Ken Powell

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(12)

Rod Clark
PPS/Secretary of State for Social Security
Department for Social Security
Richmond House
79 Whitehall
London SW1A 2NS

18 November 1998

Dear Rod

BA/POCL AUTOMATION

The contents of this letter are extremely sensitive, and should be shown only to those officials with a strict need to know.

2. The Chief Secretary met your Secretary of State, the Chancellor of the Duchy of Lancaster (Jack Cunningham), the Minister of State at the Cabinet Office (Lord Falconer) and the Minister of State at the DTI (Ian McCartney) on 17 November. Adam Sharples and Sarah Mullen (both HM Treasury) and Geoff Mulgan (Policy Unit) were also present, as were Private Secretaries (David North, Geoff Moore, you and me).

3. Sarah Mullen presented the Ministers with a situation report and possible

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options (a copy of the handout is enclosed). She said that although ICL's current offer was clearly unacceptable, the important question was whether we should terminate now or give ICL a further period of time to meet our concerns.

4. The Minister of State at the Cabinet Office opened the discussion by saying it was still unclear to him that ICL had actually moved. For example, had they exposed themselves further to risk? Had they offered to put in more money? Or were they expecting the public sector to underwrite the costs of third party financing by passing on the costs to us? Your Secretary of State also asked whether, in effect, the Government was not only being asked to underwrite both the existing £200 million of loans provided by Fujitsu to ICL but also the further £280 million of third-party financing they needed to continue?

5. Adam Sharples replied that whilst ICL had accepted a negative NPV on the expected revenues from the project and some sharing of profits with POCL on additional business, it was clear that they were expecting the public sector to underwrite a significant proportion of the financing for the deal. This was entirely unacceptable. However, the big question was whether ICL had shown sufficient movement to warrant a further time-limited period of discussion.

6. The Chief Secretary pointed out that ICL had actually failed to raise non-recourse financing three years ago. He also said that in reaching a decision on the way forward it was important that the public sector was, and was seen to be, reasonable and that the Government could satisfy the PAC that it had done everything it could to secure an agreement that was value for money in commercial terms for the public sector. Although he did not think ICL could do it, he believed

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this meant giving ICL another short period to come up with an acceptable solution in terms of vfm and transferring risk back to ICL.

7. Your Secretary of State said that other aspects of ICL's current proposal concerned him. For example, ICL were now expecting him to agree to the project and roll-out of the system with no live trial. This was unacceptable because it transferred significant risk back onto the public sector. Both the Chief Secretary and the Chancellor of the Duchy of Lancaster agreed that this was unacceptable.

8. Continuing, your Secretary of State said that by agreeing to further negotiations, he was concerned that the Government may have lost the initiative they had had in the Summer. If it was decided to continue negotiations and then subsequently terminated the contract, it would be more difficult to argue that this was on the basis of ICL failure to perform as identified in November 1997. The Minister of State at the Cabinet Office agreed that this was a possibility.

9. The Minister of State at the DTI said he was looking for two action points from the meeting. The first, was another period of negotiation to see whether ICL, and their shareholder Fujitsu, were willing to move further to underwrite the financing gap. His preference would be to make it clear to ICL that the Government was serious in seeking a commercially acceptable solution in specific areas otherwise it would pull the plug. He thought a 14 or 21 day time-limit for discussions would make this point. Second, he wanted work to start on a clear exit strategy if negotiations failed. It was important that the Government could move quickly if the next stage of negotiations failed.

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10. The Minister of State at the Cabinet Office did not think we should be too specific about the areas where we wanted ICL to move as this could be interpreted as us trying to meet in the middle ground. In his view, we should just say that the public sector was not moving from the already generous revised offer set out by Graham Corbett on 12 October.

11. Your Secretary of State asked why we had chosen the end-date of 16 December for revised negotiations. He saw some problems with this. Not only did it continue negotiations for another four weeks, but also run into the Christmas period. This could make collective decision making difficult after 16 December. If any extension were to be granted, he would be unwilling for it to go beyond a clear cut-off of 9 December. The Chief Secretary, the Chancellor of the Duchy of Lancaster and the Minister of State at the Cabinet Office agreed with your Secretary of State and were happy with a revised deadline of 9 December.

