

RESTRICTED - POLICY AND COMMERCIAL

ATTACHMENT A

**DTI PAPER ON IMPLICATIONS OF (A) A COLLAPSE OF THE
HORIZON PROJECT; AND (B) A SIGNIFICANT LOSS OF BENEFITS
AGENCY VOLUMES**

This Paper addresses two scenarios:

Scenario A

- the implications for Post Office Counters Ltd (POCL), for ICL and for Government policy more widely of a collapse of the Horizon project but with Benefits Agency (BA) payments through POCL remaining substantially at present levels; and,

Scenario B

- separately, either as result of the loss of Horizon or for other reasons; the implications for POCL of a significant loss of BA volume (and therefore revenue).

RESTRICTED - POLICY AND COMMERCIAL**SCENARIO A : IMPLICATIONS FOR POCL, ICL AND GOVERNMENT POLICY
OF COLLAPSE OF HORIZON (BUT WITH BA PAYMENTS THROUGH POCL
REMAINING SUBSTANTIALLY AT PRESENT LEVELS).****I. CONSEQUENCES FOR POCL OF COLLAPSE OF HORIZON PROJECT**

1. In addition to providing a modern fraud resistant means of delivering BA payments to recipients and providing BA with substantial administrative savings, the Horizon project is designed to:

- give POCL a powerful automated platform from which to develop new business opportunities and to retain existing business;
- provide POCL with a powerful on line point of sale information gathering and processing tool both for its own and clients' business; and
- provide counter clerks with comprehensive and continually updated information about a wide range of transactions, enabling them to concentrate on the customer, rather than the transaction.

2. **Without Horizon:**

- BA would forego £x m p.a. in administrative savings and up to £y m p.a. in fraud savings (though an extension of the bar code checking system used in the London area could be a cost effective means of reducing the latter - see para. 3 below). BA would also forego the accountability for expenditure which could remove the auditor's qualification of their accounts each year.
- There can be little doubt that in the absence of Horizon, the case for rapid introduction of compulsory ACT from the BA perspective would be overwhelming.
- Potential new clients of POCL will expect to receive sales and accounting information about their product in a timely and convenient fashion, and will find POCL's existing paper-based methods unacceptable. A number of POCL's existing clients have also made clear that without the early introduction of Horizon they will be looking for alternative outlets.
- More generally, the loss of these facilities will deprive POCL of the opportunity to modernise and streamline its internal procedures and reduce costs in order to remain competitive in the market place.

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- POCL will find its ability to take on an increasing range of new business - so as to at least offset the attrition of existing core business as a result of social and demographic changes - limited by the capacity of counter clerks to cope unaided by Horizon's electronic prompting with such a wide span of products with constantly changing prices and specifications.
- **POCL predicts that in the absence of Horizon, but with continuing benefit payment trends, in the face of growing competition they will continue to lose business to the point that by 2002-03 its present annual profitability of around £30 million will have become an annual loss of around £30m p.a.; and there will be a loss of 1000 subpost offices by that date. Reduced footfall in post offices will also adversely affect the private side of the subpostmaster's business.**

3. A number of **alternative technologies** might help POCL offset the loss of Horizon:

- **ALPS:** A relatively simple and low cost point-of-encashment system introduced in the London area and based on bar-code reading of benefit payment foils. ALPS proved itself capable of reducing encashment fraud by up to 80%, and has proved highly cost-effective. However, it leaves the benefit payment system entirely paper-based and offers none of the accountability or administrative cost savings offered by Horizon.
- **APTs:** POCL already has some 8,000 of these automated payment terminals, with a further 2,000 on order. They enable POCL to offer clients a modern, automated means for customers to pay their utility and other bills at post office counters.
- **EPOS:** Essentially an electronic till capable of capturing a range of data at the point of sale for subsequent centralised processing. A standard piece of retail functionality.

4. One advantage of such alternatives is that they represent standard generic technologies, rather than the essentially bespoke approach of Horizon. They should therefore avoid the development delays and cost over-runs that have emerged with Horizon, and could also be expected to evolve more smoothly from one generation of technology to the next. The disadvantage is that a number of disparate approaches of this kind would necessarily lack important elements of functionality of a fully integrated system such as Horizon. This loss of functionality might be offset in part by developing separately "a black box" to integrate relevant data from various systems. But this would be to revert to a bespoke solution, and as such would run the risk of delays and escalating costs for at the end of the day, a less attractive and satisfactory system than Horizon.

5. If the circumstances of withdrawal from Horizon led to claims for compensation (of perhaps £100-£200 million against POCL) the combined costs of withdrawal from Horizon and development of new systems together with the associated delays would almost certainly heavily outweigh those of continuing with the project.

