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BA/POCL AUTOMATION: PROGRESS REPORT

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Without Prejudice****BA/POCL AUTOMATION: PROGRESS REPORT****1. Background**

The BA/POCL automation project (known as "Horizon") has been under review since the contractor, ICL Pathway, was placed formally in breach of contract after a key contractual milestone was missed. The project is now over two years late. An inter-departmental report to Ministers (July 1988) and an HMT/No.10 Policy Unit report for the Chief Secretary (September 1988) considered the options for taking the objectives of the project forward. Following a Ministerial discussion, it was agreed that the parties to the contract would be given one month to establish whether a commercial basis acceptable to Government for proceeding with the contract could be found. At the same time fall-back options were prepared to provide a basis for judging whether the outcome of the negotiations offered the best value for money for the public sector as a whole. A report was presented to Ministers on this work on 23 October.

2. Following receipt of this report, the Chief Secretary wrote to ICL stating that he and his Ministerial colleagues were prepared to agree to their request for a period of two weeks for them to make progress in their discussions with the Post Office to develop a public/private partnership (letter to Keith Todd of 30 October). This was on condition that:

- non binding "Heads of Agreement" for the proposal, agreed with the Post Office, were received no later than Monday 9 November;
- the proposal was based on a realistic business case involving no explicit or implicit guarantees or commitments on the part of the public sector for future additional business;
- that ICL and the PO seriously considered the case for involving a third party with wider retail experience in the partnership - or otherwise demonstrated how the necessary skills would be acquired.

3. We have now received ICL/PO's proposal for the partnership, agreed with Post Office Counters. ICL have also provided 3 additional papers addressing commercial, contractual and financing issues. Ministers' must now decide:

- whether the partnership proposal meets the criteria set out in the CST's letter of 30 October;
- whether ICL's proposal on this and the wider deal represents sufficient movement to be a constructive basis for further (time-limited) discussions with

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the public sector;

- whether further discussions are likely to deliver a deal which represents value for money when compared to the fallback options, taking into account the risks and rewards of each option.
4. However before providing an assessment of ICL's proposals it is worth briefly revisiting the reasons why a decision on a way forward is urgently required.

2. Objectives of the Horizon project

5. Horizon was initiated in 1993 with the aim of:
- providing a more secure and efficient way of paying benefits;
 - providing DSS/BA with the means to account fully for their programme expenditure;
 - automating PO counters, to make current business more efficient and help them to win new business.

The project also had the indirect effect of helping to maintain the nationwide network by providing a secure revenue stream from POCL's biggest customer until the middle of the next decade.

6. Against the background of severe delays to the project (attributed to ICL Pathway) Ministers became very concerned that there was a serious risk that the Horizon project would fail to deliver its objectives - or would not do so in a timescale that would make it worthwhile to proceed.

7. These concerns have prompted a number of inter-departmental reviews of the project and possible alternative options. These reviews have provided an opportunity for Ministers to revisit and update the government's policy objectives for the Horizon project. The key goals might be:

- to pay social security benefits in a way that is as cheap, efficient, fraud free and convenient as possible, consistent with plans for welfare reform;
- to help to maintain a nationwide network of post offices in order to protect the accessibility of government services provided across PO counters;
- to support integrated delivery of existing and new government services and information more generally taking full advantage of new technology.

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streamlining Government's dealings with citizens;

- to improve access to basic financial services, including banking services, for poorer members of the community and the socially excluded;
- to maintain a thriving IT sector in the UK, in which ICL is a key player; while ensuring that risks transferred through PFI projects do not end up with the taxpayer; and
- against these objectives, to secure prudent use of taxpayers money.

8. Decisions on whether to proceed with the contract or to move into an endgame on the basis of ICL's failure to deliver need to be set in the context of these objectives.

3. Assessment of the ICL proposal

9. Under cover of Keith Todd's letter to Chief Secretary of 9 November, ICL submitted four papers. One meets the Chief Secretary's request for non-binding heads of agreement on a public/private partnership with POCL for further joint exploitation of Horizon, and is also signed by POCL, subject to agreement with ICL on the wider commercial issues left outstanding. The other three are from ICL alone.

10. The partnership heads of agreement, while giving no guarantees or commitments about levels of future business, envisage:

- a joint marketing executive to seek out and develop new business to be transacted over Horizon;
- a single tender arrangement with ICL for certain specified areas of work, subject to value for money and procurement considerations; and
- the possibility of involving a further partner with financial retail experience (although this has been taken no further at this stage).

11. The heads of agreement are, in the DTI and Post Office's view, a sensible way forward on which could be built a valuable partnership with ICL. We have no estimates yet of how much value might be added for either POCL or ICL (but see below on ICL's preparedness to accept a loss, which gives some indication of what they believe the partnership could be worth). Subject to HM Government consent and satisfying various legal, regulatory and contractual constraints, POCL and ICL would wish to work towards a binding agreement by the end of the year.

12. Taking the heads of agreement together with the other three papers, the proposal is an attempt by ICL to reduce its risk, making the project more secure and

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hence more attractive to sources of limited recourse finance. ICL have said that they will underwrite a loss of between £76-103m¹ NPV on the agreed core case volume assumptions. It hopes, through the further exploitation of the system with POCL, to recover some or all of this loss (though we have no figures). POCL believe that, on reasonable assumptions, ICL can expect to recover all of this and perhaps more on the back of their partnership agreement with POCL. A schematic diagram of the path of discussions so far (updating a diagram from Graham Corbett's report) is attached at Annex E.

13. Key components of ICL's proposal are:

- increased prices, and inflation risk transferred back to sponsors
- greater guaranteed volumes across the system
- a contingency fund which they suggest will incentivise the delivery of the project to timetable
- payments in advance, rather than in arrears
- a revised acceptance process
- revised contract terms which draw on recently published draft PFI Taskforce guidelines, and
- BA being no longer a party to the ICL contracts after acceptance.

