

Pathway

PATHWAY DRAFT CONTRACT RESPONSE

Ref: Contract
Version 1.0
Date: 29-Dec-95

Document Title: PATHWAY DRAFT CONTRACT RESPONSE

PWY

Document Type: CONTRACT



Abstract: This paper provides the response to the Draft Contract Version 1.5 dated 21 December 1995

Distribution: BA/POCL Core Negotiating Team
Bird and Bird
Pathway Shareholders
Pathway Banks

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Comments By: 2 January 1996

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Version	Date	Reason

0.1.2 ASSOCIATED DOCUMENTS

Version	Date	Title	Source

0.1.3 ABBREVIATIONS

BA	Benefits Agency
BES	Benefit Encashment Service
BPS	Benefit Payment Service
CAPS	Customer Accounting and Payment s System
CMS	Card Management Service
PAS	Payment Authorisation Service
PMS	Payment Management Service
POCL	Post Office Counters Limited
SSR	Statement of Service Requirements
TMS	Transaction Management Service

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1. INTRODUCTION

There are three separate contracts: an "Umbrella" agreement, a POCL agreement and a DSS agreement.

The first draft was issued by BA/POCL on 21 December for high level comment back by mid-day on 3 January.

No Schedules are included, but in all other respects, the documents are substantially complete. Timescales remain unclear.

This is a first pass brief for Pathway personnel as to the key issues. It will be re-written as input to BA/POCL.

Comments are invited!

2. HIGH LEVEL COMMENTS ON PRINCIPLES

In general, there is a lack of symmetry as between Contractor and Authorities' rights and obligations. This lack of balance represents a poor basis for an enduring business relationship - all stick and no carrot.

The possibility exists for the Authorities to be better off in the event of a default (which may not be material, but nonetheless provides a pretence for non-acceptance or cancellation) than if the contract is carried out perfectly. This goes against fundamental principles of English law.

Events of default are not defined by reference to clear SLA's or delivery milestones, nor is there any provision for step in and substitution.

There is a very high level of risk transfer. Comprehensive fraud risk, consequential loss, government legislation change and obsolescence are notable for not being within the Contractor's sole control.

As written, several of the conditions are both unbankable and uninsurable. There is a strong reliance on and requirement for parent company guarantees.

Given the lack of requirements definition at this point, there is a strong likelihood that the products and services produced initially (at Contractor's cost and risk largely ahead of award) will fail to meet all the Authorities' aspirations. The standard remedy period is just 30 days. This translates into a high level of discretion on the part of the Authorities as to whether or not they choose to accept certain services or to continue with them even after they have been

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accepted. This represents a high risk scenario for shareholders in any but the most favourable of circumstances.

Judgements are provisional based on implied intent at this stage because none of the key Schedules which define the specific terms is included.

3. SPECIFICS IN NO PARTICULAR ORDER OF IMPORTANCE

3.1 Liability and termination

Contractor liability on fraud appears unlimited, whether or not under Contractor control. It extends to impersonation of card holders and DSS and POCL staff or agent fraud. The onus is entirely on the Contractor to prove fault on the part of the Authorities in order to mitigate financial impact or to secure correction [page 66 of Main Agreement]. Yet the "overall service objectives" [page 2] appear to imply that such risk transfer should be at no/ minimal cost to the Authorities. [Also, the extent of risk transfer is completely at odds with earlier statements to the effect that a minimally compliant PFI structure was being sought, with minimum risk transfer and minimum cost.]

Limits of liability on Contractor for matters other than fraud (unlimited) are uncommercially/ uninsurably high and are in extremis difficult to quantify. At 150% of "Charges payable *over the duration*", these could exceed £1 billion [pages 69 to 75].

Consequential loss [page 74] applies to Contractor but not to Authorities.

Authorities may terminate the contract at six months notice for convenience (ie. without cause), albeit a Termination charge is then payable [pages 78 and 79]. In that event, Contractor must [pages 81 to 85] assign/ novate all assets, service agreements, licence, pass across full source and documentation, assist Authorities in transition for a fee, permit third parties to develop extensions to software, enable transfer of key personnel to the Authorities, *and* hold data on past service for six years (free) [page 53].

