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INTERNAL MEMO

TO: John Roberts

FROM: Stuart Sweetman

SUBJECT: HORIZON BOARD PAPER

DATE: 5 May 1999

For your car journey.

Here is the latest version of the Board paper without numbers and annexes. Still too long, but it is work in progress and will need more polishing. Your thoughts would be welcome.

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POST OFFICE BOARD
THE FUTURE FOR HORIZON

Purpose and Background

1. The purpose of this paper is to
   - update the Board on the progress of negotiations on the future of the Horizon programme since the last Board meeting on 27 April 1999
   - decide the Post Office's view of the way forward as Ministers are meeting imminently.

2. The timetable for the discussions has been driven by Fujitsu's written insistence to the Prime Minister (7 April 1999) for new legally binding Heads of Agreement (the "Agreement"). The Agreement would mean that Fujitsu will provide financial support for a reshaped programme, and all historic claims would be settled.

3. The "public sector" (defined as POCL, DSS/BA, HMT, DTI) agreed that POCL should lead the negotiation of the Agreement for the way forward only. The Agreement would be between POCL and ICL, but backed by parallel agreements between POCL and DSS/BA/HMT, settling the current contract relationships and establishing new agreements in a way that we are not left exposed to ICL without back-to-back cover.

Progress of Negotiations

4. At the beginning of March 1999 Ministers agreed that, under the leadership of Steve Robson, HMT, a solution (Option B) should be sought that would:

   - enable electronic payments of benefits at Post Offices using a smartcard;
   - involve mass conversion of order book holders, to this method;
   - build a system capable of developing other new services and, in line with HMT's drivers, should be cost effective for the public sector as a whole;
   - should not destabilise Option A (Horizon with the benefit card), or prejudice termination rights against ICL.

5. From the outset, we made clear to all parties that for POCL to sign the Agreement we would need a strategically and commercially acceptable case for approval by the Post Office Board. Following the last Board meeting the Chairman wrote to the Secretary to State at DTI (27 April 1999) to make the Board position clear, setting out the tests the Board would apply to a proposal (see Annex 1 for letter).

6. Negotiations have been at pace and have been intensive: throughout, relations with ICL have been good and focused on making progress. HMT's focus is on the cost and feasibility of the new service to the 'public sector' using KPMG and PA as advisors. DSS' stance has been to focus on finding a solution that transfers as much as risk and cost from them as possible.

7. It is clear there are a number of issues that unless resolved satisfactorily will prevent us being able to sign the Agreement. These issues were discussed fully at, and supported by, POEC on 7 April 1999 and at the Counter Automation Steering Group on 13 April 1999. These issues have been shared with both Steve Robson (letter from Stuart Sweetman of 29 April 1999 refers) and ICL's Commercial Director. There are also difficult issues that need to be settled between BA and ourselves if we are to be able to go ahead with B1.2 with proper cover and assurance as to DSS' role in making the solution work. These have been shared with HMT.

8. On 13 April 1999, the Prime Minister met Fujitsu's Vice Chairman, and, apparently, expressed a desire to find a solution, and in particular, one that enabled Modern Government.

The Agreement

9. The Agreement would be between POCL, ICL Pathway and ICL, and
   - builds on the existing contracts signed of 15 May 1996 for services to automate post offices (including the benefit payment card)
   - settles all claims and counter claims arising from the original contracts (but without financial payment by POCL towards that
   - scopes the new services for smartcards and electronic benefit accounts
   - describes the key commercial aspects, including pricing, timetable, system acceptance, and funding
   - requires the provision of a legally enforceable Fujitsu guarantee for ICL's obligations
   - incorporates and updates the Public/Private Partnership agreement with ICL, agreed in November 1998

10. During the course of the negotiations, variations of the alternative options have emerged. All of these would be more expensive and more risky to POCL than the current programme (Option A) unless we found further offsetting Government backing. The focus of discussion has been around the variant known as "Option B.1.2". Other variants have been rejected, having been proposed by either ICL or DSS, as either too costly or of having even greater risk to us. The key features of the "B1.2" option are described at Annex 2.

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Commercial and Financial Impact of Option B1.2

11. Annex 3 summarises our best estimates of the emerging impact of options in both NPV terms and in profit and loss impact on POCL.

12. It is very difficult to be firm about the impact, given the softness of the costings, the absence of revenue streams, and the range of the new risks. Nonetheless, it is clear that there are substantial extra costs to POCL with an adverse impact on profit and loss. In NPV terms these could, be over £1bn worse than Option A. This figure could be mitigated by returning to the extended Contract 'A' revenue terms "agreed" provisionally with DSS during the Corbett phase of negotiations (reducing our adverse figure by over £300m NPV). The remaining gap would need to fund ICL's additional costs either through lump sum development costs contracted by DTI/DSS/HMT, and/or higher charges to HMT/DSS for the banking encashment transactions (over and above guaranteed 'Contract A' payments to us). The P&L impact of this gap closure scenario from us is also shown at Annex 3.

13. This is before new risks. These are very difficult to quantify or put probability factors to at this stage, but are probably in excess of £300m in NPV terms (including becoming a bank, unless exemption is funded, or the risk of successful procurement uses challenge under EU).

