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PRIME MINISTER

HORIZON (BA/POCL): MEETING WITH MR NARUTO

Issue

How to handle your meeting with Mr Naruto (Chairman of ICL and Vice Chair of Fujitsu) on Monday 12 April.

Recommendation

2. While not making any commitments at this stage, I believe you can give a positive message to Mr Naruto about the progress that has been made over the last few weeks and the prospects for a final decision by Ministers on the options in time for the Fujitsu board meeting on 23 April, provided progress can be made in resolving the key outstanding issues. I attach (Annex A) a speaking note. I also attach (Annex B) a more detailed note for your information, setting out the progress that has been made in detailed discussions with ICL, POCL and BA, the latest information on costings, the views of each of the parties, and the issues which need to be resolved in the next few days. As this note sets out, officials have successfully developed an alternative approach with ICL, BA and POCL. This would remove the complexity inherent in the existing contract and provide better incentives on the parties to deliver the project successfully. It would also provide a smartcard which would provide the vehicle for developing Modern

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Government services. Costings have fluctuated greatly in recent days, and remain indicative. Further work is being done to finalise them. However, on latest information the alternative approach would be considerably more expensive than the Benefit Payment Card. You should not therefore give Mr Naruto any assurance as to what the final decision by Ministers is likely to be.

Progress in developing the alternative option

3. Following Jeremy Heywood's letter of 1 March, officials led by Steve Robson (HMT) and involving BA and POCL have been taking forward negotiations with ICL to develop an alternative way forward for the BA/POCL project, given ICL's failure to perform on the existing contracts. Recent work has focussed on one particular option in which the Benefit Payment Card would be cancelled and POCL would provide simple benefit accounts into which benefits are paid via ACT and withdrawn in cash using a smartcard at post offices. ICL would deliver and operate the infrastructure required, making use of much of the existing Horizon technology, and would contract with a bank to administer the accounts. POCL's aspirations to become an agent for commercial banks in (e.g.) rural areas would be developed in parallel.

4. There is still some uncertainty over the allocation of risks between the parties and the need for POCL to obtain authorisation under the Banking Act. More particularly, there is great uncertainty over the costs. We are in the process of firming up the costs. At the moment, the gap between the Benefit Payment Card Option (Option A) and the preferred alternative (Option B1) is large and almost certainly unaffordable. However, the gap is largely based on two elements - the cost of the smartcard and the cost of managing the benefit accounts - and more

Charlie Falconer
refused to sign this note
because of this phrase.

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work will be carried out in the next few days to probe whether these costs are robust. It is important to recognise that the costings of this option are indicative at this stage, and indeed have been subject to enormous fluctuation over recent days as more detailed work has been undertaken. I will be in a better position to judge likely costs by the middle of next week, and will provide you with an updated recommendation then. More details on these issues is set out in Annex B.

Meeting with Fujitsu

5. In anticipation of your meeting with Mr Naruto on 12 April, the chairman of Fujitsu, Tadashi Sekizawa, has written to you (7 April) arguing that a firm decision on the way forward must be made by 23 April when the Fujitsu Board will meet to approve their consolidated group accounts. Fujitsu's preference would be to move ahead with the alternative option being developed by officials. Their position is that unless a legally binding agreement for the future of the project is in place by then, their accounts will need to show a provision of around £300m (the money they have so far spent on the Benefit Payment Card). The letter states that Fujitsu would not be prepared to make this provision and continue to underwrite the project, and so work on the project would stop. I judge that this is a real risk, and not simply a threat to force our hand.

6. Even if the work in the next few days (on costings in particular) shows the alternative approach to be the best option from the point of view of the public sector, reaching legally binding heads of agreement with ICL may not be achievable in the timescale demanded by Fujitsu. However the parties are working to draft non-binding heads of agreement by Monday 12 April for finalisation by 19 April. Provided it looks then as if we are at least close to converting this into



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a binding agreement, this should give Fujitsu sufficient comfort for their Board meeting on 23 April.

