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POCL AND THE ICL PATHWAY DEAL

1 Introduction

1.1 I have been asked, as a member of the POCL team not closely involved with recent negotiations, to "stand back" from the deal and review it (as independently as possible for a CEC member) to confirm that the chosen direction remains sensible. In this I have been assisted by Jenny Cole and Hilary Stewart, with support also from Tim Brown and Bill Lavery: I am especially indebted to Jenny, for carrying the work forward assiduously during my period of sick leave. Keith Baines and Liz Blackburn provided financial figures to tight deadlines, and this was much appreciated. I am also deeply indebted to Joan McNamara for her patience in typing this report.

1.2 I have aimed to conduct this review within the broader context of POCL business strategy. I have summarised my interpretation of the strategic issues in Appendix A, and that analysis has guided the report.

1.3 Some views are attributed to third parties. These have not been obtained directly: the impressions were gained in interviews with POCL people and therefore reflect a collective understanding within the business.

1.4 The methodology adopted was a combination of review of documentation and series of interviews with POCL personnel. Appendices B to E record the main points of the evidence collected in this process. Appendix F includes a list of interviewees and the team's original brainstorm of the lines of enquiry the task would require.

2 Findings of the Review

Overview

2.1 I am satisfied that those directly involved in negotiations genuinely believe that it is better to proceed with Horizon on the renegotiated terms than to abort. It is, however, a measured view rather than an enthusiastic one, recognising that proceeding will bring formidable challenges.

2.2 Negotiations appear to have been informed at all stages by proper financial and strategic analysis, including the agreement of clear negotiating authority, and professional advice has been taken. The Post Office is therefore able to justify its due diligence in the matter.

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2.3 The negotiations were also subject to assurance review at appropriate stages, and contingency plans were prepared against failure.

2.4 The conclusion of negotiations with a firm decision to proceed should put an end to a protracted period of uncertainty, permitting a fresh start with renewed focus not only for the Horizon project but for the POCL business. Unfortunately, many uncertainties, unanswered questions and doubts about the future remain, so that the benefits of such a fresh start seem unlikely to be obtained without a concerted, focused and single minded leadership effort by both POCL and ICL teams to emphasise the positive.

2.5 Even on the basis of protecting benefit payments, the go/no go decision is extremely finely balanced, with neither option being fully satisfactory for POCL. Proceeding means full commitment to an automation route and a partner, neither of which are ideal in the context of realising the new Counters vision. But not proceeding would so delay the building of automated capability, and undermine the business' credibility internally and externally, as to put the vision at significant risk of becoming undeliverable.

2.6 Several senior managers, close to the project, but not principal negotiators, whose judgement I respect, express significant reservations about the risks of proceeding. These centre on their continuing doubt about the ability of ICL to deliver a satisfactory product; the absence of transparency in the PFI contract; the risk that ICL's financial fragility will endure throughout the project, with the possibility of repeated claims on The Post Office for extra contributions (which, by then having no alternative, it will be unable to resist); and doubts about POCL's own ability to give it the focus essential for success. Observation of the track record so far offers reasonable foundation for such views.

2.7 While much effort has been devoted to understanding the commercial and financial implications of the deal, the supporting Heads of Agreement on partnership with ICL were negotiated over a short period close to the conclusion. **I have found little evidence that the implications of this part of the possible contract for POCL's management <u>and for The Post Office</u> have yet been fully and systematically reviewed**. The implications may be profound. For example, how heavily does the partnership agreement constrain The Post Office from engaging in other collaborations in related areas? Is The Post Office effectively constrained to a broadly current view of the future of the counter network by its commitment to ICL, even if that were eventually shown not to meet its shareholder value aspirations? And does ICL have sufficient access to capital to be able to fund the proportion of investment in new vision development which POCL needs to be provided by its partners for the vision to be affordable? (I understand that the Heads of Agreement have technically lapsed, but write this on the basis that they would still be the basis of proceeding if the deal proceeds.)

On balance I agree that it remains right to press ahead with Horizon despite the extra cost involved, because

- it is financially better than terminating
- the alternatives are at least as uncertain and no more attractive
- it safeguards the immediate future of benefit payments at post offices
- it moves POCL to a card based technology, with the door left open to a smartcard strategy later
- the loss of credibility with key stakeholders (clients, agents, employees and customers) associated with abandoning the project would be severe
- termination will involve litigation and the diversion of much management effort to limit the financial impact, which will be strategically nugatory.
- There are however two important caveats to this conclusion

    a) I am assuming that the Post Office will be content that any constraints - such as those trailed in the previous paragraph - which the ICL partnership imposes on it are acceptable and do not affect these benefits, but am not currently able to verify that.

    b) If the deal is modified so as to limit or deny any of these benefits my conclusion will need to be revisited, (for example if there is a significant drawing back from the currently agreed levels of benefit payment transactions or the use of cards, which undermines footfall in the network.)

The financial context

2.8 The financial validity of the decision is critically dependent on the view taken of the likely response of the Benefits Agency (BA) to the collapse of Horizon, in particular of the speed at which BA would move to alternative payment methods and withdraw conventional payments through post offices. Medium term retention of current post office business is essential to support the automation implementation. (Benefit payment is about a third, and through footfall supports a further significant proportion of current counter volume.)

2.9 The negotiators take a pessimistic view of BA's intention to take payments away from post offices. (This supports their judgement that it is better to proceed with Horizon so as to retain BA business.) That view appears to be reasonably grounded in the observed behaviours and statements of BA and DSS officials and Ministers.

