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WITHOUT PREJUDICE**

BA/POCL AUTOMATION

**INTERDEPARTMENTAL WORKING GROUP
FURTHER REPORT TO MINISTERS**

11 DECEMBER 1998

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PS/Secretary of State
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**RESTRICTED - POLICY AND COMMERCIAL
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The BA/POCL automation project (known as "Horizon") has been under review since the contractor, ICL Pathway, was placed formally in breach of contract in November 1997 by both POCL and BA, after a key contractual milestone was missed. Following the failure of negotiations (the so-called Corbett discussions) to establish a commercial basis acceptable to Government for proceeding with the contract in October, ICL were given a further period of two weeks for them to make progress in their discussions with the Post Office to develop a public/private partnership as a means of enabling ICL to move further towards the public sector's position. ICL's proposal for the partnership was received on 9 November, along with 3 additional papers addressing commercial, contractual and financing issues. ICL stated they were prepared to accept a loss of around £100m NPV (although we believe they expect to recover this with the income earned from the partnership with POCL), but their commercial proposals involved a risk transfer that would have been entirely unacceptable to the public sector and would have effectively seen the public sector underwriting the whole deal. Ministers concluded that ICL's wider commercial proposals revealed insufficient movement on their part, and a wide gap remained between the two sides.

2. The Chief Secretary therefore wrote to ICL on 20 November giving them a third and final period until 9 December to reach heads of agreement with the public sector. ICL were told that they would have to make an offer which:

- .. demonstrated that they could secure adequate financing to take the project forward without the public sector bearing unacceptable risk;
- .. provided assurances that Fujitsu were standing behind the project;
- .. made an unequivocal move towards the public sector's position as proposed in the earlier negotiations.

3. Ministers also agreed that they need to be in a position to implement the fallback options quickly if an acceptable deal could not be struck by 9 December. The Chief Secretary therefore asked officials to prepare an exit strategy to the same timescale, building on the work already completed on the fallback options and including presentational handling. A presentation to Ministers by the public sector parties on the fallback option was held on 8 December. This demonstrated that there was a do-able alternative, based on a move to ACT for benefit payments timed to fit the provision of a banking capability across Post Office Counters.



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5. This report:
- .. provides an assessment of ICL's "best and final offer" of 9 December;
 - .. summarises the case for and against continuation;
 - .. sets out an exit strategy, [REDACTED]
should Ministers decide that ICL's offer is unacceptable.

2. The ICL offer

6. Ministers agreed in early September that they would consider continuation with the project provided an acceptable commercial deal could be struck between the public sector and ICL, and that the offer provided VFM compared to the alternatives. The key commercial obstacles to a deal identified in the subsequent negotiations have centred on the overall NPV gap between the public sector and ICL; the level of risk transfer to the public sector; and the acceptance testing process.

7. ICL wrote to the Chief Secretary on 9 December setting out its "best possible" offer - on commercial arrangements, project funding and system acceptance (ICL's letter as supported by 3 detailed papers as before). The headline terms of the offer include:

- .. **Commercial arrangements**
 - * confirmation that fraud risk will, as envisaged in the original contract, be borne by ICL (up to a limit of £200m over the life of the contract)
 - * revised pricing, with greater volume risk taken by ICL (if volumes fall by 90% then ICL's loss falls from -£118m to -£204m, whereas if volumes increase by 10% then their loss reduces to -£32m) and the burden of the increases largely falling on POCL
 - * withdrawal of the previous proposal for an £80m "contingency fund" to be funded by the public sector
 - * an estimated loss to ICL of £118m NPV (£269m cash)
- .. **Project funding**
 - * ICL, with Fujitsu support, funding the whole project, investing £600m (or whatever is required) - although BA/POCL need to confirm this is a legally binding guarantee
 - * an obligation on the public sector, if the contracts were terminated for Pathway default, to buy the system at its economic value less appropriate set off costs
- .. **System acceptance**
 - * the sponsors' giving up termination rights before full functionality for BA is available and after limited testing of the system in a live environment
 - guaranteed payments from the start of National Rollout
 - * appointment by agreement of an Independent Expert to resolve

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acceptance disputes quickly; the Expert would be empowered to make binding decisions for implementation without delay (subject to subsequent arbitration or legal proceedings)

Below this headline level, the ICL offer envisages further discussions on the detail although the figures in the letter (representing their best offer) depend on the assumptions about pricing etc. in the supporting papers.