7. I suggest, therefore, that you use your meeting with Mr Naruto to provide him with the reassurance that we are close to a decision. You are of course aware of the sensitivity surrounding our negotiations with ICL, given the public sector's position that it is ICL who are responsible for the delays to the project, and that we have been exploring alternative options only because ICL have failed to deliver to schedule and are in breach of contract. It will be important that the positive message given to Fujitsu does not weaken the public sector's negotiating position at this late stage in the process.

8. I understand that you will be accompanied at the meeting by Steve Robson. Charlie Falconer would also be happy to attend if you thought that would be helpful.

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nted
etc.*

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9. Copies of this minute go to Alistair Darling, Stephen Byers and Charlie Falconer.

Your sincerely

Jacob Nell

p.p. / ALAN MILBURN
9 April 1999

*[approved by the Chief Secretary
and signed in his absence]*



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Annex A

SPEAKING NOTE: MEETING WITH NARUTO, CHAIRMAN OF ICL

Legal preamble:

- You will be aware that our conversation takes place in the context of contractual differences between ICL Pathway and the public sector parties.
- You will understand therefore that:
 - Our discussion must be without prejudice and confidential.
 - The public sector parties must reserve their rights and remedies under the existing contracts.

Substantive points:

- all parties have worked hard over the last month to develop and cost a more detailed specification for the alternative option identified during the discussions between Steve Robson and ICL;
- very grateful to ICL and Fujitsu for their co-operation in trying to find a way forward;



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- understand that the parties are working hard to reach draft heads of agreement on a version of this alternative option (known as B1). However there are a number of very important issues still to be resolved, and we have to be satisfied that the new option is affordable and offers best value for money for the public sector;
- very much hope that these issues can be resolved over the next few days, so that Ministers will be in a position to take a final decision between the options, and that if the decision is to proceed with the alternative approach that it will be possible to reach non-binding heads of agreement on the basis of this decision, in time for your Board meeting on 23 April.



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Annex B

**BA/POCL AUTOMATION: PROGRESS IN DEVELOPING THE
ALTERNATIVE OPTION**

The Prime Minister agreed (Jeremy Heywood's letter of 1 March) that the public sector parties - under the chairmanship of Steve Robson HMT - should be asked to take forward negotiations on the alternative way forward which emerged from Steve Robson's discussions with ICL in February (minute from us to you of 24 February).

2. These discussions were conducted on a without prejudice and confidential basis. ICL accepted that the public sector parties reserve their rights and remedies with respect to past breaches of contract by ICL Pathway. Both sides agreed that they would not take pre-emptive legal action against any other party while discussions are continuing.

What are the options?

3. The Option of continuing with the Benefit Payment Card is Option A. In the course of the discussions to draw up a technical specification of the alternative option (option B), two variants have emerged:

Option B1

- the Benefit Payment Card is cancelled;



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- if necessary POCL (or probably a specially-formed subsidiary) would seek authorisation under the Banking Act;
- POCL or its subsidiary would provide simple "benefit accounts" into which benefits were paid via ACT and withdrawn in cash using a smartcard at post offices;
- these accounts would not offer other conventional account services (e.g. transfer of credit from another account, withdrawal at ATMs) and would appear to the benefit recipient very similar to the benefit payment card;
- BA would transfer benefits to POCL via the BACs system - in the same way as is currently done for benefit recipients who receive payment by ACT;
- ICL would deliver and operate the infrastructure required, and would manage the smartcards, using the existing Horizon infrastructure;
- ICL would contract with a bank (e.g. Girobank) to administer the accounts;
- POCL's aspirations to become an agent for the banks ("network banking") would be developed in parallel, as under option A.

Option B2

- the Benefit Payment Card is cancelled;



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- POCL enters into partnership with at least one bank (their preference would be for this to be more). This should not require authorisation under the Banking Act;
- the banks would provide accounts into which benefits were paid via ACT and withdrawn in cash using a smartcard at post offices, and which would be capable of providing other simple services, eg other payments could be made into the accounts;
- BA would transfer benefits to these accounts via the BACs system;
- ICL would deliver and operate the infrastructure and could deliver the banking hub required, but given the involvement of the banks, would probably not manage the smartcards unless appropriate risk transfer arrangements are in place;
- POCL's aspirations to become an agent for the banks ("network banking") would be developed in parallel, as under option A.