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2.10 It is important to recall that the business case for automating was always that it would be a <u>better</u> outcome than not automating, not an absolutely <u>good</u> outcome. The principal benefit of the original case was the retention of BA business by contract A. Since contract A is in place, and that main benefit is therefore flowing, even protracted delays to Horizon have appeared beneficial in casework NPVs because the costs have been deferred.

2.11 This very large financial effect has overshadowed the potential damage to POCL's strategic capability through not having implemented the basic infrastructure on the ground, and therefore not being able to move on to consider strategic improvements. Although there is an assessment of new non-benefit business attributable to automation, the financial model does not attempt to assess the impact of delay to automation on existing clients' propensity to defect. Thus there is an intuitive adverse effect of delay (including "sunk" delays to Horizon) which does not appear in NPV calculations at all. The financial casework does not evaluate POCL's "fitness to compete" as the dcf technique focuses only on measurable incremental cash flows.

2.12 The comparison of options has been done within the paradigm that a nationwide network of post offices will and should exist. So long as the outcome retains benefit payments at post offices by cards it preserves both the medium term guarantee of customer footfall and loyalty and the "jumping off" capability towards a transformed capability. The case for Horizon leads to the maintenance of existing shareholder value, or slowing its decline, rather than creating new value, (although this type of analysis is at too early stage to be the basis of immediate decisions.) While the solution preserves strategic capability this situation may be tolerable. **Were any of that to be lost in any variation of this deal it will expose the need to consider the option of not automating at all.**

2.13 Key financial parameters are summarised at Appendix B, including a comparison of the key assumptions. They confirm that the deal has a better NPV than terminating, but all options treat the position of existing clients (except BA) equally, irrespective of the timing of the introduction of automation. The sensitivity of the comparisons to the assumption about the timing of ACT is high, but even if the termination assumption is very pessimistic going ahead is still better.

2.14 Alternative options which promise continuing BA *income* levels but do not guarantee the transaction footfall or investment in it (eg by having plastic cards) may show overstated NPV's, unless the potential damage to the fabric of the counter network is factored in to the calculation. (I have not been asked to review alternative options to the main deal, such as are currently receiving political attention, but I wish to flag up that concern here.)

2.15 A financial aspect which has not been fully evaluated is that the deal transfers so much risk back to POCL that the Horizon assets will have to be on POCL's balance sheet. (See Annex 4 to Appendix B.) It could lead auditors to the view that the asset is "impaired" because the future revenue streams are insufficient to support it - a result of the deal being better than the alternatives, but absolutely unexciting. "Impairment" could lead to a significant write-off affecting P&L. Such an outcome would technically breach the clause in the negotiating brief that requires the deal not to adversely impact POCL's short term targets.

Working relationships

2.16 Since it has been the desire of BA to terminate the ICL contract and they have been frustrated by the unwillingness of POCL to support them, there is a risk that relationships with BA, some aspects of which have been adversarial, may be worsened by a decision to proceed. The importance of BA work to POCL and its customers is such that it must be a major objective to ensure sound relationships and maintain some kind of constructive partnership, across the whole range of mutual dealings. From "outside" this does appear to be a challenge, but those involved in negotiations believe that personal relationships are or can be made satisfactory. Since BA and POCL have different objectives, disagreement is at present inevitable. Once a decision is made it will be important for both parties to work together to ensure it is effectively implemented.

2.17 A summary of BA issues identified during interviews is at Appendix C.

2.18 It is equally crucial that a sound working relationship with ICL is maintained, characterised by trust and openness. Over protracted negotiations both parties will have been consciously seeking to protect themselves from the other's failures, and from legal liability. Given that there are still risks around the delivery of Horizon there is still room for defensiveness about relative responsibilities and the partnership will need to be wholehearted and proactive in its commitment to delivery.

2.19 **The deal with ICL gives them an expectation of being the Post Office's primary collaborator in developing markets associated with POCL's new vision.** Work in other parts of the Post Office could be caught by this, and needs to be co-ordinated appropriately. There is a need for clear Post Office wide understanding of the scope and influence of the ICL relationship, shared by all businesses and by ICL.

2.20 A summary of issues arising during the interviews, concerning the ICL Pathway relationship is at Appendix D.

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Focus within POCL

2.21 Issues identified in the course of the review in connection with Vision and Strategy are at Appendix E.

2.22 During the last three months' heavy commitment of activity (including Horizon, new vision development, the budget and planning round) the CEC and senior management have necessarily had to divide their labour. Directors have been withdrawn for negotiations with ICL, BA and Government. Few CEC meetings have been fully attended. Uncertainty about the new vision has grown as development work has been undertaken and communication has been held over. The future of Horizon has hung in the balance. Work has been undertaken urgently on the contingency that Horizon would be aborted. The pace and confidentiality of negotiations has prevented full communication. During my team's extensive interview programme with key managers they became aware that few people seemed to have the complete picture.

2.23 A significant result of this is that Horizon has become separated from the strategy development programme, either because strategists have come to doubt whether it would proceed (or at least soon enough to be useful), or because they regard it as an unsuitable delivery vehicle for their strategies. **It does not yet seem to be widely appreciated that if Horizon proceeds now, it will be the principal, and probably the only way POCL will have to deliver strategic change for the foreseeable future**, and every other project will have to be managed in the light of it. It is still unclear how far the partnership with ICL will have to impinge on other activities. It is also becoming evident that budgetary pressures will reinforce the need for single focus on Horizon.

