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**FROM: PETER SCHOFIELD**

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**EXTN: [GRO]**

**CHIEF SECRETARY**

cc Chancellor  
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Harry Bush  
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Adam Sharples  
Sarah Mullen  
Louise Bennett  
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**BA/POCL: AN ALTERNATIVE APPROACH**

Issue You asked Steve Robson to look for a way forward for the Horizon project which met Ministers' objectives and which did not include a benefit payment card. Steve has been discussing potential options with ICL. The attached paper sets out the alternative approach which has flowed from these discussions.

Action You are meeting Lord Falconer this evening to consider this approach. If you both believe it is worth taking forward, the next stage would be to share it with Alistair Darling and Stephen Byers and their officials.

Timing The meeting is at 6pm.

**CONFIDENTIAL - COMMERCIAL****Summary**

The attached paper sets out the approach, the advantages and disadvantages for each of the parties, and the key issues which it raises. In summary:

- there is a potential approach which allows a direct move to ACT while maintaining Post Office revenues and providing the technology and potential market for “Modern Government” services. Under this approach benefits would be paid by ACT into new “Post Office bank accounts” (not, as currently envisaged, accounts at commercial banks), which would be accessed only at Post Offices, and via a smartcard. The benefit payment card (BPC) would be abandoned;
- this approach would give the BA and DSS what they want - a move to ACT without the transition via a BPC. It would also move BA out of the contract, and so allow Horizon to proceed with a much more straightforward customer-supplier relationship (POCL and ICL);
- it will be less appealing to POCL, who have never seen their long term strategy as involving the direct provision of bank accounts. Rather than competing with the banks, they would prefer to offer themselves as potential agents for all the banks, offering counter facilities to allow the banks to reduce their branch networks;
- but, depending on the way the move to the Post Office accounts is handled, it could do more to protect footfall in post offices than the BPC;

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- it would require very careful negotiation with ICL if the Horizon and smartcard infrastructure is to be delivered within the same commercial framework as is currently on the table for the BPC;
- and could in addition involve what are as yet unquantified costs associated with the management of up to 14 million Post Office bank accounts.

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**CONFIDENTIAL - COMMERCIAL****BA/POCL AUTOMATION PROJECT**

This note sets out a possible way forward for the Horizon project, following discussions between Steve Robson (HMT) and Keith Todd (ICL). These discussions were conducted on a without prejudice and confidential basis. ICL accepted that the public sector parties reserve their rights and remedies with respect to past breaches of contract by ICL Pathway. Both sides agreed that they would not take pre-emptive legal action against any other party while discussions are continuing.

**The proposal**

2. Under this proposal, the benefit payment card (BPC) would be removed from the Horizon project. The Benefits Agency (BA) would move directly from the existing order book system to payment of benefits through ACT.
3. Benefit recipients who currently receive their benefits via order books would have a Post Office bank account set up for them. BA would pay benefits into the account.
4. The Post Office bank accounts would be simple, debit-only accounts. They could be accessed at any Post Office using a smartcard, but at least initially they would not be accessible at banks. The Post Office might enter into a strategic partnership with a clearing bank to operate these accounts for them. Subject to such arrangements being put in place by the Post Office, ICL could start to roll out a smartcard-based system into Post Offices following national rollout of the core Horizon system (currently assumed to be Spring 2001).
5. Over time, the Post Office could develop the range of services which



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were offered via the smartcard. It could also enter into negotiations with clearing banks to offer counter facilities, enabling the banks to shrink their branch network.

6. There is an important issue about how the move to Post Office accounts at paragraph 3 is made:

- (i) either the choice would be made explicit - e.g. every recipient currently paid through order books would be sent a form in which they either give details of an existing bank account into which they want benefits to be paid, or they tick a box requesting a Post Office bank account; or
- (ii) the presumption would be that all order book recipients would be paid via a Post Office bank account, and there would be a mass transfer of all such recipients to payment of benefits in this way. Benefit recipients would at any point be free to ask the BA to pay their benefits via ACT into a conventional bank account, just as they can now ask for a move from an order book to a bank account.

7. Option (ii) would mean that, because of inertia, a much larger number of recipients would be paid via Post Office accounts. This would give POCL and ICL a much greater certainty over future revenues - indeed over the long term it would give greater certainty than under the BPC option, because they would avoid the threat to revenues during the transition from the BPC to payment by ACT. Option (ii) would also give the smartcard a wider initial circulation, which would help the marketing of smartcard-based services.

8. However, option (ii) would significantly increase the number of Post

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Office accounts required and hence the cost to POCL. Of the 20 million benefit recipients, 30% (6 million) currently receive benefits through ACT. Of the remaining 14 million who receive their benefits through order books, 9 million have a current account (a further 3 million have some other form of bank/building society account). Under option (i) it is likely that most of these 9 million customers would opt to use their existing bank current accounts.

**Impact on the various parties**

**Benefits Agency**

**Advantages:**

- avoids having to develop and implement the IT infrastructure which is required specifically for payment of benefits through the benefit payment card (PAS/CMS/BES), although much of the development work has already been done;
- should allow earlier move to ACT than under original benefit payment card project.

