POL00031181

POB(94) 49

POST OFFICE BOARD

AUTOMATION AT LONDON POST OFFICES

INTRODUCTION

1 This paper seeks Board authority for POCL to enter into an agreement with the Benefits Agency (BA) under which POCL will invest £12.5m (inc. £9.7m capital) to provide automation at 1478 London post offices. The BA will effectively fund over £7m of this by advance payments as well as paying an additional quarterly fee for the enhanced service. The new system will validate benefit payments to reduce fraud, but will also handle existing and future products for both BA and other clients as well as POCL's own accounting and administration requirements.

2 The proposal has a stand-alone return of 18%. MaPEC reviewed the case at an earlier stage of negotiation and confirmed that the project required Board approval because of its size and the need to set it in its strategic context. Since then further negotiations resulted in a deal based on differently phased figures which have been vetted by the MaPEC secretariat. The Committee is available to consider any detailed investment points on the afternoon immediately following the Board meeting, should the Board so require. This urgent process arises from the need to avoid the risks associated with delay (see para. 13) and because the Benefits Agency is keen to combat fraud at the earliest opportunity.

BACKGROUND

3 In the 1994-1999 Corporate Plan the Board indicated the importance of technology to Post Office Counters Ltd in securing improved service and efficiency for clients, and taking on new services. It said "the ideal would be to take the needs of the Benefits Agency (BA) as a starting point, and to identify a single commercially available terminal which could be used for other existing and potential clients".

4 In tandem with developing the long term relationship with BA aimed at automation of the full network, negotiations have been conducted with BA for automating benefit payments at all 1478 post offices in the area within the M25. This will secure significant savings for them by reducing "instruments of payment" fraud, which has a high concentration in this area. This provides POCL with a unique and early opportunity to realise the vision of an automated platform which is critical to the success of the commercial vision, with wide potential to deliver new services, and handle existing products, in a significant part of the network, with most of the outlay defrayed by the Benefits Agency. This opportunity, the subject of this request for authority, is consistent with the strategy, accelerates its achievement, and would parallel any likely subsequent platform until it was replaced in normal course. In the event of the national automated system being implemented under the terms of the Private Finance Initiative the equipment would be sold on to the private sector partner as part of the package.

THE PROPOSAL

5 The proposal will provide PC-based terminals with capabilities for bar-code and magnetic swipe card reading and capable of supporting other devices such as smart cards if required in future. These facilities will be installed in all offices within the M25 motorway, amounting to 7% of offices and 11% of serving positions, by August 1995. The proposal will also provide the communications and data distribution services required to support this outlet capability. These will be based on the existing IT facilities at Farnborough, upgraded to handle the additional workload. (The existing Tandem system at Farnborough will need replacing as a result of obsolescence during 1995/96. Options for this replacement will be evaluated at the time. This case includes £0.6m for replacement with new Tandem equipment, which is the lowest risk, but probably not the cheapest, option.) The system will support the development of new business and provide

opportunities to improve internal efficiency. Compliance with industry standards, using PC-based equipment which is widely used in retail guarantees this development's strategic fit with any future national system.

6 In addition to these strategic advantages, London is a potential market for development of new products with London-based clients; is a potential test bed for national clients; and benefits from high visibility with opinion formers which will help in shaping further development. Direct experience of running the system will put POCL in a stronger position to assess and negotiate with potential future private sector partners. None of the substantial strategic benefits in this and previous paragraphs have been quantified for inclusion in the financial evaluation of the project, for which a cautious stand-alone approach has been taken.

7 The main features of the offer negotiated with the BA are up-front payments for establishing the service, an annual fee for its operation, bonus payments for completion on-time or early and penalties for late delivery and failure to meet agreed service standards. Details are in Appendix 1. The incentives and penalties have been reviewed with IT and with external consultants and are considered to be in line with normal practice for this type of operation

8 In addition to income from BA, POCL will be able to make savings in capital expenditure on the Automated Payments project. (See Appendix 2 for a brief description of this and other applications.) Provided that this project meets the installation timetable in paragraph 5, the majority of the terminals to support bill and pre-payment which are due to be installed in London (with British Gas as the first client using them), would not be required, as their functions would be integrated into the new general purpose terminals being installed under this proposal.

9 There will be no change to manpower requirements in outlets and only minor changes in administrative staff, with a reduction of cash account error correction work equivalent to 3 or 4 full time posts at POCL's Chesterfield accounting centre by 1999 offset by increased help desk requirements at Farnborough.

10 After intensive, difficult negotiations, BA and POCL reached provisional heads of agreement, subject to internal approvals on both sides, on 10 August. A key source of friction in getting to this point was BA's concern about the level of return POCL would make from the project, given that Government departments need normally only satisfy a hurdle rate of 6%. BA have subsequently obtained Ministerial approval in the DSS.

