



To: Harry Bush  
HM Treasury

From: Jonathan Evans  
POCL

### DISCUSSION ON OPTION 3 ETC

I attach a paper which I hope will aid our discussion this afternoon. Apologies for it being a little late, and rather long - in the timescales we didn't have time to write a shorter one.

As we discussed, I suggest we cover the issues in this order:

- 1 exploration of POCL vision analysis (need to do this first because David Chinn of McKinsey's will need to leave early)
- 2 POCL new products and services in the short-medium term
- 3 option 3 response: technology, network, financials etc.

We will be:

Jonathan Evans	POCL
Lesley Lawson	POCL
Mena Rego	POCL
Mike Granville	POCL
David Chinn	McKinsey's
Tim O'Leary	French Thornton Partnership

See you at 2.30pm.

Jonathan Evans

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## OPTION 3: HOW WOULD POCL RESPOND?

1 This paper sets out

- the threats to POCL which would arise from option 3 of the Treasury Working Party's analysis being the chosen outcome of the current Horizon debate, together with
- an analysis of the measures which POCL might take, and look to others to take, to help minimise these threats particularly in terms of maintaining nationwide network reach.

The paper is written against the background that POCL's clear preference is for option 1 to be pursued; this paper is therefore to aid understanding of the implications of following option 3.

*threats from option 3 and their causes*

2 Option 3 envisages the immediate cancellation of the entire Horizon project; POCL as a result needing to source alternative means of automating its network; benefits payments moving to ACT; and POCL seeking to recover income and footfall through establishing a banking product. The main components of the effects on POCL of this scenario would be:

- confidence would be lost in POCL - from the moment of announcement of Horizon's cancellation, the commercial sub-office market would discount the asset value of post offices, thereby triggering the initial stages of a spiral of network decline
- unless the movement to ACT were closely aligned to POCL's ability to retain footfall through the development of a simple banking product, the loss of BA income and footfall could not be matched by POCL capability to reduce its variable network costs in a managed way, thus potentially reducing future capability to handle new business
- unmanaged network decline would seriously jeopardise customer service. It could leave significant numbers of people without easy access to a post office, and therefore impair clients' ability to reach their customers, including in particular Royal Mail's ability to meet its universal service obligations
- a simple banking system would not provide sufficient functionality to be attractive to the banks in the way POCL long-term future envisages, nor would it meet the needs of other POCL clients, including Government departments. A full automation solution would therefore still be required, but the timescale for achieving this would be up to 5 years later than with Horizon, in which time many commercial opportunities would have been lost irrecoverably
- cancellation of Horizon would open up the likelihood of litigation costs and potential compensation costs for POCL which could total around £200m - £250m.

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*POCL response*

3 So how best could POCL respond to these threats? This is considered below under three main headings: technology - how we would seek to automate the network in the wake of the Horizon cancellation; income - how we would attempt to boost declining income levels; effects on the network, cost reduction opportunities, and resultant profit/loss/subsidy issues.

*POCL response - technology*

4 POCL's response to cancellation of the Horizon contracts with Pathway would have short term and longer term phases. In the short term (over 1 to 3 years) POCL would:

- take action to sustain existing automation systems (ECCO+, APT and ALPS) for longer than currently planned, to ensure continuity of service to existing clients, pending migration to an eventual replacement system. Many of these legacy systems are old, and their maintenance beyond current life expectancies would be risky and costly. Tactical additions to the APT network would be necessary to support the bill-payment and pre-payment markets, which are extremely competitive and in which the lack of automation would leave us significantly exposed
- procure a simple banking service to provide plastic card-based cash withdrawal facilities plus other simple banking transactions, probably including balance enquiries and mini-statements. This would be necessary in order to provide continuity of service to benefit customers who still wanted to use their post office after they had been compulsorily transferred to ACT payment. It is likely that this would be a stand-alone system, alongside the existing ECCO+ and APT terminals.

5 In parallel (over an estimated 5 year period) POCL would seek to fund, procure and install an integrated outlet automation service across the network that would subsume ECCO+, APT, ALPS and the stand-alone banking terminals installed as a short-term measure. In addition, this would support more complex branch banking services, the re-engineering of POCL's end-to-end business processes to improve efficiency and accuracy to meet the needs of clients, and the introduction of other products and services needed to attain POCL's strategic vision. It is likely that the outlet equipment required for this would be PC-based and similar to that planned for Horizon.

