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~~EXTREMELY~~~~RESTRICTED~~ - POLICY & COMMERCIAL  
DEPARTMENT OF TRADE AND INDUSTRY

## FAX HEADER

FOR THE ATTENTION OF:

Jonathan Evans

LOCATION:

POOL

NUMBER OF PAGES TO FOLLOW: 33

DATE: 28.10.98

FROM:

ISABEL ANDERSON  
POSTAL SERVICES DIRECTORATE  
306 RED ZONE  
151 BUCKINGHAM PALACE ROAD  
LONDON SW1W 9SS

TEL NO.

GRO

FAX NO.

GRO

## MESSAGE

Please see attached Graham Connelly's report  
to the Chief Secretary.

Isabel Anderson.

Copy: Stuart, Paul, Maria,  
Lesley, Dave M,  
Jeff Trigg

PS Obviously  
it's VITAL  
that ICL do  
not see this

I have obtained this copy of  
GC's report from HMT + DT!  
under pain of death. Please  
keep it confidential

28/10 '98 12:25

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22 OCT 1998

Treasury Chambers, Parliament Street, SW1P 3AG

Rod Clark Esq  
Principal Private Secretary to  
the Secretary of State  
Department of Social Security  
Richmond House  
79 Whitehall  
LONDON  
SW1A 2NS

20 October 1998

Dear Rod

**BA/POCL AUTOMATION PROJECT: INDEPENDENT ADVISER'S  
REPORT**

The Chief Secretary has asked me to send you a copy of the report produced by Graham Corbett at the end of last week. I enclose a copy.

2. I am copying this letter, together with the attachment, to Chris Woolford and Geoff Moore (DTI), David North and Sebastian Wood (Cabinet Office) and Geoff Mulgan (No 10).

Yours

**GRO**

**PETERSCHOFIELD**  
Private Secretary



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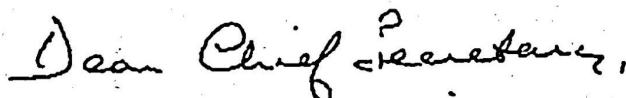
**RESTRICTED - POLICY & COMMERCIAL**

Graham Corbett CBE

95 Colchester Court,  
Old Brompton Road, London SW5 0EDTel: GRO Fax: GRO  
e-mail: GRO**WITHOUT PREJUDICE - CONFIDENTIAL**

The Right Hon Stephen Byers MP  
Chief Secretary to the Treasury  
HM Treasury  
Parliament Street  
London SW1P 3AG

18 October 1998

**BENEFITS AGENCY/POST OFFICE COUNTERS AUTOMATION PROJECT****BACKGROUND**

On 17 September you appointed me as Independent Adviser to this project with the terms of reference set out in Annex A and a reporting date of 16 October. On 16 October I reported to you orally that we had been unable to reach agreement on a commercial basis for proceeding, but that we had made considerable progress on the development of a satisfactory implementation plan, and we discussed what further steps if any might be now be considered. In making that report I used the charts attached as Annex B<sup>1</sup>.

This report and its attachments add nothing of substance to what I told you on Friday, and is therefore designed primarily to put on record the results of my assignment.

<sup>1</sup> Charts 4 and 5, showing respectively the changes as regards BA and POCL, have been omitted since the information has not been made available to the other party and is in any event highly dependent on the views taken as regards the cost of ACT processing in the case of BA and the inclusion for the first time of banking business in the case of POCL. Chart 6 has also been omitted.

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The discussions which I held with the parties, and the information developed for those discussions, were all without prejudice and confidential, and should therefore only be used with the consent of all the parties, as should the information in this report

#### THE PATH OF THE DISCUSSIONS - COMMERCIAL

Annex B chart 2 provides a graphical overview of what happened in numeric terms. The right hand number (-£310M) represents the NPV of ICL's cash flows over the life of the project with future cash flows discounted back to October 1998 values at a discount rate of 8.5% (8% real plus 2.5% inflation). Of this number £232M has been expended to date. All numbers on this chart exclude amounts to be set aside to a contingency fund<sup>2</sup>. The core case impact on ICL was developed by ICL and KPMG (acting for me) on the basis of assumptions agreed with all three parties but which ICL consistently maintained were overly pessimistic as regards (i) POCL volumes and (ii) a schedule of migration to ACT (20%:40%:40% of the remaining accounts transferring over the last three years of the contract) that was both sooner and faster than they had been planning on. It did not appear to me that there had been sufficient (or perhaps any) real discussion of this key piece of information between BA and ICL.

Little work has been done thus far on the effect of commercial sensitivities around the core case beyond project contingencies. If a deal were to be done, part of the due diligence exercise mentioned below would be to test the solution for robustness against a range of commercial sensitivities.

On 8 October, very soon after the core case had been agreed, the public sector bodies offered contract extensions of 2 and 4 years for BA and POCL respectively; POCL also offered to consider picking up the hardware costs of the refresh that any extension would make necessary and to extend payments to ICL over the contract term (now 2009) to cover banking transactions. ICL and KPMG evaluated this offer as reducing the NPV deficit from -£310M to -£242M.

