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PRIME MINISTER

HORIZON (BA/POCL AUTOMATION)

Issue

Whether to proceed with an alternative approach to the Horizon project, which has emerged in discussions between Treasury officials and ICL.

Recommendation

There are potentially greater risks, and possibly additional costs, in pursuing this new approach than if we continued with the Benefit Payment Card (BPC). It would also almost certainly mean that the Post Office White Paper would have to be delayed. But on balance, we believe this new approach fits better with the Government's objectives (as set out in Alan's minute of 25 January), and by improving the incentives on BA and POCL offers a better chance of delivering a successful outcome. And, assuming the price and conditions are agreeable, we are keen to proceed with the new option. Both Alistair Darling and Stephen Byers have written with their support in principle for the new approach.

Action

If you agree we should take this approach forward, Steve Robson (HMT), in conjunction with officials from DTI and DSS, should work with BA and POCL to develop a detailed specification and negotiating remit, before opening discussions

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with ICL. But it would help the handling with the Post Office if you were prepared to speak to the Chairman or Chief Executive to let them know of the Government's decision and make clear the Government's commitment to the new option.

Timing

Immediate, so that negotiations can begin with ICL as soon as possible.

Background

You agreed (Jeremy Heywood's letter of 28 January) that Treasury officials should explore with ICL the options for achieving the Government's objectives for this project with or without a Benefit Payment Card (BPC).

2. The new approach which emerged from these discussions is set out in detail at Annex A. It would involve dropping the BPC and moving more quickly to payment of benefits by ACT. However, it would also seek to maintain footfall revenue for the Post Office, since those benefit recipients who currently receive their benefits via order books would have their benefits paid into simple credit-only "benefit accounts" run by POCL, using the BACS clearing system, and only accessible at post offices via a smartcard.

3. It would, as now, be open to any benefit recipient to opt for payment of benefits by ACT into a conventional bank account (and eighty per cent of benefit recipients already have access to a bank account). However, we believe that a significant proportion of benefit recipients will continue to receive their benefits at post offices - either because they are amongst the twenty per cent who do not already have a bank account, or because the local post office is more convenient for them, or just because of inertia. This means that the Post Office should retain a similar level of footfall as under the BPC. It also ensures that the smartcard has

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a large initial circulation, which will help the marketing of smartcard-based services.

Assessment

4. We have looked at the costs and the risks attached to this new approach compared with the BPC (see Annex B), with the help of KPMG.

5. On the costs, the initial modelling showed that the BPC appeared to offer better value for money than the new approach. There are factors which could narrow this gap. In particular, KPMG took a cautious view of the impact of the new approach on Post Office footfall revenue. They also pointed out that the costings were highly dependant on the timetable - the value for money gap would be narrowed further if it were possible for DSS to accelerate the start of payments by ACT, provided POCL had by then installed the infrastructure necessary to support post office benefit accounts.

6. However, there are risks from pursuing the new approach which could increase the costs:

- ICL may view the change in the project specification as an opportunity to try to recoup from the public sector a significant proportion of the development costs already sunk in the BPC (perhaps of the order of £250 million), and in addition the costs of the new development work that would be needed to meet the requirements of the new approach;

- there is the risk associated with developing a new infrastructure to support the post office benefit accounts;

- potentially greater fraud risk borne by the public sector. Under the BPC,

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up to £200 million of the fraud risk (eg from stolen cards) was to have been borne by ICL. It is likely that ICL will argue that under the alternative approach, because it will be POCL who would be issuing the cards to holders of post office benefit accounts, it should be the Post Office that bears this risk;

- given the fundamental changes that this new approach will require to the original contractual basis, there are difficult issues relating to EU procurement law which would need to be addressed, and a risk of judicial challenge.

7. On the other hand, the new approach would provide better incentives for the parties (BA, POCL and ICL) to act together, which would have implications for the overall success of the project. It would take BA out of the contract altogether - their focus would instead be on getting their own systems ready for ACT. For POCL, it provides the infrastructure necessary to help build a business as the supplier of community financial services. Above all, it offers the best chance of delivering this project successfully, since the two remaining parties to the contract (POCL and ICL) will have every incentive to see the Horizon infrastructure in place as soon as possible.

8. More generally, the new approach should also provide a boost to wider Government objectives, by bringing on stream more quickly a widely available smartcard for the delivery of modern government services, and combatting financial exclusion by providing simple bank accounts to all benefit recipients.