2.24 In summary, there are drawbacks and uncertainties with going ahead, but they are not greater than those associated with termination. Going ahead will require very heavy, single minded commitment to Horizon and to the partnership with ICL in order to minimise the drawbacks.

3 Recommendations: Issues to address

3.1 The high profile of the Horizon renegotiation, and The Post Office's support of Horizon against significant opposition mean that failure to make the deal stick with a successful implementation would be politically and commercially extremely damaging. **It is of great importance for the credibility of The Post Office (not just POCL) that it should be seen to have judged the debate correctly and made the right decision.**

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3.2 Furthermore, POCL's commercial success will now depend heavily on Horizon. It will not have the funds for alternatives. Horizon must therefore be implemented in a way which ensures achievement of service and commercial goals, for customers and clients. To be sure of this, the approach to developing the business vision will need to be adapted to become visibly Horizon-centric. People's enthusiasm for finding work-arounds and alternative approaches will need to be firmly channelled into making Horizon deliver what is required. It is likely that this Horizon-centricity will need to apply beyond the bounds of the current POCL business. **Shaping for Competitive Success will need to ensure that organisation boundaries facilitate effective operation of Horizon and the ICL partnership, and not make it gratuitously more difficult.**

3.3 Communication of new vision also needs to acknowledge the centrality of Horizon. Failure to do so will give very strange signals to the network and to ICL.

3.4 The working relationship with ICL needs to change so that they do not hide behind the PFI to avoid sharing full understanding of the system's capability and construction. The effect of failure would be profound for both parties, so there is evident common ground for a worthwhile partnership. But trust must be re-established, and an environment created in which success is the sole motivator.

3.5 This is particularly important for the Horizon testing regime. Both ICL and POCL need to be committed to implementing releases that demonstrably work, since the potential for disruption and loss of credibility is enormous if the system is error prone, given the pace of planned roll out.

3.6 It is desirable to ensure that POCL's and ICL's understanding and interpretation of risk are congruent. Nothing less than the reputation of POCL is at stake, on which the projected business volumes are partly dependent. It is important that both parties recognise the high standards of accuracy required for the conduct of transactions on behalf of third parties.

3.7 As ICL Pathway has a large funding requirement there might be advantage in conducting due diligence of its financial strength and that of its parent ICL, if this has not already been done.

3.8 A significant "bridge-building" exercise with BA is indicated.

3.9 The Management Process of POCL needs to be reviewed to examine whether it will support primacy to Horizon, or whether it encourages the development of competing activities which make implementation more difficult, and which the business may not anyway be able to afford. Major Post Office wide projects should also be included in the review.

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3.10 The partnership proposition has not been subject to as extensive review as the financial deal, and now needs to receive it.

3.11 **Clear signals need to be given to managers that implementing Horizon, and working in partnership with ICL to exploit it for commercial advantage, make up the "most important game in town".** The CEC will need to back the decision to proceed with its full commitment, and not underestimate the need it brings for very sharp focus.

Roger Tabor, Finance Director POCL **January 1999**

Appendix A

The Strategic issue

- The historic role of post offices is being undermined by a combination of technological obsolescence, disintermediation, "unbundled" competition, and cost pressures on public service clients. Nevertheless customers like post offices and repositioned ways of exploiting them profitably were identified in Counters New Vision.

- It has always been a focus of counters strategy that the continued existence of a network of post offices (even if differently configured and smaller than the present) is both politically and commercially desirable, but needs to be actively secured by a sufficient volume of business. Issues about the network are at Annex 1 to this appendix.

- All potential future developments in the vision for post offices require automation of the network. Horizon is the only automation currently available. Although alternatives are both conceivable and practicable, and might be more immediately suitable, they require extensive investment, and would probably take about two years longer.

- Since repositioning the post office network requires automation first, it is critical to the future of the business to buy time to implement automation, by prolonging the viability of the current, threatened mix of business as long as possible. Payment of benefits is the most important part of this, because it accounts for more than a third of counter network revenues, and its footfall boosts other transactions.

- The Horizon related deal includes agreement by BA not to withdraw benefit payments from post offices until the end of the contract period. (Actually, to pay POCL never less than a real 3% fall, year on year.) Without Horizon this guarantee is not likely to be sustainable.

- Withdrawal of benefit payments from post offices is expected to be by compulsory automated credit transfer (ACT) to bank accounts. POCL might retain a significant share of payments if it had the operating capability to debit and credit the accounts of customers of the major banks. The Network Bank strategy to capitalise on the closure of bank branches envisages such capability, but not necessarily for all banks within the timescale for ACT.

- Horizon does not currently offer universal banking functionality but it is expected that it can be made to. The urgency to do this quickly to prepare for ACT is moderated by the longer pre-ACT period if Horizon proceeds, but similar functionality is required for the Network Bank strategy anyway.

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- Without Horizon it would be necessary to develop and implement an alternative automation approach, against the background of a likely more rapid move to ACT by BA, and a possible general question mark over the feasibility of automating post offices after the second failure in a decade. Although lessons from Horizon, and the benefit of a much better understanding now of key requirements, would increase the chances of success, this would remain a tough proposition.

- The implication of this analysis is that Horizon proceeding does buy time to prepare for ACT and to lay groundwork for the new vision. Unfortunately, though, even then, the strategy cannot be guaranteed, because the combination of the high cost of implementing and operating Horizon with the deteriorating business income prospects for 1999-2000 means that it will not be feasible to fund any major strategic development beyond automation.

- The budgetary crisis has one important beneficial spin-off: it will force absolute focus on Horizon implementation, which is in any case critical for its success. Work on other aspects of strategy and vision will not be affordable unless it is fully consistent with that focus.