14. A preliminary assessment of their proposal and its impact on the sponsors is attached at Annex A (prepared by POCL with assistance from BA). There is further work to be done on the detail of what ICL have suggested. But key concerns, which would be the agenda for any further negotiation are:

- the commercial terms proposed imply significant price increases and increases in guarantees above a level acceptable to the parties;
- the revised pricing proposals together with the proposed contingency fund would mean that the public sector would have to find an additional contribution. ICL's estimate is that this would be £121m NPV, with a contingency fund (financed by the sponsors) of £80m NPV. If the contingency is not used the sponsors would receive two thirds of this fund back through credit notes. If the contingency is used there may be countervailing reductions in payments due to delay. Further work is required to model the overall impact on the public sector. Any additional contribution would be over and above the £116m NPV implied by the Corbett proposal;
- the proposals on acceptance could lock the parties into a system before it had been fully tried and tested and would result in a significant reduction of

¹ Range depending on whether or not the proposed contingency is called

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POCL or BA's rights to termination;

- after acceptance, proposals to enable ICL to raise limited recourse financing could mean that the public sector underwriting all of ICL's borrowings; even after the offer of an additional £100m equity from ICL, this would be a significant transfer of risk to the public sector - to the extent that this could result in the project becoming an asset on POCL's balance sheet.

15. These proposals are clearly unacceptable to the public sector parties. However there are aspects of the proposal that we feel could be helpful if the project were to proceed - in particular the suggestion that the contract is restructured so that POCL take over BA's contracts with ICL.

16. DTI/POCL are of the view that ICL have moved significantly over the course of the fortnight's discussions and show signs being prepared to move further. They have settled for significantly less than originally stated aspirations of greater control on POCL's commercial future and single source supplier for all POCL's IT systems. They believe that there are reasonable grounds to believe that a deal could be reached through further negotiation. They think the gap could be closed by a combination of:

- movement by ICL recognising the benefits of the partnership proposal;
- further negotiation about commercial terms, with the possibility of some further value-added from POCL through an asset purchase (for which POCL will need a relaxation of their EFL);
- the injection of further direct funding into the project by ICL/Fujitsu.

17. DSS/BA do not agree. They do not think that ICL's proposals (particularly their suggestions on risk transfer) represent a sufficiently significant move on ICL's part to suggest that a commercial deal acceptable to Government could be struck.

18. The Treasury's view is that ICL have made a significant move, and are likely to move further, but a judgement on whether this is significant enough to give confidence that an acceptable deal could be struck is partly dependent on ICL's proposals on funding and underwriting by Government (on which we are seeking further clarification).

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4. Comparison of option 1 with the fallback options

Recap on the options

19. The impact of each option on the Benefits Agency and the Post Office are driven by the following key factors:

- the timing of the move to ACT - via the Benefit Payment Card (BPC) in option 1 and direct in options 2 and 3;
- the introduction of simple banking and full banking services at PO Counters;
- the rollout of the technology platform (whether Horizon or an alternative) for the automation of wider POCL services (for both existing and new PO clients);
- the end of the minimum floor payment from BA to the POCL.

Annex B sets out in graphical form the timings for each option.

Managing the changes to the PO network

20. The response of the Post Office under each option, and in particular how any changes to the network would be managed, will be an important factor in any decision on the way forward. There are differences of view between the parties on the ability of the Post Office to manage changes to the network under each scenario. Key issues will be:

- how to maximise POCL's existing customer base as benefit payment switches to ACT;
- how to maintain relations with existing clients who are looking to automation to improve services, and to ensure that POCL's credibility in winning new clients is not undermined;
- how to ensure that the subpostmasters (private agents who run the majority of the post office network) perceive that post office business can provide a viable future and do not voluntarily exit the market (reducing the ability of the PO to manage network closures and migrate business to other offices).

21. Under all options the Post Office will be seeking to manage a reshaping of the network, against a background of commitment to a nationwide network of post

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offices. Their objective is to retain the current levels of access, especially in rural areas, but to reduce over-provision in some urban and suburban areas, replacing some physical offices with electronic access points. Current trends would in any case see a reduction in the rural network by some 200 offices each year, and a gradual shift to ACT-based methods of payment over time (by 2009/10 almost 50% of claimants are expected to have switched to ACT). Compared to the current network of 19,000 offices, POCL believe that their vision for the future could be served by a network consisting of around 11,000 - 13,000 full service offices supplemented by 5,000-10,000 electronic access points, many of which could continue to be sited in existing post offices. In practice however we recognise that any network of the future will be constrained by the same combination of history and politics that has shaped today's network.

22. Under option 1 the benefit payment card (BPC) will provide the Post Office with a more secure customer base in the short term since claimants who do not choose ACT will continue to use the PO for withdrawal of their benefit. In the medium term (by 2004/5) the PO intend to use the Horizon platform to provide a range of banking services across its counters. POCL believe that the banks will see a commercial case for paying them to provide these services as they seek to reduce costs through closures of their branch network. Full banking services will be in place by the time BA will begin to transfer their customers to ACT on a compulsory basis. POCL are of the view that the transition from the BPC to a "smartcard" (providing banking and other services) will ensure that they maximise the number of benefit customers who continue to use the post office network. However DSS/BA believe that the Horizon project will in fact be further delayed, further squeezing the time between the introduction of the BPC and the switch to ACT; and will distract POCL from introducing banking services as quickly as possible potentially missing the emerging banking market.