12. The Chancellor of the Duchy of Lancaster said that he could agree with the suggested way ahead, using the conditions set out by the Treasury (see the last slide of the handout) subject to one change and one clarification. On the change, he thought we should delete the bracketed clause in the fourth tiret of the handout. In his view, the public sector had moved far enough and it was simply a question of whether ICL were prepared to move to us. The Minister of State at the Cabinet Office agreed. On the clarification, the Chancellor of the Duchy of Lancaster wondered why POCL were now be asked to lead the negotiations.

13. Adam Sharples said that this was the key to restructuring the deal in a simpler form. A bilateral discussion would draw a line under the BA's future financial

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exposure and make clear that the commercial risk would, in future, be borne by ICL and POCL. From then on, the BA would become a "customer" of the post office and their role would centre on discussions of risk of delivery.

14. The Chancellor of the Duchy of Lancaster thought that this could increase the risk of further delay to the negotiation. His strong preference would be for the Government to have an agreed position and that one Minister - in his view, the Chief Secretary - should make it clear to ICL that a line had been drawn and that unless they could meet the revised position set out by Corbett, the project would be terminated. However the Minister of State at the DTI said that there would need to be some discussion between the public sector and ICL to discuss other aspects of a deal not within the Corbett proposal such as acceptance testing and that POCL would be best placed to respond to ICL's proposals (but first clearing their lines with BA).

15. The Minister of State at the DTI said that we should inform Fujitsu that we were serious and, if so, and raised the question of how should we do it. He believed that we should not leave this to ICL because Fujitsu were such a major player in other parts of British industry and it was important that they knew where Ministers were coming from.

16. Geoff Mulgan agreed. He thought it vital that Fujitsu were aware of our seriousness and, if it was agreed, termination of the contract did not come as a surprise. It was agreed by all Ministers that a senior DTI official (Alastair Macdonald) should tell Fujitsu that the Government were serious in terminating the contract if ICL could not meet the public sector's requirements.

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17. Your Secretary of State said that before a final decision was made, it was important to recognise that there were two separate issues which needed to be considered and addressed: should we try to salvage the contract and what was the Government's overall objective for the Post Office? Both were inextricably linked, but the former was the most immediate and this was where the two departments differed for quite understandable reasons. His preference would be not to continue, but he would agree to a further period of negotiation, provided it was clear that he would not sign up to something that was unacceptable to the BA. On the latter question, his own view was that the Government needed to address this issue immediately as they would be asked whatever happened next. If it was decided to terminate the contract, the issue of maintaining the rural post office network in its present form would arise. Whereas, if the contract continued in some agreeable format, the Government would still need to be able to answer the question of what would happen in 2007 when the Post Office's major customer - the BA - moved over to compulsory ACT. The Chief Secretary and the Chancellor of the Duchy of Lancaster agreed.

18. The Minister of State at the DTI thought that this was difficult and the two issues could and should be separated. It was important that consideration on the viability of this project did not cut across the wider Post Office Review which had now been completed and was due to be submitted to the Prime Minister in the near future. In his view, we should focus on the commercial case for continuing with the project.

19. Summing up, the Chief Secretary said he would circulate a draft letter to

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Keith Todd within the next day which made clear:

- that ICL's commercial proposals and proposed risk transfer were totally unacceptable;

- but the Government would give ICL a final period to respond to show it was prepared to make a last effort to salvage the contract, provided ICL could secure adequate finance to take forward the project without transferring the risk back to the public sector, and moved to meet the public sector position set out by Graham Corbett on 12 October;

- this final stage would have to be agreed by 9 December. If not, then discussions would move quickly to an endgame; and

- all discussions should continue to be conducted through officials.

20. Continuing, the Chief Secretary said that, after this letter had been sent, a senior HMT official should express the Government's seriousness about termination if ICL could not meet our position. In addition, a senior DTI official (Alastair Macdonald) would talk to Fujitsu to emphasis the gravity of the situation. He also asked if officials of the official working group could continue to work up options 2 and 3 over the next few weeks. He would maintain a close interest in progress on this issue and would want weekly reports sent to him. It was essential that Ministers were in a position to implement the fallback options if an agreement with ICL on option 1 could not be reached. It was also clear that, in the event of termination, an agreed line on the alternative automation strategy for post office

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counters and the future of the rural post office network was essential.

21. I am copying this letter to Jeremy Heywood (PS/Prime Minister), David North (PPS/Chancellor of the Duchy of Lancaster - Jack Cunningham), Mark Langdale (PPS/Minister of State at the Cabinet Office - Lord Falconer), Geoff Moore (APS/Minister of State at the DTI - Ian McCartney) and to Sebastian Wood (PS/Sir Richard Wilson) and Geoff Mulgan (No 10 Policy Unit).

