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DEPARTMENT OF SOCIAL SECURITY

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From the Parliamentary Under Secretary of State for Social Security

cc: SoS
for info MOS
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Mr McTernan, SpAdv
Mr Kendall, SpAdv
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Mr Tross, ACM
Mr Mathison, BACE - by fax
Mr Kelly, PC
Mr Magee, ITSA
Mr Riggs, BA
Mr McCorkell, BA
Mr Lewis, BA POCL
Mr Cronan, BA-POCL
Mr Brown, BA Fin.
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Mr O'Neill, CCLB
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The Rt Hon Alistair Darling MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London SW1P 3AG

12 August 1997

L Collins
APS/PSC(KB)
x80625
13/8/97

Dear Chief Secretary,

Automation of Post Offices and Benefit Payments

You may recall that our predecessors announced in May last year that the post office network and the payment of social security benefits across post office counters should be automated through a major PFI project. The contract, rather unusually has three parties: my department and Post Office Counters Ltd (POCL) as purchasers and ICL Pathway, originally a specially formed consortium, but now a subsidiary company of ICL, as supplier.

The ambitions of the project are very large. For my department, the intention is completely to replace order books and girocheques as a means of providing cash benefits with a plastic card which would be swiped by post office counter staff. Successful achievement would virtually eliminate benefit fraud related to instruments of payment at the point of encashment, which now results from our existing antiquated payment methods, as well as delivering improved customer service and, not least, proper accounting information. For POCL, the project will provide an IT infrastructure at the point of sale which will support the whole range of their current business, as well as providing them with the means to develop new products and new areas of business.

A project to automate a wide range of functions in 19,000 post offices as well as social security payments to over 20 million people is inevitably complex, and that complexity brings with it serious risks. The purpose of this letter is to alert you to the fact that the project is already seriously behind its original timetable, with equally serious consequences for the business case agreed between our predecessors.

Before setting out the current position I should highlight some of the factors which appear to have led to the adoption of such a complex project. From a Departmental point of view there is an attractive case for making direct payments into bank accounts, by Automatic Credit Transfer (ACT), as an alternative means of addressing our current payment problems.

However, there has in the past been a strongly expressed view that benefit payment by compulsory ACT would have a serious effect on the post office network, particularly in rural communities where post offices play an important role. The National Federation of Sub-Postmasters mounted vociferous campaigns against ACT when the previous government gave any public encouragement to ACT and has sought to maintain the role

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of post offices in paying benefits. The decision by the previous government to go ahead with the current automation project appears to have been strongly influenced by this context.

My view is that, if the commitment to this project had not already been made, we should at the very least question whether it is sensible to sustain an expensive and outmoded pattern of payment delivery as means of delivering a hidden subsidy to the post office. The question of whether we think it right to subsidise post offices is quite distinct from questions about the most efficient and secure way of paying benefits. The problem with the previous government's approach is that they have become inextricably confused. In practical terms, it has resulted in an enormously complicated three-way project which magnifies even the normal problems of IT projects on this scale.

Whilst that may be the background to the current position our first priority now must be to ensure that the services we have procured are delivered and, as far as possible, the planned savings are achieved. If the project can be made to work, we will get the benefit sooner by this route than any other. To date ICL Pathway has scored some successes in delivering elements of the system. However, it was apparent as early as December 1996 that the programme would be unlikely to meet key programme milestones. It was also clear that both the Department's Customer Accounting and Payment Strategy development programme and POCL's systems were behind schedule. A revised delivery schedule was negotiated in February 1997.

ICL Pathway has now acknowledged that it cannot deliver to the dates agreed in February. This means that they will be in breach of contract when they fail to reach the next milestone in November. This breach of contract could only be avoided if they are able to satisfy us that they are capable of delivering the project on a revised plan which is both achievable and meets our objectives. I am also concerned about POCL's ability to support the required rate of post office automation, although my own Customer Accounting and Payments Strategy development programme is now in a position to deliver on time.