23. Under option 2 the PO will need to move more quickly to introduce banking services across PO counters in order to be ready for the switch to ACT - so that they can protect their customer base by offering cash withdrawal facilities across PO counters. They will have two years to plan this (during which the current levels of DSS funding will be sustained). The removal of the BPC from the project would in principle mean that POCL (and ICL) can focus on the early roll-out of banking services and other systems essential for POCL to sustain their business. The consultants were of the view that it would be possible to provide banking services by 2001/2 when BA begins the transition to ACT, particularly if a basic cashback facility is introduced early. However the PO believe there are risks attached to this strategy - in particular the impact on the expectations of private agents of an announcement that the BPC is being scrapped. It is likely that subpostmasters will require compensation for the loss of retail business in order not to leave the market. They are also concerned that in practice the removal of the card will not allow a re-focus

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because work on the software development of the BPC is largely completed.

24. Under option 3 the PO will also need to move rapidly to introduce simple banking services to protect its customer base. We envisage that POCL would install simple debit terminals to provide a basic cash withdrawal service before the switch to compulsory ACT, and would follow with full banking services at a later date. The consultants believe that simple debit terminals could be installed relatively quickly, but have stated that there is a risk around the commercial credibility of this strategy. POCL would have to move from a situation where they were paying the banks (for debit terminal facilities) to a situation where they were receiving payments from the banks to provide full banking services. POCL would also need to commission an alternative platform to replace Horizon to provide automation of services for its other clients, and to provide it with a means of attracting new business. An announcement that Horizon was being scrapped, and the delay to the introduction of an automation platform (although not to simple banking services) could also impact on expectations and lead to unmanaged closures. Again, compensation to retain subpostmasters in the market is likely to be required. An alternative approach would be to delay the introduction of compulsory ACT until the replacement for Horizon with full banking facilities was in place. The price for reducing the risk to the network in this way would be the savings to the Benefits Agency foregone.

25. Under both option 2 and 3 POCL and BA would therefore need to work together to develop a positive and credible strategy which ensured that BA could move to a more efficient benefit payment system as soon as possible, whilst retaining the confidence of customers, PO clients and subpostmasters in the sustainability of the network. A pro-active approach to communicating this strategy will clearly help to mitigate the risks - although BA are more optimistic than POCL about this.

Risk analysis

26. Annex C presents an analysis of the risks to the government's key objectives for the project under each option. There are, inevitably, differences of view about the size of the risks and the ability of parties to manage them successfully. DSS/BA believe that the risks around deliverability of Horizon in option 1 are very significant given the history of the project, and that the risks to all of the objectives in section 2 could be minimised by focussing on getting simple banking technology into post offices as early as possible (option 2 or 3). DTI/POCL are of the view that option 1 offers the lowest risks because it offers POCL the earliest date for full automation and, by retaining benefit recipients in the PO system carries the least risk to the network and to subpostmaster confidence. Option 1 has been validated by independent experts who judged it to be technically viable, robust and future proof.

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27. The terms that ICL have offered imply a contribution of between £121m NPV plus a contingency of £80m from the public sector. Given that the Working Group Report (23 October) assumed a contribution of £150m NPV in option 1 and 2 then the VFM analysis broadly stands: i.e. that the options are very close, and that the assessment of risks across the options is therefore crucial.

Impacts on ICL

28. A full summary of the impact of all the options on ICL is attached at Annex D. Under all options ICL is likely to face a material write-off. Cancellation would jeopardise their plans for flotation.

5. The Way Forward

29. Our assessment of the choice facing Ministers is:

- to continue with the negotiations on the basis that the ICL proposal provides grounds for believing a commercial deal could be struck with substantial further movement from ICL and (possibly) more limited movement from the public sector, taking action to minimise the risk of future problems;
- to decide that the contract is unsustainable in its current form; that the gap between ICL and the public sector cannot be closed in a way that could be justified as value for money for the taxpayer (taking into account the wider risks); and that the balance of advantage lies in opening discussions with ICL to decide an alternative way forward. This could involve a negotiation around dropping the benefit payment card (option 2), and if that failed, a negotiated settlement around ICL's full withdrawal (option 3).

30. If Ministers decide to allow a further period for negotiation with ICL then next steps are as follows:

- respond to ICL setting out a period for further discussions - a period of around one month will be required to reach heads of agreement;
- assuming that further negotiations should be led by POCL, agree quickly a negotiating remit for POCL - including whether POCL should be given an EFL relaxation to make an offer to ICL;
- at the same time ask POCL and BA to reach heads of agreement to enable POCL to negotiate on a bipartite basis with ICL.

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POCL's proposals for the negotiation are attached at Annex F.

31. If Ministers decide the contract is unsustainable then the next steps are:
- to prepare for a negotiated settlement - which may involve option 2;
 - to prepare a public announcement/presentation to minimise the impact on benefit customers and the PO network (see Annex G for an indication of the questions that are likely to arise which the Government will need to be able to answer);
 - to ask BA/POCL to work up strategy for an early move to ACT consistent with minimising the impact on PO network.

ANNEX A

ANNEX - IMPLICATIONS OF ICL PATHWAY PROPOSALS FOR PUBLIC
SECTOR PARTIES - PRELIMINARY VIEW1. Overview

- This paper represents a preliminary view by BA and POCL of ICL's latest three proposals on Commercial and Contractual Issues, Acceptance, and Funding. Legal advice has been obtained, as well as some early assessment by PO's advisors on corporate finance, and by PO's external auditors.
- Overall, the proposals as they stand would be unacceptable as a complete package. However, there does appear to have been some movement by ICL and POCL (who will have to agree with Government how any costs/risks beyond the Corbett proposals are treated) believe this is enough, (c£76 to £103m NPV over the life of the project -depending on treatment of contingency), prima facie, for talks to continue between the parties. At the last Treasury Working Group it was confirmed that BA had already gone beyond their remit and had nothing further to offer.
- However there will also need to be some issues discussed between BA and POCL prior to engaging with ICL in the light of some of ICL's proposals - eg restructuring of the contracts for PAS and CMS with the associated changes in risks, liabilities and obligations that would bring.
- There are several key areas of difficulty to take forward and resolve with ICL. These are summarised below.

