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Review of the Benefits Agency/Post Office Counters Automation Project

Working Group Report

July 1998

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1. Summary and conclusions

1.1 This is the report of an interdepartmental review of the PFI project in which ICL Pathway have contracted with Post Office Counters (POCL) and the Department of Social Security (DSS) to automate post office counters including facilities for payment of benefits using a benefit payment card (BPC). The review was commissioned because of concerns, particularly on the part of DSS Ministers, that the project was badly behind schedule, over-budget and indeed might not be viable. We were asked to consider:

- whether the project is technically viable; and if so, how quickly it can be completed and at what cost to government;
- the direct and indirect costs of cancellation and of any alternative available to deliver the project's objectives.

1.2 We set up an Independent Panel of experts to address the first question. Their view is that the project can deliver the functions expected of it, but is unlikely to be operating nationwide much before the end of 2001, some three years later than originally planned. Successful delivery would require renewed commitment from the parties and urgent measures to improve project management at POCL and resolve outstanding issues, and is not without risk. The cost of continuing is uncertain: delays and cost overruns mean ICL Pathway will make a loss without a significant extension of the life of the project or an increase in charges (last year they were looking for a 5 year contract extension or 30% more money). Neither is attractive and EU procurement law precludes substantial changes in terms.

1.3 The direct costs of cancellation are also hard to predict. ICL Pathway are formally in breach of contract as result of missing a key milestone, and DSS/BA and POCL believe this would provide sufficient grounds for termination and indeed for claims against ICL Pathway of up to £200 million. But ICL would vigorously contest this and almost certainly claim against BA/POCL for up to £335 million. The BA/POCL programme lawyer believes the Government's position is strong, but any litigation would inevitably be messy and uncertain. Indirect costs of cancelling the project depend on what is put in its place. DSS have long regarded payment direct into bank accounts by automated credit transfer (ACT) as the preferred means of payment in the long term. But this would deprive POCL of its largest source of income and so threaten the viability of the PO network unless the income could be replaced.

1.4 Against this background we think the choice for Ministers lies between three options:

1 **Seeking to continue with the project**; negotiating with ICL over a limited extension, perhaps to 2007; making plans for a three year transition to benefit payment by ACT completing by the end of the contract; and using the platform

provided by this project to develop banking and other services across PO counters;

2 **Reshaping the project by cancelling the benefit payment card** and seeking to develop the remaining elements of the programme to give POCL a banking capability; moving to ACT at a rate which takes account of POCL's ability to provide banking services, and so retain as much as possible of the benefit payment business; and redirecting administrative savings in BA to supporting POCL for the life of the current contracts; and

3 **Terminating the whole project** on grounds of non-performance by ICL Pathway; developing alternative plans for automation of PO counters; moving to ACT at a rate which takes account of POCL's ability to provide banking services; and providing some subsidy while POCL plans changes to the network.

1.5 The decision will have far-reaching consequences for the way benefits are paid to around 19 million people, and for the viability of the Post office network. Key considerations in deciding between these options are:

– **What is the best way of paying social security benefits?** Current paper based methods are inefficient, prone to fraud and hard to audit. The BPC will save perhaps £110 million a year on fraud and allow proper auditing, but will cost about the same to administer as the current system. Payment direct into bank accounts by ACT (already used by 28% of claimants) would deliver all the main benefits of the card but cost around £400 million a year less for BA to administer and would provide a better platform for welfare reform. For these reasons we agree at some point in the next 10 years it should become the normal method of benefit payment;

– **What is the impact on the post office counters network?** The central dilemma is that 80% of BA's administrative cost in paying benefits is income for POCL, and that income, together with the steady flow of claimants through post offices, is vital to the commercial viability of the network (97% of which are run as private businesses). Any significant loss of BA income which was not replaced by subsidy or revenue from other sources would mean widespread closures. POCL estimate that if all the BA income were lost, up to half the current network of 19,000 offices could close, and the remaining offices would need a subsidy to stay open. This is a highly sensitive issue, not just because these offices represent the livelihoods of self employed sub-postmasters (who have invested around £1 billion in the network) and their staff, but because people value access to a local post office and associated shop;

– **Could post office counters provide cash to claimants who get benefits paid into bank accounts?** This would suit BA/DSS because they would like to offer claimants the option of continuing to collect their cash weekly from the PO; and it might help POCL because it would provide some income and a continuing flow of customers. It is certainly possible: POCL already provide banking services for customers of the Co-op Bank, GiroBank and (on a trial basis) Lloyds/TSB. They could seek new partners, but to do this effectively on a large scale, they need new technology, either the ICL system or another. But we need to be realistic about the implication for POCL. Once benefit money is in claimants' bank accounts they may well find it more convenient to draw cash from a bank branch, cash machine (ATM) or retailer's cashback facility;

- **What role is there for post office counters in the long term?** POCL cannot rely on current sources of income to sustain it through the next decade, and in our view has been slow to develop a business strategy which addresses this challenge. The PO is pinning its hopes on providing a range of banking and financial services across counters, and becoming a 'front end' for more Government services. We see some scope for both (particularly for banking), but think it is very doubtful revenue from these sources could offset loss of income from BA. If that is right, the issue of scaling back the network or providing significant subsidy will have to be faced at some point whatever happens on this project. Option 1 postpones it for a few years and gives PO a better chance to build new sources of income;

- **What are BA and POCL's contractual obligations and the costs of termination?** We are not starting with a blank sheet. All three parties are tied in by contract, and have sunk costs in taking the project this far. Continuation would require a difficult negotiation with ICL on timetable and costs. The Government's aim in any such negotiation should be to offer the minimum concessions necessary to give ICL an incentive to continue without litigation (even if they make a loss on the project overall). On the other hand, BA and POCL believe ICL have put themselves in breach of contract and they are entitled to withdraw and seek damages from ICL of up to £200 million (an independent report by Project Mentors provides some support for this view). ICL would contend with equal force that BA and POCL share the blame for the delays and if the government parties withdrew they would seek to recover the compensation the contracts provide for (up to £335 million in the event of termination 'for convenience'). The Programme lawyer's view is that the Government's case is a strong one, but any litigation would inevitably be messy and uncertain;

- **What are the costs to government of continuation or cancellation?** There is unfortunately no simple answer to this. An early switch to ACT has the potential to bring forward large efficiency savings for DSS/BA who need to consider carefully their responsibility to deliver value for money. (Improved fraud control can be delivered under all the options.) However savings to BA would be offset by losses to POCL and the increased costs of maintaining a nationwide network of post offices. The impact on the public sector as a whole depends critically on assumptions made about income POCL could generate from financial services

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under each option. There is therefore no clear basis for choosing between the options on cost grounds, but options 1 and 2 look a bit better than option 3. In each case there are implications for DSS funding which will have to be resolved with the Treasury.

- **What would be the impact on ICL and the UK computer industry?** Failure of the project would undoubtedly be very damaging to ICL and might even bring the company down. ICL have 270 staff working directly on the project, and hope to market their system overseas. Fujitsu has plans to float ICL by 2000 which would be set back.

- **What are the implications for PFI?** This is one of the biggest PFI projects. Any move to shield ICL from the risks it took on would make it more difficult to achieve effective risk transfer on other projects, and could risk challenge from bidders who lost out in the original procurement process. It could also encourage ICL to come back for more money later. There are parallels with the National Insurance Recording System (NIRS2) project which has also suffered delays. In that case Andersen Consulting has been expected to swallow serious losses, and indeed to compensate the department for the delays.

- **How does the project link with wider government objectives?** An early move to ACT would help promote electronic delivery of government services and 'universal banking' by bringing into the banking system the estimated 2.5 million claimants who currently do not have access to a current account. This would in turn help tackle social exclusion by giving these people access to a range of services which are part of normal life for most people. Post offices also have a role in providing services locally, often in villages or on estates where there may be no other shop; and could play a growing role in future in providing an access point for government information and electronic transactions with government.

- **What are the legal constraints?** In broad terms we cannot vary the terms of the contract in a way that would allow a disappointed bidder to claim they would have won the competition on the revised terms and were therefore treated unfairly; or would allow alternative suppliers to claim they have not had the opportunity to bid for new work. This limits what could be offered to ICL to continue.

- **How will this look to the public and benefit recipients?** There are tricky problems with presenting each option. With option 1 DSS will need to take 19 million claimants through the upheaval of switching from order books to cards with the prospect of a second switch to ACT a few years later (although this could be a switch from the payment card to a similar bank card). Options 2 and 3 will immediately raise fears for the future of the post office network; and for claimants will mean losing the option of payment in cash sooner than under option 1. Such fears will no doubt be orchestrated by the Federation of Sub-Postmasters,

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CWU and rural lobby. But in each case a reasonable account could be given of steps being taken to protect the network.

1.6 To sum up on the options:

- **Option 1** will involve ICL swallowing substantial losses. If it can be delivered, it has the advantage that it secures the PO network until around 2007; and gives POCL more time to try to build new business and banking facilities to replace BA income when the contract ends. It avoids the prospect of protracted and costly litigation which could follow cancellation of the project altogether. On the other hand it means foregoing for several years the substantial efficiency savings (around £400 million a year) available to BA from moving to ACT; it involves two upheavals in the benefit payment system in the space of just a few years; and could well involve a formal direction to the BA accounting officer.

- **Option 2** costs about the same overall as option 1(on our modelling). DSS/BA believe it would give them more clarity of purpose. It could be presented as taking forward a range of Government objectives including positive steps toward universal banking. It would involve only one upheaval in the benefit system and could deliver substantial efficiency savings for BA a few years earlier than option 1. It could help ICL by making the project more deliverable, however it is not clear that there is the basis for a commercial deal with POCL on a stripped down project. The option seeks to protect the PO network from any dramatic short term dip by re-directing BA savings to supporting POCL, however loss of 'footfall' income from claimants would hit sub-postmasters and POCL bringing some closures. The faster pace of adjustment would worsen POCL's medium term prospects.

- **Option 3** offers the same benefits to BA as option 2, but complete termination would be more damaging to ICL who would be more likely to pursue claims against both POCL and BA. This would be messy and uncertain. POCL would be starting from scratch in developing counters computerisation, and the delay could be a serious blow to its business prospects. It would also be a setback for National Savings who are counting on counters automation to reduce their administrative costs. On the other hand POCL could invest in the latest generic banking/retailing systems which on their own are likely to be considerably cheaper than a system built around the requirements of the benefit payment card; and limited front end banking services could be offered quickly.

Recommendations

1.7 No option is without difficulties, but each looks doable. The Working Group, apart from DSS and the Treasury Social Security team, recommends that:

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- in line with option 1, ICL Pathway should be given terms for continuing with the project: there can be no increase in the level of payments already contracted; we are prepared to discuss an extension of contracts, but only to ensure a 5 year period of operation following full implementation; and there will be penalties if completion of roll out is delayed beyond September 2002;

- if ICL agree to these terms, the measures proposed by the Panel should be implemented forthwith. In particular a 'troubleshooter' should be appointed to work with the three parties; and POCL's management of the project must be strengthened;

- if ICL cannot accept these terms, or if the negotiations cannot be satisfactorily concluded within two months, Ministers should sanction the public sector parties withdrawing from the contracts on the grounds of ICL Pathway's non-performance and we should implement option 3.

- POCL senior management needs to be strengthened, ideally by bringing in someone with a good track record in running a retail network.

1.8 DSS recommend a similar approach with ICL, but based on option 2. Treasury Social Security team prefers option 3.

1.9 Whichever option is chosen, it is important that Ministers should give an early steer. We can provide more detailed advice on handling once the broad way forward is clear.

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2 Introduction

Background

2.1 The BA/POCL automation project (which POCL refer to as the 'Horizon' project) was initiated in 1993 with the aim of:

- providing a more secure and efficient way of paying benefits, with potential fraud savings of £185 million a year (of which around £70 million is now being saved by the Electronic Stop Notice System);

- providing the DSS/BA with the means to account fully for their vast programme expenditure, now nearing £100 billion a year;

- automating PO counters, to make current business more efficient and help them win new business. The project also helped to secure the PO network by providing a secure revenue stream from POCL's biggest customer until the middle of the next decade.

2.2 A contract worth around £1 billion was signed with ICL Pathway in May 1996. It is a huge project, involving automation in 19,000 post offices and 40,000 counter points, and providing links into DSS/BA and PO systems. The project is described in more detail in Annex D.

