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RESTRICTED - POLICY & COMMERCIAL

1. PSC(OH) and MOS(L)

2. SoS

From: Peter Mathison BA CE
Date: 1 May 1996

cc: SoS (advance)
MOS(C)
PSC(RE)
PSC(AM)
Permanent Secretary
Mr Tross DCP
Mr Riggs BA
Mr McCorkell BA
Mr Bowen BAP
Mr Clark PFD2
Mr Stott BA/POCL
Mrs Dugdale BA/POCL

BA/POCL - SUPPLIER SELECTION AND BUSINESS CASE APPROVAL

Issue: Endorsement of the BA/POCL tender evaluation recommendation, agreement that the project should proceed, and submission to Treasury Ministers

Timing: Letter(s) to Treasury Ministers need to be despatched on Friday 3 May if planned announcement date is to be achieved

<u>Summary</u>

The evaluation of suppliers' tenders for the BA/POCL Programme has now completed and the recommendation has been endorsed by the Programme Steering Committee which I chair (paras 5-9). The recommended supplier's prices, together with consequential in-house costs, have been used to finalise the BA Business Case and this has been endorsed by relevant officials within the Department (para 10). BA and POCL have also concluded negotiation of the contract between them (Contract A) on terms which I consider acceptable.

3. I have considered (paras 11-18) the affordability of the project and despite a significant shortfall of available funding in 1998-99 <u>I recommend that it should proceed</u>.

4. I am accordingly recommending submission to Treasury Ministers for final approval. A draft letter for this purpose are attached.

5. Of course, All this is in the context that Ministers have previously indicated that there is no practical likelihood of

changing the policy of continuing to offer customers the option of collecting their benefit at the Post Office. It remains the case that compulsory ACT for those who already have bank accounts would make substantial savings in both running costs and fraud. An enormous amount of effort by our negotiators has been put into minimising the prices charged by POCL and the PFI supplier. Nevertheless continuing to use the Post Office to pay benefits, and making the investment in the systems needed to do so securely, still effectively commits what is already 25% of the Benefits Agency's budget for the next eight years - and constrains achievements possible under the Change Programme.

Evaluation

5. The Secretary of State is aware (Mr Stott's submissions of 1 March and 1 April, and oral briefing on 16 April) of the progress on the tenders from the three potential service providers. The detailed evaluation of the final tenders is complete, and this morning I chaired the Programme Steering Committee which unanimously endorsed the conclusion of the Evaluation Board.

6. The selected supplier undoubtedly offers the best value for money in terms of price, risk transfer and contractual certainty. The supplier will accept substantial liability for potential fraud in the new system and offers a unit transaction price which is fixed in money terms for rates of inflation up to 6% and which applies even if volumes fall by 25% (35% by the final year of the contract). We expect the Treasury to agree that this transfer of risk satisfies the criteria of the Private Finance Initiative. The proposed card system is judged acceptable to customers, and includes provision in the price to migrate to a simple smart card around the year 2000. The system in post offices has the advantage of better resilience and performance which should minimise the risk of adverse effects on customer service.

7. However the selected supplier's technical solution does involve an added element of technical risk; the PSC was confident that this, and the supplier's performance generally, could be managed effectively by the continuing joint project management arrangements which I have agreed with the Post Office.

8. In addition the supplier would only accept a small proportion (10%) of the revenue risk if Ministers decided at some time in the future to reduce the periodicity of benefit payments. We do not consider that it is unreasonable for the supplier to wish to be protected against his customer changing the law in a way which directly impacts his revenue without reducing the service obligations which drive his costs. However Ministers will wish to be aware that, as a result, potential savings from future periodicity changes will be affected.

9. Of the other two suppliers one was very close to the selected supplier on tendered price. However there was no significant transfer of key risks and the price was conditional on a number of significant adverse contractual obligations, leading to much poorer overall value for money. The third supplier was uncompetitive on price and had sought several contractual opportunities to pass future costs to BA and POCL.