The basis of Termination/ Transfer charge is unclear [no Schedule 9].

A change in "government regulations" is deemed an example of Force Majeure (without any limitation) [page 35] notwithstanding that one of the Authorities is to be the Secretary of State for Social Security. Unless bounded, this could include the active promotion of ACT's, changing from weekly to monthly benefit encashments, privatising the post office or POCL (possibly resulting in a large reduction in the number of post offices), permitting supermarkets to cash benefits, etc..

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Force-Majeure protects the Authorities from third party action [Are the Subpostmasters third parties, could a contractor developing CAPS be deemed to be a third party?], but the Contractor is required to carry on the service if *any* other party could be held to be in a position to do so, its failure to do so within 90 days being grounds for termination. The right to termination is one way.

3.2 Operational trial and roll out of steady state services

The definitions of requirement or timetable are not clear in the absence of Schedules C2, C3 or A7.

Acceptance of the Trial system does not in itself represent acceptance of Steady State Services. there appears to be some duplication and overlap as between the two, or at the least, a need to define clearly how they differ.

The onus is on the Contractor to have assessed requirements correctly in sufficient time to develop the Trial system for "successful" Trial.

The Trial may be successful in whole, in part or not at all. The Authorities may extend the time to permit a successful Trial, but they may choose not to and to reject that part of the system. [pages 16, 17] The same applies to Steady State Services.

The notion of a pro-rated Charge in event of partial take up of either Trial system or Steady State Services needs to be related to the charging mechanism by component of service. [Charterhouse scorecard approach]

There is an implication that there could be a charge related to acceptance of the Trial system which is different from the service based charging mechanism. This does not correspond to the Charterhouse document and needs to be clarified.

The term "Roll Out Completion Date" has yet to be defined. Contract term is to be 5 years from that date.

It is still unclear how in practice card versus infrastructure roll out is to be tackled, specifically with respect to foreign encashments, or how Roll Out is supposed to be carried out viz-a-viz Operational Trial. Clause 404.2 of the POCL agreement states that "POCL may on prior written notice *defer* implementation of the *POCL Steady State Services* until successful completion of the Operational Trial" Clause 902.4 of the Main Agreement states that "in the event of any termination of the Authorities' Agreement prior to the Operational Trial Procedures being recorded as successful the Authorities shall be entitled to return the Service Infrastructure and the Contractor shall give full refund of all monies paid in connection with such returned items *and*

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the Development Services [implying a possible separate payment?], and shall reinstate the Premises to their prior state at no cost to the Authorities.” These would tend to imply an expectation that roll out may be going on in parallel to Operational Trial at Contractor’s risk.

3.3 Intellectual Property Rights

Clause 501.1 states that “Ownership of all IPR in the design of the Service Architecture (as set out in the Service Architecture Design Document) shall vest in the Authorities upon acceptance by the Authorities of the Operational Trial System.....” “Service Architecture” is defined as the overall structure of the Steady state Services, the Service Infrastructure and the Service Environment. This is a very high level (and potentially all-embracing) definition. The implications need to be understood, both with respect to existing use (as by An Post) of a similar blueprint and components thereof, and for re-use of components elsewhere (eg. in other Post Offices overseas).

Clause 506.1 of the POCL Agreement states that, where IPR remains with the Contractor, “in consideration of the payment of the relevant Charges, the Contractor grants POCL a perpetual, royalty-free irrevocable and non-exclusive licence to use, reproduce, modify, adapt and enhance the relevant Specially Written Software and to use the Documentation. If owned by another party, Contractor shall procure such a licence from the owner.

Clause 506.3 of the same agreement states that “the Contractor shall supply POCL with a copy of the source code of the relevant Specially Written Software”.

“Specially Written Software” is defined as any software written by or on behalf of the Contractor pursuant to Clause 204 (Clause 204 describing “Supply of Basic Products”, these being “all of the Products comprising the POCL Service Infrastructure”) or as Optional or Additional Product”. The implied assertion is that this is all bespoke for POCL and none derived from an existing source with IPR already spoken for.

The requirement on other than Specially Written Software is that there be a perpetual etc. licence to Use (but not to modify etc., except if escrow is invoked).

