for any major expansion of POCL's network banking activities. The Horizon platform offers the promise of removing that constraint, and opens up a scenario in which a combination of, on the one hand;

- the apparent desire by the High Street banks to continue apace with branch rationalisation programmes, closing some and refocusing the remainder on selling activities;
- yet at the same time wanting to enhance rather than reduce the service they are able to offer their customers;
- whilst also at the same time needing to accommodate large numbers of new accounts (powerfully driven by Government policies) of a kind for which they might normally have little or no appetite;

and, on the other hand,

- the ubiquity of the nationwide network of post offices;
- its trusted image with the public, and especially that sector of it unused to, and probably mistrustful of, the existing financial institutions and
- its long experience in carrying out a wide range of financial transactions on an agency basis;

together with

- POCL's need to find additional business to replace the revenue stream from the Benefits Agency;
- the desirability of keeping as many benefit recipients as possible within the post office system, not least to retain the "footfall" effect for the retail side of subpost offices; and

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- the desirability of maintaining as far as possible a balancing outflow (through withdrawals from a large number of bank accounts) for the large inflows of cash in the form of corporate deposits especially from small and medium sized companies;

and

- the Government's need to honour its commitment that all benefit recipients who wish to do so will be able to access their benefits in cash at post offices both before and after the migration to ACT from 2003 - as well as securing a credible means of ensuring that benefit recipients living away from the major concentrations of banks and ATMs can in practice access their benefits in cash without undue expense or difficulty;

begin to take on the appearance of - potentially at least - an extraordinarily serendipitous fit.

25. The reality may be less clear cut. There are important questions of timing. The longer Horizon is delayed, the more likely it is that the banks will have moved to develop alternative solutions. There are technical issues still to be fully resolved about the suitability of Horizon as presently configured to handle potentially very large numbers of on-line transactions, and about the interface between Horizon and the banks' systems. Perhaps above all lies the question of how much the banks will be willing to pay POCL for providing front-end banking on an agency basis, especially if many of the accounts are of marginal profitability (if at all) for them.

26. The Horizon Working Group will be pursuing these issues with POCL and other interested parties, such as DSS/Benefits Agency, HM Treasury and other public sector clients. It will also be important to ensure that relevant parallel strands of Government activity, such as the ongoing work on social exclusion, are properly integrated into the process. As an example, the work of Policy Action Team 14 on financial exclusion highlights the important contribution that the counters network, equipped with the Horizon platform and offering front-end banking facilities, can make towards combatting financial exclusion particularly in rural and deprived urban areas.

GOVERNMENT GATEWAY

27. A second important area of potential opportunity for POCL which the Horizon platform can open up is the delivery of Modern Government or Government Gateway applications on behalf of central, regional and local government. The Prime Minister announced in 1997 that by 2002, 25% of dealings with Government should

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be capable of being conducted by the public electronically. It has also been proposed that, subject to certain exceptions, 50% of dealings should be capable of electronic delivery by 2005 and 100% by 2008.

28. However although the potential here would appear to be enormous, there remain at this stage very great uncertainties as to timing, as to the share of such work post office counters might be expected to attract in competition with a multiplicity of alternative delivery channels, and as to the value of the revenue streams that POCL might generate from such work.

29. It is clear that the counters network has a number of powerful advantages as a potential delivery channel for Government services. Its ubiquity and its trusted image have already been referred to, and when combined with the customer profile described in paragraph 12, give the network an ability to reach large sections of the community for whom electronic access would otherwise be denied or perceived to be threatening.

30. However, there is uncertainty as to the speed with which the Modernising Government programme will come on-stream on a significant scale. There are also predictions that very large numbers of households, including the C, D and E socio-economic groups, may acquire access to the Internet through digital television a great deal more quickly than predicted. although equally there are doubts about the functionality of the early generation of set top boxes and whether many segments of society will wish to transact with Government in this way.

31. Whilst detailed assessments have been made of the significant savings to Government expected to flow from more modern ways of interfacing with the citizen, the price which Government will expect to pay will in practice take account of the prices charged by alternative delivery channels. It is believed that some third party delivery channels may be prepared to deliver certain Government services without charge/at low cost. It is likely that such cases will involve the simpler services for high net worth customers via only low cost electronic channels. Although this commercial model may have very limited coverage there is a real danger that it could be used as a benchmark for fee setting. This could impact on the economics of more universal multi-channel providers.

32. The Horizon Working Group is at a very early stage in its consideration of the potential of Modern Government applications for the counters network, and is due shortly to take delivery of a paper from CITU aimed at providing the Group with a policy perspective.

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33. Once again on Government Gateway the timing and sequence of events is crucial. The Post Office network provides an existing, proven channel which citizens freely choose to use in their interactions with Government. Indeed, half of the work that post offices do at present is of this nature (albeit on an unautomated basis). The value of such an existing proven channel for Government business was clearly demonstrated in the recent passport crisis where the contingency use of post offices was able to resolve public outcry at the passport backlogs last summer.

34. Moreover research using the People's Panel demonstrates that post offices are the preferred location for one-stop shops for Government services. Banks and supermarkets scored lower in this research for reasons such as staff knowledge, fear of cross-selling and the potential for inconsistent approaches from different companies. Proposals for alternative channels for Modern Government (such as digital interactive TV), rely on volatile forecasts and speculation about the customer preference for interacting with Government through such a channel which are unproven at present.

35. In summary, there appears to be considerable potential in utilising the counters channel as a route for Modernising Government and such an approach could certainly help in the future retention of network. However, there remain areas of debate around the Modernising Government agenda. There is a concern that if such debate takes too long to resolve, the risk increases that the network is lost, only for there to be the belated discovery that it provided a preferable and effective route for Modern Government after all.

CONCLUSION

36. The Horizon Working Group very much welcomes the work on which the PIU has now embarked, and which we see as complementary to our own task. We believe that the Horizon platform offers the counters network its best hope of a viable longer term future, and we will work towards maximising that potential. Whilst we hope that the results of our efforts will go some way to reducing the gap which will be left in POCL's income when current annual revenue of some £400 million from BA begins to fall away from 2003 onwards, it is doubtful whether revenue from new commercial activities can bridge the gap fully, at least from the outset. Setting this work in the wider context which forms the remit of the PIU study, and ensuring that relevant strands of parallel activity within Government such as the ongoing work on social exclusion are properly integrated into the process, should serve to provide Ministers with valuable insights to assist them in the decisions they will need to take on the future of the counters network.

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37. The Working Group is also seized of the critical importance that the timing/sequence of events/ announcements could have on the network. If any future development of the network is to be an ordered, managed process, confidence in the sub-office market must be maintained. The Working Group has already heard that it may be 18 months before Benefits Agency plans for ACT are finalised. There is a significant risk that there will be a hole in the timing through which the network will fall. This could therefore happen before the positive actions, which might realise the potential of the network for the nation and avoid the fall-out from the loss, can be brought to bear.

38. We are, of course, happy to provide further information or clarification on our work so far, and on the next stages of our programme. In any event we feel it will be useful for our two groups to remain in touch and to exchange views and information over the coming weeks.

Horizon Working Group
22 December 1999.