ICL stood by its opening stance of requiring a modest positive return<sup>3</sup> over the whole life of the project, notwithstanding its clear statement to the contrary in your letter of 15 September to Mr Todd. This would appear to require a positive NPV of at least £30-60M before

<sup>2</sup> The creation of a jointly managed contingency fund, with any amounts released going to ICL and the sponsors 50:50, was suggested by ICL during the course of our discussions. I adopted it in my own proposal.

<sup>3</sup> In one presentation this requirement was restated as a "fair chance to breakeven over the contract" but there were later indications that this was done without ICL's chief negotiator's consent.

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contingency, which is the left hand side of the chart. ICL did however make a number of useful suggestions for reducing or sharing risk.

I emphasised to ICL that acceptance of their objective would be tantamount to accepting that the public sector bodies had been largely or wholly responsible for the cost overruns and delays and that this was simply not a conceivable proposition within the constraints of the exercise on which we were engaged and which would not be seeking to concern itself at all with the right and wrongs of the claims and counterclaims being made by the parties.

By Friday 9 October it was clear that the parties were stuck despite some progress on BA termination rights release date and on funding issues. I was concerned that neither ICL nor POCL were taking a sufficiently realistic view, in ICL's case, of the real consequences of the project terminating, and in POCL's case, of the scale of the commercial opportunities available to them if, but probably only if, the project went ahead. (Indeed I suspect that one of POCL's problems has been the lack of a robust business plan to let them make judgements about their longer term future and the sort of investments that they should be prepared to consider to bring it about - this is only now evolving)

I was also reasonably sure that there was a potential solution which ought to be acceptable to all parties. Accordingly I undertook to develop my own view as to what such a solution might look like and this was delivered to the parties first thing on Monday 12 October.

My proposal is set out in Annex C. It sought to provide to ICL a modest (2% IRR) return on its future cash flows after contingencies (to which intra group profits should also be contributed). I estimate that this equates to a pre-contingency NPV over the life of the project of -£154M.

However, during the weekend when my proposal was being put together a number of late modelling changes were coming through from ICL, the most important of which is referred to in the 'Comments' column for item 1.1 of the schedule to my proposal. These adjustments were subsequently shown to be valid and the actual effect of my proposal was therefore to reduce the NPV to only -£203M. Although for the reasons explained below this difference has never come back onto the table for discussion, I have shown in the addendum to Annex C an example of how this could have been corrected - largely by applying lower price deflators - had a further concession been thought appropriate.

On Tuesday 13 October both EA and POCL said they would be prepared to seek to put together a deal on the lines contained in my proposal, but ICL's position was essentially



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unchanged. ICL's letter of 13 October setting out their position (and repeating the 'breakeven' formula) is attached as Annex F.

Later that day POCL agreed with the PO board a proposal whereby POCL would offer to buy immediately assets required for the project (primarily equipment for installation in post offices) believed to be valued at around £100M and also to settle a dispute over aspects of installation for £20M, thereby providing £120M of cash towards the funding issue which had been a continuing concern for ICL. I was informed of this confidentially first thing on Wednesday morning, 14 October and counselled that it should not be put to ICL unless and until ICL were prepared formally to abandon their insistence on a positive return/breakeven over the life of the project. This advice was taken and ICL were merely advised by Mr Sweetman that POCL did have a further proposal to make but would only do so following ICL's agreement to abandon their previous stance. ICL again remained unmoved, so this further suggestion has not been put to them, nor for the same reason has my own addendum to my proposal. I would in any event seriously doubt that both of these proposals should have been made, so the summary chart shows the £120M reducing the previous -£203M NPV to -£83M. It should also be noted that the mechanics of the POCL offer had still to be worked out and there may ultimately have been some countervailing reduction in later payments to ICL.

There was no further change in the position between the parties when the without prejudice discussion month came to an end at midday on 16 October.

#### THE PATH OF THE DISCUSSIONS - PROGRAMME AND PROJECT MANAGEMENT ISSUES

Soon after my appointment we established a working group of the programme directors from each of the parties working under the chairmanship of the Director of the Horizon Programme Office (HPO), now situated within POCL, and with PA Consulting keeping close to and guiding their discussions. PA's final report as of 14 October is attached as Annex E together with the HPO's high level end-to-end plan for the programme which has been signed off by all parties. Attention is drawn to the generally encouraging overall summary at the end of the PA report, but also to the continuing high risk area of acceptance procedures, both the definition of the tests themselves and the consequences of failure. As indicated on chart 6 of the package at Annex B, acceptance specification sign-off (now due between 9 and 22 November) must be achieved before any settlement could become binding on the parties.



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**FUNDING**

Loan facilities of £200M have been exhausted and additional finance of over £300M would be needed to complete the project were no changes to be made to the contract

ICL have taken the stance that its parent company Fujitsu is not prepared to play any further part in supporting ICL or Pathway in refinancing current losses or in financing the contract going forward, and that therefore either the public sector bodies have to make the project financeable on a non-recourse basis or provide finance themselves. I have equally consistently insisted that this is an unrealistic position to adopt and that any solution that seeks to place the burden of ownership on the public sector bodies is totally untenable. (Annex B chart 7 refers). The public sector bodies had agreed to explore a number of relatively minor steps that might help to make the project more financeable.

I also believe that in insisting on a solution involving no write off in ICL's or Pathways accounts, ICL seem to be excessively concerned about the implications of these accounting matters upon their relationship with Fujitsu and on their plans for the flotation of ICL, while at the same time taking a surprisingly relaxed view of the implications of contract termination and litigation on both. If there is to be any further discussion of ways forward it will be necessary to have direct discussion with Fujitsu to understand better the pressures which ICL may be under.

