

11-NOV-1998 13:45 FROM ESY FF PFI

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Fax Message

For the attention of	Tim Brown	Date	11 Nov 98
Company	POCL	No. of pages (including this)	
Fax number	GRO	Serial No.	
From	Marcus Holden		
Direct Fax number	GRO		
Direct Telephone number	GRO		

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Dear Tim,

We have now completed a more detailed review of the documentation that you gave us, and have developed our thoughts on both the accounting implications of the proposals and the more pertinent commercial implications based on comparison to broadly similar projects (or at least comparison to PFI projects generally and the draft Treasury Guidance).

Accounting - Measures for Balance Sheet Treatment

Change in project since our initial review

The broad message from our initial review (conducted under FRS5 and SSAP21 analysis) was that POCL took little of the risk/reward of ownership of the project assets, and therefore was unlikely to have an interest in them on its balance sheet. This was primarily driven by the fact that POCL was acting in an agency function for the Benefits Agency, and was not exposed to factors such as volume/demand or termination risk in the deal.


A major part of this assessment was that the bulk of the transactions handled by the system were BA related, and that there was some - at the time relatively undefined - element of benefit transferred to POCL as a result of their being able to utilise the system for their own purposes. From our discussions, this is certainly no longer the situation. There is significant usage of the system by POCL from day one, and by the end of the project there is no envisaged usage by the BA.

This by itself represents a significant change in the assessment of the treatment of the project from the POCL point of view. It will certainly result in far more risk being taken for the

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assets and will start to tip the scales from the previous clear cut assessed position. However, this in itself is not a significant issue with regard to the final treatment of the assets - obviously most PFI projects will result in some risk to the public sector party, and this element is only one part of the jigsaw.

New applicable standard

The new applicable standard of relevance in this case is the amended FRS5, which includes an application note specifically addressing PFI issues. Where non-separable payments made by a purchaser fall into both service and asset provision categories (as they will in this instance), the FRS is clear that it is the applicable reference, and the relevance of SSAP21 is significantly diluted.


In determining the nature of the asset, and its treatment by the purchaser, the FRS notes there are several 'property risks' that will be relevant:

"As noted in paragraph F19, in applying the FRS the key test is to establish who will bear any variations in property profits (or losses). Depending on the particular circumstances, a range of factors may be relevant to this assessment of profit variation. The principal factors that, depending on the particular circumstances, may be relevant are:

- demand risk (see paragraphs F24-F31)
- the presence, if any, of third-party revenues (see paragraphs F32-F34)
- who determines the nature of the property (see paragraphs F35-F37)
- penalties for underperformance or non-availability (see paragraphs F38 and F39)
- potential changes in relevant costs (see paragraphs F40 and F41)
- obsolescence, including the effects of changes in technology (see paragraphs F42 and F43)
- the arrangements at the end of the contract and residual value risk (see paragraphs F44-F48)."

It states that it is:

"important to assess the effect of all relevant factors and the interaction between them, giving greater weight to those that are more likely to have a commercial effect in practice."

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Within these property risks, the ones seen as key by ourselves are the demand, third party revenue and residual value risks, but the technology risk may also be key in IT application projects.

Impact of 'Revised Offer' terms:**Third party revenue risk**

There is no third party revenue.

Technology risk

Technology refresh cost risk is presently lying with POCL. This is a significant area where ICL might have been expected to take the 'technology' risk. The FRS is clear on this point:

"Where the potential for obsolescence or changes in technology are significant, the party that bears the costs and any associated benefits will be the one for whom there is evidence that the property is its asset."

Demand risk


The level of guaranteed transactions (and therefore revenue to Pathway) may give problems in relation to the allocation of demand risk. The FRS states that the initial question is whether there is demand risk, and follows on that where there is significant uncertainty over future demand levels the allocation of this risk is critical in assessment of asset ownership.

Assessing the risk in this case would mean establishing how realistic the tabled estimates of future demand/transaction volumes are, and then considering whether the provided guaranteed minima against these estimates allows a reasonable level of risk transfer. In our original review there was a statement that the estimates were subject to a standard deviation of 10%, and this would imply that the original guaranteed minima of 65% represented a significant risk that the actual project volumes could result in a reduced revenue stream.

That risk has been dramatically reduced, and will also be impacted by your comments that the estimates have also risen to levels that appear too high - further reducing the likelihood of deductions from the minimum payment streams.

Residual value risk

Pricing of asset transfer at the end of the project should ordinarily include an element of residual value risk to the private sector. Such residual value risk will ordinarily be demonstrated by the financial model (on which the project pricing is based) including significant residual value which the sponsor will not be required to pay, and thus a commercial risk exists of such non-payment.

