File Horizon

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Rt Hon Stephen Byers MP
Chief Secretary to the Treasury
Parliament St
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14 December 1998

Dear Stephen,

BA/POCL AUTOMATION PROJECT: HORIZON

I am grateful to Alistair Darling for copying to Peter Mandelson and myself his letter to you dated 11 December, in which he set out his initial reactions to the latest ICL proposals. I have discussed the letter with Peter, and he has agreed that I should write in the following terms, as our own initial reactions differ substantially on a number of points. You have also seen the Post Office Chairman's letter to Peter setting out the Post Office's reactions.

Overall, Peter and I believe that ICL have now made a major move towards our position which in all key elements genuinely represents their last and best offer, at least on the main elements. Although their proposals still fall some way short of meeting our demands in full, we believe that they nevertheless lay the foundations for a commercially acceptable basis on which to take the project forward.

Taking Alistair's points in turn, our understanding is that Fujitsu are indeed willing to back their commitment to stand behind the project to the tune of some £600 million with legally enforceable performance and funding guarantees, in exactly the same way as they have done for my own Department's recently awarded Elgar contract. If this is correct, as we believe it to be, it transfers from the public sector and onto Fujitsu several hundred million pounds worth of risk, represents a major concession on Fujitsu's part from their previous position, and removes at a stroke probably the largest single element of unacceptability from the earlier proposals.

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Second, we are puzzled by Alistair's suggestion that the new proposals do not "make any significant change to the 9 November proposals, which we rejected, in the overall balance of expenditure on the project between the public sector and ICL". Under the 9 November proposals the NPV gap of £224 million remaining at the end of the Corbett negotiations was extended by a further £80 million contingency fund, to be funded by the public sector partners but held by ICL (and with little prospect that much if any of it would in practice prove refundable). The whole of this contingency provision has been removed in the latest proposals. In addition, the £121 million to be funded by Post Office Counters Ltd by price increases within the contract under the earlier proposals has been reduced to around £90 million, with ICL accepting a higher level of risk on volumes, and POCL benefiting from keener prices within the guaranteed floor. To put this in perspective, if forecast traffic volumes under the new arrangements reach only 90% of forecast levels, ICL's projected pre-tax loss on the project will double from around £260 million to more than £500 million. My interpretation therefore is that on the "commercials" ICL have in practice conceded somewhere between £80-100 million as compared with the 9 November proposals, and have also taken on significant additional risk.

Third, acceptance testing. Alistair states that "ICL persist in asking for acceptance on the basis of a laboratory test of the systems, as opposed to a live trial...". We agree with him that this is a hugely important point. It would be unthinkable to sign off acceptance of the system until it has been shown convincingly to work on a reasonable scale in a live environment. But Alistair is, we believe, mistaken - ICL are asking no such thing. The company have moved substantially from their 9 November position and have now conceded that acceptance will follow live trials based on the NR2 software release at 300 offices. More specifically, there are 24 separate components of the acceptance test procedure. Some do indeed involve elements of bench and/or model office testing, but <u>all also include live trial in 300 offices</u>. Beyond that, there is contractual provision for any significant fault <u>not</u> defined in the acceptance process, but which manifests itself during live trial, to be rectified before acceptance is signed off. Finally, the contracting parties can withhold the release authorisation for national rollout if they remain dissatisfied at the performance of the system during the live trial phase. Peter and I are not clear what further reassurance Alistair requires.

Fourth, on slippage we agree that ICL's failure to hit the milestone due on 14 December is disappointing. We believe that the ICL management are no less concerned, and that they will make every effort to make good the delay. As we understand it, however, the replan of the timetable during the Corbett negotiations envisaged a window of between early July and early October for the start of live trials. ICL's management have insisted to my officials that they remain wholeheartedly committed to keeping within that window. They also stress that at no time did the Benefits Agency indicate that the latter part of the window would involve several additional months of delay to Horizon whilst the Agency concentrated on last minute Year 2000 issues. Whilst we cannot entirely rule out the possibility of further delays to Horizon, we at least have the assurance that it has been extensively and comprehensively audited by independent experts, and shown to be in good shape. Starting an entirely new replacement system would represent a far greater leap into the unknown.

Fifth, the fraud and administrative savings foregone as a result of delays to Horizon are indeed a cause for regret. It is however worth pointing out that Alistair's figure of £800 million savings foregone over the <u>next</u> 10 years if we choose to continue with Horizon is broadly mirrored by the calculations both of officials (in last July's report by the Horizon Working Group), and later of KPMG, of the negative NPV effects of cancellation on POCL (from loss of revenue, compensation to subpostmasters, and subsidy to

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maintain network at given size). Added to that is the risk of damages against us of £100 million or more from litigation. In other words, the costs of terminating Horizon whilst trying to maintain the network at something approaching its present size could equal or exceed Alistair's administrative savings.

In other words, unless we are willing to risk major and uncontrolled contraction of the network, we may need to deploy all Alistair's savings - and perhaps more - to support it. If we try to migrate recipients quickly, before the Post Office can offer full front end banking facilities, we are likely to meet strong political resistance, and most of those recipients who do migrate will be lost to the Post Office system (together with their associated footfall on the private side of the shop as well as for other postal products). The potential savings to the Benefits Agency are greatest, but so are the subsidy requirements to prevent uncontrolled network collapse, to compensate subpostmasters for closures etc. If we move in a more measured way to ACT, in line with the Post Office's ability to offer banking facilities, the damage to the Post Office's customer base and hence the need for subsidy and compensation will be reduced, but so will the potential savings to BA. Either way we shall have at the end of the transitional period a network less able to sustain itself than if we had migrated to ACT via Horizon and the benefit payment card.

For all these reasons, Peter and I now believe that there is a clear case for continuing with Horizon on the basis of the latest ICL proposals. When the wider context is given due weight, we believe the case becomes overwhelming. First, loss of the project would undoubtedly be a major blow to ICL. Just how great would depend primarily on the stance taken by Fujitsu, but they 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 Fujitsu to divest itself of the company. Given the current economic climate in Japan, Fujitsu's attitude may well have hardened. Even on a "least bad" scenario, cancellation would badly damage ICL's reputation both here and in export markets, and its future prospects.

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 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.

Finally, 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.

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I am copying this letter to the Prime Minister, Alistair Darling, Jack Cunningham, Charlie Falconer an to Peter Mandelson.

GRO

Ian McCartney