**THE WAY FORWARD**

I have formed the strong view during the last month that the continuation of the project is likely to be of real benefit from a number of angles - Post Office customers; POCL, both as a business and as a social service, and all those dependent on it; ICL's reputation and future; and that of its employees and sub-contractors. I also believe that the proposals made during the last month, particularly if the final POCL offer were to be extended in whole or in part, should provide enough of a positive incentive to ICL to proceed with the project as compared with the consequences to them of its failure. However confident ICL may claim to be as to the strength of their contractual case, I believe they are significantly underestimating the time, the cost and the uncertainty of litigation on this scale and of its consequences for their business plans. I am aware however that these and other scenarios are the subject of separate enquiries.

If there were to be a solution on the lines of my proposal, I would draw attention to items 8, 9 and 10 of the schedule to Annex C, ('running sores' list, past claims and due diligence) all of which will be crucial. I would also urge that as soon as BA can be satisfied that it has a

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system which works both on test and in practice, consideration should be given to reshaping the contracts so as to take BA out of the contractual loop and position them as a POCL client.

\*\*\*\*

I am profoundly disappointed that we have been unable to reach our primary objective and will continue to hope that some way of bringing this project to fruition may yet be found. We spoke on Friday of the possibility of a new initiative even at this late stage from ICL. In the meantime, the progress made on programme issues will be of real and enduring benefit if the project continues, and perhaps some of the commercial discussions will have served to sharpen the participants' views on the realities.

For myself, I would like to pay tribute to the hard work that all those involved brought to our endeavours, not only those attending our meetings but the many others who were providing input and back up.

I assume that your office will handle circulation of this report and its attachments to those who need it, and accordingly it is copied to no one else at this stage.

Yours sincerely



Graham CORBETT

Annexes

- A Terms of Reference
- B Charts used for presentation on 16 October (less nos 4,5 and 9)
- C Independent Adviser's Proposal dated 11 October
- D ICL letter dated 13 October
- E PA Consulting Group's summary of programme risks + high level end-to-end plan

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ANNEX A

**CONFIDENTIAL****Benefits Agency/Post Office Counters Automation Project****Terms of reference for Independent Adviser**

The Government wishes to appoint an independent adviser to facilitate discussions between the parties to the Benefits Agency/Post Office Counters automation project (Benefits Agency (BA), Post Office Counters Limited (POCL) and ICL Pathway (ICL)).

The adviser will report to Ministers via the Chief Secretary to the Treasury, Stephen Byers.

The immediate objective will be to report to Ministers within one month, by 16 October, on:

- whether there is a commercial basis for proceeding with the project which is acceptable to the parties;
- whether there is in place a satisfactory implementation plan with a detailed timetable for completing the project;
- any further action which would need to be taken to ensure successful delivery of the project

The role of the adviser will be to:

- convene and chair discussions between the parties;
- commission papers and proposals from the parties;
- independently appraise the parties' claims and contributions;
- produce compromise proposals to assist the parties to identify common ground;
- take such other action as he thinks fit to establish an acceptable basis for continuation;
- ensure the parties provide information necessary for the analysis of alternative options.

The adviser will have no power to bind the parties, who will retain full authority to agree or not agree any proposals made by the adviser or any other party.

If the project continues there is likely to be a continuing role for the adviser in facilitating progress.

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# HORIZON PROJECT

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REPORT TO CHIEF SECRETARY  
by INDEPENDENT ADVISER,  
GRAHAM CORBETT

16 October 1998

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Annex B



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# Headlines

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No agreement, no movement by ICL, and parties  
far apart, but:

- ▶ reinstatement of IA target (not communicated to parties)
- ▶ possible POCL offer (not communicated to ICL)

Progress on programme issues and acceptance

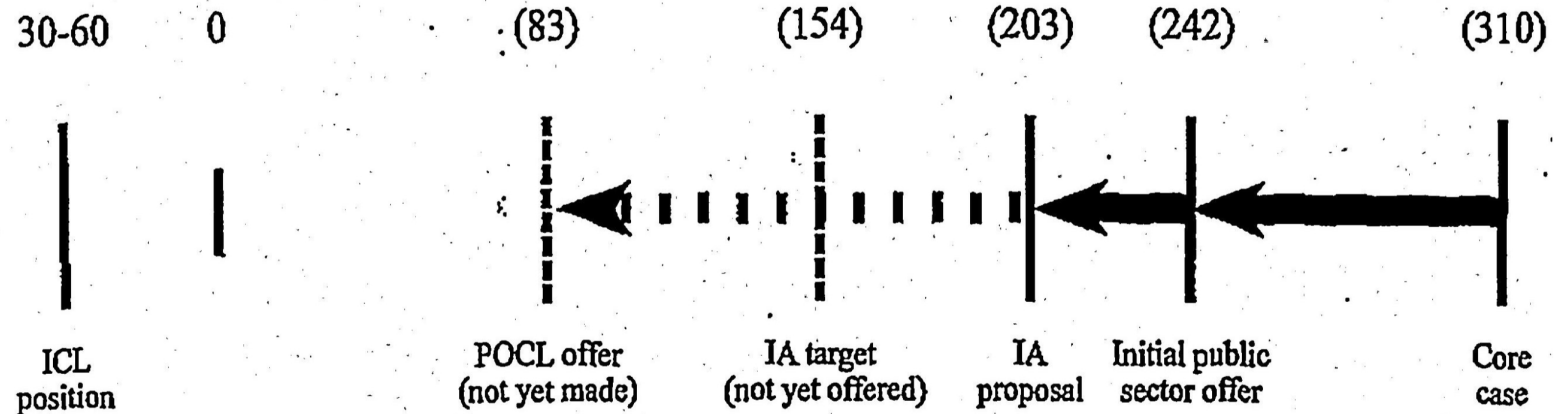
High level of mutual suspicion

ICL 'chink of light'