9. On balance, we therefore believe that this new approach is worth pursuing. Alistair Darling and Stephen Byers have both written with their support in principle. However, Stephen is concerned that taking forward this new approach will delay the Horizon project. His agreement is on condition that we can keep the

BPC option on the table as a fallback as we take forward work on the new approach.

Way forward

10. So far, the specification and costing of this new approach have been carried out solely within the Treasury with the assistance of KPMG. The Benefits Agency and Post Office have not yet been involved. If we are to take it forward, we must involve them as soon as possible. And we also need to tell ICL that Ministers would like to take this approach forward.

11. The most difficult handling issue involves the Post Office, particularly in the wake of the announcement in December that they would be given greater commercial freedoms. Their Board have already approved the BPC under the contractual terms offered by ICL before Christmas, so they may feel that they are now being overruled on a commercial decision. It will be important to make clear to senior Post Office management that there are Government-wide reasons why this approach is preferable to the BPC, and it would help to reinforce this point if you were able to give this message to the Post Office Chairman or Chief Executive personally. In addition, if the Post Office are to work seriously on this new approach, it would be important to make clear to them that the Government's firm decision is in favour of the new approach rather than the BPC.

12. Once BA and POCL have been informed, the next stage would be to draw up with them a detailed specification for the new project and a negotiating remit. While the detailed negotiations with ICL would have to be taken forward by POCL and BA, we suggest that DSS and DTI officials, under the chairmanship of Steve Robson (HMT), should oversee and direct the process. In addition (not least to maintain our negotiating leverage, as well as to meet Stephen's concerns) it would be vital to keep in play with ICL the options of proceeding with the BPC and of

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abandoning the Horizon project altogether.

13. However, the main urgency is that senior management at ICL are keen to hear from us whether we want to pursue this new approach. We would like to be able to give them an indication within the next day or two. We would therefore be grateful for your approval to take matters forward in this way.

Post Office White Paper

14. If we go down this route, we would need to decide on the implications for the content and timing of the White Paper. It would play into the hands of ICL's negotiators if we were to announce our new approach on Horizon before we have reached heads of agreement. And while we would aim to get to this stage as quickly as possible, realistically it would not be until after Easter.

15. One option would be to delay the White Paper. However, although Stephen believes that ideally the White Paper needs to be as clear and positive as possible on the future of Horizon, we understand that he does not believe it would be right to delay the White Paper on account of the project.

16. An alternative would therefore be for a much shorter and more guarded chapter on the POCL business than is currently envisaged. However, Horizon is a vital element of POCL's future strategy and a lack of clarity on the project may raise difficult handling issues, not least with sub-postmasters. Given this, it may therefore be better to delay the White Paper.

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17. Copies of this minute go to Alistair Darling and Stephen Byers, and to Sir Richard Wilson.

GRO GRO

ALAN MILBURN **CHARLES FALCONER**

24 February 1999

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Annex A

BA/POCL AUTOMATION PROJECT

This note sets out a possible way forward for the Horizon project, following discussions between Steve Robson (HMT) and Keith Todd (ICL). These discussions were conducted on a without prejudice and confidential basis. ICL accepted that the public sector parties reserve their rights and remedies with respect to past breaches of contract by ICL Pathway. Both sides agreed that they would not take pre-emptive legal action against any other party while discussions are continuing.

The proposal

2. Under this proposal, the benefit payment card (BPC) would be removed from the Horizon project. The Benefits Agency (BA) would move directly from the existing order book system to payment of benefits through ACT.

3. Benefit recipients who currently receive their benefits via order books would have a Post Office "benefit account" set up for them. BA would pay benefits into the account via ACT, just as they would into any normal bank account.

4. The Post Office benefit accounts would be simple, credit-only accounts. They could be accessed at any Post Office using a smartcard, but at least initially they would not be accessible at banks. The Post Office might enter into a strategic partnership with a clearing bank to operate these accounts for them. Subject to such arrangements being put in place by the Post Office, ICL tell us that they could start to roll out a smartcard-based system into Post Offices following national rollout of the core Horizon system (currently assumed to be Spring 2001).

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5. Over time, the Post Office could develop the range of services which were offered via the smartcard. It could also enter into negotiations with clearing banks to offer counter facilities, enabling the banks to shrink their branch network.

