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PRIME MINISTER

From: Geoff Mulgan
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cc David Miliband
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BA/POCL – Summary of position

1. You will recall that ICL, BA and POCL were given a month to negotiate a way to continue the Horizon computerisation project for the Post Offices. I sent you a brief note last week. This note sets out in more detail where we are and the options, although no decisions needs to be taken yet.

2. The last month has been used for a twin-track strategy: intensive work both to attempt to secure an agreement, and to ensure that there is a viable alternative if negotiations fail. The position now is that:

- There is no deal: the main barrier is money, and the prospects of a return to ICL. The gap is £200m – effectively ICL want the government to cover some of the losses they have already incurred.

- ICL are in a very difficult position; they can no longer see much scope for making a profit from Horizon, and they are being squeezed hard by Fujitsu who won't provide any new capital. Keith Todd's position as Chief Executive of ICL would probably be untenable if the project was cancelled.

- The work on fallback options, mainly done by KPMG, has come on well. The alternatives, involving the use of different technologies and an aggressive push into banking, look more attractive and more realistic than before.

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- The Post Office work on improving management and preparing the way for a more transparent funding regime has been weak.

- Whereas in early September it appeared that cancellation would cost government as a whole £1bn more than continuation, the latest VFM analysis shows that there is now little real difference between the options. It confirms that – in VFM terms – it would be worth making concessions for a deal but also that there is no longer a compelling economic case for continuing with the project.

3. There are now essentially two options for the government:

- First, to continue to attempt to secure a deal. This is probably achievable, although it might require another month or more of negotiation. It would require further concessions from government, and might involve some form of joint venture between POCL and ICL to run, and market, the services delivered by the new system. In the short-run this is certainly the lower risk option, particularly against a background of job losses and problems with inward investors.

- However, it is not without its own risks: we would be left with a less than perfect Benefit Payment Card long into the future; since ICL no longer see a strong commercial benefit in the project, they may not commit fully to it, threatening further delays and technical problems in the future; any joint venture might expose the government to financial obligations in the future; and a dangerous precedent would have been set in terms of bailing out a failed PFI.

- Second, to make the judgement that a deal is unlikely to be achieved. This would then lead to a swift move towards the fallback options, with BA and POCL working together to achieve a rapid transition to ACT geared to POCL's ability to offer banking services. It would involve developing the Post Office's partnerships with banks, introducing simple swipe-card technologies in Post Offices fairly quickly, to be followed up with

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more sophisticated systems later; and explicit subsidy for post offices. In the short-run this option would involve significant dangers for POCL and ICL. It would probably lead to a lengthy, and messy, legal battle with ICL.

4. The view of the DTI and HMT is that we should still attempt to strike a deal. HMT put the odds of success at around 60:40. DSS would still prefer cancellation. My view is that, although the options are finely balanced, cancellation is becoming more attractive. Although the short-term risks are higher, the long-term benefits are probably higher too, in terms of a modernised Post Office network, banking the unbanked, and moving quickly to ACT for benefits.

5. Cancellation would need very careful presentation: pinning blame on the last government for a misconceived Benefit Payment Card; giving clear guarantees to sub-postmasters that no post offices would shut as a result of this decision; a strong push on the Post Office's new global strategy; and possibly a sweetener to ICL.

6. Discussions are continuing over the next week with ICL and with the relevant ministers. A full report will be provided for you on 7/8 November. I would expect the balance of ministerial opinion to continue to favour trying to reach a deal.

7. In the interim we will continue with the twin track approach – on the one hand seeking to secure a deal, and on the other ensuring that we have as credible an exit strategy as possible.