

PM KOWIN Copy given to ... x m



Copy sent to ...
Henry Bush at
HMT at ...
request 12/12/97

RESTRICTED - POLICY MANAGEMENT & COMMERCIAL

David Sibbick
Director Posts
Room 3.18
Department of Trade & Industry
151 Buckingham Palace Road
LONDON
SW1W 9SS

Post Office Counters Ltd
Development Director

20 November 1997
54-35

Dear David,

RESPONSE TO YOUR REQUEST FOR BRIEFING ON HORIZON RELATED ISSUES

Further to Vanessa Leeson's letter of 13 November, and to our meeting last week, we agreed to your request to send you some further briefing on the subject of Automated Credit Transfer (ACT) and the impact of a compulsory approach by the DSS or HMT, together with a summary of the recent independent review by PA of Horizon. This note fulfils that request.

1. Automated Credit Transfer

No doubt you will recall that in 1992/93 a great deal of work was done by your department, the DSS and Treasury. We refreshed recently, as a contingency against the background of the BA/Pathway discussions, some of that original work and updated it in the context of the current environment. Obviously an important area was ACT and it became a stand alone Appendix to a wider confidential internal briefing report on Horizon. This report has only been circulated to senior Post Office Management. It concluded that Horizon remains central to POCL's business strategy.

I have attached that Appendix as Annex A in its entirety. I'm afraid it is quite bulky. However, the issue is complex and I thought you might find it helpful to have access to the detail as well as the summary included below.

Clearly this is both a difficult and sensitive issue. We have not discussed this review of ACT with the Benefits Agency, for obvious reasons, and would not be content for

/the

Post Office Counters Ltd
King Edward Building
King Edward Street
London
EC1A 1AA

Telephone **GRO**
Facsimile

Post Office Counters Ltd Registered in England
No: 2154540 Registered Office: King Edward Building
King Edward Street London EC1A 1AA

RESTRICTED - POLICY, MANAGEMENT & COMMERCIAL

- 2 -

David Sibbick

20 November 1997

the report to be circulated beyond the DTI at this stage. The numbers quoted are our best current estimates at this stage; absolute values are less important than the overall message, of course.

The key points are:

- ACT is perceived by BA as costing approximately 4p per transaction compared to around 40p for the current manual product. Part of this price differential is because banks do not pass on the cost of operating low average value accounts with high transaction frequency directly to customers or to BA as yet. There is a real possibility they may have to if banks were required to take on this type and scale of work (assuming they would agree to do so).
- DSS' own estimate from the work before was that some 30% of beneficiaries would remain with foils despite compulsion of ACT. We have no reason to adopt a different assumption at this stage (unless some form of social banking was imposed on the whole UK population).
- Steady state would take about 5 years to reach (again, a previous DSS assumption).
- There would be at least a 16% loss of total income to POCL from reduced BA fee income, and a further loss of 6% from volume related business, assuming no network closures with the possibility of a further, and uncontrolled, spiral of decline in volume thereafter (also see below).
- The Treasury case looks, prima facie, to be better than in 1992/93 at £130m pa at steady state only because BA would "avoid" Pathway charges of £127m pa. However, this assumes a subsidy to POCL of £288m pa to try to avoid network closures would have to be paid to sustain POCL's existence as the type of business as we currently understand it.
- Without a commitment to a very substantial subsidy POCL would probably need to close (not convert) 500 crown offices and a further 4500 SPSOs would also have to close due to considerable income, volume and footfall drop. There would be a further business loss of around 7% from these closures and POCL would still need a subsidy of over £200m pa. The network would have become unstable at this point, with both real and perceived loss of business for agents, and further closures seem to us inevitable in an uncontrolled spiral.

/Impact

RESTRICTED - POLICY, MANAGEMENT & COMMERCIAL

- 3 -

David Sibbick

20 November 1997

- Impact on Alliance and Leicester/Girobank would be considerable with nearly 75% of their corporate deposits business no longer needed (this would seriously undermine Girobank's profitability).
- Virtually all the political and socio economic difficulties scoped in 1992/93 remain relevant.
- POCL represents a significant part of the dynamics for cash distribution in the UK. You probably know that we turn over the equivalent of the whole coin value in the UK once each year across our counters. We have also played an important part in the distribution of special coin issues on several occasions. I would have thought it important, when EMU becomes a reality, that a network of automated post offices retains its critical reach strategically for the UK. Compulsory ACT would, effectively, rule out Horizon as we know it and lead to an uncontrolled series of office closures. There will also be an imbalance in the macro cash supply chain in the UK because of that.
- In addition, the uncontrolled closure of the network would forego any possibility of an automated network as part of a new 'connected' social infrastructure of the UK that could allow easy electronic access to all UK communities, for both the public, and potentially, the private sectors. We know these ideas are very much developing in Government's mind, and both the Post Office and ICL are very keen to play a full part in this.