The latest delay declared by ICL Pathway is likely to:

- put the programme back a year behind originally contracted dates
- reduce programme and administration savings further.

A provisional description of the financial consequences of this further slippage is in the Annex to this letter.

I have agreed with the BA project team that they will ensure that we for our part do everything necessary to work with ICL Pathway to develop an acceptable plan, and then to support ICL Pathway in delivering against it. Given the current contractual position and the real efforts ICL Pathway is now making to overhaul their management of the project, it would be wrong at this moment to assume that they will fail to find an acceptable way forward. But we will need to start thinking about the parameters within which we should go forward if, despite our efforts, ICL Pathway is unable to deliver.

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I see a two stage process. The first is already underway: BA, POCL and ICL Pathway have agreed that there will be an independent review of the project to report to the sponsors in September. Its conclusions about ICL Pathway's management of the project and POCL's ability to sustain rollout rates will be an important indicator of the level of risk in continuing on the present track.

The second stage will be to look at greater reliance on alternative payment routes - particularly direct payments into bank accounts. This is not without problems of its own, most obviously the fact that a significant proportion of beneficiaries do not have a bank or building society account. But that proportion is now only 20% of customers, and it is a problem which other countries have successfully addressed. In other respects the advantages are considerable. Unit costs are much lower: the cost of paying the 25% of our current customers who opt for ACT is less than 1% of the total costs for all methods of payment. The arguments about access to cash still exist, but at 22,000 there are now more automatic teller machines than post offices, as well as a significant number of outlets where cash can be obtained against Switch cards. This is, in any case, an issue to which we would need to return at the end of the present contract, however well it works. It is unlikely that card payments over post office counters will continue to be the best means of payment long into the next century.

We will be taking another close look at this project as soon as the results of the independent review are available and we are in a position to assess the impact of the new plan and ICL Pathways's performance in delivering against it. In particular, my officials will work closely with yours as soon as the impact on our financial position is clear.

I am copying this letter to Tony Blair, John Prescott, Margaret Beckett, David Blunkett and Mo Mowlam. In the light of the commercial and political sensitivity of this issue and the Post Office's obvious interest if we were to look at alternative strategies, I would be grateful to Margaret in particular if she would ensure that for the time being this issue is kept within government.

Yours sincerely

GRO

PP. JOHN DENHAM
(Approved by the minister
and signed in his absence)

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Annex A

Financial Implications to DSS of Contract Slippage

Following the February re-plan there was a £63m programme and £13m administration shortfall against the business case which formed the basis for the last PES settlement. On the basis of Treasury assurance that End of Year Flexibility would be available, my Department did not seek additional administration funding at that time, believing that the deficit could be contained and reduced. Officials did, however, alert Treasury to the continuing general risk of slippage which we suggested could add another £50m to our funding requirements.

The latest slippage declared by ICL Pathway is likely to result in a further shortfall of at least £80m programme (mainly in the PES period) and £49m administration savings over the life of the project and in addition to the February shortfalls. These are, however, high level calculations of the effect of the delay and more detailed planning over the next few weeks will be likely to reveal a further increase in the shortfall. I have looked at the extent to which I can offset these costs but I am not able to identify ways of making good the programme losses in 1997/98 and 1998/99 without additional administrative spending on fraud work.

Given the expected phasing of costs and savings, the impact of the slippage is unlikely to add to our administrative funding problems in 1997/98 and 1998/99. Beyond those years, however, the delays will have a significantly more damaging effect and additional administrative funding will probably be required. There will in addition remain the need to recognise the contingent risk in such a large and complex project.

The precise figures will not be known until the associated commercial and contractual negotiations have been completed. The business case will continue to be strong relative to a do-nothing scenario, but the returns are being eroded. Affordability is also becoming an increasing concern, especially in the face of risk of further delays.