

RESTRICTED - POLICY AND COMMERCIAL

DTI VIEWS ON CONTINUATION/CANCELLATION OF THE PROJECT

1. DTI view the 9 December package of proposals from ICL as providing an acceptable commercial basis for continuation of the Horizon project (Option 1). There are a number of wider considerations which also need to be taken into account. These strengthen the case for continuation still further.

Continuation offers the lowest risk of damage to the network from migration to compulsory ACT.

2.1 Key issues for Post Office Counters' future are:

- the timing of the introduction of automation,
- given the Benefits Agency's desire to move towards a system of payment of benefits by ACT - the timing of this switch and POCL's ability to capture a significant proportion of this business and be paid for doing so; and
- their ability to maintain subpostmasters' confidence to maintain a nationwide network of post offices.

2.2 Cancellation of the project will delay by perhaps 3 years the point at which POCL has the automated platform it badly needs to support its existing services and to expand into new areas which will contribute to the revenue base needed to maintain the nationwide network of post offices. Large and complex IT projects are notorious for their delays and there is no guarantee that another system would not equally fall subject to delay.

2.3 Cancellation of the project, no matter how firm the assurances that POCL will commission an alternative system, will damage subpostmasters' confidence. There is evidence already that the delays to Horizon are affecting the market for post offices. When subpostmasters learn that they are to lose all benefits payments to ACT, many may choose to leave the market, creating instability and uncontrolled closures in the post office network. POCL believe that a longer time period to manage the transition to ACT via the benefit payment card followed by a Post Office smartcard will give them the best prospects of achieving a managed transition. This will be crucial if POCL is to maintain anything like its present network, given that banking transactions overall are predicted to generate only about a third of the value of the current BA income.

2.4 The Horizon platform will provide a base for the development of a wider range of on-line banking services than appears possible with interim banking solutions; at an earlier point than would be possible with a replacement platform; and in a manner which should help POCL to establish a long term commercial relationship with banks which is of benefit to them. It should also enable them to

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offer electronic Government and other facilities based on a smart card at an earlier point than they would be able to do so if they had to establish a replacement system.

Implications for ICL/Fujitsu

3.1 Loss of the project would undoubtedly be a major blow to ICL. Just how great would depend primarily on the stance taken by Fujitsu, who have claimed that it could lead to the collapse of ICL. Failure of the project would mean ICL would make a total loss of around £200m in 1998; which would effectively destroy its prospects of flotation in 2000 and might indeed lead to Fujitsu to decide to divest itself of the company. Given the current economic climate in Japan, Fujitsu's attitude may well have hardened; the company itself appears to have had a bad year in 1997-98 with group post-tax profits slumping to just £26m. Even on a "least bad" scenario, cancellation would badly damage ICL's reputation both here and in export markets, and its future prospects.

3.2 It is estimated that some 270 staff are employed directly on the Horizon project at ICL Pathway (and many more at their suppliers). These jobs would clearly be at risk if the project were to be cancelled. It is assumed that other parts of ICL would either survive, or would be sold, and that the jobs concerned would therefore be at much less risk.

3.3 Cancellation would clearly damage the credibility of the PFI process generally, but particularly could be expected to make the funding of future large IT projects on a public/private partnership more difficult to put together. Interestingly, the PFI funding arrangements for Horizon have been portrayed as a model for Japan and heavily promoted as such by Fujitsu's Vice Chairman.

3.4 Cancellation would result in ICL seeking recourse to the courts to recover sunk and committed costs of around £250m. This figure would also inform what we might expect to pay for a negotiated settlement. Litigation, no matter how strong we may believe our case to be (and ICL clearly believe theirs to be equally strong), would be prolonged and messy. Whatever the eventual outcome, those costs - together with our legal costs - need to be added to the equation in the decision on whether to terminate or to proceed.

3.5 It is clear from the recent approach from Mr Naruto, Vice Chairman of Fujitsu and Chairman of ICL, to our Ambassador in Tokyo, Sir David Wright, that cancellation would have a serious effect on our relations with Fujitsu. Sir David does not doubt it. Fujitsu have been a major inward investor in the UK, with well over £700 million invested in the last decade. Whatever the justification from where we sit, cancellation would be seen in Tokyo as a major breach of faith by the

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UK Government - a withdrawal from the project because we had changed our minds on the policy but had sought to put the blame on ICL. We could expect wider repercussions on inward investment from Japan as Fujitsu's story permeated other boardrooms.

***DTI Posts Directorate
11 December 1998***