

RESTRICTED - POLICY & COMMERCIAL

To:
SECRETARY OF STATE
MR MCCARTNEY

From:
DAVID SIBBICK
DIRECTOR POSTS

GRO
151 Buckingham Palace Road

GRO

ci: Mr Scholar	
Mr Macdonald	
Mr Baker	CGBPS
Mr Macintyre	CII
Mr Hopkins	CII
Mrs Britton	CGBPS 1
Ms Hathaway	CII
Mr Whitehead	CGBPS 1
Ms Anderson	CGBPS1
Mr Corry	SpAdv
Mr Wegg-Prosser	Sp Adv

8 September 1998

**BA/POCL AUTOMATION PROJECT "HORIZON": MEETING WITH
CHIEF SECRETARY AND SECRETARY OF STATE FOR SOCIAL
SECURITY ON WEDNESDAY 9 SEPTEMBER 1998 AT 6.15PM**

Issue

1. You are to meet with the Chief Secretary and the Secretary of State for Social Security on Wednesday 9 September to discuss the way forward on the BA/POCL counters automation project, code named "Horizon".

Recommendation

2. That you note this submission which covers current background; key points for the meeting; suggested lines to take (Annex A); the Secretary of State's paper following his previous meeting with colleagues (Annex B); a paper produced by the No. 10 Policy Unit for the Prime Minister (Annex C); and general background (Annex D).

Timing

3. The meeting is at 6.15pm tomorrow (Wednesday).

Background

30 July Meeting

4. You previously met with Stephen Byers and Alastair Darling on 30 July. At that meeting, you and Ian McCartney set out the case for continuation of the project.

RESTRICTED - POLICY & COMMERCIAL

5. The Secretary of State for Social Security expressed concern that the project would lock BA into what would become quite quickly outdated technology. He felt DSS had the right to terminate without notice the contract with ICL given the latter's performance. However that right would diminish in the weeks following 12 August if not exercised.

6. The Chief Secretary suggested that if HMG were effectively subsidising Post Office Counters by incurring higher administrative costs paying benefits through post offices rather by ACT, the justification for continuing with the project would have to be that it provides the best means of sustaining the network of post office counters, giving the public sector as a whole the lowest cost outcome in the long run. To understand whether this argument stood up, he asked for more information about POCL's long term future (8-10 years) and the technology needed to deliver it. It was agreed that there were strong political reasons for retaining the nationwide network of post offices. The key question was whether HMG would best achieve this via DSS payments or through a transparent direct subsidy. The Chief Secretary would speak to the Secretary of State for Social Security about the administrative costs of his Department.

Follow-up to 30 July Meeting

7. You responded on 20 August to a letter from the Chief Secretary following the meeting. In your letter and annexes (see Annex B), you set out where POCL aims to be in 10 years time, what technology it needs to get there i.e. Horizon, explained that automation of part of the network was not a viable option, set out the importance of post offices to the communities they serve and how they can help the Government achieve its policy objectives on universal banking and social exclusion. On the cost of keeping marginal offices open, you explained that the smallest 4000 - 5000 rural offices lost POCL in the region of £20-30m a year and that further work was being undertaken in respect of urban areas. Annexes to the paper described the services POCL provides to Government departments and how Horizon will assist with these; POCL's cost structure (which typically for a retail network has the majority of its costs as fixed or semi-variable); the network and its customers and their attitudes to post offices and a description of Fujitsu's relations with the UK.

8. Since then, further analysis has been undertaken of POCL's likely strategy if the project were cancelled. POCL now take the view that they would wish to seek new bids for a Horizon type system (but without the benefit payment card) since it is only this type of functionality which will equip them to meet the needs of the business and customers. ICL would be included in the invitation to tender, and their work on Horizon should put them in a strong position. POCL estimate that

RESTRICTED - POLICY & COMMERCIAL

such a system would incur one-off costs in the region of £50-80m and ongoing average running costs of £60-100m a year. It could take 5-6 years to deliver.