2.3 A revised timetable for the project was agreed by all parties in February 1997. Since then, it has slipped 21 months behind schedule. The two public sector parties attribute the cause of the slippage to ICL Pathway in all material respects (based on an independent review of the programme by consultants Project Mentors). In September 1997, DSS Ministers became sufficiently concerned to draw this to the attention of Treasury and DTI colleagues, and discussions took place between the three parties, facilitated by PA Consulting, to see what could be done to minimise the delays. On 21 November 1997, a key milestone was missed by ICL Pathway for completing an operational live trial, and the public sector parties placed ICL Pathway in breach of contract. Since then there have been further delays to the programme, and ICL have sought extensions to the contract or increases in charges. In May this year, DSS/BA issued a notice of 'cure' to ICL Pathway, in order to protect their negotiating position.

The review

2.4 Against this background, the Secretary of State for Social Security wrote to the Prime Minister in February that 'there is a serious risk that this project will fail to deliver its objectives - or will not do so within a timescale that will make it worthwhile'. She proposed early discussions to find an agreed way forward, emphasising the urgency of a decision in view of the continuing fraud losses to DSS and the need to agree new

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timetables with ICL if the project were to proceed. DSS was concerned that, since it guarantees a minimum level of payment to POCL, it in effect carries much of the financial risk on the project and feels the effect of delays in a way that POCL do not.

2.5 In response to later correspondence the Chief Secretary proposed that before decisions were taken, an interdepartmental working group led by the Treasury should be asked to prepare an agreed analysis of the options, including an assessment of:

- whether the project is technically viable; and if so, how quickly it can be completed and at what cost to government;
- the direct and indirect costs of cancellation and of any alternative available to deliver the project's objectives.

This approach was agreed by other Ministers. This report is the result of that work.

2.6 The Working Group was made up of officials from the Treasury, DTI, DSS and the Central Information Technology Unit. The Group set up an Independent Panel under the chairmanship of Adrian Montague, head of the Treasury's Private Finance Task Force, and assisted by PA Consulting, to provide a thorough and balanced assessment of the technical viability of the project, and its likely timing and costs. Other members were Alec Wylie (former head of the Northern Ireland Social Security Agency) and Bill Robins (former Director General of Communications and Information Services at the MOD) both of whom have substantial prior experience of large IT projects. Their report forms Section 6 of this report.

Structure of the report

2.7 The structure of the report is:

- Section 3 reviews key issues to be considered in assessing the options;
- Section 4 analyses three broad options against a range of criteria;
- Section 5 contains a set of background notes on specific issues;
- Section 6 is the report of the Independent Panel.

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3 Key issues to be considered

3.1 The Independent Panel's assessment

3.1.1 The Panel's report forms Section 6 of this report. The Panel was asked to consider three main points:

- whether the project is technically viable;
- when it could be delivered;
- and at what cost.

3.1.2 In addition to examining these questions the Panel identified a number of fundamental strategic issues (such as the ability of POCL to manage this large project) which are fundamental to the programme and says there is a severe risk of failure if they remain unresolved. Resolution depends on renewed commitment and cooperation from the parties.

3.1.3 The Panel also considered with the parties a number of possible ways forward.

Technical viability

3.1.4 The Panel has concluded that the project is technically viable, although there are some risks, in particular around:

- scaleablility and robustness. The programme is probably the biggest of its kind and the system has had to be tested at the level of its component parts. The Panel is satisfied these risks are being well managed by ICL Pathway, but they nevertheless remain.
- the system is (necessarily) heavily dependent on a third party 'middleware' product called 'Riposte'. ICL Pathway have taken steps to cover their dependency on this product.

3.1.5 The Panel also believes the basic infrastructure is very robust for the future and is generally based on industry standard products. It should therefore allow POCL to compete for new business in a variety of markets, and for example develop new applications based on smart cards. If significant on-line capacity was required more development work may be needed.

3.1.6 The Panel has seen no evidence to suggest that the systems being developed by BA and POCL to connect up to the systems being developed by Pathway will not work as required.

Timetable and risks

3.1.7 The original timetable was that roll out of the full system in post offices would start in June 1997. The February 1997 re-plan put this back to January 1998. The current timetable would see it start in April 1999. The Panel's best estimate is

- that there will be a further 9 months delay to January 2000, in the start of roll out; but to make this possible, a number of outstanding issues on the critical path would have to be resolved fast (by the end of July). These issues are not considered to be insurmountable and indeed are expected to be resolvable easily provided the parties cooperate. The date could be brought forward with commitment and goodwill on both sides;

- the roll out programme should be finished within 21 months (by September 2001). This requires offices to be brought into the system at a rate of 300 a week. The Panel believes this has been properly planned and is sustainable but notes there are some risks around the timetable and the response of POCL's regionally based organisation to the demand placed on it.

3.1.8 The Panel has made a number of recommendations on how the project should be managed to deliver this schedule. These involve early resolution of outstanding issues and strengthening the Horizon Project Office (set up by POCL) and POCL management. The Panel also proposes appointing a neutral Government "troubleshooter" directly responsible to DSS and DTI ministers to help take the project forward. (This would require careful handling: DSS are concerned about possible conflicts with BA's accounting officer responsibilities; DTI would want the relationship with the PO Board to be looked at carefully). The project would effectively need to be restarted with renewed commitment from all parties.

Cost

3.1.9 The Panel reports estimates provided by the parties: the direct cost of the extra nine months delay will be £90 million for BA (in the cost of running existing systems etc), £15 million for POCL and £72 million for Pathway on top of costs already incurred. In addition BA lose fraud savings of around £110 million a year until the card system starts.

3.1.10 However the the Panel does not provide an estimate of the likely cost to Government of reaching agreement with ICL on terms for continuation of the project. At the end of last year ICL sought an extension of 5 years or 30% more money. This is a negotiating position, but the subsequent delays will have worsened their financial position. Our own **very rough** estimate is that even if the contract is extended to restore a 5 year steady state period of operation, ICL might face a shortfall of the order of £250 million. Our view is that the cost of continuing will depend on the outcome of negotiations with ICL. We are under no obligation to ensure ICL makes a return, or even breaks even. But if we want the

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project to continue, ICL will need to be in a position where they judge the losses on the project are bearable and returns from continuing outweigh the likely return from withdrawing and suing.

Options

3.1.11 The Panel explored a number of options with the parties to see if any could command broad support. These are set out in an Annex to the Panel's report.

3.2 Prospects for paying benefits by ACT

3.2.1 To put the project in perspective, and understand the alternatives, we need to look at different ways benefits can be paid, and in particular at the option of paying direct into claimants' bank accounts by automated credit transfer (ACT).

Background

3.2.2 Of the 27 million benefit claimants, around 19 million are currently paid using paper based methods across post office counters (order books or Girocheques) and 7 million are paid by ACT. The proportion paid by ACT has been rising steadily from around 16% 5 years ago to nearly 30% today. It is expected to go on rising by around 1 percentage point a year, since around half of new pension and child benefit claimants opt for ACT. The project will move the 19 million using paper methods to the benefit payment card (BPC). Annex A sets out more detail on payment methods.

3.2.3 ACT has a number of advantages:

- it is very much cheaper for BA than other methods, costing less that 2p per transaction compared to 47p for order books and 78p for giros. It is also cheaper than transactions using the BPC. (It should be acknowledged that it is cheaper for BA partly because the cost of providing cash to claimants is transferred to the banking system.)

- it gives BA a full reconciliation of transactions (as does the BPC);

- it cuts opportunities for fraud (as does the BPC);

- it is a widely used generic system which allows DSS to 'piggy back' on wider technological change.

3.2.4 For these reasons, the DSS have long seen ACT as the best long term solution for benefit

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payment. However there have been three main obstacles to adopting ACT as the standard:

- around 2½ million claimants do not now have access to current accounts;
- there are 16½ million people who do have access to accounts but do not choose ACT and may resist the change, for example because they find it most convenient to get their cash from a post office, some for mobility or health reasons;
- the loss of business would threaten viability of many post offices.

3.2.5 We consider these issues in turn:

The unbanked

3.2.6 Research by DSS, backed up by recent research by the British Bankers Association (BBA), suggests that around 90% of benefit claimants now have access to a current account at a bank or building society, leaving only 10%, around 2½ million people, without access.

3.2.7 The BBA research suggests that the great bulk of the unbanked choose not to have accounts and are not unbanked because they have been refused or would be refused a bank account. The unbanked include:

- young people who have not yet opened an account;
- people with limited funds who prefer to retain the control over their finances that a cash budget gives them;
- elderly people who may be unfamiliar with banking.

3.2.8 They will also include:

- people who have been, or would, be refused accounts because they cannot produce the standard identity required by banks, or who have poor credit records;
- people who wish to avoid the banking system for illegitimate reasons - to avoid tax, to defraud the Benefits Agency etc.

3.2.9 Most banks now offer simple credit only accounts which provide a bank card for withdrawals but do not allow overdrafts. Some banks only offer these accounts to particular groups (for example 16 to 19 year olds); other banks apply no such restrictions.

3.2.10 This suggests that if the currently unbanked were given suitable notice that they would need to open an account in order to receive their benefits, there would be no **practical**

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difficulty for most of them in them doing so. (They may of course be resistant to this for other reasons.) Those who are unable to open a full account would in most cases be able to open a credit only account. Inevitably there would be a number of people who could not open accounts for example because they have no fixed address, or suffer from mental illness. As under the BPC proposal, special arrangements would have to be made for these people.

3.2.11 However it is not clear how the banks would react to a large number of people - mostly on low incomes and some of doubtful creditworthiness - being required to have access to a bank account to receive their benefit. Banks may respond for example by introducing new charges for withdrawals. Discussions with the banks will be required, but informal soundings by DSS suggest that at least two major banks would be interested in developing their services in a way which meets the majority of DSS customers needs. The costing of options set out below includes as a contingency a sum of £30 million a year to provide an incentive, although this may well not be needed.

Will claimants with bank accounts accept the switch?

3.2.12 DSS research indicates that many benefit recipients want a method of payment which:

- allows them to collect payments in cash, and budget over a short period;
- allows local collection, typically from the post office;
- for poorer people, allows frequent (weekly) payment of small amounts;
- does not require them to collect all their benefit due at once (as the BPC does). Claimants tend to use different benefits for different things eg. using one benefit order book to "save up"; and do not like the responsibility of handling large amounts of cash.

3.2.13 Using a bank account to draw social security benefits may not be attractive for some claimants because:

- most bank accounts provide fewer access points for cash than there are post offices. So people may have to travel further to get their cash which may be a problem in rural areas and deprived urban areas, and for the less mobile.
- ATMs (automated teller machines) only provide cash in notes not coin, so a benefit claimant may have difficulty withdrawing all their benefit without going into overdraft;
- many people find bank accounts and bank machines intimidating and prefer the familiarity of the post office and the ease of controlling budgets in cash;

- the timing of payments through bank accounts may be unattractive. For example pensions paid by ACT are currently paid monthly in arrears, while order book payments are made weekly in advance.

3.2.14 Each of these issues can be addressed:

- the number of outlets for cash is growing rapidly. There are now ATMs in over 10,000 separate locations, and many supermarkets offer bank accounts and cashback facilities. The Post Office itself now offers banking facilities to customers of three banks. In the near future cashback arrangements are expected to spread rapidly to shops, garages and pubs. (Terminals are available for rent at around £15-30 a month with a charge to the retailer of 10-25p per transaction.)

- many people have become more used to using bank accounts with the rapid switch from cash payment of wages to payment by ACT which took place in the 1980s. Spreading the banking habit further would fit well with Government's objectives for tackling social exclusion, encouraging savings, and encouraging people to use the most modern and efficient means available to conduct transactions.

- DSS will be looking at the options for adjusting the "periodicity" of benefit payments to remove any deterrent to switching to ACT.

3.2.15 These changes will tend to make ACT more acceptable, but DSS believe that the most significant step towards making ACT an acceptable solution for claimants would be to provide for them to withdraw cash from their bank accounts at post offices. POCL already provides this service (using inefficient paper based methods) to customers of the Giro Bank, Cooperative bank and (on a trial basis) Lloyds TSB. But providing such facilities for millions of claimants would require investment in at least some simple banking technology. We consider below the scope for POCL delivering this, either through the Horizon project or some other system.

