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Treasury Chambers, Parliament Street, London, SW1P 3AG

PRIME MINISTER

HORIZON (BA/POCL) PROJECT

This note sets out the current situation on the Horizon (BA/POCL) Project. It summarises the extensive work that has taken place over the last few weeks to reach an agreement about how best to proceed. In summarising the position I have consulted extensively with Stephen Byers, Alistair Darling and Charlie Falconer.

We have a commitment to give ICL a decision on the way forward with this project on Monday (but ICL have said they can now wait until Tuesday). They must file end year accounts on Wednesday. Our policy aim is to move to Automatic Credit Transfer (ACT) as soon as reasonably practical and to preserve a national Post Office network. We should keep ICL/Fujitsu on board if possible. Stephen Byers and Charlie Falconer both prefer Option B1. Alistair Darling and Alan Milburn favour Option B3 if POCL and ICL can reach a sensible deal. If they cannot they would favour Option C - terminating the contract with ICL and allowing POCL to procure a new system that met their commercial requirements in the light of termination.

Background

We gave an assurance to Fujitsu that the Government will make a decision

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on the way forward for the project by Monday 10 May, although ICL have now said they can wait until Tuesday.

Economic case

2. The Horizon project was envisaged as a way of reducing benefit fraud and modernising the benefit system, whilst automating the Post Office network in a way that would help preserve footfall and therefore maintain a nationwide network of post offices. It is now three years late. Our view is that continuation with the project (Option A) is no longer viable, in view of ICL's failure to deliver and the irretrievable breakdown in relations between the parties. This view was effectively confirmed earlier this week when ICL withdrew their offer of 18 December. It is therefore dead.

3. We are left with three options. First, Option B1 - involving the creation of 15 million Post Office benefit accounts (with limited facilities), accessible via a Post Office smartcard. Benefits would be paid into these accounts by ACT (from 2002). It is the best option to preserve Post Office footfall in the short term, and the policy value for this cannot be reflected in the figures. It would place the PO in a position to win electronic Government services by having a base of 15 million smartcards. It provides automation of counter services. In this respect it has attractions, but it offers considerably worse value for money in NPV terms than the alternative options. If Ministers were to decide to pursue Option B1, ICL's current position is that the public sector parties must sign an unconditional agreement on Tuesday, and provide ICL with £180 million.

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4. The second option (Option B3) would involve POCL buying the basic system from ICL but without the benefit payment application and without the creation of special POCL benefit accounts. It would provide automation of post office counter services (from bill payment to postage rates). Benefits would be paid into conventional High Street bank accounts by ACT. The Post Office would offer simple cashback facilities (as a minimum) to access these accounts across the counter. It would also provide a platform for network banking and Modern Government with a smartcard capability, though it would not provide the certainty of 15m smartcards as under B1. It would allow BA to roll out the order book control system (a way of reducing order book fraud). BA and POCL would work together to market ACT into bank accounts accessible at the post office from 2001, in preparation for a move to ACT as the usual method of payment in 2003. The NPV figures are sensitive to changes in these dates.

5. Unlike B1, Option B3 would not tie the Post Office to ICL as a long term business partner. Such a tie in may well prove inflexible if, and when, we take forward a Public Private Partnership and, therefore, force us to bring in a private sector partner on less attractive terms.

6. POCL reject option B3 at the moment and ICL have indicated that it is likely to be expensive. POCL would prefer termination and to obtain a new system better suited to their needs. In order to make progress on B3 we would have to rule option B1 off the table and make plain that termination was the only alternative. However, when this was done over the weekend POCL still preferred termination. It is unlikely we could force POCL to do B3.

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7. The third option (Option C) would be to terminate the contracts with ICL. POCL would start afresh. A new automation system would be bought from a new supplier specifically designed to meet POCL's automation and network banking aspirations, including the ability to withdraw cash from bank accounts at post offices. BA would be given a date to move to ACT (they would like to start the transfer to ACT from 2001, although POCL say they could not be ready by then and claim they would lose substantial footfall) working with POCL to maximise retention of footfall.