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# The path of the discussions

Impact on ICL - £m NPV over whole project



NB All numbers exclude contingency - proposed by ICL to be shared 50/50 with sponsors if released

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## ICL Position

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Modest, positive IRR over contract, by means of:

- ▶ contract extension
- ▶ price increases

Opportunity for profit on incremental business

Remaining risks under Pathway's control

- ▶ resolution of programme/acceptance issues
- ▶ solving 'running sores'

Contract terms to allow non-recourse funding

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## Programme issues

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Overall plan and high level critical path agreed

- ▶ 4 months slippage on rollout (since Panel)
- ▶ but uncertainty down to +/- 4 weeks

Acceptance process

- ▶ progress made, but still high risk
- ▶ must be resolved before agreement

Programme generally de-risked

- ▶ other outstanding issues lower risk
- ▶ significant progress made during discussions



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# Refinancing

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Never has been a limited recourse project

- ▶ always relied on support of Fujitsu group

Will continue to be the case, so:

- ▶ Fujitsu investment essential
- ▶ sponsors need assurances over financing

Opportunity for finance cost savings

- ▶ as project risks are overcome.

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## The way forward?

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If ICL abandoned present stance...

■ Could envisage agreement around:

- ▶ reworked IA proposal - with some relaxation of price deflators
- ▶ perhaps all or part of POCL offer
- ▶ subject to overall VFM test

■ Before binding heads of agreement:

- ▶ agree acceptance tests and process
- ▶ complete lower level critical path analysis
- ▶ wrap up 'running sores' and contract points
- ▶ due diligence and satisfaction around funding

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TO RICHARD CHRISTOU  
GEORGE MCCORKELL  
PAUL RICH  
ICL  
BENEFITS AGENCY  
POCL  
FROM GRAHAM CORBETT  
INDEPENDENT ADVISER  
11 OCTOBER 1998

## HORIZON PROJECT - INDEPENDENT ADVISER'S PROPOSAL TO THE PARTIES ('THE PROPOSAL')

As we discussed on Friday I am now forward[ing my Proposal] for the parties' consideration. Since in one way or another it will be disagreeable to all parties I trust that each of you has, as I requested, reflected deeply on the commercial realities surrounding your decision on whether or not to pursue it. These reflections should, I suggest, have included at least the issues for each party shown in the table below. In my opinion there is still not a sufficiently realistic view being taken of the devastating effects that would be likely to follow our failure to reach a settlement.

	UPSIDES FROM SETTLEMENT	DOWNSIDES FROM NON-SETTLEMENT
ICL/Pathway	continuation of business strategy platform to new business opportunities facilitates refinancing	no assurance that sponsors will not hold ICL to contract immediate financial consequences for ICL/Fujitsu (including incremental exit costs and cross guarantees) cost, delay and uncertainty inherent in litigation effect on reputation and business opportunities effect on flotation plans
POCL	opening up of opportunities for new services scale of potential cost savings from automation and planned/controlled rationalisation of network and organisation	short-term effect on network and difficulty of subsequent recovery costs, delays and risks of restarting automation project from scratch cost, delay and uncertainty inherent in litigation
BA	reserve facility against risk of being unable to achieve 100% ACT migration	replies of achieving swift implementation of ACT without bridge provided by card cost, delay and uncertainty inherent in litigation

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My judgement is that there is not likely to be any other chance of a settlement. If however over the next five days the parties can between themselves (despite the evidence of the last two weeks) reach an alternative settlement more satisfactory to them, I would welcome that wholeheartedly.

If the Proposal is accepted as the basis of a way forward, we have much work to do before 16 October. If it is not accepted by any one of the parties, I will wish to have an urgent meeting with Messrs Todd, Roberts and Mathison together by no later than Wednesday morning. I trust that they will share my view that the seriousness of the situation we then face must take precedence over all previous engagements.

## THE PROPOSAL

The Proposal is NOT to be taken as a detailed and prescriptive solution. Rather it is intended to provide a framework around which the parties, if they are so minded, are invited by 16 October to develop NON-BINDING WITHOUT PREJUDICE Heads of Agreement which, if accepted by all parties and Ministers, would be turned into binding Heads of Agreement within the shortest possible time frame and thereafter into contract arrangements.

I must emphasise:

- that the Proposal has not been endorsed by any of the parties, nor by HMT, DTI or DSS, nor has it been reviewed by lawyers for compliance with procurement and other regulations;
- that the cash flow effects of several elements of the Proposal need to be verified and cross checked. Late changes were coming in throughout today, many of which were not immediately understandable. The Proposal is based on the numbers set out at 1, 2 and 3 below, but attention is drawn to the 'comments' column. If subsequent clarification reveals that the ICL net cash outflow should have been less than indicated I may need to propose corresponding adjustments to the extent of the concessions being sought of the sponsors and vice versa;
- that some issues need considerable further work which can only be done by the parties themselves.