Annex 1 to Appendix A

Network

- Business Plan assumption is that we continue to lose about 200 offices per year.
- Work has been carried out on assessing the optimum size of the network. There are 3 main drivers of the size of the network-efficiency, accessibility and capacity.
- Basing accessibility on 90% of the population being within 1 mile of the Post Office and 99% within 3 miles, the optimum size of the network is probably some 12,000 to 13,000 offices.
- Those offices to be closed would be medium sized offices whereas our current losses are mostly small rural offices.
- To achieve this level of reduction would take about 10 years and cost in excess of £150m in one off compensation payments. The agreed terms for compensation for loss of offices means that it is virtually impossible to save money in the year of closing a sub office.
- Based on current turnover trends and the saleability of offices it is safe to assume that at current levels of business, the sub office network is a viable proposition for agents. But trade in offices is distorted by the existence of mandatory compensation for non-renewal of the office on resignation.
- With static or threatened business volume it is increasingly difficult for POCL to afford the operating costs of a 19,000 office network. Network viability depends on assumptions about business retention on closure, but there is some evidence to support the view that a network still large enough to be called "universal" can be viable. (See 3rd bullet above)
- The cessation of Horizon and any subsequent move to ACT would impact on the income of sub offices. BA accounts for a third of POCL volume and income and therefore is a significant part of subpostmasters` pay. There is also an impact on the private business, calculated at between 10-15%.
- Installing Horizon adds to the cost base of every office, thus increasing the strategic cost pressure to have a (controlled) smaller network. But for reducing the network size to contribute towards a reduced Horizon implementation cost, closures would need to <u>precede</u> automation roll out: if network downsizing is a 10 year programme most closures will affect already automated offices.

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Appendix B

The Financial Context

Annex 1 - Summary of key assumptions

The base case before deciding to automate

The business case for the contract as awarded

- Termination option - key assumptions (Treasury)
- The deal

Annex 2 - Overall NPV, summary

- comparison with negotiating authority

Annex 3 - Sensitivity of NPV

- to further delay to Horizon
- to the timing/extent of loss of BA benefit under termination

Annex 4 - Key risks

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Annex 1 to Appendix B

Summary of Assumptions

Assumptions	**No-Automation Baseline**	**Original Business Case**	**Termination**	**Current Proposal**
Period Covered by Cash Flows	April 1996 to February 2005	April 1996 to February 2005	April 1996 to March 2010	April 1996 to March 2010
DSS Contract End date	Annual contracts	February 2005	March 2005	March 2008
Structure	Fixed + Variable [Fixed payment reduced in annual negotiations]	Current Fixed + Variable structure retained	Current Fixed + Variable structure retained	Current Fixed + Variable structure retained to March 2007, with £10m p.a. reduction in fixed payment from April 2005 Total payment of £115m in 2007/8
Girocheque migration	No payment from DSS - paid by Girobank	Addition to fixed payment when girocheques migrated to card	No payment from DSS - paid by Girobank	Addition to fixed payment when girocheques migrated to card
Guarantee	No guarantee	3% year-on-year floor until March	3% year-on-year floor until March 2002	3% year-on-year floor until March 2007
Efficiency	RPI-X% [X>1]	RPI-1%	RPI-1%	RPI-1%
ACT Migration	No compulsory ACT in costing period, but drift accelerated.	Starts April 2005, takes 3 years	Starts April 2001, takes 3 years, 20%/40%/40%	Starts April 2005, takes 3 years, 20%/40%/40%
Other (existing) non-benefits business	Business centre forecasts adjusted following audit by Irrelevant	Business centre forecasts from 1996/7 planning round	Current business plan forecasts	Current business centre forecasts reduced for lower footfall resulting from loss of BA customers

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Assumptions	No-Automation Baseline	Original Business Case	Termination	Current Proposal
New Banking business	not included	not included	Project Amber Interim Banking Full alternative solution from 2003	Universal Banking cost based on amount quoted by Pathway (lower than both POCL figures)
Other new (New Vision) business	not included	not included	not included	not included
Operational Costs	Based on PCCM	Based on PCCM	Based on ABC	Based on ABC
Pathway Contract	n/a	Ends February 2005	n/a	Ends March 2010
System costs	Extrapolation of ECCO and APT operating costs at those offices already equipped with them	Pathway tender	Project Amber costs plus estimated costs for acquiring new POCL-owned systems at all outlets	Negotiated prices from ICL Pathway
POCL Project costs	not applicable	As estimated in outline business case	High level estimates based on overall resource levels expected to be required for new project	Current Horizon and Service management business plan estimates based on work area costings

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NPV Summary

Annex 2 to Appendix B

ALL FIGURES IN £M NPV	BASIC	CUSTOMER VALUE	RISKS	TOTAL
BASELINE	153.0	0	-101	52.0
FULLY TERMINATE	(49.1)	39	-269	(279.1)
LATEST DEAL	314.7	146	-152	308.7

Annual Profit Summary

	1999/0	2000/1	2001/2	2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11
BUSINESS PLAN Note 1	30.0	6.0	(8.0)	(2.0)	36.0	36.0	36.0	36.0	36.0	36.0	36.0	36.0
BASELINE	29.0	16.0	0.9	7.2	47.3	16.5	(22.9)	(125.6)	(242.0)	(274.0)	(264.1)	(263.5)
FULLY TERMINATE	86.9	(67.7)	25.3	(64.6)	(12.0)	(63.2)	(245.9)	(246.3)	(247.4)	(248.5)	(249.6)	(238.4)
LATEST DEAL Note 2	34.2	3.8	(17.3)	(16.6)	19.4	(9.1)	(7.9)	63.8	(35.7)	(102.7)	(77.6)	(49.5)