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This highlights a problem inherent in projects of this nature, that the residual value outside of the contract is nil, and therefore the realistic level at which to set the price of transfer is also nil. This implies that the purchaser has paid for the asset over the life of the contract, which in turn is an 'on-balance sheet' indicator. However, allowance must be made for this situation in assessment of the position. Further indications should be sought, that might include how the purchaser ensures the asset is delivered in acceptable form and state of operational repair.

Initial pricing risk

The 'contingency' element definitely appears to remove much risk from Pathway for primary items such as project slippage during the construction phase (as now extended). This is a key indicator that POCL retain the risks of ownership.

Balance Sheet Treatment - Conclusion & Impact

Notwithstanding that we have only been given rough indications of the extent of the 'Revised contract' terms, and have therefore not been able to undertake a full evaluation of the position (including review of financial models), initial indications are that the project would become 'on-balance sheet' to POCL. This has been primarily impacted by the fact that there appears little transfer of the demand risk to Pathway, the assets will be fully paid for over the term of the project and there does not appear to be significant transfer of technology risk - either in the operational phase, or over the development of the project.

The impact of this conclusion is that POCL will need to account for the systems as an asset in its balance sheet and depreciate the asset over the useful economic life (ie the period until the end of the concession, with some account taken of the technology refresh). There will need to be a corresponding liability in the balance sheet, representing the liability to pay for the asset over the term of the concession. This liability will be released as payments are made over the term, and there will be an additional profit and loss charge to reflect the imputed interest payment implied by the contract.

Contract Terms

We have also considered the impact of the 'Revised Offer' terms in light of the draft Treasury Guidance, and also other FT type PFI deals of which we are aware, in order to provide some insight as to whether the terms proposed appear reasonable. Obviously overall judgements as to must be taken in the round and as part of the final contract as a whole.

TOTAL P.04

11/11/98
Copy
Sandra
Keith
Keith

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1610/P79
11 NOV 1998

SLAUGHTER AND MAY

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FAX TRANSMISSION

Date	11th November, 1998	91035	NOV 11 13:08	Document number	CA983150.056
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To	Catherine Churchard, Post Office Legal Services, Croydon			Receiving fax number	<input type="text" value="GRO"/>

Copy to
Jonathan Evans, Post Office Counters Limited, London
Paul Rich, Post Office Counters Limited, London
Mena Rego, Post Office Counters Limited, London
Lesley Lawson, Post Office Counters Limited, London
Nick Gray, Slaughter and May



Hamish

Once again, when I read Hamish's letter to you of 10th November I feel like the little boy staring at the emperor's new clothes.

The conflict issue seems to me entirely clear and simple. The fact is that in certain areas we would like Hamish to do one thing and DSS would like him to do another. For example, we would like him to promote Option 1 and stress the veto right in Contract B, whereas DSS would like him to promote Option 2. Option 1 and Option 2 are mutually incompatible.

Faced with such different objectives it is not Hamish's job to steer a fair and reasonable middle line and to do what he thinks is best for the public sector parties as a whole. It is his obligation to stand down and not involve himself in this area. That is crystal clear.

The professional conflict of interest rules which bind solicitors are there because in circumstances like this it is neither desirable nor possible for a lawyer to steer an impartial middle course.

The view of this morning's meeting (at which Stuart, Jonathan and Mena were not present) was that of the options cited in your memorandum only 3 and 4 were likely to be acceptable to POCL and that 3 was really the only practical solution. Even then it would need

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11th November, 1998

careful thought as to the practical constraints as to who seeks advice from Hamish and on what subjects.

Regards

GRO

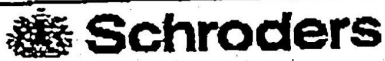
J R Triggs

11-11-98 11:40

FROM: JHS PROJECT FINANCE

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T-025 P.01/0E F-730



FACSIMILE MESSAGE

To: Tim Brown
Financial Controller
Post Office Counters Ltd
Fax no: GRO

Number of Pages: 6

From: Kathie Painter / Andrew Cox
Fax no: GRO

Date: 11 November, 1998

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POCL / Pathway

Further to your meeting and conversations with Andrew Cox earlier this week attached are brief comments on ICL's 5 November proposal.

As requested we have focused on points of interest to lenders providing limited recourse funds to Pathway. However, you should note that the specific terms acceptable to lenders in the areas covered by ICL's documents will depend on the overall terms of the contracts, the risk allocation, the level of support provided by ICL/Fujitsu in respect of Pathway's obligations and the general conditions prevalent in the market, particularly for PFI projects, at the time lenders are approached. Our comments should therefore be viewed as indicative only.

At a more general level, we would further note that the assumption that a substantial amount of debt could be raised on a true limited recourse basis for Pathway is questionable. The appetite of lenders to take significant risk in the area of IT is not proven with there being recognition that it is not an area which is easily "banked". The proposal from ICL suggests a high level of recourse for the banks to the public sector. This removes risk directly from ICL/Fujitsu, which is currently providing a corporate guarantee for Pathway's debt. Since lenders' requirements will depend on their view of the project economics and contracted basis at a detailed level it may be more appropriate to include only a sentiment relating to limited recourse finance at this stage rather than to agree a specific list of terms which may be too generous or indeed insufficient for the purposes of raising debt financing.