So each party is invited to work with KPMG over the next 24 hours (a) to assemble a set of verified and agreed numbers and (b) to have prepared sensitivities which one party or another might want to pursue. In addition, we shall of course need to deal with the information coming from the Programme Group on Tuesday and Wednesday - this may call for some nimble reaction.

The various elements of my Proposal are set out in the schedule below. In developing them I have sought to find a balance that builds upon the existing public sector offer and which provides ICL/Pathway with a risk reward, albeit on a modest scale, for continuing the project. I have not sought to provide to ICL a positive return over the whole life of the project. To this end, I have sought to procure a positive NPV of some £48M for the period from today to 2010 before allowing for interest on cash losses to date. This is calculated at a discount rate of 8.5%, and represents an IRR above this assumed cost of capital of 2%. If therefore the future cash flows were assumed to be financed on a 1:1 debt equity ratio, and if the debt service cost were to be equal to the discount rate, the return on the equity proportion would be about 12.5%. I would in practice expect ICL to be able to refinance its debt shortly after the project is fully commissioned to reduce its borrowing cost to perhaps around LIBOR plus 50bps. The treatment of the benefit from this lower debt service cost remains for consideration.

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The Proposal would, if accepted, eliminate all claims and counterclaims for events, actions and omissions to date. The concessions made by the sponsors would therefore be an indistinguishable amalgam of their desire to see the project continue and a 'no fault' contribution to the problems of the past.

I have taken the view that while the sponsors should do whatever they reasonably can to make the project 'bankable', the provision of finance by them should not form part of the Proposal. Any exploration of funding being provided in parallel with the Proposal should therefore proceed independently.

I have also taken the view that Pathway's immediate and ultimate parent companies cannot expect to play no part in the financing of the project into the future and I recommend that the sponsors and their respective Ministries satisfy themselves as to the financial ability of Pathway to carry the project forward in the event of a settlement being reached.

**GRO**

Graham CORBETT Independent Adviser  
11 October 1998

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## SCHEDULE

	Nature	Detail	£M effect for ICL (NPV)	Comments
	Core Case	NPV of total Pathway cash flows from 1996 to 2010	-310	of which -232M already spent. To achieve the target of 2% IRR for future (excluding interest on existing borrowings) the -310 needs to be reduced by 126M to -184M (see 4 below). The figure of -310 is itself subject to review as the reasons for the change from last week's number of -355 are still unclear
1.1	Contract Term	Extend BA to 3/2008 and POCL to 3/2010 (ICL bearing refresh cost - see below). ACT migration over 2006 - 2008 at 20:40:40. POCL to compensate BA for negative effect of one year of postponement. I suggest that this should be phased in from a relatively early date to be agreed.	80	This value was established by extrapolation from work done last week. I heard at 2130 on Sunday that late ICL calculations produce the apparently extraordinary result that a three year postponement of the migration to ACT (for which BA's original starting date of 2002 was so much criticised by ICL) and a five year extension of the POCL contract result in an additional LOSS to ICL of 12M. Faced with this sort of data, I despair, but to enable the process to go forward while absurdities like this are resolved, I am nevertheless continuing with the circulation of this Proposal.
1.2		Banking business to 2010 POCL to agree to guarantees at a level consistent with reasonably achievable targets	42	This again is a late ICL number, much lower than I had anticipated and therefore subject in my mind to the same concerns as in 1.1
1.3		POCL to accept refresh costs	48	
2.1	Price	Cancel 3% pa reduction from 2006 onwards	20	The ACT migration programme was not specified in the contract and I believe there is merit in ICL's complaint that it is unreasonable for them to have to cope simultaneously with reducing volume and price cuts

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	Nature	Detail	EM effect for ICL (NPV)	Comments
2.2		Some increase in volume guarantees from BA to ICL	?	ICL is seeking annual fixed fee. Currently guarantees would only bite in extremis or during the last year of ACT migration. For further consideration by the parties.
3	Contingency	Establishment of contingency fund to be jointly managed and any surplus released to ICL and sponsors 50/50. ICL to establish of such a fund as an integral part of the process whereby ICL might be expected to accept an IRR as low as 2%	-44 but see next para and below	Quantum for discussion but limited by reference to amount of head room created by foregoing adjustments. Intra-group profits (estimated at 22M NPV to end of project - ICL consent to release of this number being sought) should also be regarded as forming part of this fund, so that total amount would be 5M. This however needs to be reviewed in the light of what now appear to be significant additional costs provided for in the late ICL numbers. Components and management of the fund to be agreed by the parties before 16 October
4	Total of above		-184	of which -232M already spent, giving a positive 48M attributable to the future. Excluding interest on opening borrowings, this represents the target IRR of 2% for future cash flows
5	Programme	BA and POCL termination rights to be cancelled at end of NR2 live trial (scheduled for 5/7/99)	programme confidence	Note that in P. Copping's view if this was a supply contract it would be normal for perhaps 80% of contract value to become payable at RAB date of 21/12/98. This however relates essentially to confidence in software rather than process environment, which involves POCL at least as much as ICL. ICL is wanting 'unconditional acceptance' by 31/12/98 but total confidence is unobtainable until NR2+ rollout (April 2000).