Note 1 Includes - "new vision"
Note 2 Does not include new vision

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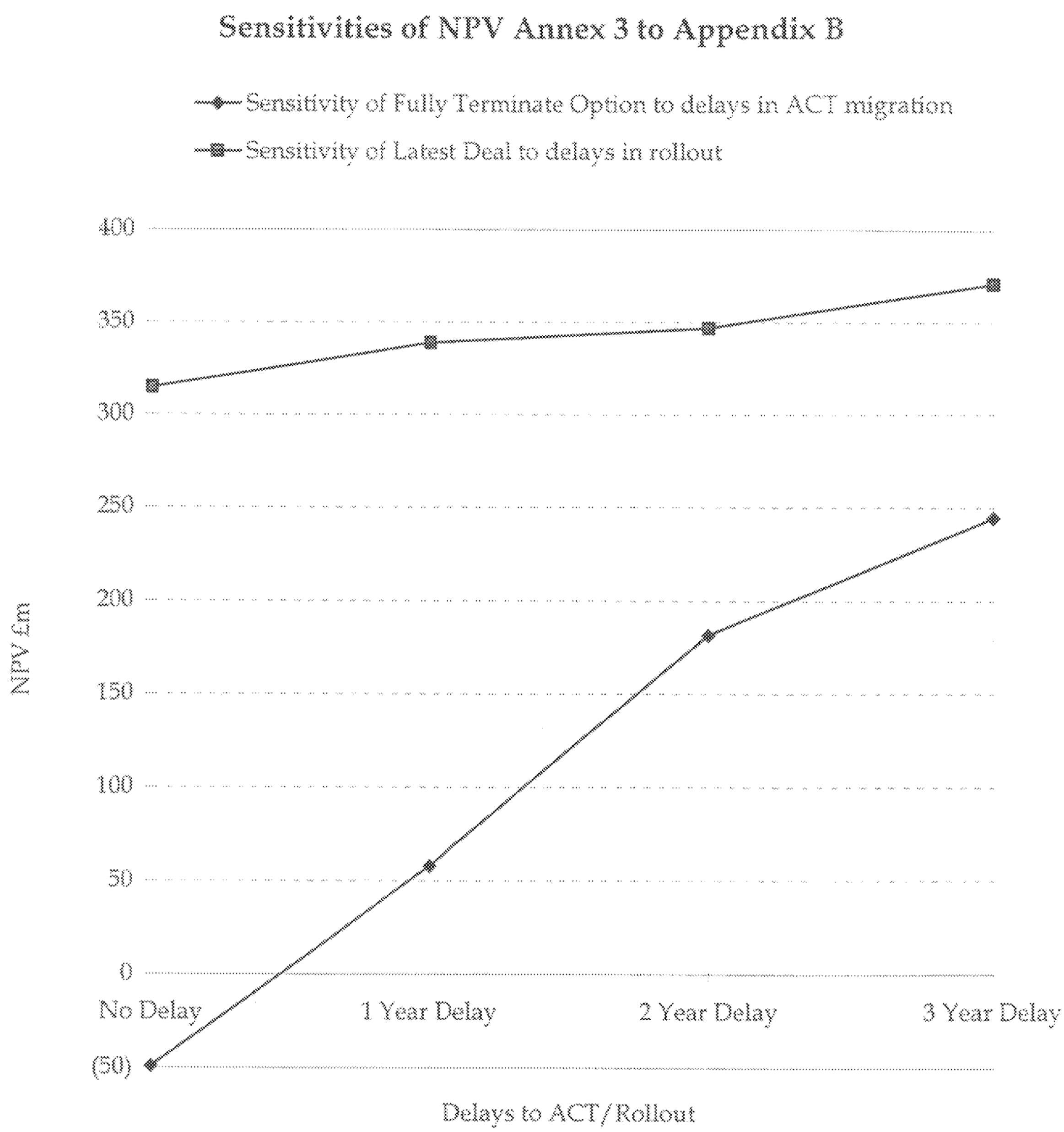

The delays to the new deal rollout do not include any assumptions about the likelihood of clients looking for other means of transacting business, because of Counters failure to deliver an automated solution

