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POB(00)7x

POST OFFICE BOARD

AN UPDATE ON THE HORIZON PROGRAMME

1. PURPOSE

1.1 The purpose of this paper is to:

- compare the financial impact of the new position on Horizon to the original business case proposal of April 1996 and to Post Office Counters Ltd's Business Plan for 1999/2000 to 2003/2004;
- provide an update on programme progress, emerging issues and the plans for future commercial enhancements.

2. FINANCIAL IMPACTS

2.1 Comparison of new business case to original proposal

2.1.1 The original business case, presented in April 1996, showed a *positive* NPV of £65m. The revised business case presented to the Investment Board in October 1999 shows a *negative* NPV of £181m. The movements resulting in the £246m worsening in the NPV are summarised in Annex A.

2.1.2 The major reasons for the decline in project NPV are:

- The original contract was arranged under HM Government's Private Finance Initiative, with ICL Pathway providing the up-front investment and Post Office Counters Ltd and the Benefits Agency paying on a per transaction basis once the system was delivered. The charging structure under the new contract is largely fixed with Post Office Counters Ltd alone making large up-front capital payments for system and an ongoing operating charge once it is in place; this significantly increases overall costs.
- Repeated programme delays, cancellation of the Benefit Payment Card and the proposed migration to Automated Credit Transfer (ACT), have led to a decrease in the incremental income anticipated as a result of implementing the Horizon system.

2.1.3 The business cases are not directly comparable in terms of assessing business impact as they rely on different baselines and costing methodologies. These differences are explained in more detail in Annex B.

2.1.4 The October 1999 cash flow, reviewed by the Investment Board included £480m funding from The Post Office reserves, in accordance with the Secretary of State for Trade and Industry's letter to The Post Office Chairman, dated 23rd May 1999. This letter stated that this amount would otherwise pass to Government on restructuring of The Post Office balance sheet in 2002/03. This will not now take place. Any Post Office Counters Ltd shortfall will be covered by Post Office Group funds. This will not have any cash flow impact.

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2.2. Revised business plan impacts

2.2.1 An initial assessment of the business impact of the Codified Agreement signed in May 1999 was presented to the Post Office Board in July 1999 (PO99/78) and of the five scenarios considered at that time, it was agreed that Scenario 2, *Horizon continues with heavy promotion of ACT from 2001*, would be taken forward.

2.2.2 The scenario has been revised to reflect the new business case and the requirement to account for Horizon Contract as an impaired asset in the current year (but does not include the impact of the current planning round). The impact of these changes on Post Office Counters Ltd's projected profit is shown in Table 1. The changes shown reflect the new contract, plans for migration of benefits business to ACT, and the associated impacts on Government Gateway and Network Banking initiatives. The major reasons for changes to profit are highlighted in Annex C.

Table 1: Impact of revised position on projected profit for Post Office Counters Ltd

£m at outturn	1999/00	2000/01	2001/02	2002/03	2003/04	TOTAL
Post Office Counters Ltd Business Plan 1999/00	30	32	50	70	77	261
Revised Position - New Business Case and Impairment	(522)	(49)	(52)	6	(82)	(699)
Change	(553)	(81)	(103)	(64)	(159)	(960)

3. ISSUES AND RISKS

3.1. Review of post-acceptance period

3.1.1 Under the terms of the Codified Agreement, signed on 28th July 1999, Contractual Acceptance was scheduled to happen in August. However, acceptance testing identified significant faults in ICL Pathway's service and Acceptance was deferred under the *First Supplemental Agreement*.

3.1.2 By 24th September 1999, most of the faults had been corrected, but ICL Pathway were still adjudged to be failing on the following three criteria:

- Helpdesks - provision of support to offices failed to meet contracted service levels;
- System Stability - software errors were observed during live trial which could have significant customer service implications when the system is fully rolled out;
- Accounting Integrity - the lack of demonstrable controls within ICL Pathway were leading to an unacceptably high level of data with integrity problems.

3.1.3 After reviewing risks it was decided that despite these recurring problems there were significant business benefits to be gained from rollout to a larger number of offices, but that this should be subject to additional obligations on ICL Pathway. These obligations form the *Second Supplemental Agreement* whose provisions include:

- Targeted reduction in faults and additional functionality to put integrity controls in place;
- The time and cost adjustments which would have been due to ICL Pathway if Post Office Counters Ltd delayed rollout are now disregarded for a period of 42 days - this significantly mitigates rollout risk;

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- Post Office Counters Ltd retaining the option to suspend resumption of rollout in January 2000, if the criteria at 3.1.2 are not met.