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	Nature	Detail	EM effect for ICL (NPV)	Comments
6.1	Fundability	Fujitsu/ICL to subscribe amount to be refinanced into redeemable zero coupon convertible, (or similar) to be redeemed out of new bank borrowings as and when project confidence at sufficient level	reduces max borrowing requirement (flowing from reduced interest cost)	Some confidence issues already identified - possible acceleration of acceptance, focus on RAB, joint contingency fund, early termination release date - but these unlikely to add up to a fundable proposition by Dec 98
6.2		Parties to complete their analysis of the list of contract points submitted by ICL to improve fundability		This should be completed and signed off within two weeks of non-binding Heads of Agreement
7	ICL Intra-group profits	Intra group profits to the end of the project are estimated at xM or xM at NPV (see comment under 3 above)	xM	Proposal is that these should be regarded as part of contingency fund - see 3 above
8	'Running Sores' list	Financial implications to be wrapped up within overall settlement (i.e no further adjustment)	nil	Operational issues to be resolved between the parties within two weeks of non-binding Heads of Agreement
9	Past claims	All past claims and counterclaims would be withdrawn without admission of liability by any party and no subsequent claim could be made by any party in respect of any event, action or omission prior to the date of the settlement.	nil	

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	Nature	Detail	£M effect for ICL (NPV)	Comments
10	Due diligence	Prior to Binding Heads of Agreement the financial data on which this Proposal is based will be subject to due diligence		As part of the due diligence exercise I propose that a combined financial model be prepared and kept updated. This will help to validate the consistency of the parties' analyses and contribute to the VFM analyses that will be required of the sponsors

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## ADDENDUM TO THE INDEPENDENT ADVISER'S PROPOSAL

As indicated in the comments to 1.1 above there was a late and unexplained difference of £72M in the effects of the extension of the contract term. This difference has now been explained to my satisfaction and it accordingly becomes appropriate to seek ways of further adjusting the terms of the Proposal to reinstate my original intention of a 2% IRR for ICL for the remaining life of the contract. The table below reproduces the first part of the schedule to the Proposal with amendments to achieve this; the principal new proposal being the introduction of a further relaxation of the price deflators built into the contracts (2.3). Given ICL's continuing insistence on achieving a break-even over the life of the project, this revised proposal has NOT been communicated to the parties, and is appended here solely to indicate that there are ways in which the original aim could still be delivered. All changes to the Proposal as given to the parties on 12 October are in bold type.

## SCHEDULE

	Issue	Detail	Net effect for ICL (NPV)	Comments
	Core Case	NPV of total Pathway cash flows from 1996 to 2010	-310	of which -232M already spent. To achieve the target of 2% IRR for future (excluding interest on existing borrowings) the -310 needs to be reduced by 126M to -184M (see 4 below). The figure of -310 is itself subject to review as the reasons for the change from last week's number of -355 are still unclear
1.1	Contract Term	Extend BA to 3/2008 and POCL to 3/2010 (ICL bearing refresh cost - see below). ACT migration over 2006 - 2008 at 20:40:40. POCL to compensate BA for negative effect of one year of postponement. I suggest that this should be phased in from a relatively early date to be agreed.	-12	This negative number needs to be seen against the positive benefits to ICL flowing from the contract extension shown in the succeeding items
1.2		Banking business to 2010 POCL to agree to guarantees at a level consistent with reasonably achievable targets	42	



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	Nature	Detail	£M effect for ICL (NPV)	Comments
1.3		POCL to accept refresh costs	48	
2.1	Price	Cancel 3% pa reduction from 2006 onwards	20	The ACT migration programme was not specified in the contract and I believe there is merit in ICL's complaint that it is unreasonable for them to have to cope simultaneously with reducing volume and price cuts
2.2		Some increase in volume guarantees from BA to ICL	7	ICL is seeking annual fixed fee. Currently guarantees would only bite in extremis or during the last year of ACT migration. For further consideration by the parties.
2.3		Further reduce deflators from 3% to 0.5% p.a. from March 2001 to 2006	55	
3	Contingency	Establishment of contingency fund to be jointly managed and any surplus released to ICL and sponsors 50/50. I see the creation of such a fund as an integral part of the process whereby ICL might be expected to accept an IRR as low as 2%	-27 but see next col. and below	Quantum for discussion but limited by reference to amount of head room created by foregoing adjustments. Intra-group profits (estimated at £xM NPV to end of project - ICL consent to release of this number withheld) should also be regarded as forming part of this fund, so that total amount would be £yM. The total amount corresponds closely to the amount required to meet the reasonable risks of programme slippage indicated by PA. Components and management of the fund to be agreed by the parties before 18 October
4	Total of above		-184	of which -232M already spent, giving a positive 48M attributable to the future. Excluding interest on opening borrowings, this represents the target IRR of 2% for future cash flows

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Annex D.

13<sup>th</sup> October 1998

Mr. Graham Corbett,  
HM Treasury,  
Parliament Street,  
London.  
SW1P 3AG

ICL

Dear Graham,

Proposed Way Forward for the BA/POCL Programme

I enclose ICL's proposals on the way forward for the BA/POCL Programme. This is based upon the discussions and presentation we made to you last week, and continues to be our position in resolving the commercial and programme issues faced by the programme.

