Rt. Hon Stephen Byers MP
Chief Secretary
HM Treasury
Parliament Street
LONDON SW1P 3AG

20 October, 1998

ICL

Dear Chief Secretary,

Thank you for your letters of 19 October and 20 October. I am sorry that you were unable to meet me today but I am well aware of the pressures on a Cabinet Minister's diary. This reply to your letter includes the points that I would have made if it had been possible for us to meet and which I have made to Mr Corbett, as you suggested.

I am sure that you have received many documents about the Horizon project and I hesitated before inflicting more on you. But I have a duty to my shareholders and to you to ensure that ICL's position is correctly understood by you and your Ministerial colleagues. It may well be that our position has been most fully and accurately recorded in Mr Corbett's report; but, as I have not seen it, I cannot assure my shareholders that such is the case. I am therefore sending you with this letter the enclosed statement of ICL's position - see Annex.

May I call your attention in particular to paragraphs 3 and 8 of the Annex which list the concessions that we have made in these negotiations so far. It is simply not true that POCL and BA have made concessions and that ICL "has not felt able to respond in a positive way".

Paragraph 10 of the Annex sets out the reasons why this project has run into such difficulties. In brief, the reasons are the detailed interference in the design work by the sponsors (in a manner quite inconsistent with a PFI contract); the fact that the BA decided to stop using the card; the delays in the BA's CAPS project; and POCL's lack of commercial drive.

So far as the last point is concerned, our view is shared within Government. For example, the report of the Government's independent panel last July said that, if the benefits of a restructured

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programme were to be achieved, "the programme would need to be driven much harder and more professionally than so far".

Personally, I deplore the confrontational turn that these negotiations have taken. I believe that the Horizon system has immense potential for the benefit of not only the Post Office and HMG, but also the citizen and taxpayer. Post Office Counters owns a unique network of direct contacts with every sector of society including the socially excluded. With vigorous commercial management this unique facility could realise its full potential.

Looking through the spreadsheets which have been the basis for the discussions to date, I am struck by the pessimism of the projections for the future volume of POCL's business which they incorporate. Such pessimistic projections would not be accepted by any commercial board of directors. If they were changed to those that one would expect to see in the business case of a commercial enterprise, the outlook for Post Office Counters would be transformed. The potential £200 million gap thrown up by the current business model would become irrelevant.

I would like to clear up a potential misunderstanding. The ICL position appears to have been interpreted by the Government as an absolute requirement for ICL to earn a positive return on the base cash flows for the project. That is not the case. However, for ICL to be able to proceed with a base case showing less than a positive return, there needs to be a prospect of our being able to recover our position later on. A solution to this problem will therefore be conditional on the introduction of commercial management in POCL.

I am troubled by the fact that there is no business case agreed between ICL, POCL, the BA and the Treasury based on figures in which all can have confidence. It would be very helpful if the Government would appoint an adviser who has the confidence of all the relevant public sector entities and can work with our financial advisers, SG Hambros, to produce an agreed business case for POCL and Pathway, taking account of all the potential new businesses.

So far as the need for greater commercial drive by POCL's management is concerned, I believe that the way forward is to put in place an innovative Public Private Partnership which unites the public service traditions of the Post Office with the commercial flair of the private sector.

I have been working on a number of ideas with my colleagues. One possibility is for ICL to take a minority equity stake in POCL, thus forming a joint venture between POCL and ICL . This would align the interests of the parties in the commercialisation of the Pathway system. Another would be to introduce into such a joint venture, as a further equity holder, a company with a record of success in the retail distribution of financial services.

If we can get the management of POCL on to a truly commercial basis, I am confident that we shall be able to plan a way forward that would be acceptable to both HMG and ICL. In order to achieve agreement, I am certainly prepared to negotiate about the distribution of the benefits. Even though the Post Office has declined to take our suggestion of an equity participation in Pathway, I would still be prepared to consider sharing with the Post Office some of Pathway's potential upside.

I hope that at your meeting with Ministerial colleagues you will agree to appoint a single negotiator authorised to act for all the relevant public sector entities. One possibility would be a senior official of the DTI (as the Department responsible for the Post Office) supported by the Chief Executive of the Post Office, John Roberts .

May I repeat my request to meet you and your Ministerial colleagues in order to discuss these ideas and any suggestions for a constructive outcome to these negotiations that you might wish to put to me?

I am sending copies of this letter to the Secretary of State for Social Security and the Secretary of State for Trade and Industry.

GRO

KEITH TODD

ANNEX

STRICTLY PRIVATE AND CONFIDENTIAL AND WITHOUT PREJUDICE

ICL RESPONSE TO THE POINTS MADE IN THE LETTER OF 19 OCTOBER FROM THE CHIEF SECRETARY TO THE TREASURY

(1) ICL has not seen Mr Graham Corbett's report of the discussions between ICL, POCL, DSS and BA about the BA/POCL Automation Project PFI contract. Therefore the responses contained below are based on the points raised by the Chief Secretary in his letter of 19 October.