3.1.4 The Horizon System has been successfully rolled out to 1,857 offices prior to the suspension of rollout for the Christmas period. The current assessment is that ICL Pathway have achieved acceptable performance levels on the system stability issue, but that further monitoring and discussion is required on helpdesk and accounting integrity issues. As a result, a final decision on resumption of rollout will be taken in mid-January 2000.

3.2. Overview of relationship with ICL Pathway

3.2.1 The codified agreement is a shift from the previous tripartite agreement (involving the Department of Social Security), to a bipartite arrangement. This has simplified the contractual relationship and led to a better definition of processes for dispute resolution.

3.2.2 The basis of payments included in the Codified Agreement are primarily fixed payments for specified deliverables. As a result, the behaviour of ICL Pathway appears to be a cost minimisation strategy in meeting their contractual requirements. This has meant that Post Office Network Unit management has had to take a firm negotiating line, and has resulted in contractual discussions being escalated to senior levels before the contractor delivered acceptable performance.

3.3. Release plans for future commercial enhancements

3.3.1 The functionality that ICL Pathway has contracted to provide at the specified price in the Codified Agreement is limited to:

... the *Core Release* providing:

- basic till and outlet accounting functionality;
- bar-coded and magnetic-stripe bill payment;
- the order book control service for benefit payment.

... and *Core Release Plus* (available in Autumn 2000), providing:

- smart card bill payment;
- a front-end for stock and cash management systems;
- infrastructure developments to improve security for automated payments and allow the provision of data direct to clients.

3.3.2 Subsequent to the Core Releases the earliest opportunity for significant software development and testing, will be Spring 2001. Prior to this, there is also the opportunity to re-engineer additional clients and products to use the bar-code, magnetic-stripe and smart card payment functionality already available.

3.3.3 Within the Codified Agreement, Post Office Counters Ltd's commitment to further development on Horizon is limited to an obligation to discuss potential partnership opportunities with ICL Pathway. ICL have been included in the Request for Information sent to potential suppliers of the Network Banking Initiative, and a dialogue has been initiated by Post Office Network Unit with ICL Pathway on potential developments in this area and in Modern Government.

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4. RECOMMENDATION

The Board is invited to:

NOTE that:

- (i) sunk costs on the programme to end of August 1999 amount to £47.8m;
- (ii) further forecast expenditure in relation to programme management and implementation costs of £42.0m was authorised by the Investment Board in October 1999;
- (iii) the committed contractual payment to ICL Pathway of £564m was authorised by The Post Office Board in July 1999;
- (iv) the following recurring costs of Horizon are forecast from the start of 1999/00;

£m at outturn	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	TOTAL
Payments to Pathway	(10)	(80)	(113)	(118)	(121)	(118)	(559)
Other costs	(1)	(2)	(2)	(2)	(2)	(1)	(9)
Total	(10)	(82)	(115)	(119)	(122)	(119)	(568)

- (v) the following key project milestones have been set:
 - Planned resumption of national rollout 24th January 2000
 - Completion of physical rollout of post offices June 2001
 - End of current contract term with ICL Pathway March 2005

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January 2000

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ANNEX A

Comparison of original case NPV with current proposal

A reconciliation of the overall differences between the original automation case and the revised business case as authorised by the Investment Board in October 1999 is summarised below.

£m	Sub-totals	Net Change	NPV at 12% TDR
Original Case - April 1996			65
<i>Adjustments to allow cashflow comparison</i>			
Rebase case to 1999/00,	45		
Omit "sunk" cost/benefits to end 1998/99	(18)		
		27	
<i>Impact of BA withdrawal/contract change on system related costs</i>			
Pathway Charges- Benefit Encashment	212		
Pathway Charges - Operating Payments	(21)		
Payments from Benefits Agency for automated benefit payment	(110)		
Capital Payments to ICL Pathway	(492)		
Payment for card issue/Back office savings	(91)		
		(502)	
<i>Loss of contribution</i>			
Incremental contribution from benefits business	(113)		
Incremental contribution from other business	39		
		(74)	
<i>Opportunity Saving</i>			
Originally proposed drawdown of £480m from Post Office reserves ¹	342		
		342	
<i>Implementation and recurring costs/benefits</i>			
Programme and Implementation costs (NRR)	(48)		
Other recurring costs	35		
Other benefits	3		
Savings on legacy automation systems	(28)		
		(38)	
New Business Case - October 1999			(181)

¹ The interpretation of the "Opportunity Saving" has been changed since the Investment Board, see Paragraph 2.1.4 in the main paper for an explanation of this change. This saving is no longer likely to be a cash flow impact, the revised NPV without the saving would be negative £523m.