3.2.16 Clearly if this were achievable, it would offer the Post Office the chance to generate some income from banking services to replace, at least in part, that lost from the Benefits Agency when it switches to ACT.

How long would it take?

3.2.17 DSS envisage that the process would involve around three years of preparation and three years of transition. In the preparation phase DSS would:

- draw up plans for a benefit by benefit migration to ACT;

- run a publicity campaign to encourage voluntary take up of ACT, explain the

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transition and offer help with opening bank accounts;

- take the necessary secondary legislation to make ACT the standard method of payment except where individual claimants can show they cannot open a bank account or ACT would be for some reason unsuitable;

- continue discussion with the banks about availability of accounts for the currently unbanked. DSS may for example aim to draw up a list of banks prepared to offer simple credit only accounts.

- maintain a dialogue with POCL on a timetable for introducing banking services over post office counters. (DSS wish to involve POCL fully in the move to ACT.)

3.2.18 In the transition phase, the DSS would:

- set a series of dates after which ACT would be the normal method of payment (other than for exceptional cases) for each benefit;

- provide continuing support and advice for claimants seeking to open bank accounts.

- paper based methods (or the BPC) would be phased out as ACT came in.

3.2.19 We agree that ACT is the best long term solution; and DSS should be planning to move to ACT at some point in the next ten years. The question is when, and whether it is now sensible to move first to the BPC?

3.3 Prospects for developing banking and other services across PO counters

3.3.1 The main reason why ACT has not been pursued in the past has been that Ministers have not been prepared to accept the damage to the post office network that would result. This was a key factor in the decision to pursue the Horizon project. So a central issue in assessing the options now is how far could POCL replace income lost from BA by developing new business such as banking services.

3.3.2 There is an opportunity for POCL to provide:

- banking services to benefit recipients who have a bank account so that they withdraw their cash over PO Counters;

- basic credit accounts (in association with a private sector partner) for the "involuntarily unbanked" - those who would not otherwise be able to obtain a bank account;

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- accessible banking services for the public in general as bank branches close.

3.3.3 These services are already provided to customers of the Girobank (in 18,000 post offices), Cooperative Bank (15,000 post offices), and (on a trial basis) Lloyds TSB (840 offices). But current paper based methods are inefficient and expensive, and customers cannot for example check their bank balance.

3.3.4 To extend the range of services it could provide, the Post Office would need to:

- develop a technology platform; and

- establish commercial partnerships with banks, and get agreement to link their systems into bank systems.

3.3.5 We consider these issues in turn.

The technology

3.3.6 There appear to be three possible routes through which the Post Office could establish banking technology;

- **building on the Horizon system**. The system ICL are installing can be adapted relatively easily to provide a wide range of banking transactions. The investment would cost around £5 million for additional hardware (keypads) and up to £10 million for software development. The main constraints on implementation are resources within ICL and POCL, and getting agreements with the banks to link into their networks. ICL are naturally focussed on rolling out the benefit payment card system first. But in principle a banking system based on one partner bank could be rolled out towards the end of 2001, and with several banks perhaps a year later. Horizon can support smart card technology, and POCL see development of a PO smartcard as a central part of their development strategy.

- by using the new **on-line debit card terminals**. Around 10 million bank customers who are regarded as too risky to hold a conventional debit card now hold 'on line' debit cards (Electron or Solo) which authorise debits or cash withdrawals up to the limit of what is in the account. The retailer runs the card through a machine linked to a telephone line which provides on-line authorisation. A counter clerk in a post office could use it in the same way. This would be quick and cheap to install (£15-30 per month rental per machine plus transaction costs) but would support only a limited range of functions, and banks are more likely to charge retailers for such transactions than to pay for them.

- **holding a new competition for a counters automation platform**. It would take

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some time to get a fully integrated system in place, but the Post Office would be able to acquire more generic banking technology, perhaps more cheaply than the Horizon system (though with more limited functions).

3.3.7 Each seems a plausible route for POCL to develop the technology for banking services,

Partnerships with the banks

3.3.8 POCL envisage that it would not act directly as a bank itself, but would act as an agent for and partner with a range of banks. The working group agrees that this is a sensible approach. The Post Office would be an extension of the banking system, not a separate 'poor people's bank'.

3.3.9 What's in it for the banks? The banks are reducing their branch networks to cut costs but they still need to provide physical access for their customers for some basic services. The PO could be attractive to the banks since it is an extensive network, in particular providing access for those in lower socio-economic groups. (55% of CDEs live within half a mile of a bank or building society whereas 78% live within half a mile of a post office. Only 9% of rural parishes have a bank or building society whilst 57% have a post office.) Furthermore it is an organisation that is trusted by the public.

3.3.10 The banks may be willing to put some of their savings from branch closures into the Post Office to provide coverage for customers that their own networks can no longer achieve, especially in rural and deprived urban areas, or to discourage customers from visiting their branches for low value cash withdrawals.

3.3.11 But this is not straightforward. The banks may not view post offices as a suitable interface with their customers. They may well see the future in the next generation of smartcard technology and be reluctant to commit to the Post Office. (The Horizon system can support smartcards, but it would require considerable design and engineering effort to enable POCL to offer banking services using the next generation of smartcards.) And there is a limit to what the banks will pay for the service.

Benefits for POCL

3.3.12 POCL, drawing on work by McKinseys, have estimated that the revenue streams they could generate from banking might be:

- £220-270 million from providing front-end banking facilities for existing benefit recipients migrated to ACT accounts with the High Street banks;

- £20-80 million from existing non-benefit recipient customers of the High Street banks who might choose to carry out some of their basic banking business at post offices;

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- £15-35 million from wholesale cash distribution for a few major banks using their current distribution network;

giving a total gross income of £235-385 million a year.

3.3.13 We regard these estimates as extremely ambitious and the timetable for achieving them uncertain. People have a wide range of alternatives to the post office for cash withdrawals. Moreover these figures do not include the additional costs POCL would incur in providing these services.

3.3.14 In short it looks perfectly possible in technical terms for POCL within a few years to offer a range of banking services with suitable technology, and therefore to offer cash withdrawals to claimants receiving benefits through ACT if they have an account with one of a range of partner banks. But there must remain a question mark over the commercial potential for POCL in the longer term.

3.4 Role of PO counters in providing wider government services

3.4.1 POCL already provides a range of government services including National Savings, vehicle licensing, TV licensing, passport applications and information about benefits. The Horizon project will make most of these more efficient and provide clients with better information. This will help POCL to retain existing clients.

3.4.2 POCL is also exploring the scope for generating new income in the medium term by becoming the 'front end' for:

- information about government services such as benefit entitlement, tax or training provision;
- registration and notification such as notifying a death to different agencies, or registering a new small business;
- interactive services such as searching for jobs or training places.

3.4.3 This would build on POCL's existing relationship with customers and trusted brand image. As well as existing paper based routes (such as vehicle licensing) these services could be provided using:

- **the Horizon platform**: Horizon allows a range of transactions (such as National Savings) to be done more efficiently, and counter staff to be prompted to ask security questions. POCL's preferred route would be to build on the planned system using smartcard technology to provide stored value and customer information, and a digital signature for security purposes. The Horizon system can support smart cards and in this sense is "future-proof" However real time on-line applications for immediate authorisation would require major changes to the system.

- **alternative (or additional) platforms**: for example POCL could provide information kiosks at branches and act as a "call centre".

3.4.4 POCL believe there are significant efficiency gains to be had by combining information services under a "one stop shop". POCL's advisers estimate that efficiency savings of around £1,000 million could be achieved across government, and that POCL might secure £160-£280 million of these savings.

3.4.5 Our view is that there is certainly scope for improving efficiency of existing services, but there must be considerable uncertainty about both the timing and the role of post offices in future provision of government services and therefore the potential for generating revenue from this source.

Summary

3.4.6 In summary:

- the provision of basic banking services in partnership with the Banks could provide a plausible alternative income stream for POCL to compensate in part for the loss of BA revenue from the switch to ACT;

- POCL may also be able to generate some income through the provision of "front-end" central and local government information - though this is much more uncertain;

- these alternative income streams are unlikely, even on optimistic assumptions, to be sufficient to replace existing benefit income and associated footfall - therefore (assuming a transfer to ACT at some stage) there will have to be some restructuring of the PO network over time and/or explicit subsidy.

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4. Options for the future

4.0.1 This section of the report looks in detail at the options now available. We have considered three families of options:

- continuing with the project;
- restructuring the project without the benefit payment card;
- cancelling the whole project.

4.0.2 All options are based on an understanding that Ministers want to find a solution which:

- gives DSS/BA a more secure and cost effective system of benefit payment, and allows claimants to continue to collect cash from post offices if they wish;
- gives POCL an automated infrastructure which will help it to deliver banking and financial services, as part of a long term strategy to preserve a viable network.

4.0.3 In each case we identify a lead variant which looks the most practical and goes furthest towards meeting the objectives of the different parties involved. Annex G models the impact of each option and sets out key assumptions. In choosing between them the following issues need to be considered:

- the feasibility of the option; what risks are there around its delivery?
- the Government's objectives for welfare reform and in particular the need for BA to implement modern methods of benefit payment;
- the impact on the post office network;
- the overall impact on public spending;
- the implications for ICL; and
- the impact on Government objectives more widely including the wish to move to universal banking.

4.1 Summary of the options

4.1.1 **Option 1** involves continuing with the contract with some limited extension of its duration:

- the project continues, including the benefit payment card, with roll out projected

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to start in January 2000.

- this would require implementation of the Panel's recommendations, a renewed commitment by the parties and agreement with ICL on funding. We do not favour any increase in charges, but some extension of the contracts to provide for 5 years of steady state operation after full implementation of the system should be considered. (Even this will probably leave ICL with a loss on the project overall.)

- for this analysis we assume contracts are extended to allow a three year transition from the BPC to ACT starting early in 2005; DSS's preferred variant is to start in 2003. In any event there must be a firm date for ending the contract, and DSS would want to present it as part of a phased transition to ACT;

- the BPC would be introduced as the system is rolled out, steadily replacing paper based payment methods;

- POCL would agree with ICL on building banking services into Horizon and seek partnerships with the banks with a view to at least some partners being in place by October 2001 and full facilities two years later.

4.1.2 **Option 2** involves restructuring the project without the BPC to allow an earlier move to ACT and parallel provision of banking services in post offices:

- BA withdraws from all contracts with ICL for development of the benefit payment card on grounds of failure to perform.

- POCL works with ICL to implement the Horizon technology which is rolled out between January 2000 and September 2001; and builds on it the capacity to offer banking services with at least some partner banks by October 2001;

- BA draws up plans to migrate to ACT over three years from October 2001. In the meantime paper based methods of payment continue and BA strengthens anti-fraud mechanisms;

- BA negotiates a new contract with POCL which leaves current arrangements in place until the migration to ACT is complete;

- the Government continues to fund POCL for the equivalent to the 'floor' level in the current contracts with BA (£370 million, declining over time) at least until 2005/6.

4.1.3 **Option 3** involves cancelling the whole project on the basis of ICL's breach of contract for failure to meet agreed timetable:

– POCL seeks to put in place a separate integrated technology platform to enable it to offer banking and other services as soon as possible. We assume some basic technology could be put in place by October 2001 (perhaps based on simple swipe card terminals) with more comprehensive facilities to provide full banking services by 2003.

– BA draws up plans to migrate to ACT over three years from October 2001. In the meantime paper based methods of payment continue and BA strengthens anti-fraud mechanisms, perhaps building on the current electronic stop notice system (ESNS).

4.1.4 In each option we think it will be necessary to take a long hard look at the viability of the PO counters network in the medium term and draw up a proper corporate strategy aimed at cutting the costs of the network while maintaining and where possible improving services, and developing new business.