2. Funding Issues

- a) ICL's proposal effectively requires the public sector to underwrite all of its borrowings and in some circumstances the equity investment on the project, including in circumstances where the project falls through ICL's default.
- b) There does not appear to be any matching or increased commitments from ICL Pathway's parent companies. In addition, there appears to be extra transfer of existing parent company underwriting to the public sector either at "acceptance", or even earlier once contractual agreements are reached. ICL claim that this approach is in line with HM Treasury PFI Task Force Guidelines - but these are draft guidelines, and not necessarily fully applicable to IT projects.
- c) There are also new explicit direct relationships and implicit liabilities to ICL Pathway's lenders for the public sector being proposed.

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- d) The Post Office's own financial advisors have analysed the funding proposal and identified a number of areas of significant concern. These are summarised at Appendix 1.

3. Balance Sheet Issues

POCL's external auditors have advised that the current terms of the ICL proposal, in particular the high level of guarantees required and the intervention rights of their senior lenders, would probably result in the project having to be included as an asset on POCL's balance sheet. This could result in a net adverse position on POCL's profit and loss, though there will be offsetting liabilities. This would mean that the project would effectively no longer be a PFI.

4. Contract Restructuring Proposals

DSS accept the principle of contract restructuring (ie POCL take over the PAS and CMS contracts in addition to those they already have with ICL) provided the benefits payment service can be safe guarded, potential legal and policy issues can be overcome and there is no increased cost to BA and POCL accept the relevant liabilities and conditions. POCL would need a more detailed understanding not only of the liabilities it would be expected to take on (on behalf of ICL) but also its obligations to ICL on behalf of BA. This will need early discussion and agreement between BA and POCL, to clarify the risk transfer to POCL and the degree to which this is covered by ICL under the Corbett proposals. Timing of this, will be critical and POCL would not be willing to undertake this prior to BA's 'acceptance' of the system, including PAS and CMS.

5. Commercial Terms

a) Pricing

ICL are seeking a significant price rise through changes to discount structure and through introduction of an RPI-2% pricing formula to replace the contracted position of no RPI linkage up to 6% and price reductions of 3% per annum over the steady state period of the contract. This represents c£200m NPV improvement for ICL, of which £80m would be used to create a 'contingency fund'. If these contingencies do not have to be used, the public sector parties would receive 2/3 of this £80m fund back through credit notes

b) Guarantees

ICL are seeking an increase in guarantees to 80% of current business plus 90% of future POCL banking business. (Current guarantees are 65% of POCL business and an average of 65% of BA business as forecast in the Invitation to Tender.) In the discussion facilitated by Graham Corbett, both POCL and DSS

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indicated that they would be prepared to increase guarantees to 75% of the revenues from currently forecast volumes.

As POCL explained to Graham Corbett, it would not wish to provide a separate guarantee for banking business but would include banking in its overall guarantee. Higher guarantees than 75% of forecast volumes could also increase the likelihood of having to treat the project as a POCL asset.

6. Acceptance

ICL Pathway's proposals on Acceptance would mean that the Contracting Authorities would be locked into the system before it has been fully tried and tested. BA and POCL have already made a very significant concession on Acceptance as part of the Corbett proposal is in waiving their termination rights at Acceptance of NR2 which does not deliver the full contracted requirements. Both parties are not willing to bring forward acceptance before the end of the Live Trial. Both parties are prepared to consider a modest increase in the number of allowable faults but not in the magnitude being proposed by ICL.

ICL have also proposed the appointment of a named expert (Peter Copping from PA) to help resolve disputes on acceptance between the parties. BA and POCL are willing in principle to accept expert facilitation (though they do not necessarily yet accept the nominee proposed by ICL) but cannot agree that the expert has the right to make binding decisions on behalf of BA and POCL.

Acceptance is a very critical point in the whole programme and under ICL's proposals would result in significant reduction of POCL or BA's rights to termination thereafter. Acceptance is a serious issue to resolve properly.

7. Other Issues

There are a number of other issues related, for example to dealing with the "running sores" in the project (treated through price rise proposals), extra risk for BA around delays around the CAPS project, and cash flow and accounting rules in paying invoices in advance rather than in arrears, as contracted.

8. Future Business Opportunities

ICL have indicated that one enabler for their move has been an improvement in their perspective of the benefits to them of further exploitation of the Horizon system, without related public sector guarantees. This has been embodied in the Heads of Agreement on POCL/ICL Partnership, signed earlier this week (but which would lapse if agreement on the other issues detailed above is not reached). ICL reached their view in the light of POCL's feedback that in principle ICL has the technical capability to play such a role.

