BEIS0000421

HORIZON AIDE MEMOIRE 26 November 1998

RECENT HISTORY

1. Ministers decided in September, on the basis of a report by officials on options for the future of the Horizon project (which included expert confirmation of the technical viability of the project) to allow a month for negotiations between BA/POCL and ICL under the chairmanship of Graham Corbett to see whether agreement could be reached on a commercial basis for continuing with the project. Officials were asked to carry out further work on fall-back options in parallel, to enable value for money comparisons to be made. Despite substantial concessions by the public sector side, and some useful progress on secondary issues, the month ended with ICL refusing to accept an outcome over the life of the contract of worse than break-even. Calculated on the Corbett "base case", this left a gap between the two sides of £225 million. There were also other unresolved issues, for example around acceptance procedures. However at the end of the month, ICL wrote to the Chief Secretary saying that if ICL could agree some form of joint working with POCL to exploit more fully the commercial potential of Horizon, this could give ICL the confidence to make a substantial offer to bridge the gap.

ICL PROPOSALS

2. Ministers agreed to allow 2 further weeks for negotiation between ICL and POCL (Chief Secretary's letter of 30 October at Annex A). At the end of it, ICL and POCL had signed heads of agreement on joint working, and on limited preferred supplier status for ICL. No progress was made on other aspects, but at the last moment ICL came forward (Keith Todd's letter of 9 November at Annex C) with an immensely complex and comprehensive set of proposals for restructuring almost every element of the Horizon contractual basis. A diagrammatic illustration of the path of discussions to 9 November is at Annex B. Key elements of ICL's proposal are:

- POCL to accept prices increased by £120 million. Inflation risks transferred back to BA/POCL;
- greater guaranteed volumes (for payment purposes) across the system;
- a contingency fund (£80 million)which ICL suggest will incentivise the delivery of the project to timetable (but seems more likely to have the reverse effect);
- payments in advance, rather than in arrears;
- a revised acceptance process;
- revised contract terms which drew on (but then went way beyond) recently published draft PFI Taskforce guidelines; and

BEIS0000421

- BA's contractual relationship relinquished after project acceptance, and taken over by POCL.

Ministers' reactions

3. Ministers at their meeting on 17 November (Annex D) expressed dismay and profound disappointment at these proposals presented to them by ICL under cover of Keith Todd's letter dated 9 November to the Chief Secretary, which also sought a further period for negotiation of the new proposals. Ministers regarded the proposals in the key areas of prices, funding and liabilities, and project acceptance procedures, as wholly unacceptable. They saw the attempt to revise almost every aspect of the contract to ICL's and Fujitsu's advantage, moving almost all liability and responsibility for funding the project's financial deficit onto POCL, as deeply insensitive, and as demonstrating a refusal by ICL to accept responsibility for the serious delays to the project which have cost the public sector hundreds of millions of pounds in fraud and administrative savings foregone. There were strong voices in favour of deciding at once to terminate the project on grounds of ICL's failure to perform. This view was only averted after long discussion in favour of a short further extension (to 9 December) subject to the conditions set out in the Chief Secretary's letter of 20 November to Keith Todd (Annex E). At the same time, Alastair Macdonald was mandated by Ministers to talk to Fujitsu, to impress upon them the seriousness of the position, and Adrian Montague, Head of the Government's PFI task force, was asked by Ministers to lead the negotiations for the public sector side. A copy of the negotiating remit subsequently agreed with the Chief Secretary is at Annex F.

Difficulties with ICL's proposals

4. First, as noted above, the financial gap between the two sides remaining from the end of the Corbett negotiations is some £225 million. The additional business opportunities for Horizon identified in the draft partnership agreement between ICL and POCL - the so-called "Golden Cloud" - might be worth £100 million. ICL have proposed that the whole of the remaining gap of £125 million should be covered by POCL through price increases within the contract. The £100 million loss (ie negative NPV) on the project which Keith Todd's letter claimed ICL was willing to accept is therefore the same £100 million which ICL also claim can be covered by Golden Cloud. Ministers saw this as a transparent and irritating charade, compounded by the further proposal that the public sector side should contribute up-front to a substantial "contingency fund" (£80 million) to be held by ICL and only released over time to the contributors as potential contingencies failed to materialise.

5. Second, whilst some modest changes in the arrangements for funding might have been seen as realistic and necessary, the all-embracing proposals from ICL, extending even to financing already in place, and extensively shifting the burden of

BEIS0000421

liability for default away from ICL and Fujitsu and onto the public sector, were seen as excessive and cynical. A similar view was taken of the proposal to remove from ICL financial liability for further delays to the project even if caused by ICL themselves.

6. Third, ICL's proposals that Horizon should be subject to a semi-automatic acceptance without full live trials were regared as totally unacceptable given the importance to the public sector side generally, and to the Benefits Agency in particular, that the system should work flawlessly and robustly in carrying out crucial benefit payment work. A more modest proposal, concerned only with ensuring independent assessment that agreed criteria had been met, would almost certainly have caused less offence.