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What is the overall impact on the public sector of the options?

£m NPV	option A	option B1	option B2
BA	1,123	1,630	1,547
payment to ICL (to deliver a loss of £126m NPV)	0	(393)	(439)
POCL	246	(209)	(414)
total NPV to public sector	1,369	1028	694

4. The overall NPV shown in the last row of the table assumes that ICL is recycled some of the savings in order to ensure that they would earn -£126m NPV over the life of the project under all options, as set out in their December 18 offer. The results show that the NPV of option A is the highest, followed by B1 (incremental cost relative to option A of £340m) and then B2 (incremental cost relative to option A of £680m).

5. The main reasons for the differences in costs are as follows:

- the specification of option B1 includes a smartcard rather than a magnetic stripe card as under option A. This accounts for around £75m;
- B1 and B2 include banking operation costs of some £250m (a large element of these costs will be subject to competitive tender).



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6. In addition, KPMG are carrying out sensitivity testing against the following:
 - uncertainties about costs - e.g. the price that a bank would charge for administration of the accounts; the costs of smartcards;
 - uncertainties about when network banking comes on stream, and about the speed of migration from "benefit accounts" to conventional bank accounts operated by POCL as an agent (a faster migration will worsen the financials for ICL but improve the financials for the public sector and vice versa);
 - recent difficulties with testing procedures in the current programme - which in BA's view may lead to a further delay to option A of 6 months;
 - failure by ICL and POCL to deliver option B1 to the timetable envisaged could delay BA's move to ACT, delaying administration savings;
7. There are also risks, some of which have not been quantified:
 - additional assumed universal banking fraud costs of up to £100m for both B1 and B2;
 - the figures assume that ICL bear the same NPV loss in both option A and option B - i.e. the loss they stated they were prepared to bear in their December 18 1998 offer (-£126m NPV). Although ICL have indicated they are content with this approach, this will require careful negotiation over the next week to make this stick;

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- the potential commercial difficulties for POCL of the migration from provider of benefit accounts to agent for banks under option B1.

What are the views of the parties about the options?

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- would prefer B1, since it would give them the same NPV loss as option A, but they would benefit from the reduced complexity of the contractual arrangements with the removal of BA from the contract.
- are not prepared to wait for B2 - would require some commitment before POCL signed agreements with the banks;
- are concerned about how the contractual boundaries would be drawn between themselves and the banking partners;

POCL

- prefer option A to either of the alternatives (B1 or B2). They are concerned at the higher costs, longer timetable and extra risks which Option B1 would bring them compared to Option A;
- In particular, POCL are concerned about taking on potential fraud risks associated with the benefit accounts, and would prefer to engage banking partners to bear this risk (i.e. a preference for Option B2 over B1);



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Which alternative option should be developed?

8. In view of the costings, the views of the parties and also the advice of the Government's advisers (PA Consulting and KPMG) that option B1 would be less costly and less risky than B2, officials agreed that option B1 should be the preferred alternative option on which to build. In any case, all parties have agreed that it would not be possible to work up option B2 in sufficient detail to be in a position to sign heads of agreement by the end of April.

9. Therefore the choice should focus on option B1 versus option A. There is of course, also the option of termination.

What other issues need to be resolved?

Allocation and management of fraud risks

- BA insist that fraud risks be transferred to POCL, in the same way that currently fraud risks associated with their benefit recipients who are paid by ACT is borne by the banks.
- further work is required to establish who will be bearing which fraud risks, and how they are managed.



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- in particular there is a difference of view between BA and ICL/POCL on the use of PINpads. ICL argue that this will be necessary if they are to bear card management risks, and the modelling assumes PINpads are installed. BA would like to be able to decide whether or not PINpads are used for customer service reasons. ICL argue that the removal of PINpads would require an additional payment to them of £50m p.a. (around £450m NPV - although this figure looks very large compared to the current levels of benefit fraud associated with paper-based systems of around £150m p.a.)