6 If the move to ACT took place in advance of full network automation functionality:

- our commercial proposition to the banks would be significantly impaired. It is therefore unlikely that we would be able to establish partnerships with more than one or two banks, and our chance of retaining benefits customers would be much reduced. This is in contrast to option 1, in which the benefits payment card acts as the means of keeping benefits customers using post offices as the method of payment switches from paper-based to ACT



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- POCL's pivotal role in the UK's cash distribution system would be disturbed. At present, POCL cycles approximately £140billion a year (60% of the UK total) through its networks - paying out some £60billion in benefits payments. There would also be significant knock-on effects for Alliance and Leicester/Girobank.

7 The functionality shortfall in the 2001-2004 period, compared with the current plans under Horizon, would be damaging to POCL in other markets, and up to now we see no easy solution to this. In particular:

- other POCL clients have indicated that they would want to start re-engineering their products soon after 2000, when their system development resources will be freed from year 2000 compliance obligations
- any move to EMU during this period would be difficult, if not almost impossible, to support on POCL's existing systems, and would certainly block development of any further products on them.

*POCL response - income generation*

8 *(We are aware that ICL Pathway have tabled an extensive document entitled "Horizon and Better Government" which identifies major commercial opportunities for POCL/ICL Pathway in the future. These are broadly in line with POCL's own views and future aspirations.)*

Annex 1 sets out the commercial opportunities that POCL would seek to realise in the short to medium term - building upon the infrastructure and capability provided by Horizon.

9 Were option 3 to be adopted and Horizon cancelled, the full potential of some of these opportunities could not be achieved and others could be lost entirely as a result of the delay in POCL achieving full technical capability providing competitors with the opportunity to move in and plug the gap in the market.

10 In the banking arena, the short term alternative to Horizon of a simple terminal providing debit/credit card authorisation would not provide the full service either to customers or to the banks/building societies that would establish post offices as a suitable alternative to a local bank branch. This would impact directly on the banks' interest in use of POCL for front end banking and the amount they would be prepared to pay for its services. This in turn would impact on the amount of business that POCL could gain from customers (both benefit recipients switching over to ACT as well as non-benefit recipient banking customers). The lack of the benefit card would remove a valuable tool for customer education and marketing of POCL as provider of banking services.

11 For other POCL clients e.g. DNS, DVLA and BBC some of their business could be retained by adapting their products to operate on POCL's existing automated payment systems. This pro-tem arrangement would not enable them to achieve the full benefits of re-engineering their own back-end processes and could

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seriously compromise the stability of POCL's existing systems. Those and other potential clients could decide to re-engineer their processes to include alternative channels or exclude post offices altogether. Such clients at risk are the DVLA and DNS who have been expressing serious concern and disappointment over the delays to Horizon. Instead, we would be looking to these clients to keep their business and their income with us for even longer, using the current outdated manual processes, and against their known preferences.

12 For those opportunities identified as part of a wider integrated service offer to Central and Local Government, utilities - etc, it would be difficult to demonstrate and develop the service offer without an automation platform in place or in the process of development. There is a limit to how much can be achieved in stand-alone demonstrations or pilots.

13 In summary cessation of Horizon would mean there was little or no prospect of developing a quick and effective response to the threat of business loss posed by the switch to ACT. Customers retained through interim arrangements would generate a lower level of income (e.g. simple banking transactions are unlikely to produce the same unit income as benefit payment) and replacement business to plug the gap left by lost benefit customers could not be found without an immediate replacement for the automated platform on which to build up a credible service offer that meets the goals identified in our latest Business strategy.

*POCL response - cost reduction whilst maintaining network stability*

14 The cancellation of Horizon, the impact of ACT and the consequent income/footfall loss all have the potential to damage POCL's finances and network. These effects would be offset in part by the pace and manner in which ACT is introduced, the speed at which alternative technology could be brought in, and the consequent capacity of POCL to offer banking and other products. Unmanaged network change itself would undermine the capability to develop new income streams and, if it is to be avoided, action would need to be taken to protect the network from collapsing between the timing of the Horizon announcement and the period at which replacement technology and new business income streams could kick in.

15 To do this, three variables would need to be managed - income, footfall and confidence.

- income - POCL would do all it could to sustain income levels, and in particular would look to Government clients to stay with us at current income levels. Without that, income levels would be such that POCL would either run at a substantial loss, or an overt subsidy to POCL and subpostmasters would be required
- footfall - a further subsidy to POCL and subpostmasters would be required to cover further income loss from footfall reduction

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- confidence - the package of subsidy/replacement income streams would have to be known and command confidence from the point of announcement of the Horizon cancellation. Otherwise POCL would be seen as a business in terminal decline, and it would be hard to avoid subpostmasters, and current and future clients from 'jumping ship' during the transition.