Please call me to discuss further, as you wish.

Best regards,

GRO

① FINANCING PLAN
- is it sufficient } need to know
- premature
Referring on work words

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Pre-reading for 2.30 meeting today need more detail

- Paul Rich
- Jonathan Evans
- Dave Miller
- Jeff Triggs
- Keith Baker?
- Sandra Rees
- Mench. Rejo.

11/11 '98 12:49 TX/RX NO.7931 P.001

11/11 '98 12:13 TX/RX NO. 0122 P02

11-11-98 11:40

FROM-JHS PROJECT FINANCE

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T-02E P.02/06 F-730

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Comments on ICL 5th November proposal

1. HEADS OF AGREEMENT

Clause	Comment
General	The PPP agreement is intended to describe the way that the POCL/ICL PPP will work together towards realising New Business Opportunities. Although the document declares that it is not legally binding, the tone suggests that it is paving the way for a more formal partnership agreement at a later date. Is this POCL's intention?
3.4	Is it POCL's intention to recruit a new partner with financial retail experience? This points towards a more formal partnership than envisaged.
4.1	If this document is to be entered into by POCL, the terms of the Related Agreements should be agreed prior to signature. This clause appears to be an attempt to bulldoze ICL's stated commercial position through the PPP.
5.3	This would appear to be a back-door attempt by ICL to get pre-emption rights upon any future POCL privatisation. Has this been the subject of any negotiation?

2. COMMERCIAL AND CONTRACTUAL PROPOSALS

Clause	Comment
2.1 (iv)	Are these the current volume of transactions forecast by the Authorities? Since the POCL guarantee runs off the forecast transaction volumes, it is important to ensure that these figures are accurate, and preferably, conservative.
2.1 (vi)	Is the PINFADS funding supplementary to what was anticipated as the "refresh" in the original contract? If so, how much is it, and when does it take place?
3.1 (ii)	What is the value of the 80% transaction guarantee in comparison to the asset acquisition offer? Any valuation should also include the valuation of the contingency, which seems to be sole POCL risk. From where has the 80% figure been derived, is it just to improve returns and bankability? Why is the proposal for banking transactions higher than for the core businesses? Liquidated Damages: This results in POCL effectively being responsible for a proportion of LDS as it is funding the contingency fund. Only if the contingency fund is exhausted does Pathway become liable. Normally, the contractor would be responsible for performance over-runs/delays prior to Acceptance.
3.1 (iv)	If a Direct Agreement is conceded, all termination rights will be subject to the banks' rights of step-in.
3.1 (viii)	If the LDS for delay are to be removed, then funding for delay will be through the contingency, which effectively makes delay a POCL risk. Presumably this is not the intention?

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3.1 (xi)	The additional value (if any) should be agreed in advance between Pathway and POCL.
4.1	The "blame culture" presumably refers to a "normal" project finance risk allocation mechanism (LDs for delay/non-performance etc.), which will likely be required by banks funding on a limited recourse basis, so that the party responsible is contractually obligated to take the non-performance risk. In this proposal, Pathway relies upon the contingency fund for overruns/non-performance and the Authorities fund the contingency. If the contingency is not required, POCL only receives 33% back. This would appear iniquitous as far as POCL is concerned, on the face of it.
4.5	See comments on 4.1 above.
6.1	Is this contract the Heads Agreement or is a further agreement proposed?
6.2	If there is a single interface between Pathway and POCL, POCL will need to be careful to "back to back" risks taken under the Pathway contract with the DSS/BA under the services relationship agreement (or whatever contract is put in place). POCL will be sandwiched between Pathway and the DSS/BA and undue pressure could be brought to bear from both sides, if necessary.
Attachment 1	Is the RPI indexation -3.4% or -2% from 1999? Is ICL now willing to accept an NPV of -£103m?
Attachment 2	Does the contingency cover Pathway non-performance? If not, how does Pathway cover this risk?