RESTRICTED - POLICY AND COMMERCIAL**II. IMPLICATIONS FOR ICL**

6. Horizon with 40 000 on line terminals capable of processing a wide range of transactions, with input capabilities including keyboard, touchscreen, bar code reader, magnetic swipe card and the new smart card technologies, together with the functionalities described above, represents one of the most ambitious and complex iT projects ever undertaken in Europe (even though there is little cutting edge “rocket science” in the technologies employed). As such it is a key building block in ICL’s strategy to reposition itself in the iT market place as a major service provider rather than as a manufacturer of hardware. In addition, Horizon could prove an important “turn key” project for ICL, since a number of foreign administrations - including notably Germany - have expressed strong interest in acquiring similar facilities. The failure of Horizon would seriously damage ICL’s and to an extent the UK’s reputation and credibility in this market. It would also lead directly to the loss of 1000 jobs within ICL during the life of the project.

7. ICL has, with the backing of its Japanese parent, Fujitsu, already sunk in excess of £100 million into the development of Horizon. A further substantial advance (perhaps another £200-300 million) will be needed to complete the project, and should be forthcoming provided there is a reasonable prospect of at least some commercial light at the end of the tunnel, almost certainly requiring some modification of the existing contract terms. Fujitsu have publicly committed themselves to a flotation of (part of) ICL in 2000, and for this will require its recent return to profitability to be sustained by a series of improving financial results along the flightpath to flotation.

III. WIDER GOVERNMENT POLICY ISSUES**Effects on Fujitsu / Japanese Inward Investment to UK**

8. In the absence of clear-cut technical evidence that the project is incapable of being brought to an acceptable conclusion any decision by the UK Government to withdraw its support for the Horizon project for short- term and parochial reasons would simply not be understood in Tokyo, and would be regarded as akin to a breach of faith. Such a conclusion could be expected to influence future decisions by Fujitsu - and probably other major Japanese companies, especially in the iT field - on inward investment to the UK. The difficulty of quantifying this risk does not make it any less real.

Private Finance Initiative (PFI)

9. Horizon is arguably the largest public/private sector partnership iT project undertaken in Europe, and as such is one of a small handful of high profile flagship PFI projects. A much publicised failure followed by protracted legal wranglings could damage the Government’s reputation with the private sector as a reliable partner for such projects, and so make partnerships harder to achieve for future projects.

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Government Direct/ Better Government

10. If Horizon were to fail, the Government would lose an electronic platform which could be adapted for use in the delivery of government services in the context of *Better Government/Government Direct*. This would be unfortunate given the potential benefits to be gained from the reach of the network which far exceeds that of its competitors, its popular brand image, and its potential trusted third party status.

Social Banking

11. Post Office Counters is already offering a limited number of banking services nationwide in conjunction with the Co-Operative Bank, and is currently trialling others with Lloyds TSB. Many of those who at present do not have bank accounts are regular customers of the Post Office, and regard it as a non-threatening honest and reliable environment in which to conduct personal financial transactions. The Horizon infrastructure could with some modification enable post offices to handle a wider range of banking transactions on its own account or in conjunction with Girobank or other banks. Failure of the project would restrict the potential for this.

SCENARIO B: IMPLICATIONS FOR POCL OF A SIGNIFICANT LOSS OF BA VOLUMES

Summary

12. This scenario looks at the consequences for the nationwide network of post offices of a substantial loss of BA volumes and associated revenues, and at possible management strategies to minimise the impact. **The conclusion is that even after drastic pruning of the network to reduce costs, AND the injection of a continuing subsidy of some £150-£200 million a year, there are serious doubts about whether the network could be stabilised at its reduced level, or whether by then it would already have embarked on an irreversible spiral of decline.** The social and political implications of a significant reduction in the network, particularly on rural and urban deprived areas, are considered.

Background

13. BA work currently accounts directly for some £410 million (including £40 million for the encashment of unemployment "green" Girocheques) of POCL's income of £1.1 billion. It is also estimated to attract a further £60 million of business to the network through the so-called footfall effect (thus a customer entering a post office to draw his or her pension may at the same time pay a telephone or other bill over the counter rather than put a cheque in the post). There is likely to be a further significant and beneficial footfall effect on the private side of the shop, contributing to the overall viability of the enterprise.