(2) ICL notes the Chief Secretary's disappointment that the discussions have failed to produce an agreed way forward. ICL acutely shares this sense of disappointment but does not accept that ICL has "not felt able to respond in a positive way" to the proposals which were presented to us during the Corbett process.

(3) We have been positive throughout. It was ICL - 15 months ago - who drew the Government's attention to the serious problems arising out of the way this PFI contract was being handled. We co-sponsored the independent report from PA Consulting which resulted in the abolition of the 150 strong PDA. When it was clear that matters still had not improved we encouraged the creation of the PFI review panel.

Throughout this period we have continued to work at risk on the project at a cost of £10 million per month. During this period of uncertainty ICL's investment has doubled to £250 million and still, today, we do not have full recognition of the genuine difficulties caused by the Sponsors. What is more - we have produced a system which works, which is popular with POCL staff and sub-postmasters and is recognised as a leader in its field.

(4) During this period we have remained silent in the face of repeated attacks on our reputation in the media - which could only have reflected briefing by "sources" in the public sector. Despite this, we have sought continuously to work in partnership with the Sponsors.

(5) We remain committed to the project and have been prepared to consider innovative ways of resolving the current difficulties. ICL regrets the fact that the Chief Secretary's letter makes no references to the proposals which we have put forward, such as, for example, the possibility of developing a nationwide system for delivering more efficient Government services and for providing a genuine commercial return from POCL's unique network.

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(6) Furthermore, ICL has made a number of proposals with regard to POCL as a commercial entity. We have suggested that one way of overcoming the residual commercial issues would be for POCL to become a shareholder in ICL Pathway and thus work with us to develop a more favourable business case.

(7) ICL considers that it would be possible to engineer a stronger business case, involving private sector partnerships, which would meet the current requirements of the Sponsors and would generate the level of revenue which would meet ICL's financial targets without significant additional new funding from BA/POCL. This is in stark contrast to the current position where ICL, in effect, is expected to shoulder a significant upfront financial write-off while still being required to complete and maintain the system for up to 10 years with little or no prospect of breaking even over this period.

(8) ICL notes that the Chief Secretary appears to consider that ICL has not been willing to move and thus facilitate a way forward which is acceptable to all parties. ICL does not consider that this is an accurate representation of our position:

(A) We offered to forego our expected returns from the Project.

(B) We offered to fund the additional risk capital requirement between now and acceptance provided that we could agree reasonable acceptance procedures.

(C) If the PO had agreed to put equity capital into the project we offered to capitalise in excess of £100 million of debt as equity to cover the significant risks in the period ahead.

(D) We offered to share with the Sponsors 50% of any contingencies not required.

(9) ICL notes that the Chief Secretary will be discussing with his Ministerial colleagues and the contracting authorities how they may wish to proceed. ICL welcomes this development. We have long believed that a major project of such importance to HMG should be subject to greater Ministerial scrutiny, not least in determining the true value of the project to the Government's wider agenda.

(10) When Ministers review this project they need to give due weight to the problems that have made it so very difficult. These problems have arisen from four principal causes, none of which were explained or made apparent to ICL in the contract negotiations and which could not have been reasonably anticipated by ICL.

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The four problems are:-

(i) The decision by the sponsors to interfere in the work on the design of the system in a manner entirely inconsistent with the principles of the PFI as explained repeatedly in guidance issued to departments by Treasury Ministers and the Treasury Taskforce.

(ii) The decision by BA to cease to use the magnetic card and to switch to ACT.

(iii) The delays in the DSS's CAPS project without which Project Horizon cannot be implemented.

(iv) The lack of commercial experience and commercial drive in POCL.

The risks to the project created by these difficulties are still very much with us as was explained in ICL's submission to Mr Corbett.

(11) ICL notes the Chief Secretary's statement that the Public Sector parties expect ICL to continue to perform its contractual obligations, as they themselves intend to do and that all parties have agreed not to initiate legal proceedings against any other party without adequate notice.

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(12) It will of course be understood that, like the Sponsors of this PFI contract, ICL has had recourse to legal advice. Our case is strong. But, at no time have we sought to litigate; rather we have preferred to work with the project Sponsors to find a practical and fair way forward.

(13) We note that the Chief Secretary states that both Public Sector parties continue to reserve all their rights against ICL "following your contractual default". ICL totally rejects any notion of contractual default, and likewise reserves all of its legal rights against the Public Sector parties. The DSS's (BA's) notices of contractual default were totally without justification. We note with interest that the Post Office (POCL) did not endorse them.

(14) Although ICL has not seen Mr Corbett's report, we are grateful to Mr Corbett for the progress he has made to date in negotiating a programme for moving forward which is acceptable to the BA and POCL and ICL. ICL therefore considers that a sound basis exists for moving forward, provided that the underlying commercial issues are addressed; to this end, ICL remains open to sensible and constructive proposals for resolving these.