TIMING ISSUES & RISKS

11 BA's original plan was to procure an automated stop list service for London on a competitive basis and they initiated EU/GATT procurement procedures in February 1994. In addition to PC-based options, they have considered systems using simpler technology similar to that used in the current Alert trial (see Appendix 2). Although this simpler technology could have been quicker to implement and cost the BA less, its only use would have been the validation of benefit payments. It would not have met longer term plans for benefit payment development, and would certainly have had no additional benefits or strategic value for POCL, its other clients or its agents.

12 In the course of negotiations, BA eventually agreed that the interim development in London be undertaken directly by POCL (as an addition to the current service contract for benefit payment at post offices), and be based on standard terminals and communications capable of a wide range of counter transactions. However, BA remain concerned about the speed with which POCL can deliver the system and thus address DSS Ministerial concern at the continuing encashment fraud level (currently £0.75m per week in the London area), which they are publicly committed to reducing.

13 Until the contract for Alert2 is signed, a risk remains that BA might revert to their earlier procurement options with unacceptable technical solutions. Delay in finalising the contract would lead to reopening negotiations on the provisional heads of agreement and forgoing the chance to avoid capital expenditure of £0.33m on automated payments terminals referred to in para. 8 above.

14 The financial aspects of this case have been reviewed by the MaPEC Secretariat and a Summary of Project Information is at Appendix 3.

CONCLUSIONS

15 There are two separate reasons for proceeding with this case:

1. Firstly, it provides a significant improvement in the service which Counters can provide to the Benefits Agency. The up-front payments and additional income from the BA will cover most of the costs of providing the system, and with the addition of some smaller, well defined, benefits the proposal exceeds the required return on this basis alone.

2. Although the project has a very small NPV it crucially secures the strategic infrastructure development the business needs at no overall net cost, and earlier than would otherwise be feasible. There are some downside risks (which arise from risk of delay and not achieving bonuses, and risk of higher than predicted costs for equipment) but these are offset by opportunities not included in the financial case to use the infrastructure to gain additional benefits, either as part of an eventual national system or by selling new services to London-based clients.

16 The alternative courses of action are not viable. Doing nothing would result in loss of credibility with POCL's largest client and put them in a poor position in the coming negotiations on the main BA contract. Alternative developments with BA-owned equipment and lower functionality are dead-ends which do not contribute to, and by diverting resources will actively hinder, the achievement of the Business' long term vision. By contrast, the development described in this paper constitutes a significant step towards providing the systems infrastructure needed to support that Commercial Vision and as such is commended to the Board.

17 The Board is invited to:

(i) Note that the project is consistent with, and will accelerate achievement of, POCL's strategy for automation at post offices.

(ii) Authorise POCL to enter into an agreement with the BA to provide the additional service described in this paper.

(iii) Approve, subject to the conditions laid down by MaPEC, the expenditure of £12.9m in a phased project. Of this sum, £12.16m is for the purchase and installation of counter terminals at the 1478 post offices within the M25, and for related software and communications. This means £8.95m capital, £2.63m non-recurring revenue and £0.58m DFE to be fully authorised. A further £0.58m, for replacing computer equipment at Farnborough during 1995/96, is to be authorised at the appropriate level when options have been evaluated

(iv) Note that this expenditure will be partly offset by receipts of £7.6m in advance income from BA who will also pay an additional fee of £1.8m per annum

WC
September 1994

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Appendix 1

Summary of Financial Benefits and Costs

1. The Current Benefits Agency Offer

Payments by BA to POCL
- £2m on signing BA/POCL agreement
- £2.2m when POCL awards main supply contract
- £1.4m when the first 100 offices are live (estimated 12 May 1995)
- £1m on 28 August 1995
- £0.4m each mid quarter from August 1995, increased in line with the RPI
- In addition BA will refund £2.1m VAT incurred by POCL.

Bonus Payments by BA to POCL
- Up to £0.6m for meeting and exceeding installation timescales

Penalties payable by POCL to BA
- £100 per office per week for delays beyond 9 October 1995, capped at £2m.
- £50 per 1% per office below 98% successful polling; £0.2m p.a. cap.
- £50 per 1% per office below 94% system availability, 96% from 1997/98; £0.2m p.a. cap.
- Refund against documentary evidence, of invalid payments due to improper use of the equipment; recoverable from agents, as with any losses due to negligence.

Force majeure clauses (including industrial action) to apply to all penalties.