8. An overall NPV gap remains. ICL have moved their position of the 9 November from a loss of between £75m and £103m (depending on the contingency) to a loss of £118m on a central case, with no contingency. In terms of the impact on the public sector, this represents a movement of £36-88m NPV. But ICL have taken on more risk through the dropping of their request for higher volume guarantees. The public sector (effectively the PO, since Ministers have already agreed that BA should not make further concessions) would need to find a further £113m NPV to close the gap, in addition to the £116m NPV already offered relative to the Corbett base case.

9. On the other hand ICL have met the public sector's requirement that Fujitsu, rather than the public sector, should stand behind the project as was the intention of the original PFI contract. ICL have confirmed verbally that the guarantee will be similar to that provided for DTI for project Elgar and that this can be converted into a legally based guarantee. Clearly BA and POCL would need to ensure that Fujitsu's support for Horizon was expressed in legally enforceable terms.

10. The proposals on acceptance testing are still unacceptable to the public sector parties as they stand. BA is rightly concerned about losing termination rights for a system which needs to support 15 million claimants before adequate testing in a live trial. But POCL believe that a way through can be found since, they argue, ICL have accepted the principle that the system must be seen to work in live operation before it is accepted.

11. A comparison of the 9 December offer with the 9 November offer and the Corbett proposals is set out in Annex A.

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12. The PO's view is set out in Neville Bain's letter to Peter Mandelson of 11 December. Their view (endorsed by DTI) is that:

- * ICL has made major moves on a number of issues; in particular it has made clear its acceptance of funding, fraud and performance risks, which substantially reduces the risk carried by POCL;
- * the commercial proposals, with no requirement for the public sector to pay for a contingency fund, represent a move by ICL of £88m NPV;
- * the system will be seen to work in live operation before it is accepted;
- * the draft Partnership Heads of Agreement already agreed with ICL would offer real benefits (if finally signed off) in developing new services; and overall that
- * the programme should go ahead with a reaffirmed commitment by all parties to its delivery.

13. The DSS/BA view (confirmed by Alistair Darling's letter to the CST of 11 December) is that:

- * the commercial proposals make no material change to the November 9 proposal;
- * acceptance cannot be authorised until there has been a successful live trial of the system and final responsibility for acceptance cannot be delegated to an Expert;
- * Fujitsu's support of the project must include a legally enforceable performance guarantee;
- * Ministers should stand back and weigh the wider issues in the balance - the justification for continuation of the project against the wider policy agenda - before reaching a decision;
- * overall, the proposals should be rejected.

14. The Horizon Programme Director has confirmed that a programme milestone will be missed in December. This slippage to the programme timetable is likely to add further delay, complicated by the Millennium, which will mean lost fraud savings and additional administrative costs to BA.

3. The Decision

15. The key objectives against which a decision should be judged might be:

- .. to pay social security benefits in a way that is as cheap, efficient, fraud free and convenient as possible, consistent with plans for welfare reform;
- .. to help to maintain a nationwide network of post offices in order to protect the accessibility of government services provided across PO counters;

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- .. to support integrated delivery of existing and new government services and information more generally taking full advantage of new technology, streamlining Government's dealings with citizens;
- .. to improve access to basic financial services, including banking services, for poorer members of the community and the socially excluded;
- .. to maintain a thriving IT sector in the UK, in which ICL is a key player; while ensuring that risks transferred through PFI projects do not end up with the taxpayer; and
- .. against these objectives, to secure prudent use of taxpayers money.

(i) The case for continuation

16. The case for continuation rests on three points:

- .. the acceptability of ICL's offer relative to the alternative option;
- .. the possible impact on subpostmaster's confidence and therefore the post office network;
- .. the impact on ICL and Fujitsu and the knock on consequences for the IT sector and inward investment in the UK.

Is ICL's offer acceptable relative to the alternative?

17. In judging whether ICL's offer is acceptable, it is important to consider not only how far they have moved from 9 November (see above), but also how their proposal compares to the fallback option.

18. The following table compares the impact of continuation versus termination (option 3) on the public sector¹. Option 1 has been revised to take into account the 9 December ICL offer (which requires a public sector contribution of £113m NPV at 6% real); and the impact of the additional slippage in the programme on BA. BA estimate that the slippage of one and half months against the Corbett programme could result in a delay of six months because of BA's year 2000 purdah (an additional cost to BA against the base case of £110m NPV). Option 3 is based on KPMG's modelling, carried out in October.

¹ The table does not show figures for option 2 - continuation without the Benefit Payment card. This option would require ICL's consent, and is therefore not, strictly speaking, a choice available to Ministers (although it may be a desirable outcome of a negotiated settlement).