Comments on Funding Proposal

1. ICL's funding proposal seeks to raise non-recourse funding by POCL, in effect underwriting the funding required and taking on a substantial proportion of the risks of the project. This would release Fujitsu from standing behind the project.
2. While the conditions purportedly being laid down by lenders are not unreasonable from the point of view of lenders, it is still not certain that any lenders would be interested in funding Pathway.
3. There is no point in agreeing to any of the changes unless they actually bring about the funding - i.e. changes should not take effect (if at all) until funding is in place.
4. It follows that there may be limited use in agreeing to some but not all of the proposals.
5. The major issues of concern on the funding proposals (aside from other concerns on ICL's other commercial proposals) are:
 - ⇒ Acceptance: the proposal is that we should sign before acceptance. It is unlikely that any lender would lend before acceptance and we should not sign up to these changes before banks are on board.
 - ⇒ Compensation on Pathway default: we have to pay off their lenders even if they default. Although this is not an unusual clause to be required in circumstances such as this, the likelihood of Pathway default is higher than typical given their track-record and, therefore, the risk to POCL greater.
 - ⇒ Set-off: we are unable to set-off any liquidated damages owed for performance failure against any compensation to Pathway and/or their lenders. This is not normal.
 - ⇒ Fraud: fraud risk is transferred back to POCL. A primary aim of the PFI was to transfer fraud risk out of the public sector.
 - ⇒ Changes: all changes would have to be agreed by Pathway and POCL would have to pay for them, even if they were Pathway generated.
6. Secondary issues are:
 - ⇒ Pathway termination: Pathway can terminate for a minor breach by POCL and lenders would be repaid, but POCL may not afford to terminate for material breach by Pathway.

- ⇒ **Direct Agreement**: it is proposed to have a Direct Agreement between lenders and POCL. This is not unusual, but transfers funding risk to us. As written there is a risk that lenders could force us to terminate if the funding agreement between lenders and Pathway are terminated.
- ⇒ **Performance deductions**: it is proposed that deductions are capped. This could leave substantial cost with POCL in coping with persistent poor performance.

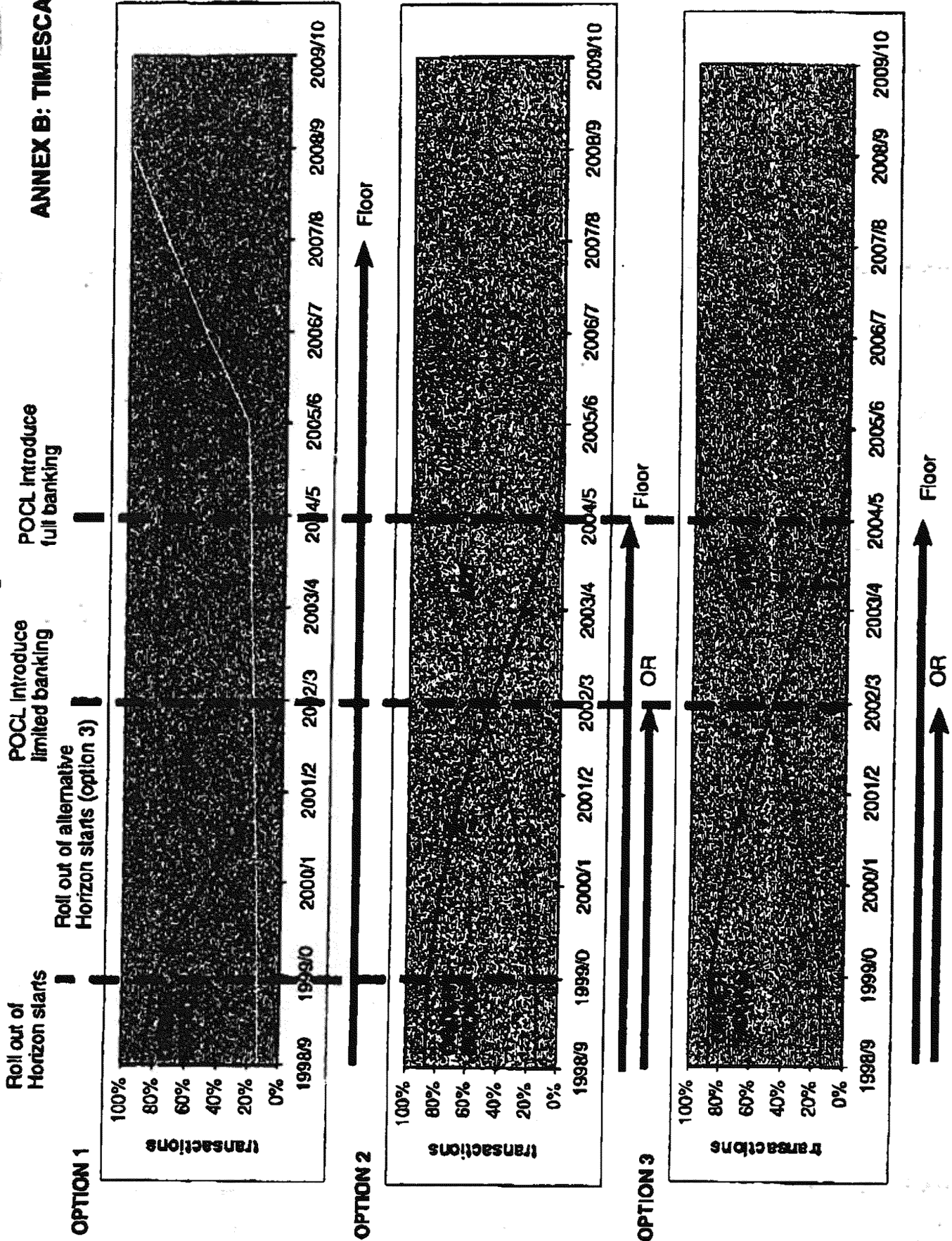
7. Other significant issues include:

- ⇒ **Compensation for termination for Authority default, force majeure for convenience**: The costs to POCL of termination are significant. Although it is not unusual for the contract to include compensation clauses the increased, exposure is substantial.
- ⇒ **Changes in Law**: POCL would take the risk of changes in law. Again, this is not unusual.
- ⇒ **Lenders' security**: the lender would have first security over the assets. This is not unusual, but could cut across our rights to buy (or use) the assets following termination.

8. The role of BA in standing behind any commitment we take on their behalf has not been cleared.
9. It needs to be recognised that Pathway already have third party lender liability of £200m.
10. From an accounting perspective, no significant risk has been transferred to ICL. It is, therefore, probable that the PO will need to recognise this as an asset with corresponding liabilities.