We have also scoped the notion of accelerated voluntary ACT, through incentives etc, and the conclusion suggests this might well be a route that DSS/BA choose to take but the impact and financial return for them is likely to be modest.

Finally we took a view as to whether BA could realistically avoid the 30% "rump" of foil based beneficiaries. There are of course options but none will work effectively without an on line validation service at each position. There is a feeling of deja vu about this!

Our overall conclusion is that compulsory ACT remains as difficult a concept to implement now as in 1992/93 and would precipitate an inevitability of a spiral of decline in the post office network, and a heavily subsidised POCL.

I think a key difference from the last time this option was considered is that there are, this time, contracts now freely entered into (within the context of government policy)

/both

RESTRICTED - POLICY, MANAGEMENT & COMMERCIAL

- 4 -

David Sibbick

20 November 1997

both with ourselves, and with ICL Pathway, for a considerable period of time. These commitments should not be ignored lightly, and, I am certain that ICL Pathway at least would not be passive about walking away from them, and that subpostmasters and Post Office staff would be very aggrieved, given that they have been advised about the existence of these longer-term commitments.

2. Independent Review of Horizon

I also attach at Annex B a high-line view of the PA Report. Again, you will recall this is sensitive and we would not wish to release the report itself at this stage as it was commissioned by BA, ICL and ourselves with the express wish that the report should not be circulated further.

The key points to emerge were that the programme was likely to take longer and cost more than originally planned, bringing pain to all parties, because of its complexity and scale but that it was feasible, and less difficult to all parties than termination, or radical changes in scope.

Actions in train are strengthening of the programme's delivery and management and a review of some strategic options to consider if any are feasible or better than the current shape of the project. As I said, the report did state that POCL had not contributed significantly to delays to date and that we also needed to take steps to strengthen our resources to ensure that position continues, and teamwork more closely and 'formally' with ICL Pathway. These are in hand.

We are now seeking that our commitment to this programme, which is still central to our business strategy, is matched by all other parties involved.

I hope this is helpful. If either you, or Mike Whitehead, need any clarification, please let me know.

Yours sincerely

GRO

PAUL RICH

Copy: Vanessa Leeson
David Morphey
Stuart Sweetman

RESTRICTED - POLICY, MANAGEMENT & COMMERCIAL**Annex B: PA Review of 'Horizon'****1. Background**

- In September 1997, an independent and end-to-end (ie across all parties involved) review of the programme was commissioned by the joint Programme Steering Committee, on which the Chief Executive of the Benefits Agency (BA) and ICL, together with the Managing Director of POCL, sit. It was conducted by PA Consultancy Group, and results shared openly between all three commissioning organisations. The report is on a controlled distribution only, with subsequent action being undertaken sensitively at this stage.
- DTI officials requested a high-line summary of this study in November, and that is the purpose of this note.

2. PA's Overall Findings

- This is a world class programme of change, is highly complex, and a major business venture for each organisation.
- In this context, much has been achieved by all teams in highly demanding circumstances.
- However, the programme is over-ambitious against its initial timescales and costs...
- ...And it is still feasible - and likely to be the best forward option given the right commitment and actions being put in place by all parties, but there are 'strategic risks' that could threaten it and undermine delivery.

3. PA's overall conclusions

- The programme will not be ready to roll out nationally to post offices before the beginning of 1999.
- Pathway's original weekly national roll out rate of post offices could prove to be over-ambitious.
- Programme costs will increase as a result of delay, and there will also be foregone fraud savings and business opportunities.
- Actions need to be taken to strengthen delivery capability across the programme.
- Residual strategic risks remain requiring senior executive attention.
- Termination would cause major difficulties for all organisations.
- Root causes of delay to date revolve around the marginality of all parties' business cases (leading to questions about scope of network/functionality), the potential conflict in agendas between BA and POCL (given BA's ACT option), and structural problems associated with the PFI nature of contracts to Pathway (for example, matters concerned with ICL's cashflow, the reality of complete risk transfer, and the level of sponsor specification and assurance about supplier services/plans).
- Changes in BA's major internal feeder systems ("CAPS") timescales were subject to a different independent review at the end of 1997, and since action has been taken to baseline these plans better, though a major replanning exercise is now under way to align these with recent Pathway slippage. There is evidence of good steps taken by BA.
- POCL has not contributed to delays to date; however, it needs to build on the action in train to strengthen its resources both to help Pathway implement, and then take control of running Pathway services, to ensure future success.

RESTRICTED - POLICY, MANAGEMENT & COMMERCIAL

- The Programme Delivery Authority (a team set up jointly by the DSS and PO to manage Pathway with staff from both organisations under a Programme Director, resourced from DSS) needs to slim down and accelerate its intended migration back to sponsors.
- Pathway under-estimated the amount of development time involved and, made more complex by PFI arrangements, the clarification between requirements and assured solutions, there needs to be a continuation of strengthening of its resources to match its delivery ambitions, a recognition of its technical dependence on a small software supplier, and better control processes put in place.