7. A preliminary view by Benefits Agency and Post Office Counters of ICL's proposals
is attached at Annex G.

Alastair Macdonald's meetings with ICL and Fujitsu.

8. Following his remit from Ministers, Alastair Macdonald saw first ICL (Keith Todd, George Hall on 19 November), and subsequently Fujitsu (Mr Naruto, chairman of ICL and a main board director of Fujitsu, together with colleagues from Fujitsu and ICL including Keith Todd, on 25 November). At both meetings Mr Macdonald spelt out Ministers' dismay and deep disappointment at the ICL proposals, which they saw as significantly widening the gap between the two sides. He rehearsed in some detail the key specific concerns as set out in the above paragraphs, and explained that Ministers had concluded that there now appeared very little prospect of bridgeing the gap between the two sides. However before taking definitive decisions on the project, Ministers were anxious that ICL should be given a final opportunity to reconsider their position in the light of the clear requirements of the public sector side. How ICL/Fujitsu responded to the opportunity Ministers had offered was of course a matter for their commercial judgement, but it was of critical importance that they fully understood its finality.

9. At both meetings Keith Todd expressed his disappointment, frustration and sense of shock that Ministers still appeared to fundamentally misunderstand ICL's position. ICL was in fact the aggrieved party, not the guilty party, yet Ministers appeared determined to punish them. ICL had put forward a positive and helpful set of interlocking proposals designed to enable the project to move forward. The company had given up its "right" to make a profit on a ten year programme of work, and was carrying - and would continue to carry - a considerable element of commercial risk. ICL had explained its position extensively to officials, but had found it difficult to gain access to the relevant Ministers. ICL could only conclude that officials had represented badly - or indeed had misrepresented - the company's

BEIS0000421

view to Ministers, who would not otherwise have reacted as they had. (At both meetings however he expressed his gratitude to DTI officials for all the help ICL had received from them over recent months). The urgent task now was to correct the mistaken impressions before it was too late. But to do this, ICL needed access to the relevant Minister(s). The future of the project now lay between ICL and POCL, but at a meeting the previous evening, John Roberts had made it clear that he had been told by Government that he had no authority to negotiate further with ICL. Ministers should now empower John Roberts to negotiate a deal.

10. At the second meeting (with Fujitsu) Mr Naruto sought to understand why a process of negotiation and discussion to resolve difficulties with the programme had suddenly become a crisis. The project was a good one, and had been technically validated both by the Government's own expert panel, and by Fujitsu's top technical experts who had great experience of major projects. It would deliver the Government's objectives both now and in the future. It was disappointing that the Benefits Agency wished by 2006 to withdraw the benefit payment card around which the system had been primarily designed, but not fatal to the future of the project provided that POCL and ICL worked together. The answer was cooperation, not confrontation, and the parties should keep talking to find solutions. He had been shocked to learn that the gap between the two sides was as great as £200 million, which was a very large sum of money for either ICL or Fujitsu, but he still believed that with goodwill on both sides, answers could be found. Fujitsu remained, as it had been throughout, fully committed to the project, and would continue to stand firmly behind it. Mr Naruto added that he had worked for 18 years with the British Government. If ICL was forced to litigate to protect its financial interests, it would do so. But he had no wish to fight the British Government in that way, especially when a solution that would benefit both sides could surely be found through further discussion.

11. Mr Macdonald ended both meetings by noting what had been said, and by stressing the finality of the opportunity that remained for ICL/Fujitsu to move to bridge the gap between the two sides if they wished to do so. He referred to the role which Adrian Montague would play in the events of the next fortnight, and urged ICL/Fujitsu to listen carefully to what he would say to them, and to consider coolly and calmly how best to respond to serve their commercial interests. He was however clear that for talks over the next fortnight to have any chance of succeeding, key areas on which Adrian Montague
would need to be satisfied at a very early stage included

- assurance that there is adequate financing to take forward the project without the public sector bearing unacceptable risk;
- Fujitsu must be clearly seen to be fully committed to the success of the project, and to stand behind it with funding and/or guarantees as necessary;
- ICL must make a substantive and unequivocal move toward the public sector's position as proposed by Graham Corbett on 12 October.

BEIS0000421

Only if these prior conditions are met could detailed negotiations begin on the range of issues on which heads of agreement need to be reached by 9 December.

ICL AND FUJITSU BALANCE SHEETS/EMPLOYMENT AND INWARD INVESTMENT

12. An extract from the recent Horizon progress report to Ministers commenting on the implications of cancellation for ICL's and Fujitsu's balance sheets, employment and inward investment is attached at Annex H.

MODELLING OF FALL-BACK OPTIONS

13. A report was produced for Ministers in July setting out three possible ways forward on the project; namely:

Option 1 - continuation with project including the benefit payment card;
Option 2 - continuation with project minus the benefit payment card;
Option 3 - termination - POCL seeks alternative technology platform.