2. Non-BA Benefits
- ECCO+ and APT Savings £1.7m
- Provision of ECCO+ functions to Agency Offices (on a voluntary basis) £0.4m

3. POCL Costs for the System
- PC-based terminals in post offices, one per counter position: Total cost £8.5m
- Cost of upgrade and new system at iT Farnborough: Total cost £1.2m
- Staff and related costs £0.6m
- Office modifications and installation costs £1.2m
- Software Development and related costs £0.4m
- Operating costs average £1.3m per annum

Appendix 2

Glossary of Systems Referred to in the Paper

ECCO+

This system is in use in the 670 largest directly managed post offices, of which 179 are in the London area covered by this proposal. It provides a terminal with a screen, keyboard with special keys for Counters' products, magnetic stripe card swipe and receipt printer at each counter service position. The terminals are used as electronic tills and all transactions are recorded on them. The system produces daily and/or weekly summaries for certain clients and prepares weekly cash accounts which are forwarded to the Chesterfield accounting centre. In some offices, the ECCO+ terminals also handle bill and pre-payment business, with an add-on unit for processing smart cards where clients require this.

APT

This Automated Payments Terminal is a custom-built terminal for the bill payment and pre-payment markets. It has a full alpha-numeric keyboard and a small liquid crystal display (similar to the displays on modern calculators) which can display 8 lines of up to 40 characters. The terminal includes a magnetic card reader and can also read and write to smart cards and recharge the smart keys used in some utility pre-payment meters. The terminals are connected to a phone line and transaction data is collected by telephone at the iT centre in Farnborough for consolidation and onwards transmission to Clients. The roll-out of APTs to 5000 offices is due to be completed by the end of March 1995. 405 of these offices are in the London area which is at the end of the roll-out programme.

Alert

This is a trial of a BA automated stop list currently in use at 180 post offices in North London. The equipment is leased by BA from a company, H-TEC, who own the design and are the sole suppliers. Each counter position has a bar-code reader and a box with coloured lights to indicate whether payment should be made after the bar-code on a benefit book has been scanned. This counter equipment is connected by cables to a PC in the back of the office which holds the stop list. H-TEC manage the updating of the stop lists by telephone from their computer centre in Southampton.

Alert2

This is the name used to denote the successor to Alert which is the subject of this paper. (For trademark reasons, the name may be changed). The function will be the same - comparing books against an automatic stop list using bar codes, but much more versatile and will subsume current ECCO+ and APT functions where these are already in place or planned. The office equipment will be based on PCs with a screen and customised keyboard similar to that used for ECCO+ and with the capability to add other devices such as printers and smart card readers as required. Unlike ECCO+, the equipment will have a high specification with the processor speed, memory and hard disk storage for reference data and transaction records needed to support future product developments and will follow all relevant industry standards, being interchangeable with similar equipment from many suppliers. The updating stop lists and collecting transaction data will be run by *i*T at their Farnborough centre.

Appendix 3

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SUMMARY OF PROJECT INFORMATION

GENERAL

Project Title: AUTOMATION AT LONDON POST OFFICES (ALPS) - PHASE 1
Project Sponsor RICHARD DYKES
Project Controller : PAUL HARRIS

FINANCIAL DATA		Constant £K	Outturn £K
Capital		8709	8951
Non-Recurring Revenue		2608	2632
Total Authorised Sum		11317	11583
Departure From Estimate		566	579
Maximum Authorised Expenditure		11883	12162
Sunk Costs:	Authorised		
	Unauthorised	176	176
Future Costs		558	575
SUM TO DETERMINE AUTHORITY LEVEL		12617	12913

FORECAST RESULTS

Net Present Value at 12%	- Pre Tax	£103k
	- Post Tax	(£350k)
Internal Rate of Return	- Pre Tax	17.7%
	- Post Tax	4.97%
Average ROCE		2.41%

EFFECTS ON TARGETS

	1994-95	1995-96	1996-97	Cum 6yrs
Pre Tax Profit £m	3.412	2.918	(1.476)	0.573
External Financing Limit £m	2.784	(5.564)	0.841	1.218

RISK ANALYSIS

Analysis indicates there is an 80% chance of a negative NPV at a 12% TDR and an 63% chance at an 8% TDR. This is partly because of the skewed nature of the risk distributions and the way these are treated in the risk analysis program. Nevertheless, there is undoubtedly a high risk of a negative return.

MANPOWER EFFECTS

There will be no change to manpower requirements

KEY TARGET DATES

Let Hardware Contract	January 1995
ALPS software user acceptance testing	March 1995
ECCO software user acceptance testing	March 1995
First office to go live	April 1995
Last office to go live	August 1995

OPTIONS

Only the proposed option has been presented in fully costed form in the financial Concurrence. This is because only one technical route satisfied both immediate client requirement and the strategic business development route. The only other option (apart from status quo) is the so called RAG option which involves the placing of special equipment used only for the Benefits Agency at each counter position. This option is currently being trialled. The option makes a zero or marginally negative NPV as it is paid for and owned by the Benefits Agency and uses up valuable counter space. It does not contribute to Counters long term strategy and has therefore been rejected.