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Message:

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To: Secretary of State

From: Sarah Graham PFD Sp Proj

Date: 16 April 1999

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BA/POCL AUTOMATION PROJECT: TOWARDS AN AGREED ROUTE FORWARD

Issue:

(i) **Briefing put forward by HMT officials to the Chief Secretary, in preparation for Monday's meeting with Ministerial colleagues.**

(ii) **Update on latest developments; and, in the light of those, initial thoughts on how to approach the meeting.**

Background:

1. The attached briefing note from Treasury officials to the Chief Secretary suggests that:

- the alternative option that they have been exploring with ICL, POCL and ourselves (B1), has turned out too expensive at £700 million npv more than the option to continue with the Benefit Payment Card;
- continuing with the Benefit Payment Card is not a realistic option, given its history and continuing delays, in addition to the "dysfunctional" contractual arrangements between the three parties;

and recommends:

- termination of the contracts with ICL Pathway, but leaving the way open in the course of a negotiated settlement to work out an outcome broadly on the lines of our "fourth way" ie POCL and ICL retaining the bones of the Horizon infrastructure; abandoning the Benefit Payment Card elements and moving forward as quickly as practicable to a banking solution along with a move to ACT as the norm for benefit payments. Under this route forward the overall objective could be achieved either with or without ICL. HMT view, with which we concur, is that ICL/POCL are unlikely to produce a cost-effective outcome on "the fourth way" unless against a background of termination.

Current position:

2. As a result of this paper, POCL/ICL appear at the last minute to have revisited Option B1. And are expected to produce figures over the weekend which will result in making this option look very different from the £700 million negative npv. At the same time, HMT say the costs of termination are beginning to look higher than originally thought – although we have had no opportunity yet to see these figures and assess their validity. Again, work is being done by KPMG on these over the weekend. Finally, it has become clear that Stephen Byers does not consider termination an option. Hence perhaps the last minute spurt to make a real effort to make B1 work.

3. Against this backdrop, HMT's paper to the Chief Secretary is being put forward only as a draft to give him something to read over the weekend. They are expecting to have a revised paper on Monday.

DSS/BA position:

4. Our key objectives are:

- to avoid getting drawn into a solution around the Benefit Payment Card, simply because there hasn't been enough time to sort out a better alternative;

and

- to find a way of avoiding getting into a conflict that we cannot win with DTI.

Key issues on the BPC continuation option are:

- **No deal has been agreed for moving forward on the Benefit Payment Card: many commercial and contractual issues remain outstanding, most crucially for us around acceptance;**

- ICL will now probably not accept it without significantly more money than the deal they appeared willing to accept before Christmas, unacceptable constraints on DSS/BA and possibly POCL;

- Recent difficulties around testing and further slippage since the November Corbett discussions do not bode well for timely delivery and risks significant additional costs further down the line, whatever agreed now;

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- There are real issues about justifying further Government expenditure on the project as it stands, given its history (the NAO are due to start work on a VFM report as soon as Ministers reach a decision).

The alternative:

5. There must be a way of achieving the objectives that Ministers set Steve Robson and his team to take forward: we believe there is (our suggested B3/"fourth way"); the only question is whether we need termination as the strategy against which to achieve that.

6. You may wish therefore rather to emphasise that there is a way forward which could consist of:

- cancelling the Benefit Payment Card – nobody wants it not even POCL: all POCL want is the funding stream;
- rolling out the infrastructure, both to give POCL (and sub post masters) the visible early automation that that brings; also the chance of paying something to ICL to buy us more time and to keep them in the frame;
- providing a further discussion period – either on the lines of "the fourth way" or some other version eg a proposal put forward by POCL.

Next steps:

7. We will arrange for you to receive any revised version of the HMT paper on Monday as soon as possible. And further handling thoughts.

8. If you wish to discuss any of this over the weekend, Vince Gaskell, Hamish Sandison and I will all make sure that we are available.