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Without Horizon

14. Without Horizon, BA's preferred strategy would be to migrate as many benefit recipients as possible as quickly as possible to accept payment directly into their bank accounts (ACT). POCL believe that such a policy could result in the loss of up to 70% of BA business volumes by 2002-03 leading to an overall loss of income (from both direct and indirect effects) of some £400 million a year - against current profits of around £30 million. (In earlier years there would be additional "one off" costs of closure - redundancy, compensation etc.). The precise profile of the impact on POCL's income would depend on the rate of uptake of ACT. There would also be a substantial and in the end unpredictable network effect.

Management Response to Loss of BA Volumes and Revenues

15. POCL have modelled the impact on the network of two courses of action (Models A and B), each designed to take costs out of the network in response to either a 70% or a less drastic 50% reduction in BA business volumes. The tables at Annex A show the results (which should certainly be regarded more as orders of magnitude than as precise forecasts) on the post office network of these exercises. **In practice, POCL unless instructed otherwise would be likely to choose a path which fell some way between these two options.** The models are based exclusively on the impact by 2002-03 of the removal of BA business volumes and associated post office business losses as compared with a 1997-98 base year. Other financial benefits and liabilities (examples are described at Annex A) which are expected to occur between now and 2002-03 are ignored.

Model A (with 70% reduction)

- Under this model POCL would close around 500 Crown (main) post offices (leaving a core of around 100 offices). Their remaining work would migrate to the larger urban subpost offices. However, the loss of volume and thus income in the remaining urban sub offices would cause 4 000 of these offices to close by 2002-03.
- A high proportion of the smaller rural subpost offices are protected by a guaranteed minimum level of payment and would therefore be likely to continue provided that the payments could continue to be financed. Nevertheless, under this model some 500 rural offices could be expected to close. This model removes £200m of costs from the network (against a £400m loss of income) and an annual subsidy of at least £200m would therefore be needed to attempt to stabilise the network at this level. It is estimated that around 17 000 jobs would be lost.

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Model B (with 70% reduction)

- Alternatively, POCL could achieve the same level of cost reduction without management action on Crown offices through a combination of managed and 'natural' closures of some 10 000 subpost offices. This reduction in the network would be fairly evenly split with some 4 500 urban and 5 500 rural offices predicted to close by 2002-03. Again an annual subsidy of at least £200m would be needed to attempt to stabilise the network at this level. It is estimated that around 25 000 jobs would be lost.

16. The geographical impact on the post office network of a removal of 70% of Benefits Agency transactions handled by POCL under Models A and B is illustrated at Annex B.

Downward Spiral of Decline

17. It is difficult for POCL to model the precise impact on the network given the instability of the business which would flow from loss of the principal source of income for the business. POCL have taken a prudent approach in their estimates. These do not take account of any potential income POCL might gain from offering an ACT type facility possibly in conjunction with Girobank which would, of course, involve the business in additional capital expenditure. **Nevertheless, there can be no guarantee that even at the levels of subsidy described above the network under either model could be maintained in a steady state.**

18. The models do not take into account potential loss of business due to client and customer dissatisfaction which would result from a reduction in network provision and quality of service at remaining outlets. A reduction in the network will inevitably increase the pressure on the remaining outlets resulting in a deterioration in the quality of service provided at many outlets and potentially unmanageable levels of business at some. This may be particularly felt in areas which have lost Crown offices under Model A. This will in turn discourage the establishment of new business, and put at risk POCL's ability to retain existing clients. It will also affect the ability of Post Office Counters to provide universal access to some Royal Mail and in particular Parcelforce services.

19. The resultant loss of reach and the negative impact of closures on the integrity of POCL's brand image will in their view result in further ongoing closures as the network becomes unstable and a spiral of decline ensues. Loss of BA work will result in reduced footfall affecting the volumes of both transactions in the post office and the private side of the subpostmaster's business (post offices are generally operated alongside a private business).

Impact on Girobank

20. Girobank's business is fundamentally built around the cash handling market, and depends on post offices taking in cash in the form of small retailer deposits which it then recycles as cash payments on behalf of BA. POCL estimates that 70% loss of BA volume

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would lead to a loss of 75% of Girobank's business and its probable withdrawal from the cash handling market. This could in turn call into question Girobank's future viability as a business.

Rural Areas/ Deprived Urban Areas

21. A significant reduction in the network would be particularly unwelcome to less mobile customers, in particular elderly and disabled customers, and would inconvenience businesses, especially SMEs and small retail outlets who use Girobank cash deposit facilities. Any reduction in the post office network is likely to be felt particularly keenly in rural areas and deprived urban areas.

22. The Government in its manifesto stated that:

"Public services and transport services in rural areas must not be allowed to deteriorate. Conservative plans would mean higher charges for letters and put rural post offices at threat."