4.2 Feasibility of the options - what are the risks?

4.2.1 The feasibility of continuing with the project has been examined in detail by the Panel, and they conclude that it is technically viable and can support banking technology. The main risks around **Option 1** are:

– **whether the problems which have dogged the project so far can be resolved.** Success of the project on a reasonable timetable depends crucially on the Expert Panel's recommendations being implemented, on ICL putting in enough resources and on the renewed commitment of the parties to successful delivery. A lot will rest on the capacity of POCL to manage the implementation phase. We believe this will need new management with business expertise at the top. DSS/BA are very reluctant to remain exposed to these risks;

– **whether satisfactory commercial terms can be agreed with ICL.** Our legal advice, summarised in Annex F, suggests that we are tightly constrained in what could be offered to ICL (and for policy reasons we would want to offer as little as possible). It is therefore very likely that ICL will make a loss on the project overall if it continues. As explained below they are not in a strong position to absorb losses. So there is a chance they will withdraw and litigate to recover what costs they can. However we think this is unlikely: continuation offers ICL the prospect of generating further revenues from the exploitation with POCL of the commercial potential of the system; and from sales of the system overseas. Litigation may well not succeed and would damage their reputation.

4.2.2 The feasibility of **Option 2** raises different issues. Technically it should be much easier to implement the Horizon system without the BPC, and this should free resources to focus on developing a banking capability (though, paradoxically, removal of this embedded

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feature could now add time and cost). POCL might also be able to cut the cost of the project by not installing kit in all offices (current plans include automating the 2,000 or so part time offices, some of which open for only a few hours a week). However there must be significant risk around:

- **whether the project remains a commercially viable proposition for ICL and POCL without the BPC.** Withdrawal of BA from the project would immediately remove the major source of revenue from the project, and POCL would be rolling out kit which had only restricted use and limited revenue generating possibilities until banking services were operational. Post offices would have fewer customers. So even with the floor payment from BA it is not clear POCL could afford the payments to ICL without further subsidy.

- **how ICL would respond.** This would depend on the outcome on the first point. They may believe they can recover more of their costs by suing for wrongful termination. However option 2 could only proceed on the basis of a negotiated settlement with ICL Pathway. If such a settlement could not be reached then option 3 would follow.

- **whether POCL can get agreement with banks in time to meet BA's schedule for moving to ACT** and whether BA can complete the transition on schedule.

4.2.3 With **Option 3** the key uncertainties are:

- **how long it would take for POCL to put in place an alternative banking platform**, if it starts from scratch and conducts a new competition? There should be little difficulty in installing basic swipe terminals by 2001; but the 2003 projection for a full integrated platform may be optimistic.

- **how ICL will respond.** Full cancellation would make it more likely that ICL would litigate to seek to recover its costs. Protracted litigation could make it difficult to implement a new integrated automation solution for the POCL, and this could damage POCL's long term business prospects. But using simple on line swipe terminals as an interim solution would allow DSS to offer benefit recipients migrating to ACT the facility of cash withdrawals from a range of bank accounts across PO counters.

4.2.4 A major area of uncertainty which applies to all the options is **whether, in the medium term, POCL can generate sufficient revenue from banking and other services to maintain the network in a stable state.** The 'medium term' comes earlier under options 2 and 3. The impact on the Post Office is discussed in more detail below.

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4.3 Implications for Benefits Agency/DSS

4.3.1 DSS have always envisaged that when the contracts with ICL came to an end they would move to pay benefits direct into bank accounts. The original timetable would have seen the BPC introduced at the end of this year and run as the established method of payment for 7 years before new arrangements were fully implemented. However delays in the project now cast doubt on whether it makes sense to progress through the BPC to ACT rather than moving direct.

4.3.2 **Option 1** gives the DSS a payment mechanism which is more fraud free and auditable than current methods by the end of 2001, with cash available to claimants over PO counters. By giving PO more time to get banking services in place it helps to ensure a smooth transition to ACT. However:

- it also means postponing by up to 5 years the substantial efficiency savings available from ACT. DSS are concerned that this option would therefore not represent value for money for BA and hence be contrary to the obligations of their accounting officer to seek maximum value for money from public funds. A Ministerial direction may be needed;

- it involves benefit recipients in two major changes in the space of a few years. The BPC would be phased in over 20 months from the beginning of 2000, involving change for 19 million claimants, and major logistical exercise by BA. Five years later DSS would begin the transition to ACT with the card completely phased out by 2008. This will complicate the presentation and the administration;

- it leaves DSS exposed to the financial consequences of further delay, and prolonged lock-in what they perceive as a hostile monopoly supplier.

4.3.3 **Option 2** has a number of clear advantages for DSS and their customers:

- it allows DSS to take forward more quickly its proposals for modernising the benefit system through ACT and payment over post office counters, bringing forward the potential savings and thus satisfying value for money requirements;

- it involves claimants in only one change rather than two;

- provided the Post Office and ICL are able to deliver, it allows claimants continued access to cash through post offices, while giving them the wider choice of banks, ATMs etc. Overall, it looks less risky in technological terms

- it supports a move towards universal banking and combats social exclusion.

4.3.4 Moreover payment book (though not Girocheque) encashment fraud can be tackled

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effectively by continuing the Order Book Control Service (OBCS) which is currently planned as part of Horizon.

4.3.5 The implications for BA under option 3 are essentially similar to those under option 2.

4.4 Implications for Post Office Counters

4.4.1 **Option 1** automates post office counters with the technology POCL say they want and need in order to offer the best prospects of becoming a viable long term business. It provides a secure income stream, and a flow of largely captive customers, for the life of the contracts. POCL argue that transition to ACT via the benefit card would help them ultimately to retain a much larger number of customers than a direct move to ACT from paper systems. Spending by these customers provides income to both the Post Office and private sides of the business, and is important to the viability of the network

4.4.2 POCL estimate that under this option there would be an average of 200 post office closures a year, roughly in line with current trends, up to the end of the contracts; and that POCL would remain broadly at its current marginally profitable position (£30 million pa on £1.2 billion turnover) until then before taking account of any income from banking technology.

4.4.3 **Option 2** would give POCL the same automation platform (**if** a viable deal could be done with ICL). This would help it to secure income from other clients such as National Savings and the utilities, and to compete for business from benefit recipients migrating to ACT. However, whereas option 1 allows POCL to build new services on the base of an effectively captive market of around 19 million claimants, under this option POCL starts to lose customers as they switch to ACT. This faces POCL with two major challenges:

- it requires POCL to develop with ICL the appropriate banking technology as part of the Horizon platform, and establish partnerships with the banks;

- income from BA, its major client will effectively disappear beyond 2005.It is very unlikely that POCL would be able to replace the loss of BA revenue by revenue from banking and other new business within that timescale.

4.4.4 There would therefore be a need for a transitional period, possibly involving payment of a direct Government subsidy to fund the network until it could be made self-financing and/or slimming down the network, reducing the number of urban offices whilst keeping the rural network intact as far as possible.

4.4.5 Any significant loss of cash outflows through post offices resulting from an early switch to ACT under options 2 and 3 could undermine the viability of Girobank's corporate deposit business which is extensively used by small firms.

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4.4.6 Cancellation of the project under **option 3** would be a serious blow to POCL:

- it would put off full counters automation with the functionality desired by POCL for some years (but gives it time to reassess what it really needs);
- commercial prospects would be damaged - many of its current clients are already very keen to have Horizon implemented and may not be prepared to tolerate the further delay and uncertainty associated with developing a new system and potential new clients may be lost;
- as BA moved to full ACT, payments to POCL would taper down from around £400 million in 2001 to close to zero by 2005, representing loss of nearly 40 per cent of current turnover.

4.4.7 POCL have provided estimates of the impact of the loss of 100% of this income on the post office network:

- 5,000 to 13,000 post offices could close (depending on whether POCL managed Crown offices were closed, or more rural and urban offices were allowed to close);
- an annual subsidy of up to £300 million would be required to attempt to stabilise the network at this level;
- there would be job losses of up to 43,000;
- compensation to sub-postmasters and redundancy payments to Crown office staff could amount to £350 - 500 million.

4.4.8 However, as explained in Annex C, the mechanism by which a loss of business impacts on the network is not straightforward. We have not been able to satisfy ourselves on the basis of the information provided by POCL that these estimates are robust.

4.4.9 POCL would need to respond to this by spending perhaps 6 months developing a serious business strategy. The impact of losing BA income could be mitigated by winning new banking business, but POCL could not realistically be ready by 2004 to replace £400 million of revenue from BA with other income streams. So in order to keep the current network of post offices, a transitional period would be needed which would involve the payment of a large subsidy to POCL.

4.4.10 If POCL is to be a viable long term business, developing the banking area is essential but not sufficient. In any case there is likely to be a need for managed reductions in the network over a period of time, focussing on thinning out the urban network and largely preserving the rural network, but perhaps with more use of mobile post offices, local

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agents and kiosks. However, this process will be hard to manage; the network could become unstable resulting in large compensation to sub-postmasters whose businesses had become unviable. Continuing the project gives POCL the best chance of a smooth adjustment path.

4.5 Financial implications

4.5.1 The financial implications of each option are analysed in detail in Annex G. The impact on the public sector has to be seen in the round with losses to the Post Office balanced against savings for DSS. The net impact can be summarised as follows (net present value of the options discounted at 6% to 2009/10)

:

£ billion	**Option 1**	**Option 2**	**Option 3**
DSS admin savings	0.4	1.0	1.3
DSS fraud savings	0.9	0.8	0.8
Net impact on DSS	1.2	1.9	2.1
Net impact on POCL	0.2	-0.6	-1.2
overall NPV saving	1.4	1.3	1.0
exit payment to ICL	0	-0.2 to +0.3	-0.2 to +0.3

4.5.2 These results should be treated with caution. The estimates of the impact on DSS are much more robust than the estimates of the impact on POCL. We have identified, but not included in the totals, a possible 'exit payment' to ICL which may result either from negotiation or litigation; but this is highly uncertain, and does not imply acceptance of any liability. With these caveats, the results suggest:

- the most cost-effective options from DSS/BA point of view are either option 2 or 3;
- however when the impact on POCL is taken into account option 1 and 2 look more attractive;
- **but the margins of error in this exercise would suggest that caution should be exercised before ranking options.**

4.5.3 Under each option there are questions about DSS funding which would have to be addressed bilaterally with the Treasury.

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4.6 Implications for ICL

4.6.1 We have considered what the impact each option would have on ICL and its parent, Fujitsu. ICL Pathway has been set up as a subsidiary of ICL which has provided BA and POCL with parent company guarantees on finance and performance.

4.6.2 The ICL Group balance sheet is not strong. In 1997 it included net assets of around £260 million. We believe around £125 million of this represents capitalisation of the work on this project, some fixed assets but mainly work in progress. This is likely to be greater now, perhaps of the order of £160-170 million. Liquidity is worsening, down from £105 million of net current assets in 1996 to £42 million in 1997. There are no obvious areas where provision for losses on these contracts have been made. There is a possibility that ICL could strengthen its balance sheet by writing back some of £200 million goodwill written off according to existing accounting regulations that have subsequently been revised, but this is not mandatory.

4.6.3 Profitability is also weak. On a like for like basis ICL made an operating loss of £7 million in 1996, and a profit of £32 million in 1997, on a turnover of £2,477 million in 1997. So the group is operating at pretty close to a break even position.

4.6.4 Under **option 3**, cancellation of the whole project, Pathway say they could suffer a loss of around £250 million. Assuming ICL stand behind Pathway, they will have to bear most of this. The implications for ICL of cancellation, other things being equal, are:

- it would have to write off a good part of the £125 million or more of capitalised assets from the project unless, say, the work in progress could be deployed on another similar project;
- it would bear a loss at Pathway that could amount to £250 million;
- thus reducing net assets by, conservatively, around £350 million; and creating a situation of net liabilities of up to £100 million before any write back of goodwill;
- it would make a total loss in 1998 of around £350 million;
- and would seemingly put at risk for many years any chance of a successful flotation (planned for 2000).

4.6.5 In these circumstance it would be possible in principle for ICL to simply wind Pathway up, leaving Pathway's creditors, rather than ICL, to foot the bill. However this is unlikely. ICL are more likely to seek guarantees, or a significant injection of new capital, from Fujitsu.

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4.6.6 In either case ICL's reputation with Government (one of its main clients) will suffer a severe setback. But if ICL sued HMG first and secured a reasonable outcome it might be able to salvage some of its commercial reputation by ensuring blame is seen to lie with the Government parties and the PFI concept, portrayed as unworkable for large IT projects.