16 Our calculations based on ACT pace and banking income timing is that Option 3 subsidies would be needed to protect network, as follows:

year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10
subsidy (£m)	5.5	49	111	210	270	312	316	320	304	280	264

These subsidies are not an alternative to cost cutting within POCL - indeed the subsidy calculations are after cost reductions of up to £100m have been assumed. These cost savings are largely a result of staff and subpostmaster reductions across the network - including the branch offices and back-office infrastructure. These figures suggest over 8000 redundancies within the overall business.

17 These subsidies could help preserve the network and allow managed change within it, but they do carry risks:

- calculation of subsidy levels would be very complex, both to agree with Government and to agree with subpostmasters
- if the package didn't command confidence - particularly at the time of announcement - the subpostmaster network could still fall into a declining spiral as subpostmasters sought to 'get out' whilst they perceived asset values might be holding up
- subsidy could render the business commercially incapable of developing future income streams through lack of incentives to subpostmasters, potential free-loading by clients and competition law challenge.

18 One final point on subsidies. The Post Office is opposed to running one of its major businesses with the need for a substantial Government subsidy for such a prolonged period - particularly as the option of avoiding this scenario exists.

#### *conclusion*

19 In its basic format option 3 leads to a smaller business, with a much reduced and still unstable network, and POCL still making a considerable loss. If POCL responded as outlined in this paper, it could potentially hold onto the network but would result in being a heavily subsidised business. This is because ACT eats into POCL's income and footfall before alternative technology can deliver sufficient replacement customers and income. Offices would need to be subsidised to keep them viable but too many customers would have been lost for the POCL fight back to do more than level off and start marginally to reduce the subsidy. There also remains the very real risk that the subsidy would not achieve network stability - particularly if any announced package is not seen as credible. All this reinforces our



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view that option 1 remains the route to follow - for the benefit of Government, POCL and the citizen.

Post Office Counters Ltd - 25 August 1998

## ANNEX 1

PRODUCTS/SERVICES THAT POCL WOULD DEVELOP ON HORIZON  
(2000-2004)

1 Market analysis underpinning POCL's future strategic direction shows that there are 3 critical markets in which POCL will operate:

- offering simple financial services and transactions including providing access to its network to Banks and Building Societies for simple services (such as paying cash in, withdrawing cash, paying bills, making savings etc) in a way that supports these organisations' strategies to reduce £4bn worth of Bank branch costs they currently incur. This will be the market that benefits encashment will migrate to over time under Government's proposals for universal banking
- providing a secure and trusted channel for citizens to transact with, and get information to and from, all levels of Government (a 'gateway to Government') in order to reduce the £9bn worth of costs across central and local Government involved in providing simple information in a way that research shows is typically perceived badly by the public at the moment. This will bring POCL into contact with Government Departments which have not done business with it to date (eg Inland Revenue, Customs & Excise);
- being part of the Post Office's overall complete distribution service so that all forms of mail and packages (physical or electronic) can be sent in an expert way at a post office.

It is important to note that the time frame for POCL to achieve the full potential identified in these markets is c 10-15 years and much has to be done to re-position POCL to face up to these markets successfully.

2 In the short to medium term ie 2000-2003/4 POCL would focus on the following areas:

2.1 *Retaining existing clients* - competitive threats for the rest of POCL's business have been increasing. Existing clients have already been offered the prospect of re-engineering their products when Horizon is in place and are eager to do so once they get past the development activities required to handle the Year 2000.

POCL's priorities would be

- develop Banking services for existing clients such as Girobank, the Co-op, Lloyds and DNS but in a way that can be extended to other financial partners too. In this way POCL would hope to sign up many



Banks and Building societies before BA begins to switch customers over to ACT.

- work with DVLA and BBC to re-engineer their products such that they could achieve maximum cost savings in their own back-end processes. In the first instance this could take the form of simple bill payment using the automated payment service within Horizon but the intention would be to migrate these two licensing products to a multi-application smartcard in the medium term. BBC and DVLA could be early subscribers to a Post Office smartcard.
- migrate clients from its existing automated payments platform to Horizon and to add new revenue collection products such as motorway tolling, payment of fines, taxes etc.

## 2.2 *new products/services*

### Household Budgeting

POCL already performs a vital role in enabling its less financially secure customers to budget for household expenses such as their gas, electricity and water bills as well as for TV Licence and telephone bills through savings stamps and plastic card based instalments schemes run by the utilities. With Horizon this service could be extended to provide customers who persistently get into debt with budgeting facility whereby they set aside a pre-designated amount from their benefit (or other income) for their household expenses.