Dealing with the unbanked

- POCL are concerned about taking on the risk of the small percentage of people who are “unbankable”, and who pose a particularly high risk because they are proven or highly suspected of defrauding banks or other financial bodies.
- BA have accepted that this would be their responsibility. They have agreed to look at alternative means of paying them benefit (which may or may not involve POCL bank, but this would be at BA’s risk).



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Guarantees

- the current contract provides ICL with guaranteed transactions volumes. The modelling for this exercise has assumed that there are no guarantees. However it is likely that ICL will seek guaranteed volumes in the re-negotiation of the contract.

Authorisation of POCL

- option B1 may require POCL to obtain an authorisation under the Banking Act 1987
- authorisation raises difficult commercial issues for POCL, who do not view becoming a bank as part of their commercial strategy. However this will in part depend how POCL place the "benefit account" product in the market.
- there may be an issue for the Treasury about the establishment of a state owned bank. However we believe this can be addressed by limiting the use to which POCL puts its authorisation - i.e. making it clear that this is solely for the purpose of providing simple benefit accounts.

Funding of POCL.

- given that the cost to the public sector of option B1 will be borne largely by POCL (whereas under option A it is borne by BA), POCL are seeking reassurance about funding, in order to confirm they have a business case.



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- transitional funding for POCL (financed from the savings to DSS - there is no scope for DSS to provide transitional funding over and above this) is an important but somewhat separate issue from the overall NPV to the public sector, and this will need to be worked through. Transitional funding will need to be structured to incentivise ICL and POCL to deliver option B1 on time.

Business case for Smartcards

- smartcard technology is more expensive than magnetic stripe technology. This adds around £75m NPV to the costs of option B1 relative to option A.
- However use of a smartcard relative to the magnetic stripe benefit payment card will simplify the user authentication and fraud management approach of B1 relative to option A, and will open up the possibility for POCL (with ICL) to develop new applications for electronic government.
- There are risks to consider when assessing the additional costs of smartcards are justified:
 - smartcard technology is still at an early stage and there is uncertainty over what technology to use and the standard to adopt. The other side of the coin is that the launch of a nationwide system of the scale for B1 could set the standard for smartcards for the future



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- the useful life of the smartcard is suggested to be a maximum of 5 years. The use of smartcards for benefit payment alone will be insufficient for recovery of the investment in this timescale. The question is then whether POCL will be able to exploit the wider potential quickly enough, and the timescale for electronic government services.

Procurement risks

- if we move to option B1 there is a risk of challenge under EU procurement law, but this risk is not thought to be a show stopper.

Conclusion

10. Further work will be required to assess these risks and resolve the outstanding issues. But on the basis of the cost information we currently have, the Government will be faced at the end of next week with a difficult decision between continuing with the Benefit Payment Card (option A), moving to the alternative approach (option B1) or cancellation:

- the Benefit Payment Card (option A) remains the cheapest way of bringing automation to post office counters. However, the Benefits Agency continue to be firmly opposed to it, and the complex tripartite contractual arrangement would remain. There has already been a further 3 month delay since November, and further delays are a possibility with knock on effects on costs to the public sector;



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- the alternative option (B1), introduces new contractual relationships which provide better incentives for the parties to act together. POCL would contract directly with ICL, and BA will no longer be a party. This will simplify the decision-making process and therefore the project is more likely to be delivered successfully. It introduces a smartcard, which could provide the vehicle for developing Modern Government services (although we would need to decide whether the additional costs of the smartcard would be justified). And by providing simple accounts to all benefit recipients, Option B1 could provide a stepping stone towards the Government's social exclusion agenda. However, the additional cost is significant, and it would delay the introduction of automation in post offices. And POCL would prefer option A over option B1;
- the final option is to terminate the project altogether, and to find an alternative means of providing electronic payment of benefits and of automating post office counters. However, this is bound to lead to messy litigation with ICL and provide uncertainty for the post office network.