**Disadvantages:**

- delays move away from paper-based systems for paying benefits by two years compared to BPC option.

**Post Office**

**Advantages:**

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- should help to maintain footfall revenue compared with ACT into conventional bank accounts, even under option (i) since a sizeable proportion of benefit recipients (those currently without bank accounts and others who opt for the Post Office bank account), will continue to come to Post Office for benefits. And under option (ii) there would be less risk to footfall revenue than under BPC;

- gets smartcard in circulation, and so generates a potential market on which to launch a range of smartcard-based services (although under option (i) unclear how attractive this potential market will be - a significant proportion of those carrying smartcards will be those unable to obtain conventional bank accounts);

- compared to the BPC approach, should mean earlier introduction of a smartcard and hence allow earlier development of smartcard-based services.

**Disadvantages:**

- under option (i), greater risk to Post Office revenue than under the BPC approach, since likely that many benefit recipients would choose to receive benefits through existing bank accounts;

- the cost of managing bank accounts and of the smartcard would be borne by POCL;

- significant change to POCL's long term commercial strategy (see paragraph 15 below).

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ICL

Advantages:

- removes BA from the contract, helping to clarify ICL's relationship with PO as its single client.

Disadvantages:

- under option (i) revenue risk as for the Post Office. ICL would also want to recover the revenues they would have received for BPC transactions;
- extra development work required for smartcard-based banking services.

Other advantages for Government:

- boost to Modern Government initiative - early introduction of technology to support Modern Government services;
- boost to social exclusion agenda by providing simple banking facilities to those currently without bank accounts.

Benefit recipients

Advantages:

- unlike the BPC option, provides a bank account to those currently without one;

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- compared to BPC and conventional ACT, provides a smartcard earlier - only an advantage if there are attractive smartcard-based services available.

**Disadvantage:**

- unlike with the BPC, there are no facilities for urgent payments or payment to nominated proxy. BA would have to find alternative method of offering these services;
- may provide a lower quality of service at Post Office counters than with the BPC (e.g. PIN required, less help on queries).

**Issues**

Offering the choice to recipients - option (i) or option (ii)?

9. The advantages and disadvantages of the two options are set out in paragraphs 6-8 above.

How much would it cost?

10. By removing the benefit payment card element of the project, there should be savings:

- to BA, who would no longer have to develop systems that interface only with the BPC - PAS, CMS, BES, although much of the development work has already been done;
- to ICL who could stop development work on the BPC, and would no

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longer have to pay for that element of the operating costs of Horizon specifically associated with the BPC.

11. But these would be offset by additional costs:

- to POCL for the management of Post Office bank accounts. POCL could do this itself or get a bank to do so. Either way it is likely to be argued that it is a loss making activity - given that the average cash balance in them is likely to be low. When banks have been asked this question informally in the past, they have quoted management charges in the range £60-100 per account per year, though this was for conventional bank accounts rather than the simple accounts we have in mind, and would have included some contribution towards the cost of the branch network which again would not be relevant here. Some commercial banks have started setting up the sort of simple, debit-only accounts we have in mind of their own accord, implying that these accounts can be profitable, and that the charge would be minimal;

- to DSS from the two year delay to the move away from paper-based systems;

- the cost of developing, producing and operating a smartcard-based banking service;

- the abortive costs and expenses of discontinuance related to the removal of the BPC;

- depending on the choice between options (i) and (ii), the risk to ICL and PO revenues.

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Negotiation strategy with ICL

12. In order to preserve our leverage on price with ICL, it would be vital to keep the Government's alternative options open (either to proceed with the BPC or to pull the whole project) until the commercial terms for this new approach have been agreed.

13. ICL would resist this. They will argue that, as the Government has changed the specification, the Government should pay ICL's sunk development costs for the BPC. ICL have already said that they would want to split the contract in two, with the Horizon infrastructure, excluding the BPC, rolled out and paid for first, and then a second set of negotiations on the smartcard and the method of paying benefits. This would essentially commit the Government to Horizon, and leave ICL in the driving seat for negotiations on the smartcard.

Negotiations with the banks

14. As already noted, there is considerable room for negotiation over the cost of managing Post Office bank accounts. The risk is that, once the Government has decided on this approach, the banks will know that POCL will probably want a clearing bank partner, and will exploit this in the negotiations.

Reaction of Post Office

15. This approach is unlikely to be appealing to POCL, who have never seen their long term strategy as involving the direct provision of bank accounts. Rather than competing with the banks, they would prefer to offer themselves as potential agents for all the banks, offering counter facilities in areas without a local bank branch. It may prove more difficult to develop this agency role if

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the banks see the Post Office as a competitor.

16. In any case, the Post Office would need to be managed carefully, particularly in the wake of the announcement of greater commercial freedom for the Post Office on 7 December. Their board have already accepted the ICL offer of 9/18 December, and they may see a decision to take forward this alternative approach as the Government overruling the board on a business decision. The loss of the BPC may also cause concern to sub-postmasters, particularly if (as ICL propose) Horizon is initially rolled out without any benefit payment facility - with the smartcard following two years later.

Procurement Issues

17. We would need to check whether such a change to the contract, without going through a further competitive tender, was consistent with EC procurement law.