6. The presumption would be that all order book recipients would be paid via a Post Office benefit account, and the move from payment via order book to payment into benefit accounts would be carried out automatically. However, benefit recipients would at any point be free to ask the BA to pay their benefits via ACT into a conventional bank account, just as they can now ask for a move from an order book to ACT.

7. This approach should mean that a large proportion of benefit recipients will continue to receive their benefits at post offices - either because they do not already have a bank account, or because a post office is more convenient for them, or just because of inertia. This means that POCL should have as much certainty over future footfall as under the BPC. It also ensures that the smartcard has a large initial circulation, which will help the marketing of smartcard-based services.

Impact on the various parties

Benefits Agency

Advantages:

- avoids having to develop and implement the IT infrastructure which is required specifically for payment of benefits through the benefit payment card (PAS/CMS/BES), although much of the development work has already been done;

- should allow earlier move to ACT than under original benefit payment

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card project.

Disadvantages:

- delays move away from paper-based systems for paying benefits by two years compared to BPC option.

<u>Post Office</u>

Advantages:

- should help to maintain footfall revenue;

- gets smartcard in circulation earlier than under BPC option, bringing forward potential revenues from smartcard-based services;

- simplifies Post Office relationship with ICL if Benefits Agency is no longer a party to the contractual relationship with ICL.

Disadvantages:

- the cost of managing bank accounts and of the smartcard would be borne by POCL;

- may not be consistent with POCL's long term commercial strategy which is to provide counter services to all the banks rather than to run its own bank accounts;

- restricts Post Office to contracting with ICL. The Post Office have previously maintained that if they lost the BPC they would wish to

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re-tender.

ICL

Advantages:

- removes BA from the contract, helping to clarify ICL's relationship with PO as its single client.

Disadvantages:

- ICL will want compensation for cancellation of the bpc and payment for the development of the new facilities;

- ICL would still need to be paid for ongoing bpc work until Heads of Agreement are signed.

- extra development work required for smartcard-based banking services.

Other advantages/disadvantages for Government:

Advantages:

- boost to Modern Government initiative - early introduction of technology to support Modern Government services;

- boost to social exclusion agenda by providing simple banking facilities to those currently without bank accounts.

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Disadvantages:

- not a clear-cut solution, involves further period of negotiation which may take three to six months and might result in failure to reach agreement with ICL;

- from a procurement perspective, to cancel a major part of the automation project and re-shape the remainder involves an inevitable risk of legal challenge.

Benefit recipients

Advantages:

- unlike the BPC option, provides a bank account to those currently without one;

- compared to BPC and conventional ACT, provides a smartcard earlier (although only an advantage if there are attractive smartcard-based services available).

Disadvantages:

- unlike with the BPC, there are no facilities for urgent payments or payment to nominated proxy. But BA would find alternative methods of offering these services.

Taking the proposal forward - negotiation strategy with ICL

12. In order to preserve our leverage on price with ICL (and in the case of the

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BPC to meet DTI's concerns about not putting the whole Horizon project at risk), it would be vital to keep the Government's alternative options open (either to proceed with the BPC or to pull the whole project) until the commercial terms for this new approach have been agreed.

13. This will require a careful negotiating strategy with ICL. They will argue that, as the Government has changed the specification, the Government should pay ICL's sunk development costs for the BPC. ICL have already said that they would want to split the contract in two, with the Horizon infrastructure, excluding the BPC, rolled out and paid for first, and then a second set of negotiations on the smartcard and the method of paying benefits. This would need to be avoided, since it would leave ICL in the driving seat for negotiations on the smartcard.

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Annex B

BA/POCL AUTOMATION: COMPARISON OF THE ALTERNATIVE OPTION TO CONTINUATION WITH THE BENEFIT PAYMENT CARD

WHAT ARE THE OPTIONS?

Following discussion with ICL, ICL have proposed an alternative option which would entail:

- dropping the Benefit Payment Card;
- the Post Office would set up simple "benefit accounts" on the back of the Horizon infrastructure;
- benefits would be paid via the BACS system into these PO accounts, or else into existing accounts;
- the account could be run by a bank on behalf of the Post Office, and would simply be a vehicle for the cash withdrawal of benefit;
- cash withdrawals from a benefit account could only be made from a post office.

We asked KPMG to model scenarios around this alternative option.

On the basis of this further work, we believe there are two main options:

Continue with the Benefit Payment Card: option 1

- project as currently envisaged;

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- transition to a smart benefit card from 2001;
- benefits paid by ACT into bank accounts from 2005 when POCL has full network banking in place.