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£bn	Option 1	Option 3 (without floor)
DSS admin savings	0.29	1.36
DSS programme savings	0.87	0.85
Net impact on DSS	1.16	2.21
Net impact on POCL	0.31	-0.73
Subsidy to subpostmasters	n/a	-0.15
Horizon refresh costs	-0.05	-
additional payment to ICL	-0.11	-
Overall NPV	1.31	1.33

19. Cashflows are shown in Annex E. The ICL revised offer would mean £1.7bn cash over ten years would be paid to ICL (under Corbett the cash payments would have been £1.5bn).

20. In summary:

- .. the figures suggest, as before, that the results are very close. The fallback option now looks marginally better value. But there are still margins of error surrounding the modelling - and in the case of option 3 these could not be resolved until the public sector parties were able to enter further discussions with the banks;
- .. there are significant risks surrounding all of the options which are not factored into the figures. These would need to be managed carefully.

The impact on the post office network

21. One of the key factors in the decision to try to find a way forward with the project in September were Ministers' concerns about the impact on the post office network. The PO's ability to manage change in the network and implement their commercial strategy depends upon the confidence of both the subpostmasters and the PO's other clients in the future viability of the business (of which a key factor is automation). An announcement that Horizon had failed would adversely affect expectations unless a clear and deliverable plan was in place for an alternative. An earlier move to ACT would also see the faster deterioration of POCL's main source of income (since DSS/BA fund paper-based methods of paying benefit).

22. There are clearly risks. But we believe that careful presentation, combined with an agreed BA/POCL strategy for moving to ACT alongside (rather than ahead of) the introduction of banking services in Post Office would mitigate (to some extent) these risks. DSS, BA, POCL and DTI have held productive discussions about how to progress the fallback option. These discussions, including further work by KPMG, have concluded that there is a viable way forward. The challenge is to maximise the value for money to Government through an integrated timetable - but until discussions/negotiations with the banks are possible then we cannot further develop the costings or get a clearer picture of the risks. All parties are fully committed to working together pro-actively to maximise value for money.

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23. Loss of the project would be a major blow for ICL. Just how great would depend primarily on the stance taken by Fujitsu, who have claimed that it could lead to the collapse of ICL. However, it is possible given ICL's other work that merely ICL/Pathway alone will be dissolved. Failure of the project would mean that ICL made a total loss of £200m in 1998; it would destroy its prospects of flotation in 2000 and might lead Fujitsu to divest itself of the company. Given the economic climate in Japan, Fujitsu's attitude may well have hardened. On a least bad scenario, cancellation would damage ICL's reputation here and in its export market.

24. The recent approach from Mr Naruto, Vice Chairman of Fujitsu and Chairman of ICL, to our Ambassador in Tokyo, Sir David Wright, suggests that cancellation could have a serious effect on our relations with Fujitsu. Fujitsu has been a major inward investor in the UK, with over £700m invested in the last decade.

(ii) The case against continuation

25. The case against continuation rests on the following:

- .. ICL have not moved sufficiently and there are further delays to the project (the project is already 3 years late). But the PO (who would have to bear the bulk of the further payments to ICL) have argued that they have a commercially viable case under the proposals, and are prepared to bear the additional costs to secure the deal;
- .. the offer no longer appears to be VFM compared to the alternative - although the results are still close and there are risks which are not reflected in the figures (for both routes);
- .. the delay to a more modern and efficient benefit payment system. Paying benefits directly into bank accounts which would fit with the Government's welfare reform agenda, and would provide, in the view of the Social Exclusion Unit, an extremely influential way of increasing people's access to financial services and reducing financial exclusion. There is also the fact that we would be implementing the Benefit Payment Card at a time when alternative, more modern solutions are available (such as Smartcard - although the PO have plans to migrate to a Smartcard eventually);
- .. the public expenditure consequences for BA. It is likely that DSS/BA accounting officers will require a formal Ministerial direction to continue with the project.

4. The Way Forward(i) Continuation

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26. If Ministers decide, on the basis of the above, to continue with the project, then:
- .. BA/POCL will need to resolve their differences on ICL's acceptance proposals, and agree a way forward with ICL that is acceptable to all the parties;
 - .. there may also be a case for pushing for further concessions in the negotiations to finalise heads of agreement (although this will carry risks, given ICL have said this is their best possible offer). We would expect POCL to lead these final negotiations, in close consultation with BA;
 - .. we envisage a low key statement to Parliament to end the uncertainty about the project. A suggested statement is attached at Annex C;
 - .. we would need to think carefully about how to minimise the risks of further delay. One important factor would be a strong renewed commitment from all the parties concerned to make best endeavours to deliver the project. The parties have also agreed that a restructuring of the contract with ICL after acceptance to remove BA (who would become a customer of POCL) would be a useful step;
 - .. we also believe there is a case for issuing some form of notice to complete under this scenario.