23. A significant reduction in the rural post office network, as predicted under Model B where with a loss of 70% of BA volumes about 5 500 rural offices are lost (out of a total of around 9 000 rural offices), would be met with strong political opposition. (The previous Government's privatisation proposals for Royal Mail and Parcelforce foundered amidst fears about the future of the rural post office network.) The combined village post office and store, is often the only retail outlet in the community, and as such constitutes an important element of the infrastructure of rural communities who often suffer from poor public transport provision and the absence of banking facilities. The Rural Development Commission in their 1997 survey recorded that 91% of rural parishes do not have bank or building society services in their area. It is also widely quoted that 60% of villages have a post office whilst less than 5% have a bank.

24. Under Model A (with a loss of 70% or 50% of BA volumes and 500 Crown office closures) 90% of the 4 500 sub post offices predicted to close themselves will be in urban areas. Under Model B, which preserves the Crown office network, the 10 000 sub post offices which would be lost divide roughly equally between urban and rural areas. Urban offices will be more severely affected than rural offices by higher levels of loss of BA work given the greater dependence of many (especially in deprived areas) on this for their livelihood and the fact that they will tend not to have the protection of the fixed minimum payment which will help to protect smaller rural offices.

25. Loss of post office facilities is likely to be felt particularly acutely in deprived urban areas where these already suffer from a lack of retail facilities. With the closure of many branches of the high street banks, particularly in deprived areas, post offices are often the only source of basic personal banking services for residents in those areas. It has been estimated that 55% of households in very run-down areas do not have a bank account and for these the post office is often the only way to receive payments, pay bills and cash

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cheques.¹ Whilst the transport infrastructure may be better than in rural areas, more complicated journeys may be unwelcome to those with limited means and with mobility problems.

Effect on Other Retail Outlets

26. In some areas, the effect of closure of a post office may well extend to the businesses in its immediate vicinity both as a result of loss of 'footfall' and the removal of a facility which hands over cash to its customers who may well spend it in the adjacent shops.

Better Government

27. Reductions in the network resulting from removal of BA work, even if at some date POCL were to be equipped with an alternative electronic platform, would reduce the reach of the network for providing delivery of government services by electronic means in the context of *Better Government/Government Direct*. As noted previously, this would be regrettable given the significant potential value of the network as a service provider in this area.

Union/ Public Reaction

28. If POCL were to manage network decline by closing Crown post offices with resulting compulsory redundancies they believe industrial action organised by the Communication Workers Union (CWU) would be likely in the Counters and other Post Office businesses. A national campaign for Government intervention to support offices at risk would no doubt be organised by the union with ready public support given past experience of public reaction to the conversion of individual Crown post offices to agency status and to the campaign by the union "Save our Post Office" in the context of the previous Government's proposals to privatise Royal Mail and Parcelforce. The National Federation of Subpostmasters (NFSP) also led a very public campaign to save post offices in reaction to the trial by DSS in 1993 of new application forms for pensioners some of which effectively removed the Post Office option. It is likely that the NFSP and the CWU would cooperate in any campaigns.

29. Subpostmasters are eligible under their existing contract with POCL for compensation for compulsory closure of their post office, equivalent to 26 months remuneration. However, there is no provision to compensate subpostmasters for loss in value of a post office or associated private business. The NFSP would be bound to lobby for the latter, which if conceded, could add greatly to Post Office costs.

¹ Source: 'The Social Responsibility of Credit Unions in the European Union' 1997 Malcolm Lynch solicitors sponsored by DGXXII, European Commission and others.

RESTRICTED - POLICY AND COMMERCIAL**Social Banking**

30. As previously indicated, the Horizon infrastructure could with some modification enable POCL offices to handle a wider range of banking transactions on its own account or in conjunction with Girobank or other banks. However, using existing technology POCL is already able to undertake limited banking facilities on behalf of the Cooperative Bank and Lloyds TSB. There is in principle therefore no reason why benefit recipients who at present choose to receive their payments through the Post Office should not be able under compulsory ACT to use POCL as the outlet for withdrawing cash from their accounts. Such a facility, might also be welcomed by many existing ACT beneficiaries. However, POCL believe that the volume of business which would remain with post offices under a social banking type solution would in no way compensate for the loss of business which would migrate to other banks or building societies with whom around 80% of existing benefit recipients already have accounts.

Payment of Subsidies

31. As noted above, the scenarios of Models A and B imply continuing annual subsidies of at least £200 million. This paper does not address the difficulties and disadvantages of subsidy at this level. Such a massive infusion of state aid on a continuing basis could not fail to attract the attention of the Brussels competition authorities. At a domestic level, there would also be issues of competition policy - for example where one shop in the village received a subsidy whilst the second, which did not have the post office counter, did not.