14. Annex 4 describes the way in which the funding gap could be met, applying the tests set out in the Chairman's letter. Essentially it asks Government to 'buy' the new banking services in phase with our costs, including those that would need to by supplied by ICL. Government would have to guarantee the Post Office this business if it was felt that part of this funding should be met by external non-recourse finance. This way of funding the gap which the new banking service creates (with no obvious buyer of this service) has been explored by POCL after taking views in the short time frame given from PO's advisors (Schroders, Ernst & Young, Slaughters & May). The details still need to be worked through given the potential complex EFL, taxation, balance sheet, regulatory procurement and if P&L issues involved.

Key Issues and Options

15. We have been hard pressed by DTI to indicate the wider value to Government of the new infrastructure and Smartcard capability building upon the White Paper on Modernising Government. Our response has been shared with HMT/DTI. The proposals build on the Government Gateway direction included in the POCL vision that the Board supported at its meeting on 8 December 1998 POB(98)80. The Board noted then that Government Gateway held the greatest element of risk for the business. It has been clear to HMT/DTI that without explicit Government wide support the Board would not take a more optimistic view.

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16. There is no easily identifiable, or predictable, way forward. Option B1.2 is turning out to be considerably more expensive than Option A, both for us, and to the public sector as a whole. KPMG has advised HMT that it would be up to £700m NPV (at 6% TDR) more expensive to the public sector, taking into account extra running and set-up costs, increased fraud risk, and settling the past with ICL. However, it does enable a wider range of Modern Government services, would be technically acceptable to DSS, gives DSS ACT savings, and avoids messy and costly termination with ICL (potential to cost the public sector up to c£300m). The critical issue is affordability.

17. Option A (or a variant of A such as using smartcards earlier) remains the most certain for us and would be our preferred way forward. Option A also remains, by far, the best VFM route for Government too. However, DSS strongly oppose this route (hence the various alternatives that have been developed) and seem to have persuaded other Ministers that it is not workable.

Two things should not be forgotten about Option A as it now stands following intensive discussions with DSS and ICL throughout 1998. First, that, for the first time POCL accepted that BA could move to ACT without hindrance and with our co-operation, provided that this was in reasonable timescales - these were negotiated and agreed as starting from 2005 and ending in 2008, without contract with BA extended to cover that period. This is critical for our business case, and DSS (HMT) are continually trying to push these timescales back. We need this period to develop the POCL strategy without causing unmanageable network change. Secondly, Option A has a migration route to social banking. It does not assume the benefit payment card is the status quo forever, but is an important first step towards migration to banking.

ICL now don't believe that Option A could ever work as they believe DSS would persistently act against its effective operation. Indeed they have written this week to HMT withdrawing, on a without prejudice basis, from the pre Christmas agreement reached with us on Option A. Option A remains, by far, the best VFM route for Government.

18. Termination remains highly undesirable, messy and expensive. Our legal stance would be that we are not liable for any termination costs and that DSS should be responsible for any settlement as well as for finding alternative automation for POCL (they have a contractual obligation to do so). In practice, this will probably be politically unacceptable.

Our longer-term contingency work has indicated that starting again would take two years longer to automate than Option A, damage our new vision, delay our process efficiency programme and provide BA with the opportunity to accelerate ACT. We would also need to bring forward our network re-shaping plans.

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A variation on termination has been proposed by DSS ("B3") that allows DSS to withdraw, but would commit POCL to continue with ICL for its residual services whilst going ahead with an ACT timetable. We have rejected it.

19. If termination was pressed upon us then there would be a number of very important conditions the Post Office should seek.
These are set out in Annex 5.

20. So, the proposed ranking of preferred options to us are:
1. Option A or a variant of it, such as introducing the smartcard earlier
2. Option B1.2 but only with the necessary funding and risk cover for POCL.
Termination can only be acceptable to us on the conditions at in Annex 5.

White Paper Implications

21. The proposed White Paper on the future of the Post Office needs to contain clear direction for the future role of POCL and its Network of post offices. The uncertainty over the future of Horizon has contributed to the delay in the White Paper publication. If the way forward on Horizon is based on Option B1 then the implications will need to be reflected in the White Paper, i.e. descriptions of

- the new benefit account service
- the role of POCL and the Post Office smartcard in Modernising Government (and potential commitments by Government to use, and buy services, or the new infrastructure)
- POCL's banking status
- the funding arrangements necessary to make Option B1.2 acceptable

Conclusion

22. The Board are invited to

(i) note the progress made on discussions with ICL and others
(ii) note the key issues that remain outstanding with ICL and DSS
(iii) note the current unclear state of the commercial assessment for Option B1.2
(iv) agree that given the levels of uncertainty involved with Option B1.2 POCL should not yet agree to enter a legally binding agreement with ICL
(v) agree that only if guarantees are given by Government to fund us, then a statement of intent for Option B1.2 with ICL could be entered into without legally binding us
(vi) agree that Option A remains our favoured way forward, but is unlikely to be politically acceptable to DSS, and ICL has now withdrawn its commercial proposals around it.
(vii) agree that termination should only proceed if firm commitments are given by Government as described at Annex 5.

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<u>List of Annexes</u>

1. Chairman's letter to Stephen Byers dated 27 April 1999
2. Key features of Option B1.2
   - schedule of new roles and responsibilities
3. Commercial Assessment of Option B1.2 v Option A
4. Paper to show how Government could pay for the new banking service to the Post Office and close our gap
5. Termination - Conditions for the Post Office

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