Annex 4 to Appendix B

Risks

Risks - Negotiated Continuation	(NPV £m)
VAT on Benefit Encashment Service and Order Book Control Services Customs and Excise have ruled that the services POCL provides to BA under Contract B (transmission services) are exempt from VAT, even though this contract is back-to-back with the services Pathway provides to POCL. The consequence of this is that either POCL charges the full amount to BA, who are then unable to recover the VAT from the Treasury, or that POCL charges the amount less VAT, in which case POCL takes a loss. POCL's view is that the former would apply, BA that it would be the latter.	-£9m
BES/PAS/CMS Price increase BA are positioning themselves as having "given" as much as they can in the Corbett proposal. The Pathway proposal includes price increases on BES, CMS & PAS which will all be contracted for with POCL. Given BA's current positioning there is a risk that POCL will not be able to recover these extra costs from BA.	+£8m
RPI on Pathway Price With the exception of the Pathway Proposal, all cases assume that Pathway would absorb RPI increases upto 6%pa. Should RPI be above this amount then Pathway charges would increase by 50% of the amount over 6%. The Pathway Proposal incorporates a pricing formula which allows for Pathway charges to be adjusted by RPI less 2%efficiency. This risk has been evaluated by assuming that actual RPI is 4.0% per annum as opposed to the working assumption of 2.5%	-£1m
Failure to achieve roll-out beat rate The contract provides for a roll-out rate of 300 post offices per week. Any shortfall below this could be the basis for a claim from Pathway for compensation for loss of income. POCL is developing plans to meet the 300 per week rate, but resourcing levels for these are critical, and the practicality of achieving this rate needs to be proven in practice - especially since independent reviews of the programme have highlighted this as a particular risk area. The Pathway Proposal roll-out guarantees are fixed and therefore a significant reduction in beat rate could trigger guarantee payments. The risk is evaluated on the basis of a 20% shortfall - i.e. 240 per week achieved rate.	-£3m
POCL Implementation costs (staffing etc.) increased. This is linked to the beat-rate risk above. If resources planned to support the roll-out prove inadequate, then POCL would need to provide additional field support staff and/or buy additional services (mainly longer training courses) from Pathway. Higher costs are already built into the replacement programme for the Termination option.	-£6m

Risks - Negotiated Continuation	(NPV £m)
Delay in achieving banking capability. Options assume a timescale for availability of network banking capability on Horizon or the replacement system. This is essential to achieving the assumed level of retention of ex-benefits customers following introduction of compulsory ACT. Any delay to this capability (or to the commercial agreements with banks to exploit it) would therefore worsen the case. The Pathway Proposal has identified separate fixed guarantees for banking transactions. Therefore, under this proposal delays to the implementation of banking on the system could have additional costs to POCL. Risk evaluated for a 12 months delay in each case.	-£7m
18 month notice of termination The Pathway Proposal includes an 18 month rolling notice period. This may result in POCL paying higher prices for longer than would otherwise have been the case. The risk has been evaluated by assuming that market prices are 50% of Pathway prices for the last 18 months of the proposed POCL/Pathway contract.	-£11m
Automation Savings not achieved The model includes savings as a result of replacing POCL's existing automation with timing varying according to the nature of the scenarios There is a risk that delays in achieving the new automation will result in loss of these savings as systems have to be supported for longer than planned.	-£17m
Other new business income attributable to Horizon not achieved The model includes contributions from non-benefits business that is automation dependant - mainly growth in automated payments and re-engineering of existing products (i.e. tactical, not longer term developments towards POCL's new strategy). There is a risk that delays in achieving the automation will put these benefits at risk as clients seek alternative channels. Higher prices in the Corbett, and especially the Pathway proposals in later years could lead to POCL being less competitive in key markets and lower market share.	-£27m
Contribution from Banking lower than anticipated The model includes income from banking on the assumption that banks would pay POCL £25 per account per annum for providing branch banking capabilities to ex-benefits customers (probably in jointly-branded accounts). This is consistent with the analysis of the branch banking market that McKinsey's undertook for POCL as part of the strategy review, but achieving this will depend on POCL's success in negotiating a share of the bank's savings. Delays and/or cancellation of Horizon would weaken POCL's position in such negotiations, as would any earlier move to ACT. The risk has been evaluated on the basis of POCL only receiving £15 per account per annum income.	-£80m
Balance Sheet Impact We have been advised by our external auditors that, in accordance with FRS5, POCL may now need to recognise the programme on its balance sheet depending on the amount of risk/reward of ownership of project assets. Due to the higher guarantees demanded in Pathway Proposal the "demand risk" is virtually transferred to POCL and therefore there is a greater probability that we will need to recognise the programme on the balance sheet. Recognition on the balance sheet could lead to serious Profit and Loss impacts which have not yet been evaluated.	Not Evaluated

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Risks - Negotiated Continuation	(NPV £m)
Changes in law The Pathway Proposal states that where a discriminatory changes in law occurs, POCL should indemnify Pathway's costs involved in implementing any resulting change that is required. The Pathway Proposal also states that Pathway's exposure to general change in law should be subject to a risk sharing mechanism.	Not Evaluated

Risks - Termination	(NPV £m)
Delay in achieving banking capability. Options assume a timescale for availability of network banking capability on Horizon or the replacement system. This is essential to achieving the assumed level of retention of ex-benefits customers following introduction of compulsory ACT. Any delay to this capability (or to the commercial agreements with banks to exploit it) would therefore worsen the case. The Pathway Proposal has identified separate fixed guarantees for banking transactions. Therefore, under this proposal delays to the implementation of banking on the system could have additional costs to POCL. Risk evaluated for a 12 months delay in each case.	-£102m
Cost of replacement solution if Horizon terminated Only broad-brush estimates are available for the cost of procuring a replacement for Horizon if contracts are terminated. Mid-line estimates have been used. The risk represents an addition to high-line cost estimates.	-£66m
Other new business income attributable to Horizon not achieved The model includes contributions from non-benefits business that is automation dependant - mainly growth in automated payments and re-engineering of existing products (i.e. tactical, not longer term developments towards POCL's new strategy). There is a risk that delays in achieving the automation will put these benefits at risk as clients seek alternative channels. Higher prices in the Corbett, and especially the Pathway proposals in later years could lead to POCL being less competitive in key markets and lower market share.	-£53m
Contribution from Banking lower than anticipated The model includes income from banking on the assumption that banks would pay POCL £25 per account per annum for providing branch banking capabilities to ex-benefits customers (probably in jointly-branded accounts). This is consistent with the analysis of the branch banking market that McKinsey's undertook for POCL as part of the strategy review, but achieving this will depend on POCL's success in negotiating a share of the bank's savings. Delays and/or cancellation of Horizon would weaken POCL's position in such negotiations, as would any earlier move to ACT. The risk has been evaluated on the basis of POCL only receiving £15 per account per annum income.	-£48m

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Appendix C

Benefits Agency

- BA accounts for a third of all POCL volume and income.
- BA strategy has 2 main drivers: cost and fraud prevention.
- Contract A applies until 2008. From 2005 compulsory ACT on the basis 20/40/40
- There was a serious threat of compulsory ACT in 92/93. This was dropped following a campaign by subpostmasters and POCL.
- A review was undertaken at that time to evaluate the impact. These findings were updated in '97. The key findings were:

  loss of 60% of BA transactions at steady state, a loss of 16% total business.