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ANNEX B: TIMESCALES



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ANNEX C: RISK ASSESSMENT

This annex presents an assessment of the risks surrounding each option against the key Government objectives:

- **Objective A:** efficient, secure and accessible benefit payment
- **Objective B:** maintenance of a nationwide network of post offices to protect the accessibility of post office services
- **Objective C:** improved delivery of existing and new services for government
- **Objective D:** improved access to banking services for the socially excluded

Annex D considers the implications for ICL and therefore the impact on the government's objectives for the IT sector.

If successfully implemented, then each option will contribute to these objectives as follows:

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	A	B	C	D
option 1	improves on present system and eliminates means of payment fraud, but delays move to (more efficient) ACT	provides PO with technology to retain existing and develop new business and secures customer base in shorter term through migrating to ACT via the BPC	provides platform for delivery of existing and new government services across PO Counters and could support initiatives such as "single account" and electronic government	allows PO to offer front end banking services providing accessibility through a trusted brand
option 2	early move to ACT delivers significant efficiency savings and eliminates payment fraud	as option 1 but reduced security of customer base due to loss of BPC and earlier move to ACT	as option 1 and removal of BPC would enable ICL and POCL to focus earlier on wider government services	earlier move to ACT brings "unbanked" into the banking system in advance of option 1
option 3	as option 2	as option 2 but delayed implementation of automation for existing and new (non-BA) clients	delayed implementation of non-banking technology platform means more likely that other channels are used for government services - without PO trusted brand and reach	as option 2

However there are risks attached to each option which may threaten the delivery of these objectives. The following tables attempt to present the potential risks around each option, how they could impact on these objectives, and how they will be

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managed by the relevant parties. There are, inevitably, differences of view about the size of these risks and the ability of parties to manage them successfully. DSS/BA believe that the risks around deliverability of Horizon in option 1 are very significant given the history of the project, and that the risks to all of the objectives above could be minimised by focussing on getting simple banking technology into post offices as early as possible (option 2 or 3). DTI/POCL are of the view that option 1 offers the lowest risks because it offers POCL the earliest date for full automation and carries the least risk of damaging subpostmaster confidence thereby reducing the threat to the network.

Option 1

Risk	A	B	C	D	Risk management strategy
BPC technology does not meet BA's requirements	✓				rigorous acceptance process
non-BPC technology does not meet PO's requirements		✓	✓	✓	rigorous acceptance process
Further delay to implementation	✓	✓	✓	✓	active project management; independent advice; common incentive structure to deliver to time
Incomplete roll out	✓	✓			common incentive structure to ensure no offices remain outside of Horizon
Lack of ICL commitment	✓	✓	✓	✓	realistic partnership arrangement between POCL and ICL with no fudges

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Option 3

Risk	A	B	C	D	risk management strategy
new technology does not meet PO's requirements		✓	✓	✓	rigorous acceptance process
Further delay to implementation		✓	✓	✓	active project management; independent advice; common incentive structure to deliver on time
100% migration to ACT delayed	✓			✓	BA plans changes to periodicity; publicity campaign
Delay to implementation of POCL banking	✓	✓		✓	POCL/ICL refocus efforts on banking requirements
negative reaction of subpostmasters and exit from postal market	✓	✓	✓	✓	presentational strategy for announcement; grant regime to incentivise subpostmasters; work closely with BA to co-ordinate timing of move to ACT
incompatibility of introducing interim banking solution and commercial strategy to introduce full banking solution	✓	✓		✓	POCL negotiate with banks a package including interim banking
banks react by charging BA customers	✓			✓	BA work with banks to reduce impact; PO introduce banking as soon as possible to reduce impact on bank branches

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This Annex reviews the implications of each option for ICL and its parent, Fujitsu. ICL Pathway have been set up as a subsidiary of ICL which has provided BA and POCL with parent company guarantees on finance and performance.

2. To recap, the ICL Group balance sheet is not strong. In 1997 it included net assets of around £260m. KPMG have confirmed with ICL Pathway that around £125m of this figure represented capitalisation of the work on this project, some fixed assets but mainly work in progress. We now think that this figure will have increased to around £200m. Liquidity had worsened from £105m of net current assets in 1996 to £42m in 1997. There is a possibility that ICL could strengthen its balance sheet by writing back some of the £200m goodwill written off according to existing accounting regulations that have subsequently been revised - but this is not mandatory. In any event this would do nothing to improve the Group's liquidity and net current asset position.
3. Profitability is also weak. On a like for like basis ICL made an operating profit of around £50m in 1996 compared to a ~~reduced~~ profit of around £35m in 1997, on a turnover of £2,477m in 1997. So the group is operating at pretty close to break even.
4. If the whole project was cancelled (option 3) Pathway would suffer a loss of around £250m. Assuming ICL stand behind Pathway, they will have to bear most of this. The implications for ICL are:
 - it would have to write off a good part of the £200m capitalised assets from the project unless the work in progress could be deployed on another similar project;
 - it would bear a loss at Pathway of £250m;
 - therefore reducing net assets of up to £450m and creating a situation of net liabilities of up to £200m before any write back of goodwill.
5. A write off of anything like this size would clearly be material. There seems little doubt that it would put at risk for many years any chance of a successful ICL flotation (planned for 2000).
6. In fact Pathway have not yet signed and filed their latest accounts - missing the end October deadline - pending the present discussions. A material write-off in the Pathway accounts could mean the ICL group having to re-file their accounts, although this is not clear cut. It could be argued that the ICL accounts were prepared on the basis of information that was true at the time - even though the adjustment is

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large it may not require a "prior year" adjustment. Either way this would be embarrassing for ICL's directors and auditors.