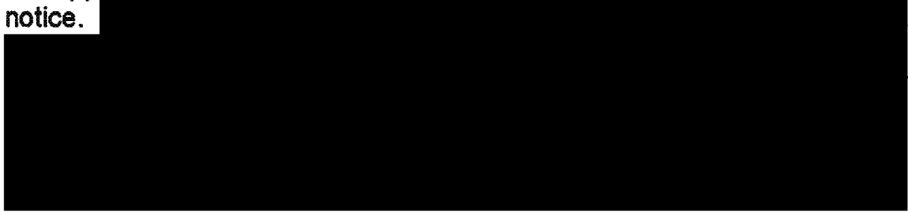
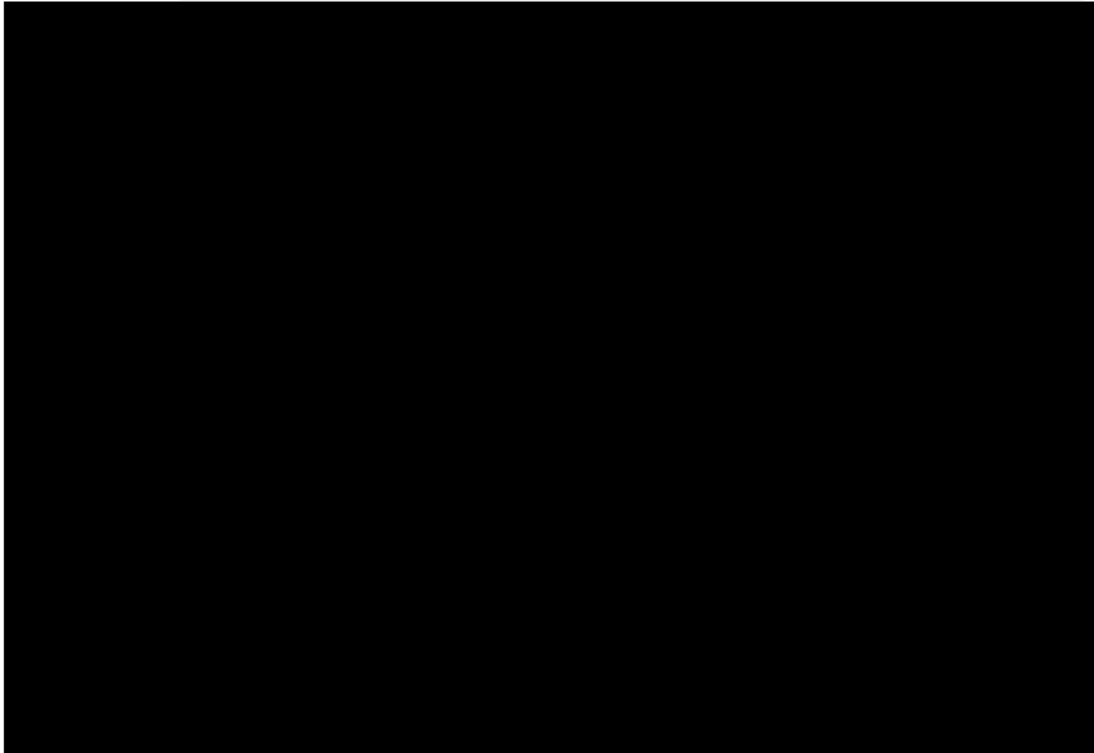
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(ii) Termination