  Loss of 6% of other POCL business through reduced footfall.
  Subpostmasters private business would be impacted by between 10-15%.

  Destabilisation of the network with about 4,500 offices being forced to close.

  Closure of 500 Crown offices.

  Unless subsidies considered, the Government would be responsible for the reduction of customer choice and the loss of about 17,000 jobs.

  The UK coin flows would be seriously affected.

  There would still be a need for a fraud prevention scheme for those benefits still paid using foils.

  There would be an adverse impact on Girobank business.

- Relationships with BA are difficult at some levels of contact. BA are reluctant partners in Horizon and interviewees felt that BA were exploring other ways of paying benefit without informing POCL e.g. the NatWest ATM benefit payment trial.
- The threat of compulsory ACT to the timescales being discussed in the current negotiations appear to be unrealistic (starting in 2001 is one date being discussed in the negotiations.)

- Given the adverse social implications rehearsed above, there must be a real doubt as to whether a rapid move to compulsory ACT is really an option for the Government. But BA could change the periodicity of payments to fortnightly (from weekly at counters and monthly by ACT) thus improving the relative attractiveness of ACT.

- The option of retaining only OBCS (option 2) is now being put forward by BA in this current round of negotiations. This does not give anything like the fraud prevention levels of the Card system (as illustrated by the recent Operation Scorpio exercise). It has been surmised that one reason why BA would be keen on this option would be if they were concerned that their own system, under development (CAPs) was at risk of not delivering to specification. I have not seen or sought evidence of that, though were that to be the case it would also pose a risk to Horizon as the systems have interdependencies.

Conclusions and recommendations

The failure of Horizon threatens compulsory ACT to earlier timescales. It also negates contract A and probably reduces POCL income (price floor protection from volume loss clause would fall). It is important to consider carefully how realistic the threat of earlier compulsory ACT is and indeed, whether compulsory ACT is really a strategy the Government would want to pursue.

The business has accepted that ACT is unstoppable whether by compulsion or migration aided by incentives. We know that the benefits to the Government are not as great as first thought since costs were understated and there is still the propensity for fraud. It may also be significant that BA are pushing OBCS as the solution in the current round of negotiations.

It is recommended that we should set up a Partnership, outside of the negotiation channel, to work with BA on how ACT is rolled out to the benefit of both parties. We should share our business plan, in particular Network Banking, and see how this could be developed to mutual advantage. Clearly, for this to happen both sides have to be committed and we have to take a much more challenging /analytical stance to BAs strategy, as well as our own, if we are to develop a strategic partnership. This recommendation is critical to the success of the project.

Appendix D

ICL Pathway

- The contract between Counters and POCL is for ICL Pathway to deliver an automated Post Office network infrastructure. The network to be connectable to other POCL systems and client systems. At each post office the electronic services to be provided are a Benefit Encashment Service, Automated Payment Service and Electronic Point of Sale service.

- Roll out should have started in June '97 with a completion date of 1999.

- Currently there are 204 sites which are trialling the Benefit Encashment Service for Child Benefit and an Order Book Control System. Release 2, which includes EPOSS is due to be rolled out in August '99 . Thereafter timescales are subject to validation.

- The POCL contract negotiating team and those close to the development of the system have expressed reservations about the professionalism and the quality of some of ICL Pathways work.

- There is a suspicion that ICL Pathway have used the fact that the contract is a PFI to avoid exposing the existence of problems. For example, requests for documentation of systems have been refused on the grounds that the PFI relationship is to provide a service, not a system, with the implication that POCL should not be concerned with the detail how. The Horizon team have resorted to documenting what they think the technical design is and passing it to ICL for confirmation.

- Testing to date has revealed some design flaws which are being resolved. There is currently no absolute assurance that Horizon will fully deliver all POCL's required outputs e.g. client settlement, agents remuneration etc. All these issues have to be resolved, but recent collaboration has been more encouraging.

- Fujitsu have given their backing to ICL Pathway for the project, and accepted a need to provide a guarantee. Draft Heads of Agreement prepared by Slaughters and May include the terms of this, but have yet to be agreed with ICL.

- The network commitment and enthusiasm to make Horizon work are impressive. On the downside, the roll out rate of 300 is thought to be too untried and high risk. There are currently no contingency plans in place if errors become unmanageable.

- All those interviewed felt there would be further slippage in timescales and expressed concern that ICL would continue to come back and renegotiate at regular intervals.

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- There are serious concerns about the development timescales. The contract allows for two new releases a year but no one is sure what this means. The latest deal with ICL excludes separate guarantees on new business and this will have to be explored further. It is also unclear how we could explore together the possibilities of new initiatives e.g. exploiting the full functionality of Escher software.