3.4 Basic Service, additions and rights to use the infrastructure and databases

The Basic Service is defined as BES, APT, EPOS, Infrastructure Services and Contingency Services. In addition, there is the possibility of “Optional Services”, not yet defined, and “Additional Services”. Likewise DSS.

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Clause 503 of the Main Agreement states that "POCL shall have the right to use the POCL Services and the Infrastructure to capture, develop and use databases containing information in relation to its customers." *Not:* "The Contractor shall provide the information services to POCL as specified in Schedule XYZ for consideration specified under Clause ABC"

Clause 106 of the POCL agreement states that "the Contractor shall ensure migration of appropriate automated systems without any reduction in existing service or security levels to POCL's clients and customers", but that "POCL will retain control itself of its critical business processes", and that "Charges for any Additional POCL Services shall be labour and materials" based. Clause 204.3 states that the Contractor shall *lease* the Leased Products (not defined) to POCL per Schedule B7 (not included).

3.5 Subcontractors, change of control, and assignment

The list of approved subcontractors can only be modified with the Authorities' express approval [page 30].

The Authorities permit themselves to assign without reference to the Contractor. There is no provision for credit guarantees by the Authorities in such event.

The Authorities may terminate if there is a change of control in the Contractor or its Parent Company [N.B. What is the intended definition of Parent Company in the case of Pathway? Charterhouse and CNT have indicated a requirement for joint and several guarantees by the shareholders, which could imply that a change in ownership of *any* of the shareholders or their Parents could trigger this condition, eg. an A&L take over.]

As stated earlier, the Authorities may terminate at six months' notice without cause.

3.6 Service definition

The implications of Clause 201 appear to be that the Contract will initially be awarded against summary requirements in Schedules B1 and B2 (not yet available), which will subsequently be replaced by more detailed Schedules within 3 months.

It is unclear what happens if there is a failure to agree those schedules during those 3 months. Alternatively, it is an opportunity to put right and clarify.

3.7 Transfer

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Transfer terms are that except in case of termination for convenience, the Authorities reserve the *option* to buy the infrastructure.

The fact that this could perversely incent the Contractor to milk assets from about four years into the contract is at odds with the objectives set out in the Charterhouse document. It is possible that "change control" procedures might address this issue by agreeing upgrades to infrastructure during the initial term which would qualify for an unconditional end of term transfer payment.

The exposure in the event of failure to perform is potentially mitigated by the Authorities right to be selective about which services they reject, but there is no assurance that such right will be exercised. Hence no step in procedure which the banks could rely on. Maximum cash/obsolescence exposure exists at a point about two years into the contract when the infrastructure has been completely rolled out and little revenue yet received.

3.8 Parent Company Guarantee versus limited recourse financing

A. Parent Company Guarantee is *mandatory* [page 88].

The required form is unclear (Schedule A11), but will doubtless specify fulfilment of all obligations, penalties, remedies and damages under the three contracts, plus post termination audit facilities for six years.

There is likely to be little scope for sharing the financing burden with the banks using limited recourse PFI structures now becoming established in other sectors. In particular, reliance on subcontractor guarantees has been ruled out.

The reasons appear to be a combination of:

- NIRS 2 did not require it (IT precedent)
- political sensitivity (fear of riots and the Public Accounts Committee)
- "Choice" (if IBM or Andersens are prepared to guarantee it.....)
- nervousness about Escher specifically (dependence on a key subcontractor)
- integrator risk (sum of the subcontractor parts does not equal the whole)

Andrew Stott was clear in his briefing at CNT on 21 December that a Parent Company Guarantee would be required and that Pathway's proposed financing structure was not acceptable.

3.9 Absent

There is no mention of Contractor being preferred supplier to POCL for new services.

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There is no notion of "partnership" with POCL in developing the business together at shared risk for shared reward, even by reference to some such intent by another name for another document. There are only control levers, penalties and exclusions.

4. BUSINESS CASE

The business case is being reviewed with a view to understanding the possible impacts.

Set against the statement by Andrew Stott that "The BA/POCL business case remains weak", it is unlikely to look good.

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