4.6.7 Cancellation would have limited financial implications for Fujitsu, since ICL represents only around 5 per cent of group shareholders' funds and 2 per cent of net current assets. However Fujitsu has underwritten a £200 million loan facility to ICL Pathway, and fujitsu itself appears to have had a bad year in 1997-98, with group profit after interest and taxes slumping from £254 million in 1996-97 to just £26 million in 1997-98. This seems to be due to the economic problems in Japan and south east Asia. So a problem at ICL is one of many, which may ease any write off necessary from taking action at ICL, or may be the straw that pushes Fujitsu into loss. Whilst Fujitsu's survival is not in any way questioned, there could still be pressure to minimise losses where possible, although ICL, it would appear, would be one of several target areas.

4.6.8 The implications of the loss of the project for employment within ICL depend on whether Fujitsu decides to divest itself of ICL subsequent to its inevitable poor profit performance. It is estimated that some 270 people at ICL Pathway are working on this project and many more at their contractors. However any IT staff released are likely to be quickly re-employed by competitors given skill shortages in the IT industry.

4.6.9 Cancellation of the project could affect perceptions of the UK Government as a partner and hence future inward investment from Japan where Fujitsu are influential. (Japan accounted for some 9.4 per cent of inward investment into the UK in 1996). There could well be an impact on Fujitsu's future strategy for the UK; they are currently planning an £800 million expansion to their semi-conductor plant in the North East. It is however difficult to forecast the precise impact.

4.6.10 Under **option 2**, cancelling the benefit payment card would damage ICL's reputation but installing the Horizon system in Post Offices would allow it to salvage something. But to remunerate the investment it is making it will need to generate income of £100-200 million a year for at least 5 years. POCL could not afford that without subsidy.

4.6.11 Under **options 2 and 3** there would be a loss of business for suppliers to ICL supporting the BPC. These include Girobank who are contracted to provide helpdesk facilities which will employ around 400 staff.

4.6.12 Under **option 1 and option 2** it is clear that on current plans ICL Pathway will make a large loss. From ICL's point of view it will want to weigh up, among other factors:

- estimates of income from continuing with the project, including possible contract extensions and a run-down period and installing banking technology; and

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- the probability the project can be completed successfully with no further delays;

against:

- the likely outcome of legal action.

4.6.13 It is not clear where the balance lies from ICL's point of view.

4.7 Presentation and handling

4.7.1 Annex E sets out recent Ministerial statements on these issues.

4.7.2 Areas of presentational difficulty with option 1 will be around what is said about the end of the contract period and the future of the counters network. It should be possible to put out a positive message on the banking services that POCL would be developing. We would also have to explain how the introduction of the BPC fitted with the Government's long term plans for ACT.

4.7.3 With options 2 and 3 an immediate difficulty would be explaining to the sub-postmasters and others why the Government had reversed its stance on the BPC and to the public in general what this meant for the future of the network in particularly rural areas. Claimants may well be concerned if plans for an early move to ACT could not be backed by an assurance that they would continue to be able to get their cash from post offices. On the other hand it would be possible to explain how ACT was a more efficient system than the BPC and would allow DSS and POCL to move forward in partnership.

4.7.4 Potential difficulties would seem to be:

- Government might be accused of wasting money on the project (if legal action or negotiation leads to large compensation payments to ICL);
- continuing with paper-based systems when a more secure card-based system is almost ready;
- public promises given to sub-postmasters and others that DSS was fully committed to the objectives of the project;
- criticism of Government from ICL, with potential knock-on effect on reputation of PFI projects.
- options 2 and 3 depend on POCL's having banking capacity for ACT by 2003-04; the working group believes this can be achieved, but it is challenging for POCL;

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- it may not prove possible to negotiate an acceptable deal with ICL to take forward only the Horizon part of the project; ICL might decide the project is not viable in the proposed form and therefore seek redress through the courts.

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5. Annexes

Annex A Benefit payment

A.1 DSS pays over £77 billion a year to 27 million benefit customers in - around one billion transactions a year. There are three methods of payment:

Method of payment	% of claimants	% of transactions	cost per transaction
order books across post office counters	67	80	47 pence
on presentation of giro cheque at post office	5	7	78 pence
via ACT to claimant bank account	28	13	1.4 pence

- Cost to BA of administering the current system is about £525 million per year, of which some £400 million is the payment to POCL;
- fraud arising from current means of payment is estimated to be around £110 million a year.

A.2 Features of existing methods of payment are:

- **Order Books** are a paper based method of payment which used since 1948. They are well liked by customers and have proved a reasonable reliable delivery system, giving customers a sense of security, but they are expensive to administer; and require recall and re-issue if claimant circumstances change - resulting in delays and sometimes hardship for customers. They are also subject to a high level of fraud due to accounting and reconciliation problems - it is not possible to reconcile encashment to an issue. About £85 million a year is lost through fraudulent encashment - of the total number of order books reported lost or stolen 63% are subsequently found to have one or more foils cashed.
- **Girocheques** are the second paper based method of payment and are the most expensive to administer. They are also subject to high levels of fraud due to reconciliation problems. About £22 million a year is lost through fraudulent encashment. Of the total number reported lost or stolen 61% are subsequently found to have been cashed.
- **Automated Credit Transfer** is a modern method of payment which is cheap to administer. Payments are only issued shortly before they are due, so a change of

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circumstances does not normally require any recovery or recall - resulting in less inconvenience or hardship for benefit claimants. There is currently no evidence of ACT payment fraud. Payments are accounted for accurately and reconciliation is fully automated.

A.3 ACT is an option open to all claimants with bank accounts. The percentage who choose to be paid by ACT has risen steadily in recent years:

Year	**1993**	**1994**	**1995**	**1996**	**1997**
% paid by ACT	16.2	22.7	22.2	25.7	28.2

- 47% of new pensioners choose payment by ACT (May 1998).
- 53% of new child benefit customers choose payment by ACT (May 1998).

US and Australian experiences of ACT

A.4 Payment of benefits directly into bank accounts has been introduced recently in Australia and is to be introduced in 1999 in the USA. Some lessons to be learnt from these experiences are:

- there have to be exemptions for some claimants. Neither Australia nor the USA has found a way so far to pay benefits by ACT to everybody;
- payment by ACT is far cheaper than paper-based methods such as sending a cheque through the post;
- the post offices in Australia and the USA have a much more limited role in benefit payment compared to the UK - only delivering cheques through the post rather than cash over counters;
- there seems to have been little difficulty making the changeover in Australia - this is probably because most recipients already had a bank account into which they paid their benefit cheques.

USA

A.5 – Benefits are currently paid by sending cheques through the post. These then have to be paid into a bank account or cashed, with the cost incurred by the recipient.

- Congress passed a law in 1996 which required all payments by the federal

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government after 1 January 1999 to be made by electronic funds transfer (ie ACT). This includes benefit payments;

- recipients of payments are required to designate a financial institution or agent to which payment should be made (some of which will charge the beneficiary a fee);

- the Treasury can grant exemptions for classes of recipients in cases of hardship or other circumstances;

- details of how this will operate are being worked out by the Treasury.

Australia

A.6 – A decision was made pre 1990 that all benefits would be paid by ACT and customers would not have a choice. Before the change payments were made by cheques sent in the post;

- now over 96% of social security payments are made fortnightly by ACT to banks and other institutions using a system similar to that used in the UK;

- conversion to ACT was not seen as a major problem for customers because a very high number held bank accounts and Australia Post was not a key player in the cheque cashing market, largely because most customers already paid their social security cheques into their bank accounts;

- it proved necessary in certain circumstances to allow exemptions which are, however, limited and difficult to obtain. Those customers not regularly paid by ACT are still paid by cheque. Payments by cheque are strongly resisted because of the administration costs, including expenses aligned to fraudulent negotiation;

- to make emergency payments Australia successfully trialed a plastic card system which utilises a "DSS Bank". This holds temporary accounts accessible via the ATM network - called electronic benefits transfer. It has now been recommended for national rollout.

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Annex B Post Office Counters Network

B.1 Post Office Counters Limited (POCL) provides services through a network of around 19,000 outlets (10,000 in urban areas, 9,000 in rural areas), covering the whole of the UK.

B.2 The network provides local communities with a wide range of **services** - access to postal services, benefit payments, banking and bill payment services, licensing and other Government services and a range of other customer driven services (lottery, bureau de change, insurance).

B.3 Local businesses make full use of these services with particular emphasis on corporate banking, cash provisioning and access to mail services.

B.4 These services are universally available through the network, with 96.8% of the UK population living within a mile of a post office. The services have a particular importance in rural areas where there may be less alternative provision (for example as the banks rationalise their branch networks). For example, an estimated 6 to 7,000 rural post offices serve local communities of less than 3,000 people.

B.5 It is estimated that 28 million people per week visit their post office.

Types of post offices

B.6 600 post offices (Crown Post Offices) are operated directly by POCL. The remaining 18,400 are operated on a variety of agency arrangements whereby POCL contracts with individuals (in a few cases with companies) to provide services on its behalf. Post Office services are provided in such cases using the agents' premises and staff - typically in an operation which also contains a private retail business. This allows cost-effective operation of the post office through shared overheads. Conversely in rural areas, many village shops are only able to survive in the face of retail pressures because of the income operating a post office provides.

B.7 POCL pays the agent for work done on its behalf. Payments are generally split into two areas - a fixed payment which is not dependent on amount of work done, and a variable payment directly related to work performed. The fixed payment is an important part of the payment made to smaller offices, the variable payment is more significant for larger offices.

B.8 POCL employs 12,000 staff directly, and the 18,400 agents themselves employ around 40,000 staff. Overall therefore about 70,000 people derive their income from Post Office Counters activities.

Sources of revenue

B.9 POCL mainly offers agency services on behalf of various organisations in the public and

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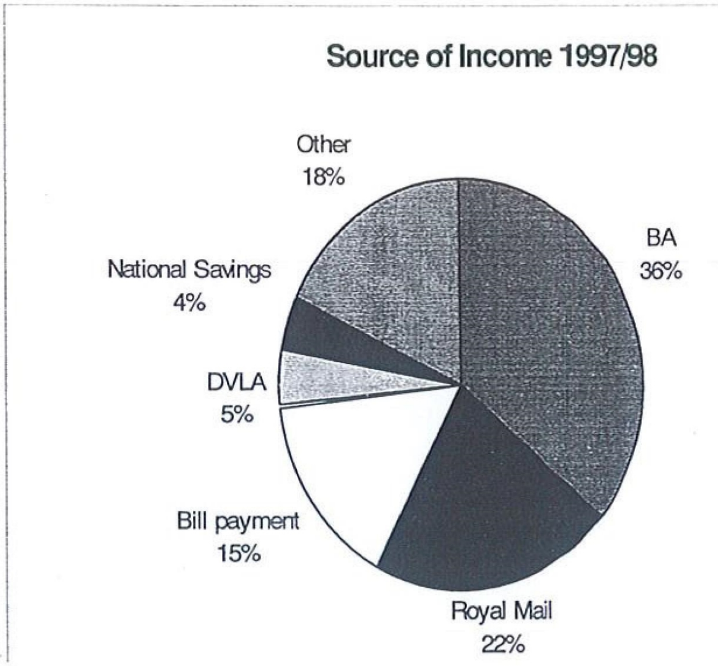
private sectors, including central government departments and agencies, local government, utility companies and banks, as well as providing the high street outlet for the Post Office's Royal Mail and Parcelforce businesses.

B.10 The following chart shows the Post Office's sources of income in 1997/8:



B.11 This shows that the Benefits Agency (including the Northern Ireland Social Security Agency) accounts for over a third of POCL's income. This business is also important because of the volume of customer visits that it brings and the opportunity to offer to these customers other services available from POCL. It also provides opportunities to sell them goods from the co-located private retail businesses. In this context, the benefits business is particularly significant in that it puts cash into the hands of the customers visiting the post office.