(Currently provisions of this service for serious bad debt cases costs DSS c £30m). POCL and ICL Pathway have developed the concept of a household budgeting product that is generating considerable interest amongst the utilities. This could be introduced very early in the life of Horizon (c2000). It would be particularly useful to vulnerable customers fearful of Banks etc or those who like to feel they have day to day control over their own finances. It also provides a valuable first step in improving the financial management skills of the socially excluded.

### Gateway to Government

POCL's aspirations in this area are based on the fact that it is uniquely placed to become a one stop shop for Government through its extensive network reach, its trusted brand and its ability to integrate information provision with transaction processing in one place.

POCL has longer term for plans for a multi-channel offer through interactive kiosks in post offices and other locations, call centres (it already has a significant operation within the corporation providing service to BBC; mail order companies and Royal Mail customers for re-direction services) and through the Internet. This means that it could offer Government Departments and Local Authorities who are currently attempting to develop and offer these services themselves within their own functional boundaries, a management service and access to integrated facilities that could be uniquely targeted to specific customers' needs. Thus advice and even access to the transaction of registering a birth could lead into information on Child Benefit, local child health card facilities etc. The fact that this activity would be a part of its core business means it would provide a comprehensive service rather than cherry picking on sectors for cross selling opportunities, as some other private sector operations would seek to do, and would be a long term player providing a consistent service, whereas other options may withdraw at short notice from unprofitable section.

POCL believes major Government clients who would benefit from early participation in this initiative are DSS, DFEE and the IR. In addition some Local Authorities may be early participants. We believe Government funding is available for encouraging electronic access to Government by the citizen. Given the goodwill of potential clients and support from Government, POCL could fulfil a vital role in pulling together a user friendly customer - centric service. POCL and ICL Pathway could very quickly develop the concept of a stand-alone kiosk, website access and access to call centre support based on existing technology components. Integrating all these with the transactional capability of Horizon would take a little longer but is believed to be achievable by 2001/2. Development of the service and extension of its use to a wider range of public/private sector partners would run over the period.

#### Registration

Post offices are already familiar to customers as places where they register their personal details ie car registration, passport etc. With further extension to this capability ie births, deaths, marriages, electoral register etc, and the Horizon capability POCL could:

- collect/send information electronically to Government departments thereby eliminating expensive forms production and paper processing and achieving cost savings

- build up a central database of personal details which could be used to update a variety of Government Department records

- use its trusted third party status to authenticate applications where important documents have to be submitted as proof of changing circumstances.

Apart from benefits to Government departments, the service could be marketed to customers as a means of ensuring all changes are logged and notified to all nominated third parties points. In effect this would build on the concept of the Royal Mail redirection service in that customers would notify the post office of a change in circumstance and this could then be communicated by the post office to other subscribers to its database services ie Local Authority, Utilities, Inland Revenue, DSS etc.

This facility will build on and extend services Royal Mail is intending to provide as part of a complete distribution service.

The centrally held database could also be cross matched to other selected databases to identify fraud risk eg Housing Benefit fraud. This facility could be set up almost immediately with Horizon but would take 2-3 years to build up and market.

#### Smartcards

Horizon will provide:

the biggest estate of smart card terminals and readers in Europe together with the card management systems to support them. Card management enables the secure issuing, tracking, backup and replacement of the card itself together with the back office and management processes associated with a secure card network.

The Horizon infrastructure will make smart card services a commercially viable option for many new government and private sector initiatives which previously would have had to fund the large costs of purchasing and installing a smaller smart card terminal estate (or accept a reduced specification, non-smart, solution for their initiative).

Smart cards will be used increasingly by the general public until they become as ubiquitous as magnetic credit and debit cards are today. Many of these uses are within the areas of public administration and electronic commerce. The Post Office can provide an ideal focus for these type of card services as an issuer in its own right and offering agency services for other organisations, in particular government bodies. Some of these might be:

- support for virtual Citizen Smartcards.
- travel and transport cards:
- local Community Cards:
- Post Office loyalty cards:



- Healthcare cards:
- Education Card
- Electronic signature and private key card

(NB Pathway have provided details on the above that are not replicated here.)

Single application Smartcard tokens are already issued and charged up at post office (payment tokens for some utilities) and will be available through Horizon. The development of a multi-application smartcard is unlikely to be achievable before internal standards are agreed. Current estimates indicate 20002/3 as the time frame for this.

*conclusion*

3 The early availability of a suitable automated platform provides many opportunities to secure existing income stream and start to develop and grow new sources of income achievement of their full potential is a longer processes, but development in technology and market make it important for POCL to acquire the automated capability now.