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ANNEX B

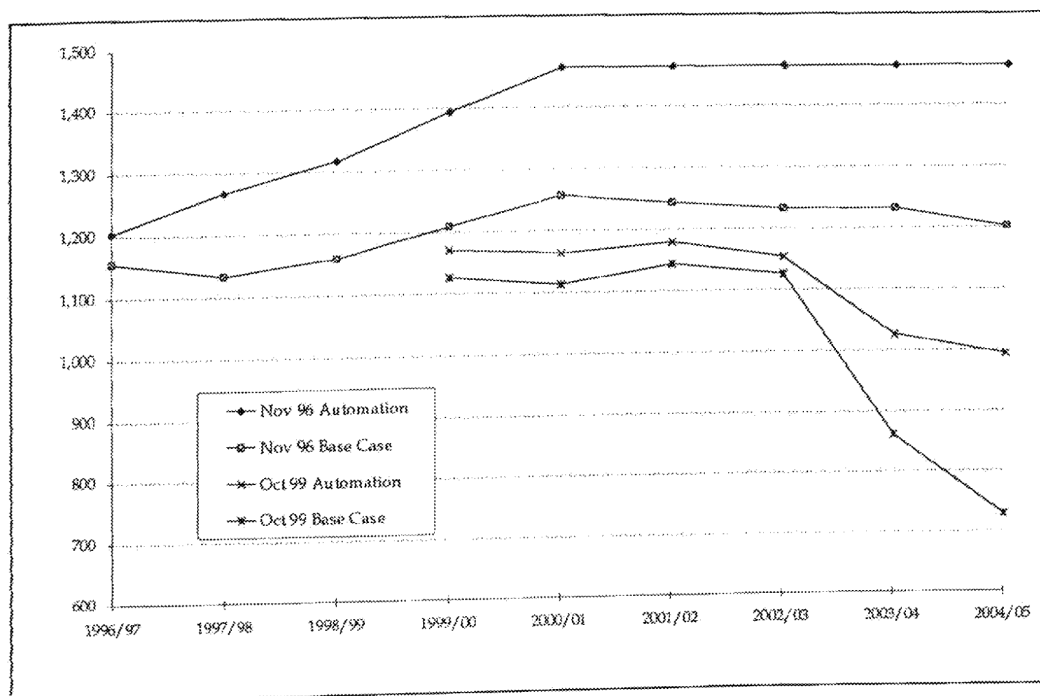
Differences in business case assumptions

Both the original and revised cases include estimated benefits in terms of contribution from clients. This is calculated by comparing estimates of contribution with Horizon against a base case of no automation. The original base case was prepared in April 1996 and reflected Post Office Counters Ltd's expectations as to likely income if automation was not extended beyond the systems in place at that time. The October 1999 case was prepared in the light of the Government's stated intention to migrate benefits customers to a bank account based benefits solution.

Figure B1 below, illustrates that both the baseline and incremental income figures are significantly higher under the original case. The main reasons for the decline in the baseline and increment are:

- The new case only shows the income derived from functionality available on the basic system. Benefits from re-engineering (allowing potentially large income streams from Network Bank and Government Gateway programmes), are omitted.
- The continued delay to Horizon has impacted client confidence, leading to a decrease both in current and future income as clients seek alternative channels and are less ambitious in their plans for engineering their products on to the Horizon platform.

Figure B1 - Comparison of incremental income for new and original business cases



Comparison of the cashflow impacts is also affected by a fundamental change in the basis of costings. The new case uses the Activity Based Costing methodology which is more effective at allocating costs to products than that used previously.

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ANNEX C

Reasons for overall movements in Profit and Loss from Post Office Counters Ltd
Business Plan to new proposals.

Em at outturn	TOTAL 1999/00 to 2003/04	Explanation of change
Income		
Benefits Distribution (including payment for automation)	(221)	Revised scenarios as per July 99 Board, increased rate of migration to ACT ² and loss of floor from 2003/4
Network Bank and Government Gateway	(278)	Migration to ACT impacts footfall which affects Network Bank offer
Other income	(111)	Migration to ACT impacts footfall which affects other business
Total Income (A)	(611)	
Expenditure		
Horizon RR		
Core products	48	Large up-front capital payments result in an overall decrease in ongoing charges
Network Bank and Government Gateway	(64)	Information from Pathway suggests higher cost of delivery than previously anticipated
Other Core costs	225	Reductions arising from volume decreases
Development		
Horizon	5	Reductions in project cost identified
Network Bank and Government Gateway	(4)	Estimates of development costs for automation on Horizon
Underlying	54	Other development costs reduced in response to footfall loss
Total Expenditure (B)	263	
Additional Depreciation		
Horizon	(571)	Write off of Horizon asset in 1999/00
Other	(42)	Depreciation related to Network Bank/Government Gateway capital expenditure
Total additional depreciation (C)	(613)	
Profit (A) + (B) + (C)	(960)	

²ACT refers to Automated Credit Transfer whereby state benefits are paid directly into recipients bank accounts.