

RESTRICTED - POLICY & COMMERCIAL**DRAFT LETTER FOR THE SIGNATURE OF THE SECRETARY OF STATE TO
THE PRIME MINISTER****BA/POCL AUTOMATION PROJECT: HORIZON**

Alistair Darling and I met yesterday to try to agree a way forward for the Horizon project on the basis of Jeremy Hayward's letter of 14 January. Unfortunately, differences remain between us, and the need for a decision is now urgent.

You will have seen the letter dated 15 January from Derek Fatchett stressing the damage that our failure to reach a decision is already causing to our relationship with Fujitsu, ICL's parent and the largest single Japanese investor in the UK, and the concerns that this negative perception will spread to the wider Japanese investor community. Let me add that I have very recently learned that the Managing Directors of ICL UK and ICL Pathway (the subsidiary responsible for the Horizon programme) have been called to a Fujitsu main board meeting in Tokyo this Friday (22 January). There must be a very real risk that if ICL have not received a positive response from us by then, they will be told by Fujitsu to terminate and sue for damages. It will be painfully visible that Fujitsu will have done so because they no longer wish to do business with a Government which they feel has treated them in a cavalier and disrespectful fashion, and after the company had responded rapidly and positively, and in good faith, to a UK Government demand for financial and performance guarantees exceeding £600 million as the price for continuing with the project.

I accept that Alistair's proposal set out in his letter of 22 December represents a genuine attempt to find a way forward that reconciles his wish to move to ACT without the transitional stage of the benefit payment card with the need to avoid as far as possible

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damage either to the nationwide network of post offices, or to ICL and its future prospects, whilst also furthering wider Government objectives on social and financial exclusion and modernising the interface between Government and the citizen.

Unfortunately, I do not believe that it is likely to be negotiable with ICL, nor that it is the best way to achieve the early introduction of a smart card and the early adaption of the Horizon infrastructure as a key delivery channel for electronic government.

It is clear that ICL are looking for a revenue stream from the delivery of electronic government on top of that from the payment of benefits through the benefit payment card (bpc) and have indicated their intention to invest £78 million to maximise that opportunity. This is the so-called "Golden Cloud" which enabled them to agree in principle on 9 December a commercial and financial deal with Post Office Counters Ltd (POCL) as the basis for taking the project forward . If we now offer to pay for this instead of for the bpc, a substantial part of their business case will disappear. We should therefore be faced with offering them substantially more than under Option 1 (continuation of the project with the bpc), either as hard cash or as bankable guarantees on minimum volumes of electronic government business - which at this stage look highly uncertain in the timescales of the Horizon contract. This would in turn have important value for money implications in comparing Alistair's proposal with Option 1.

The only way we can hope to engage ICL in discussion of this possible alternative way forward is to make it clear that Option 1 is no longer on the table. But in my judgement there is a huge risk that if, after all the delay, we now do this, ICL will simply walk away for the reason I have explained, and sue. I am clear from Jeremy Hayward's letter that this is not an outcome you wish to risk, given the effects it would have on ICL, our relations with Fujitsu, damage to the PFI process and of course the future viability of the nationwide network of post offices.

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I am also concerned that at a time when the need is for ICL to be given an early and above all clear cut decision on the way forward, Alistair's proposal would require considerable further work, particularly involving BA and POCL, before the public sector side had a fully worked up and agreed alternative proposal that could be put to ICL. I accept that with Option 1 there remains an important unresolved issue concerning acceptance criteria, but I believe that with other aspects of this option essentially in place, there would be real pressure on ICL to concede a solution on this acceptable to the public sector side.

There is an important further point. The early introduction of a magnetic strip bpc could be followed very quickly by its replacement by a smart card which for the Benefits Agency would contain exactly the same functionality as the bpc. However the existence of a PO smart card with an installed base of 20 million would give POCL an immensely powerful marketing tool to persuade banks and others to agree to include their respective functionalities on that card. But without the Benefits Agency work, POCL would have no major functionality from which to launch a smart card, whose introduction might therefore for commercial, not technical, reasons be put back for several years, by which time the opportunity to become a major force in the smart-card market would in all probability have been lost.

The fast-track introduction of a PO smart card based initially on the bpc offers the prospect - particularly with ICL marketing involvement - of building up more rapidly alternative sources of income for POCL. I believe that this should in turn enable BA to begin the migration to ACT earlier than the existing Option 1 timetable envisages. Certainly if this route can be agreed, I will want to instruct my officials to engage with

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Alistair's - with the full participation of BA and POCL - to identify a faster route to migration to ACT, which we are all agreed is our end goal.

I should add that I am aware of concerns that have been expressed that moving very large numbers of benefit recipients onto ACT may not in practice prove as pain-free or as cost-free as DSS hope. We shall of course not know until we start the process in earnest. But to make that move from the bpc, as a modern, convenient, efficient and fraud-resistant means of payment, would in my view provide far better insurance than launching it from the present paper-based system.

I am copying this letter to Alistair Darling, Jack Cunningham, Charles Falconer, Alan Milburn, Geoff Mulgan and to Ian McCartney here.