POCL Income	£ million	%
Benefits Agency	420	36
Royal Mail	251	21
Bill Payment Services	180	15
DVLA	56	5
National Savings	49	4
Other	209	19
Total	**1165**	**100**

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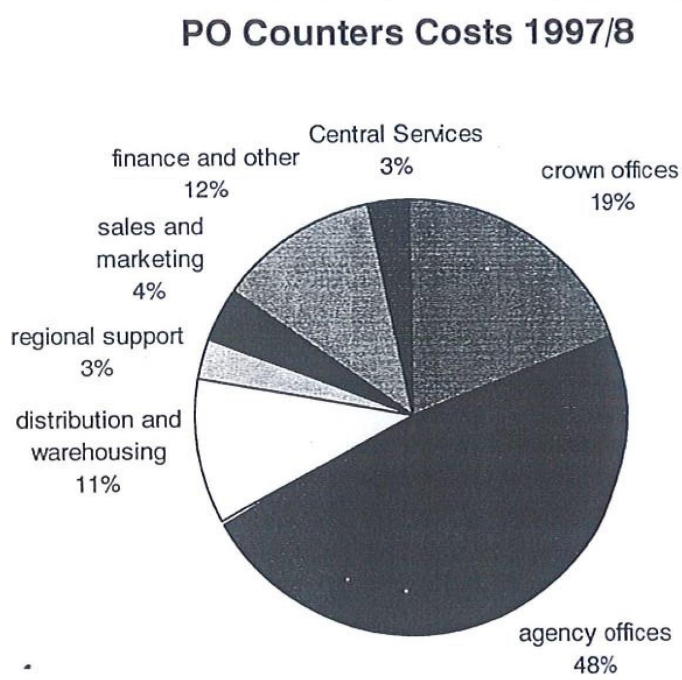
Annex C The Cost Structure of Post Office Counters

C.1 This annex discusses the cost structure of PO Counters and explains why losses of income can have a significant impact on profits and the size of the network. The remuneration of post office agents is an important factor in determining the impact of income losses on the network.

Network costs

C.2 A significant proportion of PO Counters' costs are the costs of the network: the Crown Offices and the agencies account for 64% of network costs.



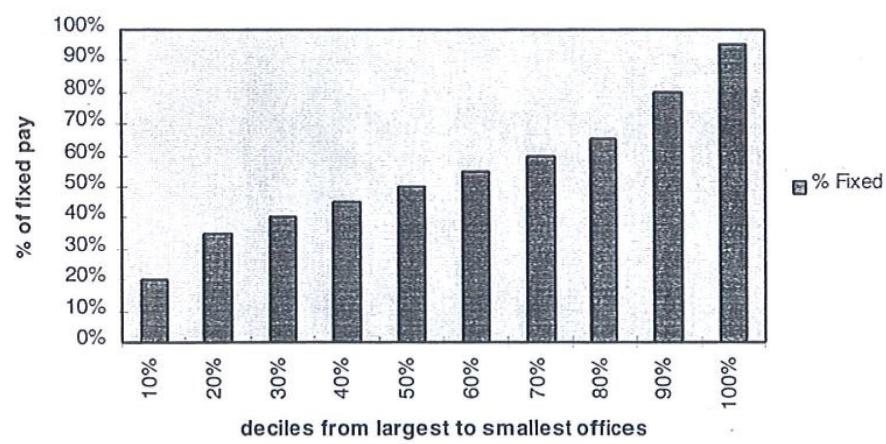
Agency income and costs

C.3 Sub-postmasters and other agents are not employees of POCL and are consequently responsible for providing their own premises and their own staff to run a post office. POCL will pay them for Post Office work done, but most sub-postmasters will gain an additional income stream by running a private business (newsagent, general store etc) from the same premises as his/her post office. This private business can utilise the customer footfall attracted by the Post Office to create further income for the agent, as well as enabling the spreading of the costs of running the post office out of the same premises. It is generally this combination of Post Office and private business which creates the income levels which, when set against the shared cost base of operating out of common premises, allow a commercially viable small business to be conducted.

C.4 POCL pays its agents for providing services on its behalf. Agents are remunerated through a system based around a fixed element (paid irrespective of the volume of work done in the office) and a variable element (based on the specific volumes of work done at the office and accordingly increasing, or decreasing with volumes handled). The calculation of the fixed payment for any particular office is determined for most offices through a formula agreed with the National Federation of Sub Postmasters which takes into account historic volume and payment levels at the office.

C.5 This is determined by the specific contract type the office works under and the volume of work handled. The very largest offices have pay which is entirely variable, whereas the very smallest have pay which is almost entirely fixed. For the largest 20% of offices the fixed element of pay represents between 20% and 35% of total pay, whereas for the smallest 20% the fixed element represents between 85% and 95% of total pay.

Fixed Payment as % of Total Pay



C.6 The rationale is straightforward. Smaller offices, often in rural areas, can attract only few customers. If these offices were paid purely on volumes of transactions the income to the sub-postmaster would be insufficient to cover the costs of providing and operating the outlet. Alternatively, larger post offices conduct large volumes of work and therefore variable payments do create the basis for a sustainable business.

C.7 The following chart shows the percentage of transactions which are benefit payments by size of office. Although the relationship is not wholly straightforward, it shows that the benefits business is "over-represented" in the smallest offices - i.e. those with the greatest

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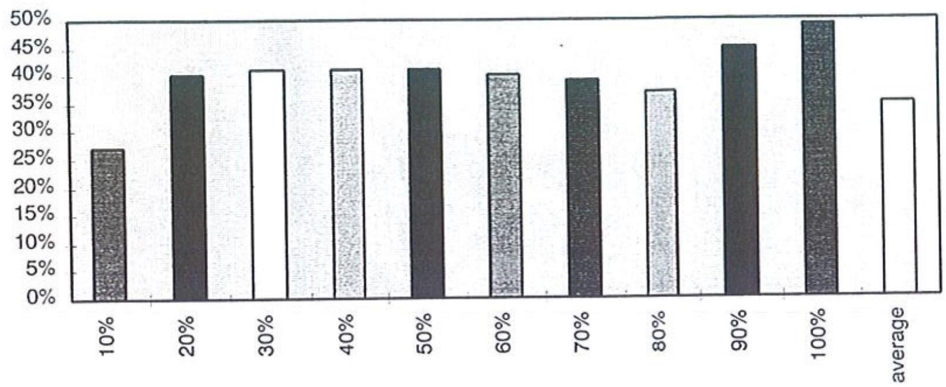
proportion of fixed payments in total payments.

Benefits as % of Total Transactions



Cost structure

C.8 A large proportion of PO Counters costs are fixed: they do not vary with the volume of business or with the number of outlets. This is for two main reasons:

- the payments to agents: for a large number of sub-post offices POCL's payments for business carried out is fixed (see above);
- PO Counters is a network industry. A significant proportion of its support costs - for example the costs of distributing cash and stock to the national network - are only partially variable with the number of outlets and the volume of business.

C.9 The following chart shows in broad terms the breakdown of variable and semi-variable costs by volume; costs which are variable and semi-variable by outlet; and costs which are fixed with outlets and volume. These are broadly as follows:

- variable costs by volume - variable payments to agents; direct support costs
- semi-variable costs by volume - variable costs at Crown Offices
- variable by outlet - Crown Office costs; fixed payments to agents
- semi-variable by outlet - distribution; warehousing; regional support
- fixed - central costs of running POCL as going concern

Only about 30% of PO Counters costs are fully variable with transactions, though the degree to which these costs remain fixed or only partially variable over time will vary.

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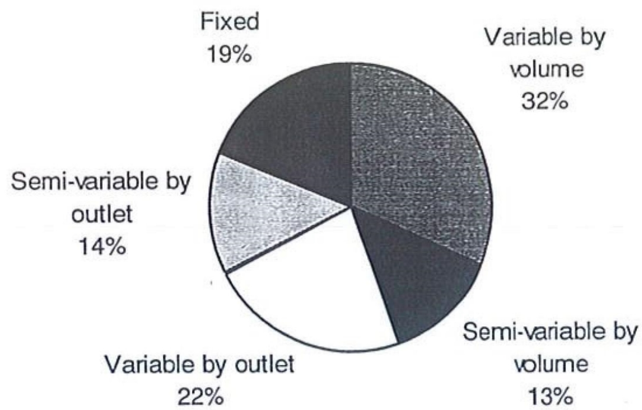
Variable, Semi-Variable and Fixed Costs



Impact of income losses on costs and the network

C.10 As income from BA falls then:

- ICL loses income from BA in its Crown offices and associated footfall. However it is able to recover some costs from the reduction in volume-related payments to its agents for BA and other transactions and other variable overheads. But these variable costs are only around 30% of total costs - and the benefits business is a greater proportion on business in smaller offices, which are more dependent on fixed payments than variable payments (see chart above). Given the small margin that POCL earns on turnover (£35 million profit on a turnover of £1.2 billion) POCL moves into loss. A £50 million loss of income would reduce POCL's profit to zero.

- sub-postmasters lose income via the reduction in variable payments from POCL for transactions carried out - due to both loss of BA business and the impact of loss of footfall on other PO transactions. This will particularly affect the larger urban, suburban and rural offices which handle a high proportion of BA transactions, for which a large proportion of their income from POCL is volume dependent, and for which PO business is a large proportion of their overall business (including retail). POCL believe there are around 4,000 urban offices and 500 rural offices which fall into this category (POCL assume that these offices will close under any scenario of loss of income from BA). Furthermore the income sub-postmasters gain from private retail activity will fall as footfall reduces. For many offices the business will no longer be viable. This will impact on the re-sale value of post offices.

C.11 Both of these impacts will lead to network closures arising both from management action to reduce costs, and from sub-postmasters who no longer found the business viable:

- in order to reduce its losses POCL will seek to reduce its network costs. This will be via closure of post offices which represent a high fixed cost - i.e. the Crown offices and the smaller rural offices - where most of the remuneration is fixed and not volume dependent;
- the reduced viability of sub-offices (particularly the larger offices dependent on BA transactions income) and the downturn in the resale market will lead to closures of agents' offices.

C.12 Network closures will mean that POCL will experience further reductions in income from BA and other transactions that were formerly carried out at POs which have now closed. The impact of this on profitability will depend on the management action taken by POCL and the extent to which this business migrates to other offices.

C.13 POCL argue that even at this point the network may not be stable. Other clients may withdraw business as the network reduces, leading to further losses of income and pressure to reduce costs.

C.14 The extent to which a downward spiral occurs rather than a managed transition to a reduced network depends on a number of factors:

- the size of the loss of income. However the marginal nature of POCL's business, its high fixed costs and the importance of footfall income means that even a small loss of income from BA can reduce profitability significantly.
- migration of business from closed offices to other offices. The greater control that POCL can have over the offices which close, the more they can ensure that rationalisation occurs in locations where offices are closely located to one another so there is a greater chance of capturing migrated business.
- the speed of change relative to the natural rate of turnover of post offices. Post offices change hands at a rate of 10% per annum, although this rate is dependent on general economic trends and varies significantly between outlets. The PO can use this turnover to manage change by seeking to reduce costs by alternative means to closing offices (or allowing them to "self-close" as they become unviable) through reducing the size and scope of offices, relocations, reducing the number of counter positions etc.

C.15 The PO argue that the more time they have to manage change the better they can work with these factors to reduce network costs and avoid disruption. Furthermore reductions in other fixed costs become possible with more time - for example the radical rationalisation of PO

Counters cash warehousing (from 300 to 20 warehouses) took around eight years to achieve. Other costs could be reduced in a shorter timescale - for example the re-organisation of POCL's field management structure took 18 months.

Agent compensation

C.16 Closure of agency offices is likely to lead to compensation to sub-postmasters. Under existing arrangements sub-postmasters are compensated by an amount equivalent to 26 months remuneration if their post offices are compulsorily closed. This applies both if the office is closed while the postmaster is in situ and when closure prevents a retiring postmaster selling on the post office business to another party. There is no current scheme for compensation for a loss in value of a post office as a result of reduced turnover although POCL would come under severe pressure to compensate sub-postmasters for loss of business arising from a government decision to move to compulsory payment of benefit by ACT.

Costs of maintaining the rural network

C.17 The Working Group asked the PO to provide an estimate of the cost of keeping the rural network open in the face of significantly reduced benefit payment business. POCL argue that it is impossible to segment out one part of the network in this way - even if a robust definition for a "rural" post office was available. As shown above, a significant proportion (around 15%) of the costs of running the network are common costs which are only partially variable with the number of outlets - for example the costs of distribution. The distribution system serves both rural and town areas and a loss of volumes would not significantly reduce costs. At present these costs are spread across the whole network, but if rural offices were kept open whilst urban offices closed these costs would fall on a reduced number of offices. So although the costs of maintaining the rural network at present (with the current network open) are relatively low, the costs of maintaining the network once urban offices were closed would be much more significant. POCL estimate the cost could range from £100 million to £300 million a year - although they believe in practice it would not be possible to target the rural network in this way.