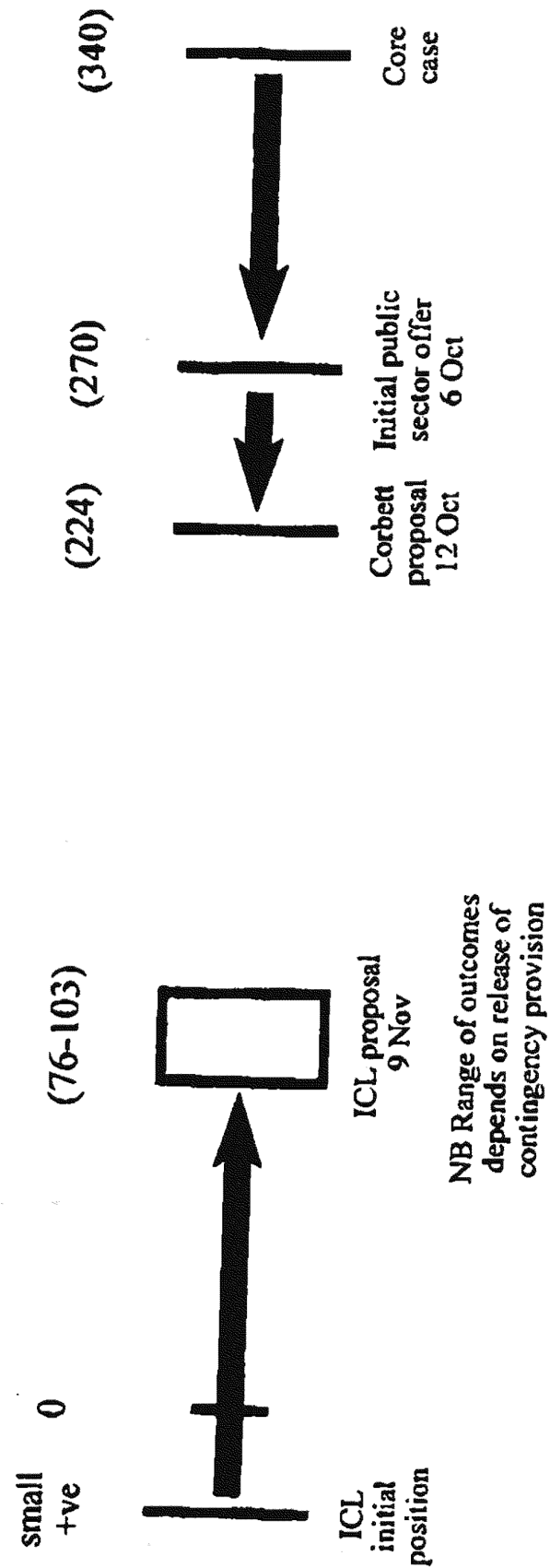
7. In these circumstances it might be possible in principle for ICL to simply wind Pathway up, leaving Pathway's creditors, rather than ICL, to foot the bill. However this is unlikely. ICL are more likely to seek guarantees or a significant injection of new capital for Fujitsu.
8. Cancellation would have limited financial implications for Fujitsu, since ICL represents only around 5 per cent of group shareholders' funds and 2 per cent of net current assets. However Fujitsu has underwritten a £200m loan facility to ICL Pathway, and Fujitsu itself had a bad year in 1997/8, with group profit after interest and taxes reducing from £254m in 1996/7 to £26m in 1997/8 due to economic problems in Japan and South East Asia. Given the current economic climate Fujitsu's attitude may well have hardened: it may well seek to divest itself of the company.
9. The implications of cancellation for employment within ICL will depend on whether Fujitsu decides to divest itself of the company. It is estimated that some 270 people at ICL Pathway are working on this project and many more at their contractors. ICL itself employs 2,700 people in the UK and a further 6,600 in Europe. However any IT staff released are likely to be quickly re-employed by competitors given skill shortages in the IT industry.
10. There is also a risk that cancellation might prejudice Fujitsu's attitude to future investment in the UK. Japan accounted for some 9.4 per cent of inward investment in to the UK in 1996. Despite the closure of their semi-conductor plant, Fujitsu remain the single largest Japanese investor in the UK and are highly sensitive to the outcome on Project Horizon. There is a serious risk that cancellation might prejudice not only Fujitsu's but other existing and potential investors' future investment in the UK.
11. Under option 1 and 2 ICL could still make large losses. Even a write-off of £50m would appear to be material (20% of net assets, 100% of annual profits).

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WITHOUT PREJUDICE ANNEX E

The path of the discussions (to 9 Nov)

Impact on ICL - £m NPV over whole project



ICL propose the sponsors would fund the £80m NPV contingency of which they would recover £52m if it wasn't required

ICL estimates except (270) and (340) which are HMT estimates extrapolated from Corbett report

ANNEX F

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BA/POCL AUTOMATION PROJECT

PROPOSALS FOR NEGOTIATIONS BETWEEN ICL AND POCL

before negotiations start

- BA and POCL to agree heads of agreement on the future contract terms etc between the two parties. The starting point for these will be the proposed agreement reached between BA and POCL under the Corbett negotiations
- these heads of agreement also to embrace issues on which joint agreement is required in response to the ICL proposals of 9 November. For example, POCL may be prepared to discuss with BA the early assumption of control of PAS and CMS if suitable terms could be agreed
- following agreement with BA, clear negotiating remit to be agreed with Government. The Post Office Board would also want to ensure that POCL's negotiating brief made sense commercially and protected its agreed shareholder returns

POCL/ICL negotiations

process

- the negotiations to be conducted directly and solely between POCL (with Post Office Executive Board involvement where appropriate) and ICL. The parties, at their sole discretion, would be free to involve specialist experts
- a senior Treasury official (Adrian Montague) to be available to act as a long-stop facilitator between the parties, but will not be part of the actual negotiations.