Drop the BPC and transfer benefit recipients to a PO benefit account: option 2A

- POCL contract with a banking partner to set up PO benefit accounts accessed by a smartcard by end 2001;
- benefits paid by ACT into PO benefit account from early 2002;
- POCL offer full network banking from 2003.

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WHAT IS THE OVERALL IMPACT ON THE PUBLIC SECTOR?

The following table shows the NPV (1999-2010 discounted to 1999) of options 1 and 2A relative to a base case of "business as usual".

£bn (NPV discounted at 6% to 1999)	option 1: continue with BPC	option 2A: PO benefit account (new approach)
net impact on DSS	1.37	2.51
net impact on POCL	0.17	-1.29
overall NPV	**1.54**	**1.21**

- the modelling suggests that the alternative option 2A is less beneficial to the public sector than continuation with the BPC

- whilst the savings to DSS are much larger under the alternative option, the costs falling on POCL are consequently much greater (reflecting the costs of setting up and operating the PO benefit account and the loss of BA income). KPMG also assumed there would be lower footfall under option 2A, though this looks pessimistic. Assuming no loss of footfall, the **NPV for option 2A would improve by up to £70 million** (see refinements section below)

- there are significant uncertainties attached to the modelling (although these are likely to be greater for option 2A than option 1)

- the NPVs do not fully reflect the risks under each scenario

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REFINEMENTS TO THE OPTIONS

KPMG also considered sensitivities around the alternative scenarios:

<u>BA move to start ACT transfer more quickly</u>

- it might be possible to start the ACT transfer more quickly than BA currently envisage - but we would need to discuss this with BA. In particular, this may be constrained by BA's IT systems

- would risk moving to ACT faster than PO could implement PO benefit accounts

<u>BA completes transfer to benefits via ACT more quickly</u>

- completing transfer to ACT over 18 months rather than 3 years would improve the NPV of option 2A by £130m as DSS savings come on stream more quickly

- we would need to discuss with BA whether this was operationally possible

- note this would not close the gap between option 1 and option 2A

<u>POCL markets its full banking more aggressively under option 2A</u>

- NPV on 2A might be improved if PO manage to transfer these customers to full banking more quickly

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BA/POCL work together to maintain footfall in option 2A at the same level as option 1

- option 2A entail greater loss of footfall than option 1, since some changes implemented by BA (e.g. periodicity) will encourage a larger shift to ACT into conventional accounts than under option 1

- it might be possible for BA and POCL to work together to reduce footfall loss - possibly saving up to £70m NPV under 2A

- note this would not close the gap between option 1 and option 2A

POCL offers a more conventional bank account

- envisages PO bank accounts offering simple bank services. Could be accessed at points other than the Post Office

- significant risk to PO commercial banking strategy - to become network banker for all banks - since banks would see this as a competing product

- greater risk to footfall - since accounts can be accessed at other non-post office locations e.g. ATMs

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THE POTENTIAL RISKS

Comparing the alternative option 2A with option 1:

- the figures are dependent on the outcome and timing of a further round of negotiations:

  - with ICL over the cost of Horizon without the BPC, and the cost of smartcard. It is far from clear that we could keep ICL to the same NPV loss negotiated by the public sector parties following Corbett. In particular, ICL would argue that they should be paid for their sunk development costs for the BPC, and it is not clear what they would charge for the smartcard;

  - with potential clearing bank partners for POCL to provide benefit accounts;

  - with all the banks to allow POCL to offer network banking services (allowing post offices to provide counter services on behalf of banks). The modelling of the alternative options assumes that POCL is able to offer network banking services from 2003. If this date were to be delayed it would hit the financial projections for option 2A compared with option 1.

- the fraud risk (e.g. from the use of a stolen card). Under Option 1, this risk is borne by ICL, and there are various BPC-specific IT systems planned to manage this (e.g. to verify the identify of the cardholder). Under ACT, fraud risk falls to the banks - in the case of the alternative approach, POCL or POCL's banking partner.

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- the development risk. The development of the BPC is almost complete. In contrast, the alternative approach requires development of a number of IT systems - in particular, the interface with the Horizon platform in Post Offices and the POCL benefit accounts.

- the impact on the network. The reaction of sub-postmasters to the removal from the project of the BPC would have to be carefully managed.