4. Action taken since

- All parties have agreed to act upon the review, in two major streams:
 - detailed and urgent action plans have been put in place by all organisations to strengthen the programme, and shared between all parties. These cover many of PA's findings above.
 - a facilitated strategic workshop to tackle the issue around root causes and strategic risks involving the Programme Steering Committee members, was held in late October this was conducted in an open and positive way under 'Chatham House Rules'. From this, a number of options are being explored, with impact statements in each organisation commissioned around, for example, the place, scale and scope of roll out and accelerating the simplification of relationships between all parties. There are complex issues involved in all these and much cross-organisation work is in hand towards this, but the programme plan is continuing in parallel (c200 post offices are being equipped with a card payment release in November too, for example).

5. Next Steps

- Programme Steering Committee members will meet again on 8 December to review this exploratory work, against current plans and for the possibility of termination, before making recommendations on a way forward to Ministers/Boards.
- Within the Post Office, the Chief Executive (who personally runs a Counter Automation Steering Group with POEC members on Horizon anyway) and the PO Board are being kept closely advised of developments. There is a PO Board meeting on 9 December, and the Chief Executive is seeking a meeting with DTI Ministers on this matter following that. There are obvious connections to the Post Office Review process, as well as Social Security and 'PFI' policies, related to these issues.

POCL
17 November 1997

Scenario:

Complete Conversion of Benefit Agency Customers to ACT by 2004/05.

Note:

- This 'new' scenario, would certainly require primary legislation to require banks to provide the service. Presumably, a decision to exit from Horizon would be taken in parallel breaking the long term agreements in place.
- There would be a time lag effect between the legislation and its effect. It is estimated that getting legislation for complete ACT would take a number of years. Therefore, volume and income loss is low to begin with, large in the 3-5 year time frame and less rapid as the remaining customers without bank accounts are transferred in the final years.

Building on previous ACT work, in a scenario where all our BA traffic is lost the following major areas of POCL business are impacted.

- No BA volume or income at steady state
- No Giro Corporate deposits
- Severely reduced bill payment volumes
- Reduced lottery volumes due to reduced cash in hand in outlets
- Some reduction in Royal Mail work.

It is not difficult to see how this would quickly add to around 50-60% volume and income reduction.

The earlier assumption was that following closure of 500 crowns and 4,500 there would be a loss of 7% of total business from closures and 6% from lost foot fall/linked transactions. Clearly this scenario changes the scale of the cliff face - from Beachy Head to the Materhorn.

We would need to close all crowns in order to save overheads and, although there is bound to be considerable uncertainty of the size of the viable residual network, it would be unlikely to be more than 6,000 Post Offices in total. This then impacts further on foot fall and volumes and the viable network might decline further. Further network reductions would continue to reduce volume and hence viability.

There is no evidence to suggest any smaller subsidy being required (£200m per annum) even after the massive network closures. To sustain the network and avoid closures a reasonable estimate would be that the related income loss has now doubled (£125m→£250m) requiring a total subsidy of around £450m.

POCL estimate

(NB: the 2004/05 becomes the new "steady state" compared to our original assumption 30% residual 244m transactions and £242m income).

	<u>2001/02</u>	<u>2004/05</u>
<i>Current view with Horizon:</i>		
Volume:	674m	636m
Income:	£390m	£396m
<i>Compulsory ACT:</i>		
Volume:	235m	0
Income:	£111m	£0

Whilst the treasury case looks better with Horizon savings of £127m and £200m, BA savings to POCL (but replaced by ACT costs) the required subsidy has grown in excess of this.

Even if legislation was passed, it is difficult to envisage the banks charging ACT for the less attractive customers at the same rate as their current customer base. The banks would need to recover the costs of: i). running the accounts and issuing stationery and cards (£25 per customer per year?); and ii). the extra cash (circa £50bn per annum) for their own branches and ATM machines.

Have we misjudged the commercial value of ACT/Social Banking in this context?

Assuming the total market for payments currently is worth £60billion pa, the 80% share by 2001/2 predicted by BA would be worth £48billion. If 10% of this money was to remain in accounts for, say, ten days on average the interest benefit would be of the order of £9.6million pa.

Of course there are issues around the cost of making cash available and of transactions whether through ATMs or across a counter.

Dealing with the bottom 20%, if the money were even left for one night by ten percent of beneficiaries it would generate around £0.24 million pa. If one were to then link in a household budgeting concept, say accounting for 20% of a family's benefits, and arranged settlement with utilities after, say, 3 banking days there could be around £0.15million pa from this "rump" alone.

So from interest alone, £10m may be acruable to the provider of a social banking product. Of course different numbers are determined by different assumptions.

You see my point about us needing a new mind set in terms of seeing social banking as an overall financial service concept rather than a necessary evil? This is of course now with Dave Waltho, to whom I'm copying this note.

Answer to
Q on
S. Reel
paper.