MRS. SARAH GRAHAM
PFD Special Projects

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History

The BenefitsAgency/Post Office Counters Ltd automation project (known as the " Horizon" project) has a long and troubled history. It was initiated in 1993 with the following objectives:

- to provide a more secure and efficient way of paying benefits. Benefits would be authorised by a magnetic strip card (the "benefit payment card", BPC) rather than via the current paper-based system. The aims were to eliminate encashment fraud (costing over £100m a year); to provide DSS/BA with the means to account fully for their programme expenditure; and to reduce administration costs (but only marginally).
- to modernise and automate PO Counters to make their current (paper-based) business more efficient, and to help them win new business.
- to provide a secure revenue stream from POCL's biggest customer (both via direct income from BA and footfall income from other transactions with benefit customers) into the next decade.
- the prospects of an automated platform has also enabled POCL to begin to develop a commercial vision for the period when income from BA reduced. This is to provide "network banking" services as an agent for the major high street banks; and to develop a " citizen smartcard" providing electronic interaction between the public and government.

A private finance contract was let to ICL Pathway after a competitive tender in May 1996, with a view to complete roll out by October 1998.

Why is Horizon under review?

It soon became clear that the complexity of the project had been underestimated and there was a final replan of the project in February 1997. However there were further delays, and in November 1997 ICL Pathway was placed formally in breach of contract by both POCL and BA after a key contractual milestone was missed. BA subsequently issued a legal "cure" notice, which (in the view of their lawyers) allows them to take steps to terminate their contracts with ICL Pathway.

The project is now running three years behind schedule. New deadlines have been set at various times and consistently missed. BA and POCL attribute the cause of the delays to ICL in all material respects and this has been endorsed by external

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reviews. Pathway has responded by blaming the public sector for the delays and has sought extensions of the contract and price increases to recoup its costs.

A number of detailed technical and policy reviews have been carried out by officials to find a way forward. Following a technical report by independent experts in July 1998, which showed that the Horizon infrastructure was viable and "future proof", the public sector parties began negotiating with ICL Pathway to reach an acceptable commercial deal. At the same time officials from DSS, HMT, DTI, BA and POCL reviewed contingency options.

Following the failure of negotiations (the so-called Corbett discussions) to establish a commercial basis acceptable to Government for proceeding with the contract in October 1998, ICL were given further time-limited periods to move further towards the public sector's position and to make progress in their discussions with the Post Office to develop a public/private partnership, as a means of enabling ICL to bear a larger loss.

ICL wrote to the Chief Secretary on 9 December (and again on 18 December to make a number of further small concessions) with their "last and final" offer. This moved further towards the public sectors' position in NPV terms (including taking on more risk) and offered the required Fujitsu guarantees on funding. The offer involved ICL taking on an expected loss on the BPC project of £126 million in net present value (NPV) terms. ICL's acceptance testing proposals (agreed with the Post Office) were still unacceptable to DSS/BA (in the light of recent experience with NIRS 2, Alistair Darling is seeking further reassurances to safeguard the delivery of benefits). The Post Office Chairman wrote to the (then) Secretary of State for Trade and Industry stating that the PO Board endorsed the deal and would bridge the remaining gap between ICL and the public sector from their resources. A number of other commercial and contractual issues remain unresolved.

However, Ministers were still unhappy with ICL's offer. They sought a solution which might be better matched to meet Government's wider objectives. After an initial set of discussions between Steve Robson (HMT) and ICL, the Prime Minister agreed (Jeremy Heywood's letter of 1 March) that the public sector parties - under Steve Robson's chairmanship - should take forward negotiations with ICL on an alternative option.

<u>The alternative option</u>

The objective was to try to find a solution which removed the Benefit Payment

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Card from the project and moved directly to a system in which benefits were paid via ACT while maintaining post office footfall revenue, and which introduced more quickly a smartcard that could form the vehicle for Modern Government services. Of the options examined by the parties, the most promising method of achieving these objectives (known as Option B1) was as follows:

- the Benefit Payment Card is cancelled;
- if necessary POCL (or probably a specially-formed subsidiary) would seek authorisation under [illegible] Banking Act;
- POCL or its subsidia[illegible] would provide simple "benefit accounts" into which benefits were paid vi[illegible]CT and withdrawn in cash using a smartcard at post offices;
- these accounts woul[illegible]t offer other conventional account services (e.g. transfer of credit fr[illegible]nother account, withdrawal at ATMs) and would appear to the benefi[illegible]ient very similar to the benefit payment card;
- BA would transfer be[illegible]s to POCL via the BACs system - in the same way as is currently done f[illegible]nefit recipients who receive payment by ACT;
- ICL would deliver [illegible] operate the infrastructure required, and would manage the smartcar[illegible]ing the existing Horizon infrastructure;
- ICL would contract [illegible] bank (e.g. Girobank) to administer the accounts;
- POCL's aspirations [illegible]ecome an agent for the banks ("network banking") would be developed i[illegible]arallel, as under option A.