progress reporting

- POCL to report progress on negotiations to a Progress Tracking Group, the purpose of which will be:
 - to ensure the outcome of the negotiations is within the remit set by Government
 - to review progress of the negotiations in order to brief Ministers
 - to provide facilitation to the negotiations where requested
- membership of the Progress Tracking Group to be HMT (chair), DTL, DSS along with POCL

timetable

- by 20 November: (assuming Ministerial go-ahead) heads of agreement reached between BA and POCL [NB this assumes BA are unable to reach agreement with POCL before Ministerial decision to continue negotiations]
- by 20 November: Government agrees POCL negotiating remit and announces to ICL resumption of negotiations
- by 11 December: heads of agreement agreed. These to be turned into fully detailed and revised contracts as soon as possible thereafter.

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ANNEX G

LINES TO TAKE IF EITHER ICL OR HMG DECIDE TO TERMINATE HORIZON PROJECT

IF ICL TERMINATES

- Regret that ICL has felt unable to continue with the project despite the public sector parties' best efforts to agree revised terms with them.

WHAT WENT WRONG? (IF ICL TERMINATES)

- This large and complex IT project became subject to extensive delays and cost-overruns, and the contracting parties were unable to agree an acceptable commercial basis for continuing with it.

IF GOVERNMENT TERMINATES

- Despite the public sector's best efforts it has unfortunately not proved possible to reach agreement with ICL on commercial terms for continuing with the project.

WAY FORWARD NOW?

- The Government remains fully committed to the objectives of the Horizon project to provide:
 - the automation of the post office counters network, to match the ambitions we have for it to become a world beating model service; and
 - a simple safe way of delivering the £billions of taxpayers' money we pay out each year in benefit payments
- But the plans we inherited from our predecessors are not now the best way to achieve these objectives, given the delays that have now occurred in the project they devised.
- We believe there is now a better way forward, exploiting the best technology and expertise available to meet the ambitions this Government has to handle its dealings with people in a modern, convenient and streamlined way.
- In particular, we want to be able to take advantage of the best modern technology and look to solutions for the future.

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- Our vision for the future is that :
 - every post office will be automated, and will offer on-line banking services in association with the commercial banks as well its current range of services;
 - people will be able to collect their benefits in cash from post offices/shops / banks and a number of other outlets - whichever is the most convenient;
 - they will be able to do this because of the banking facilities that the Post Office will install on its counters; and because we will work with the banks to provide everyone with a bank account, if they do not already have one.
- We will be achieving this massive change, moving us away from an antiquated system of paying benefits which has been around since the 1940's, by building a partnership with the banks, the commercial world, the Post Office, Government and people.
- This approach will open up the prospects of the kind of Single Government Account signalled by the Prime Minister at the Labour Party Conference, to bring together in a simpler way the many transactions Government has with each individual citizen.

EFFECT ON POST OFFICES ?

- Post Office Counters will now need to consider urgently the options for securing a replacement for Horizon, [incorporating banking facilities] but in the meantime it will be business as usual for post offices up and down the country.
- The Government remains fully committed to the maintenance of a nationwide network of post offices providing good local access.
- Fully recognise importance of post offices to communities they serve and recognise the especially valuable role played by post offices in rural communities.

IMMEDIATE CONSEQUENCES FOR BENEFIT CUSTOMERS?

- Those customers who presently use payment card will see no interruption of their payments.
- Vast majority of 18 million benefit customers will be unaffected.

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COMPULSORY ACT?

- DSS will take steps to ensure that it gets the secure, convenient and cost effective method of paying benefits which its customers need.
- Benefit recipients are increasingly opting to receive their benefits through their bank accounts, but the Government will ensure that all benefit recipients who wish to do so can continue to collect their benefits in cash at post offices.

REPLACEMENT FOR HORIZON?

- Government remains committed to offering benefit customers a secure, convenient and cost effective method of benefits payment and automation of the post office counters network.
- Government accepts it is important to future of Post Office Counters that network has modern, automated on-line platform for handling present and future business.
- Disappointing to lose Horizon, but Post Office Counters will now need to quickly consider alternative options which will help it to provide the services which its clients and customers want.

RURAL NETWORK

- The vast majority of post offices are run by private individuals who operate the facility alongside a retail outlet.
- Management of the network is the responsibility of Post Office management who seek to ensure that services continue to be provided where possible. However, when a subpostmaster resigns or retires it is unfortunately not always possible to recruit a replacement.
- The Post Office must also be sensitive to changes in shopping habits and demographic trends.
- When the Post Office are unable to retain a full time facility in such areas they will seek to establish a part-time facility where possible.

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POST OFFICE REVIEW?

- We are committed to granting the Post Office greater commercial freedom within the public sector.
- Expect to announce conclusions of Review shortly.
- Post Office Counters has extended its product range into a number of new areas in recent years, which has proved popular with customers. Important that they continue to develop in ways which will help underpin the network which is valued by many people.

IS THIS ANOTHER PFI FAILURE?

- No. The Private Finance Initiative will continue to provide successful basis for public/private sector partnerships.
- Risks transferred under PFI to the private sector must not come back to public sector.

WHAT DOES FAILURE MEAN FOR ICL'S PLANNED FLOTATION/ITS FUTURE?

- Decisions concerning the future of ICL are a matter for ICL and its parent company, Fujitsu.

WHAT ARE IMPLICATIONS FOR INWARD INVESTMENT BY ICL'S PARENT COMPANY, FUJITSU?

- Each project needs to be considered on its own merits. The Government greatly values Fujitsu's investment in the UK.

D/II/Postal Services Directorate

16 November 1998