C.18 PO Counters have not provided an estimate of the subsidy that would be required to prevent any closures of the network (although this was requested by the Working Group). They argue that such a subsidy would not be desirable, since it would undermine the commercial nature of the business.

C.19 In our view there is some scope for protecting the rural network by a phased thinning out urban offices where there is some over-provision. But this would only contribute in a limited way to meeting a revenue shortfall in the network as a whole.

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Annex D The project

D.1 In May 1996, BA and POCL signed PFI contracts with ICL Pathway for Pathway to set up and maintain a secure, automated infrastructure for POCL which would.

- allow benefit payments to claimant presenting a special magnetic stripe card, thus
- provide a more secure method of paying benefits; and
- provide an automated platform for other POCL business.

D.2 The basic idea of the project is, for **benefit payment**:

- claimants are given magnetic stripe card instead of order books and giros;
- networked computer terminals are installed at all 40,000 PO counter positions to automate procedures to assist with delivery of products and administration;
- network is linked to BA computer system (CAPS - Customer Accounting and Payment Strategy);
- claimants go to their nominated PO; counter staff swipe the card through terminal;
- the computer prompts staff to ask appropriate anti-fraud questions and tells them how much benefit to pay, and;
- beneficiary collects all money due (ie they cannot leave some of the money uncollected), and there is full automated reconciliation of transactions back to BA.

For other POCL services, the system provides:

- networked terminals with the facility for handling automated payments;
- point of sale information gathering and processing;
- up to date information for counter clerks on a wide range of transactions.

D.3 The programme comprises a number of interdependent systems and services, requiring work to be completed by, and coordinated by Pathway, BA and POCL:

- the benefit encashment service relies on feeds from BA's CAPS systems, containing customers' personal details, records of payments in and out and feeder systems for each type of benefit.
- Pathway's systems also rely on POCL providing Reference Data (details of post

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offices, products, prices, etc) and need to be integrated with POCL's existing automated systems and its accounting and management information systems.

D.4 Separate testing of systems, followed by integrated testing of 'model offices' and live trial, lead to the full national rollout of the service to all post offices and BA district offices, subject to acceptance tests at appropriate stages. Benefits migrate to the new system according to a prepared schedule.

Charges

D.5 Pathway charges to BA and POCL are driven by volume, based on a matrix of unit transaction prices which fall over time. Some payments are guaranteed in line with rollout to post offices. BA have a separate contract with POCL for counter services, the payments including fixed, semi-fixed and variable elements, with a 'floor' providing that payments cannot fall by more than a specified amount in any one year, regardless of volumes.

D.6 The programme is a large and strategic investment for ICL and its parent, Fujitsu. It is also a major business venture for the sponsors. It has been described as world-class in its scale; but is now being overtaken by other developments particularly in developing banking alongside postal services.

D.7 Pathway has taken on significant risk - including development, construction, operating, commercial and funding risks. Pathway has also taken on a degree of risk associated with encashment fraud (up to a ceiling of £200 million), although the ultimate risk of secure service for the £100 billion or so of benefit payment remains with BA/DSS.

Rollout

D.8 For a customer to have their benefit paid by card requires

- their designated 'home' post office to have Horizon installed;
- the appropriate BA district office to be ready; and
- the BA systems which support the benefit(s) concerned to have been switched across to the card. The timetables are interdependent and need to be planned accordingly.

D.9 The 'programme complete' milestone is reached when rollout to post offices and BA local offices and the switch to payment by card of the main benefits are both completed. It could be decided not to switch one or more benefits to the card, but the contracts provide for revenue guarantees to Pathway if transaction volumes on Horizon fall below certain levels.

Short term anti-fraud measures

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D.10 As an anti-fraud measure within the M25, order books are bar coded and the Automation of London post offices (ALPS) has provided a bar code reader and an Electronic Stop Notice System (ESNS) running on a PC on the post office counter. Order books can thus be checked against a file of 'stop' notices downloaded from BA's Electronic Stop Notice Control System (ESNCS) and be withdrawn if necessary. ESNS also captures and returns to ESNCS some information about order book issuance and foil encashment.

D.11 The Order Book Control Service (OBCS) extends this facility as part of Horizon.

Progress

D.12 The competition took place and the contracts were let on the basis of a detailed requirement agreed by the sponsors which was 'dropped down' to detailed service descriptions in the first few months of the contracts. The process revealed a complexity not previously properly understood. Timetables slipped. A replan in February 1997 set out new milestones formally negotiated under the terms of the contracts. Timetables slipped further and BA and POCL have issued notification of breach of contract by ICLwith BA issuing a legal 'cure' notice in response to Pathway's failure to meet a contractual milestone in November 1997. Pathway has responded by blaming the public sector parties for the delays.

D.13 BA and POCL, through their legal advisers Bird and Bird, commissioned an independent of the programme by consultants Project Mentors. They concluded:

- '...Pathway seriously under-estimated the effort and time needed to develop the services...
- 'Pathway have been responsible for the delays to the programme, since the re-plan in February 1997, that caused the November 1997 breach by not allocating sufficient resources to complete their contracted obligations within the agreed timescale...'
- 'A secondary, and ...relatively insignificant, cause of the breach is delays resulting from slow resolution of issues...We do not believe Pathway allowed sufficient time for this activity in their estimates...'

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Annex E Recent Ministerial statements

Manifesto commitments:

The manifesto said:

> *" Public services and transport services in rural areas must not be allowed to deteriorate. The Conservatives have tried to privatise the Post Office. We opposed that in favour of a public Post Office providing a comprehensive service. Conservative plans would mean higher charges for letters and put rural post offices under threat."*

Public statements on the Horizon project:

Kate Hoey MP in delivering a speech to the National Federation of Sub-postmasters on behalf of Frank Field, Minister for Welfare Reform on 12 May 1998 said (extracts):

> *"We recognise that the Horizon project is as important to you as it is to the DSS... We now have more than 25,000 Child Benefit customers using the Payment Card to collect their money at the post office. And 12 million, or 50%, of all benefit customers currently using post offices to get their money, will be ready to switch to the Payment Card by the time Horizon begins its national roll-out. This is a remarkable achievement and reflects the commitment of every one involved in the project to provide a secure, cost effective and convenient method of payment for our customers."*

> *"The Payment Card will also help cut down on paper and bureaucracy. Our new payment systems will consolidate customer details on a single database for all benefits, so in future a customer will need only report change in personal details, for example, change of address or post office, only once - the system will automatically update all benefit records. The Payment Card will also give our customers a more convenient and safer method of collecting their money, which is what they want. And it will also improve the way DSS accounts for the massive expenditure on benefits passing through post offices, now approaching £56 billion a year. The Payment Card is designed to do all these things."*

> *"The project, we know is also crucial to the future of your business. You will understand the importance of taking great care in planning the next stages of the project to ensure that we get it right."*

> *"We are committed to providing a modern, secure payment system which is cost effective, robust and fully accounted. Our partnership is crucial in making these objectives achievable for benefit payments through post offices. With your 19,000 outlets you can reach parts of the country other retailers can't, or don't want to reach. So we need you as much as the communities you serve need you. But equally, only DSS can bring in 19 million customers who want to spend as well as collect their money."*

> *"As we move towards the millennium there will be ever greater opportunities to harness*

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new technology and to expand your business. But whatever the future may hold, you can be assured that our longstanding association and commitment to providing an efficient and secure benefit payment service for people who want to collect their money at their post office is as strong as ever."

Statements in Hansard:

There have been various written statements made by Ministers in Hansard over the last year regarding the project. These have tended to focus on the expected completion of roll-out of the system, and the trial already in place. Statements have also been made about fraud savings. In an oral exchange in the House of Lords on 1 April, Lord Haskel said:

"My Lords, this is certainly a system which is designed to combat fraud. Unlike order books and giro cheques, the payment card which will be part of the system has no intrinsic value and so carries little personal information. The system will be more convenient. Any changes to the benefit payment cards will be made automatically on the system.

This is a huge project, which is under constant discussion, and Ministers meet to consider it from time to time. I am not in a position to say what the situation is regarding the budget."

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Annex F Summary of legal advice

Under procurement law is it legal:

1 to extend the contracts?

The contract term is made up of an implementation period and a fixed 5 year "steady state" period. The implementation period could be extended if objectively justified. Given the many delays to this project a 12 month extension looks perfectly possible. Significantly extending the steady state period would be problematic because a 5 year term was specified in the OJ notice for the original competition. An extension to the steady state period could possibly be justified according to the Programme Lawyer if it could be demonstrated that the additional period of operation was necessary due to "unforeseen circumstances" and could not be provided separately for "technical or economic reasons...without great inconvenience to the contracting authority", or was "strictly necessary" to the performance of the original contract.

2 to institute a wind down period after the end of the contract?

The Programme Lawyer says not until nearer the time when it might become necessary because of unforeseen circumstances (as above). Treasury Solicitor believes the risk of successful challenge to a 12-18 month wind down period is small and hence this possibility should not be ruled out.

3 to increase payments to ICL?

There is no problem about making additional payments to ICL for additional services provided the additional services have been procured properly. The Programme Lawyer considers such additional services can be acquired using the formula set out in paragraph 1 above. Treasury Solicitor has some reservations about the scope of the additional services which can be added - more of the same in the wind down period provided they are of limited duration and value is probably acceptable. New services could prove more difficult (see paragraph 5 below). More could be paid for existing services if it can be shown that the cost of the renegotiated package is no less economically advantageous than the next best offer in the original competition (IBM's). There is some scope for this although it is limited since in cash terms Pathway's offer was five per cent more than IBM's.

4 to restructure the contracts to remove the benefit payment card, as proposed in option 2?

Treasury Solicitor believes the answer is yes provided BA withdraws entirely from its contract with Pathway (as BA proposes) because on present information they consider POCL not to be covered by the procurement directives. If BA cancels only parts of its contract with Pathway, Treasury Solicitor believes there is some risk of challenge to BA and POCL. In this case the Programme Lawyer believes there is minimal risk on grounds

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that Pathway are in breach of contract. If POCL were covered by the procurement directives the likelihood of successful legal challenge would depend on whether POCL could proceed with the Horizon platform without prejudicing other potential bidders who could have provided the platform without the benefit payment card.

5 **for BA then to renegotiate with ICL for provision of the Order Book Control System (OBCS)?**

EC public procurement law would require BA to hold a competition for the provision of these computer-related services, unless the value of the consideration for the services was below the current threshold (£104,435). We believe the value of a project to deliver the OBCS system to be substantially above the threshold.

6 **for POCL to procure banking services from ICL without retendering?**

POCL envisaged from the outset that banking facilities would be part of the functionality of Horizon. POCL believe therefore that there should be no question of retendering for this work.

On the basis of current information Treasury Solicitor believes POCL is not covered by the procurement directives and therefore POCL can, in any case, procure banking services from ICL without retendering.

Under contract law:

7 **Would BA/POCL be liable for compensation on termination?**

If BA or POCL terminated "for convenience" they would have to compensate ICL according to a schedule of payment set out in the contract. If termination took place this year, BA would pay £129 million and POCL £205 million.

If BA terminated on the basis of ICL's breach of contract, ICL could be liable to BA for up to £200 million. But ICL would vigorously contest that they were in breach. It is highly likely that they would sue for wrongful termination and substantial damages. If BA lost they could be liable for up to the sum available for termination "for convenience" ie £129 million if they terminated this year.

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Annex G Analysis of financial flows

G.1 This annex analyses the financial impact on the public sector of the three options discussed in the main report. The figures are subject to varying degrees of uncertainty and should be treated with caution: they can only be broadly indicative. Key assumptions for each option are:

Key assumptions underlying options

	Option 1	Option 2	Option 3
Horizon system for POCL	Continued	Continued	Cancelled
Benefit payment card	Continued	Cancelled	Cancelled
Roll out of system starts	January 2000	January 2000	-
Roll out completed	September 2001	September 2001	-
BA commitment to contracts with ICL ends	September 2007	September 1998	September 1998
BA commitment to floor payment to POCL ends	September 2006	September 2006.	September 2001. BA negotiates terms for residual use of paper based methods after this date.
BA moves to ACT	Over a period of 3 years starting leading up to end of contract.	Over 3 years from October 2001 to 2004	Over 3 years from October 2001
POCL introduces banking services	Building on Horizon platform - technology in place by October 2001; services up and running by October 2003	Building on Horizon platform - start by October 2001; fully in place by October 2003	POCL commissions new system - limited services from October 2001; fully in place by October 2003
Fraud control system for paper based transactions	Order book control system built into Horizon system	Order book control system built into Horizon system	Some equivalent system based on that now used in London.