32. A traditional weakness of such subsidies is that they tend to reward inefficiencies and high costs, unless specific measures to counter these tendencies can be put in place. This would be one aspect to be kept in mind in deciding the delivery mechanism - national or more local - and the subsequent monitoring arrangements. Many of these same considerations would also apply to the financial assistance that could be needed to cover the transitional costs of closure, redundancy and compensation.

Postal Services Directorate/DTI

31 March 1998

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Current POCL profits £ 32m p.a. Current POCL revenue £1 100m p.a.
POCL's revenue from BA work £410m p.a.

The tables which follow (pages 11 and 12) represent a steady state position at 2002-03. The volume impact of BA loss is taken on projected steady state from 1997-98.

(It should be noted that POCL will shortly be facing a number of significant financial liabilities which are ignored in these calculations. For example, introduction of the Euro with a one-off cost of some £22m and following its establishment an annual profit reduction of £5-10m. In addition, if notes held to order status were lost this could result in a profit reduction of £8-40m. Year 2000 compliance is estimated to cost POCL £16.8m at constant prices in the period 1998-99 to 2000-01. Abolition of Advanced Corporation Tax credit and payment of family credit through taxation will also impact on POCL's profitability.)

SCENARIO A: IMPACT OF LOSS OF HORIZON ON POCL PROFITS AND POST OFFICE NETWORK

Steady state Year 2002-03 (as compared with 1997-98)

BA Volume Loss as % of Total POCL Business Volume	4%
Related Business Loss as % of Total POCL Business Volume	1.5%
Subpost Office Closures	1000
Loss Of Volume as a Result of Network Reduction	1%
IMPACT ON POCL PROFITS	-£30m

Note: The business volume loss % figures and post office closures shown above are cumulative to 2002-03.
The impact on POCL profits is steady state.

SCENARIO B: POST OFFICE NETWORK NUMBERS WITH LOSS OF 70% OF BENEFITS AGENCY VOLUMES UNDER MODELS A AND B

Steady state 2002-03 (Volume impact of BA loss taken on projected steady state from 1997-98)

	Current No's	Estimated No's under Model A	Estimated No's under Model B
Crown Post Offices	600	100	600
Urban Sub Post Offices	9 281	5 281	4 781
Rural Sub Post Offices	9 139	8 639	3 639
Total Network No's	19 020	14 020	9 020

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SCENARIO B: IMPACT ON POST OFFICE PROFITS AND NETWORK OF LOSS OF BENEFITS AGENCY VOLUMES UNDER MODELS A AND B

MODEL A Steady state at year 2002-03
Management action to close 500 Crown offices
Unplanned closures of urban and rural subpost offices

LOSS OF BA VOLUMES	70%	50%
BA Volume Loss as % of Total POCL Business	16%	12%
Related Business Volume Loss as % of Total POCL Business	6%	4.5%
Crown PO Closures	500	500
Urban Sub PO Closures	4000	4000
Rural PO Closures	500	500
Loss of Volume as a Result of Network Reduction	7%	7%
Job Losses	17 000	17 000
IMPACT ON POCL PROFITS	-£193	-£139

MODEL B Steady state at year 2002-03
No Crown post office closures
Managed and unplanned closures of urban and rural subpost offices

LOSS OF BA VOLUMES	70%	50%
BA Volume Loss As % Of Total POCL Business	16%	12%
Related Business Volume Loss as % of Total POCL Business	6%	4.5%
Crown PO Closures	0	0
Urban Sub PO Closures	4500	3900
Rural PO Closures	5500	5100
Loss of Volume as a Result of Network Reduction	7%	7%
Job Losses	25 000	23 000
IMPACT ON POCL PROFITS	-£197	-£143

Assumptions

- Volume impact of BA loss is taken on projected steady state for 1997-98.
- Assumes % loss of benefits is market share of benefit volumes. This is then converted into volume of transactions and income is based on the price mix in the contract immediately before automation contract agreed i.e. no floor levels on income etc.
- Transition costs modelled on 70% loss given below not included.
- Impact of possible customer and client loss due to deterioration in Qof S, client withdrawal due to reduced network/change in mix or holes in network is not taken into account.

Transition costs (prior to 2002-2003) include:

- Model A: Compulsory redundancies 7500 staff £50 m
Disengagement costs from leased Crown properties £40 m
- Models A and B: Compensation for subpost office closures (in line with existing contracts) @ 70% loss = £250 m @ 50% loss = £220m
(i.e. no account taken of potential additional claims)
Lost POCL rental income due to closure of subpost offices.