Progress with Option B1

Good progress was made [illegible]rk up Option B1. In a matter of weeks, this new concept was developed int[illegible]tailed technical specification, and in turn translated into a fully worked up dra[illegible]ds of agreement which is now virtually ready for signature.

However, the problem w[illegible]ption B1 is the cost. Working on information provided by the parties, KP[illegible]have modelled the NPVs of Option B1 to compare it with the Benefit Payme[illegible]rd (Option A). The results, attached in detail at

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Annex A, suggest that Option B1 could be £700m NPV more than Option A (and could be even greater, if we accept ICL and POCL's position that the system could not be rolled out until July 20[illegible]).

The main reasons for the differences in costs are as follows:

- by abandoning the benefit payment card we save around £100m NPV;
- but this is more than offset by additional costs, which are (in NPVs):
  - foregone savings to BA from abandoning the BPC and continuing with paper-based systems for longer - £240m;
  - costs to BA from moving to ACT earlier than under the BPC - £265m (note that BA [illegible] significant administrative savings (circa £400m pa) from the [illegible] to ACT but this simply a transfer payment to POCL, which ha[illegible] be compensated in this option);
  - providing a sma[illegible]rd rather than a magnetic stripe card - £70m;
  - banking operatio[illegible] costs of some £240m (a large element of these costs will be subj[illegible]ct to competitive tender - however Girobank have provided an estim[illegible]te which is higher than this).

Against these costs there ar[illegible] additional benefits to the public sector which are harder to quantify, but never[illegible]less might still leave B1 offering value for money: Option B1 brings in a sm[illegible]card more quickly than Option A; and B1 also introduces new contractual [illegible]tionships which provide better incentives for the parties to act together, a[illegible]hich would simplify the decision-making process, thereby making the project [illegible] likely to be delivered successfully.

There are also new numbe[illegible]erging that suggest that option B1 may offer POCL and ICL significantly [illegible]ter potential to earn new revenues from "government.direct" service[illegible]pared to option A - due to earlier delivery of the smartcard. These figures [illegible]ot firm, and will be worked up further over the weekend We will need to [illegible]der them further on Monday.

<u>However, on the basis of t[illegible]rent analysis, we believe that the magnitude of the differential is too large fo[illegible]project to be justified on value for money grounds. And in any case, by requ[illegible]ng [illegible]n additional £700 million in public sector subsidy</u>

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<u>relative to what was on the table last December, it looks unaffordable. Treasury officials therefore recommends that Option B1 is ruled out.</u>

<u>Should we revert to Option A (Benefit Payment Card)?</u>

This depends on whether Option A is a realistic option, both in terms of whether it is a viable on technical grounds, and whether it could be implemented against the background of the current client-supplier relationship involving three parties - BA, POCL and ICL.

On the <u>technical viability</u>, as noted above, the report of the independent panel last summer concluded that Option A is technically viable and "future proof", and should be successfully delivered, assuming firm management of the project and commitment and goodwill on all sides. That is probably still the case now. But since the report there have been further problems with testing and plans have slipped. ICL have already missed the first milestone in the timetable agreed in the course of the Corbett negotiations; and BA point to faults that emerged in the latest testing of the Model Office as an indication of further delays of at least six months. For their part, ICL have expressed concern at what they see as delays to the multi-benefits element of BA's CAPS system, which is an essential part of the successful implementation of Option A - although BA/DSS say this is totally unfounded.

The impact of a further delay on the NPV of the project has been modelled. BA estimate (although ICL and POCL do not agree) that the latest difficulties could delay roll out by a further 6 months. This would worsen the NPV of option A by around £200m NPV.