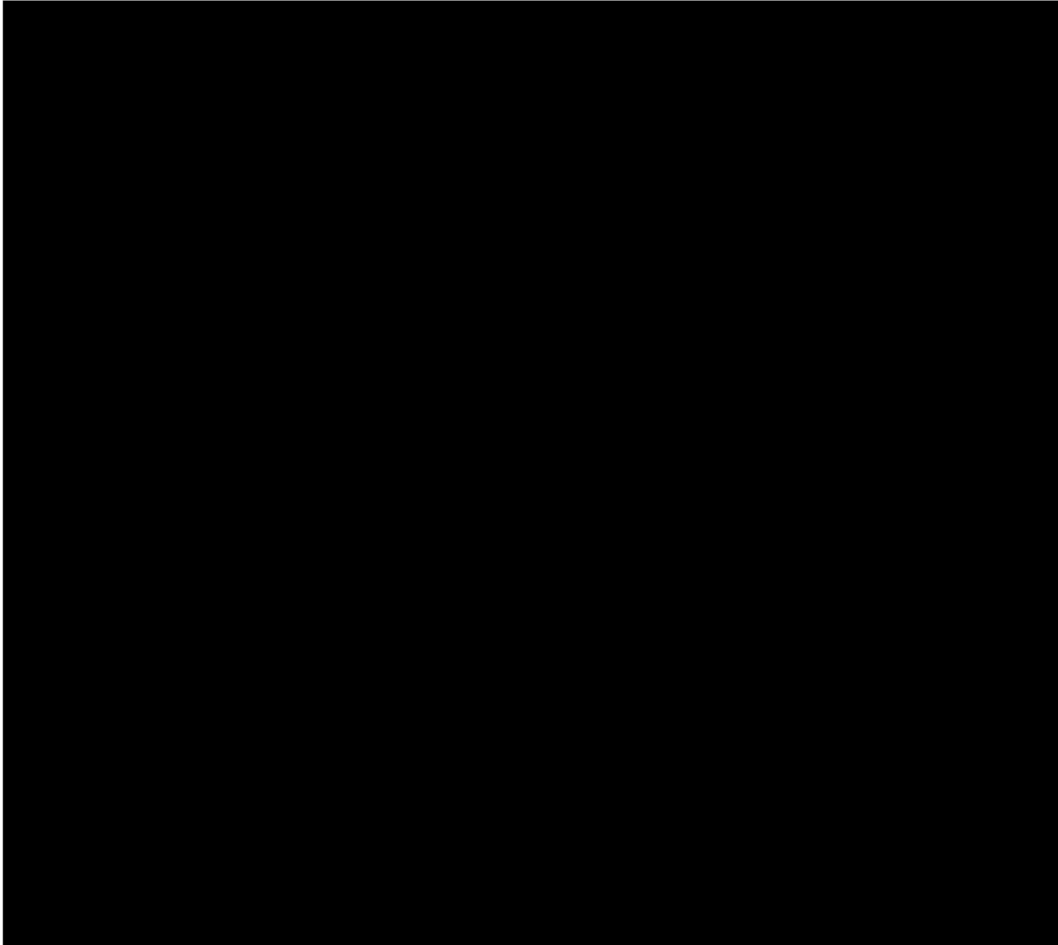
27. If Ministers decide that the ICL proposals do not provide a way forward then question arises as to what action to take.



28. The main options are:

- a. To serve a 3 month notice terminating the contracts;
 - b. To serve notice making time of the essence. This would give ICL/Pathway the opportunity to complete the contract during the time specified in the notice.
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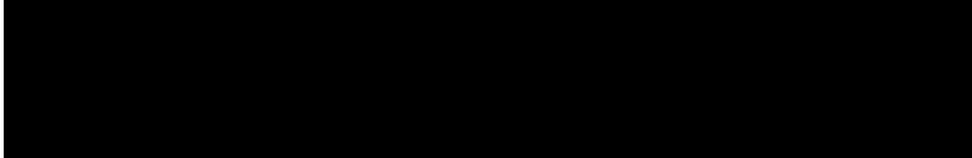


30. Ministers are therefore invited to decide:

- .. whether they wish to terminate the contract forthwith, by issuing a 3 month notice, since this is the quickest route to achieve termination:



- .. whether to issue notice that "time is of the essence", setting a reasonable period of up to 9 months for completion of the operational trial.



31. We envisage that the Chief Secretary would write to ICL in parallel, noting that the public sector could not accept ICL's offer and that discussions around a

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re-negotiation of the contract had ended.

32. Our preferred option at this point would be to seek a negotiated settlement. But this would depend on the reaction of ICL.

33. At this stage, Ministers might also be attracted to the possibility of introducing into the discussions with ICL option 2 - i.e. continuation without the benefit payment card. This would offer some of the advantages of the fallback option 3 but would avoid the adverse impact on Fujitsu and ICL. However, the PO do not favour this option. But option 2 would require the consent of ICL, so it is not, strictly speaking, a choice available to Ministers at this stage.

34. Clearly Ministers would need to be ready once notice had been served to make a public statement, in the event that ICL either issued writs or went to the press. The statements would need to provide reassurance to benefit customers, subpostmasters, Fujitsu and the IT industry. Draft statements are attached at Annex C.

35. BA/POCL will also continue to work up the fallback option, in particular, once notice has been served, by entering discussions with the banks.