3. PATHWAY FUNDING PAPER

Clause	Comment
1.2	See comments on 6.2 above.
1.3	These are issues that should only be addressed once terms are negotiated with the lenders. The need for security and a Direct Agreement will become apparent once the commercial terms are agreed and the allocation of risks in the project can be fully appreciated. Lenders would typically seek to take security over all assets that are available and can be given as security by the project company. A Direct Agreement is not unusual but would only be insisted upon if there were concerns over the termination regime negotiated between the parties. (c.f. comments on the Direct Agreement below)
2.	We need to clarify the timings of this termination payment. Does this mean "after" or "during" National rollout?
3.1	Lenders will want to see risks being allocated through agreed contractual remedies (LDs etc.). The only contractual remedy appears to be the contingency fund, which is POCL funded. What happens on Pathway default?
3.1 (iii)	We need to clarify the nature of these defaults. POCL should insist on ultimately

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	having termination rights for material Pathway default.
3.2 (i)	This is semantics - "persistent and material breach of a material obligation" - POCL should have unequivocal rights of termination for material Pathway breach. Other defaults should be included.
3.4	Even if POCL accepts no termination rights on change of control, POCL would want notice and possibly consent rights over any change in shareholding. Lenders will likely insist on a change of control mechanism anyway.
4.2	Presumably guaranteed payment volumes should decrease commensurately with the partial termination?
5.1 (j)	In what circumstances could POCL be required to fund this amount in one go?
5.1 (iv)	This should be referenced as without prejudice to any security rights that POCL may have.
6.2 (i)	If POCL pays the equity and the forecast return, there is no equity risk. This is effectively a POCL guarantee of the whole project capital.
6.2 (ii)	It is inconsistent that POCL should bear the whole debt burden of Pathway default.
6.2 (iii)	Why is POCL paying the debt out on termination for Force Majeure?
7.1 (i)	This effectively gives Pathway unilateral rights to determine the project specification. Both parties should be required to agree to changes in the project spec.. Lenders may also require consultation rights if there is going to be an impact upon the funding requirement.
7.1 (ii)	This puts all change funding risk on POCL and should be resisted.
7.1 (iii)	If POCL is to take change in spec. risk, payments should be made against a pre-set milestone schedule, rather than being a one-off capital payment.
7.1 (iv)	i.e. POCL takes the risk in the end.
7.1 (v)	Operating risk should be with Pathway, not POCL, otherwise there is no incentive on Pathway to operate the system efficiently.
8.1	The Guidelines stipulate that change in law risk should be built in to the bid price. POCL should not take all change in law risk. Pathway is better placed to assess certain change in law risk e.g. IT change in law risk.
9.4	This is vague and needs to be clarified.
10.	See general comments on the Direct Agreement below.
11.1	see comments on lenders above (clause 1.3) If POCL refreshes in 2006, then its £100m investment will automatically form part of lenders' security over Pathway assets. POCL will need to ensure that the

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	refreshment assets are carved out from the banks' security net.
12.1	How about if a corrupt gift is provided with Pathway's connivance? This should be Pathway risk (c.f. 12.2)
17.1	It is understandable that the lenders may require credit enhancement upon a change in control or identity of the Authority (e.g. upon privatisation). However, the mechanism for achieving this should be addressed at the time and POCL should not be tied in to purchasing credit enhancement insurance at this stage.

4. ACCEPTANCE

Clause	Comment
General	Generally, the burden of delivering a product to an agreed specification should lie with the contractor and the client should have rights to accept or reject the system by measuring the performance of the system against pre-set performance benchmarks. An independent expert may also be involved in this process (in this case, the Expert). In addition, the lenders may also wish to appoint their own expert. POCL should not be obliged to accept the system and should be entitled to look to the contractor for compensation (LDs etc.) in the event that the performance of the system is unacceptable. Accordingly, we would not expect revenue payments to be made to Pathway until the system had been unequivocally accepted by POCL.
2.1	POCL should be involved in determining whether Acceptance is achieved or not, especially if termination rights cease on Acceptance. If termination rights do not arise on non-Acceptance, damages should certainly be payable. POCL should also have rights to determine whether the non-Acceptance justifies starting Live Trial. Are all costs incurred during the proposed extended Live Trial period to be funded from the contingency?
3.1 (i)	Presumably, POCL should retain rights to certify a Release.
4.1 (ii)	POCL should agree the identity of the Expert.

5. DIRECT AGREEMENT

Clause	Comment
General	<p>This looks like the Treasury standard Direct Agreement.</p> <p>In this document POCL acknowledges the banks' prior security interests and defers POCL's rights of termination during the Step-in Period. As soon as notice is given to the Agent, the Agent may procure that an official representative assumes all the contractor's rights under the contract and this marks the start of the Step-in Period.</p> <p>It is not unusual for banks to request a Direct Agreement to allow them to step-in in advance of any other interested party to try to preserve their position <i>vis-à-vis</i> the borrower (for example, by introducing a substitute contractor to complete the project so that the company can start generating revenue to repay the debt). It is</p>

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generally not in the banks' interests to see the project terminated as this deprives the project of revenue-generating capacity and means that the banks have to rely on, and enforce, their physical security, which may not be sufficient to discharge the outstanding debt.

However, as a negotiating point, POCL should not concede the requirement for a Direct Agreement with the banks until the whole commercial package (particularly the termination regime) is agreed, and only then if absolutely required.

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