Treasury officials are principally concerned about the <u>relationship between the parties</u>. The Benefit Payment Card project was always a compromise between the objectives of BA and POCL. As currently formulated, it offers rather more to POCL than it does to BA:

- for POCL it locks in revenue from the BA, and the accompanying footfall, while POCL develop their long term vision - to be a provider of network banking services working as agent to clearing banks as bank branch networks are shrunk;

- for BA it offers reductions in fraud (though much of this could be achieved through other means), but delays the move to ACT which will help to reduce

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the administrative costs and risks involved in paying benefits.

Graham Corbett recognised this in his report, and the problems this caused to the incentives on the parties. He advised that, if Ministers proceed with the project, the contractual arrangements should be simplified leaving ICL with a direct relationship with POCL alone (and BA in turn contracting with POCL), once the automation platform has been rolled out.

The key issue now is whether Corbett's recommendations would still be enough, and whether we could in fact see the project through to successful roll out. Treasury officials do not believe they are. A project will not succeed against the background of dysfunctional relationships between the parties. Crucial to this we believe is the view of ICL, given that, under the terms of the PFI deal, ICL bear the risk if the project is not successfully delivered (i.e they receive no payment from BA and POCL until then). Initial indications are that Ministers would be hard pressed to persuade ICL to continue with the project. To trigger payment, ICL have to have satisfied both POCL and BA that the system is performing. Since December, there have been further disagreements. POCL had deferred the final run of testing by 2 months to allow ICL to fix the major problems. BA are not yet satisfied that all problems have yet been identified, but this is contested by ICL and POCL. ICL have indicated to us that they would now be reluctant to continue to invest in the Benefit Payment Card while the risk remains that POCL and particularly BA would not in the end accept it.

<u>Treasury officials therefore believe there is a strong risk that, even if Ministers decide in favour of Option A and can persuade BA to accept it, they will not be able to persuade ICL to continue with the project. In addition, Treasury officials judge that relationships within the project are now so dysfunctional that Option A should be abandoned.</u>

<u>Termination</u>

Given the costs of Option B1 and the question marks over whether Option A can actually be delivered, termination may well be the best way forward for the public-sector collectively. Obviously, this option is not one that any of the public-sector parties welcomes and indeed we have all expended substantial efforts to explore the alternative options presented here and others.

Under the termination option, the Horizon Project would be abandoned in its entirety. In order to retain footfall at post offices, BA would continue to pay

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be[redacted]ciaries with the paper-based methods until such time that POCL had the cap[redacted]lity to offer customers an encashment service at post office counters. Once PO[redacted] has this capability i[redacted]place, then BA would commence a process of mig[redacted]ion of beneficiaries to [redacted]CT. As a separate and uncoupled effort, POCL wo[redacted] move-up on their longer-term vision to offer simple financial transactions at post [redacted]ffice counters as an agent operating on behalf of banks and other financial intermediaries. POCL would undertake a fresh effort to procure an automation platform that could then be[redacted]ter tailored for the capabilities required to offer a valued service to prospect[redacted] partner banks, which Option A is not anyway optimised to do. DSS/BA w[redacted] need a firm timetable for the migration of benefit payments to ACT.

From the standpoint of our [redacted]ue-for-money analysis, termination looks to be of the order of [£X million lo[redacted](ie, worse) NPV than Option A yet better value for the public sector than Optio[redacted] The NPV savings are further reduced, the later that BA move to payment by A[redacted](although from POCL's point of view, this would give them more time to put [redacted]place their banking strategy and so would be less risky). But the lower value [redacted]ative to Option A could be eroded by the further delay in delivering the Proje[redacted]and, indeed as already noted, there is evidence to suggest that further delay a[redacted]oss of value to the public sector is likely to occur (possibly of the order of a fu[redacted]r £200m NPV).

The more time that elapses[redacted]re the public sector exercises its right to terminate for ICL's breach the more[redacted]y it is that the public sector's case in litigation is weakened and therefore thi[redacted]ion should not be deferred indefinitely.

It may well prove possible[redacted]lvage the Horizon automation platform for POCL (without benefit payment c[redacted]bility) as part of the settlement negotiations with ICL stemming from termina[redacted]. This could improve the NPV of the termination option. Treasury officials b[redacted]e that for the public sector to have any prospect of paying a fair and reason[redacted] price for any such infrastructure, it would be necessary first to invoke th[redacted]ntractual right of the public sector to terminate for breach. In the absence of[redacted]ination, an attempt to negotiate a procurement of those elements of the Horiz[redacted]roject that are valuable to POCL will flounder due to ICL's expectations of be[redacted]compensated for the total costs it has incurred to develop the infrastructure [redacted]which a large part of the effort relates to benefit payments)

<u>DTI and Post Office view</u>[redacted]

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DTI officials and the Post Office take a difference view, set out below.