Business Case

10. The business case, the detail of which has been extensively reviewed by the Department and has already been submitted to HMT, shows an excellent return on investment for this PFI project. With an overall NPV for DSS of £1006m including benefit savings over the 8 year contract, the business case presents a strong value for money position. By the later years of the contract it is expected that the administrative costs of the new payment system will be below current costs.

Affordability

11. In December 1995 we reported to the Secretary of State that net admin funding of £m 66/61/24 was available in the PES 95 settlement for BA/POCL and CAPS together - drawing not only on security & control programme provision but also on other provisions for accounting and other improvements. This compared then with estimated costs of £m 80/82/44 leaving a net funding shortfall of £m (14)/(21)/(21). At that stage Secretary of State was content to proceed with the next stage of the procurement on the basis that the shortfall in running costs in the early years could be managed through EYF (which HMT have indicated will be available for security and control projects) and that supplier prices were expected to fall as a result of competitive tendering.

12. However, as you know, the tenders are higher than expected - and in-house costs and savings have also been further refined. These give a net cost of £m 71/74/74 in the PES 95 period, leaving a net funding shortfall of £m (5)/(13)/(50).

13. I regard the net shortfall position in 1996-97 and 1997-98 as affordable, through the use of EYF and closer scrutiny of development and implementation costs, both in-house and of the supplier, which have at this stage a degree of contingency within them. However we would ask Ministers to bear in mind the need to contain costs when, as the project develops, we come forward with detailed proposals about aspects of implementation.

14. The position in 1998-99, with a potential shortfall of £50m, is obviously more serious. The system will have been substantially rolled out, at higher costs than expected, but not

DWP00000029

all the savings will have been carried through. There are additional risks about achieving all the expected staff savings at a time when staffing generally will be reducing sharply as a result of other activity in the change programme. Against this there are some potential opportunities for finding more savings or reducing costs. Although these cannot be relied upon to close a significant part of the gap, we do at least have time to take steps to manage the problem.

15. In addition commitment to the Benefit Payment Card project essentially fixes some 25% of the BA's budget through contractual commitments to POCL and the PFI supplier. This means that the rest of the Change Programme will have to find the required savings of 25% of the <u>total</u> budget from the remaining 75% of the base. This obviously compounds the magnitude of the task.

16. The shortfall on BA/POCL/CAPS in 1998-99 compounds the existing funding problem in that year. That problem will need to be addressed in any case and, as you know, we are working on this. Hence I conclude that the affordability issue does not outweigh the overwhelming overall business case for BA/POCL/CAPS in total public expenditure terms.

17. The Treasury are unlikely to allocate more running cost funding to allow BA/POCL to proceed - they have already signalled that, if you wish to proceed, they regard you as committed by the PES 95 settlement to finding the funding within existing allocations. The best we can do is to draw attention to the way in which funding this project increases the scale of the challenge we face. This may prove useful if we need to enter negotiations about funding the Change Programme at a later stage.

18. With the selected supplier there is the option of introducing an interim scheme of barcoding on order books beyond the existing system in the London area. This would require extra running costs of £m 2/15/8, would give no running cost savings, but would give additional programme savings of £m 3/48/2. This measure is not needed to achieve the overall level of payment fraud programme savings to which you are committed in the PES period (which latest projections suggest you will over-achieve by £30 million) and would only make an existing running cost shortfall worse. However the Treasury have indicated that, in slower time and separately from the main project approval, they would consider a spend to save case for this; a marker is left for this in the draft letter to the Chief Secretary.

<u>Next Steps</u>

19. If SoS is content, the next (and final) action in the approval process is to seek the agreement of Treasury colleagues to the award of contract. A draft letter to the CST is attached

DWP00000029

for consideration. This reflects the conclusions reached above regarding the business case and affordability questions.