RESTRICTED - POLICY & COMMERCIAL

Submissions from ICL

9. ICL claim that their expenditure on the project so far, together with forward commitments already entered into amount to some £280m (less than half the latest estimates of total project costs), they now stand to lose some £380m if the project is cancelled, and a similar amount over the existing contract term if the project continues (extending the term would help, but only to a limited extent, since financing costs are now the largest single cost of the project).

10. They have written stressing the need for early decisions. To continue with the project they will shortly need to seek further funding from their parent company, Fujitsu in Japan.

BA Accounting Officer

11. The BA Accounting Officer has claimed that he could be vulnerable to PAC criticism for failing to pursue the most cost effective (at least in a narrow BA sense) means of delivering benefit payments - ie cancelling Horizon and migrating as quickly as possible to ACT. To allay these concerns, the Secretary of State for Social Security issued the Accounting Officer with a formal direction not to take action to terminate the contract with ICL. This direction expires on 14 September. A decision to continue with Horizon and the payment card would probably require a further formal direction by Ministers.

Mr McCartney's Meeting with Fujitsu on 1 September

12. Mr McCartney called on Fujitsu in Japan where the project was discussed with Mr Naruto, Vice Chairman of Fujitsu and Chairman of ICL who was very concerned about the difficulties the project is causing Fujitsu. Cancellation would be seen as a breach of faith between DTI and Fujitsu. In addition, both his and the UK's credibility would be damaged; he had been a champion of the PFI concept in Japan and had just been appointed by the Government as a Chairman of a PFI Working Group. Fujitsu's plans to float ICL in 2000 would have to be shelved.

No 10 Policy Unit Paper

13. We have received today a joint HMT/ No 10 Policy Unit paper which the Policy Unit will put to the Prime Minister and John Cunningham (copy attached at Annex C). **The report to the Prime Minister recommends continuation with the project on condition that:**

- ICL Pathway commit to suitable terms within a deadline of one month;

RESTRICTED - POLICY & COMMERCIAL

- DSS are given a firm date after which they will have no commitment to use (or pay for) the benefit payment card, and can prepare for migration to ACT before this date;
- POCL strengthens its management of the project giving necessary authority to the project manager, and committing the resources required;
- the Post Office strengthens the management of POCL to give it a much stronger commercial focus (through outside recruitment if necessary) and explores possible partnerships with the private sector;
- a strategy is prepared for more transparent funding for POCL nationally, and at post office level so we can be much more rigorous in defining what social value added is being bought;
- a strategy is prepared for migration from the benefit payment card to a multi-functional card, which could offer users broader account like services.

14. The report sets out clearly the respective positions of Post Office Counters and the DSS in relation to the project and describes the implications for ICL and Fujitsu of continuation or cancellation of the project. As regards Option 2, dropping the benefit payment card from the project, the report comments that given the negotiating positions of the parties it is very difficult to assess whether this solution is commercially viable or makes sense in technical terms. The Post Office have come to the view that if the payment card is cancelled, the only workable alternative is to cancel the project and to re-tender.

15. If the project continues, Treasury Ministers may well look to the PO to at least partially offset the substantial additional costs which the DSS will incur as a result of the project continuing.

Current State of Play on the Project

16. The parties have been seeking to implement the detailed recommendations of the Expert Panel. A recent status report from POCL and ICL Pathway focused on positive developments whilst BA's report focused on remaining risks.

17. Key points follow overleaf.

DAVID SIBBICK

RESTRICTED - POLICY & COMMERCIAL

KEY POINTS

- Must now end damaging uncertainty. ICL will shortly run out of funds to continue the project.
- We are likely to end up paying ICL for the project whether we continue with it or not. Without it, POCL will need heavy subsidy to avoid a collapse of the network.
- Continuation buys time for POCL to adjust to a future without BA income, by generating new business and restructuring the network; cancellation is likely to result in uncontrolled decline.
- Horizon can contribute significantly to achievement of our objectives on social and financial exclusion, and electronic Government.
- Far from clear that cost savings from ACT would in practice be as great as projected when large numbers of marginal accounts are added. “Unbankable” rump may be significant and expensive to administer.
- Horizon without benefit payment card is probably unworkable in practice. Impossible to pursue part of project when in prolonged and major litigation on remainder.
- Damaging consequences of cancellation for ICL, our relationship with Fujitsu, inward investment from Japan, credibility of PFI.
- Agree decision to continue should be accompanied by conditions set out in the Policy Unit Paper.