Termination 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. At the very least it would seriously jeopardise Fujitsu's plans for ICL's floatation next year, and could lead Fujitsu to decide to divest itself of the company. Even on a "least bad" scenario of an agreed termination, the failure of the project would badly damage ICL's reputation both here and in export markets and its future prospects. DTI officials are also concerned that the effect that termination could have on our relations with Fujitsu. Fujitsu have been a major inward investor in the UK, with well over £700m invested in the last decade and the creation of around 20,000 jobs. Whatever the justification from a UK standpoint, termination 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. It also risks being seen in some quarters as a vindictive retaliation by the UK Government against Fujitsu for the latter's closure of the Newton Aycliffe plant in the Prime Minister's constituency.

From a Post Office viewpoint termination now would delay by at least two or three years the availability of the modern, on-line automated platform which POCL desperately need if it is to retain existing clients and to win new business. Loss of the benefit payment card and the Horizon platform would be seen by the 18,000 sub postmasters as a devastating blow to their commercial prospects, and no matter now carefully managed the announcement, many would simply give up. The value of post office franchises would plummet, and replacement franchisees would simply not be available. The effects of these unplanned closures on the integrity of the network as a whole can only be guessed at this stage, but could be serious.

They could well be sufficient to cause existing and prospective clients to re-evaluate the value of the network as a delivery mechanism. Under any such scenario, the true costs of termination would rapidly escalate to a point at which they significantly exceeded the cost of proceeding with either Option A or B.

The Post Office remain firmly of the view that despite the difficulties referred to earlier in this report, Option [illegible] remains their preferred way forward. The assured revenue stream for a further period of years, the highest retention of footfall, and a smooth and controlled migration at ACT and network banking mean that this option offers POCL the best prospect of transition to a viable commercial future, free from the need for Government subsidy, and with the delivery of a unique

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interface and channel of communication between Government and the citizen.

DTI officials also believe that the present unattractive profile of Option B may be significantly softened once at assessment of the revenue stream which POCL could expect from the commercial exploitation of the Horizon platform, based on work which should produce at least preliminary conclusions over the coming weekend, has been incorporated into the NPV calculations.

Finally, the delay which termination will cause to the availability of a modern online automated platform capable of delivering front end banking facilities on behalf of the commercial banks will, if serious damage to the Post Office Counters. Network is to be avoided, delay the move from present paper based methods of paying benefits by at least two or three years.

The Way Forward - Termination

If you accept Treasury officials' recommendation, which is shared by DSS/BA, then the next steps are:

- for Steve Robson to meet the Chairman of ICL to thank them for their efforts to find an alternative way forward, but to break the news that neither ICL's December offer on continuation, nor the alternative option are acceptable. They will probably not be surprised;

- to set in train the necessary legal process to terminate the existing contracts - we recommend that the parties jointly issue a 3 month notice;

- [for the Prime Minister to speak to the Chairman of Fujitsu to express his regret but provide as much comfort as possible in the circumstances that the Government remains fully committed to Japanese inward investment];

- to seek to reach a negotiated settlement with ICL, possibly involving salvaging some elements of the project (but this would be for POCL to negotiate with ICL);

- to prepare to make a public statement on the future of the project to provide reassurance to benefit customers and subpostmasters in the event that the story breaks.

On a slightly longer timescale, we suggest that:

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- POCL are given a clear and urgent timescale to work up their network banking and citizen smartcard strategy and to decide what infrastructure is necessary to deliver this - drawing on advice from the retailing and banking industry;

- DTI with HMT consider how POCL can best be incentivised to deliver their worked-up strategy successfully and as quickly as possible;

- linked to this timescale, we provide BA with a firm end-date by which time they will be allowed to move to ACT directly into bank accounts as the primary means of payment of benefit (which would at the limit be no later than currently envisaged under option A - ie 2005).