20. Once Treasury agreement is secured, the planned announcement process can commenced. Arrangements for this - PQ, NFSP speech etc - have been discussed separately. It is suggested that you write to No 10, copied to Cabinet colleagues advising that a decision has been reached and of your proposals for making the announcement. A draft text will follow once the Treasury response is received.

(approved by Mr Mathison and signed in his absence)

P. Mathison
BA Chief Executive

DWP00000029

Draft Letter to the Chief Secretary

AUTOMATION OF BENEFIT PAYMENTS THROUGH POST OFFICES.

We discussed this project with colleagues in February. I am now pleased to seek your approval to enter into a contractual agreement with a chosen supplier. I believe that the deal on offer provides excellent value for money for the taxpayer and transfers the bulk of risks into the private sector under the PFI. The costs add considerably to my constraints and difficulties in managing threats to programme expenditure within the PES 95 settlement. I am however prepared to take on that challenge.

Value for money

Your officials have recently received a copy of the business case. This incorporates the final costs of the supplier chosen by an exhaustive procurement process. The overall public sector business case including fraud savings is excellent with an NPV of £1006m over the contract lifetime. The fraud savings over the PES 95 period are higher overall - £m 49.3/63.3/179.7 compared to £m 50/81.8/131.

The project should meet its other objective by delivering small net operational savings at the end of the contract period compared to existing costs. This takes no account of the benefits from proper accounting and better forecasting that the programme will deliver overall.

Risk Transfer

The preferred supplier has agreed under the deal to accept the vast majority of fraud risk from the payments system subject to an overall ceiling of £200m over the contract. This includes all the risk of card interception before it reaches the claimant and all the risks of failing to stop a payment once card loss or theft is reported. These represent the vast majority of instrument of payment fraud amounting to £196.4m. For the residual risks (estimated at less than £8m a year) not transferred we have, for the first time, secured POCL's agreement to take a meaningful share.

The supplier's prices are fixed in money terms for any rate of RPI inflation up to 6%. (Any price increases beyond this will be shared).

The Supplier will accept most of the practical risk in benefit volumes - volumes can fall by 25% (35% by the final year of the contract) before unit prices rise. However, the Supplier could not take the specific political risk that at some stage in the future, we reduce the periodicity of benefit payments: most of his costs are fixed and he cannot control or predict such a legislative change. Accordingly the Supplier will only take 10% of this risk.

He will also accept liability for commissioning risk, either for late delivery or poor performance. Of course, despite our high level of technical confidence in the supplier solution and the detailed milestones built into the contract, we cannot exclude entirely the prospect that the supplier might simply never deliver. But I am satisfied that our exposure is quite different to that under NIRS2 when we faced a legislative deadline. We have an existing, albeit unsatisfactory, payments system on which to fall back.

Overall, I am sure that the risk transfer represents the optimum to achieve maximum value for money under the PFI.

Affordability

The costs of the Project now reflects the Supplier's assessment of full risk transfer. They are higher overall than we assumed either when funding was originally agreed for the security and control programme in PES '94 or when we looked again at the affordability question in February.

I am happy to say that the Project has been able to identify some further savings partially to offset this and, on the basis that EYF is available in the Security and Control Programme, I will be able to manage this in 1996-97 and 1997-98. But the net position still leaves me needing to find around £50 million for 1998-99 over and above the sums in the security and control package. That shortfall adds considerably to the difficulties I already face in meeting the PES '95 settlement for that year through Change Programme savings. The contractual commitment further constrains my ability to make savings on some 25% of my total running costs for the future compounding the pressure elsewhere. As you know, I am already working on these funding difficulties; delaying the Benefit Payment Card would do nothing to resolve the difficulties and would cause significant and achieveable fraud savings to be foregone.

Further Savings Option

The business case also covers an option to seek extra services from the Supplier to generate additional fraud savings from an interim extension of the bar coding system. Costs £1.2/14.5/7.4m, savings £3.2/48/2.2m. I believe that this would represent value for money but I cannot afford the costs from

DWP00000029

current provision. We have a month or so to decide whether to take up this option and I suggest our officials discuss it further.