RESTRICTED - POLICY & COMMERCIAL**ANNEX A****LINES TO TAKE****Need for Decision**

- Important that we quickly reach decisions on the project given the need for ICL and BA in particular to have a decision before committing further expenditure to the project and the need to set the project on a new footing which takes account of the Expert Panel's recommendations for taking forward the project.

Support for Continuation of the Project

- We continue to share strongly the view of both the Expert Panel and the Working Group that the Government's objectives can best be met by continuing with the project as envisaged in Option 1 - provided satisfactory terms can be negotiated with ICL.
- There are undoubtedly possibilities for POCL to generate new revenue streams, for example, offering front-end banking facilities to banks and in the context of Government Direct. Although this may never fully replace a significant loss of BA income, **option 1 offers the best prospect of achieving a viable future for POCL.**
- Maintenance of a nationwide network of post offices, although inevitably a somewhat reduced network, should help the Government in achieving its policy objectives on social and financial exclusion, and electronic Government. Unique reach of post offices is important for the less affluent and less mobile. Important that migration to ACT is done in a way which does not threaten the stability of the network.

RESTRICTED - POLICY & COMMERCIAL

Transition to ACT

- Recognise that in the longer term ACT will be the normal method of delivering welfare benefits, but important to progress to that position in a phased and controlled manner that minimises the impact on the network of post offices, especially since access to bank accounts through the network of post offices will be a key element in the acceptability of ACT.

Negotiations with ICL

- Accept that if it not possible to secure a satisfactory agreement with ICL on the basis for continuation, or the project experiences further significant problems, we will need to consider cancellation.

Costs of Cancellation

- The political and actual costs of cancellation would be high.

Post Offices

- DSS Ministers have very publicly expressed their commitment to the success of the project as a whole, and to the benefit payment card in particular. There would be a strong sense of betrayal amongst subpostmasters if the project were cancelled.
- To modernise its operations, retain existing clients and attract new clients POCL needs the full functionality provided by Horizon. Cancellation of the project will put back further by 2-3 years automation of network and jeopardise existing and potential future business leading to post office closures. Potential technology and banking partners may be reluctant to do business with POCL in the wake of a failure of this kind.

RESTRICTED - POLICY & COMMERCIAL

Industrial Implications

- Cancellation of the project risks damaging litigation with ICL who have already attributed blame for the delays to the project to the public sector parties.
- Cancellation could have serious repercussions for our relationship with Fujitsu who directly employ around 4 000 in the UK aside from around 13 000 employed by ICL in the UK (in whom Fujitsu has a 90% stake).
- The relationship with Fujitsu is already sensitive given the recent announcement of the closure of their semi conductor plant in the Prime Minister's constituency against a background of a downturn in the semiconductor market and the Japanese economy. Recent publicity about the project may well damage Fujitsu's prospects of floating ICL, cancellation would inevitably further damage these.
- Cancellation risks damaging the standing of HMG in industrial circles in Japan where it may be perceived as a breach of faith on our part and threaten the credibility of our PFI policy. There are already concerns about the suitability of PFI for major IT infrastructure projects.
- Whilst much would depend on Fujitsu's reaction, cancellation could bring ICL down with potential job losses of around 13 000.

Option 2

- **We do not believe that to pursue the Option 2 route - dropping the payment card element of the project - is sustainable.** We doubt whether this option is negotiable with ICL, other than by throwing huge amounts of money at them in compensation for their expenditure so far on the card and the consequent loss of

RESTRICTED - POLICY & COMMERCIAL

a key revenue stream. And if ICL were forced to litigate on withdrawal of the card, it would certainly bring the rest of the project down with it.

- There would be a major loss of confidence by subpostmasters, who would be quick to see that arrangements for “front end” banking would in no way offset the loss of direct BA business. Many might be tempted to sell up before it is too late, resulting in large numbers of network closures.