Yours sincerely,

GRO

R. Christou

GRO

Cc: Graham Corbett, BA  
P Rich, POCL

R Christou  
Director

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## ICL PATHWAY

### Proposed Way Forward for the BA/POCL Programme

#### 1. Introduction

Due to the way in which the contract has been handled by the sponsors, especially the Benefits Agency, ICL is faced with ever increasing costs, declining volume in full operation, no certainty about when full operation will begin and the consequent impossibility of financing the completion of the programme without a thorough restructuring of the original contract. It is completely inconsistent with the PFI concept to argue, as Graham Corbett has done, that ICL should write off its past costs and look only to the future. Under PFI the contractor's expenditure on the design, build and finance phases should be remunerated during the operational phase. In the discussions with Graham Corbett, ICL has put forward a number of proposals for solving the problems. This paper sets out the ICL position.

In parallel with the HM Treasury review, ICL has engaged in confidential discussions with the Post Office to explore proposals in which the Post Office would take a 50% (less one share) equity stake in ICL Pathway. Although such a proposal has merits in its own right, it could also provide the key to making possible the next stage of funding for the programme provided that an acceptable commercial deal can be agreed. The essential points for the equity proposal are described in the attached note by Sir Michael Butler dated 9 October.

#### 2. Proposal Objectives

ICL believes any settlement must provide a fair way forward for all parties, and must provide ICL Pathway with a fair chance to at least break-even over the contract. The committed funding by ICL to date stands at some £250m, with the expectation that a further £250m of funds will be needed to complete the programme. Whereas originally it would have been reasonable to expect to put non-recourse funding in place after full acceptance in July 1997, we are still a very long way from reaching a position where this would be possible. In all the circumstances, ICL does not consider it reasonable to try to make a distinction between the past and the future, as Graham Corbett has sought to do.

#### 3. Components of the Solution

In addition to the equity proposition there are four key components for an acceptable solution; contract term, contingency arrangements for known and future risks, achievement of contractual acceptance, and appropriate pricing arrangements. Each component has elements of flexibility, which taken together can provide an acceptable resolution for ICL Pathway. This paper describes one such combination.

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#### 4. Contract Term

The sponsors have indicated that they may be prepared to consider a contract extension with ICL Pathway to end March 2007 for BA and to end March 2009 for POCL. BA state that they would migrate all non- ACT benefit payments to full ACT by the end of their contract, on a 20%, 40%, 40% basis, starting in fiscal year 2004/5. This amounts to maintaining the period of full operation in which ICL receives revenues at five years but delivers a sharp decline in volumes within that period.

POCL's offer to extend the contract to 2009 is much more helpful, especially if POCL and ICL Pathway form a dynamic partnership to open up new streams of revenue.

Furthermore POCL have indicated that they may be prepared to fund the essential equipment upgrades and replacements required in the post office network in 2006.

#### 5. Contingencies for known and future risks

Discussions between the parties have highlighted and helped define the outstanding differences on the implementation plan and its detailed timetable for project completion. The major areas requiring contingency arrangements are:

- programme risks leading to delay
- contractual acceptance including process and sign off
- BA and POCL business volumes
- fraud risk
- service level agreement penalties
- programme costs

Although the above contingencies are being further refined between the parties ICL Pathway has included a contingency of £100m (£60m in NPV terms) in its business case to cover the likely outcome on these risks. This figure could double if the acceptance issue referred to below is not resolved.

We recognize, however, that all parties share a mutual interest in mitigating and preventing such risks materializing. ICL Pathway has offered the sponsors the principles of an incentive plan whereby if specified contingencies can be avoided, the associated cost savings can be shared on a 50/50 basis. This would offer the sponsors the prospect of cost reductions, and ICL Pathway the opportunity for a modest return on its investment in the programme. The main intent, however, is to incentivise all parties to work together to effect a prompt delivery of the benefits arising from the programme. This has not worked well in the past.

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## 6. Contractual acceptance

The speed of the acceptance process has been highlighted as probably the most critical programme risk. Given our experience since 1996, any revised programme must give us assurance that the contract will not be terminated at some date in the second half of 1999 on a relatively minor technical point.

ICL proposes that programme acceptance must be managed in a staged approach, with each stage having its own, self contained, acceptance arrangements. Deferred, or conditional acceptance, with termination rights preserved for later stages is unreasonable.

We recommend that acceptance of the first stage scheduled to go forward for national roll-out in July 1999 is handled as part of the HM Treasury review process and is completed by the end of December 1998.

The BA components of this first stage, covering use of the Payment Card for Child Benefit, and the Order Book Control Service have been subjected to extensive joint testing and have had operational exposure in over 200 post offices for very many months and are known to work well for staff and customers alike. There is no reason to delay acceptance.

The sooner full acceptance is achieved the better since non-recourse funding depends on it.

## 7. Pricing Arrangements

Given the BA's desire to get away from the use of the Payment Card as soon as possible, and the need for prices to bear some of the burden of the increased costs, ICL have proposed that the contracted prices set in May 1996 should rise in line with inflation throughout the contract period. This effectively offers the sponsors a fixed price contract in real terms.