Timing

I strongly commend this project as a major step forward to combat fraud in a way which gives excellent value for money. I would be grateful for a response during next week, in line with the timetable agreed at our meeting with the Chancellor, in order that I can let other colleagues know of our plans and can manage publicity effectively by an announcement at the conference of the National Federation of Sub Postmasters.

PJL

DWP00000029

POCL (EX VAT) 2.00 1/5/96 £m. MN.

	96/97	97/8	98/9	9/0	
WITH OBCS					
COSTS	15	63	143.	153	
ADMIN SAVINGS	(2)	(26)	(117)	~~(167)~~	Adjusted for rollout)
	13	37	26.		
Inflation 3%	-	2	2		
	13	39	28		

	96/97	97/8	98/9	
WITHOUT OBCS				
COSTS	14	49	186.	
ADMIN SAVINGS.	(2)	(26)	(117)	As above
	12	23	19	
Inflation 3%	-	1	2	
	12	24	21.	

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DWP00000029

Peter Brooke

This morning is fully consumed by selecting the best tenderer.

This late morning/afternoon Peter M, George, Andrew Rod C, Stuart Riley, Derek B & I will be stationed at Terminal House finalising

the submission to Ministers & satisfying ourselves that we have a row of beans

It would be immensely helpful if you could liaise this am with Mike Newton, Paul Greening & Gary Hall + CAPS ~~[illegible]~~ + Stuart Riley to

ensure ① (a) what admin funding (gross ~~& net~~) provisions
(b) what savings expectations

there are in the PES 95 period & one more year under the SCP (ie the third year of PES 96)
~~[illegible]~~ (Obviously this must reconcile to the aggregate funds provisions, leaving enough for the SCP other activities)

and ② that Stuart's latest "DCC" calculations fully allow for

BA/POCL
CAPS/PAGL
ESNS (including ITSA costs
OBCS ~~[illegible]~~ including costs of ITSA)

Fiona.

So that ① and ② are on a like for like basis with DB(96)1 Annex faxed yesterday

7.00 AM
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DWP00000029

Peter

A key issue is whether we expect the net effect of ~~this~~ BA/POCL/CAPS to save about £45m in districts each year = £300,000 each net. What % on is this? What do SRG think? DMC?

8 from
5 LH.
61. outturn
~~8~~4.

! 30m re rollout
not 20.

Thanks.

GRO

1/5

PLEASE ALSO ASK MIKE TO HAVE AVAILABLE TO FAX TO ME THE EARLIER (PRE TENDER) BUSINESS CASE SUMMARIES SO WE CAN WORK OUT WHAT HAS CHANGED

TENDERS UP, SAVINGS UP
BA COSTS UP etc

PES '95	96/97	97/98	98/99	99/00
	£m	£m	£m	£m
CAPS.		27.464	15.474	15.383
	62.465			
POCL.		62.864	111.367.	118.491

PES '96	96/97	97/98	98/99	99/00
✱ CAPS	61.75	59.572	60.386	41.036.
(BC) Issue.	57	59.5.	60.3	41.0.
POCL	16.18	65.377	147.928	152.607
~~BC 2.4~~	~~16.4~~	~~73.1~~	~~135.2~~	~~100.8~~
~~20.7~~	~~26.6~~	~~61.6~~	~~130.6~~	~~137.4~~
✱. Phase. 0 Accounts	—			
1 CB	3.0	—		
2 Follow-CB	6.6	—		
3 PSCS	8.1	—		
4 FC/DNA.	5.0			
5 DLA.	5.8			
6 FC/DNA.	1.7			
7 Re Ten.	—	1.7		
8 NJSA.	7.5	10.7	0.5	
9 SF.	2.3	10.2	3.8	.8
10SF.		.8	.5.	
Support Manh.	16.7	34.6	55.4	40.11.
	56.7	58	60.2	41.

DWP00000029