14. Subsequent analysis of these fall back options was carried out by KPMG which informed one strand of a further report to Ministers in October on work commissioned by the Chief Secretary. This report also provided a commentary on the one month period of negotiations with ICL chaired by an independent adviser Graham Corbett, and a report by DTI on various issues relating to the commercial exploitation by POCL of the project and the social value of the network .

Option 1

15. We have consistently supported Option 1 (with the Post Office) - provided a commercially acceptable deal can be reached with ICL - as the option which best secures the future of the post office network, minimises damage to ICL and the reputation of IT PFI projects and avoids negative repercussions for inward investment from Japan.

Option 2

16. DSS have argued both for Options 2 and 3. They have suggested that Option 2 represents a good compromise - establishing for them a banking facility in post offices for the delivery of benefits by ACT whilst keeping alive at least a part of the project for ICL and providing an automated platform for Post Office Counters.

17. The Post Office oppose the Option 2 route if Option 1 falls. They would prefer to seek tenders for a new system. They doubt anyway whether Option 2 would be a commercially viable proposition for ICL at least without payment of significant compensation to ICL for their work on the benefit payment card (bpc) which has comprised the main element of their work to date. They question whether

BEIS0000421

if litigation were being pursued on cancelling the bpc it would be possible to still work with ICL on another part of the project. We share the Post Office's concerns.

Option 3

18. Termination of the contract has many downsides. It will be necessary to seek to minimise these wherever possible. They include:

- potential damage to Post Office Counters network, subpostmasters' confidence and investments (see below);
- damage to ICL's reputation and jeopardising its flotation;
- potential damage to relations with Fijitsu and negative impact on inward investment;
- potential adverse impact on reputation of suitability of PFI for major IT projects against a background of concerns around this in the industry.

ACT

19. DSS wish to move benefit recipients as quickly as possible onto payment by ACT in view of the significant administrative cost savings to be made. Presentationally, they state that they would wish to see the Post Office still catering for their customers but in practice we believe if Horizon fails they will wish to move their customers to ACT as quickly as possible. There is already a significant trend towards increased take-up by ACT - although this tends to be focussed on pensions and child benefits rather than multiple benefit transactions. Initial discussions with a small number of banks suggest that they would be interested in this business. Whether the rates of transition envisaged by DSS in their modelling of the options are achievable in practice is we believe debatable.

20. No 10 Policy advisers whilst concerned about the implications of termination of Horizon and a switch to ACT in terms of post office closures and Fujitsu's reaction see the merit in shifting DSS customers onto ACT to help achieve Government objectives on Universal Banking and Welfare Reform. We have argued both in the context of discussions about Horizon and Social Exclusion that the reach and experience of the post office network in urban deprived areas will make them a useful tool for helping implement policies in these areas provide they can offer automated facilities.

IMPACT ON POST OFFICE COUNTERS OF FAILURE OF HORIZON PROJECT

21. Failure of the Horizon project and a policy which seeks to encourage ACT will significantly damage POCL's commercial prospects resulting in significant losses. POCL's own estimates are that if they were to lose all BA work 5 000-13 000 post offices could close whilst with a 50 % loss of BA income they estimate that 5 000- 9

BEIS0000421

000 offices could be lost - depending on the policy towards Crown offices and the rural network. KPMG however believe these losses to be exaggerated.

22. Key implications of failure of the project and a switch to ACT are listed below.

Automation plans/ future business

- It will delay the point at which POCL can offer automated facilities to handle clients' business, leading to loss of existing and future business such as electronic Government and banking work.
- A replacement automated platform will be needed - which will be costly (KPMG estimate in the region of £400m) and lacking the funding provided by the benefits payments stream.

Switch to ACT

- Announcement of encouragement of take up of ACT will damage subpostmaster confidence (subpostmasters collectively have invested over £1 billion in the post office network) leading to resignations unless assurances are given by Government that post offices will be able to provide front-end banking facilities for a number of banks. DSS however will wish to move quickly to ACT implying that POCL will need to establish interim banking facilities ahead of a full automated platform. There are concerns about the commerciality of this route and the extent to which such a system would be practicable. POCL have commissioned further work on this.
- BA income accounts for more than 1/3 of POCL income - a significant reduction in this will result in unmanaged network closures - possibly with calls for compensation and potentially numbering several thousands.

Network management /subsidy

- Closures will result in complaints and calls for subsidy in particular in rural areas.
- Estimates of the level of subsidy required to maintain the network if a significant proportion of BA income is lost vary but could amount to £ hundreds of millions. POCL are not in favour of subsidy which runs counter to their commercial ambitions.
- POCL envisage that they might in the future wish to operate a smaller physical network, though supplemented by "virtual offices" (political considerations permitting), but that to achieve this transition successfully they need to do so in a controlled fashion which will be made more difficult by the collapse of Horizon.

Postal Services Directorate
26.11.98

BEIS0000421