It would be possible to construct a payment mechanism for BA based upon an annual fee structure, agreed in advance, and based upon BA's best view of volumes and their ACT migration plan. This would provide some flexibility to the BA in the speed and choice of benefits to migrate to the Payment Card, prior to the final migration to ACT. It would also provide ICL Pathway with a predictable revenue stream.

We see the arrangements for POCL continuing as at present with the only key change being that the banking volumes are underwritten at 90% of best forecast volumes. This reflects the fact that achievement of such business rests exclusively with the business drive within POCL.

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**8. Summary and next steps**

So far Graham Corbett and the sponsors have based their positions on ICL's acceptance of writing off its past expenditure as a loss. Moreover, given the risks, the prospects of profits in the future appear dim. This is unacceptable in principle for a PFI contract and it would make it impossible to secure the financing necessary to complete the programme. We submit that ministers now need to agree a framework which would make restructuring of this PFI contract a reasonable deal for ICL and give Graham Corbett or some senior government representative a mandate to settle the problems fast on a fair basis

Richard Christou  
13<sup>th</sup> October 1998

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**ICL PATHWAY**

- ICL have no wish to cut across Graham Corbett's efforts to promote a solution to the problems in the BA/POCL programme. We will therefore concentrate exclusively on the ICL proposal for the Post Office to take an equity stake in ICL Pathway. Though it could provide the key to unlock the programme's problems, the proposal has merits in its own right.
- ICL is not aware of the Secretary of State's thinking on the future of the Post Office. But whatever the outcome of his review, it seems to us that the Post Office and Post Office Counters Ltd (POCL) in particular, will need to be enabled to operate as a modern, entrepreneurial, commercial business if its long-term future is to be assured.
- Because the ICL Pathway system has been designed with Smart Cards in mind, it can be developed to serve the Government's needs for more user-friendly and cost-effective dealing with the citizen. If the Post Office has a major equity stake in ICL Pathway, it will be better placed to help in this process as well as being able to increase its earnings, assuring the future of the POCL countrywide network.
- POCL needs a world-class IT system for many of its operations. ICL Pathway could help to re-engineer its business processes to make it more competitive. ICL would be ready to contribute its own skills in this field, into the joint venture.
- POCL and ICL working together would make a powerful team which could exploit other new commercial opportunities, including retail banking and export initiatives for postal systems.
- ICL believes that during the duration of the contract (as agreed in the current negotiations) the present ICL Pathway management should remain in place. But ICL would hope that the Post Office would buy 50% (less one) of the shares; and would, of course, welcome Post Office representation on its board; and would be open to proposals for changes in management structure or ownership thereafter.
- ICL wishes to take it as an assumption that the present negotiations will succeed. But it needs to point out that the consequences of failure would leave POCL very exposed, without a modern IT infrastructure.

Sir Michael Butler  
9<sup>th</sup> October 1998

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## Management Summary - Key Programme Risks

Risk ("Points of issue" Version 4, 7/10/98)	Impact on Programme	Probability of occurrence as at 14/10/98	Management Action in place (14/10/98 update in <i>Italics</i> )
<b>Critical</b>			
1 Speed of acceptance process (4, 7a, 7b)	Failure to complete acceptance in planned timescales could cause one or more of the parties to resort to legal action and program could stop at end '98 or before	Very high	Parties urgently reviewing : <ul style="list-style-type: none"><li>• potential to accelerate agreement of test specifications (<i>agreement reviewed on an earlier date</i>)</li><li>• the process for making acceptance decision (<i>work still in progress on detailed plans; contingency now planned into overall testing time scales</i>)</li><li>• the consequences of making decisions (<i>being dealt with in commercial stream</i>)</li></ul>
<b>Major</b>			
2 Status of plans for NR2+ (6)	Delay to commencement of go live for NR2+ with knock on impacts to multi-benefit card roll-out, specifically to the number of cards and outlets	Medium	HPO reviewing current early/best case/worst case forecasts for NR2+ go live (currently 28/2/00, 17/4/00 and 3/7/00) : final view by 13/10/98  <i>Work still in process but there is now confirmation that the worst case date for completion of RAB for NR2+ is 3<sup>rd</sup> July 2000 taking into account all key dependencies.</i>

	Risk ("Points of issue" Version 4, 7/10/98)	Impact on Programme	Probability of occurrence as at 14/10/98	Management Action in place (14/10/98 update in <i>italics</i> )
3	Service Management (2a, 2b)	Risk that NRO (NR2) will be delayed if POCL SM not ready	Medium	POCL reviewing Service Management plans to identify contingency plans that take SM off critical path for NRO (NR2). <i>POCL have de-risked NRO (NR2) dependency on service management by proposing an alternative interim arrangement based on existing capability, with full support centre coming on-line later (target Q4/99.)</i>  Also E2E review of service management is planned.
<b>Minor</b>				
4	Consistent and complete technical design for key products (1)	Mainly impacts speed of testing and acceptance process	Low	Urgent action by HPO to ensure sponsors have uniform view of testing process ( <i>Plans now in place</i> )
5	scaleability of Pathway design (3)	Unforeseen problems as roll-out proceeds	Low	Urgent action by HPO to ensure sponsors have uniform view of Pathway design ( <i>Management briefing convened by Pathway on 15<sup>th</sup> Oct to brief sponsors</i> )



# Horizon Critical Path Plan - Revised at 13th October 1998