Yours

GRO

PAUL WILLIAMS
Assistant Private Secretary

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ICL PROPOSAL

- Partnership with POCL to develop additional business
- Commercial proposals:
  - ICL underwrite a loss of £75-100m NPV; but
  - Seeking:
    - increased prices
    - risk transfer to public sector
    - greater guarantees
    - revised acceptance terms
    - contingency funded by by public sector

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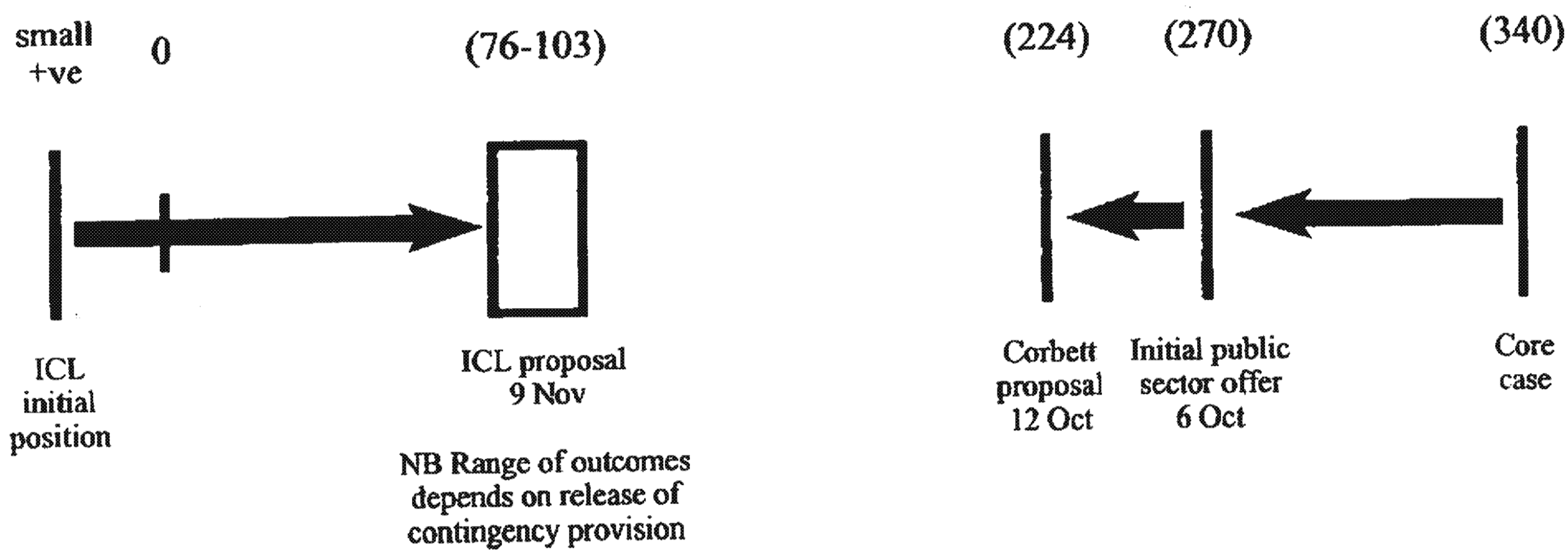
The Path of the discussions (to 9 Nov)

Impact on ICL - £m NPV over whole project



Figures are NPV at 8.5% to 1/1 1999

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

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What are the options?

- Continue with negotations
  - on basis that ICL proposal provides grounds for believing a deal could be struck
- Decide now that the contract is unsustainable
  - and open discussions with ICL on termination (which may lead to discussions on option 2)

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Can a deal be struck?

- Difficult to call, but:
  - ICL have moved (see earlier slide) now accepting loss
  - Asked them to agree terms of partnership -have done so
  - Have said their proposals are not set in stone and there is room for negotiation
  - Termination is worse for them - lose £230m with little prospect of any recovery within 3? years; puts off flotation indefinitely
- But any negotiations would have to be subject to tough conditions

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Conditions for further negotiations

- Clear message to ICL that commercial proposals are entirely unacceptable
- Proposed risk transfer to public sector unacceptable - if this means they cannot secure non-recourse finance then so be it
- End date for agreement of 16 December
- No further movement from public sector (at least until ICL move significantly)
- POCL lead negotiators reporting back to a "progress tracking group"
- Fallback options are kept alive