- Part of the final negotiation included the signing of Heads of Agreement as a "Strategic Partnership" with ICL. Although this document is "not intended to be legally binding" it is expected by the parties that it will be the basis for the relationship between ICL and POCL. Since, under SCS, POCL will not exist in its current form, one may assume that ICL expect that this agreement will be honoured by the Post Office. It is not evident that any Post Office Group body is examining the implications of this agreement beyond the boundary of the current POCL.

Conclusions and recommendations

The relationship between ICL Pathway and Counters is mixed. There are serious doubts about ICL's capability and their ability to deliver an automated network to the timescales now being discussed. Having said this, ICL see POCL as not being totally committed, being unsure what their strategy really is and not providing high quality resource to the project.

It is recommended that the outcome of the latest negotiations is used to reposition the PFI arrangements since they fundamentally change ICL's relationship with Counters, which now requires more transparency between the two parties. In addition, there need to be joint discussions with ICL Pathway to establish how to ensure live trial of release 2 goes ahead to timescale and that it is successful, providing a stable platform for the remainder of the development releases.

The impact of the Partnership agreement on wider POCL and Post Office strategy need to be urgently reviewed.

Appendix E

Vision and future Business Strategy

- Work has been ongoing to secure the future of POCL. This work has been facilitated by McKinseys.

- From this work, a number of strands were identified as being worth further scoping and programme boards have been set up to manage this work. This has taken considerable resource including some of our most able senior managers, who are therefore not available to work on Horizon implementation.

- At the same time the Post Office has been undertaking a review of its structure. The outcome of this work will be a total reorganisation of the business away from the 4 businesses we currently have. This new structure is due to be in place within the next 18 months.

- The two elements of Counters vision which significantly affect or are affected by Horizon are Network Banking and Government Gateway. These are areas in which ICL will expect to be POCL's principal partner.

- Network Banking envisions POCL carrying out cash inpayments and outpayments on behalf of one or more banks. This ties in with the banks strategy of closing branches. In order to provide this service POCL has to have an automated network which includes on line authorisation facilities and can interface with the banks own computer system. Horizon has a distributed technical architecture and although external advice indicates it can be made to accept front end banking, it will be expensive.

- To combat the threat of ACT, Counters has been developing an approach to Universal Banking which would enable benefit payments through the Counter.

- The two initiatives above need to be scoped in order to secure the long term future of Counters but it is important that throughout their further scoping there is a reality check against the business chosen counter automation strategy.

- Government Gateway requires an automated network to offer an infrastructure which would meet the Governments requirements. This suggests we need to deliver Horizon. However, during the preparation of this report, it was brought to our attention that the PO restructuring team were envisaging some aspects of Government Gateway through their Customer Management strand.

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Conclusions and recommendations

Horizon does not appear to be unequivocally at the forefront of POCL strategy. The delay in the programme roll out has allowed the development of the new vision but has also provided the opportunity to divert resource and focus. In addition, however far away Horizon is from what we would do if we were taking the automation decision now, we have to return it to the forefront of our thinking and work with it. It is recommended that we reposition Horizon within the business and, that in so doing, we ensure the Shaping for Competitive Success is also aware of Counters strategy.

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Appendix F

List of Interviewees

Name	Specialist area
Dave Morphey	Counters Vision, Project X and CEC preparation
Mike Granville	Network Strategy
Andy Radka	Services Management
David Smith	Automation Strategy
Linda Hanratty	Benefits Agency and Commercial Strategy
Tom Simmonds	Benefits Agency
Jim Green	Network Banking
Dave Waltho	Government Gateway and Commercial Strategy
Wendy Powney	IS Strategy, Project X and Network Bank
Mena Rego	Negotiating Authority
Kevin Corrigan	Negotiating Authority
Keith Baines	Negotiating Authority
Liz Blackburn	Negotiating Authority
Tim Brown	Finance and Negotiating Authority
Ruth Holleran	Horizon Project
Nick Beale	Horizon Project
Anthea Bourne	Business Planning (Project X)

In addition Paul Rich, Jonathan Evans and Dave Miller have been consulted in correspondence.

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Brainstorm of Issues to be Addressed

Questions to answer	Arguments to test	Reasons for continuing
• View of not automating? • How long without major risks before we can say main PO objectives are achieved? • Is Horizon better than not Horizon and for how long? • Impact on: Costs Risks Strategy Opportunity for benefits • What does automating but not with Horizon look like? • Is Horizon affordable? • Is the network more sustainable with Horizon?	• Automation is critical for credibility with new and existing clients. • Necessary to retain BA business and enable fraud savings. • The need to automate all offices. • Horizon is the only/best way to get this within an acceptable time frame. • It is better to do Horizon otherwise: we'd lose BA to ACT faster. an alternative couldn't be done soon/cheaply enough. the network couldn't be sustained (without subsidy.) inefficient time to deliver the new vision.	• Best available course. • Losing benefits to ACT is a real threat. • No realistic alternative • Marginal difference to not proceeding but more confidence in the outcome or significant disadvantages which could not be factored into the numerical analysis. • Certainty that there was no significant exposure to risk and this could be controlled by Counters. • It will be delivered. • A strategy in place if the same problems emerged later.

• Do we get locked in to bailing ICL out time and again? • Is the downturn in our income material to the issue? • Are there any more pitfalls to come? • Can we afford it within Profit and EFL constraints/targets?	• The deal with ICL satisfies our concerns about: the SUITABILITY of the automation solution ability to deliver on time and meets quality standards. risk of ICL running out of money again. their value as our locked-in "vision partner".	