DSS savings

G.2 Net administrative savings are based on BA modelling and are judged to be reasonably robust. Changes in administrative costs are driven by the number of transactions paid by ACT. However a large proportion of the current administrative costs of paying benefits is the fixed payment to POCL for handling order books. As ACT increases, variable payments to POCL reduce but the fixed payment remains. When ACT reaches 100% of benefit transactions total savings against the baseline are £440 million a year.

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G.3 Programme savings are expected reductions in fraud associated with paper-based payment systems. They therefore accrue both with the benefit payment card and with ACT. Fraud savings are estimated to reach £135 million a year when order books and girocheques are fully phased out.

G.4 The payment for the "unbanked" assumes that about half of those benefit recipients who do not currently have a bank account would be very unattractive to the banks (due to a variety of reasons such as low incomes, likelihood of immediate withdrawal of benefit or a (perceived) high risk of default). BA start from the position that they would not pay the banks to set up simple credit only accounts for these individuals, but we have assumed that an upfront payment of £10 per account with an on-going charge of £20 a year would be required as an incentive to the banks. The analysis assumes action is taken to provide bank accounts for this group early on in the process of transfer to ACT.

Impact on POCL

G.5 In contrast to the BA figures, the modelling of the impact on POCL of each option is judged to be less robust.

G.6 The first round impact on POCL net profits is based on POCL modelling of the impact of reduced BA income - both directly and indirectly through loss of footfall. POCL's figures suggest that the total loss of BA income of around £400 million would turn net profits, currently £30 million a year, into losses of around £270 million a year. A large proportion of POCL's costs are fixed, and so a reduction in income is not matched by a significant reduction in costs. In order to reduce costs POCL must close offices, which in turn reduces income. The more time that POCL has to manage changes to the network, the less likely this process becomes a spiral of decline. This is discussed further in Annex C.

G.7 It is assumed that POCL losses increase towards this figure as ACT increases - although recognising that under options 1 and 2 POCL is still protected by the floor payment from BA until the contracts end (it is not, however, protected against footfall losses). Once 100% ACT is achieved it is assumed that POCL's net profitability remains negative over time but gradually improves as the network is restructured and costs are driven out.

G.8 As income earned from benefit transactions and associated footfall reduces then the commercial attractiveness of sub-post offices will decline. Legally POCL is required to compensate sub-postmasters by an equivalent to 26 months remuneration if their post offices are compulsorily closed. It is likely that POCL would be placed under significant pressure to compensate sub-postmasters if the Government announced a switch to payment of benefit to ACT. The options therefore include a sum for compensation (based on POCL modelling) which broadly reflects the number of post offices that would close under each scenario.

G.9 The potential income from providing simple banking and financial services is highly speculative. It is assumed that POCL generates income from three sources:

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- the cash handling business (about £25 million a year);

- by capturing a small share (between 5 and 10%) of the £2 billion cash withdrawals market;

- by providing access to bank accounts and cash withdrawal facilities for benefit claimants who wish to continue to obtain their benefits across PO counters. It is assumed that POCL is able to negotiate a fee of £20 per account handled. The ability of POCL to retain the benefit business as ACT increases varies under each option. POCL believe that they would be able to retain around 65% of those transferring to ACT when their banking services are fully operational - but that in the earlier years the retention will be less. The analysis assumes that in option 1 retention rates are higher than in option 2 and 3 (since POCL argue they will be able to retain more business with the benefit payment card).

G.10 These estimates are, in the Working Group's judgement, optimistic about the possibilities for income generation from banking services - given the highly competitive environment in which POCL will be operating.

G.11 Set up costs under option 1 reflect POCL assumptions (confirmed by ICL Pathway). Set up costs in option 2 assume that POCL will need to pay around £75 million a year to Pathway to remunerate the investment (since payments for the benefit card have been removed, but costs to ICL are not expected to reduce significantly). Set up costs under option 3 are based on the cost of a replacement technology for POCL (expected to be somewhat cheaper than Horizon) plus an interim banking facility to deliver banking services by 2001/2.

G.12 The impact on the network of post offices was provided by POCL modelling, and are against a baseline of urban and rural closures over time. The figures are highly uncertain. POCL argue that about 4,000 urban and 500 rural offices could close whether they loose 40% or 100% of BA income. This is discussed further in Annex C.

Exit payment to/from ICL

G.13 BA and POCL's starting point is that ICL are in breach of contract due to their failure to meet a key project milestone. If the Horizon project had to be re-scoped (option 2) or cancelled (option 3) they would argue that ICL was liable for costs of up to £335 million. However either of these options would be dependent on a negotiation with ICL who would argue forcefully that the delay was due to the contracting parties. It is assumed for the purposes of the analysis that no payment is made to ICL, but the summary table below shows a range of possible payments.

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Results - NPV of the options discounted at 6% to 2009/10

£ billion	Option 1	Option 2	Option 3
DSS admin savings	0.4	1.0	1.3
DSS fraud savings	0.9	0.8	0.8
Net impact on DSS	1.2	1.9	2.1
Net impact on POCL	0.2	-0.6	-1.2
overall NPV saving	1.4	1.3	1.0
exit payment to ICL	0	-0.2 to +0.3	-0.2 to +0.3

G.14 These results should be interpreted carefully. The estimates of the impact on DSS are much more robust than the estimates of the impact on POCL. With these caveats, the results suggest:

- the most cost-effective options from DSS/BA point of view are either option 2 or 3;

- however when the impact on POCL is taken into account option 1 and 2 look more attractive;

- but the margins of error in this exercise would suggest that caution should be exercised before ranking options.

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HORIZON: SUMMARY OF CENTRAL OPTIONS

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6% to 2010	NPV @ 6% to 2005
Baseline															
DSS administrative costs		530	530	525	525	525	520	520	515	515	510	510	505		
CAPS costs		100	20	20	20	20	20	20	20	20	20	20	20		
total administrative costs inc. CAPs		630	550	545	545	545	540	540	535	535	530	530	525		
DSS programme savings (ESNS)		70	70	70	50	50	50	50	50	50	50	50	50		
% of claimants paid by ACT		30%	31%	31%	32%	32%	32%	33%	33%	34%	34%	35%	35%		
% of transactions made by ACT		13%	14%	14%	15%	15%	16%	16%	17%	17%	18%	18%	19%		
POCL profits £m		30	25	20	10	0	-10	-20	-50	-50	-60	-60	-70		
POCL network	rural	9000	8800	8600	8400	8200	8000	7800	7600	7400	7200	7000	6800		
	urban	10000	9760	9520	9290	9050	8810	8570	8330	8090	7860	7620	7280		
	total	19000	18560	18120	17690	17250	16810	16370	15930	15490	15060	14620	14080		

1 <u>**Continue with project on present forecasts then start to move to compulsory ACT from 2004/5 before the end of the contract in Sept 2006**</u>

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6% to 2010	NPV @ 6% to 2005
DSS net administrative savings (£m)		-30	-85	-90	-5	15	20	20	45	95	200	430	435	494	-145
contingency		0	0	0	0	0	0	0	-10	-10	-10	-10	-10	-28	0
DSS programme savings (£m)		0	5	110	135	135	135	135	135	135	135	135	135	868	490
payment for "unbanked"		0	0	0	0	0	0	-8	-20	-30	-33	-32	-32	-86	-5
Total DSS savings (£m)		**-30**	**-80**	**20**	**130**	**150**	**155**	**147.5**	**150**	**190**	**293**	**523**	**528**	**1248**	**340**
% of claimants paid by ACT		30%	30%	31%	32%	32%	32%	55%	78%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	15%	15%	15%	16%	16%	26%	53%	87%	100%	100%		
first round impact on POCL profits £m		0	0	10	20	30	40	50	0	0	-90	-190	-200	-142	108
compensation to subpostmasters		0	0	0	0	0	0	0	0	0	-15	-15	-15	-24	0
cost of banking technology for POCL		0	0	-10	-10	0	0	0	0	0	0	0	0	-16	-16
profits for POCL from banking £m		0	0	0	0	0	9	17	98	130	123	137	137	364	17
Total impact on POCL		**0**	**0**	**0**	**10**	**30**	**49**	**67**	**98**	**130**	**18**	**-68**	**-78**	**182**	**109**
impact on PO network	rural	0	0	0	0	0	0	0	0	0	0	0	0		
	urban	0	240	480	710	950	1190	1430	1470	1510	1550	1590	1630		
	total	0	240	480	710	950	1190	1430	1470	1510	1550	1590	1630		
NET IMPACT ON PUBLIC SECTOR														1430	449

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		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6%	NPV @ 6%
2 Continuation of Horizon without BPC, move to ACT (compulsory from 10/01), floor paid until end of contract															
DSS net administrative savings (£m)		-10	-15	-35	-15	25	75	120	435	435	435	435	435	1306	87
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked"		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-205	-115
Total DSS savings (£m)		**-20**	**-28**	**25**	**75**	**118**	**168**	**213**	**528**	**528**	**528**	**528**	**528**	**1864**	**385**
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%	0	0
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%	0	0
first round impact on POCL profits £m		0	0	10	20	30	40	50	80	-220	-210	-210	-200	-299	108
compensation to subpostmasters		0	0	0	0	0	-50	-50	-50	-50	-50	-50	-50	-209	-69
cost of banking technology for POCL		0	0	-10	-85	-75	-75	-75	-75	-75	0	0	0	-326	-235
profits for POCL from banking £m		0	0	0	10	21	43	63	63	63	63	63	63	272	96
Total impact on POCL		**0**	**0**	**0**	**-55**	**-24**	**-42**	**-12**	**18**	**-282**	**-197**	**-197**	**-187**	-561	-99
impact on PO network	rural	0	0	0	0	0	0	0	-500	-1500	-2500	-3000	-3250		
	urban	0	0	0	0	0	0	0	-500	-1000	-1500	-1500	-1530		
	total	0	0	0	0	0	0	0	-1000	-2500	-4000	-4500	-4780		
NET IMPACT ON PUBLIC SECTOR														1303	286
3 Horizon cancelled: ACT compulsory for all claimants from Oct 2001															
DSS net administrative savings (£m)		-10	-15	-30	10	95	190	290	435	435	435	435	435	1576	358
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked"		0	-7.5	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-205	-115
Total DSS savings (£m)		**-20**	**-28**	**30**	**100**	**188**	**283**	**383**	**528**	**528**	**528**	**528**	**528**	**2135**	**655**
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
first round impact on POCL profits £m		0	0	0	0	-60	-90	-130	-220	-198	-168	-147	-120	-681	-195
compensation to subpostmasters		0	0	-100	-100	-200	-100	0	0	0	0	0	0	-383	-383
cost of banking technology for POCL		0	0	0	-18	-60	-30	-58	-67	-67	-67	-67	-67	-306	-119
profits for POCL from banking £m		0	0	0	10	17	29	47	48	49	49	48	48	208	72
Total impact on POCL		**0**	**0**	**-100**	**-108**	-303	-191	-142	-239	-216	-186	-166	-139	-1162	-624
impact on PO network	rural	0	-400	-2100	-3400	-4200	-4500	-4750	-4750	-4750	-4750	-4750	-4750		
	urban	0	-760	-1320	-2490	-2650	-2650	-2820	-2580	-2340	-2110	-1870	-1530		
	total	0	-1160	-3420	-5890	-6850	-7150	-7570	-7330	-7090	-6860	-6620	-6280		
NET IMPACT ON PUBLIC SECTOR														972	31

Notes
1 A negative saving means an addition to costs
2 Baseline assumes "business as usual" with no Horizon
3 Each option is expressed as a change relative to the baseline
4 NPV figures for option 2 and 3 assume that no compensation is paid either by or to ICL
5 Note that the modelling assumes a contract end date of September 2006 in Option 1, rather than September 2007 as in the main report (the timing of the switch to ACT is unchanged).
It was not possible to reflect this change to the specification of Option 1 in the modelling in the time available. However the impact on the financial flows is expected to be minimal.