<u>Legal process</u>

Lawyers acting for DSS and POCL could not agree on the best way to achieve termination. The two options suggested were:

- to serve a 3 month notice terminating the contract;

- to serve notice making time of the essence - which would have to be a reasonable period, and could be up to 9 months.

Ministers therefore agreed that the Treasury Solicitor should seek the advice of the Law Officers last December. His advice was that if Ministers unequivocal wish was to terminate (i.e. to offer ICL no prospect of delivering the existing contract) then they should serve a 3 month notice terminating the contracts. This route is the quickest route to termination (although it involves additional legal hurdles and carries a greater risk that the public sector parties would be held in breach of contract and thus liable for damages). Lord Falconer endorsed this view.

Serving notice would be done in parallel with opening negotiations with ICL about a settlement.

<u>Presentational Strategy</u>

The handling of an announcement will in part depend on the reaction of ICL and Fujitsu to the news that the Government wishes to terminate. If ICL are prepared to seek a negotiated settlement then part of our negotiating leverage will be how termination is presented publicly. If, however, they intend to litigate, then the

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Government will have no alternative but to make it clear that termination was due to failures on the part of ICL to deliver to time or budget- despite the best endeavours of the public sector to find a way forward.

A key concern in any event will be to reassure subpostmasters about the future of their businesses. The Horizon project has, in the past, been portrayed - by the Post Office, by Ministers and by the Federation of Subpostmasters - as the vital element to secure the commercial future of the counters business. News that the project is to be scrapped will be a severe blow to subpostmasters' confidence. Ministers will need to stress:

- the Government remains fully committed to a nationwide network of post offices and fully recognises the importance of post offices to the communities they serve;
- the Government is equally committed to the automation of post office counters and the Post Office has already begun work to secure a replacement, which will give it the potential to seize new opportunities - for example the provision of banking services;
- there will be no change to the existing arrangements for the collection of benefits in cash at post offices.

The Government will also want to reassure benefit recipients that they will continue to be able to collect their benefits at post offices; and to explain arrangements for withdrawing the BPC from the early customers using it. In addition it be important to convey the message to the IT industry and Japanese inward investors that the Government has acted in good faith.

The Way Forward - Continuation

If you decide that you do not want to terminate and wish to continue with Horizon on the basis of ICL's offer of December 18, then:

- we would need to explore urgently with ICL whether their offer still stood and, in the light of their loss of confidence in the public sector, what reassurances they might require to proceed;
- DSS/BA would have to urgently resolve its difficulties with ICL/POCL's proposals for acceptance of the system and find a solution which provides adequate reassurance for Government that payments to beneficiaries will be

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safeguarded. You might want to consider appointing an independent adviser to aid this process;

- the recent disagreement between BA and POCL/ICL about systems testing and whether to delay the move to live trial would have to be resolved;

- the parties would need to sign Heads of Agreement - although this would be unlikely to be achieveable before the Fujitsu Board meeting on the 23 April: there are a significant number of outstanding commercial and contractual issues that will need to be resolved;

- the only reassurance we would therefore be able to give would be to tell Fujitsu that subject to resolution of acceptance testing, the acceptability of Fujitsu guarantees, and resolving outstanding issues their Dec 18 offer is acceptable;

- you may want to make a low key public announcement to bring an end to the uncertainty about the project - possibly via a written PQ;

For the longer term:

- we would need to take steps to ensure that the risk of further delay was minimised. This will require a commitment at the highest level in both BA and POCL to ensure that the relevant personnel work constructively with ICL to deliver the project successfully - as well as financial incentives/penalties for ICL to deliver;

- there is also a strong argument (which was one of the recommendations of the Corbett report) to restructure the contract with ICL after the system was accepted so as to remove BA, and make them a direct customer of POCL only.

<u>However, Treasury officials seriously doubt whether these steps would give any real assurance of success.</u>

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IMPACT ON THE PUBLIC SECTOR

£m NPV	**option A**	**option A (6 month delay)**	**option B1**	**Termination (ACT in 2002)**	**Termination (ACT in 2004)**
BA	1,123	90[illegible]	2,104		
payment to ICL (to deliver a loss of £126m NPV)	(36)	(5[illegible])	(315)		
POCL	179	21[illegible]	(1,405)		
total NPV to public sector	**1,266**	**1,[illegible]54**	**566**		