8. As well as the above considerations there are substantial economic and financial differences between the options. The key figures are (£ million):

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	Economic return	Additional public sector costs		
	NPV	CSR2 years	10 years	
central scenarios				
B1 (ACT 2002 - 2004)	439 283	666	918	1,780
B3 (ACT marketed from 2001, compulsory 2003-2005)	845	294	361	
C (ACT from 2001-2004)	791	461	393	
sensitivities:				
B3 (ACT from 2003-2005)	684 553	547	640 559 800	+160 1,000
Cv (ACT from 2003-2006)	577	721	675	+180

All these figures should be seen as indicative rather than precise forecasts. They depend on various assumptions, particularly the timing of the move to ACT. The central scenarios above are, in the view of our independent advisers, KPMG, reasonable and do-able provided BA and POCL co-operate to manage the move to ACT. It is clear, however, that:

659 160 nominal
820 160 VAT
950 180 deal

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- B3 and C offer a better economic return than B1;

- the cash hit under B3 and C are significantly less than under B1 both in the CSR2 period and over a 10 year timescale.

The figures for B3 and C do not include either the costs or the revenues from introducing a smart card.

9. The Post Office prefer Option B1 but are not prepared to contribute more than £37 million to the additional cash costs shown above. They have suggested that a further £190 million be taken from their customers by delaying the reduction in the postal monopoly from £1 to 50 pence by three years. The Post Office have said they would plough the net contribution they expect to make from Government Direct business under Option A back into B1 and estimate that these will be about £660m (no allowance has been made for Government Direct revenues in the figures for B3 or C). But this money is already taken into account in calculating the additional costs in the table above and so is not relevant. ICL are offering the possibility of finance to 'smooth' the spending profile, but this is simply borrowing from ICL and the interest payments will add to the project costs.

<u>Political factors</u>

10. All of the options - given that none involve the benefit payment card - will need to be presented very carefully, given the expectation amongst subpostmasters that Horizon (i.e. Option A) would secure their future. Option B1 would be the easiest of the other three options to handle. Option B3 would be harder but would

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still have ICL on board and the Post Office would still be getting automation. In the case of options B3 and option C the Government would need to argue that it would have been doing the post office and its customers no good by pressing on with a project that was already 3 years late and couldn't deliver - and that they were fully committed to providing one that did. We would make plain that ICL had withdrawn the existing project (Option A). We have looked hard to salvage something but unfortunately there was nothing worthwhile.

Positions

11. Stephen Byers and Charlie Falconer strongly believe that B1 is the best option. They argue that it offers most security of footfall in the short term by locking in 15 million customers and that it would position the Post Office to win significant electronic government business, thereby helping to preserve footfall and reducing the risk of post office closures. Option B1 keeps ICL/Fujitsu on board. They note that there is a funding gap whichever option is chosen. The figures show this as larger for B1 than the other options but they have doubts about the robustness of the figures and point out they are sensitive to the assumed dates of ACT conversion. They believe B1 would also be the surest way to secure the £2 billion plus of cash savings envisaged under Option A.

12. Alan Milburn and Alistair Darling consider that the larger funding gap with B1, and the fact that it ties the Post Office into an expensive project over a period during which we might consider a change in the ownership, present too much of a downside. They consider that the Post Office's lack of financial commitment raises doubts about their commitment to B1. They are concerned that ICL's failure

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to deliver the Benefit Payment Card on time does not bode well for delivery of a new and complex system (in contrast B3 would be buying that part of the system that is ready to roll out and is relatively simple). B3 could also provide a platform for Modern Government. The Option A savings, largely accruing to BA, referred to at the end of paragraph 11 are also available under B3 and C.

13. The Post Office favour B1. They have said that they are not interested in B3 and would prefer termination (Option C). However this may partly be a negotiating tactic (they were reluctant to consider other options while option A was on the table). If POCL and ICL cannot agree a worthwhile deal on B3, there would be termination.

Conclusion

14. We have been unable to agree on an option. Option B1 is favoured by ICL and the Post Office (for whom it offers the most financially), but has a substantial funding gap and at present unacceptable legal demands on the terms of the agreement from ICL. It provides most immediate security of footfall but ties the Post Office into a long term relationship with ICL. Option B3 provides an automated platform for POCL to develop its business in the future, is clearly more affordable than B1, but is currently opposed by the Post Office and possibly by ICL. Option C would provide POCL with a made-to-measure automation system, is more affordable than B1, but would mean the end of ICL's involvement in the contracts and could have more presentational difficulties.

15. We have set in train a handling strategy to ensure the best possible

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presentation from the Government's point of view regardless of which option is eventually agreed.

16. We would be grateful for your views.

GRO

ALAN MILBURN
10 May 1999